Clime Smaller Companies Quarterly Investment Report June 2019

Market Commentary

We pass the mid-point of calendar 2019 with a sense of the dichotomy between strong bond and strong share markets, and yet a deeply uncertain economic and geo-political environment. An example of strong markets: the broad US equity index, the S&P 500, was up 18% during the six months to the end of June (its biggest first half gain since 1997), while the Australian S&P/ASX 200 accumulation index was up 19.7%. The problem is that while stocks are marching higher, corporate profits are not. Investors need to make important long-term decisions in the face of complex macroeconomic and market conditions but are compelled to do so while presented with unprecedented challenges.

These include a staggering US$12 trillion in global government bonds yielding negative interest rates, the absence of inflation in almost all developed countries, a US economic growth cycle of almost unparalleled longevity, questions about whether the US and China can negotiate a trade deal in a political mood resembling the Cold War, and uncertainty about what a disorderly Brexit could mean for the UK and Europe.

To be more comprehensive, investors should also be pondering massive government and consumer debt in many parts of the world, the monopolistic challenges of Big Tech, "fake news" and the loss of privacy, and long-term risks such as climate change, the inter-generational divide, and the unsettling rise of autocratic populism. But let's not tackle too many issues: we restrict our comments in this report to a brief review of the markets, the economic milieu in the larger countries and regions, and our expectations for the period ahead.

From an historic standpoint, central banks have usually been responsible for an upswing coming to an end, raising rates to prevent an outburst of inflation which then triggers slowdown or even recession. However, in the current situation, central banks have played the opposite role: ensuring the long and slow recovery from the GFC is sustained by suppressing rates to unprecedented low levels. They have been free to do this because of the unusual absence of inflation, despite strong labour markets and low unemployment. The rate of inflation in industrial countries is unusually low; in fact too low for most central bankers, who fear deflation. Central banks are thus under no pressure at all to tighten monetary policy.

The central bankers are sending reassuring signals that, in the case of weak economic prospects or tensions in the financial system, they are ready and able to act. Thus, we find neither the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan or the RBA is likely to raise their key rates any time soon. While the yields on government bonds are artificially depressed, with many trading at negative yields, they are likely to rise only slowly if the central banks can manage that transition.

Against this backdrop there is apparently little need for the capital markets to be concerned about how long the recovery will last, for the central banks have signaled their readiness to provide support. But this support helps only to a limited degree: economic fundamentals and market valuations do matter. Recent economic indicators have been mixed and, thanks to the central banks, financial markets are fairly upbeat. With respect to the equity markets, we remain cautious and alert to the many risks, but do not foresee any near-term crisis.

Australia

The Australian share market recorded a stellar performance over the first half, with the ASX 200 returning almost 20%. Over the same period, the Liberal-National Coalition was returned to power, commodity prices were strong with iron ore a feature, government bond yields were lower, and the official interest rate was cut by 0.5% at the time of writing. Over recent months, there has been heightened volatility in offshore markets as the China-US trade war escalated and the AUD generally has traded weaker.

A feature has been the extraordinary return from Australian bonds, which have generated significant returns over 12 months and with ten-year yields rallying from 3% to 1.4% (an all-time low yield). It is worth noting that for a similar reduction in yield to be replicated over the next 12 months would require ten-year yields to approach zero. That would require the introduction of a sustained Quantitative Easing ("QE") policy by the RBA, a policy which it says is "unlikely".

Another standout has been Australian listed property securities (A-REITs) where market prices moved from slight discounts to NTA to a significant premium. The rally in property security prices pre-empted the RBA cash rate cut and reflected a general decline in bank term deposit rates. The performance is very much generated by the chase for yield and particularly by retail investors and savers.

Over the year to the March quarter, the Australian economy grew at a below-trend 1.8%. Consumption growth has been subdued, weighed down by low income growth and declining housing prices. Increased investment in infrastructure is providing an offset and a pick-up in activity in the resources sector is expected. The central scenario for the Australian economy remains reasonable, with the main domestic uncertainty being the outlook for consumption. We expect the RBA to maintain its rate-cutting program in support of the economy.

