OC Funds Management

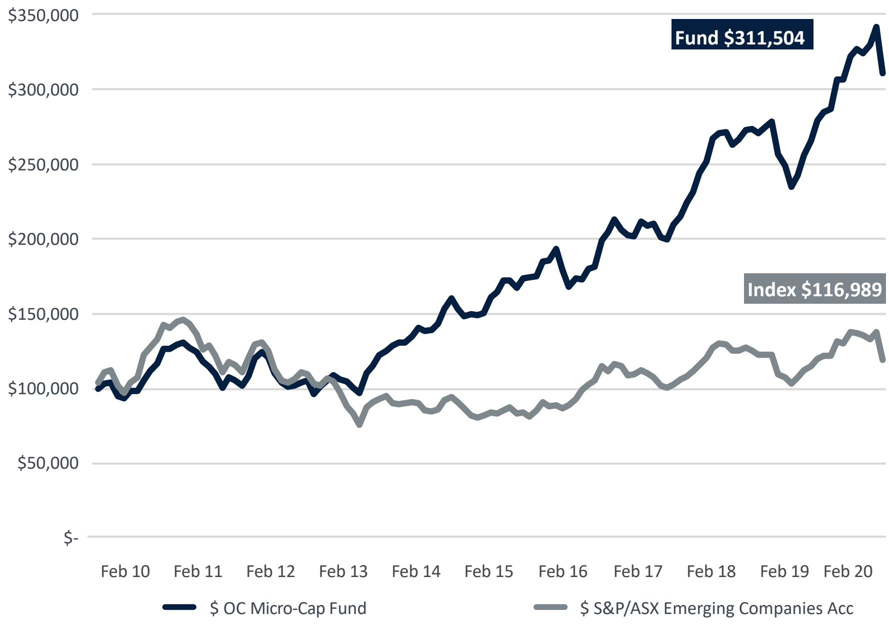
OC Micro-Cap Fund
Fund Update | 29 February 2020

9.2% Fund down -9.2% for the month

14.5% Returned 14.5% 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 29 February 2020†	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	-9.2	-4.1	22.1	14.6	14.5	16.7	12.5	13.5
S&P/ASX Emerging Comp. Accum	-14.1	-12.9	6.6	2.9	7.9	2.0	1.5	NA
Outperformance	**4.9**	**8.7**	**15.6**	**11.7**	**6.6**	**14.7**	**11.0**	**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 mid-prices and do not allow for the effects of income tax or inflation.

Performance review

The events of the February reporting season have been totally overshadowed by the emergence of the novel coronavirus (COVID-19 or 'the virus') which originated in the Hubei province of China but is now rapidly spreading across the globe. The virus is disrupting the global supply chain with many factories in China closing temporarily, while travel bans, quarantine measures and social distancing policies are being imposed in a growing number of locations. These unprecedented dislocations are interrupting trade, undermining business and consumer confidence and threatening to send the global economy into a recession.

People are understandably fearful, with conflicting data emerging about the health threat posed by the virus, ranging from seasonal flu-like symptoms for the majority of those who contract it, through to much more drastic appraisals for certain demographics of people involving mortality rates in excess of 3%. COVID-19 has invoked an overwhelming sense of fear (the biggest enemy of equity markets) amongst the global community, with much still unknown about the virus and the damage it will ultimately cause, both human and economic.

Loss of reason and the emergence of fear, caused by the presence of the virus, has the potential to do more damage than the virus itself, with people irrationally stockpiling food, medicine and essentials, cancelling travel plans and family gatherings, harming business and overwhelming the health system with unrelated cases. Against this backdrop, global equity markets, including Australian small companies, have been hit hard.

The overall reporting season was a solid one for OC Funds from a results perspective, but this was of little consequence as investor sentiment shifted rapidly to 'risk off' mode as the virus spread. Like many other investors, we initially underestimated the likelihood of global contagion occurring and the Fund's exposure to the retail, financial and mining services sectors has hurt our performance during the past fortnight. Notwithstanding this, the Fund performed well ahead of the ASX/S&P Emerging Companies Accumulation Index during the month.

