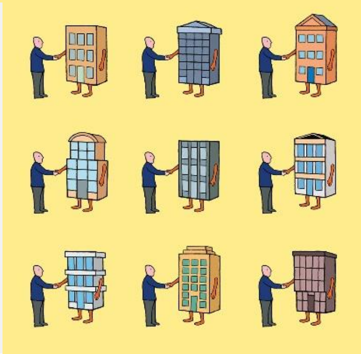
MONTANARO

ASSET MANAGEMENT

# The UK Income Strategy

- Montanaro UK Income Fund (Dublin)
- WS Montanaro UK Income Fund (UK)

## Quarterly review – Q2 2025



**Q2 Returns – SmallCap rebounds:**

- Numis SmallCap (ex-IC) Index +14% in Q2, outperforming LargeCap by 11.5%
- Q2 rally offsets earlier underperformance
- Investor sentiment improving, although decisive momentum in SmallCap has not yet been established

**Drivers / catalysts:**

- UK macro data stabilising, and BoE continues to cut rates
- Renewed M&A interest in undervalued UK assets

**Valuations / earnings:**

- SmallCap valuations remain deeply discounted vs. LargeCap and global peers
- Earnings updates generally robust, with growth expectations ahead of LargeCap

After a challenging start to the year for UK SmallCap, the second quarter saw a welcome rebound, helping the Montanaro UK Income Strategy deliver good absolute returns and outperform its benchmark.

The quarter began with Donald Trump's "Liberation Day" tariff announcement – recession fears spiked and then quickly receded as a more conciliatory tone was put forward by the White House. Tensions flared in the Middle East, as Israel and then the US targeted Iran's nuclear capabilities. The dollar continued to weaken.

In this turbulent context, it is little wonder that SmallCap – more domestically focused than its LargeCap sibling – has seen increased investor interest and a stronger performance.

# Performance & Portfolio

During the quarter, the NAV of the Sterling seed share class of the **Dublin domiciled Fund** rose by over 9%, compared to a benchmark return (IA All Companies Sector) of 7.4%.

The NAV of the sterling income share class of the **UK domiciled Fund** rose by 10% versus the same benchmark.

The Fund's domestic consumer-exposed names (retail and housing-related) generally had a good quarter, as rates were cut and consumer confidence showed tentative signs of improvement. (It's worth noting that the exceptionally hot weather of the last few weeks may cause some short-term turbulence in normal trading patterns, but we take a long-term view). Most asset managers traded well, buoyed by the strong markets. REITs continued to perform solidly in an increasingly consolidating market (where several of our names – LondonMetric Properties, Tritax BigBox and Primary Health Properties – are acting as the consolidators). Utilities also had a good quarter, insulated as they are from the global macro turbulence. Industrials saw divergent performances, as those who posted upbeat commentary and limited tariff impact (e.g. Diploma and DiscoverIE, amongst others) were well-rewarded, while some others lagged (e.g. Clarkson, the ship broker, which has seen softer freight rates and activity). Staffers also lagged as they continue to face the longest downturn this millennium; we believe they are well positioned when the recovery does eventually come (as it surely will).

It is also worth noting that the Fund continues to have no exposure to defence companies, airlines, mining companies or banks – all of which performed strongly in Q2. In addition, while there were bid rumours around some portfolio holdings (e.g. ME Group and NCC's Escrow division), the Fund has so far not benefitted from the recent flurry of takeover activity in the UK market.

The **strongest contributors** during the quarter were:

- **Games Workshop** – the owner of the Warhammer 40,000 franchise and creator of fantasy miniatures for hobbyists performed well, supported by a robust trading update.

- **discoverIE** – the designer and manufacturer of customised electronics for industrial applications saw sentiment turn positive following another solid set of results, with upgraded margin guidance and double-digit organic growth in its fiscal Q4 orders.

- **Diploma –** the specialty distributor of industrial components announced strong H1 results, supported by robust demand in data centres and aerospace backlogs**.**

The **weakest contributors** during the quarter were:

- **Bloomsbury** – the publisher known for fiction, non-fiction and academic titles weakened due to pressures in the US academic market and as investors were disappointed at the lack of announcement of a new Sarah J. Maas novel. We believe this is just a matter of time. In addition, with a Harry Potter series by HBO to come in 2026-27, and the potential to monetise their academic content through AI deals, we believe the future continues to look bright for Bloomsbury.

