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A Montgomery White Paper

OCTOBER 2013

Special IPO Edition

OzForex

OzForex is an online platform providing foreign exchange transfer services for consumers and businesses. In this whitepaper we explain why the business meets many of our tests for an extraordinary business, but why price is the only stumbling block to our participation.

OzForex is an online platform providing foreign exchange transfer services for consumers and businesses. The company is being brought to market in what is reported as being one of the hottest floats this year.

Investors should generally avoid anything hot or even warm because scalding is an all too common occurrence in the stock market. Nevertheless, the prospect of such painful experiences shouldn't preclude a thorough investigation.

OzForex is the type of business we admire at Montgomery Investment Management. The company is generating meaningful cash flows, has no debt, requires minimal capital expenditure, and is generating profit margins of 30%.

But despite its attractive fundamentals, we have decided not to participate in the offer on behalf of our investors. This is simply because of price. Nothing more. If it was offered at a cheaper price, I suspect we'd be all over it. Indeed, after assessing the upcoming group of floats, OzForex ranks as one of the best, and on a purely relative basis, if we had to pick one float to go with, it would likely be OzForex. Importantly, our decision not to participate does not mean we believe the shares won't rally strongly after the float – on that score we simply don't know (but suspect they probably will). What it means is that even the shares do rally strongly, we won't regret our decision.

Explaining this decision to you we hope to assist with ideas for what to look for when assessing an IPO, while also providing an insight into the way we invest at Montgomery.

Industry Overview

The international payments market is highly competitive, with banks controlling the primary network of foreign exchange transactions. Banks tend to charge a premium spread on these transactions, which can be many hundreds, if not thousands, of basis points. This has allowed smaller operators like OzForex to develop a niche in the market by charging a smaller spread on transactions.

Business Overview

OzForex is a provider of online international payment services in 19 countries, including 30 states in the USA. The company has two types of clients, Consumers and Business.

Consumers:

- Comprises two-thirds of the Group's income.
- Consumers are charged a spread on their foreign exchange transactions.
- Average transaction size was A$14,300 in FY13.

Business:

- Comprises one-third of the Group's income.
- Business clients are charged a fee, rather than a spread.
- Average transaction size was A$29,000 in FY13.

A major growth driver for the business is "white-labelling" – through its Branded Partnership offering, the OzForex Group provides partner companies with online and mobile app solutions that are operated by the Group.

Competitive Advantages

OzForex has a large network, and a greater presence in the United States than many of its competitors. The foreign exchange market is highly liquid, which means there is plenty of opportunity to grow, but does not offer high barriers to entry. As such, financial intermediaries tend not to enjoy the same network economies as other online platforms, such as Seek and REA Group, as scale is achieved. It is unlikely that small operators like OzForex will be able to charge a premium spread for their services, so volumes will be the primary growth driver.

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Returns to 30 September 2013

Code		Change	Outperfomance
MPF	**The Montgomery [Private] Fund**	**44.42%**	**-**
XNAJI	ASX 200 Industrials Accumulation Index	17.29%	27.13%
XTOAI	ASX 100 Accumulation Index	26.30%	18.12%
XJOAI	ASX 200 Accumulation Index	23.63%	20.79%
XAOAI	All Ordinaries Accumulation Index	20.75%	23.67%
XKOAI	ASX 300 Accumulation Index	22.12%	22.30%
XTLAI	ASX 20 Accumulation Index	30.49%	13.93%
XMDAI	ASX Midcap 50 Accumulation Index	6.51%	37.91%
XSOAI	ASX Small Ordinaries Accumulation Index	-15.85%	60.27%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested. Past performance is not indicative of future performance.

Minimum investment $1,000,000

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Click here for more information and to find out whether you are eligible.

Investment Manager Montgomery Investment Management Pty Ltd | ABN 73 139 161 701 | AFSL 354 564 | GPO Box 3324 Sydney NSW 2001 | 02 9692 5700 | www.montinvest.com | office@montinvest.com Trustee Fundhost Limited | ABN 69 092 517 087 | AFSL 233 045 # Portfolio Performance is calculated after fees and costs, including the Investment management fee and Performance fee, but excludes the buy/sell spread. All returns are on a pre-tax basis. This report was prepared by Montgomery Investment Management Pty Ltd, AFSL No: 354564 ("Montgomery") the investment manager of The Montgomery [Private] Fund. The Trustee and Administrator of the Fund is Fundhost Limited (ABN 69 092 517 087) (AFSL No: 233 045) ("Fundhost"). This document has been prepared for the purpose of providing general information, without taking account your particular objectives, financial circumstances or needs. You should obtain and consider a copy of the Information Memorandum ("IM") relating to the Fund before making a decision to invest. While the information in this document has been prepared with all reasonable care, neither Fundhost nor Montgomery makes any representation or warranty as to the accuracy or completeness of any statement in this document including any forecasts. Neither Fundhost nor Montgomery guarantees the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law, neither Fundhost nor Montgomery, including their employees, consultants, advisers, officers or authorised representatives, are liable for any loss or damage arising as a result of reliance placed on the contents of this report. Past performance is not indicative of future performance. Applications to invest in The Montgomery [Private] Fund are only considered from wholesale investors or investors willing to commit $1 million (or by invitation from Montgomery Investment Management).

