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

April 2019

The Trust aims to take strategic stakes in small companies which we believe to be significantly mispriced. Strategic investing, more than many other types, can expose investors to large troughs before any upside can be seen. Over time, we think that the ups should outweigh the downs. We believe that the portfolio is invested in companies with great intrinsic worth – those which can grow for relatively low incremental investment – are operating in growth sectors and were purchased at attractive valuations. If we can ride out the short-term troughs, which the closed-end nature of the Trust should allow us to do, then our returns should be asymmetric.

In periods of large drawdowns, we must not rush for the exit, but take stock and re-evaluate the opportunity. We use our high equity ownership and vested interest to facilitate conversations with industry experts and other stakeholders, as well as actively engaging with directors on issues. Where our thesis has been correct in companies typically with high insider ownership, contracted earnings, and high returns on invested capital, then drawdowns provide good opportunities to increase the Trust's holdings at a lower level, a wider margin of safety and with greater upside.

Blessed with perfect foresight[1]

The Trust is in the early stages of the investment journey, investments are initiated with an expected horizon of between three and seven years. While some investments have gone to plan or are ahead of plan, others have not. This begs the obvious question – are the risks of drawdown worth the pain, and is there light at the end of the tunnel for these investments?

To help answer the first part of this question we look to a study by Wesley Gray at Alpha Architects. Wesley looked at the returns from a 'God portfolio' - that is one which is invested with perfect foresight. Wesley explicitly engaged in look-ahead bias to determine the risk and return of holding the best performing US stocks for consecutive five-year rolling periods. The paper made some staggering findings: 1) Such foresight would deliver an impressive 29% per annum over the 82-year period (capacity constraints aside); 2) The portfolio would have greater volatility (standard deviation) than the market, and; 3) Despite perfect foresight, the portfolio would suffer a catastrophic drawdown of over 70%.

Summary Statistics*	5 year High MOM VW	SP500
CAGR	28.89%	9.63%
Standard Deviation	21.81%	19.40%
Downside Deviation (MAR=5%)	15.52%	14.44%
Sharpe Ratio	1.12	0.39
Sortino Ratio (MAR=5%)	1.48	0.42
Worst Drawdown	-75.96%	-84.59%
Worst Month Return	-32.69%	-28.73%
Best Month Return	44.20%	41.65%
Profitable Months	69.18%	61.45%

The results are hypothetical results and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. Additional information regarding the construction of these results is available upon request.

Source: Even God Would Get Fired as an Active Investor, Alpha Architects, Wesley R. Gray

[1] http://silverheights.com/downloads/the-world-of-money/Even%20God%20Would%20Get%20Fired%20as%20an%20Active%20Investor.pdf

