QUALITY COMPOUNDERS

Quarterly Report | March 2021

Quality Compounders Portfolio – Morgans Scone.
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*"Over the long term, it's hard for a stock to earn a much better return than the business that underlies it earns. If the business earns **6% on capital** over 40 years, you're not going to make much different than a 6% return even if you originally buy it at a huge discount. Conversely, if a **business earns 18%** on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."*

Charlie Munger, Vice Chairman, Berkshire Hathaway

Client Insights - Please let us know what you are using & consuming!

Some of the best opportunities are sitting right under our nose…consider these seven outstanding stocks that were sitting right in front of one of our team members when they had their first interaction with the product:

- 2006: First time logging onto **Realestate.com** …. stock was $3 … now $143.23 … 31.7% compound
- 2011: Purchased first couch from Nick Scali … stock was $1.6 …now $10.6 … 25.2% compound
- 2006: Looked on **SEEK.com** for career opportunities … stock was $5 … no $27.6 … 12.9% compound
- 2016: Family member started using **ResMed** Cpap machine … stock was $8 … now $27.3 … 35.9% compound
- 2009: Ordered first pizza via the **Dominos** ap … stock was $2 … now $88.30… 51.4% compound
- 2018: Hand surgeon used **Pro Medicus**' Visage imaging system to show hand x-ray on his computer … stock was $8 … now $42.5 …30.7% compound

Note: the above returns do not include dividends

We are constantly on the look out of businesses that can put their prices up each year, need very little capital to run and provide a good service to their customers. If you come across any of these in your business or day to day lives - please let us know!

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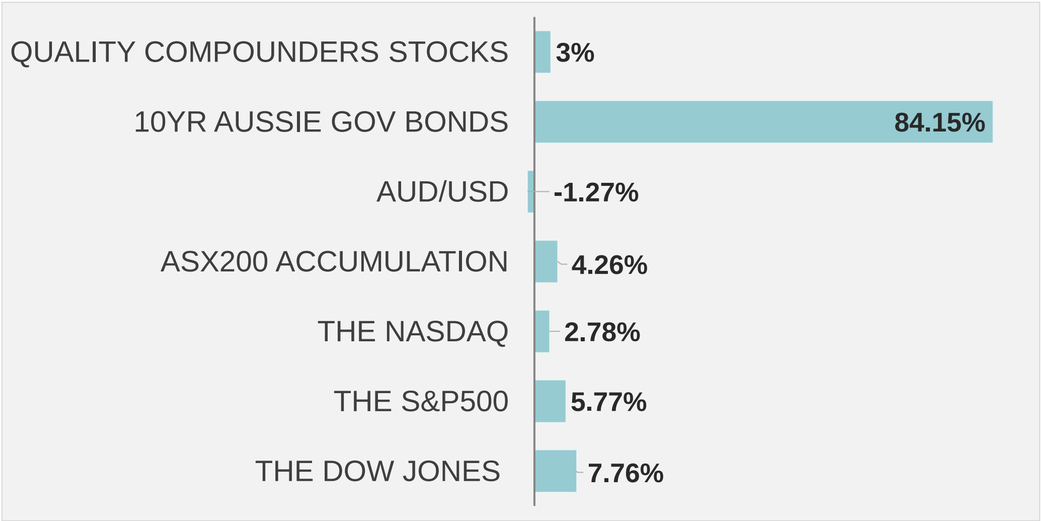
PERFORMANCE

Market Recap

The March 2021 market movements again made big positive moves:

- The DOW Jones, 7.76%
- The S&P500, 5.77%
- The Nasdaq, 2.78%
- The ASX200 accumulation, 4.26%
- The AUD/USD, -1.27%
- The 10yr Aussie Gov Bonds: +84.15%
- Quality Compounders Stocks, 3.00%



The ASX200 trades on 18.1x forward earning whilst the S&P500 trades on 23.5x earnings, a 54% & 73% premium respectively to their 10yr average P/E ratio's.

