Flinders Emerging Companies Fund

Quarterly Update: March 2024

Performance ***(after all fees and expenses)***	**1 Month** (%)	**3 Months** (%)	**1 Year** (%)	**3 Years** (% pa)	**5 Years** (% pa)	**7 Years** (% pa)	**Since Inception^** (% pa)
Flinders Emerging Companies Fund	5.09	5.27	9.38	-0.74	5.59	7.40	8.42
S&P/ASX Small Ords Accum Index	4.79	7.55	13.83	2.71	5.42	6.79	8.65
Net Value Added	**0.30**	**-2.28**	**-4.45**	**-3.46**	**0.17**	**0.61**	**-0.23**

^ 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

$135.2m

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

- **Market run continues with US and Australian cyclical risks diminishing**
- **Small caps slowly but surely starting to catch up**
- **Strong metrics for small caps in FY25**

The S&P/ASX Small Ordinaries Accumulation Index finished 7.5% higher in the March quarter, following on from the strong 8.5% return in the preceding December quarter. The benchmark has pushed higher for five consecutive months now, returning a total of 23.4% in that short period.

The Euro Stoxx index led global markets higher, up 12.4% while the MSCI World index was up 9.6%. US markets were also strong, with the S&P500 up 10.2% for the quarter. Market breadth was clearly better as the Nasdaq index, dominated by the 'Magnificent 7' stocks which had been supporting the market rally, lagged slightly with a 9.1% return, while the 30 stock Dow Jones Industrial index was up only 5.6%. Extreme performers at both ends were Japan (Nikkei up 20.6%) and China (Hang Seng and MSCI China indices *down* 3.0% and 1.7% respectively).

Commodity prices were generally up, reflective of an improving economic backdrop, particularly around the US. Base metals were mostly up (copper up 3.6% and nickel up 1.2%, while zinc was down 9.3%). Lithium prices finally had a strong bounce with an 18.6% rise in the quarter (while the 12-month performance is awful, down 74.4%). Strong performances were seen in WTI crude oil (up 16.1%) and gold (up 8.1%) which recorded an all-time high in March. The key exception was the iron ore price, down a hefty 27.8% for the quarter, which mirrored the weaker Chinese equity market's view on their economy.

The US 10-year yield increased 32bp to 4.20%, while the Australian 10-year was flat, yielding 3.96%.

A pleasing trend (from a small cap point of view!) is that the Small Ords index has continued its recent outperformance of the ASX100 index. Small caps have now outperformed large caps over 1 month (4.8% vs 3.1%), 3 months (7.5% vs 5.2%) and 6 months (16.7% vs 13.9%). The 13.8% return from small caps over the last 12 months only slightly lags the large cap return of 14.5%; a great catch up, with more expected given the underperformance over the last 2 to 3 years.

Reporting season in February saw some negative revisions to FY24 earnings expectations. However, there were positive revisions to FY25 earnings expectations. At March quarter end, FY25 EPS forecasts for the Small Ords was 21.4%; this compares to 16.1% three months prior. Interestingly, earnings forecast for the ASX100 was unchanged at 2.4% - minimal growth in that part of the market. And finally, on consensus data, the Flinders portfolio is currently forecast to deliver EPS growth of 29.3% in FY25, up from 24.3% three months prior, and is trading at a sub-market PE multiple of 14x (vs the Small Ords index at 17.3x).

Performance Review

The Fund returned 5.3% in the March quarter, 2.3% below the benchmark return of 7.5%.

Key Contributors: The quarter of course captured the interim report season in February, and associated share price reactions to new information. Case in point, utilities and telco service provider, **Service Stream (+35.1%)** reported a strong result with EBITDA several percent ahead of expectations, while net profit and earnings per share were materially ahead due to *lower* depreciation & amortisation and interest costs (a rarity this reporting season). There was continued momentum in their Telco segment as well as a stabilisation in margins in their Utilities division. Positive consensus EPS revisions to FY24 were in the 10-20% range, while the company is rapidly paying down its debt.

Uranium miner **Paladin Energy (+39.1%)** benefitted from the uranium spot price hitting multi-year highs during the quarter, exceeding US$100/lb in the first half of the quarter before settling lower. Long-term contracts with large utility companies written over the course this year will be important; prices above $80 will be very positive for uranium producers and result in a further re-rate. Aside from the commodity price, Paladin secured a US$150m syndicated debt facility in January which comfortably sees them recommence operations at their Langer Heinrich Mine in Namibia, with the company confirming that first commercial production occurred on 30 March 2024.

