GCI
GROWTH COMPANY INVESTOR

www.growthcompany.co.uk NOVEMBER 2022

City views

Two leading fund managers offer their perspectives on the UK smaller companies and property markets

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Market Outlook

Gas price weakness and lower gilt yilelds are very welcome, but do not signal an end to inflationary pressures

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The GCI Portfolio

A mis-timed gas producer purchase has not helped David Thornton's attempts to navigate choppy markets

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Best of the Blog

Angling Direct is a good example of a company with a valuation that does not reflect its balance sheet

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Editor's Opinion

David Thornton

Harold Wilson famously declared a week to be a long time in politics – so I suppose we can call the last few months a very, very long time indeed.

I have sympathy with the intentions of the infamous Truss/Kwarteng mini-budget. It was an attempt to plot a different course to the rather mediocre one we have been set on for the last decade. However, its timing and 'unfunded' tax cuts meant the project lacked credibility and was still-born. We must wait and see whether our latest prime minister plans to change the course he set while chancellor. But for now it looks like tax cuts are most certainly off the agenda, including corporation tax which as investors would have helped our earnings per share calculations.

What is certain is that Rishi Sunak would appreciate any luck that comes his (and our) way. One encouraging development has been the sharp fall in European gas prices. Earlier extremely high prices and accompanying scare stories will have curtailed demand along with some very mild weather. Gas storage facilities are suddenly full and LNG tankers waiting offshore to unload now represent a short term surplus. We are not into the winter months yet so we should not be celebrating but the implications for inflation and the budget deficit via reduced 'energy bill support scheme' costs are encouraging. Perhaps we are to be rescued by climate change!

Similarly, we will not know to what extent the carnage in the gilt market was due to the mini-budget in isolation and how much was due to forced sales by pension funds to meet margin requirements. These sales related to hedging against falls in interest rates; so when global yields rose sharply it is likely some of the overshoot in gilts was due to this activity. That selling has now abated and gilt yields are back in line with US treasuries. So perhaps Sunak's apparent credibility with the bond vigilantes is at least partly a product of this timing.

However, this is all 'tactics' rather than 'strategy'. It seems likely we will try to muddle through with higher taxes and tighter monetary policy; but not so tight that we get the crisis needed to change the policy consensus. Without a shift away from statism and towards entrepreneurship, my fear is that we get stagflation and a miserable few years for investors. ■

The next issue of *Growth Company Investor* will be published on **25 November 2022**.

GCI's Investment Policy

1. **Take a long-term view** – try to be patient and give your investments time to work out. *GCI*'s recommendations have a time horizon of 18 months. Remember that excessive trading incurs costs.

2. **Keep your portfolio fresh** – do invest for the long term, but do not be afraid to prune your holdings when necessary. Sell mistakes and stocks you no longer have confidence in. Better to take a loss and reinvest in a good stock than to soldier on with a bad investment.

3. **Diversify** – small-cap shares are riskier than blue-chips, so do not put all your eggs in one basket. Aim to hold at least a dozen stocks, but do not make the opposite mistake of holding too many (we think 20 to 30 shares are enough).

4. **Growth at a reasonable price** – this is what *GCI* looks for. The point of small-cap investment is to find growing companies. But we need to pay a reasonable, or better still a cheap, price for that growth.

5. **You have an advantage** – so use it! Professional fund managers have lots of constraints holding them back. *GCI* is here to help you exploit the freedom and clear personal objectives that you enjoy as an individual investor.

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Tristel offers possibility of upgrades as it returns to post-pandemic growth

Infection prevention business has been innovative in expanding into new segments

The business

We first recommended Tristel exactly seven years ago at 122.5p and the shares were a founder-member of the GCI Portfolio. As a quality growth stock Tristel got rerated onto a p/e of over 50x at last year's market peak and we had advocated taking profits on the way up. The company has since suffered covid-19-related disruptions which have dented its consistent historical record and the shares remain relatively highly-rated; so this recommendation might be a little on the early side. However, the Tristel story is worth revisiting since it is a high quality company which is poised to return to growth. It is also one where upgrades are a strong possibility over the next couple of years – in contrast to the average UK stock.

Tristel's business is based on its proprietary chlorine dioxide (ClO_2) chemistry. This molecule is not owned by Tristel; but it has a raft of patents covering the mixing technology and delivery systems, which include wipes, sprays, foams and gels. Importantly the products are safe and easy to use by hospital staff and are far superior to mundane bleaches. Its Cache brand is used to disinfect surfaces but the higher-margin lines decontaminate medical devices used in ultrasound, endoscopy, and ophthalmology. The disruption to hospital visits during the pandemic for non-urgent diagnostic and elective procedures has had an inevitable impact on sales patterns in the last couple of years.

The biggest product is Trio, a three-stage system of wipes used to clean, disinfect and then rinse medical instruments used in outpatient procedures and examinations. The company has been innovative in expanding its chemistry into new segments, such as the foam-based 'Duo OPH' system for ophthalmic devices. Historically Tristel has sold lower-margin disinfectant products into the animal health and life science markets but these were discontinued last year, which will allow management to focus solely on its core hospital market.

Tristel is well established in the NHS with the UK accounting for about 34% of group sales. The home market is more mature than overseas and the latter has been the main growth driver in recent years. Even so, the UK should still be capable of delivering high single-digit growth. Overseas growth

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rates had been motoring along in the 20-30% region prior to covid-19. While they now account for the majority of sales, these markets remain a big opportunity. For example, FY 2022 sales in Western Europe were £4.8m, with Italy reported separately at £1m. This compares with the UK's £11m; so given relative population sizes there should be many years of growth to come from this region alone. Sales in Central Europe (mainly Germany) are £5.4m with Australia at £4m and other Far East £2.2m. Overseas growth will also be supported by management's decision to acquire its distributors in several territories, giving it more control as well as the distributor's margin. Third-party distribution now accounts for less than 10% of group sales.

The US is a long-awaited growth catalyst which is now almost upon us. As is often the case, the FDA approval process has taken a lot longer than initially hoped, having begun in 2017. Tristel has already won approval from the US EPA for its foam-based surface disinfectant and this has just been launched by its manufacturing and distribution partner Parker Laboratories. This launch will help create market awareness ahead of the hoped-for approval of the Duo ULT device disinfectant by the FDA. The 'DeNovo' submission was made in June and approval is expected by the end of this financial year. The deal with Parker provides a royalty payment designed to deliver a similar pre-tax margin for Tristel as if it was selling directly – but without the related investment and execution risk.

Management and finances

CEO Paul Swinney co-founded the business in 1993 and CFO Liz Dixon has been in her role since 2010, having joined the company three years previously. Institutional shareholders on the register are headed by Liontrust with 10%, followed by Montanero and Aviva.

The company generates *ca* 20% returns on sales and capital employed, as might be expected from providing patented and regulated healthcare products. This has allowed it to generate cash while growing organically at a double-digit rate. Accordingly the company has been a consistent dividend payer, including specials like last year's 3p in a total of 9.6p, which translates into a useful 3% yield.

Gross margins have held steady in the 80% region over time. Price increases of 6-8% range are being implemented over the current financial year to cover cost inflation. The pre-tax profit margin has historically been 20-21% and there seems no reason why it should not return to that level as demand normalises post-covid-19. Discontinuation of non-core product lines, which was completed last year, should also support margins and allow management to focus on the higher-growth and more valuable core business. This reorganisation has been combined with investment in improved processes and infrastructure to get the company 'match fit'.

Valuation and outlook

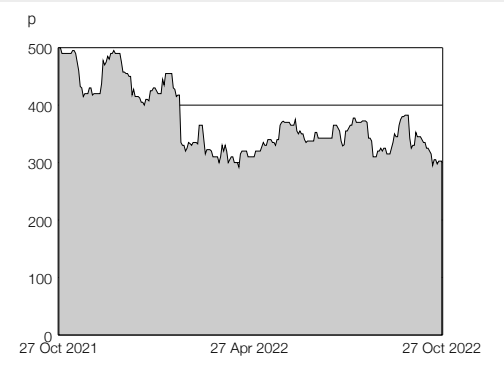
Tristel is a company that is very easy to like given its quality and historic growth record. As mentioned, investors became overly-enthused and rerated the stock to an unjustifiable level. It is hard to say this has fully unwound with a current year p/e of 28x; so it might pay to be patient. However, Tristel is now returning to growth after the pandemic disruptions. The 2024 forecast pre-tax margin of 18% looks conservative and suggests potential for meaningful upgrades.

