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[NTRODUCTION]

**Staci West (SW):** Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. This week we're discussing the current market dynamics and the outlook for UK smaller companies with David Stevenson, co-manager of the WS Amati UK Listed Smaller Companies fund. David, thank you joining me today. How are you?

**David Stevenson (DS):** Very well, thank you. Thanks for coming along to interview me.

[INTERVIEW]

**SW:** Of course. Well, I want to start by just setting the scene a little bit, so maybe give our listeners a little overview of what is the current market backdrop and how have UK companies fared of late.

**DS:** It's fair to say that the market for the asset class that I'm involved with, which is UK smaller companies, peaked in late 2021. That coincided with a period of hyperactivity during the early stages of Covid, interest rates were cut to boost economic activity, lots of companies were raising money.

Since then, it's fair to say that investor appetite has receded for the sorts of, I suppose, earlier stage risk and illiquidity with smaller companies. And that's caused outflows from small cap funds which has exerted further pressure on share prices and company valuations. So, it's been a tough time, really over the last two years, but the flip side of that is always about the opportunity that creates. And we see this as once in a very long time significant entry point for UK smaller company investing.

**SW:** And if interest rates fall, would this help UK smaller companies recover quickly, in your opinion?

**DS:** We've already seen some evidence of that. The relative performance of UK smaller companies has picked up since late 2023. And that coincided with - it wasn't just in the UK, it was equally globally - a cooling-off of inflation concerns and also a lowering of expectations about where interest rates might peak. And that was sufficient really from October of last year to drive a relative outperformance of UK smaller companies.

The way that smaller companies benefit from lower interest rates is effectively: it helps improve investor sentiment risk appetite, it helps boost domestic economic activity which is where UK smaller companies - their markets - tend to to be focused, and it offers cheaper funding - smaller companies do require funding to grow and lower interest rates helps that. So, all of those things through lower interest rates would help smaller companies.

**SW:** And so, bearing that in mind and the kind of discount that you mentioned as well in the market, does that make it an attractive time for investors to be looking at UK smaller companies?

**DS:** Yes, as I said earlier, we see this as a once in a very long time opportunity. UK smaller companies are at a material discount - 15% to UK larger companies - and the UK market as a whole is on a very significant, twice that discount or more to global equities. So you're being offered yeah, a very attractive entry point.

**SW:** And a growing feature in the UK market has been the increase of M&A activity and even share buybacks. So, I just want to touch on that for a little bit and maybe start with M&A activity. How prevalent has M&A activity been in the portfolio? Have your companies received takeover offers?

**DS:** We're seeing a definite acceleration of that activity. We've had three bids in the portfolio in the last two months, two were for IT/tech-related companies and one was for a building materials supplier. That added to activity that we've seen really over the last several years, so we're well into double digit number of bid approaches for holdings that we have in the portfolio. Those bid approaches have come from the full range of acquirers: we've seen domestic corporates acquire, we've seen overseas corporates acquire, we've seen domestic and international private equity provide bids. A good deal of that has come from the US where there's a currency benefit as well to the valuation of UK companies. And we see this activity carrying on.

Those are the main investors in the UK market at the moment. Domestic investors, institutions and private investors are the ones who are holding back and as they hold back, that vacuum has been filled by corporates and private equity. And in terms of private equity, the valuations they see for publicly-listed companies relative to what they might have to pay to invest in private companies is very attractive.

You mentioned share buybacks as well. We're also seeing significant activity from corporates themselves. It's a form of self-help for their share prices. Currently, nine of our top ten holdings in the portfolio are companies that have launched or are in the process of buying back significant material amounts of stock. We see this as wholly rational. If companies are finding that making acquisitions or investing in individual projects aren't offering the same returns as buying back their own stock, then we have no issue with that. It underpins the share price. If the share price drifts back, then the company is there to step in and acquire more stock so we see that as a positive feature really.

**SW:** You mentioned the domestic investor, so just quickly, what do you think it will take to get the UK domestic investor back into UK smaller companies?

**DS:** The data overall for fund flows is suggesting that, certainly for the first time in 2 years, domestic investors are buying more equity funds. They're moving on from the fixed income focus that they've had really for the last 2 years, as the interest rate cycle is turned. So they are buying and putting more money into equity funds. The problem at the moment is that is North American [equity] funds; they are not buying the UK market. That will come, we feel, and it probably comes from fear of missing out. If M&A activity, if share buyback activity carries on, then eventually we feel that the penny will drop that there are outstanding bargains on offer.

