OPHIR

Ophir Asset Management
Level 26, Governor Phillip Tower
One Farrer Place
SYDNEY NSW 2000

Dear Fellow Investors,

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

Month in Review

While share markets across the majority of the world's developed economies powered ahead in September, the Australian equity market instead handed back the bulk of its recent relative global outperformance and assumed its more regular role of global laggard. Weighed down by concerns of a slowing domestic housing outlook and the potential impacts from a bruising Royal Commission into financial services, the Australian market was unable to keep pace with the majority of its North American and European counterparts, **the ASX 200 finishing September -1.3%.**

Indeed, despite a variety of potentially destabilising macroeconomic and political hurdles facing global markets this month (an increasingly hostile US-China trade situation, a rapidly rising crude oil price and a late surge in US long bond yields), the S&P 500 instead recorded a fresh new high through September, while the Japanese Nikkei 225 reached levels not seen since the early 1990's. Quite incredibly, with a +7.7% return recorded for the September quarter, investors in the S&P 500 index have now experienced positive absolute returns from 21 of the past 23 quarters (going back to 2013).

	1 month	6 Months	FYTD	5 year p.a.	Inception p.a.
Ophir Opportunities Fund^	**1.5%**	**10.1%**	**7.0%**	**26.8% p.a.**	**35.9%p.a.**
Benchmark*	(0.4%)	8.9%	1.1%	8.8% p.a.	8.5% p.a.
Value Add (Gross)	1.8%	1.2%	5.9%	18.0% p.a.	27.4% p.a.
Fund Return (Net)	1.1%	9.1%	6.3%	21.5% p.a.	28.5% p.a.

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

	1 month	6 Months	FYTD	2 Year p.a.	Inception p.a.
Ophir High Conviction Fund^	**(2.1%)**	**10.9%**	**4.0%**	**20.6%p.a.**	**30.4% p.a.**
Benchmark*	(0.6%)	9.0%	2.3%	4.0% p.a.	14.7% p.a.
Value Add (Gross)	(1.5%)	2.0%	1.7%	16.6% p.a.	15.7% p.a.
Fund Return (Net)	(1.9%)	10.0%	3.5%	18.1% p.a.	24.9% p.a.

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

While some moderate post-reporting season weakness this month weighed down the performance of the Australian smaller and mid-cap space (the ASX Small Ordinaries Accumulation Index finishing the month -0.4%), **quarterly performances for both Ophir Funds have been pleasing**. Both portfolio's generated net returns in excess of their respective underlying benchmarks, with both Fund's having navigated the August reporting period well.

The Ophir Opportunities Fund generated a net return of +6.29% for the three months to September, outperforming the ASX Small Ordinaries Accumulation Index by 5.2%. On a rolling 12-month basis, the fund has generated +27.56% for investors after all fees, taking the Fund's annualised net return to investors since inception in August 2012 to +28.5% per annum.

Similarly, **the High Conviction Fund finished the quarter well, with the fund generating a net return of +3.4% for the three months to September,** outperforming the ASX Mid-Small Accumulation Index by 1.1% On a rolling 12-month basis, the fund has generated a +31.2% net return to investors, bringing its annualised after fee return to +24.9% per annum since its inception in August 2015.

