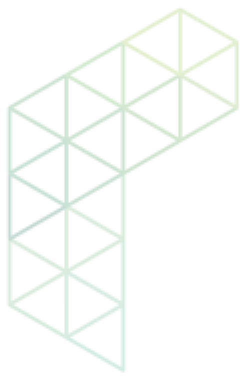


Downing

Downing Strategic Micro-Cap Investment Trust PLC

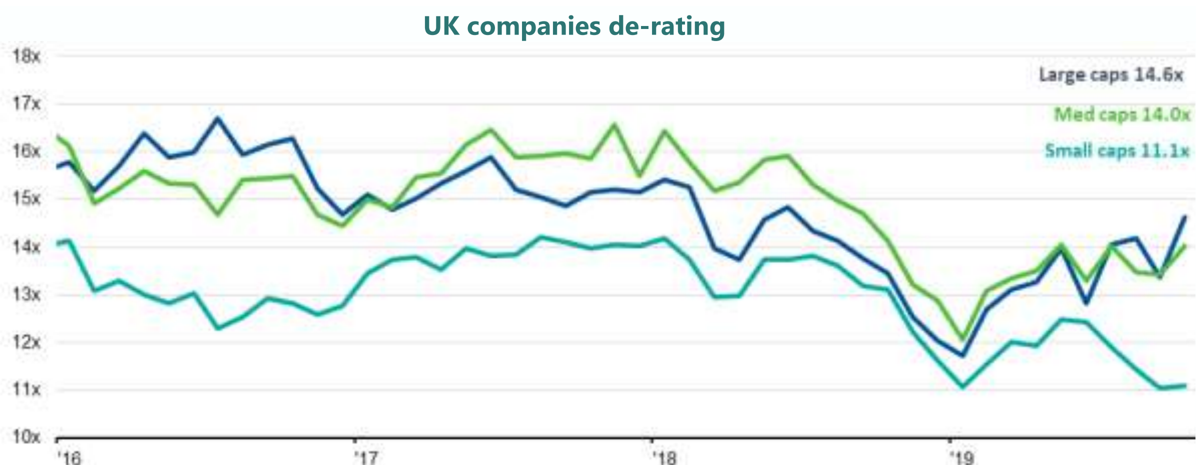
Investor Letter

October 2019

In the two and half years since its inception, the Trust and its underlying holdings have been through significant strategic change. At the outset we identified businesses that we thought had great potential to generate strong returns over the long-term; which were attractively priced; and where we could achieve a material and influential stake. All these companies presented a problem or misunderstanding which we believed could be addressed through our involvement. In our view, this was the reason that they presented good value versus their long-term potential.

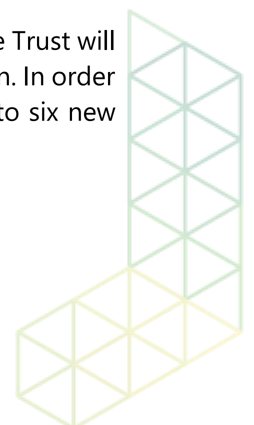
In our most strategic positions, we are happy to report that we consider many of the underlying issues to have been addressed. Unfortunately, the interim period has been accompanied by significant value erosion as several positions underperformed at the same time. We think that the Trust and its holdings have come through the worst of the drawdown period and, save some tweaking which will inevitably be required, consider the holdings in a good position going forwards to increase shareholder value.

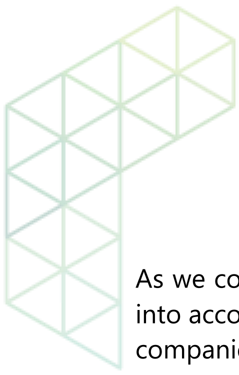
Alongside this disruption, UK companies have faced significant headwinds, with smaller companies de-rating since the launch of the Trust by over 20%. On that basis, our underlying holdings would have had to increase earnings by over 25% just to stand still – through periods of significant change, that was a tall order. Some have achieved this, such as Volex, which reported $12 million of adjusted operating profit a year ago and this year reported $21 million (or a 26% increase on a per share basis). As outlined later, we think that Volex is on the road to almost a three-fold increase in operating profits in only a few years.



