



In this quarterly edition we review performance and attribution. In our headline stories, we visit China and look into Blockchain. In addition we comment on takeovers, Atlassian and high yield bonds. Photo: "Bart and Bitcoin."



## 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 domestic economic signals seem to point to a more positive outlook. Unemployment is tracking down, Gross Domestic Product (GDP) has ticked up to an annual run rate of 2.5%, while a pick-up in business investment is suggestive of better times ahead. This is against a backdrop of weakening commodity prices offset by a lower Australian Dollar.

In all, these outcomes are not too bad and yet, companies are struggling to generate top line growth, let alone maintaining a positive profit trend. More disconcerting is the manner in which investors are reacting, brutally discarding businesses that disappoint and aggressively pushing up those that deliver. There is no room for error and this importantly highlights the rather fragile investor mindset that currently drives our markets.

In some quarters the question of business survival has risen to the fore with numerous companies becoming financially exposed. In this bucket we can include the coal seam gas operators of Santos and Origin Energy, legal operator Slater and Gordon, medical centre operator Primary Healthcare and retailer Dick Smith. All have pressing issues with their respective business models and balance sheets. Those outsiders who agitate for boards to operate with optimised debt structures, accusing companies who operate with little or no debt as being run too conservatively, should rethink their objections. As we are now witnessing, when financial circumstances change, company boards opt for the less painful route of undertaking dilutive equity raisings, much to the detriment of exiting investors.

More broadly increasing regulatory changes are a potential headwind to the economic outlook as Governments look to impose additional imposts on individuals and businesses. The areas under consideration are broad and include superannuation, personal and corporate taxes, health, medical insurance and education. As much as one can try to factor in the likely consequences of legislative changes, there are some inherent risks that are hard to protect against.

Despite the challenges posed by the current economic landscape and the issues we have raised, new opportunities continue to emerge. In some instances, a sudden and severe investor selloff can lead us to revisit a business not previously held, whilst in other circumstances this may see us adding to an existing holding.

In this edition we profile our thoughts behind our investment in Blackmores and comment on the structural economic changes unfolding in China. We discuss the notion of long term investing, as well as takeovers and new technologies involving Blockchain.

For the 2015 December quarter and the current financial year to date, the Fund has delivered gross positive returns of **11.91%** and **17.57%** respectively. In contrast the All Ordinaries Accumulation Index has delivered positive returns of **6.62%** and **0.45%** over the same period. We trust you find the report informative.

Regards,

Selector Investment Team

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## Quote: Blackmores Executive Chairman, Marcus Blackmore

*“I think our time has come.”*

In addressing Blackmores’ shareholders at the group’s 53rd Annual General Meeting in November 2015, Blackmores’ Chairman made the following observation, that the most commonly asked question by patients of their doctor when offered prescriptions for their illness, was whether there was a natural alternative.

## Performance December 2015

For the quarter ending December 2015, the Fund delivered a gross positive return of **11.91%** as compared with the **6.62%** rise in the All Ordinaries Accumulation Index.

### Performance table since inception

Returns	Gross Fund Return %	All Ordinaries Accumulation Index %	All Ordinaries Index %
3 Months	11.91	6.62	5.65
6 Months	17.57	0.45	-1.96
1 Year	21.38	3.78	-0.82
3 Years annualised	23.04	9.26	4.64
5 Years annualised	15.72	6.54	1.97
10 Years annualised	9.56	5.69	1.27
Since Inception annualised	12.32	7.61	3.13

### Fund's Top 10 holdings

Top 10 December 2015*	Top 10 September 2015*
ALTUM	ALTUM
ARISTOCRAT LEISURE	ARISTOCRAT LEISURE
BLACKMORES	BLACKMORES
CSL	CSL
FLIGHT CENTRE TRAVEL GROUP	FLIGHT CENTRE TRAVEL GROUP
OZFOREX GROUP	GBST HOLDINGS
RESMED	OZFOREX GROUP
SEEK	RESMED
SIRTEX MEDICAL	SEEK
TECHNOLOGY ONE	SIRTEX MEDICAL
<b>Top 10: 46.99%</b>	<b>Top 10: 46.39%</b>

\* Listed in alphabetical order

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 large fund managers.

*Performance attribution for the December 2015 quarter*

Top 5	Contribution	Bottom 5	Contribution
BLACKMORES	1.67%	SIMS METAL MANAGEMENT	-0.58%
SEEK	1.28%	AINSWORTH GAME TECHNOLOGY	-0.56%
ARISTOCRAT LEISURE	1.19%	GBST HOLDINGS	-0.51%
IPROPERTY GROUP	1.14%	INTUERI EDUCATION GROUP	-0.33%
TECHNOLOGY ONE	1.10%	INFOMEDIA	-0.22%

**Portfolio Commentary**

Below we provide brief commentary on some of the larger portfolio moves during the quarter.

*Top contributors**1. Blackmores (ASX: BKL)*

See 'China' quarterly article.

*2. SEEK (ASX: SEK)*

The company's share price performed strongly during the quarter, despite there being little in the way of new information. The CEO Andrew Bassat did, however, reaffirm at the group's annual general meeting held in November earlier guidance statements including that they expected:

- Revenue growth in the range of 15% - 18%,
- EBITDA growth in the range of 5% - 8% and
- Underlying NPAT of AUD\$195 million.

Management also advised the market that following strong investor interest, SEEK would be disposing of its interest in IDP Education for a total consideration of AUD\$330 million. The group's net debt position is expected to fall to around AUD\$400 million, placing the business in a strong position to reinvest and further expand into its core markets of employment and education, both locally and internationally. SEEK remains a core holding within the portfolio.

*3. Aristocrat Leisure (ASX: ALL)*

The group delivered a strong full year operating performance, complimented by its acquisition of U.S based VGT. Normalised revenues now exceed AUD\$1.5 billion while operating earnings hit AUD\$431 million for the full year. Net profit before amortisation of intangibles rose to AUD\$236 million, giving rise to an earnings per share of 37.1 cents and the full year dividend was increased by one cent to 17 cents per share. The business has made significant inroads during the past five years under guidance of CEO Jamie Odell, with a focus on the gaming segments of Class II, Class III and Digital. A key outcome of this strategy is that recurring revenues now account for 45% of group revenue, up from 24% the previous year. The integration of VGT has delivered ahead of management expectations and along with the group's existing Class III operations the company now manages an installed base of 30,489 machines, earning USD\$42.70 per day. Net debt stood at AUD\$1.4 billion, higher than market

expectations due to a depreciating Australian Dollar, although debt coverage at 2.6x earnings before interest and tax remains comfortably within management's earlier guidance. For 2016 further top line growth is expected, particularly within the key U.S. markets, while Digital operations are also set to benefit from growth in daily active users as the company positions to achieve greater scale.

#### *4. iProperty Group (ASX: IPP)*

See 'Takeovers' quarterly article.

#### *5. Technology One (ASX: TNE)*

A strong full year result has been a consistent hallmark of enterprise software company Technology One. During 2015 the business recorded revenue growth of 12% to AUD\$219 million, driven by initial licence fees up 17% to \$49 million. Operating profits rose 16% to AUD\$46.5 million, even allowing for fully expensed research and development costs totalling AUD\$41 million. Operating margins remained constant at 21%, although this hides the significant investment the company is making in cloud technology. The company's commitment to evolve the business to a cloud environment is also reflected in an increasing number of new customers (49 during 2015) opting for a cloud service, with annual contract values signed doubling from AUD\$4 million to AUD\$8 million, with a further doubling expected in 2016. Management noted a strong business pipeline for the current year, although skewed to the second half. The company has continued with the recent practice of paying out special dividends where appropriate and ended the year in a net cash position of AUD\$73 million. The company remains very well placed, financially and within the industry, to execute its "cloud first, mobile first" strategy.

