



In this quarterly edition we review performance and attribution. In our headline story, Global Demographics are revisited for a second time, nearly 10 years after our initial article. Seek (SEK) is profiled and the February 2015 reporting season is reviewed. Finally we consider the merits of long term sustainable dividend growth. Photo: "Our Globe. Big moves that are hard to slow."

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## About Selector

We are a boutique fund manager and we have a combined experience of over 150 years. We believe in long term wealth creation and building lasting relationships with our investors.

Our focus is stock selection. Our funds are high conviction, concentrated and index unaware. As a result we have low turnover and produce tax effective returns.

We seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management.

Dear Investor,

Global markets shook off growing investor concerns during the March quarter, with the Australian All Ordinaries Index posting a 8.78% return for the period. A solid reporting period provided a positive backdrop while current monetary settings continued to fuel investor demand. Share market valuations, whilst demanding in some quarters, needs to be considered on a case by case basis. Importantly, while some businesses have found conditions tough going, others have thrived, having better adapted to the changing economic landscape while also operating stronger business models.

Investors have also moved on. In this context, if we were to single out one event that suggested the 2008 financial crisis may now be behind us, it would be the sought after capital raising undertaken by investment bank, Macquarie Group in March. Now seven years on since the financial fallout, Macquarie undertook its first equity offering, raising \$500m to purchase a \$5.1b aircraft leasing book with investors eagerly taking up the \$73.50 share offer.

Mergers and acquisitions are also top of mind for many management teams as they consider life in a low growth environment, as evidenced by telco operator TPG's all cash \$1.4 billion bid for fellow competitor iiNet. Broadly speaking the following quote from a recent Australian Financial Review article still holds true, *"At the bottom of the low growth, the monetary easing in response, the currency wars and all the rest, is excessive debt."*

As such, a softly, softly approach is still seen as the most appropriate course of action, particularly in respect of expected monetary policy actions by the world's central bankers. US Fed Chairperson Ms Janet Yellen outlined an assurance that while US rates were likely to rise in the near future, any suggestion of rapid rises were off the mark. *"Just because we removed the word patient from the statement doesn't mean we are going to be impatient."* This was also confirmed by Fed projections for a year end federal funds rate reaching 0.625%, compared with the previous median forecast of 1.125% first discussed in December 2014.

Ray Dalio, founder of US investment firm Bridgewater Associates, noted that in 1937 the Fed too quickly raised rates in reverting to a more normal setting, leading to the US market relapsing following the Great Depression of the early 1930's. Dalio argues and we concur, that any tightening needs to be *"later and more delicate than normal."*

In this quarterly, we discuss the issue of demographics and how it shapes our investment approach. We profile leading global online employment group SEEK and examine a number of companies that reported during the period. Finally, we discuss why dividends play such an important role in delivering long term wealth.

For the 2015 March quarter the Fund delivered a gross positive return of **12.67%** while in contrast the All Ordinaries Accumulation Index rose **10.21%**. To all our investors we trust you find the report informative.

Regards,

Selector Investment Team

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### Quote: James Grant – publisher of the Interest Rate Observer

*“My publication is called Interest Rate Observer, Ladies and gentlemen, there are no interest rates.”*

And on the issue of Governments offering bonds at near zero or in some cases below zero, Mr Grant makes the following pristine observation.

*“They’re no longer offering risk-free return but return free risk.”*

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## Performance March 2015

For the quarter ending March 2015, the Fund delivered a gross positive return of **12.67%** as compared with the **10.21%** rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 34.

### *Performance table since inception*

Returns	Gross Fund Return %	All Ordinaries Accumulation Index %	All Ordinaries Index %
3 Months	12.67	10.21	8.78
6 Months	17.73	13.04	10.67
1 Year	24.47	13.25	8.49
3 Years annualised	28.98	14.72	9.87
5 Years annualised	15.02	8.22	3.68
Since Inception annualised	12.46	8.78	4.28

### *Fund's Top 10 holdings*

Top 10 March 2015*	Top 10 December 2014*
ALTIUM	ARISTOCRAT LEISURE
ARISTOCRAT LEISURE	CARSALES.COM
CSL	CSL
DOMINO'S PIZZA ENTERPRISES	FLIGHT CENTRE TRAVEL GROUP
FLIGHT CENTRE TRAVEL GROUP	IOOF HOLDINGS
GBST HOLDINGS	IRESS
IOOF HOLDINGS	OZFOREX GROUP
RESMED	RESMED
SEEK	SEEK
TECHNOLOGY ONE	SIRTEX MEDICAL
<b>Top 10: 48.78%</b>	<b>Top 10: 48.35%</b>

\* Listed in alphabetical order

Selector runs a high conviction, index unaware, stock selection investment strategy which typically targets 15-25 stocks for the Fund. As shown above, the Fund's top 10 positions usually represents a high percentage of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average "run-of-the-mill index hugging" fund manager. Our goal remains focused on truly differentiated broad-cap businesses rather than the closet index hugging portfolios offered by most large fund managers.

*Performance attribution for the March 2015 quarter*

Top 5 stock contributors	%	Top 5 stock detractors	%
GBST HOLDINGS	1.80	SIRTEX MEDICAL	-0.72
ARISTOCRAT LEISURE	1.75	OZFOREX	-0.54
DOMINO'S PIZZA ENTERPRISES	1.67	INTUERI EDUCATION GROUP	-0.26
RESMED	1.55	OIL SEARCH	-0.16
ALTIUM	1.28	VIRTUS HEALTH	-0.13

**Portfolio Commentary**

Below we provide brief commentary on some of the bigger portfolio contributors for the March quarter.

*Top contributors**1. GBST Holdings (ASX: GBT)*

This financial services group continued to gain investor attention following on from a strong interim result. Management also updated the market on two important developments, including the expansion of the US executive team and the signing of an original equipment manufacturers (OEM) agreement with global software provider SAP. Discussed further on page 25.

*2. Aristocrat Leisure (ASX: ALL)*

The group held its annual investor day, showcasing both gaming products and key personnel, including newly acquired US based Class II business VGT. CEO Jamie Odell outlined the group's key business focus surrounds the growth of its recurring revenue business streams. Here the company lists its combined 29,000 Class II and Class III participation machines (whereby the company shares in the win per day of each machine) as important in achieving a reliable and consistent revenue source. Thirdly, the growth of social gaming via online is gaining in importance, with Aristocrat's Product Madness operations now sitting within the top 10 global social gaming sites.

*3. Domino's Pizza Enterprises (ASX: DMP)*

The company delivered probably the standout result of the reporting season. On almost every metric, management reported above expectations. Importantly the problem region, encompassing the European network of operations reported a significant turnaround, with management now confidently expecting this trend to continue. Overall net profits jumped 44% to \$29m while dividends were lifted 39% to 24.6c. Finally, full year guidance was lifted from 25% net profit growth to 33% underscoring the positive business trends. While not explicitly providing an outlook beyond 2015, current store openings, a rebounding European division and strong cost controls suggests profit growth of above 20% can be expected over the next two to three years.

#### *4. Resmed (ASX: RMD)*

Global sleep apnea leader Resmed posted an excellent second quarter result, delivering strong revenue growth in the flow generator category. This follows the group's successful global launch of its newest product range, the AirSense 10. On the conference call Resmed management underlined that the positive trend was being maintained across all product lines, noting that the group was winning market share.

#### *5. Altium (ASX: ALU)*

Printed Circuit Board (PCB) software designer Altium delivered a significant lift in revenues and profits, along with a solid increase in dividends, accompanied by a debt free balance sheet. Discussed further on page 23.

#### *Bottom Contributors*

##### *1. Sirtex Medical (ASX: SRX)*

The company's highly expected Phase 4 SIRFLOX trial data was released in late March with the headline study results delivering a negative outcome for a statistical improvement in overall progression free survival in the first line treatment of metastatic colorectal cancer patients. Importantly, the company did confirm that a secondary endpoint was met, being a statistically significant improvement in progression free survival in the liver.

