Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

31st August 2020

The world has changed significantly since we last wrote in February - it has been an interesting time, characterised firstly by a period of extreme fear, followed by a period of euphoria. As many other market participants will comment – we currently feel like we are in a state of limbo, with a large degree of uncertainty still overhanging. Not just due to coronavirus, but the US elections and Brexit transition towards the end of the year are also likely to spark higher volatility in the near term.

We have not chased returns in these rising markets by deploying our significant cash balance. In our opinion, in times of uncertainty, and with greater uncertainty on the horizon, it feels prudent to preserve this cash for only the most compelling ideas. We have also spent considerable time focusing inwardly on what we already own to make sure those companies have the necessary attributes to survive and, latterly, thrive.

To that end, we have made some changes to the portfolio in the period. We exited in full Braemar Shipping Services and Gama Aviation, for different reasons, but ultimately where we thought there was better risk/ reward elsewhere. We also made two toehold investments and we discuss these points at the end of this letter.

Despite our caution, there are reasons to be cheerful with this portfolio from both a downside protection and an upside perspective. Firstly, almost 21% of the portfolio is in cash and another 20% is in loan notes where their value is not influenced by volatile stock markets. That makes over 40% of the portfolio which is entirely unaffected by volatility. Volex comprises just under 16%, and is trading robustly through this period. Bar a recession, we are hopeful that the company will grow earnings this year and should continue to re-rate. A further 20% is comprised of businesses which we think aren't trading much higher than what we consider to be a minimum valuation given the quality of earnings and balance sheet strengths underlying.

From an upside perspective, the opportunity is significant. Not only is there over 100% of upside potential to intrinsic value in the portfolio, but investors today can access that upside at a 27% discount to current NAV. That points to a 64% 'double discount'. The discount has historically traded significantly narrower than the current gap and we expect that discount to narrow as value creation catalysts are delivered, and the wider market begins to appreciate the quality of some UK smaller companies.

VOLEX PLC – is our largest equity position and the group has delivered some reassuring updates since we last wrote. Most notably, the 2020 full year results highlighted underlying operating profit of $31.6 million, which implied an underlying operating margin of over 8% and net cash prior to IFRS 16 adjustments grew to $31.6 million. Net operating cash flow was the standout figure at $51.7 million, albeit with a $19.6 million working capital benefit. We estimate that around half of this working capital benefit was sustained (a calculation we make from subsequent disclosures), but even removing any positive benefit generates free cash flow of $27 million.

These numbers are important as they highlight the improving quality of Volex's earnings – operating margins improving towards the targeted 10%+, and cash conversion over 100%. Overall, management's confidence in the group's ability to continue to generate strong cash returns has been underlined by the commitment to the dividend.

In terms of 2021, the group's AGM statement has reiterated that revenues and profits are in-line with last year, which we think is encouraging. This is despite lower healthcare contribution as hospitals are generally closed for non-critical procedures. Volex's primary exposure here in the complex assembly division is through large imaging equipment and these installations are currently depressed. Despite this, the rest of the business has been performing well, with EV back around pre-COVID levels and the legacy Volex business and data centres performing ahead of what we expected. In August, we noted the acquisition of Varian by Siemens Healthineers for $16.4 billion. A quick Google suggests that Silcotec (one of Volex's 2018 acquisitions) had some exposure to Varian in the past and, if we assume that they still do, this may be another strong growth driver for the business over the medium-to-long term. Varian have over 50% market share in the radiation therapy market and Siemens Healthineers have specifically highlighted this target market as well as increasing exposure to cardiology and neurology. Healthineers indicated that the incidence of cancer is expected to almost double to 25 million by 2030, representing a $20 billion per year market.

We still think that Volex is rated too cheaply given the quality of the underlying business, and the future growth potential through both organic and inorganic means. In terms of quality, we consider the following:

- Reducing customer concentration: in 2014 the top three customers represented 50% of revenue, they now represent only 25% of the revenue and we believe that trajectory is declining;
- Increasing operating margins: when we began researching Volex in 2017, the adjusted operating margin was less than 2%. In the most recent results, it is over 8%;
- Much stronger cash conversion and free cash conversion: historically Volex had appeared highly cash consumptive, investing in the wrong capex projects with low returns. That has changed, and we estimate maintenance capex to run around $4-5 million. There will be one off capex projects required to support growth, but generally Volex is considerably less capex intensive than other companies we have encountered of its size. Working capital is also much more tightly controlled, as evidenced in the most recent results;
- Improving, and generally very high, return on capital employed: in the most recent results this was almost 30% which is high on both a relative and an absolute level;
- Strong balance sheet: now with $30 million of cash, much improved from the historic net debt position.