The Ophir Funds – Net Return to Investors Since Inception

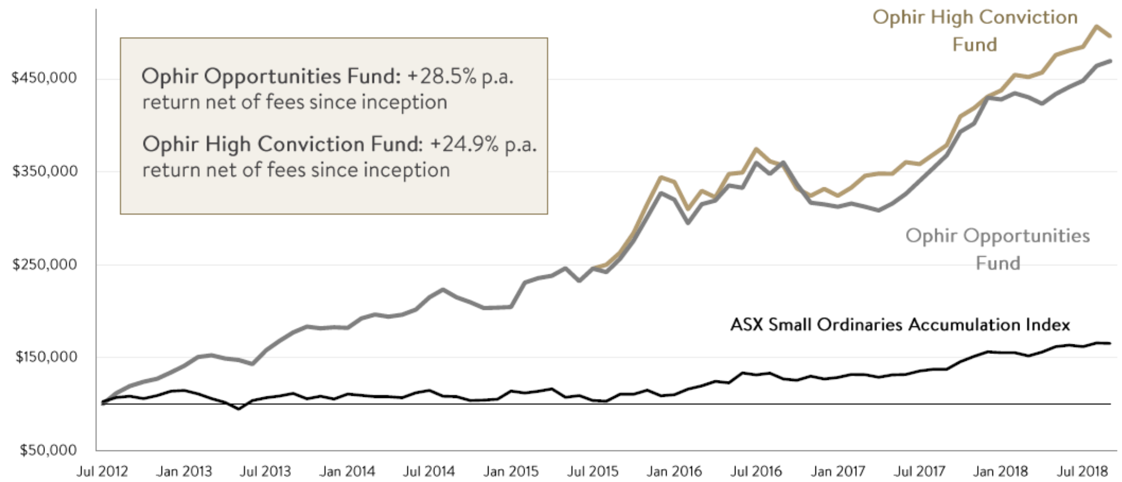


Chart above represents the net return on $100,000 invested since inception in the Ophir Opportunities Fund (August-2012). For graphical purposes, the Ophir High Conviction Fund has been added to illustrate net performance of the Fund assuming an investment of equal size as the Opportunities Fund investment at the fund's inception date (August-2015). Past performance is not an indicator of future performance.

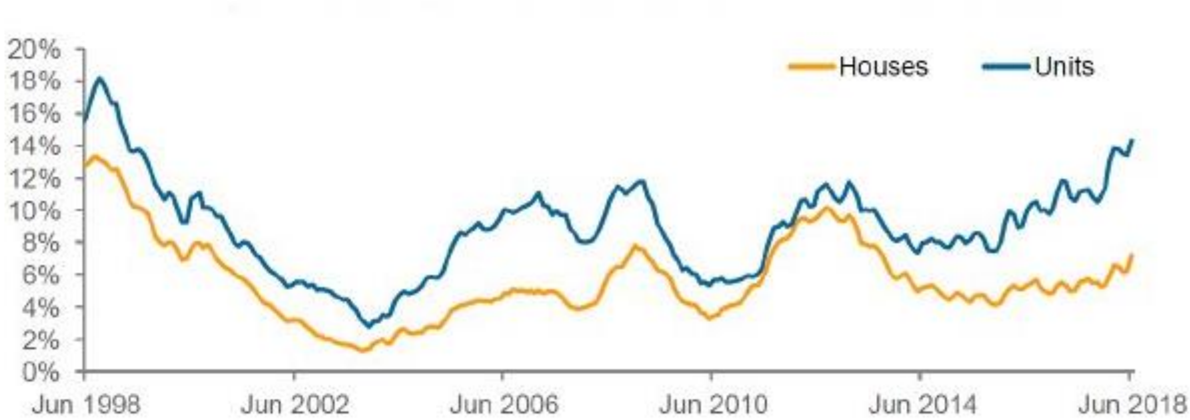
The month of September saw some divergence in performance between the two portfolios, the Opportunities Fund (+1.08% net return for September) benefiting from some broader outperformance experienced this month across businesses further down the market capitalisation curve. In the absence of any significant news flow across the majority its holdings, The High Conviction Fund (-1.85% net return for September) gave back a portion of the strong gains achieved in August, as a number of businesses that had registered strong returns post reporting period saw the impact of some profit taking.

A broadly stronger commodity complex saw businesses exposed to the resources cycle again come into favour this month, although the bulk of the outperformance was achieved across the larger-cap names - the ASX 200 Materials Index finishing the month +4.2%. Across the industrials space, deeper-value and cyclical names proved to be the outperformers this month, as capital rotated away from a number of the recent high-growth/ defensive outperformers and back toward more lower-quality style businesses.

In the absence of any meaningful new fundamental data, **the Australian market had plenty of time to focus on the weakening state of the Australian housing market** and the potential impacts of any meaningful slowdown on the outlook for the Australian economy. Concerns surrounding the state of the domestic real estate market are certainly not new, albeit it is obvious that overall home price growth has slowed recently across the major capital cities, with a number of areas now recording negative price growth year-on-year.

Interestingly, the proportion of apartments in Australian capital cities now being sold at a loss currently sits at its highest level since the late 1990's, as markets are forced to adjust to a new era of tighter credit supply and higher overall levels of apartment inventory.

Proportion of Loss-making Home Resales, Combined Capital Cities (Houses vs Units)



Source: CoreLogice Pain and Gain Report, 2Q18

Residential home construction activity, as a result, has slowed fairly significantly in a short period time, with building approvals data in August identifying a substantial -9.4% fall in August (in the face of initial market expectations for a *gain* of +1.0% month-on-month). The fall in approvals was almost entirely driven by a rapid drop-off in activity across the apartment and multi-dwelling space, with approvals for apartment construction falling -18.4% for the month.

