Kepler Trust Intelligence

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Miton UK MicroCap

After an exceptional 2020, MINI may yet have further to go...

Update
06 April 2021

Summary

Miton UK MicroCap (MINI) aims to provide shareholders with capital growth over the long-term. Managed by Gervais Williams and Martin Turner, MINI typically focusses on investment in companies with market capitalisations of less than £150m, usually listed on the AIM market.

As discussed under **portfolio**, MINI was launched in 2015 with a view to positioning an investment vehicle for the longer-term cycle that the managers perceived to be in the offing at the time. There is a deep underlying theme running through the structure of the trust, emphasising a reversal of many of the economic trends of the past three decades. Ultimately the managers expect this to result in reshoring of businesses, rising wage inflation and a change in market leadership.

They note that the UK market offers a hugely attractive subset of micro-cap companies which stand to benefit from precisely such a scenario. Operationally, many of these companies have, and will likely retain, relatively endogenous drivers of growth. Yet, as noted under **portfolio**, Gervais and Martin believe these companies are often ignored and that there is a large opportunity set in financially robust companies.

As discussed under **performance**, MINI is by a significant margin the strongest performing trust in its sector over the 12 months to 15/03/2021. Yet the managers believe we are only in the foothills in a substantial market rotation that should provide them with further tailwinds going forward.

Despite the exceptional performance, MINI remains on a **discount** of c. 8.6% (as at 15/03/2021). The board offers a redemption facility annually, which allows shareholders the opportunity to exit at or close to NAV.

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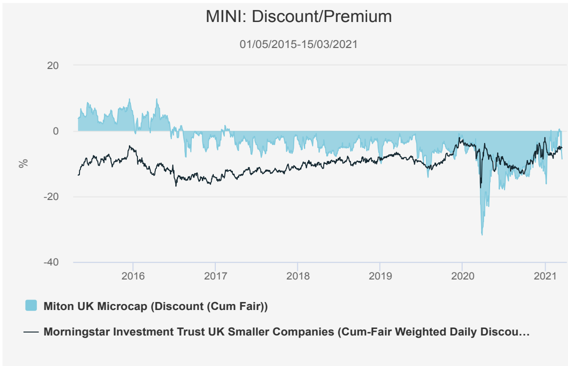
Key Information:

Price (p)	95.4
Discount (%)	-1.4
OCF (%)	1.63
Gearing (%)	-4
Yield (%)	0.1
Ticker	MINI
Market cap (£)	106,156,119



Kepler View

MINI is a portfolio constructed with a specific outlook (discussed under **portfolio**) and designed to reflect the optimal manner in which to invest should that outlook materialise. **We have significant sympathy** for this big picture outlook, though the enormous consequences of breaking out of a 30-odd-year cycle and the heuristic bias of the market is likely to mean that relative returns will encounter some near-term volatility as investors waver over the durability of the new direction.

Yet we agree MINI's process, built to capture these opportunities over the long-term whilst managing short-term risks, is well-suited to the task. The massive outperformance already enjoyed by MINI investors in recent months is, we would say, a validation of the argument that even small rebalancing of portfolios into this area can cause outsized returns due to the illiquid nature of the market. And yet, MINI's portfolio remains on a discount to the wider market.

Despite the focus on ensuring there is a margin of safety at the individual stock level, we think shareholders should be prepared for volatility; as we discuss under **discount**. The volatility that can arise in times of market stress from the illiquidity of the underlying portfolio is often matched by volatility in MINI's discount. However, we think the redemption facility should serve to anchor the discount over the long-term.

BULL
Highly differentiated investment proposition
Compelling structural growth opportunity which has started to see validation
Current discount level looks highly attractive, and annual opportunity to exit at or near NAV

BEAR
Underlying thesis may yet face further challenges, with likely knock-on effects
Charges are above average for sector
The diminutive nature of the trust's investment universe likely puts a ceiling on ultimate growth in assets

Portfolio

Miton UK MicroCap Trust (MINI) aims to provide shareholders with capital growth over the long-term. Managed by Gervais Williams and Martin Turner, MINI typically focusses on investment in companies with market capitalisations of less than £150m within the AIM market. Due in part to market structure, but also sustained macroeconomic trends, Gervais and Martin believe that there is a very significant universe of under-researched companies eschewed by most professional managers, who are unable to absorb the liquidity risk of holding small companies with relatively low daily traded cash values.

