

Standout Small Stocks For Your Portfolio



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SPECIAL REPORT | DECEMBER 2013

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PRICES CORRECT AS AT
9 December 2013

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Small stocks – Tread carefully

BY GREG HOFFMAN



“... if recent trends continue and investors grow even more optimistic, then the profits on these small stocks will far outweigh the steadier-earning blue chips.”

In July we published [5 Small Stocks Set to Shine](#), featuring stocks that, up until then, you'd probably never heard of. Here, Greg Hoffman updates you on their progress and offers three more for your scrutiny.

Small stocks are often misunderstood, which can make them a very happy hunting ground for value investors. But they should also be set in their full context: only representing a part of your share portfolio. Your share portfolio, in turn, should only be a portion of your overall investment portfolio.

This gets us to the crucial topic of asset allocation, a major theme of the work we've been focusing on at our sister service, *Intelligent Investor Super Advisor* with Richard Livingston.

Recent experience demonstrates the importance of it. Before the GFC in June 2007, 34.6% of the money in Australia's SMSF portfolios was allocated to listed shares and 24.7% to cash, debt securities and term deposits. By March 2009 — essentially the bottom of the market — SMSFs had only 26.2% allocated to shares and 30.2% in cash, debt securities and term deposits.

Investors might have made around \$20bn more as the market recovered over the past four and a half years *simply by rebalancing* their allocation to listed shares back to its June 2007 level (or better yet, increase their allocation on the basis of value). Investors, on average, didn't make that switch.

CUTTING BACK

In recent months, I've been cutting back the allocation to Australian shares in the portfolios I run as the market has moved ahead. Within that reduced allocation to shares, though, I've been increasing my exposure to smaller stocks, leaving the blue chips unchanged and reducing those stocks in the middle.

I've also been taking profits on selected smaller stocks, as you'll read in this report. But, generally, the plan has been to allocate the reduced Australian shares allocation in the portfolios to more of a 'barbell' strategy — combining high quality holdings like **Woolworths**, **ASX**, **QBE Insurance** and **Computershare** with the kind of smaller stocks offering exciting potential you're going to read about here. If we enter another bear market, the quality stocks will almost certainly hold up better than the riskier plays. But

if recent trends continue and investors grow even more optimistic, then the profits on these small stocks will far outweigh the steadier-earning blue chips.

It's important that you follow your own path in the investing world, though. So if you're uncomfortable investing at this end of the market, now is probably not the time to try your hand. Small stocks tend to get punished the most in market downturns, so the risk is quite high, even for established, profitable businesses like the three in this report.

CLEAR WARNING

July's special report on small stocks offered a very clear warning on this issue:

“What these very different investment opportunities have in common is in their ability to go off the rails. Small businesses are inherently more risky than established blue chips, which is why Intelligent Investor Share Advisor recommends you have no more than 15% of your portfolio allocated to them. Conservative investors who can't afford large losses might have less than 5%, if any exposure at all.”

That remains just as true now as it was six months ago, and explains why we started with a basket of stocks to which we're now adding. It's all about spreading the risk. There's another point to understand, too. Stocks such as those you're about to read can be great fun but we won't be producing on-going coverage. That means you're all but on your own. Do your own research and pay careful attention to each investment should you choose to proceed with them.

Having said that, you should find the following small stock picks interesting, stimulating and potentially very profitable.

Updates on previous picks

BY GREG HOFFMAN + STEVE JOHNSON

Since our July special report, the five selections are up an average of 11%. What now? Former Share Advisor research director Greg Hoffman and Intelligent Investor Fund's Steve Johnson offer their thoughts.

Since 2 Jul 2013, the date of the share prices in the original special report, much has changed. The ASX200 is up 7.3% and the ASX Small Ordinaries has risen 5.6%. Table 1 shows how the original picks have fared.

TABLE 1: ARE THE 5 SMALL STOCKS SHINING YET?

