Emerging Companies Fund

Monthly Update: November 2018

Dear Fellow Investors,

Our Emerging Companies Fund was down -4.8% in November vs -2.4% for the Emerging Companies Accumulation Index (XECAI) and +0.8% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +58.9% (assuming distributions are reinvested) vs -6.0% for the XECAI, +14.0% for the XSIAI and +8.2% for our cash-based benchmark.

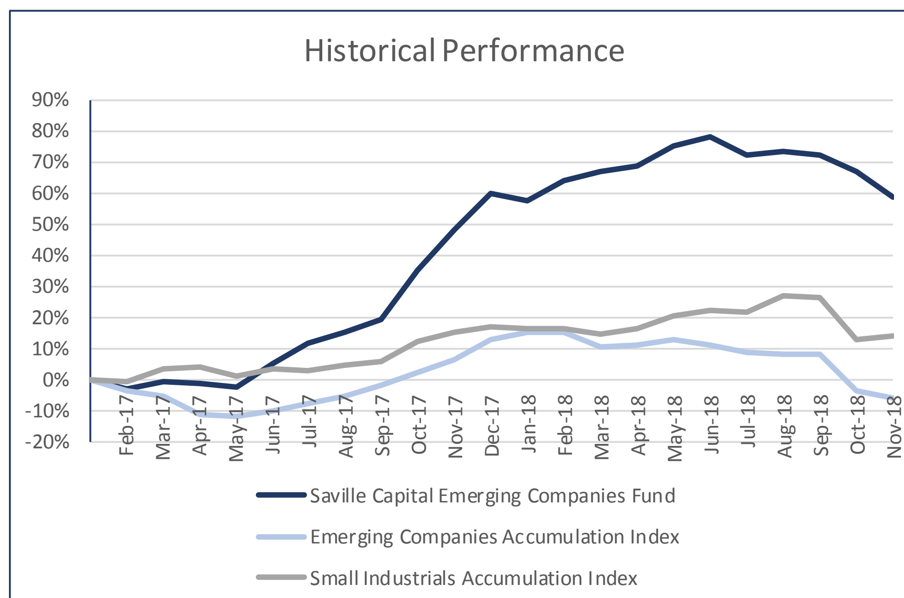
Having performed so well (in relative terms) during October, it was disappointing to see a few of our key positions decline materially in November. The Fund started the month positively, however as we moved further into November it became clear that this correction was going to extend both in terms of its depth and breadth. The market slowly shifted from having de-rated those companies during October that had run well ahead of fair value, to taking a more blunt approach and de-rating the vast majority of companies, particularly smaller and less liquid stocks. Therefore, some of our stocks which held up very well in October were no longer spared from the risk-off trade, and in many cases fell back into line with weak market performance across the last two months.

What we describe above is a consequence of fear permeating markets and unfortunately it has had a material impact on the short-term absolute performance of our Fund. However, it is important to note that we have not crystallised losses by succumbing to the herd mentality. Just as it is important to ignore the positive momentum and sell investments that have exceeded our measure of fair value in strong markets, it is just as important to employ the same discipline when momentum is weak. The easy (and common) thing to do during times of market weakness is to ignore valuation metrics and company performance in favour of gratifying the natural emotional response, which is to sell in an often vain effort to try and get in ahead of the thundering herd.

Performance summary

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	3M	12M
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%	-0.8%	-3.2%	-4.8%		-0.7%	-8.6%	+7.3%

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



Performance commentary

While more than half of the portfolio suffered declines in November, most of the Fund's negative performance came from our largest holding, Redbubble (RBL, -25%). In fact, if we removed RBL's impact, the Fund would have again outperformed the XECAI, a great result given the significant outperformance that was achieved in October, when the Fund was down -3.2% vs the XECAI at -10.9%. While ignoring RBL is purely academic, it is still worth noting that despite underperforming the XECAI in November, during this two month correction the Fund is still well ahead of the index (-7.8% vs -13.0%). Nonetheless, unfortunately the market has temporarily de-rated, albeit irrationally in our view, one of our core holdings, thus materially impairing the Fund's performance in November.

The reasons behind the decline in RBL's share price are based around very transient factors. Firstly, undertaking such a significant capital raising in a declining market was always going to leave the share price vulnerable to a capitulation trade. Inevitably these events attract some investors hoping for a quick return that will aggressively sell the stock if it drops below issue price, which can often start a vicious cycle. Secondly, RBL provided a disappointing sales update based on trading during the Thanksgiving period, albeit with the weakness entirely explained by a change in the Google search algorithms that affected October/November site traffic and was already flagged by the Company. These changes occur from time to time and have negatively (but also often positively) impacted RBL in the past, indiscriminately driving organic search traffic to competitors or simply towards paid search (i.e. Google ads that sit at the top of the list of search results).

In the context of the entire year (Thanksgiving sales make up <4% of annual revenue), it is questionable as to why the Company feels this update is even necessary, but putting that to one side, revenue growth of +18.2% on pcp (+14.3% in constant currency) came in well below 1Q FY19 revenue growth of +39.6% (+30.3% in constant currency). As such, YTD revenue is now tracking slightly below RBL's guidance for FY19 sales growth of +30% in constant currency. Pleasingly, despite the recent weaker sales, revenue from repeat customers during Thanksgiving was healthy at +28.5% growth, highlighting that excluding the Google search impact, the core business remains very sound. Unfortunately, the market focused all of its attention on the negative facets of this most recent update (in fact the stock was down a staggering -46% at one point during the month), ignoring that it is almost certainly anomalous and temporary, and that underlying momentum is strong.

Given that RBL has made content adjustments to adapt to the algorithm changes and is now starting to see the benefits of this (sales on Cyber Monday, the last day of the Thanksgiving period, were up +30% on pcp), we are confident that its next update will demonstrate a sustained return to trend growth. Not surprisingly, c.65% of 2Q sales come after the Thanksgiving period, with the most pivotal period of the year being Christmas. Most importantly, the fundamental drivers behind our positive investment thesis on RBL remain intact. It is increasing revenue via both product and geographic expansion while lifting margins by improving terms with its fulfillers and reducing its reliance on paid customer acquisition. Furthermore, RBL is trading on very modest metrics when compared with its peers (1.0x FY19 EV/pro-forma Sales and 2.6x FY19 EV/pro forma Gross Profit vs Etsy at c.9x and c.11x respectively). Hence, we will be retaining our holding in what remains a very sound business (including net cash of $28.5m, no inventory risk and a "negative" working capital cycle) with a strong and sustainable growth outlook.

In some positive news, Think Childcare (TNK, +30%) provided a brief update in which it reiterated its CY18 earnings guidance and announced the acquisition of five new centres for $7.7m. While this had no impact on our valuation of the Company, the market took comfort from the fact that improving trends in occupancy, as already foreshadowed, had continued. This is a classic example of a stock being completely oversold on momentum, not logic, and rebounding as soon as it demonstrates that the trend of short-term weak performance has definitely abated. We held our nerve with TNK through this period of weakness and expect to be writing similar comments on RBL in the not too distant future.

Company in focus: Rhinomed Limited (RNO)

RNO is a nasal and respiratory medical technology company based in Melbourne that is focused on (i) sport and exercise, (ii) wellbeing (appetite and anxiety), (iii) sleep/snoring and sleep apnoea, and (iv) drug delivery (migraine and allergies) markets. RNO's core technology is an internal adjustable nasal stent platform that is capable of delivering multiple solutions from simple dilation through to complex applications such as sensor or drug delivery. It has registered Class 1 status with US FDA, Australian TGA, Canada Health, CE Mark from the European Authority and Taiwanese FDA.

RNO currently has two products selling in the market, Mute (snoring) and Turbine (sport/exercise) and has two other products ready for imminent commercial release, being a decongestant product called "Clear" and an anxiety and sleep aid product called "Calm". Furthermore, it has a product in development that is designed to address obstructive sleep apnoea, as well as a 12-year licencing partnership that it recently signed with Columbia Care, a leading player in the global cannabis market, to develop a product for nasaly delivered medicinal cannabis.

