Flinders Emerging Companies Fund

Quarterly Update: September 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	-2.07	0.10	6.68	1.11	2.81	7.69
S&P/ASX Small Ords Accumulation Index	-4.04	-1.94	6.85	2.57	1.63	7.13
Net Value Added	**1.96**	**2.04**	**-0.17**	**-1.46**	**1.18**	**0.56**

^ 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

$146.3m

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

- **Up, up, and away! Bond yields fly.**
- **Small cap profits hang in there, care factor?**
- **Goldilocks isn't pretty enough…**

The S&P/ASX Small Ordinaries Accumulation Index finished 1.9% lower in the September quarter with industrials and resources performing in line with each other (although resources were well in front over the last month).

Global markets turned sour in September, dragging the quarter into the red. Rapidly rising bond yields and concerns about China's growth rate were the key reasons for the bearish sentiment. Large caps outperformed smalls later in the quarter and the Australian equity market fared better than most other international markets.

In the US, the S&P 500 declined 3.7% and the Nasdaq 4.1% but within the Nasdaq large tech continued to outperform the broader index. The Dow (-2.6%) was a little better but helped by the strong performance in energy stocks. European markets were mixed, with Germany and France weak, but the UK FTSE managed a 1.0% rise. Asian markets were also weak with China and Hong Kong down 2.9% and 5.9% respectively. Japan was down 4% and Korea 3.9%. NZ has been a notable struggler with the market down for the quarter, half and full year (sadly on its own with that stat…).

Commodities were all over the place with gold down 3.7% (not helped by a strong USD), but WTI oil was up 28.9%, thermal coal up 25.0%, iron ore up 5.3% and aluminium up 10.1%. Clearly, markets aren't convinced it's sustainable as the resources sectors were down for both the month and quarter – perhaps lithium was the focus, it has many grades and pricing formats, but all were exceptionally weak over the quarter.

The pivotal move over the quarter and especially the last month has been the sharp rise in bond yields – and with the exception of a brief period before the GFC, the US 10 year reached a 20 year high. While not helped by rising energy prices and US debt ceiling politics, markets were pricing a higher for longer inflation outlook. The same dynamics are the case in most advanced economies – China being the obvious exception. The converse is that economic news is generally strong and corporate profitability is hanging in there. Seems that Goldilocks is potentially being ignored.

For smaller companies, the general consensus is that the higher rates, rising costs and an iffy consumer means there is no reason to consider them, but we believe the market is wrong to take a blanket approach to the sector. Money has come out of small-caps and with less liquidity it has meant that there have been many companies with good growth prospects that have been over-sold and provide excellent upside. If confidence in the earning outlook improves and investor confidence lifts, it is this asset class that will move.

It is easy to sit in a TD yielding 4% but with a 3% yield and good earnings growth that will manifest itself in capital growth, we believe investors should keep an eye closely on the small-cap sector.

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Performance Review

The Fund returned 0.10% in the September quarter, 2.04% above the benchmark return of -1.94%.

Key Contributors: Better performers came from a range of sectors over the quarter. Integrated building services and restoration company, **Johns Lyng Group (+23.6%)** had a strong comeback after underperforming in the June quarter. A solid full year profit release and the prospect of good growth in both its domestic and US businesses saw the stock well supported. A strong management team, low capital employed and enviable market positions place it well over the next few years.

The rise in the oil price certainly helped **Karoon Energy (+34.1%)** rise, but the company also announced encouraging production levels and outlook from its offshore Brazilian Santos Basin project. Diversified industrial services company, **Seven Group (+27.3%)** continued to perform well. With its three core businesses of Westrac (Caterpillar equipment), Coates Hire and Boral exposed to infrastructure and resources expenditure, revenues have been strong and will continue to be with the pipeline of major projects across the country. While the company has re-rated considerably over the past two years, it still trades at a significant discount to the market and with good growth prospects, has more upside in front.

