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Weekly Review

RESEARCH

– Issue – 10 Feb. 2017

Australia's toll road monopoly continues to perform, though toll rises will be harder to come by in future years.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 8 FEBRUARY 2017

Transurban: Interim result 2017

Whoever said toll roads were low growth and boring? Transurban's management expects the company to pay a total dividend of 51.5 cents this year, up 13% on 2016. Underlying toll revenue increased a hearty 11% to $1.1bn for the six months to December, while earnings before interest, tax, depreciation and amortisation (EBITDA) rose 12% to $817m.

Key Points

- ***Sydney traffic excellent***
- ***Melbourne traffic poor due to upgrade***
- ***Large expansion projects flagged***

TRANSURBAN (TCL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.04	8%	Low–Med	Medium

BUY	HOLD	SELL
Below $8.00		Above $12.00

$11.04

With the exception of CityLink – which we'll get to in a moment – EBITDA margins improved for all assets, with the overall margin edging up one percentage point to 74.7%.

The result had three main drivers: regulated toll increases; cost cutting; and excellent traffic growth of 5% following the completion of several road upgrades and acquisitions.

Over the long term, though, traffic growth tends to move in sync with population growth, which is a bit over 1% in the areas surrounding Transurban's roads. Upgrades and lower petrol prices might encourage a few extra drivers in the short term, but growth in the low single digits is about as much as we can hope for over a 20-year stretch, so we won't get ahead of ourselves.

State by state

In Sydney (41% of revenue), the recently completed upgrade of the M5 motorway helped boost traffic by 3.4% while revenue and EBITDA grew 9% and 10% respectively. The strong result was thanks to toll rises, which are pegged to inflation (as measured by the consumer price index or CPI) for the M7 and M5, or – for the M2, Cross City Tunnel and Eastern distributor – escalated at the maximum of CPI or 3–4%.

The Queensland network, which accounts for 18% of revenue, had traffic growth of 20%, with revenue increasing 31% and EBITDA growing 40%, mainly due to last year's acquisition of Brisbane's AirportLinkM7 out of receivership. The 6.7km tunnel links the Brisbane CBD with the airport and achieved a 5% increase in traffic over the year.

By some margin, the worst performer was Melbourne's 22km CityLink (32% of revenue), with traffic numbers falling 1%. Toll increases, however, boosted CityLink's revenue by 2.7% and EBITDA by 2.5%.

Unfortunately, toll rises will be harder won in future years. For the first 16 years of its life, CityLink was allowed to raise prices by the greater of CPI or 1% every three months. That arrangement ended in December, and tolls will now increase by CPI alone.

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IMPORTANT INFO

PORTFOLIO CHANGES

PORTFOLIO	COMPANY	BUY/ SELL	DATE	NO. OF SHARES	PRICE ($)	VALUE ($)
Growth	OFX Group	Sell	6 Feb 17	354	$1.43	$506
Income	OFX Group	Sell	6 Feb 17	362	$1.43	$518

Continued from page 1 ...

Inflation has been low in recent years and the CPI increased a paltry 1.5% in 2016, which is below the Reserve Bank's target of 2–3%. CityLink's 'greater of' clause meant it could increase tolls above CPI while it was low, making it a particularly valuable asset that all but guaranteed satisfactory revenue growth. Now growth will depend more on improving traffic.

No pain, no gain

Management said the poor traffic on CityLink this half was due to the ongoing CityLink Tulla Widening Project, which is due to be completed in early 2018. However, the upgrade will increase the road's capacity by 30%, so it's hopefully a case of short-term pain for long-term gain.

Including CityLink Tulla, which is expected to cost around $1bn, Transurban has a $9bn pipeline of upgrade and development projects. More than $2.5bn of works are currently underway such as the Logan Enhancement Project in Brisbane and the $1.3bn NorthConnex tunnel in Sydney – which will be the longest tunnel in Australia at completion. Management said everything is on budget and running to schedule.

Management continues to negotiate with the Victorian Government for the planning and construction of the Western Distributor, with financial close expected later this year. The project will connect the Melbourne CBD with CityLink and the Port of Melbourne. Management said that if the $5.5bn project is approved, the company will need to raise equity, though most of the construction cost will be funded by debt.

Table 1: TCL interim result

SIX MTHS TO DEC ($M)	2016	2015	+/–(%)
REVENUE	1,065	960	11
EBITDA ($M)	817	729	12
FREE CASH FLOW ($M)	680	461	48
INTERIM DIVIDEND	25c (up 13%), 14% franked, ex date already passed		

Management expects full-year dividends to come to 51.5 cents, a 13% increase on the prior year, for a partially franked yield of 4.7%. Transurban has a monopoly in the eastern states, economies of scale and inflation protected revenue, though we're mindful that the company only has around 34 years to milk its assets (see ***Why Sydney Airport beats Transurban***). Nonetheless, this was a good result and we're increasing our price guide. **HOLD**

Staff members may own securities mentioned in this article.

Cost cuts at Australia's largest soft drink company will be unable to forestall earnings declines in the years ahead.

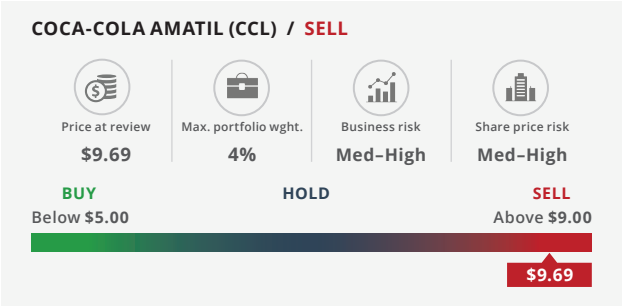
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 7 FEBRUARY 2017

Last drinks for Coca-Cola Amatil

A hot summer is undoubtedly good for Coca-Cola Amatil. If you live in New South Wales and Queensland you're currently sweltering through a heatwave, although you might be wondering where summer's gone elsewhere (at 4pm yesterday it was 33 degrees in Sydney, but just 17 in Melbourne).

