SFML Quarterly Newsletter No. 53

September 2016

In this quarterly edition we review performance and attribution. In our headline stories, we cover our recent US visit to Reliance Worldwide Corporation and Fisher & Paykel Healthcare. We take a look at Resmed, Impedimed, Home Care and Inghams Group IPO. We also comment on Glenn Stevens' departure. Photo: “The Fire Dog” – Charleston USA.

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About Selector

We are a boutique fund manager with 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,

The past quarter perfectly illustrates the times we now live in. Investors grappling with a confluence of unusual economic outcomes are prone to react, fearful of what may yet unfold.

The phrase "jumping at shadows" is an apt description of this cautious, short-term approach. A case in point, few would have predicted that our economy, post the resources peak, would have delivered annualised GDP growth of 3.3% for the period ending June 2016. The majority of economic opinions were less than positive, pointing to the imminent arrival of recession. Even fewer picked the Brexit vote outcome, and on our assessment, accurately calling the extent of the fallout is at best a long shot. The majority are tipping a U.K. recession.

There are many moving parts and so much flex in our global and domestic economies that making the big calls may seem right at the time but invariably leads to short-term paranoia. Those that fret about the looming dangers of interest rate hikes may just want to stop for a moment and consider the real possibility of the global economy returning to growth.

Unlike business cycles that can average 3-5 years in duration, financial cycles tend to be much longer and more dependent on shifts in the global economy. In this context, the 2008 financial crisis ranks highly in terms of its severity and in turn this has necessitated a much longer recovery time. There are, however, increasing signs that a pickup in activity is occurring, which will in most likelihood catch investors off-guard.

Today, this balancing act of dealing with the present, while still showing a preparedness to invest for the longer term, continues to test most participants in the market. To this end, company reporting season allows for a recalibration of expectations and a re-focus on individual businesses. It should therefore come as little surprise that this is where we spend the majority of our time. This is an approach and philosophy that has served us well in the past and we believe it will continue to do so in the future.

During the quarter we travelled to the U.S. and Mexico, undertaking a number of company investor tours which included operational visits of Fisher & Paykel Healthcare, Reliance Worldwide and James Hardie Industries.

In the following sections we comment on the healthcare sector including the growing global trend towards home-care, review the Fisher & Paykel Healthcare business and discuss ResMed and Impedimed. We outline our thoughts on Reliance Worldwide following our visit and review the upcoming market listing of poultry group Inghams. Finally, a comment on the retirement of RBA Governor Glenn Stevens and some observations on our economy.

For the September 2016 quarter the Fund delivered a gross positive return of **12.06%**. In contrast the All Ordinaries Accumulation Index has delivered positive returns of **5.30%** over the same period. We trust you find the report informative.

Regards

Selector Investment Team

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Howard Marks

Howard Marks, co-founder of the USD$100 billion hedge fund Oaktree Capital offers advice to investors, who are finding the investment landscape difficult to navigate:

"It's tough but you have to stick with your creed. If you run from bus stop to bus stop you'll never catch a bus - but if you wait at one stop, eventually you will."

On the issue of hedge fund alternatives:

"When I first learnt about hedge funds in the 1970's there were about 10 of them and they were run by 10 geniuses. Now there are 10,000 and I don't think they are run by 10,000 geniuses."

According to Marks the continuing flow of money out of active managers to low-fee index driven passive funds will eventually open up opportunities, so don't write off stock picking managers just yet:

"It's intense, widespread research that makes markets more efficient. When more money goes into passive funds over active, less fundamental research is done. Eventually this should cause the scope of bargains to increase, so I wouldn't be pessimistic…. only in the short term." ***SFM***

Performance September 2016

For the quarter ending September 2016, the Fund delivered a gross positive return of **12.60%** as compared with the **5.30%** rise in the All Ordinaries Accumulation Index.

Performance since inception

Returns	Gross Fund Return %	All Ordinaries Accumulation Index %	All Ordinaries Index %
3 Months	12.06	5.30	4.04
6 Months	14.13	9.51	7.25
1 Year	27.29	14.01	9.22
3 Years annualised	18.37	6.42	1.93
5 Years annualised	24.81	11.04	6.30
10 Years annualised	8.89	5.18	0.78
Since Inception annualised	12.71	7.69	4.04

Fund's Top 10 holdings

Top 10 September 2016*	Top 10 June 2016*
ALTIUM	AINSWORTH GAME TECHNOLOGY
ARISTOCRAT LEISURE	ALTIUM
COCHLEAR	ARISTOCRAT LEISURE
CSL	CARSALES.COM
FLIGHT CENTRE TRAVEL GROUP	COCHLEAR
GBST HOLDINGS	CSL
RESMED	GBST HOLDINGS
SEEK	RESMED
TECHNOLOGY ONE	SEEK
THE STAR ENTERTAINMENT GROUP	TECHNOLOGY ONE
Top 10: 45.22%	**Top 10: 45.45%**

Selector employs 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 represent 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 of the large fund managers.

Performance Attribution for the September 2016 Quarter

Top 5 stock contributors	(%)	Top 5 stock detractors	(%)
ALTIUM	2.36	OFX GROUP	-0.54
IMPEDIMED	1.04	BLACKMORES	-0.26
ARISTOCRAT LEISURE	0.88	CSL	-0.14
INFOMEDIA	0.79	INTUERI EDUCATION GROUP	-0.11
SIRTEX MEDICAL	0.70	NAVITAS	-0.09

Top contributors

1. Altium (ASX: ALU)

Printed circuit board design software group, with operations in the U.S., Europe and Asia. Subscription based business model, making significant progress in expanding product offering with short term aims of growing revenues to USD$100 million by 2017 and market leadership in PCB design by 2020. No net debt.

2. Impedimed (ASX: IPD)

See September 2016 newsletter Article.

3. Aristocrat Leisure (ASX: ALL)

Core gaming markets of the U.S. and Australia are delivering strong revenue and profit growth, with recurring revenue now forming 50% of total group sales. Market leader in Australia and the U.S. in video style games. Digital segment performance undergoing rapid growth. Business is primed to expand into four adjoining new market segments being; the Class III stepper market (250,000 installed base), Class II video (40,000 installed base), Class III premium participation stepper market (12,000 (installed base) and the Video Lottery Terminal (VLT) segment (30,000 installed base). Net debt of $1.4 billion associated with VGI acquisition.

4. Infomedia (ASX: IFM)

Electronic Parts Catalogue (EPC) software provider Infomedia became publicly listed in 2000 and now has its products sold in 186 countries, supporting 39 global automakers and averaging 150,000 daily users. The group's two leading products include the EPC Microcat, delivering dealers with reliable electronic data on vehicle parts and Superservice Menus, that addresses the needs of the aftermarket car service. New management team lead by CEO Jonathan Rubinsztein and CFO Richard Leon, with the business deriving over 90% of recurring revenue. No net debt.

5. Sirtex (ASX: SRX)

Sirtex's SIR-Spheres product for selective internal radiation therapy in liver cancer patients continues to grow in the company's key global markets of the U.S. and Europe. Total unit sales for the year grew by 19% to 11,934 doses with management noting continued momentum in what is a large and underpenetrated market. Clinical studies currently in progress may see the use of SIR-Spheres expanded beyond salvage markets into earlier lines of treatment, with the potential to dramatically increase the company's addressable market for Sirtex. No net debt.

Bottom attribution

1. OFX Group (ASX: OFX)

Online Money Service Bureau (MSB), leading market position in Australia, expanding global presence. Scalable digital platform, with total transaction value approaching $20 billion and net operating income passing $100 million. Repeat customers accounting for 39% of all revenues with management's "Accelerate Strategy" focused on doubling revenues to $200m by 2019 and expanding profit margins. No net debt.

2. Blackmores (ASX: BKL)

Strong brand presence in Asia spanning 35 years, covering complementary medicines and new infant formula offering, with 50% of group sales now driven by Asian shoppers. Strategic priorities centre on building consumer acceptance, product leadership and operational leverage. Regulatory risk in China remains ongoing, as Government looks to clarify rules for importing of products. Short term risk to consumer demand offset by the addressable market for western vitamins estimated at USD$20 billion. No net debt.

3. CSL (ASX: CSL)

Founded in 1916 and listed in 1994, CSL is a global specialty biotherapeutics company, conducting business in over 60 countries, generating over USD$6 billion in revenue, spending USD$614 million in research and development and reporting net profits of USD$1.2 billion for 2016. The company's core plasma business offering operating under the CSL Behring division remains pivotal to group operations. Management estimates the global opportunity for the plasma derived market at USD$25 billion, compared to current group sales of USD$5.2 billion. The acquisition of the influenza vaccine business from Novartis complements its existing operations, creating. Net debt USD$2.5 billion.

