River and Mercantile UK Micro Cap Investment Company Limited

Quarterly commentary to 31 December 2023

RIVER GLOBAL INVESTORS

Executive Summary

- UK economy outperformed expectations for 2023 given resilient consumer and falling gas prices. Lead indicators ahead of other developed economies.
- UK equity valuations at record lows with smaller companies trading close to record discounts to larger companies.
- Sentiment remains depressed despite busy quarter for M&A, improving real wages and consumer confidence and a further fall in gas prices.
- Quarterly fund performance of 1.1%, underperforming Numis Smaller Companies + AIM benchmark by 5.7%. Twelve-month performance of 0.1%, underperformed benchmark by 3.1%.
- Two further positions – City Pubs and Shanta Gold – bid for in the quarter. 4 positions which represented 12.5% of NAV at the start of the year were bid for in 2023.
- New position initiated in Windward, an early-stage enterprise software business providing AI enabled maritime insights to government and commercial customers.

Market Backdrop

Consensus expectations – outside of the BoE whose forecasts proved even less accurate – were for the UK economy to contract by 0.8% in 2023. The latest expectations are for 0.5% growth. In fact, UK real GDP growth has beaten expectations on a quarterly basis since the second quarter of 2022. Resilient consumer spending and a rapid reversal in natural gas prices were key to the improvement in growth in 2023.

Despite this, for 2023, the UK equity market was the second worst performing major index after China and UK Smaller Companies underperformed the UK market for another year. Globally, JP Morgan report that 2022 and 2023 were the worst two years of outflows for small and mid cap funds in the last 15 years. The same is certainly true for the UK which saw outflows in every month from August 2021 to October 2023. Data from Numis shows that the AuM of the entire open-ended smaller companies sector has declined from £19Bn at the end of 2021 to £9.2Bn at the end of October 2023. Crucially, we have seen the largest inflow into smaller companies in more than three years in November.

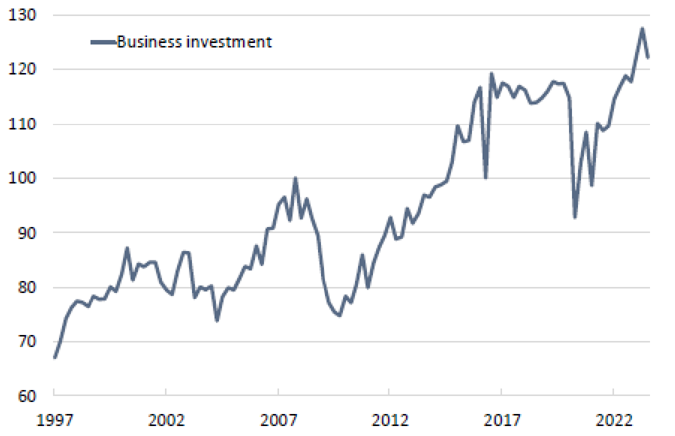
After 20 months of continuous contraction, real wage growth turned positive in July and we expect it to remain positive in 2024. Consumer spending will be supported by real increases in the National Living Wage, state pensions and working age benefits. Consumer resilience was supported by the spending of excess money balances although it is worth cautioning that whilst nominal deposits remain elevated, deposits relative to household income have now normalised[1] in the UK so we would be unlikely to see the same level of resilience were real wages to fall or unemployment to spike.

[1] *BoE Monetary Policy Report November 2023*

Challenges to the UK investment opportunity range from the UK having a unique inflation problem, a lack of business investment holding back productivity and growth and 'being too small to care about' in a global context.

On inflation, the lagged impact of energy on UK inflation is now working in our favour. The UK is now seeing the highest level of deflation in energy among its economic benchmark[2] and whilst CPI remains well above target at an annual rate of 5.1%, the 3-month and 6-month annualised rates which are less impacted by base effects are 1.4% and 2.8% respectively. Falling gas producer and commodity prices point to further falls in inflation in early 2024. The data supports the case that UK inflation has re-coupled with global inflation trends.

