NAOS QUARTERLY INVESTMENT REPORT

Q2 FY23

ASX: NCC | NAOS EMERGING OPPORTUNITIES COMPANY LIMITED
ABN 58 161 106 510

ASX: NAC | NAOS EX-50 OPPORTUNITIES COMPANY LIMITED
ABN 49 169 448 837

ASX: NSC | NAOS SMALL CAP OPPORTUNITIES COMPANY LIMITED
ABN 47 107 617 381

Q2 FY23 SUMMARY

Dear Fellow Shareholder,

Q2 FY23 was a highly eventful quarter with many core investments providing meaningful updates that provided a reasonable indication of their future prospects and execution on their respective strategies. In our view, market participants are very focussed on short-term news flow, and with the current highly unpredictable macro backdrop many investors were eagerly waiting Annual General Meeting (AGM) season and the trading updates that many companies provide at this time.

As an emerging companies fund manager with a particular focus on industrial type business CY22 was a year with little to celebrate. The S&P/ASX Small Ordinaries Index (XSO) fell by -21% for CY22, significantly underperforming its larger counterpart the S&P/ASX-100 index, which fell by just 4%. Industrial business felt the brunt of the correction with small cap industrials down -24% compared to their resource counterparts which fell by just -7% over the same period.

Looking ahead, market consensus still expects 14% earning per share growth over the next 12-month period for small cap industrial businesses. This places the price to earnings ratio (P/E) of these businesses on approximately 19 times forward earnings. It is human nature to expect the best and this is often the case with forward earnings estimates which have trended down each of the last 7 calendar years.

Clearly the macro environment has weighed heavily on investor returns of emerging companies but we believe that many investors are positioned for further weakness in business earnings in the short term. However, should factors such as inflation and interest rates surprise on the downside in CY23, then we are likely to see far more positive equity market returns over the next 12 months.

INVESTMENT PORTFOLIO PERFORMANCE SUMMARY

Investment Portfolio	Q2 FY23 Performance	Q2 FY23 Benchmark Performance^	3 Year Performance (p.a.)	3 Year Benchmark Performance (p.a.)^	Inception Performance (p.a.)	Benchmark Inception Performance (p.a.)^
NCC Investment Portfolio Performance*	+0.22%	+7.54%	+2.51%	+1.38%	+9.57%	+4.79%
NAC Investment Portfolio Performance*	-1.95%	+7.23%	+2.73%	+3.15%	+9.67%	+6.45%
NSC Investment Portfolio Performance*	-4.18%	+7.54%	+4.18%	+1.38%	+2.40%	+3.51%

*Investment Portfolio Performance is post all operating expenses, before fees, interest, taxes, initial IPO commissions and all subsequent capital raising costs. Performance has not been grossed up for franking credits received by shareholders. Since inception (P.A. and Total Return) includes part performance for the month of February 2013 (NCC), November 2014 (NAC) and December 2017 (NSC). Returns compounded for periods greater than 12 months. All figures as at 31 December 2022.
^NAC Benchmark= S&P/ASX 300 Industrials Accumulation Index, NCC & NSC Benchmark= S&P/ASX Small Ordinaries Accumulation Index

NOTABLE INVESTEE COMPANY UPDATES

BIG RIVER INDUSTRIES

ASX: BRI

Q2 FY23 Events: Guidance, Acquisition, Appointment of Managing Director

After registering a remarkable FY22 result, BRI has shown no signs of slowing down from both a financial and strategic perspective. At their AGM, BRI provided a trading update which was again ahead of market expectations, albeit just on Q1 FY23 data. To highlight just how strong the trading update was, if we were to annualise the Q1 FY23 figures it would result in a full-year EBITDA result of $61.6 million and EBIT of $49.2 million. This compares to the FY22 result of $48 million EBITDA and $35.8 million EBIT, or growth of 28% and 37% respectively. For context, the market capitalisation of BRI is $178 million with a last reported net debt balance of $21 million.

