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Downing Strategic Micro-Cap Investment Trust

Investor Letter

January 2018

In May 2017, we set out to invest in a concentrated portfolio of companies which we believe are materially undervalued but have great potential to deliver long term earnings growth. We seek to identify and implement strategic catalysts which will deliver these earnings. As a corollary, these catalysts may also result in a rerating of the shares. Typically, these companies will have strong management teams and require supportive investors in order to achieve their longer-term goals.

In the eight months since the Downing Strategic Micro-Cap Investment Trust (DSM) launched, we have invested over 52.1% of the monies raised into a portfolio of ten businesses, each with a compelling investment case. Eight of these businesses are outlined below and there are an additional two where we are looking for liquidity to provide us with a material and disclosable stake.

Name	Sector	Market cap (£m)	% of DSM	% of equity held by Downing*
ADEPT TELECOM	TELECOMMUNICATIONS	74.07	6.36%	12.63%
BRAEMAR SHIPPING SERVICES	TRANSPORTATION	83.01	4.67%	6.33%
GAMA AVIATION	TRANSPORTATION	106.25	6.03%	6.26%
RAMSDENS HOLDINGS	FINANCIAL SERVICES	55.20	5.27%	15.42%
REAL GOOD FOOD GROUP	FOOD PRODUCERS	17.45	12.72%**	10.00%
REDHALL GROUP	SUPPORT SERVICES	31.21	6.97%	22.56%
SCIENCE IN SPORT	FOOD PRODUCERS	49.78	2.96%	13.37%
SYNECTICS	SUPPORT SERVICES	37.81	6.15%	13.14%

All figures correct as at 29 December 2017
** Total percentage of Company held by all Downing managed funds*
*** Holding includes 2.16% equity and 10.56% debt split*

We are pleased with our investment progress to date. At our current run rate we expect the Trust to be fully invested by around the anniversary of its launch. Supporting this belief, we have a well progressed list of companies classified as work in progress.

Operationally, all of the Trust's positions are performing in line with our original expectations, except Real Good Food which has, as a result, gone through significant management change. The culmination of this is a business whose investment case is delayed, but not diminished.

We believe that many of the other holdings are not yet properly understood by the market and that this will come right in due course. For example, Gama and Braemar are global businesses with scale – Gama is top three in its respective sector and Braemar is arguably second – they also have great strategies and management teams who we believe can deliver these. Yet both businesses trade on single digit earnings multiples and around a 50% discount to their closest listed peers.

We have used this first investor letter to outline the individual investment cases of our investee companies. Where these companies are existing holdings – Adept, Braemar, Gama, Real Good Food, and Redhall – we also outline progress against our theses to date, albeit we are very early in the planned investment journey for all of these holdings. In future, once fully invested, we expect to use this letter to update on company specific news and views

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and for providing more detailed analysis on the portfolio which generally wouldn't be warranted in the interim or annual accounts or in a factsheet (attribution, geographic exposure, valuation, etc).

The attraction with a letter is that as the Manager of DSM, we can more readily express our own opinions. It is with that in mind that we emphasise that all the views expressed herein are our own and shouldn't be read as consensus or investee management's own views, are subject to change and should not be interpreted as investment advice or a recommendation.

Company commentary – existing holdings

Adept Telecom (ADT.L)

DSM took a 4.6% position in Adept in early August 2017 as part of a wider investment that now sees Downing managed funds controlling 12.6% of the Company. Adept is one of the UK's leading independent providers of managed services for IT, unified communications, connectivity and voice solutions, and is a business that Judith MacKenzie has known for over a decade. This long-standing relationship has given us a high level of conviction over the ability and integrity of the management team, as well as allowing us the opportunity to assess strategy and execution over a prolonged period.

The Adept investment thesis centres on the following critical success factors:

- **Higher quality earnings:** Adept has migrated from being a provider of just fixed line solutions to a provider of higher margin managed service solutions across converged telecom and IT activities. This has the advantage of introducing higher quality revenue streams to the Group at a better margin. The Company has an enviable EBITDA margin (c21%), which, in combination with the low capital expenditure requirements, makes the operating structure highly cash generative.
- **M&A:** management have made a number of acquisitions since IPO. Initially buying fixed line and integrating with the existing estate at low multiples before focusing on buying small managed services businesses that could be scaled using the Group-established distribution channels. We have been impressed with management's ability to acquire businesses at attractive prices and how the management of these target businesses are brought into the culture of Adept to the point where they become an integral part of the organic growth engine.
- **Engagement:** Ian Fishwick, CEO, and John Swaite, FD, are well known to the Downing Public Equity team. Judith first met Ian in 2006 at the IPO of the business, and over this period a strong relationship and level of understanding has been reached. Our relationship with the business is highlighted by our invitation to the Annual Group Sales Conference at which we spoke of our support for the business and were able to get a good sense of the energy and enthusiasm within the operational management team that we believe will drive the business forward. This level of engagement with management is a foundational aspect of our investment thesis.

