Downing

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Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

January 2019

It was a wild ride throughout 2018 for UK equity markets. While the year began with optimism, the end of the year was markedly worse. The NSCI AIM ex Investment Companies fell by almost 16% in the year, the FSTE AIM All-Share fared even worse, off more than 22% by the end of December. Unfortunately, it seems likely that things may get worse before they get better.

We don't think that this is a reason to divest from UK companies, or equities in general. We think that now is a good time to be allocating capital selectively into businesses which can compound earnings over the long term and where intrinsic value is far greater than the current enterprise value. All things equal, investors in our universe can own a greater proportion of the earnings of these companies than at any time in the last two years. This is no bad thing.

In the Trust's portfolio, what will be the most important determinant for long term performance will be the ability of our companies and management teams to leverage strategic catalysts for value creation. Therefore, this letter isn't going to discuss Brexit or the global economy, but rather focuses on the micro issues and opportunities in our portfolio companies. The Trust continues to hold ample cash and the current mispricings are providing buying opportunities in the names where we have the highest conviction.

Contribution

The NAV of the Trust declined by 17.2% in the twelve month period ending December 2018. This has been driven largely by three holdings – Gama Aviation, FireAngel, and Redhall. The aggregate contribution of these three holdings has been negative by slightly under 13%. Gama drove just less than half of the underperformance of this cohort. The remaining holdings have had a comparatively immaterial effect on overall performance.

Despite being a high weighting in the Trust, Real Good Food is structured largely in loan notes making the devaluation of the equity irrelevant with regard to contribution to returns. Happily, we think that the business has turned a corner in terms of trading and is now able to begin meeting our revised expectations. We think that the new management team have done a fantastic job and we welcome the decision to divest from non-core holdings and return excess value to shareholders.

The common theme across the Gama Aviation, FireAngel and Redhall sell-offs is poor execution by management. This has had a resulting effect on the markets' expectations – ultimately these had been set too high considering the developments. All three have reported that there will be changes in personnel at board level, decisions which we support. In all cases, we think that the long-term ability of the businesses to generate shareholder returns is high and all three businesses are trading at a wider margin of safety to our intrinsic value. There may be some additional pain experienced in the short term before green shoots are seen, but we are confident of the recovery. We give a more detailed review of company specific issues, lessons learned, and valuations at the end of this letter.

While these three companies have definitively underperformed, others have de-rated due to market sentiment rather than reporting lower than expected earnings or downgrading future earnings. Only a single holding, Synectics, has ended the year with more positive sentiment, where the year-end P/E is above the average for the calendar year.

Companies such as Adept and Volex, which have had strong – and in the case of the latter, very strong – trading updates and reported results ahead of expectations, have had positive share price performance. However, the share prices haven't increased as much as the earnings upgrades, resulting in a de-rating.

Valuing the holdings on their year's average P/ E (i.e. assuming sentiment ended the year flat) would generate an 8.2% uplift in NAV against the value at the year-end. There is far greater potential upside than this based on our long-term intrinsic value assumptions.

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Contribution, outlook and sentiment

