Emerging Companies Fund

Monthly Update: August 2018

Dear Fellow Investors,

Our Emerging Companies Fund was up +0.7% in August vs -0.4% for the Emerging Companies Accumulation Index (XECAI) and +4.4% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +73.8% (assuming distributions are reinvested) vs +8.2% for the XECAI, +27.0% for the XSIAI and +7.1% for our cash-based benchmark.

While on face value it might appear that the Small Industrials sector had a stellar month, we would caution investors from reading too much into this given that two of the largest weightings within that index, Wisetech Global (WTC, +40%) and Afterpay (APT, +28%), surged yet again, combining to contribute almost 40% of the index's return for the month.

Incredibly, both stocks now trade on FY19 P/Es of c.100x and c.150x respectively, with market capitalisations of c.$6.4bn and c.$4bn. While we can't definitively say that these valuations will prove to be incorrect, when stocks continue to rise daily (often by significant increments) in the absence of material positive news flow and then surge on news that should have been expected (both WTC and APT's FY19 results were broadly in line with consensus), it does suggest that a blind chase for share price momentum may have taken over. Interestingly, despite still posting a meteoric rise in August, both stocks declined c.10% and c.15% from their intra-month highs in the final week of trading.

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%	-3.1%	+0.7%					+8.6%

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

Performance commentary

The positive contributors to the Fund's performance in August were National Veterinary Care (NVL, +14%), Volpara Health Technologies (VHT, +13%), Polynovo (PNV, +11%), Redbubble (RBL, +9%), and Phoslock (PET, +8%). The key negative contributors were Millennium Services (MIL, -23%), Longtable Group (LON, -22%), yet again, Tourism Holdings (THL.NZ, -8%), and Think Childcare (TNK, -6%).

Unsurprisingly, it was a volatile month across the market given most companies were reporting their half or full year results for FY18. Pleasingly, none of the earnings results from the companies within our portfolio were significantly different from our expectations, other than perhaps LON and MIL. As a consequence, the share prices of most of our stocks performed quite well following the release of their results, during a period where there were plenty of small cap industrial stocks that did not.

While MIL's FY18 result quality was poor (statutory EBITDA was materially below the 'underlying' figure), it was not entirely unexpected given the issues that have been facing the Company. Furthermore, its FY19 EBITDA guidance of $15.5m to $17.5m was not materially below our own forecasts, albeit it was well below consensus. At current prices of c.$0.60, the guidance implies that MIL is trading on an FY19 EV/EBITDA multiple of just 2.7x to 3.2x. Hence, in our view either the market doesn't believe it will deliver on its earnings guidance given its historical track record of overpromising, or it is anticipating a significant equity raising to reduce debt, both of which are possible. We also think that the ongoing price weakness is at least in part due to a continuation of turnover within its share register (as evidenced by the ongoing changes in substantial holdings) in an illiquid stock where significant buyers are hard to find. This process is proving to be painful for investors while the business is turned around under the new CEO's leadership.

In the case of LON, we think that the market was justifiably disappointed with the financial performance of Paris Creek in its first six months under new ownership. While we had hoped the result might have proven to be a circuit breaker for LON's negative share price momentum, we actually think it gave some credibility to the selling pressure leading into the result. Nonetheless, the reasons behind the Paris Creek performance were well articulated (e.g. destocking ahead of its rebranding launch in September 2018) and we are buoyed by the prospects for this business under its new brand and pricing strategy (just released), as well as the potential that resides within its other two assets, St David Dairy (recently acquired) and Maggie Beer (undergoing a turnaround process).

The only other stock of note that materially declined in response to its results was TNK. While we are under no illusions that TNK's performance during 1H CY18 was poor, it came as no surprise given that the tough conditions facing the sector have been well publicised (caused by multiple regions now suffering from oversupply). Our mistake was assuming that the market would look through these results and instead focus on the tailwinds that will drive the business from 2H CY18 onwards, but particularly in CY19 once parents have had sufficient time to alter their working arrangements to capitalise on the increased Government subsidies that came into effect on 2 July. When coupled with the fact that TNK will be cycling very weak comps, we still expect strong growth from CY19 onwards.

In more positive news, NVL's FY18 earnings result was towards the top end of its recently provided guidance range (which was a downgrade to expectations at the time). It also reported that LFL sales are tracking at +2.5% in the first four weeks of FY19, suggesting that the unexpectedly weak trading conditions in June were anomalous. We continue to rate this business and its management team very highly, with our channel checks supporting this view. As such, we are confident that the investment undertaken by NVL in FY18 to improve its systems and processes so that it can cope with a much larger portfolio of clinics will pay dividends in FY19 and onwards, thus rewarding patient shareholders.

