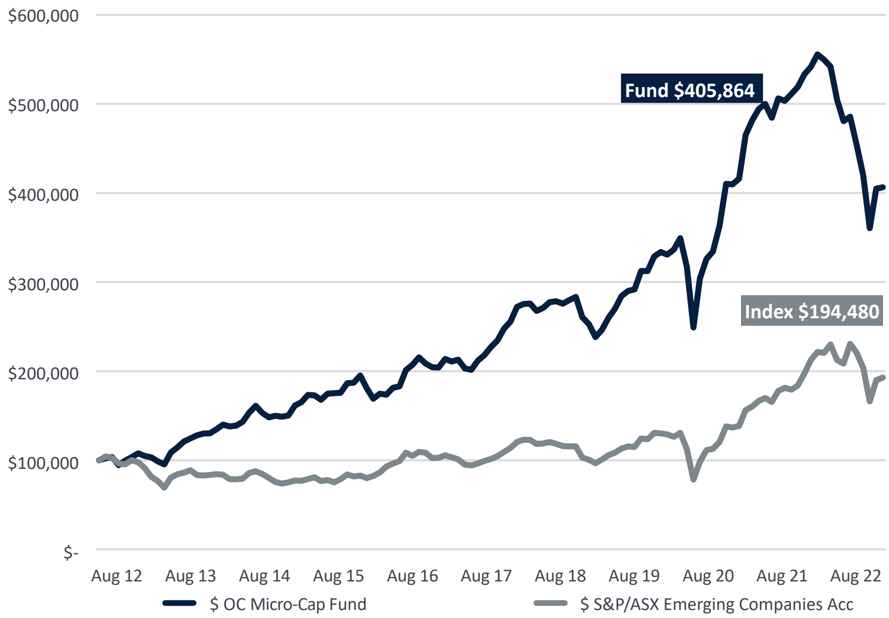
0.4%
Fund up 0.4% for the month

12.4%
Returned 12.4% p.a. for the past 5 years

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 Aug 2022† | 1 mth % | 3 mths % | 1 yr % | 3 yrs % p.a. | 5 yrs % p.a. | 10 yrs % p.a. | Incep. % p.a. (Nov 2003) |
|---|---|---|---|---|---|---|---|
| OC Micro-Cap | 0.4 | -3.3 | -23.8 | 9.2 | 12.4 | 15.1 | 13.1 |
| S&P/ASX Emerging Comp. Accum | 1.7 | -5.4 | -2.3 | 16.1 | 13.8 | 6.9 | 6.5 |
| **Outperformance** | **-1.3** | **2.1** | **-21.5** | **-6.9** | **-1.5** | **8.2** | **6.6** |

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 31 October 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 cum-distribution end-of-month hard-close mid-prices and do not allow for the effects of income tax or inflation.

## Performance review

The OC Micro-Cap Fund returned +0.4% in August on the back of a solid reporting season for most of our portfolio holdings, continuing the positive momentum we saw in the July rebound. This was behind the S&P/ASX Emerging Companies Accumulation Index which rallied +1.7%, buoyed by the strong performance of lithium and uranium stocks in the month of August. Whilst the trajectory of consensus earnings revisions was generally negative across the Australian small and micro-cap industrials market in August, we were pleased with the results of the Fund's holdings overall and remain optimistic about their prospects for the year ahead, notwithstanding the current macro-economic and geopolitical challenges.

**Nitro Software Limited (NTO +37.4%)** rallied strongly in August after disclosing a non-binding indicative proposal from a private equity consortium comprised of Potentia Capital and HarbourVest Partners to acquire all the issued capital of NTO for $1.58 cash per share. The proposal is conditional on six weeks of due diligence, exclusivity provisions and board approval. Whilst the proposal is opportunistic, Nitro reduced its guidance for CY22 Annualised Recurring Revenue (ARR) by 12% in July and requires a solid operating outcome in the second half to hit its revised guidance. NTO was a relatively small position in the Fund and we elected to sell into the private equity consortium when approached in a pre-bid raid on the NTO register at the indicative bid price. OC Funds took the view that the certainty of a 40% cash premium in the short term is likely to provide a better outcome on a risk versus return basis than banking on future ARR growth and a potential re-rate in the revenue multiple in an environment where the US Federal Reserve is hiking interest rates and may yet raise rates further than the market expects. NTO is still burning cash and any further slippage in management's forecasts is likely to be harshly treated by the market as it would result in the requirement for further equity funding before cash-flow breakeven is reached by the company. In terms of the indicative bid, the NTO board is intent on holding out for a better offer which may or may not emerge given that the current consortium holds a substantial 19.9% blocking stake.