Name	Reported results	Mgmt outlook	Sentiment[1]	Comment
AdEPT Technology	In-line	+ ve	- ve	New broker has upgraded numbers and target price. Sentiment is poor with the shares trading at the lowest multiple of forward earnings than at any point in the year. We think that this is unwarranted, owing to the visibility and recurring nature of earnings.
Braemar Shipping	In-line	Mixed	- ve	In-line reported results and positive commentary around Shipbroking and Financial divisions. Forward order book and pipeline also increased in both divisions. Comment around contract timing less bullish.
Duke Royalty	In-line	+ ve	Na	Early stage of deploying capital. Positive outlook and further capital deployed post interim results, including achieving maximum possible adjustment factor in underlying investee company's – they are beating expectations.
FireAngel Safety Technology	Downgrade	- ve	Na	Litigation and manufacturing issues led to several downgrades. Strategic changes and a new management team required to reinvigorate returns (see ROIC erosion). Longer term more positive with contract wins and regulatory drivers.
Gama Aviation	Downgrade	Mixed	- ve	Underlying FY18 results will be flat versus last year, 15% behind expectations. We think that a new governance structure and more realistic market forecasts are required. Long term investment horizon remains positive. New chairman TBC.
Hargreaves Services	In-line	Mixed	- ve	Wolf Minerals liquidation knocks earnings but doesn't have a material effect on our NAV-based investment case. Satisfactory outlook on other trading and legacy asset disposals. Property director starting is positive for our investment thesis.
Ramsdens Holdings	In-line	+ ve	- ve	Negative sentiment from director's share sale continues to overhang, however CEO bought more shares in November. Results were good, FX a little behind on 'staycation' trend. New stores opening ahead of expectations. Positive outlook.
Real Good Food	In-line	+ ve	Na	Business is now able to begin delivering results in-line with expectations. Improved governance put in place. Renshaw and Brighter are generating positive adjusted EBITDA. Value realisation is in play.
Redhall Group	Downgrade	Mixed	Na	Downgrade on contract delays which has affected cash collection. Order book and pipeline remains strong. New management team. Sorting weak contractual terms should be a win for cashflow going forwards.
Science in Sport	In-line	+ ve	Na	Recent acquisition of PhD brings positive earnings to SiS. Too early to see the progress against this new investment. Shares have rebased to below the placing price until execution is demonstrated.
Synectics	In-line	+ ve	+ ve	Bullish outlook statement, despite some headwinds in on-vehicle segment. Quick restructuring will lead to cost savings in this division. Pipeline stronger than expected.
Volex	Upgrade	+ ve	- ve	Upgraded earnings twice since the summer and completed another EPS enhancing acquisition. Shares are trading on a lower multiple despite earnings and margins improving.

[1] *Based on whether shares ended the year above or below the year's average P/E. Na sentiment where business is loss making (Redhall, Science in Sport, FireAngel); unrated (Real Good Food); or immature (Duke Royalty).*
Source: FactSet, January 2019. May not sum exactly to NAV change due to i) timing differences from valuation points; and, ii) rounding differences. Information as at 31 December 2018.

Portfolio construction

Our primary concern around risk for the Trust is avoiding businesses where we think that there could be a permanent loss of capital. Permanently lower earnings due to erosion of market share or some other structural change are also a concern, but not one which applies to any of the current holdings. We try to take a through-cycle view of our holdings and use perceived weakness to top-up on the ones with the widest margin of safety.

In 2018, significant risks presented themselves in the retail and leisure sectors. It seems likely that headwinds will continue in both sectors through 2019. Retail is particularly interesting as we don't think this is a short-term effect, rather evidence of a structural shift in the market. Retail shoppers are now buying more online which we think means permanently lower margins for the sector as they can shop around more easily. Those businesses with the greatest fixed cost bases will struggle, particularly those with long and encumbering physical store leases. There may be some value appearing in selective names, but the risks are still high. The question is whether the risk is offset by the extreme valuations.

Ramsdens is about as close as we come to traditional high street-based retail business with the majority of revenues coming from in-store sales. We think that physical stores are a cornerstone to pawning and there will therefore always be a high street presence here. While the FX business could be affected from a protracted recession as people may travel less, ultimately, travel is aspirational and over the long-term people should travel more and spend more when they are abroad. On balance, we think that the model is more counter-cyclical than pro-cyclical and the retail-like risks are more than compensated for by the valuation.

Another aspect which is likely to become topical in 2019 is internationally exposed earnings, as uncertainty in the UK looks set to increase, at the very least until the end of March. We estimate that around 54% of our portfolio revenue is generated outside of the UK which is quite a high proportion (FTSE 100 is around 76%, FTSE 250 is around 51%)[1]. We don't explicitly set out to find companies with non-UK earnings, however an analysis of revenue visibility and diversity of revenue streams is implicit in our investment process. Typically, where we have a high concentration of revenues geographically, we will seek greater visibility, through contracted earnings or order book. In all cases, we seek a wider margin of safety where revenue risks are higher. We have two holdings which are domestic only – AdEPT Technology and Ramsdens. AdEPT Technology has over 70% contracted revenues which we deem high quality. Ramsdens has lower quality revenues in this regard but was acquired at a more attractive valuation, mitigating some of the risk.

