FUNDS MANAGEMENT

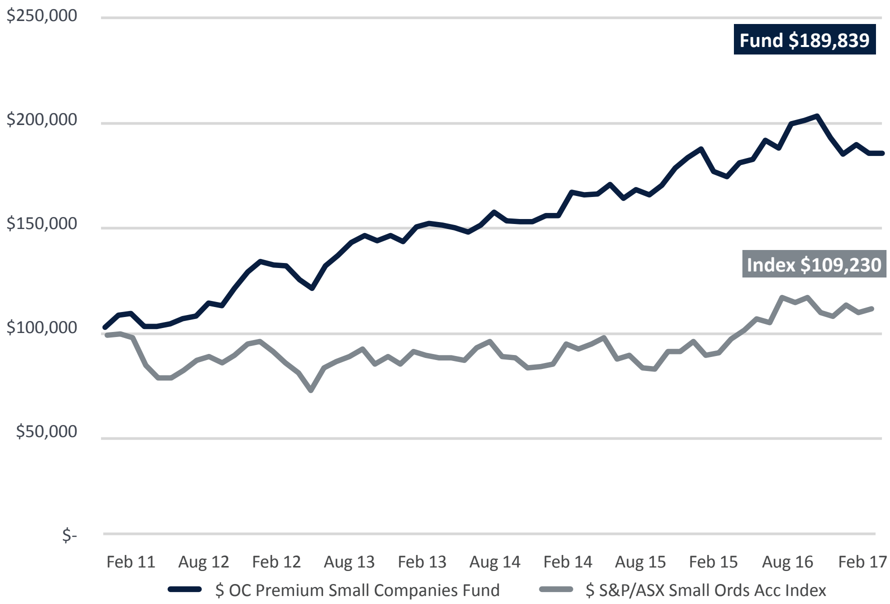
OC Premium Small Companies Fund
Fund Update | 28 February 2017

0.1% Fund up 0.1% for the month

13.7% Returned 13.7% p.a. for the past five years

We remain confident the Fund will continue to deliver attractive long-term returns

Performance comparison of $100,000 over 5 years*



Total returns

At 28 February 2017	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	0.1	0.4	7.0	7.8	13.7	12.3	3.5	10.9
S&P/ASX Small Ords Accum	1.3	2.4	16.8	5.1	1.8	2.7	-0.7	5.4
Outperformance	**-1.2**	**-2.0**	**-9.7**	**2.7**	**12.0**	**9.6**	**4.2**	**5.5**
S&P/ASX Small Ind Accum	1.7	1.7	11.4	6.6	9.4	7.6	1.3	5.8
Outperformance	**-1.6**	**-1.2**	**-4.3**	**1.2**	**4.4**	**4.7**	**2.2**	**5.0**

Performance review

The OC Premium Small Companies Fund returned +0.1% for the month of February, behind both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrial Accumulation Index which were up 1.3% and 1.7%, respectively. The Fund remains well ahead of both indices over the longer term.

During February, most ASX-listed companies released their interim results (or year-end results for those with a December 31 balance date) and it turned out to be a somewhat atypical reporting season. It was not simply a case that companies delivering on or exceeding market earnings expectations traded flat or went up, and companies that missed market expectations fell in share price. It seems recent investor bias towards lower multiple value stocks has continued to play out over the month and many of these stocks consequently performed better from a share price perspective during the month. For example, high growth, high multiple **Webjet (WEB, +0.2%)** exceeded market expectations and upgraded its profit forecast, yet fell marginally in share price in the days following. Whilst a low multiple value stock, **McMillan Shakespheare Ltd (MMS, +16.4%)**, delivered a result in line with its modest earnings expectations and re-rated in the days after the result.

One explanation for this rotation is that, with interest rates tipped to rise further in the US in the coming months, long duration growth assets have continued to de-rate due to the impact a higher discount rate has on their discounted cash-flow valuation. On the other hand, previously unloved and out of favour value stocks are re-rating as investors refocus their attention on this segment of the market where the re-emergence of signs of inflation in the global economy may even reinvigorate some top-line growth.

OC is a style neutral investor. We have no particular bias to either growth or value stocks, preferring to assess an investment on its individual merits. We focus on buying good quality businesses that are easy to understand and forecast, at a share price that leaves a reasonable margin of safety to our valuation target.