Management struck a confident tone when we spoke after the results without being overly-bullish, pointing out that the first quarter of the current year has seen 20% revenue growth which equates to a run rate of £34m. News on FDA approval, which is likely towards the end of this financial year, will move the shares. Meanwhile the stock seems to be building a base in the 300-350p range. ■

TRISTEL GROUP ▶ READ MORE

https://tristelgroup.com

GCI Recommendation – **BUY**



Ticker: AIM: TSTL
Sector: Healthcare
Mid-price: 302.5p

Spread: 295p-310p
12-month high/low: 495p/292p
Market cap: £142m

RESULTS	Turnover (£m)	Pre-tax profit (£m)	EPS (p)	DPS (p)	p/e	Yield (%)
Jul 2021 (A)	31.0	5.4	9.6	6.6	31.5	2.2
Jul 2022 (A)	31.1	4.5	8.3	9.6	36.4	3.2
Jul 2023 (E)	34.2	6.0	10.7	6.8	28.2	2.2
Jul 2024 (E)	37.6	6.8	11.6	7.4	26.0	2.4

SECTOR PEERS	Ticker	Market cap (£m)	Pre-tax profit (£m)	p/e
EKF Diagnostics Holdings	EKF	197.4	21.4	21.6
Bioventix	BVXP	176.0	9.2	0.2

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After years in the doldrums, **SRT** looks poised to steam ahead

Marine technology specialist's Systems division could prove a transformative force

The business

SRT has been listed since 2005 and the shares have traded between 20p and 50p for the last 12 years. During this time it has failed to generate a positive trend in revenue or profit. However, according to a recent trading update, interim results due on 14 November will show revenue of £18.8m and pre-tax profits of at least £1.5m. Forecasts have the full year turnover exploding to well over £50m – so at last there is something very interesting going on.

The company's technology is focused on 'marine domain awareness' (MDA). SRT entered this sector 15 years ago with its transceiver product for shipping and 340,000 units have been produced to date. Transceivers are sold through a network of over 1,100 distributors and SRT claims a market share in excess of 80%. Automatic Identification System (AIS) transceivers are an International Maritime Organisation requirement for ships over 300 tonnes in international waters. Within territorial waters the rules are country-dependent but the trend is for commercial vessels to have AIS. Regulation tends to increase over time in most fields and the drivers here are digitisation of marine traffic control, safety, security, and environmental monitoring. Gross margins are 40% and although component shortages have been a recent challenge, revenues grew 20% in the first half. A significant new product, Nexus, is due to launch next year which will broaden the range and is expected to add £5m to the £11m divisional sales base.

This is all solid stuff, but the scope for a complete transformation of the company lies in the Systems division. This initiative has been in gestation for eight years and is now starting to deliver revenue. SRT's MDA system provides the equivalent of an air traffic control system for shipping. There are two customer constituencies: coast guard agencies concerned with the safety and security of coastal borders and territorial waters; and fishing agencies needing to ensure waters are being fished legally. There has been a £25-30m R&D investment over time to develop this fully-integrated marine domain awareness system. Competitors tend to provide specific applications in silos, whereas SRT's approach combines data from coastal

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radar, patrol vessels, and satellites into a single control room view.

Management said the unique selling point is the data analytics that the system enables. For example, the Philippines tracks 90,000 vessels a day and SRT's analysis of these ships movements and behaviour creates alerts flagging up potential illegal or risky activity.

Systems projects are large and have long lead-times. Hardware is bought-in which SRT configures and installation is sub-contracted to a local partner. This structure should result in a 30% contribution margin for SRT. There are two active contracts underway. The £32m Philippines fisheries contract was won back in 2018 and the deal hit its first revenue milestone in the first half with the cash received. The final milestones should be made in the second half. There are ongoing support and data revenues (SRT sources and resells satellite data), with the prospect of a larger expansion project to follow-on if all goes to plan.

Last year saw a £40m contract to supply the MDA system to a national coast guard. This is now generating revenue with a big uplift expected in the second half as further phases are completed. Management said the client is already specifying further phases which could begin in 2024. The wider pipeline is huge. There is £271m in five contracts where there is "high timing confidence" over signing in the next 18 months. "Reasonable timing confidence" is expressed over four potential deals worth £233m – the bulk of which is slated for the 2024-5 financial year.

Management and finance

CEO Simon Tucker joined the board in 2004 and became CEO in 2008. Both the COO and CFO have been in their roles for well over a decade. Being frank, there is a credibility gap over whether the evident growth opportunity will be executed effectively by the team that has presided over the company's rather lacklustre history. This is reflected in the limited share price response to the contract newsflow and the fact that there are no institutional shareholders on the register.

Funding has been provided by private shareholders and it was a surprise that no institution joined in the £5m placing at 30p in March. However, it is worth noting that the share count has only risen 40% over the last seven years and the chart has been a picture of stability, rather than the top-left to bottom-right pattern usually associated with similar microcaps.

The fundraise resulted in £6.8m of cash in the March balance sheet. There is a bank loan of £1.6m and a loan note facility with £6m drawn and headroom for a further £6m which carries coupons of 8-10%. With lumpy milestone payments and large contracts, effective management of working capital is a key requirement and as revenues scale up it would be good to see a better funding structure in place. Broker forecasts for the March year end have a £1.8m net cash position.

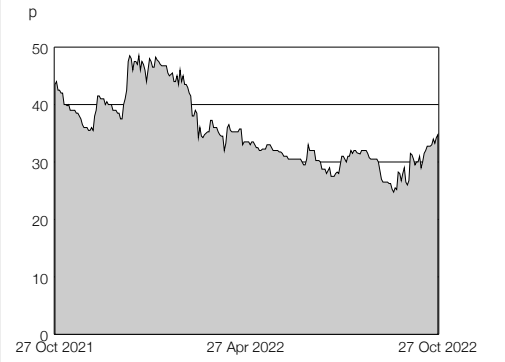
Valuation and outlook

The stock market appears to have a 'show me' attitude towards SRT. The shares look very cheap on current year numbers before we start to consider the value of the contract pipeline. Delivery of the two contracts underway on a timely basis will build credibility and there ought to be plenty of news flow on new Systems orders over the next 12 months. We should not forget the transceivers arm which is trading well and will benefit from the Nexus introduction. SRT's broker suggests this could grow to £25m+ sales in three years generating over £3m profit, which probably validates half of the current valuation. If there is such a thing as a low-risk speculation, then SRT fits the bill. ■

SRT MARINE SYSTEMS ▶ READ MORE

https://srt-marine.com

GCI Recommendation – **BUY**



Ticker: AIM: SRT
Sector: Electronic & Electrical Equipment
Mid-price: 34.75p
Spread: 34p-35.5p
12-month high/low: 48.5p/24.75p
Market cap: £62m

RESULTS	Turnover (£m)	Pre-tax profit (£m)	EPS (p)	DPS (p)	p/e	Yield (%)
Mar 2021 (A)	8.3	-5.2	-2.7	–	–	–
Mar 2022 (A)	8.2	-6.4	-3.3	–	–	–
Mar 2023 (E)	56.6	6.8	3.8	–	9.2	–

SECTOR PEERS	Ticker	Market cap (£m)	Pre-tax profit (£m)	p/e
MTI Wireless Edge	MWE	43.7	$4.0m	25.4
Filtronic	FTC	25.7	1.9	18.0

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Demand for digital transformation underpins **Kin and Carta**'s prospects

IT consultancy looks anomalously cheap given its outstanding growth rate

The business

Kin and Carta is an IT consultancy focused on the digital transformation market. The stock has been listed for decades and was originally the St Ives printing business whose legacy assets were disposed of in 2018; so the share price history needs to be viewed in that context. The IT consultancy market is vast and dominated by major system integrators like Accenture, Cognizant, Deloitte, and IBM. 'Digital transformation' (DX) is a subset of this market, specialising in getting the most out of innovations like the cloud and AI and developing new applications to foster efficiency and improve customer experience.

