Present Value

Monthly Update - May 2021

"We're guessing at our future opportunity cost… But if we knew interest rates would stay at 1%, we'd change. Our hurdles reflect our estimate of future opportunity costs." - Charlie Munger

Performance to May 31, 2021 *(after fees)*	1 month	3 months	Fiscal year to-date	Last 12 months	Since inception (Sep '17)
Performance Hurdle	+0.48%	+1.18%	+3.05%	+4.62%	+6.09% pa
Dragonfly Fund*	**-2.29%**	**-2.81%**	**+82.44%**	**+78.89%**	**+2.07% pa**

* Fund return is net of all management fees, expenses and accrued performance fees

Fund Facts

NAV	$1.0798
Inception	Sep 1, 2017
Bloomberg	EQUINDF AU Equity
APIR code	EQB7664AU
ISIN	AU60EQB76649

Portfolio Key Metrics

May 31, 2021	% NAV#
Cash (incl. cash ETF)	20%
Unlisted & Hybrids	25%
ETF	0%
Listed Equities	55%
Market cap <$100m	*70%*
Market cap $100m-$1b	*30%*
Market cap >$1b	*0%*
Top 5 positions	44%
No. positions*	23

\# May not add up to 100% due to rounding
* excludes positions <0.1%; counts multiple security types in one company as one position
Note: In-the-money convertible notes treated as equity

Key Contributors to Performance

Best	Maggie Beer Holdings (MBH), Earlypay (EPY)
Worst	Energy World Corp (EWC), Identitii (ID8)

The Fund aims to deliver a total return greater than the five year government bond rate + 5% pa over the medium-to-long term.

SUMMARY

- ➔ **MONTHLY COMMENTARY |** Dragonfly has been marking time in the past few months with catalysts ahead but none in the recent period. A key winner from April, **Energy World Corp (EWC)**, retraced in May. The month's best performers, **Maggie Beer Holdings (MBH)** and **Earlypay (EPY)**, both put out encouraging updates on their operating and financial performance during the month.

- ➔ **STOCK PROFILES** | Over the past month our weekly *Small Talk* update for Fund investors has profiled digital music industry data service **Jaxsta (JXT)**; surface chemistry company **Anteotech (ADO)**; early-stage FinTech opportunity, Parpera; and an update on the Buy Now Pay Later (BNPL) sector.

- ➔ **OUTLOOK COMMENTARY** | We are looking out for opportunities to buy small stocks we like on short-term weakness caused by tax loss selling in June (which was already underway in May). We also believe the Fund's unlisted investments, in particular, have some exciting catalysts coming up over the next six months. Oscillating inflation expectations are something to keep an eye on for the broader market and we explore the implications further in this update.

- ➔ Supportive market reactions in May to updates from MBH and EPY are reflective of our expectation that portfolio investments will progressively be recognised by the broader market as they execute - similarly in June we've just had key holding **MedAdvisor (MDR)** announce a positive operating update as this note is written.

Top Nine Positions (alphabetical order, as of May 31, 2021; ASX-listed unless otherwise stated)

AssetOwl	Geo (NZX-listed)	MedAdvisor
Ellume (unlisted)	Identitii	Scout Security
Energy World Corporation	Upsure (unlisted)	Spectur

Monthly Commentary

Lighting the way during the month were gourmet food and dairy group **Maggie Beer Holdings (MBH)** and business lender **Earlypay (EPY)** as they both put out encouraging updates on their operating and financial performance during the month.

MBH had yet another win with the retailers, securing national ranging of its new range of Finishing Sauces and Bone Broths with a launch in Woolworths and independent supermarkets slated for October 2021. It also said the Maggie Beer Products business grew net sales by 29% in April 2021 (versus April 2020). MBH completed the acquisition of Hampers & Gifts Australian (HGA) and said that this new ecommerce arm achieved net year-on-year sales growth of 96% in April. The combined business is expected to generate revenue of over $85m a year and more than $11m in trading EBITDA.

EPY has now well and truly put behind it the takeover battle that collapsed a year ago when the COVID-19 epidemic rocked markets. Based on EPY's performance since then, the bidders probably regret walking away. EPY announced during May that it achieved record transaction volumes of $199m in March 2021, up 34% on March 2020. It confirmed FY21 earnings guidance of $21m+ EBITDA and $8.5m+ net profit (excluding amortisation) with fully franked dividends totalling 2.3c a share. And EPY signalled that current operating momentum would "translate to a material increase in earnings for FY'22 over FY'21".

