Maple-Brown Abbott Australian Small Companies Fund

Monthly Commentary – 31 August 2024

Fund performance (%) [1]

	1 month	3 months	1 year	2 years p.a.	Since inception p.a. 24 Jun 2022
Fund [2]	0.0	5.5	18.3	13.3	19.5
Benchmark [3]	-2.0	0.0	8.5	3.6	8.1

Market commentary

Over the month, the Australian small caps market declined 2.0%, as measured by the S&P/ASX Small Ordinaries Index. Reporting season started on a relatively strong footing, with better than feared trading updates from many small cap companies, but turned more negative in the final week of the month with a larger proportion of earnings misses and analyst forecast cuts. Aggregate FY25 earnings per share (EPS) revisions of -2.9% for the benchmark were slightly better than EPS cuts seen in the large cap S&P/ASX 100 index, however the large cap index fared better during the month, finishing broadly flat.

Stock performance during the month was highly correlated with earnings revisions, in line with our 'earnings drives share prices' philosophy. Earnings upgrades were concentrated in the technology sector, as companies retain pricing power and the ability to flex their cost base, as well as in the financials space, as stable interest rates led to declining funding costs, and bad debts remain at low levels. This reporting season saw the last of the 'COVID winners' unwind their strong trading performance, as companies who have benefited from temporary increases in demand, inventory shortages, and pricing power saw these tailwinds evaporate and, in many cases, turn to headwinds.

The worst performers in the benchmark for the month included three well-owned stocks in Audinate (-36%), Johns Lyng (-36%) and Kelsian (-28%). This serves to highlight the risk of holding stocks too late in the earnings upgrade cycle, as the first earnings cut can lead to a significant de-rate. This is one of the core pillars of our earnings philosophy, and as such the Fund was not a holder of any of these stocks during the month.

Portfolio commentary

The Fund returned 0.0% over the month, outperforming the benchmark by +2.0%. The Fund continues to generate strong returns since inception (24 June 2022), returning 19.5% and outperforming the benchmark by +11.4% on an annualised basis.

Over the month, key performance contributors included SRG Global (SRG) and Technology One (TNE). SRG had pre-announced a solid FY24 result in July, consistent with previous guidance. The new news during the month was the acquisition of Diona – an engineering, construction and maintenance business operating in the power and water space. This appears to be an accretive acquisition of a high-quality company, with a significant order book and a lower risk contracting model. We see scope for SRG to re-rate to similar levels to peers Ventia (VNT), Monadelphous (MND), and Service Stream (SSM), provided they can deliver in coming years. Technology One continued to rally after their investor day in late July, which indicated an acceleration of their earnings growth rate to come in future years. We see the potential for Technology One to increase its historic 15% per annum growth rate to over 20%, and this remains one of the highest quality companies in the Fund with substantial growth opportunities both domestically and in the UK market.

Over the month, key performance detractors included Cooper Energy (COE) and Zip Co (ZIP) [not held]. Cooper closed out a tough FY24 year, highlighted by the troubled abandonment program on the BMG gas field, which has led to a stretched balance sheet. However, this was known and factored into our investment thesis at the time of our initial investment earlier this year. We believe the market is now missing two important drivers. Firstly, performance at their flagship Orbost asset is significantly improved this quarter and provides scope for upside to production guidance through the year. Secondly, Cooper is one of the few gas producers with a credible project to bring more supply into the tight east coast gas market, and funding milestones could start to see the market factor this into their valuation. Zip Co (not held) has staged an impressive recovery over the past year, demonstrating a strong turnaround in profitability and guiding to higher margins in the future. We are reticent to own the company at this stage given it is highly leveraged to consumers with poorer credit quality and has seen large declines in their active customer base over recent years.

Please see next page for Outlook

Notes:

1 Past performance is not a reliable indicator of future performance. Source: Maple-Brown Abbott Ltd, S&P as at 31 August 2024.

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 The benchmark is S&P/ASX Small Ordinaries Total Return Index.

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Outlook

Early hopes for a positive reporting season were culled by the end of the month, with a number of well-held small cap companies faring far worse than expected. Pleasingly, the Fund's earnings performance fared far better than the benchmark during the month, with FY25 EPS revisions of -1.3% for the Fund well above the benchmark of -2.9%. Looking further out into FY26, the Fund's EPS revisions were +0.1% compared to the benchmark of -2.3%, which aligns well with our medium-term earnings focus.

The domestic consumer remains in reasonable shape, however the wealth disparity between younger and older demographics continues to widen. Those under 45 years old are pulling back on discretionary spending and are drawing down on savings at an increasing rate, while those over 55 years old are accelerating spending due to increased savings. We remain cautious on the retail sector as a whole, with signs of consumers trading down now evident in the travel and hospitality sectors.

Labour markets are easing with companies across the board reporting declining employee turnover and a spike in job applicants. Despite this, we expect wage inflation to remain a feature over the coming year as it plays catch up to inflation, and this could be a source of margin pressure for many companies. We favour exposure to sectors that have seen acute staff shortages ease, compounded by government funded wage rises, such as aged care and childcare.

Property markets are showing mixed trends, with interest rate and house price stability leading to an increase in new listings, which is also being driven by investors selling in Victoria due to tax and regulatory changes. Years of high inflation in building materials, coupled with labour shortages, have led to a diminishing pipeline of new home builds which is now starting to affect future pipelines and volumes in the space.

Finally, mergers and acquisitions activity in the resources sector continues, particularly in the gold space given the strong performance and cashflow generation of larger producers, relative to the subdued share prices and difficult funding environment seen by junior explorers and developers. Permitting new projects is also becoming increasingly difficult in western jurisdictions, leading producers to take a buy over build approach to growth.

Despite a +17% return of the small caps benchmark since the low point of October 2023, small caps have failed to outperform the ASX 100 over this period, which is unusual compared to previous recovery cycles. Small caps earnings are showing promise, and political pressure on large business profits may supress near-term earnings growth potential of larger companies.

Our key themes underpinning the Fund include:

- **Structural growth**: Focus on structural growth stories that can grow irrespective of the macro-economic environment with niche product offerings.
- **Information technology**: Mega trends driving structural growth including AI, cloud and data centres.
- **Demographics**: Exposure to an ageing population, including aged care.
- **Cost of living**: Growing divergence between age brackets, exposed to an older demographic and non-discretionary expenditures, and avoiding industries on the government's radar.
- **Gold sector re-emergence**: Focus on companies which continue to deliver production growth, meet cost guidance, and build cash reserves as well as development opportunities.
- **Rising energy demand**: Rising power demand from electrification of vehicle fleets, AI, and data centres, with a focus on reliable baseload power required.
- **Defence spending**: Increasing geopolitical tensions, de-globalisation, on-sourcing of defence production and supply chains, and focus on securing critical and advanced minerals.

The Fund remains well positioned with regards to its core pillars of earnings delivery and sustainability factors. 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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