Emerging Companies Fund

Monthly Update: March 2020

Dear Fellow Investors,

Our Emerging Companies Fund was down -28.4% in March vs -30.7% for the Emerging Companies Accumulation Index (XECAI) and -23.3% for the Small Industrials Accumulation Index (XSIAI). Since inception the Fund is +64.0% (assuming distributions are reinvested) vs -37.1% for the XECAI, -0.3% for the XSIAI and +13.7% for our cash-based benchmark.

The panic selling that started in late February accelerated into March, fuelled by exponential growth in the number of COVID-19 cases across the globe and the increasingly strict containment response of Governments. All of this culminated in a mass liquidation event, with many investors selling equities because they either needed cash to replace lost income, were being forced to reduce debt/margin loans or were switching to cash for fear of experiencing further (unrealised) losses. It was the perfect storm for equity markets, and especially for a Fund such as ours. However, we deliberately operate in the segment with the least liquidity and the most influence of retail investors, as they are more likely to follow the trend than seek to understand the earnings, balance sheet and valuation impacts of containment measures on those stocks they own, let alone the cyclical and structural shifts that will follow. As such, with this crisis has come opportunity and we are determined to capitalise on it. Consistent with that approach, we deployed almost $7m of cash into some existing and new positions during the month. While we still ended March with a 10% cash weighting, this is deceptive given the decline in the overall portfolio. Nonetheless, with so many attractive long-term investment opportunities emerging, we do wish to retain a healthy cash balance so we can act swiftly in what has become a very dynamic market that will substantially reward insightful and decisive behaviour.

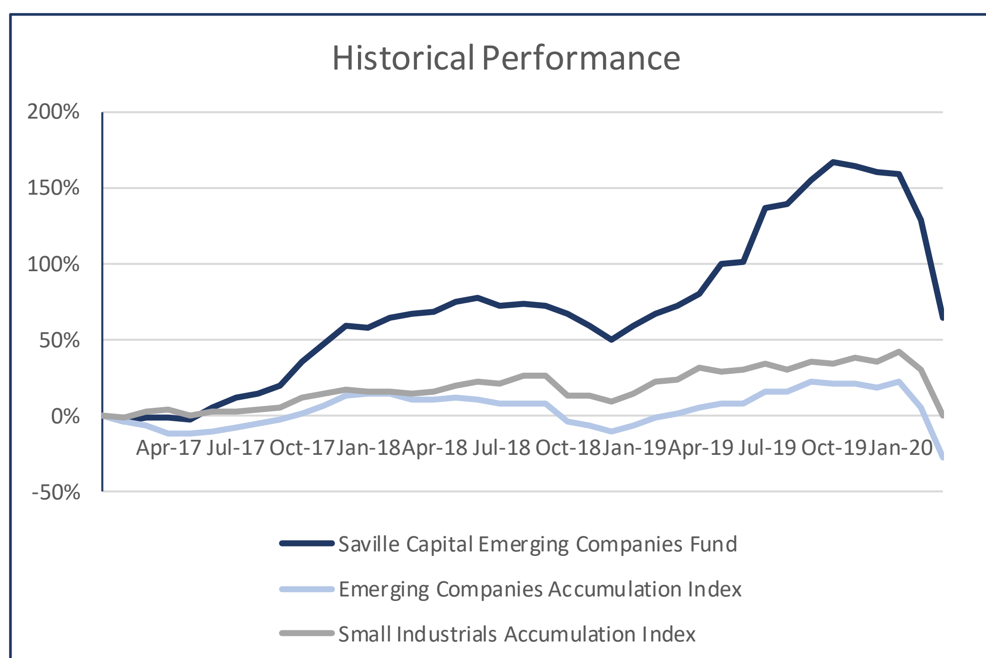
Further to that, we have decided to re-open the Fund for a short period of time to allow for additional new investment. While we understand that many existing investors will be struggling to process the sharp and significant decline in the value of their investment in the Fund (and any other equity investments held outside of the Fund), and will naturally baulk at adding further exposure, we still think it is sensible to offer the opportunity. We can’t control what has occurred in the past five weeks, but we can control how we respond to it and we think this is a great time to deploy surplus cash. Rather than aggressively sell positions to build cash during a crisis (by the time it starts, it is generally too late), we would rather deploy existing cash and any additional cash raised (up to a cap of $10m) to capitalise on the irrational behaviour of the herd. To that end, I have materially increased my own investment in the Fund, not only because I see it as a great opportunity to earn a high return on that incremental capital, but also to demonstrate to existing investors that our interests remain aligned and I firmly believe in the Fund’s future performance potential. Prior to 2020, the Fund had achieved some outstanding results and it is important to reiterate that the investment strategy, process and investment criteria behind those results is unchanged. That is not to guarantee a repeat of that level of performance, but instead to put the last couple of months into context and avoid focusing too heavily on recent events or the immediate outlook, as difficult as that might be right now.