Trial designs and their outcomes are never straightforward and while missing the primary endpoint requires a better understanding as to the details surrounding this, it is also true that the SIR-Spheres Y-90 resin microspheres SIRFLOX study was specifically targeted to treat tumours in the liver. Other than the company's release to the market, management have refrained from commenting further at this juncture, as they remain subject to the requirements of the American Society of Clinical Oncology (ASCO) Annual Meeting to be held on 29 May - 2 June 2015, at which point the full body of data will be presented.

Finally, it is important to note that being a Phase 4 trial, the company was not seeking approval to market its product but aiming to increase adoption among oncologist who require a larger sample size to measure the treatments overall benefit. Sirtex remains highly profitable, debt free and continues to build upon the "salvage" market for liver cancer patients who have exhausted all other treatment options. In this context, this trial result does not put at risk this area of the market but may limit its advancement to a first line treatment option.

##### *2. OzForex (ASX: OFX)*

Money bureau operator posted two announcements during the quarter which affected investor sentiment. The first related to third party banking provider Westpac's strategic decision to exit the money service industry. Despite the loss of this long standing relationship the group has in place banking services with another 15 institutions with management downplaying its impact on the business. The company followed this up with an announcement regarding the resignation of its CEO Neil Helm. This did not come as a total surprise since managing a listed business has its challenges and it's clear that having led the business for the past seven years, the company's move onto the ASX in 2014 has led to a

management rethink. The company is undertaking an external search for a suitable candidate, while departing Helm will stay on for a further six months to assist in the transition. We will monitor events, however, we suspect that this event will not damage the group's long term outlook and the current price weakness is providing a buying opportunity.

### *3. Intueri Education Group: (ASX: IQE)*

New Zealand based education group Intueri Education Group failed to meet its prospectus profit numbers despite revenues exceeding expectations. Management were too optimistic in some aspects of the business and our assessment of both management and the business remains under review. Discussed further on page 22.

### *4. Oil Search: (ASX: OSH)*

During the quarter ExxonMobil, operator of the PNG LNG Project announced that the operations had reached a major milestone by satisfying all of its financial completion tests set out under its original financing arrangements. For Oil Search this will result in the group receiving more than USD700 million in the Project's first distribution to co-ventures.

While the sharp fall in oil prices will impact the group's earnings profile, the company is in the fortunate position of having a long duration, low cost LNG project with significant brownfield expansion capability.

### *5. Virtus Health: (ASX: VRT)*

Leading IVF operator Virtus Health's first half earnings were impacted by weak domestic market conditions and higher non-recurring items. This was reflected in higher revenues, up 13% to \$115 million, while net profit before amortisation expenses remained unchanged at \$17.2 million. Despite tougher conditions, management has continued to expand the group's operational footprint both domestically and offshore. The group's Australian market share remains strong at 45.6% while new operations in Ireland and Singapore have begun. Management led by CEO Sue Channon and CFO Glenn Powers continue to expand sensibly, while the group's strong cash flow provides a reliable source of income generation. **SFM**



## Population demographics – does it matter?

The Chinese One Child policy is again under the microscope with senior Chinese academics calling on Beijing to urgently scrap the country's 35 year old program despite some modifications made last year. And the reasoning has the backing of statistics which show that China is facing its own demographic minefield, with a current fertility rate of 1.4 children per woman sitting well below the required replacement rate of 2.1.

As things stand, experts are now comparing China with Japan, which has the world's oldest population and is struggling economically as a result. Even if change were to be introduced, such is the time required for fertility rates to have an impact that China could fall into what experts call the "low fertility trap". Under this scenario, any country that falls below a fertility rate of 1.3 struggles to return to the replacement level. The Australian Financial Review Chanticleer column noted recently;

*"The demographic shifts - as Australia's population ages - are powerful forces. It's a significant driver of the extraordinary appetite by investors for exposure to healthcare companies and also fuelled the rush of aged care company listings on the ASX in 2014."*

It is also one of the reasons why we have chosen to write a piece on the likely global demographic moves out to 2050. Seen as slow moving, demographic trends are hard to reverse once in train, with far reaching economic consequences. For the investor, an understanding of the changing human landscape helps to better position portfolios for the inevitable impact.

Wikipedia defines demographics as the quantifiable statistics of a given population. Demographics can thus be viewed as the essential information about the population of a region and the culture of the people there. Why an understanding of such statistics is important lies in the trends that are established over long time periods.

This update follows on from our June 2006 Selector Quarterly Newsletter where we first investigated population demographics, with particular emphasis on the rising economic powers of China and India. The data, drawn from a vast array of statistics from the United Nations World Population Prospects, provided a useful backdrop when considering the world's changing landscape. While we caution readers in extrapolating their outcomes too much, the 2006 review provided the following comment;

*"As a starting point, a good demographic rule of thumb to remember is that a stable population with a birth rate of 1.3 (children per woman) loses 1.5% of its population each year and within a century will reduce in size by 75%. In Europe today, these circumstances are unfolding for a great many nations. If today's current birth rates continue, in 100 years' time, the descendants of the current inhabitants of Italy, Spain and Greece will number roughly 23% of their present day numbers. At a social level, if Europe maintains its low birth rates its character will be quite unrecognisable within a hundred years, which in the sweep of history is barely a blink of the eye. The economic consequences however are even bleaker."*

*As the World Bank argues in “The third Transition” old populations are a handbrake on economic growth. No surprises here, since with fewer workers contributing to productivity and an ageing population more reliant on care, the knock on effect for governments footing an ever mounting healthcare and pension bill looms large on the horizon.*

*These are economic consequences stem from the generational pressures of a shrinking tax base and compounded by the strong welfare cultures that dominate Europe. Many of these pension and health schemes are unfunded and are paid for out of current taxes placing enormous pressure upon future generations to bridge the funding gap.”*

The World Bank in addressing the 2015 global economic outlook cut their estimate from 3.2% to 3.0%, noting sluggish growth in Europe, Japan and a slowdown in China. Its chief economist Kaushik Basu went further, pointing to shrinking population growth in advanced countries that was putting pressure on productivity and budgets;

*“Worryingly, the stalled recovery in some high-income economies and even some middle-income countries may be a symptom of deeper structural malaise.”*

So what are we to make of the latest data set?

In 2012 the United Nations updated their projections titled; *“World Population Prospects: The 2012 Revision”*. In the following paragraphs we provide some commentary on their latest global demographic estimates. When focused purely on the population numbers, a few things stand out as **Table 1, 2** and **3** outline.

By 2050 India surpasses China as the most populous nation, while China itself is no longer growing. The United States alongside Indonesia and Nigeria are positioned for growth whilst the laggards, including Russia and Japan continue to go backwards. Australia despite its ageing profile is poised to grow strongly driven by a combination of factors.

*Table 1: United Nations Global population prospects - the top 10 and Australia*

Country	Population 2013 (million people)	Population 2050 (million people)	Growth %
China	1,400	1,400	0%
India	1,300	1,600	23%
United States	322	400	24%
Indonesia	252	321	27%
Brazil	202	231	14%
Pakistan	182	271	49%
Nigeria	178	440	147%
Bangladesh	157	202	29%
Russia	142	121	-15%
Japan	127	100	-21%
Australia	23	34	48%

Source: World Bank

*Table 2: United Nations Global population prospects by region*

Region	Population 2013 (m)	2013 % of total	Population 2050 (m)	2050 % of total
North America	358	5.0%	446	4.6%
Latin America	617	8.6%	782	8.1%
Europe	742	10.3%	709	7.4%
Africa	1,100	15.3%	2,400	25.0%
Oceania	38	0.5%	57	0.6%
Asia	4,300	59.7%	5,200	54.2%
<b>Global population</b>	<b>7,200</b>	<b>100.0%</b>	<b>9,600</b>	<b>100.0%</b>

Source: World Bank

*Table 3: Top 5 nations by population 2013 and 2050*

Rank	Country	Population 2013	Rank	Country	Population 2050
1	China	1,400	1	India	1,600
2	India	1,200	2	China	1,400
3	US	322	3	Nigeria	440
4	Indonesia	249	4	US	400
5	Brazil	200	5	Indonesia	321
	<b>Global Population</b>	<b>7,200</b>		<b>Global Population</b>	<b>9,600</b>

Source: World Bank

### *World population trends*

In 2013 the world population reached 7.2 billion and based on current estimates, is set to reach 9.6 billion by 2050. Of the current 7.2 billion, 5.9 billion or 82.5% are located in the less developed regions of the world while the balance of 1.25 billion or 17.5% reside in more developed countries. By 2050 this trend is set to accelerate with just 13.6% expected to live in developed countries.

