Where we took profits and losses in 2016

Vocus Communications

Following our sell-all report in 2015, Vocus Communications (VOC.ASX) subsequently announced a merger with M2 Group which pushed the company's share price up to around $7.50. As part of the merger M2 shareholders received 1.625 Vocus Communication shares for every M2 Group share held on 15 February 2016, and with M2 Group held in the Fat Prophets portfolio Vocus inadvertently re-entered the portfolio. We decided to reiterate our sell recommendation on Vocus Communications with investor enthusiasm getting ahead of itself on the news of the two mergers, pushing the stock price to levels that we considered to be above their intrinsic value.

While the stock rallied further after we issued our sell recommendation, hitting a high of $9.30 at the end of May, our view appears to have been vindicated over the longer term with the stock now trading at $3.77. Since then the company has proven itself to be a serial acquirer with the acquisition of Nextgen Networks and North West Cable System and the Australia Singapore Cable development project funded via a fully underwritten capital raising of ~A$452 million and an institutional placement raising ~A$200 million.

There are obviously some material risks associated with undertaking major mergers or acquisitions in such a short period of time, our caution has since proven well founded. With a bearish divergence showing in the charts we made the call to sell, locking in an annualised gain of 40.5 percent and since then we have witnessed the shares retrace 60 percent from their highs.

Diligent Board Member Services

NZX listed corporate governance Software as a Service (SaaS) company Diligent Boardmember Services (DIL.NZX) was a company we first recommended in February 2015 (FAT- AUS 710). Diligent specialises in providing boardbook portals to corporate clients, enabling them to manage their corporate documents efficiently and securely in an electronic format. What attracted us to the company was the quality of their product, their highly scalable business model and strong balance sheet with US$67 million cash and no debt. The company also boasted a strong sales force and a 95 percent customer retention rate. This led to a snowballing effect of recurring revenue streams that underpinned its strong growth profile in the US.

Ironically, a series of governance and accounting issues saw the share price pull back by over 50 percent in 2013. While this didn't change the business model or the amount of money that was coming in the door, investors lost confidence in the company and headed for the exits. At least some of this problem could be put down to the company generating its revenues in the US but being listed in New Zealand, meaning it had to comply with different reporting standards. It was only after the company had successfully restated its previous accounts that we got interested in the stock.

We weren't the only ones who saw the potential in the company, with US private equity firm Insight Venture Partners successfully making a full takeover offer for the company at US$4.90 per share (valuing the company at US$624 million) in April this year, when the company had US$70 million on the balance sheet. All shares were compulsorily acquired for circa NZ$7.10 per share, and while we believe the company continues to have a bright future ahead, there was no option to remain a holder, and we accepted a net 19.4 percent annualised return.

Qantas

<u>Our national carrier, Qantas (QAN.ASX) has been one of the star performers in our portfolio.</u> We first made our recommendation at $1.31 back in August 2014 and have since watched it become a three-bagger at its highs. We recognised the potential of the company as a turnaround play on the back of a transformation plan that was implemented under the stewardship of CEO, Alan Joyce. Under the program substantial cost saving measures were taken, with a declining oil price giving overheads a further kick downwards and helping to beef up the bottom line.

Since reaching highs of over $4 per share the company hit some turbulence however, with softer demand and a lower yield on both their domestic and international businesses putting a dampener of the company's growth trajectory. 1Q17 group revenue was down 3 percent on a year earlier and rising oil prices are making themselves felt on the cost side. Qantas continues to press ahead with its $366 million share buyback program which should provide a return to shareholders and the company continues to trade on an undemanding valuation (FY17 PE of 6.3).

Nonetheless, with some near term headwinds, we issued a sell half recommendation, locking in an annualised return of 73.2 percent.

Galileo Japan Trust

We have been bullish on Japan for some time now following the election of Prime Minister Shinzo Abe, who has implemented mass stimulus in an effort to reinflate the Japanese economy through the three arrows of his 'Abenomics' policies. The introduction of negative interest rates early in 2016 in particular has been a boon for Japanese property with cheap money flooding into the market seeking positive rental returns. In addition, strong growth in tourism and growing urbanisation has meant this effect has been felt particularly strongly in the major cities.

Flows into Japanese REITs have reached their highest levels in almost a decade, and with over 50% of their property portfolio in the greater Tokyo area, the Galileo Japan Trust has been a key beneficiary of these trends.

These attributes attracted suitor Sakura Real Estate Funds Management which offered ¥57.4 billion for 18 of its 19 properties, with the weakening of the $A against the yen making the transaction even more attractive for ASX listed Galileo. We recommended that members sell half in May, locking in a 40.4 percent annualised gain in the share price, feeling this was prudent in case the acquisition didn't go through.

