Jencay Australia Investment Fund

Quarterly report – 30 September 2024

JENCAY capital
AFS Licence Number 402024
ACN 148810413

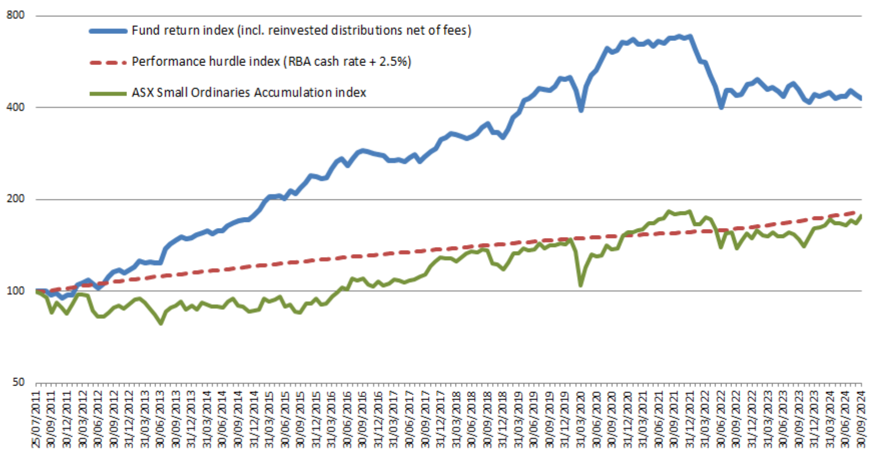
Performance

Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income. Returns are annualised apart from the Latest Quarter figures.	Since inception p.a.	Latest 5 years p.a.	Latest 12 months	Latest Quarter
Fund total return	**11.6%**	**(1.3%)**	**(7.0%)**	**(2.0%)**
ASX Small Ordinaries Accumulation Index	4.4%	4.4%	18.8%	6.5%
Performance hurdle (RBA cash rate + 2.5%)	4.6%	4.4%	7.1%	1.8%

Unit Price

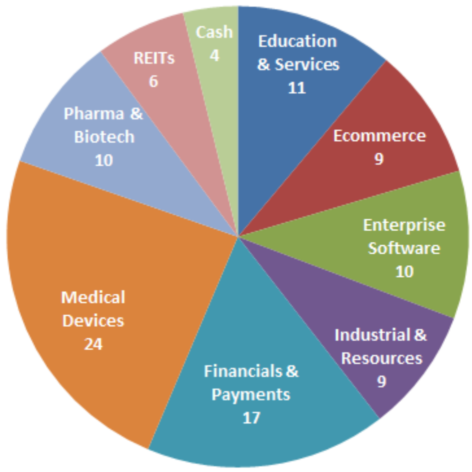
NAV per unit		**AUD 2.3198**
Application price	(0.5% spread added)	AUD 2.3314
Redemption price	(0.5% spread deducted)	AUD 2.3082

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. The chart utilises a log scale on the vertical axis to reflect relative returns more clearly.

Fund Composition



Fund size: **AUD 111m**

Top 10 stock positions as % of overall portfolio: **58%**

The Fund's unit price reduced 2% this quarter, compared to gains of 6.5% for the ASX Small Ordinaries index and 8% for the ASX All Ordinaries Index. Larger market cap companies continue to enjoy share price strength whilst smaller companies continue to languish, regardless of fundamental performance, as explained overleaf.

Tyro was replaced in the top 10 by new entrant AI Media (described overleaf) due to relative share price movements. The combined weight of the top 10 holdings reduced from 64% of the Fund to 58% driven by share price weakness for some top 10 positions (Medadvisor, Smartpay, EML and Jumbo), strong gains by a few non-top 10 holdings, and additional cash. The payments segment has been particularly weak this quarter due to negative sentiment around declining central bank interest rates, an RBA review of surcharging in the merchant acquiring space, and some stock specific developments.

