OPHIR
ASSET MANAGEMENT

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Dear Fellow Investors,

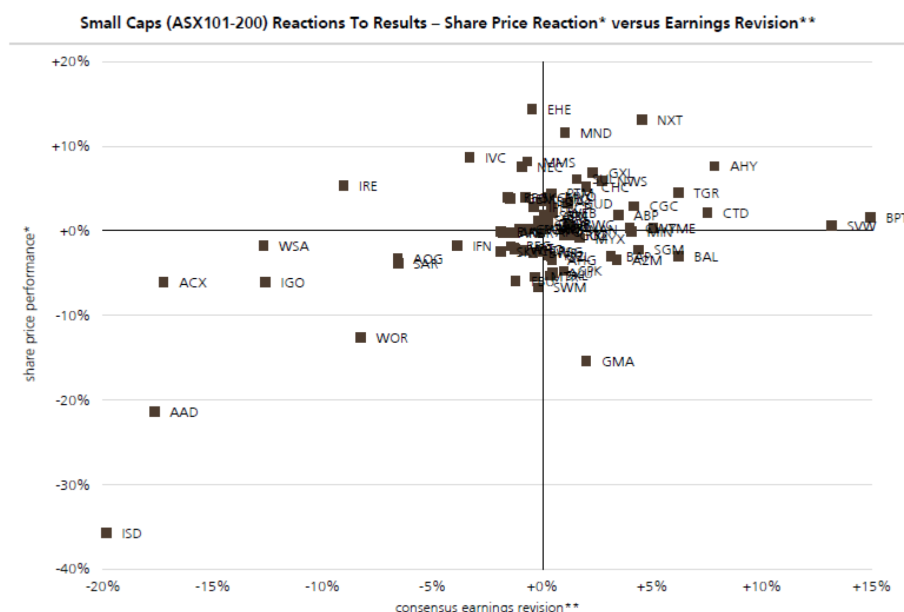
Welcome to the **February 2017** Ophir Letter to Investors – thank you for investing alongside us for the long term.

Month in Review

There is an iconic scene from the 1999 movie *Braveheart* when Mel Gibson's character William Wallace stoically commands his Scottish warriors to hold their defensive positions in the face of a charging English cavalry division – perhaps investors in the small and mid-cap growth space in recent months could identify with the scene. While we make the reference with tongue firmly in cheek, the months leading into the February 2017 reporting season certainly required investors across the small and mid-cap space to equally hold their nerve.

As a broad summary, the reporting season itself proved highly stock-specific and delivered a fairly wide divergence of results, both across sectors and within them. This was a true stockpickers reporting period, where the bulk of performance came from not only owning the right businesses, but avoiding those names that were unable to deliver on expectations.

We'll dive into some more detail in the Strategy Notes of this month's letter, however, as a whole we were broadly pleased with the performance of both Ophir Funds this month. Across the portfolio's we held 16 stocks that materially beat market expectations and one that missed – not a bad hit rate given the mixed nature of the results delivered. These 'theme-agnostic' type reporting seasons tend to favour investment managers that employ fundamental, bottom-up analysis and we were encouraged that our own investment process has continued to deliver in terms of our earnings forecasting ability.



Source: Factset

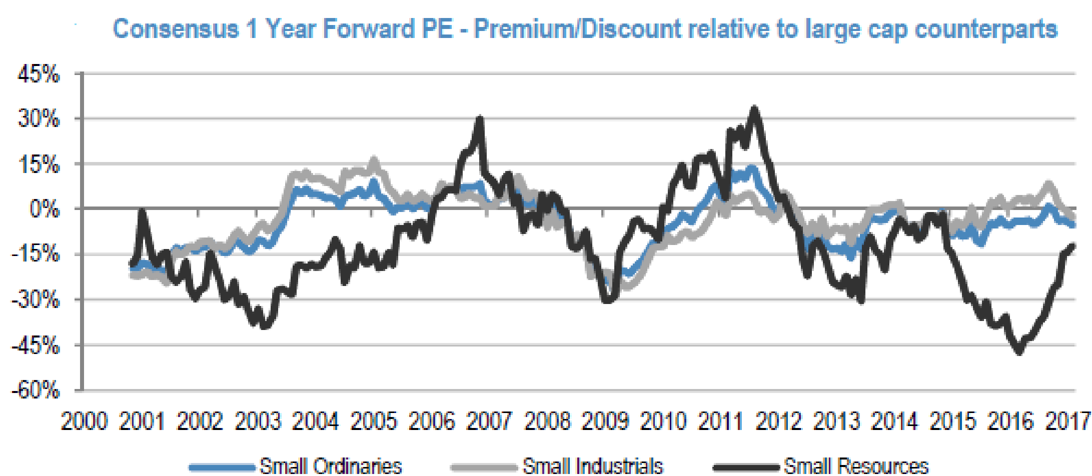
The chart above looks at companies in the ASX 100-200 in terms of share price reaction in relation to their announced earnings revision. As a general perspective, businesses that delivered results ahead of market expectations were well rewarded (top right quadrant), whereas those that underwhelmed were sold off (bottom left). At face value this would seem like a fairly obvious outcome, however, there were some subtleties in the post-results trading this month that in our view points to a broadly more optimistic outlook.

