Downing

St Magnus House
3 Lower Thames Street
London EC3R 6HD

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

Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

July 2019

The Trust's first two years have been challenging, yet we have been fortunate to retain committed and understanding investors who believe in the process and the asymmetric returns which we expect to be able to generate over the longer term.

From the outset, we did not expect these returns to be generated over a short investment horizon – strategic investing, more than many other types of investing, requires patience. However, positive returns have been less forthcoming than we expected at the beginning. In our search for undervalued and unloved companies, we have picked a few where the challenges have proven to be too much for the incumbent management. Those management teams have been replaced or refreshed and we believe that the underlying businesses should now be able to prosper.

There are many reasons to be positive. We believe that we have invested in some great companies, four of which are AdEPT, Duke Royalty, Ramsdens and Volex, and they have delivered evident increases in intrinsic value to date. This has largely been ignored by the market. As for the others, four have gone through major strategic change and are now looking in better shape. After two years' hard work we remain optimistic on the current investments. In the notes that follow, we will frankly admit to misjudging Redhall, a recovery and turnaround opportunity. In the current climate for contractors this was a mistake that we regret and have learned from.

Corporate Governance

As we discussed in our last letter, there has been a varying degree of incompetence or dishonesty within some management teams that are leading, what we perceive to be, valuable businesses. In hindsight, perhaps these businesses were justifiably mispriced. However, having identified some of these issues, we have prompted change and are pleased to say that we believe the majority of our investments now have the correct management teams in place to deliver on both their own, and our, aspirations. Change will always be required as companies evolve so we continue to monitor this capability very closely.

Since its inception, AIM has always had to deal with the 'little brother' reputation versus the main market. Lower fees and less regulation are attractive to genuine, small companies with a cost-conscious attitude. Unfortunately, they are also attractive for operators seeking to transfer value from trusting external parties, to themselves. Often it is the retail investor who loses out most, though institutions are not spared the pain.

Real Good Food

In June 2017, the Trust completed an investment into Real Good Food, a diversified food manufacturing business serving a number of market sectors. The monies were provided via equity and secured loan notes, along with a board position, on the basis that we determined the sum of the parts of the disparate businesses was far greater than the post-money enterprise value of the group.

The events which unfolded quickly post this investment resulted in a material devaluation of the Company's equity and financial position. It is only after two years of our intervention, and the new boards drive to 'do the right thing', that the intrinsic value of the business has increased.

Recently, the London Stock Exchange (LSE), issued a fine and public censure against the Company and its former directors to reflect the "inadequate corporate governance…under the leadership of the former Chairman". We think that this is a welcome intervention in sending a decisive message to management teams that seek to work around the rules as opposed to following the spirit of honesty and transparency. The LSE found that "inadequate corporate governance facilitated a culture of poor decision making, and an overly dominant former Chairman and directors who were allowed to go unchallenged. The Board failed to assert sufficient control or prevent the former Chairman and certain directors from exerting disproportionate influence. This resulted in a number of serious failures by the Company to comply with its AIM Rules obligations."

Since these problems began to emerge two years ago, we have engaged openly with our investors during meetings. Most have been supportive and understanding of the complexities faced by outsiders such as ourselves, in dealing with these matters and addressing the governance issues associated with the previous board. Indeed, if a management team seeks to defraud investors then there is little that an outsider can do to uncover this prior to investment. Hence, we rely on strong and independent insiders to act in our interests. In this case, it was only our own board position which allowed us to uncover undisclosed consultancy payments, from which many other issues unravelled.

In short, Real Good Food breached no less than seven AIM rules:

- **Rule 10:** disclosure obligation, in that the Company did not take reasonable care with respect to earnings forecasts and their expansion plan and its expected contribution to the 2018 budget.
- **Rule 13:** the Company did not make timely disclosures in relation to consultancy payments which were made to the former Chairman. These involved a related party transaction which should have been disclosed without delay.
- **Rule 19:** breach relates to various other related party and undisclosed payments made to directors.
- **Rule 10, 17, 21:** relates to director dealings in respect of the Company's Chairman dealing in the Company's shares during a close period; failing to notify that shares had been traded; and, subsequently, announcing the trade with an incorrect transaction date giving a misleading impression that the dealing did not occur during a close period.
- **Rule 31:** regards the above, collectively, demonstrating that the Company's directors failed to ensure that the company complied with its obligations and responsibilities regarding corporate responsibility, procedures and controls, and liaison with the nominated advisor.