4. Intueri Education Group (ASX: IQE)

New Zealand based vocational services provider Intueri continues to be impacted by ongoing regulatory reform. On this occasion the Australian authorities have focused on the group's Australian online operations with a preliminary report confirming either a cancellation of the existing license to operate or sanctions pending a final decision. The group's heightened debt profile and weakened earnings outlook leaves the company with few options should the regulator's final decision prove to be negative. Debt profile of $70 million deemed too high.

5. Navitas (ASX: NVT)

Navitas is an education services provider with over 120 colleges and campuses across 31 countries offering university pathways, professional and English services programs and creative media courses and diplomas. Founded in 1990 and providing courses to over 80,000 students annually, Navitas generated revenue of $1 billion and net profits of $90.1 million in 2016 and is one of the first choices for Universities seeking to outsource their student pathway programs. Pathway programs are becoming increasingly attractive to Universities as they look to generate more interest from international students (an important funding source) without compromising the learnings outcomes of students, particularly those who speak English as a second language. $56m net debt.

Home-care - a growing global trend

The changing face of healthcare is extending to the home. Where once the bulk of healthcare took place either in a hospital setting or an aged care facility, the growing adoption of new technologies, driven by the rising costs of health, is forcing governments to look for alternatives.

This has given rise to a growing movement of home-care services, in essence the treating of patients at home and away from the expensive alternative of hospital care. Here technology is also playing its part, by allowing patients to self-monitor their illnesses while remaining linked with clinicians and hospitals via cloud-enabled connected care.

While the public health system continues to strain under the weight of rising costs and an ageing population, changes to government reimbursement of medical services is having a profound impact on how care is provided.

Focus is now turning to the provision of affordable care, rather than care at any cost. Reimbursement levels are constantly under review as are the economic models that underpin them. In this regard, the shift towards value based care and away from fee for service is expected to materially alter the playing field for all healthcare providers.

Under the current structure, patients that present themselves at medical clinics for assistance would result in the provider or institution becoming entitled to a reimbursable amount for the service provided, irrespective of the number of times the patient requires aid or monitoring.

This approach is slowly giving way to what is now termed a value based payment method. Once the patient is placed on a particular treatment path, a set amount of funds is assigned to that patient over the course of the treatment period. In this way, healthcare providers and patients are encouraged to keep within the funding limits set by regulators. The growing adoption of newer, remote monitoring technologies as well as the promotion of more preventative action on the part of the patient, aims to reduce the downstream costs of care.

In the U.S. the stick being used to extract better patient outcomes is the imposition of penalties by the U.S. Centers for Medicare and Medicaid Services on hospitals that have high re-admission rates. As noted by ResMed reporting on a recent study:

"Today, nearly one in four patients with COPD in the United States will be re-hospitalized following an acute exacerbation, significantly impacting patients' quality of life and driving increased costs to healthcare systems and payers.

In a further development, health authorities including the U.S. Food and Drug Administration (FDA) have issued new guidelines supporting the adoption of digital health solutions. Under the FDA draft, manufacturers of medical devices can now start to use Real-World Evidence (RWE) to support new applications for clearance or approval. RWE refers to evidence of a product's performance and outcomes in settings that are outside of the clinical trials, such as in hospitals, doctors' suites and patients' homes.

For medical device companies, these new draft FDA guidelines have the potential to significantly alter the market landscape. Not only will this encourage greater uptake of digital healthcare services but it will also allow for patient performance feedback in the use of medical devices under a more normal user setting.

In this regard, medical device businesses such as ResMed, Fisher and Paykel Healthcare and Impedimed appear well positioned to prosper from these new developments, with each discussed in more detail below. ***SFM***

Impedimed (ASX: IPD)

At the 2016 BioShares Biotech Summit held in Queenstown, New Zealand, Richard Carreon, CEO of Impedimed, unveiled the company's newest device, SOZO, to the market. Impedimed is a specialist in the design and manufacture of devices which measure body and fluid composition in a non-invasive manner, using a technology referred to as Bio-Impedance Spectroscopy (BIS).

Impedimed currently distributes a device called the L-Dex which is primarily used to measure fluid retention in cancer patients at risk of developing lymphoedema. We wrote in detail about the L-Dex in our December 2009 Quarterly Newsletter article on Impedimed. Cancer clinics are beginning to integrate the device into clinical practices as a means of identifying lymphoedema before the effects become visible and irreversible. By measuring at-risk patients' fluid levels at regular intervals and comparing measurements with baseline readings, clinics can identify the early stages of lymphoedema. As with many illnesses, the costs of correctly identifying and then preventing its progress can be significantly lower when the appropriate tools are available, compared with treating an advanced stage of the disease.

As outlined earlier, healthcare systems are straining under the weight of rising costs and some of the largest contributors to those costs are chronic diseases, of which heart related conditions are the costliest. Research has shown that for heart failure, 13% of re-admissions occur within three days of initial hospitalisation, 33% within seven days and 61% within fifteen days. Re-admissions for chronic diseases place the healthcare system under enormous pressure.

With the frameworks that regulators are putting in place to penalise hospitals for re-admissions within certain periods, hospitals and clinicians are naturally looking for ways to monitor patients' progress post discharge to identify those that are susceptible to relapse.

Impedimed's newest device has taken the core technology from the L-Dex and placed it into a form which is intuitive and user friendly. It aims to give clinicians the ability to monitor a patient's progress and status from their home. A key leading indicator of heart failure progression is fluid build-up in the lungs and the limbs which can be measured using BIS. By providing patients with an easy-to-use, in the home monitoring device which stores and analyses all of a patient's critical data in a cloud connected platform, clinicians are able to monitor their discharged patients, thereby intervening should the circumstances dictate.

Importantly, alternative methods for heart failure monitoring have limitations, being less accurate, invasive, expensive and difficult to administer, effectively reducing its usefulness in the home setting.

Impedimed aims to integrate the use of SOZO into a workflow that has the potential to become a standard of care for chronic heart failure (CHF) patients. The company has established a medical advisory board to explore the use of BIS to detect fluid retention in CHF patients, working closely with the Harvard Clinical Research Institute to evaluate whether the device can be used to improve patient care. They have also teamed up with Vanderbilt University to test the device's design and software interfaces.

The company also established a new relationship with Redox, a provider of software tools that easily integrate data provided by SOZO with other e-health record systems used in hospitals and clinics. These steps have been taken to make the use of SOZO as seamless as possible for patients and clinicians.

Photo 1: Impedimed's newest device SOZO for easy in home monitoring

Impedimed expects to integrate the use of SOZO in a number of different healthcare settings since fluid retention and body composition are factors evident in many diseases. The design of the device also means that it can be rolled out for new uses without the need for re-engineering or re-design, thereby reducing the burden of chronic illness on the healthcare system. ***SFM***

ResMed (ASX: RMD) - patience pays off

Back in May 2015, the global leader in Obstructive Sleep Apnea (OSA) updated the market on its SERVE-HF clinical trial. The primary end point of the trial was to test whether a specific subset of patients, those with central sleep apnea and chronic heart failure, could benefit from having Adaptive Servo Ventilation (ASV) therapy applied to their treatment regime. In essence, the ASV therapy aimed to show that a patient's condition, when hospitalised with heart failure, could be improved by applying ventilation into the lungs.

The initial reading from the trial update wasn't positive, showing instead that a patient’s condition worsened, effectively putting an end to the test and resulting in an industry wide warning release. The company's valuation promptly dived by a third with the shares dropping from a high of $9.60 to their ultimate floor of $6.70.

As is often the way with clinical outcomes, subsequent analysis has shown that while some patients should be excluded from using ASV, others have been shown to benefit. While more work is required to better understand the therapy's limitations, the company's ability to continue to treat its core patient group, those suffering from OSA, remained unaffected by this trial setback.

In short, the share price sell-off presented investors with a buying opportunity. While the trial results clearly showed that some patients were off limits, this was not the case for an ever increasing number that were beneficiaries of OSA treatment.

Twelve months on and the story is quite different with the company's shares having largely recovered. The 2016 full year profit numbers have been posted and the business case remains compelling. This is not to suggest that everything is running smoothly. A competitive market place and the U.S. Government's drive to lower prices for medical devices has required constant action, both in product innovation and manufacturing efficiency.

In unveiling the company's full year numbers for 2016 the CEO Mick Farrell, son of founder Peter Farrell, gave some insight into the OSA opportunity;

"There is a huge opportunity and growth in our core market of sleep apnea. In the U.S. there is north of 60 million patients with OSA, we've only got about six million of them treated. Our penetration rate in China and India is less than 1 per cent… we've got 80 per cent of runway left in the U.S., 90 per cent in Western Europe and 99 per cent in our core market. This isn't fast food chains where you are competing over a fixed pool of goods and dividing over who gets what; this is a growing pie and we've grown our share and we are leading that."

