

MUSCIT

Investment Commentary

Q3 2024



Quarterly review

During the quarter, the NAV of the Montanaro UK Smaller Companies Trust (“MUSCIT”) declined by 0.7%, an underperformance of 5.8% versus the benchmark, as SmallCap Value outperformed Growth. The Benchmark including AIM was up just 2.5%. We hold about 15% in AIM.

Frankly, this came as a bit of a surprise. As a Fund Manager, Mr M. looks daily at MUSCIT portfolio company announcements (before the market opens) for a feeling of whether it will be a good day or not. Over a quarter, there is a sense of how things have gone. Any disappointments such as profit warnings remain vivid in the mind. There were none over the third quarter. So, this degree of underperformance was unexpected.

What seems to have happened is that there was some profit taking in some of the stocks that had done well this year – at the six-month stage, MUSCIT had *outperformed* by +1.2%. At the same time, several of the more “value” names in the benchmark went up a little. In the quiet Summer period with typically subdued trading (fund managers off on their hols), there was concern that interest rates would not fall as quickly or by as much as first thought. This led to “*growth*” (where we invest) having a setback. This was seen across all our Funds.

The strongest contribution came from **Marshalls**, a leading hard landscaping manufacturer, which saw gains in anticipation of a construction rebound in 2025. **Greggs**, the well-known bakery chain, also performed well, benefiting from strong sales driven by store relocations, iced drink offerings and lower cost inflation. **NCC**, a cyber-security business specialising in software escrow and cyber services, traded higher following solid results and the profitable sale of a non-core division.

The weakest contribution came from **4imprint**, the largest provider of promotional products in the US, which saw its stock decline (partly on profit taking) as new customer orders slowed amidst macro-economic uncertainty. **Tracsis**, a rail technology and data firm, faced reduced revenue expectations due to project delays linked to the UK election. Concerns about possible changes to the treatment of AIM in the forthcoming Budget has also led to a general de-rating of the overall market. **Kainos**, a digital transformation consulting company, guided to softer revenue for the same reason - project delays related to the UK election and new Labour government.

Manager comments

Some may assume that Summertime is a period when stock markets are quiet and fund managers escape the rain of the UK seeking sunnier climes, leaving the portfolio to look after itself. Maybe for some, but not us.

Having reduced the number of holdings traded on AIM, we have been incredibly busy looking for new ideas. We are constantly doing so - our universe changes all the time, with flotations, take-overs, spin-offs, “fallen angels” (companies that were once too big but no longer). You can never get complacent - is there a better investment opportunity out there? Active fund management will never be boring.

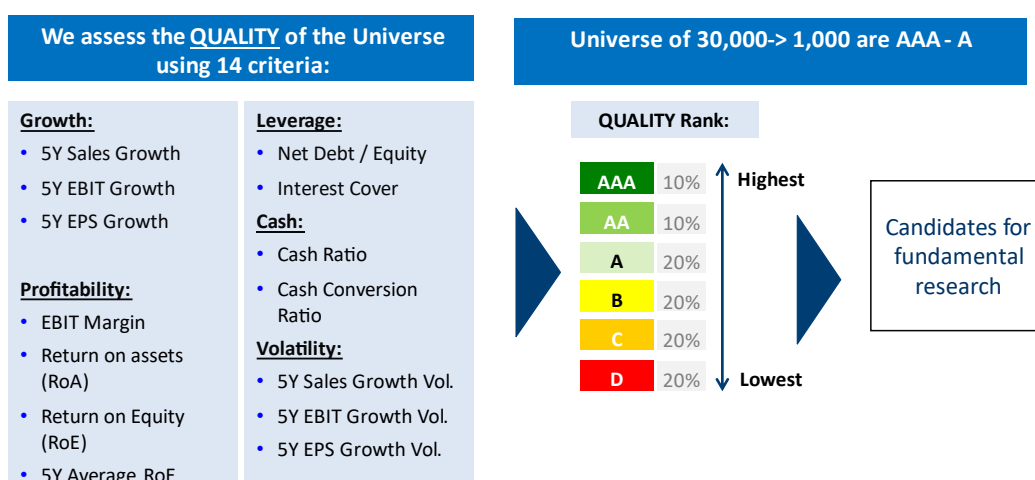
So, how do we go about finding new ideas? In this commentary, you will find out.

MUSCIT’s purpose is to give investors a portfolio of UK quoted small companies that will deliver attractive, long-term capital growth (a quarterly dividend is an added bonus). We look for high quality, well-managed companies operating in structurally growing markets. But for MUSCIT, they must be “small” - we believe it is easier for a small company to become a big company. Pretty obvious really. Not rocket science.