Two of our smaller companies, invoice lender **Earlypay (+34.2%)** and childcare provider, **Embark Early Education (+23.3%)** both had a good quarter. In both cases there had been fears of poor results and an uncertain outlook, but in both cases the company's core businesses stood up well. In the case of Embark, the decision to sell its New Zealand centres and focus on building the Australian portfolio has proved the right move and now well capitalised and producing healthy profits domestically, it can resume a growth strategy. With Earlypay, the main invoice finance business continues to see good demand and margins and with a refinance of its debt facilities expected this month, the company will see further margin improvement.

Junior telecommunications provider, **Aussie Broadband (+37.9%)** was added to the portfolio earlier in the quarter and rose strongly following a solid profit result and an outlook statement pointing to further strong growth into 2024 (although similar to our expectations). The company has significant growth opportunities in the business, enterprise and Government sectors with its expanded network and product capabilities, as well as continuing market share gains in its NBN retail division.

Key Detractors: Mineral Sands producer, **Strandline Resources (-58.2%)** was mentioned in our last monthly report as an underperformer following a discounted capital raise. The stock fell further on fears of more production delays, lack of confirmed customer contracts and potentially increased capital needs. At the time of writing, the company released an update which pointed to improved technical performance, growing production and importantly, first shipments of high value Zircon material, all of which should allay some of those concerns.

Medical device consumables manufacturer, **Trajan Group (-36.5%)** also had a poor quarter with an annual profit release that was disappointing both in its cashflow and reported bottom line profit. It is a quality provider of consumable items for global medical equipment suppliers but lower ordering levels due to higher inventories in the supply chain impacted revenues and margin. This will continue this half but calendar year 2024 should see a reversion back to solid growth.

Transit and tourism operator, **Kelsian Group (-19.8%)** slid following a profit result that was largely in line with expectations but a large jump in depreciation and amortisation charges this year resulted in bottom line forecasts being reduced by around 10%. This will have little impact on cash generation and with their newly acquired US businesses doing well, domestic tourism doing well and the activation of their new Sydney bus contracts in August, we expect very healthy growth this year.

And lastly, relative performance was impacted by a few stocks that performed strongly that we do not own. Uranium stocks went on a tear with a jump in the uranium price after more than a decade in the doldrums. **Paladin Energy (+50.7%)** and **Boss Energy (+56.5%)** were two of the larger stocks that performed well. As did medical imaging technology company **Pro Medicus (+27.3%)**.

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Portfolio Activity

Exits: The August reporting season brought about a small number of moves, three of which were exits due to a diminution of growth prospects over our forecast period. Compensation lawyers, **Shine Justice (SHJ)** continued to have cash conversion issues and the long running settlement of the Johnson & Johnson Mesh case remains unresolved, risking the costs payable to Shine. While undoubtably cheap, there remains considerable uncertainty on the earnings outlook for the company. Another exit was employment placement company, **Peoplein (PPE).** Reduced activity in the IT sector and a slower recovery in Health (largely nurse placement) plus increased costs saw margins come back in the first half of this year and will likely persist for longer than expected. While cash generation has been solid the company's growth profile has certainly diminished over the next couple of years, and consequently our valuation reduced and we sold out of the stock.

Likewise with funds management and trustee company, **Perpetual (PPT).** We saw potential valuation upside with the synergies of the **Pendal** acquisition and the strategic value and growth of the trustee business. However, the cost base is not falling, the integration is taking longer than expected and we suspect that the trustee business has not been a focus of management. There is also little sign that the potential conflicts between the wealth and funds management businesses have been addressed which may in time create regulatory issues.

Additions: During the quarter we added mining contractor and drilling company, **Perenti (PRN)** to the portfolio. The company is exposed to a broad number of commodities, has a large client base and has a number of service offerings from underground mining to drill and blast. Profitability will be helped by the recently slimmed down and restructured underperforming African operations. It recently acquired competitor in the drilling industry, DDH1 which will create synergies and new clients and technology to the group. We feel that the market has not recognised these benefits and is underestimating the company's growth over the next two years. It has compelling valuation upside, proven management and is well capitalised.

