MARTEN & CO

Update | Investment companies

22 March 2017

Strategic Equity Capital

Business as usual

The departure of Stuart Widdowson from GVQ Investment Management will, we think, have no impact on Strategic Equity Capital (SEC)'s philosophy, approach or portfolio. We met former deputy manager, Jeff Harris, who has stepped up to become lead portfolio manager and Adam Khanbhai, who becomes the new deputy manager. The management team is enthused about the prospects for SEC's future performance as former "problem children" are showing positive initial signs of recovery and the market recognises the latent value within the portfolio.

Focused UK smaller companies portfolio

SEC is managed with a focused portfolio of investments selected on the same basis that a private equity investor would use to appraise its investments.

Two of the non-executive directors added to their holdings in the wake of the announcement. Richard Locke and his wife bought 10,000 shares as did William Barlow.

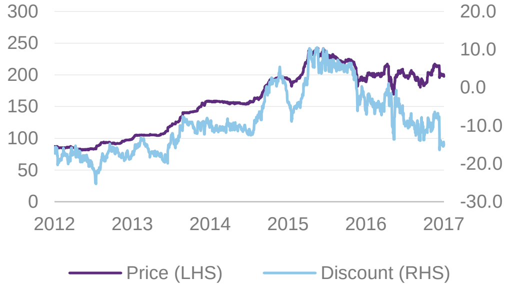
Year ended	Share price total return (%)	NAV total return (%)	Peer group * average TR (%)	MSCI UK Small Cap TR (%)	MSCI UK total return (%)
28/02/13	17.0	18.7	22.9	21.9	11.8
28/02/14	60.6	47.8	34.7	31.1	10.5
28/02/15	22.7	15.2	(2.2)	1.8	5.4
28/02/16	(1.6)	0.7	6.7	0.5	(9.3)
28/02/17	4.6	15.9	23.9	17.5	24.1

Source: Morningstar, Marten & Co, see page 5 for details of peer group

Sector	UK Smaller Cos
Ticker	SEC LN
Base currency	GBP
Price	203.25p
NAV	234.83p
Premium/(discount)	(13.4%)
Yield	0.4%

Share price and discount

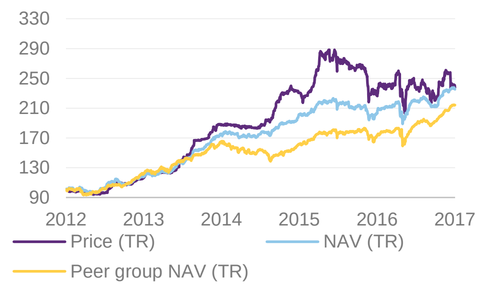
Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

Performance over five years

Time period 29/02/12 to 28/02/17



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	13 July 2005
Manager	Jeff Harris
Market cap (GBP)	141.9m
Shares outstanding	69.8m
Daily vol. (1-yr. avg.)	120,330 shares
Net cash	11.2%

click here to access our initiation note
click here to access our previous update note

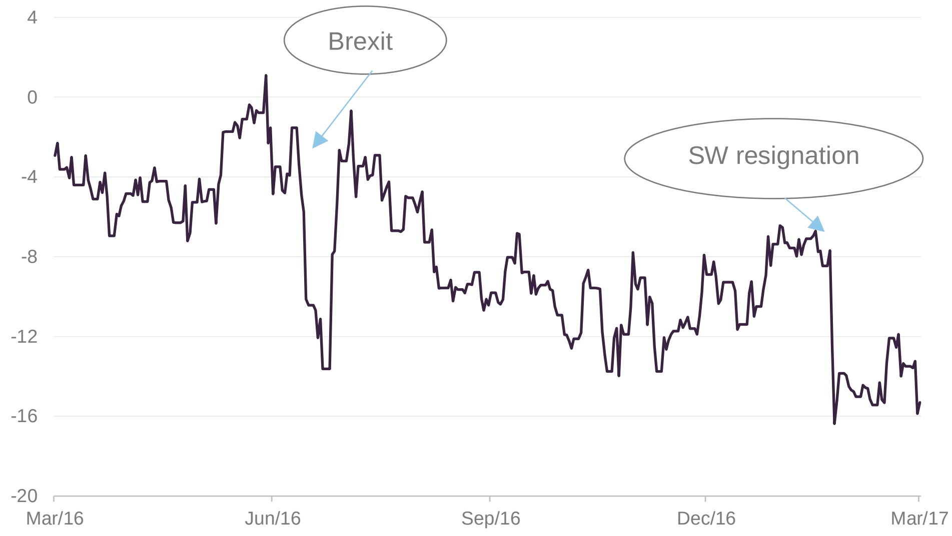
Business as usual

While, for the most part, Stuart has been the public face of SEC since Adam Steiner left in May 2014, the fund has long been managed on a team basis. Potential investments must first pass through GVQ's detailed and meticulous private equity based research process. This includes review by a panel of five industry experts. Only once an idea has been signed off by GVQ's research committee, can it then be considered for inclusion in the portfolio. This process is not unique to the SEC, it applies to all GVQ products and is core to the business' philosophy of managing client money. Jeff and Adam have been a key part of this process for a number of years and have intimate knowledge of all the stocks in the portfolio.

