WS Gresham House UK Smaller Companies Fund

Quarterly commentary – Q4 2024

Past performance is not necessarily a guide to future performance. Portfolio investments in smaller companies typically involve a higher degree of risk. Capital at risk. Extracted portfolio performance is not necessarily indicative of the performance of the fund. Not to be construed as investment advice or recommendation. Views expressed by the investment team are correct at the time of writing but are subject to change.

Overview – Q4 2024

UK equity market performance was negative in Q4 2024, with smaller company stocks underperforming their larger peers. The Deutsche Numis Smaller Companies plus AIM ex Investment Trusts Index, FTSE 100, and FTSE AIM All Share fell by **1.6%**, **0.2%**, and **2.3%** respectively.

The period was characterised by a combination of domestic and global political uncertainty which adversely affected UK equity markets and more so UK smaller companies. Many policies brought forward by the new Labour government in the Autumn budget were received negatively by investors, not least the reduced inheritance tax relief on AIM and the higher corporate costs precipitated by changes to national minimum wage and national insurance legislation. Following conversations with portfolio company management teams since the budget, we believe the recent corporate tax changes will have a broad-based inflationary impact on the UK economy as companies pass on higher costs to prices. We have seen this view mirrored by the upward trajectory of UK government bond yields in Q4, as markets expect higher interest rates for longer than previously assumed.

The negative budget impact on UK equity markets was compounded by the US election results and the subsequent US equity market rally. Having inflected to a small net inflow in November (£317 million) – the first in 42 months – UK-focused equity funds shed a further £221 million in December 2024, taking the annual total outflow to £9.6 billion.[1] Much of the UK outflows over the year, which caused more forced selling of domestic shares and falling valuations, were recycled into global and US equity funds or passive trackers, driving positive valuation momentum in non-domestic equity markets and leaving UK equities trading at a stark discount to international peers heading into 2025; a discount even more pronounced among UK smaller companies, which are now 28%, 57% and 69% cheaper than UK large caps, US large caps and US smaller companies respectively.[2]

Despite a sentiment-based valuation de-rating across the UK smaller companies space in Q4 2024, we believe our focus on resilient business fundamentals such as structural growth trends, non-cyclical markets, high-quality financials (including over 20% EBITDA margins, strong cash generation, and very low financial leverage), and capable management teams executing on clear value creation strategies, underpins a highly

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[1] Calastone UK equity fund flow data, 7 Jan 25.
[2] Bloomberg 12M forward price-to-earnings data as at 12 Jan 25 (Deutsche Numis Smaller Companies ex Investment Trusts plus AIM index versus FTSE 100, S&P 500, and Russell 2000 indices).

attractive multi-year returns opportunity going forward. Indeed, 90% of company updates during the quarter were positive or in-line compared to market expectations.

Performance – Q4 2024[3]

Performance in the WS Gresham House UK Smaller Companies Fund decreased by **1.9%** during the quarter, slightly outperforming the IA UK Smaller Companies sector which also decreased by **1.9%**.[4]

Key positive contributions during the quarter came from **Trustpilot (+1.2% CTR)** on no specific newsflow during the period, continuing positive momentum following strong interims released in September; **Elixirr (+0.6% CTR)** following the acquisition of Hypothesis Group LLC, a US-based insights and strategy firm, which is expected to be immediately earnings enhancing; and **XPS Pensions Group (+0.5% CTR)** as H1'25 results demonstrated further trading momentum characterised by double-digit growth across all divisions and operating margin expansion.

The largest detractors to performance were **Impax Asset Management (-0.9% CTR)** which lost c.£6bn of AUM in December as ongoing St James's Place restructuring prompted mandate withdrawals, driving a 7% downgrade to the FY25 profit before tax forecast and de-rating to 5.5x EV/EBITDA (c.23% intra-day share price decline) which we view as materially overdone relative to the fundamental impact; **Team17 (-0.8% CTR)** despite interim results in-line with expectations at the end of Q3 which showed double-digit organic growth and margin expansion driven by management cost control. The market is failing to recognise the significant cost discipline progress made since the profit warning at the end of 2023, with the business well positioned to grow profitably, underpinned by its back catalogue of durable franchises; and **Capita (-0.6% CTR)** as a full-year trading update guided to a revenue performance slightly below market expectations but in-line on margins due to better-than-expected cost savings. The market was also concerned about the potential cost impact of NIC and minimum wage increases announced in the October budget. Whilst a return to revenue growth and cash generation has taken longer than initially thought, we believe there is near-term potential to unlock value through further divestments, helping to simplify the equity story and strengthen the balance sheet. For example, last year Capita sold its standalone, non-core software business to MRI Software in a deal that valued the subsidiary at c.£200mn versus a market capitalisation of £264mn on the day prior to the announcement, despite the business accounting for just c.14% of group EBITDA – shining a light on the discounted valuation of the remaining business.

