Downing

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Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

November 2018

In August we made a new investment into Duke Royalty. From the Trust we contributed around £2.1 million. Duke differs to our other holdings – it is a financing business generating revenue through ultra-long-term royalty agreements which could generate an IRR under base case assumptions of 12-13.5%. We think that the risk/ return profile is attractive, and we invite you to read more on our thesis for Duke, below.

Post this investment, the Trust is 83.9% invested. We have previously commented on retaining an appropriate cash balance given the strategic nature of the holdings and the propensity for market inefficiencies to generate buying opportunities. At sub 20% cash, we are unlikely to make any further large investments unless we remove an existing holding or raise more capital. We have scope to make a few new investments in line with our concentrated holding policy of between 12 and 18 companies.

Name	Sector	Market cap (£m)	% of the Trust***	% equity held by Downing*
Adept Technology	Telecommunications	97.18	9.36%	12.69%
Braemar Shipping	Transportation	83.31	5.52%	6.59%
Duke Royalty	Speciality Finance	90.44	4.38%	6.43%
FireAngel	Electrical Equipment	30.99	2.25%	10.80%
Gama Aviation	Transportation	118.00	8.46%	6.67%
Hargreaves Services	Support Services	108.39	7.15%	5.87%
Ramsdens	Financial Services	49.65	5.25%	15.36%
Real Good Food**	Food Producers	8.38	15.75%	7.96%
Redhall Group	Support Services	15.31	4.10%	23.64%
Science in Sport	Food Producers	49.45	3.18%	12.84%
Synectics	Support Services	36.83	6.70%	13.14%
Volex	Electrical Equipment	121.49	10.22%	7.60%

All figures correct as at 28 September 2018
**Total percentage of investee company held by all Downing managed funds*
***Holding includes 0.88% equity and 14.87% debt split*
**** Includes cash*

In this letter we explore the concept of the capacity to suffer/ reinvest i.e. management's ability to forego some immediate earnings, seeking to gain greater profits and market share longer term. Long term, strategic decisions are often associated with nearer term uncertainty and periodically regressive profits and/ or cash flow. The Primary aim of the Trust is to support visionary management teams operating great businesses at attractive valuations. We think that this strategy can generate sustainable capital growth for shareholders over the long term.

Capacity to suffer

In the 1960s and 1970s, Stanford University undertook an experiment on delayed gratification. Children were given the option of one marshmallow immediately or two marshmallows if they could wait for an unspecified amount of time. Follow-up studies found that children who were able to wait longer tended to have better life outcomes.

The same follows for the long-term success of businesses, particularly those with public listings where it can be tempting to act in the best interest of the share price rather than long term value creation. The market generally loves consistency and predictability. Analysts, brokers and fund managers alike tend to prefer stories which offer smooth and consistent growth in profits and cash flow.

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With management teams increasingly answerable to shareholders, this short termism has manifested itself in companies as well. In a 2005 paper, Graham, Harvey and Rajgopal[1] surveyed executives and found that a) the majority of managers would reject a positive net present value (NPV) project if the associated investment reduced earnings below quarterly consensus; and b) value creation was avoided at the expense of smoothing earnings, to satisfy investors. In 2011, PwC[2] surveyed UK executives and found that most chose a low return option sooner, rather than a high return option further out.

Capacity to reinvest

We are typically interested in management teams who seek to maximise value creation over the long term. Thomas Russo describes this as the 'capacity to suffer' because the myopia of market thinking has become increasingly short term.

We think that this myopia is particularly prevalent in small and micro-cap companies which are typically under researched and where speculators tend to congregate for a quick profit. With regulatory changes such as MiFID II, we also believe that smaller companies are becoming increasingly under researched and the long-term value creation 'stories' are glossed over in favour of more tangible short-term reporting and performance.

However, micro-caps do have one advantage over their larger peers. Where management are able to own larger stakes in their own businesses, they should be able to make more effective long-term decisions – which may be to the detriment of the share price in the short term – without fear of losing their jobs. This 'entrenchment' can be an issue where management consistently evidence poor decision making at the expense of shareholders, though we aim to avoid these types of businesses unless there is good value and scope for change.

