

# Strategic Equity Capital

## Selective investment in UK small-cap growth stocks

Strategic Equity Capital (SEC) is an actively managed closed-ended fund investing in a concentrated portfolio of quoted UK small-cap companies using a private equity style approach. NAV total returns are ahead of the FTSE Small-Cap ex-IT index since inception and lead the peer group over one, three and five years, with recent outperformance augmented by the takeover of Allocate Software at a substantial premium. Portfolio companies are forecast to achieve strong earnings growth in 2015 and the manager sees M&A activity as a potential source of incremental performance. The manager also highlights a promising pipeline of potential investment opportunities.

12 months ending	Total share price return (%)	Total NAV return (%)	FTSE Small Cap ex IT (%)	FTSE AIM ex IC (%)	FTSE All-Share (%)
29/02/12	8.8	6.6	(3.5)	(10.5)	1.5
28/02/13	17.0	18.6	28.4	(9.5)	14.1
28/02/14	60.6	47.7	40.5	21.5	13.3
28/02/15	22.7	15.0	(3.4)	(19.0)	5.6

Note: Twelve-month rolling discrete total return performance.

### Investment strategy: Private equity style approach

The manager applies a private equity perspective, typically evaluating investments on a three-year horizon, with investment plans including an entry and exit strategy and a clearly identified catalyst for value creation. Detailed analysis of potential investments is undertaken, with a focus on cash flow generation prospects and the potential value of the company to trade or financial buyers. Portfolio companies are typically niche market leaders with resilient business models and structural growth prospects. Smaller companies, below the threshold for inclusion in the FTSE-250 index, are believed to provide the greatest opportunity for SEC's investment style, being relatively under-researched, often more open to constructive shareholder engagement, and frequently more attractively valued.

### Market outlook: Selective opportunities

Although UK small-cap shares have de-rated from their peak in early 2014 and have moved to a discount to large-caps, valuation multiples are still above three-year average levels. This suggests that earnings growth is likely to be the main driver of near-term share price performance. With forecast aggregate forward earnings growth for UK small-caps at low single-digit levels, selecting growth stocks requires a more discriminating approach. In this context, a fund such as SEC with its unconstrained, concentrated approach has the potential to provide exposure to a portfolio of companies achieving above-average earnings growth and deliver a differentiated performance.

### Valuation: Discount has recently widened

The current 8.1% discount is wider than its 12-month average of 6.4% and the recent move from a premium to a discount suggests scope for the discount to narrow as sentiment improves.

## Investment trusts

20 March 2015

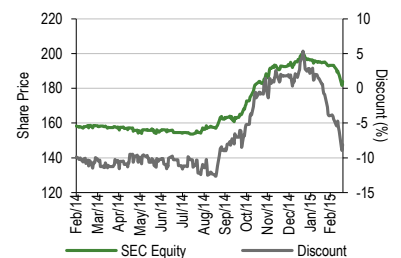
**Price** 184.0p  
**Market cap** £106.5m  
**AUM** £115.8m

NAV\* 200.1p  
Discount to NAV 8.0%  
NAV\*\* 200.3p  
Discount to NAV 8.1%

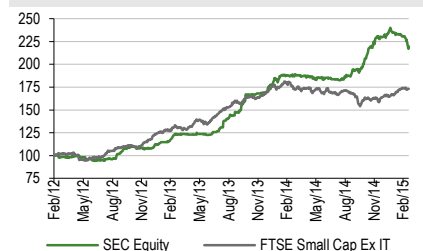
\*Excluding income. \*\*Including income.

Yield 0.4%  
Ordinary shares in issue 57.9m  
Code SEC  
Primary exchange LSE  
AIC sector UK Smaller Companies

### Share price/discount performance\*



### Three-year cumulative perf. graph



52-week high/low 201.0p 153.8p  
NAV\*\* high/low 202.3p 171.4p

\*\*Including income.

### Gearing

Gross 0.0%  
Net cash\* 10.9%

\*At 31 December 2014.