The managers are keen to ensure that the primary driver of the portfolio is stock-specific factors but maintain a broad-base of companies (currently around 128, as at 31/01/2021) to limit the stock-specific risk from any one position. Although the managers aim to ensure the majority of active risk is undertaken through stock-specifics (with Premier Miton estimating c. 83% of active risk having idiosyncratic drivers as at the end of January 2021), they are cognisant of top-down macroeconomic risks and trends, and will incorporate those insights both into stock-specific considerations and portfolio construction.

Indeed, it was following the identification of a potential long-term structural shift within the global economy that instigated the launching of MINI in April 2015. Observing that the structural forces which had driven globalisation were starting to retreat, the logical consequences of this were extrapolated. Gervais and Martin observe that over roughly the last 30 years we have been in a trend where barriers to the transfer of capital and goods were gradually removed. This in itself proved disinflationary, allowing larger companies to offshore production and reduce costs, before passing on some of these cost reductions to consumers to improve their competitive position relative to peers.

This further led to consolidation within industries on both a national and global scale, and, with increased market share and economic importance, so came greater ability of the largest companies to leverage these positions to further their own advantages. Operational efficiencies from integrating supply chains and increased regional economic specialisation further boosted nominal global economic growth but did so disproportionately to the benefit of the owners of capital and to the largest participants in consolidating markets.

Against this backdrop, markets have favoured ultra-long duration assets where the perceived pay-off remains some way in the future and has assumed increasingly optimistic growth forecasts. Investors have further crowded into these assets. Yet ultimately these trends have yielded diminishing economic returns and returns on capital deployed have fallen; productivity growth has stagnated for a decade. In the absence of productivity growth, and with a more concentrated corporate sector boasting increased bargaining power on wages, electorates are increasingly rejecting a status quo that offers them little tangible upside. Within the market, the managers note the possibility that the ongoing fallout from the Archegos situation may have an impact on the popularity of 'unicorn' stocks, and may see increasing pressures from prime brokers on hedge funds to reduce the deployment of gearing within their strategies.

The managers of MINI believe we are only at the beginning of a sustained longer-term cycle which they believe will see a reversal of offshoring, for example. Supply chains are expected to shorten and become more localised, and the relative aggregated bargaining power of labour is expected to increase (and so, therefore, labour's share of the economy will also rise). As real wages increase, marginal propensity to spend rises too, strengthening local economies in a positive feedback loop but also stoking inflationary pressures. The election of Donald Trump and the success of the Leave campaign in the Brexit referendum, followed by the defection of many lifelong Labour voters in the UK 2019 General Election, are regarded as indicative of the increasing use of the ballot box as a tool in the shifting of economic power, as are the increasing success of populist parties in Italy, France, Finland, Poland, and others, in the Western world. However, the appearance of these trends did not immediately become a tailwind to the strategy (and, indeed, the result of the Brexit referendum proved a headwind in the immediate aftermath).

Yet these factors will prove, they note, a significant headwind to the largest companies. Academic studies suggest that most productivity growth and innovation have historically come from smaller companies, and their larger peers will be less able to leverage their competitive advantages to undercut on pricing whilst pushing the cuts into their own supply chain to maintain their own margins, for example. Studies also suggest that smaller companies employ more people relative to revenue than their larger peers; as the competitive environment grows more disruptive, a feedback loop is created which further lends itself to increased upwards wage pressures.

In a more inflationary environment, which the above implies, the ability to return more immediate value to shareholders becomes more important and the likely current, crowded, positioning into long-duration assets could dissipate rapidly (we note the comments of Franco Modigliani from 2000 in this regard: "***The expectation of growth produces the growth, which confirms the expectation; people will buy it because it went up. But once you are convinced that it is not growing anymore, nobody wants to hold a stock because it is overvalued***").