DSM's investment was via a purchase of director's stock post the acquisition of Atomwide. Based at Orpington, Atomwide is the UK's leading specialist in IT for Education with more than 3,000 schools and over 2 million users. We believe that this is an attractive deal – diversifying Adept's business materially into a new stream, education – and at a reasonable price. Atomwide reported revenues of £7.5m for the year ended March 2017 with nearly 80% of turnover and gross margin coming from recurring products and services thereby continuing the transition to higher quality revenues. The price paid for the business reinforced management's commitment to only paying attractive prices for businesses and was equivalent to just over 6x profit before tax.

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Post the acquisition, Adept has over 1 million Office 365 users, one of the single largest Office 365 deployments in the world. Included in the acquisition of Atomwide was a data centre at Orpington and a specialist app development team. Since the acquisition in August 2017 the sales and finance functions of Atomwide have been integrated into the Group reporting procedures.

These features demonstrate the investment thesis is developing as expected, and we would expect further acquisitions of a similar nature in 2018 and beyond.

Braemar Shipping (BMS.L)

DSM took an initial stake in Braemar in June 2017, which we added to over the following months. As at 29 December 2017, DSM owns 3.1% of the equity whilst Downing managed funds own 6.3%, making Downing the largest shareholder. Braemar is a leading international provider of broking, financial, consultancy, technical and other services to shipping and marine related industries. Downing Public Equity has been invested in Braemar for over six years, as a result, we know the business and management team well. Our initial investment came on the back of a profit warning in the summer.

Our investment case is based on:

- **Improving margins:** we expect global GDP growth to be positive year on year, which we believe should drive a steadily increasing demand for shipping and freight volume over the long term. We also expect shipping rates to improve further, aided by a shortage of shipping supply, albeit this can be lumpy and we don't attempt to explicitly forecast global supply. We assume that the supply curve is generally trailing the demand curve over the long term.
- **Restructuring:** operationally, we believe that a restructuring could help to improve Braemar's margins through cost savings. At the time of investment, we expected that the Marine Services restructure would result in a £6m per annum cost saving from 2018.
- **M&A:** we also believe that they could dispose of lower margin businesses and build or acquire higher margin businesses which will be accretive to Group margins. This could also be supported by a move to AIM through which the company would enjoy materially lower transaction costs. This move would also introduce a new shareholder base in line with their market cap, which is relatively small for a main list company.

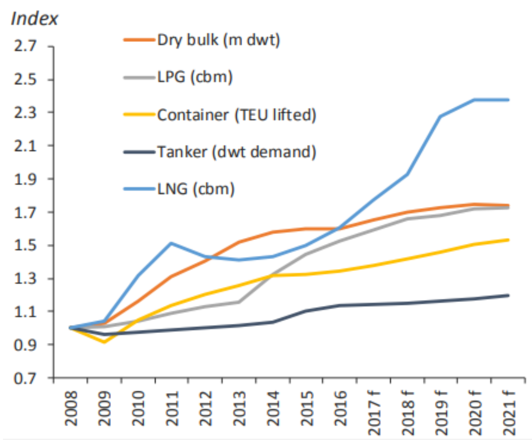
We have seen progress against most of these points. Broadly, there has been an improvement in shipbroking margins from around 6% in 2014 to 12.5% in 2017, and based on the points outlined above we believe this could get to 15.5% relatively quickly. In the best years, margins can move to the mid-twenties but we have ignored this upside for our valuation.

The interim results announced in October highlighted improving operating and financial performance. Notably, both the Technical and Shipbroking divisions performed well, the former having undergone restructuring and securing significant new project work, and the latter maintaining a healthy forward order book. Key to our cash flow based valuation methodology – recurring free cash flow generated in the six-month period was over £2.1m, a marked improvement from the prior period of a loss of around £3.4m. We expect similar financial progress in the second half.

