St Magnus House,
3 Lower Thames Street,
London, EC3R 6HD

020 7416 7780
customer@downing.co.uk
www.downing.co.uk

Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

31 August 2021

When we last wrote in February, the Downing Strategic Micro-Cap Investment Trust (DSM) share price was 72p and the NAV per share was 81.8p. We commented that the portfolio feels like a coiled spring, with pent up value, which we thought could be released on several counts. As at 31 July 2021, the NAV per share stood at 88.66p, yet the share price had declined to 70.75p, with the discount widening to 20%.

This is thoroughly disappointing given all the progress which we have made through Covid-19. Perhaps investors and ex-investors think that DSM has exhausted all its upside. We think that couldn't be further from the truth, in fact, we think we're just getting started. As we have said in every investor meeting this year – we think that the prospects for this portfolio are brighter now than at any point since the IPO in 2017.

Why are we so confident of good prospects?

1. We feel we are through the trough of the J-curve we endured at the beginning of this investing journey. Boards have been reshaped, strategies refocused, and tough positions exited with the proceeds recycled. As we own more vintages of investments, future J-curves are unlikely to be correlated going forwards, reducing drawdown;
2. Our companies are in rude health and performing admirably across the board. Insiders are buying shares in over half the portfolio and we have seen multiple upgrades from Volex, Hargreaves, and Flowtech, and considerable strategic progress with Venture Life and Duke Royalty, to name a few;
3. We have halved our exposure to Real Good Food which has been a significant barrier to investors understanding the Company (more on this on page 3). This was profitable and returned a significant amount of cash to DSM;
4. We have over 13% of cash to deploy in a market which is increasingly nervous, and we have a well progressed WIP list on which to invest that cash. But we are in no rush to do so and will wait for the right conditions and right valuations;
5. Just this month, our newest investment, Tactus, completed a significant funding round of over £40 million with a highly regarded £1.5 billion technology investment trust.
6. Finally, the portfolio presents fantastic value compared to the market and peers, and there are some exciting catalysts in play over all time horizons.

On the final point, we continue to think that the DSM portfolio offers great value, great growth, and lots of catalysts over the short and medium term. There are still compelling Covid recovery stories within our portfolio – Ramsdens, Synectics, DigitalBox and Toehold D are trading at or below 5x forward EV/ EBITDA and offer significant upside through multiple expansion and earnings growth as more normal trading resumes.

VOLEX continues to impress us, so much so, that we have been adding modestly to our position on bad days – the market is becoming impatient, and we are more than happy to take advantage of this.

The company reported an exceptional set of full year results which highlighted great progress across all divisions, but particularly within the electric vehicle division which grew revenues by 193% to $53.1 million. The electronics division grew, aided by the acquisition of DE-KA which added $9.2 million of revenue and $1.8 million of adjusted operating profit. Had DE-KA been owned for a full twelve months, the full year contributions would have been $60.7 million and $12.2 million, respectively. Medical was resilient and we are looking forward to a strong recovery here. Also of note was progress in the industrial division, which includes data centre customers, which enjoyed strong growth and where an upgrade cycle could drive significant upside.

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Management have consistently upgraded guidance since we have owned it and we think that there are several avenues for upside to consensus forecasts over the next year with current 2022 and 2023 adjusted operating profit guidance at $52.0 and $56.9 million, respectively, versus $42.9 million delivered in FY2021. We present some of our upside assumptions below.

Firstly, assuming the full 12 months of DE-KA performance (rather than just two) would alone generate a small beat on the current $52.0 million forecast at just over $53.0 million. However, management have disclosed two key catalysts here – that they have won a significant new customer, and that they are investing in new manufacturing lines which will expand capacity by around 25%. We believe that most of this capacity expansion will be filled, such is the strength of current demand and that which will be introduced by the new large customer. Napkin maths suggests that, all else equal, DE-KA alone could drive upside to the $52.0 million consensus of $2-4 million of adjusted operating profit on a fully annualised basis, with the capacity not likely to come online until H2 this year. We keep margins constant in the above, but we would expect operating leverage to come through as more volume is put through facility.