### Analysts

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[Edison profile page](#)

### Exhibit 1: Trust at a glance

#### Investment objective and fund background

Strategic Equity Capital's investment objective is to achieve absolute rather than relative returns over a medium-term period, principally through capital growth. The investment strategy is to invest in publicly quoted companies expected to increase in value through strategic, operational or management change. The investment manager follows a practice of constructive corporate engagement aiming to work with management teams in order to enhance shareholder value.

#### Recent developments

- 18 February 2015: Interim results to 31 Dec 2014 – NAV total return +10.1%; FTSE Small Cap ex-IT index -3.1%.
- 10 February 2015: John Hodson retired from Board; Richard Locke appointed as a director.
- 21 January 2015: RIT Capital acquires GVOIM and 17% stake in SEC from Hansa; no change to SEC's investment team.

#### Forthcoming

AGM	November 2015
Preliminary results	September 2015
Year end	30 June
Dividend paid	November
Launch date	19 July 2005
Continuation vote	Annual

#### Capital structure

Ongoing charges	1.27% (1.59% incl. perf. fee)
Net cash	10.9%
Annual mgmt fee	Lower of 1% of NAV or mkt cap
Performance fee	15% (see page 7)
Trust life	Indefinite
Loan facilities	N/A

#### Fund details

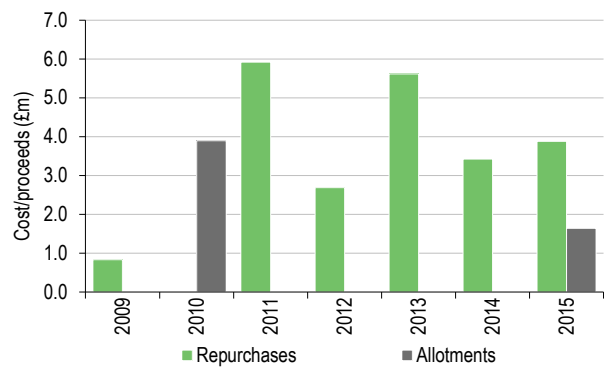
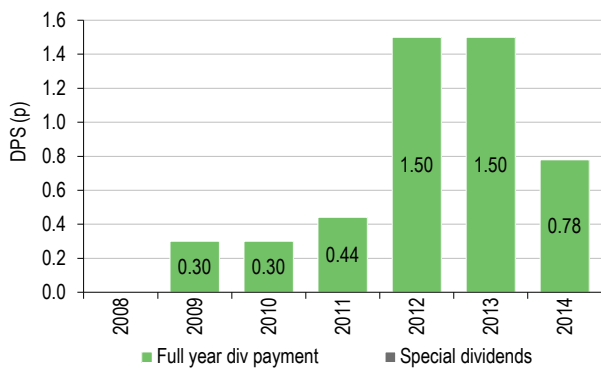
Group	GVO Investment Management Ltd
Managers	Stuart Widdowson, Jeff Harris
Address	25 North Row, London W1K 6DJ
Phone	+44 (0)20 3691 6100
Website	<a href="http://www.strategiequitycapital.com">www.strategiequitycapital.com</a>

#### Dividend policy and history

Although focused on capital growth, as an investment trust, SEC distributes 85% of income through paying an annual dividend.

#### Share buyback policy and history

SEC may purchase up to 14.99%, and allot up to 5% of shares in issue. Semi-annual tender offers are made for 4% of issued capital at a 10% discount to NAV.