Asia's population numbers, with this region including countries such as China, India, Japan, Indonesia and the Philippines amongst others, remains the most dominant population hub, with numbers set to rise from 4.3 billion to 5.2 billion. While the Asian region will house 54% of the world's population, Africa's growth rate is expected to surpass this, more than doubling from 1.1 billion to 2.4 billion.

Interestingly, the 2050 estimate of 9.6 billion people is based on fertility rates dropping from current levels. Should they remain at a constant rate, a more likely population number is 11.1 billion.

In terms of concentration, 37% of the world's people live in either China or India, while a further eight countries, namely the United States, Indonesia, Brazil, Pakistan, Nigeria, Bangladesh, the Russian Federation and Japan house a further 22% of inhabitants. India is projected to surpass China by 2028, reaching 1.6 billion by 2050.

*Table 4: World regions in 2013 and 2050*

Regions	More developed	Less developed	Least developed	Global Population
	Europe	Africa	49 countries including	
	North America	Asia	Afghanistan	
	Australia	Latin America	Angola	
	Japan	Caribbean	Bangladesh	
Population (billion)				
2013	1.25	5.0	0.9	7.2
2050	1.30	6.4	1.8	9.5

Source: World Bank

*Population age composition*

In 1950, just 8% of the world’s population was aged 60 years or older. By 2013 this hit 12% and on current projections will continue to rise to 21% by 2050. This number will see the over 60 age group exceed 2.0 billion while the number of children, being persons aged under 15, will drop from 26% currently to 21% by 2050.

At a micro level, the situation in the more developed regions of the world are further pronounced, with the proportion of older persons surpassing that of children in 2013 at 23% compared to 16%, with the over 60’s set to rise to 32% by 2050. Such a trend carries with it negative economic implications particularly for regions including Europe and Japan.

*Fertility*

With accelerating gains in life expectancy, world population growth increased sharply during the twentieth century, where it reached a peak of 2.07% per year. Since then and largely as a result of falling fertility in the developing world, annual global growth narrowed to 1.20% in 2010 and is now projected to decline to 0.51% by 2050.

As we noted earlier, population growth is highly dependent on the path that future fertility rates take. In the more developed countries, fertility rates of 1.66 children per women on average are set to rise to 1.88% and along with a sustained net migration policy, the developed region’s population is projected to remain constant at around 1.3 billion.

In contrast, the least developed nations are expected to remain the fastest growing, even with fertility rates expected to fall from 4.53 to 2.87 children per women.

The importance of such trends is best reflected in their eventual outcomes. In the context of low fertility rates, slow population growth trends leads to an ageing country profile. Importantly, in the developed nations, the number of older persons has already surpassed the number of children and by 2050, if the implied fertility rates continue, the number of older persons will be twice that of children.

Along with an older population base, the issues that many governments now face are only set to grow.

*Mortality*

While global fertility levels are expected to decline, life expectancy continues to rise. In the 1950’s life expectancy at the global level was 47 years, reaching 69 years by 2010. Over the

next 40 years, life expectancy is expected to reach 76 years. In the developed world, life expectancy is already high, sitting at around 77 years but further gains in longevity of 82 years are forecast by 2050. Asia and Africa also expected to experience further gains in longevity, moving from 56 years and 70 years to 69 years and 77 years respectively.

### *International Migration*

Of all the moving parts involved in making projections, international migration is the most difficult to measure and estimate reliably. This is because the movement of people across international boundaries is very often driven by changing social-economic, political and environmental forces.

One of the conclusions the United Nations poses in its projections, is that given the low fertility rates prevailing in developed countries and with deaths expected to exceed births for the foreseeable future, a counterbalance is the role played by net migration gains. On this score the projections reveal net international migrants to more developed regions will total 96 million over the period to 2050, offsetting the 33 million, being the excess of deaths over births.

In terms of net gains of international migrants out to 2050, the projections show the top annual intakes to include the United States with 1.0 million, Canada 205,000, the United Kingdom 172,500, Australia 150,000, Italy 131,250, Russian Federation 127,500, France 106,250 and Spain 102,500.

### *The humanity trend*

Making sense of these long dated projections, is both difficult and daunting. The case often put forward suggests that population growth is the only answer to a country's impending economic decline. An ageing population is hard to reverse and as we have already discussed, imposes additional financial pressures on governments. But a growing country also has its challenges. Population growth may satisfy the statisticians but feeding more and providing housing and employment options for a greater number is not a straight forward exercise.

By way of example, India is now seen to be the rising star. While China is still the most populous nation, India is expected to surpass it within the next decade and certainly by 2050 as **Table 1** highlights. At the point at which these two population paths cross, the median age in China is expected to be 40 while in India it will be closer to 30.

With more than half the population aged under 25, this creates both an opportunity for economic expansion but also the challenge of employing millions of new workers each year. This is a situation to be played out in many regions, including the fast growing nations of Africa and many of our Asian neighbours.

For investors, the daunting aspect of all this is in trying to put all the pieces together so as to come up with some coherent considerations. Suffice to say there are no certainties but a few observations are worth noting, based on the trending evidence thus far.

### *Looking out*

Over recent years investors have had to deal with all matter of shocks, the latest series involving oil prices, currency gyrations and perhaps the most eye catching, negative yields on central bank deposits. As highlighted by James Grant's quote in the front section of our newsletter, for the first time investors are now paying central banks for the privilege of depositing funds with them.

All these outcomes are quite clearly pointing to challenging economic times ahead. Principally, world economies are not operating in sync and as a consequence whilst some nations are making positive progress, the economic cycle for many others remains bleak.

While governments have endeavoured to stimulate activity, the majority, with perhaps the US representing the exception, have little to show for their actions. Rather, the evidence continues to point to a long, slow and grinding economic cycle as being the most likely scenario.

Under such a setting, the demographic challenges are a further amplifier of the cycle. The World Bank categorises nations into three regions, being the more developed regions, the less developed and the least developed. Suffice to say that while the more developed regions have high living standards they also possess the least attractive demographic profile.

Even to the most casual observer one can see how countries including the bulk within Europe, Japan and Russia are facing the twin problems of declining population trends and growing tension towards immigration. Jobs are harder to secure, rising youth unemployment is common and competitive business tensions are impacting company margins and profits.

As a more developed nation, Australia is also facing its demographic moment. While immigration is softening the ageing profile, it is also true that based on current numbers, those people aged over 50 years already exceeds seven million. By 2020 this figure is expected to hit nine million, increasing to eleven million by 2030. This would see a significant change in consumer behaviour, particularly when comparing spending and borrowing patterns. In short, lower levels of economic activity and the need for higher levels of government funding is invariably a by-product of an ageing population profile.

For the less developed nations, inclusive of China and India, all of Africa and Latin America, the demographic trend is far more favourable. Whereas Europe consists largely of developed nations and an ageing population profile, the less developed nations provide businesses with the opportunity to participate in higher levels of economic growth as living standards rise.

In order to take advantage of these opportunities, companies that have chosen to expand beyond our shores offer greater potential upside. While there is ample ability to do well in one location, it is also true that broader geographic exposure in stronger, well placed economies carries longer term reward.

Companies that have successfully transitioned their business to an international focus and who already enjoy strong leading market positions are best suited in these more challenging times.

### *Focusing on Australia*

Under the Charter of Budget Honesty Act 1998, an Intergenerational Report is required every five years. In March the Treasury handed down its 2015 Intergenerational Report, its fourth such review. The report focuses on the implications of demographic change for economic growth and the financial implications of current policies and trends over the next four decades.

