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Dear Fellow Investors,

Welcome to the **May 2018 Ophir Letter to Investors** – thank you for investing alongside us for the long term.

Month in Review

A re-emergence of political risk across the Eurozone this month, coupled with a fairly material mid-month rise in global bond yields, was still not enough to derail the stoic momentum currently being enjoyed by equity market investors across the majority of the developed world share markets. While a stubbornly higher US dollar is beginning to pose some issues for the expected growth rates of number of markets across the emerging economies (the MSCI Emerging Markets Index falling -3.8% over the month), a solid US corporate earnings season coupled with continually encouraging favourable economic data has kept investor sentiment suitably buoyant. The ASX 200 finished May +0.5%, with smaller capitalised businesses again outperforming their larger counterparts, the ASX Small Ordinaries ending the month +3.7%.

	1 month	6 Months	1 Year	5 year p.a.	Inception p.a.
Ophir Opportunities Fund^	**2.6%**	**8.6%**	**39.0%**	**30.2%p.a.**	**36.3%p.a.**
Benchmark*	3.7%	6.9%	25.4%	9.7% p.a.	8.6% p.a.
Value Add (Gross)	(1.1%)	1.7%	13.6%	20.5% p.a.	27.7% p.a.
Fund Return (Net)	2.5%	7.9%	37.2%	24.1% p.a.	28.6% p.a.

* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	1 month	6 Months	1 Year	2 Year p.a.	Inception p.a.
Ophir High Conviction Fund^	**4.8%**	**16.2%**	**40.7%**	**19.6%p.a.**	**32.3% p.a.**
Benchmark*	1.9%	5.2%	19.5%	4.6% p.a.	15.0% p.a.
Value Add (Gross)	2.9%	11.0%	21.2%	15.0% p.a.	17.3% p.a.
Fund Return (Net)	4.1%	13.6%	36.7%	17.0% p.a.	26.3% p.a.

* 50% S&P/ASX Small Ordinaries Accumulation Index (XSOAI), 50% S&P/ASX Midcap 50 Accumulation Index (XMDAI)

Both Ophir portfolios delivered positive absolute returns this month, the Ophir Opportunities Fund returning +2.5% after fees, while the High Conviction Fund delivered a net return of +4.1%. While both portfolios did experience some negative impact this month from positions in The A2 Milk Company (following an adjustment to consensus revenue estimates in the earlier part of the month – we discussed this in our May Strategy Notes earlier this month), we have been pleased that both strategies have largely avoided the remainder of the earnings downgrades experienced across small and mid-caps in recent weeks.

On a relative view, the High Conviction Fund comfortably outperformed its benchmark this month, while the Opportunities Fund came in under the index following a small number of positions across the mining services and contracting space seeing some compression in valuation following potential timing delays around project deliveries. This is the nature of contracting businesses and we continue to remain comfortable with the broader thematic driving expected earnings growth across the space – we discuss this in some more detail later in the months Letter.

While a headline index return across the Small Ordinaries of +3.7% might indicate a relatively benign month for investors, this time of year does have a habit of producing a number of late earnings adjustments from companies ahead of the close of the financial year. On our count, the market experienced some ~33 downgrades in May and we would expect to see this overall momentum continue into early June as management teams reassess operating performance versus budgets and market guidance. While an elevated number, this doesn't sit too broadly outside of the experience of last year (~26 downgrades were reported in May 2017), however understandably the professional investor community does tend to enter the May/June period with some degree of trepidation.