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Yet the managers of MINI note that so systematically underinvested are most investors in small and micro-cap companies with shorter timeframes to value realisation and more modest growth targets, that even small rebalancing of portfolios into this area can caused outsized returns due to the illiquid nature of the market (as has been seen in recent months, as discussed under **performance**).

Gervais and Martin note that small and micro-cap companies often have growth drivers in their businesses entirely unrelated to the global macroeconomic cycle, a situation where, even if they can prove themselves resilient, larger companies will struggle to demonstrate the same rate of acyclical growth. They further observe that the UK market is relatively unique amongst global peers in offering a significant depth of smaller companies, with more companies with a market capitalisation of less than £150m than there are in excess.

From within this deep universe, the managers look to identify companies where they believe the cash paybacks on any investment are likely to occur within a relatively short timeframe and where cash returns can likely prove abnormally high if the company succeeds. Allied to this is an emphasis on balance sheet strength, with Gervais and Martin wanting to avoid dilutive share issuance. Given the extended levels of debt in the global economy, they believe that future requirements from investment will increasingly be undertaken through equity, and instead prefer companies which can finance through cash on the balance sheet.

Companies are assessed against five key considerations on a 'traffic-light' system.

Prospects for rising turnover – The team look for companies that increase their revenue regardless of economic conditions. Often, an infusion of capital can be key to value realisation; this can be seen in the current holding in Serabi Gold. In this instance, the company was looking to conduct an equity raise to provide cash to open a mine in Brazil. There was, in the managers' view, a clear path to cash payback of this equity raise that they had high confidence in.

Sustained margins – Is the company in a position to pass on any rise in input costs to the customer/consumer?

Management of risk – Is the company management team making value-accretive decisions for the long-term, or chasing more immediate gratification? Regular meetings are undertaken with remuneration committees, for example, to understand what the management team's incentivisation looks like.

Balance sheet strength – The portfolio will usually be comprised of companies with net cash balances, or those with modest debt. The managers prefer companies with abundant assets which can be utilised to generate additional cash paybacks in the future. Not only does an emphasis on balance sheet strength help provide resilience to a more challenging macroeconomic backdrop, it offers the company the potential opportunity to benefit by acquiring assets or businesses at low valuations from financially distressed sellers. Often these assets can be integrated with very significant positive multiplier effects to the original business.

Low entry valuations – The managers prefer stocks where the price reflects previous problems, rather than those where the price is based on future expectations. Despite very significant outperformance from MINI's book in recent months, they note that MINI still trades on a valuation discount to the wider market and peer group on a Price/Book basis. In some instances, such as the relatively long-standing holding in Kape Technologies, the managers have been able to add stock in the company to the portfolio at share prices which gave a market capitalisation lower than the net cash on the balance sheet.

Idea generation comes from bottom-up research and company meetings, amongst other sources. Where the team identify an attractive confluence of the above considerations, they look to initiate a position; there is not constraint on absolute or relative position sizing, but the managers are cognisant of ensuring the portfolio is diversified by both industry and across stocks.

Top Ten Holdings

HOLDING	%
Jubilee Metals Group	6.1
MTI Wireless Edge	3.5
Corero Network Security	3.0
Totally	2.3
Inspiration Healthcare Group	2.2
Accrol Group	2.0
Jadestone Energy	1.9
EQTEC	1.9
Trackwise Designs	1.8
Supreme	1.8
TOTAL	**26.5**

Source: Premier Miton, as at 28/02/2021

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Although Gervais and Martin are selecting stocks which typically have a fairly robust 'margin of safety', they are cognisant of the potential risks that market-level headwinds can cause to near term returns. As we discuss under **gearing**, they will structurally tend to run a reasonable level of cash within the portfolio. This, they note, gives them the optionality to be reactive in an indiscriminate market sell-off without having to necessarily incur more beta relative to the market through running net exposure in excess of 100%.

