MONTANARO

ASSET MANAGEMENT

# MUSCIT

**Investment Commentary**
Q2 2024

# Portfolio

During the quarter, the NAV of the Montanaro UK Smaller Companies Trust ("MUSCIT") increased by 5% in line with the benchmark.

Since the beginning of this calendar year, the NAV has risen by 7%, an outperformance of over 1%. In comparison, the benchmark inclusive of A.I.M. gained a little over 4%.

The strongest contributions during the quarter came from **XPS**, the pensions consultant, which delivered a strong set of results. **XP Power**, the advanced power supply manufacturer, rose after receiving a potential offer from a rival, which ultimately failed to materialise. Subsequently, management confirmed that trading conditions had stabilised. **GlobalData**, the market intelligence provider, has completed an agreement with Inflexion to acquire a minority stake in GlobalData's healthcare division in exchange for £434 million in cash. This highlighted the value of the business overall and was accompanied by strong results.

In terms of detractors, **Tracsis**, the provider of software and consulting services to transportation markets, declined as the earlier-than-expected UK election, combined with some delays in signing US contracts, led it to reduce guidance for its current financial year. **DiscoverIE**, the designer and manufacturer of components for electronic applications, softened as the anticipated recovery in orders was delayed. Nonetheless, the outlook remains positive and expectations for 2025 are unchanged.

But the biggest surprise and disappointment by far came from **YouGov**, which fell by almost 60% following a profit warning. On 26 March 2024, they reported strong first half results with revenue up 9%. The acquisition of CPS GfK had completed on time in January 2024. The largest in the company's history at €315 million (an attractive price), it was said to be trading ahead of expectations. At a virtual meeting with management two days later, YouGov reiterated their confidence by increasing their mid-term guidance on sales from £500 million to £650 million, albeit with unchanged margins. With 75% of revenues already in the bag for the year and good visibility into the second half, the outlook appeared rosy.

Not so. Out of the blue came an unscheduled trading statement on 20 June 2024 when they cut their operating profit forecasts by some 38%. Yes. By almost 40%! When we spoke to them again, they blamed weak sales in May (which had continued into June) mainly in the EMEA and DACH regions due to over optimistic sales expectations and poorly qualified leads. In a nutshell, despite a good first half and improving momentum, they missed that there were pockets of weak sales management regionally who had masked the true picture. YouGov did not have time to take remedial action (cost cutting) before their July year-end.

