JM Financial Group

Issue 25: May 2017

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st May 2017)*	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**-0.73**	**-1.91**	**-0.08**	**3.53**	**3.95**	**58.59**
Small Ords Accum. Index	-2.05	-2.29	-0.87	4.92	3.55	20.56
Outperformance	**1.32**	**0.38**	**0.79**	**-1.39**	**+0.40**	**+38.03**

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.

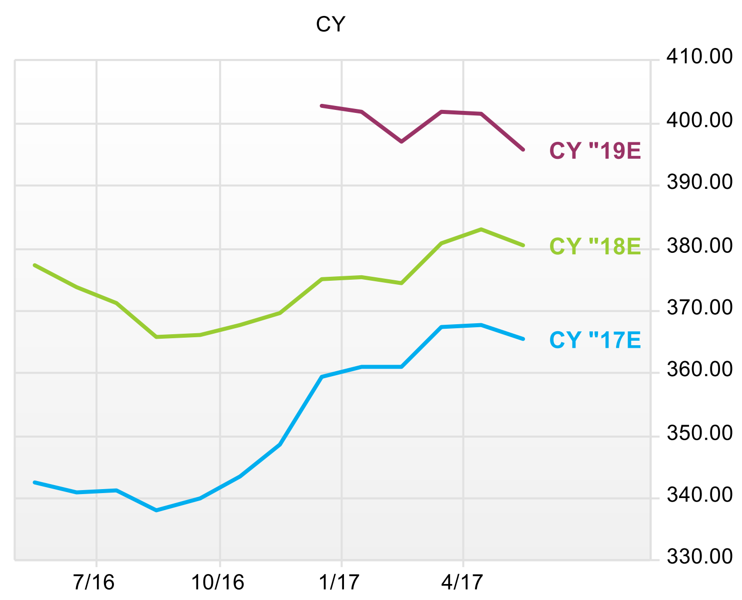
Month in Review- *A review of events that influenced the share market in May*

The ASX 500 Accumulation Index fell 2.6% in May while the Small Ords Accumulation Index fell 2.1%. The Small Ords Accumulation Index finally performed better than the broader market with the broader market having to deal with significant falls in the major banks CBA (-8.9%), NAB (-11.4%), ANZ (-14.5%) and WBC (-13%) caused by benign quarterly trading results and the new tax announced in the Federal Budget on the major banks that would ultimately see their earnings reduce by 2-3% on an after-tax basis. The Small Ords index did however have to deal with a raft of downgrades through May – in excess of 20. The Dow Jones moved marginally higher in May rising +0.4% to 21,029.

Downgrades during May were dominated by discretionary expenditure businesses, including RCG Corporation, Oroton, SurfStitch, Super Retail Group, Myer, Automotive Holdings Group, A.P. Eagers, Autosports Group and Pacific Smiles. Other downgrades included Mayne Pharma, Pact Group, Vocus Communications, Adacel, Vita Group (while a discretionary business, its downgrade related to less favourable trading terms with Telstra), Capral Ltd, Southern Cross Broadcasting, Qantm Intellectual Property and Select Harvests. While the Small Cap portfolio had exposure to one of these downgrades, Mayne Pharma, it also had exposure to the only stock that experienced a substantial upgrade in the month, Appen Group. Appen upgraded its EBITDA guidance for CY17 from mid-to-high teen percentages to 40-50% higher. The stock has rallied from $2.57 pre-upgrade to $3.67 at month end. Mayne Pharma fell from $1.35 at month's start to end at $1.08.

The JMFG Small Co strategy outperformed its benchmark for the month, has marginally underperformed calendar YTD and is marginally ahead over the last 12 months. Estimated Market PE multiples for the next 12 months for the Small Ordinaries have moderated further to 16.0x, having peaked above 18x in July 2016 and compares to around 15.4x for the ASX 200. Excluding Financials, BHP and RIO, the ASX 200 would have traded at a slight premium to the Small Ordinaries Index.

Chart of the Month – ASX Earnings Per Share Estimates



Source: Factset

This month we look at EPS growth estimates for CY17, CY18 and CY19 and in particular how they have changed over the past 6 months.