Source: Liberum SMID Monthly. October 2019.

Now that we are hopefully through the roughest patch, we are considering what the future of the Trust will look like. We have twelve holdings, and the mandate provides capacity to take that up to eighteen. In order to diversify risk and provide greater opportunities for long-term growth we intend to add up to six new positions in due course.





As we consider this, combined with the relatively attractive valuations for new money, we must also take into account that economic headwinds are growing, and trading conditions are likely to get tougher for all companies in the near term.

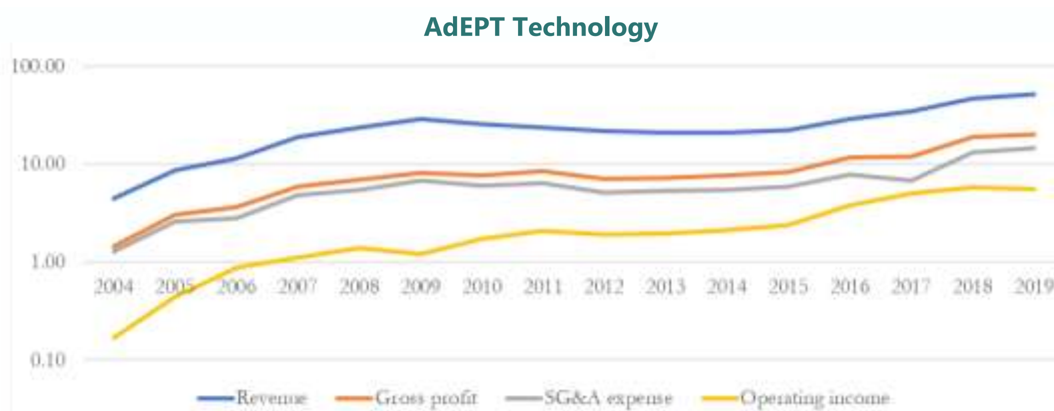
In this letter we discuss operating cash flows, free cash flow and the ability of a business to withstand a depressed trading period. An attractive model and strong, resilient fundamentals are only part of the picture. Valuation is the other important risk aspect and as we demonstrate later on, our screens are populated with more extreme value opportunities now than at any other time since the launch of the Trust.

Focus on operating cash flow

Our process is cash flow focused and we aim to identify businesses which a) have historically, or b) do currently, and c) have the near-term potential to generate significant positive free cash flow. As a minimum, we aim to satisfy a or b, along with c. The beginning of this process is to understand the drivers behind operating cash flows, then to understand the catalysts which could cause this to change. We prefer opportunities where the catalysts are tangible and within management's control. Broadly, the extent to which a business has a strong market position, high or low revenue cyclicality, high or low operating leverage, and high or low financial leverage, determines the systematic risk to that company through the cycle. All these factors feed into our understanding of operating cash flows.

In good times, high operating leverage – a high proportion of fixed costs versus variable costs – can generate outsized profits as growing revenues and high gross margins generate a greater proportion of drop through profit. But in leaner times, businesses with high fixed costs tend to struggle, particularly those with more variable revenues. If this is combined with high financial leverage the situation inevitably leads to a destruction of value.

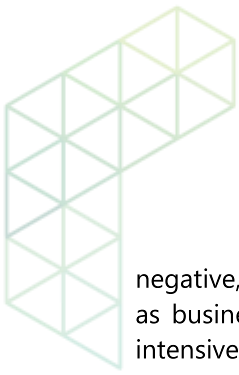
AdEPT, with its high degree of recurring revenues and relatively low concentration, combined with high margins, has attractive operating attributes. We believe that the contracted nature of the revenues provides ample support for the leverage, alongside a relatively flexible cost base in leaner times. In the last downturn, AdEPT managed to grow operating income despite revenue and gross margin pressure through a more flexible operating cost base, as shown below.



