JM Financial Group

Issue 36: April 2018

Small Companies Strategy – Investment Newsletter

Performance *(As at 30th April 2018)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Small Companies Strategy	**+1.30**	**-2.53**	**+20.48**	**+59.42**	**+92.54**
Small Ords Accumulation Index	+2.75	+0.44	+18.45	+37.02	+45.05
Outperformance	**-1.45**	**-2.97**	**+2.03**	**+22.40**	**+47.49**

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 April*

The JMFG Small Companies Strategy appreciated 1.30% in April, underperforming the ASX Small Ordinaries Index which increased 2.75%. The performance of the ASX Small Ordinaries was dominated by the ASX Small Resources which increased 6.92% compared with the ASX Small Industrials +1.46%. All sectors of the market registered positive returns during April but there was a wide variation. The Financials sector only just registered a positive return at 0.17% compared with Energy +10.81%, Materials + 7.64%, Healthcare +7.44%, and Consumer Staples, +5.77%. Excluding Financials, other underperforming sectors included Telecommunications, Utilities, and I.T.

Portfolio underperformance during the month was a function of its lack of Energy exposure, with several of the larger Small Cap energy stocks appreciating by double digit amounts through April. These included Beach Energy +30%, and Worley Parsons +14%. The portfolio did however benefit from its holdings in Temple & Webster +45.5%, Xero Ltd +13.7%, and Hub 24 +10.4%. Its weakest holdings included Livehire -22.4%, and Self Wealth -13.3%. The rally in the market saw the Small Ordinaries become a little more expensive during the month with its 12 month forward PER rising from 16.8x to 17.0x. This compares with the ASX All Ordinaries Index which increased from 15.2x to 15.6x at month end.

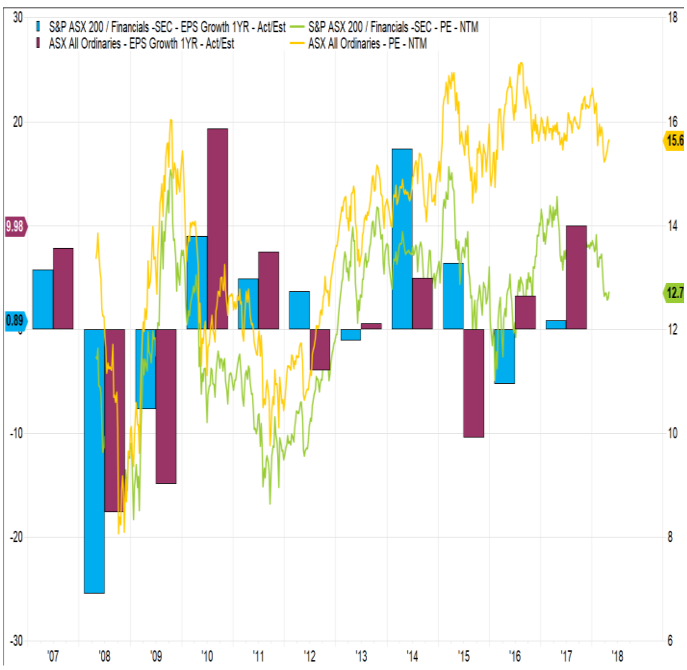
The JMFG Small Companies Strategy had a relatively quiet month in terms of trading. Small parcels of shares were sold in Temple & Webster and SRG Group, both on share price strength. We also initiated purchases in two new companies to the portfolio, The Data Exchange and Australian Ethical Investments. Our small position in Love Group was sold from the portfolio. While the portfolio cash position was cut from 17.4% at the end of March to 3.4% at the end of April, a large part of this reduction reflects an allocation of cash to SRG's Share Purchase Plan, attractively priced at $1.60 compared with its month-end price of $1.84. Likely scale-back in SRG's SPP effectively means the portfolio's underlying cash position is somewhat higher.

