Flinders Emerging Companies Fund

Quarterly Update: December 2023

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	7.10	4.43	7.37	-1.32	7.12	8.01
S&P/ASX Small Ords Accumulation Index	7.23	8.52	7.82	0.95	6.39	7.97
Net Value Added	**-0.13**	**-4.09**	**-0.46**	**-2.26**	**0.72**	**0.05**

^ 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

$161.6m

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

- **Coming home with a wet sail**
- **Small caps finally beginning to re-rate**
- **Business vs consumer – the confidence dichotomy**

The S&P/ASX Small Ordinaries Accumulation Index finished 8.5% higher in the December quarter after a sharp recovery over the last two months of the year. This pushed the yearly return to 7.8% - unthinkable when the market was down 6.1% year-to-date at the end of October.

US markets led the recovery as bond yields tumbled from their late October highs. All major US indices posted double digit gains with the Russell 2000 smaller company index the best with 15.3%, closely followed by the Nasdaq which was up 13.6% (and a whopping 43.4% for the year) and the S&P500 11.2% higher. European stocks were strong with the German DAX up 8.9% but the FTSE continued to lag, only rising 1.6%. The real contrast was Asia where all markets were strong, except both China and HK which both fell 4.3%. The contrast is even more pronounced over the year. The Japanese Nikkei returned 28.2% against Shanghai down 3.7% and HK down 13.8%.

Commodities were mixed. Oil the worst with WTI down 6.1%; gold rose 1.3%; base metals mixed - with copper and nickel weak, and aluminium and zinc strong. Iron ore continued its run rising 7.5% and dogs of the year go to lithium which continues to plummet in all its forms, thermal coal (down over 60%) and nickel (down 46%). Call that a draw between batteries and fossil fuels.

As mentioned, it was the bond rally spurred by Fed Chairman Powell's comments on the possibility of future rate cuts that set markets alight, US 10-year yields falling from a high of 4.98% on October 23rd to a low of 3.84% at year end. Quite a turnaround.

As with the US, local small caps finally outperformed their stodgy large cap peers over the quarter. Industrials in particular. As we mentioned in last month's report, it did happen far too rapidly in November for a fundamental approach to stock picking to be of use, but toward the end of the month and into December, the buying seemed more considered which we believe will now result in good smaller companies with earnings growth and good management being re-rated. In many stocks, that process has only just started.

One measure of economic health (and markets) is confidence. What has been consistent this year is the difference between consumer and business confidence. Not that business confidence has been at boom levels, but it consistently reflects what we actually see with the results of smaller listed companies – modest growth, patchy consumer demand, cost pressures, but manageable outcomes. The Westpac MI consumer confidence index remains weak and had its second lowest year on record, a level only matched at the depths of the pandemic and the GFC. While sticky, inflation is coming down, rates may or may not have 25bp yet to rise and most importantly, there is full employment. We'd look more closely at the business confidence indicators for guidance. And the recent share market rally won't hurt confidence either.

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Performance Review

The Fund returned 4.43% in the December quarter, 4.09% below the benchmark return of 8.52%.

Key Contributors: Better performers came from a range of sectors over the quarter. Neurological disease pharmaceutical company, **Neuren Pharmaceuticals (+125.8%)** had two positive releases during the quarter. The first was an announcement that its partner and distributor in the US, Acadia Pharmaceuticals. Sales of the Neuren developed drug trofinetide (treatment of Retts disease) had been significantly higher than anticipated in the September quarter and are growing strongly. The second was the announcement that another drug in phase 2 clinical trials for the treatment of a similar disease (Phelan-McDermid Syndrome) had shown very promising results.

Software provider to utility companies, **Gentrack Group (+38.8%)** performed strongly following the November release of its 2023 full year profit result. The company is continuing to win new contracts in both energy and water industries and profitability is rising sharply. Management upgraded their guidance for 2024 revenues and earnings. The industry is changing rapidly with new technology provided by companies such as Gentrack replacing legacy systems that don't provide the functionality and flexibility needed to satisfy customer demands. Diversified industrial, **Seven Group Holdings (+18.5%)** continued to perform strongly and was aided by comments at their AGM that their businesses are trading above earlier expectations. This was especially evident in the Westrac (Caterpillar dealerships in NSW and WA) business where demand from the mining industry remains at solid levels. Boral continues to see price rises and steady demand while Coates Hire is maintaining high levels of equipment utilisation with its exposure to the infrastructure sector.

Bus, ferry and tourism operator, **Kelsian Group (+22.2%)** had a good recovery in the quarter with confirmation that its newly won Sydney bus contracts were running to plan after early issues with driver availability and its on-time record has rapidly improved since that time. The company's recently acquired US operations are also performing well and they are well placed to pick up new corporate contracts over the next year. The ferry business continues to do well with its mixture of contracted revenue and exposure to the still strong tourism market.