The £300,000 fine applied is immaterial to the losses suffered by shareholders during the period. The censure is more significant, and something which we are highlighting to our non-executives to remind them of their duties.

Since these transgressions, the incumbent board has been refreshed and Real Good Food has been on a value realisation path. It now retains two core operating businesses, having realised £17 million from disposals, the bulk of this cash having been used to pay down all of the bank term debt, reducing refinancing risk. The remaining debt is that of supportive shareholders with an interest in increasing the company's equity value.

The core businesses which remain are strong and are trading well. The disposals have allowed for a cost restructuring of central overheads and we are confident about realising the underlying intrinsic value in this investment.

Value in Real Good Food aside, we are confident that the strategic progress being made across the portfolio companies will unlock shareholder value. Thank you for your continued support in the Downing Strategic Micro-Cap Investment Trust.

Kind regards,

Downing Public Equity

Portfolio activity

FireAngel Safety Technology

We indicated in April that the Trust intended to participate in the FireAngel placing at 20p per share. The Trust purchased 4.6 million shares at 20p later in the month. This allowed us to significantly average down the book cost per share, which now stands at 60p.

Redhall Group

The most significant and disappointing development in the quarter has been Redhall, which has entered into administration. Our first thoughts are with the employees of the business who face a period of uncertainty as new owners are sought. At the time of writing, three of the four divisions have found new owners.

We invested in Redhall as we believed that it was in a great position to win valuable contracts in UK infrastructure projects. These high value projects provided forward revenue visibility and, coupled with more competent management, we thought an ability to extract higher margins would result in much-improved cash generation over the investment period.

The business did prove itself capable of winning new and large contracts. And management, despite some churn, were finding efficiencies to lead to higher operating margins. The company had working capital to deliver these contracts following the placing in 2017.

However, cash collection was more difficult, particularly with the Hinkley Point C main contractor who was not delivering cash back to the business. Ultimately, we suspect that the prior turnaround management team – eager to get the share price moving – entered into these contracts on punitive terms. The new management team had identified the problems but were unable to reverse the cash outflows to save the group.

There are many lessons to be learned from Redhall. Some are impossible to know as outsiders, such as having the contractual detail on payment terms provided to customers. However, there are general conditions of which one could be aware. Firstly, to be cognisant of the position of small suppliers in the chain. Typically, there is less to be worried about when market conditions are good, however when the tide changes it can become very challenging very quickly. Secondly, to be mindful of lengthening receivables and working capital cycle. Redhall was not collecting cash and this was obvious from the accounts. We mitigated this risk by spending more time with the finance team to understand the pinch points and current financing. Stress testing the cash flows indicated significant risk around timing, though we based our decision on *eventual* cash collection. What transpired was that no cash was collected at all and the resources were insufficient to allow trading to continue.

The result for the Trust is highly unsatisfactory. We invested a total of just over £5 million in Redhall via equity and loan notes. The equity value is nil. The loan note value – secured on the cash flow of the group – has also been written down to nil.

Redhall was a mistake, and one which we are adamant will not be repeated.

Reporting highlights

	Apr	May	Jun
AdEPT Technology	Trading: in-line, acquisition		Board change
Braemar Shipping Services	New chairman	Results: in-line	Disposal
Duke Royalty			
FireAngel Safety Technology	Open offer*		AGM statement
Gama Aviation	Various	Various	Board change
Hargreaves Services		Various	Trading: in-line, disposal
Ramsdens	Trading: in-line	Acquisition	Results: in-line
Real Good Food		AIM censure*	
Redhall Group			Administration*
Science in Sport			
Synectics	Trading: in-line		
Volex			Various

** commented on in this letter*

AdEPT Technology Group

In April, AdEPT announced an in-line trading statement and highlighted underlying EBITDA is anticipated to increase by 13% and net senior debt reduced to £27.2 million, £0.8 million lower than market expectations. Following a year of strong free cash flow generation, the board anticipate distributing a 9.8p per share dividend, an increase of 12%.