The constant delivery of new apartment stock into the already over-supplied residential markets in Melbourne and Brisbane makes the subsequent downward pressure on home prices across both cities not wholly surprising, however the sudden slowdown in construction activity is noteworthy. In Victoria, for example, approvals for apartment construction fell -35.4% in August alone, with overall apartment construction activity -46.5% on a rolling 12-month basis. A decline in average home values has the obvious potential to place some pressures on a variety of consumer-facing industries (particularly discretionary retail), albeit **anecdotal feedback across our contact network of private and listed retailers has yet to show any signs of meaningful distress**.

This has been reiterated in the official data releases to data, with August retail sales (released in early October) growing +0.3% month-on-month. Perhaps more significantly, the majority of categories that tend to see some weakness through periods of consumer distress all performed well – electrical/electronics sales grew +0.7% versus trend, furniture/furnishings +2.4% and takeaway food sales grew +5.1%. Retail spend is ultimately driven by underlying consumer sentiment and, while still resilient currently, has a tendency to turn quickly. While neither portfolio currently retains a direct exposure to the Australian residential housing market, we do have a number of select investments across the retail space and we continue to monitor trading activity closely.

Looking Offshore – A Visit to the UK

With a large number of company meetings completed through the August results period, we took the opportunity in September to visit the offshore operations of a number of current and potential listed investments, including a visit to the UK.

It's difficult to remember a time when such a wide variety of Australian-based businesses were enjoying considerable success across the United Kingdom, particularly given 'Old Blighty' has long developed a fierce reputation as an investment graveyard for a variety of ASX-listed companies (see **QBE Insurance** and **National Australia Bank** collectively burning $6.1bn in losses in just two years, **Wesfarmers/Bunnings** writing down $1bn in value and subsequently closing Bunnings UK or **Slater & Gordon's** horrendous $1.3bn acquisition of UK-listed Quindell).

Despite a softer underlying economy, continual rising inflation fears and ongoing political uncertainty surrounding the structure (and impact) of Great Britain's exit from the European Union, a handful of small and mid-cap Australian businesses are instead enjoying a period of strong returns and growing market share across both the UK and continental Europe.

Home appliance manufacturer and marketer **Breville Group (BRG)**, for example, is a current holding we highlighted in our August letter (see here) as having delivered one of the better FY18 results. While the standout component of the FY18 numbers was the +16.3% sales growth generated out of the North American division, the +9.9% growth delivered from 'Rest of World' (comprising the UK, Europe and Asia) has been equally impressive - particularly in the face of a fairly tepid underlying retail environment in the majority of regions.

Via their UK/European brand 'Sage', the business has quickly established itself as a premium brand in the space, with **the company now leveraging a well-established UK foothold to launch a series of direct-to-market entries into continental Europe.** With flagged expansions into Germany and Austria this year (the business is already ranging in over 600 outlets across Germany) and scheduled launches into Switzerland and 'Benelux'[1] next year, the business is certainly resembling the characteristics of a genuine global retailer. A globally dominant, Australian-owned retail brand is a pleasing development given the void in new Australian brand powerhouses of late (the last obvious global retail product success would be likely UGG Boots, RM Williams or privately-owned Cotton On) and we're excited to see the next phase of growth play out.

It isn't all plain sailing for the business in the UK, however, with a number of our own channel checks conducted this month indicating that competitors Jura and DeLonghi are performing better than we have seen in recent times. The appliance market is a fiercely competitive space and while we continue to feel Breville's significant advantages in innovation and brand investment will continue to see strong sales momentum, we are watching the competitive environment closely.

Of course an obvious challenger to 'Australia's next global brand powerhouse' would potentially lie in children's stationary supplier **Smiggle,** the brand sitting inside the ASX-listed retail conglomerate **Premier Investment's (PMV)**. With ~67% of Smiggle's total sales now occurring outside of Australian borders, the brand already represents a strong international offering with a sizeable physical retail store presence across Australia, New Zealand, the UK, Ireland, Malaysia and Hong Kong. We have been particularly enthused with the rollout of the brand into the UK, with total store count now numbering 134 retail outlets (31 opened in the last 12 months) – a significant achievement considering the brand only launched in the UK in early 2014.

