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Clime Smaller Companies Quarterly Investment Report March 2019

Market Commentary

While the rate of growth moderated during the month of March, with the S&P/ASX200 Accumulation Index up 0.7%, the first quarter of 2019 has come as a welcome relief for growth asset investors. Following the sharp pullback last November and December, global investor sentiment and market prices have recovered some of their optimism, largely off the back of a more dovish US Federal Reserve.

The reversal of fortunes in risk assets has come despite generally disappointing macro data across Europe, the US and China and the tempering of corporate earnings forecasts globally. The rally in global equities to date in 2019 has not been driven by expectations for better growth and rising corporate profits, but by reassurance that global central banks would temper their inflation-fighting objective and seek instead to sustain the post-GFC recovery.

Another factor supporting the equity market recovery has been the sense that the sell-off late last year was overdone. The near 30% de-rating in global equity PE ratios from end-January 2018 to end-December 2018 was both brutal and unexpected, given that the world's largest economy, the US, was growing strongly and experiencing a buoyant year for corporate earnings. But of course, markets are forward-looking, and fears of "peak earnings", a Sino-American trade war, a hard landing in China and a Federal Reserve determined to "normalise" rates sapped confidence and soured the mood. The fact that many of these fears have proved either unfounded or exaggerated has supported the rebound.

Now that the first quarter is over, we must assess whether that rebound is either warranted or sustainable. Over the course of the first 3 months of 2019, the S&P/ASX200 has risen 10.9% while global markets have enjoyed similarly impressive quarterly returns. A good part of those figures may be making up the losses from the quarter before that, but it remains for the market to be tested for the most critical factor, which is value.

The likelihood of material further upside for equity markets in the short term is, in our view, now dependent on central banks allowing financial conditions to remain loose, policymakers stimulating activity through prudent infrastructure spending and fiscal relief for households, the successful conclusion to trade talks, the US economy remaining reasonably strong and some sparking of growth in the European and Chinese economies.

In particular, we highlight the effectiveness or otherwise of the broad range of measures implemented by the Chinese authorities to cushion their growth slowdown. The Chinese consumer is the "single most important (factor) in the world economy", said Jim O'Neill, former Goldman Sachs chief economist. "The next 40 years of global growth might be about the Chinese consumer. It is very unlikely that any other country could step in to drive global consumption." China has contributed around 30% of the global economy's growth since 2013, compared to 11-13% from each of India, the European Union, and the United States. The strength of China's economy is critical.

A key support to developed economies (the US, the Eurozone and Japan) remains consumption growth backed by solid labour markets and continued wage growth. To date, the absence of wage growth has been the disappointing factor in the recovery that we saw during last year, and this has been a spur to the growth of populism in many countries. A pause in the central banks' rate rising program and a well-targeted stimulus from China should provide the basis for global growth a little below trend. Resolution in trade conflicts would no doubt also reduce uncertainty and support global growth.

In an environment where economic risks are building and global growth is slowing, careful assessment of investment opportunities is required. The change in tone from the US Fed, and its increased sensitivity to growth and the financial cycle, has led to a fundamental reassessment of risks and opportunities in many financial markets, as the "lower for longer" thesis on interest rates reasserts itself. At the same time, while trade talks between the US and China seem to be progressing, the Brexit imbroglio and many other political risks remain heightened. However, these risks and changes in economic growth expectations present opportunities and an argument for active management and active asset allocation.

Clime's base case is that overall global equity returns in the medium term are likely to be positive but more muted than investors have been used to for most of the post-global financial crisis period. Nonetheless, we expect that late cycle volatility and macro-thematic market drivers combined with company-specific opportunities will provide a satisfactory set of portfolio alternatives for patient investors.

Thank you for your continued support of Clime.

Adrian Ezquerro
Head of Investments

Portfolio Commentary

Everything feels fine once again. But you could have sworn just weeks ago dire predictions abounded. The market has a short memory. However, the grim elements of elevated leverage, trade tensions, and a bent for rising interest rates haven't gone away.

