JM Financial Group

Issue 42: October 2018

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st October 2018)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Small Companies Strategy	**-7.13**	**-1.07**	**+7.84**	**+39.89**	**+90.39**
Small Ords Accumulation Index	-9.60	-7.67	+2.59	+35.06	+38.93
Outperformance	**+2.47**	**+6.60**	**+5.25**	**+4.83**	**+51.46**

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 ASX Small Ordinaries Accumulation Index declined 9.60% in October, slightly worse than the ASX All Ordinaries which fell 6.47%. The JMFG Small Companies Strategy fell 7.13%, outperforming its benchmark by 2.47% in October. The Strategy has outperformed its benchmark by +6.60% over the past 3 months, a function of a relatively high cash balance during the quarter and a number of stocks which have either continued to rise or remained stable, despite recent market declines. Stocks which continued to increase over the quarter included; Temple & Webster +80%, Enevis +30%, The Citadel Group +19%, Polynovo +16% and Australian Ethical Investment +13%.

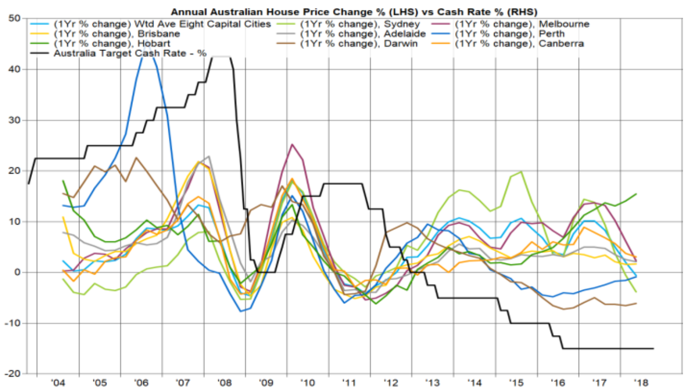
Only the Gold sector managed to gain ground in October, rising 7.6%. Other relatively strong sectors in October were defensive/yield sectors including Property -3.1%, Utilities -4.1%, and Consumer Staples -4.8%. The weakest sectors were mixed, with Energy -11.5%, I.T. -11.2%, and Discretionary Retail -8.0%. The ASX Small Resources fell 6.1%, while the ASX Small Industrials fell 10.6%.

With the large cash holding at the end of September (around 18%) and significant falls seen through October, we added three new stocks to the portfolio during the month (Mayne Pharma, Praemium and Corporate Travel Management) and added to positions across eight existing holdings. We reduced holdings in some of the strong performers during the month, including St Barbara and Polynovo, and sold our holding in Lynas Corporation following the Malaysian Government decision to review the company's operations.

With the ASX Small Ords Accum. Index falling significantly in October, its 12-month forward PER eased from 18.5x to 16.4x. While this still sits above the long-term average, which we estimate to be around 15x, the significantly lower interest rate environment, coupled with mid to high single-digit earnings growth, should support multiples above 16x. We now consider market pricing to be far more supportive of investment, and accordingly portfolio cash positions were cut through the month, to around 10% at the end of October, with further investment expected should the market continue to moderate.

Chart of the Month – Australian House Prices (ABS)

House prices in Australia are starting to ease after a sustained period of price growth. Over the past 15 years, average house prices have typically grown 6-8% p.a. The early part of the GFC saw house prices retreat briefly – ahead of a very significant rally late 2009 and into 2010 – following a reduction in the cash rate from over 7% to 3% by mid-2009. House prices eased again in 2011-12 when the cash rate increased from 3% to 4.75%. Since then, Australian house prices have been strong, during a period when the cash rate was progressively reduced to 1.5%. The exceptions were mining-dominated cities, Perth and Darwin, declining since 2015.



