Clime Smaller Companies Fund

Quarterly Update - September 2018

Investment Objective

The objective of the Fund is to generate sustainable long-term capital growth. The Fund seeks to achieve an annual total return of 8% above the Australian Consumer Price Index (CPI) over rolling five to seven-year investment periods after management fees.

Investment Strategy

The Clime Smaller Companies Fund seeks to deliver strong risk-adjusted total returns by investing in a portfolio of high quality smaller Australian companies that are attractively priced.

Investment Performance

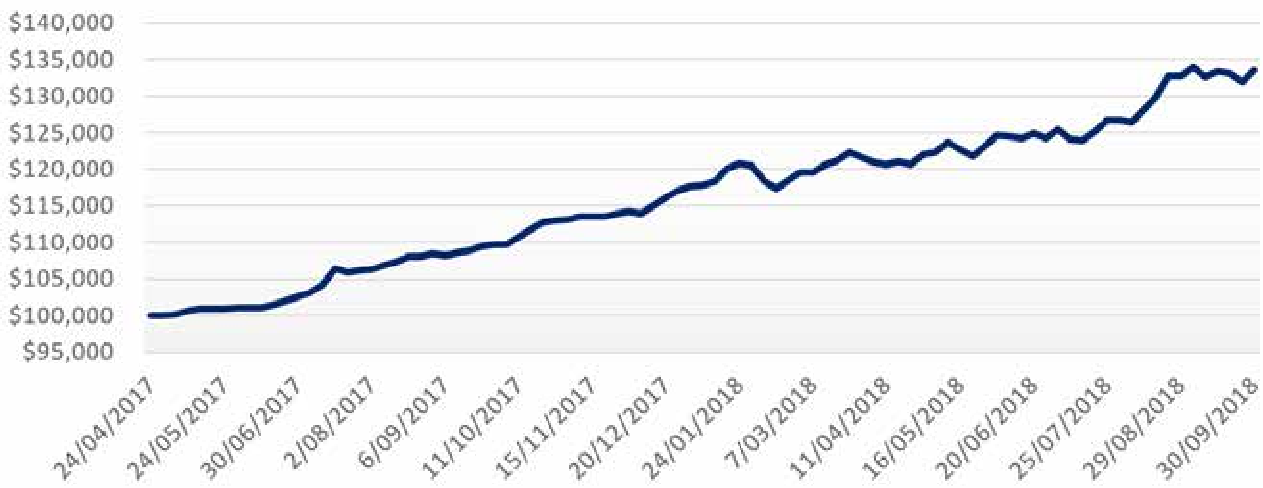
The Clime Smaller Companies Fund (CSCF) was established on 24 April 2017. The CSCF has an investment horizon of a minimum of 5 years. Short-term returns are therefore not necessarily reflective of our long-term goals.

Portfolio Total Return (30/09/18)

	Portfolio Return	Fund Objective^
1 month	-0.33%	0.78%
3 months	6.44%	2.41%
6 months	9.78%	4.85%
1 year	21.66%	9.91%
Inception*	22.32%	9.88%

* Inception: Wholesale Units: 24 April 2017. Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Returns have been calculated based on starting and ending unit prices after taking into account all ongoing fees, and assuming reinvestment of distributions. ^ CPI + 8% p.a. including GST.

CSCF: $100,000 Invested Since Inception



Source: Clime Asset Management

Prominent Fund Holdings *(alphabetical order)*

bravura	Bravura Solutions Limited (ASX: BVS)
citadel group	Citadel Group Limited (ASX: CGL)
HANSEN TECHNOLOGIES	Hansen Technologies Limited (ASX: HSN)
JUMBO	Jumbo Interactive Limited (ASX: JIN)
macquarie TELECOM	Macquarie Telecom Group Limited (ASX: MAQ)

