OC Premium Small Companies Fund

Fund Update | 30 September 2017

3.7%

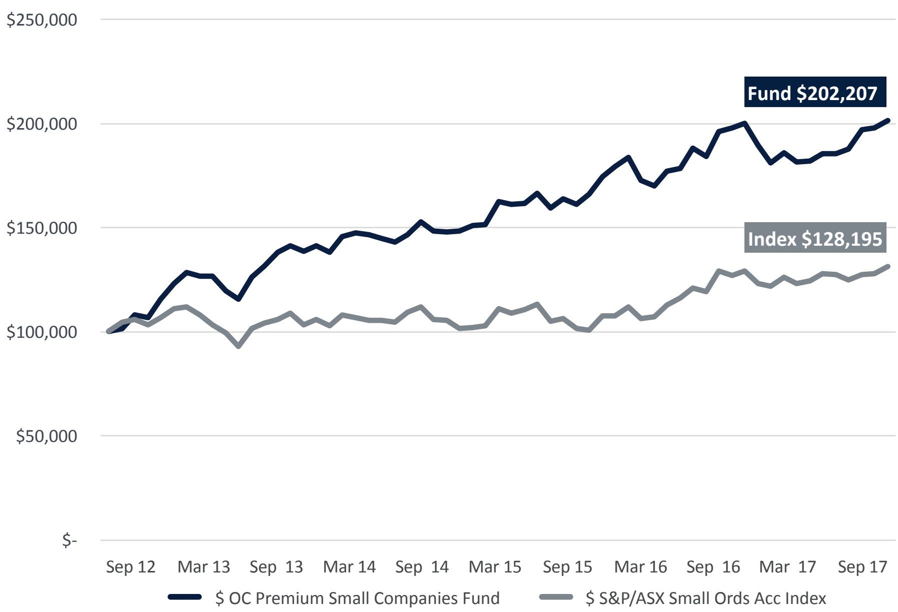
Fund up 3.7% for the quarter

15.2%

Returned 15.2% 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 30 September 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	1.4	3.7	2.0	11.3	15.2	13.0	4.2	11.3
S&P/ASX Small Ords Accum	1.3	4.4	3.0	8.1	5.1	2.3	-1.4	5.6
Outperformance	**0.1**	**-0.7**	**-0.9**	**3.2**	**10.1**	**10.7**	**5.6**	**5.7**
S&P/ASX Small Ind Accum	1.0	2.5	1.9	8.6	10.9	8.4	1.2	6.1
Outperformance	**0.3**	**1.2**	**0.1**	**2.7**	**4.3**	**4.6**	**3.0**	**5.2**

Performance review

Domestic small-cap equities performed well in the September quarter with commodity price increases driving a sharp rise in the S&P/ASX Small Resources Accumulation Index (+12.8%) and underpinning a solid increase in the broader S&P/ASX Small Ordinaries Accumulation Index (+4.4%). The OC Premium Small Companies Fund finished the quarter up 3.7%, which was behind the S&P/ASX Small Ordinaries Accumulation Index but ahead of the S&P/ASX Small Industrials Accumulation Index which finished the quarter up 2.5%.

The quarter saw the investment team meet with a record number of companies, many in a one-on-one format with the Managing Director and/or the Chief Financial Officer of the business. The insights gleaned from these meetings are invaluable not only in helping us sharpen our financial models and valuations, but also in gaining an in-depth understanding of the strategic direction of these businesses and the operational challenges or risks that may be on the horizon.

In terms of the key wins and losses for the portfolio during the quarter, we have already discussed many in our July and August reports. Nonetheless, we will touch on those that moved the needle most, in either direction, for the Fund during the quarter.

The A2 Milk Company (A2M, +55.8%) – continues to re-rate on the back of a very strong trading performance driven by ongoing gross margin expansion and continued rapid growth in sales of its A2 Platinum infant formula, especially in the large Chinese market. Management continues to exceed the financial expectations of both the overall market and our internal modelling and we have good reason to remain optimistic about the future. Management is doing an exceptional job of building a premium dairy business, leveraging its intellectual property associated with the production and marketing of 'A2 protein' based products. A2 Platinum infant formula has grown rapidly to 3.1% market share in China according to market research firm, Kantar, and we see no reason why this will not continue to accelerate, especially given the regulatory crackdown in China which ought to see brand rationalisation among competitors. The recent news that A2M's infant formula manufacturer, Synlait Milk, had received Chinese Food and Drug Administration (CFDA) approval well ahead of the deadline removes a key risk for the stock. Going forward, we see significant potential for management to grow the product portfolio and gain traction in new geographies including the US and UK markets where A2M is already investing heavily to grow its fresh milk business.

