fatPROPHETS™

Where we took profits and losses in 2019

December 17, 2019 FAT-AUS-951

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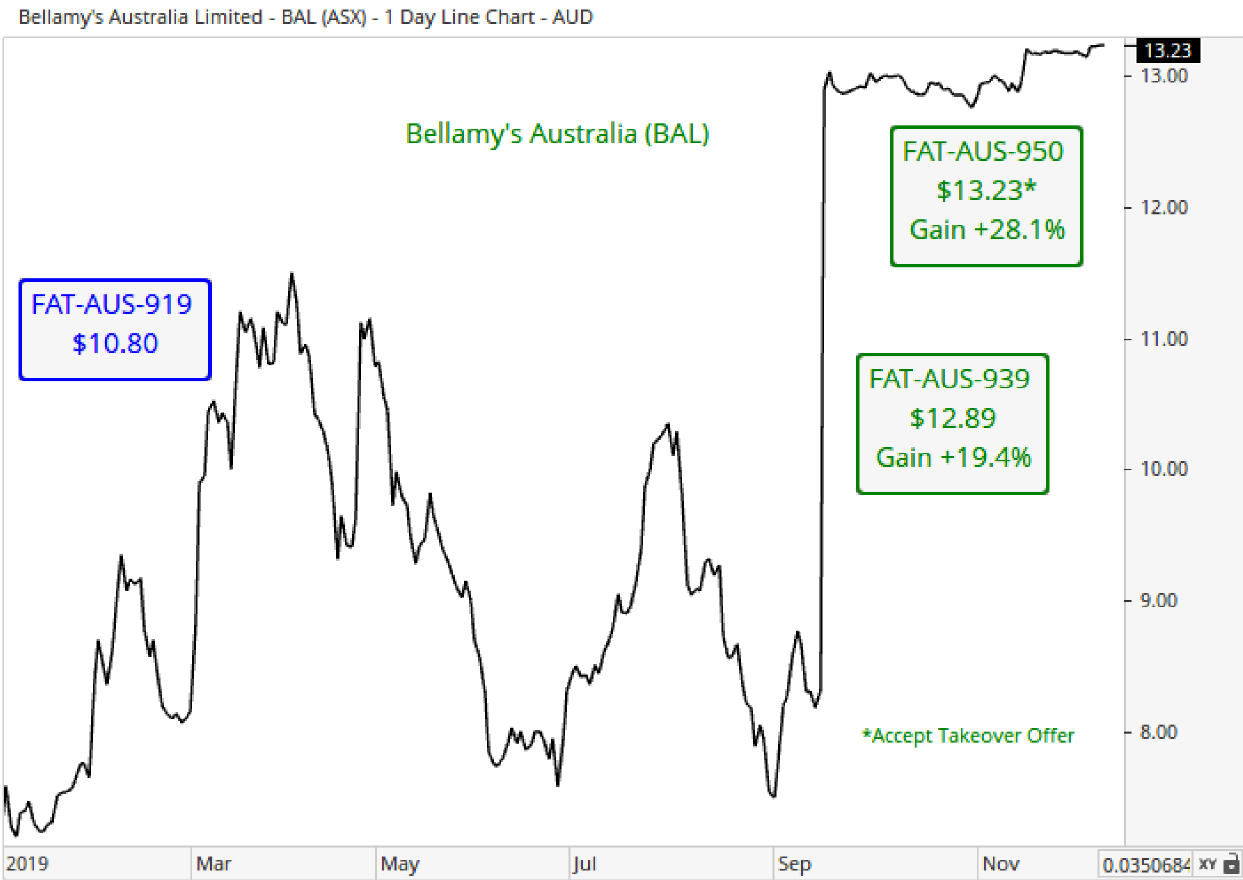
In 2019, we published a total of 8 sell and sell-half recommendations, with 7 of them resulting in positive gains and only one registering a loss. Below we provide a review of the stocks we recommended exiting or reducing over the course of the year.

The returns noted below include dividends.

