Downing

Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

19 February 2021

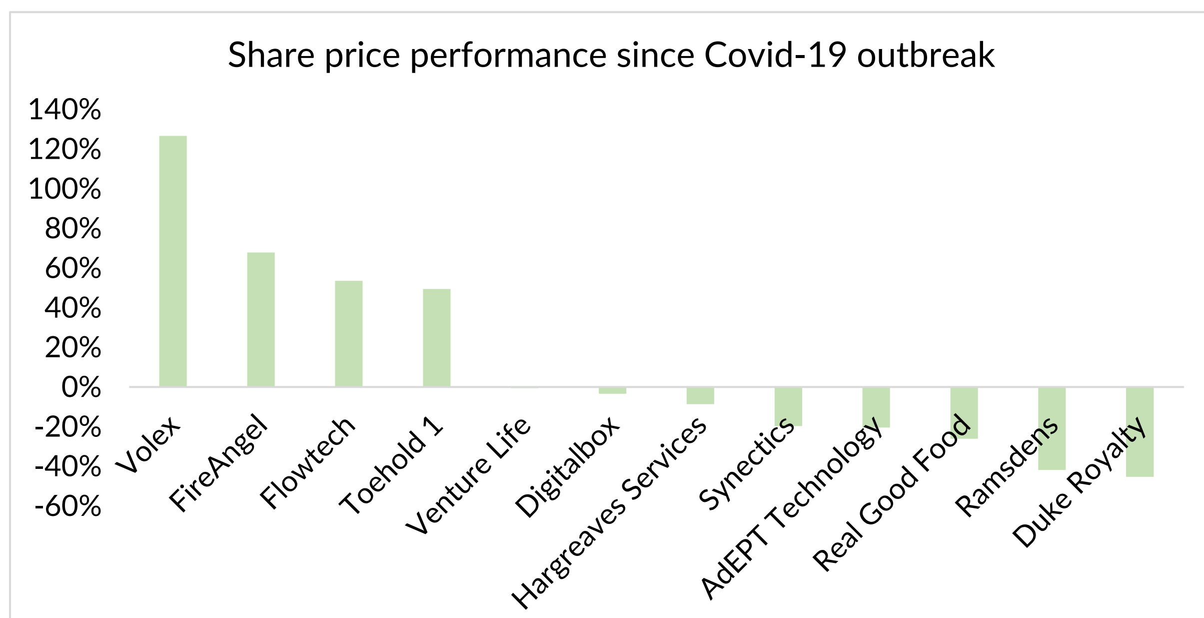
The DSM portfolio feels like a coiled spring. We believe it contains pent-up value, which we think can be released on several counts.

Why? First, our companies have not wasted the Covid-19 crisis. They have worked on their business models and emerged stronger, in some cases with our help. Second, some of them are in sectors that have actually benefited from the pandemic. Third, the formerly neglected market for UK small company shares is returning to favour. We are a domestic UK company, well positioned to benefit from an inevitable UK recovery as confidence returns and consumers start to spend a huge backlog of savings. Of course, there is a risk to these assumptions. But in our view, it is most likely just a question of timing.

In some cases, brighter prospects were expected in 2020. It could have turned out to be a lost year, but our portfolio companies have used the time wisely and we are confident that they will emerge from the Corona-crisis stronger overall. This will be complemented by tailwinds in 2021 which are seeing small and micro-cap UK companies getting more attention following a period of neglect.

We see two catalysts ahead. The broad small cap re-rating follows a sustained period of underperformance since around the EU referendum in 2016. We combine this potential small cap rotation with a general return to value investing, and see reflation coming in 2021 and into 2022 as record household savings are unleashed.

The second catalyst relates to the company and its holdings. While we have enjoyed some positive performance through 2020, mainly driven by Volex, we note that most of our positions are mainly primed for an economic re-opening. Consider that, in our opinion, none of the holdings trading below their pre-Covid-19 levels have any discernible fundamental issues other than having impaired trading due to the pandemic, then we think that these should at least return to their pre-Covid-19 levels through this year as the UK and other relevant economies re-open. This 'return to normal' assumption would drive a NAV uplift of 19.9%.



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However, we would be disappointed if these companies cannot exceed their pre-Covid-19 share prices. As we highlighted at the beginning of this letter, most of our portfolio companies have used the downtime to realign cost bases and drive efficiencies – they are better businesses at the beginning of 2021 than they were at the beginning of 2020. Therefore, we see scope for much improved performance over the medium term. Evidently, so do the management teams of our companies, with eight out of 12 reporting insider share purchases over the last twelve months.