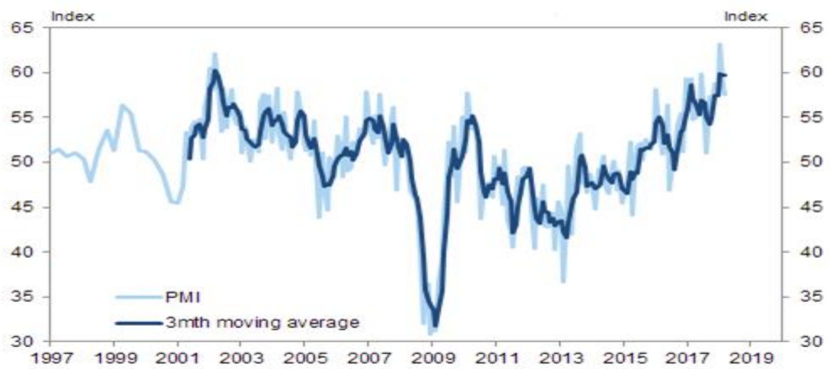
Earnings momentum continues to very much remain a key driver of equity returns at present, with businesses delivering strong growth outcomes continuing to be well rewarded whilst those that disappoint (or are expected to disappoint) have experienced fairly excessive reductions in equity value. Across the ASX small cap industrials this month, seven listed businesses (all with market capitalisations in excess of $150m) experienced losses of more than a fifth of their entire equity value over the month, indicating the market continues to remain seemingly prepared to cut and run when expected earnings are not delivered.

<u>ASX Small Industrials Index – Top 10 Best & Worst Performers</u>

	Best			Worst	
Ticker	**Name**	**Rel Perf**	**Ticker**	**Name**	**Rel Perf**
SWM	Seven West Media	43.9%	AGI	Ainsworth Game Technology	-43.1%
WTC	Wisetech Global	42.6%	AYS	Amaysim Australia	-36.5%
APT	Afterpay Touch Group	26.7%	MTS	Metcash	-23.3%
BKL	Blackmores	25.4%	AHG	Automotive Holdings Group	-21.6%
AX1	Accent Group	22.8%	BLA	Blue Sky Alternative Investm	-19.4%
EHL	Emeco Holdings	22.7%	RCR	Rcr Tomlinson	-19.4%
IEL	Idp Education	22.2%	GXL	Greencross	-19.1%
NWL	Netwealth Group	21.8%	MYO	Myob Group	-17.4%
RWC	Reliance Worldwide Corp	21.5%	TNE	Technology One	-16.4%
HUB	Hub24	20.4%	RFG	Retail Food Group	-14.7%

Despite some intra-month price volatility, **broader investment sentiment across the Australian market continues to remain relatively buoyant**, with data indicating improving business conditions continuing to align with the anecdotal feedback we are receiving from management teams leading domestic-facing businesses. The broadly encouraging outlook comes despite some divergence in local economic data in recent weeks: Australian manufacturing activity, for example, continues to remain elevated, with PMI readings still improving on three-month averages, however retail sales data reported this month continues to indicated a fairly tepid environment for consumer-facing businesses. Recent concerns around the Sydney and Melbourne housing markets will likely continue to create some caution for consumers near-term, while May also produced the second-weakest quarterly wages growth number reported since the inception of the wage price index in 1997.

