Downing Strategic Micro-Cap

Insider buying and a positive outlook for the portfolio make DSM's discount look attractive...

Update
25 June 2021

Summary

Downing Strategic Micro-Cap (DSM) aims to benefit from stock market valuation inefficiencies that exist amongst the UK's smallest listed companies. This is an area of the market that offers the potential for significant value-add from a manager. DSM's management team aim to identify catalysts for value to be crystalised, but if required they will engage with senior managements or boards in order to effect change that will be this catalyst.

DSM is by definition a 'value' investment strategy based on fundamental analysis and has a highly concentrated, high-conviction portfolio. However, the investment thesis envisages a longer time frame than most, at five to seven years. Investee companies will typically have a market capitalisation of below £150m at the point of investment, but are often much smaller. This size of company is significantly smaller than many institutional investors will contemplate, and as such DSM offers exposure to companies unlikely to be found in other funds or portfolios.

Performance since launch has not been as hoped, yet the managers believe there are clear signs that DSM's shareholders have reason to be optimistic. Certainly, as we discuss in **Portfolio**, the prospects for each underlying company appear good and clearly aligned with the wider economic recovery in the UK. The performances of Volex and Real Good Food illustrate respectively the upside potential from the investment process and how the structured approach to investing can still deliver returns whilst exposing the trust to less equity risk.

The portfolio is concentrated but DSM's strong balance sheet could provide comfort to investors. As we discuss in the **Gearing section**, DSM has cash of c. 17%. This gives the managers significant flexibility and should reduce DSM's inherent volatility.

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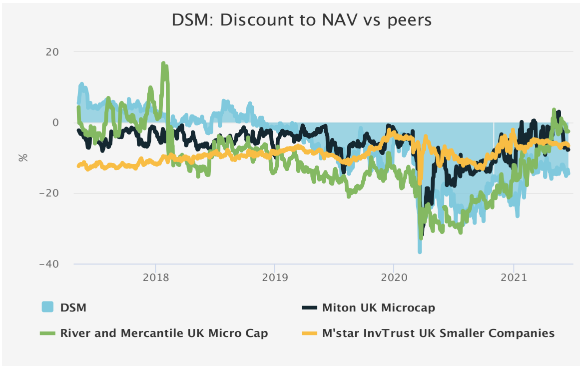
Key Information:

Price (p)	77
Discount (%)	-14.1
OCF (%)	1.76
Gearing (%)	-17
Yield (%)	1
Ticker	DSM
Market cap (£)	39,854,693



Kepler View

DSM is very different from other equity funds. The managers are highly active, with very low levels of turnover in the portfolio and a degree of focus on investee businesses which is only usually seen in direct private equity trusts. However, in our view portfolio construction offsets some of the higher-risk characteristics that the concentrated portfolio has relative to traditional equity funds.

The team are now in year three of their investment time frame for a large part of their **Portfolio**, and this is intended to be the value-accretion phase. Part of DSM's investment thesis is that at the small-cap end of the market, equity is not efficiently priced. Volex and Real Good Food provide illustrations of the team's process at work, and also the UK economic recovery should prompt operational or M&A catalysts in the portfolio companies to further validate DSM's investment proposition.

Downing estimates that the portfolio companies as a whole trade on a 40+% discount to their base case intrinsic value. Their assumptions are based on a conservative assessment of each businesses' prospects over the long term. When combined with the trust's current discount to NAV, we believe that value investors should find DSM an interesting prospective investment. DSM is a classic value play, and so if current momentum continues this discount might be expected to narrow. In our view, in terms of value opportunities, DSM is hard to beat. It seems Judith MacKenzie and the DSM team share this confidence, with their own recent purchases of shares in the trust echoed by the management teams of the underlying companies buying their own companies' shares.