Last month (April), returns were bolstered by participation in a capital raising by **Energy World Corporation (EWC)**. We participated in a placement priced at $0.08 a share and the stock closed out April at $0.115. In May it pulled back to $0.089. As we highlighted a month ago, EWC is a historically profitable and cash generative business with reported net tangible assets significantly above its current share price..

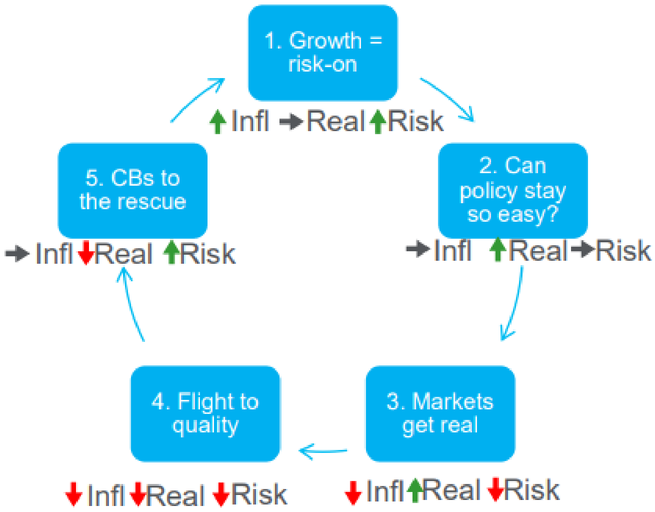
RegTech company **Identitii (ID8)** also eased off a bit - as a reminder ID8 has been one of the top contributors to Fund performance during the current financial year. In May ID8 added a credible non-executive director (financial crime and RegTech expert Tim Phillips, ex-ASIC and Deloitte) to its board but we expect what the market really wants is news of customer wins.

Inflation & the Cost of Capital

If it isn't about "meme" stocks, most of the market commentary and chatter at the time of writing this update is about inflation. The US Consumer Price Index jumped 5% in May 2021 from a year ago, the largest annual gain since August 2008 according to Bloomberg. The debate continues over whether this increase in inflation is "transitory" and reflective of the re-opening of economies OR whether it reflects a more permanent shift. The argument matters not just because central banks will try to use interest rates to control inflation if it is persistently higher but because the return investors will require will need to increase for their capital to maintain its relative buying power.

Figure 1 sets out a typical cycle for inflation, real returns and risk appetite. We suspect inflation may be higher in the next decade than the last. The global supply chain may not return to the peak efficiencies of "just-in-time" practices for years. We see pressure on wages; and shipping costs are becoming a more meaningful cost component. We think it is prudent to assume there will be some increase in the cost of capital.

Figure 1: A cycle for inflation, real returns and risk appetite



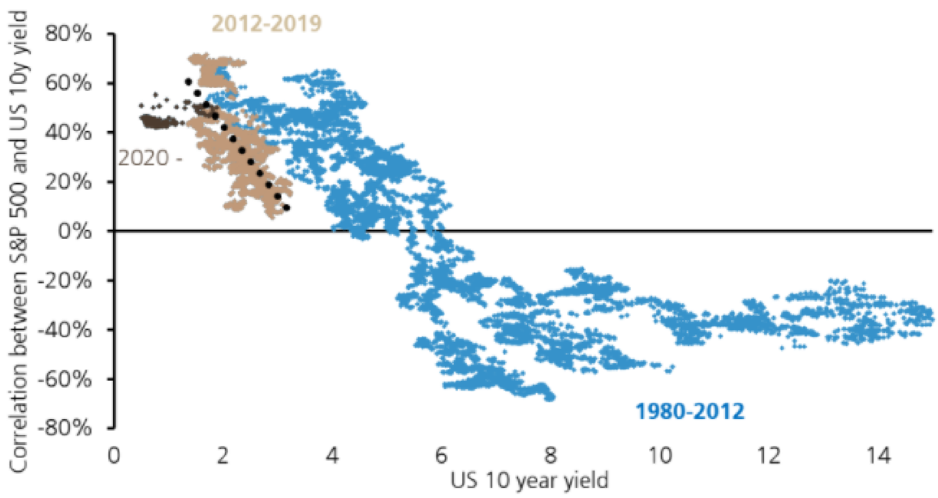
Source: Citi Research (Sep 2020)

In Dragonfly Fund's [February 2021 update] we highlighted how rising interest rates were creating volatility in business valuations reliant on cash flows that were not forecast (or hoped) to drop through until many years in the future. At that point in time, the yield on the Australian Government 10 year bond had nearly doubled to 1.85% (on March 3) from 0.97% at the end of CY2020. Since then that yield has moderated to 1.45%.

