TB Whitman UK Small Cap Growth Fund (the "Fund")

Quarterly Investment Report – Q1 2023

The Fund ended the quarter with the NAV (B class) at 95.71 (31 March 2023). This gave a return on the Fund for the first quarter of 2023 of -5.2%[1]. Our benchmark, The Numis Smaller Companies + AIM excluding Investment Companies Total Return Index (NSC plus AIM), returned -0.6%[2] over the same period. The IA UK Smaller Companies Sector (the average of the UK smaller companies open ended funds) returned -2.9%[3] over the quarter.

Since inception on 9 December 2020, the Fund has returned -4.3%[1] versus -2.0%[2] for our relative benchmark (NSC plus AIM) and -6.4%[3] for our comparative benchmark, the IA UK Smaller Companies Sector.

Economic and market commentary

2023 started with a new sense of investor optimism, buoyed by better than expected consumer and business spending data and a sense that central banks were pursuing a less aggressive rate hiking path. Talks of a 'soft landing' resumed as western economies proved far more resilient than most economists had expected.

In early March, the mood turned sour when Silicon Valley Bank became insolvent. Poor management had led to a deposit base that was heavily invested in interest rate sensitive US Treasuries, and when news broke that the balance sheet was facing meaningful write-downs on its investment portfolio, depositors requested withdrawals at a pace so fast that US regulators were forced to shut the bank down. Many of us remember the demise of Northern Rock in 2007 with depositors queuing outside cash machines and bank branches to withdraw cash. In contrast, today's social media facilitates the instant spread of news and digital banking enables instant payments. The rapid demise of Silicon Valley Bank was a stark reminder of the importance of confidence in underpinning today's normal banking activities. Fears of contagion led to the collapse of First State Bank and the takeover of Credit Suisse. Whilst we expect further volatility in the financial sector it is worth reminding investors, the Fund has no direct exposure to the banking industry and we expect the current issues to be idiosyncratic, rather than systematic.

Regulators have been quick to try to re-instate confidence in banks and there is no question that banks are much better capitalised than they were in 2008. That said, any bank is insolvent if all its depositors request their cash at the same time.

The demise of Silicon Valley Bank is typical of a late stage tightening cycle that is seeking to curtail credit growth and inflation. The US Federal Reserve has raised base rates from 0.25%[4] at the start of 2022 to 4.75%[4] and the implications of such a rapid increase in the cost of debt is

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now starting to show with some real economic pain. The effects of this on the banking sector is likely to be an acceleration in debt contraction which will help slow the economy, as banks become much more conservative in the loans they write. Expectations for additional rate rises in the US have fallen materially with the market now pricing in rate cuts by the year end.

In the UK, the Monetary Policy Committee (MPC) confirmed in their March report that although inflation currently remains elevated it is expected to fall significantly in Q2 2023. This lower than expected inflation is largely due to the near-term news in the Spring Budget on the extension of Energy Price Guarantee, alongside falls in wholesale energy prices. As a result, analysts expect the peak in interest rates could be imminent with a further 25 basis point increase to 4.5%[5] expected in the summer. GDP in the first quarter is expected to be broadly flat and the MPC are projecting GDP to increase slightly in the second quarter. This is quite a reversal from last November when the Bank of England forecast the longest recession in over hundred years.

Whether the UK suffers from a recession or not is difficult to call. We do, however, believe that the valuation contraction experienced over the last 18 months is coming towards its end with interest rates nearing the top. Investor focus should then shift to company fundamentals, earnings and the extent to which they can show resilience and indeed grow.

The majority of the underlying holdings in the portfolio continue to deliver strong growth in profitability, with 20%[1] earnings per share (EPS) growth in 2022 and a further 14%[1] EPS growth projected in 2023, with strong revenue growth offsetting significant wage, energy and raw material price increases. This is compared to the wider UK equity market, with the FTSE 100 and FTSE Mid 250 forecast to grow earnings in 2023 by -3.9%[6] and -4.1%[6] respectively. Our focus on structural growth companies with a long run-way for growth, operating with a high degree of recurring or non-discretionary revenue, gives us confidence that the portfolio will continue to deliver attractive levels of earnings growth.

Fund Composition and Quarterly Activity

Over the quarter we marginally increased our cash weighting from 11.7% to 12.4%. We continue to be selective in adding any positions to the portfolio as the risk to earnings disappointments is increasingly elevated in certain areas. We exited from a few positions to make place for a few new stocks, ensuring the Fund is constantly reflective of our best ideas. Sales included **Next Fifteen Communications**, **Aquis Exchange** and **Water Intelligence**.

New positions included **IQGeo Group**, **Foresight Group**, **Niox Group** and **XPS Pensions Group.** We continue to increase exposure to companies operating in long-term secular growth markets whose earnings are not going to be challenged by a recession or a considerably weaker consumer environment in 2023.

