Flinders Emerging Companies Fund

Quarterly Update: December 2018

FLINDERS
Investment Partners

Performance *(after all fees and expenses)*	1 Month (%)	3 Months (%)	1 Year (%)	3 Years (% pa)	Since Inception^ (% pa)
Flinders Emerging Companies Fund	-4.3	-14.9	-6.4	5.9	9.4
S&P/ASX Small Ords Accumulation Index	-4.2	-13.7	-8.7	7.4	10.4
Net Value Added	**-0.1**	**-1.2**	**2.3**	**-1.6**	**-1.0**

^ Inception date is 30 September 2015. Past performance is no indicator of future performance.

Investment Objective

Exceed S&P/ASX Small Ordinaries Accumulation Index by 3% pa (after-fees) over rolling 3 year periods

Investment Time Frame

5 years

Portfolio Managers

Andrew Mouchacca and Richard Macdougall

Risk Profile

High

Distribution Frequency

Half Yearly

Minimum Investment

$25,000

Inception Date

30 September 2015

APIR Code

ETL0449AU

M-Funds Availability

Code FEC01

Responsible Entity

Equity Trustees Ltd

Research Ratings

Lonsec: Investment Grade
IRR: Recommended
Zenith: Approved

Platform Availability

MLC Wrap IDPS, Netwealth, Powerwrap, HUB24, Macquarie Wrap, uXchange, WealthO2

Further Information

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- **Nasty quarter drags down the year**
- **Small cap valuations now compelling**
- **Is everyone bearish about 2019?**

The Flinders Emerging Companies Fund (‘Fund’) underperformed its benchmark in the September quarter returning -14.9% after expenses versus the Small Ords Index which returned -13.7%.

Small caps had their worst quarter since June 2012 but unlike that period, this downturn has been associated with a de-rating of the sector rather than a sharp deterioration in earnings. The continued lack of progress on trade negotiations between the US and China, together with generally soft Chinese economic data plus falling domestic house prices (read wealth effect) have left equity investors cautious.

So, with this backdrop, equity markets had little to cheer about. Oil had a savage fall (WTI down 38% in the period) and other commodities were also weak. Not surprisingly, one of the only places to hide was gold – which rose 7.6% in the quarter.

Of significance was the fall in the Australian dollar through December – and at writing, was only a few cents away from levels not reached since the depths of the GFC in 2009. This will have a positive impact on the earnings outlook for foreign currency earners and exporters, while a negative for importers.

However, despite recent market weakness, small company earnings are still providing significantly more growth than large caps with some excellent long term opportunities emerging (no matter what valuation methodology one might choose to use).

Performance Review

Positive Contributors: Given the only safe asset over the quarter was gold, it’s not surprising that our gold holdings performed well. **Saracen Mineral Holdings (+57.1%)** in particular was the Fund’s largest contributor. While it benefitted from the commodity price, the company also exceeded production forecasts for the September quarter and is being helped by the weaker local currency. **Helloworld Travel (+1.8%)** was a solid contributor helped by confirming profitability levels at their AGM and holding an investor day in December that improved awareness about the company’s attributes and potential.

Our largest active position, engineer and utility service provider, **Service Stream (-2.2%)** continued to outperform in the September quarter. The company announced the significant acquisition of Comdain Infrastructure in the period. Like Service Stream, Comdain provides maintenance and service work to a number of utility industries and is particularly strong in gas and water, while Service Stream has a greater exposure to the telecommunications and electricity industries. We see this as a particularly good strategic fit at an attractive price. Given the market volatility in the quarter and specifically the weakness in some sectors, avoiding certain stocks added to relative performance. Among them were **Afterpay Touch (-30.9%)** and **Mayne Pharma (-40.4%).**

Pleasingly, the Fund avoided several company downgrades that came predominantly in the last two weeks of December, including Speedcast, Autosport Group, Japara Healthcare, Bega Cheese, Propel Funeral Partners, Villa World, GTN, and BWX (for its 2nd downgrade in the quarter). Demonstrating stock selection further, over 50 emerging companies downgraded in the December quarter while the Fund was exposed to only three – Mineral Resources (which actually contributed positively over the period on the back of a value enhancing transaction with Albemarle for their Wodgina Lithium project), Redbubble (retained in the Fund) and Smiles Inclusive (exited, albeit at prices 133% above where the stock ended 2018 so minimising the impact on the Fund).

Negative Contributors: As mentioned above, **Redbubble (-46.0%)** was one company with an earnings downgrade, pointing to sales below expectation in the vital November online sales period, but also announced an acquisition and a capital raising during the quarter – a dangerous mix for any company's share price. However, the lower sales in that period were based on issues the company has bounced back from in the past – we expect that to have assisted a rebound over the critical Christmas trading period.

Bingo Industries (-40.9%) was hit hard despite reiterating earnings guidance in November. Having raised significant equity capital to fund the acquisition of Dial-a-Dump Industries, this has now been held up by the ACCC having concerns over market concentration. Despite a very attractive valuation, approval uncertainty has seen the stock sold down. Diversified industrial, **Seven Group (-37.3%)** had a very strong year up until September but gave much of it back this quarter. With its two listed investments (Beach Energy and Seven West Media) under pressure, it followed them down – despite earnings from its largest businesses (Westrac and Coates Hire) going from strength to strength.

