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OPHIR

Letter to Investors - October 2024

From Andrew Mitchell and Steven Ng
Founders and Senior Portfolio Managers

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Dear Fellow Investor,

In this month's Letter to Investors, we discuss the composition of the recent performance in our global funds. Pleasingly this has been largely driven by stock picking, with the valuation differential between small caps and large caps remaining at extreme levels.

We also talk through the timeline of our investment in Stride (NYSE:LRN), a provider of online education solutions for homeschooled students from K-12 in the U.S. Viewed as a "COVID winner", Stride had fallen from it's 2020 highs of over US$50 to US$20 in January 2021. This is when we initiated our position as we identified this as a structurally growing industry that would more than offset the impact of the return to school. More recently this company was the target of a short report, but we did the work and when the results were reported in October, we were proven right.

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Performance Update

Before we jump into the Letter, we have included below a summary of the performance of the Ophir Funds during October. Please click on the factsheets below if you would like a more detailed summary of fund performance:

The Ophir Opportunities Fund returned +5.1% net of fees in October, outperforming its benchmark which returned +0.8%, and has delivered investors +22.9% p.a. post fees since inception (August 2012).

Download Factsheet

The Ophir High Conviction Fund (ASX:OPH) investment portfolio returned +3.7% net of fees in October, outperforming its benchmark which returned -0.8%, and has delivered investors +13.6% p.a. post fees since inception (August 2015). ASX:OPH provided a total return of +0.0% for the month.

Download Factsheet

The Ophir Global Opportunities Fund returned +3.4% net of fees in October, outperforming its benchmark which returned 3.1%, and has delivered investors +15.9% p.a. post fees since inception (October 2018).

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The Ophir Global High Conviction Fund (Class A) returned +3.3% net of fees in October, outperforming its benchmark which returned 3.1%, and has delivered investors +10.7% p.a. post fees since inception (September 2020).

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The Ophir Global High Conviction Fund (Class B) returned +3.2% net of fees in October, outperforming its benchmark which returned 3.1%, and has delivered investors +21.3% p.a. post fees since inception (June 2023).

Download Factsheet

No one else wanted to look here, but we found a bargain

After a hot streak of five months, the global share market took a breather in October. The MSCI World Index (in USD) fell -2.0%; the S&P500 got off a little lighter, down -0.9%. It was a surge in the U.S. 10-year Treasury bond yield, which rocketed up +0.5% in the month to 4.3%, that weighed on share market valuations across the world.

Not only did long-term interest rates in the U.S. move sharply higher over the month, but so too did expectations for short-term rates. Only four 0.25% Fed cuts are now expected this cycle (at writing), down from eight 0.25% expected at the start of October.

Why such a sharp move higher in short and long-term interest rates in the U.S.? In short there are two key reasons:

1. U.S. economic data has continued to surprise on the upside. The unemployment rate has dropped back to 4.1%; inflation has continued to moderate back towards the Fed's 2% target; and real GDP growth is running above trend at just a shade under 3%.

2. In October polls showed momentum was swinging towards Donald Trump and a Republican win in the November U.S. election (which, unless you've been hiding under a rock has subsequently been proven right with a big win earlier this month). Trump's policy platform of tariffs, reduced immigration and tax cuts are all inflationary, so markets started pricing in higher rates. The day after the election, November 6, when it was clear Trump had won, the U.S. 10-year jumped 0.16%. Most of this rise came from higher inflation expectations (10-year breakeven inflation expectations).

A natural hedge

For Australians invested in unhedged global shares (such as those in Ophir Global Funds), October's pullback in global share markets, and more specifically the U.S. share market, was totally offset by a big fall in the Aussie Dollar versus the U.S. Dollar.

The benchmark for our Global Funds, the MSCI World SMID Cap Index posted a negative total return of -2.6% in October. But when converted to $AUD, it rose +3.1%.

Being unhedged for your global shares is usually a positive for Australian investors during declining markets. When global shares fall, the Australian Dollar often (though not always) also falls.