Take advantage of wider discount

As the fund profile section on page 6 explains in greater detail, elements of the GVQ way of managing money include using a team approach, thinking long-term and sticking by holdings as long as they can see through short-term issues. We think Stuart's departure will have little impact on the portfolio. New lead manager, Jeff Harris, along with new deputy manager, Adam Khanbhai, have been integral to the research effort on the fund, including engaging with portfolio companies. The market seems nervous however, the discount has gapped out as is evident in Figure 1, albeit largely on limited volume. We think that, if SEC was a position in a GVQ fund, they'd be using the current weakness, were liquidity available, to top up their holding.

Figure 1: SEC's discount over the year ended 16 March 2017



Source: Morningstar, Marten & Co

Semi-annual 4% tender at 10% discount at board's discretion

As we highlighted in **our May 2016 note**, SEC has the authority to repurchase up to 14.99% of its issued share capital annually and has a discount control mechanism in the form of a semi-annual tender for 4% of the share capital at a 10% discount. The board can opt not to hold the tender if it feels it is unwarranted.

The GVQ team

GVQ has been growing in assets under management in recent years (currently in excess of £700m) but the team have ambitions to expand this and are backed by RIT Capital Partners to do so.

- **Jeff Harris ACA** is now the lead portfolio manager. He had been deputy manager on SEC since May 2014 and remains deputy manager on GVQIM's open-ended funds. He joined GVQIM in 2012 as a senior analyst. Before that he was a European banks analyst at Macquarie and performed due diligence on private equity and corporate transactions as a member of the transactions services team at PricewaterhouseCoopers.
- **Adam Khanbhai CFA** is now deputy fund manager. He joined GVQIM in 2014 as a senior analyst. Before that he was a consultant at OC&C Strategy Consultants, working on commercial due diligence and strategy products for private equity and corporate clients.
- **Oliver Bazin ACA, CFA** is an analyst within GVQ's team. He joined in 2016 from Rothschild where he worked in their M&A practice with a focus on financial companies. Before this, he worked in KPMG's audit practice.
- **A new analyst** is being recruited to maintain the strength of the team.
- **Jamie Seaton** and **Jonathan Morgan** comprise the research committee. They vet all new research ideas as well as reviewing existing investments. Jamie is GVQIM's CEO. Jonathan rejoined GVQIM in October 2016 (having worked at the firm previously, between 2009 and 2014). He was chairman of SVG Capital's investment committee and worked both at 3i and Prudential's private equity business for a number of years.
- **The advisory panel** is unchanged since 2014, comprising Sir Clive Thompson, Stewart Binnie, Chris Rickard, Peter Williams and Lindsay Dibden. See our January 2015 note for more detail.

Market backdrop

UK small cap market is polarised and suffering from a lack of liquidity

The GVQ team believe the UK small cap market has become polarised. Stocks that are perceived as quality growth companies are, they think, priced excessively, leaving them vulnerable to earnings disappointment. In their view, it is important to be highly selective when choosing investments as many apparently attractively priced stocks are cheap for good reasons. They also caution that many "recovery" plays are valued optimistically.

One of the biggest problems facing small cap managers is a lack of liquidity. It is one of the reasons why they insist on owning less than 10% of any stock. GVQ think their long-term, disciplined approach to investing makes life a bit easier for them. As the availability and quality of equity research declines in response to MIFID 2, investment houses such as GVQ that do the bulk of their own research in-house will benefit. A lack liquidity and of generally available research may also help increase the number of mispriced securities for GVQ to take advantage of.

Current positioning

Figure 2 shows the top 10 positions in the fund as they were at the end of December. SEC does not release portfolio percentage weightings that often and so, while these are the 10 largest holdings, they might not necessarily be in descending order of size. Altogether, these 10 holdings accounted for 76% of the fund at the end of 2016.

GVQ's process emphasises, amongst other things, free cash flow generation and balance sheet strength as signs of the attractiveness of a holding. These are key factors that anyone looking to acquire a portfolio company would take into account.