<u>Australia PMI: Headline Index</u>

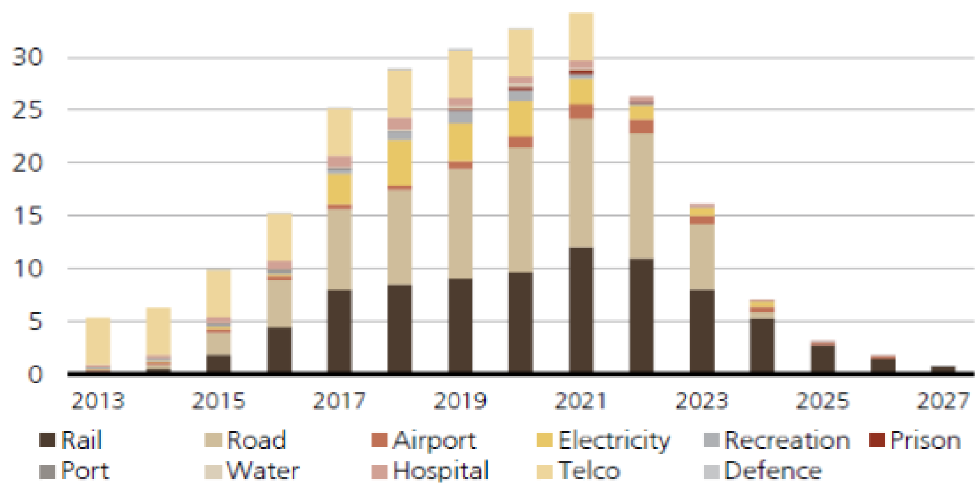


With an underlying economic cycle that continues to look relatively patchy (particularly when in comparison to global peers), **we continue to expect that businesses that are demonstrating an ability to deliver above-market growth rates regardless of the underlying cycle will continue to be well-rewarded.** As has been the case for the last ~18 months, the majority of businesses showing an ability to achieve superior growth rates continue to be found primarily in the emerging small and mid-cap space, given the bulk of larger listed businesses across the ASX continue to rely fairly heavily on the strength of the underlying Australian economy to generate growth. As a result, it has been unsurprising that the smaller listed company space has delivered fairly material outperformance over the last 12 months, with the ASX Small Ordinaries having now outperformed the ASX 20 Leaders (the 'blue-chip index') by +18.22% on a rolling 12-month basis, inclusive of dividends.

The Australian economic engine has not ground to halt by any means, however the bulk of underlying growth continues to be derived primarily from the continued recovery across the mining and resources sector, alongside the economic multiplier being generated from the enormous infrastructure roll-out across Australia's eastern states. The East Coast infrastructure boom, particularly, looks to be providing a sizeable stimulus for overall economic activity, with an enormous of work still yet to be allocated across a number of meaningful construction and engineering projects in coming years. As highlighted by the May PMI release:

"…sub-sectors that provide manufactured goods for large transport projects and construction sectors continue to report very strong levels of activity…manufacturers in the East Coast continue to report strong demand from the civil engineering, commercial building and defence industries."

UBS Australian Infrastructure Project Database ($Abn)



Source: UBS Investment Research

The recovering fortunes of the Australian resources sector is providing the other key driver of domestic economic growth near-term, following a continued recovery in global commodity prices in response to improving (and synchronised) global economic growth expectations. While iron ore finished the month slightly weaker, the broader trend maintained momentum into May with both base metal prices and oil again climbing higher, driving a continued re-rating in the listed equities of the businesses engaged in their extraction. **On a rolling 12-month basis, the Small Resources index has now appreciated +49%, delivering a total return 2.5x that of the Small Industrials (+19.6%) over the same period**.

The resilience of the broader commodity complex in recent months has been particularly impressive, given the continued resurgence of the US dollar at the same time. Traditional intermarket relationships would normally dictate that commodity prices and USD's typically move inverse to one another (given underlying commodities are priced in US Dollars). The USD Trade Weighted Index rose an additional +2.3% in May, though this hasn't appeared to slow the appetite for commodity markets, with the divergence between the two asset classes now becoming fairly pronounced. Some caution near-term is likely warranted here, given the current spread between USD's and the Bloomberg Commodity Index now sits at a similar level to early 2017 - a period that ultimately saw a fairly rapid re-alignment of the two.

US Dollar Index vs Commodity Prices

Source: Capital Economics

The recovering fortunes across the resources sector have continued to support companies within the mining services and contracting space, albeit valuations across the sector have adjusted suitably higher in anticipation of future earnings growth. The contracting space can be notoriously fickle at times, with any number of issues often creating inevitable timing delays around contract wins and project deliveries. While conditions continue to remain largely accommodative at present, a number of companies have seen some share price adjustments following moderations to near-term expectations – this is more a function of equity market investor expectations simply having drifted too far ahead of themselves, rather than demonstrative of any structural issue at the sector level.

Despite some contraction in valuation as a result, sector multiples (both P/E and EV/EBIT) still sit well ahead of the previous peak experienced in FY11, given overall margins are still below peak cycle and balance sheets are undeniably stronger than those of 7 years prior. While the sector is not a large exposure for either fund, **we do hold a small number of investments across the space given the continued favourable outlook for increases in mining-related capex and infrastructure spend.** Given overall earnings quality in the sector is at the lower-end of what we tend to look for, we continue to favour the more diversified players with operations extending beyond either single commodity operations or singular geography exposures.

