Jencay Australia Investment Fund

Quarterly report – 30 September 2016

JENCAY capital
AFS Licence Number 402024
ACN 148810413

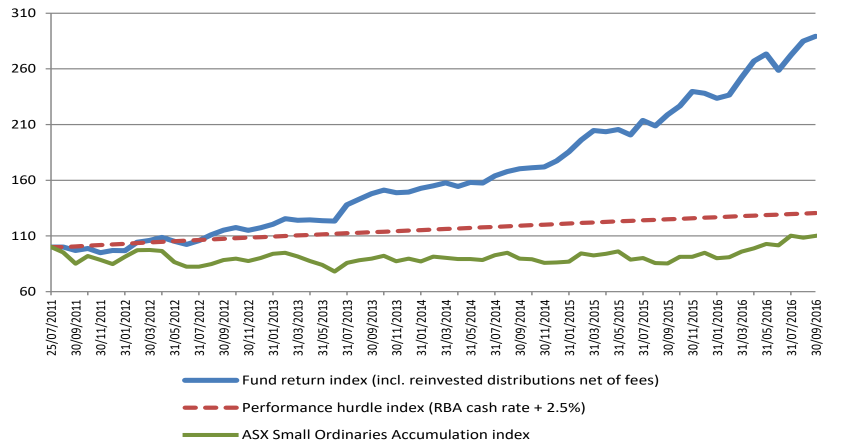
Performance

Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income	Since inception (annualised)	Latest 12 months	Latest Quarter
Fund total return	**22.7%**	**32.2%**	**11.8%**
Performance hurdle (RBA cash rate + 2.5%)	5.3%	4.5%	1.0%
ASX Small Ordinaries Accumulation Index	1.9%	29.2%	8.5%

Unit Price

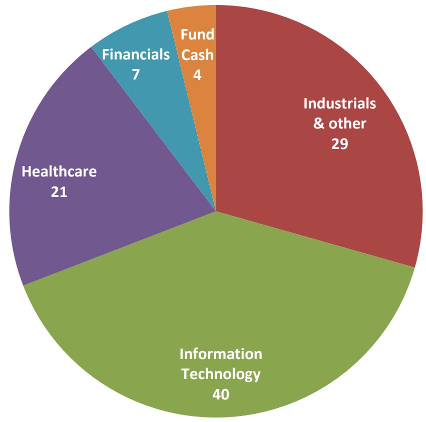
NAV per unit		**AUD 2.380**
Application price	(0.5% spread added)	AUD 2.392
Redemption price	(0.5% spread deducted)	AUD 2.368

Performance Chart



The chart tracks the movement in value of AUD100 invested in the Fund at inception, relative to the Reserve Bank of Australia cash rate plus 2.5% (performance hurdle) and relative to the ASX Small Ordinaries Accumulation index. Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income.

Fund Composition



Fund size : **AUD 51m**

The Fund enjoyed a 12% gain for the quarter compared to gains of 8.5% for the ASX Small Ordinaries Index and 5% for the ASX All Ordinaries Index. Longstanding position, Galileo Japan Trust, was sold following its IPO in Japan and planned liquidation and delisting from the ASX. Altium slipped out of the top 10 and is discussed in depth overleaf. Two stocks entered the top 10 for the first time, 3P Learning - a new fund holding, and Nanosonics, which has been in the portfolio for 3.5 years but entered the top 10 following strong price gains. Both stocks are described below.

