

# Standard Life UK Smaller Companies

## Strong track record of outperformance

Standard Life UK Smaller Companies Trust (SLS) is managed by Harry Nimmo, who aims to generate long-term capital growth from a portfolio of smaller-cap UK equities. The trust has a strong performance track record; it has meaningfully outpaced its benchmark over one, three, five and 10 years. SLS has also outperformed the majority of its peers over these periods, ranking second out of 10 funds over one and three years, fifth over five years and first over 10 years. The trust has recently changed its benchmark to include AIM stocks, reflecting SLS's increasing exposure to this area of the UK stock market, as the board and manager consider the quality of these companies has improved in recent years.

12 months ending	Share price (%)	NAV (%)	Blended benchmark* (%)	Numis Smaller Cos plus AIM ex-ICs (%)	FTSE AIM (%)	FTSE All-Share (%)
28/02/14	36.4	35.7	32.2	27.4	21.5	13.3
28/02/15	(15.7)	(7.5)	(1.8)	(6.2)	(19.0)	5.6
29/02/16	25.5	14.9	(1.8)	(1.6)	(1.7)	(7.3)
28/02/17	14.2	20.1	21.2	23.6	33.1	22.8
28/02/18	26.5	24.3	10.3	11.1	16.0	4.4

Source: Thomson Datastream. Note: All % on a total return basis in GBP. \*Numis Smaller Cos ex-ICs to 31 December 2017 and Numis Smaller Cos plus AIM ex-ICs thereafter.

## Investment strategy: Long-term, high-quality focus

Nimmo uses Aberdeen Standard Investments' proprietary stock-selection Matrix to screen the investible universe of c 650 companies, seeking quality firms with the potential for sustainable growth. Factors include earnings revision and share price momentum, as well as balance sheet strength. The manager believes that valuation is a secondary consideration, as you often "get what you pay for". Potential investee companies undergo rigorous fundamental analysis and meetings with managements are a key part of the process. Nimmo invests for the long term and the portfolio is unconstrained by benchmark weightings. At end-February 2018, net gearing was 7.4%, which is towards the higher end of the historical range and compares with the maximum permitted 25% of NAV. Gearing includes £11.1m in convertible unsecured loan stock whose final conversion date is 29 March 2018.

## Market outlook: Outperformance may continue

Over the long term, the performance of smaller UK companies, measured by the Numis Smaller Companies plus AIM ex-ICs index, has outpaced the broader UK stock market. In aggregate, they have relatively attractive growth profiles and in terms of forward P/E multiples, only modestly higher valuations than the broader UK market. This backdrop may indicate potential for further outperformance.

## Valuation: Active discount management

SLS's board actively manages the discount, aiming to keep it below 8% in normal market conditions. This is primarily via share repurchases, although there are discretionary six-monthly tender offers. The trust's share price is now close to par, with the discount having been in a narrowing range over the last 18 months. SLS's annual dividend has grown for the last 10 consecutive years, compounding at an annual rate of c 24%. Its current dividend yield is 1.4%.

## Investment trusts

28 March 2018

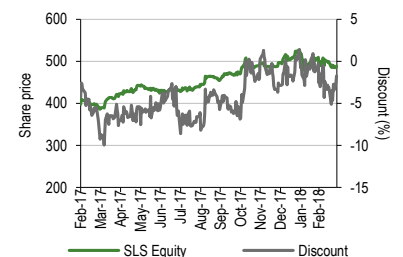
**Price** 489.0p  
**Market cap** £338m  
**AUM** £357m

NAV\* 495.7p  
Discount to NAV 1.3%  
NAV\*\* 497.5p  
Discount to NAV 1.7%

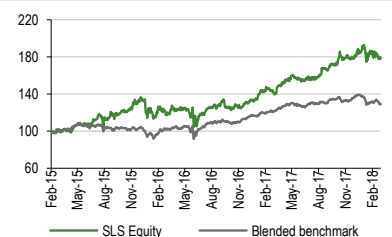
\*Excluding income. \*\*Including income. As at 26 March 2018.

