

Quality Compounders

Q4 FY22 Investor Update



12th July 2022

"If you wait for the robins, spring will be over" – Warren Buffett

QUARTERLY COMMENTARY:

The Quality Compounders team (Sam, Alex, Lachlan, and Shaun) are all personally invested heavily in the stocks we recommend, and we are more passionate than ever to find and learn about new businesses and meet with founders. We love doing what we do, and we thank you for trusting us to manage your capital, we will continue working as hard as we can to get you better results over the long term.

The portfolio returns for Q4 FY22 ended June 2022 was -22.3% vs the index which was -11.9%. This resulted in the FY2022 return for the fund of -27.9% vs the ASX All Ordinaries – 6.5%. The return since inception for the Quality Compounders has been +40.5% vs the ASX all ordinaries accumulated producing of +10.5%. The key outperformers for the portfolio for the year were **WiseTech Global +17.6%** and **Mainfreight +5.6%**.

Global equity markets continued to sell off toward the end of June with the NASDAQ falling 22% and the S&P 500 falling 16.5% as inflation forecasts continued to push long term interest rates higher. The US10 yr bond rate has almost tripled from 1.3% to 3.6% during FY22, this has a pronounced effect on the valuations of equities.

Current Portfolio: Top 5 holdings

Top Holdings	% Fund
Netwealth Group Ltd	14%
Pro Medicus Ltd	14%
Lovisa Holdings Ltd	12%
Mainfreight Ltd Common NZS	10%
Objective Corporation Ltd	9%

We thought that given we have discussed the key detractors last quarter we could provide a more detailed insight into the businesses that outperformed throughout the June quarter.



Lovisa Holdings Ltd (ASX:LOV)

We have been investors in Lovisa since their IPO in 2014. It is founder led with Brett Blundy who owns 40% of the stock sitting on the board as Chairman. The business has never raised equity since the IPO and Brett has never sold a share post the IPO. He is a very capable retailer with numerous successful retail investments and businesses.

As a business, the metrics are very attractive, the business operates company owned small format stores (~750sqft) that sell Fast Fashion jewelry (like Zara but selling accessories jewellery). These small format stores produce ~\$1000 in Gross profit per square foot of retail space which is very high. What adds to the attraction with LOV is that the store network can be rapidly scaled with ~550 stores worldwide already and a rapidly growing footprint in Europe

and the USA. Each store only costs ~\$350k of capex to fit out and can pay back this investment in 1-2yrs with a very short ramp up to sales maturity. This all results in a very capital light high returning business.

Our expectations are that Lovisa can build a global network of ~3,000 stores that at maturity can produce \$400M+ in EBIT. These huge forecasts seem unrealistic but by rolling out 100-150 new stores each year this target becomes achievable. If LOV achieved this, we believe they are worth \$75 per share.



Mainfreight Ltd Common NZS (NZSE:MFT)

We made our first investment in MFT in 2018 following a meeting with CEO, Don Braid at MFTs Auckland headquarters. We were immediately attracted to MFTs overtly passionate corporate culture, their founder leadership and capital allocation track record.

We believe MFTs competitive advantage has been developed through years of process improvements and consistently high levels of customer service. Each MFT branch is run as its own business unit, with employees incentivized through a highly simple and transparent 'profit share' bonus scheme - whereby all branch employees from the folk-lift-driver to the branch manager - share in branch profits.

When we first learnt of MFTs profit share incentive scheme, we immediately became very interested in becoming long term shareholders as this is an incentive scheme, we've studied in other high performing businesses such as: Tractor Supply, Cintas, Mars; Les Schwab and GIECO. We consider profit share incentives to be one of the most powerful tools a manager can use – few other things can instill an owner's mindset amongst employees like 'sharing in the company profits'.