As mentioned in the stock performance commentary, we added **Aussie Broadband (ABB)** to the portfolio in the quarter. ABB has evolved from its early days as an NBN retail service provider (RSP) to a telco that can offer services to business, enterprise and Government clients with its own growing physical network. It is, and will continue to, take market share from the incumbent players with a combination of service and technology with a falling cost base. While the stock has done well since purchase, we continue to see upside at current levels.

Within the gold sector we are always looking to maximise returns and will move from one producer to another if the valuation and opportunity gap provides an opportunity. We re-invested in **Ramelius Resources (RMS)** on that basis during the quarter and reduced our holding in **Silver Lake Resources (SLR)** toward the end of the month.

At the end of the quarter, we held 40 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**
Earlypay	Kelsian Group	AUB Group
Embark Early Education	Paladin Energy	EQT Holdings
Johns Lyng Group	Pro Medicus *	Johns Lyng Group
Karoon Energy	Strandline Resources	Kelsian Group
Seven Group Holdings	Trajan Group Holdings	Seven Group Holdings

^ Alphabetical order. * Denotes stock not held during this period. Attribution is for the 3 months ending 30th September 2023. Top 5 positions are effective 30th September 2023.

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Stock in Focus: Service Stream (SSM)

Service Stream (SSM) is a broad-based services company that provides construction, maintenance and other engineering services to telecommunication, gas, water and electricity utilities and transport infrastructure. The company had its roots as a provider of engineering, maintenance and connection services to both fixed and mobile telco operators and a meter reading service to electricity and gas utilities. It has grown both organically and via acquisition to broaden its business activities with major customers.

In 2021 the company acquired Lend Lease Services that expanded its reach with existing clients and also added expertise in the electricity and transport (traffic and roads) sectors. The acquisition was accretive and came with significant cost synergies that the company is still realising. In 2022 the company struck cost and implementation issues with a design and construct project with a large water utility. This led to losses and a writedown of close to $20m. This hit the stock hard and it de-rated significantly. This was not helped by persistent low margins in its utilities business. Since that time the company has met profit expectations, has growth opportunities and is seeing margins recover.

Investment Case Key Questions

1. **Growth Opportunity:** following a period of reduced profitability in 2021 and 2022, the company is back in growth mode. Its largest division (telecommunications) is seeing increased workflow from NBN, other fixed line operators and an increasing roll-out of 5G technology by their mobile customers. The NBN work will last some years as the introduction of fibre to the home (FTTH) technology is only in its infancy. Revenues in the utilities business (water, gas & electricity) is increasing, and the upgrade of electrical transmission and distribution networks will be a key area of potential growth. Importantly, margins in this business are now improving. And lastly, both transport and defence sectors are key services revenue opportunities.

2. **Management:** CEO Leigh Mackender has been in the position for nine years and has grown the company significantly in that time. Experienced public company CFO, Linda Kow has been with the firm for three years and has a record of excellent cost control and acquisition integration. The board has been through recent renewal and has a good set of skills aligned with the activities of the company. Divisional management has also been upgraded over the past 2-3 years.

3. **Financial Strength:** Service Stream has very low gearing (less than 10% net debt/equity) and strong cashflows. Importantly, being a service-based company, working capital and plant and equipment needs are modest and traditionally, the company has had return on equity in the mid-teens. While returns are closer to 10% now, we see the company consistently improving on that level over the next few years.

4. **Risks:** customer contracts are always a risk but the company is now much more diverse than when NBN expenditure slowdown impacted margins a few years ago. A broader range of customers, industries and services reduces client and contract risk. It has also exited design and construct contract bidding which also lowers risk. It has a long history of pro-active ESG attention and has a good safety record.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $1.18/s, reflecting upside of 27%. The valuation is struck on a combination of criteria and we note that the company continues to trade at a significant discount to some of its market peers that have a more modest growth profile.

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