**Top Shelf International Holdings (TSI, +21.6%)** rallied during the month following the release of a solid FY23 result and after extending its financing facility that will increase its funding runway toward cash-flow break-even. TSI is a premium Australian spirits business that produces and markets whiskey and vodka through the NED and Grainshaker brands which, to date, have predominately been sold to the mass market through its bottles and ready to drink cans. The company is also about to launch its much anticipated agave spirit, which will re-imagine the rapidly growing tequila category with a uniquely Australian brand that is targeted to have global appeal. Since extending its distribution footprint to Coles owned liquor outlets in March 2022 (Liquorland, First Choice and Vintage Cellars), NED Whisky and Grainshaker Vodka have rapidly ascended to the number one and the fastest growing Australian spirit brands in their respective spirit categories. TSI is early in its evolution, but the management team has made excellent progress building critical infrastructure and maturing inventory, securing distribution points and building two premium craft brands that have large addressable markets and global appeal. The launch of the agave spirit offering will build out the brand portfolio and TSI's world class agave farm in the Whitsunday region offers plenty of blue sky potential for shareholders. During the month, TSI announced that it had executed a credit approved term sheet to extend its loan facility with Longreach Credit Investors. This will extend TSI's senior secured loan facility to $45 million and extend the facility maturity date by 12 months to December 2024. At this point, we expect that the company will be approaching cash flow breakeven.

**Monash IVF (MVF, -6.3%)** finished the month lower despite delivering a FY22 result that was in line with analyst expectations and talking to favourable industry and company specific tailwinds that should see the company deliver strong earnings growth in FY23. Following the acquisition of key competitor Virtus in July 2022 by private equity player BGH Capital, MVF is the only ASX listed IVF provider, operating 24 clinics (114 fertility specialists) in Australia and also offering an expanding international presence in southeast Asia with five clinics (16 fertility specialists). By way of reference, Virtus was acquired at a multiple of 12x FY22 EV/EBITDA and unlisted competitor Genea was also recently transacted at around 15x FY22 EV/EBITDA; each of these deals compare favourably to MVF's current trading multiple of around 7 x FY23 EV/EBITDA. With Australia cautiously emerging from the COVID-19 pandemic, underlying demand for assisted reproductive services (including the release of pent-up demand) is only strengthening and this is being led by advanced maternal age and the availability of broader IVF service offerings (such as donor and egg freezing and genetic testing). Against this favourable industry backdrop, MVF has made significant investment in its existing infrastructure, added two acquisitions to the group (settling this month) and has been successful in recruiting a number of fertility specialists (including from the recently transacted competitors referred to above). MVF is one of the few companies comfortable issuing earnings guidance for FY23 which currently sits at "NPAT growth in-excess of 10%". Given the strong start to FY23, including the patient mix tilting toward first time patients (which is a good leading indicator of future demand), we would not be surprised to see this guidance boosted in the coming months as we see the earnings risks skewed to the upside.

**Fleetwood (FWD, -9.3%)** traded lower during the month when the company announced the earnings impact of a previously disclosed problem contract inside its modular building business which was material in the context of its group FY22 earnings result. The Rio Tinto Ti Tree Rail Camp upgrade project in Western Australia, and another smaller problem contract, impacted FWD earnings to the tune of $15-20m. These losses have now been 'ring fenced' and fully provided for in the FY22 result. FWD management has taken action to ensure these larger scale projects, which we consider outside the company's core competency, are no longer taken on by the Building Solutions division. Furthermore, FWD has implemented operational and management personnel changes, including improved cost control and procurement measures, and has introduced improved governance practices within the Building Solutions business. These issues in the Building Solutions business overshadowed what was an otherwise impressive result for FWD with both its Community Solutions and Recreational Vehicle Solutions businesses delivering solid earnings results for the group, with the 'villages' business particularly well placed to deliver exceptional earnings growth in the next few years. The jewel in the crown of this business is the purpose-built Searipple village in Karratha which is set upon 15 hectares and with over 1,300 rooms making it one of the largest accommodation villages in Western Australia. Along with the recently announced 5 year, 250 rooms per night Rio Tinto FIFO workers contract, we understand the company is in late-stage negotiations on other long term accommodation agreements which could have Searipple running at or near full occupancy by mid CY23. The positive earnings impact of Searipple as it approaches 100% occupancy should not be underestimated with analysts forecasting the earnings to as much as treble (from FY22 levels) in FY24 and FY25. With its FY23 earnings expectations now rebased and underpinned by its Community Solutions (accommodation) business, FWD represents compelling value with net cash (+$40m) and a market capitalisation of just $140m.