Reinvestment typically comes in two forms – organic and inorganic. Conceptually, and from a valuation perspective, inorganic investment (acquisition) is easier to quantify as it involves acquiring established earnings and/ or brand value. However, this will typically come at a higher price as the acquirer will also pay an intangible goodwill element over and above the net asset value of the target. This reduces the incremental return on invested capital.

Organic investment is trickier to value and much more subjective, as outsiders we must rely on management expertise and knowledge to grow value from grass roots investment. For example, establishing a new division will often require an initial fixed capital investment, but it will probably also incur operating expense investment as well. Depending on the ambitions of the management and the scale of the investment, this 'opex' may compress parent company margins until the new business achieves a full run rate. However, short term earnings regression from increased investment should pale in comparison to higher returns on invested capital over the long term. If capital stretches further then more earnings enhancing projects may be able to be carried out, therefore aggregate long-term earnings will also be higher.

Portfolio

The Trust's closed end structure is ideal for making long term investments and our investment horizon typically ranges from three to seven years. We are value investors and we employ a private equity approach to investing in the public markets – we think this is the most appropriate method of generating risk adjusted returns in small and

[1] Graham, J R, Harvey, C R and Rajgopal, S (2005), "The economic implications of corporate financial reporting", Journal of Accounting and Economics, 2005.

[2] PwC (2001), "PwC Valuation Index, Tracking the Market to Understand Value", PwC

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micro-cap companies. We invest with conviction and the Trust holds only our best ideas – enough positions to reduce stock specific risk, but few enough from which true outperformance over the long term could be generated.

Several of the investments to date have provided equity growth capital to what we believe to be great businesses at attractive valuations. Other businesses that are investing heavily or acquiring via organic free cash flows and/ or alternative, non-dilutive capital have also been added. We also have two businesses where our investment thesis points to a divestment requirement to realise value.

Investors		**Divestors**
Gama Aviation	*Adept Technology Group*	*Hargreaves Services*
Volex	*Braemar Shipping*	*Real Good Food*
Redhall	*Synectics*	
Science in Sport	*FireAngel*	
Duke Royalty	*Ramsdens*	

Our leftmost 'investors' (above) have raised around £150 million in equity capital since the launch of the Trust (Real Good Food raised a further £2.75 million in equity). These are businesses which are investing heavily – through both organic cash flow and new equity capital – in growing their moat and which, we think, have tangible and intangible value beyond what their market caps would suggest. For example, both Gama and Volex have market leading attributes in terms of scale. Science in Sport has sector leading gross margins in sports endurance, driven by a differentiated model which we think could deliver good profitability once at scale. Redhall has several lucrative public sector contracts in highly regulated end markets. Duke Royalty, our newest position, is pioneering a differentiated lending model in the UK, one which has been proven in Canada and the US.

Adept's management have made keen use of their balance sheet and alternative financing methods, funding a transformational acquisition last year via a convertible loan note. Their acquisition strategy coupled with different financing methods has earned them a fantastic EPS track record (we touched on this in the last letter). Braemar has also made self-financed acquisitions whilst Synectics and FireAngel have committed to significant amounts of R&D spend to create the next generation of products. This type of reinvestment should increase barriers to entry, IP and, ultimately, brand value over time. However, there must be a return on this investment alongside capital efficiency and we have identified several areas for improvement in some of these businesses.

At the other end of the spectrum, we have identified the requirement for divestment in both Real Good Food and Hargreaves Services. We invested in a capital expansion plan in Real Good Food and the Renshaw and Brighter subsidiaries are performing well as a result. There has also been a capital realisation programme in the other non-core subsidiaries and this has been used to pay back the term bank debt. We think that the remaining businesses are well placed to increase shareholder value (more on this on page 6). Likewise, we have identified at Hargreaves some lax capital allocation decisions in the past and think that the business warrants a different operating structure which may release capital to shareholders in due course.

