SANDON CAPITAL

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28 September 2023

Sandon Capital Activist Fund
Unitholder update

Dear Fellow Unitholders,

After a disappointing calendar 2022, the performance of the portfolio has been much improved so far in 2023. We believe the share prices of a number of investments were unduly punished in 2022 as investors rotated their portfolios aggressively out of small cap stocks into larger, more liquid companies. In many cases, there was little regard for valuation as larger capitalisation stocks became a perceived safe haven from rising interest rates.

Since the start of 2022, when central banks started raising interest rates, the S&P/ASX 200 accumulation index is up 5%. In contrast, the Small Ordinaries accumulation index is down 17%. The Emerging Companies total return index, representative of micro-cap stocks, has fallen even further, down 25% over the same period. These indices are shown below in Chart 1.

Chart 1

Source: Bloomberg, Sandon Capital analysis

Despite the strong relative performance of the S&P/ASX200, on *average*, its valuation does not look overly expensive, trading on a price-to-earnings (P/E) ratio of 15-16x, which is ~7% above the 20-year average. However, this belies the valuations of the underlying constituents of the index, particularly the dichotomy between "*growth*" companies and "*value*" companies. The shares of *growth* companies are trading at a 74% premium to the market, 31% above the 20-year average. In contrast, the shares of *value* companies

are trading at a 56% discount to the market, 10% below the 20-year average. This is shown below in Chart 2 and 3.

Chart 2

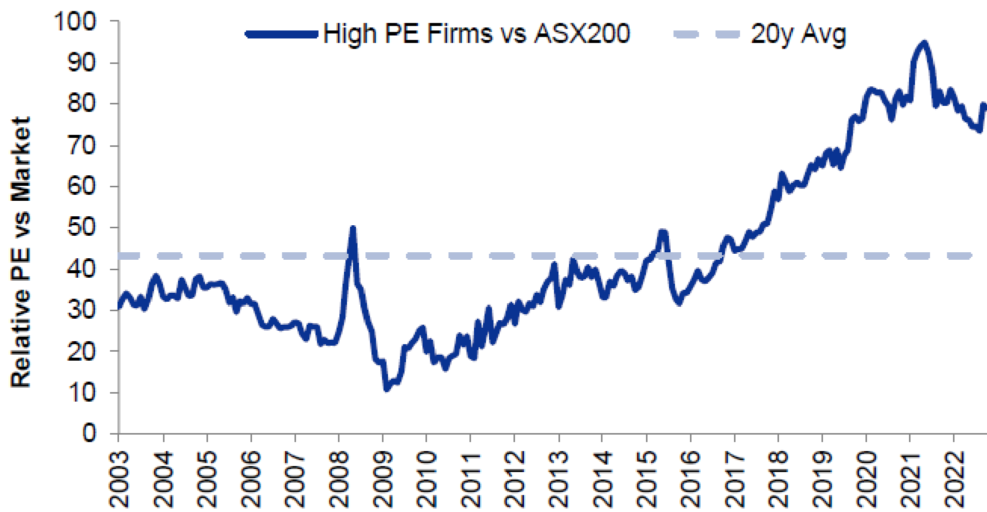
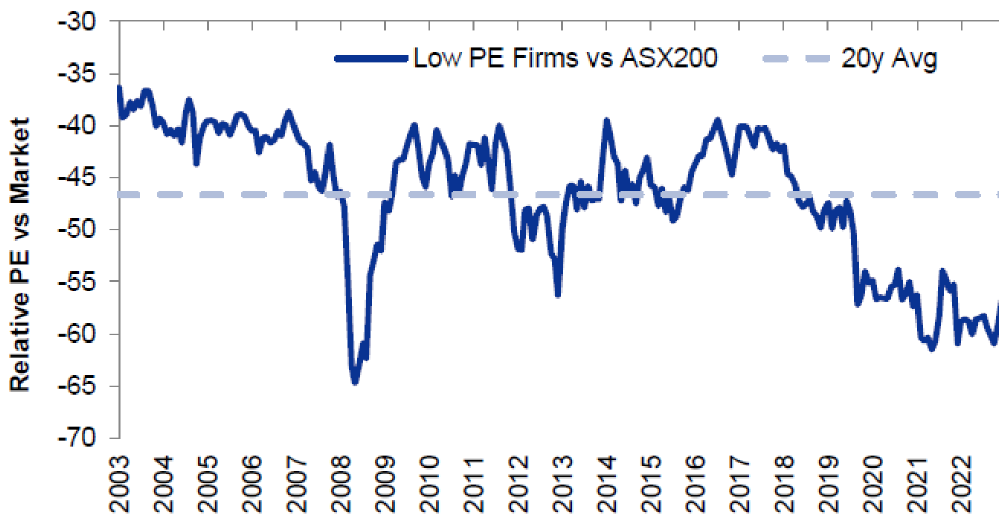