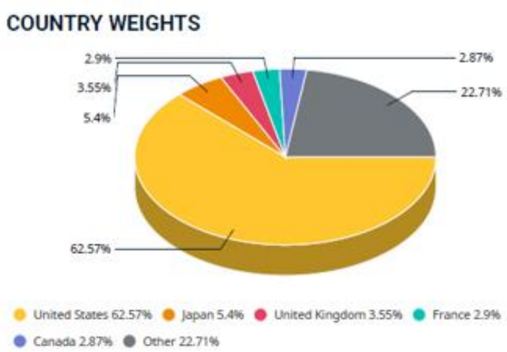
Data for real business investment has responded positively to declining uncertainty and is broadly back to the pre-Brexit trend.



In real terms. Index, 100 = Q4 2007. Quarterly data. Source: ONS

Source: Berenberg Economics. Global Outlook: the rocky road to recovery. 5 January 2023.

The final point – one we have been challenged on a lot in the last few months – is the de-equitisation of the UK market and the structural concerns which always appear more acute at the bottom of the cycle. The data below shows that both Apple and Microsoft are now larger constituents in the MSCI All Country World Index than the UK. Recent data from Goldman Sachs showed that US hedge fund positioning in US mega cap stocks is back to record highs – the definition of a 'crowded trade'.



TOP 10 CONSTITUENTS

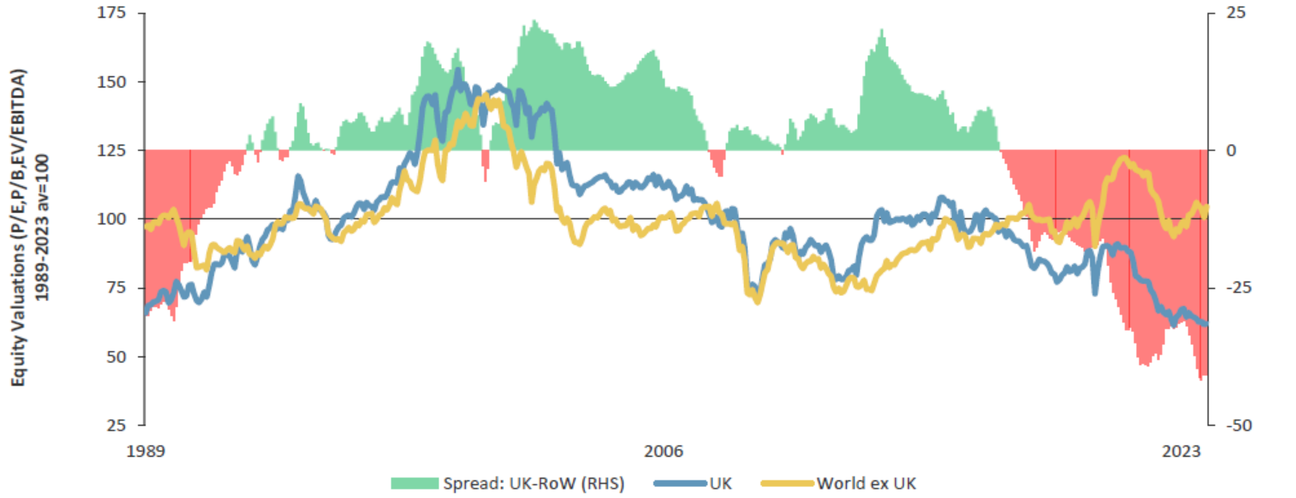
	Index Wt. (%)
APPLE	4.47
MICROSOFT CORP	3.95
AMAZON.COM	2.10
NVIDIA	1.82
ALPHABET A	1.23
META PLATFORMS A	1.17
ALPHABET C	1.09
TESLA	1.06
BROADCOM	0.74
JPMORGAN CHASE & CO	0.73
Total	18.36

Source: MSCI. December 2023.

