Weekly Review

RESEARCH

– Issue – 11 Nov. 2016

Graham Witcomb invites members to take a deep breath, accept the uncertainty and begin the hunt for value.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 10 NOVEMBER 2016

Trump is president. What now?

When a US election provokes the crash of the **Government of Canada's immigration website** you know something is afoot. 'America decided the experimental drug was worth risking the side effects', as **one political commentator put it**.

Key Points

- ***Trump impacts trade, interest rates and stimulus***
- ***Uncertainty brings opportunity***
- ***Watch for potential upgrades***

Evolution has equipped us with a serious distaste for uncertainty. We have a **preference for predictable outcomes** and this isn't one of them.

On the bright side, simply knowing who the next president will be reduces some of the uncertainty felt in the lead up to the election. Markets may rise on that news alone. On the dark side, who knows what a Trump presidency will mean for the global economy, its markets and foreign relations.

Potential fallout

Plenty of fallout ideas have been thrown around by the analyst team overnight, but the consensus is that Trump's victory won't have a large impact on most Australian businesses – with a few exceptions, which we'll get to.

That said, the future of interest rate policy now looks decidedly more hazy. US Treasury yields have gone up since Trump's win, especially at the long-dated end of the spectrum. The two-year bond is up only slightly but the 30-year bond is up 32 basis points to 2.77%.

The assumption seems to be that the Federal Reserve will hold interest rates low and provide extra stimulus in the short term to counter market uncertainty. But this also echoes Trump's pre-election threat that he would replace Fed chair Janet Yellen when her term ends in 2018 because he thinks interest rates should rise sooner.

Trump's proposed tax cuts should also provide plenty of additional fiscal stimulus, along with his plan to spend more than $500 billion on upgrading the country's infrastructure (and you thought Australia had a federal budget deficit). Trump has also pledged to tear up international trade agreements, including the 12-nation Trans-Pacific Partnership, which includes Australia, as well as the North American Free Trade Agreement. Whether that happens or not we shall see.

Lower taxes, lower interest rates, more government spending and protectionist trade policies have implications for those Australian stocks with US and Asian exposure, including **James Hardie**, **News Corp**, **Ansell** and **QBE Insurance**. **Cochlear**, **ResMed** and **CSL** all have US exposure too, but it's unlikely any of Trump's proposed policies would have a large impact on healthcare spending and their respective markets.

For the time being we aren't going to make any rash adjustments to any of our price guides. Trump's proposals can't be enacted overnight and will still need support from bigwigs in the Republican party, many of whom were against

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him in the final days of the campaign. Their level of support now will set limits on what he can actually do, although it's fair to say that Trumps' proposed military withdrawal from east Asia and, potentially, Europe, adds to the geo-political risk.

Embrace uncertainty

Today, many of us woke to a sense of bewilderment and confusion, so it's reasonable to assume that share prices are going to be particularly volatile in the coming weeks. Where does that leave us?

The first thing is to accept that uncertainty is part and parcel of investing. As Warren Buffett said in a **2011 CNBC interview**: 'The world is always uncertain. The world was uncertain on December 6th 1941, we just didn't know it … The world was uncertain on September 10th 2001, we just didn't know it … Now the question is, what do you do with your money? … If you leave it in your pocket, it'll become worth less over time. That's certain.'

We will always be making decisions in an environment of unpredictability. What matters is working with the facts as they stand and focusing on the long term. The craziness of yesterday's election result can be turned to your advantage, but only if you can keep your cool and buy high-quality companies at discounts to their intrinsic value.

With that in mind, here are a few stocks close to an upgrade, although we won't necessarily pull the trigger immediately. While we assess potentially wide-ranging impacts on valuation, please focus on our official recommendations – Buy, Hold, or Sell – and their respective portfolio limits and not get too hooked on price guides and decimal places.

Your Trump watch list

First on our watch list is **Woolworths**, which is now slightly below our Buy price. A Trump presidency isn't going to make one iota of difference to how people shop for groceries (though maybe sales of tinned tuna and candles will get a boost). We have a Buy up to $23 and if the stock falls much further, we're likely to make an official upgrade.

Employment website **Seek** is similarly hovering below our Buy price of $14. However, there's probably slightly more risk under Trump due to its exposure to China, Brazil and (gulp) Mexico. Any fallout from changes to trade between the US and these countries could encourage a local recession and fewer job listings.

Carsales.com is just above our Buy price of $10, but, like Seek, it has some exposure to countries that could be stung by recession, such as South Korea and Brazil (which is already in recession).

We're watching fund managers **Platinum Asset Management** and **Magellan Financial Group** closely, with Platinum now below our Buy price of $5 and Magellan slightly above its Buy price of $20. We won't be pouncing quickly on these two. Magellan is highly exposed to the US and Platinum has plenty of exposure to Asian markets. Any market falls will reduce their funds under management, which is a consideration we'll be pondering in coming weeks.

A few other stocks worthy of a shout out are **Commonwealth Bank**, **Sydney Airport**, **Oil Search** and **Woodside Petroleum**. The first two shouldn't be impacted by Trump to any material degree, but the others may deserve an adjustment to their valuations, depending on oil prices. All are close to upgrades, but we're happy to wait for a larger margin of safety. The catchcry here isn't so much 'fill your boots' but rather 'prepare to dip your toe'.

Of course, there are also 21 stocks already on our **Buy list**, including **Amaysim**, **ASX**, **Fleetwood**, **Myer**, **News Corp**, **Trade Me**, **Crown Resorts** and **Flight Centre**. There's nothing we love more than buying already-cheap stocks at even bigger discounts to their intrinsic value.

“We will always be making decisions in an environment of unpredictability.

Finally, in the coming weeks be mindful of **information bias** – our tendency to believe that the more information we acquire, the better our decision will be, even if the additional information is irrelevant. As **Dave Rubin** said last night, ‘Media which got everything wrong will now tell you all the things that will happen as a result of the thing they said wouldn’t happen’.

If you find it hard to pull the trigger when buying, and justify it with thoughts like ‘I’ll give it a little while longer to see what happens’, remember it is the uncertainty that delivers the best opportunities. Take a deep breath, and enjoy the hunt!

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

Disclosure: The author owns shares in Ansell, ASX, Amaysim, Carsales, Commonwealth Bank, Crown Resorts, News Corp, Seek, Sydney Airport, Trade Me, and Woolworths.