The lengthy report highlights a number of trends over this period, including estimates that the Australian population will grow at 1.3% compared to its 1.4% over the last four decades. This will see our population numbers growing from the current 23.9 million to 39.7 million by 2055. The relationship of working age people to those aged over 65 will drop from 4.5:1 today to 2.7:1 in 49 years.

In a separate report and according to PwC, the Australian economy runs the risk of sliding down the gross domestic product (GDP) stakes by the middle of the century if there isn't a renewed focus on businesses and services that will be in greater demand. Specifically it was noted that a move away from resources and towards education, science and new technologies will be needed to address this growing imbalance.

**Table 5** highlights the research findings which would suggest that Australia's position will slip from having the 19<sup>th</sup> largest economy currently, to 28<sup>th</sup> position by 2050. PwC Australia economist Jeremy Thorpe provides an important insight to the changes underway and why politicians need to shift their focus from the next election to an over the horizon strategy;

*"Australia must diversify its economy by investing in highly skilled workers and become the knowledge nation to stop us slipping out of the top 20 economies. Productivity is the only real lever we have. It's refocusing from digging stuff up out of the ground to being a smarter country operating at the higher value end of the markets in which we compete."*




Table 5: GDP ranking by 2050

**Falling from grace**

Projected GDP at purchasing power parity rankings (in 2014 \$USb)

PPP Rank	2014		2030		2050	
	Country	(\$USb)	Country	(\$USb)	Country	(\$USb)
1	China	17,632	China	36,112	China	61,079
2	US	17,416	US	25,451	India	42,205
3	India	7,277	India	17,138	US	41,384
4	Japan	4,788	Japan	6,006	Indonesia	12,210
5	Germany	3,621	Indonesia	5,486	Brazil	9,164
6	Russia	3,559	Brazil	4,996	Mexico	8,014
7	Brazil	3,073	Russia	4,854	Japan	7,914
8	France	2,587	Germany	4,590	Russia	7,575
9	Indonesia	2,554	Mexico	3,985	Nigeria	7,345
10	UK	2,435	UK	3,586	Germany	6,338
11	Mexico	2,143	France	3,418	UK	5,744
12	Italy	2,066	Saudi Arabia	3,212	Saudi Arabia	5,488
13	South Korea	1,790	South Korea	2,818	France	5,207
14	Saudi Arabia	1,652	Turkey	2,714	Turkey	5,102
15	Canada	1,579	Italy	2,591	Pakistan	4,253
16	Spain	1,534	Nigeria	2,566	Egypt	4,239
17	Turkey	1,512	Canada	2,219	South Korea	4,142
18	Iran	1,284	Spain	2,175	Italy	3,617
19	<b>Australia</b>	<b>1,100</b>	Iran	1,914	Canada	3,583
20	Nigeria	1,058	Egypt	1,854	Philippines	3,516
21	Thailand	990	Thailand	1,847	Thailand	3,510
22	Egypt	945	Pakistan	1,832	Vietnam	3,430
23	Poland	941	<b>Australia</b>	<b>1,707</b>	Bangladesh	3,367
24	Argentina	927	Malaysia	1,554	Malaysia	3,327
25	Pakistan	884	Poland	1,515	Iran	3,224
26	Netherlands	798	Philippines	1,508	Spain	3,099
27	Malaysia	747	Argentina	1,362	South Africa	3,026
28	Philippines	695	Vietnam	1,313	<b>Australia</b>	<b>2,903</b>



Source: PwC Australia report findings by economist Jeremy Thorpe

**Companies seeking growth**

With the majority of the World's population residing in either the less developed or least developed nations, those that have transported their business offering to these regions are at least offered the opportunity to experience above average growth rates.

The Fund holds a number of these businesses of which a few are highlighted below. As the next article will profile, one such company is leading online employment group **SEEK**. We featured this business in our March 2012 Selector Quarterly Newsletter, however, as it remains one of the Fund's largest individual investments, a revisit is worthy. We are also undertaking a site visit to Asia in May which we will report on in our next quarterly.

Whilst the origins of the **SEEK** business are definitely local, the vision of management to export their service offering to a wider international audience is now taking shape. Suffice to say that with leading online employment operations in Singapore, Thailand, Indonesia, Philippines and Malaysia, the business is perfectly positioned to at least benefit from the demographic trends now underway.

Gaming operators **Aristocrat Leisure** and **Ainsworth Game Technology** are also well placed to cash in on the growing tourism trade. This is very evident in the Asian Pacific region as



countries including Macau, the Philippines and Singapore, to name a few, embark on attracting more foreign capital.

Similarly the growing travel market is benefiting operators including **Flight Centre Travel Group**, who now operate from 11 countries, including mainland China, India, Singapore and South Africa. The company offers the twin benefit of operating in the more developed nations, where an older demographic population is increasingly spending more on overseas travel, as well, as establishing itself in the up and coming less developed areas.

Leading health care operators including bionic ear implant specialist **Cochlear**, sleep apnea manufacturer **Resmed**, blood plasma group **CSL**, IVF operator **Virtus Health** are increasingly extending their global network to a much wider and needy audience. As living standards rise, health demands will follow suit, more than justifying the infrastructure and investment spend now taking place.

Education providers **Navitas** and **Intueri Education Group** are also riding the wave, even though their services are being offered closer to home. As international students seek higher levels of education and broader employment options, the university pathways now available in countries including Australia and New Zealand have allowed both these businesses to flourish.

Online portals associated with auto group **Carsales.com** has been extended into the growing Asian and South American markets. Already dominant in its local market, the increasing global trend towards online adoption compliments the regions demographic shift profile.

The **iProperty Group** is another online player, however, its focus is purely Asian based. With a commanding market position in regions including Malaysia, Hong Kong and Indonesia, the business has the capability of achieving significant growth as these respective markets mature.

There are, as these businesses illustrate, abundant areas in which to grow. The preparedness of businesses to venture offshore is increasing and whilst some will fail, those that have leading technologies and dominant market positions will benefit enormously as they enter into large, untapped markets. In time, these moves will augment current operations, whilst also opening up more prospective markets in which to grow.

### *Summary*

Demographic trends are hard to fight. Once underway their long term impact can be both profound and hard to reverse. Unlike cyclical events which can be shorter in duration, demographic change can either herald strong economic growth or declining prosperity. One can never precisely know how things will turn out, however, the challenges now facing some of our more developed countries may be just beginning. **SFM**

## SEEK (ASX: SEK)

**SEEK** has built a formidable online employment business since its establishment in 1997. Founded by brothers Paul and Andrew Bassat along with co-founder Matthew Rockman, the business cemented its local job seeker leadership as the market for employment shifted from print to online.

The group's entrepreneurial approach, led by a management team that thinks long term and invests accordingly, now has the business positioned for offshore success.

While the group made its debut on the Australian Stock Exchange in April 2005, its first foray offshore took place in October 2006, when **SEEK** acquired an initial 25% interest in **Zhaopin**, one of the leading online employment sites in China.

Since then the company has made a series of new country investments as **Table 6** highlights.

*Table 6: SEEK's offshore foray*

Region	Entity	Holding	Initial Investment	Total Investment AUD (m)
China	Zhaopin	66.4%	2006	\$218
Brazil	Catho	51%	2008	\$187
Mexico	OCC Mundial	56.4%	2010	\$67
Asia*	SEEK Asia	75.6%	2008	\$554
Africa**	One Africa Media	24.4%	2013	\$20
Bangladesh	Bdjobs.com	25.0%	2014	\$5
<b>Total Investment</b>				<b>\$1,048</b>

Source: SEEK presentation material

\* Includes Singapore, Malaysia, Thailand, Indonesia, Hong Kong & Philippines

\*\* Includes Kenya, Nigeria, South Africa

*Table 7: Look through International earnings\**

Year ending	"Look Through" Revenue (\$m)	"Look Through" EBITDA (\$m)
2007	6.0	(3.2)
2008	14.2	(6.7)
2009	59.6	(8.5)
2010	73.8	9.2
2011	128.3	35.7
2012	173.9	48.6
2013	219.5	64.3
2014	254.4	80.6

Source: SEEK

\*Look through revenue and EBITDA is based on ownership as at each reporting date

Management make no secret of the reasoning behind the locations chosen. When compared to Australia's population base of 24 million, **SEEK's** combined offshore demographic exposure as highlighted in **Table 8** exceeds 2.9 billion, representing some 20% of global gross domestic product. On the face of it, the sheer weight of numbers should be compelling enough, however, these regions are located in what the World Bank describes as less developed nations.

