MARTEN & CO

Annual overview | Investment companies

30 August 2017

Strategic Equity Capital

Quality small cap focus

Strategic Equity Capital (SEC's) managers believe the current portfolio consists of very high quality smaller companies. The high cash balances that built up in 2016, on the back of events such as the e2v technologies takeover, have, largely, been redeployed. Cash drag and the fund's focus have held back returns over the past year (see page 12). However, investment activity (detailed on page 10) has generated encouraging initial returns. Longer term, the detailed private equity derived process, focus on high quality small companies and positioning of holdings in long term structural growth areas provide the managers with confidence for the future.

The team acquired a significant number of shares earlier in the year and a programme of share buy-backs operating since April 2017 appears to have stabilised the discount.

Focused UK small companies portfolio

SEC aims to achieve absolute returns over a medium-term period, principally through capital growth. 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.

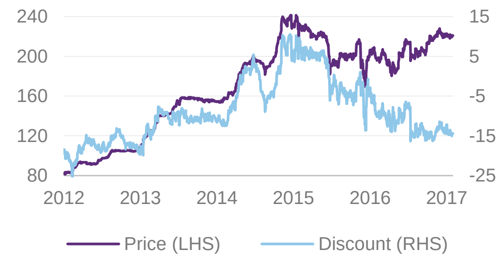
Year ended	Share price total return (%)	NAV total return (%)	Peer group * average TR (%)	MSCI UK Small Cap TR (%)	MSCI UK total return (%)
31/07/13	35.5	33.6	38.7	40.8	21.7
31/07/14	41.8	32.1	10.7	6.7	5.3
31/07/15	50.8	26.8	18.8	19.0	2.3
31/07/16	(10.5)	(3.1)	(0.2)	0.8	4.3
31/07/17	8.3	19.7	34.3	19.2	13.9

Source: Morningstar, Marten & Co, see page 12 for details of peer group

Sector	UK Smaller Cos
Ticker	SEC LN
Base currency	GBP
Price	221.125p
NAV	258.26p
Premium/(discount)	(14.4%)
Yield	0.35%

Share price and discount

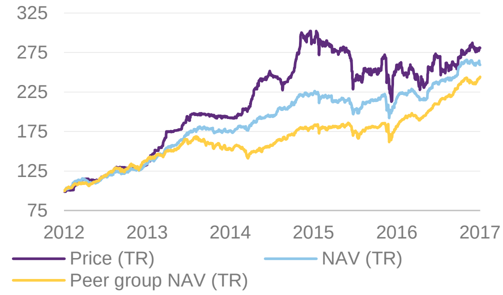
Time period 31/07/12 to 28/08/17



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/07/12 to 31/07/17



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	13 July 2005
Manager	Jeff Harris
Market cap	152m
Shares outstanding	68.613m
Daily vol. (1-yr. avg.)	134,900 shares
Net cash	7.6%

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Fund profile

Concentrated portfolio, comprised predominantly of UK-listed equities

Launched in 2005, Strategic Equity Capital (SEC) is a London listed investment trust that invests in a concentrated portfolio of predominantly UK-listed equities (typically 15-20 holdings), targeting an IRR of at least 15% per annum across the cycle.

SEC is managed by GVQ Investment Management (GVQIM or the managers), a subsidiary of RIT Capital Partners. More information on the manager is included on page 16. GVQIM applies private equity techniques towards evaluating listed companies and seeks to build a portfolio of stocks that it believes are undervalued and would benefit from strategic, operational or management initiatives. The investment process is more fully described on page 5.

Significant in-house research

Before making any investment, GVQIM carries out significant in-house research, aided by a panel of advisers (the Industry Advisory Panel – see page 17) and utilising the knowledge and expertise of an extensive network of industrialists and private equity investors.

The investment managers are well-aligned with shareholders, in our view. GVQIM employees own circa 3% of the trust and RIT Capital Partners has a 14% stake. The team has also been adding to its position in recent times, buying around 900,000 shares in Q1 and more since.

Bias to sub £300m market cap companies

SEC is overwhelmingly focused on small caps. The managers expect that the majority of its investments will be in the sub-£300m market-cap range at the time of investment 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 advent of MiFID II may, the managers believe, further enhance this opportunity (see page 4).

Unconstrained, absolute return focus

The company can invest in companies listed on other recognised exchanges, but this is 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 is not constrained by any benchmark, has an absolute return focus and does not employ leverage at the investment trust level.