Radiopharma company, **Telix Pharmaceuticals (+27.9%)** issued a trading update early in January for the December quarter, which highlighted that sales of their Illuccix product accelerated quarter on quarter. The positive share price reaction went further in February as full year guidance of a 35-40% increase in revenue for 2024 pleased the market. Mining services company specialising in the design and manufacture of dump truck bodies and buckets, **Austin Engineering (+49.7%)** upgraded 1H24 NPAT guidance in January by ~18% at the midpoint. Better revenues and operational efficiency improvements helped. Further detail revealed at their February result was even more pleasing with their order book at a multi-year high, the company demonstrating a rapid paydown in debt, the reinstatement of dividends, and issuance of FY24 guidance well ahead of the market. Finally, late in the quarter, the company confirmed an initial purchase order for a large client, converting a trial into what could be a significant program lasting up to 9 years.

Key Detractors: Invoice financing company, **Earlypay (-26.7%)** had a reasonable 1H23 result however, guided to lower than expected full year earnings in FY24 primarily due to lower lending volumes (due to a period of more conservative lending to its customers). The company has been focused on trying to get its ‘house in order’ and ensuring appropriate systems are in place to conduct their business in a more risk-focused manner, as well as refinancing their funding to achieve better borrowing costs. Building remediation contractor, **Duratec (-24.3%)** gave back the gains of the previous quarter, which was a bit hard to reconcile given that the result met expectations (there was little change to consensus expectations) and the stock was cheap. The market seemed to focus on the order book which decreased slightly from the previous update, yet this measure moves around from period to period. Cash conversion was also softer than expected, however the variance was explained by investment into contracts won in the period; this is expected to improve in H2.

Bus, ferry and tourism operator, **Kelsian Group (-16.3%)** also gave back the gains of the previous quarter, with an underwhelming result at the bottom line. While operational earnings were largely in line, large depreciation & amortisation, as well as interest charges meaningfully impacted net profits. Weaker cashflow conversion (due to the mobilisation of three new contracts and small delays in payments) and a weaker debt position also did not help. However, the recently acquired US bus operations are performing well and they are well placed to pick up new corporate contracts. Motorhome rental and sales company, **Tourism Holdings (-19.2%)** had a softer 1H24 result with lower sales volumes than expected. Again, higher than expected interest and depreciation charges associated with rebuilding their rental fleet hurt short-term earnings. Consequently, FY24 NPAT guidance was downgraded from prior expectations, to around $75m. The company reiterated its goal to deliver $100m NPAT in FY26.

Neurological disease pharma company, **Neuren Pharmaceuticals (-15.0%)** gave back some of its stellar gains from the previous quarter where the stock gained 125%. The issuance of a sketchy ‘short report’ in February on Neuren’s distribution partner Acadia Pharmaceuticals by Culper Research negatively impacted. Importantly, Neuren delivered a CY23 net profit of $157m, and has $228.5m of net cash which will help commercialise their pipeline of several other drugs that are at various trial stages; the company is catalyst rich over the next 12 months with progress announcements.

Portfolio Activity

Exits: The March quarter saw two long term holdings exited given they were approaching their 12-month anniversary of graduating into the ASX100 (as required in our mandate). These were private health insurer **NIB Holdings (NHF)** and industrial conglomerate **Seven Group Holdings (SVW)**. Seven Group, in particular has been a very successful investment for the Fund, having first invested in 2017 at $11.20/s when the company raised equity to take their shareholding in Coates Hire to 100%. The Fund exited >$40/s during the quarter. The stock was unloved at the time; remarkable given they boasted one of the most capable management teams in the small cap market. Senior management have strategically and very diligently grown earnings per share from 67c in 2017 to a forecast $2.25 in 2024, taking the company to a substantial market capitalisation of ~$15bn today.

Scrap metal recycler **Sims Group (SGM)** was the only stock exited from the portfolio specifically on the back of a weak result in February. Our expectation for an earlier cyclical recovery was pushed out, with persistently competitive scrap markets keeping margins under pressure.

Finally, gold miner **Gold Road Resources (GOR)** was sold in January following a weaker than expected December 2023 quarterly report, which highlighted labour availability issues, with lingering impacts leading to a lower than expected forecast production guidance in 2024 (and consequently higher costs). The proceeds were used to fund another gold producer, Red 5 (see below).

Additions: As mentioned above, we added gold producer, **Red 5 (RED)** to the portfolio. Its flagship project, King of the Hills, saw first gold poured in June 2022. While the project is sound and sizable (+200koz pa producer with a 16-year mine life), commissioning issues meant the stock traded down in the following period with two discounted equity raisings required. Recent quarterly reports however have demonstrated successful ramp up to steady state production, with good cashflow generation. In an important development, the company announced in early February a merger of equals with fellow gold producer Silver Lake Resources (SLR). The combination is highly complementary, with RED bringing a brand new mill with long mine life, together with SLR's strong balance sheet – the combined group creates a leading mid-tier gold company producing ~445koz in FY24 and $378m in net cash, allowing for growth initiatives to be accelerated.

