Emerging Companies Fund

Monthly Update: August 2022

Dear Fellow Investors,

Our Emerging Companies Fund was down -0.3% in August vs +1.7% for the Emerging Companies Accumulation Index (XECAI) and -1.0% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +14.7% p.a. and a total return of +114.2% vs +81.2% for the XECAI and +34.7% for the XSIAI.

Following Jerome Powell's speech at Jackson Hole on Friday 26 August, in which he simply reiterated the same message of using higher interest rates to curtail inflation, the caution in markets returned with a vengeance. As usual, the smaller and less liquid stocks were again hit the hardest, reversing what was shaping up to be another strong positive month for the Fund. Incredibly, we now have several stocks in the portfolio back at, or near, 12-month lows despite since delivering results and commentary that imply the business performance and outlook remains solid. Unfortunately, the market's obsession with the monthly rhetoric from central banks and any perceived change in tone appears to have reached fever pitch, creating embarrassing levels of short-term share price volatility.

One such example is Marley Spoon (MMM, -26%) which rose over 60% following its strong 2Q Update, but has subsequently fallen back to below where it was even prior to the quarterly. Fear of being on the wrong side of short-term market direction due to ongoing central bank action is again usurping revenue and earnings momentum indicators at the individual stock level. As such, it appears that until we reach a point where central banks explicitly indicate a pause in tightening (which may not be that far away, depending on how the economic data evolves), this volatility probably remains. We had hoped that the various declining forward-looking demand and inflation indicators would enable markets to pre-empt central banks with more confidence and ignore potential 'jaw boning' or backward-looking data, but this most recent market pullback suggests otherwise.

Interestingly, of note in recent weeks has been the increasing amount of M&A emerging in the small cap landscape, reinforcing our view that listed markets are incorrectly pricing many small cap growth stocks. As a consequence, it appears that both private equity and well-capitalised corporate suitors are now seeking to take advantage of these conditions, with some healthy premiums to current prices being offered. While it always has the potential to directly impact our portfolio, as it has in the past with companies such as National Veterinary Care and Think Childcare being acquired, it should at least provide some level of share price support for stocks in industries that are being targeted.

Performance summary

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	3M	12M
2017		-3.2%	+2.6%	-0.6%	-1.0%	+7.6%	+6.4%	+2.7%	+4.0%	+13.2%	+9.5%	+8.1%	+60.1%		
2018	-1.6%	+4.2%	+1.6%	+1.1%	+4.1%	+1.6%	-3.1%	+0.7%	-0.8%	-3.2%	-4.8%	-5.2%	-5.9%		
2019	+6.0%	+4.8%	+3.1%	+4.7%	+10.8%	+0.6%	+17.6%	+1.4%	+6.1%	+4.6%	-0.8%	-1.3%	+73.2%		
2020	-0.6%	-11.7%	-28.4%	+23.3%	+18.4%	+14.1%	+16.0%	+20.7%	+3.1%	+1.0%	+2.3%	+4.0%	+62.3%		
2021	+1.9%	+2.1%	-0.1%	+5.0%	-4.4%	+5.5%	-8.0%	+4.3%	-5.5%	+1.0%	-4.5%	-9.6%	-13.0%		
2022	-7.9%	-9.6%	-3.0%	-5.8%	-17.6%	-15.5%	+10.1%	-0.3%					-41.9%	-7.2%	-52.1%

Returns are net of all base fees, performance fees and expenses of the Fund

Performance commentary

The key positive contributors during August were Murray Cod Australia (MCA, +18%), Imricor (IMR, +16%) and Shine Justice (SHJ, +12%). The key negative contributors were Marley Spoon (MMM, -26%), IDT Australia (IDT, -13%) and Redbubble (RBL, -21%) which we have now exited.

Shine Justice (SHJ, +12%) reported another strong result, with FY22 revenue up +15% on pcp and Underlying EBITDA up +16%. While cash flow (excluding the Mesh case proceeds) was slightly down on pcp, this had been foreshadowed due to some investment in growth initiatives. SHJ still increased its final dividend by 8%, demonstrating its confidence in its cash flow position and outlook. The Company also provided FY23 guidance for EBITDA growth in the low double-digits underpinned by a solid pipeline of existing business. In addition, SHJ's balance sheet strength has it well positioned to execute on some targeted M&A deals in FY23, which management seemed confident of delivering.

