Flinders Emerging Companies Fund

Quarterly Update: September 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	1.6	5.4	5.7	15.3	13.6
S&P/ASX Small Ords Accumulation Index	2.6	3.1	3.9	11.8	13.6
Net Value Added	**-1.0**	**2.3**	**1.7**	**3.5**	**0.0**

^ 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: Recommended
Zenith: Approved

Platform Availability

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

Further Information

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- **RBA cuts – pointless?**
- **Growth AND yield in small caps – what's not to like?**
- **Currency at decade lows**

The Flinders Emerging Companies Fund ('Fund') outperformed its benchmark in the September quarter returning +5.4% after expenses versus the Small Ords index which returned +3.1%.

As a collective, Australian small caps (stocks 101-300 in the ASX) benefit from low interest rates, a low currency and availability of equity capital. Add a modest improvement in demand (high employment and some wage inflation) and there is reason to expect some growth. You might not think that possible if you spend too much time looking at the news. However, the asset class has over 15% EPS growth this financial year and a yield over 3%. And when looking at the industrial stocks, small caps have not been this cheap versus large caps for seven years…

Just a reminder that despite some high priced "darling stocks" taking the limelight, and daily Twitter silliness, there are sound investment propositions right in front of us.

Despite plenty of noise, equity markets didn't move much over the quarter. The US S&P500 was up 1.2% and the Nasdaq down 0.1%. Even the UK FTSE100 with all the Brexit cacophony was virtually unmoved, rising 0.2%. HK was the obvious exception falling 8.6% but China's equity market was flat.

Commodities were mixed with Gold up 4.4% and WTI oil down 6.8%, base metals a little weaker but nickel up a massive 38% on supply concerns. Iron ore tumbled 20.2% as Brazilian supply began to recover. The Australian dollar continued to ease, closing the quarter at US$0.6749.

So, the RBA cut rates last week to kick off the December quarter with the official interest rate benchmark now at 0.75%. The banks passed on some and kept some for themselves. What does that do in the real world? Probably a little, but we think the impact of earlier cuts is starting to have some impact. Not just housing prices but a combination of lower rates and credit availability (baby steps we admit) will begin to have a positive impact on both consumer and corporates.

Performance Review

The Fund rose 5.4% in the quarter, versus the benchmark return of 3.1%.

Key Contributors: The August reporting season always throws up a few surprises and fortunately the positive ones outweighed the negative ones again this year. Contributors came from a good spread of companies and industries and importantly, mainly from companies we have held in the portfolio for some time. South Australian technology manufacturer, **Codan (+61.1%)** continued to perform strongly for the Fund. The company exceeded 2019 full year profit expectations with improving dynamics in their two major divisions of Metal Detection and Communications. Their emerging Tracking Solutions division continues to be negligible to group earnings, yet provides the most exciting outlook for the group over the medium term. Our valuation continues to lift accordingly with the company's profit growth, as well as further diversification of the business (multiple growth drivers).

One theme that did emerge in the small cap market over the quarter was a recovery in many of the retail stocks. Infant products retailer, **Baby Bunting Group (+66.7%)** was a good example. It operates in a consolidated industry (several competitors have exited in recent times) and many of its lines are not highly discretionary, but expectations of a good profit result were low given the weak consumer figures of the first half. As it turned out, earnings were strong and the outlook is sound. The consequent re-rating of the company saw it as the second largest contributor to performance over the quarter.

Salary packaging and leasing company**, Smartgroup Corporation (+49.0%)** continued to recover from its April lows as it also posted a better half year profit result. As a company with good technology, increasing scale benefits and growing in an attractive market segment, we expect further price upside this year. Gift card and smartcard payments operator, **EML Payments (+44.9%)** also continued to re-rate during the quarter. A good profit result and confirmation that it continues to win new customers in its re-loadable card and virtual payments was important for investor confidence. Add to that, with rapidly growing revenues from the wagering industry in Europe and the opening up of that industry in the US, the company has significant growth opportunity over the next few years.

Key Detractors: The past quarter was a little unusual in that there were a number of stocks not owned in the portfolio that had a negative impact (unusual in that they were not linked by a particular theme). Every now and again the market will embrace an idea or sector where a number of stocks run and if we aren't exposed, it detracts from performance. In recent years it might have been lithium companies, milk formula manufacturers or short-term credit providers. Well, this quarter it came from a number of areas. **Bellamy's Australia (+56.7%)** received a takeover bid, financial services company, **IOOF Holdings (+25.9%)** had a significant legal case against former executives dropped, mining company, **Independence Group (+38.1%)** benefitted from a very strong nickel price and retailer, **Premier Investments (+27.6%)** surprised the market with a strong profit result. All have a decent weighting in the index and had a negative impact.

Of our own portfolio, technology service business, **Appen (-24.3%)** had a weak quarter as global technology stocks came under pressure. Their half year result was strong, pointing to further earnings upgrades going forward, yet a disappointing initial contribution from their most recent acquisition, Figure Eight, disappointed. Financial services technology provider, **Bravura Solutions (-13.8%)** also struggled in an environment where sentiment was weaker towards technology stocks.

