Equity Research;
UK Mid-Caps
'punch drunk'

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

Please note the risk warnings and disclaimers on the last page of this document.

'Events dear boy, events';

October has lived up to its notorious reputation with global indices lower. In fairness it is not a crash, but the mood has soured.

*Global events, the arrival of yet another 'open ended' war zone/ 'special military operation' in the volatile Middle East is problematic. It entails the risk of 'military creep' / escalation, a needlessly protracted conflict that could draw in other countries or spin off into proxy wars. Both logic and history attest to wars being very damaging, but in an age of nationalism at the expense of all other factors (economic, legal, humanitarian) they are sadly becoming more frequent.

The Russia/ Ukraine war is already 20 months old and unresolved. The war has displaced half of Ukraine's population. There is no global solution for those fleeing war, oppression, government bombing campaigns, ethnic cleansing, poverty, climate change etc.

*Uncertainty rises when an unquantifiable factor emerges. Despite ample risk aversion/ USD strength, which normally increases US T-bond prices, the 'group think' is that the US Federal Reserve and other central banks will remain steadfast until inflation is back to target. Gone is wishful thinking about sudden 'pivots' that ignore the problem of high inflation. The rise in US Treasury bond yields, (which are 'buys' according to both Morgan Stanley and the 'two Bills' Ackman and Gross) has been significant this month.

GT5:GOV **5 Year**	4.88	99.91	4.90%	+29	+71	5:53 AM
GT10:GOV **10 Year**	3.88	91.73	4.95%	+41	+94	5:53 AM
GT30:GOV **30 Year**	4.13	85.34	5.08%	+41	+94	5:53 AM

source; www.bloomberg.com

The rise in US bond yields across the curve reflects investor expectations that higher interest rates are here to stay, regardless of bond duration, investors need to be compensated anyway for political risks/ higher volatility that reflects geopolitical realities.

UK midcaps are 'punch drunk'

Volumes have been written about the post Brexit UK equity market. We are familiar with London's challenges notably its lack of IPO's and divergence from other major indices.

Arguably the biggest change in the last decade is not uniquely London related. Since 2018, the arrival of a growing population of >US$1trn 'mega-cap' stocks has posed a challenge to all non-US indices (the UK being one of them) that lack a mega-cap. If global equity ETFs focus on the top global 50 companies by market cap, then the reality is investors no longer 'need' to invest in non-mega cap countries.

Considerable divergence has taken place, i) between the ratings of US indices ii) between the ratings of large cap, mid cap and smaller cap indices.

The UK 250 is a real snapshot of UK plc with airlines, builders' merchants, challenger banks, asset managers residential homebuilders, property REITs, oil services, investment trusts, retailers, pubs, IT & software. It is quite an extensive mix of companies brought together by reference to their similar market capitalizations. Broadly speaking its boundaries are about £3.5bn (for a promotion to the UK 100) and about £350m (for a demotion to the UK Small Cap). The quarterly reviews of indices ensure companies are in the most appropriate index.

2023 has provided challenges for UK equity investors. But regardless of that factor, and looking solely at relative performance, a large performance gap has opened between UK large caps and their mid- tier brethren – **which has stretched to 10.33% over the last 12 months.**

source: www.ishares.com

The UK mid-cap index is also significantly cheaper (-14.48%) than 5 years ago – over this period i.e. since Q4 2018, there has been 25% inflation.

Over the 5 year period the UK mid-cap tracker, iShares Core 250 has underperformed by 16.47% in total with 10.33% in the last year.

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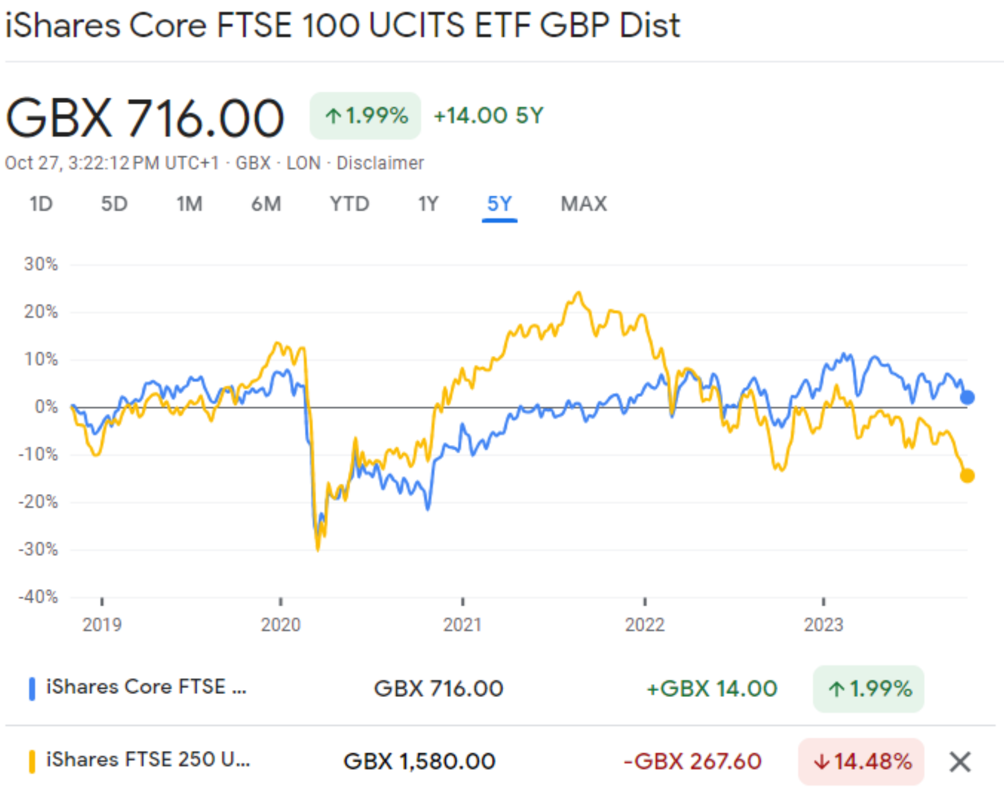

