Economic Advantage

Q2 2024 review

Liontrust UK Micro Cap Fund

Anthony Cross
Head of Economic Advantage

Julian Fosh
Fund Manager

Matt Tonge
Fund Manager

Victoria Stevens
Fund Manager

Alex Wedge
Fund Manager

Natalie Bell
Fund Manager

The Liontrust UK Micro Cap Fund returned 5.9%* in Q2. The FTSE Small Cap (excluding investment trusts) Index and the FTSE AIM All-Share Index comparator benchmarks returned 9.3% and 3.5% respectively. The average return of funds in the IA UK Smaller Companies sector, also a comparator benchmark, was 7.4%.

Although expectations for interest rate cuts in 2024 continued to moderate on both sides of the Atlantic, investors took heart from a building picture of economic and corporate resilience.

The quarter's UK inflation releases saw March and April's readings come in higher than expected at 3.2% and 2.3% respectively, but the May data – released in June – finally showed inflation easing to an annual pace of 2.0%, in line with the Bank of England's target. Meanwhile, economic growth, while muted, has turned positive, with the 0.6% expansion registered during the first quarter of 2024 the fastest growth in two years.

Encouragingly, sentiment towards UK equities appears to be on an improving trajectory – one which was not derailed by the prospect of a general election on July 4. With polls pointing towards a strong Labour majority, there was little political uncertainty for investors to price into share prices.

The prospect of a stable majority government should provide a supportive market backdrop and allow investors to look towards the likelihood of upcoming policy catalysts for the UK stockmarket.

After the significant underperformance of UK small caps in recent years, there were some signs of an improving trend in Q2: the FTSE Small Cap (ex-ITs) index return of 9.3% outstripping the FTSE 100's 3.8% rise, but the FTSE AIM All-Share still lagged with a 3.5% return.

Despite this improvement in sentiment towards UK equities, valuations of UK listed companies remain substantially lower than their long run average and their global peers. As the fund managers have highlighted on several occasions in recent months, these low valuations mean many UK companies have proven susceptible to takeover approaches from private equity or corporate acquirers keen to exploit the opportunity]

Crimson Tide (+69%), the provider of cloud-based mobile workflow solutions, became the latest holding to receive takeover interest. It was announced that Checkit, an augmented workflow and smart sensor automation company, had made an all-share offer of seven Checkit shares for each Crimson Tide share. This valued Crimson Tide shares at around 182p, a modest premium to its prior share price and a level which its board of directors viewed as too low. Subsequently Checkit upped its proposal to nine Checkit shares for each Crimson Tide share, but this news was overshadowed by the emergence of a potential cash bid from Ideagen. Disclosure of Ideagen's proposal of 312p a share saw shares in Crimson Tide soar to around 270p, with its board indicating it is considering the proposal. Ideagen itself is a former holding in the Economic Advantage funds which was acquired by a private equity group in 2022.

Gift wrap and greetings card manufacturer IG Design Group (+86%) rallied strongly on evidence that its restructuring efforts are reaping benefits ahead of schedule. The new management team has taken action to improve the financial position of the business and it is beginning to bear fruit. While a backdrop of ongoing consumer caution contributed to a 10% decline in sales to $800 million in the year to 31 March – in line with expectations – profitability improved markedly. A focus on cost efficiencies allowed a 200 basis point recovery in operating margin to 3.8%. This lifted adjusted profit before tax to $25.9 million, ahead of consensus expectations. The improved profitability led to a $45 million increase in net cash to $95 million, again well ahead of forecasts.

Zoo Digital Group (+82%) was another of the Fund's largest risers. The company provides localisation and dubbing services to globalise TV and movie content, underpinned by an innovative, cloud-based platform. Following a very tough 2023 due to the Hollywood writers' and actors' strike, Zoo Digital rallied strongly on some early signs of a recovery in activity. A trading update described customer demand in March 2024 as the highest since April 2023, following an acceleration of its pipeline. This demand recovery was maintained in April, and Zoo Digital commented that it now has good visibility on activity levels through to September. It now expects results for the year to 31 March 2024 – scheduled for August release – to be "at least" in line with market expectations.

