Emerging Companies Fund

Monthly Update: August 2017

Dear Fellow Investors,

Our Emerging Companies Fund's performance during the month was again solid in both absolute and relative terms. The Fund was up 2.7% vs +2.3% for the Emerging Companies Accumulation Index (XECAI). Since inception the Fund's absolute return is now +15.0% vs -5.2% for the XECAI and +2.6% for our cash-based benchmark, highlighting its superior relative performance.

Performance summary

	Feb	Mar	Apr	May	Jun	Jul	Aug	Inception
Saville Capital Emerging Companies Fund[1]	-3.2%	+2.6%	-0.6%	-1.0%	+7.6%	+6.4%	+2.7%	+15.0%
Benchmark[2]	+0.3%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+2.6%
Relative Performance	-3.5%	+2.2%	-1.0%	-1.4%	+7.2%	+6.0%	+2.4%	+12.3%

[1] *Net of all base fees, performance fees and expenses of the Fund*
[2] *RBA cash rate +3% (per annum)*

Performance commentary

The Fund increased in value by 2.7% during August, which was largely driven by positive earnings results being reported by the vast majority of our stock portfolio. In fact, of the 13 stocks we owned going into August, every stock reported results either ahead of or in line with expectations (with the exception of one stock which has a March year-end and therefore didn't report). As a consequence, the share prices of 11 out of those 12 stocks that did report increased in the days immediately following the release of their results. Among them, the standout performers were Afterpay Touch (APT, +22%), Lovisa (LOV, +10%), Empired (EPD, +10%), McPherson's (MCP, +9%), FSA Group (FSA, +7%), Melbourne IT (MLB, +7%) and Shaver Shop (SSG, +4%).

The only material detractors from our performance were our positions in BIG and PPH (note that PPH was the one stock we own that did not report results), both of which were down 10% and appeared to suffer from profit-taking after being up 37% and 20% respectively during July. To add some further context to PPH's share price performance in August, it is worth noting that by the end of July it was actually up c.40% on its placement price, which was undertaken in the middle of that month and in which we participated.

In terms of our performance to date, this was actually our most satisfying month. The reason for this is that while we can't control, nor predict, how investors perceive risk for companies or the market as a whole at any given point in time, through diligent research we can at least gain genuine insight into the earnings drivers of each business we assess and whether the trends are favourable and likely to continue into the foreseeable future. When we discount our forecasts with an appropriate cost of capital, we then have the foundations for an investment decision. Therefore when companies we own report their results, we receive validation (or otherwise) for the work we have done to build our own forecasts for the business.

Furthermore, what does not explicitly show up in our absolute performance figures are the benefits of the work we undertake on numerous opportunities which we elect to avoid based on the conclusions from our research activities. While we will not publicly cite examples of this, there are many stocks which we have assessed and researched in-depth over the past 12 months and as a consequence of that work made the active decision to not invest accordingly. It is these decisions which will often be the most significant driver of positive investment returns over time. That is not to say we will always avoid those companies that disappoint the market with their earnings updates, but clearly minimising our exposure to such outcomes is a critical platform in underpinning solid investment returns. Conversely, there will also be situations where our caution was unwarranted and the company we elect to avoid subsequently delivers outstanding results, but in a strategy where we are solely focused on achieving solid absolute returns, we can live with that.

Market commentary

The XECAI had another strong month, increasing by 2.3% in August, while the Small Industrials Accumulation Index (XSIAI) was also ahead, up 1.7% for the month. Interestingly, the XECAI is now 8.5% above its 12-month low recorded in May 2017.

Company in focus: Lovisa Holdings Limited (LOV)

In this update we provide a summary of why we own a company called Lovisa Holdings Limited (LOV) in the portfolio, which was up 10.4% in August following a very strong FY17 result and robust outlook commentary.

LOV operates in the fast fashion jewellery segment of the retail market with 288 stores (mostly corporate-owned) across Australia (145), New Zealand (18), Singapore (21), Malaysia (19), South Africa (50), UK (11), Spain (1), Middle East (19) and Vietnam (4). LOV exclusively develops and sources its own products directly from third party owned factories in China, India and Thailand. It averages 2,500 jewellery lines per store and launches, on average, more than 120 new lines per week, with prices typically ranging from \$6.99 to \$49.99 and an average basket size per customer of c.\$25.

