InvestSMART Australian Small Companies Fund

Monthly Update - January 2019

PERFORMANCE TO 31 JAN 2019	1 mth	3 mths	6 mths	1 yr	Since Inception (p.a.)
InvestSMART Australian Small Companies Fund	1.03%	-4.27%	-7.64%	-17.73%	2.80%
S&P/ASX Small Ordinaries Accumulation Index	5.56%	0.78%	-6.95%	-3.06%	8.91%

Key points

- **Adacel becomes one of our bigger holdings**
- **Frontier Digital Ventures performed well over the last quarter**
- **Adding Dicker Data to the Portfolio**

January was a busy period for company news. Beginning with the disappointing, **Thorn Group** announced that its business finance division expects to record a bad debt of as much as $10.5m pre-tax, relating to a single counterparty (Viewble) that has caught out several other finance companies (including Eclipse Group and Flexigroup). The bad debt and a $5.7m intangible impairment will send Thorn to a statutory loss of around $6m, (from an expected profit of $6-8m), shaving NTA by 1% to $1.21.

We've been wary of Thorn's business finance division for some time, as it lends to higher risk customers and lacks a competitive edge. But Thorn's exposure is small and non-recourse, so even if business finance completely evaporates, Thorn's net tangible assets would reduce to around $0.94 (which is around 84% higher than the current share price). Risks like business finance bad debts have been baked into the share price for some time.

Shareholders are now more reliant on Thorn's main business Radio Rentals, which isn't originating enough new leases to generate acceptable returns, but it retains lots of value in its existing leases. But it may take a more creative approach to realise this value, which is becoming increasingly likely as shareholders become more agitated.

MSL Solutions also had a disappointing quarter, with weak cash receipts and continued cash burn. A capital raising is looking more likely if it doesn't sell its non-core investment or improve operations. We're comfortable funding companies with good prospects run by competent management teams that we trust, but as MSL continues to move the reporting goalposts (the newest metric was 'NPATA ex R&D') we're becoming more cautious.

On to the positive, where we welcomed air traffic control software provider **Adacel Technologies** to our top five holdings in January. Adacel has hundreds of its air traffic control simulators installed across North America with customers such as the FAA and the US Air Force, which enables a steady stream of service revenue for ensuring uptime and improving functionality. As Adacel owns the simulator's IP, the threat of being displaced on the service contracts is low, which allows it to generate strong free cash flow and high returns on capital.

> **"AFTER TOPPING UP OUR HOLDING AT ATTRACTIVE PRICES, AND FOLLOWING THE STRONG REBOUND DURING JANUARY, ADACEL HAS BECOME ONE OF OUR BIGGER HOLDINGS. "**

But the reliability of those high margin service contracts was called into question over the past year, and especially so in October, when the FAA outsourced some service work to a small engineering firm (Adsync). Adacel responded by commencing legal action against Adsync for breaching its IP rights, which threatened to become a bigger disruption to its relationship with the FAA, and the value of the company, in turn.

Even though the dispute with Adsync is ongoing the market's nerves were calmed somewhat in January when Adacel was re-awarded a tower simulation support contract with the US Air Force, worth $32m over five years. This seems to have reminded investors that the risk of Adacel being displaced on these contracts is remote. We expect Adacel to eventually replace Adsync on the FAA field services contract too.

After topping up our holding at attractive prices, and following the strong rebound during January, Adacel has become one of our bigger holdings.

Frontier Digital Ventures announced a pleasing set of fourth quarter figures, with portfolio revenue of $41.7m (on a 100% basis) coming in ahead of its $40m guidance, with an extra investment reaching profitability ahead of schedule.

Frontier's most valuable asset, Zameen, the leading property portal in Pakistan, grew revenue 81% to reach $22.4m (on a 100% basis) for the year, which is about as big as REA Group in 2004. We're confident that our thesis is on track. Frontier's portfolio of leading property, automotive and general classifieds are undervalued with a long runway for growth ahead.

We wondered whether **Redflex**'s strong first quarter contract wins were a fluke, but after backing it up with strong second quarter orders and with guidance for first half operating earnings (before depreciation and amortisation) up 58-66%, we're more confident that its turnaround is gaining steam.

Redflex has lots of room for growth with an international sales presence and a large pipeline, and recent activity speaks to the improvements in execution. Longer term, it wouldn't surprise us to see Redflex targeted by an industry consolidation attempt. Its American and European competitors, Verra Mobility (previously American Traffic Solutions) and Sensys Gatso, both have expensive scrip (valued at 5-7x sales versus Redflex's 0.5x) and aggressive growth plans.

Audinate, owner of the digital audio protocol Dante, maintained its high growth rate with second quarter cash collections up 49% over the prior corresponding period.

Our thesis on Audinate is simple. AV users are moving from analog to digital and a single digital protocol will emerge as the industry standard. As Dante is the most widely adopted protocol, it's the most likely protocol to be adopted due to network effects. Strong growth in cash collections, a proxy for customer adoptions of Dante, gives us confidence that our thesis is on rack. We were also pleased to see that its new video protocol, which we think could be a big deal for Audinate, will be displayed to customers in early February.

