# JM Financial Group

Issue 14: June 2016

## Small Companies Strategy – Investment Newsletter

| **Performance** *(As at 30th June 2016)* | Month to Date (%) | Quarter to Date (%) | Cal. Year to Date (%) | Fin. Year to Date (%) | Rolling 1yr (%) | Inception (%) |
|---|---|---|---|---|---|---|
| **JMFG Small Co. Strategy** | **0.41** | **10.27** | **5.40** | **29.31** | **29.31** | **53.33** |
| Small Ords Accum. Index | -1.31 | 5.85 | 6.94 | 14.40 | 14.40 | 14.90 |
| **Outperformance** | **1.72** | **4.42** | **-1.54** | **14.91** | **14.91** | **38.43** |

*Although the JMFG Small Companies Strategy is generally representative of client portfolios, Individual performance may differ from the results above. These differences can arise due to various issues, some of which may relate to initial timing of investments and cash inflows and outflows. Performance is calculated on TWRR basis; non- annualised, excludes fees and the effects of franking credits and tax. Strategy Inception for Performance Data is July 1st 2014.*

### ***Month in Review-*** *A review of events that influenced the share market in June.*

The month of June was dominated by the holding in the UK of a referendum on whether or not to leave the European Union. In a surprise result the leave campaign (or Brexit) won the day, resulting in momentous movements in financial markets and the resignation of Prime Minister David Cameron. The ASX200 fell 3.4% on the day, the worst one-day fall in nine months, while the British Pound fell 10% against the $US, gold jumped 5.7% and Government Bonds around the world fell to record low yields. Japan and Germany are among a growing number of countries where investors actually pay the Government to borrow their money!

As is customary with global shocks, the markets soon righted themselves with the ASX200 recovering to finish down 2.5% for the month and 4% for the Financial Year. Oil had a flat month but finished 26% higher for the quarter, the biggest quarterly rise in 7 years, as US supply eased. Gold rose 9% for the month and 27% for the year on Brexit concerns, low interest rates and economic and political uncertainty. Commodities in general staged a comeback rising 13% this year versus a 25% decline for 2015.

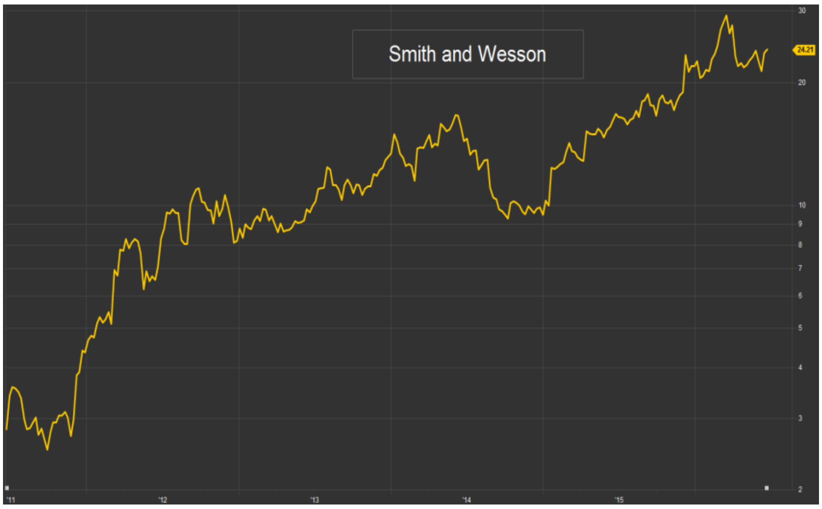
The long-term effects of the UK leaving the EU remain to be seen, but the vote result, plus the rise of Conservative hard liners around the world, reflects the growing unease that populations have around their security and prosperity. It is likely that Governments will continue to stimulate their economies with monetary measures. Further interest rate easing, particularly in Europe, is on the cards and it is increasingly likely that the US will delay increasing interest rates until at least 2017.

On the corporate front, Cadbury maker Mondelez made a takeover offer for fellow chocolate giant Hershey, producing what would become the world's largest confectioner. The bid deadline for Woolworths' Home Timber and Hardware and its Masters Home Improvement chain has been pushed out to July 18th, and Mayne Pharma (formerly Fauldings) further expanded its international business by buying a suite of generic drugs from international giants Teva and Allergan.

As we go to print, the Federal election result is hanging on a knife edge with neither party getting a clear mandate on the night.

### ***Chart of the Month –*** *Smith and Wesson and the US gun culture*

Only one week after the terrible events in Orlando, the US's second largest gun manufacturer, Smith and Wesson reported a 22% annual increase in sales and forecast "robust sales growth" for the year ahead. The sobering chart below shows the Smith and Wesson share price rising a staggering 800% in 5 years. The 'success' of companies like Smith and Wesson further highlights the endemic issues around gun prevalence in the United States which see more than 30,000 gun deaths per annum.