OptiComm (OPC, +25.8%) outperformed over the month after a well attended Melbourne investor day and the delivery of a solid maiden interim result. OC first invested in OPC at its IPO in August 2019 and recently participated in a sell down of stock which came off escrow at the February result. OPC is a builder and owner of a fibre to the home telecommunications network which provides internet and free to air TV to over 67,000 homes, predominantly in greenfield broadacre subdivisions but also in some new multi dwelling unit (MDU) developments. The interim result demonstrated good growth in average revenue per subscriber of around +8% on the prior period. This is being driven by OPC customers demanding higher speed plans as they consume more streaming content (such as Netflix and Disney+) and also through the adoption of TVs which require more bandwidth for reliable 4K streaming. We like the defensive nature of OPC's earnings and continue to hold a core position in the portfolio.

Viva Leisure (VVA, -16.4%) traded lower during February despite delivering a 1H20 result that was in line with market expectations and confirming that the integration of its recent acquisitions was progressing well. VVA owns and operates more than 75 gyms, with half in the ACT, and has recently added to its network with material acquisitions in NSW and QLD. At the half, VVA reiterated FY20 guidance for 106k members, A$59m revenue and A$14m of EBITDA. Organic member growth at recently opened greenfield sites will be augmented by the opening of further gyms later in this half including one in Pyrmont and two in Canberra. VVA was softer over the month as the equity market priced in near term risk to these forecasts given the potential for COVID-19 to disrupt the propensity of members to join and attend gyms. Whilst this is a real near term concern, VVA is well capitalised with A$18m of cash to fund both the organic network roll out and future acquisitions.

Two of the portfolio's longer term holdings, **McPherson's (MCP, -19.6%)** and Propel Funeral Partners **(PFP, -4.2%)** each had negative share price moves during the month despite delivering solid interim results in the February reporting season. PFP's result was particularly strong as we saw a normalisation of the 'death rate' (which had been weak in the prior corresponding period) combine with an increase in the average revenue per funeral to deliver outstanding cash conversion, somewhere near 100% of EBITDA. Perhaps the ultimate defensive stock, PFP also offers above market growth through its ongoing regional funeral home acquisition strategy which has been well executed to date. The MCP result was slightly ahead of market expectations and it maintained its FY20 full year guidance with some of its key product lines, including Dr LeWinn's, delivering exceptional year on year growth. MCP has a strong balance sheet and is cashed up and ready to execute a strategic acquisition or partnership to enhance its market position. Ongoing growth of its existing range, coupled with a potential acquisitions, sees MCP well placed in this market.

During the month, we exited the last of our position in recent IPO, **Nuchev (NUC, +15% since IPO)**. NUC listed on the ASX in December 2019 and had been a strong performer as the market embraced its plans to bring a range of premium, Australian made, goat nutritional products (branded OLI6) to the Australian and offshore consumer. Despite being a positive contributor to the Fund, we sold the position as we saw NUC's post IPO 'halo' begin to slip on concerns about the company's ambitious growth plans in the face of the rapidly evolving coronavirus situation and the impact it could have on consumer demand for its product suite.

Outlook

Global equity markets have fallen sharply in the past fortnight as the coronavirus outbreak spreads across the globe. Investors have moved swiftly to reduce risk as they grapple with an onslaught of negativity from the media and governments surrounding the spread of COVID-19. Much is still not known about the virus; its trajectory and just how vulnerable society may be. The World Health Organisation (WHO) has recently said that the virus has killed around 3.4% of those diagnosed, which is a frightening mortality rate. Other experts believe that this is a gross overestimate and the global fatality rate for the disease will end up below 1%. Pinpointing a reliable mortality rate is tough, given that many of those infected have only mild symptoms or are asymptomatic (up to 80%) which is likely to dramatically lower the actual toll of the disease, as most of these people are undiagnosed.

