GANES
APIR WPC0004AU | ARSN 115 121 527

MACRO CAPITAL LIMITED
ABN 14 145 321 928 | AFSL: 392401

GANES INVESTMENT MANAGEMENT PTY LTD
ABN 86 113 032 741 | AFSL 287598

Santa Claus crashed his sleigh this year…

This most recent quarter illustrates how quickly fortunes can change in financial markets. At the end of September 2018, the Fund enjoyed a 1 year return of 20.1%, a little over 5% ahead of the broader market return. A bruising three months later, the 1 year return is now -7.0% trailing the market by 3.4%. How did we get from there to here so quickly? Based on end of month values, both the Fund and the market peaked at record highs at the end of August 2018 and since then the Fund is down 16.9% and the market down 9.9%. On a relative (to the market) basis, December was particularly difficult for the Fund down 6.9% against the market down just 0.5%. This was amongst the worst months in the history of the Fund.

Performance 31-Dec-18	Ganes	All Ord Index
1 Month	-6.90%	-0.45%
3 Month	-14.52%	-8.98%
6 Month	-14.23%	-7.28%
1 Year	-6.97%	-3.53%
2 Year (p.a.)	6.91%	4.16%
3 Year (p.a.)	6.15%	6.60%
5 Year (p.a.)	6.63%	5.71%
10 Year (p.a.)	11.54%	9.14%
Since Inception (p.a.)*	7.44%	6.10%
NAV Unit Price ($)	1.5257	
Fund Assets ($ million)	20.72	

* Inception date of Fund 18/11/2005

The greatest damage in December came from the largest ten holdings in the portfolio, not just because they are large holdings but because several also experienced double digit negative returns. In order of their contribution to the terrible month, starting with the largest negative contributor, were Smartgroup (-12.7%), PWR Holdings (-10.5%), ARB Corporation (-11.1%) , Gentrack (-11.3%) and MFF Capital (-5.6%). Collectively, these five stocks accounted for 5.3% of the December loss. They also make up more than half (-8.4%) of the Fund's -14.5% three-month return. Let's have a look at each of these companies and their businesses, and ask whether this sudden loss of market value is something we should be concerned about.

Smartgroup

Smartgroup has been one of our best investments in recent years and we have written about it extensively over the past few years, so we won't rehash all the company details. The share price started the new financial year at $11.67 and with the release of its half year results in August which showed revenue up 26%, profits up 27% and a 24% increase in the dividend, it was all good news for shareholders, and the price peaked at over $13.00. In September, the CEO added to his $50m stake in the business by buying more shares on-market at $12.03 per share, another good sign for shareholders especially from this particular CEO.

Since then there have been just three announcements from the company to the market, all in October, yet the share price has fallen 25% in the past three months. Essentially, we have no explanation in terms of company performance that explains the sudden fall. What it does highlight is that volatility has returned to the market and Smartgroup is no exception, with or without any news flow.

As someone mentioned recently it's as if we have all been listening to golden oldies and chill music and someone has suddenly changed the station. We remain confident that Smartgroup is performing well and should report another strong full year result In February. The volatility we are now facing may offer opportunities to add to various portfolio holdings.

PWR Holdings

While PWR was the biggest negative contributor to the December return, it was actually one of the best performing companies in the portfolio over the October-December quarter. Led by founder Kees Weel, the company designs and produces customised cooling systems for the automotive industry, with motorsports and F1 a focus. We have visited

MACRO CAPITAL LIMITED ABN: 14 145 321 928 AFSL: 392401
Postal: PO Box 558, Wembley WA 6913 Street:Unit 2, 55 Salvado Rd Subiaco WA 6008 Telephone: 08 9217 3100 Facsimile: 08 9217 3111
Website: www.macrofunds.com.au Email: madmin@macrofunds.com.au

their manufacturing facility on the outskirts of Brisbane and were very impressed with what we saw and heard. Management maintains a laser focus on providing its global customers with bespoke solutions to complex problems. We saw first hand how they designed, fabricated and tested a cooling system that needed to fit into an almost spiral shaped cavity for one of the Formula 1 teams. To achieve this, they need highly skilled staff at all stages of the design and production process, so a great deal of attention is given to employee recruitment, development and retention. Management are also seeing significant potential for their cooling system technology in industries beyond automotive, providing additional future growth opportunities for the business.