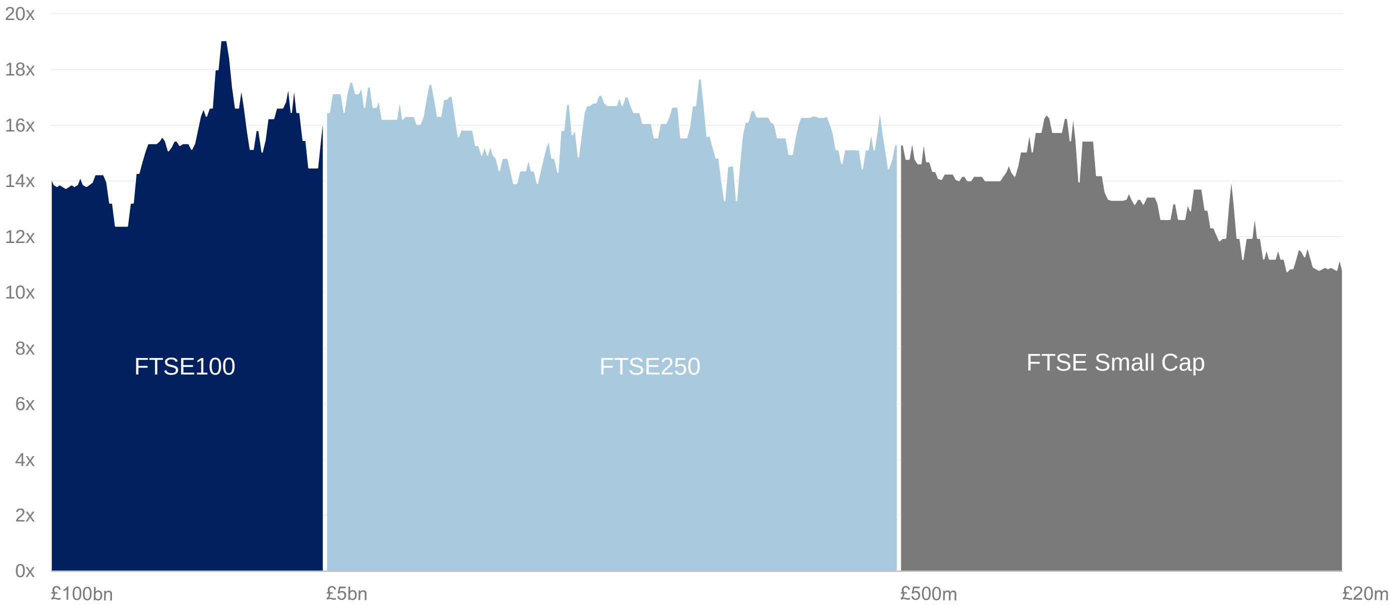
Manager’s view

No noticeable signs of slowing economy

GVQIM’s outlook is informed by the companies it meets. It says that companies are trading operationally in line or ahead of expectations. The managers are wary of the consumer environment and the absence of real wage growth but have limited exposure to domestic cyclicals. Rather, the managers believe the portfolio is attractively positioned in long term structural growth areas which can grow through the cycle. These include having exposure to the growth in regulation and compliance through Equiniti and Wilmington, diversified pharmaceutical assets such as Clinigen and Alliance Pharma and companies such as EMIS, Servelec and Medica benefiting from the transition towards digital health. The managers’ assessment supports a case that we are in a late mid-stage bull market.

Given liquidity concerns, smaller companies are, on average, trading on a discount to larger companies, as is evident in Figure 1. These figures, taken from a GVQIM presentation, show how p/e ratios vary by market cap. The data is as at 30 June 2017 and GVQIM sourced it from Liberum. The managers say that they believe a focus on genuine smaller companies should position them well over the long term.

Figure 1: P/E ratio by market cap of UK stocks in FTSE All-Share Index at 30 June 2017



Source: GVQIM, Liberum

Still finding investment opportunities

Confirming this assertion is the fact that they are still finding investment opportunities (history suggests to them that this is not the case close to the top of the market). It is true, however, in their estimation, that growth/momentum plays appear very well valued and de-ratings may be possible over time.

M&A activity could be a source of support for the market

One potential source of support for the market is the considerable funds available to private equity funds for new investments. According to Preqin data, private equity 'dry powder' (funds to invest) is at record levels standing at $906bn. This could favour the areas of the market which are attractive to GVQIM. Weak sterling may also continue to encourage M&A activity within the UK market as overseas investors take advantage of the situation. GVQIM does not invest in companies on the basis that they might be taken over. However, it does try to identify stocks that have genuine covetable intellectual property and do not have impediments to takeover.

MiFID II could be beneficial for firms with strong in-house research teams

We asked the managers what impact they thought MiFID II could have on their target market. (MiFID II will force brokers to charge for research directly rather than through dealing commissions). The managers think, and we agree, that there is a good chance that research coverage on smaller companies may reduce. In such a situation, SEC could benefit from an informational advantage given GVQIM's emphasis on a detailed, multi-stage, proprietary research process.

Investment process

Summary: private equity style approach to investing

In common with all of its mandates, GVQIM uses a distinct approach to the management of SEC, applying private equity techniques to investing in publicly traded companies. It operates with a mandate that is unconstrained by any benchmark and aims to deliver superior performance over the medium term.

Key features of the approach are:

