MARTEN & CO

Update | Investment companies

07 August 2018

Strategic Equity Capital

Confident, despite short-term setback

After a strong period of performance in 2017, when Strategic Equity Capital (SEC) beat a strong small cap index by 6%, 2018 has proved problematic.

Short-term performance has been impacted by stock specific price weakness within SEC's concentrated portfolio. SEC's managers are long-term investors, however. They have confidence in their portfolio, based on 3-to-5-year investment theses, and bought shares throughout Q2 2018, now owning around 4% of the trust. SEC's discount is towards the bottom end of its trading range; this could represent an opportunity. The board has authorised share repurchases to stabilise the discount. In the past, investors' patience has been well rewarded.

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.

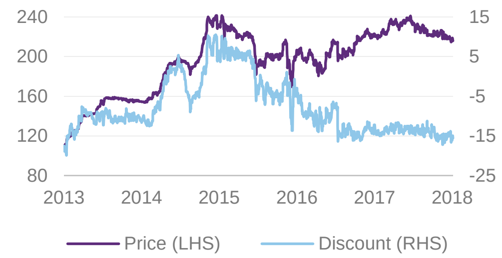
Year ended	Share price total return (%)	NAV total return (%)	Peer group * average NAV TR (%)	MSCI UK Small Cap TR (%)	MSCI UK total return (%)
31/07/14	41.8	32.1	10.5	6.7	5.3
31/07/15	50.8	26.8	18.4	19.0	2.3
31/07/16	(10.5)	(3.1)	(0.2)	0.8	4.3
31/07/17	8.3	19.7	34.2	19.2	13.9
31/07/18	(1.4)	2.2	12.7	12.0	8.7

Source: Morningstar, Marten & Co, see page 7 for details of peer group

Sector	UK Smaller Co.s
Ticker	SEC LN
Base currency	GBP
Price	216.0p
NAV	255.8
Premium/(discount)	(15.5%)
Yield	0.4%

Share price and discount

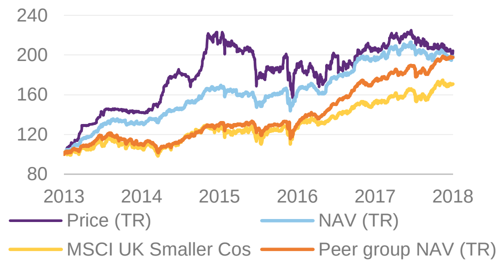
Time period 31/07/2013 to 03/08/2018



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/07/2013 to 31/07/2018



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	13 July 2005
Manager	Jeff Harris, Adam Khanbhai
Market cap	144.3m
Shares outstanding	66.8m
Daily vol. (1-yr. avg.)	115k shares
Net cash	7.6%

Click here for our annual overview note

Managers' view – confident in the face of negative sentiment

Volatility can provide opportunity for a fund such as SEC with its permanent capital and long-term approach

Generally, the market remains volatile with macro concerns, decreasing dissemination of information and thin liquidity, which can magnify share price movements (in both directions). The managers believe that this provides opportunity for SEC with its permanent capital and a long-term approach focused on intrinsic valuations. The management team's positive outlook is supported by multi-year low valuations, strong cash characteristics and strategic progress in many of the fund holdings.

In recent years, 'quality growth' as a style has helped drive returns in the smaller end of the market, sometimes pushing them to extreme valuations. In addition, high valuation multiples exist for stocks with macro exposure such as industrials, which are more cyclical. SEC has very little exposure to the UK domestic market, cyclicals and stocks trading at premium valuations (often in excess of transaction multiples).

As we explain later in this report, SEC's portfolio has been the victim of some sharp price movements. SEC's managers have confidence in their portfolio however. At the end of June 2018, the average portfolio company held by the fund was trading at an estimated 9.7% free cash flow yield, the highest in two years. Sentiment towards a number of portfolio holdings is not positive; this has provided opportunities to add to stocks that they like, at attractive valuations.

