RATHBONES SPECIALIST TAX PORTFOLIO SERVICE (STPS)

The Specialist Tax Portfolio Service team

Q3 2023 REPORT

Investors' focus has long been on the direction of inflation and interest rates, in the hope this will provide some clues on the economic outlook. We continue to believe the smaller end of the UK equity spectrum offers attractive value, though we sense some signs of psychological fatigue elsewhere in the market. This is perhaps an expected and natural step in a period of such significant transition as investors and asset prices keep adjusting to the wider implications of much higher interest rates.

This sense of malaise among some investors comes despite news in August that the Bank of England (BoE) expects UK inflation to fall to around 5% by the end of the year, which in turn aligns with the government's earlier pledge to "halve inflation this year". In late September, we finally got positive UK inflation data, leading to calls that it might now have peaked. Further reassurance was provided when the BoE held interest rates at a now 15-year high of 5.25% in September. This pause may signal that borrowing costs have now peaked after 14 consecutive rate rises since December 2021.

The UK economy has been outperforming admittedly modest expectations, but it continues to be perceived as vulnerable as it struggles with high mortgage costs, higher taxes, depleted household savings and the risk that many companies could go bust. Yet the UK's 'recession in waiting' will have to wait a little longer as GDP grew by 0.2% in August. Fears that November's Autumn Statement could include significant tax changes and steep spending cuts may well prove exaggerated. The government will be keenly aware that both would prove unpopular ahead of the looming general election

Nevertheless, further escalation of the conflict in the Middle East could lead to oil and gas inflation shocks, which would threaten the 'peak rates' narrative. Additionally, the growing consensus that rates may stay 'higher for longer' could set confidence back. That said, the prospect of higher for longer could – potentially – be well tolerated by investors if the underlying health of the domestic economy proves robust and confidence in the earnings outlook returns, driving a recovery in sentiment.

In the meantime, today's radically different interest rate environment is certainly driving changing behaviours. It now makes more sense to hold cash or pay down debt than it has done at any other time in the past two decades. A June 2023 survey of high-net-worth investors by Capgemini revealed they had one-third of their portfolios allocated to cash or cash equivalents. There does seem to be evidence of capitulation in some circles, with suggestions that some institutions have had to resort to forced selling to manage outflows. This may be why some companies' share prices have been faltering even when the companies themselves have been delivering solid results.

All this explains why the third quarter was a difficult period for UK equities; the AIM All Share declined 3.2% (-6.2% in Q2) and the largest 50 constituents of AIM fell 4.9% (-7.4% in Q2). That marks the third successive quarter of losses. According to JPMorgan Asset Management, UK stocks trade at a 40% discount to the MSCI World Average, a level some are describing as 'a once in a lifetime valuation opportunity'. Add in the smaller company 'illiquidity discount' and that gap – which should narrow when capital returns – only widens.

As ever, debate about the merits of active versus passive investment management strategies continues. Our portfolio, of course, favours a highly active approach. We believe stock selection is even more crucial in current circumstances – not because it guarantees instant gratification, but because we see it as the best way to gain exposure to excess returns over the medium and long term. In marathons, it's the competitors best prepared for all conditions and terrains that tend to outpace the rest over the long haul. We think a mid-race boost could come in the form of pension providers being encouraged to invest at least 5% in unlisted assets, courtesy of the proposed Mansion House pension and investment reforms.

We believe it's helpful to separate the cyclical rotation of capital from longer-term structural shifts, though both have been conspiring against UK stocks. Simply put, there's less capital in circulation for UK shares at present. The IPO environment remains subdued and is expected to stay so until later in 2024, with complex listing rules a hurdle. We will be discussing this and related topics with the Head of AIM later this year and will report back on our findings in next quarter's commentary.

PORTFOLIO DEVELOPMENTS

We initiated a new position in **Ashtead Technology**, a leading subsea equipment rental and solutions provider for the growing global offshore energy sector. The number of operational wind farms is set to more than double from 2021 to 2025 and the market is forecast to grow by an average of 24% a year over the next few years as part of the global drive towards decarbonisation. These wind farms are increasingly ambitious in terms of their cost and complexity, meaning the already substantial installation and maintenance market should continue to grow for many years to come. This is all translating into stellar results for Ashtead, which saw its revenues grow by 57% in the first half of 2023.

Recent M&A activity in our smaller company universe explains the gains made by some of our best performing stocks in the period, and suggests others see value in UK smaller company equities at current levels. Two portfolio companies received bids: **Ergomed**, discussed in our Q3 2022 note, which provides clinical development and drug safety monitoring services to the pharmaceutical industry, and **Instem**, a leading provider of regulatory software, again to the pharmaceutical industry. After the period end, educational software and services provider **Tribal** also received a takeover offer.

GlobalData, which provides market data and intelligence to the likes of Nestle, recently consolidated its shares. It made the move to improve liquidity and accessibility for retail investors and it has no impact on the underlying performance of its business.

Finally, a growing number of portfolio holdings are buying back their own stock. This is often a sign that management believes the equity of its company is priced too cheaply. **Next Fifteen Group**, **Craneware** and **RWS** are all currently engaged in buyback programmes.