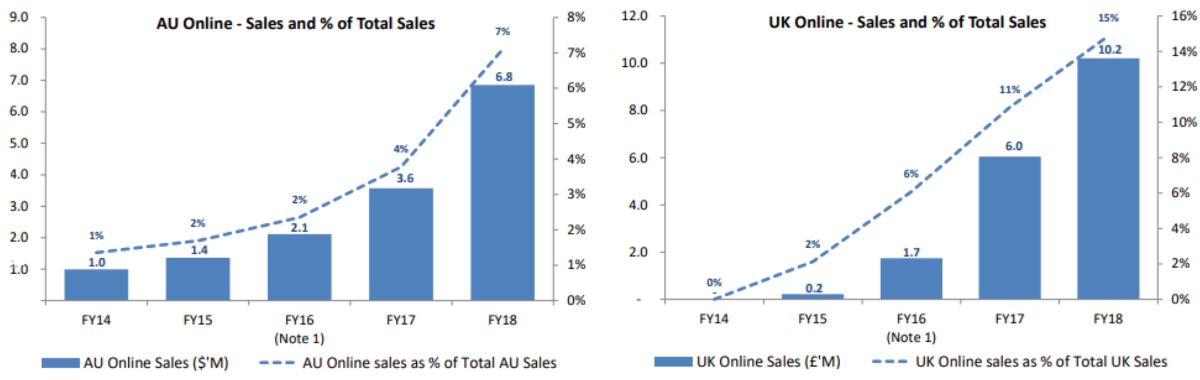
While the physical 'bricks and mortar' store rollout has been impressive (though perhaps not unexpected - this is the same business that grew **Just Group's** sales from $66m in 2008 to over $500m as at FY18), the rate of growth currently being experienced through both the company's online offering and via a handful of recently announced department store concessions has provided some interesting growth optionality that previously hadn't been expected.

Total sales from the Smiggle UK website, for example, already represent 15% of total sales generated across the region, a strong outcome given the online offering was only formally launched three years ago. For some comparison, online sales through the brands equivalent Australian portal equate to ~7% of total sales and has been achieved in twice the time as the UK experience. A growing brand awareness across the UK and Europe and appealing online functionality have ultimately combined with the launch of a variety of new online initiatives (click-and-collect, e-

[1] Belgium, the Netherlands and Luxembourg

receipts, additional payment options and increased search engine optimisation) to generate online sales growth via the UK website now significantly in excess of management's original expectations.

<u>Smiggle Online Sales Growth – Australia vs UK</u>

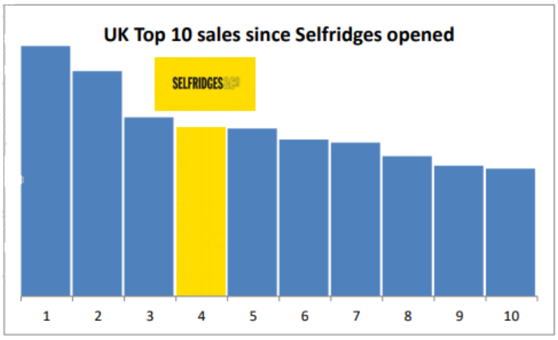


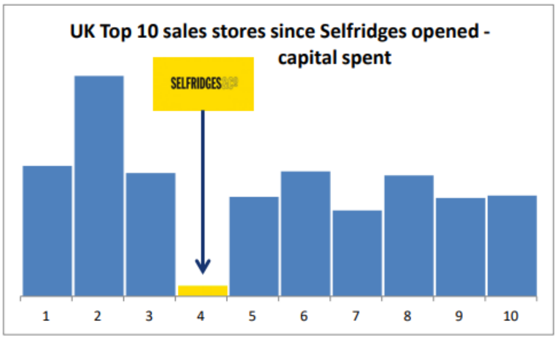
Source: Company FY18 Presentation

The obvious attraction for shareholders here is $1.00 of sales generated via the online store generates materially more underlying earnings than the same $1.00 of sales delivered via traditional walk-in stores (given the underlying costs of delivering that sale excludes a variety of overheads such as floor staff wages, premises rent, store signage and upkeep etc). This early international success and online acceptance of the Smiggle brand has seen the business now evaluating the potential for the brand to list on a variety of third-party websites (both Amazon.com and China-based Alibaba have been mentioned in recent updates) to take advantage of regions where management are not willing or not able to roll out a physical store presence (eg Thailand, South Korea or the Philippines).