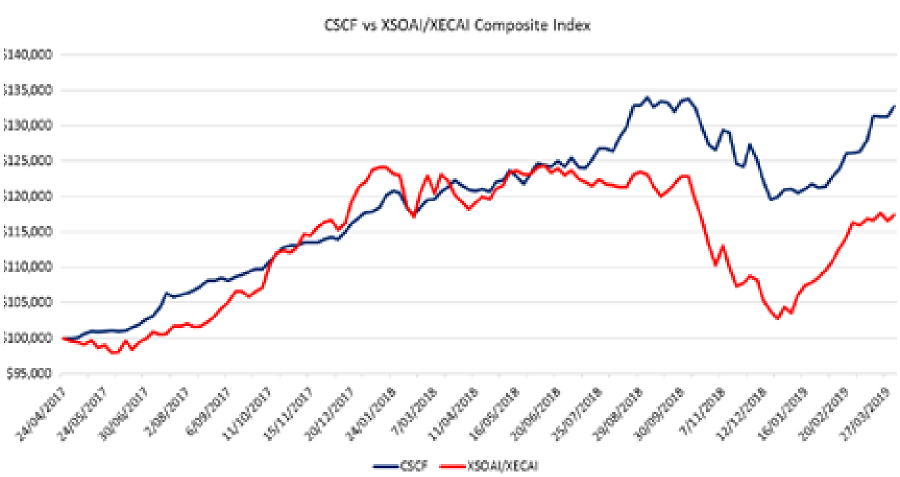
The Clime investment team takes a long-term view on investing. We encourage our co-investors to take this same approach. The CSCF seeks to achieve an annual total return of 8% above inflation over rolling five to seven-year investment periods. To meet this objective, our resolute focus remains on investing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

The 2019 calendar year is off to a strong start, turning around most of the correction in late 2018. The CSCF's investment universe is best represented by a 50/50 blend of the S&P/ASX Small Ordinaries and S&P/ASX Emerging Companies Indices. This blended benchmark generated +12.5% over the March quarter, not quite matching the -14.2% drawdown in the prior period.

The CSCF benefited from the rebound in investor confidence, delivering +9.7% (net of all fees) for the March quarter and more than recovering the -8.3% experienced in the December quarter. Though much can occur in a quarter, the Fund is now on track to meet or exceed its absolute return objective for the full fiscal year.

The recent swings across the small and emerging indices are driven in large part by liquidity (or lack thereof). We find this is especially so for the array of competitively challenged and undercapitalised names outside the ASX200. We therefore remain unwaveringly focused on the evergreen principles of value and quality.

Sound through-the-cycle absolute returns will always be the cornerstone for your investment managers. In this regard, the degree of capital stability delivered during recent market turbulence has been pleasing.

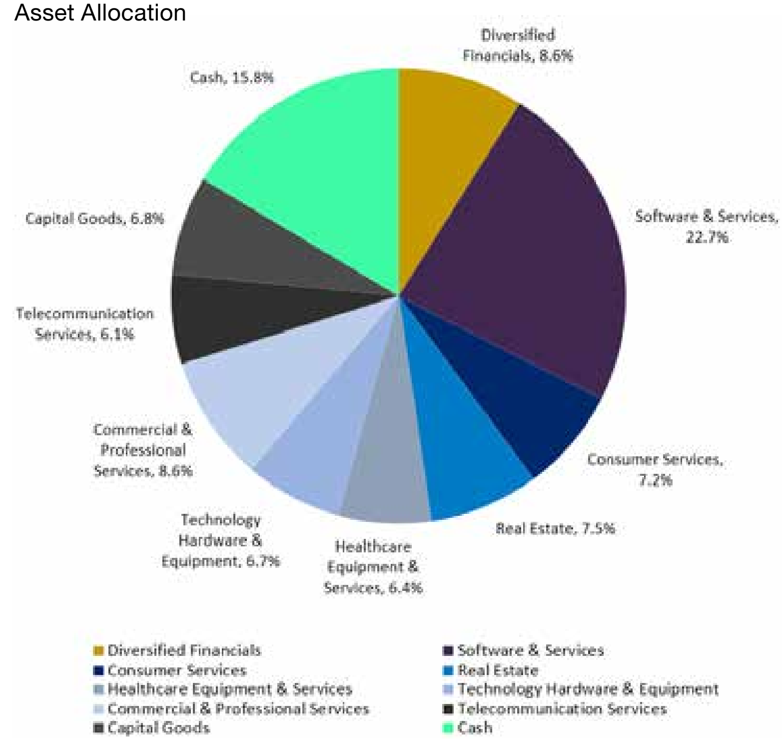


Prominent Fund Holdings *(alphabetical order)*

afterpay	Afterpay Touch Group Ltd (ASX: APT)
audinate	Audinate Group Ltd (ASX: AD8)
citadel group	Citadel Group Ltd (ASX: CGL)
Lycopodium	Lycopodium Ltd (ASX: LYL)
macquarie telecom	Macquarie Telecom Group Ltd (ASX: MAQ)

The portfolio retains diversity by sector. While capital allocated to the high-growth Software & Services sector has somewhat moderated, we expect this to remain a meaningful exposure for the portfolio given the often company-specific nature of the opportunities within the space.

