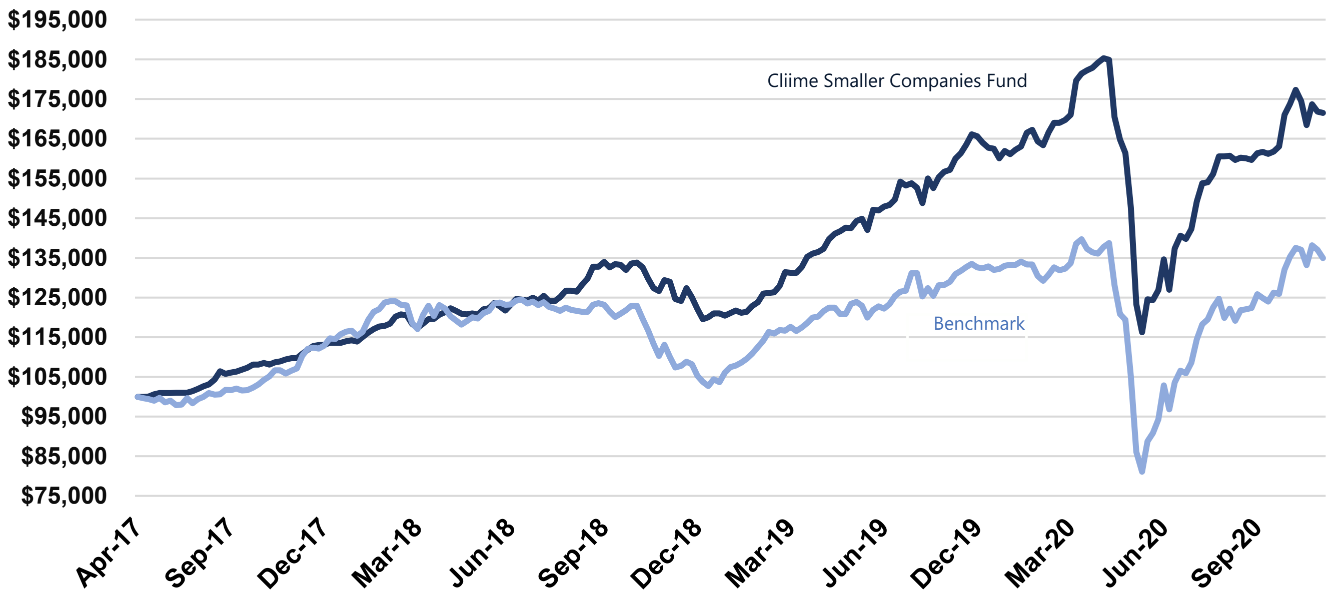
# Clime Smaller Companies Fund

## Quarterly Report September 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)* | Inception p.a. Net Return (Wholesale) | Inception Total Return | Total Fund Size |
|---|---|---|---|
| 7.4% | 17.0% | 71.5% | $50.3m |




| | 1 month | 3 months | 6 months | FYTD | 1 year | 3 years | Inception p.a. | Inception Total |
|---|---|---|---|---|---|---|---|---|
| **Fund Net Return (Wholesale)*** | -3.3% | 7.4% | 37.7% | 7.4% | 3.2% | 16.0% | 17.0% | 71.5% |
| **Benchmark^** | -1.9% | 13.3% | 51.9% | 13.3% | 1.0% | 8.8% | 8.9% | 34.3% |

*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** | $50.3m |
| **Number of Stocks** | 15-40 |
| **Cash Distributions** | Annually |
| **Eligibility** | Wholesale & Retail |

