JM Financial Group

Issue 70: February 2021

Small Companies Strategy – Investment Newsletter

Performance *(As at 28th February 2021)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Small Companies Strategy	**-2.27**	**-5.13**	**+21.85**	**+50.72**	**+189.71**	**+17.32**
Small Ords Accumulation Index	+1.55	+1.29	+11.44	+22.65	+78.05	+9.05
Outperformance	**-3.82**	**-6.42**	**+10.41**	**+28.07**	**+111.66**	**+8.27**

Although the JMFG Australian Equities Strategy is generally representative of client portfolios, Individual performance may differ from the results above. These differences can arise due to various issues, some of which may relate to initial timing of investments and cash inflows and outflows. Performance is calculated on a TWRR basis – and is after management fees, taxes (excl imp. credit benefits) and any paid or accrued performance fees. Strategy Inception for Performance Data is July 1st, 2014.

Month in Review – *A review of events that influenced the share market and portfolio in February*

The JMFG Small Companies Strategy underperformed its benchmark, the ASX Small Ordinaries Index, for the month of February by 3.82%, and for the rolling quarter by 6.42%, as the rotation from growth stocks into cheaper so-called value stocks continued. This move has been driven, in part, by higher US Treasury yields and inflationary expectations which are resulting from increased global economic activity forecasts. One area benefiting from increased economic activity is commodity prices, most of which reached new highs in recent weeks.

At JMFG, we tend to favour long duration industrial growth companies, as we believe these provide the best prospects for superior long-term performance. From time to time, when the market does rotate back to lower growth companies, it is normal to expect periods of underperformance, sometimes for months on end. From experience, we have found the best strategy is not to chase the latest market rotation but remain focused on finding companies that have a sustainable competitive advantage. It is, however, a time to increase focus on the price that one should pay for such companies, as rising rates put a spotlight on growth levels required to justify high multiples.

There were stark contrasts in sector performances in February with value-based sectors, Materials and Financials, leading returns at +7.34% and +5.20% respectively. The Energy sector also improved 2.44% on higher energy prices. At the other end of the spectrum, the high-growth, high-PER I.T. sector fell 8.92% and Health Care fell 2.94%. The small Utilities sector fell 8.02%, a function of locked in regulated returns against a backdrop of rising treasury yields providing an improving relative alternative. Consumer Staples and Discretionary fell 4.64% and 2.92% respectively, easing off relatively high multiples, having both been major beneficiaries of the lockdown environment.

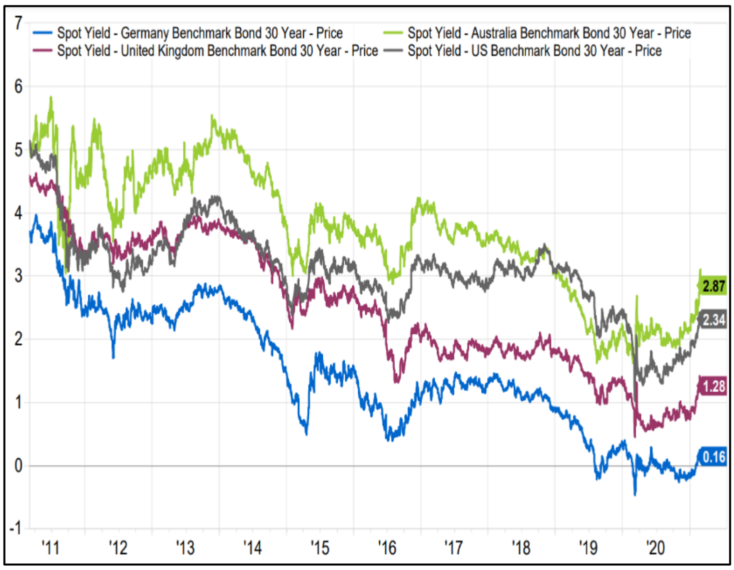
We exited our position in Sezzle, having more than doubled since topping up in November, and purchased two new stocks in the portfolio, Nine Entertainment Co. and Data#3 Ltd. We reduced holdings in Mach7 Technologies and Pro Medicus following price strength, and added to PolyNovo on price weakness having sold down at substantially higher prices in prior months. The strongest performers for the portfolio during the month included Codan +26%, Livehire +23% and Costa Group +16%, with the worst performers NRW Holdings -30%, Netwealth -18% and Opthea -17%.

Chart of the Month – The Cost of Risk

Rotation in market returns from growth to value-based companies is, in large part, a function of the rise in treasury yields, which is itself driven by improving economic activity and demand for capital. The chart to the right demonstrates the yield expansion across the US, UK, Germany, and Australia. Higher yields increase the cost of capital, which has two major impacts on the market.

