Weekly Review

RESEARCH

– Issue –
16 Dec. 2016

Flight Centre has been hit by five profit downgrades and a 33% share price decline. But don't believe for a minute that this company is 'ex-growth'.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 13 DECEMBER 2016

Flight Centre gloom is just the ticket

Making the negative case for Flight Centre is easy enough. The company reported two profit downgrades in 2014, one in 2015, then another two in 2016. As we said in ***Flight Centre's ticket to ride*** last month, another downgrade is possible in 2017. Will it be six and out?

Key Points

- ***Lots of negative news in the price***
- ***Business still growing, just more slowly***
- ***Compares favourably to competitors***

FLIGHT CENTRE (FLT) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$30.62	6%	Medium	Med–High

BUY — Below $32.00 | HOLD | SELL — Above $50.00

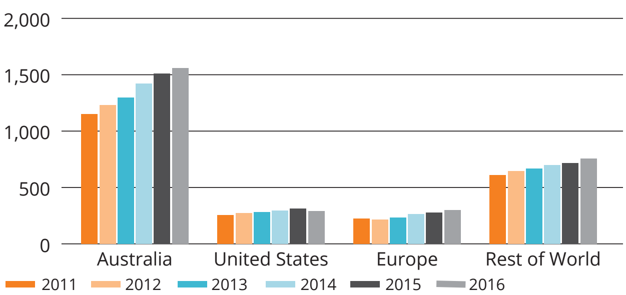
$30.62

The company has blamed airfare deflation, cost increases, Brexit, weakness in the pound, the Australian election, the US presidential election and even **mosquitoes**. Then there's the ever-present threat of online travel companies like Webjet, Priceline and Expedia eating away at Flight Centre's store-based business model.

To top it off, the company cut its 2016 final dividend by five cents, saving just $5m. It seemed like an ominous sign for a company with $500m of cash in the bank.

Flight Centre's share price has responded accordingly, falling 33% over the past three years. By contrast, **Corporate Travel** Management's share price has risen a phenomenal 203% over the same period. Even travel agency competitor **Helloworld**, formerly Jetset Travelworld, has seen its share price jump by 57% over three years.

Chart 1: Store numbers



Source: Company reports

Remember these two competitors because we'll compare them with Flight Centre shortly. It's easy to let one's perspective be coloured by the share price machinations but this review has one aim: to show Flight Centre's business is performing better than its stock.

The human touch

Before turning to the business, a caveat. We won't review the online threat again here, having covered it in ***Will the internet kill Flight Centre?***. Suffice to say that online competitors

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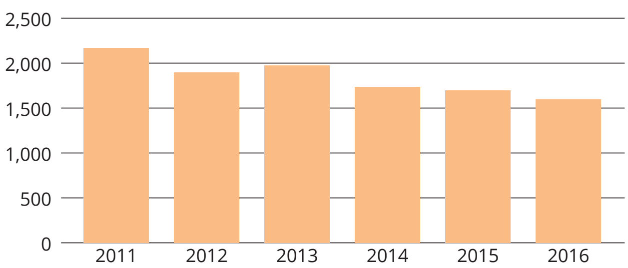
will remain a threat, but that the two distribution channels should be able to coexist.

Indeed, Flight Centre's store network is a valuable asset. Chart 1 shows that the company has continued opening stores, with a 30% increase in global store numbers between 2011 and 2016. In Australia, store numbers climbed even faster – 36% over the same period.

Chart 2: Helloworld Australia (& NZ) store numbers



Source: Company reports

This seems at odds with the conventional view that Flight Centre is mature in Australia. So why has management continued opening stores?

For two reasons. One, they're very profitable. The Australian business (including corporate travel) has consistently generated an operating margin of around 20% – very high for a retailer. And two, Flight Centre's increasing ubiquity is designed to slowly steamroll over the competition (its shops can seem a bit like rats – you're never more than six feet from one).

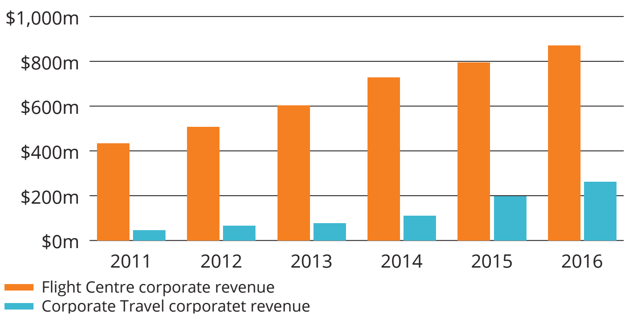
Firing line

Chart 2 shows which company is in the firing line. While Flight Centre dominates Australian travel retailing, there are still opportunities to take market share from store-based competitors such as Helloworld. That company has spent years making acquisitions to ward off the threat but its $5bn of total transaction value is being eyed off by Flight Centre (which has TTV of $10bn in Australia).

So what about the other part of Flight Centre's business – corporate travel? The conventional view is that Flight Centre is being walloped by Corporate Travel Management.

Chart 3 puts it in perspective. In 2016 Corporate Travel Management and Flight Centre's corporate travel business grew revenues by 32% and 10% respectively. With revenues that are fast approaching $1bn, though, Flight Centre is one of the world's top five corporate travel companies. Corporate Travel Management's expected $330m of revenue in 2017 isn't in the same league.