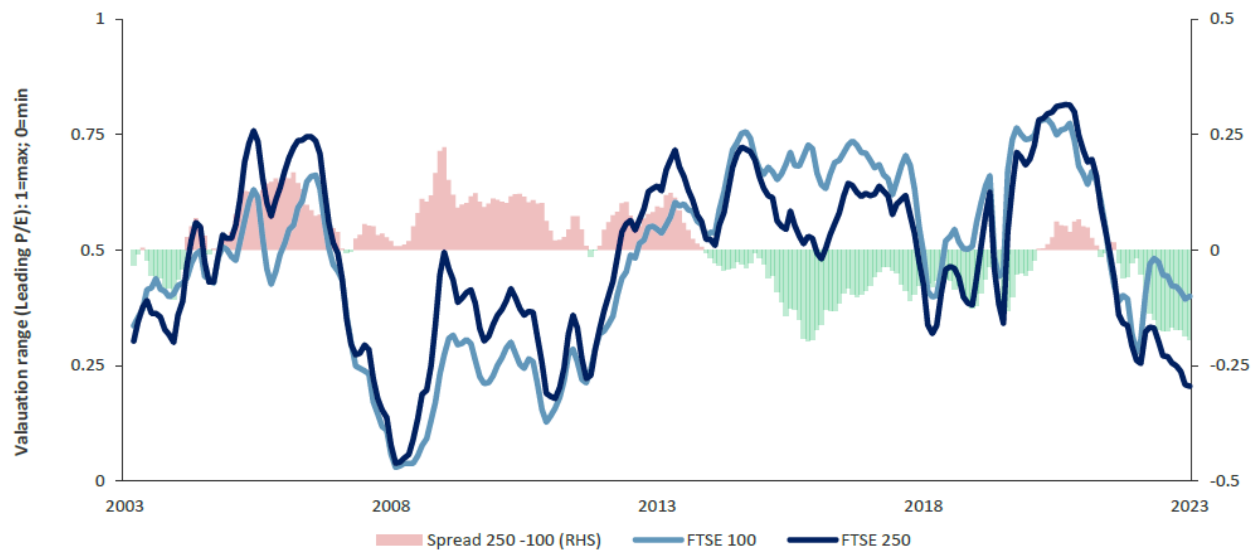
[2] *Panmure Gordon, Where now for UK inflation. 20 December 2023*

The lack of institutional support for UK equities is becoming increasingly political and we are encouraged by a growing list of proposed regulatory changes, not least the Mansion House Reforms, aimed at revitalising the supply and demand side for UK equities.

However, we would make the case that these concerns are priced in and are indeed the opportunity not the risk. UK equities are trading at a record discount to global equities, which holds true even if you adjust for the difference in sector composition. Moreover, as measured by the valuation of the FTSE 250 vs 100, the valuation spread between mid-caps and large caps has only been exceeded on one occasion in the last 20 years which was immediately after the Brexit referendum.



Source Panmure Gordon, Refinitiv



Source for both: Panmure Gordon, UK Equity at a 19% discount to its international peers. 1 December 2023.

Fund Update

Three month fund perfomance of 1.1% significantly lagged the benchmark return of 6.9%. As we have seen in the past, we tend to underperform sharp market rallies in the short term. Twelve month performance of +0.1% was 3.1% behind the benchmark return of 3.2%.

M&A was the key driver of positive performance in the quarter with both City Pub Group (+1.2 percentage points of relative performance) and Shanta Gold (+0.5) being bid for. Youngs is looking to acquire City Pubs, an exit to one of the large pub companies was always part of the strategy although it has come earlier than we expected. The 145p bid was a 46% premium to the prevailing share price and a 190% return from the 50p at which we initiated the investment in April 2020. The premium for Shanta Gold, at 7%, is unattractive and undervalues the Tanzanian and Kenyan gold exploration and production company. The opportunistic £142m bid compares to annualised EBITDA of over £70m and, following strong recent operational delivery, we expect the balance sheet moved into a net cash position at the end of 2023. The bid is approximately 40% ahead of our average book cost for the position.

Serabi Gold (+0.5) – the other gold exploration and production company that we own – rallied 66% in the quarter following strong results, a substantial investment in drilling to increase the reserves behind the key asset and positive early results from their copper-gold exploration partnership with Vale.

Renold's (+0.3) results and full-year guidance were ahead of expectations and interim operating margins significantly increased year-on-year from 8.3% to a record 12% in line with our Recovery thesis. We think the market continues to underestimate the potential for Renold to achieve sustainable double-digit margins underpinned by a highly engineered, relatively low cost but performance critical product, with the company trading at a modest 0.5x EV/sales. Whilst we consider there is further upside to margins, they have now recovered when compared to the long-term track-record and we therefore – supported by both the organic and inorganic opportunity which the company has begun to execute – transitioned the investment case from Recovery to Growth.

