RATHBONES

RATHBONES SPECIALIST TAX PORTFOLIO SERVICE (STPS)

The Specialist Tax Portfolio Service team

Q4 2023 REPORT

November and December brought a welcome return to positive equity performance thanks to a broad rally across asset classes. All eyes remain focused on interest rates, and a much-improved inflation outlook explains much of the recent positive performance. Current market pricing implies that investors expect no further rate rises in the UK from today's 5.25% Bank Rate (compared with expectations of a peak of 6.2% back in July).

The result, for now, is a fall in the cost of government and corporate borrowing, with UK 10-year government bond (gilt) yields falling by a fifth in the quarter to 3.5%. This is helpful for short-term performance as lower gilt yields make other assets relatively more attractive. Over the past 18 months or so, higher rates have reduced the attractiveness of future earnings growth, while rising borrowing costs have weighed on current profits and increased default risks. The result is that equity prices relative to profits have fallen ('de-rated') across the board, regardless of companies' quality or prospects, meaning an extremely difficult period for investors.

Investment considerations pale in comparison with the human cost of the war in the Levant. Nevertheless, we must think carefully about how developments in the Middle East pose an additional destabilisation risk heading into 2024. The Gulf region is by far the world's most important energy producer, accounting for 33% of the world's oil in 2023. Possible supply chain disruption here could shock oil prices and further increase global food insecurity, depending on how far the war and its political ramifications spread. So far, the impact on global trade has been modest, albeit rebel forces in Yemen (who share Iran as an ally with Palestinian Hamas and Hezbollah in Lebanon) have increased attacks on container ships in the area recently.

Closer to home, there is cause for optimism, with many companies reporting a stabilisation in cyclical headwinds. UK inflation fell markedly to 4.7% in October, and then dropped to 3.9% in November (from a peak of 11% in 2022). The VIX index, which measures market expectations of the S&P 500's future volatility, is at its lowest level since before the pandemic. UK equity fund outflows have moderated in recent months. It appears the world is adjusting to the recent spike in global inflation and the policy initiatives intended to tame it.

There is scope for significant further equity gains if interest rates ease back further. We're mindful of the UK's continued valuation discount to world markets shown by the MSCI UK Index's 38% discount to the MSCI World Index as of 29 December. Potential catalysts for closing this gap include new measures aimed at making it easier and more attractive for companies to list their shares in the UK, the government's so-called Mansion House reforms intended to encourage pension fund investment into high-growth companies, and merger and acquisition activity that signals the value inherent in the UK market. More than 10% of our portfolio companies have received bids or been acquired in the past year, at an average premium of 40% to their share prices.

Intense speculation about possible inheritance tax (IHT) reform in the build-up to the Autumn Statement in late November further heightened investor anxiety. Despite all those column inches, we note that ultimately IHT reform was not mentioned once in the statement itself. Changes to IHT can't be ruled out and we await the main political parties' manifesto pledges on the topic. But recent events show that what dominates headlines does not necessarily translate into concrete action.

We met the head of the FTSE AIM market in the period to discuss, among other things, the important role that investments eligible for Business Relief (and thereby providing relief from IHT) serve in providing capital and liquidity to small and growing companies. We came away reassured that this message is being relayed to the government and will continue to champion the cause where we can. A lot of promising work is being done behind the scenes here to direct investment from the likes of pension funds into smaller domestic companies, and there's a strong pipeline of candidates considering a listing.

PORTFOLIO DEVELOPMENTS

It has been an eventful period for **Tribal**, a provider of student information and other software systems to universities. Having received and recommended a 74 pence per share cash offer from its competitor Ellucian, major shareholder Jenzabar opposed the offer. At the shareholder meeting to vote on the offer, Tribal could not gather the requisite 75% of votes to approve the deal and the offer has now lapsed. We're

glad Tribal remains an independent company as it continues to offer good growth potential, supported by its solid recurring revenue base and established market position. However, we can't rule out further interest from potential bidders at these levels.

We received cash from two take-overs this period: **Ergomed** (a provider of clinical research to pharmaceutical and biotechnology companies) and **Instem** (software that helps businesses maintain US Food and Drug Administration-compliant data) in December. We have since recycled that money into existing holdings.

Reinvestment is well under way with capital being allocated across existing and new portfolio companies. The most recent addition to portfolios is **Volex**, which has a near 130-year history as a UK power cable supplier and strong relationships with blue chip customers such as Tesla. The company has evolved into a significantly more resilient enterprise under the stewardship of executive chairman and 25% shareholder Nat Rothschild. Senior management has instilled a much clearer strategic focus based on greater control over costs, and the expansion of its range of products into structural growth markets such as electric vehicles and data centres. As a result, revenues have grown at a compound annual growth rate (CAGR) of 14.2% over the past five years, with underlying operating margins almost doubling to 9.3% in that timeframe. The aim now is to take revenues to US$1.2bn (including c£200m in acquired revenues and an organic CAGR closer to 10%) by 2027 with the operating margin staying in the 9-10% range. Investors have not fully appreciated these fundamental changes and valuation multiples remain undemanding.

Smart Metering Systems (SMS) received an all-cash takeover approach from a subsidiary of investment infrastructure giant KKR valuing the group at £1.3 billion. As with Tribal, a major shareholder now opposes the offer on price grounds. We will continue to monitor developments but note that SMS remains an attractive asset that is well positioned to help the UK transition to renewable energy sources.