A large part of our investment thesis on BRI revolves around the significant opportunity within the cottage industry of trade-focussed building materials distribution businesses. A large number of these businesses have been founded, and remain operated, by owners from the baby boomer generation. These individuals are often faced with a lack of succession options, providing BRI with the opportunity to acquire these businesses, which have significant goodwill across their local customer base due to their longevity. A good example of this occurred in November when BRI announced the acquisition of Epping Timber Joinery & Hardware, which has been operating in Victoria for 57 years. This was a family-owned and founded business where ultimately the business outgrew the family. The business was acquired for a total consideration of $6 million and produces revenues of $16 million. If we assume an EBITDA margin of 10% this implies an EBITDA multiple of 3.75 times prior to any synergies from both a revenue and cost perspective.

In November, BRI appointed John Lorente to succeed current CEO Jim Bindon, effective early CY23. John has been part of the BRI business for over 5-years and currently heads the construction division, the division which is responsible for the distribution of building materials. We are favourably disposed to this appointment for a number of reasons. The most important factor in our view being the culture of the business has the best chance of remaining intact. As the current CEO has been with BRI for 20 years there is always a risk when an external candidate is appointed, especially in a business that is not overly large. We believe this appointment strikes the best balance between keeping the existing culture intact as well as having a sound understanding of how the current strategy is performing and any improvements that can be made.

EUREKA GROUP HOLDINGS

ASX: EGH

Q2 FY23 Events: Capital Raising, Acquisition, Guidance

EGH had a very eventful quarter as the company announced a capital raising to fund two acquisitions as well as a greenfield expansion, whilst at the same time providing FY23 guidance inclusive of the announced acquisitions. The company raised $28.2 million at a share price of $0.47.

As mentioned in our October Investment Report we did not participate in the capital raising even though we were the largest individual shareholder. This was primarily due to what we viewed as a lack of clarity as to how the future strategy of EGH will be funded in a way that maximises value for all shareholders

The EGH business model has the advantage of being a very simple business model supported by long-term structural tailwinds, which is what first attracted us to EGH many years ago. The challenge for management and the board is how they can grow earnings per unit in an accretive way, whilst at the same time scaling the business in a manner that maximises the chance of successful execution given their current staff resources.

Over the past 12 months things have not gone as planned for EGH. Circumstances out of their control have taken their toll, such as the devasting floods on the NSW North Coast, as well as the significant rises in interest rates which has been a significant headwind for EGH considering all their interest costs are variable in nature, with no hedging in place.

Going forward we believe EGH needs to provide detailed commentary on a capital management strategy which will be required to fund their future ambitions. In theory, EGH has several options available to raise capital such as free cash flow, equity, debt, off balance sheet funding and even the use of a funds management model. There has also been significant change across the leadership of the business, with a CEO who was appointed just over a year ago, together with the CFO, Head of Real Estate and a National Operations Manager who have all been in their roles for less than 12 months. The number of new senior hires made over the past year will be integral to the success of EGH going forward.

EGH remains an emerging business operating in a large market with significant tailwinds. If earnings per unit can once again grow at a moderate and consistent pace, then we believe EGH will be rewarded by the market with a high valuation multiple. However, if the strategic execution over the next 12-18 months is poor then we would argue the EGH platform may be better placed under the ownership of other players in the sector.

Towards the end of the quarter, we exited our position in EGH as we felt the opportunity cost was too high relative to a number of other listed opportunities. We remain attracted to the underlying thematic that drives the earnings of EGH and we will be seeking to gain exposure to the thematic via other listed businesses.

BSA LIMITED

ASX: BSA

Notable Event: Sale of APS Division

After what has been a tumultuous 12 months for BSA, the business was able to provide the market with some much-needed good news in the form of a sale of its APS Maintain Division to Fortune 150 company CBRE group for $20 million pre-transaction costs and debt adjustments. We believe that this is an outstanding outcome for BSA as the APS division has historically not been able to produce the same level of profitability as the CUI division within BSA. In FY22, the APS division lost $4 million at the EBITDA level without factoring in its allocation of corporate overheads and lease payments.