Key Points

- ***The 2016 result won't be representative of Amatil's future***
- ***Structural headwinds intensifying***
- ***Downgrading to Sell***



Whatever happens from year-to-year, though, the long-term trend in soft-drink consumption is down. It's already starting to show up in Coca-Cola Amatil's numbers: while revenues to the end of 2015 grew 6% over five years – a weak performance – operating earnings fell 24%. Most of that was due to a step down in Australian non-alcoholic beverage earnings in 2014.

Management has been busy trying to plug the holes with cost cutting. As we said in ***Coca-Cola Amatil: Interim result 2016*** back in September, it has had some success. Management is continuing down that road, selling manufacturing plants to fund cost-saving capital expenditure programs.

But cost cutting will only produce long-term earnings growth if it's eventually accompanied by revenue growth. Here, the signs are not promising. Soft drink sales were the weakest performing Australian grocery category in the 2016 financial year. In the United States, soft drink sales have now marked their 11th consecutive year of decline and per capita consumption is at 1985 levels. While long-advanced in the US, the downward trend in Australia has only recently begun.

Ten green bottles

Even if Amatil manages to eke out a little revenue growth over the next few years, it will face other headwinds. We mentioned in ***Coca-Cola target at risk*** in October that container deposit schemes will be launching in New South Wales, Queensland and Western Australia over the next 18 months. Victoria seems unlikely to hold out forever.

Then there's the threat of a 'sugar tax', similar to the one the UK is introducing on soft drinks from 2018. The current federal government's attitude is more likely a 'no' than a 'yes', but sugar taxes are becoming more common worldwide, and future Australian governments will likely consider one.

Table 1: Australian Beverages base case

YEAR TO 31 DEC	2015	2018E	CHANGE (%)
REVENUE ($M)	2,763	2,521	(9)
COSTS ($M)	2,299	2,165	(6)
OPERATING EARNINGS ($M)	464	356	(23)

While Amatil is about more than its Australian beverages business, that division still produced 66% of earnings in the first half of 2016 (the company has a calendar year end and will report its 2016 results on 22 February).

Most analysts are assuming Amatil will return to revenue growth over the next three years. In light of the accelerating 4% decline in Australian beverage division revenue in the first half, we think that's very optimistic. We've run a few scenario analyses for the division for the 2018 year and, assuming a 3% reduction in revenue annually, and that full-year costs are flat on first half 2016 levels, the effect on earnings in Table 1 is clear. This is our base case.

Cold comfort

Perhaps Coca-Cola will cut costs harder than expected, or perhaps revenue declines will be held in check by new products or clever marketing, but we doubt it. You can be sure that if Australian beverage earnings are 23% lower in 2018 then, whatever happens elsewhere in the business, the share price will be much lower. So will the dividend.

> **But cost cutting will only produce long-term earnings growth if it's eventually accompanied by revenue growth.**

The result to be released on 22 February might reassure the market. Cost cutting and lower interest charges mean managing director Alison Watkins is likely to deliver earnings growth. Don't be fooled. The medium-term earnings recovery that many analysts are forecasting to 2018 and beyond is misplaced. Amatil is a higher risk business than its excellent brands and reputation suggest.

We've previously suggested you sell above $10.00 and the stock has exceeded those levels recently. But we think the headwinds are strengthening and that Coca-Cola Amatil faces structural issues it will be unable to overcome with cost-cutting alone. We're lowering the prices in our guide and switching to **SELL**.

Staff members may own securities mentioned in this article.

After a profit downgrade, the serviced office provider is fed up and sending in the big guns to fix up its American and South East Asian operations.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 7 FEBRUARY 2017

Servcorp sends in the family

'Anybody that doesn't meet their numbers gets fairly well punished' **said Servcorp founder and chief executive Alf Moufarrige** last week after a profit warning from the serviced office provider knocked 20% off its share price.

Key Points

- ***Reduced profit guidance***
- ***Lowering Buy price***
- ***Remains HOLD***

SERVCORP (SRV) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$6.25	5%	Med–High	High

BUY Below $5.50 | HOLD | SELL Above $9.00

$6.25

Servcorp now expects profit before tax for the year to June 2017 to be around $47m rather than its previous guidance of 'not less than $56m'. Certainly it's a big miss and a correspondingly big reaction, but the issues behind the downgrade are not so surprising; indeed the company has been grappling with them for years.

Empire-sized headache

At the heart of the downgrade was the American business, from which management expected a first-half profit of around $2m, but which instead lost around $2.5m –mainly due to its operations in New York.

The main problem is the competitive nature of the US market, which management has previously described as being far more 'competitive and vicious' than any other they have encountered.

Chief financial officer Anton Clowes told us on the phone last week that competitors in the US were doing a better job of getting the word out about shared workspaces, and that Servcorp needed to improve its brand recognition.

In addition to the US, the company's operations in South-East Asia have also been underperforming, most notably in Singapore and Malaysia.

Sending in the big guns

Servcorp's experience is that most problems can be solved with some extra care and attention, so the plan is to send in its two most senior managers.

The company has removed the general manager of the US business and will now be headed up by chief operating officer Marcus Moufarrige for the remainder of 2017. His father, founder and chief executive Alf Moufarrige, will take the reins of the South-East Asian business.