USA

In recent months, the trade dispute with China has become one of the most important macroeconomic issues affecting markets. The direct economic impact of measures that have already been implemented (tariffs raised to 25% on Chinese goods in the value of USD200bn) should be limited. However, further escalations could have a significant negative impact on the US and Chinese economies. This is particularly true if companies abandon their investment plans.

Concerns over escalations in the trade dispute have given fresh impetus to rate cut expectations. The latest statements by Federal Open Markets Committee (FOMC) members suggest that tariffs that have been imposed have had little impact on economic growth so far. However, the Fed seems willing to consider taking more steps as insurance should tariffs be raised further. This means that if a 25% tariff were levied on all Chinese goods, a lowering of key rates would be likely.

The US economy has been pulling away from its western counterparts after a decade of recovering from the global financial crisis. US consumption is strong, consumer sentiment

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is close to a 50-year high, unemployment is at a 50-year low, and the share market is at an historic peak. And yet, despite solid economic growth, there is little underlying inflation. One explanation is that the US consumer has been a beneficiary of the slumping price of oil. More important, however, is the lack of wage growth – which also has political implications.

Voters will not argue with a strengthening economy, and it does not seem too unlikely that President Trump will win a second term in office. His tax cuts have been good for corporates and the wealthier part of the economy and, on the whole, the economy seems to be functioning better than many people expected.

Yet US market valuations are stretched. While stocks continue to rise, corporate profits are relatively stagnant. The ten-year average S&P 500 Price Earnings (next 12 months) ratio is 14.8 times; at present, it is close to 17 times. Expectations for S&P 500 third quarter earnings are steadily declining – at present they are actually negative. The strong rally over the last six months has been built upon low rates rather than robust earnings.

China

In recent weeks the conflict between China and the USA has escalated after first the USA and then China imposed new tariffs. US sanctions against the Chinese telecommunications group Huawei have raised serious doubts in China over US readiness to negotiate. The G20 meeting at the end of June appeared to raise the promise of a thaw in the relationship, but there remains a real danger of continued confrontation and the extension of US tariffs to all goods imported from China.

Meanwhile, the latest Chinese economic data have proved weak. The measures implemented so far by the government have not yet stabilised the economy. Earlier this year, the government set a growth target range of "6.0% to 6.5%", down from the target of "about 6.5%" for last year. We expect the government to step up infrastructure investment and create fresh incentives for consumption in a bid to keep the growth rate steady.

Eurozone

Sentiment indicators have so far painted a mixed picture for the Eurozone economy. Germany in particular is showing signs of weakness due to problems with global trade, whereas France appears to have recovered after the turmoil caused in late 2018 by the yellow-vest protests. Manufacturing conditions look particularly weak: the manufacturing Purchasing Managers' Index (PMI) is below 50 (implying contraction), and weaker still in Germany, where the PMI is at 45 and trending lower.

The Eurozone unemployment rate was 7.5% in May, the lowest level since August 2008, and down 0.8% on a year ago. However, there are substantial differences between the major Euro countries. Germany leads the field with an unemployment rate of 3.2%, whereas Spain still has an unemployment rate of 13.8% and both France and Italy have rates above the average at 8.7% and 10.2% respectively.

For the second time in the last three months, the European Central Bank (ECB) has adjusted its forward guidance and now suggests that it will not raise key rates at least until the middle of 2020. The forward guidance is for annual real GDP to increase by just 1.2% in 2019, 1.4% in 2020, and 1.4% in 2021. The ECB sees risks relating to these forecasts as "tilted to the downside". Moreover, it underscores its readiness to react to unwelcome economic developments by easing monetary policy again.

Conclusion

Central banks around the globe have turned decidedly "dovish" – and this includes the RBA. While the global economy is hardly firing, it is steady and still in recovery mode, albeit at a slow pace. On the other hand, global bond markets and share markets are priced somewhat expensively, despite the uncertainties being faced. For now, we will retain our relatively cautious outlook – particularly following the heady advances of the last six months which we think are unlikely to be repeated.

