

# Flinders Emerging Companies Fund

Quarterly Update: March 2020

FLINDERS  
Investment Partners



Performance (after all fees and expenses)	1 Month (%)	3 Months (%)	1 Year (%)	3 Years (% pa)	Since Inception <sup>^</sup> (% pa)
Flinders Emerging Companies Fund	-24.3	-30.0	-18.2	0.9	4.9
S&P/ASX Small Ords Accumulation Index	-22.4	-26.7	-21.0	-1.3	4.7
<b>Net Value Added</b>	<b>-1.9</b>	<b>-3.3</b>	<b>2.8</b>	<b>2.2</b>	<b>0.2</b>

<sup>^</sup> 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: Recommended

## Platform Availability

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

## Further Information

[www.flindersinvest.com.au](http://www.flindersinvest.com.au)

+61 3 9909 2690



- **And the world changed...**
- **The salvation of distance**
- **An extraordinary financial rescue package**

The March quarter of 2020 is unlikely to be forgotten. When we thought the bushfires had caused enough damage and trauma, COVID-19 arrives to shake the modern world and economic order in a way we haven't seen in generations.

We'd suggest that most of our readers know what markets have done since they peaked on February 20<sup>th</sup>. Yes – it's not long ago – fear acts quickly. Consequently, in this note we will spend more time on what we are thinking and what we have done with the portfolio. Plus, importantly, why we think there is abundant opportunity.

The decline in the domestic equity market in the month from the peak to the recent base on March 23<sup>rd</sup> was savage and at times indiscriminate (especially in small caps). During these events, liquidity becomes paramount and often, share price moves are random and any fundamental reasoning or value is ignored. We feel that while volatility remains elevated and great uncertainty still exists, some of the dust has settled and it is now possible to try and understand the forces at work and we are shaping an investment portfolio that is fit for the current times and provides excellent returns for the future.

We won't comment further on the virus itself (you've got 24-hour media for that) but rather the impact, the economic response and what it means to Australian smaller companies.

In broad terms, once this started we moved pretty quickly to reduce our exposure to both consumer facing stocks and any companies we held that had debt levels that could cause problems if profits fell sharply – which they will. That's a reasonably obvious thing to do but when stocks fall over 50%, those decisions can become harder and threats can become opportunities. We have also been very conscious of not losing sight of what companies can benefit when conditions improve – no matter when it is.

On the flip side, we have added a number of new names to the portfolio and increased existing positions where there has been clear overselling. These companies have the attributes we always look for – good management, growth opportunity, financial strength and in the current environment, revenue resilience.

Of vital significance (and to our mind, not fully digested by the market) are the Government stimulatory measures announced over the past few weeks. None are as important or far reaching as the JobKeeper initiative. Keeping people in work and supporting those that have been laid off until things improve is fundamental to holding the economy together. It means survival. Bills still get paid, people still spend (albeit less) and companies have a significantly better chance of surviving. This initiative changed our thinking. So rather than lead off with the performance review, what have we done?

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## Portfolio Activity

**Exits:** We exited our position **oOh!media (OML)** in early March. While we've always found the outdoor media sector attractive (and we benefitted greatly from the takeover of QMS Media), OML was shouldering a significant debt position following the acquisition of Adshel in 2019. We saw this as a risk if advertising revenues began to dry up – which they have. The recent deeply discounted capital raising to save the company vindicated our early exit. We also sold **Bapcor (BAP)** from the portfolio early in March. Automotive parts and retail are usually resilient during downturns however, this situation is different. Less travel means less servicing, fewer accidents and less consumer spending through its Autobarn outlets. Again, a large debt position was something we were mindful of. All told, the uncertainty was too high and we exited the stock at a considerably higher than current level.

We sold our remaining position in **Corporate Travel Management (CTD)**. The looming impact of the virus on the travel industry was clear, plus some disappointing results from the US business with the interim result saw us exit in February. **People Infrastructure (PPE)** was also sold due to the high risk to earnings, coupled with debt on the balance sheet. The company's labour hire and placement businesses were clearly at risk – despite an exposure to the healthcare industry. Return to work and prior levels of employment will not be a quick journey so again, we saw it prudent to exit the stock.

Other exits included **National Veterinary Care (NVL)** which was subject to a takeover bid at a tasty premium from competitor, VetPartners. We completed selling on market and deployed the cash into new opportunities. And lastly, we sold out of **Cedar Woods Properties (CWP)**. While we rate the company and management team highly and had made good returns from the stock, we felt its exposure to the new home development market would place revenues under pressure for the remainder of this year.

