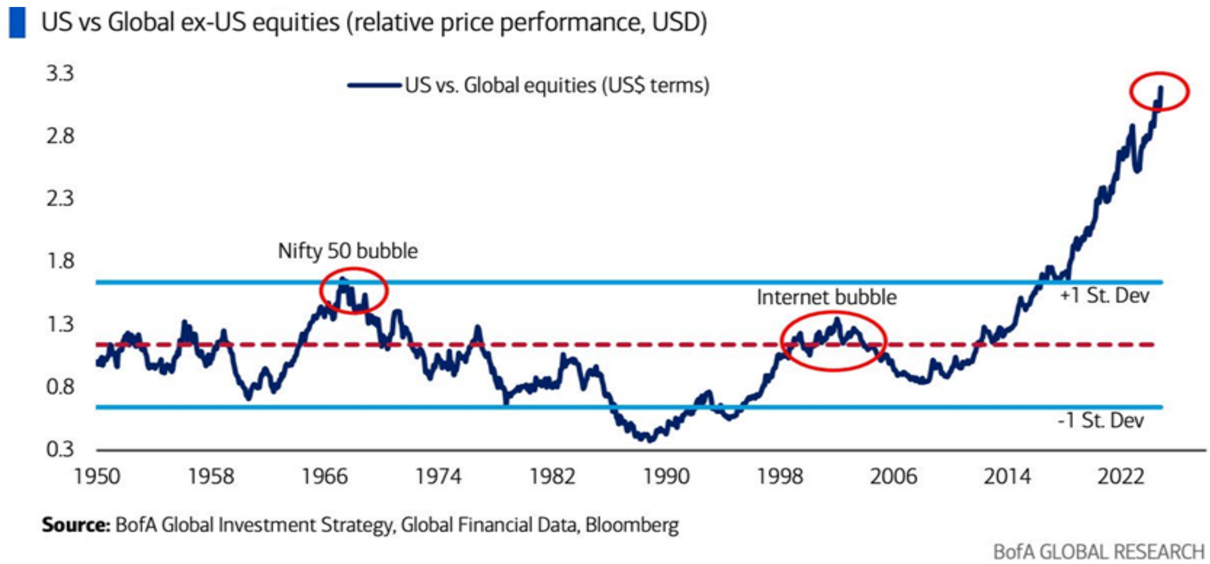
AIM Inheritance Tax Service

Q1 2025 Update

By James Rae, Head of Inheritance Tax

The last six months of 2024 ended up being a very negative period for AIM shares, both pre and post budget. The AIM index has now returned -5.6% in 2024, -8.2% in 2023 and -31.7% in 2022. This is the first time since 2000-2002 that the AIM all share index has fallen in three consecutive years. Such a period is bound to make any investor feel discouraged; however, we can draw some comfort from the performance of AIM in the years following 2002, which were very positive. In addition, AIM shares are far more mature and cash generative today.

Relative to many US peers, UK share prices have struggled. In fact, the US has now achieved its highest ever performance compared to the rest of the world.



The UK's relative performance has been made worse by UK equity outflows, which have hit AIM particularly hard due to the budget and AIM's relative illiquidity. The budget dented economic sentiment, in the short term, as businesses considered the effects of the rise in National Insurance.

Going forward, we feel that the direction of travel is clearer. We are through the UK election, the US election and the UK budget and this should mean that businesses are able to make decisions with more confidence. While we have seen negative UK macroeconomic headlines in the press, there are some silver linings. The consumer is relatively well off - UK employment rates remain exceptionally high and Rachel Reeves has significantly increased public sector pay. In addition, the increase in the minimum wage should also help workers.

The counter to this is that the cost of debt and mortgage rates remain high. This will be a factor for many; however, interest rates are expected to fall in 2025; albeit at a slower rate than previously thought. Rate cuts could be accelerated if the UK economy shows too many signs of weakness, and we see any fiscal loosening as a tailwind.

Changes to Inheritance Tax in the Budget

You will already have received correspondence from us regarding the changes on AIM; however, please find the details below.

