OC Premium Small Companies Fund

Fund Update | 30 September 2016

1.2%

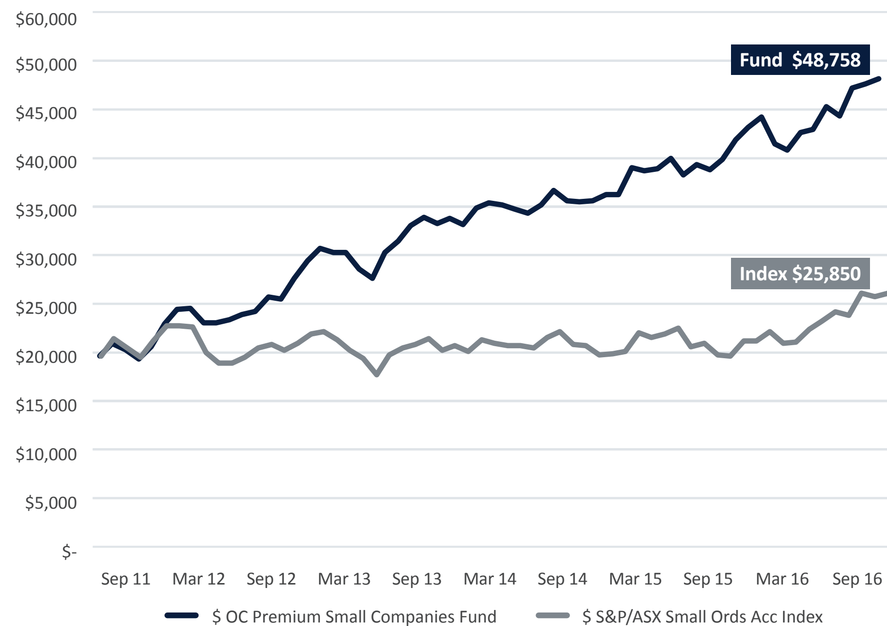
Fund up 1.2% for the September period

13.3%

Returned 13.3% p.a. for the past three years

We remain confident the Fund is well positioned

Performance comparison of $20,000 over 5 years*



Total returns

At 30 September 2016	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	10 yrs % p.a.	Incep % . p.a. (Dec 2000)
OC Premium	1.2	8.7	20.8	13.3	19.6	15.2	6.0	11.9
S&P/ASX Small Ords Accum	1.5	8.5	29.2	7.1	5.3	2.8	1.4	5.7
Outperformance	**-0.3**	**0.2**	**-8.4**	**6.3**	**14.3**	**12.4**	**4.6**	**6.1**
S&P/ASX Small Ind Accum	0.7	8.5	22.1	9.5	13.5	7.9	3.4	6.3
Outperformance	**0.5**	**0.2**	**-1.3**	**3.9**	**6.1**	**7.3**	**2.6**	**5.5**

Performance review

The OC Premium Small Companies Fund enjoyed a strong start to the new financial year returning 8.7% for the September quarter as the market shrugged off a host of global economic, political and geo-political concerns. This was in-line with both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which each returned 8.5% for the quarter. The Fund has returned 19.6% p.a. for the past five years, which is well ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which have returned 5.3% and 13.5%, respectively, over the same period.

There was limited new stock-specific news in September and the investment team was busy meeting with the management of current and prospective holdings post the August reporting season. Our best performing stocks for the quarter were, unsurprisingly, companies that released solid FY16 results and provided positive commentary about their future earnings prospects. These included **Webjet Limited (WEB, +63.6%), Ardent Leisure (AAD, +47.3%), MACA Limited (MLD, +37.7%)** and **Mineral Resources (MIN, +33.2%)**. **Altium (ALU, +42.6%)** was also a stellar performer for the Fund, but we sold the position as it reached our share price target.

Webjet (WEB) - as discussed in August, WEB announced a result that exceeded market expectations driven by an outstanding performance from the B2C (business to consumer) division where TTV margin accelerated in the second half as a result of strong operational leverage brought about by continued market share gains. However, the result itself was somewhat overshadowed by a £21m deal signed in its hotel business which provides hotel inventory to travel agents. The deal with large UK-based travel company, Thomas Cook, involves WEB taking over Thomas Cook's 3000 hotel supply contracts and in turn, WEB entering a minimum five-year deal to supply these hotels, and its other hotels, to Thomas Cook. This provides WEB's B2B (business to business) division a material step change in scale, as well as directly related financial benefits (not material until FY19), providing us greater transparency on continued high EPS growth into the future for the company. The company continued

its strong share price performance in September and, although we have trimmed our holding, we remain attracted to its capital-light business model and strong long-term growth prospects.