While producing cutting edge solutions for their clients is a core objective, Kees also makes it clear that doing this profitably is equally important. This is reflected in a pre-tax profit margin and return on assets of around 28% in FY18. We like that Kees owns a large portion of the company (34%) and directly bears the consequences of his decisions, along with the rest of us. We remain optimistic about the future prospects for PWR and this is reflected in the large weight it carries in the portfolio.

ARB Corporation

ARB is named after its founder Anthony Ronald Brown who kick-started the company in the mid-1970s after building a home-made roof rack for his Land Rover and noting the difficulty he had in obtaining quality automotive accessories. Around the same time Toyota introduced the diesel-powered Land Cruiser for which ARB developed a complete range of accessories including roof racks, bullbars and shock absorbers. The intervening forty plus years has seen 4WD and Sports Utility Vehicles (SUVs) taking an increasing share of new car sales, with SUVs now out-selling the once dominant passenger vehicles. This has been an incredible tail-wind for ARB which has been hard-pressed in recent years keeping up its product development pipeline with the new vehicle models coming to market. Today there are 63 ARB stores around Australia of which 25 are company owned. This aftermarket store network accounts for 65% of sales with a further 28% of sales coming from international exports facilitated by distribution centres in the US, Czech Republic, Thailand and the UAE. The company also has a large manufacturing facility in Thailand. ARB is ultimately a retail business and will feel the effects of an anticipated slowdown in consumer spending though it is not as directly impacted by a housing contraction as some other retailers.

Again, we feel fortunate as part owner of ARB to have the Brown family continue to be involved in managing the business. Andrew Brown, Managing Director, and Roger Brown, Chairman, own around 10% of the company between them and have a very long track record of success at building the ARB business and generating shareholder wealth. Total shareholder return for the last ten years sits at around 24% per annum. The recent significant fall in the share price does not appear to reflect any fundamental problems with the business. Rather, the fall is likely a market response to its retail exposure but also an adjustment to the high price it was trading on during the middle to latter stages of 2018.

Gentrack

Gentrack is a NZ based software business that provides mission critical software to its clients. The company is split roughly 80% into software for utilities companies in three main markets – New Zealand, Australia and the UK but has recently also expanded into Singapore where it has acquired three clients. The other 20% of the business is providing software for airport operations. The most obvious example of this is the arrivals and departures boards that passengers see but the software goes much further into the operations of an airport. It is also used by baggage handlers, air traffic controllers and even operations staff where it can calculate the rent for the retailers by monitoring sales in the stores.

Gentrack ticks quite a few boxes that we look for. The company provides software that is mission critical billing software and so therefore there are high barriers to entry. Customers are sticky and 90% of revenue comes from existing customers in any given year, however, this also means that winning clients is hard for the same reasons that they are reluctant to switch from their existing provider. Organic growth at Gentrack is therefore inherently limited and customers are in limited supply, so the company has addressed this with various acquisitions totalling more than $120m in the past two years. A trend more noticeable since the new CEO started in 2016. It is early days as to whether these have been prudent acquisitions, but they do appear to be strategically good fits for the business. From a financial perspective, they have grown revenue from $23.6m to $104m over the past 9 years and from $38m since listing in 2014. Similarly, EBITDA has grown from $7.6m to $31.0m over the same period. That's the good news.

The downside is that the company is highly exposed to Brexit and the likelihood that some smaller UK utilities may fail in the future, as well as decisions to delay various projects until after Brexit is cleared up – particularly by utility companies owned by European parents. Due to its high dividend payout ratio, the company has also had to go back to shareholders to raise capital to fund the acquisitions it has made. This is a negative for us as we prefer companies that can grow organically from their existing business with their existing cashflow, but this has only happened in the past two years and it may have been opportunistic rather than a regular feature of the new CEO. It is something we are watching.

We also note that while a large component of the company's revenue is very predictable, roughly 30% of it isn't and this can lead to surprises of both a positive and negative nature against market forecasts. This introduces an element of volatility that market commentators tend not to like but we should accept as a business reality and factor into our deliberations when contemplating the financial results. Politicians meddling in energy markets may also add some pressure to profit margins in the future.