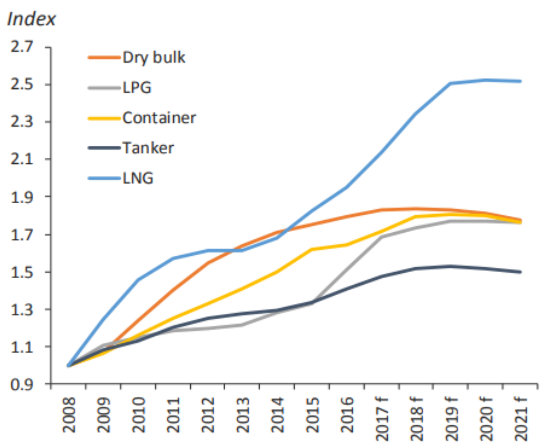
Braemar also announced the acquisition of NAVES Corporate Finance GmbH, a financial advisory business focused on the maritime industry and based in Germany. We believe this is a positive development for Braemar, adding a new division and revenue stream to the Group. We believe that the acquisition is relatively low risk as NAVES's specialism is in distressed debt which tends to be countercyclical. Over time, we expect Braemar to grow this division further to establish a full product offering with global reach.

In 2018, we expect further operational progress in terms of restructuring and the associated margin improvements. A move to AIM would be attractive for us and make sense given the intention to complete further acquisitions. At a high level, we think that the most recent NAVES deal, which incurred £1.6m of transaction costs, would have been approximately 50% cheaper had Braemar been AIM listed. Longer term, continued structural demand growth should deliver further support to our investment case.

Global demand is growing…



… but supply is tailing off



Source: Braemar Shipping Services, Preliminary Results for the year ended 28 February 2017, May 2017 presentation

Gama Aviation (GMAA.L)

DSM took its initial stake in Gama Aviation in August 2017 and now owns 3.0% of the equity, while Downing managed funds own 6.3%. Gama is a global business aviation service provider, headquartered at Farnborough airport. While our investment case in Gama is straightforward, execution will be key.

Our investment case is predicated on the following:

- **Organic growth:** we believe that Gama is operating in growth markets around the world. We expect this natural growth to be aided by the increasing cost of compliance which naturally favours players with scale, crowding out the smaller, localised operators that characterise the business aviation market. We also expect margin growth through operational efficiencies and new higher margin activities.
- **Consolidation:** Gama is one of the top three global players in the sector. Owing to the crowding out mentioned above, the fragmented market, and Gama's public listing, we believe that the company has the potential to be the consolidator of the market.
- **Rerating:** underlying the operational and market opportunity, we believe that the business is misunderstood and undervalued by the market. Key to a rerating will be Gama's ability to closely control working capital and consistently generate free cash flow. These are aspects which we believe are improving with every successive reporting period.

Gama has one of the longest investment horizons in DSM's portfolio, owing to the inorganic growth/consolidation element which we believe could be executed over many years. It is largely this aspect through which we expect to exercise our strategic influence as we can provide growth capital through time.

In the period since we invested, there has been good progress against our investment case. The June 2017 interim results highlighted markedly improved free cash generation of $5.7m. We expect similar progress in the second

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half, excluding one-off acquisition costs with respect to their Middle East operations. Key will be working capital management and this essentially depends on how successfully receivables are collected through December. This has historically been challenging but has been an area of great focus for the management team and outgoing FD. Management also outlined a four point plan to deliver operating margin improvements across the two divisions Air and Ground. The realisation of this would see Air moving from 2.9% to 5.0%, and Ground moving from 13.6% to 20.0%. We believe that these targets could be achieved organically as the business model matures geographically. Inorganic growth would expedite this and provide additional revenue on which to leverage the margin benefits.

With regards the Middle East, management made a strategic consolidation of the 51% of the existing operations which they didn't already own. They paid $5.1m for this share of a business which we expect will generate $1.1m and $1.5m of EBITDA in 2018 and 2019, respectively. This deal comes prior to the construction of a new facility at Sharjah airport in the UAE which will improve Gama's capability and overall business aviation capacity in the region. The Middle East is also undergoing regulatory reform and we expect this to drive demand for Gama's services over the longer term.

We have been highly engaged with management since the summer. The highlight of this engagement was the capital markets day in September. This was an opportunity for us to revisit the facilities in Farnborough and, more importantly, to meet the divisional management teams who outlined the opportunities that they saw in their regions.