In terms of results, **Costa Group (CGC, +24.1%)**, Australia's premier fruit and vegetable grower, announced its half-year result, which was applauded by the market. The well regarded management team at CGC delivered a trifecta of positives in its update, beating market earnings expectations, displaying strong cash flow and upgrading full year earnings guidance. Impressively, the earnings beat was delivered right across CGC's portfolio of market leading categories, including:

- +3.2% growth in mushrooms driven by increased demand,
- +75% production increase in blueberry (and raspberry category growing at +35%),
- very high quality citrus crop (70% exported, predominantly to Japan), and
- tomato prices increasing by an average of +10%.

Combined with CGC's recent move into avocados, the growth profile for the business is robust. Notwithstanding the positives, CGC is approaching our valuation which has led us to reduce our position as we are mindful there are still some agricultural and pricing risks associated with the stock and that growing conditions in all product categories (outside of Tasmanian berries) have been extremely favourable.

Recent Fund addition, data centre operator, **NextDC (NXT, +20.5%)**, re-rated after reporting a strong result, which demonstrated the operating leverage in the business model. Revenue grew 36% to $56m but the company reported EBITDA growth of 110% highlighting the high fixed-cost leverage which is one of the key attractions of the stock. We expect development costs for new data centres will moderate second-half margin growth, although the longer-term outlook for the business remains strong. Although the company did not upgrade its full-year guidance, this looks conservatively framed and we remain confident management will continue to meet or exceed expectations. NXT remains our preferred play on the cloud computing thematic with the explosive growth in data usage likely to continue for some years to come.

We added **Super Retail group (SUL, +8.3%)** to the portfolio ahead of its interim result following share price weakness which took it into our 'buy zone'. The SUL result ticked many boxes including: 1) positive like-for-like sales growth trends across all divisions in a difficult environment which has been impacted by clearance activity from competitors such as Masters and Repco, 2) gross margin and EBIT margin expansion due to operating leverage and supply chain efficiencies, and 3) strong operating cash flow from working capital releases and the five extra trading days in the first half (versus the prior corresponding period). Importantly, BCF looks to be trading strongly following a significant restructure of pricing and promotional activity and the key Super Cheap Auto and Rebel Sports businesses are also trading strongly. The company has made a solid start to the second half with sound comparable store sales growth numbers in the first seven weeks. SUL remains attractively priced at 13.5 times FY18 earnings with management well positioned to deliver on its growth aspirations.

A major swing factor for the Fund during the month was the share price reaction of **WorleyParsons Ltd (WOR, +7.7%)** which fell heavily post the result (from $9.86 to sub $8.00) after the company revealed its net debt had blown out to $920m due to four slow paying state owned customers and a failure to reduce "days outstanding" on its other debtors, despite having a concerted program involving external consultants to do so during the half. The debtor days blow out concerned us as it raised the real possibility of a heavily discounted raising in the near term. We took the conservative approach to exit the position and were mortified when Dubai-based, DAR Group, launched an on-market raid to acquire a 13% stake in the company at $10.35 per share just days after our exit at closer to $8.00 per share. Most disturbing is that DAR Group had approached the WorleyParsons board to make a full takeover in mid-November at what was then a 35%+ premium to the prevailing share price (bid at $11.00+), but the board at the time neither engaged the potential acquirer nor informed shareholders of the approach. We feel this was a highly questionable decision in spite of the conditional nature of the approach and that the board at the very least ought to have informed the market. Unfortunately, there is no silver lining to this one and it is a cruel reminder that sometimes luck is not always on your side.

The trouble-plagued **Ardent Leisure (AAD, -22.1%)** was a major disappointment for the Fund during the month, fresh from its safety incident at Dreamworld last October. A weak trading update from the key Main Event business was the catalyst for the underperformance with the sales decline in the first half for centres open for over two years continuing into the second half. Previous indications of improvement in December (provided at the January 6 trading update) were reversed with the company citing: 1) revenue decreases in two-year-old centres that experienced strong honeymoon periods in the first year, 2) higher initial operating costs in new centres, 3) slower revenue ramp-up in new centres, and 4) the impact of increasing competition. The severe share price fall was due to the importance of the Main Event roll-out for the future prospects of the group with management last year announcing the accelerated roll-out of the format in the US following the sale of the gyms business and the marinas. Our meeting with management led us to conclude the Main Event model is not broken. Greenfield Main Event sites are still achieving EBITDA return on invested capital in excess of 30%, notwithstanding the current constant centre growth issues. Moreover, theme park visitors are slowly returning post the safety incident. A further deterioration in the Main Event business would cause us to reassess our holding, but the company looks oversold at these levels.

