Flinders Emerging Companies Fund

Quarterly Update: December 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	2.2	6.3	32.1	11.2	14.4
S&P/ASX Small Ords Accumulation Index	-0.3	0.8	21.4	5.3	12.9
Net Value Added	**2.5**	**5.6**	**10.7**	**5.9**	**1.4**

^ 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

www.flindersinvest.com.au
+61 3 9909 2690

- **Cracker year!**
- **Investment opportunities remain**
- **Momentum unwind**

December saw the Flinders Emerging Companies Fund ('Fund') have its best single month against the index since we started over four years ago. This capped a strong quarter and year for the fund – rising 32.1% for the 12 months net of fees, substantially ahead of the benchmark that was up 21.4%.

Despite the strong returns in 2019, we still believe that there are terrific investment opportunities in small caps this year. Growth remains significantly above that of large companies, valuations (outside a few fizzy areas) are attractive and generally, balance sheets are in good order. Yes, the consumer is still cautious, yes, there will be a drag on the economy from the current bushfires and the drought, but we return to the broader economy where we remain cautiously optimistic about the opportunities ahead.

As for the local market, a factor that was apparent in the quarter was the unwinding of some of the stocks and sectors that had shown such momentum in the first half of 2019 – technology in particular. We have always been wary of momentum, realising at some stage that there is an unwind; a process centred around valuation makes for a far more robust and replicable process for generating returns over the cycle. This has meant selling stocks when they reach full value and re-investing into new opportunities. So, while the Fund outperformed reasonably well in the first half of 2019, we were pleased to have added significant value in the second half as we weren't caught up in stocks that were sold off aggressively (many for no reason except for a rich valuation).

Markets continued to grind higher and the quarter saw solid returns from global equities – led by US tech stocks. The Nasdaq rose 12.2% for the quarter and 35.2% for the year. The US S&P500 rose 8.5% and 28.9% over the same periods. Our markets were the most miserable over the quarter, the Small Ords up only 0.8% and the broader ASX 300 up 0.7%.

Commodities rallied late in the quarter but the resources sector lagged industrials over the quarter and year. Oil (WTI) rose 13% (35% for the year) Gold was up 3% (18% for the year) and Copper up 7% for the quarter (and a rather pathetic 3% for the year). Resource stocks underperformed industrials over the period.

Currency traders may have well stayed at home in 2019 with the AUD flat against the USD over the 12 months at US$0.70 – the range was only US$0.6705 to US$0.7275 – stability is good for Australian businesses… And we can't forget rates. The 10-year yield started 2019 at 2.32%, reached a low of 0.88% (yes, this is an Australian rate) and finished at 1.37%. Unemployment is low and banks are offering mortgages under 3%. Why zip up the bear suit?

Performance Review

The Fund rose 6.3% in the quarter, outperforming the benchmark by 5.6%**.**

Key Contributors: The quarter included the fiscal year AGM season where a growing number of companies are releasing some level of earnings guidance for the forthcoming full year. Obviously, this can be a volatile time as investors absorb the news – both good and bad. Fortunately, good ones outnumbered the bad ones in our portfolio.

The largest contributor to the portfolio actually came in the form of a takeover bid for **National Veterinary Care (+48.4%)** by competitor, VetPartners. The bid was pitched at a 57% premium to the previous closing price and has been recommended by the board. It is a pleasing outcome as we have consistently held a solid position in the stock over a number of years and have been impressed with management's ability to grow the company steadily through both organic improvements and accretive acquisitions. While it was at a market cap at the smaller end of our portfolio, it consistently satisfied the attributes we look for in a company including attractive growth and valuation.

Diversified electronics manufacturer**, Codan (+34.5%)** continues to impress with its growth prospects and profit outlook. In a December trading update, the company upgraded earnings yet again, pointing to a higher than expected profit for the current half, continued strong trading conditions and a cash balance that was also above expectation. This led to an upgraded valuation. Needless to say, the stock continued to rise. Mining contractor, **Macmahon Holdings (+41.5%)** has been a slow burn in the portfolio but clearly worth the patience. The key release during the quarter was the announcement that the troublesome Telfer Gold Mine contract with Newcrest had been re-negotiated with a positive cash outcome. This is a relief for the company as it had been losing money on this contract for some time. The company also reiterated 2020 FY revenues of $1.2-1.3bn and EBIT of $80-90m – which was also taken well by the market.

Infrastructure and mining engineer, **NRW Holdings (+40.1%)** also had a terrific quarter. We wrote about the re-rating in the company following the timely acquisition of BGC Contracting last month but December saw the stock continue to rise. And a special mention to gold miner, **Silver Lake Resources (+43.3%).** While the share price performed poorly over the September quarter with initial FY20 guidance provided in July on the softer (conservative) side, the company bounced back strongly on reserve growth, improved production and the finalisation of the acquisition of nearby gold company Egan Street Resources.