Equally, the decision to invest in a small number of department store concessions (i.e. a small Smiggle-branded 'shop' that sits within a larger department store's retail floor space) across the UK has proven highly successful, with the business now looking to add new partnerships with a variety of iconic global retailers as a result. The business currently operates concessions in three of the largest Selfridges department stores (London Oxford Street, Trafford Manchester and Birmingham), with the brand now also operating a Smiggle concession in the premium and equally iconic Harrods in Knightsbridge.

Similar to the online channel, **the earnings margin generated on sales via department store concessions is materially higher than a standalone offering** (with the store concessions leveraging the exposure to high foot traffic within department stores without the costs of long term leases and extensive store fit-outs). Smiggle's concession within Selfridge's Oxford Street store, for example, is now the fourth highest grossing store in the Smiggle UK portfolio, while the capital employed to generate those sales is materially lower. This is a pleasing development and will likely enable the brand to continue to grow a strong international presence at a far higher return for shareholders. The business has flagged the potential for more deals through continental Europe with additional concessions slated to commence opening from 2H19. We look forward to more updates.



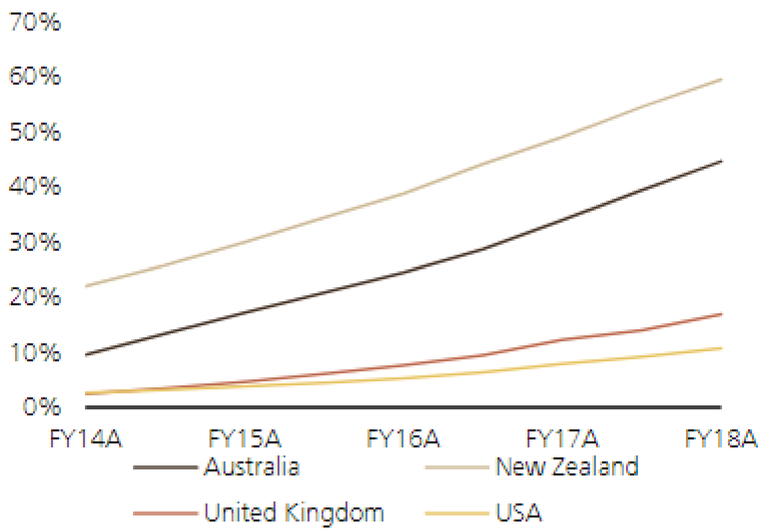


Elsewhere, cloud accounting software provider **Xero Limited (XRO)** continues to see strong growth with its own foray into the UK market, the business benefiting from a favourable regulatory tailwind provided by the UK Government's *'Making Tax Digital'* initiative (requiring UK-registered businesses with turnover in excess of £85,000 to maintain digital tax records from 1 April 2019). While cloud-adoption of accounting software solutions across the UK and Europe had initially been slow, penetration has subsequently lifted dramatically – **the UK market seeing cloud-based solutions growing from ~5% of the UK market in June 2017 to ~17% in June 2018**. Interestingly, a glance across Google search trends data for the word 'Xero' across the United Kingdom sees a similarly impressive +34% uplift in search queries for the FY19 year to date.

With an underlying market that is materially larger than any of its existing established customer base, **the runway for growth out of the UK for Xero continues to look attractive** – particularly when one considers the 17% penetration rate for the UK is well below that of Xero's more mature markets (cloud solutions now represent ~45% of the accounting software market in Australia and ~60% in Xero's original home market of New Zealand).

While the recent decision by the business to raise capital in a slightly unorthodox manner was a surprise (via the issuance of US$300m in five-year convertible notes to fund future inorganic growth opportunities), we continue to like global opportunity ahead for the business. The company used the capital raise announcement to provide a high level trading update, with management highlighting they remain comfortable with current FY19 cashflow guidance and current consensus estimates. While the valuation of the business remains at the top end (and we have adjusted our holding size recently to reflect the nearer-term risk/ reward equation at current levels), we continued to retain a holding in the business in the High Conviction Fund.

Cloud Accounting Software Penetration in Xero's Core Markets FY14 - FY18



Source: UBS Research Estimates, Xero Company Data

A New Portfolio Addition…

A relatively new addition to both Ophir portfolios recently has been plumbing and water flow supplies manufacturer **Reliance Worldwide Corporation (RWC)**, a business that floated on the Australian Stock Exchange in mid-2015 after being in private family ownership since 1986. The business primarily designs, creates and distributes products for use in 'behind the wall' applications – providing essential solutions for the vast piping networks that sit within the walls (and under the sinks) of existing homes. While the company has a variety of market-leading products across the Fittings and Pipe, Control Valves and Thermostat categories, the business is perhaps best known for its innovative push-to-connect (PTC) ***'SharkBite'*** products that have revolutionised the way plumbers approach brass pipe repair.