Source: AdEPT Technology financials. FactSet. October 2019

Are there attractive working capital attributes?

The working capital cycle is either positive (collecting cash before paying suppliers), or negative (suppliers on shorter term than customers). Our analysis then focuses on understanding how these profiles change over time. We can typically assume that a model with a negative working capital cycle will always be



negative, and likewise a positive working capital will always be positive. However, the detail is important, as businesses with a negative working capital cycle can find that growth becomes much more capital intensive than historic trading periods.

True positive working capital cycles are uncommon. In some cases, like Applegreen which we hold outside of the Trust, you can evidence an attractive positive working capital cycle. In its fuel business, customers typically pay immediately and Applegreen pays its fuel suppliers in 20 days or more.

Even when we have a good insight, working capital can act differently to what we expect. Take Gama Aviation – we understood the management business to be self-funding under normal conditions. When Gama signs a new 'tail' into its fleet the customer pays forward typically six-to-eight weeks of operating expenses and management fees. Costs incurred over the period are drawn down against this pre-funded balance and invoiced at the end of the month. This sounds great on paper, however in practice this business has absorbed more working capital than we expected. The risk of non-payment is reduced by security over the aircraft; however, this can take a significant amount of time to unwind from creditors. We are working closely with management to refine our understanding of the working capital and risk in this part of Gama's business.

More positively, in times of opportunity, companies like Ramsdens can turn inventories into cash quickly. Recently, Ramsdens booked a £0.6 million exceptional profit as they opportunistically took advantage of the high gold price and melted down some slow-moving stock. In a tougher economic climate, or a slower market for second-hand jewellery, this is an attractive and liquid channel to generate cash. Outside of the Trust, we own an industrial distributor. Distributors tend to have preferable operating conditions in downturn periods. They maintain large inventory balances which they can turn into cash with little re-investment. While revenues and accounting profits are flat or declining, cash flows after working capital are typically higher, which allows a natural de-gearing and/ or sustained shareholder distributions through tougher times. Subject to price, we think that this company could be an attractive opportunity for the Trust in due course.

Maintenance capex is key

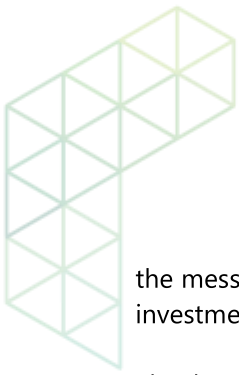
Once we have derived net operating cash flow, the final consideration is maintenance capex. We are concerned with the amount of cash required for the business to standstill and replace depleting assets. The residual cash is available for growth, reducing debt or for distribution to shareholders.

Many companies do not provide much detail on maintenance capex and it must be inferred from conversations with management or through significant analyst judgement. Depreciation can be a proxy for maintenance capex depending on the type of business, but one should determine as a minimum whether a company is over or under depreciating assets. In some cases, we see exceptional reporting quality where management go beyond what is required to provide investors with detail on what is maintenance and what is growth, such as The Gym Group, who provided an excellent overview and breakdown between expansionary and maintenance capex in their presentation of annual results.

Conclusion

Many of the Trust's companies are capital light and have low maintenance capex. Remembering that growth capex is discretionary, those which do appear more capital intensive can also turn off this spend during periods of weakness in order to preserve cash.

As our companies' head into potentially leaner times, it will be important to drive a distinction between maintenance and growth capex. In current markets where sentiment is so negative, we are pressing home



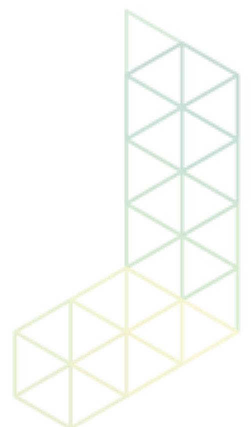
Downing

the message to our companies that improving reporting with greater detail can provide more compelling investment cases for stakeholders currently sitting on their hands.

