Emerging Companies Fund

Monthly Update: September 2022

Dear Fellow Investors,

Our Emerging Companies Fund was down –6.1% in September vs -9.8% for the Emerging Companies Accumulation Index (XECAI) and -10.5% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +13.1% p.a. and a total return of +101.2% vs +63.3% for the XECAI and +20.6% for the XSIAI.

It was yet another tough month for global asset prices as the negative market momentum catalysed by Jerome Powell's hawkish speech at Jackson Hole continued. Markets are still agonising over where the federal funds rate (and the cash rate of other central banks) needs to get to before regulators are satisfied that enough has been done to drive inflation back towards their target. Interestingly, despite minimal news flow, our portfolio outperformed just about every major index in Australia. While it is too early to tell if this trend might be sustained, and we don't manage money for relative performance anyway, we remain cautiously optimistic that June 2022 will broadly be the low point for the Fund.

It is again worth highlighting that while the trend in 10-year bond yields has been on a general upward trajectory since early August, the absolute level remains comfortably below the risk-free rate we use in our DCF models (5%). As such, we are not concerned about where yields currently sit or indeed where we think they might get to, but unfortunately many investors have been completely spooked by the rate of change over the past 12 months, coming off what was an artificially low base. It appears very low rates attracted a lot of speculative (and leveraged) capital into, and now out of, markets over the past couple of years, pushing them from extreme overbought to oversold conditions. In terms of the evolving economic outlook, the prospect of a recession in 2023 should have minimal impact on the earnings of our portfolio companies. Most of our stocks are not reliant on a robust economy to deliver strong earnings growth, instead being largely influenced by management execution and structural tailwinds, not cyclical forces.

Finally, it is important to reiterate that while our desire to typically hold several companies in the portfolio that are not yet cash flow positive (but have laid the foundations to cross that threshold in the foreseeable future) has particularly hurt us over the past 12 months, we believe it is these types of companies that offer the greatest source of share price upside (as they have in the past). But in a market which is devoid of confidence, especially in micro caps, the focus shifts from the strengths of the business model to future capital requirements, leaving these companies most prone to temporary share price weakness. While we are always cognisant of this risk, our view (supported by recent evidence) is that the good business models are still able to raise capital (albeit generally the bare minimum) in this environment, but it is incumbent upon existing investors (including ourselves) to ensure they have sufficient cash to participate and avoid any significant dilution.

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%	-15.5%	+10.1%	-0.3%	-6.1%				-45.4%	+3.2%	-52.4%

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

Performance commentary

The key positive contributors during September were Terragen (TGH, +8%), Tourism Holdings (THL.NZ, +3%), Imricor (IMR, +1%). The key negative contributors were IDT Australia (IDT, -26%), Mighty Craft (MCL, -21%), and Ansarada (AND, -10%).

THL obtained clearance from both the NZCC and ACCC for its proposed merger with Apollo Tourism & Leisure (ATL). While there remain a few (minor) conditions to be satisfied, this should pave the way for the merger to be completed by the end of CY22. We continue to believe that industry tailwinds (pent-up demand for tourism) and cost synergies of the merged entity bode very well for strong earnings growth in CY23. But, when combined with access to a much larger investor audience and improved liquidity via an ASX listing, as well as undemanding valuation metrics, it is difficult to envisage how THL won't deliver strong share price performance over the next 12 months.

IMR announced that it had raised ~A$3m from new and existing US investors at a price of $0.38/share, which was a 27% premium to the 5-day VWAP. With the exception of the CEO, who was prohibited under the Listing Rules without shareholder approval, all senior executives participated in the capital raising and all shares will be subject to a holding lock of 12 months. The funds will be used for general working capital as the Company nears commencement of the Ventricular Tachycardia (VT) trials. From our perspective, this is not only further validation that the Company is continuing to progress in a positive direction, but the funds also provide some additional runway while IMR explores other options for a more meaningful capital injection to see it through to cash flow breakeven.

MCL continued its recent share price decline despite providing bullish volume targets for its key brands in FY23, most notably Better Beer (+132% growth to 10m litres) and 78 Degrees spirits (+70% growth to 259k bottles). These volumes, combined with expected further growth across the remainder of the brand portfolio and some tight cost control, should put MCL on track to become EBITDA and cash flow positive in FY23. With this in mind, and the implied intrinsic value of its individual brands (e.g. MCL's stake in Better Beer alone could be worth $50m to $100m based on recent comps) we are bemused by the enterprise valuation (~$60m), implied for all of MCL by its prevailing share price. Still, we also have stocks in the portfolio (e.g. IDT and BDT) that are now trading more than 10% below their last published NTAs, so nothing should really surprise in this market.