BULL

- **Portfolio companies look to be in a strong position to capitalise on the UK economic recovery**
- **Highly differentiated strategy, with cash of 17% on the balance sheet giving the managers flexibility**
- **Estimated 40+% look-through discount, reflecting the discount to the manager's base case intrinsic value, and a 14% discount to NAV**

BEAR

- **Poor performance so far, illiquid nature of underlying companies and small size of the trust all mean that a narrowing of the discount is far from guaranteed over the short term**
- **Highly concentrated portfolio means that any pitfalls experienced by any investments could meaningfully impact NAV**
- **Illiquidity of underlying investments means managers may have limited room to adjust portfolio**

Portfolio

Downing Strategic Micro-Cap (DSM) aims to benefit from stock market valuation inefficiencies that exist amongst the UK's smallest listed companies. It is by definition a 'value' investment strategy based on fundamental analysis, and given the inefficiencies in this area of the market, offers the potential for significant value-add from a manager. The management team, led by Judith MacKenzie and Nick Hawthorn, employ a differentiated approach to most other trusts and funds exposed to this area of the market, in that they take a highly focussed approach to picking stocks which results in a very concentrated portfolio. Currently DSM's portfolio consists of 12 core holdings, with the range over time expected to be 12 to 18. The trust also has, at any point in time, several undisclosed toehold positions which the managers takes when they uncover an exceptional opportunity with apparent catalysts, but ahead of completing further rounds of diligence which typically include full board interviews and conversations with competitors, suppliers, customers and industry experts. The reason for the concentrated portfolio is that the team aim to buy strategic stakes (between 3% and 25%) in companies so that, if required, they can engage with the senior management or board in order to effect change which will boost the valuation of the company.

The investment thesis was designed to have a longer time frame than most, at five to seven years. Holdings are mostly identified because of an overlooked opportunity, but sometimes because of a problem or issue (real or just misunderstood by the market) which needs rectifying. Judith and her team expect to roll their sleeves up once they have built up a meaningful stake, and they actively try to influence the companies onto a better trajectory. They then hope to reap the rewards when changes are made and the better prospects for the companies are rewarded by the market. This all takes time, which is the reason why the managers expect a longer time frame for investments.

Investee companies will typically have a market capitalisation of below £150m at the point of investment, but are often much smaller. This size of company is significantly smaller than many institutional investors will contemplate, and as such DSM offers exposure to companies unlikely to be found in other funds or portfolios. The current portfolio breakdown can be seen in the chart below, which illustrates the dominance of the two largest positions, Volex and Real Good Food, which we comment on below.

Volex has been a stellar performer for the trust, having been a turnaround story, and the team hope it will be a long-term compounder. At a recent presentation, Judith and Nick commented on the prospects for the next five years for the company, which in their view will be as transformative as the past five years have been. The Downing team have been long engaged in supporting the Volex management team, but the investment of time and capital has really paid off in this case. Having originally invested £4.8m in the company, DSM has now realised a total of £8.4m by selling shares, and DSM's remaining Volex shares are currently valued at c. £6.7m (as at 31/05/2021). This represents an IRR of around 57% per annum, or a 3.2x multiple on invested capital, illustrating the strong returns achievable when things go right. The managers intend to run winners for as long as there is no sell catalyst, but at the margin (and where market liquidity allows), the managers trim or add to existing investments. The team continue to manage the Volex position from a portfolio-construction viewpoint, so that the holding doesn't become too great a percentage of NAV.