Portfolio companies remain well financed, with over half holding more cash than debt. Management teams are making use of these cash balances as valuations remain at cyclical lows. **Fintel** announced three acquisitions in the fourth quarter alone, while video game service provider **Keywords Studios** bought MPG, a highly complementary bolt-on deal leading to earnings upgrades. **Craneware**, **Next Fifteen Group** and **RWS Group** continue to buy back their own stock. Elsewhere, **Learning Technologies** completed the disposal of its remaining non-core asset, leaving the group focused on its target of reaching £850m in revenues and £175m in adjusted operating profit by the end of 2025. Towards the end of the period, data provider **GlobalData** sold a 40% stake in its healthcare division to private equity firm Inflexion at a price that implied the rest of the group was significantly undervalued.

PORTFOLIO CONTRIBUTORS

Market research firm **YouGov** collects opinions and data from people all over the world. Its insights are highly valuable to some of the largest companies in the world, including Unilever and Nestlé. Its stock was languishing at historically low earnings multiples as investors arguably overreacted to signs of temporary market headwinds and more cautious customer spending. The last three months of the year saw an encouraging rally, with the stock up 66% in the quarter. The company has been an exceptionally strong performer over the past five years, growing its revenues and share price at a rate of 17% and 25% per annum respectively. The coming year is a busy one as more than 3.7 billion people have the opportunity to vote in elections in 2024 – as a group that's carved out a strong name for itself in political forecasting, YouGov might hope to do well in such an environment.

Too often in recent times, initial public offerings have proven to benefit the seller at the expense of the buyer. We added to our investment in a recent market entrant that has bucked this trend: offshore energy equipment rental company **Ashtead Technology**. It was up 39% in the quarter and has so far proven to be an excellent example of how companies can float on the UK capital market and continue to grow, creating value for both sellers and buyers of the enterprise. Ashtead Technology bought ACE Winches in November, its eighth acquisition in the past six years. The deal is expected to enhance Ashtead Technology's earnings materially and continues the group's successful strategy of buying oil and gas equipment rental companies and incorporating them into its offshore renewables business (primarily wind farms). The attractively priced ACE acquisition coincided with an upbeat trading update leading to meaningful consensus earnings upgrades.

PORTFOLIO DETRACTORS

Unusually high demand for video games during COVID lockdowns led to higher levels of investment, resulting in a crowded release schedule for new games over the past year. As a result, many smaller developers' new releases have underperformed, realising relatively poor returns on investment. After holding up far better than some of its peers for much of the year, this has ultimately proven to be the case for *Worms* creator **Team17**, a modest holding in portfolios. There are reasons to expect performance to improve in 2024, but in the meantime the firm has prudently dialled back its estimates of the profits some future releases are likely to generate. This is undoubtedly a setback but, compared with others in the industry, Team17 remains in strong shape with attractive operating margins and a debt-free balance sheet.

Specialist translation group **RWS** faced headwinds in 2023, with several independent cyclical factors conspiring against its results. This was compounded by fears that AI could disrupt its language services business. These concerns have merit, but RWS was

investing into technology initiatives well before ChatGPT came to dominate the conversation, and its more resilient intellectual property and patent translation businesses provide valuation support. Its TrainAI product builds on years of AI experience and has performed well since its launch in February 2023, contributing to £20m of incremental revenue and some encouraging client wins in the second half of its financial year. If the company can move beyond the one-off factors affecting performance in 2023, such as a lull in demand ahead of the introduction of Europe's long-awaited unitary patent, then recent lows in the share price may well mark the nadir.

WELL POSITIONED FOR IMPROVING SENTIMENT

The final quarter of 2023 began as a continuation of previous trends, with attractive yields on cash and bonds and a 'risk-off' attitude exerting pressure on smaller company equity valuations. The much-discussed possibility of major IHT reform weighed on already mispriced risk assets.

Positive inflation data and the release of an Autumn Statement without plans to change IHT combined to mark a major shift in sentiment. The resulting broad rally in equity markets provides some welcome respite.

Our working assumption remains that we are starting a new period as businesses and economies adjust to inflation and interest rates staying higher than they have been for many years. There is still a home for 'risk-on' assets in such a world – in fact, you might argue that having exposure to investments offering higher potential capital returns becomes even more important as stubborn inflationary pressures weigh on purchasing power.

We noted in our previous commentary that when conditions turned and became more favourable, small and mid-cap equities would likely be the place to be. At that point, the question "can you afford to have exposure to this part of the market?" could shift to "can you afford *not* to have exposure?" Headwinds were severe throughout most of 2023; we have witnessed one of the worst bear markets for smaller companies in recent memory, with the AIM All-Share falling some 49% from the peak in September 2021 to the trough in October 2023. The coming year might bring further volatility around general elections, but investee companies have largely traded well amid difficult conditions so far. In our view, the recent broad-based rally does not yet fully reflect their resilient growth performance, and we believe that your portfolios remain attractively valued.

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 11 portfolio companies. 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 December 2023 AIM hosted 753 companies, a fall from 816 in December 2022 due to a subdued IPO environment – three companies were admitted to AIM in the fourth quarter – and trading related de-listings or acquisitions. The market cap of AIM's constituents totalled £79 billion in December 2023. This testified to a continuing difficult period for growth companies.

There are 11 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 final quarter of 2023 the FTSE AIM All-Share Index improved 5.1%. 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 beyond providing a rough indication of smaller company performance.

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