Emerging Companies Fund

Monthly Update: June 2018

Dear Fellow Investors,

Our Emerging Companies Fund was up +1.6% in June vs -1.7% for the Emerging Companies Accumulation Index (XECAI) and +1.4% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +78.2% (assuming distributions are reinvested) vs +10.9% for the XECAI, +22.3% for the XSIAI and +6.4% for our cash-based benchmark.

We are particularly pleased with the Fund's performance since 1 January, as during this period it is +11.3% while the XECAI has actually declined by -1.8%. One of the key drivers of such strong outperformance occurred during March when our largest position at the time, Clover Corporation (CLV), delivered an outstanding 1H FY18 result and pushed the Fund into positive territory for that month (+1.6%), against an XECAI which declined by -3.8%. Importantly, rather than sit on these gains, we have diligently converted the majority of them into cash in order to manage our risk weightings and ensure we are recycling capital into our best new ideas, instead of trying to squeeze the last drop out of existing ones. As a consequence, the Fund has now paid cash distributions of $0.29 on an initial unit price of $1.00, largely comprised of realised capital gains and some franked dividend income.

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%	+4.1%	+1.6%							+11.3%

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

Performance commentary

The standout contributor to the Fund's performance in June was Phoslock (PHK, +25%), which appears to be benefitting from engaging with a wider investment audience (it presented at a Gold Coast Investment Conference on 20 June), especially now that it is profitable and demonstrating attractive growth characteristics. Clover Corporation (CLV, +19%) also had another very strong month, however we used this strength to significantly reduce our position given it has now exceeded our DCF valuation. In our view, at a price above $1.50 the market is factoring in the realisation of some of its growth options (as discussed in previous updates), which appears aggressive. Nonetheless, we decided to retain a very modest level of exposure given the optionality that exists within the business.

While on the topic of stocks that have performed strongly and now match or exceed our DCF valuation, we took the opportunity to exit Lovisa Holdings (LOV) during the month. We first bought LOV in June 2017 at $3.52 and since then the stock has soared to in excess of $12.00, with our highest sale price of $12.27 during June, implying a gain of almost 250%. However, this overstates the impact on the Fund's performance as we have done plenty of selling in LOV at prices below $12.00 over the past six months or so in order to manage its weighting within the portfolio during its meteoric rise. While much of LOV's rerating over the past 12 months has been due to a combination of delivering outstanding financial results and embarking upon a global store rollout plan (with pilot stores now in the US, France, and Spain), we felt that a sufficient portion of the potential value creation from its future store rollout was being factored into the share price at above $12.00. This view is supported by the fact that our current DCF valuation is $12.15, which assumes LOV doubles its store footprint over the next decade.

The two key negative contributors to the Fund during June were Polynovo (PNV, -12%) and Axsesstoday (AXL, -8%). PNV didn't have any news flow of note, however it is worth bearing in mind that after an unexplained surge during May, the share price is now more or less back at where it was at the end of April. Regardless we continue to hear very positive feedback on PNV's flagship product, NovoSorb BTM, and its acceptance in the US market. While we expect that sales growth might be somewhat lumpy during the early stages of its growth trajectory as they bring on new hospitals and await re-orders, most importantly we understand that the feedback from surgeons remains very positive.

In terms of AXL, we think the weakness in its share price can be attributed to negative sentiment towards any companies involved in the provision of credit, just given the ongoing Royal Commission. Importantly, AXL is not expecting any outcomes that will adversely affect its business, in fact we understand that they think this process could create a potential opportunity for them as unscrupulous operators are forced to exit the market. Nonetheless, the overarching uncertainty is impacting market confidence.

During the month, Longtable Group (LON, -3%) announced the acquisition of St David Dairy for $15.25m, funded by a $15m institutional placement at $0.70 in which we participated. The transaction value implies an FY18 EV/EBITDA multiple of ~9x for St David, which we see as attractive in the context of its recent growth profile (32% revenue CAGR FY16-18), high margins (30% EBITDA margin FY17-18), expansion opportunities (in terms of both product and distribution footprint) as well as potential revenue and cost synergies available to LON across its existing portfolio of products and brands.

