Quarterly Commentary
Q3 2024

CRUX
ASSET MANAGEMENT

Fund Manager: Richard Penny

This is a Marketing Communication

TM CRUX UK Smaller Companies Fund

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Market Conditions

The third quarter ended with reasonable returns across global markets, despite several bouts of volatility. Concerns that economic data was pointing to a weakening US economy, a surprise interest rate hike from the Bank of Japan leading to a rapid unwinding of the now infamous 'Yen carry trade' and thin summer liquidity all contributed to equities selling off quite significantly at the beginning of August. As these concerns eased and major central banks commenced the rate cutting cycle, markets finished the quarter strongly.

In the UK, small-caps underperformed amidst overly gloomy rhetoric from Rachel Reeves in the lead up to the October budget. Mid-caps outperformed as sentiment towards cyclical stocks improved following the first interest rate cut from the Bank of England. Having recognised that disorderly communications are self-defeating, Reeves' has sought to recalibrate the overly negative messaging and is now outlining plans for higher levels of public spending through more permissive fiscal rules. Although economic growth remains modest, H1 performance leaves the UK tied for the top spot amongst the G7, whilst valuations remain low versus Europe and the US.

There were 11 meaningful M&A bids in Q3, taking the total to 40 for the year as a whole, with a total value of c.£47bn. The average premium so far this year has been c.40% with some bids exceeding a 100% premium. Last year, the majority (c.56%) of offers were from financial buyers such as Private Equity, whereas corporate buyers (c.68%) have dominated so far this year as the rate environment and economic outlook have become clearer, demonstrating the value of UK companies. Over half of bids have come from overseas buyers, further illustrating the relative value compared to global markets.

We believe that UK small-caps should benefit from an economic recovery and falling UK interest rates which should lead to a positive backdrop of attractive valuations and momentum and a reversal of the outperformance of large-cap defensives experienced over the past 2-3 years.

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Fund Performance

The TM CRUX UK Smaller Companies Fund (I Accumulation GBP) returned -3.4% against its performance comparator the IA UK Smaller Companies Sector return of -0.1% over the quarter. Thin summer liquidity and uncertainty ahead of the October budget contributed to a weaker quarter for small-caps with the FTSE AIM down c.3% over the quarter.

At a stock level, Zegona Communications was the largest contributor to performance during the quarter, up c.38% and contributing c.1.7% to Fund performance. The Fund participated in an equity raise that enabled Zegona to acquire Vodafone Spain in November 2023 at 150p and the shares ended the quarter at c.364p. During the quarter Zegona announced two separate agreements to monetise Vodafone Spain's fixed network infrastructure. The deals will be opened to external financial investors which will allow Zegona to extract upfront cash while still retaining equity stakes to participate in any future value uplift. Although subject to regulatory approval, we believe the market is materially underappreciating the potential value creation from these deals. Separately, the impressive Zegona management team are embarking on a transformation plan to improve the underlying Vodafone Spain business and have a strong track record of creating significant value for investors. Despite the strong share price performance so far, we believe there is significantly more to come.

Beeks Financial Cloud Group was another strong performer during the quarter, up c.48% and contributing c.1.3% to Fund performance. The shares moved higher following a strong trading update in July which pointed to c.30% organic growth in H2, representing an acceleration from the first half, and a higher cash balance than expected. During August, the company also announced that the contract secured with one of the largest exchange groups globally had now received regulatory approval. The company also noted that the new business pipeline continues to build, with advanced discussions taking place with other major Exchanges across the globe.

IQE was the largest detractor from performance during the quarter, down c.46% and detracting c.1.8% from Fund performance. The interim trading update saw revenue expectations lowered to the bottom end of the range previously guided by management, as some markets remain in recovery. Cashflow was quite weak during the period as they built up inventory however this should, in our view, unwind somewhat in the second half. The potential Taiwan IPO, potential CHIPS act funding and ongoing market recovery should all help the balance sheet over the short-term. IQE has under-utilised capacity with a primarily fixed cost base, meaning that as underlying markets recover and revenues grow, profitability should improve quickly.

Surface Transforms was another poor performer during the quarter, down c.72% and detracting c.1.4% from Fund performance. The Fund participated in a fundraise at 1p in May 2024 to provide the company with capital to resolve operational issues experienced whilst scaling up manufacturing capabilities. A pre-close trading update in July outlined operational improvements and management reaffirmed guidance for the financial year. The shares advanced significantly, and we took the opportunity to take some profits above the 2p level. At the end of September, management released a trading update including a significant cut to full-year expectations and a weakened cash position. We made the decision to exit the position entirely. Although the impact on performance during the quarter is of course disappointing, trimming the position whilst shares were above the 2p level meant that the round-trip experience of the Fund was broadly break-even.

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Transactions

Capita was added to the portfolio during the quarter. With the sale of Capita One realising cash proceeds of more than £200m, Capita's funding needs for the immediate future appear to have been resolved. New management is seeking to make the company more efficient, implementing change largely around digitisation and removing the too many manual processes across the business. Management have already taken decisive action in cutting costs with more to come in 2025. Capita is now focusing on working with technology hyperscalers, which will allow the group to minimise its capex yet improve efficiencies and widen the groups offering and quality, improving customer experience. We see scope for margin improvement starting from a low valuation.

Surface Transforms was exited entirely as outlined above as operational issues continue and the company is likely in need of further funding. EDX Medical, Cyanconnode, Finseta and Lifesafe Holdings were also sold to focus the portfolio on our favoured holdings.

Outlook

The recent gloomy narrative surrounding the UK economy is, we believe, at odds with the prevailing economic backdrop. Private sector balance sheets are healthy, labour markets are strong, and UK economic growth in the first half of the year was the strongest in the G7. Reacting to the improving economic situation, consumer and business expectations are recovering and inflation appears to be under control, leaving the door open to further interest rate cuts.

Simultaneously, UK companies are trading at discounts relative to global peers and from what we have seen M&A activity has shown no signs of abating. An average premium of c.40% and buyers dominated by overseas and corporate entities is illustrative of value and improving economic conditions.

We believe that UK small-caps should benefit significantly from an economic recovery and falling UK interest rates which should lead to a positive backdrop of attractive valuations and momentum and a reversal of the outperformance of large-cap defensives experienced over the past 2-3 years. The underperformance of small vs large-caps over this period is twice as bad as that experienced during the Global Financial Crisis and therefore the recovery opportunity is significant.

Fund's managed by Richard Penny have historically outperformed during economic recoveries with the L&G UK Alpha Trust returning c.173% trough to peak following the Global Financial Crisis in 2008/2009, outperforming the IA UK All Companies Sector by c.88% and the TM CRUX UK Special Situations Fund returning c.151% trough to peak following the COVID19 pandemic, outperforming the IA UK All Companies Sector by c.75%, with a significant portion of performance coming from small-caps. We believe the potential of this dedicated Smaller Companies Fund is potentially significant.

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