FUNDS MANAGEMENT

OC Micro-Cap Fund

Fund Update | 31 July 2021

Fund up 1.6% for the month

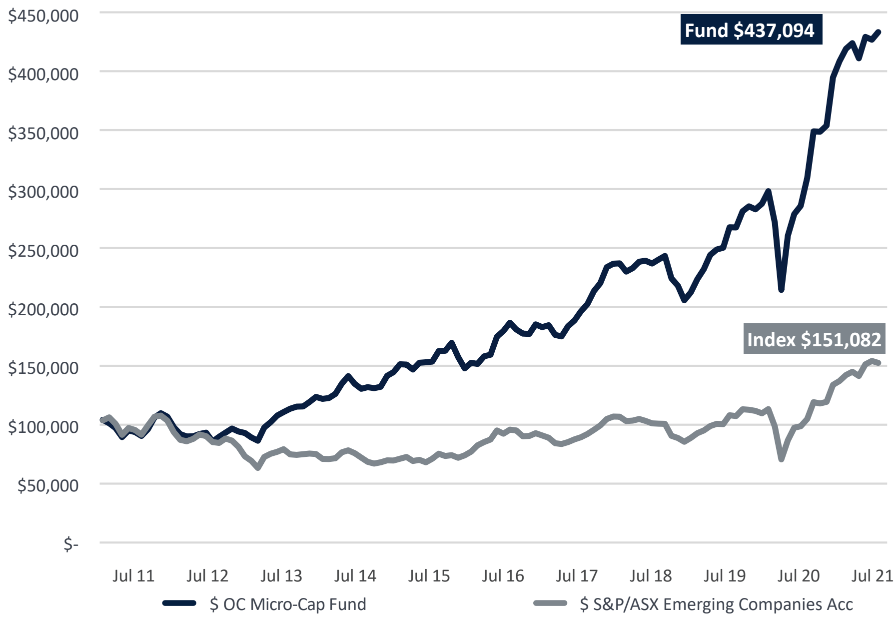
1.6%

Returned 20.9% p.a. for the past 5 years

20.9%

We remain confident the Fund is well placed to deliver strong long-term returns

Performance comparison of $100,000 over 10 years*



Total returns

At 31 July 2021†	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	10 yrs % p.a.	Incep. % p.a. (Mar 2003)
OC Micro-Cap	1.6	2.6	43.1	23.5	20.9	19.0	16.5	15.6
S&P/ASX Emerging Comp. Accum	2.8	3.6	53.1	16.8	11.2	11.6	4.2	NA
Outperformance	**-1.2**	**-1.0**	**-10.0**	**6.7**	**9.7**	**7.4**	**12.3**	**NA**

Inception date for the Fund is 21/11/2003. Inception date for the Index is 31/12/2003. The performance reflects the performance of the OC Micro-Cap Fund since the change of strategy on 30 September 2016 and the performance of the OC Concentrated Equity Fund prior to that date. Performance is after fees applicable at the time. The total return performance figures quoted are historical, calculated using end-of-month hard-close mid-prices and do not allow for the effects of income tax or inflation.

Performance review

The new financial year continued the positive recent momentum in Australian listed equities with the S&P/ASX Emerging Companies Accumulation Index recording its 13th positive month out of 16 months since the COVID-19 induced sell-off of March 2020 and the S&P/ASX 200 Accumulation Index stretching its winning run to an impressive consecutive 10 months. The OC Micro-Cap Fund started the financial year on a positive note with the Fund returning +1.6% for the month. This was behind the S&P/ASX Emerging Companies Index which was up +2.8% for the month.

Whilst July was relatively quiet from a company news flow perspective with many companies in 'black-out' ahead of August results, corporate activity kicked up another gear with several M&A proposals disclosed during the month including bids for Sydney Airport, Spark Infrastructure Group and Iress Limited. News headlines were dominated by the misery caused by the highly infectious delta variant of COVID-19 which has plunged much of the country back into lockdown and caused significant economic damage at a time when government subsidies and hand-outs have been substantially wound back.