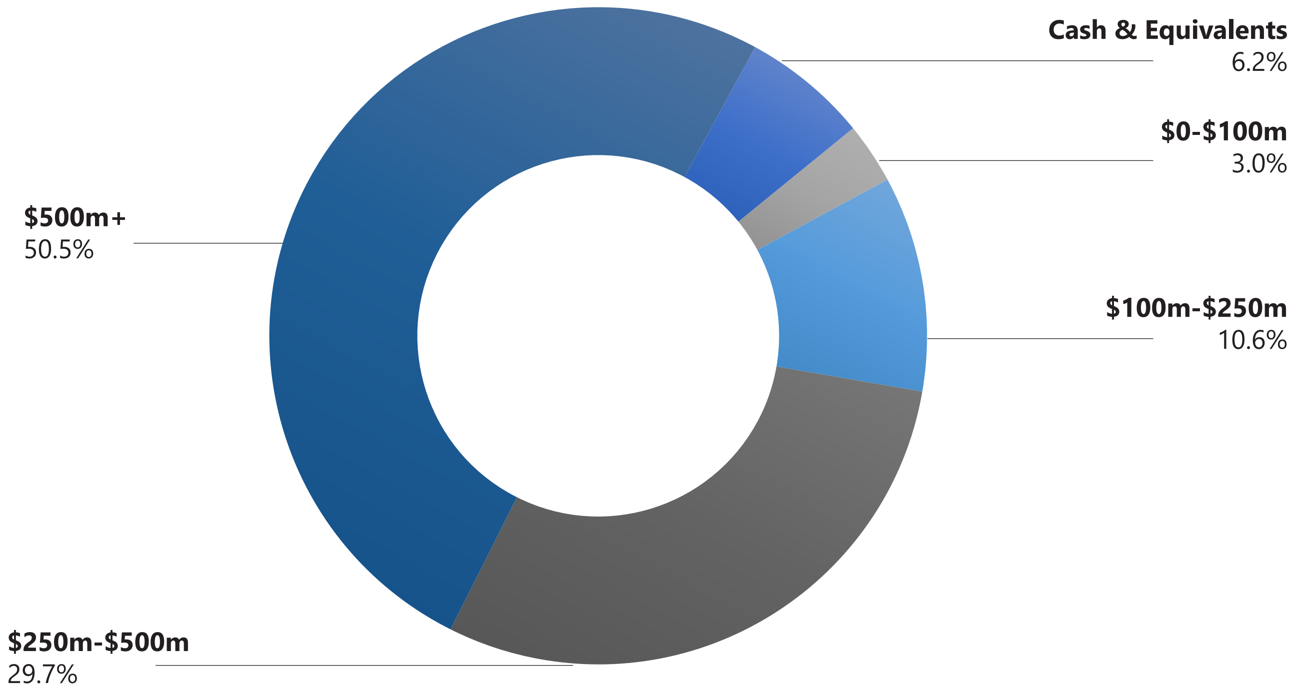
## Top 5 Holdings (Alphabetical)

| Company | ASX Code |
|---|---|
| **City Chic Collective** | CCX |
| **Hansen Technologies** | HSN |
| **Jumbo Interactive** | JIN |
| **Mach7 Technologies** | M7T |
| **RPM Global Holdings** | RUL |

## Unit Price

| Date | Wholesale Unit (exit) |
|---|---|
| 30/09/2020 | $1.5528 |

## Asset Allocation by Market Capitalisation




## Asset Allocation by Sector

| Industry | Weighting |
|---|---|
| Software & Services | 27.8% |
| Healthcare Equipment & Services | 13.1% |
| Diversified Financials | 9.8% |
| Technology Hardware & Equipment | 9.7% |
| Retailing | 9.6% |
| Capital Goods | 8.1% |
| Consumer Services | 7.0% |
| Communication Services | 5.3% |
| Media & Entertainment | 1.8% |
| Semiconductors & Semiconductor Equipment | 1.6% |
| Cash & Equivalents | 6.2% |

# Portfolio Commentary

The Clime Smaller Companies Fund returned 7.4% for the September quarter, behind the Benchmark return of 13.3%. Since inception the Clime Smaller Companies Fund has returned 17.0% per annum after fees, ahead of the Benchmark return of 9.0% per annum.