The most significant negative contributor to performance was DF Capital (-1.2). As we described in the previous update, the specialist lender had a single large loan that was in arrears which the company has now provisioned against. On our analysis, the updated guidance for pre-tax profits of no less than £2m implies underlying profits of £11-12m which is ahead of prior expectations, and we do not expect any impact on ongoing profits from this specific loan which the company has described as unique within their loan book. We added to our position at 18p, at which price the company was trading at less than 3x underlying profits and 0.3x price to book, despite exceptionally attractive NIM and loan book growth.

Supreme's (-0.7) share price rallied into the quarter following a first half trading and full-year guidance update at the end of September that was ahead of consensus driven by exceptional growth in the group's vaping distribution business. At the end of November, the company increased full year profit guidance by 15% versus guidance issued at the end of September, with estimates for FY24 EBITDA increasing by 52% during 2023. Despite these material upgrades, the shares ended the quarter lower at a valuation of <6x earnings.

Mind Gym (-0.6) issued a profit warning at its interim trading update in October. Previously the company attributed slower than expected growth to issues around the efficacy of the sales force but this is now being compounded by the weaker macro. We think there is sufficient evidence that recent weakness is cyclical rather than structural as the business continues to win projects and its pipeline is growing. Balance sheet and liquidity constraints have resulted in the company paring back selected long-term growth investments. Given depressed margins (EBITDA breakeven FY24E vs mid-term 15-20% EBITDA margin target), a depressed share price and a change of CEO, we are transitioning the position to a recovery thesis (versus a growth thesis previously). We remain cautious on timing into the second half as visibility is poor and there is a wide range of outcomes; as a result we have reduced our position.

Diaceutics' (-0.6) share price has been volatile over the past year as the business is going through a period of investment in its diagnostic commercialisation platform for precision medicine. Enterprise-level contract wins with top 10 pharma customers are important proof-points that the new model is gaining traction but growth (whilst healthy at +25% in constant currency in H1) is tracking behind our expectations. Following a strong interim trading update, the shares reversed previous gains on news of the CEO's planned succession. We believe the shares offer asymmetric risk/reward at these levels, but with a relatively nascent data strategy and an H2 weighting to contract renewals, it may take time for the market to recognise the company's growth potential.

Activity

We initiated one new Growth investment case in the quarter, an early-stage enterprise software company:

Windward's software-as-a-service solution underpinned by a unique and defensible AI based process provides high return on investment insights on the maritime sector primarily to government and commercial customers. With an R&D budget 3-4x the size of its nearest competitor, Windward is well positioned to capitalise on secular industry growth drivers – notably digital immaturity, the growing desire to automate increasingly complex compliance and regulatory requirements and demand for improved supply-chain visibility – and is on a clear path to profitability ahead of market expectations. Valuation at initial purchase was compelling at 1.5x EV/sales FY24E on our estimates vs peers on c4.5x. Post purchase, Windward issued an encouraging 3Q update which referenced trading 'comfortably inline'. This was followed by the announcement of a material customer win which bolsters our conviction in the growth thesis and accelerates the group's path to breakeven.

As discussed in the prior section, we added to our position in DF Capital on a depressed price-to-book valuation and, following updates that confirm our Recovery investment cases, also increased our investments in IG Design Group and Inspecs. We made smaller additions to Science in Sport and 1Spatial.

Purchases were funded via takeover proceeds from Instem and Smoove. We also exited Revolution Bars. We purchased the position as we expected bars to deliver a similar level of recovery to pubs but the key demographic – students – has been particularly hard hit by the cost-of-living crisis and the management team geared the balance sheet to acquire a leasehold pub business in October 2022 which has added significant risk to the investment case. We also reduced our position in Mind Gym post the profit warning.