Here's an overview of the expected impact of inflation on equities:

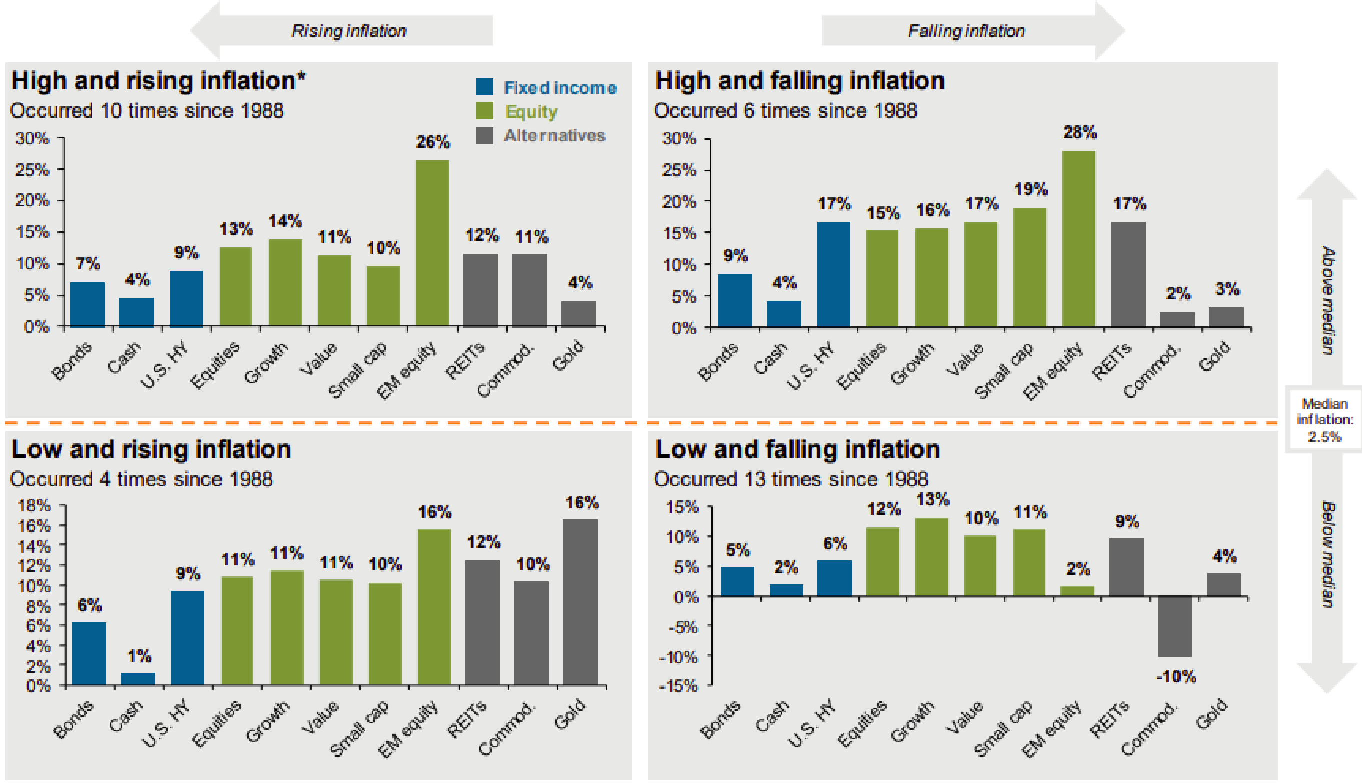
- ➔ UBS has estimated that every 50 basis point increase in the 10 year government bond yield implies a 0.6x deduction in the market P/E multiple.
- ➔ Post GFC, UBS estimated that the correlation between equities and government bond yields would flip from positive to negative should the US 10 year government bond yield rise to 3%; Figure 2 shows the correlation between the two through time and a sharp difference in sensitivity in the past decade.
- ➔ Equities - and small cap equities - have historically performed well in all inflation environments according to JP Morgan Asset Management's analysis in Figure 3.

