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[INTRODUCTION]
Ryan Lightfoot-Brown (RLB): Hello and welcome to the Investing on the go podcast by FundCalibre. I'm Ryan Lightfoot-Brown and today we're speaking to Simon Moon, the Elite Rated manager of the Unicorn UK Smaller Companies fund. Simon, thank you very much for your time this morning.

Simon Moon (SM): Thank you.

[INTERVIEW]
[0:18]

RLB: Now UK companies, both large and the small ones that you invest in fell a lot more than their developed market counterparts in the sell off earlier this year and bounced back slightly less. While other developed markets are now back to the levels they were at start of the year, the UK is still down some 20% or so, why do you think this is?

SM: Well there were a couple of reasons for this, but Brexit essentially. There's this uncertainty overhanging domestically focused companies, but basically just UK companies in general. We've all seen how the market just absolutely punishes uncertainty across the world through March and April. And you still have a large element of uncertainty with UK focused companies. And that is, I suppose, that the specter of a hard Brexit is still on the horizon. That uncertainty has carried on overhanging them, has not allowed them to recover at the rate of which other developed markets have recovered across the world.

What I would say is there is a sort of second dynamic to this in that when you look at the sort of MSCI World Index, for example, that space really should be read as MSCI US plus a few others, because the US is such an important factor of those. You know, when you remove the US from the MSCI World, so you get the MSCI World ex US, it's actually down a few per cent year on year. That's how important the US has been to driving, I suppose the picture of the UK's under performance, and within that as well, you have the tremendous share price returns of the FAANGS, Facebook, Apple, Amazon, Netflix, Google over that period. And also momentum driven trading as well with the likes of Robin hood traders. You know, these guys suck at home can't bet on football, can't bet on American football or baseball, and so they're just picking stocks to punt and you know, that has really driven momentum in the US as well. So you, you've sort of, it is without a doubt Brexit, but it's, I think the picture is being made even worse by what's happening in the States.

[2:30]

RLB: And perhaps going onto your portfolio. You obviously engage a lot with your companies, with them being a bit smaller, what did they say about how they've coped with lockdown? Are they seeing any of their competitors go under and are they worried about a lengthy recession, this sort of double dip we're talking about, or has demand started to pick up already?

SM: Yeah, it really is a mixed bag. You've got companies that are coping really well throughout this, and you've got companies that are finding it harder. You know, we speak to our investee holdings on a very regular basis. I've spoken to several of them, you know, more than two or three times over this period. And they've made themselves very available. And one good thing about I suppose, this new environment of working on Microsoft Teams and Zoom calls, et cetera, is that everyone is more readily available. Like I say, some I've spoken to some three or more times.

What you saw, what we observed, through March and April was what felt like blood on the floor. You know, it felt like companies we're all seeing a very uncertain outlook, but some of them were updating with, you know, revenues off by 80% - 90% you know, while refusing or unable to provide forward looking guidance in their statements. And you can't really blame them for that. The world was changing. What you saw subsequently in May and June, the updates on these companies was almost like a collective sigh of relief. And what we've seen is the gradient of recovery is being faster and steeper than we would have expected. I think over that period, you still got this element of uncertainty, but one of the beauties of investing in small companies is they're able to react very quickly. They are nimble and you know hats off to the Government, what they have done, the support they've given as well has stopped a number of people being made redundant and has allowed businesses to gain access to funding, which in most cases they haven't needed, but the fact that it's been there has been a tremendous support for them planning for the future as well.

So, in May and June, you did see this collective sigh of relief, this sort of guidance of what was happening. You may be down 15% - 20% year on year, which isn't good in anyone's book, but compared to how it was looking a couple of months earlier, it's, you know, it was comparatively fantastic. And I'd say as well, even within the portfolio there's generally companies - as it's something we screen on –that tend to have very strong balance sheets, you know, about half the portfolios had net cash on the balance sheet. Of those that have net debt it's around one times EBITDA (earnings before interest, taxes, depreciation, and amortization). So, you had sort of this dynamic of a really uncertain end market for most companies across the market. And you had to sort of take a view on that, investing in small companies, they tend to operate in single verticals, it tends to be a little easier to get a handle on what the drivers are for these businesses. But if you've got a business that is well financed it really takes a load off, because if you've got this uncertain outlook and the potential burden of unmanageable debt over that period as well, then that does increase the likelihood of companies within the portfolio going bust and we're pleased to say the companies in our portfolio are very well financed as mentioned. And we really put them (companies) into three baskets of continuity, resilience and recovery, and in March and April it was certainly based on the sort of resilience and recovery baskets, you know, that was certainly overweight there. But as we've come through that period, you have far more companies sort of I suppose, being promoted up into the resilience and into the continuity basket, you know, the likes of EMIS, which is a healthcare and software provider to the NHS, we've got some computer games developers in there as well as they obviously did quite well. In the resilience side, you've got some Domino's Pizza, which had to change their working practice somehow, but a lot of people were ordering pizza from home. So there was a great deal of changes occurring over this period and will continue to be the case. Some companies have actually taken advantage of it. Some companies have fortunately been business as usual. Others have had to adapt to it.