In addition to their passionate corporate culture and highly aligned incentive scheme – MFTs business is far higher quality than meets the eye. MFTs branch network offers a physical asset that is difficult to replicate. The benefits of this 'route density' is evident in the EBITDA margins generated within each geography. At the FY22 result, MFTs NZ division generated EBITDA margins of 17% on \$1,114b of sales whilst the Australian division achieved 13% EBITDA margins on \$1,289b sales. Overtime, as MFT 'sells more products to each customer', we expect the route density of their offshore branches to match that of NZ.

We feel MFT has just hit another inflection point in their growth. Logistics is now a 'board room' conversation in most corporations because of the COVID induced supply chain issues. Don Braid's son Jason (who has been in the business for 20yrs), has just been appointed to head up their US division which we believe will be a catalyst for major investment and market share growth in the US ~\$400b logistics market.

THINGS WE HAVE BEEN WORKING ON DURING THE MARCH QUARTER:

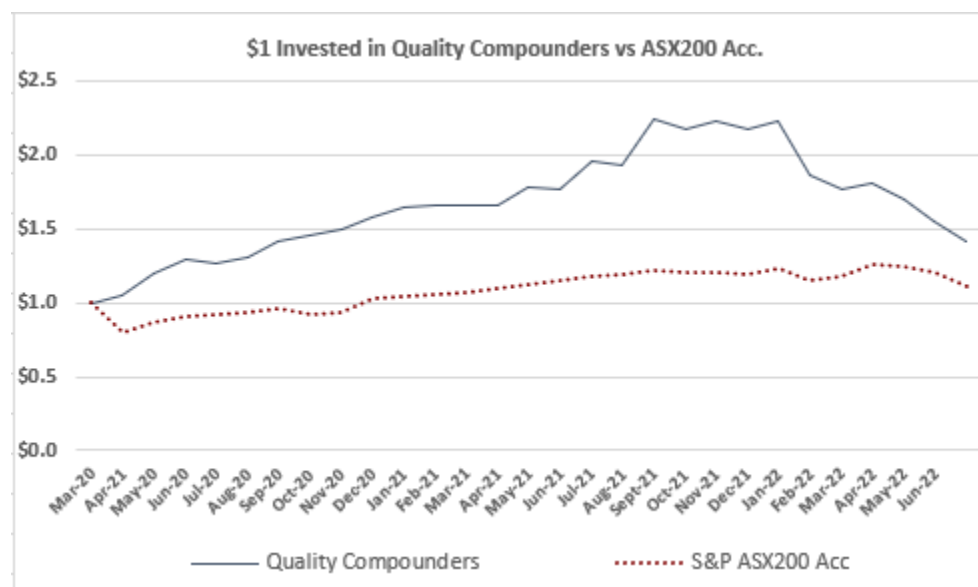
The main project outside of covering the existing Quality Compounder stocks has been a long form study of the best capital allocators around the world – we are using this study to hopefully educate our current and potential CEOs on Warren Buffett's 'guiding principals' of capital allocation. We feel that many founders could dramatically change the businesses long-term performance if they had a better grasp on these key concepts.

The team has been continuing to compound our learning during the quarter with over 20 meetings with Quality Compounder stocks management teams. We also conducted over 100 hours of company meetings with potential new companies.

We are preparing for a trip to New Zealand in late July to attend the Mainfreight AGM and meet with Don Braid and Bruce Plested to learn more about the 100-year vision for Mainfreight. We are also meeting with some more

prospective businesses to invest in, including AFT Pharmaceuticals, Vulcan Steel, Briscoe Group, Winton Land and Rakon Limited. Hopefully we can find some new investments.

Quality Compounders Performance Q2 22



	Jun22 Qtr	FY 2022	Since Inception (1 st Feb 2020)
Quality Compounders:	-22.30%	-27.93%	+40.5%
ASX200 Accumulated:	-11.90%	-6.46%	+10.5%

STOCKS WE ARE WORKING ON:

Johns Lyng is a project manager of building services. Its business is to secure contractual agreements with insurers for disaster recovery events then outsource these projects to a decentralized group of contractors to complete the physical work. JLG project manage the work and add a margin on top. It is a capital light and scalable business model we would like to see management develop their track record further before considering investment.