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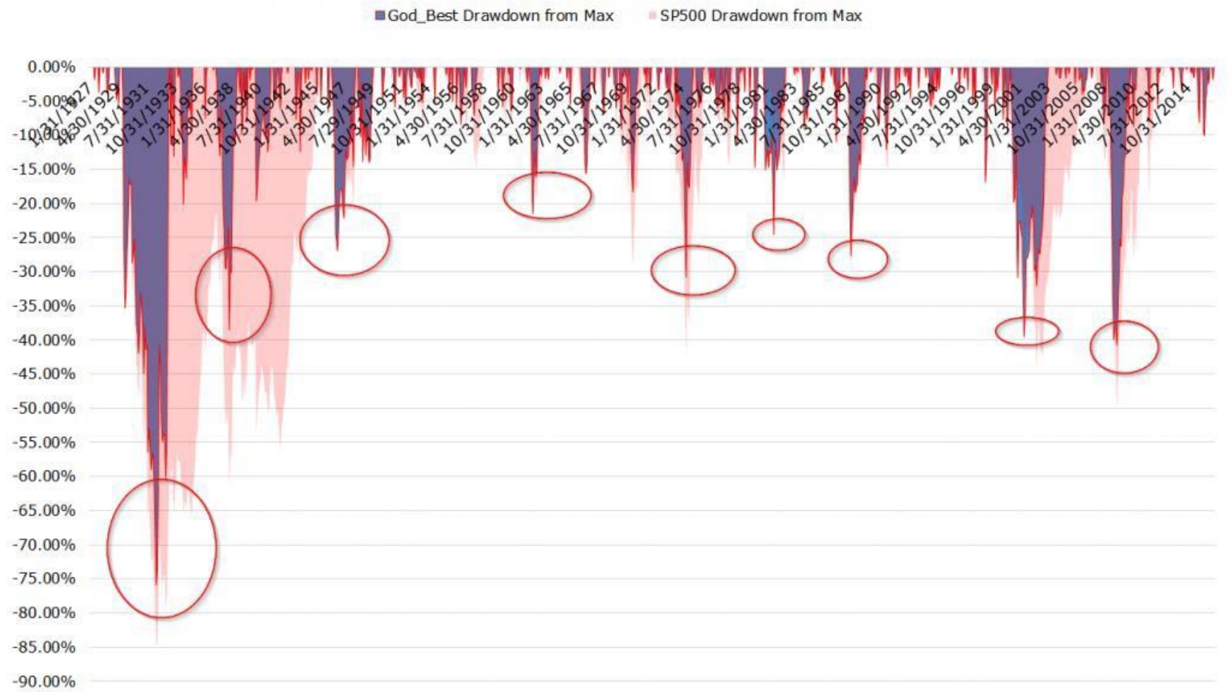
While point 1 is expected, points 2 and 3 are interesting from the perspective of the Trust. Even with such foresight, one must suffer higher than normal volatility. Perhaps less expectantly, one could expect to lose almost all their invested capital on the way to generating 29% compound returns, by choosing to crystallise losses early.

And it's not just limited to a single period. Pain is par for the course for investing and, as the chart below demonstrates, to generate the highest returns one must expect repeated bouts of crippling drawdown to enjoy great upside.



Source: https://alphaarchitect.com/2016/02/02/even-god-would-get-fired-as-an-active-investor/

The study found that even perfect long and short foresight[2], would experience 70% drawdown and higher than normal market volatility. The hedge fund strategy underperforms the passive index so materially on several occasions that it would be quite a challenge for someone with such foresight to retain their job as an active manager. Yet the hypothetical portfolio would, over the long term, generate 40% per annum versus the passive indexes 10%.

This brings us back to the title of the paper - "Even God Would Get Fired as an Active Investor". To enjoy great upside, we must also be able to endure potentially large downside. The stock market is littered with great success stories but often the path to serious returns involves serious unrealised write downs. The ones who hold on are typically rewarded.

Multi-baggers

If we accept that pain is par for the course, then how do we justify holding and reinvesting into some holdings which are held at a loss. Below, we attempt to answer the second part of our initial question "is there light at the end of the tunnel for these investments?"

First, we must understand how we expect returns to be generated. As value investors we look for businesses which are out of favour but which we expect to mean revert. A typical example is buying a business on five times earnings which has historically traded at 10 times earnings. This mean reversion relies on nothing other than market forces to generate 100% return, assuming the business can be at least as profitable as it has been historically.

2 A hedged portfolio constructed from "1) long the names we know will perform the best over the next 5 years and 2) short the portfolio of names that we know will perform the worst over the next 5 years"

The second requirement is for companies which can grow. Our detailed business analysis seeks to find competitively strong companies which can sustain growth through time. While we might end up paying slightly more to own these businesses, the potential returns can be much higher if we can enjoy multiple expansion alongside earnings growth. The best quality companies are those which can recycle cash at high rates of return – the fabled *compounders*.

One of the best opportunities to secure multi-bagging returns is to follow our money into businesses which are trading through the J-curve, typical of companies going through strategic change. This gives us a good opportunity to increase the Trust's holding at a lower level of both historic profitability and expected future profitability. Where investment cases have not changed, we must make the most of these opportunities.

We use the drawdown period to increase the diligence on the businesses and their products and services. Often, we will interview ex-employees and board members and seek opinions from industry experts and customers. Typically, we find out that things aren't quite as rosy as the management team present and in some cases, we may choose to reduce our position or exit entirely. Where the story continues to stack up then we will take a larger contrarian position in the business, at a better valuation, and ride out the negativity.

