Flinders Emerging Companies Fund

Quarterly Update: September 2020

FLINDERS
Investment Partners

Performance *(after all fees and expenses)*	1 Month (%)	3 Months (%)	1 Year (%)	3 Years (% pa)	5 Years (% pa)	Since Inception^ (% pa)
Flinders Emerging Companies Fund	-1.2	9.3	5.2	11.8	11.8	11.8
S&P/ASX Small Ords Accumulation Index	-2.8	5.7	-3.3	6.5	10.0	10.0
Net Value Added	**1.6**	**3.6**	**8.5**	**5.3**	**1.9**	**1.9**

^ 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

- **A September breather but Small-Caps have another strong quarter**
- **Still plenty of stimulus in the system and now the big budget spend**
- **And the Flinders Fund turns 5!**

After the massive moves of the March and June quarters, the modest rises in the September quarter seemed refreshingly sedate. Market records were set in the US early last month with technology stocks leading the way. Despite a modest correction more recently, equity markets remain buoyant.

Industrials outperformed resources by 6% over the quarter despite iron ore and base metals being particularly strong and gold rising. Consumer discretionary stocks (especially retailers) led the small-cap market with building material companies also strong late in the quarter. Many of the retailers have been seeing extraordinary sales growth figures – and not just with their online offerings.

The performance of the S&P/ASX Small Ords Index continues to outpace the broader market – as it has done both this year and in the past five. Why? Better growth characteristics and valuation. Something that will continue for some time yet, especially as we emerge from the Covid lockdowns and state borders begin to open. It has been a long winter (especially in this South East corner of the country) but, we are slowly coming out of the worst part. Cross border activity is beginning to rise and toward the end of the year, Victoria's economy will start its revival. There is plenty of stimulus in the system – and more to come following the 2020 budget that is aimed squarely at helping business to a position of employing more people – more effective than the sugar-hit of general cash handouts. And interest rates are not going up anytime soon.

We are cautiously optimistic about the domestic outlook and the impact will be felt to a greater degree in smaller companies. Of course, there are still some issues. State territorialism, lack of international travel, and potential overcrowding in certain sectors (do we need more infrastructure spending right now?), but it is the broader domestic economy that will benefit and exposure to that can only be fully felt in this asset class.

Performance Review

The Fund returned 9.3% in the quarter, 3.6% better than the benchmark return of 5.7%. For the 12 months, the Fund returned 5.2%, 8.5% above the benchmark return of -3.3%.

Key Contributors: The quarterly contributors came from a good range of industry sectors. Online design and fulfilment provider, **Redbubble (+101.0%)** had another outstanding quarter as the company confirmed ongoing sales momentum and importantly, rapidly improving profitability and cashflow generation. A highlight has been the growth in business from repeat customers and with the busiest months of the year ahead of them, we expect a very strong finish to 2020. Electronic products developer and manufacturer,

Codan (+57.3%) had an exceptional quarter after posting a very strong full year result. Sales of metal detection devices rose 30% and communications equipment sales were 34% higher. The group exhibited its operational leverage with EBITDA rising 50%. The outlook for growth remains promising and the company is in a net cash position of close to $100m.

Infant products retailer, **Baby Bunting (+41.7%)** has seen strong sales growth this year both through its stores and via its online offering – up 10.5% and 66.1% respectively in the June half. This growth and the 38% rise in EBITDA for the financial year was well above expectations and confirms their position as the market leader and retailer of choice in the sector. Good cost control and effective marketing were also highlights and we expect continued growth this year and next. Multi-asset class investment manager, **Pinnacle Investment Management (+31.5%)** performed well over the quarter as global markets recovered and we saw signs that retail investor flows were improving. Also helping the company was the improved investment performance from a number of managers that had lagged the market recently and in particular, the excellent performance from Hyperion Global which we expect to see grow funds under management significantly over the next few years.

