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Downing Strategic Micro Cap Investment Trust

Investor Letter

July 2018

We marked the anniversary of the Trust with a significant investment in Volex. Alongside a further loan note investment in Real Good Food and topping up on weakness elsewhere, this took us to being 79.8% invested at the end of June. As previously stated, we intend to maintain a material cash buffer to allow us to take advantage of share price weakness or to invest in new opportunities. This leaves us currently with a portfolio of 12 investments (including loan notes). Investors may expect us to add one or two smaller positions in due course.

There has been a large amount of news flow in the last quarter which we cover at the end of this letter. Significantly, we believe that Real Good Food is at a defining stage of the restructuring and turnaround and that our investors are in a good position to profit from this. Our initial investment in Sprue Aegis (renamed FireAngel Safety Technology Group) has not performed as we had hoped to date and Gama was also weaker in the period.

We have begun publishing monthly factsheets and these are available on the Downing Strategic website covering May and June 2018. The performance to date is reflective of the strategic nature of the underlying investments and our expected three to seven year investment horizon.

Name	Sector	Market cap (£m)	% of the Trust	% equity held by Downing*
Adept Telecom	Telecommunications	77.50	7.35%	12.91%
Braemar Shipping	Transportation	81.73	5.23%	6.65%
Gama Aviation	Transportation	129.77	9.10%	6.62%
Hargreaves Services	Support Services	112.56	7.37%	5.86%
Ramsdens	Financial Services	54.74	5.60%	14.75%
Real Good Food**	Food Producers	9.00	15.76%	10.00%
Redhall	Support Services	25.80	6.28%	22.80%
Science in Sport	Food Producers	53.51	3.38%	12.97%
FireAngel *(prev. Sprue)*	Electrical Equipment	34.43	2.48%	10.67%
Synectics	Support Services	38.44	6.76%	13.14%
Volex	Electrical Equipment	107.32	9.01%	7.52%

All figures correct as at 29 June 2018
**Total percentage of investee company held by all Downing managed funds*
***Holding includes 1.18% equity and 14.58% debt split*

The current portfolio offers a diverse range of value opportunities from which to generate shareholder returns. We are not dependent on exploiting a single strategy within the value stable, rather we will consider both asset and earnings based value ideas. This quarter's letter seeks to provide more colour on this process and our private equity approach to investing. We then outline the investment case of Volex (having distributed a long form note at the end of June) and cover off reporting highlights for the period.

Diverse portfolio

Value investing's roots can be found in 'deep value' ideas – buying very cheap businesses without too much regard for the underlying quality. Invariably, this disciplined approach means buying businesses at a significant discount to net assets, or better, liquidation value. As value investors we have a natural affinity to these deep value positions, but sometimes this isn't the most effective way to deploy capital and we also seek to buy intrinsically good quality businesses at bargain prices.

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NAV/ turnaround		**Value**		**Mispriced earnings/ quality**
Real Good Food	*Braemar Shipping*	*Ramsdens*	*Gama Aviation*	*Adept Telecom*
Hargreaves Services	*Synectics*	*Volex*		*Science in Sport*
Redhall		*FireAngel (prev. Sprue)*		

As the above shows, we hold a cross section of different types of value plays with different quality characteristics. It is worth bearing in mind that before we explore some businesses below, all are in the portfolio, first and foremost, because they represent attractive value opportunities. Our determination of intrinsic value is best practice (discounted cash flow), not best in class, like relative methods such as price to earnings (P/E) which are merely proxies for cash flow and which are favoured in our industry.

NAV/ turnaround

We hold a few positions where we see material upside in the break-up value of the group (although the investment case may not actually require a liquidation!). At the time of writing, these businesses trade on an average discount to book value of 42%. Although we wouldn't class these as poor-quality businesses, they do not possess great quality attributes like some others in the portfolio.

Real Good Food is an investment where we initially identified a large gap between the sum of the parts valuation and the enterprise value. We structured our investment to allow us to make changes in the company, but we underestimated the magnitude of change required which brought short term challenges to earnings and cash flow. By encouraging the board to exercise the turnaround, we aim to stabilise the business, stem losses and then work to optimise value. The long term nature of the Trust and our investment approach allow us to be supportive of these turnaround situations where we can manage the process more closely and aim to improve our returns. We now believe that the business in a good position to generate returns and return cash to shareholders.