While Australian economic growth, for the immediate near-term, will continue to rely heavily on the mining and infrastructure sectors, as small and mid-cap investors we are fortunately blessed with the ability to invest in a wide range of emerging businesses that are able to generate earnings either exclusive of the underlying cycle or from company operations in higher growth markets offshore. Undoubtedly one of the true tragedies of the Australian share market structure is the bulk of the equity investments held by Australian superannuants are still concentrated either in 'older world' businesses operating within the more mature stages of their company lifecycle (large grocery retailers, utilities, toll roads) or those heavily dependent on the underlying strength of the

Australian economy to generate growth (retail banks and financials). As a result, overall expected returns for those with a heavy tilt towards larger-capitalised Australian businesses have been somewhat disappointing in recent years, particularly when compared to a number of offshore markets that have seen their underlying equity index evolve over time to represent more 'new world' businesses and industries.

To be clear, overall expected earnings growth rates across the ASX 200 for FY18 still sit at a level that, in an absolute sense, are above trend - current consensus earnings estimates for this year sit at around ~6%, while overall total returns (i.e. including dividends) should come in just over 10%. While a double-digit return is nothing to be sniffed at, **it does begin to look decidedly pedestrian when compared to the fairly stellar earnings growth currently on offer to investors in markets overseas.**

The US share market, for example, concluded a stellar quarterly earnings season this month, **with average earnings per share growth for 1Q18 across the S&P 500 of +25% on the previous corresponding quarter** (on revenue growth of +9%). For some perspective on this acceleration in growth, the three-year average growth rate for the S&P 500 is around +6%, while average revenue growth has been a fairly mediocre +2%. While the absolute numbers delivered for 1Q18 are impressive, the momentum with which nearer-term growth numbers are being upgraded at present is equally striking – at the beginning of calendar year 2018, for example, the consensus earnings per share expectations for 2Q 2018 sat at roughly +9%. As we now head into June, consensus estimates for the same period have increased to almost +19% - a doubling in expectations over a period of just six months.

While admittedly the US economy has benefited substantially from a number of favourable company tax measures and enormously accommodative monetary settings, the most obvious driver of increased earnings per share near term (versus the Australian index, for example) is simply a function of the index being dominated by a number of larger high-growth businesses operating within 'newer world' industry sectors. This is a function of the fact that the bulk of US companies representing the largest index weights of the S&P 500 have substantially evolved over the last decade to reflect the faster growing areas of the economy, whereas the Australian market (from an index component at least) has instead remained decidedly static[1].

It was perhaps symbolic, then, that this month saw some begrudging movement in the status quo across the blue chip index, with pharmaceutical company **CSL Limited** (the former Commonwealth Serum Laboratories, originally privatised and offered on the Australian Stock Exchange in 1994 at $2.30/share) surpassing the ANZ Bank as the fourth largest company in Australia. While certainly pleasing to see such continued success from a larger-capitalised business that has focused on providing shareholders with meaningful earnings growth rather than a consistent dividend stream, unfortunately these opportunities remain fairly rare for investors across the large cap end -indeed CSL remains the only true industrial growth business available to investors within the ASX Twenty Leaders index.

The Australian superannuation sector has always been an investor cohort hungry for dividends and it's certainly not unreasonable to question whether this voracious appetite for income has exerted some influence over the corporate strategy for a number of Australia's largest businesses. While returning capital to shareholders certainly pleases those with a desire for steady and sustainable income streams, **one might question whether the pedestal on which the importance of dividends has been elevated in Australia corporate boardrooms has ultimately resulted in a**

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[1] The top five largest business in the US in 2007, for example, were Exxon Mobil, General Electric, AT&T, Microsoft and Citi. Ten years later, only Microsoft remained in the top five, the incumbents replaced by Apple, Facebook, Amazon and Google/Alphabet. Through the same ten-year period in Australia, the top five companies by index weight in 2007 – BHP, CBA, NAB, ANZ and Westpac – were the exact same companies representing the top five a decade later.

number of missed opportunities for Australian companies to reinvest capital into longer—term growth initiatives in the quest to substantially grow overall shareholder returns.

While CSL has provided a sound example this month of the benefits of investment in continued innovation and careful allocation of capital, the irony that its elevation has occurred at the same time as dividend-machine and superannuant favourite **Telstra's** declined -12% this month has not been lost. From fairly lofty heights, the business has now slipped to become the tenth largest business in Australia, following a disappointing trading update provided for their 3Q.

