Flinders Emerging Companies Fund

Quarterly Update: March 2021

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	0.19	3.47	64.20	13.05	13.38	13.77
S&P/ASX Small Ords Accumulation Index	0.79	2.09	52.15	8.32	10.68	12.03
Net Value Added	**-0.60**	**1.38**	**12.05**	**4.73**	**2.70**	**1.75**

^ 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

Warakirri Asset Management 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

- **Solid quarter but what a year!**
- **Bond yields keep rising**
- **Hey, Scotty and Greg – what have you done with those vaccines??**

The S&P/ASX Small Ordinaries Accumulation Index (the Index) reached an all-time high in mid-March before easing back slightly to post a rise of 2.09% for the quarter. In an extraordinary 12 months, the index added 52.15% and the Flinders Emerging Companies Fund rose 64.20%.

Global equity markets were strong over the quarter with one feature being the strength of cyclical sectors compared with technology or yield based sectors. Commodities had another good period, especially oil (Brent up 31%) and copper (up 14%). Iron ore and coal held their gains of late 2020. Over the quarter, small-cap industrials outpaced resources (up 3.3% vs down 2.8%) but for the twelve months, resources outperformed by 12%.

International bond yields continued to climb and Australia was no different. Our 10-year Government yield rose from 0.97% to 1.79% over the period, the steepest quarterly rise in twelve years. Regardless, the RBA still expects the cash rate to be unchanged until 2024. Monetary stimulus is significant and fiscal stimulus despite the end of JobKeeper also remains at elevated levels.

The February profit reporting period was as positive as we've seen for five years, the domestic economy is recovering strongly across virtually all sectors and the incidence of sudden Covid shutdowns has diminished. Commodity prices remain at elevated levels, the rural economy is powering along, mortgage rates remain at the lowest in living memory so unless your business is exporting wine to China or ski tours to Canada there is plenty to cheer about.

While we have some concerns about the slow vaccine rollout and the ability of Australia to live with active cases in the future, the current stimulatory environment will dominate those issues at least into 2022. So, will that cause the inflationary pressures, leading the RBA to lift rates early? Possibly. And will it derail valuations enough to see a significant sell-off this year? Due to earnings growth, unlikely – especially in small-caps. We say this because in smalls, there is a much broader representation of the domestic economy and we can still find growing companies at very attractive valuations.

The Fund's forty stocks cover a broad spread of industry exposures – mainly to Australia but many have interesting and growing revenue streams offshore. They are growing, capitalised well enough to fund their growth (vital in smaller companies) and have solid valuation support. We are still bullish on the smaller end of the market. There is ample earnings growth over the next year or so but making sure that the companies we own can maximise their opportunities and not overpaying for short term cyclical growth or unsustainable themes will also be our focus.

Performance Review

The Fund returned 3.47% in the March quarter, 1.38% above the benchmark return of 2.09%. Over the 12 months the Fund returned 64.20%, outperforming the index return of 52.15% by 12.05%.

Key Contributors: The quarterly contributors were not linked by style rotation or industry themes. The portfolio benefitted from companies with good growth attributes, being managed well and having plenty of valuation upside. It might sound like a Flinders cliché or a little boring, but we'd be a little worried if it stopped being the case. Diversified electronic products developer, **Codan (+39.0%)** produced a strong interim profit result in February as well as an accretive US acquisition (with another accretive acquisition in early April, demonstrating the power of optionality from a strong balance sheet). The company's metal detection division continues to provide growth and excellent returns but its communications business is now getting serious traction with new products and meaningful contract wins.

Also benefitting from a strong interim profit result, but also the revival of domestic leisure travel was multi-modal travel company, **Sealink Travel Group (+38.1%).** While the company has traditionally been seen as a tourism operator, its bus and ferry businesses are largely low risk, long life Government commuter contracts. That said, three of its businesses, Captain Cook Cruises (CCC), Fraser Island and Kangaroo Island are predominantly tourism based. The latter two are clearly benefitting from the uptick in domestic travel while CCC will take longer having a greater dependency of foreign tourists.