Copper producer **Sandfire Resources (+19.2%)** had a strong quarter despite the copper price rising only marginally during the quarter. Its emerging Motheo project in Botswana continues to progress well, hasn't seen cost blow-outs and is on time for production this quarter. With its Spanish MATSA project, the company will have two significant long life copper assets producing at full capacity by year-end, both with expansion opportunity and the company is well funded.

Key Detractors: Radiology group, **Integral Diagnostics (-33.6%)** came a cropper earlier in the quarter when it announced that costs remained stubbornly high and GP referrals for scans had not recovered at the pace they were expecting. Consequently, profit margins remained under pressure and recovery will take time. Integral has the added issue of having reasonably high gearing and with the cost of debt increasing over the last year their bottom line has been further crimped. While we think there will be a recovery in visitations and hence, efficiency, it will continue to be difficult to reduce running costs at centres to accord with patient numbers. The lower profitability and slower recovery saw our valuation drop significantly and we exited the stock.

International oil producer, **Karoon Energy (-22.3%)** made a company transforming acquisition at a very good price during the quarter but a weak oil price and a leaked capital raising to fund the purchase both overwhelmed the positive deal. The company paid US$720m for a 30% stake in two low cost producing assets in the Gulf of Mexico. They are long life, have good growth potential and will offset the natural production decline from their Brazilian Bauna project. The capital raising was large and not handled particularly well but the quality of the assets they've acquired and attractive valuation should see the share price recover. Trustee company **EQT Holdings (-8.8%)** drifted lower with the market weakness in October and struggled to participate in the recovery despite market linked revenues, synergies from the AET acquisition and an excellent growth profile. We'd expect better this quarter.

Insurance and emergency building repairer, **Johns Lyng (-6.3%)**, didn't participate in the late year rally, possibly due to its strong performance in the September quarter and perhaps in a market that is used to the company upgrading profit guidance. A simple confirmation that they are trading to budget and the business is performing well wasn't enough. Given the floods in North QLD, VIC and parts of NSW, the increased disaster and insurance work will keep them very busy.

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Portfolio Activity

Exits: The December quarter saw a number of good opportunities added to the portfolio and some exits where valuations had been reached or downgraded. As mentioned above, **Integral Diagnostics (IDX)** was sold after the disappointing trading update and slower than expected recovery profile. Also in that boat was auto parts distributor and retailer, **Bapcor (BAP)**. The new(ish) management team had set ambitious targets on cost reduction and efficiency gains but these had not been effective enough to compensate for difficult sales conditions in both distribution and retail. New Zealand has also been weak for the company. The lower short-term earnings and slower recovery brought back our valuation to below the share price and we exited the stock.

Construction materials company **ADBRI (ABC)** had been improving profitably in recent times with a better cost focus and rising prices for cement and concrete products. Price rises don't go on forever (unlike Government charges) and volume growth is modest and not expected to accelerate much over the next few years. We took the opportunity to switch to another smaller and rapidly growing construction materials company, Maas Group which we will touch on below.

We also completed selling **Cooper Energy (COE)** during the quarter. East coast wholesale gas prices have eased and while production difficulties have improved, they still need to spend $200m on Bass Strait well decommissioning which will continue to hinder financial flexibility. We also sold a small remaining holding in **Silver Lake Resources (SLR)**.

Additions: As mentioned above, we added construction materials company, **Maas Group (MGH)** to the portfolio. The company is based in Dubbo NSW and operates in a number of regional hubs from Eastern Melbourne to Rockhampton. It has 41 quarries and complimentary concrete operations in key regional growth centres and significant land banks for residential development in a number of these centres. We were attracted by its strong market position and high quality assets in these areas and scope to expand further. Management focus on return on assets and cash generation has also been impressive. For further information we highlight the company in our 'Stock in Focus' section of this report.

Childcare operator, **Nido Education (NDO)** was the first IPO we have participated in for close to two years. The company has a development and management model that has been highly successful in the past. The management team led by CEO Mathew Edwards previously ran a company called Think Childcare which we were an investor in and was eventually taken out by global childcare operator Busy Bees. It was a profitable investment and we were very happy to back the same team to successfully grow Nido into a significantly larger business. Given the poor market conditions when the IPO took place, the valuation was compelling.

