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# STRATEGIC EQUITY CAPITAL PLC

Q2 Update 2017

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FE Crown Rating : 4 crown rating as at 30<sup>th</sup> June 2017

Morningstar 5 Year and 3 Year Rating™ of ★★★★★ as at 30<sup>th</sup> June 2017

Money Observer: Rated Fund as at 30<sup>th</sup> June 2017

**Runner Up 2017 and 2016, Winner 2015, Highly Commended 2014:** Money Observer Trust Awards. Category: Best UK Equity Trust

**Highly Commended 2016, Winner 2015, Highly Commended 2014:** Moneywise Investment Trust Awards . Category: UK Smaller Companies

**Winner 2015 and 2014:** What Investment Trust Awards . Category: Best UK Investment Trust

**Winner 2015:** Investment Adviser 100 Club Awards . Category: UK Smaller Companies

**Winner 2015:** Grant Thornton Quoted Company Awards . Category: Fund Manager of the Year

**Winner 2014:** PLC Awards . Category: Fund Manager of the Year

**Winner 2014:** Investment Week, Investment Company of the Year Awards . Category: UK Smaller Companies

**Highly Commended 2012:** Money Observer Trust Awards . Category: Best UK Smaller Companies Trust

**Winner 2011:** Investment Trust Magazine. Category: Best Small Companies Trust

## Q2 update 2017

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Q2 UPDATE 2017

# Executive summary

- SEC was the top performing Small Cap Trust in Q2<sup>1</sup>. It delivered a total NAV return of 8.0%, outperforming its benchmark the FTSE Small Cap ex IT index (the “index”), by 5.1%
- This capped a very strong H1 2017, in which the Trust delivered a total NAV return of 13.7%, versus a total return from the index of 8.8%
- The discount at period end was 12.7%, broadly in line with the sector average at 12.3%
- We had a lot of discussion with clients regarding the cash balance during Q1; it peaked at c.17% in September last year and this did not include a further c.10% of proceeds from the e2v technologies transaction. The cash balance closed the period at c.8% i.e. nearly 20% of the Fund’s NAV has been deployed recently, the majority since March
- Principal beneficiaries of capital (as highlighted last quarter), included Medica (+67% since IPO) and Tyman (+26% since top up purchase). The Trust also initiated a new investment in Alliance Pharma and fully realised its holding in Northbridge
- We continue to believe SEC represents an outstanding collection of high quality assets. With a combination of growth and de-gearing still in excess of 20%, this supports our positive medium term outlook

## **Positive quarter. Portfolio continues to be positioned in areas of long term structural growth**

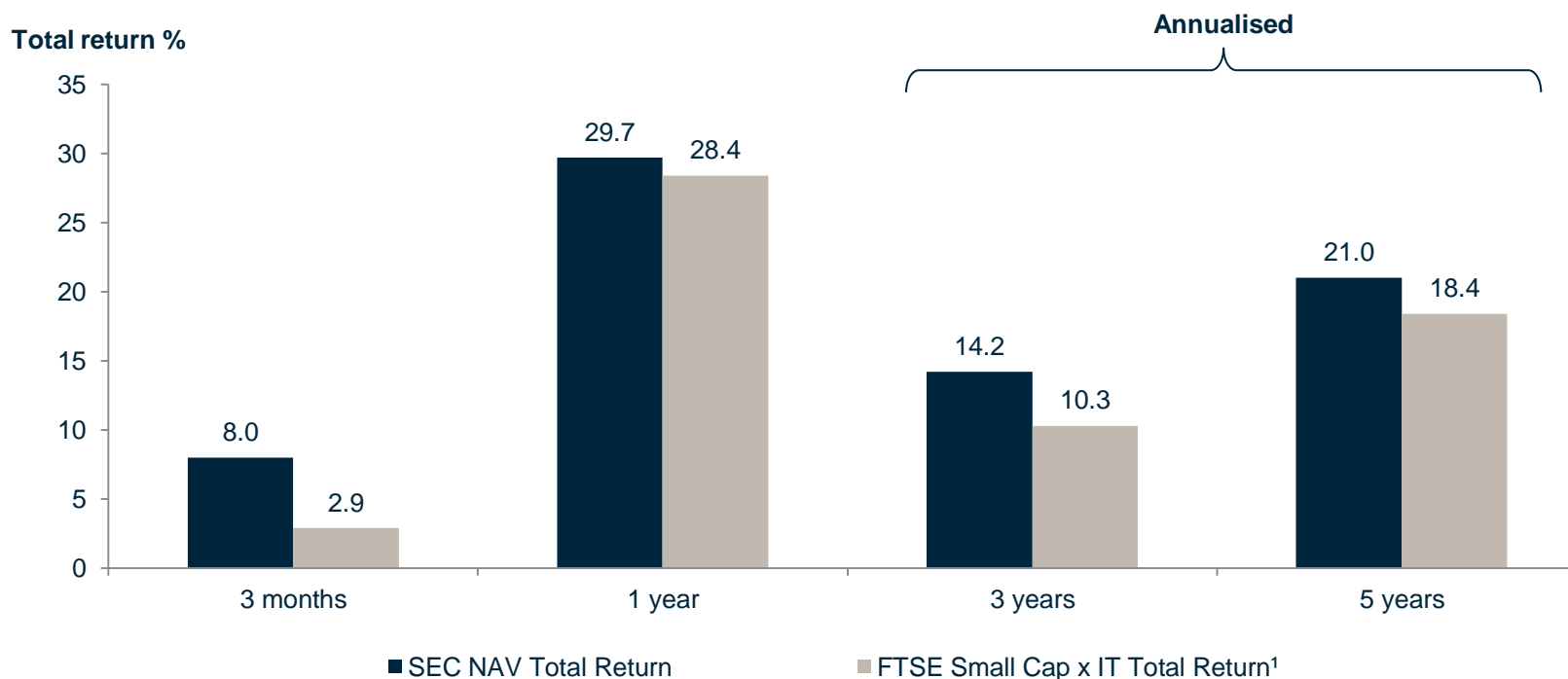
As at 30<sup>th</sup> June 2017

Source: GVQIM; PATAC; Bloomberg; Numis; Factset

Note: 1. Winterflood Quarterly Review

Past performance is no guarantee of future performance and the value of investments can go down as well as up

## SEC NAV performance against comparator index<sup>1</sup>



<b>Average Net Cash</b>	9.3%	12.0%	10.4%	10.5%
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**Strong short, medium and long term annualised absolute and relative performance driven by consistent research process**

As at 30<sup>th</sup> June 2017  
 Source: Unaudited Bloomberg; PATAC; GVQIM  
 Note: 1. Comparator index FTSE Small Cap ex Investment Trusts Total Return  
 Past performance is no guarantee of future performance and the value of investments can go down as well as up

# Q2 Attribution analysis

Positive attribution (top five)	bps	GVQIM Comment
Equiniti Group	287	AGM statement outlines good progress in contract renewals and new client wins. We believe Equiniti has a strong business model and the shares remain under-owned
Servelec Group	140	No news. Re-rates from depressed position
Medica Group	76	In-line AGM statement. No impact from NHS IT attacks. Admitted to the Small Cap Index
Tyman	61	In-line AGM statement with group well positioned for further progress
Clinigen Group	52	Company achieves positive opinion on Cardioxane. Small re-rating. We believe the medium term prospects for the company are compelling
Negative attribution (bottom five)	bps	
Northbridge	3	Holding fully realised
Tribal Group	2	Share price pauses after recent strength. Small acquisition of education social network gives indication of future direction of the company
Harworth Group	-1	In-line AGM statement. Continued director share buying
4imprint Group	-27	In-line AGM statement indicating confidence with full year forecasts
Wilimington	-32	Nine month trading statement. Continued confidence in medium term growth

**Quieter period of newsflow. Returns from growth and re-rating. No material negative contributors. Positive contributions to NAV from recent investments**

# Changes to top 10 holdings

## Top 10 Q1 2017

Company	% of portfolio
Equiniti Group	9.9
Servelec Group	9.7
Tribal Group	9.2
Clinigen Group	7.6
Wilmington	7.1
IFG Group	6.8
EMIS Group	6.5
Medica Group	5.8
4imprint Group	5.8
Tyman	5.7

## Top 10 Q2 2017

Company	% of portfolio
Equiniti Group	11.4
Servelec Group	10.5
Tribal Group	8.5
IFG Group	7.6
Clinigen Group	7.5
EMIS Group	6.6
Medica Group	6.4
Wilmington	6.2
Tyman	5.6
4imprint Group	5.4

**Significant re-deployment of capital in Q1 and early in Q2. Ceteris paribus, portfolio turnover anticipated to be low going forward in line with historical levels**



