RATHBONES

RATHBONES SPECIALIST TAX PORTFOLIO SERVICE (STPS)

Business relief (inheritance tax relief) mandates

Q4 2024 REPORT

The new Labour Government's much anticipated Autumn Budget was a key event for small-cap UK investors in the fourth quarter. In the preceding weeks, the volume of shares traded in AIM's largest and most widely held companies dropped as speculation grew over whether Business Relief on AIM shares would be removed. This weighed on the share prices of our companies, which have largely traded well through multiple challenges over the past few years, including COVID lockdowns, double-digit inflation, global supply chain disruption and interest rate hikes.

The FTSE AIM All-Share index rallied by over 4% on the day of the Budget once it became clear that Business Relief would not be lost – however, investors now face a 20% Inheritance Tax (IHT) charge on AIM holdings from 6 April 2026. Chancellor Rachel Reeves also confirmed plans to bring pension assets into estates for IHT purposes from April 2027. This could encourage people to invest personal pensions into AIM to reduce the IHT burden. And, it is worth remembering, that the AIM market is a great UK success story. AIM-listed companies often serve as important anchor institutions for local economies and, combined, contributed some £68 billion in Gross Value Added (a measurement of the nation's output, like GDP) to the UK economy across all major sectors in 2023.

AIM's role in creating wealth must not be taken for granted, however, and the nation's many stakeholders must do more to encourage funds into UK capital markets. Some £107bn worth of companies left the FTSE 350 in 2024 and that trend was similarly pronounced on AIM, where total capital raised has declined by some 71% between 2020 and 2023. Meanwhile, the likes of the Nasdaq and S&P 500 in the US, buoyed by innovative global tech titans – and, arguably, the perception that it's a better place to get funding – provide tempting alternatives.

Despite some challenges facing the UK economy, we take comfort from the experienced management teams, resilient profit margins, attractive levels of cash generation and strong financial positions across portfolios. We are excited by our holdings' ambitious strategies and believe those prospects will, in time, be afforded greater value by investors.

PORTFOLIO CONTRIBUTORS

Nichols (the owner of the iconic Vimto drink brand) had a strong quarter as the market reacted well to the group's capital markets day in November. Management set medium-term targets of growing revenue by 30% and adjusted profit by 50%. We think this is achievable given Nichols' strong, growing positions in markets across Africa and the Middle East, along with recent work to streamline the business (primarily by revamping its 'out-of-home' division in the UK, which sells soft drinks into pubs, restaurants, and theme parks).

Management consultancy **Elixirr** also performed well following its sixth acquisition since IPO, US-based Hypothesis Group, for $45m. Hypothesis comes with an impressive blue-chip customer base (to whom it provides strategic insights into customers) and has worked with the Magnificent Seven mega-cap technology companies. Its services can be sold across Elixirr's existing customers, while its American footprint accelerates Elixirr's expansion into the important US market.

Final mention goes to **RWS**, the language translation specialist, which helps the likes of Coca-Cola ensure it is understood around the world. The group has encountered some cyclical softness in recent years. More recently, concerns around the potential impact of artificial intelligence on the group's business model has hampered performance. Happily, the group reported an uptick in trading in the second half of the year. While it's too early to call a recovery, we are encouraged by the resilient profitability and significant level of investment into technological innovation which has recently given fresh momentum to group revenue.

PORTFOLIO DETRACTORS

It was another difficult quarter for kettle controls manufacturer **Strix**, whose important UK and German markets remain soft. The group is making good progress on reducing its debt and its integration of Australian maker of boiling and chilled water filter taps Billi, which could prove in time to be a transformational acquisition.

Churchill China has a long and storied history of supplying hard-wearing crockery into the hospitality industry. If you've visited a Wetherspoons recently, chances are you have sampled a Churchill plate. Hospitality sector challenges have been well documented over the past few years, from COVID to cost inflation and customers' cost-of-living pressures. Through it all, Churchill has put in a resilient display. It was, however, expecting more of an improvement across its corporate customer base in the second half of this year. With Labour's Autumn Budget increasing the cost of employment, this failed to materialise, and the company has downgraded its expectations for future profits.

In the rail industry, **Tracsis** was weak, despite being named as preferred bidder in Network Rail's tender to deliver a new "best fare" guarantee service for rail passengers. This would be via Tracsis' leading pay-as-you-go technology. The sector has encountered challenges as it enters a new five-year regulatory control period (a wave of rail infrastructure investments). Pressures should however start to ease as budgets are released in the New Year.

