

## Strategic Equity Capital

### “Business as usual”

Strategic Equity Capital (SEC) announced Stuart Widdowson’s departure from GVQ Investment Management on 7 February 2017. GVQ stress that it is “business as usual” and say Stuart’s absence has no impact on the investment philosophy behind SEC, GVQ’s investment approach or SEC’s portfolio. Jeff Harris has stepped up to become lead portfolio manager and Adam Khanbhai becomes the new deputy manager. The management team is enthused about the prospects for SEC’s future performance as they say that former “problem children” within the portfolio are showing positive initial signs of recovery and they expect the market will recognise the latent value within the portfolio.

### Focused UK smaller companies portfolio

SEC is managed with a focused portfolio of investments selected on the same basis that a private equity investor would use to appraise its investments.

Two of the non-executive directors added to their holdings in the wake of the announcement. Richard Locke and his wife bought 10,000 shares as did William Barlow.

Year ended	Share price total return (%)	NAV total return (%)	Peer group average TR (%)	MSCI UK Small Cap TR (%)	MSCI UK total return (%)
28/02/13	17.0	18.7	22.9	21.9	11.8
28/02/14	60.6	47.8	34.7	31.1	10.5
28/02/15	22.7	15.2	(2.2)	1.8	5.4
28/02/16	(1.6)	0.7	6.7	0.5	(9.3)
28/02/17	4.6	15.9	23.9	17.5	24.1

Source: Morningstar, Marten & Co, see page 5 for details of peer group

<b>Sector</b>	UK Smaller Cos
<b>Ticker</b>	SEC LN
<b>Base currency</b>	GBP
<b>Price</b>	203.25p
<b>NAV</b>	234.83p
<b>Premium/(discount)</b>	(13.4%)
<b>Yield</b>	0.4%

### Share price and discount

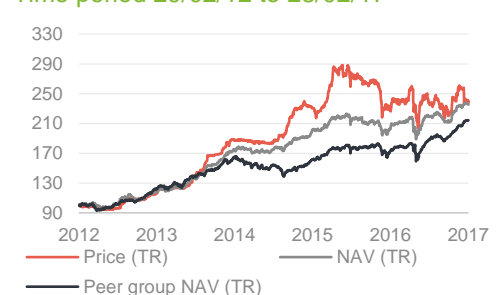
Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

### Performance over five years

Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

<b>Domicile</b>	United Kingdom
<b>Inception date</b>	13 July 2005
<b>Manager</b>	Jeff Harris
<b>Market cap (GBP)</b>	141.9m
<b>Shares outstanding</b>	69.8m
<b>Daily vol. (1-yr. avg.)</b>	120,330 shares
<b>Net cash</b>	11.2%

## Business as usual

While, for the most part, Stuart has been the public face of SEC since Adam Steiner left in May 2014, GVQ inform us that the fund has long been managed on a team basis. Potential investments must first pass through GVQ's detailed and meticulous private equity based research process. This includes a review by a panel of five industry experts. Only once an idea has been signed off by GVQ's research committee, can it then be considered for inclusion in the portfolio. This process is not unique to SEC, it applies to all of GVQ products and is core to the business' philosophy of managing client money. Jeff and Adam have been a key part of this process for a number of years and have intimate knowledge of all the stocks in the portfolio.

Discount has widened since Stuart's departure. The GVQ team believe this is a buying opportunity.

As the fund profile section on page 6 explains in greater detail, elements of the GVQ way of managing money include using a team approach, thinking long-term and sticking by holdings as long as they can see through short-term issues. The GVQ team is convinced that Stuart's departure will have little impact on the portfolio. New lead manager, Jeff Harris, along with new deputy manager, Adam Khanbhai, have been integral to the research effort for the fund, including engaging with portfolio companies. The market seems nervous however, the discount has widened as is evident in Figure 1, albeit largely on limited volume of transactions. GVQ's team believe this could be a buying opportunity.