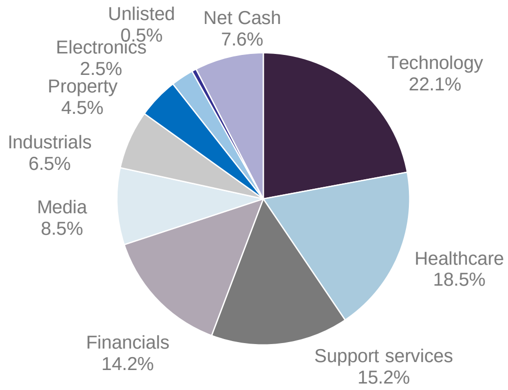
The managers believe that the changes brought about by MiFID II may perpetuate trends in the smaller end of the market. Liquidity is declining and there is a dearth of information about some stocks leading to some of the market becoming increasingly fixated on the short-term. They think that companies need to be more proactive about their external messaging and communication with the market.

Private equity liquidity should fuel more M&A activity. Strong balance sheets provide resilience

On the plus side, however, private equity funds have significant amounts of liquidity to deploy and this should continue to fuel the resurgence in M&A. Balance sheets of the companies within the portfolio are strong and the managers believe that this adds some resilience to the portfolio in the face of any economic weakness.

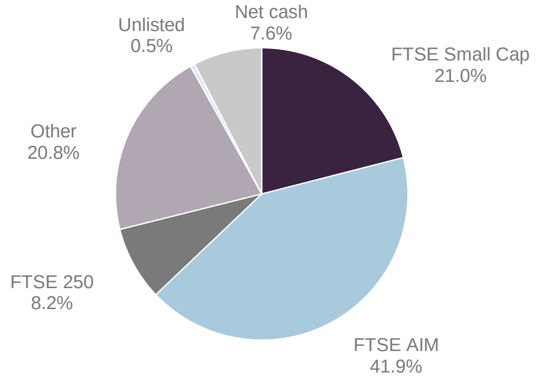
Asset allocation

Figure 1: Sectoral allocation as at 30 June 2018



Source: GVQIM

Figure 2: Index allocation as at 30 June 2018



Source: GVQIM

Figures 1 and 2 show GVQ Investment Management Limited (GVQIM)'s analysis of the distribution of the portfolio by industry and by index membership. The greatest change to industry sector weightings since we last published on SEC (using data as at 30 June 2017) has been an increase in the exposure to financials stocks at the expense of consumer services. These weightings reflect stock selection decisions rather than any thematic overlay, however (see that annual overview note for more information on SEC's investment process). One holding, Equiniti, has been promoted to the FTSE 250 Index since our last note was published.

Figure 3, which is based on numbers supplied by GVQIM, shows how SEC's portfolio compares to the FTSE Small Cap ex-Investment Companies Index. At the end of June 2018, SEC's holdings were, on average, more expensive than the average company in the index (SEC does not invest in lower valued sectors such as construction, consumer or resource companies) but had significantly stronger balance sheets and higher growth expectations.

Figure 3: SEC comparison with FTSE Small Cap as at 30 June 2018

	SEC weighted average	SEC median	FTSE Small Cap ex inv. co.s
Number of securities	18	18	157
Market cap (GBPm)	422	211	317
Consensus EV/EBITDA FY1 (x)	9.8	9.5	7.0
Consensus P/E FY1 (x)	15.5	14.9	11.2
Consensus FY1 earnings growth (%)	16.1	15.0	7.7
Consensus dividend yield (%)	2.3	1.8	3.3
Price/book FY1 (x)	2.4	1.9	1.6
Price/sales FY1 (x)	2.1	1.9	0.7
Price/cash flow (x)	19.2	19.2	13.7
GVQIM cash flow yield FY1 (%)	9.7	9.5	
Net debt/EBITDA (x)	0.0	(0.4)	1.8
Overseas sales as %	44.6	49.3	

Source: GVQIM

Disposals

Two large positions sold since our last note

Two large positions have been sold since our last publication on the company; Goals Soccer and Servelec.

