INVESTSMART AUSTRALIAN SMALL COMPANIES

30 SEPTEMBER 2017

INTELLIGENT INVESTOR

Portfolio commentary

With most companies listed on the ASX having June year ends, the annual reporting season in August is always a hectic time. Happily, our new Small Companies Fund came through the deluge of company reports pretty well, with most of its holdings reporting good results.

The fund returned 9.2% after fees and expenses in the three months to 30 September 2017 compared to 4.4% for the ASX Small Ordinaries Accumulation Index. Since inception on 1 February 2017, the fund has returned 21.5% after fees and expenses, compared to 8.2% for the index.

Recreational vehicle and manufactured housing maker Fleetwood released a terrific result, thanks to a strong performance from its Accommodation division. While sales to the resources sector have evaporated since the mining boom turned to bust, sales to the education and affordable housing sectors have more than compensated.

Adacel Technologies, the maker of air traffic control software, also reported a fine result. Although earnings fell due to lower ‘systems’ revenue as contracts were delayed, its larger ‘services’ revenue increased and the delay in contract awards means it is well placed for 2018. The board has resolved to pay a 7.75 cent special dividend in addition to the 2.25 cent final dividend.

We’ve also had some good fortune, with two of the fund’s early holdings being taken over.

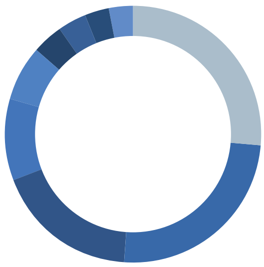
Touchcorp, in which we held a 7% weighting, merged with Afterpay to form Afterpay Touch Group, while Rubik Financial, in which we held 5%, was taken over by the Swiss technology giant Temenos.

Less positive has been the performance of comparison website iSelect, which ‘only’ achieved the midpoint rather than the upper end of its guidance for $21m–24m in earnings before interest and tax (EBIT) and its shares dropped 20%.

While growth in its Health division may be limited due to private health insurance premiums continuing to rise faster than wages, the company should benefit from the rollout of the NBN, which will require every broadband customer in Australia to choose an NBN provider in coming years.

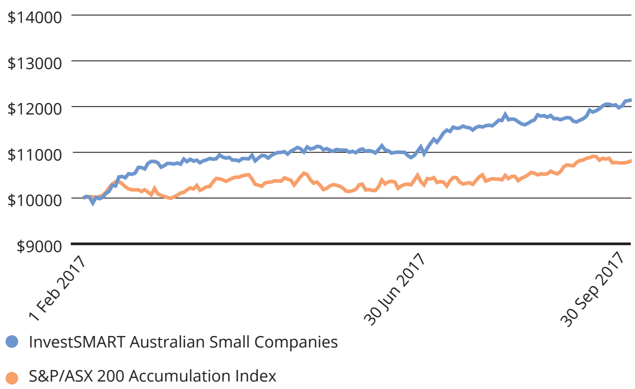
Rising energy prices should also benefit its Energy & Telco division as consumers attempt to minimise the hit to their wallets from Australia’s chaotic energy policy (or lack thereof).

ASSET ALLOCATION AS AT 30 SEPTEMBER 2017



Cash	26.41%
Consumer Discretionary	24.76%
Information Technology	18.17%
Industrials	10.13%
Materials	6.98%
Real Estate	3.98%
Financials	3.71%
Telecommunication Services	2.95%
Energy	2.91%

GROWTH OF $10,000 – INCOME REINVESTED AS AT 30 SEPT 2017



PERFORMANCE TO 30 SEPTEMBER 2017

	1 MONTH	3 MONTHS	6 MONTHS	1 YEAR	SI* (P.A.)
INVESTSMART AUST SMALL COMPANIES FUND	3.50%	9.24%	11.50%	N/A%	21.48%
S&P/ASX SMALL ORDINARIES ACCUMULATION INDEX	1.31%	4.41%	4.04%	2.98%	8.21%
EXCESS TO BENCHMARK	2.19%	4.83%	7.46%	N/A%	13.27%

Source: Praemium. Returns are after investment fees and admin fees. Returns are shown as annualised if the period is over 1 year. * Since Inception (SI) date is 1 February 2017.

