Micro-managing

What opportunities exist in the smallest part of the UK market?

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Another week has gone by with another doomsday prediction for the UK stock market, this time with predictions that small caps could all be gone by 2028. This was premised on the extrapolation of the current trend of companies either de-listing or being targets of takeovers leading to the market size falling to zero before the end of the decade. Whilst this may seem like an alarming statement, it did come with the caveat that the opposite could happen, and the market could proliferate should the right action be taken. Either way, it has again ignited conversation about the lower end of the UK stock market and what the future may hold. Here we look into the investment opportunity at the lowest end of the market-cap spectrum, the micro caps, to discuss what this somewhat forgotten-about asset class offers to investors and what could lie in store for its future.

What's smaller than small?

As the name suggests, micro caps are those companies that are at the lowest end of the market-cap spectrum. The definition of what classifies a micro cap rather than just a small cap varies, though consensus varies around companies whose market capitalisations are in the bottom 1% to 3% of the whole market. The MSCI UK Micro Cap Index which focusses on the space, includes approximately 400 companies, of which the largest (as of 29/03/2024) is £430m, with a mean average size of around £96m. However, there are several investment trusts that focus primarily on micro caps which typically invest below this. They invest from as low as c. £20m market cap up to a maximum of £150m at the time of initial investment, though often holdings are allowed to grow if the investment thesis holds.

As a result of this low capitalisation, the trusts focussing on the space need to be conscious of their own asset base. The average NAV of the trusts in the AIC UK Smaller Companies sector is £319m, according to JPMorgan Cazenove as of 04/04/2024. If a theoretically average trust were to put 3% of its portfolio into the average company in the MSCI UK Micro Cap Index, it would mean the trust would own c. 10% of the share capital of the company. This would allow them to exert significant influence but would also have implications for the ability to sell such a large position without having to take a haircut.

At present, the trusts focussed purely on micro caps have assets of between £43m and £65m, meaning this is yet to be an issue of note, though it does present challenges for open-ended funds to invest in the space, given the potential for inflows to necessitate taking larger and larger positions, enhancing the attraction of investment trusts, in our opinion.

Micro managing?

Micro caps have advantages from both fundamental and investing standpoints. One of the key fundamental advantages of small businesses is that they are nimble and flexible, which allows them to adapt quickly to changing market conditions. This can be a weakness of larger organisations which take a long time to make decisions. Smaller companies often have quite flat structures meaning the time taken for a a solution to be found for a problem may be shorter. We think this is one of the key reasons why smaller companies are able to deliver higher growth than their larger peers over time. This operational efficiency can have its drawbacks though. With a slimmer organisational structure, the decisions of a small number of individuals can have an outsized impact on the company's prospects. Should these calls prove incorrect, it can cause trouble for the business. This key man risk is still present in larger companies, although there is the potential for this to have a larger impact with smaller firms.

The smaller the company, the more focussed their product or service offering tends to be, with micro cap companies often having just one or two business lines. This means that micro caps are more likely to operate in market niches which further supports their high growth potential. However, this can create exposure to idiosyncratic factors such as losing a single contract, or from a big player entering the space and making for an uncompetitive environment. From an investing point of view, a number of micro caps have unproven, pre-profit business models such as pharma companies working on new drugs which have binary outcomes. As such, this can add to the higher volatility often present in the micro cap space.

Other market-based factors that increase the appeal of micro caps are that they are very under-researched, with very little analyst coverage, and therefore weak price discovery. As such, there are significant alpha opportunities for those who can identify the undiscovered gems in the universe. If successfully found, these firms often have long growth runways as their business develops, potentially progressing from micro cap to mid or even large caps. Should this happen, they can return many multiples of any amount invested.

As a result of the under-researched market, the micro cap space lends itself well to active managers. Not only can they commit the time to analyse the universe, but they can take large positions and deploy a private equity style approach, including taking seats on the board and using their large shareholding to instigate change. However, the downside of this is illiquidity which can contribute to volatility as well as making exiting positions challenging. One potential opportunity for exiting a position though is through M&A which has been increasingly prevalent in recent years, hence the concerns over the size of the index. This could come from private equity or other corporates seeking to add a micro cap's expertise or products into their own offering and can deliver excellent returns to existing investors.

What is going on in the micro cap market?

As is well-known, the UK market is particularly cheap at the moment, both versus its own history and versus global peers. Smaller companies within the UK are even cheaper still, with the most attractive valuations being at the lower end of the market-cap spectrum. The managers of **Aberforth Smaller Companies (ASL)** can invest in companies across the small and mid cap space, as long as they are listed on the Numis Smaller Companies ex IT Index. Their numbers show that the smaller smalls are cheap versus larger small caps. Those below £600m market cap had an average value in EV/EBITDA terms of 7.8x versus 10.3x for those above £600m, as of 31/10/2023. This means the smaller end of the small cap index is trading at a 24% discount. Fears over the country's economic woes may be a significant reason behind the weakness in smaller companies as they are typically more exposed to the domestic economy therefore often more at risk in a recession. However, there has also been a reduction in the number of investors willing and able to invest in the micro cap area of the market specifically, due to liquidity concerns post-GFC.