Figure 2: S&P 500 correlation with US 10y bond yield



Source: UBS (Jan 2021)

Figure 3: Calendar year returns in different inflation environments (US centric)



Source: JP Morgan Asset Management (as at December 31,2020)

Equities may be choppy in the short-term as inflation and interest rate expectations oscillate. In the longer run equities in general have historically held up as sound investments in most inflation environments - see Figure 3.

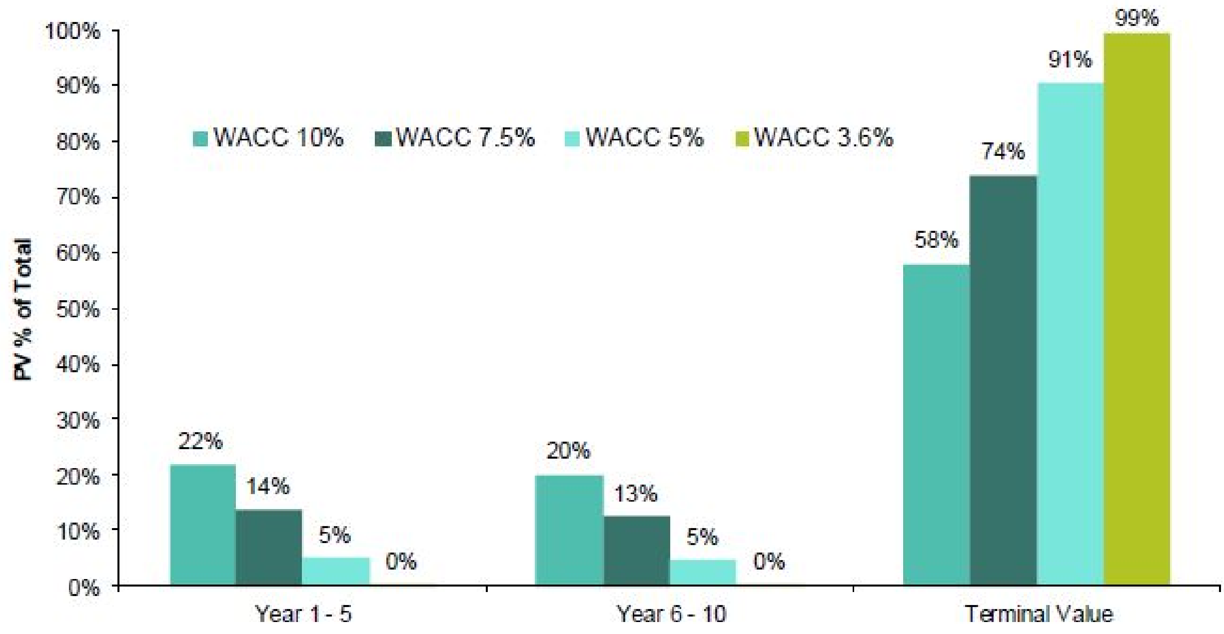
Where we see the greatest potential for volatility is among the most highly priced “growth stocks” where current valuations are dependent on cash flows that do not occur for many years.

An example of how a higher cost of capital impacts on today’s valuation of a highly priced company with high growth expectations is set out in Figure 4 (on the following page). In this example from Sanford Bernstein, when the cost of capital (the WACC - Weighted Average Cost of Capital) is very low, 42% of the current value is captured by cash flows in the next ten years BUT when the cost of capital is high, the first ten years contribute almost nothing to valuation and virtually all of the current value is dependent on the expectation of cash flows that do not occur until after ten years have passed (represented as the “terminal value”).

We ran a similar analysis for an ASX-listed company, set out in Figure 5, with high growth expectations, using consensus estimates for the first three years then a 10% annual growth rate for two years that then faded to 3.5% over ten years. In this case, the terminal value represented 87% of the estimated Net Present Value at a 5% cost of capital, dropping to 52% if the cost of capital was 10% and 30% using a 15% cost.

Dragonfly Fund has never been focused on the market “growth stock” darlings that appear to have the most to lose in valuation and we continue to hone in on unique opportunities and catalysts for individual businesses and actively engage with them.