In addition, they have historically looked to incorporate 'put' options when the pricing to purchase these options is cheap. These derivative contracts are in part priced off of volatility. When market level volatility is low and the pricing of these options relative to the potential level of protection they offer is cheap, the managers will look to incorporate these. As discussed under **performance**, the gains generated by the sale of these options provided a very significant return of cash in March 2020 which Gervais and Martin were able to deploy into a raft of attractive stock opportunities. Volatility has remained elevated since, however, making these contracts more expensive to purchase and reducing the potential payout. During our discussions, Gervais indicated that he anticipated a higher volatility environment looking forward, and hence the cost of such options makes it unlikely that MINI would have similar opportunities to initiate such protective strategies in the future.

Gearing

MINI had net cash of c. 6.2% (as at 31/01/2021). This level of net cash is fairly typical for the trust, with the managers preferring to retain a buffer to rapidly access any new investment opportunities that may arise. Cash balances moved sharply higher during March 2020 as the put protection was sold for a significant profit and the cash recycled back into the portfolio at an opportune moment.

However, the trust is permitted to gear up to 15% of NAV (at the point of deployment). This is undertaken via a £5m (c. 4.7% of NAV as at 09/03/2021) revolving credit facility with Royal Bank of Scotland, with an initial term until 2024. The trust has the option of increasing this by a further £7.5m, giving total gearing capacity of c. 11.8% of current NAV.

Gervais and Martin have yet to utilise the gearing facility since launch. However, they may do so in the future should they deem a truly exceptional buying opportunity to have arisen. As we discuss under **portfolio**, they believe it is less likely that they will be able to hold a similar level of put protection in the future as they did in Q1 2020, as they do not think such an extended and benign volatility environment (making accruing option protection relatively cheap) is likely to recur. Accordingly, without the cash injection that the sale of protective options provided in the most recent drawdown, a similar sell-off could potentially see them deploy cash balances and possibly utilise a small amount of gearing. However, outwith such extreme circumstances we would not expect to see MINI use gearing on an ongoing basis.

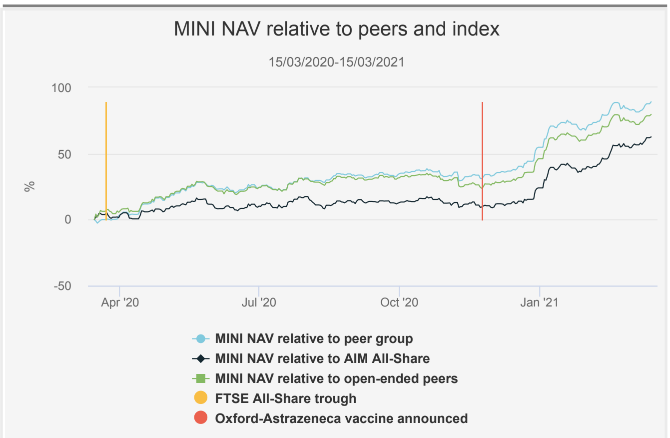
Performance

Returns from MINI have been exceptional over the previous 12 months to 15/03/2021 (with 15/03/2020 close to the market bottom after the coronavirus crash), with the strongest returns within the Morningstar UK Smaller Companies peer group over this period on both a NAV and share price total return basis (Source: The AIC). Furthermore, this has not been by a small margin. The 12-month NAV total returns of c. 125.7% over this period are c. 40% greater than the second-best performing trust within the peer group achieved over this timeframe, whilst the peer group on average saw NAV gains of c. 36.5%. A narrowing discount meant that MINI shareholders benefitted to an even greater extent, with share price total returns of 136.8%.

Whilst MINI does not have an official benchmark, we note that the FTSE AIM All-Share index returned c. 63.1% over this period. This index is not particularly reflective of the subset of the market MINI is focussed on, covering a far broader swathe of often much-larger companies outwith the strategic area of opportunity identified by the managers.