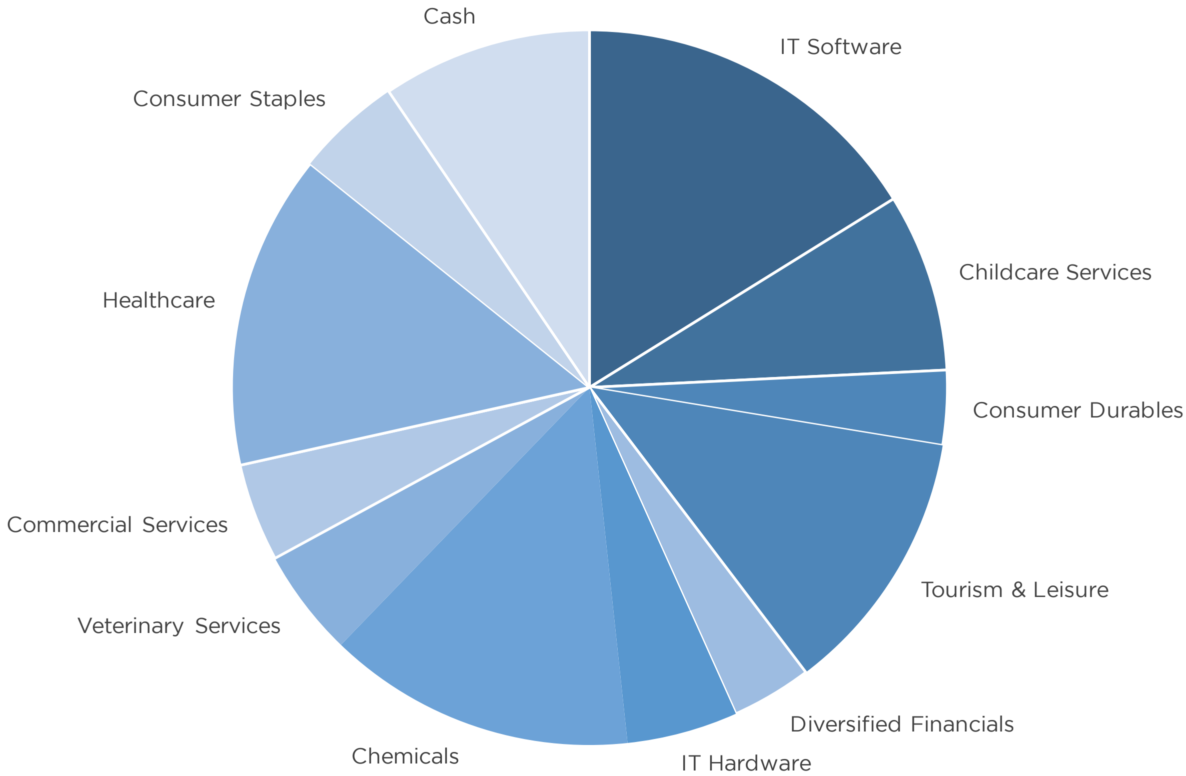
While the financial results for PNV in FY18 were never going to be very insightful given it remains in the early stages of commercialisation of its NovoSorb BTM, the positive news was that it received its registration with the TGA (in addition to already having FDA approval), thus allowing the product to be marketed and sold in Australia with immediate effect. Furthermore, we take confidence from the fact that three of PNV's directors each bought a significant number of shares at an average price of c.$0.54 during the month.

In other news, we decided to exit our position in Axsesstoday (AXL) earlier than we had anticipated. It was a tumultuous month for AXL's share price as on 2 August it provided its unaudited FY18 headline results (in line with guidance) as well as FY19 guidance, which was ahead of consensus and our forecasts. In the following days the stock rallied c.10% as the upbeat guidance was digested. However, upon release of its detailed results on 27 August, the Company announced that the CFO had resigned, with no specific reasons provided, and he did not present on the results conference call. We found this (and its timing) very disconcerting given this is a fast-growing finance company where risk control, a key domain of the CFO, is critical. As such, given the uncertainty created by his departure, we took the decision to exit our position, with an average selling price of $2.11 (note we first bought AXL at $1.85 in February 2018). Given it is now trading at around $1.65, we do feel somewhat vindicated, albeit time will tell if our caution was warranted.

In the interests of brevity, we have decided not to discuss one of our new portfolio companies in this monthly update. However we are pleased to report that we added two stocks during August, which we will discuss in detail in an upcoming monthly update.

Portfolio characteristics

We currently have 90% of our capital invested in 15 stocks, with two additions since July and one removal (AXL).



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

Please don't hesitate to get in touch should you have any questions about the portfolio.

Kind regards,

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Important Information