Pengana Emerging Companies Fund September 2014 Quarterly Review

Fund Performance

Net performance for periods ending 30 September 2014 [1]

	1 month	3 months	1 year	3 years p.a.	5 years p.a.	7 years p.a.	Since inception p.a.[2]
Pengana Emerging Companies Fund	-3.1%	5.8%	12.4%	18.7%	13.0%	5.1%	14.1%
S&P/ASX Small Ordinaries Acc Index	-5.5%	1.5%	-0.1%	1.7%	-0.3%	-5.2%	3.0%
Outperformance	**2.4%**	**4.3%**	**12.5%**	**17.0%**	**13.3%**	**10.3%**	**11.1%**
S&P/ASX Small Industrials Acc Index [3]	-3.5%	4.2%	4.2%	14.3%	6.3%	-1.8%	4.2%
Outperformance	**0.4%**	**1.6%**	**8.2%**	**4.4%**	**6.7%**	**6.9%**	**9.9%**

Fund Commentary

The Fund rose 5.8%[1] over the September quarter, versus a 1.5%[1] rise in the Small Ordinaries Index and a 4.2%[1] rise in the Small Industrials Index. **For the 12 months to September, the Fund was up 12.4%[1], outperforming the Small Ordinaries Index by 12.5%[1] and the Small Industrials Index by 8.2%**[1].

Global equity markets fell away towards the end of the quarter as confidence waned in response to weakening Chinese economic growth, increasing global geopolitical tension and speculation that the US Fed Funds rate would rise earlier than expected.

The Australian market fell 0.6% over the quarter with the month of September being particularly weak (-5.4%) as investors were spooked by a sharply falling $A and soft iron ore prices. The Small Ordinaries Index performed broadly in line with the overall market but this masked a very weak resource sector. The Small Resources Index slumped 8.6% over the quarter in response to falling commodity prices as the growth outlook dimmed for Europe and China. Of particular note was the iron ore price, crashing to a five-year low as faltering demand out of China coincided with a surge in supply.

The recent fall in the $A against the $US, if sustained, will present a new set of challenges and opportunities for a group of listed companies. Companies importing products from Asia (retailers and wholesalers are the most exposed) will need to quickly increase prices or face the prospect of having to report lower gross profit margins in future periods. Conversely companies that generate earnings dominated in $US stand to benefit as they translate those earnings back into $A. Our portfolio is currently very well positioned in this regard, as we don't own any traditional retailers or wholesalers but do have good exposure to companies with $US earnings including: **Infomedia, Altium, Resmed, Servcorp** and **GBST.**

Reporting season broadly delivered results in line with market expectations with earnings amongst the group of companies making up the ASX200 growing by 11.5%. Top line revenue growth is getting harder to come by against the backdrop of a subdued economy struggling to digest the significant and sustained decline in mining related activity. Further margin expansion is likely to prove increasingly difficult as the tail wind of many years of cost cutting and debt refinancing dissipates. We look forward to the eventual cyclical upturn in the Australian economy that will bring top line revenue growth and strong profit improvement. In the meantime we continue to focus our portfolio on those companies that have a proven ability to achieve profit growth regardless of the state of the underlying economy.

Not surprisingly, new IPOs performed strongly over the quarter as the majority of these new listings delivered results ahead of prospectus forecasts. Our concerns around IPOs are centred more on the sustainability of these shorter term results.

We will be watching trading comments from companies over the coming Annual General Meeting season for another data point on company's prospects. It does represent a period of potential share price volatility as some companies will use the forum to update the market on their 2015 profit expectations.

---

[1] All performance figures are calculated net of fees and assume reinvestment of income distributions. Past performance is not a reliable indicator of future performance.

[2] Since November 2004

[3] The Fund does not invest in resource stocks.

Pengana Capital Ltd (ABN 30 103 800 568, Australian financial services license number 226566) is the issuer of units in the Pengana Emerging Companies Fund (the "Fund"). A product disclosure statement for the Fund is available and can be obtained from our distribution team. A person should obtain a copy of the product disclosure statement and should consider the product disclosure statement carefully before deciding whether to acquire, or to continue to hold, or making any other decision in respect of, the units in the Fund. This report was prepared by Pengana Capital Ltd and does not contain any investment recommendation or investment advice. This report has been prepared without taking account of any person's objectives, financial situation or needs. Therefore, before acting on any information contained within this report a person should consider the appropriateness of the information, having regard to their objectives, financial situation and needs. Neither Pengana Capital Ltd nor its related entities, directors or officers guarantees the performance of, or the repayment of capital or income invested in, the Fund.