Later in the month, the company announced the acquisition of Advanced Computer Systems Limited (ACS). ACS is a specialist provider of IT services to the education sector, an area where AdEPT already has thousands of clients, bolstered by the acquisition of Atomwide in August 2017. ACS is expected to be immediately earnings enhancing and will bring synergy and cross-selling benefits. We think that the acquisition makes good strategic sense and also extends AdEPT's reach further north, another area of strategic focus. Alongside the acquisition, AdEPT also announced the extension of its banking facility up to £40 million via a new £5 million tranche.

In June, the company announced that Richard Bligh was joining the board. Richard was formerly COO at Gamma Communications plc. We welcome Richard's appointment as a high calibre addition to AdEPT's board and think that his experience will facilitate further growth of the business.

Braemar Shipping Services

Braemar had a busy quarter. In April, it was announced that Ronald Series was taking over the chairman role. We know Ron well from the turnaround that he engineered at DX Group, where we are also a holder, and we welcome his involvement in Braemar.

The results in May were in-line, bolstered by a strong performance from the Shipbroking division. The Finance division also performed strongly and has built a growing pipeline of business. Logistics also put in a strong performance, maintaining its UK market share. Overall, we were pleased with the results. The most significant strategic development has been the disposal of the Technical division which had been loss-making for the last two years. The division was sold to Aqualis ASA, a Norwegian consultancy and engineering group; Braemar will hold a 26% stake in the enlarged group. We welcome this divestment as it allows Braemar to focus on higher margin operating activities which are a central part of our investment thesis.

Gama Aviation

There has been significant newsflow in Gama over the quarter, which builds on the large degree of change having taken place in Q1 of 2019. We didn't comment on that change previously as the situation was still very fluid, however things seem to have stabilised for now and we offer our opinion herein.

Firstly, the accounting restatements are unpalatable, and we note that the company undertook an institutional placing of new equity on a misstated balance sheet. That misstatement was, in our view, material to the investment case predicated on stabilising working capital outflows and improving cash generation. The company has since taken the decision to remove Grant Thornton, the auditor, and replace with PwC; a decision which we welcome.

The degree of board change which has occurred this year indicates that the existing governance was inadequate, something which we underestimated when we invested. We have pushed for change at the board level since autumn last year, ultimately that change took much longer than we would have liked and is not entirely in the same guise as we expected. Hutchison, the company's largest shareholder, and who had a non-executive on the board already, took decisive steps to reshape the board and has increased its equity holding to just under 30%. While this is not the outcome we had pursued, we have since spent a lot of time with Simon To – Gama's new chairman and Hutchison's representative – and believe that minority shareholders' interests are at heart. In hindsight, the decisive action is welcomed during the period of uncertainty around the results, and the wider Hutchison network, and its experience in aviation, should be a positive for the company in the future.

The results themselves, restatements and missed expectations aside, show some promising signs of growth in parts of the Management business (8% fleet growth in US and Europe, and doubling in Asia). The key is really to get scale in these businesses and to see the operational gearing start to come through. It's a tough market but we think that there is a compelling business opportunity to scale up in Asia particularly, and the Hutchison relationship could help that. Over the long term, we still think consolidation is viable. There have been strategic changes in the Maintenance business, such as moving to Bournemouth and investment in new US facilities, both of which sound like the right long term moves but which bear the restructuring costs and operating cost investment through the P&L in the nearer term. We think that the Maintenance proposition is a good one, bolstered by some very material special missions' contracts. Gama has been winning contracts recently – two new ones total over $100 million over the life of the contracts. Elsewhere, cash generation was negatively affected by a large working capital outflow, but we expect the debtors portion to reverse as debts are collected against a few larger customers. The balance is reflective of investment for growth, particularly inventories in new maintenance locations.

2019 will be a year of transition and rebasing of financials, as clearly some of the reporting practices of the past were not prudent. The half year results should give a better indication of what the business is really capable of, alongside, we hope, confirmation from the new chairman of the strategic plan.

In our view, there remain real opportunities to improve margins and cash generation across the business. M&A activity in the sector remains buoyant and multiples are generous for businesses with scale. This gives us confidence in the strategic value of the group as a fall-back valuation. The de-geared balance sheet and Hutchison's interest provide comfort while the business transitions.