Glasgow FBO and Scottish Air Ambulance

Sharjah FBO concept

Source: Gama Aviation, January 2018

Real Good Food (RGD.L)

DSM and Downing managed funds initially invested in RGD at the end of June 2017. Downing managed funds hold 10.0% of the equity, of which 6.8% is held within DSM. DSM also holds loan notes with the majority of the debt yielding 6.5% p.a and a smaller bridging loan yielding 10.0% p.a. The purpose of the loan notes is to give client funds investor rights and to provide some security in the turnaround phase of the business. These loan notes account for 10.6% of DSM.

RGD, headquartered in Liverpool, groups its operation into three segments: Cake Decoration, Food Ingredients and Premium Bakery. The two main divisions are Cake Decoration and Premium Bakery. The Cake Decoration business, led by the brand Renshaw, manufacturers sugar pastes and decorations (under the Rainbow Dust brand name). Hayden's, the brand under which Premium Bakery operates, is a manufacturer and distributor of premium bakery products, with clients including Waitrose and Marks & Spencer.

RGD is undoubtedly one of our more 'strategic' investments, which is reflected in the fact that Downing has a board position and enhanced investor rights through the loan note holding. Our investment case is largely unchanged since we invested, albeit there have been significant operational challenges in that time. Ultimately, these have delayed the delivery of (but not diminished) certain aspects of the investment case.

The most compelling aspects of this are:

- **Growth:** our investment was to provide a large amount of capex which we believe is capable of generating enhanced return on capital and, ultimately, improved earnings in the long term. This capital injection and capex investment was made on the back of known demand for both Renshaw and Haydens products. The culmination of this spend is a group of businesses which we believe represent some of the best invested in the UK food sector (a sector which is generally underinvested).
- **Governance:** in our view, the company has been held back by poor corporate governance and, arguably, a lack of attention to profitability, sacrificed for top-line growth at all costs. We believe that this current financial weakness is an opportunity, as all the businesses have a defined niche and an attractive product offering. With the introduction of appropriate financial controls, accountability and corporate governance – which we consider RGD are well on the way to effecting – we believe that the market will assign a value to the business which is closer to our own determination of intrinsic value.
- **Valuation:** we believe that the sum of the parts is materially greater than the current enterprise value. In all of our investments there is a valuation catalyst, however, we believe that the disconnect between intrinsic value and enterprise value is particularly significant in this case. We expect that the delivery of the above two bullet points will reduce this valuation spread.

Since we invested, there has been significant managerial change in the business. This includes a new FD and a new CEO, alongside comprehensive reviews of governance and control. We believe that the team are now beginning the journey to deliver results focused on profitability, not revenue growth.

The strength of the newly established management team and the underlying quality of the divisional businesses continue to provide us with confidence that the company is now on the correct direction of travel with a highly aligned and supportive core shareholder base. We believe the structure of the investment and the investor rights inferred has allowed us to be on the front-foot to help establish the necessary changes to drive value.

In the year ahead, we will be looking for delivery on key operational targets. There have been some implementation challenges with regards the new capex which has resulted in poorer than expected margins. We also expect a ratification of the fixed cost base. The combination of these factors should allow the true potential of the business to begin to shine through.

Redhall Group (RHL.L)

DSM first invested in Redhall in June 2017. This position was taken through the Trust's participation in a large equity placing of £9.5m (of which DSM committed over £4.0m) and debt conversion of £3.75m at a 10p placing price. DSM owns 12.3% of the equity and Downing managed funds owns 22.6%. This new equity was raised to fund working capital, specifically, to allow the business to deliver its growing forward order book of nuclear contracts.

Our investment case centres on:

- **Order book:** we think that Redhall's growing order book is undervalued in terms of its potential to grow, the visibility provided, and in terms of the quality of the underlying projects.

- **Critical infrastructure:** Redhall brings material exposure to high value UK public sector contracts, specifically in nuclear projects. We know these to be very long duration – for example, Hinkley Point which we expect will be constructed over eight to ten years, and Sellafield which has decommissioning timetables out to 2120. Being the public sector, we also have visibility on the tender pipeline and quantum, to which we can assign a probability based on Redhall's success in the past.
- **Improving margin:** as the business continues to deliver on new contracts, we expect operational gearing and continuous process improvement to lift margins. This is on the back of the completion of the Strategic Turnaround Plan which was executed by outgoing CEO Phil Brierley, and was focused on exiting capital intensive, low margin contracting activities.

Over the period since investment there has been considerable progress against our investment thesis. Redhall continues to benefit from material contract wins in the nuclear sector. The most recently announced – a three-year Teaming Agreement with Cavendish Nuclear worth up to £18m – effectively underwrites Jordan Manufacturing's business over that period. Cavendish's role is to provide bespoke equipment for the treatment and management of nuclear materials at Sellafield. In fact, the Cavendish contract with Sellafield spans ten years in total and is worth up to £95m in the first three years, so we would expect there could be additional upside in the years to come for Jordan and Redhall.