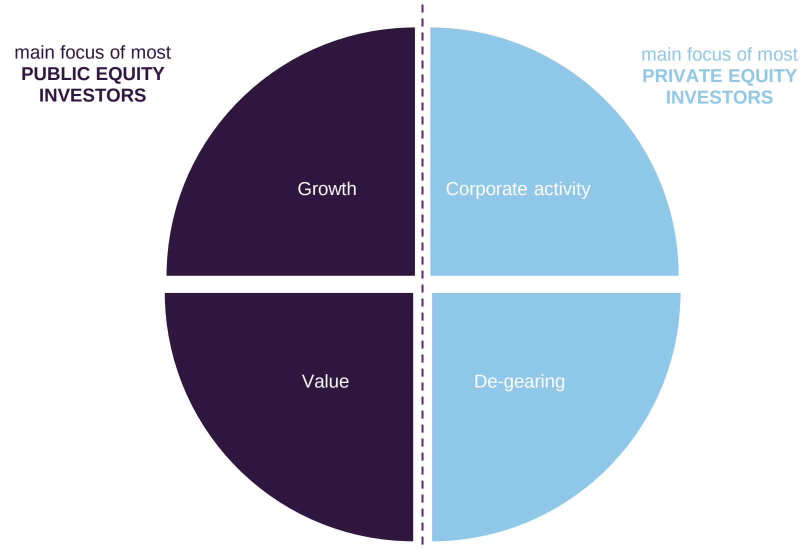
- A strong focus on a company's cash flows, post maintenance capital expenditure, as the managers say that this gives a fairer indication of a company's ongoing profitability;
- Consideration of 'real world' multiples. The team (alongside the Industry Advisory Panel, who collectively have been involved in over 350 transactions) believe there is empirical evidence that transaction values provide a better gauge of a company's fair value and use this in their analysis. This is supported through 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.

Four key drivers

The managers have a strictly defined process and screen all potential investments using their 'four drivers' of equity returns. GVQIM believes that focusing on four routes to creation rather than one in isolation (i.e. 'growth' or 'value'), gives the best chance of achieving target returns over the long term.

GVQIM draws the distinction between the factors on the left-hand side of Figure 2, which reflect the typical focus of investors in listed companies, and the factors on the right-hand side, which are the factors that private equity investors would focus on.

Figure 2: GVQIM's four drivers of value



Source: GVQIM

- **Growth**. GVQIM considers the growth in operating cash flow and prefers structural to cyclical growth. GVQIM favours businesses with the ability to defend their profitability (intellectual property, high barriers to entry, etc.), even in down markets.
- **Value**. Returns are a function of choosing appropriate entry and exit points and, reflecting this, GVQIM says it maintains strong pricing discipline based on the appropriateness of the valuation a company is trading at. GVQIM applies a target cash yield to derive a fair value of a potential investment and the scope for a business to re-rate. It frequently identifies strong candidates for the portfolio but will wait until they're trading at appropriate valuations before initiating positions. Similarly, whilst GVQIM is happy to run its winners where the target returns meet its hurdle, it will reduce and ultimately sell out of businesses where the shares have re-rated to GVQIM's target exit level.
- **Corporate activit**y. GVQIM assesses the potential of companies as an acquirer and a target. The team assess precedent transactions to identify public companies trading at a discount. All portfolio candidates are valued using an in-house leveraged buyout model to form an opinion on the potential value to a trade or private equity buyer. GVQIM seeks to avoid investing in companies with an impediment to being acquired such as a blocking shareholder or a large pension scheme.
- **De-gearing**: As is common in private equity analysis, GVQIM favours cash generative businesses. This may be a consequence of the company's operating model, high margins, efficient working capital and/or low capex requirement. Such businesses can deliver investors returns from the transfer of value from debt to equity, either through de-gearing the balance sheet, dividends or enhanced returns (buy-backs, special dividends etc.).

Concentrated portfolio

Majority of value in 10-15 positions

The portfolio is a highly concentrated one and the managers say they want to have the majority of value in 10 to 15 positions. There is a maximum of 15% in any one investment and holdings will typically have a market cap. that is too small for inclusion in the FTSE 250 Index (at the time of investment). At any one time, the managers will have an active watchlist that they are actively considering for inclusion. The managers invest with a rolling three-year time horizon, targeting IRRs of 15% over the economic cycle, and turnover is typically 25-30%. GVQIM develops entry and exit strategies, and a clearly defined route to value creation, prior to initiating an investment and closely monitors its holdings on an ongoing basis.

Cash flow analysis

Proprietary analysis of post maintenance capex cash flows

A key metric in this private equity style appraisal is an analysis of a company's cash flows – post maintenance capex. The managers highlight that, whilst earnings are important, they can be more readily manipulated and that a focus on understanding a company's cash flow and its sources of cash leakage are key to evaluating its ongoing profitability. For example, they are cautious on companies with unquantified liabilities and significant commitments to defined benefit pension schemes. They also highlight that, whilst important, focusing purely on free cash flow is problematic as this can be boosted short term by cutting back on investment, etc. which can not only undermine a company's future profitability but can lead to investments in companies that appear to be generating higher margins and trading at cheaper valuations than is actually the case. The managers say that by focusing on cash flows post maintenance cap-ex gives a fairer indication of a company's ongoing profitability.

Focus on quality

GVQIM's defines quality as companies with a high degree of IP, high barriers to entry in structurally growing markets with good operating margins and strong cash flow. This has the effect of excluding investment in some areas of the market. The managers avoid businesses that are inherently low margin (e.g. housebuilding, construction, etc.), and businesses where the primary driver of profitability cannot be influenced by management (e.g. resource companies which are heavily influenced by commodity prices). They avoid businesses in structurally declining markets and those that are overly reliant on a single product, customer, supplier or distributor. Poor accounting systems and deteriorating governance standards are also significant red flags, as are weak cash flows and excessive levels of gearing. GVQIM will not invest in companies that it does not have the expertise to analyse. As such it will avoid blue sky investments, those that are at an early stage in their life and are yet to generate positive cash flows.

GVQIM considers IPOs but says it is not usually given sufficient notice to perform its lengthy due diligence process and so rarely invests in them (only two have been bought since SEC was launched).

