Emerging Companies Fund

Monthly Update: July 2018

Dear Fellow Investors,

Our Emerging Companies Fund was down -3.1% in July vs -2.1% for the Emerging Companies Accumulation Index (XECAI) and -0.5% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +72.7% (assuming distributions are reinvested) vs +8.6% for the XECAI, +21.7% for the XSIAI and +6.7% for our cash-based benchmark. This was a disappointing start to FY19, partly due to an earnings guidance downgrade from one of our key holdings, National Veterinary Care (NVL, -21%), but also driven by ongoing index weakness, which appears to be caused by a rotation away from microcaps into mid/large caps. As evidence of this, since the start of April the Emerging Companies Accumulation Index is -2.0% while the S&P ASX200 Accumulation Index is +9.9%.

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%						+7.8%

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 July were Phoslock (PHK, +8%), Axsesstoday (AXL, +6%) and Clover (CLV, -4%). Despite starting July as the second smallest position in the Fund and finishing down for the month, CLV made a material positive contribution (both realised and unrealised) to performance as we more than doubled our position in the stock when it was trading between $1.30 and $1.40 in early July, before finishing the month at $1.56. The Fund also gained more from PHK than the headline figures suggest as we participated in a $5.5m placement completed during July at $0.36 (the stock closed the month at $0.43), the funds from which will be used for working capital requirements relating to further new projects in China.

The key negative contributors were Polynovo (PNV, -6%), Think Childcare (TNK, -6%), Longtable (LON, -20%) and, as mentioned, NVL. While TNK had no news flow, PNV's share price weakness continued despite receiving regulatory approval for the sale of NovoSorb BTM in Saudi Arabia, with Al Mofadaly signed as its exclusive distributor in the Middle East, a region which we hadn't yet factored into our forecasts.

As for LON, its share price weakness was likely due to the recent capital raising and the short term supply/demand imbalance this has created for the stock. Given LON's share price doubled in the weeks following its last placement (in November), we suspect some stock in this placement would have been bought by traders hoping for another quick gain. However no such short term gains eventuated, hence those looking to trade around the placement would have been quick to sell, with the level of urgency exacerbated once the stock dropped below the placement price of $0.70. Conversely, with many long term investors increasing their holdings via the placement, this naturally leaves a lack of buying demand to soak up any marginal selling volumes. This will correct itself over time, assuming we see evidence of improving financial results from its recent acquisitions (which we expect), however in the short term it is a source of doubt for investors, especially when the stock has no research coverage or consensus earnings forecasts.

NVL's decline was due to a disappointing FY18 earnings update in which it guided to lower EBITDA margins (15-16% vs previous guidance of 16-17%). It also provided FY19 guidance of revenue growth of >25% and EBITDA margins of 16%, the latter of which was below consensus. While in isolation the FY18 downgrade is relatively minor and easily explained (investing for growth), and the FY19 margin guidance appears deliberately conservative, this announcement comes after a similar downgrade at its 1H FY18 result. Hence, in our view, the credibility of management has been temporarily impacted and consequently, the P/E rating of NVL has significantly declined. The issue of concern for us is whether this short term margin disappointment is transient or partially structural. To be conservative, we have reduced our long term margin assumptions somewhat to reflect this uncertainty, with our DCF valuation also declining. Given the reduced gap between the share price and our updated valuation ($2.65), we took the decision to immediately halve our exposure to NVL, but still retain a meaningful position given our attraction to the veterinary industry dynamics and NVL as a market leading operator.

In other news, Redbubble (RBL, -1%) delivered an outstanding 4Q result with revenue up 34.5% on pcp and gross profit up 36.8% (with margins improving 170bps on pcp). Importantly, gross profit after paid acquisition costs (i.e. direct online marketing) was up 40.7%, which is a key metric for the business and highlights the increasing proportion of unpaid traffic to its site. Offsetting this growth was ongoing investment in its platform as it prepares to increase its product offering and scale into other markets, such that the 4Q EBITDA loss of $3.2m was slightly larger than the pcp. Nonetheless, the FY18 EBITDA loss was still an improvement on the pcp and RBL is now guiding to EBITDA profitability in FY19 of $2-4m, underpinned by another year of at least 30% revenue growth and ongoing gross margin improvement, partially offset by opex growth in line with FY18 (+19%). We remain very happy holders of RBL and increased our exposure following this great result.

Company in focus: Millennium Services Group (MIL)

