Flinders Emerging Companies Fund

Quarterly Update: March 2023

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	1.12	3.33	-15.35	13.65	5.25	8.30
S&P/ASX Small Ords Accumulation Index	-0.72	1.88	-13.19	13.15	3.89	7.98
Net Value Added	**1.84**	**1.46**	**-2.16**	**0.50**	**1.36**	**0.32**

^ 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

$165.8m

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

- **Whippy rates**
- **The consumer alive and well…..for now!**
- **The bank crisis that wasn't**

The S&P/ASX Small Ordinaries Accumulation Index finished 1.88% higher in the March quarter with resources slightly outperforming industrials. Large caps fared slightly better than smalls with the ASX100 rising 3.50% for the quarter.

With the lead from large US tech stocks (the Nasdaq was up a robust 16.8% for the quarter) local technology stocks did well together with the gold sector which recovered very strongly. Consumer facing stocks (with the exception of travel related companies) continued to struggle, as did financials and REITs.

Australia was a laggard amongst global markets over the quarter. European markets were particularly strong with France and Germany up 13.1% and 12.3% respectively. The UK still can't get out of its own way – only up 2.4%. Asian markets were also very strong, Japan up 7.5%, China up 5.9%, Korea and Taiwan up 10-12% each. Commodities were all over the place. Notable rises were gold (up 8.8%) on US Dollar weakness and flight to safety, and iron ore (up 8.1%) but the energy complex, including gas, oil and especially coal was very weak. Soft commodities were also under pressure – both these sector moves will be very important in bringing down inflation in the coming months.

Economic releases were generally stronger than expected during the quarter – as were a number of inflation indicators. This led to bond yields rising on the expectation of continued Central Bank moves. That trend came to an abrupt halt with the collapse of Silicon Valley Bank (SVB) and runs on a number of smaller regional US banks, then UBS having to subsume Credit Suisse, all in March. In that month alone, US 10-year yields moved to a high of 4.036% on inflation fears to a low of 3.330% on banking sector fears before finishing the quarter at 3.573%. So, has fear subsided? Well, it would seem so for the time being. Prompt action by banking regulators and central banks seems to have settled that industry and inflation is clearly coming down. Not surprising that markets finished the quarter on a more optimistic tone.

Australian small caps recovered well in the back half of March, but small industrials are still lagging. As mentioned last month there were some modest downgrades to forecast earnings but the sector continues to de-rate. This is not just an Australian observation. US small caps (eg. the Russell 2000 index) has significantly underperformed the larger cap indices over the quarter and year. Valuation signals are there but confidence in earnings less so. For the past year, the market has under-estimated consumer spending and yes, there are obvious headwinds, but other areas of the economy are also showing resilience and good levels of profitability.

The February reporting season provided plenty of evidence of small companies with good earnings growth, and relative to large companies, compelling investment upside.

Performance Review

The Fund returned 3.33% in the March quarter, 1.46% above the benchmark return of 1.88%.

Key Contributors: Once again, volatile reactions to economic announcements and the reporting season led to some large moves by stocks over the quarter. There was also a pick-up in M&A activity and the first trickle of IPOs.

It certainly helps when a stock in the portfolio has a takeover approach – and even better when it has also performed very well before it. Lithium developer, **Liontown Resources (+95.5%)** was just that. What attracted us to Liontown was the fact that it was a very significant resource in a well serviced mining area (Goldfields WA), well-funded to production, with offtake agreements in place with key customers (LG, Tesla, Ford). The sell-off in the wider lithium sector in mid-2022 provided us the opportunity to buy the stock at ~$1.10/s. During March, the company revealed a take-over approach at $2.50 from US based global lithium producer, Albemarle (incidentally this was not their first approach to Liontown). The stock is currently trading slightly above the bid price and we expect further news from both parties over coming weeks.

The rise in the gold price late in the quarter helped **Ramelius Resources (+36.6%)**. As a relatively higher cost producer, the company is more leveraged vs peers to the upside on a higher gold price (compared to say low cost producer Gold Road Resources, also held in the portfolio). We expect a step up in cashflows in the coming few quarters as Ramelius' new high-grade Penny mine starts to contribute. Insurance broker, **AUB Group (+14.0%)** produced a solid interim profit result from its Australian operations that continue to benefit from improving insurance rates and market share growth. It also showed that its recently acquired UK insurance business, Tysers was performing strongly and on the back of it, earnings estimates moved higher. AUB also revised up its medium-term margin targets for their various operating segments.

Global mining equipment supplier, **Austin Engineering (+40.4%)** recovered strongly from a weak December on the back of increased order flow and confirmation that they would have a much better second half and reach full year 2023 profit guidance. Improving returns from recent acquisitions and manufacturing efficiencies from its facilities in the Americas, Indonesia and WA are all adding to the improving outlook for the company over the next few years. Copper producer, **Sandfire Resources (+16.4%)** finished the quarter strongly as resources stocks recovered. We remain attracted to the company's two major assets, MATSA in Spain, which the company has the ability to grow, and its recently commissioned Motheo project in Botswana. As always with resource projects, a key investment criteria is a strong balance sheet and Sandfire has that. It will also be generating excess cash by year end that will give it further growth or capital management opportunities beyond 2024. The stock remains very attractive and helped by the dearth of opportunities in pure play copper producers with significant scale.

