



In this quarterly edition we review performance and attribution. We profile Technology One and take a look at retailer Super Group Limited. We also comment on the economic landscape and transformations. Photo

## Dear Investor,

In a re-run of the events that took hold during the latter stages of 2011, global financial markets and investors are once again contemplating the worst. Fear has taken hold and no amount of logic or reasoning will shake away the concerns of investors when all around, governments are doing their level best to destroy confidence.

In our December 2011 quarterly newsletter, we highlighted the rush to cash with ten year Australian government bonds hitting record lows of 3.7%. At the time, it was noted that this was equivalent to share investors buying businesses on price to earnings ratios (PER) of 27 times. We followed this up in the March 2012 quarterly when we quoted James Grant, editor of *Grant's Interest Rate Observer*, who unashamedly added that with US yields pushed to near zero and investors desperate to preserve their capital, abandoning all sense of investment logic, "I think it's going to be the worst investment of the next generation".

Three months on and the situation has not improved, with the run into cash becoming a stampede, reflected in ten year bonds selling at all time lows in the US, Germany, France, United Kingdom, Netherlands and Australia, just to name a few. Such is the swing, that US Treasuries are now trading on an equivalent PER of 65 times while the S&P 500 Share Index is on a 12.9 times multiple.

---

 1

Not surprisingly, the stampede into cash has been mirrored by the stampede out of shares. Investors have been pushed to the limit and are now voting in the most direct way, by selling out. Under these circumstances, it's understandable to seek cover, however what we are now enduring seems extreme. Notwithstanding the rising tide of resentment towards equities, we remain convinced that now is not the time to exit. Rather it is a time to consider the opportunities on offer. Now is the time to be in equities because the overwhelming consensus is telling you do otherwise.

Stock selection is always critical in this process, as any number of recent company profit downgrades and new capital raisings would reinforce. That said, investors are applying a significant risk discount to share valuations across the board, that in our opinion appear unjustified. In our lead article this quarter, we profile one such company that ticks all the boxes. The company is IT specialist Technology One. We follow this up with a short article on the changing economic landscape facing businesses and how one business is dealing with these changes.

Finally, over the course of the financial year, the Fund outperformed the general market, delivering a gross negative return of 1.13% as compared to the 7.04% fall in the All Ordinaries Accumulation Index. Under the circumstances, we believe this is a commendable result.

To all our investors we trust that you find the report informative.

Regards  
 Tony Scenna  
 Corey Vincent

## Table of Contents

Page 1: Letter to investors

Page 4: Company Review – Technology One

Page 13: Survival of the fittest – snapshot review Super Retail Group

Page 17: Changing economic landscape

Page 18: Transformations

Page 20: Company visit diary June Quarter 2012

## Quote

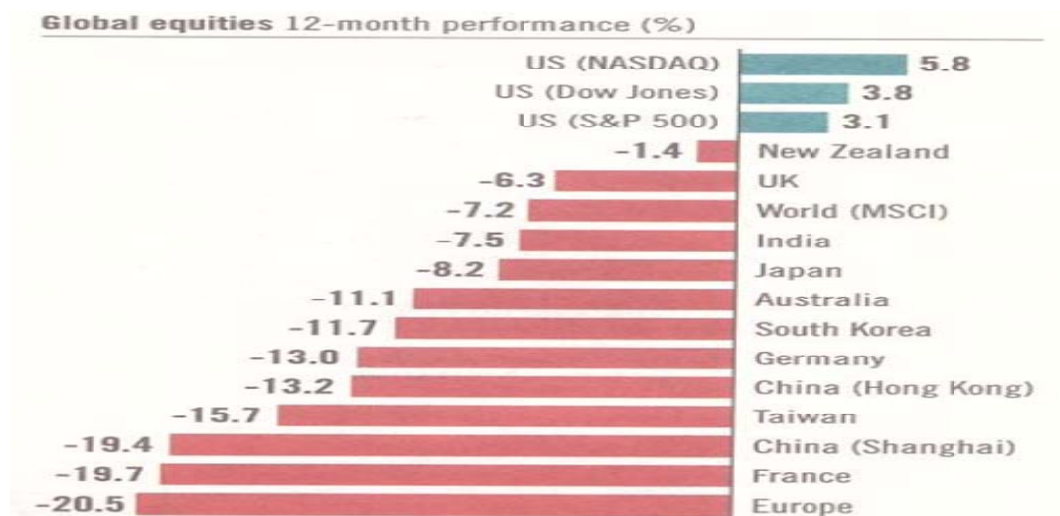
Finally a politician that gets it;

*“By making a series of sensible decisions, which build on each other and which are signalled well in advance, and by taking most people with you as you go, you can effect real and durable change, which won’t simply be reversed by the next lot who come into government.”*

*“I am at pains to point out most days in parliament – jobs are only created when business owners have the confidence to invest their own money to expand what they are doing or to start something new.”*

Who is the politician that gets it – John Key, Prime Minister of New Zealand, an edited text recently given to the Menzies Research Centre.

## Performance Global Equity Markets



Source: The Australian Financial review

3

As the accompanying table above illustrates, the past twelve months have been difficult for local investors with the index down double digit compared to positive gains recorded in the US market. That said, for all the woes emanating from Europe, the local market actually rose 0.6% since December 2011, reinforcing our view that investors are coping with a tide of negative sentiment.

