Weekly Review

RESEARCH

– Issue – 13 Jan. 2017

The Government has changed its mind about funding a second airport and Sydney Airport is playing hardball.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 5 JANUARY 2017

Who pays for Sydney's second airport?

Think of eggs and ham: the chicken is involved; the pig is committed. With a little contractual maneuvering, the Government is trying to turn Sydney Airport from a chicken into a pig.

Key Points

- *No Commonwealth funding*
- *No cost overrun protections*
- *Sydney Airport must decide by April*

SYDNEY AIRPORT (SYD) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$5.89	8%	Low	Low–Med

BUY Below $6.00 | HOLD | SELL Above $10.00

$5.89

In 2014, when the Government first approved the construction of Sydney's second airport at Badgerys Creek – around 50km west of Sydney's CBD – it got a lot of fanfare, both good and bad.

On the one hand, the population of the surrounding area is expected to increase by a million people over the next 20 years, and demand for air travel along with it. Sydney Airport has a right of first refusal to operate the second airport, which would have capacity for 10 million passengers a year – making it roughly a quarter the size of Sydney Airport itself.

On the other hand, the new airport will take a decade to build and cost billions. Who was going to pay for it?

And so a two-year consultation process began between Sydney Airport and the Government to nail down exactly what it would take to construct and to flesh out the investment merit. This came to a head a couple of weeks ago with a formal offer – the Notice of Intention – that outlines the material terms. And running at roughly 1,000 pages, there are quite a few terms to consider.

Bad news

Initially, the Government indicated that it would pay for the site's preparation, while Sydney Airport would fund the aviation infrastructure. Then the music changed, and over the past year Sydney Airport worked under the assumption that the Government would provide a cheap loan for most of the work and that Sydney Airport would have the right to withdraw from development if there were major cost overruns compared to estimates in the Notice of Intention – an extremely valuable bit of fine print.

Scrub that, the Government has now said. December's formal offer contained none of these clauses and included no cost protections or an offer of Commonwealth funding. All of the costs associated with building and operating the airport would now need to be met by Sydney Airport in return for a 99-year lease.

Continued on page 2 ...

CONTENTS

Continued from page 1 ...

To rub salt in the wound, the Notice of Intention also gave Sydney Airport just four months to consider the proposal, rather than the nine months provided for in its 2002 privatisation agreement and right of first refusal.

With an estimated price tag of $5bn, the cost of construction is roughly a third of Sydney Airport's market capitalization. Sydney Airport may already be 'substantially familiar with the terms', as the Government said to justify the shorter time, but this isn't a decision it can get wrong. Management said it's asking the Government to give it more time.

Playing hardball

What stood out about Sydney Airport's response to the Notice of Intention wasn't a particular number or forecast, it was the tone: 'the challenges facing the development of a greenfield airport cannot be underestimated' ... 'the Commonwealth's recent change in approach makes the Western Sydney Airport a challenging investment proposition,' for example.

This is a 'greenfield' project on an empty site, where construction risks and cost overruns are the norm. The new airport will take at least 10 years to finish, over which time many variables – such as traffic forecasts, aeronautical fees, and interest rates – could, and probably will, change. And that means any investment proposition is particularly hard to assess.

Management seems to be puffing its chest at the Government, hoping to get a change in terms. And it may well succeed. Given Sydney Airport's two-year consultation with the Government around the new airport's design, its local knowledge and expertise in traffic forecasting, if there's money to be made, Sydney Airport is in the best position to make it.

If Sydney Airport doesn't take up its right of first refusal, it sends a clear signal that the investment proposition is poor. The Government can offer the construction rights to other companies but takers may be hard to come by. This is an auction where only one happy couple was allowed to view the apartment's interior.

If Sydney Airport does refuse the offer, the Government is free to develop the project itself, but that carries significant operating and political risk. If it comes to that and the Government is left funding the project anyway, it may prefer to offer Sydney Airport the loan or cost overrun protections it originally kept out of the Notice of Intention.

Second airport no threat

One of the most common questions we're asked is whether the second airport poses a threat to shareholders. We don't believe so, whether or not the company takes up its right of first refusal.

True, Sydney Airport's monopoly would be broken, but not for another decade. What's more, the new airport is unlikely to cannibalise much of Sydney Airport's high-margin international traffic, which accounts for 70% of passenger-driven revenues. The number of flights an airline can make into or out of a country are capped by bilateral air services agreements, so airlines are forced to pick favourites. You can imagine how many will opt for Badgerys Creek over the city's doorstep. A second airport is only likely to increase competition for low-margin domestic passengers.

In any case, Sydney Airport currently uses only 340,000 of its 500,000 allowed flights per year, so there is still more than enough growth capacity for several decades. The airport expects to serve twice as many passengers by 2030 – an annual growth rate of a bit under 5%. Revenue growth, however, will almost certainly exceed this once you factor in rising retail rents and aeronautical fees, which will increase by a bit under 4% a year over the next few years under the most recent five-year pricing agreement.

> **Every 1% rise in interest rates would likely shave around 10% from free cash flow once the hedges roll off.**

Upgrade

What's more, the costs of running the airport are mostly fixed, which means that as revenue grows, earnings and dividends should grow faster still as a little more of each incremental dollar falls to the bottom line. We expect Sydney Airport to increase earnings in the high single digits over the long term.

The company has around $7.6bn in net debt – a slight turn off – and only around half of that is hedged against interest rate changes over the next five years. If interest rates rise, they will eventually flow through as lower earnings and the share price will probably fall if rates rise sooner than investors expect. Every 1% rise in interest rates would likely shave around 10% from free cash flow once the hedges roll off.

Our main concern is that the Government refuses to offer any financial assistance for the new airport and that Sydney Airport still accepts the offer. It would then need to take on yet more debt or raise equity, so our risk ratings would increase if this occurs.

Nonetheless, Sydney Airport has all the hallmarks of a high-quality company: decent and resilient growth prospects, able management, formidable competitive advantages and a 'light touch' regulatory environment that lets it earn good returns from its monopoly position. We won't lose any sleep over the second airport, nor any short-term fall in the share price due to interest rate movements. With a current dividend yield of 5.3%, we're happily upgrading Sydney Airport to **BUY**.

Disclosure: The author owns shares in Sydney Airport.

Compared to Brexit, President-elect Trump's victory was even less expected, but markets quickly decided they like his policies.

BY JON MILLS • INTELLIGENT INVESTOR • 9 JANUARY 2017

Portfolios weather political storms

Like Brexit, the victory by President-elect Donald Trump was a surprise. Unlike Brexit, however, markets quickly took a positive view and have continued to rise ever since. Investors are betting that Trump's planned infrastructure spending and tax cuts will combine to pump up economic growth and eventually drive interest rates higher. And when the US Federal Reserve raised interest rates by 0.25% in December, it suggested that a further three rate rises could follow in 2017, reinforcing investors' expectations of rising interest rates.

Key Points

- ***Markets react favourably to Trump surprise***
- ***Portfolios slightly beat index...***
- ***...and continue to outperform***

The All Ordinaries Index returned 9.9% for the six months to 31 December, but our portfolios slightly beat that, with the **Equity Income Portfolio** gaining 12.1% and the **Growth Portfolio** gaining 10.0%.

Since they began accepting real money for investment in July 2015, they have generated annualised returns of 16.6% and 15.7% respectively, compared to 7.9% for the All Ords; and since inception as model portfolios in 2001, they have returned 13.6% a year and 10.6% a year respectively, compared to 8.0% a year for the All Ords.