COMPANY	PRICE AT 2 JUL 13	CURRENT PRICE	% CHANGE	BUSINESS RISK	SHARE PRICE RISK
SWICK MINING SERVICES	\$0.28	\$0.29	3.6%	High	High
JUMBO INTERACTIVE	\$1.60	\$2.33	45.6%	High	High
GAGE ROADS BREWING	\$0.19	\$0.24	26.3%	High	High
MIRVAC INDUS. TRUST	\$0.16	\$0.15	-6.2%	Very high	Very high
VISION GROUP	\$0.84	\$0.74	-11.9%	High	High

SWICK MINING SERVICES

Although it's delivered a small capital gain and a fully-franked final dividend over the past six months, Swick Mining Services concerns me far more than it did. With warnings from giants like **WorleyParsons** through to smaller groups like **Forge**, **Ausenco** and **Fleetwood**, the backdrop for mining services groups continues to deteriorate. Some of these businesses are in crisis.

Meanwhile, Swick continues to buy back its own shares, pay dividends and has even invested in a new venture: laying out \$1.1m for a 23% stake in Swedish company Oreplore. This business has created a 'patented portable X-ray mineral scanner' that will 'ultimately allow accurate, real time assay and structural analysis in the field'. Swick has also committed \$5.4m in additional equity and debt funding to Oreplore over time.

There are two possible ways to view this; either as a sign of confidence or stupidity. If Swick is buying back shares, paying dividends and taking on new ventures while its underlying performance is plummeting, then management may be doing shareholders a disservice, especially if such actions precipitate the need for a future capital raising.

In the first quarter, Swick's rig utilisation rate fell to 61%, its lowest level in more than three and a half years. The average revenue per operating rig also fell, although it remained marginally higher than the same period last year. 'Material downside risk in all mineral drilling businesses

exists at this time,' management declared at the annual meeting in mid-November, while adding an upbeat note that '(n)umerous business development opportunities exist.' True and true. But anyone holding mining services stocks in such an environment should be nervous and I am. In September, I trimmed my Swick holding in the largest portfolio I run by almost 20%, taking it back to around a 2% weighting.

Swick is also heavily exposed to the gold sector, which is in a state of panic. The gold price is down heavily this year (cushioned slightly for Australian operators by the pull-back in our currency) and this is putting pressure on profit margins and reducing the appetite for exploration. None of that is good news for Swick.

Six months ago my thesis was that Swick's technological competitive advantage might see it emerge from a downturn in a stronger position. That view hasn't changed. But the downturn may be more savage than I'd expected. It would be better if management curtailed dividends and buybacks at this point to lessen the risk of having to ask shareholders for more money at an inopportune time. Expect a bumpy ride.

Disclosure: Interests associated with Greg Hoffman own shares in Swick Mining Services.

JUMBO INTERACTIVE

Jumbo Interactive meanwhile has been a lovely performer, up 45% since first covering it in early July, and managing a fully franked dividend payout along the way. The fundamental story hasn't changed much but, contrary to the share price performance, there's been a bit of disappointing news.

Jumbo has hit delays with its foray into the Mexican market and hopes to launch 'later in 2014', whatever that means. In other words, it's at least eight or nine months behind schedule. Even in Germany, a country renowned for precision engineering, Jumbo's website is a couple of months late, although it's expected to launch this month. There's been no word on potential new jurisdictions but that may be to the good given the issues encountered in Mexico and Germany. Domestically, revenue for the first half is expected to be down 10%-15% due to fewer large jackpots. In the first half of the 2013 financial year, there were 11 jackpots of \$30m or more. To the end of November this year, there had been only four.

A backward step in revenue and delays with international expansion aren't a great look for a growth stock like this but the domestic revenue dip isn't a fundamental problem. Some hitches when moving into foreign lands are to be expected. Meanwhile, Jumbo's cash pile continues to grow, as does its database of online lottery players. No need to lock in any profits here just yet.

Disclosure: Interests associated with Greg Hoffman own shares in Jumbo Interactive.

“There are two possible ways to view this; either as a sign of confidence or stupidity.”