We have little doubt that at some future point we will endure challenging times. These challenges also bring opportunity. As we have stated previously, it will be the focus on the fundamental process, the diligence to complete the necessary research, and the patience to hold the spotlight on the long term that will build value over time.

Thank you for your continued support of Clime.

Adrian Ezquerro
Head of Investments

Portfolio Commentary

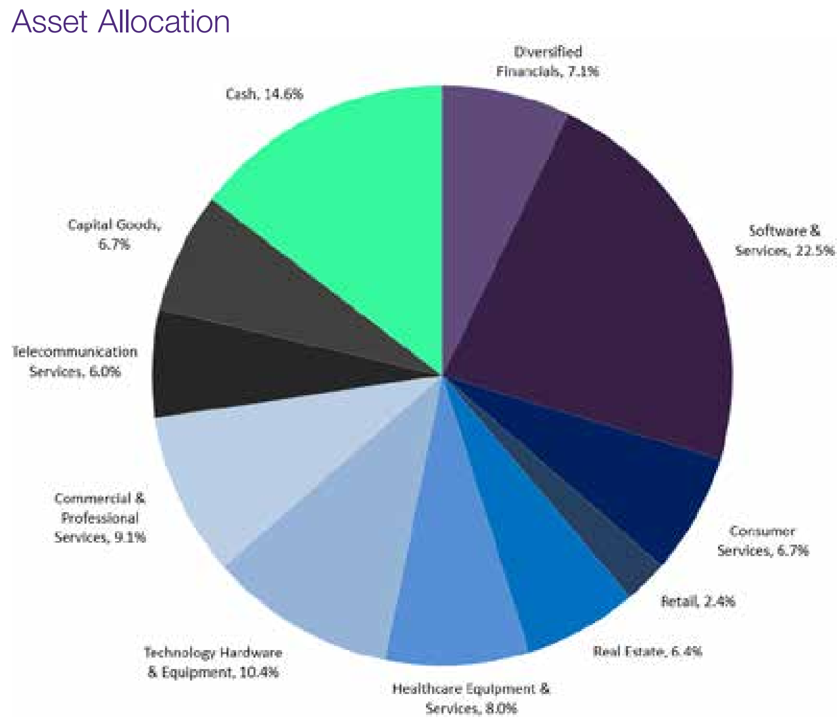
The June quarter rounded out a year that was notable for its volatility, finishing strongly and completing the U-turn from the turmoil experienced in December last year. This was largely a function of interest rates, and with expectations of accommodative monetary policy around the world, we find ourselves where we started.

Cycle or no cycle, the Clime investment team invests in niche leaders that are positioned for long term success. Applying a rigorous valuation methodology, the Clime Smaller Companies Fund (CSCF) seeks to generate returns above the small cap indices.

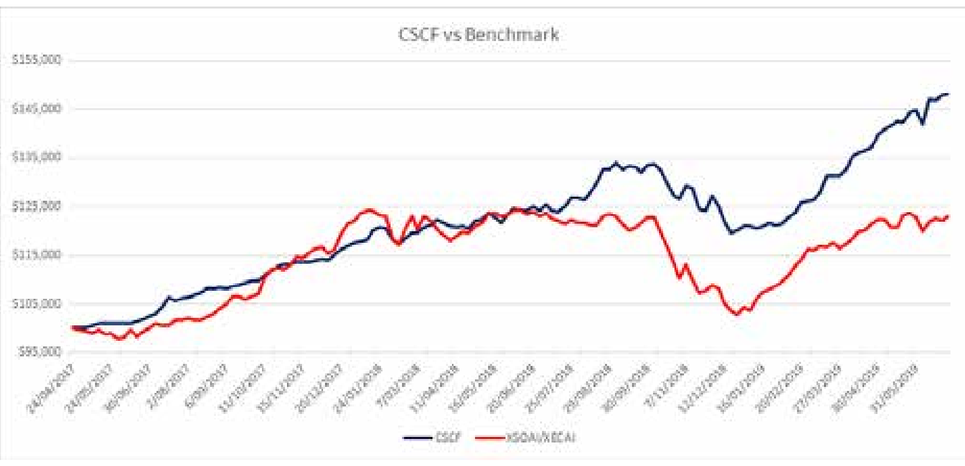
To better reflect the Fund's investment universe, from 1 July 2019 the CSCF transitioned from the previous absolute benchmark of CPI +8 per cent to a relative one made up of a 50/50 blend of the ASX Small Ordinaries Accumulation Index and the ASX Emerging Companies Accumulation Index. Client and external consultant feedback indicate that this new benchmark better reflects investor expectations.