Internally, we often talk about businesses being allowed to 'grow into their multiple'. At a very basic level, equity market investors attempt to forecast an earnings stream from a business and then value that business by applying an appropriate multiple to those earnings. Through 2014 to mid-2016, high quality and high growth businesses in the small and mid-cap space attracted higher multiples as the market was prepared to pay a higher price for those earnings (given there remained little other options available in a low-growth economy). With high multiples comes high expectations and, as a consequence, these businesses typically needed to continue to upgrade earnings to maintain their share price momentum and valuations.

This creates trading outcomes like last year where companies would deliver earnings in-line with market estimates yet subsequently see their equity valuations decrease. The resultant sell-off is known as multiple compression (i.e. the market is no longer willing to pay the same multiple for the same earnings stream) and has been a key driver of the underperformance of the Small Ords versus their larger counterparts in recent months.

In contrast, the results season this month broadly generated share price reactions more in line with what one would normally expect – businesses that beat consensus estimates by 5-10% generally grew in share price by a similar amount, essentially implying **the market now seems more comfortable with where valuations currently sit.** Most encouraging is a lot of these moves were across the growth type names that had previously come under pressure.

This isn't an exact science and admittedly there were a number of outliers – however we generally consider it positive for future fund performance when we see the market allowing good quality businesses to grow into their multiples. These periods of consolidation tend to set the business up for the next re-rate, be it from an earnings upgrade, acquisition or subsequent multiple expansion and ultimately provides us as investors with two bites of the investment cherry - the initial earnings upgrade and the subsequent multiple expansion.



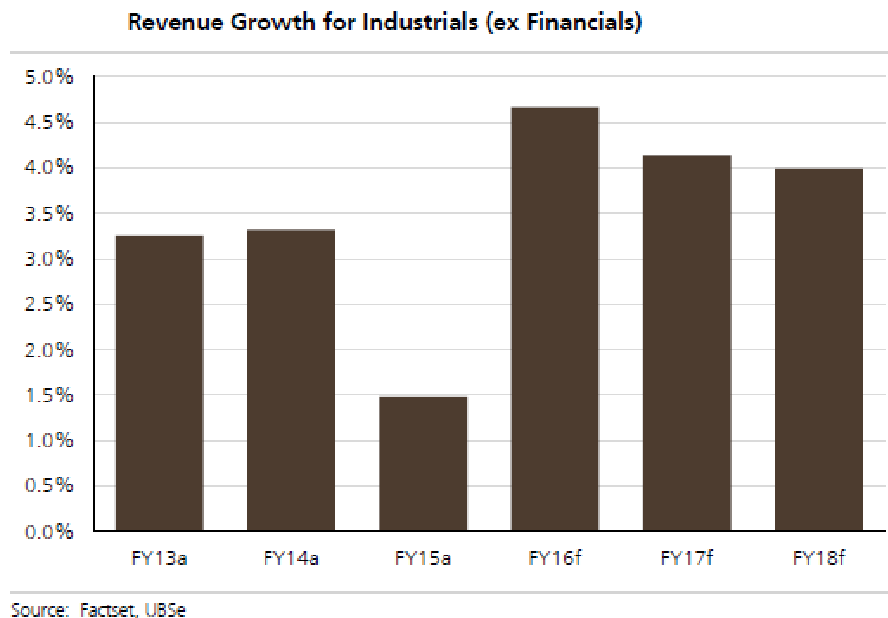
Source: JP Morgan

If we look across to the larger end of town, one could argue a number of those businesses could now be facing a period not dissimilar to where small caps were last year: the ASX 200 headline earnings per share (EPS) growth looks set to wash-out somewhere around the +19% level, which is a remarkable uplift from the -9% delivered last year. That number, however, is inclusive of the

booming resources space and if we look at just the Industrial companies within the top 200, the median EPS number falls to around +4% growth (which is below the +6% growth delivered last year).

Cost-out is still helping the profitability of those businesses and if look at the raw top line growth, the numbers fall again – on UBS Investment Research's numbers (chart below), the large cap industrials top line growth (excluding financials) is averaging just +3.3%.

