Weekly Review

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– Issue – 21 Oct. 2016

News came thick and fast on the day of Crown's 2016 AGM.

BY JON MILLS • INTELLIGENT INVESTOR • 21 OCTOBER 2016

Crown reveals potential VIP impact

Crown held its 2016 AGM at Crown Perth this year, where its new 500 room, 6-star Crown Towers hotel officially opens in December. However, investors, analysts and the media were far more interested about why **18 of Crown's staff had been arrested in China** and what impact that might have on the company's VIP business.

Key Points

- ***Chinese VIP revenue lower than estimated***
- ***Trading update also released***
- ***Hotel IPO to proceed***

CROWN RESORTS (CWN) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.10	4%	High	High

BUY Below $12.00 | HOLD | SELL Above $18.00

$11.10

Although many rumours are circulating, we still don't know the reason why. Our thoughts are with them and their families in what is obviously a tough time for all involved. However, we're financial analysts and you pay us to consider the impact on Crown's future and so we'll continue to do just that.

Chinese VIPs

Crown revealed that 12% of its revenues are earned from VIP players from mainland China. With VIP players being lower margin than mass market players (due to freebies and commissions), these players represent 'substantially less than 12%' of the company's net profit.

Our **upgrade earlier this week** was based on our estimate that *total* VIP earnings (ie from both mainland China and elsewhere) represented around 10–15% of NPAT. Despite the apparent panic selling, we also think that the worst-case scenario – that Crown loses *all* VIP revenue at both its Melbourne and Perth casinos forever – is highly unlikely.

Moreover, even if there is a significant reduction in Chinese VIPs visiting Crown's Australian casinos, we believe this will be temporary for two main reasons. Firstly, the sheer amount of wealth that is likely to be created in China in coming decades as the country continues to develop will mint many new VIPs.

Of course, that's not much help if China prevents them from gambling overseas. However, policies come and go. Even the Chinese Communist Party is subject to normal political realities, the formation and cessation of alliances, and changes in factional power.

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RECO. CHANGES	FROM	TO
Crown Resorts	Hold	Buy
F&P Healthcare	Sell	Hold
Transurban	Sell	Hold

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Crown Sydney

There is, however, likely to be a shorter-term impact not only on Crown's existing casinos but perhaps also on the profitability of Crown Sydney. This is why we've reduced our Buy and Sell prices by $1 each, to $12 and $18 respectively.

Under its agreement with the NSW government, Crown Sydney – now due to be completed in 2021 – will cater to VIPs only, with pokie machines banned. Moreover, only members and guests may enter its gambling rooms.

However, the minimum betting limits are $30 per hand for baccarat, $20 for blackjack and $25 for roulette. In our view, these aren't what an ordinary person would describe as 'VIP' limits. Moreover, management is allowed to grant guest access to people who live outside NSW or Australia, as well as to those staying at the attached hotel.

We also note that both China and Asia in general are likely to continue to be among the world's fastest growing regions in coming decades. As standards of living rise, tens or even hundreds of millions more people will move into the middle class and the number of VIPs will also increase. Their desire to travel overseas will also rise and Australia is likely to be among their favoured destinations.

As such, Crown's monopoly casinos in Melbourne and Perth are likely beneficiaries. For its part, even though Crown Sydney will compete with **The Star Entertainment**'s Sydney casino, we also doubt for similar reasons that it will become the 'world's tallest white elephant' as one journalist described it this week.

Trading update

During the AGM, management revealed that VIP play has been 'softer' than 2016 in both its Australian casinos during the first three and a half months of 2017. By contrast, non-gaming revenue rose 5% and mass market or main gaming floor revenue by 1%. All in all, not very good but not bad either.

Earlier in the day the Board signed off on the **proposed spin-off** of 49% ownership in four of the company's Australian hotels into a listed property trust, albeit after having decided to keep full ownership of Crown Towers Perth. This will free up capital that will help finance Crown's capital expenditure in coming years. As VIPs usually get their rooms for free in hotels not included in the spin-off, this transaction is unlikely to be affected by any downturn in VIP visitors.

With monopoly casinos in Melbourne and Perth, and the decline in Macau showing signs of bottoming, Crown is well placed to weather any downturn in Chinese VIPs visiting Australia. The **proposed demerger** of most of the company's international operations and planned spin-off of a 49% interest in four of its Australian hotels only add to its attractions. **BUY**.

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

Australia's two largest wagering businesses have proposed to merge, but not how we had hoped.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 19 OCTOBER 2016

Tatts and Tabcorp set to join forces

And they say you can't time the market. Two days ago, in ***There's a Lott to like about Tatts***, we said 'Potential merger talks have surfaced on at least three occasions over the past 10 years, but they have always ended over price rather than a lack of strategic merit, which gives us hope that a deal will one day be struck.'