But this is generally atypical of the businesses which we are trying to buy. If we are investing in an asset play then it is preferable to have cash generating operations alongside an asset rich balance sheet. The positive cash flow ensures that we are not eroding our margin of safety as we execute the value realisation catalysts put in place.

Hargreaves Services is a good example of an asset heavy balance sheet alongside profitable operations. Owed to legacy capital intensive operations, there is a large amount of tangible asset value. But until now, this has been difficult to access – in fact, the market discounts this materially given that the business trades on a 20% discount to its last reported book value. We think that this is the case because management have a poor track record in returning cash to shareholders. As an example, £27 million has already been realised from the sale of legacy assets, but there was only a small excess return to shareholders. The market continues to discount future realisations as well – the remaining legacy assets are carrying at £33 million on the balance sheet. There is also a plan to realise £35 million from the Property & Energy portfolio by 2021. This could culminate in almost £70 million of value realisation alongside operating businesses which management believe could generate £10 million per annum, against a market cap of around £110 million. But there must be a catalyst in place to release this excess value to shareholders. Following our engagement, Roger McDowell is set to become Chairman in August and we believe that he will more appropriately represent shareholders' interests on the board.

Value

In our 'value' businesses we see attractively priced operations which are cash generative and not especially challenging on price to book (P/B) or typical P/E metrics. In our opinion, these are medium-to-good but not *great* quality businesses in the sense of having dominant positions, wide moats, and/ or high earnings visibility.

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Volex sits in an interesting juncture where it possesses enviable scale and an ability to consolidate, but has attributes which may also be consolidated, like power cords. The business does have some tangible barriers through the quality of its products which may be hard to replicate and which its customers value highly. The indulgent capex plans of past management have also created a bloated balance sheet of written down assets, which we don't have to pay for as new investors, but which increase the capital requirements to enter the market.

However, we don't view this as a *great* quality business owing to the competitive pressures in the industry overall. We would currently rate it medium quality at best, but we think that the tweak in the strategy could increase this to good quality as management focus on the competitive advantages within the assemblies business and are therefore better positioned to combat margin pressures. We also think that this business should be able to grow faster than several others in the portfolio.

Mispriced earnings/ quality

We believe that Science in Sport (SiS) has a strong competitive advantage, that Adept has a great quality of earnings and both of these attributes are broadly unrealised by the market. These positions entered the portfolio using the same discounted cash flow approach which we use to value all of our other positions and therefore also represent good value as well as quality. Although SiS is currently burning cash to fund growth, we believe that under normalised market growth conditions the businesses can generate enough free cash flow to justify its current valuation with a material margin of safety. However, ultimately, we believe that our exit here will come from a trade sale where prudent assumptions indicate that our target returns are achievable.

SiS operates in competitive markets where margin pressure is rife. Yet the company has managed to sustainably grow gross margins from 56% in 2013 to 60% in 2017. We ask, what makes SiS's model so great that in a market of 20-30% gross margins, SiS can earn 60%? And in an expected 8-10% growth market, SiS can grow revenues at near 30%? For starters, despite being small, SiS is big in its 'endurance sports' niche. It has a differentiated and premium product which is banned substance tested and the only brand globally to hold dual certification for banned substance controls. The margins come from process and cost leadership – SiS own the value chain from procurement, manufacturing, marketing, and sales through their own SiS.com ecommerce platform. This makes their proposition unique in the sports supplements space and further increases the brand IP. Combined with sector leading margins, we think that this makes SiS a quality business with a strong moat. Crucially, we don't think that the moat is relative to smaller companies – even businesses with much larger balance sheets may struggle to generate the brand IP and market position which SiS has grown since inception. The most recent fundraising and further investment into the brand and operations should allow this to grow further.