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Portfolio commentary continued

TOP FIVE HOLDINGS AT 30 SEPTEMBER 2017

COMPANY NAME
ACADEMIES AUSTRALASIA
GLOBAL CONSTRUCTION SERVICES
KANGAROO ISLAND PLANTATION TIMBERS
REDFLEX
RPMGLOBAL

Note: holdings in alphabetical order

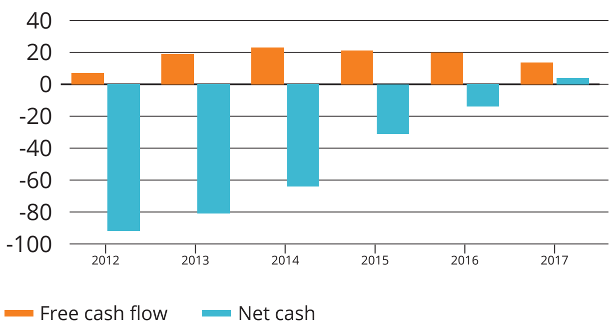
POLITICAL TURMOIL

Despite ongoing political turmoil around the world and moves by central banks, led by the Federal Reserve, to begin 'normalising' interest rates, markets keep going from strength to strength.

Investors seem to be ignoring the chance that currently very low volatility will someday increase but we're sure it will at some stage – and most likely due to something we can't foresee.

However, similar to how we manage our Equity Growth and Equity Income portfolios, we'll leave the macroeconomic forecasting to others and just concentrate on finding what we believe are attractive opportunities for the portfolio.

GCS'S FREE CASH FLOW AND NET CASH



Source: Company reports

With opportunities relatively thin on the ground, the fund's current cash weighting of 26% is above the level we'd view as 'normal', but it does leave us with some dry powder for opportunities as they arise.

GLOBAL CONSTRUCTION SERVICES (GCS)

An example of a recent opportunity is Global Construction Services (GCS).

GCS is a Western Australian labour services and equipment hire business that operates in the commercial, residential, resources and oil and gas industries.

After being formed in 2003 to acquire Security Scaffolding, a Western Australian scaffolding business, the company went on an acquisition binge both before and after listing on the ASX in 2007.

Businesses were purchased in scaffolding, formwork, temporary accommodation, concrete contracting and specialised labour hire – much of it funded with large licks of debt. GCS also established businesses in plant hire and mining vehicle hire.

The recent downturn in resources and oil and gas hit the company hard, forcing it to substantially write down its hire assets and put them up for sale. In recent years the company has also concentrated on reducing debt.

When the fund first bought GCS shares at around $0.59 in February, we felt it was being unfairly marked down due to impact of the resources downturn and past capital allocation decisions.

This was despite GCS having successfully repaid $100m in debt while having a free cash flow yield in the high teens at the time.

Those who just looked at the profit and loss statement may have missed its high free cash flow yield due to accounting depreciation being materially higher than the company's capital expenditure.

A major reason for this relates to GCS's main business of hiring scaffolding equipment. This equipment is depreciated for accounting purposes over a shorter period than its practical useful life, as scaffolding requires little maintenance capital expenditure.

Moreover, in October 2016, GCS sold its 50% share of SmartScaff, which provides scaffolding for hire in Sydney, Melbourne and Brisbane. Being equity-accounted, this investment contributed to earnings but not to cash flow, as SmartScaff wasn't paying dividends.

Back in February, we felt investors were unduly concerned over the reduction in GCS's earnings as a result of this sale, although its much higher operating cash flow has remained unaffected.

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GCS had also recently recommenced paying dividends, including a 2 cent special dividend in November 2016.

The company has also recently expanded on the east coast. In October 2017 GCS purchased 51% of Podium Glazing, a Melbourne-based supplier of architectural facades, 'for a nominal upfront sum' and potential deferred consideration depending on performance. This business contributed $5.7m in net profit before tax in 2017.

GCS also recently acquired Melbourne-based Summit, which provides construction services specialising in formwork, concreting and reinforcement to commercial, residential and retail developments in Victoria.

Then in late September the company announced the conditional sale of its equipment hire division. Representing less than 10% of the group's total revenue, should this sale go ahead, GCS will be left with net cash of around $30m. With surplus franking credits of $24m, another special dividend is possible.

The steps described above illustrate that GCS's capital allocation has improved markedly, and investors have taken note, pushing its shares up 23% since early February.

Even so, with a free cash flow yield still in the low teens, we believe the company remains undervalued.

And after the tragedy at Grenfell Tower in London, the company may also benefit from moves to check and potentially replace cladding on high rise buildings.

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