Asset Allocation



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Portfolio Commentary

Afterpay global opportunity

Afterpay Touch (ASX: APT) was a meaningful contributor over the quarter, appreciating 80% to finish at $21.10. It was a highly eventful period with accelerating traction for the business in the US reported in two separate updates in January and February, either side of a business-threatening Senate Inquiry.

Despite a determined lobbying effort funded by credit-card issuing banks, exploited by short sellers and competitors, and propelled by undiscerning journalists and consumer advocates, APT emerged unscathed from the February Inquiry. In the end, the Senate Committee essentially endorsed the product intervention powers proposed by ASIC in November last year.

This outcome was, in our opinion, entirely predictable due to the fundamental differences between traditional credit and APT's transaction-based and interest-free finance. Nevertheless, these differences were consistently ignored by those insisting APT fall under a code designed for traditional credit.

Taking transaction loss-rates as a proxy for lending standards, given a 1H19 net transaction loss rate of 0.5% (down from 0.7%) and gross losses of 1.1% (down from 1.6%), it is unlikely we'll see ASIC exercising its proposed powers, at least as far as APT is concerned. So, it is business as usual.

With a market capitalisation (at the time of writing) of over $5 billion, or about 20 times FY19 consensus revenues, there is obviously significant growth expected for the business. We approach this by assessing the addressable market, the payoff involved, and whether recent execution places the company on track to capture the opportunity. Our analysis points to APT being multiples of its current size with successful execution. Indications (admittedly early ones) are that it is well on track.

Afterpay appears to be on the way to replicating its success in Australia and New Zealand in the much larger United States market, with the United Kingdom to launch in coming months.

Beyond the US and the UK, which are home to ecommerce markets totalling $500bn, Canada, Europe and Asia remain as future opportunities. In Australia, APT captures over 10% of online transactions and is developing an increasingly prominent in-store presence, across a widening range of categories.

As at 31 December, US active merchants totalled 1,900 and customers totalled 600,000. Just over two months later APT counted its millionth US customer in early March, reportedly adding 10,000 new customers per day. At this rate, APT's US customer base will match that of its Australia and New Zealand business by end of CY19. This kind of hockey-stick growth on low sales and marketing investment suggests the emergence of early network effects in the US, which is set to drive mutually reinforcing adoption by retailers and customers.

In late March, APT announced cross-border payments enabled between Australia and New Zealand (with the US to follow shortly). This is a game-changing development in our book. A significant percentage of cross-border online shopping is from international consumers into US based retailers, and likewise US consumers to international retailers. This means future retailers in new geographies can be sold on access to millions of customers in the US, Australia and New Zealand.

In our view, the most important metrics to assess execution are continued viral trending in app downloads, online search trends and website visits. On these fronts, we have seen a clear acceleration in recent weeks.

The case for Audinate gets louder

We profiled digital audio networking technology developer Audinate (AD8: ASX) in our September 2018 quarterly.

AD8's flagship product set, Dante, comprises hardware (chips, modules) and software that is embedded within audio products of its Original Equipment Manufacturer (OEM) customers.

Dante is set to become the "de-facto standard" for audio networking having already established a dominant share of OEM adoption. Interestingly, the addressable market for the Dante Audio and AV product suites is over $1 billion, representing a very large growth runway when compared with forecast FY19 revenues of about $30 million.

1H19 results surprised on the upside with sales growth of 60% and faster than expected cash flow break-even, suggesting the business is at a positive inflection point in its journey. The result was even more impressive given that sales of AD8's Dante Domain Manager (DDM) software for AV professionals (the end-users) are yet to meaningfully contribute. AD8's existing user base of Dante-enabled equipment is a significant DDM revenue opportunity in its own right.

Jumbo Returns from Jumbo Interactive

The Clime Smaller Companies Fund is yet to turn two years old, and it already feels like we have covered this company ad nauseum. However, it's rare that a company appreciates 6-fold in this kind of timeframe, and Jumbo's (ASX: JIN) 97% gain over the March quarter alone demands another update.

A change to Powerball odds in April 2018 resulted in a step change in the frequency of large lottery jackpots, and a corresponding step change in ticket sales. FY19 has already seen two record Powerball jackpots of $100 million.

At the same time, the migration of ticket sales to the online and mobile channels is accelerating, reaching 21.5% as at 31 December, up from 17.7% as at 30 June. This trend is likely to continue because digital sales are far more convenient for the consumer.