Going forward, BSA will now essentially be a business that provides contracting services to the telecommunications and utilities industry. Historically this division of BSA (CUI) has delivered revenue between $244 million and $271 million with EBITDA fluctuating between $8 million and $21 million, prior to any corporate overheads. From a balance sheet perspective, at the end of FY22, BSA had $1.9 million of net debt with a further $15.6 million owed from the settlement of a class action payable in two instalments through FY23 and FY24. Post settlement of the sale of APS, in crude terms we believe that BSA should be on a pathway to a net debt-free position inclusive of the remaining class action payments.

Even after the share price rallying by ~100% through Q2 FY23, the market capitalisation of BSA is just ~$50 million. Assuming the remaining business can return to prior profitability levels, together with a more efficient cost base, we believe an NPAT of $8 million is realistic given the availability of tax losses. Clearly the new BSA is reliant on NBN contracts but it should be a highly cash generative business with options to grow organically and inorganically. Importantly, the industry that they are heavily exposed to has significant tailwinds as evidenced by NBN spending more than $3 billion on upgrading premises with Fibre to the Curb and Fibre to the Premise technology, as well as the 5G rollout and smart-metering technology.

Just over a year ago, NAOS portfolio manager Brendan York was appointed to the board of BSA. We did not take this appointment lightly as we clearly understood the different skillsets required to ensure we could add value for all BSA shareholders. Although still early days, we believe this addition to how we execute upon our investment strategy is already paying dividends and we will continue to consider this approach across any of our current or future investments where we believe a NAOS appointment or independent director could add significant value for all shareholders.

GENTRACK GROUP

ASX: GTK

Notable Events: Full Year Result, Upgraded Guidance

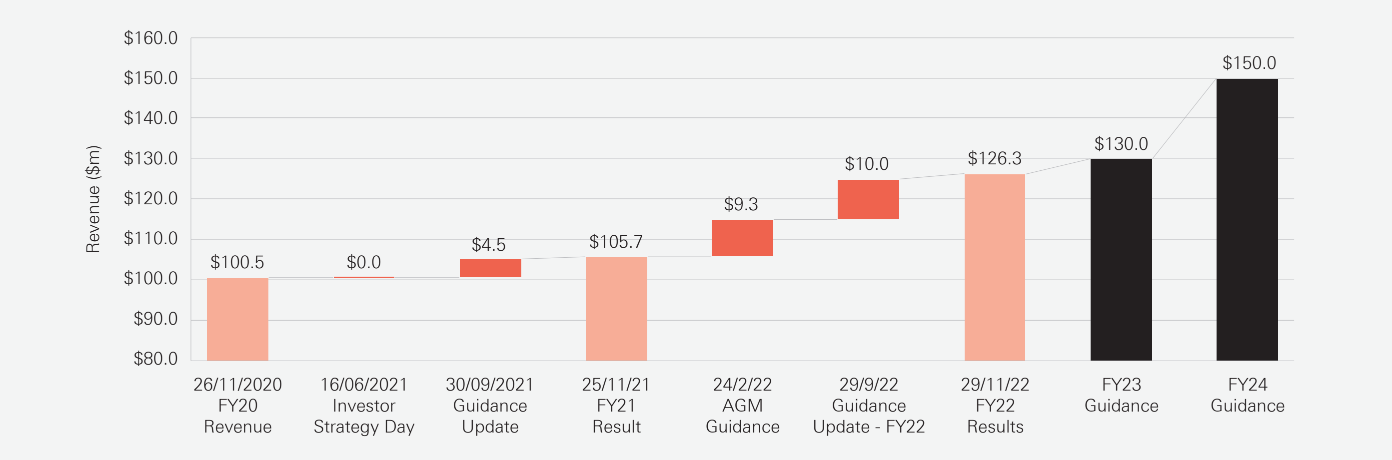
As Gentrack has a September year end, they released their FY22 results at the end of November. GTK has been one of our more recent core investments which was driven by the change of executive team and board at GTK which occurred circa 2-years ago.