$ millions	Historical			Pro forma forecast			Statutory forecast		
	12 mths FY11	12 mths FY12	12 mths FY13	12 mths Sept-13	12 mths FY14	12 mths Sept-14	12 mths Sept-13	12 mths FY14	12 mths Sept-14
Net fee and commission income	35.0	39.6	50.3	59.0	66.9	75.6	59.0	66.9	75.6
Net interest income	2.0	2.1	1.8	1.4	1.4	1.6	1.5	1.3	1.6
Net operating income	**37.0**	**41.7**	**52.1**	**60.4**	**68.3**	**77.2**	**60.5**	**68.2**	**77.2**
Employee costs	(10.2)	(12.5)	(16.7)	(20.2)	(23.3)	(26.0)	(20.2)	(23.3)	(26.0)
Promotional costs	(3.0)	(5.1)	(6.8)	(8.6)	(9.6)	(10.5)	(8.6)	(9.6)	(10.5)
Occupancy costs	(0.7)	(0.7)	(1.2)	(1.4)	(1.5)	(1.5)	(1.4)	(1.5)	(1.5)
Other costs	(3.7)	(4.3)	(2.7)	(5.7)	(6.7)	(7.1)	(5.0)	(13.1)	(13.2)
EBTDA	**19.4**	**19.1**	**24.7**	**24.5**	**27.2**	**32.1**	**25.3**	**20.7**	**26.0**
Depreciation	(0.4)	(0.5)	(0.5)	(0.5)	(0.6)	(0.6)	(0.5)	(0.6)	(0.6)
Profit before tax	**19.0**	**18.6**	**24.2**	**24.0**	**26.6**	**31.5**	**24.8**	**20.1**	**25.4**
Income tax expense	(5.8)	(5.5)	(7.1)	(7.2)	(8.0)	(9.4)	(7.4)	(6.0)	(7.6)
Net profit after tax	**13.2**	**13.1**	**17.1**	**16.8**	**18.6**	**22.1**	**17.4**	**14.1**	**17.8**
EBITDA	17.4	17.0	22.9	23.1	25.8	30.5	23.8	19.4	24.4

Figure 1. OzForex growth prospects

Growth Prospects

OzForex has experienced a considerable increase in the number of clients over recent years, with active clients increasing from 60,500 in FY11 to 91,800 in FY13. Transaction turnover has increased from $7 billion to $9.1 billion over the same period.

This growth has primarily been generated by the company obtaining financial licences to operate in 30 US states. The approvals process takes over 12 months. The company is applying for 7 more licences – while this will support growth, we believe it is unlikely that the company will sustain transaction growth of over 30% each year.

By way of example, HiFX, a competitor with yearly transactions of $14.5 billion, increased turnover by 12% in FY12. It is likely that OzForex's growth will moderate to these levels in the long term.

It is also important to note that the company is factoring in a considerable step up in earnings in the space of 3 months after FY14 – for the 12 months to FY14, NPAT is forecast to be $18.6m, while in the 12 months to September 2014 the forecast is $22.1m. The company states that September 2014 numbers reflect the full year impact of the Travelex Branded Partnership arrangements, but it would be prudent to not extrapolate this growth.

Customer attrition is an issue – for the past 3 years, around 25 to 30% of previously active clients do not use the service in the following period. We believe this reflects OzForex's focus on consumers, who tend to be single transaction customers, rather than businesses.

Net income grew by 30.5% for FY13, and is forecast to grow by 27.2% in FY14. This is despite transaction turnover forecast to grow by 38%. The decreasing growth rate is attributable to increased acquisition costs of overseas customers. The NPAT margin was 35.7% in FY11, but is expected to fall to 27.2% in FY14. Margins however are expected recover as the company increases its presence and gains the benefits of scale in new markets.

