Gresham House
Specialist investment

Strategic Equity Capital plc

Factsheet commentary – Q1 2025

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 2025

UK equity market performance was mixed in Q1'25 as smaller company stocks generally underperformed their larger peers. The Deutsche Numis Smaller Companies plus AIM ex Investment Trusts Index and FTSE AIM All Share fell by **5.9%** and **4.9%** respectively. In contrast, the FTSE 100 Index rose by **6.1%.**

During Q1'25, several dynamics negatively impacted on the performance of the UK smaller companies sector, however we have observed strong fundamental business performance across the portfolio. There were 24 company trading updates or results announcements during the period, of which 88% were in-line with or ahead of market expectations (42% ahead). However, portfolio de-rating significantly outweighed fundamental drivers of performance during the period.

A variety of factors have contributed to this de-rating in our view. Domestically, the national insurance (NIC) and minimum wage changes announced in the government's Autumn budget have continued to reverberate across the UK economy as consumers and companies prepared for implementation of new measures. We have seen a sharp and relatively broad-based slowdown in consumer footfall, particularly concentrated among low-earning consumers, as uncertainty regarding the employment outlook in that cohort has driven lower spending. While the majority of portfolio companies were insulated from these adverse dynamics, UK consumer and business sentiment has weakened since the Autumn budget, driving risk-off investor attitudes towards UK smaller companies. Moreover, the change in government policy towards inheritance tax relief available on AIM-listed equity investments has caused a handful of larger AIM-listed companies to seek main market listings, leaving an overhang of IHT focused investors who are expected to become forced sellers in the short term, albeit we expect to see those IHT funds redeployed into other AIM companies in due course.

UK equity markets also remain out of favour compared to other international markets. The first two months of 2025 saw accelerating outflows from UK focused equity funds of £1.1bn and £1.2bn respectively, with most of the money rotating into US or global equity funds. Net outflows have exerted downward pressure on UK smaller company valuations across the board. Moreover, the initial rhetoric and policies of the new US administration has fuelled geopolitical and macroeconomic uncertainty, causing multiple developed equity markets to sell off, particularly in anticipation of widespread trade tariffs.

Evidently, domestic and global circumstances are currently headwinds to equity market performance generally. Nevertheless, we take comfort from the earnings profiles of our portfolio companies which are largely insulated from external macroeconomic factors and whose management teams exercise value creation levers within their control.

Our bias towards defensive fundamental characteristics such as structural growth drivers, high margins, and strong cash generation has led to a high proportion of companies delivering results in-line with or ahead of market expectations. Over the medium term, we see the dislocation between portfolio company fundamentals and valuations – which has widened during Q1'25 – as a compelling medium-term opportunity.

Performance – Q1 2025

Despite a positive return in the previous calendar year, the Trust's NAV Total Return decreased by **8.2%** over the quarter ended 31 March 2025, underperforming the FTSE Small Cap Index (excluding Investment Companies)[1] which decreased by **6.5%**.

Key contributors to returns in the quarter to 31 March 2025 came from: **Everplay** (+1.8% CTR) following full-year results ahead of market expectations and upgrades to FY25 earnings guidance, reflecting continued strong growth and strategic progress; **Inspired (+1.2% CTR)** following full-year results in-line with expectations and announced confidence in FY25 earnings prospects following the completion of previously delayed contracts and removal of a covenant risk overhang due to a significantly strengthened balance sheet following an equity placing; and **XPS Pensions Group (+0.8% CTR)** following a full-year trading update which disclosed continued strong demand for pensions advisory services and earnings materially ahead of market expectations.

The main detractors in the period were: **Iomart (-4.5% CTR)** following a profit warning driven by higher-than-expected customer churn in the legacy self-managed infrastructure segment; **Ricardo (-3.8% CTR)** following a significant profit warning in late January driven by order delays in the high-value Energy and Environment segment as well as Rail, however, we have extensively engaged with the management team and board on a value recovery plan; and **Brooks Macdonald (-0.8% CTR)** on no specific fundamental newsflow.

Portfolio activity

We made no new investments during the quarter. However, we made several follow-on investments during the period; into **Brooks Macdonald**, an investment management services provider, which the Manager views as a leading player in the highly fragmented wealth management sector and as materially undervalued relative to precedent M&A transactions in the space; **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; and **Inspired**, a tech-enabled energy & ESG services provider which benefits from structural demand tailwinds for energy procurement optimisation and other ESG solutions and quality financial characteristics. We participated as part of an equity placing which re-capitalised the company following short-term contract delays which have now completed.

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

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We made no full exits during the quarter.

