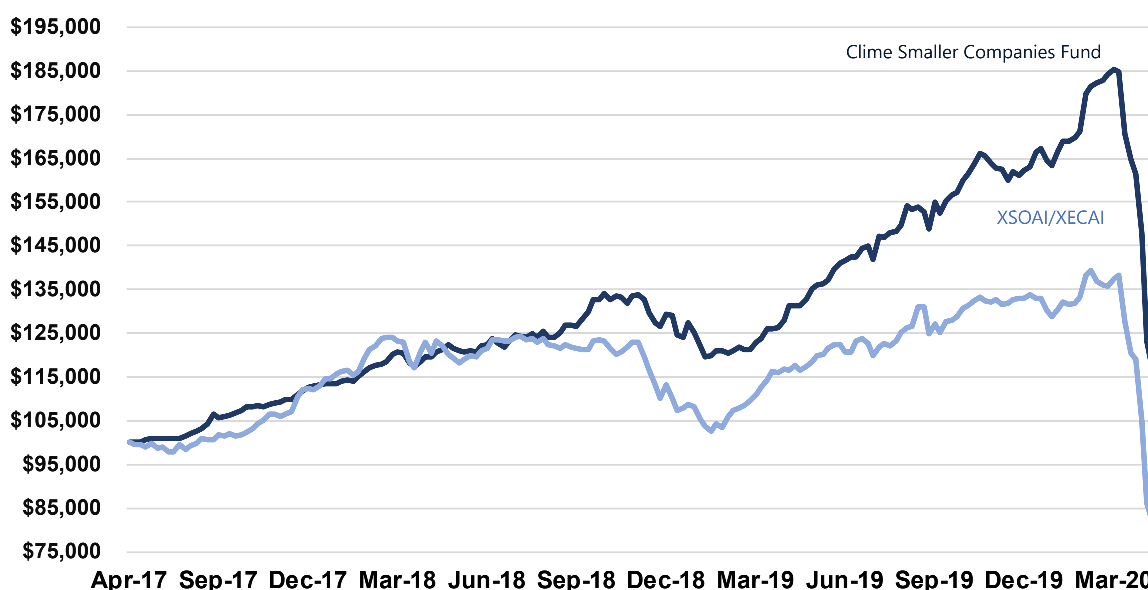
Clime Smaller Companies Fund

Quarterly Report March 2020

The Clime Smaller Companies Fund is a concentrated portfolio of high-quality businesses that are outside the ASX200 at the time of initial investment. The Fund invests in niche leaders that have superior business economics, strong balance sheets and significant growth prospects, provided they are attractively priced relative to assessed value. The Fund is designed to take advantage of the structurally inefficient and under-researched market segment of small capitalisation stocks.

Quarter Net Return (Wholesale)*	1 - Year Net Return (Wholesale)*	Inception p.a. Net Return (Wholesale)*	Total Fund Size
-26.3%	-6.1%	7.7%	$35.8m



	1 month	3 months	6 months	FYTD	1 year	Inception p.a.	Inception Total
Fund Net Return (Wholesale)*	-24.4%	-26.3%	-25.1%	-16.1%	-6.1%	7.7%	24.5%
Benchmark^	-26.5%	-32.7%	-33.5%	-28.0%	-26.3%	-4.1%	-11.6%

*Net returns are after all fees, taxes, and costs
^ CPI Trimmed Mean + 8% p.a. from 24th April 2017 and then 50% of the ASX Small Ordinaries Accumulation Index (XSOAI) and 50% of the ASX Emerging Companies Accumulation Index (XECAI) from the 30th June 2019

Fund Facts

Portfolio Managers	Jonathan Wilson & Adrian Ezquerro
Fund Inception	April 2017
Fund Size	$35.8m
Number of Stocks	15-40
Cash Distributions	Annually
Eligibility	Wholesale & Retail

Top 5 Holdings (Alphabetical)