Adept may look expensive from a traditional value sense. But it has a tremendous quality of earnings and earnings growth. The most recent results point to a track record delivering nine consecutive years of EPS growth, a feat only matched or bettered by three in over 700 AIM companies. We also rank Adept in the top quartile across all UK listed companies in five-year EBITDA and EPS CAGR and top decile in five-year dividend CAGR. Despite these impressive quality growth characteristics, we believe that the market continues to undervalue the business. Looking forward, we believe that management have the right mix of organic and inorganic growth prospects to continue to deliver market beating growth through the cycle. The continued shift to managed services should aid this and deliver more visibility on earnings.

Adept initially found its way into the portfolio on an expected free cash flow yield of 9%, after the Atomwide contribution which we deem transformational. We feel that the valuation was particularly unchallenging at the time we made the investment and the capital light model should support growth without much incremental investment. By our calculations, Adept should be able to grow at 15% per annum and also return 50% of earnings to shareholders.

Hopefully this brief overview gives a better insight into the value approach that we employ. We are not strictly limited to old school methods of value investing, meaning that we do not prescribe only to the 'assets not earnings' view. However, we do have great affinity for this belief and over 40% of the portfolio is invested in companies which are trading on a discount to book value.

Put simply, we are trying to pay the cheapest price for good quality businesses and balance sheets. There is an element of earnings and cash flow growth which is inherent to our process through the discounted cash flow derivation of intrinsic value. However, where this is the case we seek not to pay up for exceptional growth, instead modelling based on more prudent assumptions and using a higher discount rate and margin of safety.

We invest with conviction and the Trust represents the collection of our best ideas, the largest positions offering the widest margin of safety between our entry price and intrinsic value. We think that this approach, combined with the strategic mechanisms which we put in place in order to drive shareholder returns, offers our investors the best risk adjusted exposure to micro-cap value investments.

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

Kind Regards,

Downing Public Equity

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Portfolio commentary

Since we last wrote in April, covering to the end of March, we have invested over £4.4 million into new holding Volex, a further £1.2 million into Real Good Food, and around £0.75 million into holdings which evidenced share price weakness.

New investment: Volex

Volex is a heritage British manufacturer operating across two segments: power cords and cable assemblies. We have followed the business closely for over a year and believe that our entry point comes ahead of a transformational change in the strategy. Downing client funds participated alongside the Trust's commitment and now own 7.5% of the equity.

- **Growth:** we believe that the rebased business is now in a position to grow profitably over the long-term. Revenue growth should be leveraged at a higher rate through the improved operating structure which is more efficient than it has been historically.
- **Margin recovery:** we expect margin recovery at a group level from the cost efficiencies undertaken. Management have demonstrated an ability and desire to profitably grow the business, rather than previous regimes where the focus was on top line growth to try to match the cost base. Recently, there have been renegotiations of various contracts with price-ups, demonstrating the demand for quality from Volex's customers. Over the long term we believe that 10% in cable assemblies and 4-6% in power cords (PC) could be achievable operating margins.
- **Strategy:** we believe that the tweak in strategy – to exit the PC business in the medium term – is the correct one. The PC business should be worth disproportionately more to a vertically integrated player with automation, than it is to Volex, due to the quality of the customers and ability to extract greater margin. This would leave a strong cable assemblies business and cash to pursue a roll up in this industry. We think that focusing on cable assemblies, the more profitable division, plays better to the competitive strengths of the model.

Given our relatively large holding – third largest shareholder overall behind the executive chairman and another institution – this position should be relatively strategic. In the short term we expect to be involved in discussing long term incentives which will best align management and shareholders.

Work in Progress (WIP)

We are seeing a number of interesting opportunities arising and have a couple at medium-to-late stages of diligence. The market is particularly volatile right now and we think with an increasingly 'risk off' attitude, this hits smaller company equities the hardest as these businesses are viewed as the least robust.

Last time we wrote about a position for which we had "earmarked a large portion of capital…which has been WIP for over a year". This position was Volex.

We also wrote about how we expected to "make a strategic investment in a small business which we have known for some time". Contrary to what we expected, this deal has not moved on much further from when we commented last time, but it remains in the hopper at a late stage of diligence.