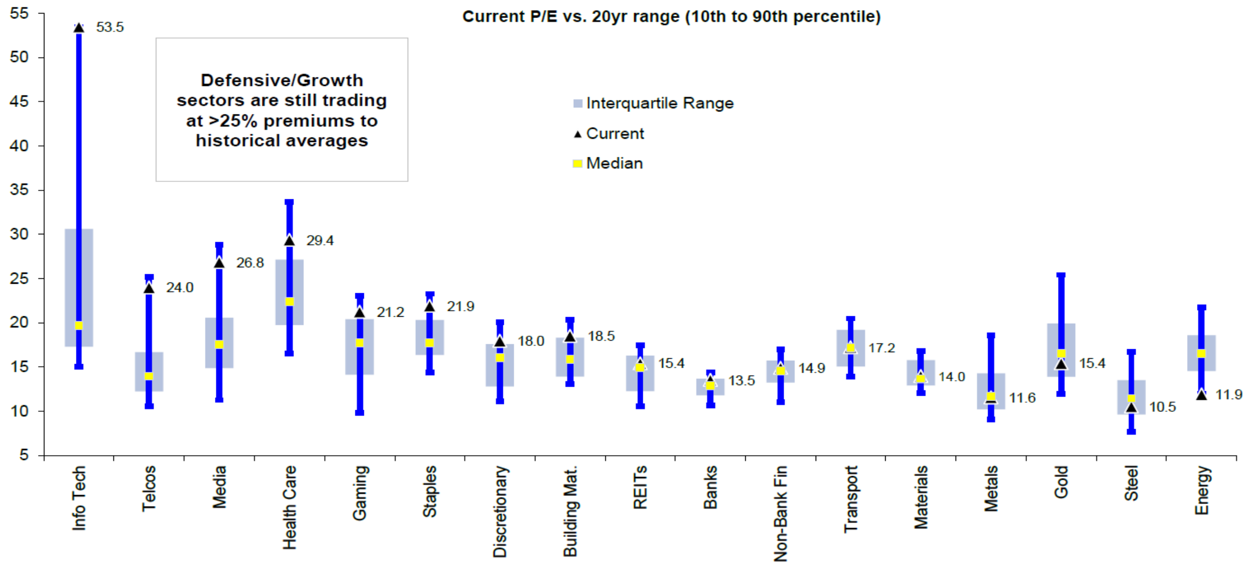
Chart 3



Source: Goldman Sachs Portfolio Strategy research

The high P/E cohort is made up of companies in perceived growth sectors such as Information Technology, Telecommunications, Media, Health Care, Gaming and Staples (i.e. supermarkets). All of these sectors are trading at the top end of their 20-year valuation ranges. It would appear that investors are piling into the shares of companies in these sectors with little regard for valuation, despite the aggressive move up in interest rates over the past 18 months. This is shown below in Chart 4.