Key Points

- ***Deal undervalues Lotteries***
- ***Combined wagering divisions will be stronger***
- ***$130m in cost cutting synergies***

TABCORP HOLDINGS (TAH) / HOLD

Price at review **$5.06**
Max. portfolio wght. **5%**
BUY Below **$3.00** | HOLD | SELL Above **$5.50**
$5.06

TATTS GROUP (TTS) / HOLD

Price at review **$4.16**
Max. portfolio wght. **5%**
BUY Below **$3.50** | HOLD | SELL Above **$6.50**
$4.16

Fast forward 48 hours, and a deal is now on the table. Unfortunately, it's not quite the one we were hoping for. Tabcorp has made a takeover bid for Tatts, in which Tatts shareholders will receive 0.80 Tabcorp shares and 42.5 cents in cash for each Tatts share held. At Tabcorp's current share price of $5.06, the offer values Tatts at $4.47 a share.

Had Tabcorp offered to buy just Tatts' wagering division – which accounts for a bit over a fifth of operating earnings – we'd probably be cheering the stocks to the finish line. We believe the current deal, however, significantly undervalues Tatts' lotteries business.

Tatts and Tabcorp sit at different ends of the quality spectrum. Almost three-quarters of Tatts' earnings before interest and tax (EBIT) is from operating all the lotteries in Australia, except those in Western Australia, where the Government runs the show. As we explained in ***The lottery that always pays***, this division is a regulated monopoly and offers a stable, growing income, while earning extremely high returns on tangible capital.

Wagering giant

Tabcorp, on the other hand, derives most of its income from tote and fixed odds betting through TAB outlets, hotels and on-track totalisators in NSW, Victoria and the ACT (it also has small Keno and Gaming services divisions). Tatts has a similar wagering operation, though only around one-third the size and with licences for Queensland, South Australia, Tasmania and the Northern Territory.

The trouble with both Tatts and Tabcorp's wagering businesses is that they are both losing market share to online operators such as Sportsbet (owned by Paddy Power Betfair), which have lower-cost business models and can therefore almost invariably offer better odds.

This is an industry where scale really matters, which is why the merger – at least from the perspective of Tabcorp shareholders – makes perfect sense.

On completion, the combined business would have revenue of over $5bn and earnings before interest, tax, depreciation and amortisation of more than $1bn. More importantly, management estimates that around $130m in duplicate costs can be cut from the combined business, which should eventually flow through as better odds and offerings for punters. This may help to stem the long-term migration of customers away from Tabcorp and Tatts and towards lower-cost alternatives.

Approval hurdles

Both companies' boards of directors support the merger and Tabcorp chief executive David Attenborough is expected to head the combined company if shareholders approve the deal.

Takeovers take a while to play out, and this one may take longer than usual. Given the heavy regulation of the gambling industry, the merger will need to pass various regulatory conditions, as well as get approval from the courts and the wagering and lottery regulators in each state.

Approval from the Australian Competition and Consumer Commission (ACCC) might also pose a hurdle because the combined entity would be the only bricks-and-mortar tote and fixed odds wagering operation in Australia. Though Tatts and Tabcorp don't directly compete in any individual

> **Takeovers take a while to play out, and this one may take longer than usual.**

state due to their exclusive licences, the difference between two large wagering outfits and one mega-bookie may rub the ACCC the wrong way.

In any case, completion isn't expected until mid-2017 and we'll keep you up to date as things develop. With a forward price-earnings ratio of 23, Tatts' current share price is below the implied offer price and below our estimate of intrinsic value. Without a material increase in the offer price – probably unlikely – we think the deal favours Tabcorp rather than Tatts. For now, Tatts is a **HOLD**.

Tabcorp shareholders will come out with a stronger company thanks to added scale and new markets. It would also get one of Australia's best businesses – Tatts' Lotteries monopoly – for a reasonable price. With an underlying price-earnings ratio of 21, we continue to recommend you **HOLD**.

Disclosure: The author owns shares in Paddy Power Betfair PLC.

Staff members may own securities mentioned in this article.

An ugly wagering division masks a wonderful outlook for Tatts' lotteries business.

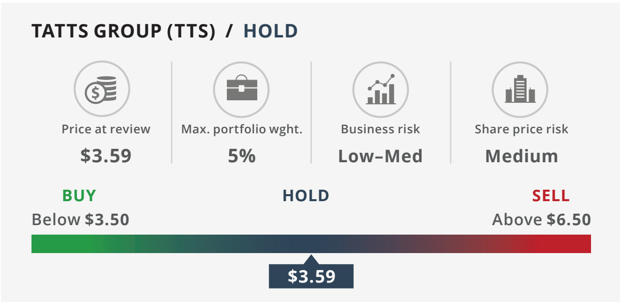
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 17 OCTOBER 2016

A Lott to like about Tatts

Talk about expensive tastes. In 2010, a man flying with Ryanair to the UK played one of their in-flight instant scratchies and won €10,000. However, he was so upset to learn that the cash wasn't ready for him on the plane, he decided to **eat the winning ticket in protest**.