1H19 revenues grew 58% on a largely fixed cost base, resulting in earnings growth of 140% to almost $13 million. In March, JIN joined the ASX300 and hit a market capitalisation of over $900 million, which saw increasing broking analyst coverage as well as institutional investor interest. With this, there is growing emphasis on JIN's burgeoning lotteries management platform business, the company's new growth leg, which has a multi-billion-dollar opportunity set. As shares appreciated to $16, and some of JIN's potential was realised, we reduced our portfolio position to better reflect the remaining opportunity.

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Portfolio Commentary

Navigating Rough Waters

Prominent holding Navigator Global Investments (ASX: NGI) weathered a difficult December quarter due to the severe global market correction. Performance was modestly negative; however this was compounded by faster than expected client attrition within the Mesirow (MAS) business unit acquired in July 2018.

NGI had expected to retain approximately three quarters of the US$5.4 billion of MAS Assets Under Management (AUM). During the December quarter melt-down, this process accelerated and NGI finished the half with US$3.9 billion of MAS AUM, representing approximately 72% retention.

With the dual effects of performance and outflows, NGI finished the quarter with US$14.7 billion AUM, down 8.8%. In January, management downgraded FY19 EBITDA guidance from US$38 to US$36 million, and shares fell 30% in the subsequent days.

The good news at this stage is that although NGI still languishes near 12-month lows, we believe AUM should recover strongly during 2H19, owing to a broad market rebound combined with a $300 million mandate joining Lighthouse in early February. AUM is likely to be ahead of the level implied in management's January guidance.

A Little More to Smile About

Leading ASX-listed dental services company 1300 Smiles (ASX: ONT) looks well positioned to drive growth in a tough market, having recently announced a material acquisition in South East Queensland.

ONT owns and operates full-service dental and orthodontic facilities across New South Wales, South Australia, and in the ten major population centres in Queensland. ONT's goal is to build out a national footprint over the coming decade.

Recent results have been typically solid. First half revenue was up 3.9% to $20.5 million while profit was up 4.3% to $4.1 million. Post results, ONT announced the acquisition of two established, multi-chair dental practices which are expected to make an immediate contribution to earnings.

Though only a small cap, ONT has a sound long term track record, with per share earnings, dividends and operating cash flow approximately tripling over the past decade. Operating cash flow has consistently exceeded reported profit, which in turn has allowed ONT to self-fund its growth objectives while also paying out consistent income to shareholders.

This track record is certainly reflected with its dividend history. With just one exception, ONT has increased its annual dividend every year since listing on the ASX. At current prices, ONT offers investors an attractive fully franked yield of 4.8%.

With a view towards longer term value creation, ONT remains well placed to deliver a growing stream of earnings and dividends to patient investors over the coming years.

Bravo Bravura

With Bravura Solutions (ASX: BVS), we remain attracted to both the quality of the offering and the large addressable market opportunity. Bravura's product functionality supports the pension, life insurance, investment products, and wrap platform markets across its key markets in the UK, Australia, New Zealand and South Africa, which comprises numerous blue-chip financial services companies. Many organisations in these markets are still running multiple legacy or competitor systems, resulting in high cost structures.

Following significant product investment and the accumulation of deep market knowledge and expertise, BVS and its core Sonata platform, is well positioned to continue capitalising on the significant market opportunity.

The company recently reported a 24% rise in revenue to $127.4 million and a 28% increase in EBITDA to $23.8 million. BVS has a strong, fertile pipeline of work from both new and existing customers, with margin expansion in the key Wealth Management segment gathering pace. BVS delivered a total return of nearly 50% for the March quarter.

An Upgrade for Austal

We introduced the investment thesis for Austal (ASB) in the December quarterly. Since that time, the company has announced a string of positive announcements, including an upgrade to FY2019 forecasts. To recap, 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.

Among other things, ASB has been awarded LCS support contracts and further US Navy contracts, which when coupled with successful delivery of various other vessels, positions the company well for ongoing growth. To that end, ASB upgraded full year revenue guidance to $1.9 billion while also delivering 1H EBIT that was significantly above prior guidance. While risks are ever present, we remain comfortable with recent execution and have solid grounds for optimism as we edge closer towards what should be another year of growth in FY20.

Manager Alignment

We 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.

The Long-Term Investment Journey Continues

The March quarter was especially pleasing due to a broad range of portfolio constituents contributing to a strong result.

Portfolio Commentary

However, the degree of volatility across the December and March quarters was unusual and given macro fundamentals haven't changed that much, we expect volatility to persist.

We are not in the business of predicting short term market movements, but rather of finding strong company-specific opportunities.

With recent gains, we have rebalanced the portfolio in the interests of capital preservation. Given a strong cash position, we are well-placed to utilise volatility.

The portfolio enters the final quarter of the financial year 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.

Jonathan Wilson
Portfolio Manager