*Table 8: International markets*

Country	Population (m)	Internet Users (m)	Internet Penetration (%)	Internet Growth (%)
China	1,350	618	46	10
Indonesia	251	71	28	13
Brazil	201	100	50	12
Nigeria	173	57	33	19
Bangladesh	166	11	7	13
Mexico	119	46	39	11
Philippines	106	38	36	27
Vietnam	93	41	44	11
Thailand	67	18	27	12
South Africa	49	20	41	20
Kenya	44	14	32	17
Malaysia	30	20	67	2
Hong Kong	7	5	74	2
Singapore	6	4	73	1
Other markets	255	9	3	n/a
<b>Total</b>	<b>2,918</b>	<b>1,072</b>	<b>37</b>	<b>12</b>

\* Source SEEK presentation 2015 – internet trends 2014

As our previous article on population trends outlined, the less developed nations, which includes Asia, offers investors a more attractive demographic profile as well as the emergence of a middle class in search of higher living standards.

We suspect that **SEEK's** forward thinking approach has them ideally placed to reap the economic returns of market leadership in nations that are positioned to grow strongly in the years ahead.

As the demographic tide rolls in, one country that is expected to be impacted is Japan. With a current population of 127m, forward estimates indicate a figure of 100m is more likely in the coming decades. This may well explain why Japanese corporations, such as Japan Post's most recent \$8.5 billion takeover of local transport group Toll Holdings, are moving to acquire offshore assets, described by some as the "demographic imperative" to act.

#### *SEEK's investment philosophy*

It is refreshing that a company sticks to its philosophy over an extended period. Internal and external pressure usually gives way when businesses confront short term challenges. **SEEK** has thus far succeeded in building a business underpinned by two core principles, firstly, focusing on a long term strategy and secondly, reinvesting for the long term.

Whilst the two may sound similar, they are quite different in practice. In our experience, companies that have been built from the ground up, by owner managers, usually approach the task of building shareholder value in a different way to those who appoint external managers.

**SEEK's** management team is of the former, focusing on the need to invest today in order to reap tomorrow's rewards. **Table 9** is illustrative of this approach, having first embarked on its

international strategy in 2006. As the figures show, the first three years were painful enough, with losses mounting and markets rattled by the onset of the global financial crisis. In year four, the numbers turned positive, a trend that has continued to the present.

To date, the group has invested approximately \$1.0 billion in capital to establish and build upon the original investments made, spanning a period of nine years. Importantly, the group has relied on internally generated cash flows to fund these new avenues of growth, having last undertaken an equity raising in 2009 post the 2008 financial crisis.

In the company's most recent half year results, over 38% of group revenues were generated from offshore operations, contributing some 31% of operating earnings. Such is the scale, that inevitably international operations will deliver the group the lion's share of revenues and profits. Perhaps the group's investment in China via **Zhaopin** best illustrates this approach and the potential rewards that are available.

#### *Zhaopin- "to recruit - to hire"*

China's most popular online job site is owned 66.4% by **SEEK**. In June 2014, more than eight years after **SEEK** made its first investment, **Zhaopin** sought a listing on the New York Stock Exchange, principally driven by a desire to promote brand awareness whilst delivering greater financial accountability. At the current share price of USD16.95 per share, **Zhaopin** is valued by the market at USD850 million, placing the group on a prospective price to earnings ratio of about 20 times. The company is also sitting on approximately USD220 million of net cash, illustrating the strong financial position underpinning the company's impressive credentials.

As **Table 9** highlights, **Zhaopin's** progress has been both measured and reflective of management's strategic intent to focus on growing a market leading position. Operating losses in the early years have now given way to strong recurring revenues and profits, allowing management to maintain an aggressive reinvestment program, as it aims to maintain its leadership position.

Perhaps illustrative of the potential, China's online employer numbers in 2013 were estimated at two million, a figure that is set to double by 2017. In comparison, **Zhaopin's** unique employer numbers sits currently at 272,000, representing a market penetration of just 13.5%. It is therefore not surprising that management remains focused on expanding the group's nation footprint in targeted markets, servicing specific industries.

We will gain a greater insight into the business and management team post our China trip in May where we will visit the Beijing operations of **Zhaopin**.

*Table 9: Zhaopin's financial progress (AUD m)*

Year	Revenue*	EBITDA*	Cumulative Profit/(Loss)
2007	25.0	(13.4)	(13.4)
2008	40.8	(19.4)	(32.8)
2009	59.9	(26.6)	(59.4)
2010	65.7	(5.3)	(64.7)
2011	97.3	18.3	(46.4)
2012	125.3	31.7	(14.7)
2013	138.23	38.4	23.7
2014	183.9	52.4	76.1
2015 (1H)	117.6	31.8	107.9

\*Zhaopin revenues and earnings before interest, tax and depreciation reported on a 100% ownership basis. Source SEEK presentation documents.

### Summary

As **SEEK's** geographical investment footprint clearly shows, management have been prepared to make the necessary upfront capital commitment to build a stronger, more durable business. We suspect the best years are still ahead for this company and management team, assisted no doubt by the changing demographic landscape and the group's first mover advantage. The Fund holds **SEEK** in its portfolio holdings.

We believe all four tenets are well covered:

1. Management,
2. Business leadership,
3. Balance sheet,
4. Capital management. **SFM**

## Reporting season updates

### *1. Blackmores (ASX: BKL)*

In 2013 Australia's leading vitamin group **Blackmores** was in a world of pain. Facing competitive pressure from fellow operator Swisse, as well as pricing demands from key customers, Chemist Warehouse and Woolworths, the group's management team led by CEO Christine Holgate were fighting fires on all fronts. A lower full year net profit of \$24.9 million ultimately ensued, while operating margins tanked from 16.1% to 11.9%.

Fast forward to the group's 2015 interim result and it is crystal clear that the changes put in train post the difficult 2013 period have delivered investors one of the stand out results of the reporting season. On all key metrics the outcomes are impressive and illustrate what can be achieved when a company is forced to re-examine all aspects of business operations.

The headline numbers showed sales up 22% to \$206 million, while net profits jumped 54% to a record half year result of \$18.6 million, on the back of strong Australian sales, up 29% to \$137 million. The group has clearly taken market share but not at the expense of profits, with operating margins climbing from 11% to 14%.

Asian sales continue to grow impressively despite ongoing political issues impacting the group's largest market, being Thailand. Overall, offshore sales grew 5% to \$37 million, with the group now operating in eight Asian countries, led by leading positions in Malaysia, Thailand and Singapore, as well as establishing a beachhead in its newest market China.

A particularly impressive aspect of the result was the generation of strong operating cash flow given the renewed emphasis placed on more effective inventory management controls. This led to lower working capital and a further repayment of group net debt, down to \$37 million, noticeably lower than the \$82 million at December 2012.

Management upped interim dividends 55% to 68 cents per share and whilst no full year guidance was provided, directors noted confidence about delivering shareholders a strong full year result. It would appear that the group is on track to deliver a net profit in excess of \$36 million and total dividends of at least \$1.60 per share. Having weathered the competitive events of the past few years, the business appears well placed, both here and abroad, to continue on its most recent path.

### *2. Ainsworth Game Technology (ASX: AGI)*

In our June 2014 Selector Quarterly Newsletter we profiled leading gaming provider Aristocrat Leisure. Aristocrat's founder Len Ainsworth parted with the company in 1994, establishing a new gaming business in 1995, this time bearing his name, **Ainsworth Game Technology**.