Top 10 Positions

Weight %	Name	Summary Investment Case
7	**nearmap**	Using proprietary technology, nearmap captures high resolution images of cities from light aircraft and renders them seamlessly on a subscription based website within 2 days of capture (a more current and clear version of Google Earth). Australian revenues are growing off a relatively fixed cost base and US sales are building. Nearmap's growth and investment is being funded internally by their strong free cash flows.
6	**Pro Medicus**	The pipeline of opportunity for their world leading radiology image viewing platform continues to grow following 8 significant US client wins in the last two years including recently announced deals with the prestigious Mayo Clinic and Mercy hospital group. Deal wins continue to justify the growing valuation although upside is not as large as it was.
6	**Adslot**	Leading supplier of workflow and trading software, purpose built for the $51b forward guaranteed online display advertising market. As one of the first movers in this space, Adslot is set to benefit from the predicted shift from manual to automated buying in this enormous global industry. During the quarter GroupM, the world's largest media buying agency, agreed to roll out Adslot's Symphony media workflow software solution, which positions them strategically as GroupM's favoured automated guaranteed trading platform.
5	**GBST**	Leader in the provision of stockbroking and wealth management platform software. Many of their products are world class which has driven strong growth in the UK and Asia. Their biggest Wealth client, Aegon recently purchased Co-funds' and Blackrock's wealth platforms and will utilise GBST's Composer platform to integrate the large acquisitions which should help to grow implementation and license revenues over the next few years.
5	**Netcomm Wireless**	Global leader in wireless communication devices with a focus on the burgeoning Machine to Machine (M2M) wireless Internet of Things. Netcomm has partnered with some of the world's leading Telco carriers and is the sole supplier of rural fixed wireless devices to Australia's National Broadband Network (NBN). AT&T is a significant recent addition to their rural broadband pipeline. The company is investing significantly in its engineering team in order to handle its growing pipeline of work which will suppress profits in the short term.
5	**3P Learning**	Online learning company, best known for its world leading online maths homework tool called Mathletics which has 4.6m users spread over 20,000 schools across the world. It also distributes Reading Eggs, a popular e-Literacy tool, and has a 40% stake in Learnosity, the global leader in generic online assessment APIs. Its longstanding CEO departed in January and a profit downgrade followed in June. The share price weakness that followed these events provided an opportunity to buy into this quality company at an attractive price.
5	**Medical Developments**	The company has been supplying Penthrox, an extremely effective analgesic (pain killer) in emergency medical settings in Australia for 30 years but only recently entered foreign markets after securing European marketing approval and distribution partners. Additional distribution arrangements/approvals were secured for new geographies including UAE, Canada and Korea during the quarter. Their world class asthma spacer is gaining traction with further international distribution arrangements signed.
5	**Austal**	The world's leading aluminium ship builder with significant, long term US Navy contracts in addition to its commercial and other military sales. The share price recovered somewhat after their disappointing 2016 results were released, potentially reflecting a belief that the worst is behind them with their growing construction and service pipeline expected to result in significantly larger profits in the future.
4	**Integrated Research**	Global leader in performance monitoring and diagnostics software for business critical IT infrastructure in particular Unified Communications and Contact Centres. 5 of the world's 10 biggest companies use their software. We anticipate strong future profit growth to result from a shift from perpetual to term licenses and strong product traction.
4	**Nanosonics**	Nanosonics manufactures and distributes a unique device that disinfects ultrasound probes using a proprietary Hydrogen Peroxide nano-mist process. With over 60% market penetration in Australia and New Zealand and 20% in the US, Trophon is gaining rapid acceptance as standard practice in the industry. As the installed base builds, dependable, high margin consumable sales grow. Although the valuation looks stretched relative to our entry price 3.5 years ago, strong growth on a relatively fixed cost base and a strong pipeline of further innovation in the Infection prevention space, make us reluctant to let go of this quality company too soon.

Altium – a valuation case study

Altium is a world leader in Computer Assisted Design (CAD) Software for Electronics Engineering. The Fund first acquired shares in the little known company in May 2013 when the share price was $1.40 and market cap $150m. Although it has slipped out of our top 10 stocks this quarter, it is still held by the Fund. We have confidence they can continue growing given their market leading product offering, excellent management, strategic nous and direct distribution model which has resulted in them winning the lions' share of new software licenses in the growing industry in recent years.

2013 Forecasts vs. Actual numbers

The forecasts we prepared in May 2013 are compared to Altium's subsequent actual results below:

			Forecast May 2013			Actuals		
Year-end	Jun-11	Jun-12	Jun-13F	Jun-14F	Jun-15F	Jun-13	Jun-14	Jun-15
Revenue	**48,340**	**55,026**	**63,690**	**68,785**	**74,288**	**60,931**	**70,670**	**80,216**
Costs	(48,485)	(47,606)	(48,000)	(47,000)	(48,410)	(49,107)	(53,154)	(58,629)
EBITA	**(145)**	**7,420**	**15,690**	**21,785**	**25,878**	**11,824**	**17,516**	**21,587**
Revenue growth			16%	8%	8%	11%	16%	14%
Cost growth			1%	-2%	3%	3%	8%	10%
EBITA growth			111%	39%	19%	59%	48%	23%

Subsequent actual revenues and expenses exceeded my forecasts whilst profits were below my forecasts.