We continue to believe that that the market is fair value based on a back drop of 1.5% 10yr government bond rates. That is, the earnings yield on the US markets 4.25% offering a 2.75% premium to bonds

Quality Compounders - Performance Recap

- The Quality Compounders portfolio underperformed ASX200 Accumulation by 0.49%
- Detailed recap of each stock is covered in the slides that follow

The factors that benefited the portfolio include:

- Promedicus: More large contract announcements
- Lovisa: A very strong 1H result, that came in significantly ahead of expectations
- Clinuvel: The market starting to understand the value within this business

The factors that weighed on the portfolio include:

- Netwealth: Announcement regarding the renegotiation of their cash margin
- Nansonics: Lack of announcement regarding their new product

March Quarter 2021 Performance	
Xero	-13.8%
Netwealth	-15.4%
Visa	-3.2%
Promedicus	+20.99%
Lovisa	+26.48%
Cochlear	+11.6%
Mainfreight	-0.14%
Objective Corp	+7.5%
Clinuvel	+21.28%
Fineos	+5.41%
Nanosonics	-29.02%

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COMPANY UPDATES

Company	MARCH 2021 QUARTER UPDATE
Cochlear®	COH reported their 1H21 result during the quarter. Implants continue to be subdued due to elective surgery restrictions still being lifted across the world. Revenue and EBIT -4% for the period. One unforeseen positive to come from the pandemic and the mandatory wearing of masks was the reported hearing difficulties that people were experiencing. COH management have often stated that education is one of their biggest barriers to market penetration as many people who require an implant either don't realise they do nor understand that there is treatment via a cochlear implant available.
Lovisa	LOV was our strongest performer for the quarter after management produced an incredibly strong result despite much of the store base being in lock down for the period. Incredibly, management were able to produce an operating margin of 20%, whilst EBIT fell 32% and revenue fell 9.8%. Management highlighted that they continue to seek rent abatement with a number of their landlords and their acquisition in Europe has opened up a number of new markets. Like-for-like sales were up 7% for the first seven weeks of 2021 highlighting the resurgence in shopping trends.
MAINFREIGHT	Mainfrieght had a very quiet quarter with no announcements from the company. We note that many of the global logistics and freight forwarding stocks are trading at all time highs.
netwealth	NWL reported their 1H21 result during the quarter. The performance of this business continues to impress us with revenue +21.7% and EBIT +30.1%. The stock was sold off following managements announcement that they are looking to re-negotiate their cash margin with ANZ bank. We do not see this as an issue and have factored a declining cash margin overtime into our numbers. Further, a declining cash margin is a double edge sword. It hurts short term profits however it also market industry entry more difficult
Objective	OCL report reported their 1H21 result during the quarter. The business continues to perform strongly with revenue +40% and EBIT +73% HOH. We remain positive on the outlook for OCL as they continue to digitise government workflows and find bolt-on acquisitions.

Company	MARCH 2021 QUARTER UPDATE
CLINUVEL	CUV: Clinuvel was up 21% for the quarter due to the pleasing half year accounts which highlighted the strong revenue growth of 58% year on year which is also a seasonal low CUV has around a 30/70 1H/2H split. This means that CUV could produce $53M of revenue for FY21 which is still only a fraction of the USA rollout. The pipeline of other uses for the core melanocortin technology is developing rapidly with the 6th new indication currently being finalized. Just as a reminder, a drug on average costs $1.5B USD to develop, of 40,000 Drug candidates only 1 is approved and only 1/3 of these approved drugs end up becoming profitable. Of $150M contributed equity CUV has earned roughly half of it back so it is on track to become profitable in the coming years. CUV remains very undervalued.
FINEOS	FCL was up 5.4% for the quarter due to new contracts being announced with large tier1 insurers such as principal financial group and USAble life. There was also a well-respected global fund manager that has taken a substantial stake in Fineos – Kayne Anderson Rudnick. We have met the KAR team in LA and think they are good long-term investors, they now own 6% of FCL.
VISA	Visa ended the quarter down 2%, the Q1 results were released on 29th Jan 2021 and highlighted a decline in revenue of 6% and an EPS decline of 3%, this was not as bad as expected for the year given the cross border transaction decline and non-existed international travel due to COVID. The opportunity is still large for Visa to convert of $18T USD of cash to digital, the second opportunity for the capture of $185T of new flows such as Business to Business is progressing with some notable wins with Door Dash and 5 global money transfer operators were onboarded in Fiscal 20 including Transferwise, Western Union and MoneyGram.
nanosonics Infection Prevention. For Life.	NAN was down 29% for the quarter and was the worst performer for the portfolio over this period. The market movement was due to lack of announcement regarding new products, it seems the short term NAN shareholders are eager for news on the next product. In our view we are pleased NAN management are taking the time to secure important approvals before announcing to the investment community. The Install base continues to expand to 25T units and prove vital to the recuring cashflow this business will generate. The next products will be incrementally very valuable and will come in time.
xero	XRO was down 13.8% for the quarter, A key factor to the IRR of XRO hinges on the success in the UK, during this quarter Sage announced some positive results with revenue growing faster than the market expected. Sage still spends over 72% of revenue on 'Sales and Marketing' this compares to 56% for XRO and we are of the view that their technology stack is too cumbersome to effectively compete over the long term. XRO are due to announce 2021 this quarter and we expect to see continued strength in subscription volume.
promedicus OUR SUPPORT YOUR SUCCESS.	PME finished the quarter up 21% this is mainly due to the large intermountain (IM) deal that was announced. IM is a large non-for-profit network that highlights the widespread applicability of the Visage product. There has been some skepticism about the product only being suitable for academic groups. PME is extremely exciting especially considering the volume of public cloud installations which expands the addressable market further for PME in our view – an On Prem hardware procurement can take 4 months vs a public cloud instance available next day with 25% the implementation time. Visage was built for the cloud and this utilization is accelerating PME's market lead in our view. FY22 will be an enormous year for PME with very large contracts coming online.