Company	ASX Code
APN Property Group	APD
Bravura Solutions	BVS
Hansen Technologies	HSN
Macquarie Telecom Group	MAQ
RPM Global Holdings	RUL

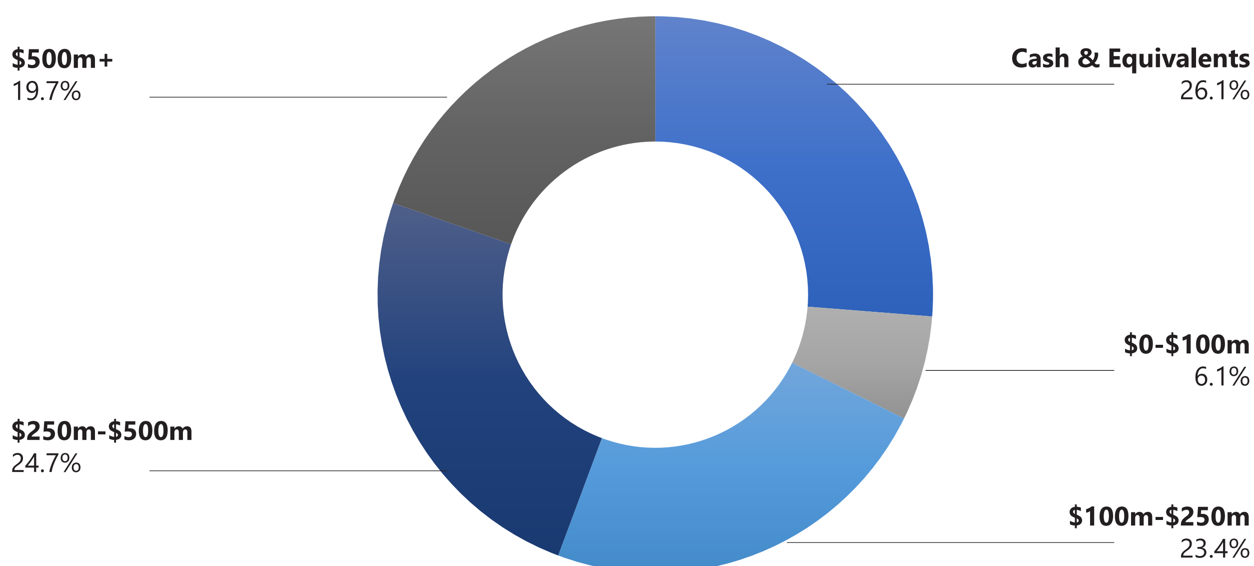
Unit Price

Date	Wholesale Unit (exit)
30 March 2020	$1.1273

Distributions

Period Ended	Wholesale Units (cents)
30 June 2019	8.2837

Asset Allocation by Market Capitalisation



Asset Allocation by Sector

Industry	Weighting
Software & Services	20.7%
Diversified Financials	14.7%
Healthcare Equipment & Services	9.7%
Capital Goods	8.2%
Communication Services	6.6%
Technology Hardware & Equipment	5.2%
Consumer Services	4.0%
Retailing	3.5%
Media & Entertainment	1.1%
Cash & Equivalents	26.3%

Portfolio Commentary

For the March quarter 2020 the Clime Smaller Companies Fund (CSCF) returned -26.3%, ahead of the Benchmark return of -32.7%. The Fund has delivered 7.7% per annum after fees since inception, above the Benchmark return of -4.1% per annum.

The Fund finished the March quarter with 26.5% held in cash and cash equivalents, up from 9% at the start of the calendar year.

Social and mobility restrictions implemented during March have put an abrupt halt to economic activity, and although containment measures have slowed the spread of COVID-19, we have little visibility on when or how conditions will return to normal.

