DMX Australian Shares Fund

January 2024 – Investor Update

A wholesale unit trust managed by:
DMX Asset Management Limited
AFSL 459 120
13/111 Elizabeth Street, Sydney, NSW 2000
Trustee & Administrator:
Fundhost Limited AFSL 233 045

Unit price (mid) based on NAV (31 December 2023)	**$1.0132**
Unit price (mid) based on NAV (31 January 2023)	**$1.0405**
Number of Stocks	41
% cash held - month end	4%
Fund size (gross assets)	$11m

1-month return	2.7%
3-month return#	7.8%
12-month return#	0.1%
Since inception (1 March 2021, p.a.) #	5.3%
Since inception (cumulative) #	16.3%

 # Returns assume reinvestment of distributions.

Dear Investor,

DMXASF's NAV increased 2.7% for the month of December, continuing its recent recovery and ahead of the broader market which itself was very mixed with the ASX 200 Total Return Index up 1.2%, but the ASX Emerging Companies Index falling 5.2%.

Commentary

Detractors this month included **Careteq** and **EDU Holdings**, each falling 14%. Careteq reversing some of its prior gains as this thinly-traded nano-cap bounces around on not very much; while EDU languished in a challenging environment where for-profit educators are only very slowly recovering student enrolments. Field Solutions too continued its decline, falling a further 10% in the wake of its poorly-received debt raise. **Frontier Digital** reversed some of its recent recovery, declining 15%, while retailer **Michael Hill** fell 8% on the back of a guidance downgrade. Retail's tough. Finally of note, **SOCO Corp** fell another 10% following its December trading downgrade.

Positive contributors though more than offset the declines, with **EML Payments** up 13% following the resolution of its disastrous Irish operations, while **Kip McGrath** rose 10% for no particular reason. **MedAdvisor** rose 30% in anticipation of a positive half-year report. The stand-out was **Findi**, the Australian holding company of a majority stake in an Indian ATM & fintech enterprise – up 57%. Findi had a substantial option exercise event in January with many investors selling some shares to fund the options exercise. This saw the shares fall from the $1.10-$1.20 zone in November to very near the 90c option exercise price. With that overhang cleared, focus has returned to its underlying fundamentals which appear very favourable, and saw the shares rise to $1.62 at month-end.

Activity

With the smaller company segment of the market having been so neglected in recent times, we're looking very closely at all our portfolio exposures as we seek to direct capital to the most compelling of an expanded opportunity set. With so little cash to put to work, and so many opportunities both within the portfolio and in our pipeline of prospects, it's a happy problem to have, but still a problem. Takeover activity has helped mitigate the problem, with **Cirrus** proceeds providing liquidity. We banked **Shriro**'s capital return in January, and have further trimmed our position here into continued subsequent price strength. Shriro remains an attractive holding for its cash generative nature and now much lower reinvestment risk profile, having returned its surplus cash to shareholders. But growth isn't obvious and other opportunities are taking preference.

These funds have been useful as we've recently established two new small positions (each of which have low liquidity and we continue to seek to add to), and have continued to add to our **Fiducian** holding, bringing this to a fuller 4% portfolio weighting. Most meaningfully, we exercised our Findi options this month, bringing the position to a full 5% weighting which has expanded to over 8% at month-end. This sizing is a little unusual for us but we're broadly comfortable given the value on offer even at these higher prices, and the strong operational execution & momentum the business is enjoying. We expect to trim to control sizing not too far from where it is now, but believe it's useful to highlight as we might expect a little more than usual volatility to the fund in the event of material movements to such large positions' stock prices in the short term.

The DMX Capital Partners report's theme this month is the challenge many companies are facing in needing to achieve or maintain reasonable profitability in the near-term, while seeking to invest heavily for long-term growth and value creation. Three positions – all also owned by DMXASF – are highlighted with commentary included in an Appendix: **Ansarada**, **Knosys** and **Careteq**.

Summary

Despite some trading downgrades with a few key holdings, we're pleased on the whole with developments across the portfolio. Our opportunity set is rich, and we're seeking to be as exposed as we can to the most prospective of these, while adhering to basic portfolio diversification principles. Takeover proceeds, when received, together with selective trimming and exiting are providing a stream of cash which we don't seem able to hold on to, as under-valued existing holdings as well as interesting new names compel the capital. A pleasing environment to be in, and we look forward to playing out the periods ahead with such an attractive backdrop.

If you'd like to discuss the portfolio or the potential to invest or add to an existing investment, please contact Michael any time at michael.haddad@dmxam.com.au or 02 80697965.

Michael Haddad
Portfolio Manager

Chris Steptoe
Research Analyst

Appendix: DMXCP commentary on companies balancing profitability with investing for growth

Ansarada (ASX:AND)

Ansarada is a company we have owned since its IPO in 2020, backed by a thesis that AND can replicate its market dominant position in deal data rooms in ANZ, in overseas geographies. It is a company that has always experienced tension between its investment spend and growing profits. When we initially spoke to Sam Riley, the AND CEO and founder, his view on the growth versus profits dynamic was encapsulated in his belief in the "rule of 40": that is, the sum of revenue growth % and EBITDA margin % should exceed 40. So, periods of strong revenue growth might be accompanied by a lower EBITDA margin and vice versa. However, with a collapse in deal activity in 2022 and 2023, the sum of AND's growth and margins was much closer to 20 than 40, and the market soured on the stock.