Key Points

- ***Wagering rebound is likely to be temporary***
- ***Lotteries in excellent shape***
- ***Margin improvement and steady growth***



There's a lesson here that mothers have been preaching for generations: don't cut off your nose to spite your face. In the investing world, though, many do just that.

There's a never-ending supply of business gurus telling us how companies can, and must, be growing. Growth stocks, growth strategies, growth funds. If a company isn't growing, we're told, it must have know-nothing management or poor industry conditions. Either way, it certainly doesn't deserve your investment.

Yet the biggest problem when it comes to investing is not too little growth; rather, it's paying too much for it. Lotteries operator Tatts Group won't be found on the *BRW Fast 100* list any time soon. But, here, we want to make the case that this is still a great company going for a reasonable price.

First, the bad news

No review of Tatts would be complete without mentioning the company's problem child – its Wagering division, which covers tote and fixed odds betting on horses, greyhounds and the like.

There's a war going on in the wagering industry and Tatts is losing ground to online competitors, such as Sportsbet (owned by Paddy Power Betfair), which has a lower-cost business model and can therefore charge lower commissions (see ***Tatts: The lottery that always pays?***).

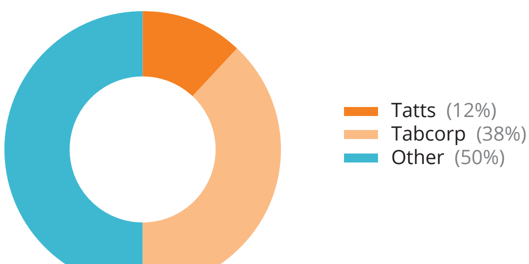
Recently, though, Tatts rebranded its wagering operations to UBET and, at least on the face of it, the strategy seems to be working. Wagering turnover increased 3% in the six months to June, compared to a 1% fall in 2015. Still, Sportsbet grew turnover 30% over that period so the division will need to do much better if it wants to keep up.

Unfortunately, with Sportsbet almost invariably offering better odds than UBET due to its lower cost structure, we'll put the latter's recent resurgence down to the temporary triumph of marketing over logic. Operating earnings for the division are still 10% below where they were in 2009.

Reason for hope

Lower growth assumptions for the wagering business are a major part of why the stock is down almost 20% since the high watermark etched in January.

Chart 1: Wagering turnover market share (2015)



Source: Source: UBS Research

But there's reason for optimism. Firstly, Tatts' wagering operations account for only 23% of earnings before interest and tax (EBIT). It's a sideshow compared to the big breadwinner – Lotteries – which we'll get to in a moment.

What's more, punters tend to have their rituals and habits. As Tatts' latest result shows, getting the best odds isn't always what customers are after – a speedy betting platform, loyalty

> **"As we've explained previously, Tatts' lottery business couldn't be more different from its gambling cousin, Tabcorp.**

programs, and a pleasant experience in the bricks-and-mortar TAB outlets are also important. With this in mind, we doubt there will be a sudden rush for the exits, just a slow migration of punters from high-cost bookies to cheaper, online and mobile alternatives.

Better still, Tatts may choose to offload the division entirely. A sale of the wagering business to larger competitor **Tabcorp** would open up several new markets for Tabcorp due to Tatts' exclusive licences to operate in Queensland, South Australia, Tasmania and the Northern Territory.

In a February interview with **Fairfax Media**, Tatts' chief executive Robbie Cooke said that a merger with Tabcorp would result in around $100m of cost-cutting synergies – most of which we assume would come from wagering, where there's the most business overlap. That level of savings will be hard to pass up if competition intensifies further. Potential merger talks have surfaced on at least three occasions over the past 10 years, but they have always ended over price rather than a lack of strategic merit, which gives us hope that a deal will one day be struck.

Don't eat the scratchie

The simplest way to gauge what the division might be worth if sold separately is to look at what investors are willing to pay for Tabcorp itself, because the company is as close as you get to a 'pure-play' wagering business.

But here's where things get whacky. Tabcorp's enterprise value (EV – the sum of its market cap and net debt) is 15 times underlying EBIT – which is on a par with Tatts' own EV/EBIT multiple.

To us at least, that doesn't make sense, even after taking into account that Tabcorp's wagering business is arguably in better shape than UBET and in more lucrative markets.

Around 73% of Tabcorp's EBIT is from wagering – which faces increasing competition, shrinking margins and a loss of market share to online operators – whereas 76% of Tatts' EBIT is from lotteries, which is the next best thing to owning the Royal Australian Mint. Investors seem to be throwing this rather big baby out with the bathwater.

