Flinders Emerging Companies Fund

Quarterly Update: December 2022

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	-5.67	3.76	-22.97	-0.18	4.22	8.10
S&P/ASX Small Ords Accumulation Index	-3.73	7.54	-18.38	1.38	2.92	7.99
Net Value Added	**-1.94**	**-3.77**	**-4.59**	**-1.56**	**1.30**	**0.12**

^ 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

$150.3m

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

- **Better quarter for small caps but a difficult year**
- **Chinese consumer: coiled spring**
- **Energy prices – happy surprises?**

The S&P/ASX Small Ordinaries Accumulation Index finished 7.5% higher in the December quarter but a poor final month still saw the index down 18.4% for the year, a disappointing finish – especially given the ASX300 only fell 1.8%. As with large caps, resources outperformed industrials for the quarter and very significantly over the year.

Global equity markets had a good quarter with the S&P500 up 7.1% and the Dow up 15.4%. Large tech stocks were very weak resulting in the Nasdaq being one of the few world indices in the red, finishing with a fall of 1.0%. European markets were very strong, France and Germany up 12.3% and 14.9% respectively. Asian markets were better.

With the exception of oil prices which were flat over the quarter, commodity prices were better. Base metals (especially nickel) were stronger, iron ore was 19.9% higher, coal recovered late in the quarter, and gold rose 9.2%. Given its increasing importance to the domestic resources industry it is worth noting that while off their peak, lithium prices remain at very elevated levels – up 60% for the year.

China has been under various stages of lockdown due to Covid for almost three years and is only just emerging from the restrictions which has been a brake on *all* economic activity. China's households have not received the fiscal support over that period that was evident in most other advanced economies. However, there are some interesting figures that lead us to believe that the spending recovery in that economy will be very large.

In the decade before Covid-19, China's new household bank deposits rose from close to 4 trillion RMB to 8 trillion RMB, and new lending figures were similar. Through 2020 and 2021, new deposits rose to 8 trillion RMB and new lending close to 9 trillion RMB. Then came the rolling lockdowns of 2022. By year end, new deposits had reached over 16 trillion RMB and lending had fallen back to 4 trillion RMB (use 1USD:7RMB to convert if interested). If these figures normalise over the next couple of years, the stimulus will be dramatic. Of course, it won't be in a straight line, but it will surprise.

And speaking of surprises, the fall in energy prices has been greater than expected over the past quarter – especially oil and gas (coal remains stubbornly high). Given their considerable influence on inflation in late 2021 and most of 2022, this is an important move. Downstream products from polymers for packaging, fertilisers, organic chemicals, and building materials will all begin to see softer pricing, as will transport, shipping, airline travel (when capacity rises – Alan?) and even down eventually to food. Good news.

Now, that was predominantly macro – so for a detailed view on how we see **small caps** this coming year, we'd like you to follow the link to our **Australian Small Companies – Market Outlook 2023**.

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Performance Review

The Fund returned 3.76% in the December quarter, 3.77% below the benchmark return of 7.54%.

Key Contributors: Given the month to month (let alone week to week) volatility in markets and the AGM season, it wasn't surprising that there were some aggressive stock moves – in both directions.

Copper mining company, **Sandfire Resources (+47.4%)** benefitted from the 9.7% rise in copper prices over the quarter but of more importance was a modest capital raise that addresses the funding of its Motheo project development in Botswana and working capital to explore and expand its reserves at its Spanish MATSA project. These are both long life assets that will provide significant growth for the company over future years and replace the DeGrussa project that is effectively finished. The production infrastructure could be sold to another regional gold/copper operator. Another positive for the company has been the recent decline in European energy prices that has helped lower operating costs at both mine and production facilities at MATSA.

Continuing recovery in the travel sector has seen online travel services company, **Webjet (+29.8%)** re-rate over recent months. The company released a very strong half year profit report in November that showed bookings already approaching pre-pandemic levels in Australia and European earnings also close to pre-pandemic levels. Pleasingly, the company hasn't wasted a crisis, with operational improvements and efficiencies being demonstrated in the better margins delivered. The company also produced outstanding cash generation which was used to pay down term debt and return to normal covenant testing well ahead of schedule. Also re-rating over the quarter, was retirement village developer and operator, **Lifestyle Communities (+25.7%)**. Despite the weakness in the overall property market due to rising rates, at the November AGM, the company confirmed that unit sales remained strong, construction was still on track despite the wet weather and pricing also remained solid.