Investment Examples

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Niox Group (£195m market cap, 1.0% NAV) is a medical device company focused on asthma diagnostics. The company was called Circassia until September 2022 and had a range of products focused on respiratory diseases. Through considerable mismanagement the company ended up with multiple products, a large inefficient direct global sales force, and a high annual R&D bill. In 2019 Circassia reported a £119m EBITDA loss from £62.4m[7] in revenue and was approaching insolvency. A new management team went about product rationalisation, selling off non-core products and focusing exclusively on the asthma product. NIOX VERO is a market leading device which tests for the measurement of FeNO, a biomarker of inflammatory asthma. Research shows that a diagnosis of asthma is much more likely when testing for FeNo. VERO is increasingly recognised by healthcare professionals as an important tool to improve the diagnosis and management of asthma. The system comprises a small portable device and a range of consumables including sensors, individual disposable mouthpieces and breathing handles. The device is sold as a one of sale, with 17k[7] sold worldwide, and individual tests are sold on a one-use disposable basis. Consequently, 90%[7] of the revenues are repeatable from sales of consumables used for routine testing. With management switching to a distributor sales model and significantly reducing the R&D spend, NIOX just reported £31.3m[7] of revenue, £7.3m[7] in Adj EBITDA (i.e., a 23% margin) and £19.4m[7] in net cash. The business is now highly profitable and there is considerable scope for ongoing organic growth through penetrating the primary care market where product awareness is currently low. The shares trade on a free cash flow yield of 4%[7] which we think can grow to 6%[7] over the next two years, with 2025 net cash growing to £50m[7] (i.e., 25% of the current market capitalisation).

Foresight Group (£440m market cap, 1.0% NAV) is an alternative investment manager specilaising in renewable energy infrastructure. Foresight has c£12.2bn[8] in assets under management, up from £2.6bn[8] in 2018, delivering a 37%[8] 5-year compound annual growth rate in assets under management. This growth rate has been achieved through both strong levels of organic growth and select acquisitions. The company is run by its founder Bernard Fairman, who founded Foresight some 30 years ago and still retains a 30%[8] equity holding. He has built a strong brand within the renewable energy and infrastructure asset management space with strong distribution capabilities and a proven ability to grow organically and through select M&A. The attraction to Foresight as an investment is that it is well positioned to continue to benefit from the drive towards a greener society, with governments and investors alike increasingly looking to allocate capital towards sources of renewable energy. Foresight typically invests in renewable energy assets (e.g., wind or solar farms) and sells the generated electricity back to the grid for a pre-determined price, providing a steady income stream for investors. 85% of Foresight's asset base is held in closed-ended structures which provides a high level of repeat revenue from management fees on those assets. 68%[8] of the asset base is institutional and 32%[8] is retail, with institutional investors spread across Europe, Australia, and the UK. There is inherent operational leverage within the business model, with operating EBITDA margins >40% and rising still. With 60%[8] of earnings paid out in dividends, the shares currently yield 6.2%[8] and

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trade on a p/e multiple of 9.8x for the year ending March 2024[8]. We see plenty of opportunity to double earnings per share over the next four years.

Outlook

Looking ahead there are growing signs that inflation, both in the UK and across major economic regions, may have peaked and the debate has shifted to how rapidly it will fall. A slower rate of interest rate hikes should help equities and any rate cut will be positive for growth equities.

We remain confident that the Fund is invested in well-managed high quality growth companies that fit our strict investment criteria. The Fund has suffered over the last 18 months from the considerable de-rating in growth equities, and it is worth noting that the average p/e on the fund holdings is now 18.5x[1], down from a peak of 30.0x[1]. Fundamentals remain strong for our holdings and as investor focus shifts back to earnings we are confident they will deliver attractive returns to investors.

Christopher Pease
Joshua Northrop, CFA

13th April 2023

Sources:
[1] TB Whitman UK Small Cap Growth Fund 31 March 2023
[2] Numis Indices & Trustnet 31 March 2023
[3] FE fundinfo
[4] Federal Reserve Funds Rate
[5] Bank of England
[6] Peel Hunt UK Market Valuations 20 February 2023
[7] Circassia/Niox Announcements & Broker Forecasts
[8] Foresight Announcements & Broker Forecasts

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Investment Process

Our investment process is focussed on identifying companies that have strong earnings growth potential with a high degree of predictability, with market capitalisations of between £50m and £2.0bn. Once we have identified a company that has strong earnings growth potential with a high degree of predictability, we look to identify three key company characteristics. These characteristics form our investment criteria which each growth company must meet and are as follows:

1. *Exceptional management with meaningful equity shareholdings*
2. *Strong and sustainable competitive advantage*
3. *Predictable and strong cash generation*

Growth companies that possess all three of these characteristics can re-invest self-generated cash at a high level of return, generating more cash which can be re-invested. It is this virtuous cycle that delivers the most consistent and attractive growth in earnings.

Risk Warning

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