under the radar report
SMALL CAPS

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MED TECH SPECIAL REPORT PART 1

This is a sector that offers you massive bang for your buck, albeit obviously at greater risk. Under the Radar's average return on the 13 stocks we cover in health and medical technology has been 112%.

In this issue we discuss how we pick the stocks, and over the next few weeks we start running through some outstanding opportunities.

There are several stocks that are running hard right now. One of those is definitely Medical Developments International (MVP), which at the moment can do no wrong. The UK authorities authorised MVP's "Green Whistle" Penthrox pain relief device for use in every ambulance service in the UK, and the company has also achieved clearance in Mexico for use in moderate to severe pain trauma cases and surgical procedures requiring analgesia. The surgical application is relatively new to MVP.

We first bought the stock at $1.18 back in May 2014 when it had a market cap of under $70m. Fast-forward three and a half years and the company has issued no more shares and its stock price is $6.40, giving it a valuation of $378m.

This company has low regulatory risk, it's got proven products, it's producing positive cash flow, and it's covered in this week's issue.

We've had some good feedback from last week's "Battery Powered" Report on lithium stocks. This could be because the ones we rated spec buyå, Pilbara Minerals (PLS), Mineral Resources (MIN) and Kidman Resources (KDR) are up an average of 11% at the time of writing. As you will read in this report the nickel miner Panoramic Resources (PAN) is also a beneficiary of battery power.

Richard Hemming
Editor

the issue

Small Talk

"The big factor in a med-tech company's favour is its potential. Although it faces big regulatory hurdles and funding issues, what you get is the opportunity to seize a slice of a global market. Once it gets that domain expertise, the sky's the limit."

UNDER THE RADAR REPORT

99% of all financial news relates to the 40 to 50 biggest companies. So what about the rest? They're Under the Radar.

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QVG CAPITAL

Chris Prunty and Tony Waters

When one of the best performing duos in the Small Cap world go out on their own, it's a good thing to find out what they think of the market, and which stocks they're buying.

TWO SMALL CAP INVESTORS WORTH LISTENING TO

After all, we started covering Chris Prunty and Tony Waters just after they kicked off the Ausbil Micro Cap fund in early 2010, and subscribers who followed some of their tips made a lot of money – stocks like Altium (ALU), Blackmores (BKL), Webjet (WEB), Maca (MLD), Sirtex Medical (SRX) and many more have done well over a long period of time.

Of course, today is different from yesterday and their portfolio doesn't have too many names of the past, which is what makes their new fund interesting. But what has remained impressive is their strict adherence to a formula, which relies upon stocks generating momentum in earnings revisions, but also their ability to get out of sticky situations!

As Prunty says to us now: "What was true back then is still true now: earnings revisions drive share prices. They set prices in the long-term and move stocks in the short-term.

"In order to execute that strategy, nothing has changed. We're looking for high returns on capital and strong balance sheets, which means that they can reinvest at those higher incremental returns. It goes without saying that we're more interested in cash than accrual earnings."

> "WHAT WAS TRUE BACK THEN IS STILL TRUE NOW: EARNINGS REVISIONS DRIVE SHARE PRICES. THEY SET PRICES IN THE LONG-TERM AND MOVE STOCKS IN THE SHORT-TERM.

WHAT A SMALL CAP MOMENTUM STRATEGY MEANS

Because the duo invest in companies whose earnings keep climbing, it is very important that there is enough liquidity, or buyers and sellers, in order that they can get out. For this reason the stocks they tend to follow are no longer the micro-caps and often look expensive at first glance.

To combat this, the pair do a great deal of analysis on what the earnings profiles look like into the future. One stock that comes to mind is the Altium (ALU) which designs and manufactures software used in electronic keyboards. Altium has been one of the great performers on the ASX, having climbed from about $3 five years ago to current levels of just over $11, which gives it a market cap of $1.4bn – not so small!

FINDING THE NEXT ALTIUM

Significantly, QVG hasn't bought Altium, but when we spoke to them in March 2015, they were buyers and the share price then was $3. Even back then it looked expensive, trading on a PE of 30 times or more, but it was their biggest holding. Prunty commented on the group's valuation philosophy back then in relation to their investment in Altium:

"We look at the cash EBIT (earnings before interest and tax) it's going to make in 12 months time and compare that to its current enterprise valuation (market capitalisation plus net debt or minus net cash). We then compare that multiple of forward pre-tax earnings to other companies in its sector.

