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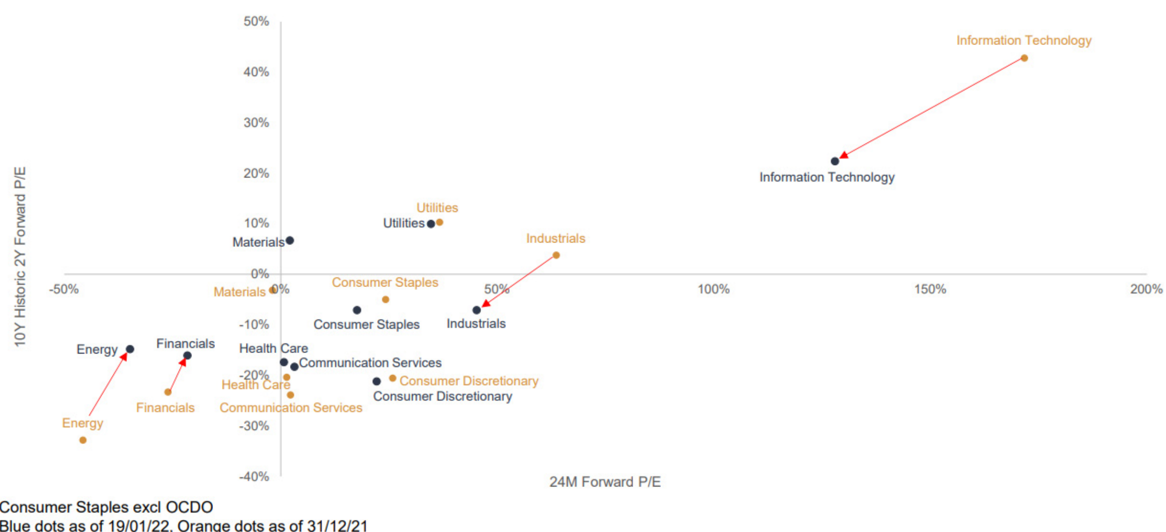
Downing Strategic Micro-Cap Investment Trust PLC

Investor Letter

The Company closed 2021 delivering a positive return of 10.2%. We are confident that the primary driver of historic underperformance – the significant restructuring of legacy positions – is now behind us. As we exit Covid, there is a clear pathway for these restructured businesses to return to improved profitability, aided by the relentless efficiency drives put in place by their management teams over the last two years.

2022 has started well. The Company ended January up 4.8% versus the AIM market, which declined by almost 10%. Many of our more quality and growth focused peers have been caught in the widely discussed rotation to value. Being at the value end of the market has been painful for a long time, but it seems that the days of "growth at any price" may be over. The geopolitical tensions cannot be ignored, with the war in Ukraine creating a very uncertain background. This, combined with interest rates already increasing and expected to pick up further throughout the year, this can only continue to strengthen the headwinds against highly rated companies which have generated so much outperformance over recent years. It no longer makes sense to pay eye-watering multiples for cash flows which are uncertain and many years away. As the chart below shows, multiple compression has been stark and painful.

FTSE Sector premiums and discounts to the market and the sector's historic multiples



Source: Investec Securities UK Strategy Perspective, 28 January 2022

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The portfolio has not been immune to multiple compression, particularly since our universe of sub £150 million market cap companies contains few investible financials, and few investible energy stocks. Volex's multiple has contracted significantly, more so than the wider industrials sector, which we think is unjust. We now think that the shares are mispriced.

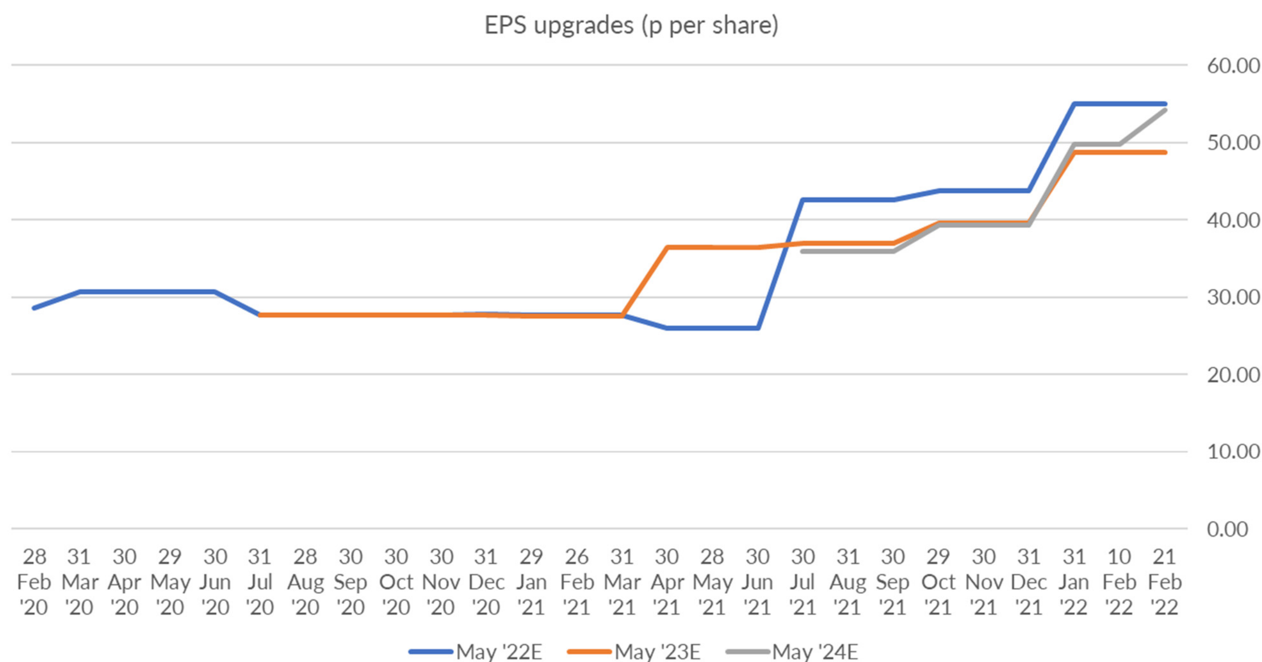
We have also been fortunate to enjoy some multiple expansion, a function of owning cheap companies which have subsequently delivered stronger than expected operating results. DigitalBox's earnings were capitalised at around 5x when we invested, today it is 12x, and earnings have been upgraded along the way. Hargreaves Services has also enjoyed a re-rating with over a 50% uplift through Covid. Tactus has attracted new investment at around double our entry multiple, and Flowtech has ground out respectable multiple expansion.

