RATHBONES

RATHBONES SPECIALIST TAX PORTFOLIO SERVICE (STPS)

Business relief (inheritance tax relief) mandates

Q3 2024 REPORT

SMALLER COMPANY SUPPORT IS CRITICAL TO "KICKSTART ECONOMIC GROWTH"

Over recent publications we've noted the ongoing impact of political events and this trend continues unabated as we head into the final months of the year. Last quarter, businesses continued to navigate significant geopolitical tensions, potential monetary policy changes and the earlier than expected UK general election in July. Following Labour's victory, attention is naturally focusing on its upcoming Budget in late October – alongside the party's manifesto pledge to "kickstart economic growth".

The tough fiscal choices ahead for new Chancellor Rachel Reeves have been well documented. While she's repeatedly insisted that many key taxes won't be raised, there's considerable uncertainty about others. That uncertainty is natural. After all, this is Labour's first Budget in 14 years and its first as a newly formed government since way back in 1997.

Budget speculation has included debate about whether it may include measures that could impact on the AIM. Over recent months we've been encouraged by the breadth of support for, and recognition of, AIM's vital role as an incubator for the national economy, alongside awareness of business relief's significance as a source of highly reliable capital – especially when capital markets are particularly turbulent.

We firmly believe that UK smaller company equity deserves support as these businesses foster innovation and bring new jobs, thereby creating wealth. We are confident that your ongoing investment has actively helped excellent companies achieve profitable growth that has benefited not just shareholders, but also many more stakeholders across our society. That investment has supported businesses in endeavours as diverse as the maintenance of our Victorian railway system to the testing of autonomous vehicles.

Looking forward, as the Chancellor contends with strapped public finances, it's clear she also needs to reinvigorate anaemic economic growth. In parallel, UK inflation continues gradually to fall, which should support further cuts in interest rates. A pro-growth policy agenda, plus lower rates, should prove positive for growth companies and the provision of growth capital.

Notwithstanding these reasons for optimism, the AIM index has been reverting to March 2024 values after a positive second quarter. While the FTSE All-Share is up close to 10% for the calendar year so far, AIM is down close to 2%. We feel this divergence is unjustified and tied to a fall in the willingness of investors to invest in UK companies, which is affecting the smallest companies the most. Shrinking UK weightings in pension funds, passive index ownership and multi-year redemptions from the UK stock market have pounded values, exacerbating longer-term trends of the UK market becoming dominated by 'old economy' companies, such as natural resources extractors, old-style banks and the like. The result, as Goldman Sachs recently highlighted, is a strong valuation case for buying the UK. Meanwhile, private equity continues to pounce. Bridgepoint completed its £626 million takeover of **Alpha Financial Markets Consulting** during the reporting period, while EQT's $2.8 billion offer for portfolio company **Keywords Studios** is set to complete in early Q4 2024.

PORTFOLIO QUALITY DRIVES NEED FOR REINVESTMENT

It is bittersweet that an AIM investor's greatest reward, in supporting a company's growth over the years, may often involve seeing it leave portfolios by way of a bid or a move to the main market. In a busy final month of the quarter, **Gamma Communications**, which enables businesses to make phone and video calls, announced its intention to move to the main market next year. We proposed to the company during its consultation phase with shareholders, which is due to conclude in January 2025, that AIM remains an attractive home in the years to come.

Late in the quarter, workplace digital learning provider **Learning Technologies Group** (LTG) announced it had received a bid from US private equity investor General Atlantic, valuing the company at £815m. LTG's equity has fallen in value over the past two years amid difficult market conditions. The news is a welcome affirmation of the business's intrinsic value, driving its shares up by over 28% on the day of the announcement to levels not seen since the first half of 2023. On the one hand, we wonder if the bid price is anchored to a multiple of cyclically low earnings. On the other, it's difficult to forecast exactly when conditions might turn. We will consider this development and have since spent time with LTG's management to better understand why it's minded to recommend the offer to shareholders.