Industry Advisory Panel

An investment advisory panel appraises every investment

All investments are assessed by GVQIM's Industry Advisory Panel (IAP). The IAP was formed in 2003 and meets monthly to discuss investment candidates in detail. It gives consideration to the quality of a business, its board and whether the members know any of the key individuals, its accounts, whether it is operating at full potential, the strategic and structural challenges it faces, as well as other risks to consider. The IAP is made up of a highly experienced team and the managers consider the IAP to be very valuable resource that helps them to challenge and further develop investment rationales. They believe this ultimately contributes to superior performance. The make-up of the panel is provided on page 17.

Engagement

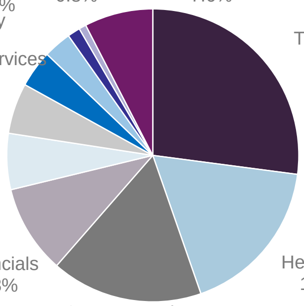
SEC is not an activist fund

GVQIM believes in constructive engagement and that shareholders should not be passive investors but should engage with the management and directors of the companies that they invest in, on matters of corporate governance and corporate strategy. GVQIM takes a holistic approach to this and its focus is on creating shareholder value for all investors. GVQIM does not seek Board representation and prefers to engage in private, after detailed and thoughtful analysis.

Before the managers make an investment, they think about any message they might want to convey to the company. They want to do that from a position of understanding which is one reason why they put so much emphasis on in-depth research, including conversations with key stakeholders; management; chairmen; senior non-executive directors; brokers; other shareholders; and, sometimes, suppliers and customers. Before they make an investment, GVQIM thinks it is important to establish a good dialogue with the people running the company and other stakeholders to understand their views. A recent focus with companies in the portfolio has been to encourage them to be more pro-active in building their relationships with existing and potential investors.

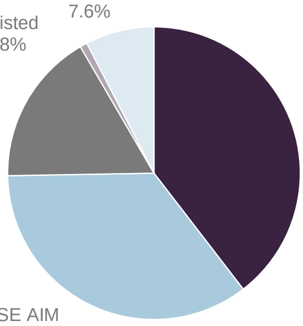
Asset allocation

Figure 3: Sectoral allocation as at 30 June 2017



Source: GVQIM Investment Management

Figure 4: Index allocation as at 30 June 2017



Source: GVQIM Investment Management

Figures 3 and 4 show GVQIM's analysis of the distribution of the portfolio by industry and by index membership. It is noticeable that the portfolio has no exposure to the FTSE 250 or FTSE 100 indices.

We have included a list of the top 10 holdings in Figure 6, overleaf. You can see that a number of investments have substantial net cash positions. This equates to an aggregate net debt to EBITDA figure for the portfolio close to zero, which compares to a c1.5x for the market as a whole. This is picked up in Figure 5 which compares SEC with the FTSE Small Cap ex Investment Trusts on a range of factors (all figures supplied by GVQIM).

Figure 5: SEC comparison with FTSE Small Cap as at 30 June 2017

	SEC weighted average	SEC median	FTSE Small Cap ex inv. co.s, loss-makers	FTSE Small Cap ex inv. co.s, oil, mining, financials and loss makers
Number of securities	16	16	116	104
Market cap (GBPm)	402	226	359	367
Consensus EV/EBITDA FY1 (x)	11.3	11.8	6.3	7.1
Consensus P/E FY1 (x)	17.9	16.8	12.5	12.8
Consensus FY1 earnings growth (%)	13.1	14.0	6.9	6.3
Consensus dividend yield (%)	2.0	2.2	3.1	3.1
Price/book FY1 (x)	3.3	2.6	1.5	n/a
Price/sales FY1 (x)	2.5	2.0	0.7	n/a
Price/cash flow (x)	18.7	16.6	10.9	n/a
GVQIM cash flow yield FY1 (%)	8.7	8.0	n/a	n/a
Net debt/EBITDA (x)	0.4	0.2	1.4	1.0
Overseas sales as %	28.9	35.0	n/a	n/a

Source: GVQIM

The portfolio remains fairly concentrated with 18 holdings, (including Harworth, a property company, and Vintage 1, an unlisted investment) in line with the investment approach. The small exposure to unlisted investments is via an investment in Vintage 1, a fund advised by GVQIM. SEC has an outstanding commitment of €1,560,000 in relation to this investment but the managers have indicated that they do not expect this to be called. 75.7% of NAV is in the top ten holdings. SEC's stocks are smaller than the average for the index. They trade on higher multiples/lower yields than the index, reflecting perhaps GVQIM's focus on quality. However, they exhibit much higher earnings growth.