The DX segment is growing at 20% pa, which is at least twice as fast as the broader IT consultancy market. A recent Gartner survey stated: "94% of CEOs want to maintain or accelerate the already intense pace of digital transformation sparked by the pandemic and 70% of CEOs expect digital technology to get more funding." This is reflected in Kin and Carta's recent performance and business pipeline. Group revenue from continuing operations grew 48% in the year to July with the US showing 49% organic growth and Europe 27%. The year-end backlog of contracted work rose 35% to record levels and the bid pipeline was up 74%.

Last year 69% of group revenue came from the US which was led for five years by Kelly Manthey who has recently stepped up to group CEO. A feature of both the US and Europe, which accounts for the rest of group revenues, is that an overwhelming majority of business comes from existing clients: 83% in the US and 93% in Europe.

A good example is a major US financial services company which has grown from a $10m account five years ago to $31m. This relationship has evolved into 24 projects across various business units involving 200 Kin and Carta employees. It has culminated in the announcement this year of a $90m two year enterprise contract – which serves to endorse that Gartner quote about accelerating DX spending.

These are big numbers and require strong management to deliver them. As a consultancy the company earns profits by selling the time of its 2,000 consultants, engineers, and

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data scientists. Kin and Carta is developing digital software solutions for its clients rather than providing products off the shelf; so ensuring resources are sufficient to deliver this growth will be a challenge while at the same time improving profitability. Some of this involves acquisitions and three were completed in the last financial year, bringing in an extra £19m annualised revenues. One of the acquired companies is based in the Balkans and ties in with the strategy of 'nearshoring' – scaling up capabilities in lower-cost regions. Similarly the company has nearshore operations in Argentina and Colombia.

It has also integrated two UK businesses and disposed of non-core activities to make Europe a pure DX offering. This should help raise margins along with sharper pricing of contracts and scale benefits from leveraging central overheads. Recent price increases of over 5% have been applied to 75% of the revenue base and new business rates are 'well above' the average legacy rate. Given the hot nature of DX market demand, pricing power should remain positive. Management targets a 13-13.5% operating margin for the current financial year, up from 11.7% last year,with further improvement expected beyond that.

Management and finances

Chicago-based CEO Kelly Matheny has been with the company 16 years, having worked alongside former CEO J Schwan who retired at the end of the last financial year. Non-exec chairman John Kerr was previously CEO of Deloitte Consulting where he led the creation of the specialist Deloitte Digital arm. There is a good institutional shareholder list headed by Jupiter with 10%, followed by 'abrdn', Fidelity, Canaccord, Aegon, and M&G.

The balance sheet is healthy with net debt of just £0.5m at the year end, down from £19m. There is an £85m credit facility committed to 2026, and while there will be a working capital requirement given the strong revenue growth rate, forecasts have net cash building nicely to over £30m in the July 2025 year. Outstanding deferred consideration relating to acquisitions is less than £13m. This will support further acquisitions and management has been explicit in looking to expand its nearshore and offshore capabilities as well as bolt-on deals to add sector or technical expertise. It has also said it will also consider a larger strategic deal in the £100m plus revenue bracket.

Valuation and outlook

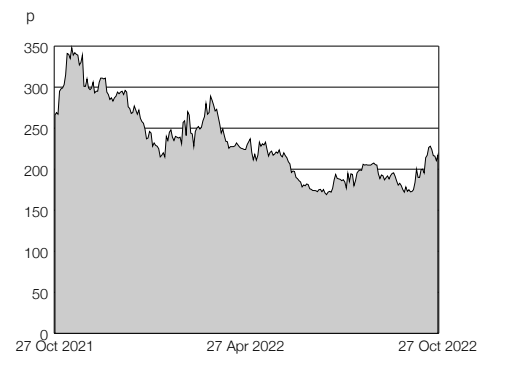
The board provides clear guidance and targets, which is something we always like to see. The company is a year ahead of its target to double organic revenue in the four years to 2025. It also anticipates increasing ebitda margins to the mid-to-high teens on this timescale from last year's 13.7%, having also indicated a *ca* 150bps jump in the operating margin this year. With Europe reorganised into a pure DX business and profitability set to improve, the new CEO can focus on exploiting the opportunities in what is a strongly growing market.

The tech sector and growth theme has had a tough time and we are not looking for it to resume stock market leadership. However, Kin and Carta appears to be anomalously cheap given its outstanding growth rate. The 'PEG' pe:growth ratio is just 0.5x, which for a predominantly US IT services business looks to be a steal. The nearest UK peer is Kainos which sells on a p/e of 32x current year earnings. There were broker upgrades after the results and demand should be robust even in a difficult economy given the mission-critical nature of digital transformation projects. The share price is 37% off last year's high but seems to be forming a nice 'saucer' formation and has just broken up through its 200 day moving average which is an encouraging signal. ■

KIN AND CARTA ▶ READ MORE

www.kinandcarta.com

GCI Recommendation – **BUY**



Ticker: LON: KCT
Sector: Technology
Mid-price: 214p

Spread: 213p-215p
12-month high/low: 348p/169p
Market cap: £374m

RESULTS	Sales (£m)	Pre-tax profit (£m)	EPS (p)	DPS (p)	P/E	Yield
Jul 2022 (A)	190.3	17.1	7.5	–	28.5	–
Jul 2023 (E)	253.5	26.1	11.4	0.6	18.8	0.3
Jul 2024 (E)	291.6	34.0	14.8	0.9	14.5	0.4
Jul 2025 (E)	335.6	42.9	18.6	1.2	11.5	0.6

SECTOR PEERS	Ticker	Market cap (£m)	Pre-tax profit (£m)	p/e
Kainos	KNOS	1,610.0	46.0	33.4
TPX Impact Holdings	TPX	36.0	4.8	4.1

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NETCALL — LONG TERM BUY

Date recom'd	Recom'd price	Price now	Gain
Dec '21	76.5p	83.5p	9%

Netcall's modest 9% gain since last December's tip should be seen in the context of the AIM index's 35% decline and a tough backdrop for growth stocks. The company has built strong revenue momentum which is forecast to see sales jump from £30m in the June 2022 year to £41m for the June 2024 year. This will bring scale benefits with improved profitability and a growing net cash position. There are two main growth drivers: the migration of legacy Customer Engagement (CE) clients to the cloud; and the Intelligent Automation (IA) platform. Further, only 15% of CE customers take the IA suite, so there is a substantial cross-selling opportunity – it is much easier to sell more to an existing client than to win new customers. An on-premise CE customer moving to the cloud provides a 50% revenue uplift and an IA cross-sell delivers a 200% increase; so farming the client base should underpin a healthy growth rate (*ca* 10%+ pa) before we consider the contribution from new logos.

Netcall's products fit nicely with the digital transformation theme. The CE arm provides a more efficient and improved customer experience; while IA using lo-code programming enables robotic process automation to both reduce costs and provide an enhanced 'Customer Experience', which is increasingly seen as a way for organisations to differentiate themselves and gain a competitive edge. The shares remain on a high p/e of 23x for June 2024, but there ought to be scope for upgrades. Further, the prospective ev:revenue multiple of 2.4x looks very attractive given the company's growth performance and prospects. Very happy to remain a buyer, especially on any weakness. ■

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Netcall: an examplar of the digital transformation theme

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Eneraqua: new opportunities opening in water sector

ENERAQUA TECHNOLOGIES — BUY

Date recom'd	Recom'd price	Price now	Gain
Apr '22	272p	300p	10%

Eneraqua is still developing a track-record as a public company following its IPO a year ago; but so far, so good. The interims to July saw a 92% jump in revenue and the full year is expected to see a 70% increase from £36.2m to £61.5m. The order book provides good forward visibility with £57m already secured for the January 2024 year at the time of October's results announcement. This underpinned guidance of £80m for the forthcoming period and since then the board has announced a further significant contract win to provide heat pumps for a new client over a three year period. Along with other wins this has added another £35m to the order book, meaning next year's target revenue is now 85% covered. The majority of contracts are forced purchases: replacing heating systems which are at the end of their lives. High energy costs are adding to the urgency of customer decision making, resulting in a buoyant market. Working capital has expanded to accommodate this growth. There has been a jump in the debtors:creditors ratio and Eneraqua is also carrying elevated stocks of key components due to long lead-times, particularly for air pumps. This ought to unwind over time and most creditors are public sector customers.