Recent Portfolio Activity

We established a position in the New Zealand listed **Freightways Ltd** over the quarter. **Freightways** has more than a 40% share of the New Zealand (NZ) express freight market. It also operates a document storage and destruction businesses in Australia and NZ. We are attracted to the stability of their NZ freight business and the high growth opportunities for their Australian documents business where they are still sub-scale.

We also added to our positions in **Veda Group** (both on market and via the private equity fund sell down), **GBST Holdings** and **Qube Holdings** (following meetings subsequent to the company's profit releases that gave us greater comfort over the direction of the company) and took advantage of share price weakness to increase our holdings in **REA Group** and **Nine Entertainment**.

We sold our positions in **Fletcher Building** and **Dulux** as we looked to reduce our exposure to building material stocks following their strong share price rise over the last eighteen months. We accepted the takeover bid by **IOOF** for our shares in **SFG Australia**. Following a tragic accident involving one of **Transpacific's** trucks the company was forced to undertake a road safety review of its entire fleet. We took the view that there was likely to be unquantifiable reputational damage and accordingly sold our small position.

Key stock moves during the quarter

Key successes during the period included **Infomedia** (+56%), **Capitol Health** (+49%), **MTU Group** (+32%), and **Veda Group** (+20%). Detractors included **Tox Free Holdings** (-20%), **Perpetual** (-5%) and **Austbrokers** (-4%).

Infomedia benefited from both the release of its profit result which exceeded market expectations and the falling $A as most of the company's earnings are denominated in overseas currencies. **Capitol Health** bounced back sharply after being sold off in the June quarter as fears surrounding the effects of the May budget's proposed GP co-payment on demand for the company's radiology services dissipated. **MTU Group** posted a solid result which encouragingly demonstrated strong organic growth across most of its product lines. Despite the recent share price rise MTU Group remains our preferred exposure in the telecommunications space. **Veda Group's** share price responded favourably to the removal of a share overhang as private equity firm PEP shareholders sold half of their shareholding in the company at $2.15. We again topped up our holding in what we believe to be one of the best small cap businesses on the stock market.

Tox Free Holdings share price fell following the release of a lower than expected profit result and cautious outlook commentary as the company navigates through the Western Australian slowdown. **Perpetual's** share price drifted lower with the broader market as the pool of equities it manages (and generates fees from) generally rises and falls with the market. **Austbrokers** was impacted by negative commentary surrounding a slight softening of insurance premiums across its network of brokers.

Outlook

5 Small Cap Investment Themes

1) 2014 year of the IPO – around 40 industrial floats over the past year.

Due to the Global Financial Crisis (GFC) there was a backlog of businesses sitting on the side lines awaiting an improved stockmarket to enable the listing of these companies. With improved investor confidence the floodgates have opened and around 40 industrial companies have listed on the ASX over the past year. The average gain above issue price for this group of stalwarts was 12% at 30 September while only 10 companies were trading below issue price.

Whilst these early returns are encouraging we are not surprised, as directors of these newly listed companies are very well schooled on the need to under promise and over deliver on prospectus forecasts. Our concerns centre more on the sustainability of returns beyond the prospectus period. The listing of Myer Holdings (which we never owned) provides a good illustration of why we remain wary. After listing in October 2009 and delivering on prospectus forecasts, Myer subsequently reported four consecutive years of profit declines. It would seem the private equity owned efficiency drive (pre IPO) did not equip the company well for the future as they had underinvested in the business. Whilst this is only one example it does nevertheless highlight one of the key risks surrounding new stockmarket floats, particularly when the interests of the vendors are not necessarily aligned with those of incoming new investors.

We are very supportive of these companies coming to market as they improve the size of our investable universe. However it is our view that the level of upside needs to be materially greater, all else being equal, to compensate for the additional risk you bear buying in at the start of their listed journey.

From this list of IPOs those that did satisfy our requirement were **Veda, Burson Group, Mantra Group, Intueri Education, Isentia Group** and **Gentrack**.

Pengana Capital Ltd (ABN 30 103 800 568, Australian financial services license number 226566) is the issuer of units in the Pengana Emerging Companies Fund (the "Fund"). A product disclosure statement for the Fund is available and can be obtained from our distribution team. A person should obtain a copy of the product disclosure statement and should consider the product disclosure statement carefully before deciding whether to acquire, or to continue to hold, or making any other decision in respect of, the units in the Fund. This report was prepared by Pengana Capital Ltd and does not contain any investment recommendation or investment advice. This report has been prepared without taking account of any person's objectives, financial situation or needs. Therefore, before acting on any information contained within this report a person should consider the appropriateness of the information, having regard to their objectives, financial situation and needs. Neither Pengana Capital Ltd nor its related entities, directors or officers guarantees the performance of, or the repayment of capital or income invested in, the Fund.

