Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

February 2020

As announced in January, we have changed the timing of the Trust's update letters to coincide with the reporting quarter end, rather than a calendar end, which was causing us some timing issues with the annual and interim reporting.

In the four months since we last wrote, the fund NAV is up 13.3%. This has mostly been driven by the sustained re-rating of Volex and Ramsdens and we have also benefitted from a recovery in Hargreaves share price following a period of underperformance. While it is pleasing to see these businesses re-rate, we are aware that there is a great deal of work to be done further down the portfolio so that the NAV can continue to grow. There will inevitably be challenges ahead this year, but we are buoyed by the strong finish to 2019 and confident that the year ahead can deliver strong returns.

At the time of writing, there is considerable concern around the threat of a global pandemic and we discuss company specific Covid-19 risks below. More generally, we are reasonably confident that over the medium and long term, investors will look at the current correction as an opportunity. However, sentiment is extremely negative and we are in no rush to make snap judgements without having fully assessed the risks.

In this letter we provide a detailed review of the top five holdings in the Trust. We review the investment theses and explore the unrealised value which we think exists in these positions. The top five holdings of the Trust account for 59.8% of the portfolio. This is a high conviction strategy and we intend to run our winners for as long as there is no sell catalyst. There may be churn in the smaller positions through the year and it is likely that we will add a couple of smaller holdings from cash and proceeds from sales.

VOLEX PLC – strongly outperformed through Q419 and into January after another great set of results in November demonstrated that the business is growing earnings rapidly and generating meaningful free cash flow. It has taken longer than we expected for a re-rating to occur, however is it satisfying to see the market finally value the business more appropriately. The shares were up 91% in the period.

For us, the highlights of the interim results were: 1) the improved operating margin performance demonstrating a path to management's targeted 10%; 2) strong cash flow – we estimate around $11 million of free cash flow in the period, and net cash of $18.2 million at the beginning of November; 3) pivoting the business away from the most commoditised and low margin power cords and focusing on higher value-add activities.

Management also put their medium-term strategy in writing – that is to achieve $650 million of revenue and generate operating margins in excess of 10% within five years. We know that they are aiming to achieve this through organic and inorganic growth so spent time over the last few months building more confidence in these numbers. We present a summary of our work below. Providing there is not a widespread economic setback, we think that these targets are realistic, prudent and achievable ahead of the five-year plan.

While the numbers look large in terms of growth, we do not think that they are unrealistic. Execution risk is highest when management try something completely new – we do not believe that is the case here. The newest areas of growth for Volex are in electric vehicles (EV), and integrated manufacturing solutions (IMS). However, EV is just building on capability which the business already had, and IMS capability and knowhow has been acquired through Servatron.

In terms of our inorganic growth assumptions, we do not think that these are radically different from the roll up ability which management have already successfully demonstrated. Our numbers generate cumulative acquired operating profit of $14.6 million, close to the $13 million of operating profit we estimate that Volex has acquired since May 2018. Our numbers assume three further deals versus the five which the business has already acquired since the Trust invested.