Outdoor media company, **oOh!media (-33.3%)** was sold down given its exposure to retailer advertising expenditure. This was despite industry data showing that Outdoor is the only advertising category still growing – and particularly in sub-categories such as billboards, where the company has a strong position. Also impacting performance was our position in mining drill and blast company, **Ausdrill (-31.9%).** Like a number of other companies that raised significant equity capital for acquisitions (in this case, to acquire competitor Barminco) the stock soon came under selling pressure. We don't anticipate any unexpected news from the company post the merger and feel the stock is trading well below even a conservative valuation.

Portfolio Activity

Additions: Among stocks added during the quarter was diagnostic imaging company, **Integral Diagnostics (IDX**). The company provides a range of medical imaging services to patients through 45 sites including 12 hospitals. Revenue growth through market share gains, industry growth through technology improvements and the potential for acquisition are all attractive (and non-cyclical) attributes with solid valuation support. A PE de-rating from the highs early in 2018 provided the opportunity to purchase the stock. **Ausdrill (ASL)** was another addition to the portfolio early in the quarter. While its recent performance has made the timing look a little premature, we remain confident that the company has an excellent outlook following the merger with Barminco. With mining industry production growth boosting revenues, acquisition synergies and a better balance sheet following the capital raising, we expect better performance this quarter.

After selling out of **Beach Energy (BPT)** earlier in the year on valuation grounds, we took advantage of the fall in the company's share price following the sharp dive in the oil price over the past quarter and bought back in. Production growth and considerable exposure to the tightening Australian East Coast gas market (2/3 of the company's production is exposed to gas rather than oil) will see good earnings growth. The company also guided to the top end of their guidance range for FY19 at its AGM. **Credit Corp Group (CCP)** was also a notable addition to the portfolio in the quarter (also on the back of a substantial PE de-rating). The company is one of the largest purchasers of debt ledgers in the country and has a very successful track record in debt collection under the current management team. Add a growing US business and domestic consumer credit business we see an excellent opportunity for the company over the next few years. We discuss the stock in further detail over the page in our "Stock in Focus" section.

Exits: We exited our holding in financial platform developer **HUB24 (HUB)** above $13/s during the quarter following the stock reaching valuation. We are still very attracted to the sector and the growth opportunities in front of both HUB24 and Netwealth (which we previously held) but we could not justify holding the stock at higher levels – especially in this market where other stocks are now offering very significant upside. Fleet management and car leasing company, **SG Fleet (SGF)** was sold from the portfolio as the lower levels of car sales is likely to crimp growth in this financial year, consequently, this impacted our valuation and we exited the stock. A similar story was behind our exit of furniture retailer **Nick Scali (NCK)**. Weaker retail sales and lower dwelling turnover resulted in us lowering our growth expectations for the next year – and its valuation was no longer supported.

At the end of the quarter we had 39 stocks in the portfolio and were holding 3.4% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	**Top 5 Detractors**	**Top 5 Active Holdings**
Afterpay Touch Group*	Ausdrill	Corporate Travel Management
Helloworld Travel	Bingo Industries	Helloworld Travel
Mayne Pharma Group*	oOh!media	Mineral Resources
Saracen Mineral Holdings	Redbubble	Service Stream
Service Stream	Seven Group Holdings	Smartgroup Corporation

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 31st December 2018. Top 5 positions are effective 31st December 2018.

Stock in Focus: Credit Corp Group (CCP)

Credit Corp Group is Australia's largest debt collection agency on behalf of large institutions such as banks. It purchases debt ledgers from these institutions under a competitive process and makes money if the amount collected exceeds that paid. The company organises payment plans, and other systems to help debtors out of a position over a period of time. Given the link with the original issuer of the debt (such as a bank or finance company) and their corporate reputation, modern collection agencies specialise more in payment options rather than demands. The company also has a growing collection based in the US and in recent years has been growing an unsecured lending book in Australia.

Investment Case Key Questions

1. **Growth Opportunity:** we expect double digit EPS growth p.a. from the business over the next 3 years, largely driven by the expansion of the US business where margins are more favourable once critical mass is reached. The domestic lending business is also growing quickly off a small base but again, margins are good. We expect modest growth in its Australian collection business, but picking up post FY19 as the credit cycle becomes more favourable.

2. **Management:** CEO Thomas Beregi and CFO, Michael Eadie have steered the company exceptionally well since 2010, growing all parts of the business, adding financial and operational disciplines, developing new technologies to assist the business and have cautiously (and organically) developed new businesses that could in time, outsize their core Australian collection business.

3. **Financial Strength:** the company is well capitalised and importantly for us, has used its capital wisely in growing the company and also growing returns to shareholders. While they could have grown either the US book or domestic lending book more aggressively, in both cases they have used their capital to maximise both the growth potential while protecting returns.

4. **Risks:** Given the recent spotlight on the finance industry, real regulatory and reputational risks exist. However, the unsecured lending industry has already had a number of reviews and we know that CCP is one of the more prudent and transparent operators. While the credit cycle may negatively impact lending if rates or unemployment rise, collections benefit. Competition risk increases when credit is freely available – we believe that is now reducing.

5. **Valuation:** our Assessed Company Valuation is currently $23.05/s, reflecting upside of well over 20%.