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

Kind regards,

Downing Public Equity



Portfolio activity

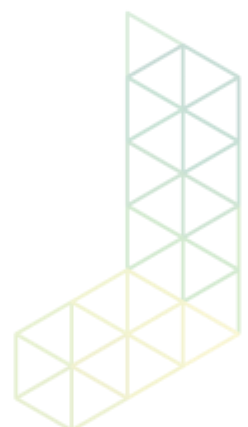
The portfolio raised £0.51 million of cash in the quarter, primarily through the distribution of partial refinance proceeds from Real Good Food to the Trust, totaling £0.34 million.

Work in progress (WIP)

Our WIP list remains strong and our screens are turning over regularly with new ideas. While not all are suitable for the Trust, some are.

It feels increasingly like a buyers' market, more so than in the recent past. Some darlings of the stock market on heady valuations are struggling to justify those ratings as they deliver lower than expected growth and/ or operational setbacks. Subject to liquidity and quality, these enter our longlist of opportunities. But we do not feel it is necessary to move quickly.

We are seeing many opportunities like the distribution business mentioned previously which present good value based on current and prior year earnings, but where the market seems overly concerned about the near-term growth or other operating issues. These are attractive if we can deduce that the issues are transitory and we can be patient, allowing growth to return. In many cases these types of opportunities are accompanied by a (growing) dividend, rewarding the investor for their patience. And such is the risk-off sentiment currently that we have over 80 companies on our screen trading at below 8x enterprise value to operating profit, which is around double that when we launched the Trust and 50% greater than a year ago.



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Reporting highlights

	Jul	Aug	Sep
AdEPT Technology	Results: in-line		CMD and letter
Braemar Shipping	Various		
Duke Royalty		Follow on	Results: in-line
FireAngel	Various		Various
Gama Aviation			
Hargreaves Services	Results: in-line		
Pennant Int'l	Acquisition	Trading: behind	Results: behind
Ramsdens			
Real Good Food		Results: in-line	Various
Science in Sport	Trading: in-line		Results: in-line
Synectics	Various		
Volex	Trading: ahead		

AdEPT Technology Group

AdEPT reported in-line full year results with encouraging financial progress across all metrics. Revenues increased by 11%, through a combination of organic sales focus and the contributions from acquisitions in the year. Gross margins were materially improved from 47.7% to 49.4%. The revenue and gross margin improvements drove an 11% increase in EBITDA, now £10.8 million. Crucially, managed services – which provide greater visibility on revenues – are now 75% of total revenue, up from 70% in the prior year.

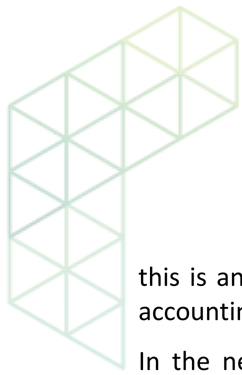
In-line with management's focus on communicating the capital light nature of the business, only 1% of revenues were expensed on capital investments. This drove free to cash flow to the firm of £6.1 million, and prior to less favourable timing on working capital, this would have been £8.8 million. The strong underlying free cash flow generation funded a 12% increase in the dividend and in future periods should contribute to the ability to de-gear the balance sheet or further value accretive acquisitions.

Management have been active in the period and have taken on board our thoughts around increased shareholder engagement and communications. In September, the company hosted a capital markets day and issued its inaugural shareholder letter from the chairman, which can be found here:
https://www.adept-technology-group.co.uk/wp-content/uploads/2019/09/Shareholder-Letter.pdf

Duke Royalty

We thought that Duke's results were positive, indicating that royalty streams are beginning to be collected and generate profit growth. There are now 12 underlying partners, six in the underlying Duke portfolio and six in the Capital Step portfolio. 100% of the potential annual adjustments have been achieved and the business announced that they have a healthy WIP list alongside refinanced debt which will lower the overall cost of debt servicing and generate more free cash flow for equity holders. Coupled with higher operating leverage going forwards – as costs stabilise and revenues grow – we think that the business is in good shape.

