Weekly Review

RESEARCH

– Issue – 18 Nov. 2016

We perform a sum-of-the parts analysis to estimate the value of Crown under three scenarios.

BY JON MILLS • INTELLIGENT INVESTOR • 14 NOVEMBER 2016

Crown: Adding up the chips

Valuations of companies are just as much an art as a science, depending as they do on the assumptions used. Moreover, the further ahead we look, the greater the inherent uncertainty in any calculations.

Key Points

- ***Crown is a complex business***
- ***Assumptions made to simplify calculation***
- ***Wide range of outcomes possible***

CROWN RESORTS (CWN) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$10.56	4%	High	High

BUY Below $12.00 | HOLD | SELL Above $18.00

$10.56

When we first upgraded Crown to Buy in ***Betting on Crown – part 1*** on 20 Apr 15 (Buy — $13.15), we took an asset-based approach. This was because Crown was – and still is – investing heavily in various projects around the world and so we needed to look many years ahead, to 2022, when Crown Sydney should (hopefully) be completed and Macau should (hopefully) have recovered from its current cyclical downturn. (See ***Betting on Crown – part 2*** for the details).

The trouble is, of course, that it's hard enough to accurately predict a company's earnings and asset values one year ahead, let alone seven – but if you don't try these things then you don't have a basis for a valuation. You just have to do your best, consider a range of scenarios and allow a fat margin of safety. You also have to be careful not to get fixated on a particular valuation and be ready to make adjustments as things change.

So, with Crown recently making a return to our Buy list after **members of its staff were arrested in China** (and after adding it to our **Equity Income Portfolio** and increasing our holding in our **Growth Portfolio**), it's time for another detailed look at the numbers.

Complex business

Like any valuation, we've made a number of assumptions in each of our three cases (see Table 1). However, the complexity of Crown and its many moving parts means some of our assumptions are intended to reduce the complexity while also maximising our margin of safety.

First and foremost, while we think the **proposed demerger** of most of Crown's international investments and the IPO of four of its hotels will provide incremental value, we've deliberately assumed none will arise in each of our three cases. We've also assumed no value for Crown's fast-growing Wagering & Online business.

Crown's 27% investment in **Melco Crown Entertainment**, which owns casinos in Macau and The Philippines and whose majority-owned Studio City Macau and City of Dreams Manila are still ramping up, only adds to the complexity. Moreover, a fifth tower is being added to City of Dreams Macau, which will add 780 rooms to the existing 1,400 rooms.

Continued on page 2 ...

CONTENTS

Continued from page 1 ...

Table 1: Crown sum of the parts

	2016 EBITDA: BEAR / BASE / BULL ($M)	MULTIPLES: BEAR / BASE / BULL	BEAR CASE ($M)	BASE CASE ($M)	BULL CASE ($M)
CROWN MELBOURNE	572 / 619 / 673	7/9/11	4,004	5,571	7,403
CROWN PERTH	221 / 239 / 260	7/9/11	1,547	2,153	2,860
CROWN SYDNEY	N/A	N/A	226	226	1,119
CROWN ASPINALLS	26 / 26 / 26	7/9/11	182	234	286
ALON LAS VEGAS	N/A	N/A	372	372	372
WAGERING & ONLINE	(5)	N/A	–	–	–
OTHER *	N/A	N/A	283	283	283
CORPORATE	(98)	10/10/10	(980)	(980)	(980)
TOTAL			**5,634**	**7,859**	**11,344**
LESS: NET DEBT			(1,812)	(1,812)	(1,812)
TOTAL EQUITY VALUE			3,823	6,048	9,532
SHARES (M)			728.4	728.4	728.4
VALUE PER SHARE ($)			5.25	8.30	13.09
MELCO CROWN VALUE PER SHARE (PER SOTP ANALYSIS IN TABLE 2) ($)			2.43	3.37	6.29
MELCO CROWN VALUE PER SHARE (BASED ON CURRENT SHARE PRICE) ($)			4.59	4.59	4.59
TOTAL VALUE (USING MELCO CROWN SOTP VALUE) ($)			**7.68**	**11.68**	**19.37**
TOTAL VALUE (USING MELCO CROWN SHARE PRICE) ($)			**9.83**	**12.89**	**17.67**

*** Nobu, Ellerston, Aspers & Queensbridge hotel JV**

There are a couple of options with this – and we've presented both in Table 1. The first is simply to take the market value of Crown's stake in Melco Crown Entertainment since it's listed on the Nasdaq. The second is to give it its own sum-of-the-parts valuation, and the details for this are presented in Table 2.

Melco Crown's earnings are likely to grow faster than those of Crown's Australian casinos due to Macau likely being at or near the bottom of the cycle and Studio City and City of Dreams Manila still ramping up. As such, we've used higher multiples of earnings before interest, tax, depreciation and amortisation (or EBITDA) than for Crown's Australian casinos.

Moreover, with the bulk of Melco Crown's capital expenditure behind it, free cash flow should rise at a decent clip, thus also justifying higher multiples.

With that said, let's start with our base case.

Base case

After the recent arrest of its employees in China, **Crown said** that around 12% of its revenues come from mainland Chinese VIPs. Further, because margins on VIP betting are lower than for ordinary punters (due to the freebies and commissions used to attract them), VIPs from mainland China represent 'substantially less than 12%' of Crown's profits.

> **For Melco Crown, we've simply annualised its casinos' results for the first nine months of the 2016 calendar year.**

Table 2: Melco Crown sum of the parts

	2016E EBITDA: BEAR / BASE / BULL (US+$M)	MULTIPLES: BEAR / BASE / BULL	BEAR CASE (US$M)	BASE CASE (US$M)	BULL CASE (US$M)
CITY OF DREAMS MACAU	738 / 738 / 800	8/10/12	5,904	7,380	9,600
ALTIRA	2 / 2 / 30	8/10/12	16	20	360
MOCHA	24 / 24 / 30	8/10/12	192	240	360
STUDIO CITY (60%)	79 / 79 / 240	8/10/12	632	790	2,880
CITY OF DREAMS MANILA (69%)	107 / 107 / 182	8/10/12	856	1,070	2,184
CORPORATE	(110)	10/10/10	(1,100)	(1,100)	(1,100)
TOTAL			**6,500**	**8,400**	**14,284**
LESS: NET DEBT *			(1,582)	(1,582)	(1,582)
TOTAL EQUITY VALUE			4,918	6,818	12,702
CROWN'S SHARE (US$M)			1,333	1,848	3,442
AUD/USD			1.33	1.33	1.33
CROWN'S SHARE (AU$M)			1,773	2,457	4,578
SHARES (M)			728.4	728.4	728.4
VALUE PER SHARE (AU$)			**2.43**	**3.37**	**6.29**

*** Melco Crown's proportionate share of cash and non-recourse debt held by its majority-owned subsidiaries**

To be conservative, in our Base case we assume Crown loses all mainland Chinese VIP business or around 8% of its 2016 EBITDA for its Australian casinos.