There have been a couple of opportunities arise from the left field. One, a highly differentiated business model which is also different from anything else currently in the portfolio. A second is in a sector which we know very well, which we have been following since 2015 and where the share price has come back to attractive levels. And a third which has long been on our screens but where we have been put off by the capital structure. This structure has now definitively and positively changed and warrants a further look.

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Reporting highlights

	Apr	May	Jun
Adept Telecom	Trading: ahead*		
Braemar Shipping		Results: in line	Trading: in line
Gama Aviation		Various	Various
Hargreaves Services		Board change	Trading: in line
Ramsdens	Trading: in line*		Results: in line
Real Good Food		New funding	Open offer commitment
Redhall			Results: behind
Science in Sport			
FireAngel *(Sprue)*		Results: behind	Board change
Synectics		Board change	
Volex		Fundraise	Results: in line

*"*commented in previous letter*

It has been a busy reporting period for our holding companies in terms of both full year and interim results and other news flow. Synectics and Adept issued results post period end, both were positive and we will cover these next time once we have met with management.

Braemar Shipping

Braemar's results were pleasing with £8.2 million of operating profit generated and underlying basic EPS of 21.1p per share, both measures increasing over 90% from a comparatively weak prior period. Net debt was higher on the back of acquisitions made in the period. Underlying cash generation was good with over £10 million before acquisition and disposal related activities and the balance sheet remains strong with a net asset value of over £90 million versus a market cap of around £80 million. The outlook is relatively positive for this financial year. Current tanker freight rates are low and this fleet is growing therefore rates are likely to remain lower for longer in this segment. However, this is offset by relative strength in the financial division and the technical and logistics divisions.

Gama Aviation

Numerous pieces of newsflow in the period included the hiring of a new CFO who will start in September; moving maintenance operations to Bournemouth which will double engineering capacity and pay for itself through capital contributions and a rent-free period; extension of the Scottish Air Ambulance (SAS) contract; and AGM statement; and, post period end, a trading statement in July.

The SAS contract extension provides further visibility on future earnings. The contract is expected to be worth £50 million from June 2020 through to June 2023. The margins on these special missions' contracts are lucrative, reflecting Gama's lifetime investment in the relationship. In June, we visited the formal opening of Gama's new Aberdeen SAS facility which cornerstones Gama's commitment to service this contract for years to come (they have successfully retendered this contract since 1991). It was great to meet the head of NHS Grampian and the head of the SAS and understand more about the strength of Gama's service. Significantly, we believe that there are other international opportunities to be won in special missions with the Middle East being a key region and the Sharjah investment providing the backbone for this opportunity.

The AGM update received a mixed response from the market. We think that the statement was cautious in tone, reflecting the first four months' trading on a business which is typically 40/ 60 1h/ 2h weighted. It referenced

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"high quality contract wins for base maintenance and design" now coming through in the second half rather than the first. Subsequently, the July trading update confirmed that expectations were in line for the full year.

Ramsdens

Ramsdens posted a healthy set of full year results to the end of March 2018. Revenue increased by 16% to almost £40 million whilst underlying EBITDA increased 31% to £7.9 million and basic EPS increased 61% to 16.3p per share. The company ended the period with net cash of £12.7 million. Management commented that the group is well positioned going into the new financial year.

Ramsdens has a well-defined strategy based around four pillars:

1. *Continuing to improve the performance of our core store estate*
2. *Expanding the branch footprint in the UK*
3. *Developing our online proposition*
4. *Continuing to appraise market opportunities presented by operating in a challenging market*

With ongoing weakness in the UK retail market and Ramsden's strong balance sheet, we think that they may be in a strong position to take market share relatively cheaply. The medium-term target of growing the estate by 12 stores per annum drives our underlying growth assumptions and we think that management will be able to deliver on this.

On the back of this positive set of results, management chose to reduce their holdings in the business. Directors and associated parties sold an aggregate of 925k shares. We believe that these share sales were to allow the directors to take advantage of entrepreneur's relief and came post expiry of the lock-up provision put in place at the time of the IPO. Post sales, management still retain material stakes in the business.