Staff members may own securities mentioned in this article.

A failed float hides a very attractive business model that's even more attractively priced.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 7 NOVEMBER 2016

3P Learning: A textbook case

The Largs Public School was Australia's first. Opened in 1858, it almost certainly featured a blackboard, from which students copied words and numbers into dog-eared workbooks. Students have been taught in pretty much the same way ever since although, slowly, the internet is having an impact. Software hasn't quite replaced the blackboard and textbook but, taking its cues from online gaming, it is changing the way students learn. And Australian company 3P Learning is at the heart of the changes, here and overseas.

Key Points

- ***Mathletics is strong in Australia and New Zealand***
- ***Potential for growth abroad***
- ***BUY up to $1.20***

3P LEARNING (3PL) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.04	4%	High	High

BUY Below $1.20 — **HOLD** — **SELL** Above $2.00

$1.04

3P's main product is **Mathletics**, an online mathematics tool used in 48% of Australian schools. Mathletics asks the same kind of questions the very first teachers at Largs would have asked their students all those years ago. The difference is in the learning environment, and how the answers are assessed.

Colourful, dynamic images make it fun for kids to learn while algorithms intelligently adjust question difficulty. Students, with the software adjusting to their learning rate, are neither bored nor disheartened. They can even compete with other students from around the world. With the competition a crusty old textbook and a blackboard, it's no wonder **kids love it**. Mathletics has brought a gun to a knife fight (okay, poor analogy for an educational product but you get the picture).

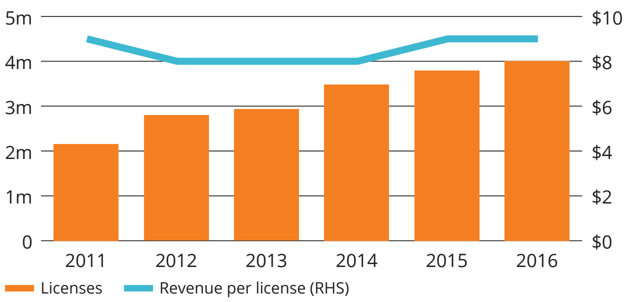
The mechanics of each module work much like the games kids play on their phones. Students receive credits for each correct answer, which they can use to improve their online avatar. This incentivises them to answer more questions, improving their maths skills by stealth. It seems to work. An independent study found that a 30-minute weekly session on Mathletics leads to a 9% improvement in NAPLAN performance. Teachers love it, too, because marking is automated and performance, by students, class and school, is easily monitored.

Building inertia

So how does 3P make money? Annual licences to Mathletics are sold to schools (just 9% of licences are sold direct to students), with fees levied on a per student basis. At less than $10 per student per year, it's a high-value item available at a low price. Fees are paid upfront too, which supports a low working capital model and great cash generation.

Mathletics is a good product but, make no mistake, it can be replicated. A well-resourced upstart would likely get change from $10m to develop an equivalent product, although that may not matter so much. The strength of the 10-year old business is in having almost half the Australian education system already on board.

Chart 1: Mathletics growth



Source: Annual reports

Teachers, educational administrators and parents are familiar with it. Mathletics is even written into over 40 curriculums. Competitors might try and displace it but it wouldn't be easy. Mathletics is already cheap, so there isn't much room to compete on price. The company's customers like it and whilst a competitor might launch a better product, it's hard to envisage it being so much better customers would switch en masse.

These traits were well understood (and marketed) when 3P floated in 2014. The brokers pitched it as 'the REA of education', which is how the eye-watering PER of 35 was justified. But with sales undershooting expectations and the surprise departure of the founding chief executive, the shares are now down around 60% on the float price.

> "3P remains a very attractive business with a hidden option inside.

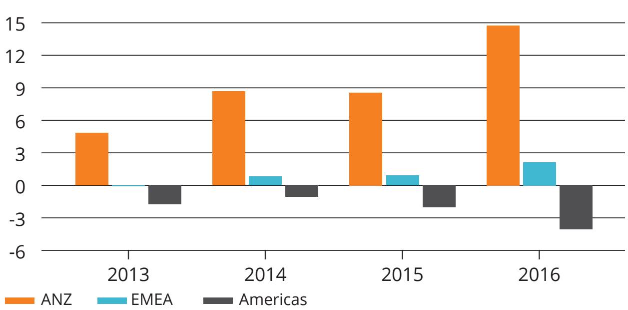
This disappointing performance is the source of the opportunity. 3P remains a very attractive business with a hidden option inside. At current prices, the Australian business is pretty cheap while the potential of global expansion is effectively free.

The company has a market capitalisation of $145m. Last year, the Australian and New Zealand business alone generated EBITDA of $15m (after incurring the corporate and development expenditure for international expansion). That means we're paying just nine times EBITDA for this business alone. With attractive cash generation and low investment requirements, this is an attractive price for a high-quality software business.

It's all about options

Now, what about those free options? The first is the global opportunity. Mathletics already has strong positions in New Zealand, the UK and Canada (used by 31%, 24% and 7% of total schools respectively). But the company's biggest target is the United States.

Chart 2: Segment EBITDA



Source: Annual reports

3P initially used a distributor but in 2012 implemented its own sales channels. That move looks to have paid off. US licences have been growing at 40% a year for the past five years, reaching one million students in June. The region still loses money (to the tune of $4m in FY16) but it has recently reached breakeven on a cash flow basis. Not much growth is required from here to swing US operations from being a drag on profits to a profit centre.

A word of caution: 3P lacks the first mover advantage overseas it has in Australasia. Consequently, its brand lacks awareness in these new markets, which are also more competitive.

It would be a mistake to assume 3P can dominate the US and Europe in the same way it does Australia. But the beauty of the software business model is the low cost of entry to new markets. Development costs have already been paid. As long as sales can be made at a reasonable cost of acquisition, 3P can make good money in large markets with smaller market shares.

The second option is in the company's untapped pricing power. Before the 2014 float, the price of Mathletics was raised by $1.50 a year, a 15% increase. There is scope for further price increases that could have a massive impact on profitability. If each Mathletics student were to pay an extra $2 a year, company EBITDA would increase by 60%.

Such an increase is unlikely to come in one fell swoop but a number of smaller increases over time looks possible. The degree to which they occur ultimately depends on the competitive environment, but the potential is clear.