The CSCF delivered +11.9 per cent (net of all fees) for the June quarter, versus the return of the new benchmark of +4.9 per cent. For the financial year 2019, the CSCF returned 18.3 per cent versus the new benchmark return of -0.5 per cent.

Asset Allocation



Performance (30/06/19)



	1 month	3 months	6 months	FYTD	1 year	Inception*	Inception (Total)
Portfolio Return (net of fees)	2.4%	11.8%	22.6%	18.3%	18.3%	19.8%	48.4%
Benchmark^	0.8%	2.3%	4.7%	9.8%	9.8%	9.8%	22.7%

* 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.

Prominent Fund Holdings *(alphabetical order)*

audinate	Audinate Ltd (ASX: AD8)
EOS	Electro Optic System Holdings Ltd (ASX: EOS)
HANSEN TECHNOLOGIES	Hansen Technologies Ltd (ASX: HSN)
macquarie TELECOM	Macquarie Telecom Group Ltd (ASX: MAQ)
NAVIGATOR GLOBAL INVESTMENTS	Navigator Global Investments Ltd (ASX: NGI)

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Hansen makes a big acquisition

One of the most significant developments over the quarter was Hansen Technology's (ASX: HSN) $166m acquisition of Canada-based Sigma Systems in early June. HSN's impeccable record of acquisitive growth over the last decade is one of the reasons it is held in the CSCF. Sigma is HSN's largest to date. Excluding synergies, Sigma will lift Group revenues and earnings by approximately 25 percent.

For HSN, growth is largely contingent on balance sheet capacity. The company started the year in a net cash position. During the half, the share price was depressed on no news, providing an opportunity to buy a high-quality business at a sub-market multiple.

For background, HSN's billing software is a 'mission critical' part of its utilities, telco and pay-TV customers' operations. The software ensures millions of end customers receive accurate and timely bills and enables various permutations of billing arrangements, which is critically important for staying competitive in de-regulated markets. Due to the mission-critical nature of billing software, switching costs are high and therefore organic growth is hard to come by, which is why HSN essentially grows via acquisitions.

Sigma is a leading global provider of enterprise catalogue-driven software to the telco and media sectors. This software assists with managing product creation and offers – a highly complex activity given the product permutations required to personalise and tailor offerings to various customers. Sigma sits adjacent to HSN's core billing and customer management software and expands HSN's scale and scope into the telco sector, increasing diversification outside HSN's traditional strength in utilities.

Excluding potential revenue synergies from cross-selling, at the time of writing HSN trades at 12 times FY20 earnings, albeit with a newly leveraged balance sheet. Despite rallying through the June quarter, we believe shares remain undervalued.

APN Property Group: The Quiet Achiever

Over the quarter, we increased our holding in specialist commercial real estate manager APN Property Group (ASX: APD). APD is a standout in its field, with a disciplined investment approach focused on income generation yielding solid long-term results. This is reinforced by the level of management and director ownership, which is approximately 40 percent of the business. Accounting for net tangible assets of approximately $113 million, during the quarter APD's asset management operation with Assets Under Management totalling approximately $2.9 billion had an implied valuation of just $14 million. With the business trading at a yield of 5.7 percent, this is a good deal in our view.

