Emerging Companies Fund

Monthly Update: July 2021

Dear Fellow Investors,

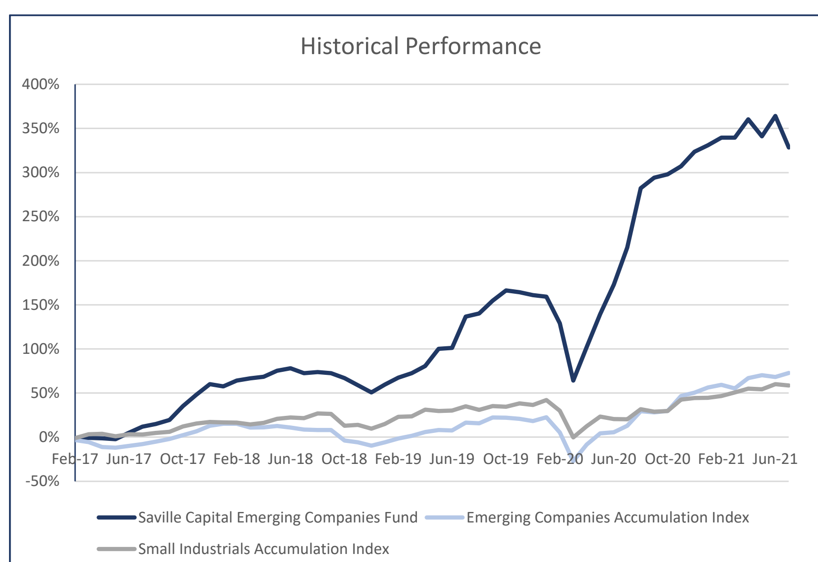
Our Emerging Companies Fund was down -8.0% in July vs +2.8% for the Emerging Companies Accumulation Index (XECAI) and -0.9% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +38.2% p.a. and a total return of +328.5% vs +72.8% for the XECAI and +58.7% for the XSIAI.

July was one of our most disappointing months for the Fund since inception, albeit largely centred around one stock (Marley Spoon, MMM, -31%) and one day (30 July, which was the last trading day of the month). We will go into the results in more detail over the page, but suffice to say that we think the market grossly overreacted to one quarterly result. As most of our investors will know, we have seen this before with other stocks we have held in the portfolio, most notably Redbubble (RBL), and no doubt we will see it again. Unfortunately, when you invest in companies that are still endeavouring to prove their ability to generate sustainable positive cash flows, the market is highly sensitive to perceived changes (even when minor) in their likelihood, timing and quantum. In our view, this often reflects a lack of detailed understanding of the business models which then manifests itself in wild fluctuations in the level of conviction many investors have towards these stocks. However, it is this dynamic which is one of the key reasons why we invest in microcaps, and particularly companies that exhibit these qualities. If you have the expertise to identify great business models that will eventually generate significant positive cash flows, before the market has seen sufficient evidence to price them correctly, then you are often able to invest at well below their discounted fair value. The price we pay for our approach is interim share price (and Fund performance) volatility.

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%	+16.0%	+20.7%	+3.1%	+1.0%	+2.3%	+4.0%	+62.3%		
2021	+1.9%	+2.1%	-0.1%	+5.0%	-4.4%	+5.5%	-8.0%						+1.2%	-7.2%	+35.3%

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



Performance commentary

The three largest positive contributors comprised Lark Distilling (LRK, +42%), IDT Australia (IDT, +24%) and Terragen (TGH, +5%). The three largest negative contributors were Marley Spoon (MMM, -31%), Murray Cod (MCA, -11%), and Imricor (IMR, -15%).

MMM reported solid 2Q revenue growth (+10% on pcp, +12% constant currency) despite cycling a very elevated comparable period due to higher order values and frequency rates during global lockdowns. More importantly, its Active Subscriber base grew +37% on pcp and the number of recurring customers increased to 70% of revenue (up 5 points on the pcp), giving a clearer picture of underlying growth. Consequently, MMM reaffirmed its guidance for CY21 revenue growth of between +30% - 35% (+36% in 1H CY21). We do note that this revenue growth is being supported by elevated marketing spend (~20% of revenue in 1H vs ~18% in pcp), but this is occurring across the entire business landscape with advertising CPMs (the price of 1,000 advertisement impressions on one web page) consistently higher than the COVID-depressed levels observed in CY20. Nonetheless, management remain very comfortable with the ROI on their advertising spend as they increase customer lifetime value via upselling incremental solutions such as ready-to-heat, breakfast, baking, snacks, and pantry items and minimise churn through an improving customer experience (more targeted meal options). All of this means that MMM continues to achieve an attractive payback period on its marketing spend of around 6 months.