Outlook – Q2 2025

Looking ahead to Q2, we remain cautious about the short-term macroeconomics and geopolitics given current headwinds, however, our portfolio companies have demonstrated good operational resilience with the majority announcing constructive earnings outlooks in this challenging environment. We remain actively engaged with management teams on their value creation strategies and have sought to address key detractors by engaging on specific value recovery initiatives.

While we expect US tariffs and the retaliatory actions of its trading partners to have an influence on the global economy and equity markets during the next quarter, we believe the strong fundamental performance of our portfolio companies reflects our emphasis on defensive, idiosyncratic characteristics, which better insulate overall Fund performance from external headwinds. 100% of equity net asset value is invested in services-focused businesses, while on average, 71% of portfolio company revenues are derived from the domestic UK economy,[2] protecting investee companies from direct tariff exposure. More importantly, we believe these companies benefit from strong positions in structurally growing markets and quality financial characteristics including very low leverage, high margins, and a high return on capital. These high-quality businesses are also managed by capable, experienced, and aligned management teams exercising value creation levers in their direct control. Indeed, recent events highlight the advantages of avoiding sectors in which key investment drivers are beyond management influence.

Over the medium term, we retain conviction that our portfolio companies are exercising clear value creation levers within management control to drive earnings growth and cash generation and therefore see a clear dislocation between company fundamentals and valuations at present. We think the Manager's active engagement strategy can support portfolio re-rating over the medium term, as it has done in the past, hence we view now as a compelling medium term buying opportunity.

While uncertainty has persisted into this year, we see upside potential to Fund performance from elevated takeover activity across UK equity markets. In the first quarter, there was an increase in activity as expected, with 15 companies with a market capitalisation of over £100 million entering bid situations at an average premium of 36% versus the undisturbed prior-day price.[3] Corporate and financial buyers are attracted to the discounted valuations available in UK equity markets which do not properly reflect the strategic value or high-quality fundamental characteristics on offer. Ultimately, this bid activity should illustrate the discounted nature of comparable businesses in relevant sectors, and demonstrate scope for organic re-rating over time.

The investment team has also seen greenshoots of IPO activity over the first quarter of 2025, with some of the businesses considering or actively pursuing listings being of considerable scale compared to those of the last two years. In this light, we continue to press for government reforms which offer structural support to UK capital markets, both in terms of alleviating downward valuation pressure and preventing ongoing de-equitisation. Part of the solution lies in promoting greater UK pension fund participation in domestic equity markets, where they are materially under-penetrated today at defined contribution, defined benefits, and

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[2] Weighted average by equity net asset value as of 31 March 2025
[3] Charles Hall, 'Pace of M&A quickens', Peel Hunt, 1 April 2025

local government levels compared to other developed western nations.[4] Should the UK pensions sector increase investment in domestic equities in-line with developed peers, this additional liquidity would help alleviate the valuation issue we describe, revitalise UK capital markets as an attractive listing venue for quality innovative businesses, and promote greater investment in the wider UK economy.

Looking ahead to Q2, we remain cautious about the short-term macroeconomic and geopolitical outlook given current headwinds, however, our portfolio companies have demonstrated good operational resilience with the majority announcing constructive earnings outlooks in this challenging environment. We believe the strong fundamental performance of the portfolio reflects our emphasis on defensive characteristics such as structural demand drivers, leading market positions, quality financial characteristics, and aligned and capable management teams.

While uncertainty has persisted into this year, we see upside potential to Fund performance from elevated takeover activity across UK equity markets. In Q1'25, there was an increase in activity as expected, with 15 companies with a market capitalisation of over £100 million entering bid situations at an average premium of 36% vs. the undisturbed prior-day price.[5] Corporate and financial buyers are attracted to the discounted valuations available in UK equity markets which do not properly reflect the strategic value or high-quality fundamental characteristics on offer. Ultimately, this bid activity should illustrate the discounted nature of comparable businesses in relevant sectors, and demonstrate scope for organic re-rating over time.

The investment team has also seen greenshoots of IPO activity over Q1'25, with some of the businesses considering or actively pursuing listings being of considerable scale compared to those the last two years. In this light, we continue to press for government reforms which offer structural support to UK capital markets, both in terms of alleviating downward valuation pressure and preventing ongoing de-equitisation. Part of the solution lies in promoting greater 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.[6] Should the UK pensions sector increase investment in domestic equities in-line with developed peers, this additional liquidity would help alleviate the valuation issue we describe, re-vitalise UK capital markets as an attractive listing venue for quality innovative businesses, and promote greater investment in the wider UK economy.

[4] Department for Work & Pensions, 'Pension fund investment and the UK economy.'
[5] Charles Hall, 'Pace of M&A quickens', Peel Hunt, 1 April 2025
[6] Department for Work & Pensions, 'Pension fund investment and the UK economy.'

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