Emerging Companies Fund

Monthly Update: December 2018

SAVILLE CAPITAL

Dear Fellow Investors,

Our Emerging Companies Fund was down -5.2% in December vs -3.9% for the Emerging Companies Accumulation Index (XECAI) and -3.9% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +50.6% (assuming distributions are reinvested) vs -9.6% for the XECAI, +9.5% for the XSIAI and +8.6% for our cash-based benchmark.

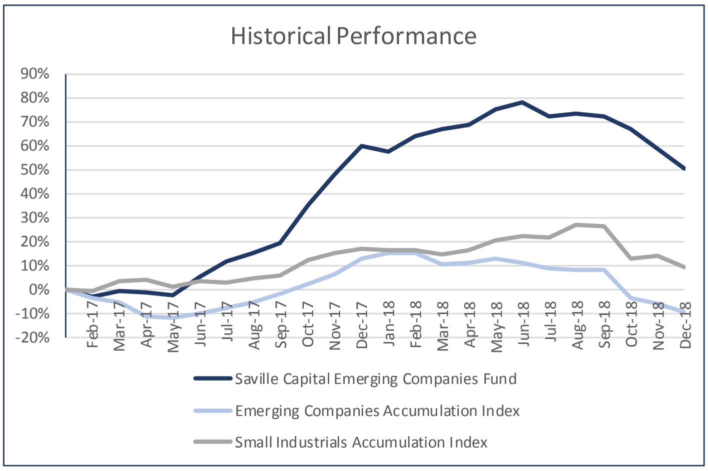
December was another challenging month for global equities, with emerging companies in Australia remaining under significant pressure as investors either accumulate cash or shift to larger and more liquid stocks. Unfortunately, the Fund's performance was yet again significantly impacted by a further sharp decline in Redbubble's share price (RBL, -23%), which accounted for about half of our negative monthly return. However, in the absence of fundamental change to the investment thesis, we must remain patient, dispassionate and focused on the long term. If RBL's structural growth outlook does change, we will take decisive action, as we have done previously, but that is not the situation here. Instead we will let others obsess about the very short term, as painful and frustrating as that process can be to observe, especially when marking our investment to market.

Incredibly, RBL's share price is now down c.45% in two months. This has been driven by a significant capital raising which has clearly left the short-term demand/supply equation for the stock heavily skewed to the latter, and a Thanksgiving sales update that fell short of market expectations, but still exhibited solid growth. Given the low risk nature of its business model, increasing scale advantages, strong long-term growth trends and the size of its addressable market, we are stunned by the amount of value destruction the market is imputing from one relatively minor data point. While further short-term softness in its sales growth rates is possible as it continues to adjust its content to restore its "unpaid" ranking within relevant Google searches, we struggle to envisage how its results over the next six months will see its share price remain at such depressed levels (relative to our estimate of fair value), let alone decline further. We note with interest that two of RBL's independent directors purchased shares towards the end of December.

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%	-5.2%	-5.9%	-12.6%	-5.9%

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



Performance commentary

Excluding RBL, the average decline of stocks within our portfolio was -2.0% in December, which was a solid outcome in the context of the weakness in most equity indices. However, RBL's diabolical share price performance influenced the portfolio to such a degree that the Fund lagged its key index for the month. Nonetheless, despite a weak end to the calendar year, the Fund still finished well ahead of the XECAI (-5.9% vs -19.9%) in 2018 and we remain confident that our portfolio (including RBL) will outperform this index, as well as our cash-based benchmark, in 2019 as some market stability is restored.

None of our stocks made any material announcements during December, however it is worth highlighting the addition of Mr Ningping Ma to the Board of Phoslock (PET, -5.3%). As well as being an existing shareholder in PET (5.3m shares), Mr Ma is a Senior Executive of Beijing Enterprises Water Group (BEWG), overseeing its commercial operations. As a reminder, BEWG is listed on the Hong Kong Stock Exchange with a market capitalisation of A$6.6bn and is a 70% owner of BHZQ Environmental, PET's largest customer and partner in China. PET believes his expertise will be invaluable in helping it to expand its operations across China, while we see it as a further endorsement of PET's reputation and operating capability in China as well as its future growth potential in that market.

Given the market backdrop of heightened volatility and fear, we thought it might be timely to provide some further insight into our current mindset and approach. Firstly, and most importantly, it is unchanged – as it should be. We don't deviate from our process simply because the market mood moves from one of greed to fear, or vice versa. We invest in companies that meet our investment criteria and offer the most compelling potential risk-adjusted returns. We don't invest in "the market" nor do we engage in the futile activity of trying to predict market direction in an attempt to game the system.