Chart 4

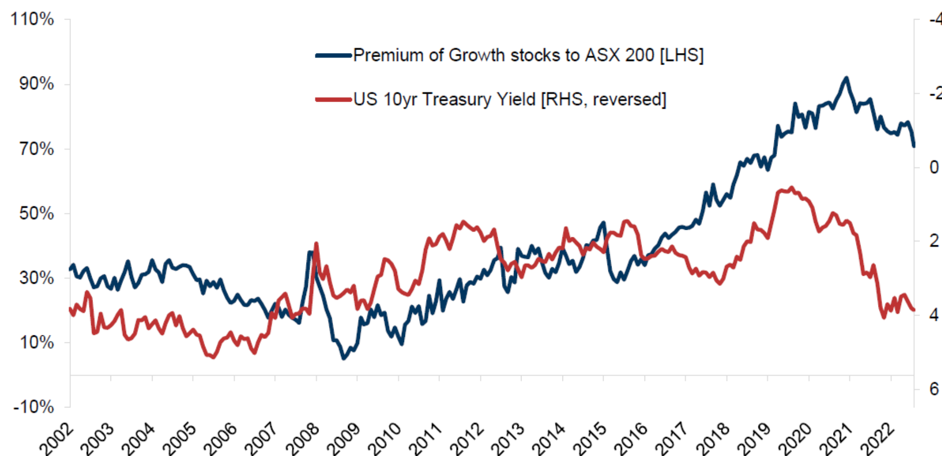


Source: Goldman Sachs Portfolio Strategy research

It is a mathematical fact that rising interest rates have a negative impact on the *value* of an asset, all other things held constant. This relationship applies whether the asset is an equity, a bond or a property. However, the *price* of an asset does not always instantaneously adjust to changes in prevailing interest rates. Nowhere is this more apparent than the multiples the market is willing to ascribe to the shares of growth companies.

In the 12 years following the global financial crisis (GFC), global interest rates headed in one direction – down. This was a boon for most asset classes as investors used a lower discount rate to value the future cash flows from these assets. The shares of growth companies marched relentlessly upwards. Now, as interest rates have returned to 'normalised' levels last seen prior to the GFC, the prices of small and micro-cap equities have been punished more than others. This is illustrated in Chart 5 below. In contrast, growth stocks have been seemingly unimpacted and continue to trade at significant premia to the market. It would seem the market is saying "*this time will be different.*"

Chart 5



Source: Goldman Sachs Portfolio Strategy research

Describing the stocks we don't own, rather than the ones we do, may seem a strange way to introduce this update. However, we do believe it important to address the current landscape for investing in equities. We believe that a high starting point for valuations does not augur well for acceptable future investment returns, particularly in a period where the cost of capital is significantly higher than it has been for much of the past 15 years.

We are not as sanguine as many in the market that interest rates are set to decline over the next 12-18 months. Quite frankly, we don't know where interest rates are headed, however in an environment of low unemployment and stubborn inflation, it would appear to be risky to speculate that interest rates will decline meaningfully in the short to medium term.

It is worth recalling the investing axiom "buy low, sell high." We believe this is an environment that augurs well for the investment performance of stocks that are trading on cheap valuations, generate respectable profits and cash flows and have strong balance sheets. In other words, stocks we can "buy low." Not surprisingly, this is how our portfolio is positioned. Many of our larger exposures have done the hard yards to improve their businesses and look set to deliver solid profitability and cash flows, even if the economic environment deteriorates. Their strong balance sheets put them in a position of strength to take advantage of the current interest rate environment, through generating income on their cash balances, deploying cash into attractive growth opportunities or simply returning it to us via capital management.

In a market that is hypersensitive to trading the next 'data point' as opposed to applying sound financial analysis, many of these companies have been ignored. The stampede away from micro and small cap stocks to liquid, larger cap stocks has not helped. However, in the short term, we expect to be rewarded through capital management initiatives and over the longer term, if the market doesn't recognise the value in these stocks, we are confident that strategic acquirers will.

The 2023 Reporting Season

The most recent reporting season was a good one for most of our investments. Those that have demonstrated consistent operational and financial performance over the past few years continued on that trajectory. Encouragingly, a number of companies that had been dealing with legacy issues, have now put those in the rear-view mirror and look set to reward us with improved performance moving forward. Below we provide some brief comments from reporting season for our largest positions. Combined, these comprise 85% of the current portfolio. All share prices are as at 19 September 2023 and all earnings estimates are broker consensus figures obtained from Bloomberg.