Equity Income Portfolio

portfolio's top performer over the first half of 2017 was **South32**, which rose 76% after an **excellent underlying 2016 result**. Rising commodity prices and further cost cuts have helped it rise materially above the $2.13 price it listed at 18 months ago after being spun off from **BHP Billiton**.

Computershare has so far been one of the biggest beneficiaries of the Trump surprise, rising 38% on hopes that the President-elect's policies might eventually drive up interest rates. Computershare earns a substantial portion of its profits from the interest on client cash balances – at least when rates aren't close to zero.

Ansell was another good performer, increasing 38% after its **2016 result** suggested an improving outlook and management announced it was considering the sale of the condom division.

Another decent performer was BHP Billiton, which rose 37% as commodity prices improved and, with them, investors' perceptions of mining and energy companies.

PMP rounded out the top give gainers, rising 30% after announcing a planned merger with larger competitor IPMG, although it is potentially at risk after the ACCC subsequently announced it was reviewing the deal.

At the bottom of the table, **OFX Group** (formerly OzForex) was the biggest loser, falling 26% after reporting a 21% fall in underlying profit in its **interim result**. Low volatility in the Australian dollar compared to the US has affected the number of new clients signing up while the fall in sterling since the Brexit referendum reduced the value of sterling-based transactions.

Table 1: Equity Income Port. transactions

DATE	STOCK (SOLD)	% BOUGHT/ PRICE	PRICE ($)
1 SEP 16	Trade Me (TME)	(2.0)	5.32
1 SEP 16	ASX (ASX)	(1.0)	51.51
1 SEP 16	Virtus Health (VRT)	(1.0)	7.92
1 SEP 16	Commonwealth Bank (CBA)	3.0	71.60
1 SEP 16	Westpac Bank (WBC)	1.5	29.55
25, 26, 27 OCT 16	Hotel Property Investments (HPI)	(2.8)	2.84
25, 26, 27 OCT 16	Crown Resorts (CWN)	3.0	10.70
21 NOV 16	South32 (S32)	(1.3)	2.58
21 NOV 16	BHP Billiton (BHP)	1.3	24.23

Even before Trump's victory, infrastructure stocks and listed property trusts declined as investors feared higher interest rates in coming years. This contributed to falls in **Sydney Airport** (by 13%) and pub owner **Hotel Property Investments** (by 11%). Sydney Airport was also affected by the Government announcing that the company would have to **front more of the cost of developing a second Sydney airport** at Badgerys Creek than originally expected.

Financial software company **GBST** and assisted reproduction provider **Virtus Health** rounded out the top five losers, both falling 8%.

> “ [CBA and WBC] are well suited to an income-focused portfolio due to their high fully-franked dividend yields.

Table 2: Equity Income Portfolio as at 31/12/2016

COMPANY	BUY PRICE ($)	QUANTITY	LAST PRICE ($)	VALUE ($)	WEIGHT (%)	RETURN (%)	DIVIDEND YIELD (%)
AINSWORTH GAME TECHNOLOGY (AGI)	2.60	153	2.11	323	1.3	–19.0	4.7
ALE PROPERTY GROUP (LEP)	3.63	218	4.21	918	3.7	15.9	4.8
ANSELL (ANN)	15.06	41	24.71	1,013	4.1	64.1	2.4
ASX (ASX)	40.33	30	49.74	1,492	6.0	23.3	4.0
BHP BILLITON (BHP)	25.37	39	25.06	977	3.9	–1.2	1.6
CARSALES.COM (CAR)	10.28	60	11.35	681	2.8	10.4	3.3
COMMONWEALTH BANK (CBA)	75.58	18	82.41	1,483	6.0	9.0	5.1
COMPUTERSHARE (CPU)	10.90	102	12.46	1,271	5.1	14.3	2.7
CROWN RESORTS (CWN)	10.71	67	11.58	776	3.1	8.2	6.3
GBST HOLDINGS (GBT)	4.99	269	3.76	1,011	4.1	–24.6	2.9
IOOF HOLDINGS (IFL)	9.08	119	9.21	1,096	4.4	1.5	5.9
MACQUARIE GROUP (MQG)	60.31	10	87.12	871	3.5	44.4	4.9
MONASH IVF (MVF)	1.30	345	2.05	707	2.9	58.1	4.2
NEWS CORP VOTING (NWS)	14.91	49	16.76	821	3.3	12.4	1.3
OFX GROUP (OFX)	2.23	362	1.68	608	2.5	–24.7	3.5
ORIGIN ENERGY (ORG)	9.15	60	6.59	395	1.6	–27.9	1.5
PERPETUAL (PPT)	49.45	20	48.76	975	3.9	–1.4	5.2
PMP LIMITED (PMP)	0.53	1203	0.68	812	3.3	28.4	5.3
SEEK (SEK)	12.33	64	14.88	952	3.8	20.7	2.7
SOUTH32 LIMITED (S32)	1.28	366	2.75	1,007	4.1	115.4	0.5
SYDNEY AIRPORT (SYD)	5.28	164	5.99	982	4.0	13.4	5.2
TRADE ME (TME)	3.03	318	4.85	1,542	6.2	60.0	3.2
VIRTUS HEALTH (VRT)	5.34	133	6.24	830	3.4	17.0	4.7
WESTPAC BANK (WBC)	30.32	31	32.60	1,011	4.1	7.5	5.8
WOOLWORTHS (WOW)	25.02	52	24.10	1,253	5.1	–3.7	3.2
CASH		973		973	3.9		
TOTAL				**24,782**	**100.0**		**3.7**

On 1 September, the portfolio sold 2.0% of its holding in **Trade Me** because, at 8.6%, it had moved well beyond our maximum recommended weighting of 6.0%. The portfolio also reduced its holdings in **ASX** (at $51.51) and Virtus Health (at $7.92) each by 1.0%, to 6.3% and 4.3% respectively.

It used the funds and existing cash to increase its holding in **Commonwealth Bank** by 3.0% to 5.2% (at $71.60) and its holding in **Westpac** by 1.5% to 3.8% (at $29.55). The two banks are well suited to an income-focused portfolio due to their high fully-franked dividend yields.

In late October, the portfolio sold its entire 2.8% weighting in Hotel Property Investments (at $2.84) to purchase a 3.0% holding in **Crown Resorts**, at $10.70, after some of Crown's staff were arrested in China.

> Nanosonics was the next top performer, rising 42% after announcing its first annual profit.