Graphite producer, **Syrah Resources (+25.6%)** had a good quarter despite losing some ground in December. The company announced an extension of its supply agreement of active anode material (AAM, high spec graphite for lithium batteries) to Tesla on completion of their US based Vidalia AAM facility. This will see Tesla account for 37% of the company's total output along with supply arrangements with both Ford and LG Chemical. Syrah also announced that it had been selected by the US Department of Energy for a grant of up to US$220m to fund the expansion of Vidalia.

Key Detractors: Invoice finance provider, **Earlypay (-54.5%)** hit a speed bump with the news that its largest client had gone into voluntary administration. While not unusual for this to occur with a customer and with conservative invoice lending policies, the company would recover its outstandings quickly and move on. However, in this case, there is trade finance and equipment finance involved – which do have security - but the work-out will take longer and has higher risk of a loss provision than its main invoice-based business. We expect some clarity over the next couple of months.

Women's garment retailer, **City Chic Collective (-63.7%)** had another poor quarter following a trading update in December. Online sales had been poor and elevated costs (mainly fulfilment) have persisted. Consequently, margins have continued to fall and the company expects to report a loss in the December half. This was certainly worse than we had expected and there will have to be a dramatic recovery in the June half for the company not to break banking covenants. With that risk, we exited the stock. While it has fallen further since, it has still been a damaging holding.

Compensation Lawyers, **Shine Justice (-20.8%)** fell following media reports that a number of the claimants in the $300m settlement of the 'Mesh' implant case against Johnson & Johnson were unhappy about the scale of the legal fees due to the company. We don't expect any change in the process; the case has been lengthy, complicated and repeatedly held up by J&J, so has ended up being exceptionally expensive. The fact that the final disbursement details are yet to be released has also added some uncertainty. We mentioned electronic products developer, **Codan (-27.7%)** in the previous report and we exited the stock during the quarter. The company continued to struggle to improve sales of metal detection devices in the African market while experiencing rising costs. Other areas are doing better, and the communications division is also growing strongly, but this financial year will be tough – and 2024 remains uncertain in those African markets.

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Portfolio Activity

Exits: As mentioned above, we exited **City Chic Collective (CCX)** following their December trading update and increased financial risk due to contracting margins. We also exited **Beach Energy (BPT**) during the quarter. The stock has been an excellent performer this year but a couple of negatives have emerged recently which increases risk to earnings over the next year or two. Firstly, the Federal Government imposed price cap on domestic East Coast gas which reduces the scope for higher priced contract renewals over the next year (or longer if the caps remain) and secondly, the delays and higher costs for its WA Waitsia LNG project. While not huge, both had the impact of lowering our valuation, so we exited the stock.

Rural supplies and agency company, **Elders (ELD)** was sold during the quarter. Long term CEO, Mark Allison announced that he would be leaving the company later this year. While we think that management renewal is a good thing, the company also lost CFO Tania Foster a couple of months earlier. Succession plans for either aren't clear. The company has also been the beneficiary of two outstanding agricultural seasons in a row, and while we are attracted to the organic growth occurring within the company, ag-chem prices, volumes and profit margins will be hard to replicate this year.

We also sold out of gold producer **Silver Lake Resources (SLR)**, mostly as funding for two better priced gold opportunities, namely Ramelius Resources (RMS) which was added back to the portfolio following a sharp sell-off in the share price, and Bellevue Gold (BGL) which is developing its large Bellevue underground project near Kalgoorlie. We participated in Bellevue's discounted placement over the quarter, which de-risks the project and accelerates development drilling. The company is now well funded and is due for first production in the second half of this calendar year.

We removed infant products retailer, **Baby Bunting (BBN)** and diversified electronics business **Codan (CDA)** during the quarter, both on profit downgrades that had ramifications on their rating and valuation. Baby Bunting has experienced a sharp drop in operating margin due to a combination of mis-managing a new customer incentive program and experiencing higher than expected transport and logistics costs. At a time when the domestic consumer has continued to spend, it was a disappointing outcome as this coming year may not provide the same revenue momentum. Codan has experienced higher costs and lower revenues from its Minetec metal detection business – largely due to difficulties in key African markets. These are likely to persist, taking the shine off the well performing communications business. In both cases, our valuation tumbled following these difficulties and we exited the stocks.

Additions: As mentioned, we added both **Ramelius Resources (RMS)** and **Bellevue Gold (BGL)** to the portfolio following the exit of Silver Lake Resources. More recently, we added trans-Tasman tourism operator, **Tourism Holdings (THL)**. The company is one of the largest global campervan and RV vehicle rental companies and has come out of the merger of Australia's Apollo Tourism and NZ listed company Tourism Holdings. The merger has created the number one player in the ANZ market with brands such as Maui, Britz, Apollo in rentals, Winnebago in RV's and Windsor and Coromal in caravans. It is now number two in North America and has a sizable operation in Europe. The synergies bringing the companies together are very substantial, they are very well managed businesses, international travel is picking up, it has exceptional earnings growth and the stock is virtually unknown despite having a market cap of over $700m.

