Investment Manager's Report

This report covers the third quarter of the financial year, 1 April 2014 to 30 June 2014.

Investment Report

We previously wrote that periods of strong NAV growth (as witnessed in the first half of the financial year) are usually followed by a period of consolidation. And so it has played out. Whilst not good news in the short-term, the minor correction we are witnessing ought to prove helpful in the long term, ensuring the balance of power lies with investors and not vendors; important when it comes to maintaining market discipline. Whilst AIM has suffered most, the setback has been fairly widespread across the market: the Small-Caps, Mid-Caps and some FTSE 100 stocks have all been hit. For the most part, the underperformance has come from highly rated growth stocks and some cyclicals. By and large, the defensive stocks have performed well. Growth companies that have missed market expectations have been hit particularly hard, irrespective of their size. The strength of Sterling has not helped and is becoming an increasingly common theme in our meetings with export orientated companies. It is also possible that the glut of primary issuance is depressing prices in the secondary markets; there is simply too much stock for the market to comfortably absorb. Despite all this, the on-going global recovery and the breadth and depth of qualifying issuance, which continues to grow in volume, leaves us confident about the medium term outlook.

In the three months to 30 June 2014, the NAV decreased from 85.42p to 82.43p. No dividends were paid, giving investors a total return of -2.99 pence per share, which translates to a loss of -3.5%. During the same period, the FTSE 100 gained 2.2% whilst the FTSE AIM All-Share fell 7.7%.

The qualifying investments made a net contribution of -2.63 pence per share with 19 out of the 57 making gains, 8 marking time and 30 losing ground.

Audioboom (+250.0%, +1.03 pence per share), one of our most recent investments, was the top performing qualifying investment. Although it remains a very small company (market cap £16m), there is considerable excitement about the company's audio content platform, which aggregates 'spoken word' programming from more than 3000 channels (including BBC, Channel 4, Sky News, CBS, ESPN and LBC) for distribution through mobile devices. Other stocks that made a significant contribution included Cohort (+28.5%, 0.69 pence per share), Science in Sports (+64.4%, 0.43 pence per share), Egdon Resources (+42.7%, 0.33 pence per share) and TrakM8 (+34.6%, +0.31 pence per share).

The biggest losses within the period came from Wandisco (-47.3%, -0.68 pence per share) and Outsourcery (-74.3%, -1.30 pence per share). Like many highly rated tech stocks, Wandisco suffered a sustained de-rating as part of a wider rotation away from the sector, although in this instance the potential need for additional funding has further undermined the share price. A recent update highlighted lower than expected growth in quarterly bookings in its legacy business, whilst the Big Data continuous availability product, which is still very much in its infancy, got a strong endorsement from Oracle. Frustrating as the recent falls have been, there were no changes to the financial year ending 2014 forecasts and the shares still remain a comfortable 200% higher than our entry price. Outsourcery is another to be hit by Balance Sheet issues, although in this case the problem has been compounded by slower than anticipated customer acquisition, which is primarily driven by their channel partners (such as Vodafone). Whilst the channel partner model gives the company great reach into the market in a cost efficient manner; it also reduces management's ability to control the activity of their sales teams and leaves them at the mercy of slow moving behemoths.

We made 4 qualifying investments over the quarter, which included one additional investment into an existing qualifying company; two secondary placing's into listed companies and one IPO.

The company that already featured within the qualifying portfolio was Imaginatik, the Innovation management software consultancy firm that raised a further £1.3m to provide additional working capital to fund their transition to profit. The qualifying investments in previously listed companies included Science in Sports, a sports nutrition company, and Premaitha, a molecule diagnostics company. The IPO investment was in Eagle Eye, a mobile wallet, mobile marketing and m-commerce specialist with strong ties to Tesco.

We made no complete or partial exits from the qualifying portfolio over the quarter.

Portfolio Structure

The VCT is comfortably through the HMRC defined investment test and ended the period at 95.73% invested as measured by the HMRC investment test. By market value, the VCT had a 75.3% weighting to qualifying investments.

The allocation to non-qualifying equity investments increased from 5.2% to 7.8%, representing the funds small participation in non-qualifying equity issues and IPOs at attractive valuations. In line with the investment policy, we increased our investment in the Marlborough Special Situations Fund from 6.2% to 7.4%. Both these changes were largely due to the receipt of proceeds from the 2013/2014 offer pending investment into suitable qualifying opportunities. The non-qualifying investments contributed -0.08 pence per share to the overall losses. Fixed income as a percentage of the fund stayed flat at 2.7% and cash ended the quarter at 7.1%, marginally down from 10.2%.

Post Quarter Update

Deal flow has continued to be strong since period end. We have made five additional qualifying investments and have a number of deals currently under consideration.

Joint Offer for Subscription of Ordinary Shares

On 1 November 2013 the Directors of Hargreave Hale AIM VCT 1 plc and Hargreave Hale AIM VCT 2 plc announced the launch of a new joint offer for subscription of new shares in both VCT's to raise up to £10 million into each company.

Since its launch on 1 November 2013 and the date of this report the offer has resulted in funds being received of £7.33m by Hargreave Hale AIM VCT 1, and the issue of 8.78 million shares.

Buybacks

In total, 224,030 ordinary shares were purchased between 1 April 2014 and 30 June 2014, at a total value of £176,942.

Dividends

There were no dividends paid out over the quarter. The next dividend was announced on 27 May 2014 for 1.75p per ordinary share and was paid on 4 July 2014.

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