Table 3: Growth Portfolio as at 31/12/2016

COMPANY	BUY PRICE ($)	QUANTITY	LAST PRICE ($)	VALUE ($)	WEIGHT (%)	RETURN (%)
AINSWORTH GAME TECHNOLOGY (AGI)	2.60	236	2.11	498	2.0	–18.9
AMAYSIM (AYS)	1.85	511	1.99	1,017	4.1	7.9
ANSELL (ANN)	15.06	41	24.71	1,013	4.1	64.1
ASX (ASX)	40.33	35	49.74	1,741	7.1	23.3
BHP BILLITON (BHP)	21.55	44	25.06	1,103	4.5	16.3
CARSALES.COM (CAR)	10.28	52	11.35	590	2.4	10.4
COMPUTERSHARE (CPU)	10.91	100	12.46	1,246	5.1	14.2
CROWN RESORTS (CWN)	11.64	66	11.58	764	3.1	–0.5
FLEETWOOD CORPORATION (FWD)	1.41	406	1.97	800	3.3	40.1
GBST HOLDINGS (GBT)	5.29	265	3.76	996	4.1	–28.9
HANSEN TECHNOLOGIES (HSN)	2.70	255	3.92	1,000	4.1	45.0
ICAR ASIA LIMITED (ICQ)	0.68	761	0.25	190	0.8	–63.2
IOOF HOLDINGS (IFL)	9.08	103	9.21	949	3.9	1.5
MACQUARIE GROUP (MQG)	60.31	10	87.12	871	3.6	44.4
MONASH IVF (MVF)	1.30	407	2.05	834	3.4	58.1
NANOSONICS (NAN)	1.66	268	3.11	833	3.4	87.1
NEWS CORP VOTING (NWS)	14.91	50	16.76	838	3.4	12.4
OFX GROUP (OFX)	2.23	354	1.68	595	2.4	–24.7
ORIGIN ENERGY (ORG)	9.17	55	6.59	362	1.5	–28.1
PERPETUAL (PPT)	49.45	19	48.76	926	3.8	–1.4
SEEK (SEK)	12.33	63	14.88	937	3.8	20.7
SOUTH32 LIMITED (S32)	1.80	415	2.75	1,141	4.7	53.1
SYDNEY AIRPORT (SYD)	5.28	162	5.99	970	4.0	13.4
TPG TELECOM (TPM)	6.52	107	6.82	730	3.0	4.6
TRADE ME (TME)	3.03	349	4.85	1,693	6.9	60.0
VIRTUS HEALTH (VRT)	5.34	155	6.24	967	3.9	17.0
CASH		958		958	4.0	
TOTAL				**24,564**	**100.0**	**14.4**

Finally, to maintain the portfolio's resources exposure but reduce the skew towards South32, the portfolio reduced its holding in South32 by 1.3% to 4.0% (at $2.58), investing the proceeds in BHP to increase its weighting to 4.0% (at $24.23).

Growth Portfolio

The Growth Portfolio's top performer for the six months to 31 December was also South32, which rose 78% as discussed previously.

Nanosonics was the next top performer, rising 42% after announcing its first annual profit. Sales for the first quarter of 2017 also improved and there are now more than 9,700 of the company's flagship trophon disinfection devices in use in North America, up more than 1,000 on the previous quarter. This growing 'installed base' is important as the company's 'razor and blade' model means it makes its real money in the ongoing supply of disinfectant cartridges to its customers.

> ## “ By contrast, iCar Asia declined 71%, making it the biggest fall in the period.

Computershare (38%), Ansell (38%) and BHP Billiton (36%) rounded out the top five performers.

By contrast, **iCar Asia** declined 71%, making it the biggest fall in the period. Most of the damage was done early in the 2017 financial year upon the release of disappointing second quarter cash flow figures that pushed expected breakeven beyond 2018 and which was followed by a capital raising.

Table 4: Growth Port. transactions

DATE	STOCK	% BOUGHT/ (SOLD)	PRICE ($)
1 SEP 16	Trade Me (TME)	(1.0)	5.32
1 SEP 16	Amaysim (AYS)	1.0	2.04
25 OCT 16	ResMed (RMD)	(3.5)	8.40
25 OCT 16	Crown Resorts (CWN)	1.5	10.70
21 NOV 16	South32 (S32)	(1.4)	2.58
21 NOV 16	BHP Billiton (BHP)	1.4	24.23
21 DEC 16	TPG Telecom (TPM)	2.9	6.52

OFX Group (formerly OzForex) was the next biggest loser, falling 26% after reporting a 21% fall in underlying profit in its interim result as noted above.

Sydney Airport, financial software company GBST and assisted reproduction provider Virtus Health rounded out the top five losers, falling 13%, 8% and 7%, respectively.

On 1 September, the portfolio sold 1.0% of its holding in Trade Me because, at 8.5%, it had moved well beyond its maximum recommended weighting of 6.0%. The proceeds were used to increase the weighting of **Amaysim** (at $2.04) by the same amount after it reported a good **2016 result**.

In late October, the portfolio sold its entire 3.5% weighting in **ResMed** (at $8.40), using part of the proceeds to increase the Crown Resorts holding by 1.5% to 2.9% at $10.70.

Similarly to the Equity Income Portfolio, in order to maintain the portfolio's resources exposure but reduce the skew towards South32, on 21 November the portfolio reduced its holding in South32 by 1.4% to 4.5% (at $2.58), investing the proceeds in BHP Billiton to increase its weighting to 4.6% (at $24.23).

In late December, the portfolio also used some of its cash to add a 2.9% weighting in TPG Telecom, at $6.52. Like its competitors, **TPG Telecom** has suffered significant share price declines as investors fret over the impact on margins as the NBN ramps up.

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

Disclosure: The author owns shares in Ainsworth Game Technology, Crown Resorts, Trade Me, and Virtus Health.

Staff members may own securities mentioned in this article.

We could be in for a tumultuous year. And the best way to deal with it might be to learn the lessons from 2016.

BY JOHN ADDIS • INTELLIGENT INVESTOR • 6 JANUARY 2017

Best books, recommendations and lessons from 2016

As the decades pass, I've come to value a little self-delusion (as does my wife, luckily). Despite living on the north coast of NSW, I've never seen a shark and happily launch my lillywhite girth into the surf without a second thought.

But over the break I downloaded an app called **Dorsal**. Offering localised shark alerts sourced from helicopters, surfers and beachgoers, it's been buzzing ever since. And so last week, instead of a refreshing dive into the ocean, I found myself floating down a tributary of the Brunswick River pondering this article, surrounded by a moat of dogs and children just in case.

If my experience is anything to go by, our awareness of threats tends to change more readily than the nature of the threats themselves. Call it the Dorsal effect. Perception, the psychologists tell us, is everything. That's certainly true in the sharemarket, where differing perceptions create the mispricings on which value investors feast.

This year, though, seems different. The possibility of a European Union break-up has breached the waterline and in two weeks Donald Trump will be president of the United States. Risks long dismissed are returning to the public sphere as a result. It's impossible, for example, to scroll through **Trump's Twitter account** and not conclude the odds of a trade war are now higher than they were a year ago.

None of which is to suggest a change in tack on the part of your analytical team. Minds may be reverberating with risks hitherto disregarded but accounting for them in portfolio decision making is a path to chaos. Instead, via three questions posed to our analysts, here's a chance to refocus, reflect on the lessons of last year and hone your skills for the year ahead.

James Carlisle, research director

1. Most memorable recommendation or article of the year

Time to hang up on Vocus (Sell – $8.93) was my pick. It followed our Buy recommendation on **M2 Communications**, with which it had merged. The call locked in a 143% gain, with the stock falling 52% since. The timing was fortuitous but the analysis wasn't. As Gaurav wrote, the market was 'not only anticipating success from the three-way merger, [but] pricing it as a certainty'. That's value investing in action – genuine independent thinking. James Greenhalgh's **upgrade of Reece** is also worth noting. Opportunities to buy high quality stocks can be fleeting. This one was short-lived but we were alive to the opportunity.

2. Book of the year

The Wright Brothers by David McCullough shows what single-minded dedication can achieve if you stay focused on the right things – even for the little guy up against better resourced giants. That's a valuable lesson for any investor in this environment.

