DMX Australian Shares Fund
September 2023 – Investor Update

A wholesale unit trust managed by:
DMX Asset Management Limited
AFSL 459 120
13/111 Elizabeth Street, Sydney, NSW 2000
Trustee & Administrator:
Fundhost Limited AFSL 233 045

Unit price (mid) based on NAV (31 August 2023)	**$0.9942**
Unit price (mid) based on NAV (30 September 2023)	**$1.0102**
Number of Stocks	42
% cash held - month end	2%
Fund size (gross assets)	$11m

1-month return	1.6%
3-month return#	10.7%
12-month return#	10.4%
Since inception (1 March 2021, p.a.) #	4.9%
Since inception (cumulative) #	12.9%

 # Returns assume reinvestment of distributions.

Dear Investor,

DMXASF's NAV increased 1.6% for the month of September, ahead of the ASX 200 Total Return Index which declined 2.8%. The broad market continues to be weak, with the smaller company sector continuing to bear the brunt of the sell-off. Smaller companies again underperformed, with the Emerging Companies Index falling 5.6%. As was the case in the prior month, most of our portfolio constituents fell in this broadly declining market. Two fresh takeover offers in September though offset decliners and helped drive a small positive return for the month.

Commentary

In a seasonally quiet month and a broadly weak market, most of our holdings declined over the month. Most impactful were an 18% decline in NZ-listed **General Capital**, and a 9% fall in **RPMGlobal**. Each for no particular reason, and handing back some prior gains. Pleasingly, RPMGlobal has in early October upgraded guidance for both revenue and profit, though not surprisingly in this market, with a muted market response.

More positively, **Academies Australia** and **Reckon** each recovered 11%, while **Earlypay** and **SOCO Corp** each rose around 20%. Mostly, we benefited from takeover offers for **Cirrus Networks** (up 43%) and less impactfully, **Diverger** (up 15%). We've emphasised in recent months the particularly attractive levels whole swaths of the market have fallen to. As highlighted in the DMX Capital Partners (DMXCP) report, many companies have been trading at valuations reminiscent of the Global Financial Crisis market trough – levels from which exceptional returns were subsequently recorded. Not surprisingly therefore, the market continues to get picked over by private equity and industry players seeking to snatch a bargain. Again, as highlighted in the DMXCP report, what has been surprising though has been how quick and prepared to deal many Boards and substantial shareholders have been. Fortunately, in some instances key shareholders have been able to drive improved outcomes.

Current portfolio holdings subject to takeover include **Cirrus Networks**, **DDH1**, **Energy One**, and now **Diverger**. Cirrus Networks, DDH1 and Diverger have been targeted by industry peers seeking to benefit from scale and synergies (together with attractive acquisition multiples), whereas Energy One has been private equity prey. In the case of Cirrus, an initial bid was improved by nearly 20% in order to secure broader support from key shareholders. We wouldn't have supported the initial bid, but at the improved price and in the absence of a higher competing offer (which was initially possible but looking less likely as time rolls on), we are supportive. While the price isn't quite top dollar, it represents a ~80% return on our investment and would free up capital for us to rotate into other more interestingly priced opportunities.

DDH1 has been disappointing, as the company is being effectively merged into a larger operator on terms that – in our estimation – substantially undervalue the business. This one's a done deal now with shareholders voting in favour (though we voted against the deal), and crucially, its largest holdings supporting the transaction. The company's largest holder has been legendary value investor Howard Marks' firm, Oaktree. Given their value-oriented philosophy and the terms they've agreed to here, we've found this somewhat perplexing. We'll receive some cash and mostly scrip in **Perenti** which we'll continue to research and ruminate on before deciding how we'll proceed.

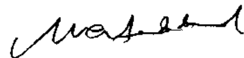
Energy One remains subject to exclusive acquirer due diligence with US-based software-specialist private equity firm STG Partners. This one's a pure cash offer, so cleaner in that sense. But the price is too low. Key holder and now-former director Vaughan Busby has publicly rejected the offer. At the price offered, we're hoping for the deal to either fail, or for a much-improved bid. With DD having dragged out for some time, we expect to know one way or the other fairly soon.

Finally, Diverger's Board and its largest (31%) shareholder – Hub24 – have agreed to be acquired by fellow ASX-listed **Count**. You know you've done a bad deal when your acquirer's stock pops 10% on the announcement. They're supposed to go *down*. It's still early days for this deal and we're hoping for an outcome more like that for Cirrus than for DDH1. The DMXCP report covers this extensively, with commentary attached here as an Appendix. In short though, we control a little over 5% of Diverger's shares outstanding, and having recently become a substantial shareholder, have received a number of approaches from other shareholders unhappy with either the deal or the price offered. With a groundswell of resistance to Count's first offer, together with the low price offered in an absolute sense as well as the even lower price when the very material and obvious synergies are taken into account, we're hopeful either the offer will be improved materially, a competing bid emerges, or the deal as proposed fails. We'd be happy with any of these outcomes.