GAGE ROADS BREWING

I trimmed my holdings in Gage Roads Brewing in September and October as the share price rose strongly and the stock became a hefty percentage of the portfolio. At around a 4% weighting, it's still too large a position given the risks of Woolies crunching margins down the track so I may cut back further in coming months.

None of that detracts from the operational story. First quarter revenue rose 15% on the same period last year and in October a new contract customer was added in UK cider producer Westons World Brands. Gage Roads will package their UK-produced Westons Premium Cider product for the Australian market.

An important test for management lies ahead. Beer consumption soars as we slump into the couch to watch the Poms get smashed in the cricket and over these peak summer months. And if we don't win the Ashes, it will probably soar because we have reason to drink. Management will see for the first time how the company's expanded facilities handle a greatly increased demand. If maintained across the whole year (which it won't be), this would see the group hit its current 2.5m case capacity so the next few months will be the company's first genuine full capacity stress-test.

Management has also identified 'potential areas for capital expenditure' which it hopes will help achieve its goal of halving operating expenditure per carton. Nothing specific has been announced but the numbers are apparently being done on various projects.

It would be quite a feat for management to meet the goals set back in 2011 of tripling production and simultaneously halving operating expenditure per carton. So far things seem on track, except for the capital cost of the project which has blown out a bit. But with bank debt backed by cornerstone shareholder **Woolworths** and that company's ability to drive volumes, there's every reason to believe the audacious 2015 goals can be achieved. I'm happy to continue holding this stock.

Disclosure: Interests associated with Greg Hoffman own shares in Gage Roads Brewing.

VISION AND MIRVAC

At Intelligent Investor Funds Management, the Christmas present were supposed to be big fat distributions from Vision Eye Institute (VEI) and Mirvac Industrial Trust (MIX). Both have disappointed. In August they announced that, despite generating significant amounts of free cashflow, they weren't intending on distributing it to shareholders. In MIX's case, management claim they need the money to attract new tenants to some recently vacated industrial properties. Meanwhile, Vision wants to pay down more debt.

Still, there has been no impairment to the underlying value of either business. With the Australian dollar down, the US economy improving and a tsunami of cheap money moving into US commercial property, Steve Johnson remains confident that an orderly liquidation is going to deliver MIX unitholders significantly more than the current unit price.

And Vision's AGM update suggests the investment case remains on track. Earnings for the first three months of this financial year were higher than the same period in 2012, despite regulatory changes having a disproportionately negative impact on 2013's numbers. At less than 10 times forecast earnings and with a huge pile of franking credits, growth is unnecessary but would be a nice bonus. The Value Fund's investment in both stocks is going to require more patience than originally anticipated. But in a raging stock market now all but bereft of opportunity, it's nice to have a few presents that can be unwrapped in 2014.

Disclosure: Interests associated with Greg Hoffman own shares in Vision Eye Institute and Mirvac Industrial Trust.

Intelligent Investor Value Fund owns Vision Eye Institute and Mirvac Industrial Trust and reserves the right to sell them at any time.

For information on the II Value Fund, which has returned 34.08%p.a. over the past 2 years, register your interest [here](#).

“Beer consumption soars as we slump into the couch to watch the Poms get smashed in the cricket.”

Running with Real Estate Corp

BY GREG HOFFMAN

COMPANY INFO

Real Estate Corp	(RNC)
Review date	9 Dec 2013
Price at review	\$0.31
12mth range	\$0.14 – \$0.37
Market cap	\$40m
Business Risk	High
Share price risk	Very High

“For each dollar of annual property management income, most agents earn more than one dollar of sales commissions.”

The last listed company to buy rent rolls now trades at \$0.001 per share. Here's why I think this stock will enjoy a far more prosperous fate.

More than a dozen years ago I bought shares in a tiny company called Aliquot Asset Management. It was trading at less than its cash backing of around \$6m, which puts colour in the word 'tiny' for you.