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ACTIVITY

STOCKS WE COMPLETED WORK ON BUT LET GO:

AirTasker (ART.ASX): We feel that that revenue growth was too low considering the type of business.

Hansen Technologies (HSN.ASX): We couldn't get comfortable with the organic growth opportunity vs the acquired growth, in addition to declining Returns on Incremental Invested Capital

Fisher & Paykel (FPH.ASX): We are becoming more focused on founder leaders and this is not founder led.

Codan Limited (CDA.ASX): We are becoming more focused on founder leaders and this is not founded led anymore with the founders recently leaving the board.

LiveChat Software (LVC.WAR): Excellent and fascinating business but it is too difficult to own on the Warsaw exchange.

Camplify (Private): Nice niche marketplace business, sightly too early.

STOCKS WE ARE STILL WORKING ON:

Cettire (CTT.ASX): This is a very interesting online ecommerce platform for Fashion. It is quite young and we want to understand the permanent opportunity to the supply chain by following this for a bit longer. COVID has created surplus stock for wholesalers and we want to understand this some more.

4D Medical (4DX.ASX): Andreas the founder has just raised capital which we are cautious about, he is starting to get closer to commercial contracts which pushes this closer to being investable in the QC portfolio.

Company Meetings

We have been busy arranging conference calls with companies to discuss COVID-19 impacts and company updates. The meetings we conducted included:

COMPANY	CONTACT
HitIQ	Mike Vegar - Founder
Cettire	Dean Mintz - Founder
EMVision	Scott Kirkland & Ron Weinberger CEO
Tinybeans	Eddie Geller CEO/Founder & Exec Team
Mad Paws	Alexis Soulopoulos – Founder
Fronteir Digital Ventures	Sean Di Gregorio – Founder
ImmVirX X 3	Malcolm McColl & Darren Shafren – Co Founders
Fineos Corporation	Leo – Industry Expert
Zapid X 2	James Sutherland – CFO
Prevatex	Greg Collier - Founder
LiveChat	Lucja Kaseja – Head of IR
Camplify	Justin Hales – Co Founder
Promedicus	Sam Huppert - CEO & Founder

COMPANY	CONTACT
Lovisa	Share Fallscheer – CEO
PWR Holdings	Kees Wheel - Founder
Nanosonics	Michael Kavanagh - CEO
Fineos Corporation	Michael Kelly – Founder
Adyen	Head of IR
4D Medical X 2	Andreas Fouras – Founder
Octahedron Capital	Ram – Founder
ImmVirX	Oncolytic Virus Expert – Spruson & Ferguson
Gefen International	Orni Daniel - Founder

What has the team been reading & listening to:

Whilst staying across the portfolio companies we are constantly trying to find new insights & opportunities through various books, news publications, journal articles & podcasts. We use these insights as both a source of new ideas and new learnings to continue to enhance our process.

The detail of the teams reading will now be released via the website Blog at www.qualitycompounders.com.au