For the June quarter a couple of notable performers included News Corporation and Sirtex Medical. In the case of News Corporation, the past year has seen management focused on improving the group's business transparency which has culminated in the company announcing the possible split of the business into two listed entities, being publishing and entertainment. We are supportive of the move and expect further positive performance over the course of the year. In the case of Sirtex, growing international awareness regarding the group's liver cancer treatment has lifted the company's profile reflected in strong dose unit sales. Flight Centre provided the Fund with the largest negative contribution for the quarter, however we expect a very strong full year result to re-focus investors on the group's cheap fundamental valuation. Also impacting performance was the Fund's holding in Pharmaxis, which took another positive step during the quarter with both final European approval as well Australian Pharmaceutical Benefit Scheme listing granted during the period. First sales are now expected this quarter with US approval sought during 2013. **SFM**

**Technology One (TNE)****Table 1: Technology One time line 1987 – 2012**

Year	Event
1987	Technology One founded by Adrian Di Marco focused on providing accounting software for business.
1999	December, business lists on stock exchange with \$1.00 per share issue price, raising \$28M, valuing company at \$101M. With a forecast NPAT of \$5.5M, the group's price earnings ratio stood at 18.5x.
1999	Technology One offering re-positioned on providing businesses with critical enterprise software solutions.
1999	Technology One service reputation built on "Power of One", whereby the company builds, implements and supports the IT requirements of its clients in a full service offering.
2000	University of Technology Sydney selects Student One software system to support student growth.
2000	Shares hit all time high of \$4.74 per share, valuing business at \$478 million.
2000	October, Technology One raises \$18M for acquisition via placement of new shares at \$4.03 per share.
2000	November, company undertakes 3 for 1 share split, increasing issued shares to 316M.
2000	December, acquires software provider ProClaim software for \$10.6M, enabling Technology One to provide a fully integrated software solution to local government.
2001	January, founder Adrian Di Marco appointed Chairman while continuing as CEO.
2001	April, company announces a 0.95 cent per share special dividend to release excess franking credits.
2001	August, announces revenue up 39% to \$40M, net profit pre amortisation up 41% to \$8.1M.
2002	May, local government client list exceeds 50, with 50% market share of 75 of largest Australian councils.
2002	July, company announces 10% on market buy back of shares, representing a maximum of 31.7M shares.
2002	November, company updates market, with net profits to fall 25% below 2002 levels of \$9.4M post technology spending slowdown, dividends of 2 cents per share maintained.
2002	November, share price hits all time low of 20 cents per share (equal to 60 cents before 3:1 share split).
2003	September, net profit drops 20% to \$7.0M, full year dividends up 25% to 2.5 cents per share.
2003	September, announces new on market 10% buy back of shares, to maximum 29.8M shares.
2003	CEO Di Marco re-affirms commitment to invest heavily in research and development (R&D) with the expected release of next generation software "Connected Intelligence CI series".
2004	August, 2004 revenue up 7% to \$50M, net profits up 35% to \$9.5M, R&D fully expensed totalling \$9.5M.
2005	November, company announces intention to open operations in United Kingdom.
2006	February, initial licence fees for the half year grew 70%, with customer numbers now exceeding 500.
2007	Company reporting period changed from June to September.
2008	Revenue exceeds \$100M, R&D investment hits \$21M, record net profit of \$17M, customer base 900.
2009	Company celebrates ten years since listing, full time employee numbers 670, R&D team headcount 500.
2010	Record revenues of \$136M, net profits of \$17.1M and full year dividends of 5.70 cents per share.
2011	Revenue passes \$150M, R&D investment \$32M, net profits hit \$20M, cash balance \$45M.
2011	Major corporations utilising Technology One enterprise software applications passes 800, significant new investment in next generation Cloud (Ci2 )software offering, new offshore R&D centre to leverage cost base.
2012	First half profits up 2% \$9.3M, full year profits expected to rise 10-15% to \$23M, FTE exceeds 1,000.

**History**

The Technology One business traces its origins back 25 years, with founder, major shareholder and current executive chairman Adrian Di Marco, developing and offering company enterprise software solutions, servicing the financial management and accounting industry. In 1989, the business established a separate division to investigate the development of large scale custom built software applications culminating in a growing client list servicing education and government organisations.

In December 1999, Technology One listed on the stock exchange, raising \$27.8 million that valued the group at just over \$100 million. These were the heady days of the technology boom, with investors keen for information technology (IT) exposure. Back then the Technology One business

was rare in what it offered investors. It actually made money, with the group forecasting in its prospectus document a net profit of \$5.5 million and a dividend payment of 1.5 cents per share. In August 2000, the shares hit an all time of \$4.74 (\$1.58 adjusted for 3:1 share split in November 2000).

In subsequent years management has invested heavily in building out the software solution offerings. Today, the group targets seven industry segments, offering ten complete enterprise software solution products. Importantly the company's key point of differentiation revolves around its commitment to customers, which management terms the "Power of One". By developing, marketing, implementing and supporting their clients, Technology One has built a successful and formidable business, which in turn has rewarded shareholders.

**Table 2: Technology One Financial Snapshot**

\$'M	2000	2005	2006	2007	2008	2009	2010	2011	2012(e)
Revenue	28.1	53.7	65.2	76.8	108.5	120.7	134.0	153.4	168.0
Operating Expenses	(14.6)	(28.9)	(36.2)	(44.5)	(65.5)	(76.3)	(84.8)	(96.4)	(104.4)
Research & Development	(4.7)	(10.2)	(12.7)	(13.8)	(21.2)	(24.9)	(27.0)	(31.8)	(34.0)
EBIT	8.8	14.6	16.3	18.5	21.8	19.5	22.2	25.2	29.6
NPAT	5.8	10.6	12.3	14.8	17.2	15.7	17.8	20.3	22.7
EBIT Margins (%)	31.3	27.1	25.1	24.0	20.1	16.1	16.6	16.4	17.6
Shareholders' Equity	14.3	38.3	39.3	44.3	50.5	57.1	63.4	68.4	69.8
Net Debt / (net cash)	(14.3)	(22.7)	(18.1)	(24.0)	(16.5)	(22.8)	(29.8)	(33.8)	(45.1)
Market Capitalisation	369.7	158.7	195.8	351.3	236.1	237.2	242.7	315.5	364.1
Enterprise Value	355.4	136.0	177.7	327.3	219.6	214.4	212.9	281.7	319.0
Buyout (%) **	2.5	10.7	9.2	5.6	9.9	9.1	10.4	8.9	9.3
ROCE (%) ***	>100	94.9	76.9	91.1	64.1	56.8	66.1	72.8	119.8
GOCF / EBITDA (%)	90.0	86.0	71.0	106.0	71.0	103.0	140.0	88.0	98.0
Underlying EPS (c)	1.9	3.5	4.1	5.0	5.8	5.2	5.9	6.7	7.5
PER	61.5	15.1	16.1	23.6	13.6	15.2	13.6	15.5	16.0
Dividend per share (c)	1.5	3.1	3.4	3.8	4.1	3.8	5.7	6.1	7.0
Dividend Yield %	1.3	5.8	5.2	3.2	5.2	4.8	7.1	5.9	5.8
Share Price 30 June (\$)	1.17	0.53	0.66	1.18	0.79	0.79	0.80	1.04	1.20
Issued shares (m)	316.0*	299.4	296.7	297.7	298.9	300.3	303.4	303.4	303.4