A new growth opportunity in the water sector is opening up for the company's Control Flow technology. New housing permits can be stalled due to constraints on the water supply. To solve this, upgrading 3-4 existing homes with Eneraqua's technology creates sufficient water savings to cover the impact of one new home, as well as saving money on heating and water bills for the upgraded homes. Positive momentum and good value on a prospective p/e of 11x. ■

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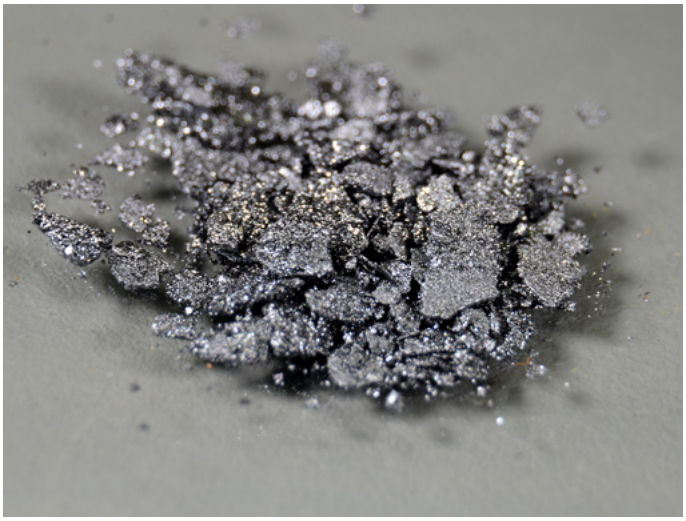
IOFINA — BUY

Date recom'd	Recom'd price	Price now	Gain
Nov '21	15.25p	21.5p	41%

Iofina's 41% return over the last year is pleasing, especially in a bear market context. The shares did hit 28p in July for a gain of over 80% but have drifted back subsequently and look good value again on a prospective p/e of 7x. The interims were solid in the context of a comparative period flattered by the sale of excess stocks which had built up during pandemic-affected trading. The iodine price of around $70 per kilo, up 40% in the first half, is well above the long-term trend due to low inventories and a long-term supply/demand imbalance. CEO Tom Becker told us there are no major supply increases planned by the industry and core demand from healthcare (mainly X-ray media) is strong as hospitals have returned to normality post-covid-19. Other markets such as biocides and animal nutrition are also firm.

Iofina is a low-cost producer and currently operates five iodine plants using brine from oil and gas wells as the feedstock. A 50% uplift in group capacity is planned from two new plants (IO#9 and IO#10) with the agreement for IO#9 having just been signed. The build cost has risen to $3.5m due to general inflation pressures but payback is estimated at under 18 months following a six month construction phase. Becker said the timing on IO#10 was not yet certain but the board is committed to the expansion programme. The historic constraints of a stretched balance sheet are no more, with net debt down to just $2.8m. Loan facilities have been agreed to support the construction of IO#9 and capex in the chemical division. ■



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Iofina: strong core demand

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Instem: increased SaaS sales driving margins growth

INSTEM — BUY

Date recom'd	Recom'd price	Price now	Gain
Nov '19	371p	590p	59%

Instem has done well overall since our tip but the stock has had a dismal run this year, falling from a high of 900p in early January. There was a downgrade to current year forecasts in the Spring, reflecting margin pressure due to wage inflation and acquisitions. Reassuringly the interims at the end of September saw earnings estimates maintained and underlying margins should improve over time due to increased SaaS content. In the near term management has sought to offset the impact of wage inflation by implementing a 12% price increase. CEO Phil Reason told us this has met with 'mixed success' so far – new contracts have seen no push-back but existing deals have been harder to get the increase agreed. On balance, a high single-digit rise should accrue in the second half therefore. Management is also addressing costs in the d-Wise acquisition with US-based external contractors being replaced by developers in India.

Most of the company's 40 SaaS clients are more recent wins, having been cloud-based from the onset. A quarter of the group's on-premise accounts are transitioning to the cloud with momentum picking up after a hiatus during the pandemic. For Instem, SaaS means lower support costs, a 40% uplift in recurring revenues, and an easier upsell of new modules. Lumpy consulting revenues will become less important as this transition progresses but in the near term this line should pick up on the back of newly won orders. Phil Reason regards the demand background as 'extremely robust' with pharma CROs 'very busy'. A prospective p/e of 17x and ev/sales of 2x offer good value, especially if we get evidence of margins trending upwards. ■

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City views

David Thornton talks to two leading fund managers about their perspectives on the UK smaller companies and property markets

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During October I interviewed two fund managers from Schroders, Iain Staples from the UK small cap team, and Nick Montgomery who heads up the 100-strong property team. Both had interesting things to say about how they manage money and the current state of their respective markets.

After taking a couple of maths degrees Iain Staples became a management consultant and subsequently moved into stock broking, joining Hoare Govett just in time for the dotcom bubble. It is possible our paths crossed at that point since I was a client of Hoare's back then, but any memory has been lost in the mists of time! He has now been at Schroders for 10 years and manages a range of small cap portfolios including a £120m IHT fund, the £200m UK Dynamic Smaller Cos retail fund, as well as several other retail and institutional funds. This range of accounts accommodates different unit sizes and risk appetites which is helpful as a fund manager – there is nothing more frustrating than having a great idea but no fund to fit it in.

Liquidity issues

I was keen to understand current experience of liquidity and fund flows from someone at the sharp end. Staples has seen some outflows but not much on the retail side, certainly no panic liquidations that might signal capitulation. Liquidity, however, is the issue that I expected it to be. It has been poor since the Mifid II regulations came in and the current bear market has only made things worse in UK small caps. Trading in stocks under a £250m market cap is described as "difficult". Like many of his peers he has to avoid microcaps and works with a minimum market cap of £100m. Having that range of accounts helps at this end of the spectrum since his IHT fund can take a useful stake in good quality situations in this size band. He has a watch list of stocks in the £50-100m range which in his view is an interesting area – microcaps which are performing, moving up the size scale, and getting on fund managers' radar.

Staples describes his style as 'GARP' – growth at a reasonable price – which chimes with our own philosophy at *GCI*. He identifies four factors to focus on which are borrowed from John Kay's *Foundations of Corporate Success*: brand and reputation; innovation; architecture; and strategic assets, such as patents or landing slots. 'Architecture' is the relationship a company has with its suppliers and employees and Staples emphasises the importance of site visits to gauge these softer issues.

Innovation themes

As well as these bottom-up factors he also seeks to exploit themes with robotics, digitisation, and climate change current areas of focus. Staples said innovation is something the UK is good at, which I tend to agree with – denigrating our country

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is almost a national pastime but we have a tremendous academic and research base which supports innovative companies.

One stock he is keen on in this theme is **Big Technologies** (AIM: BIG) which came to the market just over a year ago and has a market cap of £800m. It is highly rated but the shares have held up well in a stock market context. Its innovative product is a tamper-proof smart tag to monitor and control miscreants. The selling point is that it saves money by getting people out of prison earlier while keeping society safe. There is a huge US opportunity to exploit and with high margins it should generate cash while growing. One we should take a look at.

Another unfamiliar name highlighted was **Alpha Financial Markets Consulting** (AIM: AFM). This stock which provides a range of services to the asset management industry has developed a good track record since listing in 2017. It is valued on a mid-to-high teens multiple but enjoys a 21% ebitda margin and generates cash. Another for the watch list.

Other stocks we discussed which are followed by *GCI* included **Renew** (AIM:RNWH) which is appreciated for its defensiveness, solid execution, and the fact that it operates in regulated environments which raises barriers to entry. **Midwich** (AIM: MIDW) is a stock that has been owned since IPO. Staples praises the business model and culture, as well as strong execution. Coincidentally, I visited the company at its Bracknell HQ during the month and will report next time, suffice to say I concur with his views.