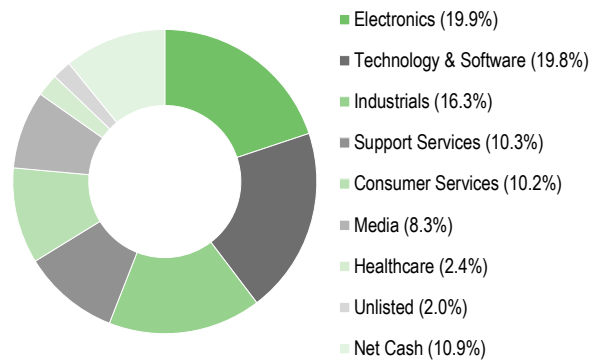
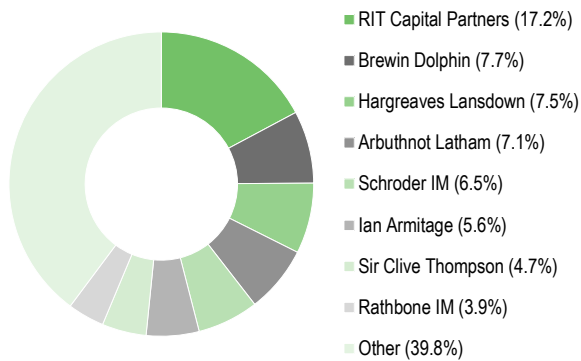


#### Shareholder base (as at 31 January 2015)

SEC's portfolio managers Stuart Widdowson and Jeff Harris hold 1.08% and 0.03% interests in SEC.

#### Portfolio exposure by sector (as at 31 December 2014)

Net cash averaged 6.6% of NAV during the six months to 31 Dec 2014 and stood at 10.9% at the period end.



#### Top 10 holdings (as at 31 December 2014)

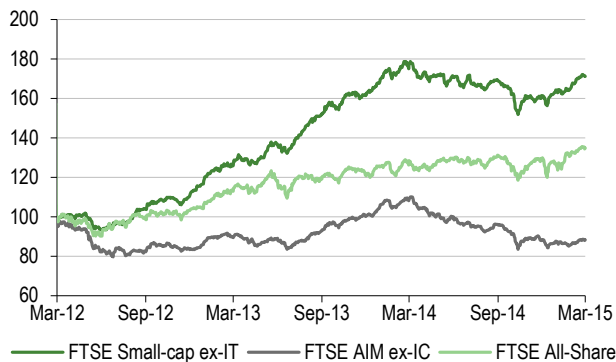
Company	Sector	Date of first investment	% of NAV	
			31 December 2014	31 December 2013
Tyman	Manufacturing	Dec 2009	11.5	10.0
Servelec Group	Software & Computer Services	Dec 2013	10.7	8.7
E2V Technologies	Electronic & Electricals	Oct 2009	10.6	11.7
EMIS Group	Software & Computer Services	Mar 2014	8.8	N/A
4Imprint	Support Services	Feb 2006	8.6	9.8
Wilmington Group	Media	Oct 2010	8.3	7.8
Goals Soccer	Consumer Services	Mar 2012	6.9	5.0
Gooch & Housego	Electronic & Electricals	Dec 2011	5.3	7.0
XP Power	Electronic & Electricals	Nov 2012	3.9	N/A
RPC Group	Manufacturing	Feb 2007	3.5	4.2
<b>Top 10</b>			<b>78.1</b>	<b>N/A</b>
Net cash			10.9	9.6

Source: Strategic Equity Capital, Edison Investment Research, Morningstar, GVOIM, Thomson Reuters.

## Market outlook: Selective small-cap opportunities

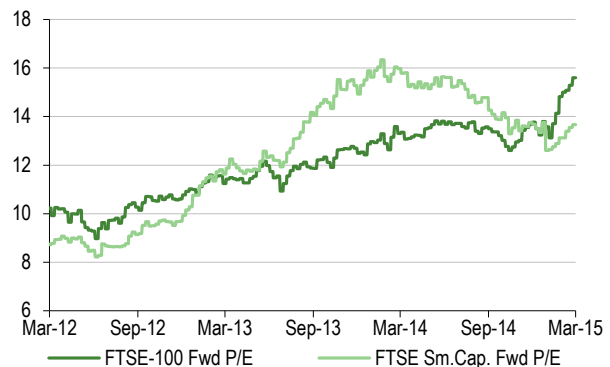
Following a two-year rally UK small-cap shares experienced a broad correction between March and October 2014, with the FTSE small-cap ex-IT and FTSE AIM ex-IC indices falling 15% and 23% respectively (Exhibit 2). Subsequently the small-cap index has witnessed a partial recovery, performing in-line with the wider market, while the AIM index has seen a more muted upturn. Exhibit 3 illustrates that the premium rating of small-cap shares has unwound over the last 12 months and the recent re-rating of large-cap shares has seen the rating of the FTSE small-cap ex-IT index compared with the FTSE-100 index move to the widest discount since mid-2012.