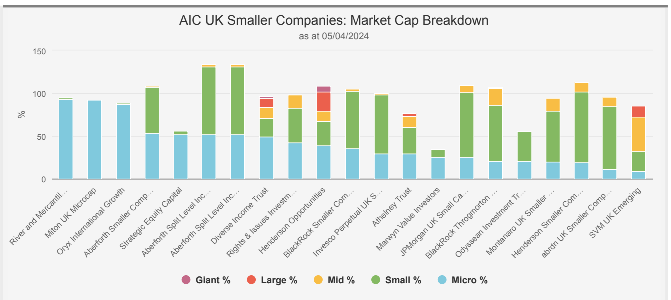
We think there may be another structural reason behind the weakness in smaller companies, particularly micro caps. The continued rise of passive investing is not supportive of smaller companies. There are very few ETFs or index funds focussed on the lower end of the market-cap spectrum, and even those that do, often don't offer much exposure. Small and micro caps lack the liquidity necessary for passives to invest at size (and often have higher bid/offer spreads too which increase trading costs substantially). Synthetic models using derivatives also can't really work, as there isn't a liquid market in them, and so passives largely focus on the FTSE 250 or above. One passive that does theoretically invest in small caps is the iShares UK Small Cap ETF which currently holds a FTSE 100 stock and has over two-thirds of the portfolio in companies over £2bn in assets. These are more than 20x the average micro cap company. As such, passive investing is unlikely to provide much support to the micro cap market and if the increasing prevalence of passive continues, it means that micro caps are unlikely to benefit as much from a revival in the UK, should sentiment return.

However, despite these factors, we believe micro caps still have a positive outlook. This is because micro cap returns can often be very idiosyncratic and individual companies can deliver exceptional returns even when the macro is weak because of their small size. Being so small, micro caps have the ability to make fairly fundamental changes with limited relative difficulty. This can dramatically change their fortunes, whether by capturing market share or cutting costs to come back to profitability. As such, a micro cap can quickly turnaround its business if the right steps are taken, despite broader economic headwinds. One example of this is Crestchic, which earned micro cap specialist **Rockwood Strategic (RKW)** a 4.8x return on their investment in late 2019 when they helped restructure the business by selling a loss-making division before accepting a takeover bid from Aggreko just three years later. These strong returns are not untypical of the micro cap sector, though we believe that good active management is required to identify them.

Investment trust options

The AIC UK Smaller Companies sector is very populous, with 24 trusts at present, and whilst a number invest in micro caps, there are several specialists that operate exclusively in them, each offering contrasting approaches. We have listed the trusts below with their market-cap weightings. We note that weightings may not total 100% due to cash and gearing levels. Micro cap exposure is in blue.

Fig.1: Sector Market-Cap Breakdown



Source: Morningstar

Whilst not listed in the table due to Morningstar data, the aforementioned RKW is one of the few trusts specialising in micro caps. We understand that the entire portfolio would qualify as micro cap under Morningstar's classification, with an average market cap of £96m, as of 31/03/2024 and the smallest holding with a market cap of just £8m. Manager Richard Staveley has a value-orientated strategy, looking to exploit the lack of research to find the extreme price inefficiencies in the space. He takes a private equity approach, looking to take large position sizes in companies and instigating change if he feels it can benefit the business. As such, the portfolio is highly concentrated at just 19 holdings as of 29/12/2023. As a result, if these ideas do pay off, they can cause significant jumps in performance. This has led to significant returns over the past few years, with the NAV up 106.2% over the past five years to 04/04/2024, versus the FTSE Small Cap ex ITs Index which returned 33.9% over the same period. As such, we believe RKW offers investors the opportunity to deliver significant returns even when the market is not in their favour.

River & Mercantile UK Micro Cap (RMMC) is also heavily exposed to companies at the bottom end of the market, though manager George Ensor has a strong growth bias in contrast to RKW. He looks for companies operating in market niches where big players are unlikely to enter and then rides these up as the growth comes through. He initially focusses on firms below £100m market cap though will allow positions to run beyond this, often taking profits on the way up. The trust has a unique structure to ensure the manager can continue to invest in firms of this size, where it returns capital to investors should assets grow materially above £100m in net assets. Partly as a result of the growth headwind, RMMC is currently trading at a significant discount of 18.5% which we think could offer an attractive entry point to the trust and add to long-term returns.

Miton UK MicroCap (MINI) in contrast offers more core exposure to UK micro caps. Managers Gervais Williams and Martin Turner have a diverse portfolio, currently holding c. 140 companies, which has led to a lack of a style bias to growth or value. The managers look for idiosyncratic stocks on unjustifiably low valuations on a bottom-up basis. They argue the negative sentiment shown to the UK stock market has made this the best investing opportunity in 30 years. The trust itself is also trading at a significant discount to NAV of c. 14%. This is over one standard deviation wider than the five-year average. As a result, we believe MINI offers investors more broad exposure to UK micro caps which is available at a particularly attractive discount at this juncture.

Conclusion

Over the long term, micro caps have delivered on their ability to provide long-term growth opportunities. However, acute weakness in the UK market stemming from negative sentiment and a weak economy has caused them to fall back in the past few years. Despite this, there are reasons to believe they could recover, and investment trusts could arguably provide an excellent vehicle for investors to take advantage of this, due to their fixed pool of capital negating the liquidity issues and allowing managers to take an active approach to the idiosyncratic space. With several of these trusts available at very wide discounts, this could prove a very attractive entry point over the long term.

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