Emerging Companies Fund

Monthly Update: May 2023

Dear Fellow Investors,

Our Emerging Companies Fund was down –5.4% in May vs -6.3% for the Emerging Companies Accumulation Index (XECAI) and -1.7% for the Small Industrials Accumulation Index (XSIAI). Since inception, the Fund has generated +7.7% p.a. and a total return of +59.8% vs +63.1% for the XECAI and +32.6% for the XSIAI.

Unfortunately, the bounce in April proved to be temporary as the mass liquidation of micro-cap industrials entered another phase, driven by a combination of an unexpected rate rise from the RBA and the commencement of tax-loss selling. Despite it being a month that contained no negative stock-specific news flow, 12 of the 16 stocks in our portfolio took another dive lower, highlighting the largely indiscriminate nature of the selling pressure. At least the tax-loss selling process concludes at the end of June and we would expect to see a bounce in July (as we did last year), but it's perplexing to watch share prices decline sharply again after such a massive de-rating has already occurred. It is clearly irrational, especially in the context of the underlying company fundamentals, but this is a market that continues to reward the myopic seller and punish the patient buyer, perpetuating a vicious cycle of liquidation that desperately needs to find a circuit breaker. Perversely, but perhaps encouragingly, as some investors continue to aggressively sell many growth/duration stocks on the ASX (particularly micro and small caps) we are seeing the opposite occur in US markets, where the NASDAQ continues to push higher and even the Russell 2000 (the US small cap index) is now finding some solid support.

As an example of how the ongoing selling is creating inexplicable outcomes, Marley Spoon (MMM, -22%) is now trading at a 40% discount to its takeover bid price of $0.21 and a 26% discount to the $0.17 at which it just raised A$52m. Furthermore, as additional evidence of how detached from reality prevailing share prices have now become in micro-caps, we have recently seen two separate takeover offers made for stocks (Limeade and Tesserent) at enormous premiums to last price (325% and 165% respectively). Yet both stocks share similarities with many in our portfolio in terms of size, liquidity, growth and cash flow profile, as well as the fact that their share prices have been in a consistent downtrend for the past two years. Where our cash and weighting thresholds permit, we continue to selectively buy into the weakness, but we are also trying to add new stocks into the portfolio to replace those that are less likely to rise sharply when market conditions improve. To that end, we exited Tourism Holdings (THL, -9%) during April (our timing was fortunate as it gave a softer than expected trading update in early May) and have replaced it with a stock that, in our view, has far greater share price upside from current levels, which we will discuss in detail once the Fund has reached its desired position size.

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%	-6.1%	+6.1%	-5.4%								-13.6%	-5.8%	-31.0%

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

Performance commentary

The key positive contributors during May were Dropsuite (DSE, +17%), Fleetwood (FWD, +19%) and IDT Australia (IDT, +8%). The key negative contributors were Mighty Craft (MCL, -40%), Marley Spoon (MMM, -22%) and Bluechiip (BCT, -17%).

Early in the month, BCT raised ~$3m at $0.025/share via a placement and SPP, with the proceeds intended to be used for continued production scaling and expansion of its sales and marketing team in North America. BCT has grown its lab customers by 93% in the past 12 months, which has placed a strain on its resources as the implementation task has diverted attention away from sales and marketing efforts, at a time when the number of sales leads in the pipeline is accelerating. As such, the funds raised are partly being used to grow the US sales and implementation team from 4 to 10, so that the Company can better capitalise on the opportunities in front of it. In the meantime, we understand that negotiations with FujiFilm Irvine Scientific continue to progress with a deal still imminent.

In response to shareholder feedback and in conjunction with its Board renewal process, MCL announced that it is undertaking a formal strategic review of the business. This includes reducing its debt load, assessing possible larger divestments to return capital to the business and realise value for shareholders, and assessing the right structure for the business going forward, including its corporate overhead. The Company intends to release the findings of its review in or around the end of this financial year. While we estimate that a conservative break-up value of MCL is likely more than double its current enterprise value (as implied by its prevailing share price), perversely the market response to this announcement has been to send its share price a further 40% lower!

FBR (-19%) announced that its first next-generation Hadrian X® robot has achieved a new sustained lay speed record of over 300 blocks per hour, far surpassing the highest ever recorded peak lay speed of its predecessor, the Hadrian 109. Achieved during the testing and calibration program, the new lay speed record demonstrates the commercial potential of FBR's robotic construction technology, with current demonstrated lay rates equating to over 70 vertical square metres of wall per hour, meaning that FBR could robotically lay, on site, the walls of a standard double brick house in a single day. The new lay speed record is expected to be surpassed as the testing and calibration program progresses. This will be followed by outdoor build activities at FBR's facilities in the coming months, after which the next-generation Hadrian X® will be available for commercial work. We look forward to seeing the Hadrian X® in action during our visit to Perth in a couple of weeks.

