OC Dynamic Equity Fund

Fund Update | 31 October 2019

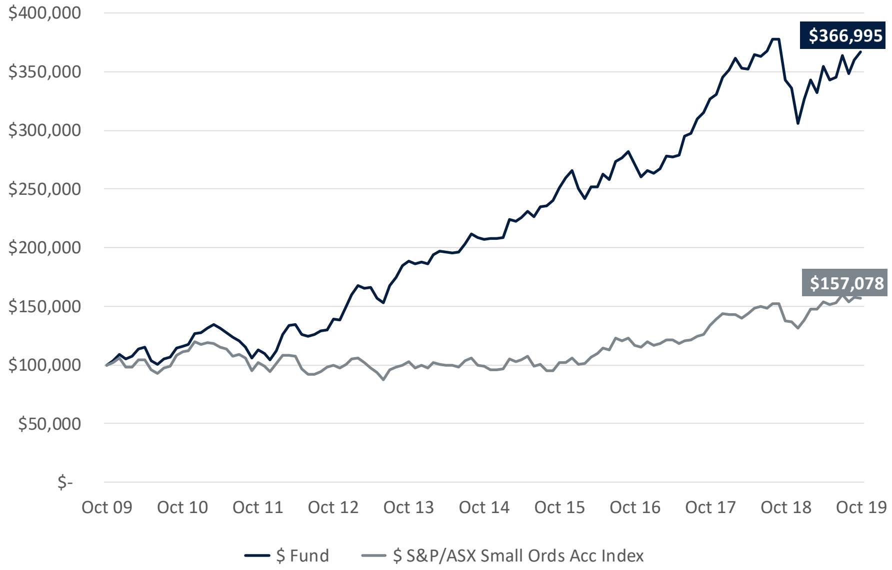
THIS MONTH

Fund up 1.9%

13.9% pa return over 10 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 month end †	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 Dynamic	1.9	0.8	7.0	10.6	12.1	14.9	13.9	12.5
S&P/ASX Small Ords Accum	-0.5	-1.8	14.4	10.4	9.6	6.7	4.6	6.3
Outperformance	**2.4**	**2.6**	**-7.4**	**0.3**	**2.5**	**8.2**	**9.3**	**6.2**
S&P/ASX Small Ind Accum	-0.5	-0.3	19.0	10.9	9.9	10.9	8.4	6.9
Outperformance	**2.4**	**1.1**	**-12.0**	**-0.3**	**2.2**	**4.0**	**5.5**	**5.6**

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.

Performance review

The Australian small-cap market weakened slightly in October against a back-drop of mixed macro-economic signals, tentative progress on the US and China trade dispute and a swathe of negative earnings revisions in the small-cap space, which is not uncommon at this time of year with the AGM season in full swing. Pleasingly, the OC Dynamic Equity Fund had a solid October, returning +1.9%. This was ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which were each down -0.5% for the month.

Long-term Fund holding, **QMS Media Limited (QMS, +33.2%),** attracted the interest of a suitor, Quadrant Private Equity, and the company subsequently entered into a Scheme Implementation Deed with the QMS board recommending shareholders accept an all cash offer of $1.22, plus a final dividend of up to 1.3c per share. We have long held the belief that the market was undervaluing QMS's suite of assets, in particular the QMS Sports business, which has some leading global sports technology and infrastructure assets and a digital media platform which looks poised to deliver significant value to shareholders following a period of investment by the company. The bid values QMS on implied takeout multiple of 9.4x CY19 EV/EBITDA. This is below recent transaction multiples including that paid by Ooh! Media Limited for its acquisition of Adshel (11.6x forward EV/EBITDA) and the price offered by French outdoor industry giant, JCDecaux, for its acquisition of QMS's larger ASX peer, APN Outdoor (which was transacted on 12.9x forward EV/EBITDA). These recent transaction multiples clearly offer some scope for a counter-offer for QMS at a higher price.