Figure 6: Top 10 holdings as at 30 June 2017

Holding	Sector	Portfolio percentage	Year first acquired	GVQIM cash flow yield (%)*	Net debt / EBITDA*	Progress vs. thesis
Equiniti	Electronics	11.4	2016	9.6	2.4	In line
Servelec Group	Technology	10.5	2013	9.54	0.1	Behind
Tribal Group	Technology	8.5	2014	6.6	(1.0)	In line
IFG Group	Financials	7.6	2015	9.1	(2.4)	Behind
Clinigen Group	Healthcare	7.5	2014	7.1	0.5	Ahead
EMIS Group	Technology	6.6	2014	8.3	(0.3)	In line
Medica Group	Healthcare	6.4	2017	5.6	0.4	Early
Wilmington Group	Media	6.2	2010	12.6	1.1	In line
Tyman	Industrials	5.6	2009	10.3	1.9	In line
4imprint Group	Support services	5.4	2006	7.9	(0.5)	Ahead

Source: GVQIM, Marten & Co, * GVQIM forecast

Figure 7: Equiniti share price 01/08/16 to 31/07/17

Source: Bloomberg, Marten & Co

Equiniti group

Equiniti is a business services company providing solutions which are 'mission critical but not core'. These include share registration administration and services and software to company's risk and compliance functions driven by the growth in regulation. The company IPO'd in October 2015 at 165p and GVQIM says that it first acquired shares for SEC in early 2016 at an attractive rating, having decided that Equiniti was mispriced and today it is trading at 268.25p. Initially, GVQIM thought that there might be a perception of an overhang on the stock as the private equity vendor retained a holding at IPO. Also, the support services sector was out of favour at the time as investors were disgruntled with stocks such as Capita, SERCO and G4S (this is despite Equiniti having a markedly different business model from these companies). The team believe Equiniti has a good combination of growth and cash flow with further re-rating potential.

The managers say Equiniti is a very stable cash generative business with a blue-chip client base an average client tenure of over 20 years in the share registration division. It generates robust cash flows that it can reinvest in growing software platforms such as KYCNet providing customer onboarding solutions. It grows primarily by selling additional services to existing clients as well as by building its client base.

Recently, Equiniti announced a large North American acquisition – the share registration business of Wells Fargo. This gives Equiniti access to the world's largest capital market. This will be funded by a rights issue. The transaction should achieve target returns through displacing a third-party IT vendor with Equiniti's proprietary Sirius platform. Cross selling to the large customer base should provide many years of growth.

GVQIM says Equiniti has high earnings visibility (c 90%) and it is well-invested in terms of infrastructure. Debt is manageable, especially given its revenue visibility and high cash generation. The business has borne significantly higher debt levels in the past and will greatly benefit from rising interest rates on both sides of the Atlantic.

Servelec

The managers have described Servelec as a mini conglomerate. It provides software, hardware and services to the healthcare, social care, education, oil & gas, energy and utilities sectors.

Servelec modestly de-rated in Q1, on no real news with the market continuing to favour earnings and share price momentum says GVQIM, and the managers topped up the holding. The share price has recovered but it is off recent highs and around 27% off its high in May 2016.

GVQIM says Servelec has good long term structural growth opportunities in areas such as the essential need to upgrade healthcare IT systems; remote monitoring of offshore oil & gas facilities; and upgrading legacy water infrastructure as part of the AMP6 spending cycle. It is also identifying other applications for its technology. For example, Servelec sensors in ATM machines can monitor usage and alert if something untoward is happening.

GVQIM believes that, as Servelec has diversified through acquisition, it has become more difficult for investors to understand and this affects its rating. One of the actions GVQIM has taken is to help the company improve its market communications.

The managers say that, being driven by largely by contracts, revenues are ‘lumpy’ and timing is uncertain but that Servelec is well positioned within framework agreements and so will benefit when funding becomes available (e.g. for government IT contracts). The managers have the benefit of taking a multi-year view and are being patient.

Recent activity

Turnover has been a bit higher than average in recent quarters (running at 30%-40% for the year, about double the usual rate) as they have reinvested the proceeds from the e2v technologies takeover in December last year, at a 48% premium to the prevailing share price (e2v was one of SEC’s largest holdings). The primary beneficiary of this investment activity was a new investment in the IPO of Medica, as well as a new position in Alliance Pharma and a topping up of long term holding Tyman.

Medica – new investment

In March, SEC participated in the Medica IPO. This is only the second time that they have bought shares at IPO since SEC’s launch. The team needs to have sufficient notice to enable them to do their due diligence. This precludes many IPOs (that and their quality threshold). During the months preceding the Medica IPO, the team met company management on a number of occasions, attended a product demonstration, spoke with the chairman and used their network to contact a large number of radiologists and healthcare professionals both in the UK and the USA.

Medica is a leading UK provider of teleradiology services which is the remote interpretation of scans by NHS qualified radiologists. Scanning volumes are increasing by 8 to 10% per year in part thanks to an ageing population and changes to NICE guidelines that require more scans to be performed. Medica work with about 100 of the 190 trusts in the UK. Only 5% of scans are currently outsourced in the UK, while in the US the figure is more like 20%, therefore they see strong growth potential.

There are two services. The out of hours service is a 24/7 service with an average response time of 22 minutes. This avoids a hospital radiologist working a night shift which can be expensive and inefficient. The other service is the routine service. There is also a shortage of radiologists in the UK (unlike the US) and, with volumes growing and budgets not, there are often backlogs in the system. Hospitals get fined if they breach prescribed processing time limits. Medica is helping clear these backlogs. This ultimately ensures better patient outcomes as they are seen and diagnosed quicker.

The managers describe this as a very high-quality business and this is the main reason that they bought it at IPO. They say 70% of growth is coming from existing customers, which, they think, suggests a strong endorsement of the service. Medica has the capacity to handle much larger volumes without significant capex. It also has proprietary technology that gives it an edge over potential competitors and the potential to move into other therapeutic areas.