The area of disappointment was the Contribution Margin (CM) of 27%, which was down vs 31% in the pcp (and 28% in 1Q) as a result of continued operational headwinds, especially in its US business. Following on from unprecedented weather disruptions in 1Q, MMM is being impacted by acute nationwide labour shortages which not only directly affected its facilities, but also its inbound food supply and logistics partners. As an example of how this impacts margin, in situations where customer deliveries are delayed (or even missed), MMM will grant free vouchers in order to preserve the customer's level of satisfaction.

Interestingly, recent US data shows that female workforce participation is at multi-decade lows, due to a combination of Government stimulus and the home schooling of children. Clearly these factors are now in the process of unwinding, so while the business impacts are likely to be transient, MMM is implementing a series of measures across the organisation and supply chain to improve productivity and quality, while also increasing prices to regain margin. However, the softer than expected 1H CM forced management to revise its CY21 CM guidance down from 30% - 31% to be in line with CY20 at 29%. In summary, we see CY21 as a transition year where MMM is cycling elevated revenue comps while still dealing with COVID-related impacts on its supply chain. In our view, the structural drivers and trends underpinning our investment thesis remain firmly intact and as such we will continue to begrudgingly accept the volatile journey to what we still expect will be a significantly larger (and profitable) business in the foreseeable future.

MCA reported another solid quarter of cash revenue, up 125% on pcp, albeit lower than 3Q due to a combination of seasonality (lower hatchery sales) and the impact of lockdowns in NSW and Victoria (e.g. restaurant closures). More importantly, the results to date from its trial with Woolworths are very positive and it is in discussions with other major retailers about launching its product into their chilled seafood sections. Furthermore, with the USA and Europe gradually re-opening, MCA is negotiating to re-enter those export markets. Despite the positive trajectory of the business, the MCA share price has recently lost momentum and given its lack of liquidity and breadth of institutional ownership, it is now succumbing to retail selling pressure that can feed on itself for a sustained period until we receive another positive catalyst (e.g. Woolworths trial moves to a longer term contract).

IMR is another key stock in the portfolio which is also suffering from significant selling pressure as the impact of COVID continues to constrain its efforts to sign contracts with more European hospitals and limiting the number of procedures existing hospital clients can undertake using IMR's heart ablation technology. Nonetheless, the Company is still progressing towards purchase agreements with several new sites and is working closely with contracted sites to progress installation, training and the commencement of procedures as COVID restrictions ease. Much like MMM and MCA, we believe the headwinds to executing on their growth plans are temporary in nature and do not

