OC Premium Small Companies Fund

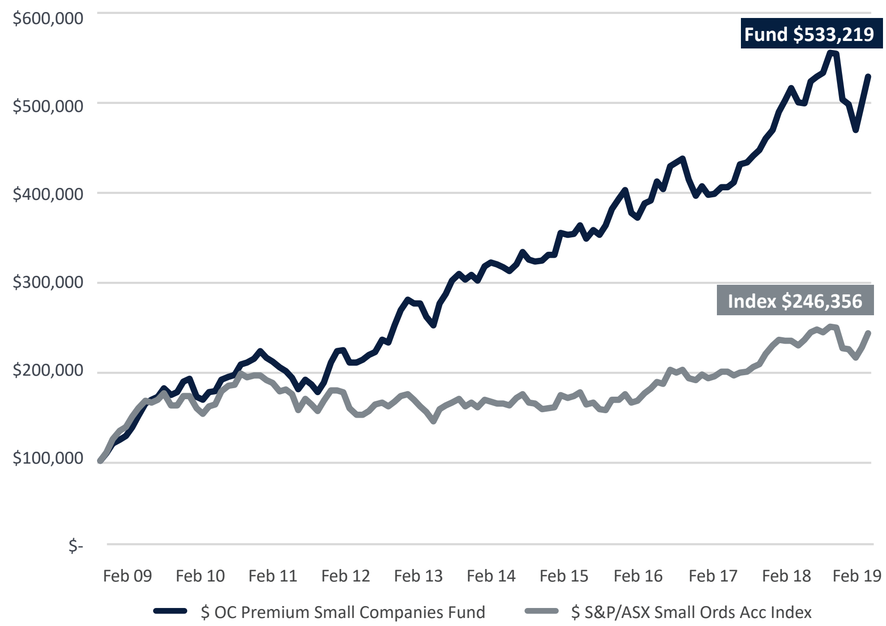
Fund Update | 28 February 2019

5.9% Fund up 5.9% for the month

18.3% Returned 18.3% p.a. for the past ten years

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

Performance comparison of $100,000 over 10 years*



Total returns

At 28 February 2019 †	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	5.9	6.2	2.3	12.5	10.7	14.2	18.3	11.4
S&P/ASX Small Ords Accum	6.8	8.0	3.5	13.4	7.7	4.6	9.4	6.0
Outperformance	**-0.9**	**-1.8**	**-1.2**	**-0.9**	**3.0**	**9.6**	**8.8**	**5.3**
S&P/ASX Small Ind Accum	7.1	7.9	5.5	11.4	8.5	9.9	13.0	6.4
Outperformance	**-1.1**	**-1.7**	**-3.2**	**1.1**	**2.3**	**4.3**	**5.3**	**4.9**

Performance review

Following a strong recovery in January, equity markets moved higher again in February and the small cap indices have now recovered much of the ground lost in the final quarter of CY18. The February reporting season threw up a mixed bag of results across the Australian small company universe. Overall results were solid, with notable exceptions from stocks exposed to the Australian consumer and housing markets which, in most instances, are facing mounting headwinds.

The strong performance of the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index during the month, up 6.8% and 7.1% respectively, had more to do with subdued earnings expectations following the December quarter sell off and the US Federal Reserve's pivot back towards a dovish stance rather than any exceptional earnings delivery across the small-cap space. Indeed, the strength of the rally surprised us, given that little has changed from a macro stand-point other than the US Fed's about face. The OC Premium Small Companies Fund returned +5.9% for the month, which was a solid result given that the Fund was conservatively positioned during the month with an average cash holding balance above 10% of the portfolio.

Amongst the best performers for the Fund during the month were stocks exposed to two of our preferred thematics, namely global leading technology names and mining services companies.