#### *Bottom Contributors*

##### *1. Sim Metal Management (ASX: SGM)*

The company updated investors at their Annual General Meeting with the disappointing news that the challenging scrap market environment had impacted earnings across its global operations. A breakeven underlying earnings result is expected for the first half 2016, compared with prior market consensus of \$153 million to \$207 million for the full year. The company is mid-way through its five year strategic plan which set an operating profit target of \$321 million. Management is now steering towards a return on capital target of 10% as more appropriate. If this is achieved, operating profits will be in the order of \$230 million in 2018, based on a capital base of \$1.6 billion. In order to deal with the current conditions, management has accelerated certain initiatives, including the redesign, closure and divestment of facilities. The company will book roughly \$230 million of significant costs, including cash costs of \$20 million. Clearly, we underestimated the severity of market conditions although the business remains in a net cash position of \$314 million.

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

The announcement to acquire U.S. Class II operator Nova Technologies for USD\$38 million during the quarter was not enough to offset group management commentary indicating a flat pre-tax profit performance for 2016 despite a strong sales growth outlook. A higher Australian dollar, which has led to increased component costs associated with the group's recently



released A600 platform, proved to be the main cause of the lower than expected profit guidance, however, this is expected to improve as volumes rise. The company also announced the retirement of General Manager of Strategy and Development Scott Clarebrough, a key executive of the company. Despite these setbacks the company business strategy remains sound and is backed by a conservative balance sheet.

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

The company provided a trading update which confirmed soft business activity in September and project implementation delays for some customers. This will impact first half earnings before recovering strongly in the second half of 2016. All up, GBST is forecasting EBITDA in the range of AUD\$19 - \$23 million compared with the AUD\$24 million earned in 2015. GBST also announced the appointment of Robert DeDominicis, who has been with the business since 2007, to the role of CEO. DeDominicis is currently based in the UK running the group's wealth division. In addition to management changes, Mr Alan Brackin, who has been a director since 2005, has been appointed Chairman of the board. He replaces GBST's founding Chairman John Puttick.

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

The fallout from the Government enquiry into the Vocational Education and Training industry (VET) in Australia has also impacted investor sentiment in NZ based Intueri Education Group. Making matters worse the company also received notification that a review would be undertaken by NZ's Tertiary Education Commission surrounding two of Intueri's schools, being Quantum Education Group and the New Zealand School of Outdoor Studies (Dive School). Management has noted that the issues raised are primarily legacy in nature with a potential 2015 financial impact of NZD\$4 - \$5 million. Previous guidance from management had indicated operating profits of NZD\$27 - \$29 million. In an investor update provided in December the company confirmed the group remained in *"a sound financial position, with strong margins and cash flows, appropriate funding and the full support of its bankers."* Despite the issues currently impacting the sector and the company specifically, Intueri's market valuation remains sufficiently attractive to maintain our current position.

### **5. Infomedia (ASX: IFM)**

Infomedia held its Annual General Meeting with all attention centred on the election and re-election of directors. The strong vote against previous executives Richard Graham and Jonathon Pollard sent a clear message. While the process was a distraction, the focus can now shift to executing the business strategy. The business remains attractive and whilst profit growth will run below revenue growth, we remain positive on the group's business direction.

## Long term investing

*"It's not meant to be easy. Anyone who finds it easy is stupid."*<sup>1</sup>

The world doesn't stand still and what makes investing difficult in the short run is in dealing with all the unknowns. Taking a longer term view doesn't make the unknowns go away but it does make the act of investing clearer.

In truth, investing is not the hard part, it's the consistency of sticking to the application that is critical. All too often the focal point for investors centres on transitory events. All businesses have issues and invariably they impact on an investors' emotions and course of action.

Controlling these emotions is the key. Rather than focusing purely on a company's valuation or share price, the analytical discussion really needs to shift to the business. This doesn't undermine the need to sell overpriced stocks but nor does it give the green light to buy assets simply because they are perceived as being cheap.

There is no perfect solution, but a better understanding of the individual business, paired with investor patience are a formidable combination. And on this score our approach is to give a business that meets our criteria the latitude to implement what is deemed necessary to deliver long term financial success.

The issue for professional money managers is that they operate in a competitive industry where performance is front and centre. There are no places to hide and in itself the natural inclination for many is to sit on the fence. This is not a good place to be because in our experience the notion that you can achieve success by investing with the herd doesn't really hold true.

We also take little comfort from acting in a contrarian manner simply to appear smarter or different to our peers. Rather, we aim to gather as much information as we deem necessary to form a view on the management team and the business. We want to invest in businesses that have longevity, substance, management integrity and latent potential.

To this end, we aim to give businesses sufficient time to get things right, to invest accordingly and to pursue sensible strategies knowing full well that the markets may not always be forgiving. Business duration is critical. We want companies that, through innovation, persistence and application, have the capacity to build long duration businesses. If we are good enough we will uncover a few but the truth is we can only judge our success in the fullness of time.

This is not to suggest we are benevolent investors; aware that our clients' capital is at risk. We are, however, mindful that as businesses evolve, timeframes change and sufficient latitude should be given where the opportunity warrants it. Companies that have the right qualities and values in place are rare, so it pays to think beyond the short term time frame

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<sup>1</sup> \*Charlie Munger, business partner of Warren Buffett, as recounted by Howard Marks in Oaktree memo to clients

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that has become all too common in a financial world that encourages haste. Once an investor makes this mental transition, the task of investing becomes a lot clearer and financially more rewarding. *SFM*

## China

Today, the emergence of economies within Asia and more specifically China are attracting attention. The China Australia Free Trade Agreement (ChAFTA) has opened the door for Australian businesses to enter the Chinese market, including those operating in healthcare, pharmaceutical service providers, hospital operators and medical groups undertaking research and development. This agreement promises to open business opportunities in time but that alone is not enough. Upfront investment stretching out years is a necessary starting point and the rewards that may follow are years beyond that.

If by chance success can be achieved, there is a fair chance that its duration will be both larger and longer than many imagine. Most commentators are quick to point out that Australia is ideally placed to benefit from the population mismatch. Our population of roughly 23 million is dwarfed by China's billion plus, which includes, some 300 million affluent citizens. On the surface it's hard to fault that logic, particularly in specific fields such as healthcare, agricultural, education and for tourism in Australia.

Most financial observers, however, view the country's progress in a one dimensional fashion, via the release of China's Gross Domestic Product (GDP) quarterly growth rates. Although expressed as a figure, what is not as well understood are the individual components that comprise it. In recent years, the headline growth rate has been in decline, from 8% per annum to the current level of 6.9%. More broadly though, it should be appreciated that the Chinese economy is in transition and as a consequence the country's quarterly growth rate needs better understanding.<sup>2</sup>

This progress is now reflected in an economy that is less dependent on expanding industrial output, investment and exports, to one more dependent on growing private consumption expenditure. This has resulted in the services sector as a percentage of GDP rising to 48% during the period 2011 – 2014, while at the same time the industrial sector has dropped to 43% of GDP.

A decade ago their contributions were reversed, which reflects the significant role that resources played in transforming the economy. Today, the USD 10.4 trillion Chinese economy is being led by the services sector, with e-commerce, entertainment and healthcare representing some of the drivers. This was evident over the September 2015 quarter with Chinese industrial production rising 5.7% compared to 6.1% a year earlier, while over the same period, spending on services rose by 8.6%. The rising level of consumption is also

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<sup>2</sup> China, Gross Domestic Product is divided by three sectors: Primary, Secondary and Tertiary. The Primary Industry includes Farming, Forestry, Animal Husbandry, and Fishery and accounts for around 9 percent of GDP. The Secondary sector, which includes Industry (40 percent of GDP) and Construction (9 percent of GDP) is the most important. The Tertiary sector accounts for the remaining 44 percent of total output and consist of Wholesale and Retail Trades; Transport, Storage, and Post; Financial Intermediation; Real Estate; Hotel and Catering Services and Others. Source Trading Economics

assisted by wages growth, which has seen the country's disposable income grow at a double digit rate for more than a decade.

