

5 small stocks set to shine



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PRICES CORRECT AS AT 2 July 2013

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5 small stocks set to shine

Introduction

There are many different types of small stock opportunities. Some are asset plays, or cigar butts, as Benjamin Graham called them; not especially high quality companies but certainly cheap ones, trading at less than net tangible assets. Steven Johnson of [Intelligent Investor Funds Management](#) highlights one such company, Mirvac Industrial Trust, in this report.

Others are overlooked growth businesses, cast aside by an indiscriminate market. Buying into such stocks while they're cheap is to bet on the growth story playing out as planned and the market cottoning on to the fact that it originally misjudged it. Reviewed (and owned) by former research director Greg Hoffman, Swick Mining Services falls into this category.

Then there are the turnarounds, previously ailing businesses that have addressed their problems and are on the road back to health. Vision Group, which delivers ophthalmological services, falls into this category. Operating initially with a flawed roll-up model, it has radically transformed the processes by which it acquires and retains the services of the medical specialists that work for it. The relatively attractive pricing is based on the notion that the turnaround success is unrecognised.

Some may call speculation a lottery but, in the case of our next stock, we argue for lottery as a speculation. Gunning for the online lotto market here and overseas, Jumbo isn't for the faint of heart but there is plenty of potential to balance the risks. It's a quintessential growth story.

Finally, there's brewer Gage Roads, which is neither an asset play or turnaround. Instead, it's another growth story, dependent on its major shareholder Woolworths, which also happens to be the largest risk to future profitability.

What these very different investment opportunities have in common is in their ability to go off the rails. Small businesses are inherently more risky than established blue chips, which is why *Intelligent Investor Share Advisor* recommends you have no more than 15% of your portfolio allocated to them. Conservative investors who can't afford large losses might have less than 5%, if any exposure at all.

But boy, aren't they fun? The ideas that follow are for those who understand the risks that investing in this end of the market inherently entails. That's one of the reasons why we're offering a selection of five stocks. The portfolio approach is one that offers the ability to spread the risk.

As we won't be producing on-going coverage of these stocks, please undertake your own research and pay careful attention to each investment should you choose to proceed with them. And again, please don't put your portfolio at risk by investing too much in any one of these.

Despite these caveats, we're sure you'll find the following small stock picks interesting, stimulating and potentially very profitable.



“ *Small businesses are inherently more risky than established blue chips.* ”

A juiced up property portfolio

KEY POINTS

MIX trades at a 25% discount to NTA and an earnings yield of 12.5%

Asset and takeover potential

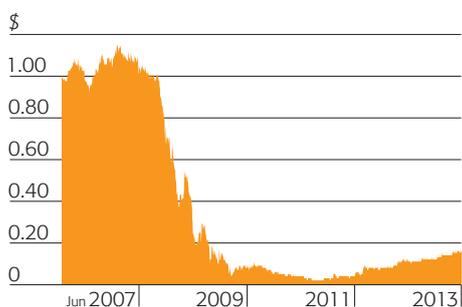
Big fall in commercial property prices could wipe it out



MIRVAC INDUSTRIAL TRUST | MIX

PRICE AT REVIEW	\$0.16
REVIEW DATE	2 Jul 2013
MARKET CAP.	\$58m
12 MTH PRICE RANGE	\$0.10–0.17
BUSINESS RISK	Very High
SHARE PRICE RISK	Very High

CHART 1: MIX SHARE PRICE



Source: Capital IQ

Looking for ways to diversify your portfolio away from the Australian economy and profit from a lower Australian dollar? How about this US commercial property trust yielding 12.5%?

You may well remember the catastrophic collapse of **GPT**, or perhaps you prefer to forget. From 2004 to 2007, the management of Australia's oldest, most conservative property trust decided they could fill shareholders' pockets, and their own boots, by embarking on what can conservatively be described as a monstrous international expansion binge.

Predictably (yes, we did call it before the event), the binge almost bankrupted this 40-year-old stalwart when global commercial property prices plummeted and debt markets froze (a heavily dilutionary capital raising in early 2009 was GPT's saviour). It, and its similarly irresponsible peers like **Centro** and **Mirvac**, became poster children for Australia's participation in the global leverage bubble.

Less well told is the story of a collection of smaller international property trusts listed at the height of the same bubble. These minnows didn't have the balance sheets, the bank relationships or the media attention necessary to help them out of trouble. All were unmitigated disasters.