3. What did you learn last year that most surprised you?

The market reaction to Donald Trump's victory rather than the victory itself surprised me. The initial response was to run for the hills but markets soon realised they'd got what they'd wanted all along – Republicans in charge of all branches of government and some serious stimulus. It was astonishing to see the rapidity of the turn, a real life case study in market inefficiency and herding.

Gaurav Sodhi, deputy research director

1. Most memorable recommendation or article of the year

I've magnanimously nominated two of my own efforts, starting with **South32**, so universally disliked it was known as CrapCo. As the share price got cheaper and cheaper – it bottomed at 90c – we retested the investment case and got to know the assets intimately, even down to their power contracts. The research gave us the conviction to stick with a stock that had halved since we first recommended it. A great lesson in the benefits of deep research and sticking to your guns. Stocks can be cheap and become cheaper still.

I was also proud of our decision to **cease coverage of gold**. In reviewing our poor record in the sector we concluded that analysis didn't have much bearing on outcomes. The gold price was largely driven by sentiment rather than demand and supply, in which case analytical time was best spent elsewhere. This disappointed some members but it was the

> **"We only find out how good or poor managers are when the business hits hard times.**

right thing to do. The fact that so few others have admitted the folly of trying to analyse the sector says as much as our mea culpa.

2. What did you learn last year that most surprised you?

Vocus and **Bellamy**'s reinforced two beliefs for me. First, never buy the hottest stock in the hottest sector. And second, analysts are terrible at evaluating management. A business with industry tailwinds and soaring demand insures against incompetent management. We only find out how good or poor managers are when the business hits hard times. Spend your time trying to understand the economics of the business and the behaviour of competitors rather than evaluating management.

Editor's note: Gaurav didn't read many books last year (he has a young son) but in a future blog post will explain how it gets around the problem of mind expansion on limited time.

James Greenhalgh, senior analyst

1. Most memorable recommendation or article of the year

James Carlisle's piece on Brexit – **Brexit Buy list** – stands out for me. It was timely, reassuring and pointed out once again that the best time to buy stocks is when there's bad news or uncertainty. Most external events rarely warrant the savage market sell-offs that occur, at least in the long term. Personally, I used the Brexit falls to top up some of my existing underpriced holdings that I judged wouldn't really be affected.

2. Book of the year

My recommendation (even to revisit) is Peter Lynch's ***One Up on Wall Stree***t. It was one of the earliest investment books I ever read, and one of the most influential. Combined with Ben Graham's advice to 'buy businesses, not stocks', I think it should be the foundation of any investment reading list.

3. What did you learn last year that most surprised you?

Investment is about making judgements about where the best opportunities are, where the odds are in our favour. And yet, last year, I worried that my judgement of odds was poor in relation to significant events like Brexit and Trump. Neither were outlier events or 'black swans' but both were considered unlikely by pundits (including bookies) and myself.

That makes me wonder what else I might be getting wrong. I've always judged the risk of a nuclear attack on a major (international) city in my lifetime probably higher than most – 10% maybe – but that figure seems low now. If we woke up tomorrow to a surprise nuclear attack/accident, or even just a trade war caused by political inexperience, it could have major economic consequences for years to come. I didn't think I'd say that a year ago, and that makes me worry that we might be overpricing stocks given these more apparent risks. Or perhaps I'm just worrying over nothing *(sorry James, can't help you with that one – Ed)*

Graham Witcomb, senior analyst

1. Book of the year

The Outsiders by William Thorndike. It looks at the stories behind a group of CEOs and how they built their companies, with a focus on capital allocation decisions and how having a long-term mindset pays off. There are plenty of lessons for managing your personal finances here. The book does a good job of giving you a feel for how management has to deal with uncertain outcomes and make calculated bets. Nicely written, though sometimes repetitive.

2. What did you learn last year that most surprised you?

For truly great businesses, it makes sense to have a margin of safety on the Sell side, not just when buying. They make a habit of delivering pleasant surprises so it's easy to be caught selling out too early. As a result, I have a greater appreciation of the Buffett line about buying into a company because you want to own it, not because you want the stock to go up.

Editor's Note: Graham also nominated South32 for most memorable recommendation of the year. Birds of a feather and all that.

“ A good rule is to avoid all floats (and especially those from private equity), with notable exceptions being any government asset being sold and some spinoff-type floats like South32.

Jon Mills, senior analyst

1. Most memorable recommendation or article of the year

I too can’t go past South32 for best recomendation, demonstrating everything we aim to provide to members. A truly hated stock, a contrarian call by Gaurav, who was willing to stick by his analysis even though its share price more than halved and members were complaining about losses. I can’t emphasise enough the valuable lessons in the history of this recommendation.

2. Book of the year

The Success Equation by Michael Mauboussin. It discusses the interaction between skill and luck in various pursuits, emphasising the importance of process in fields like investing, where luck can play a big part in results particularly over the short term.

3. What did you learn last year that most surprised you

I was surprised by how many questions we received about the latest newsworthy float being flogged by brokers. That vendors get to dress the business up for sale, choose the best time to sell and aim to get the highest price possible for their shares seems to be ignored by many, even though it is precisely these attributes which minimise your chances of making decent returns from IPOs. A good rule is to avoid all floats (and especially those from private equity), with notable exceptions being any government asset being sold and some spinoff-type floats like South32.

Andrew Legget, analyst

1. Book of the year

The Undoing Project by Michael Lewis, about two of the world’s most famous thinkers on behavioural biases and cognitive psychology. I am a big Lewis fan, especially enjoying Moneyball and The Big Short. He has a knack for making complex topics entertaining and easy to understand.

2. What did you learn last year that most surprised you?

Like James, I was surprised at the way markets reacted to events such as Brexit and the US election, both considered unlikely. After the shock subsided markets seemed to return to plugging along like nothing had happened. I remember looking over our coverage list of stocks that could be upgraded to Buy in the aftermath of these events only for most to fail to reach their trigger price. Not all bad news delivers bargains.

Editor’s Note: Andrew, like James Carlisle, also nominated Reece for most memorable recommendation of the year.

Staff members may own securities mentioned in this article.

The bidding for Woolworths' Petrol business is over and BP, rather than Caltex, has won. What does this mean for Caltex?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 10 JANUARY 2017

Caltex outgunned by BP

Woolworths has finally sold its petrol retailing arm with BP beating out larger rival, Caltex. BP will pay $1.8bn for Woolies' 527 retail fuel sites and 16 development sites.

Key Points

- ***BP buys Woolies' Petrol business***
- ***Caltex will lose a large supply contract***
- ***Caltex valuation falls slightly***

CALTEX AUSTRALIA (CTX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$30.21	6%	Low–Med	Low–Med

BUY Below $30.00 | HOLD | SELL Above $40.00

$30.21

The sale will also include a long list of conditions to allow Woolworths to maintain its 4-cents a litre fuel discount and other concessions. It's a higher price than expected and we have mixed views on the outcome.

To many, this is a surprise. Caltex is the existing fuel supplier to Woolies' network and made the initial approach to buy it. With scale benefits, existing supply infrastructure and better information, we are surprised it was outbid by BP.

Yet there are several reasons it lost this contest. Among them is the ACCC, which made it clear it would view an expanded Caltex with suspicion and, perhaps more intriguingly, Woolworths had its own strategic reasons.

Small wars

The beleaguered Woolworths has targeted smaller format Metro stores as a source of growth and aims to replicate its supermarket dominance in the convenience sector. Caltex aims to do the same with its retail format so Woolies was careful not to give a strategic rival any help.