<u>Summary</u>

We've been managing reasonably well through the current down-leg of the broader and particularly smaller companies sector. Most of our portfolio has fallen in sympathy, but takeover offers have helped prop us up. We're working very carefully to trim and potentially exit the least prospective of our portfolio holdings in order to add to and initiate new positions in very attractively priced quality businesses. Where takeover offers fall short of our expectations around reasonable valuation, we're not afraid to reject a bid or to attempt to work constructively to help secure a more appropriate price and terms. There's nothing wrong with takeover bids failing, and we believe investors shouldn't be too concerned with missing out on a quick 10-20% but to instead remain focused on a company's underlying business and the potential rewards to shareholders from long-term ownership.

If you'd like to discuss the portfolio or the potential to invest or add to an existing investment, please contact Michael any time at michael.haddad@dmxam.com.au or 02 80697965.



Michael Haddad
Portfolio Manager

Chris Steptoe
Research Analyst

Appendix – DMXCP Commentary on Diverger

DVR's proposed acquisition by Count (ASX:CUP)

We have been shareholders in DVR since 2017. That year, DVR reported an underlying profit (EBITA) of $3.3m. DVR has reported strong growth since then. By FY20, EBITA had grown to $5.7m, and, at its most recent results, DVR gave EBITA guidance of $8m-$9m in FY24. We believe that with this demonstrated long term track record of significant profit uplift, DVR is a business with an attractive growth profile and strong and capable management execution. With 90% of its income recurring through ownership of some attractive assets such as its industry leading accounting training business, and its high margin investment management business CARE ($2.7b FUM), DVR has attractive qualitative aspects. However, while DVR's progress operationally has been strong, its share price has underperformed, with DVR's shares trading at similar levels today as they were back in 2017.

While DVR highlighted that the offer represented a 27% premium to its one-month VWAP, DVR's share price had been trading at such depressed levels in recent times, that this premium, in our view, does not result in a valuation that is close to what we believe to be DVR's intrinsic value. Given the disconnect between value and share price, we consider any reference to the historical DVR share price in the context of determining fair value is effectively redundant. As set out below, highlighting the farcical nature of the transaction pricing, based on publicly disclosed FY25 earnings targets, the combined CUP/DVR business is expected to be more expensive (5x EBITA) than DVR on a standalone basis (3.6x -4.3x EBITA), even after the merged business benefits from $3m of synergies (which will cost $8m to deliver). While there are other benefits to the acquisition (improved liquidity, larger more diversified company) we struggle to see the value basis of this transaction from the perspective of DVR shareholders.

DVR's earnings profile, and implied acquisition multiples

	DVR FY23 actual	**DVR FY23 exit run rate**	**DVR FY24 guidance**	**DVR FY25 target**	**Merged CUP/DVR FY25 target**
EBITA	$6.9m	$8.2m	$8m - $9m	$10.5m - $12.5m	$22m+
Implied acquisition multiple (EV/EBITA)	***6.6x***	***5.5x***	***5.1x – 5.6x***	***3.6x – 4.3x***	***5x***
NPATA	$4.7m	$5.0m	$4.9m - $5.6m	$7.0m -$8.3m	
EPS (based on NPATA)	12.5cps	13.2cps	12.9-14.7cps	18 – 22 cps	
Implied acquisition multiple (PER)	***9.1x***	***8.6x***	***7.7x - 8.8x***	***5.2x – 6.3x***	

In its shareholder communication, the DVR board noted the acquisition multiple of 6.6x (based on FY23 EBITA of $6.9m). However, the FY23 earnings would appear to represent the low point in DVR's earnings cycle. Therefore, to us, it would seem inappropriate to base a transaction on these weaker earnings, given they do not include 1) the additional EBITA in acquired earnings during FY23; 2) the increased run-rate momentum of DVR in the second half of FY23; 3) the much-improved FY24 guidance provided to the market; and 4) the $3m in synergies available to CUP.

Indeed, if we were to adopt DVR's current earnings run rate (13.2c) then that level of earnings implies an acquisition PER (price earnings ratio) of 8.6x. If we look out to the FY25 target of ~20c EPS, then we have an acquisition PER of just over 5x. *Post synergies, these multiples significantly reduce even further to much lower, single digit PERs*. We struggle to reconcile these extraordinarily low acquisition multiples to DVR's growth profile and business quality and progress. We recognise that the EPS 'stretch' target for FY25 may be on the high side, but even achieving half the targeted uplift (i.e EPS of 16cps -17cps) over the next two years will result in DVR being incredibly good value at present levels ($1.05) and relative to a bid price of ~$1.15.

As such, we do not believe this transaction reflects the fair value of the DVR business, and that the 25%+ accretion to CUP's earnings that is expected to be generated as a result of the acquisition highlights the significant value that DVR is bringing to the transaction (and that DVR shareholders are not being appropriately compensated for), as a result of this low acquisition multiple and synergies.

We therefore cannot see sense in transacting at this price, when, based on current expectations, DVR's earnings are heading towards 20c EPS. As market sentiment towards small companies improves, and as DVR's strong growth trajectory returns, then this earnings growth should eventually drive a much stronger share price without DVR shareholders being exposed to any of the significant acquisition integration risks and costs.

We have provided this feedback to Diverger, and have advised the company that we do not intend to support the proposed scheme as it currently stands. Subsequent to the takeover announcement, DMXAM has increased its position in DVR to 5.2%, lodging a substantial shareholder notice on 3 October 2023. On the back of this, we've heard from a number of other shareholders who are similarly underwhelmed by the bid and are glad to hear we're looking for an improved offer.

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