Our estimate of Crown Sydney's value is the capital expenditure invested in it to date while our estimate of Alon Las Vegas's value is the total equity investment made by Crown to date.

For Melco Crown, we've simply annualised its casinos' results for the first nine months of the 2016 calendar year. With two new casinos recently opening in Cotai and more to follow, and infrastructure improvements such as the Hong Kong to Macau bridge and light rail being delayed, we're being conservative and using current earnings. That is, we're not adjusting for Studio City and City of Dreams Manila still ramping up, nor for any cyclical upturn in Macau.

Bear case

Here we've assumed that EBITDA for Crown's Australian casinos declines by 15%, whether due to the loss of mainland Chinese VIP revenue, a downturn in revenue from ordinary punters or a bit of both.

We've also used a lower EBITDA multiple of seven. For reference, both Crown and **The Star Entertainment Group** have traded on an average EBITDA multiple of 11 since they listed on the ASX in 2008 and 2011, respectively.

During the GFC, Crown's EBITDA multiple reached six, but this was an extreme situation and remember that we've already discounted EBITDA itself by 15%.

For Melco Crown, the only adjustment to our Base case is to use a lower EBITDA multiple of eight. This is higher than our multiple for the Australian casinos because Macau is likely near a cyclical low and Studio City and City of Dreams Manila are still ramping up.

Bull case

Here we assume that Crown Melbourne and Crown Perth maintain their 2016 EBITDA, perhaps through minimal losses to VIP revenue being offset by increases in other income from mass market punters and non-gaming. This could be helped by a doubling in hotel rooms at Crown Perth when Crown Towers Perth opens in December.

In this case, our estimate of Crown Sydney's value is its expected $1.5bn cost discounted to today.

> **With the share price currently much closer to the bottom of that range, we think the upside is more than adequate to compensate for the downside.**

We've also estimated normalised earnings for Melco Crown, assuming Studio City and City of Dreams Manila are fully ramped up and Macau has risen from around cyclical lows. It's possible that Studio City won't meet its financial covenants in calendar 2017, which could lead to its debtholders taking ownership and rendering the equity worthless to Melco Crown. However, as Melco Crown's proportionate share of Studio City's net debt (the debt is non-recourse) is around $1bn, this would actually increase the value in our Bear and Base cases but reduce our Bull case valuation by around $1.

Wide range

Putting all this together leads to a wide range of outcomes, as you would expect – from a bear case of just below $8 to a bull case of above $19. With the share price currently much closer to the bottom of that range, we think the upside is more than adequate to compensate for the downside.

No doubt it's possible for the valuation to end up outside this range, but we think we've been conservative for all three scenarios. We also think the Base and Bull scenarios are more likely over the medium to long term, which adds further reassurance.

Even so, for such a complex business with a wide range of outcomes we recommend treading carefully – so bear in mind our risk ratings of high and our 4% recommended maximum portfolio weighting. For most people it will make sense to start a bit below this level, to allow room to buy more if a better opportunity emerges. Our **Growth** and **Equity Income** portfolios, for example, currently have weightings of 3%. BUY.

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

Disclosure: the author owns shares in Crown Resorts.

Could the market's savage treatment of TPG Telecom provide an opportunity?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 18 NOVEMBER 2016

Opportunity calls at TPG

'Mr Watson, come here, I want to see you'. Legend has it that in 1876, this was the world's first telephone conversation. That simple command started an industry that has transformed the world.

Key Points

- ***Margins will fall***
- ***Resources and opportunity to offset decline***
- ***Management matters***

TPG TELECOM (TPM) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$7.01	6%	Med-High	Med-High

BUY Below $7.50 · HOLD · SELL Above $14.00

$7.01

Fortunes were built, empires were felled but for over 100 years the underlying technology barely changed. Then it did.

An industry changing this fast isn't always the best place to seek value but, thanks to yet another major transformation – the upcoming National Broadband Network (NBN) – the price of telco incumbents has crumbled and value might be on offer.

In preview, we're upgrading TPG Telecom to Buy. It's a somewhat an unusual recommendation for us, though, because the industry is undergoing structural change, so we're depending greatly on management.

Before we get into any of that, though, we need to understand why a one-time darling has fallen so far.

When margins fall

It's all to do with the National Broadband Network (NBN). Unless you've been living in a cave, you're probably aware that the government has funded a new fibre network to replace the existing copper wires that support broadband delivery. The internet, in other words, is getting new bones.

As part of the process, all internet providers will lease network capacity and become resellers on the NBN. This has a few important implications.

Most obviously, when everyone uses the same network, advantages are harder to claim. The investment in exchange **DSLAMS** made by TPG and others will become obsolete and, because wholesale costs for the NBN are higher than they are for copper access, margins will fall across the industry.

As wholesale access costs rise, scale will become more important because providers can spread all other fixed costs (like marketing and billing) over a larger customer base. Despite the democratisation of NBN access, plucky startups will still find it hard to compete with industry giants.

Infrastructure owners will retain some advantages, though. Providers will all use NBN fibre but getting on that network will require access to their own or third party wires.

Telstra, TPG and (with the purchase of NextGen) **Vocus** have fibre access to the points of interconnect, the sites that aggregate and redistribute data onto the NBN. This will continue to be an advantage in a post-NBN world. Telstra and TPG also have their own international cable access while Vocus still leases access.

Yet it is clear margins will fall and they will fall hardest for asset-heavy businesses like TPG. Table 1 shows the impact the NBN could have on TPG's margins. Under our base case assumptions, earnings growth grinds to a halt as margins crumble.

