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Downing Strategic Micro Cap Investment Trust

Investor Letter

April 2018

It has been a busy quarter for the Trust in terms of capital deployment. We made a large follow on investment in Gama Aviation, and have built out our positions in Sprue Aegis and Hargreaves Services – the 'toeholds' which we referenced in January's letter. We also took the opportunity to top up certain holdings on share price weakness. In aggregate, the Trust has deployed £8.2 million of capital since the end of December and is now 66.2% invested.

We believe that the investment cases have strengthened in all bar one of our holdings since we invested. A number have already taken decisive strategic action to grow their intrinsic value. In the case of Real Good Food, we have been tirelessly exercising control of the strategic mechanisms put in place and we believe that we are closer to realising value from this investment. Increased volatility is resulting in several interesting opportunities, and our deal flow in new names has been healthier in the year to date than at any time through 2017.

Name	Sector	Market cap (£m)	% of the Trust	% equity held by Downing*
Adept Telecom	Telecommunications	77.03	7.18%	12.98%
Braemar Shipping	Transportation	79.85	5.13%	7.01%
Gama Aviation	Transportation	154.89	9.80%	6.38%
Hargreaves Services	Support Services	106.63	6.83%	5.26%
Ramsdens	Financial Services	55.20	5.51%	14.84%
Real Good Food	Food Producers	12.55	13.46%**	10.00%
Redhall	Support Services	25.38	5.93%	22.80%
Science in Sport	Food Producers	50.89	3.13%	13.24%
Sprue Aegis	Electrical Equipment	64.04	3.50%	9.22%
Synectics	Support Services	33.81	5.78%	13.14%

All figures correct as at 29 March 2018
**Total percentage of investee company held by all Downing managed funds*
***Holding includes 1.57% equity and 11.89% debt split*

In this letter we discuss our value process and the disconnection that we are seeing in asset pricing and fundamentals in some of our holdings. From page four, we give insight into the investment cases for our newest investments, Sprue and Hargreaves, and our ongoing work in progress. Finally, from page seven, we look back at the quarter and provide more detailed analysis of our investee companies' material news flow and how this has affected our investment cases and intrinsic value.

Our process

Value investing in the UK has been out of favour for quite some time – for at least 10 years, the value premium across the NSCI (excluding investment companies) has been negative. The divergence between growth and value strategies in the UK, particularly at the smaller end of the spectrum, has become even more pronounced recently with small growth delivering a 10.9% outperformance over small value through 2017[1].

Our private equity approach is value led and while sentiment may currently be against us, we continue to believe that there is great merit in a value approach to investing. Of course, as a style, it can over or underperform the

[1] Style returns within the Numis Smaller Companies Index (excl. investment companies) for February 2018 and earlier periods

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market at any time. However, over the long term, we believe that buying businesses at a significant discount to intrinsic value will outperform, unlike growth and momentum styles which are typically transitory.

We believe that buying deeply discounted businesses reduces the likelihood of permanent capital erosion, the largest drag on performance through time. These opportunities exist because of the inefficiencies in markets – particularly so at the micro-cap end of the spectrum – yet many investors appear to lack the long-term view and patience to profit from them.

Alongside a value approach, the Trust aims to overlay various strategic mechanisms to grow and, subsequently, realise the intrinsic value of portfolio holdings. Our experience in the UK micro-cap space suggests that these mechanisms, alongside capable and well incentivised management teams, are required to be able to deploy meaningful capital in a concentrated portfolio that has the potential to earn good returns with reduced risk.

However, these mechanisms take time to deploy and typically even longer to mature, hence our average investment horizon is around five to seven years. As the Trust's portfolio matures and these strategic mechanisms evolve, the investment strategy should deliver returns which are largely uncorrelated, through the cycle and regardless of prevailing market sentiment.