Figure 1: SEC's discount over the year ended 16 March 2017



Source: Morningstar, Marten & Co

Semi-annual 4% tender at 10% discount at board's discretion

SEC has the authority to repurchase up to 14.99% of its issued share capital annually and has a discount control mechanism in the form of a semi-annual tender for 4% of the share capital at a 10% discount. The board can opt not to hold the tender if it feels it is unwarranted.

## The GVQ team

GVQ has been growing in assets under management in recent years (currently in excess of £700m) but the team have ambitions to expand this and are backed by RIT Capital Partners to do so.

- **Jeff Harris ACA** is now the lead portfolio manager. He had been deputy manager on SEC since May 2014 and remains deputy manager on GVQIM's open-ended funds. He joined GVQIM in 2012 as a senior analyst. Before that he was a European banks analyst at Macquarie and performed due diligence on private equity and corporate transactions as a member of the transactions services team at PricewaterhouseCoopers.
- **Adam Khanbhai CFA** is now the deputy fund manager. He joined GVQIM in 2014 as a senior analyst. Before that he was a consultant at OC&C Strategy Consultants, working on commercial due diligence and strategy products for private equity and corporate clients.
- **Oliver Bazin ACA, CFA** is an analyst within GVQ's team. He joined in 2016 from Rothschild where he worked in their M&A practice with a focus on financial companies. Before this, he worked in KPMG's audit practice.
- **A new analyst** is being recruited to maintain the strength of the team.
- **Jamie Seaton** and **Jonathan Morgan** comprise the research committee. They vet all new research ideas as well as reviewing existing investments. Jamie is GVQIM's CEO. Jonathan re-joined GVQIM in October 2016 (having worked at the firm previously, between 2009 and 2014). He was chairman of SVG Capital's investment committee and worked both at 3i and Prudential's private equity business for a number of years.
- **The advisory panel** is unchanged since 2014, comprising Sir Clive Thompson, Stewart Binnie, Chris Rickard, Peter Williams and Lindsay Dibden. See [QuotedData's January 2015 note](#) for more detail.

## Market backdrop

Manager believes the UK small cap market is polarised and suffering from a lack of liquidity

The GVQ team believe the UK small cap market has become polarised. Stocks that are perceived as quality growth companies are, they think, priced excessively, leaving them vulnerable to earnings disappointment. In their view, it is important to be highly selective when choosing investments as many apparently attractively priced stocks are cheap for good reasons. They also caution that many "recovery" plays are valued optimistically.

One of the biggest problems facing small cap managers is a lack of liquidity. It is one of the reasons why they insist on owning less than 10% of any stock. GVQ think their long-term, disciplined approach to investing makes life a bit easier for them. As the availability and quality of equity research declines in response to MIFID 2 (new EU-led legislation that, amongst other things, says that investors must pay to read brokers' research – QuotedData's research, which is paid for by the company, will remain free to read), investment houses such as GVQ that do the bulk of their own research in-house will benefit. A lack liquidity and of generally available research may also help increase the number of mispriced securities for GVQ to take advantage of.

## Current positioning

Figure 2 shows the top 10 positions in the fund as they were at the end of December. SEC does not release portfolio percentage weightings that often and so, while these are the 10 largest holdings, they might not necessarily be in descending order of size. Altogether, these 10 holdings accounted for 76% of the fund at the end of 2016.

GVQ's process emphasises, amongst other things, free cash flow generation and balance sheet strength as signs of the attractiveness of a holding. These are key factors that anyone looking to acquire a portfolio company would take into account.

Figure 2: Top 10 holdings as at 31 December 2016

Holding	Sector	Year first acquired	GVQ cash flow yield (%)*	Net debt / EBITDA*	Progress vs. thesis
Equiniti	Electronics	2016	9.5	2.1x	Ahead
e2v technologies	Electronics	2009	9.1	(0.1x)	In line
Servelec Group	Technology	2013	9.6	(0.2x)	Behind
Clinigen Group	Healthcare	2014	8.3	0.4x	Ahead
Wilmington Group	Media	2010	10.4	0.8x	In line
Tribal Group	Technology	2014	4.0	(0.8x)	Behind
EMIS Group	Technology	2014	8.3	(0.4x)	Ahead
4imprint Group	Support services	2006	7.4	(0.5x)	Ahead
IFG Group	Financials	2015	12.2	(2.2x)	In line
Goals Soccer	Consumer Services	2012	9.9	1.5x	Behind

Source: GVQ Investment Management, Marten & Co, \* Earnings before interest, tax, depreciation and amortisation - GVQ forecast

The managers are very happy with the portfolio and have been integral to its construction. Nevertheless a few holdings have disappointed, as discussed below, and this has held back recent performance.