For 2016, the group recorded revenues of USD$1.8 billion, operating profits of USD$429 million and net profits of USD$352 million. A USD$800 million acquisition of the leading cloud based health information provider Brightree during the past year represented the company's largest ever acquisition and positioned it as the industry's leading player in offering a connected digital solution between suppliers, health practitioners and patients.

Importantly, this has driven two positive outcomes. The first focuses on improving health compliance, with better informed patients, aimed at driving better outcomes. In short, patients given the tools to measure their well-being are better prepared to act and more likely to remain compliant with their treatment regime.

Secondly, the level of ongoing product innovation required and the growing move towards a fully integrated cloud based offering is shifting the competitive landscape from one fought purely on price to one based on who has the best cloud-based software offering.

This shift, from a pure cost focus to one involving value has further to play out. ResMed is one of three major global suppliers of Continuous Positive Airway Pressure (CPAP) equipment used to treat OSA patients, with the other two being Philips Respironics and Fisher & Paykel Healthcare. As the global leader, the group is investing a considerable sum to widen the gap between its nearest competitors. Only a few have the scale or the intellectual property to compete effectively, while those that do are addressing a considerable and growing market. ***SFM***

Chart 1: ResMed Share Price History (5 years)

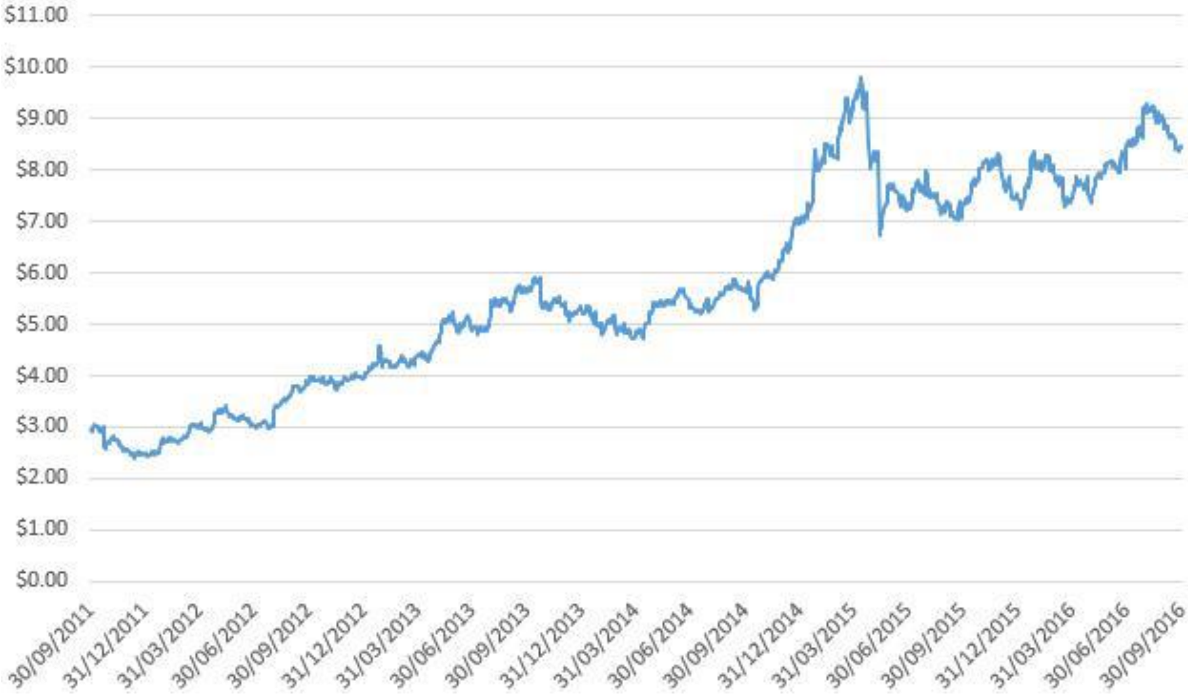


Table 1: ResMed Financial Summary (Year end June)

USD $ million (except share data)	FY16	FY15	FY14	FY13	FY12	FY11
Net Revenue	1,838.7	1,678.9	1,555.0	1,514.5	1,368.5	1,243.1
Gross Profit	1,066.5	1,011.4	989.8	940.7	820.7	741.3
Gross Margin (%)	*58.0*	*60.2*	*63.7*	*62.1*	*60.0*	*59.6*
Expenses						
Selling, general and administrative expenses	488.1	478.6	450.4	430.8	402.6	372.2
Research and Development Expenses	118.7	114.9	118.2	120.1	109.7	92.0
Restructuring Expenses	6.9	-	6.3	-	-	-
Education, Research and settlement Charge	-	-	-	24.8	-	-
Amortisation of acquired intangible assets	23.9	8.7	9.7	10.1	14.0	10.1
Total Expenses	**637.6**	**602.2**	**584.6**	**585.8**	**526.3**	**474.3**
Profit Before Tax	439.6	435.9	431.1	385.1	331.9	303.7
Operating Margin (%)	*23.9*	*26.0*	*27.7*	*25.4*	*24.3*	*24.4*
Net Profit After Tax	**352.4**	**352.9**	**345.3**	**307.1**	**254.9**	**223.0**
EPS (Diluted) (USD$)	2.49	2.47	2.39	2.10	1.71	1.44
DPS (USD$)	1.20	1.12	1.00	0.68	-	-
Diluted shares outstanding	141,669	142,687	144,359	146,410	149,316	157,195

Fisher & Paykel Healthcare (ASX: FPH)

Table 2: Fisher & Paykel Healthcare business timeline 2001 - 2016

YEAR	DETAILS
2001	21 November - Parent company Fisher & Paykel Appliances divests ownership in Fisher & Paykel Healthcare via listing on ASX, NZD and NASDAQ share markets | 99.9m fully paid shares | issue price NZ$4.50.
2001	Strong track record | compound annual growth rate 40.9% for past 5 years | 2001 full year revenue NZ$193m, operating profit NZ$79.8m.
2001	Business organised into 3 product group | Respiratory Humidification | Obstructive Sleep Apnea (OSA) | Neonatal Care.
2002	Company terminates its U.S. listing, withdraws from the NASDAQ market
2003	Group goes direct in Italy and Spain with operations serviced from company's Paris based distribution centre. Enters other markets including U.K., France, Belgium, Netherlands, Germany, Austria and Luxembourg.
2003	Fisher & Paykel receives U.S. FDA clearance for neonatal breathing circuits.
2004	Company introduces on market share buyback programme to acquire NZ$27m worth of shares.
2004	Fisher & Paykel Appliances sells remaining 19.3% interest in company at NZ$11.70 per share
2004	Under development for over three years, company announces introduction of revolutionary new breathing circuit technology, being permeable tubing that deals with condensed water that builds up in ventilators.
2004	October – Undertakes a share split of five new shares for every one old share.
2006	Group achieves revenues and net profits of NZ$290m and NZ$70m respectively.
2006	Company shares peak at AUD$3.89 (equivalent to AUD$19.45 pre-5:1 split).
2007	Company receives FDA warning letter regarding quality regulation surrounding U.S. Californian sales and distribution facility.
2008	Weaker U.S. dollar impacts the group's reported revenues and profits with sales up 3% to NZ$357m and net profits falling 31% NZ$35m.
2008	Divisional split with OSA representing 46% | Respiratory & Acute 51% | Consumables 70% of product revenue.
2009	Favourable foreign exchange lifts revenues 28% to NZ$459m and net profits 76% to NZ$62m.
2009	Announces intention to expand Auckland manufacturing site at a cost of NZ$95m, follows decision to build new site in Mexico. Overall market opportunity estimated at US$3b.
2010	Company launches new flow generator ICON. New applications for Respiratory and Acute Care generates 27% of consumable revenue. Total consumable sales contributing 75% of total group revenue.
2012	CareFusion, a leading global medical company servicing hospitals and Fisher & Paykel renew exclusive distribution agreement for U.S. hospital market, a relationship lasting 25 years.