ROLL UP - Downing case	March year end					Comments
	FY2020e	**FY2021e**	**FY2022e**	**FY2023e**	**FY2024e**	
Revenue	400.0	440.5	510.7	592.7	652.3	Grossed up from acquisitions and operating profit
U/lying op profit (EBITA)	*30.5*	*35.3*	*35.3*	*39.1*	*46.6*	Acquired becomes u/lying in next year. No growth
Acquired op profit (EBITA)	*0.0*	*0.0*	*3.8*	*7.5*	*3.3*	See acquisition table. Assume acquired on last day of prior year for full year contribution following year
	30.5	*35.3*	*39.1*	*46.6*	*50.0*	
Explicit forecasts:						
EV incremental			*2.5*	*5.0*	*8.0*	See discussion
Data incremental			*1.5*	*3.0*	*5.0*	See discussion
Servatron incremental			*2.0*	*2.0*	*2.0*	See discussion
Other IMS/ healthcare			*2.0*	*2.0*	*2.0*	See discussion
Less: consumer electronics			*-2.0*	*-2.0*	*-2.0*	See discussion
Operating profit (EBITA)	**30.5**	**35.3**	**45.1**	**56.6**	**65.0**	
Interest	-0.8	-0.8	-2.3	-2.3	-0.8	$0.8m arrangement fee + 5% on net debt (simplistic)
Exceptionals	0.0	0.0	-2.0	-2.0	-2.0	Recurring $2m of cash exceptionals pa from 2022 onwards (restructuring and deal costs/ fees)
Tax	-3.5	-4.8	-7.3	-9.4	-11.2	18% tax rate vs. 15% consensus
Profit after tax	**26.2**	**29.7**	**33.5**	**42.9**	**50.9**	Ignore non-cash: JV + share-based payments + amortisation etc
Change in working capital	-2.5	-2.7	-5.7	-3.0	-4.8	15% of organic sales delta. Assume acquisitions and u/lying don't require w/c investment as not growing
Depreciation	4.3	4.5	5.1	11.9	13.0	= maintenance capex from 2022 onwards
Net cash from operations	**28.0**	**31.5**	**32.8**	**51.8**	**59.2**	
Maintenance capex	-4.3	-4.4	-5.1	-11.9	-13.0	Steps up to 2% of revenue. Assume investment required in underlying business
Free cash flow	**23.7**	**27.1**	**27.7**	**39.9**	**46.2**	Free cash flow for valuation - pre-growth investment
Growth capex (ex acqns)		-3.0	-4.0	-6.0	-4.0	Assume reduction in 2024 as exceed target $65 million EBITA
Dividends	-1.9	-6.4	-8.4	-10.7	-12.7	25% of profit after tax
Acquisition free cash flow	**21.8**	**17.7**	**15.4**	**23.2**	**29.4**	
Other	-20.1					Broker number plug (deferred consideration etc)
Debt (drawn down)/ repaid			-50.0	0.0	29.4	Drawdown $50 million in FY2022. Degear in FY2024 as exceed $65 million EBITA - no further acquisitions
Net cash/ (debt) c/f	**22.2**	**20.0**	**-30.0**	**-30.0**	**-0.6**	Rolling $20 million operating cash and working capital cash buffer
Shares in issue	151.3	160.2	162.8	166.9	169.3	Include c12.5m incentive scheme shares
ND/ EBITDA			0.6	0.4	0.0	
Acquisition multiple		**6**	**7**	**8**	**8**	Acquisitions become more expensive (better growth and margin - not in our numbers)
Cash/ shares split		15%	shares			15% shares on consideration - around historical average
Cash available for acquisition		19.9	45.4	23.2	0.0	Debt drawn down + acquisition free cash less assumption for operating cash required
Share consideration		3.1	7.0	3.6	0.0	Gross up cash availability
Total consideration available		**23.0**	**52.3**	**26.8**	**0.0**	
Acquired operating profit		3.8	7.5	3.3	0.0	Total consideration available/ acquired multiple
Acquired revenue @ 12% margin		31.9	62.3	27.9	0.0	Gross up
Valuation - Downing case @ 140p/ 1.30 USD/ GBP						
Closing s/p @ 8x EV/ EBITA	1.35	1.45	1.56	1.95	2.36	
Closing s/p @ 10x EV/ EBITA	1.66	1.79	1.99	2.47	2.95	Use this prior year for acquisition consideration & dilution
Closing s/p @ 12x EV/ EBITA	1.97	2.13	2.42	2.99	3.54	
EPS cents	0.17	0.19	0.21	0.26	0.30	Cash EPS
P/E @ 150p	10.51	9.82	8.85	7.08	6.05	

While we hit management's target operating profit in four years versus their stated five, we do think that there is upside potential to our numbers, namely:

- Operating margin is expected to *exceed* 10%, we terminate with *just* 10%. We know that incremental growth and acquisitions are well above this 10% target. For example, we calculate that the Complex Assembly acquisitions to date are generating around a 13% operating margin;
- We assumed that new acquisitions do not grow once they are in the group, but we do assume that they become progressively more expensive. We know that previous acquisitions are generating significant growth. Servatron was acquired with prior year earnings of $2.5 million but had generated around the same amount of profit in the first half of its current financial year;
- We believe that our organic growth assumptions are prudently set. Regarding electric vehicles, we assumed no growth outside of Volex's current supply contract with one manufacturer. Upside could be that Volex can secure further EV contracts and/ or win a higher share of this customer's wallet. Data and healthcare are more traditional Volex opportunities where they have existing customer relationships and an advantage supplying premium quality cables and harnesses for mission-critical industrial applications. We expect revenue growth to be high given strategic focus and sales team recruitment and margins from this type of business run at around 15-20%. Healthcare is expected to grow from various customer and revenue synergies with acquired businesses, such as Silcotec, which shares some of the same customers as the traditional Volex business in the healthcare space. Finally, we know that Servatron has a specific contract with one client which is expected contribute incremental operating profit of up to 50% of the current year's expected profits of that business. We temper these growth expectations by running down earnings in the lower margin consumer electronics business which has experienced some headwinds recently.
- We assumed $2 million of recurring cash exceptionals, which is higher than expected, and an 18% tax rate, versus 15% targeted by management;
- And we assumed peak net debt/ EBITDA of only 0.6x – this does require $10 million of headroom above the current facility but is not a significant stretch in overall leverage terms. Our operating cash buffer of $20 million feels prudent, as do our working capital and capex assumptions.

So, what is Volex worth? We think that there is still some rating upside, along with significant growth potential outlined in our model. We think that the following are important considerations with regards to valuation versus the peer group:

1. Volex has second quartile expected operating earnings growth and top quartile expected earnings per share growth;
2. Volex has second quartile operating margins and a path to top quartile operating margins over the medium term;
3. Volex is the only company in our peer group with a net cash balance sheet;
4. Volex has top quartile expected cash conversion;
5. Volex has consistently beaten expectations since May 2018;
6. Volex has top quartile returns on capital (adjusted for cash).

Despite these top quartile quality and growth attributes (and the re-rating which Volex has enjoyed recently), the company still trades on bottom quartile valuation multiples (EV/ EBITA), trailing our peer group by around 30% (many of peers have also recently re-rated), moving towards 40% when we adjust for cash conversion.

The real opportunity here lies beyond the next two years and we have confidence that management will continue to deliver a value accretive roll-up and organic growth strategy for shareholders. If they execute, we see no reason why Volex can't generate well over 100% total shareholder return from here. That is why it remains the largest position in the Trust.

We caveat our positivity with some caution around Covid-19 where continued disruption in China would obviously affect the business in the short term. The company has updated the market twice to date, stating that manufacturing was back up and running, albeit at a reduced capacity. If we had to put rough numbers around a sustained underutilisation of the China plant and supply chain disruption for a few months, perhaps this could negatively affect 2021 operating profit by c$2-3 million. This has an immaterial effect on our terminal year outcome of only $0.9-1.3 million. We currently do not believe that this is a likely scenario and note that management have previously operated with headroom in their market numbers.

REAL GOOD FOOD PLC – continues to progress against our revised investment thesis. The underlying businesses are performing satisfactorily, and the group has returned to a positive operating profit position after 18 months of restructuring.

Renshaw (Cake Decoration) is currently the more challenging situation as the market is becoming more competitive. However, Renshaw has a track record of innovation and we believe that it has significant recovery potential from here. A testament to that is that gross margins have improved significantly to 44% versus the prior comparative period of 33%. Renshaw has historically been capable of generating in excess of 10% operating margins and we see no reason why this can't be the case going forwards. We think that this business could return to £3-4 million of EBITDA in the next 18-24 months.