\* Adjusted for 3:1 share split Nov 2000 \*\* Buyout represents EBIT / EV as a percentage \*\*\* ROCE = EBIT / (Shareholders Equity + debt – cash. Share price as at 30 June 2012

### ***What is Enterprise Software?***

Unlike consumers who look to access individual pieces of software to perform specific functions, businesses require systems that are far more complex and integrated. Organisations like Technology One have developed specific application software tools to meet specific business needs. They range from account keeping, automated billing systems, supply chain management, human resources and payroll to name a few. And while small businesses can do without such expensive tailored-made software applications, they are a must for larger complex organisations.

Deploying enterprise software is not without its issues. In fact, the rollout of large and integrated IT projects is often a source of significant business risk. This is because software is required to not only store a large amount of complex data but to also allow for interpretation of that data. In turn this allows for improved efficiency, productivity and ultimately better decision making by management. Too often however, projects face cost overruns and fail the customer brief of providing outcomes that deliver performance, scalability and robustness.

### ***Technology One business model***

The company promotes heavily the “Power of One” business model, where customers enjoy the benefit of “One Vision, One Vendor, One Experience”. In the enterprise software space, the Technology One offering is rather unique in that it is prepared to control all aspects of the service chain. In contrast major competitors including German based SAP and US based Oracle, rely on external parties to undertake the implementation side of things. This is an important point of difference that Di Marco is more than happy to exploit for good commercial reasons, noting that things often go wrong at the implementation stage.

 6
 

---

The second point of difference surrounds the company’s targeted approach, choosing to build, market, implement and support enterprise solutions targeted at seven vertical markets including;

- Local Government
- State & Federal Government
- Education
- Financial Services
- Health Departments
- Utilities
- Managed Services

These are markets where management have built up significant expertise along with a high profile customer base now exceeding 900 that includes;

- Over 130 Government departments
- Over 220 Local Governments, servicing about 30% of all national ratepayers
- Building societies and credit unions
- Over 40 education institutions
- Healthcare and aged care
- Utilities covering water, power, ports and airports

- Managed services covering media, property projects, entertainment.

By focusing on these key markets, the company has benefited in a number of ways. First it has built up leading market positions in key industry segments. This in turn has allowed the group to deepen its service, offering ten products, covering fourteen preconfigured solutions that customers are able to purchase on a per user basis under a licence model. Finally, management continues to invest heavily on improving both the intellectual property that supports the software and the service levels that customers expect.

### Research & Development

Successful companies invariably lead from the front. Key attributes include persistency and a preparedness to invest today to reap future rewards. In the case of Technology One, management has never been backward in accepting the challenge. While investors can always question whether the dollars spent today will deliver the returns expected tomorrow, it is nevertheless a hallmark that all great companies display.

In our circle of competence, companies that fulfil that requirement include bionic ear manufacturer Cochlear, obstructive sleep apnoea market leader ResMed, blood plasma supplier CSL and vitamins leader Blackmores to name just a few. Investors' familiar with the role that research and development plays will also acknowledge that financially, a dollar spent is a dollar not available for distribution. It is in this context a brave management team that stands in the way of shareholders and their profits. Equally important then is how management go about accounting for their research and development expenditure. Some companies will look to spend the money but fail to recognise it as an expense, preferring to capitalise the outlay onto the balance sheet. In doing so it gives shareholders the impression that profits are higher today than what they should be and potentially creates a problem down the track if the spend doesn't deliver on expectations.

Management teams running conservative companies do the opposite. They allocate and expense all their research and development costs in the year that they fall due, thereby lowering today's profits but removing any long term balance sheet issues. Obviously, the more a company invests, the more it needs to justify its actions to shareholders. It is a fine line, but companies like Cochlear and ResMed in particular, have shown over the past decade that taking a conservative accounting line whilst maintaining high levels of research and development investment, has left the company and shareholders in good stead. To this list we can also add Technology One, a business that has over its relatively short public life, consistently reinvested shareholder funds with the aim of enhancing and developing new revenue streams.

**Table 3: Research & development expenditure profile**

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Revenue (\$m)	28.1	39.9	47.4	48.3	51.5	55.8	66.5	78.4	110.2	122.5	135.9	156.7
R&D* (\$m)	4.7	7.8	8.1	9.3	9.5	10.2	12.7	13.8	21.2	24.9	26.9	31.8
R&D / Rev %	16.7	19.5	17.0	19.3	18.4	18.3	19.1	17.6	19.2	20.3	19.8	20.2
Net Profit (\$m)	5.8	7.8	8.8	7.0	9.5	10.3	12.3	14.8	17.2	15.7	17.8	20.3

\* Research & Development



As **Table 3** highlights, the company has cumulatively invested over \$180 million since listing in 1999. During this same period, the group recorded cumulative net profits totalling \$147 million. Expressed as a percentage, management has maintained an annual spend equivalent to almost twenty percent of revenue. The growth in company revenues and earnings over the years is supportive of this spend but management have recently acknowledged that a critical level of investment has now been reached. We will discuss the consequences of this further in the report, suffice to say at this point that scale does matter in business and that while the quantum of the spend will be maintained in future periods, as a percentage of revenue it will drop, allowing a lot more dollars to drop to the bottom line.