From April 2026, AIM shares will continue to benefit from inheritance tax relief but at a reduced rate of 50% - meaning a 20% effective rate of inheritance tax will apply to AIM shares. This rate applies no matter the value of AIM shares held.

These changes do not come into effect until April 2026. Until then, AIM shares will continue to provide 100% relief from inheritance tax to an unlimited value. This is providing the shares have been held for at least two years and at the time of death. If an investor passes away after April 2026, an AIM portfolio will be subject to the new reduced rate of inheritance tax.

What we think will happen to the AIM market going forward?

The reduction in the inheritance tax break for AIM was disappointing and we are surprised that the government created a difference in business relief between a private business and an AIM stock (when investors have under £1m of business relief and agricultural relief assets). Alongside some of our AIM service peers, we are in the process of lobbying the government to understand what the Treasury's thinking was behind this decision. Ultimately, the UK needs thriving capital markets to enable growth and AIM has been found to boost the regions, productivity and economic growth.

Our lobbying group will be aiming to do three things:

- **Gain clarity on the use of AIM shares in unused pension pots** – From April 2027, unused pension pots will be subject to inheritance tax. We would like clarity from the Treasury that investors will be able to gain business relief, at the reduced rate, on AIM shares held within a pension.
- **Restore equilibrium between AIM and some alternative forms of business relief** – There are currently some alternative forms of business relief, which don't help the UK economy grow, which will still receive business relief in full from April 2026 – again, if the investor has under £1m of assets in business relief and agricultural relief assets. From talking to ex-Treasury and Office of Budget Responsibility (OBR) staff, we believe that this is likely an oversight from the Treasury.
- **A guarantee of no further inheritance tax changes for AIM stocks for the length of this parliament**

There can be no guarantee that these talks with the Treasury will be successful; however, Rachel Reeves is struggling to boost the economy and market sentiment has turned against her. We would think that she would consider changes - especially if these can be done at a limited cost to HMRC. The budget changes will not be iron clad until the next Finance Act is released, which we believe will be in the Autumn of this year.

Particularly relative to US peers, the UK market and AIM remain on cheap valuations. Many private equity investors share this view, as demonstrated by the significant rise in take-private transactions. The uncertainty around the Autumn budget led to a merger and acquisition slowdown in Q3; however, there was an uptick in activity in Q4 and we believe that will continue in 2025. Private equity firms have a significant amount of cash to be deployed, and US dollar strength will make UK companies look even cheaper for US private equity firms.

The change in inheritance tax rules has caused volatility in the AIM market and it has made some companies question if they should move to the main market or an alternative equity market overseas. Although this is frustrating, we aren't short of new ideas for AIM portfolios at the current time - there are a significant number of businesses that have long term growth prospects which are trading at all time low valuations.

The AIM portfolios performance in 2024

Over the long term, our portfolios have generally outperformed the AIM index; however, disappointingly, this was not the case in 2024.

We have always had a bias towards higher quality, higher growth businesses. In 2024, several growth companies saw sales cycles lengthening as their customers delayed purchasing decisions due to the UK & US elections and the economic slowdown. We still feel that these businesses continue to offer best in class products that will eventually be transitioned to as their customers look to improve efficiency.

In the company updates section below, we have highlighted some of the underperforming shares from 2024. Hopefully, this adds some flavour on why we have chosen to hold on despite the fall in share price. For many of the other shares, there has been a sentiment based de-rating, contrary to underlying performances, which has been frustrating. Please contact us if you would like to discuss a particular investment.

As ever, all of our AIM shares are highly cash generative and almost two thirds have net cash on their balance sheets. Due to the high cash balances, we expect widespread share buyback activity and special dividends to continue.

