JM Financial Group

Issue 24: April 2017

Small Companies Strategy – Investment Newsletter

Performance *(As at 30th April 2017)*	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**-1.19**	**-1.19**	**0.66**	**4.29**	**14.12**	**59.76**
Small Ords Accum. Index	-0.25	-0.25	1.21	7.12	10.04	23.09
Outperformance	**-0.94**	**-0.94**	**-0.55**	**-2.83**	**4.08**	**36.67**

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 April.*

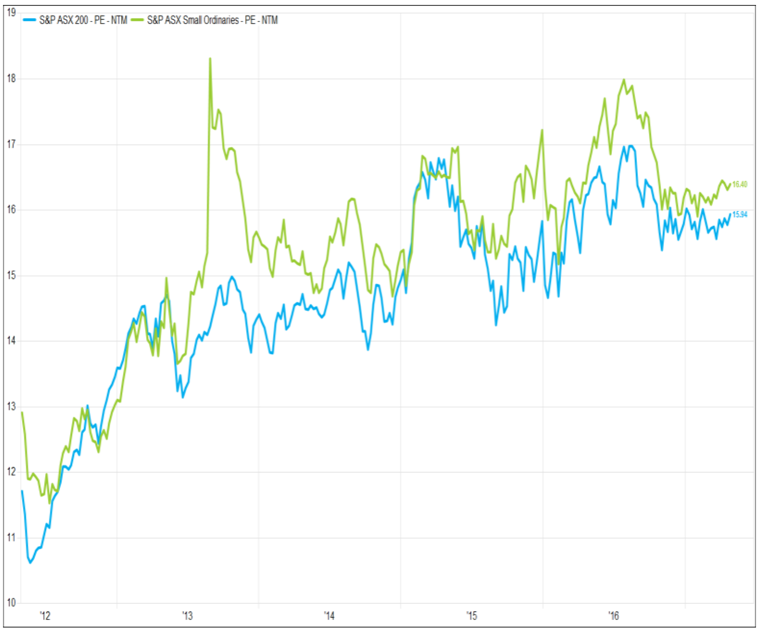
The ASX 500 Accumulation Index rose a further 0.8% in April while the Small Ords Accumulation Index fell 0.3%, making it the seventh month in succession that the Small Ords Accumulation Index has underperformed the broader market. A mix of high multiples within the Small Ords index, a result of its prior outperformance, and a range of downgrades has caused its relative underperformance. The Dow Jones continued its march forward, climbing a further 1.3% to finish the month at 20,941.

With the exception of the Telecommunications and Consumer Staples sectors, all other Industrial sectors rose, whilst Materials and Resources related sectors all fell. The Gold sector had the largest fall, -2.5%, despite a 2.9% rise in the A$ gold price over the month. Newcrest Mining announced during the month that FY17 production would be at the bottom end of the range. In the Consumer Staples space Coca-Cola Amatil downgraded volume expectations during the month while Wesfarmers came under pressure following strong quarterly sales from Woolworths' supermarket division. Telstra and the Telco sector tumbled when it was announced that TPG had won a spectrum bid and would start a fourth mobile network.

The JMFG Small Co strategy underperformed its benchmark for the month, has marginally underperformed calendar YTD and is ahead 4.1% over the last 12 months. The portfolio's best stocks for the month included BT Investment Management and our Resources exposures, St Barbara and Base Resources. Our worst performers included Godfreys, Datetix Group and Netcomm Wireless. Other small cap stocks that were strong during the month but not held in our portfolio included Mesoblast and Bellamy's Australia.

Estimated Market PE multiples for the next 12 months for the Small Ordinaries now sits at 16.4x, having peaked above 18x in July 2016. This compares to around 16x for the ASX 200. Excluding Financials, the ASX 200 would trade at a slight premium to the Small Ords.

Chart of the Month – Next 12 Month PER, ASX200 vs ASX Small Ords



This month we compare the PERs of the ASX 200 and ASX Small Ords, based on the rolling estimated 12 month forecast earnings for each index over the past five years.

The chart highlights several points over the last 5 years where the Small Ords has been expensive relative to the ASX 200. These include the latter half of CY13, through parts of CY14, and through the middle of CY16.