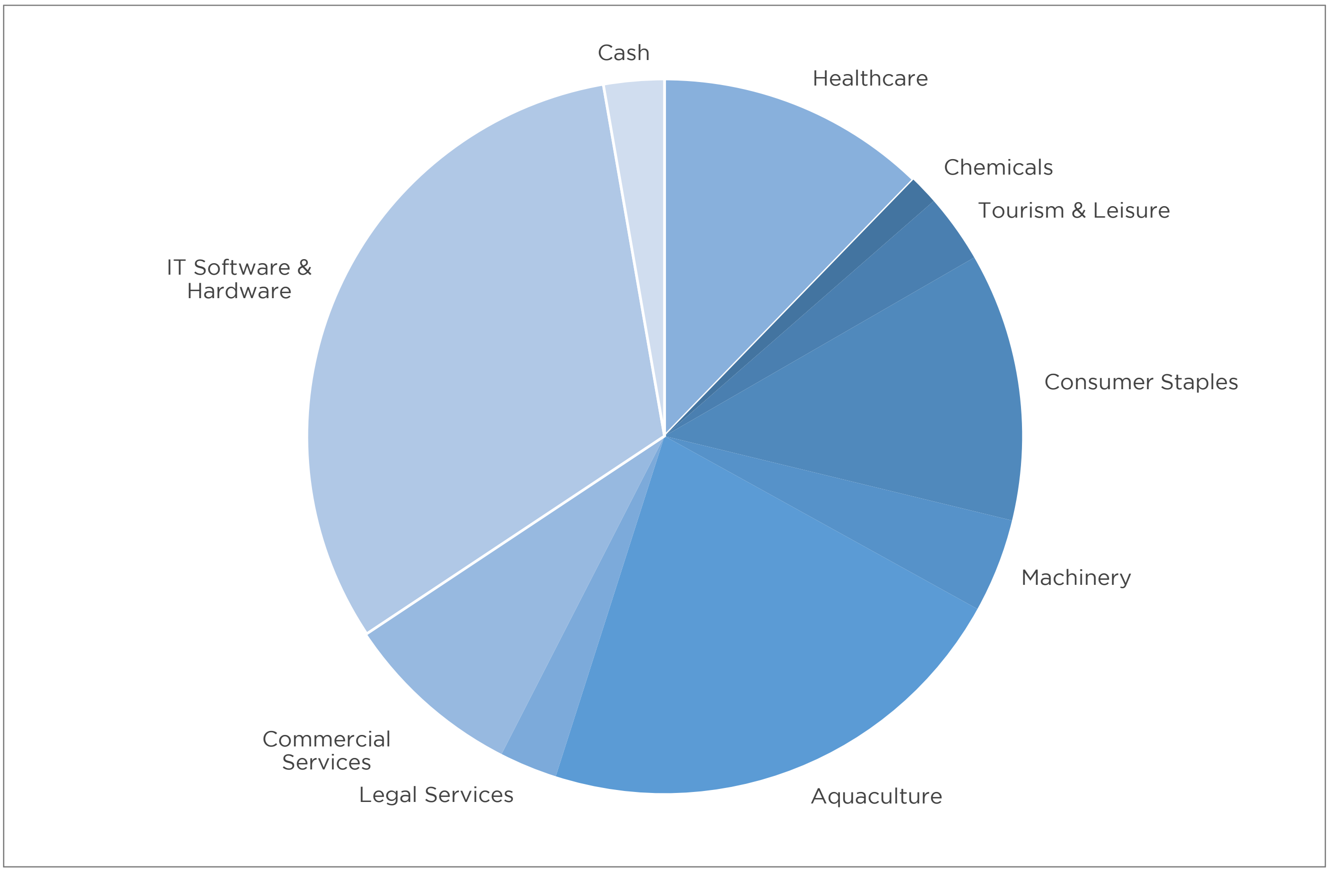
Shine Justice (SHJ, -0.2%) announced the settlement of two large class actions (Multi-site Contamination for $132.7m and Wreck Bay Contamination for $22m) that it had undertaken on behalf of clients. This is particularly relevant in the context of SHJ's disappointing cash flow performance at its 1H FY23 result, as these outcomes suggest that its guidance for a much stronger 2H cash flow result is perhaps on track to be met.

Terragen (TGH, -7%) announced some preliminary findings arising from its longitudinal study of MYLO in dairy cattle on a commercial dairy property in Queensland, its largest study to date. Key results were that cows supplemented with MYLO had 10.1% higher average milk yield after calving (an additional 2.3 litres/day) and 8.1% higher average peak milk production. While this highlights the commercial benefits of the product to dairy farmers (5% of which, in Australia, are already using MYLO), we eagerly await the methane emission reduction results from higher doses of MYLO which, if significant, should open up the market for MYLO to a much wider range of customers and stakeholders.

BirdDog (BDT, -7%) announced the appointment of Unique Beijing Solutions (UBS, established in 2002) as its distribution partner into China, with initial sales to be seeded during this quarter. The appointment of UBS was strategically aligned to coincide with the recent release of BDT's X120 camera – its first camera product retailing for under US$1,000. Following extensive market research, BDT believes X120 holds substantial potential within the Chinese market.

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 July on our performance during June.

Kind regards,

Jonathan Collett

Principal

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