Making up the bulk of the expenditure is the group's 500 plus software development personnel. During 2010 the group completed its move to its new Brisbane headquarters as pictured below. The consolidation of three offices into one of Australia's largest commercial software research and development facilities brings with it scope for significant productivity improvements as well as attracting and retaining the best technology talent.

**Diagram 1: Technology One new Brisbane headquarters**



### ***Technology One revenue model***

Some companies are protective of their revenue models, preferring to tell investors very little, in fear of what competitors may do. In stark contrast Di Marco openly explains the model, clearly outlining the three revenue stages that underpin the business case for investment. **Table 4** sets out

the three types of fees that a customer will incur while **Table 5** and **Table 6** profiles their group contribution over respective half and full year periods.

**Table 4: Technology One revenue model**

Type of Fee	Payment terms	User Numbers	Duration	Example \$
1. Initial Licence	Per module	Per user	Once off	100*
2. Consulting Fee			Once off	120
3. Annual Service Fee			Re-occurring annually	22.5

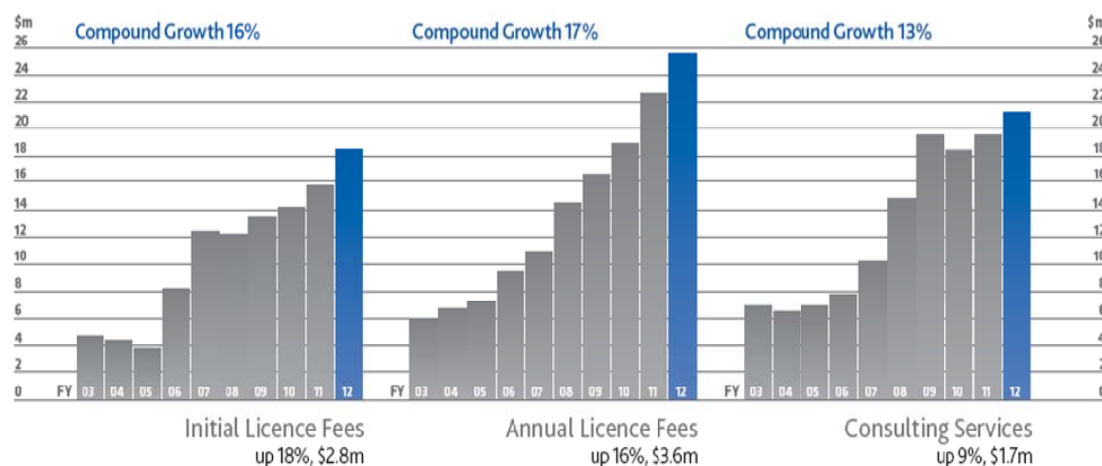
\* Calculated by number of modules purchased X number of users (company has approx 300 modules covering 10 products)

When a customer selects an enterprise software solution, it does so carefully and deliberately. The consequences of getting it wrong are profound, since in the majority of situations the software is providing mission critical solutions. It is in this context that one can begin to understand the importance of software implementation and the relationship that exists between a supplier and a customer.

Technology One's service offering is positioned in what the company describes as the middle market, notably organisations that are looking to implement complex enterprise solutions that can range in value from \$100 million to over \$1 billion. As **Table 4** highlights, the revenue streams that flow from each new contract are divided into three areas. The first is referred to as the initial licence fee and is calculated by the number of product modules purchased by the number of users who are licensed to access them. If one can imagine a university, or local council who may require a software solution to enable students to access information or staff to log onto work sheets, the number of users can vary significantly in scale. This fee is one off in nature and leads onto an implementation service fee.

9

**Graph 1: Half year revenue stream performances 2003-2012**



Di Marco highlights the implementation of the software or consulting as the crucial bit that competitors don't do, choosing instead to outsource this service to others. It is a significant point of difference and one that the company wishes to fully exploit. Under the model, the company charges an implementation fee that is one hundred and twenty percent greater than the initial licence fee value. In the example above, if the customer were to enter into a contract valued at \$100, the company would also receive an implementation fee valued at \$120. While this fee is one off in nature, each time the customer increases the number of users, buys additional modules or adds new products, the three revenue streams are re-activated for the additional revenues purchased. The last string to the revenue bow is the charging of an annual fee.

The annual service fee is as the name suggests, charged annually at the rate of twenty two and half percent of the original licence fee value. This service not only allows the company to maintain an ongoing relationship with its customers, undertaking upgrades and other services but it also allows for feedback on future product enhancements.

**Table 5: Fee contribution split 2002-2011**

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Revenue (\$m)												
Licence Fees	5.8	10.1	11.5	8.1	11.5	10.6	15.6	18.4	22.6	24.3	26.8	30.7
Consulting Fees	9.8	10.3	13.8	14.1	13.3	14.8	18.1	22.5	35.9	41.0	41.6	42.8
Annual Fees	5.0	8.4	10.7	12.4	14.4	17.2	21.1	25.6	36.3	43.1	48.5	55.3

10

Customers initially enter into contracts that are long term in nature, typically exceeding ten years. However in reality, customers are loathe in changing such critical pieces of software infrastructure or IT vendors. It is an aspect of the business that we find very appealing and best reflected in the fact that the company boasts a 99.9% client retention rate, while over two thirds of revenues generated each year are from existing customers who are either paying existing annual fees or increasing their usage via new product modules and user numbers. As **Table 5** highlights, it is a wonderful annuity model that goes some way to explaining why management is so committed to investing a significant portion of shareholder funds into research and development solutions.

### ***The way forward for Technology One***

Management have always had an eye to the future with a preparedness to spend upfront to reap long term benefits. As noted earlier, a deliberate focus has been funds directed towards new product offerings. In addition, complementing the group's onshore research centre highlighted in **Diagram 1**, management has been trialling a new offshore research and development operation based in Indonesia. The new centre currently houses over thirty personnel with an aim to continue the pilot study until year end. Should the centre deliver on its business case, management expects the group's efficiency to rise three fold.

