Quick Brown Fox Asset Management

Monthly Report – March 2016

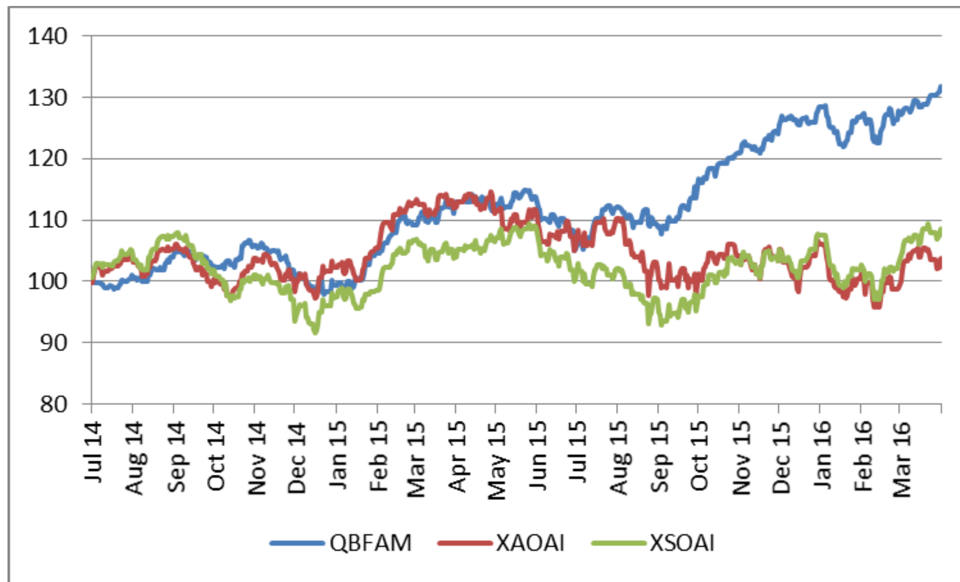
The start of March saw a strong rally for the Australian Equity Market. This rally was concentrated in the two sectors which have struggled in recent times - banks and resources. The rally in banks ended towards the end of the month with profit warnings from both ANZ and Westpac. This follows similar warnings in February from Bendigo, Bank of Queensland, Suncorp and Macquarie. ANZ attributed their downgrade to their commodities book whilst Westpac signalled that they are started to see the first signs of pressure in the consumer book with weakness in both Western Australia and Queensland.

Despite the stalling bank rally, the broader market finished up a very strong 4.74% for the month whilst the fund finished up 3.18%. Over all other time periods the fund has significantly outperformed the benchmark.

	1 month	3 months	6 months	1 year	Since Inception
					1-Jul-14
QBFAM	3.18%	2.68%	14.45%	18.13%	32.12%
XAOAI	4.74%	-2.35%	4.11%	-8.05%	3.64%
XSOAI	5.47%	1.03%	12.47%	3.72%	8.57%

