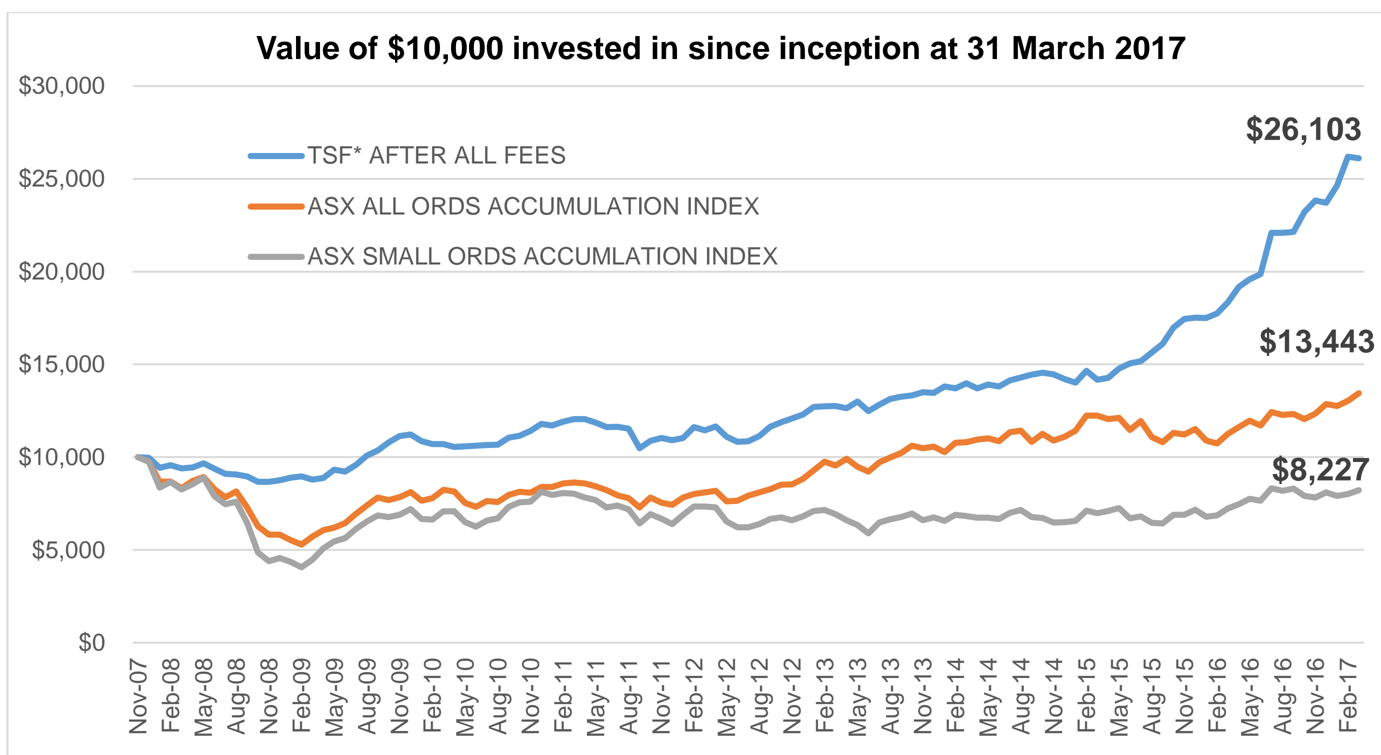
The Supervised Fund (TSF)

Monthly Report – March 2017

PERFORMANCE ANALYSIS	TSF AFTER FEES	ALL ORDS ACCUM	BENCHMARK
Month ending 31 March 2017	**-0.3%**	3.2%	0.4%
6 months	**17.9%**	9.1%	2.5%
12 months	**42.3%**	19.5%	5.0%
3 years p.a	**23.1%**	7.6%	5.0%
Since Inception p.a (Dec 2007)	**10.8%**	2.6%	5.0%



*Please note TSF returns assume reinvestment of all distributions (as do the indices).

