Weekly Review

RESEARCH

– Issue – 17 Feb. 2017

Three of News Corp's four divisions reported improved quarterly results but the one that went backwards was (of course) News and Information Services.

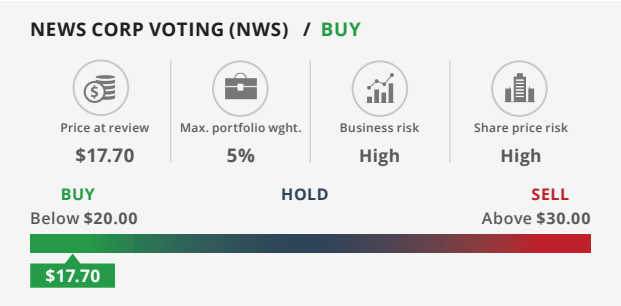
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 13 FEBRUARY 2017

News Corp: Interim result 2017

In the parallel universe that is Wall Street – for News Corporation is an American company* – analysts were delighted that second quarter earnings per share estimates beat expectations. That News Corp delivered 19 US cents of underlying earnings per share compared with the 18 US cents 'the Street' expected was enough to lift the share price 7% on Friday.

Key Points

- ***Weak advertising trends continuing***
- ***Three divisions reported profit increases***
- ***Move potential to become clearer***



Meanwhile, we were agape at a more alarming statistic. Mentioned on the conference call but not in the second quarter earnings release was that advertising revenues at Dow Jones fell 20% in the second quarter after a similar decline in the first quarter. Clearly the Wall Street Journal, the planet's best-known business newspaper, is not immune from advertiser disloyalty. It's concerning because the Journal is one of the few News Corp newspapers to which we attribute any value.

In the end, though, the result from the News and Information Services division – the one where you should expect ongoing revenue declines – wasn't all bad. After a shocker of a first quarter – see ***Weak start for News Corp and REA*** from November 2016 – the earnings decline was a more sedate 10% in the important Christmas quarter.

The news was also better elsewhere, with all three divisions reporting significant jumps in earnings. Book Publishing earnings rose 32% as the company had success with new releases over the seasonally strong Christmas period.

On the up

In Digital Real Estate, management once again indicated the division was 'well on the way to becoming the largest contributor to our profitability'. On current trends that might happen in 2018, or more likely 2019.

Digital Real Estate earnings grew 30% but, for once, **REA Group** wasn't the star. Earnings at the Australian business grew 13% as lower listing volumes offset revenue growth in premium products. While US business Move isn't yet profitable, it's close to breakeven. If management is correct about Digital Real Estate becoming its most profitable division, it is expecting big things from Move. We'll look for more evidence over the remainder of this year.

In the Cable Network Programming (Fox Sports) division, revenues were flat but earnings rebounded 31%. The reason was the absence of programming rights for the Rugby World Cup and the English Premier League in the current period.

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In the 50%-owned Foxtel, second quarter earnings fell 7%. More concerning was that average revenue per user drifted lower, to A$84 per month, as did the number of subscribers – from 2.9m to 2.8m. While some of that looks seasonal – subscribers tend to cancel during summer and re-join in winter – it's something to watch. That News Corp management wrote down the value of its Foxtel stake by $227m is an acknowledgement that competition has intensified.

Table 1: Divisional EBITDA ($USm)

END 31 DEC.	2Q17	2Q16	CHANGE (%)
NEWS AND INFORMATION SERVICES	142	158	(10)
BOOK PUBLISHING	75	57	32
DIGITAL REAL ESTATE SERVICES	95	73	30
CABLE NETWORK PROG. (FOX SPORTS)	51	39	31
CORPORATE	(38)	(47)	–
TOTAL	**325**	**280**	**16**
FOXTEL (50% SHARE)	144	155	(7)

Add to that a $310m writedown on its Australian newspaper assets and the company fell to a bottom line quarterly loss. But on an underlying basis, it was pleasing to see quarterly EBITDA rising 16% to $325m as the book, real estate and sports programming divisions improved.

As we said in ***Weak start for News Corp and REA***, we are a little concerned about the News and Information Services division. While it's a huge division, revenues are falling fast and earnings faster than we expected. That management expects Digital Real Estate to become the largest earnings contributor says as much about News and Information Services as anything.

Wonderful asset

Digital Real Estate is however a wonderful asset and we think Move is now worth more than what News Corp paid for it. We're comfortable enough with the values in our sum-of-the-parts table from ***News Corp's leap of faith*** from July 2016 although recognise that some of News' more interesting assets are buried within its most difficult division.

Our view remains that, if some parts of the business continue deteriorating, management will be forced to take action. How long this takes could have an influence on the returns we earn from here.

But the reality is that we are getting News Corp's assets at a significant discount to what we would if they were each separately listed. How the rest of the year pans out will be important, but we're sticking with **BUY**.

**All figures are in US dollars unless otherwise stated.*

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

Staff members may own securities mentioned in this article.

This financial software provider is still in the early stages of its transition to cloud-based services, but it's heading in the right direction.

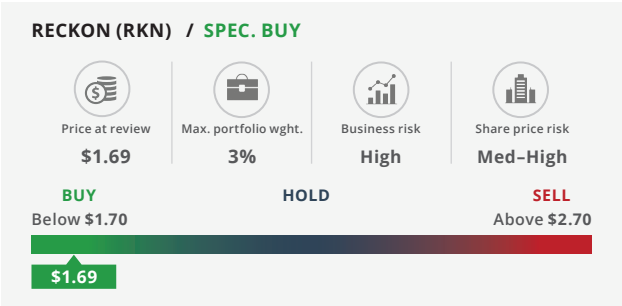
BY JON MILLS • INTELLIGENT INVESTOR • 15 FEBRUARY 2017

Reckon: Result 2016

While all three of Reckon's divisions grew revenue in 2016, its statutory net profit fell 25%, from $14.6m to $11.0m. Anyone taking the result as face value would quickly move on, but the underlying result was much more favourable.

Key Points

- ***Users rising in all three divisions***
- ***Revenue also increasing***
- ***But still in early stages of transition***



The big difference between statutory and underlying net profit is why we think there's an opportunity in Reckon. To understand why, though, we nee d to take a detour into how software businesses have changed in recent years.

Getting SAASy

Previously, most software companies would sell their products for an upfront (or perpetual) licence fee and, mainly with business customers, also earn annual maintenance or service fees. The software was typically stored or 'hosted' on the customers' computers and servers.

However, that licence fee and annual maintenance / service fee model is now being replaced with a subscription model, where customers pay a regular charge, usually monthly, for the software. This not only makes it cheaper for a customer to try a new piece of software – thereby expanding the market for the software provider – but also typically means that the lifetime value of a customer is higher.

Technological advances and the rise of smartphones and tablets have also led to many software companies supplying their software 'in the cloud'. This just means that customers access the software via the internet, as the software runs on the software company's servers or those of third parties such as Amazon AWS or Microsoft Azure.

In industry jargon, software supplied over the cloud is tagged 'software-as-a-service' or SAAS.

Under this model, customers no longer have to fork out millions of dollars for the necessary hardware and employees to run and maintain it all, while they always have access to the latest version of the software as it's being constantly updated in the cloud.

Mostly subscription...

As we noted in ***Reckon: more than meets the eye*** on 10 Aug 16 (Speculative Buy — $1.50), the company is a lot more than just a seller of small business accounting software that competes with **Xero**, **MYOB**, Intuit's Quickbooks and others. We won't go through the individual divisions again in detail as they were discussed in that article.

Table 1: 2016 result

YEAR TO DEC	2016	2015	+/(–) (%
REVENUE ($M)	97.8	91.4	7
UNDERLYING EBITDA ($M)	40.5	39.2	3
UNDERLYING EBIT ($M)	27.9	26.7	4
UNDERLYING NPAT ($M)	20.8	19.3	8
UNDERLYING EPS (CENTS)	18.4	17.0	8
INTERIM DIVIDEND	3 cents, unfranked, ex date 21 Feb 17		

Reckon has spent recent years transitioning its customers to a subscription model and this is now almost complete. Ignoring its Reckon Docs business, 82% of revenue in 2016 (the company has a calendar year end) was subscription.

But let's get back to Reckon.

As that percentage has increased it has temporarily depressed total revenue as fewer and fewer customers pay much of the cost upfront in the form of licence fees.

> **Management estimates that there are anywhere from 100,000 to 150,000 active desktop users of Reckon Accounts.**

...but still on the runway

However, in all three divisions Reckon remains at the very early stages of moving customers to the cloud. Ironically, its Reckon One product – which is the cloud-based version of its small business accounting software – is probably the furthest along in this regard despite still being far behind Xero's and MYOB's products.

While 35% of its Business division's revenue is now cloud-based, the company doesn't reveal the number of its Reckon One customers, preferring to state that it now has 39,000 'online' customers. 'Online' includes both Reckon One and customers who use its Reckon Accounts Hosted product.

So while it's clear that the number of Reckon One customers is currently fairly small, management estimates that there are anywhere from 100,000 to 150,000 active desktop users of Reckon Accounts, the desktop version of its small business accounting software. These customers helped this division's underlying earnings before interest, tax, depreciation and amortisation (EBITDA) rise 5% during 2016 (see Table 2) although, with the additional expenditure on selling and marketing Reckon One, actual EBITDA was flat for the year.

Table 2: Segment earnings

YEAR TO DEC	2016	2015	+/(–)(%)
BUSINESS REVENUE ($M)	35.5	35.4	–
PRAC. MGMT REVENUE ($M)	46.8	45.1	4
DOC. MGMT REVENUE ($M)	14.8	9.8	51
UNDERLYING BUSINESS EBITDA ($M)	20.0	19.1	5
UNDERLYING PRAC. MGMT EBITDA ($M)	19.9	19.4	3
UNDERLYING DOC. MGMT EBITDA ($M)	4.7	4.2	12

These customers are prime targets for Reckon One due to their familiarity with Reckon's accounting software and features. Along with new customers attracted by Reckon deliberately pricing Reckon One materially below competing products, this division has good prospects for growth. To help this along, the company released a Payroll module during 2016 and will continue to release more features to improve the functionality of Reckon One.

Just boarding

The Practice Management and Document Management businesses are at even earlier stages in their transition to the cloud. However, these remain the most attractive of the company's businesses. Assisted by a further 6,000 increase in the number of users of Reckon APS, to 92,000, Practice Management's EBITDA rose 3%, from $19.4m to $19.9m.

The company is continuing to dominate the market for large accounting firms in Australasia – it has three of the big four accounting firms and 70 of the top 100 as clients and it recently added a number of large clients.

Having bedded down its acquisition of US-based online document management company SmartVault, Reckon's Document Management business was the fastest growing in 2016, with underlying revenue rising 9%. Management intends to combine SmartVault with its existing document-management business Virtual Cabinet while also developing a cloud version of this product. So while ignoring currency movements, underlying EBITDA rose 12%, to $4.7m, integration and marketing expenditure meant actual EBITDA fell 44%, from $4.3m to $2.4m.

Development expenditure

In total, the company spent $22.8m on development in 2016, which it capitalises and amortises over three to four years. This expenditure depresses free cash flow in the year it's made and the resulting increased amortisation affects headline earnings in subsequent years, while new market expenditure depresses both headline earnings and free cash flow in the year it's incurred.

However, as 'more than 50%' of its development expenditure is targeted towards growth rather than merely maintenance of existing products, we estimate the company had around $23–24m in underlying free cash flow in 2016, which compares favourably to Reckon's current market capitalisation of around $190m.

A similar amount will be spent on development in 2017, with management suggesting it will decline by $4m in 2018 and return to 14% of revenue thereafter.

> **Net debt at the end of December was around 1.4x actual EBITDA but we'll be watching it closely.**

Importantly, Reckon's existing businesses provide the operating cash flow ($30m in 2016) to invest in its transition while also keeping debt manageable. Net debt at the end of December was around 1.4x actual EBITDA but we'll be watching it closely.

Operating leverage

So while Reckon remains in the early stages of its transition to a cloud-based software provider, this is also why we believe the opportunity exists.

If we are correct that the company will likely maintain its dominance in the Practice Management division while benefitting from a fast-growing Document Management division and its slower-growing Business division, then revenue should continue to rise in all three divisions.