In our humble opinion, the liquidity of listed markets, while beneficial for minimising the cost of transacting and obtaining access to capital, actually drives a lot of irrational behaviour. As an example, if we bought into a private company which met our investment criteria and was attractively priced, it would be illogical to sell out of it six months later simply because the price of similar assets had started to decline amid a growing view that economic activity might have temporarily peaked. Furthermore, we would then be sitting on that cash earning a paltry return awaiting our opportunity to buy it back from the subsequent owner at a cheaper price, presumably once we believe that the economic outlook has improved. Perversely, this assumes that the new owner would sell to us at a lower price than what was paid during a period where the outlook was inferior – unlikely!

In reality, investors selling their shares during a correction are doing so because: (1) they knew they were probably paying an excessive price for their shares, in which case they were punting based purely on momentum; or (2) they need to gratify their emotional response to watching the price (not value) of their investments rapidly decline, with a view to buying back in at lower prices when the market has bottomed and the outlook has improved (as per our example above). Unfortunately no one has yet worked out how to pick the top and bottom of market cycles, but it will never stop people from trying.

From our perspective, the market only influences our behaviour to the extent that it offers either more, or less, companies at attractive valuations, as well as the magnitude of the upside on offer. Given we adopt a concentrated strategy that focuses on industrial micro and small caps, of which there are literally hundreds, we will rarely face a situation where there is a lack of suitable opportunities. During the past 18 months, we have sold out of various stocks due to our view that their share prices had exceeded a reasonable estimate of fair value. However, we were still able to find alternative opportunities which met our investment criteria and offered attractive risk/reward characteristics. The only change was that in a couple of instances we found ourselves moving lower in terms of market capitalisation, which is an advantage a smaller fund like ours can exploit. Hence, while in our view the market was starting to overpay for some of the more prominent and liquid growth companies in the first half of 2018, the trend certainly hadn't become universal.

Company in focus: Audinate Limited (AD8)

AD8 is the leading provider of professional digital audio networking technologies to Original Equipment Manufacturers (OEMs) globally. AD8's Dante platform distributes digital audio signals over computer networks and is designed to bring the benefits of IT networking to the professional Audio Visual (AV) industry, which is largely distributed on legacy point-to-point analogue technology. Dante's core products are chips, cards and modules which are then integrated within OEM AV products that are sold worldwide.

In simple terms, AD8's patented Dante platform enables the use of standard Ethernet cables to connect AV devices in an audio network, displacing expensive analogue cables. AD8's solutions are utilised across thousands of installations within the professional AV market, which includes Corporates, Venues, Government/Military, Education, Retail, Hospitality, Healthcare and Residential. The key benefits of audio networking vs analogue audio systems include improved sound quality, reduced cabling and increased flexibility.

Dante has a clear market leadership position with >80% market share (within digital) and net new share for products released with audio networking technology of >95%. The Company is building a significant moat via OEM partnerships with tier one AV manufacturers (e.g. Bosch, Bose, Harman, Roland, Shure, Sony, Symetrix, Yamaha – also a 10% shareholder in AD8) which are licensing its Dante technology across their suite of products. Importantly, AD8 currently has 25 patents, with a further 13 applications filed, in the key markets of USA, UK, Germany and China.

AD8's growth strategy comprises of: (1) enhancing network effects by increasing the number of OEMs adopting the Dante technology (currently c.450 vs total opportunity of >2,000); (2) increasing the adoption of Dante across an existing OEM product portfolio (currently c.1,650 Dante-enabled products, up from 288 in 2014, potential is >200k); (3) releasing new software/hardware products to its OEM and AV integrator network (e.g. Dante Domain Manager, Adaptor products, Broadway chips etc); and (4) diversifying into new AV opportunities including Video networking (>$400m market opportunity).