Upside driver number two could lie in the electric vehicle (EV) segment which posted rapid growth this year, from $18.1 million in FY20 to $53.1 million in FY21. Consensus for this year indicates revenue estimates within EV of around $70 million. Based on reported growth rates, we think this could be conservative. Whilst H1 electric vehicle revenues were not disclosed, we think these were likely $12.0-15.0 million and we think that H1 exited at around $5 million per month run rate. To make $53.1 million revenue reported for the full year would mean H2 revenues of $38.1-41.1 million. Consensus suggests only 30% growth this year, and we just cannot see how the growth in this division can collapse to such a low level despite well-known supply side constraints. Looking more closely at the run rates, H2 averaged $6.6 million per month, which would annualise up to $79.2 million per annum. But if we consider ramping through the half from a H1 $5.0 million exit rate, it seems likely that the H2 exit run rate revenue could be nearer to $8.0 million, annualising to over $95 million of revenue. Assuming electric vehicle operating margins of 10%, in line with the group (in reality, they are currently higher), then there is potentially a further $2.5 million of upside assuming these run-rates continue. Finally, if management can vertically integrate this business it could be worth a further 200 basis points of operating margin, which ought to generate like-for-like earnings growth, and/ or be offset against more aggressive pricing to generate revenue growth.

We are also bullish on the recovery within healthcare, with management signalling run rates now at or exceeding pre-Covid levels. Backlog across healthcare systems is significant and as we exit the pandemic it seems likely that investment will be required to address this. Philips Healthcare recently reported almost 30% growth in order intake in its Diagnosis and Treatment division, and further double-digit growth in Image-Guided Therapy, Ultrasound and Diagnostic Imaging. Philips are a significant customer of Volex's and this recovery in healthcare demand should benefit the company. Yet Medical revenue consensus to us look to be broadly flat versus last year's $112.7 million level which ought to be very beatable this year, considering the prior year was $116.0 million.

Perhaps further out, but another potentially meaningful driver of upside, could be the move to 400Gbs speeds at Volex's data centre customers. This ought to drive replacement-like revenues from the current 100Gbs installed base. We also note various comments from management around increasing investment in this division, particularly around headcount and engineering, which is supporting new products here, including on more customised solutions which carry a higher margin.

Finally, and perhaps the most eagerly awaited, is further bolt-on M&A. We think the most likely scenario here this financial year, if not this calendar year, is an acquisition (or several acquisitions) similar in size to DE-KA (i.e. around $60 million of revenues) at around the 10% adjusted operating profit level, with Volex likely to pay in the region of 6-7x adjusted operating profit, or perhaps slightly more for a higher growth and quality asset. It seems reasonable to assume therefore that a further $6+ million of annualised operating profit could be brought into the group in short order.

Pulling these upside scenarios together and, cautiously aware of current uncertainty across global supply chains, we see a credible pathway to Volex achieving the targeted $65 million operating profit target on a pro-forma basis over the short term. A lot must go right but we think that the direction of travel here is strong. Management have proven themselves so far and we think that the market is still mispricing this compounding growth story.

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HARGREAVES SERVICES has enjoyed a fantastically profitable period of trading since we last wrote, with its German JV, Hargreaves Raw Materials Services GmBH (HRMS) driving significant EPS upgrades throughout the year to date. The profitability here has been driven by very strong commodity prices, in particular zinc and pig iron. The HRMS business is an interesting collection of operations which are worth exploring in more detail. Hargreaves owns 49.9% of the voting equity in HRMS but takes 86% of the economic benefit through additional non-voting shares. Ultimately, we think that an exit of HRMS is likely to be the ultimate outcome here, with Hargreaves announcing that it "plans to explore strategic options for HRMS with its professional advisors over the course of the next several months."

The core HRMS operation is the trading business which trades commodities such as pig iron, coal, coke and other carbon products for the steel and refractory industries. Given the (trading) nature of the business, profits can be highly variable and have ranged from €2-10 million over recent years, with revenue dependent on throughput volume multiplied by a margin. In times of strong commodity prices, the business trades higher volumes and can earn better margins contributing to the current strength in this business. It does not take commodity price risk as it backs-to-back transactions, but it does have to invest working capital to facilitate trading and in the last year, as commodity prices have been very strong, working capital has increased from €38.3 up to €64.6 million, consuming cash in the process when it makes sense to invest more into trading stock. Naturally, this ought to unwind when commodity markets soften.