### Servelec

Servelec's shares fell sharply (from 390p to a low of 208p) in the second quarter of 2016 after it warned that contract slippage would affect profits in the second half of their financial year. The stock market at the time was nervous ahead of the referendum and any disappointment was punished savagely. The shares have since recovered somewhat. The managers believe that Servelec's acquisition strategy has created a "mini conglomerate". They see significant potential for value to be unlocked given Servelec's strong market positions. They estimate that Servelec could generate £39m of cash (20% of its market cap) over the next three years. They think a sum of the parts valuation could value the company in excess of 400p per share. At 17 March the share price was 274p.

### Goals Soccer Centres

The focus of the company has switched from expansion to investment in the existing business with the prospect of achieving higher returns. The balance sheet is stronger thanks to an equity raise. SEC's managers believe the company could soon start to generate significant free cash flow. They also point out that the company has been a bid target in the past.

### Rest of the portfolio

Tribal's woes were discussed in QuotedData's note of May 2016. A rights issue, which SEC supported, has strengthened the company's balance sheet and, subsequently, the shares have recovered strongly. A disposal of a non-core asset at what SEC's managers believe was an attractive valuation has also helped. New management has identified an initial £8.5m of annual cost savings. A US peer has built up a material stake in the business.

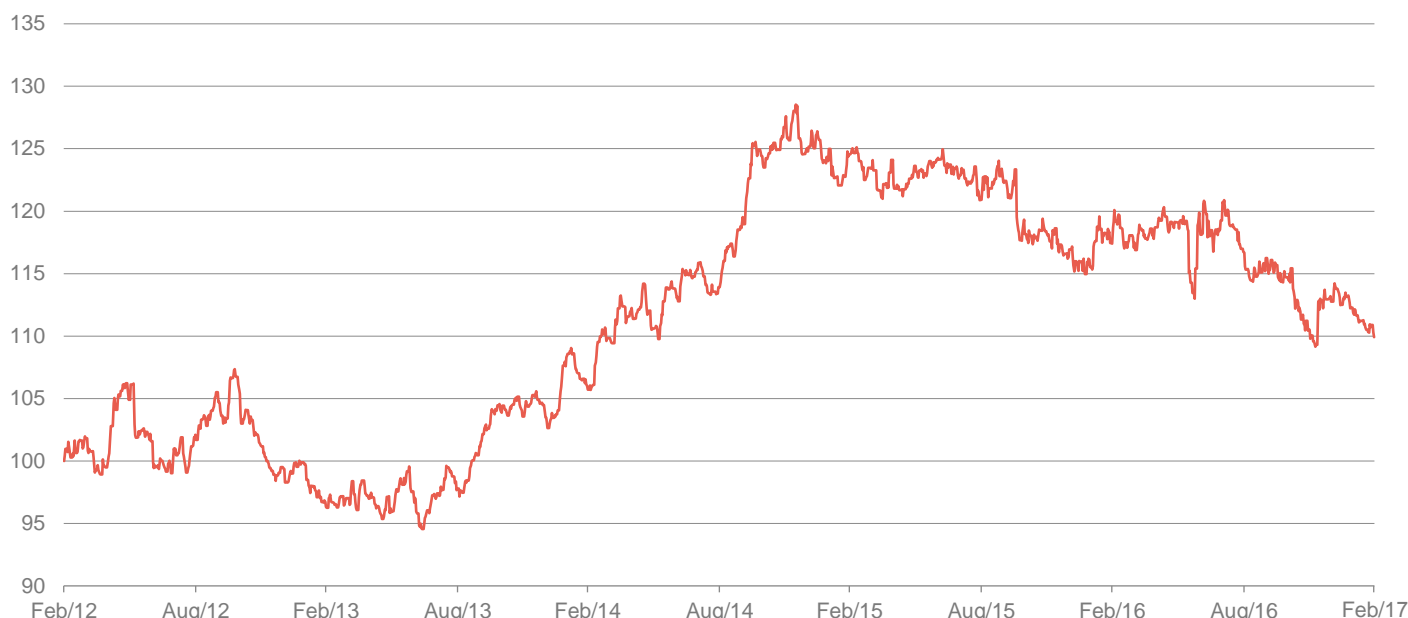
The recent bid for e2v technologies will result in a substantial cash inflow for SEC – about £15m. Jeff says deployment of capital will be driven by individual investment opportunities, as has been the case historically. Sterling weakness is attracting overseas buyers and e2v might be the tip of the iceberg in terms of bids for portfolio companies. GVQ believes that the portfolio's cash generation and balance sheet strength relative to market averages make many of these companies tempting targets for acquirers. Takeovers are not the only potential catalyst for a re-rating however.