These macro views aside, what will undoubtedly affect our performance over the next twelve months and beyond will be company specific factors. All the holdings have some long-term growth expectation, this may be organic or inorganic, however we cannot rely solely on revenue growth to generate returns. In leaner times it is important that we are invested in companies which have an ability to self-help and management teams who can make these changes. Cost efficiencies, restructurings, integrations and de-gearing, are mechanisms available to our companies to generate higher margins and more free cash flow when growth is low.

To highlight a few, Synectics has taken early action to reduce costs and has also restructured its on-vehicle division which should generate £1.2 million of annualised savings. Similarly, Braemar is about half-way through its £6 million cost reduction programme in the technical division and could have opportunity to rationalise the business through further disposals of low margin activities. In addition, Real Good Food continues its asset disposal programme which we have set out in the past. We think there is also ample opportunity to reduce central costs in this business.

Outlook

It is important to remember that only around 10-15% of our intrinsic value calculation comes from short-term forecasting periods. Conversely, strategic initiatives to grow value have almost 100% of their value in the medium to long term, well outside of this short-term window and typically beyond the view of most market participants.

[1] The Global Sales Ratio, Global and Domestic Firms, FTSE Russell
https://www.ftserussell.com/sites/default/files/the-global-sales-ratio_-global-and-domestic-firms-final_0.pdf

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We believe that we have a portfolio of attractive businesses which can generate significant shareholder returns over the long-term, one which is built around things which we deem as certainties. Jeff Bezos is famously quoted as saying the following:

> *"I very frequently get the question: 'What's going to change in the next 10 years?' And that is a very interesting question; it's a very common one. I almost never get the question: 'What's not going to change in the next 10 years?' And I submit to you that that second question is actually the more important of the two -- because you can build a business strategy around the things that are stable in time. [I]n our retail business, we know that customers want low prices, and I know that's going to be true 10 years from now. They want fast delivery; they want vast selection."*

Most of the portfolio positions have long-term growth drivers which we deem to be relatively certain. Increasing consumption of goods and data; increasing wealth; outsourcing; security; and increasing requirements for infrastructure and energy.

The year ahead is likely to be one of more strategic progress in the underlying holdings. Some do require a significant amount of effort and management change in order to unlock the potential and we are galvanising changes as required. We look forward to updating you on the progress that we have made in April.

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

Kind regards,

Downing Public Equity

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Reporting highlights

	Oct	Nov	Dec
AdEPT Technology		Results: in-line	
Braemar Shipping	Various		Board change
Duke Royalty	Reset adjustment		Results: in-line
FireAngel Safety Technology		Trading: behind	Contract wins
Gama Aviation	Trading: behind	Board change	Contract wins
Hargreaves Services	Various*		Trading: behind
Ramsdens Holdings		Results: in-line	
Real Good Food			Results: in-line, disposal
Redhall Group	Board change		
Science in Sport			Acquisition
Synectics		Trading: in-line	
Volex		Results: ahead	Acquisition

** commented on in last letter*

AdEPT Technology Group

AdEPT Technology reported in-line results in November, alongside a small acquisition. One of the key takeaways for us in the results is the increase of revenues generated from managed services to 74%, from 67%. Headline financials were also pleasing, most increasing by double digits. Following an active year of acquisitions, debt has increased quite materially and is around the upper levels of what we find acceptable in any business, however we take some comfort in coverage backed by contracted revenues Management focus on cash generation and have a track record of using the balance sheet efficiently – acquire, de-gear, then repeat. We think that 2019 will see this trend continue.

Braemar Shipping

The company has had a lot of news flow over the quarter. Operationally, the business has performed well in the Shipbroking and Financial divisions, but poorly in the Technical division. Underlying profit before tax showed a small improvement to £2.5 million, from £2.3 million last year, although non-recurring acquisition related charges reduced the statutory loss before tax to £3.8 million. The group also disposed of the loss-making Response business for just over £0.7 million. Management "expect a stronger second half performance compared with the first half of our financial year supported by an increased forward order book in Shipbroking and a strong pipeline in our Financial division." This optimism was tempered with the caveat that to meet expectations would be "dependent on the timing of certain large shipping finance projects…".

