Flinders Emerging Companies Fund

Quarterly Update: June 2021

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	2.48	8.52	37.81	13.02	12.87	14.76
S&P/ASX Small Ords Accumulation Index	3.08	8.50	33.23	8.59	11.23	13.07
Net Value Added	**-0.60**	**0.02**	**4.58**	**4.42**	**1.64**	**1.69**

^ 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

$105.1m

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, Xplore, CFS FirstWrap, MLC Wrap, Powerwrap, Navigator, IOOF, Praemium

Further Information

www.flindersinvest.com.au

- **Bond yields ease**
- **Lockdowns and lack of vaccines**
- **But the economy keeps chuggin' along…**

The S&P/ASX Small Ordinaries Accumulation Index reached another all-time high late in June to finish 8.5% higher over the quarter. Over the twelve months to June 30th, the gain was an impressive 33.2%. The Flinders Emerging Companies Fund rose 8.5% and 37.8% respectively over those periods.

Resource stocks led the market (Small Resources index rising 13.6%) with base metals, battery materials, iron ore and coal prices all strong over the quarter. The top 100 stocks were in line with smaller stocks over the quarter but over the year, smalls outperformed by 5.3%. Global markets continued to rise with both the US and Europe particularly strong on the back of increasing activity levels and bond yields easing. Asian markets by contrast were more subdued with Japan and Singapore posting slight declines over the quarter. Commodities continued to rise with only gold lacking lustre (down 7.2%). Iron ore and coal were standouts rising 30.1% and 41.6% respectively.

Probably the most surprising outcome over the quarter was the retracement in global long bond yields. At the end of March, the US 10 year bond yield was 1.74% with a shrill chorus calling it through 2.00% and inflation pressure beyond doubt. Not to be. Soothing words from the Fed about inflation being transitory, a couple of ho-hum economic releases and yields spent the June quarter in gentle decline to close at 1.47%. Good news for equity valuations, growth stocks and long dated assets.

Domestically, the economy continues to do well. Corporate earnings for most sectors are growing and investment spending is now rising. M&A activity is increasing and the stimulatory measures of the past 18 months are still very supportive, all of which are good for the small cap sector. However, we do get consistent feedback that supply side issues are an ongoing problem. Freight costs remain at very elevated levels and everything from imported components to finished major goods are slow to arrive and in short supply. Plus, we know about labour shortages in mining, construction, hospitality, healthcare and other sectors. What does it mean? Be careful before assuming that rising demand also means rising margins. A company's pricing power and market position are of increasing importance and the forthcoming reporting season will reveal more about which companies are managing these pressures and those that are struggling to.

And of course, to lockdowns. Seven different Governments and health departments (we've excluded Tassie and the ACT) with differing agendas and vastly different incompetence levels – what could possibly go wrong? While sapping confidence and further bruising the hospitality and tourism sectors, it may be the type of pause that helps reset other parts of the economy. Things had been fizzy and a short dip in demand might end up being a good thing to sustain the recovery at manageable levels. Just a thought.

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Performance Review

The Fund returned 8.52% in the June quarter, slightly above the benchmark return of 8.50%. Over the 12 months the Fund returned 37.80%, outperforming the index return of 33.23%% by 4.58%.

Key Contributors: Again, a good spread of contributors over the quarter. Telecommunications infrastructure and services company, **Uniti Group (+43.9%)** was an exceptional performer as investors recognised the longer term value of its fibre network and importantly, its growth prospects in the residential development market competing with the NBN. Its scale and ability to offer customers and developers access to Telstra (a fairly recent development) as a retail service provider bodes well for a solid growth pipeline in future years. We've mentioned **Think Childcare (+39.8%)** as a contributor in recent reports and the board recommended takeover by UK based Busy Bees means that the deal will likely be completed in the next few months. It has been a terrific investment for the fund and a good example of identifying early, a significantly undervalued company that was well run and growing.