What else? The third option is in the company's other products, Intoscience and Spellodrome, plus its licensing agreement with Reading Eggs. With existing relationships with half of Australia's schools, selling additional products like these, both here and overseas, makes sense.

Finally, 3P has minority stakes in two US-based software-as-a-service (SaaS) businesses. As these are private entities, it's difficult to value them. What we do know is that the combined cost was $56m. In the 2016 financial year 3P paid $49m for 40% of Learnosity, which provides SaaS-based applications that helps educational content providers create tests and automate marking. The smaller holding is in Desmos (costing $7m for 17%), which provides a range of graphical applications. The pair contributed almost nothing to earnings in FY16, but with Learnosity users increasing nearly tenfold in 2016, it's possible these investments will soon start to pay off.

Time to buy

It all looks rather good; A strong domestic business available at an attractive price, plus a number of options, only one of which would need to pay off to unlock real value. Below $1.20, we recommend risk tolerant investors **BUY** for up to 4% of their portfolios.

Staff members may own securities mentioned in this article.

Cheap tickets for travellers have a downside for Flight Centre – it must sell more of them. Thankfully, that's exactly what's happening.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 8 NOVEMBER 2016

Flight Centre's ticket to ride

Here's the simplest rule of economics: when prices fall, demand should rise. Unfortunately – or should that be fortunately? – this principle hasn't prevented Flight Centre from announcing a profit warning recently.

Key Points

- ***First half profit to fall***
- ***Management too optimistic about second half***
- ***Upgrading to Buy***

FLIGHT CENTRE (FLT) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$30.94	6%	Medium	Med–High

BUY Below $32.00 — HOLD — SELL Above $50.00

$30.94

International airfares have been plunging as airlines have stepped up discounting. It's the best way for airlines to get bums on seats and cash through the door.

On Friday, Flight Centre's management announced that the average fare in the first half of 2017 was 7% below the previous period. While lower prices are driving 'strong growth in ticketing volumes – particularly in Australia', total transaction value (TTV) growth has been lower than normal. With costs growing as management invests in the business, a 'subdued' first half is expected.

A couple of other factors will contribute to the lower first half profit too. Weak trading in the UK and the US, which management respectively attributed to the Brexit vote and the combined effect of the Zika virus and US presidential election, is also having an effect. The British pound's 18% devaluation since the Brexit vote has also hurt, while management admitted it scheduled too many departures for its Top Deck and Back Roads summer touring seasons.

What does this mean for the numbers?

Management now forecasts underlying profit before tax of $105m–120m for the first half of 2017 (compared with $146m last year). As Flight Centre's second half is typically stronger, and various one-offs should not recur, the full-year profit before tax is forecast to be $320m–355m (compared with $352m).

Translating that to earnings per share terms, management expects the company to earn between $2.22 and $2.46 a share this year. At the mid-point, that equates to a price-earnings ratio of 13, which looks like a bargain. Time to load up, right?

Too optimistic?

Well, yes (and no). Our view is that Flight Centre is being too optimistic in expecting a strong second half recovery. At the top end of management's range, it's expecting the second half to *grow* 20% on the previous period. That seems unlikely.

More likely is that management downgrades expectations for the full year at some point. But we think Flight Centre is cheap enough to buy even with the expectation of another profit downgrade. Using a historical average over the past two years, Flight Centre is trading on a **free cash flow yield** of about 8%. That's great value.

Here's why we don't think another downgrade this year will matter. First, we're not the only ones thinking management is too optimistic about the second half – the market thinks so too. That's why the stock is trading on what looks like a too-cheap price-earnings ratio of 13. It's probably more realistic to assume that Flight Centre will earn about $2.00 a share this year, putting it on about 15 times.

Second, whether Flight Centre's earnings recover this financial year or not doesn't matter. This management team is very focused on the long term, and in recent years it has been laying the foundations to grow profitability down the track.

It's been investing in staff numbers and systems, which will contribute to costs growing 5-7% this year. And it's building out its international network (see ***Flight Centre's ongoing evolution*** from October 2015), with recent acquisitions in Europe, Asia and India.

Bigger business

We've written a lot of words on Flight Centre over the years, and it's now a much bigger and more robust business than it was even five years ago. With the stock having fallen 17% since ***Flight Centre: Result 2016*** – and the stock looking very

> "If management is right and profit recovers in the second half, then you'll have bought a good value stock.

good value – this is our chance to upgrade (we're also lifting the recommended Buy price slightly to $32.00).

There is, however, a caveat. Flight Centre is a retailer and, when conditions turn, they can get ugly (Chart 2 in ***Flight Centre's ongoing evolution*** shows what happened to cash flow in 2009). At some point Flight Centre will again have a very weak year. And the ongoing threat from the internet retailers taking share from retail travel agents needs to be borne in mind as well.

For that reason we recommend you begin with a half-weighting in the stock – no more than 3% (our maximum is 6%). That way you'll be able to buy more if conditions deteriorate, or any subsequent profit warning is worse than expected.

Otherwise we think the stock is a decent bet at this price. If management is right and profit recovers in the second half, then you'll have bought a good value stock. If management is wrong, then the stock shouldn't suffer too much and you might get another bite of the cherry.

It's been seven years since we last had a positive recommendation on Flight Centre. It's pleasing to upgrade this high-quality company again. **BUY**.

Note: Past reviews outline the case for Flight Centre, so please read them for a full understanding of its business. We'll aim to publish a more comprehensive review of Flight Centre over the next month but don't recommend you wait if you're planning to buy the stock.

Staff members may own securities mentioned in this article.

There's good reason to believe IVF prices will decline over time. So why aren't we worried?

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 9 NOVEMBER 2016

Does low-cost IVF threaten Monash?

There's a big question mark at the heart of this article: should we fret more – or less – about IVF prices and where they'll be in 10 years.

Key Points

- ***IVF pricing may be difficult to sustain***
- ***Automation making procedure cheaper***
- ***Significant pent up demand***

MONASH IVF (MVF) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.07	3%	Med–High	Med–High

BUY Below $1.80 **HOLD** **SELL** Above $3.30

$2.07

Historically, pricing hasn't been a problem for assisted reproductive services provider **Monash IVF**. Over the past five years, the company has raised the price of an IVF cycle by around 4% a year to $9,000 or so.