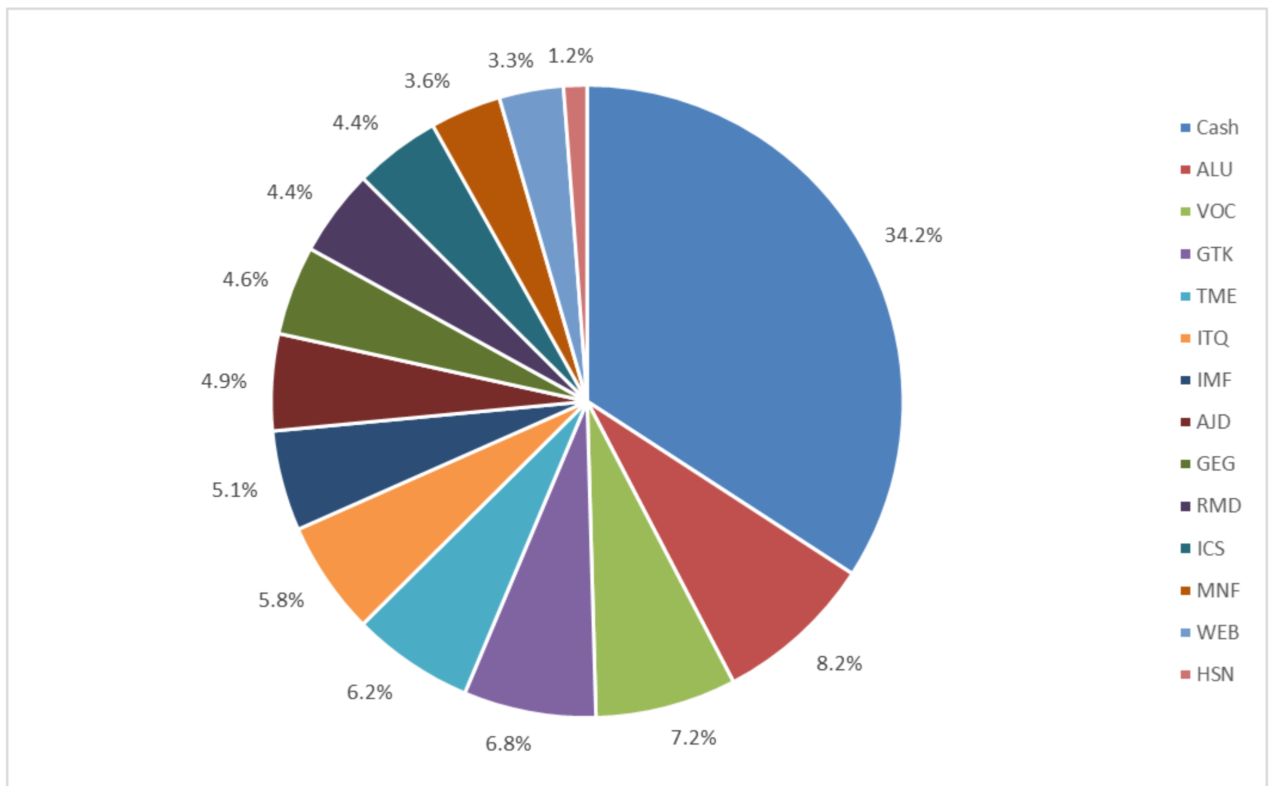
The fund continues to avoid the major sectors in the Australian market seeing significant structural and cyclical headwinds for both the miners and the banks. In contrast we are focused on finding high quality companies in sectors such as software design, online aggregators and healthcare. The challenge is finding those high quality companies at a reasonable valuation. As a result we carry an elevated level of cash which can be used to take advantage of volatility. To that end we exited one position, trimmed two and increased two others during the month.

Despite the underperformance in March, the long term track record remains well above benchmark.



The Portfolio

The fund is currently invested in 13 positions and retains a cash balance of 34%. The cash balance is up from 31% at the end of December after exiting our position in BGL whilst trimming VOC and HSN as stock prices rallied and valuations became stretched. We increased our positions in AJD and RMD on weakness.



Company Spotlight

During the month we wrote on two companies for Shareidea (shareidea.com.au). These were Gentrack Group and ICS Global. These company spotlights are below.