Growth and margins

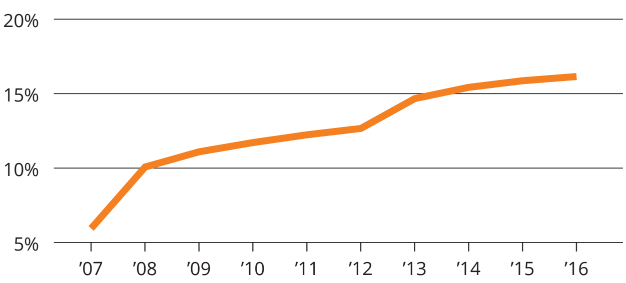
As we've **explained previously**, Tatts' lottery business couldn't be more different from its gambling cousin, Tabcorp. Tatts operates all the lotteries in Australia (outside of Western Australia), rebranded recently under the national monicker 'The Lott'. And 80% of EBIT from the Lotteries division is earned on exclusive licences with over 34 years to expiry. It's a regulated monopoly.

Growth has also been remarkably consistent, albeit slow. Lottery turnover has grown at around 4% a year over the past 20 years, and with relatively little volatility. Even during the financial crisis, turnover only fell 10%, but then quickly made up the losses – and then some – in 2011 through 2013.

There's also a good chance earnings will grow faster than revenue. A large portion of Tatts' costs are fixed so additional lottery sales fall quickly to the bottom line.

Margins should get a further boost from a shift to online ticket sales. Tatts' digital lottery sales grew 32% in 2016, though they still represent only 14% of total sales. The good thing about online sales through Tatts.com is that the company is able to bypass the commission paid to middlemen retailers, such as your local newsagent, which is typically around 9%.

Chart 2: EBITDA margin Lotteries division (%)



Source: Capital IQ

Indeed, thanks to more online sales and Tatts' fixed cost base, the Lotteries segment's operating margin has increased from 6% in 2007 to 16% today (see Chart 2). For the **2016 full-year result**, an 8% increase in revenue led to an 11% lift in EBIT from lotteries, though we expect more modest growth in the mid-single digits over the long term.

> **“That puts the stock on a price-earnings ratio of 20 and a free cash flow yield of 4.9%.**

Great company, fair price

All up, the quality of Tatts' Lotteries division outweighs the risks associated with Wagering – so long as we can buy the stock at a reasonable price.

So what's a fair price to pay for a business with reliable earnings, steady growth, long-dated operating licences, a clean balance sheet and plenty of free cash flow?

The company generated revenue of $2.9bn in the year to 30 June and an underlying net profit of $263m, or 18 cents per share, with underlying free cash flow being roughly the same. That puts the stock on a price-earnings ratio of 20 and a free cash flow yield of 4.9%. Tatts has a long-standing policy to pay out at least 90% of net profit, so the stock also sports a fully franked dividend yield of 4.8%.

Assuming annual growth of 4% or so over the long term – with slightly higher growth from Lotteries being offset by a decline in Wagering – total annual returns could be around 8–9% a year. And if the Wagering division's turnaround is the real deal, that could add an extra percentage point or two.

So while Tatts isn't going to be the next **REA Group**, if you're after reasonable growth and a steady yield, there's still a lot to like. Tatts is currently a Buy up to $3.50, with a recommended maximum portfolio weighting of 5%. We're very close to upgrading the stock and will hopefully get our chance soon. **HOLD**.

Disclosure: The author owns shares in Paddy Power Betfair PLC. Staff members may own securities mentioned in this article.

Andrew Legget shares his thoughts from the recent investor day, with fingers crossed for further price falls.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 19 OCTOBER 2016

Sydney Airport investor day

'Excuse me sir, we are going to test you for explosive material'. These words have become a familiar experience in Australian airports. This time, however, I wasn't about to board a plane, although there were a lot of those, too. Rather, I was among a group of analysts being led around Sydney's international terminal by Sydney Airport management.

Key Points

- ***Asia key growth region***
- ***Improved retail precinct almost completed***
- ***Future efficiency through technology***

SYDNEY AIRPORT (SYD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$6.53	8%	Low	Low–Med

BUY	HOLD	SELL
Below $6.00	$6.53	Above $10.00

It would take another dollar or so before Sydney Airport rejoined our **Buy List**. But as one of the country's top businesses and a longstanding favourite of your analytical team, we like to keep a close eye on it. That's what Sydney Airport's investor day was all about – seeing this business up close and personal.

Major themes of the management presentations were the growth and importance of the Asian region and how the company will use technology to improve airport efficiency and passenger experience.

Asia has been the fastest-growing destination for Sydney Airport, especially China, where total passengers increased 14% in the past 12 months to almost 1.5m. Compared to four airlines and three cities six years ago, Sydney Airport now receives direct flights from seven different airlines and 13 cities in mainland China.

The company has been active in advertising to this growing market. Sydney Airport has created a website that sits behind the Chinese firewall, allowing potential visitors to plan for their upcoming trip and advertise its range of retail stores. It's also heavily followed on Chinese social media platforms such as WeChat, where it was the first Australian airport to launch a channel. With Asian passengers spending more at the airport than any other group this is smart marketing.