However, less Medicare funding means a patient's out-of-pocket cost has risen by around 9% a year over that time to $4,200 per cycle. Given that most women require at least three cycles to fall pregnant, you can see why there's now a significant 'ouch' factor at both conception and delivery.

Higher IVF prices and increasing demand led to revenue growth of 11% in 2016, excluding last year's acquisition of Sydney Ultrasound for Women. But, as you've probably read ad nauseum by now, past performance does not guarantee future results – and in the case of IVF pricing you're right to be sceptical.

Declining costs

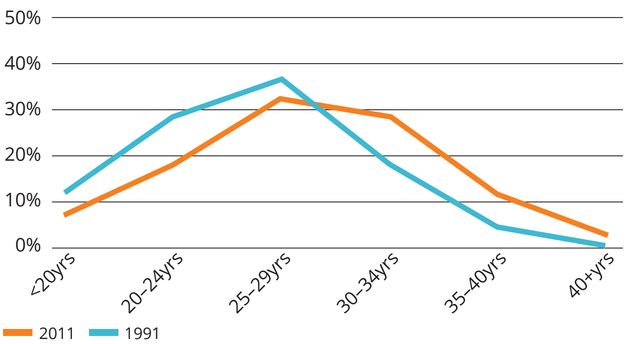
There's good reason to believe the underlying cost of therapy will decline, which – capitalism being what it is – would put downward pressure on prices due to competition.

The total set up cost of an IVF laboratory is around $2–4m. However, in 2013 **researchers in Belgium** showed that it's possible to set up a primitive IVF lab for as little as $400,000 using different culture systems. During the study, it was reported that seven of the 23 implanted embryos resulted in births, which is a comparable success rate to full-scale IVF labs – despite total expenses for the simplified lab being just 10–15% of those needed for a normal set up.

The Belgian lab was designed for use in developing countries and offers just a fraction of the services that Monash offers, but it does suggest that there's plenty of room to reduce lab costs.

The genetic testing of embryos (**PGD**) in particular is a technology-intensive process and we expect it to get cheaper over time as automation and process improvements increase efficiency (see ***Virtus Health's genetic goldmine***). Indeed, the cost of genetic sequencing is declining rapidly: in just five years, the cost of whole genome sequencing has fallen more than 95%.

Chart 1: Age of new mothers 1991 vs 2011



Source: Australian Institute of Family Studies

Another tongue twisting technology that could potentially reduce costs is robotic intracytoplasmic sperm injection (ICSI), where a machine picks up a single sperm cell and inserts it directly into the egg, rather than a clinician performing the procedure manually. Robotic ICSI was only recently developed and isn't widely used, but we expect it to gain plenty of attention in coming years as the process is perfected.

It's worth noting that wages for Monash's doctors and staff account for 65% of its total operating expenses, and there's no reason to assume that this cost component is going to decline. However, the introduction of robotic ICSI and other automations would increase the efficiency of all that labour. In 2016, Monash achieved around 125 fresh IVF cycles per

> **We think management's target for price increases of 3% a year over the medium term is ambitious.**

specialist, but it would be surprising if that number were not materially higher in 10 years time. Assuming that the efficiency gains outpace wage growth, the average cost per cycle is still likely to fall.

Mix shift

So far, however, prices have been resilient and actually increased 3–4% this year at most Monash clinics. Management believes it can raise prices a further 2–3% a year over the medium term.

Still, Monash isn't out of the woods. If prices do continue to rise, people may turn to less expensive alternatives to IVF, such as **artificial insemination** (where sperm is injected into a woman's uterus without targeting the egg specifically). It's not rocket salad, but it is a simple procedure with out-of-pocket expenses of just $1,000 compared to $4,200 for an IVF cycle.

However, success rates are less than half that of IVF, and the procedure is practically useless for women over 40, which account for just under 30% of Monash's patients.

More likely than a shift to alternative treatments is a shift away from the bells and whistles of full-service IVF clinics towards budget clinics, such as **Primary Health Care**'s bulk-billing clinics or Monash's own low-cost offering, BUMP IVF.

Indeed, despite Monash's money-spinning full-service clinics being able to raise prices this year, volume growth was mainly at the company's low-cost clinics. Prices may not be declining per se, but a shift in the sales mix towards lower cost options means the result is the same – anchored revenue growth. A larger proportion of cycles performed at low-cost clinics led to 2016's average revenue per patient being flat.

Untapped market

We think management's target for price increases of 3% a year over the medium term is ambitious. The IVF industry is highly competitive and no operator has any particular advantage over the others. As IVF labs are increasingly automated and a clinician's time used more efficiently, we expect the overall cost per IVF cycle to decline, and prices to follow suit.

So why aren't we worried by that? Because IVF is still very much an untapped market. Around one in six Australian women of reproductive age are affected by infertility. And of those 750,000, only 37,000 made use of assisted reproductive services in 2014 according to the most recent report by The Fertility Society of Australia. That's just one in 20.

In Israel, where the cost of IVF is entirely funded by the government, the number of cycles performed per capita is around 75% higher than in Australia, where Medicare funds only around half of the total cost. If prices do decline over the long term and disposable incomes continue to rise, the increasing affordability of IVF should help to unlock significant pent-up demand. Any improvements in Medicare funding – however unlikely – would provide a further boost.

In the meantime, the number of women aged 35–45 is growing at around 1% a year. Prospective mothers are also having children later in life (see Chart 1), which is leading to increasing rates of infertility. We expect these two trends to bring overall cycle growth to around 3–4% a year assuming there are no changes to Medicare funding. And if out-of-pocket costs eventually come down due to lower prices, there's room to add a few extra percentage points to that.

With a market share of 24%, high returns on capital, a clean balance sheet and economies of scale, there's plenty to like about Monash. What's more, a price-earnings ratio of 17 and fully franked dividend yield of 4.4% means the stock isn't particularly expensive, though **we prefer larger competitor Virtus Health** due to its more diversified revenues, management and lower valuation. **HOLD**

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

Disclosure: The author owns shares in Monash IVF and Virtus Health.

Staff members may own securities mentioned in this article.

Management reduced its target return on equity, which could mean reduced dividends.

BY JON MILLS • INTELLIGENT INVESTOR • 8 NOVEMBER 2016

Westpac: Result 2016

It seems that Westpac's target return on equity (ROE) of 15% – only recently confirmed at its **2016 interim result** – was indeed 'aspirational'. In a result that didn't contain any surprises (see Table 1 for the detail), Westpac chief executive Brian Hartzer lowered the bank's target ROE to a 'more realistic' 13–14% over the medium term.

