Selector High Conviction Fund
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In this quarterly edition we review performance and attribution. We profile Reece, Infomedia and Flight Centres US operations. We discuss lazy balance sheets and franking credits. Photo: Opportunities come in the strangest shape - flexing muscle.

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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.

First we identify the best business franchises with the best management teams. Then we focus on valuations.

Please forward to us contact details if you would like future newsletters to be emailed to family, friends or business colleagues.

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Dear Investor,

The world continues to emerge from a balance sheet recession post the events of 2008. The progress is tentative at times but as we have written in past quarterlies the direction is unmistakingly forward. Markets, reflecting the improving investor sentiment have continued to post positive gains with the March quarter continuing this trend.

This is not to suggest that the path is a relatively straight forward one. The appointment of new US Federal Reserve Chairman Janet Yellen, who replaced outgoing Chair Ben Bernanke, has held few surprises thus far, but the message is much the same. The US economy is set for improvement, with the unemployment rate now within striking distance of the Federal Reserve's initial target of 6.5%. This has seen the gradual winding back of the Federal Reserve's Quantitative Easing program, dubbed QE, from US$85 billion per month to the current US$55 billion per month. The time for interest rate rises is fast approaching but this too is in response to an improving economy. US Federal Open Market Committee Members now expect the Federal Funds rate to hit 1.0% in 2015 and 2.25% by 2016 end.

Locally, a series of company profit downgrades prior to the start of reporting season softened the blow for some, in what nevertheless proved to be a solid set of earnings releases. The slowdown in investment expenditure was largely expected and partly offset by good news surrounding rising housing starts and improving consumer activity levels.

The forthcoming May Federal Budget is expected to grab the headlines as the Government aims to restore some financial discipline. Unfortunately, having squandered so much in recent years, incoming Federal Treasurer Joe Hockey will have his work cut out as he undertakes the task of giving less and taking more. Business and voters have been warned to expect tough decisions, but as always the devil will be in the detail of any new policy announcements.

In this quarterly we review a number of Fund holdings including Australia's leading plumbing business Reece Australia, global travel agent operator Flight Centre Travel Group, including observations from our recent trip to visit the US operations. In addition, we review electronic parts catalogue software provider Infomedia. We discuss the merits of companies operating with "lazy" balance sheets and why franking credits carry such strong appeal among investors.

During the quarter the Fund delivered a gross positive return of **4.90%** as compared to the All Ordinaries Accumulation Index which returned **2.20%** in comparison. To all our investors we trust that you find the report informative.

Regards
Tony Scenna
Corey Vincent
Robert Lapsley

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Quote: Peter Lynch

Peter Lynch was the Portfolio Manager of the Fidelity Magellan Fund from 1977-1990 and the author of "One Up on Wall Street." His investment philosophy and performance track record during this time ranked him one of the industry's top money managers. This book is a must read and offers investors a common sense approach to investing. Below he offers investors some sound advice.

"The key to making money in stocks is not to get scared out of them. Often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long term, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient, and to own successful companies."

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Performance March 2014

For the quarter ending March 2014, the Fund delivered a gross positive return of **4.90%** as compared with the **2.20%** rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 33.

Performance table since inception

% Returns	Gross Fund Return	All Ords Index	All Ords Accumulation Index
3 months	4.90%	0.93%	2.20%
6 months	8.69%	3.55%	5.70%
1 Year	28.90%	8.50%	13.19%
3 years	16.79%	3.11%	7.74%
5 years	21.28%	8.87%	13.55%
Since inception compound p.a.	**11.27%**	**3.85%**	**8.35%**

Top 10 March 2014*	Top 10 December 2013*
Aristocrat Leisure	Aristocrat Leisure
Carsales.com	CSL
CSL	Flight Centre Travel Group
Domino's Pizza Enterprises	21st Century Fox
Flight Centre Travel Group	IOOF Holdings
IOOF Holdings	IRESS
IRESS	NIB Holdings
ResMed	ResMed
SEEK	SEEK
Sirtex Medical	Sirtex Medical
Top 10 = 52.01%	**Top 10 = 53.69%**

*Listed in alphabetical order

Selector runs a high conviction, index unaware, stock selection investment strategy which typically targets 15-25 stocks chosen 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.

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Performance attribution for the quarter

Top 5 stock contributors	%	Top 5 stock detractors	%
SEEK	+2.21	Ainsworth Game Technology	-0.26
Sirtex Medical	+1.86	ResMed	-0.16
Flight Centre Travel Group	+0.77	Reece Australia	-0.15
Domino's Pizza Enterprises	+0.76	IRESS	-0.15
Aristocrat Leisure	+0.66	Technology One	-0.12

For the quarter, the Fund performed ahead of the general share market, posting a gross gain of **4.90%** as compared to the All Ordinaries Accumulation Index which rose **2.20%**. Pleasingly the performance was delivered by a number of businesses and followed on from a better than expected reporting season.

In terms of positive contributors Australia's leading online employment group **SEEK** delivered the largest return for the Fund as investors began to appreciate the depth and scope of the group's international operations, complimented by its dominant local online employment offering. This is a business we have held for many years, it remains a core holding of the Fund and our meeting with management confirmed a number of matters. Importantly, the group is positioned as the global leader in online employment, having identified and invested heavily in four tier one markets, including the Asian region underpinned by its Indonesian investment, China, Mexico and Brazil. All are now profitable, many are paying dividends and management continues to think long term in all of its actions with particular attention being given to capital management issues. This was reflected in a 40% increase in the group's interim dividend payment.

Other significant contributors for the quarter included liver cancer treatment group **Sirtex Medical** first reviewed in our September 2009 quarterly report, **Flight Centre Travel Group** featured in this quarterly and Australia's leading pizza operator **Domino's Pizza Enterprises**, discussed in our September 2013 quarterly. Finally global gaming operator **Aristocrat Leisure** is well poised to continue to build on its recent successes, particularly in the all-important US market. Management's renewed emphasis on product innovation and significant investment in industry talent has met with considerable product success and we remain upbeat on the group's immediate profit outlook.

In terms of detractors, the list is short with fellow gaming slot operator **Ainsworth Game Technology** heading the list. The company's products continue to gain share in Australia while making similar in-roads offshore. Management is charting a sensible course and this is reflected in a conservative outlook and a balance sheet with a net cash position of $60 million. Finally, Australia's largest plumbing supplier **Reece Australia** is put under the microscope further in this report the group beds down a significant acquisition. ***SFM***

Reece Australia: (ASX: REH)

*Table 1: Reece Australia company history 1919-2013**

Year	Events
1919	Harold Joseph Reece begins selling goods.
1920	First Reece plumbing hardware store commences operations in Victoria trading under HJ Reece.
1954	Reece lists on the Australian Stock Exchange.
1958	Leslie Thomas Wilson, having commenced his involvement with Reece in 1935 supplying the group with rainwater goods, becomes a Non-Executive Director of the company.
1969	Leslie Thomas Wilson becomes Chairman of Reece, reflecting the Wilson family's growing involvement in the business, with store numbers totaling just two at the time.
1969	Alan Wilson joins the Board | becomes Managing Director 1974 – 2008 |appointed Chairman 2001 to present.
1978	Reece enters New South Wales market with Albury store opening.
1980	Reece acquires Jesco Plumbing supplies, giving the group distribution coverage across country Victoria.
1987	Company name changes from H.J. Reece Limited to Reece Australia Limited.
1987	Reece enters Sydney market with first store in Parramatta.
1988	Reece commences trading in Queensland and ACT.
1990	Reece expands into adjacent markets of Mechanical Services, Gas and Irrigation.
1994	Reece establishes National Training Centre at Ringwood Victoria.
1997	Reece acquires Plumbing World and Bridgelands, extending operations into South Australia, Western Australia and Northern Territory.
1997	Peter Wilson appointed to Board | Operations Manager 2002-04 | Chief Operating Officer 2002-04 | CEO 2008 to present.
1998	Reece launches first TV advertising campaign.
2000	Company launches retail and trade website.
2000	Reece expands plumbing store numbers to 170 | Share market capitalisation hits $350 million.
2001	Leslie Thomas Wilson passes away, having begun with Reece in 1935 as a supplier of rainwater goods and having chaired the group since 1969.
2002	Reece opens first industrial outlet, servicing contractors and industrial project works.
2003	Reece opens its 250th outlet.
2004	Net profits exceed $50 million for first time, finishing the year at $61.5 million.
2005	Reece adds refrigeration supplies to branch network and launches HVAC-R.
2005	Group annual sales $1.0 billion | share market capitalisation passes $1.0 billion mark, finishing financial year at $1.3 billion.
2006	Reece acquires LG Carder in New Zealand.
2006	Reece opens 300th outlet.
2007	Reece opens 350thoutlet | Net profit passes $100 million mark | Share market capitalisation hits $2.8 billion.
2008	Reece opens 400th outlet.
2009	Group annual sales pass $1.5 billion.
2012	Acquires Town Plumbing Supplies.
2012	Reece begins trading online with first ecommerce solution.
2012	Reece opens 450th outlet | staff numbers exceed 3,500.
2013	Reece acquires refrigeration and air conditioning operators Actrol Parts and AC Components for $280 million.

