ASSET CLASS
EQUITIES

Below the line of abandonment

UK MICRO CAPS

LIAM KENNEDY

Kestrel Partners exploits a structural inefficiency in the UK's micro-cap market

The UK's unloved micro-cap sector has stayed unloved in recent years for a number of good reasons – among them the pall of market disillusionment and uncertainty following Brexit and fallout from the collapse of Woodford Investment Management in 2019.

The Woodford episode served to highlight two factors – the lack of liquidity in the smaller end of the market-cap spectrum generally and the folly of wrapping illiquid securities in a liquid fund.

Max Royde, one of the founding managing partners at London-based Kestrel Partners, cut his teeth in small-cap broking, joining Peel Hunt in 1998 when he says UK institutional investors often had small-cap allocations all the way down the cap scale to £20m-30m.

A combination of factors has led to what Royde calls an "evisceration" of the small and micro-cap sector. Domestic institutional investors have cut their weightings to UK equities across the board in the past couple of decades in favour of global and emerging market equities on the one hand, and to private equity on the other.

"There are very few long-term, engaged investors left in our market." Royde says. "When I first started out in the market there were a couple of hundred and there are probably only half a dozen left today."

There has also been a clear drop-off in coverage of small-cap stocks by sell-side brokerage houses, an unintended consequences of MiFID II.

Mainstream small-cap managers have also shifted focus upwards towards larger market-cap sizes over the years. Many of the asset managers reporting in IPE's annual small-cap equities survey now include companies with market caps of up to €5bn in their eligible universe – up from about €1.5bn-2.5bn 10 years ago.

> **"There are very few long-term, engaged investors left in our market"**
> Max Royde

Globally, the largest constituent of the MSCI Small Cap index is worth about $8.5bn, while the median has a market cap of over $1bn.

This is a world away from the pool in which Kestrel fishes, where it defines micro-cap stocks as a market cap of below £300m.

Royde's term for this is the "line of abandonment" – below which liquidity, coverage and investors are sparse; £300m is about the current size of FTSE All-Share constituents like aviation specialist Menzies or the clothing retailer Superdry.

This combination of factors means the market is rife with mispricing and opportunities.

Kestrel invests solely in business-critical software companies applying a long-term buy-and-hold approach.

This is entirely a public equity strategy and all companies are listed on the UK AIM market – founded in the mid-1990s to attract growth companies to list in return for less onerous governance requirements. AIM now has over 800 constituents with an average market cap of about £80m.

The market "was a complete car crash" in 2009, as Royde puts it,

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when Kestrel set up shop.

After spending 10 or so years on the sell side at Peel Hunt, Royde was approached by Kestrel's founder and first chairman Ari Zaphiriou-Zarifi.

Royde says: "We basically fully agreed there was an opportunity to build an owner-like, engaged fund manager in the micro-cap space, taking significant minority positions, and working with boards to bring the companies to scale."

These firms typically have initial high costs of sale and similarly high implementation costs for clients, but they can become annuity-like cash compounders when they operate at scale, and they often have a global addressable market.

The pitch to management is typically some kind of turnaround and ongoing involvement, usually with a seat on the board.

Kestrel's task is to help overcome impediments to growth or to reset the company's strategy with a key focus on capital allocation – directing capital towards R&D, sales or acquisitions – thereby "bringing an owner-like engagement to the board".

Investee companies have strong balance sheets, very high levels of recurring revenues, "sensible" accounting policies and, as Royde puts it, "a dash of what most people in reality call activism but what is really owner-like engagement". Kestrel's position size is usually large enough to block unwanted takeovers.

One clear difference between this strategy and private equity is the lack of leverage. Another is the lack of control – Kestrel only receives the same information as other investors or board members and can only encourage management to do what it sees as the right thing.

"It's hard, but we normally get there in the end," Royde says. "It just takes a bit longer."

Liquidity terms

Kestrel currently holds 16 companies with an average market cap of around £110m. Liquidity terms for investors are a rolling 12-month lock-up, Royde says.

Current portfolio companies include Access Intelligence, a supplier of intelligence tools for PR and marketing, where Kestrel owns around 26% of the equity and sits on the board. One of its first investments was in a derivatives software specialist, FFastFill, which was sold to a trade buyer in 2013.

"The key lesson is that we are more and more engaged. We take even more responsibility for our ownership of the companies. This is something that very few investors actually do but we take our responsibilities as shareholders incredibly seriously.

"And that is giving the management team the confidence to run the businesses properly for the medium to long term, not focusing on short-term, stock market objectives."

If things go right, the gains can be considerable – and Kestrel's returns since inception of 19% annualised is evidence of this.

As Royde summarises: "We buy when it's moderately difficult and we typically sell when it's popular with the mainstream." So far, about two-thirds of exits have been by selling down to the market and about a third to takeovers.

With its small and highly concentrated portfolio, Royde freely admits that not every investment has gone well, including some early forays outside software. Kestrel has worked at refining its processes over the years and now intervenes much earlier.

"The really hard job is for companies to get to £20m-30m in revenues, but once you get to £40m, £50m or £100m, things become a lot easier. Scale and investment go up, your size, your sales even go up, and the number of clients goes up pretty substantially because you've got these enormously deep foundations of, basically, captive customers."

Kestrel recently analysed eight broadly equivalent mid-market stocks, which trade at a valuation of around 30-times EBITDA, while its own portfolio trades at about nine times. This disparity does attract attention, and Royde says Kestrel is now even getting approaches from special purpose acquisition companies (SPACs) – "that's how bad the mispricing is".

Kestrel's real issue is now to raise investor capital to execute its strategy at scale. Royde admits that the approach will simply not resonate with many institutional investors because of the liquidity and because the capacity is too small for many to make a meaningful allocation.

The firm also sits between two stools, to some extent, as it is neither fully private equity nor fully liquid equity.

However, with Brexit substantially, if imperfectly, resolved, the attention of international investors has turned to the valuation discounts widely available in the UK market. Many with the ability to deploy capital at the right sort of scale could find an interesting opportunity in British micro caps.

KESTREL PARTNERS
- **Location: London**
- **AUM: £328m (€385m)**
- **Founded 2009**

MAX ROYDE
- **2009- Managing partner, Kestrel Partners**
- **Board member of portfolio companies:**
  - **Gresham Technologies**
  - **Ingenta plc**
  - **Trailight Ltd**
- **Previously head of technology, Peel Hunt**

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