### Performance

Access up to date information on SEC and its peer group [here](#)

Figure 3 compares SEC to a peer group consisting of London listed UK smaller companies investment companies with a market capitalisation in excess of £50m. The full list is: Aberforth Smaller Companies, BlackRock Smaller Companies, BlackRock Throgmorton, Dunedin Smaller Companies, Henderson Smaller Companies, Invesco Perpetual UK Smaller Companies, JPMorgan Smaller Companies, Miton UK Microcap, Montanaro UK Smaller Companies, Rights & Issues, River & Mercantile UK MicroCap and Standard Life UK Smaller Companies.

Figure 3: SEC vs. peer group average – NAV total returns for five years ended 28 February 2017



Source: Morningstar, Marten & Co

In 2016, SEC's NAV growth was held back by the poor performance of Servelec in particular as well as zero exposure to the mining and resources sectors which have experienced a rebound over 2016. It is estimated they contributed over half of the

annual small cap index return. SEC's weighting towards the smaller end of the small cap market may also have weighed on it in recent times.

## Fund profile

Focused, small cap portfolio. Click [here](#) to access the manager's website

Launched in 2005, SEC is a UK investment trust that invests in a concentrated portfolio of UK-listed equities (typically 15-20 holdings). SEC is overwhelmingly focused on small caps although this is not actually mandated by its investment objectives. The managers expect that the majority of its investments will be in the sub-£300m market-cap range as they believe this under-researched segment (those which are too small for inclusion in the 250 Index), creates greater opportunities to identify mispriced securities. The company can invest in companies listed on overseas exchanges, but this is formally limited to 20% of gross assets, at the time of investment, and the managers do not expect this to be a significant element of the portfolio. The approach does not take benchmark weightings into account when constructing the portfolio, focuses on generating positive absolute returns rather than outperforming a benchmark, and does not employ leverage at the investment trust level although underlying companies may of course employ borrowings.

Private equity style investing in listed companies

## Private equity style valuation techniques in public markets

A feature of SEC, which makes it unique in the closed-end fund space, is GVQ's approach to managing its portfolio. In common with all of its mandates, GVQ uses an approach that seeks to apply private equity techniques to listed equity markets. More detail is available in [QuotedData's January 2015 note](#), but key features of the approach are a strong focus on a company's cash flows (post maintenance capital expenditure, as the managers say that this gives a fairer indication of a company's ongoing profitability); valuing companies using an in-house leveraged buyout model (and forming an opinion of the potential value to a trade buyer or private equity house); and seeking to identify companies that are undervalued but might benefit from strategic, operational or management initiatives (and then establishing, prior to investment, whether a process of constructive engagement can be undertaken to help effect the necessary changes required to unlock value).

It should be noted that the managers do not rely solely on the rerating of a stock. Instead they are looking for companies that offer a number of routes to value creation: earnings growth, rerating potential, cash flow and corporate activity (see [QuotedData's January 2015 note](#) for more detail). In the managers' view, this will typically lead to all-weather strategies that perform in a variety of market conditions and generally outperform most other strategies over the longer term.

