Skepticism & Imagination

Monthly Update - July 2021

"*Those explorations required skepticism and imagination both. Imagination will often carry us to worlds that never were. But without it, we go nowhere. Skepticism enables us to distinguish fancy from fact, to test our speculations.*" – Carl Sagan, Cosmos

Performance to July 31, 2021	1 month	3 months	Fiscal YTD	Last 12 months	Inception
Performance Hurdle	+0.39%	+1.43%	+0.39%	+5.50%	+5.76% pa
Dragonfly Fund	**+6.84%**	**-0.24%**	**+6.84%**	**+67.27%**	**+2.52% pa**

Performance Hurdle: aims to deliver a total return greater than the five year government bond rate + 5% pa over the medium-to-long term.
Fund return is calculated net of all management fees, expenses and accrued performance fees.

Fund Facts

NAV	$1.10248
Inception	Sep 1, 2017
Bloomberg	EQUINDF AU Equity
APIR code	EQB7664AU
ISIN	AU60EQB76649

Portfolio Key Metrics

July 31, 2021	% NAV#
Cash (incl. cash ETF)	2.0%
Unlisted & Con Notes	30%
ETF	0%
Listed Equities	68%
Market cap <$100m	*57%*
Market cap $100m-$1b	*43%*
Market cap >$1b	*0%*
Top 5 positions	53%
No. positions*	30

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 Monthly Performance

Best	Empired (EPD), Scout Security (SCT)
Worst	Geo (NZ: GEO), Identitii (ID8)

SUMMARY

➔ **PORTFOLIO REVIEW |** Some of those catalyst events that were absent in June appeared in July, along with a snap-back for stocks that were afflicted by tax loss selling. **Empired (EPD)** was in the catalyst category with a takeover offer, making it the latest in a series of deals validating long-term holdings of the Fund.

➔ Over the past month our weekly *Small Talk* update for Fund investors profiled **Spectur (SP3)** and **Viva Leisure (VVA)**.

➔ **OUTLOOK** | Annual profit reporting season is upon us. The lead-up has seen ~1.25 upgrades to consensus expectations for every downgrade within our "FIT" universe of ASX-listed micro-to-mid caps over the past month (for revenue, EBITDA and EPS). Quarterly cash flow reports were due by the end of July for earlier-stage companies so many Fund investments have already released their key financials - some exciting and no negative surprises. The severity of some of the reactions to other stocks' quarterly updates indicate that the market won't be forgiving if high flying stocks don't deliver.

➔ A great question confronting equity markets continues to be whether or not "this time is different" for valuation. In a US context, Bloomberg set out two alternative cases: one where the Price-to-Earnings (PE) ratio declines to its long term average of 16-17x; the other where "fair value" is instead set by the average PE since 1990 of ~25x. Large capital pools are going to have to confront this issue directly. Nimble investors with skepticism and imagination both look better placed.

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

Earlypay	Geo (NZX-listed)	Scout Security
Ellume (unlisted)	Maggie Beer Holdings	Spectur
Energy World Corporation	MedAdvisor	Upsure (unlisted)

PORTFOLIO REVIEW

Validation through Takeovers

In late June we reminded Dragonfly Fund investors of the Fund's long-term holding in IT consulting group **Empired (EPD)** and how well placed we felt it was to attract a bid from larger groups. We didn't have to wait much longer - global IT consultant Capgemini agreed to a takeover at a 65% premium during July, helping the Fund to a strong start to the new financial year.

"*EPD is the key remaining ASX-listed IT services business with most of the others acquired in the past decade - generally on double-digit EV/EBITDA multiples*," we noted in one of our weekly *SmallTalk* updates in June.

The EPD deal came less than three weeks after listed FinTech Novatti (NOV) raided the market to build a 19.9% stake in another long-term holding of the Fund, accounting and legal software group **Reckon (RKN)** - buying stock at a 27% premium to the previous closing price.

Earlier in calendar 2021, the Fund's holding in traffic monitoring company Redflex Holdings (RDF) was presented with a takeover offer at a 130% premium to the previous closing price (and that bid was subsequently increased).

Re-rate or be Acquired
Our view with all of these businesses has been that either the market will re-rate them as they perform OR larger companies will seize the opportunity. We hold the same view for other investments in Dragonfly Fund.

Quarterly Reporting Highlights

July brings with it an obligation for some of the earlier stage companies to deliver quarterly cash flow reports and commentary for the three months to June 30 - and typically for the financial year just ended as well.