- **Man Group** – the alternative investment management company declined as the outlook for performance fees deteriorated following soft performance in several of its strategies amid the sell-off around Donald Trump's tariff announcement. Performance fees can be volatile, but we retain conviction in the group's position as a leading tech-enabled alternatives house.

- **NCAB** – the distributor of printed circuit boards was impacted by tariff uncertainty, as most of its products are sourced from China, while demand weakness persisted across its end markets.

During the quarter, we initiated a position in **Hill & Smith.** The company is a group of specialised engineering businesses linked to infrastructure construction in the US and UK, which we believe is a long-term structurally growing market. Its de-centralised companies have strong market shares and pricing power in their chosen niches, delivering high-teen EBIT margins and >30% ROCE. Hill & Smith has a long track record of delivering solid organic growth, supplemented with bolt-on M&A, and its current low gearing leaves ample scope to make further accretive acquisitions. Given the company's strong cash generation, its c. 3% dividend — covered more than twice — could be supplemented with additional shareholder returns if material M&A opportunities do not arise.

We also initiated a position in **Hollywood Bowl** following its recent share price weakness. This opportunity arose as a result of a soft trading update caused by the exceptionally warm weather in recent months (which is not conducive to bowling indoors). But we focus on what is within company's control. To this end, the impressively data-driven management team have delivered a respectable track record of like-for-like growth (+9% since pre-Covid), supplemented with a roll out of more venues both in the UK and in Canada, which we expect to continue. The company has a net cash balance sheet and, alongside a well-covered yield of over 5%, has begun buying back shares. Notably, its formerly listed peer, Ten Entertainment, was acquired by private equity 18 months ago. It is also worth noting that its formerly-listed peer, Ten Entertainment, was acquired by private equity 18 months ago.

We sold **Kainos**, the provider of digitisation services, on concerns that the competitive environment in both its Digital Services and Workday Services divisions has structurally deteriorated. We also exited **Ricardo**, the consulting company, as it faced challenges in multiple divisions, resulting in a stretched balance sheet.

# Engagement & ESG

Engagement with **Marshalls** focused on improving the availability and consistency of quantitative data across its product suite, particularly by encouraging greater use of information derived from Environmental Product Declarations (EPDs). Marshalls confirmed it is now using EPD certification data to report on the carbon intensity of a wider range of products. Its bricks are estimated to be approximately 40% less carbon intensive than clay equivalents, based on Brick Development Association (BDA) methodology. The company is also exploring how to quantify the carbon savings of its Triblend cement alternative and will follow up with calculation methodology and aggregated data to support our analysis.

Our discussions with **Cranswick** focused on understanding the circumstances surrounding the animal welfare breaches identified at Northmoor Farm and to assess the effectiveness of its oversight following the farm's acquisition. Cranswick reported that six employees were suspended, with outcomes ranging from dismissal to retraining. It has since implemented enhanced training programmes, strengthened whistleblowing procedures and rolled out AI-enabled CCTV monitoring across all farms. An independent review led by a veterinary expert is underway, with findings expected within three months. We plan to review the published results of this third-party investigation, anticipated in Q3 2025.

Discussions with **NCAB** centred on evaluating the strength of its audit processes as a point of differentiation. NCAB described its dual-track approach, conducting quality and sustainability audits biennially at around 20 high-risk factories, which together account for approximately 75% of production. The conversation also covered the recent drop in its EcoVadis rating from Gold to Silver and efforts to raise awareness of whistleblower channels. Follow-up information with sample audit reports is awaited and developments in audit coverage and customer feedback mechanisms will continue to be monitored.

# Outlook

Despite a strong quarter for SmallCap, valuations remain well below historical averages and international peers, representing a compelling investment opportunity. This is increasingly being recognised by both private equity and trade acquirers, resulting in an accelerated pace of takeovers in the market. In addition, the pace of buybacks is the strongest it's been in a long time, suggesting Boards are also seeing buying opportunities. Indeed, over a quarter of the Fund's holdings are actively buying back shares.

As always, we remain focused on investing in companies that deliver an attractive combination of Quality, Growth and Yield. The Portfolio contains several world-class companies; market leaders in their chosen niches with diversified customers, strong margins (average of 24%) and strong balance sheets (a third have net cash), delivering high single digit earnings growth. Dividends are well-covered and announcements have been robust during Q2, with the majority coming in ahead of expectations. The Fund's current yield of c. 4% is well ahead of the FTSE Allshare at c. 3.6%. This is remarkable, given the relative growth prospects, and we believe it further underpins the valuation opportunity for the Fund and for SmallCap in general.

***Guido Dacie-Lombardo***
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