**Exhibit 2: Index performance over three years**



Source: Datastream, Edison Investment Research

**Exhibit 3: Index forward P/E multiples over three years**



Source: Datastream, Edison Investment Research

Although the current 13.7x forward P/E multiple of the FTSE small-cap ex-IT index is below its 16.3x peak in early 2014, it is above its 12.6x three-year average and considerably higher than its 8.2x low in mid-2012. This suggests that while there may be scope for UK small-cap shares to move higher through re-rating, supported by their discount relative to large-cap shares, earnings prospects appear more likely to be the main driver of share price performance in the near-term. With forecast aggregate forward earnings growth for UK small-caps declining over the last 12 months to low single-digit levels (ex. financials and resources – see Exhibit 5), a fund such as SEC with a focused approach appears well-suited to access the more selective growth opportunities within the UK small-cap universe.

## Fund profile: Highly focused UK small-cap exposure

Launched in July 2005, SEC aims to achieve absolute returns over the medium term, principally through capital growth. Its strategy is to invest in publicly quoted companies able to increase in value through strategic, operational or management change. Investments are typically made in companies below the threshold for inclusion in the FTSE-250 index. Performance is compared with the FTSE Small Cap ex-IT index, but this is not used as a benchmark for setting portfolio allocations. A concentrated portfolio is maintained, typically invested in up to 25 companies included in the AIM and FTSE Small Cap indices, with 10 to 15 holdings representing the majority of portfolio value. SEC's investment manager is GVO Investment Management (GVOIM), which applies private equity techniques including constructive corporate engagement (without seeking board representation) and a focus on cash generation and the potential this has for de-gearing and returns to shareholders. Stuart Widdowson has been SEC's portfolio manager since June 2009. He is supported by assistant portfolio manager, Jeff Harris and investment analyst, Adam Khanbhai. Extensive use is made of industry experts including a dedicated panel of industrial advisors in relation to the strategy, operations and management of potential investee companies.

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## The fund managers: Stuart Widdowson, Jeff Harris

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### The managers' view: Focused on free cash flow generation

Stuart Widdowson reflects that the fairly indiscriminate market re-rating from 2012 to 2014 saw investment opportunities arising from valuation anomalies. He highlights that the narrow valuation differential between higher and lower quality companies with similar growth prospects has largely corrected but sees potential for a similar yield-driven anomaly to develop in 2015. With a number of uncertainties in the macro environment, Widdowson expects to see periods of increased market volatility in 2015, potentially providing attractive entry points for new investment opportunities, which justifies SEC's significant cash position. Underlying portfolio earnings are skewed towards the UK and North America which he sees as offering stronger sustainable demand drivers than Europe.

A notable feature of SEC's current portfolio is the exposure to companies that have recently made a significant management change, which Widdowson considers to be a likely catalyst for improved returns. These include E2V Technologies, Wilmington and Gooch & Housego, representing 27% of the invested portfolio, which all appointed new CEOs in 2014. As an example, he cites the strong increase in the share price of E2V Technologies since July 2013 when the change of CEO was announced. He notes that SEC aims to ensure that portfolio companies have a strong board of directors and does not seek to initiate a change in CEO.

Equity markets are considered to be mid-cycle providing scope for portfolio companies with cyclical aspects to their business such as Gooch & Housego to generate superior returns as margins and ratings expand. Gooch & Housego is also a good example of SEC's focus on companies with structural growth opportunities, with the new CEO seeing scope to improve operational efficiency, R&D efficacy and the sales approach.

