Flinders Emerging Companies Fund

Quarterly Update: September 2024

FLINDERS Investment Partners

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 *	4.51	1.38	9.57	-4.28	3.56	6.79	7.90
S&P/ASX Small Ords Accum Index	5.06	6.53	18.79	-0.57	4.38	6.45	8.36
Net Value Added	**-0.55**	**-5.16**	**-9.22**	**-3.71**	**-0.82**	**0.33**	**-0.47**

^ 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

$105.1m

APIR Code

ETL0449AU

M-Funds Availability

Code FEC01

Responsible Entity

Warakirri Asset Management Ltd

Research Ratings

Lonsec: Recommended
Zenith: Recommended

Platform Availability

AMP North, BT Panorama, FirstWrap, HUB24, IOOF, Macquarie Wrap, Mason Stevens, MLC, Netwealth, Powerwrap, Praemium, uXchange, Xplore

Further Information

www.flindersinvest.com.au

- **Mr Whippy**
- **US Rates down and late Chinese stimulus = liquidity**
- **Time to look down the list – again…**

The S&P/ASX Small Ordinaries Accumulation Index finished 6.5% higher in the September quarter with industrials outperforming despite a late charge by resource stocks. Most of the gains came late in the quarter, hiding some significant volatility over the period. In both early August and September, the small cap market came close to 2024 lows before bouncing solidly. Firstly, following Japanese currency fears and secondly, when the recent Chinese stimulus measures were announced. Tucked in between was the 50bp rate cut by the US Fed. More on those points below. Better sectors included Consumer Discretionary, Financials, REITs and Tech, while Healthcare (particularly pharma/biotech), Energy and Staples all lagged.

Global markets were generally stronger over the quarter, although in the US there was late rotation out of large tech stocks in September following the Fed rate cut. This saw the broader market perform better. The S&P500 adding 5.5%, the Russell 2000 8.6% while the Nasdaq only 2.3% higher. European markets were little changed in the quarter while the late surge on Chinese stimulus saw that market up 12.4% and Hong Kong 19.3% higher, Japan fell 4.2%

Commodities were mixed. Oil particularly weak with WTI down 7.3% and Brent 9.0% lower, and gold continuing its amazing year with a 13.7% rise in the quarter – a tenfold rise in less than 23 years - a return of 10.9%pa. Iron ore looked like it was going to finish down 12% for the quarter but a last day surge saw it finish flat. Base metals were also flat but finished strongly.

The September quarter saw a bit of everything. A Japanese currency hissy-fit early, followed by weak economic data out of both the US and China which saw US 10 year bond yields fall to a 16 month low of 3.62% and equity markets weaken. Enter the Fed. The 50 bp cut in rates was at the top end of expectation "to align with inflation indicators and the labor market". Equity markets had been moving on the expectation, but bonds only reacted modestly on the news. Then hot on the heels of the Fed announcement was the Chinese stimulus package announcement which, while easy to be dismissive of, does have positive implications for both the property market and equity markets. Both moves combined is a significant boost to liquidity – something the market wasn't already short of.

So, at the risk of flogging a flagging horse, that should mean great news for the smaller end of the market. Since the US rate cut and China stimulus, the Small Ords has outperformed the ASX100 by 6%. That has been largely resource sector driven. We'd expect the small industrials to now perform strongly.

Performance Review

The Fund returned 1.38% in the September quarter, 5.16% below the benchmark return of 6.53%.

Key Contributors: Despite it being a difficult quarter for the portfolio, there were some bright lights and a number of our stocks that got hit during the August reporting season have started to recover and performed well in September. Multi affiliate funds management group, **Pinnacle Investment Management Group (+29.2%)** had another strong quarter. Affiliate fund growth was impressive in almost all asset classes and most importantly, the majority of the funds are outperforming their benchmarks. Performance fees were above expectations and with both equity and debt markets performing well, they are poised for a solid 2025.

Telco and utility service provider, **Service Stream (+20.7%)** continued to deliver to its growth expectations, posting a solid 2024 result with a solid forward workload into 2025. Improving margins in the power, water and gas businesses will be evident as older low margin contracts roll off and are replaced with more flexible terms. And with NBN spending at elevated levels plus mobile carriers 5G rollouts now accelerating, the telco division is set for another strong year. Copper producer, **Sandfire Resources (+24.2%)** was tracking better than many of its peers before the Chinese stimulus measures put a rocket under the resources sector. Good production figures from its Spanish MATSA operations and the growing Motheo project in Botswana helped confidence but the sharp rise in the copper price in the back half of September put the icing on the cake.