We don’t believe we have superior insight into the near term global economic or market outlook, but we do have great insight into the companies we own and their outlook. Due to the concentrated nature of our Fund, we have been able to meet or speak with the management teams of each company we own in the past month to increase our understanding of how they are positioned to not only weather the crisis, but also capitalise on the opportunities that will inevitably come from it. This process, along with our own independent research, gives us great comfort that no matter what the market does in the short term, our invested capital should grow via these investments in the medium to long term. Furthermore, we do have strong views on how we think society will evolve during and after this crisis, and as such we are adding exposure to those companies (both existing and new) that we think stand to benefit the most from the structural changes which will occur in its aftermath. In summary, as a relatively small and concentrated Fund, we are using its agility to our advantage.

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%	-28.4%										-37.1%	-37.1%	-4.9%

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



Performance commentary

There were no positive contributors for March, albeit Murray Cod (MCA, -4%) and IDT Australia (IDT, -4%) were the standout performers in a relative sense. Everything else in the portfolio experienced material, if not significant, declines. In fact the uniformity of the declines across the portfolio (and broader market) does highlight that the selling remains less about which companies are most exposed to the impact of containment measures, and more about investor psychology and behaviour, and the necessity of many investors to liquidate at whatever price is available for that level of volume.

In terms of our current portfolio, the stock that has been hit the hardest is, unsurprisingly, Tourism Holdings (THL, -56%). Interestingly, if you think that selling THL at the start of March would have been the right course of action, it is worth noting that it declined from NZ$2.49 to NZ$0.55 (i.e. -78%) in the space of just 16 trading days, reaching its bottom on 23 March and then almost doubling by 31 March to end the month at NZ$1.09. During the month, <10% of the shares on issue were traded at a VWAP of NZ$1.35. So unless you had the luxury of only owning a few shares and didn't want to absorb any short term 'unrealised' loss for potential long term 'realised' gain, the velocity of the price decline meant that exiting with the herd hasn't yielded significantly better results than if you had held the stock throughout. We are certain there would be many examples just like this. The bottom line is that unless you are of the view that the Company you own won't survive this crisis, or has a structurally impaired future in the aftermath (of which there are many, albeit none that we own), then selling (in size) amid the panic and crystallising those losses hasn't necessarily been any better than holding across the month. Meanwhile, you have eliminated any exposure to the potential rebound.

The earnings impact of COVID-19 on THL is obvious given that the lockdown has now halted almost all international and domestic travel in their primary markets (NZ, Australia and the USA). While THL is earning some revenue via the hiring of its campervans as mobile testing units, for self-isolation or critical care workers, this will be modest when compared to the lost revenue from tourism. In response to this, THL has cancelled its interim dividend, reduced labour expenses by ~60% over the next 12

