# Flinders Emerging Companies Fund

Quarterly Update: September 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 | -1.95 | 2.42 | 29.16 | 12.80 | 11.06 | 14.55 |
| S&P/ASX Small Ords Accumulation Index | -2.14 | 3.44 | 30.41 | 9.42 | 10.17 | 13.12 |
| **Net Value Added** | **0.18** | **-1.01** | **-1.25** | **3.38** | **0.88** | **1.43** |

^ 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

**Fund Size**

$123.2m

**APIR Code**

ETL0449AU

**M-Funds Availability**

Code FEC01

**Responsible Entity**

Warakirri Asset Management Ltd

**Research Ratings**

Lonsec: Recommended
Zenith: Recommended

**Platform Availability**

Macquarie Wrap, HUB24, Netwealth, uXchange, BT Wrap, BT Panorama, AMP, North, Xplore, MLC Wrap, CFS FirstWrap, Powerwrap, Navigator, IOOF, Praemium

**Further Information**

www.flindersinvest.com.au

- **Speed wobbles**
- **Inflation continues to lurk**
- **Lockdowns: imagining the other side**

The S&P/ASX Small Ordinaries Accumulation Index finished 3.4% higher over the quarter, reaching an all-time high on the 3rd of September before weakening toward the end of the month. Industrials slightly outperformed resources, and small caps outperformed the Top 100 by almost 2%.

Global markets were mixed over the quarter, generally firm until early September before selling off. Major US equity indices were flat for the quarter but lost close to 5% in September alone. With the exception of Japan that rose 2.3%, Asian markets were noticeably weak with Hong Kong and Korea down 15% and 7% respectively. Commodities were mixed with base metals and gold virtually unchanged (except a 13% rise in aluminium), oil was up almost 5% for the quarter and the astonishing divergence between iron ore and coal continued with iron ore falling 49% and thermal coal rising 68%. And in another plus for the rural economy, the cotton price reached a 10 year high. Add plenty of water availability and a low AUD, and that equals super profitability for that industry in Australia – after five lean years.

The weakness in September was due to a focus back on inflation fears and bond yields rising after a few months of decline. But different from earlier in the year, it had a backdrop of growth and corporate earnings slowing in the US. Daily equity moves became more pronounced and volatility rose. We've been talking about supply chain disruptions and high transport costs for some time, and they persist. The current issues in China with power restrictions (not to mention property and credit problems) has also added to dislocation and costs globally – all of which add fuel to inflationary pressures. The last thing global equity markets need, are prolonged cost increases coinciding with slowing growth.

Back in Australia, we are marching – or perhaps shuffling – to a different tune altogether (but sadly can't ignore offshore developments). With NSW and Victoria due to slowly emerge from lockdown over the next month, activity will pick up. Sure, there will be problems as there has been elsewhere in the world, but we've seen what a recovery from lockdowns looks like in the US and Europe, and we don't expect major differences. Consumers have ample ability to spend – and they will. We saw it here in the first half of this year and the economy ripped for six months. With low rates continuing, increased savings levels, wages growth and house prices higher, we shouldn't underestimate what happens into 2022. Sydneysiders and Melbournians might not be going to Noosa or the Gold Coast, but they'll be spending big closer to home…

We feel that the first beneficiaries to the local recovery will be smaller companies. We've added some new ones to the portfolio which we discuss in the next section.

## Performance Review

**The Fund returned 2.42% in the September quarter, 1.01% below the benchmark return of 3.44%.**

**Key Contributors:** A strong full year profit result from diversified investment house, **Pinnacle Investment Management (+32.8%)** saw the stock hit new highs. Funds under management continued to grow in almost all its affiliate firms, both in institutional flows but notably in retail. Performance fees were also higher as an increased number of funds exceeded their benchmarks – a trend that is continuing. Its affiliate firms cover a wide spread of asset classes, many with limited capacity constraints and most with strong track records against their benchmarks, all helping to drive a strong growth profile for a number of years.

Retirement village developer and operator, **Lifestyle Communities (+41.6%)** continues to perform strongly with its pipeline of quality projects attracting buyers at both a healthy rate and price. This has allowed the company to accelerate its growth profile with new projects in a variety of new regions around Melbourne and across Victoria. Medical device consumables manufacturer, **Trajan Group (+35.4%)** is a recent IPO that we participated in and increased our position on market. The company has operations in Australia, the US and Malaysia and supplies multinational device manufacturers consumable items for their testing and diagnostic machines. It has world leading positions in nano glass tubing products and other specialty items, many in significant growth areas of the market.