*** Courtesy of Reece Australia corporate information**

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Introduction

When I entered the funds management industry back in the eighties, one of the very first businesses that caught my eye was that of plumbing group Reece Australia. Granted, a plumbing business certainly doesn't get the heart pumping but the earnings numbers in the annual reports didn't lie and what became clearly evident, even back then, was just how good a business this was and how well management had performed.

Little did we know that some 30 years on, the Reece name would grow to the extent that it has. With a market capitalisation approaching $3.3 billion, Reece Australia now sits comfortably within the top 100 Australian listed businesses and yet few would even be aware of this, thereby passing up one of the best and most consistent performing businesses in this country.

Why Reece Australia?

In our opening quote on page two, Peter Lynch spoke about the relationship that exists between successful companies and their investment performance over the long term;

"This disparity is the key to making money; it pays to be patient, and to own successful companies."

Hopefully as you read on, what should resonate is how great businesses can be built over time and why Reece Australia remains a quality business worth owning.

Reece Australia history

When it comes to providing plumbers with products and services, Reece's business reputation has been built around a philosophy of *"having what you need, when you need it, where you need it."* This sits at the core and remains a defining aspect of a business that has achieved extraordinary growth over a long time frame. **Table 1** profiles the company's progress from start up in 1919 to today. The thing about Reece is that it has rigidly stuck to doing one thing very well, that of selling plumbing gear.

The Wilson family

The Australian Stock Exchange corporate governance guidelines provide recommendations relating to eight key principles relevant to ASX listed companies. One of the more contentious recommendations relates to the board structure. Specifically, the guidelines recommend that the majority of the Board be independent, the Chair person be independent and that different individuals exercise the roles of Chair and Managing Director.

On almost all counts, Reece would fail to meet these guidelines. The business profile in **Table 1**, outlines the involvement of the Wilson family stretching back to 1935 and with Leslie Wilson formally taking the Chairman's reigns in 1969. He was joined on the board by son Alan Wilson in the same year, before becoming Managing Director in 1974 and Executive Chairman in 2001. In 2008, the Managing

Director baton was passed onto the group's former marketing manager and another Wilson family member, Peter Wilson, who today remains in that role.

There is always a risk that what one generation achieves, another will destroy. For the Wilson's this has not been the case. If anything, the link that exists on the board between Executive Chairman Alan Wilson, aged 72 and Managing Director Peter Wilson aged 45 continues a tradition that has kept the business on a steady path. Whereas the 2001 board consisted entirely of Wilson family members, board additions have seen two independent executive directors added to the current board of six. Collectively, the Wilson family members control 67% of all shares on issue, valued at $2.2 billion.

Table 2 sets out the group's earnings profile over the past decade. If space had allowed, this consistency would have stretched over decades, illustrating why past and present management deserve due recognition. Although these numbers provide a snapshot of what has been achieved to date, they fail to highlight how it has been done which is deserving of further comment.

Table 2: Reece Australia financial summary 2003-2013

Financial Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Sales ($m)	740	872	1,010	1,113	1,309	1,437	1,508	1,504	1,564	1,519	1,535
EBIT ($m)	67	89	109	125	151	165	146	160	165	158	172
NPAT ($m)	47	62	75	87	104	114	100	114	119	114	119
EPS (¢)	47	62	76	87	104	114	97	115	119	114	120
DPS (¢)	21	28	38	44	52	57	51	58	61	61	62
EBIT margin (%)	9.1	10.2	10.7	11.2	11.5	11.5	9.7	10.6	10.5	10.4	11.2
ROCE (%)	45	74	41	40	40	36	28	31	32	29	29
Net Cash ($m)	34	46	46	51	18	7	7	114	126	158	147
No of stores	222	245	271	310	349	388	429	439	440	453	465
Avg sale per store ($m)	3.3	3.6	3.7	3.6	3.7	3.7	3.5	3.4	3.6	3.4	3.3
Avg EBIT per store ($m)	0.30	0.36	0.40	0.40	0.43	0.42	0.34	0.36	0.37	0.35	0.37

Plumbing shops

While the first Reece plumbing shop was opened in 1920, our look back on history suggests that shop openings really didn't get going until the 1970's. Since then, the business has embarked on a sensible, consistent expansion of shops throughout the country. In some cases this has led to acquisitions of existing operations, later converted to Reece shops, but the vast majority has been achieved organically. Over the past decade, store numbers have doubled and now stand at 465.

These include the traditional stand-alone Reece Plumbing shops, which are the vast majority, as well as seventeen large Bathroom Life Showrooms, showcasing the group's comprehensive range of products.

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A key strength of the plumbing store network is their location diversity. In fact, a quick search on the company's website reveals shop sites stretching well beyond the major city limits and into regional communities.

Products and customers

The Reece business has stood the test of time due largely to the products on offer and the consistency of customer service offered. Achieving this is not without its challenges but the Reece brand resonates strongly throughout the industry. The group's operations encompass all aspects of plumbing, from importing of products, wholesaling, distribution, marketing and retailing. Whilst the origins of the business centered on servicing the plumbing trade, the establishment of Bathroom Life Showrooms, takes advantage of the do-it-yourself renovation and the retail markets. The group has also extended into the commercial markets, servicing the plumbing needs of the larger players.

Reece's buying power and attention to customer needs has driven management to source top end products both locally and abroad. This remains a point of market difference. Reece provides a range of products that are not readily available elsewhere, at a price point that allows them to earn an attractive margin. The development of new products requires investment, as is the group's commitment to product testing, ensuring a high level of quality is maintained.

Service

Having worked in an independent plumbing store during my schooling years, the importance of customer service and reliability of product supply cannot be underestimated. The plumbing trade requires both and if done well ensures loyalty of business. Reece has understood this important link and invested accordingly, to ensure that not only are the shops adequately stocked but that customer feedback is accepted and acted upon.

Expanding shop locations and maintaining their visual appearance ranks high on the company's to do list. It is a message repeated in every annual report and throughout the company's literature. In fact, management has seen fit to own a number of shops in certain locations, so they are not captive to landlords. In turn, this has allowed the business to invest accordingly, confident in the knowledge of having long term tenure.

Margins and financials

If there is a criticism that can be leveled at Reece, it is their limited interaction with shareholders when describing business operations. Management provides minimal commentary in its annual reports, preferring instead to let the numbers do the talking. While many companies devote an inordinate amount of space saying very little and delivering even less, Reece delivers impressively across a range of financial metrics.

As **Table 2** outlines, the group has hardly missed a beat over the past decade, delivering solid top line growth, accompanied by robust operating profits. As you review the numbers, it is important to appreciate that this steady climb in sales has been achieved during a prolonged slowdown in new housing starts and the aftermath of the financial crisis. Despite these challenges, management has continued with the pace of expansion, opening new stores, while continuing to automate processes to drive business and warehouse efficiencies.

Most tellingly, operating margins (EBIT) remain industry best, having averaged better than 10%, at a time when most competitors have struggled to post mid-single digit returns. There are many factors contributing to this outcome, including access to an exclusive range of bathroom products and a strong commitment to customer service and business reinvestment. Today, the Reece brand is recognised as Australia's best-known supplier of bathroom products.