This, then, will be the acid test of management's faith in (err) management. It has the ring of a self-serving argument, but we have high regard for Servcorp's management and culture. It has performed well in many regions over long periods, and it's done so mostly against the same companies that it must compete against now in its problem regions. The fear, though, is that with the US and South-East Asia being recurring problems, there may be bigger issues at play.

Buy-cycle

Overlaid onto all this is Servcorp's inherent cyclicality.

Historically the company's performance and share price (see Chart 1) have performed in line with – perhaps slightly ahead of – prevailing economic conditions. In the eight or so years since the global financial crisis, Servcorp's share price has almost tripled, with last week's trading update being the first major hiccup.

Chart 1: Servcorp share price (2000–2017)

Source: S&P Capital IQ

This could be a sign that we are closer to the top of the cycle than the bottom, in which case history suggests that it could pay to be patient.

> **This, then, will be the acid test of management's faith in (err) management.**

Despite the reduced profit guidance, the company also announced that its cash position remains strong with unencumbered cash of around $100m. With no future expansion planned for 2017, the company expects this balance to rise even after paying an expected 26 cents per share in dividends for 2017, up from 22 cents per share in 2016.

Table 1: Servcorp earnings and dividends

YEAR TO JUN	2014	2015	2016	2017F
PBT ($M)	34.3	41.2	48.8	47
NET PROFIT ($M)	26.3	33.1	39.7	38
EPS (C)	27.0	34.0	40.0	38
PER*	23.1	18.4	15.6	16.4
DPS (CENTS)	20.0	22.0	22.0	26.0
DIV. YIELD (%)*	3.2	3.5	3.5	4.2
FRANKING (%)	19	30	50	50

***Using current market price**

While that is good news for Servcorp investors desiring income, it also shows that the company is finding it difficult to find attractive leases to grow its total floors. However, the cash balance should provide a useful war chest to expand when any future downturn arrives and low occupancy leads to cheap leases.

Treading cautiously

Alf Moufarrige has said that he'd buy Servcorp shares if the company was not in a blackout period, but we're not inclined to take his lead at the moment.

We're in no doubt that this is a good business, but it's a good cyclical business and we're therefore inclined to demand a wide margin of safety. With the share price still having more than doubled since our last Buy recommendation on 25 Jun 13 (Buy – $3.08), it's an approach that has served us well in the past.

We'll be watching the half-year results on 22 February, but in the meantime we're reducing our Buy price to $5.50 and our Sell price to $9. **HOLD**.

Staff members may own securities mentioned in this article.

The market was expecting a weak result from Carsales. But strong businesses can deliver pleasant surprises, which is exactly what happened.

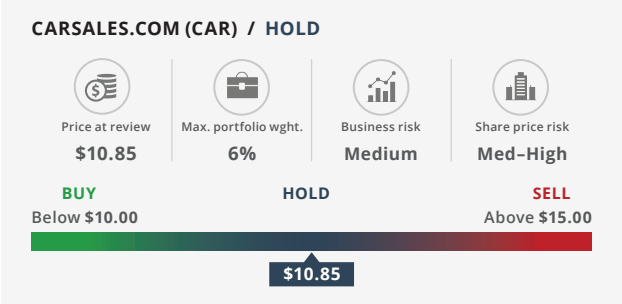
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 9 FEBRUARY 2017

Carsales: Interim result 2017

If Carsales.com's managing director Greg Roebuck is stepping down before the problems hit, there was no sign of them in the 2017 first half result. Has all the worrying we've been doing lately been for nought?

Key Points

- ***Result a little better than expected***
- ***Potential upside from new products***
- ***Pivoting to South America internationally***



In Carsales' core Online Advertising business, revenue growth was stronger than expected at 13%. Both dealer and private revenue marched upwards at a decent clip, with earnings before interest, tax, depreciation and amortisation (EBITDA) rising 9%. It was pleasing confirmation that the Carsales core business is indeed motoring (see our **November upgrade**).

Notwithstanding cyclical risks, the medium to long-term growth potential for the core business might be somewhat better than expected. The company has been introducing new products for dealers that should help accelerate vehicle turnover (car dealerships are a volume business, so turnover speed increases dealer profitability).

These products could lift Carsales' revenue growth significantly. Combine that with long-term cost growth that's likely to reduce from the first half's 12% and there's the potential for a step-up in profitability at some point.

Also pleasing was that Carsales lifted its standard private seller ad from $65 to $68 last month. It has also lifted the free ad threshold from $3,000 to $5,000. Both moves suggest the company is comfortable enough to attack main competitor Gumtree on its own turf (which has a significant share of low-value vehicle ads).

Stratton setback

What the market was most worried about, however, was the performance of finance business Stratton. While its difficulties – outlined in ***Carsales' Stratton splutters*** – meant that revenue fell 22% and EBITDA fell 49%, it could have been worse. Management indicated that Stratton was working on a turnaround, with growth expected to resume in 2018. It's too early to know if a **writedown** will be required, but management seemed confident this is more of a setback than anything worse.

While on the subject of writedowns, management wrote down the value of the stake in **iCar** Asia by $7m, as expected. The company reclassified the investment as 'available for sale', which suggests it's a seller at some point.

What's particularly interesting is how quickly Carsales has pivoted from interest in Asia to expansion in South America. Last month Carsales acquired the Demotores online automotive classifieds business for the very reasonable price of $7m. Demotores owns websites in Chile – where Carsales' chileautos.cl is already number one – as well as Argentina and Colombia.

Along with Soloautos in Mexico and Webmotors in Brazil (in which Carsales owns a 30% stake), it now has five businesses in Central and South America. It's clearly trying to take on the ASX-listed **Latam Autos** (ASX: LAA) which, like iCar Asia, has struggled with how capital hungry early-stage ventures can be. Indeed, that's something Carsales will need to watch itself.