As value investors, it is not necessarily just 'cheap today' stocks we are interested in. Cheap today can become expensive tomorrow if earnings or asset/ equity value declines. Conversely, even a stock on a high multiple can become attractively priced if it can reinvest at incrementally high rates of return and has a long runway for growth – these are great businesses to own over the medium and long term. The most dangerous position for any investor is to overpay for future growth which doesn't materialise. Declining earnings combined with a collapsing multiple gets painful very quickly and the easiest way for us to avoid this, in our experience, is to pay less on the way in. Nobody knows what the future holds (not even management) and that is truer now as we go forward than it has been in recent history.

The rapid rotation to value has caused the typical small cap premium to invert – the market is no longer willing to pay more for expected future growth. But that doesn't mean that there isn't growth to be had, just that one must search harder to find it. Combining the small cap discount with the UK's chronically undervalued equity market, makes UK small cap land an incredibly good prospect for investors hunting for mispriced and growing opportunities.

We hope that the rest of this year will build on the successes of 2021, and the strong progress made in January. In this letter we explain why we think we have a portfolio with good growth prospects, set out reasonable assumptions and outline the value drivers in the most material positions. We also set out the investment case for three new positions. We are unable to predict the future in terms of timing and *exactly* when these value drivers will be realised by the market, but what we hope to do is provide a clear indication that the portfolio is significantly undervalued over all time horizons. Combined with a discount which is as wide as it ever has been (over 20% at the time of writing), we continue to think that the Company offers an attractive and de-risked entry point to a mispriced, overlooked, and unloved area of the market.

HARGREAVES SERVICES (HSP) has overtaken Volex as the largest position in the portfolio, driven by Hargreaves' very strong relative share price performance. HSP is a complicated business with lots of assets and contracts spanning multiple time horizons. There are several attractive attributes justifying our exposure here. There are multiple levers to generate value, and many are within the grasp of the well incentivised management team – they own c. 10% of the equity and shareholders have almost 40% representation at board level. There are three earnings generating segments, and current earnings and much of the value creation opportunity in the future is uncorrelated. There is significant asset backing in an undervalued land portfolio. And since Covid, HSP has entered a strong run of EPS upgrades driven by stronger underlying performance in Services and Land, and in the German associate.



Source: FactSet consensus

At around 500p (share price at time of writing) HSP is valued at less than 10x this year's expected P/E. A slight drop in 2023 reflects lower contribution from the German associate, but the economic benefit to HSP shareholders remains the same – by way of a dividend pass through – so this is not a concern and is being replaced by wholly owned earnings (and cash) as Services and Land continue to grow. We also think guidance in coming years is too conservative with some significant projects not in consensus numbers which could drive upgrades over all time horizons.

In Services, HS2 is now ramping up and is expected to hit £40 million per annum and generate £1.5-2.0 million of earnings. There are two further contracts behind this – Lower Thames and Sizewell, similar in size to HS2 – which we think the business has a good chance of securing on similar economics. Neither of these are in current consensus. We think that these cash flows could be worth 10-20p per share depending on whether the business lands one or both projects.

Tungsten West (TW) could also have good scope to drive upgrades. TW is a tin and tungsten mine in Hemerdon, near Plymouth. It was recently fully funded through to production by completing a floatation on AIM. HSP have the mining services contract here and will also receive a royalty worth £1 million per annum for the next seven years. The royalty is in guidance, but the mining services contract, which would begin contributing in 2024, is not. This could be worth an additional £1.5 million per annum but could also generate significantly more. We think that TW cash flows could be worth a further 20-30p per share on a discounted basis and this is not in the current price. It is also important to note that management have taken lessons from past contract negotiations – there is no credit risk with TW – everything is paid upfront.

