Emerging Companies Fund

Monthly Update: February 2020

Dear Fellow Investors,

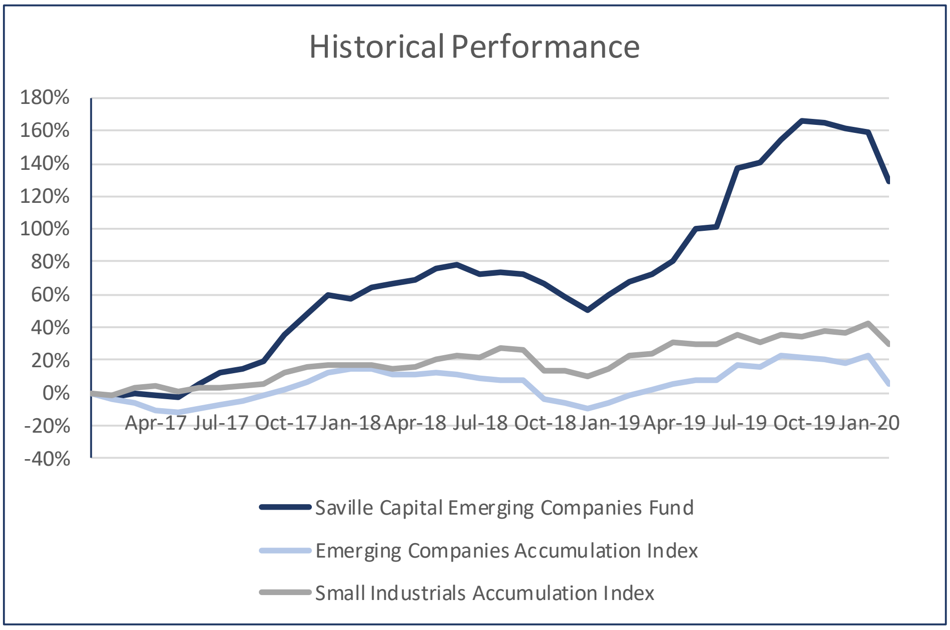
Our Emerging Companies Fund was down -11.7% in February vs -14.1% for the Emerging Companies Accumulation Index (XECAI) and -8.4% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +129.1% (assuming distributions are reinvested) vs +5.3% for the XECAI, +30.0% for the XSIAI and +13.4% for our cash-based benchmark.

As a starting point, we would caution investors against reading too much into our performance during February, either positively (which would be difficult) or negatively, as this was no orderly rebasing of earnings forecasts or equity valuations, nor was it specific in terms of correctly identifying those companies most exposed to the potential economic impact of the coronavirus (COVID-19). In our view, the pace and severity of the decline was fuelled by panic, deleveraging and liquidity (or lack thereof), which was particularly evident in our target market of microcaps, which are often dominated by retail investors who react to media headlines. While this always creates opportunity, we must accept that in the short term, it can lead to irrational share price action across stocks we already own (not just those we don't). The market action we observed during January did suggest that a degree of complacency had set in, so it was never going to respond well to a negative surprise. We expect a more rational market for stocks will resume once the current panic reverts to uncertainty, something equity investors must live with every day, whether it be a global virus, a simmering trade war or a crisis we never even considered possible. So from our perspective, the only significant change that has occurred is the way the market is pricing risk, which generally leads to opportunity for those who have surplus cash and an investment horizon longer than six to 12 months – which includes our Fund.

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%		
2019	+6.0%	+4.8%	+3.1%	+4.7%	+10.8%	+0.6%	+17.6%	+1.4%	+6.1%	+4.6%	-0.8%	-1.3%	+73.2%		
2020	-0.6%	-11.7%											-12.2%	-13.4%	+36.9%

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



Performance commentary

There were no positive contributors for February, albeit Terragen (TGH, flat) and Shine (SHJ, -1.1%) were the standout performers in a relative sense. There is little point listing the key negative contributors as everything else in the portfolio experienced material, if not significant, declines.

In terms of giving our investors some insight into our behaviour during these times, apart from trimming our position in PBH back to its desired weighting before the market correction hit (at prices between $5.50 and $6.00), we didn't sell another share in any of our stocks during the month. Conversely, during the correction we took the panicked selling of others as an opportunity to increase holdings in some of our stocks at attractive prices, as well as add a new stock to the portfolio that we had been monitoring. It's important to bear in mind that we consider ourselves owners of the businesses in which we invest, not share price speculators. So apart from when an existing investment exceeds our view of its fair value or we need to trim to manage an excessive portfolio weighting due to strong share price performance, we only sell shares when we come across information which undermines our investment thesis or implies a fundamental change to the company's long term earnings outlook (not just the next six months). This makes it easy to accumulate (where appropriate) in times of panic or weakness, while conversely trimming our exposure when the market becomes euphoric about the prospects of those companies we own.