It's also worth noting that Woolworths' network includes no property and comes with strict trading conditions that would have been difficult for Caltex to match. There is no doubt the ultimate price is a good deal for Woolworths.

There are several implications from the deal. For one, Caltex will almost certainly lose the 3.5bn litre fuel supply agreement with Woolworths. That will hurt earnings and, by lowering volumes through a fixed cost supply chain, marginally lower efficiency.

Caltex has made no indication of how much it would lose but we can take a stab at the sum. If we assume a margin of 2c per litre, the Woolworths contract would have generated about $70m in EBIT. Add in efficiency losses and the total loss might be around the $80m mark.

That's enough to lower our base case valuation from $32 a share to about $29 a share (see ***Caltex: refined and redefined***). That assumes no change to debt levels and doesn't take into account additional profit from acquisitions which would lift value to around $30 a share.

The combination of Caltex and Woolworths Petrol would have built an industry giant with greater scale than any peer. It's a shame it won't happen.

Going shopping

Caltex retains a strong balance sheet and cash flow. Attention will now turn to how it will utilise those resources. With over $1bn of franking credits available, higher dividends are likely and management has signalled they would reinvest cash in infrastructure to cement their distribution advantage.

The company has also committed to buying a fuel retail network in New Zealand and will pursue growth of non-fuel sales through its store network.

We would have preferred Caltex to win the bidding but not at any price. Too often, modest revenue growth and high cash flow encourages silly pursuits. That has not happened here.

There are headwinds for Caltex – the often cited rise of the electric car being the most obvious – but the business boasts the management track record and the financial resources to respond to that threat.

The loss of the Woolies contract lowers our price guide marginally, enough to earn a downgrade, but this is still a high quality retailer trading at a mild valuation. We are close to a Buy but are willing to be patient. **HOLD**.

Staff members may own securities mentioned in this article.

The collapse of Theranos shows the danger of investing in start-ups and why Sonic still dominates the pathology industry.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 11 JANUARY 2017

Sonic Healthcare: Lessons from Theranos

As analysts, we're used to dealing with 'truthiness' in management presentations. Statements may be accurate in spirit, but not quite backed up by the facts and figures. It benefits most companies to over-report the number of customers they have, for example, or to talk up what a product can do.

Key Points

- ***Beware unproven technologies***
- ***Industry cost structure may protect incumbents***
- ***Overpaying for hope rarely ends well***

SONIC HEALTHCARE (SHL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$21.94	5%	Low–Med	Medium

BUY Below $18.00 — HOLD — SELL Above $30.00

$21.94

So a story about a medical start-up exaggerating its strengths, then collapsing when regulators probed behind the curtain, wouldn't normally be noteworthy. Pathology provider Theranos, however, was not your typical start-up.

Founded by 32-year-old Elizabeth Holmes, the company claimed it could perform 250 or so different pathology tests but – rather than using a full-sized syringe – its technology allowed for the collection of just a few drops of blood with the prick of a finger.

Turnaround times were also said to be industry-leading, with patients getting results in a matter of hours rather than days, and costs were expected to be less than half that charged by competitors, such as Sonic Healthcare – the largest pathology provider in Australia, with a 42% market share, and the fifth largest in the US.

Sonic looked like a sitting duck. Nonetheless, a little over a year ago in ***Will Theranos destroy Sonic Healthcare?*** we explained why investors shouldn't fret. 'You should probably hope that Theranos does succeed in disrupting the pathology industry. In your head, however, you should suspect it will fail.'

What we didn't see coming was just how spectacular that failure would be. In March last year, **research was published** that suggested some of Theranos's tests were unreliable. Then the company's main lab in California failed an inspection by health regulators, who promptly revoked its licence to operate. Following accusations of potential fraud, the company's visionary founder – often branded the Steve Jobs of healthcare – was then banned from the blood-testing industry for two years. Theranos's valuation has fallen more than 90% **from US$9bn to around US$800m**. What can investors learn from all this?

Investing personality

The most obvious lesson is to beware the cult of personality. Elizabeth Holmes really was a gem to listen to, brimming with energy, intelligence and hope. You wanted her to succeed.

On top of this, the company's board of directors was among the most illustrious in the corporate world – it contained military generals, two former Secretaries of State and one ex Secretary of Defence, a former director of the US Center for Disease Control and two US senators. Surely, these titans wouldn't put their reputations on the line unless they saw genuine opportunity? Still, they were gamed too, which was probably made easier by the fact that the board of this pathology company lacked any actual pathology experts.

Good management undoubtedly adds value to a business, but being able to distinguish between good management and charismatic management isn't easy. At Intelligent Investor, you can count on one hand the number of companies we're willing to pay a premium for due to good management (and perhaps have a few fingers to spare).

Too good to be true

The next lesson is the old aphorism 'if it's too good to be true, it probably is'. The main arguments we made against Theranos didn't centre on its management – admittedly, even we were impressed by the celebrity directors and charming chief executive.

> **Theranos is an example of why we steer clear of any medical company whose therapy or technology hasn't been peer-reviewed and approved.**

Where we did see holes in the story was the technology itself and its ability to disrupt the industry as quickly as claimed.

Theranos was highly secretive and didn't provide its tests for peer review. The company had one test approved by the US regulator, but more than 130 were yet to gain approval. Maybe the business really did have a ground-breaking universal technology, maybe it didn't: the point is that it was just too early to tell.

Theranos is an example of why we steer clear of any medical company whose therapy or technology hasn't been peer-reviewed and approved. There's a grand canyon between a researcher shouting 'eureka!' and a commercial product. We'll stick to companies with proven track records of profitability.

What's more, after accounting for IT, delivery and processing, direct testing expenses are only a minor part of Sonic and Theranos's total operating costs. We doubted that Theranos's prices could be significantly lower than industry standards, even if its technology required less blood for testing. The lesson here is to look at a service's whole cost structure when considering new competition – Sonic has an established network and significant economies of scale, making it difficult for start-ups to match on price.

Diversification is valuable

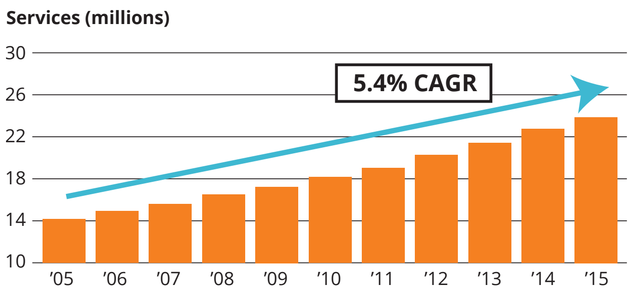
Sonic may not have the charisma of a start-up like Theranos, but it has armour Theranos lacks: a diverse range of services. Sonic offers 3,000 tests compared to Theranos's menu of 250. Even if, for the sake of argument, all Theranos's claims *were* true, it would still have been a long road before it could match competitors on the range of tests.

And if one day it did, that still wouldn't mean Sonic was doomed. Pathology is Sonic's big money spinner, but it also has a network of GPs and diagnostic imaging practices that contribute around 17% of revenue.

Diagnostic imaging, in particular, has clear and decent growth prospects, with industry volumes growing at 5% a year over the past decade and fee revenue growing at 7% a year (see Charts 1 & 2).