In Christopher Mayer's book "100 baggers", he discusses the traits of stocks which have generated over 100x returns. He makes five observations which are common with all these types of investments:

- **Start small:** small companies are more able to grow earnings through modest growth in market share. Median starting sales of $170 million
- **Hold on:** the average 100x time return took 26 years. A company compounding at 50% will take 11 years to generate 100x. A company compounding at a more realistic 10% will take 48 years
- **High returns on equity/ capital:** Charlie Munger famously quoted "it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return."
- **Low multiples preferred:** buying low multiples alongside earnings growth gears returns. But don't be afraid to pay a little more for quality
- **Owner-operated:** owner-operators typically act in the best interests of creating value for shareholders over the long term

By far the biggest challenge for the Trust has been navigating the high insider ownership/ owner-operator conundrum. While academia commonly cites this as one of the best predictors of high returns, our short-term experience has not endeared us to these types of businesses.

Real Good Food, Gama Aviation and FireAngel have had amongst the largest equity write downs in the portfolio and, perhaps not coincidentally, are (or were) owner-operated and have high insider ownership. In these cases, entrepreneurial CEOs have lacked the checks and balances of competent financial directors and wider board members. This lack of wider governance has only become evident after our initial investment, once we get to engage as owners of the businesses as opposed to outsiders. In the majority of cases there has been the opportunity to change the governance structures and we have taken those necessary actions and reinvested in the business to achieve a better outcome for our monies.

Our process is not stationary, rather it constantly evolves to try to avoid poor outcomes in the future. The poor governance trap is a part of that, and we have implemented several changes, alongside our highly engaged board of directors and investment committee, to try to mitigate these situations going forward.

We believe that the Trust holds a concentrated portfolio of great companies, many of which have historically demonstrated an ability to compound at high rates. With the correct governance going forwards, we believe that the Trust's holdings will be winners over the long-term.

It hasn't been plain sailing to date, and it certainly won't be in the future. However, following corporate developments in the quarter, four holdings are now trading ahead of our expectations, four behind, and the rest

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in-line. Consequently, we remain optimistic and believe that the Trust is demonstrating an ability to drive strategic returns.

We don't expect to achieve Christopher Mayer's 100x returns, nor do we expect 29% per annum returns, but we do believe that patience will be rewarded in some of our more challenging positions. We are working hard to engage boards constructively on problems by providing practical solutions and we look forward to updating you on progress in future letters. Alongside these more challenging positions, we do have some great success stories which are performing very well. As always, we discuss specific companies at the end of this letter.

A number of investors have requested more tangible financial information on underlying holdings. We have taken this on board. On page 10, readers will find various valuation and operating statistics of the underlying holdings, based on Downing's estimates. We also present consolidated portfolio statistics which demonstrate that the potential portfolio upside is greater than at any time in the past.

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

Kind regards,

Downing Public Equity

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Portfolio activity

In the first quarter of 2019, the Trust committed a small amount of capital to a toehold position in Pennant International. This is a company which we have followed for several years and which has generated very strong returns in our open-ended fund. We believe that the business is at a key juncture with regards to growth in coming years and the Trust's capital was used to cornerstone a small acquisition. We will report on Pennant on a more ad-hoc basis until it becomes a fuller position within the Trust.

The Trust also committed £0.7 million to Redhall by way of a short-term loan to allow the company to trade through a working capital pinch point. We explain more about the financing and our investment in Redhall on page 8.

Post these transactions, the Trust held £5.7 million of cash at the end of March 2019. The shares are trading at a small discount. After market demand has kept the discount between market value and NAV fairly small. The board has indicated that it intends to be proactive regarding buybacks should this widen at any point.

Finally, the Trust has made a commitment to purchase open offer shares in FireAngel at 20p per share. At the time of writing, it is currently uncertain what the final commitment will be – it will depend on the take up of shares by other holders. We give more detail on the rationale of this investment on page 7.

Work in progress (WIP)

Our WIP list remains strong and we believe that there are some great micro-cap businesses in our universe which are trading at very undemanding valuations.