Online travel and wholesale hotel bookings company, **Webjet (+29.1%)** bounced back strongly in the September quarter despite lockdowns in NSW and Victoria. With the long-awaited release of some clear plans for ending lockdowns in New South Wales and vague utterances to that effect in Victoria, plus airlines starting to reinstate flights, travel and leisure stocks rose strongly. Law firm, **Shine Justice (+20.0%)** has performed well all year for the fund and continued to re-rate in the September quarter. A solid profit result, improved growth profile and importantly, the chance in early November of the conclusion of the Mesh implants class action against Johnson & Johnson (no relation), all helped see the stock move higher. Shine is now positioned to grow earnings at a higher rate versus what it has delivered in recent years.

**Key Detractors:** Global online meal kit provider, **Marley Spoon (-52.5%)** had a disappointing quarter despite sales and customer growth performing to expectation in their first half result. The disappointment was in the lowering of margin guidance for the calendar year, due to higher costs in the US from labour and logistical pressures, which resulted in higher promotional expenditure to keep their customers happy. Many of these issues should be temporary, and we expect margins to resume their upward trend over the coming years as the company increases its scale substantially.

After being a strong performer for the fund over many years, electronic products developer and manufacturer, **Codan (-28.3%)** pulled back quite sharply in the September quarter. The company released a solid full year profit result and is poised to have a good 2022 financial year with contributions from their newly acquired communications businesses in the US and the release of new generation metal detection devices. What seems to have rattled the market was the retirement of long time CEO Donald McGurk. He and his team have overseen a tremendous growth period for the company, transforming it from a niche product manufacturer to being a global player (and leader) in product sectors it operates. We strongly feel the de-rating has been over-done. The company has growth prospects, excellent returns, a very strong balance sheet, a well credentialled board and proven management team. We'd expect a rebound.

While the gold price slipped less than 1% in the quarter (and went up in AUD terms), the gold sector remained unloved. **Silver Laker Resources (-19.3%)** suffered as a result and a brief shutdown of its Santa gold mine in WA meant it reduced its production guidance. This was to analyse drilling results which would have a bearing on future mine configuration at Santa. Pleasingly, the results have since led to an upgrade to reserves and extension of life at Santa. During the quarter a few sectors ran hot (pun recognised). Coal and lithium were two standouts. While we have exposure to both energy and battery materials in the portfolio, when two large members of the index such as Whitehaven Coal and Pilbara Minerals rise 66.5% and 41.4% respectively, it is going to hurt relative performance – and did. That said, we find the current valuation levels of those two companies unsustainable.

## Portfolio Activity

**Additions:** There weren't any major themes that characterised the stocks added to the portfolio during the September quarter – outside the opportunity to buy companies that have good growth qualities where a valuation gap had opened up. In fact, three of the four added, we have held in previous years. **Beach Energy (BPT)** has recently been relegated from the Top 100 – becoming part of our investment universe (it moved into the top 100 only in June 2019 – so not a long stay). We knew the key gas assets well, knew management and understood the company's growth outlook. However, the price had halved since we sold our position in late 2019 on energy price declines in 2020 and Cooper Basin reserves downgrades in early 2021. After updating our valuation, meeting with management identifying a clear under-valuation, we added the stock to the portfolio – only days after Beach had re-entered the Small-Ords.

Homewares and linen retailer, **Adairs (ADH)** was added to the portfolio during the quarter. The company has de-rated since lockdowns were introduced in NSW and Victoria. Obviously, sales through their physical stores are reduced and the current half year profit result will be subdued. However, their online business continues to thrive and by the end of this year, we would expect to see most of their stores open for business again. The company is managed well, has a balance sheet that is in good shape allowing store and product expansion and is undervalued versus peers and its own history. We took the opportunity late in the quarter to buy back in.

Also added to the portfolio was workforce management and staffing firm, **People Infrastructure (PPE)**. Like Adairs, the stock has fallen since lockdowns in June. PPE operates in three distinct industry sectors, healthcare, IT and industrial services. IT in particular has been performing strongly and the company is now beginning to see a recovery in their healthcare and industrial segments in lockdown states. The de-rate is certainly not commensurate with any earnings impact (which should only be a few percent); overall, the company should still achieve double digit EPS growth in 2022 and acquisitions will also help drive growth. We see plenty of upside in this holding.