Pengana Emerging Companies Fund
September 2014 Quarterly Review

2) Mining services – watch out below!

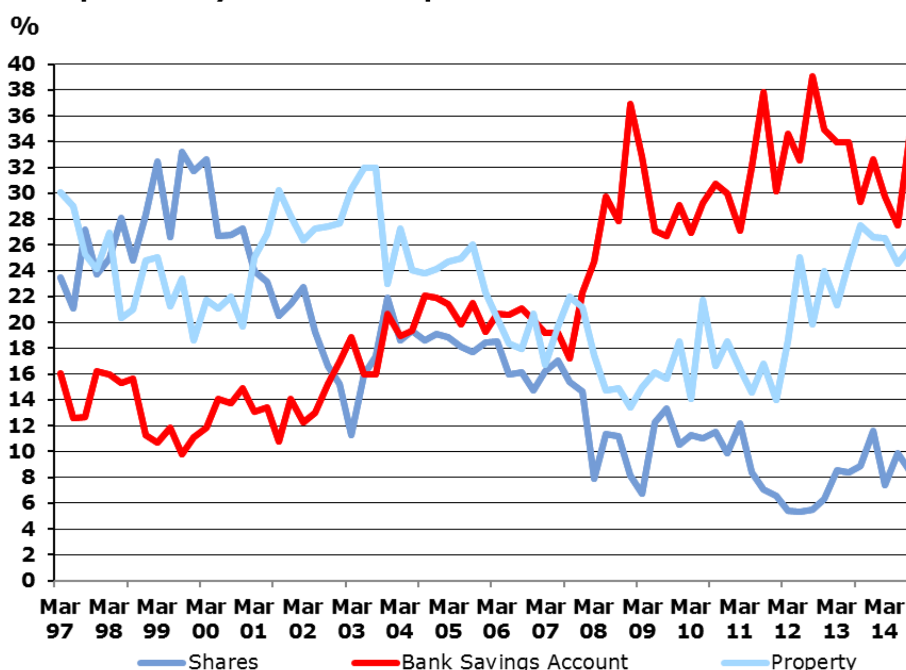
As the mining capex boom winds down we remain very cautious of companies exposed to the mining services sector. Despite what might appear currently to be cheap entry points into these stocks, we expect earnings to shrink materially over coming years. The fund has not had a significant holding in this space for a couple of years now.

Most mining service companies (particularly in WA) have large pools of capital equipment and surplus skilled workers sitting idle not earning income. The owners of the mines are using this knowledge to their advantage in tenders by slashing what they are prepared to pay for equipment and workers. Australia's largest miner BHP Billiton's recent announcements vindicate this concern; over 2014 capital expenditure and exploration spend fell 32% and this is expected to fall materially as the company resets to more appropriate levels; they also said they are taking a lot harder line on production costs that will lead to a 25% saving in the cost of extracting iron ore from the ground over the coming year.

3) Financial services – not a question of if but when flows return to equities.

It seems inevitable that when consumer confidence improves people will again turn to equities for their longer term investment exposures. The current infatuation for risk free asset classes hardly seems sustainable given the low interest rates these instruments offer and results in most of these investments generating a negative real return after tax. The recently released chart by Westpac (below) tracking a survey asking people "where do you think is the best place to invest?" is incredibly insightful. Over the next few years as investors become less risk adverse we would expect the allocation to shares will normalise back to pre GFC levels with the clear winners being financial service stocks and asset managers in particular.

As we have commented in the past we are attracted to the operating leverage that these companies offer to rising equity markets and mandated superannuation growth, the low levels of debt on their balance sheets and attractive valuations. Our key exposures to the space include **Treasury Group, Perpetual, IOOF Holdings, Magellan Financial, HFA Holdings** and **Charter Hall**.



Source: Westpac

Pengana Capital Ltd (ABN 30 103 800 568, Australian financial services license number 226566) is the issuer of units in the Pengana Emerging Companies Fund (the "Fund"). A product disclosure statement for the Fund is available and can be obtained from our distribution team. A person should obtain a copy of the product disclosure statement and should consider the product disclosure statement carefully before deciding whether to acquire, or to continue to hold, or making any other decision in respect of, the units in the Fund. This report was prepared by Pengana Capital Ltd and does not contain any investment recommendation or investment advice. This report has been prepared without taking account of any person's objectives, financial situation or needs. Therefore, before acting on any information contained within this report a person should consider the appropriateness of the information, having regard to their objectives, financial situation and needs. Neither Pengana Capital Ltd nor its related entities, directors or officers guarantees the performance of, or the repayment of capital or income invested in, the Fund.