In its most recent quarter AND reported positive cash flow from operations of $5.7m, EBITDA margins at 21%, and growth of 10%, so the sum of growth and margins is heading back towards 40. However, the company did note increased marketing spend in the second half, which may impact EBITDA margins. In its outlook AND noted "*We have focused a lot on balancing operational efficiency and investment. This enables us to continue investing in early-stage products, pursuing the significant growth opportunities ahead of us, and maintain the optionality to deliver increased profitability over time*".

With $13.8m of operating cash generated by AND in CY23 (and free cash of $5.1m), at the low point in its business cycle, it would seem that AND is managing that balance between investment and profit in a relatively sensible manner. Given the high gross margins in the business of 95%, intuitively, there should be significant operating leverage within the business, and it makes sense to spend to capture that revenue, but at the same continue to drive margin improvement.

We look forward to seeing this operating leverage start to emerge in a more favourable environment for AND – key leading indicators including deferred revenue and new business wins are all trending higher, and well above current reported revenue growth rates, suggesting an acceleration of growth in future periods.

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Knosys (ASX:KNO)

KNO, which provides knowledge management, intranet and library management software solutions, pleasingly, confirmed the business was now profitable and that it was "*On track to deliver positive EBITDA in 1H FY24 and FY24*". All of KNO's development costs are expensed, so EBITDA essentially represents EBIT. We would expect KNO's full year cash EBIT to be between $500k to $1m, with Q1 EBITDA reported as $200k+. Free cash generated for the first half was ~$600k, with KNO having $3.9m of cash at the end of January (relative to its market cap of $6.2m).

This profit has been generated as a result of KNO taking a real axe to its cost base - operating cash outflows for the half of $4.7m were down 22%, with staff payments decreasing by 28% and marketing payments decreasing by 56%.

But while the business is now profitable, growth has stalled. Although KNO did note two new enterprise wins for the quarter, which should contribute to ARR growth once implemented; and that its level of tender activity remains strong, and the pipeline of qualified leads continues to increase across the business.

With its existing sales team and product investment spend, KNO is targeting 10% organic growth - which is on the modest side. However, as a high margin SaaS company (~90% gross margins), with lowish churn, if KNO can generate an additional $1m in annual revenue (i.e. 10% revenue growth), given the high gross margins, much of that incremental revenue should flow to EBIT, providing costs continue to be controlled. Therefore, even with modest organic revenue growth and given its current cost base, it is not difficult to see EBIT soon growing to $1m+. With the market currently valuing the KNO business at just over $2m, that would put it on a 2x EBIT multiple (KNO has significant tax losses and will not pay tax for several years). As it stands today, it is currently trading on 0.25x its $9.4m ARR.

In our discussions with management, we have, and will continue to, reinforce our view that KNO needs to continue to maintain a high level of cost discipline, ensure that they are getting the most they can out of their existing sales resources, and be focussed on generating increasing profits for the company. Consistent and growing profits is what we would expect to drive a strong market re-rate, particularly from a $2m EV. It is not unreasonable to expect a growing software business with $1m+ EBIT and $10m+ of ARR to have an EV of $15m - $25m rather than KNO's current $2m.

Careteq (ASX:CTQ)

During January we published a blog article on CTQ.

CTQ released its quarterly report, which was in line with expectations, with its operational targets re-affirmed. CTQ's core business, Embedded Health Solutions, (55% owned) continues to deliver free cash flow, and remains on track to achieve its $1.5 million EBITDA FY24 target. CTQ's Sofihub monitoring business continues to grow strongly.

While CTQ is still cash flow negative across the group, we are expecting an improvement from here. Management is confident that the foundations are now in place for profitable growth, with the targeted 15,000+ Sofihub subscribers combined with the anticipated EBITDA growth for Embedded Health Solutions expected to assist the company in achieving profitability leading into FY25.

DMXAM is the largest shareholder in CTQ, and we have made it clear to the company that the focus should be on reducing its cash burn as quick as possible and reaching the breakeven milestone by the end of the financial year as guided. And, if breakeven doesn't occur by then, we suggest CTQ look to sell its unprofitable Sofihub business, where we are aware that there is a natural buyer. Removing the Sofihub drag, and re-focussing on growing the profits from its EHS and HMMR referrals businesses and becoming self-funding, we believe would be well received. And even better if CTQ can increase its share of the EHS business.

Just as important as becoming profitable is then continuing to grow profits. Too many companies that we speak to think that when they reach a breakeven position, they can then put their foot back on the spending pedal as long as they maintain that breakeven result - a mindset that in our view generally encourages cost ill-discipline and poor investment outcomes. We have and will continue to make the point to CTQ Management (and various other management teams that we speak to) that the best way to grow a stock's value is by establishing a track record of consistently growing profits. Management has indicated that they want to get CTQ into the position that it can be paying dividends, which to us is an encouraging mindset in terms of how they are thinking about the future of the business.

With an EV of $3m, and with little success or expectation currently built into the CTQ valuation, we would expect a significant market re-rate when CTQ demonstrates its ability to become self-funding and is no longer perceived to be cum-raise.