Portfolio at 31 March 2017

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	31%
Cash	12%
HGL Limited	10%
Hillgrove Resources (equity, bonds and calls)	9%
Gale Pacific Limited	6%
Base Resources Limited	4%
Po Valley Energy Limited	4%
Nine Entertainment Corp Limited	4%
ETFS Physical Gold	3%
Sirtex Medical Limited	3%
Bell Financial Group Limited	3%
NZME Limited	2%
Ariadne Australia Limited	2%
Ramelius Resources Limited	1%
APN News and Media Limited	1%

- 0.5% of capital is invested in (put) options over stock market indices.
- 2% of capital is invested in non-ASX listed investments (excluding cash).
- 5% of capital is invested in ASX200 members.
- 18% of capital is invested in oil, gas and resources companies (excluding gold).
- 6% of capital is invested in gold mining companies.
- 3% of capital is invested in physical gold.
- 65% of capital is invested in companies with a market capitalisation of less than $150m.

Commentary

During March rises in NZME Limited, Hillgrove Resources Limited, Sirtex Medical and Nine Entertainment Corporation were slightly more than offset by declines in our gold shares, HGL Limited, Po Valley Energy and Kangaroo Island Plantation Timbers Limited.

Nine Entertainment Corporation (NEC)

During the month we invested 3% of capital in Nine Entertainment Corporation (NEC). NEC owns the Nine television network, a suite of digital media assets and a 50% interest in fast growing Video-On-Demand platform Stan.

NEC has had a colourful decade; in 2007, the company's predecessor PBL Media Group was sold to private equity buyers for $5.6bln. In 2012 it narrowly avoided bankruptcy after convincing debt holders to reorganise the capital structure. These new shareholders subsequently listed the company in 2013. Since then the market value has cut in half mostly because of declining revenues, ratings and margins in the free-to-air (FTA) TV division. Today, NEC is one of the most shorted stocks on the ASX. At our entry price the company has a market cap of $870m with net debt of approximately $180m. We believe we bought the stock on a forward P/E of 8x and a fully franked yield of 8% - we think earnings will bottom this year and expect growth over the next five years.

The key contention regards the FTA TV network. It is no secret traditional media companies have struggled whilst digital media players have flourished. Over the past decade digital media companies have increased their share of ad spend from less than 5% to over 50%, and are likely to continue to grow at above market rates over the longer term[1]. Today FTA TV accounts for approximately 24% of domestic ad spend. We believe this could conceivably cut in half over the next 10 years – yet such would only represent a 25% gross revenue reduction. Even the most digitally savvy media executives believe FTA TV will continue to have a meaningful share of spend long into the future because its localised content (nightly news, live sport and reality TV) will continue to attract viewers. Our discussions with industry participants suggest FTA TV will continue to be a vital component of advertising allocation for larger clients.

Contrary to the view of many market participants, we believe the short term outlook for FTA TV ad spend is not dire. Over the past 3 months, there has been significant revolt against digital media companies for lacking an industry wide consistent definition of a viewer impression. Facebook reports a viewing based on a completely different engagement level to that of Google, Amazon, Nine Digital, Fairfax and others. The net result is clients are unable to accurately determine reach rates and thus are unable to effectively plan advertising campaigns. Furthermore, the digital media market place has evolved so rapidly it is yet to undergo supply chain rationalisation. For every dollar a client allocates to digital media, approximately 60c gets taken from the supply chain (targeting, digital trading desks, demand side platforms, and exchanges) before the spend is allocated to the digital publisher (Facebook or Google). By way of comparison, the equivalent sum for FTA TV sees 20c taken prior to the publisher. In January, Procter and Gamble (the largest advertiser in the world) announced it will not allocate any more spend to digital until these issues are addressed[2]. While these issues are likely to be resolved within the next two years they may cause a momentary flow of dollars back to old media platforms such as television.

[1] It is interesting to note that digital media has a greater market share in Australia than it does in the US. In fact, the US only allocates 36% of ad spend to digital vs Australia's 50%.

[2] http://adage.com/article/media/p-g-s-pritchard-calls-digital-grow-up-new-rules/307742/

Yet the market value of NEC seems to imply the recent aggressive revenue declines of approximately 5% p.a will continue. The below table released by WPP Limited forecasts a different outcome.