Admittedly, the problem with large and long duration public contracts is the tendency for delay. In Redhall's trading update in October, management highlighted one such delay, again in the high integrity Jordan Manufacturing business. The most significant delay they outlined was a Hinkley Point C marine works contract which we estimated to be around £8.0m. The market took this news badly, and was reflected in the share price drop. We think that this was an overreaction since the quantum was simply deferred to the next financial year rather than cancelled completely.

We expect 2018 to bring further progress against the investment case with a large backlog of tender opportunities and management's focus on delivering margin improvement. To this end, the Company appointed a new CEO (an internal hire from COO position) who has considerable experience in manufacturing and process improvement across a wide range of specialist engineering businesses.

Company commentary – new additions to the fund

In the period since our half-yearly report to 31 August 2017, DSM made three new investments in Science in Sport, Ramsdens Holdings, Synectics, and two smaller, toehold positions.

Science in Sport (SIS.L)

Science in Sport is a leading sports nutrition company that develops, manufactures and markets sports nutrition products for professional athletes and sports enthusiasts.

Downing managed funds initially invested in the company in 2013 and were impressed by the strength of the brand and the strong management team. The business has sector-leading gross margins and we believe that this will continue. We believe revenue growth will further improve utilisation of the current facility and the company's growing e-commerce business will provide additional margin support.

In 2015, Downing managed funds made a follow-on investment in SiS to support international expansion into Australia and the United States. We believe that management has now established a solid platform for continued growth in these regions.

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In November 2017, SiS returned to the market for working capital and growth investment for further expansion in the US and Italy, and into a new target market for SiS – football. DSM participated in this placing, providing £1.5 million through an equity placing at 70p to raise a total of £14.0 million from existing and new institutional holders, and a further £0.8 million through an open offer, prior to expenses. DSM holds 3.2% of the company's equity and Downing managed funds hold 13.4% in total.

We are often asked about how SiS fits into our value process as it is loss-making after heavy investment in sales and marketing. Our valuation approach in this case is centred around incremental return on invested capital on our monies. It assumes an exit at a multiple at least as great as the sector average, which we believe to be around 2.5x enterprise value (EV)/sales. On this basis, we believe that the company can deliver more than a 15% IRR over our investment horizon. There is upside risk to this valuation if the exit multiple increases, which we believe is possible due to the quality of the gross margins and brand. The most recent sector M&A has been closer to 3.0x EV/sales which would imply over a 25% IRR on our same assumptions. We are comfortable taking this exit driven view given the volume of transactions in the space.

SiS is a business which we know well, and where we have provided support to management as well as financial commitment since 2013. After this most recent fundraise, we expect that management will be focused on delivering cost effective revenue growth. We would not be surprised if the business was acquired in a few years.

SiS supported over half of GB's Rio medal haul

Whey20 – an example of SiS's innovation in protein delivery

Source: Science in Sport January 2018

Ramsdens (RFX.L)

Ramsdens is a diversified financial services provider and retailer offering foreign currency exchange, pawnbroking, precious metal purchasing and selling, and jewellery. It retails to a large, repeat and growing customer base and operates mainly in the North of England, Scotland and Wales from over 120 stores.

In December 2017, Downing managed funds invested over £7.0 million, of which DSM invested £2.6 million. DSM holds over 5.0% of the equity and Downing managed funds have over 15.0% of the equity.

At the time of DSM's investment, Ramsdens was an existing holding in the Downing Monthly Income Fund as well as Downing's IHT & ISA portfolios. Our investment process is based on highly prudent assumptions by default, until our due diligence can establish sufficient evidence that these can be relaxed. Initially, these prudent base line assumptions allowed the Ramsdens investment case to meet the return targets for these other funds, however, it didn't meet the 15% p.a. return hurdle for DSM. As we continued our due diligence process we gained a deeper understanding of the business, management's approach, and Group strategy. As a result, we have been able to expand our base line assumptions such that we now believe there to be a significant mispricing opportunity. Specifically, we believe that the payback profile on new stores should be more favourable than the market currently assumes.

We believe that the business is run by a strong and conservative management team and it has potential to deliver earnings upgrades in the near term. This may be bolstered by expansion into different products or additional store roll-out, for which we could provide strategic support.

