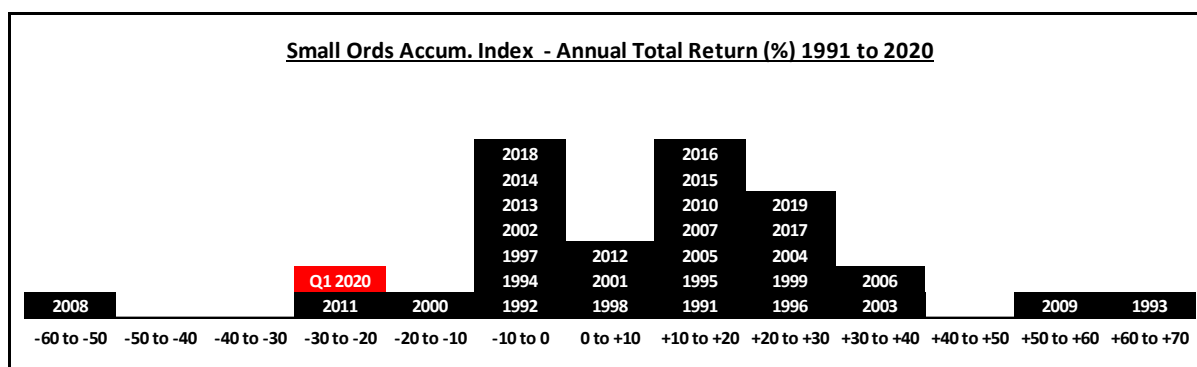


**Celeste Australian Small Companies Fund  
March Quarter 2020 Market & Portfolio Update**

**April 4<sup>th</sup> 2020**

In March 2020 a new term entered the common lexicon, ‘Covid-19’. It’s not often you can rightly feel that you are a witness to a moment in history but we are in fact living in that moment. From a Celeste perspective, Covid-19 has had a dramatic impact on our portfolio and reminded us that investing in small companies means that you experience volatility, as has been the case historically, and as is graphically illustrated in the histogram below.



Source: Celeste Funds Management

In March, the pace of equity market declines around the world has been amongst the worst on record. The Australian Small Companies Index has not been spared, having fallen 22.4% in the March 2020 month. The intra month low was a testing decline of 42.5%. For the March quarter, the Celeste Australian Small Companies Fund fell 30.7%, compared to our benchmark the S&P / ASX Small Ordinaries Accumulation Index, which dropped 26.7%. For the 12 months ended March 2020, the Celeste Australian Small Companies Fund has declined 19.4%, compared to the 21% decline in the Small Index.

The small cap market sell-off in March has been broad-based, all companies have been sold off, irrespective of fundamental traits, as investors moved aggressively into cash. The indiscriminate selling is typical of markets in panic mode.

Whilst the Covid-19 playbook is to be written, we would like to provide you with our observations and let you know how we will use our investment process to navigate the investment storm we are likely to experience for a period.

Covid-19 means that equity markets around the world have entered a period of significant volatility. The virus has effectively brought the global economy to an immediate stop, a situation that is without historic precedent. Given the elevated level of uncertainty, investors are currently anxious and susceptible to bouts of panic as the pricing of all risk, across all asset classes globally, is being reassessed.

The uncertainty in determining a point when a higher level of certainty emerges, all leads to volatility in the pricing of equities, both big and small.

Credit markets are prone to contract whilst virus infection rates rise and access to liquidity will remain an ongoing concern. The concept of 'credit rationing' will be introduced to a generation of investors with no previous knowledge of the concept. Equity markets will continue to suffer as earnings evaporate and historic valuation metrics lose their validity. The analyst's toolbox is poorly equipped to deal with the global pandemic as it has no modern historic frame of reference for what pandemic means in an interconnected, digital, 'just in time' world. Corporate solvency issues will emerge, the frequency of capital raisings will increase and often they will have a healthy hint of urgency about them.

As we have said repeatedly, having a robust investment process is critical to investing in small companies. The focus on process is especially so, in times of acute volatility, where earnings surety is minimal, and where equity markets are in panic mode and risk averse. An understanding of a company's business model, people and balance sheet dynamics will differentiate between stocks that will thrive in a post Covid-19 world, and those that will not.

Below is the "Celeste Covid-19 Check List" of key factors that we will use to guide our thinking, analysis and stock selection over the coming months.

#### **ACCOUNTING:**

- Comprehend the balance sheet dynamics of businesses. This is paramount when credit markets are dysfunctional and access to funding is critical.
- Understand what the working capital traits of a business are in moments when likely demand and sales are totally unknown.
- Understand the working capital stresses that may emerge as a business contracts due to Covid-19 and, critically, how it will fund its growth once Covid-19 has passed.
- Understand how balance sheets are structured and if the structure is tenable in an environment where demand is impossible to predict for a period.
- Reacquaint yourself with the concept of credit rationing.
- Consider the extent a business is dependent on external funding. What is the structure of that debt and who are the parties that provide it?
- What is their geographic base and bias of the financier, are they a tier 1, tier 2, or tier 3 debt provider?