The IPO was heavily oversubscribed but, as a preferred investor, SEC got a very good allocation, circa 5% of the company at 135p. Medica's shares are now trading at 212.5p.

Alliance Pharma

Alliance Pharma is a recent new investment. Liquidity arose and management believes this was from a forced seller.

Alliance Pharma is a small specialty pharmaceutical company. Its product set is quite mature (out of patent). The company has no R&D costs and therefore no associated risk. Cash flows are very strong and predictable.

Alliance Pharma recently acquired assets from Sinclair Pharma and this doubled the size of the business. The free float in Alliance Pharma's shares increased to a point where it made it investable for SEC (the managers had been following the company for some time).

The recent deal and investments have generated significant underappreciated value and provides the potential for Alliance Pharma to transition to a quality leading pan European player.

The managers also think that the portfolio and the cash flows it generates could be attractive to both trade and financial buyers.

Net debt is 2.5x EBITDA but the company has a strong record of de-gearing. They are aiming to get this to 2.0x by the end of 2017. There should be a double benefit, as the company degears, it should also re-rate.

Tyman

Tyman was a small position in SEC but the managers topped up the investment as it offers a combination of good growth and a high free cash flow yield. Subsequent results published on 7 March brought upgrades and have lifted the share price.

Wilmington

Wilmington's share price has been quite volatile and, in recent months the position has detracted from performance. A trading statement on 18 May was well received initially but GVQIM thinks investors have become nervous and overly focused on short-term earnings growth.

The managers say Wilmington offers decent free cash flow and is operating in attractive areas (such as risk and compliance). The company has been diversifying away from its legal services division and they see this as a positive.

Performance

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

We have compared SEC to a peer group consisting of London listed UK smaller companies focused investment companies with a market capitalisation in excess of £50m. The full list is: Aberforth Smaller Companies, BlackRock Smaller Companies, BlackRock Throgmorton, Downing Strategic Micro-Cap, 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 8: SEC vs. peer group average – NAV total returns for five years ended 31 July 2017

Source: Morningstar, Marten & Co

Figure 9: Highest returning sectors during the previous three months

Three months ending	Leading sector	SEC exposure
July 2016	Mining	No
August 2016	Mining	No
September 2016	Mining	No
October 2016	Mining	No
November 2016	Banks	No
December 2016	Mining	No
January 2017	Oil & Gas	No
February 2017	Mining	No
March 2017	Mining	No
April 2017	Housebuilding	No
May 2017	Insurance	No
June 2017	Technology	Yes

Source: GVQIM, Liberum

As Figure 8 shows, after a long run of very strong outperformance by SEC, 2015/2016 was a more difficult period for the fund. A handful of problematic investments (notably Tribal Group, Servelec and Goals Soccer), held back returns. In addition, due to their quality filters, GVQIM has limited exposure to many of the highest performing sectors of the UK market (see Figure 9 which is based on figures supplied to GVQIM by

Liberum). More specific to small cap, recent performance of the index and peer group has been driven by high quality growth stocks trading on multi-year high valuation multiples and often a premium to historic transactions. These stocks fail GVQ's valuation screens.

The portfolio concentration and unabashed focus on generating absolute returns rather than performing ahead of an index are good reasons why SEC's returns may diverge from both peer group and index comparators for periods of time. As Figure 10 shows, long-term returns still look strong relative to these measures. The managers think the portfolio is in very good health.

Figure 10: Cumulative total return performance to 31 July 2017

Heading	1 month	3 months	6 months	1 year	3 years	5 years
SEC Share price TR	(0.3)	4.8	4.0	8.3	46.2	180.9
SEC NAV TR	(0.9)	1.1	10.5	19.7	47.0	159.5
Peer group NAV TR	3.5	4.3	16.2	34.3	59.1	144.3
MSCI UK Small Cap TR	2.8	2.1	11.5	19.2	42.9	114.6
MSCI UK TR	1.1	3.3	6.3	13.9	21.6	55.8

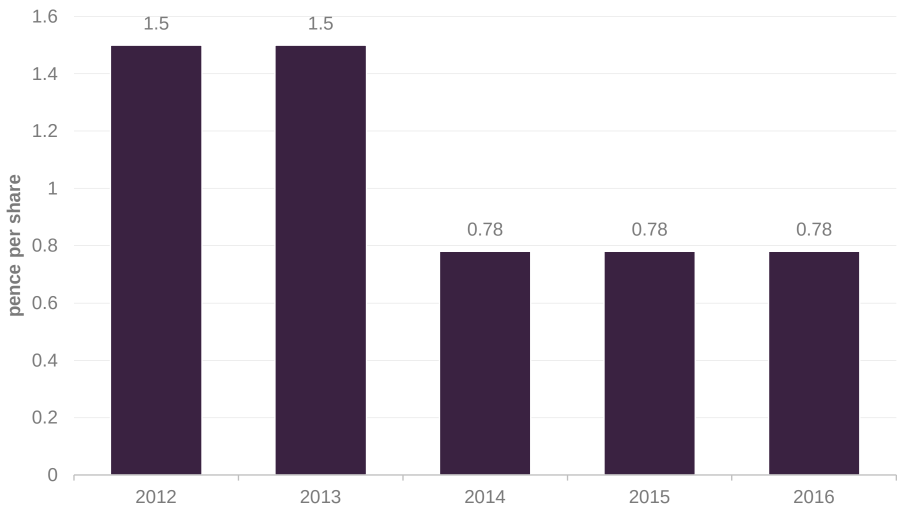
Source: Morningstar, Marten & Co

The managers have published a table that shows how various stocks contributed to performance in Q2. Topping this list was Equiniti which added 287 bp to the NAV after making a strong AGM statement. Servelec's re-rating added 140bp. New holding, Medica made strong start, contributing 76bp to returns. Wilmington was the only detractor of note and it cost the fund just 32bp.