Appen Limited (APX, +31.3%) – the speech and search technology company, which would be well known to regular readers, continued to re-rate following another excellent result and a detailed report from Citigroup, which no doubt helped to raise the company's profile. APX is a key play on the rising importance of artificial intelligence (AI) which is widely considered the next paradigm shift in the technology sector. APX is essentially an enabler of machine learning and its services are used both to provide data sets for algorithms used in AI, as well as verifying the accuracy of the results of these algorithms. APX continues to deliver outstanding results and is expanding its client base into new verticals such as automotive and security. International Data Corporation (IDC) forecasts the market size for AI solutions will grow at 55% CAGR, from US$8b in 2016 to US$47b in 2020. APX is therefore well positioned to continue its strong growth trajectory in the coming years.

MACA Limited (MLD, +32.4%) – continued its march to record highs during the September quarter and is now +163.1% over the past 24 months. MLD is a best-of-breed contract miner with a predominantly WA-based client base and a commodity focus in the gold space (almost 90% of FY18 earnings base). In recent years, MLD has diversified into civil infrastructure, predominantly in WA. But the company also has a growing presence in Victoria and NSW where it is looking to expand its recently acquired Interquip engineering business. Several years ago, MLD followed one of its Australian clients to Brazil where it now services two gold/copper miners, namely Beadell Resources and Avanco Resources, both listed on the ASX. MLD has performed well through the cycle and always maintains a strong, net cash balance sheet. This has positioned it well for the recent uptick in the gold and iron ore space. With the resources sector buoyed by strong commodity prices, MLD's project pipeline is at record levels with an order book of some $1.13b at the start of this financial year. We believe MLD is well positioned to win material contracts in the coming months and we remain comfortable with our holding in the business.

RCR Tomlinson (RCR, +27.9%) – was well supported by the share market during the quarter as it continued to execute on its plan to become a leading player in the rapidly evolving renewable energy space. RCR is a diversified engineering and infrastructure company, working with some of the world's leading organisations to provide intelligent engineering solutions to the infrastructure, rail, energy and resources sectors. RCR has a 100+ year history and its core capabilities encompass development, engineering, procurement, construction, operation and maintenance of major infrastructure, energy and resource projects. Earlier in the quarter, RCR announced it had commenced work on the construction of the $150m Pilbara Minerals 2Mtpa Lithium-Tantalum EPC project and had won two solar farm projects (worth A$315m) in northern Queensland. At the release of its result delivered in mid-August, RCR raised $90m to support its growing pipeline of projects in the renewable energy, rail and transport markets and to fund its development aspirations in the renewable energy sector. The raising was well received by investors who clearly consider RCR's record order book (+$1.4b) and expanding pipeline of renewable energy and transport projects as a precursor to continued strong growth through FY18 and beyond.

NRW Holdings (NWH, +86.1%) – performed strongly during the quarter on the back of a transformative acquisition that resulted in material upward revisions to FY18 earnings expectations for the combined business. The acquisition was partially funded by a well-supported capital raising to which OC subscribed. The core NWH business has been primarily focused on mining services in WA with a growing Queensland presence via a large cornerstone coal contract and an east coast coal production drilling business that was purchased out of administration in December 2016. NWH also has a smaller, but growing, civil infrastructure business. In mid-August, the company announced the acquisition of Golding Group, a long established east coast contractor with leading market positions in the civil infrastructure, urban development and mining services markets of Queensland and NSW. The acquisition delivers on NWH's strategy to expand its presence and service offering into adjacent and complementary sectors with a 'tier 1' client base. The acquisition essentially doubles the size of NWH and diversifies its client/commodity exposure away from the cyclical Pilbara-based iron markets. Importantly, the acquisition was 60% EPS accretive on a proforma basis and the experienced Golding management team was retained through the transaction. The acquisition looks sensible, well priced and the Fund has built a small holding in the company.

Seven Group Holdings (SVW, +11.5%) – was added to the portfolio during the quarter following several significant corporate transactions including the sale of WesTrac China to Lei Sing Hong Machinery for $540m, the acquisition of the remaining 53.3% of Coates Hire not already owned by the Group for $517m and a capital raising of $375m to increase the free float in the stock and provide balance sheet flexibility. SVW's key assets now comprise: a) Coates Hire – the leading Australian equipment hire business, with over 200 branches and a national footprint, b) WesTrac Australia, Australia's largest authorised Caterpillar dealership, including sales, finance, maintenance and resale, c) AllightSykes – a supplier of light towers, generators and pumps, and d) a 41% stake in Seven West Media. We view SVW as an excellent exposure to an expected pick-up in both the Australian infrastructure investment cycle and the mining cycle, both of which appear to be in the early stages of a recovery which could run several years.

Netcomm Wireless Limited (NTC, -36.5%) – was under pressure during the quarter despite releasing a FY17 result that was in line with our expectations and mildly ahead of consensus forecasts. The share price pressure likely stems from the lack of material news around contract wins, some slippage in consensus profit expectations for the FY18 year, and an unfounded (in our view) belief that a capital raising may be imminent. NTC is expected to significantly ramp up the deployment of its Fibre-to-the-Distribution point (FTTdp) technology as NBN Co accelerates its roll-out to one million homes which ought to underpin strong profit growth in FY18. Nevertheless, we have moderated our assumed pace of the NBN fixed-wireless take-up near term as the actual results have been slower than anticipated. Furthermore, the market has tempered its expectations around the FY18 contribution for the AT&T fixed-wireless contract given AT&T is widely expected to move at a glacial pace until the Connect America Fund Phase II action for an additional $2b funding has been decided. Despite not announcing any new material client engagements in recent months, NTC retains a strong pipeline of opportunities across fixed-wireless communications and other machine-to-machine solutions, including prospects with multiple tier-one customers and remains a small holding in the Fund.