Disconnected fundamentals

In the smaller company universe, illiquidity and a lack of natural buyers can lead to heavily depressed prices over a protracted period. This is particularly true in the current growth and momentum driven investing environment. This can often be sentiment related and not based on underlying fundamentals or operating performance. These pricing inefficiencies can provide long-term investors with attractive entry points and occasional opportunities to average down book cost throughout the holding period.

A good example that illustrates the impact of market sentiment is provided by Adept Telecom. We began investing in Adept via the Trust in August 2017 – when the business was trading on approximately 25x trailing earnings and around 12x forward earnings. The forward earnings included the contribution from the recently announced Atomwide acquisition. We believe that this was another transformational deal made at an attractive price, further demonstrating management's M&A capability. Despite this, and despite trading on a relatively low forward earnings multiple, the shares sold off towards the end of 2017 and into 2018. At its lowest point the share price reached around 260p, pushing Adept to around the cheapest forward earnings multiple in the recent history of the company. We determined that the reason for the selling was perception and sentiment related (more on page seven), rather than fundamentals driven, and bought more shares. Since then, Adept's performance has continued to exceed our own and the market's expectations and this was reflected in its trading update at the beginning of April 2018.

Gama Aviation has also been subject to negative sentiment. In April 2018, Air Partner, another listed business in Gama's sector, announced accounting issues dating back to 2010/11. Gama and Air Partner's business models are fundamentally different and we believe that this is an unwarranted over reaction to irrelevant, company specific news. The shares have since rallied slightly following a positive update from Air Partner, yet we believe Gama remains seriously cheap at these levels, trading on a single digit multiple of earnings with plenty of growth opportunities.

Redhall is a similar story, with the order book and pipeline continuing to grow. We estimate that its tangible opportunities in mid-term UK critical infrastructure projects now amount to over £100 million. While some of these projects have become delayed, the gap between what the business is worth to a long-term holder or a trade buyer, and the enterprise value, has continued to widen over our holding period. The shares are more attractively priced than when we first invested and we believe that the market continues to factor in too much risk. We explore this further on page nine.

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Strategic catalysts

It is important that we invest with strategic mechanisms to catalyse a move towards and to grow intrinsic value. These catalysts, be it short or long term, exist in all of our holdings, no more so than Real Good Food. We have provided growth capital, catalysed a change in management team, taken our own board seat, and provided additional capital through loan notes which gives us more security and control over the direction of the business. Despite subpar operating performance, the value realisation levers are within our grasp and the major shareholders are aligned on when and how these should be pulled. These mechanisms, particularly in turnaround situations, take time to bear fruit. However, when it's all said and done, we expect Real Good Food to deliver a healthy multiple of our book cost.

In other holdings, our large equity stakes allow us to engage constructively with individual boards. We are currently paying attention to management incentives, an important aspect of our investment thesis where we seek to align our interests and those of management over the long term. Excluding Hargreaves, we are among the largest four shareholders across all our positions – the top three in seven, and the single largest in three.

With our increased corporate access and in a post-MiFID II world, where we are seeing a general lack of quality information around smaller companies, we are in a great position to provide stakeholders with our detailed views of portfolio companies and we will soon be launching a new website for the Trust which should improve information accessibility. We have really enjoyed speaking to investors over the last few months – if you would like to meet one of the Trust's fund managers to discuss specific investment cases or our process in general, then please get in touch. Otherwise, we look forward to meeting investors following the full year results published in May, and we will be presenting to shareholders at the AGM in June.

With all the current uncertainty in markets we do not expect our companies to be immune to the prevailing conditions. However, the remainder of the year (and beyond) holds some exciting prospects for our investments and we believe that the portfolio is well positioned to ride out volatility given our private equity approach and value style.

We look forward to writing to you again in July to update on the progress of the Trust in the first half of the year.

Thank you for your continued support in the Downing Strategic Micro-Cap Investment Trust.