COG Financial Services Ltd (ASX:COG)

Share price	$1.385
Market capitalisation	$264.1m
Net debt / (cash)[1]	($33.6m)
FY24E P/E multiple (ex-cash)	~8x
FY24E dividend yield	6.1%

Sources: Company reports, ASX announcements, Sandon Capital analysis

[1] Proportionate share of unrestricted cash less drawn amount of corporate acquisition finance facility

COG has two business segments – Finance Broking & Aggregation (FB&A) and Funds Management (FM). Today, COG is Australia's largest asset finance broker and aggregator to small-to-medium enterprises (SME) and has a truly national footprint with a meaningful presence in each state and territory. COG's position has allowed it to become more attractive to brokers and customers by offering a wider range of products at more attractive prices.

COG's underlying businesses demonstrated another year of resilient growth in FY23 with core net profit before amortisation (NPATA) up 7%. The most disappointing aspect of the result was the performance of the company's equity accounted investment in Earlypay (ASX:EPY), which performed poorly as a result of risk management shortcomings at EPY leading to a large loss from a single customer. Following Board and management changes, we expect a much-improved performance from EPY in the year ahead.

The cash generative nature of COG's business model was again on show in FY23 with the company paying out a large dividend (current yield >6%), investing in bolt-on acquisitions and increasing its cash balance, which now stands at $56m (proportionate, unrestricted). The company also has headroom under its acquisition finance facility. We believe this sets the company up well to make further acquisitions in the year ahead, increasing its scale and making it even more attractive to brokers and customers. The "network effect" in COG's business is very powerful and the distribution footprint that it has built is almost impossible to replicate.

Fleetwood Ltd (ASX:FWD)

Share price	$1.89
Market capitalisation	$178.2m
Net debt/(cash)	($46.6m)
Enterprise value (EV)	$131.6m
Perth property value	($25.0m)
EV adjusted for Perth property	$106.6m
FY25E P/E multiple (ex-cash, property)	~4.5x
FY25E dividend yield	13.5%

Sources: Company reports, ASX announcements, Sandon Capital analysis

FWD has three business units: (i) Building Solutions is Australia's largest modular builder, (ii) Community Solutions owns and manages accommodation facilities in Karratha (Searipple) and Port Hedland (Osprey) in WA, and (iii) RV Solutions supplies parts, accessories and services to the recreational vehicle market.

After dealing with legacy problems for the past several years, FWD returned to profitability in FY23 and has recommenced paying dividends. There was much achieved in FY23 – the work and commercial close out on all of Building Solutions' major projects is now complete, a higher quality and growing Building Solutions order book has been put in place and a long-dated contract with Rio Tinto is set to underpin occupancy at Searipple for the next four years. We expect these initiatives alone to translate to a strong and growing earnings and cash flow profile for FWD for the foreseeable future.

Furthermore, we believe there are numerous growth opportunities that will augment these base earnings. There is a large backlog of major projects in and around the Karratha region that will require accommodation for workers. Greenfield and brownfield developments in the mining industry will require the construction of on-site accommodation facilities.

Modular construction is becoming more accepted due to its design, cost and time management benefits. We expect the education, retirement lifestyle, affordable housing and defence sectors to provide significant tailwinds over the medium term.

By virtue of the contracted earnings that are in place and FWD's 100% dividend payout ratio, dividend income is expected to be strong for at least the next four years. In addition, the company's net cash position supports investment in growth initiatives or capital management over and above dividends. After

a number of years dealing with legacy issues and resetting the business, we consider FWD is well placed to deliver for shareholders.

A2B Australia Ltd (ASX:A2B)

Share price	$1.57
Market capitalisation	$190.3m
Net debt/(cash)	($13.9m)
Property sale proceeds	($68.6m)
Enterprise Value	$107.8m
FY24 EV/EBITDA multiple[2]	~5x

Sources: Company reports, ASX announcements, Sandon Capital analysis

A2B operates taxi networks and provides taxi payment services. Following his appointment as Executive Chairman in March 2022, Mr Mark Bayliss announced a "*Better before Bigger*" strategy in July 2022. This led to the closure of sub-scale "fintech" initiatives, a new property strategy and a focus on regaining taxis and drivers, the lifeblood of the business.