## Best & Worst Performers for June 2016

| JMFG Small Companies Strategy | | ASX Small Ordinaries Index | |
|---|---|---|---|
| **Best** | **Worst** | **Best** | **Worst** |
| Base Resources – BSE | DateTix Group – DTX | Resolute Mining – RSG | Wellard – WLD |
| SRG – SRG | BT Investment Management – BTT | Beadell Resources – BDR | Mesoblast – MSB |
| Mayne Pharma Group – MYX | Sirtex Medical – SRX | Metals X – MLX | ERM Power – EPW |

***Hits & Misses –*** *A summation of the top hits and misses for the month of June.*

**Base Resources** – up 33.3% for the month (Held)

Base Resources benefitted from some upbeat comments from some of its competitors on the outlook for mineral sands. BSE was part of the strong showing of commodity stocks during the month.

**Resolute Mining** – up 44.4% for the month (Not held)

RSG announced it was building an underground mine at its existing mine site in Mali after completing a positive feasibility study. Also helping was the continuing improvement in the gold price, which rose 9% for the quarter.

**DateTix Group** – down 38.5% for the month (Held)

DateTix continued to spend money to build active users, rolling out its 'social commerce marketplace' to key markets in Hong Kong, Singapore, and Beijing in an attempt to further monetise its subscriber base. DTX reversed much of May's stellar gains after investors took a 'wait and see' attitude.

**Wellard** – down 48.3% for the month (Not held)

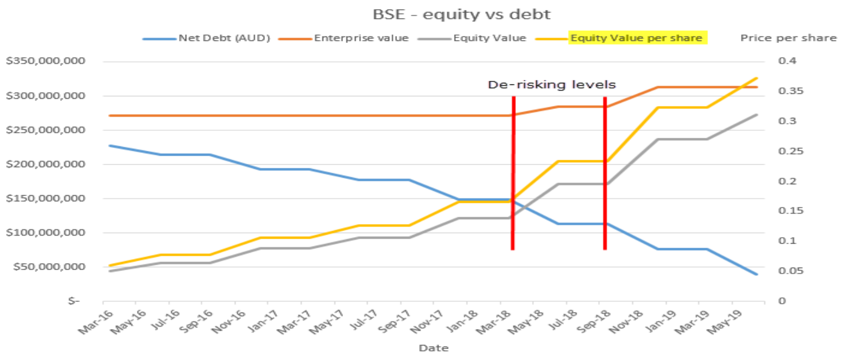
Wellard suffered an earnings downgrade after paying high prices for export cattle and experiencing customer resistance. WLL also felt the general negative investor sentiment around the live cattle export industry with reports of ongoing animal-cruelty in foreign abattoirs.

***Due Diligence –*** *Base Resources – highly leveraged and large potential*

When we are analysing small companies one of the key strengths we look for is a strong balance sheet. In many cases this means very low debt levels that are easily serviced or a net cash position. In a few very rare cases however there can be times when a company with very high debt levels can look attractive. This was the key thesis behind our investment in gold miner, St Barbara (SBM), a year ago and more recently our investment in mineral sands miner, Base Resources (BSE). For those not aware, Base currently produces 2% of the world's zircon from its Kenyan mine.

One of the most common ways to value a company is to look at its Enterprise Value (EV). Enterprise Value equals Market Capitalisation plus Net Debt. When we initiated our investment in BSE the stock was trading at 6c with a market capitalisation of $44m and a net debt level of $227m, therefore an EV of $271m.

If the company can pay down its debt through cash flow the value of the equity within the company can rise dramatically and this is how it occurs…




Based on its current debt repayment schedule, BSE will have reduced its net debt level to $150m by March 2018. From the equation above, Enterprise Value = Market Cap plus Net Debt. If we assume the company has done nothing to change the value of its business – i.e. the EV is still $271m – the new debt level is $150m then the market capitalisation must be equal to $121m or 17c per share (a theoretical 180% return over two years.) Simplistically, the value of the debt is replaced by the value of the equity, super charging the equity return.

In addition, if the company can pay down its debt it de-risks itself and becomes more "investable" to the wider market and should see a commensurate increase in its Enterprise Value, creating even more growth in the value of the equity.

Whilst this sounds like a suspiciously easy way to make high returns it is still a very, very high risk strategy and not suitable for every investor as it requires the company to create significant cash flow in order to service the debt repayments. In many instances the reason companies have such a high debt level to begin with is because the cash flows have been poor and the company has overspent. If the company cannot service the debt then it can, in a worse-case scenario, go into administration and see the value of its equity fall to $0.

Whilst the stock is up 80% since our initial investment we continue to monitor the mineral sands market closely to ensure Base Resources can continue to service its debt.