More Power from Small Caps

The old motto, “you have to be in it to win it” really does apply to many at the higher risk end of the spectrum in our universe.

This week, ImpediMed’s stock spiked 65% in one day and reached 89 cents – more than four times our 20 cent tip price, which was made seven months ago. The company has designed a product that diagnoses lymphoedema, which afflicts about a third of those who have gone through chemotherapy. The announcement this week was that the re-imbursement rate was about four times what the company had anticipated.

Subscribers who were lucky enough to take our advice and buy below 30 cents should really consider taking profits – that is, taking your costs out and letting your profits run. As Bette Davis once said, “Fasten your seatbelts, it’s going to be a bumpy night!”

Also in our tip updates it’s worth looking at one of our best buys, the carbon fibre technology company Quickstep (QHL), which has made a number of positive announcements. This stock has just as much blue sky as ImpediMed (IPD).

We also look in depth at a retailer which is turning its operations around and delivers investors fantastic fundamentals because it’s share price has fallen about 20% in the past two months. If it does turn around it is in a position to double its earnings (EBIT) in the next three years. These are the stocks where you must be careful, but you can make a great deal of money from them.

Under the Radar Report’s investment committee member Karl Siegling gives more investment advice. He is worth listing too, having more than quadrupled the money of those who invested in his Cadence Capital fund when it kicked off, some nine years ago.

Like our other regular contributors, he never ceases to deliver some interesting tips for subscribers.

Richard Hemming
Editor

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

The recent 20% share price fall in the fashion group’s stock delivers an opportunity to invest in a turnaround which should double its earnings in the next 3 years.

THE GOOD SHIP OROTON

The Oroton brand as far as investors are concerned has come under so much pressure that many have given up on the leather goods wholesaler and retailer of 75 years. We think it provides an opportunity to buy a company that still has a bright future, on the cheap.

Its price has fallen 20% in the past two months as investors bail out of retailers in general because of nervousness about the domestic economy, but also because of doubts about management’s abilities to turn around the Oroton ship.

We agree that there is much work for Mark Newman and his team to do, but we think that the market may have priced in too much negativity. This company now trades on a PE of about 8 times FY16’s earnings and on a dividend yield for that year of almost 10%. FY15 will be a difficult year, but the group has growth options and does not have financial concerns with no debt and about $10m in cash.

RALPH LOREN STARTED THE DECLINE

The honeymoon for the stock ended after it lost its Ralph Lauren licence, which generated almost $100m in revenues and $23m of the $35m in earnings before interest and tax (EBIT) in FY13. The group can now grow off a slimmer earnings base. EBIT for FY14 was $14.1m, and its dividend for FY14 was 16 cents versus 50 cents in FY13.

The real concern was the contract terms, which allowed Ralph Lauren to walk away and left Oroton with just the remaining stock as compensation. New deals with GAP and with Brooks Bros have been signed which generate more equity value for the Oroton shareholders.

But there have been more hiccups, and the selling reflects the market’s impatience with the turnaround strategy. For example, 6 months ago the GAP stock imported was the pastels range, which didn’t take into account the winter season in Australia.

MIND THE GAP

The GAP agreement has been going for a year and has reached three stores. The Brooks Bros joint venture where Oroton owns 51% has been going since February this year and kicked off with 10 stores. Both are coming off a low base, involve store rollouts and are loss making. It is envisaged they will both be profitable in FY16.

In Australia Oroton is a mature brand with 60 plus stores. The group made the mistake of combatting new international based entrants into the luxury goods sector by discounting. This strategy reduced gross margins, dipping to 62.5% from 67.2% with no increase in sales. The strategy has been abandoned and management expect margins to rebound.

The high gross margins gives us confidence that Oroton will be able to absorb any increases in prices associated with the depreciating Australian dollar.

OROTON ASIA

Arguably a bigger problem has been Oroton Asia, which has suffered from an expansion into markets where rents have skyrocketed. Oroton has five stores in Malaysia, three in Singapore, two in China and one in Dubai. The division delivered a $3.4m loss at EBIT in FY14, about half of which was associated with start up costs in China. The group intends to expand into second tier cities in China where rents are lower and envisages opening up to eight stores over the next three years.

A positive for the stock is the 10% or so of sales it generates from the internet. Owning its corporate strategy of keeping infrastructure than double in the next 3 years.

WHAT’S NEW?