Chart of the Month – The Financials Sector

This month we feature the Australian Financials sector and compare its relative valuation against the broader market. In the chart we show the Financials sector 12-month forward PER alongside the ASX All Ordinaries 12-month forward PER. It highlights the disparity that has opened up between the Financials Sector and the ASX All Ordinaries. We also show earnings growth for each index.

The PER difference gap began to open up through 2015, as it became apparent earnings growth for the banking sector in 2016 and 2017 would lag the market. This was a function of slower credit growth and a regulatory requirement for banks to recapitalise their balance sheets.

The gap began to close in late 2016, but has opened up again since mid-2017, on weaker earnings growth, and more recently on the Royal Commission findings. We had held a bearish view on the Financials sector but recently neutralised this position on valuation relativity. While EPS growth may continue to lag the market, the franked yield is attractive.



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Best & Worst Performers for April 2018

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Temple & Webster - TPW	LiveHire - LVH	Beach Energy - BPT	Blue Sky Alternative Investments - BLA
Xero - XRO	SelfWealth - SWF	HT&E - HT1	iSelect - ISU
HUB24 - HUB	Opthea - OPT	APN Outdoor Group - APO	Village Roadshow - VRL

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

Temple & Webster (TPW) – up 45.5% for the month

Its quarterly Cash Flow Statement release highlighted a full 12 month period of positive operating cashflow and, more importantly, confirmation of comparable revenue growth of 23%, without distortions from prior amalgamations of online websites.

Beach Energy (BPT) – up 30.0% for the month (Not Held)

Oil continued its rally, with West Texas Intermediate and Brent Crude rising a further 5-7% in April, extending the recovery in oil and energy prices in excess of two years. Prices have now improved from around US$30/bbl to around US$70/bbl.

Livehire (LVH) – down 22.4% for the month

Despite continuing announcements of client wins and integrations with upstream sources of talent (Google, Facebook, Job Boards) and downstream with Human Resource Management Systems (Oracle, SAP, Workday), revenue receipts have been slow in coming, causing some frustration. The weak revenue receipt was evident in the release of its most recent Quarterly Cash Flow Statement in April.

Blue Sky Alternative Investments (BLA) – down 70.4% for the month (Not held)

Ongoing negative media coverage and concerns around the integrity of underlying products and valuations has resulted in a loss of confidence, leading to the share price decline and also management changes.

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

XERO Ltd (XRO) – Another Great SAAS (Software as a Service) story

Xero is a cloud-based online accounting software for small businesses and accountants/advisors. It provides its users with seamless links between bank transactions, general ledger, invoicing, receivables and payables, fixed assets, payroll, GST, financial reporting, and expense claims. It efficiently brings together all of the information for accounting practices and businesses to produce accounts and cash flows for their clients, minimising the requirement for manual data entry.

Xero's cloud-based software provides a low-cost path to market. Its competitive pricing model has made Xero the market leader in terms of growth, with over 1.2 million subscribers and growing. Pricing starts at $25/month per account for the starter package, which allows for a limited number of bank transactions, invoices, bills and quotes, and payroll for 1 person. The standard package at $50/month provides unlimited bills and transactions, and payroll for 1 person. The premium package at $60/month includes unlimited transactions, payroll for up to 5 people, plus automated superannuation and handling of multiple currencies. Higher-tiered packages are available for businesses with larger payroll numbers.

Xero is a highly leveraged business that has only recently surpassed operational breakeven; but given its high fixed cost base, Xero has the capacity to substantially grow its operating cash flow. Xero, in its 1H18 result, reported $188m in revenue and $5.4m EBITDA. To demonstrate the leverage, this was a major improvement on the $137m in revenue and $26m EBITDA loss reported in 1H17.

Annualised committed revenue was reported to be $417m in November 2017 with many years of potential subscriber growth; particularly significant given the opportunity in the UK and North America markets, where the subscriber base is still only around 260,000 and 110,000 respectively. The Xero business is also gaining traction in South East Asia and South Africa and still has the opportunity to grow its Australian/New Zealand customer base from its current 800,000+ client accounts.