UK SMALLER COMPANY EQUITY: JANUARY SALES NOW ON

We have been through a remarkable period for takeover activity in recent years, with the likes of EMIS, Caretech, Instem, Ergomed, Sumo Digital, Smart Metering Systems and Keywords Studios all succumbing to bids. This heightened interest, we feel, is a sign that UK smaller company equity currently represents very good value.

Takeovers were again a feature of the past three months, with **Learning Technologies** (LTG) receiving a formal £802m bid from the US private equity company General Atlantic in December. Terms have been agreed but at least 75% of shareholders by value need to approve the deal for it to go ahead. We are monitoring the situation closely. Some large shareholders are opposed to the deal, however, and believe the bid price is too low. Since the end of 2021, LTG has grown annual revenue and earnings per share by 118% and 89% respectively, yet its share price has fallen by 45% and its stock is now some 42% cheaper as a multiple of earnings.

We introduced two new companies in the fourth quarter. The first is **hVivo**, which provides a range of services that help biotechnology companies speed up drug and vaccine discovery. It's well placed to capitalise on an uptick in demand following its high-profile role in accelerating the development of COVID vaccines. This backdrop helped hVivo increase its revenue from £39m in 2021 to £59m in 2023. Management is targeting £100m by the end of 2027, underpinned by significant (and largely customer-funded) upgrades to its facilities.

Cohort is the second new entrant. The experienced management team here has assembled a portfolio of six high-quality businesses providing secure communications systems to the defence industry. To say the group's products are in demand would be an understatement: its order book has grown to over half a billion pounds, with orders stretching into the mid-2030s. Cohort has taken advantage of this vibrant backdrop by agreeing terms on what will become its seventh acquisition: EM Solutions, an Australian provider of satellite communications.

Elsewhere in portfolios, cosmetics manufacturer **Warpaint** agreed to buy competitor Brand Architekts in a deal that strikes us as characteristically keen. For just £13.9m, the group is buying a business with £11.2m of tangible assets (largely cash and inventory that can be quickly sold). That means Warpaint is effectively picking Brand Architekts' brands up for roughly 10% of the price paid to originally assemble them. Warpaint has a very clear and simple route to value creation here: taking out some head office costs and driving sales growth by placing Brand Architekt's products into existing Warpaint customers' stores. Given the low purchase price, we are excited to see what returns on this investment management might realise in the years ahead.

UNDIMMED GROWTH PROSPECTS AND MODEST VALUATIONS SET THE FOUNDATION FOR FUTURE RETURNS

Investing in AIM shares has been difficult in recent times, and we are grateful for the patience you have shown over the course of a market sell-off that stretches back to 2021. We think this is largely due to temporary, cyclical factors that will at some point unwind. In the meantime, AIM offers a combination of liquidity and growth potential that is hard to find elsewhere.

We have the privilege of meeting many dozens of management teams each year. We've been struck by the disconnect between languishing stock prices on the one hand and resilient trading and excitement about the potential for growth on the other. Indeed, over the past five years, our holdings have on average increased revenue by 13% per year and profits by 8% per year. Meanwhile, the combined 'price to earnings' ratio (a measure of how expensive a stock is relative to the profit it is generating) has fallen from 23 times to 17 times. Around 10% of our portfolio – which is skewed towards high-quality growth companies – trades on less than 10 times forecast profits.

Having seen something of a false dawn in AIM in 2024 (starting off positively but hitting a political wall during the year), a natural question is whether this aborted recovery will resume in 2025. What gives us confidence is that interest rates are moderating (Bank of England Governor Andrew Bailey himself was quoted as expecting four cuts in 2025, implying a fall in rates from 4.75% to below 4%). Added to that, some political uncertainty has been removed (even if the detail is not as we would have designed it ourselves) and the focus now turns to economic investment and growth. Business Relief-qualifying AIM investments have an important role to play in delivering that growth.

Assuming a continuation of these trends, fund flows should return to smaller-company equities and share prices could recover. Our companies remain fundamentally attractive growth propositions. They are established, profitable and cash generative. Many of them have cash on the balance sheet, enabling them to make value-enhancing acquisitions and to invest in operations. While valuations can rise and fall over the short term, ultimately, they are tethered to the level of earnings a company generates. Earnings across our profitable and sensibly managed companies are well placed to continue their growth.

Wishing all our clients and advisors a happy and prosperous 2025,

The STPS team

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 with 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 £69 billion in December 2024, a fall from £71.9 billion in September, 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. Banks, resources, recruiters, and car dealers also do not meet our criteria.

BENCHMARK

In the fourth quarter of 2024, the FTSE AIM All-Share Index returned -2.3%. 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

The Specialist Tax Portfolio Service team
Telephone: 0151 236 6666