While the cause of Telstra's difficulties are certainly varied, one could argue that the long-term protection of a near-sacrosanct dividend for so many years may ultimately have contributed to its current position. With a shareholder register dominated by yield-seeking superannuants (as at the 2017 Annual General Report, 44% of Telstra's shareholders held less than 100,000 shares), the business had committed to providing shareholders with a regular and forecastable dividend stream, which most likely has come at a cost to internal R&D and capex budgets over the years. Telecommunications is typically a capex-heavy industry and one that is often subject to a high level of motivated competition – this would typically require businesses within the sector to recycle profits back into innovation and growth initiatives in order to ensure the business remains competitive and at the front of the technology curve. This obviously becomes a difficult proposition for a business that has built a shareholder base on the expectation that a large degree of profits will be returned each year in the form of fully-franked dividends.

Even after recently adjusting its dividend policy, maintaining the guided 22cps dividend return for FY18 for the next four years will still require the business to return in excess of ~85% of its underlying earnings to shareholders, which may still leave little in the tin for future growth initiatives. The business now finds itself in the unenviable position of underperforming from an earnings perspective, while increasingly exposed to rising competitive threats and now potentially requiring a cut to the dividend to fund future growth.

The key takeaway here is investors should not be afraid to back management in reinvesting capital into a business when total shareholder returns will benefit from this initiative over the longer-term. Larger-cap US companies have for some time enjoyed the substantial competitive advantage provided by having a supportive shareholder base willing to delay dividends or cash profits in the quest for material growth (and the substantial uplift in equity value that this has often created). US retail behemoth Amazon provides the most obvious example – in February, the business reported quarterly profit of US$1.86bn for the fourth quarter of 2017, despite generating revenues of over US$60bn. For a sense of how patient shareholders have been, the US$1.86bn generated by the company in the fourth quarter is more than the entire *cumulative* profits generated by the company over the 58 previous quarters since the company's IPO in May 1997.[2]

While Amazon is an extreme case, it has been pleasing to see growing shareholder support toward managers of higher-growth Australian businesses in the Australian small and mid-cap space, allowing them the flexibility to aggressively reinvest back into their business over the pursuit of near-term cash profits. We recently discussed fintech businesses **Xero (XRO)** and **Pushpay (PPH)** as two examples of businesses that have provided shareholders with a substantial return on this support (you can read this here), while data centre provider **NextDC (NXT)**, payment platform company **Afterpay Touch (APT)** and aerial imaging business **Nearmap (NEA)** all provide similar examples of businesses reinvesting capital into the business to ensure significant future growth paths.

[2] While it has taken 14 years to even get to that point, total shareholder returns have been obviously incredible – for anyone with the gumption to invest US$10,000 at the IPO and hold on to today would be holding an investment north of US$4.9m in the company.This feat would have proven an incredible exercise in patience, however - in 16 of the past 20 years, the share price of Amazon has experienced price declines intra-year of more than 20% from high to lows, while investors would also have needed to retain considerable faith in the fortunes of an online book store that had lost -95% of its value in the midst of the dot-com collapse in the 2000s.

This isn't a view, however, that businesses with the want or ability to pay dividends should not be avoided – rather, it is our view investors should be prepared to support high quality managers that are desirous of reinvesting their capital into value-accretive initiatives that will meaningfully benefit the business over the long term, rather than demanding the shorter-term 'sugar hit' of capital returns. Ultimately, when it comes to capital management initiatives, **the businesses we find most attractive in our own investment universe are those that already have an embedded optionality of accrued cash** – in our experience, favourable situations tend to arise in businesses where balance sheets are unconstrained, free cash flow is improving and managers are provided with the flexibility to either deploy that capital into accretive opportunities or return it to shareholders.

Network services provider **Service Stream (SSM)**, for example, is a largely people-based business that we currently own in the Ophir Opportunities Fund that provides sub-contracting installation services to larger telecommunication, gas and electricity companies. With fairly minimal ongoing capex requirements for the business near-term, the company currently pays out half its earnings per share as dividends to shareholders (providing an approximate ~4% dividend yield at the current share price). With cash flow generation continuing to climb as a result of increased earnings and improving working capital – the business has increased its cash balance every half since 2015 – the company now sits on an accumulated cash balance in the vicinity of $60m.