Portfolio Summary

COMPANY	% OF NAV AS AT 31/05/2021
Volex	13.2
Real Good Food (incl. loan notes etc)	9.3
Hargreaves Services	8.5
FireAngel Safety Technology	8.3
AdEPT Technology	7.9
Flowtech Fluidpower	6.7
Ramdens Holdings	6.5
Synectics	5.4
Venture Life Group	4.6
Tactus Holdings	3.3
DigitalBox	3.0
Duke Royalty	2.4
Other	3.4
Cash	17.4

Source: Downing LLP

Real Good Food has historically been a greater percentage of the portfolio (c. 20% of NAV as at 31/10/2020), but following the sale of the Brighter Foods division and repayment of part of the loan note held by DSM, this is now 9.3% of NAV. The majority of the remaining holding is represented by loan notes and a convertible, with equity in the company representing 0.4% of NAV. The structured approach to the investment in Real Good Food has limited DSM's exposure to the downside, and on capital realised the investment has so far generated an attractive IRR just under Downing's target annualised return for investments of 15%. We believe this transaction proves the value of the Downing team's private equity style approach to investing in undervalued opportunities, and also the value of the team identifying (and via activism helping to bring about) catalysts for value creation. However, investors have had to be patient, and this must remain the case if DSM is to see a profitable exit. We understand that the Real Good Food board is intent on realising as much value as possible for the company's remaining Renshaw division and property assets, which would enable the board to repay the remaining loan notes and potentially also offer upside to the share price. As such, there remains tangible potential upside to this investment, depending on the progress that the board makes.

According to Downing, many of the trust's other holdings have seen tangible progress made since the start of 2021, and they represent what the chairman of DSM notes in the annual results as "a portfolio for future national recovery". Confidence in the underlying prospects of the portfolio's businesses is illustrated by nine of 13 portfolio companies having management teams buy stock in their own business since the beginning of the COVID-19 crisis. Additionally, the Downing team have also been adding to their shareholdings in DSM, a further signal of confidence.

Significant Investments / Manager Comments

COMPANY	INSIDER BUYING	OUTLOOK
Real Good Food	-	Brighter Foods disposal. Renshaw recovery expected and cost base rationalistion.
Volex	Yes	Strong demand expected to continue across most markets. Healthcare recovery into 2022?
AdEPT Technology	Yes	Well positioned for growth in 2021.
Hargreaves Services	Yes	Continued progress across Land and Services businesses and JV.
Ramsdens	Yes	Recovery expected post-reopening and international travel.
FireAngel	Yes	Refinanced. Strong connected-home trading.
Synectics	Yes	Material efficiency savings announced. Recovery expected on gaming market reopening.
Venture Life	-	Traded well ahead of expectations through 2020. £30m of cash for acquisitions.
Flowtech Fluidpower	Yes	Trading well. Taking share. Cost savings coming through. UK recovery/reopening play.
Digitalbox	-	Ongoing scope to improve monetisation rates and continue value-accretive roll-up.
Duke Royalty	Yes	Much improved underlying performance and visibility of holdings.
Tactus	Yes	Trading significantly ahead of budget. Multiple levers for value creation and realisation.

Source: Downing LLP

The team have been putting cash to work in a number of different opportunities. Typically, they will initiate a small position in a company which they wish to get to know better (a 'toehold'). Over time, once their due diligence process finishes and if the prospects for the investment still look attractive, they will then look to add to the holding until they get to their target minimum of 3% of the company. Given the ambition to scale investments, the team do not disclose the names of these companies until they have bought a disclosable position. We understand that the team currently have two toeholds.

One other new investment is the trust's first unlisted investment, which was completed on 30 April 2021. The DSM team have invested in Tactus Holdings, a strongly performing IT supplier, which has (amongst other contracts) recently signed a significant deal with the Department for Education. The fundraising that DSM participated in was made to enable the purchase of PC gaming specialists CCL Computers. DSM has invested around half of its purchase through a debt instrument and half through equity, representing a structured approach designed to minimise the downside but offer equity upside.