Bellamy's Australia

Shares in infant formula maker, **Bellamy's Australia** (ASX.BAL) were added at the end of April (FAT-AUS-919) on the back of its exposure to the fastest growing segment of the infant formula market – organic formula – as well its exposure to China which is known for its low breastfeeding rates and rising incomes. The Australian branding also helped as a mark of high quality considering that locally produced infant formula had a negative reputation due to the 2008 melamine scandal that tragically caused the lives of 6 infants.

Later on in the year, in September (FAT-AUS-939), Bellamy's clinched an offer from Asia's second largest dairy company, China Mengiu Dairy Company (Mengniu), to wholly acquire the infant formula maker. This was an attractive jump (~59%) compared to its last traded price at the time and, given the several hurdles (regulatory and shareholder), we opted to lock in the first 'tranche' of gains and netting a solid 19.4% absolute return.



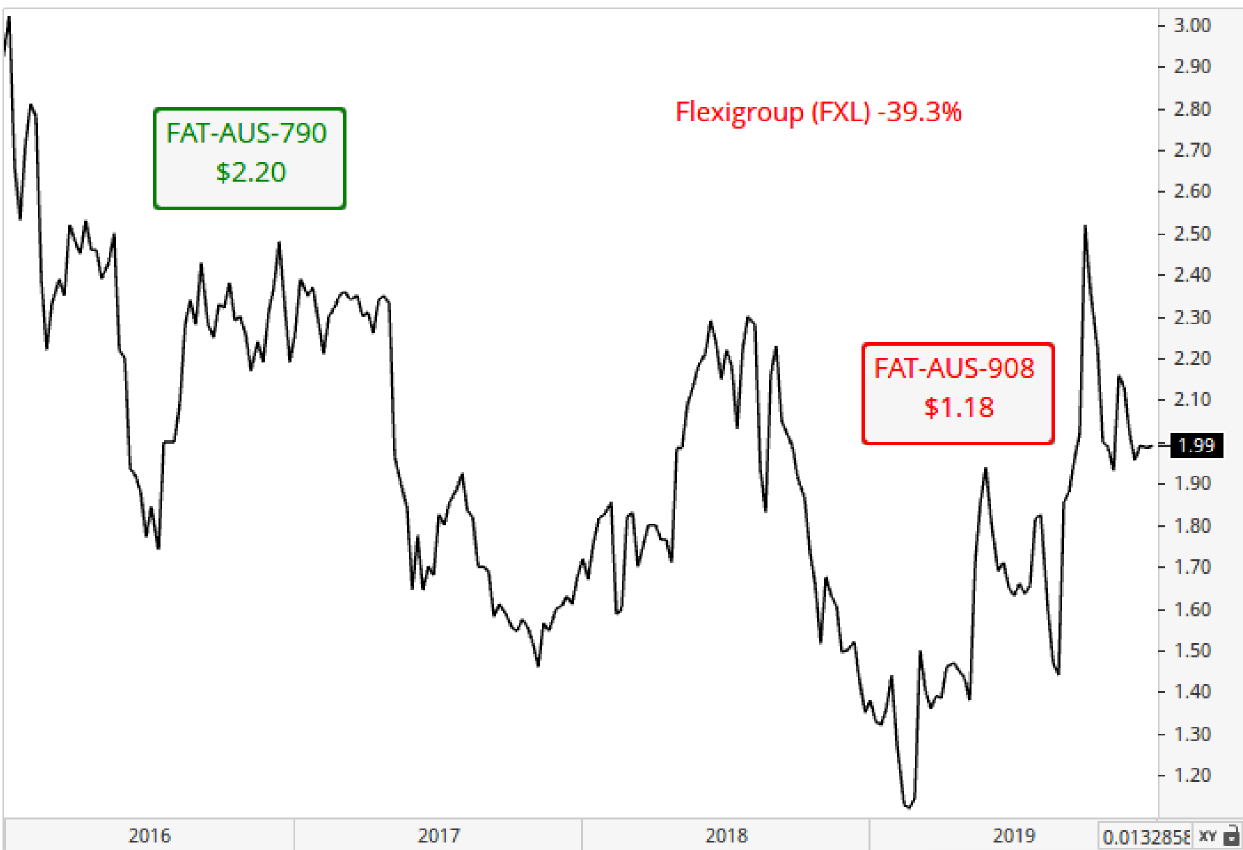
Last week (FAT-AUS-950), following the green light from regulators like the Foreign Investment Review Board, the Supreme Court of New South Wales and the company's shareholders (~98.9% in favour), we issued a Sell/Accept Offer recommendation considering that the offer from Mengiu is a 'done deal' and with the shares trading close ($13.23 vs $13.25) to the offer, would lock in a solid 28.1% gain for Members (more so for those who bought at lower prices) and all under 8 months.

