**Market data**

EPIC/TKR	GHS
Price (p)	847
12m High (p)	935
12m Low (p)	800
Shares (m)	3.655
Mkt Cap (£m)	31
EV (£m)	28
Free Float*	80.7%
Market	AIM

*As defined by AIM Rule 26

Description

GHS applies P/E techniques to quoted small-cap investments to deliver long-term superior returns. Its focus on value stocks may deliver additional returns when they return to favour.

Company information

Fund Mgr	Tony Dalwood
Fund Mgr	Graham Bird
Chairman	David Potter
	www.ghsplc.com

Key shareholders

Gresham House	19.3%
M&G	11.7%
Smith and Williamson	8.6%
River and Mercantile AM	8.6%
Unicorn Asset Managers	3.4%
Hargreaves Lansdown	3.4%

Diary

Weekly	NAV update
Jun-18	Finals
Jul-18	AGM
Nov-18	Interims

Analysts

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Gresham House Strategic PLC (GHS)

Double discount offers real value

GHS is an investment company that applies private equity (PE) techniques, together with a “value” philosophy. At its half-year-end in September, it had a focused portfolio with 12 investments representing 75% of NAV; since then, it has spent or committed further capital, bringing its available cash balance to £3m. It aims to distribute half of realised gains through either dividends or share buybacks. To this end, it paid a 15p maiden dividend in FY17 and bought back 1% of its shares. It is currently trading on a 26% discount to NAV; management aims to close this gap over time.

- ▶ **Strategy:** The managers aim for a considerably higher level of engagement with investee company stakeholders – management, shareholders, customers, suppliers and competitors – to identify market-pricing inefficiencies and support a clear equity value-creation plan, targeting above-market returns over a longer-term investment horizon. This is part of the private equity technique.
- ▶ **Undervalued:** GHS is focussing on undervalued smaller companies – typically less than £250m – where it believes there are value-creation opportunities through change, whether that is strategy, operations or management. It expects to own stakes for between three and five years.
- ▶ **NAV growth to date:** Since the first NAV release in August 2015, the NAV has risen 13%, despite carrying a weight of cash as the investment policy was applied. Over the same period, the FTSE SmallCap Index rose 21%, with growth stocks continuing to outperform value.
- ▶ **Risks:** In addition to the straight look-through risks to the concentrated underlying holdings, shareholders face the risk that the discount to NAV does not narrow or may even widen further. While the share price is naturally anchored to the NAV, wide variations can persist for long periods of time.
- ▶ **Investment summary:** In Tony Dalwood and Graham Bird, GHS has some very experienced and successful managers. Their strategy to pursue close engagement in undervalued smaller companies is sound, although currently unfashionable. Fashions change and investors buying today have the advantage of being able to buy £1 of undervalued assets for just 74p.

GHS's current portfolio

	Value (£m)	% of portfolio	Investment proposition
IMImobile	17.1	42.0%	Undervalued, strong growth prospects
Be Heard	4.4	10.8%	Buy & build, organic growth, cash-generative
Northbridge	2.7	6.6%	Recovery and growth
M J Hudson	2.1	5.2%	Pre-IPO opportunity
Miton	1.7	4.2%	Operational gearing, improve ROCE
Centaur Media	1.4	3.4%	Strategic refocusing
Tax Systems	1.3	3.2%	Strategic change and expansion
Escape Hunt	1.2	2.9%	Site rollout, growth, high RoCE
Quarto	1.2	2.9%	Organic and acquired growth, cheap
Other investments	4.6	11.3%	
Cash	3.0	7.4%	
Total	40.7	100%	

Source: GSH

Note: As at 29/12/17 using bid price share data

Investment case

All the advantages of an Investment Trust with none of the restrictions

We regard GHS as an ideal investment vehicle: it has the advantages of an Investment Trust – closed-end nature, ability to gear – without any of the restrictions – distribution rules and limits on holdings size. It also has £15m of tax losses that can be offset against both capital gains and income.

The managers were appointed in August 2015, and have been steadily employing their investment process. They target smaller companies, which tend to be overlooked because of their size and are under-researched, illiquid and find it harder to raise growth capital. They are looking for companies that are profitable and cash-generative but that could benefit from input on strategy, operations or management.

GHS aims to take influential minority stakes – in association with its sister vehicle Gresham House Strategic Public Equity fund – of between 5% and 25%. It then engages with the company and management, and all the other stakeholders: customers, suppliers, etc.

The engagement can take many forms, including the provision of equity or debt capital to finance investment, enhancing operations using consultants and in-house experts, beefing up investor relations, and helping to set strategic objections and milestones.

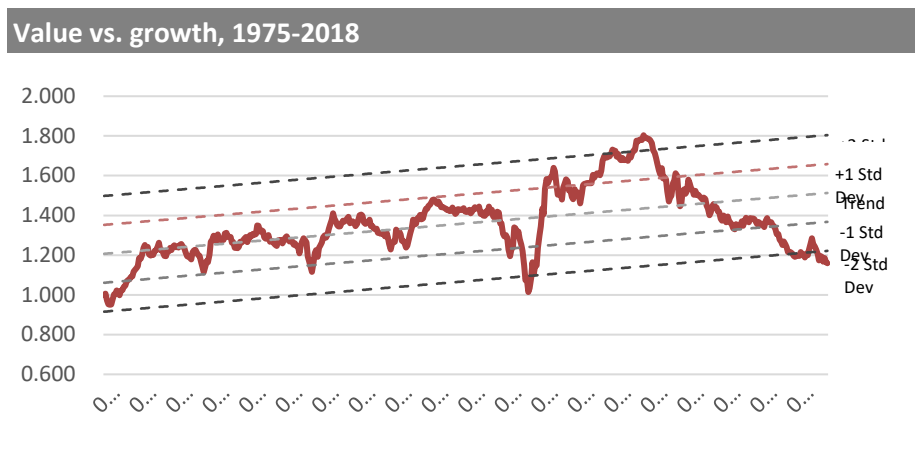
The management team launched this strategy while working at SVG Investment Managers over 15 years ago, and built an impressive track record.