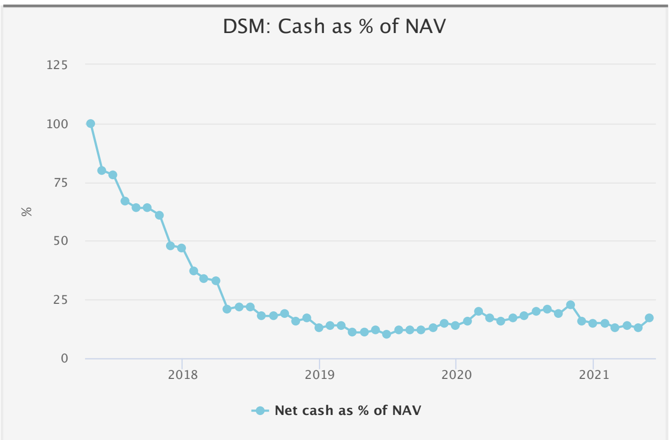
Being a value investor, Downing has a base case estimate of each of its holdings' intrinsic value, to which the firm buys shares at a significant discount. As we discuss in Discount, Downing currently estimates that the portfolio as a whole trades on a 40+% discount to this intrinsic value. At the same time, DSM trades on a 14% discount to NAV, making the 'look-through' discount of 48% compelling in our view. If the UK continues to experience a strong rebound towards economic normality, the valuations for these companies might start to attract attention from corporate (M&A) investors. The team are looking to deploy a proportion of DSM's significant cash balance, yet are likely to continue to hold a significant cash buffer to enable them to take advantage of any share price weakness or support businesses through corporate activity such as M&A. It is worth noting that none of the portfolio companies needed financial equity help through the 2020 pandemic-related lockdowns.

Gearing

DSM has the ability to gear up to 15% of NAV at the time of borrowing. The prospectus makes it clear that gearing might rise above this level as a result of market movements, and in such a scenario the board would not "prejudice shareholders" by forcing the manager to realise investments "in a disorderly manner" and reduce gearing. However, as the graph below shows, DSM has not so far employed any gearing – and instead has run with a decent cash balance at all times. The underlying holdings are relatively illiquid, and the portfolio is highly concentrated, which means the managers prefer to have cash to deploy if opportunities present themselves.

In our view the significant cash balance should be a source of reassurance for DSM's shareholders. However, the high cash balances should not be taken as a sign of a lack of dynamism in the portfolio. As we note in the **Portfolio section**, Volex's very strong share price performance has prompted the team to take profits from a portfolio-management perspective, and they have avoided keeping the exposure to the company at too high a percentage of NAV (currently 13% as at 31/05/2021). The team have been active in recycling this cash into a number of newer investment 'toeholds'. Alternatively, cash can also be directed at buybacks should the board see fit (which continue to be accretive to NAV given the current discount of 14%).

