Emerging Companies Fund

Monthly Update: November 2022

Dear Fellow Investors,

Our Emerging Companies Fund was down –3.8% in November vs +3.3% for the Emerging Companies Accumulation Index (XECAI) and +2.7% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +12.5% p.a. and a total return of +97.6% vs +73.7% for the XECAI and +33.0% for the XSIAI.

As we foreshadowed in our last update, in the absence of stock-specific news flow that generates strong buying interest, micro-cap industrials (particularly those with minimal liquidity and institutional ownership) continued to encounter selling pressure. Given that the primary cause of the rout that started in this sector ~12 months ago (i.e. a sustained sharp rise in bond yields) has now demonstrably abated (10yr bond yields are down at ~3.4%, from a peak reached in October of ~4.2%), it is hard to rationalise ongoing share price declines from already depressed levels. It appears to be retail capitulation, the evidence for which lies in the impatient manner by which many stocks are being traded, with sellers consistently crossing large bid/offer spreads, chasing whatever liquidity is available with scant regard for any news flow or valuation support. Furthermore, the general uniformity and consistency of the weekly share price declines across such a wide range of stocks/sectors suggest sentiment is completely overriding stock valuations.

One example of illogical investor behaviour we are seeing is in FBR, where Brickworks (BKW) has now amassed a 19.9% stake, having paid as much as $0.055/share. In fact, we sold over 50m shares (half our stake) to them at that price in October. Not only does this establish a potential floor to any price that may be offered in a takeover, BKW's interest should provide significant validation of FBR's commercial prospects to other shareholders. Yet since BKW announced that it had reached this threshold, FBR's price has declined ~30% to $0.039/share, highlighting just how myopic and liquidity-driven the micro-cap industrials market has become. Another example is Hydration Pharmaceuticals (HPC), which also declined almost 30% during November (on just 1% turnover) despite recently announcing a $12m funding facility, a record October sales result (+80% on pcp) and the launch of its co-branded product with ambassador Shay Mitchell. Once again, negative share price momentum (on minimal volume), not positive operational momentum, seems to be the overwhelming driver of short-term performance in the current market.

Unfortunately, as long-term investors, there is little we can do to mitigate against such unpredictable behaviour. We do have to accept that part of the objective of rapidly raising interest rates is to encourage or force speculators to liquidate, sending asset prices lower, translating to a negative wealth effect that stymies consumption, ultimately flowing through to lower inflation. All we can focus on is the operational performance of the businesses we own and take solace from history showing that these periods do pass.

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%	-6.1%	+2.0%	-3.8%		-46.4%	-7.8%	-51.5%

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

Performance commentary

The key positive contributors during November were Imricor (IMR, +34%), Pentanet (5GG, +8%) and Ansarada (AND, +3%). The key negative contributors were Hydration Pharmaceuticals (HPC, -27%), Marley Spoon (MMM, -25%) and FBR Limited (FBR, -24%).

MMM raised A$16.3m via an institutional entitlement offer at $0.165, which was supported by key existing shareholders and the CEO (who invested another ~$750k). The proceeds will be used to provide a working capital buffer over the next 12 months as MMM transitions to being sustainably EBITDA positive. To that end, the Company reiterated its guidance of €2m to €4m EBITDA in 4Q CY22 and issued guidance for positive EBITDA in CY23, albeit skewed to 2H following traditional marketing investment in 1Q. While MMM still had €21.6m in cash available prior to this capital raise, the Company decided that the margin of safety was insufficient relative to the risk of anything unforeseen that might force it to raise capital under circumstances where it couldn't set the terms of the deal. It goes without saying that after being a strong contributor to performance, MMM has turned into an incredibly disappointing investment for the Fund. However, if we take a step back and ignore the share price movements, it is important to highlight that when we first invested in MMM it was in the process of transitioning to positive EBITDA (a key attraction) underpinned by strong revenue growth and expanding margins. While the pandemic provided some tailwinds (subscriber growth) and headwinds (margin pressure), the fundamental investment thesis is unchanged, except that the revenue base is now much larger than when we first invested and the customer proposition is stronger (expanded menu, premiumisation, gourmet grocery selection, ready to heat meals). On that basis, we remain as shareholders and look forward to having our faith rewarded as it delivers positive EBITDA and gradually improves its cash flow and balance sheet.