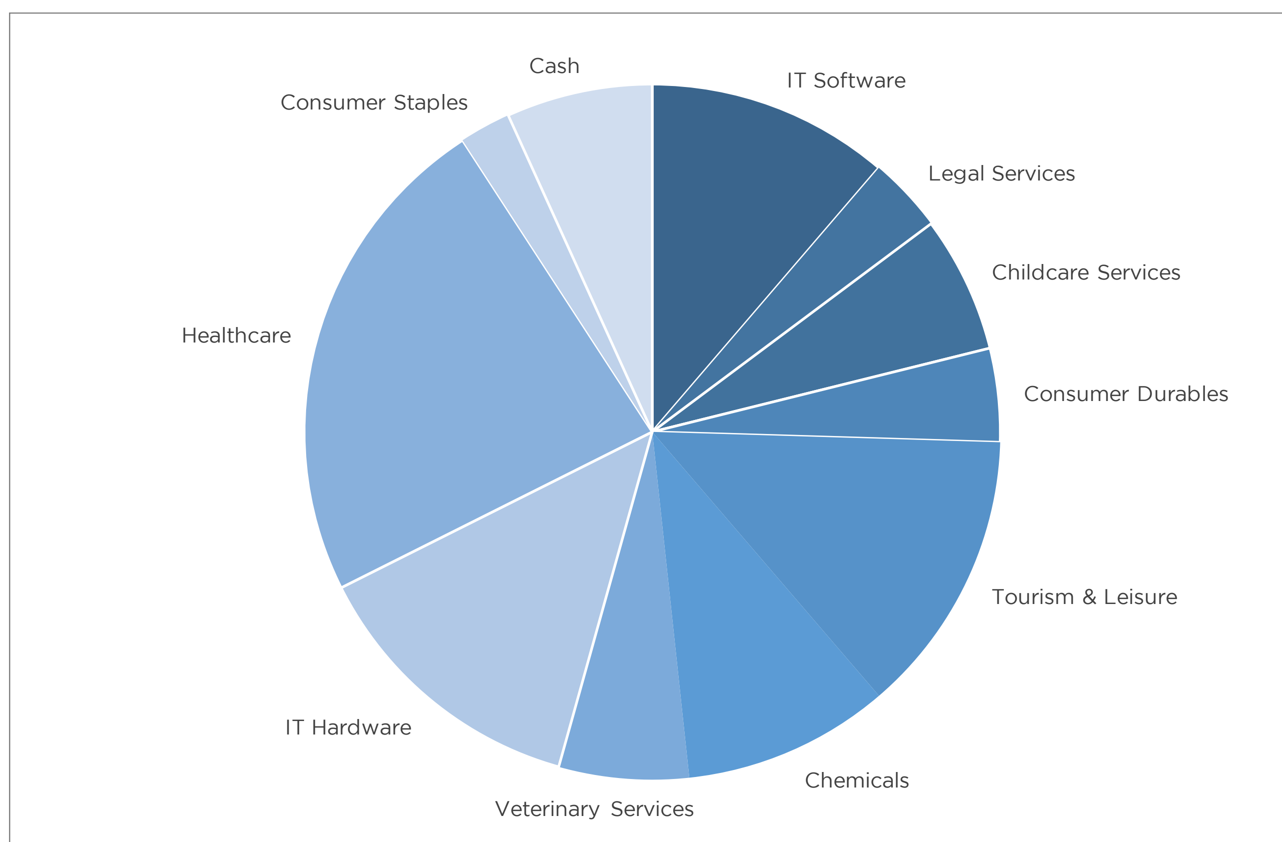
RNO has now delivered seven consecutive quarters of revenue growth, with total units shipped up 50% in FY18 and QoQ revenue growth of 30% in 1Q FY19 (vs 4Q FY18). As at 2Q FY19, RNO products (mostly Mute) are in over 11,000 stores globally (having just added another 4,500 stores in 1Q FY19), the majority of which are in the US, including Walgreens, CVS and Rite Aid, but also in the UK via Boots. The incumbent competitor to Mute, which is the Breathe Right Strip, currently sells in 80,000 stores across the US. Prior to being sold to GSK for US$566m in 2006, CNS Inc (the owner of Breathe Right) was generating annual sales of c.US$120m and we understand that it still accounts for c.90% of category sales, hence taking market share from Breathe Right is RNO's most logical immediate target. Within Australia, RNO has recently brought its product distribution back in-house which should have a positive impact on revenue from 3Q FY19 onwards. RNO's products are manufactured by ChinaMed in Guangdong (China) with sufficient capacity to support sales of $30m pa (annualised sales are currently c.$5m). RNO earns an attractive gross margin of c.70% on its product sales, with an average retail sale price of c.US$22.

RNO recently raised $5m at $0.21/share (in which we participated) in order to meet its ongoing working capital needs and fund continual research and development into nasal based products. The funds will also be used to assist with increased marketing and branding of the Company, particularly in the US and UK. Based on our conversations with management, this additional capital will be sufficient to fund the business until it reaches cash profitability, which we expect to occur in the next 6 - 12 months. Importantly, customer and independent expert reviews of RNO's products are generally very favourable, suggesting that as its distribution footprint expands, market penetration will continue to increase. Furthermore, for such a small company, RNO has an excellent board and management team who collectively own c.7% of its shares. In addition, we note with interest that a prominent investor, Whitney George (head of Sprott Asset Management in New York), owns over 20% of the Company in his personal name. We understand that his decision to invest was largely based on his own positive experience with using Mute.

Based on our financial modelling we are very comfortable with our entry price of $0.21/share, as evidenced by the fact that on our forecasts it is trading on an FY21 P/E of just 7x. However, with the Company still in the early stages of its growth trajectory, and several products still in development, it is difficult to confidently derive an absolute valuation. To mitigate this, we applied a range of volume growth and margin scenarios, all of which gave us valuations that were comfortably above the current share price, despite applying a high cost of capital to reflect the execution risks. With a rapidly expanding distribution footprint, a pipeline of exciting new products and large addressable markets, we think RNO has the potential to create significant value for shareholders over the next three to five years. We see ongoing strong product sales results, an imminent shift to profitability and commercialisation of its decongestant product as the key near term catalysts for the share price to re-rate higher.

Portfolio characteristics

We currently have 93% of our capital invested in 14 stocks, with one removal and one addition since October.



I would like to reiterate that we remain very confident in our investment strategy and process, as evidenced by our own significant investment in the Fund.

We recognise that this continues to be a challenging period for equities, especially microcaps (XECAI is now down -16.7% in 2018), but we remain resolute in our ambition to deliver strong risk-adjusted returns for our investors over the long term.

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

Kind regards,

Jonathan Collett

Principal

Saville Capital

+61 3 9769 1789

jcollett@savillecapital.com

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