In response to current market conditions, we consolidated the portfolio with 5 exits and 2 additions. We introduced or increased the weighting in businesses with robust demand drivers (e.g. enterprise software, datacentres, online) and net cash balance sheets. We exited or de-weighted those with demand headwinds (e.g. retail, travel) and/or leverage.

Although these adjustments commenced in early February, we were surprised by the magnitude and speed of the global sell-off in equities. It was the largest one-month drawdown in history. A swifter adjustment may have helped soften the impact, however few names escaped panic selling. Indeed, certain high-quality businesses were 'thrown out with the bathwater', providing good buying opportunities, which are discussed below.

At this stage we believe the portfolio is well positioned to either weather a further deterioration in markets or benefit from any (surprise) improvement. We have ample cash reserves to deploy into businesses that may be unfairly or indiscriminately sold off, while the existing portfolio is made up of undervalued, high-quality businesses that are, like a coiled spring, poised to reinvest and grow when conditions normalise.

As discussed in the attached macro commentary, despite the extreme sell off over February and March, the market remains expensive against likely severe earnings downgrades to come in the June quarter. In our view, risks are generally to the downside, and we are prepared for this.

EXITS & TRIMS

Our focus in response to COVID-19 was to increase cash levels and limit our exposure to businesses facing sudden demand headwinds.

We will leave readers to research the biological and epidemiological aspects themselves, however in relation to financial risk management, we believe it is prudent to assume current restrictions are the status quo until the population is vaccinated. Expert consensus is that this is at least 12 to 18 months away.

During February and March we exited otherwise high-quality businesses that depend on foot traffic or gatherings for income.

We exited travel services provider **Helloworld (HLO)**, due to uncertainty around both domestic and international travel restrictions. We exited store network operators **Collins Foods (CKF)** and **Lovisa (LOV)**, as limited foot traffic in the near term will see sharp income declines over fixed costs for both businesses. Our exit of **EML Payments (EML)** followed similar logic, with sharply lower underlying demand for reloadable mall gift and reloadable betting cards over the foreseeable future.

We also liquidated positions in commercial property holdings **Elanor Commercial Property Fund (ECF)** and **Prime West Group (PWG)** to crytsalise profits and increase portfolio cash.

TRIMS

We reduced weights to businesses for which we maintain a positive long-term view but that either have leveraged balance sheets or are debt exposed. Debt lowers the margin for error in execution, and the margin narrows in economic downturns.

Afterpay (APT)

We continue to see a bright long-term future for Afterpay (APT), however its relatively new business model is about to be tested in coming months, and we want to observe how this plays out with minimal risk to the portfolio.

In APT's favour are its dynamic risk management, short duration receivables (30 days), and strong balance sheet. APT has assembled a world-leading risk and analytics team, led by Silicon Valley luminary Xin Ge. Xin's previous roles include Head of Risk at Uber, VP of Global Seller Risk Management at PayPal, and Director of Risk Analytics at eBay. Our understanding is that APT's risk systems operate at the level of the Stock Keeping Item (SKU), as opposed to geography. This is an important distinction, as it implies APT can control credit quality even in locations where there is significant distress. As per its March announcement, the balance sheet has $403m cash and $694m undrawn facilities. The business is not under immediate pressure to cover operating expenses.

The issue at this stage is the unprecedented economic disruption caused by COVID-19. In the US, APT's key growth market, more jobs were lost over two weeks in March (9.9 million) than during the 3-year duration of the GFC (9.7 million). There is further downside on this front, in our view. APT has proven loss rates can be controlled under normal economic conditions, but we want to see further proof of execution in the new environment before re-establishing a meaningful position.

Citadel Group (CGL)

We reduced our holding in information management software company Citadel (CGL) to a small portfolio weight as the company was set to move from a strong net cash position to a fully leveraged one in early April, after the completion of its $200m Wellbeing acquisition.

Wellbeing is a UK based provider of radiology and maternity patient data management systems. CGL has pedigree in this field domestically, with data management solutions focusing on oncology and pathology segments in Australia. The rationale for the acquisition was the promising cross-selling opportunities in both Australia and the UK.