In this letter a year ago, we summarised our investment rationale. While the macro supply/demand dynamics are long-term, we have seen progress against the restructuring. Some operating efficiencies have already been demonstrated and there has been a disposal. Ultimately, however, this remains a complicated business and one which management haven't managed to get firing on all cylinders for some time. Braemar Shipping announced that that chairman was stepping down at the end of 2018. We are actively engaged in the process of finding suitable candidates.

Duke Royalty

Duke Royalty's results were in-line, but it is early days and we do not consider these numbers particularly helpful to understand progress in the business as it scales up and deploys capital. The key takeaway for us has been the strong performance of the underlying investments – three have now reported revenue growth in excess of 6%. This means that Duke Royalty max out their royalty reset adjustment for the following year and the investees

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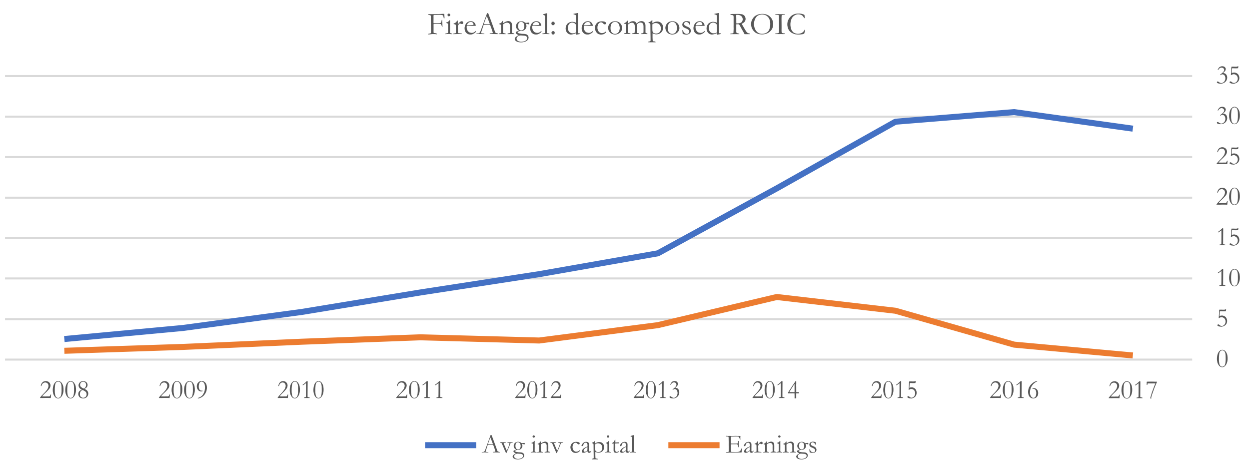
increase payments by 6%. As the business scales, we expect to see the share price grow in order to contain the growing dividend.

FireAngel Safety Technology

We have talked at length about the operating issues at FireAngel Safety Technology in past letters. A litigation followed by poor execution of a manufacturing change and failure to notice erosion of market share in Germany have compounded into underperformance for 2018. We are very encouraged that John Conoley has been appointed as chairman at the end of January. John has extensive experience turning around troubled electronics and tech businesses and is currently on the board of eServGlobal. Having recently visited the manufacturers' site in Poland with John and the management team, we have confidence that the building blocks are in place to restore value. It is evident that recent years have seen a marked erosion of return on invested capital. However, we think that with the right focus on realigning the capital base and some rigor around investment decisions, the business can return to these high levels of profitability.



Source: FactSet, January 2019

Our thesis is based around legislative and structural growth drivers, and ultimately a recovery in ROIC over the long term. If the business can generate its 10-year average ROIC on current average invested capital, then earnings would be almost £8 million per annum. The five-year average guides us to over £5 million. Therefore, we still think that there is an attractive business at an attractive valuation, if focus can be directed to the right areas. Investors will have to be patient for returns owed to the structural drivers which will take time to generate revenues, and the operational changes, which will take time to leverage revenues into greater profits.

