Flinders Emerging Companies Fund

Quarterly Update: March 2022

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 *	4.95	-5.97	5.61	12.33	12.22	12.48
S&P/ASX Small Ords Accumulation Index	5.26	-4.21	9.68	9.63	9.89	11.67
Net Value Added *	**-0.31**	**-1.75**	**-4.07**	**2.70**	**2.33**	**0.81**

^ Inception date is 30 September 2015. Past performance is no indicator of future performance. Information relates to the Flinders Emerging Companies Trust Class B. Source: Citigroup

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

$150.7m

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 bad start then commodities come to the rescue**
- **RBA: The Purple Wiggle!**
- **Plenty to like about the domestic economy**

The S&P/ASX Small Ordinaries Accumulation Index finished 4.21% lower in the March quarter. Small resource stocks outperformed industrials by an extraordinary 23.6% over the quarter and by over 50% for the 12 months.

Despite a solid recovery in March, global equity markets were weaker over the quarter with rising rates, inflationary fears and the Russian invasion of Ukraine. Technology and healthcare sectors were notably weak with the Nasdaq down 9.2% vs the Dow Jones easing 4.6% over the quarter. European markets were also weak and the Chinese market fell over 10%. The broader Australian market was a clear exception with the ASX 300 accumulation index finishing in positive territory with strength in major resource stocks.

Bond markets had a very poor three months with yields rising more over the quarter than at any time over the past decade. With inflation persisting (and growing) in parts of the economy, yields will rise further prompting the RBA to acknowledge that it is awake to these issues and suggesting that official rates will rise in June following the election.

Commodity prices continued to charge ahead and will have a very beneficial impact on the domestic economy this year. Iron ore rebounded by over 30%, coal 55%, nickel 60%, Oil 35% and most grains were up 20-30%. With only a modest appreciation in the Australian dollar the revenue generation from the mining and agricultural sectors is currently massive – and likely to stay that way for some time.

It is difficult to understand why equity market commentary is so bearish considering: unemployment is now the lowest in a generation; we are now seeing wage growth; interest rates (while going up) are still at very low levels; corporate balance sheets are in pristine health; demand is very strong; consumer spending is recovering; COVID is fading as a health fear and an economic factor; politics is mortifyingly uncontroversial; and markets are near record highs. Perhaps markets are reflecting the unknown of what the current inflationary pressures really mean. At a micro level, rising costs are hitting businesses both large and small but, pricing power and cost control is helping maintain margins. Mortgage rates will rise, tempering property prices but will have to rise beyond expectation to really crimp household spending ability.

At a more macro level, the dip in Chinese activity is being caused by lockdowns. These are temporary – but may be recurring due to their elimination strategy. The US economy remains surprisingly strong – as does Europe despite higher energy prices due to the war in Ukraine and sanctions. Yes, inflation and rising rates are clouds but, there are plenty of significant positives that will keep Australian corporate earnings strong this year and into 2023. Far too early to be zipping up the bear suit – maybe it's just the Sydney weather…

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Performance Review

The Fund returned -5.97% in the March quarter, -1.75% below the benchmark return of -4.21%.

Key Contributors: The Fund's contributors over the quarter came from a range of industries due to a number of positive developments. Telecommunications and utility industry service provider, **Service Stream (+29.8%)** had been out of favour for a couple of years following a reduction in NBN contract values. Last year the company made the major acquisition of Lend Lease Services which brought a number of complimentary businesses as well as new industry exposure such as transport. At the company's interim profit result in February, they confirmed profit guidance, synergy benefits and an improving growth profile. We would expect a further re-rating of the company over the course of this year.