Overall, we think that the portfolio is attractively spread across multiple value creation strategies. Some of these will take longer than others to deliver. Some will be successful whilst some may require additional thought before more capital is committed. However, we think that there is upside potential and much to play for in each holding.

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

Kind Regards,

Downing Public Equity

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Portfolio commentary

In the three-month period ended 28th September 2018 we committed around £2.1 million of capital to Duke Royalty and approximately £0.2 million to other existing holdings which we considered to be mispriced.

New investment: Duke Royalty

Royalty financing offers private business owners a source of long-term capital without suffering refinancing risk or any loss of control. Duke is an alternative lender through its unique royalty finance offering. It provides investors with exposure to established, growing and cash generative private businesses. The business is the first of its kind in the UK listed space and employs a model which has been proven in other western countries. Downing client funds own 6.4% of Duke and it makes up 4.4% of the Trust. Our summary investment case is as follows:

- **Proven model:** Duke is the first listed, non-resource, royalty finance offering in the uncontested European market. It is rolling out a product that has been hugely successful in North America since its inception in the 1980's - that market is now worth over £50 billion.
- **Opportunity:** Duke's offering comes at a time when mainstream banks, constrained by capital adequacy rules, have focused lending to the most prime customers, leaving a significant number of SMEs unbanked and requiring expansionary capital. This has led to a growing alternative finance market in Europe, but one without a royalty finance offering other than Duke's.
- **Visibility:** Duke's royalty finance product involves the investment of £5-20 million in a European SME in return for a regular annual royalty set at an initial 12-13.5% yield. Royalties are typically paid over a 25-40 year period but can be structured perpetually as permanent capital. Under these terms, Duke's investment is typically returned by years 6-7, leaving a minimum of 18 years of royalty payments to come.

Work in Progress (WIP)

This period has been busy with reporting and WIP. We converted one of the deals which we mentioned in the last letter – Duke Royalty – and ultimately rejected committing any further resource to the two others we mentioned. As with any idea, these companies will enter a list of 'potentials' which we maintain alongside positive catalysts which would cause us to reassess our view of the business. Most often, this catalyst revolves around price.

In early October we saw a widespread market correction which has generated several new ideas, although few have a highly strategic element which we seek and would fall into the category of being generally undervalued. These companies warrant further work on a valuation basis and there is potential for a strategic element to evolve over the course of our diligence.

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Reporting highlights

	Jul	Aug	Sept
Adept Technology	Results: in-line	Acquisition	
Braemar Shipping			
Duke Royalty	Fundraising		Results: in-line
FireAngel		Trading: behind	Results: behind
Gama Aviation	Trading: in-line*		Results: in-line
Hargreaves Services		Results: in-line	
Ramsdens			
Real Good Food			Disposal
Redhall Group			Trading: behind
Science in Sport	Trading: in-line		Results: in-line
Synectics	Results: in-line		
Volex	Trading: ahead		

**commented in previous letter*

Adept Technology Group

Adept continues to impress with full year results in July delivering the 15th consecutive year of increased underlying EBITDA, up 24.8%. Profit before tax and adjusted fully diluted EPS increased by 32.8% and 26.2%, respectively, and year end net senior debt was only marginally higher at £17.6 million. This excludes the convertible loan notes used to acquire the Atomwide business earlier in the year. In line with our investment thesis, revenue visibility continues to increase with managed services now 70% of total sales, up from 55.4% last year. Underlying free cash flow generation continues to be strong as the business remains capital light spending only 0.8% revenue on capex in the period.

Post full year results, Adept also announced the acquisition of Shift F7, a specialist provider of IT services to the commercial sector. Shift F7 has approximately 75% of gross profit from recurring revenues which will be accretive to Adept's own recurring profitability, whilst also bringing further exposure in London and the South East.

Adept continues to perform in line with our thesis. If we had one qualm, it would have been that, historically, management have done little to market this great business. However, with a change in broker we now expect this to change going forwards.

