

MARCH 2021 QUARTERLY REPORT

Portfolio Performance

The fund has recorded another solid quarter with the unit price up 6.1% to \$3.73 at the end of March. For the past year the fund reported a return of 56.4%, outperforming the market by 18.1%. Over the longer term the fund has provided a return of 9.2% per annum for the last 10 years and 11.6% per annum since inception.

It has now been just over a year since we saw the worst of the Covid-related market falls. The fund has enjoyed a rebound that has been surprising when compared against previous sharp declines such as the Global Financial Crisis. However, the rebound has not been uniform across the portfolio. Our larger holdings such as PWR Holdings, Domino's Pizza and ARB Corporation have all been hitting record highs recently which has led to the strong fund performance. While others such as MFF Capital, Magellan Financial Group and Altium remain relatively flat over the course of the year.

Despite strong recent returns, I remain confident the fund can continue to deliver returns consistent with the past. That's because some companies in the portfolio still offer reasonable value in my view.

There were some minor changes to the portfolio during the quarter. This followed reporting season, but was more as a result of a shift in my thinking which I will expand upon shortly.

Nearmap was sold and a new company was added to the portfolio leaving the total number of companies unchanged. The new addition is in an industry that may be considered boring. But it is quite profitable, requires little capital, and we have achieved successful results in the past in this sector.

Cash remains less than 5% of the fund.

Performance as at 31 March 2021:

	Fund (net of fees)	ASX 300 Accum. Index
3 months	6.1%	4.2%
1 year	56.4%	38.3%
3 years p.a.	10.4%	9.7%
5 years p.a.	12.2%	10.3%
10 years p.a.	9.2%	7.9%
Since Inception (p.a.)*	11.6%	9.1%
Value \$10,000 invested since inception	\$75,976	\$50,241

*Inception date of Fund is 14/10/2002

Unit Prices as at 31 March 2021:

Entry Price	\$3.7414
Unit Price	\$3.7321
Exit Price	\$3.7228

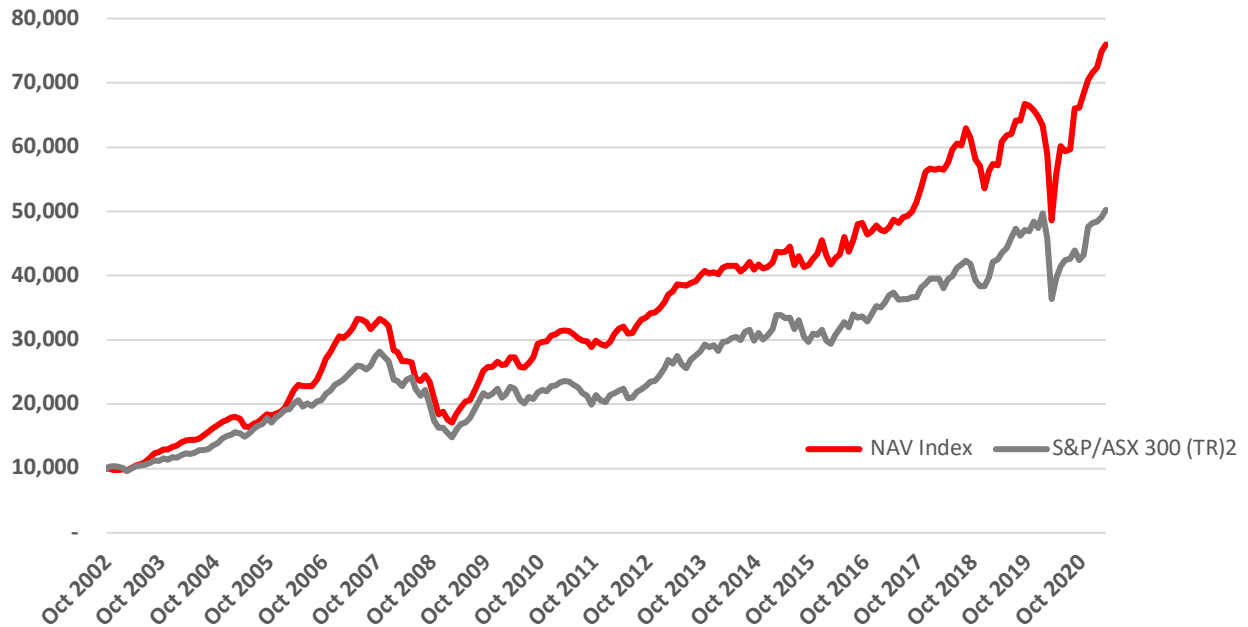
Top 10 Holdings:

Company	Code	Weight (%)
PWR Holdings	PWH	13.0
Domino's Pizza Enterprises	DMP	10.5
ARB Corporation	ARB	8.7
Reece Australia	REH	8.6
Dicker Data	DDR	6.7
MFF Capital	MFF	6.6
Lovisa	LOV	6.1
Magellan Financial Group	MFG	4.9
Cochlear	COH	4.4
AUB Group	AUB	4.0

Top 5 Sector Exposure:

Sector	Weight (%)
Consumer Discretionary	33.9
Information Technology	22.8
Financials	19.8
Industrials	7.9
Healthcare	7.3
Cash & Other	8.3

Fund Performance



While the table on the first page shows the performance of the fund over various time frames the graph above provides a visual representation of the fund against the ASX300 benchmark since inception.

“Attempts at market timing are a source of risk, not protection”

Howard Marks

It is now a full year since the market reached its lows and the turnaround due to government stimulus has been remarkable. Some of the better buys for the fund during the worst of the March falls were Lovisa, Carindale Property Trust and Domino’s Pizza Enterprises. Seeking to buy and own sound businesses at sensible prices (or ridiculously cheap prices in some cases), has proven to have been the better strategy rather than trying to dance in and out of the market reacting to macro events. Just missing a handful of positive days in March and April last year would have affected the returns for the past year by more than you might think.

Less than half the companies in the portfolio reported a positive return for the recent quarter. That is, most companies fell during the period despite a reasonably good profit reporting season. Importantly, however, some of our larger holdings produced returns that more than offset these falls. PWR led the charge with its price up 27% on the back of a very good result, but Lovisa and AUB Group were not far behind.

On the downside Altium, Audinate and Magellan Financial Group all fell during the quarter. Altium reported a result below expectations and the Magellan share price has been weaker as its investment performance has lagged market indexes in recent months. Given their track record neither are cause for concern at this time.

Changes in the Portfolio – and a change in thinking

In recent months valuations for some types of companies appear to have become quite unrealistic. To me they appear to be based on hope and promises rather than any business fundamentals. Social media appears to be playing a large part in this, along with the allure of easy money for traders and speculators. Many companies that are current market darlings are making losses and have negligible revenues. In many cases they have questionable and variable calculations of EBITDA but are providing investors with promises of very bright futures.

At the risk of sounding like a grinch, some may prove to be wonderful investments, but my guess is that most won't. Companies making losses and continually asking for more capital from their shareholders is not a long-term sustainable business strategy, it only works in rising markets, particularly if raising capital relies upon an ever-higher share price. With the "frothiness" surrounding these businesses I am reluctant to say it looks like 1999/2000 again (markets are never exactly the same), but it has caused a change in my thinking and led to reducing the limited exposure we have to these types of companies within the portfolio.

The fund has always largely consisted of profitable businesses that pay a dividend and have little requirement for additional capital from shareholders. Some may call these businesses boring, but I think most unitholders like it like that. And I would too if our roles were reversed. However, in recent years I have added three companies to the portfolio that are currently loss-making with the view that as these companies scale their activities they will become very profitable and shareholders will do well.

Over the past nine months, each one has gone to the market to raise more capital from shareholders when, to my mind, they didn't need to. And far from ensuring their path to profitability this appears to have emboldened the management of at least two of them to double-down on their spending and incur further losses into the future. Given my concerns about this as a long-term business strategy, this was more than my patience could tolerate. As a result, one has been sold, one has been trimmed, and the third has been maintained. The third business should be profitable in the near future and the current price could look a bargain if my expectations prove close to how events unfold.

Why PWR Holdings is our largest investment

It is unusual for most funds to have their largest holding at more than 10% of the portfolio, so I thought it may be helpful to explain why PWR is our largest holding. And why I am comfortable it remains that way. For context, PWR was initially purchased in mid 2016 with additional purchases in late 2017. Our average purchase price is \$2.52 against a current price at the end of March of \$5.73, so a large part of the current valuation is unrealised gains, rather than outright purchases.

I have written about PWR a number of times in previous updates so for the sake of brevity for new unitholders I will just provide the basics of the business. PWR was founded by Paul Weel (hence the initials, Paul Weel Radiators) in the mid 1990's to make radiators for the Holden Racing Team V8 Supercars. He was joined some years later by his father, Kees Weel, the current Managing Director, who also owned a radiator business.

With a focus on motorsports, in 2009 they decided to have a crack at providing cooling systems for Formula 1. To say they have been a huge success in this is to understate things. In 2009 Marston dominated the industry supplying every F1 team, but PWR scored a major coup when Red Bull became their first major customer in 2010.



