FUNDS MANAGEMENT

OC Micro-Cap Fund

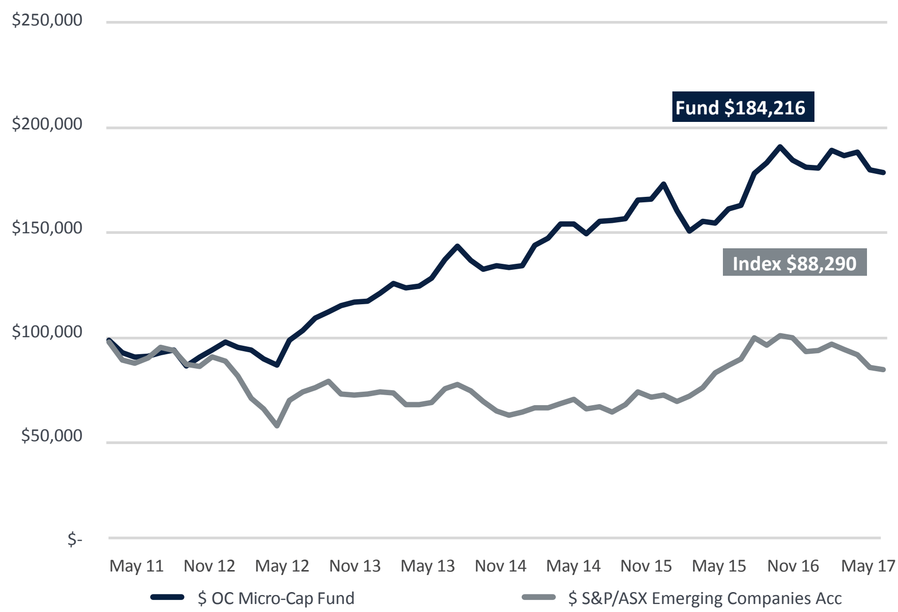
Fund Update | 31 May 2017

-0.8% Fund down 0.8% for the month

13.1% Returned 13.1% p.a. for the past five years

We remain confident the Fund is well placed to deliver strong long-term returns

Performance comparison of $100,000 over 5 years*



In October 2016, the OC Concentrated Equity Fund became the OC Micro-Cap Fund. The Fund previously comprised three underlying investment strategies, one of which, the Emerging Leaders strategy, is now the primary underlying investment strategy of the OC Micro-Cap Fund.

Total returns

At 31 May 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. (Nov 2003)
OC Micro-Cap	-0.8	-4.5	11.2	13.2	13.1	11.7	8.1	12.7
S&P/ASX Emerging Comp. Accum	-1.0	-8.9	-2.1	6.3	-2.5	-0.1	-3.6	5.4
Outperformance	**0.3**	**4.4**	**13.3**	**6.9**	**15.5**	**11.8**	**11.7**	**7.3**

Inception date for the Fund is 21/11/2003. Inception date for the Index is 31/12/2003. The performance reflects the performance of the OC Micro-Cap Fund since the change of strategy on 30 September 2016 and the performance of the OC Concentrated Equity Fund prior to that date. Performance is after fees applicable at the time.

Performance review

The OC Micro-Cap Fund finished May down 0.8%, which was just ahead of the S&P/ASX Emerging Companies Accumulation Index, which was down 1.0%. Micro-cap stocks continue to be under pressure and the broader micro-cap index has performed poorly over the past six months (-8.2%), although the OC Micro-Cap Fund has done a solid job of protecting investors' capital falling a moderate 1.4% comparatively over the same period. We continue to reiterate that negative price action has created some compelling opportunities from a value perspective which ought to reward investors over the longer term.

The lacklustre performance of the domestic micro-cap companies index has been driven, in part, by a raft of earnings downgrades that have impacted numerous micro-cap names of late including **RCG Group**, **Select Harvests**, **Qantm Intellectual Property**, **Murray River Organics** and **Seymour White**. The so-called 'earnings confession' season ahead of the end of financial year is often a treacherous time for investors and this year has proved no different. The Fund was relatively unscathed with news flow across our holdings, on balance, positively skewed (**Appen Limited**, **Apollo Group** and **Codan Limited all upgraded**) despite a profit downgrade from Fund holding, **Apiam Animal Health**, discussed below.

Appen Limited (APX, +38.0%) – the speech and search technology services company was an outstanding performer in May after announcing a material upgrade to its full-year earnings guidance. APX is a global leader across its two divisions namely content relevance, which provides smart data to improve the relevance, and accuracy of search results and language resources, which provides data used in speech-recognition technologies (e.g. Apple's Siri) and other machine-learning technologies. APX counts nine of the world's 10 largest technology companies as clients and continues to add new clients and increase margins. APX is extremely well placed to continue to benefit from the rise of machine learning, as well as voice-based technologies. Despite the scope of the upgrade (EBITDA is now expected to be 40-50% above CY16, up from previous guidance of mid-to-high teens EBITDA growth), we see further scope for earnings upgrades over the balance of the calendar year based on the current order book and the strong operational momentum across the business.