Synectics (SNX.L)

Synectics is a leader in the design, integration, control and management of advanced surveillance technology and networked security systems. It has two main business segments: Systems, and Integration and Managed Services. It operates mainly in heavily regulated industries, including gaming, transport and critical infrastructure, high security and public space applications and oil and gas.

We have been following Synectics since early 2017 and, although we liked the business initially, we believed that the valuation appeared stretched and we could not find any sizable liquidity. Over the course of the last few months, we have been on site and spoken to several board members. We have been impressed by their long tenure, detailed knowledge of the business and understanding of its potential. Subsequently, we have gained further confidence in our forecasts, underwritten by numerous large contracts.

In December 2017, the share price weakened and a liquidity opportunity allowed us to take a 13.1% equity stake across Downing managed funds, of which 9.1% is now held by DSM.

Our investment case is predicated on the strong and growing forward order book, which has increased by 28% in the first half of their 2017 financial year. We see great potential in the gaming market where Synectics has an existing client base of global casino owners and operators. Having recently restructured (on the back of the oil and gas boom and bust – O&G was a key sales channel), we believe that the business is more operationally geared and could double its return on capital employed in the mid-term. We also value Synectics' focus on managed services which contribute c25% of higher quality recurring revenues.

We see the opportunity with Synectics on two levels - the first is an improvement in operating performance and the second, more strategic, is consolidation potential in what is a fragmented sector with exposure to highly regulated markets.

Toeholds

We are currently in the process of completing due diligence on two additional companies where we have taken toehold positions. The first is a business which Downing Public Equity has known for several years. It is in the middle of a strategy change but we believe it has potential as a long-term value play. We would expect this position to be highly strategic if we build a material stake. We have taken a small position based on available liquidity and the scale of the value opportunity which we believe could materialise.

The second is a company on which we have completed our diligence but have been unable to engineer sizable liquidity. We expect that we will be able to build a disclosable position in DSM in the coming months. The business has interesting opportunities in highly regulated markets across the UK and Europe.

Work in progress (WIP)

Our WIP has evolved significantly over the period since the Trust launched. Our list is structured into companies in which we are already invested across our other Downing managed funds, and a list where we are not holders but have identified an attractive opportunity that merits further due diligence. These may be where we have historically been holders but sold out as we lacked fund scale to take a strategic position to allow us to effect change. The split at launch was around 30% existing and 70% new names, this has evolved now to be more heavily weighted to new names as we have converted several deals involving existing investments.

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We have stepped away from a few late stage potential investments to date. The first was a large deal where we exited the process at the eleventh hour as it appeared that the terms had moved against us (literally) overnight, in terms of both valuation and structure, and the management team changes were not as strong as the ones which we proposed. There were two others which we found had compelling valuations but lacked management quality or alignment.

We assess the quality of a management team in terms of: qualitative aspects, which typically involves interviewing the executives and forming an opinion on their experience and operational performance; and quantitative aspects, whereby we look at their history of capital allocation decisions and decide whether these have been in the interests of (minority) shareholders. We also assess how aligned management are with our interests going forwards.

Including the toeholds mentioned above, we believe that our current WIP looks decidedly healthy in terms of progressed due diligence where we would be comfortable taking a full position tomorrow if the opportunity came along.

One opportunity of note which could become a large position in DSM is a company which we have been engaged with for over 12 months. This business has some exciting growth drivers and is at the beginning of a multi-year strategic journey which we believe could deliver material revenue growth and margin accretion. It is a company which we have tracked for 12 months. In this time, we have met management on numerous occasions, been on site in the UK and in Europe, and had countless hours of phone calls refining our investment case. Despite all of this, to date, there has not been an event to allow us an entry point.

Behind these relatively mature ideas, we have a longer list of names requiring further due diligence or where we are already investors and expect that there may be a liquidity event. In terms of priorities, we try to bring as many ideas to a conversion stage as possible, then we simply wait for a catalyst if it is not immediately available.

There is follow-on potential in a number of our existing holdings. We hope to see progress from Gama Aviation in rolling out their inorganic strategy which would most likely require external financing. Adept is also employing a roll up strategy and this could require further funding down the line. Braemar and Synectics may also present an opportunity to provide further capital.

This has been our story so far. 2018 is an exciting prospect with a portfolio of names in which we have great conviction. Undoubtedly, there will be some hurdles throughout the year, but we believe that our active approach puts us in a strong position to generate long-term shareholder returns despite short term fluctuations.

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

Kind regards,

Downing Public Equity

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All information and figures correct as at 29 December 2017.

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