Paying for growth

The very best businesses are those that remain relevant to the consumer and are positioned for growth. Reece operates in an industry that is just that, however, as any owner will attest, staying at the forefront requires ongoing re-investment and sensible expansion. Reece's modus of operation is evident on any visit to a store or showroom. The shops are clean, inviting and serviced by staff who know the product range well. Inventory is on display and the group's considerable investment in information technology (IT) has allowed the business to cope with store expansion.

Serviced by distribution centres, store numbers have grown as demand and new opportunities dictates. As **Table 2** illustrates, management has continued to expand the network of stores despite tougher economic conditions. Importantly, this expansion has been largely organic in nature and funded totally from within the group's own cash resources. Other than when the company listed, management has never undertaken a capital raising from its shareholder base. In fact, such is the group's strength, that at December 2013, Reece was holding net cash of $147 million, despite store numbers doubling over the past decade.

Balance sheet

In keeping with management's conservative style, the group's balance sheet is just that, conservative. The company's main assets include cash and working capital items being, receivables and inventories. The largest asset is the group's considerable investment in property plant and equipment, valued at $423 million. At balance date, freehold land and buildings are recorded in the accounts at $203 million compared to current market values of $301 million.

As we noted earlier, the group ended the 2013 financial year in a net cash position of $147 million, with the largest liability being payables. Total equity stood at $765 million, indicating that Reece generated a return on capital employed (EBIT | shareholders equity + debt - cash) of 29% for 2013.

Management's disciplined financial approach is also reflected in the group's growing pool of franking credits, which stood at $346 million, equivalent to $3.46 per share.

Online

In 2012, Reece opened its online trading platform to the public. The site allows Reece customers to access product pricing, build product lists and generate customer quotes along with the convenience of ordering online. Rather than viewing this offer as anything but a necessity, it does reflect a management team that is responsive to the changing ecommerce landscape.

Business opportunities

For a family that has traditionally given big acquisitions a wide berth, what then are we to make of Reece's recent decision to invest $280 million acquiring the Actrol group? This business is a specialist industrial wholesale group providing components, units, systems and refrigerated gases to the Australian heating, ventilation, air conditioning and refrigeration (HVAC-R) industry. CEO Peter Wilson commented on the importance of this purchase:

"The acquisition represents a unique and exciting opportunity for Reece to establish a presence in Australia's refrigeration and air conditioning industries. Actrol Parts and AC Components represent a compelling strategic fit with Reece and one that will enable us to grow our wholesale trade business and diversify our offering to our customers."

Whilst management has had a presence in the HVAC-R industry dating back to 2005, it has played second fiddle to the group's plumbing operations. This acquisition is set to change the business dynamics, with the Actrol Group, owning 79 branches and 5 distribution centres. Few financial metrics are available, although it is clear from industry discussions that this is a business that Reece has sought to own in the past. Reece management has undertaken significant due diligence, knows the Actrol management team and understands the industry dynamics well.

The Actrol Group website notes a business history spanning over 60 years, and one that has remained in private hands, although ownership has changed multiple times. The most recent sale took place in 2010 to private equity group Catalyst Investment. In 2013 the Actrol group reported revenues of $220 million and operating profits of circa $45 million, although this figure was inflated from a one off benefit related to the carbon tax introduction. Based on management comments following the purchase, a more normal level of operating earnings would see profits at $30 million, placing the acquisition on a multiple of nine times.

In completing the $280 million transaction, Reece noted the acquisition would be earnings per share accretive in the current year and that sales would exceed $100 million for the period under ownership (approximately 5 months). In addition, Reece confirmed that it would take on debt to finance the deal, an event that in itself speaks volumes to management's preparedness to seize this opportunity.

Interim result

For the interim results to December 2013, Reece lifted total sales 7.5% to $844 million, while net profit rose 8.5% to $59.6 million. Management noted that the improved result was driven by better conditions in the building industry aided by like for like sales growth, estimated at 5% and the opening of eleven additional branches. The company provided no formal full year guidance, although we estimate net profits for 2014 to fall within a range of $125 - $130 million.

Summary

The Reece business metrics are strong and the management ethics that underpin the organisation are sound. As we noted earlier, it is very hard to fault the business and those that run it. This is a quality business operating a durable "franchise". The Fund has held a core holding in Reece for some time and it is our intention to maintain that investment for the foreseeable future. On a final note, that independent plumbing business where I worked for many years is now owned by Reece Australia. ***SFM***

Infomedia (ASX: IFM)

This is a business that we have followed since its share market listing in 2000. With an issue price of $1.00 per share the business listed with a market capitalisation of $315 million. Today, the company is larger in size, having successfully grown its Electronic Parts Catalogue (EPC) offering, yet the shares trade below the original listing price and the group's market value sits around $228 million. For shareholders, the past decade has seen little capital reward, although the outlook now appears brighter. Having dusted off the files, we recently caught up with management and walked away with a new found interest in the business and more confident of its future prospects.

This opportunity highlights what some investors already appreciate, that investment decisions should be made on a case by case basis. Having the patience to observe a business from the sidelines and only choosing to engage when the circumstances dictate, is an important discipline.

That said, many investors still struggle with when to jump on board. For our part it helps if you have an understanding of the company's past. It won't protect against error but it does provide a backdrop to gauge whether the business is making progress. And this is important, because sometimes a business can appear to be standing still or even going backwards, when in fact the fundamentals are on the rise. On this point, we believe Infomedia's business metrics are on the rise, supported by a management team and an operating model suited for the times.

The early days

Under the guise of Infomagic Australia, Richard Graham founded the business in 1988 as an importer and distributor of software for Apple Macintosh and Microsoft computers. Graham concluded correctly that despite early success, long term sustainable growth could be better served by owning

its own intellectual property, rather than acting solely as a distributor of other companies' products. In 1991, the company established a product development division and purchased the complete intellectual rights to an automotive EPC project called Microcat. In January 1992, Microcat was launched in the Australian automotive market for the Ford dealership group.

In 1994, the company's name was changed to Infomedia, with the company's goal to make the Microcat EPC, the automotive industry's guide to ordering parts, making the microfiche and paper based systems obsolete.

In 1997, Microcat was launched internationally when Ford Europe exclusively licensed its parts catalogue data to Infomedia, to produce a version of Microcat for Ford's European dealers. In 1999 following a successful rollout in Europe, Ford granted the company, additional distribution rights to expand into Canada, Japan, Mexico and the USA.

In 2000, the company sought to list onto the stock exchange, having grown the EPC subscription base from near zero to 24,000. In addition, while Ford still dominated in terms of subscriber numbers, the company had successfully expanded the parts catalogue data to include deals with other leading car brands including, Daewoo, Daihatsu, General Motors, Honda, Hyundai, Isuzu, Mitsubishi, Nissan and Toyota.

At the time of its listing, businesses linked to the internet were in hot demand. With a solid track record, Infomedia's shares were eagerly sought, offering investors an opportunity to buy into a business that was profitable. However, as **Table 3** highlights, the years that have followed the group's listing delivered less than what was expected. At the time of its float, the shares were sold on a prospective PER of 19.8x, providing little room for disappointment. Unfortunately, things did not go according to plan and a number of events, largely outside the company's control impacted the group.

Table 3: Infomedia's financial performance 2000-2013

Year	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13
Sales ($m)	20.9	36.1	44.5	62.6	69.6	59.1	55.6	54.6	51.7	54.3	45.3	44.1	45.7	48.7
EBITA ($m)	11.8	19.3	19.4	26.2	29.7	21.4	24.8	23.4	19.9	15.8	18.1	18.8	17.7	20.1
NPAT ($m)	7.6	12.8	13.4	18.3	20.6	14.5	18.1	15.3	13.1	10.5	11.3	10.0	8.5	10.1
EPC (000)*	24.0	30.2	38.8	46.6	51.5	46.7	49.0	54.5	59.9	57.5	58.5	65.8	70.5	73.5
Rev ($)**	870	1200	1147	1343	1351	1265	1390	1001	863	944	774	670	648	662

** Electronic parts catalogue*
*** Average Subscription revenue per annum*

Table 4: Electronic Parts Catalogue – product split

Product Subscriptions	2005	2006	2007	2008	2009	2010	2011	2012	2013
EPC	46,000	47,000	52,000	56,000	52,000	51,000	54,544	55,296	57,542
Superservice	550	1,600	2,500	3,900	5,500	7,500	10,438	14,611	16,742
Total Subscriptions	**46,550**	**48,600**	**54,500**	**59,900**	**57,500**	**58,500**	**65,842**	**70,512**	**73,464**

The Electronic Parts Catalogue (EPC) market

The company prospectus in 2000 laid out the reasons why the EPC market was set for growth. If for a moment you can image your own vehicle and all the parts that go into making it function, you can perhaps start to appreciate the complexity facing the automotive industry when ordering parts. This complexity only increases as cars age and new models are introduced. It was noted that one vehicle manufacturer in Europe had details on more than 19.5 million vehicles, 500,000 parts and 6,000 service operations, all of which Microcat processed and stored.

