

Emerging Companies Fund

Monthly Update: January 2018



Dear Fellow Investors,

Despite some positive announcements from a few of our portfolio holdings, our Emerging Companies Fund had a moderately negative month in January. The Fund was down -1.6% vs +2.1% for the Emerging Companies Accumulation Index (XECAL) and -0.4% for the Small Industrials Accumulation Index (XSIAI). While we were disappointed with this outcome, it still needs to be taken in the context of a very strong period of performance over the preceding seven consecutive positive months. Since inception (which is now 12 months) the Fund's absolute return is +57.6% vs +15.2% for the XECAL, +16.7% for the XSIAI and +4.5% for our cash-based benchmark.

Performance summary

	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Inception
Saville Capital Emerging Companies Fund ¹	-3.2%	+2.6%	-0.6%	-1.0%	+7.6%	+6.4%	+2.7%	+4.0%	+13.2%	+9.5%	+8.1%	-1.6%	+57.6%
Benchmark ²	+0.3%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+0.4%	+4.5%
Relative Performance	-3.5%	+2.2%	-1.0%	-1.4%	+7.2%	+6.0%	+2.4%	+3.6%	+12.8%	+9.1%	+7.7%	-2.0%	+53.1%

¹ Net of all base fees, performance fees and expenses of the Fund

² RBA cash rate +3% (per annum)

Performance commentary

The highlight of the month was Lovisa (LOV, +14%) which provided a very positive 1H FY18 sales and trading update in which it reported like-for-like (LFL) sales growth of +7.4% (and total sales growth of +18.8%) on pcp. This was a particularly strong result in the context of its 3% to 5% long term target and even more so given it was cycling LFL sales growth of +12.6% in 1H FY17. We were conservatively forecasting +2.5% LFL sales growth in FY18, so this result came in well ahead of our (and the market's) expectations. As a consequence, the Company expects 1H FY18 EBIT of \$34.5 to \$35m, which is growth of between 22% and 24% on pcp, another outstanding result. The only other material positive contributions to the Fund's performance came from Spirit Telecom (ST1, +33%) which delivered another positive quarterly update and National Veterinary Care (NVL, +4%).

Somewhat unsurprisingly, the key detractor from our performance was Longtable Group (LON, -15%). In our view it continues to suffer from profit-taking following on from its large capital raising completed in late December. As a reminder, the raising was done at \$0.03 and the stock finished December at \$0.047, before declining to \$0.04 during January. As highlighted in our last monthly update, we remain very confident in the Company's prospects and its potential value. As long term holders we are not concerned by these short term share price fluctuations, they are merely another opportunity to buy.

PolyNovo (PNV, -8%) experienced a tumultuous month having peaked at an all-time high of \$0.59 during the middle of January (up from \$0.52 at 31 December) before finishing on its monthly low of \$0.48. The volatility appears to have been driven by a Heads of Agreement it signed with Establishment Labs, a global medical device company focused on breast aesthetics and reconstruction technologies. Under the terms of the agreement, the two parties will jointly develop a range of medical devices for use in breast aesthetics and reconstruction, which is a \$3bn market growing at 20% pa. The terms of the agreement will be announced upon contract signing. In order to help explain the share price reaction, we believe that the market may have been anticipating a different partner for this opportunity or an actual contract to have been signed by now, with accompanying

financial details. From our perspective, neither is particularly relevant as we don't yet even have this opportunity factored into our forecasts or valuation given the clinical trial process takes three to five years, let alone whether it is then commercialised. The other key negative contributors were Melbourne IT (MLB, -12%), Think Childcare (TNK, -9%) and Clover (CLV, -7%) which all experienced share price weakness on no news flow.

Finally, we exited HUB 24 during the month following on from another strong quarter of inflows onto its platform. While we remain attracted to the industry thematic, our updated price target for HUB was \$11.00 so therefore as it approached and breached that level, we took the opportunity to sell our interest. We first entered HUB at \$4.50 in March 2017 and our average exit price during January was \$11.12, delivering a c.150% gain over that period.

Company in focus: Phoslock Water Solutions Limited (PHK)

PHK was established in 2002 and provides innovative water technologies and engineering solutions to manage nutrients and other water pollutants in lakes, reservoirs, canals and rivers. PHK's leading product is called Phoslock which was developed by the CSIRO to significantly reduce excess phosphate (which encourages growth of algae) safely from the environment. PHK is an international business with existing projects in many different countries across China, Europe/UK, Canada, US and Brazil. It has recently established a new factory in Changxing, China which has significantly lowered its costs of production, as well as substantially increasing its capacity to service future growth. The factory's capacity is now 15,000 tpa (which equates to \$40-50m of sales revenue) and there is scope to increase this to 45,000 tpa over time with only modest incremental investment.

In a transformational deal for the Company, PHK signed a strategic co-operation agreement with Beijing BHZQ Environmental Engineering Technology Limited (BHZQ) in May 2017. BHZQ has over 30 contracts for large water remediation projects in China valued at over A\$4bn. BHZQ is 70% owned by Beijing Water Enterprises Group, a Hong Kong listed company with a market capitalisation of >A\$7bn. To highlight the strength of the relationship, BHZQ's General Manager, Zhigang Zhang, joined the Board of PHK and entities associated with Mr Zhang now own 30m shares and 30m performance options in PHK. The options are exercisable based on certain sales and profit targets being achieved over the period to 30 June 2019.

