Gresham House
Specialist asset management

Strategic Equity Capital plc

Factsheet Commentary – Q3 2021

Overview

Although markets were incrementally positive over the quarter, this masked significant intra-period volatility. Investors nerves were tested by developments which, although largely unrelated, have compounded to dampen sentiment markedly since our last update. Global supply chain disruption and tight labour market conditions continued to stoke fears that current high levels of inflation would prove to be less 'transitory' than central bankers contend. At a micro level such supply side pressures provided operational challenges for businesses across a range of sectors. This has tempered growth expectations for the global economy.

In the UK these pressures were most visible in queues at petrol pumps due to a chronic lack of HGV drivers, and spiking wholesale gas prices – up more than 3 times over the quarter – forcing a number of energy intensive businesses to contemplate shutdowns. Further from home financial markets also had to contend with potential financial contagion from the default of Evergrande, a large, highly indebted Chinese property developer. With so much to distract, it is almost possible to forget about the global pandemic that is still ongoing. As we approach winter the risk of a resurgence cannot be completely discounted.

Given this backdrop it was not surprising to see significant volatility in both markets and stocks. By way of example, the FTSE All Share Index was up 2% over the quarter, however the peak to trough movement during the period was more than four times as high. To some extent, these were conditions that we anticipated and wrote about in our previous update. Whilst the current uncertain outlook does make for a challenging investment environment, we do not think that this is the same as a bad investment environment. The fundamentals remain encouraging for UK small cap investors that are able to take a long term view and look through potential short term noise. The discounted valuation applied to the UK and to UK smaller companies in particular remains material. In addition, the M&A environment remains very active with significant activity in terms of both IPOs, secondary issuance by listed companies to support acquisitions, and buyouts from private equity and foreign buyers.

This dynamic market environment continues to offer a number of attractive investment opportunities. We remain selective and disciplined in our approach, seeking high quality companies with attractive long-term capital growth characteristics at sensible valuations.

Performance[1]

The fund delivered a NAV Total Return of -0.2% over the quarter, modestly lagging the Small Cap Index which increased by 2.7%. As noted above, this masked significant volatility over the period with the Small Cap Index moving by over 10% peak to trough. On the same basis the peak to trough fund NAV movements over the period was less than 7%, demonstrating the defensive positioning and resilience of the portfolio. In contrast to recent periods, dispersion of returns across the portfolio was relatively high, and largely reflected increased market volatility and swings in sentiment rather than company specific developments, which were broadly positive and lends us cause for cautious optimism.

Key contributors to returns came from: Brooks Macdonald (+13%), a UK wealth management firm, which reported strong growth and margin performance on the back of accelerating net inflows and market beating investment performance; XPS Pensions Group (+7%), a provider of actuarial and consulting services to UK pension funds, which re-rated following robust full year results in June; and Ten Entertainment Group (+14%), a UK ten pin bowling operator, which upgraded expectations as trading conditions improved markedly after lockdown restrictions eased.

The main detractors in the period were: Hostelworld (-24%), a hostel focused travel booking platform,

[1] *Where holdings' returns are stated, please note these are Total Returns, including dividends, for each of those stocks over the quarter.*

which de-rated as sentiment towards international travel soured due to continued restrictive travel regulations; Inspired (-11%), a UK B2B provider of energy and ESG services, which reported in line results, however, cautioned on the impact of exceptional energy market conditions on new business activity; and Hyve Group (-16%), a global exhibitions company, which also de-rated despite an encouraging return to large in person events over the period including in the important UK and US markets.

Portfolio activity

Portfolio activity was heightened during the period, largely as a result of proceeds being received from holdings in **Equiniti** (8.1% IRR) and **Proactis** (-19.7% IRR) which, as noted previously, were subject to private equity bids that completed in the period. Whilst the return generated by both investments was disappointing and below the 15% pa targeted by the fund, we view this as a reasonable outcome for our shareholders given the operational challenges faced by both businesses, and the ability to redeploy this capital in more attractive opportunities. Our holding in **Harworth Group** (18.0% IRR) was also fully realised following positive operational progress which drove a strong recovery in the share price over the course of the year.