Our newest investment, IT distributor **Dicker Data**, which we acquired in mid-January, announced an 8% upgrade to FY18 pre-tax profit guidance towards the end of the month.

We've been hunting for aligned managers with a history of strong execution and there's no better example than Dicker Data. Founder and CEO, David Dicker, owns 38% of the business and receives all of his remuneration via Dicker Data's quarterly dividend, which even makes Warren Buffett's $100,000 salary seem extravagant. We like our managers to have 'skin in the game' but there's a strong argument David Dicker has 'soul in the game'. Having your name on the door tends to do that.

Dicker Data's business is simple. As the third largest IT distributor in Australia, it plays an important role in getting computer hardware and software from overseas manufacturers to Australian users. Dicker Data earns a skinny gross margin of 9% for its efforts, but low capital intensity allows it to generate healthy returns on capital in the mid to high teens. Its main physical asset is a 4000-square metre warehouse in Kurnell NSW, which it owns.

Since listing in 2011, Dicker Data has steadily diversified manufacturer relationships, amassed industry awards, groomed the next generation of leaders and generated consistently higher profits and dividends to shareholders. Despite a market cap just below $500m, Dicker Data has a small free float due to the 71% combined shareholding of David Dicker and ex-wife Fiona Brown. While that keeps large investment funds away, it's perfect for a fund of our size and another reason why the stock is mispriced

IT distribution is unlikely to capture investor's imaginations like medicinal cannabis or buy now pay later schemes but we're fine with boring companies, run by good people, bought at attractive prices.

If we think 30 years ahead, Australia will be consuming far more IT goods and manufacturers are likely to still favour outsourced distribution. But it will take only modest investments in capacity expansion and automation for Dicker Data to process the higher throughput, which bodes well for sustainable profitability over the long term. There may even be another consolidation opportunity or two, like Dicker Data executed brilliantly in 2014 when it acquired competitor Express Data.

PORTFOLIO ALLOCATION

ASSET ALLOCATION

Sector	Weighting
Information Technology	39.84%
Consumer Discretionary	24.91%
Cash	12.05%
Financials	7.25%
Materials	4.42%
Real Estate	4.38%
Energy	3.12%
Communication Services	2.13%
Industrials	1.91%

TOP 5 HOLDINGS

Security	Weighting
Thorn Group	7.80%
Trade Me	7.79%
Adacel Technologies	6.21%
Hansen Technologies	5.63%
RPMGlobal Holdings	5.51%

Performance numbers exclude franking, after investment and admin fees; excludes brokerage. All yield figures include franking. All performance figures, graphs and diagrams are as at 31 January 2019.

InvestSMART Group Limited (INV) was founded in 1999 and is a leading Australian digital wealth advisor which has over 32,000 clients and over $1.4B in assets under advice. InvestSMART's goal is to provide quality advice and low cost investment products, free from the jargon and complexities so commonly found in the finance industry, to help you meet your financial aspirations.

The Fund

The InvestSMART Australian Small Companies Fund is a concentrated portfolio of 10 - 25 Australian listed small companies and cash, that seeks to deliver moderate to high total portfolio returns over the long-term.

Investment objective

The Fund's investment objective is to deliver long-term capital growth by investing in small Australian companies.

Why the InvestSMART Australian Small Companies Fund?

Suitable for those looking to diversify their Australian equity exposure, take advantage of the potential missed opportunities that are often overlooked and not well-researched by larger fund managers.

Actively managed by our investment team, the InvestSMART Australian Small Companies Fund allows investors access to these opportunities at a lower fee structure than most fund managers.

Who manages the investment?

Alex joined the team in July 2016 to provide dedicated research on small capitalisation companies (small caps) and is supported by our Investment Committee, chaired by Paul Clitheroe. Alex has over 8 years successfully managing private portfolios, and prior to joining the team, held various roles in funds management and international research. Alex is a Chartered Financial Analyst (CFA) charterholder and holds a degree in Finance and International Business from Griffith University.

Key Details

INVESTMENT CATEGORY
A portfolio of individually selected Australian Equities

INVESTMENT STYLE
Active Stock Selection, Value Investing Approach

BENCHMARK
S&P/ASX Small Ordinaries Accumulation Index

INCEPTION DATE
1 February 2017

SUGGESTED INVESTMENT TIMEFRAME
7+ years

NUMBER OF STOCKS
10 - 25

INVESTMENT FEE
0.97% p.a.

PERFORMANCE FEE
10.25% of the excess of the Fund's performance above the benchmark^

MINIMUM INITIAL INVESTMENT
$25,000

STRUCTURE
Managed Fund

SUITABILITY
Suitable for investors who are seeking domestic equity exposure with a growing stream of dividends to offset inflation

PORTFOLIO MANAGER
Alex Hughes, CFA

^Benchmark is the greater of the S&P/ASX Small Ordinaries Accumulation Index and the RBA Cash Rate in each 12 months to June 30. Performance fees are only accrued if the Fund Net Asset Value (NAV) is higher than the NAV when last performance fee was paid (high watermark).

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InvestSMART Funds Management Limited
PO Box 744
Queen Victoria Building
NSW 1230 Australia

Phone: 1300 880 160
Email: invest@investsmart.com.au

www.investsmart.com.au