The importance of accurate data cannot be underestimated. Parts and service staff need to be certain that the information they are viewing in the catalogue relates to their specific customer's vehicle. They need to be assured that the unique Vehicle Identification Number (VIN) of the customer's vehicle is in fact correct. This is what Infomedia has prided itself on, the ability to take the raw data provided by the car manufacturers and convert the information into a user friendly electronic catalogue and now updated weekly.

The introduction of personal computers during the early 1980's saw the first EPC's for car dealers appear. Over the ensuing years and with the growing complexity of new car makes and models, the industry's move from the traditional paper and microfiche to the more efficient and reliable EPC offering gathered pace.

Today, Infomedia's EPC offering has shifted from one delivered in a compact disc format to one now available online and accessed via a web browser. Major competitors to Infomedia's Microcat EPC include ProQuest Business Solutions, now part of the $US3.1 billion listed Snap-on group, and car manufacturers who have kept the service in-house. ProQuest pioneered the EPC in 1987 when it developed a version for General Motors Corp. Today, Proquest services more than twenty automakers, enabling 100,000 parts technicians at 35,000 automotive dealerships to access original parts information.

Infomedia's Business Model

What originally drew us to the company at the time of listing was its relatively simple business model combined with a unique product offering. The EPC market was in its infancy and Infomedia along with Proquest were at the forefront of that technological change. The business model saw Infomedia enter into arrangements with automakers to license and convert their raw data into software with clear and easy-to-use images, which it then sold to thousands of dealers around the world.

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Each subscription, representing one software application sold for roughly $50 per month or about $600 in annual revenue, based on current exchange rates. As **Table 3** highlights, returns for software companies can be incredibly attractive and Infomedia was no inception in the earlier years, enjoying operating margins north of 50%. This is no longer the case as we will explain further, however, even on today's numbers, Infomedia possess attractive financial metrics.

Ford Europe

The group's most significant breakthrough arose in 1997, when auto manufacturer Ford Europe exclusively licensed its parts catalogue data to the company, thereby introducing 18,000 Ford dealerships to the group. Using a UK distributor, Infomedia quickly built up a significant presence and by 2004, the Ford Europe dealer base represented 35% of the company's overall Microcat customer number of 51,500.

However, 2004 would prove to be a watershed year for the group, following Ford Europe's decision to terminate data exclusivity in July, opting instead to introduce an in-house EPC product aptly named FordEcat. As a consequence, Microcat found itself competing head to head with the car manufacturer's own product in a market they once dominated. Suffice to say, changes were necessary and management responded in kind, installing senior management into the market and taking over direct marketing from its previous distributor.

What when wrong?

The numbers don't lie and **Table 3** highlights a number of alarming trends that partly explains why Infomedia, despite its attractive business qualities, has been a poor investment since listing. As company founder and then CEO Richard Graham noted back in 2010 when considering the company's plight, *"subscription numbers are the highest they're ever been, yet profit is the lowest. This is not the way the business model was supposed to operate."*

Yet that is exactly the situation management has found themselves in, with subscription numbers tripling since listing from 24,000 to 73,500, on revenues that have more than doubled from $21 million to $49 million while net profits have remained virtually unchanged at $10 million.

The loss of Ford Europe exclusivity was further compounded in 2006 when US General Motors undertook a similar decision to move away from Microcat, management undertook a long term re-assessment of the group's business direction. Additional funds were ploughed into research and development and offices were established both in Europe and the US to directly service the existing customer base.

In addition, the company launched a second product into the market place under the title Superservice Menus. Whereas the group's EPC Microcat delivers the dealers with reliable electronic data on vehicle parts, Superservice Menus address the needs of the aftermarket car service. It allows

car dealers to accurately quote for the repair of a vehicle using online data that instantly generates a list of services to be undertaken including quotes for parts and labour.

These initiatives have all come at a cost. Not only did the company incur significant upfront costs in launching directly in Europe and the US, but it also had to contend with rising license fees charged by the auto manufacturers. And if there is a weakness in the Infomedia business model, it is simply that neither they nor their competitors, own the data that is used to produce the catalogues. In short, as long as the data is provided at a fair price, Infomedia can continue to service and grow the market opportunity but the risk of losing data access remains a constant threat.

To top things off, Infomedia has had to deal with a strengthening local currency. As the majority of earnings are derived offshore, over the past decade the group has been on the wrong side of a weakening US dollar and Euro currency. Its impact can be best seen in **Table 3** which crudely calculates the annual average revenue per subscriber since 2000. Despite the introduction of hedging to provide some protection, per subscriber revenue has slid from a 2006 peak of $1,390 to current levels of $660. In short, the company needed to sell double the volume of EPC's just to stand still. However, we suspect currencies may be finally turning in favour of the company.

Management

On the surface it's been hard to fault the board or management team. Founder Richard Graham has only recently stepped aside as CEO and Chairman, having also offloaded the majority of his 100 million shares in the business. Similarly, long serving director Myer Herszberg has also recently sold his holding leaving few shares in the hands of management. Normally this would not be seen in a good light, however, a founder's exit is often accompanied by change. Having followed the fortunes of Infomedia for over a decade, we are of the view that the changing of the guard and the introduction of new investors to the company's share register at the expense of the founders is a positive step.

Importantly, Andrew Pattinson was appointed CEO during 2013, having established Infomedia's UK based European subsidiary in 2004. He returned to Australia in 2009 where he has been responsible for the group's global solutions and systems direction. All up, Pattison's tenure with Infomedia spans 25 years.

Infomedia – where to from here

The past decade has been tough on both the Infomedia business and investors alike. What could go wrong has gone wrong and many have rightly labeled Infomedia as a "gunna" stock. On the facts alone it's hard to argue with this, but we suspect that a lot of the hard work and investments made have not gone to waste. The business is fundamentally sound and the industry's direction is supportive of the group's products and services. Having endured, we would highlight the following developments as perhaps having a profound positive impact on the company's immediate future.

In the 2011 Annual Report, Graham reaffirmed the company's core values as twofold, namely, product innovation and realising fair value for the contribution that the group's products delivered to its customer base. In addressing the first, the company has maintained a long term commitment to product innovation. This can be seen with its leading Microcat EPC and Superservice Menu product offerings continuing to deliver year on year subscription growth. The adoption of the internet as a means of delivering product is now accepted, with customers embracing the power of online delivery of real time data.

Importantly, these advances are addressing the company's second core value, by empowering customers with greater choice, enabling a lift in productivity. The progressive move to supplying weekly product data updates, accessed online and offered as either a EPC subscription or a combined Superservice Product Suite is very much moving to the founder's business vision, where connectivity and product integration is of paramount importance.

It's all about the bottom line

Having correctly identified and transitioned the business to meet the changing needs of customers, management's final piece aims to address the sales side. Having held subscription prices constant, the company has historically focused on driving sales via a twenty-five strong sales team. In 2013, management complemented this approach, with a number of new initiatives. These include the adoption of professional third party sales representatives, licensing of Superservice solutions components for integration into third party systems and finally, licensing of some of Infomedia's proprietary capital to enable third party solutions.

Summary

Infomedia shareholders have endured a tough decade but the outlook offers optimism. A combination of factors are now working to collectively deliver efficiency benefits and market share growth. Moving to a core software code will streamline operations while the shift to online access and adoption of cloud based services will reduce costs, lift margins and improve customer service. At an industry level, the past decade has seen no new competitive threat emerge.

Having dealt with the demands of the auto makers, the EPC market remains the domain of the incumbents, of which Infomedia is one. The lower Australian dollar is also playing its part along with a more aggressive marketing sales strategy that will open up the product suite to a more diverse customer base. All in all, the scene is now set for Infomedia to reap some of the benefits of a sustained period of investment and favourable industry tailwinds.