YEAR	DETAILS
2012	Company releases new Eson nasal mask that follows on from the F&P Pilairo nasal pillow masks. All masks incorporate the RollFit Seal technology, minimising pressure on the nasal bridge.
2012	Group revenues of NZ$517m, net profit NZ$64m recorded.
2012	Share price hits 6-year low of AUD$1.45.
2013	Company releases new full face mask, Simplus and raises profit guidance to NZ$69m–NZ$70m.
2013	New flow generator range released ICON+. Company delivers record result, sales NZ$556m and profits of NZ$77m. Gross margins lift to 55%.
2014	Full year guidance raised within the range of NZ$90m – NZ$95m. Announces expansion of Mexican manufacturing facility. Delivers full year sales NZ$623m and net profits up 26% to NZ$97m. Gross margin hits 58.6%.
2015	Record revenues NZ$672m and profits of NZ$113m. Gross margin lifted to 61.1%.
2015	CEO Michael Daniell retires, following 33 years with the healthcare business.
2015	Company transitions to direct sales model in the U.S. Global team expanded to 3,500.
2016	New CEO Lewis Gradon appointed, having been with the company for 32 years, most recently as Senior Vice President Products and Technology.
2016	Business delivers 14% constant currency growth in revenue to NZ$815m, with net profit up 19% to NZ$143m. Gross margins 64%. Net debt NZ$44m. Market capitalisation hits NZ$5.7 billion.
2016	Management reaffirms market opportunity of USD$6b, covering the Hospital (Respiratory & Acute Care) and Homecare (OSA) markets.
2016	Recurring products incorporating consumables and accessories approximate 83% of total revenues.
2016	Shares hit all-time high of AUD$10.11 | FPH commits to manufacturing expansion in Mexico and NZ.
2016	September – Selector undertakes U.S operations and Mexican plant tour.

Background

Fisher & Paykel Healthcare is a business success story. Its origins can be traced back to its New Zealand parent company bearing the same name, white-goods manufacturer Fisher & Paykel. The decision by management back in 1980 to invest in a start-up medical division that was housed within the group now looks like a master stroke. Headed by General Manager Mike Daniell, the medical operations gained momentum over the ensuing years, before separating from its parent and listing onto the stock exchange in 2001.

Led by CEO Daniell, who's involvement with the Fisher & Paykel group tallied some 37 years, the healthcare business has continued to flourish, ending 2016 with sales of NZD$818 million and net profits of NZD$143 million.

The medical business that started with revenues of NZD$233,000 and 15 employees, now employs over 3,500, based in 36 countries and serving over 120 regions around the globe.

The retirement of Daniell in 2015 led to the internal appointment of Lewis Gradon as the new CEO. The choice of Gradon, a Fisher & Paykel Healthcare employee of 33 years, of which almost half was spent as Senior Vice President of Products and Technology, speaks volumes of the group's desire to maintain the culture that has underpinned its success to date.

From a standing start, the group's medical products offering has expanded into adjacent markets, including invasive ventilation, obstructive sleep apnea and more recently non-invasive ventilation, nasal high flow therapy and surgical humidification. In respiratory humidification the group is now positioned as the world's leading player, servicing an addressable market that is expected to experience ongoing growth.

The Business Case

The following points highlight the key attributes supporting the Fisher & Paykel Healthcare business case.

1. Market leadership in Respiratory Acute Care (RAC) with large installed base,
2. Large addressable global market in adjacent patient settings,
3. Few competitors,
4. IP ownership with significant ongoing R&D spend,
5. Direct sales force,
6. Consumable business model,
7. High gross margins,
8. Manufacturing leverage,
9. Organic business focus,
10. High return on capital employed and
11. Conservative balance sheet.

The Business

The group's operations are centred around the healthcare market and can be considered as two distinct parts. The first involves the provision of respiratory invasive ventilation products in a hospital setting. This is a global market opportunity where the group enjoys a market share north of 80%.

In more recent years the company has taken its knowledge of invasive ventilation into adjacent markets. This has resulted in the extension of products into newer fields including the non-invasive ventilation market, the hospitals surgical setting, as well as the at-home market. In all, some 7 million patients are currently being serviced annually by the company from an estimated addressable market exceeding 50 million.

The second business line addresses the obstructive sleep apnea (OSA) market, where it competes with the two largest players, ResMed and Phillips Respironics. This is a market estimated to be currently worth USD$3 billion and growing at 6-8% p.a, with over 20 million Americans already diagnosed with OSA from a total OSA global market population expected to exceed 50 million people in developed countries.

Combined, Fisher & Paykel estimates that it's two divisions sold medical devices used in the treatment of more than 10 million patients during 2016. Based on management guidance the company believes this figure could increase to 30 million over the next 10-15 years.

Homecare: Obstructive Sleep Apnea (OSA)

In our September 2012 Quarterly Newsletter we put forward the ResMed business case where we defined OSA;

"People with OSA experience re-current episodes where respiratory airflow ceases during sleep. These episodes are due to a temporary collapse of the upper airway. This happens when the muscles, which normally hold the upper airway open during sleep, relax and cause the airways to narrow. If the throat is particularly narrow or the muscles relax too much, the airway can become completely blocked. This is called obstructive apnea."

The 2012 article also set out the industry dynamics including the dominance of the two major players being ResMed and Philips Respironics. Fisher & Paykel entered the industry in later years but have since built a formidable position in one segment, being the supplier of consumables, specifically masks.

The OSA business is made up of two parts. The first involves the provision of an airflow generator that allows for the introduction of air into the patients' airways, by way of a nasal or full face mask. The air pressure that is applied acts like an air splint to keep the upper airway open to prevent OSA. These flow generators involve a one-off sale, with replacements typically taking place with new product releases.

The more attractive and higher margin segment of the OSA business sits with the sale of consumables that support the use of flow generators. In much the same way that the classic razor and blade business model works, the requirement for users to replace masks regularly provides operators in this space with a highly attractive annuity type revenue model.

For its part, Fisher & Paykel derives 45% of group revenue servicing OSA, of which 15% comes by way of flow generator sales and 85% through masks. This is important to appreciate as flow generators carry the lowest gross margins while at the other end, masks are the highest as well as having the advantage of being interchangeable with all other competitor flow generators.

Here, the group's RollFit mask seal technology has proved to be a significant point of difference, driving strong patient compliance and growth across the full range of mask offerings. This is reflected in a disproportionately greater market share in masks, with the group's flow generator installed base sitting at sub 10% whereas masks are estimated at 15% and upwards of 50% for new mask sales.

Hospital: Respiratory Acute Care (RAC)

The other side of the business is the Respiratory and Acute Care (RAC) division. This makes up the balance of group sales, delivering 55% of total revenue. With over 30 years of respiratory knowledge in delivering heated humidification, the group has cemented itself as the leading player in treating patients in an intensive care unit (ICU).

Here the company's key point of difference lies in its ability to deliver warm, humidified air at higher flow rates than its competitors. Within the hospital ICU setting, some 7 million patients require heated invasive ventilation treatment. Of these, 5 million are serviced by equipment supplied by Fisher & Paykel, with the balance continuing to use older Heat and Moisture Exchanger (HME) technology.

While growth rates in this segment are expected to remain modest, the company has been applying its technology to less developed but significantly larger markets that service patients outside the ICU setting, principally in the hospital ward, surgery and at home.

The driver behind this growing opportunity has been the introduction of the High-Flow Nasal Cannula (HFNC) Oxygen Therapy (OT). This treatment provides high flow heated humidification for adults and children which differs from traditional cold OT. A growing body of medical opinion is supporting such wider use with patients enjoying greater comfort and fewer infections, while hospitals incur lower out of pocket expenses as a result of fewer re-admitted patients.

As the leading proponent of OT in hospitals, the company's Optiflow therapy is its key product offering. This consists of a stand-alone mobile humidifier, the AIRVO, plus consumables such as a nasal cannula and chamber for single patient use. As such, a high proportion of revenue is consumable in nature, giving rise to higher gross margins. Management refer to this market segment as the "New RAC" since it enjoys much higher growth rates than the traditional "Old RAC" segment which has historically addressed patients within the ICU.

The addressable market for "New RAC", although difficult to pin down, is estimated to be in excess of 50 million patients, with the majority of the opportunity sitting within the hospital ward and emergency department setting using HFNC Optiflow products.

Intellectual Property

The company has consistently invested in the business, maintaining on average an annual fully-expensed research and development spend of 9% of group revenue. During 2016 this totalled $73.3m, with 500 employees out of a total 3,500 workforce focused on product innovation. This has given rise to differentiating technologies and the strongest barrier to competitive responses, reflected in the group's RollFit seal technology underpinning the group's range of masks and the patented Evaqua expiratory tubing used in RAC products that delivers gas at higher flow rates than competitors with minimal levels of condensation.

Direct U.S. Sales Force

In 2015 the company made the decision to end its distributor relationship with U.S. healthcare group CareFusion. This followed the takeover of CareFusion by Becton Dickinson and mirrored the group’s shift to a direct sales model successfully implemented in 30 other key markets.

The transition undertaken during the past year is expected to deliver significant ongoing benefits. While the group picks up the additional costs of ramping up its sales and marketing, the removal of a distributor margin as well as long term relationships formed when dealing directly with its hospital customer base more than justifies the move.