A highlight for us was that wearables tech company **Spacetalk (SPA)** reported a 182% increase in revenue for the June quarter to $3.0m. Revenue for the full FY21 was up 14.3% on the prior year to $15.1m, with device sales in Australia up 85% and app subscription revenue up 76%. Cash burn for the quarter was approximately $700k. *Disclosure: Equitable Investor's Martin Pretty is a non-executive director of SPA.*

Here's some more quarterly results that pleased us:

➔ MedTech company **MedAdvisor (MDR)** reported a 26.1% like-for-like June quarter revenue increase to $13.3m. MDR reconfirmed its CY21 revenue guidance of $55m to $57m at a ~55% gross margin and noted that 100% of targeted revenue in the US for the remainder of CY21 is contracted. Operationally, in the US the % of drug stores in its network that have agreed to move to digitisation has lifted to 30% from 12.5% over the course of the June quarter. In Australia, MDR said its local ARR is now $6.6m.

➔ App-based DIY home security business **Scout Security (SCT)** reported $1.4m in cash receipts and net operating cash burn of just $15k for the June quarter. It said its US telecommunications partner (previously it announced a partnership with Windstream) had received stock and was currently training a large sales team, pending market launch. SCT's global security partner Prosegur has selected a second Spanish-speaking market to launch its white-label of SCT's product, Qido, having recently launched in Peru. *Disclosure: Equitable Investors' Martin Pretty is a non-executive director of SCT.*

➔ Remote monitoring technology company **Spectur (SP3)** reported positive quarterly cash flow of $333k on $2.05m revenue for the June quarter. SP3 sold 134 units in the quarter, up from 50 in the December quarter and 91 in the March quarter. Total revenue in the June quarter run-rated at $7.2m a year with recurring revenues (subscription and rental revenues) at $3.2m a year. SP3 said it has "a strong forward order book of commitments which extends well into FY22".

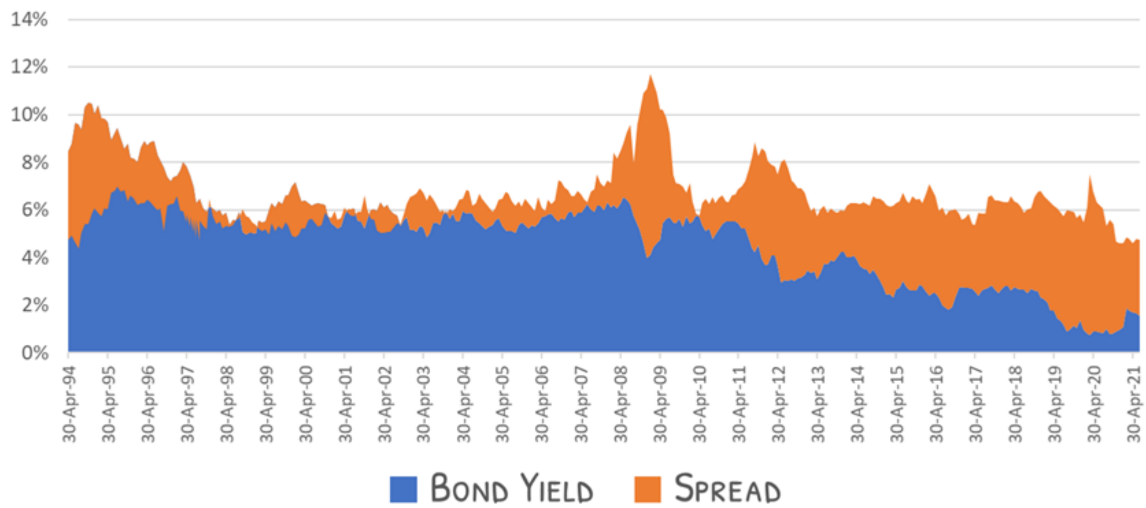
➔ FinTech **8Common (8CO)** reported a 33% year-on-year increase in June quarter SaaS and transaction-based revenue to $720k for an annualised $3.0m. 8CO said user levels increased 33% to 166k over the course of FY21. Veritas Securities commented that "Core business metrics (user numbers and SaaS revenues) slightly exceeded our expectations." 8CO then came out with the exciting development that its travel and expense management solution has been mandated for a whole-of-government offering (at the Australian Commonwealth level) - followed by a capital raising in early August..

OUTLOOK

The quandary framed in terms of US valuations on the front page of this report is similar in Australia. The PE on the S&P/ASX All Ordinaries Index was 21.1x at the end of June. Its long-term average is 14.3x and over the last decade it has averaged 16.1x (using reported earnings). So relative to historical averages, the question in both the US and Australia may be framed as one of "to what extent should we expect valuation multiples to contract and how much of that can be covered by growth in earnings?"