September Quarter Update

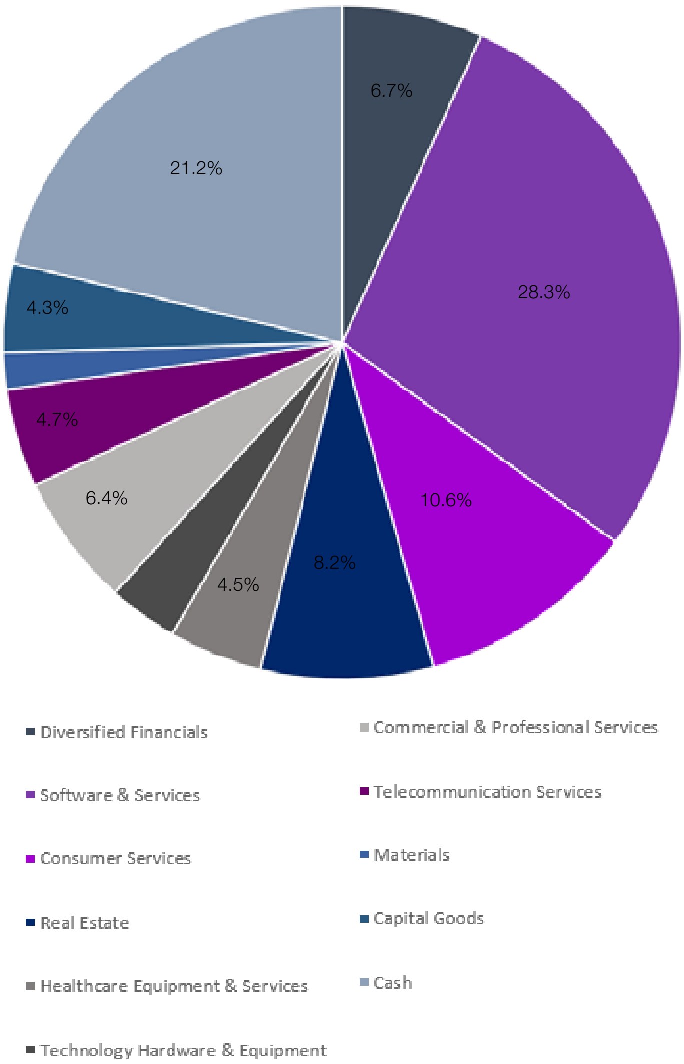
Since the Fund's inception, we have sought to take advantage of neglected, under-appreciated growth opportunities typically more prevalent outside the ASX's major indices. At its core, the Clime Smaller Companies Fund (CSCF) remains focused on finding great companies early in their development cycle. The goal is to then support these companies as they continue to execute and deliver sustainable long-term growth.

The September quarter, and more specifically the August full year reporting season, provided further evidence that we are on the right track in this endeavour. While our investing journey is taking place over much longer time frames, the August full year reporting season provided another strong reference point of successful execution and we remain comfortable with our core portfolio positioning.

Specific to portfolio returns, The CSCF again enjoyed a productive quarter, with a broad range of constituents contributing positively to aggregate portfolio returns. Significant positive contributors for the September 2018 quarter were **Jumbo Interactive** (JIN), **Bravura Solutions** (BVS), **Folkestone** (FLK), **Citadel Group** (CGL), **Macquarie Telecom** (MAQ) and **Collins Foods** (CKF). The most significant detractors were **Redflex Holdings** (RDF), **Axsesstoday** (AXL) and **Veris** (VRS).

Though our drive to generate strong returns is clear, we spend as much time thinking about risk. In fact, a clear focus on capital preservation has long been one of the cornerstones of Clime's investment philosophy.

At its core, Clime's investment process seeks to mitigate risk by acquiring a part share in a diverse range of high-quality businesses at meaningful discounts to our calculated intrinsic future value. As illustrated below, and while there remains a reasonable allocation to the high-growth Software & Services sector, we have built out significant diversity by sector. This ensures that the portfolio is not excessively exposed to sector specific risk. Ultimately the process seeks to sensibly balance risk management with the desire to benefit from investing in sensibly priced, higher growth opportunity, wherever that may lie.



Exceeding Expectations

As highlighted above, several core holdings met or exceeded expectations when delivering their full year FY2018 results during the quarter. This was arguably headlined by leading digital lotteries retailer, Jumbo Interactive (JIN).

JIN produced an excellent full year result, one that comfortably exceeded both upgraded company guidance and analyst estimates. Revenue was up 23% to $39.8m, profit from continuing operations surged 55% to $11.8m while the company generated operating cash flow of $17.2m.

One of the company's main attractions remains its growth certainty, which is based on two foundations. The first is a structural shift of sales to online channels. Online sales as a percentage of the total more than doubled over the last five years to 18% at present, and this trend will likely continue for the next few years. The second is that the online channel consists of just two players including Tabcorp (thelott.com) and JIN (ozlotteries.com). Significant barriers to entry suggest that competition is unlikely to disturb the existing market structure for at least the medium term.