This week, but overwhelmingly the sentiment has been negative in the past two months, which provides a buying opportunity. The stock trades on a prospective FY16 dividend yield of 6% without including franking credits. Management is trying to fill the big earnings gap after it lost the Ralph Lauren contract. Its ability to recover should see earnings more than double in the next 3 years.

WHY WE LIKE IT

There has been a bit of life in Oroton’s shares this week, but overwhelmingly the sentiment has been negative in the past two months, which provides a buying opportunity. The stock trades on a prospective FY16 dividend yield of 6% without including franking credits. Management is trying to fill the big earnings gap after it lost the Ralph Lauren contract. Its ability to recover should see earnings more than double in the next 3 years.

WHAT’S NEW?

The FY14 result delivered in September was its first since Oroton was forced to hand back its Ralph Lauren distribution licence in July 2013. The licence generated 50% of the group’s profits. In FY14 sales were $124.7m, while its EBIT was down 60% to $14.1m. The dividend was slashed from 50c to 16c. Under a new MD Mark Newman the group has a new corporate strategy of keeping infrastructure in place and growing sales through new products and expansion in Asia.

ORL - Share Price

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SOURCE: ASX
RESEARCH TIP UPDATES
There is much to read in this week’s section. One of our best buys is delivering the goods and we still like it; while our other picks that have doubled and more this year could be set for a breather.

ASG (ASZ)
IT SERVICES

Shortly after the annual results, the company won business from the Department of Defence’s Centralised Processing Project, as a sub-contractor to Lockheed Martin, with a potential annual EBITDA contribution of well over $2m. Ironically enough, Lockheed Martin were reported to have been a bidder for the company in 2013; a bid that was withdrawn once profit problems became apparent.

The Lockheed Martin DoD deal reflects opportunities ASG has been addressing to deliver increased services to the Federal government customers, which now include the Maritime Safety Authority and Transport Bureau, with services delivered through a cloud-based dedicated Federal Government hosting platform.

Management emphasises that the strategic move started in 2011 from a sales driven focus to recurring revenue from hosted software-as-a-service is finally paying off in the current financial years. Revenue and earnings growth are said to be baked into existing contracts, with some capacity for further business wins, which may not deliver further growth until FY16. These contracts will tend to have quite long lead times.

The balance sheet has improved dramatically, strong operating cash generation and the post balance sheet sale of a data centre for $11.7m has strengthened the company further. No dividend has been paid since 2012, but investors must be expecting some income joy in the next financial year, although the company does not appear to have made any comment at all.

Management is confident that the cloud-based trends the company is levering off are accelerating and sustainable, and that tier one enterprises and government clients are increasingly aware of the benefits of subcontracting in-house functions on a major scale. This needs to be to the point where the cost savings and complexity reductions are compelling and for some organisations, irresistible.

As an early adopter of managed cloud delivered business, management is positioning the business to be an implementation partner for larger multinational organisations. But the higher quality recurring revenue only represents part of their business, so there may still be transitional issues.

RADAR RATING: The stock may even be cheap at these levels, despite a good run. Definitely hold on if you got in on either of our Spec Buy tips this year, and we’ll have another look if there is any weakness.
IMPEDIMED (IPD)
DIAGNOSTIC TECHNOLOGY

“You didn’t misread it” was Rick Carreon’s first words to us after the announcement that caused his company’s stock to spike 65% in one day to reach 89 cents – more than four times our 20 cent tip price, delivered only seven months ago.

The company has designed a product “L-Dex” that diagnoses lymphoedema, which afflicts about a third of those who have gone through chemotherapy. This week it announced that the re-imbursement rate of US$112.67 from the US Centres for Medicare and Medicaid Services (CMS) was about four times the $30 amount that the company had publicly anticipated.

You won’t find a better example of under promise and over deliver than that.

The company’s shares spiked in September when the American Medical Association classified its product not just for breast cancer on which its testing had been done, but for all cancer indications, which is a market four times bigger and equates to over US$350m a year.

Brokers are now flocking to the stock and the two valuations are over $1.70, but having had conversations with the company for a while now, it’s worth noting three important points:

First, the reimbursement rate although good, should go for three years at best, and remember it’s from the government, which means it can be subject to unanticipated change.

Next, there is no doubt the company will be raising money. ImpediMed has about $9.5m in cash and will now do a large number of pilots for oncology practices. This means that it’s product is going to be tested for two months or more, which costs money.

It won’t be at least until FY17 that the business will be profitable and the brokers’ discounted cash flow valuations are highly dependent on no hiccups occurring.