It lowers the long-term discounted value of earnings streams, thereby reducing valuations of companies without a commensurate increase in earnings growth. This impact is more pronounced for companies with earnings skewed to the outer years of forecasts – i.e. the high-PER, high-growth companies that have underperformed over the last couple of months.

Higher interest rates provide a more attractive alternative to other asset classes including equities. In other words, higher interest rates provide a more attractive relative return and therefore attract capital away from equities and other asset classes into fixed interest products.



Source: Factset financial data and analytics.

Best & Worst Performers for February 2021

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Codan (CDA)	NRW Holdings (NWH)	Zip Co (Z1P)	Service Stream (SSM)
Livehire (LVH)	Netwealth Group (NWL)	Virgin Money (VUK)	NRW Holdings (NWH)
Costa Group (CGC)	Opthea (OPT)	Starpharma (SPL)	Bellevue Gold (BGL)

Hits & Misses – *A summation of the top hits and misses for the month of February*

Codan (CDA) – up 26% for the month. Codan announced record half-year profit, up 36% on the prior corresponding period. It also announced an acquisition of a tactical communications business with existing US government agencies as customers, diversifying the company's revenue sources and geographic exposure.

Zip Co (Z1P) – up 43% for the month (Not held). After announcing strong December quarterly results in January, Zip continued to be strong through February. The company is also contemplating a secondary listing on the NYSE or NASDAQ as management considers Zip to be undervalued relative to Afterpay and the US listed Affirm.

NRW Holdings (NWH) – down 30% for the month. NRW disappointed during February with its first half profit results missing expectations. Notably, EBITDA margins were lower than historically reported margins, particularly due to high staff turnover and travel restrictions.

Service Stream (SSM) – down 40% for the month (Not held). Service Stream had its revenue fall 17.7% compared to the prior corresponding period. The company also downgraded its full year profit and revenue guidance due to delays in commencing new work.

Due Diligence – *A closer look at a stock of interest*

Top Shelf International Holdings (TSI)

Ned Whisky and Grainshaker Vodka

Top Shelf International is a newly listed whisky and vodka manufacturer based in Australia. The company sells its whisky under the brand 'NED Australian Whisky' and vodka under the brand 'Grainshaker'.

Over the last 5 years Top Shelf has invested heavily in increasing the potential production quantity with the current facilities having production capacity of 400,000 cases of whisky and vodka bottles per annum. As whisky must undergo maturation for more than 2 years (required by law) before it can be sold, Top Shelf has also invested heavily in its whisky inventory so that by the end of FY21 it expects to have on hand over A$106m in sales value of NED, 243% more than at the end of FY20. Alternatively, vodka requires no maturation so, since establishing Grainshaker in October 2020, Top Shelf has been able to scale up Grainshaker production quickly with vodka achieving similar monthly sales to NED Whisky, which was established in FY15.

In December 2020, Top Shelf completed its acquisition of the Eden Lassie agave farm. Agave is the primary ingredient in the production of tequila and is usually grown in hot and arid regions like Mexico. Top Shelf is planning to launch its tequila product this year.

Having raised funds in its IPO last year, the company is well capitalised to proceed in expanding its production and sales over the coming years. With its production capacity substantially expanded and a solid inventory level, the company is now focused on improving its distribution, sales channels, and brand awareness.

NED Whisky's price positioning versus local and international competitors

Pricing	Value → Mainstream $30	$40	Premium $50	$60	Super Premium $70	$80	$90	$100+
Scotch/ Bourbon	• Johnnie Walker Red • Cougar • Grants • Canadian Club • Ballantines	• Jim Beam White • Jack Daniels • Wild Turkey • Jameson • Chivas 12	• Gentleman Jack • Monkey Shoulder • Johnnie Walker Black • Woodford Reserve	• Johnnie Walker Green • Johnnie Walker Gld • Jim Beam Black • Makers Mark • Glenfiddich • Glenlivet 12	• Glenmorangie 10 • Talisker Storm • Laphroaig	• Aberlour • Talisker 10	• Chivas 18 • Lagavulin • Balvenie Double • Macallan	• Johnnie Walker Blue • Royal Salut • Ultis
Australian		*Filling out an important space in the Australian spirits category*	NED	• Starward • The Grove	• 23rd Street Distillery • The Gospel • Tasmania Spirit	• Whipper Snapper	• Hellyers Road • Old Kempton • Corowa	• Archie Rose • Limeburner • Lark • Launceston
Japanese					• Suntory • Akashi • Kamitaka	• Tenjaku • Kirin	• The Chita • Mars • Nikka	• Yamazakura • Hakushu • Wakatsuru
% of total market value	53%		27%	8%	11%			

Source: *Top Shelf Internation Holdings Ltd. – IPO Prospectus, 08 Dec '20*