The balance sheet remains in pristine condition, with $40m of corporate cash and no debt as at 30 June 2018. However, this figure excludes approximately $14m of cash from options exercised by Tabcorp and employees since 1 July. On our assessment, JIN likely has more than $50m in corporate cash at this point, after paying out its final dividend of 11 cents per share, fully franked. The business only requires $15m in working capital (for day-to-day operations), so we see the potential for further special dividends on the horizon.

Another noteworthy bright spot for the portfolio during the quarter was the performance of Bravura Solutions (BVS). BVS delivered a strong full year result, with FY2018 numbers and guidance both well ahead of expectations.

Group revenue was up 15% to $221.5m, 67% of which is recurring in nature, Group EBITDA was up 18% to $38.6m and net profit was up 27% to $27.0m. BVS generated a substantial amount of cash during FY2018, with operating cash flow of $46.2m, further strengthening an already solid balance sheet. As at balance date, BVS was in a net cash position of $25m.

BVS' core software platform, Sonata, remains the key driver of group growth. Sonata revenue increased 32% to $122.5m, having achieved client wins in its key markets of Australian, New Zealand, the UK and South Africa during the year.

Wealth Management (WM) divisional revenue, inclusive of Sonata, was up 26% during the year to $155.1m, while WM EBITDA surged 52% to $46.2m. This highlights the significant operating leverage within the division, with EBITDA margins increasing five percentage points versus the prior corresponding period to 30%.

With continued successful execution and an abundance of opportunity, we remain optimistic about the company's medium to long term prospects.

We were similarly pleased about the progress made by core holding Citadel Group (CGL) during FY2018, as evidenced by the stock's performance post the release of its full year results. Importantly, the outlook remains particularly upbeat across all key business units.

Revenue was up 10% to $108.5m, EBITDA was up 13% to $34m and net profit attributable to equity holders was up 39% to $15.8m, though the rate of profit growth was marginally assisted by a lower percentage rate of tax.

Management continue to execute well, with a record number of contract wins and extensions (totalling $74 million) announced during the period. In turn, this continues to build the revenue visibility for the group. As it stands, no material contracts are due for renewal in FY2019, while the average tenure of contracts remains greater than four years.

CGL remains well positioned with a strong net cash balance sheet, capable management team and a significant contract pipeline of $800m, of which 60% is in higher margin Software-as-a-Service (Saas) opportunity. These attributes provide a strong foundation for the continued delivery of solid levels of compound growth in the coming years.

Corporate Appeal

Portfolio holding Folkestone (FLK) received a takeover offer during the September quarter. Given a solid financial foundation, embedded growth and a stock price that appeared modest when compared with our appraised valuation, hindsight suggests corporate interest shouldn't have come as a major surprise.

In aggregate, this was a pleasing outcome for CSCF investors given the sound mix of capital growth ultimately delivered and fully franked income received from FLK over the life of this investment. Barring any unforeseen changes, given the unanimous support of the board of the solid all-cash bid from well-funded suitor Charter Hall, we expect the scheme to be implemented in the coming weeks.

Data & Digital Delivering

Enterprise cloud and telco solutions provider Macquarie Telecom (MAQ) also performed well over the quarter, following the delivery of strong FY2018 results. The positive longer-term outlook was further strengthened by the announcement of significant expansion plans.

From its inception in the early 1990's, MAQ has positioned itself as a specialist services provider to government and medium to large enterprises, for which requirements are relatively complex.

In its first decade, MAQ's offering revolved around telecommunication services where the company acted as a value-adding reseller of voice, mobile, data and co-location products. Soon after listing in 1999, MAQ added hosting operations between 2001 and 2003, with two datacentres in Sydney (CBD and Macquarie Park) and one in Canberra. Benefiting from the trend of business IT resources migrating offsite, the Hosting segment has grown to become MAQ's primary earnings driver and now contributes around two thirds of Group earnings before tax, depreciation and amortisation (EBITDA).

We believe MAQ's team led by founders David and Aiden Tudehope is high calibre, as reflected in the Group's industry leading Net Promoter Score of +70, which represents 'excellent' customer loyalty, and its position with the hosting market as a specialist in cyber security and customised hybrid cloud services. FY18 results surprised on the upside, with EBITDA of $48m coming in at the top end of the upgraded guidance range of $47m to $48 (increased in June from $44m to $46m due to one-off items).

The major announcement accompanying the result was new plans to almost quadruple capacity (in terms of Mega Watts – MW) across the datacentre portfolio to over 45MW, via an expansion of the Macquarie Park campus from 10MW to 43MW. The initial capital expenditure will be $75m-$80m, the bulk of which will be incurred across CY2019.