# Top 10 holdings<sup>1</sup>

Company	Vintage	Sector	GVQIM Funds % of company	Return potential <sup>2</sup>	Progress vs thesis	GVQIM CF yield <sup>3</sup> NTM <sup>4</sup>	Net debt/ EBITDA NTM <sup>4</sup>	Catalysts	Market leader <sup>2</sup>
Equiniti Group	2016	Support Services	>5%	Medium	In line	9.6%	2.4x	Delivery of organic growth and cashflow. Becomes more broadly owned	Yes – niches
Servelec Group	2013	Technology	>5%	High	Behind	9.4%	0.1x	Progression in UK secondary healthcare. UK water AMP6 spending cycle	Yes – UK niches
Tribal Group	2014	Technology	>5%	Medium	In line	6.6%	-1.0x	Delivery of operational improvements; new platform development; contract wins	Yes
IFG Group	2015	Financials	>5%	High	Behind	9.1%	-2.4x	Margin improvement in James Hay; increase in interest rates; M&A	#2 in high end SIPPs
Clinigen Group	2014	Healthcare	>3%	High	Ahead	7.1%	0.5x	Continued organic growth; spec pharma M&A; development of technology platform	Yes – niche
EMIS Group	2014	Technology	>3%	Medium	In line	8.3%	-0.3x	Organic growth; operational restructuring; new CEO; patient; balance sheet	Yes – UK
Medica Group	2017	Healthcare	>3%	Medium	Early	5.6%	0.4x	Growth; increasing investor profile	Yes - UK
Wilmington	2010	Media	>5%	High	In line	12.6%	1.1x	Organic growth; de-gearing; M&A	Yes – niche
Tyman	2009	Industrials	>5%	Medium	In line	10.3%	1.9x	Integration of acquisitions; growth and de-gearing	Yes - niche
4imprint Group	2006	Support Services	<3%	Medium	Ahead	7.9%	-0.5x	Continued US growth; prospect of enhanced cash returns	Yes - US niche

**Some re-rating over the quarter. Portfolio in good health with strong balance sheets and favourable medium term prospects**

As at 30<sup>th</sup> June 2017. Source: GVQIM analysis; PATAC

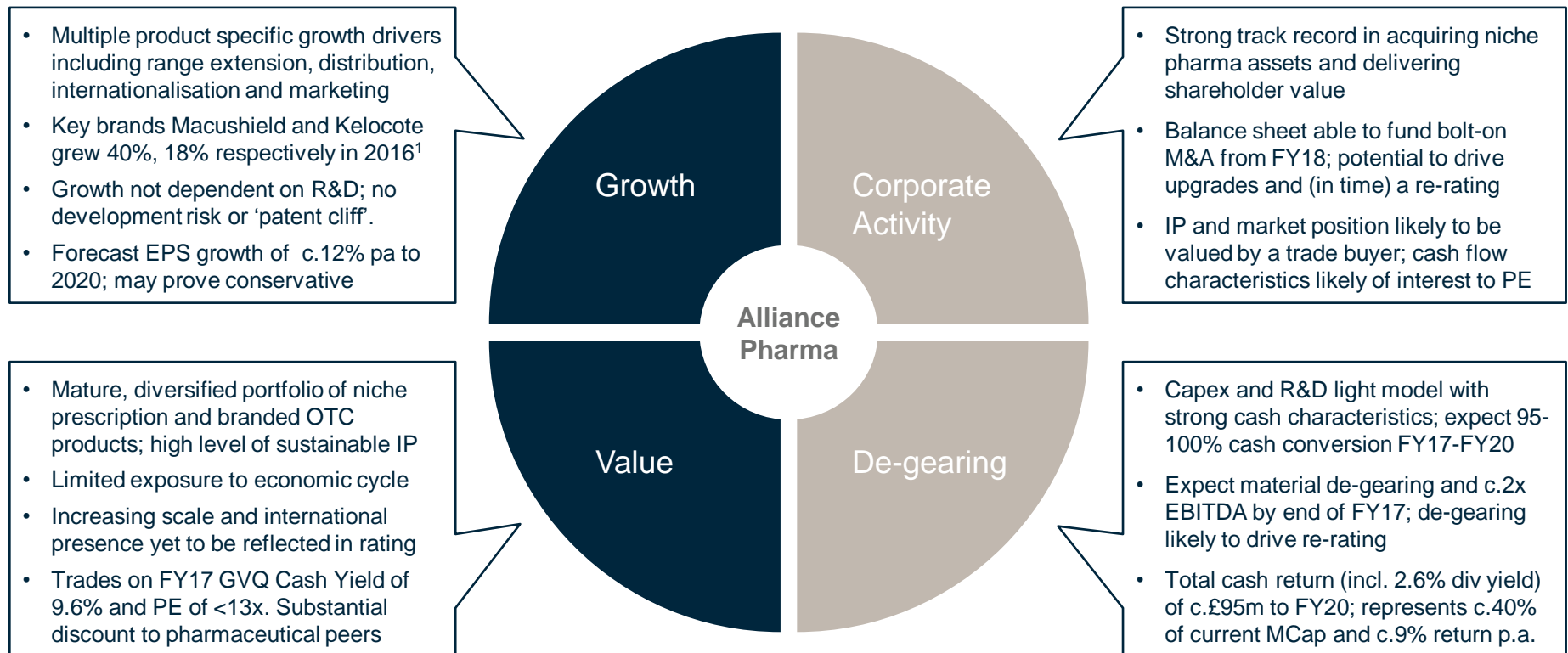
Note: 1. Top 10 holdings representing c.76% of NAV. 2. In the opinion of GVQIM. 3. GVQIM cashflow yield: (12m forward Cash EBITDA minus maintenance capex)/(market capitalisation plus 12m forward net debt).

4. NTM: Next Twelve Months

Past performance is no guarantee of future performance and the value of investments can go down as well as up

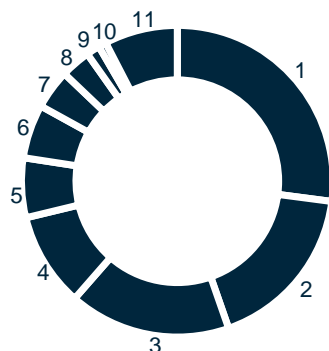
# New investment: Alliance Pharma

## Alliance Pharma – a mature diversified pharmaceuticals company

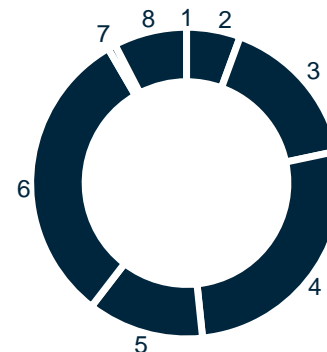


## Alliance Pharma offers robust growth and cash flow characteristics at a substantial discount to peers

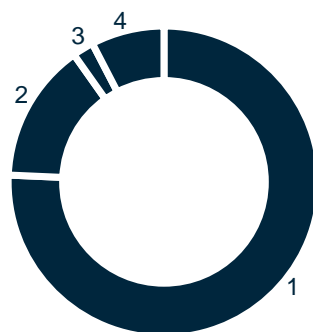
# Highly concentrated and unconstrained portfolio



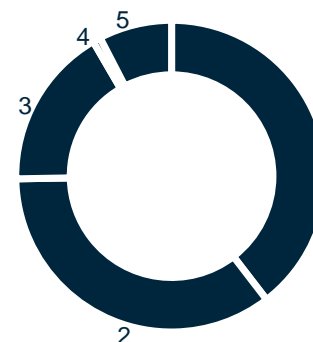
Sector exposure by value		
1	Technology – software & services	27.1%
3	Healthcare	17.6%
3	Support Services	16.8%
4	Financials	9.8%
5	Media	6.2%
6	Industrials	5.6%
7	Consumer Services	4.1%
8	Property	3.1%
9	Electronics	1.4%
10	Unlisted	0.8%
11	Net cash	7.6%



Value by market cap band		
1	<£50m	0.0%
2	£50m - £100m	5.6%
3	£100m - £200m	16.1%
4	£200m - £300m	26.7%
5	£300m - £500m	12.1%
6	> £500m	31.2%
7	Unlisted	0.8%
8	Net cash	7.6%



Concentration		
1	Top 10	75.7%
2	Rank 11 - 15	14.5%
3	Smaller holdings	2.2%
4	Net cash	7.6%



Value by index membership			No. Holdings
1	Small Cap	39.6%	6
2	Aim	35.2%	8
3	Other*	16.9%	3
4	Unlisted	0.8%	1
5	Net cash	7.6%	

## Genuine small cap portfolio with attractive sector exposure

As at 30<sup>th</sup> June 2017

Source: GVQIM

Note: \*\*Other\*: UK listed companies which are not eligible for inclusion in indices either due to liquidity or dual listed with only standard list on the LSE, with market cap. of £150-£350m