Gama Aviation

The single largest detractor to performance in the year has been Gama Aviation. We took a larger weighting in the business at the time of the fundraise which centred around management's plans to organically and inorganically grow PBT by around $9 million for the full year to 2019. Discounting management's plans, we still thought that the shares offered good value with higher than average growth potential.

This plan for growth in the short term is not going to materialise in its entirety. There is evidence of the US maintenance expansion moving ahead and we think this has great merit and there are regulatory drivers which should provide a tailwind to this business. However, the planned acquisitions – which carried the bulk of the earnings accretion in the near term – have not been executed. We think that this is partly due to the underperformance of the joint venture in Hong Kong which has subsequently raised questions around governance and diligence, areas which we now think needs to be addressed. The announcement at the end of January furthers our belief that the correct checks and balances have not been in place. This is something which we underestimated when we initially invested.

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In November, the chairman announced that he will step down and there has already been the introduction of a strong, independent non-exec earlier in the year along with a new CFO who we think is particularly competent. A strong, City facing chairman will be key for the next part of the group's journey.

There remains evidence of a good and competitive business underlying these issues. The company announced reassuring contract wins at the end of December, providing further visibility on earnings. The two contracts are expected to be worth £27.5 million over five years and between £66 million and £88 million over eleven years. Both are within special missions and endorse the strength of the business in this area. They are expected to be earnings neutral in 2019 and accretive thereafter. These build on the £50 million Scottish Air Ambulance contract extension announced in 2018.

The year ahead will be one of great change. Rebased expectations, following the failure of the growth plan, and a change in the chairman, at the very least. Ultimately, we still think that there are reasons to be positive and the underlying drivers of our long-term thesis remain intact – opportunity to consolidate; regulatory tailwinds; and some market leading positions. It is going to take longer than we expected and will require a different approach from management, but these are things which can be fixed and there is a strong platform from which to do this.

Hargreaves Services

We commented on the October developments in our last letter. In December, the business announced a pre-close trading update that "the Board expects to report interim results in line with its expectations. Both revenue and underlying operating profit are expected to show growth over that reported for the six months ended 30 November 2017, deriving from improved trading within the Group's UK businesses." Net debt has reduced slightly at the half year and further legacy asset disposals are expected in the second half. The share price was especially weak in the final quarter of the year, we therefore find a greater margin of safety against our NAV-based valuation. The RICS red book valuation points to 573p, around 100% upside from the current share price. In our view, one of the main catalysts to realising an uplift in value could be spinning out the property division into a 'prop co' and the underlying operating company 'op co'. We think that this would allow the entities to be valued more accurately and close the gap between market value and intrinsic value.

Ramsdens Holdings

Ramsdens reported a respectable first half with results slightly behind the comparative period last year due to lower FX demand on the back of an exceptionally warm UK summer, and higher costs from opening more stores and infrastructure investment. The payback on new stores is relatively quick – they are expected to begin positive contribution by year two of trading. Four new stores were opened in the period and a further four since the period end. We are encouraged by the pace of this roll out and collectively they are trading ahead of initial expectations. We think that the shares still offer good value and growth potential as stores mature and the roll out progresses.

Real Good Food

In December, the company announced first half results in-line with our revised expectations and the disposal of R&W Scott to its management team via a management buyout. The financial results continue to bear the brunt of the restructuring activities through the P&L. However, the two core businesses which remain, Renshaw and Brighter, are both profitable and we think that these businesses are materially undervalued by the enterprise value of the group. We expect the business to continue its programme of disposals through 2019.