Company	Insider buying?	Downing's 2021 Outlook
Real Good Food	-	Strong run rate earnings in the subsidiaries driven by cost efficiencies in Renshaw and continued growth in Brighter. Stated intention to restructure the balance sheet.
Volex	Yes	Continues to beat expectations. We see further upgrade potential through bolt-ons
AdEPT Technology	Yes	Steady trading through Covid-19 but strategically well positioned for 2021
FireAngel	Yes	Positive year on year trading to end 2020. Housing authority new deals to continue this year
Hargreaves Services	Yes	Now a non-coal business. Services business growth this year. More land disposals
Ramsdens	Yes	Heavily affected by lockdown but a strong recovery/re-opening play. Solid balance sheet
Synectics	Yes	Material efficiency savings announced. Significant recent contract wins. Recovery/ re-opening play
Venture Life	-	Traded well ahead of expectations through 2020. £30m of cash for acquisitions
Flowtech Fluidpower	Yes	Cost savings coming through. UK recovery/ re-opening play
Digitalbox	-	Ongoing scope to improve monetisation rates and continue value accretive roll up. New Chair.
Duke Royalty	-	Much improved underlying performance and visibility of holdings
Toehold 1	Yes	Mixed trading through Covid-19 + strategic change. Very strong medium- and long-term prospects

The final point worth mentioning, at January month end DSM sat at a significant discount to NAV, although this has narrowed in recent weeks. We think that DSM's discount deserves to continue to reduce. Looking at similar UK smaller company investment trusts, discounts have narrowed below 10% and in some cases are trading around parity. Prior to Covid-19, the company's discount averaged 3% and we see no reason why it shouldn't trade at this level.

Combine a narrowing discount with a 'return to normal' trade through this year and one arrives at upside of almost 40%. Combine a narrowing discount with our discount to intrinsic value of around 50%, and one arrives at upside of over 130%. Consider that the company retains 12% of its NAV in cash and 40% of the NAV is still trading below pre-Covid-19 levels – if one believes that the future will be brighter than the prior 12 months, then now is a compelling time to buy the company's shares.

In this letter we will review the top three equity holdings (Volex, AdEPT, and Hargreaves Services) along with the new holdings we have made since the last letter in Digitalbox, Flowtech Fluidpower, and Venture Life.

VOLEX remains the largest equity position in DSM. 2020 really was an inflection year for the business and it enjoyed significant multiple expansion. In our most recent investor marketing calls we have been asked about the investment case for Volex given the share price increase and whether we can justifiably continue to hold.

We think there is still a significant runway for the Volex share price. At the time of writing, the shares are still trading on around a 20% discount to sector peers. We think is unwarranted due to the quality and growth characteristics which we set out in the February 2020 letter – higher growth; better cash conversion; higher margins and higher returns on capital than most of its peers. In the last letter we set out a pathway to $65 million of operating profit by FY2024, and we now think that this could be achieved earlier. Consider operating profit of $20.9 million in the most recent financial half year. Also consider Volex's exposure to electric vehicles (EV) and the growing run-rate here, along with other structurally growing areas such as data centres, and the positive read across from other Volex peers and/ or target sectors, particularly in consumer electronics. Combined with Volex's most recent acquisition, DEKA, which should generate at least a full year EBITDA contribution of €8.9 million and where we think there is upside risk here too given management's comments around further capacity investment in the business. Over a longer period we think DEKA could be a $10 million operating profit business, with strong growth drivers given its market leading position as the most cost competitive operator in the power cord market. This latter point we find compelling for the wider Volex group, with the opportunity to transfer this knowledge into Volex's Asian business, which would allow more competitive tendering in markets which Volex doesn't currently serve.

These earnings tailwinds may be tempered by some increasing FX headwinds and copper price inflation, DEKA also hasn't completed in January as expected, but this is a timing issue rather than anything fundamental. Longer term there remains a significant growth runway for the business, both organically through structurally growing areas such as EV, data centres, and medical. But also, through acquisitions. We think that $65 million of operating profit can translate down to around $50 million of normalised free cash flow, or $40 million after dividends. Assuming acquisitions going forwards are more expensive at 8x operating profit, there is a pathway for Volex to double its $65 million operating profit target over the next 10 years, drawing down on the new $100 million facility could accelerate this realisation. Well executed roll-up stories with top quartile fundamentals and ample opportunity for capital deployment can trade at up to double Volex's rating, so the potential here is still high and unrealised, in our opinion.