This group listed in 2001 and following a difficult few years, firmly established itself in the domestic scene, winning market share from the likes of **Aristocrat** as well as receiving regulatory approval to sell into offshore jurisdictions including the highly contested US market.

Following strong year on year growth since 2011, the group's 2015 interim performance fell short of investor expectations. Despite management guiding to a lower first half, the result nevertheless underwhelmed the market. Group revenues fell 8% to \$112 million while regional segment earnings dropped 17% to \$52.5 million. Net profit was largely unchanged at \$34.6 million due largely to a significant foreign exchange gain totalling \$10 million.

However, as is often the case, these numbers don't necessarily tell the whole story. Investors, particularly professionals, are notoriously quick to jump off when any disappointments emerge. As the **Blackmores** update highlights, businesses are constantly being challenged and setbacks are part and parcel of everyday life. Our focus is not so much driven on whether results are delivered in any given period but on the overall progress a business is making.

On this score, **Ainsworth's** first half update is reassuringly on the right track. While Australian sales fell 34% to \$54 million, the majority of the slowdown was as a result of regulatory changes in Victoria and delays in product approvals. Management remains confident that the second half will see these issues addressed.

Offshore, the result is much more pleasing. International revenues jumped 45% from \$40 million to \$58 million, with the North American market leading the way, with sales up 47% to \$30 million and segment profits up 47% to \$12.9 million. The US market remains a key strategic priority for management as it looks to build a significant long term presence, with plans to construct a purpose built facility in Las Vegas now in train.

The importance of the US market to the group should not be underestimated. Having only recently entered the market, **Ainsworth** sold 1,116 machines during the half, up 39%. In addition, the group lifted its installed base of recurring machine units from 780 to 1,223 while the average fee per day earned dropped from USD37 to USD33. Overall, the group is in the very early stages of product rollout in a market that is significantly larger in scale.

Financially, **Ainsworth** remains debt free, with net cash of \$54 million. Despite the lower first half, management is pointing to a higher full year result, led by the group's international operations and assisted by an increased contribution from domestic markets.

### *3. Intueri Education Group (ASX: IQE)*

The real test of any business is the level of achievements measured over many years. However, it also pays to deliver in your maiden year as a publicly listed company, something that education provider **Intueri** failed to do. While full year group revenues hit the mark, coming in at \$77.5 million, the same could not be said of operating earnings which at \$14.5 million, fell some 10% short of the group's prospectus numbers.

This was partly driven by higher operating costs, as the company increased marketing spend and took on additional staff to improve group compliance. However, the main issue surrounded lower domestic student revenues of \$44 million, compared to the \$49 million expected. Despite expressing confidence in achieving this target at the half way mark, management admitted to taking their eye off the ball.

While domestic revenues, which accounted for 57% of total sales were softer, the two remaining divisions performed ahead of expectations. The group's International student division reported revenues of \$19.2 million while the newer Australian Online operations posted sales of \$12.1 million, well ahead of the \$7.3 million expected.

The business has certainly faced some challenges in its first year as a publicly listed company. Operating in a highly regulated industry, management emphasises the importance of maintaining high learning standards. Despite the earnings setback, the group reiterated operating earnings for the 2015 year to fall within the range of NZ\$30 - NZ\$33 million. The share price decline post the group's results announcement now sees the business trading on an undemanding multiple of 10x accompanied by a fully franked dividend of 6.5%.

#### 4. *Altium: (ASX: ALU)*

In our December 2014 Quarterly Newsletter we featured an introductory piece on **Altium**. At the time we reported that **Altium** had 129 million shares on issue and a corresponding market capitalisation of AUD425M. The company delivered one of the standout results of the 2015 interim reporting season and now boasts a market capitalisation of circa AUD570M.

On page fourteen of that Newsletter, we identified the business foundations and four key areas of focus;

1. A new CEO who has a long history with the business	COMPLETED
2. Relocation of the business to the key USA market	COMPLETED
3. New and timelier product releases	FOCUS
4. A focus on annuity income driven by subscription sales	FOCUS
5. A push into both the high and low end of the market opportunity set	FOCUS
6. Net cash of USD\$64 m to close technology gaps - acquiring technology or businesses to achieve this	FOCUS

We provided our initial views and now look to expand on those areas that were under focus with a brief update.

The new and timelier product releases and push into both the high and low ends of the printed circuit electronic software design market saw the company make three releases in the half, as set out below.

#### **New and Timelier Product Releases and a Push into both the high and low end**

Three releases occurred in the H1 2015.

##### 1. *Circuit Maker*

This is at the low end of the pyramid and was released on a term based licence. Essentially Circuit Maker is free with tool upgrades that cost up to \$1,000. This product is an attempt to capture future users. Circuit Maker is currently in beta testing, and will become available from May 2015.

##### 2. *Circuit Studio*

Also at the low end of the pyramid this is a product released in conjunction with Premier Farnell (Premier Farnell are a Global PCB Parts Supplier - as a channel distributor). This is a paid professional tool for designers of one off projects or infrequent tool use. Circuit Studio



retails at \$2,500 plus a \$400 annual subscription fee, of which 35% is paid to Premier Farnell and the balance passed onto **Altium**. Sales of Circuit Studio started in February 2015.

### 3. PCB Works

Represents the world's first "SolidWorks" (dominant player in Mechanical CAD design referred to MCAD) collaboration, which effectively links ECAD and MCAD design for the first time. **Altium** are signing SolidWorks distributors globally to sell the software product, with a suggested retail price of \$5,000, split 60%-70% to **Altium** and the balance to SolidWorks. Sales of PCB Works will start in April 2015.

Under both these partner arrangements **Altium** will only record their percentage of the revenue sales without incurring any additional costs. **Altium** refers to this as the leveraged sales model in that they are leveraging the sales networks and distribution capabilities of leaders in niche segments of the PCB market.

Management have flagged that they expect a contribution from these three products from financial year 2016 onwards, with an initial top line revenue figure of \$10 million considered a good outcome. Currently **Altium** make no adjustments to their three year aspirational revenue target of \$100 million, but as always this remains subject to change.

A fourth release is expected later this year.

### 4. A High End Tool

A high end tool is in the final research and design stages with the marketing strategy expected to be discussed at the full year results briefing. This is new to us. We had previously flagged that entry into the top end of the pyramid would most likely occur post **Altium** partnering or acquiring assets in this space – referring to a need to close the credibility gap as the company is seen as a specialist in the mid-tier of the pyramid rather than the top end.

We still expect them to pursue both of these avenues in time, however, its initial entry into the high end is imminent and we flag it as an important achievement for the company. This approach will be dovetailed with a previously acquired business called "Tasking" and supported by endorsements from existing customers.

Tasking is a division of **Altium** and its software design is predominantly used in the auto market. Tasking is a compiler - it takes code in language that a programmer understands and is confident in using to make designs. This language is then transformed into code for electronics software or one that a computer chip can run. In Europe, 75% of cars have software, run on Infineon chips, with some code designed by Tasking. To this point the Tasking division has been largely ignored by **Altium**. This will now become a key focus as the group looks to enter the high end PCB market.

Today, **Altium** is building a top end market play around Tasking, believing that with existing relationships like Infineon, an opportunity will open up that services the auto makers' very large investment budgets. Selector expects acquisitions will be used to assist this drive into the top end.

### Shift to Subscriptions

In its results commentary, **Altium** noted they have seen a strong uptake of subscriptions and boldly stated that they, given time, hope to change their business model from a perpetual licence to one of annual subscriptions.

### Other

Importantly, the interim dividend was lifted by 50% to AUD 8 cents per share with management aiming to progressively lift the amount paid out over time.

### 5. *GBST Holdings: (ASX: GBT)*

**GBST** is emerging as a global player in the provision of software solutions for financial markets. The company has 66 million shares on issue and a market capitalisation of \$360M at the time of writing. At its core, the company's software business model delivers increasing scale benefits as more clients adopt the services offered.

