FUNDS MANAGEMENT

# OC Micro-Cap Fund

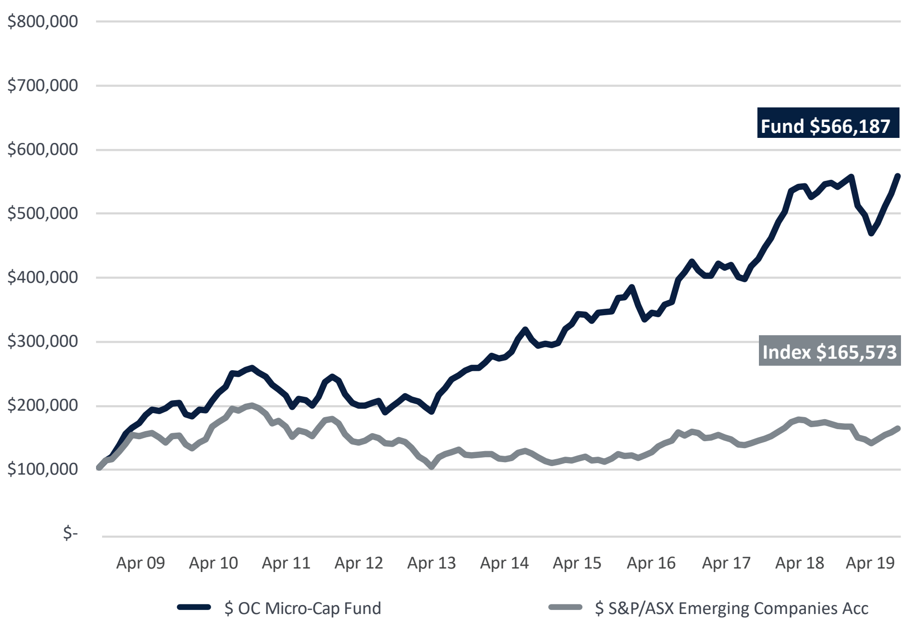
Fund Update | 30 April 2019

**5.3%** Fund up 5.3% for the month

**19.0%** Returned 19.0% p.a. for the past ten years

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

## Performance comparison of $100,000 over 10 years*




## Total returns

| At 30 April 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. (Mar 2003) |
|---|---|---|---|---|---|---|---|---|
| OC Micro-Cap | 5.3 | 15.4 | 4.9 | 17.9 | 15.6 | 13.2 | 19.0 | 13.5 |
| S&P/ASX Emerging Comp. Accum | 4.3 | 12.4 | -4.8 | 6.9 | 7.6 | -0.7 | 5.2 | NA |
| **Outperformance** | **1.0** | **3.1** | **9.7** | **11.0** | **8.0** | **13.9** | **13.8** | **NA** |

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 continued its positive start to the new calendar year with broad based strength across the portfolio driving a +5.3% return for the month. This was once again ahead of the S&P/ASX Emerging Companies Accumulation Index which was up 4.3% for the month.

One of the key stock contributors was **NRW Holdings (NWH, +24.4%)** which has been a solid performer for the Fund this financial year as it continues to re-rate on the back of consistent operating performance and a strong pipeline of opportunities. NWH is well positioned to deliver an excellent FY19 result with the company upgrading earnings in the first half and continuing to announce incremental contract wins into the second half. The company has a forward order book of around $2.4 billion and it ought to be debt free by the end of the financial year. The NWH civil business is in line to win a significant amount of work in the coming years on the back of the iron ore replacement and sustaining tonnes projects from BHP, RIO and FMG which have approval to begin construction and are critical to the iron ore majors maintaining their production levels in the coming years. It is, therefore, unlikely that these projects would be cancelled regardless of what transpires in the global economy because this would result in the iron ore producers having significantly smaller businesses going forward. In a promising sign, NWH has already been awarded some early works on BHP's South Flank, FMG's Eliwana and RIO's Koodaideri projects.

Rapidly growing online retailer **Kogan (KGN; +59.9%)** was opportunistically added to the portfolio in March when its share price dropped back sufficiently for the stock to be once again considered a micro-cap under the OC investment process (sub $350m market capitalisation). The investment team keep an eye on stocks coming back into the micro-cap investment universe so that we are well positioned to analyse such stocks and take advantage of any share price moves that we assess to be temporary rather structural or more permanent declines.