## Outlook

The equity market rally stalled in late August as it became clear that key central banks including the US Federal Reserve (the Fed) and our own Reserve Bank of Australia (RBA) remained firmly focussed on reducing inflation back to within the targeted bands. The market had rallied since July on the belief that the aggressive global market sell-off had been overdone and that central banks would begin to moderate rate increases in the coming months before eventually cutting rates in the back half of next year. Given the strength of the employment market and the overall economy in the US and Australia, we remained of the view that this was unlikely outcome and the Fund stayed the course with its defensive portfolio positioning. The Fund's solid performance over July and August was therefore the result of excellent portfolio specific news, as opposed to 'timing' the market and pivoting the portfolio for the short and sharp bounce that transpired.

The good news is that we have been well positioned as the market has recommenced its decline. Fed chairman Jerome Powell's succinct Jackson Hole address was the catalyst for the sharp reversal in markets as he made it abundantly clear that inflation remained public enemy number one for the US central bank. The US employment market remains very strong, albeit we saw some moderation in the jobs data last week. Against this robust economic backdrop, it remains clear that the Fed will continue to hike rates until such time that it is becomes apparent that the inflation dragon has been slayed. With the Fed also beginning Quantitative Tightening (QT) in September, which will serve to reduce liquidity in the system, it presents a particularly challenging backdrop for risk assets including equities. As a result, the Fund remains conservatively positioned from both a sector positioning and cash weighting perspective. The risks of a US recession are elevated, and we retain minimal direct US exposure in the portfolio. Europe and the UK face an even more challenging outlook with stagflation setting in and a monumental energy crisis likely to send the region into a protracted recession over their winter. Readers will be aware that we have been bearish on Europe and the UK for some time and have limited exposure to that region in the Fund.

Our own central bank, the RBA, is charting a similar course to its US counterpart with the rhetoric coming out of Martin Place now remarkably similar. Notwithstanding a falling residential property market and deteriorating consumer confidence, the domestic economy, including the jobs market, remains on solid footing. The RBA has made it clear that rates will continue to move higher until such time that inflation is in check. On Tuesday, the RBA increased the cash rate a further 50 basis points to 2.35% which is the highest level we have had since 2013, when it was 2.5%. It is also the first time the RBA has undertaken five consecutive rate increases since it adopted the 2-3% inflation target back in 1990. Whilst Governor Philip Lowe made it clear that the pace of future rate increases will be 'data driven', it seems more likely than not that we will get another 50-basis point hike at the RBA's October meeting, especially with June quarter GDP printing at an impressive 0.9% or at 3.6% year on year since the RBA's commentary. Whilst these interest rate increases will inevitably slow the Australian economy, we continue to believe that our country is better placed than Europe or the US to avoid a recession. Key commodity prices remain strong, particularly coal, oil and gas and soft commodities. For instance, BHP is reported to have paid $18.5b in taxes and royalties alone to the Commonwealth in FY22. The national accounts are in good health and we are a rare global beneficiary of high commodity prices which leaves the Federal government well positioned to stimulate the economy should the necessity arise.

Reporting season has just wrapped up and it was refreshing to meet company management teams in person, after several years of online meetings. Despite the strong rebound in equity markets in July, the Fund was conservatively positioning heading into August given our view that we had yet to see the macroeconomic headwinds reflected in company profit margins, as well as our concern about their implications for forward looking earnings expectations.

Overall, reporting season was better than expected in the domestic small-cap space and the Australian economy remains robust despite the well documented challenges. For instance, it was interesting to observe that the consumer discretionary sector, a space which we had been cautious on heading into results, reported better than expected results. Moreover, solid trading amongst retailers has generally continued into July and August (e.g. recent trading statements from Baby Bunting, Nick Scali and Universal Stores), albeit against a locked down prior year comparison and with the usual caveats from management about the uncertain economic environment ahead.

From a consumer perspective, a common area of softness in results was in the e-commerce space, where companies continue to cycle one-off benefits that they experienced during lockdowns. The New Zealand economy was typically observed as being softer than the Australian economy (e.g. commentary from Nick Scali, Bapcor and Adairs) reflecting the impacts of longer lockdown periods, lower levels of government stimulus, a more advanced interest rate tightening cycle and a different economic mix with lesser commodity price windfalls.