OzForex's ability to grow earnings is driven by volumes, rather than pricing power. The aim for the company is to increase the number of transactions – this can be done by increasing the number of new clients, increasing the conversion rate, increasing the average transaction size, and increasing the frequency of transactions.

Risks

One risk to OzForex's business model is regulatory risk. If money laundering laws become more prudent, OzForex will be required to direct additional resources to background checks of customers, which will squeeze margins, scare some clients off due to the inconvenience, or both.

OzForex relies on banks to conduct its business, particularly with the hedging of contracts. There is a risk that banks will cease dealing with the Group – this has occurred in OzForex's past and may occur again in the future at short

Who are the Existing Owners and what will be their interest at the Completion of the Offer?

Existing Owner	Existing Interest (%)	Shares held prior to the Offer	Shares held at the close of the Offer (%)	Shares held at the close of the Offer
G&A Lord Pty Ltd as trustee for the Lord Family Trust	17.58%	40,071,000	4.00%	9,600,000[1]
Matthew Gilmour	17.58%	40,071,000	4.00%	9,600,000[1]
Macquarie	19.90%	45,372,000	Nil	Nil
Funds associated with Accel Partners	22.70%	51,756,000	Nil	Nil
Funds associated with The Carlyle Group	20.40%	46,512,000	Nil	Nil
Carboni Pty Ltd	1.85%	4,218,000	0.46%	1,110,000[1]

[1]These Shares will be subject to voluntary escrow arrangements

Figure 2. Significant interests of key people

notice, especially if any bank sees OzForex as a threat. Listing on the ASX certainly raises the head above the parapet but, as we have seen with companies like Credit Corp, there are some business lines that the banks just don't seem that interested in. In any event, one would be more likely to see a bank's cousin-brand such as Commsec, Etrade or Ubank start competing on slimmer margins rather than adopt the rather anticompetitive tactic of shutting down OzForex through the cessation of services. Investors really keen to understand the business in detail would do well to enquire about the service level agreements OzForex has in place with the banks.

There is a risk that competitors will pressure OzForex to lower the spread – the driver of margins – but we believe this risk is low given the liquidity of the market and the comfort with which the large banks are able to charge significant premiums. If OzForex can gain the benefits of both the network effect and high switching costs, they may be able to sustain high margins for longer.

Quality of the business

The business is attractive – it is generating meaningful cash flows, has no debt and requires minimal capital expenditure. The company has profit margins of ~30%, and bad debts were less than 0.0008% of transaction turnover in FY13 (but a higher proportion of the company's true revenue).

The company has a large variable cost component, as the registration of users is an intensive process. This means that while the company's earnings are scalable, the margin expansion will be limited by the customer acquisition costs. In the medium term, we currently believe OzForex's profit margins could recover to over 30%, and the company might experience double-digit earnings growth.

OzForex is expecting to debut on the ASX with a market capitalisation of $480 million.

Purpose of the Float

It is important to understand why a company is being floated. Some are designed for owners to realise a return on their investment, perhaps because growth is maturing, while others are coming to market because of bright growth prospects that require a capital injection to be fully realised.

Keep in mind that transactions are generally timed to benefit the vendor. Altruistic motives are rare when it comes to selling what is often the vendor's biggest and last asset sale.

It appears that the primary purpose of the OzForex IPO is to provide incumbent shareholders with an opportunity to realise a return on their investment. While the company has stated that it will be looking to expand into new markets, the funds will predominantly be directed to the owners.

Additional uncertainty has also been created by the change of structure on the board. Due to the sell-down by existing