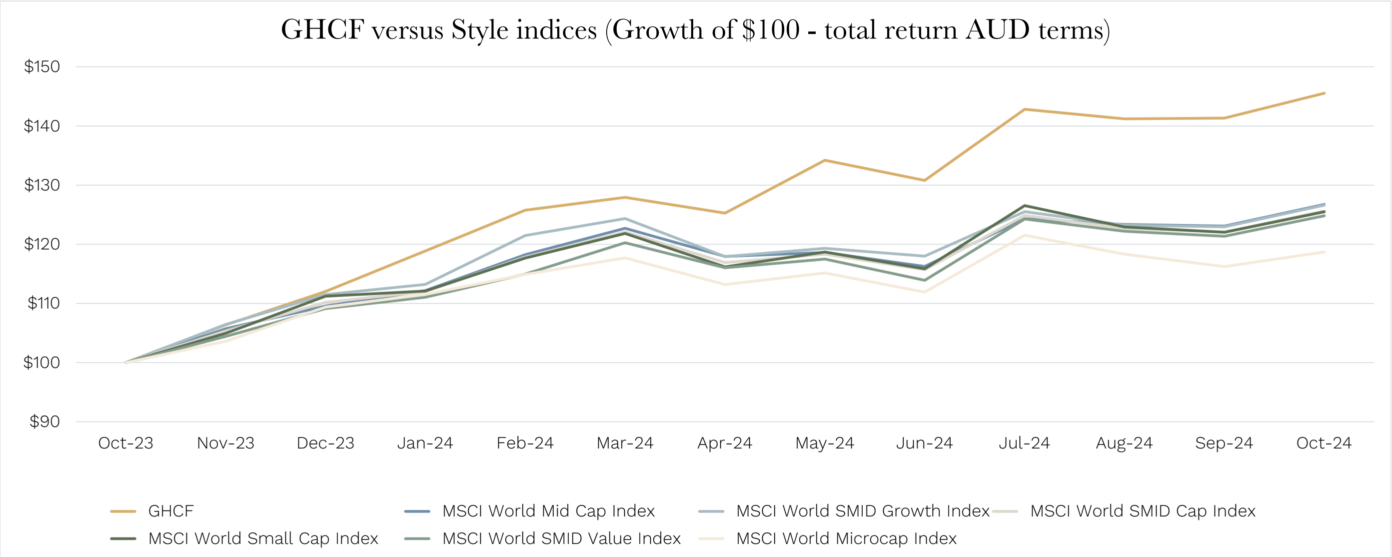
Two charts you should know about

Before we get into our stock in focus for the month, we wanted to highlight two quick charts we think you should know:

1. Ophir Global Funds: A strong year driven by stock picking

The Ophir Global Opportunities Fund and the Ophir Global High Conviction Fund had a tough late 2021 and early 2022 when interest rates ripped higher and small-cap growth valuations got torched. But over the last year their performance has surged. While their benchmark, the MSCI World SMID Cap Index NR (AUD), was up about 26% in the last 12 months to the end of October, both Funds were up about 46% That's about 20% outperformance!

So what drove that outperformance?



Source: Ophir & Bloomberg. Data as of 31 October 2024.

In the chart above we show how $100 invested a year ago into the Ophir Global High Conviction Fund has grown versus the same investment into our official benchmark. We've also included different size (mid, SMID, small, micro) and style (growth & value) indices.

It's clear that the last year's outperformance was not due to size factors – as you can see mid, SMID and small caps all performed similarly and were lagged by microcaps. Growth and Value styles of investing also provided very similar results.

So Ophir's small-cap growth company bias didn't generate the outperformance.