Property

While not a core focus for *GCI*, it is always worth knowing what is going on in the property sector, and the asset class has a decent record of conserving value during inflationary periods. However we have entered an inevitable period of weakness as property market values adjust to the new interest rate environment and take on board the risk of lower demand from a weakening economy. We discussed these issues with Nick Montgomery in the context of **Schroder REIT** (LON: SREI) which has a market cap of £220m with the shares at 45p, equating to a substantial 43% discount to June's NAV and a current yield of 7%. The NAV is updated quarterly and we are due to get September's number in a couple of weeks.

For the market as a whole, Montgomery expects to see an overall decline in capital values of 15% between 2021 and 2023 based on a 4% 10 year gilt yield and normal property yield spreads. At the time we spoke the gilt market was in an unruly post-mini-budget state, which would have implied a bigger correction for values had it persisted. On the plus side, low sterling is attractive for overseas buyers and there is much less leverage in the system now compared to the global financial crisis.

One of the hottest parts of the market has been industrials with yields compressed to 3% for quality assets. SREIT has a 50% weighting to industrials but Montgomery pointed out that this is focused on multi-let estates which have a lot of scope for adding value through active management. An example is the Stanley Green trade park in Manchester where lease events, and obtaining consent for a high quality new warehouse on an empty lot created a big uplift on cost – the strategy is to buy on a high starting yield and then turn a grade B- asset into a B+. The portfolio yield is 5.2% against a benchmark which is sub-4% and this gap widens further when reversionary yields are taken into account (ie current market rents are higher than those in SREIT's existing leases).

Net loan-to-value is low at 29% and 75% of the debt is fixed for 14 years at 2.5%, which Montgomery said it is the lowest rate in the peer group and looks a great deal. The company bought back £10m shares last year when the discount moved above 40% and he expressed confidence in the board's ability to move the dividend forward and buy back stock to support shareholder value. ■

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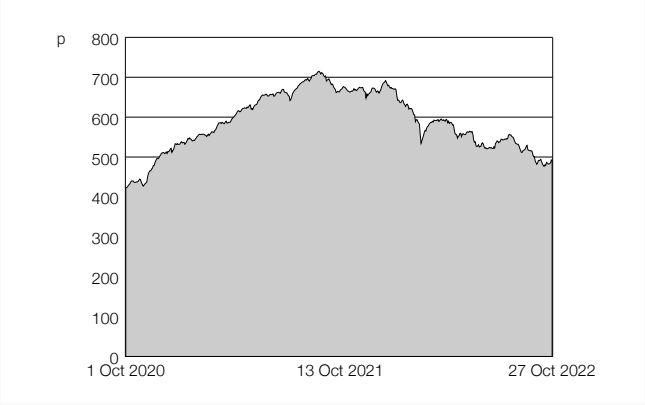

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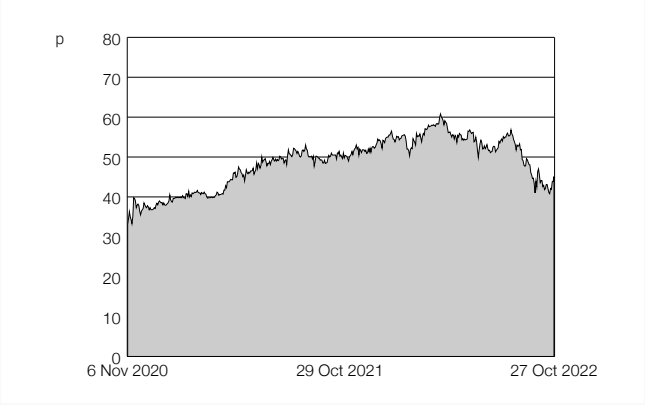

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Share news, results and updates

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1SPATIAL Ticker SPA Sector Technology Market cap £50m Share price 45p BUY

1 Spatial focuses within the GIS world of geographic information on Master Data Management (MDM). This is a strongly growing segment of the software industry which seeks to deliver consistent, accurate data across an enterprise and the clients that interact with it. Clients upload geospatial data to 1Spatial's platform to verify it before using it in specific applications. Together with cloud-based applications such as traffic management plans for the UK market and NG911, which is getting good traction in the US, this approach is growing the proportion of higher-quality recurring revenue. Margins will also benefit from these increasing SaaS and applications revenues.

Revenue momentum continued to build in the first half to July with growth of 11%. Annualised recurring revenue (ARR), a key focus for management, grew 29% to £15.2m in the context of a group revenue forecast this year of £30m. The medium term aim is to get ARR up to 60% of the group, with 80% a longer term possibility. New customer wins include HS2 and further US states including its eighth NG911 contract with Arkansas.

The US market has grown to 23 clients from a single one (the US Census) over the last five years and the pipeline remains positive. The shares only trade on a 1.5x multiple of ev:sales and a modest prospective p/e of 13x. ■

BEEKS FINANCIAL CLOUD Ticker BKS Sector Technology Market cap £96m Share price 147p HOLD

Beeks raised £15m in April to support its move upscale into providing outsourced networks and low-latency connectivity for tier one financial and exchange clients. These deal sizes are larger and require front-loading of capacity to win and execute contracts. There has also been an increase in overheads to support this growth as well as an office move. The increased share count coupled with these higher costs means earnings are expected to be flat in the current year to June, then grow 20% in the following year. Over these two years revenues are expected to rise 64% to £30m, which should start to bring scale benefits and ease the funding of further growth. Further, the larger-scale customers take ownership of their hardware which reduces the burden on Beeks' balance sheet. The current cash balance is £8m and only £4m of this is expected to be consumed over the next two years.

The Proximity Cloud service for larger institutions has been running for a year with contract values totalling $5.2m and a growing pipeline. Exchange Cloud launched in June with ICE (owner of the NYSE and other exchanges) as the initial customer. Sales cycles are long but the world's top 20 exchanges are the target market. There is scope for upgrades and Beeks' sector focus puts it in a strong position. Strong growth prospects but the 27x prospective p/e looks high enough. ■

BOKU Ticker BOKU Sector Technology Market cap £380m Share price 127.5p HOLD/BUY

Boku is now solely focused on payments having exited its identity verification business. This is a dynamic market and its emphasis is shifting towards new payment methods. The core Direct Carrier Billing (DCB) service where Boku's platform enables mobile customers to charge purchases to their mobile phone bill has "completed its steepest phase of growth" according to CEO Jon Prideaux. There is still growth in DCB but a bigger opportunity is in local payment methods (LPMs), specifically e-wallets and real-time payments.

LPMs are particularly popular in Asia where traditional cards and the duopoly of Visa and MasterCard has a less strong hold. In Prideaux's words LPM is exploding and is a much larger addressable market than DCB.

A recently won multi-year agreement with Amazon to provide LPMs in Asia and Africa is both an illustration of the opportunity and an endorsement of Boku's platform from the world's leading ecommerce company. Payment stocks were one of the hottest themes of the bull market and have predictably been amongst the hardest hit with Boku down from over 200p at the high. The Amazon deal and recent results have seen a turnaround with a strong bounce from the 80p level. The prospective p/e is 32x but the shares are a play on this secular growth opportunity in LPM which should deliver operational gearing through a platform where most costs are fixed. ■

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CRANEWARE Ticker CRW Sector Software Market cap £606m Share price 1,705p BUY

We tipped Craneware at 1,195p in 2017 but cooled our enthusiasm when it became overvalued during the bull market mania for growth stocks. The shares are now half the price reached at the peak and look interesting again following the transformational acquisition of Sentry. This has doubled the company's revenue base and created a major player in the provision of software to US hospitals and pharmacies. Synergies savings of £10m have been realised which has maintained the ebitda margin around the 30% level despite Sentry coming into the group with a mid-20s margin. There has been a negative impact on cash flow due to Sentry billing monthly and Craneware annually in advance, the aim is to migrate Sentry customers onto Craneware contracts over time. Initial cross-sales have been achieved and with the client base comprising 40% of US hospitals there should be plenty of potential with Sentry bringing 300 new logos into the group. Looking forward, CEO Keith Neilson sees 70% of growth coming from the existing customer base with the company still just "scratching the surface".

Management expects double-digit annualised recurring revenue growth in the current year with scope to accelerate into the mid-teens. This suggests broker forecasts of 10% revenue growth are on the consevative side. A current year p/e of 21x looks attractive for a nicely growing US software stock with almost $200m sales. ■

FIRE ANGEL Ticker FA Sector Industrials Market cap £15m Share price 8.3p SPECULATIVE BUY

Our tip in May at 16.8p has not gone well. The company has a history of disappointment so there was always a risk it might let us down.