Real Good Food

Post period end, Real Good Food issued a circular outlining the reasons why the board believe that it is appropriate to grant whitewash waivers of the Takeover Code, allowing the majority shareholders to take over 30% without triggering a mandatory bid for the company. In this document the board detailed the turnaround strategy which we have discussed in previous investor letters, and the aim to divest from the non-core activities while optimising the value of Renshaw and Brighter Foods. This is the final stage in the refinancing of the business, and the issuance of the convertible loan note (which this whitewash circular refers to), optimises the Trusts entry price. The company has also announced the proposed appointment of two new independent non-execs.

Compared to 12 months ago, the company has adopted financial rigour, has a defined strategy to drive efficiencies and has a funded plan to realise shareholder value. Our sum of the parts valuation still stands and we believe that returns commensurate with the execution risk of this investment will be realised.

Redhall

Following on from our last update in April, Redhall announced in the interim results that their order book has continued to grow – now £37 million, excluding an £18 million framework agreement won by Jordan Manufacturing for Sellafield. As we pointed to last time, the focus must now shift from growing the order book to order book delivery and earnings growth. On this basis, Redhall were behind estimations, but we think that this transitional stage as contracts ramp up is not reflective of the underlying earnings potential of the business.

We challenged management on the level of cash burn in the period with the group ending March 2018 on £4.5 million of net debt. We have been reassured that the large working capital investment to deliver material portions of the order book have now been completed and the business should be self-funding as contract delivery commences going forwards.

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FireAngel (prev. Sprue Aegis)

We announced in our last letter that we had been building a position in FireAngel. We had been doing so on the basis of a market over reaction to litigation concerns and the stock write off (both discussed in length in the last letter). All of our valuation scenarios pointed to a wider margin of safety as the market cap had eroded by around £30 million which was more than our adjustments indicated would be prudent.

Unfortunately, what we failed to take account of was a drop off in trading in the German market. Alongside the litigation prospect, management seemed to drop the ball on trading and as a result the numbers and outlook were poorer than we had expected. Followers of this business will have become used to recurring trading issues over the last few years – all of a different nature but collectively disruptive to the creation of long term shareholder value. Evidently, we hadn't discounted enough management's ability to navigate trading difficulties going forwards and this led to us investing initially at a higher level than the shares currently trade.

In these situations we revisit our investment case for evidence of why we should continue to own the business. We commented before that there are legislative drivers, improving margins, and market growth, all of which should make this a viable long term investment. All of these assumptions still stand and we still believe that these should lead to profitable operations and an attractive long term investment. These attributes are hard to replicate and give the business a position of strength within the sector.

In our view, issues have arisen through the failure of management to professionalise processes and systems to a standard commensurate of a business of this size. It has been announced that the current executive chairman (Graham Whitworth) is to step aside on the appointment of a new chairman. We have great respect for Graham as one of the founders of the business which has grown revenues by over seven times in ten years. We believe that the opportunity to bring in a new chairman will help to address what we perceive to be the operational challenges of the business, the support of Graham will aid this process.

Clearly, this is a year of great change for the business. Our initial investment has not performed well, but at current levels the shares look attractive if the business can achieve a new level of free cash flow from which to grow. We believe that there are tangible growth opportunities and large contracts to be won in a number of regions which would transform the earnings of the business. However, there is a great deal of execution risk in this, alongside a transitioning management team, and we must ensure that we have the appropriate controls and assurances in place and that we understand the dynamics well enough before we commit further capital. If we cannot gain these then we will exit the position at a loss and reinvest the proceeds in a better opportunity. Watch this space.

Volex

We distributed our investment thesis on Volex in June and provide an abridged version above. Volex also announced results for their 2018 financial year which signalled a positive resurgence in operating performance. Underlying operating profit increased from $9.1 million last year to $11.5 million in 2018; the business turned its first statutory net profit since 2012; and it ended the period with $9.9 million in cash. Free cash flow generation was a little below our estimations owed to increased working capital commitments. This is on the back of a large investment ahead of ramp up in production for two new and potentially large customers. There were non-recurring cash costs of $1.6 million in respect of reorganising the business, and a further $1.6 million interest costs which will be reduced going forwards given the cash balance and obvious potential to renegotiate financing terms on the back of the balance sheet and operating strength. Overall, we think that the business is now in a good position to grow revenues and earnings going forwards.

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