Strong markets and good performance, means that investment managers are likely to do well. **Pinnacle Investment Management Group (+29.8%)** has certainly done that (and worth noting that it is up 210.5% for the 12 months). Within its broad range of boutique affiliates and investment strategies it has a number that are performing particularly well and will contribute performance fees to the group. Fund growth is strong and especially impressive into the more stable retail investor base. Another contributor was the diversified miner and services company **Mineral Resources (+41.3%)**, which we have held in the fund for many years and, on the back of its success has been promoted to the top 100 Index. We have mixed feelings about this since on one hand it has done well enough to get there (and been a great performer for the Fund) and on the other, it will have to leave the portfolio and we still think it has an excellent future.

Other stocks worth mentioning that performed well were ready to cook meal provider, **Marley Spoon (+26.4%)** showing that its growth is not just driven by Covid lockdowns. Specialty building and restoration services firm, **Johns Lyng Group (+32.1%)** continues to grow strongly and had the added benefit of increased work from NSW floods and Victorian storms and copper producer, **Sandfire Resources (+23.7%)** was helped along by a higher copper price driving higher than expected cash generation.

Key Detractors: A little like the better performing stocks, the quarter's poorer performers were from a broad range of industries. Medical imaging technology developer, **4DMedical (-28.8%)** slipped back as the US continued to struggle with Covid earlier in the quarter. With hospitals focussed on Covid patients, research projects and less urgent services were put on the backburner. This is now changing and already 4DMedical is back doing trials in the US. We expect this quarter to be considerably more productive. While we have done well with our investment in Think Childcare, its competitor, **Evolve Education (-29.3%)** issued a profit warning. Lower occupancy as well as teacher shortages (due to international border closures) in its New Zealand centres being the major reasons. We believe this to be transitory, and the company is expected to return to strong growth in FY 2022 and remains particularly undervalued.

As we highlighted in the April monthly, digital payments and gift card provider, **EML Payments (-29.0%)** fell on the news that it was being investigated by its European regulator (the Irish Central Bank) for matters relating to its compliance with anti-money laundering and terrorism financing regulations. The investigation is expected to take a number of months and until resolved will keep the stock under pressure. We believe that the market is pricing in a worst-case scenario of the company losing its licence to operate in Europe and loss of all revenues – an outcome that is highly unlikely.

Industrial services and investment company, **Seven Group (-9.8%)** lagged the market as mining service companies struggled (Seven owns the Westrac WA and NSW Caterpillar dealerships) and its investment in Beach Energy came under pressure. We are very comfortable with how both Westrac and Coates Hire are performing in both mining and infrastructure and the company is already sitting on over $1bn in paper profit on the recent investment in Boral, further underpinning our valuation.

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Portfolio Activity

Additions: Given our focus on valuation there will always be times when a company's prospects and earnings decline and we sell out. Conversely, if conditions begin to improve for such a company and a low share price provides opportunity, we are happy to re-invest. That was the case twice during the quarter. We re-established a position in utilities engineering and service provider, **Service Stream (SSM)** after the company's share price had dropped sharply over the past six months following the loss of contract revenues from NBN and higher costs associated with operating under Covid restrictions. The company will return to growth in FY 2023, is well managed, well capitalised and has a core of recurring revenue contracts. We feel the current valuation discount is far too large. Also re-added to the portfolio was financial servicers software provider, **Bravura Solutions (BVS).** With a significant earnings base in the UK, the company was hit with the double impact of Brexit and then Covid. Earnings suffered and new contract opportunities pushed out. We now believe most of these issues are behind them and expect a significantly improved growth profile over the next few years.

We have seen more opportunities in IPOs in recent months – better quality businesses with more sustainable earnings growth. One we added was medical instrument developer and manufacturer, **Trajan Group Holdings (TRJ)**. The company specialises in high end, glass based consumable components for diagnostic machines. They manufacture in Australia, Malaysia and the US and have research capabilities in both Australia and the US. TRJ has grown both organically and through strategic acquisition over the past decade and has an extremely experienced management team that still have a significant shareholding in the company.

Earlypay (EPY) is a business finance company specialising in invoice and trade finance plus a growing equipment finance division. While having a new name, the business has been going for 20 years and has an experienced management team. The opportunities in invoice and trade finance are considerable. It is a much more entrenched and widely used market in the US and UK, and in this country had been largely the domain of the banks but they have now withdrawn from the market. This has allowed companies like EPY and larger competitor, Scottish Pacific to grow their businesses – helped by the large banks funding *them*. EPY has a technology edge over its competitors, reducing funding costs, high returns and an excellent distribution capability. Most importantly, it is very undervalued.

