RATHBONES SPECIALIST TAX PORTFOLIO SERVICE (STPS)

Business relief (inheritance tax relief) mandates

Q2 2024 REPORT

With the summer solstice now behind us, the macroeconomic public discourse has shifted. Central bank interest rate cuts are now a reality in Canada and the EU (both cutting by 25 basis points in the period), with Switzerland and Sweden making similar moves. The UK is likely to follow soon – though notably later than initially expected in late 2023. Commentators have instead concerned themselves with a busy slate of political elections that, in combination, can materially affect geopolitical and trade priorities across the UK, North America and Europe.

Former Prime Minister Rishi Sunak surprised many with the news that the UK's General Election was to be held on the 4 July, but the Conservative Party could not translate this into success at the poll booth. Labour won by a landslide, but the more significant story might be the relative success of the smaller parties, with the likes of Reform, the Liberal Democrats and the Green Party all increasing their share of seats.

Meanwhile, in France, the far-right Rassemblement National (RN) had built a strong position heading into a snap election. However, a surprising result on the second round of voting of 7 July was no clear winner, with left-wing alliance the New Popular Front (NFP) winning 182 seats, the centrist Ensemble Group with 168 seats and RN and its allies securing 143 seats, leaving France currently without a Prime Minister or Government. President Emmanuel Macron has been an active, centrist figure in the EU for the past seven years, but the RN's gains could limit his room for manoeuvre at home and is symptomatic of increasing right-wing sentiment in parts of the EU. Finally, in the US, far from reassuring his base, President Joe Biden's presidential debate sparked renewed questions over his faculties that led to him stepping down and endorsing Vice President Kamala Harris after period-end. A second Donald Trump presidency later this year is a very real possibility.

The conclusions of these political battles are set against a backdrop of recovery in broader equity markets.

For UK small-caps there are some signs of appetite for risk returning. We are encouraged by the successful flotation of computer chip maker Raspberry Pi and its subsequent circa 40% share price gain in the first weeks of trading. Though we did not participate as it was not an AIM listing, such examples of innovative UK companies joining the public ranks should strengthen the case for investment in junior markets. Alongside this, we note the pick-up in initial public offerings in Europe and more secondary placings in the UK. We are hopeful this continues in the second half of the year as IPOs are often viewed as the barometer for improving domestic economic health.

PORTFOLIO DEVELOPMENTS

Smaller company valuations remain highly attractive to prospective suitors attuned to high-quality growth assets and prevailing sentiment. This quarter, the board of video game development services provider **Keywords Studios** announced it had agreed to the terms of a cash acquisition by private equity firm EQT valuing the company at £24.50 per share. Though down slightly from the initial £25.50 per share teased in May, this comes after a trading update pointing to softer than expected first half trading, and still presents an attractive c.67% premium to the undisturbed share price of £14.70.

In that time, Keywords has built itself into the clear market leader in video game outsourcing, making it a less risky and more title agnostic 'picks-and-shovels' alternative to listed video games developers whose financial performance are more directly tied to the

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success of a handful of video games. It is three times the size of its nearest competitor, but with just a 6% share of the market. Given this position, we believe that Keywords has many years of growth ahead of it and we would prefer to retain our holding for the long term. We will consider our stance closely ahead of the shareholder vote to ratify the deal, but we expect the acquisition to be accepted by most.

Alpha Financial Markets has also received a bid, this one from Bridgepoint Advisers at 505p per share. The group provides consultancy services to the financial services industry and has built up a strong reputation in a growing market. It is well placed to continue this success with a clear growth strategy under an experienced management team. It is no surprise, then, that the company received a bid. As with Keywords, we invested in Alpha for the long-term opportunity and so, while the boost in share price is welcome, we would happily give that back to keep our stake in the years ahead.

Elsewhere across portfolios, education software provider **Tribal** settled its dispute with Singapore university NTU for £3.1 billion, while **Alliance Pharmaceuticals** successfully appealed its CMA review. Both developments enable these companies to move on from a period of uncertainty. We have, however, since sold our position in Alliance on account of a change in its strategy that requires higher levels of investment than we envisaged when we bought the shares.

At the end of Q1, we sold our shares in **Smart Metering Systems** to provide some certainty ahead of the completion of its takeover by the US private equity giant KKR. We swapped it for the efficiently managed and highly profitable **Tatton Asset Management** and **NIOX Group**, a medical business focused on asthma diagnosis technology.

PORTFOLIO RISERS

Engineering services business **Renew's** capital markets day was a highlight of the quarter, providing an opportunity for us to travel to Glasgow to see the company's equipment in action and talk to employees. Demand for Renew's specialist engineering services remains robust regardless of ruling party, with the maintenance and renewal of critical UK infrastructure supported by large, non-discretionary operating budgets. The demand outlook in Renew's water division is particularly buoyant, with trade association Water UK forecasting its addressable market at £46bn over the next five years. Meanwhile, the group's recent acquisition of Excalon for up to £26 million allows it to expand into the £22.2bn electricity transmission and distribution market.

