under the radar report

SMALL CAPS

ISSUE #144
11 JUNE 2015

Stepping to Success

In this issue we cover a company punching well above its weight and supplying the US government with defence related equipment. The need to be patient is important, as it was when we first tipped the ship producer Austal, which has almost tripled since we covered it in May 2013.

The big difference with Quickstep today compared with the past is that its technologies have been commercialised. Commercialisation is the Holy Grail for any technology company and the good news is that you can purchase this fast growing company very cheaply.

We also cover three other buying opportunities at different ends of the risk spectrum as well as our other tip updates.

A must read for those running their own portfolio is our interview with a new small cap fund manager on the block, Cyan Investment Management, which is run by Graeme Carson and Dean Fergie. Carson has been a highly rated broking analyst for some years and Fergie has run money for National Australia Bank with considerable success.

Carson's statement that he and Fergie constantly re-evaluate their holdings by asking whether they are still buyers cannot be over-emphasised. But neither can his comments on return on capital employed and the re-investment of profits:

"There is no point having a good return on equity if you're not investing in your own company. You won't get that compounding earnings growth, which is the key to any small cap success."

the issue

Richard Hemming
Editor

SMALL TALK

"Every day we ask ourselves, if we weren't invested in these companies, would we buy it today – the common sense test."

GRAEME CARSON

CYAN INVESTMENT MANAGEMENT

99% of all financial news relates to the 40 to 50 biggest companies. So what about the rest? They're Under the Radar.

Published by Under the Radar Report Pty Ltd
Suite 504, 19A Boundary Street, Rushcutters Bay NSW 2011, Australia.
Telephone +61 2 9331 1999 Email radar@undertheradarreport.com.au

Editor Richard Hemming
ABN: 65147404662. AFSL: 409518.
Website www.undertheradarreport.com.au

QUICKSTEP

The carbon fibre specialist is finally starting to reap the rewards from big defence spending and technology commercialisation with several opportunities "on the boil, in the short-term".

QUICKLY IMPROVING FUNDAMENTALS

In Quickstep's world of manufacturing and technology things do not happen quickly. But the good news for this company is that the eight-year wait could be over.

This impatience is evidenced in the stocks' 38% share price decline from the start of the year, but there have been a number of developments of late that indicate the company has turned the corner, from being an innovative company with potential, to delivering upon the growing demand for cost effective & fast produced carbon fibre from the aerospace and automotive industries.

Quickstep should not need new funds. It has about $2.6m in cash and $15m in subsidised debt and is now cash flow positive. Its sales are on track to triple this year to $35m and then to increase to about $48m.

The group is producing carbon fibre parts for Joint Strike Fighter (JST) and Super Hercules using conventional autoclave or oven based technology. It is a subcontractor to giants in the industry: Lockheed Martin, Northrup Grumman, Airbus and BAE Systems.

Because they are military contracts there are high barriers to entry from offshore competitors. More important, however, are the hurdles surrounding its technology.

THE QUICKSTEP TECHNOLOGY IS DELIVERING

Carbon fibre is time consuming and expensive to produce. Quickstep's two proprietary technologies produce carbon fibre at a fast rate and 35% cheaper than conventional means. "Quickstep", effectively replaces the autoclave as a curing or heating system, but it is 25 times faster and more effective. While "Resin Spray Transfer" is designed to enable volume at low cost.

INCREASING DEMAND FOR CARBON FIBRE IN AEROSPACE PARTS

Quickstep has just delivered on its €4.2m (A$6m) contract with Russian satellite producer ORPE, using the above technology to produce a 6m by 4m carbon fibre part, which is used to shield the satellite during launch. Says Quickstep director Philippe Odouard: "A single aisle aircraft needs big parts and this contract demonstrates that our technology is scalable and that we deliver."

INCREASING DEMAND FOR CARBON FIBRE IN AUTOMOTIVE PARTS

It is also delivering on its $8m contact with the French technology and manufacturing giant Thales to produce parts for 1300 "Hawkei" armoured vehicles, which are replacing Army Land Rovers. Says Odouard: "This contract is important because it irons out the issues for vehicle production and it validates our technology. Both these contracts are huge in terms of credibility, which is why customers are more interested."

NEW CONTRACTS IN THE NEAR FUTURE

As we say in *What's New?* Odouard says that it is only a matter of weeks or months before Quickstep signs a material contract with an aerospace and/or automotive company.