The Tishman Speyer Office Fund was taken over at a 53% discount to listing price. The **Multiplex European Property Fund** still trades but is wallowing in more debt than its assets are worth and has cost float investors 97% of their initial capital. And **Real Estate Capital Partners USA Property Trust**, which recently liquidated its assets, paid out most of its investors at less than 4% of its 2005 float.

Only two managed to right the ship, both disasters for investors. But through time, luck and decent management, five years since the financial crisis almost brought them unstuck they're now on a stable footing. One is **RNY Property Trust**, the largest holding in the [Intelligent Investor Value Fund](#), and the second is the subject of this review; Mirvac Industrial Trust (MIX).

MIX owns 29 industrial properties in the Chicago, Illinois area of the United States. As a key transport hub and one of the main industrial areas of the US, Chicago is one of the country's largest industrial property markets.

Inside MIX

When MIX listed in 2005, it owned 41 B-grade properties—older assets with lower quality tenants and less access to key transport infrastructure. Today, the assets remain B-grade but there are only 29 of them. A near-death experience in 2010 (the unit price traded at an insolvency implying level of 1.6 cents) led to a significant debt restructure and the transfer of some of its assets to lenders.

Since then, the news has been all good. The units now trade at \$0.16 each, already almost 10 times the all-time low. Although the deal cost unitholders some net tangible assets, it was transformational for the company.

New long-term debt facilities cover the remaining assets, all parent-level debt has been repaid and the trust is generating significant amounts of free cashflow which is being distributed to unitholders. They're currently enjoying an earnings yield of 12.5%.

But this isn't just a straightforward yield play. Thanks to low interest rates and attractive valuations, the economics of US commercial property make MIX an interesting asset play. There are two strings to this argument.

First, MIX's assets are valued on its books at a capitalisation rate, or required return, of 8.6%. About 60% of the value of those assets is financed using debt costing just 4.4% per annum. That means an investment at today's prices should generate a cash return in excess of 14% on the equity portion of an investment.

The second point concerns the price of MIX units on the ASX. Currently, they trade at a discount to net tangible assets of more than 25%. That makes an investment even more attractive.

Unfortunately, management fees, listing costs and other overheads pilfer a significant portion of the underlying earnings. Even so, net of all costs MIX will generate about 2 cents per share of operating profit this year; a return of more than 12% on the current unit price.

Now, why wouldn't that give you pause for thought, especially as it derives from US dollars (your reference rate should be US interest rates, not the higher local figure)?

MIX's cashflow has been used to repay expensive interim finance but, now that this debt has been repaid in full, the company has announced a distribution of 0.5c for the half-year to 30 June. It should rise significantly from here.

As can be seen in Chart 2, the lease expiries are nicely spaced out over coming years. And recent new rental deals have been struck at figures close to existing arrangements. Assuming the US doesn't fall back into recession, rental income should be relatively stable, delivering a more than respectable long term return. Australian investors can enjoy the benefit of some nice currency and economic diversification, too.

Likely return

There's also potential for short-to-medium term upside from a takeover or asset sale. The manager, Mirvac, has made no secret of its desire to focus exclusively on Australian assets and MIX is the last remaining vestige of its offshore expansion folly. With management working towards an exit for the past few years, perhaps one isn't far away.

The trust has certainly been tarted up for sale with management indicating it wants to sell the entire portfolio as a single lot with existing debt facilities in place. That means a buyer would benefit from attractive, locked-in interest rates. It would also imply that any break costs to MIX of exiting the current facility would be avoided.

There remains one more task to complete before a sale. Management has suggested there are still five 'non-core' assets which, if disposed of, would leave them with a very saleable portfolio. That process is likely to be completed by the end of the calendar year, making a sale of the remaining portfolio likely within the next 12–18 months.

So the base case for owning MIX is a nice yield for the foreseeable future. The upside is a sale or takeover at a healthy premium to the current price.