One, a manufacturing business on which we have been conducting diligence for some time, is trading on only two times historic operating income – a highly distressed valuation, commensurate with the operating difficulties the business is experiencing. As value investors, we must determine whether these difficulties are transitory and there is a catalyst for a rerating.

Cyclical businesses can be a great hunting ground for bombed out share prices. We are appraising a further opportunity in a business operating in an environment near cyclical lows, compounded by transitory operating headwinds. It is a company which we know well from wider Downing client funds.

Alongside our WIP, we are working very hard on our portfolio companies, particularly those going through strategic change where the gap between intrinsic value and the current enterprise value is greatest.

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Reporting highlights

	Jan	Feb	Mar
AdEPT Technology		Directorate change	
Braemar Shipping	Trading: in-line		Trading: in-line
Duke Royalty		Acquisition	
FireAngel	Various	Contract win	Results: in-line + placing
Gama Aviation	Various	Receipt of overpayments	Various
Hargreaves Services	Results: in-line		
Ramsdens			Acquisition
Real Good Food	Disposal	Settlement agreement	Disposal
Redhall Group	Results: behind + funding		Directorate change
Science in Sport			Results: in-line
Synectics		Results: in-line	New contract wins
Volex			Trading: ahead

AdEPT Technology Group

In February, Chris Kingsman stepped off the board of AdEPT after joining in November 2017. He stated upon his departure "I have thoroughly enjoyed my time working with the team at AdEPT. The business is extremely well run, and Ian has built a platform that will allow our new CEO to build a long-term growth company." Chris maintains the single largest shareholding in the business. The share price has traded backwards since Phil Race was appointed as CEO in December and Chris stepped down in February. We think that the company offers good value in a business with over 70% recurring revenues and a strong management team who have delivered as expected over recent years.

The company presented at Mello in late 2018 and Ian Fishwick, former CEO, now chairman, gave a refreshingly candid view on why the family and founders continue to hold a substantial shareholding. “Recurring revenue, turning into profits, not doing loads of capex, (=) cash machine”. These are the types of businesses we want to back over the long term.

The video can be found here: https://www.youtube.com/watch?edufilter=NULL&t=387s&v=bdE6dBYqlYo

Duke Royalty

The most material piece of news came in February when Duke announced that it had purchased its only known UK-based competitor. “The acquisition more than doubles Duke's royalty portfolio, increasing the company's core investments from five to eleven and thereby significantly accelerating the company's growth plans and providing portfolio diversification benefits. The new Royalty Partners are in a range of diversified industry sectors, including new investment sectors such as telecommunication services, media, recruitment, insurance broking and technology solutions.”

We have had several questions from investors asking to explain more about the royalty financing method and how we expect it to generate returns for the Trust. Firstly, royalty financing should provide ultra-long-term streams of earnings, typically between 25 and 40 years. Royalty partners typically sign up to a monthly distribution of 12 to 15% per annum, this then grows in line with revenue but is collared at +/- 6%. The following demonstrates how the royalty financing model works in reality:

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	y1	y2	y3	y4	y5
Hypothetical royalty financing by Duke (£m)	10.0				
Hypothetical revenue of royalty partner (£m)	50.0	58.5	64.4	63.1	65.6
Hypothetical y-o-y change in royalty partner revenue	5%	17%	10%	-2%	4%
Change in distribution (collar +/- 6%)	5%	6%	6%	-2%	4%
Hypothetical annual royalty based on intiial 13% cash-on-cash yield	1.30	1.37	1.45	1.53	1.50
Per annum cash-on-cash yield to Duke Royalty	13.0%	13.7%	14.5%	15.3%	15.0%
Cummulative return for Duke Royalty (£m)	1.30	2.67	4.12	5.65	7.15
Cummulative return for Duke Royalty (%)	13.0%	26.7%	41.2%	56.5%	71.5%

Source: Duke Royalty management, hypothetical example of returns

We believe that the advantages to potential royalty partners are that they achieve a reasonable cost of capital which won't dilute their equity and won't introduce refinancing risk at the end of a term. Additionally, over private equity, they won't be expected to exit the business at the end of the investment horizon.