Yield 1.4%  
Ordinary shares in issue 69.2m  
Code SLS  
Primary exchange LSE  
AIC sector UK Smaller Companies  
Benchmark Numis Smaller Cos plus AIM ex-ICs

## Share price/discount performance



## Three-year performance vs index



52-week high/low 528.0p 386.0p  
NAV\*\* high/low 522.7p 421.8p

\*\*Including income.

## Gearing

Gross\* 14.5%  
Net\* 7.4%

\*As at 28 February 2018.

## Analysts

Mel Jenner +44 (0)20 3077 5720  
Gavin Wood +44 (0)20 3681 2503

[investmenttrusts@edisongroup.com](mailto:investmenttrusts@edisongroup.com)

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**Standard Life UK Smaller Companies Trust is a research client of Edison Investment Research Limited**

## Exhibit 1: Trust at a glance

### Investment objective and fund background

Standard Life UK Smaller Companies Trust (SLS) aims to achieve long-term capital growth through investment in a diversified portfolio mainly consisting of UK-quoted smaller companies. SLS started life as Edinburgh Smaller Companies in 1993 and Standard Life Investments (now Aberdeen Standard Investments) assumed management from 2003.

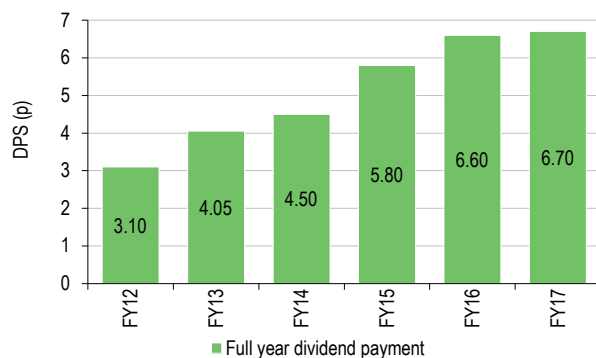
### Recent developments

- 28 February 2018: Six-month results to 31 December 2017. NAV TR +14.2% versus benchmark +8.9% TR. Share price TR +16.6%.
- 15 December 2017: Announcement that SLS has drawn down £15m of the £20m revolving credit facility agreed with RBS in November 2017.
- 1 November 2017: Announcement that SLS has entered into a £45m unsecured loan facility with RBS – a five-year term loan of £25m and a five-year revolving credit facility of £20m.

Forthcoming		Capital structure		Fund details	
AGM	October 2018	Ongoing charges	1.06% (as at H118)	Group	Aberdeen Standard Investments
Final results	September 2018	Net gearing	7.4%	Manager	Harry Nimmo
Year end	30 June	Annual mgmt fee	Tiered (see page 7)	Address	1 George Street, Edinburgh, EH2 2LL
Dividend paid	Apr and Oct/Nov	Performance fee	None	Phone	+44 (0)345 6002268
Launch date	1993	Trust life	Indefinite	Website	<a href="http://www.standardlifeuksmallercompaniestrust.co.uk">www.standardlifeuksmallercompaniestrust.co.uk</a>
Continuation vote	N/A	Convertible loan stock	£11.1m nominal		

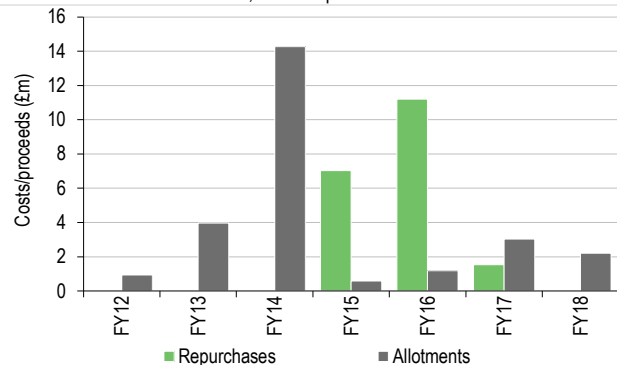
### Dividend policy and history (financial years)

While focused on SLS's long-term capital growth objective, the manager pays close attention to the potential for dividend growth, and SLS's ordinary dividends have compounded at c 24% pa over 10 years.