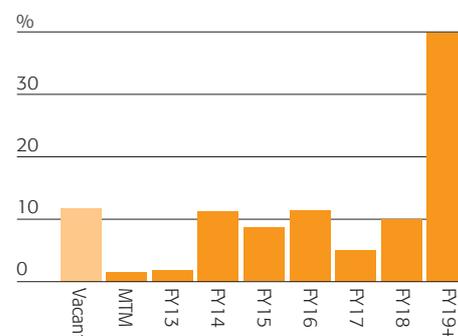
But let's not get carried away. This trust could still go under. At 63%, the debt-to-asset ratio is still high. A 20% decline in commercial property prices—quite possible in the event of another serious recession—would leave MIX severely distressed once again. Moreover, a 30% decline would likely wipe out unitholders (as soon as the loan-to-asset ratio rises above 75–80%, the ability to refinance or liquidate at anything like book value becomes remote).

Whilst we believe MIX's property values are more likely to rise than fall, the risk is real and significant. On balance an investment in MIX offers excellent diversification benefits to an Australian-focused portfolio and high prospective returns to boot.

Disclosure: Intelligent Investor Value Fund owns MIX and reserves the right to sell it at any time.

For information on the II Value Fund, which has returned 21.45%p.a. over the past 2 years, [register your interest here](#).

CHART 2: LEASE EXPIRY PROFILE



Source: Company reports

“*Australian investors can enjoy the benefit of some nice currency and economic diversification, too.*”

With the share price falling to as low as \$0.12, the board announced the inevitable 'strategic review' and then informed investors that what they thought was a flawed business model was ... well ... a flawed business model. Insiders saw it early but as usual, shareholders were the last to know.

Vision would pay a doctor a large sum of money for his practice (yes, they were all males), sign him up to a five-year agreement and then underpay him during the term of that agreement. Not surprisingly, when the five years were up (or before in some cases), the doctor would leave, taking Vision's revenue with him.

It all came down to this; for the business to survive, shareholders had to give more of the pie to staff—enough to actually hang on to them.

The new remuneration system gave doctors a share of the revenue they generated, which was generally significantly more than their old level of pay. In the three years since, we estimate doctor remuneration has increased by \$10m per annum, or roughly 25%, despite fewer doctors on the payroll.

This was a turning point. Right when shareholders were most pessimistic, the company had implemented a sustainable business model that remained surprisingly profitable. And some of the staff cost increases were offset by cuts elsewhere. As Vision hoped, the new model seems to have incentivised doctors to actually generate more revenue rather than leave the business entirely.

TABLE 2: THE NEW VISION

DATE	EVENT
30 SEP 2010	Dr Gerard Suttore re-signs under the new model
15 OCT 2010	Dr James George announces he won't be re-signing once his contract ends
25 OCT 2010	Provides guidance at AGM of revenue \$96m–\$101m and EBITDA of \$23m–\$26m
20 DEC 2010	Four doctors recontract, three long term, one (Dr Ng) only for 12 months
2 FEB 2011	Brett Coverdale signs on as interim CFO
31 MAY 2011	Settlement with Dr Eshun-Wilson for \$750k (paid in 72 monthly instalments)
4 JUL 2011	Dr McCoombes quits (\$1.5m in annual revenue)
6 JUL 2011	Stephen Godfrey quits, Paul Ng quits. Vision updates guidance to EBITDA of \$27m to \$29m
29 AUG 2011	Dr Jim McAlister signs up as new Doctor Partner
20 OCT 2011	Provides guidance at AGM of revenue \$110m and \$24m EBITDA
1 FEB 2012	Signs agreement with Medibank
3 FEB 2012	Dr George Smith signs on from the UK
20 FEB 2012	Delivers half-year revenue of \$56.5m and EBITDA of \$13.9m. Updates guidance to \$112m revenue and \$27m EBITDA
27 MAR 2012	Dr Brad Bowling joins as Director Partner

Since July 2011, Vision haven't announced one doctor resignation and has signed three new doctor partners without an acquisition. This success shows up on the top line. The company's revenue increased 4% in 2012 and is expected to be about the same this year, despite a significant hit from an adverse regulatory ruling on allowable theatre charges.

As the stock price recovered, the directors took the opportunity to raise new capital and repay debt, leaving Vision with a very manageable \$50m of net debt on the balance sheet. Both financially and operationally, the business is now on a stable footing.

Vision isn't going to be the world's greatest business but the stock is cheap and the returns should come in a very tax efficient manner for anyone in a super fund or on a low tax rate.

What about the valuation?

Vision should generate net profit of about \$10m this year and, with substantially lower debt in 2014, \$12m is the baseline for 2014. It should grow modestly from there.