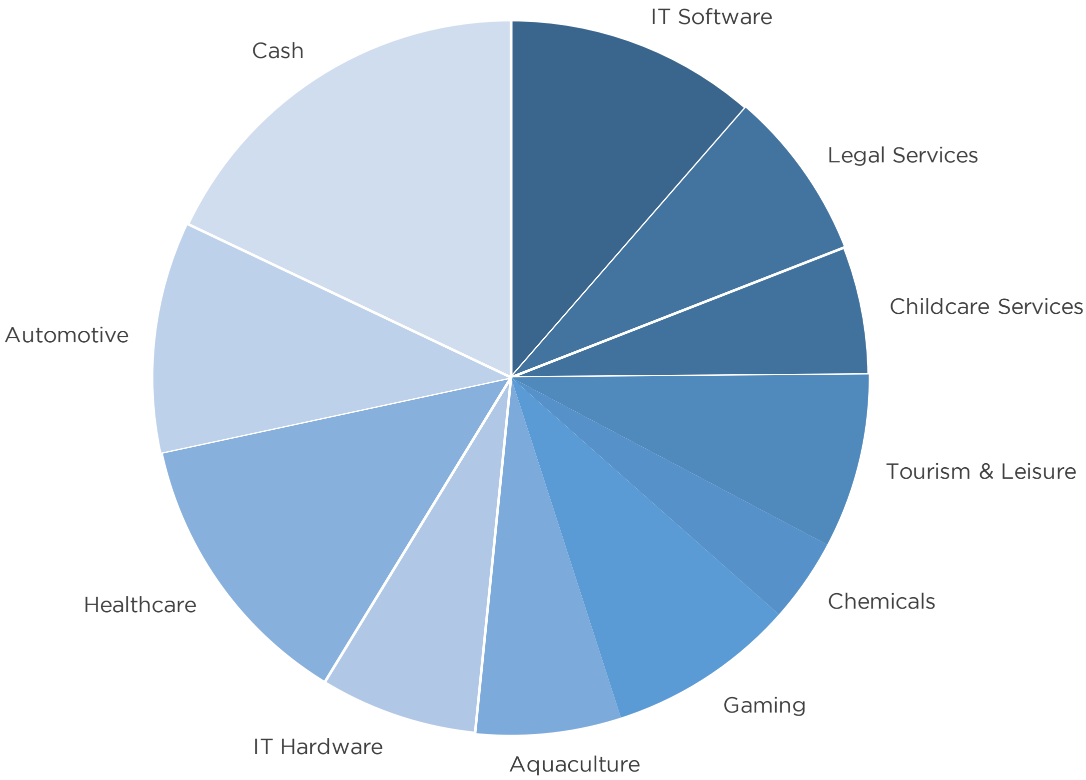
Nonetheless, it is worth outlining how the portfolio is positioned to weather the COVID-19 storm, to provide some additional comfort. Firstly, perhaps the most important attribute a company can have during a short-term crisis (if we can call it that) is a solid balance sheet. We currently have 13 stocks in the portfolio, 10 of which are net cash including seven that have raised capital in just the past six months and the remaining three with no obvious capital requirements in the next 12 months, if at all. This is a very important distinguishing feature when assessing which companies could be most affected during a short-term shock to both the economy and capital markets. Of the three companies we own that do have some debt, being Tourism Holdings (THL), Think Childcare (TNK) and Shine (SHJ), fortuitously the first two both raised capital in the past 12 months to reduce debt to sufficiently modest levels, while SHJ already has relatively limited debt and is on track to eliminate most of it within the next six months from the Mesh case settlement. Therefore, across our portfolio, we don't foresee any situation where there will be an emergency capital raising or onerous debt refinancing.

Furthermore, we see minimal potential earnings exposure to the COVID-19 containment measures amongst our portfolio companies. This is largely by design given our attraction to buying long term, structural (as opposed to cyclical) growth stories. The only company that could be materially affected is THL given the reduced international travel that will occur while attempts are made to contain and avoid exposure to the virus. We don't expect it to affect domestic demand for campervan rentals in its key markets (NZ, Australia and US), in fact it might be positive, but clearly international demand (particularly from China) will take a short-term hit. Importantly, THL has the capacity to deal with these short-term headwinds given its robust balance sheet and ability to manage its fleet size through increased used vehicle sales and reduced manufacturing of new vehicles. However, even if we allow for an 'Armageddon' style scenario in which THL's FY20 NPAT falls to zero (note that it generated NZ$13.1m of NPAT in 1H and reiterated FY20 guidance of NZ$24m at the end of February), but keep our forecasts unchanged from FY21 onwards, our DCF only declines by ~5% to NZ$4.30 (vs current share price of NZ$2.60 and a share price decline of 17% in February alone). So, with that in mind and an FY21 P/E of just 12x, we continue to use weakness in THL's share price to increase our holdings.

In terms of stock specific news flow, the only companies to report which hadn't recently updated the market on their progress were SHJ and IDT. Both companies reported pleasing results, particularly SHJ which continues to execute on its strategy of increasing its cash conversion of earnings via the use of external litigation and disbursement funding. This not only leads to a higher dividend payout ratio (note that the interim dividend was up 20% on pcp) but also a better return on its funds employed. We remain attracted to SHJ given its improving cash flow and return metrics, combined with steady revenue growth, rigorous cost control and potential for accretive acquisitions funded by the significant amount of cash it should receive following the conclusion of the Mesh case. Meanwhile, IDT achieved positive EBITDA (up from a loss in the pcp) and looks poised for a period of significant revenue and earnings growth, and sustained profitability as it ramps up its commercial scale medicinal cannabis manufacturing and develops a proprietary product/partnered product portfolio.

Portfolio characteristics

We currently have ~82% of our capital invested in 13 stocks.



Please get in touch should you have any queries regarding the above. Thanks again for your interest and support and I look forward to providing another update in early April on our performance during March.

Kind regards,

Jonathan Collett

Principal

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