Exits: During the quarter we sold out of automotive parts distributor and retailer**, Bapcor (BAP).** The company continues to perform well with supportive dynamics both in its retail and wholesale businesses. However, the stock had reached our valuation so we sold our position. Likewise, our position in **Redbubble (RBL)**. The company is well placed in its industry but profit growth will not match revenue growth as the company spends more on promotion and distribution to grow its market share (the investment amount being larger than we expected whilst still being unclear). RBL had been an excellent performer for us over the past couple of years but the share price exceeded our revised valuation and we sold.

Mining and infrastructure contractor, **NRW Holdings (NWH)** was sold early in the quarter. The company has had cost issues in some of its larger West Australian operations due to the tight labour conditions in the Pilbara brought on by Covid related travel bans. While these should ease somewhat, it is still a factor in WA and will be at least for another year. Lockdowns on the east coast don't help either. Due to the heightened earnings risk into 2022 we reduced our earnings outlook and valuation.

At the end of the quarter we had 42 stocks in the portfolio and were holding 3.4% cash.

Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Marley Spoon	4DMedical	Codan
Mineral Resources	Evolve Education	Marley Spoon
Pinnacle Investment Management	EML Payments	Pinnacle Investment Management
Think Childcare Group	Gold Road Resources	Shine Justice
Uniti Group	Seven Group Holdings	Uniti Group

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th June 2021. Top 5 positions are effective 30th June 2021.

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Stock in Focus: Liberty Financial Group (LFG)

Liberty Financial Group is a non-bank financial institution that provides mortgage and personal financial products to the consumer market. The company was founded in 1997 to provide mortgage finance products. It is now one of the larger non-bank providers of mortgages, and a significant player in the auto-finance market plus consumer lending through its MoneyPlace business, commercial lending products and insurance offerings. It has a long history of profitability and growth and came to the equity market with a modest IPO in December 2020.

Investment Case Key Questions

1. **Growth Opportunity:** The company has a demonstrated track record of growing revenue and importantly earnings under the guidance of the current management team. With innovative products, customer service and faster approval processes, Liberty has been able to gain a good share of the mortgage broker derived market. This is increasing as banks struggle to offer much more than price. Other areas are growing strongly as the major banks back away from small business lending and vehicle finance – a trend that will continue for many years. With low funding costs and good credit control, Liberty is well placed to benefit from these market dynamics.

2. **Management:** The senior management team has an average of over ten years with the company – a period where the loan book has grown by almost 20% per annum. CEO Peter Boyle has been with the company for over 15 years and Executive Director and founder Sherman Ma remains with the company and did not vend stock into the IPO. The company has consistently upgraded its systems and technology to improve customer service and win market share and been prudent in its lending standards and credit control.

3. **Financial Strength:** With close to $500m of cash and liquid assets on its balance sheet, Liberty has sufficient capital to fund its current forecast growth trajectory. However, like all lenders, higher growth means higher appetite for funding and that takes capital – both equity and debt. If the company looks to accelerate growth to take advantage of market opportunities or make an acquisition, we would expect it to come to market for funding. In the current environment, we would look at such an outcome as positive. The other important aspect of the company's financial position is its funding cost. With an $11bn book of premium lending, Liberty has the scale to access funding at attractive and competitive rates – placing it at an advantage to smaller lenders and in a position to still compete with the majors.

4. **Risks:** Lending money is a business of risk assessment. Liberty has grown consistently for almost 25 years through various economic conditions including both the GFC and Covid periods. The current management team has been through those downturns which lifts our confidence in their ability to manage credit and capital risk under different market conditions. Macro risks are also important to evaluate for finance companies. Current conditions are very supportive; demand is high, low rates help lower funding rates and credit quality healthy. ESG risks include regulatory compliance with APRA, ASIC and the ACCC and importantly board structure which at the moment is 50/50 independent and executive with the chair being independent.

5. **Valuation:** Our current assessed company valuation (ACV) is $10.43, providing 39% upside to the current share price. The valuation still places the company at a 20% discount to the major banks but with considerably more growth, opportunity and diversity of revenue.

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