The Carbon Pulverisation Plant (CPP) is a €28 million investment by HRMS which grinds coal and other carbon products to produce coal dust. This is again used in the steel and refractory industries and is being used in Germany to replace brown lignite coal which produces around twice the carbon footprint of coal dust and has been the backbone of German industry and power generation for decades. The Green agenda in Germany currently is to phase out brown coal by 2038, although emissions regulations likely mean this must be quicker. While the facility is currently ramping up from current break-even level of c100k tonnes, it has capacity to produce 400k tonnes which ought to generate €3-4 million of profit. The market is still evolving here, but around 2 million tonnes of brown coal dust are sold in Germany so it seems reasonable to assume that the CPP can find a market for 300k tonnes to take it to capacity.

The final operation is DK Recycling which HRMS bought in 2019 for €1 when it was generating €130 million of revenue and losing €2 million per annum. Management turned this around to profitability and it now contributes positively to the group. DK recycles waste product – mainly dust containing iron and zinc – from the steel manufacturing process. DK offers a neat environmental and financial solution since its process avoids the landfilling of this material and its gate fees are also lower than those of a landfill. Competitors do not have the recycling capability and are therefore more exposed to the current commodity price increases. Management's aim of €4 million of profit from DK over the medium term seems reasonable to us.

The question is then how to value HMRS. We think it is fair to take a reasonable multiple on the trading outcomes of DK Recycling and the CPP plant which in combination might be worth around £50-60 million based on Hargreaves 86% interest. Recall also that there is significant asset backing in here to support this. The trading business is more volatile and requires a through the cycle view, but we think it could be worth another £10 million or so. Overall, there is considerable value in HRMS. Right now, Hargreaves' shareholders realise this value through a £3.9 million dividend which is passed straight through to Hargreaves' shareholders and is supplemented by cash generation from the group. Adding in the Services and Land value we still believe that the intrinsic value sits comfortably above the current share price and there is considerable scope to generate shareholder value here through numerous catalysts.

REAL GOOD FOOD (RGD) has had a busy 12 months, having disposed of their majority stake in Brighter Foods to The Hut Group (THG) plc for a gross consideration of £43 million. The offer from THG broadly equates to 8.6x annualised FY20 EBITDA and 11.7x (unaudited) EBITDA for the last 12 months ended 31 March 2021. This in turn has led to a neutralising of the pension fund liabilities, and a repayment of debt of £23.1 million to Loan Note Holders, of which DSM is one.

The impact for DSM was a significant return of capital, interest and redemption premium, totalling over £5.3 million. This payment greatly reduces exposure to RGD to around 9% (down from over 21% as at 28 February 2021), and importantly provides a return on the investment – repayment incorporates accrued interest (to early May 2021) and a redemption premium payment representing 15% of the principal being redeemed (equivalent to 7.5% of DSM's full 10% loan note holding).

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This repayment highlights the ability to drive strategic value from this position, where Downing holds the right to a board position and have been highly engaged with the turnaround of the business. Going forward, the board of RGD has stated the intention to continue to drive value from the remaining assets – predominantly Renshaw and Rainbow Dust.

We continue to assess what the residual value of the remaining assets might be. Helpfully, this is now easier to discuss as the house broker has published an update post the Brighter disposal and balance sheet restructuring. The business last reported £21 million of debt, 99.6 million shares in issue, and a 2.3p share price giving an EV of a little over £23 million.

Against this, we highlight £2 million of EBITDA potential this year, after £1.5 million of central costs. With sales and cost savings initiatives coming through, there is reasonable scope for the business to achieve £3 to £3.5 million of EBITDA in 2023 after central costs. We think that the right way to value – the way a trade buyer would view the opportunity – is on a pre-central cost basis as these would be absorbed into a larger group. On that basis, £4 million ought to be a conservative assumption a few years out.

The final consideration is the property assets valued at £7.5 million, of which two sites are currently vacant and held for sale. A trade buyer may also find value in disposing of the in-use site to move production elsewhere, releasing the balance. We think that a 7x multiple would be modest for this manufacturer, and a discount to Brighter's 8.6x exit. This would imply £28 million of value, while a £5 million exiting EBITDA would achieve £35 million of value. Without the property upside and ignoring the pension fund liability which has now been neutralised, this would suggest 7-14p of equity value versus a current share price of 2.3p.