Car companies are now interested in the technology for two reasons. The first is, the car manufacturers are no longer going broke as they were in 2008 when he first spoke to them. The second is the increasing requirement for fuel-efficient cars in Europe and the North America. The European Union wants automakers to cut fleet CO2 emissions to 95 grams per kilometre by 2021, down from an average of 123g/km currently. The European Parliament voted last year for a CO2 target of 68g/km to 78g/km for 2025. The US is moving in the same direction, although its requirements are not as onerous. Reducing the car's weight is the most cost effective way of complying with the regulations.

CARBON FIBRE GOING FROM BOUTIQUE TO MAIN STREET

"Three years ago only luxury car businesses were looking at carbon fibre, but in the past 18 months everyone is interested because of the CO2 emission reductions," says Odouard.

There is no doubt that the carbon fibre producer is punching above its weight with a clientele that is much bigger than it. The need to be patient has been important, but the key difference with Quickstep today compared to even one year ago is that its technologies have been commercialized. ■

RADAR RATING **BUY**

SHARE PRICE **$0.155**

MARKET CAP **$60M**

ASX CODE **QHL**

DIVIDEND YIELD **0%**

BULL POINTS

- FAST SALES GROWTH
- PROVEN TECHNOLOGY AND ABILITY TO EXECUTE
- CASH FLOW POSITIVE
- DEMAND GROWING FROM AUTOMOTIVE & AEROSPACE

BEAR POINTS

- LONG SALES CYCLE
- MINNOW DEALING WITH GORILLAS

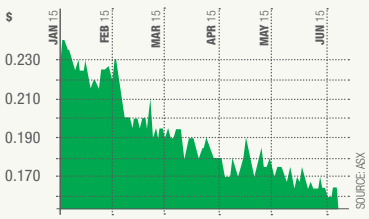
WHY WE LIKE IT

Quickstep is producing fast revenue growth from conventional carbon fibre production, plus its technology, which improves the speed and cost of producing carbon fibre, has been commercialised. The company's US$775m of agreements over 20 years to produce carbon fibre for JSF and Super Hercules aircraft underpins its value. The stock will take off if it secures a significant agreement for volume with an automotive and/or aerospace company for its technology.

WHAT'S NEW?

Quickstep's revenues are on track to double this year to $35m & then reach $48m next year through its conventional carbon fibre production for military aircraft. The company has confirmed that it is now cash flow positive and should be making profits in FY16. Following the successful delivery of its carbon fibre technology. Quickstep's executive director Philippe Odouard told Radar it has "several opportunities on the boil in the short-term in both automotive and aerospace – we're talking weeks or months, not years."

QHL - Share Price



RESEARCH TIP UPDATES

THINKSMART (TSM)
CONSUMER FINANCE TECHNOLOGY

ThinkSmart released an upgrade to its FY15 NPAT guidance to $3.5m from $3m, based on favourable foreign exchange movements, improved sales volumes and reduced bad debt write-offs. The company also forecast a 1.5 cents fully franked dividend for FY15, offering a yield of just under 5%.

The company has a proven technology and is expanding in the UK market where it has 10 years' experience. The group developed a technology which allows retailers to access credit ratings and their customers to access funds straight away.

The profit upgrade reinforces our view that this is an attractive business with good returns and ongoing growth in the UK and Europe which is currently well disguised in an ASX listed vehicle.

The new forecast suggests an adjusted earnings multiple of around eleven times. If the (reduced) cash balance is taken out of consideration, the earnings multiple falls below seven times. The revenue and business growth rate suggests a higher multiple is warranted, but shareholders will have to remain patient for any substantial re-rating until after the domicile issue is resolved. ■

RADAR RATING: We rate the stock a BUY for those comfortable holding an overseas listed share, if that eventuates. Patience will be required, however.

RADAR RATING **BUY**

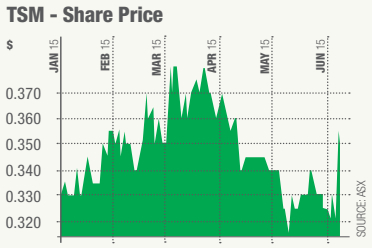
CURRENT PRICE **$0.35**

MARKET CAP **$34M**

NET CASH **$16M**

TIP DATE **19 MAR 2014**

TIP PRICE **$0.40**



OSPREY MEDICAL (OSP)
MEDICAL TECHNOLOGY

Osprey has continued to work slowly towards full sales infrastructure in the US, as well as seeking further marketing approvals from the US Food and Drug Administration, the FDA, through clinical trials which should be complete by the end of this year.