That would place it on a PER of 13 at today's \$0.84 stock price. The directors have flagged a return to dividend payments this year and, with \$28m of franking credits in the bank, anything you receive will be fully franked. A payout ratio of 40–50% of profits has been suggested, which would translate into a 3%–4% fully-franked yield.

In today's income-starved market that may prove very popular. Vision needs a few more years of consistent performance before it regains investors' trust but by the time that happens, the stock price is likely to be well ahead of today's levels.

Disclosure: Intelligent Investor Value Fund owns Vision and reserves the right to sell it at any time. For information on the II Value Fund, which has returned 21.45% p.a. over the past 2 years, [register your interest here](#).

“Right when shareholders were most pessimistic, the company had implemented a sustainable business model that remained surprisingly profitable.”

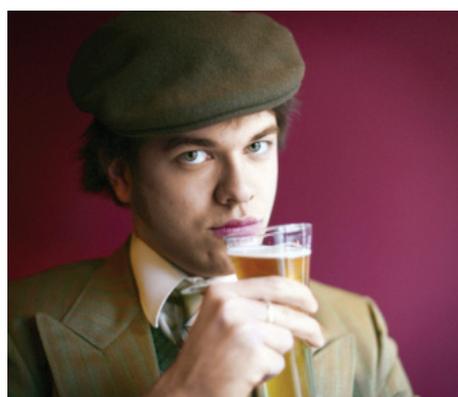
The Great Gage Roads

KEY POINTS

Woolworths' involvement changed the game in 2009

Gage Roads has a clear growth path

The risk is whether Woolies lets it earn a decent return



GAGE ROADS BREWING CO | GRB

PRICE AT REVIEW	\$0.19
REVIEW DATE	2 Jul 2013
MARKET CAP.	\$71m
12 MTH PRICE RANGE	\$0.05–\$0.20
BUSINESS RISK	High
SHARE PRICE RISK	High

CHART 1: GRB SHARE PRICE

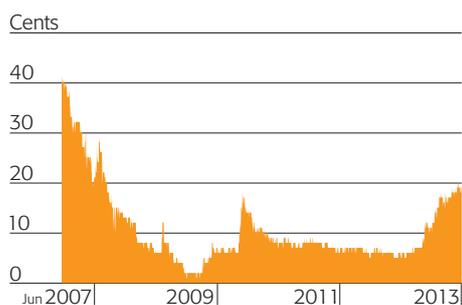


TABLE 1: 2016 BACK-OF-THE-ENVELOPE ESTIMATES

	\$'000
REVENUE	50,000
DIRECT COSTS	28,100
INDIRECT COSTS	4,500
EBIT	17,400
FINANCE EXPENSES	1,200
PRE-TAX PROFIT	16,200
AFTER-TAX	11,340
EPS (C)	2.8

Former research director Greg Hoffman takes a long drink from this craft beer brewer, hoping to repeat his success found with the brewers of that lovely tippie, *Little Creatures*.

'You can't repeat the past,' says Nick Carraway in F. Scott Fitzgerald's classic *The Great Gatsby*. 'Can't repeat the past?' Gatsby replies, incredulous, 'Why, of course you can!'

Today, I'm hoping to rekindle past success with a small West Australian brewing company. In early 2007, in my then capacity as Research Director of *Share Advisor*, I toured Australia's capital cities presenting my views on investing along with a couple of small stocks that I'd purchased.

One of those was Little World Beverages, a stock too small on which to place an official recommendation, although I did sneak in a couple of articles over the years ([Taking a Little look](#) and [What's on our radar screen?](#) see issue 245).

Little World more than four-bagged in less than seven years and paid nice dividends on the way to being taken over by Lion last year. Over the period of Little World's listed life, a few other boutique brewing hopefuls joined boards, including **Empire Beer Group**, **Oz Brewing** and **Gage Roads Brewing**.

Empire Beer failed in the brewing and hospitality game and was eventually transformed into **Car Park Technologies** (ASX code CPZ) by Chris Morris of Computershare fame. Oz Brewing ended up in administration in 2008 and was last seen in the west central African nation of Gabon, acquiring potash assets based on data gathered in the 1950s (seriously).

That leaves Gage Roads Brewing as Australia's only listed brewing company. And boy, doesn't the share price chart tell a story?