Australia's best mall?

Head of retail, Glyn Williams, gave us a guided tour of the revamped retail precinct of the international terminal where he hopes the new changes will allow the airport to garner more of that spending.

Williams grasp of the numbers and the importance of consumer psychology and experiences in retail was impressive. 'Passengers are less likely to spend if they are stressed', said Williams, so a lot of effort has been spent on making the retail precinct a relaxing place to be. With the highest spending per square metre of any retail precinct in Australia he appears to be doing a good job.

The company also uses technology and predictive analytics to work with customers in reducing the time it takes to get through security. Once cleared, they now walk into a completely renovated retail precinct with a straight path through the facility replacing the former winding road of consumerism.

According to Williams, whilst this has reduced customer engagement points, it led to a rapid change in the pace of passengers moving through the terminal. More time is now spent wandering the aisles of duty-free stores, new specialty retailers and enjoying the premium dining options. The result is more spending and greater leverage in lease negotiations with specialty retailers.

Going high-tech

The theme of reducing passenger stress extends to new smart gates that allow passengers to check in and clear customs more quickly. The company is also exploring new technology including augmented reality that could allow passengers to use their smartphone cameras to show the way to their gates. Passenger tracking, wi-fi and push notifications could also permit the company to send promotions directly to passenger phones and boost retail spending.

> **The recent legalisation of ride-sharing in NSW has also led to increased usage of its new parking facilities, helping to increase revenue.**

The recent legalisation of ride-sharing in NSW has also led to increased usage of its new parking facilities, helping to increase revenue. And the company is in negotiations with the NSW government to add new roads to reduce the airport's famous congestion (of which the analyst was a victim on the way home).

As for the future second Sydney airport, the company said little, other than it feels well placed to operate the facility but would only do so if it made sound financial sense.

Last reviewed on **18 Aug 16** (Hold - $7.36), Sydney Airport's share price has fallen 11% since. There was no guidance or information stemming from Monday's investor day that would lead us to change that view but management's grasp of detail was impressive and this remains one of Australia's best assets. Unfortunately, until the price nears $6 we won't be upgrading the stock to Buy, but we have our fingers crossed for further price falls. For now, **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 portfolios by **clicking here**.*

Staff members may own securities mentioned in this article.

Regulatory changes are hitting industry profitability. But with Estia's share price down 64% in ten months, is this an opportunity?

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 20 OCTOBER 2016

Aged care providers sink to new lows

'I've got it!', said someone in a boardroom meeting, *'a fool-proof idea.'* The plan was simple enough. To counter Government funding cuts to the aged care sector, a provider could introduce new fees for those residents paying their own way – creatively named 'capital refurbishment fees' and 'asset replacement contributions'. The fees would amount to around $15 per bed per day, adding millions in revenue. *'Problem solved!'*

Key Points

- ***Regulatory change hitting the bottom line***
- ***Management team upheaval and insider selling***
- ***Looks cheap but too much uncertainty***

ESTIA HEALTH (EHE) / AVOID

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.64	N/A	Med–High	Med–High

The quotes are made-up but the idea, which the Federal Government has since quashed, wasn't. Listed aged care operators **Estia Health**, **Japara Healthcare** and **Regis Healthcare** introduced these fees earlier in the year but the Government took away the punch bowl in September by **deeming the fees unlawful**.

Before we go any further, let's note the aged care industry's love of jargon, often requiring the code-breaking skills of a wartime spy. It's worth defining a few terms.

The industry is heavily subsidised by the Government, which pays a fixed daily amount per resident based on their required level of care. Around two thirds of Estia's revenue is from this payment system, known as the 'Aged Care Funding Instrument' (ACFI).

Residents with few personal assets are entirely funded by the Government and are known as concessional residents. Those that partly pay their own way are called non-concessional residents. Providing care for this last group is Estia's biggest money-spinner by far.

RADical lending

Residents can pay for their accommodation using one of two methods, a 'daily accommodation payment' much the same as rent, or a lump-sum upfront payment called a 'refundable accommodation deposit' or RAD.

When landlords dream of the perfect way to bill their tenants, it probably looks something like a RAD. Based on the location and quality of services offered at an aged care facility, RADs can be used for capital expenditure needs at new and existing facilities and to repay certain debts. To put it another way, RADs are essentially an interest-free loan to the aged care provider.

Estia's $650m RAD pool is recorded as a current liability on its balance sheet – one that, in theory, may need to be repaid within 12 months. However, around 90% of low care non-concessional residents choose to make their accommodation payment through a RAD, which means the RAD from an incoming resident can be used to refund the RAD for residents leaving a facility. That makes the RAD pool more like a revolving loan, much like your credit card, rather than a current liability. And an interest free credit card with a $650m limit is a huge source of value.