The group's AVERT technology reduces by 40% the amount of dye (contrast) injected during commonly performed heart procedures, which protects the kidneys from damage known as CIN. Prevention of CIN reduces hospital stays; the use of kidney dialysis and ultimately death. The company has enough cash to get to the next phase in 2015 where its product should be labelled for reducing CIN events – a market estimated to be worth US$1.3bn.

It is unusual to see a company as small as Osprey make the transition from a great product idea to delivering revenues through a wholly-owned sales and distribution structure in the US. There are many risks with this strategy, but it is hard to fault the company's progress in building its sales infrastructure while it waits for additional FDA approvals which will allow greater marketing claims to be made about its dye delivery system called AVERT.

Osprey has recently hired a second sales professional for the Houston region, particularly in order to service the Texas Medical Centre, one of the largest facilities in the world.

The usage performance of existing accounts seems impressive, with double the number of hospitals ordering the system, at an average sale price of US$450 per consumable, than the second quarter. Gross margins should be healthy. The physician user base has doubled, and usage is becoming embedded.

RADAR RATING **SPEC BUY**

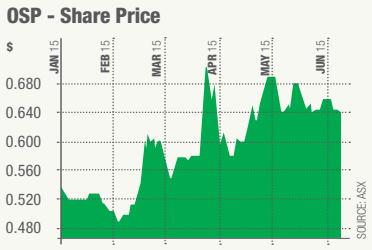
CURRENT PRICE **$0.64**

MARKET CAP **$99M**

NET CASH **US$20M**

TIP DATE **26 NOV 2014**

TIP PRICE **$0.55**



The patient recruitment for the clinical trial should be almost complete. The clinical trial is attempting to support five additional marketing claims for the AVERT system, these are dye savings, reflux reduction, image quality, CIN reduction (toxic poisoning from die overdose) and hospital cost savings. The possibility exists that other uses of dye for surgery may lend itself to the AVERT system, and various trials are now taking place with respect to those possibilities. ■

RADAR RATING: The company is well-financed at this stage for its plans, but it remains a speculative venture, one which will pay off well if it management's plan is successful. SPECULATIVE BUY.

REDFLEX (RDF)
TRAFFIC LIGHT TECHNOLOGY

Redflex issued a somewhat predictable profit downgrade indicating that its US business continues to fight the headwinds of regulatory resistance and the consequences of previous corporate corruption. We have always said the company faced a long climb out of the hole it dug for itself. Why predictable? For one thing the share price did not react much, which in part is because the bad news keeps coming for Redflex. Even where contracts have not been cancelled, delays and other difficulties have slowed its ability to offset the inevitable contract losses and write-downs from the prior misconduct.

Ongoing restructuring is required to reduce costs to meet lower revenue expectations.

The guidance has been changed from a full-year operating loss of $10m to a potential full-year loss of $18m, as well as up to $8m of non-cash write-downs on the balance sheet additional to those already identified in FY15.

While the bad news does keep coming for Redflex, the size of the numbers are not as bad as they might be. New management in the US is throwing the kitchen sink into this financial year.

On a more positive note, the company expects FY15 EBITDAI ("I" stands for impairments) to be positive in the range of $18m to $19m, suggesting a $9m EBITDAI outcome in the second half, flat on the first half. The EV/EBITDAI multiple is theoretically around four times, and FY15 should be the trough earnings year (excluding impairment), so the value is clear, but how to realise the value for shareholders may be less apparent.

The Student Guardian business in the US is now operating profitably, although growing slower than expected. Management see some prospect of an improved regulatory environment for speed cameras and the possible challenge of traffic light camera banning legislation, which has had a negative impact on Redflex profits.

Further bad news is that the chief executive of the non-US business has announced his resignation, and will be replaced in due course. This is not a vacancy at the very top of the company, nor of the problem division, but it is not a positive development. ■

RADAR RATING: Redflex would not pass most fund managers' investment criteria, but we still think that there may be value for a private investor who is prepared to accept the operational risks that are embedded in the company's history. Patience will be required and the stock is relatively illiquid, so we think that some time can be taken to establish a reasonable position for your portfolio. SPECULATIVE BUY.