"Technology One (TNE) and IRESS (IRE) trade on close to 20 times, whereas Altium, even after its recent run, trades on 9 times. It's the cheapest, it's got the best balance sheet, the highest growth and the largest addressable market."

GOOD IDEAS BUT LITTLE QUALITY IN TODAY'S MARKET

It is also interesting that these days the pair aren't seeing as many quality companies or businesses that they like the price of. Consequently their cash holding is relatively high at 15% of their funds under management. Although it must be said that the pair aren't idle; the cash level was 30% a couple of weeks ago.

To compensate they are holding relatively small portions of a large number of companies – some 40 when we spoke. A large number of these companies are involved in cyclical businesses, whose profits ebb and flow according to supply and demand factors. You have to be very alert on the timing front and take profits faster than you would if the business was profitable in any types of conditions (like an Altium). As we stated above, it also means that the pair need to invest in companies which they can get out of quickly, if their thesis proves wrong (meaning at the bigger market cap end of the Small Cap spectrum).

As Prunty says: "What we're exploiting now are some good ideas but they're not the quality of business that would lead us to own sizeable weights."

THEMATIC INVESTING

Having said that, there are a number of interesting themes that the pair are exploiting, which we'll list below:

Niche commodities leveraged to electric vehicles

Electric vehicles will be an increasing proportion of the global fleet, and batteries need commodities like graphite; lithium and rare earth. Prunty says: "Mineral Resources (MIN) is the stock that best expresses that theme in our portfolio. It's now the world's largest lithium producer by volume. What we like even more is that the group is extremely good capital allocators over time."

Mining services benefiting from the resource recovery

The pair like NRW (NWH) which is a contract coal miner in Queensland and also does civil work in WA. It's had a big run, more than doubling in price from 60c to just over $1.20 in the past few months after an acquisition it made has started to deliver. Even after the price rise, Prunty still likes it: "The benefits of the acquisition are only now coming through and with better sales and marketing we think earnings can keep growing."

Global fund managers

QVG owns the fund platforms Platinum Asset Management (PTM) and Pinnacle Investment Management (PNI) which have both been performing extremely well. The former, in particular, is once again delivering strong returns and is the vehicle of Kerr Neilson, a well-known player in local markets.

As Prunty says "Kerr is back! You can see from public statements that he's more engaged on the marketing and distribution side, which coincides with a phenomenal 12-month trailing performance."

QVG'S TOP 5 HOLDINGS @ 31 OCTOBER 2017

1. **AFTERPAY TOUCH (APT)**
   LAY-BY PAYMENTS SERVICE
2. **MOTORCYCLE HOLDINGS (MTO)**
   AUS MOTORCYCLE DEALERSHIP OPERATOR
3. **SMART GROUP (SIQ)**
   SALARY PACKAGING FOR THE PUBLIC SERVICE
4. **LOVISA (LOV)**
   JEWELERY MANUFACTURER AND RETAILER
5. **MNF GROUP (MNF)**
   TELECOMMUNICATIONS AND SOFTWARE

Platinum's performance has occurred when the other big domestic player in active funds management, the Hamish Douglass run Magellan Financial Group (MFG) is struggling by its lofty standards. Prunty says: "There is increasing scepticism around Magellan's desire to grow (funds under management) at all costs."

Consumer finance

This area is growing because the big banks are not focussing on profitable niche areas. Says Prunty: "We like the management team of Credit Corp (CCP) in particular because the people there are honest and capable, plus they're incentivised, owning 5% of the company."

The fund also owns Afterpay Touch (APT) after its merger with Touchcorp. The group has been growing fast, but it's shares have been climbing faster! "It looks extremely expensive but if it can grow anywhere near historical rates it won't look expensive."

QUALITY VALUE GROWTH (WITH A DOSE OF HUMILITY)

QVG stands for Quality Value Growth and the Chris Prunty and Tony Waters have been around for long enough to know that they won't get every investment right and that humility means a great deal when it comes to investing. As they say: "Our focus is on the hunt for the next good idea and maintaining the discipline and humility to admit our mistakes quickly and cut the losers… We're looking for companies with proven business models relatively early in their lifecycles." ■

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