This deal was successful with shareholders receiving a special distribution of $2.61. Combining the special distribution with our sell half recommendation earlier in the year, investors have received more than a 60 percent return since we first recommended the company in February 2015.

Trilogy International

Backing up our two separate sell-half recommendations on Trilogy (TIL.NZX) in 2015, we issued a third sell-half recommendation. The company has transformed since we initially recommended the stock, by vertically integrating via the acquisition of New Zealand distributor CS Company and securing a 25 percent stake in Chilean rosehip oil producer Forestal Casino. The acquisition of CS Company in particular has added significant scale to the company's operations. Their FY16 result exceeded guidance, with double digit revenue growth underpinned by demand for its signature rosehip oil products driving the result, underscoring management's decision to increase the dividend by 51 percent on the previous year.

Given the strong run in the share price however, with Trilogy trading at 26 times FY17 earnings and on a dividend yield of 1.4 percent, we thought it was prudent to take a bit more off the table at $4, and locking in an annualised return of 207 percent. We may have been a bit premature on our call, with the stock rising further to hit $5, but since then it has drifted back to $3 so we feel comfortable with our decision. While we still like the company, management have delivered a softer than expected 1H17 result, with NPAT growth of 10 percent on a year earlier to NZ$3.5 million and the acquisition of CS Company reducing margins. We also remain cognisant of some execution risks relating to the company's rapid growth trajectory.

Energy Action

Energy Action (EAX.ASX) is a company that Fat Prophets helped bring to the market in 2011 as a joint lead manager in the IPO. The initial listing was a success with the stock closing at a 30 percent premium to its listing price on the first day of trading.

While a relative minnow with a market cap of $30 million we were impressed by the company's 11 year track record of sustained earnings growth, strong level of profitability and debt free balance sheet. We also saw the company as set to benefit from rising energy prices, with the company's core business being the efficient supply of energy to Australian businesses.

While we believe the chips were once stacked in the companies favour, businesses operate in a dynamic environment and favourable traits can be eroded over time. Unfortunately, there wasn't a large moat around the company's service offering, with an increasingly competitive electricity and gas market putting pressure on margins. While the underlying operations continued to perform resiliently, the company's balance sheet had also deteriorated following the acquisition of energy consultancy company Energy Advice, with Energy Action holding $8.8 million in debt on the balance sheet at the end of 2015, which resulted in a steep rise in financing costs pushing the bottom line into the red.

These developments combined with the substantial changes happening in the industry with new solar and battery technology rapidly evolving, influenced our decision to exit the stock at a 16.9 percent profit since our initial buy. Although we note there were also significant opportunities to trade this stock given its volatility during the time we held it in the portfolio.

Michael Hill International

Michael Hill International (NZX, MHI) is a company that we both added to the portfolio and took profits on in 2016. What attracted us to the company was the progress they were making on their international expansion program and the company's stated intention to list on the ASX, with Australia making up the bulk of revenue and the company headquarters being located in Brisbane.

The stock had retreated significantly over 2015, with an outstanding tax dispute with the IRD hanging over the company relating to the transfer of intellectual property to Australia in 2008, which could have potentially cost the company $40 million.

We believed that the operational performance still warranted a closer look however and that while unpleasant, in the worst case scenario the company had the resources to foot the bill. This provided a good entry point into the stock and since then the company has listed on the ASX and resolved the dispute with the IRD for a cost of NZ $30.3 million but after contributing to tax pooling arrangements over the previous years the residual amount of $22.6 million was funded from the group's existing financing facilities with no impact on their store roll out program.

In August we had the long serving CEO step down on good terms, with the markets largely shrugging this off. CFO Phil Taylor has stepped in until a replacement has been found. The company continues to execute well and in addition is rolling out another line of stores, Emma & Roe which has been performing well.

Given the strong run in the share price we thought it was best to take some profits off the table at $1.74 (66.5 % gain) which looks like it was a sensible call given the stock has pulled back to around $1.30 with a number

of options being exercised in November at prices ranging from A$0.82 to A$1.32.

Mirvac

The trend towards a greater number of people living in inner city/ metropolitan multi-dwellings and improving macro environment for residential property with low interest rates and strong urban population growth resulted in the integrated real estate company Mirvac (MGR.ASX) entering our sights back in 2013. The company is comprised of both an investment division and a development division with the former delivering passive income with the later providing an active earnings upside.