Hansen Technologies Limited (HSN, -16.3%) – de-rated following the release of its FY17 result which showed margins had retreated to the lower end of the company's 25-30% guidance range and organic growth had slowed to 2% on a constant-currency basis below management's 4-8% target range. It was a disappointing quarter for the company which was under pressure in July following an equity placement at a discount to fund the acquisition of Enoro (see our July 2017 report) and the release of guidance that was below analyst expectations. Notwithstanding these near-term negatives, we continue to view Hansen as a quality business with solid cash flows and a sticky customer base that can grow its earnings irrespective of the underlying economic conditions in the markets in which it operates. We expect organic growth to normalise in FY18 to its long-term average of around 4-8% and we back the high calibre management led by Managing Director, Andrew Hansen, to utilise the strong balance sheet to continue to make value-adding acquisitions as they have consistently done over many years.

Outlook

Domestic economic conditions remain challenging and we have spoken at length lately about the issues facing the consumer with discretionary spending under pressure, wages growth low and household debt at elevated levels. Undoubtedly it is a tough environment for retailers, especially in light of the imminent arrival of Amazon, the ultimate disruptor, with a full retail presence in Australia.

On a more positive note, the RBA's confidence in a non-mining investment recovery appears to have strengthened with its October Statement citing a "large pipeline of infrastructure investments… also supporting the outlook". This corresponds with our own view that east coast infrastructure spending will increase significantly over the coming years particularly in areas such as road, rail, transport, telecommunications and renewable energy. The OC portfolio is well represented by companies that ought to benefit from an uptick in spending in these areas with **RCR Tomlinson**, **Bingo Industries**, **Netcomm Wireless, Seven Group Holdings**, **NRW Holdings** and **MACA Limited** all expected to be beneficiaries to varying degrees.

Likewise, the outlook for mining capex is expected to improve going forward, following a material reduction in spending since the cycle last peaked in 2012. Project-related activity has finally bounced off its lows and lead indicators, such as heavy equipment sales and utilisation levels, have started improving. We met with a host of companies exposed to the mining capex cycle over the quarter and the overwhelming majority cited growing tender pipelines and increased activity levels which ought to bode well for the mining service providers within our portfolio including **MACA Limited**, **RCR Tomlinson**, **NWH Holdings** and **Seven Group Holdings**.

Conditions in the global economy remain largely unchanged from last month with major global economies, including the US and China, showing ongoing signs of strength. The International Monetary Fund's (IMF) updated global forecast, scheduled for release this week, will likely be "even more optimistic" according to IMF Managing Director, Christine Lagarde, in a speech last week at Harvard University.

In China, growth is being underpinned by increased spending on infrastructure and property construction which in turn, is fuelling commodity price rises which is good for both resource companies and Australia's national accounts. The US outlook remains clouded by political inertia, stalling the proposed implementation of tax cuts and infrastructure spending, which would otherwise support above-trend growth. US growth momentum, nevertheless, remains solid led by a consumer rebound, an uptick in capital spending and a labour market at full employment. The US Federal Reserve continues its path towards monetary policy normalisation, although there is some uncertainty about who will lead the Federal Reserve going forward with incumbent President Janet Yellen's term set to expire in February 2018 and Stanley Fisher, the vice chair, having announced his resignation, effective mid-October.

The situation on the Korean Peninsula remains tense with North Korea threatening to unleash a "barrage of nuclear strikes" against the US if it continues "mischievous" behaviour such as flying bombers near the border. Trump continues to incite the North Koreans, recently threatening to "totally destroy" the nation if it poses a threat to the US or its allies and mocking leader Jim Jong Un as a "Rocket Man" on social media and during his first address at the UN General Assembly early in September. At this point, the market continues to largely ignore the verbal jousting by both sides, although military engagement of any sort would undoubtedly snap the market from its state of seeming indifference.

IPO activity remains subdued at present, although secondary market placements have been commonplace in recent weeks. Independent fund platform administrator, Netwealth, is the only shining light on the new float horizon and we are meeting with the management team, who we know well (both OC and the broader Copia Group are a client) for a second time this Friday as part of the process.

Following our post-reporting season management catch-ups, which have finally concluded, we are once again heading out on the road with an extensive list of companies, competitors and sites to visit in the coming weeks. We thank our investors for their ongoing support and remain committed to our goal of generating strong long-term risk-adjusted investment returns for our clients.

Top 5 holdings#

Company	ASX code
Bapcor Limited	BAP
Bingo Industries Ltd	BIN
Blue Sky Limited	BLA
Eclipx Group Ltd	ECX
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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