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Ganes Focused Value Fund *ARSN 117 119 712*
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GANES CAPITAL MANAGEMENT LTD

GANES FOCUSED VALUE FUND – MARCH 2017

Unit Prices*

	31.03.17	30.06.16	30.06.15	30.06.14	30.06.13	30.06.12	30.06.11	30.06.10	30.06.09
Entry Price ($)	**$2.7804**	$2.6379	$2.5890	$2.5716	$2.4721	$2.0377	$2.0438	$1.8024	$1.5322
Unit Price ($)	**$2.7707**	**$2.6287**	**$2.5800**	**$2.5626**	**$2.4635**	**$2.0306**	**$2.0366**	**$1.7961**	**$1.5268**
Exit Price ($)	**$2.7610**	$2.6195	$2.5709	$2.5537	$2.4549	$2.0235	$2.0295	$1.7898	$1.5215
Distribution (cents per unit)	**2.1121**	**8.8129**	**8.0993**	**4.0178**	**4.5014**	**4.8340**	**6.7378**	**5.8396**	**6.6702**

* Unit prices are quoted pre-distribution. The *total* distribution paid during the financial year is shown.

Past Performance*

	Ganes Focused Value Fund	ASX300 Accumulation Index	Margin
3 months	-0.5%	4.7%	-5.2%
6 months	-1.4%	9.9%	-11.3%
1 Year	11.2%	20.2%	-9.1%
2 Years (p.a. compound)	4.4%	4.5%	-0.1%
3 Years (p.a. compound)	4.6%	7.5%	-2.9%
5 Years (p.a. compound)	8.4%	10.8%	-2.5%
7 Years (p.a. compound)	8.3%	7.2%	1.1%
10 Years (p.a. compound)	4.4%	4.2%	0.3%
14 Years (p.a. compound)	11.7%	9.8%	1.9%
Inception	11.4%	9.3%	2.1%
Value of $10,000 invested at inception (14/10/2002)	$47,643	$36,970	

Largest Ten Holdings

Beacon Lighting (BLX)
Nick Scali (NCK)
Reece Australia (REH)
Clydesdale Bank (CYB)
Smartgroup (SIQ)
PM Capital Global Opportunities (PGF)
Gentrack (GTK)
Trade Me Group (TME)
ARB Corporation (ARB)
PWR Holdings (PWH)

Portfolio Allocation

Top ten	54.1%
Other shares	41.3%
Cash	4.6%

* Fund performance is net of all fees and expenses, and assumes reinvestment of distributions. Investments can rise and fall in value. Past performance is not necessarily indicative of future performance. The fund currently invests substantially in smaller companies that may involve unique risks. The Product Disclosure Statement details the risks associated with an investment in the fund and is essential reading for investors.

For the year ending 31st March the Fund return was 11.2% versus 20.2% for the benchmark ASX300 Index, which represents a relative underperformance of 9.1%. Over our preferred time frame of 5 years the Fund return was 8.4% per annum versus 10.8% per annum for benchmark Index representing an underperformance of 2.5%, although investors should recognise that Fund returns are net of all fees, while the Index does not incur any fees. However, our goal is to beat the index after fees over this timeframe. Since inception in October 2002 the Fund has returned 11.4% per annum versus 9.3% per annum for the benchmark representing an outperformance of 2.1%.

Whilst the ASX300 is presented as the benchmark for the Fund, the portfolio holds no resemblance to the Index as the manager generally avoids resource companies. If we were to compare Fund performance against the Small Ordinaries Index instead, it has beaten this index by 6.1% per annum over the past 5 years and 5.2% per annum over the past decade. This is not to shift the goal posts but to highlight that Australia's largest companies, and banks in particular, have been market favourites in recent times and play a big role in determining broad market returns. In fact the Small Ordinaries is still in negative territory after ten years while most bank shares have delivered double-digit returns over the same period.

Investors search for yield, particularly fully franked dividends, has made the banks attractive investments particularly with their quasi-monopoly position within the Australian economy and a surging property market underwriting strong loan book growth. We are not making predictions, but with Australian household indebtedness at record levels against income, and property unaffordability at record levels despite record-low interest rates we are having difficulty seeing how the next few years could work out as well for bank shareholders as the past few have. Certainly with bank stocks rising more than 20% over the past year (ANZ and Westpac rose more than 30%) it is hard to see that performance being replicated again for the coming year as APRA attempts to reign in growth in their loan book through capital risk measures.

A cruel outcome in investing is that the most popular asset of each decade usually impoverishes its owners over the next decade, (internet stocks in 2000 for example). And this can also be said now for small cap stocks which produced very strong returns leading up to the GFC and have delivered a negative return of -0.8% per annum over the past decade. Hence, why we are cautious of chasing returns in the banks just because that's where the best returns have been recently without meeting the same fate.

