JM Financial Group

Issue 15: July 2016

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st July 2016)*	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**10.23**	**10.23**	**16.07**	**10.23**	**36.00**	**68.85**
Small Ords Accum. Index	8.57	8.57	16.09	8.57	22.29	24.75
Outperformance	**1.66**	**1.66**	**-0.02**	**1.66**	**13.71**	**44.10**

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 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.

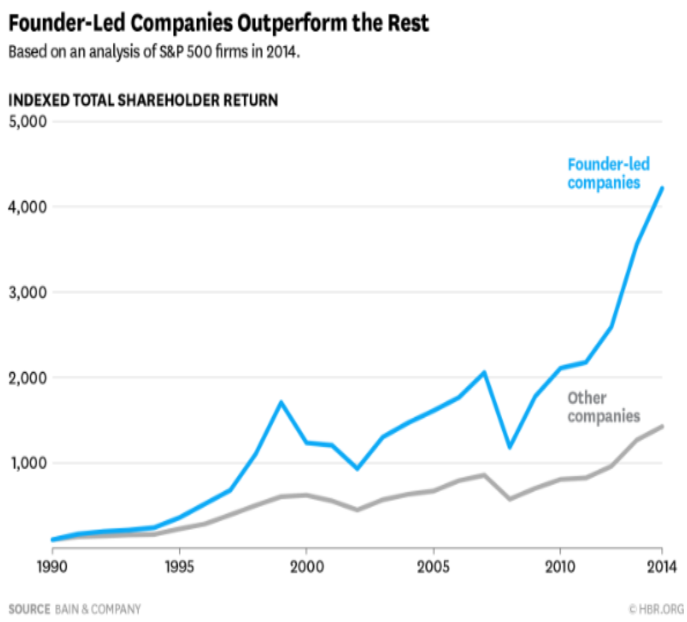
Whilst the rise appeared to be somewhat of a reversal of June's Brexit related panic selling, interest rates were again the major driver of markets with the US now unlikely to raise rates anytime soon and the RBA recently cutting rates to their lowest ever levels for the second time this year. In such a low interest rate environment investors are shying 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 Catapult Group announced a $90m acquisition of US video analytic software provider XOS, funding the purchase through a $100m capital raising.

***Chart of the Month –** The founder's mentality*



We stumbled across an article earlier this year that pleasingly confirmed something we at JM 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 often founded for a special purpose and in most 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 for 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.

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.

Currently 45% of stocks held by the JMFG Small Companies Strategy are founder led.

Best & Worst Performers for July 2016

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Temple & Webster - TPW	Wellcom - WLL	Whitehaven Coal - WHC	Asaleo Care - AHY
Catapult - CAT	Datetix - DTX	Energy World Corp. - EWC	Syrah Resources - SYR
Base Resources - BSE	Medical Developments - MVP	Maca Ltd - MLD	1-Page Ltd – 1PG

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

Temple & Webster – up 32.1% for the month

There was finally some light at the end of the tunnel for Temple & Webster (TPW) after a horrible six month period that included a revision to revenue forecasts and the departure of the CEO. With one of the former founders taking control of the reins the business has focussed on removing duplicate costs and consolidating two of its market leading retail websites. These actions appear to be working with the company reconfirming its goal of cash flow breakeven in 2018.

Whitehaven Coal – up 53.8% for the month **(Not held)**

A bounce in export coal prices in July sent shares in Whitehaven Coal running to levels not seen since 2014. Despite the incredible rise there remains some concern as to whether short term thermal coal prices can be sustained.

Wellcom Group – down 6.3% for the month

With 20% of revenues coming from the UK, Wellcom was a victim of Brexit related selling in July. Although the stock came off mildly we are confident that such a high quality business can withstand any short term currency related selling.

Asaleo Care - AHY – down 35.2% for the month **(Not held)**

Asaleo Care fell heavily during the month after flagging aggressive discounting by rival toilet paper producers and increased pulp costs.

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 paper over 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. As seen in the table to the right, the portfolio includes a number of products with well established, dominant market positions.

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.