Whilst the duration and severity of the virus remains unknown, it has roused an overwhelming sense of fear right around the globe which will have follow on economic consequences. As people become more scared, they tend to disengage from economic activity and reduce levels of consumption. Some of the behaviour we have seen of late is totally irrational, such as hoarding toilet paper (which is produced domestically and is unlikely to be rationed). But fear is a powerful emotion that can evoke an irrational response which can cause negative feedback loops that can have real economic consequences.

There are two ways the coronavirus will affect the economy. In the first instance there is the supply side disruption from China and other impacted regions where quarantine restrictions have vastly reduced factory and other manufacturing output. The Chinese economy has taken a severe hit from the aggressive measures that the central government imposed to curtail the spread of the virus. A leading indicator of this has been recent manufacturing data out of China, such as the official purchasing managers' index (PMI), which hit a record low 35.7 in February, demonstrating just how dramatic the impact has been. There has been significant disruption to the global supply chain and shortages of key manufacturing components and finished goods will be a persistent problem for many companies and a key challenge to navigate in the coming months. The good news is that China's actions appear to have worked, or at least slowed the spread of the virus, laying the groundwork for an eventual recovery in activity.

The other way the virus is impacting the economy is on the demand side through how people respond to its threat. Already people are cancelling travel plans, reducing spending and avoiding crowded places. In some instances, entire provinces or regions are being quarantined. The ultimate economic damage will depend on how far people retreat from their normal activity and what type of measures governments might adopt to stem the spread of the virus. It is difficult to gauge the likely scope of such measures as experts are struggling to understand some basic facts about the virus, including its mortality rate and how transmissible it is. What is crystal clear is that the virus will weaken the economy; we are just unsure how much damage it will do and how long it will go on for.

Central banks, including the Reserve Bank of Australia and the US Federal Reserve, have rushed to cut interest rates, but this has done little to appease investors as easier monetary policy and increased liquidity is unlikely to be a panacea for a crisis of this type. Central bank liquidity will not restore the international supply chain nor encourage fearful people to head outside and spend. Indeed, the Federal Reserve's emergency 50 basis points interest rate cut on in early March only served to sow more seeds of doubt in the minds of investors unnerved by unrelenting headlines relating to the virus's spread.

What is required is a large targeted government response, fiscal or otherwise, which will instil some confidence back in a public buffeted by media coverage which is becoming increasingly negative and sensationalist. Such a package will need to target the supply side of the economy and keep businesses functioning until the crisis passes. The Morrison government is widely expected to announce a large stimulatory policy response in the coming days, the nature of which remains unclear, although keeping people in work until the crisis has passed would be the key focus of the package (which Treasurer Josh Frydenberg has said will cost "billions"). Tax relief and investment incentives are likely to form the cornerstone of the package, and the states and territories are also under pressure to adopt their own plans, including offering small businesses payroll tax relief. Clearly the Federal government's coveted first budget surplus in more than a decade is now off the table.

The number of global COVID-19 cases now exceeds 100,000 and, despite the large human cost, our role as fund managers is to respond appropriately to ensure the best investment outcomes for our clients. Unfortunately, the timing of the sharp sell-off in response to the global contagion coincided with the Fund having significant exposure to the travel, technology, financial and mining services sectors which have since been in the front line of investor de-risking. We have been busy repositioning Fund holdings, but the speed of the sell-off has resulted in some near-term pain for investors.

It is clear that highly leveraged companies will be impacted as credit markets have tightened significantly in a short space of time and so we have been exiting holdings that have any material debt that needs to be refinanced in the short-medium term. Credit spreads, which measure the price firms are prepared to lend money to the government versus the price they are prepared to lend to corporate borrowers, have risen sharply making it harder for lenders without prime credit ratings to raise fresh funds or refinance upcoming debt obligations. From a portfolio perspective, it is prudent to err on the side of caution and reduce our exposure to these stocks, as we can always buy them back should credit markets recover in the coming months once the virus is contained.

