BROOKS MACDONALD

AIM: A Compelling Investment Proposition

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London's AIM has recently experienced some performance issues and hit a 20-year low in listings. However, Ewan Millar, Senior Investment Director, and Joe Capaldi, Investment Director, discuss why there is much to be hopeful about for London's market for smaller growing companies.

AIM market: a recent history

London's AIM market has recently experienced a difficult period in 2022 and through much of 2023. High inflation and the resultant central bank interest rate hikes heaped pressure on stock markets in general but on AIM shares more than most.

Stock markets, particularly smaller-cap shares, can often be momentum-driven. It was undoubtedly a period of negative momentum that prolonged the market weakness following the initial sell-off of the AIM market. Valuations were compressed to almost unprecedented levels despite the fundamentals of the underlying companies remaining largely in good health.

New Labour government support

Before winning the general election, the Labour Party conducted a Financial Services review and outlined several supportive measures as part of a wider agenda to bolster UK economic growth. The review, titled 'Financing Growth', was co-signed by the now Chancellor of the Exchequer, Rachel Reeves. It explicitly supported the financial sector, stating that "we will unashamedly champion our financial services as one of the UK's greatest assets".

Key to the resulting proposals from a UK investors' perspective was a section titled 'Reinvigorating our capital markets'. This highlighted concerns regarding the recent decline in UK-listed companies and stressed the importance of capital markets in driving economic growth and innovation. In short, this included proposals that indicate likely ongoing support for growth-focused investments (such as AIM companies).

The proposals include a pension and retirement savings review, establishing a British Tibi scheme (named after Phillipe Tibi) and increasing retail participation in capital markets. A common thread throughout is supporting and promoting investment in UK plc assets and UK capital markets.

This suggests that despite some questions regarding the ongoing validity of the current inheritance tax relief on certain AIM companies, the new Labour government will likely continue to support it. The policy complements Labour's growth agenda by stimulating further investment in small and growing companies in the UK's junior (AIM) market.

The valuation gap

The AIM market's recent low was in October of last year. The Brooks Macdonald AIM Service returned 9.1% and 10.7% in November and December 2023, respectively. The sharp reversal in fortunes was a 'pivot' in expected central bank interest rate policy and a consensual belief that the next movement in interest rates would be a cut rather than another hike. Despite this partial recovery, there remains a considerable valuation gap. At the start of 2022, the average price-to-earnings (P/E) multiple of the companies in our AIM portfolio was 25x, but as at the end of June, it was just 16x. This is for a portfolio of companies that are, on average, expected to deliver double-digit annual profit growth in the years ahead.

Looking ahead

The considerable M&A interest in the portfolio holdings has validated our belief that the portfolio is grossly undervalued and has substantial valuation upside potential. Since September last year, nine portfolio holdings have been subject to full acquisition approaches or bids for a considerable piece of the business. The average premium to the prevailing share price paid by the private equity or trade acquirer was 55%.

Given the removal of much of the recent political risk, the growth prospects of the companies in the portfolio and the existing valuation anomaly, there is much to feel optimistic about. For these reasons, we continue to view AIM portfolios as a compelling proposition, providing significant potential capital returns and efficient tax planning.

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