RAMSDENS most recent results, published in June 2021, highlight the resilience of the group's diversified business model. Ramsdens had been one of the Company's worst performing stocks through the Covid crisis, given its exposure to physical pawn broking stores which were closed during the prolonged UK lockdown. International travel restrictions also had a material impact on the group's foreign exchange business. However, the company has delivered a robust performance and its pre-tax loss limited to £0.1 million represents a strong result under the circumstances.

Part of the initial attraction to Ramsdens for us was the strong balance sheet. Despite the challenges of the pandemic, the balance sheet remains strong with net assets having increased £0.5 million to £35.5 million from £35 million at 31 March 2020, and net cash at £15 million, with an undrawn revolving credit facility of £10 million.

Gross revenue decreased by 26% to £10.4 million through tight control of overhead costs and by utilising the government furlough schemes as applicable. Foreign currency exchange was down 89% YoY to £20 million as a result of international travel restrictions imposed through the worst of the pandemic. However, we believe that the outlook is positive for this part of the business, reflected in the strong desire for people to travel abroad as restrictions ease. In pawnbroking, gross profit was down 26% YoY as customers borrowed less, and those with loans repaid them. We expect lending volumes to revert to previous levels as conditions normalise. Jewellery retail performed well, with revenues increasing by 14% YoY to £8.1 million. Gross profit from the purchase of precious metals decreased by 28% to £2.3 million, reflecting reduced high street footfall during the lockdowns.

Undoubtedly, Ramsdens has fared better than many other high street retailers who often employ much more efficient balance sheets and were less able to absorb the losses encountered during the Covid disruption and lockdowns. Ramsdens' management team remain confident and are positioning the business for future growth. It has reported a pipeline of six new stores, including debut sites in London and the South East. It is also investing to further grow the company's online presence. We believe that Ramsdens is well positioned to resume its growth trajectory as restrictions are lifted, and also outperform weaker competitors as we return to more normalised trading conditions.

FLOWTECH announced a positive half year trading update, which showed a strong recovery in trading in the period with group revenues of £55.3 million versus £59.6 million from the 2019 pre-Covid period. The first part of our thesis is based around a post-Covid recovery, so we are encouraged to see the strong revenue performance. There was some caution around cost pressures in H2, particularly through supply chain and logistics, but we are confident that recovering demand, particularly in the OEM sector, can offset headwinds. Overall, we continue to think that the company is guiding market estimates conservatively and there ought to be upside to current consensus over the course of the year.

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NEW HOLDINGS

TACTUS is the newest investment for DSM which we completed in May this year. This is an unquoted business where we have invested 50/ 50 into the equity and into 10% yielding loan notes. This is not a typical investment for DSM but we do have the ability to hold 10% of the NAV outside of listed companies. These must be exceptional to offset the lack of liquidity which we enjoy on our listed positions.

Tactus is a UK business which designs, markets, and sells IT hardware - mainly budget laptops and notebooks in the B2B channel. They do not manufacture themselves but outsource this to several Chinese partners within the China Technology Ecosystem. As a result, the Tactus business is capital light and generates exceptional returns on equity.

The skill here is navigating and connecting many supply chains to deliver on spec hardware for the customer and to deliver this into global markets on time and at a lower cost than anyone else. With the global IT component shortages we are seeing just now, we only think that these networks and access to supply are going to be more important, at least in the short term until supply catches up or demand lessens.

Tactus had a fantastic Covid year, having won a large Department for Education tender, and this has put the business in the scopes of potentially much larger customers such as Best Buy in the US where an initial order of GeoBooks is now on the shelves and selling well. But there are plenty of other sizable customers behind this and we think that Tactus is just at the beginning of a journey to becoming a household name in devices just like Lenovo, HP or Dell. In fact, in November 2020, Tactus was second behind Lenovo in terms of devices sold, outselling HP in third place and Dell, Apple and ASUS combined. But Tactus are playing at the budget end of the market where these larger players don't particularly want to compete with lower values and quantities, so we think that they do have an exploitable niche in the market.

Our involvement was to fund the acquisition of CCL Systems which mainly sells IT components and hardware but has a burgeoning PC gaming system building business which Tactus are investing in to take share in the PC gaming space. Management's strategy here is to consolidate the PC gaming e-commerce space in the UK, and this platform will also provide a D2C channel for the Tactus products.

As per press reports, the CCL and Tactus combination has created a £125 million revenue company with CCL having generated five consecutive years of double-digit revenue growth, including £65 million in the last year.