Once the capital is fully deployed then the business is expected to achieve a healthy run-rate of around £8 million of operating cash flow with a targeted pay-out of between 80% and 100% in 2020. This places the business on a worst case full run-rate dividend yield of around 8%. The business retains around £9 million of cash to deploy, which we expect will be drawn down in the next financial year. Given the pace of deployment, Duke is progressing ahead of our investment thesis.

The Trust's returns should be generated through a combination of both distributable yield and capital growth. Based on the numbers above, we think that an 8% yield on our 44p cost per share is much too high. We expect that once the model has proven successful then the share price will have to grow by around 100% to contain this yield, giving a more normal 4% dividend yield. Assuming the company hits these numbers, that would imply a total shareholder return over three years of around 120% and an implied IRR of 30%. Of course, it is unlikely that everything will go exactly to plan, however our margin for error remains high on this investment given the expected returns and those required by the Trust.

FireAngel

FireAngel's results were in-line with revised expectations given the annus horriblus of 2018, albeit well behind those on which we initiated our investment. Alongside these results, the company announced an open offer to raise up to £6 million to reduce indebtedness; for investment in the connected homes proposition; and for working capital. While it is disappointing for what we believe to be such a promising business to experience these operational challenges and poor execution during 2018, we have stated our intention to remain supportive, underwriting the placing. There has been significant management change, with a new chairman joining the board, a new COO and a restructuring of the product development function. Without this, we would not have continued to support the company.

The investment case remains focused on a business which has continued to generate high gross margins; where demand is driven by regulation; and where structurally growing markets underlie the products. The most recent news flow has been centred around contract wins from social housing and there are additional drivers in markets such as Germany and the UAE which we expect to drive sales further. Margins have been heavily depressed due to a bundled production move and exiting a legacy distribution agreement. However, the adoption of Flex production in Poland should yield benefits over the medium to long term. Prior to the placing, the company had already announced a strengthening of the management team, and we visited the new production facility in Poland in January to understand more about the changes and risks going forward.

We are confident that this is a business which can return to, and hopefully exceed, previously reported levels of profitability. We think that there is very material upside to follow-on monies and significant upside on blended monies, with a greater degree of strategic control afforded by our higher equity weighting.

Ramsdens

Our investment thesis on Ramsdens centres around an attractive valuation and mispriced growth. While organic growth has been the focus to date, a large cash balance has always indicated that acquisitions could be possible. In the period, management proved its ability to source keenly priced acquisitions in the retail space to bolster the 136 organic Ramsdens stores.

The deal with The Money Shop will add 18 new stores and five new loan books, and is expected to contribute an additional £600k to 2021 earnings, that equates to a 9% uplift (and a 5% uplift to 2020 earnings). At £1.5 million, paid in cash, that looks like an attractive valuation from any perspective. In addition, there is scope to increase the profitability of the acquired stores from £33k up to the Ramsdens average of £48k, which could represent a deal struck at less than 2x pre-tax earnings.

Despite this, the 2018 valuation hovers around 6x EV/ EBIT. While Ramsdens is not a "sexy stock", and is no doubt affected by the negative sentiment in retail, we find the valuation highly erroneous for a company which is delivering ahead of (our) plan. Combined with a net cash balance sheet of around £10 million; a dividend yield of around 5%; a forecast free cash flow yield of almost 13%; and relatively short lease exposure on the estate, we think that the shares still offer investors great risk/ reward. Ramsdens closest listed peer, H&T, trades on a forward EV/ EBIT multiple of over 8.7x, with (in our opinion) a lower quality model – five-year average return on equity of 7.9% and return on invested capital of 6.7% – and less growth opportunity. We think that Ramsdens fundamentals could easily support a similar rating, implying around 45% upside.

Redhall

Redhall continues to be a challenging situation. Despite parts of the thesis, such as revenue visibility and structural demand from infrastructure projects, materialising as expected, Redhall finds itself in a poor situation with its customers who are facing their own cash constraints. This has made collecting cash for project work difficult, and shareholders were required to provide short term financing in January to allow the business to trade through a working capital pinch-point. The Trust participated in the form of a £0.7 million short term loan for a nine-month term. This loan will earn a 12.5% exit fee and therefore generate an IRR on the Trust's investment of just over 19%.