The road ahead

The company struggled in its first few years as a listed entity. The turning point came in 2009 when **Woolworths** struck a deal to acquire a 25% ownership stake and contracted Gage Roads to brew 350,000 cases of beer per year.

It was a genuine win/win arrangement. Gage locked in a decent whack of revenue and Woolworths got a dog in the fight against the pricing power of Australia's brewing duopoly.

The first purchase I made was back in June 2010 at 6.8 cents per share, after the initial euphoria of Woolworths' involvement had worn off (the price spiked up to current levels in late 2009).

This financial year Gage Roads should produce more than \$22m in revenue—10 times the figure it achieved in 2008, the year before Woolworths came along—from which a seven-figure net profit should be expected.

Even better, the company has a clear growth path. In 2011, management began a significant capacity expansion project, scheduled to be completed in March next year. The project's two main aims are to almost triple production capacity to 3m cartons per year and to reduce operating costs per carton by 50% by the 2015 financial year.

Much of this volume will be delivered through Woolworths' various arms, including Dan Murphy's, BWS, Woolworths liquor and the ALH pub network. But a number of clients have also signed up Gage Roads to produce their beers under contract, providing some diversification of income.

In fact, it was after a spate of such announcements in January this year that I purchased significantly more stock (at around 14 cents per share). The clients included the Australian marketing division of San Miguel Yamamura Packaging Corporation, Duckstein Brewery and McLaren Vale Beer Company.

These announcements made it more likely that Gage Roads would not only have a decent shot at selling its increased production capacity but also that it might do so at a reasonable profit margin.

Let's do some back-of-the envelope numbers. Table 1 shows the company achieving \$50m of revenue in 2016, with a net profit in excess of \$11m, or 2.8 cents per share. If such figures were achieved, we can expect a share price of more than 35 cents, roughly double today's price.

The main risk is in Woolworths gouging more profit out of Gage Roads by demanding the benefits of scale are passed on to it via lower prices. Anyone that's supplied either of the retail majors will tell you that's a huge risk. Screwing suppliers is in their DNA.

Engage

But there's something slightly different about Gage Roads' position. Gage's value to it is largely as a bargaining chip against the major brewers. Its purpose is to keep them honest rather than screw Gage for every possible cent. But it may still go down that path, in any case.

The company's contract brewing operations and its proprietary labels (Gage Premium, Sleeping Giant IPA, Atomic Pale Ale, Gage Pils and Wahoo) offer some protection but it wouldn't be pretty if Woolies were to play hardball. If it did, our profit estimate could halve, or worse.

In that case, earnings per share might be closer to one cent and the share price 10 or 12 cents. So that's the likely range of outcomes: a doubling (or more) over the next three years if everything goes to plan, with the risk of 45% loss if margins get crunched by Woolies.

In the meantime, I'll keep doing my bit by drinking the company's products. And for those, like me and Gatsby, trying to replicate past glories, Fitzgerald's famous closing line beautifully encapsulates our plight: 'So we beat on, boats against the current, borne back ceaselessly into the past.'

Disclosure: Interests associated with Greg Hoffman own shares in Gage Roads Brewing.

“The main risk is in Woolworths gouging more profit out of Gage Roads by demanding the benefits of scale are passed on to it via lower prices.

Taking a swing at Swick

Who would buy into a mining services stock in such a treacherous environment? Former research director Greg Hoffman, that's who. Here, he explains why he's taking a swing at Swick.

Let's run through the idealised checklist, the factors we'd all like to see when considering a new investment opportunity.

First, you'd want a company run by an owner-manager with lots of industry experience. Then you'd look at the debt, hoping for a conservative balance sheet. If the company had a sustainable competitive advantage with the potential for substantial future growth, so much the better.

Then, having established the bona fides, you'd look at the valuation, hoping to see a single-digit PER and, at the very least, a respectable fully franked dividend yield.

And where can you find just such a company right now? Please take a seat while I utter the words 'mining services sector'.

With resources companies shelving billions of dollars in expenditure, mining services groups—mostly competing on price—have been spinning profit warnings faster than a diamond-cut drill. Take mining equipment rental group **Emeco Holdings** as an example. It recently managed an impressive two profit warnings in nine weeks, with its shares down 60% as a result.

Your current research director, Nathan Bell, has kicked around in the sector but came away chastened (see [Avoiding mining services \(for now\)](#) from 4 Jun 2013). But I think I've found a valuable nugget that's been cast onto the slag heap, so to speak.

