LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT FEBRUARY 2022

FUND PERFORMANCE TO 28 FEB 2022

	1M	3M	6M	1yr	3yr p.a.	5yr p.a.	SI[3]p.a.
Net Fund Performance[1]	2.2%	-2.2%	-4.8%	11.4%			9.0%
Benchmark Performance[2]	-0.0%	-7.7%	-9.1%	5.0%			7.2%
Excess Return	2.2%	5.5%	4.3%	6.4%			1.8%

1. Return net of 0.89% p.a. management fee. **2.** S&P/ASX Small Ordinaries Accumulation Index. **3.** Inception date: 31 Oct, 2019. Past performance is not a reliable indicator of future performance, p.a performance is annualised.

The Longwave Australian Small Companies Fund increased by 2.2% during February 2022, outperforming the 0.0% decrease in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 2.2% over the month.

A ROD TIDWELL MARKET

Only six months ago, we quoted Charlie Youakim, CEO of Sezzle (SZL) in his comment to the Sydney Morning Herald that for his team it is all about "growth, growth, growth" and we noted at the time this was pretty much how most investors interpreted results in the August 2021 reporting season. A prime example of this was Nanosonics, who all but told investors in August that near term earnings would decline (F22 consensus estimated EPS was revised down 23% the next day) but the stock was rewarded with a +22% one-day price increase post result as the increased estimated TAM (total addressable market) was considered far more pertinent to immediate value.

What a difference six months makes.

This reporting season, it is Rod Tidwell, fictional NFL wide receiver in the movie Jerry McGuire who provides a more relevant quote.

"Jerry my house is falling apart. Nobody's looking out for Rod Tidwell. I'm supposed to be a superstar..... This is what you're gonna do for me. SHOW ME THE MONEY!"

The average superstar investor in small cap growth stocks during February must have felt like their house was falling apart (although as we have noted here, here and here financial statements have suggested this for some time). During these results, if companies did not show investors "the money" they were swiftly sold.

Tyro (TYR) CEO, Robbie Cook on the result conference call brought shades of Charlie Youakim to the analyst question of when shareholders may see EBITDA margins sustainably expand after they declined again in 1H22: *"so it's growth, number one; it's demonstrating operating leverage, number two; and that will -- it should -- drive an EBITDA positive outcome".* Tyro fell 33% in the next two days. Not quite the 75% fall of Sezzle or 42% decline in Nanosonics since August last year, but a clear message from investors that growth and TAM at the expense of all else is wearing thin and a clear path to profits is now required.

This is before we consider why EBITDA is the goal of most management teams. Again, as we have noted previously, positive EBITDA is not consistent with positive cash flow given the adopted accounting of many Australian high growth names. Many of these companies are even further from a true profit goal.

Profitability is more than a matter of scale. The assumption that more sales will leverage fixed costs into higher profits should hold true – and can easily hold true in a spreadsheet – but reality tends to be different. Again, let's look at Tyro. Tyro had A$50m of sales in F2014 and produced an EBIT of A$4m. Eight years later, sales are expected to be six times higher around A$320m in F22 and EBIT is forecast to be a loss of (A$20m). Maybe the *next* A$200m of revenue will make all the difference, or maybe shifting from growth to profitability takes more than just filling right a few more columns on a spreadsheet.

"For too long, investors have rewarded [companies] for growth/TAM w little attention to profits. As a result, so many soft[ware] [companies] have been organized in a way that they now produce massive losses. This will be difficult to reverse & is a real problem for the industry. To change into profitable growth you have to change the org structure, modify the priorities of the leadership team, develop a new approach to measuring operating activities, and transform the culture." – Orlando Bravo, Founder of Thoma Bravo, Growth Private Equity.

TOP 10 HOLDINGS

Name (Alphabetical)
Beach Energy Ltd
Brickworks Ltd
Corporate Travel Management Ltd
CSR Ltd
Fletcher Building Ltd
News Corp
Sims Ltd
Spark New Zealand Ltd
Viva Energy Group Ltd
Whitehaven Coal Ltd

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM[2]
Communication Services	7.9	5.5
Consumer Discretionary	14.8	13.8
Consumer Staples	3.3	5.1
Energy	9.2	5.5
Financials	11.4	10.8
Health Care	4.6	5.8
Industrials	11.0	8.1
Information Technology	5.3	9.1
Materials	21.7	20.6
Real Estate	7.3	15.8
Utilities	0	0
Cash	3.5	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Novonix Ltd
Sims Ltd
SSR Mining Inc
Viva Energy Group Ltd
Whitehaven Coal Ltd

Bottom 5 - Detractors
Brickworks Ltd
Cimic Group Ltd
Janus Henderson Group PLC
Mainfreight Ltd
Nufarm Ltd

CONTINUED

MARKET DISTRACTION PROVIDED INVESTORS AN OPPORTUNITY

Our investments have been focused on the forgotten parts of the small cap market and many of our larger holdings delivered 'the money' in their recent results:

Sims Ltd (SGM): A very strong result. Prices (particularly in non-ferrous) are expected to remain strong due to decarbonisation demand for Aluminium scrap and copper. Management expects conditions and operating performance to continue – as they expected back in August.

