Emerging Companies Fund

Monthly Update: June 2020

Dear Fellow Investors,

Our Emerging Companies Fund was up +14.1% in June vs +1.3% for the Emerging Companies Accumulation Index (XECAI) and -2.3% for the Small Industrials Accumulation Index (XSIAI). Note that we are paying a final distribution of ~17.2 cents/unit for FY20. Since inception, the Fund is +173.1% (assuming distributions are reinvested) vs +5.6% for the XECAI, +20.5% for the XSIAI and +14.5% for our cash-based benchmark. On an annualised basis, the Fund has generated a return of +34.2% p.a. since inception.

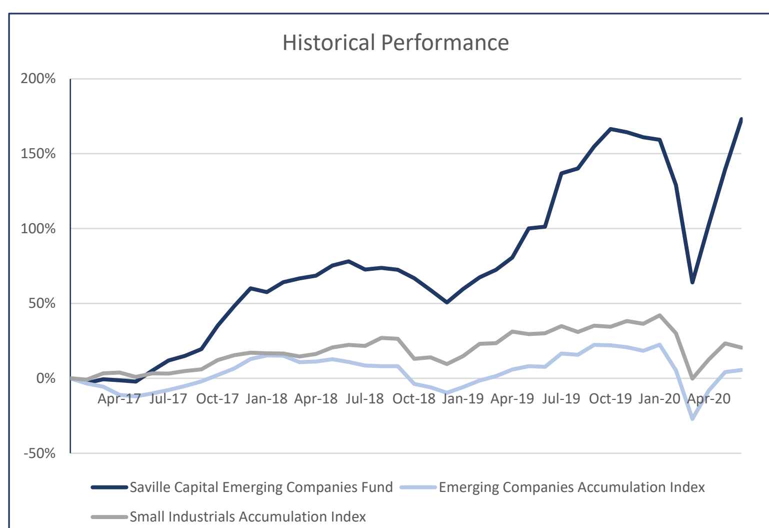
While market volatility persisted in June, with a mild positive end result, our Fund again generated very strong performance given its exposure to some key short and long-term structural winners arising from the effects of the pandemic on human behaviour/habits. As we have previously mentioned, the Fund was already exposed to some of these stocks prior to COVID-19 given our desire to own structural growth stocks, but forced and/or voluntary lockdown has helped to accelerate some of these structural trends. Fortunately, the market was slow to identify a lot of the beneficiaries and we were able to add to existing positions (at very low prices) as well as establish new positions, all of which have generated significant value for the Fund in recent months and continue to do so.

Nonetheless, we would caution investors against extrapolating our recent relative and absolute performance. This is a unique environment with considerable volatility and uncertainty, so while we remain agile and alert to the opportunities, we must also be cognisant of the risks that still face our (and any) investments. That said, we much prefer these conditions to those of late 2019, where compelling opportunities were more difficult to find in an increasingly benign environment for industry and the broader economy.

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%	+23.3%	+18.4%	+14.1%							+4.6%	+66.5%	+35.7%

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



Performance commentary

The two key positive contributors for June were Marley Spoon (MMM, +68%) and Redbubble (RBL, +66%). The two key negative contributors were Bluechiip (BCT, -23%) and Catapult (CAT, -21%). Without the strong index tailwind of the prior two months, we saw far greater dispersion of share price performance among the stocks we own. In particular, we think tax loss selling played a role in some of the ongoing weak performance among our less liquid positions.

RBL delivered an impromptu trading update during the month, announcing that as at 22 June its marketplace revenue growth was +107% on pcp for the 4Q FY20 to date. Furthermore, it generated operating EBITDA of $11.9m up to 31 May 2020 (up 101% on pcp), with a cash balance of $56m at that date. All of these were well ahead of consensus expectations and led to substantial earnings and valuation upgrades among the brokers. Given that RBL was clearly the largest position in our Fund as we entered June, it is fair to say we were expecting it to outperform market expectations at its next quarterly result, however even we were surprised by the magnitude of this upgrade. Based on our own channel checks (e.g. web traffic data and capacity upgrades by fulfillers), we thought revenue growth of at least 50% for the quarter was possible, but we never contemplated >100%. It was also pleasing that RBL has formally committed to a reorganisation which will generate $5.6m in annualised savings from what we have long considered to be an inflated cost base. Despite the consequent surge in its share price, we still think RBL represents compelling value based on a range of relative and absolute valuation metrics. We expect that demonstration of a sustained shift in the size and profitability of its business over the next six to 12 months will see it re-rate towards the significantly higher trading multiples of its key local and offshore peers.