We are sufficiently confident that the current outlook provides investors with room for optimism. A relatively clean balance sheet, aided by net cash of circa $11 million and a fully franked dividend yield of 5% adds to our conviction. ***SFM***

Flight Centre Travel Group - a global operator (ASX: FLT)

During the quarter we travelled to the US to attend an investor briefing covering the operations of Flight Centre Travel Group. While the Australian operations continue to steal the limelight, offshore expansion is becoming an increasingly important component of the group's business aspirations.

Brief background

Flight Centre opened its first store in Sydney back in 1982, before beginning a nationwide expansion that saw store numbers grow to 30 by 1987. In 1990, New Zealand was added to the network and this was followed by openings in other countries including the UK, Canada and South Africa.

In 1995, Flight Centre listed on the local stock exchange, issuing just 12.3 million new shares to the public. In addition 4.1 million new shares were offered to staff while the founders retained 60.0 million, giving a total issued capital of 76.4 million shares. The shares were issued at $0.95, valuing the company at $72.6 million.

Back then our initial reservations when considering the merits of investing in a travel agency group were quickly dismissed following our meetings with management, including founders Graham Turner, Jim Goldberg and Geoff Harris. Two things struck us instantly. The first was the high operating margins the group enjoyed and secondly, the significant expansion opportunities that remain open, funded almost exclusively using the company's internal cash flow resources.

At the time of listing and for a number of years that followed, most analysts focused on the group's very low net income margin as a point of concern. Calculated as profits before tax, divided by the total transaction value (TTV) of tickets sold, the margin sat in the 1%-2% range. This, however, misrepresented the true profitability of operations.

A better and more accurate indicator was what the group made on the commissions earned. In essence, since the group carries no inventory and is purely paid commissions on tickets sold, the group's operating margin, calculated as earnings before interest, tax and depreciation divided by commission revenue provided a better picture on the group's financial health. As things would have it, operating margins sat closer to 20% and a real appreciation for both the business and the investment opportunity that presented itself became readily apparent.

Since its listing in 1995, the group has grown considerably. As **Table 4** highlights, back in 2000 the business operated 635 shops, wrote $2.4 billion of ticketed revenues, earned $62.0 million in operating profits and banked just on $40 million in net profits. For the full year 2013, the group's operations approached 2,500 shops, with total TTV of $14.1 billion, delivering operating profits totaling $345 million and net profits of $244 million.

Table 4: Flight Centre Travel Group financial summary 2000 - 2013

	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13
TTV ($b)	2.4	3.0	3.6	4.5	5.9	6.9	7.8	8.9	10.9	11.2	11.0	12.2	13.2	14.3
Rev ($m)	n/a	n/a	n/a	n/a	774	872	977	1120	1411	1481	1530	1641	1791	1969
EBIT ($m)	62	70	91	97	118	106	111	139	200	88	163	236	281	340
NPAT ($m)	40	43	62	76	92	78	79	106	143	37	140	172	200	240
Rev | TTV %	n/a	n/a	n/a	n/a	13.1	12.6	12.5	12.6	12.9	13.2	13.9	13.5	13.6	13.8
EBIT | Rev %	n/a	n/a	n/a	n/a	15.2	12.1	11.4	12.4	14.2	5.9	10.6	14.4	15.7	17.3
EBIT | TTV %	1.7	1.4	1.7	1.7	1.6	1.1	1.0	1.2	1.3	0.3	1.3	1.41	1.5	1.7
Stores	635	778	975	1228	1422	1479	1570	1950	1995	2020	2152	2243	2362	2481

As impressive as these numbers are, from a shareholders perspective what is truly remarkable has been the relatively low level of additional capital needed to achieve the results generated. With the exception of two acquisitions requiring capital, one being 4.4 million shares at the issue price of $18.00 in 2003, raising $79.6 million and the other undertaken in 2007, comprising 4.3 million shares at $23.50 per share and raising $100 million, growth has been organically achieved.

Flight Centre Travel Group - today

In purely TTV terms the group sits within the top ten global travel agency writers as **Table 5** highlights.

Table 5: Leading global travel agencies ranked by Total Transaction Value (TTV)

Global Travel Agents	2013 ($B)
Expedia	34.0
American Express	29.2
Priceline	28.5
Carson Wagonlit Travel	27.7
BCD Travel	21.2
HRG	16.6
Flight Centre Travel Group	14.1
Orbitz Worldwide	11.2
AAA Travel	3.7
Travel leaders Group	2.9

** Source: Travel Weekly & Macquarie Research*

As we noted earlier, TTV is a guide but not the key barometer of success. That said, scale is becoming increasingly important, both for the traditional bricks and mortar operators and the newer online players. The revenue generated from point to point travel, as illustrated by a Sydney to Brisbane trip, has become increasingly commoditised and is the domain of online booking portals. International travel on the other hand, is a little more complex and many still prefer the assistance of a travel agent.

Brands

Table 6: Flight Centre Travel Group brands

Major brands	Activities
Flight Centre	Flight's flagship brand in the leisure and small business travel market in 11 countries.
Liberty Travel	Flight's large scale entry in the US leisure travel market with more than 150 stores.
Escape Travel	Flight's second largest retail brand with 127 stores and 11 franchised stores.
Student Flights	Targets the youth travel market out of Australia, NZ, South Africa and the UK.
FCm Travel Solutions	Manages business travel programs for mid to large sized businesses.
Corporate Traveller	Corporate travel brand with a focus on small and medium sized businesses.
Infinity Holidays	Flagship wholesale brand providing accommodation, air travel, tours, cruises.
Travel Money Oz	Purchased Perth based Nationwide Currency Services in 2006 renamed in 2011.Stores 54.
Leisure brands	
Back-Roads Touring Co	Provides regional tours.
Cruiseabout	National, store operating, retail cruise brand.
Discount Cruises	Online cruise agency based in US.
Flight Shop	Flight's Indian operations.
Gapyear.com	Social network and travel advice website.
My Adventure store	Adventure travel retailer with 11 stores.
Overseas Working Holiday	Wholesaler of working holidays exclusively to Flight Centre stores.
Quickbeds	Online booking website for last minute accommodation.
Travel Associates	Boutique travel agency with 36 stores located Australia, NZ, South Africa and the US.
Corporate brands	
Campus Travel	Travel specialist for the education and research sectors.
cievents	Provides specialised services for conferences and events markets.
Stage and Screen	Travel agency services for companies operating in the film, music and sports industries.
Travel Club Getaways	Highly specialised and personal travel services partnered with Corporate Traveller.
Wholesale brands	
Explore Holidays	Wholesaler to Flight's retail outlets in Europe.
GOGO Vacations	Wholesaler of holiday packages and Flight's largest supplier of land products.
Other	
Advance Traders	Distributor of a number of bike brands and accessories.
Employment office	Low cost recruitment organisation.
Flight Centre Business School	Provides management and business courses for individuals and corporates in Australia.
Flight Centre Travel Academy	Low cost provider of tourism courses.
Healthwise	Provider of health and wellness services.
Moneywise Global	Financial services business providing financial advice.
99 Bikes	Joint venture retailer of bikes and bike accessories.

The segment offering perhaps the group the greatest upside is in the Corporate or business travel market space. The group has already made significant inroads with over one third of group TTV and forty percent of profits generated from this division. In addition, increasing compliance and travel regulations are driving a growing percentage of corporate business to external travel consultants. Importantly, the market opportunity is large with few global players.

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A key strength of the group has been its ability to reinvest and innovate both in brand and service offerings. While the brand name Flight Centre dominates the local store landscape, the group has worked hard to segment the travel market and offer branded shops to address specific travel and customer needs. **Table 6** sets out the brands that make up the Flight Centre offerings.

These collective brands have allowed the group to expand into niches as well as develop new revenue streams. Segmentation has also allowed multiple brands to compete effectively in the same market whilst restricting competitive responses. Ultimately though, the group must compete on both the price and quality of services offered. In markets where Flight Centre dominates, including Australia, the group's scale has proved advantageous. In newer markets, growing public awareness takes time but the outcomes have proven to be largely consistent if history is a guide.