Netcomm Wireless (NTC, +32.1%) - bounced strongly after news filtered out NBN Co is set to announce an expansion of its Fibre-to-the-Distribution point (FTTdp) roll-out to one million homes, up from the 700,000 homes currently announced. NTC would be an obvious beneficiary as it is the incumbent technology provider to NBN Co in enabling the deployment of FTTdp technology. NBN Co CEO, Bill Morrow, told a senate estimates hearing the focus on FTTdp was about enabling a greater portion of the network the ability to deliver speeds in excess of 100 Mbps in the future. Some analysts are speculating NBN Co may go even further and replace a larger portion of the remaining Fibre-to-the-Node (FTTN) roll-out with the superior FTTdp technology. While this would likely prove to be a windfall from NTC, it is not in our current estimates. NTC has a strong pipeline of opportunities across tier-one customers, such as Nokia, across fixed-wireless telecommunications and other machine-to-machine solutions and remains a core holding in our portfolio.

Updater, Inc. (UPD, +13.2%) - US-based technology company, UPD, enjoyed another strong month as the broader market becomes more comfortable with the value of the platform that continues to be built out by management. UPD offers home movers a service to complete tedious and time-consuming tasks efficiently (such as updating/changing address) and at the same time allows businesses to communicate with these consumers in a timely manner. This opportunity for businesses to effectively market to consumers during the moving process is considered highly valuable as people tend to make important, long-term decisions when they are moving house (for example, around choosing insurance products and utility providers). UPD is growing its market penetration of the US mover market with its last published benchmark at +7%; but we would currently estimate penetration to be at around +10% and growing rapidly with a CY17 target of 15%. Since the end of the month, UPD has announced the signing of a pilot program with US behemoth, AT&T. AT&T is world's largest telco and one of the largest listed corporations in the US with a market capitalisation of approximately US$237bn. It has a leading position in the US fixed-line telephony market and also in subscription TV (cable), broadband internet and mobile. We estimate AT&T has the second largest marketing budget in the US and is among the top 10 advertisers globally. For a company of AT&T's size and complexity to sign a pilot program with UPD is a strong endorsement of UPD's platform. With further updates on market penetration and pilot programs expected over the balance of CY17, we remain excited by the future prospects of Updater.

Catapult Group (CAT, -21.8%) - share price action was disappointing during the month but we continue to see the business as representing excellent value and offering long-term growth for the patient investor. CAT is the market-leading developer of wearable analytic software solutions for athletes (it has contracts with the AFL, NRL, ARU, Cricket Australia and many of the world's elite sporting clubs). At the start of the month, CAT completed a small capital raising ($14m) for the acquisition of two strategically important and complementary businesses. At the time, CAT also affirmed its previous FY17 earnings guidance and highlighted excellent growth metrics including:

- +24% growth in unit sales for the third quarter (v prior corresponding period), and
- ongoing growth of subscription orders, now accounting for 69% of all elite orders (with a total subscription fleet now over 12,500 units).

We understand CAT may have recently been the subject of some selling through the loss of investment mandates from some of our peers. We see CAT's market-leading product and a large addressable market as great business attributes and believe CAT represents compelling value at these levels and we continue to hold the position.

Apiam Animal Health (AHX, -43.3%) - is a production animal health business OC has held as an emerging leaders stock since it IPO'ed in December of 2015. AHX is a vertically integrated business providing a range of products and services to support the health and wellbeing of production animals (i.e. beef and dairy cattle, sheep, poultry and pigs). Unfortunately, despite having exposure to various favourable industry thematics, AHX has not yet been able to capitalise on its market-leading position. It disappointed the market with soft earnings guidance during the month, including blow-outs in systems implementation budgets, and we have lost confidence in management's ability to execute on what we consider to be a sound business strategy around consolidating the leading industry players in the sector. While we believe the issues management have encountered in recent times are far from terminal for AHX, and the lower earnings guidance may ultimately prove to be too conservative, we will stand aside from the stock until we see concrete evidence the business is back on track.

Outlook

One month is a long time in markets with the domestic outlook deteriorating in May, especially from a sentiment perspective, notwithstanding RBA Governor Philip Lowe's relatively upbeat assessment of the overall economy in the RBA's official June Monetary Policy Decision statement. As expected, the RBA left the cash rate unchanged at 1.5% and the accompanying statement remained relatively upbeat.

The RBA's statement included an incrementally positive view that business conditions have improved, capacity utilisation has increased and business investment has picked up (outside of mining areas). The RBA suggested it is not concerned about a soft March quarter GDP print, dismissing it as "quarter-to-quarter variation in growth numbers" and reiterating their view "economic growth is still expected to increase gradually over the next couple of year to a little above three per cent".

This is somewhat at odds with our anecdotal feedback from corporate Australia which suggest economic conditions have become more challenging domestically, particularly in the consumer discretionary space or in sectors of the economy exposed to the housing market where early signs of softening are becoming apparent in the key Sydney and Melbourne markets. The OC team has been extremely active of late, meeting with over 100 companies during the month of May and very few comments from cyclically exposed companies align with the RBA's view that business conditions have improved in Australia of late. Rather, most are suggesting operating conditions in Australia remain challenging and highly competitive, albeit most do not believe that environment will deteriorate further into the new financial year.

