OC Premium Small Companies Fund

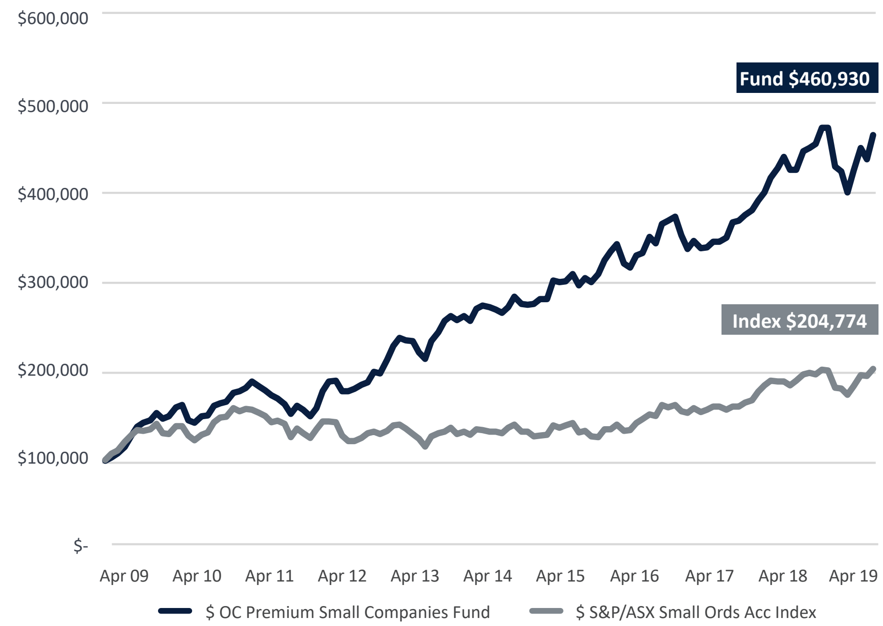
Fund Update | 30 April 2019

6.3% Fund up 6.3% for the month

16.5% Returned 16.5% 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 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. (Dec 2000)
OC Premium	6.3	9.3	9.2	11.8	11.3	13.6	16.5	11.4
S&P/ASX Small Ords Accum	4.1	11.0	7.2	11.8	9.1	5.2	7.4	6.2
Outperformance	**2.2**	**-1.8**	**2.0**	**0.0**	**2.2**	**8.4**	**9.1**	**5.2**
S&P/ASX Small Ind Accum	6.3	14.3	13.0	11.5	10.2	10.4	11.3	6.8
Outperformance	**0.0**	**-5.0**	**-3.8**	**0.3**	**1.1**	**3.3**	**5.3**	**4.7**

Performance review

The OC Premium Small Companies Fund bounced strongly in April with broad based strength across the portfolio driving a +6.3% return for the month. This was ahead of the S&P/ASX Small Ordinaries Accumulation Index, which was up 4.1%, and in-line with the S&P/ASX Small Industrials Accumulation Index which was up 6.3% 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.

Core fund holding, **Seven Group Holdings, (SVW, +11.3%)**, announced a sizable (albeit not unexpected) profit upgrade and stated that it now sees underlying EBIT on a continuing basis to be up approximately 40% on FY18, well in-excess of the 25% underlying growth anticipated at the start of the financial year. SVW has been a 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% stake in the ASX listed Beach Energy (BPT).

WesTrac has been a stellar performer with the servicing segment of the business particularly robust, driven by machine rebuilds and customers executing sophisticated maintenance programs to productively extend machine age. Not all has gone to script as the weakness in the Coates Hire business has carried over from the first half with delays in major project commencements continuing into the third quarter, particularly in Queensland which has been impacted by unseasonably wet weather and floods. The bodes well into FY20 as these major east coast infrastructure projects ramp up, given the strong operating leverage in the Coates business. SVW management has a habit of under promising and over delivering so we won't be surprised to see the full year SVW result come in ahead of the recently revised guidance and we believe consensus earnings expectations for FY20 remain too low for the stock.