Flexigroup

Diversified financial services player, **Flexigroup** (ASX.FXL) was the main blot on the copybook during the year, added to the portfolio back in September 2016 (FAT-AUS-790) when it emerged from restructuring initiatives that resulted in the divestment of low margin business. The company also, then, made a meaningful acquisition that bolstered its core business as well as recruiting senior management with impressive backgrounds.

Earlier in the year though, in February (FAT-AUS-908), we opted to make a full exit as the company issued a profit warning as its underlying business grew slower than anticipated. Investor sentiment on the company was also impacted by the final Royal Commission report that implied that the big banks wouldn't face "*severely negative consequences*" which may lead to more intense competition. There was also the issue of the company recently being under the direction of new management. With significant uncertainties abound, we noted that an exit would be the most prudent course of action.

FlexiGroup Limited - FXL (ASX) - 1 Week Line Chart - AUD

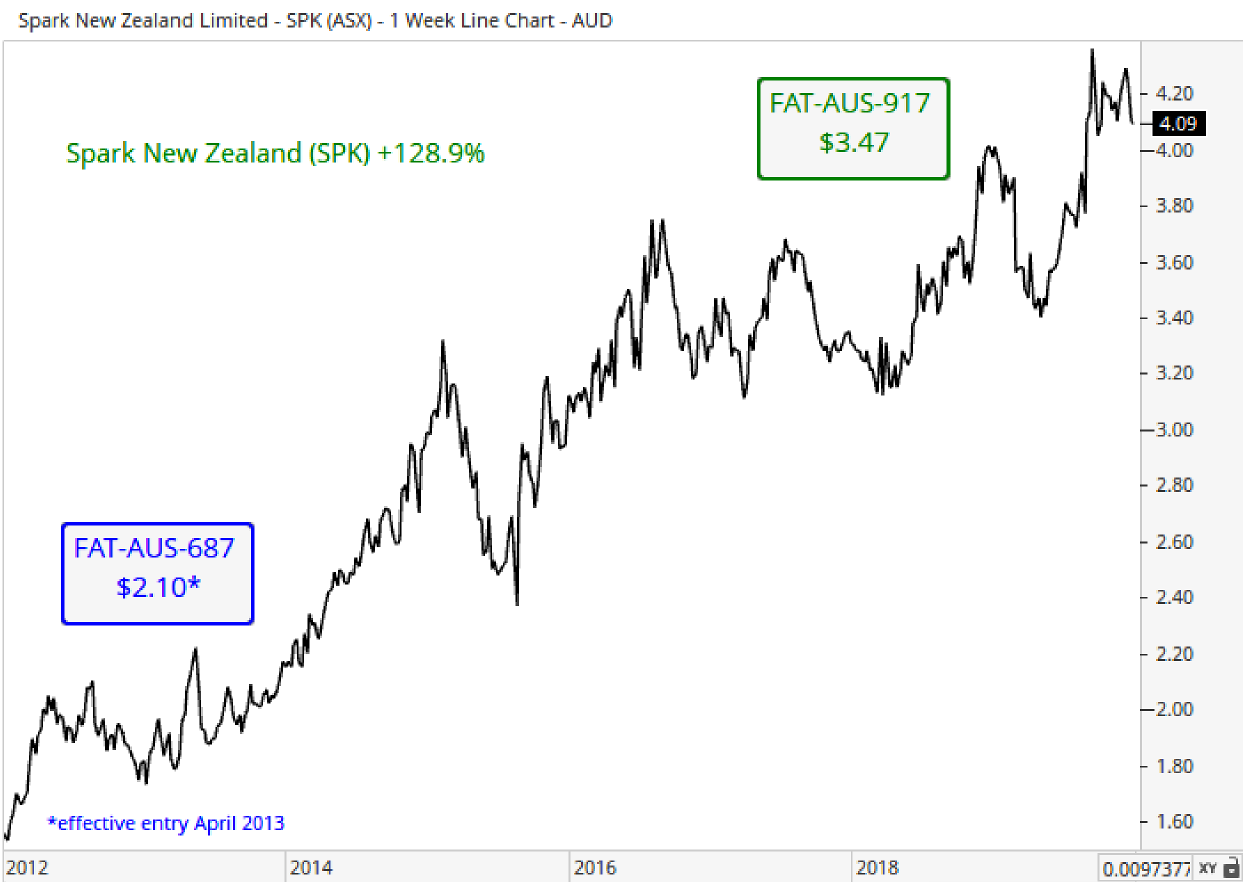


Since that point, unfortunately (and on a relatively rare occasion), our decision proved premature as the shares stage a recovery and even hit a high point in September when new management made a greater focus on the 'buy-now-pay-later' sector to serve the millennial demographic and ended up one of its fastest growing segments (+250% yoy).

Spark New Zealand