South Korea stunner

Brazil's economic woes took a toll on Webmotors in the first half, with EBITDA falling 24%. But at SKencar in South Korea, the company's largest and most advanced international business, earnings went the other way, rising 18%. While Carsales' 2014 acquisition of a 50% stake in SKencar looked expensive at the time, its performance has justified the company's confidence.

Adding it all up, the $7m iCar Asia writedown means Carsales reported net profit fell 8% to $47m. On an underlying basis,

> **Adding it all up, the $7m iCar Asia writedown means Carsales reported net profit fell 8% to $47m.**

though, net profit rose 5% – not enough to get the blood pumping, but decent enough in the circumstances (see Table 1).

Table 1: Carsales interim result 2017

YEAR TO 31 DEC	2017	2016	+/(–) (%)
REVENUE ($M)	178.6	167.3	7
EBITDA ($M)	83.2	81.5	2
NPAT ($M)	54.4	51.6	5
EPS (C)	22.6	21.5	5
DPS (C)	18.7*	17.8	5
FRANKING (%)	100	100	N/a

*** interim dividend, ex date 23 Mar**

Note: Figures are underlying results

With the core business performing a little better than expected in the first half – and showing future promise – the stock jumped 8% yesterday. Partly the share price increase also reflected the market's relief that Stratton's woes look temporary, even though it's unlikely to return to peak earnings any time soon.

Management said the second half had started well and, as January and June are seasonally strong car-buying months, there will be the usual second-half bias. So underlying earnings per share of 47–48 cents looks achievable in 2017.

More important than any one year, though, is the longer-term growth profile. Early signs are that the core business might not be as mature as thought, although we still expect there to be some cyclicality. Also reassuring is that Stratton looks likely to recover in 2018.

Good things tend to happen to great businesses, although we prefer to buy on bad news, which is exactly what we did a few months back in ***Carsales' core business motoring***. We're a little more reassured after this result, and very happy to **HOLD**.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in Carsales. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Staff members may own securities mentioned in this article.

Despite the Brexit surprise, CYBG is progressing well since being spun off from NAB last year.

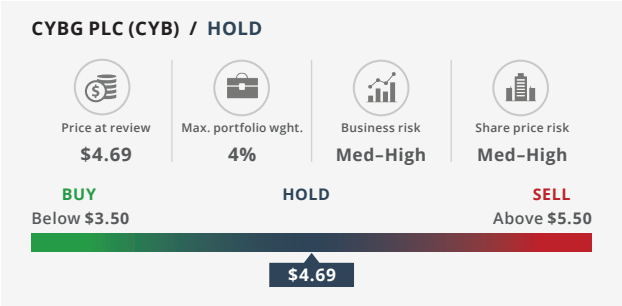
BY JON MILLS • INTELLIGENT INVESTOR • 6 FEBRUARY 2017

CYBG's Duffy does the blocking and tackling

Four-time Super Bowl-winning quarterback Tom Brady will receive most of the accolades should his New England Patriots win a fifth title today. Yet victory will be just as much due to his offensive line: five large gentlemen – averaging 190cm (or 6 foot 4) and 143 kg – who perform the 'simpler' tasks of blocking and tackling marauding defenders to give Brady time to complete his passes.

Key Points

- ***Aggressively cutting costs***
- ***Expanding assets and distribution***
- ***Price guide increased***



Luckily for CYBG chief executive David Duffy, who presented the bank's first-quarter trading update last week, most of his work after **NAB** spun off CYBG last year (see ***NAB gets shot of CYBG (almost)***) on 1 Feb 16 (Hold — $4.00) involved the banking equivalent of blocking and tackling rather than emulating Brady's pinpoint passes.

Simple fixes

Like Graham Kerr at fellow spin-off **South32**, Duffy has wasted little time cutting costs: 8% of staff have already departed and 10% of branches have been closed.

And that's just the start: Duffy plans to use every tool in the banker's playbook to raise CYBG's return on tangible equity (ROTE) from 5.2% to 'double-digits' by 2019, two years earlier than the target set at the IPO.

Duffy believes CYBG can slice another £100m in costs to reduce its **cost-to-income ratio** from a currently bloated 74% to 55–58% by 2019, a year earlier and slightly less than the 60% targeted when it first floated. To achieve its own target, CYBG will have to invest an additional £200m over the next few years, closing branches, automating currently paper-heavy processes and reducing other costs.

Competitors, however, have their own plans and Virgin Money, for example, has a target of getting its own cost-to-income ratio of 59% down to below 50% by the end of 2017.

Lower rates

The 'income' part of the cost-to-income equation is less within CYBG's control, relying as it does (**see here**) on the level of interest rates and the difference between the bank's total interest income and total interest expenses.

Here, low interest rates are both helping and hindering. On the plus side, low interest rates have helped reduce CYBG's cost of funding, with average deposit costs now 0.72% (down from 0.78% in 2015) helped by the roll-off of higher yielding term deposits from 2012 and the continued increase in current accounts.

With 90% of its funding coming from deposits – by contrast, **Commonwealth Bank** obtains 66% of its funding via deposits – CYBG should be minimally affected if turmoil in financial markets increases the costs and difficulty of obtaining wholesale funding.

Unfortunately, lower interest rates – and competition – have also affected interest income. Rates on new mortgages – 68% of which are fixed rate – have fallen 0.44% to 2.77% and, with mortgages comprising 59% of the bank's average interest-earning assets, the higher rates achieved on new business loans (3.51%) compared to existing business loans (3.21%) haven't compensated.