While we were initially drawn to the business due to the fairly material growth opportunity ahead of the company in providing installation and often misunderstood maintenance services for the national NBN rollout, the capital position provides an additional attractive set of outcomes for us as shareholders. Ultimately, we are now in a position to benefit from management either choosing to deploy that capital toward an accretive acquisition or take advantage of an increased dividend payout or capital return should the leadership team feel no suitable opportunities exist (the business paid a 5cps capital return in FY16). In the meantime, we are paid an ongoing 4% dividend yield to hold a business with a still-considerable runway of growth opportunities ahead of it, strong balance sheet and highly capable management team.

Bedding and homewares retailer **Adairs (ADH)** provides another interesting case in point – the business has progressively de-levered its balance sheet since floating in June 2015 with a debt position that made up approximately 1.1x the company's earnings before interest, tax, depreciation and amortisation (EBITDA). Through accelerating free cash flow, the outstanding debt now represents just 0.3x EBITDA, while the company's capex requirements for store fit-outs has materially reduced in recent times as a result of shopping mall owners now funding a greater proportion of this expense due to the more difficult environment in attracting tenants.

Similar to the Service Stream example, the business is now in the attractive position of seeing increasing cash generation while organically growing earnings, which provides management with the optionality to either deploy that additional capital into new growth initiatives, or return a greater proportion to shareholders. We hold a great amount of respect for the management team as disciplined capital allocators and are more than happy to collect the ~5% dividend yield at current prices while we wait.

Announcing the 'Hard Close' of the Ophir High Conviction Fund

Earlier this month we communicated to investors our decision to 'hard close' the Ophir High Conviction Fund to all additional investment, effective **Friday 15th June.**

As many would be aware, restricting the size of the capital we manage in each of the Ophir investment funds remains a core pillar of the investment philosophy employed across all the Ophir Funds since the business was started in 2012. In our view, limiting the capacity of the funds managed in each strategy effectively ensures overall investment returns are not impacted by the size of the underlying fund. This is particularly important in investment strategies that focus on identifying emerging small and mid-cap companies.

As a result, we took the decision to close the **Ophir Opportunities Fund** to all additional investment in 2015 (including to staff), with the fund continuing to remain hard closed today. More recently, we announced the soft close of the **Ophir High Conviction Fund** in March this year, thereby restricting all additional investment into the fund to existing unit holders only.

As a result of strong performance from the fund and continued investor inflows, we now feel it is the appropriate time to close off the Ophir High Conviction Fund to all additional investment.

As communicated earlier this month, we will no longer be accepting any additional capital into the Ophir High Conviction Fund – Class A (OPH0002AU) from new or existing investors after Friday 15th June. We greatly appreciate the support that investors have provided us since launching the original Ophir Opportunities Fund in 2012 and are continually grateful of having attracted an investor base that shares our views on limiting capacity.

The Ophir High Conviction Fund was launched in 2015 as a 'best ideas' extension strategy, aimed at providing investors with a concentrated exposure to a portfolio of high quality companies listed outside the ASX 50. The Fund has delivered +26.6% per annum net of all fees since its inception and we very much look forward to ensuring we can continue to provide the best possible structure to deliver continued long term performance over the years ahead.