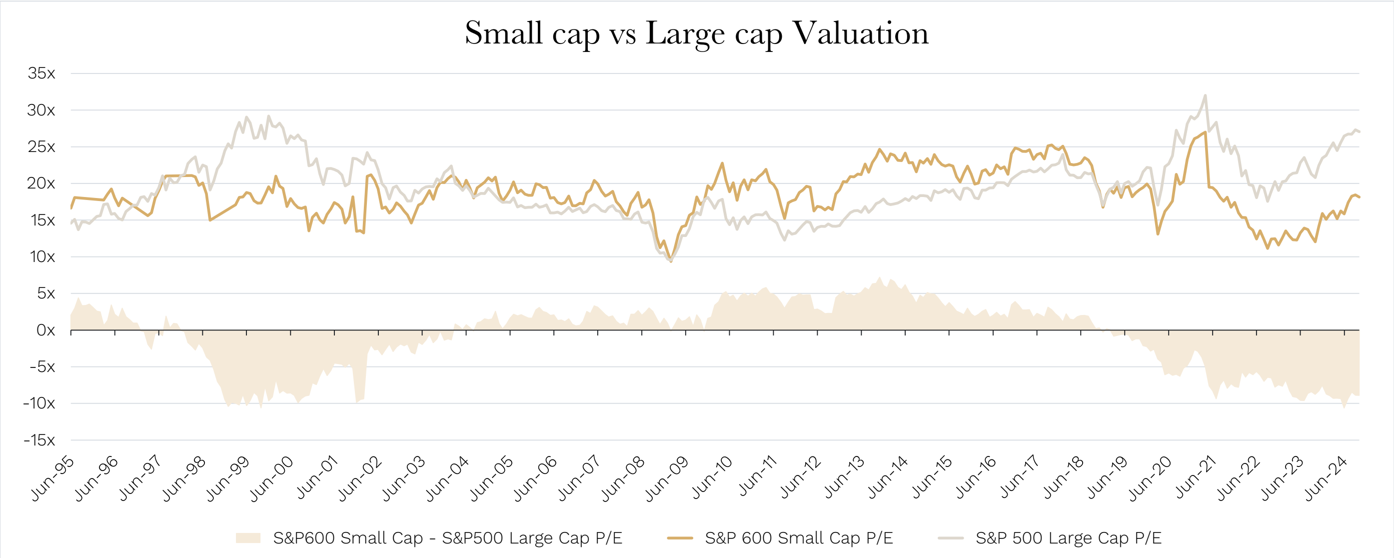
What was it then?

It was good old-fashioned stock picking.

All the top contributors to performance beat the markets expectations on their earnings results and raised guidance for future results. That's exactly what our investment process targets and that – rather than size or style – is the most sustainable form of outperformance for our funds.

2. The valuation 'catch up' still hasn't happened

Some investors might have been wondering if the Ophir Global Funds' strong performance over the last year was because small-cap valuations simply caught up with the stocks that have led this bull market since 2022 – ie. large caps and the Magnificent 7?



Source: Ophir and Bloomberg. Data to 31 October 2024.

But as you can see in the chart above, both small (gold line) and large (grey line) caps have both benefited from valuations (here price to earnings ratios) increasing. Yet the gap (shaded area) has not closed.

So, it's still highly likely there is a period ahead in the next five years where small caps will catch up and outperform large caps due to their much cheaper starting valuations.

On a relative basis, small caps are the cheapest they have been in a quarter century and to us they represent a once in a generation relative opportunity to large caps. This year's strong performance in the Ophir Global Funds has not changed that.

Stride: The company no fundie wanted to see

In January 2021 vaccines were rolling out, people were starting to travel again; and the share market had flipped back from 'stay at home' stocks to the 're-opening trade'. That was when we attended the Needham Growth Conference in New York and found one of our best stocks of the last few years.

The Needham Conference is one of the biggest small-cap investment conferences. Fund managers were lining up to meet the management of companies primed to capitalise on the tidal wave of services spending as consumers emerged from hibernation.

So, what did we do? We asked the conference organisers: "*What are the companies at the conference with the least requested number of meetings by fundies?*"

The company that no one wanted to see was Stride (NYSE:LRN). Stride provides online education solutions to kindergarten through Year 12 students in the U.S. and their solutions are used in the classroom. But originally and still, they are used by students homeschooled for various reasons including bullying, parental preferences; even for child actors.

When we were all going to 'work from home' during COVID, students were going to 'learn from home'. Stride's share price rocketed from around US$20 to over US$50 between March and August 2020 as demand, and expectations of demand, for their products and services ballooned.