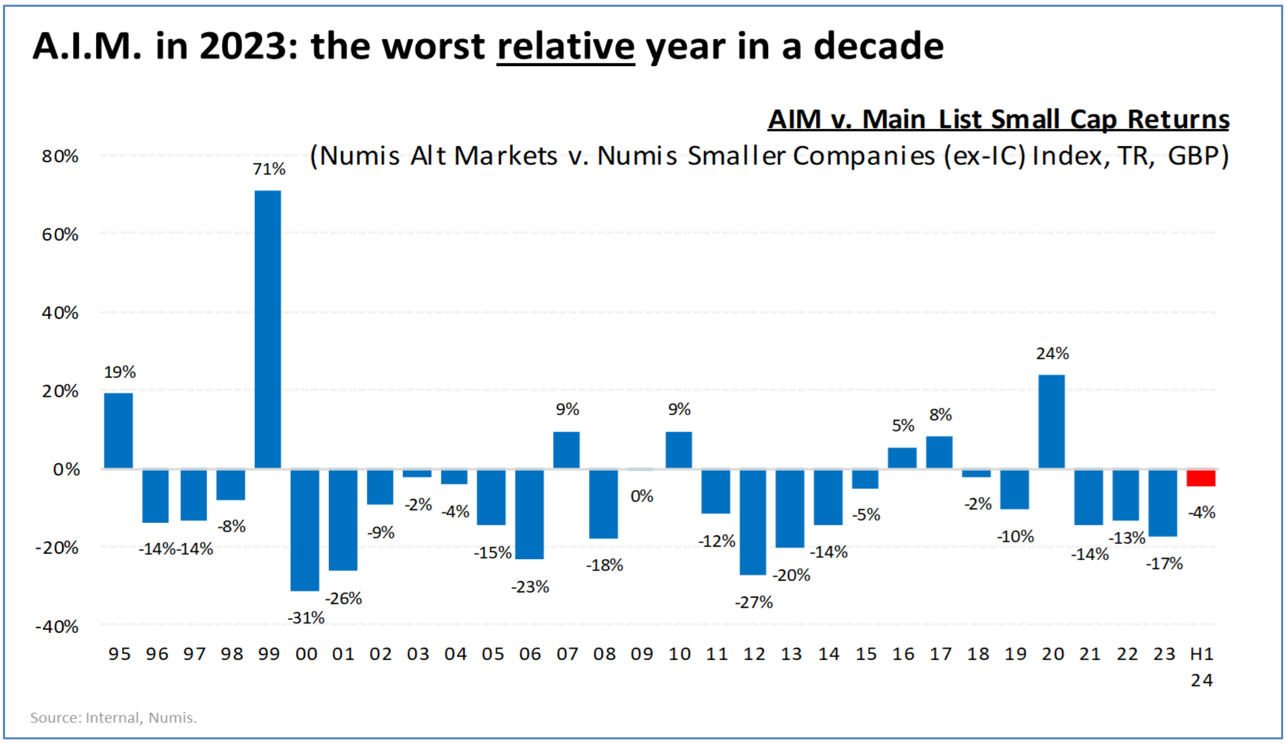
The City shows no mercy to a company that raises forecasts substantially one day and slashes them less than three months later. It raises big questions about management credibility - the Chief Executive Steve Hatch came from Meta and was appointed in August 2023, so has a short (and now already tarnished) track record. This is a reminder of why we like well-established companies with management who are seasoned and have lived through several economic cycles. Steve invested in the business in the second half expanding the sales team in the US and made other strategic hires, expecting the positive momentum to continue. He was wrong. The illiquidity of A.I.M. also meant that there was nowhere to hide when he broke the bad news - price movements on A.I.M. can be exaggerated due to the lower liquidity and can be particularly savage, such as in this instance.

Giving management the benefit of the doubt, this may be a case of a major acquisition leading to them to take their eye off the ball. Competition has increased and elections in the US may have led clients to rein in spending temporarily. It should be possible to fix weakness in sales management and to sort out the accuracy of the order book (there is a high level of contracted recurring revenue anyway). From 2003 until the profit warning, revenues had grown by 28% CAGR and the market capitalisation reached $2 billion in December 2021. With so much uncertainty and a price that has fallen by 75% from its high, we will continue to hold for now. However, such developments suggest the need for caution. YouGov may take a long time to recover. This is a real test for new management. Certainly, it will take a long time to restore investor trust and confidence.

**What have we been doing?**

Sometimes there is no reason to do very much over a quarter. It is easy to fall into the trap of forever tweaking a portfolio seeking perfection and becoming a "busy fool". We avoid trading as it seldom works over the long term and simply adds cost, which hurts performance. As Quality Growth investors, time is on our side. Just be patient and back the best management teams that you can find. Let them do the rest. We have created a high conviction portfolio, so there should not be the need for a lot of change.

But the second quarter kept us busy. Firstly, we reduced marginally our overall exposure to A.I.M. partly due to uncertainty about what a new Labour Government might do to the IHT benefits of A.I.M. and partly due to the poor liquidity. If you want to invest in companies traded on A.I.M. then a closed-end vehicle such as an investment trust makes perfect sense, but liquidity remains poor not helped by the difficult track record in recent times:



We have eleven A.I.M. investments currently that represent about 17% of the portfolio, a figure that is likely to fall to around 15% in time. We would put this "strategy" down to reducing risk somewhat. A.I.M. will always be a classic "lobster pot market" in my humble view: you can get in but you can't get out.