Following the renewal of the Board and management, the turnaround at A2B has been swift, with the company returning to strong profitability in FY23 after losses in the previous two years. This earnings improvement, combined with the completion of the sale of the Bourke Rd, Alexandria property has allowed the company to declare its first dividend in three years. The settlement of the O'Riordan St, Alexandria property towards the end of this calendar year is expected to result in the payment of a special fully franked dividend of 55cps, equating to more than one third of A2B's current share price. The remaining property in Oakleigh, VIC has been placed on the market, and whilst it is the least valuable of A2B's legacy properties, its sale may also result in additional funds being returned to shareholders (we estimate 5-10cps).

We believe the operating environment for A2B is solid, with the positive momentum seen in FY23 extending into the early part of FY24. The size of the fleet and the driver pool both continue to grow, and the fare increases implemented throughout FY23 will provide a full year's benefit in FY24. The company has guided to a 20% improvement in operating EBITDA, with this being partly offset by incremental rent of $2m following the sale of the O'Riordan St property. With a capital light business model, a strong balance sheet, a renewed focus on profitable growth and an undemanding valuation, we consider A2B is well placed to deliver sustained returns to shareholders.

Global Data Centres (ASX: GDC)

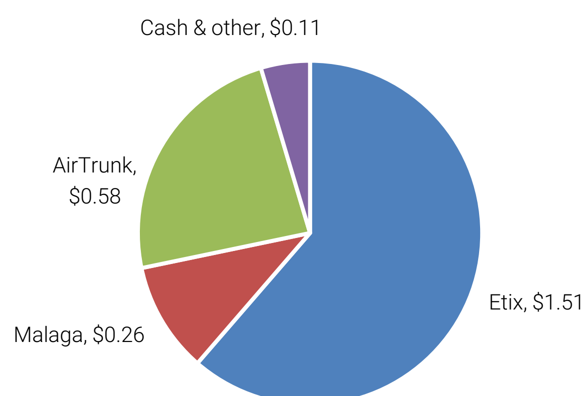
Share price	$1.815
Market capitalisation	$140.3m
Fair value NAV	$2.47

Sources: Company reports, ASX announcements, Sandon Capital analysis

GDC owns a portfolio of data centres in Asia Pacific and Europe. The largest asset is a majority ownership stake in Etix Everywhere (**Etix**), an owner and operator of 10 edge (or regional) data centre businesses in France, Belgium, Colombia and Thailand. The company also owns the Malaga data centre in Perth which is contracted exclusively to Fujitsu, and has a stake of ~1% in AirTrunk, an owner and operator of hyperscale data centres in the Asia-Pacific region.

[2] Based on company guidance of $22m EBITDA in FY24

Breakdown of GDC Fair Value NAV ($2.47/share)



Following feedback from several large investors (including Sandon Capital) and an internal strategic review, GDC announced in April 2023 that it would adopt a focus on "value realisation". Under the new strategy, GDC will seek to realise the value of its existing assets over the medium term through asset disposals. This has also led to changes to the management fee and performance incentives, both of which are aligned with investor outcomes.

The explosion of investment into artificial intelligence (AI) by large cloud providers such as Microsoft, Google and Amazon has seen the valuations of publicly listed hyperscale data centres increase materially throughout the course of 2023. In our opinion, this has not been captured in the reported valuation of GDC's AirTrunk stake and we expect a significant uplift as and when this asset is monetised. Longer term, we also expect edge (regional) data centres to be beneficiaries of the AI boom and this bodes well for GDC's holding in Etix. As assets are monetised over the next two years, we expect the fair value NAV of GDC to approach $3 per share.

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Coventry Group Ltd (ASX: CYG)

