

Flinders Emerging Companies Fund

Quarterly Update: December 2021



Performance <i>(after all fees and expenses)</i>	1 Month (%)	3 Months (%)	1 Year (%)	3 Years (% pa)	5 Years (% pa)	Since Inception [^] (% pa)
Flinders Emerging Companies Fund *	4.14	1.04	16.14	19.38	12.39	14.10
S&P/ASX Small Ords Accumulation Index	1.41	2.03	16.90	15.71	11.17	12.95
Net Value Added *	2.73	-0.99	-0.76	3.67	1.21	1.15

* Fund performance numbers are unaudited. Final numbers will be available on our [website](#) mid-Jan 2022. ^ 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

\$149.0m

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



- **A year to forget – except for investment returns**
- **Inflation. Out, damned spot! Out, I say...**
- **Why small cap equities will continue to perform**

The S&P/ASX Small Ordinaries Accumulation Index finished 2.0% higher in the December quarter and gained 16.9% over 2021. Small resource stocks outperformed industrials by over 15% in the quarter led by energy and battery material companies.

Yet again, US equity markets led global markets higher. The strength in the US was broadly based with the S&P500 Index rising 10.6%, more than 2% above the Nasdaq and 3% above the Dow Jones. Other markets were more subdued but generally still posted gains. Hong Kong, Korea and Japan being the exceptions declining between 2% and 5%.

Commodity markets remained robust in the quarter despite indications of slowing growth in China. Iron ore seemed to find a base after halving earlier in the year and while coal prices fell over 20%, they remain at historically elevated prices and double where they were this time last year. Base metals were strong – particularly nickel and zinc, gold was up 4% and remarkably stable in US dollar terms over the year and while the oil price was flat over the quarter, WTI was up 13% in December and is up 55% over the year.

With the subdued economic growth in China and signs that growth in the US has past peak recovery, bond yields were flat over the December quarter despite inflationary signals not dissipating. Energy prices, food, labour and commodities remain at high levels and will continue to impact inflation figures in most economies. Some may be transitional, much will remain. Perhaps it's not Lady Macbeth's nightmare but it will be an increasing concern.

Domestically, rates will also be an important consideration but, the expected economic recovery has only commenced now (albeit tempered by Omicron). And, although we have seen the bottom in fixed rate mortgages, rates will continue to remain low – at least for most of this year. Inflation will rise but as Philip Lowe has often reminded us, the RBA will be focused on rising wages as the trigger to increase rates. This is good for domestic corporate earnings in 2022. While there are cost pressures, healthy consumer and business demand plus product shortages means that businesses have improved pricing power and are well placed to pass on increased costs – especially in the current half year.

Given smaller companies are more domestically focussed we are expecting far better earnings growth in 2022 and 2023 than we expect from large companies. We feel that there are good opportunities to find these stocks at valuations that are not stretched. Parts of the market is populated with promise – and at times, very expensive promise. This can make the overall market look overcooked. We are confident that the current portfolio is well set for 2022, exhibiting well above market earnings growth with significant valuation upside.

Disclaimer and Disclosure

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Performance Review

The Fund returned 1.04% in the December quarter, 0.99% below the benchmark return of 2.03%.

Key Contributors: The stand-out performer for the quarter was graphite producer, **Syrah Resources (+70.0%)**. A good deal of the price rise came in December when the company announced an offtake agreement for future battery anode graphite production with Tesla. Syrah already produces refined natural graphite from its Balama mine and production facility in Mozambique. It is the largest high grade graphite deposit in the world and the only one of significance outside China. The company is now close to final investment decision (FID) on manufacturing battery grade graphite at its US plant using its Balama graphite as a feedstock. We expect the Tesla agreement to be the first of more supply deals, but certainly the largest.

Following a significant acquisition in the US, property services company **Johns Lyng Group (+49.1%)** continued to re-rate (the stock is up 190% for the year). In December the company announced the acquisition of US based Reconstruction Experts (RE) for US\$144m plus earnout provisions. Like Johns Lyng, RE is a provider of insurance focused repair services to residential properties. Operating in 4 of the most populous states in the US, the business is profitable, growing, has an established and experienced management team and is highly accretive to Johns Lyng at the acquisition price.

Nickel and Lithium producer, **IGO Limited (+29.2%)** performed well with strong prices for both basic and refined lithium products continuing. The company also announced the agreed acquisition of fellow WA nickel producer, Western Areas (WSA). While in the short term there is limited value added from the merger of both company's nickel operations, WSA's significant Odysseus/Cosmos project will add over 10 years of low-cost production from 2023. Medical device and consumables manufacturer, **Trajan (+25.8%)** had another strong period driven by a number of complimentary and strategic acquisitions enhancing its position as a growing international supplier of high-end consumable products to the diagnostics industry. The largest of the companies acquired, Axel Semrau, based in Germany specialises in laboratory chromatography software and detection – similar to products currently manufactured by Trajan. Importantly, it gives them a European presence to add to their Australian, Malaysian and US operations.

Key Detractors: Electronic products developer and manufacturer, **Codan (-26.9%)** slipped further in the December quarter despite confirmation of higher profits in 2022 and the appointment of a new, well credentialed replacement for long time CEO, Donald McGurk. Sales of its Minelab products remain strong despite supply-chain disruptions and the two recent US acquisitions of DTC and Zetron in the field communications division are doing well and will provide solid growth over the next few years. We remain of the view that the stock has considerable upside. We mentioned that we had exited online meal kit provider **Marley Spoon** in our October report and that it had been a detractor from performance in that month – impacting the quarter. As we outlined at that time, we are believers in the growth of the industry, but success requires a higher level of working capital than we felt that company had access to without an equity injection.

