Flinders Emerging Companies Fund

Quarterly Update: June 2019

FLINDERS Investment Partners

Performance *(after all fees and expenses)*	1 Month (%)	3 Months (%)	1 Year (%)	2 Years (% pa)	Since Inception^ (% pa)
Flinders Emerging Companies Fund	0.8	4.2	3.3	17.0	13.0
S&P/ASX Small Ords Accumulation Index	0.9	3.7	1.9	12.5	13.6
Net Value Added	**-0.1**	**0.4**	**1.3**	**4.5**	**-0.6**

^ 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
Zenith: Approved

Platform Availability

MLC Wrap IDPS, Netwealth, Powerwrap, HUB24, Macquarie Wrap, uXchange, WealthO2, CFS FirstWrap, Xplore

Further Information

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- **FY19 a tale of two halves**
- **Many market themes, but stock selection critical for outperformance**
- **Gold and bonds at record levels**

The Flinders Emerging Companies Fund ('Fund') outperformed its benchmark in the June quarter returning +4.2% after expenses versus the Small Ords index which returned +3.7%. FY19 was clearly a year of two halves, with the index in the December half returning -12.7%, while the June half bounced back strongly returning +16.8%. Overall for the year, the index gained +1.9% and pleasingly, the Fund outperformed in each half delivering a total return of +3.3%.

Markets in FY19 faced several challenges including, the US-China trade war, the US Fed reversing directions on interest rates setting the tone for rates globally, and in Australia, softer house prices, a weak consumer, and a Federal election. Perhaps, a +1.9% return for the year is not a bad outcome given these challenges and remembering that the benchmark was up +24.2% in FY18.

Within the Small Ords index, there was a significant divergence in performance between Industrials (+6.4%) and Resources (-12.7%). This performance differential resulted in a +4% 'free kick' to relative performance for any fund not invested in Resources given that this sector accounts for ~20% of the benchmark. The Fund continues to invest in resource stocks and importantly, strong stock selection led to positive gains in these holdings (see the 'A Note on Resources' section below).

Gold is worth a special mention. The commodity rose 9.1% in the quarter, finishing above US$1,400/oz for the first time since 2013. Spurring the rise has been the synchronised falls in interest rates globally and sizable central bank buying (particularly China and Russia). Significantly for Australian gold producers, this equated to over A$2,000/oz, a record high, and a level that is highly profitable for many of the listed gold producers.

One of the biggest surprises for the year was the move in bond yields globally. After an almost universal view that US yields had bottomed in 2017 and would increase in 2018 and beyond, yields suddenly changed course in November 2018. Ultimately, the US 10-year bond yield finished FY19 lower than the previous low in September 2017. Similarly, Australian 10-year bond yields finished the year at lows not seen since August 2016.

Looking forward, at least into the second half of this calendar year, we have become incrementally positive on the Australian economy given recent developments, namely:

1. The Coalition returning to government, thereby taking off the table Labor's proposed changes to capital gains tax, introduce franking credit reforms, and remove negative gearing concessions, while implementing the Coalition's plan for a First Home Loan Deposit Scheme and delivering on their substantial personal tax cut policy.
2. APRA's proposal to loosen residential loan serviceability tests.

3. The RBA reducing the cash rate in June to a historic low of 1.25%, with a further easing bias this year, in the attempt to reduce the unemployment rate and boost inflation back towards is 2-3% target range.
4. Funding costs significantly improving for the banks, with the majors raising debt at record low yields. This should lead to more competition for lending in general.

On the back of these developments, in recent weeks we've witnessed house prices stabilising and improving auction clearance rates, suggesting some improvement in sentiment.

Performance Review

The Fund rose +4.2% in the quarter, versus the benchmark return of +3.7%.

Key Contributors: The strongest contributors to Fund performance came from a variety of industries. Payment system and gift card provider **EML Payments (+68.7%)** was a standout performer over the quarter, with contract win announcements with bet365 and Smartgroup, as well as the earnings accretive acquisition of UK based gift card provider Flex-e-Card. An investor update also confirmed guidance with strong growth expected in FY19, and the longer-term opportunities in US sports wagering were a highlight.

