Emerging Companies Fund

Monthly Update: February 2023

Dear Fellow Investors,

Our Emerging Companies Fund was down -8.1% in February vs -4.2% for the Emerging Companies Accumulation Index (XECAI) and -1.7% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +9.0% p.a. and a total return of +69.1% vs +72.0% for the XECAI and +34.1% for the XSIAI.

The recurring theme of the past 15 months returned in late February, with rhetoric from central banks yet again driving forecast rates (and bond yields) back up towards their recent peaks. This set off another wave of selling pressure, with the micro-cap, growth and long-duration stocks most impacted (again). Despite many of these stocks having not participated in any meaningful rally when yields were retreating, they were still hit hard, most acutely among the smallest/least liquid positions in the portfolio. In fact, our bottom five stocks (generally our smallest by market cap) declined by another 25% (on average), yet several delivered material positive news flow. Most of the declines were captured in the final week of trading, where the Fund moved from having been broadly flat again for the month to sharply down on another bout of indiscriminate selling. It is quite remarkable that so many stocks are reaching new lows on macro inputs that are no different to where they were nine months ago. The only difference is that the economic and inflation data is now generally signalling that a peak in rates is likely imminent. Regardless, central bank rhetoric continues to overwhelm stock-specific news flow, earnings momentum and valuation in the micro and small cap sectors. As an example, following its strong 4Q result and the emergence of 468 Capital (German VC Fund) on its register with a ~20% stake, Marley Spoon (MMM, +10%) had surged from $0.155 to $0.245 (+58%) before the macro narrative took over yet again, giving back most of its gains. While it has become a dysfunctional market for so many stocks, this is providing some outstanding long term investment opportunities for investors in the sector with excess capital to deploy.

Looking forward, we remain very positive about the potential returns for the Fund when the sentiment in markets inevitably shifts back to equilibrium. Pleasingly, we are now seeing media commentary from other investors highlighting the valuation divergence between large caps and micro/small caps, citing this as unsustainable and an obvious opportunity to generate strong returns, as and when markets normalise. While events specific to stocks in our portfolio is the ultimate driver of returns over time (and can also provide a short term positive on significant news flow), the performance of the broader portfolio will remain heavily influenced by the flow of funds in the space reversing its current course. As such, increasingly positive commentary about the sector is a likely precursor to that process, leading to a more balanced market that will reward us for staying true to our process in the face of significant and persistent price declines.

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%	-6.7%	-49.9%		
2023	-0.2%	-8.1%											-8.3%	-14.4%	-44.9%

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

Performance commentary

The key positive contributors during February were Imricor (IMR, +26%), Marley Spoon (MMM, +7%) and Dropsuite (DSE, +7%). The key negative contributors were Ansarada (AND, -18%), Terragen (TGH, -42%) and Hydration Pharmaceuticals (HPC, -36%).

The key highlight from Murray Cod Australia's (MCA, flat) 1H FY23 results was a +50% increase in its biological assets since 30 June 2022, including a +250% increase in spawning over the prior season. This is what will underpin a huge increase in saleable fish over the next few years, rapidly taking the current run rate of >500 to ~5,000 tonnes pa, before eventually reaching its target of 10,000 tonnes pa by 2030. This is being facilitated through a new greenfield hatchery, which will take capacity from 5,000 to 10,000 tonnes pa, and the ongoing addition of new ponds, noting that MCA plans to increase its existing footprint from 50 ponds to 100 ponds by the end of this year. All of this will require capex of $8.5m, which is fully funded via its cash reserves of $17m. Finally, given that demand continues to substantially exceed supply, MCA plans further price rises during 2023, having already increased prices by 20% (from $20/kg to $24/kg) in 2022.

While SHJ's revenue grew by 9% on pcp in 1H FY23, EBITDA declined by -2%, NPAT declined by -18% and cash flow went from +$6.7m in the pcp to -$8.9m – a disappointing outcome. Cash flow was affected by expenditure in growth activities, including class action investigations, additional team members and file numbers, compared with slower than anticipated case resolutions, as well as expenditure in marketing and recruitment. SHJ is still guiding to low double-digit EBITDA growth in FY23 and a return to positive operating cash flow, suggesting that none of these issues are structural. But unfortunately, in this market it is to be expected that any short term disappointments will be severely punished, as was the case with SHJ's latest results, despite the fact it had delivered consistent positive results for several years prior and should going forward.