Management had the idea of buying 'rent rolls' (the rights to manage investment properties on behalf of owners) from real estate agents and combining them into a property management outfit that would use technology to keep its costs low and generate handsome profits.

It announced the acquisition of eight rent rolls in quick succession, amassing more than 1,000 properties under management. While I managed a profit on the investment (a low purchase price can work wonders), Aliquot never turned one from the business before exiting it. I last spotted the stock trading at 0.1 cent per share under the name Bone Medical, with a director named Leon Ivory. When I saw a higher profile company trying to do the same thing a few years later I avoided it but nevertheless followed the story. Last year, finally, I made a purchase and the story has significantly improved since then. Even with the stock rising 580% over the past two years, there's great potential for further gains.

Here's why. Run Corp (recently renamed Real Estate Corp) listed for \$1 per share in late 2005. The prospectus boasted heavy-hitting names like Frank Cicutto, former **National Australia Bank** CEO, who was chairman of the board alongside property high-flyer John McGrath as a director. You can see how reality stacked up against the prospectus forecast in Table 1.

TABLE 1: PROSPECTUS VS REALITY

	2007 (FORECAST)	2007 (ACTUAL)
REVENUE	41,186	25,153
OPERATING EXPENSES (EXCL. IMPAIRMENT)	24,986	24,607
EBITDA	16,200	546
DEPRECIATION	709	423
AMORTISATION	5,396	4,147
EBIT	10,095	-4,024
NET INTEREST EXPENSE	4,473	3,659
TAX	1,687	-1,754
NPAT (EXCL. IMPAIRMENT)	3,935	-5,929
NPAT (REPORTED, INCL. IMPAIRMENT)	3,935	-17,052

Not only were the numbers disappointing but the boardroom was generating plenty of drama. Cicutto had quit in February 2007 and McGrath followed in July with

the company litigating against McGrath, who subsequently paid out a settlement in 2008. By late 2007, the group's \$42m debt burden was weighing heavily and the share price was wallowing at less than 10 cents. To me, the company looked like Aliquot with more debt.

The change in the past six years couldn't be more marked. Table 2 shows the latest full-year numbers against 2007's. Revenue has grown modestly, operating costs have been reduced and interest costs have been slashed. That combination has delivered an operating profit.

TABLE 2: SIX YEARS OF PROGRESS

	2007	2013
REVENUE	25,153	27,626
OPERATING EXPENSES (EXCL. IMPAIRMENT)	24,607	22,109
EBITDA	546	5,517
DEPRECIATION	423	339
AMORTISATION	4,147	1,456
EBIT	-4,024	3,722
NET INTEREST EXPENSE	3,659	1,387
TAX	-1,754	817
NPAT (EXCL. IMPAIRMENT)	-5,929	1,518
NPAT (REPORTED, INCL. IMPAIRMENT)	-17,052	1,518

The group now carries less than \$15m of debt, down from more than \$42m in 2007. A remarkable deal was done in late 2011, which involved swapping \$35.6m of debt owed to NAB for \$20m owed to **Macquarie**. The company is in decent financial shape today, which begs the question: what are the prospects for revenue growth? Here's where things look particularly bright. Having realised that property management is likely to be a steady earner rather than a stellar one, Real Estate Corp has figured out what virtually every other real estate agent already knew: a large part of the value of a rent roll is as a pipeline for future lucrative sales opportunities.

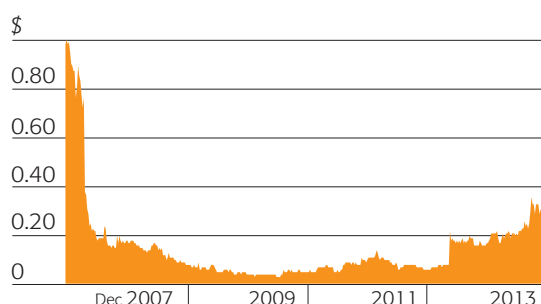
For each dollar of annual property management income, most agents earn more than one dollar of sales commissions. In the last financial year, Real Estate Corp earned \$23m of management income and just \$3m of sales commissions.