Although not exited from the portfolio, it's worth pointing out that we reduced positions on some other consumer facing stocks that we felt were susceptible, including **Webjet (WEB)** and **Baby Bunting Group (BBN)**. In both cases, we have subsequently bought stock back at much lower prices.

**Additions:** New stocks represented a combination of stocks with a robust earnings profile in the current conditions but still had the valuation upside we look for. In addition, there have been some where we feel the market has overly discounted a company for either the wrong reasons or because of a liquidity impact. We added currency exchange services provider, **OFX Group (OFX)** due to the increased level of activity in transactions as currency volatility increased in February and March. The company has never gained the market share from the banks that common sense would suggest (bank customer inertia again?), but increased marketing and more awareness of the cheaper exchange on a simple digital platform amongst younger users gives us confidence that growth will improve. Also in financial services, was the addition of unsecured lender, **Money3 Corporation (MNY)**. MNY specialises in finance for used cars. The company has a long history of growth in this sector, has good systems, healthy margins and understands its customer base. The current crisis saw the stock lose over 70% of its value on the basis of a sharp rise in unemployment and default rates. We believe that the current Government JobSeeker initiative reduces that risk considerably – especially in the unsecured credit sector. Consequently, we bought the stock late in March.

Fund Manager, **Pinnacle Investment Management Group (PNI)** was added early in the quarter and performed strongly before the market downturn. Its excellent suite of investment vehicles gives us confidence in its future growth and we have added to the stock at very attractive levels more recently following a steep selloff. Commuter and tourist transport company, **Sealink Travel Group (SLK)** was added back to the portfolio in March, on the basis of its Government backed commuter revenues. The recent merger between Sealink and Transit Systems Group resulted in a large reduction of exposure to tourism and the company is now predominantly an operator of low risk, long term guaranteed Government contracts. Sure, there will be some loss of revenue from Captain Cook Cruises and Fraser Island but they are now much diminished as a percentage of the group and we still see it as a very undervalued stock.

Agricultural supplies and services business **Elders (ELD)** was added to the portfolio in March. The sector is one of the few bright spots in the domestic economy with both recent drought breaking rains increasing demand for this season plus agricultural output seeing increased demand. **Wisr (WZR)** is another unsecured lender added to the portfolio. With a rapidly growing digital offering, solid funding capability and falling borrowing costs, it is an attractive investment

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opportunity. The stock was hit exceptionally hard over February and March (as all consumer finance companies were) however, again, we believe that the JobKeeper program will also help Wisr continue to grow strongly in its market and help contain credit risk.

Given the changes made to the portfolio, in a rapidly evolving market, there are two things to reinforce:

1. That our individual portfolio holdings can see it through the foreseeable future given their balance sheet strength.
2. The portfolio is balanced with sufficient risk to perform well when markets normalise.

## Performance Review

**The Fund returned -30.0% in the quarter, versus the benchmark return of -26.7%.**

**Key Contributors:** And now, onto the ups and downs in an incredibly volatile market. The quarterly contributors were quite different to those of March, so it's worth touching on both. The top contributor for the quarter was building and insurance claim maintenance provider, **Johns Lyng Group (-0.1%)**. Most of its gains were following the bushfire period where it has sharply increased work from insurance claims. The stock also outperformed the market in March. Our gold exposure also contributed strongly over the quarter. **Saracen Mineral Holdings (+10.9%)**, **Silver Lake Resources (+3.0%)** and **Gold Road Resources (+2.6%)** all added value over the period with the gold price about the only commodity to post gains and the Australian dollar weak. Profits for each company are growing strongly with expansion options and strong balance sheets all remain undervalued.

For the month of March when the market really fell sharply, it was two of our longer-term holdings that shone through. **Service Stream (-11.4% for the month)** and **Appen (-5.0% for the month)** both held up pretty well. Not surprisingly, so should their earnings. Both companies have had market releases suggesting that their businesses (utility services for Service Stream and large IT company R&D spend for Appen) are holding up well in current conditions.

**Key Detractors:** In hindsight (everyone in this industry has plenty of it...), we held travel company **Webjet (-70.4%)** for too long (albeit we reduced our exposure as mentioned above). It has a good business in Australia and a great one in its WebBeds business globally. However, the acceleration of COVID-19 into Europe at such a pace brought those revenues to a complete halt. Consequently, the demand for working capital saw the company needing to re-capitalise with an equity raise. While a disappointing outcome, the company is now in a much stronger position to prepare for future growth opportunities and we continue to hold the stock.