As has been noted above the Fund returned 11.2% for the past year, considerably more than available from sitting in cash, but less than the broader market and while we are not too focused on returns in any one given year against an index that bears no resemblance to the Fund portfolio, it can be instructive to see where that difference came from.

The simplest explanation is that the portfolio only had six companies that outperformed the index, including; Smartgroup, Nick Scali, Cochlear, Gentrack and Austbrokers and these were more than offset by our holdings in companies which underperformed the market.

Unfortunately some of our larger holdings underperformed quite significantly with Flight Centre and PWR Holdings down more than 20%, AP Eagers down 13% and ARB down 7%, while a number of other large holdings such as Magellan Capital and Beacon Lighting reported only modest returns for the past year.

But we should never confuse share price performance for business performance and on this basis the portfolio has performed reasonably well. Profit reporting season finished last month and so we will use this opportunity to expand on that, especially in light of the companies that have underperformed the market.

Flight Centre has been a long-term core holding of the Fund having first purchased their shares in February 2005, and it has often been our largest holding over the past decade. And despite a frequently volatile share price it has performed reasonably well.

But the full year results in August last year raised concerns for us, that the long held belief that the internet would render the company obsolete, were starting to show through in the financial results. Of course this development is not something new, more than a decade ago analysts were writing the company off as being a dinosaur and hence why we were able to purchase shares at nearly 10 times earnings even in a buoyant pre-GFC market. Following the GFC the share price was down nearly 90% at one point and its subsequent strong rally was one of the main reasons for the Fund outperformance following the GFC.

Our key metric for the business over the years has been growth in TTV (Total Transaction Value) and the margins the company can earn on the sale of airfares and holiday packages to customers. In August last year the company reported for the full year that TTV rose nearly 10% but pre-tax profit fell slightly. In the latest half-year results this trend continued despite management stating at the November Annual General Meeting that they would be disappointed if profits didn't rise in 2017.

For the December half-year TTV rose a very modest 1% but revenue fell and net profit was down 26% on the prior year. There were some foreign exchange factors but overall it appears competition, particularly from online operators and the airlines themselves, has become decidedly more intense. Further, it provided guidance that profits this year will fall 6-7% against the previous prediction just a few months ago of an increase, marking the fourth profit downgrade in a row. By comparison online operator, Webjet achieved organic growth of more than 20% and upgraded its profit forecasts – this is not an endorsement or recommendation of Webjet, we don't own any shares, but provides a stark contrast between the results of the two businesses.

In light of the latest results, and in fact leading up to them, we have reduced our holding significantly as it has become apparent that the future for this business does not appear as bright as its past. So while it has taken a decade for the predictions to come true, and we would add they are only starting to come true and have not fully arrived by any means, we have taken the decision to reduce our holding quite significantly over the past few months.

PWR Holdings was added to the portfolio during 2016 and has contributed the most to Fund under-performance over the past year. Our timing in buying just prior to Brexit has detracted from Fund performance by slightly more than 1% over the past 12 months.

PWR is a Gold Coast based engineering company involved in design, manufacture and supplying of cooling solutions (radiators and engine and transmission coolers) to the auto sports industry, which represents 65% of their business. Most of this is to F1 teams, and in particular Red Bull, and PWR estimates it supplies almost 50% of all cooling systems used in F1. In addition it is estimated to be largest supplier in the Nascar championship. The remainder is providing cooling systems in the automotive and aftermarket sector to car manufacturers (high performance and low production runs) and emerging technologies (supplying cooling systems to battery driven cars and military).

The company was established in 1987 by the current Managing Director and 38% shareholder, Kees Weel, and listed on the ASX in November 2015 at $1.50. Prior to listing the track record of the business was strong with revenues more than doubling in the previous three years and net profits tripling to $10.7m in 2016. The company's profit margin (EBIT margin) was over 30% and it earns returns on shareholders Funds of more than 30% without the use of debt. These financial metrics are very attractive to us.

In addition, we believe the company has strong moat characteristics as its cooling systems are mission critical, but relatively low cost items within a racing team budget, hence purchasers are less price sensitive than in most industries. The company has a high level of Intellectual Property within the business as it designs and manufactures on-site in Australia with a high level of customer specification. And it appears the company has very high market share.

We concluded the shares were not cheap but we were prepared to pay up for a high quality business with a strong growth profile. And then came Brexit. The company incurs nearly all its costs in Australian dollars but earns most of its revenues in UK pounds and since the UK has signaled its intention to exit the EU the UK pound has fallen 25% which has come directly off the bottom line at PWR.

At the time of purchase, the two factors that concerned us the most were paying too much because we could see the similarities in the company and the profile of ARB Corporation (which has been a very successful investment for the Fund earning nearly 20% per annum for the past decade), and the volatility in earnings of having a revenue and cost base in different currencies, although these should even out over time under normal circumstances. To a large extent that is exactly what has played out in the first six months of ownership.