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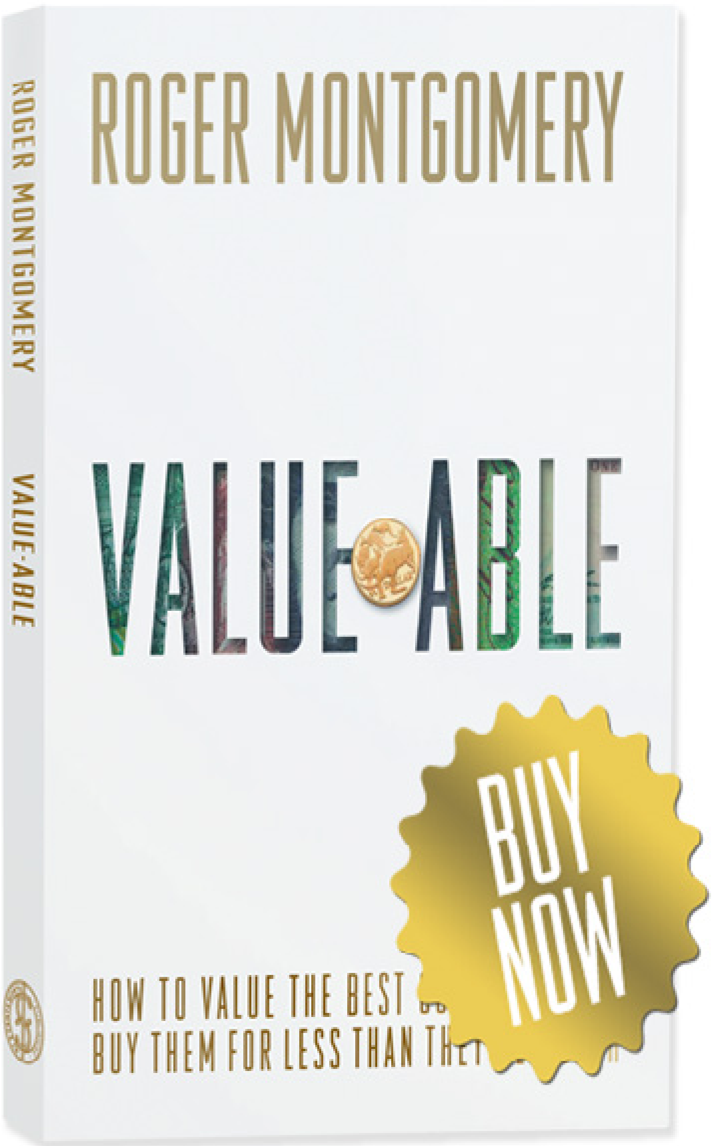

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owners, many of the new board members, while experienced, have had no prior involvement with the company.

This doesn't necessarily discount the prospects of the business, indeed The Reject Shop is an example of a float (at $2.00) where many founders were selling down or out and yet the share price more than sextupled. When directors maintain a considerable share in the business however, it provides a greater level of confidence. In this instance, only 8.46% of the company will be retained by the current owners.

Valuation

OzForex is expecting to debut on the ASX with a market capitalisation of $480 million.

The company is forecasting NPAT for FY14 of $18.6 million, and profit to September 2014 of $22.1 million. The Price to Earnings multiple is a metric that is commonly used to determine the value of a new listing – including the estimate for the yearly profit to September, the 12 month forward multiple is 21.7 times rather than 25.8 times. While this makes the implied premium more attractive when compared to Seek and REA, on this basis the market price suggests it is expecting considerable growth to be maintained.

As discussed previously, we believe there will be significant pressure maintaining current growth rates. While the international payments market is highly liquid, we believe it will be challenging for the company to build sufficient wide and deep barriers to entry to allow it to grow above inflation for the long term. While OzForex appears capable of generating double digit growth earnings growth in the medium term (this is something investors might not wish to ignore), it would be appropriately conservative to assume a growth rate that nears inflation.

The cost of equity is an important consideration – at what rate would you be happy to invest your money with this type of company? While the risks of the industry are well detailed, OzForex is a quality business that is generating attractive growth rates. We believe that a 10% cost of equity would be reasonable.

With these admittedly conservative assumptions, we believe an appropriate valuation for the company is $440m, or a discount of 8% to the expected market capitalisation.

There is potential upside to this valuation. Here are three scenarios which could justify a valuation of $480 million by modifying our existing assumptions:

- As OzForex increases penetration overseas, it is likely that its NPAT margin would increase to historic levels.
- A discount rate of 10% may be too conservative to reflect the risks of the business. If we adopted a discount rate of 9.3% we would arrive at a value of $480 million, *ceteris paribus* (all things being equal).
- The company may achieve more favourable growth rates, particularly as a listed entity. If you were answering an exam question about why a company lists on the stock exchange, you would mention that being listed increases brand awareness, increases the confidence of clients in the service, and provides access to capital in order to fund acquisition or expansion. But much of this is hypothetical. For example, if ASX listed status were used as leverage to raise capital to expand, why not do it at the IPO?
- A terminal growth rate of 4% would equate to a value of $480 million, *ceteris paribus*.

OzForex is issuing 240 million shares at $2.00 per share. Adopting a 10% discount rate, we arrived at an estimated valuation of $1.84. Keeping in mind we seek extraordinary businesses trading at discounts to our estimate of value, the OzForex IPO meets the first hurdle, but at the IPO price, it doesn't meet the last.

Investors that are willing to use a lower discount rate and accept a higher-than-inflation growth rate can arrive at a valuation estimate that approximates the offer price or is even higher. This is encouraging, and as returns over the long run will match the performance of the business, all that remains is to satisfy one's self that the prospects remain bright.