Emerging Companies Fund

Monthly Update: May 2022

Dear Fellow Investors,

Our Emerging Companies Fund was down –17.6% in May vs –7.7% for the Emerging Companies Accumulation Index (XECAI) and –7.4% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +17.0% p.a. and a total return of +130.8% vs +91.4% for the XECAI and +35.3% for the XSIAI.

Consistent with the ongoing bear market in micro-cap industrials, every stock in our portfolio declined in May, with only one of our companies giving cause. The negative share price momentum created by the "rising interest rates = sell emerging/growth stocks" narrative has now fed into a liquidity squeeze, which has a disproportionate impact on our investment strategy. This is a natural part of the bear market cycle and can often signal the final stages of the de-rating process. Valuation metrics, asset-backing and operating performance outlook become irrelevant and therefore trying to rationalise monthly share price moves is futile. Many of our stocks are in almost constant decline, yet the macro data is no longer materially changing (for now), in fact US 10yr bond yields declined in May and Aust 10yr yields were broadly flat. Our focus remains on the companies we own (including some recent site visits) and how they are performing at an operational level, as well as continuing to monitor the market for new opportunities. In times like this it is important to focus on the fact that we are invested in real assets/businesses, and the monthly movements in the Fund's unit price are more a reflection of mood, than value. For what it's worth, we again increased our personal investment in the Fund at the end of May.

We did, however, exit two positions during the month at a profit (vs average entry price), which has helped to increase our cash position and will likely lead to another distribution being paid after 30 June. This is consistent with our approach since inception, where we always take decisive action when the facts supporting our investment thesis begin to change, which then feeds into our valuation and view on its position in the portfolio. In both cases, their March quarterly results were materially below our forecasts, which when combined with other factors specific to those companies, led to our decision to sell.

As an example of how irrational the environment has become for certain stocks/sectors, Marley Spoon's (MMM, -27%) enterprise value is now 20% lower than when it listed on the ASX in July 2018. Yet based on Company guidance and consensus, MMM's revenue will be >€400m in CY22 (vs €92m in CY18), its Gross Profit will be >€200m (vs €38m in CY18) and its EBITDA loss will be <€15m (vs €35m loss in CY18), likely turning EBITDA positive in 4Q CY22. So, despite now being a Company that is over four-times larger and on the verge of being EBITDA/Cash Flow positive, its 'market value' has declined. Incidentally, in July 2018 the US 10yr bond yield was at the same level as it is today (just under 3%), and more importantly the 'real' yield (adjusted for inflation) was much higher then, than it is now.

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%	-3.0%	-5.8%	-17.6%								-37.4%	-24.8%	-47.8%

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

Performance commentary

There were no positive contributors during May. The key negative contributors were Imricor (IMR, -43%), Pro-Pac Packaging (PPG, -37%) and Terragen (TGH, -36%).

Following the announcement of the sale of its Rigid packaging business for $56m and a reiteration of its FY22 earnings guidance in early April, PPG followed up in May with a downgrade to its guidance. Management commented that April actual results ended up being well below expectations, and it now expects this performance to continue into May and June. Unsurprisingly, this comes as a result of ongoing constrained raw material supply (notably resin) and an inability for price increases to keep pace with rising costs. To mitigate against this, PPG is now implementing price increases on all existing volumes (including its production backlog) as opposed to just newly contracted volumes. While this should improve its results into FY23, PPG now expects its FY22 underlying PBT result to be circa $5.0m (Vs 1H PBT $4.2m), implying a 2H that will be just above breakeven.

The two stocks we exited during May were Lark Distilling (LRK, -17%) and Universal Biosensors (UBI, -27%). LRK's 3Q FY22 result suggests to us that a lot of the low hanging fruit may have now been picked, with the strong revenue growth generated last year becoming harder to sustain, exacerbated by the fact that it doesn't appear any closer to securing a permanent CEO. That said, we still like LRK longer term, but in this dynamic environment we decided that our capital is better placed elsewhere. UBI's 1Q CY22 result was significantly below our expectations, which was then followed up by an unexpected (both in timing and quantum) capital raising. Similar to LRK, we are still attracted to UBI's long term prospects, but its financial metrics are not improving quickly enough for us at this stage (especially in the context of its market valuation), as such we would prefer to watch from the sidelines until we can get some more comfort around its ability to convert its significant market opportunities into demonstrable commercial success.