Key Points

- ***Earnings flat***
- ***But EPS fell due to capital raising***
- ***Dividend up slightly***

WESTPAC BANK (WBC) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$30.17	10%	Low–Med	Medium

BUY Below $27.00 · HOLD · SELL Above $40.00

$30.17

The headwinds noted in ***ANZ: Result 2016*** are the reason why. Westpac's 2016 ROE was 14% (on a cash earnings basis) so this less aspirational target implies management believes things will stay the same, at best, in coming years.

Flat earnings

As for 2016, the bank's result was, on the face of it at least, flat.

Westpac's net interest income increased 8% due to loan growth and higher interest rates charged to individual and business customers offsetting increasing cost of deposits and other funding. However, net interest margin (the difference between interest received on its assets and interest paid on deposits and other funding) was steady at 2.06% (excluding Treasury and Markets).

Total income only increased 3%, though, as non-interest income fell 7% due to the partial selldown of **BT Investment Management** and lower income from its card business.

Software shenanigans

Things were more interesting on the cost side. Westpac's **cost-to-income ratio** was also flat, at 42.0% (rounded to the nearest tenth of a percent). It actually fell slightly without rounding, allowing management to not only claim its cost-to-income ratio was 'peer leading' (that is, better than **Commonwealth Bank**'s 42.4%) but also that it had 'maintained positive jaws' – income rising faster than costs.

However, both claims are only valid because Westpac changed its software capitalisation and amortisation policies in 2015. (See ***ANZ, Asia and accounting shenanigans*** for more on expensing versus capitalising software expenses).

Table 1: Westpac result

YEAR TO 30 SEP ($M)	2016	2015	(%)
NET INTEREST INC.	15,348	14,239	8
NON-INTEREST INC.	5,855	6,301	(7)
TOTAL INC.	21,203	20,540	3
OPERATING EXP.	8,898	8,635	(3)
CREDIT IMPAIRMENT	1,124	753	49
PROFIT BEFORE TAX	11,181	11,152	-
CASH EARNINGS	7,822	7,820	-
EPS ($)	2.34	2.46	(5)
DIVIDEND ($)	1.88*	1.87	-

*** 94 cent final div, fully franked, ex-date 14 Nov, DRP (no discount)**
Note: all figures are on a cash basis

On adopting its new policies, Westpac wrote down $482m in capitalised software – or around 23% of its 2015 opening capitalised software balance.

While software amortisation is included in 'cash' earnings, the $482m writedown wasn't – and never will be. To show how this led to 'positive jaws', let's perform a rough calculation and assume that the $482m in capitalised software written off at the end of 2015 should instead have been amortised over three years consistent with the average software amortisation period noted in the 2016 presentation.

In this scenario, the extra $160m in software amortisation in 2016 would have pushed operating expenses up by 5%, led to 'negative jaws' and, to top it off, meant that Westpac's cost-to-income ratio would have *increased* to 42.7% (= ($8,898m + $160m) / $21,203m for those interested).

Cash earnings would also have fallen rather than remain flat and, after adjusting the intangible asset balance, 2016 ROE would have been around 13.7% rather than 14.0%.

> **Regulators are still finalising the latest round of regulations.**

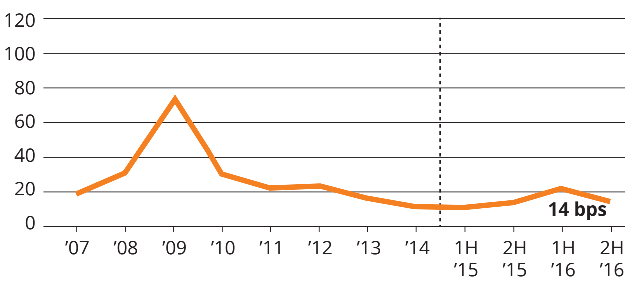
That's before considering the $1.7bn balance of capitalised software remaining after the $480m writeoff at 30 Sep 15. Granted, the bank's more conservative accounting policy means that these costs will also be presumably amortised over three years. However, because additions to capitalised software in 2016 amounted to $700m compared to $570m in amortisation, the $1.7bn historical balance is effectively still not affecting the profit and loss statement. At least, not yet.

Of course, we're assuming the $1.7bn represent real assets otherwise the auditors would surely have required them to be written down to fair value *[maybe management has an aspirational view of their value, too? – Ed]*.

Provisions still low

On a more positive note, after four major problem borrowers pushed provisions to 0.21% of average loans in the ***2016 interim result***, in this result they returned to near-historical low levels of 0.14% of average loans (see Chart 1). Low milk prices are hurting our friends across the ditch while the secondary effects from the mining downturn are ongoing. Westpac – and this analyst – are closely monitoring Westpac's exposure to commercial and residential property but at this stage provisions seem to have stabilised.

Chart 1: Impairment charges (bps)



Source: Chart recreated from Westpac Group Full Year 2016 Results, Nov 16

Despite the additional capital raised a year ago resulting in earnings per share falling, the total dividend increased slightly.

The $1.88 total dividend represents a payout ratio of 80%, at the top of the target payout ratio of 70-80% but accounting for the dividend reinvestment plan, falls to 72%. As we noted in ***ANZ: Result 2016***, global regulators are still finalising the latest round of regulations. But at this stage it seems Australia's banks may not be forced into more major capital raisings once the new regulations become applicable.

Management will address the payout ratio when the new rules are known but, in the interim, will concentrate on attracting customers 'whose sole motivation isn't price'. We wish them luck with that. With competitors such as **NAB** and **ANZ** able to concentrate more fully on Australasia as they resolve their problematic foreign operations, increased competition along with banking services ultimately being commodity products might make this difficult.

In any case, barring anything major like a recession or commercial or residential property meltdown, any dividend cut will likely be minor. **HOLD**.

*Note: The Intelligent Investor **Equity Income Portfolio** owns shares in Westpac and Commonwealth Bank. 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.

It was a very poor first quarter for News Corp, while its digital real estate subsidiary REA Group grew more slowly than expected.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 10 NOVEMBER 2016

Weak start for News Corp and REA

You won't hear many 'Great quarter, guys!' exclamations on the analyst conference call for News Corporation. Most of its quarters are far from great because total revenues will certainly continue to fall for a while yet. And the first quarter of 2017 was particularly unpleasant.

