JM Financial Group

Issue 15: July 2016

Investment Newsletter

Market Performance (As at 31st July 2016)	July 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	6.29	7.94	4.02

***Month in Review** – A review of events that influenced the share market in July.*

Brexit fears were quickly set aside in July with the ASX All Ordinaries and ASX Small Ordinaries rising over 6% and 8% respectively. This was the best performing July for seven years with a number of well-known stocks hitting all-time highs. (TPG, Domino's Pizza, Webjet, Sydney Airport and JB Hifi to name a few.)

The strong market performance wasn't just seen in Australia, with the US market hitting record highs including nine consecutive days of rises, a feat that's only occurred seven times since 1980.

Whilst the rise appeared to be somewhat of a reversal of June's Brexit related panic selling, interest rates were again the major driver of markets with the US now unlikely to raise rates anytime soon and the RBA recently cutting rates to their lowest ever levels for the second time this year. In such a low interest rate environment investors tend to shy away from bonds and fixed income products seeking higher returns in riskier assets such as shares and real estate.

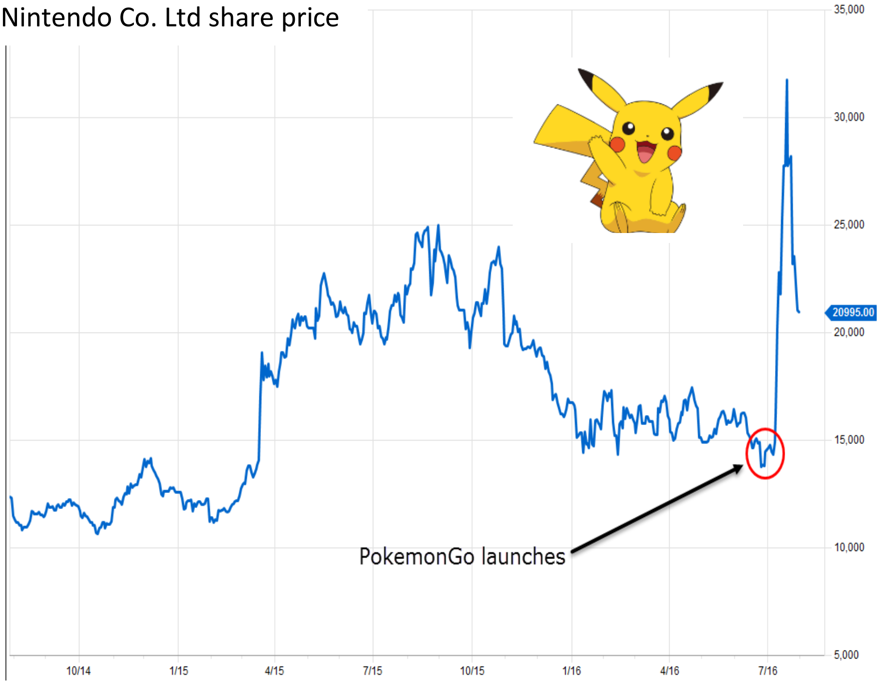
Some of June's political tensions eased during the month with the election night stalemate finding a resolution with the Turnbull led Coalition winning just enough seats to form government. The question will now be whether policy can be effectively passed with such a small majority in the House of Representatives and an increasingly diverse Senate.

Despite the bounce in equity markets oil prices retreated in July as increasing stockpiles and disappointing drawdowns indicated weaker than expected demand. The West Texas Intermediate (WTI) price fell nearly 15% over the month, the largest fall since December 2015, as fears over an impending oil glut spooked the market.

At a stock level, Woolworths' new CEO, Brad Banducci, announced further restructures including the closure of thirty loss making stores and five hundred head office redundancies in an attempt to turn around its underperforming grocery and retail businesses. Whilst the additional $960m in asset impairments was a surprise, Banducci indicated the worst may be over for Woolworths.

***Chart of the Month** – Pokemon madness*

Nintendo Co. Ltd share price



The world was gripped with Pokemon madness during the month with the Pokemon Go app being downloaded an extraordinary 75 million times.

Nintendo, part owner of the app developer (Niantic) rose strongly as investors began to factor in the potential future earnings from the game. At one stage Nintendo shares were up 100% across the month, adding $19 billion to the company's market value. The hot air came out of the price late in the month though when the company down-played the short term earnings benefits.

Although we at JMFG are yet to embrace Pokemon Go, (*having only just grasped Space Invaders and Pacman*), the Pokemon phenomenon does highlight the extraordinary leverage and appeal that software companies have.

It's one of the few industries where a product only needs to be created once yet can be sold millions of times with very little incremental cost.

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Due Diligence – *A closer look at a company of interest*

Mayne Pharma (MYX) – a company transforming acquisition

One of the easiest ways to destroy shareholder value is via a large international acquisition, historically the undoing of many Australian companies. At JMFG we are always somewhat suspicious of acquisitions as they are often used by management to cover holes in the current business. They can also potentially stretch the balance sheet and the seller often has a much greater appreciation of the intricacies of the business than the acquirer does.

