A rising tide does not lift all small cap boats

24th February 2020

2018 was an obvious turning point for investor appetite toward the stock market, notably small caps. Indeed, the past eighteen months have dealt a choppy, and often uncomfortable, ride for investors and corporates alike. Much has changed in the small cap arena; not least, the unintended consequences of MiFID II percolating through the system, but also how key political and economic events have played out. In addition, other more discrete trends have also gathered momentum (climate change, for example).

Our latest ***Radnor View*** examines the evolving dynamic between small cap corporates and their institutional investor base. We specifically examine how **fund flows, valuations** and **liquidity** are intrinsically linked and how a **clear understanding** of this dynamic can help contribute to a much more efficient equity strategy.

Recap – Recent stock market events

Share prices have been volatile since mid-2018. Exhibit A shows this graphically, charting four important but diverse small cap sectors and their 12-month forward PE Ratios over the past two years. Our commentary below provides a high-level recap of key events, which tally with the graph:

1. **January 2018 - MiFID II Implementation** – Truth be told, the first six months of the new MiFID II world were largely uneventful, from both a valuation and liquidity perspective (see *'Mind the Gap'* ***Radnor View*** Dec 2019 here). Nevertheless, implementation of this new framework was undoubtedly shaping the platform for future events;

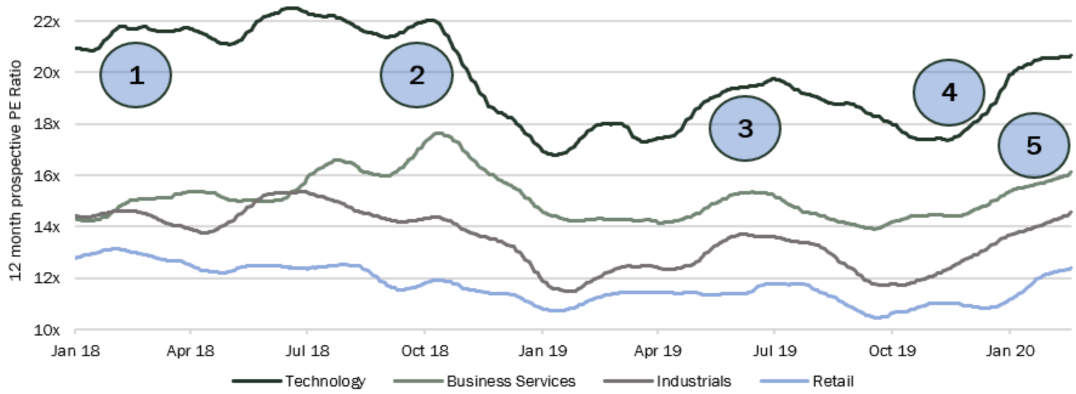
2. **October 2018 - Market Sell-off** - Whilst there was no specific catalyst to this sharp 'market correction', many would argue this was a culmination of several issues across the Atlantic; trade wars (US and China), US interest rate rises and a general flight from the FANGs. Most UK sectors suffered as a result and, unsurprisingly, the Technology sector was impacted most;

3. **June 2019 - Woodford scandal** – The suspension of Neil Woodford's flagship fund brought the increasingly sensitive topic of liquidity to the surface. Small caps felt this most and remain under heightened scrutiny;

4. **December 2019 - UK General Election** - A slow and painful build up, from late summer 2019 to a pivotal general election (officially confirmed in late October), saw markets struggle to hold any momentum through to its mid-December conclusion;

5. **January 2020 - Relief Rally** – Oxymoronically, a much clearer trajectory into the Brexit unknown has been reflected in a re-rating across the board. Retail remains the laggard, while Technology is re-approaching previous highs. Industrials have enjoyed a healthy initial rally, albeit recent warnings suggesting a difficult outlook, particularly from a Chinese supply chain shock from the Coronavirus.

Exhibit A – Small cap sector valuations



Source: Factset, Radnor Capital Partners.
Note: 12-month forward PE Ratio; Rolling 30-day average; includes only profitable small cap and AIM companies over £40m market cap; non-market cap weighted; excludes material outliers. Comprises 139 stocks in total.

Small cap fund flows have played a critical role

Prospective **valuations** are a useful indicator of confidence and **momentum.** Nevertheless, this only tells part of the story. **Fund flows** (measured by net subscriptions/redemptions at open-ended funds) provide a critical insight into institutional portfolio managers' **ability** to invest. It is also worth clarifying that open-ended funds contribute approximately two thirds of the c.£23bn of funds dedicated to small caps.