Key Points

- ***Weak results for NIS and Fox Sports***
- ***Book Publishing set for reasonable year***
- ***Slower growth from REA Group***

NEWS CORPORATION (NWS) / BUY

Price at review **$16.01**

Max. portfolio wght. **5%**

BUY Below **$20.00** | HOLD | SELL Above **$30.00**

$16.01

REA GROUP (REA) / HOLD

Price at review **$52.28**

Max. portfolio wght. **4%**

BUY Below **$40.00** | HOLD | SELL Above **$75.00**

$52.28

News Corp is a complicated beast, so let's dive straight in. Overall, first quarter earnings before interest, tax, depreciation and amortisation (EBITDA) fell 21% to $130m (see Table 1). While that's a poor start to 2017, there's reason to think the rest of the year will be better.

EBITDA for the News and Information Services (NIS) division slumped 45% but most of that was due to negative currency effects, investment spending on digital businesses and transaction costs related to its takeover of UK radio company Wireless Group. Nevertheless, a 10% decline in advertising revenue – including a 21% decline at the Wall Street Journal – was concerning.

Management called it 'mayhem' in the advertising market, inferring this was a particularly volatile quarter. We said in *News Corp's leap of faith* in July 2016 that management will not stand idly by while earnings erode and it doesn't appear to be: the company has launched further cost reduction programs for Dow Jones (US$100m) and News Corp Australia (A$40m). The current (second) quarter is NIS's strongest of the year – thanks to Christmas – so it will be one to watch.

Bright spot for books

Book Publishing was a bright spot, with first quarter earnings rising 14% as profitable new titles were released. The outlook is positive here and we're hopeful full year earnings will be better than last year's $185m.

Foxtel also reported flat EBITDA although the decision to cease Presto hit the bottom line. Pleasingly, the average (monthly) revenue per subscriber was down only 3% to $88, while the number of subscribers was stable at 2.9m. Foxtel has agreed a new deal with HBO so programming costs might rise from here, but management was evasive about the magnitude.

Table 1: Divisional EBITDA 1Q17 (US$)

DIVISION	1Q17	1Q16	CHANGE (%)
NEWS AND INFORMATION SERVICES	46	83	(45)
CABLE NETWORK PROG. (FOX SPORTS)	14	28	(50)
BOOK PUBLISHING	48	42	14
DIGITAL REAL ESTATE SERVICES	67	57	18
OTHER/CORPORATE	(45)	(45)	0
TOTAL	130	165	(21)
FOXTEL (50% SHARE)	143	140	2

Fox Sports was the other big first quarter disappointment, with higher programming rights hitting earnings to the tune of 50%. But the costs look like one-offs and management explained full-year EBITDA for Fox Sports should be higher than the $124m reported last year.

REA Group

With management hanging its hat on the Digital Real Estate division, there's a lot riding on its performance. REA Group's first quarter revenue rose 16% as results from the acquisition of iProperty were included, although EBITDA rose only 9%. With an 8% downturn in property listings due to a vendors' strike – particularly in Sydney and Melbourne – REA's 2017 result may disappoint.

Lower listings help explain the weakness in REA's (and News Corp's) share price in recent months – REA's price has fallen almost 20% in recent months. We're expecting REA to report around $1.80 in earnings per share in 2017, which places the stock on a prospective price-earnings ratio of 29. It's an

> **Elsewhere within the Digital Real Estate division, Move (realtor.com) is going from strength to strength.**

exceptionally high quality business, though, and we'd look to upgrade around $40.00 (all else being equal). **HOLD**.

Elsewhere within the Digital Real Estate division, Move (realtor.com) is going from strength to strength. Revenues rose 9% during the quarter and, with the release of new products, revenue is expected to accelerate in the second half. Management noted that it expected Move to be 'meaningfully profitable' from here. While not yet evident in the results, Move might be worth multiples of its $950m purchase price eventually (News and REA Group own 80% and 20% of Move respectively).

Getting better?

So, while News Corp's first quarter looked dire, the rest of the year shouldn't be so bad. Book Publishing seems to have a pipeline of new releases, Fox Sports will benefit from strong audience numbers, and Move's growing profitability should become more obvious with time.

Offsetting that, there are always a few negatives. The NIS division looks troubled and cost cutting will become increasingly harder without damaging content quality. Foxtel's first quarter stabilised but structural challenges remain for subscription television. And REA Group might be in for a period of slower growth.

With the acquisition of Wireless Group and the litigation settlement for News America Marketing, News Corp's cash balance has been dwindling and is now down to US$1.5bn. We expect it should stabilise around that level, assuming there are no further acquisitions.

At this stage we're comfortable with our valuation but there's an argument for knocking a few dollars off our price guide if the year fails to improve. It depends somewhat on whether the performance of Move steps up next year, as well as movements in the REA Group share price. Our recommendation remains **BUY** but be aware there is some downside risk to our Buy (up to $20) price.

Note: It's difficult to determine the effect of Donald Trump's presidential victory on News Corp at this stage. We don't think it's particularly material but it is, of course, early days and there remains considerable uncertainty. A weaker US dollar - widely expected after a Trump victory - would on balance be a mild positive for News Corp's Australian shareholders.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in News Corporation. 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.

Two famous professional investors wrote books on how ordinary investors have an edge over their paid counterparts.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 7 NOVEMBER 2016

How you can beat the professionals

It's fair to say that if the rest of the stock market knows more about a particular stock than you do, then you're unlikely to be able to buy it cheaply. Worse still, you might be duped into buying a stock that looks cheap but which has unknown horrors lurking within it.

It's interesting, then, to look at how some of the most successful investors have gone about gathering information and conducting their research. The revealing thing is that while they all stress the importance of reading annual reports and other material, they also make additional efforts to uncover insights into companies and their products.

Scuttlebutt

One of the first people to write about the subject was Philip Fisher. Fisher's book, Common Stocks and Uncommon Profits is on our further reading list, so quite a few members will probably have read its second chapter titled 'What Scuttlebutt can do'.

Depending on when you last went to sea, a scuttlebutt is a cask of fresh water, or a drinking fountain, on a ship's deck. And it was around these scuttlebutts that sailors would swap the latest rumours and gossip - 'Did you see the size of that albatross?', that sort of thing.