Ardent Leisure (AAD) - continued to re-rate in September following the sale of the Goodlife health clubs and the Hypoxi weight loss businesses. The gyms had been seen as an ongoing headache with business transformation underway in order to combat the increasing prevalence of cheaper 24-hour small format gyms and the sale was seen as representing a fair price. The full-year result in August appeased market concerns, with solid performances across all divisions particularly in bowling, which is benefiting from a number of initiatives introduced from the US Main Event business. The sale of the lower returning health club business will allow management to redeploy that capital into the high growth, but capital hungry, Main Event roll out in the US. With the sale of the marinas business still tracking to management's schedule, the company is now in a strong position to accelerate the roll-out of Main Event, which is a quality business that has achieved very high returns on invested capital.

Mining services companies, **Mineral Resources (MIN)** and **MACA Limited (MLD)**, were among our better performing stocks in the quarter reflecting the improved outlook for both businesses and the sector in general. MIN and MLD are highly regarded operators who ought to continue to benefit from increasing activity in the coming years as the commodity cycle rebounds. Both companies currently earn the majority of their profits from crushing, screening and processing ore for quality clients across a number of different commodities and mine sites. Both have a strong reputation among their clients and typically operate under long-term contracts. Importantly, both MIN and MLD have strong net cash balance sheets that position them well to weather any commodities downturn.

Scottish Pacific (SCO, +18.8%) - an IPO the Fund participated in early in the quarter, was another strong performer. SCO operates in the debtor finance market primarily in Australia where it is a top three provider of debtor finance solutions with 20% market share, but also with a presence in New Zealand and the UK. Debtor financiers, such as SCO, provide financing to SMEs to bridge the cash flow gap between their expense cycles and the collection date of their receivables. SCO has a number of key characteristics we believe will make it a solid contributor to the portfolio over the longer term, including its scale and competitive position, which will provide it with a meaningful cost advantage, a large distribution network, which should underpin its growth, a solid track record in credit assessment and an experienced management team led by industry veterans with combined decades' experience in the sector.

On the negative side of the ledger, **Vocus Communications' (VOC, -26.0%)** share price has performed poorly since August. We see the main catalysts for this recent underperformance as a confluence of events including: i) senior management turnover with the resignation of pre-merger Vocus CEO (and post-merger executive director), and the subsequent sell-down of his substantial shareholding and the resignation of the CFO, ii) market concerns around the amount of acquisition-related activity over the past 18 months including recent broker questions about the accounting treatment of one-off acquisition-related costs and 3) competitor TPG's recent FY17 guidance downgrade which cited increasing margin pressure in an NBN world.

Our team has been vigilant in assessing each of these concerns and we remain a comfortable shareholder, albeit we acknowledge the risk profile of the stock has increased with the management turnover and the high level of M&A activity. In a merger of this size, senior management turnover is inevitable as synergies are extracted and required skill sets necessarily change. Current Managing Director (ex M2 Telecommunications MD), Geoff Horth, is an industry veteran and is held in high regard by our investment team. He is backed up by an experienced senior management team that includes M2 Telecommunication founder, Vaughan Bowen. While M&A activity has been elevated, the telecommunications landscape has changed rapidly and the combined Vocus, M2 Telecommunications and Nextgen businesses have a mix of assets that will allow the company to be a key player in an NBN world. While integration risks remain our key concern, we note the management team's outstanding pedigree in M&A over a long period and we are comfortable with their acquisition accounting which is consistent with their past approach.

On the question of margin pressure under NBN, we note some clear differences between the TPG and Vocus businesses. Simply put, there are different economics in an NBN transition for TPG where margins were higher to start with due to their high proportion of subscribers using on-net DSL services (i.e. where TPG owns the equipment in the local phone exchange and delivers the service from there at high margin) compared to Vocus that offers predominantly low-margin off-net services (i.e. re-selling Telstra services). Under an NBN environment where wholesale access costs are uniform and players compete for retail broadband clients on service and price, this may result in margin compression for TPG but not necessarily for Vocus.

APN Outdoor (APO, -20.3%) - a major disappointment during the quarter was the unexpected negative earnings

revision from APO, which was released with its half-year result. As discussed in August, although the share price fall seems disproportionate to the quantum of the earnings downgrade, we have nonetheless taken the conservative approach to exit the stock until we get further clarity around the trajectory of sales into the critical September to November period. Industry contacts and data released in recent weeks suggest that conditions for APO may have stabilised, but we remain concerned about the prospect of ongoing price deflation in APO's static inventory which is a higher proportion of their earnings compared to listed peers QMS and Ooh!Media. Although the stock looks to be reasonable value given its growth profile, we will remain on the sidelines until we can get further clarity or confidence that operating conditions have sustainably improved.

