

Emerging Companies Fund

Monthly Update: February 2018



Dear Fellow Investors,

Our Emerging Companies Fund delivered another month of strong positive performance. The Fund was up +4.2% vs -0.2% for the Emerging Companies Accumulation Index (XECI) and -0.1% for the Small Industrials Accumulation Index (XSIAI). This was a particularly satisfying outcome given the increased levels of market volatility combined with a reporting season where any earnings results that came in slightly below consensus expectations were significantly punished by the market. Pleasingly, the vast majority of our portfolio delivered results that were either in line with or ahead of our (and consensus) forecasts. Since inception the Fund's absolute return is +64.1% vs +15.1% for the XECI, +16.6% for the XSIAI and +4.8% for our cash-based benchmark.

Performance summary

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2017		-3.2%	+2.6%	-0.6%	-1.0%	+7.6%	+6.4%	+2.7%	+4.0%	+13.2%	+9.5%	+8.1%	+60.1%
2018	-1.6%	+4.2%											+2.6%

Returns are net of all base fees, performance fees and expenses of the Fund

Performance commentary

The highlight of the month was again Lovisa (LOV, +15%), which reported a very strong 1H FY18 result, with the primary new information since its recent trading update being its gross margin, which came in at an impressive 80.4% (vs our conservative forecast of 75.0% and pcp of 77.8%). It also mentioned that it has recently launched a pilot store in France, in addition to its current pilot stores in Spain and the USA. Phoslock (PHK, +19%) also had a strong month in which it reported better than expected margins for 1H FY18 and reaffirmed its FY18 revenue and EBITDA guidance of \$21 to \$23m and \$3.5 to \$4.5m respectively. The other key contributor to the Fund's performance was Redbubble (RBL +24%), a stock we purchased in late January following its strong 2Q FY18 update and one which has continued to re-rate since then (we discuss this stock in detail over the page).

We exited two of our holdings during the month, being ST1 and BIG. Our decision to sell ST1 was purely based on valuation. We first bought ST1 via a placement at \$0.12 in August 2017 and our average exit price in February was \$0.213, a gain of c.78% over that period. However, our decision to sell the remainder of our holding in BIG was related to our increasing concerns over its ongoing practice of issuing stock at heavily discounted prices to the same curiously named entities. As mentioned in our November update, we more than halved our position in BIG during that month in part due to these concerns, thus reducing it to one of the smallest exposures within the Fund. However, we retained an interest on the basis that we expected this practice to cease given the Company's increasing size and cash balance. Furthermore, we had discussions with the Company to that effect and were assured that the parties who had been issued stock were not related to the Company nor its directors and that the stock issuance was based on arm's length transactions that were simply agreed when the share price was much lower.

Nonetheless, when BIG released its most recent Appendix 3B after market close on 2 February, it disclosed further heavily discounted stock issuance as well as a significant amount of stock issued to a new US Advisory Board member for nil consideration, which at the time equated to c.\$8m in value. In our view, this was not only completely unjustified

but also a blatant continuation of this concerning trend, which led us to sell the remainder of our holding the following trading day at an average price of \$3.00. This has proven to be a very prudent decision given the revelations in the press since then regarding the nature of BIG's relationship with some of these entities that have received heavily discounted stock. While we have independently met with some of BIG's customers who were very happy with the services provided and price paid for them, what is now very questionable is the "quality" of the recently reported quarterly cash revenue figures given the apparent financing arrangements behind them. This would be deeply concerning for existing investors and certainly validates our decision to react swiftly to previous disclosures made by the Company that made us increasingly uncomfortable.

Company in focus: Redbubble Limited (RBL)

Established in 2006, RBL provides a global online marketplace (www.redbubble.com) where over 600,000 independent artists upload their designs and creative works, and if/when it is ordered by a customer, the product is manufactured on demand by a network of third party fulfillers. RBL therefore enables independent artists to offer for sale a wide variety of products (e.g. apparel, stationery, housewares, bags, wall art) that showcase their designs to a global customer base, but without having to concern themselves with the difficulties of payment, marketing, manufacture and logistics. Put simply, artists just nominate their margin (typically 15%) and RBL takes care of the rest.