The Ophir Funds – Gross Return of $100,000 Since Inception

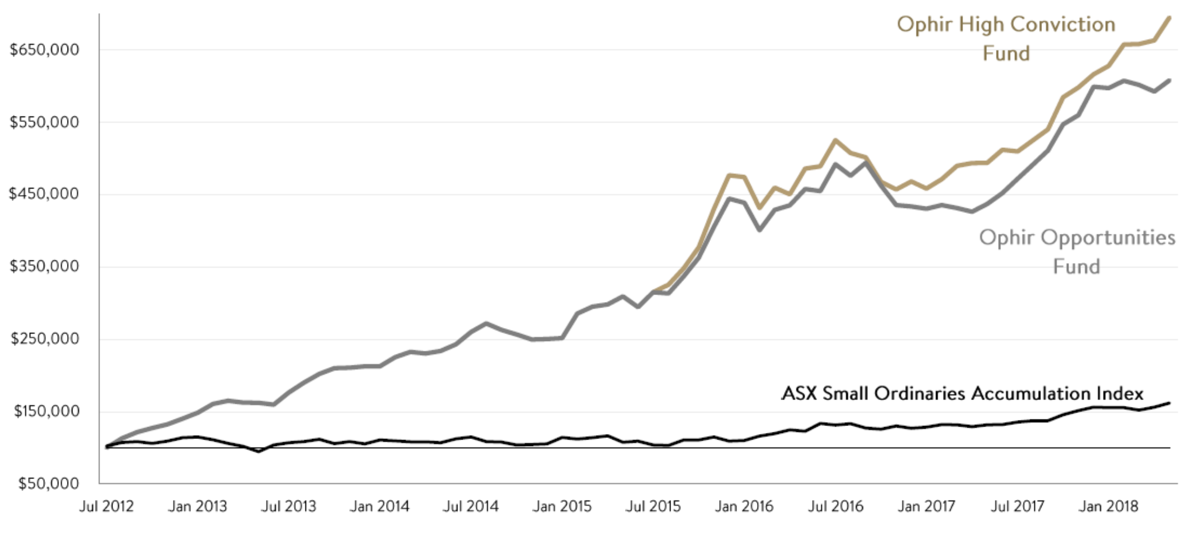


Chart above represents gross value of $100,000 invested since inception in the Ophir Opportunities Fund from August 2012. The Ophir High Conviction Fund has been added to illustrate the comparative performance of the fund assuming equal investment amounts in the Opportunities Fund at its inception date in August 2015. Past performance is not a reliable indicator of future performance.

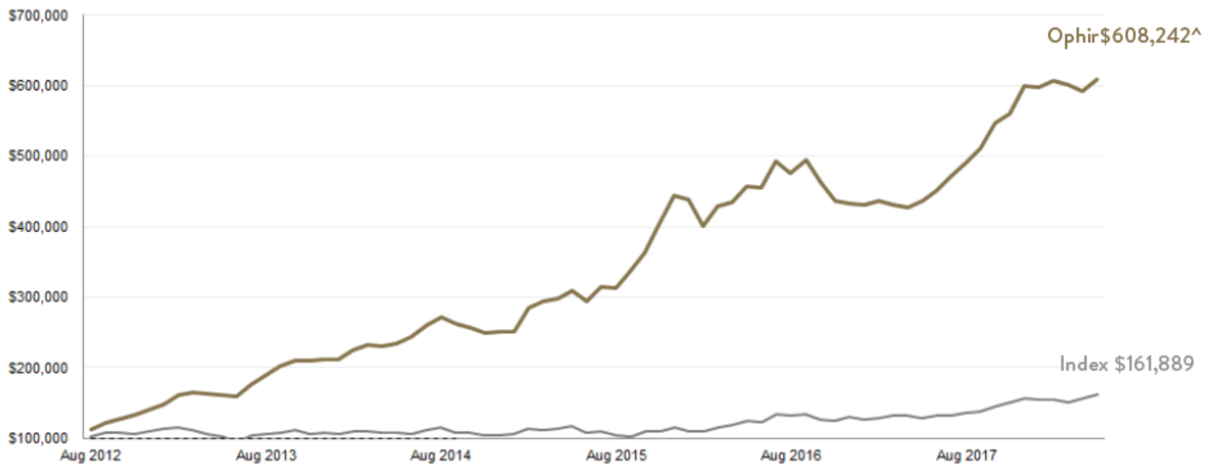
As always, thank you for entrusting your capital with us.

Kindest regards,

Andrew Mitchell & Steven Ng
Co-Founders & Portfolio Managers
Ophir Asset Management

The Ophir Opportunities Fund

Growth of A$100,000 (pre all fees) since Inception



* Chart represents gross value of $100,000 invested since inception and assumes dividends reinvested. Please note past performance is not a reliable indicator of future performance.

The **Ophir Opportunities Fund** returned +2.6% for the month, underperforming the benchmark by 1.1%. Since inception, the Fund has returned +508.2%, outperforming the benchmark by 446.4%.