Consumable business model

Apart from the sale of OSA flow generators and respiratory ventilation units, the bulk of the company's revenues comprise the sale of consumable products, which are non-standard and designed only to work with Fisher & Paykel products. In 2016 this represented a revenue split between hardware and consumables of 16% and 84% respectively. The contribution lift from consumables is not only desirable but a positive trend that has been underway for many years.

With over 500 individual consumable pieces making up the range of OSA and RAC products, management note that for a hospital, the average cost of all consumables required per patient is circa $60 over a 5-day visit, or roughly $10 per day.

And whilst individual product margins are not provided, gross margins for consumables are north of 70% while hardware devices earn margins of less than 40%. In aggregate, the trend in gross margins has been positive, lifting from 53% in 2012 to 64% in 2016.

Manufacturing

The business operates two manufacturing facilities, made up of the 82,000 square metre New Zealand site and the newer 18,000 square metre Mexican plant. Being larger and more established, the New Zealand based facility currently undertakes 73% of production as well as any new product releases. That said, the Mexican facility continues to ramp up with 27% of all consumables undertaken in the facility and management expectations of lifting this well beyond 50% in the foreseeable future.

The Mexican operation enjoys a significant cost advantage of 30% over its New Zealand facility, helping to lower operating costs and contributing to an ongoing lift in group gross margins.

U.S. Site Visit

During September we joined company management on a hosted investor tour of the group's U.S. operations and a site visit of the company's Tijuana manufacturing facilities in Mexico. From a standing start in 2009, the Mexican operation now houses some 811 employees and contributes 27% of total manufacturing volume. The planned ramp up in production, discussed below, will see this grow to circa 40%, with the balance supplied from the much larger New Zealand operations.

Photo 2: Site layout for FHP's newly proposed "greenfield" manufacturing facility

The importance of the Mexican operations should not be underestimated. The manufacturing build has been in the words of management "flawless", providing the group with a secondary point of manufacturing capability in an alternate time zone to the group's home territory of New Zealand.

So successful has been the experience to date that management have recently committed to a further expansion with the purchase of 15 hectares of freehold land, located at Tijuana - La Encantada, to ultimately lift production capacity by a factor of four, thereby meeting expected demand well into the next decade. Senior management and staff on site are predominately of Mexican origins, providing excellent ongoing relationships with the Government and the company.

This long term methodical planning process is typical of Fisher & Paykel and underscores the company's belief in the latent product demand that remains within the markets that it services. At its core, the company emphasises the importance of its people and our brief time spent with senior management and production staff illustrated the mutual respect that exists.

While the company continues to build market share in both segments of hospital and homecare, this has only been possible because of the group's preparedness to invest upfront and plan long term. Our visit suggests things remain very much on track.

Photo 3: Site of FPH's newly proposed Mexico manufacturing facility

Financial Performance 2010- 2016

Table 3 reflects the company's financial progress since 2010. Due to the significance of international earnings contributing to company earnings, the movement in foreign exchange rates can have a material impact on reported numbers. As such, *Table 3* looks at the business on a constant currency basis, with 2016 representing the base year. Over this period, revenues have grown from NZD$414 million to NZD$737 million, with gross margins rising from 45.2% to 61.6% resulting in sharply higher operating profits of NZD$156 million compared to the NZD$27.3 million recorded in 2010.

New manufacturing operations in Mexico have contributed to the lift in gross margins while the move into more value adding consumables including OSA masks and RAC humidification aided the group's strong operating leverage. The company reports the return on average shareholder equity at 39.7% for the 2016 year, while a focus on pursuing an organic growth strategy has left the business in a financially strong position with net debt sitting at NZD$44 million, representing a gearing ratio of less than 10%. ***SFM***

Table 3: FPH constant currency Income Statement

	Year ended 31st March						
NZ $000	2010	2011	2012	2013	2014	2015	2016
Operating revenue	414,095	424,548	457,683	507,566	572,838	649,203	737,027
Cost of sales	226,823	224,182	237,632	247,808	259,234	267,120	282,800
Gross profit	187,272	200,366	220,051	259,758	313,604	382,083	454,227
Gross Margin (%)	***45.2***	***47.2***	***48.1***	***51.2***	***54.7***	***58.9***	***61.6***
Other income	4,269	1,200	2,400	2,400	3,700	5,000	5,000
Selling, general and administrative expenses	123,543	130,732	136,467	148,142	171,091	181,920	223,455
Research & development expenses	35,272	39,277	41,988	45,720	54,146	64,987	73,288
Total operating expenses	158,815	170,009	178,455	193,862	225,237	246,907	296,743
Operating profit	32,726	31,557	43,996	68,295	92,067	140,176	162,484
Operating margin (%)	***7.9***	***7.4***	***9.6***	***13.5***	***16.1***	***21.6***	***22.0***
Financing expenses (net)	5,394	5,177	3,898	4,707	7,755	9,225	5,982
Profit before tax	27,332	26,380	40,098	63,588	84,312	130,951	156,502

Reliance Worldwide Corporation (ASX: RWC)

Birmingham, Alabama is typically two flights west of LAX. On a September Sunday we met with Altium in the beachside suburb of La Jolla, Southern California. Monday we crossed the U.S. / Mexican border, on foot, heading south to Tijuana to visit Fisher & Paykel Healthcare (see separate story).

U.S. customs police boarded the bus, sniffer dogs joined in and then 30 odd fund managers, analysts and corporate types were herded off the bus for the short walk across the border through razor wire and holding pens. The impressive fence extends 300m out to sea. It makes you wonder if Donald Trump's wall, paid for by the good old Mexicans themselves, will add much value. I suppose it depends on who wins the contract to build it.

We got into Birmingham at midnight on Tuesday. So it was Wednesday morning that we found ourselves on another bus, this time heading north through Warrior, Dodge City and Good Hope, on our way to Cullman, Alabama. Cullman apparently has various impressive tourist attractions.

We didn't see any of those. Instead we headed straight for the 550,000 square foot operation of Reliance Worldwide Corporation (RWC).

RWC's Cullman facility consists of 3 manufacturing plants and a distribution centre. They produce valves for hot water systems, behind the wall "push-to-connect" plumbing fittings called the "SharkBite" and PEX pipe, a flexible pipe that can be used as an alternative to the standard copper pipes. Together these products represent the materials required for 'rough plumbing' a house. Combined these items generate USD$300 million or 68% of RWC group revenue.

RWC plans to disrupt, revolutionise and dominate the 'rough plumbing' market in the U.S. In this article we ask some simple questions on how you do that. Remember, this is an industry that doesn't change much.

Why do it in Alabama?

In 2002 RWC bought the 88,000 square foot Cash Acme manufacturing facility from Tyco International. Cash Acme was founded in 1912 and has manufactured valves and fittings in Cullman, Alabama, since 1995. The acquisition provided RWC with a skilled manufacturing workforce in a central location in the U.S. market. The Lufkin and Webb Wheel buildings pictured bottom left and right have been vacated and may be acquired by RWC at some future point, providing ample scope for expansion.

Photo 4: Reliance Alabama Manufacturing Facilities

What is the US opportunity?

Significant capital has been invested since 2002. As a result, RWC now operates across two campuses that are six times larger than the original acquisition, equating to the 550,000 square feet facility outlined above. Full time staff have grown from 75 to 300 and USD revenues have increased 25-fold compounding at an impressive 20% over a 13-year period.

To date the rapid expansion has come at the expense of operating efficiencies. Management believe they now have the operational scale that justifies a focus on projects that will extract these benefits. Supporting this efficiency drive, are new scalable IT platforms provided by SAP and Salesforce.

Today, "push-to-connect" has a 10% share (by volume) of the USD$400 million "rough plumbing fittings" market.

- RWC's brass SharkBite fitting and PEX pipe offer has 80% share of the 10% of the US "push-to-connect" market.
- 70% of this is sold into the repair and remodel segment market.
- RWC does not currently supply the new construction market, however, the launch of EvoPEX is pending. EvoPEX is an end to end solution for new home construction.
- EvoPEX targets additional markets that could be as large as USD$2b - $3.5b.

The opportunity is two-fold. Firstly, it leverages the benefits of a world class manufacturing and distribution facility to substantially grow the 10% share of the rough plumbing market. Secondly, EvoPEX will provide the impetus for an expansion into a new, significantly larger market.

To support this, RWC believe they have a first class customer list with excellent distribution points across the USA. This includes the recent addition of big-box operator Lowe’s, which is discussed later.

From our site inspections and discussions with management, it appears that the major infrastructure pieces are in place and capacity for expansion exists. This business is now all about execution.

Which products are potentially disruptive?

SharkBite Fittings

On our plant tour we watched brass “push-to-connect fittings” made from scratch. The process is part traditional metal lathe, combined with 7th generation state of the art robotics wrapped in Italian machinery. Single operator oversite is required at each station. The process is somewhat hypnotic at first viewing, as robotic arms twist and turn the 2-meter-long brass rods into highly polished 5cm - 7cm finished fittings. The process appears efficient.