Past performance is no guarantee of future performance and the value of investments can go down as well as up

# Morningstar small cap investment trust overlap analysis

	ASL	BRSC	THRG	CRS	DNDL	HSL	IPU	JMI	MTU	SLS	SEC
ASL		10%	4%	9%	8%	13%	11%	17%	7%	2%	0%
BRSC	10%		49%	3%	11%	23%	33%	30%	28%	30%	6%
THRG	4%	49%		0%	8%	10%	20%	17%	21%	24%	4%
CRS	9%	3%	0%		0%	2%	4%	1%	1%	0%	0%
DNDL	8%	11%	8%	0%		14%	14%	14%	16%	9%	3%
HSL	13%	23%	10%	2%	14%		26%	15%	18%	17%	4%
IPU	11%	33%	20%	4%	14%	26%		24%	30%	28%	9%
JMI	17%	30%	17%	1%	14%	15%	24%		17%	23%	5%
MTU	7%	28%	21%	1%	16%	18%	30%	17%		31%	3%
SLS	2%	30%	24%	0%	9%	17%	28%	23%	31%		4%
SEC	0%	6%	4%	0%	3%	4%	9%	5%	3%	4%	

**A differentiated approach with limited overlap with other smaller company investment trusts**

# Portfolio investment themes

## DIVERSIFIED PHARMA

Demographic and population changes increase need for treatments

Access to medicines. 80% of the world's population has limited or no access to right medicines

Diversified portfolios of pharmaceutical brands. Not dependent on binary outcomes

**Clinigen**  
**Alliance Pharma**

## DIGITAL HEALTH

Digital maturity agenda; replacement of legacy IT systems with modern care management systems

Converged care agenda; integrated health journey to encourage a joined up approach to case management

Remote healthcare to address shortage of clinicians and improve patient care; 'Telemedicine'

**Servelec**  
**EMIS**  
**Medica**

## REGULATION AND COMPLIANCE

Increasing compliance and regulatory burden

Need for information and reliable, auditable and cost effective technology driven solutions; 'RegTech'

Examples include MiFID II, anti-money laundering and KYC

**Equiniti**  
**Wilmington**

## PENSIONS AND SAVINGS

Increase in complexity and need to 'self-manage' investments and seek advice

Ageing populations with increased longevity of investments

**IFG**  
**Brooks Macdonald**

## INFRASTRUCTURE AND BUILDING

US single family housing activity remains behind long term levels. 2.5 new homes per thousand inhabitants compared to c.60 year average of 4 new homes

Increasing demand for well-connected industrial and logistics space and regeneration of brownfield sites for housing development in the UK

**Tyman**  
**Harworth**

**We target companies with strong positions in markets supported by long term structural growth**

# Portfolio valuation

	SEC weighted average	SEC median	FTSE UK Small Cap ex investment trusts*	FTSE UK Small Cap ex investment trusts, oils, mining and financials*
Number of securities	16	16	116	104
Market cap (£m)	402	226	359	367
Consensus EV/EBITDA FY1	11.3x	11.8x	6.3x	7.1x
Consensus price earnings FY1	17.9x	16.8x	12.5x*	12.8x*
Consensus FY1 earnings growth	13.1%	14.0%	6.9%*	6.3%*
Consensus dividend yield FY1	2.0%	2.2%	3.1%	3.1%
Price/book FY1	3.3x	2.6x	1.5x	-
Price/sales FY1	2.5x	2.0x	0.7x	-
Price/cash flow	18.7x	16.6x	10.9x	-
GVQIM cash flow yield FY1 <sup>1</sup>	8.7%	8.0%	-	-
Net Debt/EBITDA	0.4x	0.2x	1.4x	1.0x
Overseas sales as %	28.9%	35.0%	-	-

**Portfolio growth prospects higher than the market despite lower leverage. Growth prospects improved over the quarter alongside some re-rating**

As at 30<sup>th</sup> June 2017

Source: Factset portfolio analysis; Bloomberg; Peel Hunt; \*Index is ex loss makers – i.e. valuation and yield is flattered. Harworth Estates & Vintage excluded from analysis

Note: 1. GVQIM cash flow yield: (12m forward Cash EBITDA minus maintenance capex)/(market capitalisation plus 12m forward net debt); 2. Enterprise Value/Net Operating Profit after Tax

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# OUTLOOK

## Positives:

- Private equity deal volumes the highest level since 2007, up 29% to \$143.7bn in the first half of 2017. CVC closes the largest Europe-based fund in history, at €15.5bn
- 2017 has seen the return of inflows into the IA UK Smaller Companies sector with April seeing the strongest month for inflows since March 2014
- UK smaller companies remain under-researched providing opportunity. This is likely to be accentuated from next year with the introduction of MiFID II
- UK IPO market has been strong in the first half of this year
- UK corporate balance sheets in aggregate are strong. Debt financing remains generationally cheap

## Negatives:

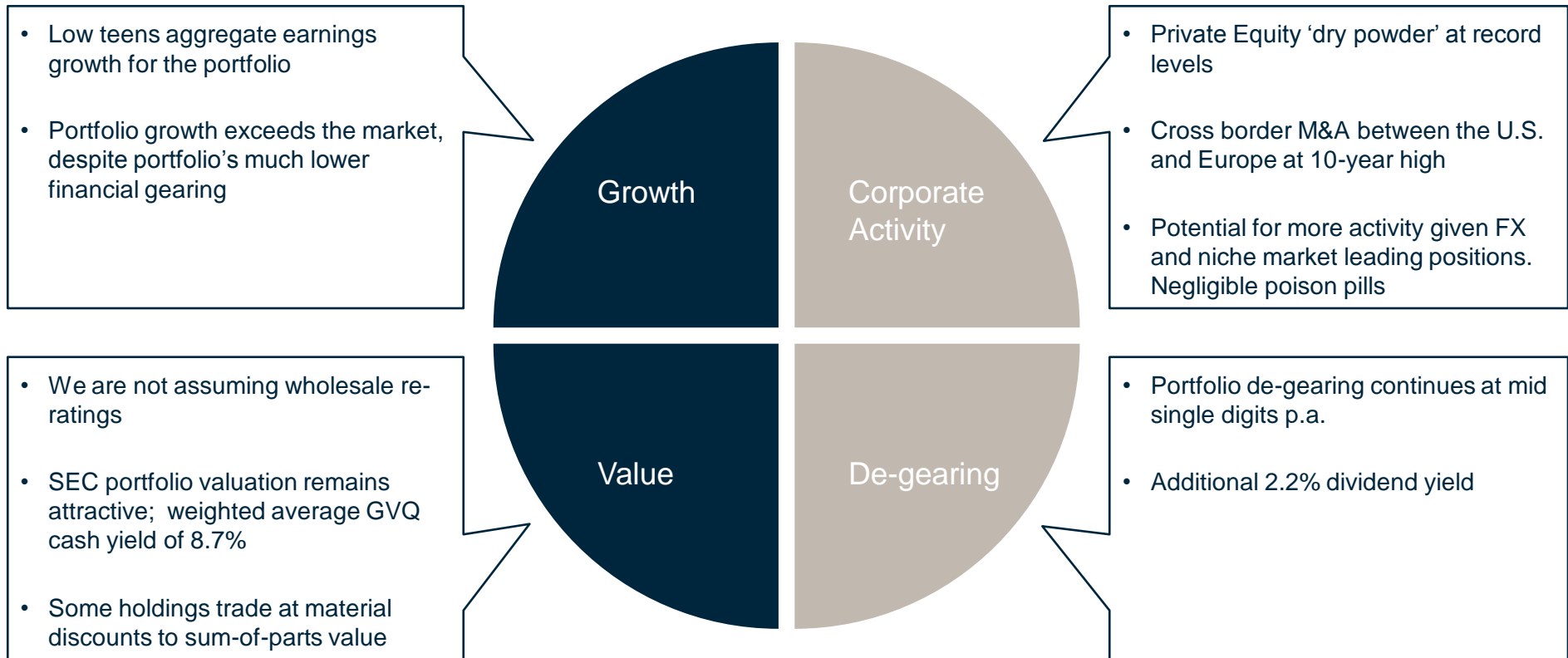
- Growth outlook uncertain. Upwards pressure on inflation. Stagflation?
- Global debt ratios materially higher than a decade ago. Potential adverse impact of tightening on US dollar denominated debt
- FX tailwind becoming a headwind? Recent UK market earnings growth has been aided by weak sterling
- Significant uncertainty remains in the global geopolitical system
- Liquidity in smaller companies remains poor
- Areas of over-valuation in the equity markets. Some stocks trading at premia to history and precedent transactions

**Uncertainty and volatility are continuing features of the market. We retain a selective and disciplined investment process**