The share price reacted negatively to the news of the R&W Scott disposal, presumably because this was realised at below cost. This does not mean a loss for the Trust, we were not shareholders at the time Scott's was acquired therefore it is irrelevant if the disposal price does not justify the original acquisition price. The main consideration should be that the business is now free of term debt. We expect that future proceeds from disposals will be utilised firstly to return value to the 10% and 12% loan notes. The total loan note liabilities, after some convert to equity, are materially below the combined proceeds we would expect from the disposals of the core businesses, which historically have generated over £8.5 million of EBITDA. We think that growth and cost efficiencies should mean that these businesses are at least as profitable as this over the next twelve to eighteen months when we expect them to be disposed. This could leave a residual value to equity holders of around 2.5 times the current share price, based on Stockdale's assumptions, which we outlined previously.

Redhall Group

Redhall announced that full year results would be delayed and that the newly appointed CEO, Wayne Pearson, had decided to step down. This is a disappointing development and the market has interpreted that there are issues internally. Since then, the Trust has invested £0.7 million alongside Lombard Odier in a £2 million short-term debt facility to fund working capital. The loan carries an exit fee of 12.5% and is for a period of eight months. The term of the loan reflects the short-term nature of the funding requirement. We will, in due course, comment on the full year results, expected shortly. We continue to think that there is great value in the long-term order book and that there are significant opportunities in UK infrastructure which Redhall is in a good position to win. We also think that there is strategic value in the business which is far greater than the current value of the enterprise.

Science in Sport

SiS completed the acquisition of PhD Nutrition Ltd. from private equity owners for a total consideration of £32 million, representing around 12x EV/ EBITDA and around 1.4x sales. Despite the merits of the deal, we thought that the price was too high, we therefore chose not to support it from the Trust or other Downing funds. Ultimately, the attraction now is that this is a much larger group with a wider product set – management estimate that their addressable market is seven times larger with PhD's acquisition. Given the profitability of PhD, this also goes some way to funding the losses of SiS as that business continues to scale. We think that the combined entities will make an attractive portfolio of premium and high margin sports nutrition businesses to a strategic buyer.

In January, the business announced a trading statement indicating that revenue growth was on target. The company is hosting a capital market's day at the end of January which we attended.

Synectics

The company issued a trading update in November pointing to weakness in the on-vehicle sector being offset by stronger results in global gaming security. The net cash position is also expected to have strengthened to approximately £6.5m and the pipeline for new business is stronger than expected. As mentioned earlier, the management team has taken swift action to reduce the operating costs associated with on-vehicle activities. Recurring savings of around £1.2 million are expected in this unreported financial year, while the actions leading to these savings will amount to around £2 million, largely non-cash exceptional adjustments taken in the current financial period.

We believe that the shares still offer good value and there are compelling structural dynamics which make the shares attractive in the medium-to-long term. With an increase in volumes, perhaps through a recovering oil and gas market, the earnings should benefit from operational gearing.

Volex

It was a busy final quarter of 2018 for the company, releasing ahead of expectations results in November and then an earnings enhancing acquisition of GTK in December. The November results made for good reading overall. After central costs, and including the contribution from acquisitions, the group reported $9.9m of underlying operating profit in the first half alone, versus $11.5m for the whole of the last full year. One area of note is the downturn in profitability of cable assemblies. We think that this is transitory whilst some operational and capacity issues are overcome and growth investment is made. There have been some one-off movements in the cash flow, principally working capital build to service several new contracts. This should be cleaner in following years.

The acquisition of GTK in December looks like a strong strategic fit. The UK-based business manufactures electronic solutions including cable assemblies, displays and connectors and is focused on the Northern European market. For the year ended July 2018, GTK reported revenues of £15.8 million and underlying operating profit of £2.3 million – that is adding back costs incurred under private equity ownership. The business will fit into the cable assembly division and will be immediately accretive to operating margin, 14.6% plays our normalised operating margin assumption of 8-10% for the division. Volex paid only 5.7x EV/ EBIT for the business (£12.5