Declining funding

The law says that providers can only charge residents for care and services when the resident receives a direct benefit. However, those euphemistic 'capital refurbishment fees' mentioned earlier were – at least on paper – being charged so that the facility could invest in its infrastructure. The aged care providers were essentially double charging, because the resident was already obtaining that benefit by providing a RAD.

The ban on capital refurbishment fees, asset replacement contributions and several similar fees may only be the beginning. In its 2016-17 Budget, the Government detailed $1.2bn in funding cuts to the ACFI over the next four years.

A back-of-the-envelope calculation shows the impact on Estia. In its **annual report**, the Aged Care Financing Authority found that residential aged care operators collectively earned

> **“When the shipbuilder, captain and first mate all head for the life rafts, it doesn’t guarantee there’s an iceberg in sight. But it should give one pause.**

$15.8bn in revenue in 2014-15, with $10.6bn coming from the Government. We don’t have the 2016 revenue figure but it’s probably around $16.8bn.

Estia had revenue of $447m in 2016, implying a market share of around 2.7%. Apportioning that $1.2bn funding cut across the industry, the clawback would imply $32m in lost revenue for the company.

Table 1: EHE result

YEAR TO JUNE	2016	2015	+/(–) (%)
OPERATIONAL PLACES	4,010	5,842	46
REVENUE ($M)	447	298	50
EBITDA ($M)	92.7	70.7	31
NET PROFIT ($M)	51.2	44.6	16
EPS (C)	28.3	24.5	16
FINAL DIVIDEND	12.8 cents, fully franked, ex date already passed		

Given the complexity of the ACFI, we can’t tell how that would impact the profit line. But it’s safe to assume that, because a large proportion of Estia’s costs are fixed, a 2% or so decline in revenue for each of the next four years would lead to a greater than 2% drag on net profit.

The Government continues to review aged care funding with more policy changes expected to be announced in late 2017. All of this adds an uncomfortable haze to an already complicated industry.

Revised guidance

The ban on capital refurbishment fees was bad news but for Estia its timing was worse. A few days earlier the company had released a poor full-year result, showing net profit 8% below management forecasts. Combined, the red ink and regulatory change caused Estia’s stock to tank 45%.

Then, earlier this month, Estia announced it expected underlying earnings before interest, tax, depreciation and amortisation (EBITDA) to decline from $93m in 2016 to $86–90m in 2017.

As recently as August 29, management said it expected EBITDA growth of ‘at least 13%’, or around $105m in 2017. So how does $16m or so evaporate in six weeks? The change in forecast was explained by a ‘lower projected occupancy growth rate’ and ‘reappraisal of non-labour operating costs’, which sounds a lot like ‘we had an overly-optimistic outlook in our prospectus’.

Abandon ship

Management expects underlying EBITDA of $86–90m in 2017, with consensus forecasts for earnings per share of around 23 cents. That would put the stock on a forward price-earnings ratio of about 12.

On the face of it, that looks dirt cheap, particularly when you factor in the RAD business model.

Unfortunately, between the funding cuts, ongoing regulatory overhaul and the oversupply of places mentioned **in our last review**, we just can’t get comfortable with Estia. In fact, that statement applies to the entire industry.

There are other red flags, too. Quadrant Private Equity – which floated Estia in December 2014 – sold its remaining 16% shareholding in May at $5.56. Then Estia’s founder, Peter Arvanitis, sold his entire 9% shareholding last month at $3.15. Chief executive Paul Gregerson and chief financial officer Joe Genova also resigned a month ago, after the share price collapsed.

When the shipbuilder, captain and first mate all head for the life rafts, it doesn’t guarantee there’s an iceberg in sight. But it should give one pause.

Estia has a new, temporary executive team in place, led by ex-Summerset Group chief executive Norah Barlow. The revised guidance for 2017 suggests she is already taking a more conservative stance than previous management, which is a good sign. Nonetheless, with several red flags and a very uncertain regulatory outlook, we’re happy to chuck this stock in the too hard basket. **AVOID**.

Despite its humble beginnings, Bayes' Theory has many important applications, and provides a useful tool for updating our thinking.

BY PHILIP BISH • INTELLIGENT INVESTOR • 18 OCTOBER 2016

The theory that cracked the enigma code

It was the year 1761, and Thomas Bayes the English Presbyterian minister and mathematician had just passed on. At the request of relatives, his friend Richard Price was sorting through his papers when he made a unique discovery.

He came across something titled '*An Essay towards solving a problem in the Doctrine of Chances*', which Bayes had written many years before. In it, Price noticed a remarkable formula.

Price spent the next two years developing the ideas in the essay before sending it to the Royal Society of London, where it was published in 1763. With the essay published, mathematicians were astonished at what they saw, and Bayes was immortalised.

Bayes' theorem (see image above) is a mathematical formula for calculating conditional probabilities, based on the idea that when we update our initial belief with new objective information, we get a new and improved belief. This new belief becomes the starting point for the next round of belief updating. To see some real life examples of how the Bayes' formula works, **click here**.