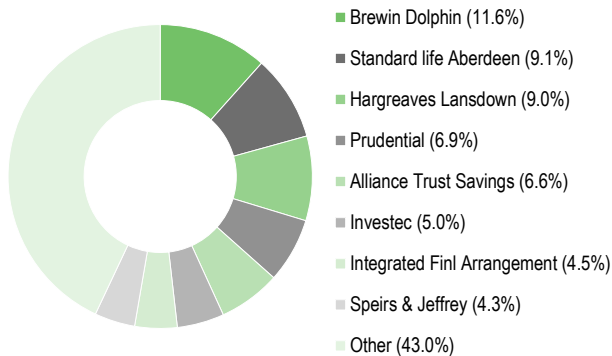


### Share buyback policy and history (financial years)

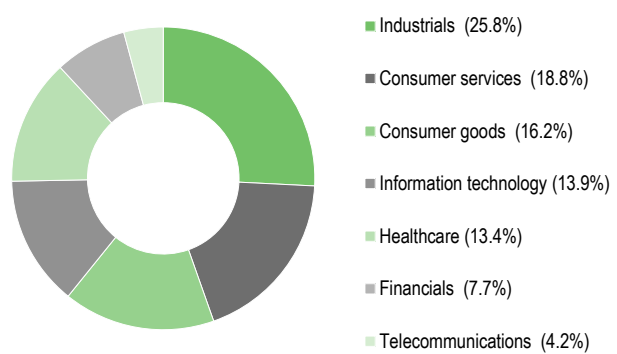
The board is focused on managing the discount such that the share price discount to cum-income NAV is less than 8%. This is managed via share buybacks and periodic tender offers when required. Allotments since March 2014 relate to exercise of CULS, which expire at end-March 2018.



### Shareholder base (as at 23 March 2018)



### Portfolio exposure by sector (as at 28 February 2018)



### Top 10 holdings (as at 28 February 2018)

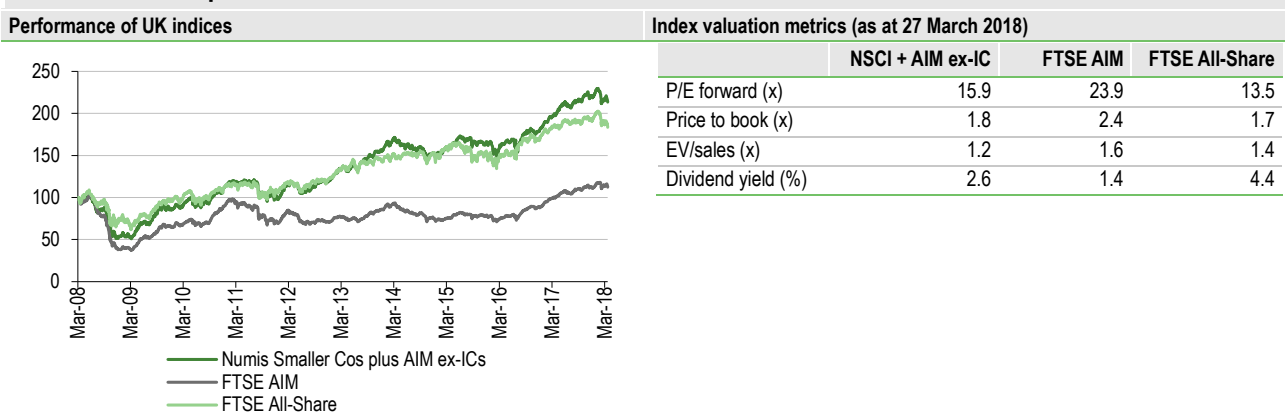
Company	Sector	Portfolio weight %	
		28 February 2018	28 February 2017*
NMC Health	Healthcare	4.1	4.2
Dechra Pharmaceuticals	Healthcare	3.9	3.3
First Derivatives	Information technology	3.7	2.8
Fevertree Drinks	Consumer goods	3.6	4.2
Abcam	Healthcare	3.2	N/A
JD Sports Fashion	Consumer services	3.1	3.2
Cranswick	Consumer goods	3.1	N/A
Midwich	Industrials	3.0	N/A
Accesso Technology	Information technology	2.9	N/A
Hilton Food	Consumer goods	2.8	N/A
<b>Top 10</b>		<b>33.4</b>	<b>33.4</b>

Source: Standard Life UK Smaller Companies Trust, Edison Investment Research, Bloomberg, Morningstar. Note: \*N/A where not in February 2017 top 10.