The potential is clear, which is why management has been building up its sales team. At 30 June last year, RUN had 15 sales people. At 30 June this year, the number had grown to 20 and by 30 September it was 28.

It's reasonable to assume that Real Estate Corp could get to \$6m or \$7m in annual sales commissions over the next couple of years as its sales force grows and the current hot property market drives volumes and prices higher. This could add up to 50% to the group's latest net profit of

\$1.5m in fairly short order. But, more importantly, it would prove that the company's property management operations can provide a lucrative source of leads for its sales team. The next stop might be generating 50 cents in sales commissions for each dollar of management revenue. That would account for around \$11m or \$12m in annual sales commissions, at which point profits should be mounting up nicely.

CHART 1: RNC SHARE PRICE SINCE LISTING (DEC 2005)



Source: Capital IQ, Dec 2013

Management has timed its run (pardon the pun) at the property sales business perfectly.

Another benefit of an active sales presence is the potential to grow the rent roll business further by offering management services to purchasers of properties not already on the group's books. The company also has a couple of other growth options. It recently appointed former **Computershare** executive Andrew Heard to head up its Agentplus business.

Agentplus offers outsourced 'technology and administration services' to real estate agents. Around 26,000 landlords are currently using this technology and the group sees significant potential to increase the

six-figure profit this unit generated last year.

The other growth opportunity is a new online service called Maintenance Matcher. Its aim is to 'match the right job with the right provider in the most time efficient manner'. From what I can tell, it's a kind of online marketplace for maintenance jobs (the RUN business itself sub-contracts some 50,000 maintenance jobs each year). The site is due to launch soon.

Agentplus and Maintenance Matcher are best seen as free options. The reason I like the stock is that by good luck or good judgment, management has timed its run (pardon the pun) at the property sales business perfectly. At today's share price, you're not really paying anything for the two technology businesses. The rent rolls also add some asset backing. And while that backing is not strictly 'tangible', there is an active market for such assets. Even if we knock \$10m off the group's own \$60m valuation for its rent rolls, that leaves \$50m on a pure 'asset basis'. Subtracting all liabilities (a tick under \$24m), leaves \$26m. That's more than half the current valuation. This would be a total liquidation valuation, attributing no value to the RUN brand, sales potential, Agentplus, Maintenance Matcher and even the few million of cash and receivables on the balance sheet.

So if something does go awry, the downside should be limited to 40% or 50%, which is not so bad in a small stock with lots of potential. The upside could be 80%, 100% or more over the next four or five years, plus a moderate, fully franked dividend on the way through. A takeover offer is not out of the question, either. There's a few different ways to win with this one.

Disclosure: Interests associated with Greg Hoffman own shares in Real Estate Corp.

Wilson HTM's hidden value

BY GREG HOFFMAN

COMPANY INFO

Wilson HTM	(WIG)
Review date	9 Dec 2013
Price at review	\$0.55
12mth range	\$0.17 – \$0.74
Market cap	\$57m
Business Risk	Med-High
Share price risk	High

It's been a dire few years for full service stockbrokers but a stake in a growing funds management business means there's a lot of value in this one.

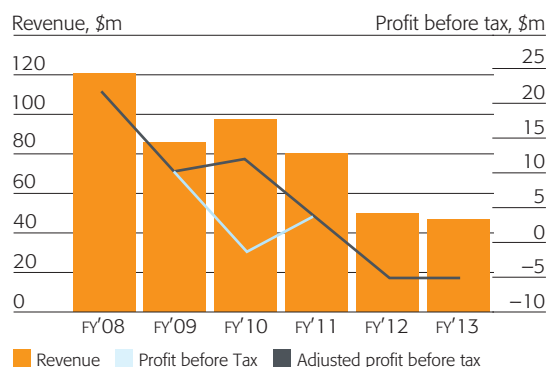
There's a fair chance you've heard of Wilson HTM. It boasts a corporate history stretching back almost 120 years, though last year its traditional stockbroking and wealth management business managed to not only lose \$6m but also its CEO, who departed after allegations of inappropriate conduct.