This will allow Reckon to benefit from **operating leverage** – even more so if development expenditure does moderate in coming years – as once it covers its fixed costs, any further revenue from additional customers will mostly fall to the bottom line.

Moreover, should the company successfully transition to a SAAS model in all three divisions, not only will earnings rise but their recurring nature will likely mean each dollar of earnings will be more highly valued than the high-single digit multiple the market currently places on the stock.

The latter also gives us a margin of safety (just) at current prices. **SPECULATIVE BUY**.

Disclosure: the author owns shares in Reckon.

As expected, Rio's result was stunning. If iron ore prices hold, things could get even better.

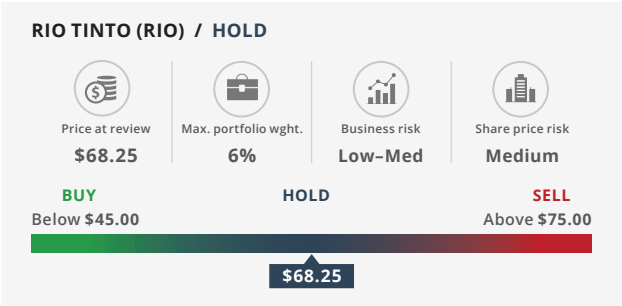
BY GAURAV SODHI • INTELLIGENT INVESTOR • 13 FEBRUARY 2017

Rio Tinto: Result 2016

Surging commodity prices promised a stellar result and Rio Tinto obliged, reporting a 12% rise in underlying earnings to US$5.1bn.

Key Points

- ***Underlying earnings up 12% to US$5.1bn***
- ***Boosted by US$1.2bn in cost reductions***
- ***Capex cut by 36% to US$3.0bn***



However, that rise was generated quite unexpectedly. Commodity prices cut US$500m from earnings, while cost reductions provided a US$1.2bn boost. Since 2012, Rio has stripped out a staggering US$7.8bn in costs, a sign of both excess during the boom and atonement during the bust.

Capital expenditure has been cut just as savagely, falling from a peak of over US$17bn in 2012 to just US$3bn.

Free cash flow was unsurprisingly strong, rising 15% to US$5.4bn and Rio made a big dent in its net debt, which fell 30% to US$9.6bn. Capital expenditure should increase over the next few years as Rio pursues new projects.

Investors who have demanded more sobriety from big miners will be pleased as new spending – on the Silvergrass iron ore mine, expansion at Oyu Tolgoi and Amrun bauxite – will deliver low-cost output at excellent rates of return. Although capital expenditure will double to US$6bn, free cash flows should also rise.

The core iron ore business still delivers about 90% of EBITDA and was aided by higher volumes and lower cost.

Fine asset

Only two years ago, it cost Rio US$20 a tonne to extract iron ore; last year it was US$13 a tonne and it could fall further. Even with modest prices, the division generates return on assets (ROA) of about 30%. As the spot price rises, the ROA could be closer to 80%. This remains arguably the finest mining asset anywhere.

Poor results from the Kennecott copper mine lowered earnings from copper, while aluminium profit was steady despite lower prices, evidence of impressive cost control in that business. Yet Rio remains mostly an iron ore business.

Full year dividends of US$1.70 per share are generous and could rise with cash flow but, importantly, Rio now has more discretion about how much to pay since axing its 'progressive dividend' policy.

If current commodity prices hold, the company should report a stellar half-year result in August as it captures the benefit of higher prices and lower costs.

Table 1: Rio final result 2016

YEAR TO DEC	2016	2015	+/– (%)
UNDERLYING EARNINGS (US$BN)	5.1	4.5	12
OP. CASH FLOW (US$BN)	8.4	9.3	(10)
UNDERLYING EPS (US$)	2.84	2.48	14
DPS (A$) *	2.23	2.97	(25)
CAPEX (US$BN)	3.0	4.7	(36)
NET DEBT (US$BN)	9.6	13.7	(30)

*** Final div of A$1.6362, up 8%, ex date 23 Feb**

We've been surprised by persistent strength in iron ore markets, which have turned largely on policy decisions in China. Those decisions could revert as quickly as they were changed. Our price guide for Rio reflects a dismal view of iron ore prices which we will re-examine later this year. The rest of the market shows no such hesitation and the share price suggests the boom is back.

We are closer to selling than buying but acknowledge that this was a fine result that will be even better next time. **HOLD**.

Staff members may own securities mentioned in this article.

A sharp increase in raw material prices couldn't have come at a worse time, but this result still had its bright spots.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 14 FEBRUARY 2017

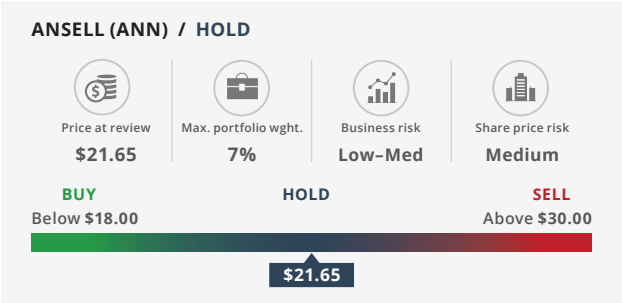
Ansell: Interim result 2017

Sometimes you read a financial report and there's only one paragraph that matters. For glove and condom maker Ansell, it was this one:

'Over the last few months we have also seen a significant increase in market prices for our key raw materials. We expect this to result in unfavorable cost inflation with approximately a US4c headwind to EPS in H2 compared to H1. Plans are being developed to offset this impact including selling price increases, however the time taken to implement these actions will see the benefit largely delayed until F'18'.

Key Points

- ***Raw material prices increasing***
- ***Sexual Wellness margin improvement***
- ***Branded product sales doing well***



Let's take a look at what that means for the company and shareholders point by point. The first thing of note is that raw material prices have increased significantly in the last few months – particularly in the weeks since the books closed for this result in December. Ansell's two main inputs are rubber latex and nitrile rubber – a synthetic material more resistant to punctures, acids and oils than natural latex – but the company also relies on a host of other chemical additives to make its products. More than half of Ansell's raw input materials saw price rises of 30% or more in recent months, with the cost of some commodities doubling.

The cost of raw materials consistently fell between 2011 and 2016, which helped Ansell widen margins. With raw materials accounting for around 50% of manufacturing costs, the sharp reversal these past few months will certainly put an end to that. Management says investors should expect an earnings per share headwind of four US cents in the second half of the year, or around 8–9%.

Product pricing troubles

The real issue with our key paragraph, however, is the final sentence. The company needs to raise the selling prices of its gloves and condoms to offset the increase in raw material costs – and it couldn't have come at a worse time.

Between 2009 and 2015, Ansell had very little organic revenue growth due to lacklustre sales and declining prices (though overall revenue grew thanks to acquisitions). Finally, in 2016 the company managed to reverse that trend for some key categories, including industrial gloves, emerging market sales and the Sexual Wellness division.

Table 1: ANN Interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE (US$M)	776	785	(1)
EBIT (US$M)	105	99	6
NPAT (US$M)	69.8	69.6	1
EPS (US CENTS)	47.4	45.6	4
INTERIM DIVIDEND	20.25 US cents, unfranked, (up 1%), ex date 17 Feb		

If Ansell is now forced to raise prices to keep up with rising material costs, it could well stop this improvement dead in its tracks. Management is now playing a delicate balancing act. Ansell operates in a highly competitive marketplace and if the company raises prices too quickly compared to competitors it's likely to lose market share. On the other hand, if it raises prices too slowly, the combination of subdued selling prices and rising input costs will squeeze margins and take an axe to profitability.

Bright spots

Thankfully, this is where the bad news ends. Overall, this was a good result and, despite the issues mentioned above, management maintained its forecast for full-year earnings per share of US$1.00–1.12.

A drag on this result and the last was the Medical division after it was hit by falling sales in Russia. Lower oil prices caused government budget cuts to hospitals, which encouraged them to switch from Ansell's premium glove products to cheaper alternatives.

> **Over the last couple of years, Ansell's management has consolidated its portfolio of products to just a few core brands, such as HyFlex and Gammex.**

On top of this was the botched replacement of a major production line, which meant the company had insufficient capacity to meet demand.

Management said both those issues are moderating; sales in Russia increased 21% this half. Although the division's overall sales fell 2% for the six months to December, with production capacity back to normal management expects the division to return to growth for the remainder of the financial year.

Ansell's largest division, Industrial, saw a slight decline in sales of 1% to US$326m but profitability improved markedly – earnings before interest and tax (EBIT) was up 12%. The strong result was down to a shift to higher margin products, with sales of branded Industrial products growing 11%.

Over the last couple of years, Ansell's management has consolidated its portfolio of products to just a few core brands, such as HyFlex and Gammex. We're happy to see the company reduce the number of its brands to a few big banner names as the added brand recognition usually comes with a smidgen more pricing power. That flows through to wider margins, as was the case in this result.

Margin improvement

Just in time for Valentines day, the Sexual Wellness division improved considerably with condom sales in emerging markets rising 9%, led by China and Brazil. Overall revenue was up 4% and EBIT up 46% due to improving plant efficiency and profitability in China. At 2016's full-year result, management **flagged a potential sale** of the division – which is the third largest maker of condoms in the world – so the Chinese turnaround and top line growth is well timed.

Overall, Ansell's revenue fell 1% to US$776m. Total EBIT rose 6% thanks to the margin improvement at Sexual Wellness and Industrial but net profit rose just 1% to US$69.8m due to a higher tax rate. The company's recent share buy-back, however, increased earnings per share by 4%.

Management expects underlying earnings per share of US$1.00–1.12 in 2017, up 2–17% before taking into account the sale of Ansell's small Onguard footwear business. That implies a forward price-earnings ratio of around 16 using the midpoint of the range at today's exchange rate. The share price is up 40% since we upgraded the stock in ***Ansell: good news, bad news*** from 4 Feb 16 (Buy – $15.49) and we're sticking with **HOLD**.

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

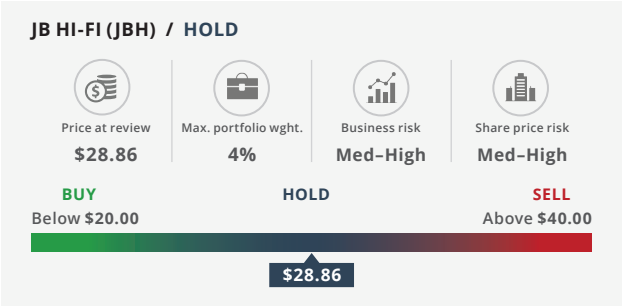
Disclosure: The author owns shares in Ansell.

The JB Hi-Fi brand continues to bask in the afterglow of vanquishing Dick Smith, while The Good Guys acquisition has made a promising start.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 14 FEBRUARY 2017

JB Hi-Fi: Interim Result 2017

We certainly weren't expecting The Good Guys acquisition to come unstuck immediately – see JB Hi-Fi: Good Guys, bad buy? from September 2016. Nevertheless, the strong 2017 interim result has made us look overly cautious once again.



We certainly weren't expecting The Good Guys acquisition to come unstuck immediately – see JB Hi-Fi: Good Guys, bad buy? from September 2016. Nevertheless, the strong 2017 interim result has made us look overly cautious once again.

All JB Hi-Fi's divisions – bar the small New Zealand operation – performed very well. The Australian business was once again an absolute star, with operating profit rising 22%. Same-store sales were up 8.7% as the company continues to derive benefits from the collapse of Dick Smith. However, profit growth of this magnitude looks unlikely beyond 2017 as market share gains begin wearing off.

As they do, earnings from The Good Guys will take up the slack. The company has only owned the appliance retailer since 28 November and so it contributed $14.3m of operating profit (EBIT) during the seasonally strong month of December.

Also particularly noteworthy was that same-store sales growth from The Good Guys accelerated to 3.5% in January. Some of this will be related to the recent hot weather, but management was still confident the business would improve into the second half. It also looks like our concerns about store management disruption might have been overblown, with company management noting on the conference call that the Muir family did a good job restructuring The Good Guys for sale (presumably because the alternative sale method was an initial public offering).