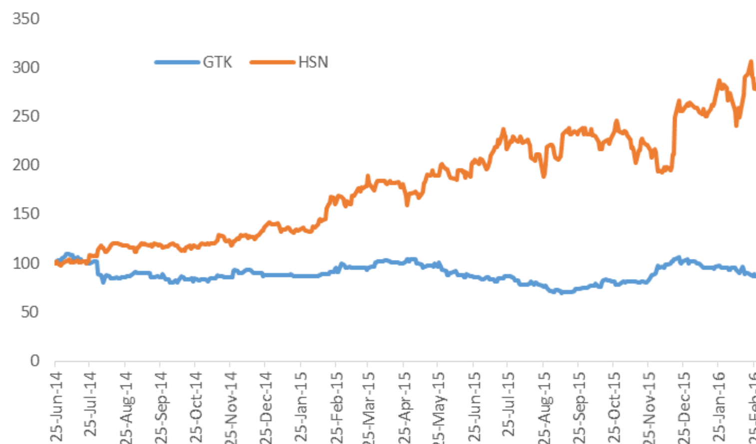
Gentrack Group

I first started looking at Gentrack Group (Gentrack) after having some success investing in a company called Hansen Technologies (Hansen). Hansen is a company which designs billing software for Energy and Utilities companies, pay TV operators and Telco providers. In the last few years it has gone from strength to strength with contract wins and acquisitions delivering profit growth and a large PE rerating.

Whilst researching Hansen it became apparent that the industry dynamics for this type of software are attractive with:

- A high degree of recurring revenue (Gentrack estimate that 50-60% of their revenue is "highly likely" to reoccur);
- Low additional costs of bringing on customers, leading to high margins.
- Very low capital costs leading to high returns on capital.

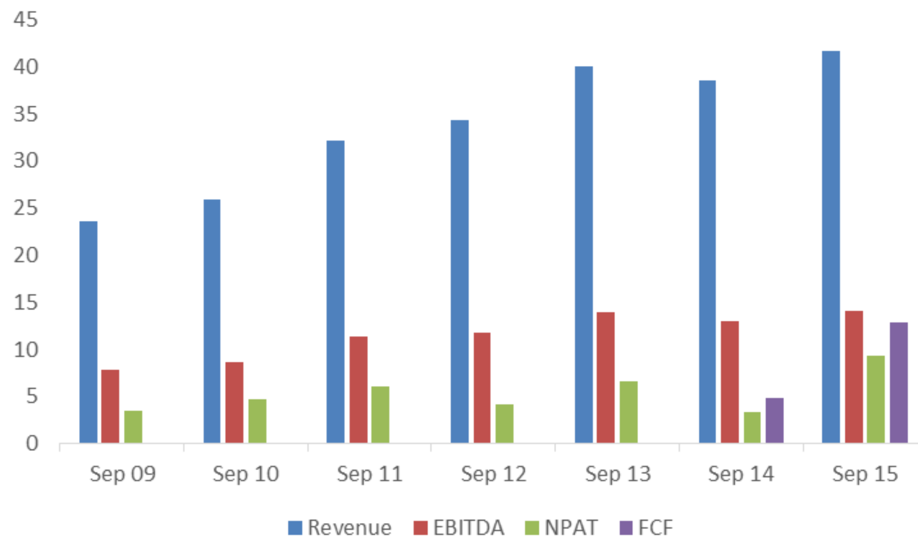
Gentrack is a New Zealand based competitor to Hanson in the utilities space. However their shares have struggled. Since listing the GTK share price has fallen 9% whilst HSN over that time period has risen 180%.



The discrepancies don't end there. Gentrack trades at a P/E of 16x versus Hansen at 26.5x. Why is this? Well the reasons are two fold, firstly Hansen does have a substantially higher rate of earnings growth over the last two years (with a 31% jump in eps for the December half on the back of acquisitions). Secondly, Gentrack made the cardinal sin of downgrading barely 6 weeks after listing. For a newly listed company this can severely impact credibility with the institutional market.

Normally, the early downgrade would be a rather large red flag but in the case of Gentrack it is a bit different. Gentrack is not a roll-up of multiple businesses, there are no proforma earnings in the prospectus to work through and it certainly isn't a poor quality retail business packaged up to look good by Private Equity.

