Emerging Companies Fund

Monthly Update: March 2017

Dear Fellow Investors,

Firstly, I would like to thank all of you that have invested in the Saville Capital Emerging Companies Fund at such an early stage. I appreciate the faith you have shown in both me and the investment strategy I am undertaking within the Fund. I am excited about the long-term opportunity before us and will continue to utilise my best endeavours to increase the value of our combined invested capital.

Performance commentary

The Fund officially started investing capital on 15 February, so it has now been operating for just six weeks. During that period we have gradually entered the market as both opportunities and new ideas arise from our research activities.

Despite taking a cautious approach during reporting season, with a general preference for owning low P/E and high yield stocks, the Fund's performance still suffered from unusually high levels of share price volatility. As such, the Fund's performance (-3.2%) during its first two weeks, while a very short window, was clearly disappointing. To put this into context, however, the Emerging Companies Accumulation Index, which is arguably the best proxy for gauging market sentiment towards those stocks most likely to be targeted under our investment strategy, was down 3.4% during the same period.

Since then, the Fund has rebounded solidly as those stocks negatively impacted in February have at least stabilised or started to improve, while the stocks we have added post February's reporting season have generally performed very well. As a consequence, the Fund generated a positive (+2.6%) return in March. Meanwhile, the Emerging Companies Accumulation Index fell a further 2.3% during the month, reflecting ongoing negative sentiment towards that part of the market.

Market commentary

In order to explain why we have observed weak share price performance from many micro and small cap stocks of late, often including those that delivered solid earnings results during February, it is worth highlighting a phenomenon that is elevating the usual levels of volatility in that part of the market at the moment.

Unfortunately, over the past six months the small cap funds management industry has experienced some significant redemptions from industry super funds seeking to take more money in-house for investment under their own internal strategy. This creates a window of forced selling from those small cap managers affected by the redemptions, which then feeds through to the near term share price performance of the stocks they own, some of which are not particularly liquid relative to the volume of selling required in a short space of time.

The effects of this process have also been exacerbated by a general rotation of money away from micro and small caps (particularly industrials) and back into large caps (particularly resources). This is evidenced by the index movements since September 2016, during which time the Emerging Companies Accumulation Index has declined by 7.8% while the All Ordinaries Accumulation Index has increased by 10.3%

While these factors provide long term opportunity in high quality micro or small cap industrial stocks that are impacted by this market inefficiency, it causes short term share price movements which are not easily predicted (both in terms of quantum and duration) and can be counter-intuitive for many stocks given their prevailing solid earnings performance and undemanding valuation metrics.

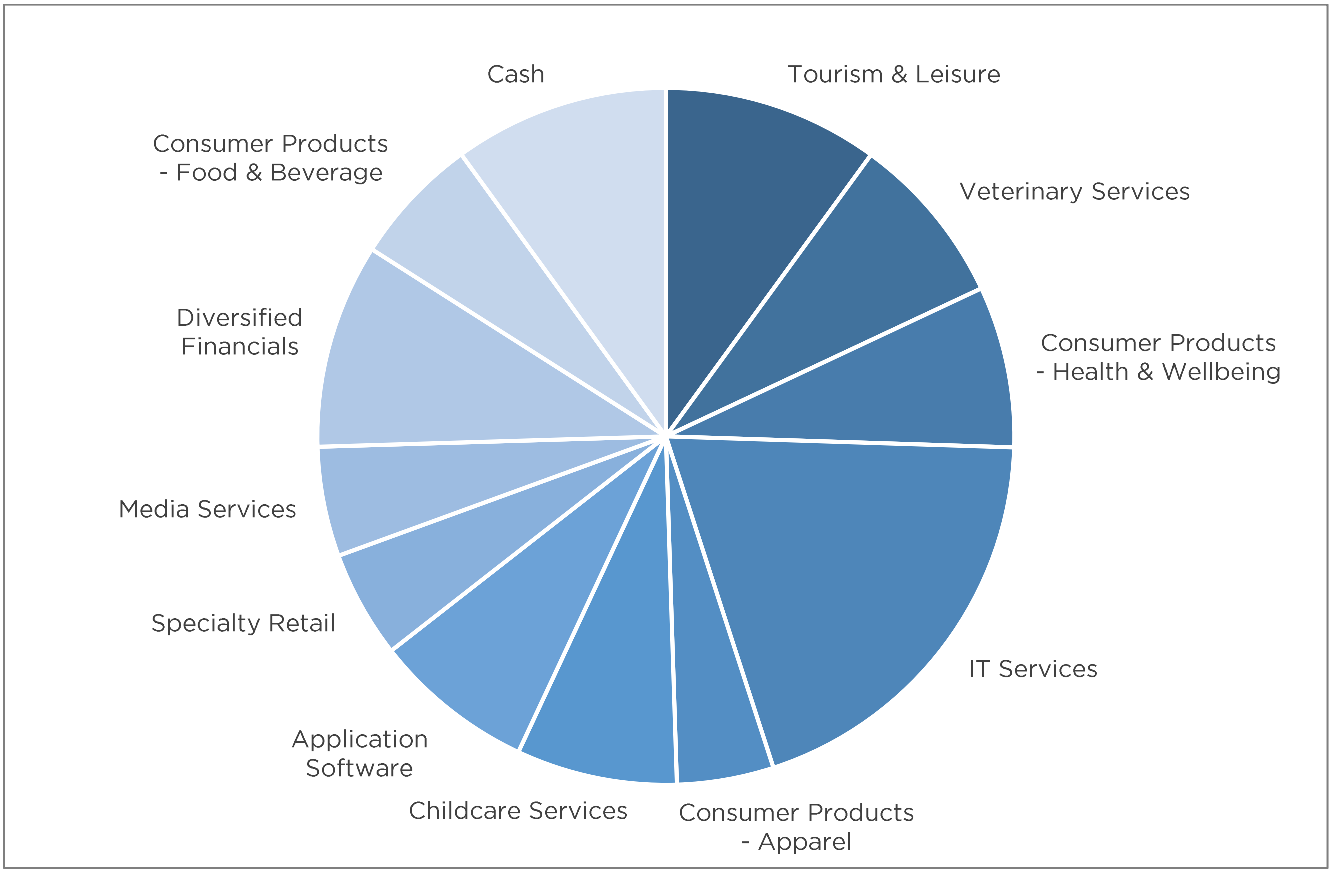
Nonetheless, while the increased liquidity associated with reporting season provided a platform for some aggressive selling to take place in those stocks affected by redemptions, this part of the market appears to be stabilising, and in some cases the stocks affected are slowly recovering. However, unfortunately the effect such sharp negative share price movements can have on the market's rating (eg P/E ratio) of a particular stock can linger well beyond the initial frenzied selling period - therefore we must be patient and remain opportunistic.