Figure 2: Top 10 holdings as at 31 December 2016

Holding	Sector	Year first acquired	GVQ cash flow yield (%)*	Net debt / EBITDA*	Progress vs. thesis
Equiniti	Electronics	2016	9.5	2.1x	Ahead
e2v technologies	Electronics	2009	9.1	(0.1x)	In line
Servelec Group	Technology	2013	9.6	(0.2x)	Behind
Clinigen Group	Healthcare	2014	8.3	0.4x	Ahead
Wilmington Group	Media	2010	10.4	0.8x	In line
Tribal Group	Technology	2014	4.0	(0.8x)	Behind
EMIS Group	Technology	2014	8.3	(0.4x)	Ahead
4imprint Group	Support services	2006	7.4	(0.5x)	Ahead
IFG Group	Financials	2015	12.2	(2.2x)	In line
Goals Soccer	Consumer Services	2012	9.9	1.5x	Behind

Source: GVQ Investment Management, Marten & Co, * GVQ forecast

The managers are very happy with the portfolio and have been integral to its construction. Nevertheless a few holdings have disappointed, as discussed below, and this has held back recent performance.

Servelec

Servelec's shares fell sharply (from 390p to a low of 208p) in Q2 last year after they warned that contract slippage would affect profits in the second half of their financial year. The stock market at the time was nervous ahead of the referendum and any disappointment was punished savagely. The shares have since recovered somewhat. The managers believe that Servelec's acquisition strategy has created a "mini conglomerate". They see significant potential for value to be unlocked given Sevelec's strong market positions. They estimate that Servelec could generate £39m of cash (20% of its market cap) over the next three years. They think a sum of the parts valuation could value the company in excess of 400p per share. At 17 March the share price was 274p.

Goals Soccer Centres

The focus of the company has switched from expansion to investment in the existing business with the prospect of achieving higher returns. The balance sheet is stronger thanks to an equity raise. SEC's managers believe the company could soon start to generate significant free cash flow. They also point out that the company has been a bid target in the past.

Rest of the portfolio

We discussed Tribal's woes in **our note of May 2016**. A rights issue, which SEC supported, has strengthened the company's balance sheet and, subsequently, the shares have recovered strongly. A disposal of a non-core asset at what SEC's managers believe was an attractive valuation has also helped. New management has identified an initial £8.5m of annual cost savings. A US peer has built up a material stake in the business.

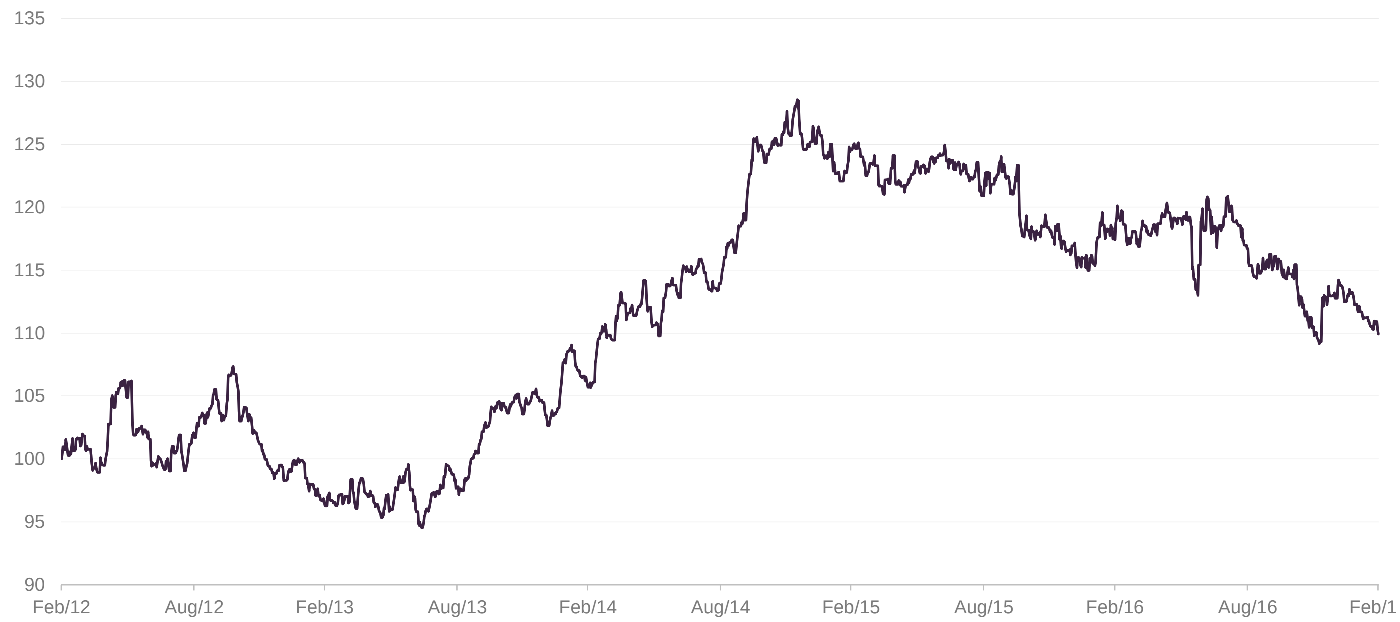
The recent bid for e2v technologies will result in a substantial cash inflow for SEC – about £15m. Jeff says deployment of capital will be driven by individual investment opportunities, as has been the case historically. Sterling weakness is attracting overseas buyers and e2v might be the tip of the iceberg in terms of bids for portfolio companies. The portfolio's cash generation and balance sheet strength relative to market averages make many of these companies tempting targets for acquirers. M&A isn't the only potential catalyst for a re-rating however.