We've mentioned **Think Childcare Group (+42,5%)** a number of times over the past few months as a contributor due to a number of takeover bids. At the time of writing in April, the stock had just received what looks like a final knockout bid of $3.20 per share from UK operator, Busy Bees. That's another 38% above the end of month close – and quite some distance from when we were buying the stock in September last year at 70 cents.

Telecommunications infrastructure company, **Uniti Group (+34.5%)** benefitted from a good interim result, but importantly, greater clarity of its growth prospects and financials after a hectic December quarter where they completed the contested acquisition of OptiComm, bought the Telstra owned Velocity fibre business, plus raised capital. We expect the company will see increased activity in the 2022 FY with the jump in housing starts and increasing market share against NBN Co. Fund manager stable, **Pinnacle Investment Management (+31.5%)** had the twin benefit of rising investment markets (especially equities) and a resumption in performance fees from a number of its key affiliate funds. This is expected to continue into the current half. The group is expanding its distribution capability both in the US and Europe as well as improving its market penetration of domestic retail investors.

Key Detractors: Mining and infrastructure contractor **NRW Holdings (-31.3%)** fell following the release of a disappointing interim profit result. While the company is integrating recent acquisitions well, has a strong balance sheet and won significant contracts, a combination of delays to some East Coast contracts but more significantly, cost increases in WA led to tighter margins than anticipated. A number of these costs were one-off as the WA labour market suddenly tightened in the absence of interstate workers and other input costs jumped. We expect some reversal this half and recent contract wins give us improved confidence in the company's growth outlook.

Not owning a $3.5bn market cap stock in the small ords index that then rises 55% in a quarter will always hurt relative performance. **Lynas Rare Earths (+55.0%)** was that stock. Yes, the company has strategic (read not Chinese) products that are important in the future of electric vehicles (neodymium and praseodymium – NdPr – significantly reduce the weight of magnets in electric motors) but to justify the current stock price, both production and prices have to far exceed current forecasts so we are unable to justify the current valuation. X-Ray scan software developer, **4DMedical (-29.2%)** had a poor quarter after highlighting that access to hospitals in the US had been disrupted due to Covid-19 – not entirely surprising. Importantly, the company announced good news during the quarter in that the Australian Government had granted it $28.9m through the Medical Research Future Fund (MRFF) to fund its four-dimensional lung X-Ray developments. The company matched that amount in an equity raise and SPP putting it in an extremely strong financial position to bring its technology to market. The improving Covid-19 situation in the US should also help the company from an operational perspective through the rest of this year.

Portfolio Activity

Additions: Plus-size women's apparel retailer **City Chic Collective (CCX)** was added to the portfolio in March. The company has operations in Australia, North America and the UK both in store and online. The online segment in particular is growing and importantly, margins are expanding as the online channel outpaces in-store. We are particularly positive on their opportunity in the US with its brand, The Avenue. Management has proved themselves adept at maximising their position in the market and running an efficient retail operation in challenging conditions.

Also added to the portfolio in the quarter was **Southern Cross Media (SXL).** SXL operates the Austereo radio network throughout major capitals and regional Australia (best known with TripleM, Hit and Mix stations). It also operates a network of digital stations and podcast services through Listnr and PodcastOne. The company also operates as a TV network affiliate in regional Australia under the Southern Cross brand. The recovery in the Australian advertising market has started to recover. Advertisers are now becoming more confident in spending and promoting products and rates are increasing. This started in the traditional television market toward the end of 2020 and is now beginning to benefit other traditional media operators such as radio. We expect the recovery to last quite some time and SXL has reduced its cost base significantly, improved its digital offerings and is well placed to see excellent growth over the next two years.

We added specialised drilling services company **DDH1 (DDH)** to the portfolio during the quarter, firstly with a modest investment at the IPO then in the market as the price drifted below issue. The company provides drilling services to the base metal, gold and lithium sectors for exploration, mine development and production. It has been in operation for over 15 years, delivered industry leading returns, consistently grown market share and is well capitalised. The company has considerable valuation upside and a strong growth profile backed by industry capital expenditure over a number of years.