Another area of investment has been the group's expansion into the United Kingdom. Having entered the market in 2005, the path to profitability has been a long time coming. In the latest half year result, the UK subsidiary recorded a \$780,000 loss and while management has expanded into a

second office, the build up of new clients and the annuity type nature of the business would suggest that a breakeven result is still some time off. That said, Di Marco remains committed to the task although his main attention remains the local market.

### **Financials**

Since listing in 1999, Technology One has plotted a deliberate and consistent path, with its primary objective to build a better, more sustainable business. **Table 2** provides an outline of the group's financial progress since 2000. While there are many ways to interpret the data set, the most obvious and pleasing aspect of the numbers are their underlying trends. Specifically, the key indicators of revenue, profits and dividends are all heading north.

Management have steered the business in a sensible and largely organic manner right from the start. While operating margins have fallen from 31% in 2000 to a forecast 17.6% in 2012, the reasons behind the fall involve the group's deliberate commitment to reinvest profits into the business. This is reflected in the research and development cost line, which has spiked from \$4.7 million in 2000 (or 16.7% of group revenue) to \$34 million in 2012 (20.2% of group revenue). As we noted earlier, this is a cost that lies within management's discretion, from which future products and profits are expected to flow. As such, while profits could have been higher if not for the additional spend, management has seen fit to plough more money into product development. As we will address a little further in the review, the benefits of this spend are now set to flow.

 11
 

---

The other most pleasing aspect of the company's progress to date has been its conservative stance. Since listing, the company has kept a clean balance sheet, carrying no net debt, cash of \$45 million and with all research and development costs written off. To this we would also add that the company's growth to date has been achieved without recourse to shareholders and in times of market volatility, management has seen fit to buy back company shares. All in all, the financial report card is not only pleasing to the eye but underlies one of the key attractions of the group – that the interests of both customers and shareholders are considered paramount in any decision making activity undertaken.

### **Company outlook**

After a decade of significant product investment, Di Marco told investors at the recent half year results presentation that profit margins were now set to rise over the ensuing five years. His reasoning put simply is that the group was now ready to leverage the considerable level of research and development investment made over recent years. The completion of the group's extended product range was seen as an important inflection point that would allow the company to grow revenue and profits at a faster pace than product investment.

To this end Di Marco forecast research and development spend as a percentage of revenue would fall from the current 20% to 18.5% by 2016, with 15% seen as a long term target. Should he meet this target the actual dollar spend, although rising from \$34 million to \$47 million, would be significantly lower than the \$67 million, had the group maintained its 20% level of research and development spending. **Table 6** outlines our take on what this could mean to shareholders in terms of revenues, profits and dividends looking out five years.

**Table 6: Technology One earnings snapshot 2012 -2016**

Year	2012(e)	2013(e)	2014(e)	2015(e)	2016(e)
Revenue (\$m)	168.0	186.0	202.0	223.0	245.0
EBITDARD* (\$m)	71.1	80.0	86.8	97.9	107.7
R&D (\$m)	(34.0)	(37.3)	(40.3)	(41.2)	(45.3)
EBITDA** (\$m)	37.1	42.7	46.5	56.7	62.4
D&A (\$m)	(7.5)	(6.7)	(6.7)	(7.3)	(8.1)
EBIT (\$m)	29.6	35.9	39.8	49.4	54.3
NPAT (\$m)	22.7	26.2	29.0	36.1	39.7
EPS (c)	7.5	9.1	10.1	11.9	13.1
DPS (c)	7.0	8.0	9.0	12.0	13.0
PER (x)	16.0	13.2	11.9	10.1	9.2
Yield (%)	5.8	6.7	7.5	10.0	10.8
Revenue Growth %	10.0	10.7	8.7	10.4	9.9
R&D / Revenue (%)	20.2	20.1	19.9	18.5	18.5

\* EBITDARD – earnings before interest, tax, depreciation, amortisation, research & development.

\*\* EBITDA – earnings before interest, tax, depreciation & amortisation.

While we are mindful that trying to extrapolate profit numbers five years out is fraught with danger, the Technology One business model has proven to be a very consistent earner; built around a strong product development pipeline and revenue model that promotes at its core, long lasting customer relationships. As **Table 6** highlights, by reducing the research and development spend to more historical levels and lifting revenues by around ten per cent per annum, net profits are set to almost double to \$39.7 million by 2016, along with a dividend yield approaching 11% fully franked, based on a purchase made today.

### Ownership

The two major company shareholders collectively control 40% of the business with founder and executive chairman Di Marco holding 18.2%, while original angel investor, the Mactaggart family holding the balance with 21.9%. It is perhaps appropriate to provide some background on the role that the Mactaggart family has played, and in particular Dugald Mactaggart who recently passed away. During the early years when Di Marco was looking to establish the Technology One business, he turned to Mactaggart for funding, having assisted his business years earlier. It is a relationship that has lasted the distance and perhaps speaks volumes of how the right management team coupled with the right shareholder base can deliver the right business outcomes.

### Summary

When we first consider whether a business is worth buying we ask ourselves four questions;

1. Do we rate management?
2. Do they operate a business that is unique or well positioned?
3. Do they possess a strong balance sheet?
4. Do shareholders feature highly in management's opinion and actions?

Selector Funds Management Limited

ACN 102756347 AFSL 225316

Level 3, 66 Hunter Street Sydney NSW 2000, Australia

Telephone 612 8090 3610 Web [www.selectorfund.com.au](http://www.selectorfund.com.au)

On our assessment the company ticks all the boxes. The business is well positioned to grow with an attractive and well established revenue model, accompanied by a clean balance sheet with net cash, a management team that has delivered for current shareholders as well as investing for future shareholders and a financial record that stands the scrutiny of even the most ardent critic. **SFM**

### **Survival of the fittest**

During the past quarter we visited a number of businesses and listened to and interviewed many management teams. Perhaps more than ever the question that appears to be most on the mind of investors is business longevity. Will the business grow, will it prosper and will it actually survive?