Canadian based iron ore producer, **Champion Iron (CIA)** was added to the portfolio during the period. Quality iron ore producers are a rarity in small caps but CIA fits the bill with experienced management, a series of expansion opportunities, long life, strong balance sheet and sensitivity to the rising iron ore price. While the stock has already performed exceptionally well, we feel it still hasn't reflected the current commodity price. And lastly, we added health insurance company **NIB Holdings (NHF**) to the portfolio later in the quarter. The company will benefit from rising premiums and the normalisation of the healthcare industry after a number of years of dislocation. Higher interest rates also help its investment returns. The company is well managed by a team led by Mark Fitzgibbon who has been there since Judas played for the Galilee seconds, is prudently geared and is trading at a significant discount to valuation.

At the end of the quarter, we had 36 stocks in the portfolio and were holding 4.2% cash.

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Performance Attribution^		Key Portfolio Positions^
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
AUB Group	Baby Bunting	AUB Group
Lifestyle Communities	City Chic	Johns Lyng Group
Sandfire Resources	Codan	Kelsian Group
Syrah Resources	Earlypay	Readytech Holdings
Webjet	Shine Justice	Shine Justice

^ Alphabetical order. * Denotes stock not held. Attribution is for the 3 months ending 30th December 2022. Top 5 positions are effective 30th December 2022.

Stock in Focus: ReadyTech (RDY)

ReadyTech (RDY) is an Australian software as a service (SaaS) company that operates in the Education, Employment, and Government & Justice segments. In each segment, RDY's products are specific to enterprise customers (local government and councils within Government, TAFE customers within Education etc), and a long history of R&D investment has allowed the company to constantly win new customers and grow its revenue base. RDY currently has a stated organic revenue target of over $160m by FY26 (which would mean an organic CAGR in the high teens over that period). Complementing the company's organic growth is a strong acquisition program, where RDY has acquired companies to build out their product set further, acquired capability, and achieve wider reach. As with many SaaS companies, the business delivers superior financial outcomes including high returns, high margins, high recurring revenue, and low capital requirements. The business was founded in 1998, listed in 2019, and is founder-led.

Investment Case Key Questions

1. **Growth Opportunity:** in recent years, RDY's growth strategy has been twofold: 1. Organic growth which has been around the mid-teens level p.a. through a combination of further penetration of work within existing clients and new client wins; and 2. Acquisitive growth, several of which have been made since IPO which have been earnings accretive. The company has delivered EPS growth of ~18% p.a. in the three years to FY22; we expect a higher level of growth out to FY26 as revenue synergies from acquisitions contribute and operating leverage comes through.

2. **Management:** CEO and co-founder Marc Washbourne has led the business since 2006. Marc was one of the founders of the JobReady business and has over 25 years experience in technology and software solutions within the education and employment industries. CFO Nimesh Shah has been with the business since August 2017 and has held CFO and senior finance positions in companies including iSentia, Fairfax and Dell; he has strong capabilities covering acquisitions which has been a key feature of RDY's evolution.

3. **Financial Strength:** the company is very modestly geared following the most recent acquisition of IT Vision at 0.9x net debt/EBITDA. The company has typically paid for acquisitions through a combination of cash and scrip; the strong cashflow generation by the company has meant a quick paydown in debt which in turn has enabled further EPS accretive and strategic acquisitions. Gearing has remained around the ~1x net debt/EBITDA level over the last four years (since listing).

4. **Risks:** competition, typically against different competitors in each vertical for long-term recurring revenue contracts, can lead to aggressive pricing. Integration risk given acquisitions are a core part of the company's growth strategy.

5. **Valuation:** our Assessed Company Valuation (ACV) is currently $4.92/s, reflecting upside of 45%. While the stock should trade at a premium to the market given that RDY is a successful and growing SaaS company, the premium is minimal at the moment. Furthermore, the stock trades at less than half the 41x PE that its closest listed peer Technology One trades at. Interestingly, RDY received an unsolicited bid from Pacific Equity Partners (PEP) at $4.50/s, which was announced in November 2022, a 39% premium at the time. There are two significant RDY shareholders which ultimately made a binding transaction difficult with PEP walking away from the bid in December 2022; however, the development does highlight the undervalued nature of the stock.

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