Commuter transit and tourism company **Kelsian (-17.1%)** fell after not winning either of two bus contracts, both of which would have added further scale and synergies to its current bus concession footprint in Australia. The Melbourne and Sydney contract were both significant in size and while not in our forecasts or valuation of the company, it was a disappointing outcome and the stock re-traced. The tick-up in domestic tourism is now helping its Sealink operations and further transit opportunities are expected over time.

And on the theme of tourism, online travel company, **Webjet (-18.5%)** was performing well with the ending of lockdowns in NSW and Victoria but that came to a halt with the emergence of the Omicron variant of Covid-19 throughout the world. Once again, State Government handling of border controls was inconsistent and the sharp increase in cases has stretched testing and tracing dramatically. The wave will pass but it continues to weigh on tourism and hospitality.

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Portfolio Activity

Additions: During the quarter we added to existing positions that were still exhibiting strong growth characteristics but may have been left behind by the market and were still showing good valuation upside. There was only one addition to the portfolio during the period, infrastructure and mining contractor, **NRW Holdings (NWH)**. We had previously owned NWH and sold our position in early 2021. The company had been experiencing sharp cost increases in a number of contracts but particularly in the Pilbara iron ore region which was experiencing a number of expansion projects. This also coincided with the slowdown of a number of East Coast infrastructure projects (mainly Covid related). The company is now through the largest impact of cost increases and infrastructure spending has picked up again. However, the company continued to de-rate and a significant valuation opportunity opened up.

While NWH is a cyclical company, there is still considerable capital expenditure activity in the resources sector, the forward work expectation for infrastructure is still very positive and cost pressures in WA have been addressed. The company has a strong balance sheet, an experienced and good quality management team and improving returns over the next three years.

Exits: During the quarter we exited **Mineral Resources (MIN)**. The company has been a wonderful performer for the fund over many years. However, given that we have a limited time to sell stocks that move into the ASX 100 (12 months) and the stock nearing valuation, we exited the position.

We also sold our position in financial services software company, **Bravura Solutions (BVS)**. While its customer base (wealth management and funds administration companies) have been doing well over the past couple of years in Australia, Bravura's UK business has been comparatively subdued. A combination of Covid and Brexit has seen investment decisions delayed and its medium-term growth outlook decline. Consequently, it lost valuation support and we exited the position early in the quarter.

And as mentioned earlier in the performance commentary, we sold our position in **Marley Spoon (MMM)** on working capital constraints leading to increased financial risk.

At the end of the quarter we had 40 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
IGO Limited	Codan	Baby Bunting
Johns Lyng Group	Kelsian Group	Codan
Syrah Resources	Marley Spoon	IGO Ltd
Trajan Group Holdings	Pilbara Minerals *	Seven Group Holdings
Zip Co *	Webjet	Syrah Resources

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

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Stock in Focus: NRW Holdings (NWH)

NRW Holdings (NWH), provides diversified contract services to the resources and infrastructure sectors throughout Australia. It operates through three segments: Civil; Mining; and Minerals, Energy & Technologies. Services include private and public civil infrastructure construction, mine development, bulk earthworks, contract mining, drill and blast services as well as materials handling, onsite maintenance, and shutdown services. The company has diversified extensively in recent times through the acquisition of Golding in 2017, BGC and RCR Mining Technologies in 2019 and Primero in 2020. These businesses have provided geographic, industry and capability diversification to the group, reducing the dependence of west coast iron ore mining and construction related activity which was a feature of its history. A combination of capital discipline and solid cashflow generation have ensured that the group remains well placed to execute on further value enhancing acquisitions.

Investment Case Key Questions

- Growth Opportunity:** after a busy 2020 which saw revenue growth of >80%, growth slowed to ~10% in 2021. However, it was the increase in costs due to border closures in response to Covid, that saw margins fall. Importantly, the outlook for the business remains solid, with revenue growth supported by growing pipeline of opportunities in resources and infrastructure, cost moderating as border restrictions ease and reduced skew to activity in the Pilbara (where skilled labour shortages were the most acute). We expect earnings growth of ~15%pa over the next 3 years.
- Management:** CEO Jules Pemberton, together with CFO Andrew Walsh are industry veterans that have developed a strong culture of financial discipline and operational safety. Their experience through previous economic cycles has been the foundation of the strategic focus on diversification to limit exposure to any one market or commodity.
- Financial Strength:** we expect net debt to equity to improve from ~20% in 2021 to ~10% in 2023. Effective delivery of operational cashflow and disciplined capital management has seen the company maintain an improving balance sheet which is sufficient to support both organic and acquisitive growth initiatives.
- Risks:** global and domestic economic activity are the key risks for the company together with irrational competitor behaviour.
- Valuation:** our Assessed Company Valuation (ACV) is currently \$2.29/s, reflecting upside of ~30%. The stock is currently trading at a significant discount to the market, at 7.3x 2023 earnings. In our view, given the growth outlook, balance sheet strength and experienced management team, we feel that a 10x PE multiple applied to forward earnings is more appropriate. This compares to a PE for the small cap industrials sector of ~20x with expected earnings growth <10%.

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