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UK Small Cap - Valuation v Liquidity

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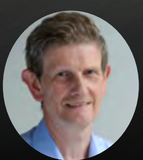

By
Scott McKenzie, Fund Manager

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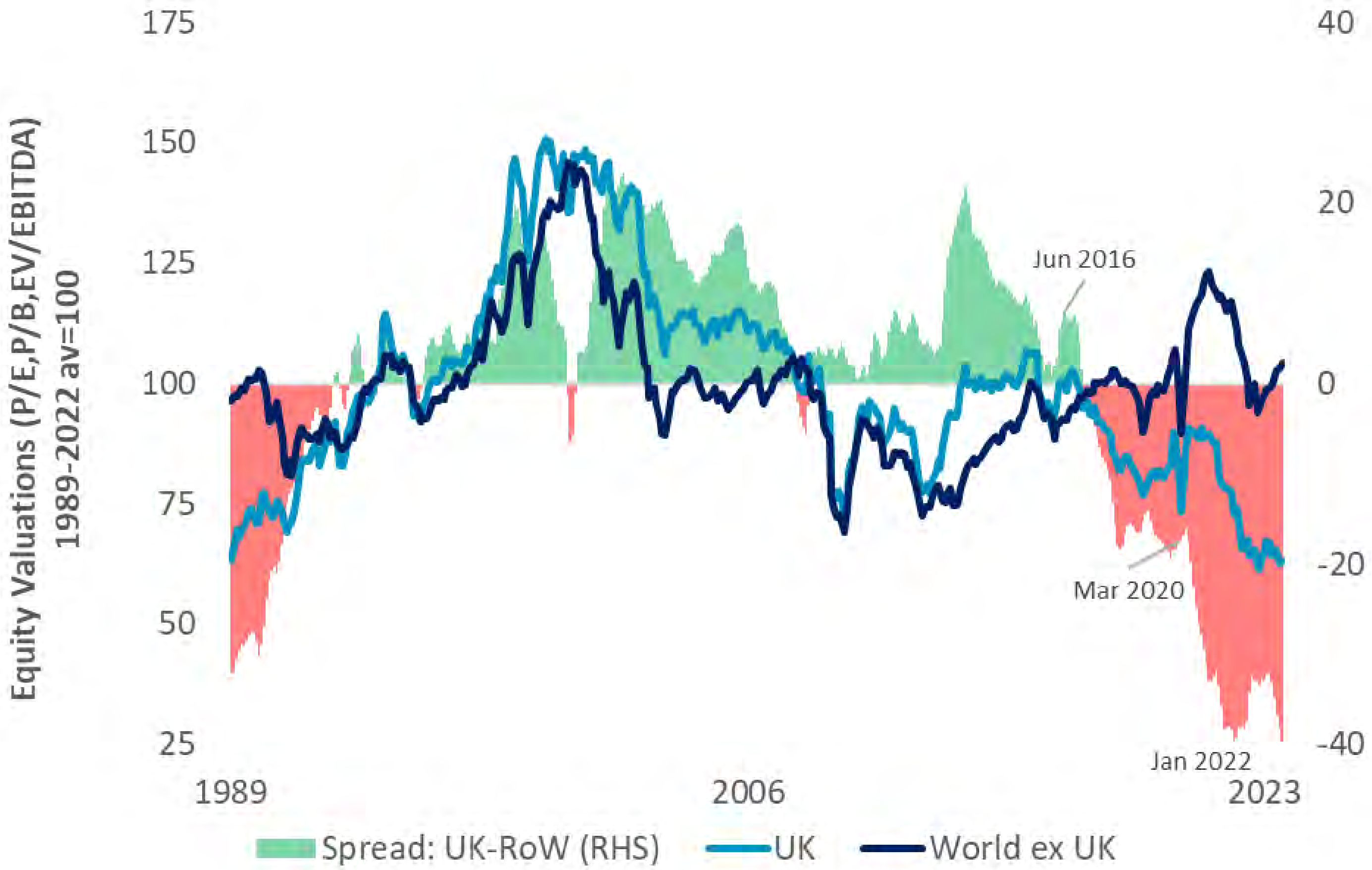
The UK equity market has been unloved for many years now and 2023 has seen a continuation of this trend. So far this year the FT Allshare index is broadly flat compared to a >15% return in the S&P500 and more than 10% from global equity markets overall. As the chart below shows we can track this trend back to the Brexit vote in 2016. Indeed for much of the preceding 10 years, UK shares traded on a valuation premium to the rest of the world (shown in green). Since 2016 the relative valuation has been in steep decline such that today UK shares trade on a 40% discount to other global markets (shown in red).



Source: Panmure Gordon, Refinitiv (at 31/07/23)

The key reasons for this decline are a combination of political, economic and index construction factors.

Politics – Brexit has significantly undermined confidence in the UK which has been exacerbated by chaotic government post COVID and no less than three prime ministers in the past year, albeit under Rishi Sunak a sense of stability and focus is being rebuilt.

Economics – the above factors have led to weakness in sterling, falling productivity, low levels of GDP growth and stubbornly high inflation. As a result interest rates and bond yields have risen faster in the UK than elsewhere.

