Results analysis Downing Strategic Micro-Cap

Reporting results for the year ending 28/02/2021, the momentum behind DSM's portfolio continues...

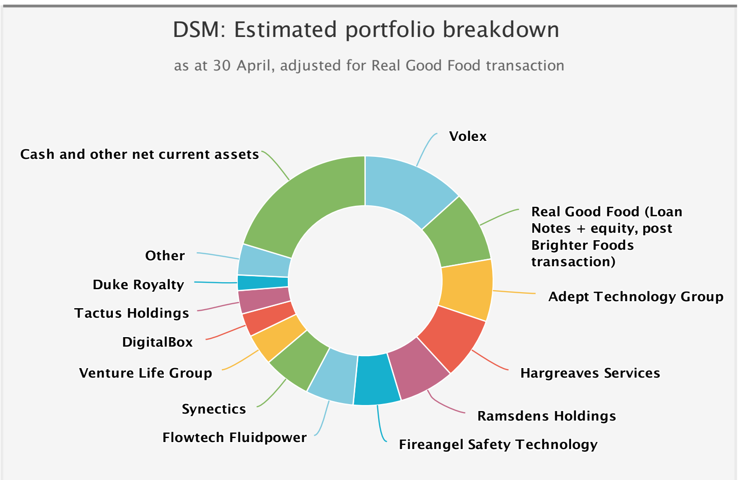
Update
11 May 2021
Kepler Trust Intelligence

Downing Strategic Micro-Cap (DSM) has published its annual report for the year ending 28/02/2021. The £46m trust aims to benefit from market inefficiencies amongst the UK's smallest listed companies. The management team employ a highly concentrated 'value' investment strategy based on fundamental analysis. They aim to buy strategic stakes (between 3% and 25%) in companies at prices that suggest a good 'margin of safety', but that are mispriced thanks to a problem or issue (real or misunderstood), but which is surmountable. Where necessary, the team engage with the senior management or board in order to effect change.

Since the start of the last financial year (largely 'pre-covid', 29/02/2020) the NAV return has been 26%. Much of these gains have come during 2021, which has seen a revival in interest for 'value' as an investment style as well as the UK equity market. Since the start of 2021, NAV performance has been respectable compared to the Numis Smaller Companies Index, with DSM's NAV total returns of 15.9% comparing to 16.3% for the index. The weighted average of the AIC UK Smaller Companies sector over the same period is 19.6%, likely boosted by the large Aberforth Smaller Companies Trust which has seen a strong bounce in returns also reflecting value coming back into favour.

Currently the portfolio consists of 13 meaningful holdings (over time the range is expected to be 12-18), but doesn't include 'toehold' investments, which reflects the high conviction and concentrated investment approach.

Fig.1: Portfolio Breakdown



Source: Downing, Kepler Partners LLP

According to Downing, many of the trust's holdings have seen tangible progress made since the start of 2021. For example, over 60% of the underlying positions have seen management teams buy stock in their own business over the last twelve months. All have reported positive trading updates, and many have reported significant new contract wins that should impact and underpin earnings over the next year.

Kepler view

As the graph below shows, NAV momentum has continued since the financial year end. A significant divestment from DSM's largest holding, Real Good Food (RGD, of which more below) is a key development for the trust, and the repayment of around half of the outstanding loan notes at a premium to par contributing to a c. 1% uplift in NAV. We believe this transaction proves the value of the Downing team's private equity style approach to investing in undervalued opportunities, and identifying (and, via their activism, helping to bring about) catalysts for value creation. As a result of the RGD transaction, cash will stand at c. 20% of NAV, giving the team plenty of flexibility to pursue new investments.

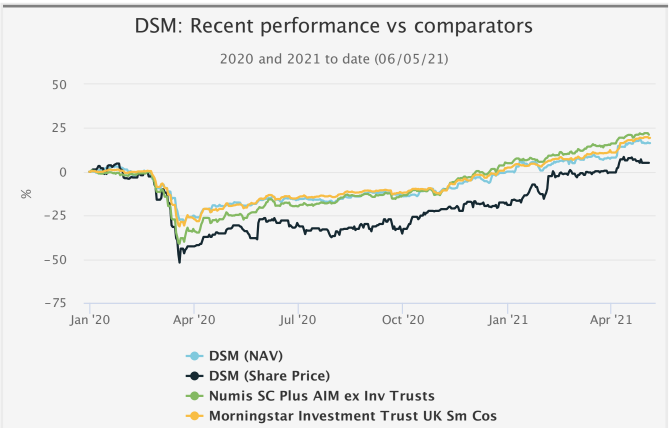
Significant Investments / Manager Comments