PEX

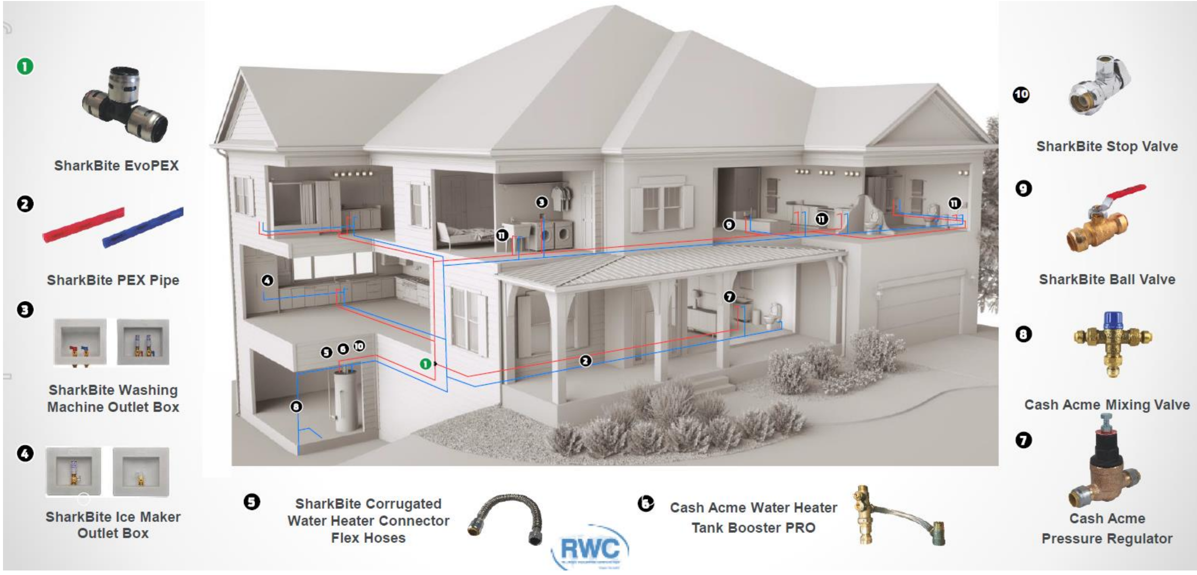
PEX is a form of polyethylene with cross-links. It is formed into tubing, and is used predominantly in building services pipework systems, hydronic radiant heating and cooling systems, domestic water piping, and insulation for high tension (high voltage) electrical cables. It is also used for natural gas and offshore oil applications, chemical transportation, and transportation of sewage and slurries. PEX has become a common alternative to polyvinyl chloride (PVC), chlorinated polyvinyl chloride (CPVC) or copper tubing for use as residential water pipes.

We watched this product extruded and colour coded for hot and cold water applications. The finished product is rolled into coils for efficient storage and transport purposes.

EvoPEX

In 2017 RWC will launch EvoPEX – a complete rough plumbing system for the new construction market. EvoPEX includes fitting joints and PEX pipe. It is an end to end simple solution.

Photo 5: EvoPEX complete rough plumbing system for new construction (no tools, flames or chemicals)



Why are SharkBite and PEX and EvoPEX considered disruptive?

SharkBite's disruptive qualities stem from the "push-to-connect" installation process. The key disruptive element is speed of installation. It is faster and safer than solder or crimp alternatives. It requires less training and/or a less skilled installation team. Furthermore, the end result is superior. There are multiple justifications for this claim.

- Process of "push-to-connect" is simple, hence less room for error.
- The benefits of PEX pipe are discussed below.

PEX pipe has a list of advantages that include:

- **Easier installation** – Installing PEX is much less labour-intensive than copper pipes, since there is no need to use torches to solder pipes together, or to use glue to attach pipes to fittings. We address the importance of the labour advantage below.
- **Flexibility** – PEX has become a contender for use in residential water plumbing because of its flexibility. It can bend into a wide-radius turn if space permits, or accommodate turns by using elbow joints. In addition, it can handle short-radius turns, sometimes supported with a metal brace; in contrast, PVC, CPVC and copper all require elbow joints.
- **Direct routing of pipes** – PEX can run straight from a distribution point to an outlet fixture without cutting or splicing the pipe. This reduces the need for potentially weak and costly joints and reduces the drop in pressure due to turbulence induced at transitions.
- **Lower materials cost** – Cost of materials is approximately 25% of alternatives. One account suggested that the price of copper had quadrupled from 2002 to 2006. While

this may be associated with a once in a century commodities super cycle, plumbers have a similar long memory cycle when the “hip pocket” is impacted.

- **Non-corrodible -** PEX, unlike copper, is not subject to corrosion from minerals or moisture.
- **No fire risk during installation** – The oldest and most common method for joining copper piping is to solder pieces together using a gas fired blow torch.
- **Less likely to burst from freezing** – The general position is that PEX plastic materials are slower to burst than copper or PVC pipes, but that they will burst eventually since freezing causes water to expand. In 2007 a home expert suggested that PEX water-filled pipes could endure "five or six freeze-thaw cycles without splitting" while copper would split apart promptly on the first freeze.

Inevitably with any new product some element of “change” is introduced. Key draw backs include:

- **Initial adjustment to a new plumbing system** – There were a few reported problems in the early stages as plumbers and homeowners learned to adjust to the new fittings, and when connections were poorly or improperly made, but home inspectors have generally not noticed any problems with PEX since 2000.
- **Fitting expenses**. – Generally, PEX fittings, particularly SharkBite “push-to-connect”, are more expensive than copper ones, although there is no soldering required. Due to the flexibility of PEX, it generally requires fewer fittings, which tends to offset the higher cost per fitting. In addition, professional labour savings are significant as addressed below in the working examples provided by RWC.
- **Possible health effects** – There was controversy in California during the 2000’s regarding health concerns. Several groups blocked adoption of PEX for concerns about chemicals getting into the water, either from chemicals outside the pipes, or from chemicals inside the pipes such as methyl tertiary butyl ether and tertiary butyl alcohol. These concerns delayed state-wide adoption of PEX for almost a decade. After substantial "back-and-forth legal wrangling", which was described as a "judicial rollercoaster", the disputing groups came to a consensus, and California permitted use of PEX in all occupancies. An environmental impact report and subsequent studies determined there were no causes for concerns about public health from use of PEX piping.

Photo 6: New EvoPex range for new home construction

EvoPEX combines the benefits discussed above in an end to end solution for the new home construction market.

How important is the labour component in plumbing?

According to www.eyeonhousing.org the trade of plumbing is projected to face a labour shortage of highly skilled plumbers by 2022, as trained graduates fall short of replacing the retiring workforce. This opens the rough plumbing market place to new innovative solutions that require less labour.

RWC believe labour savings are the single most important element of their disruptive growth strategy. Their new product innovation is designed and built to exploit the 20% arbitrage in relation to the trade labour shortage.

First time installs - Professional time saved installing EvoPEX

Location	South Carolina	South Carolina	Mississippi
House Size (Square Feet)	3180	2000	1200
# of Bathrooms	3	3	2 and crawl space
Rough in Crew (men)	2	2	2
Time (H): EvoPEX v Solder	1.5 v 6.5 hours	4 v 7.5 hours	1.5 v 4 hours

The table above, with real jobs in the field data[1], demonstrates the significant saving generated through ***first time installations*** by crews that have not previously used a "push-to-connect" system. Remember it requires no flame, no glue, no tools, less joints and less training.

RWC believe that the large builders in new home construction in the USA want to buy and install systems. The gold standard is building an end-to-end solution system. RWC believes EvoPEX will gain share on the basis that it is a true end to end solution which is faster, stronger, better.

As an aside, we travelled from Alabama to South Carolina to visit James Hardie (JHX). A key project builder that we met with said that the single largest limiting factor to the growth of his business was labour shortages for new siding installations, echoing RWC's claim.

[1] Data provided by Reliance Worldwide Corporation.

How do you dominate rough plumbing in the U.S?

This is an important question lost on many.

RWC is in its prospectus year. It's a year when a new company establishes some trust and followers, maybe some true believers if they are fortunate. If a company strays from this "book of truths", then they can expect the same question, asked from hundreds of angles, while their share price is shredded before the answers even leave management's lips.

In its prospectus RWC outlined a two-way exclusive relationship with Home Depot, the largest listed US big-box retailer or home hardware chain with more than 1,700 sites across the States. This relationship has allowed RWC to dominate the "push-to-connect" fittings market in the U.S. to date. As noted above "push-to-connect" has circa 10% share (by volume) of the market and RWC are dominant in this space with a circa 80% market share.

