Ralton Smaller Companies

Quarterly Report
September 2015

Investment profile

A professionally managed portfolio of Australian shares

The Ralton Smaller Companies model portfolio is a separately managed account, or SMA, actively managed by Ralton Asset Management (Ralton). SMAs are professionally managed portfolios of direct shares whereby the investor receives beneficial ownership of the underlying securities.

Investment objective

The objective of the Ralton Smaller Companies SMA is to provide investors with long-term capital growth and some tax-effective income from a concentrated portfolio of smaller capitalisation ASX-listed shares. The portfolio aims to deliver a return superior to that of the market over periods of five years or longer while at the same time seeking to minimise the risk of investment capital loss.

Key portfolio features	
Inception	1 February 2008
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Authorised investments	ASX listed companies that are not included in the S&P/ASX 50 Index
Number of stocks	25-40
Cash allocation	0% to 15%
Tracking Error	5% to 9% per annum
Investment horizon	At least 5 years
Ratings	MORNINGSTAR ★★★★ Approved Lonsec Research

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	2.03	1.66	7.93	15.18	11.83	6.80
Income return	*0.92*	*1.21*	*2.96*	*3.46*	*3.72*	*3.84*
Growth return	*1.10*	*0.45*	*4.97*	*11.72*	*8.11*	*2.97*
S&P/ASX Small Ords Acc Index	-0.53	-3.90	-4.90	-1.22	-2.54	-3.35
Difference	**2.56**	**5.56**	**12.83**	**16.41**	**14.36**	**10.16**

**Since Inception p.a., Feb 2008*

The portfolio is designed for investors who...

- Seek long-term capital growth and some tax-effective income.
- Expect consistent above-market returns.
- Have a long-term investment horizon of at least five years and accept the risk of equity markets.

Portfolio structure

No.	Company name	ASX Code
1	Ardent Leisure Group	AAD
2	Macquarie Atlas Roads Limited	MQA
3	Super Retail Group Limited	SUL
4	Aristocrat Leisure Limited	ALL
5	Tassal Group Limited	TGR
6	Pact Group Holdings Limited	PGH
7	Fisher & Paykel Healthcare Corporation	FPH
8	Village Roadshow Limited	VRL
9	SAI Global Limited	SAI
10	Fletcher Building Limited	FBU

GICS sector	Ralton	Index	+/-
Consumer Discretionary	37.0%	21.9%	15.2%
Consumer Staples	11.4%	7.0%	4.4%
Health Care	10.6%	8.7%	1.9%
Energy	4.4%	3.0%	1.4%
Materials	15.0%	14.4%	0.6%
Industrials	13.2%	13.5%	-0.3%
Utilities	0.0%	0.7%	-0.7%
Financials (ex-Property)	6.3%	8.7%	-2.4%
Telecommunication Services	0.0%	3.3%	-3.3%
Information Technology	2.0%	6.3%	-4.3%
Property	0.0%	12.6%	-12.6%
Total	100.0%	100.0%	

Quarter in review

Performance summary

- The S&P/ASX Small Ordinaries Accumulation Index fell 3.90% for the September quarter, with Energy the worst performing sector and Consumer Staples the best.
- The Ralton Smaller Companies Portfolio added 1.66% for the September quarter, outperforming the benchmark by 5.56% for the period.
- Our overweight position in the Consumer Staples and Consumer Discretionary sectors was the key contributor to portfolio performance.

Portfolio commentary

Quarterly performance attribution

Top contributors	Positioning	Key detractors	Positioning
Blackmores Limited	Overweight	Cash Converters International	Overweight
Macquarie Atlas Roads	Overweight	Sky Network Television	Overweight
Ardent Leisure Group	Overweight	Transpacific Industries	Overweight

Positive contributors

Blackmores Limited (BKL, +93.9%) – BKL shares posted stellar profit results for the FY15 financial year: sales for the BKL group rose 36% and profit growth was an even more impressive, 83%. Each of the three divisions, namely Australian retail, Australian BioCeuticals and Asia, each produced impressive trading results. Sales to Chinese customers have been very strong with Chinese consumers buying stock in Australia for consumption or larger scale distribution back into China. China is also opening up direct channels for sales of vitamins and similar products to China via various Free Trade Zones (FTZ). The Shanghai FTZ has only recently opened and it is this channel to market that offers the most upside to BKL and indeed why investors have excitedly pushed the share price so high. The Shanghai FTZ offers a simple sales channel for both BKL and Chinese consumers, a lower tax rate or tariff on imported goods and allows government to monitor and regulate products coming into China. Overall, the strength of BKL's brands and growth options in Asia continue to underpin the long-term outlook, although we have again reduced our position in the stock as the price has moved higher.

Macquarie Atlas Roads (MQA, +22.3%) - shares in MQA added value for the quarter, outperforming many of its infrastructure peers. MQA's key asset, the French Toll Road, APRR, continues to deliver modest profit growth, driven by traffic growth, price increases and cost savings. With the ECB currently 'printing money' in an effort to drive inflation (and avoid deflation), MQA is a likely beneficiary, as its toll increases are linked to inflation in France. At a group level, MQA continues to simplify its debt structure, reduce its debt and, therein interest paid, which overall should allow for growth in dividend payments going forward.

