

Market Returns and Portfolio Performance

The local market rose 1% during the quarter, and has fallen slightly over the last half year. Given the 1 year return of 8.5%, it is clear that the last year has been very much two contrasting halves with strong growth in the first half focused on the post Trump election period in November and December, and a weak second half. With the big 4 banks such a large part of the Australian indices, they tend to play a significant role in general market movements and that is particularly the case in the last year, with strong positive returns in the first half of the year and negative returns in the second half. The best returns in the large cap space (S&P/ASX100) over the last year have come from Qantas and a basket of resource related businesses including CIMIC, Alumina, Iluka, South32, and Rio Tinto. The sectors these businesses operate in are not where we prefer to invest, as we tend to avoid capital intensive businesses and ones where a host of extraneous variables (eg. Commodity prices, FX) impact the business.

Performance 30-Sep-17	Ganes	All Ord Index
1 Month	2.67%	0.05%
3 Month	6.64%	1.02%
6 Month	10.78%	-0.53%
1 Year	10.27%	8.53%
2 Year (p.a.)	13.91%	11.24%
3 Year (p.a.)	9.90%	7.30%
5 Year (p.a.)	10.51%	10.08%
10 Year (p.a.)	6.04%	3.01%
Since Inception (p.a.)*	8.02%	6.38%
NAV Unit Price (\$)	1.6741	
Fund Assets (\$ million)	27.08	

* Inception date of Fund 18/11/2005

Notable in the last several months has been the out-performance of smaller companies following a sustained period of under-performance which now stretches back a decade or more. If you had invested \$10,000 in the Small Ordinaries index at the end of September 2007, today that would be worth just \$8,679 even after including and reinvesting dividends.

While we are not averse to investing in larger companies, the smaller end of the market is our preferred hunting ground and the performance of the portfolio has benefited a little from the return to favour of smaller companies in recent months. While the large cap end of the market had a strong first half and weak second half, it was quite the opposite for the Fund with a minus 0.5% return in the first half and a positive 10.8% in the last six months. While the Fund has out-performed the market over the last 1 year by 1.7%, we are more interested in maintaining the longer term out-performance over several years which is currently evident. It is important to note that the Fund returns are net of all fees and transaction costs, whereas the market returns are based on hypothetical portfolios and do not bear any fees or transaction costs.

Our Thesis on a Recent Acquisition

Domino's Pizza was among those companies that had their share price slammed after failing to meet market expectations when announcing their 2017 results during August. Its shares fell 20% on the day and the shares are now down nearly 40% from their highs for the past year.

We had owned Domino's for a number of years, originally purchasing the shares in November 2006 when they had slumped on news that the company had purchased the European territory rights to France and The Netherlands and then the failure of a marketing campaign in Victoria led to a challenging year in the Australian operations. Following discussions with management, we determined this was a short-term blip and provided a real opportunity for investors.

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The investment performed even better than we expected but unfortunately we also sold way too early as the price rose strongly in subsequent years. While market commentators might argue the shares became too expensive, there can be no argument that the company has delivered stellar business performance for over a decade as it continues to expand in Europe and more recently, in Japan.

The table below provides a snapshot of the number of stores in the Domino's network as well as the company's targets for 2025. With an expected doubling of stores over the next 8 years, the runway for the company remains long, particularly in Europe.

	2007	2012	2017	2025
Australia / NZ	467	559	777	1,200
Europe	196	349	865	2,600
Japan	-	-	493	850
Total	663	908	2,135	4,650

In the latest results, the company reported Network sales growth of 18% (this represents sales made by all the stores), while company revenue increased by 15.4%. Profitability was even better, with EBITDA in underlying

operations up 28% along with NPAT by the same percentage. Earnings per share and dividends were up by 27%. To any business owner, these figures would present a very happy picture. But the market was unimpressed because management had promised earnings growth in the region of 32% and hence was disappointed, and as stated previously the shares fell 20% on the day of the results.

However, this market reaction has provided us with the opportunity to once again become shareholders in this wonderfully profitable business. Return on shareholders' equity remains above 30%, with little use of debt and the same management team that has delivered the growth of the past decade is still in place and owns a big stake in the business. That provides a good degree of certainty around delivering on its forecasts.

Our investment thesis is that Europe will become the jewel in the crown for this business over the next decade as the company has recently added Germany to its territories, which is the 4th largest pizza market in the world and the company can triple its store count and simultaneously improve profitability as it fills out its store network. The company reported an EBITDA margin of 18% for Europe in the latest result, up from 15% last year and an EBITDA margin of 6% just 5 years ago. However this compares to EBITDA margins of more than 30% in Australia which is much more mature and typical of other Domino's entities.

We are conscious that the company could face stiffer competition over the next decade than it has in the past as food delivery services like Uber Eats continue to grow, providing every restaurant and takeaway shop the ability to deliver their menu which didn't exist as recently as a few years ago. But on our estimates, profits should still more than double over the next 8 years, and while the Australian business should be quite mature by that stage, there will still be significant growth left in the European business.

On that basis, we believe we could earn a double-digit return per annum over the medium to long-term from here. Indeed, the company has already predicted growth of 20% for the coming year and given the chastening experience of over-promising in 2017 - we think they should achieve this.

We are constantly trying to find good quality businesses selling for reasonable or hopefully attractive prices but usually this only happens when some short-term event clouds the company. In this case, missed earnings guidance by management, in what was still a very good result, has provided that opportunity for us.

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Reporting Season Wrap

As is our usual practice at this time of the year we provide an update on the reported results of the top five holdings in the Fund. It is notable that the top five holdings this year are identical to the top five holdings one year ago, and is testament to our stated preference to holding our best ideas for as long as possible. These five companies account for 41.1% of the portfolio and are therefore important in determining the future returns of your investment in the Fund.