Key Detractors: A combination of lower vehicle sales in the Australian market and higher insurance costs resulted in **Smartgroup Corporation (-43.2%)** issuing a profit warning toward the end of the quarter. While slower (yet still growing) vehicle registrations had been largely anticipated, changes to the terms of insurance products sold by Smartgroup had not. This is expected to drag on profitability in future years – not just 2020 – which had a meaningful negative impact on the company's growth profile and thus our valuation. Consequently, we exited our position in the stock.

Online design retailer, **Redbubble (-23.6%)** was another stock that had sales issues during the quarter. Given the importance of November and December to yearly revenue (Black Friday, Cyber Monday, Thanksgiving, Christmas), the company's update in December was a little underwhelming. While the recent acquisition of TeePublic is performing better than expected, the core Redbubble sales figures were disappointing. We are expecting better like-on-like growth figures in the first half of this year as a number of initiatives implemented by the company including new product launches, and increased brand partnerships contribute.

Portfolio Activity

Additions: New stocks in the portfolio included insurance claims builder and services group, **Johns Lyng Group (JLG)**. The company operates Australia wide and has been increasing the range of services offered to most of the major insurance companies and increasing market share through better systems, customer service and well-trained trades people. The company had excellent organic growth prospects but has also made acquisitions that are adding scale and new services to the group. It has low capital requirements and cash generation is attractive. We added the stock early in the quarter and it has already been a solid contributor to performance.

Also added was defence aerospace component manufacturer, **Quickstep Holdings (QHL)**. The company has matured from a technology development business to a profitable manufacturer of components for international firms such as Northrop Grumman and BAE Systems. It has significant opportunity to expand its client base and take on more contracts which should improve both margin and returns. It also retains some important technological IP that places it in a strong position to add products with existing clients. The company trades at a significant discount to our assessed company valuation and we see good upside over the next year or two.

We mentioned **Redbubble (RBL)** as a detractor to performance this quarter. We did add it to the portfolio in October at higher levels but took the opportunity to purchase more stock following the price fall in December. We are confident that the company can resume its higher growth rates and the company should begin to show more consistent profitability. The share price has recovered around 10% since.

Exits: We exited our position **in QMS Media (QMS)** in the quarter. As mentioned a couple of months ago, the company was bid for by private equity firm, Quadrant. We do not expect a higher bid and took the opportunity to sell out and invest the cash elsewhere.

Beach Energy (BPT) has been one of our best contributors over the past four years and sadly we lose the stock to the Top 100. This is a credit to the management team at Beach and we wish them well. While we could have held them a little longer (we have 12 months once something moves into the 100) the company had reached our valuation during the quarter so we sold. And we mentioned earlier that we sold out of **Smartgroup Corporation (SIQ)** following the downgrade and drop in our assessed valuation of the stock.

At the end of the quarter we had 38 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
Codan	Fisher & Paykel Healthcare *	AUB Group
Macmahon Holdings	Quickstep Holdings	NRW Holdings
National Veterinary Care	Redbubble	Service Stream
NRW Holdings	Smartgroup Corporation	Shine Corporate
Silver Lake Resources	Victory Offices	Webjet

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

Stock in Focus: Centuria Capital Group (CNI)

Centuria Capital Group is a property fund manager with currently over $7bn of assets under management. The company specialises domestically in office, industrial, and more recently healthcare assets, offering investors access to both listed and unlisted funds. The manager's expertise in these sectors allows them to optimise a particular investment property over time (yields, occupancy etc), thus increasing value for investors.

Investment Case Key Questions

1. **Growth Opportunity:** This is substantial, as the demand for CNI's property investment products which have typically offered a yield of +6% in recent times compares very favourably to term deposit rates which are yielding <2% to investors in the current low interest rate environment. We expect this low rate setting to continues for some years, meaning that demand for CNI's products should remain robust. Assets under management have grown by several hundred millions of dollars per year recently, and is likely to grow by ~$1bn p.a. going forward, all of which attracts management fees and in some cases performance fees.

2. **Management:** Co-CEO's John McBain and Jason Huljich have worked together for over 20 years, and know their areas of specialties within property, particularly the office space, very well. Their years of experience, and close relationships with various stakeholders including investors, agents, brokers etc. leaves them well placed to continue to grow the business.

3. **Financial Strength:** the company is reasonably capitalised, with net debt of $123m at FY19 equating to 4.9x interest cover and 17.5% operating gearing ratio. Of the two listed REITs that CNI manages (CMA and CIP), CNI has substantial equity investments in those equity vehicles; as they continue to grow through the acquisition of properties, we would expect CNI to raise equity as appropriate to ensure a prudent level of gearing.

4. **Risks:** Key risk is around changes in bond yields – a substantial increase may dampen demand for CNI's products.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $2.70/s, reflecting upside of ~20%. The stock remains attractively valued at ~16x FY21 earnings, which is significantly lower than the current small cap industrial multiple, as well as larger listed peer Charter Hall Group.