**GBST** comfortably surpassed market expectations in the half year to December 2014. Pleasingly, revenue generated offshore surpassed domestic revenue for the first time. Operating earnings (EBITDA) and margins (EBITDA) both grew, while cash flow was a highlight. The company ended the period with no debt and with net cash, an important milestone delivered for the first time.

The United Kingdom was the standout region with three new customer implementations undertaken, taking the total to nine. Today, the GBST Composer platform is at the heart of UK regulatory changes that started eight years ago and which have resulted in the establishment of four million new mandatory pension accounts over the past three years.

The group is developing a very strong reputation in the UK for software solution delivery, successfully deploying projects on time and on budget. This is in stark contrast to its nearest competitor Bravura who undercut **GBST** to win three significant deals. Our understanding is that their aggressive pricing has really bitten both the competitor and the clients. Each of the three implementations have suffered delayed start dates and cost overruns that are significant enough to see Bravura closed to new business.

**GBST** has a strong pipeline in the UK and we expect to see an additional two to three new implementations in the second half of 2015. Margins will continue to improve as scale is achieved.

Australia is the cash cow of the business. It is a more challenged market and a similar performance is expected in the second half of 2015. Some projects have been delayed but they have not gone away. In fact, according to the company the pipeline of new work has improved.

Recent announcements relating to the business in the USA reflect the very strong performance of the foundation client, Raymond James, and the importance of achieving business scale. While Raymond James has entered into a second phase of work, **GBST** is in need of another client. In response **GBST** has put what appears to be a strong and experienced senior management team on the ground in the USA for the first time in order to secure new

business in the region. Like the UK, the USA offers bulge bracket clients and **GBST** is in the position to provide a global solution. This should yield success in the years ahead.

As a specialist financial software service provider **GBST** is growing rapidly (maybe even straining at the sides a little) and has publicly stated that it is disappointed that it is not executing at a more rapid clip. In the half **GBST** announced a distribution agreement with managed services behemoth **SAP**. **SAP** has a very sophisticated sales network with access to the world's leading financial customers.

The initial agreement will see **SAP** distributing a single **GBST** module developed for Europe's Financial Transactions Tax, a stamp duty type tax levied on all transactions – a typical knee jerk reaction from cash strapped regulators and Governments post a global financial crisis type event.

Early success will likely see this relationship extend to cover sales of core **GBST** products which have been built so as to be compatible with **SAP's** product suite. While it is too early to pencil in numbers and build in expectations this relationship has the potential to deliver global SCALE ... or more likely a corporate transaction. *SFM*

## iProperty Group Limited (ASX: IPP)

In the September 2014 Selector Quarterly Newsletter, we provided a short profile on **iProperty Group**, an Asian based online real estate classifieds business. In it, we outlined why we felt confident about **iProperty's** competitive standing and the size of the opportunity on hand.

Recently appointed CEO Georg Chmiel has been at the helm for just a year. During this initial period, Chmiel has reaffirmed the group's core focus whilst making considerable progress in each of the company's key markets. Importantly, during the recent half, management announced the purchase of Hong Kong based competitor SquareFoot.com.hk from Australia's leading online real estate business **REA Group**, with consideration involving the issue of 5 million new shares. Thailand's leading online real estate classifieds business was also added late in the half, for AUD6m cash and AUD2m in stock.

By engaging earlier with the developer market, the company provides a compelling alternative to competing online real estate businesses. **iProperty** has identified that by engaging with developers of new property, more value can be added than at the typical later stages of a sales cycle. Having the ability to source large amounts of data on buyer preferences, information including the size of units sought and at differing price points can be shared with developers, something subscale competitors struggle to provide. By engaging earlier in the development pipeline, **iProperty** has seen increased developer interaction with this trend likely to continue.

### iProperty's Primary Markets

#### *Malaysia – iProperty.com.my*

During the December 2014 half year, the company extended its lead over **PropertyGuru**, its closest rival and despite significant price rises (60% increase for subscriptions and between 70% and 100% increase for depth products) **iProperty** subscription rates were maintained.

Malaysia continues to generate healthy operating margins of greater than 50% despite continued investment in the business to maintain product supremacy. Although still immature, the Malaysian market is illustrative of the latent potential of **iProperty's** other Asian operations, as the structural shift of advertising spend from print to online unfolds.

#### *Hong Kong – GoHome.com.hk & SquareFoot.com.hk*

As we outlined in our September 2014 Quarterly Newsletter, **iProperty** and **REA** consummated a deal whereby **iProperty** has taken ownership of **REA's** SquareFoot.com.hk website, Hong Kong's number two player. In exchange **iProperty** has issued **REA** Group five million shares, valuing the deal at \$15 million.

Aside from their willingness to accept script as consideration, the involvement of **REA** as a shareholder, along with board representation adds value in a number of areas, particularly in regards to technology sharing and business collaboration.

Operationally **iProperty** increased prices for subscriptions and depth products during the year and plans are in place to increase prices by a similar magnitude next year.

### *Singapore – iProperty.com.sg*

In September we noted that **iProperty** had written down the goodwill associated with the Singaporean business as they saw the need for ongoing investment. Despite those expectations, management have formulated a strategy which will see them move into a breakeven position, possibly even a small profit by the end of financial year 2015. **iProperty** will now use Singapore as their international developer sales hub and will move away from their initial focus on the purely domestic developer and agent market.

This model involves marketing property developments to Asian investors on behalf of international developers. Given the demand from Asian investors for real estate in other countries, this opportunity is potentially larger than what we had originally anticipated in Singapore.

### *Thailand – ThinkOfLiving.com*

In February, 2015 **iProperty** announced an agreement to purchase Thailand's number one real estate classifieds website ThinkOfLiving.com for AUD6 million cash and AUD2 million worth of **iProperty** shares as well as an earn-out payment contingent on the business's performance. ThinkOfLiving.com is already profitable, and has a strong focus on the developer market, although it has yet to monetise the agent advertising business.

While **iProperty** can utilise learnings from other markets to develop a more coherent agent model, the group has also acquired a number of technologies in ThinkOfLiving that can be rolled out across its other websites.

The purchase immediately gives **iProperty** the number one market position. Operating in a country with a population of 68 million people with roughly 180,000 apartments sold annually in the Bangkok area alone, the annual real estate advertising spend is estimated at AUD130 million. Of this total, only 2% is currently sold online. Management describes the maturity of Thailand as similar to that of Malaysia five years ago. As with all of **iProperty's** market leading businesses, we expect the Thai business will capture the lion's share of advertising dollars shifting from print to online.

### *Indonesia – Rumah123.com*

Indonesian operations are loss making and the least mature. Nationally approximately AUD120 million is spent on real estate advertising compared with Malaysia's AUD270 million annually. This is despite Indonesia being home to a population of 250 million compared to Malaysia's 30 million.

In spite of strong competition from **PropertyGuru**, **iProperty** has strengthened its leadership position by delivering more value through greater sales leads to developers and agents. This has allowed **iProperty** to increase subscription prices even as Property Guru has been lowering theirs. While the group expects to register ongoing losses in this market, the long term prize is large enough to justify its ongoing investment.

## Summary

There are four core premises to our investment rationale:

- **Market leadership in the online classifieds business is critical.** During the year **iProperty** consolidated its leadership position in Malaysia, Hong Kong and Indonesia whilst also acquiring the leading player in Thailand. In the online classifieds business, market leadership can be a virtuous cycle. Higher volumes of user traffic entice more listings from agents and developers, while more listings attract more traffic. **iProperty** is focused on improving the value of their offering, by delivering more leads and better outcomes for agents and developers thereby reinforcing the cycle.
- **Pricing power flows from market leadership and affordability.** The table below illustrates the cost of subscribing to **iProperty's** basic advertising packages in both Malaysia and Hong Kong, the cost of premium listings in those markets and the commissions the agents keep after completing an average transaction.