Fig.1: Net Cash



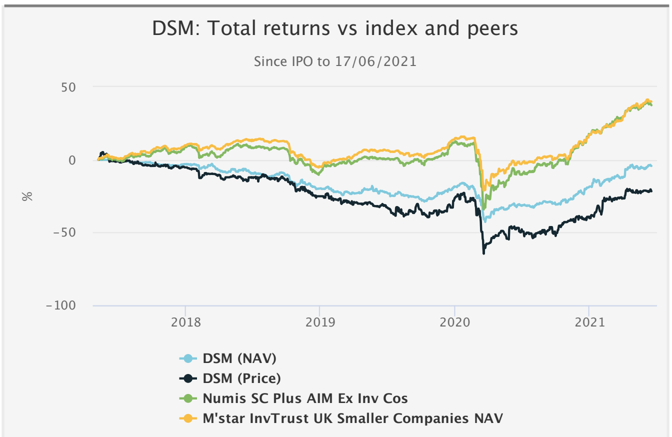
Source: Downing LLP

Performance

Downing targets returns of 15% per annum over a five- to seven-year period. DSM was IPO'd on the main market of the London Stock Exchange in May 2017, initially raising gross proceeds of £55.6m. The management team have always been clear that the investment thesis required a long-term time perspective to start to show results. By the October 2019 quarterly letter to shareholders they appeared to be getting more confident that the work they had put in – both in selecting the companies for the portfolio and then working to improve the management arrangements, incentives and governance – would soon start to show results. The pandemic put paid to those immediate hopes, yet now that we are largely through the worst of the pandemic (as we discuss in the **Portfolio section**), the fundamentals and outlook for each of the underlying companies seem to be increasingly positive. Now in year three of the investment time frame for a large part of the portfolio, Judith and the team appear to have confidence that we are starting on the upward part of the J-curve for the portfolio. This is evidenced by their own recent purchases of shares in the trust, and is also echoed by the management teams of the underlying companies buying shares in their own companies in nine out of 13 cases.

The graph below shows distinct signs of the J-curve that Judith refers to. Since IPO, NAV and share price performance has been challenging – partly as result of market dynamics which have not favoured 'value' strategies, where instead the market has long been fixated on (and rewarded) growth. That said, there have been some missteps by DSM's managers which have added to the underperformance. This historical performance notwithstanding, we believe that investors should be more interested in the prospects of the current portfolio.

Fig.2: Performance



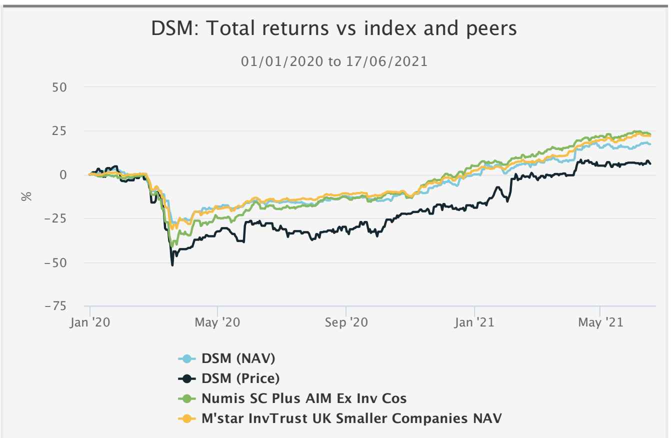
Source: Morningstar

Past performance is not a reliable indicator of future returns

As we note above, Judith and her team thought they would be in 'realisation mode' for one or more of their investments during 2020. Part of the managers' raison d'être is that they aim to invest in companies whose prospects are fundamentally undervalued by the market (the team believe that currently the portfolio is trading on a 40+% discount to their estimate of its intrinsic value). Being undervalued already means that one might hope that this gives these companies an element of downside protection in market falls. The NAV experience of Q1 2020 supports this thesis (see the graph below), although as with any performance metric, there are no guarantees that this will occur in the future. As well as valuations not having been stretched going into the crisis, several of the trust's holdings proved operationally resilient, which also helped protect on the downside. DSM's recovery from the lows has marginally lagged that of its peers, which we would attribute to the micro-cap effect. The managers are investing in esoteric out-of-favour businesses where the value is not always obvious, so these typically lag 'up-cycles' in which capital flows into the more easily understood, larger and more widely covered universe.

Since the start of 2021 (to 24/06/2021), NAV performance has been respectable compared to that of the benchmark Numis Smaller Companies Index, with DSM's NAV total returns of 17.5% comparing to 18.7% for the index. The weighted average of the AIC UK Smaller Companies sector over the same period is 23.6%, likely boosted by the large Aberforth Smaller Companies Trust, which has seen a strong bounce in returns that is reflective of value coming back into favour.

Fig.3: Performance



Source: Morningstar

Past performance is not a reliable indicator of future returns

As we note above, we think all the signs are there that DSM's recovery in performance can continue, and the managers are adding to their shareholdings, as is also the case for the majority of the underlying holdings' management teams. With a positive outlook for underlying earnings and a strong balance sheet, DSM looks to be in a good position to benefit from the continued economic recovery in the UK. With the UK equity market now more in favour from an international perspective, any improvement in overall market valuations may (eventually) feed through into DSM's portfolio.