Table 1: Profit estimates, 2017–2020

	2016	2017	2018	2019	2020
REVENUE ($M)	2,400	2,500	2,600	2,800	3,100
EBITDA MARGIN	32%	32%	30%	28%	26%
EBITDA ($M)	768	800	780	784	806
DA ($M)	120	150	156	168	186
EBIT ($M)	648	650	624	616	620
INTEREST ($M)	66	60	50	40	35
PBT ($M)	582	590	574	576	585
NPAT ($M)	407	413	401	403	409
EPS (C)	0.48	0.49	0.47	0.48	0.48
PER	15	14	15	15	15

Asset owners like TPG and Telstra typically earn higher margins than resellers such as iiNet and Vocus: iiNet and Vocus generate earnings before interest, tax depreciation

> **Between now and 2020 millions of households will be forced to switch their broadband service before copper wires are abandoned.**

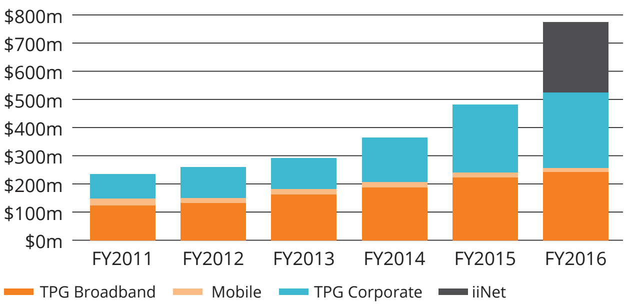
and amortisation (EBITDA) margins of 24% compared to broadband margins of 40% and 41% for TPG and Telstra respectively.

Providers who own infrastructure also enjoy higher incremental margins and additional customers improve the economics of their business. The NBN will alter this and TPG's EBITDA margins should fall to reflect a larger component of customers leasing NBN capacity. The future of TPG will depend on how the business offsets this margin decline.

Restoration

We've assumed margins will bottom at around 26%, a dangerously precise number that reflects our view that TPG will make higher margins than resellers but lower margins than today. We've also assumed revenue growth of 4–7% between now and 2020, by which time all of TPG's broadband customers will have migrated to the NBN.

Chart 1: EBITDA by segment, 2011–2016



Source: Company reports

Why will revenue rise? A few reasons.

The most simple is that average revenue per user (ARPU) will increase as customers switch to the NBN. As we have explained, however, that rise won't be enough to offset higher costs. TPG paid about $15 per user per month to lease copper wires but will now pay closer to $50 per user per month for NBN access.

Between now and 2020, however, millions of households will be forced to switch their broadband service before copper wires are abandoned. With about 7m households switching, this will be the biggest ever '**churn**' event the industry has ever encountered and low-cost providers like TPG are likely to pick up market share.

The NBN will disrupt the retail market substantially but, for the past few years, most of TPG's growth has actually come from the corporate segment (see Chart 1), where TPG has built the largest dark fibre network in the country and one of the largest metro fibre networks.

TPG has used this infrastructure to lure businesses to establish direct connections between multiple offices, servers and data centres. Since the purchase of AAPT, TPG has generated most of its EBITDA growth from corporates and, before including iiNet, corporate accounts generate more than half its profit.

The NBN will not be as disruptive here and we expect TPG to continue making inroads in the corporate segment.

Building fibre attracts high upfront costs but it also generates sensational economics that make new customers extremely profitable with incremental margins exceeding 80%. Competition is also less likely to replicate fibre connections and customer churn is low.

Fair price, cheap option

TPG now boasts 17,000km of fibre, an asset base that should generate outstanding returns despite the NBN. In 2009, TPG held just $135m in property plant and equipment on the balance sheet; last year this rose to over $900m. In that same time, return on assets has risen from 4% to 12%.

TPG's outstanding success is built on a simple strategy: build infrastructure and fill it with customers. This strategy is now limited in the retail segment but still viable among corporates.

There are other options available to compete in the retail market. A quirk in the NBN legislation allows fibre owners to extend legacy assets by 1km to connect to buildings. TPG, as one of the largest fibre owners, is exploiting this quirk to build an independent fibre to the basement (FTTB) network that will connect thousands of buildings and many more customers to fibre internet.

FTTB will bypass the NBN and it should offer broadband at roughly half the price of NBN plans while delivering superior margins. This will go some way to offsetting expected declines.

Another option being pursued is a 4,000km fibre network for Vodafone which has signed a 15-year deal to underpin

> **The point here is that, contrary to appearances, TPG is no capital pig.**

the construction of the project. Vodafone alone will provide almost $1bn in revenue and every additional customer TPG attracts along that fibre should provide a staggeringly high margin. And finally, the business is bidding on a mobile licence in Singapore which would introduce a new revenue stream.

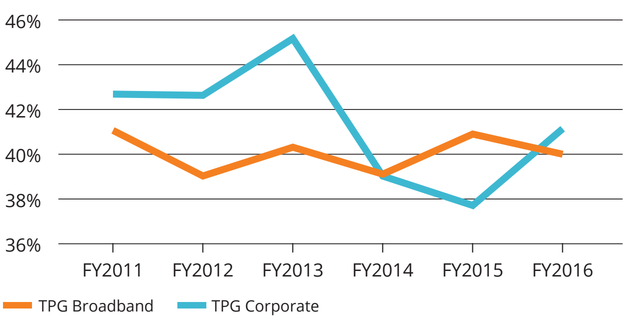
All these options could potentially offset margin decline but are being ignored in today's valuation. TPG may not appear obviously cheap but it is fairly priced and comes with plenty of new ways to lift profit.

Even if earnings remain flat there is a good chance that free cash from the business will exceed profits. To see why, we must delve into the balance sheet.

A capital pig?

The balance sheet is revealing. Total assets of $3.7bn suggest this is a capital hog, an impression strengthened by depreciation and amortisation charges that have averaged 11% of revenue over five years and consistently high capital expenditure.

Chart 2: EBITDA margins, 2011–2016



Source: Company reports

Yet peer closer at the business and another view emerges.

Less than $1bn of tangible assets – largely infrastructure built by TPG – sit on the balance sheet. These assets shouldn't be capital intensive because, once laid, there is little maintenance needed for fibre.