Combined with a slight reduction in average interest-bearing liabilities, the result of all this is that the **net interest margin** rose slightly in 2016, from 2.23% to 2.26%, although it has declined to 2.22% so far in 2017.

Even if net interest margins remain constrained in coming years, Duffy can compensate by cranking up loans and utilising the benefits of **operating leverage**. To that end, mortgages rose 6.5% to £21.8bn in 2016 while ignoring some less profitable, 'non-core' loans in run-off, while lending to small and mid-sized businesses rose 6.1%, to £6.4bn. We'd expect this trend to continue.

> **In the meantime, though, there's the thorny issue of Brexit.**

B ... rilliantly simple

While traditionally concentrated on its core regions of Scotland and northern England, the use of mortgage brokers and its recently released 'B' digitised operating platform are helping expand CYBG's reach throughout the United Kingdom. 27% of customers new to B live outside CYBG's core regions and are younger and more affluent to boot.

CBYG's competitors are also improving their digital offerings, of course, but although CYBG is the largest of the UK's 'challenger banks', it's only the sixth-biggest overall – behind the much larger Lloyd's, HSBC, Barclays, Royal Bank of Scotland and Santander – and has plenty of scope to grow.

British regulators are helping with this by, amongst other things, making it easier to switch between banks – although that of course is a double-edged sword.

Advance(d) bank

British regulators are also encouraging CYBG to move from being a 'standardised' bank to an 'advanced' bank. ***Taking a regional (bank) tour – part one*** has the fascinating details on bank capital regulation but, in summary, 'advanced' banks are permitted to hold less capital against their mortgages and other loans on the basis that they have better risk controls and knowledge of the potential losses within their portfolio.

Similar to Australia's big four banks, the big five banks listed above qualify as 'advanced' banks. Their resulting lower capital requirements along with the advantages of scale give them significant competitive advantages over the 'challenger' banks such as CYBG.

Should it obtain 'advanced' status in 2019 as currently hoped, CYBG will have surplus capital to help it increase lending, invest further in its business, acquire a competitor or return to shareholders. Either way, along with cost cuts and rising net interest income, this is the third major way in which Duffy hopes to obtain double-digit returns on tangible equity by 2019.

Brexit effect

In the meantime, though, there's the thorny issue of 'Brexit'.

At the moment, it remains unclear how the UK will even engineer its departure from the European Union, let alone what effect it might have. Despite all the media alarmism, though, the UK's economic indicators have proved resilient so far and CYBG noted that it hadn't yet 'seen any negative impact on asset quality'.

Any reduction in the demand for loans, though, could dent CYBG's earnings, particularly if interest rates stay 'lower for longer'. If (/when) the economy does enter a recession, it would shine a light on the quality of the loans obtained through the use of brokers.

Table 1: CYBG 2016 result

YEAR TO 30 SEP (£M)	2016	2015	+/(–) (%)
NET INTEREST INCOME	806	787	2
NON-INTEREST INCOME	183	177	3
TOTAL INCOME	989	964	3
OPERATING EXPENSES	(729)	(727)	-
PROFIT BEFORE IMPAIRMENTS	260	237	10
IMPAIRMENTS	(39)	(78)	(50)
PROFIT BEFORE TAX	221	159	39
CASH EARNINGS	143	103	39
CASH EPS (P)	16.2	14.3	13

Note: no dividends declared, all figures are underlying amounts

CYBG's provisions as a percentage of gross loans now stand at 0.12% (and were even lower in the first quarter of 2017). That's cyclically very low, and has been helped by continued increases in British property prices and the Bank of England's reduction in official interest rates to 0.25% following the Brexit referendum. A return to more normal levels would, even in the absence of an outright recession, make Duffy's double-digit ROTE target harder to achieve.

Increasing price guide

So far, then, CYBG is on track to becoming the more efficient and higher returning bank foreshadowed ahead of its demerger. However, we retain a healthy dose of the scepticism outlined in our **intitial analysis** and would require a substantial margin of safety to buy the stock.

If CYBG manages its target of double-digit ROTE by 2019, this would point towards a price-to-tangible-book multiple of around 1. We're raising our Sell price to around that level and our Buy price to around two-thirds of tangible book value. **HOLD**.

Staff members may own securities mentioned in this article.

With its general insurance division back on its feet, the focus switches to the lagging Bank and Life divisions.

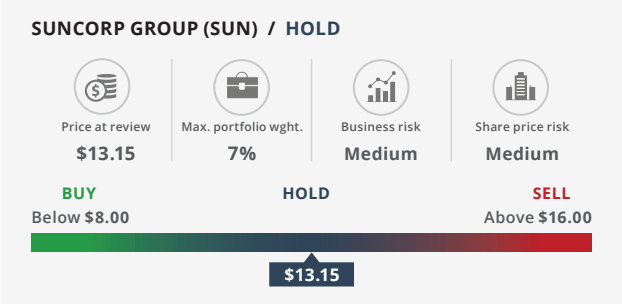
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 10 FEBRUARY 2017

Suncorp: Interim result 2017

Suncorp's Australian insurance operations had a bumper year. Unfortunately, it was completely offset by poor performance at all the other divisions. Overall, net profit for the six months to December rose just 1% to $537m despite an 11% increase in revenue to $8.6bn.

Key Points

- ***General insurance improvement***
- ***Bank posts flat profit***
- ***New Zealand ops disappointing***



The general insurance division's net profit increased 42% to $369m thanks to lower claims expense, cost cutting and strong top line growth.

Gross written premium (the industry's measure of revenue) rose 6% overall, with Motor and Home insurance both up 2% and Commercial insurance roughly flat. The needle mover, however, was Suncorp's compulsory third-party insurance lines, which recorded a 27% increase in premiums due to the company's expansion into the South Australian market and growth in New South Wales.