To our mind, there are a couple of negative factors affecting sentiment towards the company. Firstly, the market views the Capital Step acquisition as higher risk, and generally there have been some funding's agreed at higher than expected yields which would indicate higher risk. We think that this risk is being adequately diversified across the portfolio. And secondly, the short attack on Burford Capital may have cast negative light across all models which might be viewed as 'exotic' or where they are not easily understood. We think that



this is an overly prudent view as Duke's model is highly proven outside of the UK, is cash generative and accounting profits are matched by cash.

In the near term, operating profit is expected to step up to around £10 million, alongside shareholder distributions of over £6 million would generate yield of around 7%. We expect return generation in the form of dividend yield, alongside multiple expansion to rebase the growing yield to something closer to a 'market yield' and as the business makes good on its ability to reinvest and grow.

Gama Aviation

Gama issued results which were in-line, albeit the cash performance was not encouraging as the business continues to struggle to collect from a couple of outstanding debtors. However, there were some genuine one-off movements in the cash which should reverse in the second half – large items like the helicopter funding which we understand is in the latter stages of having finance agreed. Central costs have increased materially following investment, which was required post the fundraise and presumably, considering the governance and control failures which were uncovered earlier in the year.

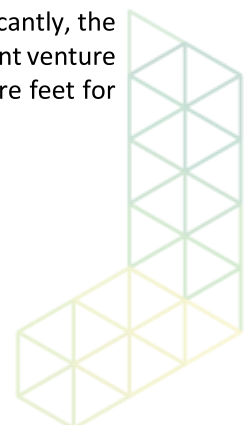
The management business, despite being a part of the model which we initially liked – owed to the regulatory barriers, the asset security, the visibility on contracts/ tails, the asset light nature, and the working capital profile – is now something which we are finding more challenging. In our conversations with the board at the AGM we expressed these concerns alongside the active market in the US for all things business aviation.

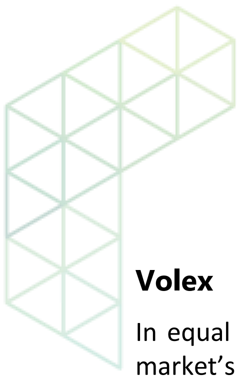
We are positive regarding the maintenance business and several high-profile special missions' contracts. The Bournemouth move is generating much improved operating margins. The US business is still depressed following a round of investment; however, we are hopeful that this can begin generating operating margins closer to those of the European business. CASL in Hong Kong looks to be recovering, albeit the P&L contribution there only tells half the story. CASL has high depreciation charges and we understand that business generates high operating cash flows (we think around $4-5 million, while the P&L shows closer to $1 million). Gama's share of profits via a dividend is a) at the discretion of CASL management; and b) proportional to the P&L rather than the cash flow. We have urged the Gama management to pursue a greater, cash-matched contribution from the Chinese associate.

The appointment of a new CFO from Signature – whose specialty is in fixed base operations – alongside Hutchison's history in aircraft maintenance, makes us think that this may be the focus for the business going forwards. While more capital intensive, maintenance possesses many of the same attributes which we like in the management business, such as barriers to entry and regulatory drivers.

Hargreaves Services

Hargreaves' full year results offered some encouraging takeaways regarding the strategy and our realization-themed investment thesis. Legacy assets reduced from over £60 million to £12.8 million, with further reductions expected through this current financial year. Hargreaves Land, the prop-co which we have pushed for, is key to our thesis and received further investment in the period. Cash generated from the legacy mining operations is expected to fund property development opportunities going forwards. As we have written previously, Blindwells has achieved its first conditional sales of fully serviced plots and this marks the beginning of an expected 10-year journey to develop land for around 1,600 homes. Greater Blindwells, which now has approval in principle, will add a further 900 homes on land owned by the group. Finally, and significantly, the business has identified other development opportunities and Hargreaves Land has entered into a joint venture to develop a six-hundred-acre site with planning permission for 3,100 homes and 1.5 million square feet for industrial commercial and logistics use.