We are familiar with the strength of healthcare data management businesses via our holding in Mach7 Technologies. Typically, customers are sticky and recurring software revenues drive strong returns on invested capital.

However, the acquisition and associated borrowing was badly timed, in our view. With a share price of $3.00 (at the time of writing), the enterprise trades at a modest multiple of 7 times EBITDA. However, debt is 2 times EBITDA, which leaves little margin for error.

Integral Diagnostics (IDX)

On 30 March diagnostic imaging provider Integral Diagnostics (IDX) announced that it was experiencing reduced diagnostic imaging volumes in community clinics, some of which may be closed for a period. The split of work is roughly 50/50 between hospital and community sites.

However, there will be pent up demand when activity resumes. IDX earnings should recover strongly post the lockdown.

Net debt is elevated at 1.7 times EBITDA, however with $62m in cash and $75m in undrawn debt, a capital raise is unlikely.

We reduced our holding in IDX over February and March as we expected a short-term reduction in discretionary imaging as healthcare resources focus on tackling COVID-19. On a long term view the stock is attractively priced below $3.00.

ADDS

The market sell off also included instances of indiscriminate selling in high quality businesses whose operations are supported by cash-laden balance sheets, and that have uninterrupted demand drivers.

Mach7 Technologies (M7T)

Mach7 Technologies (M7T) provides imaging data management software to multi-site healthcare networks in the US, South East Asia and the Middle East. It has 100% customer retention over 10 years of operation, with notable customers including the Hospital Authority of Hong Kong and Sentara Healthcare in the US.

The stock was sold off from a February high of $0.93 to a low in March of $0.3. M7T has since recovered to $0.53 at the time of writting. With $23m cash and no debt, the enterprise trades on a forward free cash flow yield of about 7%. We increased our holding in the company.

As per M7T's 18 March update, there has been no change to the company's outlook, which includes $32.5m tenders to be awarded this calendar year, and a pipeline of over $100m. For context, FY19 was M7T's best year to date, with contracts totalling $21m in value won over the year.

Near term contracting may slow, however COVID-19 is highlighting the need for investment in streamlined healthcare and telemedicine. M7T is in the right place at the right time.

Electro Optic Systems (EOS)

Defence and space technologies developer Electro Optic Systems (EOS) was also unfairly caught in the sell-off, in our view, with shares falling from $10.00 in February to $3.00 in March. EOS contracts to allied governments globally, and as such demand will be unaffected by the economic downturn.

With cash of $78m, no debt, and a contract pipeline for its Defence products of $3bn, EOS is well placed over the medium term. At $3 the enterprise was trading at 7 times forward EBITDA. We increased our holding in the business.

The long term opportunity in EOS is potentially immense. Presently, the Defence segment drives the financials. In the future we think the Space and Communications segments will be the primary earners. These divisions were available as free options during March.

The Space segment tracks and manages objects in space (space junk and space assets). The Space Communications business includes ground satellite receiver technologies for navy and defence, and US spectrum licenses for satellites to be launched in mid-earth orbit (by mid-2024). Interestingly, EOS already has initial commitments totalling $100m per annum for proposed MEO satellite constellation.

RPM Global (RUL)

RPMGlobal (RUL) is the leading global provider of mining operations enterprise software, with solutions covering mine design, costing, operations schedule, and equipment maintenance. It has a client base of leading miners, contractors and yellow-kit equipment providers. It is our largest holding.

RUL is the sole provider globally with full SAP enterprise system integration and certification. The Software business will benefit from increasing IT utilisation in mining from very low levels currently. In 1H20 total annualised recurring revenue (software maintenance and subscription revenues) totalled $35m. Subscription annual recurring revenue (ARR) as of 11 March was $11.4m, up from $4.3m as at 30 June 2019. This is very impressive.