	Average Transaction Commission (AUD\$)	Base Package Cost Per Year (AUD\$)	Depth Product Cost Per Unit (AUD\$)	Base Package Cost as % of Average Commission	Depth Product Cost as % of Average Commission
Malaysia	\$3,200.00	\$600.00	\$11.00	18.75%	1.83%
Hong Kong	\$15,000.00	\$300.00	\$1.70	2.00%	0.01%

What is evident from the table is how little online real estate advertising costs for an agent compared with what an agent can earn in commission (after paying a share to their agency) on an average transaction. It is important to understand how early in the process **iProperty** is at the moment, even in the case of Malaysia. As online advertising accelerates, the group is in a powerful position to exercise its market pricing power as witnessed in numerous other developed markets. This is something we underestimated with our investment in **REA**.

- **iProperty has a strong management team with a clear strategy.** Since taking the helm of **iProperty**, CEO Georg Chmiel has sharpened the company's operational approach and undertaken a number of important strategic acquisition. The involvement of leading online property player **REA** has provided early validation on the group's progress to date as well as providing ongoing support to the longer term business potential.
- **With net cash of roughly AUD12m at December 2014 I Property has a robust balance sheet. *SFM***

## The importance of dividends

One way a business can be measured is the cash return it generates. If a business does not generate cash its shareholders are dependent on capital appreciation.

Investors often place too much emphasis on the dividend alone. We would argue that it is more prudent to make an assessment on the earnings profile of the business and how much of those earnings might reasonably translate into a dividend, without starving it of capital.

By way of example, over the 20 years to the end of February 2015, the All Ordinaries Index has returned 5.79% annually. In contrast, the All Ordinaries Accumulation Index, which is calculated by reinvesting dividends, returned 10.14% annually. Over the same period, an investor with an initial investment in \$10,000 would have seen that grow to \$68,992. However, of the \$58,992 dollar value added to the initial investment, more than 60% of the growth is delivered by reinvested dividends, while capital appreciation is responsible for less than 40% of the value added. This highlights the importance of dividends in the role of wealth creation.

*Table 10: All Ordinaries vs All Ordinaries Accumulation Index, March 1995 – Feb 2015*

	All Ordinaries Index	All Ordinaries Accumulation Index
Annualised Return	5.79%	10.14%
Initial investment value	\$10,000.00	\$10,000.00
Ending investment value	\$30,808.16	\$68,991.50
Dollar value added	\$20,808.16	\$58,991.50
Dollar value added from dividends and reinvested dividends	\$0.00	\$38,183.33
Dollar value delivered by capital appreciation	100.0%	35.3%
<b>Value delivered from reinvested dividends</b>	<b>0.0%</b>	<b>64.7%</b>

The prospect of holding a business for ten years might be difficult to stomach, however, businesses take time to grow, and good businesses can take many years to develop into great businesses. The patience required is an important temperament, even for professional investors, but it is a skill we endeavour to practice.

A notable example is **Flight Centre Travel Group (Flight Centre)**, which listed on the Australian Stock Exchange in December 1995, some 20 years ago. **Flight Centre** closed on its first day of trading at \$1.21, compared to the float price \$0.95 per share. Some savvy investors sold out on day one, locking in a tidy profit. Fast forward and **Flight Centre** now trades at \$40 per share but more importantly has progressively lifted its dividend payout over the years to the current level of \$1.55 per share.

**Flight Centre's** remarkable achievements over this period have been no easy feat. Delivering these results has required a strong management team executing consistently in the face of the sometimes inconsistent demands of impatient investors. Operating through the turbulent period of 2008 certainly tested the mettle of both management and shareholders. The

emergence of online competitors and the structural challenges to the traditional shop front has also led to persistent questions on whether the business model is the right one. And of course they have made many mistakes along the way. Irrespective of the challenges, **Flight Centre** has adapted to the environment with a preparedness to invest, consistent with its business strategy.

Shareholders who took profits on day one would have scoffed at the suggestion that the company might one day pay back more each year in dividends than they were taking off the table. This situation, however, illustrates our point perfectly. A stock can look overpriced at certain points in time, but the longer term prize on offer may not always be apparent. Eschewing short term profits in favour of holding quality businesses for long periods of time can generate better outcomes for investors.

The key point we wish to illustrate here, is that efforts to measure the progress of a business on a quarterly or even semi-annual basis is subject to many shortcomings and is often contrary to how successful management teams run their businesses. Investors need not ignore such developments, but more important is that the message delivered by management remains consistent with the results and actions undertaken.

When long term investment horizons are combined with good quality businesses capable of delivering modest earnings growth, investors can find the cash returns delivered over time more than adequately reward a patient strategy. **SFM**



## Company visit diary March Quarter 2015

### January

IFM	Infomedia conference call	07/01/15
RMD	Resmed 2 <sup>nd</sup> Quarter results briefing	28/01/15

### February

JBH	JB Hi-Fi HY15 results briefing	02/02/15
NVT	Navitas HY15 results briefing	03/02/15
EGP	Echo Entertainment HY15 results briefing	04/02/15
FXL	Flexigroup HY15 results briefing	05/02/15
REA	REA Group HY15 results briefing	05/02/15
SDA	Speedcast International investor day	06/02/15
ANN	Ansell HY15 results briefing	09/02/15
COH	Cochlear HY15 results briefing	10/02/15
CSL	CSL HY15 results briefing	11/02/15
DMP	Domino's Pizza Enterprises HY15 results briefing	11/02/15
CPU	Computershare HY15 results briefing	11/02/15
ASX	ASX HY15 results briefing	12/02/15
BAP	Burson Group HY15 results briefing	12/02/15
GBT	GBST Holdings HY15 results briefing	13/02/15
SDF	Steadfast Group HY15 results briefing	13/02/15
SEK	SEEK HY15 results briefing	17/02/15
IVC	Invocare HY15 results briefing	17/02/15
ZPIN	Zhaopin Q215 results briefing	17/02/15
CAR	Carsales HY15 results briefing	18/02/15
SRX	Sirtex Medical HY15 results briefing	18/02/15
IFM	Infomedia HY15 results briefing	20/02/15
JHX	James Hardie Industries 3 <sup>rd</sup> Quarter results briefing	20/02/15
IPP	iProperty Group FY14 results briefing	20/02/15
SUL	Super Retail Group HY15 results briefing	20/02/15
NHF	NIB Holdings Hy15 results briefing	23/02/15
VRT	Virtus Health HY15 results briefing	24/02/15
FLT	Flight Centre Travel Group HY15 results briefing	24/02/15
BRG	Breville Group HY15 results briefing	24/02/15
JIN	Jumbo Interactive HY15 results briefing	24/02/15
IRE	IRESS FY14 results briefing	25/02/15
VED	VEDA HY15 results briefing	25/02/15

AUB	Austbrokers Holdings HY15 results briefing	25/02/15
AGI	Ainsworth Game Technology HY15 results briefing	25/02/15
IQE	Intueri Education Group FY14 results briefing	26/02/15
SAI	SAI Global HY15 results briefing	26/02/15
IFL	IOOF Holdings HY15 results briefing	27/02/15
SRF	Surfstitch Group HY15 results briefing	27/02/15

### March

MYX	Mayne Pharma Group conference call	02/03/15
APE	AP Eagers FY14 results briefing	03/03/15
MND	Monadelphous Group HY15 results briefing	05/03/15
ALU	Altium Hy15 results briefing	06/03/15
BKL	Blackmores HY15 results briefing	06/03/15
ACG	Atcor Medical Holdings conference briefing	11/03/15
IFM	Infomedia management meeting	11/03/15
NHF	NIB Holdings management meeting	12/03/15
TOX	TOX Free Solutions HY15 results briefing	12/03/15
PXS	Pharmaxis management meeting	16/03/15
AFG	AFG IPO management meeting	17/03/15
TNE	Technology One conference meeting	18/03/15
RHP	Rhipe conference meeting	18/03/15
AWI	Australasian Wealth Investments conference meeting	18/03/15
ALU	Altium conference meeting	18/03/15
EBT	eBET conference meeting	18/03/15
ALL	Aristocrat Leisure investor day	24/03/15
MYS	MyState management meeting	24/03/15
SGM	Sims Metal Management investor presentation meeting	25/03/15
DTL	Data#3 management meeting	26/03/15

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