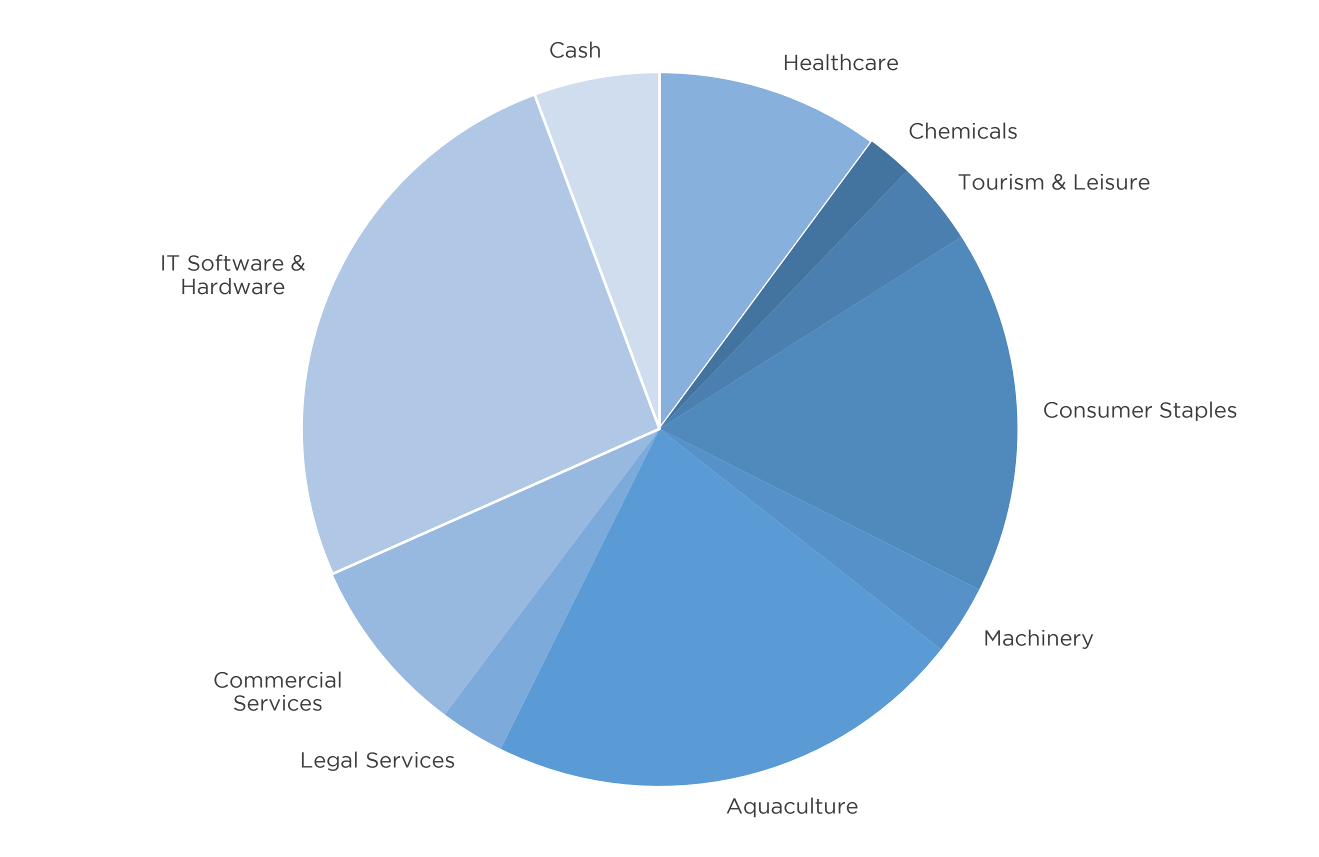
HPC reported record sales in January (up +70% on pcp), despite this being a seasonal low (winter) period for the Company. This was driven by increased sales volumes to Canadian retailers, marketing initiatives undertaken with Shay Mitchell and a more pronounced cold and flu season. Pleasingly, this was achieved during a period where decreased marketing spend was being implemented, highlighting its organic growth potential even with a stricter cash management focus. Despite this positive update, the share price was hammered lower (-36%) throughout the month, providing yet another example of how dysfunctional the market for so many microcap industrials has become (for now).

FBR Limited (FBR, -24%) also declined significantly throughout the month despite announcing that the Company's next-generation Hadrian X® robot has laid its first blocks, autonomously passing blocks through the entire robotic system before laying them. Having spoken with the Company, they consider this to be a significant milestone during the commissioning phase. The program will now move to a testing and calibration phase in which the team will optimise the system, increasing the laying speed of the Hadrian X® before commencing field testing in the next quarter. Once commissioning is complete, the Company will then proceed to commercial deals being signed with various partners. As further evidence of their confidence in this machine delivering on its targets, a second next-generation Hadrian X® is already in the manufacturing phase.

Fleetwood (FWD, -11%) reported a 1H result (EBITDA of $8.7m, +28% on pcp) that was broadly in line with our expectations. With $40m of net cash, a Building Solutions division now back to almost breakeven (and positive EBITDA expected going forward), RV Solutions continuing to deliver solid results and Community Solutions on the verge of a likely surge in demand at its Searipple Village as new long term projects in Karratha come online, we think the stock remains very well positioned to enjoy a step change in its earnings over the next 12 to 24 months. Despite this, FWD is trading on <2x FY24 EV/EBITDA and ~5x FY24 NPAT, with a 100% payout ratio as dividends resume this year.

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 April on our performance during March.

Kind regards,

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