Clime Smaller Companies Fund

Quarterly Update - December 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.

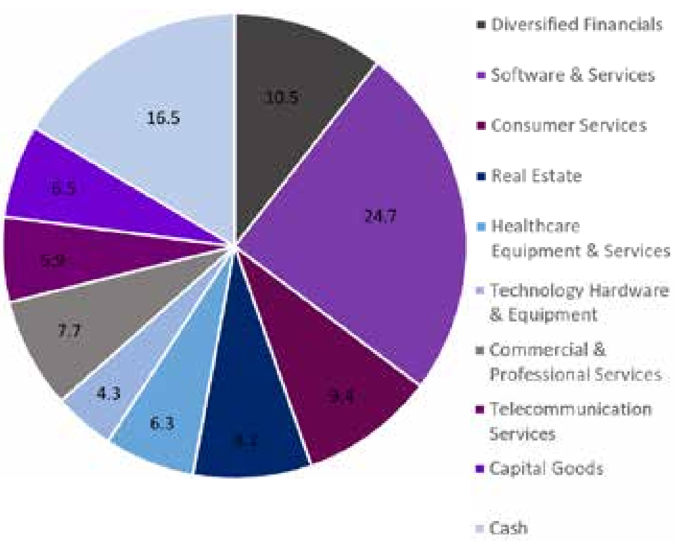
Prominent Fund Holdings *(alphabetical order)*

Holding
Citadel Group Ltd (ASX: CGL)
Hansen Technologies Ltd (ASX: HSN)
Jumbo Interactive Ltd (ASX: JIN)
Macquarie Telecom Group Ltd (ASX: MAQ)
Navigator Global Investments Ltd (ASX: NGI)

Portfolio Total Return (31/12/18)

	Portfolio Return	Fund Objective^
1 month	-5.01%	0.80%
3 months	-9.41%	2.39%
6 months	-3.57%	4.86%
1 year	2.76%	9.89%
Inception*	11.97%	9.87%

* 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.



December Quarter Update

We have often opened our investor communications with a reiteration of the principles that underpin the Clime Smaller Companies Fund (CSCF). With the bears starting to growl and volatility re-emerging, there's no better time to reconfirm our objective and strategy.

The Clime investment team takes a long-term view on investing. We encourage our co-investors to continue taking this same approach. The CSCF seeks to achieve an annual total return of 8% above inflation over rolling five to seven-year investment periods. To meet this objective, our resolute focus remains on investing in a portfolio of high quality smaller Australian companies that are attractively priced.

In what was a difficult close to the calendar year, the CSCF delivered a return of -9.4% (net of all fees) for the December quarter. While all major indices recorded losses for the quarter, the S&P/ASX Small Ordinaries and S&P/ASX Emerging Companies Indices came under particularly heavy selling pressure. These indices respectively delivered total returns of -13.7% and -16.4% for the quarter alone.

With general macro-economic uncertainty building in a climate also impacted by geopolitical tensions, volatility increased markedly late in the year. In turn, this appeared to drive a broader rotation of capital from smaller and emerging companies to their larger, more liquid counterparts (and/or cash).

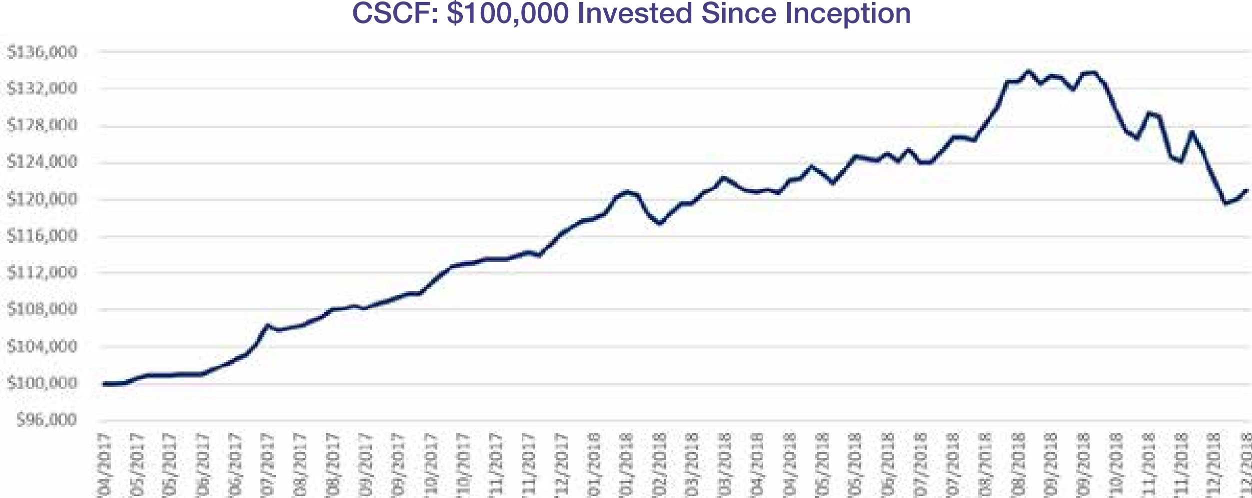
Liquidity, or in the case of micro-cap companies, a lack thereof, has been a considerable driver of return differentials of late. With Australia's premier microcap index officially hitting bear market territory (defined as a 20% retracement from its highs), investors have generally not been rewarded for going too far 'down market'. We are therefore mindful of liquidity yet continue to focus on the evergreen principles of value and quality.

While the focus of this update will be the December quarter, with calendar year 2018 coming to a close, it's also worthwhile briefly reflecting on the year that has been. The CSCF generated a modestly positive return of 2.8%, which on a rolling 12-month basis is below our absolute return target. However, it is noteworthy that the two most relevant comparative indices, the Small Ordinaries Accumulation Index and the Emerging Companies Index, delivered total returns of -8.7% and -19.9% respectively for CY2018.

As we articulate above, generating a sound through-the-cycle absolute return will always be the focus for your investment managers. With that said, risk management and mitigation remain a key pillar of the investment process. In this regard, the degree of capital protection delivered during what has been a sharp correction has been pleasing.

Consistent with prior quarters, the portfolio retains diversity by sector. While capital allocated to the high-growth Software & Services sector has somewhat moderated, this remains a meaningful exposure for the portfolio. As we have often noted, 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.

CSCF: $100,000 Invested Since Inception



Source: Clime Asset Management

CSCF vs Small Ordinaries Accumulation & Emerging Companies

Source: Clime Asset Management

Setting Sail

During the quarter we initiated a position in leading designer and manufacturer of aluminium defence and commercial ships, Austal Ltd (ASB). Established in 1988 and listed on the ASX in 1998, ASB has designed and delivered over 300 vessels for over 100 clients in 54 countries.

Austal is an Australian shipbuilder and global defence prime contractor which designs, constructs and sustains some of the world's most advanced aluminium commercial and defence vessels. ASB is today Australia's largest defence exporter and the only ASX-listed shipbuilder. Austal delivers iconic monohull, catamaran and trimaran commercial vessel platforms – including the world's largest trimaran ferry and multiple defence programs such as the Littoral Combat Ship (LCS) and Expeditionary Fast Transport (EPF) for the United States Navy.

The company is well positioned to deliver strong earnings growth over the medium term, driven by three key factors: (i) Steady revenue growth and material margin improvement in its core US Defence business, (ii) Strong growth in recurring support and maintenance revenues, and (iii) A solid rebound to profitability in ASB's Australasian business is expected. We review these factors below.

Positively, ASB is one of only two manufacturers of the LCS program, along with Lockheed Martin. Over time, given a strong 'learning curve', margins have materially improved. Essentially, ASB's specialist shipbuilding workforce is becoming more efficient, resulting in a reduction in labour hours per vessel and an increase in delivery velocity.

The support business is increasingly providing a strong baseline of recurring revenue. Typically, 10% of the capital cost of a vessel is allocated to annual maintenance programs, with the Original Equipment Manufacturers best positioned to provide services. As ASB delivers more ships, particularly LCS, this component of ASB's total group revenue becomes more prominent. Support revenue is therefore forecast to approximately double over the coming three years to $400m, representing an EBIT contribution of between $24m and $28m per annum. Given an average ship life of 25 years, this effectively becomes a growing source of recurring revenue.

Management have forecast a rebound to profitability in its Australasian business in FY2019 and beyond. This guidance is underpinned by increased Australasian defence expenditure, a strengthening global passenger transport market and a subsequent improvement in global demand for high speed ferries. As one of only two global manufacturers of high-speed catamarans, ASB is well placed to absorb growing demand for not only global fleet expansion but a significant phase of fleet replacement. This is occurring at a time when ASB has successfully invested in expanding manufacturing capability in lower cost Asian jurisdictions.

While we are positive about the prospects of ASB over the medium term, the business is exposed to several risks that require ongoing evaluation. ASB is dependent on receiving a steady stream of new contract awards to maintain its revenue base. Failure to win new contracts would severely impair the value of the business. ASB must then continue to execute well to maintain adequate profitability. A one per cent EBIT margin 'miss' can significantly impact the bottom line.

Beyond the above, it's worth acknowledging the strong bargaining power of ASB's customer base. The lion's share of ASB's defence business services the US Government. While the niche of defence shipbuilding has a narrow competitive field, the strong bargaining power of the US Government in turn effectively places a ceiling on margins. Somewhat mitigating this is the US Government's desire to ensure the 'industrial base' and associated skills/capacity is at least maintained.

A Welcome Addition

We also took the opportunity to add Wellcom Group Limited (ASX: WLL) to the portfolio during the quarter. WLL is a global technology-based creative production and marketing services company with operations spanning Australasia, Europe and North America. Founded in 2000 by Chairman and major shareholder Wayne Sidwell, WLL listed on the ASX in 2005 at $1.00 per share and today services a large 'blue chip' client base comprising the likes of Adidas, CBA, L'Oréal, Tesco and Woolworths.

Since listing, investors have received over $2.40 of fully franked dividends whilst shares appreciated to nearly $5.00. This wonderful track record has rewarded long-term shareholders, who have enjoyed total shareholder returns of 18 per cent per annum over the past decade.

wellcom Sidwell family precursor businesses have operated in related marketing and creative production industries since 1918, with family run business principles still evident in WLL's operations and capital management strategies today. WLL is now a niche leader in the provision of end-to-end creative production services, a one-stop shop for large tier one corporates encompassing production, digital, social, video and print services. WLL's own Knowledgewell (KW) software platform further embeds WLL within its clients' operations, and acts as an online collaborative environment for marketers to plan, create, manage, and repurpose data and digital content.

WLL has an increasingly global footprint that provides strong pillars of growth in much deeper markets. To achieve this, WLL have sensibly acquired businesses in the US and UK over the past 6 years, which now in aggregate represent a significant growth driver for the group. As such, the business is well placed to provide global solutions to a growing multi-national client base.

The Knowledgewell software platform provides high margin SaaS opportunity. According to management, WLL is the only digital creative production company to have built its own enterprise level proprietary software. KW is a cloud-based SaaS encompassing Digital Asset Management (DAM), Product Information Management (PIM) and Marketing Resource Management (MRM).

With over 100 clients, customer concentration is relatively low while the churn rate is also understood to be low. WLL 'Hubs', which are specialised teams deployed to work on site with clients, tend to become embedded in the operations of its diverse, high quality client base. When combined with Knowledgewell implementation, the 'stickiness' of WLL's revenue base increases further. As a result, many clients have been with WLL for long periods of time. For example, clients such as Woolworths and Australia Post have been with WLL for 16 years. The expanding client-base now includes globally significant businesses such as Adidas, Woolworths, Coles, Australia Post, ANZ, CBA, Louis Vuitton, Stockland, GAP, Google, Telstra, Tesco.

The business is built on a strong financial foundation, with a healthy balance sheet and sound history of free cash generation. WLL has generally been conservatively financed since inception, with current net debt of just $2.2m (ND/Equity of 3.6% and EBIT interest cover of 50x). WLL generated operating cash flow of $15.1m for FY18 while the aggregate five-year operating cash flow of $59.4m comfortably exceeds reported profit over the same time frame (ratio 115%).

We remain attracted to the 'owner manager' style apparent in WLL's leadership and believe the board and senior management ranks are highly aligned with minority holders. With demonstrated capital discipline, significant tenure, industry experience and large insider ownership, it is probable that WLL has the internal resources to continue executing on their growth path.

Looking ahead, management has forecast 10% to 15% EPS growth in FY2019. AGM commentary subsequently reaffirmed guidance while noting 'a strong first quarter'. It appears likely that UK profitability will lift substantially in FY2019 post the recent Tesco implementation, while WLL's Australasia and US businesses continue to track to expectations. Specific to risks, leverage to broader economic activity and global marketing trends, competitive intensity within specific lines of work and stock liquidity are key factors we are monitoring.

Small-Cap, Large Market Opportunity

Mach7 Technologies (M7T) is a US-based healthcare IT company at a positive tipping point on its journey. A software pureplay specialising in healthcare imaging and unstructured data management, M7T enables hospital systems to consolidate patient-specific data from numerous sources and deliver the right information to the right people, including various practitioners and patients themselves.