Kees (Right) in the PWR factory at Ormeau.

Today, Marston have basically left the industry and PWR supply all the teams on the F1 grid. But PWR is more than just F1 cooling systems. In recent years PWR have built upon their technology base by supplying cooling systems for various high-performance, niche production cars such as the \$4.5million Aston Martin Valkyrie, and have also moved into aerospace and military applications. It is these latest moves that provide the opportunities for the future.

PWR has been a good news story and the financials have reflected that with growing revenues, attractive profit margins and high returns on shareholder capital. But anyone with some financial understanding can spot that. It's why the business has high profit margins and returns that's important.

I think there are two components to answer that. And a third point to highlight the growth potential.

They dominate a niche industry.

Technology investor and billionaire, Peter Thiel, author of *Zero to One* has written, "competition is for losers". That may sound arrogant, but he makes an important point. Companies that dominate a niche can extract higher profit margins and it provides the platform to expand into adjacent markets.

Tackling a market where you have 1% market share with the goal of getting to 10% - a 10-fold increase – sounds like an impressive growth opportunity. In reality, it means you probably have many competitors trying to do exactly the same thing. This usually leads to price wars and the customer is often the winner in these battles, not the supplier. Barriers to entry in this fragmented type of market structure are usually non-existent.

As a rule of thumb, niche markets make it easier to create barriers to entry. That's because without large growth opportunities it becomes harder for potential entrants to scale against an incumbent – there simply isn't enough business to defray the fixed costs of entering the market. An important dynamic to consider is understanding future supply from other potential entrants rather than the growth in customer demand. Barriers to entry and scale are hugely important when assessing this.

Bruce Greenwald in *Competition Demystified* also believes in dominating 'local' (niche) markets rather than competing against industry giants in open fields. He believes that pre-tax returns on invested capital of more than 25% over a long period of time are clear evidence of the presence of competitive advantages. PWR's return on invested capital is consistently above 30% per annum. This is a business with competitive advantages.

Their product is mission critical but not expensive in the overall cost for the purchaser.

I discovered the benefits of this business model when looking at aerospace supplier Precision Castparts which makes valves for Boeing and Airbus.

The valves that Precision Castparts make are not expensive in relation to the cost of the manufacture of aircraft, but they are mission critical. This means they are able to make attractive margins on their products. With F1 budgets in the hundreds of millions each year, PWR probably represents no more than 1% of the annual spend for most teams. But a car without a reliable cooling system will not finish the race. This makes price a secondary consideration in evaluating who to buy from. We see something similar with ARB Corporation and their products. If you are driving in a remote area, quality and reliability become far more important than any savings on a cheaper but inferior product.

And like ARB, I believe PWR possesses a level of customer captivity which flows into attractive profit margins on their products. PWR generates pre-tax profit margins on sales of close to 30% in most years.

Optionality on growth in aerospace and military provides a big runway for growth – this is the future.

Clayton Christensen in his book, *The Innovator's Dilemma*, described how the steel industry was disrupted by new entrants taking the low margin small jobs that the incumbents didn't want. They then moved up the food chain, taking more and more business off the larger incumbents. Listening to Kees talk about the new contracts they have won in aerospace, there appear to be some similarities.

As the new kid on the block PWR has been given the small, unattractive jobs that other bigger competitors aren't keen on. It appears the customers have been happy with the results and, judging by the recent financial results, these jobs are still profitable for PWR because they received bonus payments for early delivery against normal industry standard delivery times. So, similar to F1 where PWR provides a bespoke solution to each team, they are delivering a quality product in faster timeframes against their larger established competitors which should lead to more contracts.

Any analysis of the company's financial statements highlights that this is a good business, but the dominance of niche industries and barriers to entry show this is a business with some serious competitive advantages. Add in the optionality of new growth opportunities in adjacent markets and it's easy to see that the business has the platform to become much larger over the coming years. I am more than happy to wait while this plays out rather than take profits now.

And lastly, there's an intangible and unquantifiable element that I don't often come across. Kees has been in this industry for 30 years and he is a committed, competitive founder. When the CEO of the business says "I'm passionate about what we do; I sleep, eat and shit radiators, mate" that's a founder I want as a business partner.

Who we should be thanking

Lastly, while it's pleasing to report a return of 56% for the past year, the reality is that the management teams of the respective businesses we own have been working tirelessly to grow their businesses and manage their operations under unusually trying conditions. So when looking at the fund's returns please say thankyou to them for our returns – they have worked much harder than me in achieving them.

As always, feel free to call or email me if you require any further information about the fund.

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