Results analysis: Schroder UK Mid Cap

SCP remains well positioned for a recovery in UK mid-caps...

Update
28 November 2024

- **Schroder UK Mid Cap (SCP) has released its financial results for the year ending 30/09/2024. Over the year, the trust delivered a 17.3% NAV total return, versus its benchmark, the FTSE 250 ex-Investment Trusts Index, which returned 21.4%. The trust's peer group, the AIC UK All Companies sector, returned an average of 21.7%.**

- **While absolute performance was strong, relative returns were impacted by a shift in the mid-cap sector that favoured interest rate-sensitive companies with weaker balance sheets. Given the managers' focus on quality factors, SCP has limited exposure to cyclical companies.**

- **Although the trust underperformed over the one-year period to 30/09/2024, its long-term returns have been very strong. The managers have significantly outperformed the benchmark over five- and 10-year periods. For instance, SCP returned 26.5% over five years (to 30/09/2024) compared to 5.5% for the FTSE 250 Ex Investment Trust index, and 85.7% over 10 years (to 30/09/2024) versus 33.7% for the benchmark.**

- **The proposed final dividend, combined with the interim dividend of 6p per share already paid on 09/08/2024 should bring total dividends for the year to 21.5p per share, representing a 4.8% increase compared to the dividend paid in the previous financial year. However, with revenue return per share of 20.54p, the dividend is not fully covered.**

- **The discount slightly widened during the year from 12% to 12.3% (as of 30/09/2024). Notably, most investment trusts in the AIC UK All Companies sector are trading at double-digit discounts, as UK equities remain an out-of-favour asset class. However, since the publication of the annual report, the discount has narrowed slightly to 11.3% by 26/11/2024, which is in line with the 11.5% average discount of the AIC UK All Companies sector.**

- **Net gearing increased to 9.5% as of 30/09/2024, up from 6.8% at the end of the previous year. Gearing was a net benefit to performance as a result of the rising market.**

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- **SCP may invest up to 20% of the portfolio in off-benchmark names. The board has amended this policy to allow the company to hold shares in companies listed outside of the UK.**

- **The managers have taken advantage of attractive prices to add companies benefitting from structural growth in market niches. This includes engineering company Renishaw that the managers consider to be exposed to several secular growth trends such as AI and quantum computing.**

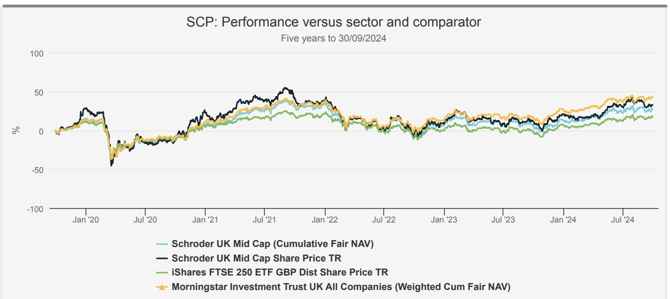
- **Outgoing chairman Robert Talbut discussed the valuation opportunity stating: "We continue to remain optimistic about the outlook for UK mid-caps and the company's portfolio holdings, which are largely focused upon longer term growth businesses."**

Kepler View

The managers of **Schroder UK Mid Cap (SCP)**, Jean Roche and Andy Brough, aim to build a concentrated portfolio of the best ideas from the UK's index of medium-sized companies, the FTSE 250. The managers may invest up to 20% of the portfolio outside of this benchmark, including in overseas-listed companies. Both Jean and Andy have extensive experience to support their stock selection approach, which should drive the 40-50 stock portfolio to deliver outperformance of the benchmark.

In the financial year to 30/09/2024, the trust returned 17.3% on a NAV total return basis. Whilst this was a strong return in absolute terms, the managers underperformed the benchmark by 4.1 percentage points. With the Bank of England lowering interest rates, cyclical companies have benefited from a tailwind. However, this may only be a temporary drawback as the companies SCP invests in should be less reliant on monetary policy to deliver long-term returns. In fact, SCP has outperformed the FTSE 250 Index over longer periods such as five and 10 years.

Fig.1: Five-Year Performance



Source: Morningstar

Jean and Andy believe that recent upgrades in forecasts for the UK economy forecasts may counter bearish structural arguments against UK equities. They also see FTSE 250 companies as undervalued relative to their FTSE 100 peers, despite offering higher prospective dividend yields and stronger earnings outlook. As a result, the managers expect the valuation gap between FTSE 250 and FTSE 100 stocks to close over time. Moreover, they argue M&A could further support performance going forward, as the premium paid on takeovers averaged 52% in 2023, compared to the typical level of 30%-40%. In our view, these factors could provide significant support for a long-term recovery of UK mid-caps.

The paid and proposed dividends for the financial year 2024 total 21.5p per share, up from 20.5p in 2023.With revenue per share at 20.54p during the period, the dividend is not fully covered. However, we note that the trust has revenue reserves equal to more than 100% of the dividends paid in 2024. With an implied dividend yield of c. 3.6% based on the share price as at 26/11/2024, SCP offers the highest yield in the AIC UK All Companies sector, where the simple average stands at c. 2.8%. The dividend has been increased regularly since inception and is, in our opinion, one of the differentiating features of SCP, despite not being an explicit goal of the managers.

Despite the strong absolute performance, SCP's shares still trade at a double-digit discount, as most of the trusts in the AIC UK All Companies sector do. We believe this discount presents an attractive entry point for long-term investors, especially considering SCP's strong long-term performance.

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