Despite the ongoing low cash rate at 1.5%, house prices are again under pressure. The chart above shows annual house price changes each quarter to June 2018. Sydney prices declined in the June quarter, taking the national average into negative territory. All of the evidence points to further declines across Sydney and Melbourne in the September quarter, with several other states likely to follow. Domain reported a September quarter national decline of 2.6% vs the June quarter, with Melbourne 3.9% lower. Clearance rates in Melbourne and Sydney have consistently been under 60% for some time. Pressure is building on several fronts. While the cash rate is low, out-of-cycle rate rises are starting to occur, but many other factors are potentially coming into play. A likely change of government and changes in capital gains and franking rules may affect buyer sentiment and income respectively. Other factors not helping are the weaker equity market, low wage growth, rising fuel prices, tighter lending from the banks and the weaker A$ feeding through to inflation.

Best & Worst Performers for October 2018

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
St Barbara – SBM	Vault Intelligence – VLT	Saracen Mineral Holdings - SAR	Kogan.Com – KGN
Medical Developments – MVP	Pinnacle Investment Mgmt Grp – PNI	Lynas Corporation – LYC	WPP Aunz – WPP
Mach7 Technologies – M7T	Praemium – PPS	St Barbara – SBM	Corporate Travel Mgmt – CTD

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

St Barbara (SBM) – up 19.2% for the month

Several announcements through the month provided support, including a quarterly production update, quarterly report, AGM presentation, and announced forward sales of 50,000oz of gold in 2020 at a predicted price of A$1,809/oz. The stock was also supported by a US$20/oz increase in the gold price over the month.

Saracen Mineral Holdings (SAR) – up 31.4% for the month (Not Held)

Similar to St Barbara, a quarterly production update and quarterly report and AGM supported the share price, along with a US$20/oz increase in the gold price over the month.

Vault Intelligence (VLT) – down 53.2% for the month

A downward restatement of prior period contracted annualised recurring revenue, due to incorrect company calculations, was a major blow to management credibility, particularly following their $5m capital raising in the preceding month.

Kogan.com (KGN) – down 50.0% for the month (Not held)
One can only look at Kogan with a degree of cynicism, with significant founder/executive equity sales in September realising $40m and a disappointing trading update in October, with weaker than expected sales and gross margins announced.

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

Catapult (CAT)

Catapult creates a range of technologies to help athletes and teams maximise their performance, by providing integrated player data and video combined with analytical applications, and an athlete management systems. Catapult was founded in 2006 and listed on the Australian market late 2014. It has developed a global business with over 300 employees and over 1,800 professional team clients across 128 countries and 35 sports.

The opportunity however is still significant, with over 10,000 professional teams and the opportunity to sell into a further 10,000 semi-professional or high-level amateur teams. The current professional addressable market is loosely estimated to be worth $450-$550m, with significant additional revenue potential in the semi-professional or high-level amateur (prosumer) market. Catapult is developing simplified versions of its technology for the prosumer market, aimed at either individuals or lower-ranking amateur teams.

Catapult generated $73m of revenue in FY18 and has guided for $86-88m in FY19. It also guided underlying core EBITDA of $11-$13m in FY19, up from $8.0m in FY18, indicating each additional dollar of revenue converts to around $0.30 in cashflow.

After early success and much hype, Catapult's share price went from $0.50 on listing to around $4 by the end of 2016. It subsequently retreated to around $1, through a period of cash burn and several acquisitions, which ultimately rounded out the business to a more complete player assessment and management system.

The company is now far better positioned to take advantage of the significant opportunities in front of it, being cashflow positive with a net cash balance at the end of September 2018 of $33.6m.

During the September quarter Catapult signed up new leagues and teams, including: National Hockey League (US); Milwaukee Bucks and San Antonio Spurs in the US NBA; S.L. Benfica in Portugal; FC Copenhagen in Denmark; Argentinos Juniors in Argentina; Sportivo Luqueno and Sol de America in Paraguay; and Colchester United and Chelsea FC (renewed) in the UK.

Prosumers Add To The Professional Market Opportunity