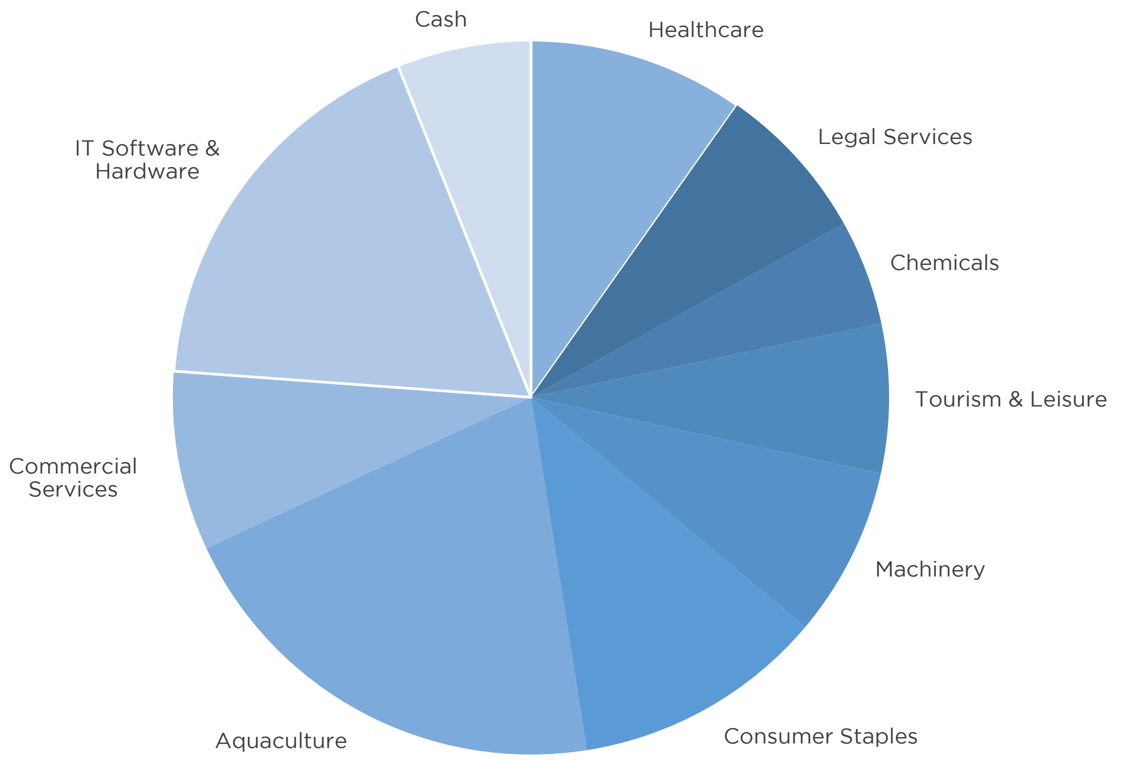
Company in focus: Pentanet Limited (5GG)

5GG is investing in an Australian-first mesh network to deliver high-speed wireless gigabit internet (initially focused on Perth) as well as offering a cloud gaming service via an exclusive partnership with NVIDIA in Australia. 5GG offers exposure to: 1) technology capable of offering superior customer experience vs the NBN in a region characterised by poor connections; and 2) the consumer wallet in the disruptive cloud gaming industry. Importantly, the Company's fixed wireless hardware is deployed over the top of existing network infrastructure, substituting high operating margins (>85%) for capital intensity to build out last mile connections. Furthermore, changing media consumption patterns (e.g. streaming) and the proliferation of data downloaded are key drivers of internet premiumisation in Australia, underpinning our structural investment thesis for 5GG.

While still in its infancy, 5GG has delivered demonstrable success in customer acquisition thus far, with telco subscriber growth of ~60% p.a. since FY20 (with only 1% churn) and already over 200,000 registered members on its cloud gaming platform. The key driver of earnings growth will be the network rollout and gradual migration of customers onto neXus (its proprietary mesh network), delivering higher revenue and margins per customer. This growth will be complemented by the addition and subsequent conversion of cloud gaming subscribers from free-trials to paid subscriptions. 5GG is founder-led (the Board owns >23%), has >$13m in cash and will transition to EBITDA positive as it builds out its network and delivers a superior customer experience to the NBN in Perth. Notably, at even just 10% market penetration in Perth, 5GG would be a highly profitable Company.

Portfolio characteristics

We currently have ~94% 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 November on our performance during October.

Kind regards,

Jonathan Collett

Principal

Saville Capital

+61 3 9769 1789
jcollett@savillecapital.com