Since Electronic Medical Record (EMR) was mandated in the US in 2009, consolidating and streamlining clinical data has been a significant challenge across the country. About three quarters of clinical data still lives outside EMR, and poor interoperability is cited as a key contributor to medical errors and malpractice claims.

Having joined the ASX via a reverse listing in 2016, we saw potential in M7T based on early validation of its platform among top tier academic hospitals as well as large commercial hospital systems such as Broward Health and Sentara Healthcare. It also attracted a high calibre management team of industry veterans including Mike Jackman, the former Americas Region CEO of Healthcare Digital at GE Healthcare, as CEO in August 2017 and David Chambers, the former CEO of Pro Medicus (ASX:PME) and Visage7, as Non-Executive Director in August 2018.

In May 2018, M7T announced a partnership with radiology viewing technology developer Client Outlook, enabling M7T to participate in the PACS (Picture Archiving and Communications Systems) replacement market in addition to VNA (Vendor Neutral Archiving). The new offering effectively expands M7T's addressable market from US$800m to over US$3 billion globally and increases the potential value of individual contracts. As highlighted in November's presentation, M7T's contract pipeline has increased by over 50% in the last 15 months, and now exceeds US$100m. The opportunity is sizeable relative to the company's A$29m market capitalisation (at the time of writing).

Interestingly, the PACS and VNA market is dominated by a small number of larger players such as FujiFilm, IBM, GE Healthcare, AgFa and Lexmark. These solutions emerged out of traditional equipment and film businesses, which created vendor-specific data silos. M7T is in a strong strategic position from a capability perspective, as its system was designed from the ground up specifically to solve interoperability issues. Indeed, Mike Jackman and David Chambers both cited existing capability as a key reason for joining the company.

Two significant contracts were announced in November 2018, including a 5-year A$15m contract with the Hospital Authority of Hong Kong (HAHK) and a PACS modernisation contract with Sentara Healthcare. HAHK encompasses 43 public hospitals and is regarded as one of the highest quality health systems in the world.

In November 2018, the CSCF participated in a $3m placement to provide additional working capital for the HAHK implementation. We look forward to updating investors on this holding over coming months.

Jumbo Upgrade

New Powerball odds in effect since April 2018 helped see a sharp rise in jackpots over the half, which had a materially positive effect on lottery ticket sales. In December, prominent fund holding Jumbo Interactive (JIN) upgraded full-year earnings forecasts by 28% and now expects to deliver earnings of $20.5m for the full year, a 68% increase on FY2018.

JIN also announced the signing of its first 'Powered by Jumbo' customer in the Mater Foundation, with revenues expected from FY20. Powered by Jumbo is a SaaS version of JIN's internal lotteries management system and will be marketed to charities and governments globally, which is a multi-billion-dollar addressable market.

Parting Ways

The investment committee made the decision to exit our small holding in Kangaroo Island Plantation Timbers (KPT) during the quarter. The decision followed the announcement of a further delay in the execution of the KPT business plan.

Our thesis was initially based on the likely and perceived imminent approval by the South Australian government for KPT to build a deep-water wharf on Kangaroo Island. The wharf would subsequently enable exports of large quantities of eucalypt woodchip from the island.

We seek to invest in either highly profitable companies or, in a small number of cases, emerging companies with a clear path to near term profitability. Furthermore, the CSCF is a reasonably concentrated portfolio and positions are maintained not only where we see significant opportunity, but also where sound execution is evident. While we hold KPT's senior management in high regard, given the number of delays KPT has faced in recent times, unfortunately the investment no longer satisfied this criterion.

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 hold ourselves to account when considering the core value of alignment. We invest alongside our clients, and upon the same terms as clients. Accordingly, several members of the Clime investment and executive team are meaningfully invested in the Fund. In addition, the lead Portfolio Manager added to his family's investment in the Fund during the December quarter.

The Long-Term Investment Journey Continues

The December quarter provided a reminder that challenging times can appear at any time on the long-term investing journey. Hindsight suggests the probability of a correction occurring was higher given the somewhat elevated earnings multiples broadly apparent.

In practical terms, the significant fall in equity markets has restored a degree of value to company valuations. Given a strong cash position, we are well-placed to utilise volatility to continue sensibly building out exposure to a range of high-quality smaller companies. While we acknowledge the more disappointing shorter-term outcomes, it's about sticking to the process as this focus delivers positive long-term results.

The portfolio enters the February reporting season in good shape. In aggregate, portfolio metrics specific to profitability ratios, balance sheet strength, cash generation and earnings growth remain strong.

Thank you for your ongoing support.

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