Integrity Transparency Conviction

Clime Smaller Companies Fund

Monthly Investment Report - July 2018

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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.

Fund Profile (Wholesale^)

Investment Manager	Clime Asset Management Pty Limited
Investments	The Fund invests in those companies that are outside of the S&P/ASX200 Index and above $50m market capitalisation at the time of establishing a position.
Inception Date	24 April 2017
Income Distributions	Annual. Unless otherwise requested, distributions are automatically reinvested.
Management Fee	1.03% p.a.
Contribution Fee	Nil
Minimum initial investment	$100,000
Minimum additional investment	$10,000
Minimum balance	$100,000
Expenses	0.21% p.a.
Withdrawal Fee	Nil
Performance Fee	Performance Fee of 20% of Fund's total return above investment objective of CPI^^ + 8% pa inc. GST.
Investment Horizon	Suggested minimum 5 years

^As defined by the Corporations Act
^^Trimmed mean Consumer Price Index as measured by the Reserve Bank of Australia

Portfolio Total Return (31/07/18)

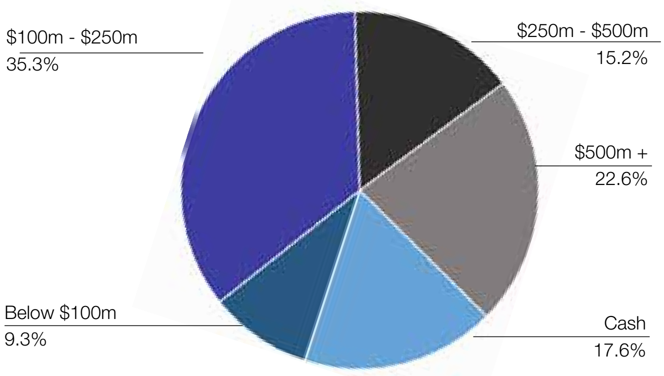
	Portfolio Return	Fund Objective^
1 month	1.02%	0.81%
3 months	3.83%	2.41%
6 months	5.16%	4.80%
FYTD	1.02%	0.81%
1 year	19.43%	9.91%
Inception*	20.53%	9.88%
Inception (Total)	26.17%	12.68%

* 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.

Distributions

Period Ending	Wholesale Units (cents per unit)
30 June 2018	4.3495
30 June 2017 (Inception 24/4/17)	0.1372

Asset Allocation by Market Capitalisation



Prominent Fund Holdings *(alphabetical order)*

Axsesstoday	Axsesstoday Limited (ASX: AXL)
bravura	Bravura Solutions Limited (ASX: BVS)
Elanor Investors Group	Elanor Investors Group (ASX: ENN)
JUMBO	Jumbo Interactive Limited (ASX: JIN)
NAVIGATOR GLOBAL INVESTMENTS	Navigator Global Investments Limited (ASX: NGI)

Summary

The Clime Smaller Companies Fund (CSCF) delivered a steady return of 1.0% (net of all fees) for the month of July, a return positively impacted by a significant update from one specific portfolio holding. We discuss this position in further detail below.

A critical component of investing is the assessment of a company's long-term prospects. Admittedly, any such assessment is likely to be imprecise in nature. However ultimately, one must consider how the world will develop and whether this will help or hinder the operations of the company in question. While a consistent feature of Clime's investment approach, in today's rapidly evolving world of disruption via technology, what constitutes a 'demonstrated track record' for these types of businesses needs to be assessed accordingly.

One business that is increasingly changing the way many in the retail industry are doing business is Afterpay Touch Group (ASX: APT). With a fresh, innovative take on the old fashioned 'lay-by', APT has enjoyed viral success with an offer that allows its end customers to 'buy now, receive now and pay later'.

Afterpay at its core is an incredibly simple concept, one that has effectively turned the economics of credit cards on its head and in the process, significantly disrupting what was an established consumer finance market segment. Not long ago it was accepted that consumers would, through charges and interest, pay for access to credit. This made sense as the consumer benefits from instant gratification. However, the most significant benefactor of consumer credit is often the merchant. Whilst the consumer needs to eventually pay back their loan, the merchant receives the full benefit upfront. What's more, credit card users typically have larger basket sizes and conversion rates compared with others using alternative payment methods.

By flipping the cost of credit from the consumer to the retailer through a fee of between 4% to 6%, Afterpay can offer consumers interest-free finance that is paid back over eight weeks in four instalments. This, in turn, leads to consumers again having larger basket sizes and conversion rates than other payment types, even credit cards.

Afterpay has proved attractive to millennials, who turned away from credit cards in droves after the Global Financial Crisis (GFC), presumably attracted to the no interest offer combined with capped fees that means it cannot create a spiraling debt situation.

What initially attracted us to Afterpay in its formative stages was the fact that the company established a customer base of 1 million customers and almost 9,000 integrated merchants whilst spending less than $1m on marketing. This is highly unusual and suggested the emergence of early stage network effects. APT was swiftly building on its first mover advantage to carve out leadership in its specific payment niche, reinforcing the growing network effort. A whole cohort of Australian society was not 'buying now and paying later', they were 'Afterpaying It'.