## Market outlook: Earnings driving outperformance

Exhibit 2 (LHS) shows the performance of UK indices over the last 10 years. The Numis Smaller Companies plus AIM ex-ICs index has outperformed both the FTSE AIM and FTSE All-Share indices over the period. Despite this outperformance, its forward P/E valuation is only modestly above that of the FTSE All-Share and considerably lower than the FTSE AIM index, suggesting that superior earnings growth has been the main driver of performance. It is interesting to note that while UK smaller-cap equities sold off more sharply than larger-caps following the result of the UK's European referendum, they have more than made up for this period of underperformance, which may be due to their relatively favourable growth attributes. A lot of smaller-cap companies have international or niche operations, increasing their resilience to periods of domestic economic weakness. For investors seeking exposure to smaller-cap UK equities, a fund with a well-defined investment process and a strong long-term performance track record, may be of interest.

**Exhibit 2: Market performance and valuation metrics**



Source: Thomson Datastream, Edison Investment Research, Bloomberg

## Fund profile: High-conviction, small-cap investment

Standard Life Investments (now Aberdeen Standard Investments) took over management of SLS on 1 September 2003, following a prolonged period of underperformance. Lead manager Nimmo employs Aberdeen Standard Investments' proprietary stock-selection Matrix to construct a portfolio of c 55 holdings, aiming to generate long-term capital growth. The manager adopts an unconstrained approach, and since 1 January 2018, performance is measured against the Numis Smaller Companies plus AIM ex-Investment Companies Index (previously Numis Smaller Companies ex-Investment Companies Index). There are portfolio guidelines in place: a maximum of 5% in a single company; up to 5% in companies with a market cap below £50m; a maximum 5% in 'blue sky' investments; and up to 50% in AIM-listed companies. The board has delegated gearing responsibility to the manager within a range of 5% of NAV in cash to 25% debt (at the time of drawdown). At end-February 2018, net gearing was 7.4%. Despite a focus on capital growth, annual dividends have increased every year since 2007, compounding at c 24% pa over the period.

## The fund manager: Harry Nimmo

### The manager's view: Underappreciated asset class

Nimmo believes that UK smaller companies is an underappreciated asset class. He says that in this sector, where market caps are up to £1.7bn, investors can find focused and innovative companies, with higher growth potential than larger-cap companies and dynamic management teams. A lack of

both buy- and sell-side analyst coverage means that Nimmo and his team are able to find interesting investment opportunities, at attractive valuations, within the smaller-cap space.

The manager highlights what he believes is an improvement in the Alternative Investment Market (AIM). In December 2010, more than 45% of AIM's total market cap was in oil & gas and mining companies. By December 2016, the largest sectors were pharmaceuticals and general retailers (both c 10%). Over this period, within the AIM 50 index, the market cap of early stage 'blue sky' companies reduced from 74% to 22%, while the amount of more mature dividend payers increased from 16% to 68%. While the valuation of AIM stocks remains relatively high, the manager suggests this reflects real near-term growth potential. SLS has been increasing AIM exposure within the portfolio in recent years and the maximum permissible investment in these companies has been increased from 40% to 50% (42% at end-December 2017).

Nimmo remains excited about the outlook for UK smaller companies, and SLS in particular, which he describes as his largest personal investment by some margin. He notes that all of the trust's top 10 holdings are experiencing rising earnings estimates. The manager says this is unusual, as there are normally a few that are not seeing positive revisions at any one time. He notes that the overall Matrix score for the portfolio is very high and has been so for the last few months and he believes this bodes well for the trust's short-term investment performance.

