Emerging Companies Fund

Monthly Update: February 2022

SAVILLE CAPITAL

Dear Fellow Investors,

Our Emerging Companies Fund was down –9.6% in February vs –1.9% for the Emerging Companies Accumulation Index (XECAI) and –2.1% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +24.9% p.a. and a total return of +208.8% vs +95.9% for the XECAI and +45.0% for the XSIAI.

Following a period of poor performance for the Fund, due to a combination of some stock-specific events and significant market headwinds, the risk-off environment was compounded by Russia's invasion of Ukraine. As has been the case in the past, during times of uncertainty the portfolio of stocks we typically own bear the brunt of any panicked selling as their share prices can gap down sharply with a modest number of sellers/transactions. Meanwhile, unlike some Funds (and indices), we are not benefitting from an exposure to commodity stocks to buffer the short-term impact on the Fund's returns. Furthermore, we are also deliberately not trying to manage additional short-term downside by trimming those stocks that are in a sustained downtrend or buying those that are performing relatively well (in fact, we are more inclined to do the opposite). This shouldn't be misinterpreted as blind stubbornness, as we have always shown a willingness to exit positions when our thesis is clearly proven to be incorrect, but merely a reflection of our belief that we are always best to avoid chasing the herd, particularly in times of market distress. Given we are not actively seeking to attract more FUM and we don't manage the portfolio to a particular benchmark, this also enables us to accept very poor short-term performance (as difficult as this is to do) to ensure we don't constrain our full participation in the rebound when conditions for our Fund become more favourable, and/or the businesses we own have had sufficient time to deliver the outcomes which validate our investment thesis and provide a commensurate share price re-rating.

The past six months has been the most unusual and challenging business operating environment that we can ever recall, yet the market is making significant bets (both in favour of some stocks and against others) that this is the new normal. Clearly some of these operating headwinds may persist for a while longer, but to extrapolate recent revenue growth rates, margins and opex investment to justify a view that many emerging businesses (particularly those that aren't yet profitable) are 'broken', as many in the market appear to be doing, makes very little sense to us. That's not to say that the market hasn't been too exuberant about some emerging businesses prior to this period, including some we have owned, but it would be difficult to argue that the current market environment is more rational than the previous 20-year period during which we have been analysing stocks. As an example, when we are observing IPOs completed in late CY21 of solid businesses that are already down more than 50% (despite being fully funded), it becomes clear that we are operating in a market where fear appears to be usurping logic.

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%	+4.3%	-5.5%	+1.0%	-4.5%	-9.6%	-13.0%		
2022	-7.9%	-9.6%											-16.7%	-24.7%	-30.4%

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

Performance commentary

The key positive contributors were Ansarada (AND, +11%), Universal Biosensors (UBI, +6%) and Redbubble (RBL, +2%). The key negative contributors were Imricor (IMR, -21%), Murray Cod (MCA, -12%) and Lark Distillery (LRK, -26%).

While we were pleased to see AND's share price re-rate following the release of its strong 2Q result in late January, unfortunately Marley Spoon (MMM, -13%) couldn't sustain its rebound despite being up almost 25% in early February in response to its 2Q result. The latter just highlights the power of long-term negative share price momentum and how difficult it can be to reverse, especially when there is still some potential for a future equity raising. Nonetheless, we are confident that if the Company can demonstrate that its CY22 guidance will be achieved (or even prove to be conservative) then a sustained share price re-rating remains inevitable, which will also help to improve its range of funding options.

MCA has experienced a difficult few months with omicron impacting both sales (restaurant closures) and distribution (supermarket deliveries). Meanwhile, an unusually cold and wet late spring/summer in regional NSW has significantly lowered pond water temperatures, resulting in reduced spawning numbers and slower fish growth. The omicron impact on sales and distribution is now rapidly unwinding so we should see improvement over the coming quarters, however the weather impact on spawning and growth will delay some future sales. To help mitigate against future weather events, MCA is investing in a new temperature and light controlled indoor facility near Mildura aimed at out of season breeding, thus reducing the reliance on natural spawning each spring. While weather impacts are always a risk for any agriculture or aquaculture stock, MCA still operates in a far more stable climate than most of its peers. As such, we don't see this as a new systemic risk for the stock, despite the ongoing negative share price reaction.