Tourism Holdings (THL, +12.5%) announced that it expects to report underlying NPAT of NZ$17.5m to NZ$19m, which was well ahead of consensus expectations. The market had expected THL to report a significant loss in 2H FY20, however this guidance suggests that it will still generate a modest underlying profit in 2H. This has been driven by strong vehicle sales performance, particularly in the US, which has had the added benefit of reducing its expected net debt position to NZ$140m to NZ$145m (vs previous guidance of NZ$165m to NZ$175m). Finally, THL received commitments from its banking partners for debt funding of approximately NZ$225 million, consisting of a number of tranches maturing between September 2021 and July 2022, therefore ensuring that it does not require any additional equity. While THL continues to face challenges posed by various border closures and lockdown measures, we remain of the view that it is well positioned to navigate its way through, and out of, this crisis better than most operators in the tourism industry, which isn't being appropriately reflected in its share price.

Think Childcare (TNK, +0.0%) provided a trading update in early June noting that its attendance across the Group is now 64% and occupancy is 74% (albeit effective paid occupancy is 80% once it accounts for Government transition payments). Despite the potential for a temporary return to remote learning in Melbourne schools, we continue to expect that TNK will demonstrate earnings resilience in the face of the COVID-19 crisis. It also announced that its development arm, TND, has acquired six purpose-built Nido services for $5m (currently operating at 40% utilisation), with funding also now secured ($11.5m) to execute on its development pipeline of 24 services over the next 18 months.

In early June, Micro-X (MX1, -3.6%) announced that it has now formally submitted the Rover (to be deployed in military hospitals) to the FDA to go through its 90-day review process. Once FDA approval for the Rover has been obtained, which it expects later in 2020, MX1 will begin commercialisation via the Company's direct sales channel, allowing for greater control of the sales processes and superior product revenues and margins by not using distributors. MX1 plans to also seek CE Mark and TGA registration within the next 12 months to enable commercial access to the European Union and Australia.

Company in focus: Marley Spoon Limited (MMM)

Marley Spoon (MMM) provides subscription-based weekly meal kits across eight countries comprising of Australia, USA Austria, Belgium, Denmark, Sweden, Germany, and the Netherlands. It is currently only one of two companies that has global scale in the meal kit industry, the other being Hello Fresh. As of 31 March 2020, MMM had approximately 240,000 active customers across its two brands, Marley Spoon and Dinnerly (which offers cheaper and more family friendly meals). In the US, it has a partnership with Martha Stewart to enhance its brand recognition. The Company was founded in 2014 and is headquartered in Berlin, Germany. It has now developed over 26,000 different recipes and offers a vast array of meals for its customers to choose from each week. Importantly 92% of MMM's revenue in CY19 was from repeat customers and management estimates that it generates less than 4% churn on customers that order more than six times with them.

While MMM has been a clear and ongoing beneficiary of lockdown due to COVID-19, what principally attracted us to the business was that it was already demonstrating significant growth (CY19 Net Revenue +41%) and operating leverage due to a structural shift towards online grocery shopping and convenience. So while the onset of lockdown across many of its markets in March and April saw this growth rate accelerate to >100%, it already possessed some of the key characteristics we seek in potential investments.