Established in 2013, St David is an artisanal dairy brand that produces a range of high quality milk, yoghurt, butter and cream products from its own micro-dairy in Fitzroy (Vic), sourcing its milk directly from a supplier in Drouin (Vic) that practices low density dairy farming. Its customers include some of Melbourne's leading cafes, restaurants (e.g. Vue de Monde), coffee roasters and specialty grocers. There are numerous strategic benefits of this acquisition such as providing a channel for in-conversion biodynamic organic milk from Paris Creek Farm while also maximising its revenue per litre and cross-selling opportunities of other LON brands/products to existing large and high-profile customers of St David, particularly within Victoria. We also see this acquisition as being consistent with LON's strategic ambition of creating a suite of premium branded food businesses that over time can form an entity that is far more valuable than the sum of its parts.

In other news, RBL announced that its CEO, Martin Hosking, will be transitioning the CEO role to Barry Newstead, RBL's current COO, effective from 1 August 2018. Importantly, Martin will remain involved with the Company as a Non-Executive Director and committed shareholder. Given Barry has been with RBL for almost five years, this appears to be a logical and seamless transition. As investors, we have a strong preference for an internal candidate to take over key leadership positions as it demonstrates that the company has a culture which is focused on developing its own talent pool, while also avoiding the risk of disenfranchising senior staff because they are overlooked for a promotion in favour of bringing in a complete outsider to the business. We also note with interest that Goldman Sachs recently initiated on RBL with a Buy recommendation and a $1.90 target price (vs current price of $1.58). This was noteworthy given that previously the only two brokers that provided research coverage on RBL were the Joint Lead Managers on the IPO.

Finally, TNK established a new five-year syndicated debt facility with Macquarie Bank during the month, increasing its debt capacity from $29m to $58m, which based on our forecasts underpins the next few years of centre acquisitions without any need for further equity. This should come as welcome news to investors as the share price has been under significant pressure ever since TNK announced that it wasn't extending its facility with ANZ. At the time, TNK noted that its decision not to execute the new agreement with ANZ was because it wanted to avoid paying onerous undrawn facility fees, particularly given that it wasn't expecting to start drawing on the additional debt capacity until CY19.

Company in focus: Volpara Health Technologies Limited (VHT)

Founded in 2009 from research originally conducted at Oxford University, VHT (based in New Zealand) is focused on the early detection of breast cancer by improving the quality of breast imaging analytics using artificial intelligence. Its clinical support software, VolparaDensity™, provides real-time feedback on breast density, compression, dose and quality, while its enterprise-wide software, VolparaEnterprise™, assists breast clinics to more efficiently manage their businesses. As a result of its software, patients have a higher chance of breast cancer detection and a safer screening experience, while image clinic owners experience productivity, compliance, and profitability improvements.