G8 Education (GEM, -19.8%) - the half-year update from GEM was clearly disappointing with analysts moderating full-year earnings expectations on the back of the impact of more onerous 'carer to child' ratios and weak trading conditions in its WA childcare centres (due to the weaker Perth economy). Our subsequent meetings with management lead us to believe these issues are being managed and there are a number of other initiatives being undertaken which will see GEM post full-year numbers in-line with expectations. Over the coming months, GEM will aim to meet earnings forecasts by pushing through price rises, more effectively managing the rostering of staff under the new ratio model, controlling capex spending in centres, continuing to increase occupancy, rationalising some underperforming centres and favourably refinancing its debt. This will leave GEM well positioned to continue to sustainably grow its earnings and at these current share price levels, we believe it offers value. Recent contact with management gives us confidence that the full-year guidance remains on track.

Outlook

Following the strong performance by the Fund in the September quarter, we would describe our longer-term outlook for our portfolio as one of cautious optimism, albeit we are conservatively positioned heading into the December quarter with some major economic, political and geopolitical events on the horizon which could bring about near-term market volatility. These include:

- the US Federal Reserve widely expected to begin increasing interest rates in either December or early 2017
- the acrimonious US election campaign being in its final stretch with Americans going to the polls in November
- Brexit uncertainty remaining with no clear roadmap laid out for the UK's exit from the EU
- Italy facing its own controversial referendum in December
- Spain struggling to form government and the increasing prospect of a third election in December.

Geopolitics adds to the uncertainty with continuing turmoil in the Middle East, China and its neighbours' escalating hostilities in the strategically important and oil rich South China Sea and North Korea remaining highly unpredictable.

Against this backdrop, the Fund has increased its cash holdings to just over 10% having exited a number of companies that have reached our valuation, including **Altium** and **iSentia**. We also sold **APN Outdoor** due to its recent earnings disappointment.

The domestic economy continues to muddle through its transition away from a resource-led economy towards broader-based drivers of economic activity. The transition is being supported by historically low interest rates with the RBA cutting rates again during the quarter to a cash rate of 1.50%, although accompanying commentary suggests it has moved to a more neutral outlook for policy, at least until third quarter inflation data is released. We expect the RBA to remain on hold until the end of 2016 before resuming the easing cycle in 2017. Overall, the Australian economy is in reasonable shape with Q2 GDP up 3.3%, the strongest year-on-year pace for four years, and unemployment 5.6%, its lowest level in three years.

The portfolio does not have material domestic cyclical exposures although we do have a number of consumer-related stocks with strong management and robust business models that continue to post strong like-for-like growth and have ongoing store roll-out potential. These include **Bapcor** and **Baby Bunting**, both of which reported excellent FY16 results and have strong operational momentum heading into FY17. We also added vertically integrated specialty home furnishings retailer **Adairs** to the portfolio during the quarter. We have been impressed by the Adairs business model and management team since the company listed in June 2015. Unfounded rumours of a sell-down by private equity backer, Catalyst, created share price weakness in early September which provided the Fund with an attractive entry point into the stock.

IPO activity remains elevated and the investment team has been busy doing due diligence on a number of upcoming listings including **Murray River Organics, Veem,** and **Apollo Tourism & Leisure**, to name a few. Where

possible, this involves site visits, competitor analysis and management meetings as part of our due diligence process. It is rare that we take large positions in IPOs due to our conservative investment process and the unproven nature of these businesses and their management in a listed environment. Nevertheless, new floats provide a rare opportunity to invest in a company that has not undergone market-wide price discovery and therefore may, on occasion, be under-valued.

We remain confident the Fund is well positioned with quality companies that will perform well in the current economic environment. We thank our investors for their ongoing support.

Top 5 holdings#

Company	ASX code
Bapcor Ltd	BAP
Blue Sky Limited	BLA
Mineral Resources Limited	MIN
QMS Media Limited	QMS
Webjet Limited	WEB

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* The performance comparison of $20,000 over 5 years is for illustrative purposes only. All returns shown are based on Australian dollar figures. Past performance is not a reliable indicator of future performance. The total returns shown are prepared on an ongoing basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX Small Ordinaries Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index. There is no guarantee these objectives will be met.

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments. The securities listed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.

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