So while the headline figures are giving rise to some concern, a closer look at what is driving the numbers is revealing. From our perspective, the shift is a boon for some while causing headaches for others. Topping the list of industries impacted by the structural adjustment are our resource based operators, including our iron ore producers. The increasing supply and demand imbalance is reflected in sharply lower iron ore prices and increasing competitive tension.

In contrast, travel is high on the winners list as noted by former Australian Ambassador to China Geoff Raby, who told the Australian Airports Association during the quarter that the shift from export-led growth to consumption-led growth would see scope for a significant rise in Chinese outbound travel numbers, *"It is a very big shift in Chinese consumption patterns that is under way driven by rising per capita incomes. Much of the growth is in tourism, recreation and entertainment, including sport. You can just see and feel the huge growth in consumption of these activities."*

Furthermore, the country's latest five year plan to build 7,500 public hospitals via private investment over the next decade illustrates the significant business opportunities now opening up. However, the level of interest extends beyond hospitals with the George Institute's China Relations Director Professor John Knight noting the trade agreement positioned *"Australian healthcare to be not just for our country, but for the region. Demands for high quality healthcare in China is a constant, unlike the boom and bust cycles of many other industries such as the resources sector."*

Below we comment on a few businesses being influenced by the economic changes now under way.

### **Sydney Airport (ASX: SYD)**

Sydney Airport is a single asset business with operations centred on the three passenger terminals, catering for domestic and international passengers. For this reason, Sydney Airport is perhaps one of the best barometers of the changing travel patterns of Chinese citizens. Over recent years the two-way traffic between Australia and mainland China has been on the rise, with passenger numbers between the two regions doubling since 2008. The Airport's monthly traffic updates illustrate the growing importance of China's travelling tourists, who now sit as number three of nationalities passing through Sydney Airport, behind Australians and New Zealanders, but in front of the UK, U.S, Korea and Japan.

The current data suggests that this is just the beginning with reports that less than 3% or some 32 million of China's population of 1.4 billion took overseas trips beyond the shores of Hong Kong, Macau and Taiwan. As the market matures and visa restrictions are eased, the number of Chinese tourists travelling overseas is forecast to hit 200 million by 2020.

## The Star Entertainment Group (ASX: SGR)

### *Brief history*

The current operations of Echo Entertainment started life as the Sydney Harbour Casino before its most recent name change to the Star Entertainment Group. As a back drop, in December 1994 Leighton Properties and Showboat won the right to develop New South Wales' first casino. This gave rise to the building of a temporary casino in 1995 and its permanent site in November 1997. After a short stint as a listed entity, the group was acquired by fellow gaming operator Tabcorp in 1999.

In June 2011 Tabcorp chose to separate the company's assets, leading to the re-listing of the casino assets into the Echo Entertainment Group. The enlarged operations included the original Star City Casino as well as the Queensland casino assets of Jupiters' on the Gold Coast and Townsville, along with the Treasury Casino in Brisbane. The value ascribed to these assets on listing was \$4.27 per share, a price only recently surpassed during 2015.

Following a tumultuous period of instability, that included the loss of two chief executives as well as the emergence of the Crown Group's successful winning of a second casino licence in Sydney, the group has emerged with real purpose and direction. Operationally, management is led by former Tabcorp and Echo Entertainment Group chief financial officer Matt Bekier who took over the running of the business in 2014 following the departure of U.S. born John Redmond.

Today, The Star Entertainment Group, comprises three casinos following the sale of the Townsville operations in January 2014. One of these is The Star Sydney, which was established in 1995. It operates under a 99 year lease that expires in 2093, although its ability to operate exclusively expires in November 2019.

The two Queensland facilities include the Jupiters' Hotel & Casino Gold Coast, established in 1985, operating under a perpetual licence and the Brisbane based Treasury Casino. This Casino is now being merged into the Group's recent success, as the preferred operator of Brisbane's new Queen's Wharf Integrated Resort. The \$3 billion plus resort is expected to begin construction in 2017 with a completion date of 2022.

The Star has partnered with Hong Kong based organisations Chow Tai Fook Enterprises and Far East Consortium in forming the joint venture. The project will be split in two, with the residential precinct, involving the construction of 2,000 apartments to be jointly developed by the Hong Kong partners while the Integrated Resort that includes the casino, will be 50% owned, funded and operated by The Star under a long dated casino management agreement.

Under the final agreement announced in November with the Queensland Government, The Star Entertainment Group will contribute all up \$1.0 billion into the project and will earn 60% of earnings, comprising a 50% take of the integrated resorts earnings as well as a 10% operator management fee of net revenues generated. Funding for the project will be sourced from existing company cash and by drawing down on debt facilities, which remain at conservative levels.

Management have secured a very good outcome with the Queensland State Government, having locked in a 25 year period of casino exclusivity within a 99 year license period. The Resort's location within the City's central district, that has it positioned on the foreshore, is seen as one of its draw cards.

With two joint venture partners who are both financially strong and well connected in Asia, Star management are banking on the resort attracting significant international tourist interest. As the Sydney Airport's statistics reflect, China tourism is on the rise, so it's very likely that if the offering is significantly attractive, the group's level of enthusiasm will be rewarded post the Integrated Resorts opening in 2022.

In the meantime, the Star Sydney continues to post solid improvement in market share as well as committing to further upgrades as it readies to take on Crown Resorts post 2020. No doubt the group will face some significant challenges, both from a competitive perspective and on project execution over the ensuing years. That said, we like management's strategic and operational focus, assisted by a tourism outlook that lends weight to rising international demand, driven by a growing and affluent Asian customer base.

#### CSL (ASX: CSL)

Blood plasma group CSL is positioned to grow its China business, with long term expansion plans remaining in place despite the economic slowdown. As CEO Perreault noted, *"This is not resources, this is healthcare, and if China is going to continue to invest in healthcare, which they are, then hospitals will see more people, because of the influx from the rural areas into the urban areas. A small city in China is one million people. This is a massive country...I think there is still opportunity there. Even when we see a slowdown in China growth, it is still massive growth in a country of that size."*

The group's progress has been slow and deliberate, having entered the Chinese market in the early 2000's. To date sales have been restricted to one product, albumin, which is used in emergency surgery to restore lost blood as well as in the treatment of burns. Sales have risen from USD13 million to around USD300 million today but importantly the company's preparedness to invest for the long term has allowed the group to steal a march on its competitors, where it now controls 25% - 30% of the albumin market.

As Perreault outlined it took a long time to build relationships in China and to develop trust which is why the outlook for the region is so important, *"China is clearly an area that is strategically quite important to CSL and for the long term strategy of the company we would be silly to ignore it... China has come to a certain standard of healthcare now that they don't want to go backwards so I think you will see investment there. As countries develop they start off with things like sanitation, vaccination, infection, and then move into areas such as rare diseases."*

For investors it would also be foolish to underestimate the long term potential of this important market. While the current sales profile is solid, it forms a small part of the group's total sales revenues of USD5.5 billion.

However, looking out twenty years from now, its contribution is set to grow significantly. What is now required is a willingness on the part of the company to continue to invest and investors who can appreciate China's changing health needs.

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

In the last reporting period Blackmores' management revealed an impressive set of numbers. For the full year group sales rose 36% to AUD472 million. Breaking down the four quarters reveals an accelerating top line, with first quarter sales of AUD98 million compared to fourth quarter numbers of AUD146 million. Importantly, this level of growth translated to the bottom line with full year net profits rising 83% to AUD46.6 million and operating margins expanding from 11.3% to 15.3%.

Investors have responded in kind, pushing up the share price and market capitalisation to AUD2.6 billion. Driving this growth has been the group's Asian expansion, particularly within the fast evolving Chinese market. This has led many to question whether the recent explosion in Chinese demand for complementary medicines is sustainable. Management certainly believe that the demand for trusted brands is both strong and durable, even though forecasting the level of demand is difficult.

It is important to appreciate that Blackmores has earned the right to operate in China, having entered the Asian region 35 years ago, with operations that span most countries including Thailand, Malaysia and Singapore. More specifically the arrival of CEO Christine Holgate in 2008 spurred the group to renew its efforts in this fast growing segment, with particular emphasis on entering the Chinese market.

It did so in typical Blackmores fashion; in 2012 it applied for a Wholly Foreign-Owned Enterprise status (WFOE), sensibly bypassing a quick entry to ensure a more lasting and controllable expansion path. While achieving WFOE status is more difficult and time consuming it ensures that the business does not require a mainland Chinese investor as a partner. In short, Blackmores retains 100% ownership, thereby ensuring brand and expansion control. The appointment of Peter Osborne to head the group's Asian business, following his previous role as one of Australia's most senior trade diplomats working with the Australian Trade Commission in the region, has also been critical in this process.

That earlier decision is now proving important as the group begins to enjoy rapid take up of complementary products, often referred to as alternative medicines, from Chinese consumers. In the 2015 year, Blackmores' management estimated that Asian sales totalled AUD150 million of the group's total reported sales of AUD472 million. Of this, direct sales to Asia rose 26% to AUD84 million while roughly, another AUD66 million was sold through the Australian market, with products earmarked for China's Free Trade Zone (FTZ). In total, some 31% of group sales ended up in Asian markets and specifically China, underlying the rapid take up and further illustrative of the region's underlying potential.

### ***Shanghai and Indonesia visit***

During the quarter we travelled to Shanghai, China, accompanying Blackmores on an investor tour that included a site visit of the city's FTZ, management presentations as well as meetings

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with government representatives and distributors. The Shanghai FTZ was originally established in August 2013, being the first FTZ in the country. The Zone covers an area of 120 square kilometres and integrates four existing bonded zones in the district of Pudong.

The Zones have been established as a testing ground for a number of economic and social reforms that allows foreign trade to take place without the red tape often involved in getting Government approval. However, in setting the rules, the Government has also published the Zone's "negative list" of businesses, which effectively informs organisations on commercial activities that are not considered appropriate with examples including internet cafes, lotteries, and news organisations.

The principle aim of the FTZ is to reduce or remove obstacles impeding business activities. Businesses that carry out operations within the FTZ can operate and sell into the Chinese market thereby avoiding current tariffs of up to 35%, although postal tax of 10% still applies. The impact on the Blackmores China business as a result of the opening up of the FTZ has been significant, with strong growth achieved in China bound, Australian sales of vitamin products. As we noted earlier, this has seen products sold into the FTZ, both directly by the company and indirectly through Australian pharmacy partners including the likes of MyChemist, hit AUD66 million during the 2015 financial year before accelerating to AUD55 million in the first quarter of 2016.

CEO Holgate is sensibly steering a conservative line but also highlights the opportunity, noting that the market for western vitamins in China is currently estimated at USD20 billion, with Australian companies accounting for about AUD200 million of this, *"It is a massive marketplace, even if it never grows, to move into. We have strong attributes to support growth there."*

#### *Joint Venture Partners*

Blackmores have also sought to build long standing relationships with key partners including Shanghai Pharmaceuticals and Sinopharm, two of China's largest pharmaceutical manufacturers and distributors of health related products. During the past quarter the company added Australian-based milk producer Bega and Indonesian pharmaceutical group Kalbe Farma as joint venture partners to further develop the market opportunities now opening up for the group.

The Bega partnership brings together two well credentialed organisations that will result in Bega developing and manufacturing a range of nutritional products, including infant formula for the Chinese market that will be branded as Blackmores product. Bega will be the exclusive supplier, via its Tatura division, of this range with first products expected in early 2016.

In contrast, the Kalbe Farma partnership represents a further extension of the Company's brand presence into a new and significant region, being the Indonesian market. Kalbe is one of the largest healthcare companies in South East Asia, thereby opening up the distribution of Blackmores products into the Indonesian market which is now planned for 2016. This is a country with a gross domestic product of AUD1.2 trillion, supported by a population base of 250 million. With a rising middle class of 50 million, where more than half of the population

are under 30 years of age, Indonesia is well versed in the use of complementary medicines. And in a similar vein to other Asian countries, this desire for trusted brands will likely extend to companies including Blackmores.

### *Building scale*

Addressing shareholders in October 2015, CEO Holgate commented that one of the biggest challenges for the group was in forecasting customer demand as evident by the unprecedented growth currently being experienced. That challenge was on show in the 2016 first quarter numbers which showed sales rising 65% to \$162 million, while operating profits jumped 151% to \$33 million, giving rise to margins of 20.4%, compared to the corresponding first quarter margins of 13.4%. These results underscore the significant operating leverage the group has been able to extract from the quantum leap in production volumes as well as the greater purchasing power now available to the company.

To put some numerical context to the production transformation currently underway at the group's Warriewood distribution facility, the company bottled vitamins at the rate of 250 million capsules per month during 2015. During the final quarter of financial year 2015, this monthly run rate was lifted to 350 million with management indicating a further spike to 500 million by 2016 financial year end and 750 million capsules by calendar year end 2016. At that juncture, bottled vitamin capsule numbers would have effectively tripled, providing some early indicator of how management is viewing the near term outlook.

Should this unfold, group revenue numbers are most likely to top the AUD1.0 billion mark, while maintaining current operating margins would see net profits nearing AUD150 million and earnings per share of AUD8.70. The events of the past few years illustrate perfectly that a company's progress is never a straight line. The troubled period the company found itself in two years ago has now given way to a more optimistic outlook.

We never seek to invest by taking a short term investment approach. Businesses that can deliver long term superior returns are built over a considerable time frame and staying the course when conditions are less than ideal is not without its challenges. Blackmores' is certainly an example of a business that has worked long and hard to be in the right place at the right time.

Chairman Marcus Blackmore at the group's 53rd annual general meeting held in 2015, echoed those thoughts when he addressed shareholders by stating, "*I think our time has come*" of the public's desire for natural alternative medicines. As we outlined in our opening comments, Blackmores management have consistently steered a very conservative and sensible business line. The Asian opportunity is indeed significant and to this end, investors will do well to better understand its potential before contemplating an early exit. **SFM**

## Takeovers

Not all investments work out as initially planned. Some are simply bad from the start with little chance of recovery. Others promise much but never quite fulfil their potential, whilst others leave us far too early, robbing current owners of future financial rewards.

To the latter point, we are of course referring to company takeovers. The actions of one business looking to acquire another, are driven by many motives, either to expand, to remove a competitor or simply a desire to appease investors. When the intentions are right, the rewards can be long lasting and significant but this is rarely the case when it comes to transformational deals.

From the perspective of the acquiree, the news is equally chequered. Takeovers are meant to be a source of good news to those receiving the offer. A chance to take the money and move on to something new. This is certainly true of many deals but not all.

What in certain circumstances looks like being a pretty good deal, can in a relatively short time frame prove most unattractive. It's not that we are against takeovers by itself, it's just that we are loath to exit businesses that are destined for greater things, simply because we are offered a takeover premium that reflects the immediate outlook.

In short and as a general comment, we value less the cash banked today, preferring to accept the potential for longer term returns. This is obviously a judgement call on the part of the investor but it's one that we are more than willing to make if the circumstances dictate.