## Asset allocation

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### Investment process: Proprietary stock-selection Matrix

Nimmo has six principles for successful investment in small-cap companies, which he follows consistently through economic cycles. These are: look for sustainable growth; go for quality; run your winners; concentrate your efforts; management longevity; and valuation is secondary. He aims to buy tomorrow's larger companies today, seeking quality growth firms that have proven business models and a higher level of recurring revenues. The investible universe of c 650 companies is screened using Aberdeen Standard Investments' proprietary stock-selection Matrix. Factors include: earnings growth and estimate revisions, StarMine estimates (an indication of estimate stability and dispersion), the Altman Z-score (bankruptcy test), valuation, share price momentum and director dealing. Stocks are assigned a Matrix score between +35 and -35, with scores of +10 to +35 deemed potential buy candidates and scores between -10 and -35 potential sells.

Companies considered for investment undergo thorough fundamental analysis, which includes assessing the resiliency of a company's business model, including analysis of a company's market share, barriers to entry and pricing power. The resulting portfolio comprises c 55 high-conviction holdings, which the manager believes can be held for the long term. At end-February 2018, SLS had a 94.6% active share (a measure of how a portfolio differs from its benchmark, with 100% representing no commonality and 0% representing full index replication). SLS's holdings are regularly reviewed to check that their Matrix scores remain attractive. They may be sold or trimmed if there is deterioration in the Matrix score, the original investment thesis no longer holds true, or if the position size has grown larger than 5% of the portfolio.

### Current portfolio positioning

At end-February 2018, SLS's top 10 positions made up 33.4% of the portfolio, which was in line with a year earlier and five positions were common to both periods. The trust's unconstrained investment approach is reflected in Exhibit 3 and there continues to be zero exposure in the basic materials, oil & gas and utilities sectors. The manager considers that the financial metrics of resource companies are often unattractive and that many have weak corporate governance track

records. Over the last 12 months the largest changes in sector exposure are industrials (+3.8pp) and consumer services (-4.9pp).

<b>Exhibit 3: Portfolio sector exposure (ex-cash and gearing, % unless stated)</b>			
	Portfolio end-February 2018	Portfolio end- February 2017	Change (pp)
Industrials	25.8	22.0	3.8
Consumer services	18.8	23.7	(4.9)
Consumer goods	16.2	17.2	(1.0)
Information technology	13.9	13.5	0.4
Healthcare	13.4	11.0	2.5
Financials	7.7	7.5	0.2
Telecommunications	4.2	5.2	(1.0)
	<b>100.0</b>	<b>100.0</b>	

Source: Standard Life UK Smaller Companies Trust, Edison Investment Research

While stocks are selected on a bottom-up basis, there are growth themes represented within the portfolio. These include 'vets and pets', where SLS has holdings in CVS (veterinary services in the UK and the Netherlands), Dechra (veterinary pharmaceuticals) and Eco Animal Health (medicines for disease control in livestock and companion animals), and 'consumer choice and provenance' with holdings in Cranswick (pork products), Hilton Food Group (meat processing) and Fevertree Drinks (premium drink mixers).

Companies within the retail sector are experiencing mixed fortunes, particularly as a result of increased ecommerce at the expense of traditional 'bricks and mortar' revenues, but SLS has an overweight retail exposure. Holdings include Ted Baker, which has been in the portfolio since 2003. The manager says that business is rebounding, after a more muted operational performance. Another retail position is Joules, which along with Ted Baker has a successful online operation and is now a prominent player on the UK High Street. It has also expanded operations overseas such as in Germany and the US. The holding in auto retailer Motorpoint was initiated at its May 2016 initial public offering (IPO). Motorpoint is the largest independent vehicle retailer in the UK, primarily selling nearly-new cars: up to two years old with low mileage. In an industry which does not always have a good reputation, Motorpoint is unusual – its focus on everyday low pricing and customer service means that it gets high client referral ratings. While the company had a profits warning following the IPO, the manager says the business has since recovered and the current share price is now above the level at the time of the offering.