GTK upgraded its FY22 guidance prior to release of its full-year results, so in essence the FY22 result was somewhat known. However, on release of the FY22 results, upgraded guidance for FY23 and beyond was provided. Pleasingly, this was a significant upgrade in future profitability expectations as well as the long-term growth potential of the business. Management had previously provided revenue targets out to FY24 over two years ago, but the FY24 revenue target of $130 million was brought forward an entire year to FY23, with FY24 revenue upgraded by 15% to $150 million, as shown in the chart below. EBITDA margins for FY24 were revised to 12%-17% from the original guidance of 15%-20%, as 3% of group revenues will now be spent on global expansion activities outside of GTK's three core markets. What makes the guidance even more exceptional is that GTK will lose circa $26 million of revenue that will roll off over FY23 and FY24, due to customers leaving GTK as a result of insolvency processes associated with the recent energy market issues in the UK. Taking this into account GTK is adding $54 million of revenue over two years on a current base of just $126 million.

We retain a high level of conviction in GTK as a core investment over the next 3-5 years for two main reasons. The first of these is the significant industry tailwinds that exist in GTK's main markets. GTK expect that 25% of all meter points globally will transition to new IT systems which represents a >$1 billion opportunity across ~200 utility companies. GTK has demonstrated recently that it is able to secure new Tier-1 and Tier-2 customers and successfully implement their systems in a seamless manner, which is a key risk for any IT migration.

We also see the current valuation of GTK as extremely attractive. GTK is a business that services customers that operate in highly regulated environments and hence are rather sticky clients. The business has excellent cash flow generation/conversion, and all of its research and development is expensed. This amounted to ~$20 million in FY22, and thus the reporting EBITDA approximates to a cash EBITDA, which is very rare for Australian listed software businesses which generally capitalise R&D expenditure. Finally, GTK predominantly operates in 3 international geographies and is now executing on a global expansion strategy, as evidenced by the recent signing of a large Singaporean utility company. This is also a rarity for an Australian-listed software business as many only operate within Australia and New Zealand. If management forecasts are to prove correct and in FY25 GTK produces $175 million of revenue and an EBITDA margin of 17%, then cash EBITDA for GTK would be ~$30 million. Of note would be the net cash position of the business which could reach close to $50 million. Using Objective Corp (ASX: OCL) as a comparative software business, which has similar attributes albeit a higher level of recurring revenue, OCL trades on 29 times EV/EBITDA. Even if you apply a 30% discount this would result in a valuation of $6.42 / share for GTK based on FY25 targets, which we see as particularly compelling given GTK's current share price.

Gentrack Group Revenue - Guidance & Historical Results



SAUNDERS INTERNATIONAL

ASX: SND

Notable Events: FY23 Guidance, Contract Wins

SND continues to go from strength to strength and Q2 FY23 showed no signs of a slowdown in momentum. In Q2, SND secured two substantial contracts, the first of these being a $9 million contract with Parks Fuels, for the development of extra diesel storage as part of the Federal Governments 'Boosting Australia's Diesel Storage Program'. Although not material in its own right, the client has been issued a grant to build a second facility in Port Kembla with the contract yet to be awarded. We would argue SND has a high likelihood of winning this work given the above. The second contract was a $44 million contract to build the aviation fuel terminal at the new Western Sydney Airport. For context this is the second largest contract awarded to SND in the company's history and represents just the first stage of a two-stage project.

SND also provided FY23 guidance at their AGM, at both the revenue and EBITDA level. Revenue is expected to be between $190 million and $220 million (FY22: $130 million) and EBIT margins are expected to be between 6.5% and 7.5% (FY22: 7.21%). Clearly, SND is going through a period of significant growth when compared to the $66 million of revenue reported in FY20. With this growth comes a significant amount of execution risk, especially as SND is in large part a contracting business. We believe these risks are adequately reflected in the margin guidance, especially as it has been provided some 8 months out from year-end. If execution can continue as planned, and unknown variables such as weather remain benign then we believe EBIT margins may potentially exceed guidance.

Over the past 4 years, Mark Benson and his team have transformed SND from a sub-scale contracting business with a high fixed cost base and a very narrow work focus, to a business that now has scale, provides more complementary services along with its core offering, expanded into select adjacent industries and works with Tier-1 clients with a significant exposure to defence. We continue to believe that if achieved, the FY23 guidance will not just be a flash in the pan but the start of a new base that SND can continue to build upon. The value of live tenders and pipeline jobs continues to increase and now stands at over $1.5 billion, and we expect SND to continue to put itself in the best position possible to secure further large contracts with Tier-1 clients.