JB Hi-Fi is currently in a sweet spot. As its store rollout matured in Australia, the collapse of Dick Smith helped it take market share. Now that's tailing off, the company will benefit from the sales and earnings of The Good Guys, even if it's a weaker and more cyclical business than the JB Hi-Fi business itself.

Table 1: JB Hi-Fi interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
REVENUE ($M)	2,616	2,117	24
EBIT ($M)	181	138	31
NPAT ($M)	125	95	32
EPS (C)	116.3	95.0	22
DPS (C)	72*	63	14
FRANKING (%)	100	100	N/a

Underlying numbers, *ex date 23 Feb

With good management – something JB Hi-Fi undoubtedly has – the company might be in for a few years of earnings growth yet. It's enough reason to **HOLD**, even if we have our doubts about the long term.

Staff members may own securities mentioned in this article.

The wealth giant's life insurance division produced a terrible result, as expected, and there are some worrying signs in its wealth management business.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 15 FEBRUARY 2017

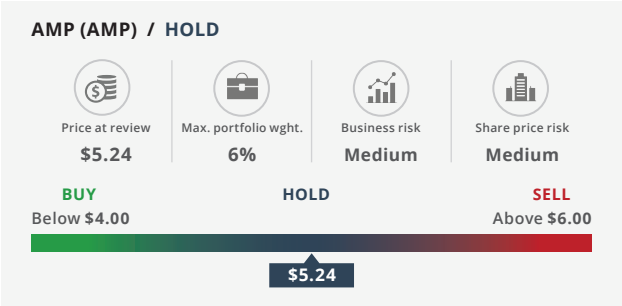
AMP: Result 2016

The blow-up in AMP's wealth protection business last year was fully evident in its final result last week.

Changes to assumptions about future claims rates, amongst other things, knocked $485m from the profits of its Wealth Protection business. That this was $16m better than flagged hardly dulled its impact, and it took the division to an underlying net loss of $371m, compared to a profit of $234m in 2015. At the group level there was an additional writedown of $668m, which meant that 2015's $972m net profit became a $344m loss.

Key Points

- ***Reinsurance deals with wealth protection risks***
- ***Wealth management struggling for fund flows***
- ***AMP Bank performing well***



Some medicine has been taken. The new assumptions themselves set a lower hurdle for the future and the company has entered into a reinsurance deal with Munich Re, which will share 50% of the premiums and losses on $750m of premiums in its retail portfolio.

That effectively cedes around a fifth of the division's annual premium (of $2bn), its risks and its profits (which are expected to fall by about $25m a year as a result of the deal). In return, Munich Re paid AMP a one-off payment of $530m.

The deal means that AMP needs about $464m less capital to support the business and, after setting this against a bunch of other comings and goings (profits, dividends, changed loss assumptions and last year's $600m redemption of AXA Notes), it finds it has $500m spare to hand back to shareholders via an on-market share buyback.

Management is hoping to sign on for more reinsurance in due course, but stresses that it depends on market conditions and pricing. From our point of view, the more reinsurance the better, since it saves on Panadol around results time. Almost as importantly, it reduces the potential for surprises and allows us to have a better stab at valuing the company.

Weak fund flows

The headaches continue, however, with AMP's Wealth Management business, where the fund flows can sometimes resemble a bunch of eight-year olds with a large pack of Pokemon cards.

As ever, though, the clear winner was the North platform, which enjoyed total net cash flows of $4.9bn, up from $4.5bn in 2015, and ended 2016 with $27.1bn in assets under management (AUM) compared to $20.9bn at the start. It was helped by the launch of the **MyNorth** low-cost online product and a preference (from both new and existing customers) over the Flexible Super product, whose net cash inflows fell from $1.5bn to $92m. That was better, though, than AMP's other retail platforms, which between them saw net outflows of $3.6bn compared to net outflows of $2.8bn in 2015.

Table 1: Divisional breakdown

UNDERLYING NET PROFIT ($M, YEAR TO DEC)	2016	2015	+/(–) (%)
WEALTH PROTECTION	(371)	234	n/a
AUST. WEALTH MGMT	418	428	(2)
AMP CAPITAL	148	142	4
AMP BANK	120	104	15
NZ	145	141	3
MATURE	167	174	(4)
TOTAL FROM BUSINESS UNITS	627	1,223	(49)

Including $0.3m of inflows to corporate superannuation products, AMP enjoyed net inflows of $1.8bn, compared to $4.9bn in 2015, and total AUM on AMP investment platforms rose 6% to $110bn.

> **The star of the show, though, was the business that had been the smallest until last year's insurance blow-up.**

Management gave market weakness and uncertainty ahead of the new super rules in November as one reason for the weak cash flows and pointed to an improvement in the December quarter. Chief executive Craig Meller noted that markets improved significantly over the year and that 'there tends to be a 9- to 12-month lag between market improvement and investors returning to the marketplace in the retail sector' (he's obviously not talking about *Intelligent Investor* members).

There's a suspicion, though, that the improvement may just be a temporary kicker from the one-off opportunity for high net worth individuals to put $540k into super before 1 July.

There's also a concern that cash flows are suffering partly as a result of the sharp drop in adviser numbers from 3,657 to 3,087. Management said that about half the fall was due to a tightening of classification criteria, with the other half being retirements. Most of those no longer being counted were not very productive, explained management, so there shouldn't be a major impact on cash flows. It will be worth watching this closely in coming periods.

Table 2: Net profit adjustments

YEAR TO DEC ($M)	2016	2015	+/(–) (%)
UNDERLYING NET PROFIT	486	1,120	(57)
GOODWILL IMPAIRMENT	(668)	–	n/a
AXA AMORTISATION	(77)	(80)	n/a
RESTRUCTURING COSTS	(19)	(66)	n/a
OTHER ITEMS	(66)	(2)	n/a
NET PROFIT	(344)	972	n/a
UNDERLYING EPS (C	16.4	37.9	(57)
DPS (C)*	28.0	28.0	0

***Final div of 14c, 90% franked, ex date 22 Feb**

Fee margins continued their relentless march downwards, falling from 1.12% to 1.07% and management expects them to continue to fall at this rate. This pushed Wealth Management revenue down by 3% to $1,342m, but a 2% fall in costs meant only a 2% fall in divisional net profit to $418m.

AMP capital increases margin

Better news was to be found at AMP Capital, where AUM crept up 3% to $165bn, helped by a particularly strong second half, which benefited from a $1.5bn turnaround in the group's CLAMP joint venture in China (see ***AMP: Result 2015*** for more detail on this).

About 66% of the AUM came from other AMP business units (down from about 68% in 2015), with the remainder coming from external mandates. The former attracted fees of about 0.20% (similar to 2015) while the latter generated 0.47%, up from 0.45% helped by a deliberate shift towards higher-margin mandates on property and infrastructure.

Total fee income increased 5%, although this was partly offset by an 8% rise in costs due to the international expansion and a 'one-off rebasing' of the division's remuneration scheme. All up, AMP Capital increased underlying net profit by 4% to $148m.

AMP Bank on the charge

The New Zealand financial services unit increased underlying net profit by 5% to $145m, while the Australian mature business saw profits fall 4% to $167m.

The star of the show, though, was the business that had been the smallest until last year's insurance blow-up. AMP Bank should pass the compromised wealth protection business this year, and it will soon pass some of the other units if it keeps growing at the current rate: in 2016 it contributed an underlying net profit of $120m, 15% ahead of 2015's $104m and almost double the $61m it made five years ago.

In 2017 it managed to increase its loan book by 13% to $17.1bn, almost all of which is residential mortgages (about three-quarters of which are owner-occupied). To support the growth the bank competed aggressively for deposits, which increased by 20% to $11.5bn, yet it was also able to increase its net interest margin from 1.59% to 1.67% whilst simultaneously tightening credit criteria. Impairments remained at a tiny 0.04% of loans.

> **Transforming a business of this size and complexity would be quite a trick, and that's a key reason that we prefer other more focused players in the financial services industry.**

Too much 'restructuring'

So there's good and bad in the result, but (absent further insurance problems) the main profit driver will remain the wealth management business. This is showing some worrying signs, in terms of cash flows and adviser numbers, and we're not convinced by management's plans to improve things.

There's too much emphasis, for example, on expensive restructuring programs, which make you wonder what they're doing the rest of the time. Keeping a lid on costs should be a normal part of business.

Other elements of the strategy are also slightly unnerving. If you need to 'transform ... [your] business to centre on customer', for example, then it doesn't say much for where you are now.

The company's proposed new 'digital spine' is also sensible enough, but it's garnished with a bit too much spin for our liking, as a 'full omni-channel capability with a robo-advice engine that will support all our channels to provide more channel choice for customers, making advice more accessible and more affordable for them and more efficient and profitable for us and our advisers'.

Transforming a business of this size and complexity would be quite a trick, and that's a key reason that we prefer other more focused players in the financial services industry, notably **Perpetual** and **IOOF**.

Price guide

It also doesn't help that AMP's price has now risen to higher than its level just before the October warning. With earnings per share currently expected to land at around 34 cents for 2017, the stock is now on a prospective price-earnings ratio of about 15.

The final dividend was maintained at 14 cents (franked to 90%) for the fourth half in a row. If that's maintained for the next two halves, it'll give a payout ratio for 2017 close to the middle of the target range of 70–90% and a 90%-franked dividend yield of 5.3% (although this is somewhat academic for a company that's splashing cash on share buybacks).

We're putting a price guide back on the stock, but it will be fairly conservative given the issues outlined above, with a Buy price of $4 and a Sell price of $6.00. If further steps are taken to reduce insurance risks or if fund flows continue to improve we may move it higher. Of course the converse also applies. **HOLD**.

Staff members may own securities mentioned in this article.

CSL achieved excellent growth across the board, with margin improvement and floundering competitors to boot.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

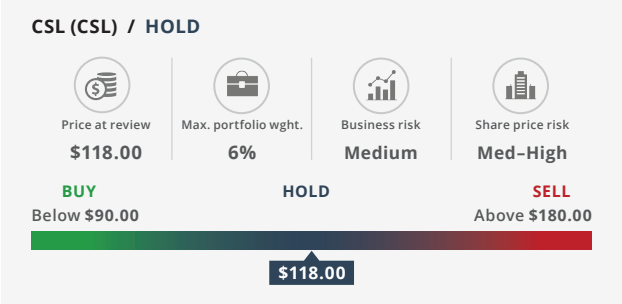
CSL: Interim result 2017

'CSL delivers exceptional performance' was the opening line of the results announcement. We have to agree.

Revenue increased 18% in constant currency terms to US$3.7bn due to strong demand for the company's antibody, albumin and specialty products. Underlying net profit was even more impressive, rising 36% to US$806m thanks to the brilliant economics of blood fractionation – which we'll get to in a moment – while underlying earnings per share rose 39% to US$1.77 due to CSL's ongoing share buyback.

Key Points

- ***Antibody, albumin and specialty growth***
- ***Margin expansion and economies of scale***
- ***Supply constraints at competitors***



But let's put the juicy numbers aside for a moment and get the bad news out of the way. The company's haemophilia products continue to disappoint with sales rising just 2% to US$514m.

Haemophilia is an extremely rare and expensive disease to treat. The cost of treating a 50kg child with a blood-clotting protein known as Factor VIII, for example, can run as high as $300,000 per year.

It's common for governments to use a tender system whereby they purchase large batches of Factor protein via a reverse auction. This introduces an incentive to make medicines more affordable but, as the auctions happen at irregular intervals, it also causes CSL's sales to be lumpier than when it supplies individual organisations with a steady stream of product. CSL won a lower share of a large tender in Poland this half which, among other things, led to a 6% decline in plasma-derived haemophilia products.

Thankfully, man-made haemophilia products (known as recombinant coagulation proteins) picked up most of the slack with sales increasing 15%. This was mainly down to strong sales of Idelvion, a Factor IX protein, following its launch in the US and Europe earlier in the year. Management noted that Idelvion has been extremely popular among patients with strong conversions from the company's older Factor IX products, despite patients tending to be loyal to products that have been successful for them in the past. Haemophilia is potentially life threatening, so the decision to try something new isn't taken lightly.

Behring powerhouse

Haemophilia results aside, there really wasn't anything to dislike about CSL's half-yearly report.

