

# Emerging Companies Fund

Monthly Update: September 2017



Dear Fellow Investors,

Our Emerging Companies Fund's performance was again strong, up 4.0% for the month. While the Emerging Companies Accumulation Index (XECAL) was also strong, (+3.3%), we note that the average Industrial company within that index was broadly flat and the Small Industrials Accumulation Index (XSIAL) was only up 1.0% in September, implying the strength largely came from Resources (which are deliberately excluded from our strategy). Since inception the Fund's absolute return is now +19.5% vs -2.1% for the XECAL and +3.0% for our cash-based benchmark, highlighting its superior relative performance.

## Performance summary

	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Inception
Saville Capital Emerging Companies Fund <sup>1</sup>	-3.2%	+2.6%	-0.6%	-1.0%	+7.6%	+6.4%	+2.7%	+4.0%	+19.5%
Benchmark <sup>2</sup>	+0.3%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+3.0%
Relative Performance	-3.5%	+2.2%	-1.0%	-1.4%	+7.2%	+6.0%	+2.4%	+3.6%	+16.5%

<sup>1</sup> Net of all base fees, performance fees and expenses of the Fund

<sup>2</sup> RBA cash rate +3% (per annum)

## Performance commentary

The Fund increased in value by 4.0% during September, which was underpinned by solid performance from the majority of the portfolio combined with some dividend income. In the past we have observed that those companies that deliver strong earnings results typically continue to see further share price appreciation in subsequent months, and this period was no exception. The key positive contributors were Pushpay (PPH, +27.1%), HUB24 (HUB, +19.8%), Lovisa (LOV, +14.2%), BIG Un (BIG, +13.4%), National Veterinary Care (NVL, +11.0%), Afterpay Touch (APT, +10.8%), and Tourism Holdings (THL.NZ, +8.5%).

In terms of news flow, APT announced partnerships with Target and Jetstar, the latter representing its first (and exciting) step into the travel vertical. BIG upgraded its 1Q FY18 cash revenue guidance to at least \$14m, which was a 12% increase on initial guidance provided only a month earlier. It also provided a very promising update on its US operations, noting that it already has contracts in place with an annual value of >\$US6m.

The only significant negative performer was our position in Shaver Shop (SSG, -34.4%) which provided surprisingly downbeat guidance for FY18. The magnitude of the downgrade to consensus (and our) expectations was even more puzzling given that LFL sales in FY18 currently sit at +11.9% and it has solid tailwinds including a significant portion of its stores still in ramp-up, strong online sales momentum and the additional income from recent franchise buybacks. Despite this, the mid-point of SSG's FY18 guidance implies lower EBITDA than FY17, suggesting the Board and Management are observing some potentially significant cyclical or structural headwinds. In light of this, we made the decision to exit the stock as our investment thesis was largely predicated on FY18 being another year of strong growth for the Company, which no longer appears to be the case.

We also decided to exit our position in McPherson's (MCP), having owned it since the Fund's inception in February. The reason for our decision to sell was largely based on lack of further valuation upside, however we also took the view that a switch in focus from transformation (i.e. margin improvement) to growing its revenue base would be far more

difficult to deliver, particularly in a weak consumption environment. We first entered MCP at \$1.26 and our final exit price was \$1.55, so when combined with its interim dividend of \$0.06, we earned a healthy 28% return on our investment over a seven month period.

Finally, we exited our position in Pushpay (PPH), solely on valuation grounds. We entered the stock via a placement completed during July at \$1.42, which compared with our own valuation of \$2.40. Incredibly, the stock reached \$2.30 during September based on no new information, hence we had little choice but to sell our position. We remain attracted to the long term investment thesis behind PPH, but its strong growth outlook appears to be largely captured in its current share price, particularly given the execution risks.

## Company in focus: Think Childcare Limited (TNK)

In this update we provide a summary of why we own a company called Think Childcare Limited (TNK), which was down 3.3% (after adjusting for its dividend) in September.

TNK owns 39 childcare centres (plus an additional three centres currently subject to settlement), with the vast majority located in Victoria. These centres comprise in excess of 3,200 licensed childcare places with average occupancy of c.70-75% and average fees of \$108/day. TNK also manages a further 24 centres, mostly for its incubator partners such that once these centres meet certain criteria (e.g. reaching minimum occupancy levels), TNK has the option to acquire them at 4x EBIT, which is broadly consistent with the industry multiple. This incubator model provides a solid pipeline of further acquisition opportunities for TNK to add to its portfolio over time.