The Fund's cash position increased from 1% to 4%, driven by meaningful net inflows into the Fund.

Top 10 Stock Positions

Weight %	Name	Summary *(recent developments in italics)*
10	**Medadvisor**	Medadvisor's digital medication adherence platform links patients to pharmacies via a proprietary patient management system, App and SMS service in Australasia and the US. *The company delivered according to expectations for F24 and provided an encouraging 5-year growth plan. Nevertheless, the share price has been weak - potentially due to some investors taking profits following last quarters big run up, and caution around a technology refresh which will be implemented over the next 18 months.*
7	**Praemium**	Praemium operates a market leading, modern wealth management platform in Australia that is taking share from the large, legacy institutional platforms. *2H24 results surprised the market on the upside which bodes well for F25. The company is about to launch a new wrap platform for the mid-market that could help accelerate inflows.*
6	**Smartpay**	Leading operator of card payment terminals in New Zealand and challenger in merchant acquiring in Australia. A launch of New Zealand Acquiring is targeted for late this year following the achievement of important milestones. *The RBA is currently reviewing interchange costs and surcharging in Australia which has created potential uncertainty for merchant acquirers and Smartpay's share price has dropped in response. We believe the risk of changes that would be materially negative for Smartpay is low.*
6	**3P Learning**	Online learning software for school and home markets with products that include Reading Eggs, Mathletics and Mathseeds. *3P delivered a softer result than expected but are optimistic a new sales strategy, that incentivises use of more than one of their products on a school-wide basis, will inject growth.*
5	**Aroa Biosurgery**	Fast-growing challenger in soft tissue wound care and surgical scaffold products, with a superior tissue source (sheep forestomach) and proprietary processing technology that confer Aroa a cost and quality advantage over peers. *Aroa's hernia product distributor in the US reported weaker than expected revenue growth in the June quarter which could have some impact on Aroa revenues.*
5	**AI Media**	Leader in the provision of live caption services primarily to broadcasters. AIM emerged in our top 10 for the first time this quarter - we provide more background on the next page.
5	**EML Payments**	Provider of prepaid debit cards and payment solutions in Australia, North America and Europe. Applications include shopping mall gift cards, corporate incentives, mobile wallets and salary packaging. *New well-credentialed Chair and CEO appointed. With the Sentennial sale approved by regulators and PFS deconsolidated, most legacy issues are behind them, with future growth the priority. A large portion of EML's revenues comprise interest on their sizeable float – recent central bank rate reductions have weighed on the share price.*
5	**Jumbo Interactive**	Reseller of official Australian Lottery tickets via the www.ozlotteries.com website with about a 20% share of online lottery sales in Australia. Jumbo is successfully diversifying revenues by leveraging their exceptional lottery platform into SAAS and managed services for charity and state lotteries. *Jumbo delivered an exceptional F24 result due to a big run of jackpots which will be hard to match in F25. They were "rewarded" with a 20% price drop! Jumbo's harsh treatment is a good example of current market short-termism.*
5	**Articore Group *(formerly Redbubble)***	Articore Group owns *www.redbubble.com* and *www.teepublic.com* , two leading global marketplaces linking independent artists with 3rd party fulfillers for on-demand production and distribution of unique apparel and other items to end customers. *The company achieved its objective of cashflow breakeven in F24. A new initiative to further leverage their fulfilment network will launch shortly - a print-on-demand and fulfilment option for artists/creators that have their own storefronts (on places like Youtube, TikTok, Instagram).*
4	**Clinuvel**	Clinuvel's orphan drug Scenesse is a unique hormone replacement implant used to treat patients with erythropoietic protoporphyria (EPP), a rare skin disease that causes intolerance to light. Their IP is being utilised to develop drugs in adjacent areas such as Vitiligo, DNA skin repair, as well as stroke recovery and Parkinson's treatment. *A solid F24 result was reported with growth in both revenue and earnings notwithstanding investment in their clinical programs. Completion of the Vitiligo Phase 3 clinical trial has been slightly delayed.*

Contrasting earnings and share price performance for small vs. big stocks

In our quarterly report for June 2023 we tabulated median share price performance for the ASX, segmented by size buckets but did not relate the share price movement to changes in fundamentals. Given the continued trend of share price underperformance by the smaller companies, we have taken the analysis a step further and compare the price performance to earnings per share (eps) performance – the table below shows stock price changes over a two-year period segmented based on market cap size bucket and direction of earnings movement[1] relative to the Jencay portfolio experience over the same period.