Also added was nickel, gold and soon to be lithium producer, **IGO (IGO)**. The company's assets have been traditionally in nickel through its 100% owned Nova project and gold through its 30% interest in the Tropicana mine, both located in WA. In December 2020, the company agreed to acquire a 49% stake in Tanqui Lithium Energy which has a 50% stake in the productive Greenbushes lithium mining operation and 100% of the Kwinana Lithium Hydroxide plant for a total of $1.9bn. These are very quality long-life assets, and the timing of the acquisition is excellent as lithium prices are expected to rise further with the rapid increase in EV production in coming years.

Exits: During the quarter we sold out of insurance broker, **Steadfast Group (SDF).** This was purely based on valuation. The stock had performed very well (especially since October last year) and while we still consider the industry to be attractive (the Fund continues to have exposure to listed competitor AUB Group) and the company very well run, valuation upside was very modest and more attractive opportunities existed. A similar reason was behind the exit of **Harvey Norman (HVN).** The stock performed very strongly and has produced the revenue and profit uplift we had anticipated when we purchased the stock last year. Better margins, good cost control plus the company's exposure to both spending on household goods and consumer electronics led to a rerating of the stock and our valuation was reached.

At the end of the quarter we had 40 stocks in the portfolio and were holding 3.0% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Codan	4DMedical	AUB Group
Pinnacle Investment Management	Cooper Energy	Codan
Sealink Travel Group	Lynas Rare Earths*	Elders
Think Childcare Group	Macmahon Holdings	Integral Diagnostics
Uniti Group	NRW Holdings	Seven Group Holdings

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 31st March 2021. Top 5 positions are effective 31st March 2021.

Stock in Focus: Macmahon Group (MAH)

Macmahon Holdings is a Western Australia based mining services group with operations predominantly in Australia as well as in Indonesia. Its core business is in providing clients with mining capability in both surface and underground settings. It also operates a small civil construction business. Macmahon is exposed mostly to the growth in both gold and copper production, and to a lesser extent metallurgical coal used in the steel making process. The company has impeccably navigated the challenging market conditions caused by COVID-19, specifically cost pressures driven by State border closures which limited access to experienced staff – Macmahon grew earnings margins in the period placing them amongst a select group of winners in the sector.

Investment Case Key Questions

1. **Growth Opportunity:** The company has a demonstrated track record of growing revenue and importantly earnings under the guidance of the current management and board. The company delivered EBITA of $46.5m in the first half of 2021 and is guiding up to $100m for the full year. The outlook for the business continues to look strong with a current order book for $4.2bn, and a tender pipeline of $7bn of which half resides with existing customers. Since delivering the interim result the company has converted a number of these opportunities into contracts and are well placed to continue to win work assisted by their track record of good corporate governance and safety.

2. **Management:**. Management team has been led by CEO Michael Finnegan since late 2016, having joined the business in 2014 with over 20 years industry experience particularly with an operational focus. This was critical in turning around two problematic contracts for Macmahon when Michael joined, namely Tropicana (Anglo/IGO) and then Telfer (Newcrest). In addition, a board of seven directors who are predominantly independent and ably led by Eva Skira and encompasses a significant level of industry and market experience. We view this board as exceptional given the size of the company i.e. <$500 market capitalisation.

3. **Financial Strength:** The business is conservatively capitalised with Net Debt / EBITDA of ~0.5x and interest cover ~6x. The company has been prudent in relation to acquisitions and recognise that these opportunities must be balanced against investing organically which typically generates returns of ~15% (at the EBIT level). The company has indicated that expansion of the underground business remains a priority and from a balance sheet perspective, is less capital intensive to operate in than surface mining.

4. **Risks:** The key risks to the investment thesis include: 1) a project becoming problematic, which impacts profitability and can then impact the balance sheet; and 2) collapse in the price of the underlying commodities that Macmahon are exposed namely gold and copper which leads to a client cutting back on capital investment which eventually curtails production. In our view, the above risks are mitigated by the competency and skill of the management team, together the supply / demand dynamics for the commodities particularly copper, which currently favours producers.

5. **Valuation:** We value the company on a forward multiple of 10x FY22 profit which is around half the PE of the Small Industrials Index (18.6x), for an assessed company valuation of $0.28/Share or >30% above the current share price making it incredible value at current prices and exceptional given that the earnings of the business continue to grow.