Gentrack is a business that has been around since 1989 and has been consistently profitable over at least the last six years:

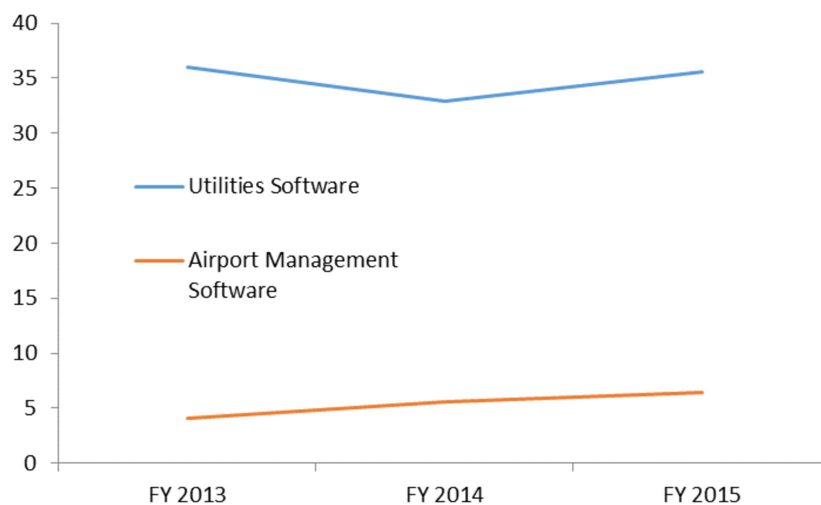


The company's revenue stalled in 2014 as a few contracts were delayed and the NZD rallied. Growth has resumed off the new base in FY15 and looks set to continue in FY16.

The company has two key products:

- Gentrack Velocity which is a software solution for billing within Utilities companies
- Airport 20/20 which is an operational software system for airports handling all areas from aeronautical billing, flight information display, resource management as well as passenger and baggage processing systems

The utilities business is the larger of the two and has broadly been flat in recent years. It was the cause of the downgrade in FY14. On the other side, the Airports division has seen revenue grow by 56% in the last two years (whilst doubling EBITDA last year). The company has a dominant position in Australasia and is growing rapidly offshore with 9 of the top 100 busiest airports globally in their customer base. Amongst this are airports such as Hong Kong International, London City and JFK in New York.



The company estimates the global market for Airport operational software to be US$370m, they currently have revenue of NZ$6.5m. This implies that there is plenty of blue sky.

So despite the rough introduction to listed life, the growth is there. The company has guided to revenue growth of 10%+ in FY16 but flat EBITDA on increased staff and systems spend. The company is actively recruiting new staff in Auckland, Melbourne and London in order to keep up with the current growth pipeline. Australia and the UK are the focus in terms of growth.

So the future looks bright despite the struggles in the share price. What does mean for the valuation? A simple DCF is below:

	30/09/2009	30/09/2010	30/09/2011	30/09/2012	30/09/2013	30/09/2014	30/09/2015	30/09/2016	30/09/2017	30/09/2018	30/09/2019	30/09/2020
Revenue	23.6	25.9	32.2	34.3	40.1	38.5	41.7	45.9	50.5	53.0	55.6	58.4
EBITDA	7.8	8.6	11.4	11.8	14.0	13.0	14.1	14.1	17.2	18.0	18.9	19.9
EBITDA Margin	*33.1%*	*33.2%*	*35.4%*	*34.4%*	*34.9%*	*33.8%*	*33.8%*	*30.7%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*
D&A						2.3	2.3	2.5	2.8	2.9	3.1	3.2
EBIT								11.6	14.4	15.1	15.8	16.6
Tax								3.2	4.0	4.2	4.4	4.7
Capex % of sales						*0.3%*	*0.9%*	*1%*	*1%*	*1%*	*1%*	*1%*
Capex								0.4	0.5	0.5	0.5	0.5
FCF						4.9	12.8	10.4	12.7	13.3	14.0	14.7
Discounted FCF								10.4	11.5	11.0	10.5	10.0
Terminal Value												113.9
Value												167.4
Upside												9.6%

The following has been assumed:

- Guidance for this year holds (although we think the company has learnt from prior mistakes and there is potential upside there)
- Revenue growth of 10% the year after and 5% through to 2020
- A normalisation in the EBITDA margin
- Terminal growth of 4%
- A discount rate of 10%

There are a few things worth noting:

- FCF conversion is excellent, typically well above 100% due to low capex and high non-cash amortisation
- The company expenses all R&D through the P&L
- The forecast EBITDA growth rate over the next four years is 8.9%, which is below the 10.6% over the last six years

So we have a September 30 valuation of $167.4m or $2.30 per share (9.6% above the current share price). Add in a dividend yield of 4.7% and the numbers start to stack up. The beauty of these companies is that one or two contract wins can skew the numbers to the upside and add significant value. Ultimately this is a company that can grow its value over time. The company also has cash of $12.4m and has stated it would be happy to take on debt up to 1x EBITDA for appropriate acquisitions. This effectively gives it $26m of fire power.

The key risk in any investment is future earnings. When 50-60% of your revenue is “highly likely” to reoccur, then by definition 40-50% of your revenue is not “highly likely” to reoccur. This means this is a project based component every year which can be volatile, hence some years (like FY14) the company will fail to meet guidance and the share price will suffer accordingly.

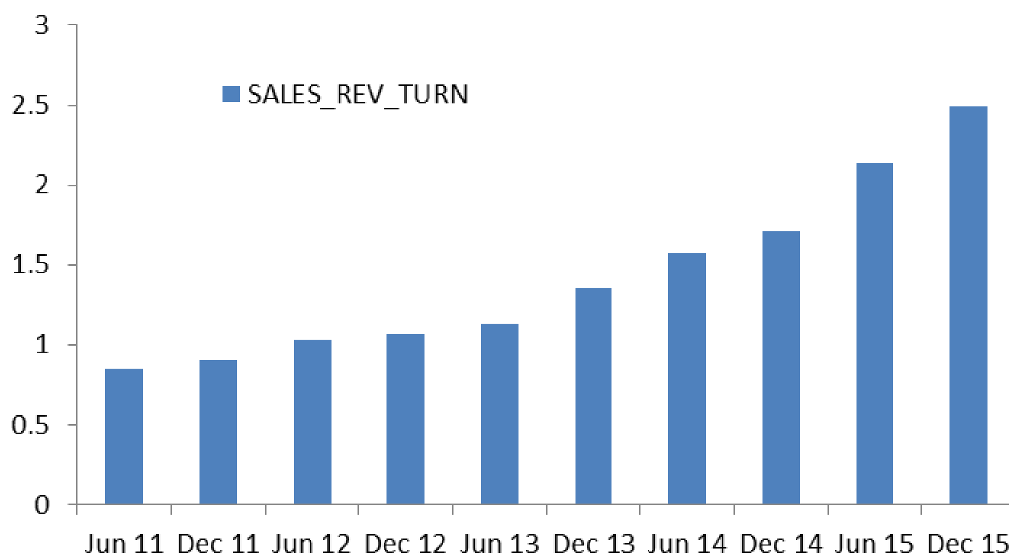
ICS Global

It's not often you come across a $17m company that is consistently profitable with a strong proportion of reoccurring revenue. When you do come across such a company, you have to ask yourself what's the catch? In the case of ICS Global (ICS), the catch is a convoluted structure sitting on top of what is a very interesting business in the UK.