The half-year result just announced was an ugly headline with profits down 44% on the prior year but in many respects the result was better than it appears on the surface. The 25% fall in the UK Pound hurt revenue as mentioned previously and the impact was about $2m off the net profit for the half, which would have otherwise allowed the company to report a flat result.

In addition the business is highly seasonable due to the F1 season and is usually split 70/30 to the second half but management believe this year it will be closer to 80/20 hence the first half result is not indicative of full year profits. Amongst the positives for the company organic growth was 11.8% and UK Pound sales were actually up 23.9%. The company has also won some OEM contracts which should be an attractive ongoing business. This is not a huge part of the business at the moment (less than $1m per annum and 5% of sales) but should become meaningful over time.

Motorsports revenue was up 15% on prior year and changes to F1 and Supercar designs should see higher demand for the company's products in coming seasons. This is a business where complexity and technology enhances their competitive advantage and drives further sales. Operating cashflow was much lower than last year as the company invested in working capital ahead of the F1 season but the Balance Sheet remains strong and even in a bad first half the EBITDA margin was still nearly 20%.

The shares are down more than 30% in the past six months, and fell 15% in March alone, but we believe if the company can deliver the growth we think they are capable of, then the current price will look compelling in a few years time. Buying quality businesses at reasonable prices can usually only happen at times of uncertainty and the currency crash in the UK has provided that opportunity. We added to our holding during the month.

ARB Corporation, another of our larger holdings also detracted from Fund performance with the shares down nearly 10% over the past year. But the company results have been solid and over the longer-term patient shareholders have been well rewarded. Investments such as ARB are typical of why the Fund will under-perform at various times. It has delivered a return of 18% per annum over the past decade, and we have owned it even longer, but at times it will underperform the market over the short-term.

Looking at the first half results released in February, sales were up 6.2% to $185m despite some foreign currency headwinds that all exporters faced and an industrial dispute in the company's factory in Thailand that disrupted production. The company opened two new stores in December and three more stores are expected to be opened in the second half. Currently, the company is building a new warehouse and has a new distribution facility operating in Dubai. All good news for shareholders and these initiatives point to a positive outlook for future sales growth.

Importantly, pre tax profit was up 8.2% to $32.2m and the EBIT margin expanded to 16.8%. However, the result underwhelmed the market, and the price has fallen 20% from its highs in September last year. We continue to like the company's prospects over the medium to longer term and the company remains a core holding in the portfolio.

Magellan Capital (formerly Magellan Flagship Fund) is a listed investment company that holds a portfolio of international investments, has achieved good returns over the past decade, and has been one of our better performers (but just not this year). After many years of strong returns the shares have taken a breather and remained relatively flat around the $1.85 mark over the past year, however the asset backing (NTA) behind the shares has risen 19% from $1.78 to $2.12 during the same period.

As happens with all investments at various times, Magellan appears somewhat out of favour currently and has gone from selling at a premium to its asset backing to now selling at a discount. We note that Chris Mackay, the investment manager for the Fund, has been buying shares on market recently and, given he already has a $100 million stake in the Fund, we view this as a positive sign and are content to maintain our stake.

We started adding insurance broker **Steadfast** (SDF) to the portfolio in the lead up to the result, joining competitor AUB Group (formerly Austbrokers) in the portfolio, in anticipation of better times ahead for the insurance sector as premiums rise as the insurance cycle improves.

SDF was founded in 1996 as a service provider to insurance brokers and this network of brokers is now the largest general insurance broking network in Australia catering primarily to SMEs. The IPO in 2012 saw the company take an equity stake in 62 of the network brokers and continue to provide services to 280 broking businesses. SDF now shares in the profits from its equity brokers who earn fees and income from product providers, as well as continuing to earn Marketing and Administration fees from the network brokers. Over the past five years 107 brokers have joined the network and only one has left, with the number of brokers currently at 348 constituting 28% market share.

In the recently reported results revenue was up 7.7% and EBITA up 10.5% to $66.7m following a double-digit increase in business written by the brokers. This growth was split almost evenly between organic growth and acquisitions with the broking operations reporting a strong performance.

Management continues to focus on growing the broker network and the company's equity stake in broker businesses, and is looking to grow its business in NZ, Asia and Europe. Our investment in AUB has been very successful and we believe Steadfast is another attractive business in this sector that should offer good returns over the coming years.

We have constructed a portfolio that we believe constitute good quality businesses providing good returns on capital and with attractive growth opportunities. We are investors in the Fund and these are the types of businesses we would be happy to own if the roles were reversed.

With the Fund fully invested across a variety of industries and the companies within the portfolio generally performing quite well we remain confident about the future prospects for the portfolio over the medium to long term.

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