CSL's main division, CSL Behring, increased sales 18% to US$3.0bn, helped by strong demand for plasma-derived antibody products (known as immunoglobulins), which help to prevent infections when a patient's immune system isn't functioning properly. Immunodeficiency disorders affect around one in 10,000 people.

The main drivers of Behring's result were Hizentra, which allows patients to use a portable pump to self-administer their dose by injection under the skin, and Privigen, an intravenous antibody treatment. Sales of Privigen – already the company's top-selling product – increased an astonishing 34% in constant currency terms. The product was also introduced to Australia for the first time following a successful national tender.

'Privigen and Hizentra together accomplished over $2bn of combined sales for the very first time. There is significant scope and opportunity to continue to grow both of these products as we focus on gaining approvals for new indications, such as **CIDP**, as I mentioned in the US for Hizentra, and the expansion of our geographic footprint', said management.

CSL's performance in antibodies has been stellar in recent years. The overall antibody market has grown at 11% a year since 2011, with CSL's sales of antibody products growing at 13% a year. This suggests the company has consistently increased market share.

> **As CSL grows, its margins improve, and it now has higher operating margins than almost all its competitors.**

A major reason for this has been CSL Plasma, the company's network of 160 plasma collection centres. CSL has consistently stayed one step ahead of demand – since 2011, the company has increased the number of US collection centres by 18% a year, compared to only 6% for the rest of the industry.

CSL's deep, reliable source of plasma – a significant competitive advantage – meant that manufacturing could keep up with the sharp increase in demand for antibodies over the past six months, whereas competitors Baxalta and Grifols experienced supply constraints.

The albumin egg special, please

Revenue from albumin increased a healthy 19% in constant currency terms. Albumin is a concentrate of plasma proteins extracted from blood and used to treat burns, severe blood loss and in various surgeries. Chinese sales led the result, rising 35% thanks to increasing sales to small-city hospitals. Management also singled out Brazil and Turkey as having particularly strong sales growth.

Table 1: CSL interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE (US$M)	3,677	3,136	19
UNDERLYING EBIT (US$M)	1,095	815	38
UNDERLYING NPAT (US$M)	806	607	36
EPS (US$)	1.77	1.31	39
INTERIM DIVIDEND 64 US cents unfranked, (up 10%), ex date 15 March			

Sales of specialty products – which often have '**orphan drug status**' and get special government incentives – grew 25% thanks to Kcentra and Beriplex. Sales of Berinert, which treats a rare disorder that causes swelling of the face and extremities, were also strong thanks to supply disruptions at competitors.

In July 2015, CSL bought the influenza vaccine operations of Swiss healthcare company Novartis and combined it with CSL's own vaccine business, bioCSL. Seqirus, as the new division is known, is the second largest flu vaccine maker in the world and had a solid second year, with revenue up 14% in constant currency terms. The result was underpinned by the introduction of a seasonal flu vaccine that offers protection against four strains of influenza, rather than three, which garners higher prices.

As we explained in ***CSL solves chicken and egg problem***, the division shows promise despite losing money under Novartis and since CSL bought it. Management said 'the integration of the Novartis acquisition with our existing bioCSL business is substantially completed and the turnaround in performance is on track for what we expected'. The division broke even for the six months to December, though this is also the strongest financial half due to the Northern Hemisphere flu season. It's unlikely that the division will turn a full-year profit until 2018.

Economies of scale

A large proportion of CSL's costs are fixed, including blood collection centre infrastructure and manufacturing plants. This means that as volumes increase, the fixed cost can be spread across a higher number of sales, giving CSL significant **operating leverage**. As CSL grows, its margins improve, and it now has higher operating margins than almost all its competitors.

No result in recent years has showed the benefit of these economies of scale more than this one. The company's earnings before interest, tax, depreicaiton and amortization (EBITDA) margin increased 5.25 percentage points to 34.5% due to that delightful combination of fixed costs and strong sales growth. The turnaround of Seqirus was also a contributor and management said margins should continue to expand as the company transitions to the use of more man-made proteins in the haemophilia division and expected growth in high-margin specialty products.

Management expects net profit to rise 18–20% in 2017 and earnings per share are likely to grow slightly faster due to the company's ongoing share buy-back. The stock has more than tripled in the five years since our initial Buy recommendation on **18 Mar 11** (Long Term Buy – $33.97). CSL has a clean balance sheet, several competitive advantages, decent growth prospects and a reasonable forward price-earnings ratio of around 28. We're increasing the price guide and continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

It may not set the world on fire, but there was much to like about the pathology provider's latest results.

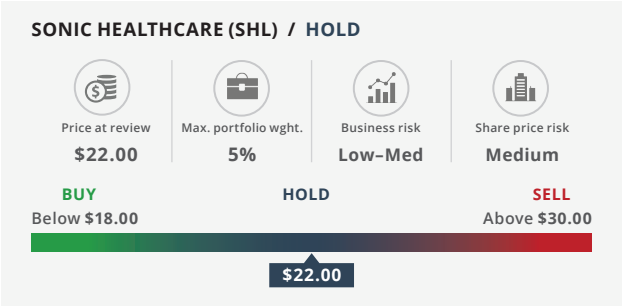
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 15 FEBRUARY 2017

Sonic Healthcare: Interim result 2017

Some investors are drawn to the Ferraris of the stock market – fast movers and epic crashers. Others prefer Volvos – steady and safe, without too much adrenaline. Sonic Healthcare, Australia's largest pathology network, falls squarely in the latter camp and this interim result was a case in point: revenue grew 5% to $2.5bn for the six months to December after removing the effect of currency fluctuations. That won't make it to the front page of the *Financial Review*, but investors can still sleep well.

Key Points

- ***Good Australian revenue growth***
- ***German expansion on track***
- ***Medical centres increase revenue despite fee freeze***



Interestingly, and despite management's strong push into foreign markets, it was Sonic's Australian lab operations – accounting for a quarter of total revenue – which carried most of the weight. Revenue increased 7% for the division, though a bit under 3% of that growth came from a recent acquisition in South Australia. Nonetheless, management was quick to point out that growth was still ahead of the overall market and that the company gained market share.

Unfortunately, however, top-line growth didn't benefit the Australian division's earnings before interest, tax, depreciation and amortisation (EBITDA), which rose only modestly due to higher collection infrastructure costs.

The company's US division (22% of revenue) had organic revenue growth of just 3.3%, though management noted this was 'the highest level for several years'.

A strained US healthcare budget will be a drag for the foreseeable future making the recent business restructure and its associated US$10m of cost cutting particularly important.

Sonic's largest US lab – Texas-based CPL – is doing well with management noting that volumes continue to grow strongly. The company also recently announced a partnership with Baptist Memorial Healthcare (headquartered in Tennessee) to operate a bacteriology laboratory that will serve 17 hospitals.

European expansion

Sonic's European operations performed admirably with 6% organic revenue growth achieved in both Switzerland and Germany.

Table 1: SHL interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	2,476	2,453	1
EBITDA ($M)	407	399	2
NPAT ($M)	197	188	5
EPS (C)	47.1	45.9	3
INTERIM DIVIDEND	31 cents, 20% franked, (up 3%), ex date 7 March		

This is a positive sign and suggests strong volume growth despite the German government's recent reductions in reimbursement funding pools. This is an anchor on top-line growth, though it may actually be working in Sonic's favour by pressuring smaller operators to sell to the company.

As Sonic makes these bolt-on acquisitions, it can then benefit from economies of scale by cutting duplicate expenses and spreading the cost of fixed infrastructure across a larger volume of tests. Sonic has made several small acquisitions in Germany over the last couple of years, **most recently in January**, which bodes well for future earnings growth.

Sonic's other European operations were less impressive, with Belgian revenue flat due to mandated fee cuts in early 2016, while the UK operations only achieved 3% organic revenue growth. Management, however, noted the expansion of its large Manchester lab to accommodate two recently awarded sexual health contracts for Central and Southern UK.

> **Overall, cost-cutting and various efficiency initiatives helped expand operating margins.**

Imaging and Medical

Sonic's Australian imaging and medical centres – which collectively contribute 17% of revenue – increased revenue 4% and 6% respectively. That's nothing to write home about but, given a Medicare fee indexation freeze for GP clinics introduced last year, it was still respectable. The medical centre result was also ahead of larger competitor **Primary Health Care**'s GP operations, which saw revenue decline 5% over the period.

Overall, cost-cutting and various efficiency initiatives helped expand operating margins. Total EBITDA was up 6% and net profit rose a healthy 10% to $197m in constant currency terms.

Management believes the company is on track to achieve EBITDA growth of 5% on a constant currency basis in 2017 – with acquisitions expected to add up to 1% more – putting the stock on a forward price-earnings ratio of around 20.

This was a decent interim result and we're pleased to see solid organic growth in Sonic's core Australian market and in Germany, where the company is expanding. With a dominant and growing market share, economies of scale, and a well-executed international expansion, there's plenty to like about Sonic. We're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

This was another good result given the tough conditions facing all the big banks.

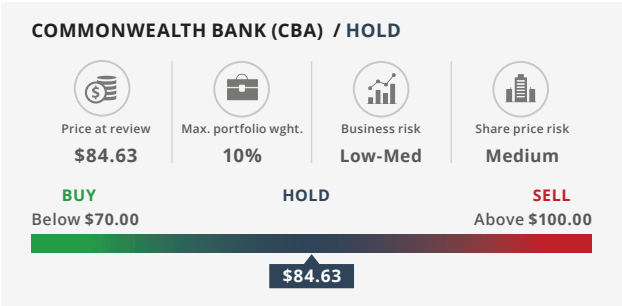
BY JON MILLS • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

CBA: Interim result 2017

In light of the continuing tough conditions facing the big four banks, Commonwealth Bank's interim result was about as good as one could expect.

Key Points

- ***Cost growth contained***
- ***Provisions still at cyclical lows***
- ***Dividend up a smidgeon***



On the plus side, like its competitors, CBA 'repriced' (ie hiked) rates on home loans but part of the benefit from this move was offset by increased competition in both home and business lending. However, the real culprit was on the liability side of the balance sheet, where competition for deposits and increased costs of wholesale funding more than offset the gains on the asset side.

Deposits remain at 66% of CBA's total funding and part of the recent scramble for deposits among the big banks was driven by new regulations which require them to hold more stable deposits (such as term deposits) to reduce the chances of a liquidity crunch.

All in all, CBA's **net interest margin** fell slightly, from 2.15% to 2.11%.

Due to recent political events overseas, the increased volatility in markets helped the bank's trading arm, which generated a 21% increase in income, to $600m. Along with better results from CBA's credit card business and increased merchant fee income, this helped offset falls in its insurance and funds management businesses.

Cost out, squared

With credit growth expected to be low and competition cranking up in Australasia – especially now that **NAB** and **ANZ** are concentrating more on their home turf – costs are even more of a focus than usual. Chief executive Ian Narev's goal is to keep cost growth to 1% a year on average, although he acknowledges this will be difficult to achieve.

However, his bank was successful in doing so in the first half of 2017, with operating expenses indeed only rising 1%, from $5,210m to $5,284m.

So despite fairly mundane income growth of 3%, this meant CBA's **cost-to-income ratio** fell to 41.5%, making it one of the world's most efficient banks.

Table 1: CBA 2017 interim result

SIX MONTHS TO 31 DEC ($M)	2017	2016	+/(–) (%)
NET INTEREST INCOME	8,743	8,427	4
NON-INTEREST INCOME	4,002*	3,993	1
TOTAL INCOME	12,745*	12,420	3
OPERATING EXPENSES	(5,284)**	(5,210)	1
PROFIT BEFORE IMPAIRMENTS	7,445	7,152	4
IMPAIRMENTS	(599)	(564)	6
PROFIT BEFORE TAX	6,862	6,646	3
CASH EARNINGS	4,904	4,808	2
CASH EPS ($)	2.86	2.86	-
INTERIM DIVIDEND	$1.99 (up $0.01), fully franked, ex date 22 Feb 17, DRP (no discount)		

*** Excludes $397m gain on sale of Visa stake**

**** Excludes $393m software amortisation write-off**

What cost growth there was, was in part due to rising wages (as a result of a new Enterprising Bargain Agreement kicking in) but more to increases in software amortisation, which comprised 58% of the increase.