Agribusiness **Elders (ELD)** was reintroduced into the portfolio (previously divested in 2022). Since our previous holding, the share price had derated in line with a period of EPS downgrades over the past 18 months as domestic weather conditions led to headwinds for the business. This seems to have played out, with improved weather conditions leading to expected tailwinds going forward. We expect positive outlook comments when the company reports in May 2024.

Offshore service vessel company, **MMA Offshore (MRM)** was bought in the quarter. MRM operates 20 vessels, servicing the offshore wind, oil, gas, government and defence industries. Following a near-death experience, current management have done a terrific job turning the company around, improving the balance sheet, and setting MRM for growth over the coming years. Strong demand for offshore services is coupled with a decline in vessel supply in recent years, leaving current well capitalised operators like MRM with good prospects to grow well. This was obviously recognised, as MRM received a bid at $2.60/s late in the quarter. This was at a skinny 11% premium to the last traded price, yet the MRM Board has recommended the Scheme of Arrangement. We await to see further developments.

Finally, the Fund participated in the IPO of Australian copper producer **Metals Acquisition Ltd (MAC)** in February. The main asset - the CSA mine located in Cobar NSW - was acquired from Glencore, and the first two quarters under ownership have demonstrated a substantial improvement in production and operations. Value should also be created by exiting expensive subordinated debt, and we expect major improvements to the resource base through a detailed drilling program currently in place.

At the end of the quarter, we held 40 stocks in the portfolio and were holding 3.5% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	**Top 5 Detractors**	**Top 5 Active Holdings**
Austin Engineering	Duratec	AUB Group
Gentrak Group	Earlypay	EQT Holdings
Paladin Energy	Kelsian Group	Johns Lyng Group
Services Stream	Neuren Pharmaceuticals	Karoon Energy
Telix Pharmaceuticals	Tourism Holdings	Webjet

^ Alphabetical order. * Denotes stock not held during this period. Attribution is for the 3 months ending 31st March 2024. Top 5 positions are effective 31st March 2024.

Stock in Focus: Karoon Energy (KAR)

Karoon Energy (KAR) is an Australian listed oil and gas producer with assets based in the US and Brazil. The company's flagship project is Bauna, located in the Santos Basin in offshore Brazil. Karoon acquired the asset off the Brazilian national oil company Petrobras in November 2020. Bauna was already in production however since acquisition, Karoon has enhanced the project with the development of the nearby Patola discovery as well as enhancing existing field operations. This led to production growing from ~15k barrels of oil per day (bopd) to over 25k bopd before natural decline.

In late 2023, Karoon acquired their second producing asset, a minority stake in the Who Dat project in the Gulf of Mexico. The project was acquired from and, is operated by, LLOG Exploration Offshore and has several discovered fields as well as exploration prospects. The project adds more than 60% to Karoon's proven and probable reserves. Since acquisition the company has already participated in a drilling campaign to add further production to the project. Recently, the company approved funding for additional appraisal (low risk) and exploration (higher risk) wells demonstrating the prospective inventory within the portfolio.

Investment Case Key Questions

1. **Growth Opportunity:** Karoon has had a clear focus on growth with intervention and developments programs in Brazil, together with acquisitions driving production from ~15k bopd to a forecast rate of over 30k bopd in 2024. We expect a combination of appraisal and exploration activities to keep production above 30k bopd over the medium term. This results in significant cash build over the next few years with an estimated ~$500m of net cash by 2026. In turn, this provides significant capital to undertake further organic (development of existing discoveries and exploration of prospect inventory) and acquisitive growth activities as well as the prospect of capital management initiatives including dividends and buybacks.

2. **Management:** Coinciding with the 2020 acquisition of Bauna, the company undertook both a board and executive overhaul bringing in deep experience to drive the growth of the business. That came in the form of industry veteran Bruce Phillips (ex-AWE) as chairman of the business at the time appointing Dr Julian Fowles to the position of CEO and MD on the back of his deep international petroleum industry experience. Current Chairman, Peter Botten, adds to the depth of the company's leadership with 40 years experience in the sector, with ~25 years as Oil Search CEO.

3. **Financial Strength:** Karoon is in a strong financial position following the recent Who Dat acquisition which was accompanied by a $480m equity raising to fund the ~ $1.1bn acquisition. The use of associated debt and available cash leaves the business with ~$140m of net debt. However, we forecast this position to swing quickly to net cash on the back of ~ $900m in earnings in 2024 and 2025 allowing the business to continue its investment in existing projects as well as consider new assets.

4. **Risks:** Key risks include geological variances with the pre-development case impacting reservoir performance; facility interruptions due to mechanical failure; commodity price fluctuations.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $2.89/s, reflecting upside of ~34%. After a period of digestion following the equity capital raise in November 2023, the share price has found a base and benefitting from both improved oil prices as well as company driven initiatives to grow production.