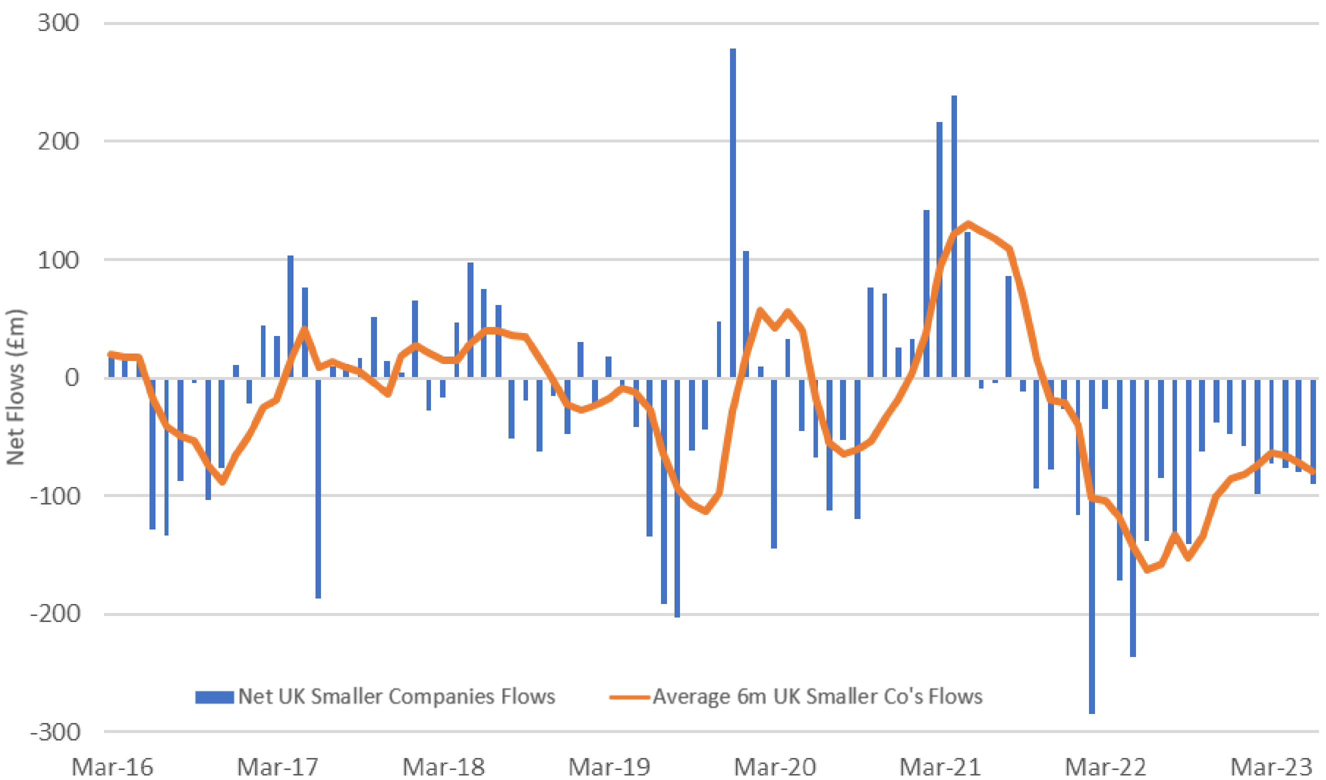
Index – the UK market (dominated by the FTSE100) has a far less dynamic composition than the US, with very low exposure to technology and high exposure to mature sectors such as banks, oils and mining. The attractions of London as a listing venue have diminished post Brexit and low valuations have encouraged growing companies to list elsewhere or remain private.

All of the above factors have led to a rapidly depleting pool of liquidity and we have seen significant redemptions in UK equity funds, both at a retail and pension fund level, such that the UK is now less than 5% of the MSCI World index, having been more than 20% at its peak.

Poor returns and weak liquidity have meant that smaller companies have borne the brunt of the derating of UK companies. The chart below shows the price-earnings ratios of UK companies by market capitalisation. The further down the capitalisation scale we go the lower the valuation. This has left UK smaller companies (especially those below £250m) friendless, with limited new investor appetite.

Source: Panmure Gordon, Refinitiv (at 31/07/23)

This has been exacerbated by redemptions from IA UK Smaller Companies Funds, which have escalated rapidly over the past 18 months, putting further downward pressure on share prices, as shown below.



Source: Panmure Gordon, Refinitiv (at 31/07/23)

Where do we go from here?

Most market analysts would acknowledge that UK smaller companies are now an exceptionally cheap, if unloved, asset class. There are considerable challenges in re-establishing the UK market as an attractive place for companies to list and raise capital, but we do detect a greater commitment from the Chancellor, the FCA and others to address these increasingly urgent problems. These combined could provide some powerful catalysts to incentivise investment in UK listed companies in the years ahead.

From a macro perspective a clear peak in UK interest rates and gilt yields, as well as moderating inflation, could all have a strongly positive impact on current valuations. This would hopefully signal a bottom in earnings expectations which can then propel markets forward. Given the current illiquidity in smallcap, the recovery when it comes could be rapid.

We believe that the biggest challenge for UK small and midcap markets is therefore not one of valuation but one of liquidity, and there is an increasing need to attract a broader investor base to the asset class. At Amati we continue to focus on businesses with conservative balance sheets, sustainable margins and strong cash generation, and currently there are plenty such companies available at highly attractive prices. If investors don't take the opportunities now available in the UK markets, then private equity and trade buyers will continue to do so instead and listed UK businesses will be acquired at bargain prices.

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Smaller Companies - Investment in smaller companies can be higher risk than investment in well established blue chip companies. Funds investing significantly in smaller companies can be subject to more volatility due to the limited marketability of the underlying asset.

Please ensure you read the Risk Warnings above. Before making an investment, you should ensure that you have read and understood the relevant Key Investor Information Document, available from Smaller Companies Fund Literature.

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