Flinders Emerging Companies Fund

Quarterly Update: September 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 *	-9.78	0.62	-24.99	0.63	6.27	7.84
S&P/ASX Small Ords Accumulation Index	-11.20	-0.47	-22.56	-0.80	4.07	7.17
Net Value Added *	**1.41**	**1.09**	**-2.43**	**1.43**	**2.19**	**0.67**

* Fund performance numbers are unaudited. Final numbers will be available on our website mid-October 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

$137.1m

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

- **Wake me up when September ends…**
- **Zero shades of grey**
- **What's priced into the small cap market?**

The S&P/ASX Small Ordinaries Accumulation Index finished 0.5% lower in the September quarter with the month of September snuffing out a recovery, falling 11.2% alone. The drop was sparked by a higher than expected inflation figure in the US and a swift reaction from the Federal Reserve on proposed interest rate rises. And down it all came after a couple of promising months.

For the quarter, Australian equities fared very well against their global peers with US, European and Asian markets generally down 5-10%. Commodities were weaker led by a 23% fall in Brent crude; only coal posted a rise. With US yields rising rapidly, the US Dollar strength saw our dollar slip to US$0.64 – a level that will have a significant impact on many small cap stocks.

Resources and industrial stocks were both reasonably flat over the quarter despite the weakness in resources in September. Small caps and the top 100 were also similar over the quarter. Despite the volatility, sector performance in smalls was also consistent over the quarter with only the REIT sector being conspicuous with a fall of over 7%.

With such a macro focussed market it seems that every announcement or economic release is met with a 'good' or 'bad' interpretation – no matter how close to a consensus expectation (if there is really such a thing). And with that comes a market reaction to those releases that resembles financial Tourette's. So perhaps we should turn down the noise a little and look at what's being priced in and what opportunities the market has thrown up over the past month or so.

On consensus figures (that term again) at the end of September, the small ordinaries index has a forecast earnings growth rate for FY 2023 of 6.6%. This compares to expectations of 10.1% in January – not a large change. Considering the interest rate rises, political issues, inflationary pressures and risk of recession, it's surprisingly modest over a nine month period. The price to earnings ratio of the small ordinaries over the year has dropped from 16.1 times 2023 earnings to 14.0 times. But importantly, during this period of volatility there has been a disparity in how companies are valued on a perceived macro view versus what their real underlying business performance is.

At the beginning of the year the expected earnings growth of our portfolio for FY 2023 was 22% and the P/E ratio was 13.1 times. Today the growth expectation is 23% and the P/E for FY 2023 is 12.2 times – a very modest price to pay for that lift in profits. The point is, there is growth to be found in small caps regardless of some of the macro headwinds. It's a large and broad universe of companies and industries with very different drivers to the top 100. We view the recent de-rating of small caps as a significant opportunity.

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Performance Review

The Fund returned 0.62% in the September quarter, 1.09% above the benchmark return of -0.47%.

Key Contributors: The quarter contained a number of chunky stock moves in both directions, not surprising in a market that has been so volatile on a month-by-month basis and a period that contained the full year reporting season.

Mining and infrastructure contractor, **NRW Holdings (+44.5%)** was a standout contributor over the quarter. The company produced a solid profit for the 2022 financial year and pointed to a good pipeline of contracts and opportunities that will provide growth this year and next. Importantly, management seems to have arrested a number of the cost pressures that were impacting industry margins in the December half of 2021. Another strong performer was lithium company, **Liontown Resources (+41.2%)**. We added Liontown to the portfolio in June after the stock had been sold down to well below our valuation. While not yet producing, the company is fully funded through its development phase and has offtake agreements with some of the worlds leading battery and EV producers. The company's Kathleen Valley project in WA is one of the world's larger high grade hard rock lithium deposits with a significant mine life.

Our other battery material stock, graphite producer, **Syrah Resources (+32.8%)** also performed strongly. While still constrained by shipping capacity from their East African port facility, graphite pricing has been rising steadily over the year and with Chinese production (that dominates global production) slowing over the northern winter, that price strength will likely continue.

Pinnacle Investment Management (+20.7%) was a contributor over the quarter despite a 19.4% fall in September with weak global equity markets. The stock almost trades like a geared equity instrument in volatile markets despite having an enviable spread of asset classes and growing businesses amongst its affiliates. Any recovery in markets should see it re-rate quickly. And lastly, mineral sands company, **Strandline Resources (+22.7%)** is now on the cusp of production and cashflow (in the next three months) from its Coburn project in WA. Like Liontown, the project is fully funded, large and has a long mine life. Strandline will become a significant player in the industry having offtake agreements with a number of global customers.

Key Detractors: Digital payments and gift card provider, **EML Payments (-35.0%)** fell again, this time on the resignation of the CEO following further delays to a resolution with their European regulator, the Central Bank of Ireland over compliance controls. Sadly, there were no consequent changes at board level outside a London based non-executive director assuming the CEO role for a company based in Brisbane. We exited the stock before the full extent of the price drop occurred but still a frustrating experience.

Utilities service provider and engineer, **Service Stream (-21.1%)** dropped after a poor full year profit result in August. The company suffered from delays and cost overruns on a single (but large enough) water utility contract in QLD mainly due to wet weather and resourcing constraints. With that behind them and the integration of the Lend Lease Services acquisition going to schedule, the company will see solid growth this financial year. Also suffering from a result that was not taken well by the market was **City Chic Collective (-28.4%)**. Not that the plus size retailer's actual 2022 profit was bad, it was the higher than expected inventory level that spooked the market. The company pointed to the seasonal build of stock and the growth in sales justifying the position and guided to lower inventory over the next six months. We don't expect large discounted clearance sales as some in the market do.