PORTFOLIO CONTRIBUTORS

Over the past three months, positive contributors have included **Cerillion**, which provides billing and charging software solutions primarily to the telecoms industry. Because its software is critical for its customers, Cerillion's sales cycles are long and complex. But, as a result, customers rarely leave once onboarded, resulting in highly reliable revenue streams. Its Evergreen programme, which gives customers regular access to new features and improvements, illustrates its recognition of the importance of encouraging customers to adopt multiple products.

Difficult, but necessary, renegotiations with its US distributors in 2023 contributed to Cheshire- based woundcare specialist **Advanced Medical Solutions** (AMS)' robust half-year results. Core skin adhesive and hernia mesh fixation products LiquiBand and Fix8/LiquiFix delivered remarkable sales growth, with their US sales up 54% and 79% respectively, validating management's decision to renegotiate with its distributors. The company completed its acquisition of specialist suture provider Peters Surgical in July following an earlier deal for collagen-loaded dressing specialist Syntacoll. Together, these deals should nearly double AMS' surgical revenues to around 80% of group sales over the next few years – something many investors seem to have missed.

Management consultancy challenger **Elixirr** reported 14% organic sales growth despite headwinds faced by the broader global consulting industry at present. Elsewhere, healthcare software provider Craneware exceeded forecasts, leading to upgraded earnings forecasts. **Craneware's** clients face considerable operational, financial and regulatory challenges in delivering quality care, so they rely heavily on robust suppliers, like Craneware.

PORTFOLIO DETRACTORS

Next15 Group owns a collection of businesses that use technology and data insights to help their customers drive organic revenue growth. Recent trading has been difficult due to more cautious spending across its technology and public sector customer base. This cyclical softness has been compounded by the cancellation of a large, very profitable customer contract that had been expected to run until 2027. The news was received poorly and Next15's shares now trade on just seven times next year's earnings (with the cancelled contract removed). The group remains profitable and cash generative and its longer-term growth aspirations are undimmed – though rightly investors are cautious.

Rail technology specialist **Tracsis'** shares have continued to drift after trading in line with revised guidance released following the temporary disruption to its UK rail technology, transport consultancy and traffic data businesses caused by July's unexpectedly early general election. Tracsis is now cheaper on multiple valuation measures than it was during the COVID-19 pandemic, despite doubling its North America sales pipeline (a key mid-term growth lever) over the past 12 months.

The shares of offshore industrial equipment rental business **Ashtead Technology** succumbed to some profit-taking following the publication of its first-half results. We viewed the update positively and were encouraged by the reported growing customer backlog, 16% organic revenue growth, and 39% increase in adjusted profit before tax. Management also provided an upbeat outlook statement and noted that the group enjoys substantial commercial opportunities.

CONCLUSION: MARKET PERFORMANCE FAILS TO REFLECT STRONG TRADING

Solid progress has been made in the battle against inflation, and it looks likely that interest rates will continue to fall in coming months. That said, political risk clearly remains elevated at present and financial markets have recently turned more volatile again. Investors will be watching our Autumn Budget in October carefully, while keeping a close eye on the US election in November. Against this backdrop, we will maintain our focus on fundamentals and quality as we evaluate any opportunities that emerge as we head into year-end. Notwithstanding current challenges, we look forward with optimism.

We believe that our companies are in good shape both operationally and financially. Valuations continue to look attractive. At the time of writing, the model portfolio now trades at an aggregate 18 times earnings (down from 21 times at the end of August) for a basket of companies forecast to grow revenues by 9% at a profit margin of 15% the following year. That, we feel, is growth at a reasonable price.

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 8 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'. Subdued IPO numbers are a function of the cycle and appetite for growth when competition for capital is high. 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 £71.9 billion in September 2024, a fall from £76.5 billion in June, continuing a difficult period for growth companies.

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 bottom-up stock selection approach favours 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 do not meet our criteria.

BENCHMARK

In the third quarter of 2024, the FTSE AIM All-Share Index returned -3.1%. Rathbones use this as a benchmark for Specialist Tax Portfolio performance though it is not ideal because it is 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.

Past performance is not a reliable indicator of future performance.

ADDITIONAL INFORMATION

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