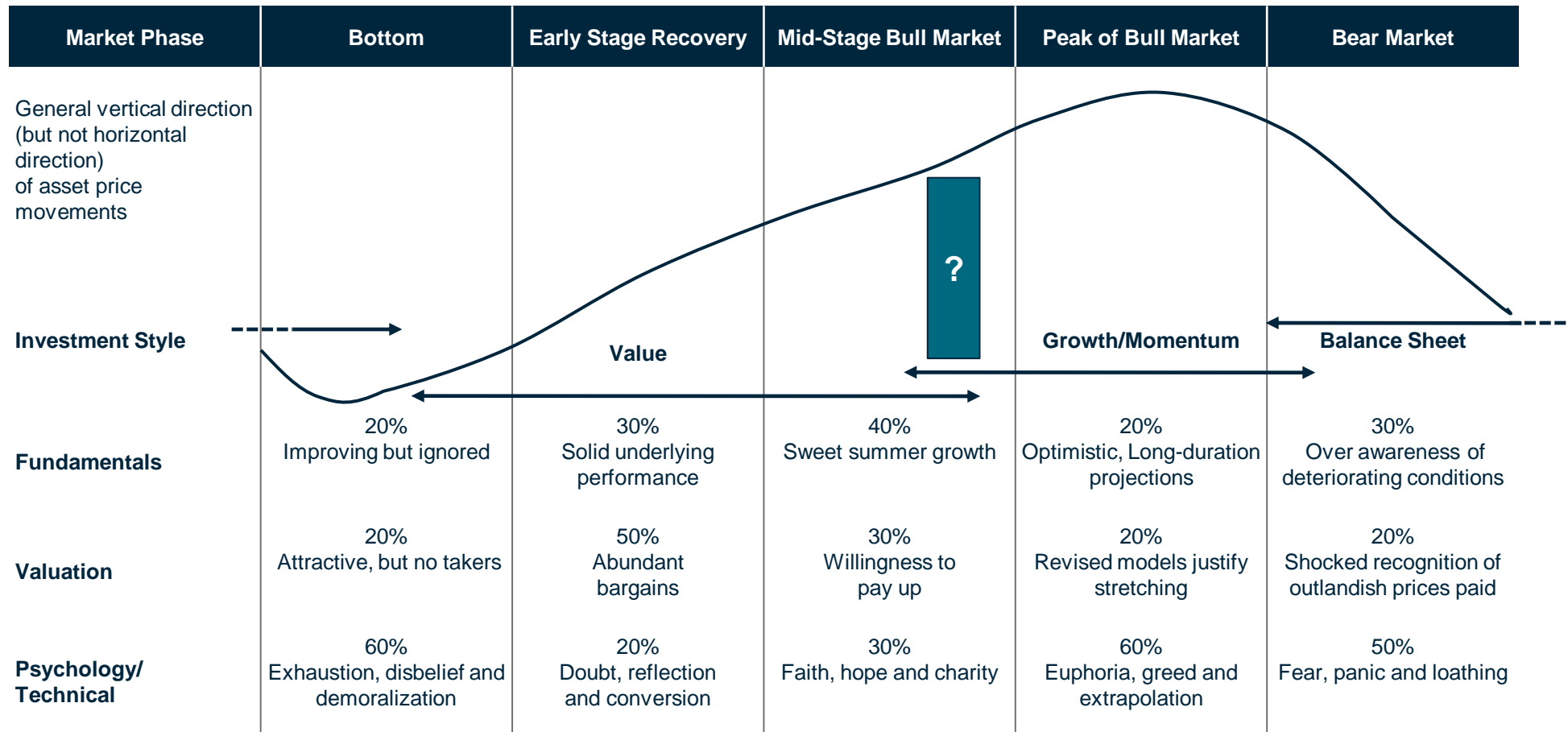
# Earnings growth, cashflow and M&A to drive returns

## SEC portfolio



**We continue to target double digit annualised returns from the portfolio over the medium term**

# The investment cycle – where are markets now?



**Fundamentals, valuation, investment style and psychological factors suggest late mid stage...**

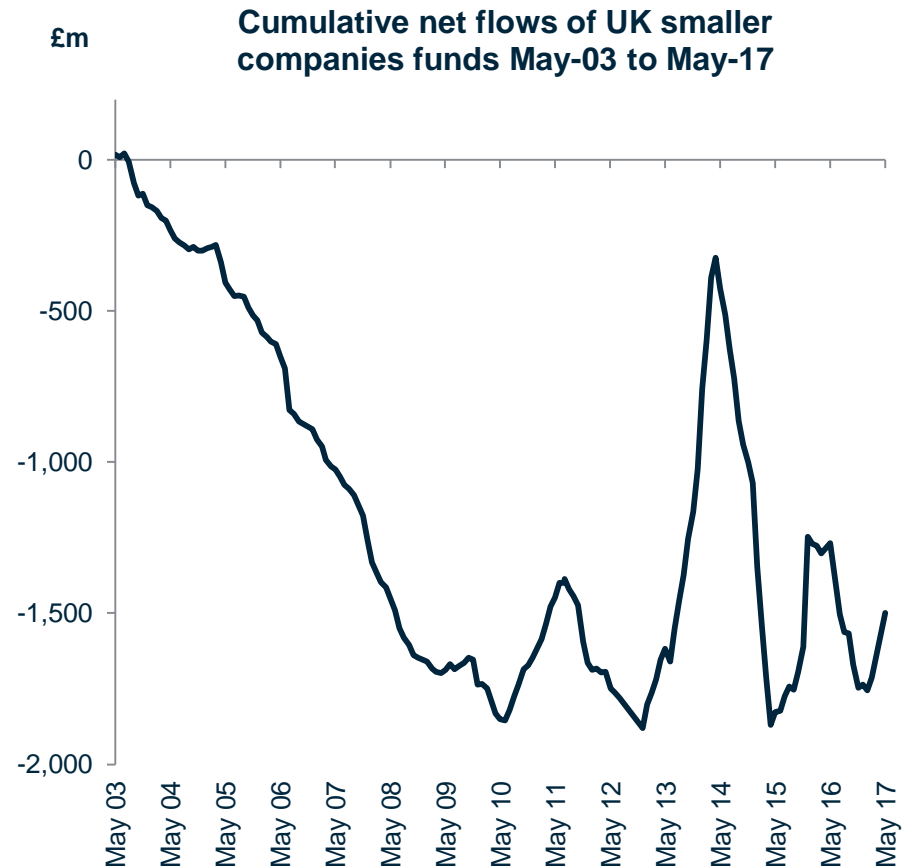
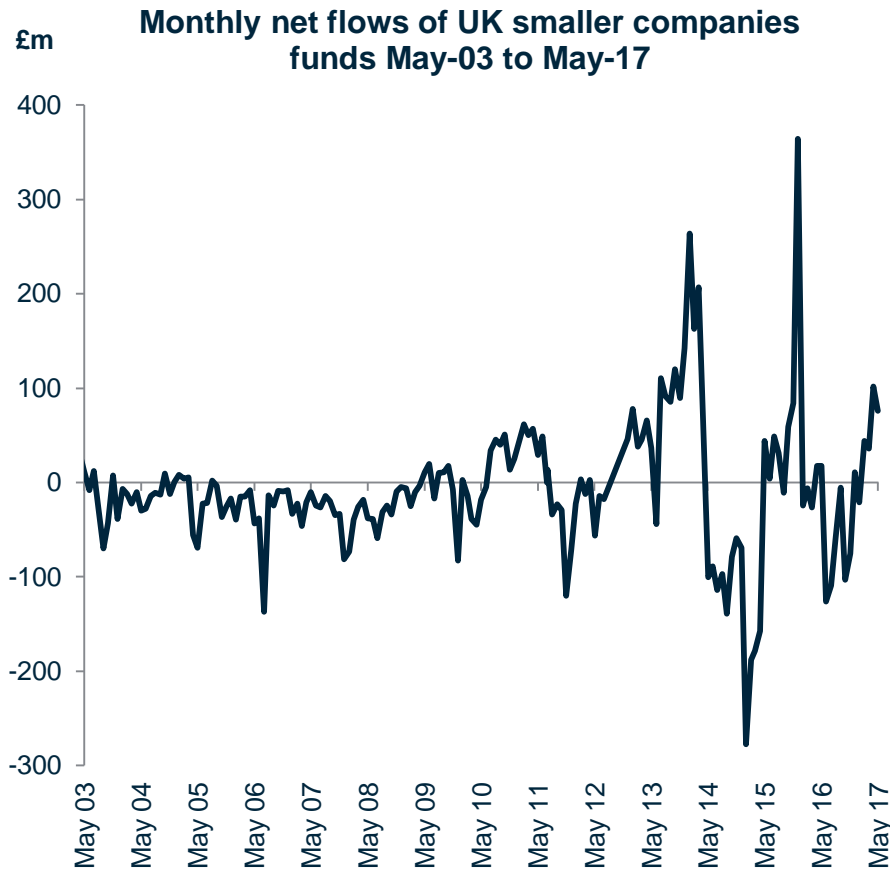
# Bear market checklist