The share price of long term fund holding **Rhipe Ltd (RHP; +21.1%)** rallied early in the month when it unveiled an agreed deal to be acquired via scheme of arrangement by global peer, Norwegian based, Crayon AS. The 100% cash deal, priced at $2.50/share, is unanimously recommended by the RHP board (in the absence of a superior proposal) and represents a healthy 30% premium to 30 day vwap price for the shares. An added bonus for RHP shareholders is the ability for the RHP board to declare a fully franked special dividend of up to $0.13/share which unlocks franking credits for Australian investors. The agreed multiple being paid by Crayon is attractive for RHP shareholders as it prices in today the growth that RHP management was hoping to execute on in the coming years. This ambitious growth strategy was not without risk, with a relatively high degree of expenditure budgeted for entry into the lucrative Japanese market. Further, there is potential for increased competition within RHP's core markets to threaten margins. We are pleased with the outcome for the Fund's investment in RHP, particularly as conditions are minimal, and we expect to hold the position through to completion to access franking credits for our underlying unit trust investors.

The Fund participated in the IPO of **Trajan Group (TRJ; +35.4%)** in June 2021 and the stock continued to rally in July after the successful debut and as the broader market gained a greater awareness of the business. TRJ was founded by Stephen and Angela Tomisich in 2011 and manufactures high precision consumables for liquid and gas chromatography and mass spectrometry testing workflows. This precision componentry is used in the analysis of biological, food and environmental samples in life sciences applications. TRJ customers include the original equipment manufacturers (OEMs) of these gas chromatography and mass spectrometry testing platforms which sell TRJ manufactured product under OEM branding, as well as end consumers such as life sciences testing organisations. TRJ has also developed a portfolio of innovative technologies such as the hemapen which is a micro-sampling tool. The hemapen could enable the collection of four samples from a single source used by anyone in any place. This has the potential to disrupt large industries such as pathology.

Trajan should deliver defensive organic growth with improving profit margins, due to the offshoring of some manufacturing, in addition to operating leverage. TRJ is also likely to continue to be acquisitive of complementary businesses (having itself been founded through the combination of two acquisitions) as its pre-IPO track records indicates, where it executed on five acquisition targets which were all funded from internally generated capital.

Eroad Ltd (ERD; +9.6%) shares traded higher for the month after announcing a capital raise and the proposed acquisition of Coretex, a telematics provider to customers in North America, Australia and New Zealand which specialises in the 'less than a truckload' and refrigerated transport segments, as well as the construction, waste and recycling markets. We have previously spoken about ERD in the April update. To recap, ERD is a transportation technology services company which helps trucking transport companies, mainly in NZ and the US, manage truck fleets, improve safety and comply with various regulatory fuel tax regimes. The product comprises both vehicle-installed hardware and software as a service which generates high quality recurring revenue with 95% customer retention. The acquisition of Coretex gives ERD access to additional verticals and capabilities – such as the intrastate 'less than a truckload' customer segment. The deal will also accelerate the technology and product roadmap of ERD. Furthermore, Coretex adds more scale to ERD's newer US and Australian businesses and there is likely an opportunity to cross sell ERD systems to some current Coretex clients. We participated in the equity raise to fund the proposed acquisition of Coretex which remains subject to NZ competition authority approval.

Silk Laser Australia (SLA; -11.9%) shares traded lower in July following an equity raise ($20m) to partially fund the acquisition of Australian Skin Clinics (announced at the end of June) for a headline price tag of $52m. COVID-19 related lockdowns are likely to have further impacted the SLA share price during the month, in addition to 'stock indigestion' post the capital raise and acquisition. SLA has a network of 61 corporate owned clinics nationwide which provide beauty treatments such as laser hair removal, cosmetic injectables, skin treatments, body sculpting and skincare. SLA has been growing through the roll-out of additional clinics (both wholly owned and in partnership with nurse operators), and organic growth from existing clinics, many of which are yet to achieve full revenue maturity. Given cosmetic injection treatments are usually required to be ongoing, nurse injectors often form enduring customer relationships. SLA seeks to align successful nurse injectors via the distribution of equity at a clinic level. SLA acquired Australian Skin Clinics (including the Cosmetic Clinic in NZ) which is a franchised clinic network predominantly across QLD, Vic and NSW. This acquisition adds 56 franchised clinics to SLA's existing network of 61 corporate owned clinics with limited geographic overlap given SLA's strongest presence is predominantly in SA and WA. In addition to modest upfront cost savings, SLA is expected to generate better procurement costs in the medium term given the better buying power of the combined network. We continue to hold SLA as a core portfolio position with strong growth anticipated in the short-medium term.

Outlook

Readers will be painfully aware that the Australian economy is again being impacted by yet another broad-based lockdown this time brought about by the highly infectious delta variant of COVID-19 with around 16 million Australians across threes state directly impacted. Despite the emergence of the COVID-19 vaccines, there seems to be no easy pathway through this pandemic, as policy makers are once again having to balance competing priorities, being an appropriate health policy approach, which will necessitate physical distancing and other short-term measures which will undoubtedly harm economic activity, against the reality of a market-based economy, which requires highly interconnected trade and cross border commerce in order to function in an orderly manner.