It's not a great place to start, a fact compounded by a rather ugly Chart 1, which shows just how precipitous the fall in revenue and profitability has been.

Other than the obvious potential for a cyclical bounce, what's the story? Let's start with the most valuable piece of the puzzle, which, on the numbers, is not the traditional stock broking business at all. Wilson HTM owns a 79.3%

stake in Pinnacle Investment Management, an incubator of funds management businesses.

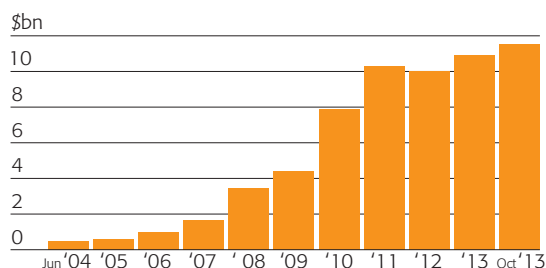
CHART 1: WIG REVENUE AND PROFIT BEFORE TAX



Source: Wilson HTM annual meeting presentation, Nov 2013

Pinnacle owns stakes of between 19.8% and 39.7% in each of six fund managers. You can see the impressive overall growth in their funds under management — right through the GFC period — in Chart 2.

CHART 2: PINNACLE'S FUNDS UNDER MANAGEMENT



Source: Wilson HTM annual meeting presentation, Nov 2013

The fund managers under Pinnacle's umbrella had more than \$11.6bn in combined funds under management as at 31 October this year. The fact that this is spread across a number of different managers provides some protection against bad performance or 'key person risk' for any single funds manager. The downside is that economies of scale aren't achieved in the same way they would be if that total amount of funds under management were within one business.

These funds management businesses earned a combined \$47.3m in total revenues in 2013. Pinnacle's share of the net profits was \$8m. Applying a low PER of 12 and a high one of 16 (lower than the likes of **Treasury Group** and **BT Investment Management**) delivers a total value of \$96m–\$128m. As Wilson HTM owns 79.3% of Pinnacle, it's a simple matter of multiplication to arrive at the value of its stake, which is shown in Table 1.

TABLE 1: WILSON HTM SUM-OF-THE-PARTS

	LOW	HIGH
SHARE OF PINNACLE (79.3%)	76	102
WILSON HTM	29	46
CASH & PRINCIPAL INVESTMENTS	14	17
TOTAL ASSET VALUE	119	164
LESS		
CORPORATE COSTS (CAPITALISED)	15	15
NET VALUE	104	149
SHARES ON ISSUE	104	104
VALUE PER SHARE (\$)	1.00	1.43

Now let's turn to the task of valuing the group's other operations. They've recently been loss-making, so we need an alternative to a PER valuation. In this case I've used a price-to-revenue ratio. These operations, which include stockbroking and funds managed directly by Wilson HTM (about \$1.4bn), generated more than \$57m of revenue in 2013.

By way of comparison, **Bell Financial Group** (which also recorded a loss in its last full financial year), trades at more than one times revenue, while profitable WA-based **Euroz** trades at several times its 2013 revenue (partly

explained by the hefty amount of cash and asset value on its balance sheet).

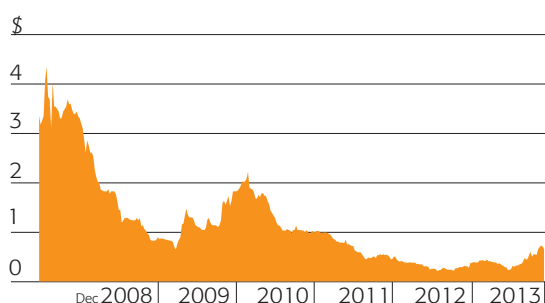
Erring on the conservative side, let's use a low figure of 0.5 times revenue and a high figure of 0.8 times. That gives a valuation range of \$29m to \$46m for the group's traditional businesses.

