JM Financial Group

Issue 16: August 2016

Investment Newsletter

Market Performance (As at 31st August 2016)	August 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	-1.33	6.50	10.72

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

After a very strong start to the financial year the Australian market took a breather in August with the ASX All Ords falling 1.33% as the investment community digested a large number of end of financial year results.

As is frequently the case, August was quite a volatile month with a number of company share prices moving up and down more than 20% following the release of their fiscal year 2016 results. Often it is not the results themselves but rather the earnings outlook statements for the next year which draw the most attention.

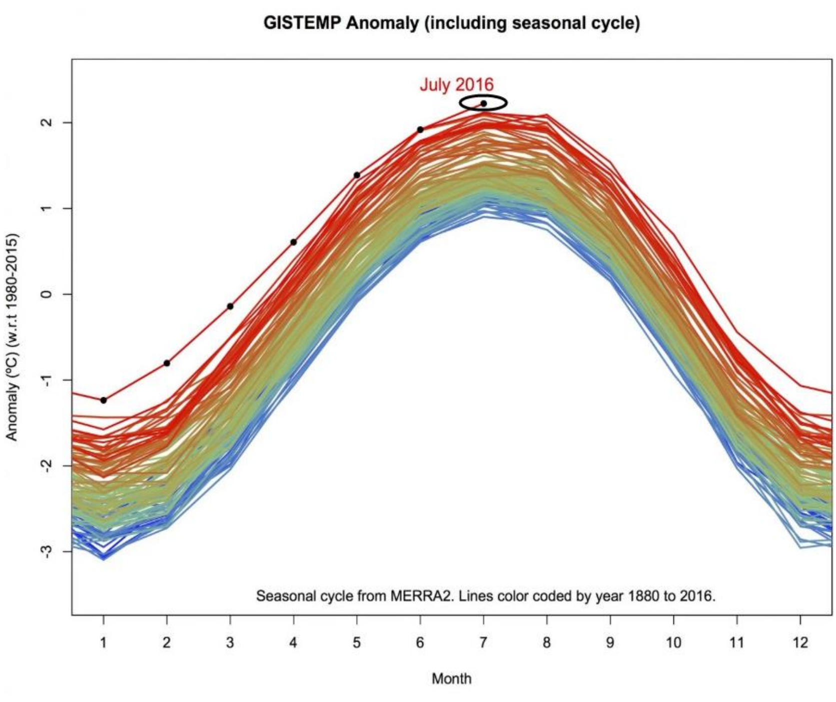
On balance "reporting season" was mildly disappointing with earnings growth still patchy. Once again growth was more evident at the smaller end of the market where the underlying economic environment is less of an influencing factor on the ability of a company to grow its revenues and earnings.

With investors more focused on our domestic equities the impact of global market movements took a back seat until late in the month when Fed Reserve Chair, Janet Yellen, left the door open for an interest rate increase in September. With mixed economic data points in the U.S showing no sustained trend we believe an interest rate rise this calendar year is by no means a certainty.

Amidst the results Woolworths finally announced the sale of its Home Timber and Hardware business to Metcash and the painful closure of its Masters Hardware franchise. One of the more spectacular and well publicised failures in recent corporate history.

After an exhausting reporting season catching up with over 25 companies for one-on-one meetings, attending a number of company presentations and dialling in to numerous conference calls we have a number of stocks on our radar that look appealing from an investment perspective. We look forward to updating you further as we do more work on each.

Chart of the Month – *It's getting hot in here.*



During the month NASA confirmed that July 2016 was the hottest month ever recorded. Marking ten consecutive months of record breaking heat across the globe.

Whilst this information has far reaching consequences for the environment we cannot ignore the flow on effects for Australia's agricultural industry.

For example, California produces 85% of the world's almonds and has been experiencing five years of drought conditions. With water scarce, nut production has decreased and almond prices have skyrocketed.

This has been of great benefit to local producer, Select Harvests (SHV) but if prices remain at elevated levels we may witness a substitution effect as buyers seek out cheaper almond alternatives such as walnuts.

The agricultural sector has been appealing to us from an investment perspective for a number of years but the NASA data does highlight the fragility and risk of investing in a sector that is so heavily exposed to factors beyond its control.