Brighter Foods (Food Ingredients) has been the unexpected winner in the RGD stable. When we invested, that business generated around £2 million of EBITDA. Based on the latest group interims, which showed around £2.5 million of EBITDA, we expect that this business could generate up to £5 million of EBITDA this year. Brighter Foods manufactures nutritional food bars and we believe that there is a structural undersupply of capacity in the UK and European market for this rapidly growing medium of consumption.

Based on these numbers, we arrive at a group which we think can generate up to £9 million of EBITDA. We believe that a buyer could find material cost savings from the removal of central costs if the business were separated or acquired into a larger business. Therefore, some additional value could be ascribed to this upon exit.

RGD has stated that it seeks to return value to stakeholders. Given the previous track record of disposals and distributions, it is not unrealistic to think that there may be a crystallising event for the remaining operating subsidiaries in due course. We expect that the proceeds would be used to pay down shareholder loans initially with excess value accruing to the equity. Recall that the Trust has its exposure through:

- Equity = 0.61% of NAV
- Vanilla loan note = 12.97% of NAV (10% coupon; 7.5%/ 15% redemption premium)
- Convertible loan note = 2.81% of NAV (12% coupon)

The vanilla loan notes currently carry a coupon of 10% and a redemption premium of 7.5% if redeemed prior to 31 March 2020, growing to 15% if redeemed post this date. It currently seems more likely than not that the loan notes will not be redeemed prior to March 31.

The convertible loan notes, negotiated in May 2018, are convertible at 5p per share and carry a coupon of 12% until 17 May 2021. On this day, unless the convertibles are converted into ordinary shares or are redeemed in full, a redemption premium fee will be payable. This fee mechanism is intended to generate a return which would equate to a 30% per annum interest rate from the date of the loan notes until and including the redemption date.

Under our current expected outcomes of residual value, we think that the equity portions of the portfolio could generate a 3-4x return, assuming conversion of the convertible. If the loan notes run to term, then they should generate a c45% upside in current value of £5.6 million.

A significant point of interest when we meet investors is around the ability for the loan notes to be repaid. A milestone was achieved in August 2019 when the company secured a new £8.8 million credit facility which allowed it to repay certain debt facilities provided by the Trust, other Downing client funds and the other two major shareholders. Downing received £1.25 million in total. We think that this is indicative of the renewed financial health of RGD.

We think that 2020 is likely to be the defining year for the Trust's investment in RGD.

RAMSDENS HOLDINGS PLC – has also enjoyed a rerating in the period with the share price up 25%. This has primarily been driven by a strong set of interim results in December 2019, followed by an update that the business was trading ahead of expectations, in January. There has been significant change in the shareholder register with one existing holder and one new holder purchasing in excess of 10% of the share capital between them.

Our investment thesis has not changed in Ramsdens and we continue to be impressed by management's ability to create value. The acquisitions of certain 'The Money Shop' stores and loan books earlier in 2019 accelerated the company's progress against our thesis. In total, the group now operates 160 stores (including four franchised sites) and has a growing online presence. All the 123 stores which have been open for over two years are profitable.

We have written extensively in the past on the attractive quality and growth attributes of Ramsdens, those include:

- Diversified business model demonstrating resilience to headwinds and improving reliability of earnings. The business operates across four divisions and there is a natural hedge between these, as demonstrated over time;
- Ability to generate around 10% earnings growth. We expect this through a combination of new stores rolling out; increasing contribution from less mature stores or through improving the economics of acquired stores; and operating leverage increasing drop through on the relatively fixed central cost base;
- Higher than average margins for a company of this size – over 65% gross margins and around 15% operating margins with scope to improve this;
- Higher than average returns on capital employed – well in excess of 20%;
- Relatively capital light, with short lease exposure. Although we do note that working capital and capex will increase over the coming years;
- Strong and growing dividend backed by a very healthy net cash balance sheet (£12.3 million at September 2019);
- We have also commented on the ability of the business to generate one-off profits through liquidating gold inventory when the price is high. This has generated £0.8 million of exceptional profits recently.