COMPANY	INSIDER BUYING	2021 PROGRESS ON CATALYSTS
Real Good Food	No	Divestment & return of capital
Volex	Yes	Achieved better than expected earnings
AdEPT Technology	Yes	Earnings accretive acquisition
Hargreaves Services	Yes	German JV trading well
Ramsdens	Yes	Strong recovery play post-lockdown
FireAngel	Yes	Good news flow on Connected Home. Placing to secure growth initiatives are achieved
Synetics	Yes	Significant margin improvement. Material Systems contract win
Venture Life	No	Earnings ahead of expectations. Deal flow strong
Flowtech Fluidpower	Yes	Cost savings executed. Strong recovery anticipated
DigitalBox	No	New Chair, Board changes. Scope to improve monetisation rates and acquire
Duke Royalty	No	Good underlying performance, fundraise

Source: Downing

Of note in this regard, is the trust's first unlisted investment which we understand completed on 30 April 2021 in Tactus Holdings. DSM has invested around half of its purchase through a debt instrument and half through equity, representing a structured approach. Tactus Holdings is 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.

Fig.2: Performance



Source: Morningstar

Past performance is not a reliable indicator of future results

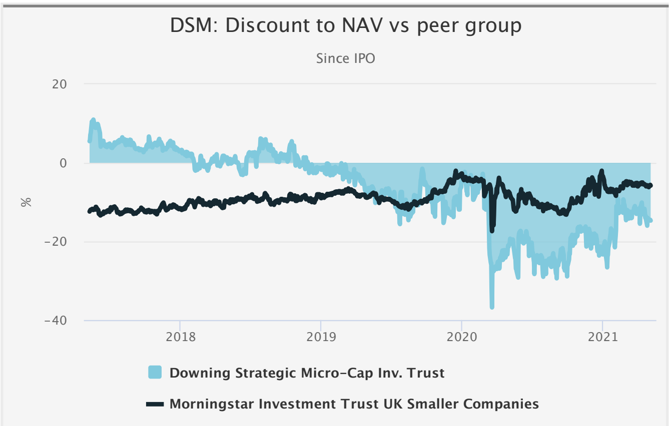
The managers are fundamentals based, which means taking an absolute view as to how future cash flows and assets can be valued, and looking for a catalyst for value to be realised. In the current market, with multiple indications flashing that markets are potentially getting ahead of themselves, this should provide some reassurance for investors. Part of the manager's raison d'etre is that they aim to invest in companies whose prospects are fundamentally undervalued by the market. Being undervalued already, means that one can hope that this gives an element of downside protection in market falls. The experience of Q1 2020 supports this thesis (see graph above), although as with any performance metric, there are no guarantees that this will occur in the future.

The progress at RGD (the sale of the Brighter Foods investment, with a c. £20m gain made over three years) marks a further step forward on what Downing hope will be a profitable investment journey overall. The team invested in RGD's equity, but a majority of the capital through loan notes and a convertible. This structured approach has limited DSM's exposure to the downside, and on capital realised has so far generated an attractive IRR of just under Downing's target annualized return for investments of 15%. With the remaining stake (loan, convertible and equity) accounting for just under 10% of NAV, it remains an important investment for shareholders. With the RGD board intent on realising as much value for the company's remaining Renshaw division and property assets, further value crystalisation appears to be more a question of "how much" and "how long", rather than "if?"

In other cases, as has been the case with largest holding Volex, the Downing team have regular engagement with the senior team, and provide a steer where possible. The team report that conversations are now focussing more on reporting to the market as the business transitions from a turnaround story to (what the team hope will be) a long-term compounder. Volex has been a star performer within the portfolio. Having originally invested £4.8m in the company, DSM has now realised a total of £8.4m by selling shares, and holds remaining shares currently valued at £5.9m. This represents an IRR of around 50% per annum, or a 3x multiple on invested capital, illustrating the strong returns achievable when things go right. Many of the other holdings in the portfolio represent what the chairman of DSM notes in the results as "a portfolio for future national recovery".

Downing estimate that the portfolio as a whole trades on a 43% discount to its base case intrinsic value. Coupled with that, DSM trades on a 13% discount to NAV, a meaningfully wider discount than the peer group as we show below – making the 'look through' discount even more compelling. Many of the underlying companies should benefit from the UK's strong rebound to economic normality following the successful vaccination programme and the managers will be joining us in July to discuss their outlook for a UK which, after years in the wilderness, may finally be coming back into favour. This event is open to private and professional investors, and you can register your interest by **clicking here**. For investors interested in keeping up to date on developments in DSM's concentrated portfolio, it is worth registering on DSM's **website** for AGM news, manager presentations, webinars, and the quarterly Investor Letter.

Fig.3: Premium / (Discount) To NAV Since IPO



Source: Morningstar

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