Gresham House
Specialist investment

Strategic Equity Capital plc

Factsheet commentary – Q1 2024

Past performance is not necessarily a guide to future performance. Portfolio investments in smaller companies typically involve a higher degree of risk. Capital at risk. Extracted portfolio performance is not necessarily indicative of the performance of the fund. Not to be construed as investment advice or recommendation. Views expressed by the investment team are correct at the time of writing but are subject to change.

Overview – Q1 2024

UK equity market performance was mixed in Q1 2024. While recent inflation data beat economic expectations, investor optimism was better reflected in large-cap stocks which outperformed their smaller counterparts over the period; the FTSE 100 grew 3.0% while the FTSE AIM All Share declined 2.4%. Weaker small-cap performance was largely attributable to further outflows from UK equity funds. According to recent Calastone data, March 2024 marked the 34th consecutive month of net UK outflows and the worst month since February 2023. Many small-cap fund managers remain 'forced sellers' of stock, driving further short-term price weakness despite strong fundamental performance in many instances. While creating short-term pressures, we believe these market dynamics present a compelling opportunity to invest in quality UK companies at attractive entry valuations.

During the quarter, the valuation gap between UK smaller companies and their larger domestic peers as well as smaller international peers widened; UK equities now trade at a record 45% discount to global counterparts. Moreover, UK outflows into North American equity funds were greater in Q1 2024 than over the previous nine years combined. Investors continue to exhibit a 'risk-off' attitude toward UK stocks, partly due to the attractiveness of cash investments in the current interest rate environment, which combined with high inflation and rising mortgage rates, has drawn capital away from UK equity funds over the last year. However, we saw catalysts emerge for more positive UK fund flows over the short-to-medium term. Our stock-specific research showed that the amount of cash held on UK investment platforms started to reduce during Q1 2024, while government initiatives such as the British ISA could help draw capital back into UK smaller companies and induce a broader re-rating of the space.

We recognise that macroeconomic and geopolitical uncertainty persists, but we are confident that our portfolio companies are strongly positioned to navigate external headwinds. Our consistent focus on capable management teams, clear value creation strategies with growth levers within management control, structural market tailwinds, defensible competitive positions, and attractive financial characteristics, gives us confidence that our holdings can continue to grow earnings and generate cash throughout the cycle.

Newsflow across the portfolio was largely positive in Q1 2024, as several companies delivered positive trading updates.

Performance - Q1 2024[1]

The Trust's NAV Total Return increased by 0.8% over the quarter, outperforming the FTSE Small Cap Index (excluding Investment Companies)[2] which decreased by 1.0% and outperforming the UK Smaller Companies Investment Trust sector which decreased by 0.1%.[3]

Key contributors to returns in the quarter to 31 March 2024 came from: **Fintel** (+13.3%), which in addition to strong full year results which demonstrated 240bps of margin expansion, announced two further strategic bolt-ons that broaden the capabilities that Fintel can provide to intermediaries; **Trufin** (+38.0%), following a strong start to the year for all divisions, exceptional early take-up of the "Balatro" game published by Playstack, and a non-core divestment at an accretive multiple; and **Wilmington** (+14.2%), on results which demonstrated increases in both revenue and earnings, along with the announcement of an uplift in the interim dividend.

The main detractors in the period were: **Tribal** (-20.5%), following two adverse news events – 1) its Recommended Cash Offer being blocked by another shareholder, and 2) its entry into mediation over the disputed NTU contract. Despite this, FY23 results were slightly ahead of expectations with strong cash conversion and core ARR growth, leading to forecast upgrades; and **Inspired** (-19.1%), despite positive newsflow. Inspired's FY23 results came in ahead of expectations, with 20% EBITDA growth at a Group level, double digit revenue growth in two divisions and >100% growth in its ESG division. In addition the Group disclosed a series of new KPIs evidencing the good progress made in its cross-selling strategy.

