JM Financial Group

Issue 30: October 2017

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st October 2017)*	Month to Date (%)	Quarter to Date (%)	Cal.Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Small Co. Strategy	**+6.84**	**+6.84**	**+11.19**	**+8.43**	**+6.24**	**+70.01**	**+76.53**
Small Ords Accum. Index	+6.02	+6.02	+11.92	+10.69	+15.19	+34.84	+35.42
Outperformance	**+0.82**	**+0.82**	**-0.73**	**-2.26**	**-8.95**	**+35.17**	**+41.11**

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 a TWRR basis; non-annualised, and includes fees (post 1 Jan 17) but excludes 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 October*

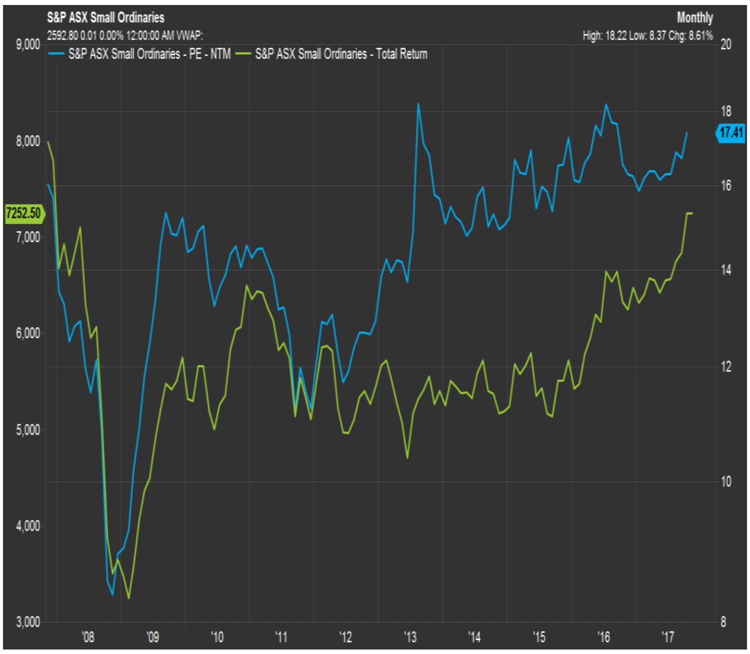
The JMFG Small Companies Strategy increased 6.84% in October, ahead of the Small Ords Accumulation Index which increased 6.02% (ASX Small Resources +6.48% and ASX Small Industrials +5.91%). The market was strong across the board, with strongest sectors including I.T. +8.6%, Energy +6.5% and Consumer Discretionary +6.0%. Lagging sectors included REITs and Telecommunications, +2.2% and +2.4% respectively, with other yield sectors also underperforming Small Ords with Financials (ex-REITS) +3.2% and Utilities +5.0%.

From a low point in May this year, the Small Ordinaries Index has risen over 12%. Multiples are starting to look stretched again, with the forward 12-month rolling Price to Earnings Ratio (PER) now at 17.4x based on consensus *Factset* data. To put this in perspective, over the past ten years the Small Ordinaries Index has briefly peaked at a touch over 18x on just two occasions before retreating to around 16x.

There were some large moves across our portfolio during the month. A company we introduced into the portfolio early in the month, BIG Un Limited, is up 88% for the month and 71% since we purchased it. Catapult Group recovered dramatically, rising 46%, having been in a long downtrend prior. New Century Resources rose a further 19% in October after rising 15% since our purchase in late September, and European Cobalt has rallied 20% since our purchase mid-October. The Resource theme continues to be a major driver within the Small Ordinaries. Poor performers for the portfolio in October included Love Group and Stokes which fell 28% and 14% respectively. Each of these companies accounts for less than 1.5% of the portfolio.

Other companies added to the portfolio during the month included Hansen Technologies and Echo Resources. No stocks were sold from the portfolio but we did trim positions across several stocks on price strength, including Appen, New Century Resources, Hub 24, Catapult and GTN. Our position in QMS Media, a somewhat disappointing performer in the portfolio, was also trimmed.

Chart of the Month – Small Ordinaries Index & 12-month forward PER



Based on historic data, the Small Ordinaries Index is starting to move into expensive territory again, with the Index trading at 17.4x the 12-month forward rolling Price to Earnings Ratio (PER) based on *Factset* consensus data. On two occasions over the past decade (August 2013 and July 2016) the Index has traded above 18x the 12-month forward PER. On each occasion, it subsequently retreated to 16x or less.

The reversion back to 16x PER however can be caused by several factors. These include:

1) A decline in the value of the Index.
2) A growing earnings base as the rolling 12-month period progresses forward.
3) An adjustment in earnings expectations.

For example, from Jul 16 to Jan 17 the Small Ordinaries Accumulation Index fell 6% but the 12-month forward PER declined 13%. The second and third factors shown above also had an influence in the forward PER multiple. So while we are taking a more cautious view of the market at present, downside may be limited given a backdrop of improving global economic growth.