Performance

Access up to date information on SEC and its peer group **here**

We have compared SEC to a peer group consisting of London listed UK smaller companies investment companies with a market capitalisation in excess of £50m. The full list is: Aberforth Smaller Companies, BlackRock Smaller Companies, BlackRock Throgmorton, Dunedin Smaller Companies, Henderson Smaller Companies, Invesco Perpetual UK Smaller Companies, JPMorgan Smaller Companies, Miton UK Microcap, Montanaro UK Smaller Companies, Rights & Issues, River & Mercantile UK MicroCap and Standard Life UK Smaller Companies.

Figure 3: SEC vs. peer group average – NAV total returns for five years ended 28 February 2017



Source: Morningstar, Marten & Co

In 2016, SEC's NAV growth was held back by the poor performance of Servelec in particular as well as zero exposure to the mining and resources sectors which have experienced a rebound over 2016. It is estimated they contributed over half of the annual small cap index return. We believe SEC's weighting towards the smaller end of the small cap market has also weighed on it in recent times.

Fund profile

Focused, small cap portfolio. Click here to access the manager's website

Launched in 2005, SEC is a UK investment trust that invests in a concentrated portfolio of UK-listed equities (typically 15-20 holdings). SEC is overwhelmingly focused on small caps although this is not actually mandated by its investment objectives. The managers expect that the majority of its investments will be in the sub-£300m market-cap range as they believe this under-researched segment (those which are too small for inclusion in the 250 Index), creates greater opportunities to identify mispriced securities. The company can invest in companies listed on overseas exchanges, but this is formally limited to 20% of gross assets, at the time of investment, and the managers do not expect this to be a significant element of the portfolio. The approach is not constrained by benchmark, has an absolute return focus and does not employ leverage at the investment trust level although underlying companies may of course employ borrowings.

Private equity style valuation techniques in public markets

Private equity style investing in listed companies

A feature of SEC, which makes it unique in the closed-end fund space, is GVQ's approach to managing its portfolio. In common with all of its mandates, GVQ uses an approach that seeks to apply private equity techniques to listed equity markets. More detail is available in **our January 2015 note**, but key features of the approach are a strong focus on a company's cash flows (post maintenance capital expenditure, as the managers say that this gives a fairer indication of a company's ongoing profitability); valuing companies using an in-house leveraged buyout model (and forming an opinion of the potential value to a trade buyer or private equity house); and seeking to identify companies that are undervalued but might benefit from strategic, operational or management initiatives (and then establishing, prior to investment, whether a process of constructive engagement can be undertaken to help effect the necessary changes required to unlock value).

It should be noted that the managers do not rely solely on the rerating of a stock. Instead they are looking for companies that offer a number of routes to value creation: earnings growth, rerating potential, cash flow and corporate activity (see our January 2015 note for more detail). In the managers' view, this will typically lead to all-weather strategies that perform in a variety of market conditions and generally outperform most other strategies over the longer term.

Well-resourced and aligned investment manager

Strong alignment between manager and investors

SEC has been managed by GVQ Investment Management (GVQ) and its predecessors since launch (GVQ Investment Management was formerly GVO Investment Management and SVG Investment Managers). GVQ has assets under management of over £700m and was acquired by Lord Rothschild's RIT Capital Partners in January 2015. The investment managers are well-aligned with shareholders, in our view. GVQ employees (excluding Stuart Widdowson) own over 2% of the trust and RIT Capital has a 14% stake.

Previous research

Further information is available in our earlier research notes – **Cashing up!** – published on 10 May 2016; **Measured expansion on strong performance** – published 16 July 2015; and **Different, in a good way** – published 27 January 2015.

Figure 4: Marten & Co. previously published research on SEC

Title	Note type	Date
Different, in a good way	Initiation	27 January 2015
Measured expansion on strong performance	Update	16 July 2015
Cashing up!	Update	10 May 2016

Source: Marten & Co.

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