Software writedown

And that's without including the $275m writedown (or around $393m before tax) of capitalised software (see ***CBA writes down software, sells Visa stake*** on 19 Dec 16 (Hold — $81.20)) that the bank took on 31 December 16.

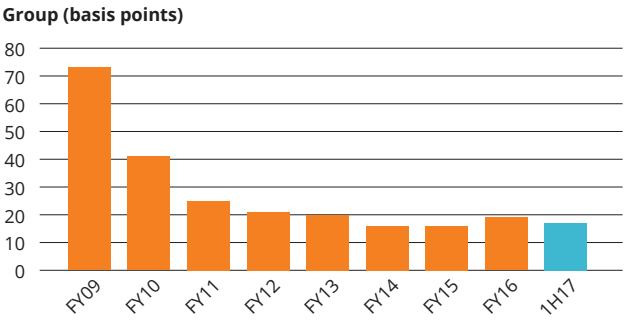
That is, the $220m in software amortisation in the first half included amortisation relating to the 17 projects subsequently written off at 31 December 16. Chief financial officer David Craig revealed that these projects would have continued to have been amortised over the next three years, so the writedown will save CBA around $131m a year in

> **When your goal is to keep expense growth to 1% per year, having an extra $131m buffer up your sleave certainly helps.**

amortisation costs. To put this in perspective, CBA's software amortisation in 2016 was $379m.

When your goal is to keep expense growth to 1% per year, having an extra $131m buffer up your sleave certainly helps. With the $393m effectively taken out of the cost line, we'll have to wait and see whether CBA claims 'positive jaws' (income rising faster than operating costs) in future periods as Westpac did this year after similarly writing off some of its capitalised software (see ***Westpac: Result 2016***).

Chart 1: Loan impairment expense



Source: CBA 1H17 results

While $393m might seem like real money, the bank continues to invest heavily in software and still has around $2bn in capitalised software on its balance sheet. Much of the additional expense is on digital platforms which tend to be amortised more quickly. So, with the pace of technological change quickening, it will be interesting to see whether further writedowns occur and how the bank treats them (see ***ANZ, Asia and accounting shenanigans*** for more).

Provisions

While on the subject of writedowns, it was good to see the increases in home loan arrears noted in ***CBA: Result 2016*** have, for the most part, flattened out. As a result, impairment expense is still 'bumping along the bottom' (see Chart 1).

As such, total provisions as a percentage of credit risk weighted assets fell to 1.02%, less than half the 2.09% they reached in 2011. As we've noted in relation to all the big banks in recent times, we'd expect provisions to average out at higher levels over the course of the cycle.

Along with slower credit growth and perhaps further additional capital requirements being imposed by APRA, growth in earnings and dividends will be harder to come by.

For its part, though, as shown by its 16% ROE, CBA remains best placed among the big four and so was able to raise its dividend slightly. At 70% of first-half earnings, this gives it good wiggle room to maintain its full-year payout at between 70–80% of earnings.

As long-term members will know, we've had concerns about the Australian housing market for some time, yet have been proved wrong. However, with the various tailwinds that have supported Australian housing prices moderating or even reversing (see ***APRA takes a sickie***), this is something we'll continue to monitor. **HOLD**.

*Please note our recommended maximum portfolio weightings of 10% for CBA individually and 20% for the banking sector as a whole. More conservative investors and those with other exposure to the property market should use lower limits.

*Note: The Intelligent Investor **Equity Income Portfolio** owns shares in Commonwealth Bank and Westpac. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Staff members may own securities mentioned in this article.

It was a modest year of growth for this billing software maker, but that's nothing to sneeze at.

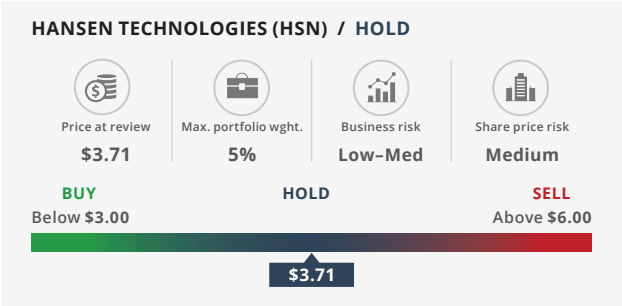
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

Hansen: Interim result 2017

'We take a 10+ year view with what we do' was how billing software maker Hansen Technologies closed its half-year results presentation, and that's exactly the approach investors need to take, too.

Key Points

- ***Modest organic revenue growth***
- ***Margin squeeze not an issue***
- ***Net profit still up 7%***



The stock is down 9% today after a disappointing result – or, at least, *relatively* disappointing – but it doesn't change our long-term view of the company's prospects. Revenue rose 18% to $87m overall, though the bulk of that was from the acquisition of a small US-based software business for energy retailers.

Underlying organic revenue growth was 4.5% after excluding the effect of currency fluctuations, though unfavourable currency movements – namely, a decline in the British pound – eliminated all that growth when revenues were translated back into Australian dollars.

At **last year's interim result** we said, 'it's only reasonable to expect organic growth of 5–7%. Hansen is more akin to a utility than a high-powered tech stock and we don't expect the bumper growth of this past year to be repeated in 2017.'

Organic revenue growth of 4.5% this past half lies just outside of our expected long-term range, but it's nothing too extreme. The bulk of Hansen's revenues are annuity-style and recurring, with yearly price escalations built into most contracts, so we won't lose any sleep.

Earnings before interest, tax, depreciation and amortisation (EBITDA) rose a modest 7% to $23.8m. Hansen's operating margin contracted from 30% to 27% due to the **recent acquisition of US-based PPL Solutions**, which operates on lower margins. Excluding PPL Solutions, margins were largely unchanged.

Management has a knack for finding savings in the years following an acquisition so, all things being equal, we wouldn't be surprised if Hansen's operating margin shows some improvement over the next year.

Underlying net profit rose 10% to $15.3m. Free cash flow, however, fell 16% to $13.2m due to an increase in capital expenditure after the company moved offices in London and Auckland. Capitalised software development costs also increased during the period. Ultimately, though, with very little need for ongoing capital expenditure – besides the odd new laptop or office chair – Hansen is a highly cash generative business and we expect free cash flow to match net profit almost one-for-one over the long term.

Management expects revenue of $165m–175m in the 2017 financial year with an EBITDA margin of between 25% and 30%, which suggests a net profit around the $27m mark. That puts the stock on a reasonable forward price-earnings ratio of around 25.

Table 1: Hansen interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	86.9	74.0	18
EBITDA ($M)	23.8	22.3	7
UNDERLYING NPAT ($M)	15.3	14.0	10
UNDERLYING EPS (C)	8.5	7.1	7
INTERIM DIVIDEND	3 cents, fully franked, (unchanged), ex date 7 March		

Hansen's share price has more than doubled since we upgraded the stock to Buy on **29 Oct 14** (Buy – $1.52). This wasn't another year of the double-digit earnings growth that shareholders have come to expect but, with captive customers, a clean balance sheet, stable revenues and a well-executed international expansion, there's plenty to like about Hansen. We're nudging up our maximum recommended portfolio weighting and continue to recommend that you **HOLD**.

*Note: The Intelligent Investor **Growth Portfolio** owns shares in Hansen Technologies. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Disclosure: The author owns shares in Hansen Technologies.

The airport operator has posted a year of excellent growth in international traffic with a decent increase in distributions.

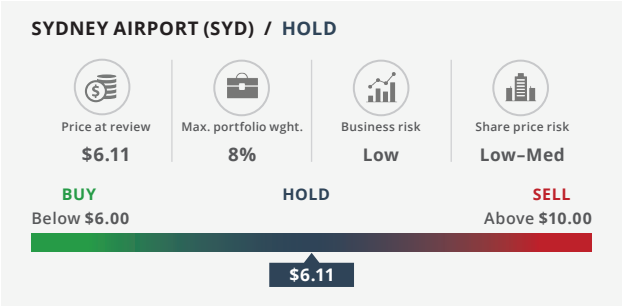
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

Sydney Airport: Result 2016

Rising incomes and urbanisation in Asia have worked wonders on Sydney Airport's profitability. Passenger growth was excellent for the year to December: up 18% from China; up 19% from Korea; up 15% from Indonesia; and up 31% from Japan. Overall, international passenger numbers grew 9% and domestic passengers increased 4%, which helped boost total revenue by 11% to $1.4bn.

Key Points

- ***Strong international passenger growth***
- ***Property and Parking revenue lacklustre***
- ***Net debt to EBITDA ratio improving***



Sydney's remoteness relative to major markets means that flights are expensive (have you noticed?) so – to borrow a mining term – Sydney Airport sits high on the 'cost curve'. However, as incomes rise in Asia, holidaymakers have more disposable income, which puts Sydney within financial reach.

This, combined with increasing seat capacity from more flights and larger aircraft, underpinned the strong international passenger growth this year. Nonetheless, the airport's own long-term projections for passenger growth are only around 5%, so this year is more a welcome anomaly than anything to get used to.

Aeronautical revenue, which accounts for around half the total, rose an impressive 16%, while the increasing flow of Chinese passengers – who tend to spend more in the terminals – also benefited the airport's retailers, with retail revenue up 12%.

The transition to a new duty-free operator is largely complete, with the majority of stores in the new fashion precinct now open. The new dining precinct is also open and, in this analyst's opinion, a visit to Bridge Bar in Terminal 1 is a very good way to ensure your seatbelt is tightly fastened.

Property revenue rose a lacklustre 2%, though management noted a 99% occupancy rate and a new hotel being constructed, which is expected to open in mid-2017. Revenue from the airport's car parks increased 4%, which was attributed to the growing popularity of new online booking system leading to higher utilisation rates.

Net debt increased from $7.4bn to $7.7bn, though net debt as a multiple of operating earnings improved from 7.4 to 6.9.

Sydney Airport's capital expenditure, which is funded entirely by debt, tends to grow more slowly than revenues due to the airport's **operating leverage**. This means that although net debt generally increases each year, the airport is deleveraging at the same time so debt becomes more manageable.

Without too much surprise, management stayed mum regarding the new Western Sydney Airport. There was no material news and the company has until 8 May 2017 to accept or reject the Government's offer to **build and operate the second airport**.

Table 1: SYD result

YEAR TO DEC	2016	2015	+/– (%)
AERO. REV. ($M)	702	606	16
RETAIL REV. ($M)	296	264	12
PROPERTY REV. ($M)	204	201	2
PARKING REV. ($M)	156	151	4
TOTAL REV. ($M)	1,365	1,229	6
UNDERLYING EBITDA ($M)	1,107	1,003	10
DPS (CENTS)	31.0	25.5	22
FINAL DIVIDEND	16.0c (up 23%), unfranked, ex date already passed		

Management expects 2017 distributions of 33.5 cents per share, an 8% increase on 2016. Sydney Airport's share price is hovering just above our Buy price of $6.00 and if the stock moves much below this level – **as occurred in January** – we're likely to upgrade. For now, though, with an unfranked distribution yield of 5.5% based on 2017 estimates, we're sticking with **HOLD**.

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

Disclosure: The author owns shares in Sydney Airport.

Resources and Bunnings may have saved the day, but Wesfarmers' management will be fighting more fires than ever in 2017 and beyond.

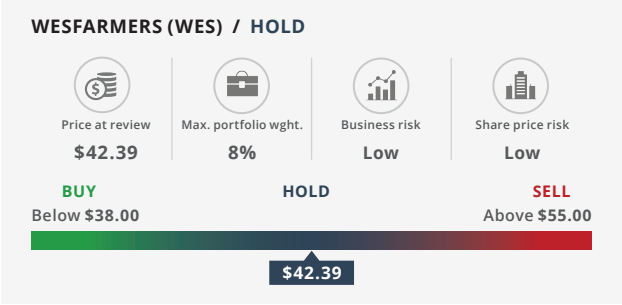
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

Wesfarmers: Interim result 2017

Between them, Coles and Bunnings still generated two-thirds of Wesfarmers' earnings in the first half of 2017. But for the first time in a long while profits from the two giants moved in opposite directions – and arch-rival **Woolworths** – was largely to blame.