weeks and deferred most of its capital expenditure. All of these measures are designed to buy THL time before its business can resume its tourism operations. Fortunately, in the likely event that international travel remains restricted for a prolonged period, THL can and will pivot to much greater revenue from domestic tourism, just as it did in the aftermath of 9/11. Furthermore, it can reduce its fleet through the sale of campervans, which has continued during this period. Importantly, THL has over NZ$100m available to it in undrawn debt facilities, over NZ$300m in equity and a supportive syndicate of banks. At current prices of NZ$1.00, THL is trading on 3.7x FY19 NPAT and 3.0x FY19 EV/EBITDA and at a 45% discount its last quoted NTA of $1.83 (this will obviously reduce somewhat if debt is increased to cover losses). Clearly FY20 and FY21 earnings aren't going to match FY19 levels, but beyond that we see no reason why revenue and earnings won't return to normal, and could actually exceed expectations given the behaviour of tourists in the aftermath of COVID-19 may become more biased towards exploring the great outdoors rather than visiting large cities. Hence, in exchange for the risk that the current lockdowns remain in place for over six months and THL is eventually forced to raise equity (a scenario under which we would expect to be able to keep ourselves whole anyway), we believe we are getting a ~25% return on our capital for investing today.

In other news, Carbon Revolution (CBR, -59%) elected to undertake a pre-emptive capital raising of $25m at $1.50, bringing its cash balance to over $50m. This was done in order to ensure it could continue to grow with greater security in relation to funding working capital and securing key raw materials during this period of uncertainty, as well as better positioning the Company to cope with temporary production shutdowns at some of its key customers (e.g. Ferrari and Ford) and the potential for it to have to temporarily halt work at its own production facility. Despite this, and having to withdraw its FY20 guidance, the Company has stated that customer demand remains strong and forward orders are still in place. From our perspective, while the decision to raise more capital so soon after the IPO is disappointing, we must accept that no one could have foreseen these circumstances and as such it was prudent to protect the Company's future rather than be potentially forced into an emergency capital raising six months from now. The value of its intellectual property and customer contracts are unchanged, so we not only participated in the capital raising but bought more as it traded down to below $1 in the aftermath, noting that it closed back at $1.50 at month end.