Pengana Emerging Companies Fund
September 2014 Quarterly Review

4) Spoilt for choice - we continue to favour companies that can grow in any economic cycle.

Volatility distracts many investors from their medium term goals, which is to invest in quality stocks at the right price. At the end of October our fund will have a ten year track record of traversing a wide variety of economic conditions and outperforming the market on each occasion.

Whilst confidence in the Australian economy is fragile valuations are compelling amongst the 60 stocks that make up our portfolio. These companies largely own stable businesses which do not rely on a strong economy to grow, have strong proven management and are generally under researched by the stockbroking fraternity.

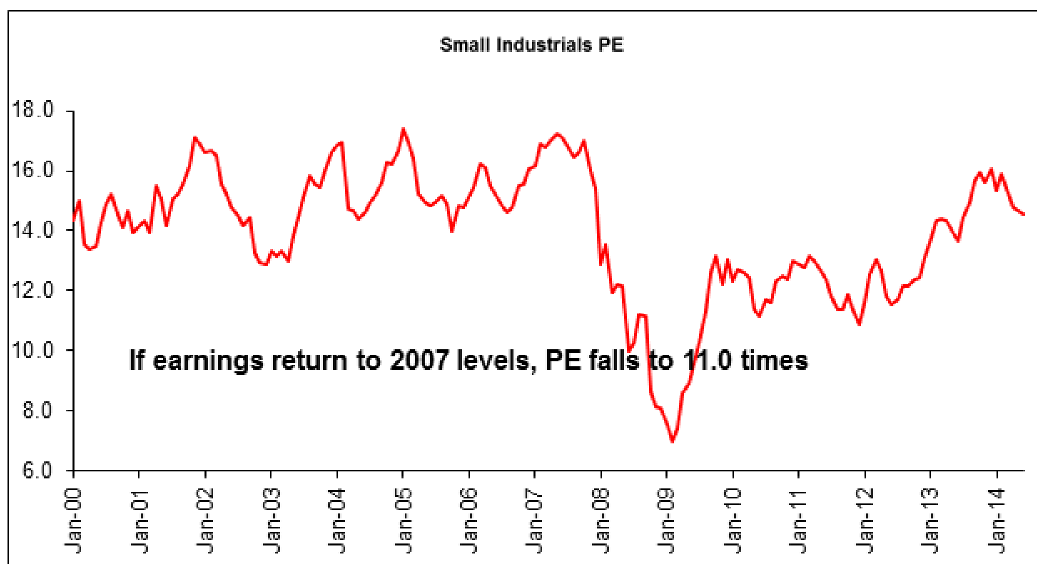
Good examples of companies which meet these criteria are **Veda Group, Mainfreight, GBST** and **Capitol Health**.

Our approach remains constant, that regardless of market volatility the single most important driver of performance remains bottom up stock picking. In this regard we are spoilt for choice with an investable universe of around 800 stocks to trawl through. We firmly believe to unlock value in small caps there must be regular company contact, which is particularly critical to fully appreciate the risks surrounding the investment proposition. To this end we conducted 81 one on one meeting's with management during the quarter just concluded.

5) Overall valuations not demanding.

Currently Australian small cap industrial stocks are trading on a forward looking PE of around 14 times. Whilst the PE multiple has expanded considerably from the crisis levels of the GFC it is not as high as it might look. With the help of a recovery in the Australian economy we expect small cap stocks to return to the profit levels enjoyed prior to the GFC in which case based on current valuations their PE multiples fall to 11 times. If shares were to then trade back to the ten year average PE multiple enjoyed before the GFC of 15 times, Australian small cap industrial stocks share prices would as a whole rise near 40%.

Overall we remain confident that PE valuations will re-rate as earnings grow and investor time horizons lengthen.



Source: GSJBW

Pengana Capital Ltd (ABN 30 103 800 568, Australian financial services license number 226566) is the issuer of units in the Pengana Emerging Companies Fund (the "Fund"). A product disclosure statement for the Fund is available and can be obtained from our distribution team. A person should obtain a copy of the product disclosure statement and should consider the product disclosure statement carefully before deciding whether to acquire, or to continue to hold, or making any other decision in respect of, the units in the Fund. This report was prepared by Pengana Capital Ltd and does not contain any investment recommendation or investment advice. This report has been prepared without taking account of any person's objectives, financial situation or needs. Therefore, before acting on any information contained within this report a person should consider the appropriateness of the information, having regard to their objectives, financial situation and needs. Neither Pengana Capital Ltd nor its related entities, directors or officers guarantees the performance of, or the repayment of capital or income invested in, the Fund.