Key Points

- ***Another stunner from Bunnings***
- ***Coles surprisingly weak***
- ***New MD from November***



Coles' operating profit declined 3% but, excluding property transactions, the underlying fall was closer to 8%. Management attributed this to the impact of increased competition on gross margins. With Woolworths investing around $1bn into lower prices over the past year and Aldi expanding into South Australia and Western Australia, the remainder of 2017 will be tough.

Down, down

While the Coles result was weaker than expected, Bunnings Australia reported another surprisingly strong result, with profit up 10%. As **JB Hi-Fi** has taken advantage of the collapse of Dick Smith, so Bunnings has capitalised on Masters' exit. The Bunnings result was even better than it looked because the company absorbed $30m in costs to close 11 stores as it prepares to move into 15 former Masters sites.

It's still too early to say much on Bunnings UK. The business reported a sizeable loss of $48m in the seasonally weaker first half but the first Bunnings pilot store is now open. Management has reported 'pleasing' customer feedback but there's a long way to go.

In Department Stores it was another tale of two retailers. Kmart was the star once again, with earnings rising 16% although management warned it was approaching peak margins (something we've also warned about). Target's sales plunged 18% but management vigorously attacked the cost base, allowing the business to remain profitable (just). The turnaround will take time, but there's clearly a lot going on behind the scenes and we're confident Target's earnings can grow from here.

Officeworks has been one of Wesfarmers' success stories, having doubled its profit since acquisition. First-half earnings growth was a subdued 5% but it remains a very strong business. So it was somewhat surprising to hear Wesfarmers has put it up for sale, perhaps by initial public offering.

As with all assets Wesfarmers won't sell unless it gets the right price, and our view is that the $1.0-$1.3bn valuation the market has applied is way too low (our 'high' value from **Wesfarmers counts on Chaney** is around $1.9bn).

Table 1: Divisional EBIT ($m)

SIX MONTHS TO 31 DEC	2016	2015	+/(–) %
COLES	920	945	(3)
BUNNINGS AUSTRALIA/NEW ZEALAND	770	701	10
BUNNINGS UK AND IRELAND	(48)	na	na
KMART	371	319	16
TARGET	16	74	(78)
OFFICEWORKS	62	59	5
RESOURCES	138	(118)	na
CHEMICALS, ENERGY AND FERTILISERS	187	104	80
INDUSTRIAL & SAFETY	52	36	44

You'll remember too (from ***Wesfarmers' coal curveball*** last month) that the Resources division is also up for sale. Here too we suspect Wesfarmers expects more from the assets than the market does.

With the Resources result having been flagged last month, it was in line with expectations. Higher coal prices generated

> **Wesfarmers is apparently 'slimming down' in preparation for the management transition.**

a $256m turnaround in earnings although forecasting the second half is nigh on impossible. While revenues were lower for the two remaining Industrials businesses, Chemicals, Energy and Fertilisers (down 8%), and Industrial and Safety (down 5%), the earnings performance was a lot better. Each reported significant lifts in earnings thanks to higher ammonium nitrate sales at the former and benefits from the recent restructuring at the latter.

Seamless transition

We'd been expecting Richard Goyder to step down as managing director and he announced his retirement earlier this week. Industrials boss Rob Scott will take over as managing director following this year's annual general meeting. The change is very much the 'Wesfarmers way', with a long lead time and a youthful internal appointment.

Table 2: Wesfarmers interim result 2017

SIX MONTHS TO 31 DEC	2016	2015	+/(–) %
REVENUE ($M)	34,917	33,462	4
EBIT ($M)	2,429	2,110	15
NPAT ($M)	1,577	1,393	13
EPS (C)	140.1	124.2	13
DPS* (C)	103.0	91.0	13
FRANKING (%)	100	100	N/a

*** interim dividend, ex date 20 Feb.**

Also notable is that Wesfarmers is apparently 'slimming down' in preparation for the management transition. It recently sold the Coles credit card book for around $900m. Add to that another $4–5bn that might be raised from selling the Resources division and Officeworks and company's $5.4bn of net debt might be almost eliminated.

Why that might be we'll discuss at a later date, but it's likely that Wesfarmers' is entering a more difficult period. We also wonder whether the board is 'clearing the slate' to allow for another big acquisition down the track. Our view is that the board didn't select Rob Scott, with his 'mergers and acquisitions' experience, for nothing.

Altogether, Wesfarmers' overall result looked somewhat better than it was. Most of the 13% increase in net profit came from a coal price-driven turnaround of the Resources business. Management will be fighting numerous battles over the next year as it tries to defend early market share losses to Woolworths, and advances the turnarounds at Target and Bunnings UK. We're still confident of an opportunity to buy around $38 a share at some point and remain very happy to **HOLD**.

Staff members may own securities mentioned in this article.

Yes, the results were excellent but, considering where commodity prices are, should they have been better?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

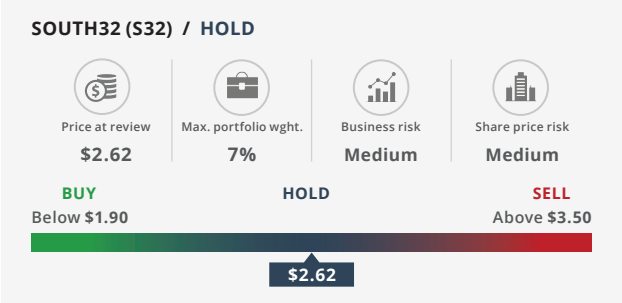
South32: Interim result 2017

South32 surprised no-one by delivering stunning increases in all the columns that matter in its latest interim result.

Take your pick: underlying earnings before interest, tax, depreciation and amortisation (EBITDA) rose by 96%; earnings before interest and tax (EBIT) by 390%; and earnings per share by the small matter of 1,700%. Operating cash flow was healthy and capital expenditure appropriately severe so the free cash flow, at US$626m, was decent. Yet it could have been better.

Key Points

- ***Decent result***
- ***Strong cash balance***
- ***More cost cuts to come***



Higher working capital held back cash flow a little but that should be released in the next result and volumes were weaker. It is also possible that time lags delay the impact of commodity price increases and currency movements have blunted some of the gains.

Good not great

Revenue confirms the muted price gains, increasing just 8%. South32's impressive cost control combined with higher prices to lift margins from 20% last period to 37%. The balance sheet is perhaps the best in the industry with net cash of US$859m.

Some of that cash will be used to fund a US$200m coal acquisition and to pay an interim dividend of US$192m, or 3.6 US cents per share (unfranked, ex date 9 March). Over the second half, South32's cash pile should easily surpass US$1bn and some might be disappointed with the modest dividend.

The company says excess cash will not be left to pile on the balance sheet so there could be an acquisition, more exploration expenditure or a larger dividend payment coming. Given the short lives of many of its mines, we would prefer to see cash ploughed back into the business than paid out as dividends.

Mine breakdown

As usual, Cannington was a standout, generating EBIT of US$165m even as grades fell. Cannington has been a wonderful asset and barely consumed any cash for a decade, but grades will fall as the underground mine is exhausted.

Official reserves are dwindling but the orebody should support decades of mining with additional resources from a possible open pit operation. Mine plans haven't been finalised but we expect mining to continue for years.

The biggest turnaround came from coal and manganese which collectively lost US$30m last year but generated US$490m in the first half. This result was aided by opportunistic output additions from the company. This is the kind of flexibility a larger miner would struggle to exhibit.

Table 1: S32's interim result 2016

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
REVENUE (US$M)	3,221	2,981	8
UNDERLYING EBITDA (US$M)	1,064	542	96
UNDERLYING EBIT (US$M)	691	141	390
UNDERLYING NPAT (US$M)	479	26	1,700
OP. CASH FLOW (US$M)	697	426	64

Worsley, however – South32's largest asset by value – was disappointing. Higher caustic soda prices and currency moves detracted from profit which fell compared to the same period last year. Even so, this remains one of the lowest-cost alumina assets anywhere and profit to date doesn't reflect its potential.

Lower costs to come

Despite already having savaged costs at all its mines, management suggests there can be additional cost cuts as

> **South32 has enjoyed a fantastic turnaround, with its share price up about 130% over the past 12 months.**

efficiency gains and productivity has not yet been perfected. This fits our original investment case that the asset base, which comprised just 3% of profits within BHP, was grossly neglected.

South32 has enjoyed a fantastic turnaround, with its share price up about 130% over the past 12 months. It is no longer cheap but, at a small premium to net tangible asset value, neither is it dear. We are reliant on commodity prices but, with costs continuing to shrink and the best balance sheet in the industry, we're sticking with **HOLD**.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in South32. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Disclosure: The author owns shares in South32.

The ACCC has stepped aside and PMP can complete a company changing merger. What now?

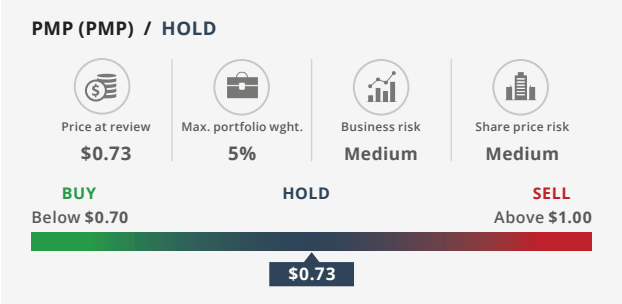
BY GAURAV SODHI • INTELLIGENT INVESTOR • 17 FEBRUARY 2017

PMP merger gets green light

The ACCC has announced that it will not contest the proposed merger between PMP and its largest rival, IPMG, which operates the Hannan print business. The ACCC acknowledged that, although the deal would lessen competition, market conditions had changed since the same deal was proposed and knocked back in 2001.

Key Points

- ***ACCC will not contest the merger***
- ***Industry conditions will improve***
- ***Could still be cheap***



The merger has been a key part of our investment thesis for PMP and is unquestionably good news for shareholders.

Combined, PMP and IPMG will control about 80% of the heatset print market, primarily involved in printing catalogues and magazines. A decade ago, such market dominance would be unthinkable but, with the magazine industry dramatically smaller and the industry swamped with overcapacity, a decision to knock back the deal would almost have been a death sentence to both firms.

Better industry conditions

The ACCC made specific mention of IVE group, a listed print business that has grown by acquisition, as a major competitor that would restrain the merged group.

IVE is an interesting case study. It recently acquired Franklin, a major catalogue competitor to PMP, and has helped reduce industry capacity. A smaller number of larger market participants should show supply restraint and could lead to industry profits rising. IVE itself trades on an enterprise value to earnings before interest, tax, depreciation and amortisation (**EV/EBITDA**) multiple of 10 which is high for this kind of business. PMP, in contrast, trades on EV/EBITDA of just 4 times.

The ACCC didn't mention that most of PMP and IPMG's customers are large retailers with dominant market positions. We understand that one of the major supermarkets raised concerns with the ACCC about the deal and we imagine the regulator chuckled a little as they heard the plea for protection.

With the deal now allowed to proceed, PMP should be on surer footing. The business has estimated $40m synergies at the EBITDA line but we think that is a gross underestimation and true savings could be twice that number.

Still cheap?

If we assume the combination of PMP and IPMG can generate $60m of EBITDA and add $40m of synergies, it isn't hard to imagine $100m of additional EBITDA from the new entity, which might be worth about $500m on modest multiples, after restructuring charges.

IPMG will own 37% of the new business so PMP itself could be worth about $270m compared to a market capitalisation of $210m today. In short, there may still be value on offer.

We will need to do more work on the extent of the efficacy gains and how much margin of safety to seek in a poor quality business with an improved industry structure.

The stock is up around 11% today and 14% since we reported on the **ACCC's possible intervention** just before Christmas. That puts it 39% up on our **original Buy recommendation** from June 2015, excluding dividends. It's therefore worth keeping a close eye on our 5% maximum recommended portfolio limit; this remains a poor quality business albeit one which has demonstrated capable management.

PMP shows the value of contrarian investing and why we seek ideas where others do not. We've again increased our price guide but our recommendation remains **HOLD**.