Intangible assets worth about $2bn dominate the asset side of the balance sheet, much of which is goodwill from acquisitions.

It's noteworthy that TPG capitalises and then amortises customer lists from acquisitions but, since marketing costs are already expensed, there's a strong case that this expense is being counted twice and, again, this depresses net profit.

The point here is that, contrary to appearances, TPG is no capital pig. The business chews through plenty of capital expenditure but the bulk of it is discretionary. Its cash flow is strong and steady.

Rather than maintaining assets, capital expenditure is directed to building new ones on which TPG will earn decent rates of return. This could be a compounding machine for years.

Free cash flow, then, depends heavily on the investment decisions of management. If capex rises, we expect it will be because new opportunities are found and profits will rise too. If capex falls, free cash flow will grow. What at first glance appears a capital intensive business actually isn't.

Free cash flow for a business with discretionary capex is hard to predict but we've given it a shot in Table 2.

Table 2: FCF estimate, 2017–2020

	2016	2017	2018	2019	2020
REVENUE ($M)	2,400	2,500	2,600	2,800	3,100
EBITDA MARGIN	32%	32%	30%	28%	26%
EBITDA ($M)	768	800	780	784	806
CAPEX ($M)	280	400	300	300	200
EBIT ($M)	488	400	480	484	606
INTEREST ($M)	66	60	50	40	35
PBT ($M)	422	340	430	444	571
FCF ($M)	295	238	301	311	400
FCF/SHARE (C)	0.35	0.28	0.35	0.37	0.47
FCF YIELD (%)	5%	4%	5%	5%	7%

Capex will be high for the next few years as TPG builds Vodafone's fibre network but it should then fall back to historic averages, which, at current prices, presents a free cash flow yield of 7%.

TPG is capable of generating free cash flow of $300m–400m per year and its balance sheet is in fair shape. It has both the resources and the opportunities to offset lower margins. At today's price, however, with a price-earnings ratio (PER) of 15 and an enterprise value to EBITDA multiple of about 9, those options are absent from its valuation.

> "The greatest risk is from competition.

Risks

That doesn't mean there's no risk, though.

The greatest risk is from competition. An entire industry faced with declining margins could react unpredictably and a price war could erupt as competitors fight for market share. With 80% of industry revenue in the hands of the top three providers, we expect more rational behaviour but that is far from certain.

There is also a risk that TPG decides to buy its way back to higher margins and does so badly. Founding chief executive David Teoh owns 34% of the business and has all his wealth tied to it; Soul Patts Chairman and TPG director Robert Milner is also buying shares. We hope that is enough to dissuade such action.

This isn't the time to back up the truck but it is time for action. Our portfolio limit for TPG is 6% but we recommend taking an initial stake no higher than 3%, leaving room to buy more if it gets cheaper. For the first time in years, TPG joins our buy list. **BUY**.

Staff members may own securities mentioned in this article.

Stratton and iCar Asia aren't working out so well for Carsales, so it's good news that the Australian advertising business is humming along nicely.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 17 NOVEMBER 2016

Carsales' core business motoring

Carsales.com can't take a trick at the moment. Two of its investments have come a cropper at the same time. First there was the company's finance division Stratton, which we covered in ***Carsales' Stratton splutters***.

Key Points

- ***Weakness in Stratton and iCar Asia***
- ***Other international investments doing well***
- ***Core business strong and profitable***

CARSALES.COM (CAR) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$9.93	6%	Medium	Med–High

BUY Below $10.00 | **HOLD** | **SELL** Above $15.00

$9.93

Then came the news yesterday that the two Carsales directors on **iCar Asia**'s board had resigned (see ***iCar Asia directors resign***). The market is likely to view this as a failure of Carsales' Asian growth strategy. Unless Carsales makes a bid for iCar Asia – which is still possible but unlikely we think – it might be a seller of its 17% stake.

Assuming the relationship has broken down, Carsales is likely to write down its investment in iCar Asia at some point. Based on the $22m carrying amount in Carsales' 2016 accounts, a writedown of about $12m would be made at iCar Asia's current share price of $0.19.

As we said in ***Carsales' Stratton splutters***, we suspect the outlook for a recovery of the (50%-owned) Stratton is less likely than the market (and management) has been assuming. Stratton has been overly reliant on one lender that paid it volume-based bonuses.

If we make the rather pessimistic assumption that Carsales eventually writes off the $56m in goodwill on its Stratton investment, that takes us to $68m in total writedowns. With $260m in equity, the balance sheet should be able to cope with that, although writedowns can be an issue for asset-light businesses like Carsales.

Emerging markets

The company's other international investments, SK Encarsales in South Korea and Webmotors in Brazil seem to be ticking along nicely enough. Although we're cognisant of the economic climate in Brazil and that there's a little more risk in emerging markets due to the election of US President-elect Donald Trump.

Most importantly, the core Australian business, which accounts for 80% of revenue, is performing well. We're expecting it to deliver around 10% growth in revenue and earnings in 2017. There's the cyclical and competitive risk we've talked about in recent reviews, of course, but there's no doubt Carsales' dealer and private automotive listings business is the market leader – and a first class one at that.

Assuming (pessimistically) that Stratton earns nothing in 2017, then we'd expect earnings per share to be about 45 cents – or flat on last year. Management and the market's expectations seem to be for about 47–48 cents, although the former hasn't given explicit guidance.

On a conservative basis, then, the stock is trading on a forecast price-earnings ratio of about 22 and a free cash flow yield of a little under 5%. Despite the temporary lack of earnings growth, those numbers are reasonable enough for a cash-generative market leader suffering a bit of bad news. The stock has fallen 6% since our **last review** and we're upgrading to **BUY** up to $10.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in Carsales. 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 supplier of infant formula has been a sharemarket darling since listing, but will China's love for its organic products continue?

BY PHILIP BISH • INTELLIGENT INVESTOR • 15 NOVEMBER 2016

Does Bellamy's have the winning formula?

Infant formula supplier Bellamy's has all the hallmarks of a stock from which we'd normally run a mile: a soaring share price, a high price-earnings ratio, and a business model that relies on growing exports into new markets.