The roll that technology plays, the migration to online and the globalisation of economies has placed businesses on high alert. While none of these changes are new, the speed at which these trends are taking hold has taken many by surprise and led to the question of viability for many long standing companies. In this context, names like Kodak, Dell and even Nokia are a few that in their prime dominated their field only to have succumbed to newer technologies or more aggressive and relevant competitors.

For investors, the burning issue that must be addressed when assessing a business is whether the threats faced are cyclical or structural in nature. Both are damaging to a business, however the more permanent and therefore more destructive are the structural changes that emerge. It is not surprising then, that the biggest structural issue facing business is the extent to which online has allowed end users to connect directly to suppliers of goods and services, thereby bypassing a layer of costs and fee generating services.

 13
 

---

In this context, online has allowed for greater price transparency which has decimated some businesses while forcing others to adapt. For those who do adapt, the use of technology and acceptance of online as a powerful business tool, are better prepared for the battle.

In our earlier article we profiled Technology One and how its significant investment in research and development had positioned the business to remain both relevant and industry leading. Below we shine the light on domestic retail player Super Retail Group and specifically its most recent acquisition of the Rebel Sports business.

### **Super Retail Group (SUL)**

#### ***Brief History***

The business was founded in 1972 by Reg and Hazel Rowe, providing an automotive mail order service, followed by an expansion into retail stores in 1974. A name change in 1981, to Super Cheap Auto, set the stage for a significant organic store roll out, predominately in the home state of Queensland and extending into the New South Wales market in 1997.



The external appointment in 1998 of Bob Thorn as managing director underscored the group's growth trajectory, which at the time of its stock exchange listing in July 2004, had the company valued at \$210 million and store numbers approaching 200.

The group expanded into the recreational arena in 2005, with the store launch of BCF stores (Boating Camping & Fishing). However, a critical turning point for the group came with the internal appointment of new managing director Peter Birtles in 2006. With a retailing background that included over a decade with UK Boots group, Birtles has elevated the business in a number of areas, none more important than the introduction of product sourcing and supply logistic systems that better underpins the group's multiple brand strategy.

Since his appointment, Birtles has executed on both an organic and retail acquisition drive that has seen the group acquire bicycle business Goldcross Cycles in 2008, outdoor leisure group Ray's Outdoors in 2010 and more recently, sports operator Rebel Group in October 2011. A name change to Super Retail Group in 2011, illustrated the diverse nature of the business and the six brands that it now represents. **Diagram 2** sets out the groups' operations and the current store penetration.

**Diagram 2**



**Table 7: Super Retail divisional split**

Year	2006	2007	2008	2009	2010	2011
Group Revenue (\$m)	526	625	715	829	938	1,092
EBIT (\$m)	28.9	38.1	45.7	55.1	65.8	87.5
NPAT (\$m)	16.5	22.3	25.8	32.1	38.1	55.6
Return on Capital (%)	11.7	13.9	14.1	15.6	16.8	17.5
<b>Divisional Revenue (\$m)</b>						
Auto & Cycle (\$m)	482	625	559	623	686	708
EBIT (\$m)	32.6	37.9	41.6	42.5	48.2	63.6
Leisure (\$m)	44	99	156	206	252	384
EBIT (\$m)	(3.4)	1.8	7.9	16.4	21.3	32.0

### Rebel Group

In October 2011, Birtles announced the purchase of sports retailer Rebel Group from private equity vendors, outlaying \$610 million in the process. The group funded the deal with a combination of new debt totalling \$296 million and new capital provided by existing shareholders to the tune of \$334 million.

15

Comprising 92 Rebel Sport stores and 36 Amart All Sports stores, the newly acquired business is now housed under the company's newly formed third division, aptly named Sporting Goods Retailing. Following this purchase, the Super Retail Group is now comprised of 564 retail stores, with annual revenues of \$1.7 billion and earnings before interest and tax (EBIT) of \$155 million.

At a time of intense debate regarding the structural shift of retail business from traditional bricks and mortar stores to online, the move by Birtles carries with it additional risk. Having acquired the retailer on reasonably attractive financial terms, it is now up to the management team to lift net profits over the next five years, so as to hit its stated return on capital hurdle of 20%. Should it succeed, profits from this division are likely to exceed \$120 million per annum.

### Investor day

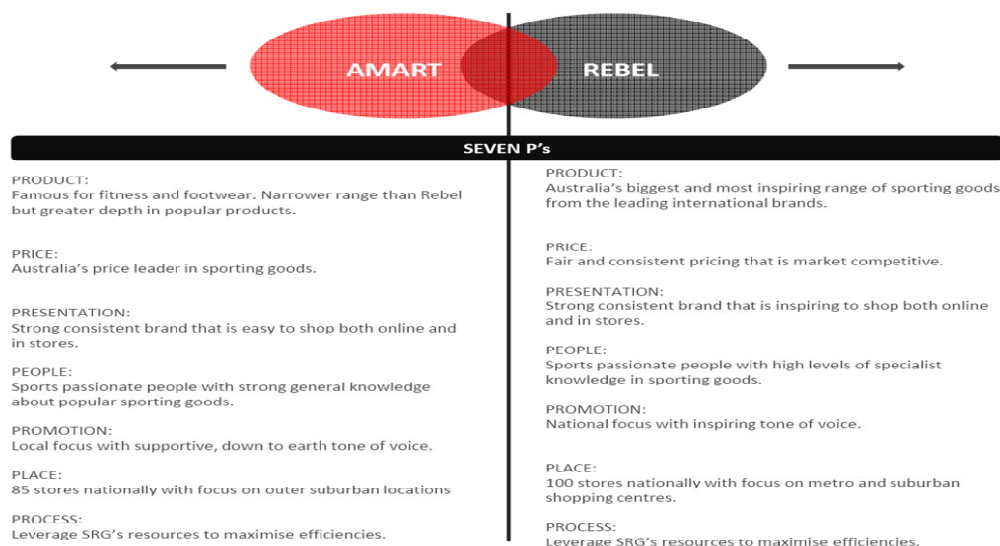
During May we attended the Super Retail investor day, specifically focused on the Rebel business. As with any presentation that talks to the future, vision and aspiration are fine but what counts are results. As things currently stand, the combined operations of Rebel and Amart, enjoy a 19% share of a market valued at \$3.2 billion. By 2017, management expects to lift its share to 33%, equal to \$1.0 billion in revenue. Store numbers are expected to rise from 127 to a figure closer to 185, largely driven by the Amart store rollout which is expected to rise from the current 36 to 85.