We show MINI's NAV performance relative to the broader peer group, relative to open-ended peers, and relative to the FTSE AIM All-Share index over this period in the chart below. After displaying more rapid recovery from the downturn than comparators, the rate of outperformance tempered somewhat before accelerating rapidly after the announcement of the development of a COVID-19 vaccine on 23/11/2020.

Fig.1: MINI NAV Returns Relative To Peers And Index



Source: Morningstar

Past performance is not a reliable indicator of future results.

The holdings in put option contracts will have helped offset NAV drawdowns in the worst of the crisis on a mark-to-market basis, and their sale in March 2020 supplied Gervais and Martin with a substantial capital boost. We note from MINI's previous annual report that, in the financial year to 30/04/2020, the sales of derivative contracts contributed a net c. £2m to returns, on a market cap of c. £60m and NAV of c. £71m as at 30/04/2020. Whilst this helped offset downside participation on a NAV basis, the indiscriminate nature of the sell-off meant that MINI suffered nonetheless.

Whilst a cash buffer further helped, the realisation of these put contracts ensured Gervais and Martin had the opportunity to deploy new capital into severely beaten-up stock opportunities and has helped them significantly exceed market upside in the recovery. Initial upside was boosted as corporates themselves in some instances sought to take advantage of cheap valuations to buy other companies. Takeover activity for companies such as Rockrose saw these companies bought for significant premiums to their market value, and boosted MINI's upside capture.

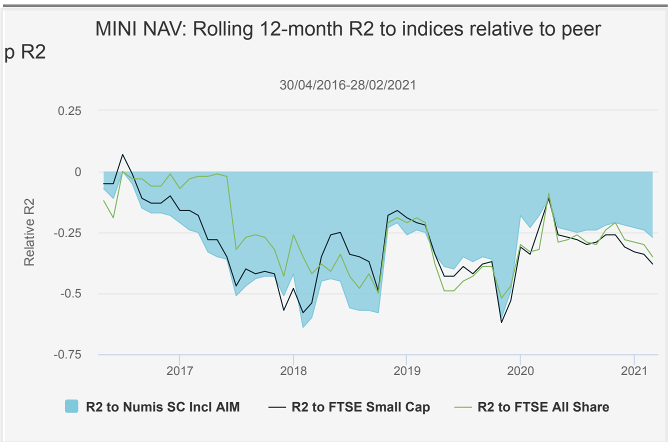
We would suggest that much of the acceleration of outperformance post November 2020 has been the result of marginal market order flows reassessing basic solvency expectations of lightly owned areas of the market.. In areas with thin liquidity (due to low free floats), low-to-zero wider analyst coverage, and little institutional ownership, small increases in net buying pressures can have outsized upside benefits as market makers struggle to match selling orders to buyers.

Gervais and Martin have noted that the thin coverage and thin participation of professional investors in the micro-cap market should afford opportunities for relatively lowly correlated returns to broader stock markets, where total return outperformance need not be achieved solely through the assumption of additional market risk (beta).

In the chart below, we can see that MINI's NAV has proven less correlated to wider UK equity indices than the Morningstar UK Smaller Companies peer group average has. This shows the rolling R2 of MINI minus the rolling R2 of the peer group, so when the line is below 0 it shows that MINI was less correlated than the peer group average over the preceding 12 months to that point.

Thanks to this strong 12 months, MINI has now significantly outperformed since launch. It has generated NAV and share price total returns of c. 107.5% and c. 80.2% respectively to 15/03/2021. This represents outperformance of peer group and AIM index, though we reiterate that the strategy is focussed on identifying opportunities very much within the lower market cap bands of this broad index.