Key Points

- ***Profit now catching up with share price***
- ***Talented management team***
- ***Risk of oversupplied market***

BELLAMY'S AUSTRALIA (BAL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.01	3%	High	High

However, with a strong profit result and a recent share price drop, Bellamy's shares are now more reasonably priced. With demand for infant formula in China set to grow, we've decided to give the company a chance and take a closer look.

Humble beginnings

From its humble beginnings as a family run company in Launceston, Bellamy's is now a major player in the Australian infant formula market and has expanded into China, Hong Kong, Singapore, Malaysia, Vietnam and New Zealand.

Its products are sold in supermarkets, pharmacies, specialist baby stores and online, and its toddler formula and baby cereal are both ranked No. 1 in Australia.

In the nine years since chief executive Laura McBain joined the company, Bellamy's has grown revenue by an average of 63% per year, to $245m in the year to June 2016, and its net profit has increased to $38m (see Table 1). Since the company listed in 2014, its shares have risen from $1 to around $11 today, although they hit $15 as recently as August.

Behind this growth has been astonishing demand from China for infant formula, especially formula from Australia (which has a high reputation for food standards), especially organic and especially Bellamy's.

Too many tins

Surprisingly, less than 1% of the world's milk supply is organic, partly because it takes three years for a farm to be certified as organic. We are now, though, seeing signs that supply may be catching up with demand – both for normal and organic formula – as companies around the world rush to cash in on the 'white gold' of infant formula.

At its recent AGM, **Bega Cheese** (which recently formed a formula joint venture with **Blackmores**) announced a surprise writedown of $5m–7m on its share of infant formula inventory. The reason cited was a short-term oversupply, however distribution and branding were also issues. Parents view Blackmores as a vitamins brand rather than an infant formula brand, so at this stage its infant formula hasn't gained the necessary traction.

In contrast, **A2 Milk**'s most recent quarterly update showed steady revenue growth and that demand for its infant formula in China was still growing.

Table 1: Bellamy's full year 2016 result

YEAR TO 30 JUN	2016	2015	+/(–) (%)
REVENUE ($M)	245	125	95
GROSS PROFIT ($M)	112	41	171
EBIT ($M)	54	12	342
NPAT ($M)	38	9	326
EPS (CPS)	39	10	306
DIVIDEND (CPS)	11.9	2.9	310

Brand is important as Chinese parents and parents everywhere want to be sure they're feeding their babies the safest and healthiest products.

As Bellamy's has been in China for seven years, it has had time to build its reputation, brand and distribution capabilities.

Demand rising

China undoubtedly remains the big growth opportunity. 18m babies are currently born in China each year but this is expected to rise to 21m after the controversial one-child policy was ditched this year.

> **"The company's products are currently sold at 4,400 of a possible 7,000 distribution points and it now has a market share of 15–20%.**

Table 2: Bellamy's social media rankings

RANKING	BRAND	WEBSITE	FACEBOOK	INSTAGRAM	TWITTER	YOUTUBE
1	Bellamy's Organic	1st	1st	1st	1st	3rd
2	Heinz for Baby	3rd	2nd	–	–	2nd
3	Rafferty's Garden	10th	3rd	4th	3rd	11th

Ranking of social engagement as listed by BrandData for Infant Nutrition brands in the Australian marketplace

At present, only 25% of Chinese mothers breastfeed. But with living standards in China rising, parents are becoming increasingly health conscious and want formula that is both safe and healthy. The demand for overseas formula has increased after several food safety scandals, including a **tragedy in 2008** in which melamine-tainted formula caused the hospitalisation of 54,000 babies and the deaths of six.

This has led to a 'grey market' in Australia, where Chinese shoppers (known as 'daigou') buy infant formula from Australian supermarkets and onsell it to locals in China for up to three times the price.

Bellamy's also sells into China through a variety of websites including Tmall (the 18th most visited website globally), where it has a top ten presence in baby formula.

One concern – or potential opportunity – is the introduction of new Chinese regulations that aim to improve food safety and protect consumers.

The new laws, which will take effect in January 2018, will limit manufacturers to selling only three brands each in China and will also tighten labeling requirements. The changes are expected to reduce the number of infant formula brands in China from over 2,000 to less than 250.

If it's successful in obtaining a new registration as we expect, Bellamy's might benefit from reduced competition in the Chinese market. However, there's a small risk of it missing out, which could be very damaging to its prospects: China represents around 25% of Bellamy's sales, however daigou sales, which are included in its Australian sales numbers, may be up to 25% more.

No doubt Bellamy's also has other export opportunities, but given the large opportunity in China and South East Asia, it's currently focusing on this region.

Australian momentum

In Australia, Bellamy's has also been increasing its market share. The company's products are currently sold at 4,400 of a possible 7,000 distribution points and it now has a market share of 15–20%.

That puts it in the enviable position of having built a strong position but also with momentum and room for further growth.

One big factor in Bellamy's success has been its talented chief executive, Laura McBain, who has been widely credited with transforming the company, and was named the 2013 Telstra Business Woman of the Year. McBain's skills are reflected in Bellamy's strong presence on eCommerce platforms and in social media, where it's ranked first in social engagement for infant nutrition brands in Australia (see Table 2).

Oversupply?

As well as the risk from Chinese regulation, there's also the possibility of a product recall or a major supermarket deciding to reduce its range of formula.

However, our main concern with Bellamy's is not with demand but rather with supply. That supply will catch up with demand eventually (and potentially overshoot) is a fundamental rule of economics, and our concern is that Bellamy's only has a relatively youthful brand to protect it when this happens.

> **Baby formula is not a product that people use throughout their lives, so there isn't an opportunity to build lasting brand loyalty.**

Baby formula is not a product that people use throughout their lives, so there isn't an opportunity to build lasting brand loyalty. After Bellamy's has attracted new parents, it may only get to run with them for a few years. In such a dynamic market, positioning can change quickly, as Bellamy's itself has shown.

Weak cash flow

Bellamy's 2016 earnings per share (EPS) was 39 cents, which puts it on a historical price-earnings ratio of 28. However, it made about two-thirds of that profit – or about 25 cents per share – in the second half, which gives it an annual EPS run rate of 50 cents and brings its adjusted price-earnings ratio down to 22.

