Intelligent Investor Australian Small Companies Fund

Monthly Update - 31 October 2019

Portfolio Manager: Alex Hughes

INVESTSMART

PERFORMANCE TO 31 OCT 2019	1 MTH	3 MTHS	6 MTHS	1 YR	2 YRS (P.A.)	S. I. (P.A.)
II Australian Small Companies Fund	1.25%	4.69%	8.00%	10.56%	-1.34%	7.52%
S&P/ASX Small Ordinaries Accum. Index	-0.50%	-1.84%	2.24%	14.41%	8.34%	11.43%
Excess to benchmark	1.75%	6.53%	5.76%	-3.85%	-9.68%	-3.91%

The fund delivered a 1.25% return (net of fees and expenses) during October. The benchmark retreated by 0.50%. It was pleasing to back up September's strong return with another acceptable month.

Main contributors included **RPMGlobal** (RUL, 10% for the month), **Donaco** (DNA, 37%) and our new holding in **Australian Ethical** (AEF, 15%).

Owning a quality business as it transitions from obscurity to ubiquity is one of the main attractions of small cap investing. This process appears to be underway for RPMGlobal with a second stockbroker initiating coverage during the month. Despite a sharp run in its share price, RPMGlobal remains undervalued with a long runway for subscription software growth.

Donaco's new CEO continues to make a positive mark with September quarter EBITDA up 167% to $8.9m. As we discuss later in this report, we've voted against resolutions 9 through 20 at the upcoming AGM, and we suggest fellow shareholders follow suit.

Hansen (HSN, -10%) and **Dicker Data** (DDR, -11%) drifted lower on no news and **Matrix Composites** (MCE, -16%) did so on low volume.

New investments

We attended the International Mining and Resources Conference this month to gather insights about RPMGlobal. Ironically, the spirited demonstrations out front gave us more insight into fund manager **Australian Ethical**, a recent addition to the portfolio.

Australian Ethical is the most obvious provider of ethical superannuation. Amidst a field of blandly named competitors like SunSuper, Hostplus and Statewide that signal little to laymen, Australian Ethical's virtues are instantly recognisable. This lowers search costs for the growing number of investors out to shape the world with their investment decisions.

The business has considerable momentum with funds under management compounding at 30% p.a. over the last five years, augmented by market leading client retention. With a predominantly fixed cost base, profitability could increase materially if current trends continue.

We also added a starter position in **Palla Pharma** (formerly TPI Enterprises), an integrated manufacturer of opiate based pain killers.

Palla's proprietary water based manufacturing process, which extracts the active ingredient from poppies, has two important benefits. It's cleaner than competitors who use toxic solvents and its significantly cheaper. Palla can produce narcotic raw material at 30% of the operating cost and 20% of the capital cost of its two main competitors.

The 2017 acquisition of Vistin, a Norwegian based manufacturer of consumer-ready pain killers, saw Palla become just the third integrated manufacturer in the world. Together, this gives Palla a structural growth opportunity to replace polluting high cost providers with its cleaner, cheaper alternative. A proprietary manufacturing process, access to inputs and extensive regulatory approvals stands as important competitive barriers.

Several issues have kept us on the sidelines over the years, such as missed production targets, Vistin integration issues and rising debt levels, but there's evidence they're being addressed. Palla recently raised capital to strengthen its balance sheet and expand capacity. Integration issues appear to be subsiding. Breakeven was reached in June after capturing just 4% market share, with a fivefold increase in production targeted out to 2021.

An important milestone looms next year when a legacy contract manufacturing contract expires. By not renewing the low margin contact, Palla will unlock capacity and enable greater integration between its divisions, which should drive a material improvement in margins. We recently bought a starting position (2%) which we plan to build upon if management continue to execute.

Vote for stability at Donaco

Donaco's AGM on November 29th is important for shareholders. A group of shareholders, led by former chief operating officer Gerald Nicholas Tan Eng Hoe, have requisitioned an extraordinary general meeting to roll the board on that day. It's an important event with serious consequences. The fund has voted **AGAINST resolutions 9 through 20**. Here's why we think other shareholders should too.