There is a lot to like about the business, and it has rewarded shareholders since listing, perhaps too much as the price ran ahead of the underlying progress of the business. But there is some justification for recent price falls and with a more recent track record than some other portfolio holdings, we are watching with a close eye on developments within the business.

MFF Capital

MFF capital is an Australian based listed investment company providing the Ganes Value Growth Fund with exposure to a portfolio of high-quality international businesses focused on U.S. listed companies. As at the end of December, the largest five holdings in the fund were Visa, MasterCard, Home Depot, Bank of America and Alphabet. In the MFF Capital December 2018 update, the portfolio manager Chris Mackay said they had 'deployed more capital in a month than we have for a number of years and purchases were entirely in existing holdings' indicating his confidence in the portfolio at prevailing prices. We are attracted to the high-quality businesses in the portfolio, to the thoughtful long-term view that Chris Mackay takes in managing the portfolio, to his willingness to invest his family money in the fund (currently around $166m) and to the relatively modest fees and costs that investors in the fund incur.

It's not all bad news….

As you will have heard us say many times over the years, short term performance good or bad is something we should not pay too much attention to and a one-month return is very short term in our view. However, the extreme negative return for December is unusual for the Fund and we thought worthy of explanation. In the September 2018 Fund update we noted '…the recent strong performance has outpaced the underlying performance of many of the businesses so future short-term returns could be muted…'. The consequence could have been an extended period of

MACRO CAPITAL LIMITED ABN: 14 145 321 928 AFSL: 392401
Postal: PO Box 558, Wembley WA 6913 Street:Unit 2, 55 Salvado Rd Subiaco WA 6008 Telephone: 08 9217 3100 Facsimile: 08 9217 3111
Website: www.macrofunds.com.au Email: madmin@macrofunds.com.au

moving sideways or a sharp adjustment. It seems that we have travelled down the second path, and the heightened volatility may not yet be over.

Not everything in the portfolio lost ground in December, with five holdings earning a positive return. The best performer in the Fund was Trade Me Group. This company is New Zealand based with online businesses traversing the classifieds, property, motor vehicles and jobs spaces. Effectively it's the NZ equivalent of eBay, realestate.com.au, carsales.com.au and seek.com.au all in the one stable. This is one of the most profitable businesses on the planet with an operating profit of $138.2m on revenue of $250.4m in FY18. These fat margins have attracted competitors and the company has had to make significant investments in the business in recent years to defend its turf. Lower margins and greater investment has impacted on profit growth and the stalled share price has caught the attention of two corporate raiders. In December, the company entered into an agreement to sell 100% of the shares in the company to APAX partners for NZ$6.45 per share and this clearly sheltered the company from the December market sell-off. The shares were purchased for the Fund at an average of AUD$3.42 per share starting in late 2013 so the capital gain along with dividends has produced a decent return for the Fund.

Another good news story for the Fund (though it is still early days) is Nearmap. We have been following the company for several years but made our first purchases in late 2018 at $1.51. Nearmap provides its clients with cloud-based high-resolution aerial images. For example, NRG Solar, uses Nearmap to 'view and measure roof size, configure panel type, and calculate energy output estimate, such as kilowatt production per year, with a desktop in an office'. This saves the company more than 25 hours a week in site visits and allows sales consultants to focus on serving customers rather than collecting data.

The market for Nearmap's product is growing at a much faster rate than the general economy providing a tailwind for the industry and for Nearmap. The Australian Nearmap business is now extremely profitable and these profits and cashflows are being used to establish the business in the U.S. where the revenue and profit potential are multiples of that here in Australia. Nearmap is also a disruptor in the U.S. market with its subscription model. Nearmap owns proprietary imaging technology and constantly invests in this to stay ahead of its competitors. In FY18, the Australian business grew subscription numbers by 13%, average revenue per subscriber (ARPS) by 25% and reduced churn to 7.5%. The U.S. business, off a lower base, lifted subscription numbers by 56% and ARPS by 55%. Overall, annualised contract value (ACV) was up 41% over the prior year. As we write this update, the company has told the market of continued strong growth pushing the share price above $1.80.

Our general assessment is that the businesses within the portfolio are continuing to progress well and the poor recent performance is a consequence of heightened market volatility and a re-rating of some companies in the portfolio where the share price had got ahead of underlying fundamentals.

A distribution of 4.73 cents per unit has been paid to unitholders on the register at 31 December 2018.