- Now that the AUD has declined significantly against the USD, some 15% in March alone, understand where risk may exist as hedges roll off and where pricing power is minimal.
- Understand what risk may exist with a business when it's purchasing is in AUD and they have a customer base habituated to buying around fixed price points.

Earnings are totally impossible to predict for both FY20 and FY21. As an analyst, dust yourself off and stop obsessing about it. As someone responsible for the hard earnings of your client base, focus on those companies that can survive, pass through the eye of the storm and benefit from an altered competitive dynamic and sectoral disruption in the medium term.

### **BUSINESS MODEL:**

- Focus on the businesses that you are confident can navigate unprecedented challenges to their sales/demand outlook.
- Examine how the business has operated in historical periods of economic dislocation, understanding its durability, its 'muscle memory' of hard times.
- As it is impossible to determine sales and revenues in the short term, move your focus to identifying the drivers of demand. If you clearly identify the sources of demand at a company you will be better equipped to understand the potential sales improvement in that company in a post Covid-19 world.
- Consider the inventory dynamics of the business, how easy is it to wind inventory down, and wind inventory up.
- How well placed is the company to fund its sales growth in a post Covid sales environment, having worked diligently to squeeze cash out of the business as Covid-19 hit?
- Is supplier risk concentrated, or are there multiple suppliers? Will the supplier survive an unprecedented level of global order cancellations? Is the supplier a listed or unlisted company?
- How long has the company been in operation? Does the company have a history of dealing with recession, operational unknown, crisis in its customer and supplier base, funding markets ceasing up?
- Is the cost base of the business fixed or variable, how much plasticity is there in the cost base?
- Remember that Return on Equity, Return on Capital Employed, Gross Profit Margin, and both Cash Flow and Free Cash Flow, can all be useful indicators of a company's underlying quality.
- Will the company benefit from any sectoral disruption/consolidation?

## **PEOPLE – EXECUTIVE & BOARD:**

- Focus on Management & Boards with history of navigating challenging economic environments.
- Is the business founder-led, is there alignment in the executive and shareholder base?
- Understand how the management are dealing with employees and suppliers as the true character of individuals is often more observable when times are tough.
- Assess how management are dealing with the employee base. Is the executive focus inappropriately weighted to the short term, with little consideration given to the long game? How employees are treated when times are tough can build long term loyalty and commitment to a company. This is true goodwill that is irreplaceable.
- Are you investing in a business where the Management & Board have lived and survived extreme environments or one where there is minimal history and no substantive corporate playbook?

Whilst uncertainty is the norm at present, we must ensure that we don't lose sight of the fact that some things are changing and are known. We know that the response from Central Banks and Governments around the world has been swift, decisive and without precedent. Central Banker initiatives and Government stimulus are gradually coming to grips with the coronavirus pandemic, its severity, societal impact and economic fallout. Whilst at this point optimism is a rare commodity in investment markets, we believe that one need maintain some balance and perspective, as without these traits an ability to create wealth over the long term as an investor is limited. It is volatility and uncertainty that creates market mispricing opportunities.

The words of the Rudyard Kipling poem "If", seem terribly appropriate for a Covid-19 world. We have taken the liberty of providing the poem, in its entirety, below (*acknowledging that this is not common practice for an investment quarterly newsletter and that the final lines should refer to women as well as men....it is a product of its time*).

We hope that you, your family and loved ones stay safe and healthy.

Frank Villante  
CIO / Portfolio Manager  
Celeste Funds Management  
April 4th 2020

## IF

### RUDYARD KIPLING

If you can keep your head when all about you  
Are losing theirs and blaming it on you,  
If you can trust yourself when all men doubt you,  
But make allowance for their doubting too;  
If you can wait and not be tired by waiting,  
Or being lied about, don't deal in lies,  
Or being hated, don't give way to hating,  
And yet don't look too good, nor talk too wise:

If you can dream—and not make dreams your master;  
If you can think—and not make thoughts your aim;  
If you can meet with Triumph and Disaster  
And treat those two impostors just the same;  
If you can bear to hear the truth you've spoken  
Twisted by knaves to make a trap for fools,  
Or watch the things you gave your life to, broken,  
And stoop and build 'em up with worn-out tools:

If you can make one heap of all your winnings  
And risk it on one turn of pitch-and-toss,  
And lose, and start again at your beginnings  
And never breathe a word about your loss;  
If you can force your heart and nerve and sinew  
To serve your turn long after they are gone,  
And so hold on when there is nothing in you  
Except the Will which says to them: 'Hold on!'

If you can talk with crowds and keep your virtue,  
Or walk with Kings—nor lose the common touch,  
If neither foes nor loving friends can hurt you,  
If all men count with you, but none too much;  
If you can fill the unforgiving minute  
With sixty seconds' worth of distance run,  
Yours is the Earth and everything that's in it,  
And—which is more—you'll be a Man, my son!

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