Since we invested, Tactus has acquired a further business, MendIT, which should contribute up to £1 million of EBITDA through warranty capture. The group was also awarded the Device Partner of the Year by Microsoft and is now a Gold Microsoft Partner which will generate considerable rebate contribution going forwards. Relevant to Tactus (and CCL) is the recent acquisition by HAL Holding N.V. of Pro Gamers Group, an online retailer and distributor of computer gaming equipment and accessories with both own and third-party brands. This deal was struck at a valuation implying 1.3x EV/ Sales. Applying a similar multiple to the above revenue figure would imply a valuation for Tactus around £160 million.

In August, Tactus completed a new £40 million round of investment with Chrysalis Investments. Chrysalis is a FTSE 250 listed technology investor and, following a well-publicised 2020 merger, Chrysalis is now part of Jupiter Asset Management who have been the largest investor in IPOs in the London market in recent times and Chrysalis' fund is exceptionally well regarded.

As part of this transaction, DSM has redeemed its 10% loan notes in full, representing cost of £759k and value of £798k, a small profit but an IRR in-line with the Trust's targeted return. DSM also sold a small amount of equity to Chrysalis to facilitate their transaction achieving the required scale for their investment vehicle. The partial exit plus valuation uplift on the equity generated a £1.07 million uplift in the NAV. The directors have valued the remaining shares, cost £1.0 million, at £1.6 million which reflects a considerable discount to the latest investment round. As Tactus is a new investment, DSM continues to take a conservative approach to the valuation of its residual equity stake, currently totalling around 3.4% of current NAV. As the year progresses and there is greater visibility on the earnings and strategic progress of Tactus, DSM may release this discount when it is appropriate to do so.

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TOEHOLDS: Readers of our factsheets will know that we have been reasonably active with toehold positions through Covid and some have found it hard to track the progress of these into and out of the portfolio. We have named these A through E and provided some explanation of where these have ended up.

As per the June DSM factsheet, in Toehold E we took a small position, having completed multiple rounds of calls with management, the board, investors, industry experts and competitors. The company was subject to a bid approach 15 days after we acquired our starting position and we fully exited based on risk weighted to the downside should the bid not be successful. The company was just over 3% of NAV pre-bid which was only a small premium (+14%) to our average cost. Given our small initial stake (less than 3% of the equity), and the shareholder structure, we were not able to push for an improved price. This is a disappointing outcome given the time invested and the long-term potential of the company which we thought could result in significant upside on our cost price, but it does highlight that our approach can uncover quality assets which are strategically attractive to others.

Name	Description	Status
Toehold A	Consumer healthcare	Progressed to full position. Venture Life
Toehold B	Distributor of critical parts and components	Progressed to full position. Flowtech
Toehold C	Renewables components and services	Profitable exit into market post latter stage DD
Toehold D	Consumer discretionary retailer	Remains toehold. Awaiting catalyst
Toehold E	Consumer services	Profitable exit into bid process.

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

Kind regards

Downing Fund Managers

Downing

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Portfolio construction (as at 31 July 2021)

Name	Sector	Market cap (£M)	% of the Trust	% equity held by Downing[1]
AdEPT Technology Group	Telecommunications	61.82	6.60%	9.02%
Digitalbox	Media	6.69	2.95%	21.05%
Duke Royalty	Speciality Finance	150.36	2.81%	0.87%
FireAngel Safety Technology	Electrical Equipment	28.07	6.59%	16.31%
Flowtech Fluidpower	Electrical Equipment	77.48	6.78%	6.48%
Hargreaves Services	Support Services	169.64	11.93%	7.03%
Ramsdens Holdings	Financial Services	53.37	6.94%	12.80%
Real Good Food[2]	Food Producers	3.04	9.60%	7.52%
Synectics	Support Services	22.51	5.26%	10.80%
Tactus Holdings[3]	Technology	-	4.25%	-
Venture Life Group	Medical Equipment & Services	111.99	6.06%	2.50%
Volex	Electrical Equipment	556.31	14.17%	2.56%
Toehold D	Retailers	203.75	2.28%	0.52%
Cash and other assets			13.78%	

[1] Total percentage of investee company held by all Downing managed funds.

[2] Real Good Food holding includes 0.34% equity and 9.26% debt split.

[3] Tactus Holdings includes 2.54% equity and 1.71% debt split

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