For decades, the standard approach for plumbers to mending a damaged brass pipe has been the removal of the affected area (via a metal saw), followed by the welding and soldering of a replacement brass connection to the existing pipe. The SharkBite solution essentially replaces the laborious and costly welding component of the repair, with the connectable brass solution easily clipping onto the end of each pipe to then establish a newly completed connection. The ease of use and relatively fast installation time provides an obvious appeal to plumbers (along with the added attraction of not requiring any specific tools to install with the added ability to be used on wet pipes), the product also resonating well across the growing DIY market.

With more than 60% of homes aged over 34 years and a large amount of the population located in cities prone to freezing (and infinitely more prone to damaged pipes as a result), the push-to-connect solution has experienced significant success in the United States, **with the business now generating over 50% of group sales within North America**. After a lucrative 9-year exclusive distribution agreement with US hardware giant Home Depot, the SharkBite product range has now broadened its distribution base with the addition of the number two big-box retailer in the US, Lowe's. As at the end of FY18, Reliance's products were available in over 23,000 outlets across the America's, with the business generating over $560m in net sales across the region.

Despite the large distribution footprint, the push-to-connect market is still relatively early on the adoption curve, with traditional welding, soldering or crimping techniques still being utilised by ~90% of the market. Our own discussions with various plumbing solution providers, contractors and wholesalers would suggest that awareness and adoption of PTC products continues to grow and the runway for further market share gains as a category look particularly attractive.

The business displays a number of characteristics that we typically find attractive in higher-quality, growth-orientated businesses:

- **Defensive earnings stream** – the majority of sales are geared toward the repair and re-model corners of the home improvement market, and less towards the more cyclical new-home construction market. While RWC itself produces over 14,000 different products, the core PTC product range is essentially deployed for use in emergency situations and for the management of general wear and tear;

- **Extensive runway for growth** – while the SharkBite range is the comfortable market leader in push-to-connect products, the broader PTC market as a whole still represents only a small portion of total piping repair solutions. With sales in the US consistently growing at over 10% per annum, there remains a large market share prize for the taking across North America, with the company recently broadening the global opportunity set with a large acquisition in the UK;

- **Conservatively geared** – despite recently purchasing UK competitor **John Guest** for $A1.2bn, the company still retains a fairly conservative balance sheet (at approximately ~1.3x EV/EBITDA), providing management with flexibility for future growth acquisitions;

- **Tenure and Alignment of Management** – reflective of its private, family-owned history, the Chairman and CEO of the business have all been with the business in excess of 27 years and, crucially, oversaw the latest expansion from FY06 that delivered compounded net sales growth (in constant currency) of over 13% per annum. The founding family continue to retain a holding of ~10% of the outstanding shares on issue and recently participated in the capital raising associated with the John Guest acquisition.

After following the business for some time and meeting with management on a number of occasions, **we took the opportunity to purchase shares in the company this August**, capitalising on a negative share price reaction to the company's full year earnings release. With the business coming into the result with a fairly full valuation and a high degree of expectation for an earnings beat (in addition to some continued indigestion from a $945m capital raising conducted in May to fund the UK acquisition), the share price promptly fell -8.5% in response to a FY19 outlook that was broadly 'in-line'. **Our own view is the guidance will likely prove conservative with the company appealing to us as a potential multi-year growth story** and we were happy to use both the attractive price levels and heightened liquidity to build a new position in the company in both the Ophir Funds.

Following this, we took the opportunity whilst in the UK to visit the manufacturing facilities of the company's newly acquired John Guest business – purchased by Reliance out of private family ownership in May this year. John Guest provides an obvious strategic fit for the company, given the business is the global leader in *plastic* push-to-connect products (the company selling over 145m fittings globally in calendar year 2017). Similar to the Reliance experience with their brass SharkBite range in the US, the business is experiencing a high level of growth as end users embrace the reduced installation time and improved durability of the PTC product and provides Reliance with an increasingly diversified (both geographically and via product category) portfolio.