Chart 3: Flight Centre vs Corporate Travel Mgmt



Flight Centre might not be growing quite as fast but underestimating it would be a mistake. For all the fun management has on the conference calls – and **in the new head office** – the company is utterly ruthless with competitors, suppliers and, occasionally, customers. Flight Centre's strong management is a large part of the reason the stock has ten-bagged since *Intelligent Investor* put a buy on the stock (don't read it, it's embarrassing).

If Flight Centre's TTV, store numbers and revenue are still growing, then why has earnings per share growth taken a tumble (see Table 1)?

> “ Flight Centre is now being priced as ‘ex-growth’, when it’s more likely that the slowdown is temporary.

Well, if revenue is growing but earnings aren’t, there’s only one conclusion: costs have risen. Some of this has been very deliberate. Management has been investing in store staff salaries in recent years; in 2015 in Australia and in 2016 in the United Kingdom and New Zealand. It has also invested more in advertising, product and improving the customer experience.

Table 1: Flight Centre revenue and earnings

	2012	2013	2014	2015	2016	2017E
TOTAL TRANSACTION VALUE ($M)	13,238	14,259	16,049	17,598	19,305	19,700
REVENUE ($M)	1,827	1,986	2,245	2,397	2,666	2,700
NET PROFIT ($M)	200	246	207	257	245	210
EPS (C)	200	246	205	255	242	208

Source: Company reports, II estimates

In 2017 foreign exchange losses, too much touring capacity, as well as further investment in staff, stores and technology has been taking a toll. As a retailer, slower revenue growth does present challenges because costs rise naturally every year. This year one-off items and slower growth will conspire to cause net profit to fall again.

Does this matter?

Great track record

We don’t think so, for two reasons. First, like companies in the online classifieds sector, Flight Centre has been investing for growth in certain market segments and geographies. Management’s track record speaks for itself, so it’s hard to believe the investments would be frivolous.

Second, Flight Centre is now being priced as ‘ex-growth’, when it’s more likely that the slowdown is temporary. Table 2 shows a comparison of some key valuation shortcuts for its Australian competitors. However you measure it, Flight Centre is not expensive.

There’s no doubt that Flight Centre faces some headwinds this financial year. And future growth will be less than it has been historically – the 3.3% growth in Australian store numbers in 2016 was the slowest since 2010.

Table 2: Valuation shortcuts

	FLIGHT CENTRE	CORP. TRAVEL MGT	HELLOWORLD
ASX CODE	FLT	CTD	HLO
SHARE PRICE ($)	30.62	16.08	3.85
2016 PRICE-EARNINGS RATIO (X)	12.5	37.2	203.7
2015/2016 FREE CASH FLOW YIELD (%)	8.6%	2.6%	-2.8%
2016 EV/TTV (%)	13.8%	43.7%	8.7%
2016 DIVIDEND YIELD (%)	5.0%	1.5%	0.5%

It’s possible we’ve been a little early in upgrading the stock. As we’ve said in **previous reviews**, downturns in Flight Centre’s business can be sharp. Another profit downgrade is possible given that management’s second-half expectations look optimistic. In our view, however, the market has at least partly factored this in.

We continue to recommend an initial half-weighting in the stock (up to 3% of your portfolio) to account for the risks of being too early. The stock was particularly weak yesterday thanks to some **negative broker research**, which gives us another chance to jump aboard. We’re upgrading to **BUY**.

Staff members may own securities mentioned in this article.

Crown today announced a trading update, the further selldown of its Melco stake and the cancellation of its proposed demerger.

BY JON MILLS • INTELLIGENT INVESTOR • 15 DECEMBER 2016

Crown cashes in on Melco

Well, that was a surprise.

Only six months after announcing **plans to spin off** most of its international operations and hotels, Crown today announced the sale of just under half of its 27.4% stake in Melco Crown Entertainment, which owns casinos in Macau and The Philippines.

Key Points

- ***Demerger won't proceed***
- ***Listed property trust IPO still planned***
- ***Disappointing trading update due to VIP declines***

CROWN RESORTS (CWN) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.37	4%	High	High

BUY Below $12.00 | HOLD | SELL Above $18.00

$11.37

The company will use the $1.6bn in proceeds to repay $800m in debt, pay a special dividend of $500m (or around $0.69 per share) and repurchase $300m in shares (all figures in Australian dollars, unless otherwise specified).

Crown is also investigating selling down part of its remaining 14% stake in Melco Crown and, while we await a further announcement on that front, its shares have been suspended from trading.

Demerger won't proceed

To top it off, the company also won't proceed with its proposed Alon Las Vegas project and will look towards 'optimising the value' of this investment, including selling it. Crown has spent around $380m on this project so far.

All in all, this marks a sudden change in strategy and makes the proposed demerger of most of Crown's international operations (see ***Crown demerger: enhancing value?*** on 22 Sep 16 (Hold — $13.29)) moot.

As such, the demerger now won't proceed but the company still plans to sell 49% of its stakes in four hotels and their associated retail precincts into a listed property trust.