Fisher's approach was to use the modern equivalents on land to garner everything he could about a company and its industry. Investors should also actively seek out a company's employees, Fisher maintained, and talk to its suppliers, customers, any relevant trade associations and even research scientists where appropriate.

The obvious problem with all of this is that its success rather depends on who hangs around your particular scuttlebutt. It just isn't practical for most of us to gambol up to a director of our target company's supplier on the 10th tee and ask 'so, Bert, Australian Resources...does it pay its bills on time?'

To be fair to Fisher, his book was first published in 1958 when the dissemination of corporate information happened, er, rather differently. A more modern and accessible view can be obtained from Peter Lynch's One Up on Wall Street, which is also on our further reading list.

Pertinent facts

The book focuses on using what you already know to beat the professionals. At one point Lynch reminisces about summoning CEOs to his office as the star manager of Fidelity's Magellan fund in the 1980s, before adding:

'On the other hand, I can't imagine anything that's useful to know that the amateur investor can't find out. All the pertinent facts are there waiting to be picked up.'

Most of these pertinent facts, he says, are in the annual reports, but what you can't get from the annual reports, you can get from your broker, by calling or visiting the company or by 'kicking the tyres'.

With the broker, the key, he says, is to be firm - you are the customer after all. With the company, the key is to be polite, constructive and demonstrate that you've already done some research. Also, if you're a shareholder, then say so. According to Lynch, 'Many companies would welcome a chance to exchange views with the owner of 100 shares from Topeka'.

Lynch also talks about the importance of picking up information from talking to people, although generally at a more mundane level than Fisher. One of his most successful investments was in La Quinta Inns, which was mentioned to him by someone at a rival Holiday Inn and another was in Hanes, which made 'L'Eggs hosiery which was a tip he received from his wife.

Warning

Lynch is also quick to add some words of warning on the subject of verbal information. The emphasis you can get from people will change depending on who you're talking to:

'When looking at the same sky, people in mature industries see clouds where people in immature industries see pie.'

Depending on a whole host of unknowable factors, you could get a huge range of replies about the same thing from different people, or even from the same people on different days. According to Lynch, 'there's no reason for the investor to waste time trying to decipher the corporate vocabulary. It's simpler to ignore all the adjectives'.

> **“After all, you don’t often see these big ‘flash Harrys’ procuring tinned sardines from Woolworths.**

Companies are also mostly there to be visited and ‘have their tyres kicked’. It’s mostly here that Lynch suggests that the private investor can steal a march on the big money managers.

After all, you don’t often see these big ‘flash Harrys’ procuring tinned sardines from Woolworths.

Not so Peter Lynch. Before investing in La Quinta he spent several comfortable nights in their motor inns; before he bought Pic ‘N’ Save he visited their stores and, before he bought Taco Bell, he tucked into a few tasty burritos. We can only guess how he reached his conclusions about L’Eggs.

Processing

Again, though, some words of warning. Gathering information is vitally important to the investor but it can be positively dangerous if the information isn’t processed correctly.

To begin with, you need to be very careful about applying your own tastes and prejudices across the whole world. You might like a certain new brand of orange juice because of the lovely chunky bits, but it might be that the rest of Australia are getting fed up pulling the bits out from between their teeth.

You also need to be aware of just where your particular experience fits in the grand scheme of things. Just because the fruit and vegetables are crisp and fresh at your local supermarket doesn’t mean that they’re the same in every other similar supermarket in the country. But, if you went to five such supermarkets and they all achieved the same high quality, then you might be on to something.

Perhaps the best example of this comes from Warren Buffett’s investment in American Express back in 1964, after its reputation had become tarnished by a fraud in New Jersey.

The stock plummeted on the basis that the company’s reputation, and therefore its future, was in doubt.

To size up the situation, Buffett went down to his local steakhouse and sat behind the counter to observe that the patrons were still paying for their meals with the card. In downtown stores in his hometown of Omaha, people were also using the card and stores were accepting it.

He correctly surmised that if this was happening in middle-American Omaha, then it would also be happening everywhere else. American Express was not going down the gurgler and it still had a bullet-proof franchise. He made a large investment in the bombed-out shares and was repaid handsomely for his time and effort.

Discipline

But you can’t think about your own private research in isolation. Despite your best intentions, it might be that you’re behind the times and that the valuation of a bank, for example, is already fully reflecting the expected success of that innovative new mortgage product you’ve just applied for. And, in any case, is that new mortgage product really going to make that much difference to a company the size of your typical bank?

While you’re getting into a lather about this one product, the rest of the market might correctly be focusing on a bad debt situation that’s quietly blowing up in the bank’s face.

Gathering information and ideas is all for the good, but it doesn’t absolve you from the usual disciplines of research and valuation.

Trade Me meeting update

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 11 NOV 2016

TRADE ME (TME) / BUY

Price at review	Max. portfolio wght.	BUY Below $5.25	HOLD	SELL Above $7.50
$4.45	6%	$4.45		

Trade Me held its annual meeting yesterday. Although we didn't attend, there was little significant news in the announcement to explain the recent weakness in the share price (if you attended, please let us know any interesting titbits below).

Management did however indicate there had been a downturn in property listings for Trade Me Property (similar to what's happening in the Sydney and Melbourne markets). This might knock a couple of million dollars off earnings this year, so it's possible our stretch target of NZ$160m in earnings before interest, tax, depreciation and amortisation (EBITDA) for 2017 is a stretch too far.

Cost growth has however been lower than expected, while total revenue growth is in line with expectations. That suggests that Trade Me's other divisions are perhaps offsetting the weakness in Property. Management confirmed that earnings growth rates would be higher than 2016 in both the first half and for the full year.

Altogether, recent price weakness makes the stock somewhat more attractive than in ***Trade Me: Result 2016*** (the share price is down 14% since that review). It's not sufficiently underpriced to jump to the full 6% weighting at this stage but you could consider topping up at these prices. BUY.

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

Disclosure: The author owns shares in Trade Me.

Virtus Health's share price falls

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 8 NOV 2016

VIRTUS HEALTH (VRT) / BUY

Price at review	Max. portfolio wght.	BUY Below $7.00	HOLD	SELL Above $11.00
$6.65	5%	$6.65		

IVF provider Virtus Health's share price has fallen 19% since its **positive full-year result** released in August. We haven't seen any material news that would affect our valuation, though the company continues to face pricing pressure at its budget clinics, and ongoing Medicare reviews add a dose of regulatory risk. The stock now sports a price-earnings ratio of 15 and a free cash flow yield of 7% – not to mention a fully franked dividend yield of 4.5%. Virtus benefits from economies of scale, has plenty of free cash flow and decent growth prospects. Having brushed below our recommended Buy price, we're upgrading to **BUY**.