Having been in a distinct uptrend since the middle of CY16 there has been a marked change in the last month, with a clear rollover in estimates. While growth is still forecast from one year to the next, the base level of earnings for CY17 is under pressure. Commodity price improvements were a large part of the upgrades through CY16 but they have not been a factor in recent downgrades. This is despite a significant fall in the iron ore price since March. Analysts upgraded resource earnings in CY16 on higher spot prices. However, upgrades to longer-dated forecasts were more muted. Recent declines in the spot prices for iron ore have not taken the ore price below long-term forecasts.

While several factors have caused downgrades (new bank tax, company specific issues) a component has been consumer related and this in our view presents the major risk to the market and economic growth from here. We still have confidence in a level of underlying growth but further downgrades could compromise confidence.

Best & Worst Performers for May 2017

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Appen - APX	Mach7 Technologies - M7T	Netcomm Wireless - NTC	Quintis - QIN
Netcomm Wireless - NTC	Catapult Group International - CAT	Wisetech Global - WTC	Vita Group - VTG
HUB24 - HUB	Mayne Pharma - MYX	Isentia Group - ISD	Sigma Health - SIG

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

Appen – up 38% for the month

Significant earnings upgrade with CY17 EBITDA guidance increased from mid-to-high teens to up 40-50%. Growth in artificial intelligence is likely to be an ongoing growth theme over the next decade and Appen is well placed to exploit these opportunities.

Wisetech Global – up 24% for the month **(Not held)**

A leading global provider of logistics software with a strong growth track record and enormous operating leverage as their software product continues to gain market share. Confirmed guidance provided at the 1H17 result.

Mach7 Technologies – down 33% for the month

Lack of new contracts and a poor quarterly cash-flow result for the March quarter has damaged confidence that Mach7 will get to cash-flow breakeven and ultimately profitability for some time.

Quintis – down 75% for the month (**Not held)**

A contract loss in May, along with a credit rating downgrade and a recent short-seller report suggesting the business has a "Ponzi-like structure and will struggle to service its debts" conspired to send the stock spiralling. It was suspended from official quotation on 17 May.

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

HUB24 (HUB) – A Diversified Financial Services Company

HUB24 offers an investment and superannuation platform with a comprehensive range of investment options with transaction and reporting solutions for individuals, companies, trusts, associations, and self-managed superannuation funds. Their platform solution provides advisers with the technology to efficiently manage and add value to clients. HUB24 was established in 2007 by a team with a strong background in financial services, and the business was acquired by InvestorFirst in 2010 in what was effectively a reverse takeover. Its name was subsequently changed to HUB24 in 2013.

Since the end of 2012 HUB24 has been a strong market performer, rising from a price in the mid $0.30/share range to a price currently around $5.60/share. The strong performance reflects growth in Funds Under Administration (FUA). FUA was reported at $5.05b on 20 May, up from $4.4b at 23 February. HUB24 grew FUA by $1b in 5 months, which compares to 7 months for growth from $2b to $3b and $3b to $4b and 11 months to grow from $1b to $2b.

Upside potential for HUB24 is significant with superannuation assets, wrap platforms and managed portfolios forecast to have strong growth over the next decade. For HUB24, with 0.5% market share (*Analysis of Wrap, Platform and Master Trust Managed Funds*, Sept 2016) and the fastest FUA growth rate at 101% over the past four years, upside potential is significant. HUB24 is at the point of significant operating leverage. Having endured losses for several years and ongoing investment in platform technology, HUB24 is poised to grow profit rapidly over the next few years, and potentially well beyond. Revenue has expanded from $2m in FY13 to $44m in FY16, with operating income declining from a $7m loss to sub $2m loss in FY16. Revenue in 1H17 was $27m (+32%) and operating income moved from a $1.3m loss in 1H16 to $1.3m gain in 1H17. Projections are for revenues to grow to over $100m by FY20 and operating income to exceed $30m. While competitive risks do exist, HUB24 does look well placed to continue its success in a growth segment.