Jencay Australia Investment Fund

Quarterly report – 31 December 2024

JENCAY capital
AFS Licence Number 402024
ACN 148810413

Performance

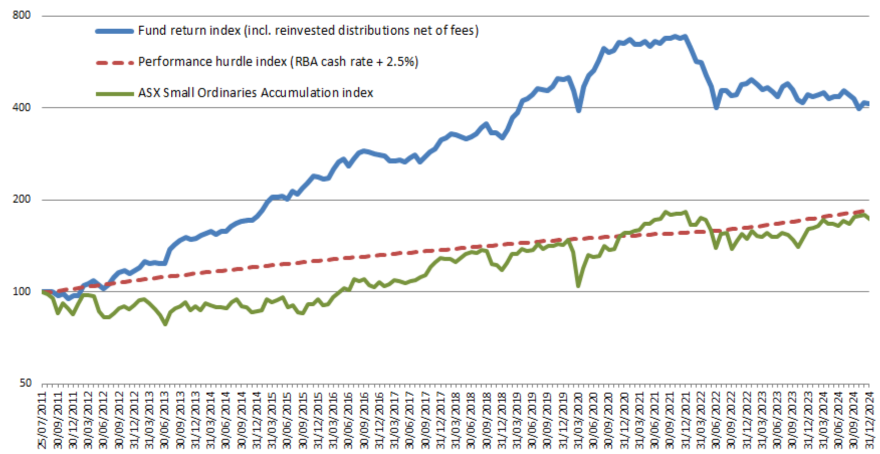
Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income. Returns are annualised apart from the Latest Quarter figures.

	Since inception p.a.	Latest 5 years p.a.	Latest 12 months	Latest Quarter
Fund total return	**11.1%**	**(3.7%)**	**(7.5%)**	**(4.0%)**
ASX Small Ordinaries Accumulation Index	4.2%	4.0%	8.4%	(1.0%)
Performance hurdle (RBA cash rate + 2.5%)	4.7%	4.6%	7.1%	1.7%

Unit Price

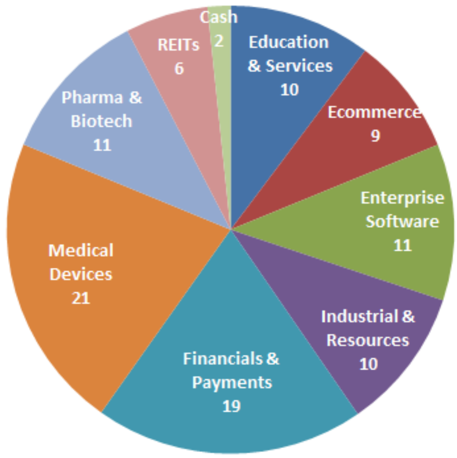
NAV per unit		**AUD 2.2266**
Application price	(0.5% spread added)	AUD 2.2377
Redemption price	(0.5% spread deducted)	AUD 2.2155

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 106m**

Top 10 stock positions as % of overall portfolio: **55%**

The Fund was down 4% for the quarter relative to 1% declines for both the ASX Small Ordinaries and All Ordinaries Indices.

Strong price rises for AI Media, Aroa and Payfare were not sufficient to offset the sharp price reductions suffered by Medadvisor and Smartpay in the quarter. Clinuvel and Articore were displaced from the top 10 by Tyro and Payfare, following a bid for Payfare, and due to relative share price movements.

With our continued investment into the unloved microcap space, the Fund's cash balance reduced from 4% to 2% however Payfare (5% weight) should convert to cash shortly.