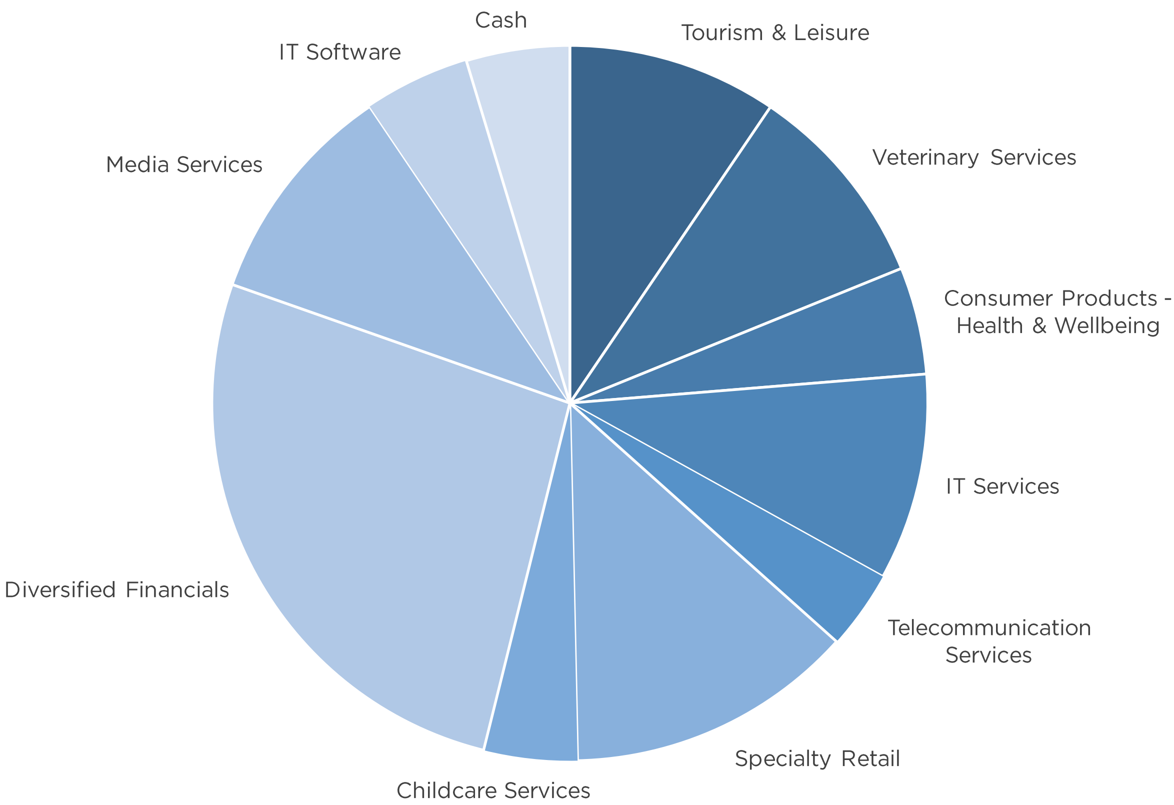
Fast fashion retailers, including LOV, source trends from runway shows, prominent high street shopping strips and online fashion blogs, making them available for mass market consumption in short time frames. They do not release products on a seasonal basis, but respond to trends as they occur. Importantly, it takes LOV only 8-10 weeks to develop, source and merchandise a product. The combination of a 50sqm floor space and a homogenised layout allows LOV to have strict criteria when identifying and securing potential store sites in new regions, facilitating the roll-out of stores quickly, at low cost. In order to manage risk, LOV will operate a pilot store in a new region for 6-12 months before committing to a roll-out. Despite its expanding global footprint, LOV is able to closely manage the inventory of every store via its daily inventory monitoring software.

LOV generated like-for-like (LFL) sales growth of 10.3% in FY17 and has averaged 8.0% over the past three years. LOV has a long term target 3-5% LFL sales growth and pleasingly it is tracking above that level in the first six weeks of FY18, albeit it is still very early days and we must be mindful that it is cycling a very strong pcp. It is targeting the addition of 20-30 stores in FY18, having added 38 in FY17 on a net basis (but this included the acquisition of 17 stores in South Africa).

Based on our forecasts (which are c.5% above consensus), LOV is currently trading on a FY18 P/E of 15.0x (but is net cash), EV/EBITDA of 8.6x and yield of 4.3%. For a business that generates an ROCE of >100%, we don't see these metrics as particularly demanding. Furthermore, we have a DCF valuation of \$5.95 (vs current share price of \$4.60) which is based on modest LFL sales growth in its current markets (c.2-3%), continued store roll-out (we assume an average of 17 new stores pa, largely within Europe) and a long term gross margin of 75% (vs 78.8% in FY17). Importantly, while we have LOV reaching 430 stores within the next decade, this can be achieved within its current geographic footprint and does not include entering new markets such as the US. In our view, the key risk to our investment thesis is LOV's ability to maintain a gross margin in the mid-70s over the long term (albeit noting that its average over the last six years has been 77.4%).

Portfolio characteristics

We currently have c.95% of our capital invested in 16 stocks, with the remainder held in cash. We added three new positions to the portfolio during August which we will discuss in subsequent versions of our monthly update.



Thanks again for your interest and support and I look forward to providing another update in early October on our performance during September. 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

+61 3 9769 1789

jcollett@savillecapital.com

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