ID verification software developer **GB Group** helps businesses build trust with their customers by monitoring online transactions for suspicious activity. As more commerce is done online, so too does the need to safely authenticate digital transactions. Demand for GB Group's services boomed during the COVID-19 pandemic, when we spent more time online leading to greater vigilance, thus playing into GB's hands. One customer's feedback advised that through the level of fraud deflected from their business, GB Trust paid for itself in just 17 days. A subsequent normalisation in activity once those restrictions ended proved a stiffer headwind than anticipated. Happily, the group has worked its way through much of this adjustment and a well-received trading update in April showed signs of improving trends in its largest division heading into the new financial year.

Elsewhere in the portfolio, the automotive testing technology business **AB Dynamics** posted good financial results in April, helped by the fast-evolving and ever-changing nature of the global car market. Increasingly complex vehicles, the launch of new electric models and the general tightening of global safety standards have supported AB Dynamic's growth over the past decade. It remains a world leader in the provision of testing equipment to the global auto market and its customers include many well-known US and European car brands.

PORTFOLIO FALLERS

In terms of detractors from our performance, in late June polling and consumer research business **YouGov** disappointed investors with a profit warning stemming from its data products division. Although demand for data-related services remains high globally, increased costs following a period of investment coupled with high levels of cut-price (and possibly unsustainable) competition have conspired to materially impact profits in 2024. Recent management changes seem to have compounded the situation in the eyes of investors too. We have placed the company under review following these developments.

Another detractor includes transportation industry software company **Tracsis**, which has been impacted by the timing of the UK General Election (noting that government procurement activity is in some cases temporarily suspended ahead of the election). Despite this, we remain confident on the group's longer-term ambitions and US prospects. Business consultancy **Next Fifteen's** share price slipped after reporting caution from its technology customers and confirming that its full-year profits would likely be second-half-weighted this year. We think the group's longer-term opportunity remains significant: it has made meaningful increases in sales both organically and through buying rivals. Despite that, its valuation is undemanding, with shares trading at nine times forecast earnings.

CONCLUSION

The global stock market recovery that started last autumn continues and, while political and economic risks remain elevated, portfolio performance for the quarter has been positive. There are some promising signals of activity returning to the smaller end of the equity market and – following 36 months of consecutive outflows from UK markets according to Calastone – valuations appear very attractive to us.

Some companies continue to grapple with challenges such as lengthening sales cycles and corporate customers focused on cost cutting over investing in future growth, but this is largely reflected in share prices. And many of our portfolio companies are reporting solid and even record levels of business.

The overall result at the portfolio level is resilient and we are excited by the growth strategies our companies have in place.

Meanwhile, from an economic perspective, inflation appears to be returning to target levels, global supply chain constraints have eased, and unemployment remains low. Political change is afoot, however, with elections and their results now holding investor attention in the UK, France and the US. Technological change – especially progress in artificial intelligence – is rapid, yet most companies and their customers generally remain cautious on its use. In time, it seems likely that interest rates will start to fall (as they have already in Europe) and uncertainty will start to ease. This potential tailwind, together with a long-term focus and attractively priced smaller company valuations by historical standards, gives us optimism for the future.

STEWARDSHIP

As a responsible investor, Rathbones prioritises engagement with portfolio companies where it can make the most impact in addressing systemic environmental and social challenges and add value to clients' portfolios. During the reporting period, Rathbones engaged with 19 portfolio companies and attended 38 meetings. Following engagement, we will be monitoring diversity, pre-emption rights, director independence, boards that may include directors who could be perceived as sitting on an excessive number of boards and putting remuneration reports to 'Say on Pay' shareholder votes.

PORTFOLIO STRATEGY

This portfolio takes a longer-term approach to investing. Rathbones invests in AIM-traded companies that stand up in their own right, while qualifying for relief from inheritance tax.

ALTERNATIVE INVESTMENT MARKET (AIM)

AIM set out in 1995 to provide smaller, growing companies earlier and more efficient access to the public markets – a 'growth escalator'. In June 2024 AIM hosted 718 companies, a fall from 816 in December 2022. Subdued IPO numbers are a function of the cycle and appetite for growth when competition for capital is high; however, there have been ten new issues so far in 2024, against 15 in the whole of 2023. Takeovers reflect still attractive valuations for home grown market leading ventures while the debate escalates on de-listings and capital markets reform. The market cap of AIM's constituents totalled £76.5 billion in June 2024. This testified to a continuing difficult period for growth companies. There are 8 ventures valued at over £1 billion, co-existing with a public venture capital market and early-stage micro capitalised opportunities. From September 2018 all AIM companies adopted a governance code and then a policy of 'comply or explain' with the UK Corporate Governance Code. This increased disclosure is building confidence in this market.

THE RATHBONES INVESTMENT APPROACH

We aim to invest in profitable, established, cash generative AIM-traded companies with growth characteristics and strong competitive advantages – we prefer quality opportunities that we expect to stand the test of time. This is a bottom-up stock selection approach favouring highly visible revenue streams in growth markets with little direct exposure to the consumer, avoiding airlines, retailers, and pawnbrokers. Banks, resources, recruiters, and car dealers also don't meet the criteria.

BENCHMARK

In the second quarter of 2024 the FTSE AIM All-Share Index made a total return of 3.89%. Rathbones use this as a benchmark for Specialist Tax Portfolio performance though it's not ideal because it's not a like-for-like comparison. Not all AIM shares qualify for Business Relief meaning the relevance of the index is limited for this tax-advantaged portfolio strategy beyond providing a rough indication of smaller company performance.

IMPORTANT INFORMATION

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