source: www.ishares.com

The reasons for mid cap divergence in 2023 can be attributed to:-

i) Lack of oil majors and mining companies in the mid cap index – commodity linked investment have outperformed in 2023.

ii) Tighter UK monetary conditions hurt smaller companies faster due to their greater reliance on bank syndicated variable funding.

iii) Weak sterling helps large cap companies due to their global footprint whilst mid-caps are sourcing more from abroad, hence cost of sales and margins are hurt by weak sterling.

iv) UK mid-caps are more sensitive to political turbulence. The next election is likely to return a majority Labour government whose fiscal approach will be more relevant to mid caps than blue chips.

According to data from www.ishares.com the tracker fund for the UK 250 index is exhibiting notable fundamental value features. Notably its P/E has moved down to 10.4x from normal levels in the mid-teens. The P/B (price to book) ratio has moved to 1.2x hence the entire index is being valued at just 20% above balance sheet net assets.

iShares FTSE 250 UCITS ETF

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Portfolio Characteristics

Number of Holdings as of 25/Oct/2023	234	Benchmark Level as of 26/Oct/2023	GBP 14,380.36
Benchmark Ticker	FTPTT250	12 Month Trailing Dividend Distribution Yield as of 25/Oct/2023	3.56%
Standard Deviation (3y) as of 30/Sep/2023	16.65%	3y Beta as of 30/Sep/2023	1.000
P/E Ratio as of 25/Oct/2023	10.40	P/B Ratio as of 25/Oct/2023	1.20

source: www.ishares.com

Plentiful levels of generous M&A activity in 2023

Evidence supporting the thesis of cheap UK mid cap valuations lies in significant M&A activity over 2023. Takeover activity, whether ultimately successful or not, has involved 11 mid cap companies and occurred in a multitude of mid-cap sectors.

Target	Acquirer	Premium	Sector	COMMENT
Civitas Social	Wellness	44.4%	Property	Completed
Ergomed	Pemira	28.3%	Pharmaceutical services	Completed
Hyve Group	Providence	41%	Exhibition services	Completed
Kape Tech	Unikmind	26.5%	Digital Security	Completed
Lookers	Global Auto	46.6%	Auto retailer	Completed
Mediclinic	Remgro (parent co)	23%	Private hospitals	Completed
Network Intl	Brookfield	58%	Payment services	Near to completion
Restaurant Group	Apollo	37%	Leisure	Ongoing
Renewi	Apax Ptns	54.4%	Waste & Disposal	Deal failed
THG	Apollo	45%	Personal Care	Deal failed
Wood Group	Apollo	70%	Oil Services	Deal failed

Source; CSS Investments Ltd

Furthermore average takeover premiums involving an offer from an unrelated acquirer at 45% have been generous. The lowest premium (23%), of Mediclinic International came from the parent company/ majority shareholder Remgro.

Conclusion

A financial rebalancing has occurred over 2023 as companies and consumers have re-prioritized their spending habits and undertaken balance sheet management. Some companies have paused their dividend payments to prioritise debt reduction, a step that is rarely taken well by shareholders.

Despite the poor context, it is difficult to see substantial downside risk in UK mid-caps. Indeed there should be a recovery in 'punch drunk' UK midcaps due to the inexpensive nature of their absolute and relative valuations, but also their recovery/ growth potential. Investors may be overlooking earnings growth heading into 2024 as higher pay settlements impact consumer demand.

The recent flurry of mid-cap UK takeover activity suggest interest from competitors, parent companies and private equity giants in making takeover approaches. Generally these offers have been generous and allowed shareholders to monetise their investments. Private equity interests already hold over 11,000 companies and the list is still growing.

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