Top 10 Stock Positions

Weight %	Name	Summary *(recent developments in italics)*
8	**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. *Solid 1H results reported and guidance for a profitable, cash-positive 2H25 reiterated. Compelling clinical data for their Myriad product was released.*
7	**Praemium**	Praemium operates a market leading, modern wealth management platform in Australia that is taking share from the large, legacy institutional platforms. *Spectrum, their new full-service wrap platform, launched in the quarter. Spectrum appears differentiated in some important ways, reinforced by a large new client win. The share price has responded positively.*
6	**EML Payments**	Provider of prepaid debit cards and payment solutions in Australia, North America and Europe. *EML endured a volatile share price this quarter – up strongly following a well-received AGM strategy update and respectable year-to-date performance – but giving up a chunk of the gains when the new CEO was surprisingly let go and the Chair stepped in as Executive Chair.*
6	**Medadvisor**	Medadvisor's digital medication adherence platform links patients to pharmacies via a proprietary patient management platform, App and SMS service in Australasia and the US. *The share price almost halved after flagging that a sharp pullback in vaccine programs (Covid and RSV vaccines) would materially impact 1H revenues. Program revenues can be lumpy period-to-period, but Medadvisor is successfully diversifying their revenue sources via material expansion into new brand programs which will benefit 2H25 and beyond.*
5	**AI Media**	Leader in the provision of live caption services primarily to broadcasters. *A couple of important European broadcasters were secured for their Lexi/iCap offering. Automated voice translation planned to launch in 2025 – a large potential market where AIM is poised to be the first in market with a fully automated offering.*
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 started the year slowly due to a run of small lottery jackpots.*
5	**3P Learning**	Online learning software for school and home markets with products that include Reading Eggs, Mathletics and Mathseeds. *Acquired Literacy Planet, an online reading tool targeted at year 3 to 8 with respectable revenues and installed base, for a modest consideration. Literacy Planet should complement 3P's Reading Eggs, which services a younger cohort.*
5	**Payfare**	Leader in embedded finance solutions for gig-economy platforms. *An unconditional offer at 90%+ premium to prior trading price was received from Fiserv. After Doordash, Payfare's biggest customer did not renew its contract in September, the Payfare share price plunged to roughly cash value. We more than doubled our holding at those depressed levels and will end roughly square after this position converts to cash within the next quarter – demonstrating the importance of buying when downside is protected, even after suffering losses.*
4	**Tyro**	A leading provider of merchant acquiring and payment services in Australia with significant share in the health, hospitality, and retail segments. *Tyro reaffirmed guidance for F25 at its AGM notwithstanding the RBA payments review and a tough trading environment.*
4	**Smartpay**	Leading operator of card payment terminals in New Zealand and challenger in merchant acquiring in Australia with the imminent launch of acquiring in New Zealand. *Continued penetration into the Australian market in the first half, notwithstanding noise around the RBA card fee review. NZ acquiring progressing - with 2k merchants pre-signed to date pending commercial launch early this year. The investment in NZ acquiring pushed Smartpay into transient losses in the first half. The share price continued its slide in the wake of the RBA review.*

Contrasting Jencay's valuation with the ASX All Ordinaries

In our previous quarterly report we demonstrated that, over the past few years, the majority of the big companies on the ASX enjoyed share price gains even if their earnings went down, whilst the smallest companies almost universally suffered steep share price losses even when they managed to grow earnings.

Share price performance is the opposite side of the coin to valuation - i.e. following price gains, upside shrinks - conversely following price drops, upside expands. In this report we will contrast the valuation metrics for our portfolio to the ASX All Ordinaries thereby setting the scene for expected future long-term returns for both.

ASX All Ordinary Index

Since 2010, the ASX All Ordinaries index has exhibited the following return and valuation metrics:

	Average	Current - F24
Return on Equity (ROE) (%)	12.2	10.4
eps growth (% annual)	3.4	(9.2)
Sales growth (% annual)	2.9	4.2
Price/Earnings (x)	16.9	20.3
Price/Book Value (x)	2.0	2.1
Enterprise Value/Sales (x)	2.1	2.3

Source: Factset

Although the index has performed relatively strongly (up 30% total over the last three years) recent fundamental performance has been poor with earnings going backwards and a return on equity of 10.4%, below the historic averages of 12%. As a result, valuation metrics (P/E, P/Book) are above historical averages and look stretched.

Assuming the ASX can return to generating an average ROE of 12% p.a. with a dividend payout ratio of 67%, earnings growth is likely to average 4% p.a. (12% ROE x 0.33 retention rate) and index investors should expect a long-term total return of 7% p.a. combining the 4% growth and 3% current dividend yield.

The Price/Book ratio of 2.2x is too high relative to the 12% average ROE - a ratio of circa. 1.2x-1.5x is more appropriate for shareholders desiring returns of circa. 10% p.a. This implies the ASX All Ordinaries Index is at least 50% overvalued i.e. 33% downside to get to fair value.