Good price

Crown will receive US$18 per share from the sale of 13.4% of Melco Crown, which represents around $4.93 per Crown share at current exchange rates. Again using today's exchange rates, this is around halfway between our estimated values for Melco Crown in our Base and Bull case scenarios in Crown: adding up the chips on 14 Nov 16 (Buy — $10.56).

So we think Crown has received a decent price for this stake, albeit of course at the expense of it being worth even more should Macau stage a sustained recovery.

The reduction – and potential elimination – of Crown's exposure to Macau at a decent price goes a long way to eliminating the concerns that we felt were weighing on the stock when we first upgraded Crown to Buy in Betting on Crown – part one on 20 Apr 15 (Buy — $13.15).

Moreover, the $800m reduction in net debt further eases the other major concern then: how the company would fund its substantial capital expenditure plans in coming years, including on Crown Sydney and, since then, its new hotel joint venture in Melbourne.

VIP revenue down

Offsetting this is the disappointing – but not surprising given the recent arrests of Crown's employees in China (see ***Crown staff arrested*** on 17 Oct 16 (Buy — $11.70) – trading update included in today's announcements.

Total revenue for the first 23 weeks of 2017 has fallen 12% on a normalised basis due to a 45% reduction in VIP turnover. (Due to the large amounts they bet, earnings from VIPs are highly volatile and so casinos normalise their revenue and earnings based on the theoretical rather than actual win rate on VIP betting).

> **"Crown's shares are suspended and so we don't know what the share price will be when trading recommences.**

For our Base case in ***Crown: adding up the chip***s, we'd assumed that earnings before interest, tax, depreciation and amortisation (or EBITDA) from VIPs would halve and this appears to be approximately what has occurred so far in 2017. We note that due to freebies and commissions, VIP earnings are lower margin than earnings on ordinary or mass market gamblers.

Strategic retreat

As a result of this change in strategy, Crown will now be a predominantly Australian-focused company with monopoly casinos in Melbourne and Perth and a future Crown Sydney, along with stakes in a number of smaller businesses including its fast-growing Wagering and Online business.

Crown's shares are suspended and so we don't know what the share price will be when trading recommences. We're also awaiting a further update on the potential sale of part of Crown's remaining 14% stake in Melco Crown.

With these necessary caveats in mind, we reiterate our existing price guide and our Buy recommendation, but note that we may adjust the latter depending on the share price once Crown begins trading again. **BUY**.

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

Disclosure: the author owns shares in Crown Resorts.

How did we lose 96% on a Strong Buy recommendation? John Addis has the story.

BY JOHN ADDIS • INTELLIGENT INVESTOR • 12 DECEMBER 2016

5 from 15:
Timbercorp – our worst Buy ever

It is one thing to lose 30% or even 70% on a stock and quite another to lose almost the whole lot. And it is something different again for that to happen to a former Strong Buy recommendation. That's what makes Timbercorp our worst call ever.

Key Points

- ***Watch out for commitment bias***
- ***Make sure every stock you own has a sustainable business***
- ***Don't let losses undermine your confidence***

In picking five recommendations from the past 15 years – **Roc Oil**, **ARB Corporation** and the **iron ore boom** have previously featured – **Timbercorp** was thus an unavoidable and unpleasant choice.

In the 18–year history of *Intelligent Investor*, I recall just one other example of a Buy recommendation going under – **Croesus Mining** in March 2005. Croesus was always presented as a speculative recommendation, so its failure was no great cause for alarm.

Timbercorp was different, as Chart 1 reveals. The folly of the period from April 2007 to September 2008 has a numerical expression. Over 18 months, we made seven Buy recommendations and nine Strong Buys. That's conviction for you. The eventual 96% loss may not have been a total wipeout but it was close enough.

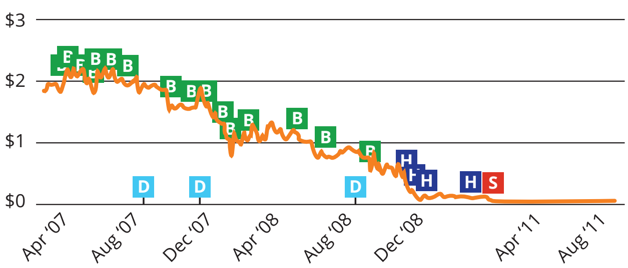
The first recommendation from 10 Apr 07 – ***Timbercorp ripe for the picking*** (Strong Buy – $1.85) – laid out the investment case. Timbercorp produced managed investment schemes (MIS's), selling slices of 'small farms to investors with a tax problem'.

The MIS's purchased cheap rural land to establish timber plantations, subsequently extending the schemes to olive and almond production. Tax laws permitted MIS investors to claim 100% of the tax deduction upfront. So attractive was the proposition an entire industry sprung up to promote them.

By 2007, the Federal Minister for Revenue – one Peter Dutton – had cottoned on, perhaps after a few nudges from the Australian Taxation Office. Over $1bn a year was being claimed in MIS-related deductions and Dutton wanted to curtail it. The result was that from July 2008 investors in horticulture schemes were excluded from claiming upfront deductions (timber-related schemes were still permissible).

In 2006, horticulture accounted for almost three-quarters of Timbercorp's revenue. The new rules halved its share price. This was the genesis of the opportunity, or so we thought. As our first positive review from the period described it: 'Mr Market has overreacted, though, and in a big way. The stock is now trading on a PER of less than 7, but the company has locked-in future revenue increases, related to past sales, that will almost offset the loss of income elsewhere. This stock is cheap, and it's our first Strong Buy recommendation in a long time.'

