Emerging Companies Fund

Monthly Update: April 2018

Dear Fellow Investors,

Our Emerging Companies Fund had a solid April, up +1.1% vs +0.3% for the Emerging Companies Accumulation Index (XECAI) and +1.5% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund's return is +68.3% vs +11.2% for the XECAI, +16.2% for the XSIAI and +5.6% 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%	+1.6%	+1.1%									+5.3%

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

Performance commentary

The highlight of the month was again Clover (CLV, +31%), which continued its share price re-rating following on from its outstanding 1H FY18 result. There were no other positive contributors of any note, highlighting that general sentiment towards micro and small cap industrial stocks remains fairly subdued, particularly those stocks without any news flow. For example, if we look back at the last couple of months since the companies reported their first half, or in some cases full year, results we can see numerous stocks within our portfolio that are now down 10-15% on very little, if any, additional news flow. Examples of this are National Veterinary Care (NVL, -15% since 28 February), Longtable (LON, -15%) and Think Childcare (TNK, -10%). While we can't be certain that there won't be any negative news flow to come that may justify this weakness, we do take comfort from the work we have done assessing the quality of their assets and management teams, which all bodes well for longer term shareholder returns. Furthermore, there could be short term factors at play, such as fund redemption activity driving some forced selling. As such, we would not be at all surprised to see a rebound in these stocks over the next few months.

The most notable decline in April was Redbubble (RBL, -16%) which provided its quarterly business update. Despite delivering another strong quarter of growth with revenue and gross profit (after paid acquisition costs) both up +24% on pcp, the market wasn't impressed that momentum slowed somewhat from the December quarter, albeit that this was largely explained by some minor one-off issues. From our perspective, the story remains completely intact. The business continues to rapidly gain market share, reduce its reliance on paid acquisition, reduce fulfilment costs and use its growing scale to generate further operating leverage. In our view, the March quarter will merely prove to be a slight pause in momentum for its key indicators, as opposed to anything systemic in nature.

In addition, Lovisa (LOV, -2%) announced that its CEO, Steve Doyle, has resigned, with the Founder and Managing Director, Shane Fallscheer, continuing to lead the Company. Despite the fact that this announcement was released with another positive trading update (LFL sales for YTD to the end of 3Q FY18 are +7.6%), the market reacted negatively and sent the stock down 13% before it staged a strong recovery towards the end of the month. Our own channel checks appear to confirm that there is nothing sinister regarding Steve's departure, he is simply seeking a new challenge. Hence, we remain investors in LOV, albeit we have almost halved its portfolio weighting since February.

Company in focus: Clover Corporation Limited (CLV)

In the interests of preserving some of the Fund's new investment ideas, this month we thought we would revisit an existing holding that has performed particularly well for the Fund. We first discussed Clover Corporation (CLV) in our November 2017 Update after building a position in the stock during October at prices below $0.60 (vs closing price of $1.24 at the end of April). Given its recent strong share price performance and expanded broker coverage, we thought it would be timely to revisit why we liked CLV and why we continue to retain exposure to it within the Fund.

Our initial decision to invest in CLV followed an extensive due diligence process which included two meetings with management, one being after their FY17 result and the other when we toured their manufacturing site in Altona. Fortunately, having conducted detailed research on both Bellamy's and A2M in the past, we were already very familiar with the infant formula sector and its key drivers. Hence, we were intrigued as to why a Company with principally the same positive revenue drivers (being a key supplier to that industry) was trading on such modest forward earnings multiples both in absolute and relative terms (at the time of entry we estimate it was trading on an FY19 P/E of <12x).