Kind Regards,

Downing Public Equity

Downing

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Portfolio activity

Since we last wrote in January, we have invested over £5.6 million into Sprue Aegis and Hargreaves Services, both of which were previously identified as toehold positions. We also invested £1.8 million into Gama Aviation to support its growth strategy. The rationale for these investments is outlined below. The culmination of these investments (and a further £0.8 million which was used to take advantage of share price weakness) is that the Trust is now 66.2% invested.

New investment: Sprue Aegis

Sprue is a major designer and distributor of smoke and carbon monoxide detectors, and other safety-related devices, in Europe. Those incorporating Sprue's own technology/ IP are sold under its brands FireAngel (the UK's number one retail brand of detectors), FireAngel PRO, AngelEye, Pace Sensors, and SONA. The business has filed over 100 patents to protect its smoke and CO sensing technology, as well as the IP around its next generation Internet of Things products.

Downing has been an investor in Sprue since 2013, and as a result we know the management team well. Downing client funds currently own 9.2% of the equity and it comprises 3.5% of the Trust. Our investment case in Sprue is predicated on:

- **Legislative drivers:** the Company benefits from country legislation which is driving the adoption of fire protection products. This was evidenced in France in 2015 and is now underway in Germany. Guidance is for the purchase of smoke alarms with a 10 year lifespan. Therefore, in more mature markets where there is high penetration, we are already beginning to see a replacement cycle on the installed base.
- **Improving margins:** gross margins on Sprue's products differ to those of typical white goods – earning around 30% and over 45% on IP enabled products. When these are combined with an improved operational structure, we expect conversion to profits and cash flow to improve. After a temporary fall in earnings in 2016 (due to a product recall) the Company has reorganised its internal systems and process testing. Additionally, the move to Flex in Poland for manufacturing and supply of smoke detectors is progressing to plan and we believe this will enable the Company to control production costs more closely. Finally, the termination of a distribution agreement with BRK Brands will save £2.9 million in annual distribution fees.
- **Market growth:** Sprue has robust technology and IP around device interactivity, owing to its long tenure in the sector. While there are new upstarts in the Internet of Things (IoT) sector, who are investing heavily to gain market share, we believe that Sprue's technology is superior. Sprue has historically not exploited this IoT market potential and we believe that doing so could offer material upside.

Our relatively large percentage holding of Sprue across Downing client funds reflects our confidence in the investment case. As with many regulatory drivers, while they may provide visibility, the speed of adoption can often deviate from initial expectations. We expect that Sprue will be a long-term investment as it takes advantage of the growing market opportunity, notwithstanding any trade interest owed because of its enviable market position. In addition to improving underlying operations, we also expect that there may be strategic opportunities which will arise in the sector.

Post period end, Sprue's share price has reacted negatively to the early termination of the BRK Brands distribution agreement. We think that this is a buying opportunity, as discussed further on page 10.

New investment: Hargreaves Services

Hargreaves (HSP) is a Scottish based conglomerate of infrastructure and commodities businesses which has historically been held in the Downing UK Micro-Cap Growth Fund. We lost conviction in early 2016 when visibility on the legacy coal business's operating costs began to diminish, and promises of asset realisations were looking too uncertain. However, through 2017, there were three notable developments against our sell theory:

1. In March planning permission was granted for the East Lothian Blindwells site. This planning, approved in principle, is for up to 1,600 homes on part of a 392 acre site, less than 15 miles from Edinburgh. This is the first phase of a wider plan for over 3,200 homes in the area to be developed over 12-15 years;
2. In May, the Group announced that it had disposed of surplus underground mining equipment. This appeared to be a further step towards the cost rationalisation of the coal mining business, which is in decline;
3. In June, the creation of Brockwell Energy was announced which will oversee the spin-off of the Group's energy project interests.

Following these announcements in 2017, which we concluded could result in a material NAV uplift and/ or cash returns to shareholders, and news of the CEO buying shares in December 2017, we resumed intensive diligence. We began buying shares before the end of the year. In February 2018, we engineered sizable off market liquidity which has resulted in Hargreaves becoming 6.8% of the Trust and Downing managed funds controlling 5.3% of the equity.