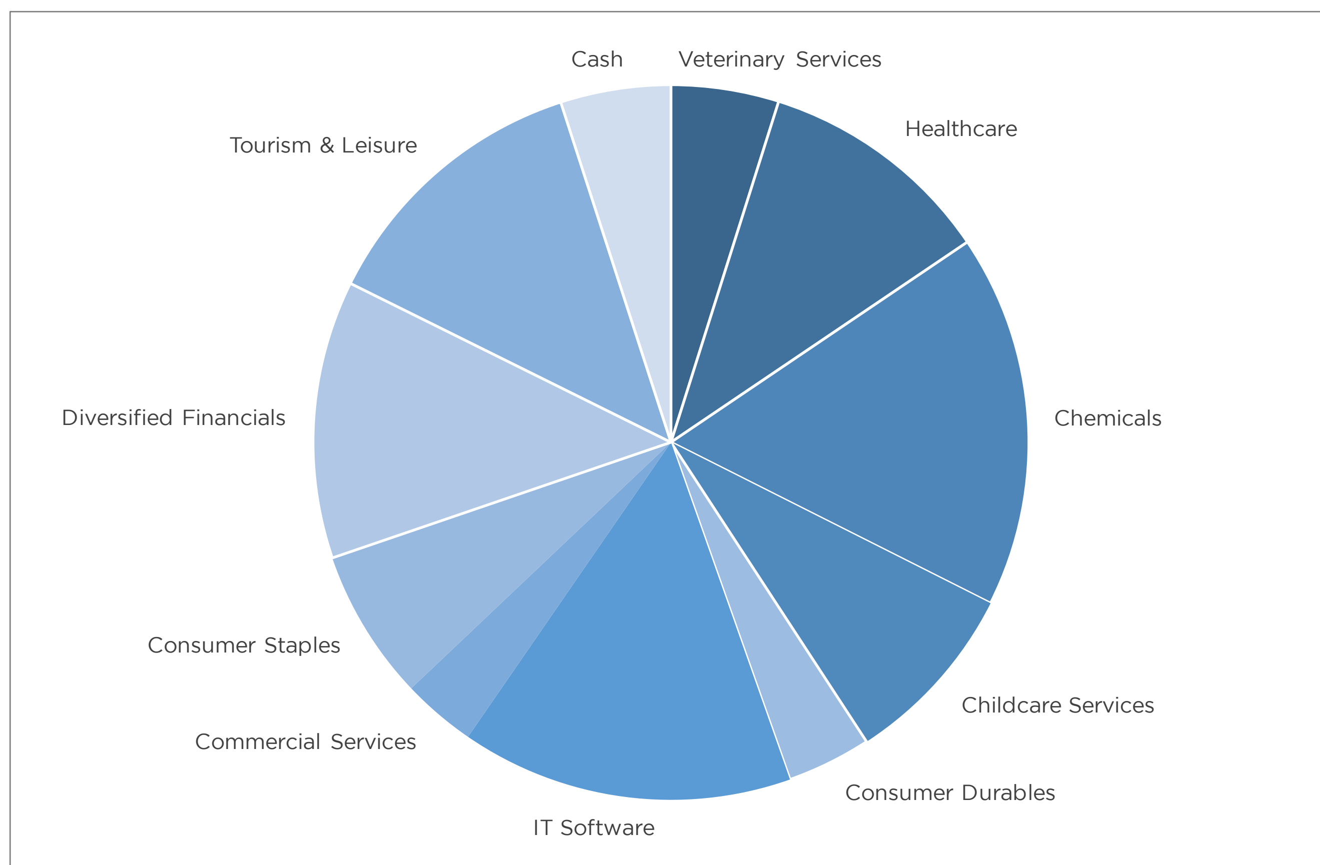
MIL is a cleaning and security service provider operating in Australia and New Zealand, primarily servicing retail shopping centres, commercial properties, government, education and sporting facilities. Since listing on the ASX in November 2015 at $2.25/share, MIL has seen its share price more than halve due to missing its prospectus forecasts and subsequent earnings guidance provided thereafter. Unsurprisingly, both the CEO and CFO have been replaced in the past 12 months or so, with the new CEO (Craig Hanley) already having a demonstrably positive impact on MIL's success in winning new tenders (e.g. Vicinity Centres), particularly within the security division. Prior to joining MIL, Craig was CEO of Securecorp up until it was sold to Shanghai-listed China Security & Fire in 2016. Importantly, our industry channel checks suggest he is very well regarded and therefore appears to be the right person to grow this business and create value for shareholders.

MIL operates in low margin industries (EBITDA margins are typically 5-7%) due to their highly competitive nature and low barriers to entry, as such it is not a business that we typically like to own. However, given it is a services business with people at its core; a strong management team and corporate culture has the potential to drive significant value creation. Furthermore, it is a business capable of generating an attractive return on capital, particularly with increasing scale, that has low exposure to the economic cycle.

Based on our forecasts, which are below consensus, MIL is very attractively priced (FY19 P/E of <7.5x and EV/EBITDA of <3.5x). While we don't expect the FY18 result to be the catalyst for a rerating, we think that the Company can provide solid revenue growth and a gradual improvement in margins over the next two years driven by the scale benefits from further contract wins and gradual reductions in overhead. This will also enable the Company to reduce its gearing (currently too high at 1.5x net debt/EBITDA) and reinstate its dividend. As such, we expect that the FY19 result has the potential to not only provide a much higher earnings base upon which to value the Company, but also deliver a P/E rerating as the market's confidence in its leadership and outlook is restored. We also take confidence from some of the directors buying the stock in the past few months.

Portfolio characteristics

We currently have 95% of our capital invested in 14 stocks, with no additions since June.



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

As evidence of our confidence in the valuation and earnings outlook for the stocks within the Fund, as well as in our process to continue to identify new attractive investments, we further increased our personal investment in the Fund as at the start of August.

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

Kind regards,

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