Long-time readers will be aware we have been cautious on the domestic economy for some time and we have positioned the portfolio accordingly. We have commented in the past that part of the beauty of domestic small and micro-cap investing is the stock universe is highly diversified. Irrespective of the prevailing macro-economic conditions, there are usually pockets of opportunity where stocks are performing well operationally or where value is still apparent. In that sense, it is a great universe for stock pickers like us.

As is often the case for OC, the portfolio holds several companies that can grow their earnings largely outside of the economic cycle including **AMA Group**, **National Veterinary Care**, **Millennium Group** and pre-IPO fresh produce supplier, **Nutrano**.

The Fund also owns companies exposed to the increasing use and value of data which remains relatively unaffected by domestic economic conditions. Data has been called the oil of the 21st century: an immense, untapped, valuable asset that powers the digital economy. The Fund has several holdings benefiting from the exponential growth in data consumption and our increasing dependency on data in the informational age including **Appen Limited** and **Netcomm Wireless**.

Despite our caution on the retail space, we still have selective exposure to the consumer discretionary sector via **Baby Bunting** and **Kogan.com**. Both stocks have been sold down on news of Amazon's entry into the Australian market (see April 2017 Fund Update). Each of these businesses has unique characteristics that will allow them to compete and continue to prosper notwithstanding Amazon's arrival in 2019 and we believe they have been oversold.

IPO activity has slowed of late with a number recent prospective IPOs such as **Wesfarmers** spinning out Officeworks, hydro-tap company **Zip Water** and pub operator, **Dixon Hospitality**, all being pulled from the market after failing to excite fund managers with their lofty price expectations.

We would not be surprised to see corporate activity accelerate in the coming months with private equity firms cashed up, interest rates low and several companies looking vulnerable following disappointing operating performance in recent times.

The adage 'sell in May and go away' again proved profoundly wise with the Australian market selling off once again during the month. The Fund remains conservatively positioned with a cash balance around 10% but recent stock price falls have seen us begin to deploy some capital into stocks we had previously considered too expensive.

Top 5 holdings#

Company	ASX code
Appen Ltd	APX
EML Payments Ltd	EML
Pacific Current Group Ltd	PAC
Pacific Energy Limited	PEA
Updater Inc	UPD

Fund overview

Long only and benchmark unaware, the OC Micro-Cap Fund (previously the OC Concentrated Equity Fund) is predominantly invested in 25 to 60 micro-cap stocks listed, or about to list, on the Australian Securities Exchange (ASX) or the New Zealand Stock Exchange.

The Fund aims to provide investors strong long-term capital growth by investing in companies with:

- a market capitalisation of less than $350 million at the time of initial acquisition
- sustainable business models, and
- attractive investment qualities.

Over a rolling five-year period, the Fund aims to provide a total return of 5%+ in excess of the S&P/ASX Emerging Companies Accumulation Index.

Strategic asset allocation	
Listed securities (including hybrid securities such as convertible notes, redeemable preference shares and partly paid shares)	70 - 100%
Cash	0 - 20%
S&P/ASX 300 Index	0 - 20%
Unlisted securities*	0 - 10%
New Zealand listed securities	0 - 10%
Derivatives	0%

**Must have a pathway to IPO within six months.*

Number of stocks	25 - 60
Maximum ownership of any company	7.5%
Maximum absolute stock position	8%

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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 Emerging Companies 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.

Past performance is not a reliable indicator of future performance. The total return performance figures quoted are historical, calculated using end-of-month mid prices and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. The performance is quoted net of all fees and expenses. The indices do not incur these costs. This information is provided for general comparative purposes. Positive returns, which the OC Micro-Cap Fund (the Fund) is designed to provide, are different regarding risk and investment profile to index returns. A performance fee of 20.5% is accrued daily on any excess performance (after deducting the management fee) above the performance benchmark within a performance period. Any accrued performance fee will become payable if the Fund's return is positive at the end of the performance period. If the Fund's return is negative, any performance fee accrual will continue to be carried forward. The performance benchmark is the return of the S&P/ASX Emerging Companies Accumulation Index. The inception date of the S&P/ASX Emerging Companies Accumulation Index is 31 December 2003. This document is for general information purposes only and does not take into account the specific investment objectives, financial situation or particular needs of any specific reader. As such, before acting on any information contained in this article, readers should consider the suitability of the information for their needs. This may involve seeking advice from a qualified financial adviser. Copia Investment Partners Ltd (AFSL 229316, ABN 22 092 872 056) (Copia) is the issuer of the OC Micro-Cap Fund (ARSN 126 537 424). A current PDS is available from Copia located at Level 25, 360 Collins Street, Melbourne Vic 3000, by visiting ocfunds.com.au, by calling 1800 442 129 (free call) or by emailing clientservices@copiapartners.com.au. A person should consider the PDS before deciding whether to acquire or continue to hold an interest in the Fund. Any opinions contained in this document are based on information available to Copia at the time and may be subject to change without notice. Copia is under no obligation to update or keep any information contained in this document current.