Fig.2: MINI NAV: R2 To Indices Relative To Peer Group

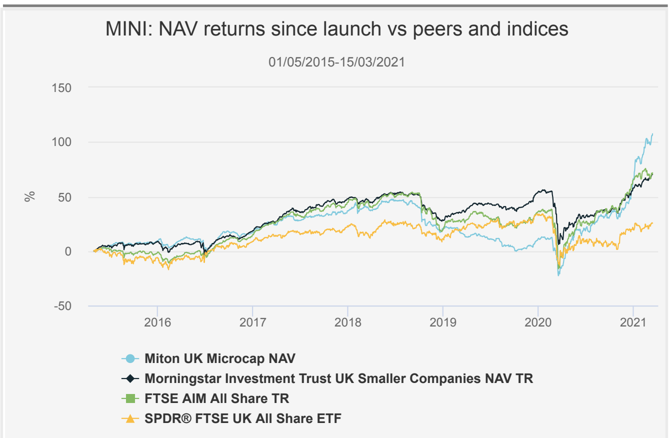


Source: Morningstar

Past performance is not a reliable indicator of future results.

As we can see in the chart below, much of this outperformance has been generated over the previous 12 months. The post-Brexit period proved challenging as an absence of market recognition of value opportunities proved a headwind to many micro-cap opportunities. Stock-specific headwinds persisted, but often included drawdowns in the market value of companies to the point where the market value was at or near the level of net cash companies held on their balance sheets, essentially valuing other tangible and intangible assets as worthless. Gervais and Martin believe the structural pathologies which have proven a tailwind over much of the last 12 months are likely to persist in a new long-term market cycle.

Fig.3: MINI: NAV Returns Since Inception Vs Peer Group Average Nav Returns And Aim Index



Source: Morningstar

Past performance is not a reliable indicator of future results.

It's reasonable to question whether the degree of recent outperformance can be realistically expected to repeat. Yet we note the current circumstances are seemingly aligned with the founding philosophy of the trust (as discussed under **portfolio**). Whilst the specific circumstances are perhaps unlikely to be repeated, should we see an extended cycle in line with the managers' expectations then, this should, we think, continue to prove supportive. The 'hunting ground' of the micro-cap universe will likely remain too illiquid for many or (indeed) most professional investors in most instances, so valuation opportunities should remain. Yet value-accretive corporate transactions should continue to attract wider attention and provide routes to value realisation.

Dividend

MINI shares currently yield c. 0.1% (as at 18/03/2021) on an historic basis. Whilst the generation of cash within portfolio companies is a focus of the investment process, this need not necessarily extend to looking for dividends. Revenue returns within MINI saw drastic cuts over much of 2020, as many constituent companies (in line with the rest of the UK market) took precautionary action to defer or cancel dividend payouts. MINI's managers also undertook a degree of rotational activity, and there was a trend towards exiting positions which paid higher dividends (with some positions also subject to takeovers). Given the focus of the managers on balance sheet strength and the optionality this affords company management teams to undertake value-accretive acquisitions or capital expenditure in times of economic stress, we think a decline in aggregated dividends from the underlying portfolio in such a period is entirely in keeping with the management style.

However, the managers do note that they anticipate that, as companies mature and grow, they will often be in a strong position to return excess cash flows to investors via dividends. Whilst income will prove a by-product of the investment process within MINI, we expect there will be certain years where higher distributions, in line with what has previously been seen, are paid out. Revenue reserves, however, are low, and it is unlikely there will be significant recourse to using these to boost distributions.

Management

MINI is managed by Gervais Williams and Martin Turner of Premier Miton. Gervais joined Miton in March 2011 and is Head of Equities of the company. After starting as a portfolio manager in 1985, Gervais has spent the majority of his career as head of UK smaller companies at Gartmore. Martin Turner also joined Miton in 2011 and has had a long-term working relationship with Gervais. Martin has widespread experience in the investment world as head of small/mid-cap equities, at companies including Rothschild, Merrill Lynch and Collins Stewart.

