



SPOTLIGHT ON OUR SMALL CAPS



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Following the three papers we published in the wake of the Covid-19 market sell-off ([‘Positioned for recovery’](#), [‘The value puzzle’](#) and [‘Fund dividend update’](#)), this paper looks specifically at the Fund’s small cap exposure. This dovetails with the second report and provides further weight to our view and that paper’s conclusion: we now have one of the best quality portfolios (within the value part of the market) in the Fund’s 15-year history. This follows the changes we made since the start of the pandemic. These changes pivoted the Fund towards better quality stocks but, importantly, still clearly in the ‘value’ part of the market.

Small cap weighting and performance

Since we launched the Fund in November 2004, our small cap weighting has varied between 2.5% and 23%, with a formal cap of 25%. The table below shows the Fund’s market cap breakdown at the end of June, which is similar to its position today.

Following the well-publicised events at funds elsewhere in the UK Equity Income universe, we reduced our small cap weighting in June 2019 from c. 22-23% to c. 18-19%, with a new soft cap of around 20%. Without this c. 20% ceiling we would have a materially higher exposure. This is because the upside opportunity is so significant, as we detail in this paper.

The next table shows that our small cap holdings have been an important driver of the Fund’s overall relative performance since inception. The scale of the outperformance in a number of years (e.g. 320bp in 2010) has been significant relative to the average capital allocation, which has been c. 15% across the 15-year period.

Fund market cap

	Fund weight (%)	Index weight (%)	Active weight (%)
Large cap	66.59	80.61	-14.03
Mid cap	13.74	16.20	-2.47
Small cap	18.18	3.19	+14.99
Cash	1.50	0.00	+1.50

Source: JOHCM as at 30 June 2020.

Fund relative return contribution

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Mid cap	+11.0%	+3.7%	+0.7%	+6.6%	+5.9%	+3.0%	+2.8%	-1.3%	+1.5%	-1.4%	+3.1%
Small cap	+2.7%	+3.2%	-0.8%	+2.8%	+2.9%	-0.6%	+1.8%	-1.1%	+2.8%	+1.1%	-0.4%

Source: JOHCM/Statpro as at 31 December 2019. Benchmark: FTSE All-Share TR Index (12pm adjusted).

In recent years the performance contribution from our small cap names has been reasonable but less material. It has been a tough few years for small caps in general. The Brexit vote and subsequent political paralysis, the Woodford Equity Income Fund’s high profile liquidity travails, and, most recently, Covid-19 have all hurt sentiment and hit asset flow to this part of the market.

Despite these serious headwinds, as the table above shows, the Fund’s small cap component has, on average, made a slight positive relative contribution over the past four years. It is this context, though, and these headwinds that have created the considerable opportunity that we detail in this paper.

This table also shows how powerfully the Fund performed in 2009-10. This came after we had had a period of difficult performance during the financial crisis, similar to what we have seen since the start of Covid-19.

Our current small cap exposure

As mentioned above, we currently have c. 18% of the Fund’s capital employed in small caps. The table on the next page highlights the bulk of this exposure and all the sizeable individual names. In the next section we provide a few words on each stock – the fundamental position and the valuation. There are common themes here: Covid-19-related policy response or related supply-side change beneficiaries; being on the front foot; and very cheap valuations. For each stock, we have also highlighted the potential upside using very prudent assumptions.

SThree is a global leader in STEM recruitment whose main end use markets are life sciences, technology and engineering (including themes such as AI). This market footprint is in the middle of trends that will accelerate due to Covid-19 (e.g. working from home, technology adoption), or in sectors that are benefiting (life science). SThree’s main markets are Germany and the USA.

The recruitment group saw an initial drop in revenue in the second quarter of 2020 that was smaller than forecast and materially better than its broader competitors, such as Hays. Recent commentary from management suggests the recovery will likely be strong due to the end use market exposures. SThree grew 25% p.a. over the six years pre-Covid-19, and management had pre-pandemic ambitions to double earnings over five years, based on the likely acceleration of the markets in which the company operates.

SThree's share price is down 33% since February. It has net cash on the balance sheet. If the management team were to reach the previous earnings targets, the stock would be on a P/E of c. 4x. On a typical P/E of 12x, the stock has 200-300% upside scope over time. And, as with a number of stocks discussed in this paper, SThree is a potential takeover candidate. It occupies market positions that all the larger global recruitment companies covet and are now trying to pivot towards in a Covid-19 world.