The Telco business delivered a solid result with 12% EBITDA growth on flat revenues due to cost insourcing over the year. In late June, MAQ signed a wholesale supply agreement with NBN Co, which will enable MAQ to sell telecommunication and data services such as SD-WAN to businesses across Australia, including regional areas. First customers are expected in 2Q FY2019. The deal is a significant growth opportunity for the Telecom segment, which has been flat in recent years.

Despite MAQ's shares rallying this year, we see further opportunity for growth within both segments. Given historical Hosting EBITDA returns on capital expenditure of approximately 30%, the Macquarie Park expansion could see MAQ become a significantly more valuable business in the future.

A common theme on the journey of the Clime Smaller Companies Fund is that of "deep pools of opportunity". We aim to build a collection of high-quality smaller businesses that can reinvest cash flow to grow into much larger businesses over time. However, few make the transition without a high-quality product and/or service offering, backed by capable management teams.

Our investment process therefore involves critically assessing the probability of execution in each case, which essentially boils down to understanding the quality of the offering, the propensity of consumption, and the breadth of competition. A large addressable market, enthusiastic customers, and a narrow competitive field is a great combination. This appears to case with Audinate (AD8), a recent portfolio addition.

AD8's flagship "Dante" technology enables professional audio networking over IP, which represents a step-change in performance and productivity versus traditional point-to-point analogue audio distribution. Essentially, using Dante, audio equipment in commercial settings can be connected to existing ethernet infrastructure and configured remotely via software.

The interesting part from an investment standpoint is that Dante is emerging as the "de-facto" standard protocol in the industry. From our discussions with early adopters, the switch to digital technologies is permanent, and they strongly advocated Dante as an effective and easy to use system.

On the supply side, original equipment manufacturers (OEMs) are increasingly designing Dante chips into new product lines, resulting in what we believe is an insurmountable gap between Audinate and competing audio networking solutions in terms of total products per protocol. We see a growing network effect of increasing adoption of end users and OEMs, leading to a potential monopoly industry structure.

Trading at a multiple of 10 times trailing revenue, AD8 seems expensive upon superficial review. However, the addressable market is estimated to be close to $1bn, and although still early in the journey, AD8 is well positioned as the emerging leader in the space. On our numbers, just capturing 10% of the opportunity would deliver a solid outcome for shareholders.

Funds, Fast Food & Falling Short

Despite rallying handsomely over the year, we continue to see opportunity in the growth prospects of hedge fund manager Navigator Global Investments (NGI). NGI is the parent of Lighthouse Partners, a multi-manager hedge funds business based in the US. Lighthouse owns underlying assets in portfolios and appoints specialist investment managers to trade them within certain guidelines.

Lighthouse's proprietary 'Managed Accounts' platform sets the business apart within the notoriously opaque hedge funds and alternative investments space. The platform allows Lighthouse to collect real-time data on portfolios to track managers' adherence to mandates, providing more transparency and better governance compared to traditional Fund of Hedge Funds. It also provides a "look-through" on net positions across multi-manager portfolios, enabling more efficient capital allocation and risk management.

In the last two years NGI near-doubled assets under management (AUM) to US$16.1bn (as at 30 September). This was driven by strong net fund inflows, this year's acquisition of Mesirow's hedge fund division (from 1 July) and steady overall performance. Mesirow alone added US$5.4bn in AUM. Total potential consideration is a mere US$10m earn-out to be paid over the next 7 years, which we view as an exceptional outcome for NGI. We see significant cost synergies coming out of the merged entity, however we also expect some near-term attrition of legacy Mesirow AUM as certain mandates mature.

FY2018 results were pleasing. Net operating revenue was up 17% to US$80m while EBITDA was up 15% to US$34m. As we have previously noted, EBITDA translates strongly to underlying cash profit and free cash flow, as NGI is a capital light business and has significant deferred tax assets. The balance sheet is in excellent shape, with no debt and cash and investments totalling A$75m.

The future looks bright with global opportunities for institutional mandate wins, as well as new business from sales of Lighthouse's Management Accounts Platform as a product to other investors, which could make up a large part of the business in 5 years' time. Although the market for Managed Accounts is large and the competitive field is narrow, future Managed Accounts business is not yet included in analyst forecasts. NGI already trades at a meaningful discount to appraised value, so in our view the new growth avenue comes for free at current prices.