KGN is an online retailer known for its price leadership through digital efficiency and it is not often we get a second chance to own a business of this quality; having previously held KGN through its July 2016 IPO. Since re-acquiring our position, KGN has launched a new vertical, being Kogan Marketplace, increased the size of its debt facility to provide more flexibility for growth and provided an upbeat March quarter earnings update. We will continue to hold KGN whilst it represents value and whilst management delivers on its growth objectives.

OC Micro-Cap minnow, **Micro-X Ltd (MX1; +23.4%)**, enjoyed a relief rally during the month on the back of an alliance it signed with global major, Thales Group, which is capped at about A$25 billion. Thales Group is a French multinational company that designs and builds electrical systems and provides services for the aerospace, defence, transportation and security markets. After an extended period of due diligence on Micro-X and its core proprietary carbon nanotube emitter technology, Thales signed an alliance agreement with MX1 wherein the two companies will collaborate on the global sales and support of MX1's counter-terrorism Mobile Backscatter Imager for the assessment of improvised explosive devices and in the field of airport security. The alliance comes with A$10m of funding from Thales via a 6-year convertible loan note. The deal is important for MX1, in not only providing additional development capital for the business but also in that it provides critical endorsement of MX1's carbon nanotube technology (which has already been commercialised in the area of mobile X-ray through its Carestream distribution agreement) which can now be fast tracked into the development and rollout of other verticals such as security and defence. We are pleased to see MX1 is now heading in the right direction once again and we look forward to further positive developments.

Medi-tech business **Next Science (NXS; +60.0%)** came onto the ASX boards mid-month as one of the hotter IPO's for 2019 and certainly lived up to expectations. NXS has four FDA cleared products currently available in the US market to treat and manage surgical site infections and chronic wounds. NXS owns 100% of the patent protected intellectual property relating to its Xbio technology. Although medi-tech is typically outside our core investment universe, our micro-cap team always wants to see and listen to new stories and the NXS technology and advanced pathway to commercialisation was something that resonated with our team through the IPO process. We took a small position for the Fund in the IPO and were pleasantly surprised by the market reaction post listing. We have since sold down our holding as we see the NXS share price as a little too rich for us at current levels.

**Capitol Health (CAJ, +20.5%)** was added to the portfolio recently on the share price pullback following the delivery of a disappointing half year earnings update in February. Melbourne based, CAJ provides diagnostic imaging and related services through its 58 clinics in Victoria, Tasmania, and Western Australia. The company's facilities are predominantly community-based, rather than hospital-based, with priority given to service and minimisation of administrative burdens for healthcare professionals so that the radiologists can deliver optimal, efficient, accurate healthcare service outcomes for patients. We believe CAJ is well positioned in a constantly evolving healthcare market, with the company set to benefit from increased government/medicare funding for diagnostic imaging and a trend toward higher value modalities such as magnetic resonance imaging (MRI). CAJ is also an ongoing beneficiary of the aging population where demand for imaging services dramatically increases as patients grow older. We see CAJ as relatively cheap compared to peers and our view is backed by the company who has an active share buyback in place with capacity to buy a further +10m shares on market. We believe CAJ is well placed regardless of the forthcoming federal election outcome with both sides of politics looking to increase funding to the sector and we see CAJ as a solid defensive micro-cap position.

There was no material negative news flow across the portfolio in April, although we remain extremely vigilant ahead of the "earnings confession" season and have been busy meeting with a raft of listed and unlisted companies to help stay abreast of any developments which may impact our investment universe.

## Outlook

Global markets continued to march higher in April and the domestic small cap market followed suit, continuing the strong rebound of equity markets across the globe in 2019. The impetus for the rally continues to be more accommodative monetary policy from central banks, many of whom have flipped from a path toward normalisation of rates to a far more dovish bent in recent times.

In Australia, monetary policy has been front of mind for market participants in recent weeks, particularly since a benign inflation print in late April (Q1 inflation was unchanged) prompted widespread calls for a cut in the official cash rate. The annual inflation rate is now back to a headline 1.3% and underlying inflation is just 1.6%, well below the RBA's targeted band of 2-3% leading to speculation that the RBA would cut rates at the May meeting, notwithstanding the imminent Federal election.