Despite selling its New Zealand assets to focus on Australia, childcare operator, **Evolve Education (-20.0%)** slipped over the quarter. The company is now debt free, cashed up and in a position to buy centres in Australia or undertake capital management – a good position to be in at this time in the childcare industry. Not holding **New Hope Coal (+81.8%)** in the portfolio also impacted relative performance with the stock higher on continued strength in the thermal coal market.

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Portfolio Activity

Exits: As mentioned above, we exited **EML Payments (EML)** following their inability to resolve their regulatory issues over the past year, the high costs of the process and the likelihood that those elevated expenses will continue into 2023.

Telecommunications infrastructure provider, **Uniti Group (UWL)** exited the portfolio after the completion of its takeover by the Morrison & Co consortium. As mentioned in earlier reports, the company had been an outstanding contributor to the fund but was ultimately taken over at a full valuation. The last company to be sold was gold miner, **Ramelius Resources (RMS)**. The company is more exposed to higher costs facing the industry (staffing, fuel, capital inputs) resulting in constricted cash generation. This in turn has led to the company delaying growth initiatives. Consequently, our valuation has been negatively impacted and we exited the stock.

Additions: During the quarter we added mining equipment manufacturer, **Austin Engineering (ANG)** to the portfolio. The company manufactures excavation tools, truck buckets and other high tensile steel mining products in Australia and both North and South America. A new management team in 2021 has seen the company cut costs, increase its order book and now generate returns well above its cost of capital. Pent up demand for many of its products has meant improved pricing and confidence in revenue levels of the next few years. The very accretive acquisition of Mainetec which produces large scale excavation buckets will also help growth in future years.

We also bought back into auto parts distributor and retailer, **Bapcor (BAP).** A new management team, a recovering market and a growing position in the truck parts market gives us confidence that returns can be improved over future years. This led to an increase to our valuation, signalling healthy upside to the share price.

And the third company added to the portfolio in the September quarter was **Gold Road Resources (GOR)**. This was essentially a switch from Ramelius. Gold Road's 50% owned Gruyere project is a single, large scale and relatively simple operation. It has lower costs and importantly, less fuel intensive than Ramelius that has significantly more ore trucking in its process. Gold Road is also exhibiting solid production growth that should continue into 2023.

At the end of the quarter, we had 38 stocks in the portfolio and were holding 4.5% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Liontown Resources	Codan	AUB Group
NRW Holdings	EML Payments	Elders
Pinnacle Investment Management	Evolve Education	Shine Justice
Strandline Resources	New Hope Corporation *	Silk Logistics
Syrah Resources	Service Stream	Trajan Group

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th September 2022. Top 5 positions are effective 30th September 2022.

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Stock in Focus: AUB Group (AUB)

AUB Group (AUB) operates insurance broking and underwriting businesses in Australia and New Zealand. The company provides insurance broking and advisory services primarily to SME clients; distributes ancillary products; and designs, distributes, and manages insurance products on behalf of licensed insurance companies. The company has been listed on the ASX for almost 20 years but, the company's history goes back more than 100 years. Growth has been driven by the consolidation of the sector, market share gains, investment in business systems to streamline access to insurance products across the market, efficient quotation for winning/maintaining client business, growth in underwriting services and most importantly underlying growth in premium rates (which has over the last 3 years remained solid at between 5% to 6% pa). In recent times, AUB has expanded further up the value chain through the acquisition of Tysers in the UK which provides wholesale insurance broking products and services. Tysers offers an opportunity to grow into different product offerings into the Australian an NZ business's but mostly offers AUB access to a larger proportion of the overall insurance market.

Investment Case Key Questions

1. **Growth Opportunity:** As highlighted earlier, growth has come from a number of sources and importantly the company has a track record of consistent profit growth of ~15% pa for the last 5 years. Importantly this growth continued through the period of economic shock driven by COVID highlighting the defensive nature of AUB's revenue stream. Prior to the acquisition of Tysers we forecast earnings per share (EPS) growth to remain ~15% for the next 3 years. However, given the highly accretive nature of the acquisition which completed in September 2022, we forecast eps growth of ~30%pa for the next 3 years.

2. **Management:** CEO Mike Emmett has significant experience in global customer facing business services roles having worked with PWC, Accenture, IBM and EY as well as senior executive roles in the insurance industry with QBE, CEO of travel insurance group CoverMore. CFO Mark Shanahan has extensive senior finance roles with investment bank Macquarie, broking group Tullet and Prebon and Fund Manager Australian Ethical. Both Mike and Mark have held their roles with AUB for the last 4 years and over that period have delivered consistent accounts, clear strategy and most importantly solid returns for their shareholders.

3. **Financial Strength:** The business is highly cash generative, which has allowed for a capital structure which supports debt. This has been important given part of the strategy has been to consolidate the sector. The recent substantial acquisition of Tysers was supported by an equity raise which maintains gearing at ~30%.

4. **Risks:** the key risks for the business including poor due diligence in relation to acquisitions, a decline in premium rate growth due to exogenous events including a lack of natural disasters, any reduction of investment in systems and business processes which may impact the ability to attract advisors and adequately compete with market participants.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $25.14/s, reflecting upside of +30%. The stock is currently trading at a steep discount to other listed peers (SDF and PSC), which is unwarranted given its earnings certainty (particularly in this environment), high earnings growth, above market ROE, and solid dividend yield.

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