As well as quality, Volex also offers significant growth potential. Organically, we expect this to come from the sectors described above. The business also has $30 million of cash and $30 million of available facilities with which to consolidate its markets. Management's medium-term target is to deliver $65 million of operating profit. At its current forward rating, that would imply a medium-term share price of around 300p, almost 2x the current level. We expect that the shares should continue to perform strongly as management hit milestones associated with this earnings target. On a final note, management continue to purchase shares in Volex which we consider a strong signal, particularly in this period of uncertainty.

REAL GOOD FOOD PLC – has had a mixed trading period through the corona-crisis, however our expectations of a favourable exit for this investment are unchanged. The turnaround is now bearing fruit with group revenues up by 9% to £67 million and adjusted EBITDA up 178% to £5.4 million, helped by improved trading and a reduction in head office costs.

Within this mix, it is worth noting that Brighter Foods revenues increased 67% in the year to March 2020, with a new contract secured with a global customer in January, generating only a three-month contribution in the financial year.

Cake decoration was proving more difficult in the period to end March 2020, with pockets of weakness in sugar paste and marzipan offset by strength in frostings. It does remain a more price competitive market, but the business has so far proven to be resilient. Combined with overhead reduction of 11% and a further cost base review in 2021, we are confident of a positive contribution and we see scope in more normal times for EBITDA recovery back towards historic levels.

The business acted quickly through the corona-crisis and furloughed around 140 staff. As with all our portfolio companies, cash conservation became key. Both Brighter Foods and Renshaw were significantly impacted by reduced demand in the period, but we expect a broad recovery in line with other similar business and the general economic reopening which has occurred since the business update on the 8th of April.

In July, the business also updated on an increase of funding arrangements. This is a working capital facility with Leumi ABL Limited, and constituted an increase of £2 million amounting to total invoice discounting facility utilised of £10.87 million. This is significant in the current situation as it improves financial flexibility but also underlines the financial strength of the entity, in our view.

To recap, our investment comprises a small amount of equity, and a larger amount of convertible and vanilla loan notes. The vanilla loan notes had a mechanism which increased the redemption premium from 7.5% to 15% if the notes weren't redeemed before 31st March 2020. That date has now lapsed and therefore the full 15% premium now applies. As we have outlined in the past, the convertible loan notes, negotiated in May 2018, are convertible at 5p per share and carry a coupon of 12% until 17th May 2021. On this day, unless the convertibles are converted into ordinary shares or are redeemed in full, a redemption premium fee will be payable. This fee mechanism is intended to generate a return which would equate to a 30% per annum interest rate from the date of the loan notes until and including the redemption date.

In our last letter we closed out our comment on RGD that we thought 2020 was likely to be a defining year for the company. Unfortunately, that was prior to COVID-19 taking a hold worldwide, and it seems likely that our expectation may be deferred. However, it is not all doom and gloom as we have been using our extra time from a lack of travelling around the UK to spend more time speaking to our private equity contacts. Our anecdotal takeaways from these conversations are as follows:

- M&A market decline around 90% for the two months of full lockdown;
- Three advisers we spoke to have executed between five and seven deals each in the last six weeks. But these were deals that were 75% across the line pre-COVID-19. These were a combination of strategic bolt-ons and private equity buyers returning to the market;
- There is a strong pipeline building into the third and fourth quarter of this year;
- Good appetite from both private equity (as banks are lending again) and corporate buyers;
- International buyers are in the UK, but logistically finding it difficult (getting on site etc), so what is happening here is that they are spending more time on deals and advisers now tend to drive shorter short-lists;
- Fear of a 2nd COVID-19 wave still looming but definite momentum to just get on with well-priced and/ or strategic acquisitions

RAMSDENS HOLDINGS PLC – prior to COVID-19, the company was performing exceptionally well. Underlying profit before tax was up 19% and all three segments grew by double digits, in the 12 months to 31st March 2020. Free cash flow was also very strong, around £7.6 million.

