Flinders Emerging Companies Fund

Quarterly Update: December 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	2.56	12.31	11.12	11.16	11.72	13.73
S&P/ASX Small Ords Accumulation Index	2.76	13.83	9.21	6.57	10.45	12.19
Net Value Added	**-0.20**	**-1.52**	**1.91**	**4.59**	**1.27**	**1.54**

^ 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

- **Despite everything else, investors have a good 2020**
- **Small caps outperform large caps again**
- **State Governments risk putting the brakes on recovery**

A strong finish to the year saw the S&P/ASX Small Ordinaries Accumulation Index (the Index) reach record highs in December and close out the year 9.2% higher than at the end of 2019. Small caps performed in line with large caps (both up 13.8%) over the December quarter but outperformed by 8.5% over the year. The Flinders Emerging Companies Fund doing 1.9% better again.

Rather than summarise the trials and tribulations of 2020 in this note (we've all seen plenty of those articles over the break), we'll provide a few market highlights and some insights as to our thoughts for smaller companies in the year ahead.

As well as being a universally strong quarter for equities, a highlight was also the performance of commodities (with the exception of gold, which was essentially flat over the period). Iron ore and thermal coal were both up 32%, Brent oil up 23%, copper 17% and other base metals, agricultural commodities and industrial metals all rallying. At the same time, the US Dollar was weakening against most major currencies and bond market yields started to rise. Much of this was due to the Covid-19 vaccines being approved and the Biden election possibly leading to expansionary policies. Higher bond yields (and potentially higher implied discount rates) have also led to the relative underperformance of many highly valued tech stocks.

This has resulted in greater investor focus on cyclical sectors – not just in the US but in all markets. Australia is no exception. This is where some care is needed. As mentioned in last month's report, this economy has largely (despite State one-upmanship) been open for business and stimulus has been having an impact on the economy for some time. Consequently, some of our more cyclical sectors had already recovered. In some cases those valuations have started look stretched.

Risks still lie in State Governments opening and shutting borders thereby upsetting supply chains and sapping consumer confidence. Credit availability will be an issue this year for smaller businesses and the impact of JobKeeper winding up is yet to filter into the employment market. While positive on a recovery this year, it won't all go smoothly.

We expect very good earnings growth in 2021 from small caps. They are more exposed to the recovery than their larger peers and we feel that there will be excellent opportunities in all sectors – as there always are in this part of the market. Even more so this year, is the importance of focussing on valuation as momentum shifts can be very short term. Our portfolio is balanced across many industries, has an excellent growth profile and significant valuation upside. We feel that it will be a year of good returns, and hopefully, with much less of the drama of 2020…

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Performance Review

The Fund returned 12.3% in the quarter, versus the benchmark return of 13.8%. For the 12 months, the Fund returned 11.1%, versus the benchmark return of 9.2%.

Key Contributors: The quarterly contributors came from a very diverse range of industry sectors. Iron ore and lithium miner, and service provider, **Mineral Resources (+50.3%)** had the double benefit of significantly higher iron ore prices plus a renewed interest in the lithium battery complex with the election of Democrat, Joe Biden in the US (Electric Vehicle subsidies and a renewables focus). The likelihood of increased subsidies for electric vehicles in Europe also helped sentiment. We mentioned in our November report that our holding in childcare provider, **Think Childcare Group (+91.6%)** had been subject to two takeover bids. Private equity underbidder, Alceon proceeded to purchase 19.9% of the company on market at $1.75/s in December and then bid for the whole company at that price (vs their previous bid of $1.35/s). We await rival bidder, Busy Bees' response.

Infrastructure and mining contractor, **NRW Holdings (+43.8%)** rewarded patient holders in the December quarter. The company has been executing on its growth strategy, winning contracts at good margins and has made accretive acquisitions this year but it has taken until the recent quarter for those attributes to be reflected in the share price. It remains one of the Fund's larger positions and we still believe it exhibits significant valuation upside. Debt collection and consumer credit company, **Credit Corp Group (+75.3%)** finished the year strongly following the announcement that it had acquired the Purchased Debt Ledger (PDL) book of distressed competitor, Collection House for $160m – its largest ever transaction. We expect the transaction to be highly profitable with close to $200m of debt under arrangement included in the deal. Credit Corp still has finance facilities of close to $400m for further PDL acquisitions or lending growth at its disposal.

