DMX
ASSET MANAGEMENT

DMX Capital Partners Limited
Investing in the most compelling small and micro-cap value opportunities

WHEN TO BUY

DMX Asset Management, November 2018

<u>SUMMARY</u>: ***Prior to buying any new positions or adding to any existing positions, we always ask ourselves 2 simple questions: i) Is this a high quality company? ii) Is this an under-valued stock? If both answers are a resounding yes we generally proceed in purchasing that stock. Whilst our approach is wonderfully simple, each of these 2 key questions requires a lot of work to answer with conviction.***

1. IS THIS A HIGH QUALITY COMPANY??

Finding high quality businesses to invest in means sifting through many, many companies which don’t make the grade. The higher the grade required, the more sustainable and repeat-able the process in our opinion. Our shopping list for high quality stocks is long and hard to achieve:

i) Profitability & cash flows

The first deal breaker for us in the high quality search is whether a company is profitable and cash flow positive. In our minds profitability and positive cash flow generation are both core to what a business should be about, and thus we are not willing to speculate on loss-making companies which are aiming to more than cover their costs in the future. And it is not just the short term risks we are aware of: loss-making companies carry longer term risks far beyond the headline losses in our opinion. If a business is loss-making it often indicates an “empire building” mindset in management, poor strategic choices, structural problems with the business model, and cost mismanagement issues. This is obviously not always the case but in our experience the hit rate with these issues is high, and we are not willing to risk shareholders’ funds where these risks are high.

When looking at profitability we are interested in comparing a company’s reported earnings with its reported cash flows. In our experience, it is common to come across companies where their reported earnings are significantly higher than their reported cash flows. The difference is usually explained by the company’s accounting choices. For example, we recently did some work on a retirement village owner and operator which looks very cheap on statutory earnings at around 8x this year’s earnings. However, when we analysed the company’s accounts it became apparent that much of this year’s earnings are coming from expected property revaluations and thus the company’s cash flows, and the profitability of the underlying business, are likely to be significantly lower. We decided the stock was expensive as a result. We are looking for the contrary scenario whereby reported earnings are below reported cash flows reflecting conservative accounting strategies. Companies which fall into this category tend to be led by management teams focused upon under-promising and over-delivering.

ii) Visible organic growth drivers

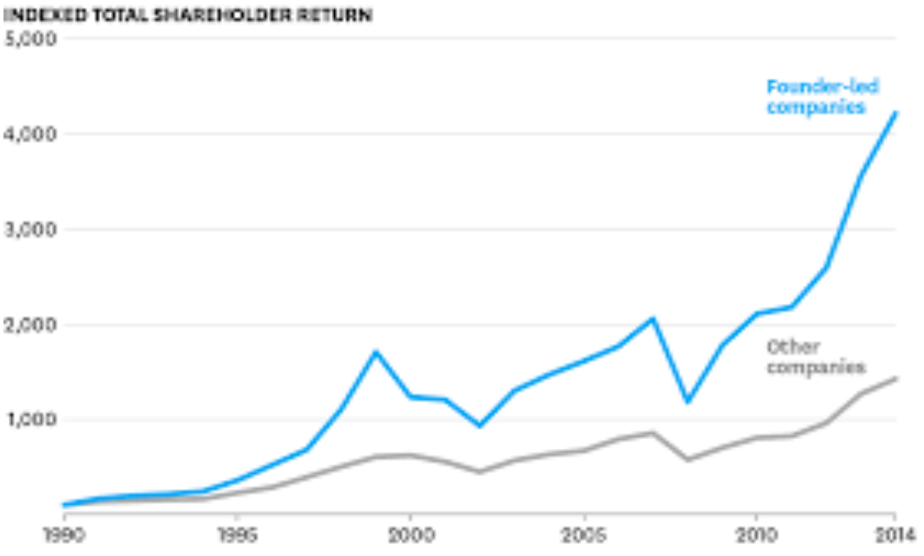
Next on our shopping list is companies which have clear and visible organic growth drivers which management can articulate.

We often come across businesses which are focused upon capturing a macro theme or trend. When we read through their presentations we generally find many inspiring charts highlighting the enormous growth potential of this macro trend/theme. However, after reading such presentations we are often left wondering what the company actually does and why it will benefit from these macro drivers. This is not what we are looking for.

We are looking for companies which have clear strategies in place to grow their businesses independent of macro trends. We'll discuss business tailwinds later in this article (these are also on our high quality list) but we need to see clear organic growth strategies from management. And we also need to understand exactly what a company's growth strategies mean in terms of day to day business activities.

iii) Aligned management & family companies

We have previously written of our preference for companies in which management are personally invested, of which family/founder companies are a great example. Having "skin in the game" is a highly effective means of ensuring management are thinking of shareholders' best interests at all times. The evidence is compelling:



iv) Strong balance sheet

There are many reasons why we like companies with strong balance sheets including:

a) Lower financial risks – Companies with net cash surpluses don't need to pay interest and are thus far less exposed to financial risks in the event of a business slowdown, rising interest rates, etc.

b) More earnings to distribute as dividends – Management of debt free companies only need to think of equity holders since there are no debt holders ahead of them in the queue waiting to be paid. This means shareholders are well placed to receive attractive dividends payouts, and it also means management thinking is all about shareholders which in our experience is a good thing.

c) Greater flexibility to expand when opportunities arise – Companies with strong balance sheets are well placed to make opportunistic investments when the opportunities present themselves. This is a significant advantage in our opinion since it is often hard to predict when acquisition opportunities are likely to arise.

v) Business tailwinds

In addition to the organic business drivers already mentioned, we like to invest in companies with industry tailwinds behind them. In our experience, being in the right industry at the right time often makes it easier for a company to exceed the market's earnings expectations.