The company also recently announced the financial close of its Westfield site in Fife. This is a substantial industrial site which will benefit from the construction and operation of an EfW plant. The land has been leased to the plant and generates a 35-year index-linked rental, and there are further plans for a 30 MW solar farm. Once constructed, it is expected that the remainder of the site would attract industrial tenants looking to benefit from cheaper energy costs. In our view, the energy sites tied to the industrial land could attract a premium infrastructure-type yield. We think that the discounted value of Westfield could be upwards of 30p per share.

And there remains significant value in the rest of the land portfolio. Blindwells continues to make progress having recently completed the 197 plot, £9.6 million sale to Persimmon. Phase 5 (300 plots) is currently under negotiation, and we think likely to complete this year. The remaining phases to be delivered of the next decade have a Gross Development Value of £140 million. And then there is Greater Blindwells, a site which is larger again, expecting to receive planning by 2027.

At the time of writing, HSP has also announced the conditional sale of land at Blindwells and Unity. The latter is more significant and is expected to generate over £50 million of revenue in FY24 for the JV, in which HSP have a 50/50 interest. Brokers have only assumed an incremental £1.5 million of profit from this, despite returns targeted at 15%, so there may be further upgrades to come from this.

Consensus EPS for 2023 and 2024 is 49p and 54p, respectively. We think that a fairer multiple closer is closer to the five-year average of 15x, versus around 9x today. This reflects the de-geared and de-risked balance sheet, impeccable recent trading performance, and multiple and uncorrelated levers for value creation. Add on the discounted value of any (or all) of the projects not in guidance and the upside is very significant.

VOLEX shares de-rated significantly over the period, mostly post the half year results in November. This has, in our opinion, created a mispricing. At our interims, we referred to Volex as a compounding growth story. It is now a compounding value story which are rare opportunities even in the current risk-off climate.

The half year results were good, but the market clearly expected better. Operating earnings growth of 31.3% was exceptional, but operating margin declined by c100bps and was 70bps below management's target, so earnings *could* have been $2 million better. On a like-for-like basis, operating profit growth reduced to single figures, and below this line, interest costs, tax and dilution eroded further earnings per share progress.

Cash flow was also weaker on the back of increased working capital to meet demand in the face of tight supply chains, and capex, which will continue to increase in H2 as management are now investing for considerable growth in the next few years. This may also have caused some concern given management's prudent management of the balance sheet in the past.

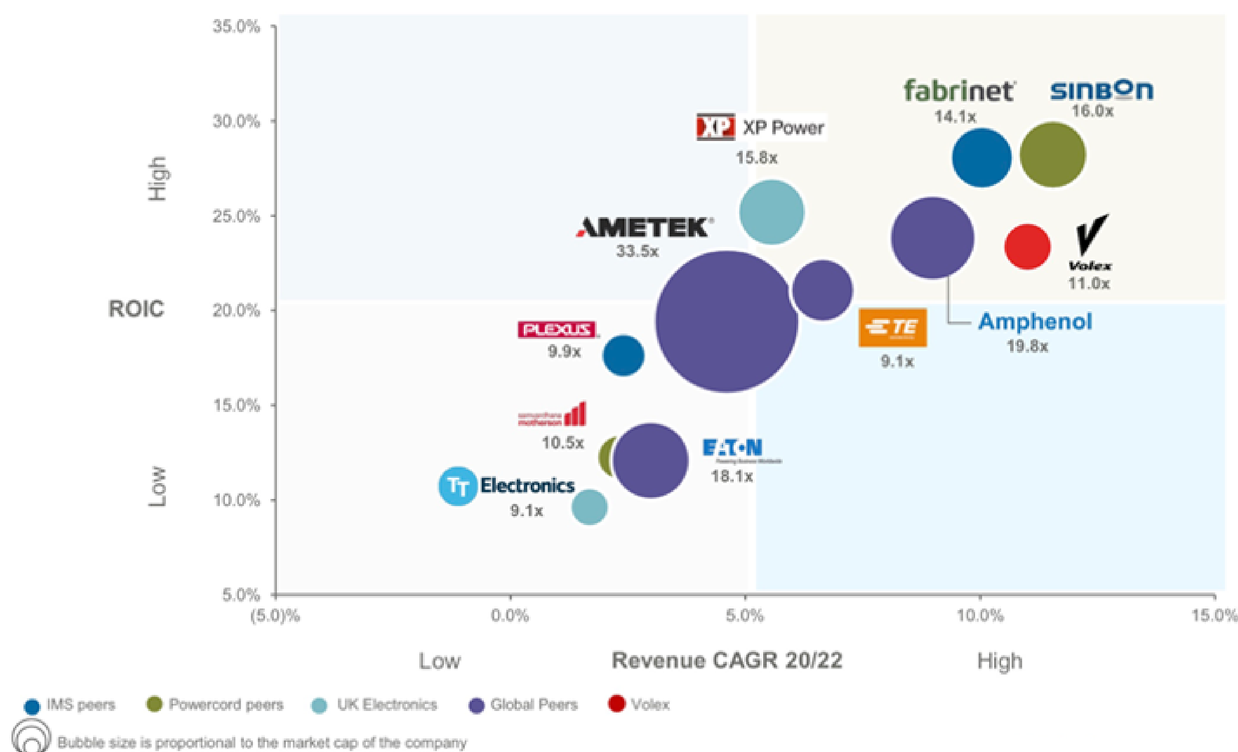
The sector has de-rated significantly, with industrials contracting by over 20% – due to a combination of concerns around supply chain and increasing interest rates driving lower expected returns. Volex has seen multiple compression of over 40%. Yet we know that Volex continues to trade well this year. In the recent refinancing announcement, management stated that the business continues "to perform robustly, successfully navigating the current supply chain challenges while demonstrating our ongoing ability to pass through inflationary cost increases."