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

Disclosure: The author owns shares in Virtus Health.

Virtus lowers growth forecast

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 10 NOV 2016

VIRTUS HEALTH (VRT) / BUY

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$6.52	5%	Below $7.00		Above $11.00

$6.52

IVF provider Virtus Health has warned that it has experienced weak fresh IVF cycle activity in the first quarter of the financial year, with the number of cycles down 5.9% compared to the prior corresponding period. What's more, the overall market fell just 3.5% implying the company has lost some market share. Virtus noted that the loss of market share is mainly due to a poorly performing Victorian market, where **Primary Health Care** recently opened a new bulk-billing IVF clinic.

It's a disappointing result, but we won't lose any sleep. We expect Primary to continue to take market share, but mainly by expanding the market rather than poaching customers from Virtus's full-service offering, as has been the experience in NSW where Primary opened its first clinic in 2014. IVF has historically been volatile due to its high cost and discretionary nature, so our valuation of the company already includes these short-term swings in demand.

The number of IVF cycles performed each year has grown at around 3% annually since the government reduced financial assistance in 2010. We think 3–4% market growth is a reasonable long-term assumption, with the 7% growth achieved last year and 6% decline this past quarter being blips on a long-term trend.

As we explained yesterday in ***Does low-cost IVF threaten Monash?***, IVF is a huge untapped market and increasing rates of infertility make it hard for us to imagine a world where there is not substantially more demand for IVF in 10 years' time than there is today. Virtus is the market leader with economies of scale, a clean balance sheet and excellent returns on capital, so we expect the company to still command the lion's share of that market.

The stock currently trades on a price-earnings ratio of 15, a free cash flow yield of 7% and a fully franked dividend yield of 4.4%. That's a fair price for a quality business with reasonable growth prospects – even if they're somewhat lower in the short term than we would have expected a few months ago. We're sticking with **BUY**.

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

Disclosure: The author owns shares in Virtus Health.

Valuation and inflation

*I found this an **interesting article**, regarding lower inflation rates long term, from your partner site InvestSMART . Could you discuss the implications for II stock valuation methods and whether you already factor in structural changes to inflation.*

11 Nov 2016 – **James Carlisle**: Callum writes on economics for Eureka Report and those articles feed through to InvestSMART. Intelligent Investor writes on stocks (and stock valuation) and those articles feed through to InvestSMART and Eureka. In the middle there's some overlap, and we won't always agree. That's all good, because it takes different opinions to make a market. In this case I'd make the point that real interest rates are pretty low at the moment even with low inflation, because interest rates are also low. And with the need to generate some growth, I think it's hard to imagine interest rates heading much higher without some inflation. Over the long term these things tend to sort themselves out and tend to be pretty well discounted by the bond market. This is what we use to give us our cues for discount rates to put into our valuation models (such as they are, we don't tend to do detailed discounted cash flow valuations, other than for amusement ;-). Those discount rates might need to rise, for sure, but if they do it will likely be alongside higher growth – and in any case, we demand a far higher return from stocks than from cash and bonds to provide a margin of safety. Over the long term we'd expect real assets such as shares and property to do pretty well, as they have in the past.

Stop loss recommendations

Why don't you give any guidelines with your Buy recommendations for the setting of 'stop losses'?. Your Buy, Hold and Sell guide prices are clear, but surprisingly no 'stop loss' indicators are given, and obviously a stock with a buy recommendation could head south to well below your 'guide Buy price'. So I think it's important to have a 'stop loss' guide to take out the uncertainty of how long to hold a falling stock. I have understood the first rule of investing is to always set a stop loss, the second rule being not to ignore rule 1! I'm very much aware that the managing of our investments is of course our responsibility, but some guidance with the important subject of 'stop losses' would be appreciated. I know in the past that when some recommendations have 'not worked out' (to put it kindly) , your policy has often been to 'cease coverage' usually with no Hold or Sell guides, which rather left subscribers holding that particular stock in a difficult position.

11 Nov 2016 – **James Carlisle**: I've commented on the subject of stop losses a couple of times before and, rather than repeat myself, would point you to these posts – **https://www.intelligentinvestor.com.au/stop-losses-do-not-stop-losses-1799271** and **https://www.intelligentinvestor.com.au/stop-losses-do-not-stop-losses**. The bottom line is that stop losses do not stop losses - they merely crystalise them and they only make sense if you think shares move about in predicatable trends, which we don't.

I also think you've slightly miquoted Warren Buffett, who said, rather glibly I think, that the first rule of investing was not to lose money, and the second was not to forget rule 1. So he never actually suggested using stop losses and it would run contrary to his philosophy to suggest it. I think perhaps that line has been stolen by chartists – but it takes us back to the point that setting a stop loss does not in fact stop you from losing money – only not investing money in the first place can do that.

Over the years on Intelligent Investor (which is now responsible for stock research across InvestSMART Group, including Eureka) we've been very open about our losses and, on previous Buy recommendations, we'll recommend selling before ceasing coverage. There were, however, a number of Eureka recommendations on which we did cease coverage when the Eureka and Intelligent Investor coverage lists were brought together. In each case we explained our reasoning, but apologies if you've been left in the lurch.

Westfield

WFD (a stock I own) has declined from over $10 a few months ago to $8.76 today. Any thoughts on what is driving this price reduction. I note it is still well below your buy price.

10 Nov 2016 – **Andrew Legget**: There's no news specific to Westfield that is driving the recent fall in its price that I am aware of. The entire listed property sector has fallen, with the A-REIT sector index down almost 11% since the start of August, as expectations around interest rates have been revised upwards. This was again seen today, with long-term bond yields rising on the announcement that Donald trump will be the next US president. While the market has largely shot up, listed property companies on the ASX are down.

Westfield actually released a 3rd quarter update today and there was nothing in that announcement that stood out with specialty rent growing 3.6% across its entire portfolio. Its US$2.5b worth of developments under construction and US$5.8b worth of future development is also still expected to yield a healthy return of around 7–8%.