Jencay Portfolio

Jencay has experienced poor aggregate price performance over the last 3 years, and its valuation ratios now look comparable with the ASX Indices - we compare median multiples and growth for Jencay's top 10 positions with those of the ASX All Ordinaries Index below:

	Jencay top 10	ASX All Ords
eps growth % - latest	15.5	(9.2)
eps growth % - 2yr fwd CAGR	54.5	9.0
sales growth % - latest	14.0	4.2
sales growth % - 1yr fwd	11.3	3.2
Enterprise Value/Sales (x)	2.4	2.3
Enterprise Value/EBITDA	8.4	9.5
Price/Book Value (x)	2.4	2.1

Source: Factset and Jencay

In sharp contrast to the ASX All Ords, we expect the Jencay portfolio to produce far stronger sales and earnings growth and higher ROE, yet valuation ratios like EV/Sales, EV/EBITDA and Price/Book are comparable!

Jencay's unit price is now roughly 25% of our estimated fair value for the portfolio i.e. a **75% discount to fair value** which is about the biggest discount since inception of the Fund.

Contrasting valuation metrics for the strongest ASX growers only

We filtered the biggest 500 ASX stocks to identify those that have grown sales and eps >10% CAGR over the last 3 years, and that are expected to continue growing at least at those rates for the next 2 years. We then split the sample by size (i.e. top 200 and 201-500 in market cap) and compared their median valuation ratios to the Jencay top 10, as shown below:

	ASX top 200	ASX 201-500	Jencay top 10
Qualifying stocks (#)	12	11	10
Price/Earnings (x)	64.9	20.7	20.0
Price/Book Value (x)	12.4	2.4	2.4
Enterprise Value/Sales (x)	12.2	1.6	2.4
Enterprise Value/EBITDA (x)	38.4	10.8	8.4
2yr f/cast eps CAGR (%)	30.3	25.6	54.5

Observations from the table above:

- Only 12 companies in the ASX top 200 (i.e. 6%) managed to meet the growth criteria for this selection exercise. A further 11 companies in the balance of the ASX All Ordinaries universe (i.e. stock 201 to 500 in size) met the selection criteria.
- The valuation metrics for the biggest companies (ASX top 200) show a massive premium (at least 4x more expensive!) relative to the smaller companies (201 to 500) that achieved similar growth rates.
- Valuation metrics for Jencay's top 10 are in line with smaller companies exhibiting strong growth, indicating that this part of the market has been almost universally shunned.

Summary

Assuming a stock is worth $2 but trading for $1, upside is 100%. We contrast two possible scenarios after buying the stock for $1:

1. *the share price drops by 50% to 50c. The upside potential is now 300% i.e. $1.50 on 50c.*
2. *the stock price jumps to $3. Although the stock is up 200%, it is overvalued relative to the $2 fair value with a likely downside of 33.3% ($1/$3).*

In the short term, the distortions above can continue (or even expand) but in the long-term the price should converge on the $2 fair value - the investor in scenario 1 should make a spectacular return while the scenario 2 investor suffers steep losses.

The ASX All Ordinaries index (driven by large caps) has enjoyed years of strong price increases notwithstanding modest fundamental performance (i.e. multiple expansion). As a result, it is at least 50% above our estimate of fair value and likely to endure modest returns over the medium to long term. Jencay's performance, in contrast, has been impacted by declining microcap share prices over the last three years, despite solid aggregate fundamental performance (i.e. multiple contraction) and therefore demonstrating exceptional upside which is likely to be harvested over the medium to long term – similar to scenario 1 above.

Cash Conundrum

Large caps (and therefore the overall market because the large caps carry the most weight in market indices) are overvalued and due a correction. Microcaps in contrast are undervalued and exhibit extraordinary upside potential given recent neglect by the market. This dichotomy is rare and makes asset allocation and cash weighting decisions more difficult than usual – ordinarily in an expensive/euphoric market you would want to hold above average cash levels to enable re-entry at a more attractive level in future – however microcaps have already endured a crash and Jencay has been investing its cash into the opportunity. How microcaps perform in a weak overall market is difficult to predict given this contradiction, but the hot money is now in large caps and absent from microcaps, which suggests microcaps should outperform in a weak market. Although we would ideally prefer a higher cash weighting at this point in the cycle, we cannot resist deploying capital when upside potential is so large.

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)