Our initial entry into Auckland-based telecom, **Spark New Zealand**, was based on the company's turnaround – which we consistently backed – under then-CEO Simon Moutter wherein the company has made a dramatic (and impressive!) transformation. Notably, we are pleased to see substantial progress with its highly profitable Cloud business making tremendous gains (amidst low penetration) as well as with its *Quantum* cost cutting programme.

As evident in the chart below, the company's performance has been impressive (though admittedly there were a few dips along the way – part and parcel of a major restructuring) with the shares progressing towards higher peaks.



However, we opted for a profit taking manoeuvre in early April (FAT-AUS-917) as the company announced a 'surprise' departure of Mr Moutter with no 'real' reason given other than "*it was time.*" That added a layer of uncertainty was displeasing given that management still had a number of initiatives still left unfinished.

This move resulted in a handsome 128.9% gain, though the shares since have trailed up 17.9% – with our concerns seemingly unfounded – as new management proved supportive of the initiatives set by the predecessor, Mr Moutter, as well as the telco chalking up market share in mobile, wireless and especially cloud services.

Vocus Group

Another telco and this time servicing both Australia and New Zealand, **Vocus**, is a third-time returnee to the Fat Prophets portfolio having been added on the back of its acquisition spree (and attractive valuations) before we ultimately exited in March 2016 when it was "*becoming too big for its boots.*"

