Liontrust UK Micro Cap Fund

December 2022 review

Fund managers: Matthew Tonge, Anthony Cross, Julian Fosh, Victoria Stevens and Alex Wedge

The Liontrust UK Micro Cap Fund returned 3.1%* in December. The FTSE Small Cap (excluding investment trusts) Index and the FTSE AIM All-Share Index comparator benchmarks both returned 1.3% and -1.9% respectively. The average return of funds in the IA UK Smaller Companies sector, also a comparator benchmark, was -0.6%.

The FTSE All-Share Index's December decline took it close to a flat return for 2022 as a whole, registering a small 0.3% total return. In capital terms, stripping out the benefit of dividend income, the index fell 3.2%. As we observed a few times during the year, there was a large divergence in returns to different size segments of the market: the FTSE 100 total return for 2022 was 4.7%, but the mid-cap FTSE 250 lost 17.4% and the Small Cap (ex-IT) index dropped 17.3%.

A slowing in the pace of US consumer price inflation in November to 7.1% – the lowest level in a year and below the 7.3% forecast – raised hopes of a US Federal Reserve pivot to less hawkish policy in 2023. However, as it lifted interest rates by 50 basis points to 4.25% - 4.5%, the US central bank issued forecasts of rates peaking at 5.1%, with no cuts projected until 2024.

The portfolio's December stock rankings were bookended by two stocks with very different exposures to the global economy's recovery from the Covid-19 pandemic. On the downside, **YourGene Health** (-84%) suffered a very heavy drop. The molecular diagnostics group had already endured a torrid 2022 as revenues tumbled due to Covid-19 related sales falling away. Only last month a trading statement expressed confidence in meeting full year sales guidance, but December's interim results rowed back on this, instead downgrading full-year forecasts to £18m - £20m. This would imply a greater than previously expected EBITDA loss of £3.5m to £4.5m pre-exceptional items. To cope with the losses, YourGene was forced to explore emergency funding options including business divestments. It also conducted a placing and retail offer to raise over £6m at 0.3p a share, a hefty discount to the 1.9p share price prior to the profit warning. The Fund did not participate in the placing; the managers had been reducing the position ahead of this warning and completed its sale shortly after the end of the month. The heavily loss-making, high-risk nature of the investment means that it no longer fits with the usual profile of profitable, cash generative micro cap investments selected for inclusion in the Fund.

By contrast, the Fund's best performer was **On The Beach** (+34%), as full-year results detailed the extent to which activity has recovered since Covid-19 travel restrictions were lifted. In the year to 30 September 2022, adjusted revenue rose to £144m from £31m a year earlier. While the prior year's trading was severely impacted by lockdowns and travel restrictions, these constraints only affected the first four months of the 2022 financial year. Revenue is now back to a similar level to the 2019 financial year – the last before Covid-19 emerged. Although the first quarter of its new financial year (calendar year Q4) is historically its quietest trading period, On The Beach has still seen encouraging trends. There has been a continuation of growth in premium, long-haul and B2B areas, and the group has a better forward order book than the equivalent period three years ago (pre-Covid).

The position in On The Beach was added to the portfolio last month after its market capitalisation dropped into the Fund's investment universe following two years of significant business disruption from the pandemic. The Fund managers believe the company possesses strong intangible assets in several areas including distribution, IP and brand, while also having a strong owner manager culture.

Cohort (+23%) announced a 29% year-on-year increase in revenues to £77.5m in the six months to 31 October, with adjusted operating profit tripling to £5.0m. The sales increase for the defence and security technology mini-conglomerate was driven by demand from the UK Ministry of Defence and export revenues for its Chess division. Order intake (£88.6m) exceeded revenues, pushing its order book up to a record level of £304m. The outlook for the second half of the year is robust: over £80m of the order book is deliverable during the period, meaning that it has visibility on over 95% of the consensus analyst forecast for full-year revenues.

As announced earlier in the year, **Oxford Metrics** (+22%) deferred £3.5m of orders unable to ship due to supply chain disruption. As a result, revenue growth in the year to 30 September was restricted to 4.5%. However, the provider of high precision motion measurement technology issued upbeat outlook comments within its full-year results. While demand has remained strong throughout, it now thinks that supply chain constraints are gradually easing.

CMO Group (-19%), the online retailer of general building materials, issued a profit warning flagging multiple issues. Firstly, a stock valuation error at its Total Tiles business means that it has overestimated achievable margins for 2022, with a -£0.7m impact on EBITDA. In addition, despite sales running ahead of the prior year's level, the company notes that buying patterns have shifted to lower margin categories – a trend it attributes to the cost-of-living crisis. Furthermore, CMO now expects its order book to unwind more slowly than normal due to stock availability and customers extending the completion times of their projects. All taken together, these issues are expected to limit 2022 EBITDA to £2.2m, below analyst forecasts of around £3.5m. Despite these short-term setbacks, the fund managers still believe CMO will play a key part in disrupting the building products industry, which has so far been slow to move online and is still dominated by bricks-and-mortar players. CMO has strong proprietary intellectual property in its modular software platform, as well as a key distribution network advantage in having built up hundreds of relationships with product suppliers over the years.

Tribal Group (-16%) also issued a profit warning. The software provider to the education sector announced that the underperforming Nanyang Technology University contract is now on track to have a worse-than-expected negative EBITDA impact of £9m this financial year and register a £12m loss over the life of the contract.

Attraqt left the portfolio following its takeover. Shares in the provider of merchandising, search and personalisation software to online retailers had been under pressure due to its exposure to a softening retail outlook. In September, it accepted an offer from US Digital Experience Platform software provider Crownpeak Technology which was at a 71% premium to Attraqt's prior closing price, albeit below the levels it had traded at a several months earlier.

Earlier in 2022, **Charles Stanley Group** also left the portfolio due to a takeover. One of the features of the Economic Advantage investment process is the frequency with which its holdings have proven attractive to acquirers.

The tables were turned for insolvency, restructuring and company sales advisory group **K3 Capital** (+24%), as the company itself became the target of takeover interest. In December it confirmed the receipt of expressions of interest from multiple parties and announced it is now in advanced discussions with Sun European Partners regarding a possible cash offer of 350p per share.

Positive contributors included:
On the Beach (+34%), K3 Capital Group (+24%), Cohort (+23%), Oxford Metrics (+22%) and EKF Diagnostics (+19%).

Negative contributors included:
YourGene Health (-84%), Microlise Group (-21%), CMO Group (-19%), Tribal Group (-16%) and Adept Technology Group (-11%).

Discrete years' performance (%), to previous quarter-end:**
Past performance does not predict future returns

	Dec-22	Dec-21	Dec-20	Dec-19	Dec-18
Liontrust UK Micro Cap I Acc	-17.1%	33.6%	12.1%	29.1%	3.0%
FTSE Small Cap ex ITs	-17.3%	31.3%	1.7%	17.7%	-13.8%
IA UK Smaller Companies	-25.2%	22.9%	6.5%	25.3%	-11.7%
Quartile	1	1	1	2	1

*Source: Financial Express, as at 31.12.22, total return (net of fees and income reinvested), bid-to-bid, institutional class.
**Source: Financial Express, as at 31.12.22, total return (net of fees and income reinvested), bid-to-bid, institutional class.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/glossary.

Key Risks:

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

The portfolio is primarily invested in smaller companies and companies traded on the Alternative Investment Market. These stocks may be less liquid and the price swings greater than those in, for example, larger companies.