In management's view, the company's sports offering sits squarely between traditional department stores and specialty retailers. As a sports destination retailer, the group's key strength resides with



its leading market position and brand strength. While Rebel will cater for the sporting enthusiasts, Amart will offer a more community focused and price conscious service offering.

**Diagram 3: Sports retailing vision**



On the issue of pricing, management offers the following that "prices will be fair, competitive and market consistent". In order to more readily compete with online offerings, the group will actively engage with suppliers, including the likes of Nike and Adidas, to offer relevant product at varying price points. The aim is not to beat online prices but to deliver what the consumer wants at a price that supports the store infrastructure.

Management cites the online risk as the biggest on the radar but also notes that the opportunity to grab significant market share is equally big. The record so far suggests that Birtles and his team know something about running retail stores. The success of Super Cheap Auto in particular is testament to management's ability to tackle many of issues that plague business owners. As **Table 7** highlights, over the past five years, revenues at the group's Auto division has risen 47% to \$708 million while EBIT has jumped 95% to \$63.6 million. Similarly the group's return on capital has improved from 11.7% to 17.5% over the same period.

As the group's former chief financial officer, Birtles has a feel for the numbers and an eye on costs. In an environment of rising costs and competitive threats from online, now more than ever management teams need to manage their costs more effectively. While the focus should be on driving more sales, our sense is that companies have to do both and avoid borrowing excessively. Those that can adapt to these conditions will thrive and be better positioned to tackle the structural issues that are at hand. **SFM**

## The changing economic landscape

The Australian newspaper recently published an article on the changing face of industry. Specifically the article centred on a report titled “A snapshot of Australia’s Digital Future to 2050” sponsored by IBM. The report highlighted the need for businesses and governments to look beyond the current minerals boom and towards the burgeoning Information and Communication Technology (ICT) industries to exploit its potential.

With business and government discussions now centred on ways to improve productivity, the shift within business is to embrace technology to not only combat the online threat but to reduce costs and improve efficiency.

The report also warns that;

“As ICT becomes a utility service – as electricity did during the industrial age -- up to 15 traditional industries, including free-to-air television and newspaper publishing, could be wiped out by the advance of digital technology by 2050. High-speed broadband spells the decline of traditional retailing in the decades ahead. Much of wholesale trade may eventually be cut out of the equation, as the new utility will enable producers to target end-consumers without the need for middlemen. **Table 8** profiles how our economy may look by 2050 and the contributions flowing from various industries.”

17

**Table 8: Changing mix of industry revenue**

<b>Changing mix of industry revenue</b>			
GDP \$ trillion (2012 prices)		\$1.4 trillion 2011	\$5.3 trillion 2050 (F)
AGRICULTURE	2.2		3.7
MINING	7.3		4.4
MANUFACTURING	8.2		5.4
UTILITIES	2.1		2.6
CONSTRUCTION	7.9		6.5
WHOLESALE TRADE	4.2		3.9
RETAIL TRADE	4.4		3.1
TRANSPORT & POSTAL	5.1		4.6
MEDIA & TELECOM	3.2		4.4
FINANCIAL & INSURANCE	9.7		8.0
RENTAL & REAL ESTATE	2.0		2.8
PROF. & TECHNOLOGY SERVICES	6.6		6.9
ADMIN & SUPPORT SERVICES	2.3		3.2
PUBLIC ADM. & SAFETY	5.0		5.2
EDUCATION & TRAINING	4.5		5.2
DWELLING OWNERSHIP	8.1		7.0
IND TAXES ET AL	6.4		8.0
ACCOM. & FOOD SERVICES	2.3		3.5
HEALTH CARE & SOCIAL ASSISTANCE	5.9		8.5
ART & RECREATION SERVICES	0.9		1.2
PERSONAL AND OTHER SERVICES	1.7		2.1

Source: The Australian

As **Table 8** highlights, by 2050 the driving forces of the economy are unlikely to be the mining and manufacturing sectors. While crystal ball gazing has its issues, it is hard to stand in the way of progress, particularly when the external forces are so powerful. This was most evident during the past quarter with the announcement from Fairfax Media that it was shutting down its Sydney and Melbourne printing presses and moving the traditional broadsheet newspaper formats for the Sydney Morning Herald and The Melbourne Age to a tabloid.

In truth, Fairfax has struggled to adapt its business model to the new world, as revenues shifted from hardcopy newspapers to online. New competitors, including the likes of carsales.com, the REA Group and SEEK, having stolen a march on the incumbents, now dominate their respective sectors for these sought after revenue streams, once dubbed Fairfax's "rivers of gold". We doubt that this will be the last move by Fairfax management as it looks to take its offering into the digital age. However the jury is still out on what the new revenue model will look like and whether consumers are prepared to pay for online content to the same extent that Fairfax once enjoyed.

As the Fairfax experience highlights, business leaders will be forced to adapt to the new challenges that the online world brings. Investment in new technologies and broadening the product and service offering to cater for these challenges is necessary. Those that grasp the challenges head-on are not guaranteed of success, however to ignore them is to ignore economic reality. **SFM**

## Transformations

Too often in business life, past disasters are dealt with by way of a new management team and transformational undertakings. They mean well, but to the ordinary investor, it just adds up to more costs and more promises. Already this year and particularly this last quarter a number of companies have sought new capital and undertaken more transforming feats to arrest poor performance. To this list we can now add a business where one of our portfolio managers cut his teeth in funds management – Perpetual.