Given the above attributes, we do not consider Ramsdens to be expensive and still see meaningful upside in the share price through both multiple expansion and continued growth in earnings over the medium term.

Ramsden's FX business likely would be affected by lower travel as a result of Covid-19. However, the business carries a natural hedge with gold and other precious metals whose prices have increased significantly in the current uncertainty.

ADEPT TECHNOLOGY GROUP PLC – has not enjoyed the share price appreciation of some of the other companies we discuss in this letter. In fact, its share price has done nothing when you consider our book cost of 320p versus the current share price of 330p. We do not think that this means it has not created any value in that time, rather the market is looking in the wrong place for value creation.

AdEPT is a buy and build platform in the telecoms and cloud managed services space. An unfortunate corollary of buying and building is that the consolidator tends to generate high recurring non-cash charges, particularly in amortising acquired intangibles. We think that the problem with this is that the market is mostly focused on accounting earnings and has a distrust for companies that present a high amount of adjustments or exceptionals. In a smaller company universe of over 700 companies, we are looking for a reason to say 'no', before we say 'yes'. Given finite resources, AdEPT probably sits in the former camp for many.

An example. Suppose we presented you with 'adjusted EPS' of 30p and 'statutory EPS' of 8p. You think that this looks like an unattractive situation as the delta between the two is large. You are prudent and relatively cautious of adjusted numbers, so you assume that the economic earnings are closer to 8p, and therefore this business is trading on over 40x. You move on to the next one.

What we are really interested in is the free cash flow per share. EPS *should* be a proxy for this, but unfortunately this is not always the case. Assume then that free cash flow per share is 26p. Suggesting that despite the non-cash adjustments to 'statutory EPS', that the 'adjusted EPS' is largely backed by cash generated by the company and offering a better reflection of underlying earnings of the business.

That scenario is how AdEPT's financials present themselves. We are not concerned with the current situation and looking forward a few years to when the amortisation and some other one-off costs drop away, we think that Adept can generate 35-39p of accounting EPS which will more closely reflect the economic reality on the cash flow statement. We are more concerned by companies presenting EPS figures with very little cash generation behind the accounting earnings.

A business of this quality – over 20% EBITDA margins, capital light, and nearing 80% recurring revenues in managed services – should command a significantly higher multiple than it currently does. The business trades on a forward free cash flow yield around 10%, versus the wider market which is rated around 5% or better. Adjusting for this would generate 100% upside from the current level.

We do think that the end game for AdEPT is a trade sale. There is currently over £30 million of debt in the business and if management can pay this down over the coming years, that could equate to additional equity value of over 100p per share.

HARGREAVES SERVICES PLC – share price was up strongly over the four-month period, around 32%. There were some notable announcements in the period, namely an acquisition and disposal generating a £2.4 million profit and the signing of a 10-year mining services contract at Hermerdon, and positive interim results.

Our Hargreaves' investment thesis is largely the same as when we invested with our valuation grounded only in the land and property value. However, we think that there is value growing in the underlying operations which would generate intrinsic value upside with limited downside.

Hargreaves Land has over 4,700 permissioned residential plots, and a further 1,200 in planning. It also has 4 million sq. ft of permissioned commercial floorspace and a further 125,000 sq. ft in planning. In the prior year, Hargreaves entered conditional contracts for the first 222 homes for a total value in excess of £10 million, expected to complete in FY2020, demonstrating the viability of our property-based valuation. The third phase of 188 plots at the Blindwells site has now been released to the market. The Hatfield Link Road, which has been granted planning for 3,100 homes and 2 million sq. ft of commercial space, is expected to complete this calendar year and we think that this could generate an attractive return given the growing demand for strategically located logistics and commercial warehousing in the UK. The company published an independent Red Book valuation to May 2018 which indicated that the incremental value generation from the property portfolio could be £35-50 million – or 100-150p per share, versus the current share price of 300p.