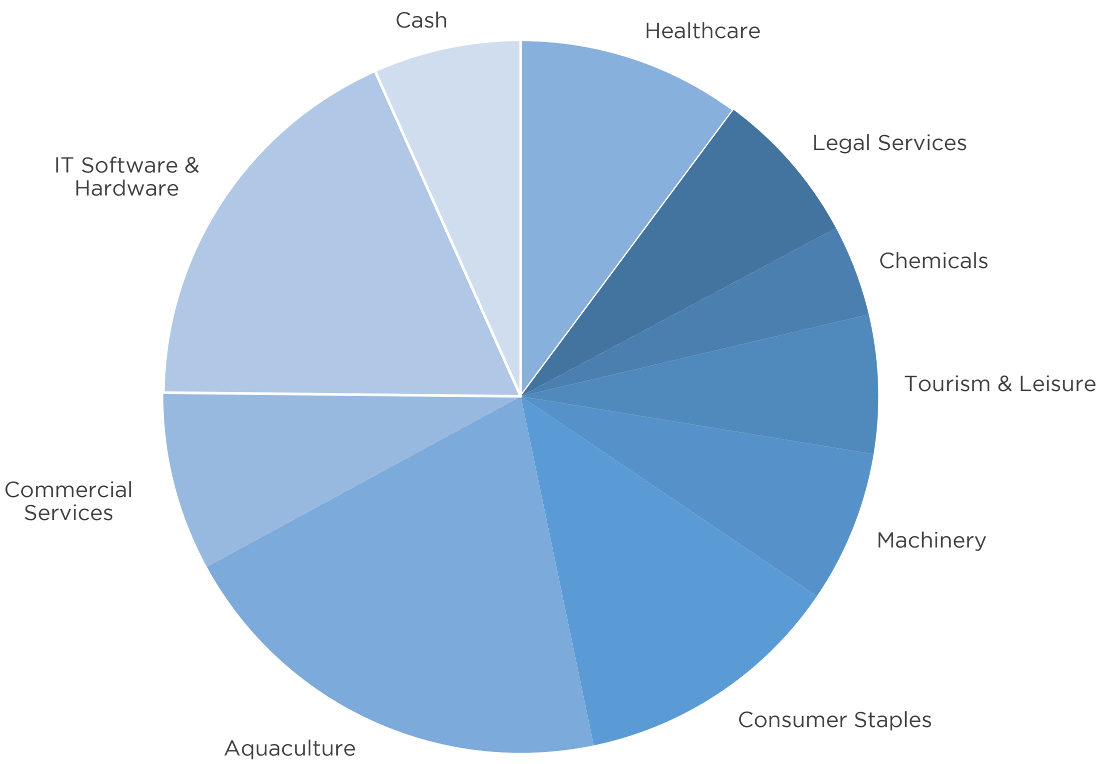
Tourism Holdings (THL, +11%) delivered another admirable result given the impact of lockdowns across Australia and New Zealand during FY22, with its net loss of NZ$5.4m an improvement of NZ$8.9m vs the pcp. It even delivered a positive result at the EBIT line, being NZ$6.9m vs an EBIT loss of NZ$8.3m in FY21, largely underpinned by another year of strong vehicle sales and margins. As you'd expect, the Australian rentals business had a very strong second half of FY22 and is now set up to deliver a record EBIT result in FY23. Meanwhile, after a drawn-out process of re-opening its borders, New Zealand is finally starting to show significant improvement as it returns to profitability in FY23. As such, THL is expecting to grow its fleet size by 20% in FY23, supported by a healthy balance sheet that has NZ$200m of headroom in its debt facilities. With regard to the proposed merger with Apollo Tourism, THL is continuing to work with the ACCC and NZCC, with a decision expected in September. If it is approved, and we see no rational reason for it not to be, then we would expect it to be finalised by the end of 2022. Regardless, we continue to rate THL as one of the best managed businesses in our portfolio and look forward to seeing it return to sustainable profit in FY23 (as per Company guidance) and beyond.

FBR Limited (FBR, +5%) didn't report any earnings results of significance (revenue <$1m) given it is still principally in the development and commercialisation phase of its robotic bricklaying machine (Hadrian X). But what was of significance was that Brickworks (BKW) increased its holding to 11.94% after purchasing an additional ~5% stake at ~$0.048 (a 23% premium to the prevailing market price) via a crossing with an existing institutional holder. While we obviously can't speculate on what BKW's intentions are with regard to how much of FBR it wants to own, it is clearly very positive that it has remained an ongoing buyer since investing $1.9m via a strategic placement at $0.018/share in July. Given that FBR expects to achieve construction completion and commissioning of the next generation Hadrian X (targeting a lay rate of >500 blocks per hour) within the next six months or so, completed in collaboration with Liebherr-Mischtechnik, it certainly wouldn't surprise us if its appeal to potential corporate suitors continues to increase from here.

We decided to exit RBL after its FY23 opex guidance far exceeded our (and the market's) expectations. We invested back into RBL earlier this year on a view that the market was pricing in extreme pessimism on revenue, margins and customer acquisition costs in FY22 and beyond. Furthermore, we thought that its forecast opex investment would be largely contained to FY22 and that we would see the benefits of this flow through in higher (quality) revenue growth from FY23 onwards. Ironically, RBL's 2H FY22 results were as we had hoped (i.e. there was no further deterioration in revenue growth, margins or customer acquisition costs), which in isolation should have driven a significant share price re-rating, but the unwelcome shock came in the FY23 guidance which forecast another significant step up in employee costs. The timing and quantum of these "investments" was well beyond expectations and comes at a time when the demand environment remains fragile, which has the potential to put the business under pressure should the return on this investment not transpire. It also further pushes out the path to profitability during an environment where the market wants to see some evidence of operating leverage.

Portfolio characteristics

We currently have ~93% of our capital invested in 15 stocks.



Please get in touch should you have any queries regarding the above. Thanks again for your interest and support and I look forward to providing another update in early October on our performance during September.

Kind regards,

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Important Information