What we do like however is times when a seller is forced to divest a business for non-operational reasons. This is the case with Mayne Pharma's recently announced $881m acquisition of the Teva speciality generics pharmaceutical portfolio. Teva is currently acquiring Allergan's generic drug business for US$40bn and due to competition issues the US FDA is forcing Teva to divest a number of assets.

As previously mentioned this is one of those rare instances where the seller is motivated to sell a business for non-operational reasons and in all likelihood would retain the assets if they could.

Figure 1: The acquired portfolio contains a number of market leading products

Summary of on-market Acquired Portfolio

Product	Market size[1] (US$m)	Market position[2]	# of generic competitors (excludes acquired product)
Product 1	100	#1	2
Product 2	130	#2	2
Product 3	100	#1	3
Product 4	100	#1	5
Product 5	60	#2	2
Other	1,130	-	≤5
Total	1,620	-	≤5

Another tick in the box for this acquisition is that that Mayne already has significant experience in producing and manufacturing generic products. Management understands the industry and these products should integrate into the existing generics business quite easily. In fact, Mayne should be able to improve trading terms and leverage its current sales and manufacturing facilities to improve margins and generate significant cost and revenue synergies.

In order to fund the acquisition Mayne raised $888m in new capital and $100m in debt facilities, with the retail entitlement issue priced at $1.28 per share. With such a strong rationale for the transaction we were happy to participate for clients where applicable and at the time of writing Mayne was trading at $2.00, up an impressive 56% on the entitlement price. With the acquisition complete we now wait to see if management can deliver on the market's lofty expectations.

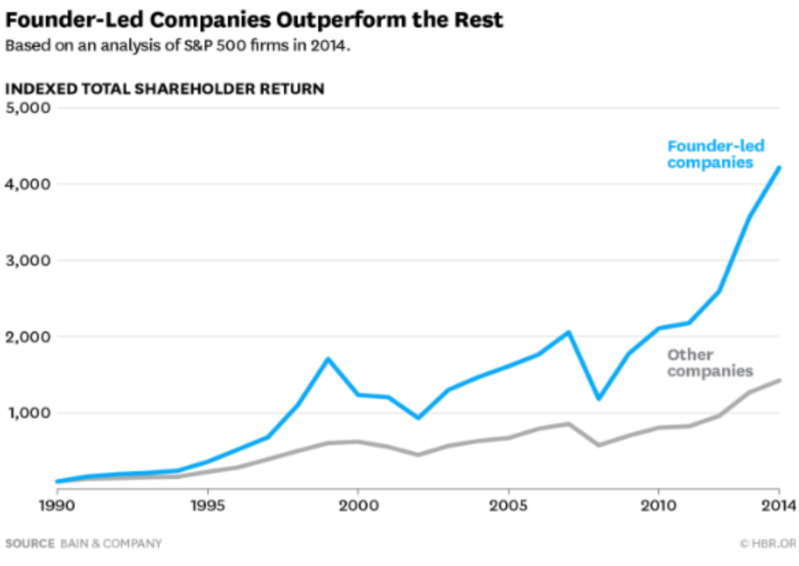
Thematic Discussion – *The founder's mentality*

We stumbled across an article earlier this year that pleasingly confirmed something we at JMFG had believed for some time; that founder led companies outperform. The article by Bain and Co. traced the performance of founder led companies (or companies where the founder was still heavily involved) and discovered they outperformed the S&P 500 by over three times.

One of the main reasons outlined for the outperformance was that these companies had the ***founder's mentality***. They were businesses founded for a special purpose and in many cases that purpose was to disrupt and innovate an industry.

The other major driver of outperformance was the ***owner's mindset***, where the leaders of the company take responsibility for risk and cost. When the CEO is a large shareholder and/or the founder, they feel the pain that all shareholders do when value is lost through poor decision making.

We find time and time again that founders often make long term decisions that aren't influenced by the pressure to hit near term earnings forecasts or to earn short term incentive bonuses. And most importantly, founders make decisions with a great deal of their personal wealth at stake.



Often when we sit down with CEOs the first question we ask is "How long do you see yourself in this role?" Frustratingly, the most common response is "three to five years". Whilst they may have the noblest of intentions, without a long term stake in the company a CEO can lack true accountability for decisions that erode shareholder wealth.

With these findings in mind it's no surprise to then note that some of the world's most successful technology businesses had founder CEOs for most of their lives including Oracle, Intel, Microsoft, Apple, Dell, Google, Amazon and Facebook. Whilst founder led Australian companies tend to be earlier stage, small companies, we are attracted to a number of founder led companies such as Qube, Vocus, Technology One, Sirtex, Doray Minerals and QMS.