Moreover, with the company expanding at such a clip and so needing to maintain high levels of inventory to meet that growth, its profits are mostly being sucked into working capital, meaning cash flow is poor. That's not necessarily a problem, because the cash should start to flow once the growth moderates, but it does add a degree of uncertainty to the valuation.

On that basis, and with the other risks mentioned above, we'd want to see a greater margin of safety before investing in Bellamy's. It's an interesting business, though, and could provide an opportunity in the future, so we're initiating coverage with a recommendation of Hold.

We're not going to put a price guide on the stock at this stage though, as its rapid growth and the uncertainty over its valuation could lead to anchoring problems and do more harm than good. **HOLD**.

Staff members may own securities mentioned in this article.

OFX has reported a disappointing interim result, but the second half should reveal more about the success of the company's rebranding.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 18 NOVEMBER 2016

OFX: Interim result 2017

Shares in OFX Group have tumbled 15% after it reported a 21% fall in underlying net profit for the six months to September.

Key Points

- ***Underlying profit lower***
- ***Active clients flat***
- ***Remains a hold***

OFX GROUP (OFX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.37	3%	High	High

The fall reflected low volatility in the Australian dollar compared to the US dollar (which reduces the impetus for new clients to sign up), as well as the fall in sterling since the Brexit referendum (which reduces the value of sterling-based transactions). Management also reported that some clients in the UK had stopped making high value transactions due to the uncertainty caused by Brexit.

These factors caused net operating income to remain flat on a year ago, and an 18% increase in expenses led to a 25% fall in underlying earnings before tax, depreciation and amortisation (EBTDA*).

Higher expenses were expected as part of the company's strategy to increase revenue to $200m by 2019, but the increase nevertheless took the market and ourselves by surprise. It's also disappointing that the increased marketing efforts haven't flowed through into active clients, which only increased by 0.5% since March.

Much of the marketing has been based around promoting the brand, though, rather than trying to attract clients directly, so management said it had expected a lag. Chief executive Richard Kimber also pointed out that the increase in active clients, albeit slight, was an improvement from the six months to March, when a marketing hiatus ahead of the rebranding to OFX had led to a slight fall in active clients. As he put it, they have 'now taken the most risky part [of the rebranding] off the table' and that looking forward the transition 'has much less risk to it'.

We hope so – but for the moment we'll have to take that on faith from management, because it's not really showing up in the numbers. We're not particularly surprised by that. As we said when reviewing the **full-year result** in May, 'where exactly margins and profits end up over the next half or two is of little significance', and for the moment we're still happy to back management to make a success of the rebranding and return the company to growth.

We shouldn't have to wait long to find out either way. The company expects to 'maintain the momentum in transactional growth' (of 7% half on half) in the second half, and it expects 'equivalent revenue growth' (assuming the Australian dollar continues to trade around current levels).

Supporting this forecast, Kimber pointed to the growth the company has been experiencing in corporate clients (which tend to transact more often), the impact of seasonality from online retailing over the Christmas period, and confidence in the work the company has been doing on improving its rate of conversion of traffic into active customers (Kimber said the company had always been pretty good at managing 'the top end of its funnel').

Table 1: OzForex half year 2017 result

SIX MONTHS TO 30 SEP ($M)	2016	2015	+/(–) (%)
TURNOVER	9,600	10,000	(4)
NET OPERATING INCOME	54	54	0
EXPENSES	39	33	18
LONG AND SHORT INCENTIVES	2	3	(33)
UNDERLYING EBTDA	14	18	(22)
UNDERLYING EBT	12	18	(33)
UNDERLYING NPAT	10	12	(17)
ACTIVE CLIENTS (THOUSANDS)	152	151	1
TRANSACTIONS (THOUSANDS)	419	392	7
AVE. TRANSACTION (THOUSANDS)	23	26	(12)
FINAL DIVIDEND	2.8c, fully franked, ex date 12 Dec 16		

With expense growth now expected to moderate and a lower effective tax rate of 24% due to the company now being designated as an 'offshore banking unit', management expects full-year net profit to be slightly higher.

> **"The proof of the pudding will be in the eating, though, and it's hard to have confidence.**

With $21.8m to beat, that means the company will need to make $12.1m in the second half, which would be an improvement of 25% over the first half. If it's successful with that, then earnings per share will come in at around 9.2 cents 'or slightly higher', compared to the consensus of around 10.0 cents ahead of the result, which perhaps explains the share price reaction. However, if the company achieved these numbers, it would also have considerable momentum and the price-earnings ratio of 15 would look cheap.

The proof of the pudding will be in the eating, though, and it's hard to have confidence. As such it's a highly speculative situation and it's difficult to rate the odds. As a result, we're not ready to upgrade the stock, even to a speculative buy, or reinstitute the price guide. We do, however, continue to recommend that you **HOLD**.

** OFX holds significant amounts of client cash while waiting to settle deals. As a result, interest forms an important part of its operating profit, so it uses 'earnings before tax, depreciation and amortization' as a reporting measure rather than the more common 'earnings before interest, tax, depreciation and amortisation'.*

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

Disclosure: The author owns shares in OFX.

Another non-core acquisition, another fiasco. Acquired only a year ago, King Content is already proving troublesome for iSentia.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 17 NOVEMBER 2016

iSentia's King loses its crown

The tea and biscuits at today's iSentia annual general meeting came with a bitter aftertaste. In ***Risks rising for iSentia*** from July 2016, we said: 'If the August 2015 acquisition of King Content doesn't produce the strong earnings growth expected from it in 2017, then market expectations are certainly at risk'.

Key Points

- ***King Content will produce a loss this half***
- ***Full-year forecasts look optimistic***
- ***Media monitoring business unaffected***

ISENTIA (ISD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.38	**4%**	**Medium**	**Med–High**

At the meeting the company announced King Content had indeed toppled over in 2017. The division will produce a loss (at the earnings before interest, tax, depreciation and amortisation, or EBITDA, line) of $2m in the first half of 2017. Apparently the business has lost clients and failed to win new ones.

Management expects everything to be hunky-dory for King Content in the second half. A new divisional chief executive and a revamp of the sales team is expected to be making a difference already, with a 'positive contribution expected for the full year'.

At the group level, management said first-half EBITDA would be below the previous period, but that full-year revenue and EBITDA growth would be in high single digits.