### iProperty Group (ASX: IPP)

iProperty Group is a case in point. During the past quarter, 23% major shareholder and fellow online property operator, the REA Group, lodged a full takeover offer for the shares not already owned, thereby valuing the group at \$720 million. The alternative offers of \$4.00 cash per share or a combined cash and scrip offer in a new unlisted entity, was met with general market acceptance, including the iProperty board who saw fit to endorse the bid immediately.

The usual commentary suggesting the offer was pitched at an attractive percentage premium over the preceding one and three month volume weighted average share prices may win over investors keen to bank a quick return but does little to appease others who are asked to forgo a longer term reward.

In our September 2014 Quarterly Report we provided an in depth look into Asia's dominant online real estate portal operator, the iProperty Group, noting:

*"In June 2014, the REA Group purchased a 17.2% stake in iProperty for \$106.3m, equivalent to \$3.40 per share. In REA's investor presentation, the group identified the iProperty holding and the Asian region as being a critical component to their future growth strategy. REA's purchase provides some validation to iProperty's business case and leading market position.*

*There are few companies in a better position than REA to judge the strategic and competitive standing of an online real estate listings business and we doubt that REA would have made*

*such a substantial investment without a degree of certainty about the likely competitive outcomes in iProperty's key markets."*

Having since lifted its stake to 23%, the REA Group has now seen fit to acquire the whole business. From their vantage point the rationale for moving now seems pretty clear, as any delay would simply push up a future take out price. Those who doubt our reasoning should consider the group's most recent half yearly update, which underlined the company's accelerating revenue line, accompanied by a first time positive operating cash flow.

This shift into positive cash flow should not be underestimated, particularly for online players who are clear market leaders. The scale benefits and pricing power leverage enjoyed by being number one in markets as big and immature as those in Asia is significant and long in duration.

REA is fully cognisant of how this story is likely to pan out having itself rebuffed a takeover offer back in 2005. At the time, News Corporation, now parent of REA itself, took aim with a \$2.00 per share cash offer, valuing the whole business at \$232 million. The REA independent directors rejected the offer despite it being later lifted to \$2.50 per share. News Corporation ultimately failed in its offer and has remained a majority shareholder with a 61% interest.

At the time of the original takeover offer, REA Group turnover stood at \$33 million delivering pre-tax profits of \$5.4 million. Today, some ten years on, REA has a market capitalisation of \$6.5 billion, with revenues of \$522 million and net profits of \$185 million, giving rise to earnings and dividend payments of \$1.40 and \$0.70 per share respectively. Current REA shareholders can thank the independent shareholders' rejection of the former deal.

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

In a similar vein, the Sirtex Medical story is one that may never have made it this far had it not been for some minority shareholders who saw past U.S based pharmaceutical group Cephalon's \$4.85 cash offer in 2003. Requiring a 90% acceptance level to ensure compulsory acquisition, the \$267 million takeover offer fell just short, with 88% of shareholders accepting, including long time holder Hunter Hall. Despite the rocky period that followed, the company gained significant traction post the appointment of current CEO Gilman Wong and the subsequent exit of founder, inventor and major shareholder Dr Bruce Gray.

Today, the business has moved on from the \$10 million of sales recorded in 2003, with revenues topping \$175 million on dose sales exceeding 10,000 and net profits of \$40 million, all giving rise to earnings and dividends per share of \$0.71 and \$0.20 respectively. To date, the group's lead product, the SIR-Spheres Y-90 resin microspheres to treat liver cancer patients, has been sold in more than 900 medical centres in over 40 countries with total doses exceeding 55,000. The group's market capitalisation sits at \$2.2 billion based on the current share price of \$40 per share.

### **Summary**

The excitement of receiving a takeover offer quickly wanes when shareholders are asked to give up the potential for longer term rewards. There are no guarantees that things will work

out but investors would do well to at least consider the power of time as much as the dollar banked when tossing up whether to sell or hang on.

**SFM**

## Blockchain

### Introduction

Theo Priestley, Forbes Magazine enterprise technology, start-ups and disruptive trends writer is calling it out as his numero uno prediction for 2016 and Russia is busy trying to criminalise its offspring. So what is all the fuss with Blockchain?

Before diving in, it is important to acknowledge that we are not experts in this field. With that in mind, we have chosen to compile several pieces written by some of the more knowledgeable and interesting voices in the global discussion around Blockchain.

The Economist notes that Blockchain began life in the mind of Satoshi Nakamoto, the brilliant, and so far unidentified creator of Bitcoin—a “purely peer-to-peer version of electronic cash”, as he put it in a paper published in 2008. To work as cash, Bitcoin had to be able to change hands without being diverted into the wrong account and be incapable of being spent twice by the same person. To fulfil Mr Nakamoto’s dream of a decentralised system the avoidance of such abuses had to be achieved without recourse to any trusted third party, such as the banks which stand behind conventional payment systems.

But starting with the basics, like the name suggests, a Blockchain, not surprisingly, is a chain of blocks. Think of all blocks being equal, like a toddler’s set of blocks. They can be lined up next to each other in a row or a chain with a clear start and finish. And like all chains the start and finish are linked by the middle blocks. The first block is the genesis block, it’s the original. It is followed by, in linear chronological order, every block laid thereafter.

The two big differences between a Blockchain and the toddler’s set of blocks? The toddler can trash his blocks when bored. A Blockchain however is a permanent record of stored information from start to finish that records data points. It can also be downloaded by every computer attached to a network in real time, but more on that later.

### The Russians aren’t coming

Casual observers often have trouble separating Blockchain from Bitcoin, the cryptocurrency. If that’s you, you’re not alone. The Russian Finance Ministry has only just taken the first steps in making the distinction. Recent statements suggest they still see the two as somewhat joined at the hip.

Just last month, Russian deputy finance minister Alexey Moiseev said the Ministry was working on a draft law that would seek to punish those converting cryptocurrencies into the Ruble with up to four years in prison.

*"We appreciate the potential relevance of Blockchain technology for the development of e-commerce and therefore we feel that it should be allowed and developed, but Bitcoin themselves, in particular, the implementation of the Bitcoin transactions into the real economy, in the real banking system can be very dangerous,"* he concluded.

Moiseev also elaborated on the reasons the Ministry of Finance believes new rules are necessary, citing the digital currency's association with money laundering and terrorism

financing. But while Russia may be looking to potentially criminalise Bitcoin-to-Ruble conversions, Moiseev said that he did not perceive Bitcoin to be a threat to Russia's national currency.

While Bitcoin is the best way to explain what Blockchain is all about, understanding the distinction between the two is critical. Banks will not touch Bitcoin but they may deploy a Blockchain.

In banking terms each block can represent an individual transaction and each transaction is linked to the transaction that preceded it and the one that succeeded it, providing a full history of banking transactions that can never be erased. And most importantly, a block can only be added by consensus of a majority of connected nodes (computers). In the world of Bitcoin this is called Mining, which we discuss in detail later.

### Key Benefit

Mike Gault is the founder and CEO of Guardtime. Which if you take Mike's word, Guardtime is the first and only platform for ensuring the integrity of data and systems on an industrial scale. He previously held a postdoctoral fellowship researching quantum computation at the Tokyo Institute of Technology.

According to Mike, the key benefit of Blockchain is security in cyberspace. It allows total strangers to hold and exchange digital money in a completely transparent way — without having to trust each other or any central authority. Falsifying events in the Blockchain would be equivalent to getting more than half of the computers in a network to all lie in the exact same way, at the exact same time, without any ability to coordinate beforehand. In short, it can't be done.

This is the key, so to speak, to Blockchain. It allows people to know for certain what is happening in the digital world. Today, every interaction you have online relies on a central trusted authority. No matter what you do online, you're trusting someone to tell you the truth — whether it's your bank giving you your statement balance, your email service provider telling you your message was delivered, or your antivirus software assuring you that everything's okay.