FireAngel Safety Technology

The results in September revealed nothing materially new about the underlying business and finances, with management having already delivered the bad news in prior months. Last time we talked about how we were reviewing our investment case in FireAngel, owing to several operational issues and management oversights. In the period, we have achieved greater clarity on the strategic plan which we believe has merit, albeit with a refreshed management team. When we review the businesses returns over the long term, we think that there is a highly operationally efficient model capable of coming through. However, for whatever reason, this had not been the focus of management as the company grew. We think that with a refined cost base and renewed focus the business should be able to revert to these types of returns and efficiency.

The business has recently signed two new supply agreements which confirms that the demand side is still strong. These supply agreements will constitute both a hardware upfront element and a managed service recurring element, in line with the model moving more towards connected home products.

Gama Aviation

In October, Gama announced that their 2018 full year results are likely to be $3 million behind expectations which would mean an underlying operating profit of around $17-17.5 million. We think that this will make them broadly flat versus 2017. This is very disappointing post the fundraise where expectations do not appear to have been managed appropriately. We think the downgrade is a combination of lower than expected growth combined with higher costs from operational investment, on the back of the growth strategy, which hasn't yet generated the expected revenue. Additionally, there has been some disruption in the business from changes like the move to Bournemouth.

Regardless, there have been some positive developments against our long-term investment thesis. Firstly, there has been progress in the US identifying the new base maintenance locations. Gama has chosen to go down the route of organic expansion which, whilst slower to generate returns, should generate a higher return on invested capital over the long term. Secondly, the Air division has demonstrated modest gross profit growth in the newer regions Asia and the Middle East which we crudely infer as an increase in the fleet and/ or management fees. The US also demonstrated a small uplift in gross profits. Thirdly, the Ground business, whilst disappointing in Europe particularly, has some positive catalysts, not least the Bournemouth move which is expected to bring efficiency savings over the long term.

The interim results were negatively affected by one off exceptionals of $4.3 million. There were additional discontinued items which we now expect to drop away bar some onerous lease costs in Oxford which should run off from mid next year. The result should be cleaner financials going forwards, which is good progress.

We believe the business has attractive and investible attributes such as the visibility on management fees and maintenance contracts and global scale which brings a competitive advantage and barriers to entry. These quality aspects should be leveraged by management. There is also the opportunity to grow by selective acquisition or, as above, by organically widening the service offering in established regions. This type of growth may be accompanied by an underlying business which is growing less than expected but which, nevertheless, has good long-term drivers. We think that there are also potential margin improvements available across the business which would offer an additional route to earnings progression. We think that the introduction of a new full time CFO, effective from September, will provide further financial rigour. This should hopefully lead to the company underpromising and overdelivering as management become more adept at internal forecasting and setting achievable expectations.

Hargreaves Services

Hargreaves reported in line results, although there were several exceptionals as the business continues to realign. The key takeaway for us is the balance sheet strength, with greater detail on the property valuation coming through. Whilst reported book value equates to 424p per share, there have been some revisions formalised in the red book valuation pointing to a £20 million uplift in the property market value and a £28 million uplift in the development value, combined worth a further 149p per share, or 573p in total. This compares to the current share price of around 340p. Post results, the business announced the disposal of Brockwell Energy for an estimated £21 million with an approximate £4 million uplift to NAV. While the underlying businesses continue to perform in line - £9.4 million of underlying operating profit to the full year – a large customer has recently entered administration to which Hargreaves have around £5 million net exposure and further personnel exposure of up to £3 million. This is a disappointing development, but one which does not materially affect the primary part of our thesis which revolves around NAV uplift and realisation.

Real Good Food

In the period, Real Good Food announced the disposal of Hayden's bakery, with the proceeds used to pay down the rest of the term debt. At the time of our investment into the group, there was an allocation to Hayden's for new capital equipment to improve throughput and efficiencies, particularly on a new yumyum line. This investment was made on the back of contracted demand from supermarkets. Post investment, Hayden's began underperforming on margin assumptions whilst demand remained promising. Ultimately, and with the rest of the change which was going on in the group, the management team decided that it was better to divest this business now, rather than try to recover margin and bring it into profitability. On an annual run rate, we think the business was losing around £2 million and this cash could be used better elsewhere. The exit price was at net asset value which is disappointing but also reasonable given the cash losses.