During February, the Fund exited two long-term shareholdings, namely **Vocus (VOC, +8.4%)** and **Aconex (ACX, +12.9%)**, following material intra-month share price spikes in both stocks. Both had downgraded their earnings forecasts in recent months but were sold down to levels that made a complete exit of our holding at the time unappealing on valuation grounds. The share price of ACX spiked from $3.02 at the start of the month to over $4.00 prior to the release of its interim result and we used it as an opportunity to exit the position. The VOC share price was up strongly on the back of a result that suggested the full-year earnings guidance was achievable. However, the company's cash flow was weak due to poor working capital management and a one-off accounting gain on the profit and loss statement with no corresponding cash receipt. These issues, coupled with the company's recent earnings disappointment, led us to exit the remainder of our stake.

Outlook

The domestic economy bounced back from an unexpected half-a-percent contraction in the previous quarter with GDP printing at 1.1% in the fourth quarter, taking 12-month rolling GDP to a respectable 2.4%. Strong increases in export prices, particularly coal and iron ore, helped drive a record trade surplus in December and the terms of trade surged 9.1% in the quarter. Consumption growth also spiked 0.9% during the quarter, but it appears to have been driven by households dipping into their savings given wage growth was again weak. Australians, it seems, are spending more on purchases but saving less.

We would caution investors about reading too much into the quarterly data which can be lumpy, as evidenced by the remarkable turnaround from the third-quarter negative print. That said, the domestic economy appears to be on a solid footing and the RBA still expects growth of around 3% this year.

The dual-speed economy seen in the mining boom has reversed with NSW and Victoria continuing to do the heavy lifting fuelled by a housing construction boom, while the mining states are still adjusting to lower levels of mining investment despite recent increases in commodity prices.

Much has been written of late about strength in the Australian property market and the sustainability of recent price rises with the OECD joining the chorus of warnings last week in stating that the biggest threat to the Australian economy is from a hard landing in the property market. This echoes recent testimony from RBA Governor Philip Lowe to a parliamentary economic committee in late February where he warned household debt was rising much faster than income and that cutting rates could further fuel the housing boom. Until rates rise materially (for which we see no immediate catalyst), we cannot see a circuit breaker to trigger a property collapse. Notwithstanding this, the Fund currently has limited direct exposure to the domestic housing market.

From a global perspective, little changed during the month. China remains on a solid growth trajectory with President Li Keqiang recently announcing that the government aims to deliver economic growth of 6.5% in 2017, down from the 2016 target of 6.5-7.0%. The Chinese government is tolerating slightly lower economic growth to give it scope to push through reforms to deal with the recent build-up in debt, particularly within the infrastructure investment and property development sectors. A solid Chinese economy is obviously a positive for the Australian economy and has helped to support commodity price strength over the past year. We nevertheless caution that any moves by the Chinese central government to rein in credit growth could have negative implications for the resources sector.

In the US, the economy remains on a solid footing with recent economic data suggesting the Federal Reserve is closing in on its two policy goals: stable inflation near 2% and full employment. The Fed's preferred inflation measure has moved up to 1.9% and unemployment has fallen to 4.8%, approaching the level the Fed views as sustainable over the longer term. A rate rise is all but assured on the March 15 meeting in Washington with Federal Reserve Chair, Janet Yellen, explicitly supporting a hike, barring any unanticipated developments, at a speech she made in early March.

Our observation on the economic outlook from reporting season was mixed with strengths and weaknesses tending to be company specific rather than being driven by underlying macro-economic trends. Take, for example, the retail space where **Super Retail Group**, **Nick Scali** and **Premier Investments** all reported buoyant results ahead of market expectations in contrast to **Adairs**, **RCG Corporation** and **The Reject Shop** which fell well short of investor expectations. Indeed, a cursory analysis of the 10 best and worst performers in the S&P/ASX Small Ordinaries Index for the month of February is supportive of this thesis with no industry sector outside of materials (mining) standing out on either side of the positive/negative ledger.

We believe our process of investing in well-managed businesses where the key drivers are relatively simple and easy to forecast and where there is a sensible margin of safety between the current share price and our underlying valuation, remains a prudent approach that we believe will continue to deliver solid longer term returns for our investors.

The investment team will be out on the road for much of March assessing new investment opportunities and meeting with the management of current holdings and their competitors. The Fund is conservatively positioned with a cash weighting of around 10%, however we are in the process of adding several new holdings to the portfolio.

Top 5 holdings#

Company	ASX code
Bapcor Ltd	BAP
Blue Sky Alternative Investments Ltd	BLA
Mineral Resources Limited	MIN
Speedcast International Ltd	SDA
Webjet Limited	WEB

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* The performance comparison of $100,000 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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