There has been some cash drag on returns over the past year. Net cash peaked at 17% in September 2016 and the takeover of e2v technologies added a further circa 10% to the cash position towards the end of the year. At the end of June 2017, net cash stood at 7.6%. We described how the cash has been deployed on page 10. These investments have generated good initial contributions to NAV.

Dividend

Figure 11: SEC five-year dividend history



Source: Morningstar, Marten & Co

The directors expect that returns for shareholders will derive predominantly from capital appreciation. SEC pays one dividend for each financial year and, for the last three years, this has been set at 0.78p. Over the year to 30 June 2016, the revenue return per share was 0.44p and so part of the dividend was paid from reserves.

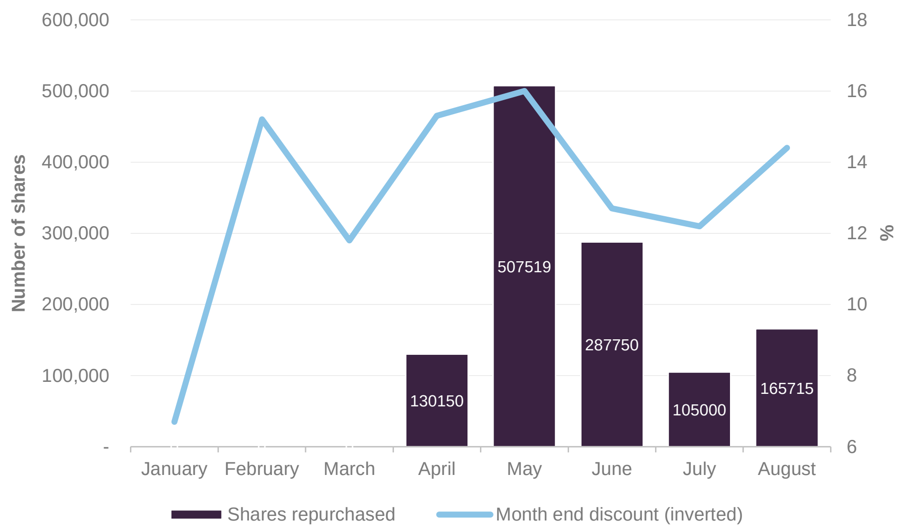
Premium/Discount

Figure 12: SEC premium/(discount) 31 July 2012 to 28 August 2017

Source: Morningstar, Marten & Co

SEC, which had traded on a premium for much of 2015, saw its discount widen over the course of 2016, reaching a low of 16.4% in February 2017, immediately following the resignation of SEC's previous lead manager. At this point, two non-executive directors bought shares in the company and the discount stopped widening. On 27 March 2017, SEC reported that two shareholders holding just over 5% of the fund between them, had attempted to lodge a requisition for a meeting at which shareholders would have been asked to approve a policy of repurchasing shares at a 5% discount. The requisition was invalid. Nevertheless, the company commenced a programme of share repurchases which had the effect of narrowing and stabilising the discount, as is evident in Figure 13.

Figure 13: SEC share repurchases and discount 2017 year to date



Source: Morningstar, Marten & Co

The directors feel that, as before, the discount will narrow when the fund's performance is towards the top of its peer group for a sustained period. In the meantime, they are happy to repurchase shares when they are available at attractive levels of discount. They have also said that they would consider the reintroduction of tender offers, if the shares traded at an unacceptable discount over a sustained period.

Fees and costs

The management agreement was revised in July 2014. GVQIM gets the lower of 1% of the market capitalisation of the fund and the net asset value (which gives them an incentive to work to drive the discount down but does not reward them if the fund goes to an excessive premium).

GVQIM also gets a performance fee of 15% of the excess return over the FTSE Small Cap ex Investment Companies Index over rolling three year periods provided that the index has returned at least 2% per annum (otherwise the hurdle is 2% per annum). The maximum payable in any one year is 1.75% of the NAV – excess amounts are carried forward to future periods. There is a high watermark.

The contract can be terminated with 12 months' notice by either party but no notice need be given if the shareholders vote against the continuation of the company.

Company secretarial and general administrative services are undertaken by Personal Assets Trust Administration Company.

Ongoing charges ratio falling

SEC's annualised ongoing charges ratio is 1.28% (based on the six months to end December 2016) – down from 1.4% at 30 June 2016.

Capital structure and life

SEC's capital structure is straightforward – just ordinary shares and no gearing. There are 68,612,757 of these in issue and, in addition, 1,246.134 shares are held in Treasury. These may be reissued.

No gearing

SEC's articles permit it to borrow up to 25% of the NAV but GVQIM says it has no intention of gearing the fund and SEC hasn't had a borrowing facility since July 2012.

The company's year-end is 30 June and it usually holds its AGMs in November.