Chart 1: A long green decline



Source: S&P Capital IQ; Intelligent Investor

With each share price fall provoking a reiteration of that view, plenty more followed. The final paragraph of our last positive review of **17 Sep 08** (Strong Buy – $0.625), sums it up. Nothing much had gone right to this point. We had underestimated the capital-intensive nature of the business and the resultant pile of debt; the Murray-Darling basin was in severe drought; and credit markets had seized up. But none of that justified 'a share price around one-third of the company's net assets – comprised of land, water and investor loans. We've upped our share price risk rating a notch, but we're sticking with STRONG BUY.'

The bad news kept on coming and, with confidence in management ailing, on **13 Nov 08** (Hold – $0.50), with the share price down 73% since our initial recommendation we downgraded before eventually selling out on **17 Apr 09** (Sell – $0.072). The total loss was 96%. Had we waited another six days when the administrators were called, it would have been 100%. So much for small mercies. How did we get it so wrong for so long?

> **“During the slide from over $2 a share towards zero, there were warning signs, not just of a dud business but poor management struggling with a deteriorating situation.**

1. Timbercorp sold dud products

Ostensibly, Timbercorp sold timber and horticulture investments. Documentation promoting its schemes featured images of its plantations, rows of trees as far as the eye could see and olives ripening in the sun. What the company really sold were tax deductions, a point unwittingly made by former CEO Sol Rabinowicz's **LinkedIn profile**. It makes no mention of Timbercorp but does say he was CEO of a 'financial services company' from 1996 to 2009.

That's a better description. Some financial planners were paid commissions of up to 10% to sell MIS products. The more popular these schemes became, the more likely the rules would change to inhibit their growth. Timbercorp's business model was dependent on the generosity of the government. As analyst Steve Johnson said in ***Timbercorp's darkest hour*** (Sell – $0.072) on 17 Apr 09, it's impossible to build a sustainable investment selling a dud product.

For the same reason we've avoided **McMillan Shakespeare**, a company with a business model that can be wiped out by the stroke of a legislator's pen.

2. Over-reliance on debt

Timbercorp's business model was also precariously funded. MIS schemes typically ran for 30 years and yet the company financed them with short-term debt. The balance sheet from 30 September 2006 showed net debt of $193m but a year later it had increased to $413m. Timbercorp's projects came with a fat 'capex tail' that required funding. We hadn't realised this at the point of our initial recommendation and, when we did, we didn't give sufficient weight to its importance.

3. Victims of the commitment principle

During the slide from over $2 a share towards zero, there were warning signs, not just of a dud business but poor management struggling with a deteriorating situation. We had many opportunities to accept we might have had this one wrong but neglected to take them. The commitment principle explains why.

Steve Johnson acknowledged its impact at the time of the Sell recommendation: 'The 2007 half-year balance sheet came out just a few months after our original Strong Buy recommendation and showed that most of the cash had disappeared. This was a riskier proposition than we had anticipated. But the pressure to remain consistent with our original view made reversing a Strong Buy recommendation, on the back of one balance sheet, difficult. A change would have been right, but would have seemed flippant, flighty and short-term.'

Strong Buys are rare in our history and we knew that many members acted on them. That made it harder to accept the evidence that things were not playing out as we hoped. We were unable to cut our losses when the evidence suggested we should, a bias also at play in **Roc Oil**.

Of course, there were other factors at play. We had had prior success in the sector, successfully recommending two other timber plantation companies, **Forest Enterprises** and **Great Southern Plantations**. It's possible these favourable experiences meant we had our guard down when it came to Timbercorp, assuming that MIS companies were inherently stronger than they were because we had made money on them in the past.

An uncertain world

What else? In retrospect, events that were previously unforeseeable – a change in regulation, unsustainable debt, a financial crisis – take on a degree of inevitability that lead us to believe they *were* in fact predictable. That's the final message from a self-flagellating exercise like this. Had Timbercorp worked out, the risks would have not changed but the outcome would mean you wouldn't be reading about them here.

As behavioural psychologist Amos Tversky wrote: 'All too often, we find ourselves unable to predict what will happen; yet after the fact we explain what did happen with a great deal of confidence ... It leads us to believe that there is a less uncertain world than there actually is, and that we are less bright than we actually might be.'

That might be the most important lesson from Timbercorp's failure. The world *is* uncertain and mistakes *will* be made, but neither of these things need stop us from becoming successful investors. Once one can accept that failure and uncertainty are integral to the process of being successful, wipeouts like Timbercorp become easier to deal with.

This insurer's new cost-cutting strategy is unlikely to improve profits, but it's still important.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 14 DECEMBER 2016

IAG: Cutting costs to stand still

In your heart, you probably hope that Insurance Australia Group will succeed in its three-year strategy to cut costs and grow earnings per share by 10% a year. In your head, you should suspect it will fail.