Going forward, we will remain invested in higher quality companies, which we believe offer even better long-term returns following some of the falls in 2024. We aim to invest in as many mission-critical businesses as possible – where their product is vital to the underlying customer. There are also a number of key themes that we are continuing to increase exposure to:

- Defence – We believe that ongoing geopolitical instability means that global government spending on defence will continue to increase. This includes cyber-security.
- Technology – As labour costs rise, we feel that the world will become increasingly automated. In addition, we think there will be continued government support as they desperately seek productivity gains.
- Energy Transition - Russia's invasion has shown the need to rely on your own energy supply. This will lead to further investment in the sector and in particular green energy. We believe

that the green transition will remain a global theme – even in the US where many businesses have already started projects.

We have assessed the impact of Trump's return for all of our companies – particularly regarding tariffs. Many of our stocks generate significant revenues in the US and we continue to view this as a positive, with the US economy performing well. Nearly all of our exposure to the US is through software, rather than hardware and we feel that tariffs on software services would be extremely unlikely – particularly as this could start a trade war and software services are America's greatest export. We have asked each company with hardware sales in the US about possible impacts, and they believe that they can either transfer production to their own US manufacturing sites or a US based equipment manufacturer.

Company Updates

CVS Group

Description

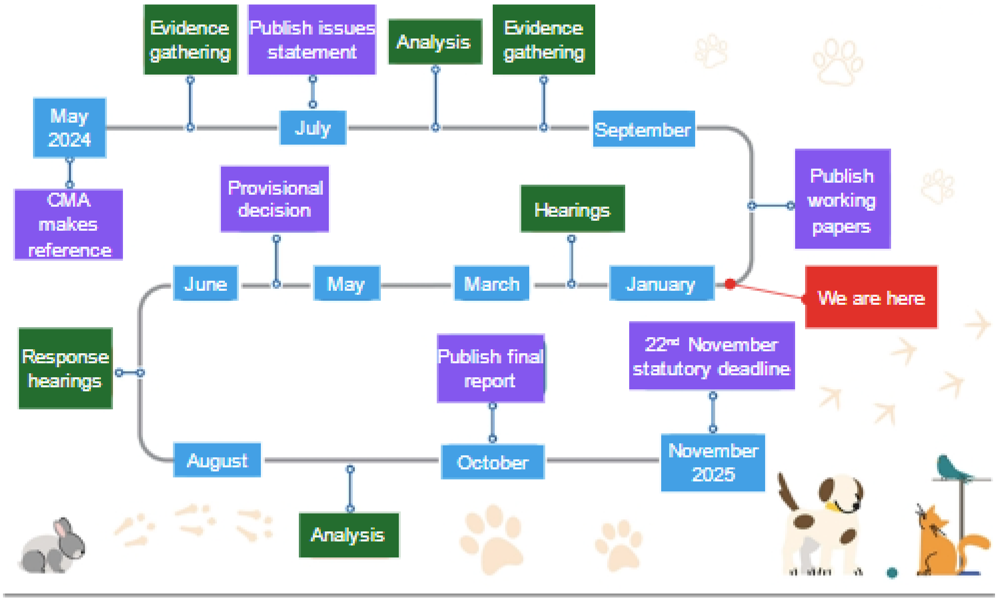
CVS owns over 500 veterinary surgeries throughout the UK and Australia. These surgeries also include referral practices, providing first class specialist treatment. CVS's laboratories provide diagnostics services for the veterinary industry and pet crematoria. The Group includes Animed Direct, an online store selling medicines, pet food and other animal related products. CVS is the UK's leading provider in a fragmented market with the opportunity to expand geographically and by increasing the range of ancillary services, such as own branded drugs and insurance. The Competition and Markets Authority (CMA) are currently conducting a market investigation on the industry, which is holding the share price back.

What Happened?

In May 2024, the Competition and Markets Authority (CMA) announced that it would launch a formal investigation into the vet market after finding issues which it thought would impact consumers' ability to make informed decisions. The full investigation was a surprise to the market as investors thought that that the CMA would be more likely to accept a number of remedies that had been proposed by the industry.

