Flinders Emerging Companies Fund

Quarterly Update: March 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	-0.2	13.1	7.6	11.8	12.6
S&P/ASX Small Ords Accumulation Index	-0.1	12.6	5.8	11.4	13.4
Net Value Added	**-0.1**	**0.5**	**1.9**	**0.4**	**-0.8**

^ 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: Recommended
IRR: Recommended
Zenith: Approved

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

Further Information
www.flindersinvest.com.au
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- **Now that was some recovery!**
- **Yield and tech lead the way**
- **Economy in a post-Hayne, pre-election funk…**

The Flinders Emerging Companies Fund ('Fund') outperformed the surging small caps benchmark in the March quarter returning 13.1% after expenses versus the Small Ords Index which returned 12.6%.

After such a poor December quarter for smaller companies, they staged an exceptional recovery in the March quarter outperforming large caps by close to 200bp. Both resources and industrials posted similar gains and within industrials, tech related stocks and high yield securities led the way. Interim profit reporting season brought its usual volatility to the sector but on balance, upgrades were similar to downgrades and net earnings for the small ords index was little changed over FY19 and FY20. Given the economic backdrop, a good result.

On that topic, we have seen the domestic economy struggle in certain sectors. Anything exposed to consumer discretionary spending has been weak – notably housing related items and the automotive industry. A combination of weak housing prices and tighter credit from the banks putting the brakes on spending. The flip side is that infrastructure activity and mining have seen good growth helping the capital end of the economy.

Offshore equity markets were also strong over the quarter. The S&P500 up 13.0% and the Nasdaq 16.5%, European markets generally up 5-10% and Asian markets also firm (China up 23% a standout). Commodities recovered strongly; iron ore up 21% on global supply disruptions, copper up 11% and nickel 22%. Gold was up a modest 1% but oil rebounded 28% in the quarter.

There was no shortage of action in the bond market either with global yields falling sharply over the period. A combination of weaker US and European economic data plus political and trade issues saw an inverted US yield curve for the first time in many years. Locally, our 10 year bond yield gave up 23%, moving from 2.32% to an unsustainable 1.78%.

Performance Review

Positive Contributors: Not surprisingly, it was a tech stock with global revenues that was our largest contributor. Machine learning enabler, **Appen (+74.0%)** had a great quarter with both earnings upgrades and a strategic acquisition. While the company raised $285m in new equity to fund the acquisition of US based tech company, Figure Eight, the market absorbed the new stock comfortably. We still see valuation upside given its growth profile and strategic positioning. **Bravura Solutions (+49.3)** and **Webjet (+33.3)** were also a couple of technology/online related companies that performed well for the Fund.

While the December quarter saw excellent performance from gold stocks, it was pleasing that our emerging producer, **Gold Road Resources (+49.2%)** continued its performance into the March quarter. Only months away from first production from its world class Gruyere deposit in WA, investors are now more aware of its growth profile and long mine life which was behind us adding the stock to the portfolio last year.

Other notable contributors to performance were engineering contractor, **NRW Holdings (+47.4%)** which continues to win profitable contracts in both the mining and infrastructure sectors, and drilling contractor, **Ausdrill (+37.0%)** which is benefitting from greater activity and production volumes in the mining industry. Agricultural supplies company, **Ruralco Holdings (+43.3%)** was subject to a takeover bid from Nutrien, the Canadian owner of competitor Landmark, and **Beach Energy (+53.9%)** had an excellent bounce with good production figures and a higher oil price over the quarter.

Negative Contributors: When tech stocks run, there is often little differentiation between them and consequently, valuations, attributes and business models get somewhat blurred. That's a polite way of saying we think a number are overvalued; we don't own them and they detracted from relative performance**. Altium (+49.7%)** and **Afterpay (+69.0)** were cases in point. Both companies have compelling business models and are growing rapidly. And in the case of Altium, we've owned the company and made excellent returns in the past. But as a firm that sticks closely to a valuation process we simply can't justify the current risk/reward trade-off with either.

Two of our tourism related stocks detracted from performance during the quarter but for completely different reasons. **Helloworld Travel (-28.0%)** fell following allegations that the company had been offering free personal travel to politicians. Given that the company has a large contract with the Federal Government due for renewal later this year – the potential of losing it would have a reasonable impact on earnings. Campervan and RV hire company, **Apollo Tourism & Leisure (-22.9%)** drifted lower following an uninspiring first half profit result and perceptions that lower consumer spending and credit constraints that are impacting the auto industry would also slow sales of campervans and caravans. Salary packaging and novated leasing company, **Smartgroup (-8.4%)** was also weak on the auto industry dynamic that saw stocks fall right across that sector.