Key Points

- ***Cutting floor space and old systems***
- ***Competitors also cutting costs***
- ***Savings won't lead to profit growth***

INSURANCE AUSTRALIA GROUP (IAG) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$5.84	6%	Med–High	Med–High

BUY	HOLD	SELL
Below $4.50		Above $7.50

$5.84

There's something poignantly human about management's belief that it can find $250m a year in cost savings and that most of that (after tax) will flow through to net profit. The cost savings themselves – as outlined in a **recent strategy day** – seem credible enough. It's that 'flow through' factor that could be a problem.

As with most things, the devil is in the detail. So, before we explain why the plan may not succeed, we need to explain what the plan actually is.

First on the to-do list is to change the absolute bare minimum in the Australian and New Zealand operations, other than to improve the customer experience. The overall market is growing at around 3–5% and that's perfectly decent.

Customer focus

The main initiative on this front, as management put it, is to 'deliver deeper customer engagement through a more intimate understanding of their needs, their wants, their desires'. It sounds racy, but unfortunately there wasn't much detail on how the company might actually achieve this, nor on how the plan differs from what we imagined IAG would already be doing. Surely customer satisfaction is a round-the-clock job, not something that only comes up at strategy days?

In any case, IAG has a formidable franchise in Australia with brands including CGU and NRMA, as well as a 60% share of the personal insurance market in New Zealand. The company has a loyal customer base with a lower churn rate than most other insurers, so we don't expect it to have trouble keeping up with the general market – particularly if some of the cost savings outlined below get reinvested into marketing.

Next on the to-do list is to achieve high single-digit growth in Asian markets – Thailand and Malaysia, in particular – through organic policyholder growth and acquisitions.

As a general rule, we're about as comfortable with Asian 'growth-by-acquisition' strategies as we are with eye injections. Our concern isn't that Malaysia and Thailand's insurance needs aren't growing; it's that IAG will be caught overpaying for acquisitions if it stretches to meet growth targets.

That the company wrote off $60m from its Chinese business in 2015 isn't a great start. However, with the Asian operations only making up 4% of total gross written premium – an insurer's measure of revenue – it's still only a sideshow to the Australian operations.

Cost cutting

What does offer hope is the latest cost-cutting program. Management believes it can cut $250m of costs between now and 2019. This would reduce IAG's $2.5bn operating cost base by 10%, with the bulk of the savings extracted from the $1.6bn it incurs in underwriting expenses.

A key initiative is to consolidate IAG's claims and policy administration software systems from 32 to just two. By decommissioning dozens of legacy platforms, management expects to cut underwriting expenses and for claims management to be more streamlined. Claims handling is already migrating to the company's 'Guidewire' platform, which will become one of the two main pillars by the end of 2018.

Another major cost-cutting program is to combine many satellite offices into a few central hubs and, in so doing, reduce the overall floor space needed to run the company. IAG currently uses 187,000m2 Australia-wide, which will be

> **We don't put much faith in the cost-cutting initiatives translating into earnings per share growth in and of themselves.**

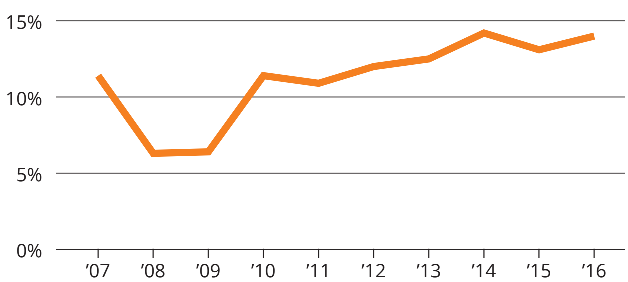
reduced to 156,000m2 by 2019. Major reductions will occur in Melbourne and Sydney as the company exits leases previously held by **Wesfarmers**' insurance business prior to its **$1.9bn acquisition in 2014**. IAG believes the plan will cut its rent bill by 16% over the next three years.

Cost savings ≠ profit growth

So what's the problem? Well, it's easy to look at a company's income statement and say 'right, if we cut operating expenses to this, net profit would have been this'. Unfortunately, reality doesn't work like that.

IAG's major competitors are also scraping around for savings: **QBE** has a US$700m cost-cutting plan underway, which is due to complete in 2018, and **Suncorp** has earmarked $170m in cost cuts over the next two years.

Chart 1: Underlying insurance margin (%)



Source: Company reports

Insurance is largely a 'commodity product', meaning that there's little to differentiate one policy from another. Customers tend to be focused on price and that makes the industry extremely competitive. As the three major insurers cut costs, lowering premiums is likely to follow. We expect most of IAG's $250m of savings to wind up in the hands of customers, not the pockets of shareholders.

History has given us some precedent. In 2014, IAG outlined a two-year plan to cut $230m of costs, mainly driven by savings from the Wesfarmers acquisition. At the time, the company had an underlying insurance profit of $1,230m and insurance margin of 14.2% (see Chart 1).

All things being equal, had we taken those numbers and assumed all of the cost cuts would flow through to profit, we might expect a 2016 result of $1,460m and a margin of 17%. Instead, IAG achieved $1,149m in underlying insurance profit with a margin of 14%. We would have overestimated the company's profitability by 27%.

That's not to say cost cutting is pointless; it's actually an ongoing necessity for IAG just to stand still and remain competitive. We came away from the strategy day encouraged that management is focused on efficiency, but we don't put much faith in the cost-cutting initiatives translating into earnings per share growth in and of themselves. That's far more dependent on growth in gross written premium and higher returns from IAG's $13bn investment portfolio (see *Can IAG float our boat?*).

