You don’t have to pay up for Growth

We often talk about the Fund being consistently cheaper than its benchmark (the ASX Small Ordinaries index). Looking at FY18 consensus numbers at 31 December 2017 (all data in Table 1 from Factset consensus), the Fund had a PE of 16.1x vs the index at 18.9x, despite having a substantially higher EPS growth profile of 39.3% vs the index at 10.6%.

Table 1

Portfolio/Index Attributes	Portfolio	Index
EPS Growth	39.3%	10.6%
Sales Growth	23.2%	9.1%
PE	16.1x	18.9x
Dividend Yield	2.4%	3.4%
Price/Cash Flow	11.6x	12.7x
EV / EBITDA	7.8x	10.2x
Return on Equity (ROE)	15.1%	10.4%

Source: Factset, Flinders Investment Partners. Based on FY18 consensus estimates

Simplistically looking at the Fund multiple might lead one to conclude that the fund has a value bias, but that that would be incorrect. In fact, it has been stock selection when constructing the portfolio that has allowed for a lower fund valuation while allowing for a vastly superior earnings growth profile relative to the index.

As a starting point, we've had a view over the last 12-18 months that the smaller end of the Small Ords index has provided strong growth opportunities without the need to 'pay up'. Consequently this is the part of the market that we have been focused on, including some stocks outside of the ASX300. A simple exercise of splitting high growth (let's say >20% EPS growth in FY18) industrial stocks[1] into two groups illustrates this point:

1. Industrial names in the top largest half of Small Ords constituents with >20% EPS growth in FY18 - **FY18 PE is 34.8x** [2 3]
2. Industrial names in the bottom smallest half of Small Ords constituents with >20% EPS growth in FY18 - **FY18 PE is 19.8x** [3]

Clearly, the smaller stocks continue to offer a fertile hunting ground for high growth. We also believe the gap between the two is unsustainable; offering a clear alpha opportunity.

To get a bit more granular, we can illustrate the Fund positioning through some stock examples. At the smaller end, stock holdings include RCR (13.6x), SSM (12.7x) and some ex-300 holdings including AHX (12.6x), NVL (18.9x) and ATL (15.3x). All of these names

[1] The analysis throughout will focus on industrial stocks. Although there are several resource stocks in the Fund (typically lower PE stocks) which may drag down the overall Fund PE, that is not the case relative to the index as the Fund has consistently been underweight resources vs the index since inception ie. the lower PE of the Fund relative to the index is not a result of an overweight to resource stocks.

[2] Three names in particular skew the multiple higher: ACX (160x), NXT (104.6x) and WTC (80.3x). Even when excluding these names, the multiple for this larger cohort is high at 25.5x, nearly 6x PE points higher than the smaller cohort in group 2.

[3] Equal weighting all stocks

offer >20% EPS growth in FY18 and equally importantly, a runway of growth over subsequent years.

Even at the larger end of the Small Ords index, our preference has clearly been for high growth companies with reasonable valuations, with holdings including SDA (16.5x), SIQ (17.6x), WEB (19.9x), BAP (16.8x), BIN (19.2x) and SVW (18.8x). Again, all of these companies offer >20% EPS growth in FY18 with elevated growth subsequently. The corollary of this is that we have largely avoided names with elevated multiples including APT (48.9x), WTC (80.3x), BKL (34.8x), BAL (28.7x) and NXT (104.6x). Clearly these have performed exceptionally well, but we come back to the point that you don't need to pay up for high growth stocks (which have also performed well), thereby also allowing for a higher margin of safety if things go wrong.

A couple of final points. Firstly, the Fund in recent months has rotated out of holdings as they've reached/exceeded our valuation including ACX, ALU, MTR, PME and LOV (the latter two being ex-300 stocks). We continue to maintain a strict valuation discipline. Secondly, there are of course some higher multiple stocks in the Fund where we see tremendous growth prospects with continued valuation support. Some names include APX (30x), HUB (37.6x), EML (24.1x), and a couple of new inclusions to the Fund given their recent de-ratings, CTD (24.2x) and TNE (28.2x).

Overall, we're comfortable that the Fund has been constructed in a strictly pro-Growth fashion without having excessive valuations as a negative feature. The rigorous focus on valuation discipline remains a core part of our investment process[4]. We continue to believe that this approach will lead to the best returns for our investors.

Flinders Investment Partners
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[4] An outcome of the valuation discipline that Flinders adheres to should mitigate downside to investors from a scenario of increasing interest rates (typically negative for growth stocks as higher rates negatively impact valuations of long duration / high PE stocks).