Goals Soccer

The managers have sold the stake in Goals Soccer; it had been a ‘drag’ on SEC’s performance. They say that the company’s market position had changed fundamentally and the sale was a response to this violation of their investment thesis. Historically, the business was cash generative, with a strong market position. A proliferation of competing businesses damaged margins (in 2009 there were around 50 artificial pitches in the UK; today there are around 700). The growth in the provision of pitches is a result of the efforts of local authorities and the Football Association. Goals Soccer’s offering started to look expensive relative to these new competitors and sub-par. New management are attempting to revitalise the business by investing in facilities but higher ongoing capital investment requirements and higher staff wages lowered returns. SEC sold its stake in September last year. Mike Ashley (of Sports Direct) acquired a stake around that time and increased this in February 2018.

Servelec

Servelec was bid for in November last year, capping a bumpy ride for SEC with an annualised return of around 15%. End market conditions had impacted the company’s growth rate and this led to a fall in its share price. However, the strategic value of the company was obvious to them and the acquisition of the company by Montagu Private Equity validated this view. The deal completed in January 2018.

10 largest holdings

Figure 4: Top 10 holdings as at 30 June 2018

Holding	Sector	Portfolio percentage (%)	Year first acquired	GVQIM cash flow yield (%)*	Net debt / EBITDA* (x)	Progress vs. thesis
Tribal Group	Technology	8.7	2014	8.4	(1.4)	In line
Wilmington Group	Media	8.5	2010	11.6	1.2	In line
Equiniti	Electronics	8.2	2016	6.7	2.4	In line
IFG Group	Financials	7.7	2015	9.8	(2.1)	Behind
Clinigen Group	Healthcare	7.2	2014	7.1	1.1	Ahead
4imprint Group	Support services	6.9	2006	7.8	(0.8)	Ahead
EMIS Group	Technology	6.9	2014	9.3	(0.3)	In line
Tyman	Industrials	6.5	2009	12.5	1.6	In line
Medica	Technology	5.1	2017	8.4	(0.1)	Early
Harworth	Real estate	4.5	2016	n/a	n/a	In-line

Source: GVQIM, Marten & Co, * GVQIM forecast

The conviction that SEC’s managers have in their portfolio is evident in its concentration with over 70% of the NAV invested in the 10 largest holdings as at 30 June 2018.

Some of these are discussed on the following pages.

IFG Group

Figure 5: One-year share price

Source: Bloomberg, Marten & Co

SEC's managers believe that IFG has two good assets in Saunderson House and James Hay but that this is not reflected in IFG's rating. Its share price dropped from around 185p at the end of March to a low of 125p towards the end of May 2018 (the shares are currently 137.5p). The principal cause of this was IFG's decision not to sell Saunderson House, despite having received indicative bids at valuations in-line with expectations. This was due to execution risks relating to the transaction that they believed would have jeopardised shareholder value. SEC increased its position at the end of May to 9.74% of the company. SEC's managers see no fundamental change in the intrinsic value of the assets.

The managers point to the valuations of listed peers and transactions in the sector which suggest that the company is trading at a substantial discount. They report that Saunderson House is trading well, as is James Hay. A trading statement released on 9 May revealed that James Hay's client numbers increased by 3.3% year-on-year and price and interest rate increases boosted both revenues and profits. Saunderson House's client numbers increased by 9.8%. The combined business has around £30bn of assets under administration or advice and has a market cap of £140m. (AJ Bell has around £42bn of assets under administration and values of around £500m have been put forward for its forthcoming IPO). The new management team is thinking about the options for the business and is focused on shareholder value.

Saunderson House charges are based on time spent serving the client rather than being transaction related or calculated with reference to AUM. SEC's managers think that this is a strength as it could make its revenues more robust. They think it is also less cyclical than peers, as clients are more likely to ask for advice in times of market stress.

Equiniti

Figure 6: One-year share price

Source: Blomberg, Marten & Co

Equiniti's share price was quite strong leading up to March this year and the managers took advantage of this to take significant profits, as it rose by around 60%. The investment case has progressed as the company acquired Wells Fargo's business and Capita's problems have seen them take market share.