Swick Mining Services claims a competitive advantage in underground diamond drilling. This type of drilling involves using diamond-encrusted drills that cut around the target and allow for 'cores' to be extracted for analysis (see image to right).

Some years ago, Swick designed and developed the 'Swick Mobile Diamond Drill', snappily described as an 'innovative, highly mobile jumbo mounted underground diamond drill rig that sets industry benchmarks for productivity, safety, value and versatility.'

Rather than sell this development to a global player like **Boart Longyear**, managing director Kent Swick (son of the company's founders) decided on a more ambitious but

KEY POINTS

Swick claims to have a technological advantage

Owner/manager with a long term game plan

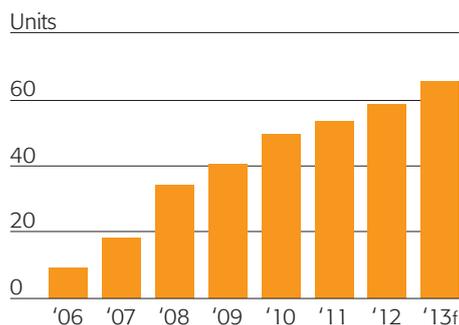
Strong cash flow has enabled growth, dividends and a share buyback

SWICK MINING SERVICES | SWK

PRICE AT REVIEW	\$0.28
REVIEW DATE	2 Jul 2013
MARKET CAP.	\$48m
12 MTH PRICE RANGE	\$0.24–\$0.48
BUSINESS RISK	High
SHARE PRICE RISK	High



Diamond drills in the rough

CHART 1: UNDERGROUND DIAMOND RIGS

Source: Company reports

“If Swick has a genuine advantage in being able to drill at a lower cost per metre due to superior rig design, it's possible that the company could pick up market share.

much longer game: to retain this competitive advantage and build a global business around it. Chart 1, which shows the growth in Swick's fleet of underground diamond drill rigs since the company listed, suggests it's been successful in this goal.

Swick has its own research and development team and Kent Swick's background is as a mechanical engineer. He retains a key focus on his company's technological advantage, as this extract from a recent interview shows:

'Tendering opportunities for our underground diamond drilling division remains (sic) strong. The Company is confident of its ability to further increase its global market share in this area as a result of recent key engineering developments that have strengthened the Company's competitive advantage. This is a result of the high powered, high quality standard of the in-house Swick mobile diamond drill rig, development of the underground rod handling system and the benefits of the semi-automated electronic drill functions.'

He provided further insights in the same interview about the nature of Swick's work:

'The Resource sector is obviously under pressure and there are many reviews of discretionary and non-discretionary expenditure being undertaken by both clients and suppliers. In general, the type of work that Swick specialises in is non-discretionary spend and is, in the main, a required process when mining underground. Potential does exist that customers may seek to lower their rig utilisation rates or defer non-essential drilling. Whilst Swick has not had any contracts cancelled as a result of the current conditions, start dates of recently awarded work were pushed out by up to a month.'

If Swick has a genuine advantage in being able to drill at a lower cost per metre due to superior rig design, it's possible that the company could pick up market share and continue to expand even through an industry downturn. The question is whether there is any evidence to support this proposition.

I think there is. In October last year, Swick was awarded a one-rig, six-month trial at the Neves-Corvo copper/zinc mine in Portugal. This was expanded to a two-rig trial which will last until the end of this calendar year. Neves-Corvo had six underground rigs in operation at the time the trial began, so this would be a significant win in itself.

World's largest gold mine

Meanwhile, last month Swick was awarded a contract at Grasberg in Indonesia, the world's largest gold mine. Owner Freeport-McMoRan is currently transitioning Grasberg from open pit to underground mining.

The initial contract is for two rigs over 12 months but 'Swick understands that there is significant long term potential for the Company, well beyond the initial term, as well as potential to significantly increase rig numbers over time as demand grows.'

One could hardly argue that with over 60 rigs around the world, a handful of additional placements is conclusive evidence of a company set to buck the fallout in the mining services sector. But this is encouraging circumstantial evidence.

Let's now look at the company's financial position. Table 1 shows 'common size' balance sheets as at 31 December 2012 for Swick, Ausdrill and Boart Longyear. This type of analysis converts the absolute numbers in each balance sheet item into a percentage of total assets, allowing for a more direct comparison between different sized businesses.