The final piece on the asset side of the puzzle is cash and principal investments. These totalled \$18.6m at 31 October and have been included at \$14m and \$17m in the low and high valuations.

After adding up each of these figures, we need to deduct \$15m to account for the costs of being a listed corporate entity. What we don't need to do is deduct the debt shown on the balance sheet because it is not corporate debt (it's related to financial products which have offsetting assets).

As the table shows, the low valuation comes out at \$1 per share and the high — which I'd hardly describe as wildly optimistic — is over \$1.40 per share, more than twice the current share price.

CHART 3: WIG SHARE PRICE SINCE LISTING (JUN 2007)



Source: Capital IQ, Dec 2013

At its recent AGM, the group reported improving brokerage volumes and a turnaround in the profitability of its traditional operations on the same period last year. If corporate confidence and sharemarket activity continue to build over the coming months, then the traditional business might turn a respectable profit for the year. In summary, Wilson HTM's traditional businesses have been doing it tough but offer good potential after recent cost-cutting efforts have left them well positioned for an upturn in volumes. But it's Pinnacle that has grown without a lot of fanfare to become the jewel in the crown — something far more valuable than the traditional operations.

That view, apart from being confirmed by the numbers, was also supported by an announcement from Treasury Group in September that it 'was in discussions with a consortium in relation to WIG' but those discussions did not lead to an agreement at the time.

There's every chance that Treasury, or another predator, might return at some stage. But with several sophisticated key shareholders such as Deutsche Bank and Steven Wilson, there's no chance of a low-ball bid being successful. I suspect a bid would have to be at least \$1 per share to even be considered.

Disclosure: Interests associated with Greg Hoffman own shares in Wilson HTM.

If corporate confidence and sharemarket activity continue to build over the coming months, then the traditional business might turn a respectable profit for the year.

Taking a punt on eBET

BY GREG HOFFMAN

COMPANY INFO

eBET	(EBT)
Review date	9 Dec 2013
Price at review	\$2.70
12mth range	\$1.00 – \$3.40
Market cap	\$41m
Business Risk	High
Share price risk	Very High

Now that eBET is ahead of its breakeven points in all three businesses, revenue growth should translate into strong profit growth.

This company sells the proverbial shovels and picks to those mining for gold in the poker machine industry. And its latest product is setting the industry alight.

Australians' love of gambling has spawned many multi-billion dollar companies. From **Tabcorp** and its casino spin-off **Echo Entertainment** to **Tatts Group**, **Crown**, **Aristocrat** and the explosive growth of **Ainsworth Game Technology** (founded by industry mogul Len Ainsworth as a second act to his success at Aristocrat).

Compared to those giants, the subject of this review is not only a minnow but also sports a name straight out of the original tech boom: eBET. Famous fund manager and author Peter Lynch might be quite interested, being fond of smaller companies with growth potential (and especially those with unfashionable names).

eBET has three divisions. Let's start with the 'Gaming Systems' division, which is currently driving the company's revenue and profit growth. It sells systems to venues running poker machines that help them reduce costs and increase turnover. The division recorded \$14m of revenue in the 2013 financial year, up 48% on 2012.

NEW SYSTEM PROVES POPULAR

The group's 'CARD IT' system has been going gangbusters lately. It enables machines to transfer credits onto magnetic cards for cash payouts at a central point, or for loading into a different gaming machine altogether. Customers don't have to wait for an attendant before collecting from a machine, saving time for both parties. And venues already eschewing cash in favour of ticket-in-ticket-out (TITO) systems benefit by avoiding problems like printer jams and other associated hardware issues. At 30 June, in eBET's home market of New South Wales, 92 venues had installed the CARD IT system on a total of 8,945 poker machines. By late November, that number had increased to 100 venues and 9,900 machines (about 10% of the market).

Recently, the company announced that after successful trials in two venues, CARD IT had received regulatory approval in Queensland, Australia's second-largest gaming machine market. At the same time, eBET announced it would be rolling out the system 'across at least 17 venues covering 2,212 poker machines' (almost 5% of that state's machines). Such figures are encouraging, with management confident of further success over the coming year.