Growth in the NSW residential market in particular was one of the key drivers expected to give the bottom line a kick upwards with solid population growth and low vacancy rates underpinning strong demand for residential space. Mirvac also had a robust balance sheet with a FY16 gearing ratio of 23.6 percent and an Interest Cover Ratio of 5 times.

Our thesis on the stock proved correct with a corresponding upward movement in the share price, but with the shares looking fully valued and residential property reaching what we believe to be near the peak of the cycle, we foresaw growing risks to the downside. Furthermore, more stringent credit criteria for property purchases by foreign investors is likely to dampen demand for residential apartments, with Chinese investors in particular, providing a tailwind to demand.

Whether we've timed our exit correctly remains to be seen with the stock currently flat on our recent exit price, but with the changing macro conditions and the shares trading at 15 times FY17 earnings and a

prospective yield of 4.9 percent we were happy to sell and lock in an annualised return of 10.6 percent per annum.

Boral Limited

Similarly, a recovery in the cyclical housing market in Australia and the US is what made us take a closer look under the bonnet at international building and construction materials company Boral Group (BLD.ASX). The company holds market leading positions in the Australian cement and construction materials market and at the time of our recommendation in 2013 derived 73 percent of its revenues in Australia, 11 percent from Asia, 10 percent from the US and 6 percent from the rest of the world.

Back then the company had reported a $212 million FY13 net loss due to significant impairment and restructuring costs, but excluding these one-offs the net profit from continuing operations was up 8 percent year on year to $115 million. Essentially the investment thesis was based on a cyclical recovery in the Australian and US housing markets and with Boral's large market share we expected the company to be one of the key beneficiaries.

An improving housing sector has seen FY16 NPAT grow to $256 million but weakening revenues in the Construction Materials & Cement division and the recent sale of its 40 percent stake in its Boral CSR Bricks joint venture could signal that the peak of the building cycle is in the rear view mirror. The US market continues to look promising but with the company trading at 15.6 times FY17 earnings estimates and offering a dividend yield of 4.1 percent we decided to lock in a 6.6 percent annualised gain as we believe there is better value to be found elsewhere.

Ironically, the shares took a tumble a few weeks later after the company announced a significant acquisition in the US. Boral revealed the US$2.6 billion acquisition of US construction firm Headwaters. The company produces a range of construction materials for housing and infrastructure, and the deal will boost Boral's revenue in US dollars by more than 60% to US$1.8 billion. Given Donald Trump's spending plans, management at Boral are no doubt upbeat about the transaction, but we believe that the company has overpaid, and it seems the market might be coming to the same conclusion.

The acquisition was sealed at an Enterprise Value to EBITDA multiple of 10.6 times, or 7.5 times after accounting for projected synergies of US$100 million within four years. It is a fairly full price, and Boral's CEO has also acknowledged as such. The deal could be a good one, but is certainly big, and management will need to be on the money with their forecast synergies which are needed to make the numbers work given the price paid.

The transaction is being funded by a discounted $1.6 billion renounceable rights issue and a $450 million institutional capital raising at $4.80 a share.

Clydesdale Bank

Earlier this year Clydesdale bank (CYB.ASX) was spun-off from NAB to enable both banks to focus on their core operations, with the shares of the newly independent entity to be traded on both the LSE and ASX. The timing of the IPO was unfortunate, with growing concerns about another financial crisis weighing on the IPO price.

At the time we recommended that Members hold onto their shares due to our belief that the UK banking sector had undergone a significant transformation post the GFC and was now much more adequately capitalised and Clydesdale had demonstrated the ability to generate strong asset growth despite having de-risked its balance sheet.

As part of the deal shareholders received one share in Clydesdale for every four shares they held in NAB and shareholders could choose whether they received their shares listed on the LSE or the ASX. They debuted at the low end of the range of £1.80 on the LSE and $4.08 on the ASX.

Since then we have witnessed significant carnage on the UK market following the Brexit vote, and while we are less concerned about the potential adverse impact that a mismanaged Brexit could have on the banks near term profitability, the corresponding marked decline in the pound sterling which makes the company's earnings less enticing in AUD terms, which we see as a deal breaker.

While the investment qualities than underpinned our decision to retain Clydesdale Bank remain intact, the share price has a major drag on it in the form of a weaker pound sterling and uncertainties around the magnitude of the impact of the Brexit, with the Bank of England estimating that it could lower the country's real GDP by 3-6 percent. Given the shares were 'free' however, with NAB shares now trading at a much higher than where they fell to post the split, investors can be happy with this windfall and should hopefully see an improved operational result from a more streamlined NAB in the coming quarters.

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