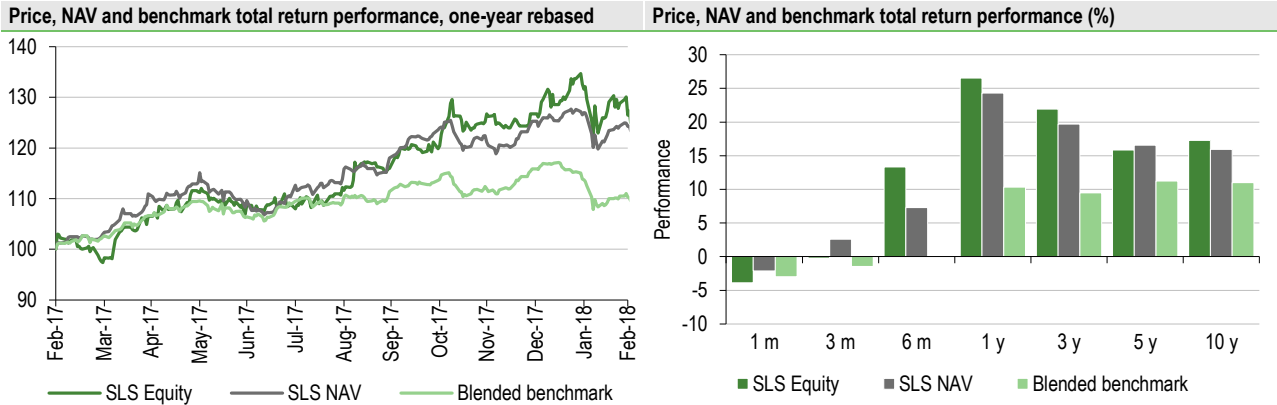
Nimmo notes that there has not been a lot of activity in the portfolio over the last six months; he says that sometimes "less is more" and he believes it is beneficial to run winning positions. The most recent new holding is Blue Prism, purchased in January 2018. It was acquired via a placing and has subsequently performed well. The manager met the company prior to its IPO, but considered it to be too early stage 'blue sky'. Blue Prism offers productivity tools and has been successful in replacing white collar workers with software that automates manual administrative processes. It is the only company in the portfolio that is not yet profitable.

## Performance: Long-term record of outperformance

In H118 (six months ending 31 December 2017), SLS's NAV and share price total returns of 14.2% and 16.6% respectively were meaningfully ahead of the Numis Smaller Cos ex-ICs Index total return of 8.9%. The outperformance was driven by positive trading results from portfolio companies, which outweighed the effect of SLS's lack of exposure to resource stocks. The strongest contributors to performance were: software and services company First Derivatives, which continues to have a strong matrix score; private healthcare provider NMC Health, which is performing well, but SLS has reduced its holding due to the position size; and Fevertree Drinks, which is now the leading mixer brand in the UK with a growing international presence.

As shown in Exhibit 4, over the 12 months to end-February 2018, SLS's 24.3% NAV total return is more than double the benchmark's 10.3% total return. SLS's share price total return has been even stronger (+26.5%), which is reflected in the reduction in the trust's discount over the period.

#### Exhibit 4: Investment trust performance to 28 February 2018



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

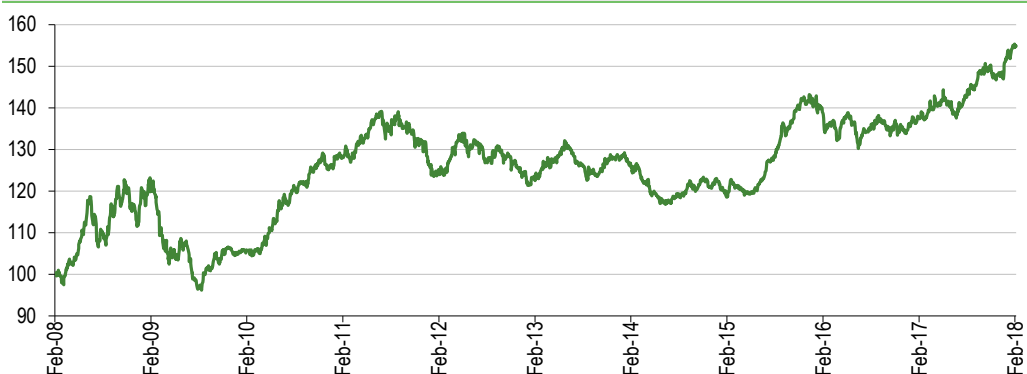
SLS's relative returns are shown in Exhibit 5. The trust has meaningfully outperformed its benchmark in both NAV and share price total return terms over all periods shown (with the exception of the last month).

#### Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative blended benchmark*	(0.9)	1.3	13.3	14.7	38.2	22.4	73.6
NAV relative to blended benchmark*	0.9	4.1	7.3	12.7	30.6	26.3	54.8
Price relative to Numis Smaller Cos plus AIM ex-ICs	(0.9)	1.8	13.4	13.9	34.3	29.1	127.1
NAV relative to Numis Smaller Cos plus AIM ex-ICs	0.9	4.6	7.4	11.9	26.9	33.3	102.5
Price relative to FTSE AIM	(1.2)	(1.6)	9.6	9.1	19.6	39.7	330.2
NAV relative to FTSE AIM	0.7	1.2	3.8	7.2	13.0	44.2	283.5
Price relative to FTSE All-Share	(0.6)	0.4	14.3	21.2	52.6	46.7	158.6
NAV relative to FTSE All-Share	1.2	3.2	8.2	19.1	44.3	51.5	130.5

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-February 2018. Geometric calculation. Benchmark is Numis Smaller Cos ex-ICs to 31 December 2017 and Numis Smaller Cos plus AIM ex-ICs thereafter.

#### Exhibit 6: NAV total return performance relative to blended benchmark over 10 years



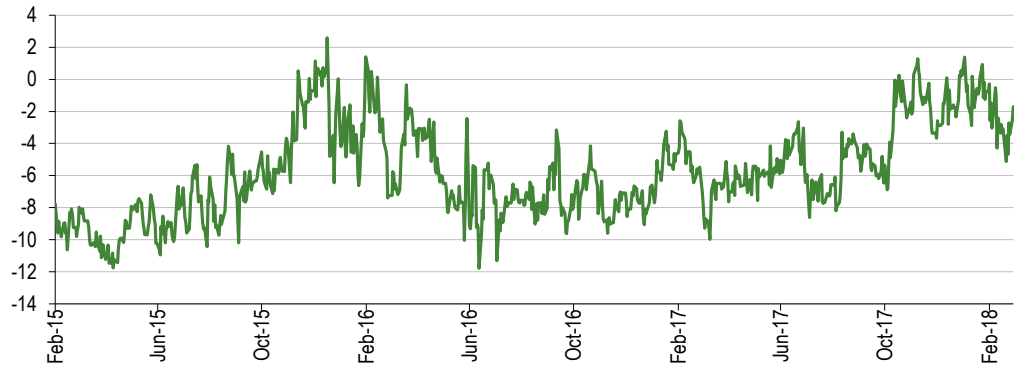
Source: Thomson Datastream, Edison Investment Research

## Discount: Now trading close to par

As shown in Exhibit 7, SLS's share price discount to cum-income NAV has been in a narrowing trend over the last 18 months. The current 1.7% discount compares to the range over the last 12 months of a 10.0% discount to a 1.4% premium. SLS's discount is narrower than its averages over the last one, three, five and 10 years (range of 4.2% to 5.7%) and is currently the narrowest in its

peer group (see Exhibit 8). SLS's board actively manages the discount, aiming to keep it below 8% in normal market conditions. Share repurchases are the preferred method, but these may be supplemented with discretionary six-monthly tender offers (last conducted in July 2015).

**Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)**



Source: Thomson Datastream, Edison Investment Research

## Capital structure and fees

SLS currently has 69.2m ordinary shares and £11.1m 3.5% convertible unsecured loan stock (CULS) in issue. The final conversion date for the CULS is 29 March 2018 and all stock is expected to be converted given that the trust's current share price is well above the 237.2542p conversion price. Full conversion would result in the number of shares in issue increasing by c 6.7%. Coupled with the proceeds of the CULS conversion, at the current price this would imply NAV dilution of c 3% and the shares trading at a small premium.

On 15 December 2017, SLS announced that it had drawn down £15m of the £20m revolving credit facility that it agreed with the Royal Bank of Scotland on 1 November 2017. Combined with the £10m of the £25m five-year, fixed-term loan drawn in November 2017, the weighted average interest rate on drawn borrowings is c 1.9%. Nimmo commented that he was able to employ gearing to acquire high-quality companies at attractive valuations due to an element of stock market 'fatigue', which was partially due to a high level of share issuance. The board has delegated the decision on the level of net gearing to the manager – a range of 5% of NAV in cash to 25% debt, at the time of drawdown, is permitted. At end-February 2018, net gearing was 7.4%, which is towards the higher end of the range over the last 10 years.