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Best & Worst Performers for October 2017

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
BIG Un – BIG	Love Group Global – LVE	Bellamy's Australia – BAL	Isentia Group – ISD
Catapult Group Int – CAT	Class – CL1	Clean Teq Holdings – CLQ	Thorn Group – TGA
European Cobalt – EUC	Stokes – SKS	Blackmores – BKL	Vita Group – VTG

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

BIG Un Limited – up 88.2% for the month (71.2% since adding)

Several announcements in October including cash receipts of $15m up 488% on 1Q FY17, launch of TV shows on Apple TV, BIG video program package integrated into GoFundraise's platform, BIG Review TV partnership with HotCopper and a partnership agreement to broadcast the Wayfarer Travel Show on Sky News Business Channel all combined to see a dramatic lift in share price.

Bellamy's Australia – up 59.9% **(Not held)**

Guidance was upgraded through the month, with strong early trading leading to revenue growth for FY18 being upgraded to 15-20%, from +5-10% prior, and EBITDA margin of 17-20% from 15-20% prior.

Love Group Global – down 27.8% for the month

Love Group released its 1Q FY18 4C cashflow statement – underlying growth in cash receipts of 2% and a higher operating cashflow loss of $282k versus $69k in 4Q FY17 detracted from growth in matchmaking orders.

Isentia Group – down 44.38% for the month (**Not held)**

FY18 guidance was released to the market during the month, with revenue forecast to be $133-$138m and EBITDA of $32-$36m. This compares to reported revenue of $155m and EBITDA of $41.5m in FY17. The group is also exiting the disappointing King Content business.

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

Echo Resources (EAR) – Gold Mine Redevelopment

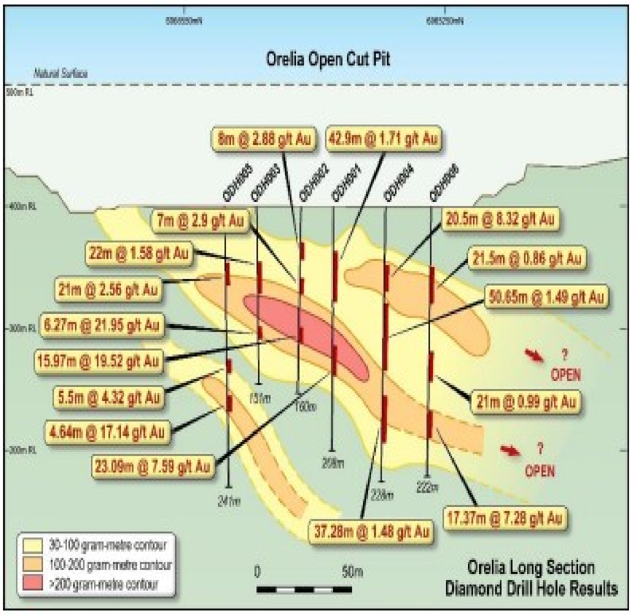
We see Echo Resources (EAR) as a prospective lower-risk gold opportunity given it has an existing mineral resource of 15.9Mt at 2.1g/t for 1.1m ounces at its main ore body, Orelia, in the Leinster district in W.A. In addition it has an existing processing facility (Bronzewing) within 10km from the main ore body which can be refurbished to be ready for throughput for under $20m. In this regard EAR does not have the same level of risk as a typical gold exploration company. EAR also has other prospective deposits around the Orelia location, as well as prospective deposits in the Empire District, which sits 40-80km from Bronzewing. If all goes to plan, production should be in place within 12-18 months. The company is suggesting it should be able to mine 2Mt per annum at 2.1g/t – which, at 93% recovery, would produce 138,000 oz per annum. At a gold price of A$1,550/oz, EAR could generate over $210m of revenue annually. At an all in sustaining cost (AISC) of A$1,150/t, the annual pre-tax profit could be in excess of A$55m/yr.

Saracen is an interesting comparison to EAR as it operates in the same general region, at its Carouse Dam and Thunderbox operations, in a combination of open pit and underground mining. EAR will initially be open pit, with the prospect of moving underground at a later date.

In FY17, Saracen had an AISC of A$1348/oz, however this included an underground mining cost of A$336/oz compared with an open pit mining cost of A$146/oz. Other major costs should be similar with the exception of ore cartage which is A$36/oz at Saracen and could be up to A$30/oz higher at EAR given the 10km distance to the processing facility.

Saracen achieved an AISC of A$1,008/oz in 1Q18 and expects to achieve an AISC in the order of A$950/oz over the next three years. Should Echo be able to achieve a similar outcome, and adjusting for grade differential, open pit only mining initially, and higher cartage costs, EAR has the potential to achieve an AISC below A$1,000/oz as it moves to full production.

With a potential minimum mine life of 7-8 years, based only on the Orelia mineral deposit, its enterprise valuation of $82m looks undemanding and the risk/reward attractive in relation to a potential A$55m+ of potential annual pre-tax cashflow.



Orelia Long-Section with Recent Diamond Results