# Flinders Emerging Companies Fund

Monthly Update: May 2022

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 * | -7.88% | -5.40% | -10.10% | 7.32% | 11.15% | 10.42% |
| S&P/ASX Small Ords Accumulation Index | -7.01% | -3.58% | -4.56% | 5.50% | 8.49% | 9.90% |
| **Net Value Added *** | **-0.87%** | **-1.82%** | **-5.55%** | **1.83%** | **2.66%** | **0.52%** |

^ 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**

$143.8m

**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

- **Small Caps clobbered**
- **Complex Energy**
- **Long Covid**

The Small Ords Accumulation Index was crushed 7.0% in May with technology, battery material and consumer discretionary stocks all very weak. Energy and agriculture stocks performed strongly. Notably, large caps outperformed smalls by a large margin (S&P ASX100 Accumulation only fell 2.2%), creating attractive valuation opportunities.

Global markets fared better with the S&P500 flat on the month, China up 4.6%, Hong Kong up 1.5% and most European markets stronger. Bond yields spiked early in the month but eased on global growth fears to generally finish lower than they started May. The stand-out moves were that of the energy complex – both here and offshore.

International energy prices were on the rise before the invasion of Ukraine. But with a combination of sanctions, bulk coal carrier shortages, Chinese port closures, Australian floods and general energy demand increases, oil, gas and especially coal markets have tightened significantly. Thermal coal rose 31% in May; it is now up 56% for the quarter and 290% for the year. Given that the majority of Australia's electricity generation is coal fired, and even allowing for long term contracts, the cost of producing power is rising.

Gas is just as problematic to Australian corporate profitability but for different reasons. Like Western Australia, the East Coast exports significant quantities of gas. But unlike WA, there is no reservation of gas for domestic consumption – a poor decision made over a decade ago. In a world short of energy, every molecule produced for export is exported; none for us. Consequently, a product that was selling for $3/GJ a few years ago has now risen tenfold – or more (with AEMO recently enforcing a $40/GJ price cap on the local energy market). And to be fair, the RBA couldn't have seen it coming but they will have to deal with the inflationary consequences – not that rate rises will – cost-push inflation doesn't work like that. We are in an energy pickle and it will take some time to sort – best avoid companies with high energy inputs, and a reason to own domestic gas producers.

The other area of concern (before turning positive) is that of rolling absenteeism caused by Covid. While many industries can cover and are more suited to working from home, the issue is certainly having an impact on others such as retail, medical, technical services, building and transport. While temporary, it is dragging on and adding further to the cost base of many companies. We would expect commentary on margins in the forthcoming full year results to reflect this as well.

Having touched on the increasing cost pressures being faced by companies, for now, demand is still strong. Households are spending and retail sales are still recovering. Rate rises are coming but we feel that the market de-rate over recent months has largely reflected that impact. Small caps have retreated close to 20% this year with virtually no reduction on profits to date. The Flinders portfolio is at a substantial discount to market. It is a portfolio of highly profitable companies well positioned for the next few years.

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## Performance Review

**The Fund returned -7.88% in May, 0.87% behind the benchmark which returned -7.01%.**

**Key Contributors:** Electronic products developer and manufacturer, **Codan (+10.8%)** bucked the market trend in May following an investor day at their Adelaide facilities and earnings guidance which translates to a record FY22 full year profit. It was also important in confirming the growth prospects in both its Minelab metal detection division and the communications businesses. There is considerable progress in integrating and growing the two recent communications acquisitions which are trading ahead of expectations, giving the company significant opportunity to expand into that market. Codan retains a strong balance sheet, has a very high return on capital and continues to trade at a large discount to the market. Also performing well was invoice finance company, **Earlypay (+7.0%)**. The past quarter has seen two earnings upgrades on the back of increased invoice lending volumes from corporates and continued growth in equipment finance. The company also seems to be winning market share through finance brokers. Also notable was that its largest shareholder, Consolidated Operations Group (COG), increased its shareholding from 17.4% to 19.9% during the month. This was COGs first move on the register since launching a takeover bid in early 2020.

Utilities and telecommunications service provider, **Service Stream (+6.8%)** recovered after struggling in April. The company has contracted services revenues that are particularly defensive and predictable. The integration of the Lend Lease Services businesses purchased in 2021 is on schedule to deliver the expected synergies and provides the company with numerous growth opportunities over the next few years. We also expect to see increased expenditure from the mobile telecommunications companies on 5G expansion over the next year as network and infrastructure sharing agreements have recently taken place. As one of the chief contractors to that industry, Service Stream will benefit.

Given the strength of energy prices, and in particular the price of domestic gas, it wasn't surprising to see **Beach Energy (+6.2%)** well supported. The company has an enviable position in East Coast gas supply and the current shortages are likely to persist for some time, underpinning price. The company also announced the appointment of Morne Englebrecht as the new CEO of the company after having been acting CEO since the departure of Matt Kay in November last year.

**Key Detractors**: Insurance building services operator, **Johns Lyng (-32.9%)** suffered a sharp sell-off despite no negative news or diminution of the company's strong growth profile. It was however, valued at a large premium to the market (due to its strong growth history and outlook). This premium has been eroded significantly but we expect the growth posted by the company's core businesses and catastrophe earnings over the next year or two will restore that valuation premium. Plus size female apparel retailer, **City Chic Collective (-20.4%)** continued to struggle despite being another company where the earnings forecasts would seem to be intact. Most discretionary retail companies underperformed in May on the impact of higher fuel prices and potential interest rate hikes crimping spending patterns. While this is true at the margin, low unemployment, emerging wages growth and a strong household balance sheet (not to mention the end of an election campaign focussed on cost of living), the de-rating of the stock seems overdone.

Contract drilling operator, **DDH1 (-21.6%)** was another company in the portfolio to drop despite no meaningful earnings issues. We are all aware of labour disruptions due to Covid, especially in WA. These have had an impact on mining company production levels but with commodity prices still at healthy levels, they continue to spend on both production drilling and exploration. We regard the fall in May as excessive, considering the stock already had a very modest valuation based on conservative earnings forecasts that factor in these cost headwinds. Also detracting from performance was consumer finance company **Wisr (-23.8%)**. The company is growing quickly with sharply rising revenues supported by conservative credit quality and has just become cashflow positive. While the March quarter update was positive and metrics will improve significantly throughout the remainder of 2022, the market is finding it difficult to embrace stocks in the early stages of profitability.

| Performance Attribution^ | | Key Portfolio Positions^ |
|---|---|---|
| **Top 5 Contributors** | **Top 5 Detractors** | **Top 5 Active Holdings** |
| Beach Energy | City Chic Collective | AUB Group |
| Codan | DDH1 | Codan |
| Earlypay | Johns Lyng Group | Service Stream |
| Evolve Education Group | Trajan Group | Shine Justice |
| Service Stream | Wisr | Syrah Resources |

^ Alphabetical order. * Denotes stock not held. Attribution is for the 1 month ending 31st May 2022. Top 5 positions are effective 31st May 2022.