OC Micro-Cap Fund

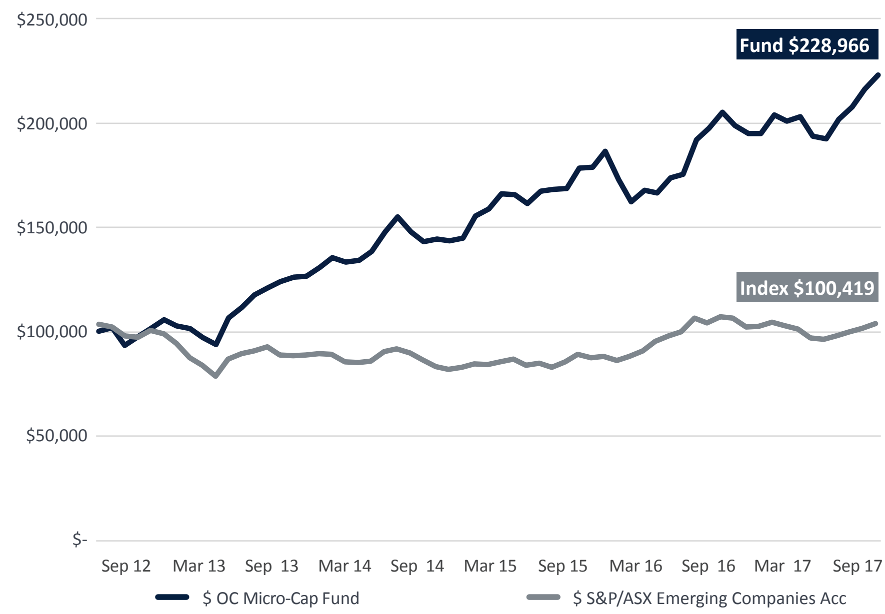
Fund Update | 30 September 2017

10.7% Fund up 10.7% for the quarter

18.1% Returned 18.1% 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*



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. (Nov 2003)
OC Micro-Cap	3.3	10.7	8.8	15.2	18.1	12.3	10.4	13.6
S&P/ASX Emerging Comp. Accum	3.3	8.9	-4.3	7.5	0.1	-1.4	-2.9	N/A
Outperformance	**0.0**	**1.8**	**13.1**	**7.8**	**18.0**	**13.8**	**13.3**	**N/A**

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 September quarter was a strong one for domestic micro-cap equities, with commodity price increases underpinning a sharp share price rise for numerous junior resource companies. Despite having limited exposure to speculative micro-cap resource stocks, the Fund had an excellent quarter, returning 10.7%, ahead of the S&P/ASX Emerging Companies Accumulation Index which was up 8.9%.

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 getting a more in-depth understanding of the strategic direction of the business and 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 a few that moved the needle, in either direction, for the Fund during the quarter.

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, which 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 ore 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 remains a comfortable holder of NWH.

Zenitas Healthcare (ZNT, +40.7%) – the healthcare operator enjoyed a strong quarter after it followed up two earnings-accretive acquisitions announced earlier in the quarter (see July report) with a strong inaugural result as a listed player. ZNT's underlying NPAT was 9.1% ahead of the prospectus forecast despite revenue being around 10% behind forecast due to the company's sensible decision to exit certain low-margin, high-risk elements of the Home Care division. Particularly pleasing was the organic growth guidance of 7.5-10.0% which, coupled with the Nextt Health Care and Dimple acquisitions, ought to underpin a strong FY18 result. Despite the strong share price appreciation during the quarter, the company continues to trade at a ~40% discount to domestic healthcare service peers. We expect this discount to close in the coming year as the company builds scale and executes on its vision to become a leading provider of community-based healthcare servicing allied health, home care and primary care.

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.

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.

Micro-X (MX1, -11.9%) – underperformed during the quarter after it failed to capitalise on the momentum of its June announcement regarding important regulatory approvals received by its US distribution partner, Carestream Health. Adelaide-based Micro-X is developing and commercialising a range of highly innovative products based on proprietary carbon nanotube emitter technology. This technology enables the miniaturisation of a number of x-ray applications relevant to large global markets such as the healthcare, military, security and anti-terrorism sectors. MX1's first go-to-market product is a portable patient x-ray machine that is materially lighter and more user friendly than conventional hospital-based x-ray solutions. Carestream Health received FDA approval in June to commence marketing the carbon nanotube powered portable x-ray product (known as the DRX Revolution) to the large US market in what was seen as a critical step in Micro-X's pathway to profitability. Unfortunately, Micro-X suffered from a lack of news flow during the September quarter and the share price retreated as a result. We find that evolving businesses such as Micro-X require ongoing news flow to continue to command the attention of the market. Importantly, our investment thesis remains intact and we remain comfortable Micro-X is on the right pathway with this product, as well as others in the pipeline. In a further positive update, MX1 handed over its first commercial production units to Carestream Health in early October

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 **Netcomm Wireless**, **NRW Holdings** and **SRG** 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 **Imdex**, **NWH Holdings** and **Pacific Engergy** and **Codan**.

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 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
Appen Ltd	APX
Family Zone Cyber Safety Ltd	FZO
Jumbo Interactive Ltd	JIN
Millennium Services Group Ltd	MIL
Updater Inc	UPD

CONTACT COPIA

1800 442 129 | clientservices@copiapartners.com.au | copiapartners.com.au

John Clothier	General Manager, Distribution	0408 488 549 | jclothier@copiapartners.com.au
Adam Tweedale	State Manager, Southern Region	0425 804 727 | atweedale@copiapartners.com.au
Angela Vincent	State Manager, Northern Region	0477 347 260 | avincent@copiapartners.com.au
Sean Paul McGoldrick	Account Manager, Northern Region	0421 050 370 | spmcgoldrick@copiapartners.com.au
Iain Mason	Director, Institutional Business	0412 137 424 | imason@copiapartners.com.au
Jacinta King	Business Development Associate	0413 962 922 | jking@copiapartners.com.au