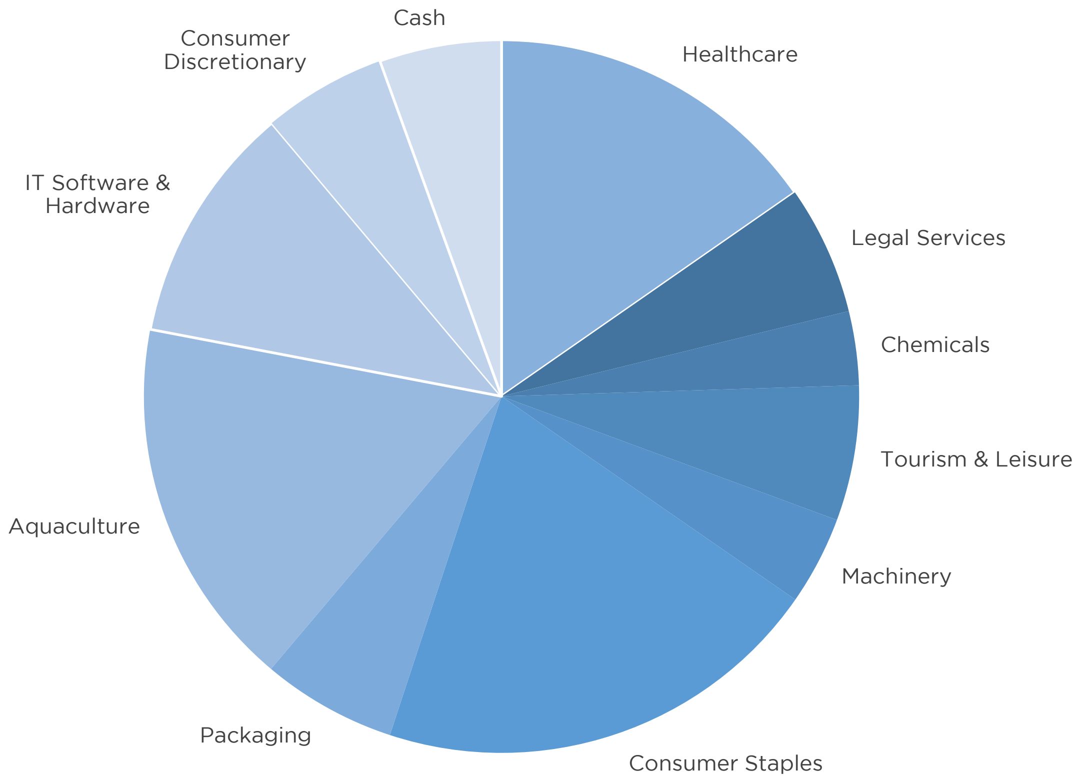
LRK suffered a share price decline following the sudden exit of its CEO, who had executed a highly successful turnaround of the business. Given that his departure was solely due to personal reasons and LRK was already in the process of executing a mutually agreed succession plan, we don't believe it will disrupt the strong momentum of the business. Thankfully, we had used LRK's share price strength in late CY21 to significantly reduce our exposure to the stock, so the impact of the decline was a lot less than what it would have been several months ago. Nevertheless, we retain a holding in the Company as the foundations for LRK's future success have now been built, including a whisky bank that is estimated to be worth just under $400m (vs LRK's enterprise value of ~$200m), a strong management team (beneath the CEO) and a proven branding and product strategy.

Pro-Pac Packaging (PPG, -4%) delivered a result that was in line with its December guidance (unsurprisingly), being underlying PBT of $4.2m (down from $11.7m in the pcp). As previously mentioned, the effects of COVID-19 on global supply chains and labour costs/availability limited the business's ability to convert work in progress during 1H FY22. However, recent price rises and a gradual normalisation of the labour environment has given PPG the confidence to provide PBT guidance of $7.8m to $11.8m in 2H FY22 (vs $7.1m in pcp). Delivery of earnings within this range would be a great outcome in the context of 2H being the seasonally weaker half for the business, which would then bode well for the operating momentum it would take into 1H FY23. Importantly, while the cost pressures have been well documented, revenue has returned to growth (+4.4% on pcp) and this is expected to accelerate over the next 12 months as the move towards greater diversification and onshoring of supply chains continues to gather pace.

Finally, Shine Justice (SHJ, -2%) had another strong earnings result, with 1H revenue up 13% on pcp, EBITDA up 15%, and its dividend up 25%. The only area of disappointment was its operating cash flow, which was down on pcp due to investment in growth initiatives, specifically additional staff, new files and investigations into new class actions. However, with minimal net debt (including $43m of cash) and more proceeds to come from the Mesh case, it makes sense for SHJ to enter an investment phase to drive further growth.

Portfolio characteristics

We currently have ~95% of our capital invested in 16 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

Saville Capital

+61 3 9769 1789
jcollett@savillecapital.com

Important Information