Offshore expansion

Offshore expansion really began in 1990 with the first shop opened in New Zealand. Today, operations are carried out in ten locations other than Australia and include the UK, New Zealand, South Africa, Canada, the US, Singapore, Greater China, Dubai, UAE and India.

As **Table 7** highlights, while the overseas operations have lifted their contribution to TTV to 40% as at the end of 2013, their overall share of profits as measured by earnings before interest, tax and depreciation (EBITDA) sits at 22%. This is partly a function of a very strong performance from Australia which continues to report impressive growth despite its relative size and immaturity of offshore operations.

It is estimated that the group’s market share in Australia sits at 30% for the leisure travel market and 20% in business travel. Operating margins top 25% reflecting the group’s dominant position, where it enjoys scale benefits from airline operators. In time, we suspect these same benefits will flow to offshore divisions. Already UK operations are delivering improving margins as higher store numbers, and increasing TTV levels deliver greater volume benefits.

The group’s offering extends well beyond air travel, including hotel accommodation, car hire, cruise ship bookings, packaged holidays and travel insurance. Many of these services attract higher margins and it is management intentions to grow the non-air side of the business.

Offshore operations

Table 7: Flight Centre Travel Group geographical split

	FY12	FY13	1H14
TTV $m			
Australia	7,885	8,518	4,349
US	1,684	1,727	850
UK	1,154	1,187	695
Rest of World	2,410	2,669	1,431
Other	144	159	102
Total	**13,278**	**14,259**	**7,426**
Revenue $m			
Australia	1,022	1,111	570
US	203	208	106
UK	156	173	99
Rest of World	300	332	172
Other	106	127	81
Total	**1,786**	**1,950**	**1,028**
EBITDA $m			
Australia	261	305	148
US	18	19	(3)
UK	30	38	19
Rest of World	40	37	17
Other	(18)	(9)	(11)
Total	**331**	**390**	**170**
EBITDA Margins %			
Australia	25.5	27.5	26.0
US	8.8	9.0	(3.2)
UK	19.1	21.9	19.6
Rest of World	12.3	11.0	10.1
Other			
Total	**18.5**	**20.0**	**16.5**

UK operations

In 2003 the group undertook its most significant acquisition, acquiring the privately held corporate travel operator Britannic Travel for roughly $122 million. With a TTV of $400 million, Britannic lifted the group's overall UK TTV to about $700 million, thereby providing Flight Centre with sufficient scale to undertake a more aggressive rollout.

Importantly, the Britannic acquisition also provided invaluable insights into the corporate market that serviced the business community. Fast forward a decade and the UK market is the group's second most profitable region and importantly, set for substantial growth.

At the 2014 interim results, management noted the 250th store opening which included new Hyperstores, representing multiple teams in one location, alongside impressive TTV and EBIT growth of 25% and 33% respectively.

Over the past decade, UK EBIT has compounded at a growth rate of 24% and management has set an internal target of doubling TTV by 2017. Should this target be achieved, TTV would jump from £750 million to £1.5 billion. In Australian dollar terms, our currently weaker dollar would see this TTV rise to $A2.8 billion compared to $A1.2 billion, while EBIT would jump from $A34 million to $A92 million on our forecasts. On all accounts, UK operations are on track and management remains optimistic on the opportunities open to them in this all important region.

US operations

Not dissimilar to the group's 2003 acquisition of Britannic, Flight Centre's most significant investment in the US market occurred in 2007 with the purchase of privately held Liberty Travel for $US135 million. The Liberty Travel operations comprised 193 retail shops as well as 40 wholesale locations via GOGO Vacations that services the Caribbean and cruise ship markets of North America.

TTV at the time of acquisition totaled $US2 billion and the business was acquired on a purchase multiple of 6.8x, equal to an EBITDA of $US19.8 million. However, as CEO Turner noted, management's purchase proved to be badly timed, having come just months before the global financial crisis hit. Operationally, the retail business was suffering on a number of fronts, including the group’s employee culture. For a business like Flight Centre where the culture is so embedded within its operating ethos, this was a major setback and one that required change.

The "Family, Village, Tribe" model so successfully implemented by Turner throughout the group's other operations is based on observing how tribes have successfully survived over the centuries by staying small, nimble and alert to the challenges.

At Flight Centre the model of "Family, Village, Tribes" results in staffs being divided into small units, or families, who compete with other families in their tribe. Typically staff numbers in each "family" range between four and seven and each member becomes fully accountable for the profits and losses generated. In turn, each village competes against other villages with the top performers rising through the ranks to senior management roles. At its heart the model is very much about individuals taking responsibility for their own actions and in turn being rewarded for success. As Turner notes:

"The person who runs the shop, the team leader, they need to accept that it’s their business and they're incentivised to make that business work, look after the customers so they come back, make a profit in that business, look after their people, develop their people. That's absolutely key."

In hindsight, despite the financial crisis not helping matters, management simply overestimated the benefits that Liberty would deliver. Poor store performance as well as a lack of higher valued products was further compounded by staff operating with few business incentives. Since the acquisition, US operations have been revamped with an emphasis on installing the business and cultural values that have worked throughout the group's other operations, including the now rising star, the UK. While the group has taken a backward step in profits since acquiring Liberty, there is confidence that the changes made are now delivering results.

Our trip confirmed that a number of issues have been addressed. Importantly our meeting with US management included President of US operations Dean Smith, President of US Corporate John Beauvais and Flight Centre's top business writer Charlene Leiss. The message was clear that US operations were now ready for sustained growth having endured some tough years.

All three divisions are now trading profitably, driven in large part by sustained productivity improvements. The group's Liberty retail stores have been revamped and include the new Hyperstores similar to those being rolled out in other countries. New products, extended operating hours and a renewed marketing campaign has set in place a solid base for growth.

The group's second business, GOGO Vacations wholesales packaged holidays including its key Caribbean and American tours to external travel agents throughout the US. Management has undertaken an extensive analysis of both existing customer profiles and product offerings to address margin compression. In a similar vein to the Leisure division, a great deal of work has now been done to drive the business forward. New product offerings particularly centered on the all-important European travel market are now being addressed. Whilst Americans are known to travel in greater numbers within their own country, over 10 million still travel annually to Europe, making this a much bigger market than the one currently serviced by the group's Australian operations.

Finally the group's Corporate division offers the most compelling business opportunity in the US. This is a business that has grown organically from its inception in 2000. A series of smaller corporate acquisitions undertaken in 2006 and 2007, being Bannockburn Travel Management and Garber Travel Services respectively, provided the necessary base of corporate experience and systems to tackle this market.

The Liberty acquisition provided additional volume, however, the real driver has been the implementation of Flight Centre's proven business model in a specific market segment, that being the business travel.

While the larger players including American Express and Carlson Wagonlit have opted to fight it out for the big corporate accounts, Flight Centre management have sought to address the smaller

corporate accounts where annual travel expense budgets can range from as little as $100,000 and up to $50 million.

As President of US corporate John Beauvais noted during the conference, the group's two key brands include FCm and Corporate Traveller and the markets they address are roughly worth $US300 billion, broken into three equal buckets. The first bucket of $US100 billion relates to the existing corporate travel market. The second considers the unmanaged corporate market where companies still undertake the task of booking flights in-house while the third involves specialist events such as group bookings of sporting teams and conferences for example.

Flight Centre is addressing all three market segments with considerable success. Lessons learnt from other offshore locations are being successfully applied but the quality of personnel now aboard, largely a result of earlier acquisitions at Bannockburn and Garber are proving their worth. Not dissimilar to Flight Centre's experience when acquiring UK's Britannic Travel, the Liberty purchase is finally benefiting from years of reinvestment, increasing scale and product innovation.

The group's corporate offering is now nationwide, serviced by offices in 17 US States across the country. Since Flight Centre owns all its brands including global brand FCm, it has flexibility on both the products offered and their pricing. As Beauvais noted, Flight Centre is now seen as a top five global player for the corporate market and record wins of new accounts, including the likes of Bacardi, Newmont and MoneyGram has set the stage for long term growth and market share gains.

Most importantly when quizzed on the need for future acquisitions, Beauvais emphasised the strategy was very much an organic one. Having spent so much time and effort on bedding done the Liberty Travel acquisition, management is in no hurry to be distracted from the business opportunity that has years, if not decades to run.