The underlying insurance margin increased from 10.1% to 11.0%, which is below the company's target of 12.0% but a step in the right direction.

Sadly, the merriment in the Australian operations wasn't matched across the Tasman; Suncorp's New Zealand insurance division had a dismal year. Net profit more than halved to $36m due to the Kaikoura earthquake last November and some residual reinsurance costs from the 2011 Canterbury earthquake. Though premiums grew 5% thanks to growth in Home and Motor lines, the underlying insurance margin was a pitiful 3.8%.

In the company's investment portfolio, returns fell 40% to $70m due to rising bond yields causing losses on its fixed-income assets. A higher stock market, however, offset some of the pain.

Bank and Life

Suncorp's Life Insurance division had a tough year, with premiums growing just 0.4%. Net profit fell 52% to $11m due to income protection claims increasing and more unemployed workers letting their policies lapse. The company said it was exploring 'strategic alternatives' for the division, which might include its sale or a partnership. Given the division is struggling even while unemployment is low, we would hate to see how it performed during a recession so would be happy to see it go.

Table 1: SUN interim result 2017

SIX MTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	8,638	7,797	11
INSURANCE PROFIT ($M)	369	259	42
BANK PROFIT ($M)	208	207	0
NEW ZEALAND ($M)	36	78	(53)
NPAT ($M)	537	530	1
EPS (CENTS)	41.1	40.6	1
FINAL DIVIDEND	33 cents, fully franked, (up 10%), ex date 21 Feb		

Suncorp Bank also had a lacklustre year with net profit flat at $208m due to rising competition for customer deposits and the Reserve Bank's decision to lower interest rates.

Suncorp's net interest margin fell slightly to 1.78%, which is at the lower end of management's target range of 1.75–1.85%.

The net interest margin measures the difference between the interest the bank pays on its funding, such as deposits, and the interest it receives from making loans, such as mortgages. The net interest margin is generally a good proxy for the intensity of competition within the industry – as competition increases, margins and returns on capital decline, which seems to be the case this half.

> **Overall, return on equity rose slightly from 8.3% to 8.5%, though — along with margins — remains below management's target of 10% (are you detecting a theme?).**

Surplus capital

Overall, return on equity rose slightly from 8.3% to 8.5%, though – along with margins – remains below management's target of 10% (are you detecting a theme?).

We're pleased to see the turnaround in the Australian insurance division and the company is leaps and bounds ahead of where it was a few years ago. The strong performance increased Suncorp's excess capital, which currently stands at $448m compared to $346m six months ago. Management said the company 'remains committed to returning surplus capital to shareholders' and the board declared a fully franked interim dividend of 33 cents, up 10%.

Until interest rates start to rise, low investment returns are likely to be the norm and growing competition for loans and deposits at Suncorp Bank are likely to weigh on growth, although management expects a recent increase in mortgage rates to improve the net interest margin in the second half of the financial year. The stock trades on a price-earnings ratio of 16 and a fully franked dividend yield of 5.4%. We're increasing our price guide slightly and continue to recommend that you **HOLD**.

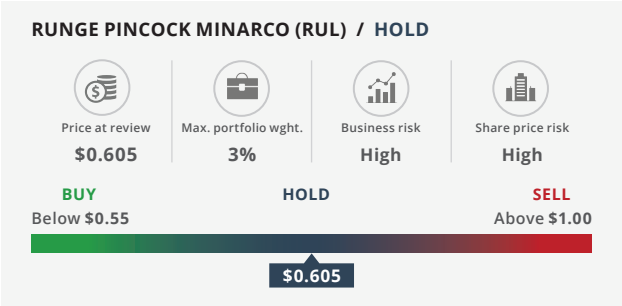
Staff members may own securities mentioned in this article.

Strong licence sales and cost control return RungePincockMinaco to profitability.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 7 FEBRUARY 2017

Runge firing on all cylinders

Yesterday's trading update shows all is well at RungePincockMinarco. Record license sales. Further cost cuts. A return to profitability. It was a cracking update.



It also went a long way towards addressing investors' recent concerns, such as:

1. The prospect of new licence sales in a challenging resources market, and whether the 'deferrals' in 2016 were cancellations;
2. The integration of iSolutions, Runge's biggest software acquisition to date; and
3. The viability of the advisory business.

The standout feature of the update was the record licence sales, which rose 110% over 1H16, nearly eclipsing what was sold in 2016. It's always good to seeing growing license sales, but a strong reversion after a year marred by 'deferrals' is also a tick for management credibility.

Investors' minds were also put at ease about the integration of iSolutions. Under Runge's ownership, licence sales increased 500%, showing the acquisition was an intelligent one in the first place (a rarity) and that the integration has progressed well. The potential for combined Runge and iSolutions products remains significant and synergies are also expected to be $2.4m, up from the $1.8m initially expected.

There is mounting evidence that Runge is an intelligent acquirer, boding well for the recent purchase of Fewzion short interval control software in December.

After 5 years of losses, the advisory business will also turn a $0.9m profit. But the additional cost savings found are even more encouraging. Runge will incur costs of $0.6m on redundancies in the first half, but this will translate into $4.8m a year in ongoing savings. This involved relieving those employed on boom-time employment arrangements and replacing them with the much lower market rates of today. This is a big step towards returning Runge to sustainable profitability.

After another big year of research and development, Runge will report EBITDA of $3.1m for the first half. We initially pencilled in $8m for the full year, and with strong business momentum behind it, our thesis remains on track.