Gold miner, **Silver Lake Resources (+21.1%)** benefitted from a firm gold price over the quarter but more importantly, the company was conspicuous in managing its costs and logistics better than most of its peers and keeping gold production at healthy levels during the December quarter. The company also benefitted from the well-priced acquisition of Harte Gold in Ontario, Canada, adding to the company's future production growth. Also performing well was domestic gas producer, **Beach Energy (+24.2%)**. Obviously helped by the rising oil price over the quarter together with an increase in domestic gas price over the period. We expect this to continue as global LNG markets remain tight and therefore limited capacity available to the Australian market from the large Queensland producers.

Resources and infrastructure engineering and construction company, **NRW Holdings (+24.9%)** continues to perform well since we added it to the portfolio in December. A solid interim profit result, new contract wins and a pick-up in its core infrastructure and mining sectors sees the company well placed to grow strongly over the next few years. Combined with an experienced and proven management team and a strong balance sheet, we expect further upside to the share price.

While only up modestly for the quarter, it is worth mentioning **Uniti Group (+6.3%)** was subject to two separate takeover bids in March and the stock was up 44% in that month and over 100% for the twelve months. It has been a terrific performer for the Fund since we added the stock in mid-2020. The joint bid at $5.00 by HRL Morrison/Infratil and Brookfield is close to our assessed valuation of the company but, we expect other bidders to emerge given the insatiable demand for real assets in the market.

Key Detractors: There were some hefty falls in the March quarter, some associated with the falls in certain high growth sectors and some following the February reporting season. We saw a de-rate in a few of our holdings but interestingly, minimal downgrades to earnings forecasts. The most significant de-rating was that of global 'plus size' apparel retailer, **City Chic Collective (-38.2%)**. Given the lockdowns late last year, the company posted a creditable interim profit result and maintained earnings guidance. However, a sharp build up in inventory (and cash decline associated with it) seemed to unnerve the market. The company pointed to a deliberate strategy to have product available for an expected recovery in sales in the current half (both online and in-store) which we are now seeing. Converting that inventory to sales will see a significant positive impact on cash generation and margin. We expect the stock to recover in the near term.

Fund management group, **Pinnacle Investment Management (-31.0%)** came under pressure in the quarter due to the fall in equity markets (despite having a broad range of affiliates in other asset classes) and the likelihood of lower performance fees from affiliate, Hyperion (growth stocks under pressure). While retail inflows for a number of affiliates in January and February were likely to have been subdued, recovering markets in March (ASX accumulation indices back near all-time highs…) bodes better for revenues this quarter and improved retail flows. Strong growth from non-equity affiliates will also be supportive through this year. Medical imaging technology firm, **4DMedical (-37.0%)** also fared badly despite an agreement with Australia's largest radiology company, i-Med to place the 4DX lung scanning devices into a number of i-Med's clinics. The company remains well placed to continue to roll out its products in the Australian market over the next year and we anticipate the same in the US later this year and next with the Department of Veteran Affairs.

Personal lending company, **Wisr (-31.2%)** fell despite reporting exceptionally strong lending growth, improved margins due to lower funding costs and solid credit quality. The company also generated positive cashflow in the December quarter which will expand further throughout this year. A number of personal lending companies saw selling on the back of the weak buy now pay later and fintech sectors despite posting strong results.

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Portfolio Activity

Exits: It was a relatively stable quarter for portfolio activity with just two additions and two exits. We completed the sale of **Southern Cross Media (SXL)** early in the quarter. The company had seen improving advertising revenues late last year but increased competition and subdued ratings from a number of its key radio assets will keep a lid on its recovery this year. Also leaving the portfolio was lithium and nickel producer **IGO Ltd (IGO)**. The stock had moved into the ASX100 index a year earlier and as such, we had to exit the stock.