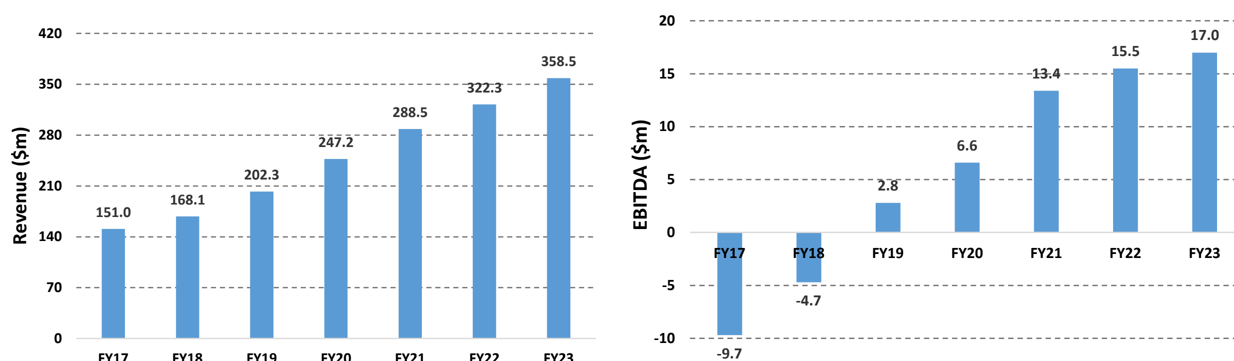
Share price	$1.20
Market Capitalisation	$110.8m
Net debt / (cash)	$33.5m
Enterprise Value	$144.4m

Sources: Company reports, ASX announcements, Sandon Capital analysis

CYG supplies industrial products and services to the mining, infrastructure, energy, manufacturing, construction, agriculture and defence industries through its two divisions: (i) Trade Distribution, which distributes fasteners and other industrial products through a network of 48 branches in Australia and 17 branches in New Zealand, and (ii) Fluid Systems, which designs, manufactures, and supplies hydraulics, lubrication, fire suppression and refuelling systems and products through 15 branches in Australia.

Following changes at Board and management level in 2017, CYG successfully transitioned from operating losses to profits, which have continued to grow strongly in recent years. The Fluids business has seen solid demand from the mining industry and has successfully diversified into other sectors such as agriculture and aquaculture, renewable energy, defence and food & beverage. The turnaround in the Trade Distribution business has been a long, slow grind with business largely rebuilt from the ground up. There have been

significant improvements in culture, people and customer service and the business is now in a position to improve margins, which we expect to drive profit growth at the Group level for the next 3-5 years.



One aspect at CYG that had previously disappointed us was the poor generation of cash flow. Over the last two years there has been an improved emphasis on translating profitability into cash flow and we have been encouraged with the outcomes that have been delivered. Through a sharper focus on managing working capital, CYG is now generating solid free cash flows, and we expect this to contribute to further debt reduction over the next 12 months. As gearing is currently above target levels and the management team is implementing a companywide enterprise resource planning (ERP) system upgrade, we expect larger acquisitions to be off the agenda for the foreseeable future. However, organic growth remains strong, with the company pointing to continued double digit top line growth throughout the early part of FY24. With COVID-driven supply chain issues now in the rear-view mirror and the Trade Distribution rebuild complete, growing revenues combined with margin improvement should deliver continued growth in earnings.

BCI Minerals Ltd (ASX: BCI)

Share price	$0.275
Market capitalisation	$331.7m
Net debt / (cash)	($7.0m)
Investments	($11.9m)
Enterprise value	$312.8m
NTA per share	$0.345

Sources: Company reports, ASX announcements, Sandon Capital analysis

BCI owns a royalty over the Iron Valley (IV) iron ore mine in Western Australia. The company is also developing the world class Mardi salt and potash project in Western Australia, having invested over $370m in the project to date. Mardi is rare amongst resources projects, having an inexhaustible resource (seawater) and requiring minimal capital expenditure once construction is complete and production has commenced.

After announcing in April 2022 that inflation was expected to significantly increase the capital cost of the Mardi project, BCI finally updated the market in June 2023. The capex required to complete the project has escalated by ~60% from ~$1 billion to ~$1.6 billion as a result of inflationary pressures and a redesign of parts of the project. Despite the significant increase in capex, the economics of the project remain attractive, with steady state annual earnings (EBITDA) now expected to be $384 million, up from the previous estimate of $256 million.

Discussions with customers required to underpin the debt financing of the project have progressed with a non-binding, conditional term sheet executed with Japanese company, Itochu, for 3.6Mt of salt offtake in

the first five years of the project. Furthermore, BCI has signed a non-binding memorandum of understanding (MOU) with Indonesian state-owned entity PT Mineral Industri Indonesia for the potential offtake of up to 1Mtpa of salt production as well as a potential equity investment of up to $100m.