The manager sees potential for the recent increase in M&A activity to be sustained and, following the offer for Allocate Software, would not be surprised if other portfolio companies received bid approaches in 2015. The takeover of Allocate Software by HgCapital (at a 35% premium) is seen as a strong validation of SEC's approach and reinforced the manager's conviction in the potential for top 10 holdings EMIS and Servelec which he considers higher quality businesses with superior growth potential, trading on a material discount to Allocate's exit multiple.

A strong and diversified pipeline of opportunities is reported with four new investments recently initiated including Clinigen (July 2014), a specialist pharmaceuticals services and products business, a sub-sector seen as offering attractively valued opportunities. Having previously avoided the sector, SEC has recently invested (c 2% of NAV) in a financial services company expected to see a mid- to long-term benefit from the change in annuity legislation.

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## Asset allocation

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### Investment process: Disciplined fundamental approach

The manager undertakes detailed analysis of potential investments, seeking companies with sustainable sources of competitive advantage that have scope to improve returns. These are typically niche market leaders with a high level of recurring earnings and minimal gearing that generate strong cash flows. The manager avoids companies that are dependent on discretionary UK public spending or consumer discretionary expenditure and vulnerable to rising inflation. The process involves running cash flow models for c 150 stocks and valuations are assessed against the potential value of the company to trade or financial buyers rather than market multiples.

Stocks are selected without reference to a benchmark but with an awareness of the portfolio's sector composition. At any time, there are probably three or four immediate candidates for inclusion

and perhaps a similar number of investments that are relatively mature within the portfolio. In a typical year, two to three new names would be added to the portfolio. Smaller companies are believed to provide the greatest opportunity for SEC's investment style as they are relatively under-researched, often have more limited resources, and frequently can be more attractively valued.

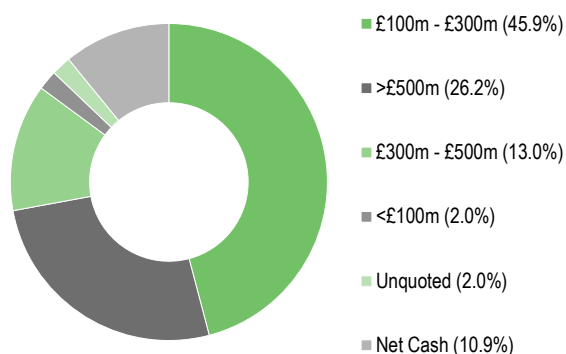
## Current portfolio positioning

SEC's portfolio is highly concentrated with 19 direct holdings at end December 2014 and the top 10 representing 88% of the invested portfolio (78% of NAV). There has been a shift in the portfolio split by market cap (see Exhibit 4) over the last six months, with exposure to companies above £500m market cap increasing from 5% to 26% due to market movements. However, companies with market caps between £100m and £300m still represent the largest component of the portfolio and the manager remains focused on companies below the threshold for inclusion in the FTSE-250.

Although SEC's 10.9% net cash position at end December 2014 was similar to a year earlier, the 7% average cash balance in H115 was lower than the 12% average in FY14. Exposure to unquoted securities has increased from 1.8% to 2.0% due to SEC's investment in Vintage I, a diversified fund of private equity funds, seeing strong valuation gains. While SEC has a commitment to invest a further £1.2m, Vintage I's adviser 3i has indicated that no further net drawdowns are expected.

While investments are typically made with a three-year holding period envisaged, there is a willingness to take a longer-term view and two top 10 holdings have been in the portfolio for over seven years (see Exhibit 1). Portfolio turnover was an annualised 30% during the six months to 31 December 2014, in-line with the previous financial year. Activity is expected to pick up in 2015 with three new investments initiated since the sale of Allocate Software and the manager expecting that one or two portfolio companies may seek to raise equity in the near term.

