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Economic Advantage

January 2024 review

Liontrust UK Micro Cap Fund

				
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The Liontrust UK Micro Cap Fund returned -0.1%* in January. The FTSE Small Cap (excluding investment trusts) Index and the FTSE AIM All-Share Index comparator benchmarks returned -2.2% and -1.0% respectively. The average return of funds in the IA UK Smaller Companies sector, also a comparator benchmark, was -0.1%.

The year kicked off with investors continuing to debate whether key economies will avoid recession and execute a 'soft landing' in the face of pressure applied by two years of rising interest rates.

Markets retreated slightly from their late-2023 conviction that this year will bring swift interest rate cuts as inflation comes down to target. There had previously been growing talk of Goldilocks conditions in which economic activity is sedate enough to allow for interest rate cuts but not so low that it might contract. On balance, January's data seemed to edge investors more towards the 'too hot' scenario in which evidence of economic strength might delay or reduce the extent of rate cuts.

The Economic Advantage investment process intentionally adopts a bottom-up focus and avoids any attempt to position portfolios based on a macroeconomic view. As such, we spend a lot of time gauging conditions through company-level news flow. In this respect, January is often an informative month due to the volume of companies providing trading updates for the period to 31 December.

Overall, trading updates coming through from the Fund's companies were solid, which is testament to the resilience many of these businesses display in the face of more challenging economic conditions. While many companies recognise that the outlook is more uncertain than normal – and contains headwinds and challenges in certain sectors – it also seems sufficiently benign that many companies have been able to successfully execute their growth plans.

It was notable that companies delivering such in-line updates were generally rewarded with a positive share price response, which we see as being indicative of generally more upbeat investor sentiment.

Beginning with the positive updates, Microlise (+29%) announced 2023 trading was slightly ahead of expectations, with revenue up 13% to almost £72m and adjusted EBITDA (earnings before interest, tax, depreciation and amortisation) up 14% to £9.4. Microlise provides telematics software and hardware to vehicle fleet operators. An improvement in new vehicle availability in the second half of the year allowed Microlise to speed up the delivery of its pipeline. The company expects further good growth in 2024, achieved through a combination of organic growth and the impact of recent acquisitions. It also expects profit margins to improve as it focuses on cost base management and scale efficiencies.

Nexteq (+19%) also announced that it would beat expectations, with adjusted profit before tax "comfortably ahead" of consensus forecasts after margins improved in both its Denistron and Quixant businesses. While Quixant supplies computer platforms for the casino gaming and slot machine market, Denistron's display components feed into a diverse range of industrial sectors. As Nexteq has previously indicated, the company's order book is normalising from elevated levels as easing supply chain problems allow customers to reduce their inventory levels. As a result, sales for the year fell 4% to $115m. For 2024, Nexteq expects broadly flat revenues, with margins continuing to improve.

Shares in Hvivo (+24%) maintained their momentum following a December trading update which announced a large contract and better-than-expected trading during 2023. Hvivo is a contract research organisation that specialises in designing and managing "human challenge" drug trials. We like the intellectual property strength the business has both in the scientific know-how of designing and implementing these studies, as well as within the "challenge agents" themselves (these essentially the formulation of a sample virus to use in the clinic setting to infect individuals).

In January Hvivo announced a new contract to test a biotech companies treatment for the common cold and released another full-year trading update. It achieved 16% sales growth to £56m in 2023 and now expects to hit £62m in 2024, with 90% of this forecast already contracted in its £80m orderbook. EBITDA margins improved from 18.7% to 22% and the company generated cash of £37m during the year. Following a special dividend last year, Hvivo now plans to implement a regular annual dividend payment, reflecting its strong cash generation and high contracted sales.

Of those companies to issue more disappointing updates, shares in Bango (-49%) were hardest hit. Its trading update disclosed some unexpected costs from its DOCOMO Digital acquisition which will constrain 2023 profitability.

Bango is a mobile payments specialist that provides a digital vending machine (DVM) service, allowing telecoms companies to offer a range of content and service options that can be bundled into subscriptions. It acquired the payments business of NTT DOCOMO Digital for €4m last year in a deal which is expected to significantly enhance future earnings but has resulted in unexpectedly high short-term costs.

Bango announced that adjusted EBITDA for 2023 will be below analyst expectations partly due to $3m of unexpected Docomo costs and unfavourable currency exposures. EBITDA for 2023 is now expected to be $5m - $6m, in-line with last year's outcome but below analysts' expectations of around $12m.

James Cropper (-44%) also fell heavily after issuing a trading update noting negative trends at both its legacy Paper Products unit and its faster growing Advanced Materials business. The former has seen supply chain destocking and high inflation hit customer demand, while Advanced Materials has suffered from delays to hydrogen energy projects – a sector it has targeted with specific technical fibres.

It now expects revenues in the year to 31 March 2024 of £103m – which compares with analyst consensus of over £120m – and adjusted profit before tax only marginally better than breakeven, rather than the £6m expected.

Zoo Digital Group (-41%) provides localisation and dubbing services to globalise TV and movie content, underpinned by an innovative, cloud-based platform. Last year, trading was heavily affected by the Hollywood writers' and actors' strike, leading the shares to tumble. While Zoo Digital expected sequentially stronger trading after the strike was resolved in November, it now believes that entertainment projects are taking longer to regain traction. Q4 revenues are set to be significantly lower than previously expected, with a larger full-year loss (for the period to 31 March).

Lastly, Frenkel Topping Group (-21%) warned that revenues and profits for the year will be 6% to 7% below market forecasts. The company provides financial services in the personal injury and clinical negligence marketplace. Helped by acquisitions, its assets under management rose 12% to £1.34bn, but this growth was lower than hoped for. A higher interest rate environment led many potential clients to keep funds in cash rather than invest.

Positive contributors included:

Microlise (+29%), Calnex Solutions (+27%), Hvivo (+24%), Bigblu Broadband (+22%) and Nexteq (+19%).

Negative contributors included:

Bango (-49%), James Cropper (-44%), Zoo Digital Group (-41%), Tribal Group (-21%) and Frenkel Topping Group (-21%).

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

	Dec-23	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust UK Micro Cap I Acc	1.0%	-17.1%	33.6%	12.1%	29.1%
FTSE Small Cap ex ITs	10.4%	-17.3%	31.3%	1.7%	17.7%
FTSE AIM All Share	-6.4%	-30.7%	6.1%	21.7%	13.3%
IA UK Smaller Companies	0.5%	-25.2%	22.9%	6.5%	25.3%
Quartile	2	1	1	1	2

*Source: Financial Express, as at 31.01.24, total return (net of fees and income reinvested), bid-to-bid, institutional class. **Source: Financial Express, as at 31.12.23, 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