Portfolio activity

We made no new investments during the period.

We made one full exit during the period: from **Raspberry Pi.** The Fund invested into Raspberry Pi during its June 2024 IPO, we were attracted to the structural growth drivers underpinning the industrial automation landscape and high calibre management team. However, as a result of a significantly oversubscribed IPO, the Fund (like many peers) was scaled back to a significantly underweight position size, and the post-IPO share price performance reflected this as other investors sought to grow their IPO allocations. However, with

3. Please refer to the factsheet for full UCITS-compliant performance figures.
4. The IA UK Smaller Companies sector comparator is used for illustrative purposes only.

a sub-scale weighting in the Fund, materially elevated stock valuation (vs. at IPO), and a compelling opportunity set to deploy capital elsewhere, we opted not to grow Raspberry Pi's weighting in the Fund but rather to redeploy that capital elsewhere. This resulted in an unusually short holding period for the Fund of approximately five months, albeit consistent with an unusually short and rapid appreciation in share price and valuation multiple in that same period of time. We still believe Raspberry Pi to be a high-quality company led by a high calibre team, and will continue to follow its future development with interest.

We made several selective follow-on investments during the period, including into: **CVS Group** an integrated veterinary services business which we believe benefits from structural growth tailwinds, alongside internal levers to drive margin expansion, and is trading at an attractive valuation due to the Competition and Markets Authority (CMA) initiating a review of the sector earlier this year, the outcome of which we do not expect to materially impact the business value over the long term; **Next Fifteen,** a digitally-enabled growth consultancy, which has a strong market position across its key end markets with a blue-chip customer base, however the loss of one significant contract, alongside what we deem to be transitory end market headwinds, have weighed on near-term earnings and consequently the share price, leaving the business trading at an attractive valuation, particularly on a sum-of-the-parts basis; and **Telecom Plus**, a capital light B2C multi-utility re-seller (energy, broadband, mobile, and insurance) which continues to deliver double-digit customer growth and increased multi-service penetration supported by a differentiated partner selling model, creating shareholder value over the medium-to-long term.

Outlook – Q1 2025

Looking ahead to this year, we see a number of short-to-medium term factors supporting continued strong Fund performance prospects and believe our companies remain well positioned to offset external headwinds such as high interest rates, low economic growth, and UK government-driven cost inflation. We continue to see the benefits of our consistent and repeatable private equity approach to UK public market investing, leveraging a high-quality expert network to independently validate key investment judgements, providing a sustainable 'edge' over the wider market in terms of investment appraisal and portfolio monitoring.

We also see upside potential to Fund performance from elevated takeover activity across UK equity markets heading into 2025. While the uncertainty around the Autumn budget led to an M&A slowdown in Q3'24, we observed an uptick in activity during Q4 and anticipate deal momentum continuing into this year. During 2024, buyers paid on average a 44% premium for UK companies, greater than the five-year average despite elevated deal funding costs amidst higher interest rates.[5] From conversations with our private equity network, we understand that private buyers continue to assess the UK market for deal-flow opportunities given the attractive valuations on offer and the relative shortage of investment opportunities in a subdued private M&A market. With c.$4 trillion of 'dry powder' yet to be deployed,[6] we expect that takeover activity, alongside divisional carveouts, will offer attractive returns for the Fund in 2025.

We highlight an emerging nuance to this theme in the Smaller Companies space, with carve-outs – where a parent company sells a subsidiary company or business unit – of which there have been 20 'meaningful' instances through 2024. Carve-outs are an underrated yet powerful way for UK companies to unlock real value,

[5] Bloomberg data.
[6] Charles Hall, 'Strategy', Peel Hunt Research, 2 Oct 2024.

with several recent examples where businesses have sold off divisions at valuations higher than the prevailing group valuation - sometimes selling for more than the entire market cap.

For example, in early 2023 Ascential launched a strategic review of its three distinct business units: Digital Commerce, Product Design (WGSN) and a market-leading events business. While we considered each business to be high-quality, they were not complementary within a single group, a cohesive strategy became difficult to form and Ascential was left trading at a sharp discount to its implied sum-of-the-parts value. Management acknowledged these challenges, launched a 'break up' value creation plan, and ultimately sold all three business units for a total value of c.£1.9 billion versus a market capitalisation of £915 million prior to the announcement of the strategic review. Evidently, carve-outs can be a compelling tool for management teams to overcome market discounts and create shareholder value.

More broadly, we welcome calls for government reforms in 2025 to encourage UK pension fund participation in domestic equity markets, where they are materially under-penetrated today at defined contribution, defined benefits, and local government levels compared to other developed western nations.[7] Any incremental liquidity as a result of supportive policies would aid marginal buying of UK shares and in turn bridge the stark valuation arbitrage to other developed equity markets and precedent M&A transactions.

Important information

[7] Department for Work & Pensions, 'Pension fund investment and the UK economy.'

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