Fletcher Building (FBU): Business is performing well ahead of market expectations despite COVID headwinds. Seeing lots of inflation in costs – but easily passing them on at the moment. Margin and ROIC uplift partially cycle but partially turn around post Formica sale in 2019.

Viva Energy (VEA): Despite disruptions during 2021 it was another strong result. No guidance given for F2022 but they are starting the year in a much better place (stronger consumer demand, expected recovery in aviation, higher refining margins). Upside from investing balance sheet capacity over the next 2-3 years.

Pexa Group (PXA): Strong property transaction volumes saw higher revenue and earnings from the Pexa exchange business. New growth initiatives (Pexa UK, Insights and Ventures) provide longer term upside potential.

Monadelphous (MND) / NRW Holdings (NWH): Both companies have seen closed borders in WA put pressure on margins due to labour availability. As legacy contracts exposed to this risk complete, the margins are stabilising with an expectation of margin recovery and growing revenue pipeline during CY2022.

Newscorp (NWS): Surprised the market with growth in the news media segment and significant improvement in margins due to new digital content license and ad share with Google and Facebook. Digital transformation on track across multiple segments.

SmartGroup (SIQ): Revenue growth was slightly better than expected. Given the constraint from lack of new cars this won't improve until 2H CY22. Margin was better, cash flow solid and paid an unexpected special dividend.

One unexpected curiosity late in reporting season was the possible change in the outlook for lithium. The standard bull case is supply unable to keep up with demand in the medium to long term. One of Australia's leading lithium producers (Allkem) shared industry projections that have gone from forecasting large and growing deficits out to 2030 (presented in August 2021) to a picture six months later (at their February 2022 result) of lithium deficits peaking at about half prior estimates in 2024 before returning to surplus by 2026 as far more supply is now expected to come to market. We hold no position here.

PORTFOLIO POSITIONING AND PERFORMANCE

Fund performance in February was mostly dominated by fundamental results through reporting season. Contributors included some of the names discussed above that we own and who are continuing to deliver for shareholders (Viva Energy, Sims, Monadelphous, Iluka, Genworth and SmartGroup among others) as well as a continued re-pricing of former growth stars being re-assessed on their profit performance (Novonix, Zip Co, Life360, Telix, Imugene and PointsBet) that we don't own.

Detractors during the month included holding such as Janus Henderson, Mainfreight, Brickworks and despite what we thought was a good result, Newscorp. We also held no position in some strong index performers including Cimic Group (announced a takeover bid from their majority owner), Nufarm, Graincorp and Invocare.

At a sector level, our underweight to technology and overweight energy contributed the most. Our underweight to real estate and overweight consumer discretionary were the biggest detractors.

Reported inflation and future inflation expectations have increased. Investor acceptance of growth over profits has reversed. Interest rates have increased and are heading higher. Geopolitical considerations have added risk and uncertainty. The market regime has clearly changed and yet a lot of market value still rests upon assumptions which no longer apply. We continue to see a lot of opportunity in quality, growing businesses at reasonable value and many companies we are happy to avoid until share prices catch up to reality.

Fund characteristics	
NAV	A$1.1271
Redemption unit price	A$1.1237
Inception Date	31 Oct, 2019
Minimum Investment	A$25,000
Management Fee	0.89% p.a.
Performance Fee	-
Buy / Sell Spread	0.30% / 0.30%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Distribution frequency	Half-yearly
Portfolio FUM (A$m)	5.8
No. of Holdings:	124
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	187.3

INVESTMENT OBJECTIVE

The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the long term.

The Fund aims to provide long-term capital growth through investment in a diversified portfolio of high-quality Australasian small companies (outside S&P/ASX 100 Index at time of investment or expected to be within six months).

INVESTMENT STYLE

Longwave's investment philosophy is underpinned by the belief that the stocks of high-quality small companies outperform the benchmark over time, and as such, an active approach to investing in high-quality stocks provides value to investors who might otherwise have invested passively. Longwave believes in the value of a deep and fundamental understanding of the securities in which we invest.

Signatory of: