Weekly Review

RESEARCH

– Issue – 14 Oct. 2016

Sterling's flash crash shows we're not yet out of the woods on Brexit, but the threat of a Trump presidency seems to be receding.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 10 OCTOBER 2016

Portfolios bounce back after Brexit

What a difference a few months makes. Markets took a hammering right at the end of the 2016 financial year thanks to the **Brits' decision to leave the European Union** – and took our portfolios down with them – but three months of mostly sober reflection have reassured investors that the world is not about to end.

Key Points

- ***Portfolios outperform strongly***
- ***Reporting season favourable***
- ***Well placed for long term***

Last week's 'flash crash' – where sterling fell 6% against the US dollar in a matter of minutes – shows that the UK isn't out of the woods yet, but markets are taking the view that any damage is likely to be contained. Meanwhile, the greater threat to global stability – a Trump presidency – appears to be receding.

The All Ordinaries Index returned 5.3% for the three months to 30 September, but our portfolios came in well ahead of that, with the **Growth Portfolio** gaining 13.1% and the **Equity Income Portfolio** gaining 11.4%.

Since they opened their doors to investment in July 2015, they have generated annualised returns of 21.7% and 19.6% respectively, compared to 5.9% for the All Ords; and since inception as model portfolios 15 years ago they have returned 11.0% a year and 13.7% a year respectively, compared to 7.9% a year for the All Ords.

Growth Portfolio

The **Growth Portfolio**'s top performer for the September quarter was **South32**, which gained 57% as investors anticipated and were delivered an **excellent full-year result**. Although the headline loss was a whopping US$1.6bn it was mostly due to asset writedowns and operating cash flow actually jumped more than 50% to over US$1bn.

Nanosonics was also up strongly, gaining 55% after delivering its **first annual profit**. Management reported that sales of its Trophon probe sterilisers jumped 74% in the key North American market and noted that it is now being used in 48 of the top 50 US hospitals. The installed base is particularly important because it drives recurring sales of high-margin disinfection cartridges.

Hansen Technologies is another fast grower, and it duly **delivered a 40% rise in revenue** for 2016 and a 43% rise in earnings per share. It was enough to push the stock up 39% for the quarter and it has now tripled since it was added to the (then model) portfolio two years ago.

Other notable performers were **Monash IVF** and **Amaysim**, with gains of 38% and 33% respectively.

Set against these high-fliers was a horrible performance from **iCar Asia**. At the end of June it had been plodding along nicely towards its targeted breakeven in 2018, at what now looks like a very distant share price of 85 cents. Then **receipts for the June quarter fell short** of expectations, before the

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company **warned on 2016 losses**, abandoned its breakeven target and **raised capital**. All that knocked the stock down to 29 cents at the end of September, handing us a 66% loss.

The only good news is that we began all this with a weighting of only 3%, so the damage has been limited. With the path to profitability now much less clear, iCar has become decidedly more speculative and that's discouraged us from buying more, although we're content to hang onto what we have.

Table 1: Growth Portfolio 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

OFX Group (formerly OzForex) was another significant faller, losing 18% as investors fretted over increased competition in international payments – including an agreement between **Commonwealth Bank** and the UK's Barclays Bank – and potential disruption from 'blockchain' technology. The stock looks cheap at current prices but, again, given the risks involved we're content to sit on our hands.

The Growth Portfolio's only **disposal** in the quarter was the one percentage point reduction of Trade Me on 1 September at $5.32; and the only purchase was the use of those funds to increase our holding in Amaysim at $2.04.

We remain very comfortable with **Trade Me**, but its weighting (at 8.5%) had moved well beyond our 6% recommended maximum and we were keen to increase our investment in Amaysim after an **excellent full-year result** showed that our investment case is on track, with subscribers growing strongly and margins expanding.

You can see a full list of holdings on the **Growth Portfolio's homepage**.

Equity Income Portfolio

Our **Equity Income Portfolio**'s best performer was also South32, which benefited from an excellent result, as described above.

South32's former parent, **BHP Billiton**, also performed well, returning 21% despite a **headline loss** for 2016 of US$6.4bn. As with South32, the loss was due to writedowns forced by past mistakes of capital allocation, but the underlying net profit of US$1.2bn was a decent effort given weak commodity prices. New management continues to make strides at recuperating the big miner.

The portfolio's other top performers were Monash IVF and **Ansell**, with gains of 38% and 28% respectively. Both companies reported full-year results that suggested past difficulties were behind them.

Monash saw a 12% increase in IVF cycles in Australia, increasing its market share from 23% to 24%, and a 10% increase in cycles in its nascent Malaysian business. Price rises meant that revenue rose 25%, while a slower rate of cost growth meant that net profit increased by 35%.

Table 2: Income Portfolio transactions

DATE	STOCK	% BOUGHT/(SOLD)	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	CBA (CBA)	3.0	$71.60
1 SEP 16	Westpac (WBC)	1.5	$29.55

Ansell, on the other hand, saw **profits go backwards**, with revenue falling 4% and net profit down 15%. That was, however, at the upper end of the **guidance provided in**

"The good news is that any increase in rate expectations is likely to be accompanied by improved prospects for growth.

February, which caused the stock to fall 20% and prompted us to buy. Growth is expected to return this year and the market also cheered plans to sell the company's condoms division to focus on its other operations (mostly gloves) that sell to businesses rather than consumers.

The only significant faller in the quarter was OFX Group (formerly OzForex), which lost 18% as described above.

On 1 September we **reduced some of our largest holdings** – Trade Me by 2.0 percentage points to 6.6% (at $5.32), and **ASX** (at $51.51) and **Virtus Health** (at $7.92) each by 1.0 percentage points, to 6.3% and 4.3% respectively. The funds (and some cash) were used to increase our holdings in Commonwealth Bank by 3.0 percentage points to 5.2% (at $71.60) and **Westpac** by 1.5 percentage points to 3.8% (at $29.55).

We remain comfortable with Trade Me, ASX and Virtus, but wanted to bring their weightings down after share price increases. Commonwealth Bank and Westpac are both Holds, but were (and still are) close to their Buy prices and are particularly well suited to an income-focused portfolio due to their high fully franked dividend yields.

You can see a full list of holdings on the **Equity Income Portfolio's homepage**.

Greatest threat

In spite of the excitement (or perhaps horror) around Brexit and Trump, the greatest short-term threat to our portfolios – as for markets generally – is that interest rate expectations rise. That would force investors to raise the 'opportunity cost' they put into their valuation models and knock down their valuations accordingly.

The good news is that any increase in rate expectations is likely to be accompanied by improved prospects for growth. Both our portfolios are largely comprised of stocks that add value and enjoy plenty of pricing power, and that should enable them to take their share of any growth that eventuates.

As ever, the sharemarket could see some sharp movements in the short term as investors adjust their expectations for rates and growth. But that's the penalty for being in an asset class that tends to outperform others over the long term. We see no reason for that to change.

*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 Amaysim, iCar Asia, OFX Group, Trade Me, ASX, Woolworths and GBST.

Staff members may own securities mentioned in this article.

Trade Me has a new competitor (of sorts). Could the 800-pound gorilla of social media crush the Kiwi classifieds site?

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 12 OCTOBER 2016

Trade Me and Facebook square off

In March last year British classifieds website Gumtree – owned by eBay – pulled out of New Zealand. The reason was unstated but clear as crystal – Trade Me is just too dominant. If Kiwis want to sell stuff, they know there will be more buyers on Trade Me, even if it costs them about 8% of the sale price.

Key Points

- ***Facebook Marketplace is a 'new' free classifieds venue***
- ***Facebook's network effects represent some threat***
- ***Trade Me likely to remain dominant long term***

TRADE ME (TME) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.94	6%	Medium	Medium

BUY	HOLD	SELL
Below $5.25		Above $7.50

$4.94

Trade Me's dominance, not to mention its ubiquity, is why it's such a great business. But it's not bulletproof. As we said in our August upgrade in ***Trade Me: Result 2016***: 'there's the ever-present risk that a new or existing competitor tries to take market share'.

Facebook's recent announcement that it has launched 'Marketplace', a forum for trading goods, in the United States, the United Kingdom, Australia and New Zealand is an example of a new competitor. Except Facebook Marketplace is not really a new competitor at all, but more about that in a moment.

The threat of Facebook's 1.7bn users selling stuff to each other was enough to cause eBay's share price to fall 3% after the announcement. In a delayed reaction, Trade Me shares have since fared worse, with the stock down by almost 10% from recent highs (and 5% from our most **recent review**). Is it time to panic?

No frills

To answer that question, let's consider what Facebook Marketplace is – and what it isn't. It's a free, no-frills classifieds service that's currently offered through Facebook's mobile app to over-18s only. It's primarily designed to help you buy or sell stuff near you.

Marketplace isn't likely to become a direct revenue-generation tool for Facebook. Instead, your activity – including what you buy, sell or even view – will presumably be used to sell you advertisements. (Remember: If the product is free, you're the product.) Facebook Marketplace, then, is designed to keep you within the Facebook ecosystem for the purpose of gathering better data on you.

Just like the Australian classifieds sites, Trade Me has always competed with free listing venues such as craigslist and Gumtree. Kiwis may also have heard of postanote.co.nz. So Facebook Marketplace is just another free listings venue, although its powerful network effects mean it should be taken seriously. Trade Me's management doesn't have its head in the sand, recently stating that it has a 'healthy degree of paranoia' about the potential impact of Facebook on its business.

It's worth noting you've always been able to sell stuff on Facebook, and that this new venue just formalises it – for the second time. Facebook launched an earlier version of Marketplace in 2007, although it didn't take off. And around 450m people already use Facebook 'buy and sell groups' every month. So the latest version of Facebook Marketplace isn't really a 'new' venue at all.

Is free too expensive?

There are also various disadvantages with free listing venues. They're no frills, so they usually lack features. They don't facilitate payments or logistics, nor is there a feedback facility. And because they're free and light on regulation, there can be safety and security issues. Already there have been reports of fraud by people using Facebook Marketplace, as well as illegal items for sale.

> “We often say you rarely get buying opportunities without a little bad news.

But perhaps Trade Me's most significant advantage compared with Facebook Marketplace is the obvious one. It's a well-trusted existing classifieds venue where people go to buy and sell stuff. Facebook isn't.

Facebook is primarily for social contact; Trade Me is for selling stuff. Facebook has a record of failure in this area; Trade Me has a record of success. Facebook Marketplace is free and will attract some stingy sellers and tyre-kickers; Trade Me costs a small amount and is more likely to attract serious buyers and sellers.

Table 1: Trade Me vs Facebook Marketplace

	TRADE ME	FACEBOOK
PRIMARY PURPOSE	Classifieds site	Social contact
CURRENTLY AVAILABLE	Desktop and mobile app	Mobile app only
HISTORY IN CLASSIFIEDS	Long-term success	Failed before
COST	7.9% (success fee)*	Free
REVENUE MODEL	Listing/success fees	Advertising
SELLERS	Consumers/businesses	Consumers
FACILITATES PAYMENT	Yes	No
FACILITATES DELIVERY	Yes	No
FEEDBACK FACILITY	Yes	No

***Most items. Other fees may also be charged.**

Facebook Marketplace could make a dent in Trade Me's business, particularly in the short term as people try it out. We'll be watching closely, and clearly Trade Me's management will be too. But Trade Me has seen off competitors in the past and there's a strong likelihood Facebook Marketplace will fail again.

The risk of new competitors has always existed, but the actual entry of Facebook is real evidence of 'new' competition. So there's an argument for dropping our valuation a little – and therefore our $5.25 Buy price.

That said, we're confident Facebook is a threat at the very edge of Trade Me's business. Our assessment is that the two can happily co-exist, or that Facebook will eventually drop this feature just as it did the last time.

We often say you rarely get buying opportunities without a little bad news. Here's the perfect example, and we're upgrading Trade Me to **BUY** again at a price up to $5.25 (with the same caveats as in ***Trade Me: Result 2016***).

*Note: This review should be read in conjunction with our more comprehensive reviews on the company, including T**rade Me: Result 2016**, **Trade Me: Interim result 2016**, and **Trade Me: Result 2015**.*

*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.

The entertainment company's share price fell 9% after it released its full-year result, but was it such a horror movie?

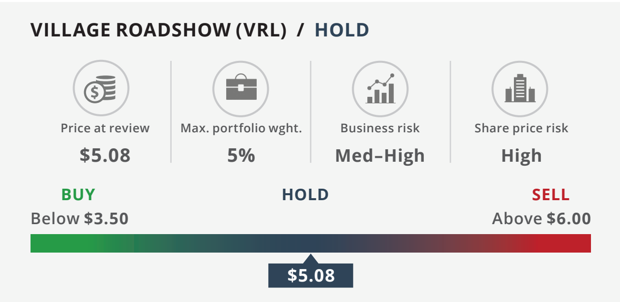
BY ANDREW LEGGET • INTELLIGENT INVESTOR • 11 OCTOBER 2016

Village Roadshow's reporting season flop

According to the final slide in Village Roadshow's 2016 annual result presentation, 'people will always want to go out!'. So confident is the company in this claim that management even added an exclamation mark.

Key Points

- ***Film distribution under pressure***
- ***Higher ticket and food prices boosting cinemas***
- ***Theme park stable***



To be fair, management's probably right. Ever since the motion picture camera was invented in the 1890's people have attended cinemas for their entertainment. Even before motion pictures – going back to ancient Greece and before – theatres drew people together with plays and other shows.

The biggest problem for Village, though, isn't whether people will still want to go out but what they're doing when they're at home.

Content Distribution

Five years ago, Village's biggest profit generator wasn't its theme parks or cinema exhibition business but its film distribution business. How times have changed. Despite Village still being among the top three distribution businesses in Australia, this division's operating profit has since halved to $21m.

The problem is that the overall size of the market is shrinking: with the increasing popularity of video-on-demand (VOD) platforms such as Netflix or Stan, fewer people are buying DVDs. As a result, the home entertainment market (DVDs and television) shrank by around 4% in 2015 after contracting by around 6% the previous year. Although the digital download market increased by 7%, this was off a much lower base and is yet to offset the change.

Nevertheless, Village is confident that things will improve in 2017. The company has completed a restructuring of this division, including closing its New Zealand branch, and this should lead to lower costs.

However, as always, the key will be the success of the titles it distributes and this is something that can't be accurately predicted. So far there is reason for optimism after the success of the DC Comics/Warner Brothers' Suicide Squad and Bad Moms: both took turns at the top of the box office in August.

Even so, with more people using VOD services to watch content and fewer watching DVDs, the distribution chain has undergone a fundamental shift. Village will be hoping that the digital dollars coming in catch up with the analog dollars going out, but it might be waiting a while.

Using an earnings before interest and tax (or EBIT) multiple of six times, we value the distribution business at around $220m in our base case, which assumes slightly lower revenue but also lower costs (see Table 1). Although the multiple remains the same, our bull case assumes revenue growth and lower costs whilst the bear case has revenue falling and costs increasing.

Cinema Exhibition

Despite 2016 boasting six of the all-time 50 highest grossing movies in Australia, total admissions to the company's cinemas increased by only 1% on the prior year. Compared to 2011, admissions have increased a more reasonable 4% but as Village has increased its screens by 6% since then, fewer people are visiting each individual Village cinema.

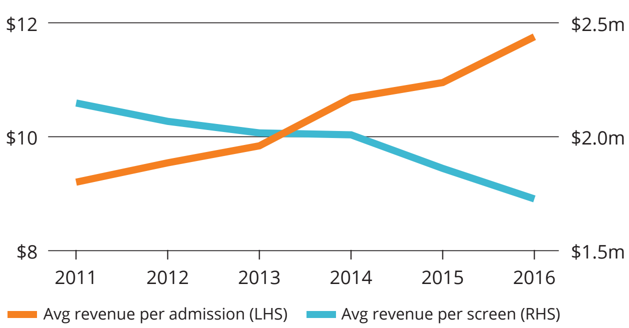
This trend isn't limited to Village but is consistent across all cinemas in Australia. According to Screen Australia statistics, whilst the percentage of Australians that go to the cinema has remained stable in recent years, the frequency of visits has dropped. The average person visited the cinema 6.8 times in 2014 compared to 7.8 times in 2004 and 10.7 times in

> **In the cinema business, total admissions are a key profit driver as a cinema will typically use ticket sales to cover operating costs whilst food and drink sales drive profit.**

1994. Considering the increased cost of going to the movies, as well as expanding entertainment options both inside and outside of the home, it isn't unreasonable to expect that this trend has continued into 2016.

Despite this, Village has been able to generate year-on-year revenue growth of almost 6% per year since 2009 thanks to higher ticket prices (helped by enhanced viewing options such as Gold Class and Vmax) and more expensive food and beverages (see Chart 1). In the cinema business, total admissions are a key profit driver as a cinema will typically use ticket sales to cover operating costs whilst food and drink sales drive profit.

Chart 1: Cinema statistics



Source: Company reports

Assuming Hollywood keeps producing movies that people want to see, the key question is: how much more can Village raise prices without pushing people away? This is especially true with technology making it easier to watch movies outside of cinemas, and studios considering shortening the exclusivity period exploited by cinemas before movies become available via other means such as pay-TV or Netflix.

In valuing the cinema business, our base case assumes a modest increase in the average revenue per admission but that total admissions remain around 25m per year. Using an EBIT multiple of eight times leads to a value of around $520m. Our bear case assumes a slight fall in both admissions and revenue, whilst the bull case assumes higher admissions and higher revenue.

Theme Parks

Compared to the challenging film market, the company's theme park division is relatively stable; in fact, operating profit barely budged from the year before.

The company blamed the lack of growth on a new subscription-based membership program for its Gold Coast properties including Warner Bros. Movie World and Wet'n'Wild. Under this model, revenue is recognised pro-rata across the 12-month membership period and so, with the subscription model being introduced in the second half of 2016, a large amount of revenue was deferred to 2017.

There always seems to be some reason why this division under-delivers, but it makes a change to hear complaints about something other than the weather (although this was still mentioned).

Table 1: Village Roadshow valuation

VALUATION ($M)	BEAR	BASE	BULL
CINEMA EXHIBITION	390	521	634
THEME PARKS	357	489	632
DISTRIBUTION	96	219	346
MARKETING SOLUTIONS	70	100	130
TOTAL OPERATIONS	913	1,329	1,743
VREG	160	160	160
CORP COSTS	–300	–300	–300
NET DEBT	–535	–535	–535
ENTERPRISE VALUE	238	655	1,068
PER SHARE	1.48	4.06	6.63

Even so, there are at least a few clear areas where the theme park division should be able to grow: the company has signed an agreement to bring the Topgolf concept (a golf driving range that also acts as a party venue) to Australia, as well as new attractions and extended trading hours at its Sydney Wet'n'Wild property which should help boost attendance. The company is also aiming to expand in China, with properties set to open in mid-2017 which Village will manage.

> **Even that range could prove too narrow and we wouldn't be astonished to see better or worse outcomes than our bull and bear estimates.**

Lack of disclosure around the Chinese venture makes it difficult to value. We'll stick with our **estimate of $120m**, which gives us about $490m for the theme park business in our base case when added to the properties on the Gold Coast, in Sydney and Las Vegas. For its theme park properties in Australia and Nevada, we estimated total guests, the average revenue each guest generates, total expenses and depreciation charges to calculate normalised operating profit figures under our three cases. We then used an EBIT multiple of eight to estimate the value in each case.

Other businesses

The company's new marketing solutions business, which operates consumer rewards and loyalty programs, continues to show potential, with operating profit of $7m in 2016 following the acquisition of UK sales company Opia. This division continues to sign up new clients and should grow faster than the other divisions in the years ahead. In our valuation we have used an EBIT multiple of 10 times.

The final part of the Village puzzle, film production, comes from its 47% ownership of Village Roadshow Entertainment Group (or VREG). The entire carrying value of the equity portion of this investment was written down to zero on Village's balance sheet, which justifies our previous decision to assume the value of Village's ordinary share investment is zero. This leaves only the preferred shares, which we value at around $160m.

Valuation

In sum, Village Roadshow operates in a risky and fast-changing environment. There's a wide range of potential outcomes, as you can see from our 'bear, base and bull' valuations in Table 1. Even that range could prove too narrow and we wouldn't be astonished to see better or worse outcomes than our bull and bear estimates. With this in mind, we have increased Village's business risk to medium-high.

What of its valuation? We'd want to see the stock at or below our base case valuation to recommend it as a Buy and we'd likely suggest selling it anywhere above our bull case valuation. As a result, we're lowering our Buy price to $3.50 (from $4) and our Sell price to $6 (from $7). **HOLD**.

Staff members may own securities mentioned in this article.

In the first of a series of five articles on some of our most memorable recommendations from the last 15 years, John Addis looks at ARB Corporation.

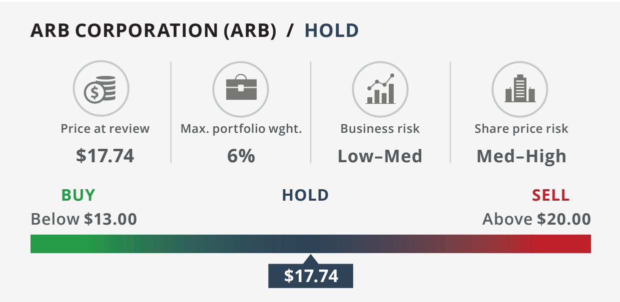
BY JOHN ADDIS • INTELLIGENT INVESTOR • 14 OCTOBER 2016

5 from 15 – ARB Corporation

For me at least, much of the last 15 years can be summed up in two figures. The first – 3 – is the number of kids I have acquired over the period. The second – 468 – is how many Buy recommendations Intelligent Investor made between June 2001 and June 2016. I'm grateful those two numbers are not reversed. Life is tricky enough.

Key Points

- ***It's often worth paying up for good businesses***
- ***Use deep research to get comfortable with high multiples***
- ***Don't let good stocks go too easily***



To mark the 15th anniversary of the launch of our model **Growth** and **Equity Income** portfolios and our latest **recommendations report**, each fortnight over the next few months I'm going to examine a recommendation from the period.

This isn't an exercise in boosterism, although analytical team members past and present should feel proud of their contribution to our 3.7% annual outperformance of the All Ordinaries Accumulation Index.

It won't just be winners, though; we'll also be looking at two of our biggest ever losers. The real purpose is to show how value investing works in practice, from the demands it places on your analytical skills to the psychological turmoil Mr Market can induce, and how to overcome it.

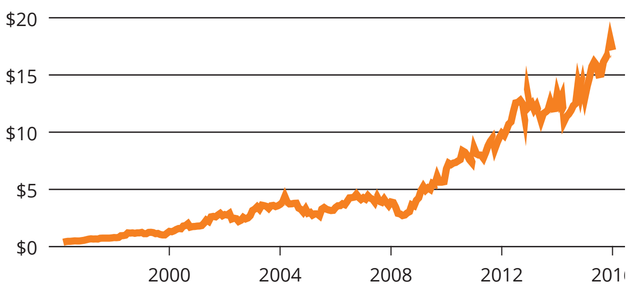
Each recommendation is its own journey, full of bumps, breakdowns and satisfying vistas. We hope sharing some of the high and lows of a few memorable trips will be enlightening. Let's start with a company originally recommended over a decade ago and sold, slightly controversially, in 2013.

Car parks and carpets

In the midwinter of 2004 analyst Gareth Brown returned from a Victorian holiday where he'd made a side trip to a company in Melbourne's outer-suburbs. He spoke of a daggy building in a low rent industrial estate and a car park stuffed with dirty off-road vehicles. Inside, the carpets were threadbare, supporting ancient filing cabinets and busted desks. Gareth was impressed.

He'd spent months prior to the visit researching ARB Corp, a manufacturer and distributor of four-wheel drive components founded in 1976 by Tony Brown after an expedition to Cape York. The company was then run, as it is now, by Anthony's brothers Roger and Andrew. By 2003, ARB had increased profits by an average of 29% a year over the previous decade. As Gareth wrote in his first **review** in October of that year, 'in compiling a list of excellent businesses, ARB is up there with the best of them'.

Chart 1: ARB Corp 20-year share price



Source: S&P Capital IQ

Back then return on equity stood at about 26% and had grown in each of the previous five years. The problem was the price. Even though we stated 'the odds of this company growing its earnings at a good clip for the next decade are good,' a PER of 20 and an uninspiring yield of 2.4% produced a Hold recommendation.

More research followed, along with the company visit. That produced three key insights, the first being the quality of this company's management. ARB was stacked with 4WD enthusiasts and run by highly capable, energised owner managers. To quote the original Buy recommendation: 'It's a cliché, but for a business to reach its full potential, managers must treat it as a passion rather than as a pay cheque.'

> **“ARB already had a few hits on its hands, including the Air Locker and Old Man Emu suspension kits – the first 4WD accessory to sound like a boutique beer.**

That was ARB down to a tee. Salaries were modest and executive options packages non-existent. At the 2002 AGM, so the story goes, Roger Brown took the leftover sandwiches back to HQ for the enjoyment of his staff. Much as corporate boards might try, you can't buy that kind of commitment.

Second, the company invested heavily in research and development. According to a company profile, management's adage is that 'if it's not broken, break it anyway and find a better way of making it'. ARB already had a few hits on its hands, including the Air Locker and Old Man Emu suspension kits – the first 4WD accessory to sound like a boutique beer. But the chances of new and better products were high and the market for 4WD accessories was growing. Finally, ARB's typical customer was an enthusiast that appreciated highly engineered, reliable products.

Those three factors were an enticing combination. Good management kept manufacturing costs down, high levels of investment produced great products, and the company's market niche was a large and growing pool of aficionados prepared to pay top dollar. The result was a consistent EBIT margin of 15%, more than twice that of its nearest competitor.

Biting the bullet

None of this had gone unnoticed. Two years previously ARB shares were trading at around $2. Now they had climbed over $3.50. We bit the bullet anyway, calling ARB a Long Term Buy at $3.53 on **19 Aug 04**.

Our confidence was immediately tested with the stock registering a 25% loss over the next 18 months – to $2.66. But having done the work, we were comfortable with the stock and **continued to recommend buying**. Hopefully members were able to take advantage of the lower prices.

A recovery above $4 followed but the stock again fell below $3 in the midst of the global financial crisis in early 2009. We kept saying buy and that proved to be the **best opportunity of the lot**, with the share price subsequently embarking on an almost relentless rise to its current level above $17.

We first **downgraded to Hold in April 2010** at $6.00, for no reason other than price. We got two more opportunities to buy, in **August 2010** and **again a year later** but that was it. By **21 May 2013** the share price had climbed to $13.49 having met all our expectations and then some.

Trading on a multiple of 22 times that year's earning we baulked. Fretting about the potential fallout from the then-looming mining bust, we made making our solitary Sell recommendation and removed the stock from our model Growth Portfolio. We should have held our nerve, but you can't have everything.

From beginning to end ARB had delivered a return of 23.9% a year over the decade we owned it. So, what can we learn from this potted history?

1. Deep research pays off

Even a cursory look at ARB's annual reports of a decade ago revealed the company's quality. This was more than a low margin metal basher. The 'softer' factors were less obvious: the level of commitment among managers; the loyalty of customers and staff; and the quality of its products. It was these factors, not the high return on equity or profit margin, that got us to a point where we were comfortable paying a seemingly high price for the stock.

It's a mistake to think that everything important can be gleaned from a company's accounts. Deep research must also address the softer side of analysis, the art as much as the science – the sandwiches and the car park. Rich rewards await those that make that commitment (or pay someone else to do it for them).

2. It's worth paying up for quality

One of the problems with value investing is that it can lead us to a conventional conception of value. Ben Graham saw cheapness purely in terms of asset value – buying a dollar's worth of assets for 50 cents. Graham's protégé Warren Buffett, however, shifted over the years (much assisted by his partner Charlie Munger) to an approach that focused on high-quality businesses, producing ample cash flows that could be reinvested at high rates of return.

In 2004, ARB, at 20 times earnings, wasn't cheap in the Graham sense. But after getting to grips with it, the Buffett perspective made sense. We paid what looked like a high price but in return got an even higher return. As senior analyst James Greenhalgh puts it: 'Quality stocks can look expensive for a time but they have a habit of surprising on the upside'. That's been true not just of ARB, but also **Cochlear**, **ResMed**, **CSL** and plenty more. Quality is usually worth paying for.

> **“That highest-ever rating of around 30 times earnings, though, is hard to stomach.**

3. Don’t let good stocks go easily

Other team members may disagree but I think over the years Intelligent Investor has had a tendency to let go of good businesses too easily. ARB is a case in point. Having sold out in 2013 at a price of $13.49, we quickly upgraded it to Hold a few months later after a price fall and have stuck with that recommendation ever since, most recently in ***ARB shifts back into gear*** (Hold – $17.74). Between those two recommendations the share price rose a further 32%.

Worse mistakes have been made. The All Ordinaries Index returned 27% in the period, so ARB has hardly shot the lights out – particularly since the gains are purely the result of its P/E ratio increasing; earnings have been flat over the period. Still, there’s plenty more time to regret our Sell recommendation. As research director James Carlisle put it in our latest review: ‘ARB is being rated at its highest ever because its prospects are as strong as ever.’

That highest-ever rating of around 30 times earnings, though, is hard to stomach. That’s why I – having ignored James’s recommendation to sell in 2013 – also ignored his latest recommendation to Hold and sold my shares. There’s a fair chance I’ll regret that, but I’ll try not to beat myself up about it. No-one said this was easy.

4. Hang on and enjoy the ride

Humans have a tendency towards action, maybe because simply doing stuff is life affirming. Investing is no different. We tend to think of it as buying and selling rather than sitting. ARB proves the value of inactivity, of sitting.

Once you’ve found a well managed, growing company, and you’ve bought in at a reasonable price, don’t get sucked into thinking there’s an even better one just around the corner. Overtrading can ruin your returns. Sometimes the next big thing is the stock you already own.

Note: The Intelligent Investor ***Growth*** *and* ***Equity Income*** *Portfolio used to own shares in ARB Corp and we wish they still did.*

Disclosure: The author used to own shares in ARB Corp and will probably wish he still did.

Staff members may own securities mentioned in this article.

The owner of Channel 9 appears to be doing all it can to reduce exposure to the industry that made it what it is today.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 12 OCTOBER 2016

Is Nine Entertainment short selling television?

Welcome to spring, the time when Australians traditionally clear out their clutter and prepare for the year ahead. This year, Hugh Marks and the team at **Nine Entertainment Co** (ASX:NEC) seem to be getting in on the act.

If recent rumours are true, Nine is looking for buyers for its stake in the Australian News Channel (owner of the Sky News Australia network). This would follow up its recent sale of its $33m stake in **Southern Cross Media Group** (ASX:SXL).

It is not hard to see why Nine might be losing interest in the broadcasting medium it helped introduce in 1956 when Bruce Gyngell welcomed the nation to television. The Australian free-to-air advertising market has declined by around 1.5% a year since 2011, a trend which is expected to continue. Channel Nine's operating profit is also 11% lower than in 2012, the first year of results after its IPO.

Pay television has also come under extreme pressure as faster download speeds have led to people embracing digital streaming services such as **Netflix** (NASDAQ:NFLX). Researcher Roy Morgan estimated in a recent report that more people now have a streaming video on demand (SVOD) subscription than Foxtel subscription. Unsurprisingly, Foxtel's average revenue per user has been falling, something that may continue with the announcement of a cheaper package that includes no set top box.

This is a global trend, especially in North America. People are shunning television broadcasts of sporting content and turning to digital mediums. Sporting bodies in America have started selling more broadcasting rights to digital providers such as **Yahoo** (NASDAQ:YHOO) and **Twitter** (NYSE:TWTR) as well as launching their own digital streaming services.

In fact, Bloomberg recently reported that some television channels have been forced to give away advertising slots during NFL games due to a fall in viewers. ESPN (owned by **The Walt Disney Company** (NYSE:DIS)) has lost more than 10 million ESPN subscribers since 2013, a big reason for its recent activity in acquiring a stake in the MLB's digital streaming business and its reported interest in acquiring Twitter and Netflix.

It's a big call to turn your back on the industry that used to be your bread and butter. But if the rumours of Nine are true, that's what it's doing. One shouldn't conclude this is a foolish move, either. Dumping the declining parts of the business in order to focus on digital distribution and content ownership might be the best strategy to deliver a sustainable, growing business. In fact, such are the changes in this industry it may be the only one.

Bradken's takeover offer

BY GAURAV SODHI • INTELLIGENT INVESTOR • 6 OCT 2016

BRADKEN (BKN) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$3.22	1%			

For the fifth time since the mining bust, Bradken has received a takeover offer. This one, from Hitachi, values the business at $3.25 per share, a healthy premium to the pre bid price and several times the lows of 50c reached last year.

For the first time, the bid has management attention with the board suggesting shareholders accept the all-cash bid. The prospective price is fair but hardly generous and, given the history of the business, another bid could eventuate.

We have recommended Bradken at over $3 and at around $1 so, depending on your entry price, this has either been phenomenally successful or a disappointment. Again, it highlights that buying in tranches remains a sound strategy. With the share price still at a small discount to the bid, we recommend you **HOLD**.