Stocks by mkt cap size	Mkt cap	Median 2yr eps change	ASX universe median 2yr price change %			Jencay portfolio				
	largest stock $m	*%*	*all stocks*	*2yr eps up*	*2yr eps down*	*no. stocks*	*portfolio weight %[2]*	*2yr eps up (% weight)*	*2yr eps down (% weight)*	*average 2yr price change %*
Top 100	241,832	5.5	24.0	37.0	**15.6**	-	-			
101-300 (small-ords)	3,713	4.0	15.8	36.0	-3.3	3	13	13	-	-16
301-500	494	1.4	1.8	37.9	-16.9	8	46	31	15	29
501 down	136	-5.4	-56.9	**-53.8**	-60.0	11	24	20	4	-41

[1] "all stocks" includes the universe of stocks with a primary listings on the ASX subdivided into market cap size buckets (rows) and further split by direction of eps (up or down) in the columns to the right.
[2] weights add up to 83% - the remaining 17% comprises stocks listed on foreign exchanges plus cash

Source: Factset and Jencay

Key observations from the table above:

Large market caps

The median large company grew eps modestly over the last two years (5.5% median eps increase for top 100) yet enjoyed strong median share price gains of 24%. The top 100 were almost immune from share price drops – those that suffered eps declines over the period were up a median **15.6%**! Below the top 100, median price performance declined in line with market cap, especially for those whose earnings went backwards.

Small market caps

The smallest companies on the ASX (501st in size down to 1785 in size) reduced eps modestly (5.4% median eps decrease for the smallest companies) yet suffered a staggering median price drop of 56.9%! In stark contrast to the large companies, the smallest companies almost all suffered share price losses (85% of them), with little differentiation between those that grew earnings (median price drop of **53.8%**) and those whose earnings contracted (median price drop of 60%).

Jencay Portfolio

Jencay owns three stocks in the small ordinaries index (i.e. 2nd line in table above) – Jumbo Interactive, Clinuvel and Tyro. Although all three have grown earnings strongly over the two years, they are down 16% on average – this is out of line with performance in that part of the market. Our representation in the third category (301-500 in size) has fared significantly better, up 29% on average vs. 1.8% up for the median, supported by earnings improvement. Jencay's stocks in the smallest category have suffered a 41% average price decline, despite solid earnings improvement, which is modestly better than median for this part of the Universe.

It has been difficult to achieve respectable returns in the small end of the market over the last two years given the dynamics described above.

History of small vs. big company share price performance

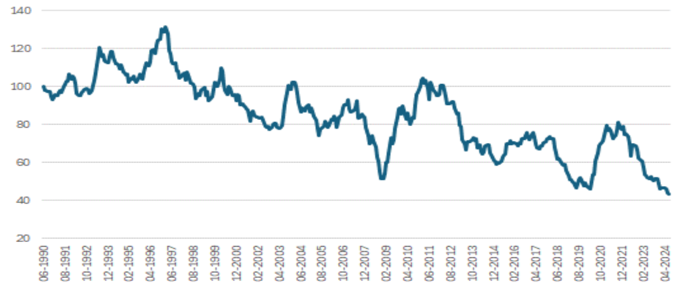
Many people acknowledge the distortion and inefficiency I have attempted to convey above, but wonder whether it will correct/change and if so, when? The chart below is instructive:

AQR US small minus big factor (SMB) reflected as in index

Source: AQR. We have utilised AQR data because it incorporates data for all US listed companies over almost a century in comparison to indices that only reflect a selection of stocks and weights them by market cap. The AQR SMB factor is calculated as the monthly performance difference between a portfolio of the smallest 50% of stocks ranked by market cap minus portfolio of the biggest 50% of stocks ranked by market cap.