Fuel Storage Tank Construction Project, Darwin, NT. Source: Saunders International


NAOS
INVESTMENT
IN FOCUS

BIG RIVER INDUSTRIES

ASX: BRI

OVERVIEW

BRI is a manufacturer and distributor of timber and building products with a market capitalisation of ~$178 million. The business was founded over 100 years ago in Northern NSW and today it has sales of >$400 million via 25 sites across Australia and New Zealand, employing >570 staff. Key to the BRI strategy is the pure focus on trade customers/ clients as opposed to DIY or retail customers. 25% of BRI's revenue is manufactured by BRI, with another 25% directly imported by BRI and the balance sourced from large local supply partners. From an FY22 revenue mix perspective, 41% is related to detached housing, 21% to commercial projects, 15% to multi-residential dwellings and the balance split between three further segments including alterations and additions.

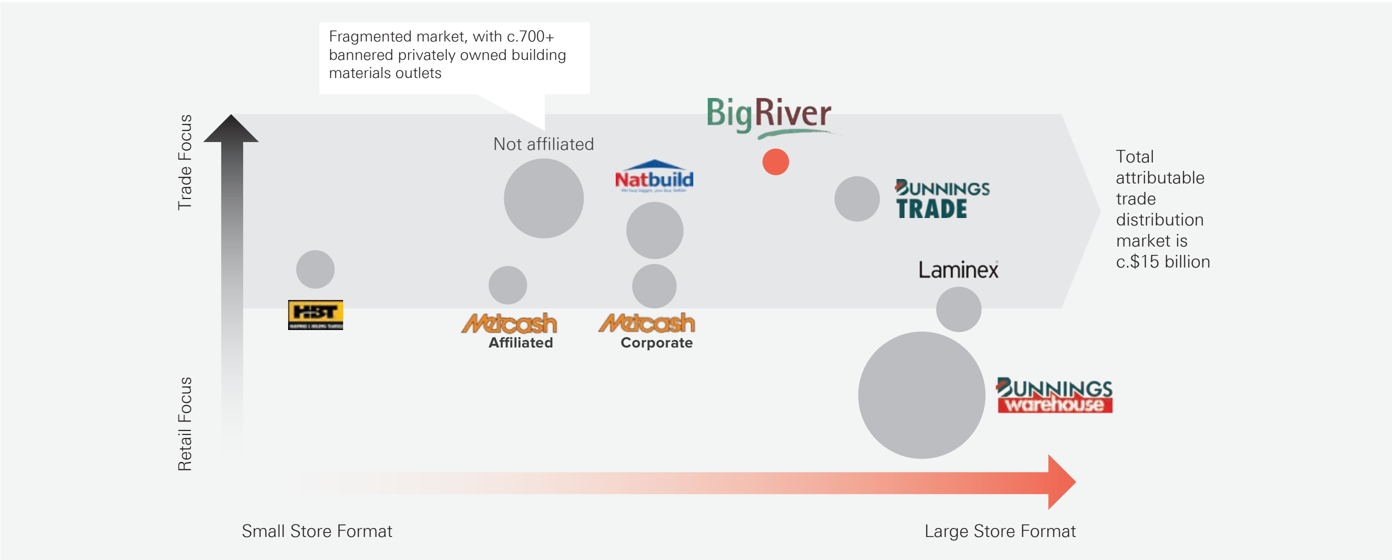
COMPETITIVE ADVANTAGE

The competitive advantage of BRI essentially boils down to two main principles. The first of these is the BRI network of 25 sites across Australia. This allows BRI to service both smaller trade clients, and large clients who have networks across the country and want to rely on a small number of suppliers. Secondly, BRI's scale provides several advantages including a broad stock range which can meet most customer needs, competitive pricing for customers due to BRI's consolidated buying power and finally the diversified supply that BRI can source which generally means customers will not be waiting extended periods for product supply for current construction projects.