Donaco International is a South East Asian gaming business founded by Tan Sri Lim Goh Tong, the late founder of Singapore's esteemed Genting Group. Tan Sri Lim Goh Tongconstructed the Aristo International in Northern Vietnam in 2002, a five-star resort with 400 rooms. His grandson Joey Lim then became CEO, spearheading Donaco's ASX listing in 2012 and the $527m acquisition of Star Vegas Casino in Cambodia in 2015, a 385-room resort with 170 gaming tables and over 1,000 gaming machines.

As part of the deal, Donaco acquired Star Vegas's buildings and entered a 55-year lease with Thai businessman Somboon Sukjaroenkraisri for the land. Somboon received 18% of Donaco's shares as part of the purchase as well as a seat on Donaco's board.

At its peak in 2017, Donaco delivered an operating profit (before depreciation and amortisation) of $65m. But then everything unravelled and Donaco languishes with a $74m market capitalisation today.

Donaco alleges that Somboon breached his non-compete clause when he began competing in a neighbouring property in 2017. The competition hurt Donaco's earnings - Star Vegas's EBITDA fell from $67m to $27m today - and the casino's carrying value suffered a $344m impairment. This sparked the fiery legal battle that's still burning today.

> **We strongly recommend you vote AGAINST resolutions 9 through 20 at the upcoming AGM.**

Donaco is seeking $350m of damages in the Singapore Arbitration court; however, a Cambodian court has ruled that Somboon is within his right to cancel Donaco's lease of Star Vegas. Everything hinges on the Singaporean arbitration, which is set to hand a decision later this year. Donaco could lose its biggest casino or receive an enormous legal settlement.

The important vote

Donaco maintains that its legal case in Singapore is strong. A $500m acquisition normally receives extensive legal attention to protect against any and every eventuality, and Singapore also has a good reputation for upholding the law. But Donaco shareholders have learned to not be surprised by anything.

Perhaps the best indication that Donaco's legal claim has merit is Somboon's response - he's gone to considerable lengths to absolve himself of any liability. On the surface, the upcoming AGM looks to be a case of a disgruntled ex-employee out for revenge and vindication. But as described in the Notice of Meeting for AGM: *'There is evidence that Mr Tan is a business associate of Somboon Sukjaroenkraisri, the Thai vendor of the Star Vegas business'.*

Mr Tan has proposed the removal of Donaco's five existing directors and that they be replaced by himself and four other directors of the requisitioner's choosing. It's possible that Mr Tan is acting on behalf of Somboon, with the intention of cancelling the Singaporean arbitration to remove Somboon's potential legal liability. If that's the case, Donaco shareholders would be significantly worse off by voting in Mr Tan and his mates. Given the risk, the best course of action is to vote AGAINST resolutions 9 through 20 at the upcoming AGM.

Table 1: Bear case

ALL MILLIONS EXCEPT PER SHARE VALUE

	EBITDA	MULTIPLE	VALUE
Star Vegas	0	6	0
Aristo	18	6	108
Corporate costs	−8	6	−48
Enterprise value			60
less net debt			−8.6
less outstanding vendor payment			−19
Equity value			32.4
Shares			823.6
Per share value			$0.04

Source: Company reports, analyst estimates

There's always the chance that Mr Tan isn't acting on behalf of Somboon, of course. But it still seems silly to vote him in anyway. The last thing Donaco needs right now is more board instability, and given the chaos and wealth destruction he presided over as chief operating officer between 2017 - 2019, I struggle to see how he's a better fit.

The art of portfolio management

You may be wondering why we're wasting our time with a risky tiddler like Donaco? The answer is because it offers a highly asymmetric payoff.

Starting with the bear case, if we assume Donaco loses the Singapore arbitration and its Cambodian casino, all that will remain is the Aristo International in Northern Vietnam. It's likely that this casino is worth north of $100m, with FY2020 EBITDA on track for $18m or so. The Aristo has decent prospects as the Vietnamese Government is a minority owner and the casino is an important employer in the region.