This is an unusual situation where delivery against our investment case is damaging the liquidity of the business. Evidently, not all contracts are created equal and not all customers are good payers. The effects for small and micro companies of customers squeezing credit are often outsized and negative. The management team has identified this problem and we are confident that it is something which can be written into future legal agreements – it does appear to be contained to only two major contracts. This gives us some confidence that the business can trade profitably going forwards, but ultimately this is a business that should be part of a larger entity. We are encouraged that Joe Oatley, previously NED, has stepped up as chairman. Given his knowledge of infrastructure contracting with Hamworthy Plc and Cape Plc, we believe the company to be in capable hands, and he has our support.

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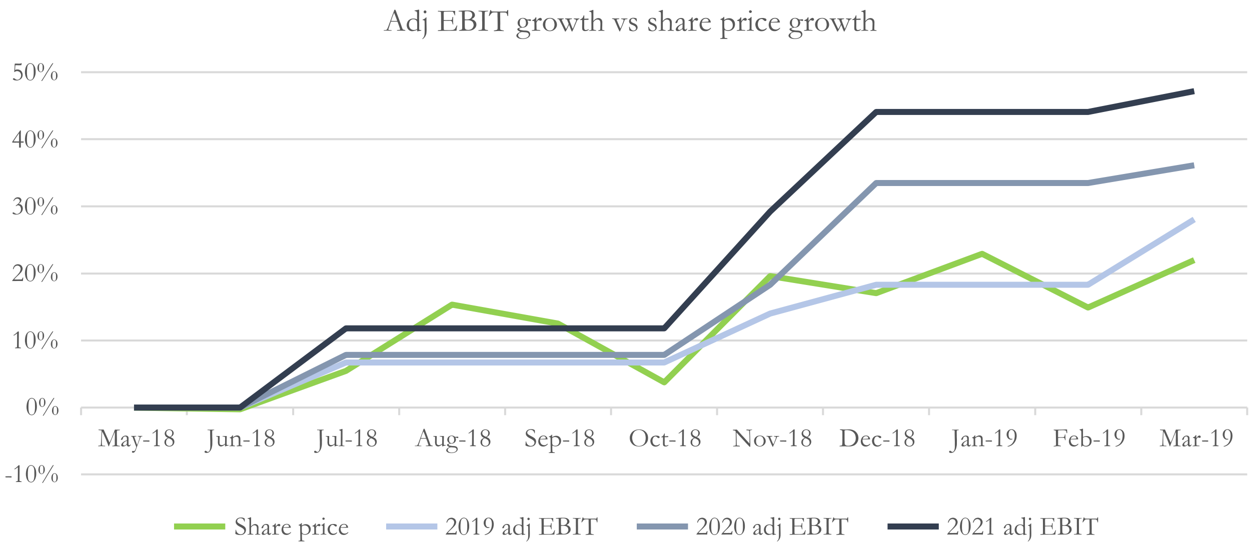
Volex

Management continues to deliver a thoroughly impressive turnaround. At the end of March, the company announced a year end trading update and its fourth earnings upgrade since we invested in May 2018. So far, adjusted operating profit has been upgraded by 28%, 36% and 47% for 2019, 2020 and 2021, respectively, through a combination of organic growth and acquired contributions. The share price still significantly lags these upgrades.



Source: Downing/Liberum

We talk about high quality companies as those which can generate high returns on invested capital and we like businesses which can reinvest free cash flows at high rates of return. Volex has had a chequered operating history and the industry doesn't immediately conjure the expectations of high returns. However, with a step change in profitability – operating margins now approaching levels last seen in 2012 – and, we believe, more sustainable operating practices, alongside an aligned management team, we think that Volex warrants serious consideration.

With net invested capital of around $100 million and forecast free cash flow between $15 and $20 million, implied 15-20% cash returns would be remarkable. Management have also demonstrated that return generation isn't just restricted to internal reinvestment, which can be a limitation to growth over the long term. With three acquisitions completed since May 2018 at multiples paid between 3-5.7x EV/ EBIT, average external reinvestments can generate in excess of 20% returns. We believe that there remain many similarly valued opportunities in the space.