Staff members may own securities mentioned in this article.

Telco reviews are coming

BY GAURAV SODHI • INTELLIGENT INVESTOR • 6 OCT 2016

TPG TELECOM (TPM) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$8.16	6%			

VOCUS COMMUNICATIONS (VOC) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$5.70	5%			

TPG and Vocus have both fallen close to 40% over the past few weeks as questions emerge about margin stability in a post NBN world. While the timing of this concern is odd – we raised it months ago when we **slapped a Sell on Vocus** – the content is legitimate.

With both TPG and Vocus now near or below our buy prices, we are looking at them in detail. This is not a fleeting opportunity created by irrationality; caution is needed. We're removing price guides while we complete our research but we will reinstate them with the next review. We're working on it now so expect it later this month. No action is needed for the moment.

Staff members may own securities mentioned in this article.

Godfrey's showing signs of stress

What should I do with the GFY stock I currently hold? I own 20,000 shares at an average buy price of $1.12. The market price is $0.705. Should I buy more to bring down my price average or hold out with the hope the price will go above $1.12?

13 Oct 2016 – **James Greenhalgh**: I can only provide general advice under our financial services licence, so I can't say what you should do personally I'm afraid. Godfrey's is not a stock we cover, so I also can't provide any definitive advice on whether to buy or sell either.

Whenever you're re-evaluating your ownership of a stock, you should ask yourself a couple of questions. First, do you still understand the business? And second, what is your (current) valuation? (which may be different from your original valuation). **Bear in mind that your original purchase price is not relevant to any decision to buy or sell, only your current valuation**.

What I can say about Godfrey's is that – like most small retailers – it is a high risk business. So your valuation should consider the range of potential outcomes. Those outcomes include a strong recovery, but also that the business fails.

I'm not saying Godfrey's will fail, but there are some signs of stress. The company has a lot of debt ($23m) for a market capitalisation of $29m. Also, its fixed charges cover ratio, a common measure of how well a retailer can meet its fixed obligations such as rent and interest, is 1.7. Generally I'd consider a ratio of under 2 to be a sign of stress. There's a reasonable chance of a capital raising for Godfrey's I think.

It's important not to simply 'hope the price goes above $1.12'. You need to re-evaluate the business, your valuation, and your reason for buying it. If these reasons still hold, and the value on offer has improved, then by all means buy more (assuming your portfolio weighting is acceptable). But if you've made a mistake, or bought a too-high weighting, then sometimes it's best to bite the bullet. I hope that helps.

Lovisa is one for the watchlist

Wondering if anyone has taken a look at Lovisa? In particular I'd be interested in what sort of value you might assign to their international growth prospects.

13 Oct 2016 – **James Greenhalgh**: Wow, Lovisa is growing fast, isn't it? I must admit I wasn't even aware of this jewellery retailer until you mentioned it – although, in fairness, I'm not in the core demographic.

For the benefit of other members, Lovisa is a retailer selling jewellery in the 'fast fashion' mould – it's essentially disposable jewellery at a very cheap price point. In some sense it reminds me a bit of Smiggle, the very successful stationery retailer owned by Premier Investments.

The stock is certainly interesting, although pretty high risk. It doesn't look wildly expensive for a fast-growing company although, as you indicate, all that growth is coming from overseas. That's often where a lot of smaller fashion retailers come unstuck (Smiggle's success notwithstanding). Lovisa looked cheap at the $2.00 float price but less so now obviously.

I'll take a closer look at it in coming weeks but it's not the highest priority given, if we were to recommend it, the recommendation would almost certainly be speculative. My concerns are that this is fashion at its riskiest – any product or marketing mis-steps could kill the company. And the jewellery is – how shall I put this? – bling-tastic. Changing trends could be poison.

Lovisa is now expanding into the UK, which is perhaps a source of great opportunity but also high risk. It could make or break the company and it's hard to know which it will be. If anyone has any thoughts on Lovisa, or knows any customers in its demographic (unlikely to be our members!), then please let me know via the Q&A section.

Who are nominees?

Amongst the substantial shareholders listed for many stocks one often sees names such as 'national nominees', 'UBS nominees' or 'pershing Australia nominees'. Who are these investors? Are they 'collective custodians' investing funds on behalf of other businesses and organisations or something else entirely?

13 Oct 2016 – **Andrew Legget**: A simple example to explain this is if you were to purchase overseas shares through eTrade. When you purchase shares of your favourite global company, eTrade's structure means you become the beneficial owner of those shares. The legal owner, however, will likely be a 'nominee' style account linked to the bank they have teamed up with. Simply, it is typically an account where the legal owner and beneficial owner are different. Why these have been set up and who are the actual owners behind it can differ across banks but they are quite common.

This paper I have found goes into detail on the subject if you want to know more.