But by January 2021, the time of the Needham Conference, the balloon had popped. As students returned to school, investors thought there'd be no durable increase in demand, so Stride's share price returned to US$20. In any case, fundies had turned their attention elsewhere.

What we found when we decided to dance with the 'wallflower' Stride

Stride was the proverbial 'wallflower' at the prom. But we decided to dance with Stride and we found:

- A company structurally benefitting from increasing adoption of virtual schooling more generally (despite schools having been reopened), which could lead to sustained growth in a market in which Stride was a leader.
- Defensive revenue growth of 8-10% revenue, underpinned by state government budgets that fund the 70 schools across 35 US states in which Stride had solutions.
- This was flowing through at high incremental profit margins, driving what we expected would be 20%+ earnings growth.
- A depressed EV/EBITDA (Enterprise Value to Earnings Before Interest Tax Depreciation and Amortisation) valuation multiple of just 5x.

Of course, we never just take what the company says at face value, so we got to work. We checked data around individual school's login traffic; called enrolment centres for intel, including the number of open enrolment applications; spoke to public and private school peers around market share changes; and spoke with school district budget allocators to ensure funding was rock solid.

We initially bought Stride later in January 2021 between US$22-25. And we have held ever since, building our conviction and knowledge around the business.

And boy has it delivered. From financial year 2020 through to 2024 it has:

1. Doubled revenue from US$1.04 billion to US$2.04 billion
2. Improved EBITDA margins from 11% to over 18%, and
3. 10x'ed profit from US$24.5 million to US$240 million (12 months to Sept 2024)

Fuzzy Panda tests our conviction

But then last month our conviction was really tested.

Fuzzy Panda (FP) – no not a Sesame Street character, but a well-known short-selling organisation – released a report on the 16th October dubbing Stride "the last COVID over earner".

The stock tanked over -9% on the day, but Stride was down -24% if you include the falls leading up to the report, when FP was clearly putting on their short position.

FP was essentially claiming that Stride was a big beneficiary of the US$190 billion in Federal emergency relief funding program for U.S. schools during COVID. The funding was ending in September 2024 and FP warned Stride's profits were about to "fall off a COVID cliff.

Australian investors in ASX listed companies probably aren't that used to "short reports" as they're not that prevalent domestically. However, they are big business in the U.S. and par for the course if you've been investing there long enough. The playbook is simple.

Take a short position, put out a scary short report questioning the company's profits, many investors shoot first dumping the stock (regardless of the merits of the short report), the shorter closes the short by buying back the stock at the now lower price, pocketing a tidy profit. Sometimes there is merit to the short report, sometimes it's just hot air.