In fact, there's always the risk that a single provider of information could lie, or simply be wrong. That's why Internet security is such a disaster today. We are trusting sources that can be hacked, manipulated or compromised. And increasingly we are trusting them with our most precious personal data and life events.

The Blockchain could change all of that. It sounds incredible, but by enabling this distributed consensus, it can actually create a true record of events, past and present, in the digital world.

Crucially, it does this without compromising privacy. You can record the fact that the event happened, and even that it happened correctly, without exposing confidential details about the subject matter or the parties involved. This explains why Bitcoin enables black-market

transactions, despite the public nature of the ledger, the users themselves can remain completely anonymous. And this is exactly what the Russian Ministry of Finance doesn't like.

But ultimately, the good here far outweighs the bad. For example, one key emerging use of the Blockchain involves "smart contracts." You could rely on the decentralized network to confirm that a contract of any kind was executed properly (or even to execute it automatically), without revealing any confidential information about the parties or the transaction. The team at Ethereum, a start-up that launched in March, has built a scripting language to enable this. The implications for trust and transparent business dealings are simply enormous.

The sort of programmability Ethereum offers does not just allow people's property to be tracked and registered. It allows it to be used in new sorts of ways. For example, a car-key embedded in the Ethereum Blockchain could be sold or rented out in all manner of rule-based ways, enabling new peer-to-peer schemes for renting or sharing cars. Further out, some talk of using the technology to make by-then-self-driving cars self-owning, to boot. Such vehicles could stash away some of the digital money they make from renting out their keys to pay for fuel, repairs and parking spaces, all according to pre-programed rules.

The financial community has finally started to move beyond the Bitcoin hype, as some of the world's biggest banks begin to research Blockchain applications. The country of Estonia, which secures much of its banking infrastructure with a Blockchain, boasts the lowest rate of credit card fraud in the euro zone. And start-ups like Bitreserve are enabling completely free online-money transactions, without the volatility and risk associated with Bitcoin.

*"We can think even bigger — let's put health records, voting, ownership documents, marriage licenses and lawsuits in the Blockchain. Eventually, every dataset and every digital transaction could leave a "fingerprint" there, creating an audit trail for any digital event throughout history, without compromising anyone's personal privacy."*

As Mike Gault described above, every type of document and type of record could be made a part of Blockchain technology. In which case, every piece of transacted data within the Internet of Things (IOT), every handshake between devices and the passing of information between them, could also become part of the Blockchain. From a corporate point of view, this is invaluable and could be the backbone of the Industrial Internet.

Theo Priestley, from Forbes, believes that for Blockchain, this is only the beginning. He points to the following definition from Nathan Hourt, CTO of FollowMyVote, "A Blockchain is an audit trail for a database which is managed by a network of computers where no single computer is responsible for storing or maintaining the database, and any computer may enter or leave this network at any time without jeopardizing the integrity or availability of the database. Any computer can rebuild the database from scratch by downloading the Blockchain and processing the audit trail".

Priestley also suggests, Blockchain has the potential to upset the apple cart among today's storage providers. Why?



- Cost – A decentralised storage system would reduce the cost of storage
- Security – Client-side encryption is superior
- Speed – A decentralised Peer-to-Peer network would beat a centralised server

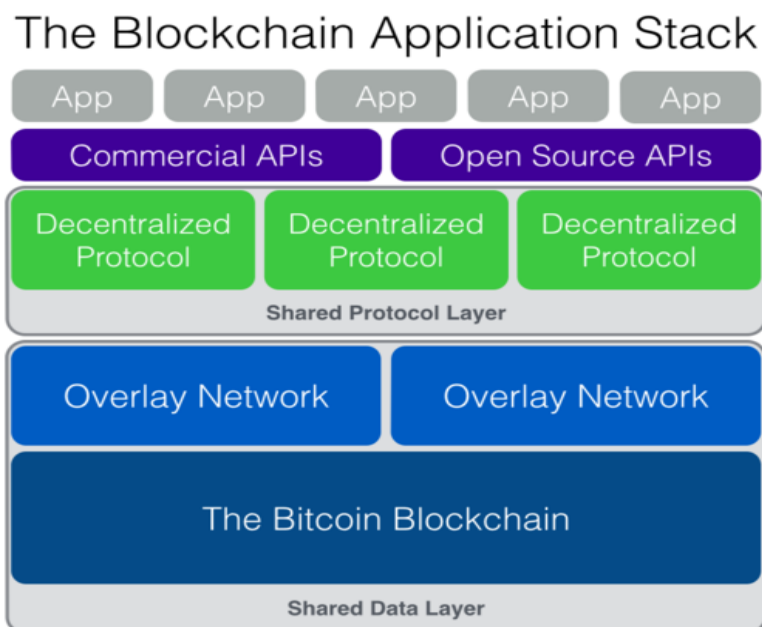
When you consider that Dell and others are currently pushing analytics to the edge of the network as an IOT strategy, it makes perfect sense to do the same for storage. Which puts vendors whose strategy is to sell Flash arrays and multiple servers of centralised storage capacity in a quandary in the next few years. Even the ECM (Enterprise Content Management) market could be at risk. It also puts into question just how long cloud-based storage services can hold out at the same time.

Theo Priestley predicts that:

- Blockchain will become the lynchpin for security, data transactions and authentication for the Internet of Things and the Industrial Internet, and that the
- Blockchain technology will ultimately disrupt centralised and cloud based storage services.

### The Future

So how does Blockchain look 10 years out? Joel Monegro from Union Square Ventures workshopped some ideas at the Bitcoin Hackathon called HackBit. He also provided a simple illustration, called the Blockchain application stack.



The basic idea is that everything inside the grey rectangles is decentralized and open source. These are the Shared Data and Protocol Layers. Nobody controls these parts of the system, and they can be accessed by any person or company. Using Bitcoin as an example, the

Blockchain is the shared data layer and the Bitcoin protocol is a Decentralized Protocol that's part of the Shared Protocol Layer.

Each layer gets thinner the higher up you go. You'll also notice that the Shared Data and Protocol Layers cover about 80% of the entire stack. Internet applications today are built on top of open, decentralized technologies like TCP/IP and HTTP, but if you were to graph the current internet application stack as shown above, those open, decentralized protocols would probably only make up about 15% with everything on top being private and centralized.

### *1. Miners and the Blockchain.*

Mining, according to Wikipedia, is the process of adding transaction records to Bitcoin's public ledger of past transactions. This ledger of past transactions is called the Blockchain as it is a chain of blocks. The Blockchain serves to confirm transactions to the rest of the network as having taken place. Bitcoin nodes use the Blockchain to distinguish legitimate Bitcoin transactions from attempts to re-spend coins that have already been spent elsewhere.

Mining is intentionally designed to be resource-intensive and difficult so that the number of blocks found each day by miners remains steady. Individual blocks must contain a "proof of work" to be considered valid. This proof of work is verified by other Bitcoin nodes each time they receive a block. Bitcoin uses the hashcash (a cryptographic algorithm) proof-of-work function.

The primary purpose of mining is to allow Bitcoin nodes to reach a secure, tamper-resistant consensus. Mining is also the mechanism (or algorithm) used to introduce Bitcoins into the system. Miners are paid a transaction fee as well as a "subsidy" of newly created coins. This both serves the purpose of disseminating new coins in a decentralized manner as well as motivating people to provide security for the system. Because Bitcoin has real-world value, the operators of these machines are incentivized to keep them running. Importantly it's not controlled by a single entity and it's accessible to everyone.

Bitcoin mining is so called because it resembles the mining of other commodities, it requires exertion and it slowly makes new currency available at a rate that resembles the rate at which commodities like gold are mined from the ground.