If all goes well for Runge over the next few years and management executes on its plan, we can see the stock being worth as much as $1. Considerable risks remain, though, so we'd require a wide margin of safety to this value to persuade us to buy the stock. We're lifting our Buy price to $0.55 and our Sell price to $1.00, but the stock remains a **HOLD**.

Disclosure: The author owns shares in RungePincockMinarco.

Shipping containing business Royal Wolf should be spewing cash but isn't. What did today's result tell us?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 7 FEBRUARY 2017

Royal Wolf's howler result

Royal Wolf (ASX:RWH) is a business that sells and leases shipping containers. It may sound lousy and it is definitely boring but there are some interesting dynamics at play in this market.

Shipping containers have long useful lives and high residual values: they can retain up to 70% of their original cost after 20 years of use.

Combine that with a large, liquid secondary market for containers and it's clear that the business can match its vast inventory of shipping containers – over $200m worth – to demand levels.

In boom years, Royal Wolf buys more containers, utilising cash and increasing the size of its leasing fleet. In lean years, it sells surplus units to generate cash and reduce the size of its fleet. The impact of this inventory management is that the business sucks in cash in boom years but should release plenty of cash in lean ones.

Attractively, utilisation levels should remain constant as the size of the lease fleet adapts to industry conditions.

That means we avoid the low asset utilisation that kills the economics of traditional equipment leasing businesses such as **Emeco** (ASX:EHL) or **Ausdrill** (ASX:ASL).

Shipping containers are hard to move and one of the few advantages available to suppliers is to be able to cheaply move containers to where they are needed. Royal Wolf has the largest distribution channel in the country and should be able to move the largest number of containers at the lowest price

It currently trades on an EV/EBITDA multiple of about 6 times. So why did the share price fall by 6% today as it realised half year results? The investment thesis isn't quite playing out.

The headline numbers were ok. Revenue fell because container sales declined and leasing levels increased. Sales generate revenue but it is leasing activity that determines profit.

Despite a 16% decline in revenue, EBITDA actually rose and margins expanded from 22% to 27%. What the problem, then?

Cash conversion, a traditional strength of the business, was abysmal. EBITDA of almost $20m translated to operating cash flow of just $6m as working capital ballooned. Capital expenditure of $10m was higher than expected but far lower than the $30m spent over the boom years. Shipping containers depreciate faster on the balance sheet than they do in real life.

Instead of strong free cash flow the business generated negative free cash flow of $13m for the half year. So far, expected free cash flows haven't materialised and higher working capital is the culprit. Although this result was a howler, Royal Wolf may still be interesting.

Disclosure: The author owns shares in Royal Wolf.

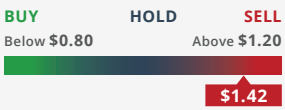
Growth and Equity Income portfolios trade

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 6 FEB 2017

OFX GROUP (OFX) / SELL

Price at review
$1.42

Max. portfolio wght.
3%



Following our downgrade last week, the Intelligent Investor Growth and Equity Income portfolios have sold their holdings (of about 2%) in OFX Group, at a price of $1.43.

Find out how you can invest directly in this and other Intelligent Investor and InvestSMART portfolios by clicking here.

Staff members may own securities mentioned in this article.

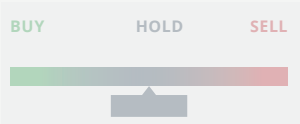
What to do with Hunter Hall Global Value?

BY MITCHELL SNEDDON • INTELLIGENT INVESTOR • 8 FEB 2017

HUNTER HALL GLOBAL VALUE (HHV) / HOLD

Price at review
$1.19

Max. portfolio wght.
15%



Like sands through the hourglass, so are the days of Hunter Hall. It seems ever since founder and chief investment officer Peter Hall decided to call it a day there has been non-stop drama. Or at least that is what is being portrayed in the financial media.

For those unaware, charismatic front man Peter Hall decided after 23 years at the helm that he had had enough. On Christmas eve he notified the Hunter Hall board of his resignation and promptly sold 19% of the funds management company **Hunter Hall International** to **Washington H Soul Pattinson** for $1 per share. On the day the sale was announced the shares had traded as high as $3.10.

Plenty of speculation followed and Soul Patts has put in a bid for the rest of the business – as has Pinnacle Investment Management. Integral to the value of the funds management business is the management contract between it and listed investment company (LIC) Hunter Hall Global Value. The LIC makes up about a third of the fund manager's total funds under management. Anyone looking to buy the business would want to make sure that stays put.

In an **article last week** the AFR reported that Soul Patts is buying up shares in the LIC (since confirmed with a subsequent substantial shareholder announcement) in an attempt to block Wilson Asset Management from significantly decreasing the size of the LIC (or even winding it up completely) through an equal access share buy back at net tangible asset value. The buyback would give investors the chance to sell their shares for their underlying value, which was last reported to be $1.24 after tax. The shares are currently trading at about $1.19.

All the drama aside, what does it mean for shareholders of Hunter Hall Global Value?

We would recommend holding on to your shares. They are still trading at a discount to net tangible assets and if Wilson is successful you will realise the full value of those shares. Alternatively, the Hunter Hall investment team will continue to manage the portfolio.

If you're not a holder than we don't recommend jumping in now. There are too many variables and the current discount of 3.5% isn't big enough to justify taking the plunge and making yourself the meat in tHe fund manager sandwich.

Staff members may own securities mentioned in this article.

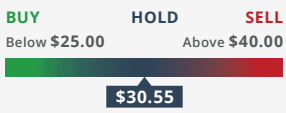
NAB: Q1 update

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 8 FEB 2017

NAB (NAB) / HOLD

Price at review
$30.55

Max. portfolio wght.
10%



After some nasty shocks in recent years, National Australia Bank is laying down some really boring results and that's just how we like it.