The overall, upward sloping albeit jagged trend reflects US small caps outperforming large caps over many decades (based on a purely passive approach). There have been multiple extended periods of underperformance by small companies during that long history, notably from the late 40s to late 50s; late 60s to mid 70s; mid 80s to early 90s; mid 90s to late 90s and then again more recently. Each prior period of underperformance was followed by strong outperformance.

AQR Australia small minus big factor (SMB)



In contrast to the US, Australian small companies as a group have underperformed Australian large caps since AQR tracking started in 1990. The ASX contains a larger proportion of tiny, lossmaking businesses than the US market (i.e. poorer quality businesses including a host of junior miners and explorers with no revenues) which likely accounts for the difference. Nevertheless, the trend is also very cyclical with prior periods of underperformance subsequently reversing. The current equivalent SMB index for Australia is down about 50% from its prior peak in December 2021, its biggest % decline since 1990.

Summary

Currently, it seems that large caps can do no wrong in investors eyes, while small caps can do no right, regardless of underlying fundamental performance!

The inefficiency of the market over the last few years has been astounding – when poor fundamental performance of the large companies is met with solid price gains and strong fundamental performance by smaller companies is met with price declines, we either have a big problem…or a big opportunity.

Share market history suggests that these distortions will narrow or reverse and although timing the turning point is impossible, we feel strongly that the lions' share of outsized risk adjusted return opportunities reside in the smaller cap end of the market given their recent inequitable treatment.

A word on AI Media (AIM) – our new top 10 position

AIM, a stock that we started buying in late 2021, emerged in our top 10 this quarter following a share price jump prompted by the release of very ambitious 5-year targets (revenue $150m vs. current $66m; and EBITDA of $60m vs. current $4m).

AIM is a leader in the provision of live caption services for broadcasters in the US and Australia. It has been in existence for over 20 years and is still led by its smart, passionate founder who retains a 17% shareholding. The industry is somewhat in crisis as the traditional method of human captioning is replaced by machines (automated speech recognition systems (ASR)). AIM is both a victim and beneficiary of this shift – four years ago all their revenue was derived from human services, but has declined to 50% of the total, as the growth of AIM's technology solutions (came via acquired US business EEG Media) have more than offset the decline in human captioning but at a gross margin almost double that of human services.

Their technology offering, which includes the placement of hardware in broadcasters' studios that enable the live caption feed, followed by SAAS and ASR services, is market leading. AIM's Lexi ASR engine adds a layer on top of large language models that assists in interpreting context, names, localisation, multiple speakers etc. which combined with their embedded hardware and ability to get live captions into the broadcast feed with little latency, provides a strong competitive differentiator and moat.

Although AIM's share price has more than doubled over the last 3 months (we have taken a little off the table), at its current enterprise value of $150m, it is valued at just over 2x revenue and less than 10x F27 expected EBITDA - still modest for a leader in its chosen niche that is rapidly taking share from its legacy human services competitors and growing technology revenues at circa. 30% p.a.

Fund Key Features

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 most bargains are found amongst small caps.
Investment universe	Securities publicly traded on a recognised securities exchange and cash to be held on deposit
Investment restrictions	▪ Maximum of 40 individual securities ▪ Maximum exposure of 15% to a single security ▪ No direct short positions ▪ No leverage at Fund level
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%.
Redemption notice	6 months' redemption notice required otherwise 5% early exit penalty to be applied
Custodian & Administrator	Apex Fund Services Pty Ltd (head custodian and Administrator) and JP Morgan Chase Bank N.A. (sub-custodian)

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