Ardent Leisure (AAD, +24%) - rose following its August profit results, recording solid 5% profit growth for the FY15 year. Ongoing progress from the US-based Main Event big box entertainment rollout saw profits rise 85% for this division. Perhaps more pleasing was the improved results from the Australian gyms or healthcare division in the second half of the year. You may recall poor results from this division in February this year had been our catalyst to enter the stock, following the share price fall. Although profits for the full year ended up down 17%, management has been able to improve key operating trends for net membership growth and profit trends for those gyms that have been rapidly converted to the 24/7 model.

Underperformers

Cash converters (CCV) - has been a recent underperformer for the portfolio and was reluctantly sold in August. The stock has been plagued by negative publicity in the media around its payday loans business in recent quarters, coupled with ongoing litigation concerns. Although we have stuck with the investment until now, the move by major lender, Westpac, to withdraw its funding (loans) to CCV in August was a significant event. Although the company can likely find alternative sources of funds, we recognise this introduces an unknown element of risk to the business as uncertainty exists as to the cost and tenor of replacing this source of lending. Reluctantly, we elected to sell and crystallise a loss for investors, believing the outlook for CCV had become more uncertain.

Sky Network Television (SKT, -20.7%) - pay TV operator, SKT, was sold down on concerns for a flat profit outlook in coming years. SKT is the dominant pay TV provider in NZ and is a strong and stable business. Despite this, we recognise the competition for people's entertainment dollar is intensifying. Although noting the recent negative trends in eyeballs and marketing dollars in the largest pay TV market, the US, we tend to believe the industry will endure, although in NZ we note the outlook for profit growth in the short term is muted as competition continues to nip at SKT's heels.

Transpacific Industries (TPI, -11.7%) - waste services company, TPI, underperformed in a weak market and weighed on portfolio returns. Recent years have been quite disruptive for TPI, with the business undergoing management change, asset sales and significant restructure and re-organisation of business functions. However, despite the share price fall during the period, we felt the August profit results contained some distinct positives. In particular, we would point to recent changes in the sales model and highlight that progress was evident on this front for the main Cleanaway business. Secondly, the benefit of waste internalisation – delivering waste to your own company's landfill – was also evident following the acquisition of a key landfill asset in Victoria. In July, TPI appointed Vik Bansal to the position of CEO. Mr Bansal has most recently led Valmont Industries in the US, however he has considerable experience in corporate Australia and hence his desire to return home to assume a CEO role. Our recent first meeting with Mr Bansal left a positive impression, however investors will be looking to what progress he is able to make in what has been a challenging company to manage in recent times.

Portfolio adjustments

During the quarter we...

SOLD: Cash Converters International (CCV), Energy Developments Limited (ENE), iiNet Limited (IIN), Monash IVF Group (MVF)

BOUGHT: Austbrokers Holdings Limited (AUB), Costa Group Holdings Limited (CGH)

Portfolio additions

We added two stocks to the model portfolio during the quarter.

Austbrokers Holdings (AUB) - firstly, we bought back into AUB during the quarter, having satisfied ourselves that headwinds from the premium cycle had abated. AUB is focused on insurance broking and has ownership stakes in a network of insurance brokers across Australia that offer a range of insurance services to its network of clients, largely SME-type businesses. Insurance premiums in Australia are in an up cycle, so AUB can produce organic top line revenue growth and additional growth from the addition of new broking firms to its network.

Costa Group Holdings (CGC) - the second stock, CGC, was recently listed with major shareholders, the Costa family and US private equity group, Paine and Partners, selling down their holdings to new investors. Costa is a horticultural company, one of Australia's leading producers of blueberries, raspberries, citrus and mushrooms. The key attraction from our vantage is CGC's exposure to key 'premium' food categories, with the 'berries' segment currently experiencing very strong growth in volumes. CGC is assisting here by expanding capacity, specifically growing product in new locations across the country to ensure they are able to constantly supply product to consumers year round, as distinct from such fruits being 'just' seasonal. By increasing availability to consumers, the shelf price becomes more stable, consumers therefore consume product as part of their daily diet and volumes increase. This trend is increasing.

CGC has expended significant capital on its production capability. Much of its production relies on irrigation and is either undercover or indoors and so the outright risk of seasonal impacts such as wind, rain and drought is minimised. Further, CGC has built considerable intellectual property and know-how in both the genetics of various fruits but also soil content (substrate) and growing techniques. From our vantage, they appear a leader in their fields. We draw some parallels to our recent successful investments in Bega Cheese (BGA) and Tassal Group (TGR). For each company, the growth outlook is strong, the premium food theme is present and the capital has largely been invested.