Naturally, there is a finite pool of institutional capital that can be deployed into small cap names: at times of net subscriptions, more is available to both top-up existing positions and explore new ones; redemptions sees a reverse of this trend, often resulting in the requirement to trim more liquid holdings to satisfy cash demands from clients, thus placing downward pressure on share prices.

Exhibit B below represents net subscriptions/redemptions within the mainstream small cap unit trust space over the past two years. A 'down month' represents net redemptions, while an 'up month' equates to net subscriptions.

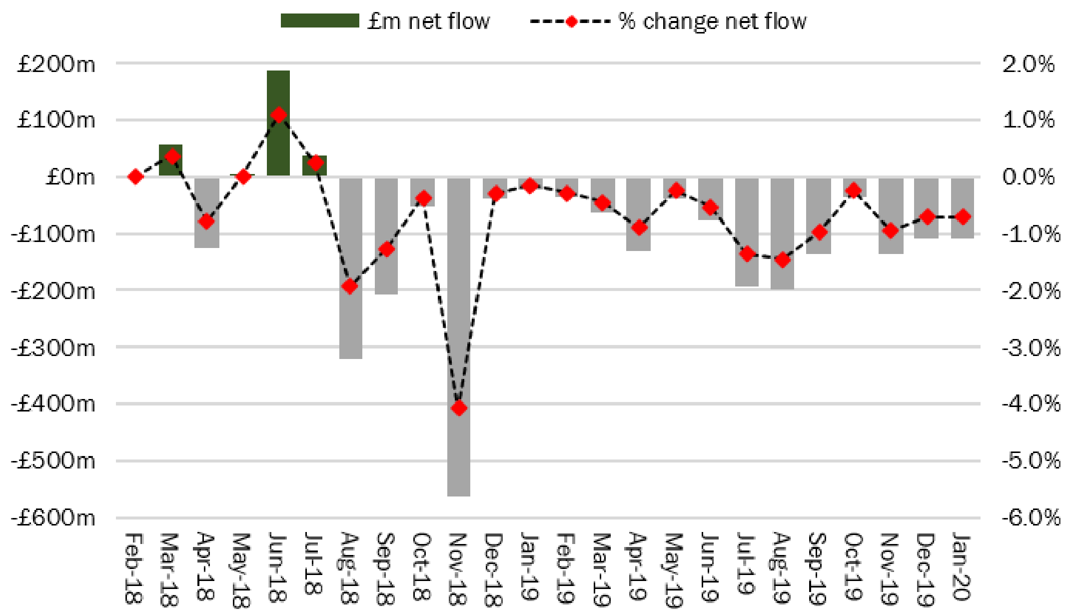
Comparing Exhibit B (below) and Exhibit A (above) yields some interesting correlations:

- Increases in **net redemptions precede market selloffs** by around 2 months – observe July 2018 and July 2019;

- This suggests that **pressure on fund manager liquidity** is likely a contributing factor to declines in valuations. Due to a more limited pool of capital from smaller company dedicated funds, this dynamic is far more prevalent among small caps (versus mid/large caps);

- The general trend since mid-2019 (within small caps) has been one of **falling monthly redemptions**, thus supporting the market re-rating. Conversations with the buyside suggest this is set to continue over the short term as confidence tentatively returns.

Exhibit B – Monthly Small Cap Unit Trust net fund flows



Source: Factset, Radnor Capital Partners.

Further to the above, **Exhibit C** below shows the collective AUM of all mainstream UK Small Cap unit trusts. In spite of the significant redemptions of late-2018, and continued outflows since, headline AUM has nonetheless grown since January 2019.

What does this mean?

- Share price performance of holdings **has more than compensated** for redemption requests;