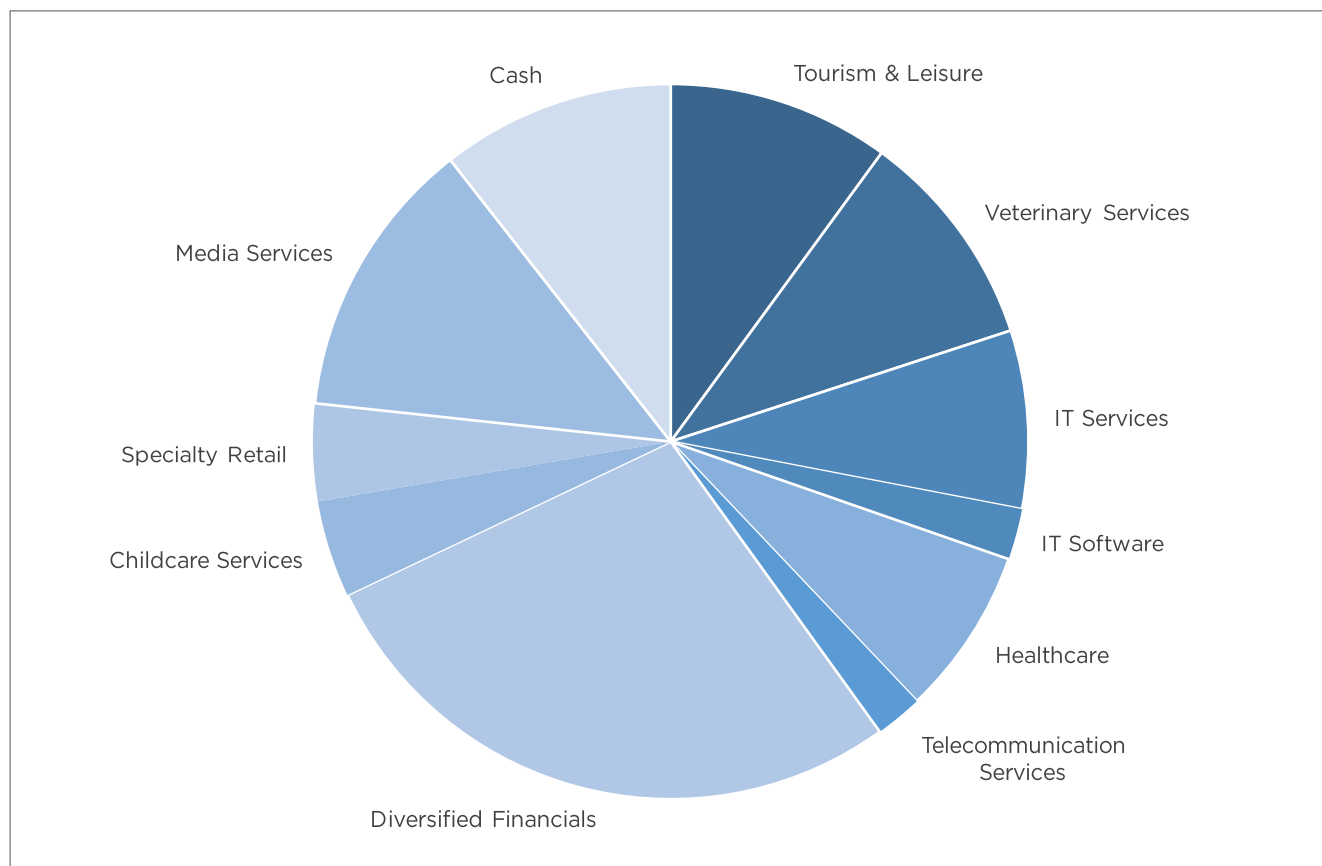
TNK's approach is somewhat different to its listed competitors (e.g. G8 Education, GEM) in that its growth strategy isn't solely centred on the acquisition of high occupancy centres, but also using its expertise to identify, acquire and operate new 'greenfield' centres. As an example, TNK expects to open five new 'greenfield' centres in 2018. While investing capital in new centres is generally more risky than acquiring existing centres, the potential returns are clearly superior. Therefore, if executed well, it can be a greater source of valuation upside. As such, our own opinion of TNK's CEO, Mathew Edwards, combined with independent views we have sought from conversations with other key industry players, gives us confidence that he is more than capable of executing this strategy to the benefit of shareholders (including himself given he has a 34% stake).

We are attracted to the childcare industry given the trends of increasing female workforce participation and a growing desire among parents for their children to engage in more hours of pre-school education (above the typical standard hours for kinder programs). However, demand growth from these factors has been constrained by a stagnation in the Government funding scheme given the \$7,500 Child Care Rebate threshold has not been increased since 2012. Furthermore, occupancy rates have also been impacted by an escalation in 'greenfield' centre activity in recent years. However, with the revised Government childcare package providing a substantial increase in subsidies for most families from 1 July 2018 onwards, combined with a forecast reduction in the supply of new centres occurring from CY18 onwards, we expect that the childcare industry is about to enter a period of renewed occupancy growth combined with ongoing fee increases.

Based on company guidance, TNK is trading on a CY18 P/E of 10.1x and EV/EBITDA of 6.8x, while offering a yield of c.6%. This is cheap in both absolute and relative terms (GEM trades on a CY18 P/E of 14.1x). Our DCF valuation is currently \$2.50 (vs \$1.89 at 30 September), which is based on average occupancy of 75% and inflation-linked growth in fees from CY18 onwards, both of which are conservative. We also assume that TNK continues to grow its portfolio to a target of 100 centres within the next decade. Importantly, it already has 75% of this target locked in when you combine its existing portfolio with the centres it is currently managing on behalf of its incubator partners. We see its CY18 result as a key catalyst for the stock given its valuation metrics imply that the market is sceptical about TNK's ability to meet its earnings guidance for that year.

## Portfolio characteristics

We currently have c.90% of our capital invested in 14 stocks, with the remainder held in cash. We added one new position to the portfolio during September 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 November on our performance during October. In the meantime, please don't hesitate to get in touch should you have any specific questions about the portfolio.

Kind regards,

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