Labour shortages and wage inflation were perhaps the most frequent callouts during the company meetings and calls we attended during the period. Labour cost pressures that companies are seeing at present reflects not only the level of wage increases driven by mandated minimum wage regulations but also a lack of labour supply. Supply has been constrained by two years of border restrictions and lockdowns resulting in minimal levels of net migration of skilled labour. Examples of this include Symbio Holdings and Aussie Broadband which called out +8% wage inflation in their employee bases as they fight to retain talent. In addition to tight wage pressure, it is noteworthy that some companies are looking to attract workers in other ways. Labour markets are highly competitive and innovative companies are going to great lengths to attract and retain their number one asset: their people. For example, Mineral Resources have built a new $100m plus head office in Perth to attract and retain key talent. The world class head office includes a fully subsidised café and restaurant, a commercial grade gym, free child-care, family zone for parents and a wellness facility providing medical and psychological services.

Supply chain challenges and employee absenteeism were also called out by many companies during the month as an issue in FY22, with both continuing to weigh on the outlook in many instances. With respect to supply chain constraints, we continued to see delays in the delivery of capital goods to customers, such as new cars, heavy mining equipment and IT hardware. To compensate many companies have built up customer order books to record levels. In industry parlance, companies have moved from a 'just-in-time' inventory policy to a 'just-in-case' policy. Whilst supply chain bottlenecks and port congestions are slowing ameliorating and freight prices seem to have peaked for now, we are keeping a close eye on the inventory positions of a number of companies (e.g. City Chic Collective, Kogan Limited and Adairs Limited) which may be forced to write down or clear inventory at a discount if the demand environment drops away.

With interest rates rising rapidly, balance sheet health was a key focus of the OC Fund's team, particularly in assessing cyclical companies where a drop in demand brought about by an economic slowdown could lead to debt covenant stress. Overall, corporate balance sheets appear to be in the best shape they have been in many years. A combination of government handouts during the pandemic and strong operating performances in recent years had left most balance sheets in rude health. Indeed, a number of companies with strong confidence in their outlooks and robust balance sheets announced stock buybacks during the period (e.g. Eagers Automotive, Omni Bridgeway and Ridley Corporation) which were generally well received by the market. Companies with excess capital should be well placed to weather any macro-economic weakness and emerge stronger from a competitive perspective with the ability to make well priced acquisitions in the coming 12 months.

Overall, we continue to see the near-term macro-economic and geopolitical outlook as uncertain. Reporting season certainly had an element of 'kicking the can down the road' from management, with the lack of outlook commentary from many small caps moving investor focus to the next update from companies at either the upcoming AGM season or interim results period in February.

Little has changed with our portfolio positioning during the month with an overriding focus on quality business models at reasonable valuations continuing to provide a margin of safety. Our preferred portfolio themes include:

- Quality businesses that can grow their earnings outside of the economic cycle, e.g. Propel Funeral Partners and Regis Healthcare;
- Companies with pricing power that can weather a sustained increase in inflation, e.g. Probiotec Limited and Trajan Group; and
- Services businesses that are cycling lockdowns in FY22 and ought to benefit from the re-opening of the domestic economy, e.g. Silk Laser Clinics and Viva Leisure Group.

There are a raft of quality growth companies with long-term structural growth drivers that may become attractive if the market continues to sell-off aggressively. These include some of the higher quality online businesses (REA Group, Domain Group Holdings, Carsales.com and Temple & Webster Group) and defensive global growth companies such as Domino's Pizza Enterprises. These stocks have all sustained material share price falls this year and screen well under our investment process in terms of operational risk assessment but, until recently, had been valued above what we see as an attractive entry point.

We remain cautious on the consumer environment as we expect cost of living pressures, higher interest rates and a softer housing market to impact household discretionary spending. Shareholders of retailers are likely to be nervous about trading updates during late December as we head into the important Black Friday and Christmas trading periods. Looking further into CY23, cyclical stocks such as retailers and niche financiers are likely to require macro conditions to stabilise, and the rates cycle to show signs of peaking before outperforming.

The Fund remains 'cashed up' at present, with a cash balance in-excess of 10%, providing ample flexibility to capitalise on any pull back in the market in the coming months. Whilst this level is well above our typical cash weighting of around 4-6%, we feel it is prudent in view of the elevated macro-economic and geo-political risks which could provide a cheaper entry point into stocks in the coming months, with some of the quality names in the small-cap space on our radar. Post our reporting season management catchups, we will once again head out on the road with an extensive company visitation program planned in the coming two months. We thank our investors for their ongoing support and remain committed to our goal of generating strong long-term risk-adjusted returns for our clients.

## Top 5 holdings#

| Company | ASX code |
|---|---|
| Cedar Woods Property | CWP |
| Monash IVF Group Limited | MVF |
| Probiotec Limited | PBP |
| Propel Funeral | PFP |
| Silk Logistics | SLH |

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

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