Time to buy?

So at what price might we be interested in buying IAG? Management expects gross written premium to be flat in 2017, or around $11.3bn. However, it expects the insurance margin to decline to 12.5–14.5%, with consensus estimates for earnings per share of 35 cents.

Given the volatility of IAG's underwriting profit and its exposure to catastrophe risk, we don't want to be caught overpaying, so an earnings multiple of around 13 is as far as we're willing to go.

With a forward price-earnings ratio of around 17 and dividend yield of 4.4%, there isn't enough on the table to whet our appetite – particularly given growth will be hard to achieve and we don't expect the current cost-cutting program to boost margins over the long term. Nonetheless, IAG is a well-managed company, with strong brands and economies of scale. We're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

After strenuous denials, Santos is raising fresh capital for the second time.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 16 DECEMBER 2016

Santos goes to market. Again.

At its investor day last week, Santos chief executive Kevin Gallagher suggested the company's enormous debt was under control. Santos, said Gallagher, would generate enough operating cash flow over the next two years to cut debt by US$1.5bn to US$3bn.

Key Points

- ***Santos to raise $1.5bn***
- ***Proceeds to repay debt***
- ***No closer to an upgrade***

SANTOS (STO) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$3.94	3%	Very High	Very High

BUY	HOLD	SELL
Below $3.00	$3.94	Above $5.00

This would be done by splitting two dozen non-core assets into a separate unit and selling assets over time while core gas and LNG assets would lift Santos out of trouble. With higher oil prices and lower costs, management was adamant that the business was on the mend and debt under control.

Days later the company announced a $1.5bn capital raising, a move that sent the share price crashing 10%, making previous promises ring hollow.

Santos will issue $1bn of fresh equity at $4.06 to institutional investors and launch a $500m share purchase plan (SPP). Existing shareholders will be able to buy up to $15,000 worth of shares at a 2% discount to market prices.

For debt or growth?

Santos denies the capital raising is needed to reduce debt yet will use the raising to reduce debt.

Confused? You're not alone.

At best, management is using higher oil prices to opportunistically raise cash and pay off debt. That's prudent and is arguably overdue – we noted in ***Santos: Interim result 2016*** that additional cash was likely to be needed.

Yet if that's the case, why not just say so? Management has been coy about admitting that this is a debt reduction measure and is clinging to the story that the cash is to pursue growth. We doubt it and wonder what else is going on at Santos.

Whatever the cause, the raising does provide much-needed debt relief. With oil price hedging and lower debt, the threat of going bust is far lower but that doesn't make Santos any closer to our Buy list.

No closer to Buy

There is a clear path to redemption for the business: sell assets (in particular a slice of PNG LNG), accept write-offs and shrink the business to a level appropriate for its cash flow.

There are no signs that this will happen.

We are sorely tempted to Sell and be done with Santos. Yet the company's break-up value, likely at least $6 a share, is enough to keep us holding. We don't recommend buying more shares in the SPP and we're cutting our recommendation prices to account for dilution and a higher risk of operating problems.

This capital-raising is a welcome measure that lowers risk but Santos is no closer to an upgrade. **HOLD**.

Tatts has received a more generous takeover bid from private equity.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 14 DECEMBER 2016

New takeover offer for Tatts

Lottery and wagering operator Tatts Group has received a second, more generous bid from a group of private equity investors. The 'Pacific Consortium' – which includes First State, Morgan Stanley, Kohlberg Kravis Roberts and **Macquarie Group** – have proposed a two-step purchase of the company that puts more cash in the pockets of shareholders and better reflects the value of Tatts' lottery business.

TATTS GROUP (TTS) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.56	5%	Low–Med	Medium

BUY Below $3.50 — **HOLD** — **SELL** Above $6.50

$4.56

As we explained in ***The lottery that always pays***, this division is a regulated monopoly and offers a stable, growing income, while earning extremely high returns on tangible capital.

Step one of the offer is to separate Tatts' wagering and gaming businesses from its lottery operation. Step two is to give shareholders $3.40 in cash and one share in the now independent wagering business (in effect, buying the lottery business for $3.40 per share). The cash component will comprise $3.105 in cash, a 20 cent fully franked special dividend and a 9.5 cent fully franked interim dividend.

Pacific Consortium also outlined the possibility for the wagering operations to be sold in parallel to Tabcorp, given the company already has an offer on the table. It believes the wagering business could garner $1.60 per share. Alternatively, the wagering business would be listed on the ASX as a standalone entity. We would be hugely surprised if Tabcorp wasn't interested given it has identified $130m of savings by combining the two wagering businesses – it's just going to be a matter of price.

Adding the cash and possible sale or listing of the wagering business, it implies a total value per Tatts share of $4.40–5.00. That compares well with the Tabcorp offer of 0.80 Tabcorp shares and 42.5 cents in cash for each Tatts share held, which implies a value of $4.09 given Tabcorp's current share price of $4.58 (see Tatts and Tabcorp set to join forces).

Tatts' board hasn't formed a view yet on how the new bid stacks up against the proposed Tabcorp merger. There's no need to do anything for the time being, and there are several conditions to the deal that could mean it falls through, such as the renewal of Tatts' Victorian lottery licence on similar terms to the existing contract.