INDUSTRY TAILWINDS

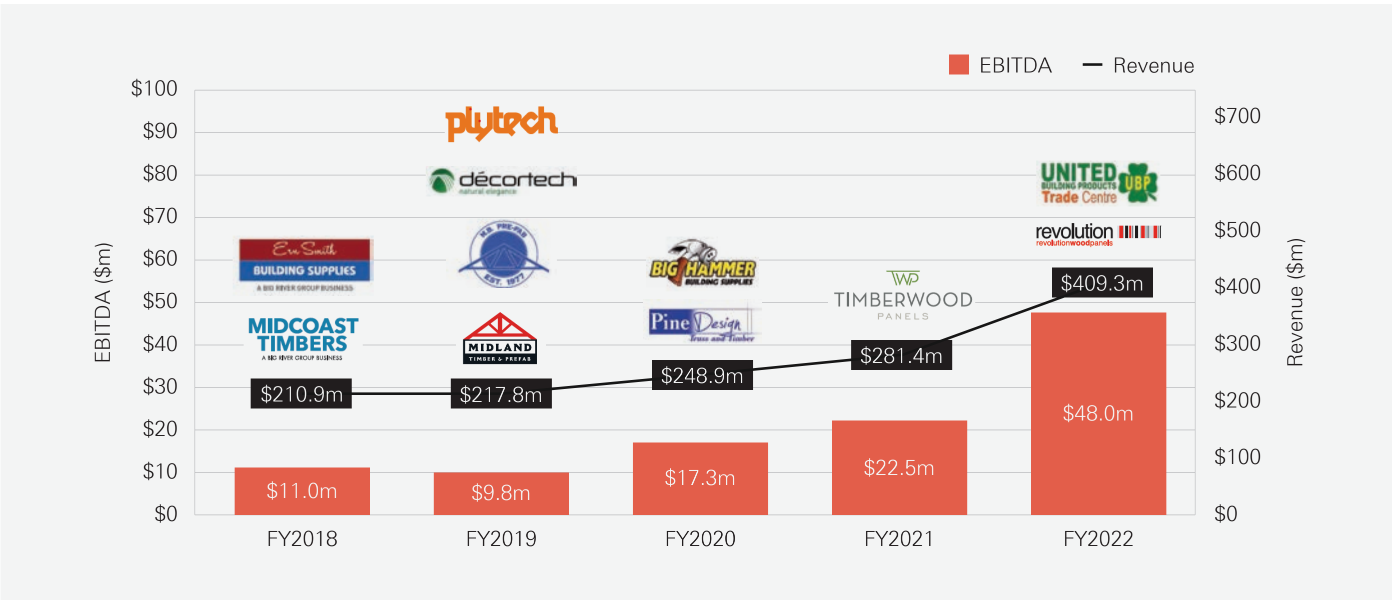
BRI is heavily exposed to construction activity across Australia and New Zealand with a particular focus on different types of residential and commercial activity. The total value of the general trade building supplies market is circa $15 billion in Australia alone and BRI commands a market share of ~3%. We don't profess to be experts on macro-economic conditions but building activity has remained relatively resilient and consistent over the long term, especially as population growth continues to outpace the completion of new dwellings (due to a lack of land) and hence a shortage of homes persists. Importantly, BRI also has a diversified exposure to many of the sectors that make up construction activity (i.e., detached houses, civil, infrastructure, etc) meaning BRI is not overly exposed to any one segment in boom or bust times.

Australian general building supplies market



The other observation to note is that within the trade market for the distribution of building materials there are approximately 700 un-bannered businesses operating that are varied in size but generally owned by people from the baby boomer generation with few succession plans/options. In our view, this should continue to be a fruitful ground for BRI to continue to consolidate businesses that add to their geographic footprint and/or product range, thereby increasing its moat.

Acquisition success a key competence



Source: Big River Industries

MANAGEMENT & ALIGNMENT

As mentioned previously BRI is >100 years old and up until just ~5 years ago was a family business with its headquarters in Grafton, NSW. The unique culture within BRI is what we believe sets it apart from its peers with a very flat organisational structure that promotes new ideas and accountability from all staff members. This has clearly resonated across the group as the average tenure for staff is now ~10 years. Since leading the business from 2005, CEO Jim Bindon will retire from BRI in March 2023 with his replacement coming internally in the form of John Lorente, who has run the construction products division at BRI and has been at the firm since 2018.