On Tuesday, the RBA held firm keeping the cash rate at 1.5% which was perhaps unsurprising given that the April meeting board minutes suggested that "[t]here was not a strong case for a near-term adjustment in monetary policy." The unemployment rate remains a healthy 5% and with tax cuts promised by both political parties it is perhaps not surprising that the RBA is keeping its powder dry for the time being, particularly given that changing monetary policy just prior to an election risks the central bank being dragged into a political fight.

But with the weak inflation print, the RBA's narrative that a strong employment market will ultimately drive inflation is breaking down. Despite the robust employment market, there are several indicators of a soft economy with the consumer doing it tough with negligible real wages growth, falling house prices and tight credit conditions weighing on the outlook for domestic consumption. For some time, OC Funds has been more circumspect about the prospects for the domestic economy than the RBA (see January monthly) and the portfolio has been positioned accordingly, with limited exposure to the housing market.

Irrespective of the May decision by the RBA, it seems likely that the die has been cast and the next move will be down for Australia's official cash rate and the bond markets are pricing in a rate cut in the second half of this calendar year, with two cuts a real possibility. The post meeting statement issued by Governor Phillip Lowe indicated that there was "still spare capacity in the economy" and the RBA downgraded its economic growth forecast to about 2.75%, from 3%. The RBA seems to be signalling to markets that if the unemployment rate does not fall below the current 5% and drive a lift in the inflation rate, then a rate cut would most likely follow.

In terms of the portfolio, the following sectors that may benefit from an interest rate cutting environment:

- companies with a sustainable dividend yield which become relatively more attractive in a falling interest rate environment;
- consumer and property related stocks, assuming one believes that lower rates will actually stimulate demand, which remains debatable given that interest rates are already historically very low;
- offshore earners that may benefit from further devaluation of the Australian dollar as interest rate differentials blow out versus major trading partners who hold rates steady;
- long duration growth stocks (including technology and healthcare) which may benefit from lower rates given there is less opportunity cost associated with holding these companies over the long term from a time value of money perspective.

A further positive US jobs report in early May underscores the strength of the US economy and has further allayed the fears of an imminent US recession which haunted the markets at the end of last calendar year. The US economy has now added jobs for 103 months in a row, the longest streak of job creation on record and the unemployment rate is just 3.6%, a near 50-year low.

The jobs report is a major boost for Trump and the robust economy may have emboldened him to reignite the trade war with China which took an unexpected negative turn over the weekend, with the US administration announcing that the existing tariffs of $200b on imports from China would increase from 10% to 25% this week and that increased tariffs on the remaining imports from China would follow shortly thereafter. This is in stark contrast to statements from the White House as recently as last Friday that trade talks were going "very well". Clearly the US is seeking to bring the negotiations to a head with the administration concerned that talks were moving too slowly.

Whilst the situation remains fluid, China announced on Wednesday that its top trade negotiator, Vice Premier, Liu He will visit the US for trade talks at the invitation of US Trade Representative, Robert Lighthizer and Treasury Secretary Steven Mnuchin, in a positive sign it is seeking to keep the negotiations on track. The re-escalation in trade tension has seen volatility spike and appetite for risk assets such as equities fall sharply, and markets have sold off accordingly.

This serves as a timely reminder of Trump's fickle predisposition but also reinforces the current volatile nature markets themselves given the sharp sell-off it has precipitated, as well as the delicate state of the geo-political relations between the two global super-powers. The Fund remains conservatively positioned in the current environment with a cash weighting in the low double digits. Our over-arching focus is on capital preservation for our investors and our cash balance affords us ample fire power should the trade war re-ignite or if the domestic economy continues to soften, both of which could throw up some interesting opportunities to purchase quality stocks at a reasonable valuation.

## Top 5 holdings[#]

| Company | ASX code |
|---|---|
| Clover Corporation | CLV |
| Jumbo Interactive | JIN |
| National Veterinary | NVL |
| Over The Wire | OTW |
| Propel Funeral Partners | PFP |

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

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[†]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 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 10 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.

Past performance is not a reliable indicator of future performance. 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.