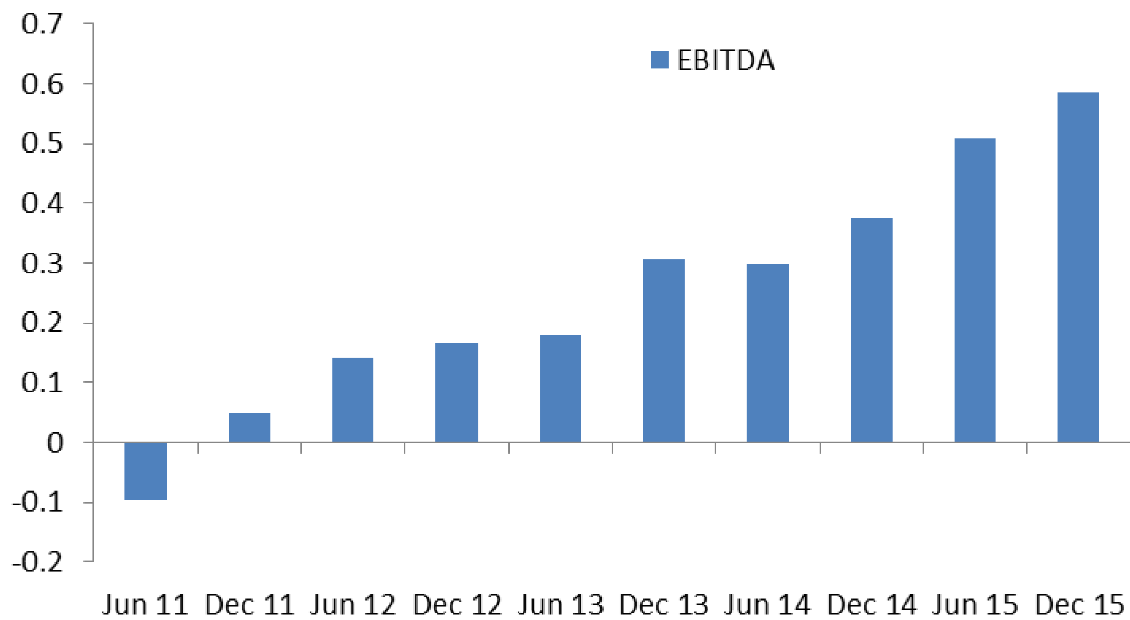
ICS is a holding company, it has a board of directors and management team based in Australia. The major asset of the company is its full ownership of MBC (Medical Billing and Collection), the largest medical billing and collections provider in the UK. In what is a highly fragmented industry (in fact over 90% of medical centres still handle it internally), MBC appears to have a "first mover" advantage and they estimate they have somewhere between 5-10% of the potential market.

Through their platform, MBC can handle insurance payments directly making it easier for customers. This in turn leads to bills being paid and claims being received on the spot and reduces bad debts for the medical centre. For their part in this, MBC take 4% of total billings. The arrangement benefits both parties. Typically MBC will provide a discount for the first year in order to get more centres to trial the product and increase to the full fee after that period. Having seen the benefits of increased fee collection, MBC hopes centres will stay on. As a result a large proportion of revenue can be seen as "recurring". The lack of competitors in the space means the centre would typically have to shift back in house.

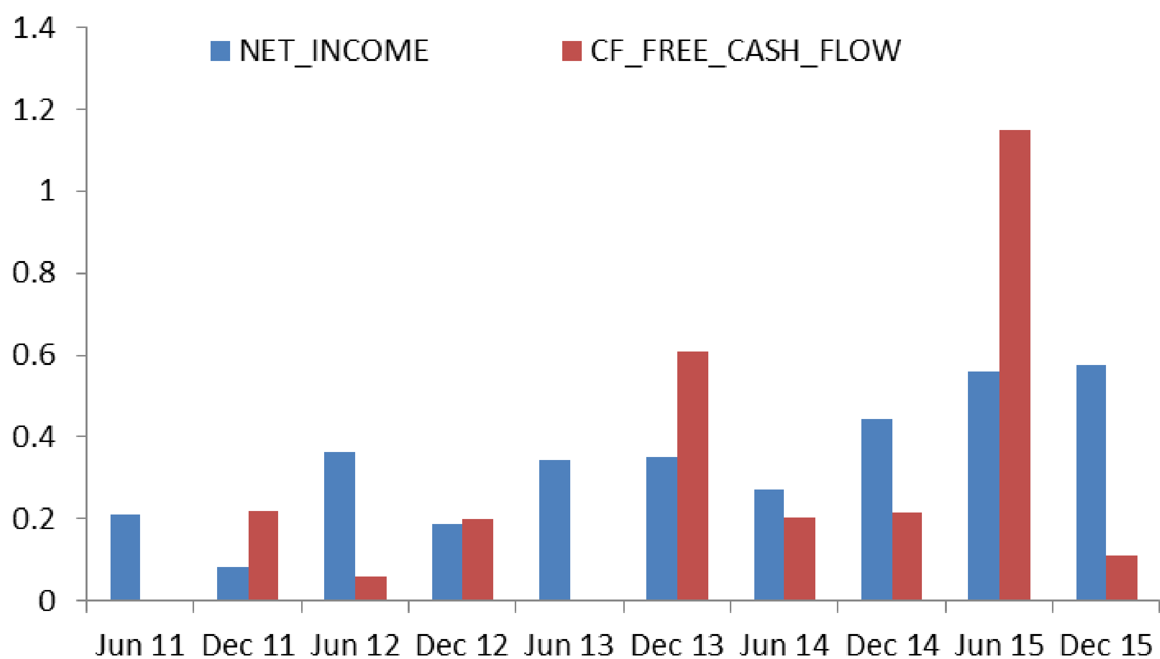
Since disposing of their other loss making businesses in 2010 and focusing on MBC, the company has been consistently profitable and seen strong growth in sales:



EBITDA:



Profit and Cashflow:



In the first half of the FY16 year, the company achieved revenue growth of 43% (26% in GBP terms with a 17% from currency), profit growth of 30% and dividend growth of 33%. These are staggering numbers and are at odds of a company that trades at 14x earnings.

Below is a quick valuation of the company.

	30/06/2011	30/06/2012	30/06/2013	30/06/2014	30/06/2015	30/06/2016	30/06/2017	30/06/2018	30/06/2019	30/06/2020
Revenue	1.69	1.93	2.19	2.93	3.85	5.26	6.05	6.96	8.01	9.21
EBITDA	-0.05	0.19	0.35	0.60	0.89	1.21	1.51	1.81	2.16	2.58
EBITDA Margin	*-2.9%*	*9.9%*	*15.8%*	*20.6%*	*23.0%*	*23.0%*	*25.0%*	*26.0%*	*27.0%*	*28.0%*
EBIT										2.6
Tax						0.0	0.0	0.0	0.0	0.8
Capex % of sales	*24%*	*0%*	*2%*	*7%*	*1%*	*2%*	*2%*	*2%*	*2%*	*2%*
Capex	0.40	0.003	0.04	0.20	0.04	0.1	0.1	0.1	0.2	0.2
FCF						1.1	1.4	1.7	2.0	1.6
Discounted FCF						1.1	1.3	1.4	1.5	1.1
Terminal Value										18.9
Add Cash										1.3
Value										25.3
Upside										49.5%

We've made the following assumptions:

- Adopted company guidance for this financial year;
- Taken a 15% growth in revenue for the 4 years following – results in a c. 75% increase in revenue which in market share terms is very achievable;
- Assumed margins continue to grow over that period to 28%;
- The company currently has c. $20m of tax losses, we have assumed zero tax for the next 4 years but in 2020 have the company paying tax in order to get our terminal value – therefore we have not taken into account the full benefit of the tax losses.

Now obviously the tax losses can add significant upside to this valuation, but for us the greater upside potentially comes from near term growth. If the company carries the momentum from this year into the next, then growth in the short term will surprise on the upside and the valuation will be pushed significantly higher.

There are a number of risks with ICS

- The most obvious one is addressed above, the structure of the company and the presence of board and management in Australia may lead them to "do a deal" in order to justify their presence. To that end the company invested $250k into Open Learning, an Australian based education software business, in 2015. With free cash flow comes temptation, to managements credit they have been well constrained to date.
- Anytime you invest in healthcare, regulation and government policy is an issue. The rise of Jeremy Corbyn to leader of the opposition in the UK
- Competition – whilst the company has a first mover advantage, the industry remains fragmented. ICS doesn't have the biggest balance sheet so if a larger company did decide to enter the space it could make life difficult.
- The Brexit – this is a more immediate risk, the move towards the referendum has driven the pound lower, The