**Exits:** During the quarter we finally exited **Think Childcare (TNK),** and its takeover by Busy Bees of the UK has been completed. It was an excellent contributor to the fund's returns over the time we held the company. We also exited salmon and prawn aquaculture company, **Tassal (TGR).** There were two main reasons, one short term and one long term. The short-term reason is that international salmon prices have fallen significantly over the past few months and with lockdowns impacting domestic food service demand, Tassal has had to export more of its production – into a market that is now falling. The longer-term issue is that the cost and ability to grow production in Tasmania will be under pressure due to tighter environmental regulations recently announced by the Tasmanian Government.

We also sold **Gold Road Resources (GOR)** early in the quarter, reducing our exposure to gold companies from three to two, Silver Lake Resources and Ramelius Resources, both of which are more diversified and have better growth prospects.

And lastly, we exited residential property developer, **Cedar Woods Properties (CWP)**. With the expectation of macro prudential measures on mortgage lending and the expected removal of state/federal government incentives given house price appreciation, coupled with rising input costs, all diminished our upside case for the stock.

At the end of the quarter we had 42 stocks in the portfolio and were holding 3.1% cash.

| Performance Attribution^ | | Key Portfolio Positions^ |
|---|---|---|
| Top 5 Contributors | Top 5 Detractors | Top 5 Active Holdings |
| Lifestyle Communities | Codan | Baby Bunting |
| Pinnacle Investment Mgt | Marley Spoon | Codan |
| Shine Justice | Pilbara Minerals ***** | Elders |
| Trajan Group Holdings | Silver Lake Resources | EQT Holdings |
| Webjet | Whitehaven Coal ***** | Seven Group Holdings |

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th September 2021. Top 5 positions are effective 30th September 2021.

## Stock in Focus: Codan (CDA)

**Codan** (CDA) is an electronic products developer and manufacturer with two major divisions: 1. Communications (Codan branded); and 2. Metal Detection (Minelab branded). The company operates from 17 locations globally, with +700 employees, selling into +150 countries. Substantial R&D investment over time (~$30m p.a. in recent years) has resulted in defensible IP and market leading products and enabled CDA to take share from competitors. Excellent financial metrics around margins, returns and cash generation has allowed CDA to recently acquire two substantial businesses (DTC and Zetron) in its Communications division, which increases their addressable market and should drive further growth. The company was founded in 1959 and is headquartered in Adelaide, Australia.

**Investment Case Key Questions**

1. **Growth Opportunity:** CDA has delivered multiple earnings upgrades since we first invested in the business in 2016, while earnings per share has grown 35% p.a. over the last five years to FY21. This has been largely due to their Minelab metal detection business. Metal detection has two distinct markets – artisanal gold mining in developing countries, and recreational mining in developed countries. Minelab's products are best in class – think deeper metal detection in more soil types vs their competitors. Going forward, further market share increases in recreational mining in the developed world, new product development and geographic expansion globally should continue to drive growth. Within the Communications division, CDA has made two substantial acquisitions in 2021, which effectively increases the company's total addressable market into the billions of dollars. This Communications segment is expected to be a key enabler of growth over the next few years, supporting the double-digit EPS growth profile that we expect the group to continue to deliver on.

2. **Management:** Donald McGurk joined the company in 2000 and has led the company since 2010. He advised the Board at the FY21 result in August of his intention to retire sometime in the following 9-12 months. This development seems to be a key reason as to why the stock has underperformed since the result. He has no doubt overseen a tremendous period of growth for the company and we commend him on his role. Yet, each divisional head at CDA is highly experienced and has been with the company for many years, as has the CFO Michael Barton, and we expect a smooth transition to a new CEO with the right skillset to oversee the next period of growth for the company.

3. **Financial Strength:** the company is great generator of cash and has been adding to its cash balance consistently over the last few years. This allowed the company some optionality which it executed on earlier this year by making two earnings accretive acquisitions in DTC and Zetron. Currently, the company continues to be in a net cash position. Product gross margins are high and ROIC has been ~35% in recent years, with a proven track record of product development and release, which we expect to continue.

4. **Risks:** metal detector sales have historically been volatile, but mitigated by what is now a broad range of products and geographies. Risk of a poor CEO appointment over the next 12 months. FX risk as 85% of sales are outside of Australia.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $18.28/s, reflecting upside of >43%. The stock is currently trading at a discount to the market, which is unwarranted given its unique IP and market leading products, several drivers of growth, and high returns.