Over the past 30 years or more, we have built a proprietary screening tool to help us find good new ideas. Rarely do ideas come from stockbrokers - we like to find them ourselves and this tool is a starting point. Any new investment must fall within the Deutsche Numis Small Companies Index (the smallest 10% of the UK stock market). Currently, this is any quoted company below £1.7 billion in size. Although our screen is packed with useful data, it is so easy to use that even Mr M. can do so. The first step was to eliminate all other companies larger than £1.7 billion: the number of companies left was 699. Any amazing, new idea is hiding somewhere among them waiting to be found. That was the task for the Summer.

We are “Quality Growth” investors. The second step is to eliminate the rubbish. We screen the core universe for “Quality” using 14 financial ratios equally weighted shown below:

We rank companies to identify the highest quality (AAA - D)



Source: Montanaro

We want to invest in the best: AAA rated companies are the “best”, the top 10% highest quality companies. If you stick with A – AAA companies, you are probably on the right track. This screen took us down to 107 companies (many already owned).

The third step looks at sector exposure. Although we are index agnostic and don’t care if a good investment falls outside the benchmark - for example by having grown (hopefully) - we monitor the different sectors and sub-sectors that make up the benchmark. It would not be prudent to have all your eggs in one basket (for “basket” read “sector”). We closely look at where the portfolio is over or underweight by sector in case we are taking macro risks beyond our control. Some we cannot avoid: for example, we don’t invest in banks, biotech, commodity, defence and oil and gas companies - another time I will explain why. If Russia invades Ukraine sending energy and defence companies through the roof, it is just tough s**t for us.

When we look for a new idea, we start by seeing where we are underweight (all things being equal, since we are triple weighted in technology - where there are great, high growth businesses - currently we would not look for more). So, in the Summer, where were we underweight and how big are the sectors within the index (shown in brackets below)?:

1. Telecommunications (3.4%);
2. Financials (22.1%) - banks are 3.3% and insurance 3.2%;
3. Retailers: (4.1%);
4. Travel & Leisure: (7.2%)

To an extent, the choice of sectors to over or underweight comes down to the personal preference of the fund manager. Consumer discretionary sectors such as Travel, Leisure and Retail are tricky as they can be totally unpredictable. They rely on consumer confidence that is fickle (just ask Burberry). I will never understand women and shoes / handbags. Lacking any generous donors offering to buy me clothes, Mr M. tends to steer clear - come to think of it, our Compliance Officer wouldn’t let me have “freebies” anyway as they would breach our Gifts and Benefits Policy. Clearly fund managers live by higher standards than some politicians.

The most obvious sector in which to look for new ideas for us was Telecommunications. From our screen, there was only one AAA rated candidate to consider: Gamma Communications (“Gamma”). So, now the research process could begin.

But Gamma was first admitted to trading on AIM on 1 October 2014 almost a decade ago. Some may ask: why haven’t you looked at it before. Fair question and the answer: we have. And here we have to confess to fund manager behavioural bias ... Mr M. likes to invest in sectors that he likes, understands and can relate to. What Warren Buffett more eloquently calls a “circle of competence”.

At its simplest level, Gamma is involved in telephones and Mr M. hates telephones. How can anyone talk on the phone for more than a minute? Only one person ever rings and that is Mrs M. Even then, she knows never to call when in the office (“too busy”, “in a meeting”). Although Mrs M. has learned some wily ways over the years. Having texted recently only to receive the usual reply, another text followed saying “*I have broken my arm*” – prompting an immediate call from Mr M. In case she reads this, boy who cried wolf springs to mind...

Nonetheless, Mr M. has read numerous Gamma annual reports over the years. Although they read well, we had a full weighting in AIM (which we consider riskier due to the liquidity risk and often inferior corporate governance). MUSCIT also had an investment in Spirent which offered the promise of double digit, non-cyclical growth through the 4G and 5G roll-out which sounded much sexier than the probably more pedestrian growth of telephones (the reality was exactly the opposite as it turned out). So, Gamma never seemed to be a priority. This changed with the take-over of Spirent and the reduction in our AIM exposure.

For anyone still awake, here comes a health warning: what follows is not in any way a recommendation to invest in Gamma. On the contrary, this note is almost certainly a kiss of death and will jinx things. But this is what we did next....

Plagiarism. When we launched MUSCIT in March 1995, there were over 35 UK small company investment trusts. Today, there are just seven, if you exclude Aberforth who are “value” investors. In the old days, Harry Nimmo (Standard Life) and Mike Prentis (Blackrock) were the closest to us in terms of the type of companies that we all liked. Both outstanding fund managers in my view, sadly and worryingly both have retired. But I would always look at their portfolios for ideas.