Lending growth and higher trading income meant that revenue for the first quarter (to December) rose 1% compared to the quarterly average for the September half. This was supported by a flat net interest margin, suggesting that mortgage repricing has been able to offset higher costs on term deposits.

The impairment charge dropped 23% as less additional 'overlay' was deemed necessary for risks in the mining and agricultural sectors.

Expenses, however, rose 5% due to the timing of salary increases and redundancies. The overall result was a 1% fall in cash earnings (again, compared to the quarterly average for the September half) to $1.6bn.

The cash earnings figure was slightly below expectations due to the higher than expected increase in expenses, but this was offset by commentary reiterating the target of $200m in cost savings for the 2017 financial year, as well as for income growth exceeding cost growth.

The stock is up 9% since we wrote up its **2016 final result** in October, and 26% since we **upgraded to Buy** in the aftermath of the Brexit vote back in June.

With full-year cash earnings per share likely to be little changed from last year's $2.45, the stock is on a low-looking price-earnings ratio of 12.5. And so it should be with impairments at unsustainably low levels and low single-digit growth the best we can realistically hope for over the next few years.

The stock does offer a fully franked dividend yield of 6.5%, but that's as likely to fall as it is to rise in the short to medium term, with the current payout ratio at 80% compared to a target of 70–75%. **HOLD**.

Staff members may own securities mentioned in this article.

What's the difference between Navitas and IDP?

You haven't addressed why universities want to outsource this lucrative operation to Navitas. My take is it's essentially a distribution business which requires scale. If a university needs to recruit students from 10 countries and each country has 10 major cities, it needs to operate 100 offices, not a core operation the university wants to run. If Navitas can represent 20 university, that 100 offices fixed cost is now 1/20. It looks like it has significant moat. Do you agree with this reasoning? But then, it begs the question: what makes an unversity prefer Navitas' model over IDP's, which also has the scale? (I understand there is the issue with shareholding. Lets ignore that for the sake of this discussion.) On business of student placement alone, it looks like the difference between Navitas and IDP is Navitas operates also an on-campus foundation year curriculum. Why does an university want to outsource this?

9 Feb 2017 – **James Greenhalgh**: Great question. It's a fundamental difference between Navitas and IDP Education (ASX: IEL) that Navitas provides first-year education to students before they enter university proper. IDP simply sources international students on behalf of universities. You can see this in the difference in business model – Navitas charges something like $20,000 to students for their first year education (they pay fees to Navitas). IDP receives something like $2,000 for each student (from the university) for each student that commences. So they're quite different business models.

Otherwise I think you're thinking about the student sourcing aspect more or less correctly. Navitas has a network of student recruitment staff globally although it's not as extensive as IDP's, whose business is partly student sourcing (not education itself).

My understanding is the students are also somewhat different. Navitas students usually need to improve their English, which they can do in their first year of the (Navitas-operated) foundation course. IDP-sourced students go straight into the University student mainstream (whether there's much practical difference in English ability is an interesting question).

So why do universities 'outsource' this? Well, outsourcing isn't quite the right word because it might imply they used to do it themselves. I'm not aware of any universities that once provided foundation courses in-house who subsequently outsourced it.

I think the main answer to your question is that some universities struggle to attract international students because they are second/third tier and therefore not as well known outside Australia. Navitas is therefore the 'bridge' which acts to match students to the appropriate course and university environment. The first tier/sandstone university/group of eight are not Navitas partners because Navitas concentrates on smaller/less well-known institutions.

I also gather that some universities just aren't very good at the marketing side of it (and, as you say, sourcing requires economies of scale anyway). Australian universities easily find local students because they're already aware of reputations/degrees/campuses, whereas international students aren't. Then there's the issue that university academics don't necessarily want to be de facto English teachers or hold students' hands. It is a lot more work and therefore time-intensive (hence why Navitas charges high fees).

Some universities do operate in-house foundation courses but it seems many prefer to have someone else do it – someone like Navitas or competitor Study Group. It is slightly more of a business activity than a research/academic activity, and most universities prefer to focus on the latter.

It's possible I'm missing a major reason here but that's my general understanding thus far. And with Macquarie's decision to 'in-source' its foundation program not going so well (at least according to Navitas management) it's a disincentive for other universities to go it alone.

Commonwealth Bank

I have concerns about CBA shares following an article in the W/E Australian titled: "Commonwealth Bank vulnerable as lenders feel pressure" where Morgan Stanley are quoted extensively re CBA being on 14.4 times forward earnings vs 13 for WBC and 12.5 for ANZ and NAB. They forecast difficult times ahead for CBA with a forecast of a price of $68. (Currently it is $82.16). Should I sell now?

8 Feb 2017 – **James Carlisle**: The market is made up of differing opinions, so you should always be careful of basing your decisions on one source. Morgan Stanley is indeed 'underweight' on CBA, with a price target of $68, but others have different opinions: Deutsche Bank, UBS, Macquarie, Morgans and Bell Potter, for example, are all neutral or hold, with price targets around $80.

Bear in mind also that these broker opinions both reflect and influence opinions across the market. There are good arguments that stocks are likely to offer the best value when the brokers are saying sell and the worst value when they're saying buy. Brokers are very good at forecasting short-term earnings performance, but I wouldn't pay much attention to their recommendations or price targets.

There are good reasons why CBA has a higher price-earnings ratio than the other banks – it has the strongest retail business, which is likely to give lower average impairments over the cycle and a higher return on equity (thereby enabling more growth – eventually – for each dollar of retained profit).

Please note that we're unable to provide personal advice, but we're in the neutral camp and would be interested in buying the stock around $70 or below and would likely sell if it got up to about $100.

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