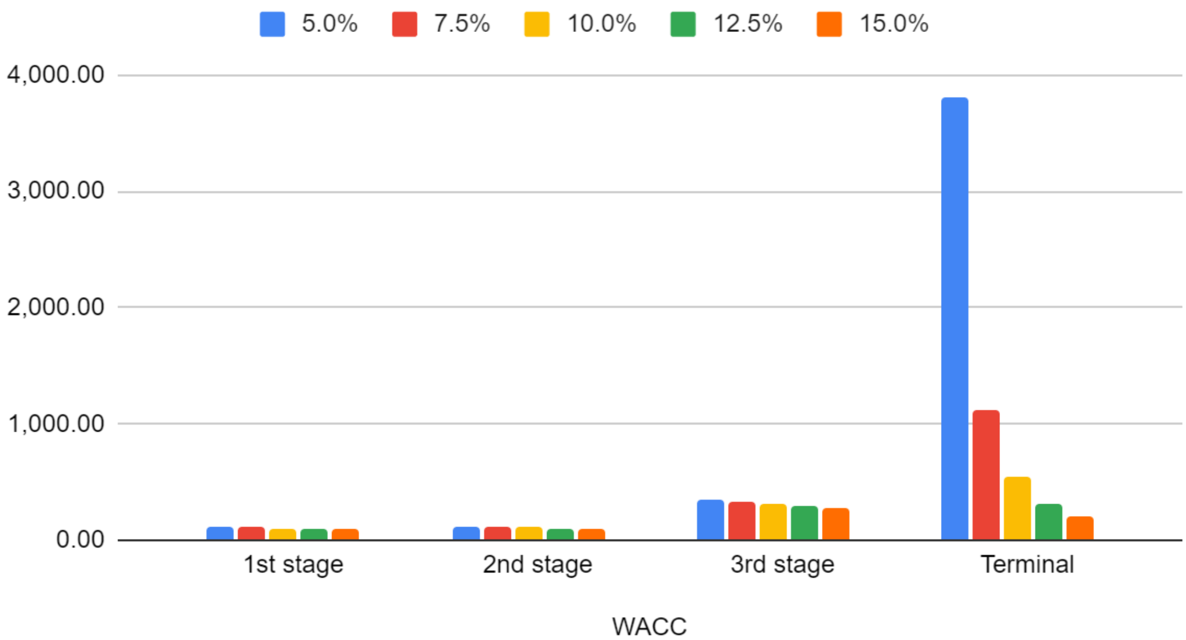
Figure 4: Proportion of Net Present Value derived from future cash flows for high growth company



Note: For the analysis we use a 3-stage DCF model. We assume 10% growth rate in the first stage (year 1-5), then fade the growth rate over years 6-10 to a terminal growth rate of 3.5%. We vary the WACC from 10% to 3.6%.

Source: Sanford Bernstein

Figure 5: Modelling Net Present Value of a well known high-growth ASX listing at different WACCs



Note: First stage is three years based on high growth consensus estimates; 2nd stage is two years assuming 10%pa growth; third stage fades growth over five years to 3.5%.

Source: Equitable Investors

Fund Details

Strategy	Long only. Seeking growth or strategic value at an attractive price.
Management fee	1.5% pa
Expenses	Capped at 0.5% pa
Benchmark	5 Year Australian Government Bond Yield + 5% pa
Performance fee	20% (above benchmark)
High watermark	3 year rolling
Minimum initial investment	$50,000, wholesale only
Investment Manager & Trustee	Equitable Investors Pty Ltd
Custodian	Sandhurst Trustees
Administrator	William Buck Managed Funds Administration (SA) Pty Ltd

Key Characteristics

Unique Opportunities	Invests in businesses that often lack widespread investor awareness.
Proprietary Research	Continually updating investment views, meeting companies, researching, evaluating.
Constructive Approach	Open dialogue with companies assists in maximising value.
Expertise	Equitable's directors have over 50 years of experience.
Alignment of Interests	Seeded by the Manager & all our best ideas go into the Fund.

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Dragonfly Fund has the capability to "swap" shares in a company or companies for Fund units where Equitable Investors finds them attractive and suitable investments. To date we have used this capability sparingly, rejecting all but a very small number of proposals, but we continue to seek favourable opportunities. Further info is available here.

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