3 Year Demand Forecast

Media Type (calendar year)	**2017**	**2018**	**2019**
Television	-1.7%	-0.5%	-0.5%
Digital	11.2%	10.2%	7.6%
Outdoor	5.3%	5.0%	0.3%
Radio	3.2%	0.1%	0.4%
Newspapers	10.0%	-1.5%	-1.0%
Magazines	-5.0%	-0.7%	-0.3%
Cinema	5.3%	5.0%	2.5%
Market	**4.2%**	**5.2%**	**3.9%**

Source: GroupM Forecast 24 Feb 2017

WPP Limited owns the largest media agency network in Australia and can be thought of as one of the major ‘gate keepers’ of advertising spend. As part of our due diligence we met with WPP who advised that FTA TV players are under-pricing inventory compared to other media forms. Accordingly, the dollar value of FTA TV advertising allocation may actually increase over the next few years. Our forecast assumes a less positive outcome.

NEC’s FTA TV market share is also important. Over the past 10 years, this has ranged from 34% to 41%, and currently sits at the lower end of this range. Recent programming success has resulted in a slight improvement in ratings share. We believe the current programming strategy will continue to reap share gains, particularly at the expense of the Ten Network, which is currently under financial stress. Share gains are particularly relevant – If NEC were to increase share to the midpoint of its 10-year range, shareholders would see a 30% increase in earnings per share.

Even if market share does not improve and TV ad spend continues to decline it seems NEC will likely be able to maintain its FTA TV EBITDA. Management has flagged $50m worth of planned cost-outs over the next two years (FY2017 TV EBITDA is expected to be ~$150m). Additional savings are likely as the company shifts content to higher margin localised product. While some savings could be eroded from increases in cricket broadcasting rights, we do not believe such will be excessive. Furthermore, Australian FTA TV license fees are likely to decline over the next 3 years; Australian broadcasters pay 4.5% of revenue as a fee to the government. The equivalent fees have long since been reduced in Europe and the US. The video viewing landscape has changed and this fee is now obsolete. The fee abandonment would increase NEC earnings by a further 30%. We do not include this cost saving in our forecast but expect the FTA TV lobbyists will succeed in efforts to have these fees materially reduced in the next 3 years.

NEC's suite of digital media assets generates approximately 20% of group earnings and has a monthly audience reach of 15m people. In fact, NEC's domestic Australian digital reach is third to Google and Facebook[3]. We believe it fair to assume NEC maintains this share of digital spend and grows in line with the market.

The 50% interest in Video On Demand (VOD) platform Stan is potentially a game changer. The VOD market is growing at more than 40% p.a and industry forecasts suggest the market will reach 8m subscribers within 5 years. We estimate Stan will have approximately 850,000 subscribers by June which places it a clear second to Netflix. We believe there is room for two players in the market and believe late entrant Amazon will have difficulty competing with the two incumbent platforms and Stan's content assets will be difficult to match.

NEC and Fairfax have invested almost $200m in Stan to date and the vehicle is expected to break even in 2018. If Stan can maintain its current 30% market share and the industry growth forecasts prove accurate, Stan will triple the subscriber base over the next five years by which time NEC would see additional annual EBITDA of $40m. While there is a risk that Stan loses share to new entrants, we believe the odds of continued success are favourable - our forecast assumes Stan doubles its subscriber base within 4 years.

Our base case forecast displayed below sees NEC's digital and share of Stan EBITDA almost match that of the FTA TV division within 5 years. With this in mind, we believe the current valuation metrics are attractive.

SIAL NEC MODEL OUTPUT	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Growth in FTA TV market	-3%	-1%	-1%	-3%	-3%	-3%
NEC FTA TV market share	36%	37%	37%	37%	37%	37%
Stan subscriber numbers (m)	0.85	1.06	1.28	1.53	1.84	2.20
NEC Earnings growth	-17%	20%	17%	-3%	5%	5%
Digital and STAN EBITDA Contribution	17%	19%	24%	35%	39%	42%
TV EBITDA Contribution	83%	80%	75%	65%	61%	58%
EV/EBITDA at entry price	**6.4x**	**5.5x**	**5.0x**	**4.9x**	**4.5x**	**4.2x**
Dividend yield (fully franked)		8%	10%	9%	10%	10%

We expect material deregulation of the 'old media' industries as well as heightened corporate activity could provide additional catalysts for NEC. In any event we are comfortable owning the stock as a going concern given its low gearing, enviable valuation and outlook for modest growth. While we cannot accurately predict the future we believe NEC's risk-reward balance is desirable.

The fund is open to new applicants. Please contact us if you would like to discuss the strategy and outlook.

Mitch Taylor – 24 April 2017.

[3] https://mumbrella.com.au/nine-rejects-yahoo7s-claim-third-player-market-behind-facebook-google-429192

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