<u>Acquisition Creates Global Leader in PTC Products</u>

	Americas		EMEA		Asia Pacific
	USA	Canada	UK	Europe	Australia
Brass PTC	#1	#1	Launched	Minimal	#1
Plastic PTC	#1	#1	#1	Top 2-3	#1
PEX pipe	Top 3	Launched	Top 2	N.A.	#2
Water heater valves[1]	#1	#1	#1	N.A.	#1

Shading represents key changes arising from the acquisition

Source: RWC Presentation – Acquisition of John Guest

The quality of the manufacturing facilities we visited certainly provide a testament to the previous owner-managers (the UK-based Guest family), with all sites presenting as exceptionally high-quality and well-run operations. Automation levels across each facility were high, whilst employees (a number of which were multi-decade in tenure) displayed an impressive level of product and broader market knowledge. While the UK operations are already well-established, there is the benefit for some further gains to be extracted – indeed Reliance have already upgraded the synergy expectations for the acquisition by some 50% to $30m.

Long-term family-run businesses tend to be 'run for cash' and can sometimes be slightly starved of growth capital – staff at one John Guest site, for example, detailed that inventory levels were typically run low (so as less working capital is tied up in the business) which had often left a number of key products out of stock. **The dreaded *'Out of Stock'* sign on a retailer shelf can often deliver a dual blow to retailers** – the revenue lost from a customer sale, plus the added doubt now created in a customer's mind that the particular retail outlet struggles to maintain its range and a competitor may be worth investigating next time. Under the Reliance management (and balance sheet), inventory levels across the range have already been significantly boosted, with a number of retailers we spoke with providing encouraging feedback.

All early signs would indicate that the integration is progressing well and, given we have yet to see any meaningful round of cost-out activities, there may be some further upside to the expected synergy extraction. Similar to Breville's experience, we'd expect the business will now use its established position in the UK as a beachhead to launch into continental Europe – a sizeable opportunity given the PTC market remains in its early infancy in most regions.

Ultimately, we feel the business can realistically deliver a fairly consistent 10-12% earnings growth per annum over the coming years, with the added growth optionality of new markets as they progress into Europe and Asia. With approximately 75% of sales now generated outside of Australia, the business will benefit from ongoing weakness in the Australian dollar and (while exposed somewhat to the Australian home construction cycle) is suitably diversified across international markets to weather any material slowdown in the domestic housing market.

We have some news…

Finally, we're excited to shortly be in a position to provide investors with **an update regarding a new development for one of the Ophir Fund's.** The update follows a fairly length period of due diligence, planning and investor discussions and we're certainly looking forward to being able to share an update shortly.

To ensure you're receiving these updates, please ensure you are signed up to our 'Letter to Investors' email distribution list or, alternatively, visit our *'News & Insights'* section of our website at www.ophiram.com/news-and-insights.

We're looking forward to sharing some more details shortly.

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

Kindest regards,

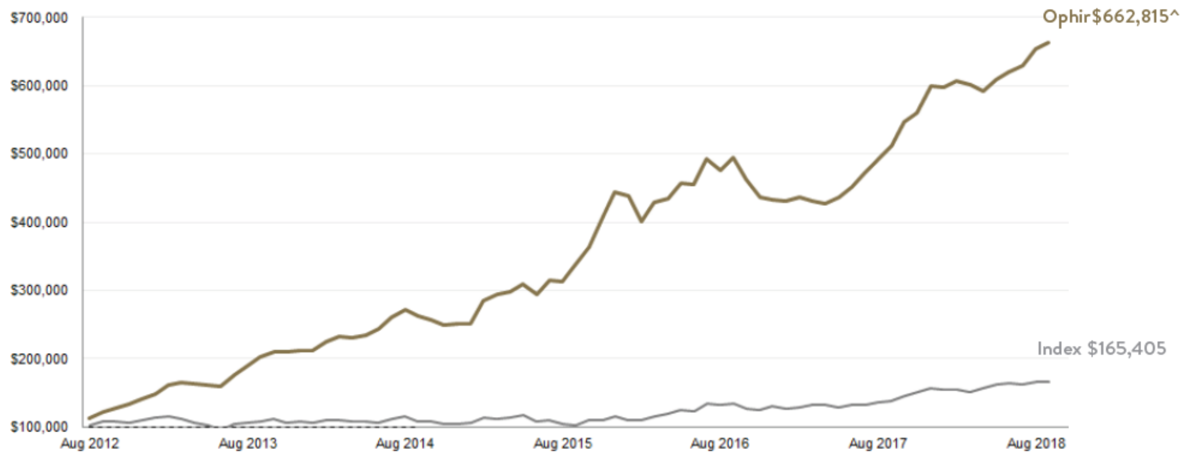
Andrew Mitchell & Steven Ng

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 +1.5% for the month, outperforming the benchmark by 1.8%. Since inception, the Fund has returned +562.8%, outperforming the benchmark by 497.4%.