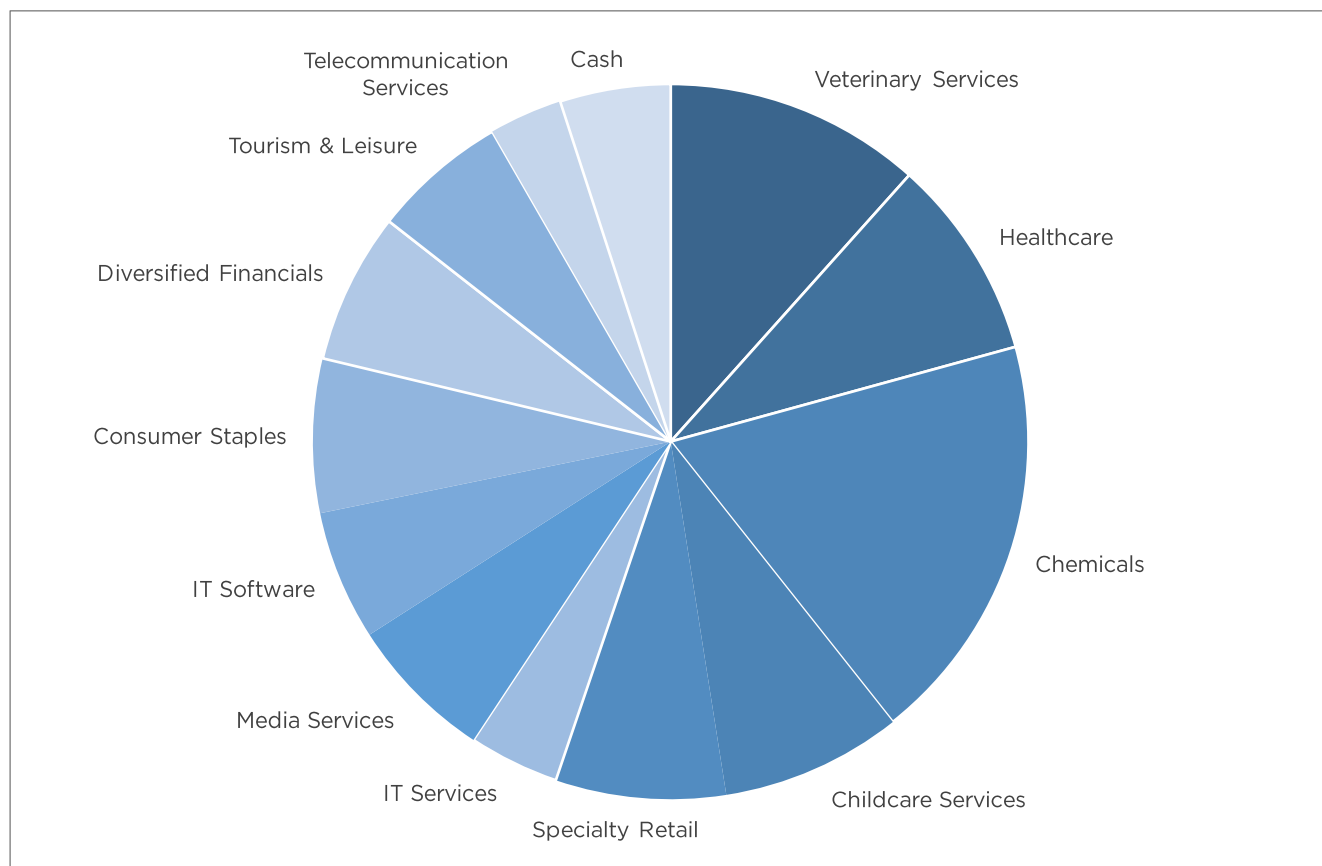
The opportunity for PHK in China is enormous, as evidenced by the fact that the Chinese Government has allocated A\$400bn to address its water quality issues. It has 2,865 lakes, 98,000 water reservoirs and 536,000km of rivers and canals that are classified as highly polluted. To put the size of the opportunity into context, China has 5,000,000 ha of polluted lakes, however PHK would only need to treat 3,700 ha of water to exhaust its current production capacity and reach sales of c.\$45m (up from \$6.2m in 1H FY18). This ignores any associated consulting fees it may earn as part of its deployment of the Phoslock product. As such, PHK only needs to be a very small part of the solution in China in order for it to achieve outstanding earnings growth over the next few years.

It is a combination of this strategic agreement in China and growth in other markets, such as Brazil, that has underpinned PHK's revenue guidance of \$22m in FY18 and \$40m in FY19. Furthermore, PHK anticipates generating its maiden pre-tax profit in FY18 of \$4m, which it then projects to increase to \$9.35m in FY19. If we ignore tax (PHK has \$28m of accumulated tax losses), then this guidance puts PHK on a "cash" FY19 P/E of <14x, based on its January closing price of \$0.27. To further highlight its compelling value, we have arrived at a DCF valuation of \$0.40 based on what we regard as modest assumptions. We also note that PHK has no debt and \$7m of cash in the bank.

Finally, we believe that PHK has a very strong Board and management team, particularly for a company of its size, that has demonstrated strong discipline with regard to cost control and capital deployment, giving us additional confidence that it can execute on its growth plans and crystallise the significant potential value for shareholders.

Portfolio characteristics

We currently have c.95% of our capital invested in 13 stocks, with the remainder held in cash. As mentioned, we sold one stock during the month (HUB), but replaced this with another investment which we will discuss in a future monthly update.



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

Kind regards,

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