You can see from this analysis that Swick has by far the highest cash balance and also the lowest gross debt. In fact, it has close to no net debt (borrowings minus cash). It also has the lowest percentage of intangible assets on its balance sheet, meaning a larger percentage of shareholders' equity is backed by hard assets.

This strong footing, combined with healthy free cash flow, has allowed Swick to knock up an impressive trifecta over the past six months: simultaneously funding its own growth, buying back shares and paying out fully franked dividends.

If profitability can be maintained at these levels, then today's share price will prove a very attractive purchase. In the event of any growth, spectacular gains are possible.

Let's now look at what might go wrong. Swick operates in a sector currently awash with profit warnings. It may fall victim to the same fate. In current conditions it wouldn't be completely unexpected but, more worryingly, it would be a sign that management is financially naïve (or worse).

TABLE 2: COMMON-SIZE BALANCE SHEET COMPARISON

	31 DEC 2012		
	BOART LONGYEAR	AUSDRILL	SWICK
CASH	4.0%	5.5%	13.5%
RECEIVABLES	11.6%	14.4%	13.3%
INVENTORIES	23.7%	16.9%	10.7%
PP&E	27.9%	53.1%	58.9%
INTANGIBLES	18.6%	4.7%	2.7%
OTHER ASSETS	14.2%	5.4%	0.8%
TOTAL ASSETS	100%	100%	100%
PAYABLES	12.6%	10.3%	10.5%
BORROWINGS	26.7%	36.4%	14.9%
PROVISIONS	5.5%	0.8%	3.0%
OTHER	4.7%	2.5%	2.4%
TOTAL LIABILITIES	49.6%	50.0%	30.8%
EQUITY	50.4%	50.0%	69.2%

If Swick's position has deteriorated markedly since its update in early May, then management's silence is resulting in share repurchases at higher prices than necessary. And depending on the severity of any deterioration, it might also be a good idea to conserve cash rather than spend it on a share buyback.

One can only hope management is not so foolish and that its continued share repurchases are a sign of confidence, signalling that this investment thesis is on track. If not, I'll feel like an absolute dunce for holding a mining services stock in such a treacherous environment.

The eventual outcome with this stock is unlikely to be boring. Swick is either just another mining services commodity business which is about to see its profits slashed, or it's altogether different: a hidden gem with a technological advantage that may just emerge from this downturn in a stronger competitive position. Only time will tell, but I've already put my money where my mouth is.

Disclosure: Portfolios managed by Greg Hoffman own shares in Swick Mining.

Jumbo heads to international ball

Jumbo Interactive is in the business of selling lottery tickets online. There is no task more fitting for a speculative stock like this, explains Greg Hoffman.

Compared with queuing at the newsagent, or the prospect of a pocketed winning ticket going through the wash, playing the lottery online makes a great deal of sense. A bit like paying bills online: do it once and you won't go back (except for my 70-year old father, who seems to enjoy a good old-fashioned Post Office queue).

This is no fad. Around 8% of lottery tickets are now sold online in Australia, with Jumbo building a valuable customer list of about 1.5m people on its www.ozlotteries.com database. In the UK, 15% of lotto tickets are sold online and in Finland twice that. If management's expectations for the year prove accurate, the company's lottery sales will have quadrupled over the past five years, to more than \$100m.

Further rapid growth seems assured, but there's a problem; Jumbo is not a licensed lotteries provider, relying on its relationship with Tatts Group for its viability in Australia. The company's response to that threat is sensible, mainly because it has few other choices, but also contradicts our long-held view of such strategies. Yes, Jumbo is expanding offshore.

First was the USA. Jumbo formed a joint venture with Retail Gaming Solutions, run by Jeff Perlee, a '20-year veteran of the US lottery industry' who 'served as Director/CEO of the New York Lottery and general counsel with the Illinois lottery'.

Recent success

The joint venture has had some recent success with energy giant Hess Corporation. A successful pilot program of Jumbo's technology in 10 'Hess Express' gas stations saw lottery sales increase by an average of 38%. As a result, Hess is rolling out Jumbo's technology across its network of more than 800 locations.