Volex

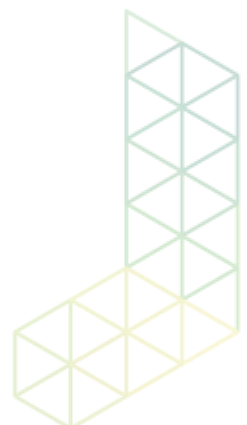
In equal measures, we continue to be both impressed at management's progress and astounded and the market's lack of empathy with Volex's story. There has been some material news since the results were published in June, which we discussed in our last letter.

Volex announced the acquisition of Servatron, a Washington-based company supplying printed circuit board assemblies and sub-assembly solutions to a diverse range of customers. The price paid, $28.5 million versus last year's profit before tax of $2.5 million looks relatively expensive versus Volex's prior transactions. However, Servatron generated almost as much profit before tax in the first half of its current financial year, than it did in the whole of last year. Annualising this indicates they may have paid around 7x profit before tax, which seems a fair price given the growth.

The annual report included some disclosure around bonus performance targets for this financial year with a range from $24.4 to $28 million operating profit and 80-90% cash conversion. Given their management's track record of delivery, we are confident that they will achieve within this range, putting Volex on only a 4.7-5.4x EV/ operating profit multiple for this year. We like defined incentive targets and they can be a reliable indicator of a conservative outcome for the year.

We continue to be deeply impressed with Volex's performance and look forward to a time when the market might also wake up to the opportunity. Until then, the value anomaly persists…

Source: consensus estimates. October 2019.



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Portfolio construction (as at 30 September 2019)

Name	Sector	Age[1]	Progress against thesis[2]	Market cap (£m)	% of the Trust[3]	% equity held by Downing [4]
AdEPT Technology Group	Telecommunications	2.25	Ahead	83.19	10.04%	11.15%
Braemar Shipping Services	Transportation	1.50	Behind	62.30	3.75%	2.71%
Duke Royalty	Speciality Finance	1.25	Ahead	95.94	5.69%	6.37%
FireAngel Safety Tech	Electrical Equipment	0.75	Behind	13.67	2.79%	17.56%
Gama Aviation	Transportation	1.75	Behind	45.82	3.91%	6.62%
Hargreaves Services	Support Services	1.50	In-line	76.81	6.34%	6.85%
Pennant International	Software & Services	0.75	Behind	28.17	1.85%	5.20%
Ramsdens	Financial Services	1.75	Ahead	59.21	7.78%	15.63%
Real Good Food[5]	Food Producers	2.00	In-line*	6.85	18.80%	7.88%
Science in Sport	Food Producers	1.75	In-line	64.17	2.88%	5.59%
Synectics	Support Services	1.75	In-line	28.03	7.46%	12.52%
Volex	Electrical Equipment	1.25	Ahead	129.79	14.16%	7.15%

[1] Weighted average age of the Trust's investment, including initial investment and all follow-on investments. Rounded to nearest 0.25.
[2] Based on Downing's interpretation of progress against original investment thesis, or revised thesis, where applicable.*
[3] Includes cash
[4] Total percentage of investee company held by all Downing managed funds.
[5] Real Good Food holding includes 0.93% equity and 17.87% debt split.

Portfolio valuation statistics *(as at 30 September 2019)*

	P/Book	P/ earnings[6]	Margin of safety[7]	Upside[8]
Average	1.42	9.27	46.18%	106.66%
Median	1.20	10.22	48.42%	94.21%
Weighted average	1.45	8.19	32.60%	65.28%

[6] *Normalised as: (Downing expected EBIT – (cost of debt * debt))* (1 – tax rate).*

[7] *1 – (current price/ intrinsic value). Intrinsic value = Downing estimate. Price from FactSet*

[8] *(Intrinsic value/ current price) – 1. Intrinsic value = Downing estimate. Price from FactSet*

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