Webjet Limited (WEB, +15.9%) continued to re-rate during the month following its strong interim result update which highlighted the strong competitive position of the company's B2B division and demonstrated early evidence of the leverage which will come as the business scales up. WEB is an online consumer (B2C) and wholesaler (B2B) travel company offering accommodation, flights, packages, cruises, car rental, motorhomes and associated travel products and services with operations in Middle East, the Americas, Asia and Europe. Most investors will be familiar with WEB's B2C business (the traditional Webjet online business) which continues to grow at three times the rate of the overall market. Investors are typically less familiar with the B2B "web-beds" business, which is involved in the online provision of hotel rooms to digital partners and is now the number two player globally and continues to take market share. Whilst there was not a specific catalyst for the stock during the month, management presented at two major broker conferences where they focussed on articulating the growth plan for the B2B hotels business which has the potential to be the driver of earnings growth for several years to come.

A2 Milk (A2M, +17.2%) was a strong performer for the Fund after holding its investor day early in the month which highlighted the company's continuing evolution from a branded Australian liquid milk and infant formula business into a rapidly growing global nutrition firm. 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. A2M continues to grow market share in the large Chinese infant formula market and following a period of strong revenue growth in the UK and North America, management has been able to demonstrate a pathway to profitability in those markets. In early May, A2M released a third quarter trading update which reiterated the prior 41% revenue growth rate for FY19 and EBITDA margin guidance of 31-32%. Management is investing in increased marketing activities and has highlighted a further commitment to building the brand in FY20, particularly in the key Chinese and US markets which will be the key growth drivers for the business in the foreseeable future. We remain optimistic about the long term future of the A2 Milk business and it remains a core portfolio holding.

Austal Limited (ASB, +18.7%) has enjoyed a nice re-rating since being added to the portfolio early in April following extensive due diligence from the investment team including a recent site visit to the company's support centre in San Diego, USA. Austal is an Australian-based global ship building company and defence prime contractor that specialises in the design, construction and support of defence and commercial vessels. The company has grown in stature in recent years following a successful expansion into the US market where it has established a large modern shipyard in Mobile, Alabama which is the prime contractor for the US Navy's Littoral Combat Ships (LCS) and Expeditionary Fast Transport Vessels (EPF) programs. Austal has more recently increased its Asian shipbuilding capabilities by opening a manufacturing facility in Vietnam to complement its facility in the Philippines and Vietnam which, coupled with its Aulong JV in China, gives the company a significant cost advantage over most global peers.

ASB is gaining a reputation building high quality, cost competitive vessels that can service both military and commercial needs at a time when the opportunity set in both sectors is expanding. The company has an order book of around $5.2 billion, a strong pipeline of opportunities with the US Navy and excellent recent track record of operational execution at a time when that navy is committed to expand its fleet. Additionally, ASB's sustaining and support business has been gaining momentum and growing revenue at a compound rate of 30% per annum underpinned by US Navy work. This has the potential to be a +$400m revenue opportunity for the business in the next three years. Additionally, ASB ought to benefit from the start of a global high-speed ferry replacement cycle which is being driven by an increasing demand for fast ferries, an ageing global fleet and more onerous environmental regulations. The company has a strong pedigree in the high speed ferry space and has significant capacity to expand its operations. We acknowledge that ship building is not without risk but the ASB management has delivered strong results in recent years and has a solid platform for sustainable growth.

We exited our position in **GUD Holdings (GUD; -0.9%)** during the month as we became more cautious about its earnings outlook. GUD operates in the manufacture and importation, distribution and sale of automotive products and water pumps. The weaker Australian dollar is a short-medium term headwind for many Australian based importers, including GUD. Whilst key GUD products dominate their categories, maintaining margins in the face of increasing cost of goods sold (driven by a weaker AUD) requires players such as GUD to be able to pass on price rises to their end customers. We think this could be a challenging proposition for GUD given the increased competition between GUD's distributors and the softer end markets we are currently observing in the automotive sector. Additionally, the extended period of drought across much of east coast of Australia is suppressing the demand for GUD's water pump products. We believe GUD has a strong stable of brands and will continue to watch the business for an opportunity to re-enter our 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 consumer sensitive stocks and 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 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 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
Mineral Resources Ltd	MIN
Nextdc Limited	NXT
Seven Group Holdings	SVW
The A2 Milk Company	A2M
Webjet Limited	WEB

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 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.