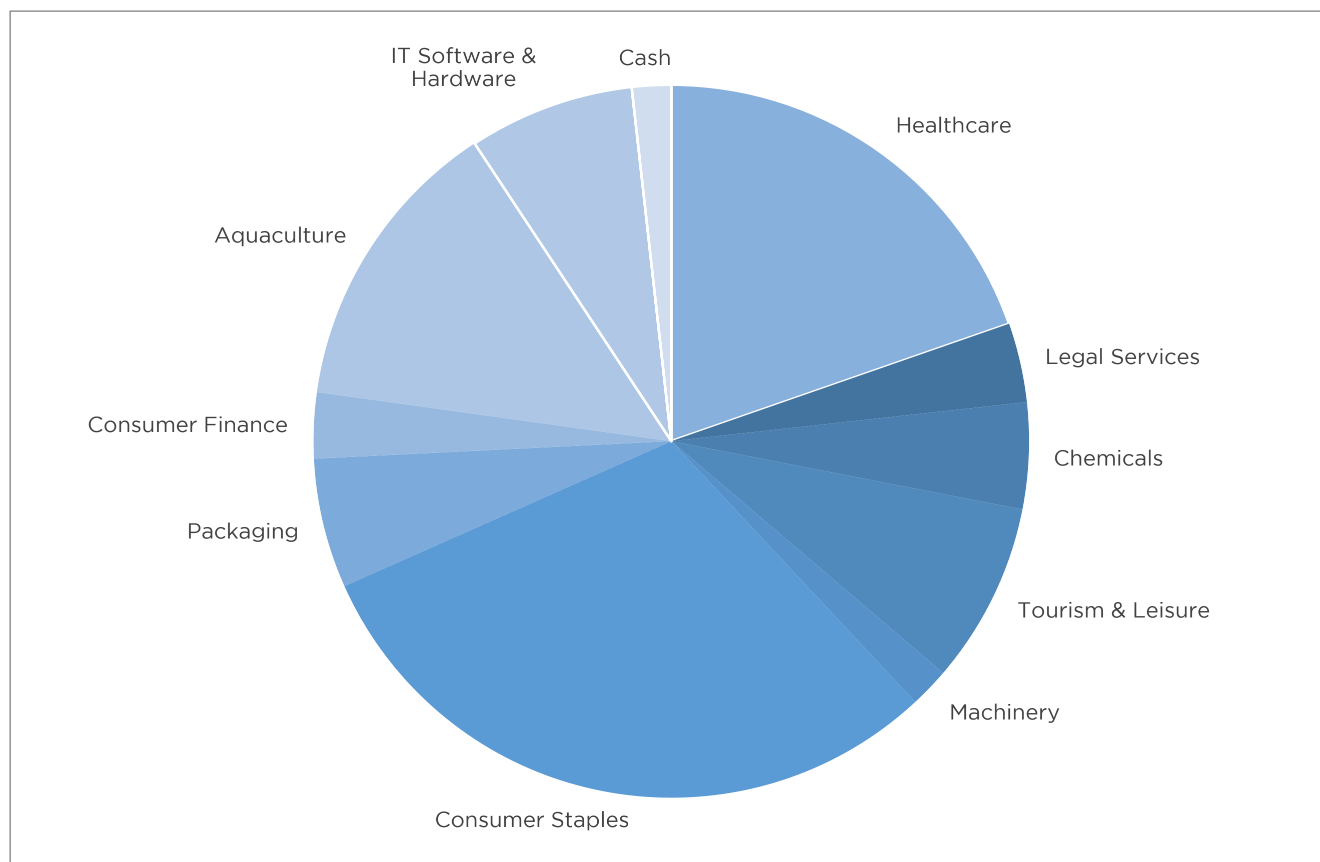
represent a structural change that undermines our investment thesis. That is not to say the delays don't affect valuation, but the impacts are relatively minor and certainly do not warrant taking any action when the share prices are already significantly below our view of long-term value. So while the declines hurt short term Fund performance, we believe it would be irrational to exit these stocks simply because investors with perhaps less patience/conviction have decided to do so.

TGH continues its progression towards eventually becoming a major supplier of biological supplement products to the Australian and New Zealand agricultural industries, with revenue growth of +49% on pcp. Sales of *Mylo* were up 63% compared with the pcp, and +32% on 3Q, reflecting an uptake of 12k mature dairy cows on *Mylo* for the quarter. Conversely, sales of *Great Land* were down by 17% on pcp due to the increased sales focus on *Mylo* and the introduction of *Great Land Plus* from 1 July 2021, which has meant the running down of existing *Great Land* inventories. *Great Land Plus* is a concentrated version of *Great Land* that will deliver better outcomes for both TGH and its customers. Importantly, *Mylo* is generating annual recurring revenue of $1.6m for mature cows, with a churn rate of just 4.6%. This forms a meaningful (and rapidly growing) revenue baseline for the business, which is then augmented by *Mylo* applications to the seasonal calf market in spring and autumn (which accounted for the vast majority of *Mylo* sales in FY20). We remain bullish on the growth prospects for TGH, particularly given it has only penetrated 4.3% of the Australian dairy cow market and is in the process of launching in the New Zealand market, which is 3.5x the size of Australia (thus similar early success over there should push TGH into profitability). Meanwhile, we eagerly await the results of its study with the University of Queensland into the potential of *Mylo* to reduce greenhouse gas emissions which, if statistically significant, could be a game changer for the Company.

In some positive news for the Fund, LRK delivered an outstanding 4Q result, with net sales up 244% on pcp driven by a significant uplift in its average price per litre to $216 (vs $132 in the pcp). This now brings the Net Sales Value of its Whisky Bank at maturation to $239m, with further growth to be driven by a combination of increased production as well as new product initiatives and channel diversification. The Company is now projecting that it will be cash flow neutral over the next 12 months, with internally generated cash flows supporting the continued building of the Whisky Bank. Based on our discussions with management, it still appears that there are many exciting opportunities ahead for this business, both in terms of product development and expanded distribution. As such, despite its significant share price rise since we invested (it is up >300%), we are backing management's ability to continue to execute on their strategy to leverage an iconic brand, creating further incremental value for shareholders and putting it firmly on the radar of global premium liquor businesses looking to add unique brands to their suite of products.

Portfolio characteristics

We currently have ~99% of our capital invested in 16 stocks. Note that our minimal cash position is a function of the large distribution we paid out to unitholders during July, this should be back at levels more consistent with our average by the end of August.



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 September on our performance during August.

Kind regards,

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