Revenue in the six months to June was up 15% but gross margin, a key focus for management and central to the recovery story, was down from 23.5% to 21.9%. The main issue is what management calls 'purchase price variance' (PPV) – the extra costs incurred to secure supplies of components.

Inventories were too low and the company was operating "hand to mouth" in the first quarter according to chairman John Conoley. Without these additional costs he reckons gross margin would have been 28%.

These issues also constrained volumes in the higher-margin connected product range. The second half will still suffer from higher PPV but only £250k compared to the first half's £1.6m.

Price increases are being imposed and the benefit of these should be felt from Q1 next year. A weaker dollar will be a help, but the key is to drive up the share of connected products in the sales mix.

The company aims to be cash generative in the second half with September described as "very strong" and the fourth quarter usually the best of the year. We have to wait until late 2024 for the Techem deal to kick in with royalty revenues, which has potential to transform prospects. ■

GATELEY Ticker GTLY Sector Support Services Market cap £228m Share price 182p BUY

As a provider of legal and professional services to UK corporates it is no surprise the shares have drifted down this year but at least they have done less badly than the AIM market average. CEO Rod Waldie told us he is confident the group will be resilient given its performance during previous recessions. Salary pressures have been felt, especially in legal, given a strong market backdrop in the last couple of years. The average pay rise was 12% this year but most of this has been passed onto clients without much push-back. This pressure should abate given the uncertain economic outlook. Post-pandemic benefits have been a sustained reduction in travel and office space. The company has diversified by acquisition into other corporate consultancy practices which reduces risk and provides cross-selling opportunities. One potential cyclical exposure is £25m of revenue from housebuilder clients but Waldie points to ongoing strategic land buying and post-Granville Tower legal work within this.

Margins were held back last year by an increase in investment in the Property division with new teams taking time to become productive. Assuming salary costs remain under control and the company's historic resilience is also displayed by the newer business units, the stock offers solid value. The current year p/e to April is 11.4x and there is a healthy 5.2% yield. ■

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GREATLAND GOLD Ticker GGP Sector Mining Market cap £405m Share price 8.1p BUY

We covered Greatland as a 'speculative buy' at 1.7p in January 2019's Digest. This is another brief update on progress and we will aim to provide a fuller discussion of the story next month.

Since we last spoke to the company it has renewed its board with directors from big company backgrounds in the Australian mining sector and fully-funded its 30% share of development costs for the Haveiron project. At the time of our earlier tip this was a wholly-owned prospect which subsequently delivered hugely promising drilling results. A farm-in deal was concluded with Newcrest who are moving towards developing what could be a new world-class gold mine.

A bonus for the project is that Newcrest owns the Telfer processing facility only 45km away which currently serves a mine close to the end of its life. With this infrastructure already in place Haveiron production should start in 2024 with costs expected to be in the bottom quartile.

The resource estimate has been significantly upgraded as the project has progressed with broker estimates of NPV in the 18-25p region. Greatland has secured a A$220m debt facility along with a A$60m equity investment from Wyloo Metals who have an option and warrant to subscribe a further A$120m. This also provides funding for further exploration drilling in the nearby 100% owned Paterson licences. ■

K3 CAPITAL Ticker K3C Sector Financials Market cap £184m Share price 250p BUY

We tipped K3 in July and a catch up with management after the results announcement for the year to May confirmed our positive view on the stock. Momentum is clearly strong with upgrades in last year's numbers and the first quarter of the new financial year having started strongly. If we annualise the £6.5m ebitda earned in that latest quarter we get £26m which compares with a consensus forecast of £22.3m. The original Business Sales division is much less cyclical than might be expected given its focus on the SME sector. Decisions to sell are often driven more by personal factors such as retirement, rather than the economic backdrop and the business model has retainer fees covering the division's overhead. The sales pipeline is still strengthening despite a record first quarter, with more deals going into legals during the period than left the process through completed sales.

The Tax division should provide a resilient performance during a slowdown with 84% of current revenues contracted to deliver recurring fees. The service offering has been expanded and this division stands to benefit from cross-referrals and leveraging K3's database marketing. Restructuring is a counter-cyclical business which will benefit from the upturn in corporate insolvencies. Management has invested in overseas offices and headcount growth which had a £05m drag on ebitda during the year. Cheap on a p/e of 11x with upgrades likely and a 6% yield. ■

MISSION GROUP Ticker TMG Sector Media Market cap £40m Share price 44p BUY

Mission always looks modestly valued and given the economic backdrop its discount has widened further.

The first half saw revenue and profits ahead by 10%, though earnings growth was constrained by higher tax and interest costs. Management said it is on track to make the full year numbers and although this means a second half bias, the proportion of profit that needs to be delivered is similar to the company's historic trading patterns. CEO James Clifton did point out that September is usually a strong month but was slower than usual, possibly due to the Queen's death restraining advertising and marketing activity. The novelty of a winter World Cup is also an unknown, given the natural strength in seasonal marketing spend into the Christmas period. Clifton said he can see how the group can deliver on expectations and a 4% increase in the interim dividend is a positive signal.

The company has been acquisitive but aims to keep the debt profile low for now. Net bank debt was £7.1m at June, down from £10.3m in December and remaining earn-out obligations are just £2.5m. This implies year-end leverage ratio of 0.5x with forecasts suggesting a move into net cash position in 2024, which is reassuring. The appointment of an outside non-exec chair is another positive. Good value on a p/e of 6x and a 6.7% yield. ■

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PROPERTY FRANCHISE GROUP Ticker TPFG Sector Real Estate Market cap £79m Share price 247.5p BUY

The shares had held up well, moving above 300p in the wake of September's results, only to come under pressure during October – presumably in response to rising mortgage rates.

Given an exceptional 2021 for house sales due to the stamp duty holiday and pent-up demand related to the pandemic, this year has seen the market revert to more typical transaction volumes.

CEO Gareth Samples says the 620,000 sales in the first half is consistent with 1.3 million for the full year as conveyancing backlogs are cleared, which is better than the 1.2 million long term average. The sales pipeline was 15% ahead at June and when we spoke in late September his view was that the market remained strong with no sign of a drop in the key indicators.

The Hunters acquisition increased the estate agency content but the stable lettings business along with internal growth initiatives should provide resilience. Hunters is increasing its lettings business and the group has acquired eight books in the first half with a target of 20 for the year. EweMove has been slower but 40 new territories should be sold this year. There are 170 franchisees and Samples sees 1,200 as the ultimate goal.

The balance sheet should return to net cash by the year end and the stock trades on a 2022 p/e of 9.6x and 5% yield. ■

REAL ESTATE INVESTORS Ticker RLE Sector Real Estate Market cap £56m Share price 31.3p BUY

REI's value credentials are clear: a 50% discount to NAV and a 10% yield covered by earnings. Management has been a net seller of property over the last couple of years which has brought the loan-to-value ratio down to 40% and further sales are in the pipeline.

REI benefits from having small lot sizes which are attractive to still-active private investors both from the UK and overseas. Aggregate sales in the first half achieved 28% above book value with more recent deals closer to book. All the group's debt is fixed at 3.5% for the next two years, with its interest rate hedge now in profit.

Occupancy is set to improve having been stuck around 85%, mainly due to a couple of offices which became vacant during the pandemic.

The Oldbury unit is in legals which will bring in £600,000 rent when let in the context of £14m group revenue, while most floors at the Telford site are now let. If all pending leases are signed, occupancy will rise to 90%. Rent collection has normalised post-covid-19 and was over 99% in the latest quarter.

The strategy is to continue reducing debt via disposals where it is sensible to do so and maintain maximum flexibility over capital allocation decisions. A buy-back is possible at some point and a bid for the company would be entertained by the board. ■

SANDERSON DESIGN Ticker SDG Sector Household Goods Market cap £84m Share price 123p BUY

The market has been reassured by the recent interim results with the shares recovering 36% from a bombed-out 90p low. Group revenue was flat in the latest half but earnings were up 13% boosted by a strong period for licencing revenue which comprises royalties with a 100% gross margin.

