Emerging Companies Fund

Monthly Update: September 2018

Dear Fellow Investors,

Our Emerging Companies Fund was down -0.8% in September vs -0.1% for the Emerging Companies Accumulation Index (XECAI) and -0.4% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +72.4% (assuming distributions are reinvested) vs +8.1% for the XECAI, +26.5% for the XSIAI and +7.5% 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%	+4.1%	+1.6%	-3.1%	+0.7%	-0.8%				+7.7%

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

Performance commentary

The key positive contributors to the Fund's performance in September were Polynovo (PNV, +6%), Volpara Health Technologies (VHT, +5%), as well as two recent additions, IDT Australia (IDT, +23%), which we discuss in further detail over the page, and Bluechiip (BCT). While BCT's share price was down for the month, we acquired our stake via a discounted institutional placement completed on 10 September, and pleasingly it ended the month +8% above the placement price. Excluding Millennium Services (MIL), which we will discuss in further detail below, the key negative contributors were yet again Think Childcare (TNK, -7%) and Longtable Group (LON, -8%), as well as National Veterinary Care (NVL, -6%), FSA Group (FSA, -7%) and Phoslock (PET, -4%).

Despite having only owned MIL for a short period with a view to seeing it through an 18 month turnaround under new management, we decided to exit our position during September. This decision followed a thorough review of its FY18 result (released on 31 August) and a subsequent meeting with management. While we think the business still has the potential to execute a turnaround and therefore achieve a substantial share price re-rating at some point, we came to the view that the risk of a potential equity raising during the intervening period (to reduce debt) has increased substantially given its weak FY18 statutory earnings result. While ordinarily this would not necessarily be a catalyst for us to sell, given its negative share price momentum and lack of liquidity, our concern is that a raising could be done at a farcically low price, thus either forcing our hand to commit additional funds to the stock or risk suffering significant and permanent dilution. Given it is not a stock in which we wish to hold a large position, we thought the most sensible course of action was to cut our losses and sell at $0.55, which was -25% below where it started the month, impacting the Fund's performance by -1% in September.

In other news, NVL raised $18m to fund the acquisition of the Pet Doctors Group in New Zealand, comprising 23 clinics and 2 training centres. The acquisition materially increases NVL's scale in NZ to become the market leader with a combined network of 33 clinics. The significantly larger business will enable NVL to leverage supplier deals and other procurement benefits to achieve growth in its NZ managed services division, launched in August. The business was acquired on an FY18A EV/EBITDA multiple of 5.3x and is expected to deliver annualised revenue and EBIT of NZ$31.2m and NZ$4.5m respectively, as well as FY19F EPS accretion in the mid-single digits. Given this acquisition is a step change for NVL, taking its total clinic footprint to 92, and has been under negotiation for several months, it provides context to the increased opex undertaken by NVL during FY18 (impacting margins), as this was required to absorb the new business. Interestingly, while Pet Doctors operates the same Practice Management System as NVL, it has no clinic KPIs nor does it operate a wellness program, creating significant potential for improvement.

Finally, during September we met with the management teams of almost all the stocks within the Fund's portfolio and came away confident that our investment thesis remains intact, or in some cases even strengthened. As such, assuming market conditions don't significantly deteriorate, we are very optimistic about the next 6-12 months for the Fund.

Company in focus: IDT Australia Limited (IDT)

Established in 1975, IDT operates in the pharmaceutical industry providing a flexible and comprehensive service from early stage API (Active Pharmaceutical Ingredient) development through to finished drug formulation, clinical trial research and scaled commercial manufacturing for global distribution. Based in Boronia (Victoria), IDT's manufacturing facilities are fully cGMP compliant and are regularly audited by the US FDA and Australian TGA. IDT is predominantly focused on high potency and very specialised drugs, having undertaken work for multiple global pharmaceutical companies including Pfizer, Johnson & Johnson, Roche and Bayer.

While IDT's business model had proven to be successful and generally profitable over time, in order to extract greater leverage from its expertise and materially increase utilisation of its manufacturing capacity, it undertook a strategic shift in late 2014 by acquiring 23 US generic drug products for US$18m. However, the reasons behind this decision were quickly undermined as the barriers to entry for new US generics were substantially lowered via shorter review periods and the number of potential buyers significantly reduced due to consolidation in the wholesale sector, leading to pricing erosion of between 5% and 60% across IDT's portfolio.