Mining and infrastructure engineer, **NRW Holdings (-60.4%)** was also costly. In our mind, this was way overdone. While the company has some debt following the acquisition of BGC Contracting in 2019, and there were uncertainties over the impact of the WA Government closing fly-in-fly-out workers from interstate, the company has enough liquidity and the actual impact on earnings should be relatively minor. Pleasingly, the stock has rallied 30% since the end of March. We mentioned the purchase of online personal finance provider, **Wisr (-37.1%)** earlier. The company has outstanding growth prospects and is very well capitalised. We purchased more stock in March close to its lows and it too has also rallied.

Debt collector and personal lender, **Credit Corp Group (-54.4%)** was caught in a tide of selling in March. From a high of just over \$37.00 in February, it bottomed a month later at \$6.25 then added more than 100% over a handful of days. Credit Corp is a purchaser of debt legers, mainly from banks which it then collects over a period of time – often years. It is the best regarded in the sector, the largest and the best capitalised. It also has a conservative consumer lending book that has high margins and low defaults – they know their customers better than anyone. The extraordinary volatility was often to do with implausible stories and little understanding of their industry. Again, the JobKeeper allowance will certainly help Credit Corp as well. Needless to say, we still hold the stock, and in fact bought more in late March.

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Performance Attribution <sup>^</sup>		Key Portfolio Positions <sup>^</sup>
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
AP Eagers *	Fisher & Paykel Healthcare *	Austral
Gold Road Resources	NextDC *	Johns Lyng Group
Johns Lyng Group	NRW Holdings	Service Stream
Saracen Mineral Holdings	Webjet	Shine Corporate
Silver Lake Resources	Wisr	Tassal Group

<sup>^</sup> Alphabetical order. \* Denotes stock not held. Attribution is for the 3 months ending 31<sup>st</sup> March 2020. Top 5 positions are effective 31<sup>st</sup> March 2020.

## Stock in Focus: Tassal Group

Tassal Group (TGR) is Australia's largest aquaculture company. TGR's major operations are its Tasmanian salmon farms and processing facilities. Over recent years it has branched into seafood distribution and most recently, significant investment in entering the Queensland prawn farm industry. First production from these expanding facilities will be this year. Tassal operates the full value chain from hatcheries, growing and processing and sells to the retail sector (supermarket chains), wholesale and export markets. The management team is experienced and has an excellent history of growing the company's market position and profitability.

### Investment Case Key Questions

- Growth Opportunity:** Consumption of salmon in Australia has grown at close to 10% per annum for the past decade. This has been driven by changes in diet, availability and relative price. We see little reason for the growth opportunity to change. The health aspects are clear versus other proteins and wild catch fish are rising in price and falling in volume. The domestic market is largely a 'fresh' market – meaning that imports only play a small part. Add that there are only three major players in the industry and very limited waters for successful production, it has naturally high barriers to entry. Importantly, the expansion into prawn farming now gives the company another excellent growth opportunity. Prawn consumption is also growing (although quite seasonal) and the industry is fragmented and lacks scale, science and capital – all of which Tassal has plenty of. Production is forecast to grow from 2,400 tonnes this year to over 20,000 tonnes in the next five years.
- Management:** CEO Mark Ryan and CFO Andrew Creswell have a long history of successfully growing the company, increasing returns and importantly, growing the industry and its importance for the Tasmanian economy. The team has managed to balance the high capital need of salmon farming with availability of debt and equity and a careful eye on maintaining profitability and cashflow. We also feel that the company has navigated the environmental aspects of the industry better than others.
- Financial Strength:** Farming Atlantic Salmon is a capital-intensive activity. So is prawn farming (although less so, being land based). Consequently, a strong balance sheet and access to funding is vital. In late 2019, the company raised equity capital (\$125m) to help fund both the capital expenditure on the new prawn expansions and also expand its Tasmanian facilities. This reduced gearing to under 20% and gives the company comfortable headroom especially with cashflow generation of close to \$80m this financial year.
- Risks:** Aquaculture, like livestock farming has climate risk (salmon grow faster in colder water), so water temperature will impact yield. Disease prevention is also vital. Intensive farming always holds disease risk and both salmon and prawns are no exception. Fortunately, Tassal has been an industry leader in this regard. Price risk has reduced over time as the market growth and longer-term contracts has helped consistency. And lastly, environmental issues have led to a reduction in production volumes allowed in Macquarie Harbour (TGR's main farming area). Any further reduction would be detrimental to short term production volumes. However, this is not expected.
- Valuation:** our Assessed Company Valuation (ACV) is currently \$5.34/s, reflecting upside of >50%. The stock remains attractively valued at ~10.5x FY21 earnings, which is significantly lower than the current small cap industrial multiple – its largest discount to market for 7 years – with earnings resilience.

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