Hargreaves Services

Hargreaves has had a mixed period. On the negative, the company announced that it has a material exposure to British Steel, which has been trading through administration. The board has made adequate provisions against the deterioration of this business, estimating its exposure at £4.5 million if British Steel were to stop trading. Currently, British Steel continues to trade as a significant part of the UK's steel supply as it is being funded by the Government until alternatives are found. We think that the ability to close British Steel completely is low as the UK lacks the infrastructure to support the importing of the equivalent steel which it contributes. This would lead to a rapid deterioration of the UK's construction industry. While not an ideal situation, this would allow a more orderly winding down of the British Steel exposure.

The company also announced the conditional sale of 10.75 acres of land at Blindwells, Edinburgh, to Bellway. The transaction is valued at £9 million to Hargreaves on completion of planning permission and approvals expected in the second half of 2020. This is a significant development on our investment thesis, demonstrating the viability of the NAV realisation of the land assets. The Blindwells site totals 390 acres and has planning permission for 1,600 homes.

The trading update in June indicated that underlying results, before exceptionals related to British Steel and Wolf Minerals, would be in line with expectations and would show growth versus the prior period. Net debt at the year-end reduced materially to £17.9 million, from £30.8 million in the prior year.

Ramsdens

In the period, Ramsdens announced a further acquisition of four The Money Shop stores, and 12 loan books. Ramsdens used £0.5 million of cash for the purchases which are expected to be earnings accretive by around 4%, on top of the 9% accretion from the prior acquisition of stores which we talked about last quarter. We think that this consolidation adds a compelling growth element to the investment thesis on top of a business which has healthy organic growth and self-help margin opportunities. The business retains ample cash to continue selective bolt-ons from failing high street competitors. We note that H&T Pawnbrokers recently undertook a placing to acquire 65 stores and 29 loan books from The Money Shop. This adds credibility to the strategy, and we believe that Ramsdens had the pick of the best stores before H&T picked up the rump.

The results in June met expectations and show further progress against our thesis, with double digit organic growth and improving mix. We continue to believe that the shares are rated too cheaply on sub 6x EV/ EBIT, double digit operating margins; a net cash balance sheet and over 15% free cash flow returns on invested capital.

Volex

Volex announced a positive set of financial results in June, following the transformational placing undertaken last year. Progress continues to be made in improving the operating margins of the divisions. Power cords reported

6.7% operating margins, having been around 2% since new management took over. Cable assemblies reported operating margins of 7.8%. We are confident that management will achieve the targeted 8% and 10%, respectively.

A key driver of the growth in the period has come from acquisitions, but there is still evidence of acceptable organic growth – power cords, excluding the Apple decline, of over 10%, and organic cable assembly growth of 8%.

In our view, the shares remain significantly underappreciated, priced at around 6x EV/ EBIT. Granted, there is some uncertainty around US and China tariffs, but Volex has mitigating strategies in place. The business is growing organically; it is able to grow inorganically at a reasonable price, around 6x; it is generating considerable cash, with over $10 million of free cash flow in the second half of 2019 alone. Finally, management expect to be able to return to the dividend list at the interim and we expect a maiden distribution for the year of three cents per share. Free cash flow returns on invested capital approaching 20% are, in our view, highly compelling for a business of this nature which has tangible asset backing.

At the end of June, Volex announced the acquisition of Ta Hsing Industries Ltd. The market had a muted reaction to the announcement despite its indication of earnings accretion. We think the strategic rationale behind the deal is overlooked. Ta Hsing will vertically integrate Volex with its supply chain, providing a lower cost route to commoditised power cord supply. This will allow Volex to compete more effectively on price and, along with the automation previously outlined, it should be able to increase competitiveness and improve margins more sustainably. We think that this is a shrewd move with good strategic rationale to build a better business. Over the longer term we expect that the team will be able to replicate the Ta Hsing capabilities in its other manufacturing locations, which will create a much higher quality and defensible business. In terms of margin effects, we think that an operating margin gain in the power cords business would not be an unreasonable assumption - this could be worth around $1 million of operating profit.

The business retains a healthy net cash balance sheet which should aid refinancing discussions which are ongoing. We also expect that management will continue to consider smaller and attractively priced acquisitions. We look forward to the 2020 financial year.