Appen Group (APX, 46.9%), Altium Limited (ALU, 32.3%) and Afterpay Touch Group (APT, 15.9%) were strong contributors to the Fund's performance during the month with all three posting outstanding financial metrics. APT additionally benefited from a relatively benign outcome from the Senate Committee inquiry into consumer credit including the "buy now, pay later" sector. Each of APX, ALU and APT have dominant positions in their respective industries and their leadership position appears to be strengthening. Importantly, all three continue to exceed consensus expectations on key financial metrics. Valuation aside, these companies tick most boxes, but the vexed question is what is a fair valuation to pay for these stocks?

The Fund has been progressively reducing portfolio weightings in each of these names over the past 12 months as their share prices have approached our valuation, (despite of valuations consistently being increased over the past year due to the ongoing delivery of upside earnings surprises). Following a large increase in their market capitalisations, all three stocks are material components of the small ordinaries index (ALU number 1, APX number

4 and APX number 15) which limited the alpha (index relative performance) generated from these stocks during the month. Whilst these stocks were strong contributors from an absolute return perspective, they are no longer held at materially above the benchmark weight. Whilst we continue to expect APX, ALU and APT to grow at a rapid clip in the coming years, our smaller positions are reflective of the narrowing gap between the current share price and our internal valuations.

The Fund holds a select few mining and oil & gas services companies who have the following attributes: strong competitive advantage, diversification across commodity and mine site, a robust balance sheet, and well-regarded management. These companies rallied strongly during the month with **Ausdrill Limited (ASL, +38.1%), Monadelphous Group (MND, +20.6%)** and **NRW Holdings (NWH, +23.6%)** each posting solid results and presenting outlooks statements that suggest that the coming years ought to deliver robust earnings growth, largely from projects that are well funded and unlikely to materially slip from a timing perspective. Core fund holding, **Seven Group Holdings, (SVW, +22.6%)**, is also expected to be a major beneficiary of the strong domestic commodity cycle via its wholly owned WesTrac subsidiary, which holds the Caterpillar dealerships in WA, NSW and ACT, and to a lesser extent through plant hire business Coates Hire and its energy assets which include a 28.6% in listed ASX stock **Beach Petroleum (BPT, +16.11%)**.

Long term readers will be aware that OC Funds tends to be quick to exit companies that materially disappoint from an earnings perspective, or where our investment thesis is proven to be incorrect or where we feel that we have been misled by management. In our opinion, many investors have cognitive biases that either prevent them from taking a material loss on stocks when the overwhelming evidence is that it is the rational thing to do and/or they anchor to prior perceptions around valuation, even in the face of new information that ought to alter their valuation. This can be a costly mistake as taking the first loss, whilst painful, is often an investors best outcome as news often get worse before it gets better.

In two recent instances, the Fund has retained positions in companies that that have materially disappointed the market (and our own) expectations due to our view that the market reactions to the negative news at the time was overly harsh, namely **GTN Limited (GTN, +37.1%)** and **Speedcast International (+33.3%)**. Despite our general investment rules, we are not irrational (or spiteful) sellers and, in both instances, we felt the stocks have been oversold by the market. During the month we were rewarded for our patience as GTN and SDA both rallied strongly following the release of results which were in-line with their revised earnings guidance. We have retained our holding in GTN for the time being as we expect earnings to recover to play out in the coming year, while we have used the recent share price strength in SDA to reduce our holding.

The **Citadel Group (CGL, -19.4%)** was sold off during the month after reporting a first half result that was below analyst expectations. CGL is a leading software and services company that specialises in secure information management in complex environments. The company has a raft of long-term contracts in the fields of defence, national security, health, education and government with high quality counterparties such as the Queensland government, Brisbane City Council, the Department of Defence and Royal Adelaide Hospital. CGL's clients place a premium on security, integrity and experience, with price often a secondary consideration, which has resulted in an offering with strong barriers to entry, that is difficult to replace, and with margins that are at a premium to peers.