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

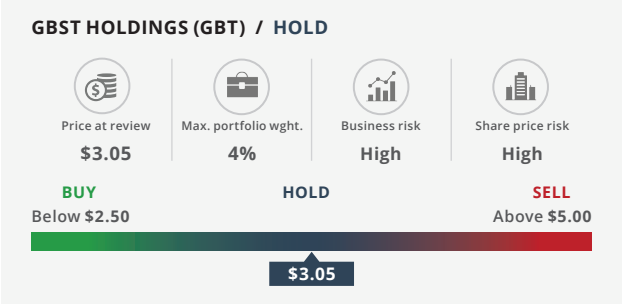
Disclosure: The author owns shares in PMP.

After last week's downgrade, there were few surprises in GBST's half-year accounts.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 14 FEBRUARY 2017

GBST: Interim result 2017

We weren't expecting many surprises in GBST's half-year result. The damage had already been done via the downgrade a fortnight ago (see ***More project delays hit GBST***). With the headlines numbers already flagged, further dissection was somewhat of a formality.



Revenue was down 20% to $45.4m. Contracts deferrals in the UK were responsible for $5.2m of the decline, with depreciation of the pound detracting a further $3.8m. The loss of a capital markets contract with Pershing, which took the opportunity to shift to a competitor instead of upgrading from GBST's SHARES to Syn, explained most of the $1.9m decline in the Australian division.

Operating earnings (before depreciation and amortisation) were also in line with the $8m expected. This was up on the prior period's $6m, but it significantly undershot the higher expectations held before the trading update. In an otherwise disappointing half, cash conversion was good with each dollar of operating profit (before depreciation and amortisation) converting into $0.97 of operating cash flow. No concerns with the balance sheet either, with $12m of net cash.

After two disappointing years, growth is on everyone's minds. In GBST's case, it is not only desired but required, to justify the current enterprise value to EBITDA multiple of 16 times.

Assistance could (still) come from industry forces. GBST estimates they hold a 25% share of the UK's adviser platform market (the largest), a market expected to expand by 35% in the coming years due to more outsourcing. This provides ample opportunity for growth provided GBST can win their share. Here, success will depend on whichever software the client deems best, which largely depends on GBST's execution.

To put its best foot forward, GBST has amplified research and development expenditure, to the tune of $9.1m in the half. The focus is primarily in three areas: Project E-VOLVE, an upgrade to Composer's technology architecture, transitioning clients from SHARES to Syn, and project CATALYST, a 'path to unify GBST's platforms through a common technology stack'. We expect investment to remain elevated at around 20% of revenue through to financial year 2018.

Table 1: GBST interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–)(%)
REVENUE ($M)	45.4	56.7	(20)
EBITDA ($M)	8.0	6.0	33
NPAT ($M)	4.4	2.3	93
EPS (C)	6.5	3.4	91
INTERIM DIV.	3.7c fully franked, down 33%, ex date 31 March		

Due to the evolving nature of technology, it's hard to say whether this investment will leap GBST in front of competitors, or merely catch them up. Time will tell. That said, the oligopolistic nature of the industry does mean that market growth could keep GBST and its competitors – notably **Bravura** – well fed; and, with one large contract win, earnings prospects could improve dramatically. **HOLD**.

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

Staff members may own securities mentioned in this article.

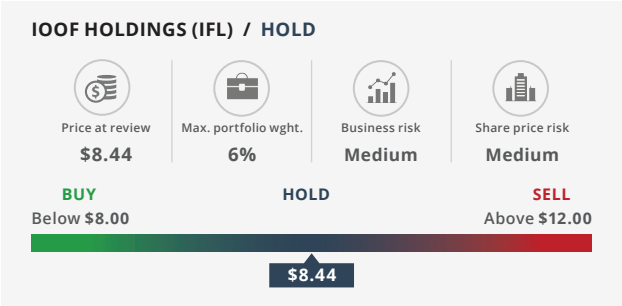
Margin pressures are taking their toll on this wealth manager.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 15 FEBRUARY 2017

IOOF: Interim result 2017

The funds are flowing in for IOOF, but its interim result shows how much it's struggling to turn that into profit.

The fee margin in the Platform business fell to 0.58% in the six months to December, from 0.62% in the previous half and 0.65% in the one before that. That would be fine if customers were simply migrating to cheaper, more efficient platforms, because it should push operating costs down. But these were broadly flat, resulting in a net operating margin of 0.30%, down from 0.32% in the previous half and 0.37% in the one before that.



The Advice business saw something similar, with the fee margin falling to 0.43% from 0.46% in both the previous two halves, and costs actually rising. These were affected by a redistribution of corporate charges following the Perennial disposals in the prior year, but nevertheless meant a fall in the net operating margin to 0.21%, from 0.23% in the previous half and 0.24% in the one before that.

The immediate financial impact of these margin pressures is that underlying net profit and earnings per share each undershot consensus estimates by about 6%, falling 17% from the first half of FY16, to $79.4m and 26.5 cents respectively.

Of course margin pressure has been a feature of this industry for a while, but we were nevertheless shocked by the extent of it shown in this result. So it seems was the market, which has knocked the share price down by almost 10%.

The big question, of course, is to what extent this points the way for the future. Falling margins are to some extent already reflected in the share price, which is why it's on a price-earnings ratio of about 16 (based on new expectations for about 54 cent in EPS for 2017). That's despite some favourable industry tailwinds – at least in the form of fund flows from mandated superannuation.

Table 1: IOOF interim result

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
FUMA ($BN)	109.4	103.4	6
AVERAGE FUMA ($BN)	106.8	104.9	2
GROSS MARGIN ($M)	257.6	275.1	(6)
GROSS MARGIN (%)	0.48%	0.52%	(8)
OP. EXPENSES ($M)	165.3	165.1	0
UNDERLYING OP. PROFIT. ($M)	111.7	128.7	(13)
NET OP. MARGIN (%)	0.21%	0.25%	(15)
UNDERLYING NET PROFIT ($M)	79.4	95.4	(17)
UNDERLYING EPS (C)	26.5	31.8	(17)
INTERIM DIV. (C)	26c fully franked, down 9%, ex date 8 March		

We're meeting with management on Friday and will have more to say after that. For the time being, though, we're reducing our Buy price to $8 and our Sell price to $12. We're also nudging down our recommended maximum portfolio weighting from 7% to 6%. **HOLD**.

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

Staff members may own securities mentioned in this article.

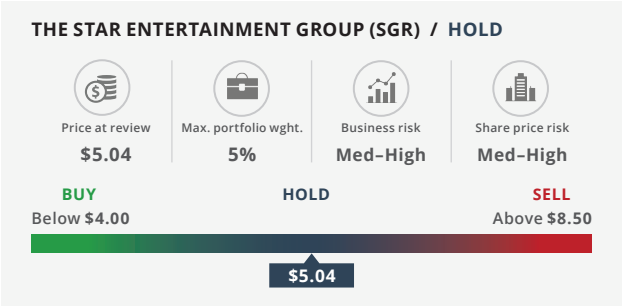
Both VIP and domestic revenue fell, but the latter is already recovering.

BY JON MILLS • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

Star Entertainment: Interim result 2017

The Star Entertainment Group experienced an 'interesting first half' in its VIP business according to chief executive Matt Bekier on today's analyst call.

That's one way to put it.



As expected, the arrest of Crown's employees in China (see ***Crown staff arrested*** on 17 Oct 16 (Buy — $11.70)) had a marked effect on the interim result (see Table 1). Although VIPs who had trips booked at the time of the incident still arrived at the company's casinos, that soon changed. After VIP revenue fell only 4% in first four months of the half, it plummeted 27% in November and December.

An actual win rate of 1.62% didn't help – the theoretical win rate* on baccarat, the game of choice for Chinese VIPs, is 1.35% – as the VIPs lost their money too quickly. We feel their pain.

Along with the lull in VIP business later in the half, this pushed VIP turnover down 12% and hence normalised VIP revenue also fell, by 11%.

Things haven't improved so far in the second half, although Chinese New Year occurred in January this year rather than February so this makes comparisons difficult. Management is understandably being cautious in enticing more VIP business from North Asia (mainland China, Macau and Hong Kong), but we expect the VIP business to bounce back over the medium term.

Domestic mixed

On the domestic front, refurbishment activities affected both the Sydney and Gold Coast casinos, pushing non-gaming revenue down 3% and, with there temporarily being fewer machines on the floor, slots revenue also fell 3%.

The company's new loyalty program was launched in November and punters were given an additional $13m in free play on the slots. This free money was 'played through very quickly' in November and December.

By contrast, table revenue inched up 1%, primarily due to a 4% rise in Sydney.

Table 1: SGR interim result 2017

SIX MONTHS TO DEC	2017	2016	+/(–) (%)
REVENUE ($M)	1,174	1,219	(4)
UNDERLYING EBIT ($M)	175	210	(17)
UNDERLYING NPAT ($M)	107	130	(18)
EPS (C)	13.0	15.7	(17)
FINAL DIVIDEND	7.5 cents (up 36%), fully franked, ex date 21 Feb, DRP (no discount)		

As the refurbishments have been completed, these declines have proven temporary, with domestic revenue rising 11% between 1 January and 12 February. This was helped by the earlier Chinese New Year – particularly in Sydney where there is a large Chinese community – but unlike in the VIP business, the trend in the company's domestic business is positive. **HOLD**.

**Due to the large amounts VIPs bet, casinos normalise VIP income to reflect the theoretical rather than actual win rate to reduce earnings volatility.*

*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.***

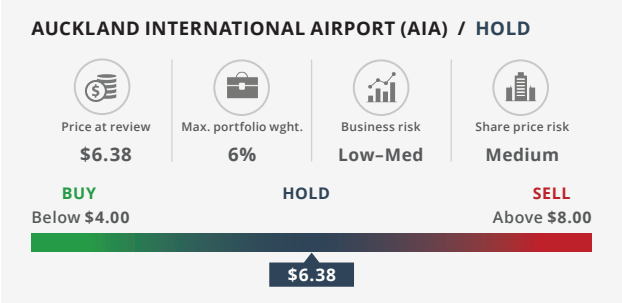
Disclosure: the author owns shares in Crown Resorts.

Strong international traffic growth underpinned another good year for Auckland Airport.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 17 FEBRUARY 2017

Auckland Airport: Interim result 2017

'We are currently investing more than $1 million every working day on our core airport infrastructure,' said Auckland International Airport's management.



The airport is booming – 50% more international airlines now service the airport compared to just 18 months ago. Several construction and upgrade projects are underway to support this growth, including a new international departure area and extension to the terminal to provide space for more A380 aircraft. Various ground transport and parking improvements are also underway.

Echoing ***Sydney Airport's full-year result***, Auckland Airport has posted impressive numbers for the six months to December: total passengers increased 12% to 9.4 million, with both international and domestic passenger numbers growing by 12%.

Revenue rose 11% to NZ$311m, which was attributed to the strong growth in traffic and an uptick in revenue from the company's investment properties. Costs broadly rose in line with revenues; underlying earnings before interest, tax, depreciation and amortisation (EBITDA) also increased 11% to NZ$236m.

Underlying net profit rose 19% to NZ$124m and was aided by lower interest expense on the company's NZ$1.9bn of net debt. Statutory net profit got an NZ$18m boost from the revaluation of the airport's investment properties.

Underlying earnings per share rose 19% to 10.4 NZ cents and the board declared an interim dividend of 10.0 NZ cents, up 18%. Management expects full-year net profit of NZ$235–243m, which would be an increase of 11–14% on 2016. With an unfranked dividend yield of 2.8%, we're sticking with HOLD.

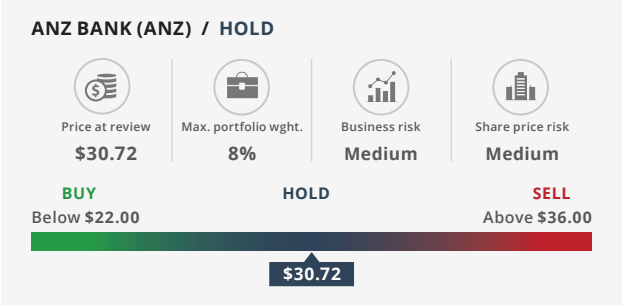
Staff members may own securities mentioned in this article.