In recent months, the shares have been weaker (36% off their peak). This is despite record half year results ahead of market expectations and earnings upgrades. The team have used this weakness to buy back many of the shares sold at higher levels earlier this year and have strong conviction that the share price will revert to better reflect the quality and ongoing progress of the company.

Wilmington

Figure 7: One-year share price

Source: Bloomberg, Marten & Co

Wilmington is a stock that SEC has held for some time. Its share price has been quite volatile over the last couple of years. The managers were concerned that the performance of the business was weak and there was no organic growth. They also thought the company's investor relations efforts could be improved.

Due to these issues, and the long tenure of the previous chairman, last year, after consulting with other investors, SEC's managers encouraged the company to find a new chairman. They introduced Martin Morgan (ex-chief executive of Daily Mail & General Trust) who was appointed in February this year. The managers see his appointment as very positive in the long-term. SEC's managers believe that there are some potentially valuable assets hidden within the firm's portfolio, including within the risk and compliance division where Wilmington provides information, training and accreditation services.

Post quarter end the business released a negative trading update and its shares fell sharply. The managers say that, whilst disappointing, this is likely to accelerate a review of the company's strategy and portfolio, potentially improving the prospects for a return to a positive trajectory over the medium term. Wilmington has since announced the sale of ICP, its specialist leading credit reporting company.

4Imprint

Figure 8: One-year share price

Source: Bloomberg, Marten & Co

4Imprint was one of the standout positive contributors to SEC's returns in 2017. This year its shares have moved sideways. The company has been repositioning its sales efforts from catalogues to online marketing, TV and radio. SEC's managers see the potential for its revenue growth to accelerate from current levels (12% over 2017). They are backing the management team to make the strategic decisions needed to reposition the company and are looking past the short-term impact of this. Much of the company's revenue is dollar denominated. Stronger sterling was a headwind to returns last year but the sharp reversal in the exchange rate since mid-April should prove beneficial.

EMIS

Figure 9: One-year share price

Source: Bloomberg, Marten & Co

In January 2018, healthcare software company, EMIS saw its share price collapse from close to £10 to £7. This was due to problems with its web product for GPs. EMIS tackled the problem quickly and compensated NHS Digital at a cost of £11m. Trading elsewhere in the business is robust, the relationship with NHS Digital seems strong and the shares have recovered to £9.11 today.

In April this year, another healthcare software company, Allocate Software, (an SEC holding some time ago) was acquired by Vista Equity Partners for a rumoured 15x EV/EBITDA. EMIS is the only listed company in this area now. SEC's managers think it looks attractively valued relative to the levels at which M&A deals have been done in the sector.

Alliance Pharma

Figure 10: One-year share price

Source: Bloomberg, Marten & Co

Alliance Pharma was a new investment in 2017. A large acquisition had increased the level of gearing in the business and this put off some investors. However, SEC's managers' analysis showed that strong cash flow should allow the debt to be reduced quite quickly. The company is delivering growth in high single digits. SEC's managers think that the company's earning quality is high – pointing to the resilience of the business in downturns. Cash is also being reinvested in adding new products. Most recently, Alliance Pharma raised £34m from investors to fund the purchase of anti-dandruff shampoo brand, Nizoral.

Alliance Pharma has been SEC's most successful investment this year. Between initial investment and 30 June 2018, the stock returned 87%. SEC's managers have been taking profits.