Fund management holding company, **Pinnacle Investment Management Group (+40.0%)** performed strongly with equity markets improving but more importantly, better relative performance from a number of individual funds that will help generate performance fee income. The group has been growing its exposure to the retail market at the expense of institutional investors, a strategy that allows the company to grow with more sustainable margins and a lower risk profile.

Key Detractors: As mentioned in our October report, beauty products and household consumables company, **McPherson's (-55.3%)** struck problems with excess inventory; first in hand sanitiser and then in key beauty product, Dr LeWinn's. Neither issue had been expected or well communicated with the market – nor a capital raising that fell between the two announcements. We exited the stock as the previous outlook for the high growth Dr LeWinn's brand is less certain. Until December, the gold price had struggled during the quarter and our gold holdings with it. **Ramelius Resources (-18.6%)** and **Silver Lake Resources (-22.5%)** both detracted from performance over the period. However, the price of bullion has rallied without much reaction from gold equities. We'd expect that to change in early 2021, and the holdings we have exhibit both excellent underlying growth characteristics and have very strong financial positions.

A reduced NBN contract renewal came as a negative surprise for utilities service company, **Service Stream (-12.0%)**. With NBN work transitioning from connection to maintenance and reduced regional scope of work over the next two years, revenues and profit contribution will be reduced in their telecommunications division. While contracts with electricity and water utilities will increase, as will 5G mobile expenditure, they won't compensate for the NBN reduction until 2022.

Portfolio Activity

Additions: Earlier in the December we re-established a position in **Cedar Woods Properties (CWP)**. With its solid portfolio of residential and light commercial development projects and exposure to the improving Perth and Melbourne markets, we felt the risk profile had reduced considerably for the stock and took the opportunity to buy back into the stock after exiting with the onset of Covid-19. Also added to the portfolio was trans-Tasman childcare group, **Evolve Education Group (EVO)**. Like Think Childcare Group earlier in the year, uncertainty in the industry during Covid-19 due to changing Government support and funding measures kept investors away and the stocks struggled. But both companies were well

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run, had excellent assets and, in our view, were considerably undervalued. Since that time both companies have had positive trading updates and a re-rating process has seen their stock prices begin to move. In the case of EVO, we believe that there is plenty to come.

Also added to the portfolio during the quarter was **Event Hospitality & Entertainment (EVT).** The company owns the Rydges Hotel group which also runs the growing and successful QT Hotels in major cities and destinations in Australia and New Zealand. It also owns Greater Union Cinemas and the Thredbo ski resort and Thredbo Hotel. Clearly, the company has been bruised badly by Covid-19 in 2020 and is still being impacted. However, despite the current clusters and border closures, we expect its businesses to begin to recover in 2021 with rising occupancy from domestic tourists followed by increasing business travel later this year and into next. Cinema patronage will take longer to recover but in time will be a good contributor again. EVT has solid runway of growth and excellent market positions in the hospitality industry.

Late in the quarter we participated in the **Liberty Financial (LFG**) IPO and bought stock on market. We are attracted to the company given its spread of lending exposures (mortgage, auto and personal), its strong market position and importantly, its ability to continue to grow as the large banks retreat from non-mortgage sectors of the credit market. With an experienced management team and an undemanding valuation, we see further upside in the stock.

Exits: During the quarter we sold out of financial markets platform business, **HUB24 (HUB).** This was purely based on valuation. We added the stock to the portfolio earlier in the year at half the price and it re-rated far more quickly than we anticipated – not a bad problem to have. We are still attracted to their business model, quality management team and growth prospects but the stock had run out of valuation support and we saw better opportunity elsewhere. A similar story with selling out of **Appen (APX)** during the quarter. We have held the stock for a number of years with initial purchases made under $4/s in 2017 and it has added considerable value to the portfolio. With it moving into the Top 100, we had a year to sell, but took the opportunity to exit (fortunately prior to a downgrade issued by the company in December).