We're seeing some signs more recently that companies coming out with good news flow, good announcements in terms of trading or contract wins or whatever. we are seeing share prices pop up by 15 to 20%. That's different from the last two years where, for the most part, share prices didn't react to good news. The share prices reacted to bad news, but they didn't react particularly to good news. So that suggests to us that perhaps some of the selling pressure is now beginning to come off; there are fewer sellers now and indeed some marginal buyers of these companies on this sort of news flow, and it doesn't take very much really for that to cause a spike in share prices. And as that momentum continues, then we feel retail investors will hopefully return to the UK market. They certainly are seeing headlines every day about how cheap the UK market is, so hopefully the penny drops, as I say.

**SW:** And do you expect these UK smaller companies to continue to be targeted whilst they're so cheap?

**DS:** Yes. This activity out with domestic investors, we see no reason why that's going to stop, they see the bargains. It's up to the rest of us to join in really.

**SW:** And shifting slightly a bit more to your portfolio specifically, could you just give us a few examples of some companies that you have in the portfolio that you are just really excited about at the moment?

**DS:** Yeah, I've got a couple of examples, which are in our top ten. We invest right across the smaller companies universe from the top of mid-cap down to AIM.

One of our larger holdings is just moving up, has just moved up from the AIM market to the main list. So it's probably not very well known to mainstream investors, but it is a £900m market cap company, so quite significant. It's a business called Alpha Group [International plc]. The origins of the business were in foreign exchange and treasury management services, but it's diversified into banking services for alternative investment funds, primarily private equity funds, and it's seen significant growth in both those areas. And these are areas where mainstream banks are retreating from, so these are specialists, almost FinTech services that the larger banks don't do. Alpha Group is generating, we think, 20% compound growth over the medium-term from its financial services activities. Cash is 20% of market cap and the business generates high margins. So it ticks a lot of the boxes for what we look for in quality growth companies.

Second example would be probably better known to everybody, it's Trainline. Trainline is the national ticketing platform, which is dominant in the UK but is moving increasingly into Europe as those markets deregulate. The great thing for Trainline is that having invested heavily to create its UK platform, it doesn't have to do the same degree of investing in in Europe. So, the top line growth that it will enjoy as it penetrates those markets will flow straight down to the bottom line profitability.

Trainline is £1.5bn market cap so it's at the upper end of the size scale in our portfolio. It really recently announced very strong results. It's upped its year-on-year revenue growth forecast towards double digit. The shares had a bit of a wobble recently when Labour announced that it was going to nationalise train operators if and when it gets into power. But the key thing for us is that it announced also that it was not going to set up an alternative ticketing service. And the announcement of its policy came from Trainline's offices. So we see Trainline's growth not being particularly impaired if there's a change in government going forward. Again, it's a high margin business, so it ticks a lot of the boxes of what we look for.

**SW:** You mentioned that you can invest across the market cap for small and mid-cap. Have concerns over liquidity made you more wary of investing in that lower end of the small cap market and these early stage companies?

**DS:** Yes, quite simply in the environment that's existed for the last couple of years we're simply not getting the proper risk reward for taking that illiquidity risk at the lower end of our universe. This is a much more difficult environment for earlier-stage, smaller companies than we saw in the market peak. And for us, we feel that some of that may well be structural; markets do self-repair and risk appetite does increase and eventually trickle down, but in this instance, we think it may take longer to return this time. So we've managed down that exposure within the portfolio and reduced the number of holdings in that space.

**SW:** You hinted slightly earlier, but just to wrap up, do you remain optimistic about the rest of the year for UK markets and for your fund?

**DS:** Yeah, we feel we are closer to a turning point now than we have been for quite some time so we'll throw our hats in the air for that! Confidence measures are improving; both business and consumer indicators of economic activity, the so-called PMIs - the Purchasing Manager Index levels - are also improving. And the key thing is that the UK doesn't look too bad from that point of view. We actually currently have PMIs that are above the US and above the Eurozone. So sometimes it pays not to believe everything that you read in terms of the bleak headlines in the press.

As we've already discussed, we are seeing ongoing corporate and PE buying of UK companies, which tells you that that attractive valuation is very real, it's proven. So, I think you put all those things together and there is reason to be cheerful and optimistic. The missing piece is certainly buying from UK domestic investors; if we can get retail investors and pension funds allocating to UK companies again, then there's lots to go for.

**SW:** Well, on that note, hopefully everybody listening has had a change of heart towards the UK. David, thank you very much for joining me.

**DS:** Not a problem. Thank you.

**SW:** An unconstrained portfolio, seeking structural UK growth businesses that can grow faster than the economy, this fund is managed by a highly experienced team of small cap specialists. The portfolio of 65-70 companies focuses on structural growth businesses, which the managers' believe can add value in the under-researched small and mid-cap part of the market. To learn more about the WS Amati UK Listed Smaller Companies fund please visit fundcalibre.com