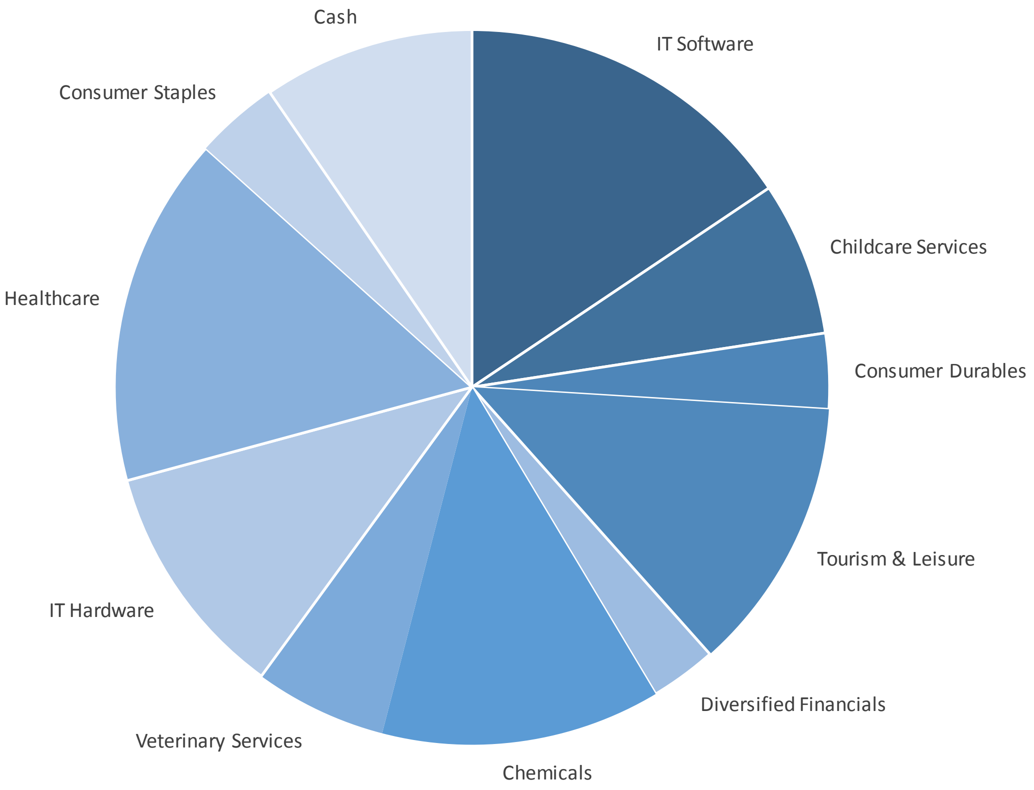
As a consequence, following a strategic review, IDT decided to sell the majority of its generics portfolio to ANI Pharmaceuticals for US$2.3m in April 2018, and instead focus on advancing a select generics portfolio (primarily Temozolomide, an oral brain cancer drug distributed by Mayne Pharma) and build upon its existing Contract API and Development businesses. Furthermore, by July, IDT had appointed David Sparling as its new CEO, after he had served in that role in an interim capacity since February 2018. In a further positive development, IDT entered into an agreement with Cann Group Limited (ASX: CAN) during August to provide manufacturing support in relation to medicinal cannabis-based product formulations intended for supply to patients in Australia and overseas.

Despite offering significant valuation support (IDT was trading below NTA when we first started researching the Company), our interest was piqued upon a thorough review of its FY18 result, particularly its 2H. Revenue increased from $5.0m in 1H to $8.3m in 2H, while its underlying P&L improved from -$3.1m in 1H to +$0.2m in 2H. Most importantly, it transitioned from a gross operating cash flow deficit of -$6.2m in 1H to a surplus of +$1.2m in 2H. When coupled with an NTA of $31.2m, underpinned by a net cash position of $14m and PP&E of $18.7m (over half of which is land and buildings), the investment proposition appeared compelling when compared with a market cap of $31.8m (at the time of our investment). Furthermore, if we look back over time, only a decade ago IDT was generating revenue of >$30m, EBITDA of >$12m and NPAT of >$7m and ROE of >20%, with much the same fixed asset base as what it has today.

Assuming IDT can grow its revenue back to >$30m over the next 5 to 10 years and restore EBITDA margins to c.35% (they peaked at 40%), then we value the Company at $0.25/share (vs current share price of $0.16 and our entry price/NTA of $0.13). This DCF valuation ignores the upside from potentially becoming a manufacturer of choice in the medicinal cannabis sector. Interestingly, since our entry into the stock, IDT has announced an on-market share buyback of up to 10% of its issued capital (commencing 10 October), citing its improved financial performance over the recent period and noting its forward projections indicate that a portion of its cash position is now surplus to requirements.

Portfolio characteristics

We currently have 90% of our capital invested in 15 stocks, with one addition and one removal since August.



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

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

Kind regards,

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