The market is now pricing Volex as if earnings and returns are going to decline to their historic average. But we think that the significant re-structuring undertaken over recent years, combined with new wins in structurally growing markets and organic and inorganic reinvestment means that the business is unlikely to mean revert.

The investment proposition here is not about the short term. It's about Volex' ability to compound over a longer period. In five or ten-years' time, it is unlikely to matter whether operating margin this year was basis points lower than expected or net debt was higher.

What really matters for equity returns over the long term is (free cash flow) return on invested capital and lots of opportunities to deploy free cash flow generated at incrementally high rates of return. As the chart below demonstrates, Volex has amongst the highest ROIC and revenue growth prospects across UK and global peers, yet it trades at a significant discount to peers with similar or poorer metrics. The market is not pricing Volex' improved fundamentals.

22E ROIC vs. Revenue CAGR 20–22E[1]



Source: Downing

Businesses generate ROIC by combining margin and invested capital turnover. Thus, management have a constant challenge to balance the optimum margin profile and optimum investment in the group's capital to generate revenues. There isn't a linear relationship between ROIC and valuation (a 30% returning business is not twice as valuable as a 15% returning business) so it is not purely a case of maximising margin or minimising invested capital, or both. And since returns are more durable than growth (companies can't grow at 20% p.a. forever), *protecting* high returns is paramount for long term value creation, and intrinsic value is maximised where management invest for growth *and* to protect their competitive advantages. This is all positive, but the short-termist City typically rewards companies that dare to mention investment with a lower share price, at least over the short term.

Volex operates across four key verticals – EV, Industrial (datacentres being the key growth driver), Consumer and Medical – all present significant growth opportunities which require investment to exploit. In some cases, the markets themselves are growing quickly, such as EV (25%+ per annum) and Medical (5-7.5%+ per annum), in others market growth is lower (Consumer 2.5-5%) but Volex are investing to take share. Datacentres is now attracting R&D expenditure so that Volex can be at the leading edge of the 400G roll-out.

In all cases, management are focused on driving efficiencies to increase margins, but the point is not to harvest those efficiencies through higher margins back to the group today. Volex are reinvesting those savings back into the customer relationship, helping to increase their wallet share and further embed their value add within the customers' supply chain. A good example is in Electric Vehicles where management have spoken of their investment in various manufacturing efficiency programmes, in particular vertical integration of the cable which is the key cost driver as well as being a technically challenging process with extremely high cosmetic requirements. The vertical integration investment will pay back quickly while allowing Volex to maintain margins and service customers who are growing rapidly, and where certainty of supply is a key differentiator.

This contradicts the optimum short-term approach which would be to charge the highest price possible. But in thinking like c. 30% equity owners, management are focusing more on the longer term and making sure that the business is optimised for the future. Doing this correctly will present opportunities to win naturally higher-margin work anyway, (think cable assembly progressing to more complex sub-assembly or full box builds, or high margin data cables borne out of lower margin industrials) while also protecting the company's market position. The more we listen to management talk about the operating model and value proposition they are trying to create for their customers, the more excited we get by the long-term potential.

This has been done before. Amphenol's Adam Norwitt talks about how his customer's want "one throat to choke". Over the last two decades, the management at Amphenol have built, through acquisition and organic growth, a platform for servicing customers' increasingly complex needs across the electronics supply chain. They have become a reliable *partner* to their customers and have helped them to simplify their own supply chains, generating cost savings. We think that Volex management are at the early stages of executing a broadly similar, value enhancing playbook for their stakeholders.

Investing in vertical integration, adding new manufacturing capabilities, continually improving processes, and doing it all locally across a global manufacturing footprint builds Volex as a credible one-stop-shop and a value enhancing proposition for its often-global customers. Recent investment will involve building out the company's PCBA capabilities in Mexico which will enhance low-cost production opportunities for Volex's North American healthcare customers. These decisions require investment today to generate high returns and growth tomorrow, and to protect these into the future.

So, that is what we think this year is going to show – operating and financial progress, in the face of challenging supply chains, and significant investment to cement growth opportunities into the future. We are unsure how the (short-term minded) market is likely to respond, but with consensus expecting 19-20p of adjusted earnings this year, the shares trade a little over 13x. Investors shouldn't lose sight of the fact that this is a top-quartile ROIC business, with substantial growth opportunities (22-24p of earnings expected by 2024) and an aligned and proven management team with strong track record of earnings upgrades. We think that earnings should be capitalised around 20x.