Global scrap metal and recycling operator, **Sims Ltd (SGM)** was a new addition over the quarter. The share price has stagnated over the past two years, and following strong profitably in 2021 and early 2022, returns have been poor. This was largely due to a lower ferrous scrap price in most of their key markets. Steel prices have been low and volumes were also subdued. This is changing. Scrap metal is the key raw material to make steel in electric arc furnaces (EAF) that compete (and are taking market share) with blast furnaces that use iron ore and coking coal as inputs – both of which have seen strongly rising prices over the past six months. This has in turn pushed steel prices higher despite no significant jump in steel demand in either China or the US. The short-term attraction is that the scrap price is only just beginning to catch up with competing inputs. The long-term attraction is that EAF production is gaining market share and has a significantly lower carbon release per tonne of production. Add a strong balance sheet, experienced management and a leading industry footprint, plus an attractive valuation, we viewed it as an excellent opportunity.

The last addition to the portfolio during the quarter as mentioned in the contributors section was **Neuren Pharmacueticals (NEU)**. The advances made by the company recently are very significant. They have leading science in a number of brain development diseases and disorders and have been developing products in that area for over 20 years. Now with rapidly growing sales and close to $200m in cash for development, the future looks very exciting.

At the end of the quarter, we held 39 stocks in the portfolio and were holding 3.5% cash.

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Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	**Top 5 Detractors**	**Top 5 Active Holdings**
Gentrack Group	EQT Holdings	Johns Lyng Group
Kelsian Group	Integral Diagnostics	NRW Holdings
Neuren Pharmaceuticals	Johns Lyng Group	Pinnacle Investment Management
New Hope Coal *	Karoon Energy	Sandfire Resources
Seven Group Holdings	Telix Pharmaceuticals	Seven Group Holdings

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

Stock in Focus: Maas Group (MGH)

Maas Group (MGH) is a diversified industrial and real estate company operating in regional areas of Eastern Australia. MGH's largest operating segments cover Construction Materials (quarries, concrete, asphalt), Civil Construction and Hire (equipment hire, civil construction), Commercial Real Estate (construction, developments) and Residential Real Estate (residential developments). MGH benefits from the large infrastructure developments and infrastructure rollout taking place across regional Eastern Australia. MGH supplies aggregates from 41 quarries, concrete from 17 plants, and has 550 assets for hire. MGH also has a landbank of ~8000 residential lots, and ~$870m of value in completed commercial property. The business was founded in 2002 by Wes Maas (founder and CEO) and is headquartered in Dubbo, NSW.

The current opportunity in MGH exists given the underperformance and de-rate of the stock over the past 18 months, due to the company increasing its investment in real estate at a time when interest rates were increasing – this decreased free cash flow and increased balance sheet leverage. This negative combination of factors has passed and has already been reflected on the share price; investors should look towards the company's strong earnings growth driven by robust regional infrastructure spending and an improving regional property market, a cheap valuation, the strong suite of hard assets and an improving returns profile back to more historic levels.

Investment Case Key Questions

1. **Growth Opportunity:** earnings growth expectations were high following the IPO in late-2020, and while MGH did in fact deliver very strong growth, earnings forecasts were revised down over the course of FY23 which saw the share price retrace. Earnings seem to have rebased, and going forward, most segments should deliver good earnings growth. The exception is the Residential Real Estate segment which saw earnings down a hefty 56% in FY23; while this is currently expected to deliver flat earnings growth in FY24, there's upside risk from the relatively low base. Overall for the group, we expect CAGR EPS growth of ~25% over the next three years, as the company continues to grow across all segments, and their Residential Real Estate segment experiences a rebound.

2. **Management:** CEO and Founder Wes Maas founded the company in 2002, taking it from one bobcat and a tipper truck, to a substantial and diversified listed company it is today. He has been instrumental in setting the company's strategy, values and culture. Craig Bellamy joined MGH as CFO in 2019 so was part of the IPO process. He has previously held CEO and CFO roles at other ASX listed entities.

3. **Financial Strength:** MGH has substantial real assets and strong cash conversion (targeting +85%), so can support a higher level of gearing (leverage target of 2-3x EBITDA). MGH is currently targeting the sale of non-core/lower return assets, and has enough surplus capital which currently allows them to conduct an on-market buy-back. While the company has been acquisitive in recent years, the focus over the near-term is to not acquire further (unless privileged quarry assets which rarely come up for sale arise), allowing gearing to come down and cashflow to improve.

4. **Risks:** impact of higher interest rates – lowering consumer confidence, which in turn causes the Residential Real Estate segment to remain depressed. Competition – particularly irrational pricing in construction materials. Project delays and cancellations. M&A – as an acquisitive company, risks of a poor acquisition or integration risk.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $4.59/s, reflecting upside of 20%. The stock is currently trading at around 12.5x 1yr forward PE, a discount to other construction material companies, while a temporarily low return on capital employed in FY23 should see steady improvement over the coming years.

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