Harvey Norman has been a founder led business we have not researched before. It meets several criteria including a long ~35yr listed operating history and a strong competitive advantage through its strategic property ownership. It is predominately a franchise business that earns franchise fees from its retailers and owns the underlying property which is strategically located and provides critical security in recessionary environments. Australia has not seen a recession since the early 90's, during these times retailers can cease to exist unless they are unwaveringly strong. Many retailers have no assets and disappear quickly without the trust of their creditors.

STOCKS WE NEED TO STUDY MORE:

Reece continues to be of interest to us, we are eager to see how returns on equity start to ramp up post the Morsco acquisition, it will be very interesting to see this occur over the next 6 months. If the price of REH declined significantly we could accept more uncertainty around Mosco's success but at the current valuation we feel we need a margin of safety in the acquisition price for the uncertainty surrounding such a big acquisition.

PWR Automotive has been on our list for some years, we have met with the founder Kees Weel several times over the past 5 years including at their IPO where we saw their manufacturing facility. Lachlan attended a further site visit during the quarter, and we are continuing more work. The motor sport business line is a niche monopoly however, the key determining factor of their valuation is how fast the emerging technology segment grows, we would like to understand this more and see some more traction before investing. Again, if the valuation declined, we could accept uncertainty around the Emerging Technology segment.

SUMMARY AND OUTLOOK:

This quarter has continued to be quite volatile for equity valuations as interest rate forecasts change so materially and quickly. We believe that equity markets will continue to be volatile for the next 6-12 months as we finally clear through all the additional credit that has been injected into the world economy and supply and demand rebalances for labor and goods. These events are opportunities, they teach us a lot about how to invest for the long term and they weed out the weaker businesses and competitors in industries. Bear markets are painful in the short term but are an important part of a healthy sustainable share market. Having said that we understand how painful this period is for investors that have just joined us. We believe the businesses in the portfolio will continue to grow and rational valuations will eventually follow earnings.

Regards,

Quality Compounders Team

www.qualitycompounders.com.au

This presentation is provided for general information purposes only and is not intended as an offer to enter into any transaction. This information contained in it is not necessarily complete and its accuracy can not be guaranteed. We have prepared this presentation without consideration of the investment objectives, financial situation or particular needs of any individual investor. Before a client makes an investment decision, a client should, with or without Morgans' assistance, consider whether any advice contained in the presentation is appropriate in light of their particular investment needs, objectives and financial circumstances. It is unreasonable to rely on any recommendation without first having spoken to your adviser for a personal recommendation. The information contained in this presentation has been taken from sources believed to be reliable. Morgans Financial Limited does not represent that the information is accurate or complete and it should not be relied on as such. Any opinions expressed reflect Morgans' judgment at this date and are subject to change. Morgans and/or its affiliated companies may make markets in the securities discussed. Further Morgans and/or its affiliated companies and/or their employees from time to time may hold shares, options, rights and/or warrants on any issue included in this presentation and may, as principal or agent, sell such securities. The Directors of Morgans advise that they and persons associated with them may have an interest in the above securities and that they may earn brokerage, commissions, fees and other benefits and advantages, whether pecuniary or not and whether direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities, and which may reasonably be expected to be capable of having an influence in the making of any recommendation, and that some or all of our representatives may be remunerated wholly or partly by way of commission. The presentation is proprietary to Morgans Financial Limited and may not be disclosed to any third party or used for any other purpose without the prior written consent of Morgans. Morgans Financial Limited (ABN 49 010 669 726 AFSL 235410)
A Participant of ASX Group
Principal Office: Level 29, Riverside Centre, 123 Eagle Street, Brisbane QLD 4000
This document has been prepared by Morgans Financial Limited in accordance with its Australian Financial Services License (AFSL no. 235410). The views expressed herein are solely the views of Morgans Financial Limited.