Hargreaves is a pure (but not straightforward!) NAV play. As with most conglomerates, there is an inefficiency discount applied and part of our thesis is based around closing this gap by carving out more efficient operating segments and/ or asset disposals and returning the cash to shareholders. Our investment case is predicated on the following:

- **Value creation:** we believe that there is between £35 million to £50 million of value creation potential over and above the current book value of HSP in the next five years – the first plot sale at Blindwells should act as validation of this. The spin-off of the wind energy assets into Brockwell Energy could also generate material upwards revaluation as they are developed. We sense checked the energy valuation with Downing's own renewables team who have been investing in similar assets since 2010.
- **Value realisation:** we are currently engaging management and believe that they are aligned with our views on cash and returns to shareholders. The business targets a 40% payout ratio but in a capital asset intensive business, returns to shareholders have been reduced through high recurring capex. In 2017, cash realisations were £25.5 million from legacy assets, but post reinvestment this sum is materially reduced. We expect that the winding down of the legacy capital intensive activities will increase distributable cash.
- **Reducing risk:** the winding down of the legacy coal business and associated reduction in inventory reduces the risk to our NAV play and frees up additional cash for developing NAV accretive projects with higher returns, or distribution to shareholders.

Hargreaves will be a longer term holding for the Trust, with an operating business alongside a NAV realisation play which holds the key to significant long-term value creation. We look forward to updating on progress on both aspects of the investment case in due course.

Follow on investment: Gama Aviation

We wrote to investors at the end of February 2018 outlining our assessment of Gama's newly announced placing (this text is copied in the appendix for reference). Downing participated in this placing, contributing over £3.2 million across client funds. The shares were placed at 245p, a 7.5% discount to the price around the roadshow. As a result, Downing client funds now own 6.4% of the equity and Gama comprises 9.8% of the Trust.

Since the placing, Gama has announced a positive set of full year results for 2017. We discuss these in greater detail from page seven.

Work in progress (WIP)

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We have sufficient work in progress and reason to believe that we can be fully invested by the anniversary of the Trust launch in May. We are dependent on external fundraising timetables which always have the potential to change, but we are confident that we should meet this target. At the very least, subject to final due diligence, these funds have been earmarked for both growth and working capital in some great businesses.

Specifically, we have earmarked a large portion of capital for a transaction which has been WIP for over a year. The timeline for the completion of this has inevitably drawn closer and, conditional upon final due diligence, we hope to cornerstone the deal across Downing client funds in the coming month, again subject to external timetables.

We are also expecting to make a strategic investment in a small business which we have known for some time. Despite a period of difficult trading, we believe that management has identified an attractive acquisition which would be complementary to the existing business and has the potential to be materially earnings enhancing. Our diligence process has already commenced and, provisional expectations are that this deal could complete by the end of May or early June.

These investments in aggregate could account for up to 15% of NAV which would take us across our 80% fully invested threshold. In line with our value methodology, we will retain an ample cash buffer to allow us to take advantage of share price weakness, or should there be a new and deeply discounted investment which we would like to add to the portfolio.

Given current market volatility, opportunities are presenting themselves regularly and we have added a few interesting new positions to our WIP. These ideas range from UK-only services businesses through to manufacturers with international sales exposure. The diligence process on these businesses will accelerate through the coming months.

Company highlights

	Jan	Feb	Mar
Adept Telecom		Director buying	
Braemar Shipping		Acquisition	Trading: in-line*
Gama Aviation		Fundraise	Results: in-line
Hargreaves Services		Results: in-line	
Ramsdens			
Real Good Food	Trading: behind		Funding update
Redhall			Trading: behind + contract award
Science in Sport			Results - in-line
Sprue Aegis			Distribution update
Synectics		Results: in-line	

* pre-exceptional litigation settlement

Adept Telecom

Throughout February, Directors purchased over £3 million in shares which we believe has aided the share price and perception. Sentiment had been weak following the Directors share sales in August 2017 which gave the Trust its initial stake in the business. We believe the recent buying is a reversal of this negative signal. The shares were mispriced through the latter quarter of 2017, around 20% below the level at which we entered and when the Atomwide deal was announced. We are confident that they will continue to rerate as the market realises the potential in this deal and Adept's successful track record in the space.