Utility service provider **Service Stream (+33.2%)** had little in the way of newsflow, aside from an investor presentation early in the quarter suggesting that operations were performing to expectations and that the recent acquisition of Comdain Infrastructure was performing well. The stock has been a top 5 holding in the Fund for over two years, on the basis that the stock had all the hallmarks of an attractive investment: strong growth at an attractive price (consistently trading at a sub-market multiple), well capitalised, with exceptional management delivering on the group's strategy. The market seems to have caught onto these desirable attributes. Similarly, ship and ferry builder **Austal (+51.6%)** has been a portfolio holding since early 2017 on the basis that it was an attractively priced company (also a sub-market multiple) with good growth characteristics. This holding has required patience, with little movement in the share price until late 2018, from which the share price has nearly doubled.

Waste management company **Bingo Industries (+47.7%)** is one that we've written about previously, having held the stock going into ~15% downgrade issued by the company in February 2019. In an extraordinary (and painful) development, the stock was down ~50% on the day of the downgrade, falling from a share price of $2.30/s, to $1.17/s. The Fund added to the position meaningfully at this stage, and on the back of successful completion of the highly accretive DADI acquisition and the commencement of a share buy-back program (all likely at the time of the downgrade), the share price almost fully recovered (finishing the quarter at $2.26/s) delivering strong returns for the Fund.

Key Detractors: Several key detractors for the Fund were due to earnings downgrades being issued. Tourism operator and campervan company **Apollo Tourism & Leisure (-56.5%)** downgraded earnings twice in May, citing difficulties in the sale of used campervans in the US and Australia, as well as lower forward rental bookings domestically. Emerging specialty platform provider **Praemium (-32.2%)** lost a major longstanding client in ANZ Private to an alternative provider. Remote site power generation provider **Zenith Energy (-18.1%)** faced several headwinds including one of its clients (gold miner Gascoyne Resources) having Voluntary Administrators appointed, a second client (Dacian Gold) revealing operational issues leading to a strategic review, as well as a dilutionary and material equity raise in May. For each of these three stocks, the diminution of valuation on the back of reduced earnings meant the Fund exited these holdings.

Insurance broker **AUB Group (-20.2%)** issued a small downgrade to earnings for FY19, mainly due to continued underperformance in its Risk Services division due to lower than expected case volumes from the NSW workers compensation scheme, as well as some cost over-runs of a new underwriting agency system that is being implemented. Health insurance company **NIB Holdings (+46.4%)**, not held, was the Fund's largest detractor for the quarter with the stock rallying post the Federal election, as the defeated Labor party had considered implementing a 2.0% cap on premium increases for two years. The stock is one of the largest in the Small Ords index, so perhaps herding to liquidity further supported the share price in the quarter.

Portfolio Activity

Additions: We introduced specialty baby retailer **Baby Bunting (BBN)** during the quarter. The company has emerged as the clear leader in its category with the closure of several specialty competitors in the last 2-3 years. Consequently, the outlook has improved for growth on the back of further store rollout and positive like for like sales growth. The Fund immediately bought a position in property developer **Cedar Woods Properties (CWP)** following the outcome of the Federal election and APRA's announcement on relaxing lending standards for residential loans. We have actively followed the company for several years, and felt that the timing was right given previous headwinds were looking to become tailwinds for industry demand. The company provided a third quarter FY19 operational update in May which highlighted strong growth expected in earnings in FY19, and the stock was trading around a PE of ~8x. Both stocks mentioned here should benefit from our view of an improved consumer environment in the second half of this year.

The Fund also initiated a position in childcare operator **Think Childcare (TNK)** in the quarter. A rebalance in the supply and demand of childcare centres (following a period of overbuild), increases in childcare funding together with a cheap company valuation, supported the investment thesis. Think Childcare, has a higher growth profile than listed peer G8 Education, trades more cheaply, and is a founder-led company who has a substantial holding in the company and with many years' experience in the sector.

Finally, the Fund participated in its first IPO in over a year, with the listing of **Victory Offices (VOL)**. The company is a serviced office provider in Australia, with 19 sites currently in operation. We expect the rollout of 6-8 sites p.a. over the next few years to be the driver of strong earnings growth. Like Think Childcare above, we like the founder-led nature of the business, and the IPO was very attractively priced at under 10x PE.

Exits: As mentioned earlier, the Fund exited **Apollo Tourism & Leisure (ATL), Praemium (PPS)** and **Zenith Energy (ZEN)** given negative earnings developments and loss of valuation appeal. Importantly, we acted quickly to protect further capital loss (particularly with ATL which sold off a further ~40% after the Fund exited).