Debt funding of the project has been well progressed with the company recently receiving credit approvals for $650m of facilities from key Government debt providers, Northern Australian Infrastructure Facility (NAIF) and Export Finance Australia (EFA). A further $150m in project financing from two leading commercial banks (Australian and International) has also recently received credit approval. The company expects to raise a further ~$180m in project finance to fund Mardie salt, some of which may be supplied by Export Development Canada (EDC) which has provided a non-binding letter of interest to participate. The final piece of the funding puzzle for Mardi will be an equity raising which we expect to be undertaken during the December quarter.

Magellan Financial Group Ltd (ASX: MFG)

Share price	$9.40
Market capitalisation	$1,705.5m
Net debt / (cash)	($375.1m)
Investments	($777.4m)
Enterprise value	$553.0m
FY24E P/E multiple (ex-cash, investments)	~4x
FY24E dividend yield	7.5%

Sources: Company reports, ASX announcements, Sandon Capital analysis

MFG is our latest campaign. The company is an Australian-based global funds manager that invests across three strategies: Global Equities, Infrastructure Equities and Australian Equities. MFG was established in 2006 and became a leading asset management franchise in Australia, especially among retail investors and independent financial advisers. However, investment underperformance as financial markets emerged from COVID-19 and then personnel change led to a loss of confidence and substantial fund outflows.

Today, market perceptions of MFG are negative, and we believe the company to be deeply undervalued and misunderstood. A large portion of MFG's current market capitalisation is accounted for by cash and investments that we consider non-core. We believe this provides downside protection for our investment. In order to stabilise the business, and return to strong long-term profitability, we have made five recommendations to the MFG Board. These include:

(1) Return excess capital to shareholders
(2) Prioritise the existing business
(3) Review the cost base
(4) Provide further Share Purchase Plan (SPP) relief, and
(5) Accelerate Board renewal and improve Board diversity

MFG recently delivered a financial result for FY23 that was in line with expectations. Importantly, the inflated cost base has been addressed which augurs well for future profitability. The company has also recently announced director changes that provide an influx of funds management experience. Our ongoing concern remains the excess capital that MFG is carrying on its balance sheet. The small special dividend declared with the FY23 result does little to placate these concerns. In keeping with our concerns around the hoarding of capital, the CEO and the new Chair seem committed to acquisitive growth; a strategy we do not consider prudent for MFG.

Midway Ltd (ASX: MWY)

Share price	$0.675
Market Capitalisation	$59.0m
Net debt / (cash)	($1.0m)
Net (cash) from plantation sale	($33.6m)
Enterprise Value	$24.4m
NTA per share	$1.41

Sources: Company reports, ASX announcements, Sandon Capital analysis

MWY is one of Australia's largest wood fibre processors and exporters with mills in Geelong, Myamyn, Brisbane, Bell Bay and Melville Island. The company owns 19 hectares of land at Geelong Port and is developing an asset management business specialising in the management of forests and voluntary carbon offsets.

MWY has undergone significant Board and management changes in recent years, and this has resulted in a change in strategic direction. The company has exited its loss-making logistics business, sold its non-core property and forestry assets, and embarked upon a grain strategy to defray the burden of the take-or-pay agreement for the ship loader at Geelong Port. Regulatory approvals have resulted in significant delays in the implementation of the new strategy, with the grain strategy still yet to be delivered. If and when complete, the path becomes clear for the company to return a large amount of capital to shareholders and focus on its medium-term objective to build a forestry and carbon management business.

Despite the disposal of non-core assets and a turnaround in operational performance, an improvement in MWY's financial performance has yet to be seen due to a cyclical downturn in Chinese fibre markets and the adverse effects of currency hedges put in place by previous management. We estimate the currency hedges have cost the company in excess of $30m in pre-tax profits over the last 2-3 years. These currency hedges have now rolled off, with MWY no longer having to sell its products at an effective rate A$/US$ exchange rate well above 70c, and we are also starting to see the emerging signs of a recovery in Chinese fibre markets.