2. IS THIS AN UNDER-VALUED STOCK?

In our opinion, this is a question of whether a company's intrinsic value is significantly higher than its current stock price so as to allow a sufficient margin of safety at the time of investment.

As Warren Buffet famously wrote to shareholders in his 1994 Berkshire Hathaway letter,

"Intrinsic value is a highly subjective figure that will change both as estimates of future cash flows are revised and as interest rates move. Despite its fuzziness, however, intrinsic value is all-important and is the only logical way to evaluate the relative attractiveness of investments and businesses."

There are two key two drivers of a company's intrinsic value:

i) Business Fundamentals

All businesses are evolving, ever-changing entities. When valuing a business investors are simply aiming to capture a snapshot of future cashflows at that point in time, factoring in all known opportunities and risks. However, this snapshot of future cashflows is likely to change over time. Diligent value investors must be prepared to test and adjust their cashflows assumptions over time.

The inherent challenge here is in reliably estimating future cash flows. Judging by the number of companies that fail to meet their profit guidance numbers, it is challenging enough for company insiders to accurately forecast their current year earnings. For outsiders' or analysts to accurately forecast a company's cashflows 5 or 10 years into the future, the challenge is magnified.

At DMX we look to overcome this issue by investing in companies with a solid track record of generating cashflows, and use the historical cash flow data to help support our estimates of future cash flows. We look for companies where there is there is good visibility around the fundamentals of the company, and thus the cash flows the investment will deliver over time.

ii) Interest rates

Interest rate changes are the second driver which impact upon future cashflow assumptions because the risk free rate of return is a key input in the discount rate used to derive a present value of future cashflows. As a result, future cashflows are worth more in a low interest rate environment than in a high interest rate environment.

With the 10 year US Treasury yield currently near record lows at only 3.25% and Government interest rates all around the world at similar historic lows, global asset valuations have been pushed upwards in recent years. The competition for yield has intensified as it has become scarcer.

"Everything is expensive because this thing at the heart of the system has gone to all-time lows," Antti Ilmanen.

When adjusting future cashflow assumptions to take into account changing interest rates, in our opinion it is important to bear in mind how current and future interest rates will impact upon future economic growth rates. This is particularly relevant right now because interest rates were much higher in past decades than they are at present. This means that global economic growth was able to withstand higher interest rates in the past which arguably reflected higher underlying global economic growth. We believe it would be a mistake to simply extrapolate the growth most companies have reported over the past 5 years looking forward, since interest rates are telling us that future economic growth will be far lower than past economic growth. And yet, this is exactly what the vast majority of analysts are currently assuming. The temptation to simply extrapolate is too strong for most. In our opinion, this makes most analysts' current DCF assumptions far too high. A well thought out intrinsic value analysis will take the underlying economic growth rate into consideration.

DMX CAPITAL PARTNERS – 3 EXAMPLES OF HIGH QUALITY UNDER-VALUED STOCKS:

1. ***Kip McGrath Education Centres Limited (ASX:KME)***

QUALITY*:* At its AGM, leading tutoring company Kip McGrath noted that its FY18 result (41% increase in profit) was the seventh consecutive year of increased profits, and said that based on results to date, FY19 will likely continue that trend. The increase in profit has been (and should continue to be) driven by an increase in the number of students taught. Students being tutored are increasing because of:
1. The global market has shown an annual growth rate in excess of 10% in recent years;
2. The company's initiative in doing national advertising has yielded significant student growth; and
3. KME's products and service have improved with the new software that has been written.

We continue to expect strong revenue growth and margin expansion to deliver an EPS increase of 20% in FY19.

UNDER-VALUED: Despite the recent rally KME is still trading at 13.5x FY19 with excellent growth prospects ahead.

2. ***Gale Pacific (ASX:GAP)***

QUALITY: Gale Pacific reported a pleasing trading update – noting that it expected growth in first half earnings for FY19 and was confident in achieving earnings per share growth in FY19. Growth is under-pinned by the roll out of product into the United States, where GAP see a large opportunity given sun protection awareness is building and there is presently no clear market leader in the category. GAP has an impressive distribution capacity through national retailers such as Home Depot as well as a strong Amazon presence.

The company continues to focus on becoming a faster growing, more profitable, innovative, global fabrics technology business, and while progress to date has been slower than expected. We recently spent time with management where they demonstrated some new innovative fire-resistant coverings for the commercial market. We continue to believe that GAP has significant earnings upside.

UNDER-VALUED: At 10x net earnings, there is compelling value on offer here.

3. Apollo Tourism and Leisure (ASX: ATL)

QUALITY: ATL manufactures, rents and sells campervans, and bullishly noted that increased market activity was generating a wealth of opportunities. ATL highlighted that the global rental business outlook is positive, with tourism industries performing strongly in all operating regions, however did note that geo-political risks are an area of focus, and in particular, Brexit and US trade tariffs have the potential to impact confidence in those geographies. Recent feedback from tourism operator Sealink was that inbound tourist numbers from Europe and United States remain very strong, which is positive for Apollo's Australasian high season.

Apollo continues to invest in digital initiatives to provide industry leading guest experiences while adding new retail sales sites and leveraging of distribution network synergies is expected to boost RV sales revenues. Ancillary revenue streams such as finance and insurance and servicing remain a focus for growth.

UNDER-VALUED: Apollo reaffirmed its NPAT guidance of $22m – $24m (representing ~20% growth), and with a market cap of $255m, puts it on a PE of only 11x.

CONCLUSION: ***At DMX we aim to maintain a simple and sustainable investment process. We invest in under-valued, high quality smaller companies which we believe can significantly outperform over the long term. KME, GAP and ATL are great examples of the types of smaller companies we aim to hold for long term outperformance.***