This position is fortified by having product available on shelves > 95% of the time. Product innovation and IP is also key, as addressed above. So the game is all about growing the 10% while maintaining the 80%.

So when RWC management announced that the mutually ***exclusive*** Home Depot deal had been terminated in its prospectus year, questions started to fly quicker than you could "push-to-connect" or join the dots.

The explanation provided seems reasonable to us. RWC were approached on multiple occasions by Lowe's. Lowe's are the second largest major big-box home hardware retailer who also have circa 1,700 stores across the U.S. RWC had rejected these approaches previously, however, on this occasion they considered that the opportunity to be a part of the new Lowe's push into the professional plumbing category to be both compelling and importantly, a one off opportunity.

The partnership with Lowe's is designed to grow the market (the 10% by volume) and in turn cement RWC as the dominant player (80% share of the growing 10%). This is the key stated aim of the RWC management team.

Exclusivity does not work when two competing parties are involved. So exclusivity with Home Depot was always going to be a casualty of the decision to supply both parties. Unfortunately, this was the point that required minute examination during the hour we collectively had with management.

We are of the opinion that Home Depot has little alternative but to continue to stock and supply the RWC SharkBite product, PEX pipe and soon to be released EvoPEX system. It is the leading product in the space. Our confidence was increased by the Lowe's approach. We understand that Lowe's had exhausted every other "play" in the "playbook" in an attempt to gain a footing in the "push-to-connect" rough plumbing space. The Lowe's playbook included a failed relationship with a competing supplier. On this point RWC simply state that no dominant competitor exists.

The Lowe's experience leaves Home Depot with two choices, or "plays" in U.S. parlance. Continue to support the RWC relationship and their own customer base or make an uneconomic business decision to punitively punish an upstart at the expense of their customers. While this is not outside the realms of possibilities, we think it is the less likely outcome.

RWC's new relationship with Lowe's will not be without its challenges. Suppling two large big-box operations requires capacity uplift, additional warehousing and proven logistics expertise. It appears the pieces are in place. Our site visit provided comfort that the Cullman campus could be expanded via acquisition of adjoining sites to meet these requirements. We have confidence in the RWC management team. It's now all about execution and relationship management. ***SFM***

Glenn Stevens - you're not kidding

Our investment approach is best described as bottom up, one where the individual merits of a business and the management team are considered largely in isolation to the external macro-economic environment. It's not that we ignore these developments but more broadly aim to accommodate them once we have established the individual merits of each investment under consideration.

However, the external economic setting has a much more important part to play when viewed over an extended period of years or decades rather than months. The financial crisis that hit in 2008 is one such event that continues to shape our thoughts. Australia's financial setting remains strong but the inevitable passing of time along with weaknesses in revenues and rising expenses has resulted in a growing national debt pile and an economy less able to deal with external shocks.

It is with this thought in mind that we reflect on recent comments from our now retired Reserve Bank of Australia (RBA) Governor Glenn Stevens and newly re-elected Federal Treasurer Scott Morrison.

Ex-RBA Governor RBA Glenn Stevens

In handing over the reins to his deputy Philip Lowe, retiring Reserve Bank of Australia (RBA) Governor Glenn Stevens used his departing speech to highlight the growing political trend of avoiding the tough decisions in addressing the economic fallout of low growth, as he noted on the 10 August:

"When specific ideas are proposed that will actually make a difference over the medium to long term, the conversation quickly shifts to rather narrow notions of fairness, people look to their own positions, the interest groups all come out and the specific proposals often run into the sand. If you think this rather other-worldly discussion will not have to give way to a more hard-nosed conversation, we are kidding ourselves."

Whether Stevens will be proven correct or not, the topic of governments taking greater fiscal responsibility is without question a priority that all politicians must address. Contrast that with company boards and management teams that have no choice but to confront the truth when things turn sour. Tough decisions, cost cutting and a refocus on the key priorities is what usually follows, along with a shareholder base that either stays or chooses to exit.

Governments don't necessarily have the same luxury. They govern for a term and at the very least aim to be re-elected for a further period. It's not an ideal arrangement and jeopardises the need for prudent and responsible action. Here, Stevens is absolutely right. Inaction will catch up with all of us and we are kidding ourselves if we think we can pay lip-service to the difficult task of restoring the fiscal budget.

As to negative interest rates which we have commented on in the past, he offers the following views:

"At least one of the issues with a negative interest rate policy is that to implement it in a way that's effective and broad based and not damaging to bank earnings, that's very difficult, and that's being found in those other jurisdictions."

On the outlook for the U.S. where we remain positive he notes:

"U.S. inflation is going to be pretty low for a while. I think in the United States, it is actually inching up, which it is meant to, but in many other places it's going to remain quite low by the look of it, including here. Beyond 2018, well, I don't know. I don't think you can know."

Federal Treasurer Scott Morrison

In a further attempt to set up an open dialogue with the electorate, the Treasurer along with the Prime Minister is looking to press home the importance of dealing with the economic reality of budget deficits and rising debt levels. While Governments can be easily accused of raising alarmist views the facts are supportive of the potential consequences that Treasurer Morrison is trying to convey.

Following multiple years of budget deficits our Government is currently sitting with gross debt of $430 billion, a figure which the Treasurer notes, that under a worse-case scenario of a doing nothing approach, would see this figure exceed $1 trillion over the next decade.

More disturbing, is the mindset that has become mainstream in the community of what is expected from governments, as the Treasurer outlined in a recent speech:

"There is a new divide, the taxed and taxed-nots. Deficits are dismissed as temporary, cyclic and self-correcting. If it means services are maintained, then deficits are OK - just increase the taxes or increase the debt.

A generation has grown up not ever having known a recession, of seeing unemployment rates at more than 10 per cent, with one million Australians out of work or mortgage rates at 18 per cent or where inflation is actually a problem, rather than an aspiration.

In addition, a generation has grown up in an environment where receiving payments from the government is not seen as the reserve of the disadvantaged, but a common and expected component of their income over their entire life cycle, and not inconsistent with self-reliance.

On current settings, more Australians today are likely to go through their entire lives without ever paying tax than any other generation. And more Australians are likely today to be net beneficiaries of the government than contributors – never paying more tax than they receive in government payments."

These are genuine concerns and the long term dangers of doing nothing is not a pleasant scenario. Currently, the Government's gross debt profile is giving rise to annual interest payments of $16 billion a year. This is a not insignificant amount and the lack of accountability from all political quarters is ultimately placing further demands on individuals and businesses who not only pay the rump of the taxes but are being asked to dig deeper.

When used sensibly and conservatively, debt may bring about economic benefits that can be particularly powerful. Unfortunately, the same is true when left uncontrolled, a point Treasurer Morrison has rightly highlighted.

"Once that debt fully takes hold, it will build its own momentum and will only grow more difficult to tame."

We are not holding our breath that sanity will prevail but remain hopeful that sufficient pressure will be applied to drive home some sensible outcomes. ***SFM***

Buyer Beware – Inghams Group

The private equity sale of Inghams Group is on track for an expected $1.5b public listing. The Inghams business is the largest poultry producer in the Australian and New Zealand regions with sales of $2.3b and market shares by value estimated at 40% and 35% respectively.

On the surface there are many things to like about the business. Obviously its market leading position in Australia is a key positive, assisted by regulations that restrict the importation of competing produce. With the two main players controlling upwards of 75% market share, the poultry business is all about scale and extracting efficiencies along the whole value chain.

Importantly, the Inghams brand is well respected among consumers with a long history dating back to 1918. Demand for poultry continues to outstrip other forms of proteins such as beef, pork or fish, with this trend expected to continue. The business is also vertically integrated allowing for efficiencies to be gained across the group's 345 facilities and nine distribution centres.

The sale of the business to private equity group TPG Capital in 2013 has now resulted in the current owner's decision to exit via a public listing. The appointment of Mick McMahon as CEO will be well received by investors. A no-nonsense executive, McMahon now has the task of extracting those efficiencies whilst reinvesting significant sums, circa $160-$200m over the next five years, under the aptly named Project Accelerate.

However, concerns remain around the involvement of Private Equity. While we don't profess to know all the intricacies regarding the company's financial details a few points are worth noting. As we commented earlier and following 94 years of private ownership the business was sold by the Ingham family to TPG in 2013 for a reported $880m.

In 2014 and under new ownership, the company sold the majority of its freehold property for a reported $540m, subsequently paying out some $550m in dividends and taking on substantial debt. This type of action is typical of private equity, investing little in the way of equity upfront, selling off hard assets only to be replaced by long term leases and distributing significant dividends often funded via higher levels of debt.

The business also embarked on a $400m investment program in order to build capacity and restructure the group's South Australian operations. The current Project Accelerate is a continuation of this program while current annual stay in business capital expenditure sits above $30m per annum.