Post period end, Adept announced a positive trading update, highlighting that underlying EBITDA would be ahead of expectations of a 23% year on year increase, and lower than expected net debt. This progress against our thesis is welcome – we still believe that the shares are significantly undervalued and offer both great value and unrealised growth potential.

Braemar Shipping

In February 2018, Braemar announced the acquisition of Atlantic Brokers Holdings Ltd for £4.8 million. Atlantic is an established broker for ICE coal and CME Clearport coal futures and options. The acquisition helps to diversify the broking business into other streams outside of oil – which is a large proportion of the business – and particularly into dry bulker opportunities which should have synergy benefits across the Group.

In March 2018, the Group published a trading statement which was broadly positive and in-line with expectations pre-exceptionals, highlighting around £8 million of operating profit for the full year. The exceptional was a cash cost of £750,000 on a legacy litigation dating as far back as the early 2000s. Given the nature of the litigation, we are not concerned about any recurring element going forwards. Management's outlook statement was particularly bullish and we note that this tone has been consistently reiterated in our most recent conversations. Given the recent restructuring and diversifying acquisitions, we believe that the coming years will be rewarding as the business continues to deliver on our investment case.

Gama Aviation

In the lead up to reporting results, we noted strong performance from Gama's US joint venture partner, Gama Aviation Signature Aircraft Management, a new contract win, and a number of new additions to the fleet in the

US and Asia. Richard Kearsey also joined the Board from the Close Brothers Aviation division to head up M&A at Gama. Throughout his 27 years' in aviation financing with Close, Richard has likely had direct or indirect experience with most operators in the industry and therefore makes a strong addition to the business.

The full year results were positive, with $14 million of free cash flow generated and growth in both the Air and Ground divisions. We like the contracted nature of the Air business where Gama earns income through management fees rather than a margin on the sale of consumables, such as fuel. This was evident in the Asia division where there was a decline in revenue, as two aircrafts flew very little in the period (therefore generating less revenue on pass through costs), but gross profits increased as Gama earned more in management fees through fleet growth. We think that this demonstrates the resilience of the model as even if assets aren't flying they are still generating drop through profit. Once signed into the fleet these assets also tend to be fairly sticky.

The story is similar on the higher margin Ground business where regulatory drivers mandate maintenance based on flying hours or calendar days, whichever comes first. This provides good visibility, alongside regulatory cycles which drive additional maintenance work.

2018 will be a pivotal year for the business as management embark on several organic and inorganic growth opportunities. We also hope to see operating margins grow further as the model matures internationally. This sets the stage for 2019 and beyond, from which we expect the business to move to a new level of profitability and cash generation as management deploy the £48 million from February's fundraise. We expect that underlying free cash flow could double in this time once these strategic initiatives are fully implemented. For more detail on the recent strategic developments, please see the appendix to this letter.

Hargreaves Services

Hargreaves' interim results, announced in February, highlighted operating performance was broadly in-line with our expectations, with some onerous earthworks contracts contributing a £2.8 million loss on an otherwise satisfactory set of results. These loss-making contracts are expected to be completed by the end of April 2018. The continuing operations are now in a good standing going forward and, with a reduced debt burden, this gives us confidence in a stronger second half, alongside progress with our NAV realisation thesis.

Ramsdens

Post period end, Ramsdens issued a short trading statement which highlighted that results would be marginally ahead of expectations. We will provide a fuller update on these results and progress against our thesis when more detail becomes available in June.