This leaves the group with two core, cash generative subsidiaries – Renshaw and Brighter Foods – as well as a couple of smaller subsidiaries. Renshaw and Brighter are both performing well on a revenue and profit basis. Stockdale, Downing's house broker, recently published a note which pointed to combined historic EBITDA of these businesses of over £8.5 million. This would value the group today at under 1x EBITDA, and sub 5x EV/ EBITDA. Given the potential for these businesses to grow and the stability of the capital structure of the group (no third-party debt) we think that this represents great value although it is unlikely that market sentiment will adopt this view until more progress can be demonstrated. There is still hard work to be done to ultimately realise value, but we believe the management team in place are top class and now well aligned to an outcome which should favour shareholders.

Redhall Group

Redhall's results were disappointing, highlighting further delays which have been detrimental to the share price of this small, niche engineering business. Whilst Redhall has a quality order book of public sector projects, the business is sub-scale and the inherent lumpiness which comes with this is proving a major hurdle for the progress of the share price. There is no doubt in our mind that Redhall's potential, as evidenced by the quality of the order book, is materially undervalued by the market and we will take the necessary steps to close the gap between market value and fair value.

Science in Sport

SiS reported good progress in its interim results with headline revenue growth of 20%. Crucially, the core business is generating respectable profits before investment in the new vertical, football, which consumed around £0.6 million of cash. We expect that the core business might generate in the region of £1.5 million pre-football investment for the full year. This reflects the lower marketing spend in the mature region, which should slowly revert to a market-like growth rate of around 8%, consuming less cash to do so. This core profitability is a key part of our investment case – demonstrating that the business can generate cash in a mature state.

At the time of the placing, management outlined plans for growth in Italy, the US, and the football vertical. Italy is growing very quickly and should generate around £1 million of sales annualised. This region is also highly profitable and should begin to break even from FY 2019 if growth continues. The US is absorbing heavy investment but growing well, 297% versus the first half last year. As expected, there is increased working capital consumption from this growth, but management are trialling a new distribution model with Amazon which should release inventory build-up going forward. Overall, international sales grew by over 50% and constituted 34% of total sales. In our opinion, football has been slow on the back of delayed contract signing with Manchester United. This business is now generating around £0.75 million in revenue. It increasingly feels like the market potential here is greater than we expected but may take a little longer to fully reap the benefits. SiS are very well regarded in the top league teams with 75% of the Premiership and 70% of the Championship signed up, and we expect that this will trickle down to the grass roots in due course.

Synectics

Synectics continues to impress by slowly but surely delivering on our expectations. The interim results in July highlighted revenues increasing modestly to £34.7 million but a materially higher order book, up 18% since year end to £28.8 million. Cash profits were ahead of our expectations albeit predominantly on working capital gains which should normalise out in the second half. Net cash was reported as £9.1 million whereas management comment that current average net cash should reduce to around £5 million. Regardless, we are still pleased with the underlying performance which reflects higher investment going forwards. In total, the P&L absorbed £1.3 million of R&D spend whilst £0.2 million was capitalised. This R&D and investment in business development resource elsewhere should help the business to leverage the operational gearing in future periods.

In August, the business announced a material new contract with Serco to replace the CCTV systems at six of their UK-operated custodial sites. This multi-million pound project has already begun and is expected to complete in early 2019.

Volex

Management reported a particularly positive AGM statement outlining both revenue and profit growth in the first quarter, following investment in the sales team and efficiency savings elsewhere. As a result, the house broker increased FY19 adjusted EBIT by 7% and FY20 by 8% based on better mix in the power cords division – given Apple's continued decline, and growth elsewhere – and early benefits of ongoing cost initiatives across the business. We believe there is additional opportunity for incremental gains from the integration of the recent acquisitions on which we expect to get more detail at the interims in November.

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