Colour us sceptical. After doing the numbers, management is implying EBITDA of around $22m in the first half and $33m in the second. That's a significant increase given King Content's underperformance is a very recent occurrence. King Content's customer base is much more concentrated than iSentia's core media monitoring business, while its revenues are lumpier. To count on a fast turnaround seems unwise.

If we assume management is correct, though, then iSentia will produce earnings per share of about 17 cents in 2017 (compared with 16 cents for 2016). That would place the stock on a price-earnings ratio of 14 at a share price around $2.40. It's not particularly high given the quality of the core media monitoring division.

Too high

But 17 cents looks potentially optimistic. We suspect there's the risk of another downgrade although, given today's 26% share price slump, the market appears not to believe management's forecast either.

We don't tend to give companies with a private equity heritage the benefit of the doubt. It gives us no comfort to be proven right about King Content so quickly (see ***iSentia's unfriendly trends***), but the acquisition always looked like a 'di-worse-ification' to us.

We're going to remove the price guide on the stock at this stage pending further analysis (which might not be for some time). If you're a shareholder, though, remember that iSentia's core media monitoring business looks to be unaffected. The stock looks much better value than before and there's certainly enough reason to **HOLD**.

Staff members may own securities mentioned in this article.

CSL's new wonder drug is one step closer to commercialisation – but it's not there yet.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 16 NOVEMBER 2016

CSL's cholesterol drug passes Phase 2

In ***A billion reasons to love CSL's new drug*** we explained how an ambitious research project could transform the company and add US$1.0bn to net profit if the drug in question – dubbed CSL-112 – makes it through the clinical trial process to commercialisation. Today, CSL is one step closer.

CSL (CSL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$99.12	6%	Medium	Med–High

BUY Below $80.00 **HOLD** **SELL** Above $150.00

$99.12

To recap: early research suggested that when CSL-112 was injected into patients, it would flush out bad cholesterol from their bodies, dissolve life-threatening plaques and reduce the overall chance of heart attack. A Phase 2 clinical trial involving 1,258 patients was completed in April.

The results are in, and they're positive. The study showed that CSL-112 doesn't damage the liver or kidney as similar prospective drugs had done in other studies. The results also confirmed CSL-112's unique 'mechanism of action', whereby it removes cholesterol from plaque in the arteries, which reduces the chance of subsequent heart attacks.

And the line we were hoping for: 'The AEGIS-I results support continued planning for Phase 3'.

A Phase 3 clinical trial for CSL-112 will require 12–15,000 patients – 10 times as many as necessary for Phase 2 – and may take four years to complete. At the lower end of expectations, it will cost US$250m but may cost as much as half-a-billion.

With this in mind, we're a bit surprised that there hasn't been a larger share price reaction to today's news. Perhaps the wording of the brief was less optimistic than investors were expecting. Or maybe the market was already pricing in the trial's success because it wasn't ended early on safety concerns like CSL-112's predecessor drug.

In any case, more data is still being collected in an ongoing Phase 2 study of heart attack patients with moderate kidney impairment, so the Phase 3 trial may never get off the ground if the results of that trial are negative. A final decision on the Phase 3 trial is expected in mid-2017.

As we have **said previously**, only around a quarter of the drugs related to cardiovascular disease in Phase 2 clinical trials make it to Phase 3, and – even then – around half of those in Phase 3 fail to reach commercialisation. The odds of CSL-112 failing are still far higher than the odds of success, so it's important we don't get ahead of ourselves. Nonetheless, this was a positive result for shareholders and we continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

Carsales.com's directors on the iCar Asia board have left the building. It's not good news.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 16 NOVEMBER 2016

iCar Asia directors resign

Perhaps we weren't alone in our **dissatisfaction with the flow of information** from iCar Asia's management. Today the company announced that both of **Carsales.com**'s directors on the board had resigned.

ICAR ASIA (ICQ) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$0.203	2%	Very High	Very High

Clearly it's not a positive, and iCar Asia's share price fell 12% as a result. As outsiders we can only speculate why, but presumably there has been some disagreement at board level over the management or strategic direction of the iCar Asia business.

(It's possible that Carsales's directors have resigned to allow the company to launch a takeover, but it's probably unlikely).

So what now? Carsales still has a 17% stake and may decide to exit the register, although a buyer is not obvious. Our view is that the other major shareholder, Catcha Group, is more likely to be a seller than a buyer at the right price (even though it recently topped up its stake to 27% in the capital raising at 32 cents a share).

Relationship breakdown

Longer term, any breakdown in the relationship between iCar Asia and Carsales means that the former won't benefit from the latter's management expertise. Perhaps new managing director Hamish Stone resented Carsales' interference.

To make matters worse, President-elect Donald Trump's victory has thrown Asian bond yields and currencies into a spin. Any further weakness in Malaysian and Indonesian currencies could again affect used car imports, as it has over recent months.

iCar Asia remains a very speculative situation. With losses likely until 2020, there's a risk the share price keeps falling – a market capitalisation of $65m for a portfolio of loss-making websites doesn't seem particularly cheap. But we can also see upside if Carsales sells its stake to a trade buyer, or there's a merger with Latam Autos (to give two examples).

iCar Asia is in no danger of failure thanks to the capital raising, which makes it seem like the wrong time to sell. But with the reasons why we originally bought – including the Carsales relationship – having now largely evaporated, our patience is wearing thin. **HOLD**.

*Note: The Intelligent Investor **Growth Portfolio** owns shares in iCar Asia. 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.

Is Adairs now a Buy? Almost certainly not, and the clue is in the company's margins.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 15 NOVEMBER 2016

Don't you Adairs

So homewares retailer **Adairs** (ASX: ADH) reported a profit warning recently. As a private equity float that's just barely out of its forecast period, a downgrade is almost obligatory.

(Yesterday's private equity float disaster, debtor finance group **Scottish Pacific** (ASX: SCO), couldn't even manage five months of listed life before its downgrade).

Adairs share price dropped 42% on 3 November to $1.48, well below its June 2015 issue price of $2.40. If you're still being offered retail floats from private equity firms, you need to slap your broker (or better still, give him the sack).

Adair to compare?