QMS will require additional capital in the coming 12 months to execute on its strategy in the Sports business and possibly also in the Australian Outdoor business, particularly if the company is successful in winning Sydney, Melbourne Airport, Sydney Rail and Brisbane Rail. Furthermore, we expect growth to moderate in the outdoor space following a period of rapid digitisation which has seen most key QMS sites convert to digital in recent years. The more challenging operating environment in the media space, as evidenced by downgrades from outdoor peer OML and, more recently by Southern Cross Media (which operates nationally across radio and regional television markets), will also make growth harder to come by. The proposed takeout price represents a 39.1% premium to the 3-month volume weighted average price for the stock, and we intend to accept the bid in the absence of a higher offer.

Evolve Education (EVO; +55.3%) was a strong performer for the Fund during month as the first signs of an expected corporate turnaround in this previously struggling childcare operator began to emerge. Australian childcare industry veteran, Chris Scott, and his deputy Chris Sacre, have been at the helm of the business for almost 6 months and they are slowly, but surely, implementing a new strategy led by key board and management changes, an extensive cost reduction exercise and sensible centre acquisitions in the Australian childcare market. Inside the last two months, EVO has acquired 10 operating childcare centres across Melbourne and Queensland, which appear to have been purchased on reasonable earnings multiples, that will contribute materially to overall group earnings immediately. We continue to back the new management team to stabilise and turnaround the kiwi operations, whilst growing the Australian business, and we look forward to continued positive developments from EVO.

Southern Cross Media (SXL, -33.6%) was the key detractor for the month following a disappointing earnings update where management flagged challenging trading conditions across both the radio and television segments for the first half of FY20. We were aware that these markets were soft but thought it was adequately captured in the stock's low earnings multiple. However, we were caught off guard by the broad scope of the deterioration in conditions with management flagging an expected 8.5% decline in group revenue in the first half, with both the radio and regional television sectors impacted. Commercial Radio Australia industry data subsequently showed a soft September quarter, with metro radio advertising down 10% year-on-year. The key regional television market also appears be soft, compounding the operational challenges faced by the group. The Fund exited most of its position immediately following the trading update. The small residual balance is likely to be exited over the coming month with the share price currently recovering from what we consider to be oversold levels.

Horticultural company, **Costa Group (CGC, -18.0%),** was a small detractor for the Fund (the portfolio position size was under 1% of Fund capital) after announcing that its well documented issues had recently compounded resulting in a further profit downgrade accompanied by an entitlement issue to repair the stretched balance sheet. Regular readers will be aware that we recently bought into the stock following a disappointing earnings update in May on the mistaken belief that the downgrade cycle for the stock was at an end and that earnings ought to recover in CY20 following a wretched run of seasonal and pricing issues (which particularly impacted the key mushroom, blueberry and raspberry markets).

Disappointingly, the prior issues impacting mushrooms and raspberries have deteriorated further and the severe drought in eastern Australia has resulted in dry and hot conditions in several of CGC's key regions affecting fruit size and yields in avocados, blueberries and the late season citrus crop. The company raised capital at $2.20/share to repair its balance sheet and the Fund participated in this offering given the size of the discount on offer. We have subsequently exited our small position at around $2.65. Whilst the seasonal issues could improve for CGC into CY20, the company's revised earnings guidance assumes a moderate abatement of drought conditions in Australia and more normal season and crop cycles in Australia and Morocco. This is not a foregone conclusion and we do not believe that the current share price is low enough, given the possibility of a further earnings miss in the short to medium term.

Outlook

The global economy remains patchy with the International Monetary Fund (IMF) warning in October of a synchronised global slowdown, as the US-China trade war begins to take its toll on global trade and manufacturing. The IMF now expects the world economy to grow at 3.0% in 2019, down 0.3% on its forecast six month ago and the slowest rate of expansion since the global recession of 2009. Central banks continue to respond to the economic challenges with accommodative monetary policy and the US Federal Reserve cutting rates for the third time this year in late October. In China, the People's Bank of China has reduced the cost of one-year funds provided to banks (for the first time since 2016) in a bid to stem a selloff in debt markets.