Ramsdens has been the Trust's worst performing stock through the corona-crisis, given its exposure to physical pawn broking stores – all of which had been closed – and the foreign exchange business, given most of the summer has been spent in lockdown, it has suffered extremely negative sentiment. Despite this, the company has performed reasonably robustly considering the circumstances and has made the most of the government furlough schemes where applicable.

Part of the initial attraction for us to Ramsdens was the strong balance sheet. We often look for companies which have balance sheet optionality where a company has tangible levers which it can pull to release cash in times of stress. Hargreaves also has what we describe as balance sheet optionality, which we describe below. Unlike Hargreaves, Ramsdens has a net cash position, which has been eroded somewhat through lockdown as the company has burned cash through the period of closures. But undoubtedly, Ramsdens has fared better than many other high street retailers who often employ much more efficient balance sheets and have been unable to absorb the losses encountered from coronavirus shutdowns. The optionality we refer to, in Ramsdens' case, is the significant quantity of precious metals on the balance sheet held within 'inventory'. We estimate that the company carried £11.6 million of gold and other precious metals at 31st March. Management have prudently been able to liquidate some of this through the last few months in order to generate cash to fund operations. Not only that, but they are liquidating these metals at much more favourable prices – we estimate that the spot gold price has increased by 23.7% since the last balance sheet date. Alongside readily liquid precious metals, the company also carries a significant amount of float for its foreign currency business.

As we have moved into a period of economic reopening, the majority of Ramsdens' stores are now fully open.

How do we view Ramsdens going forwards? Well, in our opinion, they have one of if not the strongest balance sheets on the high street, and certainly stronger than the nearest competitor H&T. This should guarantee survivability, but also an ability to thrive and we do expect Ramsdens to recover over the medium term. It is perhaps an unfortunate corollary of the current situation that Ramsden's pawnbroking service may perform strongly, combined with a period of increasing gold prices. With a current market cap of £40 million, and last reported net cash of £11 million, an enterprise value of £31 million – excluding any cash burn since the end of March – generates an unlevered free cash flow yield of over 25%. Assuming earnings half this year, we still think that the risk/ reward in Ramsdens over the medium term is highly asymmetric.

ADEPT TECHNOLOGY PLC – provided a reassuring COVID-19 trading update which highlighted that sales order intake had fallen significantly less than management's assumptions, partly attributed to the beneficial public/ private split which AdEPT maintains. While installations were lower, particularly in on-site project work, AdEPT was kept busy in the education sector where it worked on cloud migrations, helped by the Department for Education's provision of additional funding to assist schools in moving to the cloud to support remote working. Finally, debtors and cash generation was strong through the period, with debtor days actually falling from 48 to 42 days, and the business was able to repay an £8 million term loan which it drew down at the beginning of the corona-crisis for liquidity purposes.

AdEPT's results for the year to 31 March 2020 were equally reassuring. Revenue increased by 20%, EBITDA increased by 9% and margin increased to 19%, and cash conversion was much improved to 82%. Recurring revenues at 75% were also stable. AdEPT continues to be lowly rated, in our view, given the quality of the underlying model which combines moderate growth with revenue visibility, high margins, and low capital intensity. We suspect that the biggest turn off for the market is the level of debt in the business, and we are engaging regularly with management over the correct handling of this. While the overall quantum and ability to pay isn't concerning to us, optically it can provide a significant hurdle for potential investors who are even more wary of indebtedness in the current climate. We hope that the appointment of a new broker can begin to generate new interest in the shares which offer great value at the current price.

SYNECTICS PLC – Since February Synectics has communicated well with shareholders, issuing two business updates during the heart of the virus, three contract wins, interim results and Directors share purchases.

One of the contracts will see Synectics' Security division provide, install and maintain safety critical on-board surveillance systems for Irish-based bus operators Dublin Bus and Bus Eireann as the NTA transitions to low emission and electric buses.