[6:45]

RLB: Absolutely, looking forward to the next stage of the government support starting to run out now and there are rumors, sort of conjecture about a second lockdown. We've seen some localized lockdowns, are your companies worried about that at all?

SM: You know, lots of them are geographically specific. So many of them are, especially industrials, they will be in one particular region within the UK. If you got a lockdown in the West Midlands, Castings, for example, would probably struggle at that point, but that's so specific. I don't really think you can predict those. That (a localised second lockdown) would be better for the country as a whole, you know, those localized lockdowns would I suppose, smooth the recovery out of this, rather than having another complete national lockdown would be very detrimental to the country.

[7:34]

RLB: Thank you, and one of your largest sector weights, you kind of alluded to it, would be engineering type companies. The UK's had a great history of engineers, Brunel and Stephensons, for example, but British engineering today is not quite as big as it was, mostly because everyone's focusing on technology. I know you said you've got some of the gaming stocks where the British companies are doing very well, but can you tell us a little bit more about the engineering sector and what you liked so much about those companies?

SM: Yeah there's echoes or those names that you mentioned. Yeah, it's that we're a country with a huge heritage in industrial engineering, birthplace of industrial revolution, and that does leave an indelible mark. I think what you've seen over the last 200 years plus, since the birth of the industrial revolution is it's occurred, you know, we've got the lasting legacy of it. It is really high- quality niche engineers throughout the UK that are just they're smaller, they're world leaders, but they're smaller. So in the Numis Smaller Companies Index, it is I think you know, when you look at industrial goods and services as a whole, I think it's about 17%. So it's a pretty big sector as it is. Industrial engineers are a smaller element of that. But, you know, if you look at, if you look at the whole, I'm sure, well I'm fairly sure it's the largest sector, but it's very well represented within the UK smaller companies fund because you know, these are world leaders. We don't pat ourselves on the back enough for it in the UK, it's something we're very bad at as well, patting ourselves on the back and giving credit where it's due.

But these are world leaders, but they're in really niche areas, either the likes of Goodwin, which is a company that just so few people heard of, it's right in the middle of Stoke, it must be one of the primary employers in Stoke, and it's a world leader in steel casting. This is a huge scale. This is, this is sort of outline for boats, this is giant flow controls for nuclear power stations. This is sort of large-scale parts for controlling sort of nuclear contaminated waste and that sort of thing. It's a hundred thousand tons. I think there's two other companies in the world that can forge and cast a steel of that size. And just walking round the sites like I did about a year and a half ago, it was the last time I was up there, it is genuinely awe inspiring and fairly mind blowing how large these things are, a complete world leader. You know, just some quick example they make the Rolls Royce submarine engine, which is the most powerful gas turbine engine I think at sea. And they are an absolute integral manufacturer of a serious component for that. But yeah, I can reel off a few others, but I'm conscience of the time. But yeah, we're really fortunate in this country to be very well represented by a number of pretty small-scale engineers that are just absolute, absolute high-quality companies.

RLB: That was an amazing testimonial, thank you Simon.

SM: Sorry, I get very, very excited about it.

[10:50]

RLB: No, it's great to hear. And one of the other industries that we've touched on a couple of times, is computer gaming companies, which ones do you own that our listeners may have heard of, and do you think they'll remain as popular now once everyone's back at work and at school?

SM: Yeah that's a really, really good question. You know, you have had the lockdown boom for these companies, being people staying at home and in many cases twiddling their thumbs, unfortunately. And if they're doing that over a joypad with one of these companies' games then all the better for us. You mentioned earlier, we have a pretty rich heritage in the UK as well of developing computer games, we've been sort of doing this hobbyist since the 1980s which has sort of grown into a pretty serious industry now. The two we have are Frontier Developments which have the focus of theme park management or managerial style of games. So they have Planet Coaster and Planet Zoo, which are, as you can probably guess, games where you make theme parks and zoos and control the guest experience. And these are really in depth. You can control the amount you charge people for popcorn, what's in the ingredients and how much you promote, and you know, how long the cues are and where they are and where the loos are and that sort of thing. Some people love it. It's probably not for me, but I have played on that game and the zoo one as well. They also do Jurassic World Evolution, which was a huge license for them and was incredibly popular at release. Again, it's, you're managing a sort of dinosaur-based theme park or Jurassic World, which goes wrong and repeatedly goes wrong, unfortunately, and you'd have to sort of control all these flash points.

One of the other, or the other, computer game developer we hold is called Codemasters and they have the F1 franchise, they have various other driving franchises as well, but their main one is Formula One. What they've done very successfully is really engage with eSports over this period. So you've had this dearth of sporting activity -so if you can have a virtual version of it all the better and it gets new eyeballs of people that like F1 but never really viewed themselves as computer game players before. And now, suddenly, got very interested because they saw our whole F1 series played out virtually on one of Codemaster's previous iterations, Codemasters F1 2019. And the reintroduction of Formula One into physical form occurred with, which coincided with, F1 2020, which was released a couple of weeks ago to tremendous critical acclaim to be honest, it really is. I think it's on a site called Metacritic, which is a collator of game reviews - I think it’s the most popular or highly rated game on Xbox, very highly rated on PC and PlayStation and the sales have been, I'm sure, very good on that as well.