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PORTFOLIO OVERVIEW

Company	WHY WE LIKE THE BUSINESS
Cochlear®	**BUSINESS:** COH has an installed base of ~440,000 hearing implants, most, if not all of their patients will have to upgrade their processor or implant at some point in the future, this creates a huge 'latent' value in the patient installed base which cannot be replicated. We estimate the life time value of a Cochlear Implant patient to be ~$100,000 **INDUSTRY:** COH has a unique industry positions as the market leader in hearing implants with 60% market share. This is a very tight niche with only a few (~4 competitors). COH spends > 60% of the industries R&D budget. **GROWTH:** The World Health Organisation estimates that < 5% of the world's population who need a hearing implant, actually have one.
Lovisa	**MANAGEMENT:** Hold 40% of the stock & are very experienced retailers **BUSINESS:** LOVs low basket size creates an almost habitual purchasing pattern from its core customers – who shop for regulator outings or dress-ups. LOVs low priced, high turnover products enables global leading store unit economics – generating ~$20,000 in sales per square metre which compares favourably with the likes of LuLu Lemon ($15,600); Tiffany ($27,900) & Apple ($55,460). It takes a management team with significant 'tactile knowledge' to execute a complex supply chain. This 'tactile knowledge' is incredibly difficult to replicate with both time & money **GROWTH:** We believe that LOV can grow their stores from ~450 today to ~2,000 over the next 10 years
MAINFREIGHT	**MANAGEMENT**: MFT have a very special culture that has been curated over the past 30yrs by the current management. Culture is a very difficult if not impossible competitive advantage to reverse engineer / replicate. One of MFTs core business lines is 'less-than-container-load' (LTL) services, the execution of an LTL service is highly differentiated to a full-container-load (FCT) given the multiple contact points involved with one truck servicing multiple customers. Conversely, FCT is a highly commoditized A to B transportation service. It is MFTs highly engaged & motivated staff that enable the execution on this higher margin, LTL service. **BUSINESS:** MFTs network of warehouses & branches would be both costly & difficult to replicate. Further, as branches are added to MFTs network they create a more compelling offering to their existing customer base in addition to another route they can be monetized **INDUSTRY:** The transport logistics industry is characterised by a number of large underperforming/slow moving participants who we believe MFT will take share from overtime. MFT currently sell all 3 of their products to just 31% of their 500 largest customers, we believe this is likely to increase overtime.

Company	WHY WE LIKE THE BUSINESS
FINEOS	**BUSINESS:** FCL provides a software service that is essential to the daily functioning for insurance companies. Errors in core claims processing software can lead to sever regulatory breaches and in some cases bankruptcy for an insurer. This critical function enables FCL to charge recurring revenues for their software and this fee is typically increased each year. Further, due to the deeply integrated nature of FCLs software, they experience very little customer churn, as highlighted by their top five customers having been with them for >8yrs. In addition, 50% of FCLs annual revenues are recurring **GROWTH:** The industry is still processing the majority of their claims through legacy systems that are > 30yrs old. These systems are now becoming increasingly costly to maintain. In addition, consumer lead demands for an ability to interact digitally, we believe, will see a number of insurers start to outsource their systems to providers, such as FCL. We expect this conversation process will see FCL on average, double their revenues per customer over a five-year period. **MANAGEMENT:** Founder, Michael Kelly is FLCs largest shareholder holding 60% of the business. Further, we also believe that Michael has instilled a high-quality culture at FCL, with 88% of FCLs senior executives having been in the business for > 15yrs
nanosonics	**INDUSTRY:** NAN is the world leader in the disinfection of ultra-sound probes through its product the Trophon. Management have stated that there is currently no competitive offering to the Trophon. This is a very niche market, one that is unlikely to attract significant competition given the small total addressable sales versus large barriers to entry. **BUSINESS:** NAN has 22,000 Trophon units installed across North America; EMEA & Asia Pacific. This installed base is highly valuable and difficult to replicate or penetrate as hospitals are unwilling to consider an alternative if the current product preventing the spread of inflection. Hospitals typically have to upgrade their Trophon every five years and NAN is able to sell a consumables product along with the Trophon unit – creating a 'razor blade' type model. Further, the hospitals sales cycle is typically very long, creating a barrier to entry into this very niche industry. **MANAGEMENT:** NAN is lead by Michael Kavanagh, who spent 10yrs a COH prior to joining NAN
VISA	**BUSINESS:** Visa has a compelling protocol (rules based), two-sided (demand & supply), branded network effect that is incredibly difficult to replicate. The network effect is created as each incremental merchant that is added to Visa's payment network creates more value for the existing customers (more places to use their credit card), and each customer that is added creates more value to the existing merchants (more potential customers). Due to this powerful network effect - Visa has pure pricing power – whereby it can increase its prices each year whilst only spending very little on incremental capital & experiencing little customer churn. **GROWTH:** Visa management believe that the business is at an inflection point, which will result in a 10x increase in the volume of transactions process across their network over the next 10yrs. This will be driven by the conversion of cash, as online sales grow as a percentage of retail sales, and as business to business payments become more seamless. **INDUSTRY:** Visa is a global duopoly, that often collaborates with their main competitor – Mastercard. Stable, concentrated industry structurers are typically indicative of strong future profitability