Like all value investors, we love price falls – they often highlight opportunities to buy a business going cheap. Is Adairs now good value?

Well to answer that question, take a look at Adairs' margins in Table 1.

As an analyst, you get to know what sort of margins are 'normal' in an industry. Generally, I'd consider that a listed specialty retailer might manage an **operating margin** somewhere in the range of 4%-8% in reasonable economic conditions (in other words, expect worse in a recession).

The very best might be able to manage a margin above 10% for a time, but it often doesn't last. Look to **OrotonGroup** (ASX: ORL) for a former market darling that earned an 18% margin in 2012 and now earns less than 5%.

Turning to Table 1, you can see Adairs earned an operating margin of just above 5% in 2012. Somehow, under private equity ownership, earnings rose almost six-fold between 2012 and 2016, with the margin more than tripling to 16%.

Let me be very clear. That margin is simply not *normal* for a specialty retailer.

So I'm willing to bet the recent profit downgrade is just the beginning. On 2 November management announced that earnings before interest and tax (EBIT) would be about 15% lower for the 2017 year. Implicitly, management is saying its 2017 operating margin will be about 13% (see Table 1).

Even a 13% operating margin is still sky-high. So what would happen if the operating margin returned to 5%, which is where it was only five years ago?

A little more number crunching gives us earnings per share of 4.9 cents under that scenario. So today's share price of $1.65 looks downright expensive if more normal margins come to pass.

Double Adair?

If you're a shareholder you might take comfort from the fact two directors bought shares on market recently. I wouldn't. Both sold far more shares in the 2015 float than they bought on market last week.

I've no idea when Adairs will report its next profit downgrade – or even if it will. All I know is that the investing odds should be in your favour. With Adairs they weren't at the time of the 2015 float – and they certainly aren't now.

Table 1: Adairs margins

	2012	2013	2014	2015	2016	2017F
SALES ($M)	133.9	143.9	167.9	210.9	253.2	270.9
OPERATING EARNINGS ($M)	6.9	12.3	21.8	33.0	40.4	34.6
OPERATING MARGIN (%)	5.2%	8.5%	13.0%	15.6%	16.0%	12.8%

Source: Prospectus numbers, Capital IQ and II forecast based on management numbers

Depth of research

As a long term member of Intelligent Investor, I sense change in direction with some of the recent decisions that I feel deviates from principles that II has previously adhered to.

A few of these are:

a. Including LIC as a special sector for research is beyond me. I cannot see how II can add value given NTA is disclosed regularly & chances of mis-pricing is low.

b. II has started sending mails that includes lot of articles regularly. I really appreciate the efforts taken by II team to send the mail. However I find the content very light and "noisy". Real insights are rare. Maybe there is an opportunity to re-direct these efforts. I subscribe to II for quality – not for quantity.

c. Some of the recent recommendations seem very light on analysis. I am a big fan of contrarian positions taken by II – eg. PMP, ACR, SYD, STO etc. However, 3PL let me down in terms of depth of analysis. I am surprised it passed through dragon's den :)

While I admit that II is best amongst its peers, its looking weak against its previous best!

17 Nov 2016 – **James Carlisle**: It's always a great thing when a business's customers care enough about the product to write in about it, so I appreciate your comments. The simple answer is that Intelligent Investor hasn't changed a bit – least of all in its principles – but we are now part of a larger group that's trying to appeal to a wider audience, so there will be times when the content intended for that wider group gets directed towards people that don't want it. Some of that should be customisable and we're trying to make it more so, but it's important to bear in mind that it's effectively being provided for free, because the new subscription price includes all three products – Intelligent Investor, InvestSMART and Eureka Report – and they all come with their own resources.

Mitchell Sneddon (the LICs analyst) came together with Eureka Report. He's a great LICs analyst and, while it's an area that might not be of interest to all II members, it's undoubtedly of interest to some, so we decided it made sense to make it available. I agree that mispricings are rare, but they appear from time to time and we've had buy recommendations on LICs in the past (eg MMC Contrarian and Templeton Global Growth are a couple of examples).

We've also been joined by two more analysts this year, Alex Hughes and Phil Bish – Alex will be working predominantly on small caps, while Phil will be helping on LICs and anywhere and everywhere else. Both are excellent analysts and are already making an important contribution to the team. So Intelligent Investor is better resourced than ever and we're trying to use those resources as effecitvely as possible. I'm sorry if you've felt that some of the recent recommendations are 'very light' on analysis, but I can confirm that the analysis behind the scenes is as deep as ever and the hurdles set by the Dragons' Den are as high as ever.

You might have a point, though, about how that analysis is presented and we'll give that some thought. Intelligent Investor has always had a broad membership and we try to pitch articles at the right level for most people. People often say they want to see the deepest possible analysis, but often it can distract from the key points behind a recommendation (I'm not suggesting that deeper analysis would distract you, Ganesh, but this is true for many people).

So we're constantly trying to hit the right balance between detail and clarity, and we don't always get it right. That said, however, I think Alex's article on 3P Learning was excellent – but I might have a distorted view of things after seeing and hearing the very thorough research he presented to the Dragon's Den.

Probably with a new stock like 3PL we should err on the side of including more detail rather than less, to act as a base from which to build, and we generally try to do that. Perhaps in this case we could have written more and we'll certainly take your feedback on board.

3P Learning

Since I work in a school, I decided to ask the maths teacher what he thought of Mathletics. He clearly wasnt too impressed: said the kids quickly get used to it and figure out how to get around the system and avoid the challenges. Generally, he thought there were better things around. just thought it might be useful to have some feedback, in view of your current recommendation of 3P Learning, so am passing it on.

14 Nov 2016 – **Alex Hughes**: Thanks for passing this on. It's always helpful for us to have insights from the coal face.

With that said, I always find this kind of information difficult to interpret. With any product, you will find that some people will love it and some will hate it. Coca Cola has millions of critics around the world, but that doesn't prevent it from having a very profitable global business.

If there was evidence that this feedback represented a large portion of the school population, I would be concerned. But there is nothing to suggest this is anything but an isolated case. What I find interesting is that this particular teacher may not be a fan of the product, but they are still a customer, which reflects the importance of Mathletics in the Australian educational system.

Thanks once again, and if you come across anything else, please send it through.

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