US earnings

As things stand, the Corporate division continues to dominate, contributing close to 50% of TTV and the lion’s share of profits. It is also a trend that is unlikely to change, although all three divisions are now set to move solidly into profit. Importantly, management is upbeat that for the first time since the Liberty acquisition, the product offering, service levels and technology now available to customers are world class.

The severe winter which the US has just experienced has hit the economy and travel patterns hard in the latest reporting period. Typically the Leisure divisions, being the retail shops and the GOGO Vacations operations, enjoy a seasonally stronger second half. In contrast, the Corporate operations experience more consistent trading patterns throughout the year.

For the interim, TTV rose 25% from $715 million to $894 million, while commission revenue increased 21% to $106.6 million. At the pretax profit line, the group reported an expected loss of $7 million, which was slightly higher than the $6.7 million incurred in the previous period. As noted the severe weather impacted operations but management is still aiming to report a pre-tax profit of $12-$14 million for the full year.

Should the group deliver on this, operating margins would still only represent a return of 8.5% compared to margins of 23% in the UK and 30% in Australia. The US result is also masking the performance of the Corporate division which continues to enjoy TTV growth in excess of 20% per annum. We suspect that over the next five years, US operations could collectively lift operating profits above $30 million, thereby lifting margins to a more acceptable 12%. In time, management is still of the view that the US operations could become the group's second largest profit region.

Finally, we walked away with the knowledge that management clearly understands the market opportunity open to them. And importantly they see no need to complicate what they believe is a wonderfully simple business. One that is organically driven and centered on servicing a growing client base.

Flight Centre evolution

Over the years the Flight Centre business has evolved. While it is still a travel agency business, the breadth and scale of the organisation has surpassed our expectations set some years back. Importantly, the business has met the challenges and where necessary made sensible changes. These include maintaining a significant cash buffer which stood at $401 million at the interim. This cash is in addition to funds held in the company's client account relating to prepaid travel tickets, which totaled $594 million at December.

The business also changed its commission structure with airlines, ensuring a more consistent upfront commission fee and one less driven by big one off bonuses. This has allowed the group to invest and grow the business in a more sustainable manner.

Following a name change the group is now known as the Flight Centre Travel Group. In the words of management *"Flight Centre Travel Group is transitioning from a travel agent to a world class retailer of travel products to leisure and corporate customers."* In doing so, the group is looking to ensure that the business can continue to differentiate itself from others and by evolving the service offering.

Since listing

As **Table 4** highlights, the group has delivered consistent growth over a long time span. Management rightly points out that since listing in 1995 more than $1 billion of dividends have been paid out to shareholders. This is despite maintaining a very conservative payout ratio of circa 50% and with over $238 million worth of franking credits still available.

Despite this growth, market share in Australia still sits at only 30% for the leisure market and 20% for corporate business. In offshore markets, the group has barely scratched the surface and this partly explains why management's issue is not about growing the TTV but ensuring that sustainable growth can be maintained. To this end, the company aims to grow the top line by 8% - 10% per annum, thereby allowing the business to cope with the stresses and strains of hiring and training new staff and future leaders.

Summary

The business is not without risk, evident by the threat from online bookings and ongoing commission deals as well as the constant events that plague the travel industry. That said, management has done an excellent job in steering the group, from one predominately based in Australia to one that has significant scope for global expansion. And the really pleasing aspect is that management has achieved this without too much fanfare and by adopting a conservative, business-like approach. ***SFM***

The "lazy" balance sheet – an unappreciated asset

In life, referring to someone as being lazy implies a negative trait, something to avoid. In business, the term "lazy" when used in reference to a company's balance sheet conjures a similar image. Many company boards and management teams often speak about the need to have an efficient balance sheet, one that doesn't hoard cash and one that carries sufficient debt so has to operate to its maximum potential. It all sounds rather sensible in theory, but in business, things don't always go according to plan. Events happen and circumstances change, often with negative consequences.

Years of investing experience has steeled us to expect the unexpected and helped to form our views on this issue, which unsurprisingly, differs somewhat to the accepted norm. So let us now briefly explain why "lazy" balance sheets are in our opinion an unappreciated asset. We prefer companies that by their very nature are less reliant on using debt to grow and are comfortable in holding large amounts of cash on their balance sheet. This invariably leads to criticism from those on the outside but good companies often use this so called lazy asset to their long term advantage.

You may well ask how we have come to this view and the answer is rather simple. Good businesses display certain characteristics. Generally speaking they often enjoy leading market positions and as a by-product end up generating the highest margins and the strongest profits. They are also good generators of cash and are less capital intensive in nature. Management also plays its part, choosing to pay dividends from available company cash and not from borrowed funds. It's a subtle point but investors often fail to appreciate, that just because a company declares a dividend, doesn't mean it has the funds readily available. In many instances company boards pay dividends from borrowed funds just to appease shareholders, knowing full well that the payment is unsustainable.

It therefore should come as no surprise to investors that the Fund holds many businesses that fit the "lazy" balance sheet test. A few names that spring to mind include Flight Centre Travel Group (net

cash $401 million), ResMed (net cash $536 million), Sirtex Medical (net cash $48 million), Jumbo Interactive (net cash $17 million), Infomedia (net cash $11 million), Technology One (net cash $60 million), Ainsworth Game Technology (net cash $60 million) and Breville Group (net cash $9 million).

Equally important is what is done with the cash. Some companies may choose to pay increasing amounts in dividends but all of them appreciate the business flexibility of holding cash, allowing them to act quickly should an opportunity arise. In our September 2013 quarterly newsletter we profiled two businesses held in the Fund, namely IRESS and Domino's Pizza Enterprises. Both companies make the investment grade, possessing the business qualities we seek. During the past year both undertook strategically important acquisitions, some might say game changing, and in each instance a "lazy" balance sheet with cash in the till allowed the management teams to undertake the transaction without substantially diluting existing shareholders or becoming beholden to the banks.

During the past quarter, Reece Australia, profiled in this report, SEEK and Carsales.com have all put their cash to work, announcing significant business transactions. If we were to summarize our thoughts on this topic we would probably utter the words, acting prudently. We have no time for management teams that have a zeal for growth funded by debt, nor do we look favorably upon businesses that are starved of re-investment dollars just to meet market expectations.

No, our preference is to align our investments with management teams that act prudently to build sustainable businesses, which over the long run can deliver meaningful returns to shareholders. If this means maintaining a "lazy" balance sheet in order to achieve this outcome, then so be it. ***SFM***

Franking Credits – the unsung hero of investing

Most investors understand that significant tax benefits are conferred on those who receive income in the form of franked dividends as opposed to unfranked dividends. Many, however, fail to understand exactly how franking credits work and the impact that they can have on after tax investment returns. Hopefully by the end of this section you will have a better understanding of franking credits and how they might affect you in your situation.

What are Franking Credits?

Dividend imputation was introduced in 1987 by the Hawke, Keating Government, two years after the introduction of the Capital Gains Tax on the 20 September 1985. Prior to the Dividend Imputation Taxation System's introduction, a company would pay tax on profits before paying dividends to shareholders, who then were required to declare those dividends as income in their personal tax returns, paying tax for a second time on those original profits made by the company.

This double taxation effect is illustrated in **Table 8** assuming a company pays out 100% of its after tax profits as dividends to shareholders and the shareholders are paying a marginal tax rate of 45%.

Table 8: Double Taxation effect

Category	Income	Cumulative Tax Paid
Company Profit Before Tax	$100.00	$0.00
Company Tax paid (30%)	-$30.00	-$30.00
Net Profit after Tax	**$70.00**	**-$30.00**
Dividend Distribution to Shareholder	$70.00	-$30.00
Shareholders Income Tax Paid (45%*)	-$31.50	-$61.50
Shareholder Post Tax Income	**$38.50**	**-$61.50**
Company Tax Rate		*30%*
Shareholder Marginal Tax Rate		*45%*
Shareholder's effective tax paid on original company earnings		*62%*

**Top marginal tax rate in 2014 is 45% excluding the Medicare levy.*

The end result of this system saw the tax office clipping the ticket twice on the same profits. Dividend imputation seeks to eliminate the double taxation effect by allowing companies to distribute “franking credits” with dividends. Franking credits are tax credits or offsets which allow investors to offset their tax payable on those dividends.

