Strategic Equity Capital plc

Factsheet commentary – Q2 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 – Q2 2024

UK equity markets delivered a positive performance in Q2 2024, with smaller company stocks rising in-line with their larger peers: the Numis Smaller Companies plus AIM index rose **5.0%**; the FTSE AIM All Share rose **2.8%** while the FTSE 100 grew **2.7%**. Although UK investors added materially to equity fund holdings, inflows were biased towards North American, European, and global equity funds. UK-focused equity funds shed a net £532 million over the period, although outflows were markedly lower in June than in previous months during the year-to-date. More broadly, equities benefitted from some institutional reallocation as investors switched out of bonds following recent price appreciation driven by renewed hopes of UK and US interest rate cuts mirroring Europe.[1]

Through our investment activity we continue to see 'forced selling' of UK equities, reflecting the continued (albeit abating) outflows from this asset class. We believe this trend partly explains the current dislocation between trading multiples of UK smaller companies and private precedent transactions across a variety of sectors. Our recent management meetings with private equity firms suggest two drivers of M&A activity continue to co-exist: buyout firms have much excess capital to deploy, and private-to-private deal-making is subdued by high valuation expectations. Resultantly, private equity pipelines have turned to the UK public market with a bias towards smaller companies where prices are 'cheaper' still. On a next-twelve-months price-to-earnings basis, UK equities trade at a c.35% discount to global equities, while UK small-cap stocks below £500m market cap trade at a further 25-40% discount to their larger domestic peers.2 Moreover, bid premia for UK stocks remained above historic averages despite elevated interest costs; for example, Bridgepoint bid for a Fund holding, Alpha Financial Markets Consulting, at a 50% premium to the undisturbed share price prior to a possible offer announcement in May. All of this reflects the compelling valuation opportunity across UK smaller companies.

Macroeconomic and geopolitical uncertainty persisted during the period, but we saw reasons for cautious optimism. Importantly, UK inflation slowed to 2% in May: the lowest level for almost three years. Accelerated real wage growth was reflected in the highest level of UK consumer confidence since mid-2021, with noticeably improved outlooks on personal finances and the wider economy. However, consumer propensity to make 'major purchases' remains materially below the 25-year average score and UK household saving rates are markedly higher than across other G7 economies, likely due to higher mortgage costs and memory

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[1] Calastone, "June tops off a record six months for equity fund inflows…", July 2024.
[2] Berenberg and Bloomberg data.

of recent economic trauma.

While Q2 saw green shoots of improving sentiment, we are only selectively exposed to consumer trends with a focus on structural growth themes such as “indie” video gaming, resilient customer offerings characterised by niche or hobbyist demand profiles, and strong competitive positions.

More broadly, our portfolio construction seeks to mitigate external risks through a focus on high-quality, well-managed businesses with clear value creation strategies, long-term structural demand drivers, and durable competitive advantages, prioritising opportunities where key investment drivers are within the control of management teams and avoiding business models which are exposed to wider market factors.

A consistent investment philosophy, strong relationships with company management teams, and an extensive specialist network underpin our confidence that our portfolio companies will continue to grow earnings and generate cash throughout the cycle. As an indicator of portfolio quality and resilience, c.93% of company updates in the fund have been in-line or positive relative to market expectations during the year-to-date.

Performance - Q2 2024[3]

The Trust’s NAV Total Return increased by 13.8% over the quarter, outperforming the FTSE Small Cap Index (excluding Investment Companies)4 which increased by 9.3% and outperforming the UK Smaller Companies Investment Trust sector which increased by **11.1%**.[5]

Key contributors to returns in the quarter to 30 June 2024 came from: **XPS Pensions Group (+29.4%)**, which delivered FY24 results ahead of market expectations with >20% revenue, EBITDA and EPS growth and further forecast upgrades, in addition to gaining FTSE 250 inclusion from 24 June; **The Property Franchise Group (+34.9%)**, which announced a strategic acquisition (The Guild of Property Professionals and Fine & Country) in addition to providing a trading update with lettings revenues up 9% YTD and sales revenues up 20% YTD; and **Alpha FMC (+52.8%)**, following a Recommended Cash Offer from Bridgepoint at a 50% premium to the undisturbed share price.