Additions: We added fund manager, **Pendal Group (PDL)** to the portfolio during the quarter. The company experienced fund outflows in the December quarter largely due to one large global fund in the UK based J.O.Hambro group losing institutional mandates. This had been flagged to the market in December but seemed to surprise the market when confirmed in January. The stock dropped even further to a point where we saw a compelling entry point. A large majority of its Australian and global funds are performing well and the 2021 acquisition of US based manager, Thompson, Siegel & Walmsley now gives the group critical mass in that market. While we don't expect FUM growth in the short term, we expect to see improving momentum into the second half of 2022 and into 2023. The merger approach by Perpetual announced last week suggests the stock is still significantly undervalued given its growth potential and superior funds management business compared to its suitor.

Also added to the portfolio was nickel producer, **Panoramic Resources (PAN)**. PAN has recommenced production at its Savannah project in the North Kimberley region of WA. It has a growing production profile of nickel (with associated copper and cobalt) and significant exploration prospectivity within and surrounding its existing mining operation. The company has a quality management team, is well capitalised and will generate very strong cash flow over the next year with the current underlying commodity prices. With modest price and growth assumptions, the company has significant valuation upside.

At the end of the quarter, we had 40 stocks in the portfolio and were holding 3.4% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Beach Energy	City Chic Collective	Codan
NRW Holdings	Codan	Elders
Service Stream	4DMedical	Seven Group Holdings
Silver Lake Resources	Pinnacle Investment Management	Shine Justice
Zip Co *	Whitehaven Coal *	Uniti Group

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 31st March 2022. Top 5 positions are effective 31st March 2022.

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Stock in Focus: Earlypay (EPY)

Given its name, **Earlypay (EPY)** could be mistaken for yet another buy now pay later aspirant. In fact, it is a long-standing provider of invoice finance and equipment finance to Australian small to medium businesses (SME). The company also has a trade finance business which broadens their offering to existing customers. Earlypay is highly profitable, low risk and growing rapidly.

Invoice finance is the system whereby a company can borrow against invoices to customers in order to free working capital quickly. Usually, these invoices are to large safe customers that pay slowly e.g., large Australian corporates that can dictate payment terms to their counterparties. Borrowing against an invoice can free cash in days rather than a small business being paid in months. Banks used to provide this type of working capital finance but over the past decade have effectively left the market. The skill of an invoice finance company is to assess the risk of an invoice and charge appropriately against that risk. Earlypay have been successfully doing this for over 20 years.

Investment Case Key Questions

1. **Growth Opportunity:** Invoice, trade and equipment finance companies are growing strongly as banks have focussed on mortgage lending and have left these 'niche' business products to others. There are relatively few companies with the capital and skill to successfully provide these services efficiently and well. Earlypay has market leading technology and an experienced team of credit assessors which has seen it gain market share. Adding equipment and trade finance to their offering has increased their growth opportunities with both new and existing clients. Invoice finance is growing its market share of business lending and there is still a long way to go. It has less than half the market share than it does in either the US or UK.

2. **Management:** CEO Daniel Riley and COO James Beeson are experienced operators and have navigated the company exceptionally well through Covid and are now growing the company strongly as the economy recovers. They are conservative with a strong focus on shareholder returns and risk. Overhauling their credit and customer service systems in recent years has given them a good lead on their competition and helped lift their market share with finance brokers and in the direct market.

3. **Financial Strength:** Lending growth absorbs capital. Earlypay has a strong balance sheet following a capital raising in 2021 but also generates capital due to its strong profitability. It also has access to a growing warehouse funding facility with large local banks. These facilities and other debt funding instruments put into place over the past two years are also dropping the company's cost of funding new business, leading to higher margins.

4. **Risks:** Invoice lending is inherently lower risk than personal or business lending against cashflow. There is security and it is made up of many regular short-term transactions. Risk is identified early. Equipment finance does need greater assessment, but machinery and vehicles are some security. Rising interest rates are passed on quickly and tend to improve margins as the cost of funding facilities lag.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $0.91 providing 98% upside over the current share price. The company has over 20% compound EPS growth over the next three years, pays a healthy yield and is a key player in an expanding market. While it is one of the smallest companies in the Flinders portfolio, we see it as a great growth opportunity.

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