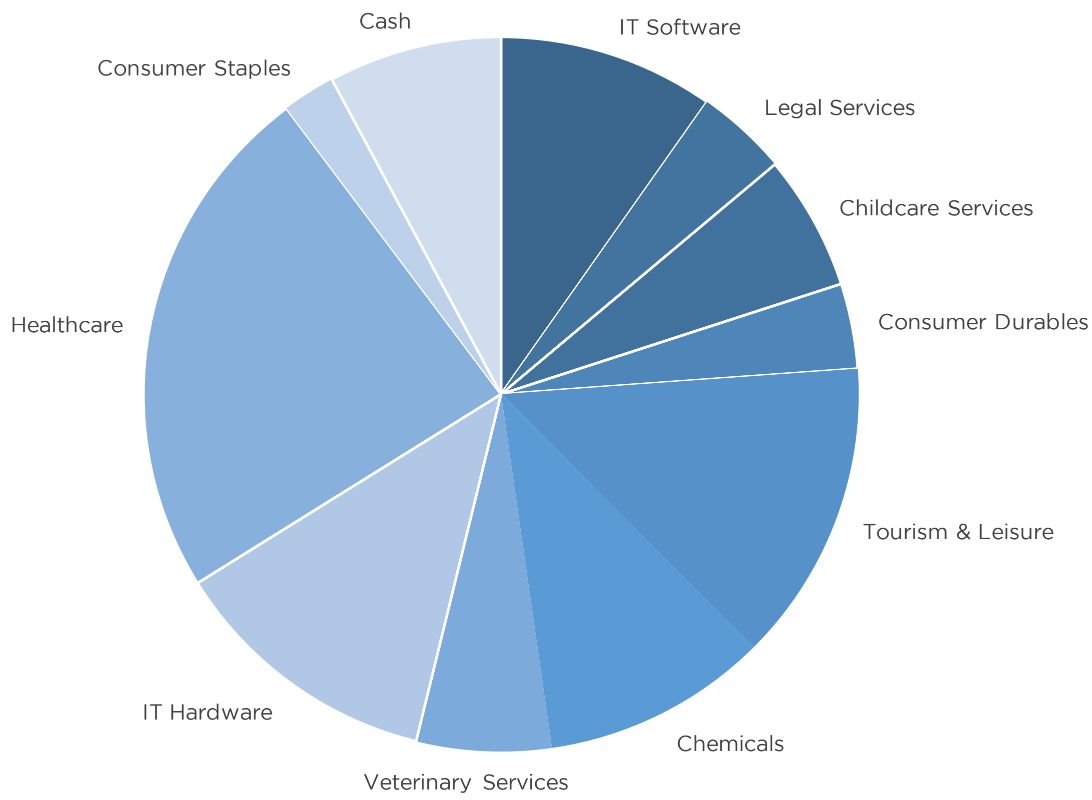
Apart from the obvious strategic value of AD8's technology, we are also attracted to its core business metrics. AD8 achieves high gross margins (c.75%) on its product sales, of which 99% are in USD vs only 25% of its opex in USD, so the weakening AUD is a strong tailwind. Furthermore, AD8 is already modestly EBITDA positive with significant potential earnings leverage as its sales continue to grow (we estimate its FY17-22 revenue CAGR will be >30%). Given much of AD8's growth can come from the rollout of Dante across the full AV product suite of existing OEM partners, we see the risk around AD8's sales growth as relatively low vs many other technology companies.

We first acquired a position in AD8 in August 2018 as part of a sell-down by its early stage venture capital partners at $3.50/share. Since then the XECAI has declined by -16% while AD8 is still trading slightly ahead of our entry price, albeit we certainly didn't buy it as a short-term trade. Assuming AD8 can reach 20% share (5% currently) of the entire addressable Audio market within the next decade (we have ignored the Video opportunity for now), with a long-term gross margin of 70%, then we arrive at a DCF valuation of $5.10/share. AD8 is also net cash ($12.8m as at end of 1Q FY19) and appears highly unlikely to require any further external capital to fund its growth outlook.

The challenge for many investors looking at AD8 would be its near-term capitalisation metrics, which at FY19 EV/Sales of 8.7x and FY19 EV/EBITDA of 92.6x, are eye-watering to say the least. However, based on our forecasts, within three years both of these metrics will be at a far more palatable 4.8x and 14.5x respectively. Importantly, the risk around AD8's near term earnings growth pathway to achieve these metrics is low given the OEM partnership model outlined above, where much of its growth will come from in-fill penetration of existing licensing relationships as they roll out Dante across more of their products to capitalise on the switch away from analogue within the Audio market.

Portfolio characteristics

We currently have 92% of our capital invested in 14 stocks, with no additions or removals since November. The only changes we made were rotating some cash out of those stocks which have performed strongly of late into those offering more compelling relative value.



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

Kind regards,

Jonathan Collett

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Important Information