The underlying Distribution and Services business continues to tick along, and we would expect this to potentially benefit from HS2 spend in due course, up to around an incremental £1.5 million of operating profit. Combined with the above-mentioned contract, which is worth around £1 million per annum, subject to the project going ahead. There is also the ongoing investment in the German associate, HRMS. Hargreaves owns 49% of this business but receives 86% of the economic interest. This is expected to begin returning cash to Hargreaves' shareholders' in the form of an additional 12p per share pa. Overall, management's long-term target for the underlying operations is to generate £10-15m million of operating profit per annum.

Finally, there is potentially around £30 million of excess coal inventory which has accumulated due to lower prices, this may unwind over the next couple of years and could reduce net debt near to zero. We are reassured that the contract with British Steel continues to run, which we had not considered in our calculation of intrinsic value.

Hargreaves is a complex business to understand from these snapshot updates. We therefore expect to write a longer thesis in due course outlining the value opportunity in more detail.

WORK IN PROGRESS AND OUTLOOK

We have been on several site visits in the period as we further due diligence into several interesting new opportunities and look to top up underweight holdings in the Trust. We have also been active in trimming certain positions which were overweight or where the investment thesis has changed materially.

While the market has enjoyed some resurgence since the election in Q4 2019, we still think that there are many mispriced opportunities which have great potential to deliver our target returns over the long term. We expect to be able to introduce some of these to the portfolio over the next six months.

Downing

Portfolio construction (as at 31 January 2020)

Name	Sector	Age[1]	Progress against thesis[2]	Market cap (£m)	% of the Trust	% equity held by Downing[3]
AdEPT Technology Group	Telecommunications	2.50	Ahead	78.22	8.35%	11.46%
Braemar Shipping Services	Transportation	2.00	Behind	65.41	3.48%	2.70%
Duke Royalty	Speciality Finance	1.50	Ahead	110.95	4.87%	3.71%
FireAngel Safety Technology	Electrical Equipment	1.00	Behind	11.58	2.10%	17.48%
Gama Aviation	Transportation	2.25	Behind	36.59	2.76%	6.59%
Hargreaves Services	Support Services	2.00	In-line	101.64	7.42%	7.43%
Pennant International Group	Software & Services	1.00	Behind	30.70	1.66%	4.92%
Ramsdens	Financial Services	2.25	Ahead	73.39	8.54%	14.21%
Real Good Food[4]	Food Producers	2.25	In-line*	5.10	16.39%	7.88%
Science in Sport	Food Producers	2.25	In-line	58.34	2.25%	5.54%
Synectics	Support Services	2.00	In-line	26.69	6.37%	12.52%
Volex	Electrical Equipment	1.50	Ahead	246.53	19.05%	6.41%
Cash					16.75%	

[1] Weighted average age of the Trust's investment, including initial investment and all follow-on investments. Rounded to nearest 0.25.
[2] Based on Downing's interpretation of progress against original investment thesis, or revised thesis*, where applicable.
[3] Total percentage of investee company held by all Downing managed funds.
[4] Real Good Food holding includes 0.61% equity and 15.79% debt split.

Portfolio valuation statistics (as at 31 January 2020)

Name	P/ book	P/ earnings[5]	Margin of safety[6]	Upside[7]
Average	1.55	10.86	43.17%	122.94%
Median	1.22	11.85	42.00%	73.70%
Weighted average	1.73	10.25	28.92%	61.44%

[5] Normalised as: (Downing expected EBIT – (cost of debt * debt))* (1 – tax rate).
[6] 1 – (current price/ intrinsic value). Intrinsic value = Downing estimate. Price from FactSet
[7] (Intrinsic value/ current price) – 1. Intrinsic value = Downing estimate. Price from FactSet