The valuation still looks erroneously cheap to us. Management too, with the executive chairman and CFO buying over 300,000 shares between January and March. With the year end net cash position pointing to an enterprise value of around $150 million and expected underlying operating profit of between $25 and $26 million, the shares trade on only 6x forward. Much of that valuation is backed by tangible book value, so we think that the downside protection is good here. The market may still be concerned about the concentration of several customers; however, management has proven an ability to reduce this, with the top ten now contributing under 60% of revenues. With a bullish outlook and "substantial identifiable opportunities for both divisions to improve sales and margins" we remain very happy with our position in Volex. An indicated return to the dividend list will hopefully provide a catalyst for the share price over the coming year.

Management recently posted a short video explaining more about the group and strategy, which can be found here: https://www.youtube.com/watch?edufilter=NULL&v=GNAH2E7wvio

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Valuation and operating statistics *(as at 31 March 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	3.55	6.53	9.75	7.62%	9.22%	5.38%
Braemar Shipping	1.83	0.90	10.50	7.00%	9.47%	9.47%
Duke Royalty	Net cash	1.03	11.12	7.19%	N/A	N/A
FireAngel	0.82	0.63	4.70	16.40%	21.19%	21.38%
Gama Aviation	Net cash	0.27	3.80	21.06%	34.40%	33.20%
Hargreaves Services	1.59	0.95	12.61	5.89%	17.63%	11.11%
Pennant International	Net cash	2.95	12.18	6.57%	14.67%	14.54%
Ramsdens	Net cash	1.50	6.30	12.69%	30.63%	24.40%
Real Good Food	2.59	0.75	5.54	12.76%	-2.66%	-2.29%
Redhall Group	0.99	0.38	4.18	18.29%	-10.83%	-7.87%
Science in Sport	Net cash	2.54	-13.30	-6.01%	-25.87%	-26.78%
Synectics	Net cash	0.71	6.49	12.33%	4.01%	3.88%
Volex	Net cash	1.48	6.28	12.75%	9.37%	4.20%

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, 31 March 2019*

Portfolio construction *(as at 31 March 2019)*

Name	Sector	Age[5]	Progress against thesis[6]	Market cap (£m)	% of the Trust[7]	% equity held by Downing[8]
AdEPT Technology	Telecommunications	1.75	Ahead	76.08	8.51%	12.11%
Braemar Shipping	Transportation	1.50	Behind	51.87	4.10%	6.59%
Duke Royalty	Speciality Finance	0.75	Ahead	86.94	4.79%	6.37%
FireAngel	Electrical Equipment	1.25	Behind	9.65	0.76%	10.73%
Gama Aviation	Transportation	1.50	Behind	41.05	3.35%	7.12%
Hargreaves Services	Support Services	1.25	In-line	97.48	7.45%	7.02%
Pennant International	Software & Services	0.25	Early	43.25	2.63%	5.28%
Ramsdens	Financial Services	1.50	Ahead	56.28	6.76%	16.77%
Real Good Food[9]	Food Producers	1.75	In-line*	5.71	17.79%	7.90%
Redhall Group[9]	Support Services	1.75	Behind	5.99	3.48%	23.91%
Science in Sport	Food Producers	1.50	In-line	63.87	2.59%	5.64%
Synectics	Support Services	1.25	In-line	38.26	9.57%	12.86%
Volex	Electrical Equipment	1.00	Ahead	134.84	13.49%	7.38%

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 *Includes cash*
8 *Total percentage of investee company held by all Downing managed funds*
9 *Real Good Food holding includes 0.69% equity and 17.10% debt split. Redhall holding includes 1.82% equity and 1.66% debt split.*

Portfolio valuation statistics *(as at 31 March 2019)*

	P/ book	P/ earnings[10]	Margin of safety[11]	Upside[12]
Average	1.45	7.61	46.54%	132.63%
Median	0.92	7.59	49.42%	97.69%
Weighted average	1.37	6.15	35.53%	76.33%

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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