Excluding the lower multiple Financials Sector, which accounts for 39% of the ASX 200 and currently trades on a forward 12 month PER of 14.5x, we estimate the remaining 61% of the market trades around 17x forward 12-month PER. If we also exclude the Materials sector which trades on 13.1x forward 12 month PER, a sector which comprises 15.5% of the ASX 200 and is dominated by BHP and RIO, the remaining 45.5% of the market trades on a forward PER slightly above 18x.

The ASX Small Ords does not appear expensive on a relative basis. However that is dependent upon Small Ords earnings forecasts being achieved. With confession season typically beginning in May, the next couple of months may be critical in supporting/negating that view.

JM Financial Group
AFSL 238397 ABN 68 007 364 132

Level 8, 140 Bourke St, Melbourne, VIC, 3000
Ph: +61 3 9627 9900

Web: www.jmfg.com.au
Email: enquiries@jmfg.com.au

Best & Worst Performers for April 2017

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
BT Investment Mngmnt - BTT	Godfreys Group – GFY	Mesoblast – MSB	Ten Network Holdings - TEN
St Barbara – SBM	Datetix Group – DTX	Bellamy's Australia – BAL	The Reject Shop – TRS
Base Resources - BSE	Netcomm Wireless - NTC	BT Investment Mngmnt - BTT	Vita Group - VTG

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

BT Investment Management – up 19% for the month

Ongoing strength driven by growth in Funds Under Management, which grew from A$87.0b at December 2016 to $91.2b at 31 March 2017. Composition of the growth included A$1.9b in net inflows, A$2.5b in investment performance less A$1.9b in forex impact.

Mesoblast – up 38% for the month **(Not held)**

Positive clinical trial results in its cell therapy treatment to grow heart muscle as well as successful interim analysis of efficacy endpoint in its Phase 3 trial for chronic heart failure.

Godfreys Group – down 17% for the month

No news for the month but the stock continues to decline following a poor interim result and a generally weak performance from discretionary retailers with Harvey Norman, JB Hi-Fi, Myer, Premier Investments and Super Retail Group all declining in April.

Ten Network Holdings – down 53% for the month (**Not held**)

Another disappointing result announced through the month with its Television EBITDA declining from A$10.1m in 1H16 to a A$2.4m loss in 1H17. High debt levels, which are now current liabilities, and significant asset impairment does nothing to inspire.

Due Diligence – *a closer look at a stock of interest*

Base Resources (BSE) – What a difference a year makes.

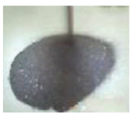
In February 2016 Base Resources was trading at a low of 2c per share. By February 2017 it had traded through 30c per share and more recently traded as high as 36c. Much has happened since February 2016. Prices achieved for its mineral sands products have increased dramatically. Most importantly net debt has been reduced and quarterly operating cash flow is expected to push toward $50m from the June quarter of this year. In the context of A$169m net debt at December 2016 and a market value of $245m, cash flow pushing toward $200m annually is significant.

The titanium dioxide pigment industry has improved substantially over the last two years following closure of high cost production and ongoing demand growth. Political disruption to ilmenite exports from India and suppressed production due to environmental issues in China have also played a part in pushing up prices.

The net result has been a significant rise in prices. Prices for Base Resources' ilmenite increased over 130% between May 2016 and March 2017. In a recent quarterly, Base confirmed further price rises, with June 2017 quarter ilmenite prices commencing approximately 200% higher than the start of the financial year.

Zircon is mainly used as a raw material in making refractory bricks, furnace linings, and in the ceramics industry where its opacity and hardness gives a whiteness and durability to tiles, sanitaryware tableware.

Ilmenite is mainly used to make pure white, highly refractive and ultra-violet light absorbing titanium dioxide (TiO_2) pigments for use in protective house and car paints, paper, plastics, ink, rubber, textiles, cosmetics, sunscreens, leather, and ceramics.



Rutile is another titanium dioxide form which is naturally occurring in Australia, USA, India, and South Africa. Rutile is used in the manufacture of titanium dioxide pigments, and in welding electrodes and other titanium metal applications.

While production of ilmenite (~465kt est FY17) in tonnage terms for Base Resources far outweighs production of rutile and zircon (90kt and 35kt est respectively), rutile generates up to 50% of annual sales. To date price rises for rutile have been modest. However there are increasing signs of an emerging supply deficit in this high grade / high value segment of the sector. Base Resources confirmed in their last quarterly they now expect rutile prices to experience upward momentum through mid-2017. Should this occur, the profit and cash flow potential of Base Resources could improve significantly above current expectations.