RADAR RATING **SPEC BUY**

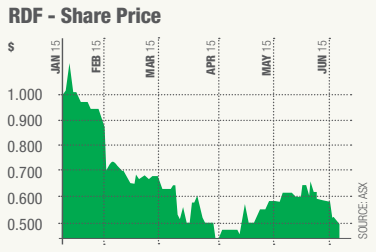
CURRENT PRICE **$0.46**

MARKET CAP **$54.3M**

NET DEBT **$18M**

TIP DATE **2 JUL 2014**

TIP PRICE **$1.01**



BELLAMY'S (BAL)
ORGANIC BABY FOOD PRODUCER

As a result of strong domestic sales, Bellamy's Australia has reviewed its forecast, and expects that the full year NPAT will be between $7.6m and $8.3m. This is a 20-25% increase on the previous forecast, which was flat half-on-half. The revised forecast implies that the second half will be up to 40% higher than forecast.

A few weeks ago (when the share price was $3.49), Radar said *"we envisage positive news flow coming up in the next six months, and what's not to like? This is a genuine growth story, the likes of which are few and far between."* Existing holders should not let go, but it is too late for our tastes to chase the stock at these prices until we hear further news from overseas markets. ■

RADAR RATING: At some point the stock will stop going up and we will review things further at that point. We have repeatedly said that the stock is expensive and is likely to remain so, a view that this upgrade has not changed. HOLD.

RADAR RATING **HOLD**

CURRENT PRICE **$4.27**

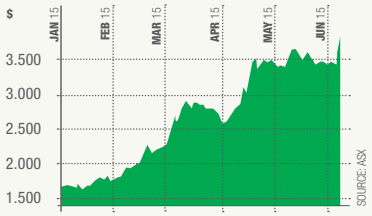
MARKET CAP **$406M**

NET CASH **$17M**

TIP DATE **11 MAR 2015**

TIP PRICE **$2.80**

BAL - Share Price



FANTASTIC (FAN)
FURNITURE MANUFACTURER AND RETAILER

Fantastic's shares have returned 71% in the past 12 months as investors climb aboard again after a period in the listed wilderness. Volume has not been heavy, and the rise could continue for a while as institutions become more interested.

The company is benefitting from a strong product offering with improved perceived quality and a clear pricing proposition at the value end of the market. A swift recovery from past missteps both with the eponymous main brand and the Plush business has been impressive and sustained. There are scores of operational and supply chain initiatives for an aggressive management to pursue, demand is robust and should remain so while the housing market remains strong and as long as interest rates do not rise suddenly.

A 6 cent final dividend should be affordable, but will keep the full year dividend well above the board's intended long-term payout ratio of 60%. The most likely positive outcome that can be hoped for is that the dividend is held at 12 cents annually for a couple of years, as earnings grow into the payout ratio, supported by a strong cash position. There might be room for another special dividend if conditions remain strong. ■

RADAR RATING: After a strong run since the results and more recently, we cannot recommend the stock as a Buy, but we do think existing shareholders should stay invested, and wannabee shareholders may hope to get some nearer $2-$2.20. HOLD.

RADAR RATING **HOLD**

CURRENT PRICE **$2.25**

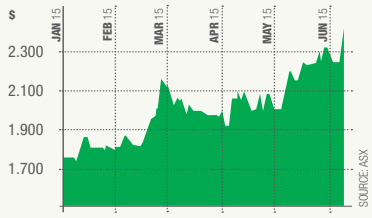
MARKET CAP **$246M**

NET CASH **$10M**

TIP DATE **21 MAR 2012**

TIP PRICE **$2.36**

FAN - Share Price



MCPHERSONS (MCP)
CONSUMER PRODUCTS WHOLESALER AND MARKETER

McPherson's have issued a downgrade from a forecast 5-10% growth to a forecast 20-25% decline in full year pre-tax profit. Only a few weeks ago we said: *"Management is keen to highlight progress in a number of divisions from recently acquired brands, but we are slightly concerned that the risks may be on the downside through potentially disappointing performance from some of the new brands in the second half, despite the reduction in commodity prices which should deliver lower product costs."* Our mistaken recommendation of Speculative Buy was qualified by the comment that "we would not recommend overexposure to the stock at this stage". But we were still wrong to take the glass half full approach in this case.

The company's downgrade was blamed on additional marketing costs and distribution gaps for some acquired brands, difficulties in passing on exchange rate related costs in private-label contracts, underperformance in Home Appliances and New Zealand restructuring costs. All of the identified problems have been addressed and solutions implemented. It is hard at this stage to establish if the problems are transitory issues in an otherwise sound collection of businesses, or whether there is something more fundamental. Numerous growth initiatives have been pursued and paid for across the group's product and business lines, so if organic growth in revenue and profits remains elusive, that might reflect bigger problems with the whole middleman business model. ■

RADAR RATING: We would like to see more progress in the sale of the company's Multix brand to strengthen the balance sheet. Since the prospective yield has effectively been cut, and we stated that the dividend was the reason to buy it, the right course of action is to switch our view to Sell, especially if you can use the tax loss. However, we do not think that there is currently significant risk of substantial permanent capital losses from here, so our recommendation is to HOLD on if you have the stomach for a long wait.

RADAR RATING **SELL/HOLD**

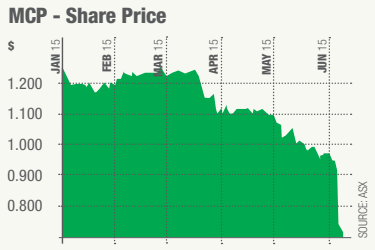
CURRENT PRICE **$0.68**

MARKET CAP **$67M**

NET DEBT **$69M**

TIP DATE **12 NOV 2014**

TIP PRICE **$1.21**



the professional investor

Dean Fergie

Graeme Carson

CYAN INVESTMENT MANAGEMENT

Under the Radar Report speaks to a small cap fund which has been going for less than a year, but has already wracked up a return of 22% after fees. We think that the pair's common sense philosophy will keep delivering.

LET'S TALK STOCKS

It is refreshing to see two fund mangers who don't harp on about their process but talk about lesser known stocks and have been walking the walk in a relatively short time.

Names such as AMA Group (AMA), Lindsay Australia (LAU), Opus Group (OPG), Lovisa (LOV) were mentioned, along side better known stocks including Vita Group (VTG), Capitol Health (CAJ), Bellamy's Australia (BAL) and M2 Communications (MTU).

Cyan Investment Management's fund was kicked off in July 2014 by ex-National Asset Management fund manager Dean Fergie and by ex-broking analyst Graeme Carson.

RETURN ON EQUITY AND RE-INVESTMENT OF EARNINGS

The fund does not have market cap limitations, but its current holdings in 20 stocks tend to be at the smaller end of the spectrum. Carson sums up the pair's philosophy:

"We find value in smaller industrial companies that we understand and can value. Ideally, these companies have good return on capital employed and are re-investing their earnings.

"There is no point having a good return on equity if you're not investing in your own company. You won't get that compounding earnings growth, which is the key to any small cap success."

KNOW YOUR LIMITATIONS

"Not investing in stuff we don't understand or which we think is too risky" is something you hear often from the team, but they actually do what they say and don't consider investing in resources, biotechs, mining services or listed property stocks. This leaves a universe of about 160 companies from which they are looking for three factors: high return on capital employed; cash generative and "a clear growth strategy".

THEY LIKE ROLL-UPS

Looking through its portfolio, and it's clear that the Cyan team is heavily invested in so-called "roll-ups", or "consolidation" businesses. These are listed companies which purchase smaller unlisted companies in the same industry on lower multiples in order to boost their earnings per share. Good examples of this strategy include the funeral services operator InvoCare (IVC), the childcare services provider G8 Education (GEM) and one of Under the Radar's stocks, the dental services provider 1300 Smiles (ONT). The strategy works when there is cheap financing available, but can go spectacularly wrong, as happened with ABC Learning – the child care centre roll up which went bust.

SO FAR SO GOOD PERFORMANCE-WISE

So far, albeit in a relatively short time, the pair's strategy has worked. Its C3G fund returned just under 22% after fees in the nine months to 31 May, which compares with the Small Ords Accumulation Index return of just over 4% during that period.

It is also worth mentioning that the pair have found it difficult to find value during their short time and have an average cash balance during the period of 35%. This makes their performance even more impressive, in our view.

TOP 10 HOLDINGS

(no particular order)

NAME	ACTIVITY
Vita Group (VTG)	Telsta store owner
AMA Group (AMA)	Panel beating consolidator
Bellamy's (BAL)	Organic baby food
Freelancer (FLN)	Jobs finder
Capitol Health (CAJ)	Diagnostic imaging
iiNet (IIN)	Internet services provider
Praemium (PPS)	Wealth management
Lovisa (LOV)	Fashion jewellery retailer
Blue Sky Alternative Investments (BLA)	Fund of funds
Money3 (MNY)	Payday lending

WILL THIS PERFORMANCE CONTINUE?