Clearly the health response to delta variant taken by our leaders and those in many other countries suffering similar outbreaks will again materially weaken the global economy. Once again industries which have endured great hardship will again bear the brunt of it including hospitality, entertainment and travel with many of the businesses in these sectors again greatly restricted. Fortunately, the Fund has relatively limited exposure to these sectors. Absent this time (at this stage at least) is the government safety net in terms of JobKeeper and rent relief and other material government subsidies which have now been wound back or have ended. Notwithstanding this, the horrible foreboding about an economic Armageddon that was felt last year is also absent this time around given that the vaccines program is making progress and people overall remain generally optimistic that better times are ahead. Perhaps this helps to partially explain the strange dichotomy that has emerged between the financial markets which are at record highs and the overall near-term economic picture with the prospect of a short sharp recession in this country a real possibility if the lockdown is extended for much longer.

Perversely, the extent to which the delta strain has tempered the global growth outlook over the past month and led to a lessening of inflationary expectations may have served to preserve the longevity of the current bull market in equities. Inflationary concerns have been front of mind for almost all market participants in CY21, OC Funds included, with the rapid escalation in long bond yields potentially seen as a harbinger of an overheating global economy which may eventually require central bank intervention in the form of interest rate rises to quell the threat of inflation. However, the past two months have seen the 10-year bond yield in both Australia and the US fall considerably on the back of a more subdued economic outlook thanks to the delta variant which has alleviated the prospect of near-term interest rate rises that would have almost certainly been detrimental to company valuations and equity returns had they proven necessary.

As August reporting season kicks off there is a strong sense of déjà vu amongst the OC Funds investment team as we find ourselves once again in midst of a COVID-19 induced lockdown and the medium for communication for our post reporting company meetings is once again digital, namely Zoom, Microsoft Teams and Webex. Whilst these meetings are no doubt an efficient medium of communication, we still have a preference for face-to-face meetings when given the choice. The nuances that can be gleaned from management's demeanour, body language and levels of general enthusiasm from an in-person audience cannot be underestimated, and these subtleties are much harder to discern from a digital meeting. Nevertheless, we must play the hand we are dealt, and we have a busy month coming up with well over a hundred company meetings already locked in.

Given the uncertainty brought about by the ongoing lockdowns we expect that many companies will be reluctant to provide forward earnings guidance when reporting, particularly those exposed to the overall economy given the impossibility of predicting what may unfold in the coming months. The delta variant has thrown a significant curve ball at the market, but we have not materially changed our portfolio positioning in recent weeks given that our portfolio holdings have solid balance sheets to trade through near-term challenges, and the market is forward looking and therefore focused on the earnings recovery that ought to play out once the population is largely vaccinated.

We reiterate what we said last month: "In such an environment it can be difficult to position a stock portfolio with 'lockdown' and 'reopening' beneficiaries whipping around at the whim of the national and global COVID-19 tally. As investment managers, we look through the 'noise' of the media and near-termism and structure the portfolio with quality stocks that we believe will perform strongly over the next 12 to 24 months". We live in a time of great uncertainty. It is difficult to predict whether other strains of the virus will emerge and derail the vaccination efforts or conversely whether the worst is already past us and the pathway to economic recovery will be smooth from here.

The August reporting season has already kicked off with several small-cap stocks releasing generally positive results in the first week. That said, the bulk of small and micro-cap companies tend to release their results in the back half of the month following sign off from their auditors. We look forward to reporting back to our investors in early September on our thoughts and observations following financial-year-end reporting in August. During this time, we will be meeting with most of our core portfolio holdings, as well as many of their competitors and other potential investment opportunities. We believe the Fund is well positioned going into the results period and we remain confident in our ability to generate strong long-term investment outcomes for investors.

Top 5 holdings#

Company	ASX code
Adairs Limited	ADH
Booktopia Group	BKG
Cedar Woods	CWP
MNF Group Ltd	MNF
Monash IVF Group Ltd	MVF

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments.

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[†]The total return performance figures quoted are historical, calculated using hard-close end-of-month mid-prices and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. The performance is quoted net of all fees and expenses. The index does not incur these costs. This information is provided for general comparative purposes.
[*]The performance comparison of $100,000 over 10 years is for illustrative purposes only. All returns shown are based on Australian dollar figures. Past performance is not a reliable indicator of future performance. The total returns shown are prepared on an ongoing basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX Emerging Companies Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index.