Mach7 at an Inflection

US-based Mach7 Technologies (ASX: M7T) is on track to deliver a maiden cashflow-positive 12-month period. This is off the back of recent milestone contracts with Hospital Authority of Hong Kong (HAHK) and Sentara Healthcare in the US.

M7T develops healthcare imaging and data management software that addresses inter-departmental interoperability issues within healthcare systems, as well as the management and distribution of patient data.

Although by market cap M7T is the smallest company in the CSCF (at around $74 million, at the time of writing), we see a large opportunity due to the early validation and global applicability of its software.

In the burgeoning field of Enterprise Imaging, M7T has a strong reference site in Hong Kong's network of 43 public hospitals. M7T's solution enables access to clinical data across any location in Hong Kong. As the benefits of Enterprise Imaging become more apparent, M7T will be well positioned to address demand from similarly sized hospital systems in the US.

Back in the US, M7T's PACS (Picture Archiving and Communication System) modernisation project with Sentara also provides a reference site at scale, and a platform for growth in the US$2 billion PACS replacement market.

The June quarter saw Board and Executive changes, with Mike Lampron moving from COO to CEO and Managing Director, and former Promedicus (ASX: PME) CEO, David Chambers appointed as Chair. We see a bright future for M7T, however investment outcomes will depend on further contracts.

Helloworld Travelling Nicely

Travel services provider Helloworld Travel (ASX: HLO) was added to the CSCF during the quarter. In 2016, HLO merged with the Australian Outback Travel Company (AOT), which was founded by Andrew and Cynzia Burnes. The Burnes husband-wife duo replaced the previous leadership team in 2016 and subsequently delivered merger synergies along with margin expansion on growing revenues.

In April, management reiterated FY19 EBITDA guidance of $76 - $80 million, representing growth of over 20 percent. We forecast another year of double-digit growth in FY20, although this assumes supportive economic conditions.

Despite an upbeat outlook, HLO was sold off during the half on perceived political risks. Leading into the Federal election, members of the ALP insinuated improper dealings between CEO Andrew Burnes, who is also the Liberal Party's federal treasurer, and members of the LNP, including former Treasurer and HLO shareholder, Joe Hockey. Helloworld has held whole of government travel management contracts since 2014.

An LNP re-election and a lack of evidence didn't affect market sentiment, however, providing an opportunity to invest in a well-capitalised, cash generative business in the midst of a successful turnaround.

Audinate? Sounds Good

During the quarter, we participated in Audinate's (ASX: AD8) $20 million institutional placement. The offer price of $7.00 was well north of the $3.50 level at the start of the year. Nevertheless, we thought it was an attractive price relative to our assessment of value.

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AD8 develops digital networking technology under the "Dante" brand name in the form of chips and software. Dante technology is embedded in professional audio equipment across a growing list of brands. Dante-enabled audio equipment can be networked via computer networks, a significant improvement on legacy "point-to-point" audio distribution.

Though still in its early stages, industry insiders are unanimous that the shift to digital will be a complete and permanent one. AD8 owns the IP over the enabling technology – essentially a monopoly. In our view, shares still reflect only a low percentage capture of AD8's addressable market.

By all accounts, Dante featured prominently at this year's Infocomm conference in Orlando in mid-June. Infocomm is the world's largest Audio-Visual trade show, with approximately 50,000 attendees over three days in June. At the conference, several marquee audio brands co-branded their offerings with Dante.

The conference also featured the commercial launch of Dante AV, which enables digital networking of audio and now video. Yamaha, a global leader in professional audio equipment, announced in June that it has adopted Audinate's Dante AV Product Design Suite, around which it plans to develop a host of new products targeted at the pro-AV market.

Although the new AV product is not expected to contribute materially to FY20 revenues, it doubles AD8's addressable market to approximately $1 billion and potentially underwrites long term growth for AD8.

A Setback for Citadel

Citadel (ASX: CGL) was a key detractor during the quarter due to a material downgrade in May. Citing delays to contract decision making in the lead up to the Federal election, management guided FY19 EBITDA 34 percent lower to between $22 million and $24 million. Shares fell commensurately on the news and failed to recover over the rest of the quarter. Despite the news, we maintained our position because the nature of the downgrade didn't fundamentally change the outlook of the business.