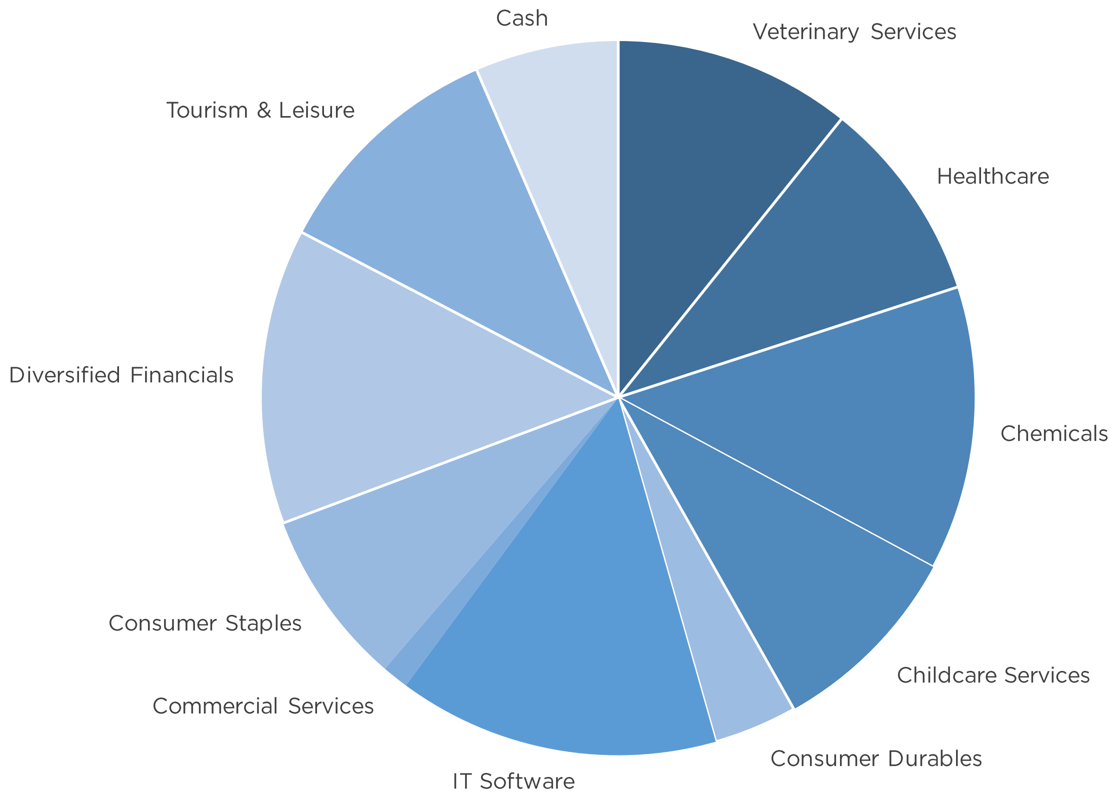
VHT has a number of patents (34) and trademarks (39) and regulatory clearings, including FDA, CE and TGA, as well as over 273 science publications supporting its technology and services. Importantly, there are regulatory tailwinds driving increased adoption, particularly in the US market with new FDA regulations (known as EQUIP) aimed at ensuring safe and high quality screening is achieved as well as US State laws (>30 States) which require breast density information to be given to each patient. As a consequence, 3.2% (1.3m) of women screened in the US are to be analysed by Volpara, with VHT forecasting this to reach 9% by the end of FY19 and current sales visibility to attain ~20% penetration of the US market, which would be an outstanding achievement.

In terms of the addressable market, VHT estimates that globally there are 75m breast screenings per year, with the number of breast cancers predicted to double by 2030 due to lifestyle, diet, and other changes. Importantly, VHT has established a first mover advantage in this segment of the market and intends to capitalise as much as possible. Therefore, VHT is undertaking a land and expand strategy via a SaaS revenue model with recurring dynamics and gross margins in excess of 70%. Its revenue per woman is typically within a range of ~US$1.90 to $3.60, with potential to grow this significantly over time. During April, VHT raised $18m via a Placement (in which we participated at $0.60) and SPP to further accelerate its rapid growth in the US market, to roll out new features that can underpin higher fees per woman and to begin the roll out of direct sales into Asia. While VHT will be doubling its sales team (from 11 to 22) during FY19, beyond this it intends to keep its cost base relatively stable in order to maximise profitability. In fact, we forecast that VHT will be profitable and cash flow positive from FY20 onwards.

Based on our modelling, we have derived a DCF valuation of A$1.50 for VHT (vs current share price of $0.80) which is largely based on VHT achieving 25% share of the US breast screening market within the next decade, earning average fees of US$8.50 with gross margins of 80%. Given VHT remains in the early stages of this journey, we have applied a 17% cost of equity to reflect its higher risk profile. Clearly VHT still has a long way to go before these metrics can be achieved, however given its rapid rise to a meaningful level of market share in such a short space of time, combined with its regulatory tailwinds and strong management team, we have a high degree of confidence that its ambitions can and will be realised. Furthermore, while we have invested in VHT based on our view on the value of its future cash flows, we are also drawn to the fact that a SaaS company with a singular focus that is rapidly gaining market share within the US is likely to attract attention from incumbent service providers to the breast screening industry.

Portfolio characteristics

We currently have 93.5% of our capital invested in 14 stocks, having replaced LOV with a new stock during the month.



Thanks again for your interest and support and I look forward to providing another update in early August on our performance during July. 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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Important Information