**Exhibit 4: Portfolio split by market cap at 31 Dec 2014**



Source: Strategic Equity Capital, Edison Investment Research

**Exhibit 5: Portfolio characteristics vs index**

	End Dec 2014	End Dec 2013	FTSE Small cap ex-IT
Price/earnings ratio (FY1)	15.4x	15.7x	13.8x
Dividend yield	2.3%	2.2%	2.8%
Price/book ratio	5.7x	2.4x	1.5x
Price/sales ratio	2.4x	1.8x	0.7x
Price/cash flow ratio	13.6x	16.5x	12.8x
GVOIM cash flow yield	9.8%	10.1%	N/A
Forecast earnings growth (FY1)	14.4%	13.0%	5.2%*
Forecast net debt/EBITDA	0.3x	0.0x	1.6x

Note: \*0.8% ex. financials and resources

Source: Strategic Equity Capital, Edison Investment Research

At 31 December 2014, portfolio companies are valued at higher average multiples than the FTSE Small Cap ex-IT index but have stronger forecast earnings growth and lower gearing (Exhibit 5). The manager considers the portfolio's c 15x PE multiple with c 15% prospective earnings growth to be substantially better value than the index's c 14x PE multiple with c 5% earnings growth and highlights that the portfolio P/E multiple is similar to the index if adjusted for gearing. The decline in portfolio P/E multiple from 15.7x to 15.4x over the year is despite an 18% increase in NAV.

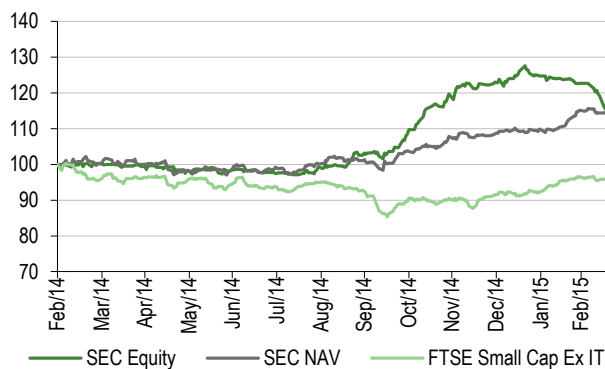
## Performance: Outperformance since inception

SEC has outperformed the FTSE Small-cap ex-IT index over one, three and five years and since inception in terms of share price and NAV total return (Exhibit 7), helped by a strong performance over six months in both absolute and relative terms (see Exhibit 6). Exhibit 8 illustrates SEC's two

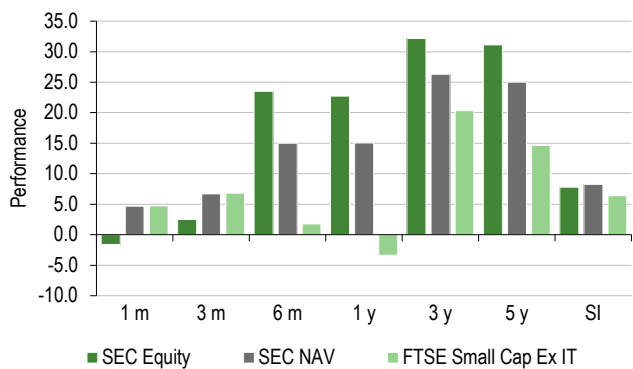
periods of strong relative performance during the last five years with one less-pronounced period of underperformance. Outperformance from early-2010 to end-2011 and late-2013 to end-2014 was achieved against flat and mixed index performances respectively. While underperforming from early-2012 to mid-2013, SEC achieved a strong absolute performance and the performance differential, particularly evident in Q4 2012, can be attributed to a small number of larger, leveraged stocks in the index including Enterprise Inns and Thomas Cook where SEC did not have exposure.

### Exhibit 6: Investment trust performance to 28 February 2015

Price, NAV and index total return performance, one-year rebased



Price, NAV and index total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Since inception (SI) represents the period since 19 July 2005. Three- and five-year and SI performance figures annualised.