Mining and infrastructure contractor, **NRW Holdings (+18.8%)** performed strongly over the quarter. The company continues to win new work and margins are improving. With a $5.5bn order book and a similar amount out in active tenders, 2025 looks like another strong year. The company has close to $250m in cash, ample to fund its growth ambitions. Recent acquisitions have been accretive and will provide growth options with new customers over future years. The experienced management team is executing well.

Key Detractors: As mentioned in the August monthly, reporting season led to some bruising with a few of our stocks being hit hard after not meeting expected profitability or pointing to a soft beginning to the 2025 financial year. Neurological drug developer, **Neuren Pharmaceuticals (-28.8%)** suffered in July after the US distributor of its DAYBUE drug for Retts disease released a lower expected sales figure for the first quarter. While the company expects sales to recover in Q2 (and has consistently re-iterated guidance), the stock continued to sell off through August and September.

Also in the August report, we discussed two portfolio companies that had downgraded their FY 2025 earnings outlook: multi modal transport company, **Kelsian (-18.0%)** and building restoration and services provider, **Johns Lyng Group (-33.7%)**. Both these companies are successfully growing their businesses, improving earnings and are led by experienced and proven management teams. While we were disappointed by the August outlook statements, we view the market reaction to both stocks as well overdone. In both cases, we purchased more stock. Pleasingly, they are up 14% and 12% respectively since their lows.

Gold producer, **Bellevue Gold (-26.1%)**, unexpectedly raised capital in July – always a recipe for some investor angst. The raising was for the right reasons, namely drilling for resource expansion, cutting its debt position and freeing up working capital for longer term production expansion. However, the pace of expansion toward 250,000 ounces pa in 2028 was a little underwhelming. We feel the company has been given little credit in bringing on a quality gold project on time and budget and is now in a position to generate significant cashflow – especially with a cost base below many of its peers.

Retirement village operator, **Lifestyle Communities (-31.8%)**, was sold off heavily in July following a 7:30 Report episode questioning their (and the industry's) business model regarding certain charges and fees. The negative coverage was a contributing factor to the company withdrawing their home settlement guidance. We remain comfortable that LIC have one of the more palatable fee structures in the industry, combined with a very attractive product for their customers. Negative sentiment towards the residential property market is likely to turn with interest rates expected to fall in 2025.

Portfolio Activity

Exits: We sold out of copper producer **Metals Acquisition (MAC)** in July. As a single asset producer with limited stock liquidity it had been outperforming its copper producing peer, Sandfire Resources (SFR). While we also held Sandfire, we thought it a better quality and more liquid opportunity and increased our position at the expense of MAC.

Also leaving the portfolio in the quarter was **Pinnacle Investment Management (PNI)** the stock has been a remarkable performer this year and had been one of our strongest contributors. The company is well managed, has good growth opportunities but toward the end of the quarter, it surpassed our valuation and we exited the stock.

A smaller holding in the portfolio we exited was uranium miner **Peninsula Energy (PEN)**. A good quality resource in Wyoming, the company is the process of restarting the project that ran from 2015 until idled in 2019 due to low uranium prices. The company looking to be back in production late this year. Our larger uranium holding, Paladin Resources (PDN) had been discounted sharply during the quarter, to the extent that we saw far greater upside to that stock and switched out of Peninsula. And lastly, we completed selling a small balance in medical consumables group **Trajan (TRJ)**.

Additions: During the quarter we added stocks from a diverse range of industries to the portfolio. Radiology and imaging group, **Capitol Health (CAJ)** was added following the announcement of the proposed merger with Integral Health (IDX). The industry was knocked around during the pandemic as surgery levels and GP visits dropped sharply. It has been slow to recover and revenues and margins are still below pre-Covid levels – but have recently been recovering. The merger makes sense with complimentary geographic strengths and significant cost synergies available.

During the quarter we participated in the IPO of offshore marine services business, **Bhagwan Marine (BWN)**. The company operates almost 100 vessels that service the offshore oil and gas industry, marine infrastructure service and construction, and is based in Western Australia. It is a founder led organisation with experienced management and long-standing large customers. The industry is in good shape and due to reduced supply of vessels over the past decade, there are fewer participants. It will be some years before supply could impact the market in WA. Solid spending growth from the LNG industry, Defence Department and Government infrastructure is also expected over the next 5 years.

Vysarn Limited (VYS) is a small but rapidly growing water services business. Its main customer base is the mining industry, iron ore in particular. The company offers test pumping, reinjection services and hydrogeological drilling. It also has a water management consulting arm. In September the company announced the acquisition of both Waste Water Services and CMP Consulting which gives them growth options in adjacent services including water authorities on both the West and East Coasts. A placement to fund the purchases gave us an entry to the company at an attractive price.