FLOWTECH continues to recover from Covid wherein its cyclically exposed revenues were impaired due to forced closures of its customers. In the most recent trading update, management signalled those revenues had almost returned to pre-Covid levels and the business was performing in-line with expectations.

But the business has failed to really capture the imagination of the market – we thought that the shares ought to have performed better over the last 12-months.

This is a good business with a leading market share and strong value-add position in the market. They are a distributor and provide a critical service to customers who need parts and spares expedited, typically next day, to allow their own business's capital assets (machines, assembly lines, construction equipment) to get back up and running. Flowtech earns respectable margins and should generate reasonable operating leverage as it grows, which it should, since management have been talking about the opportunity to continue taking market share.

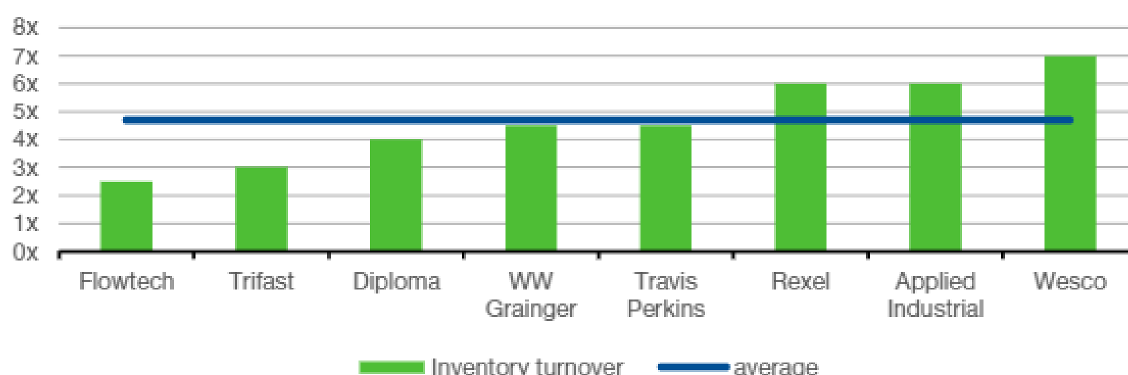
The value creation proposition here is reasonably simple:

- Build revenues back to pre-Covid, c. £112 million, and from there grind out low-to-mid single digit growth
- Maintain gross margins at 35%, with some growth potential over the medium and longer term
- Deliver operating cost savings, much of which will be reinvested into the e-commerce platform
- Focus on driving best in class working capital turnover
- Ensure the operating platform is well invested for growth

Putting all these together, we see a pathway to well over a 10% free cash flow yield from here, with the majority delivered by self-help. Revenue growth contributes only around 10% of our free cash flow growth assumptions; margin expansion from operating leverage and cost savings drives 30%; and working capital improvements drive around 60%.

Flowtech is never going to be a high growth business, but it doesn't need to be to generate a great outcome from here, with most of our intrinsic value levers within management's ability to grasp.

Figure 3: A 4x stock turn would see Flowtech rank in-line with global peers



Source: Liberum, Bloomberg

Source: Liberum, Flowtech Fluidpower – Initiation, Going Global. 26 January 2022.

Our primary value driver comes from a focus on working capital and improving inventory turn. Management's aim is to move the business towards 3.5-4x inventory turnover, which the chart above demonstrates is not a challenging position given how efficient some peers can be. Success here will transform the business and generate significantly more free cash flow – double digit free cash flow margins are on the cards – which will naturally result in a much higher quality business with improved returns on capital and greater distributable free cash flow. This matters here because we expect that Flowtech will return to a buy-and-build strategy over the medium and long-term once the operating platform is well established.

New broker, Liberum, recently initiated on the business with a 200p 12-month price target – broadly like our own near-term assumption of fair value. Like Liberum too, we find a longer-term fair value far more than this, over 400p, on the basis that management execute perfectly on the organic growth, margin and working capital strategy which they have outlined. We also factor in the potential to de-leverage which would add a further 20+p to equity value.

REAL GOOD FOOD has been discussed at length in previous Investor Letters. The once food conglomerate is now a focused food ingredients business that has gone through material turnaround. Around £60 million has been realised through divestment in the last four years, allowing term debt to be repaid and more significantly a repayment of DSM Loan Notes providing a 12% IRR on this capital investment through interest and redemption premium.

The DSM investment comprises a loan note, convertible loan note and equity – highlighting the strategic nature of the investment.

The remaining business is Renshaw – a Liverpool-based manufacturer of cake decorations primarily focusing on fondant icings, marzipan, frostings and caramels. Although the business suffered through Covid with lower wholesale sales, a high level of absences and supply chain disruptions, the business continued to trade with a positive EBITDA. Significant cost has been taken out of the business in previous years allowing efficiencies to be achieved – these initiatives continue.

