Flinders Emerging Companies Fund

Monthly Update: February 2019

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	6.6%	8.5%	4.1%	13.8%	13.0%
S&P/ASX Small Ords Accumulation Index	6.8%	8.0%	3.5%	13.4%	13.8%
Net Value Added	**-0.2%**	**0.5%**	**0.7%**	**0.3%**	**-0.8%**

^ Inception date is 30 September 2015. Past performance is no indicator of future performance. Information relates to the Flinders Emerging Companies Trust Class B.

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: Recommended
IRR: Recommended
Zenith: Approved

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

Further Information
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- **New year bounce continues into February**
- **Little change to earnings expectations during reporting season**
- **Upgraded earnings outlook for Flinders Emerging Companies holdings**

Market

The Small Ords Accumulation index built on January's strong gains, with a 6.8% return in February. Small Industrials rose 7.1% while Small Resources rose 5.8%. The ASX100 Index also performed well, finishing up 5.9% for the month.

Global equity markets lagged Australia, with the S&P500 rising 3.2%, the FTSE up 2.3%, and the Nikkei up 3.0%. Bond rates fluctuated, with 10-year US Treasury yields eventually rising 8bp over the month to 2.71%. Commodities were mostly positive with base metals and oil strong (copper +6.3%, nickel +5.3%, WTI +6.0%), iron ore up slightly to US$85/t, and gold down slightly to US$1,319/oz.

Markets rallied on the back of a more dovish rate outlook from both the US Federal Reserve as well as the RBA following numerous softer macroeconomic data points, particularly in China and Europe where PMIs fell, some to contractionary levels. The RBA downgraded their GDP forecasts for Australia, with now a 'more evenly balanced' view on where rates head next. In the US, while manufacturing ISM and payrolls data beat expectations, retail sales and housing starts were quite weak. This contributed to the Fed backflipping on their rate tightening aspirations, effectively handing back the punch bowl to markets, which supported the strong 'risk on' environment seen in markets in February. Some progress in trade war talks between the US and China also assisted sentiment.

Portfolio

The Fund rose +6.6%, versus the benchmark return of +6.8%.

Key Contributors: unsurprisingly, most of the top contributors were from Fund holdings that delivered a strong result in February, either beating expectations and/or confirming strong growth. Machine learning enabler **Appen (+47.0%)** was one such company, reporting a full year result that was substantially ahead of guidance as well as consensus. The stock was already a top contributor in January, so it was encouraging to see the company deliver a result which demonstrated that demand for their services continues unabated. Similarly, **Webjet (+30.6%)** reported an interim result that showed it was on track to exceed company guidance for the full year. In particular, the company's WebBeds division was a highlight, growing its top line well and expanding its margins more quickly than previously thought.

Mining services companies **Ausdrill (+38.1%)** and **Seven Group Holdings (+22.6%)** demonstrated that a long tail of work and demand for their services underpinned their respective earnings growth profiles, with good valuation support present. Seven's result in particular was impressive as the operational businesses of WesTrac and Coates positively surprised across nearly all metrics. Both stocks were sold off heavily in the December quarter, so they also enjoyed somewhat of a relief rally.

And finally, agricultural services company **Ruralco Holdings (+47.5%)** was a substantial contributor on the back of a bid for the company by Canadian fertiliser giant Nutrien (owner of the Australian agricultural services business Landmark). The Fund has had a holding in the stock since February 2017 when the company raised money at $2.66/s for some earnings accretive acquisitions. The stock has remained stubbornly around the $3/s mark for much of the last two years despite the company growing its earnings, so it was pleasing to see that the value of the business was recognised by Nutrien, which resolved to pay $4.40/s in cash, a 44% premium to the last traded price.

Key Detractors: of the detractors, a reasonably clear theme was the extent to which the market was willing to sell off any companies that disappointed, particularly if there was any hint of exposure in the business to the domestic consumer. The view there presumably is that if any consumer softness is evident now, then that softness is likely to continue into the future given fears of a weaker domestic economic backdrop going forward. **Smartgroup Corporation (-16.9%)** and **Apollo Tourism (-15.9%)** were two such companies with the former missing full year expectations due to weaker novated car volumes and lower yields (albeit they sell to a 'defensive' client base of government, healthcare and charitable clients), and the latter reducing full year expectations to the lower end of the previous guidance range. We're mindful that in both cases, the revision to earnings are minimal, yet the de-rating has been aggressive; we don't expect the attractive growth profile of each company to materially diminish further in the forecast period.