The Fund experienced a volatile start to financial year 2021, punctuated by a pleasing August reporting season (+10%) in-between subdued June and September months. We expect elevated volatility to remain a feature as the year progresses, fuelled by uncertainty relating to COVID-19 and the US election and enabled by highly accommodative monetary and fiscal policy.

An unintended consequence of the increased liquidity from reduced interest rates and fiscal measures is a rise in speculative activity, as witnessed (for example) by strong demand within high-risk market segments such as fintech start-ups and micro-cap miners.

The result was a much stronger performance down the market cap spectrum. For the September quarter, the ASX Emerging Companies Index (XEC) returned 21.3%. The ASX Small Ordinaries Index (XSO), by contrast, rose 5.7%. The Fund's benchmark is a 50/50 blend of these two indices, although it is weighted to more established smaller companies with an average and median market capitalisation of approximately $500 million. September performance was therefore more reflective of the XSO component.

Our strategy and process hasn't deviated amongst the rapid shifts in the market. We haven't been tempted by the early stage mining sector because it is not our area of expertise. We have participated in a small handful of capital raisings in companies that have attractive growth prospects in the current environment. Portfolio turnover remains low.

'Niche leadership, strong balance sheets, and large opportunity sets' continue to be the defining characteristics of the portfolio. A total of 20 out of a total of 24 holdings have net cash on their balance sheet, while two thirds of aggregate portfolio revenue is sourced in much larger markets offshore.

Ultimately, we are positioning the portfolio to deliver a healthy free cash flow yield over the next 3 years, subject to a reasonable level of execution on the part of each management team. Our top 5 holdings, being CCX, HSN, JIN, M7T, and RUL, reflects our current view of the best opportunities in pursuit of this goal.

**Contributors**

**Hansen Technologies (HSN)** was a standout of the FY20 reporting season, comfortably exceeding pre-COVID guidance and expectations. Heading into the result HSN was trading at a free cash flow yield of approximately 8%, and represented an excellent buying opportunity, in our view. HSN boasts 99% customer retention, 70% recurring revenue, and has a solid M&A pipeline to build its earnings base in coming years. Although the stock rallied 36% over the quarter, we remain happy holders.

**Mach7 Technologies (M7T)** also delivered a strong full-year result, though key details were largely pre-announced. The outlook for M7T has never been better following the acquisition of Client Outlook in June. Mach7 and Client Outlook are complementary best-in-class solutions in the North American US$3 billion medical imaging software market. As indicated in the presentation accompanying the Client Outlook acquisition, M7T has an active tender pipeline totalling A$40m over the next 12 to 18 months, including two 80+ US hospital systems. One of these is expected to be awarded before the end of the calendar year.

There were no surprises in the result of **Jumbo Interactive (JIN)**, however the strategic outlook was the highlight. Firstly, only 28% of lottery tickets are sold online in Australia, which underwrites long term growth for Jumbo's core Australian lotteries business. Secondly, JIN's new lottery management SaaS business, Powered by Jumbo, was boosted by the announcement of a term sheet signed with LotteryWest, the Western Australia lottery operator. Lotterywest represents a high-quality government reference site to aid its international growth strategy, particularly in the $21 billion US State Lotteries market. Shares sold off sharply on the announcement, perhaps due to the absence of financial details that are yet to be agreed and finalised. Directors bought stock, however, and so did we.

**Detractors**

Litigation funder **Omni Bridgeway (OBL)** was a notable detractor, after the judgement on 28 August relating to the Westgem litigation (a multi-year, high value case) found in favour of the defendant. The claims of OBL's funded clients were dismissed. On 25 September OBL announcement it had lodged an appeal.

Although Westgem may not fall in OBL's favour, the case represents 22% of the Estimated Portfolio Value (EPV) of OBL's wholly owned balance sheet investments and just 1.9% of the EPV OBL's total case book across investments held on the balance sheet and via fund structures. The investment case for OBL is intact.