	Start of Proper Bear Markets Mar-00	Oct-07	February 2016 Market Trough	Now
<b>Global Equity Valuations</b>				
Trailing PE	33	17	16	20
Fwd PE	24	14	14	16
DY	1.3	2.1	2.9	2.4
CAPE	48	30	18	23
Global Equity Risk Premium	1.0%	3.3%	5.5%	4.0%
<b>US Yield Curve (10Y minus 2Y)</b>	-0.5	0.0	1.0	0.9
<b>Sentiment</b>				
Global Analyst Bullishness (std dev)	1.7	1.0	0.0	-0.3
US Panic Euphoria Model	1.09	0.42	-0.60	0.1
Global Equity Fund Flows Previous 12m <sup>1</sup>	\$300bn	\$50bn	\$47bn	\$145bn
<b>Corporate Behaviour</b>				
Global Capex Growth (YoY)	8% (1999)	11% (2007)	-2% (2015)	3% (2017e)
M&A (Previous 6m as % of Mkt cap)	6.1%	4.2%	4.0%	2.3%
IPOs (Previous 12m as % of DM Mkt cap)	0.70%	0.40%	0.28%	0.20%
<b>Profitability</b>				
Global RoE	12.2%	16.1%	11.2%	10.9%
Global EPS Growth, Previous 12m change (peak to trough)	14%(-38%)	14%(-57%)	-6%	+10%
<b>Balance sheets / credit markets</b>				
Asset/Equity (US Financials)	16x	16x	10x	10x
Net Debt/EBITDA (US ex Fins)	1.8x	1.4x	1.5x	1.6x
US HY Bond Spread	600bp	600bp	850bp	398bp
US IG Bond Spread	175bp	175bp	215bp	116bp
<b># of sell signals</b>	17.5/18	13/18	5/18	2/18

Red=worrying, Amber=perhaps, White=not worrying

**Bear market checklist, we believe, supports our view of late mid-stage bull market with only 2 out of 18 sell signals**

# UK Smaller Companies OEIC flows



## Smaller companies funds have seen a return to net inflows in 2017

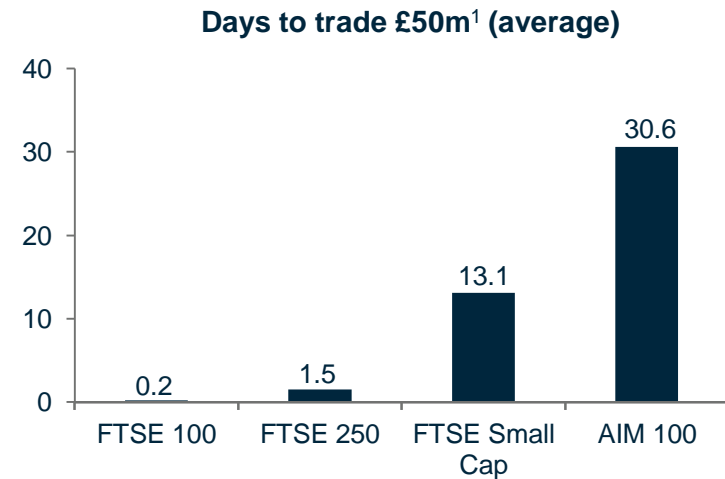
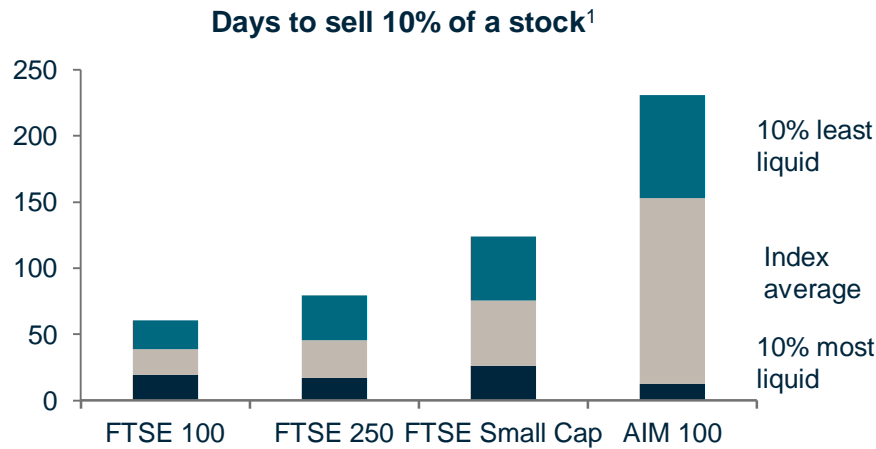
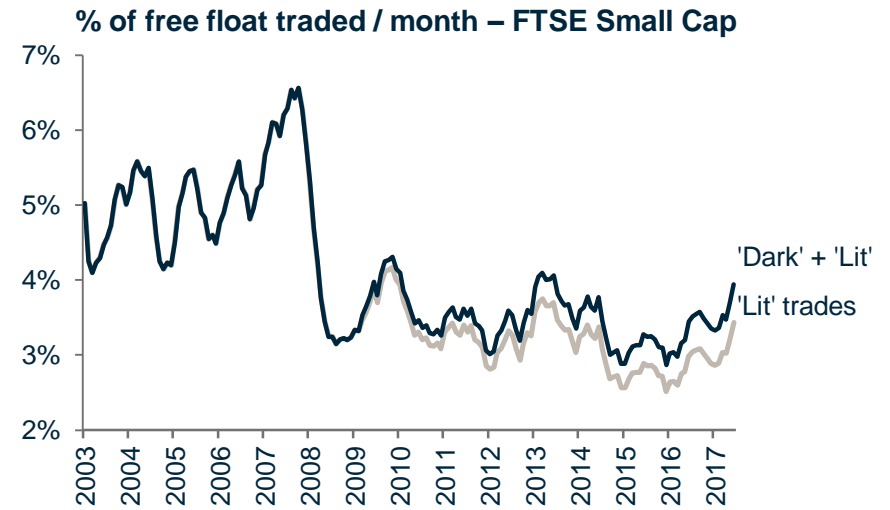
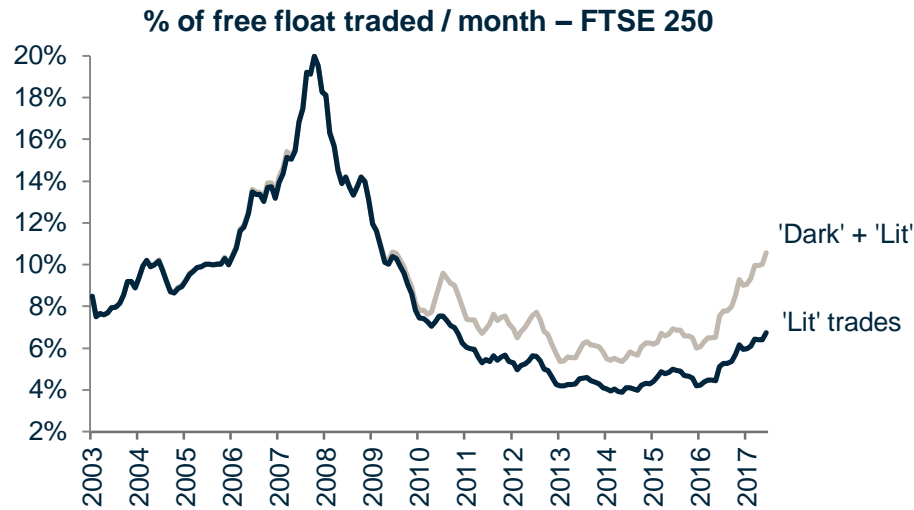
As at 31<sup>st</sup> May 2017

Source: Investment Association

Note: Total AUM in the IA UK Smaller Companies Sector in May 2017 was £15.0bn

© GVQ Investment Management Past performance is no guarantee of future performance and the value of investments can go down as well as up