PROACTIS Holdings

Figure 11: One-year share price

Source: Bloomberg, Marten & Co

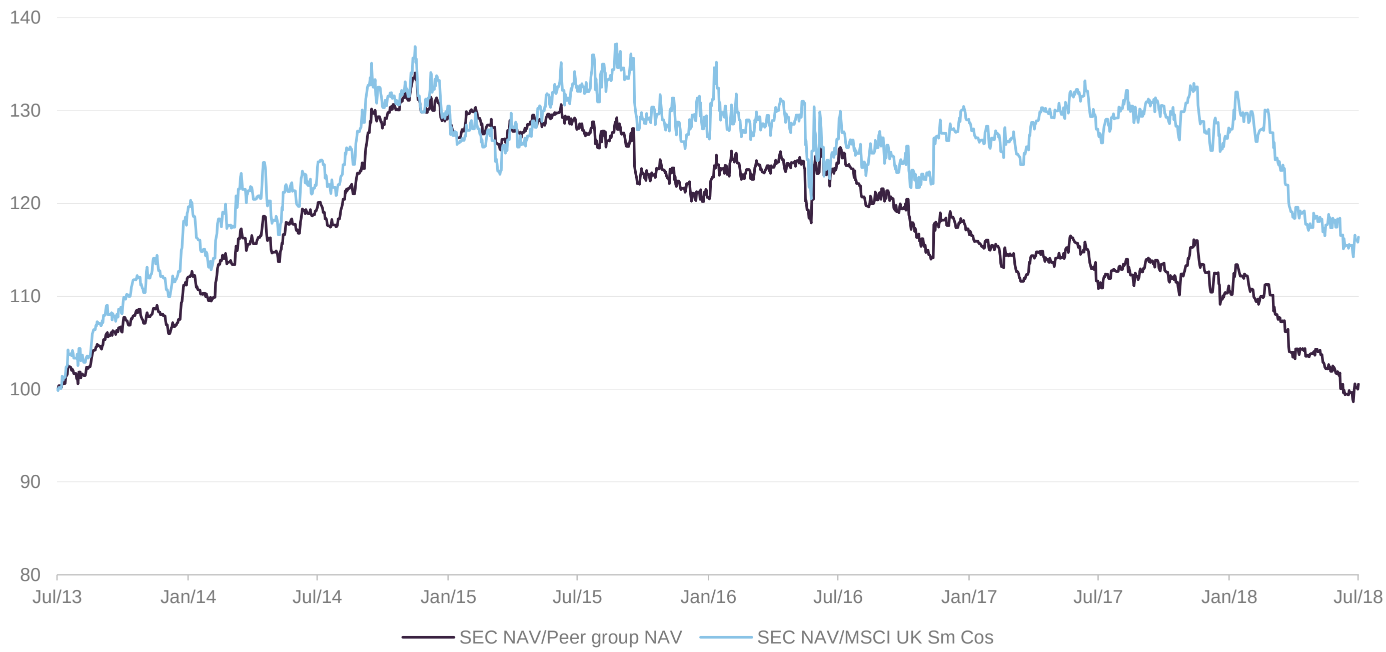
PROACTIS Holdings is digitising procurement and account payable processes. Its shares dropped by almost 50% in April after it reported the loss of two large customers; BP and Shell, exacerbated by FX headwinds due to the strength of sterling (a factor that should have partially reversed since the announcement). This led to around 15% downgrades to profit expectations. Although large, neither of these two customers were typical of the rest of its customer base, which tends to be public sector bodies and SMEs. They were also customers of a single product line rather than taking multiple modules from PROACTIS' suite of products. Their loss had been expected but not for some time, hence the profit warning.

The managers believe these losses were isolated, were encouraged by 35 new customer wins in the period and news that the integration of the recently acquired Perfect Commerce is proceeding to plan. They believe that the company is on track to deliver £5m in cost savings. They also say that, setting BP and Shell aside, customer retention has been market leading historically (at around 95%), reflecting a strong underlying proposition; approximately 85% of revenue is recurring.

PROACTIS is ranked sixth globally for companies in its field, despite its relatively small size. The market is growing but remains fragmented and hence there has been a significant amount of M&A in the sector from both private equity and trade buyers. SEC's managers view PROACTIS as attractively rated, both compared to previous transaction multiples and listed peers like Coupa and Basware, and have therefore increased their holding since the profit warning.

Performance

Figure 12: SEC's NAV relative to peer group average NAV and MSCI UK Smaller Companies over five years to 30 July, total returns, rebased to 100



Source: Morningstar, Marten & Co. *Note: the peer group of London listed, UK smaller companies focused investment companies 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. This peer group has been selected on the basis of having a market capitalisation in excess of £50m.