Portfolio activity

The Trust made two new investments during the quarter; into **Pinewood Technologies**, a critical SaaS provider to the automotive dealership sector, which was formerly part of Pendragon Group. The Manager was attracted to significant recurring revenue (90%) and margin profile (c.25% EBIT margin and double digit expected growth); and **Alpha FMC**, a challenger consultancy firm primarily focused on financial services sector, which is well known to the Manager.

In addition, the Trust made a number of follow-on investments during the period; into **Team17**, an independent video game developer and publisher which is well known to us. Following an unexpected profit warning in November and subsequent review, we believe the long-term fundamentals of the business remain strong and that the current reduced share price offers an attractive opportunity to establish a position in the Trust; **Belvoir Group**, and **The Property Franchise Group**, which are similarly well known to the Manager, and which merged in the period to form the leading UK residential franchised estate agency group; **Iomart**, a leading UK datacentre and cloud services provider, and **Ricardo**, the global strategic, environmental and engineering consultancy. Both **Iomart** and **Ricardo** were already large holdings for the Trust and have been upweighted further to capitalise on the attractive valuation opportunity alongside strong business fundamentals.

The Trust made three full exits during the quarter; from **Ten Entertainment Group** (25.0% IRR), following its

1. Full performance history can be viewed in the associated factsheet
2. Where holdings' returns are stated, please note these are Total Returns, including dividends, for each of those stocks over the quarter
3. Not official benchmark, used for comparative purposes only

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Recommended Cash Offer from Trive Capital; from **Wilmington** (8.2% IRR) and **Hostelworld Group** (9.2% IRR) which, whilst the Manager believes these are good quality businesses, no longer fit the mandate of the Trust as well as other opportunities. In addition, the Trust's shareholding in **Belvoir Group** (72.6 IRR%[4]) was exchanged for shares in **The Property Franchise Group** pursuant to their all share merger in the period.

Outlook – Q2 2024

We assume that elevated macroeconomic and geopolitical uncertainty will continue to drive market volatility over the coming months. Global investors remain particularly sensitive to new inflation data and interest rates, while conflicts in Europe and the Middle East threaten regional stability.

We believe that volatile conditions benefit stock-pickers focused on business fundamentals, particularly given the further profit warnings across the UK market during the quarter, which demonstrates how optically 'cheap' stocks are not so attractively priced if market earnings expectations lack a solid foundation. We are placing additional emphasis on our differentiated, network-based due diligence approach, gleaning insight and expertise from high-quality professionals and industry specialists. This allows us to build conviction in key components of investment theses and avoid 'value traps' which appear in a subdued market. However, notwithstanding an unexpected deterioration in the external environment, we are seeing greenshoots of improving market sentiment and potential catalysts for a re-rating of the UK small cap space.

Importantly, a growing number of M&A deals across the UK small-cap market is providing further evidence of a disconnect between market valuations and company fundamentals. US and European private equity firms have turned their focus towards the heavily discounted smaller end of the UK market, seeking to purchase companies with high-quality fundamentals at relatively low valuations to offset higher deal funding costs. Indeed, the average one-day premium across UK public-to-private transactions grew to 52% in 2023 from a five-year average of c.40% despite the higher interest rate environment. We expect that M&A activity will remain an important driver of short-term returns, while over the medium term, we see the arbitrage between public-to-private transaction multiples and company trading multiples as a catalyst for a broader re-rating of the UK small-cap market.

Positively, we are also observing a meaningful increase in UK public market corporate activity so far in 2024, signalling that investors are more willing to support high quality businesses with their funding needs. The increase in activity has primarily focused on secondary sell downs and primary capital raises of meaningful size, with an average deal value of £418mn, rather than IPOs. Helpfully, the majority of companies have seen a strengthening share price post-deal, which helps further build investor confidence. Collectively, these factors leave us cautiously optimistic on UK equity market performance during the remainder of 2024.

Important information

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4. Annualised figure based on c.5 month holding period

(no.682776).

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