DFS is the dominant player in the UK sofa market. It has 34% market share with its competition in retreat. As a result of Covid-19, the third-largest operator, Harvey's Furniture, has entered administration and two other smaller competitors have suffered the same fate. Consequently we believe that a 40%+ market share is a realistic target in the next few years.

Self-evidently sofas cannot be disintermediated by the internet, which is why DFS is our only general retail stock. Its cost base is likely to fall as a result of Covid-19 as retail rents decline and marketing spend can be trimmed given a reduced competitor set, particularly given Harvey's demise. With people likely to be more focused on their home and furnishings in a post-Covid-19 world where staying in is the new going out, and due to some pent up demand, June's trading update highlighted like-for-like revenue growth of +69% in recent weeks. Modelling single-digit revenue growth and market share capture, and using the same 12x P/E we used for SThree, would give 60% upside in the share price from its current level and these revenue and market share forecasts should be beaten.

Randall & Quilter (R&Q) is an insurance company that has been quietly repositioned over the last few years and has recently appointed a new CEO to accelerate this strategic change. It has two business lines, both of which will benefit from the consequences of Covid-19 on the insurance sector.

The first business acquires and manages legacy books (effectively it is a smaller version of Phoenix Insurance, a large cap stock also held in the portfolio). Brexit and regulatory change, along with Covid-19, are leading to an acceleration of deal flow, with returns >15%.

The second area has more underlying growth as R&Q acts as an agent between the customer-facing insurer and the reinsurance community, taking a 5% commission in the process. The business started 2-3 years ago, has a run rate of written premia of US\$900m, with a two-year premia target of US\$2bn and an annual earnings target of US\$50m.

Valuing the first business at 1.5x book value (in line with the 15% ROE) and the second business on a P/E of 15x (a discount to peers) would create a target share price of 363p versus the current share price of 155p. The company raised US\$100m off-market from private equity insurance capital to accelerate growth post-Covid-19. We also think the new CEO is likely to do a better job of communicating the company's growth path, which means the fundamentals should be valued more appropriately by the market.














Asset manager **Polar Capital** has had a good crisis, helped by its growth-biased US equities fund and technology and healthcare-themed funds. Its most recent trading statement highlighted AUM back above previous peak levels, with strong asset flow momentum returning. It has best-in-class funds in Europe in the sectors that have led the market. It is also focused on accelerating this growth via the addition of new teams (the addition of a US-based Global/Global ex-US Value team being the most recent example), with small acquisitions also likely. The stock is on a P/E of 10x, has net cash and yields 6+%. As we laid out in our [first paper](#), we expect a major reversal of the value versus growth trade in the future. If this style unwind happens, Polar Capital will face headwinds, but the majority of the rest of our portfolio holdings would experience a strong tailwind. This is a very cheap, well-managed hedge on that view.

Central Asia Metals is a small cap mining company whose main metal exposures are copper and zinc. As we have written previously, we expect these commodities, particularly copper, to be well placed given demand from clean energy investment and electric vehicles. The copper price is now back to a one-year high due to Covid-related supply shutdowns and strong demand from a recovering Chinese economy.

The stock's valuation is very low; at 170p, the free cash flow yield is c. 20%. The company has limited debt and the shares should produce a normalised dividend yield of between 6-9% in 2021. This type of stock should trade on a free cash flow yield of c. 10% at the most, which would put the share price back where it was two years ago, which was double the current share price.

Diversified Gas & Oil is a consolidator of small conventional (mainly gas) wells in north-eastern USA. The acquisitions it has made have been at compelling prices reflective of distressed sellers. This has created a powerful network effect, as distance between each operation is low, prompting material improvements in margin and cash flow. A focused management team has also driven productivity of the acquired asset base higher. With production hedged two years out, the stock is on a free cash flow yield of over 20% and a dividend yield of 10%. The upside potential for this stock is material but less than similarly valued Central Asia Metals, reflecting the lower reserve life and higher fade rate.