The pair believes it will because of their common sense style of investing:

"It's about not investing in things we don't understand or not investing in loss making businesses and avoiding the pitfalls. Dean (Fergie) has outperformed benchmarks by 5% over 20 years.

"Every day we ask ourselves, if we weren't invested in these companies, would we buy it today – the common sense test."

BIGGEST HOLDINGS

In answering the above question, however, we think it's better to look at what they do hold. The fund's biggest investments are in the Telstra store franchise Vita Group (VTG), the organic baby formula producer Bellamy's (BAL), the panel beating consolidator AMA Group (AMA).

The share price charts of all three stocks replicate a hobbit looking up at Mordor, and yet the duo maintain they will keep going up. Although it's worth noting they have been "trimming" their position in all three to keep them from overwhelming the portfolio.

AMA Group has a market cap of almost $200m and a historic PE of 33 times, which both seem high for a company in an industry not known for its exponential growth, but Carson points out the bigger picture for panel beaters in consolidation mode:

"There has been a big structural change in the underlying industry. A lot of companies have been struggling because of the impact the insurers are having on the industry. One of the two big insurers, Suncorp has been buying up panel beaters. It's basically going from a cottage industry to being big business.

Other panel beaters are generating work through IAG, and it's these that AMA Group has been buying."

RECENT PURCHASES

Other stocks his fund has been buying more recently include fashion jewellery retailer Lovisa (LOV), diagnostic imaging group Capitol Health (CAJ) and rural Australia logistics specialist Lindsay Australia (LAU).

The pair have been taking profits in the first two, which are also consolidation stories. Lovisa has expanded Australia wide and is now taking its business international; while Capitol Health is expensive, but remains in the early stages of consolidation.

Another purchase the fund has made recently is Money3 (MNY), the pay-day lending specialist and (yes) another consolidation story.

"We've been in and out of this one but there is definitely significant earnings leverage in terms of growth from secured lending. The industry is being cleared up and this stock looks cheap trading on a PE of 12 times, but generating EPS growth of 40% this year and 20% next year.

"We think it's at the top end of the bottom end of the industry."

THE COMMON SENSE APPROACH

Watching the progress of a new fund is more interesting than one which is seasoned. There are so many more ways it can go. For what it's worth, we think that the pair's common sense approach is one that will stand the test of time. ■

BEST MONEY MAKING IDEAS

AS AT 10 JUNE 2015

*Return includes dividends and is after brokerage

COMPANY	ASX CODE	INDUSTRY	MARKET CAP $M	NET CASH/ -NET DEBT $M	DIVIDENDS	ORIGINAL TIP DATE	TIP PRICE $	LAST PRICE $	RETURN %
BENTHAM IMF	IMF	Services	292.8	-84.0	Y	14-Nov-13	1.71	1.77	12.3
INGENIA	INA	Property	289.1	0.4	Y	24-Jan-13	0.27	0.43	68.5
LOGICAMMS	LCM	Mining serv.	53.1	20.0	Y	28-Jun-12	1.07	0.74	-9.4
MACA	MLD	Mining serv.	187.6	16.0	Y	26-Mar-15	0.91	0.81	-13.7
QUICKSTEP	QHL	Manufact.	62.7	-10.0	N	29-May-14	0.17	0.16	-18.4
RCR TOMLINSON	RCR	Engineer cntr.	268.6	-18.1	Y	9-Apr-15	1.97	1.94	9.3
RECKON	RKN	Info Tech	283.6	-48.0	Y	22-May-14	2.12	2.25	10.4
SOMNOMED	SOM	Biotech	118.7	-8.2	N	2-Oct-14	2.09	2.45	17.2
SUNDANCE ENERGY	SEA	Oil & gas	280.2	-61.0	N	10-Apr-15	0.58	0.51	-12.1

PLEASE NOTE: THIS LIST IS IN ALPHA ORDER. PLEASE GO ONLINE TO CHECK OUR FULL COMPANY RESEARCH.

Published by Under the Radar Report Pty Ltd
Suite 504, 19A Boundary Street, Rushcutters Bay NSW 2011, Australia.
Telephone +61 2 9331 1999 Email radar@undertheradarreport.com.au

Editor Richard Hemming
ABN: 65147404662. AFSL: 409518.
Website www.undertheradarreport.com.au