Key Detractors:

Financial Service software developer, **Bravura Solutions (-23.2%)** struggled during the quarter. Despite delivering an FY20 result in line with expectations, they guided to a flat profit outlook in FY21, which disappointed. We believe this to be a conservative outlook, and while new contract wins can be lumpy, the pipeline is as strong as it has ever been. With over $100m of cash on its balance sheet and 77% of its revenue base now recurring, we are very confident that the stock will begin to re-rate. **Sandfire Resources (-16.8%)** has been very disappointing given that its main commodity, copper, was up over 8% over the quarter. While production levels were largely in line with expectations, slightly higher costs kept profitability subdued. With mine life at its WA operations now under 3 years, management must bring on projects in Botswana and Montana quickly to fill the gap.

Online currency exchange, **OFX Limited (-21.7%)** was also a detractor from performance during the September quarter. While the company has been successfully growing its corporate and small business customer base, the low-end transaction market which is partially reliant on foreign workers, students and backpackers has been weak during the pandemic. Consequently, growth has been more modest than expected and is likely to remain that way into 2021. We exited the stock during the quarter. Also detracting was digital payments and card company, **EML Payments (-14.7%)**. Exposure to the US and European gift card market has led to a recent derating of the stock, but with the opening of malls across both continents, the strength of their wagering card and salary packaging divisions plus the integration of the recently acquired Prepaid Financial Services business, we expect a good recovery later this year. The stock has a strong growth profile, excellent return on capital and plenty of valuation upside. We increased our position in EML toward the end of the quarter.

Portfolio Activity

Additions: We were more active with portfolio positions in the September quarter than we were in the June quarter as opportunities presented themselves and others reached our assessed valuations. Early in the quarter we added financial advice software provider, **HUB24 (HUB)** to the portfolio. We have held the stock in the portfolio previously and highly rate the management team, products and market opportunity. The stock had lagged the market more recently despite its business still doing particularly well, with overhang from the downward movement in cash rates and potential for increased competition. This provided a significant valuation gap and we took the opportunity to add it back to the portfolio at attractive prices.

Also added in the quarter was online pre-packaged meal provider, **Marley Spoon (MMM**). The company provides fresh ingredients and recipes in a ready to cook format. It operates in Australia, a number of European countries and the US. While Covid lockdowns have certainly helped kick along their business over the past six months, there is strong underlying growth and an increasing acceptance of the product. Scale, systems and customer service are all vital in the industry and Marley Spoon has proven itself by rapidly growing its customer base and improving margins. It is significantly undervalued compared with global peers and on our own forecasts.

Emerging medical image technology company **4DMedical (4DX)** is a recent IPO that we added to the portfolio. The company is well advanced in an imaging technology that creates a 3D scan of the body over a time sequence, that provides greater information to clinicians to diagnose disease. It has particular use in scanning lung tissue during breathing. The technology uses existing X Ray applications and is cheaper than both CT Scans and MRI. While not yet profitable, the company has approvals in a number of jurisdictions that will lead to early market availability. Telecommunications infrastructure and services company, **Unity Group (UWL)** was added in August. The company is acquiring its competitor OptiComm, to form the largest competitor to NBN Co in housing estates and dwelling developments. With scale in both the fibre infrastructure and retail service provider sectors of the market, the company can access good recurring revenue streams and expand into new areas. The company has solid valuation upside and a proven and capable management team.

Beauty products and household consumables company, **McPhersons (MCP)** is another stock we added to the portfolio during the quarter. Like HUB24, we have previously held it and know the management team and business well. While its domestic household products business (Multix) showed modest growth, there is excellent sales momentum in the Dr LeWinn's products both in the domestic market and in China. Importantly, margins in this fast-growing brand are strong, leading to a significant upgrade to our forecasts and valuation.

Exits: As mentioned above, we exited **OFX Group (OFX)** during the quarter after lowering our valuation. We also exited personal finance company**, Money3 Corporation (MNY)**. We added the stock to the portfolio in early April when the JobKeeper program was introduced and the stock added close to 70% quite quickly to reach our valuation.