From an alignment perspective, Directors and management represent over 65% of all shares on issue, which we believe would be one of the highest on the ASX. Key executives within the Group are incentivised through both STI and LTI plans. The STI plan is an annual cash bonus focused on current year performance to Board-set financial hurdles and personal objectives. The LTI plan provides for performance rights vesting into ordinary shares on the achievement of EPS CAGR % growth hurdles over a 3-year period with further escrow conditions attached following vesting. This promotes long term commitment to the business.

FREE CASH FLOW GENERATION & ROIC

As BRI is predominantly a distribution business, we would expect BRI to convert a large part of its earnings into cash and have a relatively low capital expenditure profile. This has been reaffirmed in FY21 and FY22, where gross operating cash flow conversion to EBITDA was 83% and 89% respectively. Over this period capital expenditure averaged $3.90 million with a large portion related to the one-off manufacturing consolidation project on the closure of their Wagga Wagga site, which took place across 2021 and 2022.

From a ROIC standpoint, BRI's largest exposure on the balance sheet is inventory. The business model requires a relatively high level of inventory, which in slower economic times could potentially lead to a large asset exposure on the BRI balance sheet. Pleasingly over the previous 2-years BRI has been able to manage its inventory balance satisfactorily against a profitability profile which has increased substantially. This has seen ROIC figures increase from just 7.19% in FY21 to 16.26% in FY22. Going forward we believe a low to mid double digit ROIC is maintainable.

Big River Prefab site, Geelong, VIC. Source: Big River Industries

OUTLOOK & GROWTH LEVERS

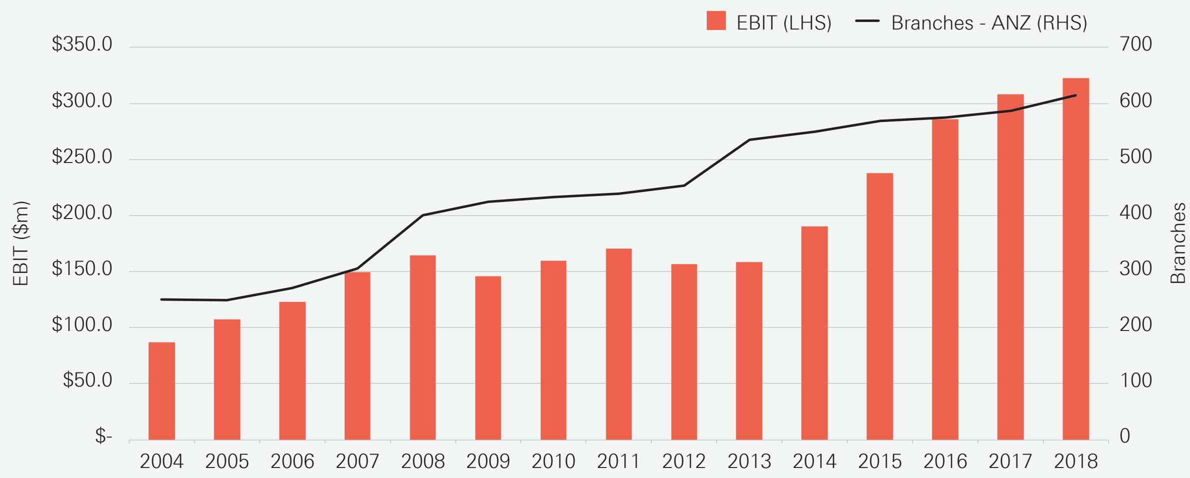
As a small player in a large industry, we believe BRI has a significant runway for future growth both organically and inorganically, just as Reece Plumbing (ASX: REH) and Tradelink did many years ago within adjacent industries. We see no reason why BRI cannot double or even triple its network size over the next 5-10 years, especially as its competitive advantage should only increase alongside the scale of the business.