Not only do these system sales generate good up-front profits (\$1.8m in 2013) but they also feed eBET's 'Gaming Operations' division, its largest by revenue. This division receives income from ongoing licence fees, hardware maintenance and software support fees. It also encompasses Odyssey, a Queensland-based business

that monitors 20% of that state's gaming machines. Almost all of the Gaming Operations division's \$21m of revenue is recurring. And while it made a relatively modest profit of \$771,000 in 2013 (a profit margin of just 3.7%), that bottom line figure should rise noticeably in the coming year as the benefit of recent system sales flows through, as well as market share gains in the Queensland monitoring business (at the expense of industry giant Tatts Group).

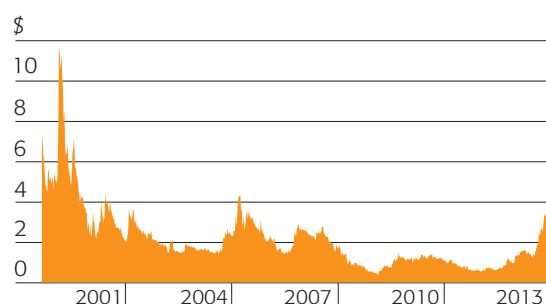
eBET's third division is 'Gaming Machines'. It uses existing relationships with venues to sell machines manufactured by American group WMS Industries. Regulatory hold-ups for most of the 2013 financial year saw this division's revenue fall by 32% to \$7.4m. With approvals now in place, the stage is set for a rebound in the coming financial year.

So 2014 should be a growth year for each of eBET's divisions. And the company's balance sheet is in good shape, with \$3.8m of debt almost completely offset by \$3.4m in cash.

So, what's this company worth?

Dealing with the valuation of a business at this stage in its life is tricky. Now that eBET is ahead of its breakeven points in all three businesses, revenue growth should translate into strong profit growth. And when the profit numbers are relatively small, the percentage increases can easily impress.

CHART 1: EBT SHARE PRICE SINCE LISTING (AUG 1999)



Source: Capital IQ, Dec 2013

2013's profit of \$2.7m (excluding the profit it made on the sale of a division) could double or more over the coming few years. And the group's bank of accumulated losses means it shouldn't be paying tax for some time. If \$5m profit could be reached in fairly short order then today's market capitalisation of \$41m would look rather appealing, particularly if the company could maintain profit growth for a number of years thereafter.

What of the risks? While system sales are currently growing strongly, that may reverse in a few years' time when CARD IT finds its natural level of market share. To offset that, management believes it can find other third party products and systems to add to this sales channel.

The Gaming Systems division is the current star and should drive profitability for the next few years but it's the steadier revenues from the Gaming Operations division that hold the most appeal from a valuation perspective. This annuity-style revenue growth should be valued on a hefty multiple.

The Gaming Machines division has been somewhat disappointing since the distribution arrangement with WMS was first struck in July 2009. We'll have to wait and see if the results over the coming year begin to justify eBET's efforts to date.

The market for gaming machines in NSW alone is estimated to exceed \$130m annually, so the opportunity is obvious, as is the potential to expand into other states (the WMS offering has already been launched in the smaller ACT, SA and NT markets).

In short, 2014 should be the first year where all three of eBET's divisions contribute meaningfully to its bottom line. And this synchronised growth could continue for a few years yet. Meanwhile, the group should be building annuity-type income that can provide a stable source of profits if the Gaming Systems and Gaming Machines divisions flatten out or falter at some point.

By way of disclosure, eBET has grown to become the largest holding in the portfolios I run and I have been trimming back holdings in recent months. That's not a bad sign. This is a small stock with all of the attendant risks that entails. But it's likely to remain one of my top holdings as I believe the growth opportunity is as clear as it is exciting.

Disclosure: Interests associated with Greg Hoffman own shares in eBet.



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