Whilst the half yearly numbers were slightly behind analyst expectations, we believe that the market has underappreciated the quality of the CGL business model with the recent pivot towards higher quality recurring software-as a-a-service (SaaS) revenues gaining serious traction, up 39.1% year-on-year to $16.8m. This will result in a margin hit near term, as evidenced by the half yearly result, as the company forgoes short-term licence fees on some contracts in favour of higher quality, stickier long term recurring SaaS revenues and wears some upfront implementation costs during the transition period. But ultimately, margins ought to track materially higher in the medium term and we would expect the stock to re-rate due to the higher quality earnings stream. CGL has a very strong pipeline of SaaS opportunities, particularly from its flagship Citadel-IX platform, its stock valuation remains compelling versus peers and the company remains a core Fund holding.

Bingo Industries (BIN, -20.1%) - the rapidly expanding waste collection and recycling company had a tumultuous month with the share price initially falling 49% on the back of a profit downgrade before regaining some of the lost ground after receiving ACCC approval for the transformational Dial a Dump (DADI) acquisition. The downgrade came as the downturn in residential construction started to bite, leading to BIN deferring its regular price rise to coincide with the introduction of the Queensland waste levy which was subsequently delayed. In addition to this, the company delayed its expansion projects, pending the ACCC decision on the proposed acquisition of Western Sydney based landfill and recycling company, DADI. While the stock began to recover from its oversold levels almost immediately, the biggest catalyst was the ACCC approval of the DADI acquisition on the last day of the month. The acquisition allows for the optimisation of Bingo's network to feed this larger scale site and significantly reduces capital requirements elsewhere. As further unexpected positive surprise came with this announcement, as the company announced a share buyback to be funded with the proceeds from the forced divestment of one of its transfer stations, expected to be sold significantly above book value. We held our nerve during this period of volatility, confident that the stock had been oversold on mostly transitory impacts and that the ramp up in infrastructure projects and growth in Victoria would, in time, off-set the impact of slower NSW housing starts.

Earlier in the month, the Fund began opportunistically accumulating a position in fast fashion jewellery retailer, **Lovisa Holdings (LOV, +39.2%)**, after the share price fell below $7.00. Lovisa has built a highly successful, vertically integrated business model, through which it develops, designs, sources and merchandises 100% of its Lovisa branded products. The company has over 320 stores across Australia, New Zealand, Singapore, Malaysia, South Africa, Spain, France, the USA and the United Kingdom and franchised stores in the Middle East (Kuwait, the United Arab Emirates, Saudi Arabia, Oman and Bahrain) and Vietnam. Lovisa has developed a model that ensures trends are quickly identified and its target customers (being fashion conscious females aged 25-45) are provided with an affordable, quality product range.

The Lovisa share price has been under considerable pressure since mid-2018 when it began cycling more challenging same store sales (SSS) growth numbers in its mature Australian market and SSS growth started printing negative. The stock has fallen from a high of $12.50 in June 2018, but in that time management has made considerable in-roads into building out new territories, particularly in the UK, US and France, which are now in full roll-out mode. Whilst a store roll-out target has not been provided, these are large markets with the potential to double the company's current store foot-print. There is much to like about the LOV business model, including strong gross margins, greater than 75%, payback periods on new stores of less than 12 months, low capacity intensity (self-funding model), large roll-out potential and high levels of management alignment, including highly regarded retailer Brett Blundy (who was behind Bras N Things, Sanity and Adairs), who is Chairman with a 40% stake in LOV. We are prepared to look through a near term slow-down in Australian SSS (which ought to turn positive in the coming months) due to the significant potential of the low capital intensity global roll-out. The Fund accumulated a small position ahead of the result and topped up after the company confirmed the US and French roll-out and indicated it was experiencing an improved trading performance since year end across all markets in its half yearly result.