### *2. Overlay Networks*

This is where things start to get interesting. Developers are starting to build networks that work in parallel to the Bitcoin Blockchain to perform tasks that the Bitcoin network can't, but that makes use of the Bitcoin Blockchain to, for instance, time stamp or validate their work.

One example is Counterparty, a financial platform with a webwallet and currency called XCP created by destroying Bitcoins of all things. Another might be Side Chains, a chain that runs from the Blockchain but is new or superior and needs funding. Whatever form these overlay networks take, the one thing they have in common is their connection to the Bitcoin Blockchain, and how they benefit from its network effects to achieve liquidity without having to bootstrap their own alternative cryptocurrency and/or Blockchain like alternative solutions such as Ethereum requires.

### 3. Decentralized Protocols

Thanks to the Blockchain, for the first time we can develop open source, decentralized protocols with built-in data (thanks to Overlay Networks and The Blockchain), validation, and transactions that are not controlled by a single entity. This is where the traditional architecture of software businesses begins to break down. The best example of a decentralized protocol on top of a Shared Data Layer is Bitcoin, and we're already well aware of how it's affecting money and finance.

Companies like eBay, Facebook and Uber are very valuable because they benefit tremendously from the network effects that come from keeping all user information in centralized private silos and taking a cut of all the transactions. Decentralized protocols on top of the Blockchain have the potential to undo every single part of the stacks that make these services valuable to consumers and investors. They can do this by, for example, creating common, decentralized data sets to which anyone can plug into, and enabling peer-to-peer transactions powered by Bitcoin.

In fact, a number of promising teams have already begun working on the protocols that will disrupt the business models of the companies above. One example is Lazooz, a protocol for real-time ride sharing and another is OpenBazaar, a protocol for free, decentralized peer to peer marketplaces.

### 4. Open Source and Commercial APIs

Protocols are hard for the average developer to build on top of, so there's an opportunity in making it easy to connect to them. Whether it's a good business in the long term is up for debate, what's certain is that it is a very important part of the stack. Making it quick and easy for developers of any skill set to quickly build an application and experiment on top of these decentralized protocols is paramount to their success.

These will be either commercial services or open source projects. Good examples of this trend are Chain.com's APIs and Coinbase's Toshi for Bitcoin. They both serve the same purpose, but Chain is a hosted, commercial service, and Toshi is Open Source.

### 5. Applications

This is the consumer-facing part of the stack. Applications built atop this architecture will, in most cases, work very similarly to the ones we have today – just like Coinbase works similarly to PayPal. The big difference to consumers, however, is that because they are built on decentralized protocols, they will be able to talk to each other, just like different e-mail applications and Bitcoin wallets can interoperate.

Monegro likes the fact that the stack is growing from the bottom up. *"First we had miners, the Blockchain, and Bitcoin, and now we're building everything else on top. As far as I know, the most significant revolutions in technology have been built this way".*

Monegro believes this imposes a very interesting and important set of challenges for developers, entrepreneurs, and investors alike, as so much of the value in the current Internet stack can be commoditized by this architecture. But he believes the best thing about this stack

is that the user is better off thanks to lower or non-existent take rates, switching costs, individual ownership of data, and consumer market power. And this is what must be understood by investors in the private internet silos of eBay, Facebook, Google etc.

### Back in real world the Blockchain cometh

In early October the Australian Financial Review reported that The Australian Competition and Consumer Commission is investigating why Australian banks are closing the accounts of Bitcoin businesses, amid concerns banks are colluding to block emerging competitors. They are doing this at the same time as they all invest in early stage Blockchain research and development projects.

ACCC chairman Rod Sims told The Australian Financial Review the investigation was in its early stages, but had started with requests being sent to banks to explain their actions. He hoped to get to the bottom of the matter within a couple of months.

In late October the Australian Financial Review reported that Bitcoin's much-lauded transaction record, Blockchain, is being seriously considered as a replacement for the Australian Securities Exchange's clearing and settlement system.

Managing Director Elmer Funke Kupper said the ASX, which is in the middle of replacing its trading systems, had a once-in-a-generation opportunity to install the best technology, and Blockchain could reduce cost, save time and cut complexity in the clearing and settlement of trades, currently done by a system known as the Clearing House Electronic Subregister System (CHES).

*"We have set up our equities post-trade systems as a separate business headed by Cliff Richards, who has just joined us from NAB trade," Mr Funke Kupper said. "We are engaging with firms domestically and overseas about the new technologies that are available to get cost out of the equity market."*

On November 19, the United States Patent & Trademark Office (USPTO) published Goldman, Sachs & Co.'s patent application 20150332395 or *"Cryptographic Currency for Securities Settlement."* Described are *"methods for settling securities in financial markets using distributed, peer-to-peer, and cryptographic techniques"*, using a cryptocurrency named SETLcoin.

These comments followed, it provides *"settlement services for virtually all broker-to-broker equity and listed corporate actions"*. It offers *"radical transparency and true settlement (which) combine to grant real, unambiguous ownership, nearly instantly. If you buy it, you own it. It's that simple."*

As we have discovered, cryptocurrencies such as Bitcoin are lauded for their trustless nature, that is to say, there is no reliance on a trusted third party. Goldman's patent filing however allows for the possible introduction of an *"Authoritative source"* such as the Securities and Exchange Commission, there are no prior ownership rights when an SETLcoin is first issued,

therefore, one or more trusted nodes or a government entity, such as the Security Exchange Commission, or other entity, can verify and authentic the issuer's transaction."

The list of applications for block chains are growing by the day...or maybe by the block.

### Problems, but don't worry

We have looked around the web to try to understand the problems that face Blockchain. And they are not a whole lot different to every day computing issues like Malware viruses or Malleability attacks.

*"Over the last 24-48 hours, we've noticed a number of our customer's transactions modified and rebroadcast with a new transaction number. This attack is being applied to almost all transactions on the network and is not targeted at Coinkite or our users. This is a nuisance only and does not put your funds at risk."*

Established in 2013 Peter Bray from Coinkite claims to have helped thousands of start-ups from all over the world safely and easily use Bitcoin.

The most asked question is possibly about scalability of Blockchain. Wikipedia had the best comparison data that sheds interesting light. By way of comparison VISA handles on average around 2,000 transactions per second (tps) and a daily peak rate of 4,000 tps. It has a peak capacity of around 56,000 tps, however they never actually use more than about a third of this even during peak shopping periods. PayPal, in contrast, handled around 10 million transactions per day for an average of 115 tps in late 2014.

Let's take 4,000 tps as starting goal. Obviously if we want Bitcoin to scale to all economic transactions worldwide, including cash, it'd be a lot higher than that, perhaps more in the region of a few hundred thousand tps. Today the Bitcoin network is restricted to a sustained rate of 7 tps due to the Bitcoin protocol restricting block sizes to 1MB. From here it gets more complex but the short answer is that 4,000 tps is achievable. Optimisation is then an option and new technologies and software developments will advance the cause.

### Finally, for those who care – a Bitcoin transaction

The critical three parts of a Bitcoin transaction:

1. Bitcoins are not perfectly fungible... when you move (or spend) them, you're spending some specific Bitcoins
2. In order to spend them, you have to prove you're entitled to do so. And you do that by providing the solution to a challenge that was laid down when they were sent to you in the first place. This challenge is usually just: *"prove to the world that you know the public key that corresponds to a particular Bitcoin address and are in possession of the corresponding private key"*. But it can be more sophisticated than that.
3. When you send Bitcoins somewhere, you lay down the challenge for the next owner. Usually, you'll simply specify that they need to know the public and private key pair that correspond to the Bitcoin address the coins were sent to. But it can be more

complicated than that. In the general case, you don't even know who the next owner is... it's just whoever can satisfy the condition. *SFM*

## TEAM – Atlassian

During December 2015 Australian based software company Atlassian saw fit to list on NASDAQ. The company was founded in 2002 and provides software covering a number of applications, arming developers and project managers with the necessary tools to build software products and services. In essence Atlassian helps developers to collaborate in order to plan and build better software outcomes.