We arrive at a bear case valuation of four cents a share after netting off Donaco's net debt and the Star Vegas lease payment it has withheld from the vendor whilst legal action is pending.

It doesn't take J.K Rowling's imagination to outline Donaco's bull case, which hinges on Donaco winning its Singaporean arbitration and retaining Star Vegas. Collecting an arbitration award from Somboon will be difficult, so we're only assuming Donaco cancels his 18% holding of Donaco shares and foregoes the outstanding lease payment, but we acknowledge Donaco could receive more than that. The bull case assumes that Star Vegas' profitability improves but remains well below prior levels.

Table 2: Bull case

ALL MILLIONS EXCEPT PER SHARE VALUE

	EBITDA	MULTIPLE	VALUE
Star Vegas	50	8	400
Aristo	18	8	144
Corp costs	−8	8	−64
Enterprise value			480
less net debt			−8.6
less outstanding vendor payment			0
Equity value			471.4
Shares			675.4
Per share value			$0.70

Source: Company reports, analyst estimates

This presents a payoff structure of around -70% to 700% at current prices. Most investors shy away from situations like this due to the prospect of a large loss, but astute investors know this can be managed by limiting the position's size. For instance, a 1% position in Donaco has the same portfolio impact as a 10% position in a business that offers a -7% to 70% return.

Donaco isn't for the faint of heart and if previous management gets enough votes, the consequences could be serious. If you're already a Donaco shareholder, it's time to speak up. We strongly recommend you vote **AGAINST resolutions 9 through 20** at the upcoming AGM.

Portfolio allocation

ASSET ALLOCATION	
Sector	**Weighting**
Information Technology	38.4%
Consumer Discretionary	25.1%
Cash	10.8%
Communication Services	7.0%
Energy	5.3%
Industrials	5.2%
Other	4.0%
Financials	3.5%
Health Care	0.8%

TOP 5 HOLDINGS	
Security	**Weighting**
Audinate (AD8)	9.8%
RPMGlobal Holdings (RUL)	8.9%
Seek (SEK)	5.2%
Lovisa Holdings (LOV)	5.0%
Academies Australasia (AKG)	4.6%

InvestSMART Group Limited (INV) was founded in 1999 and is a leading Australian digital wealth advisor which has over 32,000 clients and over $1.4bn 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 Intelligent Investor Australian Small Companies Fund is a concentrated portfolio of 10 - 40 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 Intelligent Investor 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 Intelligent Investor 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 11 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 - 40

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

^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).

Important information

While every care has been taken in the preparation of this document, InvestSMART Funds Management Limited (ABN 62 067 751 759, AFSL 246441) ("InvestSMART") makes no representations or warranties as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. This document is solely for the use of the party to whom it is provided.

This document has been prepared by InvestSMART. The information contained in this document is not intended to be a definitive statement on the subject matter nor an endorsement that this model portfolio is appropriate for you and should not be relied upon in making a decision to invest in this product.

The document is general information only and does not take into account your individual objectives, financial situation, needs or circumstances. In preparing this report, InvestSMART has relied upon and assumed, without independent verification, the accuracy and completeness of all information available to us. To the maximum extent permitted by law, neither InvestSMART, its directors, employees or agents accept any liability for any loss arising in relation to this report.

The suitability of the investment product to your needs depends on your individual circumstances and objectives and should be discussed with your Adviser. Potential investors must read the Product Disclosure Statement (PDS) and Investment Menu (IM), and FSG along with any accompanying materials.

Investment in securities and other financial products involves risk. An investment in a financial product may have the potential for capital growth and income, but may also carry the risk that the total return on the investment may be less than the amount contributed directly by the investor.

Past performance of financial products is not a reliable indicator of future performance. InvestSMART does not assure nor guarantee the performance of any financial products offered.

Information, opinions, historical performance, calculations or assessments of performance of financial products or markets rely on assumptions about tax, reinvestment, market performance, liquidity and other factors that will be important and may fluctuate over time.

InvestSMART, its associates and their respective directors and other staff each declare that they may, from time to time, hold interests in Securities that are contained in this investment product. As Responsible Entity, InvestSMART is the issuer of the product.

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