Please click here to visit QuotedData.com for an up-to-date comparison of SEC and its UK smaller companies peer group

Figure 12 shows that, over the five years to the end of July 2018, SEC has outperformed the MSCI UK Smaller Companies Index. However, as is clear from Figure 13, the second quarter of 2018 was relatively weak, reflecting some of the stock specific issues that we highlighted on pages 5 to 6 and strength in areas of the market where SEC has no exposure.

SEC's 'private equity' approach results in it having a highly concentrated portfolio focused on strategic assets at the smaller end of the market cap spectrum. This means that its performance can diverge markedly from other members of its UK smaller companies peer group.

SEC's performance relative to the peer group average has been held back by the absence of a handful of very highly rated growth companies from its portfolio such as Fevertree and Blue Prism. Such parts of the market are not compatible with SEC's cash generation and valuation focused strategy. The market has been favouring growth over value for some time. SEC's managers view this as potentially at risk due to what they perceive as sky high valuations and growth expectations. They believe SEC should be of interest to investors looking for a differentiated strategy. There is a high level of dispersion in the returns of the peer group over the past five years; on an NAV total return basis SEC ranks eighth of 14 trusts with the worst fund returning 48% and the best 155%.

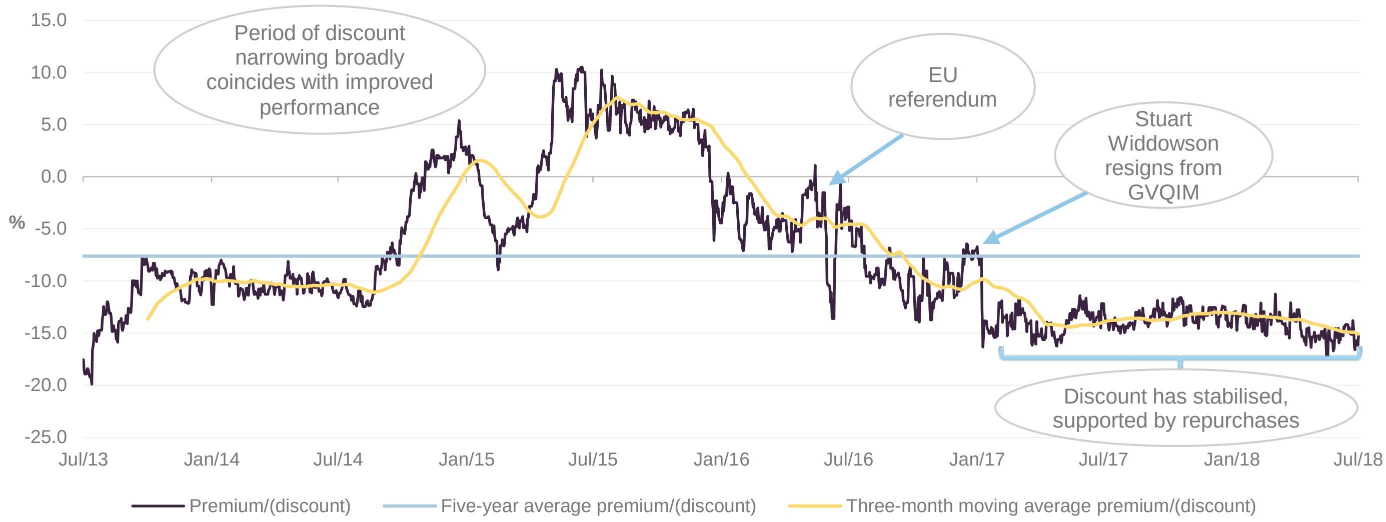
Figure 13: Cumulative total return performance to 31 July 2018

Heading	1 month	3 months	6 months	1 year	3 years	5 years
SEC NAV	(0.5)	(0.9)	(6.4)	(1.4)	(4.4)	104.5
SEC share price	(0.6)	1.6	(4.1)	2.2	18.5	98.6
Peer group avg. NAV	0.3	3.5	5.2	12.0	34.5	70.7
Peer group avg. share price	0.9	6.2	4.0	16.3	56.6	104.9
MSCI UK Small Cap	0.3	3.5	5.2	12.0	34.5	70.7
MSCI UK	1.5	4.0	5.0	8.7	29.2	39.2