Outlook

While a dovish pivot from the Federal Reserve over the past two months and low expectations leading into reporting season helped the market stage a solid rally in February, the global economy is now facing a low growth backdrop. On the heels of the Fed's dovish rhetoric, the European Central Bank pushed out a planned rate hike, slashed its growth and inflation forecasts and surprised the market with a new round of policy stimulus to address continued weakness and widespread uncertainty. The reversal came in the same week that Canada's Central Bank took a sudden dovish turn and disappointing data points from Australia and China instilled a sense of caution in markets. Mounting evidence of a world slipping back to a norm of benign inflation and a murky growth outlook has forced the recent dovish tilt of central banks across the region, reflecting a coordinated pause in tightening and more supportive macroeconomic policies to be expected in the short to medium term.

Investors breathed a sigh of relief as the White House delayed tariff increases on Chinese goods beyond the end of February deadline, citing substantial progress being made in trade talks between US and Chinese negotiators. The confirmed extension was accompanied by positive news flow on significant breakthroughs, such as discussions involving China buying more US goods in the agriculture, energy and semi-conductor sectors, market access, technology transfers and mutual respect for monetary policy autonomy. Markets also appeared to have priced in the optimism arising from various news reports outlining the possible scenario for both sides to iron out the final details of a formal agreement at a potential meeting in early April.

To throw in another element of optimism, there are tentative signs of a turnaround in Chinese growth momentum as policymakers seek to pull off a gradual deceleration while grappling with a debt legacy and the trade standoff with the US. The Chinese 2019 GDP growth target was set at a range of 6.0 to 6.5% and this shift to a band gives policymakers room to move given other pressing concerns regarding poverty alleviation and systematic deleveraging.

Fiscal stimulus and tax reform are the new agenda items as the Chinese Premier Li Keqiang presented the government's Work Report in the 2019 Nation People's Congress and announced two trillion RMB cut (roughly 0.6% of GDP) in total VAT and social security contributions to support the manufacturing, transport and construction sectors. In addition, for government-led spending, the predominant focus remains on off-budget infrastructure investment. As the annual window for issuance of special bonds to support local municipal infrastructure spending was opened in late January, well ahead of the usual summer timing, the additional liquidity should contribute to an easing in the broad fiscal stance in the coming months. Over the next few weeks, the release of economic data on retail sales, investment, credit and industrial production should provide fresh clues on the impact of its easing policy and extent of Chinese growth stabilisation.

On the domestic front, the RBA is following the global trend, dropping the previous tightening bias to take an "evenly balanced" stance on the direction of interest rates in response to disappointing domestic macroeconomic performance and the uncertain impact of falling house prices on consumption growth. December quarter GDP growth was just 0.2% quarter on quarter, with a fall in housing investment, weaker consumer spending and business investment and a detraction from trade only partly offset by solid public demand.

In our view, a slowdown in household consumption growth is a key domestic macro risk. While the RBA research found that the wealth effect is highest for spending on motor vehicles and household furnishings, recent weakness in January retail trade (with a bounce of just 0.1%) and February car sales data (down 9.3% on the level of a year earlier) is pointing to a near-term slowdown and perhaps, more importantly, providing more concrete evidence of spill-over from the cooling housing market.

Observations from reporting season also suggested that the impact of a slowing housing market was felt far and wide. While property developers such as AVJennings (AVJ) on average reported sluggish sales momentum, building materials, construction and housing related companies including Boral Limited (BLD) missed on what were already low expectations given the well-flagged decline in multi-dwelling and residential construction activity as well as delays to key infrastructure projects. In the retail space, the results were mixed with Super Retail Group (SUL), Lovisa Holdings (LOV) and Nick Scali (NCK) delivering buoyant results ahead of market expectations in contrast to retailers closely linked to housing cycle and automotive slowdown such as Automotive Holdings Group (AHG), which materially underperformed profit expectations due to negative wealth sentiment and regulatory changes to automotive finance and insurance.

Results from reporting season have heightened our conviction that the key themes underpinning our portfolio will continue to outperform over the medium-term.