Although COVID-19 may slow purchasing decisions by miners in the short term, the overall effect is likely to be positive as RUL enables remote planning and operation of mining assets. RUL has captured less than 5% of the addressable revenue opportunity.

We estimate RUL will finish FY20 with around $40m cash and no debt. During the sell off the enterprise traded as low as 8.5 times FY20 EBITDA. We increased our holding.

If RUL can continue to sustain ARR growth rates over the next couple of years – and we believe it can – the stock should trade comfortably over $2.00.

Bravura Solutions (BVS)

Wealth and funds administration software provider Bravura Solutions (BVS) was another good business thrown out with the bathwater during the month of March.

For background, BVS provides mission critical software supporting some of the world's largest superannuation, pension, and wealth administration entities.

Almost 80% of revenues are recurring, the balance sheet has $100m cash and no debt, the business has sales visibility over the next 18 months, and it is head and shoulders best-in-class. Despite these attractive characteristics the enterprise was available at 15 times FY20 earnings. We took the opportunity to add to our holding.

Closing words

The pandemic will likely drive a period of heightened volatility over coming months. There will be great opportunities, but some otherwise good business may not see the other side. Resilient earnings, focused management and strong balance sheets are imperatives at this time.

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.

Thank you for your ongoing support.

Jonathan Wilson
Portfolio Manager

Adrian Ezquerro
Head of Investments

Fund Information

Investment Objective

The Clime Smaller Companies Fund is a concentrated portfolio of high-quality businesses that are outside the ASX200 at the time of initial investment.

The Fund invests in niche leaders that have superior business economics, strong balance sheets, and significant growth prospects, provided they are attractively priced relative to assessed value. The Fund is designed to take advantage of the structurally inefficient and under-researched market segment of small capitalisation stocks.

Its objective is to outperform a blended benchmark comprising 50% of the Small Ordinaries Accumulation Index and 50% of the Emerging Companies Accumulation Index.

Investment Methodology

The Clime Smaller Companies Fund has a quality focus with a valuation discipline. Fund holdings are characterised by:

- A competitive advantage, leadership within a specific niche
- High levels of profitability and margin
- Low financial leverage
- Capital-efficient growth and cash generation
- Capable management aligned with shareholders
- Sustainable long-term growth
- Attractive share prices relative to assessed value

Position sizing reflects not only our assessment of valuation and quality, but also the degree of strategy execution.

Portfolio Managers

Jonathan Wilson

Jonathan has 6 years of investment experience, specialising in growth strategies. He was the founding Co-Portfolio Manager of the Clime Smaller Companies Fund. Jonathan holds a Bachelor of Engineering, Bachelor of Commerce from the Australian National University and is a CFA Charterholder.

Adrian Ezquerro

Adrian, Clime's Head of Investments, has 13 years of investment experience. Adrian was the founding Portfolio Manager of the Clime Smaller Companies Fund. Adrian holds a Bachelor of Science from the University of Wollongong, and a Graduate Diploma of Applied Finance from Kaplan Professional.

Fund Information

Name	Clime Smaller Companies Fund	**Investor Eligibility**	Retail & Wholesale
Structure	Managed Investment Scheme	**Minimum Investment**	Retail: $10,000 Wholesale: $100,000
Investment Universe	Ex-ASX 200 at initial investment	**Liquidity**	Weekly Unit Pricing Applications and Redemptions
Benchmark	50% of the ASX Small Ordanairies Accumulation Index & 50% of the ASX Emerging Companies Accumulation Index	**Fees**	Retail: 1.23% management and 20% performance Wholesale: 1.03% management and 20% performance
Stock Holdings	15-40	**Admin**	Mainstream Fund Services Pty Ltd
Stock Limit	15% at cost	**APIR Code**	Retail: SLT5667AU Wholesale: CLA1557AU
Fund Size	$35.8m	**Platform Availablity**	Netwealth, HUB24

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