Source: Morningstar, Marten & Co

Premium/discount

Figure 14: Premium/(discount) over five years



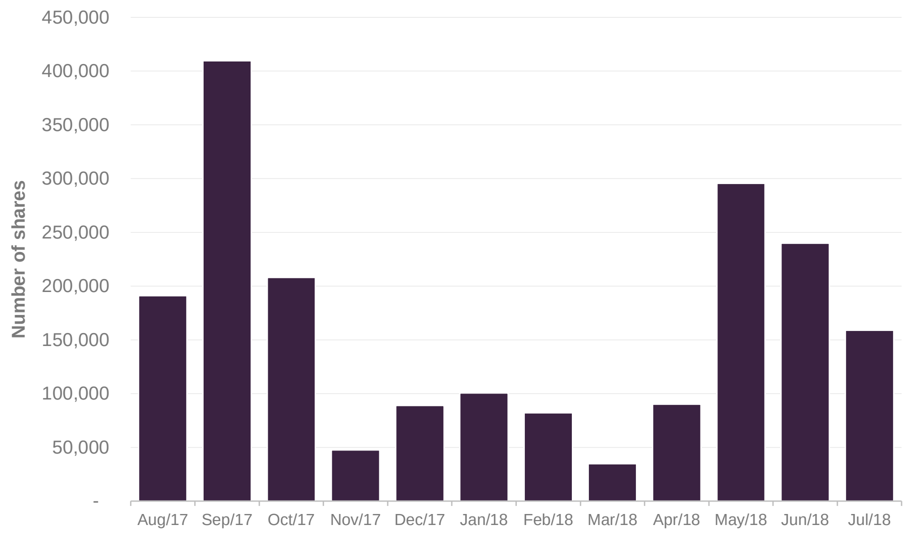
Source: Morningstar, Marten & Co

Modest buy-backs have stabilised discount

Over the past year, SEC's discount has moved within a range of 11.3% to 17.2% and, at the time of publication, it is 15.5%.

SEC's discount has stabilised over the past 18 months, supported by a modest level of share buy backs.

Figure 15: SEC share repurchases over the past year



Source: Bloomberg, Marten & Co

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) targeting an IRR of at least 15% per annum across the cycle. SEC is mainly 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 creates greater opportunities to identify mispriced securities. The trust 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 is not constrained by benchmark, has an absolute return focus and does not employ leverage at the investment trust level.

Private equity style valuation techniques in public markets

Private equity style investing in listed companies

A particular feature of SEC is GVQIM's approach to managing its portfolio. In common with all of its mandates, GVQIM uses an approach that seeks to apply private equity techniques to listed equity markets. More detail is available in **our August 2017 note**, but key features of the approach include:

- 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 our August 2017 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.

Investment manager's successful MBO

Strong alignment between manager and investors

SEC has been managed by GVQ Investment Management Limited (GVQIM) and its predecessors since launch (GVQIM was formerly GVO Investment Management and SVG Investment Managers). GVQIM has assets under management of over £640m.

On 21 December 2017, GVQIM's senior management announced a management buyout of the business from RIT Capital Partners. RIT Capital Partners retains its stake in SEC and has expressed a desire to remain a long-term holder in the trust. The trust is managed by Jeff Harris, assisted by Adam Khanbhai.

The investment managers are well-aligned with shareholders, in our view. GVQIM employees own around 4% of the trust.

Previous publications

Readers interested in further information about SEC, such as investment process, fees, capital structure, trust life and the board, may wish to read our annual overview note **Quality small cap focus**, published on 30 August 2017, as well as our previous update notes and our initiation note (details are provided in Figure 16 below). You can read the notes by clicking on them in Figure 16 or by visiting our website.

Figure 16: Marten & Co. previously published notes 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
Quality small cap focus	Annual overview	30 August 2017

Source: Marten & Co.

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IMPORTANT INFORMATION