We added intellectual property (IP) attorneys, **IPH Limited (IPH)** at the result in August. We participated in a discounted equity raise to fund the acquisition of Canadian IP firm Bereskin & Parr which was slightly EPS accretive. This was coupled with a better than expected result (as the previous negative momentum in Australian filing volumes turned), and a cheap valuation multiple not seen since 2018. Modest earnings growth from here should drive a re-rating over time.

At the end of the quarter, we held 45 stocks in the portfolio and were holding 2.8% cash.

Performance Attribution^		**Key Portfolio Positions^**
Top 5 Contributors	Top 5 Detractors	Top 5 Active Holdings
Alumina *	Bellevue Gold	AUB Group
Megaport *	Johns Lyng Group	Credit Corp Group
Pinnacle Investment Mgt Group	Kelsian Group	MAAS Group
Sandfire Resources	Lifestyle Communities	NRW Holdings
Service Stream	Neuren Pharmaceuticals	Service Stream

^ Alphabetical order. * Denotes stock not held during this period. Attribution is for the 3 months ending 30th September 2024. Top 5 positions are effective 30th September 2024.

Stock in Focus: Credit Corp Group (CCP)

Credit Corp Group (CCP) is a financial services company that's largest division collects from purchased debt ledgers (PDLs – non-performing loans from banks, other lenders and utilities) in Australia, NZ and the US, and a smaller Australian unsecured lending division. The debt collection business has been in operation since 1985 and has grown to be the largest in Australia. It has a history of good regulatory compliance and counts the largest Australian financial institutions as their counterparties.

The US business has been in operation for almost a decade and has now reached critical mass. Despite teething issues during the pandemic including staffing, low PDL activity and more recently, higher delinquencies, the business now looks in good shape and is in a strong position to grow over the next few years. The lending business focusses on unsecured, personal loans usually of 1 to 3 year duration. It is a higher margin and return business where the company can manage growth depending on the prevailing customer and economic conditions.

Investment Case Key Questions

1. **Growth Opportunity:** There are two key drivers to the company's growth profile over the next few years. Firstly, the US PDL acquisition and collection business. Over the past two years, the level of US credit card outstandings has grown significantly. While employment remains at healthy levels, personal debt is high, and banks (and other card issuers) have a larger pool of non-performing loans. At the same time, the industry has consolidated and there are fewer purchasers of these portfolios. This has led to improving returns – most notably as CCP has reduced collection costs over the past six months. This industry dynamic will last for some time, and we are of the view that CCP can leverage their current position to be a much larger player in the large US market.

   Secondly, the Australian business has been underperforming for a number of years. This reflects the underlying health of the consumer, full employment and cautious spending following the pandemic and early rate rises. This meant lower credit card balances, lower non-performing loans and consequently, a large decline in banks and other lenders selling debt legers. That dynamic is changing. While it will take some years to revert to pre-pandemic levels, it will normalise off a low base. Plus, in the past four years, the industry has consolidated and pricing has improved. We are expecting modest growth from the company's lending business – it is already doing exceptionally well.

2. **Management:** CEO Thomas Beregi and CFO Michael Eadie have been leading the executive team for close to ten years and have grown the company well, often through difficult industry conditions. They have steered the company through a period of market consolidation in Australia, taking advantage of competitors missteps and financial issues. Growing a business in the US is never straight forward but they now have scale, financial strength and the infrastructure to take the business to a new level. Both management and board are risk-averse and very focussed on return on capital.

3. **Financial Strength:** The company has a strong balance sheet, with $150m of cash and undrawn facilities available giving them good headroom to grow their book both in Australia and in the US. There is also the opportunity for acquisitions if presented at the right price.

4. **Risks:** Buying debt ledgers is based on the assessment that you will be able to collect more than you've paid for the debt – and the cost of financing the purchase. Lending is based on the assessment that the customer can pay back the loan and service the interest. Both rely on sound credit risk assessment. Good systems, people, data and compliance are vital. CCP have been operating in the industry for almost 40 years and while some have been difficult, they have managed internal and external risks particularly well. Many of their competitors have fallen away. Some of the external risks include a sudden surge in unemployment, sharp increases in interest rates or irrational competition – none of which seem to be likely in the next year or so.

5. **Valuation:** On a price to earnings basis, CCP is trading at close to a 10-year low, with two of its major divisions poised for good growth. Our assessed Company Valuation (ACV) is currently $23.77/s, reflecting upside of 53%.