Gold producer, **Silver Lake Resources (-25.5%)** suffered following a disappointing quarterly report, particularly on the cost front. We view this as a short-term outcome that the company is addressing and expect both production growth into 2020 and a reversal of the September quarter cost increases. **Webjet (-18.8%)** also had a difficult quarter. While the full year result was largely in line with market expectations, growth forecasts for its European hotels booking business was moderated. This was exacerbated toward the end of the quarter when partner Thomas Cook, was placed into administration. The company has clearly identified the costs associated with the issue but concern still remains about ongoing dislocation in the industry. We feel that the fall in the share price has been well overdone and the company remains well placed to continue growing in that market segment even without Thomas Cook.

Portfolio Activity

Additions: We introduced media company, **QMS Media (QMS)** into the portfolio during the quarter, taking advantage of a capital raising following the acquisition of sports media and services company, TLA Australia. While QMS is generally known for its outdoor (mainly billboard) business, its sports business is rapidly growing and will represent over 25% of group earnings next financial year. And significantly, it already has a global footprint that has the possibility of growing exponentially over the next five years. The company also now has an improved balance sheet after selling down its New Zealand outdoor business to MediaWorks.

Also added to the portfolio was labour outsourcing company, **People Infrastructure (PPE)**. PPE specialises in providing labour, HR and other administrative services to the healthcare, community and IT industries. It has solid organic growth and will also benefit from a number of acquisitions made in the last several months. An experienced management team and further market opportunities add to the investment proposition.

Centuria Capital (CNI) is a property funds management company with a strongly growing portfolio of quality office, industrial, and now healthcare assets. The company has historically had a substantial retail investor base, yet they have recently secured a significant new institutional mandate which we expect to be followed by others over the next year, further adding to its funds under management. With investors seeking yield following RBA rate cuts and management proving their industry bona-fide over recent years, we expect excellent asset and revenue growth in the future.

Exits: It seems like a long time ago that Canada's Agrium (via its local Landmark subsidiary) made a bid for **Rural Holdings (RHL)**. That's probably because it was. With the ACCC and FIRB approvals behind, shareholders finally voted through the acquisition. We hung on to our position until the end due to the $4.40/s bid price including an 84c fully franked dividend – a nice sweetener for the Fund and therefore our investors. Also exited was **Reliance Worldwide Corp (RWC)** which moved into the top 100.

At the end of the quarter we had 38 stocks in the portfolio and were holding 3.1% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Baby Bunting Group	Appen	AUB Group
Codan	Corporate Travel Management	Codan
EML Payments	Independence Group*	Service Stream
Gold Road Resources	Silver Lake Resources	Shine Corporate
Smartgroup Corporation	Webjet	Smartgroup Corporation

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

Stock in Focus: Cedar Wood Properties (CWP)

Cedar Woods is a residential and commercial property developer with operations throughout Australia. Its core products include land subdivisions, townhouses, apartments as well as office developments. Cedar Woods typically focuses developments in suburban locations close to transport infrastructure and at various price points in order to attract a broad range of buyers. The diversified nature of the company's geographic footprint and products provide an element of earnings protection through the cycle.

The Fund initiated a position in the company in May, immediately 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, with the stock trading around a PE of ~8x at the time.

Investment Case Key Questions

1. **Growth Opportunity:** The company delivered record levels of revenue and profits in 2019. Importantly, despite the difficult residential property market conditions, Cedar Woods enters 2020 with around $330m in pre-sales and hence, their residential sales will grow in the FY20 financial year. At a group level, we expect a year of consolidation in profits in 2020, and growth to resume in 2021 on the back of an improving market for housing on the back of record low interest rates, personal tax cuts and an improvement in access to credit.

2. **Management:** Managing Director Nathan Blackburne has been with Cedar Woods for close to 17 years, fulfilling several roles including Victorian State Manager, Chief Operating Officer and the last 2 years as Managing Director. He has close to 30yrs experience in property markets which leaves him well placed to lead the organisation through the various market conditions and industry evolution. Importantly, Nathan is supported by a diverse and experienced board of director led by William Hames who co-founded the business back in 1987.

3. **Financial Strength:** the company is conservatively capitalised, with net debt position of ~$100m supporting its land holdings and development activity. Importantly, interest cover remains at greater than 15x (earnings), hence providing adequate flexibility to enhance the portfolio for longer term growth.

4. **Risks:** Key risks are around consumer demand for housing product. This can obviously be shaped by the prevailing market for house prices and the ability of the consumer to access credit.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $8.11/s, reflecting upside of ~20%. The stock remains attractively valued at less than 11x 2020 earnings below the median level for its peers of close to 13x. We feel the company remains well placed to benefit from a recovery in the Australian housing market, signs of which we are clear from both a recovery in auction clearance rates and bounce in property prices nationally.