Gresham House
Specialist investment

Strategic Equity Capital plc

Factsheet commentary – Q4 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 – Q4 2024

UK equity market performance was negative in Q4 2024, with smaller company stocks underperforming their larger peers. The Deutsche Numis Smaller Companies plus AIM ex Investment Trusts Index, FTSE 100, and FTSE AIM All Share fell by **1.6%**, **0.2%**, and **2.3%** respectively.

The period was characterised by a combination of domestic and global political uncertainty which adversely affected UK equity markets and more so UK smaller companies. Many policies brought forward by the new Labour government in the Autumn budget were received negatively by investors, not least the reduced inheritance tax relief on AIM and the higher corporate costs precipitated by changes to national minimum wage and national insurance legislation. Following conversations with portfolio company management teams since the budget, we believe the recent corporate tax changes will have a broad-based inflationary impact on the UK economy as companies pass on higher costs to prices. We have seen this view mirrored by the upward trajectory of UK government bond yields in Q4, as markets expect higher interest rates for longer than previously assumed.

The negative budget impact on UK equity markets was compounded by the US election results and the subsequent US equity market rally. Having inflected to a small net inflow in November (£317 million) – the first in 42 months – UK-focused equity funds shed a further £221 million in December 2024, taking the annual total outflow to £9.6 billion.[1] Much of the UK outflows over the year, which caused more forced selling of domestic shares and falling valuations, were recycled into global and US equity funds or passive trackers, driving positive valuation momentum in non-domestic equity markets and leaving UK equities trading at a stark discount to international peers heading into 2025; a discount even more pronounced among UK smaller companies, which are now 28%, 57% and 69% cheaper than UK large caps, US large caps and US smaller companies respectively.[2]

Despite a sentiment-based valuation de-rating across the UK smaller companies space in Q4 2024, we believe our focus on resilient business fundamentals such as structural growth trends, non-cyclical markets, high-quality financials (including c.20% EBITDA margins, strong cash generation, and very low financial leverage), and capable management teams executing on clear value creation strategies, underpins a highly attractive

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[1] Calastone UK equity fund flow data, 7 Jan 25.
[2] Bloomberg 12M forward price-to-earnings data as at 12 Jan 25 (Deutsche Numis Smaller Companies ex Investment Trusts plus AIM index versus FTSE 100, S&P 500, and Russell 2000 indices).

multi-year returns opportunity from here.

Performance – Q4 2024[3]

Despite a positive return in the calendar year, the Trust's NAV Total Return decreased by **2.4%** over the quarter ended December 2024, underperforming the FTSE Small Cap Index (excluding Investment Companies)[4] which decreased by **1.0%**.

Key contributors to returns in the quarter to 31 December 2024 came from: **XPS Pensions Group** (+1.8% CTR) as H1'25 results demonstrated further trading momentum characterised by double-digit growth across all divisions and operating margin expansion; **Trufin (+1.4% CTR)** following two unscheduled trading updates which both materially increased already upgraded full-year earnings guidance due to the continued sales momentum of two games within the games label division, Playstack; and **Netcall (+1.0% CTR)** following full-year results which showed exceptional 58% growth in profit before tax and relayed a confident outlook.

The main detractors in the period were: **Iomart (-3.7% CTR)** following an underlying profit downgrade in conjunction with a large strategic acquisition which increased near-term financial leverage; **Brooks Macdonald (-1.3% CTR)** despite making two acquisitions which are expected to be immediately earnings enhancing; and **Team17 (-1.1% CTR)** despite interim results in-line with expectations which showed double-digit organic growth and margin expansion driven by management cost control.

Portfolio activity

We made one new investment during the quarter: into **Next 15 Group**, a digitally-enabled growth consultancy, which has a strong market position across its key end markets with a blue-chip customer base, however the loss of one significant contract, alongside what we deem to be transitory end market headwinds, have weighed on near-term earnings and consequently the share price, leaving the business trading at an attractive valuation, particularly on a sum-of-the-parts basis. In addition, we made several follow-on investments during the period; into **Diaceutics**, a proprietary data business focused on the biopharmaceutical industry, with over 80% gross margins, which is shifting its business model towards higher quality contracted recurring revenues, and whose proposition quality is being reflected in accelerating new contract momentum; **Team17**, an independent video game developer and publisher which has a strong market position, with earnings underpinned by a resilient back catalogue of durable franchises, which continues to trade at an attractive valuation; and **Ricardo** a global strategic, environmental, and engineering consultancy, which is undergoing a strategic transition to refocus on the higher growth, higher margin, and lower capital intensity parts of the business, where growth is underpinned by environmental structural tailwinds.

We made no full exits during the quarter.

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

Outlook – Q1 2025

Looking ahead to this year, we see a number of short-to-medium term factors supporting Fund performance prospects and believe our companies remain well positioned to offset external headwinds such as high interest rates, low economic growth, and UK government-driven cost inflation. We continue to see the benefits of our consistent and repeatable private equity approach to UK public market investing, leveraging a high-quality expert network to independently validate key investment judgements, providing a sustainable 'edge' over the wider market in terms of investment appraisal and portfolio monitoring.

We also see upside potential to Fund performance from elevated takeover activity across UK equity markets heading into 2025. While the uncertainty around the Autumn budget led to an M&A slowdown in Q3'24, we observed an uptick in activity during Q4 and anticipate deal momentum continuing into this year. During 2024, buyers paid on average a 44% premium for UK companies, greater than the five-year average despite elevated deal funding costs amidst higher interest rates.5 From conversations with our private equity network, we understand that private buyers continue to assess the UK market for deal-flow opportunities given the attractive valuations on offer and the relative shortage of investment opportunities in a subdued private M&A market. With c.$4 trillion of 'dry powder' yet to be deployed,[6] we expect that takeover activity, alongside divisional carveouts, will offer attractive returns for the Fund in 2025.

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 through 2024. 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. We believe carve-outs can be a compelling tool for management teams to overcome market discounts and create shareholder value.

More broadly, we welcome calls for government reforms in 2025 to encourage UK pension fund participation in domestic equity markets, where they are materially under-penetrated today at defined contribution, defined benefits, and local government levels compared to other developed western nations.7 Any incremental liquidity as a result of supportive policies would aid marginal buying of UK shares and in turn bridge the stark valuation arbitrage to other developed equity markets and precedent M&A transactions.

Important information

[5] Bloomberg data.
[6] Charles Hall, 'Strategy', Peel Hunt Research, 2 Oct 2024.
[7] Department for Work & Pensions, 'Pension fund investment and the UK economy.'

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