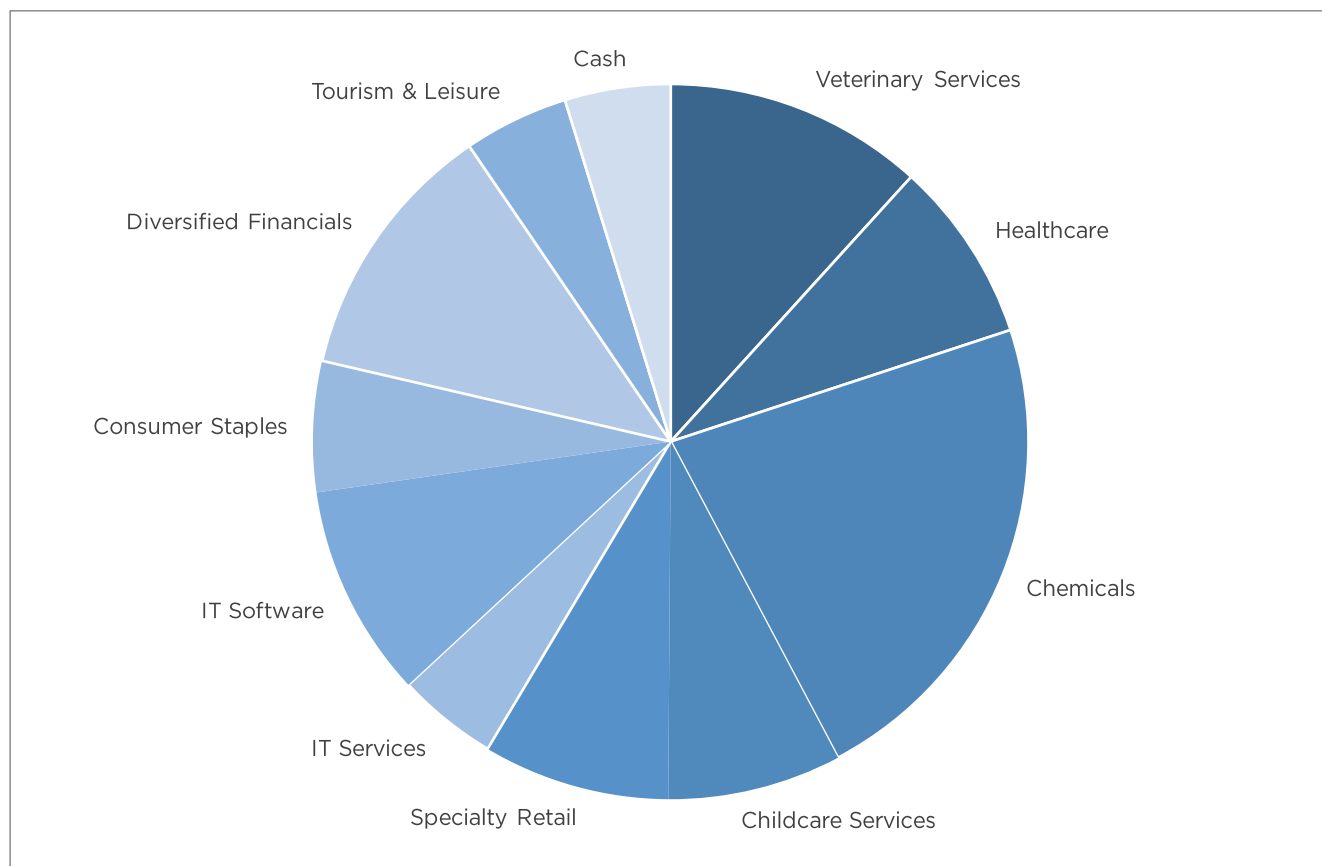
In CY17, RBL had 3.5m unique customers, 269,000 artists sell a design on its platform, 14m unique products available for sale, 15 fulfillers across 28 locations (comprising six different countries) and 66 different product types. In 1H FY18, RBL generated gross transaction value (GTV) of \$129.8m (93% from outside of Australia), up 31.7% on pcp and based on an average order value of around \$45. This GTV growth is particularly impressive considering that it exceeds the growth achieved in FY17 of 22.7%, so the trend is accelerating. A key driver of this is RBL's increasing use and optimisation of paid acquisition sources, such as Google and Facebook ads (RBL had 127.5m visits to its site in 1H FY18, up 39.3% on pcp). Its gross margin (after paid acquisition) was a healthy 25% and it is on track to move into ongoing EBITDA profitability in late FY18. Note that it generated \$2.6m of EBITDA in 1H FY18, but it is the seasonally stronger half due to the Christmas period.

The key investment attractions of RBL are its simple business model (positive working capital, no inventory risk or logistics costs), operating leverage (revenue growing at 1.5-2x expenses), barriers to entry through increasing scale/network effect and scope for further strong revenue growth. This growth can be achieved through launching new products (RBL believes there are 260 potential product lines) combined with increasing penetration of existing markets and expansion into new markets. RBL currently generates sales in over 20 countries, but its sales per capita is less than half of that in Australia in all those countries except the US, UK and New Zealand. Consequently, in the past couple of years RBL has launched native language sites in markets such as Spain, Germany and France where it is now seeing increasing penetration and very strong revenue growth.

Despite now achieving genuine scale, the opportunity for RBL remains significant given that global sales of the products it offers are in excess of \$22bn, putting RBL's effective market share at less than 1%. Furthermore, there is an increasing consumer trend towards buying more meaningful, relevant and distinctive products with designs that, while not truly unique, are exceedingly uncommon. This is particularly the case among the millennial cohort, who comprise 52% of RBL's customer base. Following discussions with RBL management and our own detailed modelling, we have arrived at a DCF valuation of \$3.00 (vs our initial entry price of c.\$1.50 and current share price of \$1.87) based on RBL reaching GTV of c.\$900m within the next decade combined with margin expansion as a result of improving terms with its fulfilment providers and natural operating leverage within the business. RBL also has a conservative balance sheet (\$28m net cash as at 30 June 2017) as well as an experienced senior management team and Board with strong shareholder alignment (they collectively own 36.1% of the Company).

Portfolio characteristics

We currently have c.95% of our capital invested in 12 stocks, with the remainder held in cash. As mentioned, we sold two stocks during the month, but replaced one of these 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 April on our performance during March. 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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