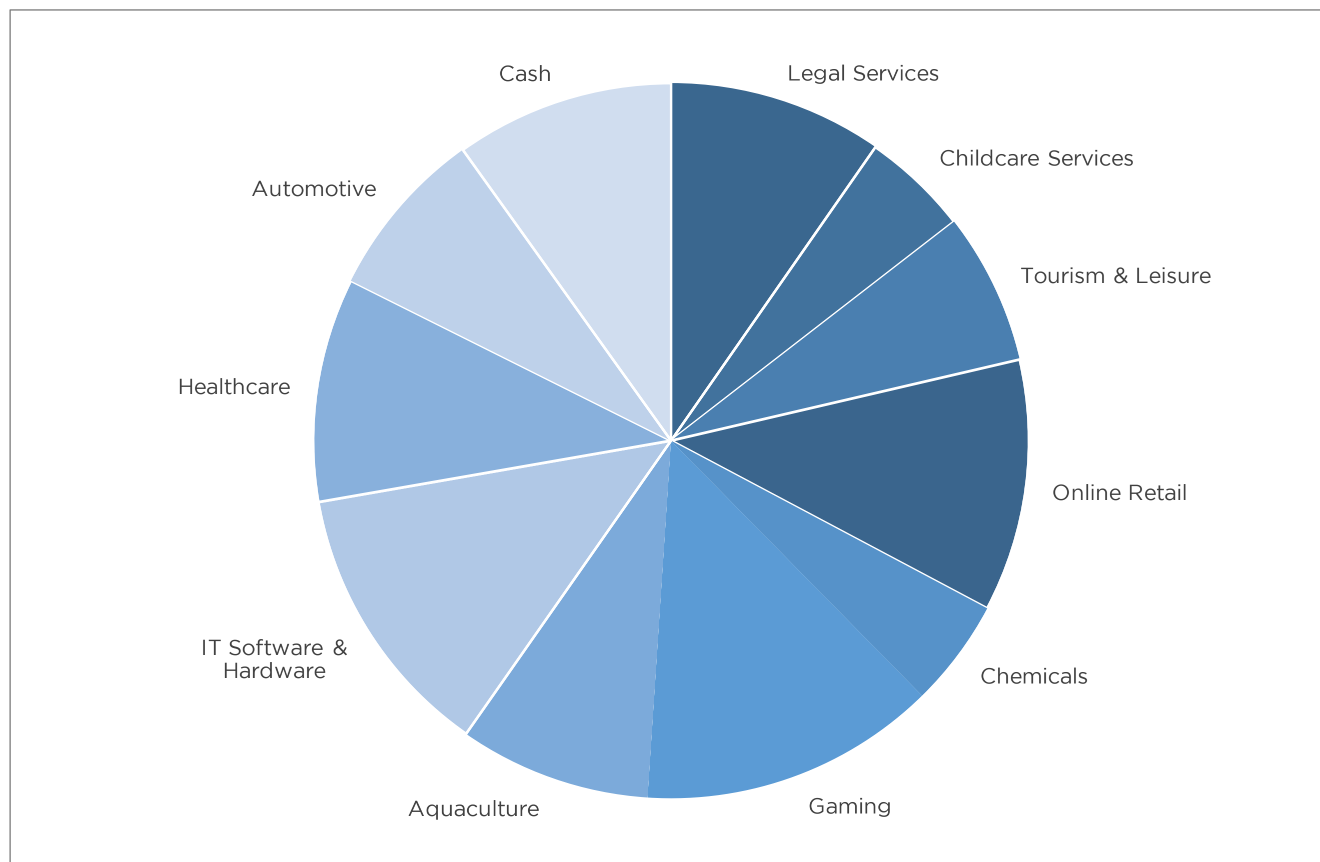
Most of our other companies gave market updates highlighting the impact containment measures are having on their businesses, none of which caught us by surprise. Importantly, we believe that two of our largest positions, Redbubble (RBL, -37%) and Pointsbet (PBH, -37%), are very well positioned given their business models are entirely online and both currently occupy only very modest share of both the online and offline commerce within their respective industries, as well as being net cash with a high proportion of variable expenditure. While there are no guarantees in such a fluid environment, we see this as a very strong starting position for both businesses as we transition into what we expect will be a sustained structural shift to far more commerce being transacted via online channels.

Furthermore, while sales growth for Bluechiip (BCT, -33%) will likely slow again after its 3Q given it doesn't occupy an essential function in a constrained environment for global logistics, we think it is very well positioned to prosper in the aftermath. This is based on the likelihood its key OEM partner (Labcon, US) will benefit from the inevitable bias back towards local procurement within western nations, particularly medical and pharmaceutical, as well as an increased focus on process integrity in those industries, which BCT can help facilitate. Further to that point, we believe that IDT is very well positioned to benefit as an FDA and TGA approved GMP pharmaceutical manufacturing plant with significant excess capacity, based in Melbourne. IDT has previously manufactured drugs for global pharmaceutical companies such as Pfizer, but much of this work was lost about a decade ago when there was a seismic shift of pharmaceutical production to lower cost countries such as China and India, exacerbated by the strong AUD. However, while IDT has pivoted towards medicinal cannabis manufacturing, its pharmaceutical expertise and capacity is unchanged. In the meantime, the stock continues to trade at or near NTA, which largely comprises of cash plus industrial land and buildings.

Finally, one stock we have recently added to the Fund, Micro-X (MX1, -29%), has become a direct and immediate beneficiary of the COVID-19 pandemic as it manufactures mobile, lightweight battery powered X-ray machines that are now being ordered by hospitals across Asia and Europe to help detect pneumonia. While we haven't invested in MX1 for the short term uplift in sales, as an early stage business that is seeking to disrupt the market, this is a great opportunity to accelerate product adoption and awareness, leading to significantly increased sales and market share into the future.

Portfolio characteristics

We currently have ~90% of our capital invested in 14 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 May on our performance during April.

Kind regards,

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