After a string of failed new business ventures, a prolonged downturn in investment markets and an ageing investor base growing weary of share markets, Australia's leading independent wealth manager announced a three year transformation program costing all up \$70 million, to deliver ongoing permanent cost reductions of \$50 million per annum. In his webcast address to investors, newish CEO Geoff Lloyd, having been appointed in February, outlined three core strategies under the heading "Transformation 2015". While the use of the word transformation covers many sins, Lloyd trotted out the word sixteen times in his presentation.

As a general rule investors should be very fearful of companies that announce transforming acquisitions or transforming restructures. Perpetual is no exception, however at its core, the business is a simple one and from what we gleaned, Lloyd seems to understand that and is now aiming to execute on returning the business to a more streamlined, focused, wealth management business. Again, we are mindful of the dangers of long term transforming deals but this is one business we are prepared to give some leeway too and will watch with interest. **SFM**

## Company visit diary June Quarter 2012

### April

ABC	Adelaide Brighton Cement UBS conference	04/04/12
AAD	Ardent Leisure UBS conference	04/04/12
IFL	IOOF Holdings UBS conference	04/04/12
TNE	Technology One UBS conference	04/04/12
N/A	BIS Industries UBS conference	04/04/12
N/A	Skywest UBS conference	04/04/12
IIN	linet UBS conference	04/04/12
MQA	Macquarie Atlas Roads UBS conference	04/04/12
REA	REA Group UBS conference	04/04/12
IRE	IRESS UBS conference	04/04/12
WHC	Whitehaven Coal extraordinary general meeting	16/04/12
SRX	Sirtex management site meeting	17/02/12
SXY	Senex Energy RBS conference	18/04/12
DSL	Drillsearch Energy RBS conference	18/04/12
AQC	Ambassador Oil & Gas RBS conference	18/04/12
BPT	Beach Energy RBS conference	18/04/12
JIN	Jumbo Interactive management meeting	18/04/12
PXS	Pharmaxis Q3 conference call	09/04/12
WOW	Woolworths Q3 conference call	20/04/12
TNE	Technology One half year results presentation	23/04/12
CCP	Credit Corp management meeting	29/04/12

### May

FLT	Flight Centre Macquarie conference	02/05/12
SKE	Skilled Group Macquarie conference	02/05/12
SAI	SAI Global Macquarie conference	02/05/12
LCM	Logicamms Macquarie conference	02/05/12
IMD	Imdex Macquarie conference	02/05/12
TOX	Tox Free Solutions Macquarie conference	02/05/12
ILU	Iluka Resources Macquarie conference	02/05/12
TPI	Transpacific Industries Macquarie conference	02/05/12
MQG	Macquarie Group Macquarie conference	03/05/12
CPU	Computershare Macquarie conference	03/05/12
ORL	Oroton Group Macquarie conference	03/05/12
SUL	Super Retail Group Macquarie conference	03/05/12
RWH	Royal Wolf Macquarie conference	04/05/12
ARP	ARB Corporation Macquarie conference	04/05/12
FXL	Flexigroup Macquarie conference	04/05/12
IFL	IOOF Holdings Macquarie conference	04/05/12
NVT	Navitas Macquarie conference	04/05/12
WTF	Wotif.com Holdings Macquarie conference	04/05/12
FLT	Flight Centre management meeting	08/05/12
CXD	CathRx investor conference	09/05/12

BBG	Billabong International investor conference	09/05/12
NWS	News Corporation Q3 conference call	09/05/12
PXS	Pharmaxis management meeting	11/05/12
IPR	Ipernica management meeting	15/05/12
N/A	Deals Direct management meeting	15/05/12
JIN	Jumbo Interactive management meeting	15/05/12
ACG	Atcor Medical Holdings management meeting	16/05/12
SYD	Sydney Airport Annual meeting	17/05/12
BXN	Bioxyne management meeting	17/05/12
CPB	Campbell Brothers full year results presentation	21/05/12
DTL	Data#3 investor day	21/05/12
SUL	Super Retail Group investor day	22/05/12
TNE	Technology One investor day	22/05/12
MYS	MyState management meeting	24/05/12
CVW	Clearview Wealth management meeting	24/05/12
ASZ	ASG Group management meeting	24/05/12
QFX	Quickflix management meeting	24/05/12
MLB	Melbourne IT management meeting	24/05/12
SEK	SEEK conference call	30/05/12
FXL	Flexigroup conference call	30/05/12
PRG	Programme Maintenance full year results	30/05/12
SRX	Sirtex site visit	31/05/12
SHL	Sonic Healthcare site visit	31/05/12
COH	Cochlear site visit	31/05/12
<i>June</i>		
RHC	Ramsay Health Care UBS conference	07/06/12
BKL	Blackmores UBS conference	07/06/12
N/A	iSelect UBS conference	08/06/12
RMD	ResMed Inc UBS conference	08/06/12
NHC	New Hope Corporation RBS coal conference	13/06/12
QRN	QR National RBS coal conference	13/06/12
COK	Cockatoo Coal RBS coal conference	13/06/12
NCR	Nucoal Resources RBA coal conference	13/06/12
CLR	Carabella Resources RBS coal conference	13/06/12
BND	Bandanna Energy RBS coal conference	13/06/12
SMR	Stanmore Coal RBS coal conference	13/06/12

### Selector Funds Management Limited Disclaimer

The information contained in this document is general information only. This document has not been prepared taking into account any particular Investor's or class of Investors' investment objectives, financial situation or needs. The Directors and our associates take no responsibility for error or omission; however all care is taken in preparing this document. The Directors and our associates may hold units in the fund and may hold investments in individual companies mentioned in this document. **SFM**

Selector Funds Management Limited

ACN 102756347 AFSL 225316

Level 3, 66 Hunter Street Sydney NSW 2000, Australia

Telephone 612 8090 3610 Web [www.selectorfund.com.au](http://www.selectorfund.com.au)