Company	WHY WE LIKE THE BUSINESS
xero	**BUSINESS**: XROs platform enables SMEs to manage the day-to-day accounting of their business. This central source of truth for an SME enables XRO to charge annual (recurring) fees for (on average) seven years (average customer life) and currently 98% of their revenue is recurring. XROs customers stickiness is a function of its two-sided network effect. Like Apple's 'ap store', XRO also earns revenue from SME application providers. The more applications on their platform, the more value XROs customers are likely to gain from being able to easily connect to their service providers. The more customers on the XRO platform, the more value they create for the application providers. Further, XRO has enable the accountant as a friendly middleman to both sell and educate their customer base on the software. **MARKET** opportunity: Currently, only 20% of the world's SEMs have adopted cloud accounting software (ex ANZ) – there are many millions of potential subscribers in UK and North America to convert. Further, XRO also processes billions of transactions across its platform which we believe it will be able to monetize **INDUSTRY STRUCTURE:** XRO has only really one major competitor – US based Intuit. Both players are highly profitable and in the best position to continue to penetrate cloud accounting systems into SMEs.
pro medicus OUR SUPPORT YOUR SUCCESS.	**MANAGEMENT**: PME founders, Sam Huppert & Anthony Hall Still own 55% of the business and are very experienced managers. They have allocated capital incredibly well since founding the business in 2000. Further, PME has a very stable management team with all senior executives having been in the business of over eight years **BUSINESS**: PMEs Visage Imaging Platform is a world leader in radiology imaging software – servicing a number of the world's leading hospitals including The Majo Clinic; Ohio Hospital; Cleveland Clinic; Duke University; German Government Hospital. These customers are contracted for typically 5 to 7yrs and are charged per scan. We estimate that >85% of PMEs revenue is recurring and PME is also able to increases their prices each year these factors combined, create a highly attractive & predictable revenue stream **MARKET OPPORTUNITY:** The North American PACS market is >$2B USD with PME growing the fastest with still only ~4% market share
CLINUVEL	**BUSINESS**: CUV is the only treatment for patients suffering for Erythropoietic protoporphyria (EPP – a rare blood disease which causes a severe reaction to sunlight) – making it a legal monopoly. This treatment needs to be administered by a clinical professional / friendly middleman at regular intervals, creating a lifetime patient value in excess of $1m. **INDUSTRY**: The FDA granted CUV market exclusivity for the distribution of SCENESSE. Legalized monopoly industry structures tend to create high long-term shareholder value **MANAGEMENT**: CUV achieved FDA approval through a total investment of ~$330m, this compares with most drug companies who would typically spend in excess of ~$1b. Wolgen's disciplined use of equity capital in addition to his very considered newsletters provides us with a lot of confidence in his ability to execute **GROWTH**: We believe that CUV will materially expand the market opportunity of SCENESSE overtime, with management identifying an additional five use cases.

Company	WHY WE LIKE THE BUSINESS
netwealth	**MANAGEMENT:** The Heine family still own 60%+ and have built a very good culture and long term orientated business model (not winning unprofitable business) **BUSINESS:** NWL is the market leader in wealth management software in Australia. 90% of NWLs earnings are recurring and they have very long-term customer relationships. NWL is a beneficiary of both rising equity markets (7% CAGR) & interest rates (NWL receives a margin on cash accounts). Due to NWLs customer focus & market leading functionality, they have created a 'friendly middleman' through the financial planner. **GROWTH:** The total industry is ~$1T in FUA size and grows at 10% CAGR due to super contributions & asset price growth. NWL currently only have 3% market share
Objective	**MANAGEMENT:** Tony Walls owns 66% of the company, has built a strong culture of integrity and can do attitude. **BUSINESS:** OCL product suite is very sticky with 99% customer retention and is a strong beneficiary of the growth in unstructured data management. The OCL business produces 95% gross margins and has grown revenue from $50M to $70M over the past 5 years while utilising no additional capital. Due to the core functionality being embedded in customer workflows and training the switching costs are very high and extremely painful to move from. **GROWTH:** The content management industry is forecast to be a $15B USD market growing at 14% CAGR (Fortune business insights).

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QUALITY COMPOUNDERS

We focus on finding and investing in capital light, price making businesses that are founder led with a growing competitive advantage. We are radically open minded and long term investors.

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