Patience

The strategy takes time to work

Buying things that are unfashionable and overlooked are not instantly transformed. GHS says it has an ideal holding period of three to five years. Similarly, if you're buying something that is out of fashion, you don't want to sell it before it is back in fashion.

Since the financial crisis in 2008, growth stocks have outperformed value stocks substantially and consistently. This is probably largely a function of interest rates being suppressed to near zero. As interest rates pick up, we would expect this to have a significant impact on the value to growth dynamic.



Source: Bloomberg data

Portfolio metrics

GHS has produced a table that demonstrates the “value attractions” of its investments across its portfolio, excluding three private companies and one listed company whose public forecasts are under review (Quarto plc). The value applied to its holdings reflects the 24% discount applied to GHS’s NAV as at the end of 2017, and the data are weighted by the size of its holdings.

GHS and indices’ valuation metrics

	GHS (mkt price)	GHS (NAV basis)	FTSE SmallCap	FTSE All Share	FTSE AIM
EV/sales	0.8x	1.0x	1.1x	1.5x	1.7x
EV/EBITDA	5.3x	7.0x	8.1x	8.7x	13.5x
Sales growth	16%	16%	5%	4%	9%
Net debt/EBITDA	-0.3x	-0.3x	2.0x	1.3x	0.5x

Source: GHS, Bloomberg, Hardman&Co

We have added in a column showing the metrics based on NAV. It is clear that, even without the discount, GHS’s holdings are cheaper than their peers’ on both sales and EBITDA. They are also expected to grow faster and have no net debt in aggregate.

Fees and discounts

Discounts are a natural function of fees

GHS hopes that, over time, the market will appreciate its ability to add value and that the discount to NAV at which it trades will duly narrow. There can be no guarantee of this but, if the managers are able to demonstrate that they can consistently add value, we believe it is likely that the discount will indeed close.

It is, however, natural for a fund to trade at a discount to the value of its underlying investment. All other things being equal, this reflects the capitalised costs of future fees. GHS charges an annual management fee of 1.5% and an annual performance fee of 15% over a 7% hurdle, reflecting the intensive nature of the strategy.

Fund Manager: Gresham House

The managers, Tony Dalwood and Graham Bird, highly experienced

GHS is managed by the Strategic Equity investment team within Gresham House Asset Management Ltd, a wholly owned subsidiary of Gresham House plc (www.greshamhouse.com, AIM GHE). Tony Dalwood established SVG Investment Managers and launched Strategic Equity Capital plc in 2005, gaining direct experience in building businesses. His previous appointments include CEO of SVG Advisers, membership of the UK Investment Committee of UBS Phillips & Drew Fund Management, Chair of Downing Active Management Investment Committee and Chair of the Board of Schroders Private Equity Funds.

Graham Bird spent six years as a senior executive at PayPoint plc, gaining direct experience of running a business. He was a fund manager and Head of Strategic Investment at SVG Investment Managers and a Director at JPMorgan Cazenove.

Private Equity approach

GHS trading at bigger discount than more established, larger peers

There are a number of quoted vehicles adopting a PE fundamental approach.

Peers' premiums/discounts to NAV				
	Ticker	Market Cap (£m)	Latest NAV (p)	Discount to NAV (%)
Gresham House Strategic	GHS	32	1153	-26%
Strategic Equity Capital	SEC	158	273	-14%
Aurora	ARR	92	207	1%
Crystal Amber *	CRS	197	191	0%
North Atlantic Smaller Co IT *	NASCIT	414	3530	-18%
Marwyn Value Investors Ltd	MVI	113	219	-30%

*Source: Hardman & Co Research; prices as at 31st January 2018; * latest monthly NAV end-Dec.*

Since we first reproduced this table, in September 2016, the pattern of the discounts has remained fairly stable, but with an average widening of the discounts of about four percentage points and Crystal Amber losing its 9% premium.

Caveats

No complete control and limited gearing

While GHS's approach to due diligence and engagement mirrors the private equity model, it does miss out on two important elements: control and gearing. Most private equity investors are in control of their investments, either themselves or through a consortium of like-minded players. GHS has only an influential stake.

Secondly, a meaningful, although not the major, contributor to private equity returns over the years has been the favourable tax treatment of interest expense. PE investments are loaded up with debt and pay minimal, if any, tax. Since the private equity house owns the whole structure, it is indifferent to the value of the tiny amount of equity. Listed companies cannot behave in the same fashion.

Neither point undermines the rationale for investing with GHS's strategy; they just show two advantages that are not available to GHS.

Investment conclusion

Many commentators are cautious about equity valuations following strong market runs and what have been perceived as stretched valuations. The pond in which GHS is fishing has seen neither the strong investment performance nor the rise in valuation metrics. Combine this fundamental attraction with the current significant discount to NAV, and investors can buy into a portfolio of stocks at a double discount.

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The full detail is on page 26 of the full directive, which can be accessed here: <http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf>

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