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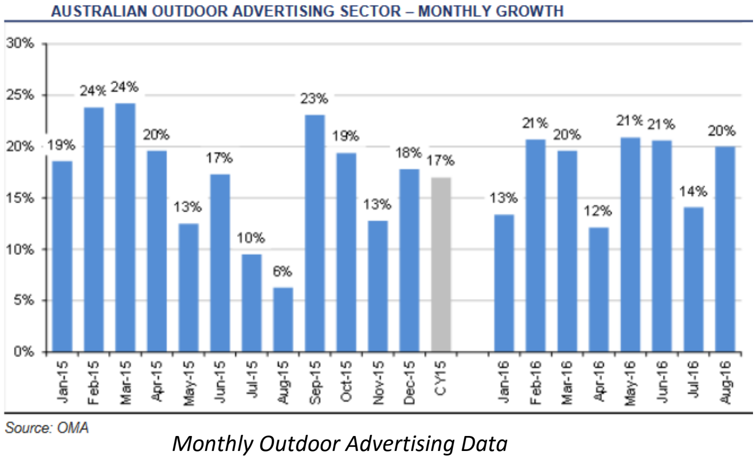
Due Diligence – *A closer look at a company of interest*

QMS Media (QMS) – gaining market share in a growing industry

One of the sectors we have mentioned at times over the last year has been the Outdoor Media Sector which is seeing significant growth in revenues through the conversion of static billboards to digital and by attracting greater share of advertising spend as free to air tv, radio and print battle with structural change. Of the three listed outdoor advertising companies, we chose to invest in QMS Media, the smallest and perhaps the most disruptive.

Despite industry growth numbers looking impressive, the sector was de-rated by the market during the month following APN Outdoor's (APO) disappointing FY17 earnings guidance. On the day of APO's announcement the stock fell 35%, and its peers Ooh media (OML) and QMS Media (QMS) were sold down 15% and 13% respectively.

This is something we have seen numerous times before – when a company flags a slowdown in growth the market then extrapolates this out to all companies operating in that sector regardless of the specific differences in business models, clients, assets etc. After meeting with QMS management we feel confident that the issues affecting APN Outdoor are in fact company specific and not a sector wide issue.



Monthly Outdoor Advertising Data

Conversely, we believe QMS is winning market share and could at some stage become a takeover target if APO's woes continue to impact its organic growth strategy.

As with all investments we can never be certain that our thesis is correct but we feel this is an instance where doing the leg work, meeting management and getting to the bottom of the issue puts us in a better position than the "shoot first, ask questions later" sellers. Time will tell.

Reporting Season Wrap – *The Good,The Bad and The Ugly*

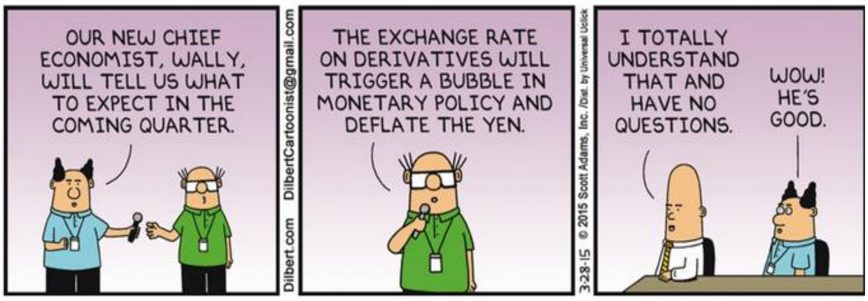
As alluded to earlier in the newsletter reporting season was volatile with a number of stocks moving greater than 20% following their results release. On balance the disappointments overshadowed the positive surprises with the underlying economy providing no free kicks. Despite the volatility, quality businesses again shone through and below we have noted a few winners and losers from reporting season.

The Good - Treasury Wine Estates (TWE) – Rallied 12% after a strong earnings report which showed the wine business had executed on its turnaround strategy announced two years ago with the recently acquired Diageo assets contributing above expectation.

SRG Ltd- The company formerly known as Structural Systems was finally rewarded for the business transformation strategy undertaken over the last 18 months. The stock rallied 18% after announcing a 53% increase in profits, vindicating the company's strategy to focus on higher margin work. With a diversified revenue base and plenty of cash on the balance sheet we feel comfortable that SRG can continue to deliver strong shareholder returns.

The Bad - APN Outdoor (APO) – After being one of the market's top performing stocks over the last two years, the announcement of a reduction in forecast growth for FY17 came as a complete surprise and saw the stock sold down 40% in a week.

A rather blunt reminder to management that no matter how strong the business may appear the market does not like negative surprises.



A typical company meeting in reporting season…

IPH – Patent attorney IPH Ltd, was sold off heavily in August after falling short of the market's revenue expectations. Despite recording 42% earnings per share growth and guiding to further growth in FY17 the shares fell 16% over the month. This was quite disappointing from a business that has previously delivered strong performance for client portfolios. We don't believe anything has occurred within the business to change our view on its fundamental value however we remain watchful for any deterioration in operations.

The Ugly – Estia Health (EHE). A number of months ago we discussed the Aged Care sector and our reluctance to invest in it due to a number of factors. Needless to say we were breathing a sigh of relief that we followed our own advice when we saw Estia Health fall heavily after missing earnings forecasts, announcing the replacement of the CFO in the process. Adding to the pain for investors one of the founders announced his resignation from the Board of Directors two days later and the sale of his 17m shares (9% of the company).