Financial year 2020 completes Omni Bridgeway's (OBL) 5-year strategy to transform from an Australia-focused litigation funder to a globally diversified litigation fund manager. The business now invests in legal disputes exclusively via a number of geographically defined funds in which it coinvests, typically in the order of 20% of the underlying capital. The funds strategy increases OBL's exposure to legal disputes in terms of number and dollar value, ultimately to yield smoother and higher quality income.

OBL boasts outstanding unit economics on individual legal disputes, which should yield high returns to shareholders over what is a multi-year reinvestment runway. OBL has options to upsize its funds under management (FUM) by a total US$1 billion before 2024, representing a potential 64% increase on the current FUM base of A$2.2 billion. We'll likely receive new details around the next 5 year growth strategy at the AGM on 19 November.

The near term is interesting because OBL's balance sheet investments are in run-off and Funds 1-3 will soon enter the profit-share phase, meaning OBL could generate over 40% of its current market capitalisation in operating cash flow over the next three financial years, based on projections of EPV.

The company also has net cash and receivables totalling $156 million to accelerate its global expansion. Near term demand is set to be boosted by insolvency disputes in the US in particular, as well as potentially favourable litigation funding regulation in Australia, which could open the door for OBL to reinvest in local class actions.

## New additions

During the quarter and ahead of respective results, we initiated positions in two high quality Australian small caps: **Nick Scali (NCK) and Codan (CDA)**. NCK is a leading retailer of premium furniture, with a store network that spans Australia and New Zealand. Founded in 1962 by Nick Scali and listed on the ASX in 2004, NCK has an excellent track record of delivering consistent earnings growth and a steadily increasing stream of fully franked income to shareholders.

Over many years, NCK has proven itself to be a best in class Australian retailer, exhibiting a strong and growing position of leadership within the premium furniture market. Recent written order sales growth rates of 70% compares to industry growth rates of 20% to 30%. NCK is thus strongly taking market share and we anticipate near term results to be exceptional. Taking a longer term view, we believe NCK is well placed to continue creating value for shareholders in the years to come.

CDA was established in Adelaide in 1959 and listed on the ASX in 2003. Initially focused on electronics engineering and communications, the company subsequently acquired Minelab Electronics in 2008, which had developed advanced handheld metal detection technology. This acquisition was followed by the additions of Minetec and Daniels Electronics in 2012, resulting in three segments focussed on servicing an international customer base across Metal Detection, Radio Communications and Mining Tracking Solutions (Minetec).

CDA's recent result was outstanding, with the company delivering revenue and profit growth of 29% and 40% respectively for FY20. With a strong industry position reinforced by a focused R&D program, global footprint, strong balance sheet and high quality management team, the outlook for the company looks equally positive.

## Closing Comment

The portfolio has come through a volatile reporting period in sound shape. While we expect volatility to continue, as domestic and global economies edge out of the pandemic inspired recession, the support of low interest rates and enormous levels of fiscal stimulus lead us to believe risk assets will retain a reasonable degree of support in the near to mid-term. In turn, this adds support to our constructive portfolio positioning that retains its focus on high quality Australian small caps.

| | |
|---|---|
| **Jonathan Wilson** | **Adrian Ezquerro** |
| Portfolio Manager | 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<br>Wholesale: $100,000 |
| **Investment Universe** | Ex-ASX 200 at initial investment | **Liquidity** | Daily Unit Pricing<br>Applications and Redemptions |
| **Benchmark** | 50% of the ASX Small Ordanairies Accumulation Index &<br>50% of the ASX Emerging Companies Accumulation Index | **Fees** | Retail: 1.23% management and 20% performance<br>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<br>Wholesale: CLA1557AU |
| **Fund Size** | $50.3m | **Platform Availablity** | Netwealth, HUB24, OneVue, Praemium, Wealth Portal |

### Contact Information

**Investor information**
Clime Asset Management
Ph: 1300 788 568
Email: info@clime.com.au

**Administrator**
Mainstream Fund Services
Ph: 1300 133 451
Email: registry@mainstreamgroup.com