Results analysis: Downing Strategic Micro-Cap

DSM's interims illustrate continued progress, with insider buying from both manager and underlying companies...

Update
01 November 2021

- **Downing Strategic Micro-Cap (DSM) has reported its interim results for the six months to 31 August 2021, showing a continuation of the strong bounce-back from the pandemic induced market falls of 2020. The NAV per share on 31 August 2021 was 93.74p, an increase of 15.5% on the NAV per share on 28 February 2021 (81.16p) and an increase of 39.2% on the prior interim NAV per share of 31 August 2020 (67.36p).**

- **DSM has a concentrated portfolio of investments in small companies. They have been selected by the managers because they believe their prospects are materially undervalued, and in some cases, in need of some strategic involvement. The managers summarise their activities in this regard as "boards have been re-shaped, strategies re-focused and tough positions exited".**

- **The manager's report that they are not complacent, with inflation, interest rates, and supply chains all potential headwinds. They believe "inexpensive cash generative businesses of which this portfolio has plenty", offer elements of defensive qualities. Having 12% of the NAV in cash (at the time of writing) "provides an opportunity to capitalise on market turbulence and any mispricing that tends to accompany market volatility".**

- **The managers have been "unusually bullish" on the prospects for DSM since the start of 2021 (see investor letters on the DSM website). These letters illustrate the team's progressive confidence in the portfolio, with phrases such as 'coiled spring' and 'best ever prospects for the portfolio' conveying some of their enthusiasm for the companies that DSM holds. The interims illustrate that the portfolio has made good progress and prospects are improving.**

- **Despite the sound performance by investee companies, and considerable uplift in NAV, the managers continue to believe that they stand at a considerable discount to intrinsic value. The team view their stocks as unreasonably overlooked, even though "each has a likely exit". Downing believes their "worth should be realised nicely in time and they currently offer excellent value".**

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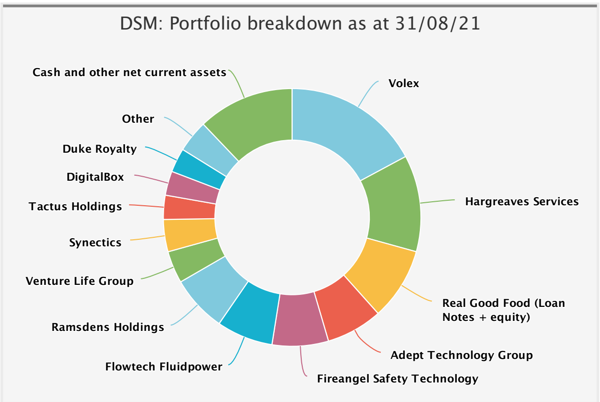
- **The board look to buy-back shares of the trust if the discount drifts out beyond par for a company like DSM. Hitherto par has considered to be broadly 12-15%, but the chairman states that the board hopes they will be able to get the discount to single figures in a healthy market.**

Fig.1: Investments



Source: Downing

Kepler View

In the most recently published factsheet (30 Sept), the manager commentary makes reference to holding Venture Life being a disappointing investment, but that others such as Digital Box and Flowtech Fluidpower have delivered strong results and share price performance. We also note that Synectics announced very recently a significant project for West Midlands Police, although its share price doesn't appear to have reacted yet. DSM's NAV has declined modestly from the interim date, along with the market, down from 93.74p to 90.13p as at 27/10/2021 (-3.8%). The discount remains in low double digits (12% at the time of writing).

Underpinning DSM's strategy is the expectation by the managers that the prospects for their underlying portfolio companies are underappreciated by the market. It is this that gives them the opportunity to purchase shares at attractive valuations at the outset. Within the portfolio there is a balance of very different investment drivers, but until the wider market (or an acquiror in an M&A transaction) better appreciates these companies' prospects, investors need to have patience until an opportunity presents itself for full value to be realised. As it stands, DSM offers a highly differentiated exposure to small companies which are unlikely to be found in other fund portfolios, with the exception of Tactus, of which more below.

It would appear that both managers of the trust and the underlying management teams of the portfolio companies see the significant value inherent in current share prices. The management team have been personal buyers of stock in DSM, as have other Downing related parties. Perhaps more importantly 9 of 14 portfolio investments have seen management teams buying stock in their own companies. This is a positive sign, and shows that those closest to the coal face remain positive on prospects. As suggested in the interim statement, in time the market must start to recognize the value "otherwise they will most likely be targets for international corporate activity".

Tactus is DSM's only private investment, which has been a stellar investment thus far despite only having been held since April 2021. Tactus is also owned by Chrysalis Investment Trust, the growth focused trust which trades at a 5% premium to NAV. Reflecting their cautious approach, we understand that the Tactus valuation used by DSM's board is at a discount to the transaction value in which Chrysalis invested. The difference in these valuations, not to mention the divergence in each trust's discount, exemplify why DSM is a potentially attractive investment for investors with a value mindset.

We will be publishing a full note on DSM in the coming weeks, following the interims. Please click **here** to be alerted when it is published.

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