Put another way, **roughly 45% of the ASX 200 index (ex-resources) will not post revenue growth higher than 3%.**

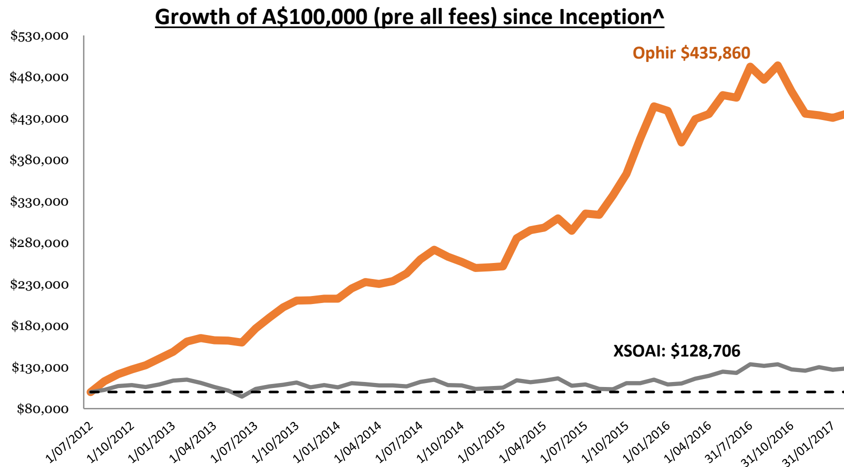


Source: Factset, UBSe

At the same time, the ASX 200 Industrials Index has added ~8% from the start of FY17, taking the Price to Earnings (PE) ratio somewhere around ~18x forward earnings. This would suggest to us that a good degree of the recent outperformance at the larger end of town has come from multiple expansion and in our view we continue to feel there are better opportunities for growth in the small and mid-cap space where valuations have compressed and the growth on offer is arguably higher. For some context, if we use forward consensus forecasts for companies within the Ophir High Conviction Fund (on a portfolio weighted basis, excluding resources), **the portfolio currently offers 10.1% top line growth, 13.7% EPS growth for a FY18 multiple of 16.2x** (vs the ASX 200 Industrials ~18x PE for 3.3% top line and 4% EPS growth).

For the month, the ASX Small Ordinaries finished +1.3%, slightly underperforming the ASX 200's contribution of +1.6% albeit this was a function more of stock specific results than any broader move. Sector performances were broadly mixed, although it was worthwhile noting the under performance of the Materials names (-3.7%) despite being the sector that delivered the majority of the EPS growth.

The Ophir Opportunities Fund



The **Ophir Opportunities Fund** returned +1.2% for the month, underperforming the benchmark by 0.1%. Since inception, the Fund is up +335.9%, outperforming the benchmark by +307.2%.

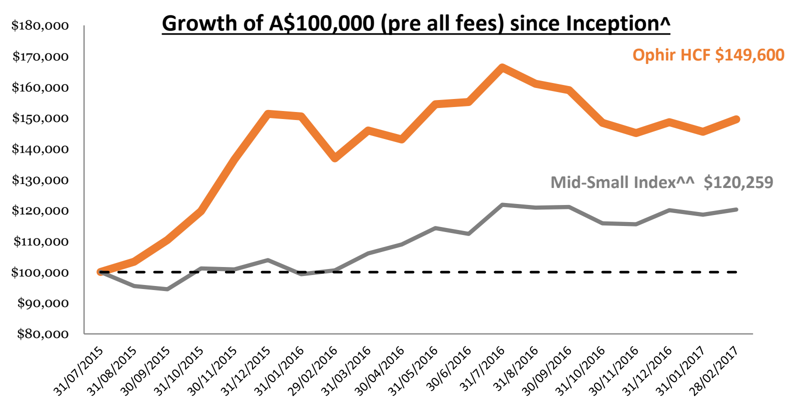
The February 2017 Unit Price is **$2.3778**

	1 Month	6 Months	1 Year	Inception (p.a)	Since Inception
Ophir Opportunities Fund (Gross)	1.2%	-8.5%	8.7%	37.9%	335.9%
Benchmark*	1.3%	-2.1%	16.8%	5.7%	28.7%
Value Added	-0.1%	-6.4%	-8.1%	32.3%	307.2%

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

Key contributors to the Opportunities Fund performance this month included **Mt Gibson Iron (MGX), Costa Group Holdings (CGC) and NextDC (NXT).** Key detractors included **Sundance Energy (SEA), CBL Corporation (CBL) and Galaxy Resources (GXY).**

The Ophir High Conviction Fund



The **Ophir High Conviction Fund** returned +2.8% for the month, outperforming the benchmark by 1.4%. Since inception, the Fund is up +49.6%, outperforming the benchmark by +29.3%.

The February 2017 Unit Price is **$1.3524**

	1 Month	6 Months	1 Year	Inception (p.a)	Since Inception
Ophir High Conviction Fund (Gross)	2.8%	-7.1%	9.2%	29.1%	49.6%
Benchmark*	1.4%	-0.5%	19.6%	12.4%	20.3%
Value Added	1.4%	-6.6%	-10.4%	16.7%	29.3%

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

Key contributors to the High Conviction Fund performance this month included **Mayne Pharma (MYX), Costa Group Holdings (CGC)** and **NextDC (NXT).** Key detractors included **CBL Corporation (CBL), Mineral Resources (MIN)** and **Credit Corp (CCP).**

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