Real Good Food

Despite our optimism in the January letter, it was disappointing for the Company to issue a lacklustre trading statement at the end of January. This indicated that trading in the last few weeks of the Christmas period had not met expectations, despite being in-line up to that point. We believe that there was some opportune discounting by a competitor which impacted Renshaw sales and that UK grocery weakness and the impact of over-stocking in overseas markets reduced volumes further. The new management team also took the opportunity to rebase expectations – a prudent action which we welcomed as prior rebasing had not been prudent enough. The note also highlighted the continued operational work going on throughout the business to right size the cost base and ensure governance and accounting practices are in line with the norm.

Importantly, management highlighted that all the Group's debt, except £1.75 million of term loan and an invoice discounting facility, sits with Downing and the two other major shareholders. This should appease investors that, along with the majority shareholders' continued support, the Company's direction rests in the hands of the major shareholders, all of whom are aligned on how to extract value from the Group going forwards. There will be further restructuring and financing of the business in the coming months.

Our original investment case indicated that the operating costs of the Group were high and that there was an opportunity to rationalise the business which would improve the post-investment balance sheet and the continuing operating performance.

Post period end, we are pleased to report that the management team have disposed of Garrets Ingredients for approximately £1.8 million cash consideration on a debt and cash free basis. This was a non-core commodities trading business which contributed a £0.9 million operating loss in 2017. The proceeds from the sale will be used to reduce the debt of the Group. This is the beginning of the new CEO, Hugh Cawley's, strategic influence and we expect the following quarter will be similarly productive in implementing cost saving measures.

Redhall

In March, Redhall announced further contract awards and a trading update. The trading update reiterated the timing difficulties with some of the Group's most lucrative contracts, and the Board indicated that reported results for the current financial year would be adversely affected. The deferred contract refers to a Hinkley Point C project with Balfour Beatty. While the delay is disappointing, 'scope creep' often means that contract values grow over time. Based on historic evidence, when we apply this to the Balfour's contract we think that the initial £8 million awarded may have grown to over £12 million, with a lifetime value of up to £25 million.

The update also mentioned the framework agreement with Cavendish Nuclear. Of a 10 year deal to supply Sellafield Nuclear, Redhall have won an anticipated £18 million over the first three years. Not only does this £18 million underwrite Jordan's business, given the overall duration and quantum, there is obvious potential for this to grow.

The contracted order book now amounts to £35 million, excluding the £18 million framework agreement which should convert in due course. The beauty of Redhall's business, for investors with the time to research it, is that contracts and tenders are publicly available. We have spent a considerable amount of time trawling through public documents to uncover the Company's true potential and believe that it has tangible mid-term opportunities of over £100 million in some of the UK's largest infrastructure projects. This should grow as more projects come online.

Of course, turnover is only half the story. Care needs to be taken with the operating structure and efficiency to ensure operational gearing. The new CEO, Wayne Pearson, has the correct experience having managed several process engineering businesses in Melrose plc's impressive portfolio. High integrity engineering margins should be in the region of 25-30%, therefore we expect his experience should start reaping rewards for shareholders in terms of growing profitability. Having raised working capital last year to fund the delivery of its order book, the Company's long-term prospects are as good as they have ever been.

Synectics

In February, Synectics reported its full year numbers which were in line with our expectations. We were pleased to see an increase in reported return on capital employed from 7.6% to 8.5%. This is a key driver of our investment case as the business improves operational efficiencies and grows revenues. This is paired with increased capex and £500,000 of discretionary R&D in the current year and 2019, which the business will use to grow into new product verticals. While increased expenditure may have the effect of softening nearer term profits, we expect that it will reap rewards in longer term. Management continue to believe that under normal conditions the business can grow revenues significantly and can achieve an 8-10% operating profit margin. We believe that there are some interesting strategic opportunities in Synectics' sector and we are assessing these closely.