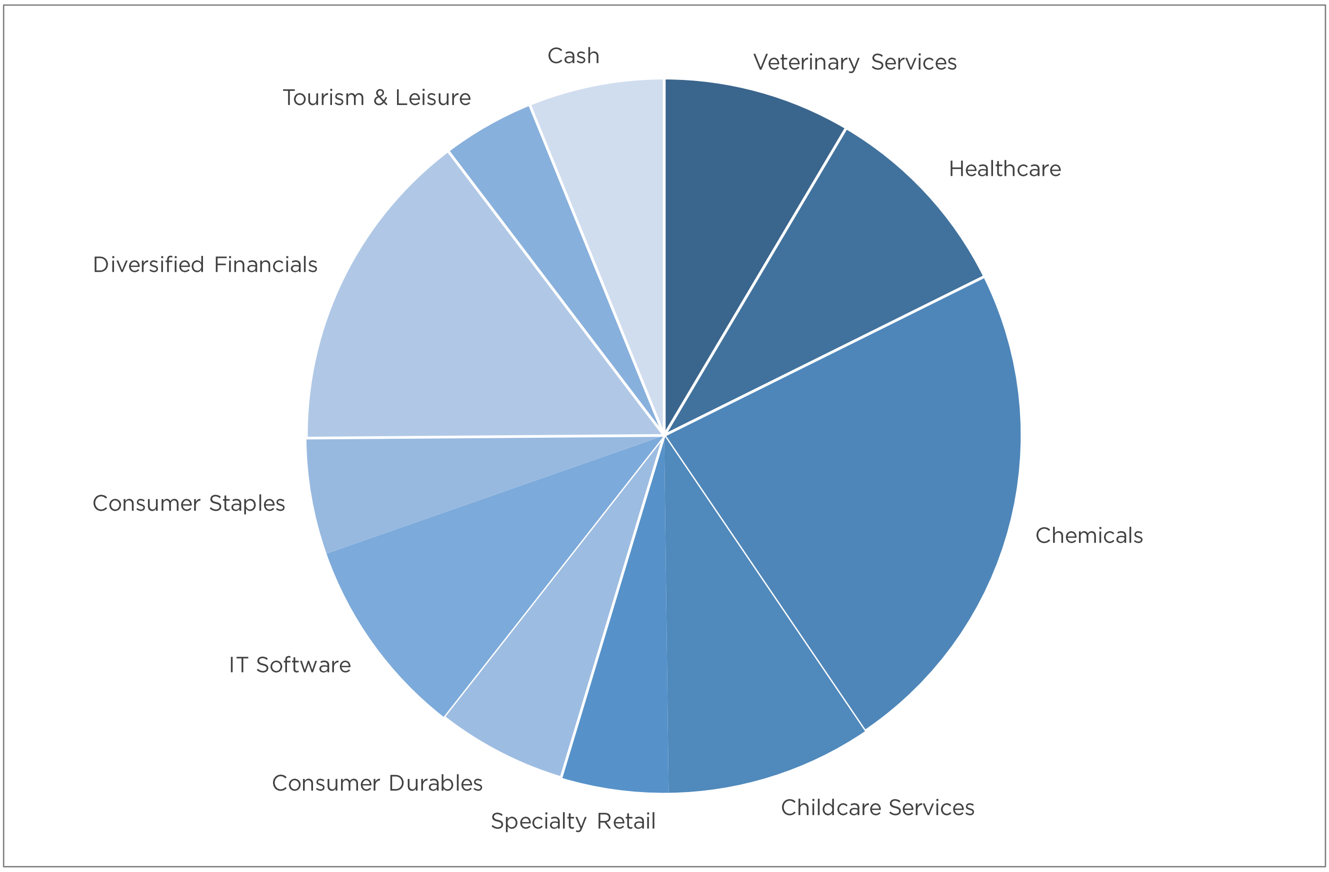
The investment proposition became even more compelling when we looked at CLV's gross margin history (24.2% in FY17, having troughed at 20.2% in FY15 after averaging 38% from FY10 to FY13) and learned that it was in the process of renegotiating key contracts to try and restore its gross margin back to at least 30%. The final attraction for us was the optionality within its business, specifically exploring opportunities to leverage its technological expertise and competitive advantage into other products (e.g. sports drinks). In our view, its small size (market cap of <$100m) and lack of broker coverage (only Select Equities had published any research on it at that point) were key reasons why this stock was flying under the radar, despite exhibiting numerous positive attributes. Just on that point, we note with interest that according to a recent report published by Goldman Sachs, nearly half of the S&P/ASX Small Ordinaries Index is now covered by fewer than five analysts. Furthermore, they observed that stocks with fewer than five brokers covering them have typically traded at a 5% discount to the market with volatility that is 20-30% higher. From our perspective, this can only be a positive as it expands the opportunity set available to our Fund through greater potential for market mispricing.

Since our entry into CLV, it has delivered an exceptional 1H FY18 result driven by a combination of very strong revenue growth and ongoing margin expansion (as we discussed last month). While the result itself drove material earnings upgrades, it has proven to be the catalyst for a broader and more significant re-rating, highlighting the benefits of identifying and investing in attractive microcap opportunities as early as possible. In our view, the result provided important validation of the strategy embarked upon by new management in 2015, thus elevating their credibility in the eyes of the market. When coupled with the stock's increasing size and liquidity, it has opened it up to a far broader institutional investment base, which in turn has the effect of attracting more broker coverage. For example, Ord Minnett has recently initiated with a $1.40 price target, albeit noting that this could increase by a further c.$0.40 should CLV be able to execute on some of its potential growth options (e.g. entry into the sports nutrition market).

Based on our updated modelling, we now have a DCF valuation of $1.45 which is based on consistent future growth in its core business, combined with further margin expansion. But, like Ord Minnett, we have assumed minimal upside from its potential growth options. Interestingly, while the stock has rallied incredibly hard in the past couple of months, on our forecasts it is still only trading on an FY19 P/E of c.20x. This remains relatively undemanding compared with other fast growing domestic food companies, especially when coupled with its growth outlook (we forecast FY18-21 EPS CAGR of c.30%). So, while we continue to carefully manage its weighting within the portfolio to reflect the closing valuation gap, it remains a core holding in the Fund.

Portfolio characteristics

We currently have 94% of our capital invested in 12 stocks, with no change in the stock portfolio from last month, albeit we have added one stock since month end.



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