# FTSE Small Cap liquidity remains low



**FTSE 250 liquidity almost 4x that of Small Cap – and unlike Small Cap is back to 2006/7 levels**

As at 30<sup>th</sup> June 2017

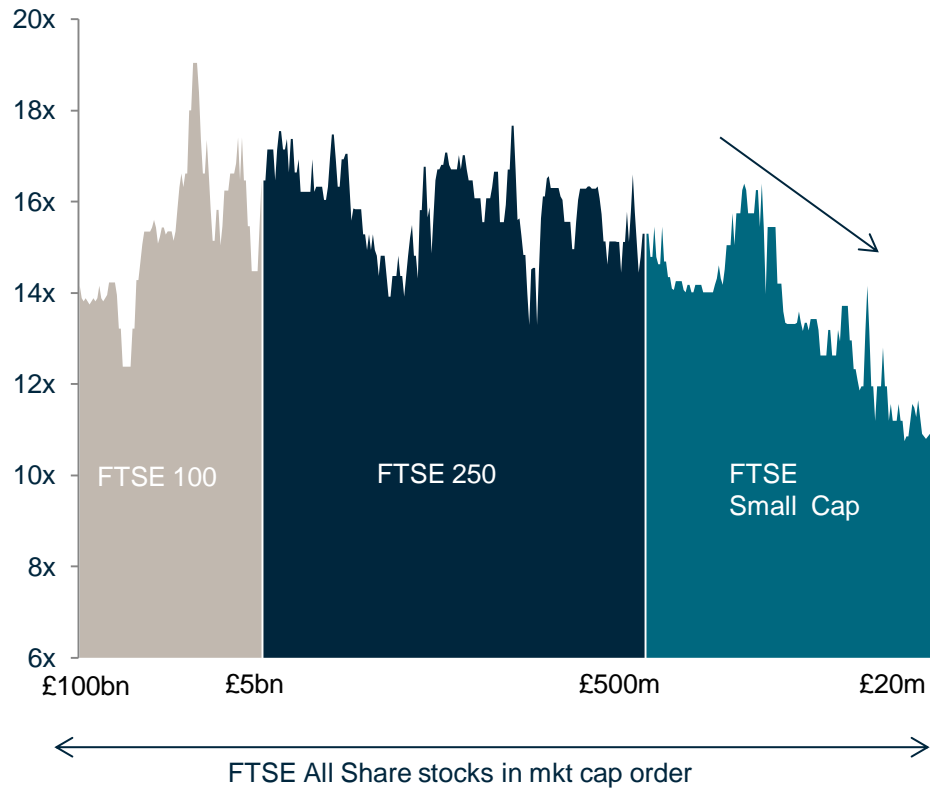
Source: Liberum, Bloomberg

Note: 1. Assuming 100% of daily volume

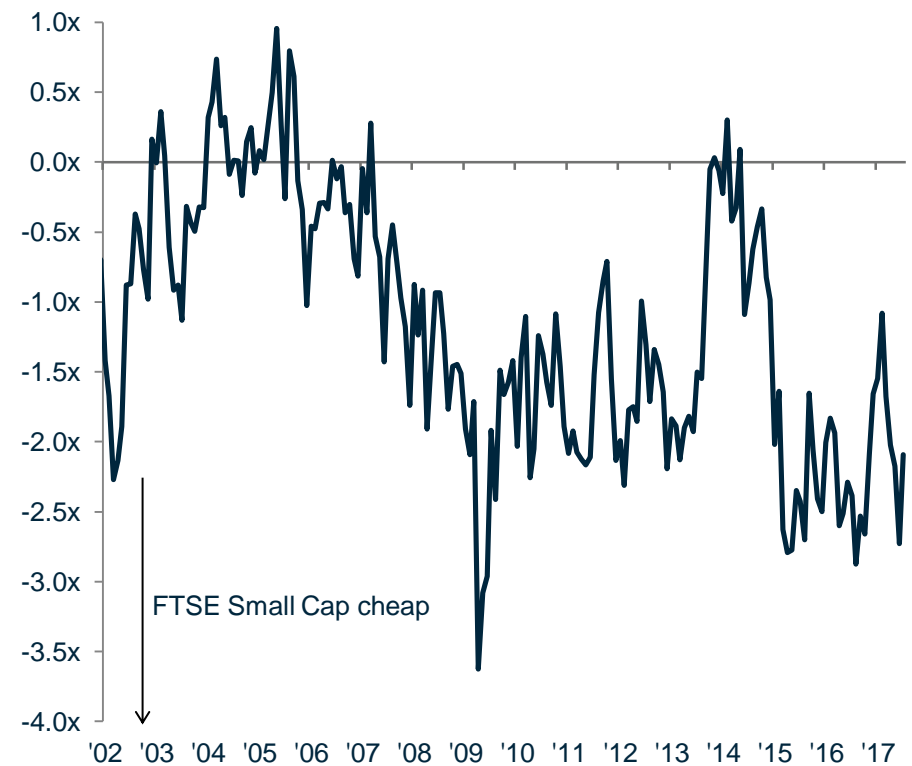
Past performance is no guarantee of future performance and the value of investments can go down as well as up

# A 'Small Cap discount'?

12m forward rolling median P/E



Median P/E Small Cap vs. FTSE 250



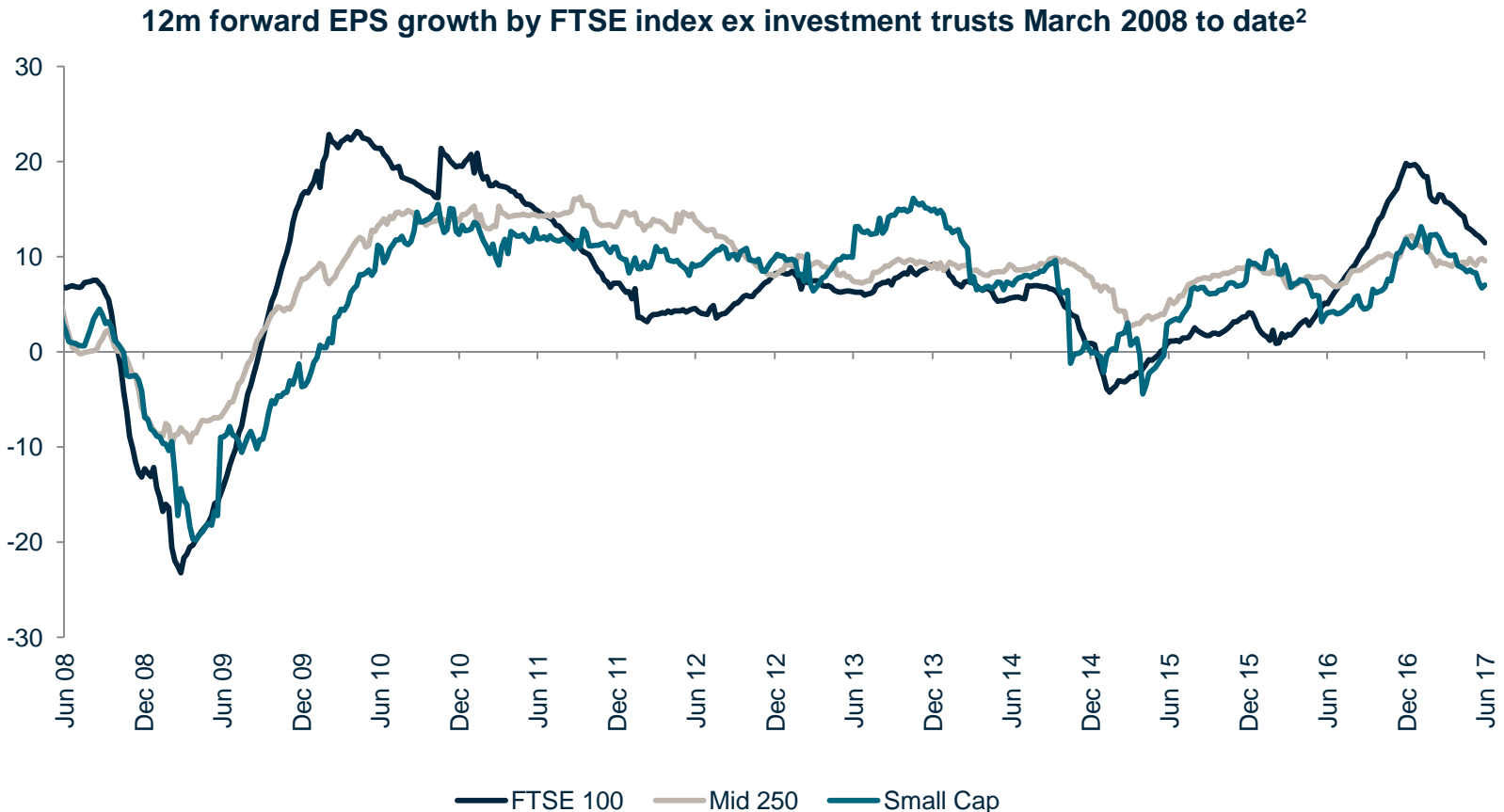
## Has desire for liquidity opened up valuation opportunities in small cap?

