PERENNIAL VALUE MANAGEMENT

Perennial Value Smaller Companies Trust

Monthly Report
31 May 2016

	Month	Quarter	FYTD	1 year	3 years	5 years	Since Inception^
	%	%	%	%	% p.a.	% p.a.	% p.a.
Perennial Value Smaller Companies Trust*	2.5	10.3	7.9	1.4	7.5	1.7	9.6
S&P/ASX Small Ordinaries Accum. Index	4.1	13.1	15.9	6.9	6.9	0.2	5.7
Value Added (Detracted)	**-1.6**	**-2.8**	**-8.0**	**-5.5**	**0.6**	**1.5**	**3.9**

*Net performance (including performance fee). ^Since inception: March 2002. Past performance is not a reliable indicator of future performance.

Perennial Value Smaller Companies Trust

The Trust aims to grow the value of your investment over the long term via a combination of capital growth and tax effective income by investing in a diversified portfolio of Australian shares predominantly outside the S&P/ASX 100 Index, and to provide a total return (after fees*) that exceeds the S&P/ASX Small Ordinaries Accumulation Index measured on a rolling three year basis.

Portfolio managers:
Grant Oshry and Andrew Smith

Risk profile:
High

Trust FUM (as at 31 May 2016):
AUD $115 million

Income distribution frequency:
Half yearly

Minimum initial investment:
$25,000

Trust inception date:
March 2002

APIR code:
IOF0214AU

- **Markets continued their rally in May, with the S&P/ASX Small Ordinaries Index (the Index) up 4.1%.**
- **Two earnings downgrades impacted relative performance to the Index, with the Trust ending up 2.5% after fees.**
- **The Perennial Value Smaller Companies Trust (the Trust) trades on an FY17 price-earnings ratio of 11.0 times, being a 30.0% discount to the ex-100 market.**

Market Activity

Globally, markets were mixed with the S&P500 up 1.5%, the Nikkei 225 up 3.4%, the FTSE100 down 0.2% and the Shanghai Composite down 0.7%. The Federal Reserve left rates unchanged and commodity prices rolled over as expectations for the resilience of China’s first quarter rally waned. Iron ore ended the month down 25.0% and copper was down 7.0%, while Brent oil remained on trend, up 4.6%. In Australia, the Reserve Bank of Australia (RBA) cut interest rates by 25 basis points on a lower outlook for inflation than previously forecast. The Australian Dollar (AUD) finished the month at 72 US cents, down 5.0%.

Utilities (up 28.1%) was the strongest sector followed by information technology (up 7.2%). Energy (down 0.2%) was the only sector to finish the month in the red.

The Index bucked the age old adage of “sell in May and go away” by delivering a strong 4.1% return for the month. The Trust was impacted by two earnings downgrades, ending the month up 2.5% net of all fees.

The largest downgrade was from private hospital and day surgery provider Pulse Health, (down 36.9%) largely due to a loss of volume at their Westmead rehab hospital owing to doctors, who had previously referred patients, now retaining them. Pulse Health have been implementing measures to combat this, but were unable to offset during the current period. Additionally, there has been a general softness in surgical volumes across the industry, which also put pressure on earnings.

New Zealand general insurer Tower (down 11.9%) downgraded their earnings largely due to flattish premium income being unable to offset a significant rise in claims costs. Disappointingly, the company announced that their on-market buy-back would not continue, preferring to rather use their capital to maintain the dividend. We expressed our view that a balance of capital management via both a buy-back and dividend was our preference, given the permanent earnings per share accretion a buyback affords. We subsequently halved our holding by selling on market as we are concerned by the ‘tail-end’ of the Canterbury earthquake claims coupled with yet further IT expenses.

Having gained 18.0% in April, Emerchants (down 10.8%) consolidated during the month following last month’s equity raise, while Melbourne IT (down 7.7%) and Independence Group (down 6.2%) also detracted from this month’s performance.

The best performing stock during the month was Sino Gas & Energy (SEH) (up 34.8%), which added to last month’s 14.0% gain as the market digested the sale by its former joint venture partner in late April. The transaction provided a read through valuation for SEH of $0.16 per share (versus month-end closing price of $0.12). Sino Gas’s new joint venture partner, China New Energy Mining Limited (CNEML) appears well funded and committed to a progressing development of the Sanjiaobei and Linxing assets. In addition CNEML key management include former senior executives from a number of large state owned enterprises including SEH project participants; China National Petroleum Company (CNPC) and China National Offshore Oil Corporation (CNOOC). We believe this gives a positive read through the technical assessment of the project and longer term value.

Perennial Value's resources analyst Sam Berridge at the Sino Gas's site in the Sanjiaobei (Source: Perennial Value Management)

Smartgroup (up 34.8%) benefitted from the Labor Government's confirmation that it will retain the current arrangements on salary packaging and related Fringe Benefit Tax.

Owner of Kentucky Fried Chicken (KFC) outlets predominantly in Queensland and Western, Australia Collins Foods (up 23.6%), which was introduced to the portfolio last month, announced its entry into New South Wales by acquiring 13 KFC outlets around the NSW and Victorian border which was partly funded by issuing scrip to the vendor.

Life Healthcare Group (up 22.8%) regained some of its prior month's losses, while Australian Agriculture Company (up 22.0%) delivered a strong full year result (March year-end) reporting its strongest operating cash flow result in the company's history.

Trust activity

During the month, we participated in the APN News and Media (up 15.9%) entitlement offer, taking up all our rights at $0.53. The company also announced that they will be demerging their New Zealand assets and that APN and Fairfax were in exclusive discussions to explore a merger of both their New Zealand assets. All this news was well-received by the markets, affording us the ability to take some profits at an average $0.69 cents. Having acquired the GOLD ETF (exchange traded fund) at the end of March at an average of $153.77, we exited our holding at an average $165.93 to return 8.0% over the 6 week period, following hawkish commentary from the US Federal Reserve pointing to a looming US interest rate rise.

Following some share price retracement, Nufarm was added to the portfolio at an average $6.86 as we are comfortable that the Western Australian winter cropping season is off to a good start following above average rainfall, while the East coast received reasonable, but patchy rain in early May, which has led to an increase in activity levels.

The Trust ended the month with 54 stocks and cash of 7.0%.

Outlook

With many small cap stocks trading on lofty price-to-earnings multiples (which we do not hold in the Trust as they do not meet our value process) and little margin of safety, the Trust offers value trading on 11.0 times FY17 Price to Earnings and 9.8 times price/free cash flow, representing a very significant 30% and 34% discount respectively to the ex-100 market.

As always, our focus will continue to be on investing in quality companies which are offering attractive valuations.

Asset Allocation

Sector	Trust weight %	Index weight %
Energy	5.8	3.7
Materials	6.1	18.3
Industrials	9.0	10.2
Consumer Discretionary	35.1	23.1
Consumer Staples	6.0	8.0
Health Care	3.7	6.7
Financials-x-Real Estate	9.1	7.9
Real Estate	9.9	12.1
Information Technology	6.2	7.7
Telecommunication Services	1.1	1.4
Utilities	1.1	0.9
Cash & Other	7.0	-

Rounding accounts for small +/- from 100%.

For all other enquiries, please contact us on 1300 730 032
or visit www.perennial.net.au

Signatory of:

PRI Principles for Responsible Investment