The business should be capable of generating a £3-4+ million EBITDA post the impact of Covid and supply chain issues. More recently though it was frustrating to note that after a very solid first half of the year the company had hoped to make significant progress over the seasonally busier second half of the year. Sales in December and January were lower than anticipated due to severe shortages and erratic deliveries of certain ingredients, compounded by high absences because of the Omicron variant, which affected the ability to fulfil customer orders. However, these issues appear to have been short-term and the company expects them to ameliorate in the coming months. This will mean that EBITDA is likely to be around £0.5 million, like the previous Covid-affected year. Cash remains at around £2.7 million and the company will report cash inflows for the second half despite the frustration in short-term trading.

It often feels that it is one step forward, then two steps back with Real Good Food – progress having this time being hampered by elements outside their control, something certainly common across the food services sector. It must be remembered that despite these short-term setbacks the business trades profitably at the EBITDA level before the shareholder loan note interest obligations and has enhanced the relationship with key clients through new product development – allowing some costs to be passed on in these key client relationships. As we enter a new trading year in April, we expect that accelerating self-help measures should enable RGD to deliver on the aspirational return to £3-4 million EBITDA targets.

The company has recently stated the desire to maximise stakeholder value and reduce loan note debt. We expect further news on organic and inorganic opportunities through the course of 2022. The business has many levers to pull for value realisation, including property and land assets.

DIGITALBOX hasn't gained much airtime in our letters since we invested only at the end of 2020, and because the position size has been too small to warrant discussion within our top holdings. DSM invested at 4.9p, and with the share price at the time of writing over 15p, Digitalbox has grown to over a 7% position in the Company's NAV.

Management really impressed us in the year. Their ability to take underperforming assets and turn them around quickly is deeply satisfying to watch from the sidelines (or the from board, where we have observer rights). The company is another which has successfully generated earnings upgrades through the year, particularly in Q4, aided by the strong digital ad market.

But it isn't all market driven. Management deserves great credit for building a scalable operating platform and for investing in content that has considerable value. Digitalbox's inventory remains hot property and this is reflected in their market-beating yields.

Source: https://adrevenueindex.ezoic.com/ - The Online Ad Revenue Index

The digital ad market has started the year strongly with most forecasters expecting 2022 to generate double digit growth again this year. In what is typically the weakest month of the year, the digital ad revenue index (chart above) is approximately 25% higher than it was at the same time last year. Whether this translates to 25% higher revenues remains to be seen, but since the operating leverage now is so high, a 10% beat on next year's revenue would generate a 30% beat on the current £1.2 million of expected EBITDA.

We think that the prospects for Digitalbox this year are very good. Management are focused and incentivised, given the quantum of their own shareholding in the business. They have built a scalable technology platform and proven that their inventory is valuable. They have also proven that they can acquire and create value quickly from underperforming assets. And they are likely to end this current financial year with around £2 million of net cash on the balance sheet. This cash is likely to be used to complete further value enhancing acquisitions, we expect one to land this year.

DigitalBox has re-rated considerably, from around 5x EV/ EBITDA where we invested to now around 12x consensus 2022 earnings (£1.2 million), dropping to 8.5x in 2023. This still presents considerable upside to digital publishing peers which can trade significantly higher, albeit with larger scale, more liquidity and longer track records. The LadBible recently IPO'd at close to 25x, slightly above where Future tends to trade. That being said, there are plenty of value drivers here to generate further multiple expansion and earnings growth – ad spend tailwinds and an acquisition would certainly help both. Overall, we think that there is a credible short-to-medium-term pathway here to a £2 million+ EBITDA business and that ought to be priced around 25p.

NEW POSITIONS

Since the last letter we have added three new positions to the portfolio with a total cost of £6.5 million.

CENTAUR MEDIA is an international provider of business information, training and consultancy, creating value through premium content, analytics and market insight within the Marketing and Legal segments.

Centaur operates under several flagship brands, namely The Lawyer, MW Mini MBA, Influencer Intelligence and Econsultancy, with the latter three brands forming part of their marketing arm, XEIM. The Lawyer is a well-established and resilient title in the legal market, providing analytics, white papers, and research through a subscription model.

The Lawyer is seen as the 'bible for the UK legal industry', having reported on the legal market since 1987. Its differentiated content has allowed it to migrate to a paid subscriptions model and migrating to digital for all business lines. This is an attractive business generating over 30% margins. Growth is coming from improving the revenue mix in both events and content-based client engagement.

Meanwhile, XEIM services the marketing sector with content, research, marketing solutions, and training. Growth has been derived across all divisions but particularly in Econsultancy and the MW Mini MBA – a marketing MBA that has become industry leading and grown exponentially through Covid.

The diagram below gives an overview of the company activities

Segment	Brand	Premium content	Marketing services	Training and advisory	Events	Marketing and advertising solutions
Xeim	Econsultancy, Oystercatchers	✓		✓	✓	✓
	Influencer Intelligence, Fashion & Beauty Monitor	✓				
	Mini-MBA			✓		
	Marketing Week					✓
	Festival of Marketing				✓	
	Creative Review / Design Week	✓			✓	✓
	Really B2B		✓			
The Lawyer	The Lawyer	✓			✓	✓

Source: https://www.edisongroup.com/publication/flagships-lead-the-way/28693/

We were attracted to Centaur because it has a clear barrier to entry in the provision of its content through established brands. The management team, which was brought in to restructure the business some years ago is professional, financially astute and their track record is one of sound financial management and cost control. This is evidenced by the closure of loss-making activities and a clear focus on margin improvement over the last three years.