ADEPT TECHNOLOGY has continued to trade robustly through the ongoing pandemic given that 78% of revenue is generated by recurring managed services. Balance has been affected by the ability of technicians to be on-site and there has been a reduction in activity by those customers naturally experiencing more difficult trading conditions due to the pandemic. Half year 2020 saw a 14.2% reduction in underlying EBITDA to £5.2 million and EBITDA margin fell to 18.4% from 19.8% in 2019. Management decided not to implement short term cost cutting initiatives to help protect the margin, which should leave the business with sound foundations to progress as lockdown measures are eased over the coming months.

Reassuringly, AdEPT continued to generate cash throughout the period, with underlying EBITDA conversion to free cash flow (including leases) of 97%, albeit flattered slightly by some VAT deferrals. Nonetheless, this allowed the business to repay £10 million of debt in the period. Cash performance was supported by additional improvements in customer debt collections, improving to 33 days from 45 days in the same period in 2019. We believe this demonstrates the cash generative nature of the underlying and core managed service business, along with essential nature of these services to customers, despite the ensuing global pandemic. This is acutely evidenced by the announcement that AdEPT has helped the Department of Education transition over 500 schools to cloud enabled digital education platforms since the outbreak of Covid-19.

Annualising the free cash flow highlighted above places the group on an EV/FCF of 8.5x, assuming no recovery or future growth. Given the high proportion of revenue visibility, low capital-intensity, and the cash generative nature of business, we believe that AdEPT is undervalued on both a relative and absolute basis. We continue to engage with management to pursue the exercise of deleveraging the balance sheet based on the cash generation within the business model. We assume that the business can unlock £35 million of shareholder equity over the next 3 years, 196% uplift on shareholder equity as of the half year results, equating to 44% compound annual growth rate. Outside of this, we note ongoing and publicised activity with trade and private equity market consolidators completing acquisitions on multiples far in excess of the current trading multiples of AdEPT. We think that given the robust trading through the pandemic, this low valuation won't go unnoticed.

HARGREAVES SERVICES had a lacklustre performance through most of 2020, with delays around land disposals affecting the land business, and delays in HS2 deployment affecting the services business. Internally, we had discussed how we thought this could set up Hargreaves for a bumper 2021 – we now strongly believe that this will play out.

News flow since results were announced in July has been positive for the changing investment story. Hargreaves had a legacy coal business and the group held a significant coal inventory related to this. We viewed this as balance sheet optionality where the coal could be sold and the cash utilised to pay down debt. This has now played out, as per the announcement made on 24 December 2020. Hargreaves has sold all speciality coal to a joint venture, HRMS, for £24 million, and expects to retain no material coal inventory by the end of May this year. While the coal activities still sit within a JV, HRMS is independently financed and there is no recourse to the Hargreaves group. We think this somewhat tidies up the perception of Hargreaves and shows a clearer roadmap to being coal free. It also de-gears the group of bank debt and leaves it able to negotiate improved banking terms going forwards. The business should now present as a more investible opportunity with more sustainable wholly owned operations.

The way we view it, there are three value creating drivers in the business now. The first is the Distribution and Services division. Confusingly, this division has three segments – Production and Distribution, Industrial Services, and Specialist Earthworks. The coal operations sat within P&D, this segment will now be focused on organically growing in transporting industrial, household, and clinical wastes. Specialist Earthworks includes HS2 which we think could be worth around £1.5 million per annum to the business over the next five years, with upside potential from further contracts on a reasonably fixed operating cost base. This is alongside various other recently announced contracts in the Industrial Services division such as Castle Peak and Black Point power stations in Hong Kong, and a mechanical services framework with Severn Trent Water. This division had previously been the source of much disappointment with exposure to British Steel and various onerous civil engineering contracts, all of which are now resolved.

The land business view is relatively piecemeal and the company hasn't updated its gross development value for the group since the Red Book valuation in 2018. We have been given snippets of new information, and alongside new projects since then, such as Unity – a 2 million square foot logistics and commercial site along with 3,100 homes – and Bridlington – a 45,000 square foot pre-let warehouse development. Bridlington is probably closer to how we should think about the opportunity at Hargreaves Land – that is lower capital intensity, turnkey projects. Management are targeting 15%+ returns on capital in this division, commensurate with a property developer.

Finally, is the JV, HRMS. Hargreaves own 49.9% of this but receive 86% of the economic interest. HRMS comprises a number of activities such as a carbon pulverisation plant which is just coming online, alongside a coal trading business (where the group's coal now sits). Ultimately, we think that it is management's intention to dispose of this business once it is operating at scale – that equates to around £8-12 million of potential earnings, according to management. A lot

needs to happen for this to be realised. In the meantime, Hargreaves is due to begin receiving a dividend from this entity which will be passed straight through to Hargreaves' shareholders.