Further, we saw early evidence that Afterpay was building a moat around its business through its substantial retail and consumer dataset, its rapidly growing loyal customer base and its ability to be the largest or second largest (after Google AdWords) referrer of traffic to retailers' websites. Not even PayPal (a US$100bn payments behemoth) receives the brand exposure Afterpay receives from its merchants, who advertise its service on every single page, even before their users reach the online checkout.

Though the Afterpay concept is simply understood, there is heated debate over whether it is a transactions business (ala PayPal) or simply tantamount to consumer credit. We think this is an unhelpful distinction, because it's a blend of both. The experience at the point of sale is identical to that of any other transactions provider, but it also involves Afterpay (short-term) taking on risk.

Given its popularity among millennials, an arguably risky cohort, Afterpay's loss ratio of below 1% is confounding to those who view it purely as a credit service. We believe two unique features help provide relevant context. Firstly, Afterpay is monopolistic, which means that for most retailers it is the sole 'buy now pay later' option for their customers.

Secondly, by design Afterpay automatically shuts out late payers from the service. For the shopper, being overdue effectively results in being shut out of a convenient payment option, so users are especially motivated to manage their outstanding balances. It also means Afterpay is an ever-refining platform, one that is increasingly creating a win-win partnership with both its retail network and the end customer.

APT's July 2018 ASX update provided a raft of data points and metrics that reinforced its standing as a viral success (at least domestically). With more than 2.2 million customers and 16,500 retailers on-boarded, the company is now a major payments player in the Australian payments market, one with significant global potential. Several other data points provided further evidence of APT's growing influence in the retail payments landscape:

- APT processed $2.2bn of total underlying sales in FY2018, up 289% on the prior corresponding period;
- Q4 underlying sales of $736m was up 171% on Q4FY17 and 39% on the prior quarter;
- Gross Losses and Net Transaction Losses trended down in Q4 FY18 and generally improved over H2 FY18, despite the increased underlying sales performance and merchant diversification in the same period. Consequently, a stronger Net Transaction Margin is expected in H2 FY18 compared to H1 FY18;
- Today, it is estimated that Afterpay processes more than 10% of all physical online retail in Australia while over 10% of the purchasing Australian population has transacted with Afterpay since inception;
- Repeat Afterpay transactions represent approximately 92% of monthly total transaction value, further reinforcing the sense of growing customer loyalty;
- New verticals including health, beauty, entertainment and travel are being rolled out.

The above key points were well received but it was arguably the early stage progress in the US market that has many investors excited. As we have often noted in prior CSCF reports, we remain attracted to those companies that can execute in much deeper pools of offshore opportunity. The U.S. presents an enormous opportunity for Afterpay.

In 2017, total U.S. retail sales were more than US$3,800bn, with over US$450bn purchased online, which compares to the Australian online market of approximately US$18bn. As noted by the company, the U.S. online fashion market alone is US$60bn compared with Australia of US$3bn.

Since launching in the U.S. in mid-May 2018, over $11m of underlying sales was processed in the first full month, June 2018. By comparison, it took approximately 16 months for the Australian Afterpay business to achieve $11m of cumulative underlying sales. APT closed its update by revealing guidance, noting 'FY18 Group Revenue and Other Income is expected to be in the order of $142m, FY18 Group EBITDA is expected to be in the order of $33m to $34m.' To put this result and effective tipping point into context, APT delivered an EBITDA loss in FY2017.

Investors adjusted their views swiftly, adding 52% to APT's market value during the month of July. However, with a current market capitalisation of approximately $3bn, a significant amount of APT's future success is being accounted for in today's valuation. On a three to five-year view, a large range of outcomes specific to execution and profitability remain and management still has much to do to grow into today's market valuation.

Analyst estimates reflect this, with the company forecast to deliver EBITDA of between $314m and $501m by FY2022. A continuation of near flawless execution will be required to achieve the implied EBITDA CAGR, so the operational progress of APT is something we continue to closely examine and evaluate.

As such, we remain cognisant of the risk factors to which APT is exposed. The main three we see for Afterpay are competition from a well-funded, established player such as Paypal, a serious economic downturn and/or government intervention that seeks to more heavily regulate the buy now, pay later sector.

With the above noted, given a strengthening network, highly scalable platform, high-quality management team that now includes several US based technology heavyweights, and (relative to traditional businesses, short) demonstrated track record we remain optimistic about the long-term opportunity set for the business, both at home and abroad.

For the clear majority of ASX listed companies, full year FY2018 reports are due to be delivered during the month of August. Although the time frame in question is short by investing standards, the August full year reporting season is arguably one of the more important periods for investors. This provides investors with a window of opportunity to examine how each company is travelling against expectations. Some investment theses are confirmed, some are strengthened while others are questioned.

Whatever the coming month may bring, with a solid cash weighting, we remain well positioned to take advantage of opportunities as and when they become apparent. We look forward to the reporting period and to sharing the outcomes with you in subsequent monthly reports.