Gresham House
Specialist investment

Strategic Equity Capital plc

Factsheet commentary – Q3 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 – Q3 2024

UK equity market performance was broadly positive in Q3 2024 as smaller company stocks outperformed their larger peers, particularly those listed on the main market: the Numis Smaller Companies plus AIM ex Investment Trusts Index rose **2.5%** while the FTSE 100 increased by **1.8%**. However, the FTSE AIM All Share Index fell by **2.7%**.

Over the period, the prospect of medium-term political stability returned as the new Labour government secured a 157-seat majority at the July general election. Although some investors harbour concerns around potential changes to personal and corporate tax in the upcoming budget, we view the government transition as a long-term positive for UK equity markets. A stable political platform with a strong majority and clear mandate contrasts with the volatility and policy uncertainty experienced under previous administrations. While the impact of individual policies will vary by sector or company, we believe greater political certainty is conducive to longer-term corporate planning and investment which can lead to more sustainable economic growth and structurally higher stock market valuations. We also view this stable political environment as a relative strength of the UK compared to other developed markets in Europe and North America with polarised elections, rising far-right influences and increasing social discontent.

The UK economic environment also appears to be improving, with real GDP and inflation outperforming the European Union and US so far during 2024. Similarly, consumer and corporate balance sheets are de-leveraging in line with trends since 2008/09, business investment is on an upward trajectory, and mortgage rates are falling as markets expect lower interest rates, freeing up disposable income for consumption. These conditions support accelerating economic growth which feeds into positive momentum for UK corporate earnings and the opportunity for a broader re-rating of the UK equity market.

Despite these positive indicators, investors withdrew c.£1.2bn from UK-focused equity funds in Q3. Asset allocators continue to favour other global equity markets, especially the US, or fixed income investments as interest rates remain high. Moreover, recent geopolitical uncertainty in the Middle East and selling pressure on AIM stocks has had an unfavourable short-term impact on UK equity fund allocations, negating positive political and economic developments. As a result, we continue to see a structural disconnect between UK stock market valuations and the long-term returns opportunity presented by the numerous high-quality companies in our portfolio. At quarter-end, UK equities traded on an average 11% and 42% discount to European and US peers respectively - the steepest discount to global equities in over 30 years - as well as a discount to precedent M&A transactions across sectors. This is despite relative political stability, lower inflation and higher real GDP, as well as strong business fundamentals whereby capable and incentivised management teams are executing on clear value creation strategies to consistently grow earnings, generate cash, and pay sustainable and increasing dividends over time.[1] This discount was steeper still in the UK smaller companies space, which traded at a c.30% discount to UK large-caps at period-end.[2] We consequently see a highly attractive long-term returns opportunity to gain exposure to high-quality UK smaller companies on subdued valuations, at a time when re-rating catalysts are increasingly visible.

One such catalyst is M&A activity which continued apace during Q3 as private equity or strategic trade buyers look to capitalise on suppressed UK-listed company valuations, which may serve to expose the undervaluation theme. There were eleven bids for UK public companies over the period, taking the year-to-date total to forty at an average premium of 40% and some materially higher. We highlight an emerging nuance to this theme in the Smaller Companies space, with carve-outs – where a parent company sells a subsidiary company or business unit – of which there have been 20 'meaningful' instances over the year-to-date. Carve-outs are an underrated yet powerful way for UK companies to unlock real value, with several recent examples where businesses have sold off divisions at valuations higher than the prevailing group valuation - sometimes selling for more than the entire market cap. This shines a light on just how severely undervalued the remaining parts can be.[3]

For example, in early 2023 Ascential launched a strategic review of its three distinct business units: Digital Commerce, Product Design (WGSN) and a market-leading events business. While we considered each business to be high-quality, they were not complementary within a single group, a cohesive strategy became difficult to form and Ascential was left trading at a sharp discount to its implied sum-of-the-parts value. Management acknowledged these challenges, launched a 'break up' value creation plan, and ultimately sold all three business units for a total value of c.£1.9 billion versus a market capitalisation of £915 million prior to the announcement of the strategic review. Evidently, carve-outs can be a compelling tool for management teams to overcome market discounts and create shareholder value. Another such example pertains to Brooks Macdonald, which recently disposed of its international business to focus on its core UK operations where growth prospects are strong across discretionary fund management, model portfolio service (MPS), and financial planning. This disposal also freed up capital to fund the high-quality acquisition of LIFT in October where revenue and cost synergies are believed to be material.

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[1] Berenberg quarterly data.
[2] Bloomberg data: all UK companies ex investment trusts less than £250m market cap.
[3] See more from Cassie Herlihy, Associate Director Public Equity: Unlocking value through carve-outs - Gresham House

Performance – Q3 2024[4]

Despite a positive return in the calendar year to date, the Trust's NAV Total Return decreased by **6.6%** over the quarter ended September 2024, underperforming the FTSE Small Cap Index (excluding Investment Companies)[5] which increased by **6.2%**.

Key contributors to returns in the quarter to 30 September 2024 came from: **XPS Pensions Group (+0.4% CTR)**[6], 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 June 2024; **Costain Group (+0.3% CTR)**, a new holding acquired by the Trust in this calendar year, which has demonstrated strong progress towards its medium term margin target along with healthy cash generation and a number of contract wins including under the AMP8 water framework; and **Halfords Group (+0.1% CTR)**, on no specific news in the quarter.