To calculate tax payable on franked dividends, an investor adds their franking credits to the dividends received to arrive at the “grossed up” before tax income. It is this “grossed up” dividend income on which the investor’s marginal tax rate is levied. Franking credits are used as an offset to the tax payable, as those credits represent the tax that a company has already paid prior to the distribution of dividends.

If the tax owed is greater than the amount of the franking credits, the investor pays the shortfall between tax owed and the franking credits. If the tax owed and the franking credits are of the same value, no payments are needed and if the investor’s tax owed is less than the value of the franking credits, the excess can be used either as a tax offset (to reduce the investor’s overall tax bill) or the investor may receive that excess as a tax refund.

Australia is one of only a few countries in the world (including Malta and New Zealand) which have imputation systems. The United Kingdom has a similar system whereby investors are entitled to a tax credit, but which is not necessarily representative of the tax already paid by the company. Germany and France did away with their dividend imputation systems in the early 2000’s. Countries such as the USA, Hong Kong, Singapore and Canada’s taxation systems have no form of dividend imputation and as a result, on average, you will observe a lower dividend payout ratio in these countries due to the associated tax disadvantages.

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Australia's Dividend Imputation System and its implications for investors

Double taxation, as incurred by investors in countries where franking credits are not distributed with dividends, are a cost and act as a handbrake on the economy by diminishing investment returns. In short, double taxation is an investment deterrent.

The removal of double taxation with the introduction of dividend imputation increases the after tax returns that investors can earn from a business. The table below illustrates a number of scenarios for investors with different marginal tax rates:

Table 9: Investor scenarios

	Investor 1	Investor 2	Investor 3	Investor 4	Investor 5
Investor Marginal Tax Rates	0.0%	19.0%	32.5%	37.0%	45.0%
Company Profit Before Tax	$100.00	$100.00	$100.00	$100.00	$100.00
Company Tax	-$30.00	-$30.00	-$30.00	-$30.00	-$30.00
Company Net Profit After Tax	**$70.00**	**$70.00**	**$70.00**	**$70.00**	**$70.00**
Fully Franked Dividend Paid to Investor	$70.00	$70.00	$70.00	$70.00	$70.00
*Franking Credits Distributed with Dividend**	*$30.00*	*$30.00*	*$30.00*	*$30.00*	*$30.00*
Grossed up Dividend	$100.00	$100.00	$100.00	$100.00	$100.00
Shareholder Tax Payable	$0.00	-$19.00	-$32.50	-$37.00	-$45.00
Shareholder's Franking Credit Tax Offset	*$30.00*	*$30.00*	*$30.00*	*$30.00*	*$30.00*
Investor's Tax Benefit/Liability**	$30.00	$11.00	-$2.50	-$7.00	-$15.00
Post Tax Dividend Income	**$100.00**	**$81.00**	**$67.50**	**$63.00**	**$55.00**

*When an investor receives $70 in dividends, a common mistake is for investors to believe they have received franking credits amounting to 30% of the value of the dividends. The correct calculation is to divide the dividend by 70% and then multiply by 30%. This means that on fully franked dividends, the value of the franking credits conferred amounts to approximately 42.8% of the value of the dividend.

**Tax benefit or liability is calculated as the investor's tax payable on the grossed up dividend less the Franking Credit tax offsets distributed with those dividends

As illustrated in **Table 9** the dividend imputation system means an **investor ends up being levied their marginal tax rate on the original corporate pre-tax profit rather than on their dividend income**. As investors receive dividend distributions out of corporate after tax profits, investors can end up receiving tax refunds when they have a lower marginal tax rate than the company. This leads us to a quick summary of different types of investors and how they stand to benefit the most from dividend imputation.

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Individual Investors

Individual investors can fall into any of the examples outlined above. For investors who already pay a marginal tax rate higher than the corporate tax rate (those paying 33%, 37% and 45%), they will still owe extra tax on the dividends they receive, however the tax owed will be greatly diminished by the franking credit offsets. For investors paying the lower marginal tax rates (0% and 19%) franked dividend income will result in tax credits, reducing their overall tax bill.

This is best illustrated by referring to **Table 9**. Investor 1 is paid fully franked dividends of $70 and receives a $30 franking credit rebate, resulting in an after tax income of $100. Compare that to Investor 5, who incurs the highest marginal tax rate, receiving fully franked dividends of $70, however, the franking credit rebate fails to totally offset the investor’s tax bill, leaving him with a post-tax dividend income of $55.

Superannuation Funds

Superannuation and Self-Managed Super Funds (SMSFs) are subject to income tax. As long as a super fund is a complying fund (visit the ATO website for more details on what constitutes a complying fund) a concessional rate of 15% will apply. This low concessional rate allows a super fund to receive fully franked dividends free of further tax, resulting in tax refunds.

Summary

The introduction of the dividend imputation taxation system in 1987 paved the way for companies to pass on profits to shareholders, the rightful owners of the business, in a tax effective manner. Franked dividends really are the unsung hero of investing. Knowing how they work can make a big difference in your investment returns over time. ***SFM***

Company visit diary March Quarter 2014

January

	RMD	ResMed Inc Q114 conference call	13/01/14
	TRS	The Reject Shop trading update conference call	24/01/14
	COH	Cochlear jury verdict conference call	24/01/14
	RMD	ResMed Inc management meeting	28/01/14
	SGF	SGFleet IPO management briefing	31/01/14
February			
	TRS	The Reject Shop conference call	03/02/14
	NVT	Navitas interim results conference call	03/02/14
	OSH	Oil Search investor relations meeting	04/02/14
	EGP	Echo Entertainment interim results conference call	05/02/14
	FXL	Flexigroup interim results conference call	06/02/14
	NVT	Navitas conference call	10/02/14
	OFX	OzForex Group management meeting	10/02/14
	COH	Cochlear interim results briefing	11/02/14
	CRZ	Carsales.com interim results briefing	12/02/14
	DMP	Domino's Pizza Enterprises interim results briefing	12/02/14
	CPU	Computershare interim results briefing	12/02/14
	SKE	Skilled Group interim results briefing	02/02/14
	ASX	ASX interim results briefing	13/02/14
	CSL	CSL interim results briefing	13/02/14
	ANN	Ansell results briefing	17/02/14
	SAI	SAI Global interim results briefing	18/02/14
	SRX	Sirtex Medical interim results briefing	18/02/14
	ALL	Aristocrat Leisure annual general meeting	19/02/14
	SEK	SEEK interim results briefing	19/02/14
	IPP	iProperty Group conference call	19/02/14
	SAI	SAI Global management meeting	19/02/14
	PXS	Pharmaxis site visit	20/02/14
	SUL	Super Retail Group interim results briefing	20/02/14
	BRG	Breville Group interim results briefing	20/02/14
	TRS	The Reject Shop management meeting	21/02/14
	CWN	Crown Resorts interim results briefing	21/02/14
	IFM	Infomedia interim results briefing	21/02/14
	NHF	NIB Holdings interim results briefing	24/02/14
	SDF	Steadfast Group interim results briefing	24/02/14
	AGI	Ainsworth Game Technology interim results briefing	25/02/14
	IFL	IOOF Holdings interim results briefing	25/02/14

	AUB	Austbrokers Holdings interim results briefing	25/02/14
	FLT	Flight Centre Travel Group interim results briefing	26/02/14
	JIN	Jumbo Interactive interim results briefing	26/02/14
	SRX	Sirtex Medical clinical briefing meeting	26/02/14
	VED	Veda Group interim results briefing	26/02/14
	IRE	IRESS full year results briefing	26/02/14
	VRT	Virtus Health interim results briefing	26/02/14
	OSH	Oil Search acquisition conference call	26/02/14
	JHX	James Hardie Industries PlcQ3 conference call	28/02/14
March			
	SEK	SEEK conference call	03/03/14
	IPP	Iproperty management meeting	04/03/14
	FLT	Flight Centre Travel Group US site visit	05/03/14
	TOX	Tox Free Solutions management meeting	19/03/14
	GXL	Greencross management meeting	19/03/14
	OZF	OzForex management meeting	25/03/14
	SRX	Sirtex Medical site visit	27/03/14
	VRT	Virtus Health conference call	28/03/14
	IFM	Infomedia site visit	28/03/14

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