Core designs for linens tend to have perpetual licences but shorter-term collaborations such as with Next in women's wear might be a 2-3 year venture. Further potential deals are under discussion with management keen to exploit its rich archive of designs.

Elsewhere the Morris brand goes from strength to strength with sales growth of 28% in the UK and 54% in the US. The US is benefiting from improved distribution and delivered record sales last year. That record only amounted to £15m however, so there is plenty more to go for: CEO Lisa Montgomery pointed out that rival Colefax generates 60% of its sales in the US. Having got the distribution network and product right for the US market, the plan is to prudently increase marketing spend.

Management is confident it can cover cost pressures. Prices were increased by 9% in February and 6% in August with twice yearly reviews going forward. Forecasts are maintained for the current year with profits next year held flat, which puts the shares on a p/e of 9x. ■

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ScS Ticker SCS Sector Retailers Market cap £54m Share price 150p BUY

Results for the year to July were fine and a little ahead of expectations. The main reason for the 12% decline in earnings was the removal of £7.6m of pandemic-related business rate relief. However, ScS and its peers selling home furnishings and flooring face an uncertain outlook. The first 10 weeks of the new financial year have seen order intake 7.8% below the pandemic-free comparable period of 2019. The Queen's funeral had some impact but management told us trading is lumpy and inconsistent with some weeks flat and others down.

The company gained 0.7% market share last year and we would expect its competitive position to strengthen further during the downturn. ScS has a very strong balance sheet and a lot of flexibility built into its cost base. Management states that almost 75% of its cost base is variable; for example last year saw a £3.6m reduction in payroll costs due to the performance-related element and a headcount reduction.

The year-end cash position was £71m with customer deposits £26m; in October these numbers were £77m and £30m respectively. There is a current year lease liability of £20m and no bank debt. Importantly, goods are made to order so there is no risk of becoming overstocked. Although the shares have bounced from the 120p level, they still offer great value on a 9% yield and 8x p/e. ■

SMARTSPACE SOFTWARE Ticker SMRT Sector Software Market cap £11m Share price 38p BUY

The market cap has shrunk to just £11m with the shares down 80% from the mid-2021 highs. However, strong top-line growth and a move into ebitda and cash flow break-even next year means there is plenty of upside potential for a patient investor.

The SwipedOn visitor, desk and meeting room management product accounts for £4.5m ARR (annualised recurring revenue) out of a group total of £5.2m. Its ARR grew 35% over the last year to July supported by a rise in ARPU to £84 pm from £59 over the 12 months driven by upselling more modules and repricing legacy customers. At the end of September ARPU had improved further to £91. Growth in enterprise customers supports better pricing and permits a 'land and expand' strategy: the software gets installed at a single site and then is adopted throughout an organisation. Sales are direct but the team is only five strong with most purchases made online. A Korean version has been launched and there is focus on expanding into less competitive Asian markets.

Space Connect has been held back by its partner Evoko's slower than expected sales of its new meeting room panel. These come loaded with Space Connect software so there is upfront and recurring royalty payments when panels are sold. Things are now picking up with the monthly run-rate above budget. Cheap on 1.4x prospective ARR. ■

S&U Ticker SUS Sector Financials Market cap £265m Share price 2,180p BUY

S&U delivered a strong first half and describes current trading as encouraging. Chairman Anthony Coombs sums up the outlook well: "Rarely in S&U's 84 year history has the strength of current trading and first half performance contrasted so starkly with the current frenzy of pessimism and gloom surrounding the UK's prospects." Interim profits were up 5% against a comparative flattered by a lower than normal impairment charge. That reflected a strong collections experience driven by a change in approach to managing defaults. The aim is to keep the customer in their car if possible by being more flexible with payment plans. Arrears are being collected better and strong second hand car values mean lower losses on repossessions. Healthy employment rates and job vacancies also argue against an overly-gloomy outlook. The newer Aspen property bridging finance arm has grown strongly and achieves excellent collection rates. Its net loan-to-value is only 64% which offers a healthy backstop and the average term is only 11 months. Most defaults result in an extension to the term and satisfactory exit, with only one repossession in the last 18 months.

Prudent, experienced underwriting is combined with a strong balance sheet. Leverage is only 73% and provisions, which include an IFRS9 forward-looking calculation, are 25% of receivables. A current year p/e of 8x and 6% yield offer good value given the quality of the business. ■

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The GCI Portfolio

A mis-timed gas producer purchase has not helped David Thornton's attempts to navigate choppy markets

Another disappointing month slips by as the bear market grinds on. The month saw further weakness early on in the wake of political and gilt market turmoil. Some semblance of stability has been restored but markets remain febrile and confidence is in short supply.

Risers

Our modest underperformance over the month masks some turbulence below the surface. I will get the winners over with first since that will only detain us briefly.

Sanderson Design had a welcome 28% bounce on its interims which you can read more about in the Digest. It still looks good value and we continue to like the self-help story and value in the design archive.

Equals rose 8%, recovering ground lost last month in post-results profit taking. **Bioventix** was marginally up on a solid set of results and we will update on these next time. Sadly this wraps up the positive side of the ledger.

A problem purchase

I must now address last month's horror story which was my ill-timed purchase of UK gas producer **IOG**. The shares fell 39% which knocked 1.5% off the portfolio value – fully accounting for our underperformance against the AIM index over the period.

The company has successfully developed and moved into production its Saturn Banks gas project in the North Sea at a time of record gas prices. Unfortunately it encountered some early production problems which caused lower output levels than originally hoped.

Management had announced initiatives to solve these problems and I was tempted to take advantage of a depressed share price and back them to be successful. It has now been hit by more bad luck with difficult drilling conditions curtailing the production anticipated from the new Southwark field due later this year, together with a four week shut-in to repair Saturn Banks. Further, there has been a significant downgrade to recoverable reserves due to reservoir issues.

Clearly management has been too optimistic and there have been changes at the top with the CEO and COO departing.

Rupert Newall has stepped up from the CFO chair and reassured the market about the company's liquidity, saying

RETURNS TO 27 OCTOBER 2022

	Since last month	Since inception (20/10/15)
GCI Portfolio	-2.1%	134.5%
FTSE All Share Index (total return)	1.6%	43.9%
AIM All Share Index	-0.6%	8.7%%

PORTFOLIO SUMMARY (starting capital £60,000 on 20 October 2015)

Stock	Holding	Purchase date	Purchase price (p)*	Purchase cost (£)*	Current price (p)	Current value (£)
Motorpoint	4,214	19/12/19†	282	11,967	147	6,195
Somero	3,788	26/1/16†	158	6,017	383	14,489
Niox	33,906	23/6/21	29.75	10,097	37.5	12,715
On the Beach	2159	20/5/16†	178	11,043	103	6,344
Bioventix	276	21/2/18†	2,140	5,921	3,380	9,329
Sanderson Design	12,645	25/11/20	78.5	9,936	123	15,490
Kape Technologies	3,300	30/9/21	424	14,002	224	7,392
Renold	76,500	25/11/20	13	9,955	21.6	16,524
R&Q Insurance	6,907	27/10/21	188	12,995	72.5	5,008
Equals	11,000	25/8/22	94.25	10,383	88.5	9,735
H&T	2,280	25/8/22	461	10,521	439	10,009
IOG	30,000	28/9/22	18.5	5,560	11.3	3,390
Serica	2,220	28/10/22	316	7,025	316	7,015
					Cash	17,042
					Total	**140,677**

** Adjusted for partial sales and additions; † added to or reduced holding subsequently.*

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that no incremental funding will be required to get through this. He has also added to his shareholding and it is tempting to join him by averaging down but we will wait to see the next news release.

We were greedy in buying IOG, believing it to be bombed out after disappointing newsflow. Particularly when, as observed in last month's review, quality plays like Kistos and Serica were available on modest valuations. As it has turned out, a sharp fall in the gas price has seen these two shares give up 10-15% in recent weeks and they now look exceptionally cheap.

In a concentrated portfolio it might make sense to cut IOG and switch into **Serica** which is trading at 316p currently. I still think IOG is worth persevering with for now at these levels but would like some proper exposure to the theme; so will spend some of our cash on Serica.