Dividend

DSM has no stated dividend target. The board has stated that dividends will only be paid if income exceeds the running costs of the trust, and only to the extent that the board cannot retain this income. Investment trusts are required to pay out a minimum of 85% of distributable income (i.e. of income after costs). For the last financial year (ending 28 February 2021), the board paid a dividend of 0.8p, representing a yield on the current share price 1% on 24/06/21.

A large part of the income generated in the last financial year was related to interest on the loan DSM made to Real Good Food. Nearly half of this loan has been repaid in the current financial year, and so with only c. 10% of NAV currently in fixed interest (through Real Good Food, and via a fixed income security of unlisted Tactus), income will be expected to be lower. Given this and the board's intentions, over the longer term DSM is therefore unlikely to appeal to income investors.

Management

Judith MacKenzie is lead manager of DSM. The trust is co-managed with Nick Hawthorn. Josh McCathie and Cheryl Vickers are also involved in the day-to-day management of the trust. Judith joined Downing in October 2009, and is a partner as well as heading Downing Fund Managers. Previously she was a partner at Acuity Capital, a buy-out from Electra Partners, managing AIM-quoted VCT and IHT investments and a small-cap activist fund. Prior to Acuity, Judith spent nine years as a senior investment manager with Aberdeen Asset Management Growth Capital as co-fund manager of the five Aberdeen VCTs, focussing on technology and media investments in both the public and private arenas.

Nick joined Downing in September 2015, having previously worked for Aberdeen Asset Management and BP Investment Management. He has over eight years of experience in the industry and fulfils board-observer duties on portfolio companies alongside day-to-day fund management.

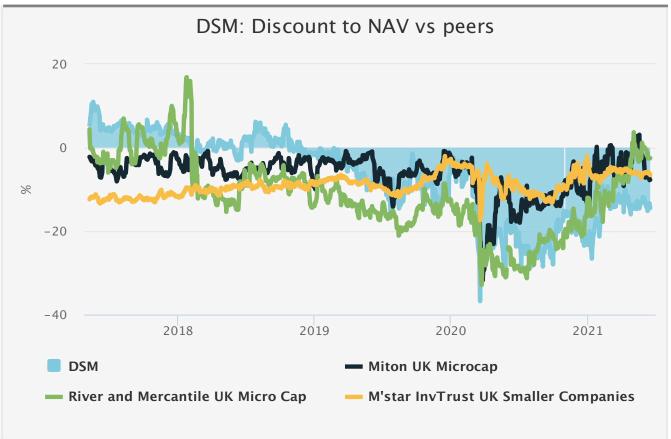
Downing was founded in 1986, and is privately owned. The company manages a range of different funds, including VCTs, enterprise investment schemes and business-relief products, plus over £100m in quoted funds. In total, the group has assets under management of c. £1.4bn. The group's teams work closely together, sharing ideas across public and private market investments.

The DSM team provide detailed commentary on the trust's portfolio holdings and developments within the portfolio, which can be found on **DSM's microsite here**.

Discount

Since its IPO, DSM's investors have seen first hand the effect that optimism and pessimism can have on the share price of a relatively illiquid investment trust. The graph below shows that DSM benefitted from a consistent premium rating in the first years of its life, which in the depths of sentiment about the pandemic was replaced by a very wide discount to NAV. Since then the discount has narrowed, although at 14% it remains wide by the standards of both the UK Smaller Companies investment trust sector and the trust's micro-cap specialist peers.

Fig.4: Discount



Source: Morningstar

The board has a stated policy of monitoring the discount and has undertaken to buy shares back "if the discount widens materially". Nonetheless, with the unique challenges that 2020 presented, the chairman stated that the board would hold back from making share purchases until the full impact of COVID-19 became clear. The board was as good as its word, and has been making buybacks since then – at times on a very wide discount to NAV, which has been accretive to NAV. At the time of writing, the last buyback to date occurred on 24 June, at a discount of c. 14%. The discount narrowing appears to be due to a combination of shareholder demand combined with share buybacks. We understand that the management team have shown their confidence in the trust by adding to their shareholdings in May 2021.