Portfolio disposals

We sold four stocks from the portfolio during the quarter, with two of the sales the result of merger and acquisition activity.

iiNet (IIN) – in July, we exited the last of our position in IIN, one of the portfolio's long-held positions. Although the acquisition of iiNet by TPG Telecom (TPM) was still subject to ACCC approval at the time, the deal has been approved by shareholders and hence we sold the stock on market, effectively accepting the TPG offer, though not wanting to receive TPM shares.

Energy Developments (ENE) - we also sold our position in ENE during the quarter. ENE's board and major investors have agreed to a takeover of DUET Group (DUE) at $8 per share. By selling the stock on market, we have effectively accepted the offer price, adjusted for the time value of money.

Monash IVF (MVF) - we also sold our holding in medical services provider, MVF, which provides IVF (in vitro fertilisation) and ultrasound services across a range of clinics in Australia. MVF was in the press for what we consider the wrong reasons in August with news of doctor dissent and concerns from various doctors (IVF specialists and laboratory staff) being raised with the board about patient care and the overlap with corporate strategy. Such matters are a concern for a people or service focused business, particularly once they escalated into the public forum. As we were unable to confirm with the company the nature and degree of such claims, we took the decision to sell our position in MVF, with a view to revisiting the stock if we are able to satisfy ourselves that such concerns are not material.

Cash Converters (CCV) – we also sold CCV, as described previously.

Investment approach

A three-stage investment process

Intensive bottom-up research is the cornerstone of the entire process, supplemented by top-down economic and thematic views. The process is disciplined and consistently applied, using a number of proprietary qualitative and quantitative techniques to ensure that targeted companies have been thoroughly scrutinised. The aim is to uncover undervalued businesses. The companies that Ralton typically invests in are those with strong and reliable management, good profit and dividend growth expectations, reasonably predictable future profits and cash flows, and a very clear business model.

Stage 1: Defining the investment universe (screening)

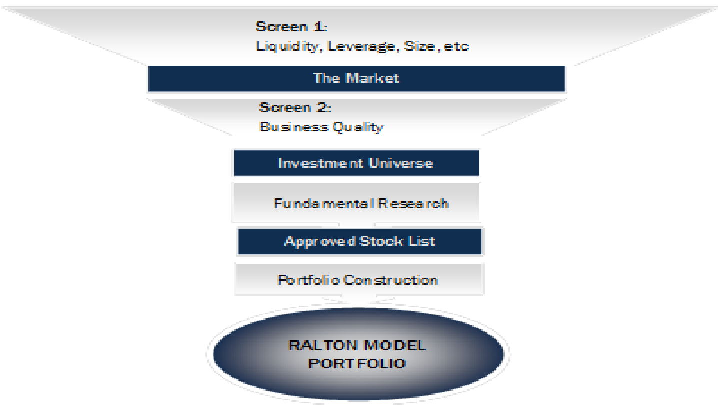
The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

Stage 2: Bottom-up fundamental company research

Ralton's research programme is focused on understanding the key drivers of business performance and returns, namely people, operations, products and services, and market dynamics. For companies remaining in the Investment Universe, a detailed assessment is made of executive management, interviews competitors and suppliers, reviews financials, and forms a clear view on the outlook for the company's industry.

Stage 3: Portfolio construction

Risk management and capital preservation are key themes underlying the portfolio construction framework. With a focus on actively managing down-side portfolio risk for investors, Ralton constructs an efficiently diversified portfolio of high quality, undervalued companies, and invests for the long term (typically 3 to 5 years) in an effort to maximise after tax-returns.



About the manager

Ralton Asset Management is partnered with Copia Investment Partners, an administration and distribution specialist providing a range of tailored services to each of our leading boutique investment partners.

Ralton is a value manager with a fundamental investment approach designed to identify quality businesses trading at a considerable discount to valuation. The process is guided by three fundamental beliefs:

- markets are not perfectly efficient and the true value of a business is not always reflected in its share price
- undervalued companies can be identified through detailed and intensive research, and
- capital preservation is critical to wealth creation.

The investment team

Andrew Stanley *BEc, LLB, ACA, FFin, MA AppFin*
Head of Australian Equities, Ralton Model Portfolios

Andrew Stanley is the lead portfolio manager for the Ralton portfolios. He is supported by a dedicated and highly experienced team of investment professionals each with an average 18 years' investment experience. Andrew has been working in financial markets for more than 24 years, including the past seven years managing the Ralton portfolios. Prior to Ralton, he was an Executive Director at UBS in Hong Kong, and over the course of his career has held senior positions with major investment institutions in Melbourne, Hong Kong, Tokyo and New York. Andrew started his career at Arthur Andersen in Melbourne.

Roger Walling *BOptom, MBB*
Portfolio Manager, Ralton Model Portfolios

Roger Walling is responsible for stock coverage of several industry sectors and assists with the portfolio management process. He has over 12 years of direct funds management experience, including the past seven years managing the Ralton portfolios. Previous to Ralton, Roger was a shareholder and employee of Cinnabar Equities, a Global Healthcare Fund. In his role as a Senior Analyst, he had sub-sector and stock investment decision responsibility. Prior to his career in financial markets, Roger practiced as an Optometrist.

More information

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