Portfolio characteristics

As you will note from the chart below, we have now invested ~90% of our capital, with the remainder sitting in cash. We are pleased to have been able to identify and invest in 15 stocks that meet with our strict investment criteria, combining to create a portfolio (ex-cash) that offers an FY17 yield of ~4%, but with plenty of scope to grow earnings and dividends into the future.

We have been true to our style-agnostic approach, with the portfolio comprising a mixture of "unloved" industrial companies on P/E ratios that are at a significant discount to peers (unjustifiably in our view) and those companies that are trading more in line with peers but which we believe offer superior earnings growth prospects.

Our single largest sector exposure is IT Services, reflecting our view that industry revenue will continue to outperform expectations over the next few years due to the ongoing transition of business data and functionality into the Cloud, while also offering potential for further consolidation (ie M&A) which should drive multiple expansion.



Company in focus: National Veterinary Care Limited (NVL)

In each monthly update we will provide a summary of why we have invested in a particular stock, starting this month with one of our largest holdings, National Veterinary Care Limited (NVL), which was up 14% in March.

NVL currently owns 54 veterinary clinics across Australia and New Zealand, up from 34 clinics when it first listed on the ASX in August 2015. NVL is growing its earnings through the acquisition of vet clinics (target is 5 – 10 pa), as well as organically via a combination of operational improvements within its portfolio (benchmarking, training, expansion of services, targeted marketing) and structural industry drivers (increasing levels of pet ownership and a greater willingness of owners to spend on veterinary services to maximise their pet's quality of life and longevity).

Importantly, the veterinary services market is highly fragmented, with ~90% of the ~2,500 clinics in Australia under individual ownership. We understand that only five corporate entities (including NVL) own more than 10 clinics, with Greencross Limited (GXL) by far the largest with 134. Hence the industry remains ripe for further consolidation, with NVL suggesting it has a solid pipeline of potential acquisition targets, subject to agreement on price (NVL typically pays 4-5x EBIT).

Furthermore, having spent considerable time with NVL management, we have observed first-hand the comprehensive strategies they are employing to improve the standards of care and earnings performance of the clinics within their portfolio. We have also utilised our personal and professional networks to speak with competitors and customers of NVL to validate the current industry performance and outlook while obtaining an assessment of how NVL is positioned versus its peers within that landscape.

All our research to date gives us confidence that NVL will deliver an excellent return on our capital over the next few years, underpinned by EPS growth of at least 10-15% pa and a current DCF valuation of >$3.00/share (vs share price of $2.45 as at 31 March 2017).

Thanks again for your interest and support and I look forward to providing another update in early May on our performance during April. In the meantime, please don't hesitate to get in touch should you have any specific questions about the portfolio.

Kind regards,

Jonathan Collett
Principal
Saville Capital