The balance of gold miner, **Saracen Minerals (SAR)** was sold after moving into the ASX100 Index and while we had some more time to hold the stock, we saw better upside in **Ramelius Resources (RMS)** which we began buying in the June quarter. And lastly, we sold out of waste management company, **Bingo Industries (BIN)**. We downgraded our valuation on the basis that its exposure to the commercial construction industry as a source of waste had continued to decline. While attracted to the business longer term for industry consolidation and scale, it provided limited valuation support.

At the end of the quarter we had 40 stocks in the portfolio and were holding 4.0% cash.

Performance Attribution^		**Key Portfolio Positions^**
Top 5 Contributors	**Top 5 Detractors**	**Top 5 Active Holdings**
Baby Bunting	Bravura Solutions	Baby Bunting
Codan	EML Payments	NRW Holdings
HUB24	Mesoblast *	Redbubble
Pinnacle Investment Management	OFX Group	Service Stream
Redbubble	Sandfire Resources	Shine Justice

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th September 2020. Top 5 positions are effective 30th September 2020.

Recent Research: Actively Managed Small Caps are a Core Portfolio Holding

The Small Ordinaries Index has outperformed the ASX 200 benchmark in the last five years but underperformed over the last 10 years. Interestingly, the median small cap manager has outperformed both benchmarks, as well as the top quartile large cap (Australian Equities) manager over all periods including the 10-year period. This leads us to conclude that a small cap exposure is core to any portfolio allocation to equities, and any exposure to the sector should be via an actively managed strategy.

We would encourage our readers to read the full report behind our rather surprising findings.

Stock in Focus: Shine Justice (SHJ)

Shine Justice (SHJ) is a law firm with about 50 practices throughout Queensland, NSW, Victoria and Western Australia. The group specialises primarily in damages-based plaintiff litigation, particularly in personal injury where they are a top three player with a 7% market share in Australia. Other practice areas include class actions (with the pipeline of cases increasing significantly in recent times, and currently sitting at 37 cases at various stages), family law, medical law and abuse law. The firm was founded in 1976 and is headquartered in Brisbane, Australia.

Investment Case Key Questions

1. **Growth Opportunity:** having been through a period of remediation, SHJ delivered 13% growth in NPAT in FY20, and is well-positioned to continue to grow at similar levels. Two areas should contribute: 1. Growth in personal injury as the current growth in client enquiries and file openings couples with margin expansion, and 2. Growth in class actions – of the current 37 cases, 16 have been filed and 21 are in the pipeline. A substantial step change in growth is possible, as the firm is in the final stages of the significant 'Mesh' class action against Johnson & Johnson. While SHJ were successful in the class action, the decision has been appealed and the outcome should be known in the coming months. Tens of millions of dollars are due to SHJ for their work over the last several years, which if positive, will totally transform the company's balance sheet, allowing them to pursue growth initiatives more aggressively.

2. **Management:** Simon Morrison is the MD, who obviously knows the business very well being a co-founder. He is a significant shareholder, holding about a quarter of the business. Ravin Raj is the CFO and joined the company in November 2016. He has decades of experience as a CFO, most recently at previously listed ASX company Watpac and has been instrumental in managing the cost base of the business to ensure strong operational margins.

3. **Financial Strength:** the company's balance sheet is much improved compared to three years ago, with ~$20m net debt in FY20 which equates to 0.4x net debt/EBITDA only. A successful outcome in the Mesh class action mentioned above would translate into a strong net cash position. The nature of SHJ's 'No Win, No Fee' model means it funds legal fees over the duration of a case. This has traditionally meant a weaker cashflow conversion profile. But management have undertaken a deliberate strategic focus to improve cash generation and as such the profile has been improving in recent years. We expect the current ~60% conversion to improvement to 70-80% over the medium term.

4. **Risks:** regulatory change and tort reform is an ongoing risk, as the firm must operate within the legal framework in place; competition in personal injury and class actions (impacting share of work and rates charged).

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $1.13/s, reflecting upside of >43%. The stock is extremely cheap at 5.5x PE (who said single digit PE stocks growing their earnings can't be found?). We expect even better returns in the event SHJ are successful in the Mesh class action appeal.