Chief executive Shayne Elliot continues to make ANZ a simpler and more efficient bank.

BY JON MILLS • INTELLIGENT INVESTOR • 17 FEBRUARY 2017

ANZ: Q1 trading update

It's amazing what a new chief executive can accomplish if he or she has the right priorities, and Shayne Elliott's promise to create a 'simpler, better balanced' ANZ is already bearing fruit.



As noted previously, it makes sense for ANZ to keep its Asian institutional business, to help support and develop its Australian institutional business, but we agree with Elliot's plans to dismantle the bank's retail presence in Asia.

To that end, the disposal of its retail and wealth businesses in five Asian countries and 20% stake in Shanghai Rural Commercial Bank will complete later in 2017 and early 2018, with the proceeds helping boost the bank's capital balance.

Things are already improving on that front due to a strong first quarter, with underlying cash profit rising 20% to $1.83bn. As a result, ANZ's **common equity tier one capital ratio** is now 9.5% – and that's after paying its 2016 final dividend of 80 cents per share. By contrast, CBA reported a 9.9% ratio in its **2017 interim result** but will shortly pay its interim dividend.

A 4% rise in underlying revenue along with a 1% fall in underlying costs both contributed. However, like CBA, the rising cost of deposits along with a 4% rise in household deposits pushed down **net interest margin** by 'several basis points' (one basis point equals a one-hundreth of a per cent).

The market was expecting lower provisions and they duly arrived. ANZ's total provision charge for the first quarter was $283m, although this includes a $42m reversal of collective provisions. By contrast – and ignoring the $147m Oswal sttlement – the bank's 2016 quarterly average was around $450m.

So while various seasonal influences mean the first quarter is traditionally good provisions-wise, ANZ may now enjoy a lower provision charge as a percentage of gross loans and advances this year than in 2016. Management had previously expected this year to be 'broadly the same' as 2016 in percentage terms.

We'll have to wait but, in any case, we'd still expect provisions to average out at higher levels across the cycle, **as noted in the 2016 result**.

Happily, this update reduces the chances of further dividend cuts but they remain a possibility. **HOLD**.

**Please note our recommended maximum portfolio weightings of 8% for ANZ individually and 20% for the banking sector as a whole. More conservative investors and those with other exposure to the property market should use lower limits.*

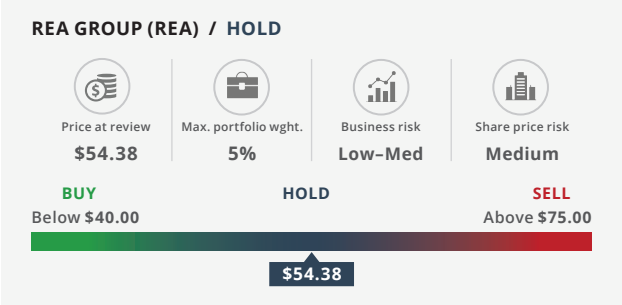
Staff members may own securities mentioned in this article.

Slowing profit growth seems at odds with this company's premium price but it will only be temporary.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

REA Group: Interim result 2017

After a long period where 20%-plus profit growth had become the norm, REA Group fell to earth in the first half of 2017. Excluding its European operations, which the company sold this month, revenues rose 16%.



Australian revenues grew only 12% as listings volumes weakened, with management reporting double-digit falls in Sydney and Melbourne. However, the inclusion of the iProperty Asian listings business for the first time took revenues up a notch.

Unfortunately iProperty is not all that profitable yet, partly because REA is investing in the business and partly because transaction volumes also turned down in Malaysia and Hong Kong during the half. So growth in earnings before interest, tax, depreciation and amortisation (EBITDA) was weaker at 13%.

It was weaker again at the net profit line, which grew just 6% as higher amortisation and interest charges took another slice of earnings. This sort of growth seems a poor showing for a stock that trades on a 2017 prospective price-earnings ratio of 30.

If you're a shareholder, though, don't worry too much. Profit growth will pick up again in the second half as listing volumes were depressed in the previous period. Beyond that, real estate agents – or rather, vendors – should steel themselves for another round of price increases. **Fairfax Media**'s *Domain* has just jacked them up, so there's nowhere to hide.

Table 1: REA Group interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
REVENUE ($M)	337.3	289.8	16
EBITDA ($M)	200.1	176.7	13
NPAT ($M)	121.8	115.3	6
EPS (C)	92.5	87.5	6
DPS (C)	40.0*	36.0	11
FRANKING (%)	100	100	N/a
INTERIM DIVIDEND	40c fully franked, up 11%, ex date 3 March		

Note: Figures are underlying results

We've noticed some members believe a housing downturn will hit REA Group hard, but that's not necessarily the case. In fact, the opposite might be true. Given REA's importance to our **News Corporation** recommendation it's an issue we'll explore in a full review over the coming months. The stock is little changed since ***Weak start for News Corp and REA*** from November, and the recommendation remains **HOLD**.

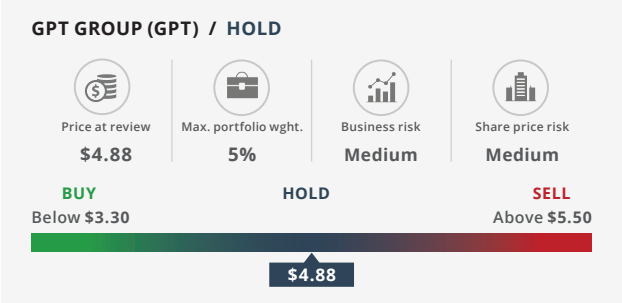
Staff members may own securities mentioned in this article.

A terrible year for retailers has not hurt GPT Group's shopping centres, while Sydney's office market continues to boom.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 14 FEBRUARY 2017

GPT Group: Result 2016

When you earn more than half of your distributable profit from shopping centres, retailers entering administration is not a good thing. Sixteen retailers entering administration is a disaster.



This is exactly what happened to GPT last year, but you wouldn't know it from its annual results.

The company's retail division generated like-for-like income growth of 3.8%, higher than the 3.0% generated by the portfolio in the previous year. Rather than fall, occupancy also improved to 99.6%, from 99.2%, with new leases signed on better terms than the ones they replaced.

Outside the retail division, GPT's office properties were the standout. A 1% improvement in occupancy and rental growth drove the office portfolio's like-for-like income up 6.3% and net asset value up 9%. Sydney remains GPT's biggest market with its office properties rising in value by around 12% compared to 7% for Melbourne and 3% for Brisbane. The company's logistics properties increased like-for-like income by 1.4%.

In addition to increasing income, management has been working hard on reducing costs. Staff numbers fell 9%, leading to a $3m reduction in corporate overheads, and borrowing expenses fell 15% to $100m.

With strong income growth and lower costs, distributable profit rose 7% to $537m but don't expect this to continue in 2017. GPT expects distributable profit over the next 12 months to increase by just 2%.

The company's cost reductions are largely complete and income will be affected by asset sales and a lack of performance fees, as well as receiving no more interest from the Indigenous Land Corporation for a loan linked to the sale of the Ayers Rock Resort.

However, with GPT expecting reduced incentives due to less leasing activity, distributions are expected to outpace distributable profit increasing by 5%. This means total distributions should be around 24.5 cents, giving a prospective unfranked distribution yield of just over 5%.

Table 1: GPT Result 2016

YEAR TO DECEMBER	2016	2015	+/(—) (%)
TOTAL REVENUE ($M)	705	688	2
BORROWING EXP. ($M)	103	118	(13)
DISTRIB. PROFIT ($M)	537	502	7
DIVIDEND (C) *	23.4	22.5	4
GEARING (%) **	25.1	26.4	(5)
NTA PER SHARE ($)	4.59	4.17	10

***11.9 cent final dividend (unfranked), ex date already past**

****Gearing = net debt / (total tangible assets – cash)**

With our expectations of long-term growth of approximately 2–4% depending on economic conditions, the implied pre-tax total return of 7–9% is too low to encourage us to recommend the stock. However, it may make sense for those interested in a steady income to **HOLD**.

Staff members may own securities mentioned in this article.

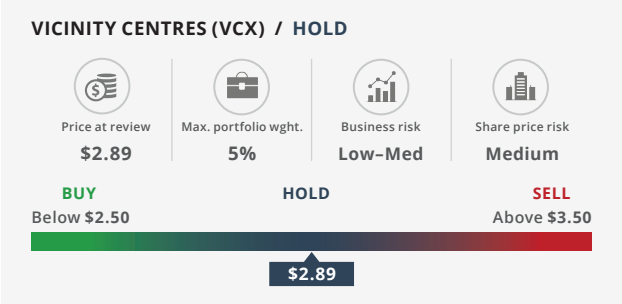
Despite recent retail failures, this owner of shopping centres continues to perform well.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 16 FEBRUARY 2017

Vicinity Centres: Interim result 2017

So far only two major retail property owners have announced results this reporting season but the theme is already clear.

The last 12 months have been very difficult for Australian retailers and at least 16 brands have shut their doors and entered administration. However, despite these brands having many stores inside the nation's shopping centres, the companies renting space to these retailers have felt little impact.



Vicinity Centres is the latest example. More than 138 stores were linked to the spate of administrations in the retail sector and at least 88 were handed back to centre management. However, almost all of these stores have been re-leased to stronger retailers under terms at least consistent with what existed before.

In fact, over the past six months, the company completed 667 lease transactions with average terms 1.7% longer than the expired lease. The company's total occupancy also remained at 99.4% and, although property income fell 2.4%, this was mainly due to asset sales, with comparable property income up 3.0%.

Part of Vicinity's success has been due to the company proactively remixing the type of retailers it puts inside its centres.

Vicinity has reduced the total floor space dedicated to women's clothing by 12% and increased the space dedicated to retail services and cafes/restaurants by 32% and 20% with shoppers seeking more experiences. The company also continues to see strong demand for space from international retailers.

One highlight was the recently completed redevelopment of the company's flagship Chadstone shopping centre in Victoria. The property was revalued 12.2% higher and is now worth over $5.3bn (Vicinity's 50% share is worth $2.6bn). In fact, Vicinity's share of this gain made up over half the $508m increase in property value.

Table 1: Vicinity Interim Result 2017

SIX MONTHS TO DEC	2016	2015	+/(—) (%)
NET PROPERTY INCOME ($M)	461	472	(2)
BORROWING EXP. ($M)	(83)	(86)	(3)
DISTRIB. PROFIT ($M)	376	378	(0)
DIVIDEND (C) *	8.7	8.8	(1)
GEARING (%) **	23.7	25.6	(7)
NTA PER SHARE ($)	2.73	2.59	5

***8.7 cent dividend (unfranked), ex date already past**

****Gearing = net debt / (total tangible assets – cash)**

The company still has a development pipeline of over $3bn which includes another $666m upgrade to Chadstone which should help drive further growth in the future.

For the full year, Vicinity expects underlying earnings per share of around 18.7 cents per share, of which it will pay out between 90% and 95% in distributions. Using the midpoint of this range, the stock is currently trading on an unfranked distribution yield of 5.9%. **HOLD**.

Staff members may own securities mentioned in this article.

Sydney Airport's price climbs

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 14 FEB 2017

SYDNEY AIRPORT (SYD) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$6.26	8%	Below $6.00	$6.26	Above $10.00

Well, it was fun while it lasted. Sydney Airport's share price has risen 6% since we upgraded it in Who pays for Sydney's second airport? from 5 Jan 17 (Buy – $5.89). There's plenty to like about the company: decent and resilient growth prospects, formidable competitive advantages and 'light touch' regulators. Nonetheless, with a current dividend yield of 5.0% we're downgrading the stock to **HOLD**.

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

Disclosure: The author owns shares in Sydney Airport.

FSA Group's price rises

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 17 FEB 2017

FSA GROUP (FSA) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$1.38	3%	Below $1.20	$1.38	Above $2.00

FSA Group's share price has risen 14% since Selling canoes in the Sahara and 44% since we initially upgraded it in FSA Group: Interim result 2016 on 26 Feb 16 (Speculative Buy – $0.96). The company will release its 2017 interim financial report later this month and we will cover the result in detail. In the meantime, having moved past our Buy price, we're downgrading to **HOLD**.

Disclosure: The author owns shares in FSA Group.