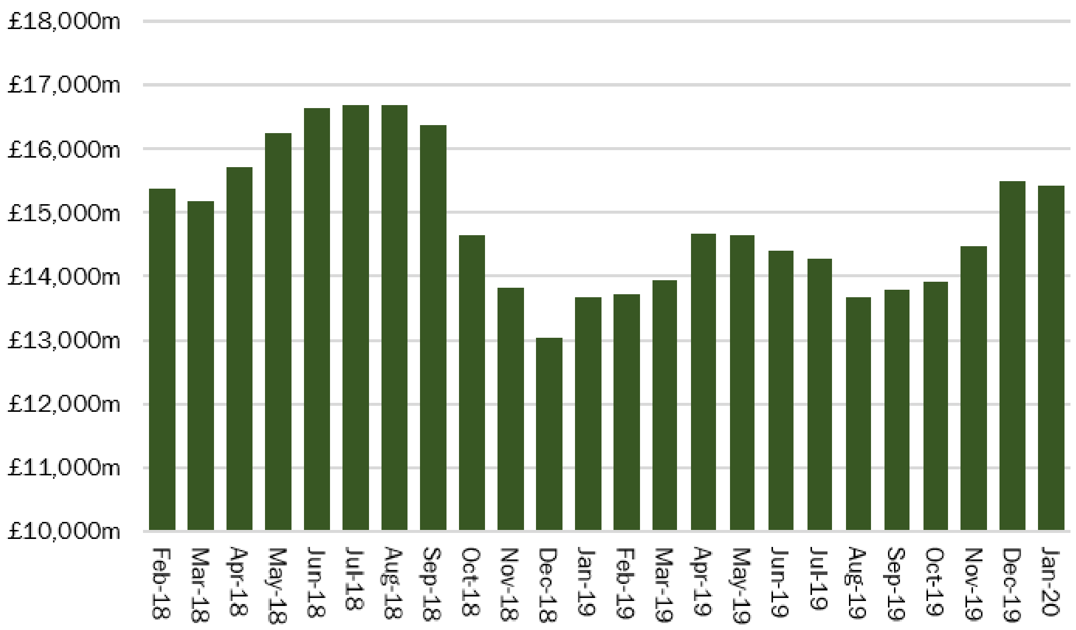
- Fund managers are likely to have liquidated or trimmed **'easier to sell'** holdings to satisfy redemptions;

- Portfolios may now comprise **'harder to sell'** holdings, or those where the fund manager has 'higher conviction';

- Until sector inflows become more pronounced, fund managers **will have to sell to buy.** This means they are likely to remain more discriminating when considering portfolio activity;

- This is **not the case for all funds.** Despite headline outflows, of the 43 unit trusts we monitor, 7 have experienced net inflows in past year. Naturally, this means no obligation to sell existing holdings in order to buy new.

Exhibit C – Total UK Small Cap Unit Trust AUM, £m



Source: Factset, Radnor Capital Partners.

A busy start to 2020

As widely anticipated, there has already **been a substantial increase in the number of primary and secondary fundraises so far in 2020.** Companies are inevitably eager to strike while the iron is hot, raising money amid improved market conditions post-election. Examples include:

- **IPOs** – Possibly the best indicator of renewed confidence in stock markets, new issues are back in the spotlight following a largely quiet 2019, and an especially quiet second half;

- Successful IPOs include: **Nippon Active Value** (Japanese Small Cap Investment Trust; raised £103m); **Inspecs** (Eyewear; raised £94m); and **FRP Advisory** (Restructuring advisory; raised £80m);

- Intentions filed include: **Ninety One** (formerly known as Investec Asset Management; £189m target raise); **Calisen** (Infrastructure assets; £300m target raise), **Cabot Square Alternatives** (Closed-end investment company, infrastructure and property alternative assets; target raise £200m);

- **Property** - Following the quietest quarter (Q4/2019) since Q3/2013, and a largely uneventful January, in the last week alone four property companies have either tapped the market or declared their intention to do so. This represents a combined c.£300m of fresh capital. Our *'Property Insights'* ***Radnor View*** outlined the landscape and Radnor's outlook in January 2020, here.

Concluding thoughts

A rising tide in the stock market does not necessarily raise all small cap boats. Valuations may be improving and fund managers anecdotally expressing more **comfort in the outlook**. However, investment decision-making incorporates many subtle considerations. The resumption in new issues and increase in secondary offerings brings **increased competition** for fund manager attention and capital. Smaller companies therefore need to remain cognisant of their **capital markets goals** and **strategic messaging**, including:

- A **proactive** approach to Investor Relations;
- A differentiated and **articulate** equity story is paramount;
- Targeting the most **relevant** pools of capital, based on its sector, size, financials, etc. This is a continuous process;
- Remember, there is **an investor for every story**, and the small cap world does not end with the mainstream unit/investment trusts. A well-constructed share register should strike the correct **balance** between supportive long-term holders and marginal buyers/ liquidity providers.

For inquiries please contact:

William Game
Associate Director, Radnor Capital Partners
+44 (0) 203 897 1834

Mike van Dulken
Senior Associate, Radnor Capital Partners
+44 (0) 203 897 1831

ENDS.