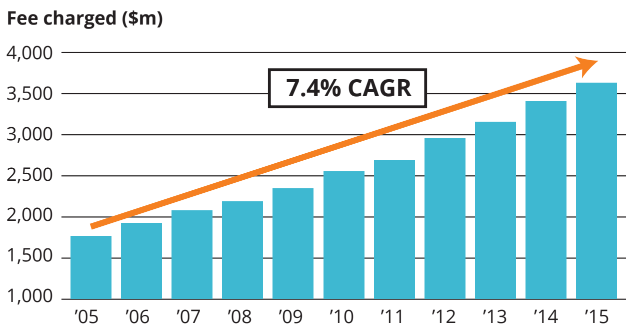
Sure, had Theranos panned out, the pathology industry may have faced some headwinds but the lesson here is don't throw the baby out with the bathwater when it comes to individual companies: differentiated services and unrelated segments could reduce much of the risk.

Chart 1: Diagnostic imaging volume growth



Source: Medicare, UBS

Chart 2: Diagnostic imaging benefits growth



Source: Medicare, UBS

Overpaying, the ultimate sin

In the winter of 1998, Sonic's largest competitor, **Primary Health Care**, listed on the ASX at $1.40. The stock nearly quintupled to $6.55 over the following two years as investors began to appreciate the enormous opportunity before them: an ageing population, economies of scale in a growing industry, and a revolutionary business model of low-cost, 24-hour medical clinics. Surely this company was going to be big.

> **Where they went wrong was in overpaying for that future growth.**

Unfortunately, things didn't go well for those early investors; today, the share price is still 39% below its 2000 peak. But here's the kicker – in the 18 years since it listed, Primary's revenue increased 44-fold, with net profit growing from $4m to $75m. Those ebullient early investors had been absolutely correct in their forecast of an increasingly profitable company. Where they went wrong was in overpaying for that future growth.

Was Theranos really worth US$9bn – 50% more than Sonic – despite practically no revenues, no profits, and a black-box technology nobody could explain? The future is always uncertain so it was impossible to know for sure, but there aren't many historical precedents for that situation working out well for investors.

Sonic achieved revenue of $5.0bn in the 2016 financial year and $451m in net profit. Management expects operating earnings to grow 5% in 2017, putting the stock on a forward price-earnings ratio of around 19.

The Theranos saga is a reminder that it pays to keep things simple. With a commanding market share, various competitive advantages and economies of scale, there's every reason to believe Sonic Healthcare will still dominate the Australian pathology market 10 years from now. We're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

This cement manufacturer and importer has produced good returns in a tough sector, although it won't be immune from the cycle forever.

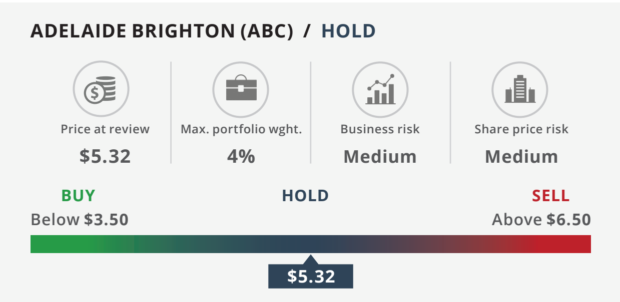
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 12 JANUARY 2017

Adelaide Brighton: laying foundations

Pop quiz: What's the difference between cement and concrete? 'Who cares?', you might say, but the difference helps explain why Adelaide Brighton, Australia's second largest cement manufacturer, is a better business than its 'building materials' classification suggests.

Key Points

- ***Favourable industry structure***
- ***Earnings supported by sequential booms***
- ***Very profitable lime business***



When mixed with water, cement is the glue that binds concrete together. It comprises only 10–20% of the volume of concrete although, as a vital but energy-intensive ingredient, it's a greater proportion of the cost. The remaining components of concrete are aggregates such as sand and gravel or crushed stone.

If your eyes are starting to glaze over, perhaps a New Idea-like exposé of the inter-connected nature of the Australian cement industry will re-gain your attention. The industry is almost more incestuous than the ancient Egyptian royal family.

Because cement is a key ingredient of concrete that's usually uneconomic to transport long distances, Adelaide Brighton's building materials competitors tend also to be customers and suppliers. The aggregates produced by major cement competitor **Boral** might be mixed with Adelaide Brighton's cement to produce Boral concrete, for example.

Tangled tale

Cement Australia, the nation's largest cement manufacturer and a largely eastern states joint venture between European companies Heidelberg (Hanson) and LafargeHolcim, is a customer of Adelaide Brighton in South Australia and Western Australia. Then there's the fact that Adelaide Brighton has a Victorian distribution joint venture with its 35% shareholder Barro Properties as well as a Queensland joint venture with Boral. It's all very complicated.

As Cement Australia, Adelaide Brighton and Boral hold more than 90% of the cement manufacturing market – and rely on each other as suppliers and customers – the industry is probably best described as 'gentlemanly'. The complementary nature of the materials required to produce concrete and the industry structure mean there is little incentive to engage in cutthroat competition.

No wonder the ACCC knocked back Boral's $1.55 a share takeover bid for Adelaide Brighton back in 2004. If there was any industry where three players becoming two might lead to a 'substantial lessening of competition', it's this one. Boral sold its 18% stake in Adelaide Brighton in 2009 at $1.95 a share but its corporate judgement has never been particularly astute. These days the stock is around $5.30.

Speaking of judgement, when it comes to Adelaide Brighton, our own hasn't been any better. We've historically lumped Adelaide Brighton in with other building materials companies when, in truth, some are more equal than others. In our defence, though, unlike Boral we don't live and breathe cement.

Our more recent analysis of the industry suggests that the previous Avoid recommendations on Adelaide Brighton – **see this one** from 26 March 2013, for example – have been too harsh. Since then the stock has risen a not inconsiderable 52%.

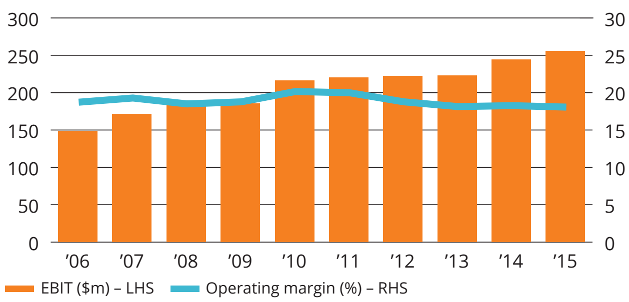
Rock-solid

The long-term financial history of Adelaide Brighton – see Chart 1 – shows it to be a solid performer. Over the past ten years, earnings before interest and tax have risen steadily. The only time sales and earnings fell in that period was during the 2009 global financial crisis but it wasn't a serious downturn. Margins actually rose.

> **“ And Adelaide Brighton is better than average, partly because its business is not just building materials.**

In fact, operating margins have been surprisingly consistent at above 18% – high in this sector but the company's lime business is extremely profitable (more on that shortly). Even free cash flow has been pretty decent over the years, mainly because cement manufacture doesn't require significant new investment in plant or technology. In fact it hasn't changed hugely since English bricklayer Joseph Aspdin took out a patent for manufacturing cement in 1824.

Chart 1: Earnings and margins



Source: Company reports

Adelaide Brighton's consistency might suggest our previous concerns about an eventual cyclical downturn have been misplaced. Indeed, its financial history fits **Peter Lynch**'s definition of a '**stalwart**' pretty nicely.