Nonetheless, we think this new bid better reflects the value of the company's lottery monopoly, offers more pricing certainty given that it's mainly a cash offer, and still leaves open the prospect for Tabcorp and Tatts' wagering businesses to merge and cut out duplicate costs.

The two proposals could take some time to play out – and who knows, maybe Tabcorp will up its bid. We'll keep you up to date as things develop and, with a forward price-earnings ratio of 25, we continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

Owners of deep sea oil rigs are reporting steady margins and decent cash flow but there's more to the story.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 13 DECEMBER 2016

Hidden risks in oil drilling

OPEC's deal to limit supply is being greeted with euphoria by traders, who have pushed oil prices up above US$50 a barrel. Equity markets have been equally jubilant with energy stocks rising strongly as expectations of higher oil prices are reflected in valuations.

Oil is fashionable again and investors are looking at how to profit from the recovery. One idea is that offshore drillers, who were savaged during the downturn, should profit as prices improve. We should be sceptical about that thesis.

Floating drilling ships that are used to access deep sea oil and gas reservoirs remain under-utilised.

Deep sea drilling vessels are some of the most expensive on the oceans and each costs more than US$500m to build. Over the boom years they were leased for up to US$700,000 a day to companies exploring or producing from difficult-to-access locations. Such heady rates encouraged new construction, much of which is only now hitting a very different market.

Lease rates have fallen to well under US$300,000 a day and there are still about US$56bn worth of new rigs under construction. Some of that activity can be scrapped but much of it is already committed and will keep lease rates depressed for years even if demand recovers.

The industry already suffers from chronic overcapacity. As much as half of the global floating rig fleet is unutilised and, as these rigs require substantial cash to maintain, the industry is trying new ideas to limit cash costs.

Older ships are being scrapped altogether to help keep costs down. For the first time in history, asset owners are also shutting off engines, or 'coldstacking' rigs. This improves cash flow but it is a risky move.

Tens of thousands of electrical and mechanical systems work together to make these vessels work and each will have to be reset when engines are eventually fired up again. No one has ever turned off one of these rigs and turned them back on again, and industry insiders are divided about the impact.

Owners of offshore drill rigs appear to generating decent cash flows despite the downturn – maintaining a coldstacked rig costs about US$15,000 a day compared to almost US$50,000 for an operating rig – but they are also accepting additional risk.

Coldstacking has helped preserve margins for rig suppliers in the downturn and flattered cash flow but risks could be lurking once idle ships are eventually turned on.

Bellamy's shares suspended

BY PHILIP BISH • INTELLIGENT INVESTOR • 14 DEC 2016

BELLAMY'S AUSTRALIA (BAL) / AVOID

Price at review $6.68 | Max. portfolio wght. N/A% | BUY HOLD SELL

The situation at Bellamy's appears to be going from bad to worse. Just 12 days after its shock revenue downgrade, Bellamy's has requested a suspension from trading, after issuing a trading halt on Monday.

According to the announcement, 'The company expects the suspension to last until the earlier of the commencement of normal trading on 21 December 2016, or the release of an announcement by the Company'.

The reasons behind the suspension are yet to be revealed but it doesn't look good for Bellamy's shareholders. There are questions hanging over Bellamy's management about who knew what and when; and why there was no disclosure of the situation at the company's AGM in October.

Confidence in management is nearing zero and, whatever the announcement, it looks like being a tough road ahead for Bellamy's. **AVOID**.

Disclosure: The author owns shares in Bellamy's.

Crown recommences trading

BY JON MILLS • INTELLIGENT INVESTOR • 16 DEC 2016

CROWN RESORTS (CWN) / BUY

Price at review $11.58 | Max. portfolio wght. 5% | BUY Below $12.00 | HOLD | SELL Above $18.00 | $11.58

As flagged yesterday (see ***Crown cashes in on Melco***), Crown has further reduced its economic stake in Melco Crown. The company has sold a further 2.8% of its Melco Crown shares for US$16, an 11% discount to the US$18 at which it sold a 13.4% stake earlier this week. Crown has also entered into a hedge that locks in a price of US$16 for another 5.5% of Melco Crown. After these transactions, the company retains an exposure to 5.7% of Melco Crown.

As a result, Crown now plans to pay a special distribution of around AU$0.82 per share (increased from AU$0.69 per share) and repurchase $500m in shares (increased from $300m).

Crown shares have risen upon recommencing trading this morning but are still a little below our Buy price of $12. We're nudging down our risk ratings and increasing our recommended maximum portfolio weighting to 5%. **BUY**.

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

Disclosure: the author owns shares in Crown Resorts.

Myer downgraded

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 13 DEC 2016

MYER (MYR) / HOLD

Price at review $1.30 | Max. portfolio wght. 3% | BUY Below $1.25 | HOLD | SELL Above $1.80 | $1.30

Myer's share price is now above our recommended Speculative Buy price. We're downgrading the stock to **HOLD** once again.

Staff members may own securities mentioned in this article.