The Enigma code

In 1774, the brilliant French mathematician Pierre-Simon Laplace expanded upon Bayes' theorem, before the theorem all but disappeared from sight until the 20th Century, when British codebreaker Alan Turing used it during the Second World War to help crack the 'unbreakable' Enigma code, a development that helped the Allies win the war.

Turing developed a system based on Bayesian theory that enabled him to guess a stretch of letters in an Enigma message, calculate the probabilities, and add more clues as they arrived. With this method he could reduce the number of wheel settings to be tested, which subsequently led him to cracking the code.

With the advent of the computer age, the use of Bayesian theory has exploded, into such areas as artificial intelligence, robotics, law, imaging technologies and medical diagnostics.

In 1996, Bill Gates said that Microsoft's competitive advantage was its use of Bayesian networks. Bayes techniques are also used in spam filters, voice recognition systems, recommendation systems and in Google search.

Despite Bayes' theorem being a clever mathematical formula, the good news is that you don't need to be a mathematician to be able to apply Bayesian thinking to investing or your everyday life.

The main challenge is that updating our beliefs with new objective information can be quite difficult. The economist John Kenneth Galbraith said: 'Faced with the choice between changing one's mind and proving there is no need to do so, most people get busy on the proof'.

Commitment and Consistency

Psychologist Robert Cialdini believes that one of the reasons it isn't easy to change our thinking is the 'Commitment and Consistency Tendency', which he describes in his book *Influence*. Cialdini explains that when people make a commitment, there is a natural tendency to want to appear consistent to that commitment, especially in front of other people.

Consistency is highly valued and, in most cases, it's in our best interests to be consistent. As a result, we fall into the habit of being consistent all the time, even when it would be better to modify our approach.

However, being able to change tack when we receive new objective information is a valuable skill for investors. It may help us scramble out of an investment mistake, or it may help us get into a quality stock that we had previously misread. The important thing is to have our facts straight and to process them appropriately.

The economist John Maynard Keynes summed up Bayesian thinking perfectly when he said, 'When the facts change, I change my opinion. What do you do, sir?'

Crown staff arrested

BY JON MILLS • INTELLIGENT INVESTOR • 17 OCT 2016

CROWN RESORTS (CWN) / BUY

Price at review $11.70 | Max. portfolio wght. 4% | BUY Below $12.00 | HOLD | SELL Above $18.00 | $11.70

The Chinese government has arrested 18 Crown staff, including a number of Australian citizens, for alleged 'gambling crimes'.

Details are scarce as the Chinese government hasn't yet informed Crown why its staff were detained. In response, other casino companies including **The Star Entertainment Group** have pulled their staff out of mainland China.

Gambling is banned in mainland China and it's also illegal to market gambling facilities even though they're located outside mainland China, such as in Macau or overseas. However, Crown and its competitors are allowed to promote tourism and their Australian resorts, which of course also include their casinos and it's this grey area which is likely behind the arrests.

On the one hand, this could be a spat solely related to Crown: perhaps it's unwittingly annoyed someone who has used the endemically corrupt nature of the Chinese government to return the favour. As such, it may also potentially affect the collection of debts from Crown's Chinese VIPs but, if so, this will be a one-off impact for Crown as it adjusts its business.

Even so, this spat is still likely to affect all companies operating in China, not just Crown, as they change their marketing activities in China to avoid being subject to similar actions from the authorities in future.

Of potentially greater concern, however, is the longer-term impact on the flow of Chinese gamblers – particularly VIPs – to Australasia. As such, this will also affect not just Crown but competitors such as The Star Entertainment Group and **Sky City Entertainment**.

Even if it does reduce the flow of VIPs, Crown's casinos in Melbourne, Perth and Sydney (eventually) will likely still be pumping out cash a decade or two hence as noted in ***Betting on Crown – part one***. An eventual revival in Macau – and initial signs are positive as noted **here** and **here** – along with the **proposed demerger of Crown's international operations** and potential spin-off of a minority stake in most of its Australian hotels are also reasons to view Crown's future favourably.

Due to uncertainty over the VIP issue, however, we're reducing our Buy price to $12 (from $13) and our Sell price to $18 (from $19) to give us a bigger margin of safety. With Crown's share price down 10% this morning, though, that still means an upgrade to **BUY**.

*Note: The Intelligent Investor **Growth Portfolio** owns shares in Crown Resorts. 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.

F&P Healthcare's share price falls

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 18 OCT 2016

F&P HEALTHCARE (FPH) / HOLD

Price at review $8.72 | Max. portfolio wght. 4% | BUY Below $5.00 | HOLD | SELL Above $9.00 | $8.72

Fisher & Paykel Healthcare's share price is down 13% since ***F&P Healthcare sues ResMed*** from 16 Aug 16 (Sell – $10.03). The company is growing rapidly, continues to improve its balance sheet and management expects several new masks and flow generators to be released in the coming year. Net profit of NZ$165m–170m is expected in 2017, up around 17%, putting the stock on a forward price-earnings ratio of 32 using the midpoint of that range. We see better opportunities on our **Buy list** but with the stock now more reasonably priced, we're upgrading to **HOLD**.