Although CGL is pivoting to SaaS/Software as the future revenue driver under the 'Citadel 2.0' strategy, most of its revenues still come from relatively lumpy managed services contracts to Government and Public Sector clients. Noting the company's very strong client retention, we expect the work to fall in 1H20 as per the May update.

We also expect to see traction from the Software business in FY20, driven by the new and highly scalable Citadel-IX information management platform. The incremental revenue opportunity across the software portfolio is ~$100 million, which is significant relative to CGL's $225 million market cap.

Afterpay Under Scrutiny

Afterpay Touch (ASX: APT) has come under fresh regulatory scrutiny from anti-money laundering agency AUSTRAC, which ordered an audit of its AML/CTF Program on 13 June. The issue has divided opinion, and outcomes won't be known until AUSTRAC has considered the final audit report, which is due 120 days from an external auditor's appointment. We will provide an update when the findings emerge. Although it is a serious matter, we do not see the underlying business changing as a result.

On the final day of the financial year, the market reacted negatively to news Visa Inc. will be piloting instalment functionality with select card issuer and merchant clients in early 2020. The functionality is simply an addition to Visa's payment rails, with potential new instalment programs to be manufactured and managed by issuers (predominantly banks). Although competing instalment products may emerge, the new functionality doesn't solve the economic issue for banks that lies at the heart of APT's success: APT is entirely free for consumers, which fuels a potent network effect of increasing adoption by consumers, and therefore merchants.

Banks likely face a dilemma in attempting to draw consumers to their own instalment programs: they need to be free for the consumer, but this will be at a significant potential cost of cannibalising their credit card business. Card issuer instalment programs are likely to derive most of their revenues from consumers, missing a key selling point of APT's offer. Meanwhile, we are seeing accelerating traction from the US and promising initial traction from the ClearPay business in the UK, which launched in May. We see APT entering 2020 in a strong position.

Austal Swimming with the Tide

Leading Australian shipbuilder and global defence prime contractor Austal (ASB, +51.3% return for the quarter) has delivered strongly in recent months, following an upgrade to its earnings outlook at the half year result in February. ASB started the quarter as a small cap but ended the quarter as a mid-cap given its June promotion to the ASX200 index.

ASB was accumulated for the CSCF in the first half of FY2019 at less than $2.00 per share and has since rallied strongly, through Clime's assessment of value, to $3.52 per share (at the time of writing). Despite the strong recent execution and buoyant outlook, given the premium to value, we decided to exit the position progressively in the weeks leading up to quarter end. ASB delivered a total return of 80.7% for the Fund during FY2019.

Electro Optic Systems (+49.5%) is a leading Australian technology company operating in the space and defence markets. EOS operates two research centres in Australia and has significant production facilities in both Australia and the United States. The Company also has a production support depot in Singapore and offices in Alabama, Arizona, Abu Dhabi and Germany.

EOS upgraded earnings forecasts during the quarter and now expect to achieve compound earnings growth of 45% over the next two calendar years. Management added, 'EOS currently has over $2.4 billion of tenders under consideration by existing EOS customers. This is expected to increase to over $3 billion by 31 December 2019. These tenders are subject to lengthy review and award processes but at least 50% [$1.6 billion] will be awarded during 2020 and 2021. The company expects to achieve substantial contract awards going forward to support even higher growth.' Accordingly, we remain upbeat about the medium to long-term prospects for the company.

Portfolio Commentary

Manager Alignment

We take the opportunity to reiterate a 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 June quarter was pleasing with a broad range of portfolio constituents once again contributing to a strong result.

We enter the new financial year cautiously optimistic, noting complex macroeconomic and market conditions make for a challenging environment. Nevertheless, we have a sound investment process and are well positioned with a strong cash position to take advantage of opportunities as they arise.

Thank you for your ongoing support.

Jonathan Wilson
Portfolio Manager

Adrian Ezquerro
Head of Investments

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