Science in Sport

SiS reported positive full year results in March. Revenue growth was 28% and gross margins were resilient at around 60%. SiS.com, which is highly accretive to gross margins, grew by 58% to £4.6 million of revenue in the year and we expect that 2018 will drive a similar growth rate following the continued investment in the online platform. In Italy and the US, the two regions earmarked for growth in the placing at the end of 2017, revenues grew by 110% and 523%, respectively. In the period leading up to the results, SiS announced a partnership with Manchester United Football Club – the largest and most supported football club in the world. We were pleased to note that the marketing efforts around this have delivered a strong payback to date, with the promotional/ sampling gels returning more than cost in accompanying orders through the .com website. Of course, the acid test is delivering further database growth and conversion over the next year.

Sprue Aegis

Towards the end of March, Sprue made an unexpected announcement that BRK Brands, Inc. – for whom Sprue was a distributor in the UK and Europe – had terminated its distribution contract eight days early and as such BRK would not buy back any stocks of unsold products. This termination was already known to the market as it had been announced on 31 March 2017, with the preceding 12 months acting as a written notice period. For BRK to terminate the agreement alleging breach of contract with just days until natural termination was completely unforeseen by both management and investors. It is our understanding that BRK's parent in the US, Newell Brands, is currently going through an activist proxy battle and that this may be an attempt to shore up its balance sheet. In any case, we view it as a positive that Sprue will be separated from this corporate distraction.

Sprue's announcement conveyed little in the way of the economic impact from the termination. This ambiguity, the strong wording (legal jargon), little reassurance from auxiliary commentary, and perhaps lingering doubt around the recent departure of the FD, lead the shares to sell off by over 20% on the day, and they remain off around 30% at the time of writing.

We have been topping up our position having adjusted our valuation for the lack of stock buyback and found an even greater margin of safety at these levels as the shares have sold off by more than the present value of the adjustment. We are happy to do this based on the one-off nature of the termination. The interim results published in September 2017, indicated that the gross book value of BRK stock held by Sprue at the end of June 2017 amounted to £4.8 million and the recoverable amount was at least £3 million. Subsequently, the company has confirmed that the gross book value as at 31 March 2018 was £4.3m. We had already adjusted down our valuation by £4 million, effectively writing off the entire value of the stock. The termination of the agreement is saving Sprue £2.9 million in distribution fees per annum, so this adjustment is offset entirely in little over a years' trading.

This is a further example of how irrational and imperfect markets create bargain opportunities for fundamentals driven value investors. In this case, the market cap has eroded by around £30 million, far greater than our £4 million stock write down scenario indicates would be prudent.

Appendix: Gama Aviation investor note dated 23 February 2018

On 9 February, Gama Aviation announced a proposed placing to raise £48 million to accelerate growth and take them closer to their strategic aim of becoming the global leader in business aviation services.

We believe that the business already has a compelling investment rationale. Revenue visibility and quality earnings (70% of gross profits are contracted, and a further 20% which could be deemed 'recurring' in nature), cash generative, regulatory barriers to entry, and geographically diverse. In addition, it is run by a capable and ambitious management team, the same one who founded it around 35 years ago and who, post this fundraise, will retain over a 20% shareholding.

Gama is a business aviation services company providing aircraft management and maintenance services to a global fleet of aviation assets. It also operates prestigious special missions' contracts such as the Scottish Air Ambulance, which it has managed since 1991, and the MoD Shadow programme, managed since 2008, amongst others.

The proceeds from the share issue are intended to provide both organic and inorganic growth capital. Significantly, an affiliate of Gama's existing partner in Hong Kong (Hutchison Whampoa), Hutchison Capital Holdings Limited, will take a large and strategic stake in the business with a £32.7 million commitment which will buy them 21% of Gama's enlarged equity. We think that this is significant – a multi-billion-dollar Chinese infrastructure conglomerate realising Gama's growth potential.