The investment case is simple: the company has a clear plan to get to 23% margins in 2023 (currently it is sitting at Covid affected margins of around 16%, improving to 19% on Q4 run-rate) with a capital light operating structure. When these margins are achieved, we think that the company will generate around £7 million of cash which presents a 12% free cash flow yield. At this time, assuming no acquisitions, net cash would amount to over one-third of the current market cap.

A peer group with similar levels of top-line growth and operating margins, in normal times would have a valuation of over 15x EV/ 2022 EBITDA, versus Centaur on under 7x.

The third way of considering the valuation is on a sum of the parts basis. This in many ways can be flawed, as it requires corporate action and cost to drive the outcome. However, very crudely we believe that The Lawyer could be worth c. £35 - £40 million (on the basis of recurring subscription revenues, turnover of £8-9 million, 33% margins, brand value and a 15x multiple). Separately XEIM which is a c. £35 million+ turnover business at 20%+ margins which should trade at c. 10x = £70 million. This would assume that a central plc overhead of c. £2 million was removed from the businesses. This, combined with net cash would imply a valuation of around £125 million, a premium to the current EV of £54m.

Recent trading update in January highlighted continued strong momentum through Q4, with revenue and profit outperformance against expectations. Higher margin revenue streams nudged the margin above the forecast 15% for the year or an implied H2 margin of 19%, demonstrating management are well on track for the aspiration of 23% margins in 2023. Working capital with this company is always well controlled and net cash was £3 million ahead of expectations at £13 million, albeit there will be some unwind during 2022.

In short, there is a lot to like about our entry point, the quality of management execution, and a defined path to value creation. We look forward to reporting on further progress during 2022.

NORMAN BROADBENT (NBB) is less than 2% of DSM but Downing client funds now hold an influential stake of almost 20% of the equity. NBB offers a bespoke mix of high-quality Search, Interim Management, Research & Insight, Assessment & Development solutions. A recognised but historically uninspiring brand, NBB has market presence but had struggled to gain scale. However, it is profitable, modestly cash generative, and provides a platform for growth. After executing a turnaround in 2017 and a return to stability, Downing and other strategic shareholders recently refreshed the Chair and CEO positions, having identified a strong 'buy-in' team to take NBB to the next level of organic and inorganic growth.

Management is key in people businesses like recruitment where the assets walk out of the door every evening. Peter Searle, an accomplished entrepreneur in the recruitment sector, became Chair mid-2021. Prior to NBB, Peter grew Delphi before it was sold to Adecco in 1999, and he became CEO of Adecco UK. He left Adecco in 2006 to join Spring Group plc which he subsequently grew and sold to Adecco in 2009. In 2015, he left to join AirSwift – which he left in 2021 to join Norman Broadbent as Executive Chair. Peter brought in Kevin Davidson as Chief Executive who has a proven track record in executive search. Kevin built Ducaus Partners from scratch in 2016 to $5.5 million turnover and 16% EBITDA margin, he also took Maxwell Drummond from a small four people business to 55 employees across eight global offices generating £10 million revenue and 12% EBITDA margin.

The investment case here is simple: add core quality fee earners in attractive and growing verticals (like renewables) and generate operating leverage on the already well-established operating platform. This is a management team who have done it before, and who we are backing to do it again. Valuations for well run (10%+ EBIT margin) businesses tend to trade at between 8x-10x earnings. We believe this team can make key hires and create a £1.5 million+ EBITDA business in the coming 2/ 3 years. This does not assume any acquisitions. We would then expect an exit either through share liquidity or a corporate exit, generating an equity return of between 3-4x monies.

A 'strategic parties' shareholder list (including the Moulton family and recruitment sector veteran Pierce Casey) indicates that the likelihood of corporate activity is high – over 55% of the equity is held by these parties and Downing.

Just after January month end, we added **NATIONAL WORLD (NWOR)**, an illiquid and under-the-radar company trading at the bottom end of the main market. NWOR was a reverse into the regional publishing assets of the old Johnston Press. The management team are top calibre, with experience seldom found in £70 million market caps. David Montgomery has a decades-long career in newspapers and considerable experience in newsprint consolidation. Vijay Vaghela is exceptionally well referenced and comes from Reach where he was group FD for almost 16 years. And Mark Hollinshead also brings career-long media experience to the group, having been managing director of the Daily Record and Sunday Mail, and COO at Trinity Mirror (now Reach). David and Vijay worked closely together on prior venture Local World, formed in 2013, which acquired certain regional news assets and subsequently exited these to Reach in 2015, increasing equity value by 289% in the process.

The story has several contrasting elements. Namely, declining print married with growing digital; transitioning ad revenues to subscriptions; and organic complemented by inorganic growth. These are all at early stages, but management have begun putting the foundations in place to build a valuable and scalable multi-platform publishing business.