Key Detractors: Compensation lawyers, **Shine Justice (-22.1%)** fell after a softer than expected 1H23 result. This was primarily due to a period of investment in the business as 42 new fee earners were hired in the period; new hires are typically not as productive in the first few months as they settle in, leading to slower case resolution. Furthermore, there was a shortfall in the cash expected due to delays in receipt of payment from two litigation funders that Shine uses. These issues are largely timing related, with a reversal expected in 2H23. The company has reiterated FY23 guidance for low double digit growth in earnings. Retirement village operator **Lifestyle Communities (-16.5%)** delivered a result that was to expectations, with medium term settlement guidance reiterated; the share price presumably sold off on the back of weak housing sentiment as well as some residential housing developers going bust; the small cap property sector underperformed over the quarter. We remain very comfortable with Lifestyle's business given the customer base and regions that they sell into (many that have seen *increases* to median house prices), their builder/suppliers used, etc.

Nickel miner **Panoramic Resources (-14.3%)** suffered as nickel was one of the weaker commodities over the quarter, down 24.1%. The company delivered a Life of Mine update for their Savannah project, with a two-year mine life extension to FY35, and good upside to extend further. Modest annual production increases are expected, while costs are forecast to be higher. Mining and civil contractor **NRW Holdings (-11.6%)** delivered a 1H23 earnings result broadly in-line, yet abnormal rainfall and delayed project awards negatively impacted margins, while cash conversion was weaker due to timing of prepayments and a large working capital build in preparation of upcoming projects. We expect most of this to unwind in 2H23, and management reaffirmed FY23 revenue and earnings guidance.

Portfolio Activity

Exits: There was minimal change to the portfolio over the quarter. **Pendal Group (PDL)** was consumed by **Perpetual (PPT)** as the takeover for the company was finalised. We retain a holding in PPT.

Additions: Oil company **Karoon Energy (KAR)** was added to the portfolio during the period. KAR is the only oil pure play in small caps, and operates in the Bauna oil field in the Santos Basin off the coast of Brazil. While the valuation of the company has been growing in line with growing production milestones and exploration success, the share price has largely traded sideways in the last several months given top-down macro concerns and uncertainty. Interestingly, oil has lagged other commodities despite the demand profile improving with China reopening. Furthermore, OPEC+ seems to have a firm view on putting a floor on the oil price around $80 a barrel. KAR is highly levered to any improvements here.

At the end of the quarter, we held 36 stocks in the portfolio and were holding 3.6% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
AUB Group	Lifestyle Communities	AUB Group
Austin Engineering	Neuren Pharmaceuticals *	Credit Corp Group
Liontown Resources	NRW Holdings	Johns Lyng Group
Ramelius Resources	Panoramic Resources	Kelsian Group
Sandfire Resources	Shine Justice	Syrah Resources

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 31st March 2023. Top 5 positions are effective 31st March 2023.

Stock in Focus: Sandfire Resources (SFR)

Sandfire Resources (SFR) is an Australian listed copper producer that is soon to become the largest pure play copper producer on the ASX following the takeover of OZ Minerals by BHP (scheduled to complete mid-April '23). Sandfire's first producing asset, the DeGrussa project in Western Australia was a high-grade deposit where underground mining commenced in 2013, and mining completed in October 2022. While the plant is now moving into a care and maintenance phase, it was the earnings generated from this mine that has been a foundation for the company's future with operations now in Botswana, Spain and the US. The three project sites are at varying degrees of evolution from development, commissioning to production. The assets provide further upside to the company through exploration and near-mine acquisitions. To demonstrate the opportunity, the current Reserve of 1.4mt Copper Equivalent (CuEq) has the potential to expand towards the current Resource of 3.45mt CuEq, with further exploration and delineation. This additional material would add more than 15 years to production, on top of the already attractive and material mine life of at least 10 years. The company offers organic and inorganic growth options (where most other produces are ex-growth) and a pure exposure to an essential future facing metal.

Investment Case Key Questions

1. **Growth Opportunity:** The company is currently commissioning its Motheo copper project in the prospective Kalahari copper belt in Botswana. This together with their MATSA project in the Iberian Pyrite Belt in Spain will deliver >100,000t of copper and >90,000t Zn from 2024. The company's footprint in the Kalahari is large and underexplored, and the previous private equity owner of MATSA undertook limited exploration, providing a strong growth driver for additional operating life. We expect profits to more than double from US$100m in 2024 to more than US$200m in 2025.

2. **Management:** Founding MD and CEO Karl Simich stepped down in September 2022 after 15years. Brendan Harris commenced in the role of CEO and MD in April 2023. He has extensive listed company mining experience, most recently as the inaugural CFO of South32 and then later as the company's head of global commodity marketing and human resources. Prior to this he held roles with BHP and in investment banking where he led the metals and mining team for Macquarie. Jason Grace (COO) has been with Sandfire since 2019 and most recently was in the role of interim CEO. Matthew Fitzgerald (CFO) was appointed in 2011 and has therefore presided over the company's growth. The board remains strongly independent with six independent non-executive directors out of seven on the board.

3. **Financial Strength:** The company is in the midst of delivering the Motheo project and hence at peak spend currently (total >US$300m). The transformational acquisition of MATSA in September 2021 cost US$1,865m and was supported by an equity raise. Despite these calls on capital, we expect modest gearing of ~20% at the end of June 2023 (FY23). We also expect strong free cashflow generation to occur from 2024 such that the balance sheet would be in a net cash position by 2025.

4. **Risks:** Key near term risk surrounds the commissioning of production at Motheo; Costs (namely power prices) at MATSA; Commodity prices and currency; Resource quality.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $7.45/s, reflecting upside of ~20%. We expect the stock to attract a premium of 20% to its NPV valuation since it is well capitalised, growing and is the largest copper producer listed on the Australia share market in a largely consolidated sector.