Valuation and operating statistics *(as at 28 June 2019)*

Name	Net debt/ Downing FCFF[1] (x)	EV/ book value (x)	EV/ Downing EBIT[2] (x)	Downing FCF yield[3]	10y average ROE[4]	10y average ROIC[4]
AdEPT Technology	3.77	7.24	10.82	6.84%	9.22%	5.38%
Braemar Shipping Services	1.75	1.41	11.44	6.44%	6.42%	6.47%
Duke Royalty	Net cash	1.12	12.12	6.60%	#N/A	#N/A
FireAngel Safety Technology	Net cash	1.01	9.39	8.52%	21.19%	21.38%
Gama Aviation	0.19	0.92	8.86	8.96%	23.04%	22.21%
Hargreaves Services	1.59	0.78	10.41	7.13%	17.63%	11.11%
Pennant International	Net cash	2.20	9.08	8.81%	14.67%	14.54%
Ramsdens	Net cash	1.61	6.35	12.59%	28.03%	23.05%
Real Good Food	1.52	0.66	3.48	21.41%	-2.66%	-2.29%
Science in Sport	Net cash	1.34	-16.73	-4.78%	-25.87%	-25.27%
Synectics	Net cash	0.60	5.43	14.72%	4.01%	3.88%
Volex	Net cash	1.42	5.46	14.66%	9.41%	4.89%

[1] *Free cash flow to the firm, normalised as: (Downing EBIT*(1 – 20% tax rate)). Maintenance capex and working capital proxied by depreciation and amortisation. Based on Downing estimates and for comparison of portfolio companies only.*

[2] *Downing underlying EBIT assumptions*

[3] *Free cash flow to equity/ firm enterprise value, normalised as: (Downing EBIT – (2.5%* net debt))*(1 – 20% tax rate). Maintenance capex and working capital proxied by depreciation and amortisation. Based on Downing estimates and for comparison of portfolio companies only.*

[4] *Source: FactSet, 28 June 2019*

Portfolio construction *(as at 28 June 2019)*

Name	Sector	Age[5]	Progress against thesis[6]	Market cap (£m)	% of the Trust[7]	% equity held by Downing[8]
AdEPT Technology	Telecommunications	2.00	Ahead	85.80	9.37%	11.28%
Braemar Shipping Services	Transportation	1.25	Behind	59.73	3.74%	4.48%
Duke Royalty	Speciality Finance	1.00	Ahead	93.94	5.28%	6.37%
FireAngel Safety Technology	Electrical Equipment	0.50	Behind	29.24	5.84%	17.64%
Gama Aviation	Transportation	1.75	Behind	55.68	4.51%	6.95%
Hargreaves Services	Support Services	1.50	In-line	75.49	5.84%	7.03%
Pennant International	Software & Services	0.50	Early	32.68	2.03%	5.20%
Ramsdens	Financial Services	1.75	Ahead	56.12	6.90%	15.97%
Real Good Food[9]	Food Producers	2.00	In-line*	7.20	18.37%	7.90%
Science in Sport	Food Producers	1.75	In-line	74.92	3.12%	5.63%
Synectics	Support Services	1.50	In-line	32.56	8.29%	12.86%
Volex	Electrical Equipment	1.25	Ahead	141.77	14.30%	7.29%

[5] *Weighted average age of the Trust's investment, including initial investment and all follow-on investments. Rounded to nearest 0.25.*

[6] *Based on Downing's interpretation of progress against original investment thesis, or revised thesis*, where applicable*

[7] *Source: MISL. Includes cash*

[8] *Source: Factset. Total percentage of investee company held by all Downing managed funds*

[9] *Real Good Food holding includes 0.90% equity and 17.47% debt split.*

Portfolio valuation statistics *(as at 28 June 2019)*

	P/ book	P/ earnings[10]	Margin of safety[11]	Upside[12]
Average	1.53	8.55	40.86%	82.18%
Median	1.15	9.47	40.27%	67.77%
Weighted average	1.47	6.19	34.67%	63.69%

[10] *Normalised as: (Downing EBIT – (2.5%* debt))* (1 – tax rate). Excluding Science in Sport with negative P/ earnings.*

[11] *1 – (current price/ intrinsic value). Intrinsic value = NPV of free cash flows under Downing base case assumptions. Price from FactSet*

[12] *(Intrinsic value/ current price) – 1. Intrinsic value = NPV of free cash flows under Downing base case assumptions. Price from FactSet*

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