Therein lies the most sensible way to think about Hargreaves' valuation over the short and medium term. The company is expected to pay a 20p dividend from this next financial year. The current share price implies a little under 7% yield based on this. We think this is too high and with the bad news hopefully now behind the business and with a cleaner capital structure and simplified operations, we think it warrants an implied yield of 5%. Another way to approach valuation could be a NAV approach, which suggests a very similar answer to the 5% yield of around 390p, with scope to grow in due course.

NEW HOLDINGS

Since our last letter, we have made several new investments. We acquired a 21% stake in Digitalbox, an internet advertising company which owns three online-only titles through which it generates advertising revenue. Downing LLP hold investor rights in this company, including the right to be an observer at board meetings. We also invested into Venture Life, a leader in developing, manufacturing and commercialising products for the self-care market, which we have followed for some time through our ownership in other funds and which we think has reached an interesting juncture with significant growth prospects. We have also been building a stake in Flowtech Fluidpower, a specialist supplier of technical fluid power products and services. Flowtech is another company we have known for some time which has been affected by Covid-related lockdowns but where we see significant recovery potential combined with an efficiency exercise to drive a much more profitable group going forwards.

DIGITALBOX is a £7 million market cap digital media publisher with a platform optimised for mobile viewing – the fastest growing medium for online content consumption. The company monetises three titles, Entertainment Daily, the Daily Mash, and now, The Tab, which was purchased in October last year.

Digitalbox utilises a programmatic ad stack to monetise its titles – that is an automated process for matching supply and demand of advertising inventory. Programmatic advertising is the way the industry has headed online as it allows for more targeted ads based on a user's browsing history in real time. What we specifically like about Digitalbox's model is its targeted nature, i.e. The Tab caters specifically towards the student market where we think it should generate specific marketing responses and create a high value niche. The other aspect we like is its cost-conscious approach to creating content which allows it to generate attractive margins even at relatively low scale.

We view Digitalbox's value creation opportunity across two buckets. Organically, we see scope to continuously improve title monetisation. As an example, we think that Entertainment Daily can generate around £12 of revenue per 1,000 sessions, compared with The Tab at only £3-4 pre-acquisition, despite having broadly similar content length. Combining improving monetisation with a largely fixed cost base leads to rapidly improved earnings and we think that The Tab can go from an EBITDA loss making business, to EBITDA profitable in the twelve months post-Digitalbox's acquisition. Inorganically, the opportunity is to continue to consolidate under-monetised titles and improve their earnings. There are a plethora of opportunities which have lacked investment to move online in the transition from print media, and Digitalbox is well capitalised to take advantage of these.

Ultimately, we expect to crystalise value from our £1.2 million investment in Digitalbox through a trade sale. We view the recent board shuffle as positive in this regard with Marcus Rich having been appointed Chairman in early February. Marcus was previously Chief Executive of TI Media where he led the sale of NME.com to Bandlab Technologies and ultimately oversaw the company's sale to Future plc.

VENTURE LIFE was announced as a new position towards the end of 2020, although it is a company that we have followed for the best part of two years. We built our position over the course of last year as our investment case continued to play out, and as other significant developments unfolded.

Firstly, our investment case which centred around increasing own-brand product diversification, utilising latent capacity within the manufacturing base which in turn should unlock significant operational gearing. This is due to a relatively fixed cost base and margin accretion from increased mix towards own-brand products. Progression along this line of thinking was most noticeable in the half results, in which an 80% increase in revenue resulted in nine-fold increase in adjusted profit before tax, which eclipsed the profits made in the whole of the previous financial year. Despite these impressive results, we believe that this is the beginning of this journey. Based on the half year results, management believe full year utilisation will be around 56%. Furthermore, 65% of the top line growth was organic, with 15% from 5 months of contribution from the PharmaSource BV which will deliver greater margin accretion as synergies are enacted and manufacturing is moved into Venture Life's facilities. PharmaSource BV was acquired on similar multiples as previous acquisitions of <7x profit before tax, before synergies. Previous acquisitions are now trading on <3x profit before tax, following manufacturing integration, yet these acquisitions are still exhibiting double-digit growth 2 to 4 years post acquisition. We believe these returns will manifest into impressive returns on capital invested as the business scales to utilise excess capacity and recycles capital into further growth. We were initially able to access this return profile for less than 9x earnings, which we felt was a steep discount to comparable businesses that are not as vertically integrated as Venture Life.