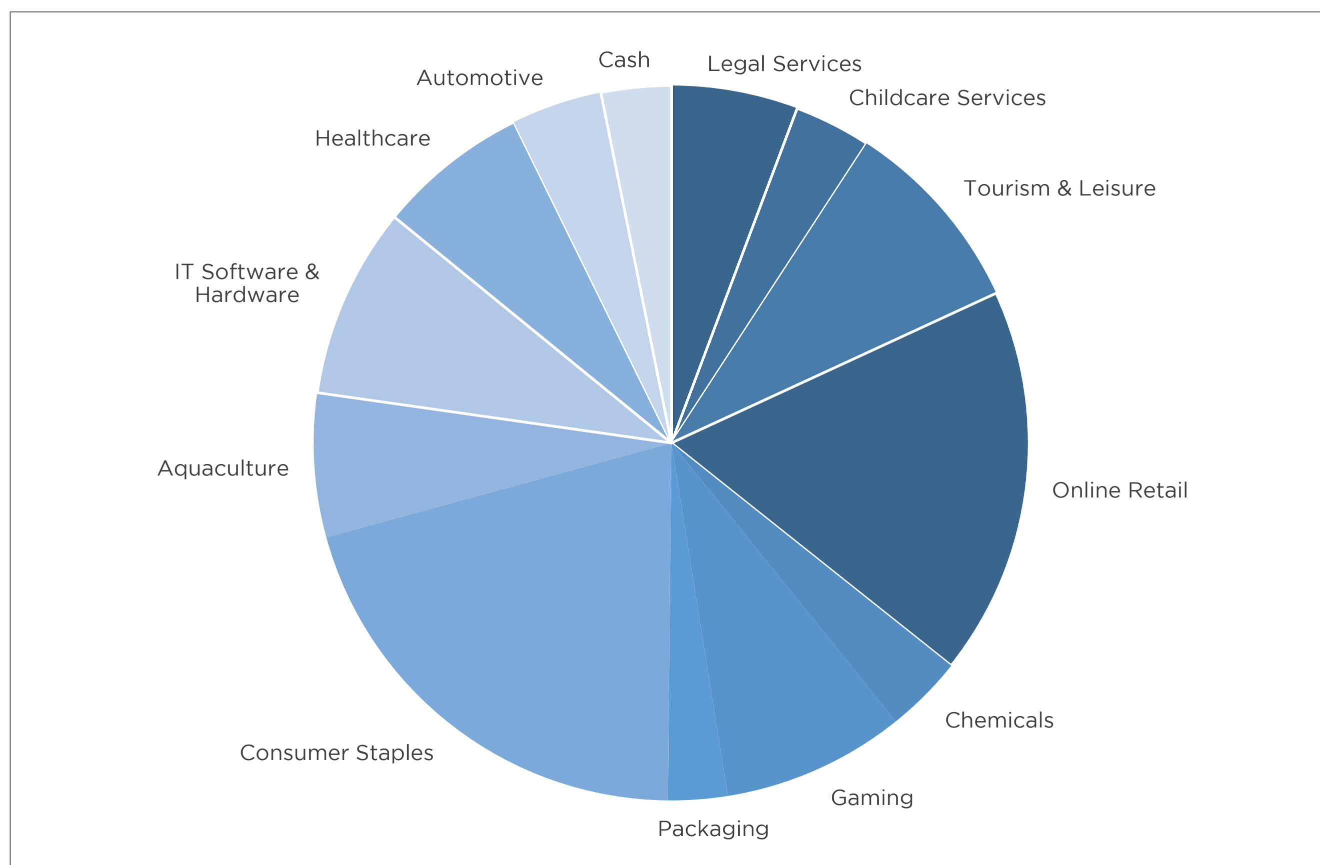
Our previous concern had been the length of time and amount of funding that may be required for MMM to reach cash flow breakeven, however the onset of COVID-19 effectively addressed that issue in the space of just one quarter. Further to that, it has positioned MMM to capitalise on a much cheaper advertising landscape (customer acquisition costs have substantially reduced), as well as an environment where we believe consumers are permanently changing habits, not just for a few weeks. Our view is that if lockdown forces a change in consumer behaviour that results in an inferior customer experience, then a habit will not be formed. But given that weekly meal kits offer a superior shopping and dining experience for a significant cohort within the community, as well as competitive pricing, we believe that this event has merely accelerated a structural shift that was already well underway. Importantly, meal kits is an industry in its very early stages that is tapping into the enormous global grocery market, as opposed to trying to lure customers away from restaurant dining. This is supported by the fact that Woolworths has invested capital (debt and equity) in MMM and has a partnership agreement which gives MMM access to its supply chain and rewards customer base.

In 1Q CY20, MMM generated Net Revenue growth of +46% on pcp and a Contribution Margin of 29.5%, up 5 percentage points on pcp, demonstrating significant operating leverage. It has now forecast to become both EBITDA and cash flow positive in 2Q CY20, not only removing the reliance on equity markets to fund its growth, but also giving it greater flexibility with regard to its level of investment in acquiring new customers. Our view is that its recent growth rate of ~100% not only has the potential to increase further, but will be sustained at these levels for longer than the market anticipates. While some of the increase will unwind as more cities emerge from lockdown and existing customers revert back to ordering 2 to 3 meals per week (instead of 4 to 5), we think the positive network effect of acquiring so many new customers in a short space of time will create its own tailwind as those customers share their positive experience with friends and family (noting that MMM already acquires 30% of its new customers via word of mouth). In addition, MMM's increased advertising presence on recent popular TV programs has been notable, which will help drive further customer growth at a significantly reduced price.

We acquired our initial stake in MMM at $0.72 in early April and added to our position following its 1Q FY20 result later that month. Even at current prices of ~$1.95, we think the stock represents compelling value on relative and absolute valuation metrics. Its key peer, Hello Fresh, trades at a significant premium (>100%) on an EV/Sales and EV/Contribution Margin basis, suggesting that as MMM builds scale and proves that it is now in a position of sustainable positive free cash flow (like Hello Fresh already is), it can close that gap.

Portfolio characteristics

We currently have ~97% of our capital invested in 15 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 August on our performance during July.

Kind regards,

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