Management team

GVQIM was founded in 2002. It specialises in using the techniques employed by the private equity industry to investing in quoted companies and they believe they are one of the leading firms doing this in Europe. They do the bulk of their own research, aided by an extensive network of industrialists and private equity professionals. Their fund managers have extensive private and public equity experience, and invest in GVQIM's products. It 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.

In addition to SEC, GVQIM manage the GVQ UK Focus Fund and the GVQ Opportunities Fund.

In December 2014, RIT Capital Partners, the London listed investment vehicle for Lord Rothschild and his family, acquired GVQIM. GVQIM's managers will retain their investment autonomy under the new arrangement. There is the potential for RIT Capital's network to be a valuable source of investment ideas for GVQIM's clients, including SEC.

- **Jeff Harris ACA** is the lead portfolio manager. 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 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 GVQIM'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 rejoined 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. He has over 30 years' experience in private equity.

Board

All of its members are non-executive and all but one, Sir Clive Thompson who also sits on SEC's Industry Advisory Panel, are considered to be independent of the manager.

Richard Hills is chairman. He has substantial investment company board experience. Richard is chairman of SQN Structured Finance and is currently on the boards of two other investment companies: JP Morgan Income & Capital and Henderson International Income.

William Barlow joined the board in February 2016. He is chief executive officer of Majedie Investments, a director of Majedie Asset Management and was previously chief operating officer at Javelin Capital. Previously he was an equity portfolio manager at Skandia Asset Management and managing director of DNB Nor Asset Management (UK).

Josephine Dixon was finance director of Newcastle United between 1995 and 1998 and thereafter served as commercial director, Europe and the Middle East at Serco Group until 2003. She has substantial investment company board experience and is currently on the boards of Ventus VCT, Worldwide Healthcare Trust, F&C Global Smaller Companies, Standard Life Equity Income Trust and JP Morgan European Investment Trust.

Richard Locke was appointed as a director with effect from 10 February 2015. Mr Locke has been a managing director of Fenchurch Advisory Partners LLP since 2007, having formerly spent nineteen years at Cazenove & Co/JPMorgan Cazenove.

Sir Clive Thompson is deputy chairman. He is best known as chairman and prior to that chief executive of Rentokil Initial. He is a former president of the CBI, member of the Committee on Corporate Governance and deputy chairman of the Financial Reporting Council. He is also a former director of J Sainsbury, Wellcome, Seeboard, Caradon and BAT Industries. Sir Clive is deemed to be non-independent by virtue of his membership of SEC's Industry Advisory Panel (see below).

Figure 14: Board statistics

Heading	Appointed	Length of service (years)	Annual fee (GBP)	Shareholding
Richard Hills	05/03/2014	3.4	35,000	60,000
William Barlow	01/02/2016	1.5	24,000	10,000
Josephine Dixon	14/07/2014	3.1	27,500	10,000
Richard Locke	10/02/2015	2.5	24,000	30,000
Sir Clive Thompson	19/07/2005	12.1	24,000	2,679,102

Source: Marten & Co.

Industry Advisory Panel

The Industry Advisory Panel is unchanged since 2014, comprising Sir Clive Thompson, Stewart Binnie, Chris Rickard, Peter Williams and Lindsay Dibden.

GVQIM consider the Industry Advisory panel plays a valuable role in GVQIM's investment research process.

Sir Clive Thompson is a board member. For SEC's Industry Advisory Panel he advises on business services, consumer services and FMCG companies. He is joined there by:

Stewart Binnie, formerly Chairman of Aurora Fashions. Member of the Investment Committee of the Schroder Private Equity Fund of Funds business, a member of the board of Schroder Ventures Asia Pacific Fund; and has advised Schroders plc on private equity related issues since 2005. Stewart is also a Former Partner of Permira (formerly Schroder Ventures) and Schroder Finance Partners. Stewart advises on retail, media and technology stocks

Lindsay Dibden spent a 23-year career in private equity investment. He was a founder partner of HgCapital, establishing its Healthcare practice in 1996, which he led for 16 years. During his career, he was involved in more than 30 transactions. Prior to retiring from the partnership in 2012, Lindsay served on the firm's Investment Committee and Executive Committee. He is now the owner of two healthcare businesses providing care in the home across the counties of West Sussex and Hampshire. In addition, he acts as an advisor to Spring Ventures, Alvarez & Marsal and EVOCO AG and actively manages a diverse portfolio of other investments.

Chris Rickard, former CFO of Taylor Wimpey plc, Whatman plc, VT Group plc, Weir Group plc and Meggitt plc. Previously he was Head of Corporate Development at Morgan Crucible. Has led numerous successful financial and operational restructurings, as well as executed more than 100 acquisitions, mergers or disposals. Chris advises on industrials, business services and healthcare products.

Peter Williams, Finance Director from 1991 to 2011 of Daily Mail and General Trust plc, a worldwide media business, spanning newspapers, online consumer businesses, business information and exhibitions, with a current market capitalisation of around £2.6 billion. Peter is currently a Senior Independent Director of Perform Group plc, a FTSE 250 digital sports media business. He is also a director of Ibis Media VCT plc, a small listed VCT that specialises in early stage media investments. He specialises in the media sector

Previous research

Further information is available in our earlier research notes – **Business as usual** – published on 22 March 2017; **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 15: 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
Business as usual	Update	22 March 2017

Source: Marten & Co.

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