At quarter end, the Clime Small Caps team enjoyed attending the annual investor day of leading Quick Service Restaurant (QSR) operator, Collins Foods (CKF). We were pleasantly surprised to concurrently learn of the just-inked agreement with Taco Bell (also a Yum! Brands subsidiary) to roll out 50 new Taco Bell restaurants by 31 December 2021. This follows a successful pilot in Brisbane and is in addition to the three Taco Bell stores planned for the remainder of calendar year 2018.

The Taco Bell roll-out opportunity adds solidly to our investment thesis, which centres on several factors. These include the global expansion opportunity available to CKF due to the inherent strength of KFC's global brand, the strength and consistency of cash generation and CKF's management proficiency which has it positioned as one of Yum Brands' preferred Australian franchisees.

Although CKF listed a relatively short time ago in 2011, the business has been refining its practices for many decades. In fact, this year marks the 50th anniversary of the company's first KFC franchise in 1968. Building out nationally from its headquarters in Queensland, CKF's ongoing greenfield store roll-out and acquisition program has seen the Australian store network grow to 227 stores, representing 35% market share. We expect CKF's share to grow due to its plans to add 8 to 9 stores per annum over the next 5 years, accounting for almost half of forecast total market growth.

More recently, management initiated on a global expansion strategy via store network acquisitions in the relatively under-penetrated markets of Germany (Nov 2016) and Netherlands (Sept 2017). CKF now operates 18 stores in Germany and 17 in the Netherlands, providing a solid platform from which to replicate the successful Australian growth strategy. The European business is set to add 6 more stores in FY19, with 8 to 10 stores per year over the next 4 years.

The combined total stores in Germany and the Netherlands of 217 is almost one-third of the 640 Australian store count, despite encompassing a population more than four times Australia's. When coupled with the Taco Bell store roll-out program, we believe CKF is well-positioned to deliver solid double-digit growth in per share earnings over the medium term.

While we are pleased with the steady aggregate progress of the fund, we acknowledge that there are always areas for improvement. Many have heard of the old saying that even the best investors generally only get about 6 out of every 10 investments right. Though ultimately it is still to be determined, our investment in troubled equipment finance business, Axsesstoday (AXL), probably won't be one of those six.

Just weeks after delivering a superficially upbeat FY2018 result and FY2019 earnings forecast (which was subsequently reiterated), the company entered a trading halt citing the board's desire 'to conduct a detailed review of the Company's business strategy.' This halt was later extended to a voluntary suspension, an announcement that was coupled with news of the CEO's departure and an inadvertent breach of financial covenants.

At the time of writing, AXL remains suspended from trading. While we await further updates from the company, given the passage of time, we do not expect any news received to be positive. As such, the CSCF investment valuation committee has taken a proactive approach by reducing the value of this holding to better reflect our assessment of its likely near-term value.

While disappointing, we can draw some lessons from the experience and reiterate our strong belief that the aggregate portfolio view remains sound. The setback is surmountable, and we remain optimistic though measured in our view on the outlook for both the market and our portfolio.

An important pillar of our portfolio construction is the continued focus on financial strength. Most of our investee companies have strong net cash balance sheets and we are comfortable to remain invested alongside high calibre, aligned management teams.

We are also pleased with the outlook for self-funded earnings growth. In aggregate, prospects remain bright, particularly for companies growing into much larger pools of opportunity, both domestically and internationally. This is particularly reflected in aggregate forecast earnings growth for our investee companies, which currently exceeds 20% for FY2019.

As illustrated in recent monthly updates, we have access to meaningful cash reserves that can be readily deployed into sensibly priced opportunity should we see volatility continuing in the coming months. As has always been the case since inception, our enduring focus remains on building and maintaining a portfolio full of high quality smaller Australian companies.

Manager Alignment

We would like to take the opportunity to reiterate a further philosophical cornerstone of our investment process: alignment. We seek to invest in companies that have products and/or services that we believe in, backed by highly capable and aligned management teams. Furthermore, we also hold ourselves to account when considering the core value of alignment. We pride ourselves in investing alongside our clients, and upon the same terms as clients. Accordingly, several members of the Clime investment and executive team remain meaningfully invested in the Fund.

The Long-Term Investment Journey Continues

While we are approximately 18 months into what will be a long investment journey, we remind investors of the Fund's recommended investment time frame of five to seven years. A reasonable amount of volatility has returned to markets in recent weeks, and while we have no decisive view on near-term market trends, we expect that at some future point we will endure challenging times. These challenges also bring opportunity and it will be the enduring focus on the fundamental process, the diligence to complete the research and the patience to hold the spotlight on a long-term horizon in sensibly deploying capital that will build value over time.

Thank you for your ongoing support.

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