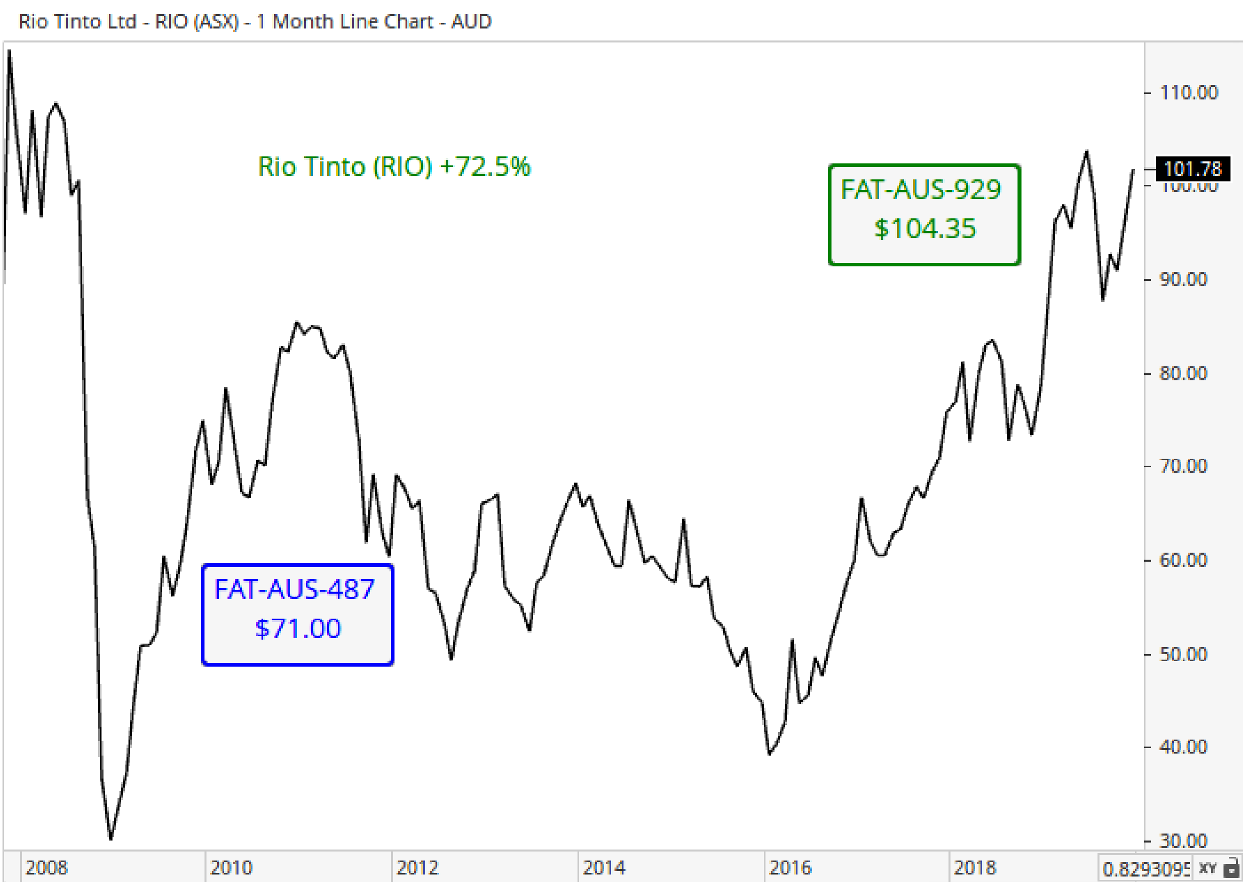
It made a return in March 2018 (FAT-AUS-866) when it vindicated our March 2016 call to sell when its share price hit multi-year lows and (again) at attractive valuations. After holding Vocus for about 14 months, the shares of the group have made a steady climb under the leadership of CEO Kevin Russell but saw a boost when it received takeover interest from various suitors. We then took the opportunity to realise some gains with a sell half recommendation in May (FAT-AUS-923).

Our call to take some profits on Vocus have ultimately proven prescient as it was near the top price level for the year – earning investors who bought at the initiation note a considerable 92.2% gain. The shares, however, took a tumble as the suitors, one after the other, pulled their respective bids.

Regardless of the reason for the pullbacks by bidders, though, we maintain a positive long-term view on the group given that it is still at the halfway point of its three-year turnaround plan under Mr Russell.