The main detractors in the period were: **Inspired (-1.5% CTR)**, following interim results which revealed a strong optimisation project pipeline but flagged some risks to the timing of those projects converting into revenue particularly around the calendar year end; **Fintel (-1.4% CTR)**, following interim results which demonstrated double digit revenue growth albeit with some margin decline, with full year guidance maintained; and **Tribal Group (-1.0% CTR),** despite in-line interim results and the operational separation of its education services division which gives the Group strategic optionality**.**

4. Full performance history can be viewed in the associated factsheet
5. Where holdings' returns are stated, please note these are Total Returns, including dividends, for each of those stocks over the quarter
[6] -1.1% reflects the total return (dividends reinvested) to XPS shareholders in aggregate over the quarter. However, the Trust significantly reduced its stake in XPS during the period at a share price materially higher than the quarter-end level, which resulted in XPS being the single largest positive contributor to the Trust's performance during the quarter.

Portfolio activity

We made one new investment during the quarter; into **Diaceutics**, a proprietary data business providing real-time insights into test dependent therapies for the biopharmaceutical industry, a large and strongly growing market. Diaceutics has collated a proprietary database and pipeline with a breadth of testing laboratories across the globe, accounting for over 450 million weekly testing event data points, and is able to provide real-time insights to developers of precision medicine drugs to aid in their commercialisation efforts. The majority of Diaceutics' revenues are recurring, and its order book (which grew 16% in the 12 months to June 2024) gives it strong visibility over its earnings trajectory.

In addition, we made a number of follow-on investments during the period; into **Team17**, an indie 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 we believe 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; **Iomart Group**, a leading UK datacentre and cloud services provider; **Ricardo**, the global strategic, environmental and engineering consultancy; **Costain Group** a leading UK infrastructure engineering and consultancy services provider which is positioned to benefit from UK infrastructure expenditure and which we believe 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, we believe 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.

We made one full exit during the quarter: from **Alpha Financial Markets Consulting** (+115.3% IRR) following its Recommended Cash Offer from private equity firm Bridgepoint.

Outlook – Q4 2024

Entering Q4 2024, UK equity markets face short-term domestic and international political uncertainty, causing lower UK consumer confidence and rising bond yields. However, disinflation has continued and run-rate economic growth is currently the strongest in the G7. Notwithstanding unforeseen economic shocks, we consequently believe there are visible drivers of improved UK equity market performance.

Our meetings with major UK wealth and asset managers held across the Gresham House strategies have demonstrated that there are substantial excess deposits in the consumer banking system above long-term averages. Even if a proportion of this excess is rediverted into the consumer economy or into 'risk' investments such as UK small-cap equities, then we expect this to strengthen the corporate earnings environment and stock market valuations over the medium term. Potential catalysts for this shift out of excess deposits may include lower inflation and easing cost of living pressures, improving GDP growth, domestic political stability, and higher levels of consumer confidence.

While there are encouraging signals of more favourable UK equity market conditions, we emphasise two investment performance drivers uncorrelated to broader market or economic developments. Firstly, we continue to hold and invest in high-quality UK companies whose long-term earnings growth and cash generation prospects are largely independent from external forces. We actively position the portfolio to benefit from structural growth themes across a variety of sectors whereby key value creation drivers are detached from broader UK or global economic developments. Although there remains substantial performance upside here, we believe our portfolio is not reliant on re-ratings to drive alpha, i.e. share prices can be driven by consistent earnings growth and cash generation from underlying operational performance, disconnected from wider macroeconomic or geopolitical factors.

Secondly, private equity and strategic M&A activity remains elevated across the UK equity market as valuations are discounted versus international markets and private M&A transactions. We understand from conversations within our private equity network that private equity investors continue to assess the UK equity market as a source of deal-flow, given the attractive valuations (even with bid premia applied) on offer and the relative shortage of investment opportunities in the private M&A market, where transaction activity remains subdued. We also anticipate that private equity will continue to deploy on new deal opportunities in the UK equity market given elevated levels of 'dry powder' (c.$4 trillion).[7] We therefore expect that takeover activity, alongside carveouts, will continue to provide an attractive source of Fund returns and liquidity into Q4 and beyond.

Overall, we remain confident that our portfolio companies will continue to grow earnings and generate cash throughout the cycle. As an indicator of portfolio quality and resilience, 94% of company updates in the fund have been in-line or positive relative to market expectations during the year-to-date.

Important information

[7] Charles Hall, "Strategy", Peel Hunt Research, 2 Oct 24.

smaller companies may be less liquid than securities in larger companies. This Document is provided for the purpose of information only and before investing you should read the Prospectus and the Key Investor Information Document ("KIID") as they contain important information regarding the Fund, including charges, tax and fund specific risk warnings and will form the basis of any investment. The Prospectus and KIID are available from www.strategicequitycapital.com. Investors are reminded that past performance is not indicative of future results. No person, especially those who do not have professional experience in matters relating to investments, must rely on the contents of this Document. If you are in any doubt as to the matters contained in this Document, you should seek independent advice where necessary. This Document has not been submitted to or approved by the securities regulatory authority of any state or jurisdiction. This Document is intended for distribution in the United Kingdom only. Any dissemination or unauthorised use of this Document outside the United Kingdom by any person or entity is strictly prohibited. Please contact a member of the Gresham House team if you wish to discuss your investment or provide feedback on this presentation. Gresham House is committed to meeting the needs and expectations of all stakeholders and welcomes any suggestions to improve its service delivery.

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