Costa Group Holdings (CGC) issued an earnings downgrade in May pointing to several factors which were affecting the business. This was disappointing given the diverse nature of their business in terms of products and farming geographies and the fact that they had reaffirmed guidance at an investor conference in April. The emergence of several new issues may linger on the company for some time, which pointed to further risk to future earnings and hence a reduction in our valuation on the stock to the point where we saw limited upside. Consequently, we exited the holding.

Finally, **Viva Energy REIT (VVR)** is a specialist service station property trust that we exited during the quarter due to the stock hitting our valuation. The Fund has rarely held property trusts due to their typically low growth profile, however, VVR have a higher growth profile and management have done a solid job of acquiring sites accretively. Ultimately, the share price performed well and exceeded our valuation of the company (no doubt helped by falling bond yields) and we sold.

At the end of the quarter we had 37 stocks in the portfolio and were holding 3.0% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	**Top 5 Detractors**	**Top 5 Active Holdings**
Austal	Apollo Tourism & Leisure	Mineral Resources
Bingo Industries	AUB Group	Service Stream
EML Payments	Praemium	Shine Corporate
Integral Diagnostics	NIB Holdings*	Smartgroup Corporation
Service Stream	Zenith Energy	Webjet

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th June 2019. Top 5 positions are effective 30th June 2019.

A Note on Resources

FY19 saw a dramatic divergence in performance between Industrials (+6.4%) and Resources (-12.7%). The Fund has held Resource companies throughout the year, with a slight underweight vs the index. While this might suggest a drag on performance, stock selection was good. 6 out of our 9 investments outperformed the index (+1.9%) over the year, leading to positive added value (see table below). In the case of Western Areas, we exited the company in the December half, and the stock has continued to underperform the index in 2019, which added value to the Fund. We will continue to search for opportunities in Resources, as is the case with all other sectors in order to deliver returns for our investors.

Saracen Mineral Holdings	77.5%
Gold Road Resources	51.4%
Cooper Energy	48.0%
Sino Gas Energy^	8.7%
Beach Energy	3.8%
Mineral Resources	3.7%
Small Ordinaries Index	**1.9%**
Small Resources Index	**-12.7%**
Sandfire Resources	-20.6%
Red River Resources*	-21.6%
Western Areas*	-44.0%

*Not currently held   ^ Takeover

Stock in Focus: Gold Road Resources (GOR)

GOR is an emerging Australian gold producer, with its 50/50 JV Gruyere project in Western Australia having commenced gold production in the June quarter. GOR's JV partner in the project is proven global miner Gold Fields. The project has a long life (12 years), is low cost (All In Sustainable Cost of A$1,025/oz) and with a forecast annual production of 300,000 oz, making it one of the larger gold producers in Australia. The project is fully funded, and GOR has some exciting exploration potential in the prospective Yamarna exploration tenements held exclusively by the company.

Investment Case Key Questions

1. **Growth Opportunity:** the company poured first gold in June, with production due to increase over the next several months. GOR has guided to a production range of 75-100koz in CY19, ramping up further to 300kozpa nameplate in CY20. The company has experienced some delays since construction of the project commenced in early 2017, however, this is immaterial in the context of a 12-year mine life. From an earnings perspective, the company is expected to go from a slight loss-making position in CY19, to a strong profit in CY20 (NPAT of +$50m).

2. **Management:** MD Duncan Gibbs has over 30 years of field and management experience and has held senior executive positions with AngloGold Ashanti, Acacia, and Shell/Billiton. He joined the company in September 2018, and previously had highly relevant experience as General Manager at leading global gold producer AngloGold Ashanti's Sunrise Dam and Tropicana mines.

3. **Financial Strength:** the company is conservatively capitalised, with a small net debt position given the Gruyere project is in the midst of commissioning and with gold production just commencing. The company has A$150m in debt facilities available to it, yet we expect the company to be in a net cash position by early CY20 as production ramps up. GOR is well funded to execute on its exploration program to add to current reserves.

4. **Risks:** Key risks are around the commissioning of the Gruyere project as it ramps up to full production run-rate; any issues could result in cost overruns or delays in reaching full production. Exposure to the underlying gold price, as well as the AUDUSD exchange rate given the commodity is traded in USD.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $1.44/s, reflecting upside of ~46%. The stock has been trading at a discount to its Net Present Value (NPV) in the recent history as construction of the Gruyere project has been ongoing (given risks around the commissioning of projects of this type). This discount to NPV was 30-40% in late 2018, compared to a narrower discount currently. Our ACV applies a small premium to NPV, which is reasonable given many gold mining peers of similar size are currently trading at a 30-50% premium to NPV.