We expect this growth will be derived from two main sources. The first of these will be organically; not necessarily via store expansion but by gaining more market share through acquisition of new customer accounts. We believe BRI should also continue to gain more wallet share of their existing customer base, as their customer proposition becomes more compelling.

Secondly, we expect BRI to be an active consolidator within the industry especially as there are >750 independent businesses operating across Australia, some with >50-year trading histories and a number with revenue profiles >$100 million. As we said earlier, these owners have few succession options and BRI provides a real alternative that can give these owners certainty over the legacy of their staff and businesses, without a large corporate mentality.

The BRI valuation is clearly factoring in a reduction in future earnings, as the market expects its core markets to reverse as macro conditions become less accommodating for construction-related activities. As we stated previously, BRI is exposed to many construction sub segments that are not overly correlated with each other thus providing a level of revenue stability for BRI over the medium term. As an example, BRI also has exposure to the Renovations and Alterations segment. One reference point for this underlying market is outlined in the below chart, showing how Reece Ltd's (ASX: REH) growth in both EBIT and number of stores has increased consistently over multiple cycles. Reece has a slightly different product mix, specialising in plumbing and bathroom supplies, but operates in a number of similar market segments to BRI and has a parallel strategy in terms of organic and inorganic store roll out. BRI will not be immune from a significant economic slowdown, but we firmly believe the business has numerous levers it can use to grow revenue regardless of the economic backdrop.

Reece Ltd
Historical EBIT and Branch Growth, 2004 - 2018



Source: FactSet


NAOS
OUTLOOK

OUTLOOK

Looking ahead, Q3 FY23 will bring with it half-year (HY) reporting for a significant majority of listed businesses. At NAOS we focus on the long-term outcomes but are aware that short term results form part of much longer-term trends. This HY reporting season will be of significant interest as many investors will be expecting commentary around 2H trading to be somewhat weaker than 1H due to many of the macro factors at play, particularly the significant rises in interest rates over the last 9 months.

As you would expect, many of our core investments are exposed to significant changes in the macro environment but as they are emerging businesses and often only serve a small percentage of their total addressable market, we firmly believe they can offset any softness in the wider economy with internal initiatives that can drive market share growth as well as margin improvement, which over the longer-term should drive significant shareholder returns.

Next quarter we will be paying particular attention to the following updates:

- BRI will release their 1H FY23 result, and after producing a stellar Q1 FY23 trading update it will be interesting to see if this has continued. If the momentum has continued into Q2 then this would imply that BRI is trading on a very undemanding multiple of <8 times P/E which we believe undervalues the business by >50%.

- SND has previously provided guidance for FY23, but successful execution on their large project in the Northern Territory (NT) is critical. Any clarity on the progress of this project will be key, especially as it is the wet season in the NT. Again, and like BRI, if management can execute on a solid 1H result as per the FY guidance then it would imply SND is also trading on an undemanding multiple. SND also has a large cash balance on its balance sheet, providing it with significant optionality for M&A opportunities.

- Maxiparts (ASX: MXI) will also release their half-year results, and as this will be the first set of financial results without any one-offs relating to the legacy operations, there should be a far clearer view of the potential of the MXI business. Listed comparable Supply Network Limited (ASX: SNL) reached record highs in December, highlighting the strong demand dynamics they are seeing, which we also expect MXI to experience. We also believe MXI is trading on 50% of the valuation that SNL trades on when taking an 18-month view.

- BSA should have completed the sale of their APS division by the time the HY results are released. This will place much greater emphasis on the performance of the CUI division as it becomes the majority of BSA's earnings going forward. As both FY21 and FY22 were affected by COVID-19, we will be interested to see if the earnings profile of the CUI division has changed so far in FY23. If the CUI division has reverted to its historical norms, and together with the significant tax losses BSA has on its balance sheet, BSA could be trading on a mid-single digit P/E, with little net debt.

The NAOS team thanks all of our fellow shareholders for your continued support and for entrusting us with your capital.

Kindest regards,

Sebastian Evans

Managing Director and Chief Investment Officer,
NAOS Asset Management Limited

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