### Exhibit 7: Share price and NAV total return performance, versus indices (percentage points)

	One month	Three months	Six months	One year	Three years	Five years	Since inception
Price versus FTSE Small Cap Ex IT	(6.0)	(4.0)	21.3	27.0	32.3	95.7	13.4
NAV versus FTSE Small Cap Ex IT	(0.1)	(0.1)	13.0	19.1	15.6	53.9	18.5
Price versus FTSE AIM ex IC	(4.9)	3.8	34.1	51.5	159.0	246.8	169.2
NAV versus FTSE AIM ex IC	1.1	8.1	24.8	42.1	126.3	172.6	181.4
Price versus FTSE All-Share	(5.1)	(2.1)	18.6	16.2	69.1	139.4	2.6
NAV versus FTSE All-Share	0.9	1.9	10.5	9.0	47.7	88.2	7.3

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-February 2015. Geometric calculation.

### Exhibit 8: NAV total return performance relative to index over five years



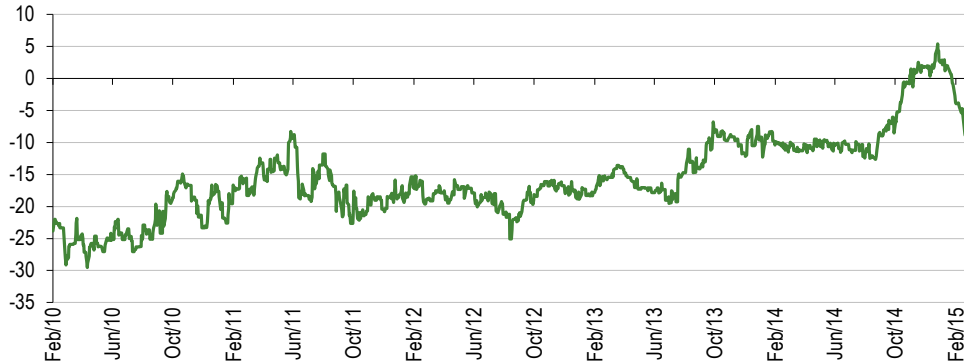
Source: Thomson Datastream, Edison Investment Research

## Discount: Has recently widened

SEC's share price discount to NAV (including income) has narrowed substantially over five years from c 25% to c 5% (Exhibit 9). Semi-annual tender offers, to re-purchase up to 4% of the issued capital at a 10% discount to NAV, act as the primary discount control mechanism. With the shares trading at a discount of less than 10%, only 0.1m shares (0.2% of issued capital) were re-purchased in the November 2014 tender offer. Between mid-November 2014 and mid-February 2015, the shares traded at a premium to NAV and 0.8m shares were issued. The current 8.1%

discount is wider than its 12-month average of 6.4% and the manager attributes the recent widening largely to small retail investor flows driven by CGT considerations. The recent move from premium to discount suggests scope for the discount to narrow as sentiment improves.

**Exhibit 9: Share price premium / (discount) to NAV including income over five years (%)**



Source: Thomson Datastream, Edison Investment Research. Note: Negative values indicate a discount, positive values a premium.

## Capital structure and fees

SEC has 57.9m shares in issue after the repurchase of 0.1m shares and allotment of 0.8m shares in the current financial year. The trust has authority to purchase up to 14.99%, and allot up to 10% of issued share capital. Gearing up to 25% of NAV is permitted although SEC currently has a policy of operating with no gearing. Cash resources provide flexibility to exploit investment opportunities; net cash stood at 10.9% at end December 2014, similar to the 9.6% cash position a year earlier.

SEC pays GVOIM a management fee at the lower of 1% pa of NAV or 1% pa of its market cap. GVOIM is also entitled to a 15% performance fee on returns more than 2.0% pa above the FTSE Small-cap ex-IT index total return over rolling three financial year periods. Performance fees are subject to NAV being above a high watermark and are capped at 1.75% pa of NAV with any excess deferred to a later period where the performance criteria have been met but the cap not reached. For FY14, management and performance fees were £0.9m and £0.3m, and ongoing charges were 1.27% (1.59% including performance fees). In H115, performance fees of £1.7m were accrued, equating to 1.7% of closing NAV, reflecting SEC's relative outperformance since June 2012.