Still at the top of the portfolio is **Smartgroup** with the share price improving from \$7.19 to \$9.22 over the last 12 months. The company continued to deliver with another strong half-year result easily beating market estimates with revenue up 57% to \$95m and NPAT up 63% on the prior year to \$30m, although this includes earnings from the acquisitions made last year. Earnings per share was up an impressive 42% on the same period last year to 25c and 11.5% on the second half (which included the acquisitions). The company delivered organic growth of 12% driven by 2.6% in package growth, 7% from acquisition synergies and the balance by pricing growth. In a sign of confidence, the dividend was increased by 68% to 20c. The company has also delivered on the synergies it outlined at the time of the Selectus acquisition.

As a result of the growth and acquisitions, the company now manages 267,000 packages (up 44% on last year) and 55,000 novated leases (up 57% on last year). This is more than double that of just 3 years ago. The business remains incredibly profitable with EBITDA margin of 40% and NPAT before amortisation margin of 32%. Cashflow remains strong at \$26m for the half-year which was 86% of NPATA. Capex is minimal. Net debt remains at \$74m against shareholders equity of \$196m and finance costs are covered by more than 15 times. Return on equity remains very attractive as does return on assets. No guidance has been given by management but there appears to be no reason why the company won't continue to perform well.

Also entrenched in its (second) place position from this time last year is **ARB Corporation**. As we said last year, the 34% return for the prior 12 months was well ahead of the growth in the underlying business so it is not surprising to see a negative return for the last year with the share price down from \$18.16 to \$17.30.

Sales were up 7.2% to \$382.6m and NPAT up 3.6% to \$49.1m in a solid if slightly lower growth result than shareholders are used to, as NPAT has grown at more than 10% pa for the past decade. Earnings per share also grew by 3.6% or 62.1c and the dividend has increased by nearly 8% to 34c per share. The Australian aftermarket was up 4.6%, exports up 14.3% and OEM up 5.3%. Export sales have been the growth engine of the business in recent years despite strong new car sales in Australian.

The company continues to expand its store network opening another 5 new stores and now has 61 ARB stores in Australia of which 25 are company owned. The company stated that 3 of the stores are brand new and made no contribution towards the 2017 result. Additional warehouse facilities come on line in August in Victoria as well as a new store in Canningvale WA that will free up some warehouse space in that state.

Cashflow was strong at \$62.2m and despite \$20m in further fixed assets across the group, cash conversion on profit was a healthy 85%. Profit margins remain attractive with an operating margin of 17.5% and Return on equity of nearly 20%. The balance sheet remains very strong with no debt and nearly \$28m in cash. The company does not provide guidance and has a conservative approach but the Directors stated they remain positive and optimistic for the future.

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Magellan Flagship Fund is a listed investment company which we have held for a number of years that holds a portfolio of international stocks rather than an operating business. Accordingly, the financial results of the company are not particularly worthy of comment. However, it is worthwhile noting the movement in its Net Tangible Asset (NTA) per share over the year. The pre-tax NTA on 30 September 2016 was \$1.957 and this has increased to \$2.375 over the 12 months since then, with a small headwind move in the AUD/USD rate from 76 to 78 cents over the same period. While the NTA is up 21% the share price has risen just 10% from \$1.73 to \$1.91. It seems that the upcoming option exercise date has provided quite a drag on the share price as a number of shareholders sell MFF to fund their exercise of MFFO. MFF appears particularly good value at current prices, particularly in relation to NTA backing, and Chris Mackay (MFF portfolio manager), has been an active buyer on market in recent times. It has been another year of low turnover for MFF with few changes in the top end of their portfolio and Visa and Mastercard still the largest holdings accounting for 23.9% of the portfolio.

Clydesdale Bank reported its third quarter trading update at the start of August with results in line with expectations. A large part of the Clydesdale turnaround strategy is improved efficiency and lower costs, so it was pleasing to see that operating expenses are now expected to be below GBP680 million ahead of prior guidance of GBP690-700 million. The market has welcomed the trading update and the share price finished in September at \$5.14 up from \$4.39 a year ago.

Rounding out the top five is **Cochlear**. This was another good result from the company with revenue up 7% to \$1.24bn and profits up 18% to \$224m. Earnings per share grew by 18% to \$3.91. EBIT was up 20% to \$315m but FX gains were a large driver of this, although it was still up 15% in constant currency terms. The dividend was increased by 17% to \$2.70 and is fully franked. Implant growth was 8% with the company selling over 30,000 units for the year, and service revenue increased a modest 10% which is predicted to be a growth engine for the company in coming years with 450,000 life time clients already.

All geographies recorded solid growth, with The Americas sales up 18%, EMEA up 7% and Asia Pacific the laggard with just 4% growth. The R&D spend is expected to be \$160-\$170m for the year (up from \$150m this year), but constant at 12% of revenue. The big news for the company is the September release of the latest Nucleus Sound 7 processor which is 25% smaller and 24% lighter with a battery life 50% longer than the current product. Given such a big product improvement it was surprising that sales held up as well as they did. The outlook statement included an upgrade to profit forecast of \$240-\$250m, which is 10% increase on this year.

Current Activity and Outlook

The Fund continues to be effectively fully invested with 98.5% of capital deployed across 24 companies of varying sizes. We remain confident in the future prospects of businesses underlying the portfolio and note their above average profitability and balance strength.

As in previous years, the Fund will pay a distribution for the quarter. The September distribution is 0.57 cents per unit for the quarter.

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