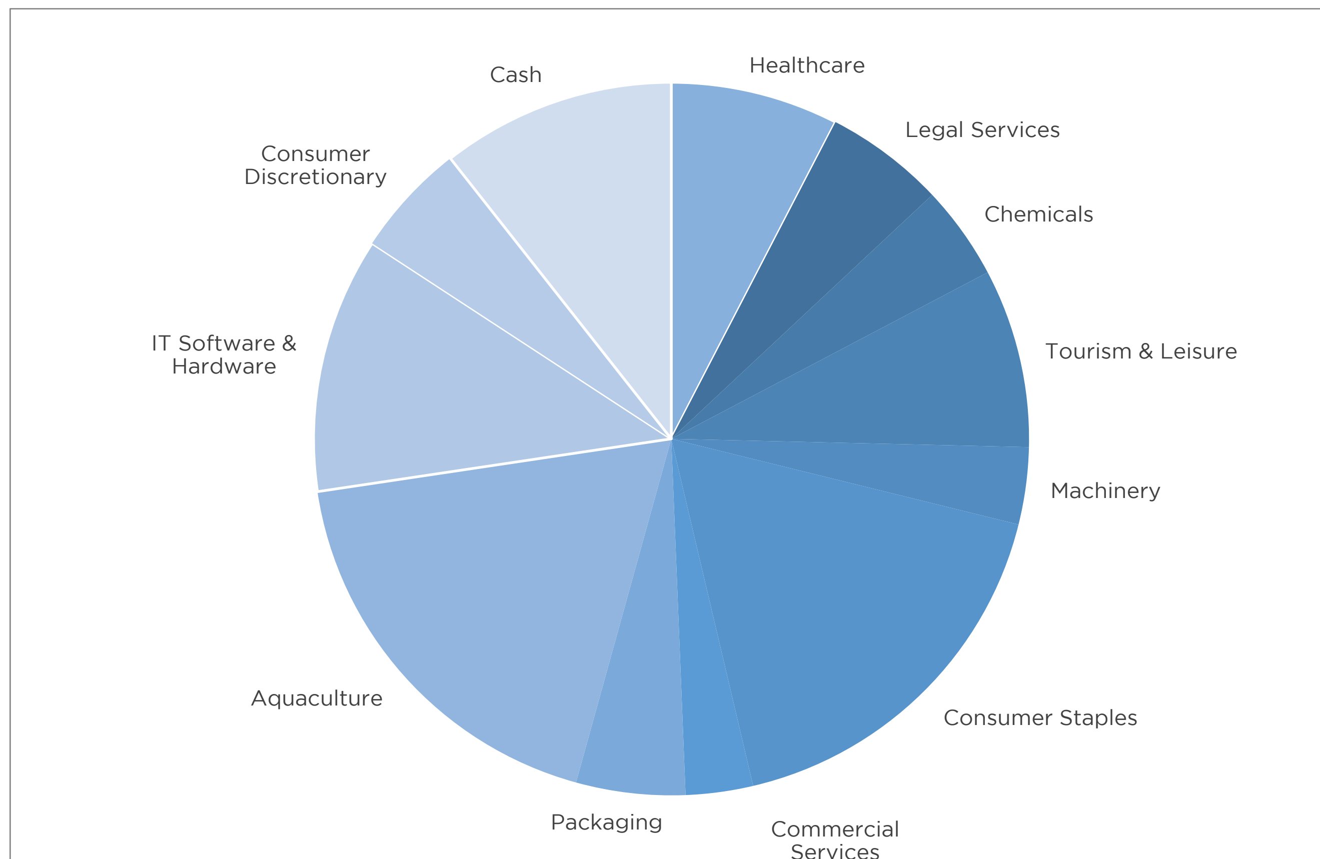
In other news, during the month we visited various companies in-person, including some that are in the portfolio and several that are not. The two highlights were seeing the Hadrian X109 (robotic bricklaying machine developed by FBR) operating at a new housing development in Perth and visiting MMM's fulfillment centre in Sydney. It is one thing to meet with management (virtually or in-person) and discuss any recent developments, but being on-site to observe and inquire is always the greatest source of insight and comfort.

Firstly, with regard to FBR, while there are still some creases to iron out in order for it to reach its desired bricklaying speeds (the Hadrian X110, which is being built in consultation with Liebherr, is targeting 500 bricks per hour), the core technology and mechanical engineering work is already in place. We briefly watched the Hadrian X109 constructing the wall of a townhouse that is part of a 16-lot housing development in Willagee, Perth. In addition to the speed benefits, the Hadrian X109 operates with precision, generating far less wastage and a cleaner/safer building site. Nonetheless, given FBR is still burning cash and awaiting full commercialisation of its technology, the stock is heavily out of favour in the current environment. However, with the MoU now in place with Liebherr and a target completion date of early CY23 for the HadrianX110 (which is the key pre-cursor to a commercial agreement with Liebherr), we feel compelled to retain exposure to the stock so that we can participate in the likely significant upside when these milestones are met.

Secondly, our visit to MMM's fulfillment centre in western Sydney was also very worthwhile. Not only did we gain a better understanding of its physical operations, we were provided with insights into the many efficiencies (and margin improvements) that remain available to MMM as it continues to scale its operations. Management remained steadfast in their commitment to deliver CY22 guidance, highlighting that being EBITDA negative has been a choice, not imposed upon them. As an example, NZ-meal kit provider My Food Bag (MFB.ASX) generates an EBITDA margin of ~17% on one-third of the revenue MMM currently generates, largely because it isn't investing for growth. At the same margin, MMM would generate >$100m of EBITDA vs its current EV of just ~$130m. Yet despite offering far less growth, MFB trades on ~1x CY22 EV/Sales vs MMM at 0.2x.

Portfolio characteristics

We currently have ~90% 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 July on our performance during June.

Kind regards,

Jonathan Collett

Principal

Saville Capital

+61 3 9769 1789
jcollett@savillecapital.com

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