Portfolio Positioning

We are looking to build a portfolio of companies that have a clear opportunity to create shareholder value in one of three phases of the company lifecycle – Growth, Quality and Recovery. We continue to have a bias towards Growth which is 51% of the portfolio, compared to 21% in Quality and 24% in Recovery which includes Asset Backed[3]. The changes from the end of the prior quarter are largely a result of the Instem acquisition completing (which was a large Quality position) and the transition of Renold from Recovery to Growth.

Despite our exposure to Growth, and indeed earlier stage growth where profitability is depressed through a high reinvestment rate, the portfolio valuation is in-line with the benchmark valuation on book-to-price, earnings yield and EBITDA-to-enterprise value and meaningfully cheaper on cash flow yield we are essentially value neutral but with a strong bias to companies that have historically grown faster than the market. The portfolio-weighted average growth in sales and earnings over the last three years has been 22% and 41% respectively, whilst the equivalent data for the benchmark is 18% and 27%.

On 1-year forward consensus forecasts, just 2 of our 39 positions are forecast to be loss making at EBITDA – MaxCyte and Windward – representing less than 2.5% of the NAV combined. Both positions have a strong net cash balance sheet and we believe existing cash resources will be sufficient to fund each company to profits.

We have always been cautious of leverage. 70% of the portfolio is net cash and of the remaining 30%, 50% has strong tangible asset backing to support leverage. For example, SigmaRoc has significant mineral reserves, Capital has a fleet of almost 100 drilling rigs, City Pub has freehold property, Shanta has proven gold reserves and Diversified Energy has gas reserves against which it has secured lending.

Outlook – Not wanting to be penny-wise and pound foolish!

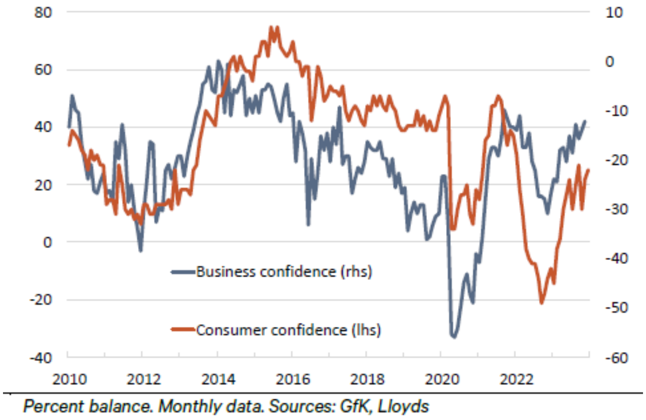
We made a similar argument in the previous update but turn to some commentary from JP Morgan this time who use the line – "And above all, it is about not wanting to be penny-wise and pound foolish![4]". They make the case that during an entire equity market cycle, the outperformance of small and mid-caps is never greater than in the first 12-months post a recession linked equity low "so it doesn't make a lot of sense to risk (the opportunity) and time the last 100 or 200bps of SMid underperformance". We are encouraged by the 3.7% relative outperformance of smaller companies in the final quarter of 2023.

[3] As of 6th January 2023

[4] *JP Morgan. The SMid View. 5 December 2023.*

Whilst we only have a single data point – we are also encouraged by November's inflow into UK smaller companies – the first in over two-years.

The UK composite PMI for December came in at 52.1, up from 50.7 in November and ahead of expectations. In fact, the compositie PMI for the UK is the highest of all major ecomomies and ahead of the global composite PMI of 50.4. Business and consumer confidence has also been on an improving trajectory with business confidence close to multi-year highs. Finally, the 2024 forward curve for UK gas currently sits 40%[5] below the BoE's assumed level in their November Monetary Policy Report which has implications for energy bills and services inflation.



Source: Berenberg Economics. Global Outlook: the rocky road to recovery. 5 January 2023.

This all leaves ample scope for the cascading effect of greater risk appetite to drive flows into the smaller end of public equities, where valuations are generationally attractive (the same cannot be said for large caps in general), particularly if there is a decent economic growth backdrop. Furthermore, as higher interest rates were a key bear case around small caps, owing to greater exposure within these companies to floating rate debt, it stands to reason that they should be among the bigger beneficiaries as rates stop rising and eventually decline.

As ever, thank you for your support.

George Ensor

January 2024

[5] *Panmure Gordon. A Strong start to the year for UK economic data. 4 January 2023.*

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