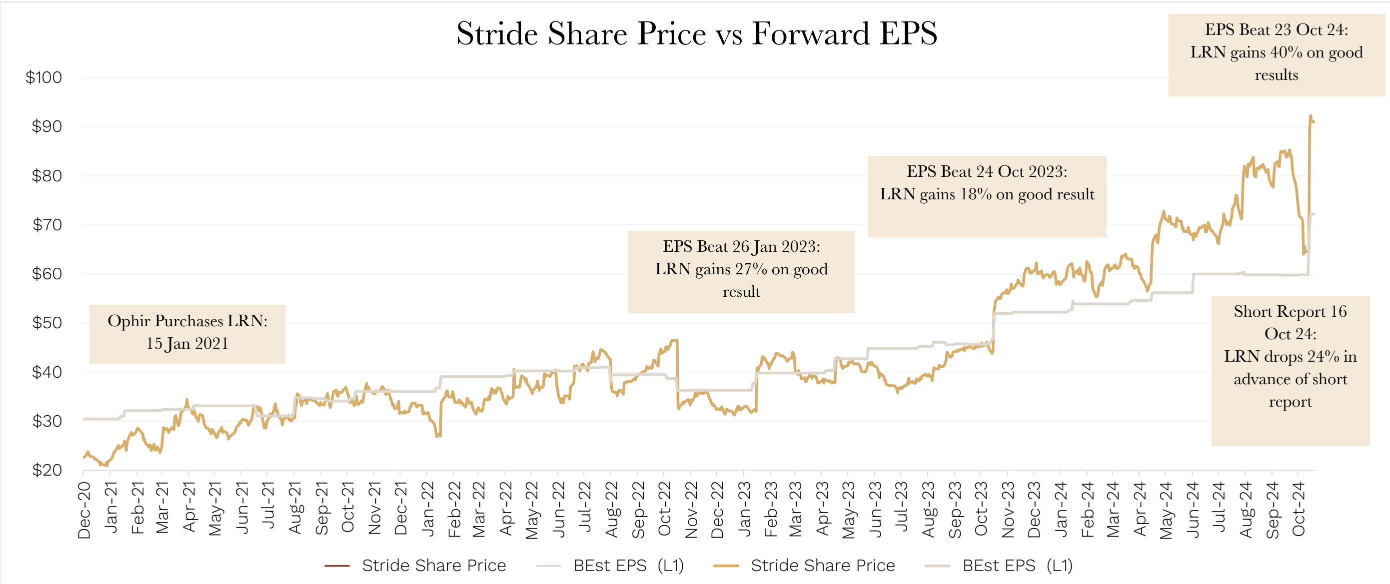
Over the last three years we have owned the stock we have spoken with Stride's management on multiple occasions each quarter. We have found them diligent, trustworthy and conservative.

But we also did more work.

We already knew from the publicly available individual school budgets that the federal COVID funding was used to offset funding from the states during COVID. But we also went through the corresponding publicly available state budgets in detail that showed the states were increasing their education spend to offset the federal grant funding that was ceasing. So, this gave us comfort there was no big looming funding shortfall from state schools for Stride's offering. This gave us the conviction to hold through the short report.

When Stride reported its September quarter results aftermarket on the 22nd of October, it blew the market's expectations away. both at a revenue and profit level.

The next trading day the stock popped around +40%!



Source: Ophir & Bloomberg. Data as of 31 October 2024.

The future of Stride

So where to next for Stride?

Even though they are the largest online education provider in the U.S. by enrolment, they are still very underpenetrated across schools. They can also fuel growth by entering or expanding into education verticals including:

1. **Experiential learning**: Through extended, augmented and virtual reality modes; AI voice and chat learning software; and games and simulation teaching solutions.

2. **Learning support**: Building out their tutoring business which we think could add 30-40%+ to today's earnings over the medium to longer term, given their existing relationships with students and teachers.

3. **Workforce and talent development and acquisition**: Providing certifications to the increasing number of US high school leavers who are shunning four-year college degrees and opting instead to directly enter jobs. Stride already owns a business called Tallo, which connects students from Stride-powered schools to opportunities (the Tallo app has 1.7million users already!).

A long career ahead

Today, Stride is still growing earnings at 20%+. That's two to three times the market's growth. Yet it operates in a defensive end market with a large share of its revenues underpinned by state government education budgets. It's a great all-weather stock.

But its valuation is lower than the market. Stride trades on a still cheap 13x price to earnings ratio. Most of the share price move since we have owned has actually been driven by earnings growth and not valuation expansion. We think it could still be a 20x P/E business.

So while it's been a great performer for our Funds, we still think there is a long 'career' ahead for Stride.

...**the hard work pays off**

It would have been easy to crack during the Fuzzy Panda short drama and sell Stride.

The only way to know whether to 'keep the faith' or to 'fold' is to put in the work and back yourself. It won't always work out on your side, but if you go the extra mile, it will more often than not.

We are proud of the team and the work they have done which allowed us to keep our conviction in Stride.

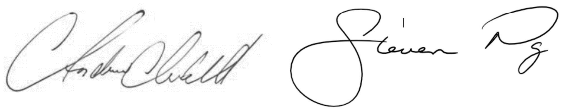
We're also glad we took that meeting that no one else wanted back in 2021!

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

Kindest regards,

Andrew Mitchell and Steven Ng

Founders and Senior Portfolio Managers
Ophir Asset Management



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