	1 Month	1 Year	5 Year (p.a.)	Inception (p.a.)	Since Inception
Ophir Opportunities Fund (Gross)	2.6%	39.0%	30.2%p.a.	36.3%p.a.	508.2%
Benchmark*	3.7%	25.4%	9.7%p.a.	8.6%p.a.	61.9%
Gross Value Add	(1.1%)	13.6%	20.5%p.a.	27.7%p.a.	446.4%
Net Fund Return	2.5%	37.2%	24.1%p.a.	28.6%p.a.	333.6%

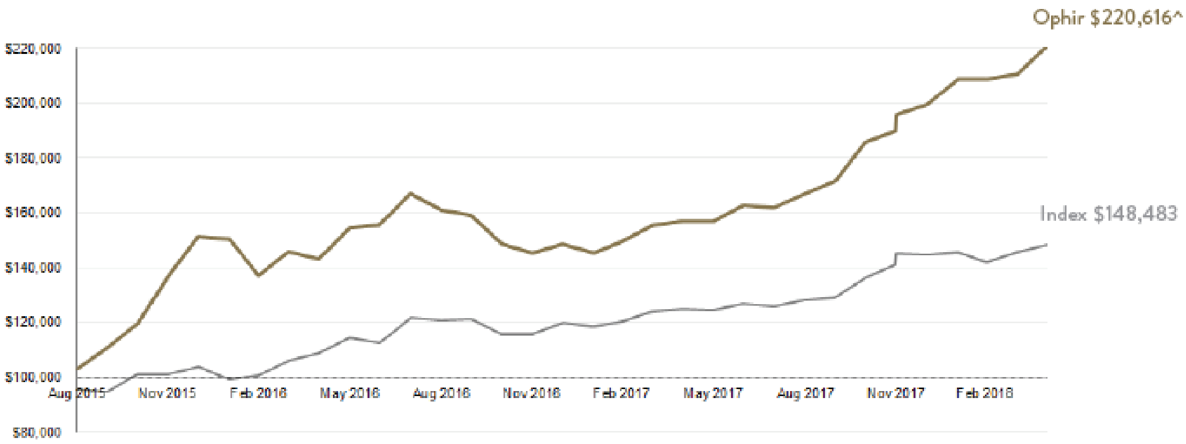
* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	Buy Price	Mid Price	Exit Price
May 2018 Unit Price – Opportunities Fund	2.8438	2.8339	2.8240

Key contributors to the Opportunities Fund performance this month included **Afterpay Touch (APT), Pinnacle Investment Management Group (PNI)** and **Lovisa Holdings Ltd (LOV).** Key detractors included **Integrated Research Limited (IRI), Maca Ltd (MLD)** and **RCR Tomlinson Limited (RCR).**

The Ophir High Conviction Fund

Growth of A$100,000 (pre all fees) since Inception



* Chart represents gross value of $100,000 invested since inception and assumes dividends reinvested.
Please note past performance is not a reliable indicator of future performance.

The **Ophir High Conviction Fund** returned +4.8% for the month, outperforming the benchmark by 2.9%. Since inception, the Fund has returned +120.6%, outperforming the benchmark by 72.1%.

	1 Month	1 Year	2 Year(p.a.)	Inception (p.a.)	Since Inception
Ophir High Conviction Fund (Gross)	4.8%	40.7%	19.6%p.a.	32.3%p.a.	120.6%
Benchmark*	1.9%	19.5%	4.6%p.a.	15.0%p.a.	48.5%
Gross Value Add	2.9%	21.2%	15.0%p.a.	17.3%p.a.	72.1%
Net Fund Return	4.1%	36.7%	17.0%p.a.	26.3%p.a.	93.4%

* 50% S&P/ASX Small Ordinaries Accumulation Index (XSOAI), 50% S&P/ASX Midcap 50 Accumulation Index (XMDAI)

	Buy Price	Mid Price	Exit Price
31 May 2018 Unit Price – High Conviction Fund	1.9249	1.9191	1.9134

Key contributors to the High Conviction Fund performance this month included **Afterpay Touch (APT), Challenger Ltd (CGF)** and **IDP Education Ltd (IEL).** Key detractors included **The A2 Milk Company Ltd (A2M), Ausdrill Limited (ASL)** and **RCR Tomlinson Limited (RCR).**