Rio Tinto

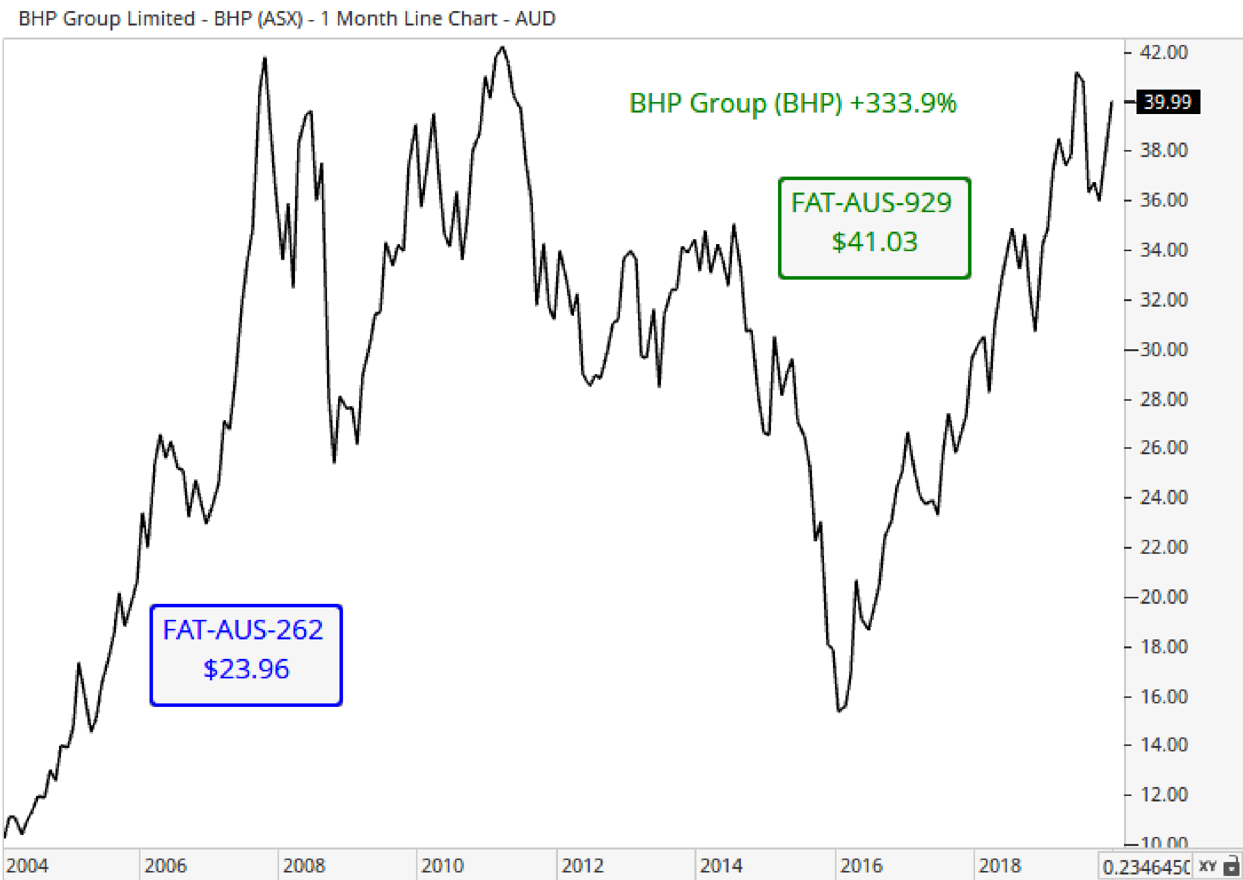
A rise in the iron ore price to nearly US$130 a tonne and record levels, was the catalyst to take some profits off the table in Rio Tinto. The iron ore price has subsequently traded back down to US$94 a tonne. The company had been, in the few years before the iron ore price hit its 2019 peak, expanding its iron ore capacity to 282 million tonnes from 208 million tonnes in 2013. With Rio Tinto well leveraged to iron ore, its increased production profile and a rising iron ore price were a recipe for major profits, and Rio Tinto did not disappoint.



Apart from its iron ore operations Rio Tinto had reported a string of ordinary quartiles during 2019, and we took the view that a weakening in the iron ore price would not be partially offset by its other operating divisions. We took advantage of a rising share price on the anticipation of higher profits as an excellent sell half opportunity (FAT-AUS-929).