Current market value vs. our 2013 valuation

In May 2013 we valued Altium at $320m or $3 per share. Despite underperforming our forecasts, it currently has a Market Cap of $1.2b and a share price around $9, three times the value we placed on it just 3.5 years ago. Either the current market valuation is ridiculous or our initial valuation was understated. We do not believe the current market valuation is ridiculous which implies our initial valuation was too conservative, but why?

The answer is that we modelled Altium over too short a time period and used a terminal earnings multiple (EV/EBITA of 12x) that proved to be too low given Altium's ability to generate strongly growing free cash flow. Fortunately we did not sell out of Altium when it hit $3 but we may have erred in trimming our position too early. We now do 20 year forecasts for quality growth companies like Altium and although we know our forecasts will not be correct, it gives us a better feel for the sensitivities around the valuation and assists in appreciating why a quality cash generative company that can grow free cash flows for many years is so valuable.

Revised Altium valuation

Altium is worth over AUD 1.8b assuming:

- Revenues grow at an initial rate of 15% p.a. and this growth rate declines to 0% evenly over the next 20 years;
- Costs/Overheads grow at 60% of the revenue growth rate, consistent with the recent past;
- A terminal (20 year) P/E multiple of 10x and 10% discount rate.

Based on the above scenario it seems that Altium still has reasonable upside. However, the valuation is very sensitive to the assumptions used, as illustrated by the following table showing the sensitivity of the valuation (in AUD millions) to the key assumptions of Initial Revenue growth and Terminal earnings growth:

		Terminal earnings growth rate			
		-5%	**0%**	**5%**	**9%**
Initial Revenue growth %	**10%**	863	1,174	1,920	5,114
	15%	1,336	1,862	3,264	12,255
	20%	2,044	2,910	5,286	22,441

The table suggests that upside still significantly outweighs downside in spite of the seemingly lofty current forward P/E multiple approaching 30x.

Key learnings:

- Altium does not need to reinvest capital to grow, as its main investment is in R&D which is expensed as incurred, therefore it can distribute all its profits and still grow earnings in comparison to most companies that must retain a large portion of profits to invest for growth. DCF should capture this "cost" but simple P/E comparison does not and is probably the biggest source of valuation error in the market.
- Very high quality scalable companies that can grow free cash flows over multiple years without significant reinvestment are often underappreciated. We will endeavor to take significant care before selling such companies, but it may be unavoidable if we need cash to invest in even more attractive opportunities. As an example we needed to trim some positions to invest in 3P Learning during the quarter.
- Valuation is very difficult and is certainly not a perfect science. Incorporating a range of assumptions and modelling longer term assists our understanding of the risks and upside.

Fund Key Features

Comprehensive Terms are contained in the Information Memorandum which can be downloaded from the website www.jencay.com.au or sent to you upon request

Custodian	JP Morgan Chase Bank N.A.
Administrator	White Outsourcing Pty Ltd
Fund auditor	PricewaterhouseCoopers
Inception	25 July 2011
Investment strategy	The Fund seeks to generate attractive risk-adjusted returns over the long term and protect capital by buying securities trading significantly below fair value (bargains) and holding cash on deposit when bargains are not available in the market. The Fund has a small cap bias in accordance with the Manager's opinion that the majority of bargains are found amongst small caps.
Product type	Wholesale managed investment scheme available to wholesale clients and sophisticated investors
Investment universe	All securities listed on the Australian Securities Exchange (ASX) and cash to be held on deposit
Fund size cap	$200 million in net subscriptions. To manage liquidity the Trustee may limit the quantum of monthly inflows.
Investment restrictions	▪ Maximum of 40 individual securities ▪ Maximum exposure of 15% to a single security ▪ No short positions ▪ No leverage
Minimum initial investment	$100,000
Minimum additional investment	$20,000
Minimum redemption amount	$20,000
Base management fee	1% p.a. excluding GST. Management Expense Ratio 1.025% p.a. inclusive of non-recoverable GST.
Performance fee	20% of returns above the Hurdle rate subject to a high water mark. The Hurdle rate is the Reserve Bank of Australia Cash Rate Target plus 2.5%.
Entry fee	None
Buy spread	0.5%
Sell spread	(0.5%)
Redemption notice	6 months' redemption notice required otherwise 5% early exit penalty to be applied

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