Next month, Jumbo is set to commence online sales in Mexico. Here, the deal involves a long-term agreement with Sorteo Games, which owns two national lottery systems and distribution licenses. Jumbo has also paid US\$2m for a 6% stake in Sorteo, with an option to invest a further US\$3m.

Jumbo CEO Mike Veverka is excited by the potential in Mexico, pointing to the country's population of 110m people, 40m of whom are connected to the internet, and a 'strengthening middle class', the key demographic of those who buy online lottery tickets.

Germany is the third leg of Jumbo's international push. In October it will launch its products in the northern German state of Shlewsig-Holstein and is in the process of obtaining a nationwide license (fewer than 3m of the country's 80m population live in Shlewsig-Holstein).

KEY POINTS

Online lotteries have a strong tailwind

Jumbo is expanding abroad, with early signs of success

A strong balance sheet provides flexibility and peace of mind

JUMBO INTERACTIVE | JIN

PRICE AT REVIEW	\$1.60
REVIEW DATE	2 Jul 2013
MARKET CAP.	\$69m
12 MTH PRICE RANGE	\$1.05–\$3.28
BUSINESS RISK	High
SHARE PRICE RISK	High



A lotto ticket with your gas?

“ Australian companies rapidly expanding overseas usually unnerve me. But rather than by acquiring existing businesses, Jumbo is doing so organically.

TABLE 1: POTENTIAL 2016 PROFIT

REVENUE	44
COSTS	25
PRE-TAX PROFIT	19
NPAT	13.3
EPS (C)	29.6
PER	12
SHARE PRICE	\$3.55

Australian companies rapidly expanding overseas usually unnerve me. But rather than by acquiring existing businesses, Jumbo is doing so organically. This is a low risk method, the failure of which would not place the company in jeopardy.

In fact, with no debt and a cash pile at 30 June expected to top \$14m, it's hard to imagine Jumbo's viability being threatened in the short term (the reported cash balance will be even higher but the company holds several million dollars on behalf of clients).

I recently asked CEO Mike Veverka what keeps him awake at night. He replied that the company's reputation would be hurt by its websites crashing due to high traffic (when there's a massive jackpot, for instance) or if the company were found to have sold lottery tickets to a minor, in which case it would be in breach of the law.

I think there's another concern. Jumbo's reseller agreement with Tatts in Victoria is up for renewal over the coming weeks and NSW follows in December. What if Tatts didn't allow Jumbo to re-sell lottery tickets any more?

Because the vast majority of its revenue comes from national games, this wouldn't have a significant impact on Jumbo's business for more than four years. Because the games are national, Jumbo only needs to retain an agreement with Tatts in one state or territory in order to sell tickets online in all of them.

As Jumbo signed a five-year reseller agreement with Tatts in the Northern Territory in September 2012, even in the worst case of Tatts never renewing another agreement with Jumbo, the game wouldn't be over until late 2017.

By that time, shareholders will hope that the company has established itself in at least one of its three new major overseas jurisdictions. So what might the upside look like in three years' time?

Sky's the limit

Jumbo might make a great success out of two or three of its current international opportunities. And Veverka hopes to add at least one or two new territories to the company's list each year. So, for the optimist, the sky is the limit. But for conservative value investors examining a speculative investment, let's keep our feet planted on the ground.

Assuming it's business as usual with Tatts and that annual growth in Australian revenue runs along at 15%, Jumbo would generate \$36m in Australian revenue in 2016. And let's also assume that one of the overseas jurisdictions gains enough traction over the next three years that it grows to be one third the size of the current Australian business (let's call it \$8m in revenue). With its recent success in the US, this isn't a huge leap of faith.

Then Jumbo's revenue would hit about \$44m. It's difficult to estimate what Jumbo's cost base might be, Table 1 assumes that the current cost base of about \$20m increases by 25% to 2016. So today's buyer could reasonably expect to double their money if things panned out this way. And there should be some nice dividend payments, too (Jumbo has been paying dividends since 2010).

The upside potential is much larger, of course. Jumbo appears to have leading industry technology but this is a small technology company dancing among giants in the worldwide lottery business.

A misstep or two could see Jumbo leave the ball somewhat bedraggled, or worse. But if it stays the course and delivers on its early signs of promise, shareholders will be riding home in a pumpkin carriage and Australia's insatiable gambling industry will have spawned another global success story.

Disclosure: Portfolios managed by Greg Hoffman own shares in Jumbo Interactive.

Notes



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