We are now eight months into the CMA's market investigation and we should have initial findings in four to five months and final recommendations within nine months. We expect the news to be at its most negative when the CMA publishes its initial notice of remedies in May/June. These tend to include some of the more extreme remedies which are then diluted for the final report. Thereafter, we feel that the news flow will be more encouraging with the uncertainty removed and investors refocussing on the fundamentals of the business.

CMA Vet Investigation Timetable:



Source: CMA

Having considered all of the potential outcomes for the CMA's investigation, we believe that the share price is more than reflecting a worst-case scenario. We also feel that the CMA tends to go for sunlight remedies, such as disclosure of price lists or disclosure that a medicine may be available at a cheaper price elsewhere, rather than implementing hard price caps or asking a company to dispose of some practices. This is what it has tended to do historically, and this wouldn't have a significant impact of CVS Group's profits.

The investigation creates uncertainty; however, we expect to see a beefing up of the veterinary regulatory body, which could increase bureaucracy going forward. We also believe that the vet industry will have to disclose price lists more clearly which could impact some like-for-like practice revenue growth. The CMA may also place a cap on the cost of prescriptions; however, CVS already charges lower than its industry peers and we therefore don't think that this will have a significant impact.

CVS continues to acquire more practices in Australia and should benefit from further economies of scale, such as drug pricing from suppliers, as they grow. Fundamentally, we feel that the share price is too cheap at c. 10x P/E considering the quality of the underlying business. Once the uncertainty surrounding the investigation is out of the way, we believe that CVS could be a potential acquisition target for Private Equity if the shares continue to trade at these levels.

Focusrite

Description

Focusrite creates trusted, high fidelity audio devices and software, for both professional and amateur customers, in the music industry. They make audio interfaces (for example, devices that can covert sound from microphones/guitars to digital signals that can be processed through a computer or speaker). They have product lines for huge concert venues to smaller equipment for podcasting, video game streaming and social media sharing, which are growing in popularity.

What Happened?

Before and during the pandemic, Focusrite consistently had good growth. Its content creation division was particularly strong during Covid as we all looked for new hobbies. This led to many of us buying musical instruments and the audio equipment that goes with it. Post the pandemic, it was difficult to know what would happen to sales at Focusrite as fewer people were buying equipment for home, but the audio reproduction market (concerts) was reemerging. In 2022, there was then a spike in demand from distributors as companies tried to get ahead of the component shortage crisis. This meant that a lot of Focusrite's distributors overstocked Focusrite's products and they have been gradually selling these positions rather than buying new equipment from Focusrite. Again, it was difficult to know the quantum of this problem.

Focusrite is a quality business and has a highly regarded product portfolio which should mean that it is well placed for any improvements in its end markets. A lot of the built-up inventory held by suppliers has now gone; however, there could be some further challenges ahead. For example, increased tariffs on China, imposed by Trump, could negatively impact Focusrite's US sales. Consumer demand has not recovered yet; however, the group can see the number of product registrations for its products (users register a product when they buy it) slowly rising meaning that there could be some green shoots ahead.

The group's audio production brands (festivals/concerts) have continued to perform well. Focusrite supported major festivals like BST Hyde Park and Glastonbury last year - showcasing advanced audience coverage technology. With the industry's continued recovery and robust demand for high-quality live audio, the group hopes to exceed market forecasts in this area, leveraging its comprehensive product portfolio and healthy order pipeline.

After the falls in the share price, Focusrite is trading on around 11x P/E with a 3% dividend yield. This share price would indicate that the market doesn't feel that the company has any hope of recovery. While we don't expect the business to reach the growth rate that it achieved a few years ago, we do think that there is a reasonable chance that the share price can recuperate, especially if there is any recovery in end markets.

Oxford Metrics

Description

Oxford Metrics develops software and builds motion capture cameras that enables the interface between the real world and its virtual twin. Their smart sensing software helps over 10,000 customers in more than 70 countries, including all of the world's top 10 games companies and all of the top 20 universities worldwide. Founded in 1984, they started their journey in healthcare, expanded into entertainment, winning an OSCAR and an Emmy, then moved into defence and engineering. They have a track record of creating value by incubating, growing, and then augmenting through acquisition, unique technology businesses. The Group trades through its market-leading division: Vicon, which specialises in motion capture; digitising the movements of everyone from athletes to astronauts.