Ceasing coverage on NRW

BY GAURAV SODHI • INTELLIGENT INVESTOR • 14 DEC 2016

NRW HOLDINGS (NWH) / COVERAGE CEASED

Price at review $0.67 | Max. portfolio wght. N/A | BUY HOLD SELL

When NRW's largest customer refused to pay bills totalling around $100m, the indebted contractor looked as though it would go bust. By the grace of its banks and a fortunately timed contract win, NRW narrowly escaped corporate death and has now repaid debt and is starting to win new projects – the latest being a road contract for **Rio Tinto**.

NRW will avoid going under but it was a close thing and it demonstrates that even better than average businesses in the mining services sector can make tumultuous investments.

Originally part of our **mining services mini portfolio**, NRW is resurrected and doesn't appear dear, trading on an enterprise value to earnings before interest, tax, depreciation and amortisation (**EV/EBITDA**) multiple of six and at a small premium to book value. Yet we won't be recommending mining services stocks without the comfort of a portfolio approach. After an unhappy time on our coverage list, a Sell is no longer warranted but neither is further research time. **CEASE COVERAGE**.

Disclosure: The author owns shares in NRW, bought when it was on our Buy list.

CSL share price fall?

I have been following CSL for some time and as far as I can see there has been no negative announcement from the company or from research agencies such as yourself in recent months . Nonetheless the CSL share price keeps falling . I notice you have a buy price of 80 dollars . Is the company that overpriced and how likely is it that it will ever get to $80 to justify buying it.

10 Dec 2016 – **Graham Witcomb**: It's a bit of a mystery to me too. The American Society of Hematology annual conference was earlier this month where CSL presented some data on potential haemophilia drugs, one of which is in Phase 3 trials and has recorded adverse events (bad news), but that's nowhere near enough to change the valuation by the extent of the share price move.

The only big thing I can think of could be some ongoing concern around a Trump presidency as he has very up in the air ideas around reining in drug pricing and the pharmaceutical industry (that seem to change on a daily basis).

It's more a sense of uncertainty, rather than any crystal policies and how they would affect CSL is anyone's guess at this stage. No doubt some of CSL's therapies are extraordinarily costly ($300k a year for some haemophilia drugs!) but they also treat rare illnesses and have orphan drug status. There still needs to be a financial incentive for companies to research these drugs for small populations that would otherwise get overlooked.

Other than that, I haven't seen any material news, so this just seems to be the ebb and flow of the market. Our valuation and Buy price are unchanged. We can never tell when, if ever, we will have the chance to upgrade CSL. The share price movement is out of our control, we just focus on trying to make the most accurate valuations. Hopefully we get to upgrade soon as CSL is a wonderful company.

Investing in stages

I have recent receive a sizeable amount of cash from a property sale. I already have some shares and intend to invest this new cash into shares now also. How would you generally suggest investing larger sums? I was thinking to buy some of the current recommendations and then add more as they come out over the next year to average the entry point out. What would be a rough guide for breaking up a 8% 'buy' recommendation into multiple purchases? Are 2% lots too small?

9 Dec 2016 – **James Carlisle**: First of all, please bear in mind that we're not able to provide personal advice since, amongst other things, we know nothing about your personal circumstances, so you'll need to interpret our general advice to suit your particular situation.

That said, the best way to go from zero per cent invested to fully invested with a large sum, generally speaking, is gradually. There are a couple of reasons for this: first you smooth out your entry points to avoid the market's peaks and troughs; and second you can be patient as the best opportunities appear to build your portfolio.

The second point is probably the key to it. If you just went out and bought all our Buy recommendations right now, or all the stocks that you personally thought looked undervalued, then you'd end up with a very unbalanced portfolio. The better bet is to be patient, see what opportunities appear and build a portfolio over time.

In that respect, it's less about buying small chunks of investments now, in the expectation of buying more later, and more about being picky with the stocks you buy. If and when something looks attractive, then you might as well buy the entire starting stake that you'd want for a portfolio.

Note, however, that this doesn't mean buying up to our 'maximum recommended portfolio weighting' straight away. That is deliberately stated to be a maximum, so with most investments, we suggest starting well below that level – around half in many cases – to give some scope for the holding to grow before breaching the maximum if things go well, or to purchase more if the price falls and the stock becomes more attractive (which aren't necessarily the same thing).

Thoughts on car dealer group AP Eagers

Could I have your view on AP Eagers (APE) please? Appears to have good fundamentals and growing earnings, yet its share price has declined over 30% in recent months. What do you think might be behind this price decline, and in your opinion is it a reasonable buy at current levels ?

13 Dec 2016 – **James Greenhalgh**: We don't cover car dealership group AP Eagers although I have looked at it personally in the past. Up until recently it has looked fairly expensive, although (without providing a formal view) I'd consider the pricing now about right. I'd certainly not call it underpriced just yet.

Part of the reason for the share price fall is that ASIC has been looking at (cracking down on?) the financing and insurance side of car dealerships. As finance and insurance is a significant part of how dealers make their money, this could have significant ramifications for the industry's business model.

We recently downgraded AP Eagers competitor Automotive Holdings in Automotive Holdings: Result 2016 partly for these reasons. We made some comments on AP Eagers in that article that might be of interest, as might the comments section at the end of the review.

Sorry we can't provide a more definitive view. We would be interested in commencing coverage on AP Eagers at some stage, but it would likely be at levels below this (when it might represent better value).