PERFORMANCE CONTRIBUTORS

Ergomed is one of our longest-held companies and is a tremendous example of how enterprises can grow with the help of capital markets and a supportive shareholder base. However, the group needs to make substantial investments across its business to drive further growth and is recommending a cash offer from Permira of 1,350p per share, a 28% uplift in value. We view this as a fair price, valuing the company at approximately 21 times earnings before interest, tax, depreciation and amortisation (EBITDA). Ergomed's founder and executive chairman Miroslav Reljanović has accepted the proposal and the court-sanctioned takeover deal is likely to go ahead. With cash expected to come in by the end of the calendar year, we are considering how best to redeploy our capital.

Instem is a leading expert in its healthcare markets where it helps with data collection, analysis, and regulatory submissions management. As with Ergomed, management here believes that significant funding is required to capitalise on its exciting ToxHub data sharing and processing platform and believes this might be better achieved away from public markets. A recommended cash offer from Archimed of 833p per share represents a 41% increase to the undisrupted share price, but we felt that this price didn't reflect Instem's market positioning and long-term potential.

PORTFOLIO DETRACTORS

Strix manufactures kettle safety controls and other water temperature management components. Its shares have fallen on the back of continued weakness in consumer spending which, along with its higher level of debt from its recent acquisition of Billi (which makes boiling and chilled taps) means its leverage is higher than the market would like. Management is focused on cash generation and bringing down its borrowing. Billi itself was purchased at an attractive price and has performed well in the year, so if the group can hit its near-term targets and reduce leverage, we believe this new division can generate good value for shareholders.

Learning Technologies, a market leader in digital workplace learning and talent management, has been caught out by widely reported softness in the US recruitment and technology markets (something that's not hurt LTG alone). We believe the stock is currently too cheap despite the difficult backdrop. Its operating profit remains relatively resilient, but the shares are trading at just a third of the group's five-year average valuation based on enterprise value/EBIT and price-to-earnings. Negative sentiment seems to be overwhelming the business's decent underlying performance. That said, market conditions remain fragile and, as with Uniphar and Strix, LTG's net debt position at a time of higher interest rates has pushed its financing costs up, further weighing on earnings and sentiment. We believe value can be realised over time by reducing net debt and returning to growth as markets recover.

CVS Group provides veterinary services in the UK, the Netherlands and now Australia. Its expansion into the latter market this year marks an exciting development, and the capable management team has so far competently executed on a five-year growth strategy that includes refurbishing vet clinics and acquiring well-regarded practices. This renewed focus on high-quality care drove solid growth in the financial year to 30 June 2023, with organic revenue growth of 7.3% and earnings per share beating forecasts by around 2%. Unfortunately, a Competition and Markets Authority (CMA) review into veterinary industry pricing led to many selling shares. Our work so far leads us to believe that vets' price rises have largely been driven by cost increases (primarily wages for vets and nurses, professions which remain under-supplied and in-demand). We expect an update from the CMA on its findings in early 2024.

We remain close with our portfolio companies and met with the management teams of Strix, Learning Technologies and CVS many times in the quarter. Items on our agenda included monitoring group cash flows, banking covenants, trading momentum and visibility, and investment plans.

CONCLUSION

Portfolio company operational performance largely remains resilient overall despite the de-rating of valuations in what has been a trying period for many asset classes as risk has been mispriced. Smaller companies, including AIM stocks, have been under-owned for some time now, as shown by nearly 29 months of outflows from UK equities. Current valuations, we feel, are at or near cyclical lows as economies around the world process the steepest interest rate rises in decades. The value on offer across our universe is evident in the heightened number of inbound bids on AIM.

UK smaller companies have often outperformed following the peak in interest rates. In our view, a recovery at some point is more likely than not and it might be swift when it happens; remaining invested in well-managed, financially healthy smaller growth companies is an excellent way to benefit. Equities have historically delivered superior longer-term performance, and, ultimately, we expect this track record to continue, though past performance is not an indicator of future returns. For any market recovery really to gain momentum, clear evidence will need to emerge that inflation has been brought under control and that interest rates really are at or near their peak. The US market, which has comfortably outperformed the UK this year and appears to be ahead of us on this journey, is a good example of this dynamic in action.

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 a number of portfolio companies on a variety of ESG (environmental, social and governance) issues.

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. In September 2023 AIM hosted 778 companies, a fall from 816 in December 2022 due to a subdued IPO environment – three IPOs were completed in the third quarter – and trading related de-listings or acquisitions. The market cap of AIM's constituents totalled £85.8 billion in September 2023 – a decline from £150 billion at the close of 2021. This testified to a continuing difficult period for growth companies. There are 10 ventures valued at over £1 billion, co-existing with a vibrant venture capital market and early-stage 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 third quarter of 2023 the FTSE AIM All-Share Index declined 3.2%. We 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. The FTSE AIM All-Share Index is highly concentrated: the 10 largest constituents account for 22.6% of the index's total value. The index truly has limited application other than as a rough indication of smaller company performance.

INHERITANCE TAX REFORM SPECULATION

According to press reports, Prime Minister Rishi Sunak is considering a cut to inheritance tax (IHT), a move seen in some circles as political kite-flying. The Institute for Fiscal Studies projects that IHT could generate £15 billion a year by 2032, a significant line item to the nation's finances; there's been a notable lack of information on potential IHT reform from the Treasury so far. Shadow Chancellor Rachel Reeves has intimated that a Labour government might tighten IHT rules. Speculation about IHT reform remains rife in the countdown to the Chancellor's Autumn Statement and a general election - neither the Conservatives nor Labour have given explicit manifesto pledges about IHT changes and the scale of the legislative challenge involved in doing so should not be underestimated.

IMPORTANT INFORMATION

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