What Happened?

Vicon (the motion capture systems part of Oxford Metrics) had a poor trading update at the end of 2024 as it saw a slowdown in orders from a number of different end markets. Entertainment was impacted the most, reflecting the widely reported slowdown in the global games industry and subsequent content creation contraction. In addition, there was some slowdown from both engineering and life sciences customers – the latter was due to delayed academic funding.

Amidst a tough trading environment, the group has made clear operational progress. They have developed new markerless motion capture technology which is on track for commercial delivery in 2025. Markerless revenue will be limited in the first year; however, the group has secured ten cornerstone customers who have been beta testing the product. This product is unique in the industry and, if successful, should lead to software as a service revenue which the group has not had before. Historically, Vicon's sales have been one-off and therefore lumpy.

Three years ago, Oxford Metrics sold part of its business, Yotta, for £52m. This is why the company still sits on a cash pile of around c.£50m today. The total value of the company is only c.£65m according to the current share price and we therefore feel that this is far too cheap.

Oxford Metrics has been gradually using the cash to create a new smart manufacturing division through acquisitions. In 2023, the group bought Industrial Vision Systems (IVS) and at the end of 2024 they bought Sempre who are measurement specialists solving manufacturing challenges. This builds on the capabilities acquired from IVS in the previous year. IVS makes vision inspection machines that can help further automate a manufacturing process. We think that the investment in this new division makes sense in a world where labour costs continue to rise and automation becomes increasingly important.

Whilst the profit downgrades have been very disappointing, we believe the group's market-leading intellectual property, market positioning and opportunities are undiminished and that demand/ sales cycles will eventually improve. If we exclude cash, the market thinks that this company is worth c.£15m – which feels ludicrous for a business that has regularly had profits of above £4m in recent years.

Solid State

Description

Solid State is a value-added electronics group supplying durable components, assemblies, and manufactured units for use in specialist and harsh environments. The Group specialises in complex engineering challenges often requiring design-in support and component sourcing. Serving industries with demands for complex, performance-critical products, the Solid State trading brands have become recognised industry leaders through consistently delivering product quality, high service standards and comprehensive technical support. Through an in-depth knowledge of its core markets and available technology, Solid State is an established supplier to clients with exacting standards in the defence, energy production, aerospace, environmental, oceanographic, industrial, robotics, medical, life sciences, and transportation sectors.

What Happened?

Solid State has been building a strong presence in the defence industry – which we expect to grow considering the geopolitical landscape. More recently, they have fulfilled large contracts for NATO.

One of these has now been delayed (c.£20m), despite it originally being signed off by a senior general and just awaiting the final tick box approval. This is due to Labour's strategic defence review which will end next summer. The company feel confident that this is a temporary delay and that expected orders will still be received in due course, albeit that they will fall outside of the current financial year. Management's confidence feels reasonable as the order is for communication equipment for the British Commandos. The Ministry of Defence has bought a number of these systems for the commandos before and they currently don't have enough for every platoon. This is particularly frustrating as they have ill equipped commandos in Cyprus, at the current time, who have been asked to be ready for action if necessary.

There has also been some weaker market segments such as rail and industrial; however, we are not concerned about these long term. Defence would have made up for this shortfall if there hadn't been the defence review. Since the year end, the group has seen a pick-up in order intake, with a significant increase in the order book. The company has also reported positive leading indicators, such as the rate of design activity which could mean that the electronics market has reached the bottom of the cycle. This gives us confidence that the group can return to strong growth going forward.

Tracsis

Description

Tracsis is a leading provider of software, hardware and services for the rail, traffic data and wider transport industries. The majority of UK transport operators use Tracsis software for timetabling, stock planning and distribution, labour resource planning and many other critical functions. Tracsis focus on providing niche solutions which are often critical to the highly regulated rail network. These are hard to replicate, and the industry has high barriers to entry. The Group also has a traffic and data services division which focusses on improving traffic monitoring and flow. Tracsis has a significant amount of net cash on the balance sheet and is therefore well positioned to make further acquisitions going forward to further accelerate growth.