As we discuss in the **Portfolio section**, many of the underlying companies appear to have weathered COVID-19 well, and are positioned for strong operational performance during 2021. Downing estimates that the portfolio as a whole trades on a c. 40% discount to its base case intrinsic value. When this is combined with the discount to NAV that the trust trades at, we believe that value investors should find DSM an interesting prospective investment. The managers' view is that if inflation becomes more entrenched, this will likely favour their companies' valuations, which are 'short duration' when compared to typical growth stocks. DSM is a classic 'value' play, and so if investor interest continues, then both the discount to intrinsic value and the discount to NAV for the trust might be expected to narrow. Other catalysts for a narrowing of the discount could be a further M&A transaction from Real Good Food (a 9.3% holding in the trust), which could enable the repayment of its remaining loan to DSM (at a premium), as well as providing further validation of the managers' investment approach.

Over the long term, the board hopes to manage the discount back to where it was before COVID-19 (i.e. narrower than 10%, although without setting an explicit target). There is a periodic redemption facility at the discretion of the board, but the board stated in the May 2020 annual report that it was not a time when it was in the best interests of shareholders for the trust to realise investments. Given the strong performance since then, the board has been proved entirely correct. In the most recent annual report (published in May 2021), the board stated that it hopes to grow the trust rather than shrink it, but remains committed to continuing to listen to shareholders' views.

Charges

DSM pays the manager a fee of 1% of market capitalisation per annum. Paying a management fee on market capitalisation, rather than on the more usual NAV, provides an incentive for the manager to try to help any discount that appears to narrow. There is no performance fee. The overall OCF for the financial year to 28 February 2021 was 1.84%. This is relatively high in the context of both micro- and small-cap trusts, but is probably to be expected given the small size of the trust (which has net assets at the time of writing of £46m). We note that Downing has agreed to rebate any management fees to ensure that the OCF is no higher than 2%.

ESG

DSM is by no means an ESG fund, yet the fundamental premises behind the investment strategy do mean that DSM is aligned with ESG principles in many ways. Firstly, the team take a long-term view on investing. Taking a long-term view requires the managers to consider whether business models are sustainable and resilient as regards climate change in the long term. The team do not exclude any businesses from consideration but do look to evaluate whether ESG risks are reflected in the current valuations, and also look to influence management teams towards change and value creation through active engagement. They believe that they can help enhance disclosures and accountability and ensure that any change which needs to happen will happen.

The team believe that improved corporate governance is a vital tool for value creation, which means the trust is aligned with ESG principles in this way too. DSM's managers see good governance as absolutely critical to the long-term success of their investments, and as we discuss in Portfolio, they aim to take strategic stakes in their investee companies so that they can effect change and ensure that good management and governance are delivered. Downing sets out its expectations of investee companies and their boards. Specifically the firm looks for an independent chairman who leads an "effective, questioning, challenging board", and each board member should be effective and knowledgeable. Also, each company should be familiar with the Quoted Companies Alliance's work on corporate governance and that organisation's ESG guide. Downing states that it "will take action" if companies or boards do not measure up to its expectations.

As evidence of this active influence, Judith reports that she and her team have overseen 20 board changes since they started investing for the trust. Within DSM's portfolio, Judith observes that they have had to be a lot more active in putting in place acceptable governance structures than they had originally envisaged. In our view, this shows the value of fund managers (in general) incorporating ESG into their analysis. The Downing team's engagement means that investors can be confident that the underlying companies in DSM's portfolio are likely to have strong governance. On the other hand, environmental and social factors are not a central part of DSM's investment thesis, although they are monitored as part of the pre- and post-investment processes.

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