The main detractors in the period were: **Iomart Group** (-12.0%), despite in-line results but following some small consensus downgrades reflecting organic growth expectations and the ability to pass-through cost increases from VMWare; **R&Q Insurance Holdings** (-98.6%), which filed for liquidation in Bermuda and whose shares are now suspended from trading; and **Benchmark Holdings (-11.1%),** despite encouraging Q2 momentum but perhaps reflective of the ongoing “Strategic Review” which has yet to lead to any significant announcements**.**

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

Portfolio activity

We made two new investments during the quarter; into **Costain Group**, a leading UK infrastructure engineering and consultancy services provider which is positioned to benefit from UK infrastructure expenditure and which the Manager believes trades at a significant discount to intrinsic value; and **Halfords Group**, the provider of B2C automotive and cycling parts and services, and B2B fleet management services. Halfords has faced some recent headwinds in its B2C offering as bicycle sales mean-revert from an elevated COVID comparator period (exacerbated by sector-discounting as a large cycling competitor entered into Administration) and as some consumers delayed car tyre replacement. However, the Manager believes that these transitory issues have weighed disproportionately on Halfords' valuation, and Halfords' B2B business continues to trade strongly, following good progress by the management team in repositioning the Group towards B2B services. Both Costain and Halfords are well known to the Manager having been long term investments in other funds under management.

In addition, we 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; **Brooks Macdonald**, a UK wealth manager which the Manager believes is well positioned to play an active role in the consolidation of the UK wealth management sector and whose valuation reflects a material discount to sector M&A transactions; **Alpha Financial Markets Consulting**, a financial services-focussed consultancy which received a Recommended Cash Offer from Bridgepoint during the period, at a 50% premium to the undisturbed share price; **Iomart Group**, a leading UK datacentre and cloud services provider, and **Ricardo**, the global strategic, environmental and engineering consultancy.

We made two full exits during the quarter; from **Pinewood Technologies** (98.2% IRR[6]), following its separation from the Pendragon automotive dealership group and special dividend; and **LSL Property Services ("LSL")** (-12.5% IRR), following an improvement in trading performance as end-market conditions revert from a challenging 2023. Whilst the Manager continues to believe that Pinewood and LSL are high quality businesses, given the highly concentrated high conviction approach the Manager sees better alternative opportunities elsewhere for this portfolio. With regards to LSL, which transitioned its estate agency business from wholly-owned to franchised (a decision supported by the Manager), the Trust also has franchised estate agency exposure via The Property Franchise Group.

Outlook – Q3 2024

We saw green shoots of economic improvement in Q2 and are cautiously optimistic that positive trends can continue into Q3. UK CPI is now tracking the target inflation level, UK investors have priced in their expectations of two interest rate cuts by the Bank of England in H2, and we have already seen cuts by the European Central Bank.[7] Similarly, UK consumer confidence is at its highest level in almost three years, albeit consumption remains subdued as shown by recent household saving data. However, with real wages growing, the short-term prospect of unwinding mortgage costs, and the relatively 'de-leveraged' UK

[6] Annualised figure based on a <1 year holding period
[7] Bloomberg.

household compared to 2008/09,[8] the economic environment looks more supportive of rising consumption than at any point over the last couple of years.

Turning to UK equity markets and interest rates, the prospect of falling bond yields and price appreciation in Q3 may create a favourable 'denominator effect' for UK equity fund flows whereby asset allocators re-weight portfolios towards equities to meet their target asset class exposures. The ensuing liquidity injection into UK funds, and UK smaller companies, could alleviate the downward share price pressure of the last two years caused by 'forced selling'. UK smaller company valuations may then bridge the wide arbitrage versus their larger UK and international peers, as well as precedent M&A transactions. We see these conditions as supportive of a re-rating of UK smaller companies.

On a similarly positive note, we have seen a growing number of 'early look' and formal pre-IPO meetings during Q2 and into Q3. While equity capital market activity during 2024 has primarily focused on existing listed businesses, notable larger UK IPOs of Raspberry Pi and Aoti took place during Q2, along with a smaller IPO of AI-focused IntelliAM in early July. Together with the prospect of improving economic conditions and the possibility of rising UK stock-market valuations, investor and corporate confidence will have grown by observing strengthening post-deal share prices in each instance. We therefore expect further IPO activity to present new opportunities into H2 2024.

Important information

[8] Simon French, Panmure Liberum, "What does the UK economic inheritance look like?", July 2024

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