Staff members may own securities mentioned in this article.

Transurban share price falls

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 18 OCT 2016

TRANSURBAN (TCL) / HOLD

Price at review $10.60 | Max. portfolio wght. 8% | BUY Below $7.50 | HOLD | SELL Above $11.00 | $10.60

Toll road operator Transurban's share price has fallen 10% since ***Transurban: Result 2016*** on 10 Aug 16 (Sell – $11.79). Management expects to make total distributions of 50.5 cents in 2017 (up 11%), for a forward partially franked dividend yield of 4.8%. As a regulated monopoly, Transurban has many competitive advantages and its inflation-protected revenue is a bonus. There are better opportunities on our current **Buy list**, but with Transurban's share price having moved below our recommended Sell price, we're upgrading to **HOLD**.

Staff members may own securities mentioned in this article.

Whitehaven Coal

Given the staggering gains in coal stocks such as Whitehaven from their lows earlier in the year. Is your recommendation still to AVOID?

20 Oct 2016 – **Gaurav Sodhi**: It is. A few months ago, WHC wasn't even cash flow positive and had to repay $1bn of debt. It was at serious risk of going bust and priced that way for good reason. No one imagined the Chinese authorities would wake up one morning and order coal mining to stop, instantly lifting prices and rescuing the business. WHC will repay debt and generate a surplus if coal prices hold but consider what drove prices higher: this has little to do with cyclicality and the rally is reliant on the whims of Chinese authorities. I consider this to be a weakness not a strength and this makes the avoid case stronger.

Aristocrat and portfolio limits

A question about portfolio limits, Aristocrat (ALL) has gone from strength to strength and as such now makes up 28% of my portfolio's value. I know this is way too much considering the recommended limit of 5%. My question is should I be selling out of it to get below 5% even though the recommendation on ALL is HOLD?

19 Oct 2016 – **Jon Mills**: Firstly, in terms of our HOLD recommendation on Aristocrat, the company has been hovering around our current SELL price of $16. It's due to report its half-year result at the end of November so unless it's share price rises materially above $16 and stays there for a decent period (say, a week) between now and then, we'll have an update in November. I should note that, at this stage, we're considering raising the Sell price (again), as we're usually reluctant to let go of a good company and Aristocrat seems poised to keep growing its business in the United States.

I'm unable to give you personal advice and so you'll need to decide whether to adjust the weighting of Aristocrat in your portfolio. I acknowledge that this isn't very helpful but unfortunately regulations constrain how I can respond to your question. I can however suggest you read research director James Carlisle's article ***What we mean by Buy, Hold and Sell*** and John Addis's article ***Risk ratings and porfolio weightings*** which should assist you. Cheers, Jon.

Proxy voting advice

I note that you do provide some corporate action around transactions. I have a general question about proxy voting.Do you see the intelligent investor service to provide proxy voting recommendations? I ask because whilst professional investors can get access to this kind of advice, as a small shareholder, corporate governance as well as sustainability of earnings is no less important to me. Would appreciate your response to this matter.

17 Oct 2016 – **James Carlisle**: As you note, we do provide recommendations around corporate actions, and therefore – very often – implicitly about how to vote, but we try not to stray far from things we think will directly affect a company's value. The reasons are simple: for one thing everyone is different and will have different opinions about pay, environment, gender diversity, corporate governance and so forth; but perhaps more importantly, the time we spent advising on such matters would be time not spent on actually valuing companies and making recommendations on that, which is what most of our members pay us for.

Somnomed strategy

Somnomed seems to be going from strength to strength on the back of another record quarter for sales (Sept 2016). However, looking at their cashflows and seemingly high relative staff, operating and marketing costs, is II comfortable in management's approach going forward?

21 Oct 2016 – **Graham Witcomb**: Let me start by saying we can only offer general advice, so it's important to take your personal situation into account before acting on our recommendations. Having said that, the new strategy to operate sleep clinics and sell directly to customers makes us a little nervous, but management has done a commendable job to date so we're willing to give them the benefit of the doubt for the time being. The company also has around $16m of cash on hand, which should be plenty to fund their immediate growth plan and the jump in staff and marketing costs is to be expected as they ramp up their sales effort.

Our main concern is with price, rather than strategy. As **we said in our last review**, we're happy to hold SomnoMed for the long term, but it's still a young, one-product company, with a new business model and new chief executive, all of which add risk. For many of our members, it may have become a larger slice of their portfolio than we think is warranted due to the share price having tripled since our original upgrade, so we reiterate our maximum portfolio weighting of 2% and recommendation to take profits as the share price increases.