In terms of financials there are always issues when a business transitions from private to public hands, however, a quick comparison between prior years reveals a note of caution. While sales have steadily climbed from $1.89b in 2014 to $1.95b in 2016, group operating earnings (EBIT) experienced a rougher ride, hitting $102m in 2014, before falling to $81m in 2015 and recovering to $133m in the 2016 year.

For 2017, company sales of $2.4b have been forecast, with earnings lifting to $148m, reflecting an improvement in operating margins from 5.8% to 6.2%. The cause for the dip in earnings in 2015 can be sheeted home to some poor decisions surrounding seasonal turkey demand, which has since been rectified.

From here on the main game is on extracting more value from existing operations through the introduction of greater operational efficiencies. As things stand, the business is expected to generate earnings before interest tax and depreciation (EBITDA) margins of 8.0%, whereas a possible five-year target post Project Accelerate could see this sitting somewhere in the low double digit range. Management is fully aware of the consequences of overpromising, so the expectations are that the forecast numbers have been conservatively struck.

Add to that the significant number of investment bankers on board and a reasonable conclusion could be drawn that the business is likely to get a positive endorsement, with the shares likely to be priced around 15x the group's 2017 net earnings. For TPG Capital, this sale follows on from previous exits involving the group, including Myer in 2009, at an issue price of $4.10 per share and Healthscope in 2014, at an offer price of $2.10 per share.

Table 4: IPO Joint Lead Manager Inghams valuation ranges

Joint lead managers to IPO	Valuation range ($b)
UBS	1.1 - 1.6
Macquarie Capital	1.3 - 1.7
Goldman Sachs	1.3 - 1.5
Citi	1.4 - 1.6
Morgan Stanley	1.1 - 1.5
Credit Suisse	1.3 - 1.7

Source: The Australian

While there is merit in the business, we see no compelling reason to jump on board at this juncture. ***SFM***

Company visit diary September 2016 Quarter

July

PXS	Pharmaxis management meeting	05/07/2016
TNE	Technology One management meeting	06/07/2016
SHM	Shriro site visit	07/07/2016
AGI	Ainsworth Game Technology management conference call	07/07/2016
CAT	Catapult Group acquisition conference call	13/07/2016
RKN	Reckon management meeting	20/07/2016
Google	Google Morgan Stanley Digital Consumer Forum	15/07/2016
FDV	Frontier Digital Ventures pre-IPO management meeting	26/07/2016
ACR	Acrux BioShares Biotech Summit	29/07/2016
IIL	Innate Immunotherapeutics BioShares Biotech Summit	29/07/2016
RNO	Rhinomed BioShares Biotech Summit	29/07/2016
CYC	Cyclopharm BioShares Biotech Summit	29/07/2016
ALC	Alcidion BioShares Biotech Summit	29/07/2016
CGS	Cogstate BioShares Biotech Summit	29/07/2016
IPD	Impedimed BioShares Biotech Summit	29/07/2016
PXS	Pharmaxis BioShares Biotech Summit	29/07/2016
NAN	Nanosonics BioShares Biotech Summit	29/07/2016
ACG	Atcor Medical BioShares Biotech Summit	29/07/2016
FTT	Factor Therapeutics BioShares Biotech Summit	29/07/2016
ASX	ASX listings team BioShares Biotech Summit	30/07/2016
VHT	Volpara Solutions BioShares Biotech Summit	30/07/2016
RAP	ResApp Health BioShares Biotech Summit	30/07/2016
DVL	Dorsavi BioShares Biotech Summit	30/07/2016
OPT	Opthea BioShares Biotech Summit	30/07/2016
ADR	Adherium BioShares Biotech Summit	30/07/2016
AXP	AirXpanders BioShares Biotech Summit	30/07/2016

August

NVT	Navitas FY16 results briefing	02/08/2016
OFX	OFX Group Annual General Meeting	03/08/2016
COH	Cochlear FY16 results briefing	09/08/2016
RKN	Reckon management meeting	09/08/2016
IFL	IOOF Holdings FY16 results briefing	09/08/2016
CAR	Carsales.com management meeting	10/08/2016
ALL	Aristocrat Leisure AGE Trade show	10/08/2016
CPU	Computershare FY16 results briefing	10/08/2016
IFL	IOOF Holdings management meeting	10/08/2016
REA	REA Group management meeting	11/08/2016
JHX	James Hardie Industries Q1FY17 results briefing	12/08/2016
JBH	JB Hi-Fi FY16 results briefing	15/08/2016
JHX	James Hardie Industries Q1 FY17 investor relations meeting	15/08/2016

DMP	Domino Pizza Enterprise FY16 results briefing	16/08/2016
CSL	CSL Limited FY16 results briefing	17/08/2016
IRE	IRESS Limited HY17 results briefing	18/08/2016
BAP	Burson Group Ltd FY16 results briefing	18/08/2016
IPH	IPH Limited FY16 results briefing	18/08/2016
SYD	SYD Airport HY17 results briefing	18/08/2016
SOM	SomnoMed Limited FY16 results management meeting	18/08/2016
ASX	ASX Limited FY16 results management meeting	19/08/2016
PSQ	Pacific Smiles Grp FY16 results management meeting	22/08/2016
NHF	NIB Holdings Limited FY16 results briefing	22/08/2016
MYS	MyState Limited FY16 results briefing	22/08/2016
SEK	Seek Limited FY16 results briefing	22/08/2016
GBT	GBST Holdings FY16 results management meeting	22/08/2016
OSH	Oil Search Ltd FY16 results briefing	23/08/2016
NAN	Nanosonics Limited FY16 results management meeting	23/08/2016
TOX	Tox Free Solutions FY16 results briefing	23/08/2016
VRT	Virtus Health Ltd FY16 results management meeting	23/08/2016
NEA	Nearmap Ltd FY16 results briefing	24/08/2016
ACX	Aconex Limited FY16 results management meeting	24/08/2016
SRX	Sirtex Medical FY16 results management meeting	24/08/2016
MYO	MYOB Group Ltd HY17 results briefing	25/08/2016
FLT	Flight Centre Travel FY16 results briefing	25/08/2016
BKL	Blackmores Limited FY16 results management meeting	25/08/2016
ALU	Altium Limited FY16 results management meeting	25/08/2016
SGM	Sims Metal Management FY16 results management meeting	25/08/2016
SRX	Sirtex Medical FY16 results management meeting	25/08/2016
WTC	Wisetech FY16 results management meeting	25/08/2016
AGI	Ainsworth Game Technology FY16 results management meeting	25/08/2016
IQE	Intueri Education FY16 results briefing	29/08/2016
IFM	Infomedia Ltd FY16 results briefing	29/08/2016
RWC	Reliance Worldwide Corporation FY16 results briefing	29/08/2016
JIN	Jumbo Interactive FY16 results briefing	29/08/2016
FLT	Flight Centre Travel FY16 results management meeting	29/08/2016
QUB	Qube Holdings Ltd FY16 results management meeting	29/08/2016
SGR	The Star Entertainment Group FY16 management meeting	29/08/2016
3PL	3P Learning Ltd FY16 results management meeting	29/08/2016
FXL	FlexiGroup Limited FY16 results briefing	30/08/2016
IFM	Infomedia Ltd FY16 results management meeting	30/08/2016
TTS	Tatts Group Ltd FY16 results management meeting	30/08/2016
MAI	Mainstream BPO FY16 results briefing	30/08/2016
MVF	Monash IVF Group Ltd FY16 results briefing	31/08/2016
ABC	Adelaide Brighton FY16 results management meeting	31/08/2016
KSL	Kina Securities Ltd FY16 results management meeting	31/08/2016

September

NHF	NIB Holdings Limited FY16 results management meeting	01/09/2016
BGA	Bega Cheese Ltd FY16 results management meeting	02/09/2016
IQE	Intueri Education HY17 results management meeting	02/09/2016
NVT	Navitas Limited Investor relations call - ECU JV announcement	13/09/2016
ALU	Altium Limited USA tour meeting	11/09/2016
FPH	Fisher & Paykel Healthcare USA tour meeting	11/09/2016
FPH	Fisher & Paykel Healthcare USA tour meeting	12/09/2016
HOAG	HOAG Sleep Lab USA tour meeting	13/09/2016
RWC	Reliance Worldwide Corporation USA tour meeting	14/09/2016
JHX	James Hardie Industries USA tour meeting	15/09/2016
JHX	James Hardie Industries USA tour meeting	16/09/2016
CSL	CSL Limited FY16 results management meeting	20/09/2016
IRE	IRESS Limited Acquisition conference call	26/09/2016
BAP	Burson Group Ltd FY16 Results Briefing	27/09/2016
MYS	MyState Limited FY16 Management meeting	30/09/2016