For all that, though, here's our current view. Adelaide Brighton is still cyclical; it's just that cement demand cycles have been obscured by a rolling series of booms over the past decade.

Boom-boom-boom

First up was the resources boom. As that petered out a few years back, the Reserve Bank engineered a switch to a housing construction boom. Now that the five-year long apartment construction boom is tailing off, some of the slack should be taken up by infrastructure development. Various road and rail projects are planned or underway around Australia – and they'll need a lot of cement.

With this sort of demand – and growth? – baked in, it's no wonder that Adelaide Brighton is trading on a 2016 forecast price-earnings ratio of 18 (it has a calendar year-end). But earnings are a little inflated by property profits – management forecasts property disposals will contribute $7m to the $190m–$200m net profit expected for the 2016 year.

With another $120m of property sales to support profits over the next decade, the company is also paying out special dividends – 13 cents over the past eighteen months. A time of buoyant conditions – which often goes hand in hand with special dividends – is not in our experience the time to be buying a building materials company, even a better than average one.

And Adelaide Brighton is better than average, partly because its business is not just building materials. The company is also Australia's largest producer of industrial lime, which is used mainly in the alumina and gold industries.

Sweet lime

Whilst the profitability of the lime business is not disclosed (it's conveniently hidden within an obfuscatory 'Cement, Lime, Concrete and Aggregates' segment), it's certainly a much greater proportion of earnings than its 12% of revenue would suggest. Hence why one of management's three main growth strategies is to 'grow the lime business'. This could be a significant source of earnings growth – and a high margin one at that (think 40% operating margins).

Adelaide Brighton has its attractions and may continue to defy the cycle for some time yet, but we can't get comfortable with the price. It's certainly not cheap at 18 times earnings and almost three times book value. International competitors such as LafargeHolcim and Heidelberg Cement trade at close to book value.

Our price guide is deliberately wide because the range of outcomes is too (we're likely to adjust the guide over time). Earnings might keep growing for a few years yet, but they could also be close to a peak if the infrastructure boom proves less profitable than the housing one.

In summary, the stock is closer to a Sell than a Buy, and it's one where you should keep your portfolio weighting reasonable (we suggest no more than 4%). Adelaide Brighton is however a decent enough business to **HOLD**.

Staff members may own securities mentioned in this article.

Our annual review of the top investing resources the net has to offer.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 5 JANUARY 2017

Best value investing resources for 2017

In *The Art of War*, Sun Tzu proposes that 'Every battle is won or lost before it is ever fought.' Investing can be highly rewarding – both financially and intellectually – but it also carries risks. Before putting your money to work it's important to do a little reading first. Your analyst team is constantly on the lookout for new and insightful value investing resources and below is an updated list of our favourites for 2017. The **education section** of our website is also filled with useful information.

As always, if there are any other online sources, articles, Facebook or Twitter accounts you find useful then please feel free to drop the details in the comments section at the bottom of the page.

Australian business news

- ***The Australian Financial Review*** (**@FinancialReview**) – This is daily required reading for any Australian investor.
- ***Business Spectator*** (**@BusinessSpec**) – a valid alternative to The Australian Financial Review, though unfortunately no longer free.
- ***The Sydney Morning Herald*** (**@SMH**) and ***The Age*** (**@theage**) – these broadsheets are becoming less relevant, but we still look at them every day.
- ***The Australian*** (**@australian**) – has become more relevant since its tie up with The Wall Street Journal.
- ***MacroBusiness*** (**@macro_business**) – coverage of what's driving the Aussie economy, plus general coverage of the local business environment.
- ***LivewireMarkets*** (**@LivewireMarkets**) – a new and great stream of commentary from financial leaders on what's happening in the markets.

International news

- ***The Wall Street Journal*** (**@WSJ**) and ***Financial Times*** (**@FinancialTimes**) are wonderful international newspapers. Much of the good stuff is for subscribers only, but we don't mind paying up for high quality content.
- ***Quartz*** (**@qz**) is my personal favourite. If you like reading The Economist each week, you'll love a little Quartz each day.
- ***Value Walk*** is a great news feed for value investing specific articles, or check out Value Investing World for a constant feed of links to interesting articles from around the web.
- ***The Economist*** (**@TheEconomist**) is without equal when it comes to a weekly update of the world and financial news that matters most. ***The New York Times*** (**@nytimes**) also has impressive business reporting.
- For following the 'news flow', we use ***Bloomberg*** (**@BloombergNews**), ***Yahoo Finance***, and ***Google Finance***.
- Traditional finance magazines like ***Fortune*** (**@FortuneMagazine**) and ***Forbes*** (**@Forbes**) are worth a look and ***Bloomberg Businessweek*** is a favourite of analyst Gaurav Sodhi.

Prominent value investors

- **Guru Focus** (**@gurufocus**) is an aggregator site for information on respected value investors, as is **Greenbackd** (**@Greenbackd**).
- **Berkshire Hathaway** is the source for Warren Buffett's wonderful annual letter to shareholders.
- There are many fund manager websites worth visiting, but we've highlighted the following because of the excellent content they make available to all – **GMO** for the research and commentary Jeremy Grantham provides, Kerr Neilson's **Platinum Asset Management**, **Hussman Funds** for a weekly Grantham-esque style market update, and our friends at **Forager Funds Management** (**@ForagerFunds**).

Investing newsletters (subscription services)

- ***Intelligent Investor*** (**@value_investing**) and ***Eureka Report*** – Naturally, we recommend these newsletters for Australian stock research.
- ***Grant's Interest Rate Observer*** (**@GrantPub**) is focused on interest rates and economic issues with a contrarian bent.
- ***Value Investor Insight*** (**@VILetter**) covers similar ground but is published more regularly.

> **Before putting your money to work it's important to do a little reading first.**

- The ***Graham and Doddsville newsletter*** from Columbia Business School is an excellent quarterly read and is free.

Investing podcasts/videos/other

- Of course, none of our analysts ever miss an episode of ***Intelligent Investor* podcasts**.
- Never dry or dull, **Planet Money** explains tumultuous economic events in ordinary language.
- Give **Slate Money** a go if you like your podcasts short and feisty and **Startup Podcast** if you're starting a new business.
- **Econtalk**, a favourite of our founder, John Addis, is about 'how the essential insights of economics can help us understand the world around us and lead better lives'. It's out of date now, but still worth a listen.
- The Financial Times' **Alphachat** produces an interesting podcast.
- Tune in to **Boardroom Radio** (**@boardroomradio**) or **Open Briefing** (**@openbriefing**) for a range of presentations/briefings from Australian companies.
- The **Manual of Ideas** is another great source for overseas ideas, often from prominent investors. Check out their **youtube** channel too.
- If you like a broad range of topics, from botany to corporate strategy, check out the expert talks at **TED.com** and, a new personal favourite, **BigThink**.
- One of the most useful tools I've come across is **investorpa.com**, which sends company announcements straight to your Inbox, and don't forget **InvestSmart** for helpful portfolio monitoring tools.

Favourite Twitter accounts

Wondering who to 'follow' on Twitter? Here's a few of our favourites.