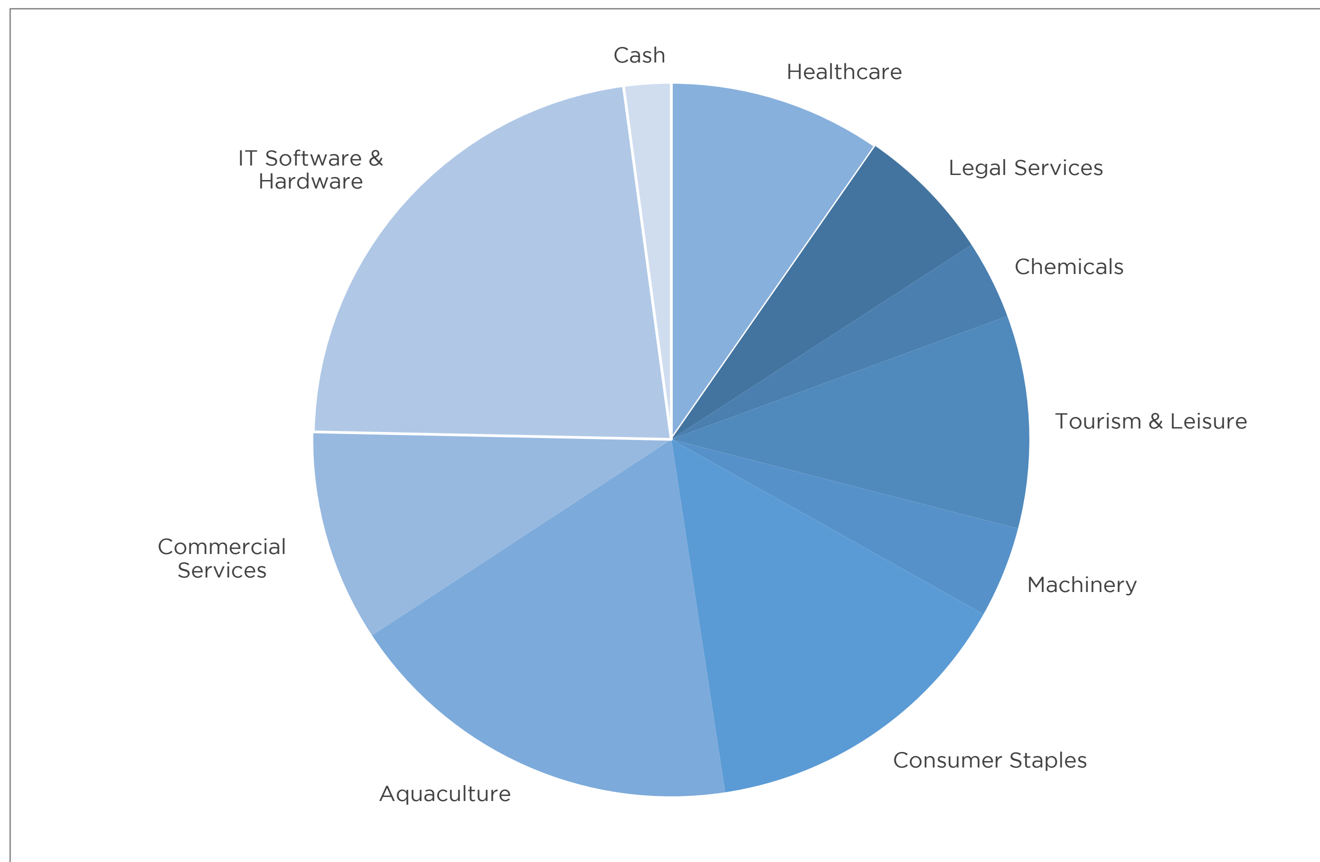
Company in focus: Dropsuite Limited (DSE)

DSE operates a cloud-based software platform that specialises in providing services that enable businesses using Microsoft 365 and/or Google Workspace to securely backup, archive, recover and protect their data. The efficiency benefits of utilising cloud-based applications such as Microsoft 365 are driving rapid adoption across the global business landscape, however the downside of migration to the cloud has been the greater potential for corporate data security breaches. As such, increasing corporate governance, compliance and insurance requirements are now dictating that cloud-based data is backed up by a reputable third-party such as DSE. One of the key positive attributes of DSE is its partner-led business model, which enables better/faster scaling across sales, support and marketing, as well as minimal marginal costs to service a growing revenue and user base. DSE currently has 473 IT reseller partners across more than 100 countries, in addition to thousands of Managed Service Providers (MSPs) that support almost 900k users of its software. This has enabled the business to rapidly grow in a cost-efficient manner with minimal capital intensity and attractive gross margins (66%), underpinning sustainable positive EBITDA and cash flow with an Annual Recurring Revenue (ARR) base of $23.3m (up 66% on pcp). DSE also has a strong balance sheet (net cash of $22.3m) that is expected to be used on accretive acquisitions to complement its existing product suite.

With the global data backup and recovery addressable market sitting at $22.2bn, growing at a CAGR of 24%, and >350m existing users of Microsoft 365 and Google Workspace (of which DSE has 0.3% share), we think the Company has significant runway for ongoing strong growth. DSE's competitive advantages are its ability to seamlessly integrate with the leading PSA (professional services automation) platforms used by MSPs to run their operations, as well as provide backup services to any user platform, geography, market segment and industry vertical (including approval for use within the US Government). This positions DSE as a one-stop shop for MSPs, enabling it to price its product at a 25-30% premium to most competitors, with strong customer satisfaction levels evidenced by its <3% revenue churn. We acquired our stake in DSE at an average price of ~$0.20/share and expect that given its long-term structural growth potential, its ARR multiple of ~5x can easily be maintained, driving share price performance consistent with its ARR growth.

Portfolio characteristics

We currently have ~97% of our capital invested in 16 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 January on our performance during December.

Kind regards,

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