Other fallers

Elsewhere, **Motorpoint** fell 18% after a trading update. We have long liked the company's strategy and positioning but its investment in growing market share at a time of a weakening market makes for an uncomfortable P&L. **Kape** fell 13% and trades on a prospective p/e of 6x. We wrote the stock up last month and cannot add any more other than to say it looks even cheaper now. ■

Please do bear in mind that this is purely an exercise. We hope you find it interesting; but the GCI Portfolio does not constitute investment advice and will not be suitable for everyone. Actual 'real world' results might differ from those presented in the magazine. Individual investors should always seek personalised investment advice from a professional. The GCI Portfolio includes dealing costs and dividends.

Market Outlook

Gas price weakness and lower gilt yilelds are very welcome, but do not signal an end to inflationary pressures

The Editorial (see page 3) observes that while a week can be a long time in politics, a month in current financial markets can feel closer to an aeon. In late September we had a collapsing gilt market and sterling heading rapidly toward parity with the dollar. Amazingly, the 10 year gilt now yields 0.5% less than its US counterpart and a pound is worth $1.15 and €1.16. The mini-budget no doubt had an influence but the dramatic moves in the bond markets were not confined to the UK and the dollar's unilateral strength exaggerated the weakness of sterling. Pension fund LDI-related margin calls played their part in turbo-charging the gilt market's downward move and the UK government's PR presented an open goal for anyone who fancied shorting bonds or choosing a currency pair to short against the dollar.

These gyrations show up in the rebound of the FTSE 250 over the month which is the best index proxy for UK plc. Clearly the return of a sub-4% gilt yield helps valuations and government finances. The weakness in the gas price also provides some relief for households and the government's energy bill support scheme. However, it is too much to hope that this signals an end to the inflationary pressures for this cycle. Gas storage will need refilling as winter usage increases and has benefited from an unusually mild autumn. Meanwhile the Brent oil price has recovered 14% from its low a month ago to $94. Experience tells us that inflation simply does not disappear after spiking upwards – there will likely be aftershocks and further adjustments over the coming months at the very least.

Markets seem to be moving on daily speculation over whether the Fed and other central banks will 'pivot' away from their tightening trajectory or whether there is more to come. The monetary authorities in the western world have lost so much credibility over the last decade that one would expect them to err on the side of hawkishness in order to recover their reputations for prudence. On the other hand, some persistent inflation might be the price we pay to avoid crashing the economy.

We have remarked several times that the stock market has (as usual) moved well ahead of earnings downgrades. These are starting to come through. **Meta** (aka Facebook) delivered a shocking Q3 this week and fell 25% on the day and it has now fallen 74% from last year's high. Bear markets tend to destroy the sector and stock leadership of the preceding bull and the scale of Meta's downfall suggests we have moved a long way through the process. **Amazon** has also plummeted on its Q3 figures in accordance with this script. It will be informative to see whether the wider indices hold up or break to new lows in reaction to this newsflow. ■

CAPITAL RETURNS TO 27 OCTOBER 2022

	AIM	FTSE Small Cap (ex. ITs)	FTSE Mid-250 (ex. ITs)	FTSE 100	S&P 500	Nasdaq
1 month	-1.5	0.6	5.7	1.3	4.4	-0.3
Year to date	-33.5	-24.7	-24.7	-4.2	-20.1	-31.0
1 year	-34.0	-24.8	-24.1	-2.5	-16.4	-29.2
3 years	-9.1	6.3	-13.8	-3.4	26.0	30.9

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Best of the Blog

Angling Direct is a good example of a company with a valuation that does not reflect its balance sheet

"Severe bear markets like the one we are currently enduring throw up some extreme deep-value situations.

Often this means having to grit your teeth and assume existential risk. If there is a lot of debt on the balance sheet it could end up sinking the company or destroying equity value, making the outcome binary: either the company survives and the shares go up a lot; or it fails. However, it is possible to find several situations in the microcap world where survival seems almost guaranteed yet valuations are distressed. A strong balance sheet combined with rock-bottom valuation means 'only' patience and nerve are required.

A good example is **Angling Direct** (AIM: ANG) to whom I spoke after this week's July interim results. Here are some stats:

Share price	29p	Net current assets	£24.1m
Market cap	£22.4m	Stocks	£17.1m
Net cash FY Jan '23	£14m	ev/sales	0.1x
Enterprise value	£8.4m	ev/stocks	0.5x
Revenue FY Jan '23	£73.8m	ev/ebitda	3.8x
Leases	£11.6m		

Broker net cash forecasts were downgraded modestly along with profits due to current weak trading and uncertainty surrounding the outlook. However, ANG is still expected to report a healthy net cash position, giving an enterprise value (market cap minus net cash) of just £8.4m. This is half the value of stock in the interim balance sheet. The stock trades at a 28% discount to its net tangible asset value of £31.3m (40.5p per share).

Net current assets (stocks plus cash plus debtors; minus creditors and lease liabilities) stood at £24.1m which is 8% more than the stock market values the whole company at.

Being debt-free and having meaningful liquidity is a huge comfort in uncertain times. True, the company has leasehold obligations, but these are also nuanced. For example, its new European distribution centre in the Netherlands has a five year break-clause and management told me they had negotiated the right to sublet the property when agreeing the lease. The company has no intention of exiting Europe, but the point is that lease liabilities are often not as onerous as debt owed to the bank. At January's balance sheet date only £4m of lease liabilities extended beyond five years.

The ev/ebitda ratio is very low at 3.8x. This incorporates a downgrade and uses the lower pre-IFRS 16 ebitda forecast. Last year the company made £5.2m ebitda so the historic ratio is just 1.6x.

That historic ebitda number also understates the earnings potential of the company which is still at a relatively early stage of its development. It aims to be a category killer in the highly fragmented fishing tackle sector. This means growing market share through its stores and online, which involves balancing near-term profitability and cash conservation with investing in growth. It aims for a gross margin around the current 35% region in the UK, so the benefit of increasing own-brand content in the sales mix is being reinvested to maintain price leadership. Europe suffered start-up losses of £0.7m in the first half due to marketing costs and keen pricing. Management told me the second half gross margin should be more resilient with supplier price rises slackening off and more focus on raising margins in Europe.

Fishing ought to be a relatively resilient sector. It is an affordable pastime and a good stress-buster. Expensive equipment sales might slow but on the other hand ANG earns good margins from bait sales which are more like a recurring revenue line. A big problem this year was the unusually high temperatures in August, usually ANG's strongest month. This deterred both fishermen and fish (fish can be distressed by associated low oxygen levels in water and are more reluctant to feed). September saw some recovery but trading is generally volatile and unpredictable with the best week so far in the second half up 18% on last year and the worst down 44%. This uncertainty encouraged management to downgrade forecasts to "not less than £2.2m ebitda" for the current year to January.

The shares fell from 36p to 32p when the company updated on trading in August when ebitda was guided down to £3.0-3.4m and dropped another 10% on the interims when the latest £2.2m minimum forecast was introduced. Despite the disappointment, management deserves credit for timely updates and in particular for putting the numbers in the RNS. The broker forecast for 2024 is an improvement to £2.7m ebitda which compares with £4m in FY 2021 and £5.2m in FY 2022. So expectations are set at levels that offer a lot of recovery potential. Of course further downgrades are possible but the upside is substantial – a return to last year's profitability and a still-modest 5x ebitda multiple implies a share price of 72p. ■"

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AIM Newcomers

Company	Sector	Adviser	Type of issue	First dealings	Market cap (£m)	Issue price (p)	Funds raised (£m)
Aurrigo Intl	Technology	Singer	Placing	15/9	20.6	48	8.0

AIM Movers – 1 month to 27 October

AIM 100 index

Risers	%
Atalya Mining	44.7
Seeing Machines	29.9
Cerillion	27.0
Impax Asset Mgt	26.7
Boku	26.6

Fallers	%
Inspecs	-64.8
GB Group	-39.4
Watkin Jones	-37.4
Numis	-29.1
ITM Power	-26.5

AIM All-Share index

Risers	%
Trackwise Designs	169.2
Quadrise Fuels	103.5
Baron Oil	75.0
7Digital	73.7
MobilityOne	71.3

Fallers	%
Parsley Box	-83.2
Xeros Tech	-79.3
DeepVerge	-73.5
Glantus	-70.3
TPX Impact	-65.2

Companies in this issue