MYNETPHONE (MNF)
TELECOMMUNICATIONS

MyNetPhone’s share price has been on a tear in the past few weeks and a presentation at the annual general meeting reinforced the healthy characteristics of the business as growth continues. We need to remind ourselves that there are always risks with a company that has grown fast from a small base, partly by acquisitions. And these risks may reveal themselves through acquisitions that do not deliver; where the numbers of acquired companies turn out to be gilded; or where management fail to make forecast integration savings.

But at the moment, we do not see any of these issues, just a company using a proprietary business model to grow revenue organically and by acquisition in the lower reaches of
the telecommunications market, translating revenue growth into earnings growth on a relatively fixed cost base. As MyNetPhone grows and bigger shareholders climb on board, more questions need to be asked.

Acquisitions continue to provide much of the revenue growth and FY15 should see continued incremental growth from the acquisitions of Pennytel made in the previous financial year, and of iBoss early in this financial year. Gross margins increased 300 basis points to 41% in FY14, driven by economies of scale and a higher margin product mix. The company paid out about 50% of its 9 cents per share earnings in FY14 dividends.

The company is priced richly. It has forecast FY15 earnings growth of just over 20%. This compares with a price earnings ratio of 35 times historic numbers, and about 30 times prospective earnings. Acquisitions have formed an important part of that growth path, and this is likely to continue. Management estimate that it has 50% underutilised capacity on their network, offering opportunities for low-cost revenue enhancement leading to improved margins across the whole of the business.

RADAR RATING: MyNetPhone is a very impressive growth company which is selling on a price-earnings growth multiple of about 1.5 times, which may not be too high a price to pay for a business that not only has attractive growth opportunities and has successfully delivered growth for four straight years. Nevertheless, we suggest that subscribers take some profits off the table. Otherwise hold for now.

QUICKSTEP (QHL)
CARBON FIBRE TECHNOLOGY

Quickstep has made a number of announcements since the last update, which reinforces our confidence in the Bankstown based emerging carbon fibre composite producer.

Production continues apace on parts for the Joint Strike Fighter (JSF), as well as a long-standing order for wing flaps for the Hercules C130J transport plane. Both these orders give an idea of the strength and capability versus weight ratio that the Quickstep’s carbon fibre is able to deliver. The company has been involved with the JSF program for a number of years, and is just now gearing up to deliver vertical tailfins for the aircraft, suggesting that the US procurement department has been very happy with what they’ve seen so far.

Even though we think that much of the current share price is underpinned by the value of existing capabilities and aerospace contracts, the excitement or juice in the stock has been the possibility that it may deliver radical changes through its carbon fibre production technology to the auto market.

There have been two relatively minor (on their own) developments for Quickstep’s progress in the automotive sector, with Quickstep agreeing to supply certain body parts for a vehicle launched by Thales for the defence customers. The group has also received Federal and State government assistance to locate an automotive manufacturing capacity in Geelong, where the addition of new automotive related manufacturers must be incredibly welcome.

RADAR RATING: The Idle Speculator indicated last week that he would buy some for the Under The Radar Report portfolio, and we think the stock remains a buy below 25 cents, with our interest getting stronger as the price drifts down towards 20 cents.
THE FINANCIAL TREND IS KARL’S FRIEND

Last May when we spoke to Under the Radar Report’s investment committee member Karl Siegling, his fund was overweight in financial services with nine of its 20 top holdings in the sector.

He compared the potential of the sector for investors with resources stocks in the early 2000s because its companies benefit from low interest rates and from the massive and growing pool of superannuation savings.

Fast forward to today and his fund performance has continued to be strong, despite the weaker market conditions, and it’s still overweight in financial services.

“Our portfolio is skewed to favourable trends because that’s the way our process works. Interest rate sensitive stocks will still do well, which was the case back then. We scale into holdings, and then scale out, selling a third of our position each time.”

The stocks his fund still holds in the sector include the big banks NAB, ANZ and CBA as well as the regional banks Bendigo & Adelaide Bank (BEN) and the Bank of Queensland (BOQ), the mortgage insurer Gemworth (GMA), the consumer lending specialist FlexiGroup (FXL) and the fund manager Henderson (HGG).