What Happened?

Tracsis had a couple of setbacks in 2024; however, we feel that the share price falls are extremely overdone. Tracsis suffered during the lead up to the UK election as government bodies slowed purchasing decisions. Following the election, there was a slowdown in the sales of their remote conditioning monitoring equipment (used to remotely inspect the rail network) as the government looked to review purchasing decisions. This delay will only negatively impact network rail as the track will have to be visually inspected until these units are ordered. We feel that both of these impacts are temporary.

We continue to feel that Tracsis has a chance to land some very significant contracts which would buoy the share price if they were to do so. Unfortunately, as these contracts will be awarded by the UK government or public bodies in the USA, we don't have a clear timeline. One positive signal, which hasn't been recognised by the market, was the award of "preferred bidder status" for the procurement of a Pay As You Go (PAYG) tap converter system across GB rail. When operational, the PAYG system will aim to provide a reliable best fare guarantee for travellers using PAYG across GB rail. This would obviously be a very significant win.

The company has branched out into America where there is an enormous opportunity in rail. They won a $9m contract with Indiana rail about 18 months ago and they have put final bids in for two new contracts which are similar in size, or bigger. Considering the due diligence that has been done by these rail companies on Tracsis, and the incumbent's terrible track record and limited technology, we think that they are in a very strong position to win these.

The group has around £20m of net cash on the balance sheet (Market Capitalisation of c.£130m) and remains very cash generative. Some of Tracsis's products remain unique and it therefore is in a very strong position with customers. It currently trades on a P/E of around 12x and this feels far too low for a company with significant growth potential.

YouGov

Description

Yougov is a market leader in real-time research and named as one of the world's top 25 research companies. Their goal is to be recognised as the world's leading provider of high-quality market and opinion data. The management team are extremely confident that they can scale up the business very effectively and rapidly increase margins. In 2019, the board set a five-year management target of doubling group revenue, doubling adjusted profit margin, and achieving earnings per share growth of 30% annually, which they achieved. Their new medium-term target is to grow revenue to £500m and get adjusted operating margin to 25%.

What Happened?

Yougov has suffered from increased competition in its data products division, particularly for clients that are mid-small size that don't need all its data. They are countering this with a new product that will be available in the coming months.

Although YouGov had a profit warning in June because they weren't winning as much new business as expected in data products, they have not been losing significant business. Management thought that the group would grow faster and put costs in place anticipating this. This was obviously a very serious error of judgement; however, they announced a cost optimisation plan soon after the profit warning. This should amount to a cost saving of £20m per annum – 70% of which will be in the 2025 results.

YouGov bought GFK Consumer Panel Services (CPS) for €325m at the start of 2024. Considering the market capitalisation of the whole of YouGov is now £425m, the YouGov share price feels too cheap. CPS is expected to contribute £26m of profit in 2025 and this will lend significant support to current market expectations for 2025. CPS has not suffered any setback from increased competition and has been performing better than expectations since it was purchased.

YouGov has some debt, but they are paying this down rapidly as the company remains extremely cash generative. There are questions over the management team which we have raised with the board; however, ultimately, we feel that the share price is too cheap – currently trading on a 10x P/E. This is a company that has grown significantly historically, and we believe that it has the technology and data to be able to do so again. At this price, Yougov also looks like a very interesting takeover target.

We appreciate that this has been an exceptionally frustrating period to invest in AIM companies. While there have been a number of successful investments, these have been outweighed by companies affected by negative market and economic sentiment. Hopefully some of the detail above provides some insight into why we have made the decisions that we have. We continue to believe that we are invested in shares with great long-term potential that are trading at extreme lows.

We still feel that all it will take is for the future outturn to be less bad than expected to move the AIM market appreciably.