Most of our fund commentaries see a spread of short-term 'winners' and 'losers' as portfolio holdings experience the inevitable short-term successes or headwinds in their pursuit of the longer-term capital growth potential for which we hold them. Q2 was no exception, with Inspiration Healthcare (-39%) one of a handful of portfolio disappointments to consider alongside the areas of strength already mentioned. It had released a trading update at the start of 2024, warning that results for the year to 31 January 2024 would fall short of expectations due to a delay in receiving a large export order. In a May update, Inspiration Healthcare commented that it is still yet to receive the order. While it still expects to receive the order this year, it has been necessary to seek waivers from end-April covenant tests on its debt. It has arranged modified covenants due next year and also successfully raised gross proceeds of £3 million, conditional on the passing of the capital raising resolutions at a July General Meeting, to provide additional liquidity headroom.

CMO Group (-36%) also tumbled after it reported on a worse-than-expected fall in demand during 2023 as cost-of-living pressures and unusually wet weather depressed the domestic construction sector. The decline was particularly sharp within tiles, where sales fell 31%. CMO's overall revenue dropped 14% to £72 million during the year. While the wet weather and weak demand carried over into Q1 2024, CMO has seen some signs of improvement in Q2.

Corporate training business Mind Gym (-21%) was another to slip as full-year results showed more evidence of soft demand as companies maintain cautious HR budgets. Over the year to 31 March, Mind Gym saw an 18% drop in sales to £44.9 million, which resulted in a small EBITDA loss. The company has responded by cutting costs, stripping out £11 million of annualised expenditures. This helped it recover from a £4.1 million EBITDA loss in the first half of the year to a £3.8 million gain in the second half and sets it on course to regain profitability next year.

The Fund's holdings in Tatton Asset Management and fintech provider Fintel were sold after they grew to exceed the £275 million market cap level at which the Fund begins a managed exit from positions.

Over recent years, the Fund has been keen to take advantage of the long-time horizon of the Economic Advantage process by deploying excess capital to top up existing smaller company holdings trading at depressed valuations, where we believe the medium-long term potential has been fundamentally overlooked by the market in the short term. The fund managers have also been on the lookout for new ideas where the companies in question exhibit the potential to compound growth strongly over future years. During Q2, the Fund initiated two new positions: Focusrite and Gaming Realms.

Focusrite is a global music and audio products group that develops and markets proprietary hardware and software products used by audio professionals and amateur musicians. It is currently held in the Liontrust UK Smaller Companies Fund and Liontrust Specials Situations Fund due to the significant strength in IP of its products as well as broad international footprint across 240 territories. It also has a strong culture and brands. Focusrite was held in the fund previously and sold when it became too large in 2019. However, the company's market cap returned to the Fund's range following some destocking and other post-Covid unwinds.

Gaming Realms is an international developer, publisher and licensor of mobile games, building a portfolio of highly popular gaming content and brands with the most significant being the game Slingo. The game has a unique "game mechanic" which is a large part of its popularity and the name Slingo has also become an important source of IP in its own right. The game is increasingly global in nature with the US presenting a large opportunity as states change their online gambling rules.

Positive contributors included:

IG Design (+86%), ZOO Digital Group (+82%), Crimson Tide (+69%), Bango (+40%) and Property Franchise Group (+35%).

Negative contributors included:

Inspiration Healthcare Group (-39%), CMO Group (-36%), Mind Gym (-21%), Calnex Solutions (-19%) and Nexteq (-18%).

Discrete years' performance (%) to previous quarter-end:

	Jun-24	Jun-23	Jun-22	Jun-21	Jun-20
Liontrust UK Micro Cap I Acc	13.6%	-3.8%	-15.9%	59.5%	4.6%
FTSE Small Cap ex ITs	18.5%	-0.3%	-14.6%	65.2%	-12.3%
FTSE AIM All Share	3.4%	-12.5%	-29.0%	42.5%	-2.8%
IA UK Smaller Companies	14.1%	-5.5%	-22.1%	53.1%	-6.5%
Quartile	2	2	1	2	1

*Source: Financial Express, as at 30.06.24, total return (net of fees and income reinvested), bid-to-bid, institutional class. **Source: Financial Express, as at 30.06.24, 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/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The Fund may invest in companies listed on the Alternative Investment Market (AIM) which is primarily for emerging or smaller companies. The rules are less demanding than those of the official List of the London Stock Exchange and therefore companies listed on AIM may carry a greater risk than a company with a full listing.

As the Fund is primarily exposed to smaller companies there may be liquidity constraints from time to time, i.e. in certain circumstances, the fund may not be able to sell a position for full value or at all in the short term. This may affect performance and could cause the fund to defer or suspend redemptions of its shares. In addition the spread between the price you buy and sell units will reflect the less liquid nature of the underlying holdings.

Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

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.

Disclaimer