The business has enjoyed incredible success, founded on the premise that, *“if you make a great piece of software, price it right, and make it available to anyone to download from the internet, teams will come. And they’ll build great things with it. And they’ll tell two friends, and so on, and so on.”*<sup>3</sup>

And the teams have come, with the financials pointing to strong revenue growth, high gross profits and a willingness by management to re-invest significant amounts back into the business. The company’s outlook certainly justifies the market’s enthusiasm for the stock which now has the business valued at USD5.6 billion.

While the company espouses the notion of teams, a quick look at the shareholder structure reveals something quite different. With 208 million shares on issue, the company has seen fit to issue two classes of shares, being A and B. The B Class shares are held by the founders and early backers, representing 74.7%, while the A Class shareholders make up the balance and are largely new investors via the float.

That seems fine except that the voting structure has the B Class shareholders receiving ten votes per share while the A Class shareholders are only entitled to one vote per share. The upshot of this has the B Class shareholders controlling 96.7% of the voting power.

For an organisation that espouses a philosophy of *“no bullshit”* on their website and a TEAM approach, this type of ownership structure is fundamentally out of step in a modern age and remains a blight on what appears on first blush to being a very successful business. **SFM**

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<sup>3</sup> Atlassian founders Scott Farquhar and Mike Cannon-Brookes

## High Yield Bonds

### Quote: Seth Klarman, Baupost Group:

*"Contrary to the promises of underwriters, junk bonds were a poor investment. They offered too little return for their substantial risk. To meet contractual interest and principal obligations, the number of things that needed to go right for issuers was high while the margin for error was low. Although the potential return was several hundred basis points annually in excess of U.S. Treasury securities, the risk involved the possible loss of one's entire investment... We may confidently expect that there will be new investment fads in the future. They too will expand beyond the rational limitations of the innovation. As surely as this will happen, it is equally certain that no bells will toll to announce the excess. Investors who study the junk-bond debacle may be able to identify these new fads for what they are and avoid them."*

Comments similar to this will probably surface in coming months following recent turmoil in "high yield" bond markets. One casualty of the turmoil has been US based Third Avenue Management, the manager of the Third Avenue Focused Credit Fund who wrote to investors during the month to inform them that they were liquidating the fund's assets and would not allow further investor redemptions.

High yield bonds are also commonly known as "junk bonds" due to their sub-investment grade credit ratings. The premise of junk bonds is that for receiving higher interest payments, investors are prepared to lend to companies that fall short of the investment grade credit rating. The higher yield became particularly desirable to investors over the last few years as investors struggled to find government and investment grade corporate bonds that offered attractive yields.

The proposition appeared all the more appealing when packaged in a vehicle that offered investors good liquidity such as an Exchange Traded Fund (ETF) or an open ended mutual fund. While the managers of these vehicles can theoretically offer fast redemption terms to investors, they cannot necessarily sell the fund's assets quickly enough in the event of a high number of redemptions, causing what is similar to a bank run. The liquidity investors believe they are getting is not quite what it seems.

Now when junk bond ETFs and open ended mutual funds run into issues, the peddlers of these products are often quick to blame liquidity rather than credit quality. As Bear Stearns and Lehman Brothers collapsed in 2008 many of those who sought to reassure the public that all was well made the same claims. There are significant liquidity issues which have magnified the junk bond market's turbulence today but there has also been a rapid deterioration in the credit quality of the companies that issue junk bonds.

Over the last few years, oil frackers operating in the U.S have issued large volumes of junk bonds and an increasing percentage of the frackers' operating cash flows have been diverted to meeting interest payments. At the same time, they have seen the profitability of their operations diminish as oil prices slumped. This is just one sector, but it is illustrative of the



pressures that have been placed on junk bond issuers. Rest assured this is not only a liquidity issue.

Ironically though, the quote in the opening paragraph was written by Seth Klarman in his book *Margin of Safety* which was first published in October 1991. He discussed the collapse of the junk bond market in the 1980's and suggested that there was a high likelihood of similar excesses re-occurring. He probably did not envision events unfolding in the today's junk bond market in such a similar fashion but it appears they are. While many have steered clear of these issues, it is obvious that a significant number have been caught holding assets that are much riskier than they originally considered, in spite of history's lessons. **SFM**

## Company visit diary December Quarter 2015

### October

LNK	Link Group IPO investor briefing	01/10/15
PWH	PWR Holdings IPO investor briefing	08/10/15
IRE	IRESS investor conference call	12/10/15
FPH	Fisher & Paykel investor day	13/10/15
GBT	GBST investor conference update	13/10/15
DMP	Domino's Pizza Enterprises acquisition conference call	14/10/15
HUB	Hub24 investor presentation	14/10/15
PPS	Praemium investor conference presentation	14/10/15
N/A	Carsguide investor conference presentation	15/10/15
NHF	NIB Holdings acquisition conference call	15/10/15
COH	Cochlear annual general meeting	20/10/15
WEB	Webjet investor conference presentation	20/10/15
SUN	Suncorp investor conference presentation	21/10/15
CZZ	Capilano Honey investor conference presentation	21/10/15
VIT	Vitaco Holdings investor conference presentation	21/10/15
IPH	IPH investor conference presentation	21/10/15
FLT	Flight Centre Travel Group investor conference presentation	21/10/15
SGR	The Star Entertainment Group investor conference presentation	21/10/15
KSL	Kina Securities investor conference presentation	21/10/15
IQE	Intueri Education Group investor day site visit	22/10/15
SGR	The Star Entertainment Group site visit	23/10/15
GBT	GBST investor briefing	23/10/15
IFM	Infomedia annual general meeting	26/10/15
NVT	Navitas investor day site visit	27/10/15
REH	Reece annual general meeting	28/10/15
BKL	Blackmores annual general meeting	29/10/15
SDF	Steadfast annual general meeting	30/10/15
IEL	IDP IPO investor briefing	30/10/15

### November

REA	REA Group acquisition conference call	02/11/15
BKL	Blackmores Q116 investor briefing	02/11/15
SEK	SEEK conference call investor relations	03/11/15
NHF	NIB Holdings annual general meeting	04/11/15
SGR	The Star Entertainment Group annual general meeting	04/11/15
OFX	OzForex Group HY16 results briefing	10/11/15
BRG	Breville Group annual general meeting	11/11/15
SRX	Sirtex Medical site management meeting	12/11/15
BKL	Blackmores China site investor tour	16/11/15
AGI	Ainsworth Game Technology acquisition investor briefing	17/11/15

BKL	Bellamy's Australia China investor tour	18/11/15
SGM	Sims Metal Management conference call trading update	18/11/15
BKL	Blackmores Indonesian investor tour	18/11/15
JHX	James Hardie Industries Q216 conference call	19/11/15
ZPIN	Zhaopin Q2 FY16 conference call	19/11/15
N/A	SunRice growers meeting presentation	20/11/15
Z	Zillow investor presentation	20/11/15
TNE	Technology One FY15 results briefing	24/11/15
ALL	Aristocrat Leisure FY15 results briefing	25/11/15
OFX	OzForex Group onsite management meeting	30/11/15

## December

FPH	Fisher & Paykel FY15 results briefing	02/12/15
SPL	Starpharma health conference presentation	02/12/15
AXP	AirXpanders health conference presentation	02/12/15
ALT	Analytica health conference presentation	02/12/15
CSL	CSL research and development day	10/12/15
DMP	Domino's Pizza Enterprises acquisition conference call	16/12/15
BGA	Bega Cheese management meeting	17/12/15

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