Secondly, as we pointed out in the last report, we wanted a replacement for Spirent which was being taken over at an agreed offer. Where we have no strong view about market outlook, we typically wait for the deal to complete and gratefully receive the cash. Why sell in the market and pay commission to brokers? On the other hand, we will take a small discount to the offer price rather than wait for the cash if we feel that the market is undervalued and likely to go up. It is all about maximising returns to investors.

So, we re-invested all the proceeds from Spirent into **Bloomsbury**, a company which has been held in our UK Income Fund for several years. The reason for initiating a holding in MUSCIT is the conviction that Bloomsbury offered growth as well as income (potentially top-line growth of 5% - 10% p.a.). It ticks all of our "Classic Montanaro Stock" boxes:

## What is a classic "Montanaro" company?

1. **Established:** long history of trading over different cycles
2. **Quality:** in control of own destiny – high recurring revenues & pricing power
3. **Mkt leader:** growth market with high barriers to entry
4. **Focused:** a simple business we can understand
5. **Predictable:** "*must have*" products / services to broad list of clients
6. **High returns:** double digit & rising EBIT margins & good cashflow
7. **Low risk:** must be profitable with a strong balance sheet
8. **Attractive:** sensible valuation (GARP)
9. **Overlooked:** under researched – a "hidden gem"
10. **Outstanding:** exceptional management with a strong ESG culture

**We are "Quality Growth" Investors**

Source: Internal.

Nigel Newton founded the business in 1986 at the age of just 31. He may well be the longest serving Chief Executive in the UK, so he has certainly lived through many economic cycles. It is a simple business to understand, probably best known as the publisher who discovered J.K. Rowling (Harry Potter still accounts for a substantial portion of sales). The publishing portfolio is well diversified with separate divisions including Academic and Professional, Consumer (Adult and Children) and Digital Resources - which benefits from a trend for students to learn on-line.

Bloomsbury announced recently the highest year-end results (to February 2024) in 37 years with sales +30% and pre-tax profits +57%. The Fantasy Fiction genre was a key driver for growth in the Consumer division thanks particularly to the success of Sarah J. Mass, who is one of the world's top selling authors – sales may now have surpassed Harry Potter. She has sold almost five million print copies from her three popular series - Throne of Glass, Crescent City and A Court of Thorns and Roses - so far this year, making her the bestselling BookTok author of the year to date: read here.

The good news keeps on coming. On 29 May 2024, Bloomsbury announced the acquisition for £65 million of the US Rowan & Littlefield academic publishing business. Nigel described the deal as "*transformational*" and immediately earnings enhancing, bringing over 97,000 new titles to the Group. He has waited years for this opportunity to materialise.

Finally, this quarter saw us participate in the first IPO for MUSCIT since Auction Technology Group in February 2021. This was both exciting and a lot of work.

By way of background, we invest rarely in IPOs because we prefer to invest in companies that have been publicly listed and have many years of trading history. The listing process is not easy for a small private company and the demands once listed are not trivial. Dealing with the City and our endless (probably quote annoying) questions is also not for the faint hearted. On the other hand, the prospectus does provide a huge amount of information which we love. Old hands will tell you that the trick is to read the prospectus backwards. All the fine print and the bad bits (such as litigation and related party transactions) are at the back which few bother to read or don't have the stamina to do so.

There have been few IPOs in recent times possibly due to Covid, the Ukraine war, subsequent supply chain issues, inflation, rising interest rates and of course weak investor sentiment. No-one likes the UK to say the least. Just 23 companies came to the market in 2023, down by 49% and raising less than £1 billion, the lowest total since 2010. This could not go on.