SLS has a tiered management fee structure of 0.85% of gross assets up to £250m and 0.65% above £250m. The performance fee was removed in 2012. In H118, the annualised ongoing charge was 1.06%, which compares to 1.08% in FY17.

## Dividend policy and record

SLS aims to generate long-term capital growth, but also pays dividends twice a year in April and October/November. The FY17 dividend of 6.7p was a modest 1.5% increase versus FY16. However, this should be considered in a wider context, as over the last 10 years, dividends have compounded at an annual rate of 23.7%.

An H118 interim 1.5p dividend has been announced, which is in line with H117. The manager continues to reduce exposure to larger, more mature companies, reinvesting the proceeds in newer, faster-growing companies, which he believes will deliver improved capital and dividend growth in

the future. At end-H118, SLS had revenue reserves of £4.7m, which is equivalent to c 1x the FY17 dividend payment. Based on its current share price, the trust has a 1.4% dividend yield.

## Peer group comparison

Exhibit 8 shows the 10 largest trusts in the AIC UK Smaller Companies sector. SLS's NAV total return is above the peer group average over all periods shown, ranking second over one year and three years, fifth over five years and at the top of the peer group over 10 years (c 97pp above average). SLS's ongoing charge is higher than average, although no performance fee is payable. The trust has an average level of gearing and a lower than average dividend yield, which is consistent with its objective to generate long-term capital growth.

**Exhibit 8: Selected peer group as at 23 March 2018\***

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Standard Life UK Smaller Cos	335.5	20.9	64.3	105.0	367.6	(3.2)	1.1	No	107	1.4
Aberforth Smaller Companies	1,198.6	7.5	26.7	77.2	189.4	(10.1)	0.8	No	101	2.2
BlackRock Smaller Companies	636.8	19.8	62.8	119.9	350.9	(9.8)	0.7	Yes	110	1.6
BlackRock Throgmorton Trust	349.6	19.8	63.6	115.5	328.1	(12.7)	0.9	Yes	130	1.9
Henderson Smaller Companies	629.0	15.3	42.8	94.7	279.3	(9.2)	0.4	Yes	111	2.3
Invesco Perpetual UK Smaller	160.5	13.2	54.1	100.7	236.6	(5.5)	0.8	Yes	100	1.6
JPMorgan Smaller Companies	176.5	21.4	43.4	77.7	213.3	(13.4)	1.1	No	112	2.1
Montanaro UK Smaller Companies	183.1	9.8	22.3	37.5	169.5	(18.1)	1.2	No	103	1.9
Rights & Issues Investment Trust	171.4	12.7	81.3	162.5	325.5	(10.3)	0.5	No	100	1.5
Strategic Equity Capital	153.5	12.0	31.8	118.1	244.4	(13.6)	1.3	Yes	100	0.3
<b>Average</b>	<b>399.5</b>	<b>15.2</b>	<b>49.3</b>	<b>100.9</b>	<b>270.5</b>	<b>(10.6)</b>	<b>0.9</b>		<b>107</b>	<b>1.7</b>
<b>Rank (out of 10 funds)</b>	<b>5</b>	<b>2</b>	<b>2</b>	<b>5</b>	<b>1</b>	<b>1</b>	<b>4</b>		<b>5</b>	<b>9</b>

Source: Morningstar, Edison Investment Research. Note: Performance as at 22 March 2018. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

Following the retirement of former chairman David Woods at the October 2017 AGM, there are now four directors on SLS's board; all are non-executive and independent of the manager. Chairman Allister Langlands was appointed as a director in July 2014 and assumed his current role in August 2017. The senior independent director is Carol Ferguson, who was appointed to the board in February 2009. The other two directors and their dates of appointment are Caroline Ramsay (August 2016) and Tim Scholefield (February 2017). Ferguson has announced her intention to step down following the October 2018 AGM and the board is actively seeking a new director.

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