I think the dynamic you were talking about you know, whether people will continue after lockdown ends - they will obviously have less time to play games, so they will game less. But what you've had here is a permanent increase in your customer base given that people just wouldn't have touched computer games before and just would have viewed it, maybe as an activity. They didn't think they had any interest in it - you've opened the door to them and you're not opening the door to them in their sort of physical format -where they've gone in and they bought a disk and then leave the shop and played a few times and forget about it. They've all bought it digitally. So they've downloaded it, which is a better margin, which is fantastic for the developers, but B it's a route to the customer, a direct route to the customer, so you can see where they've engaged in your game, how much they played it, and you can keep them updated on improvements to the game, updates to the game, new elements of it. You know, you can, you can really bring them back to the game and keep them engaged in it, which is a customer experience if go back five years in computer games, or five or 10 years, you wouldn't have had that at all. It would have just been a minuscule aspect of your customer base. And now you've got all these new customers. Yes, they will play less once lockdown ends but they will be engageable with.

[16:25]

RLB: That's really interesting, thank you. Stepping back a little bit, what is sort of your outcome for UK smaller companies? I know we talked about the Brexit overhang, that's going there, do you see some resolution later this year or has perhaps COVID affected the outcomes of Brexit more so?

SM: That's a very good question. I think the specter of a hard Brexit does overhang many UK companies, which is, which is really unfortunate. I think if you canvass all our investing companies, the vast majority would see that as the, the least preferable outcome. I suppose, with the COVID environment you do have, the disruption caused by a hard Brexit would probably come out in the wash a lot faster than it would given the world is changing a lot faster, if that unfortunately did happen, but I think everyone's absolutely hoping for a sensible resolution to it.

[1627]

RLB: And I imagine the companies that you've described being the sort of niche industry leaders and very good at what they do, they can perform well, regardless of sort of the Brexit outcome?

SM: Yeah, absolutely. I mean, they're very well insulated because you can't get that product anywhere else, you make sure you get it from them right. That is definitely the case. And you know, you would expect all of them to fair better, but I'm sure that for all of them, the most preferable outcome is, you know, sensible agreements are made and there is as much friction-free trade as possible with our European neighbors and international neighbors.

(17.07)

RLB: Absolutely. Well let's hope so. And so with those niche companies, why do you think some of the UK smaller companies in the UK, are the ones that can be able to shine?

SM: Well, the historic record for a start. I mean, if you look back over the last 65 years, there are some very serious studies going into this, and it just shows, continued outperformance for UK smaller companies. I think on a compounded basis the MSCI the bottom 10% by market cap of the index has returned about 17% on a compounded basis per annum, versus 11% for the All Share, you know, and over a 60 plus year period – that obviously translates as pretty huge total return outperformance, and you know, why do they outperform, they're small, they're nimble. They're able to react really quickly. Like we've seen over the last few months to very trying economic conditions or, you know, they can right size quickly, they can scale up quickly as well. You know, they're able to grow. It's the law of small numbers, if there is such a thing, it's far easier to double a workforce of a hundred people, or revenue of a hundred million than it is something far, far larger. And that, and that sort of a small and nimbleness just can continue.

You also have a lot more skin in the game as well. Management stakes within the businesses tend to be far higher further down the market cap scale, and that keeps everyone's eye on, well, I say the prize, but basically cash generation. And cash generation is the lifeblood of businesses and that keeps them ticking over. Well, I suppose for a fund manager like me at the smaller end of the market cap scale, it's a really drastically inefficient market as well, MIFID II has exacerbated that. So the inefficiency of the market is you know, when you compare the number of analysts looking at FTSE 100 companies to those looking at small cap companies, you can't really compare them. Because it might, it might be one or two, or maybe zero looking at a small company and it might be dozens looking at a large company. So you can't, in my opinion, take a different view on the meat and bones of a company up there (with the large companies). But at the small end of the scale, you absolutely can and the prices are often, like I say, very inefficient and wrong in the market. And that gives you just a great opportunity to pick up some, some hidden gems.

And, you know, as you've seen again, in the last few months with small companies, they're hit harder when the market sells off, you know volatility hates small companies and uncertainty does as well. And it hits them really hard, but they also recover faster as well. And in every major market sell off, we've seen since I've been a fund manager, since I've even been looking at the markets they've sold off harder, but they've always recovered harder as well. So it does provide really good opportunity and fairly clear entry points to get into small companies as well.

RLB: Anyway, Simon that was really interesting, I'm sure we've used a lot of your time. So thank you very much for, for giving that to us today.

SM: No problem at all, thank you very much.

RLB: Thank you, and if you'd like to find out more on the Elite Rated Unicorn UK Smaller Companies fund, please visit our website fundcalibre.com and if you'd like to hear more from FundCalibre's other Elite Rated managers, don't forget to subscribe to the Investing On The Go podcast for more content.