We felt that things might start to improve this year: private equity always need to realise some of their investments to lock in some returns allowing them to raise more money – time was running out; investment bankers need to earn fees to get their Christmas bonuses (the old Ferraris needed replacing); the London Stock Exchange needed to show that the UK was a good home for international companies to list, especially those in technology. So, all parties had a vested interest to celebrate a successful flotation. Any deal would be "priced to go". Step forward: "**Raspberry Pi**"!

Raspberry Pi is a Cambridge-based developer of computer boards and computing units selling into two markets: Education and Enthusiasts and Industrial & Embedded (meaning computer nerds and kids on the one hand and companies on the other). Eben Upton established the Raspberry Pi Foundation in 2008, a charity to ignite a passion for computer science in young minds. The subsidiary Raspberry Pi made tiny, credit card sized, computer boards selling for less than £15 in the hope that schools would give them to their pupils to create low-cost computer platforms. Products now include semi-conductors, compute modules and various accessories. He became Chief Executive in 2012.

The prospectus made fascinating reading and was 182 pages long. It was one of the cleanest out of hundreds that I have read in my career – no obvious issues and not a typo in sight (an instant rejection in my book). I also have a few simple rules: "follow the money" – if private equity and management are selling, count your fingers. In this case, the seller was the Foundation not private equity (good news); management were not selling and collectively would hold around 5% of the company (interests aligned); ARM and Lansdowne Partners were buying at the flotation price (also Sony Semiconductor Solutions were recent investors); the Foundation would remain the largest shareholder and recipient of much of the over £160 million raised (more ticked boxes).

For us, at around £500 million it was an ideal size – too small for many of the large institutions and in our sweet spot (it was profitable and sales and operating profit from 2021-2023 had risen by +90% and +100% respectively). We had two meetings with the investment banks and a lengthy one with the management team, who confirmed our confidence in them and the investment opportunity.

The issue was some 10x oversubscribed and more than half the institutions who applied for shares went away empty handed.

As long-term shareholders, we were fortunate to receive an allocation that we have since increased to our target weight. Raspberry Pi started trading on Thursday 10 June 2024 at a price of £2.80 per share and recently touched £4.20 – the market capitalisation has risen from £500 million to £800 million. Although we were optimistic that it would do well, please do not believe for a moment that this is always the case. In this instance, all the stars were aligned.

There is a sequel to the story. In the prospectus, I noticed that one of the founders was David Braben (Chairman of Frontier Developments) whom we have known for many years. We spoke to him and learned a great deal more about the history of Raspberry Pi than a prospectus can tell you. The following article is illuminating: read here.

We also found this *"very cool video from 13 years ago"* (the words of our Analyst): watch here.