48% RETURN IF YOU LISTENED TO KARL

But its biggest holding continues to be Macquarie Bank (MQG), which has increased 48% since he first mentioned the stock in July 2013 in Under the Radar Report. When it was $45 his fund had already doubled its money, having purchased it the prior year when it was deeply out of favour. These days the stock is close to $61.50 and generated $4 for shareholders after selling its stake in Sydney Airport (SYD), plus it has another $1.30 of dividends payable next month.

His approach of investing more when a stock goes up is often at odds with private investors, he says:

“Most people would buy Mac Bank at $24 and sell at $34 and be pleased. But this strategy means you leave 100% (of potential profits) on the table. We think the stock will go to $75.

“You’ve got to let your winners run and cut your losses. I can’t emphasise this enough.”

IT’S ABOUT SCALING IN AND SCALING OUT

“Scale” and “Scaling” are words you hear a lot from Siegling, because it has worked. In the 12 months to 30 September, Cadence’s fund has returned almost 11%, compared with the ASX All Ordinaries return of just under 6%. Moreover, if you invested in his fund when it kicked off about nine years ago, you would have made almost 18.5% a year return, compared to the All Ordinaries 6%.
It is a phenomenal performance driven by a combination of stock picking, but more importantly Cadence utilises a system, which scales into winners, and out of losers. Like most things in the markets, it’s easy to talk about, but hard to achieve in reality.

Its process enables Siegling and his team to capitalise on trends better than others, who rely heavily on Modern Portfolio Theory, which says that you maximise your return and minimise your risk by carefully spreading your investment eggs.

Siegling’s approach purchases an initial 1% of the portfolio in a stock his team likes, and then it builds upon that position if that stock moves in a positive direction. If the stock keeps going up, Cadence keeps buying until it reaches 5% of the portfolio (on the basis of its original cost). Karl and his team rely upon a program it developed, which alerts them to occasions when its system advocates buying and selling.

**SCALING OUT OF A LOSER**

Macquarie Bank shows the process working on the way up, but Siegling says it also works to limit losses, such as the firm’s highest profile casualty, the salary packaging group McMillan Shakespeare (MMS). This group’s stock fell almost 65% in one day in July 2013 after the government indicated that it would crack down on the use of fringe benefits tax for salary packaging. Siegling says that his fund had been cutting its position prior to the announcement because of weakness in the stock. However, he also notes that the 20 plus days the stock was in a trading halt is unprecedented in developed markets.

Another stock he sold following declines include job auctions site Freelancer (FLN). His firm’s ability to secure stock in the small IPO offering is probably a story in itself. This is a stock whose issue price was 50 cents, but which shot up to $2.60 a day or so after listing. It has since slunk back down to 70 cents.

**A NEW HOLDING**

An upcoming IPO he is excited about is IPH, which is the holding company for the 128 year old patents law firm Spruson & Ferguson. There is evidence that the demand for this stock was extremely strong. IPH received bids from more than 100 institutions, as well as strong retail demand for its $166m initial public offering. Its stock is expected to trade on the ASX on November 19.

Says Siegling of IPH: “This is a great business model with strong revenue streams, plus it’s an old business. We like it a lot.”

**TWO OTHER HIGH ACHIEVERS**

Two small caps his fund has been buying which are doing extremely well are fast food specialist Retail Food Group (RFG) and the liquefied natural gas technology group LNG (LNG).

The former’s shares took off after it announced it was attempting to become an Australian coffee powerhouse through spending $163.5m to buy the Gloria Jean’s Coffees chain. RFG will now have 358 stores throughout Australia and 420 around the world.
“The company is capitalising on Australia’s love of fast food. This is a growth market,” says Siegling.

LNG (the company) has probably been the most spectacular stock on the ASX. Its founder Maurice Brand has captured the US hedge fund manager’s imagination with a technology that he says enables liquefied natural gas to be produced at a much cheaper cost than conventional technology. The stock traded below 30 cents a year ago and is now close to $4, having reached as high as $4.46 in September. Siegling’s fund had sold out of its initial position, but has been buying back.

“The key to this stock is understanding America’s next big export will be energy. When Russia threatened to block the Ukraine’s energy supplies, Obama flew over there and promised funding and gas supply. It was a win win and has had a massive impact on energy prices.”

For a stock picker, Siegling certainly doesn’t shy away from the big picture.

### TOP HOLDINGS

**CADANCE CAPITAL FUND**

**TOP HOLDINGS AS AT 30 SEPTEMBER 2014**

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TOP BUY RECOMMENDATIONS
As at 5 NOVEMBER 2014

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*Return includes dividends and is after brokerage.

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