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Strategic Equity Capital plc

Factsheet Commentary - Q4 2021

Overview

The quarter was dominated by the dual threats of increasing inflation and the Covid Omicron variant. We have been anticipating heightened volatility for some time driven by the aftershocks of the pandemic as they impact the economic recovery. The market as a whole largely took these concerns in its stride, albeit there was significant dispersion in returns across sectors and companies as each of these factors exerted itself on both sentiment and underlying performance.

Despite some easing of the supply constraints over the quarter, persistently high energy costs and tight labour market conditions conspired to drive inflation[1] to record highs; UK CPI reached a decade high of 5.1% in November in the UK forcing the Bank of England to raise rates, albeit incrementally to 0.25%, the first major central bank to do so. A similar situation is playing out across the world; Germany reported that consumer prices in November hit 5.2%, a 29 year high, whilst post period end the US provided perhaps the starkest indication of what is to come with a CPI print of 7% for December, a 39 year high. This raises two critical questions for investors to ask. First, to what extent can companies pass these costs on to their customers? Second, will this lead to a tightening cycle that will begin to support a prolonged rotation away from highly rated growth stocks to those with greater value characteristics? In this environment we believe we are well positioned with our focus on high quality companies with pricing power, and our valuation discipline founded on time-tested cash flow-based techniques.

The second key event in the quarter was the emergence of the Omicron variant. Despite strong initial indications of its mild nature from South Africa, many countries responded with a return of restrictions from the now well-worn public policy Covid playbooks. The UK appears to be ahead of the curve in terms of relaxing restrictions as it was with the original vaccine roll out and subsequent booster programme. With Omicron cases starting to wane across a number of countries around the world, we are hopeful that 2022 will see a return to a more normalised environment, this is unlikely to be smooth or uniform across different sectors and segments of the economy.

These factors, as well as rising geo-political tensions in Ukraine adding additional uncertainty, will no doubt continue to challenge investors during 2022. However, we are encouraged by the long-term fundamentals which remain positive for the UK small cap sector, and for our strategy specifically. The discounted valuation applied to the UK, and to UK smaller companies in particular, remains material and the M&A environment remains very active. 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[2]

The Fund delivered a NAV Total Return of 2.1% over the quarter, ahead of the FTSE Small Cap Index which decreased by 0.5%. This was in contrast to the FTSE All-share Index which was up 4.2%, illustrating both the diverging fortunes of different sectors across the market, and the continued underperformance (and in our view, undervaluation) of smaller companies. Over 2021 as a whole, the absolute performance of the Fund has been pleasing, with NAV Total Return of 26.6%. Although this has modestly lagged the FTSE Small Cap Index (+31.3%) we believe it is a creditable performance given the Fund's lack of exposure (by design) to the more cyclical sectors which, by and large drove the

[1] *Sources:*
Bank Rate increased to 0.25% - December 2021 | Bank of England | US inflation jumped 7% in December as prices rise at rates unseen in decades | US economy | The Guardian | Rising prices: Key inflation measure CPI hits a 39-year high in December 2021 - CNN | Germany: Inflation hits 29-year high of 5.2% | News | DW | 29.11.2021 | UK inflation to remain more than double BoE's target for entire year (cityam.com)

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

market as the economy rebounded strongly from the severe disruption experienced in 2020. The market's performance over the last quarter was driven by similar factors, albeit for differing reasons, with the top three performing sectors in the FTSE All-share being Industrial Transportation, Industrial Metals and Mining and Banks.

Key contributors to returns in the quarter came from: Clinigen Group (+45%), a specialty pharmaceuticals company, which was the subject of an recommended bid from Triton Partners, a European private equity fund; River and Mercantile Group (+30%), a UK asset management firm, which agreed to sell its core fiduciary solutions division to Schroders, and subsequently announced a recommended offer for its remaining asset management division from UK listed peer AssetCo; and Brooks Macdonald Group (+6%), a UK wealth management firm, which reported continued positive fund flows over the period.

The main detractors in the period were: Hyve Group (-16%), a global exhibitions company, which de-rated on concerns that the emergence of the Omicron variant would hamper the recovery of the events industry; Hostelworld (-17%), which de-rated for similar reasons as sentiment towards international travel deteriorated; and LSL Property Services (-6%), a diversified real estate services company, which declined modestly on concerns regarding cooling activity levels in the UK property market.

Portfolio activity

Portfolio activity over the quarter returned to more normalised levels following a busy Q3. We fully realised our holding in Alliance Pharma which has been a strong performer in the Fund since our initial investment in 2017, generating an annualised return of 32%. Although we believe the prospects for the company remain strong, the stock had rerated to a level which left less margin of safety and we see better opportunities to redeploy the capital elsewhere.

Realisations totalled £15.8m in the quarter which almost entirely related to the proceeds from the exit from Alliance Pharma, and materially reducing our position in Clinigen (which we had topped up earlier in the period) as the shares traded above the bid price in the aftermath of the Triton's approach. This was redeployed by building stakes in recent investments Ricardo and Nexus Infrastructure, as well as more incremental top-ups into existing holdings Ten Entertainment, Inspired and Hyve Group, the latter of which undertook a placing to finance a small complementary acquisition. No new positions were initiated in the quarter. In total, purchases of £9.3m were made over the quarter, resulting in net cash position of 7.2% at the period end.

In aggregate, since September 2020 the Fund has made purchases totalling £75.7m, which represents 34% of closing NAV; and similarly, realisations over this period have totalled £76.5m, or 50% of opening NAV. The weighted average market capitalisation of holdings purchased was £359m, compared to £691m for those realised leading to an average market capitalisation of the Fund's current holdings of £393m at the period end. On a like for like basis (i.e. using December 2021 share prices) this compares to £542m at the end of September 2020. Over the last 15 months turnover in the portfolio has been modestly above historic levels; this has been 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 constructively engage with our portfolio companies. We now view this transition as essentially complete; excluding our position in Clinigen (which remains the subject to a recommended private equity bid) the average market capitalisation of the Fund's current holdings sits at £293m - firmly in the size range where we believe our investment strategy can be most effective. Absent further takeover activity, we would expect portfolio turnover to revert to more normalised levels going forward.

Outlook

Whilst we expect Covid related disruption to wane over the course of 2022, it is increasingly becoming clear that inflationary pressures will continue to persist for some time. Supply side disruption – both in terms of labour and supplies – will continue to create operational challenges across a range of sectors. 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 noted with interest the strong trading update issued by ten pin bowling operating, and portfolio company, Ten Entertainment Group early in January. This illustrated succinctly both consumers appetite to return to 'normal life' activities, as well as their appetite to spend on leisure experiences.

Taken in aggregate we believe this is an attractive environment to invest; whilst ongoing uncertainty can be challenging, it also provides the opportunity to unearth good long-term investments 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 both the pandemic, and of an inflationary environment – 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.

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