Portfolio Activity

Additions: We have always been attracted to the growth profile and management skills of horticulture operator, **Costa Group**. However, lack of valuation upside precluded us from investing. In January the company announced a downgrade to anticipated 2019 profits based on lower citrus volumes, expansion delays to a new mushroom facility and subdued demand in some other categories such as avocados and berries. This led to a share price drop of close to 40%. Given that the majority of the downgrade was based on issues that would pass by mid-year, we saw an opportunity to add a good quality growth stock to the portfolio at a 25% discount to our valuation.

We also added financial services technology provider, **Bravura Solutions** to the portfolio during the quarter based on improving growth prospects and solid valuation upside. We have outlined the investment thesis in the "Stock in Focus" section below.

Exits: We mentioned above the poor performance of **Helloworld**. We made the decision to exit the stock quickly after the Government issues came to light, and potential for lower consumer confidence to impact outbound tourism volumes. While the stock has kept falling since our exit and there is potentially some valuation support, until there is more clarity as to the future of their Federal Government contract, we would be unlikely to re-enter the stock – governance risk remains heightened. We had a modest holding in emerging zinc producer **Red River Resources**. A combination of production issues due to Queensland flooding, and higher costs as they are commissioning a new mine saw our valuation drop and we exited the stock.

Another stock to suffer from the dip in consumer confidence and spending was homewares and manchester retailer **Adairs**. While it is a strong performer in its category with an excellent on-line offering and rising market share, the backdrop of household spending caution and a lower local currency crimping margins for importers saw our valuation come back and we exited the stock.

At the end of the quarter we had 39 stocks in the portfolio and were holding 2.9% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Appen	Afterpay Touch Group*	Corporate Travel Management
Beach Energy	Altium*	Service Stream
Gold Road Resources	Apollo Tourism & Leisure	Shine Corporate
NRW Holdings	Helloworld Travel	Smartgroup Corporation
St Barbara*	Smartgroup Corporation	Webjet

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 31st December 2018. Top 5 positions are effective 31st March 2019.

Active Management in Australian Small Companies – Skill versus Style

As a follow up to our first note on Active Manager Skill in Australian Small Companies in February 2019, we've produced some research comparing Skill versus Style. In a very interesting finding, in the period from 2016 to now, a period where cross-sectional volatility has been low and the median Australian small company manager has underperformed, *Value as a style has outperformed Growth significantly* (as measured by the MSCI indices). This data is contrary to what has often been suggested by commentators in the recent period. Our takeaway from the research is that investment style is *not* the reason for underperformance in the last three years, but rather, lack of skill in stock selection and portfolio management has been the reason. Please see here for the full report, or visit our website (under News & Reports → Research Insights).

Stock in Focus: Bravura Solutions (BVS)

BVS is a global enterprise software provider to the financial services industry, specifically to the wealth management and funds administration segments. 'Sonata' is their flagship product in the Wealth Management division, which is used by financial institutions to administer financial products such as investments, wrap platforms, life insurance, and superannuation. The company operates in eight countries including the UK, Australia, New Zealand, Europe and South Africa. The software is leading edge, and impressively while over $100m has been invested in development over the last few years, over 70% of this has been client-funded, thereby improving the returns of the business.

Investment Case Key Questions

1. **Growth Opportunity:** the company has delivered a three-year EBITDA CAGR to FY18 of 28%. With 3-4 new Sonata client wins per year expected to continue, and additional module sales to existing clients, we expect earnings to deliver a three years CAGR from FY18 to FY21 of +20%. Importantly, the number of modules taken up by existing clients has been higher than expected (since IPO in 2016), and this strong demand contributed to the company increasing its FY19 guidance at the 1H19 result.

2. **Management:** MD Tony Klim originally joined the company in 2008 and has extensive experience in international financial services, and internet banking and payment systems. Martin Deda is CFO and an Executive Director with over 30 years of experience in the IT and professional services industries. Both have successfully overseen BVS as a listed entity meeting or exceeding expectations.

3. **Financial Strength:** the company is well capitalised and in a net cash position. Capex and working capital requirements are low, so we expect cash levels to continue to increase, however the company is on the lookout for acquisitions particularly in order to enter new geographies.

4. **Risks:** the nature of BVS' offering leads it to having a smaller number of large clients, so potential loss of customers is a key risk. BVS has been winning a large proportion of its tenders; a resurgence in competition is something to be mindful of.

5. **Valuation:** our Assessed Company Valuation is currently $6.36/s, reflecting upside of ~20%.