For much of 2020 we held three gold producers in the portfolio. During the quarter we consolidated that to two and sold out of **Gold Road Resources (GOR)**. While an outstanding long-life asset, the Gruyere gold project (50% owned by GOR) has a lower growth profile than our other two gold stocks (Ramelius Resources and Silver Lake Resources, mentioned above) and less valuation support, hence it was the one to leave the portfolio.

Another stock we sold from the portfolio after holding it for a number of years was **Service Stream (SSM)**. As mentioned above, the company will struggle to provide earnings growth over the next couple of years with the significant reduction of revenues from NBN contracts. The company has good longer-term prospects and a balance sheet that gives it plenty of acquisition opportunity. However, the closer term lack of growth has had a negative impact on our assessed valuation so we exited the stock. A similar deterioration in growth led us to exit financial services software developer**, Bravura Solutions (BVS)**. With a large part of its business based in the UK, delays in potential new contract decisions and disruption to implementation activity both due to Covid-19 and Brexit have led to the lower growth outlook. While largely temporary, we expect it to be at least 2022 before some level of revenue momentum returns.

At the end of the quarter we had 38 stocks in the portfolio and were holding 3.2% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Credit Corp Group	Gold Road Resources	Baby Bunting
Mesoblast *	McPherson's	Codan
Mineral Resources	Ramelius Resources	NRW Holdings
NRW Holdings	Service Stream	Seven Group Holdings
Think Childcare Group	Silver Lake Resources	Shine Justice

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 31st December 2020. Top 5 positions are effective 31st December 2020.

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Stock in Focus: Uniti Group (UWL)

Uniti Group is a telecommunications infrastructure and specialty services company. The largest part of the group is its fixed optic fibre network to residential housing developments and apartments across Australia – competing with NBN Co. It also has a Retail Service Provider (RSP) division that serves customers with billing and value-added services. The last division is specialty telco services that deals with businesses requiring 1300 and 1800 number services. Uniti has grown rapidly through acquisition in recent years but the company's management team has a strong record of integrating new businesses, extracting synergies and identifying new opportunities in the industry.

Investment Case Key Questions

1. **Growth Opportunity:** There are excellent growth prospects providing physical long life fibre cable to households. Following the acquisition of both OptiComm and Velocity this year, the group has 170,000 active customers, an additional 95,000 connected but not yet active and a further 220,000 premises contracted for connection. All of those are already or are potential customers for Uniti's RSP division. While the core part of the business is in new development projects, there is also scope to expand into existing areas not yet covered by fibre to the premise and also to commercial/industrial park developments. The RSP business can grow its presence in the consumer market and can leverage into the small business sector via the customer base of specialty services mentioned above. Acquisitions may be on pause for a while as the company integrates OptiComm and Velocity and reduces debt.

2. **Management:** CEO Mick Simmons and Executive Director, Vaughan Bowen have significant experience in growing businesses in the telecommunications industry. They have assembled a strong team and importantly, have a proven track record of integrating acquisitions and adding shareholder value. They are clearly aiming to grow the company to a more significant size over the next few years.

3. **Financial Strength:** Following the on-market acquisition of OptiComm and the purchase of Telstra's Velocity network, the company has increased debt levels. However, it has been matched with more equity and cashflow is very strong out of most of their business units. The company's cost of debt is low. Net Debt/EBITDA is expected to fall from 2.3 times to less than 2.0 times before the end of this year and interest cover is very comfortable. Importantly, the infrastructure assets are long life, generate steady cash and have minimal capital requirement once built.

4. **Risks:** Telecommunication infrastructure is a regulated industry due to the NBN roll-out. There was a recent regulatory review into the provision of services into new estates and developments and there is nothing outstanding of significance. We don't expect further reviews for some years. Competition with NBN will continue in these markets, and while NBN could drop prices, we would see this as unlikely at a time they are looking to lift returns. Acquisition integration is always a risk, but management have the systems and experience to give us confidence in successful execution.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $2.13/s, reflecting upside of 25%. The valuation includes modest assumptions on the synergies that may be attained from the recent acquisitions.

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