Despite this, the near-term risk of a recession in the US economy appears to be low, as we see strength in the jobs market persisting with further robust job creation in October and key measures of housing and consumption all remaining healthy. The US Federal Reserve Chairman, Jerome Powell, recently ticked off an extensive list of reasons why he feels the US economy is robust and signalled there would be no further rate reductions unless the economy takes a considerable turn for the worse.

There was plenty of news on the trade war during the month, with Trump announcing mid-month that China and the US had reached a tentative agreement for a trade deal. Not surprisingly, this was met with a healthy degree of scepticism, although the US did agree to suspend some tariffs and China purportedly agreed to buy up to US$50b in US farm products and accept more American financial services. China has sounded a more cautionary tone on the latest round of talks although the state-run People's Daily newspaper in China called the latest round of talks constructive, frank and efficient and noted that the two sides were moving toward a resolution. In further positive developments, it was reported in China that Beijing's top trade negotiator and Vice-Premier, Lie He, had reached "*consensus on principles*" during talks over the weekend with key US trade negotiators. *"The two sides had a serious and constructive discussion. The two sides agreed to properly resolve their core concerns"* according to China's Commerce Ministry.

In more recent news, it has been reported that Beijing has asked the Trump administration to eliminate duties on US$110b in goods imposed in September and withdraw threats of new tariffs. Negotiators are also discussing lowering the 25% duty on about US$250b of goods that Trump imposed last year. It is not yet clear how Trump will respond. The positive trade rhetoric has driven markets higher in early November although many investors, including the OC Funds investment team, remain unconvinced that a lasting resolution is imminent with some key issues yet to be resolved.

Little has changed in domestic economy since last month and the Reserve Bank of Australia (RBA) kept rates on hold at 0.75% in early November, having cut rates by 25 basis points at each of the June, July and October meetings. Ahead of the central bank's Statement on Monetary Policy, to be released on Friday 8th November, Reserve Bank Governor Philip Lowe reinforced its central scenario for the domestic economy to grow by around 2.25% this year, which is above the rate expected by the IMF which recently cut its growth forecast for Australia to 1.7%. Dr Lowe has hosed down prospects of further near-term rate cuts, saying the economy is set to return to "trend growth" next year, which will cut unemployment and boost wages. We remain more circumspect on the prospects of the domestic economy, with retail sales still soft, wages growth low, inflation below trend and unemployment creeping higher. As a result we remain underweight domestic cyclicals.

Last month we spoke of the healthy IPO pipeline ahead and the rigour with which we approach the investment process for potential listings. A month can be an eternity in equity markets and in recent weeks we have seen the bulk of these listings cancelled as vendors refused to meet the valuation expectations of fund managers, such as OC Funds, who typically set the price on these deals. The crux of the issue is the gulf between the valuation expectations of the private equity vendors (most of the mooted IPOs had private equity owners) and those of the institutional purchasers which could not be bridged with the bid/offer spread too wide. In part, this may be due to the high valuations being paid recently in unlisted markets by private equity funds which are awash with cash, with institutional fund managers unprepared to pay similar multiples of revenues or earnings for businesses with no listed track record from exiting private equity vendors who are renowned for extracting full value in IPO exits.

In recent weeks a succession of floats from the big end of town, including Latitude Financial, RetailZoo, MPC Kinetic, PropertyGuru, Onsite Rentals and FunLab, have failed in their bid to join the bourse and have had their IPOs shelved. It will certainly be a lean end to the calendar year for the investment bankers. The OC investment team review each of these deals and undertook detailed due diligence on several. But ultimately, we were not prepared to meet the expectations of the vendors. Capital preservation is a key tenet of our investment philosophy and doing the work on a deal, and subsequently passing on it, is a regular part of what we do.

The OC team is busy travelling most of November visiting current and prospective holdings, unlisted competitors and industry experts. We remain confident that we can continue to generate our investors solid long-term returns and thank you for your ongoing support.

Top 5 holdings#

ASX Code	Company
APX	Appen Limited
MIN	Mineral Resources Limited
NXT	Nextdc Limited
SVW	Seven Group Holdings
WEB	Webjet Limited

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

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