Pengana Emerging Companies Fund September 2014 Quarterly Review

Company Visits

Our central belief is that contact with management is the key to unlocking value within the smallcap sector; hence during the quarter we made **direct contact (one on one) with over 81 companies** - see below. The table below shows the listed companies with which we had direct contact during the period (note that for many of these we had multiple meetings).

A2 Milk	Equity Trustees	Lifestyle Communities	Royal Wolf
Altium	Eservglobal	M2 Group	Runge
Amcom Telecommunication	Ezidebit	Macquarie Atlas Roads	Sealink
APN News & Media	Flexirent	Magellan Financial	Servcorp
Arcpac	Freightways	Mantra	Seven West Media
Ashley Services	G8 Education	Mortgage Choice	Slater and Gordon
Austbrokers Holdings	GBST Holdings	My Net Phone	Speedcast
Aveo Group	Gemtrack	National Storage	Spruson & Ferguson
Big Air Group	GUD Holdings	NIB Holdings	Tassal Group
Billabong	Hansen	Nine Entertainment	Toxfree Holdings
Blue Sky	Healthscope	Ozforex	TPG Telecom
BPS tech	HFA	Pact Group	Transfield
Bulletproof	Ibuy Group	Perpetual	Transpacific
Burson Group	iiNet	Property Guru	Treasury Group
Capitol Health	Indoor Skydive	Pulse Health	Veda Group
Charter Hall Group	Infomedia	Q Limited	Villaworld
Decimal	Intueri Education	QUB Logistics	Vocation
Dick Smith	Invocare	Realestate.com.au	Vocus
Dicker Data	IOOF	Regis	
Dominos	Isentia	Resmed	
EBOS Group	I-Webgate	Rhype	

Fund Description

The Pengana Emerging Companies Fund seeks to combine the skills of highly experienced small company investors (near 40 years' experience between the two fund managers) with a limited fund size to provide above market returns over the medium term. Our benchmark is the S&P/ASX Small Ordinaries Accumulation Index. The fund managers, Steve Black and Ed Prendergast, are part owners of the business and investors in the Fund, providing a strong incentive to perform. The Fund has strong research ratings from all major research houses and over the period since its inception has delivered returns well above benchmark.

Fund Features

Style	Bottom up stock picker	**Management Fees [4]**	1.3340%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index	**Performance Fees [4]**	20.5% of the performance above the Benchmark
Investors	Soft closed	**Fund Size**	0.5% of the Benchmark capitalisation
Minimum Initial Investment Amount	A$25,000 (direct)	**FUM at Month End**	$624m
Inception Date	1 November 2004	**Application Price at Month End**	A$ 2.4565
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	**Redemption Price at Month End**	A$ 2.4418

Contact Details

Pengana Capital Limited, Level 12, 167 Macquarie Street, Sydney, NSW 2000, Australia ▪ T +61 2 8524 9900 ▪ F +61 2 8524 9901
ABN 30 103 800 568, AFSL 226566

For further information, please visit our website at www.pengana.com or contact:

Advisors & Retail Clients: Justin Brooks, +61 3 8663 7906, justin.brooks@pengana.com
Advisors : Damian Crowley, +61 2 8524 9970, damian.crowley@pengana.com

[4] All percentages are on a GST inclusive basis less applicable reduced input tax credits. Please refer to the Product Disclosure Statement for a more detailed explanation.

Pengana Capital Ltd (ABN 30 103 800 568, Australian financial services license number 226566) is the issuer of units in the Pengana Emerging Companies Fund (the "Fund"). A product disclosure statement for the Fund is available and can be obtained from our distribution team. A person should obtain a copy of the product disclosure statement and should consider the product disclosure statement carefully before deciding whether to acquire, or to continue to hold, or making any other decision in respect of, the units in the Fund. This report was prepared by Pengana Capital Ltd and does not contain any investment recommendation or investment advice. This report has been prepared without taking account of any person's objectives, financial situation or needs. Therefore, before acting on any information contained within this report a person should consider the appropriateness of the information, having regard to their objectives, financial situation and needs. Neither Pengana Capital Ltd nor its related entities, directors or officers guarantees the performance of, or the repayment of capital or income invested in, the Fund.