Redde Northgate is the market leader in van rental in Spain and UK. Whilst there was an initial Covid-19 hit to rental activity, there appears to have been a recovery in hire rates as a result of strength in key end use markets (construction and logistics/parcel delivery

Fund small cap exposure	
Stock	% of portfolio
 s three	1.50%
 dfs	1.45%
 R&Q	1.40%
 DIVERSIFIED GAS & OIL	1.40%
 CENTRAL ASIA METALS PLC	1.30%
 redde NORTHGATE	1.20%
 POLAR CAPITAL	0.80%
Construction	
 COSTAIN	4.00%
 GallifordTry	
 norcros	
 SFR	
 eurocell	
 KELLER	
 TYMAN	

Source: JOHCM

networks). There has been a supply shock to the van market, too, with fewer new vans feeding into the system during the lockdown months. This supply contraction, coupled with the higher demand, means prices have strengthened markedly as the market for used vans has reopened. Used van prices are a key driver of both profits and the company's net book value.

Redde and Northgate merged late last year, with Redde's more innovative and aggressive management team assuming leadership for the combined group. The synergies are likely to be higher than expected. The balance sheet is strong. The stock trades materially below the company's tangible book value, which is mainly made up of vans, and is on P/E of 5x. And like many of the stocks covered in this paper, we believe the share price could double.

Construction – the government's chosen path to post-pandemic recovery

The government is clearly targeting infrastructure and the housing market to underpin the recovery from the Covid-19 economic deep freeze. Infrastructure spending has accelerated, with HS2 confirmed and a series of road contracts announced since March. More recently, the July mini budget highlighted more construction-related spending.

It is also clear after the Carillion and Kier corporate debacles that the terms of trade for government contractors have improved, in both margin and cash flow terms. On the housing front, indications from estate agents, trading updates from house builders and other sources suggest housing activity has restarted strongly as lockdown has eased, with enquiries and exchanges moving back to pre-Covid levels.

We have c. 11% of the Fund in the construction sector, with 4% in small cap exposure. **Costain** and **Galliford** are contractors that have benefited from the increased contract awards mentioned above. Galliford's market capitalisation only trades in line with the value of its net cash. Based on an exit P/E of 10x and our earnings forecasts, Costain could see its share price more than double. If the board's own targets are met, it could treble from its current level.

Severfield is the UK's leading structural steel manufacturer for large buildings. It stands to benefit from higher infrastructure spending (particularly HS2) as well as growth in the build of data centres and logistics warehouses. It should also gain share from less well financed competitors in the sector.

Norcros, **Tyman** and **Eurocell** provide products that feed into the housing cycle, either new-build or repair and maintenance. There is also evidence in two of the three names of competitors failing, which will create significant market share opportunities. Valuations here are very low. Norcros, by way of example, is on a free cash flow yield in the recovered year of c. 20%.

Conclusion

By providing some bottom-up granularity around the fundamental prospects and the valuations of our smaller cap stocks, we hope that you understand why we are so excited about this part of the portfolio. As you can see, these are not embryonic businesses whose success depends upon technology disruption or a new business model to succeed. Instead they are well established and well-financed groups with experienced management and, in almost all instances, the opportunity to grow their market shares during this period of economic weakness. However, in all cases, valuations are extremely modest because the wider market has chosen to avoid these less-liquid stocks. Clearly we require greater capital upside to offset the lower liquidity in this part of the market. But as you can see, we think many of these stocks could double over the next few years, and many of them would still look fairly modestly valued. If the stock market chooses not to re-rate these kinds of stocks than many will be taken off the market by private equity or larger acquisitive companies.

JOHCM UK Equity Income Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	31.07.20	31.07.19	31.07.18	31.07.17	31.07.16
A GBP Class	-25.28	-9.50	9.83	26.45	-5.06
Benchmark	-16.81	1.33	9.17	15.33	4.06
Relative return	-10.19	-10.68	0.60	9.63	-8.77

Past performance is no guarantee of future performance.

Source: JOHCM / Lipper Hindsight. NAV per share calculated net of fees, net income reinvested, 'A' accumulation share class in GBP. Performance of other share classes may vary and is available on request. Inception date: 30 November 2004. Index return is net income reinvested, adjusted for 12pm.

Source: JOHCM/Bloomberg unless otherwise stated. Fund launch date 30 November 2004. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Any forecasted dividend yield quoted is prospective and not guaranteed. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. The Fund's investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. Source: JOHCM/Bloomberg/FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE" ® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.