As at 30<sup>th</sup> June 2017

Source: Liberum

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# 12-month forward EPS<sup>1</sup> growth projections



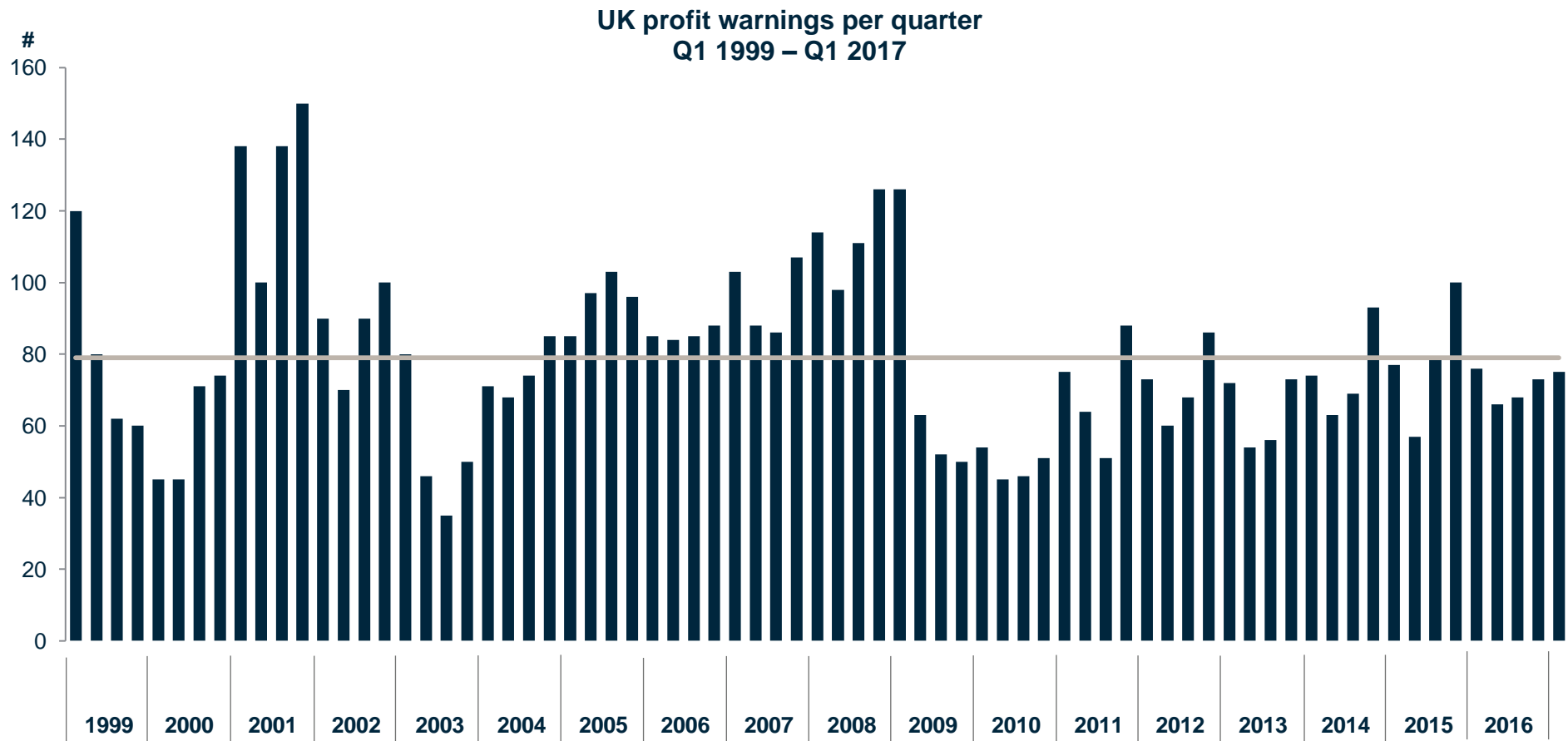
**FTSE Small Cap earnings projections have reduced over the quarter; this highlights the need for a selective approach**

As at 30<sup>th</sup> June 2017

Source: 1. EPS = earnings per share 2. Peel Hunt

Note: Index excludes loss makers

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**Latest data shows profit warnings below long term average. However, recent warnings evidenced particularly in UK consumer sectors. Fund cautious on outlook here and retains limited exposure**

As at 31<sup>st</sup> March 2017

Source: Ernst & Young

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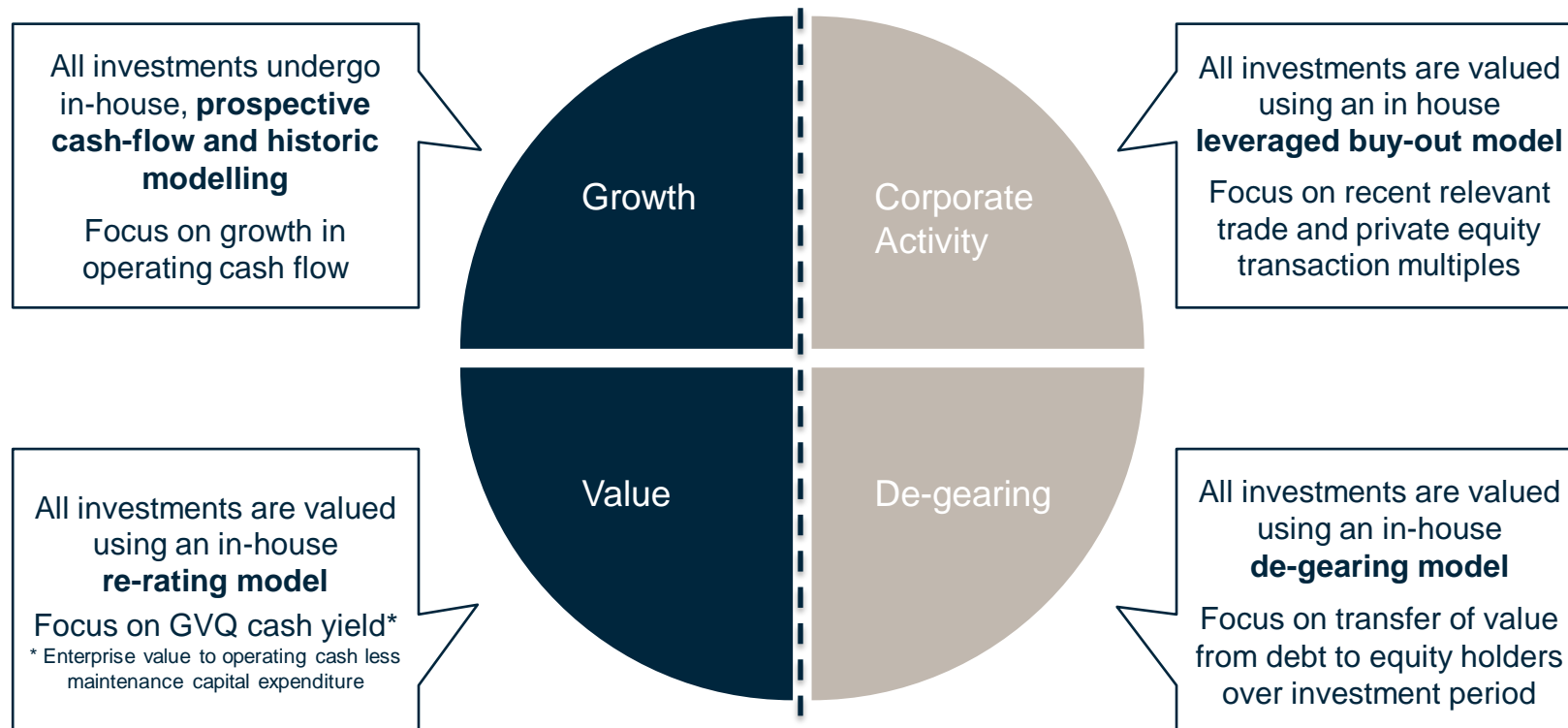


# APPENDIX

# How we identify value in potential investments

## Main focus of most PUBLIC EQUITY INVESTORS

## Main focus of most PRIVATE EQUITY INVESTORS



We focus on four key drivers of shareholder value creation to maximise the chance of success

# There are strict criteria for inclusion in our funds



GVQIM's research process aims to identify high quality coveted assets with attractive cash flows

# How we identify coveted assets

We look for characteristics which GVQIM believes potential acquirers value highly

Qualitative	Quantitative
<ul style="list-style-type: none"><li>• Niche market leaders</li><li>• Orderly end markets, with some growth</li><li>• Sustainable business model/franchise/uniqueness</li><li>• Overseas earnings</li><li>• Able to pass on price increases</li><li>• Intellectual property</li><li>• Operational know-how</li><li>• High barriers to entry</li></ul>	<ul style="list-style-type: none"><li>• High and/or improving ROCE</li><li>• Strong cash conversion</li><li>• Limited capex or working capital investment needed to finance growth</li><li>• Recurring revenues/profits/cashflows</li><li>• Ideally achieving, or has potential to achieve double digit operating profit margin</li><li>• Realisable surplus tangible fixed assets and/or working capital</li></ul>