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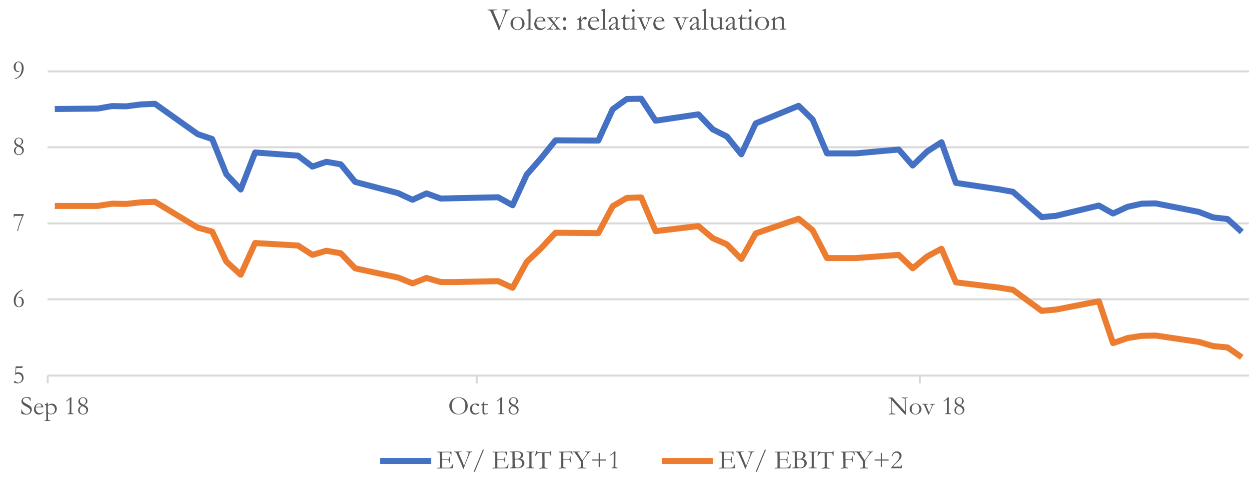
million in cash, the rest in shares). When coupled with the exceptional growth rate of 14% per annum over the last three years, and the opportunity for synergies, we think that this is an attractive price.

Since we invested in May, Volex has now upgraded April 2019 earnings three times. Firstly by 7% in July, then again around the results by another 7%, and now by 5% following the GTK acquisition. But it is further out where investors should see the benefits from a full year of earnings of the acquisitions and margin improvements.



Source: FactSet, January 2019

Despite the positive progress, the shares have de-rated quite strongly, particularly in the last quarter of 2018. If 2020 is now the most representative year of underlying earnings (full contribution from GTK), our numbers point to a group on only 5x EV/ EBIT. We see even more upside in the longer term once cable assemblies begins firing on all cylinders. The business still has ample firepower for acquisitions and we think that vertical integration, specifically, purchasing a supplier, could be a shrewd strategic move which would provide sustainably higher margins across the group.

We think that this is a group which could be generating $30 million of operating profit in the medium-to-long-term. That would represent almost a three-fold increase to operating earnings than when we invested, or double on a per share basis. With a little luck, we may achieve some multiple expansion along the way as the market realises the growth potential, particularly in higher margin cable assemblies. A return to the dividend list would likely prove a good nearer-term catalyst for the share price.

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Portfolio construction

Name	Sector	Market cap (£m)	% of the Trust***	% equity held by Downing*
AdEPT Technology	Telecommunications	82.01	8.60%	12.37%
Braemar Shipping	Transportation	63.66	4.80%	6.59%
Duke Royalty	Speciality Finance	87.34	4.63%	6.37%
FireAngel Safety Technology	Electrical Equipment	18.82	1.53%	10.78%
Gama Aviation	Transportation	76.36	6.04%	6.71%
Hargreaves Services	Support Services	90.58	6.57%	6.87%
RamsdensHoldings	Financial Services	52.27	6.03%	16.30%
Real Good Food**	Food Producers	6.16	17.18%	7.96%
Redhall Group	Support Services	13.15	3.60%	23.91%
Science in Sport	Food Producers	65.86	2.59%	12.79%
Synectics	Support Services	35.14	8.11%	12.86%
Volex	Electrical Equipment	129.39	12.52%	7.46%

All figures correct as at 31 December 2018
**Total percentage of investee company held by all Downing managed funds*
***Holding includes 0.73% equity and 16.45% debt split*
**** Excludes cash*

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