All the UK small company investment trusts remaining today have sound portfolios managed by sensible people. From the latest annual reports, Gamma is held by four out of five of our peers. This was an encouraging and notable endorsement (we can always of course all be wrong).

What does Gamma do? With thanks to Berenberg:

“Gamma is a UK provider of on-premise and cloud-based communications solutions. It was founded in 2001 with assets acquired from Atlantic Telecom. Over time, it has constantly evolved its product offering to adapt to industry trends, from voice telephony to UCaaS solutions and now into new cloud-based verticals. The UK is its main market, representing 85% and 90% of revenue and EBITDA respectively, although it has also entered the Netherlands, Spain and Germany.”

Putting that into English and to quote the company: *“we help businesses communicate ... 50% of the UK market is using legacy systems and they will move into the Cloud ... Germany is a big wide open space for us as 90% is still legacy ... in 25 years, Germany will be as huge a market as the UK today ... 89% of revenues are recurring ”.*

The core product is Horizon, a UCaaS product (Unified Communications as a Service). Quite a mouthful. This cloud private brand exchange (PBX) business allows customers to make calls over the internet rather than using analogue telephone lines. This is cheaper than using traditional copper lines and allows customers to scale up and down the number of lines more easily. They have over 800,000 users in the UK and 500,000 users in Teams. You are probably a client but don’t know it – we discovered that we are.

Gamma was added to our New Ideas “hopper” for discussion among the team. George Cooke (Head of Investments) agreed that it should go forward for detailed due diligence and allocated Gamma to our Telecoms Analyst Gaspar to do the work. His job was to gather enough information to present to our four-man Investment Committee for us to decide if it should be added to our Approved List. This is a list of companies that have passed our investment process and represent the highest quality companies we can find. Fund Managers can then invest if they so choose.

Gaspar arranged or gathered the following:

1. “Tracking” on the company: i.e. any recent news on the company in the public domain such as YouTube videos;
2. Comments from Expert Networks: we pay for access to industry professionals, often former employees, to provide insight;
3. Background on the Board;
4. Broker research (where we have access);
5. Two virtual meetings with the company each lasting an hour;
6. Completed Quality and ESG checklists as well as a detailed financial DCF model;
7. A two-part presentation to the Investment Committee: the first to consider if Gamma was a Quality company and the second on Valuation, to determine if it would make a good investment

We are always focused on what makes a Company special, what are the USPs: *“The USPs are the high quality of service, significant experience running telco networks and the unique distribution network with over >1500 channel partners that has been built over 20 years”* (thank you, Gaspar).

SmallCap is all about people. We place great emphasis on the Board and review their backgrounds and careers to see what they have achieved and if there are any serving on Boards of other companies in which we invest. In this instance, the former Chairman was Richard Last (who retired after completing his stint). Richard and I were on the Board of Lynx Holdings plc back in 1995, so a big tick in the box.

Looking at the current Board: there are three Chartered Accountants (we like bean counters) and two MBAs; shared Boards include Computacenter, discoverIE, Polar Capital, Boku. Remarkably, the Chairman is also the Chairman of Raspberry Pi (!) – (please see the last commentary). **The icing on the cake was to learn that the CFO is a passionate Arsenal supporter.** Need I say more ...?

Part of the investment process includes producing a detailed SWOT analysis: what are the company's "Strength, Weaknesses, Opportunities and Threats"? Of particular interest for us is to discuss future news flow and catalysts that might make the share price go up.

Gamma was added to our Approved List on 22 August. From the decision to consider it as a new idea took four weeks. MUSCIT first invested on 27 August at a price of £15.25. We have taken a half position and will increase the holding either on weakness or as they move to the main list.

POST SCRIPT

On 10 September 2024, Gamma announced interim results for the period ended 30 June 2024. Needless to say, an anxious moment.

They reported sales up 10%; profit before tax up 11%; adjusted earnings per share increased by 13% and the dividend by 14% (dividend decisions are one way to measure confidence in the outlook). More importantly, two key catalysts we were hoping for were both announced: an acquisition in Germany (an important market for future growth) and a stated intention to move from AIM to the full list in the New Year.

Breathe a sigh of relief. The shares closed the quarter at £16.68. Phewww.....

Before putting away the trusted quill - AI does not get a look at these commentaries and would probably blow a fuse if it did – this has been a good week. The announcement of lower inflation than expected led to the portfolio *outperforming* by about 3% over two days. Wow. This shows how quickly UK SmallCap can turn around and perhaps signals a return to quality growth doing well. Not before time ...

Charles Montanaro

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