As investors, we are trying to remain dispassionate and not get caught up in the wave of hysteria that can accompany rapidly falling markets and doomsday like headlines that inevitably come with a pandemic. COVID-19 is a significant economic challenge, make no mistake, and one which will likely result is Australia's first recession (albeit a technical one, namely two quarters of negative growth), in almost 30 years. The short-term supply and demand side shocks caused by COVID-19 will also likely result in a recession in Germany, Italy, Singapore and possibly even the mighty United States, notwithstanding the US just reported unemployment data near a 50-year low of 3.5 per cent.

We are not experts on coronavirus, and despite listening to countless calls with global experts in the past few weeks, anything we have to say about its trajectory would be little more than a guess. We are nevertheless heartened by the resilience demonstrated in China, which, despite clear systemic failures in the early stage of the outbreak, now appears to have contained the virus and is on a path to restarting its huge industrial engine which will eventually help power a global recovery. Other countries too, with strong healthcare systems such as Singapore, have been able to minimise the spread of the virus, which is cause for hope in Australia.

We look to recent similar episodes globally for clues as to what might happen next. SARS (severe accurate respiratory syndrome), MERS (Middle Eastern respiratory syndrome) and COVID-19 are all respiratory illnesses caused by the same large family of viruses called coronaviruses. Coronaviruses are actually quite common and are the source of many common colds that people get and recover from every day. COVID-19 has mortality rates far lower than SARS, but this also makes it harder to detect and contain. Whereas SARS caused a 12 per cent fall in the Australian share market over a two month period, the COVID-19 outbreak has seen the market fall by a similar amount in just two weeks. In the instance of SARS, stocks bottomed within days of the WHO declaring it a global health crisis even though the virus itself raged for months to come.

Whilst the COVID-19 crisis clearly has much to play out from an economic and health perspective we remain cognisant that the market is likely to bottom, as it did in the case of SARS, well before the economic data recovers, or the health authorities declare the worst of the outbreak has passed. It is impossible to know when the market will bottom, or if indeed it has already. The crisis is however likely to present us with a once in a decade opportunity to purchase some quality businesses at compelling valuations at some point in the coming weeks or months. We already have a short-list of beaten-up stocks we expect to recover quickly from oversold levels once that time arrives, and we patiently await that opportunity.

Top 5 holdings#

Company	ASX code
National Veterinary	NVL
Probiotec Limited	PBP
Rhipe Ltd	RHP
Viva Leisure Limited	VVA
Zenith Energy Ltd	ZEN

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. Soft close unit prices are interim unit prices struck at month end before all transactions for the month have been completed. Performance data available on the OC website, ocfunds.com.au, however, is based on hard close unit prices which are struck after all transactions for the month have been completed.

* 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.

Past performance is not a reliable indicator of future performance. Positive returns, which the OC Micro-Cap Fund (the Fund) is designed to provide, are different regarding risk and investment profile to index returns. A performance fee of 20.5% is accrued daily on any excess performance (after deducting the management fee) above the performance benchmark within a performance period. Any accrued performance fee will become payable if the Fund's return is positive at the end of the performance period. If the Fund's return is negative, any performance fee accrual will continue to be carried forward. The performance benchmark is the return of the S&P/ASX Emerging Companies Accumulation Index. The inception date of the S&P/ASX Emerging Companies Accumulation Index is 31 December 2003. This document is for general information purposes only and does not take into account the specific investment objectives, financial situation or particular needs of any specific reader. As such, before acting on any information contained in this article, readers should consider the suitability of the information for their needs. This may involve seeking advice from a qualified financial adviser. Copia Investment Partners Ltd (AFSL 229316, ABN 22 092 872 056) (Copia) is the issuer of the OC Micro-Cap Fund (ARSN 126 537 424). A current PDS is available from Copia located at Level 25, 360 Collins Street, Melbourne Vic 3000, by visiting ocfunds.com.au, by calling 1800 442 129 (free call) or by emailing clientservices@copiapartners.com.au. A person should consider the PDS before deciding whether to acquire or continue to hold an interest in the Fund. Any opinions contained in this document are based on information available to Copia at the time and may be subject to change without notice. Copia is under no obligation to update or keep any information contained in this document current.