The JPI Group assets constituted the third largest regional newspaper publisher in the UK. NWOR has taken control of established heritage titles such as The Scotsman and the Yorkshire Post and has since launched several regional 'World Sites' and a new online national 'NationalWorld.com'. Management have unpicked the centralisation which drove the decline of the heritage brands, with editorial and commercial responsibilities pushed back into the regions. The acquired assets have been heavily restructured, generating £5 million of annualised cost savings to date and with more to come as significant printing and office contracts come up for negotiation this year and next. These savings will allow management to re-invest in digital and quality content to drive growth. NWOR is also free of legacy pension liabilities and fixed costs and assets tied to printing activities which are a millstone around many other legacy-publisher's necks.

Ad-supported businesses and subscription-supported businesses are quite different. While the aim is to transition to the latter, realistically the business is going to be dependent on both for the foreseeable future. Ad revenues are driven by volume of traffic, whereas subscription requires much more finessing around lifetime value, acquisition costs and churn. This is less science and more art since some methods for converting a cohort of registrants to subscribers will not work for others. But through data and tracking, management will be able to target users with different content and introductory or renewal rates and this should improve conversion. Much is achieved from trial and error and that requires the right infrastructure to deliver effectively over many users.

The transition won't happen overnight, but this is not a bad thing since the print titles are highly cash generative, and more time will allow management to get the reinvestment right. Early signs are positive with digital ad revenues, page views, and digital subscription revenues growing strongly. The size of the prize in digital is significant since we think that print operating margins of around 10%, will be replaced by digital operating margins which are much higher. This obviously depends on scale, but since there is basically zero incremental cost to serve a digital audience, and the cost base is fixed (versus print cost bases which are high and variable), we think that there is a pathway to 20-30% operating margins here. Digital is also advantageous since the potential audience is much larger. The New York Times has already achieved more than 6x as many digital subscribers than their peak print circulation since digital content can be consumed anywhere in the world. National World's own title, The Scotsman, is gaining traction in regions which the print copy couldn't access, and in August reached a record 19.5 million page views.

This investment is not without risk. But the heavy lifting in declining print to 'variablise' that cost base has already been achieved. Combined with strong revenue growth and operating leverage in digital, and an experienced and aligned management team at the helm, we think that the prospects are strong. NWOR has £22 million of net cash and is trading on around 5x EV/ EBITDA and almost a 15% free cash flow yield, so there is sufficient optionality for value creation here. Peers such as Reach are more expensive, more complicated, and run a considerably more capital-intensive operation. If these businesses need to reinvest print cash flows to grow then NWOR has, in our view, the cleanest structure from which to do that.

NWOR's cash is likely to be deployed into print assets at low valuations, or digital assets at higher valuations. Or, as we expect might be the case, a mix of both. In all scenarios, there is reasonable expectation of multiple and earnings expansion and a share price materially above where it is today. The current valuation must be viewed alongside a business with declining print revenues, but we still think this is particularly cheap given earnings should still grow through a combination of digital transition and continuous cost savings. If management can't find a transaction, then the business probably accumulates its market cap in net cash before the end of the decade. In our opinion, that is not a terrible downside.

Like Local World, we expect that an exit is the most likely route to value crystallisation. This could be to private equity looking for a cash generative stand-alone asset, or an international print publishing group looking for an established and scalable digital platform to leverage their existing titles. Timing is uncertain, but we do expect this will be a longer journey than management's previous venture. We think that there are two key aspects to creating a strategically valuable enterprise here. The first is obviously the content itself – digital must be growing, profitable and have intrinsically valuable inventory, with the bonus of a highly cash generative print business in run-off. The second is the digital infrastructure. We think that any buyer would be looking for a well-structured, scalable, and portable digital publishing platform which could be used as a vehicle to continue consolidating the space in the UK and internationally.

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

Kind regards

Judith MacKenzie & Nick Hawthorn

Portfolio construction (as at 31 January 2022)

Name	Sector	Market cap (£)	% of the Trust	% equity held by Downing[1]
AdEPT Technology Group	Telecommunications	55.82	6.03%	8.94%
Centaur Media	Business Services	71.23	6.99%	4.56%
Digitalbox	Technology	16.29	7.34%	21.05%
FireAngel Safety Technology	Technology	27.16	6.45%	16.22%
Flowtech Fluidpower	Industrials	84.24	8.01%	7.99%
Hargreaves Services	Industrials	162.41	10.44%	6.54%
Norman Broadbent	Business Services	4.56	1.10%	17.97%
Ramsdens Holdings	Finance	55.41	7.37%	12.66%
Real Good Food[2]	Consumer Non-Cyclicals	2.54	10.19%	7.88%
Synectics	Business Services	16.46	3.84%	10.80%
Tactus Holdings	Consumer Retail	-	3.63%	-
Venture Life Group	Consumer Non-Cyclicals	64.43	2.36%	1.71%
Volex	Technology	474.57	10.16%	2.19%
Toehold A	Finance	138.09	3.04%	1.00%
Cash and other assets			13.05%	

[1] Total percentage of investee company held by all Downing managed funds.

[2] Real Good Food holding includes 0.42% equity and 9.77% debt split.