We believe coveted assets retain value even in tough times, and are more likely to be acquired

# Our Black List screens out companies with fundamental business risks

## Operational

- Excessive reliance on a single product, customer, supplier or distributor
- The primary driver of profitability cannot be influenced by management (e.g. resources)
- Inherently low margins
- Structurally declining markets

## Financial

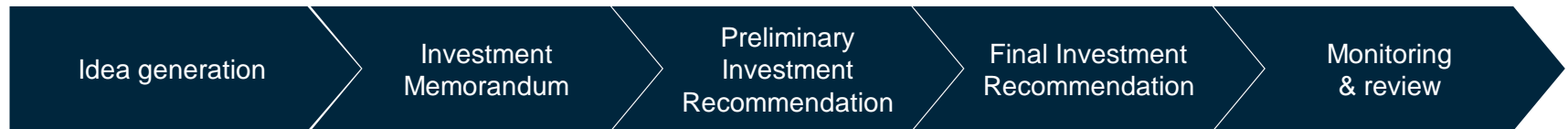
- Poor accounting systems or controls
- Weak cash flows – especially when reported profits look good!
- Excessive gearing

## Governance

- Controlling shareholder with misaligned interests
- Below average/deteriorating governance practices
- Stakeholders unwilling to engage constructively

**We have learnt what to avoid from previous experiences**

# Research Committee ensures consistency of approach

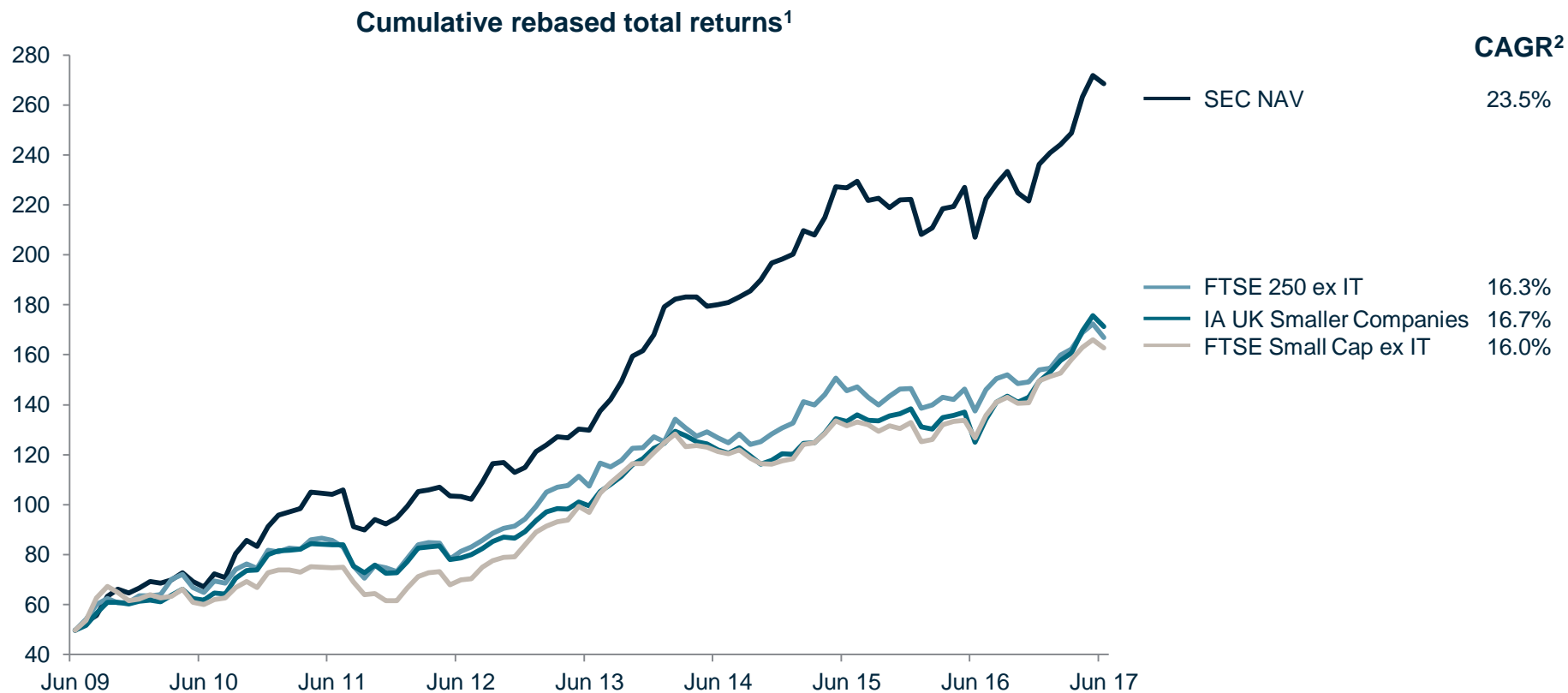


<b>Materials</b>	<ul style="list-style-type: none"> <li>• Watch list</li> <li>• M&amp;A transactions</li> <li>• Cash flow screen</li> <li>• Yield screen</li> <li>• Four drivers screen</li> <li>• LBO screen</li> <li>• Directors dealing</li> </ul>	<ul style="list-style-type: none"> <li>• Company description</li> <li>• Investment thesis</li> <li>• Cash flow model</li> <li>• LBO model</li> </ul>	<ul style="list-style-type: none"> <li>• Company meeting</li> <li>• Management analysis</li> <li>• Stakeholder analysis</li> <li>• Qualitative financial analysis</li> <li>• Feasibility</li> </ul>	<ul style="list-style-type: none"> <li>• Counterparty analysis</li> <li>• Due diligence verification</li> <li>• Bespoke research</li> <li>• Forensic accounting</li> <li>• Management referencing</li> </ul>	<ul style="list-style-type: none"> <li>• Progress against original investment thesis</li> <li>• Proposed changes to target price</li> <li>• Changes to consensus estimates</li> </ul>
<b>Debate</b>	<ul style="list-style-type: none"> <li>• Are we focusing on the right stocks/sectors?</li> <li>• What is happening in trade and private equity?</li> </ul>	<ul style="list-style-type: none"> <li>• Is there are credible case for investment?</li> <li>• Does the company meet our basic criteria?</li> </ul>	<ul style="list-style-type: none"> <li>• Peer group review</li> <li>• Work together to identify key due diligence questions and investment risks</li> </ul>	<ul style="list-style-type: none"> <li>• Have we properly answered all of the key questions?</li> </ul>	<ul style="list-style-type: none"> <li>• Automatic review against thesis every 12 months or earlier as required</li> </ul>
<b>Output</b>	<ul style="list-style-type: none"> <li>• New idea</li> </ul>	<ul style="list-style-type: none"> <li>• Initial Target Price</li> </ul>	<ul style="list-style-type: none"> <li>• Due diligence questions</li> </ul>	<ul style="list-style-type: none"> <li>• Final Target Price</li> </ul>	<ul style="list-style-type: none"> <li>• Watch list</li> </ul>

**Industrial Advisory Panel involvement**

**Multi-stage research process; fully documented and scrutinised using a variety of methods and people**

# Long term track record



**Strong cumulative performance since process improvements in June 2009. No use of gearing or derivatives**

As at 30<sup>th</sup> June 2017

Source: IA; Bloomberg; PATAC; iii data

Note: 1. FTSE Small Cap, FTSE 250 and IA data rebased to SEC start NAV June 2009. 2. CAGR: compound annual growth rate  
Past performance is no guarantee of future performance and the value of investments can go down as well as up

## Calendar Year annual performance<sup>1</sup>

	2017 YTD	2016	2015	2014	2013	2012
Share Price Total Return	12.0%	-1.6%	14.2%	32.6%	61.4%	25.6%
NAV Total Return	13.7%	6.3%	12.1%	18.0%	46.0%	21.3%
FTSE Small Cap ex Investment Trusts Total Return	8.8%	12.5%	13.0%	-2.7%	43.9%	36.3%
IA UK Smaller Companies	14.6% <sup>2</sup>	8.1%	14.7%	-1.7%	37.4%	22.5%

**Established track record of successfully employing private equity techniques in the quoted market**

As at 30<sup>th</sup> June 2017

Source: 1. GVQIM; Capita; Bloomberg; Trustnet. 2. Preliminary estimates based on Trustnet & Morningstar data  
Past performance is no guarantee of future performance and the value of investments can go down as well as up



# Contact details

For further information regarding the SEC please contact the GVQ Investment Management marketing team below, or visit the Company's website: [www.strategicequitycapital.com](http://www.strategicequitycapital.com)

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