	1 Month	1 Year	5 Year (p.a.)	Inception (p.a.)	Since Inception
Ophir Opportunities Fund (Gross)	1.5%	29.6%	26.8%p.a.	35.9%p.a.	562.8%
Benchmark*	(0.3%)	20.3%	8.7%p.a.	8.5%p.a.	65.4%
Gross Value Add	1.8%	9.3%	18.0%p.a.	27.4%p.a.	497.4%
Net Fund Return	1.1%	27.6%	21.5%p.a.	28.5%p.a.	369.1%

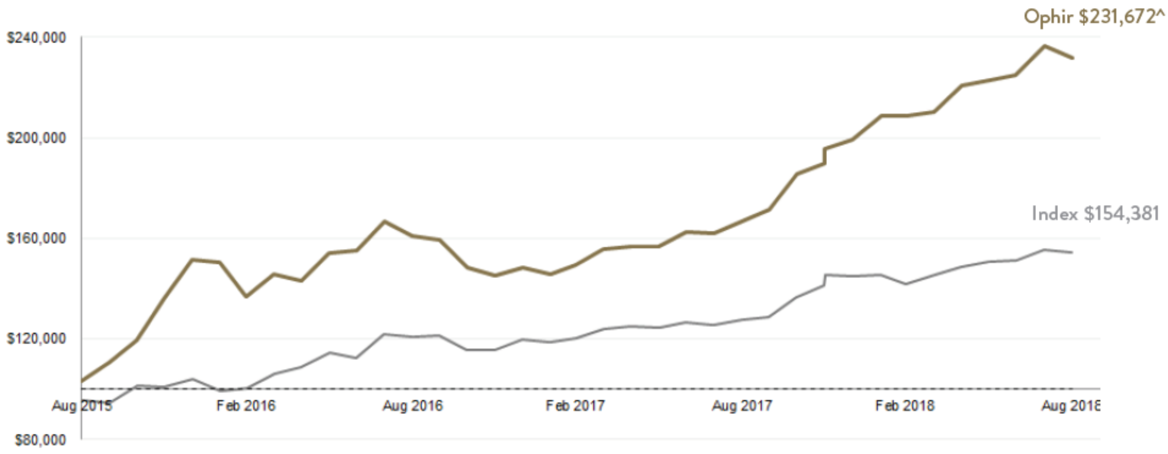
* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	Buy Price	Mid Price	Exit Price
Sept 2018 Unit Price – Opportunities Fund	2.6115	2.6024	2.5933

Key contributors to the Opportunities Fund performance this month included **Aurelia Metals Ltd (AMI), Jumbo Interactive (JIN)** and **ProMedicus Limited (PME).** Key detractors included **The A2 Milk Company (A2M), Experience Co Ltd (EXP),** and **NextDC Limited (NXT).**

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 -2.1% for the month, underperforming the benchmark by 1.5%. Since inception, the Fund has returned +131.7%, outperforming the benchmark by 77.3%.

	1 Month	1 Year	2 Year(p.a.)	Inception (p.a.)	Since Inception
Ophir High Conviction Fund (Gross)	(2.1%)	35.1%	20.6%p.a.	30.4%p.a.	131.7%
Benchmark*	(0.5%)	19.8%	4.0%p.a.	14.7%p.a.	54.4%
Gross Value Add	(1.5%)	15.3%	16.6%p.a.	15.7%p.a.	77.3%
Net Fund Return	(1.9%)	31.2%	18.1%p.a.	24.9%p.a.	102.1%

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

	Buy Price	Mid Price	Exit Price
30 Sept 2018 Unit Price – High Conviction Fund	1.9846	1.9727	2.0100

Key contributors to the High Conviction Fund performance this month included **Mineral Resources (MIN), Pushpay Holdings Ltd (PPH)** and **Seven Group Holdings (SVW).** Key detractors included **The A2 Milk Company (A2M), NextDC Limited (NXT)** and **Webjet Limited (WEB).**