New toehold positions were established in **Nexus Infrastructure** as discussed in our previous update, **River & Mercantile Group** and **Ricardo**. River & Mercantile is a UK focused financial services firm which provides asset management and advisory solutions to wholesale and institutional clients. Whilst we note recent speculation regarding the break-up of the firm, as well as the appointment of high profile industry figure Martin Gilbert to the Board, our investment is predicated primarily on the attractive position of the company in providing fiduciary management services to pension funds, and potential for the asset management division to scale materially following significant investment in distribution and fund management capabilities. Having said this, we believe the company is undervalued on a sum-of-the-parts basis and a break-up may catalyse returns ahead of our original thesis. Ricardo is a global strategic environmental and engineering consultancy. The company has an enviable heritage in optimising internal combustion engines for automotive clients. However, today it is increasingly focusing on deploying its technical expertise in activities and sectors related to supporting the transition to a low carbon economy, including rail networks, energy and environmental policy, and developing hybrid and electric vehicles. We believe the importance of this strategic shift is underappreciated by the market and has the potential to support significant growth and re-rating over the long term. Graham Ritchie, a former Intertek executive, was appointed CEO in the period which may be a catalyst for an acceleration of this strategy.

Realisations totalled £19.2m in the quarter which almost entirely related to the proceeds from the exits from Equiniti, Proactis and Harworth. This was redeployed into the new positions noted above, as well as incremental top-ups into existing holdings: Brooks Macdonald, LSL Property Services, Clinigen and Tyman. In aggregate purchases in the period totalled £14.0m, resulting in a more normal net cash position of 4.7% at the period end.

In aggregate, since September 2020 the fund has made purchases totalling £66.4m, which represented 30% of closing NAV; and similarly, realisations in the period totalled £60.8m, or 40% of opening NAV. The weighted average market capitalisation of holdings purchased was £327m, compared to £608m for those realised. The average market capitalisation of the fund's current holdings is £363m at the period end; on a like for like basis (i.e. using September 2021 share prices) this compares to £290m at the end of September 2020. Over the last 12 months turnover in the portfolio has been modestly above historic levels; this was a function of heightened volatility in equity markets, as well as our stated strategy of increasing our focus on companies at the slightly smaller end of the market cap spectrum (£100m-£300m market capitalisation at the point of investment). This strategy has enabled us to increase the average size of our equity stakes across the portfolio in order to provide a more effective platform from which to constrictively engage with our portfolio companies. Absent takeover activity, we would expect portfolio turnover to revert to more normalised levels going forward.

Outlook

We expect current market conditions – as described earlier – to persist for the remainder of 2021 and into 2022. Supply side disruption and inflationary pressures will continue to create operational challenges across a range of sectors. This is likely to lead to an elevated level of profit warnings following a benign period over the first half of the year; Ernst & Young data showed Q2 had the lowest number of profit warnings since their records began 22 years ago. We view this as unsustainable. Having said this, the longer-term outlook remains positive. Business and consumer confidence continue to recover as the world emerges from the pandemic and strong demand-side drivers support robust economic projections into 2022 and beyond.

We believe this context, whilst creating some challenges, will provide an attractive environment in which we can unearth good long-term investment opportunities at attractive valuations. At a portfolio level, we have limited exposure to companies that are directly impacted by the issues noted; a direct output of our highly selective, quality-focused investment approach. Second and third order effects of the pandemic, as ever, can be difficult to predict. However we believe agile smaller businesses with strong management teams will have the opportunity to take market share and build strong long-term franchises.

We continue to believe that our fundamental focused investment style has the potential to outperform over the long term. The Fund will maintain its focus on building a high conviction portfolio of less cyclical, high quality, niche growth businesses which we believe can deliver strong returns through the market cycle regardless of the performance of the wider economy.

Past performance is not necessarily a guide to future performance. Portfolio investments in smaller companies typically involve a higher degree of risk.