## Dividend policy

Although principally focused on capital growth, in accordance with its investment trust status, SEC distributes 85% of its income, paying a dividend annually in November. While SEC has revenue reserves equating to 1.59p per share which provide some capacity to smooth payments, dividends may fluctuate from one financial year to the next. A decline in portfolio yield and a modestly higher ongoing charge in the year to 30 June 2014 contributed to a reduction in net revenue available for distribution and a lower dividend being paid than in the prior year (see Exhibit 1). Capital distributions to shareholders are made through semi-annual tender offers.

## Peer group comparison

Exhibit 10 shows a comparison of SEC with a selected peer group comprising the constituents of the AIC UK smaller companies sector excluding funds with a market cap below £30m. SEC's NAV

total return leads the peer group by a substantial margin over one, three and five years and, in terms of risk-adjusted returns, its Sharpe ratios of 2.2 and 2.4 over one and three years stand at the top of the peer group. This performance has been achieved without the use of gearing and SEC's 11% net cash position ranks it as the lowest geared fund in the peer group. SEC has the highest ongoing charge in the peer group by a small margin and the lowest dividend yield, reflecting its capital growth focus. Although widening recently, SEC has one of the narrowest discounts in the peer group.

#### Exhibit 10: UK smaller companies closed-ended sector peer group as at 18 March 2015

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex par)	Ongoing charge	Perf fee	Net gearing	Dividend yield (%)
Strategic Equity Capital	106.4	12.9	95.8	196.0	2.2	2.4	(7.8)	1.33	Yes	89	0.4
Aberforth Smaller Companies	1,030.2	(0.1)	73.2	119.9	(0.1)	1.4	(11.0)	0.82	No	103	2.3
BlackRock Smaller Companies	386.9	(0.6)	56.9	150.6	(0.3)	1.4	(14.5)	0.71	Yes	109	1.5
BlackRock Throgmorton Trust	214.6	1.2	53.9	137.0	(0.1)	1.3	(16.8)	1.13	Yes	133	1.5
Dunedin Smaller Companies	92.5	(0.1)	57.8	115.3	(0.4)	1.6	(15.7)	0.80	Yes	102	2.7
Henderson Smaller Companies	450.5	5.3	77.8	167.5	0.2	1.6	(11.7)	0.46	Yes	109	1.9
Invesco Perpetual UK Smaller	185.7	2.4	55.7	105.4	0.1	1.7	(7.2)	0.84	Yes	97	3.9
JPMorgan Smaller Companies	136.8	(3.5)	57.1	116.9	(0.8)	1.3	(16.6)	1.13	No	109	1.2
Montanaro UK Smaller Companies	157.3	(1.3)	35.8	106.8	(0.5)	1.0	(17.7)	1.32	No	105	1.6
River and Mercantile UK Micro	52.7							1.8	Yes		
Standard Life UK Smaller Co.	205.4	(2.7)	51.1	134.4	(0.8)	1.4	(7.8)	1.19	No	100	1.5
<b>Average</b>	<b>274.4</b>	<b>1.4</b>	<b>61.5</b>	<b>135.0</b>	<b>(0.0)</b>	<b>1.5</b>	<b>(11.3)</b>	<b>0.97</b>		<b>106</b>	<b>1.9</b>

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

The board comprises five non-executive directors, four of whom are independent. In September 2014, Richard Hills (appointed March 2014) took over as chairman from John Hodson (appointed July 2005) who retired from the board in February 2015. Hills has substantial investment trust experience and sits on the boards of JPMorgan Income & Capital and Henderson Global Trust. Josephine Dixon was appointed in July 2014, replacing Michael Phillips (appointed August 2007). Dixon is a director of Worldwide Healthcare Trust, Standard Life Equity Income Trust, JP Morgan European Investment Trust and F&C Global Smaller Companies. Ian Dighé, chairman of Miton Group, (appointed November 2009) and Richard Locke (appointed February 2015) are the other independent directors. John Cornish (appointed September 2006) stepped down from the board in November 2014. Sir Clive Thompson (appointed July 2005) is deemed a non-independent director due to his role on GVOIM's Industry Advisory Panel (details on website [www.gvoim.com](http://www.gvoim.com)).

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