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Economic Advantage

October 2023 review

Liontrust UK Micro Cap Fund


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The Liontrust UK Micro Cap Fund returned -6.1%* in October. The FTSE Small Cap (excluding investment trusts) Index and the FTSE AIM All-Share Index comparator benchmarks returned -5.9% and -6.2% respectively. The average return of funds in the IA UK Smaller Companies sector, also a comparator benchmark, was -5.9%.

The month saw a continuation of the themes that characterised the third quarter, with investors adjusting to the expectation of higher-for-longer interest rates and large-cap shares continuing their recent run of outperformance.

Events in Israel and the Gaza Strip dominated global news during the month. Although global equity markets retreated in October, there was otherwise only moderate evidence that the conflict was leading to typical flight-to-safety patterns in financial markets. Gold did rise 7% to $1983 an ounce, but oil (Brent crude) dropped 8% to $87.4 a barrel and government bond prices remained under pressure due to rising yields.

Within the UK market, the large-cap FTSE 100 Index fell 3.7%, while the FTSE 250 mid-cap Index dropped 6.3%, the FTSE Small Cap (ex investment trusts) Index slid 5.9% and the AIM All-Share lost 6.2%.

On several occasions this year we've highlighted corporate takeover activity as a theme, noting that the UK's discount to other markets and its own long-term average – particularly acute at the small cap level – is leaving some stocks vulnerable to opportunistic private equity or corporate investors.

Tribal Group (+18%) recommended a 74p-a-share cash offer from US-based Ellucian, a provider of cloud technology to the tertiary education sector. The proposed deal is a 41% premium to

Tribal's prior share price. However, having initially jumped to trade close to the offer price, shares in Tribal slid to around 64p at month end after it was announced that the UK Competition and Markets Authority would be investigating the proposed deal.

On the last day of the month it was announced that **Sopheon's** (+62%) board of directors had agreed to a £10-a-share cash offer from Wellspring, a US private equity investor in technology companies. The offer level values the enterprise innovation management software provider at £115m, and is roughly double the prior day's share price.

A trading update from Cyber security software specialist **Intercede Group** (+21%) disclosed 10% constant currency growth in revenues to £7.0m in the six months to 30 September, in line with its expectations. It also revealed that positive operating cash flow and good working capital control had posted cash reserves to £9.7m, up from £8.3m six months ago. It has no debt.

In fact, around 76% of the Fund's companies are in a position of net cash. Because the Economic Advantage investment process focuses on intangible asset strengths, it has a bias towards less (physical) asset-intensive businesses, while its focus on a strong owner-manager culture (through the 3% minimum senior management equity ownership) tends to lead it to businesses with a more conservative business ethos focused on organic growth and lower balance sheet gearing.

Beeks Financial Cloud (+20%) grew revenues 22% to £22.4m in the year to 30 June, with underlying EBITDA (earnings before interest, tax, depreciation and amortisation) rising a third to £7.9m. While it merely maintained its financial guidance for the new financial year, its outlook statement is noticeably upbeat. The company provides cloud computing and coactivity services to the financial sector. It notes that there are currently significant tailwinds to the growth of cloud computing in this sector, which has led to a record pipeline of opportunities. In particular, it highlights its Exchange Cloud product as potentially transformational, with its first two contracts secured – with the largest stock exchange in Africa as well as NYSE owner Intercontinental Exchange – and discussions ongoing regarding others.

As well as the upbeat news from Intercede and Beeks Financial Cloud, there were also three profit warnings which led to heavy share price losses.

Corporate training business **Mind Gym** (-34%) slipped after warning that clients are deferring spending, particularly in the US. While it expects activity to be stronger in the second half of the year to 31 March 2024, it still thinks revenues and profits will fall significantly short of market expectations. It has responded by cutting capital expenditures as it awaits an upturn.

A profit warning from **Quartix Technologies** (-31%) cut forecasts for both revenues and earnings for this year and next. The vehicle tracking software provider grew its fleet of subscribed vehicles by 13% to 259,000 in the first nine months of the year. Overall, new units installed are ahead of the run-rate at the same time last year, but there have been notable contractions in the rate of fleet growth in the UK and USA. The company is focusing on stimulating customer base growth over the next year, following a strategic review led by Andy Walters, Quartix's founder and former CEO who has recently returned as Chairman.