New hybrid and hydrogen-powered vehicles have been ordered by the NTA from UK and European bus manufacturers, and will take advantage of Synectics Security's latest recording technology, integrated reversing systems and comprehensive in-territory support.

Also within the transport sector, Synectics' IMS division has been awarded a new three-year framework agreement by Stagecoach, the UK's largest bus and coach operator. The contract is an extension of Synectics' 18-year relationship with Stagecoach, and covers the delivery of safety critical on-vehicle surveillance systems and maintenance support for its fleet of over 8,000 vehicles.

Meanwhile, it was encouraging to see that the leisure industry had 'reopened', and Synectics' Systems division was awarded a new five-year multi-million dollar support contract by a major casino operator for its flagship resort in Asia, further extending an existing long term relationship.

Under the contract, Synectics will continue to provide support and development of its market-leading Synergy 3 software platform, which plays an integral role in ensuring operational integrity, security and regulatory compliance at the resort.

These contracts underpin our belief in the scalability and flexibility of the Synergy platform to develop, and Synectics' proven ability to develop functionality as new requirements emerge.

Synectics is underpinned by a strong balance sheet, with £4.6 million of net cash as at 31 May 2020.

It is interesting to note that there has been a considerable amount of corporate activity in the sector. A few years ago, Motorola Solutions had no video surveillance products. It has now acquired Aviglon, IndigoVision and most recently, Pelco, making the company one of the largest in video surveillance. This confirms our view that a 'solutions' approach to this sector will gain market share, as opposed to a traditional seller of boxes – Synectics should ultimately be a benefactor of the consolidation taking place in the sector.

TOEHOLDS – as we have outlined in recent factsheets, we have deployed just over £1 million in new positions. Currently we have been unable to acquire sufficient shares at our desired valuation in this rising market to make these disclosable positions. However, we are confident of being able to achieve this and look forward to updating in due course.

Both are very different in terms of the value creation plan and catalyst. Toehold 1 is a recovery and self-help, much like the value play book which was used at Volex. It has been through a period of, arguably, over investment and the management team have enacted a plan to right size the cost base to drive margins higher. This is coupled with an aggressive policy to manage down working capital which is enabling the business to de-gear in the short term and will result in much improved capital efficiency over the medium and long term. The business has been affected negatively by COVID-19, but it continues to generate cash through this period. Ultimately, we expect that its revenues this year may be 10-20% below last year. It is currently trading around 6x EV/ historic operating profit. If management can execute their cost saving plan, of which just over half has been identified and actions taken, then it would be trading on 3x, assuming no revenue growth. Toehold 2 is completely different, an overlooked company which is growing quickly, and quicker through the corona-crisis. Despite this, it has not attained such a lofty premium as other, larger COVID-19 winners. We have been buying our shares at less than 10x earnings, and we expect the earnings to grow rapidly. Over the medium term, we expect that higher volumes will generate higher revenues and operational gearing on a largely fixed cost base given the business runs around 50% capacity. We think that this should present a much better quality business in due course with mid-teen operating margins and high cash conversion.

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

Kind regards

Downing Fund Managers

Downing

Portfolio construction (as at 31 July 2020)

Name	Sector	Market cap (£m)	% of the Trust	% equity held by Downing[1]
AdEPT Technology Group	Telecommunications	60.32	7.70%	9.79%
Duke Royalty	Speciality Finance	49.94	2.76%	3.60%
FireAngel Safety Technology	Electrical Equipment	15.19	5.34%	20.65%
Toehold One	Industrial Goods & Services	44.77	1.83%	4.57%
Hargreaves Services	Support Services	67.79	6.38%	7.36%
Pennant International Group	Software & Services	14.94	1.02%	4.47%
Ramsdens Holdings	Financial Services	40.09	5.92%	14.18%
Real Good Food[2]	Food Producers	4.98	20.73%	7.88%
Science in Sport	Food Producers	44.58	1.63%	4.15%
Synectics	Support Services	23.13	6.97%	12.52%
Toehold Two	Medical Equipment & Services	67.81	1.94%	1.57%
Volex	Electrical Equipment	207.82	15.25%	5.39%
Cash			22.54%	

[1] Total percentage of investee company held by all Downing managed funds.
[2] Real Good Food holding includes 0.69% equity and 20.03% debt split.

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