MAPLE-BROWN ABBOTT
INVESTMENT MANAGERS SINCE 1984

Maple-Brown Abbott Australian Small Companies Fund

Monthly Commentary – 30 November 2023

Fund performance (%) [1]

	1 month	3 months	1 year	Since inception p.a. 24 Jun 2022
Fund [2]	7.0	-0.8	5.9	16.0
Benchmark [3]	7.0	-2.9	-3.2	4.2

Market commentary

The Australian small caps market staged a significant recovery in November, with the S&P/ASX Small Ordinaries Total Return Index increasing 7.0%, more than reversing the 5.5% decline in October. In the previous month, we highlighted increases in global and domestic bond yields, a stronger than expected domestic inflation print and hawkish RBA commentary, leading the market to expect that further interest rate tightening may be required. Just one month on and the market is adopting a 'soft landing' narrative, with declining inflation releases, bond yields falling, and the expectation of a peak in interest rates with material cuts expected throughout 2024 - all pointing to a more favourable equity market outlook.

The company trading updates announced over the Annual General Meeting (AGM) season highlight top-line demand moderating, although pleasingly, earnings revisions have not been materially weaker than what we would normally see at this time of the year. Elevated labour costs, weak productivity, higher interest rates and the lower Australian dollar present risks to cost expectations, although the growth outlook and household balance sheets continue to remain more resilient than previous expectations. In addition, companies are navigating the challenging macro-economic environment, with cost-out programs providing offsets to weakening demand.

Portfolio commentary

The Fund returned 7.0% over the month, in line with the benchmark return of 7.0%. The Fund continues to generate strong returns since inception (24 June 2022), returning 16.0% and outperforming the benchmark by 11.8% on an annualised basis.

Over the month, the key stock contributors included Neuren Pharmaceuticals (NEU) and Genesis Minerals (GMD). Neuren's share price increased following the September quarterly update from their US partner ACADIA Pharmaceuticals, which showed a material revenue beat to guidance for Neuren's Daybue product sales (US$66.9m for the quarter compared to guidance of US$45-$55m). Revenue guidance has been set for US$80-87.5m in the December quarter, although based on our proprietary research, we believe this is overly conservative. Genesis Minerals rallied on the back of a strengthening gold price and increasing market expectations for the company's five-year mine plan update scheduled for March 2024. Genesis continues to be a core medium-term holding in the Fund, backed by a strong management team with an excellent track record of project execution.

Key stock detractors included Karoon Energy (KAR) and IPH (IPH), with both companies announcing acquisitions during the month. Karoon acquired a share in an existing oil and gas producing field in the Gulf of Mexico, satisfying their goal to grow and diversify their production base. The acquired asset is high quality although fully priced, and with the stock now trading below the equity raising price, we believe this represents a significant discount to our valuation. IPH announced their third acquisition in the Canadian market in just over 12 months, consolidating their position to now represent approximately 25% of patent filings in that market. We believe the company is well positioned to take significant cost-out of the acquired businesses and lift margins over the coming years. Current gearing is elevated due to additional debt being used to fund the acquisition, however, at 2.2x Net Debt/EBITDA this represents a comfortable level for a defensive business with highly predictable cash flows.

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Notes:

1 Past performance is not a reliable indicator of future performance. Source: Maple-Brown Abbott Ltd, S&P as at 30 November 2023.

2 The Fund's performance is based on the movement in net asset value per unit plus distributions and is before tax and after all fees and charges. Imputation credits are not included in the performance figures.

3 S&P/ASX Small Ordinaries Total Return Index (Benchmark).

Want to find out more?
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Outlook

Macroeconomic indicators continue to drive equity markets, with significant swings on a month-to-month basis, depending on the shifting market views regarding inflation and interest rate expectations. While we don't profess to have any insight into the short-term direction of equity markets, we have been surprised by the material underperformance of the S&P/ASX Small Ordinaries Index relative to the S&P/ASX 100 Index since the start of the 2022 calendar year. We believe this underperformance has been more liquidity (rather than fundamental) driven with much of the negative outlook already 'priced in' to Australian small companies, at least on a relative asset class basis. This sets the scene for a significant recovery for Australian small caps when interest rates peak and/or broader economic fundamentals improve.

Company earnings have been remarkably resilient and continue to confound fears of far more negative revisions in the face of higher interest rates, weaker demand and cost inflation. For example, the retail sector has performed better than expected, driven by the savings rate normalising from elevated levels and the older demographic benefiting from rising interest rates. Many Australian small cap retailers reported record sales results over November which includes the Black Friday and Cyber Monday promotion periods. While this bodes positively for December 2023 half year results, we caution that traditional Christmas buying patterns of consumers are moving earlier to these sales events. We believe the market may be surprised by a weaker than expected December month on the back of this phenomenon.

In the resources sector, we are seeing a divergence between select commodities. Gold has benefited from the changing narrative regarding interest rates and is back above US$2,000/oz on the expectation of interest rate cuts throughout 2024. The representation of Australian small cap gold companies has risen recently, now comprising approximately 10% of the S&P/ASX Small Ordinaries Index by weight. The Fund has benefited from holding four gold companies which continue to deliver production growth, meet cost guidance and build cash reserves.

At the other end of the resources sector, lithium and other battery materials have experienced significant price declines. Slower than expected electric vehicle (EV) demand in China has resulted in destocking across the battery supply value chain. The spodumene price, critical to most Australian small cap lithium producers, has now fallen close to 80% from its peak of US$8,000/t late last year. High-cost producers are now becoming marginal, and we may see some support for the lithium price into 2024, although the demand outlook needs to improve. Another interesting dynamic is the emergence of several large new spodumene discoveries, notably in the Pilbara region. These are attracting corporate interest, although the market is yet to question the impact on longer term supply-demand dynamics and whether this could lead to a lower long-term price forecast.

The Fund has been rotating out of defensive exposures that have been strong performers into cheaper cyclical stocks where we see earnings support. In addition, the weighting towards the resources sector has increased in recent months although continues to remain underweight relative to the benchmark.

The Fund remains well positioned with regards to its core pillars of earnings delivery and sustainability. Going forward we see solid earnings potential, better than benchmark sustainability characteristics and a superior risk profile for the stocks held in the Fund.

For latest Fund factsheet [click here.]

Want to find out more?

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