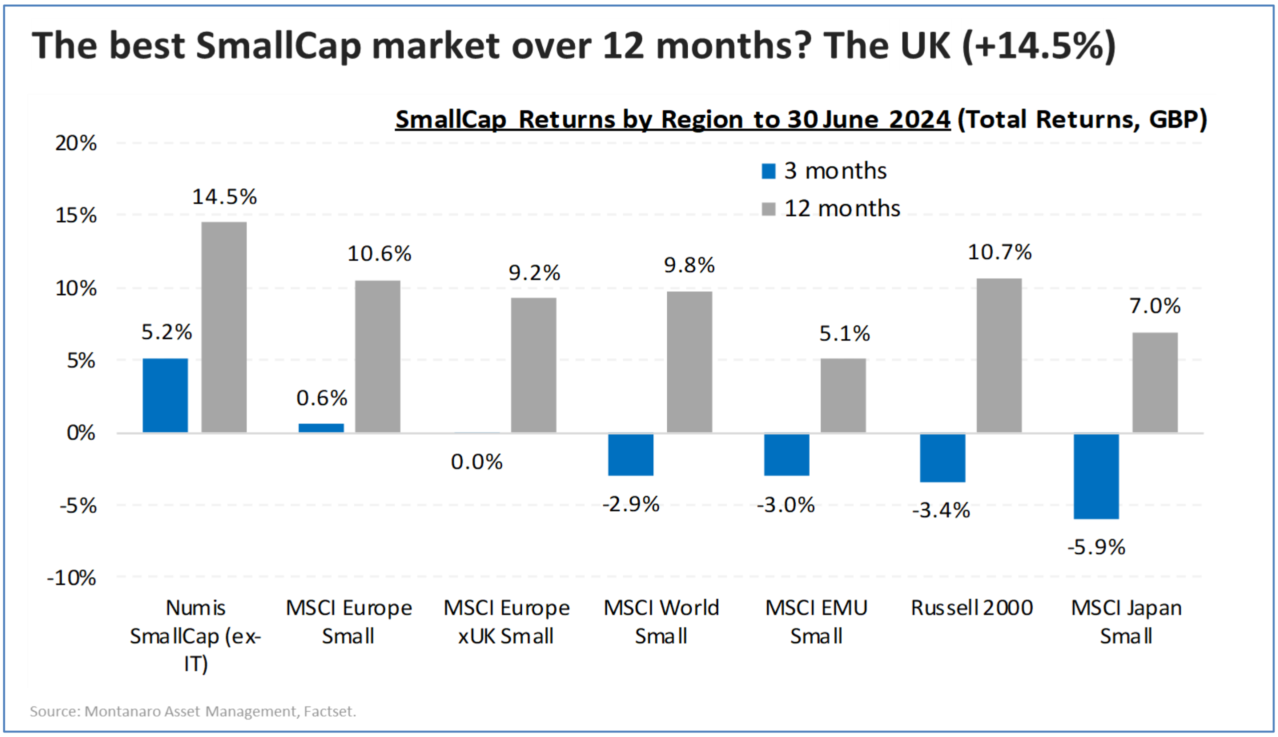
I have long argued that investing in UK SmallCap is all about the people. It is remarkable how often paths cross and a network of contacts built over decades can bring insights and connections that are quite unexpected. This is also why we feel it is essential to meet the management teams of the companies we support.

Although this quarter has been exhilarating and busy, it seems that we will not be bored during the next. We have identified several new ideas that we will share with you, if they pass our due diligence, when next I put pen to paper.

# Outlook

Domestic equities have been in the doldrums in recent years, evidenced by UK SmallCap outflows exceeding those of the Global Financial Crisis. The shadow cast by more glamorous international markets remains a long one - in June, Nvidia became worth more than the entire FTSE 100.

Despite this, at the end of 2023 we suggested that the conditions might be ripening for the "SmallCap Effect" to emerge from its multi-year hibernation. There are signs that a thaw may have begun. Something of a "silent recovery" is at play.  Over the past 12 months, SmallCap has outperformed LargeCap by some 2%.  Although few commentators seem to have noticed, UK SmallCap fared significantly better than its European and global contemporaries over the past quarter as the chart below illustrates:




Investors appear to be growing concerned about the "concentration risk" in global markets.  Some recent research that we found interesting was published by Bridgewater: *The life cycle of market champions*: *"a consideration for investors today is that most investors' portfolios have higher exposure than ever to the current champions [the large tech stocks]… over a third of a typical US-market-weighted portfolio is allocated to the current basket of champions, and in a world portfolio, this share ends up close to 20% - the highest in over 50 years"*.

The P/E discount of UK SmallCap to global equities now stands at -39%.  The Price/Book discount v. LargeCap is at its widest since 2009.  There has been a notable pick-up in M&A activity in the SmallCap space as trade buyers and private equity are taking advantage of low valuations.  The IPO market is looking healthier than it has done for some time.  The success of Raspberry Pi reflects improving investor sentiment.  One swallow does not a Summer make of course – and where is the sunshine and why could we not bring it home? – but things feel a little better these days at least in the world of UK SmallCap.  Shhhhhh whisper it for now.  No-one seems to have noticed …

**Charles Montanaro**
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