But we can throw another variable into the mix - equities' valuation relative to bonds. The Australian 10 year government bond is now priced on a yield of 1.19%, down from 1.53% at June 30 and way off its long-term average of 4.9% (over 27 years of data) and its 2.6% average for the past decade. The Earnings Yield (Earnings / Price) is the inverse of the PE and allows us to compare equities with bonds. Currently investors receive a spread of 3.2% as compensation for taking on the risk of equities - and that is significantly greater than the long-term average spread of 1.4% BUT lower than the 3.67% average over the last decade.

Figure 1: Historical end-of-month bond yields and the spread to the S&P/ASX All Ordinaries earnings yield



Source: Iress, Equitable Investors

What isn't clear is the extent to which earnings growth can bridge the gaps between current and historical average valuation metrics in order to support prices.

Sections of the equity market have become lazy "beta" grazers (using index funds and ETFs etc) or speculators riding momentum - and both have done well in recent years, reinforcing belief in these approaches. Both strategies will ultimately confront the valuation question. We think nimble investors can instead construct focused portfolios consisting of companies that aren't hyped up, analysed to death or simply floating on the passive investment bubble to higher valuations. Regardless of whether large cap equities face headwinds, we see plenty of scope, largely among smaller companies, for valuation upside driven by execution of strategy and opportunism.

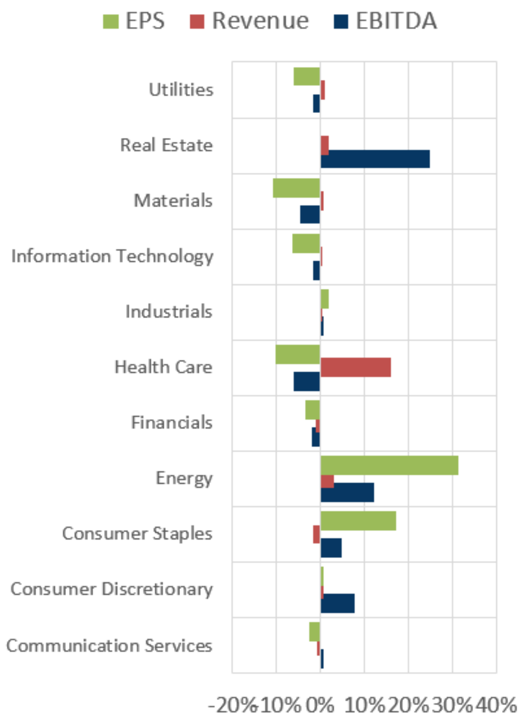
Reporting Season

That brings us to the ASX's profit reporting season - a four-and-a-bit week bombardment of earnings announcements and zoom presentations through August.

Quarterly cash flow reports released in recent weeks have set the stage for a reporting season where the valuation question should be front and centre. At some point businesses have to start validating valuation with performance. Meal kit company Marley Spoon (MMM) had been a COVID-19 "lockdown" darling but came up short with its quarterly and has been punished. Its share price fell just over 30% in July and has fallen further in August. MMM had reported "impressive sales growth (+10%, +12% cc, +41% underlying) offset by higher costs", according to Wilsons. The broker downgraded its FY23 EBITDA forecast for MMM by 90% to $1.9m from $18.7m. MMM's Enterprise Value (EV) had peaked at ~ 1.5x analysts' revenue expectations in February but is now 0.9x.

Earnings estimates have been gently rising as analysts get more bullish. In our "FIT" universe of micro-to-mid caps we saw EPS estimates increased by a median of 0.4% during July, with 17% of companies with analyst coverage receiving upgrades compared to 14% suffering downgrades..

Figure 2: "FIT" Universe FY21 estimate changes in July by sector average



Source: Sentieo, Equitable Investors

The Energy sector experienced the strongest average uplift in earnings expectations - for our "FIT" universe this primarily means service providers rather than explorers and producers. Fuel refiner and retailer Viva Energy (VEA) reported a 34% recovery in June half-year EBITDA as its refining margin expanded and volumes recovered.

Downgrades in the Materials sector within the "FIT" universe are not mining related. The largest impacting on that sector was for wood chip exporter Midway (MWY), which in late May provided earnings guidance but warned there was a timing risk relating to a shipment due to be loaded late in June. Pro-Pac Packaging (PPG) and crop chemicals business Nufarm (BUF) were others in the sector to have analysts downgrade forecasts for FY21.

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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STOCK SWAP

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.