Helloworld Travel (-15.8%) delivered a credible interim result with the company on track to meet full year guidance, yet the company was caught up in poor optics with their "Whole of (Federal) Government" contract coming under scrutiny, with allegations of impropriety. It's reasonable to assume that there will be added scrutiny on Helloworld when the contract comes up for renewal later this year, adding risk to the future earnings of the company. **Altium (+32.3%**, not held**)**, continued its remarkable run, reporting another strong result, with margins in particular expanding well ahead of expectations. Consensus earnings were revised 5-10% higher, with the stock re-rating even further from a PE of ~42x, to ~50x. The stock is now the largest in the Small Ords index; not holding the name meant it was a key detractor.

Performance Attribution^		Top 5 Active Positions^
Top 5 Contributors	Top 5 Detractors	
Appen	Altium*	Corporate Travel Management
Ausdrill	Apollo Tourism & Leisure	Service Stream
Ruralco Holdings	Helloworld Travel	Seven Group Holdings
Seven Group Holdings	Reliance Worldwide Corporation	Smartgroup Corporation
Webjet	Smartgroup Corporation	Webjet

^ Alphabetical order.   * Denotes stock not held.

Bingo Industries – A Case Study

It's worth commenting on portfolio holding Bingo Industries (BIN). The company reported a surprise earnings downgrade on 18 February which resulted in the stock dropping 49% on the day (an outsized sell-off relative to the earnings downgrade). This in itself would've made it the worst detractor from performance for the month. However, with a pending announcement from the ACCC for the clearance of the substantial acquisition of Dial A Dump Industries (DADI), expected to be materially accretive to earnings, it made sense to remain in the stock. Even in the event of a negative outcome, we would have expected a buy-back to be announced, given the cash on balance sheet, which would have been highly accretive given the share price fall post-downgrade. Essentially, either outcome would have resulted in a material uplift to earnings, in the order of 30-50% on our numbers. Given the situation, the Fund in fact purchased a material amount of stock on the day of the downgrade at ~$1.20/s. Subsequently in the month, the ACCC approved the acquisition of DADI, and BIN finished the month at $1.67/s, up ~43% from its lows, meaning the stock did not detract as materially. To stress here, it was the fundamentals that drove our decision making, ultimately leading a superior outcome for our investors. Please read further here, or visit our website (under News & Reports → Research Insights).

Active Manager Skill in Australian Small Companies

We've recently produced some research on how active management in the Australian small companies space has fared through various volatility regimes. It has been demonstrated that while the median Australian small companies manager has outperformed the benchmark return over a long period of time, there are sustained periods where the median manager has underperformed, and these have coincided with periods of low volatility. We conclude that in order to determine the skill of the manager, assessing their performance in subdued (low volatility) conditions is critical as it may reveal failings in stock selection, and/or portfolio management. Please see here for the full report, or visit our website (under News & Reports → Research Insights). As a side note, in what has been a challenging low volatility environment since launching the Fund in August 2015, we are pleased to have delivered top quartile performance to our investors.

Post Reporting Season Changes to Earnings

Following the release of company results during reporting season, the Fund continues to demonstrate favourable metrics with regards to growth and valuation. Pleasingly, while the Small Ords index saw a slight downwards revision to EPS growth in FY19 and a slight upwards revision in FY20, the Fund saw upwards revisions to both years: +3.7% in FY19 and +0.9% in FY20 (based on Factset consensus). For the Fund, this translates to EPS growth of +19.6% and +25.7% in FY19 and FY20 respectively, together with a PE multiple of 15.6x and 13.2x (again for FY19 and FY20). Please see table below.

Portfolio Attributes	2019		2020	
	Portfolio	Index	Portfolio	Index
EPS GROWTH	19.6%	10.5%	25.7%	13.1%
SALES GROWTH	28.6%	7.0%	8.7%	4.6%
PE	15.6	18.9	13.2	16.6
DIVIDEND YIELD	2.6%	3.1%	3.0%	3.4%
EV / EBITDA	8.3	9.6	6.8	8.6
ROE	11.7%	10.0%	13.3%	10.6%

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