- **@WarrenBuffett** – Sure he's only sent out nine tweets, but how can you be a value investor and not follow Mr Buffett?
- **@ConversationEDU** – Academics often write stuffy, excessively complicated papers that no layman can understand. The Conversation seeks to change that, with shorter more 'journalistic' articles from our country's brightest.
- **@ForagerFunds** – always insightful commentary from Steve Johnson and the team.
- **@ABSStats** – Wondering what's happening in Australia? The ABS is a wonderful (free) source of stats about our country, plus the guys who run the twitter account **are hilarious**.
- **@John_Hempton** – John runs **Bronte Capital**, where he specialises in accounting frauds, one of the sharpest minds in the game.
- **@danariely** – Dan Ariely is Professor of Psychology and Behavioural Economics at Duke University. He also writes an interesting and entertaining blog **here**.
- **@DanielPink** – Dan Pink is a US-based author and public speaker. He's written extensively on behavioural science and how incentives should be applied in the workplace.
- **@mungerisms** – Excellent quotes, facts and links on value investing.

Ceasing coverage on Automotive Holdings

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 9 JAN 2017

AUTOMOTIVE HLDGS GROUP (AHG) / CEASING COVERAGE

Price at review **$3.91** | Max. portfolio wght. **N/A** | BUY HOLD SELL

In ***Automotive Holdings: Result 2016***, we downgraded the recommendation to Sell on concerns about the company's refrigerated logistics division, management changes and regulatory reviews of the industry by ASIC. Since then the stock has declined 16%, although it's not cheap enough for us to consider upgrading.

If the stock falls significantly, or some of our concerns are resolved, we might consider re-commencing coverage on Automotive Holdings (including, perhaps, competitors such as **AP Eagers** or new listing Autosports) in the future. But to make room for more prospective opportunities, we're **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

Bellamy's trades again

BY PHILIP BISH • INTELLIGENT INVESTOR • 11 JAN 2017

BELLAMY'S AUSTRALIA (BAL) / UNDER REVIEW

Price at review **$5.35** | Max. portfolio wght. **N/A** | BUY HOLD SELL

After a one-month suspension, Bellamy's resumed trading today with its shares closing 20% lower at $5.35.

Revenue for 2017 is forecast to be in the range of $220m to $240m with EBIT expected to be between $22m and $26m. Inventory levels have now ballooned out to between $105m and $110m.

The EBIT forecast was adversely impacted by the renegotiation of key contacts with suppliers, which is expected to result in Bellamy's paying shortfall payments of between $11m and $13m each year for the next two years.

Laura McBain will be leaving the company, to be replaced in the interim by Chief Operating Officer Andrew Cohen.

We will review the announcement in further detail, and provide an update early next week. In the meantime the company is **UNDER REVIEW**.

Disclosure: The author owns shares in Bellamy's.

IOOF downgraded

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 11 JAN 2017

IOOF HOLDINGS (IFL) / HOLD

Price at review **$9.34** | Max. portfolio wght. **7%** | BUY Below **$9.00** HOLD SELL Above **$14.00** | **$9.34**

The share price of IOOF Holdings has increased more than 13% since we recommended the company in IOOF dodges the lynch mob (Buy — $8.28) on 11 January 2016 and is now well above our buy price of $9.00. As a result, we are downgrading our recommendation on the company to **HOLD**.

Staff members may own securities mentioned in this article.

Ceasing coverage on SAI Global

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 9 JAN 2017

SAI GLOBAL (SAI) / CEASING COVERAGE

Price at review **$4.74** | Max. portfolio wght. **N/A** | BUY HOLD SELL

In December, SAI Global shareholders voted for the scheme of arrangement. You should now have received your takeover consideration of $4.75 a share (contact the share registry if you haven't). We're **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

Sale of Woolworths' fuel business

I am interested in your thoughts on the WOW petrol sale to BP. It seems to me like this was almost a quasi capital raising in that they achieved a beefed up sale price in place of keeping some of the costs involved.

Usually when one sells a business they will sell it all - that is the revenue it generates along with the costs as well. Yet in the statement to the asx it has the following "The Fuel Business reported sales of $4,611.8 million in FY16 with EBIT before significant items of $117.8 million. Included in the FY16 EBIT are overhead and other costs that will remain with Woolworths following the completion of the transaction of $13 - $19 million... Also included in the FY16 Fuel Business EBIT is the cost of funding the full 4cpl fuel discount offer of approximately $70 million (excluding GST) in FY16. Upon completion, Woolworths will equally fund the 4cpl fuel discount offer with BP."

WOW is retaining approx. 16M of costs of the 118M EBIT it makes.... What the??? and to add to that it will fund half the 4c discount. It seems they have structured the deal so they get more cash up front (i.e the quasi capital raising) than the entity was worth (book value) so they could more easily fund their cap ex going forward (i.e. lowering prices to better compete, store refurbs etc etc) along with strengthening their balance sheet to ensure credit ratings and covernants are intact.

I read this deal as WOW wanting/ needing extra cash to fund their transformation that is not going quite as expected/planned (read as being more expensive/bigger cash drain than originally planned). What do you guys think?

12 Jan 2017 – **James Greenhalgh**: I agree the sale of the fuel business has effectively taken the place of a capital raising (something I highlighted as possible in ***Woolworths – competition cuts in Part 1***). With nothing else really available to raise a chunk of money (Big W will take years to turnaround and Woolworths would not get full value for it yet), the fuel business was the most obvious candidate to help raise some cash. With the ACCC putting the kibosh on fuel discounts greater than four cents a litre some time ago, it isn't really necessary for Woolworths to own a petrol business any more anyway.

When you add back the overheads and the cost of the fuel discount to the $118m of earnings, the price equates to about the same multiple that Caltex trades on, so the $1.8bn raised from the sale seems about right to me. It's probably a little better than expected given BP will share the cost of the fuel discount in future (BP should get a volume benefit from having a discount system in place). Admittedly Woolworths food business will now incur (half) the cost of funding the petrol discount, so I suppose you could see this juggling of costs as helping to boost the cash proceeds.

Otherwise I don't read anything sinister into Woolworths keeping some of the overhead cost. In fact this is pretty normal in business sales where there is some cross-subsidy across businesses. As the fuel and food/convenience operations apparently share some staff and systems, it's not necessarily easy to separate them easily. I can't remember specific instances, but I've definitely seen vendors retaining some overhead cost in other transactions.

You might be right about the transformation not going smoothly (it's likely to be a long road, as we've said). But I'm not sure it's specifically evident from this transaction (I like your skepticism though!). It's been pretty clear to the market that Woolworths should raise capital somehow, and the sale of the fuel business seemed the best way to do it. All up, I'm pretty happy with the way things are working out so far, although there might well be setbacks.

Oil production / shale oil thesis

Keen to hear an update on whether your global oil production / shale oil thesis is still on track, and what do you perceive as potential impacts (if any) of Trump Presidency on US production levels. Considering the above, how close do you think BHP & WPL are to fair value at present?

8 Jan 2017 – **Gaurav Sodhi**: That is certainly a large question. Shales have been holding up better than expected with costs continuing to defy expectations and getting even lower. The new figure I've seen is around US$55/bbl for breakeven from US shale but we will see how much cash flow is made at that level. One big problem is no consistent or accurate accounting of these figures. Output from shales has declined but, in the Permian shale, rigs are back and output could go higher. It hasnt been as bad as we had expected.

Interestingly, BHP has become probably the best driller in the Permian and is performing well there. The oil division recently made a decent acquisition in the Gulf of Mexico. BHP will report excellent results come Feb unless something drastic happens. WPL is becoming less an oil related stock and more LNG and gas. It appears that LNG and oil may end their long link and WPL will be a low cost LNG business more than anything else. I think both are Holds at current prices with iron ore the big unknown for BHP.