Calnex Solutions (-58%) had already warned earlier this year that the macroeconomic backdrop was leading many of its telecoms customers to take a cautious approach to investing, meaning lower demand for the test and measurement tools Calnex provides to the sector. In a new profit warning in October, Calnex cut its forecasts further, saying that revenues in the year to 31 March 2024 are now likely to be 20% to 30% below market expectations. While it had previously seen a cautiously improving outlook, this has not materialised and order inflow has remained subdued. Calnex is confident of a return to growth in the following year, characterising current low orders as delayed rather than cancelled. It also highlights its £13.5m cash position as leaving it in a good position to weather a short-term downturn.

The extent of the share price fall for Calnex is testament to the level of pessimism still baked into share prices, particularly at the lower end of the market cap scale. Many businesses are clearly experiencing some degree of impact from broader macroeconomic pressures in the short term, but the market appears singularly unwilling to look through these challenges to the longer-term picture, even where companies – such as the majority of those in the Fund – have the balance sheet strength to ride out the current volatility. Valuation multiples across the small and micro cap universe have compressed to very low levels, offering extremely rare levels of longer term upside opportunity.

While it is easy to wonder whether the extremity of the valuation gap between UK stocks and those listed on other global markets will persist in perpetuity, the Economic Advantage team are increasingly optimistic that there are several catalysts which may yet turn the tide strongly in favour of UK equities.

One is M&A activity. 14 companies across the Economic Advantage fund range have experienced inbound M&A interest since the start of 2022: five takeovers have completed, six are pending (with several set to complete in the very near term), and three companies have had approaches which have since fallen away. While M&A activity is always a double edged sword, at the very least it does help to crystallise in investors' minds the level of latent value within share prices at current levels, and provides an influx of capital for recipients to redeploy across other holdings where they see such attractive opportunity. It is worth highlighting that 13 of these 14 approaches have been for small and micro cap companies across the range, demonstrating where acquirers see the greatest value.

Another potentially very meaningful catalyst is the possibility of government policy intervention. Much has been written about July's "Mansion House Compact", which saw Chancellor Jeremy Hunt and a number of the country's largest pension funds agree to invest 5% of assets by 2030 in "unlisted equities" – a definition which includes stocks quoted on the Alternative Investment Market (AIM), where over 20% of the Fund's NAV is currently invested. Several other potential policies have also been discussed and debated by the industry and in the press, including the idea of introducing a 'Great British ISA', where savers benefiting from tax incentives would be required to invest in UK listed companies within the ISA wrapper. We are yet to see which of these other policies may gain the most traction with policymakers, but it seems clear that, in recent weeks, the momentum has accelerated behind calls for the government to recognise the need to stimulate UK equity markets and ensure that our domestic stock market retains its status as a thriving venue for companies to list and prosper for the long term. We cannot help but feel eager to bang that drum.

Discrete years' performance (%) to previous quarter-end:

	Sep-23	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust UK Micro Cap I Acc	2.4%	-26.6%	63.2%	10.6%	-2.5%
FTSE Small Cap ex ITs	12.7%	-24.4%	72.4%	-12.7%	-7.8%
FTSE AIM All Share	-8.3%	-34.3%	30.8%	11.0%	-19.4%
IA UK Smaller Companies	2.2%	-31.9%	51.1%	-0.4%	-7.1%

*Source: Financial Express, as at 31.10.23, total return (net of fees and income reinvested), bid-to-bid, institutional class.

**Source: Financial Express, as at 30.09.23, total return (net of fees and income reinvested), bid-to-bid, institutional class.

For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The Fund may invest in companies listed on the Alternative Investment Market (AIM) which is primarily for emerging or smaller companies. The rules are less demanding than those of the official List of the London Stock Exchange and therefore companies listed on AIM may carry a greater risk than a company with a full listing.

As the Fund is primarily exposed to smaller companies there may be liquidity constraints from time to time, i.e. in certain circumstances, the fund may not be able to sell a position for full value or at all in the short term. This may affect performance and could cause the fund to defer or suspend redemptions of its shares. In addition the spread between the price you buy and sell units will reflect the less liquid nature of the underlying holdings.

Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Disclaimer