Strong alignment between manager and investors

## Well-resourced and aligned investment manager

SEC has been managed by GVQ Investment Management and its predecessors since launch (GVQ Investment Management was formerly GVO Investment Management and SVG Investment Managers). GVQ has assets under management of over £700m and was acquired by Lord Rothschild's RIT Capital Partners in January 2015. GVQ employees (excluding Stuart Widdowson) own over 2% of the trust and RIT Capital has a 14% stake.

## Previous research

Further information is available in QuotedData's earlier research notes – [Cashing up!](#) – published on 10 May 2016; [Measured expansion on strong performance](#) – published 16 July 2015; and [Different, in a good way](#) – published 27 January 2015.

**Figure 4: Marten & Co. previously published research on SEC**

Title	Note type	Date
Different, in a good way	Initiation	27 January 2015
Measured expansion on strong performance	Update	16 July 2015
Cashing up!	Update	10 May 2016

Source: Marten & Co.

# QuotedData

QuotedData is a trading name of Marten & Co which is authorised and regulated by the Financial Conduct Authority  
123a Kings Road, London SW3 4PL  
0203 691 9430

[www.quoteddata.com](http://www.quoteddata.com)

Registered in England & Wales number 07981621,  
2nd Floor Heathmans House  
19 Heathmans Road, London SW6 4TJ

Edward Marten  
([em@martenandco.com](mailto:em@martenandco.com))

Christopher Bunstead  
([cb@martenandco.com](mailto:cb@martenandco.com))

## Investment company research:

James Carthew  
([jc@martenandco.com](mailto:jc@martenandco.com))

Matthew Read  
([mr@martenandco.com](mailto:mr@martenandco.com))

## IMPORTANT INFORMATION

This note was prepared for Strategic Equity Capital by Marten & Co (which is authorised and regulated by the Financial Conduct Authority).

This note is for information purposes only and is not intended to encourage the reader to

deal in the security or securities mentioned within it.

Marten & Co is not authorised to give advice to retail clients. The research does not have regard to the specific investment objectives, financial situation and needs of any specific

person who may receive it.

This note has been compiled from publicly available information. This note is not directed at any person in any jurisdiction where (by reason of that person's nationality, residence or otherwise) the publication or availability of this note is prohibited.

**Accuracy of Content:** Whilst Marten & Co uses reasonable efforts to obtain information from sources which we believe to be reliable and to ensure that the information in this note is up to date and accurate, we make no representation or warranty that the information contained in this note is accurate, reliable or complete. The information contained in this note is provided by Marten & Co for personal use and information purposes generally. You are solely liable for any use you may make of this information. The information is inherently subject to change without notice and may become outdated. You, therefore, should verify any information obtained from this note before you use it.

**Investment Performance Information:** Please remember that past performance is not necessarily a guide to the future and that the value of shares and the income from them can go down as well as up. Exchange rates may also cause the value of underlying overseas investments to go down as well as up. Marten & Co may write on companies that use gearing in a number of forms that can increase volatility and, in some cases, to a complete loss of an investment.

**No Advice:** Nothing contained in this note constitutes or should be construed to constitute investment, legal, tax or other advice.

**No Representation or Warranty:** No representation, warranty or guarantee of any kind, express or implied is given by Marten & Co in respect of any information contained on this note.

**Exclusion of Liability:** To the fullest extent allowed by law, Marten & Co shall not be liable for any direct or indirect losses, damages, costs or expenses incurred or suffered by you arising out of or in connection with the access to, use of or reliance on any information contained on this note. In no circumstance shall Marten & Co and its employees have any liability for consequential or special damages.

**Governing Law and Jurisdiction:** These terms and conditions and all matters connected with them, are governed by the laws of England and Wales and shall be subject to the exclusive jurisdiction of the English courts. If you access this note from outside the UK, you are responsible for ensuring compliance with any local laws relating to access.

No information contained in this note shall form the basis of, or be relied upon in connection with, any offer or commitment whatsoever in any jurisdiction.