The first portion of capital will be used to buy out Hutchison and Gama's existing joint venture in Hong Kong. This is a highly strategic region with high quality business aviation assets – large transcontinental jets which typically generate $2-2.5 million of revenue p.a. each. Considering that Gama's operating profit margin target is 5% on the aircraft management side, that they already manage a handful of jets in Asia, and that Hong Kong alone has a fleet of over 120 jets which they can target, we believe that this is a compelling purchase which has great potential to grow earnings.

Hutchison's other business aviation interest in Hong Kong, a 20% shareholding in China Aviation Services Ltd (CASL), will also be purchased by Gama. CASL's long standing business is in providing passenger jet heavy maintenance at Hong Kong International airport, but in late 2017 Gama and CASL announced a partnership aiming to grow the business aviation maintenance side where both CASL and Gama see great potential. This is significant as there has historically been no business aviation heavy maintenance capability in Hong Kong, so owners of that 120+ strong fleet must reposition their aircraft elsewhere at potentially great expense and inconvenience. Management guide towards 20% operating margins in the maintenance business over the long term and we believe that revenues here could grow to around $15-20 million. Additionally, we believe that start-up risk is reduced as Gama are plugging into CASL's existing infrastructure and will even use some of CASLs surplus engineering labour, where appropriate.

The next regions earmarked for investment are the US and Middle East. Since we invested back in January 2017, we have pushed for management to build out high margin, heavy maintenance capabilities in the US. What they currently have are over 30 mobile units – engineers in vans – which drive around airfields carrying out lower margin light maintenance. The higher margins come from intensive, heavy maintenance work where Gama currently have no capability in the US. They will invest $10 million to construct and fit-out two hangars, one west coast and one east coast. On the basis that Gama currently manage a fleet in the US of over 200 aircraft into which they can immediately cross sell this maintenance capability, we believe that this could do $10 million revenue in the first full year and could scale up to around $40-50 million – the same level as in Europe and where the operating margins run around 20%.

In the Middle East, Gama is to begin constructing, later in the year, a new 40,000 sq metre hangar and maintenance facility at Sharjah International airport. Gama have an existing operation in Sharjah which we believe has proven popular as a lower cost and more convenient alternative to Dubai International and Dubai South. An exclusivity agreement will protect Gama's interest here for five years after construction.

The balance of proceeds will be used to fund acquisitions in aircraft management and maintenance operations. We believe that these should be highly earnings accretive as they are simply building scale and leveraging existing

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infrastructure. There should be considerable synergy benefits also. As a starter, we wouldn't be surprised to see Gama significantly scaling up their Middle Eastern aircraft management business ahead of the Sharjah build. There may also be some attractive opportunities in European management and maintenance businesses.

Recently, there have been some promising Board changes which we believe set a great precedent for shareholders going forwards. Simon To, the highly regarded Executive Chairman of one of AIMs largest businesses, Hutchison China MediTech, will join Gama's Board. Richard Steeves, formerly of Synergy Health, which he grew from £12 million to £1.4 billion market cap, has also joined as a non-exec, and Neil Medley, former COO at BAE Systems, has joined in the same COO role at Gama. Alongside the chairman Sir Ralph Robins – who was on the board of Rolls Royce for 20 years, 10 of which as Chairman – we believe that this creates a heavy hitting board with a wealth of blue chip experience in global and high growth businesses.

Next year will be the first full year of contribution from the acquisitions and organic investment. WH Ireland expect $10 million of incremental profit before tax from the use of proceeds, at which point the business should be generating well over $30 million p.a. ($33.1 million actual). Applying this incremental profit to the capital light model, and the business should be generating more free cash flow through which it can pursue additional, non-dilutive, growth opportunities.

Since we invested, management have done everything that they said they would in terms of improving cash conversion and progressing their corporate strategy. We believe that the shares continue to look cheap at only 8.8x 2019 earnings. With growth opportunities aplenty, quality earnings, a strong balance sheet, experienced management team and a strengthened board, we believe that it deserves to be rated at least in line with its peers at 12.5x.