MWY's nascent asset management business is cornerstoned by one of the world's largest insurers, Munich Re. In addition to earning management fees for land/plantation services provided to Munich Re, these plantations will also be valuable sources of timber for MWY's underutilised mill at Geelong. Longer term, we believe MWY should sustainably generate annual free cash flow of $15-20m (vis-à-vis the current enterprise value of <$25m). In addition to the proposed 19.5cps special dividend that MWY has flagged, we expect these strong cash flows to enable other capital management opportunities.

IDT Australia (ASX: IDT)

Share price	$0.062
Market Capitalisation	$21.8m
Net debt / (cash)	($6.7m)
Enterprise Value	$15.0m
NTA per share	$0.069

Sources: Company reports, ASX announcements, Sandon Capital analysis

IDT owns strategically valuable (and underutilised) pharmaceutical manufacturing assets in Melbourne.

In September 2022, the company announced the departure of its CEO. This was followed by significant changes at Board level with two directors retiring, making way for two new directors, Mark Simari and Geoff Sam. Both Mark and Geoff are experienced and accomplished professionals in the health care space. Mark Simari became the new Chairman at the end of the 2022 calendar year.

The strategy at IDT has been reset, with new CEO, Paul McDonald, focusing on the legacy active pharmaceutical ingredient (API) market as well as two growth opportunities: i) Advanced Therapies – fast growing mRNA and cancer-targeting antibody drug conjugation (ADC) technologies, and (ii) the burgeoning medicinal cannabis and psychedelic markets to treat mental health problems

Having run down its capital during the COVID-19 era and with limited revenues, we recently supported a capital raising undertaken by IDT that underpins the new strategy through a capital expenditure program and investment in working capital. The company is well placed to take advantage of the plethora of growth opportunities in front of it and we look forward to the new Board and management team returning the company to profitability in an expedited fashion.

We hope this letter has provided you with a better understanding of how our major investments are performing operationally and financially as well as the financial market context that explains why their share prices do not yet reflect their intrinsic values. We remain confident of the medium-term prospects for the current investments in the portfolio.

We have now been applying our investment approach for more than 14 years. The table below shows calendar year returns for SCAF since inception. We believe our approach of sound financial analysis combined with activist techniques to preserve or enhance value, will continue to deliver satisfactory results for our investors. At this point, we're obliged to remind you that past performance is no guarantee, nor indication of, future returns.

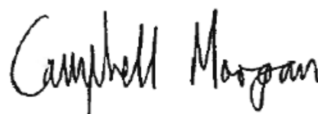
Annual Returns (unless otherwise stated)	**SCAF**	**S&P/ASX200 Accumulation**	**Small Ords Accumulation**
4 September 2009 to 31 December 2009	5.0%	11.0%	11.3%
to 31 December 2010	14.5%	1.6%	13.1%
to 31 December 2011	7.8%	-10.5%	-21.5%
to 31 December 2012	11.1%	20.3%	7.0%
to 31 December 2013	27.1%	20.2%	-1.1%
to 31 December 2014	16.7%	5.6%	-3.8%
to 31 December 2015	3.6%	2.6%	10.2%
to 31 December 2016	13.1%	11.8%	13.2%
to 31 December 2017	5.5%	11.8%	20.0%
to 31 December 2018	1.3%	-2.8%	-8.7%
to 31 December 2019	14.8%	23.4%	21.4%
to 31 December 2020	15.9%	1.4%	6.4%
to 31 December 2021	30.0%	9.8%	5.4%
to 31 December 2022	-29.2%	-1.1%	-18.4%
CYTD to 31 August 2023	10.7%	6.7%	3.5%
Cumulative since inception	**262.6%**	**197.0%**	**79.9%**

Sources: SCAF trustees, Bloomberg.
Note SCAF returns are after all fees and expenses.

We are grateful for your continued support, confidence and patience, without which we could not do what we do.

On behalf of Campbell Morgan and myself, if you have questions or would like to discuss the portfolio, please do not hesitate to contact me at 0408 936 357.

Yours sincerely,



Gabriel Radzyminski
Chief Investment Officer
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Portfolio Manager
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