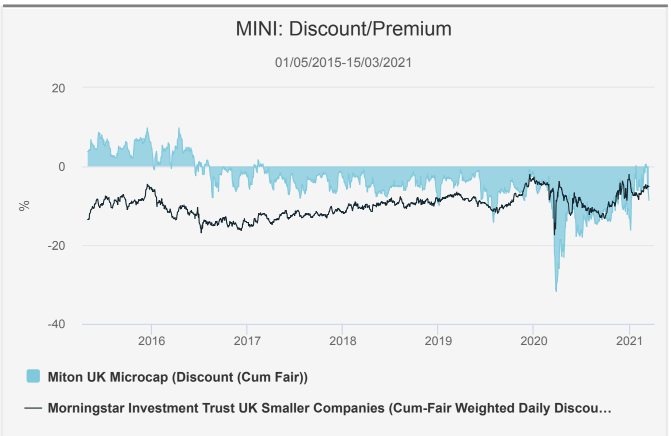
Both Gervais and Martin are part of a tight-knit team of six UK-focussed managers at Premier Miton: an asset management firm that has genuinely active management at the core of its business. The company runs multi-asset and equity funds, as well as investment trusts.

Discount

MINI currently trades on a discount of c. 8.6% (as at 15/03/2021), well below the average discount since launch (on 01/05/2015) of c. 3.7%. As the graph below shows, the trust first moved to a modest discount in 2016, against a backdrop of more muted sentiment towards domestic UK assets following the Brexit referendum. Whilst the redemption structure operated by MINI helped to support the discount somewhat, the discount proved relatively intractable before a rapid deterioration in market sentiment led to further discount widening in Q1 2020.

The discount narrowed sharply in recent months as share price gains outpaced NAV gains. Interestingly, this presaged announcements of the successful developments of COVID-19 vaccines and we accordingly do not think this reflects merely a relief rally. Similar dynamics can be somewhat seen in the broader UK Smaller Companies sector, but more mutedly amongst the UK All Companies sector. In part we think this likely reflected the tentative steps of investors starting to align themselves for a more 'risk-on' environment that escalated into accelerated upside, but also perhaps the start of a more positive reappraisal of the wider UK market. Sentiment surveys still suggest institutional investors are underweight the UK market (as do lower market valuations), but they also show this has started to come in. We think that, if the more positive relative outlook for the UK market can be sustained (**as we think likely**), then this narrowing of the discount is likely to prove 'sticky'.

Fig.4: Discount/Premium



Source: Morningstar

MINI operates a redemption facility, which allows shareholders to request the redemption of all or part of their holdings at a price at or close to NAV on an annual basis. This is operated at the discretion of the board. This is designed to avoid the presence of any large overhang of sellers, should an institutional holder wish to exit a large position. In the previous redemption period in June 2020, c. 27 million ordinary shares were redeemed, equating to c. 19.5% of the free float at the time.

Charges

MINI has an OCF of 1.68%, above the unweighted average of the AIC UK Smaller Companies sector 1.08% (Source: JPMorgan Cazenove). The OCF is inclusive of the management fee, which was reduced to 0.9% from 1% of the market capitalisation in September 2020. Premier Miton has agreed that if necessary it will rebate a sufficient level of management fee so as to ensure the OCF does not exceed 2%.

The KID RIY figure is 1.93%, above the unweighted sector average of 1.89%, though we would caution that calculation methodologies can vary. We would comment that we think this reflects in part the smaller scale of assets but also above-average turnover that will typically be seen. Fees, as with other costs across the trust, are charged at 75% to capital and 25% to income.

ESG

Environmental Social and Governance (ESG) factors are considered throughout the managers investment process. The approach emphasises engagement with management teams as opposed to an exclusionary policy, and the trust has several holdings in areas such as oil & gas where investors with exclusionary ESG criteria might not traditionally allocate. Meetings with remuneration committees are undertaken on an ongoing basis, seeking to understand compensation packages and what management behaviours they are likely to incentivise. External ESG research is also utilised, but due to their size many of the underlying companies will not typically appear on broad ESG screens themselves. Accordingly, purely quantitative assessments of MINI may not give a full picture of the integration of ESG considerations to the investment process. Morningstar Sustainalytics, we note, does not currently produce an ESG rating for MINI, likely in reflection of the fact the underlying holdings do not themselves have ratings.

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