- **Resources and mining services sectors are an area of relative strength**: Mining stocks have re-rated on the back of a commodity price rally, partly driven by supply disruptions, and the sector is the only pocket of the market, aside from technology stocks (mentioned earlier), offering strong earnings momentum and considerable EPS upside. Strong capex expectations announced by the miners appear to show that the mining construction downturn has bottomed out. Mining services companies are the key beneficiaries of production and those with strong competitive advantages, robust balance sheets and well-regarded management remain as preferred exposures for the Fund. A number of these selective holdings rallied strongly during the month, including Ausdrill Limited (ASL, +38.1%), Monadelphous Group (MND, +20.6%) and NRW Holdings (NWH, +23.6%).

- **Offshore earners outperformed**: As we have now become more circumspect about the domestic economy, the portfolio remains skewed towards companies with robust earnings growth which ought to generate a premium rating in a slowing growth environment, or companies that can grow their earnings outside of the economic cycle or offshore earners. Given the recent dovish shift by central banks and anticipation of further supportive macro policies, global growth is expected to stabilise at a lower level. Broader risk appetite has also been supported by increased Chinese stimulus and easing US-China trade tensions in the near-term. The Fund's holdings in offshore earners include Appen Group (APX, 46.7%), Altium Limited (ALU, 32.3%), Reliance Worldwide Corporation (RWC, -6.2%) and A2 Milk (A2M, +14.0%).

The investment team will be out on the road for much of March, including interstate and offshore, assessing new investment opportunities and meeting with the management of current holdings and their competitors. In contrast to the market turbulence during the December quarter, where investor sentiment swung wildly on perceived progress or setbacks, the influx of news related to sector's and company's underlying performance from the reporting season have provided higher quality and more transparent indicators on how the economy is tracking and propelled the market participants to focus on fundamentals once again. We have a strong understanding of the key business drivers of companies within our portfolio and a firm belief that the market will reward their earnings and cashflow generation over the medium-long term.

Top 5 holdings#

Company	ASX code
Mineral Resources Ltd	MIN
Nextdc Limited	NXT
Reliance Worldwide	RWC
Seven Group Holdings	SVW
Webjet Limited	WEB

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments.

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

John Clothier	General Manager, Distribution	0408 488 549 | jclothier@copiapartners.com.au
Iain Mason	Director, Institutional Business	0412 137 424 | imason@copiapartners.com.au
Mani Papakonstantinos	Distribution Manager	0439 207 869 | epapakonstantinos@copiapartners.com.au
Matthew Roberts	Distribution Manager	0438 297 616 | mroberts@copiapartners.com.au
Jude Fernandez	Distribution Manager	0414 604 772 | jfernandez@copiapartners.com.au

[†]The total return performance figures quoted are historical, calculated using soft close, 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 index does not incur these costs. This information is provided for general comparative purposes. Soft close unit prices are interim unit prices struck at month end before all transactions for the month have been completed. Performance data available on the OC website, ocfunds.com.au, however, is based on hard close unit prices which are struck after all transactions for the month have been completed.

[*] 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.

Past performance is not a reliable indicator of future performance. Positive returns, which the OC Premium Small Companies Fund (the Fund) is designed to provide, are different regarding risk and investment profile to index returns. A performance fee of 20.5% is payable annually on any excess performance (after deducting the management fee) above the benchmark, S&P/ASX Small Ordinaries Accumulation Index, to 30 June. A performance fee is only payable where the Fund has returned 5% or more since the last performance fee was paid. 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 appropriateness of the information to 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 Premium Small Companies Fund (ARSN 098 644 976). A current PDS is available from Copia located at Level 25, 360 Collins Street, Melbourne Vic 3000, by visiting ocfunds.copiapartners.com.au or by calling 1800 442 129 (free call). A person should consider the PDS before deciding whether to acquire or continue to hold an interest in the Fund. Any opinions or recommendation contained in this document are subject to change without notice and Copia is under no obligation to update or keep any information contained in this document current.