BHP Group

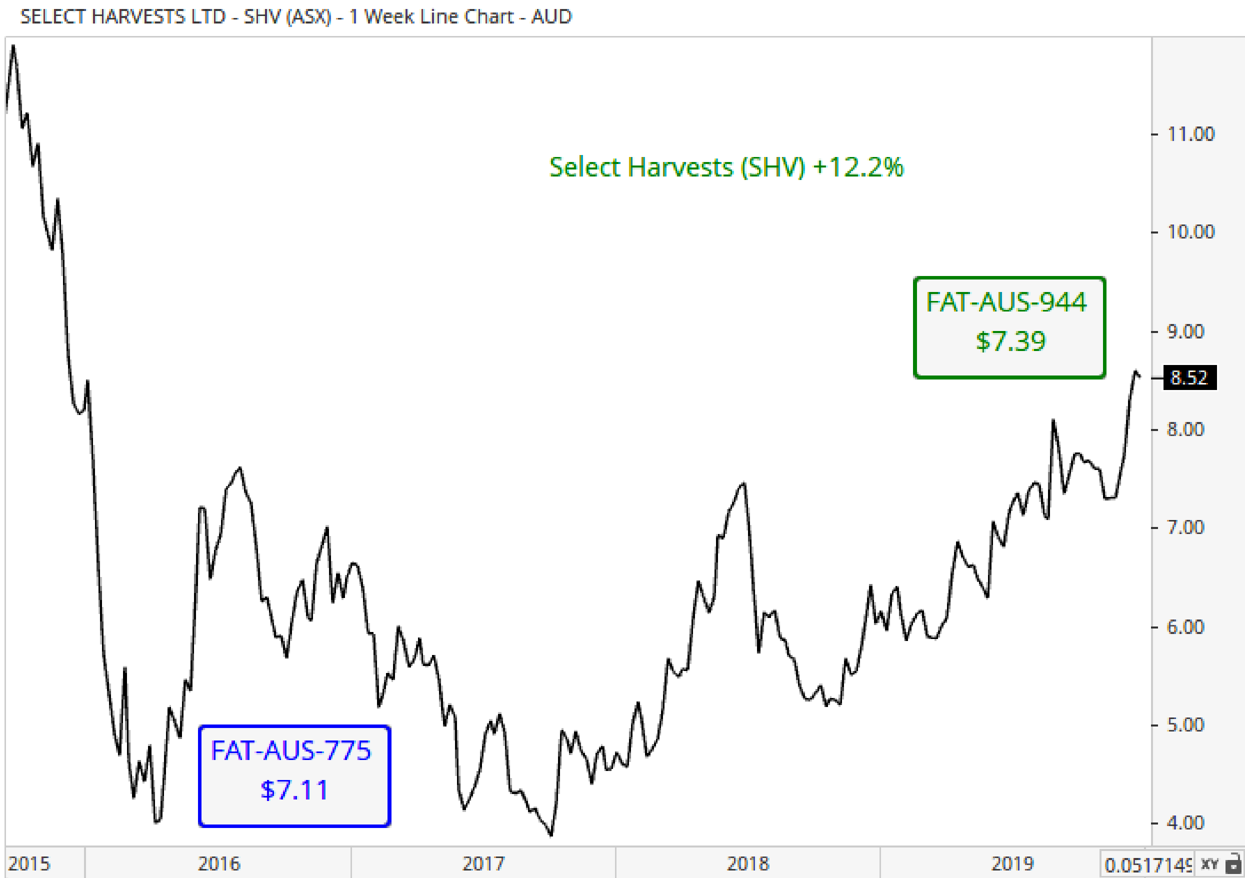
A rise in the iron ore price to nearly US$130 a tonne and record levels, was the catalyst to take some profits off the table in BHP Group. The iron ore price has subsequently traded back down to US$94 a tonne. The company had been, in the few years before the iron ore price hit its 2019 peak, expanding its iron ore capacity to 238 million tonnes from 170 million tonnes in 2013. BHP's increased production profile in iron ore and a rising iron ore price were a recipe for major profits, and it did not disappoint.



However, the company was battling on the energy front with weaker oil prices and a significant shale oil investment that was underperforming and were buffeting the share price. The company has cashed in its shale oil assets, selling these to BP plc. Copper was also underperforming both operationally and price wise to also buffet the share price. The anticipated profit growth from iron ore pushed the share price higher and provided an excellent sell half opportunity (FAT-AUS-929).

Select Harvests

Finally, vertically integrated almond producer, **Select Harvests** (ASX.SHV) was added to the Fat Prophets portfolio at the end of May 2016 (FAT-AUS-775) on the back of improving sentiment as the almond sector saw rising demand with secular changes in global dietary trends. The company also have solid management whom enacted a number of initiatives that position it well to ride the wave. Valuations, at the time, were also appealing along with an attractive dividend yield.



From that point, however, the fact that the company was fully exposed to one key commodity along with headwinds has made investing in Select Harvest quite a roller coaster ride. There were also some developments on macro front that made us revisit the case such as increasing supply from California (responsible for ~80 of global supply) and worsening drought in Australia – bad for a water intensive crop – leading to rising costs.

That said, we opted to walk away at the end of October (FAT-AUS-944) with the increasingly difficult conditions that would buffet management and the company. While the shares have since 'grinded higher' that call resulted in Members locking in an absolute gain of 12.2%. We still see closer Sino/US relations as being a potential headwind to the almond grower in 2020, and now that a Phase One trade deal is done, with China committing to a greater level of agricultural purchases from the US.