Additional developments during the year that are worth noting are as follows:

- Signing of an exclusive long-term distribution agreement in China with minimum purchase obligations worth €168 million over a 15-year period.
- Ramped up production of hand sanitiser gel within 11 days to produce €3.2 million of revenue at the half year from zero before the pandemic. The initial investment was €110,000 and was initially designed to support Italian hospitals on a compassionate basis. But following strong demand from retailers, it evolved into DISINPLUS, a new range of anti-bacterial products.
- Supported Cardiff University with both in-vitro and in-vivo studies of the effectiveness of mouthwashes containing Cetylpyridinium Chloride (CPC) in reducing Covid-19 viral load within the mouth. The in-vitro study proved 99.999% effectiveness within a 30 second exposure. The full results of greater lengths of time and the in-vivo study are to be released in 2021.
- Raised £36 million of equity in December to pursue acquisitions that will accelerate the path towards utilising latent manufacturing capacity.

Whilst Venture Life has somewhat benefitted from the Covid-19 outbreak, this was never part of our original investment case. However, this has highlighted the additional optionality to create value that is embedded in the manufacturing base and the expertise which can be leveraged to extend product lines of existing and acquired product portfolios.

FLOWTECH FLUIDPOWER is a value-added distributor of hydraulic and pneumatic consumables into a wide array of sectors predominantly in the UK and Ireland. Flowtech is a leading UK player in this space, with pre-Covid revenues of over £110 million, and it sits between much larger global manufacturers and a highly fragmented and localised cohort of smaller distributors. The company's high service levels, broad stock offering and exposure to maintenance, repair and overhaul markets were key attractions for us, and these attributes facilitate Flowtech's relatively high gross margins of over 35%.

Prior to DSM's purchase of shares, the company had been on a buy and build strategy to consolidate this fragmented distribution network. The company reported a disappointing set of results in 2018, along with a change in strategy. Both of these piqued our interest as we thought that the business was fundamentally attractive with high margins and various self-help levers which we thought could be easy efficiency-wins due to the un-integrated acquisitions which had been completed in prior periods. Ultimately, we didn't invest DSM in Flowtech until mid-2020 which seemed a reasonably de-risked entry point given the temporary effect that Covid-19 would have the company's revenues, falling from a peak of £110 million to a little over £95 million with a more significant fall in earnings due to operating leverage. The other aspect we like, typical of a distribution business, is its ability to generate cash in downturns as it naturally invests less into working capital.

We see great scope for the business to emerge from 2020 as a much stronger organisation. Covid-19 has allowed management to make deeper cost savings quicker than expected and ultimately, they aim to deliver £5 million of operating cost as the business returns to growth over the medium term. Historically, Flowtech has been capable of earning EBITDA of over £9 million on £112 million of revenues, pre cost efficiencies. On this recovery case, it is attractively priced at less than 8x EV/ EBITDA. Combined with the cost savings outlined, the working capital efficiencies, and some growth through a recovering UK industrials sector – we see scope for the business to generate over £15 million of EBITDA and also to accrue around 20p of equity value through de-gearing. Beyond this organic case, there continues to be a significant consolidation opportunity which the business should be in a better position to capitalise on.

To summarise, we are optimistic about the year ahead. Several macro catalysts are now bearing fruit, with the spotlight now shining on UK companies, small and micro caps, and value. Moreover, we have a well-positioned portfolio full of their own specific catalysts for the year ahead following almost four years of strategic overhaul. The company retains cash and we continue to assess new opportunities, particularly those which have been temporarily distressed due to Covid-19 and lockdowns, and where there is a path back to a resumption of normal trading.

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

Kind regards

Downing Fund Managers

Portfolio construction (as at 31 January 2021)

Name	Sector	Market cap (£m)	% of the Trust	% equity held by Downing[1]
AdEPT Technology Group	Telecommunications	62.83	7.40%	9.15%
Digitalbox	Media	7.42	3.59%	21.11%
Duke Royalty	Speciality Finance	65.77	2.86%	3.24%
FireAngel Safety Technology	Electrical Equipment	25.31	7.04%	19.36%
Flowtech Fluidpower	Electrical Equipment	57.86	3.99%	6.19%
Hargreaves Services	Support Services	90.07	7.05%	7.36%
Ramsdens Holdings	Financial Services	41.17	6.09%	15.07%
Real Good Food[2]	Food Producers	3.48	17.24%	7.88%
Synectics	Support Services	20.91	5.16%	12.29%
Toehold 1	Energy	31.53	3.34%	4.98%
Venture Life Group	Medical Equipment & Services	110.73	5.05%	2.19%
Volex	Electrical Equipment	491.77	16.62%	2.97%
Cash and other			14.57%	

[1] Total percentage of investee company held by all Downing managed funds.
[2] Real Good Food holding includes 0.39% equity and 16.85% debt split.

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