Weekly Review

RESEARCH

– Issue –
24 Feb. 2017

A surprisingly strong sales result suggests Woolworths' turnaround is well underway.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Woolworths: Interim result 2017

John Durkan, Coles's managing director, seemed rattled on last week's **Wesfarmers** conference call. Now we know why. Woolworths produced 3.1% **same-store sales growth** in the second quarter of 2017 – much better than anyone expected. Coles's comparable number was 1.0%.

Key Points

- ***Strong same-store sales growth***
- ***2017 EPS weaker than expected***
- ***Tit-for-tat price reductions a risk***

WOOLWORTHS (WOW) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$26.63	8%	Low	Low–Med

BUY Below $23.00 — HOLD — SELL Above $35.00

$26.63

Woolworths' quarterly sales growth excited the market – sending the stock up 4% – although it's largely a result of mathematics. Woolworths' base was a weak sales number last time, whereas Coles's was a strong one. The mathematics would always favour Woolworths this period, as we noted in **Woolworths: Competition cuts in** – Part 2 on 21 Jun 16 (Buy – $21.13). You'd hope that cutting prices by $1bn would spur sales – and it has.

We also said that Woolworths' problems were self-inflicted and therefore fixable. In this result there was more evidence that managing director Brad Banducci has been working on a long list of issues, even if the result itself was disappointing.

Excluding Masters and the fuel business that BP intends to buy, sales rose 3%. But there was damage to margins – earnings before interest and tax (EBIT) fell 15% to $1,301m. Net profit fell 17% to $786m and the interim dividend was down a whopping 23% to 34 cents fully franked.

Concentrating on the food business, it's astounding that the EBIT margin has now almost halved from around 8.0% to just 4.3% in what is the seasonally stronger first half. This is considerably worse than we expected a year ago.

Waste not, want not

Diving deeper, the issues Banducci is fixing can be seen in the **gross margin** and **cost of doing business**. Surprisingly the gross margin rose from 27.4% to 27.8%, despite $1bn of price reductions over the past 18 months. This was partly due to significant progress with an important issue – reducing inefficiencies that were leading to stock losses. Less food is now being wasted, and customers are noticing that what's on the shelves is better quality.

You also expect businesses going through a spot of trouble to cut costs. Not Woolworths. The company's cost of doing business rose from 22.2% to 23.5% in the first half. A significant part of the increase here was staff incentives – management explained $110m in bonuses had been paid to staff as business metrics have improved. Motivated staff lead to better outcomes – and here's the proof.

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Banducci has been throwing money at the problems in the food business, with the evidence being a collapse in margins. On the conference call he all but admitted some of it was indiscriminate spending designed to do whatever it takes to save Woolworths. Expect management to target spending more carefully in future, which suggests margins have bottomed.

Elsewhere the liquor, hotels and New Zealand businesses performed creditably in the first half. Only Big W was particularly problematic, echoing its counterpart Target over at Wesfarmers. Sales fell 6% and, despite cost reductions, the business only broke even on a trading basis. Writedowns took Big W to a bottom line loss and there might be more to come.

One of the perverse things about investing is that the market looks forward. You'll often see the share price rising while earnings are still declining, just as we're seeing now with Woolworths. The stock is up 8% since the upgrade in ***Woolworths takes tough decisions*** from 29 Oct 15 (Buy – $24.70) but a whopping 25% since we said our long-term return expectations had increased in ***Woolworths: Competition cuts in***. Remember: if you're not buying on bad news, you're not getting an underpriced stock.

We're not claiming credit here – we certainly didn't foresee the speed of this turnaround. And if anything we're less keen on Woolworths 18 months on. Earnings per share are worse than we originally expected for 2017 and yet the stock surge means the forecast price-earnings ratio is now 23. The turnaround has arguably been fully priced in.

No, I'm lower

With Coles's John Durkan apparently surprised by Woolworths' price reductions, the risks have risen. He acknowledged that Woolworths' prices were now comparable to Coles but that he wanted to return to price leadership. Tit-for-tat reductions are a risk.

With Woolworths' share price having soared, the doom merchants have gone quiet. It doesn't mean the risks have gone away. But there's no doubt that Woolworths' management has been making excellent progress to fix the business. Masters is history, the food business turnaround is well underway, and only the relatively insignificant Big W remains problematic.

Table 1: Woolworths interim result 2017

SIX MONTHS TO 1 JAN	2016	2015	+/(–) (%)
REVENUE ($M)	29,059	28,315	3
EBIT ($M)	1,301	1,523	(15)
NPAT ($M)	786	944	(17)
EPS (C)	61.3	74.8	(18)
INTERIM DIVIDEND (C)	34c fully franked, down 23%, ex date 2 March		

Figures are underlying results

If you followed our recommendations over the past 18 months, you'll own a smallish stake in Australia's largest supermarket group. The returns from here are unlikely to be outstanding, but it's undoubtedly a very high-quality business. HOLD.

Note: The Intelligent Investor ***Equity Income Portfolio*** *owns shares in Woolworths. 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.

Prices were up, costs were down and cash was spent wisely. This was a fine result from BHP.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

BHP Billiton: Interim result 2017

We all knew it was coming but no one thought it would be this good. Let's get this out of the way first: BHP's interim result was a cracker, serenaded by the most thoughtful and disciplined capital allocation we have seen from BHP.

Key Points

- ***Stunning result***
- ***Lower costs and higher prices drove margins***
- ***Conservative capital allocation shown***

BHP BILLITON (BHP) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$26.55	8%	Med–High	Med–High

BUY Below $20.00 — HOLD — SELL Above $35.00

$26.55

Perhaps the mining colossus has learnt its lesson or perhaps a punishing share price fall and widespread condemnation has restrained the business.

Whatever the reason, BHP made plenty of money and made plans to spend it wisely. We can ask no more from a miner.

Table 1: Interim EBIT by commodity

SIX MONTHS TO DEC (US$M)	2016	2015	+/(–)(%)
IRON ORE	3,230	1,927	68
PETROLEUM	360	(199)	n/a
COAL	1,628	(342)	n/a
COPPER	914	101	805

Price rises, of course, helped, with all divisions registering solid gains in earnings before interest and tax (EBIT). As expected, iron ore and coal did most of the heavy lifting although copper performed better than expected.

More than price rises

BHP reported an average iron ore price of US$55 a tonne, far below spot prices and just 25% higher than the previous period which suggests that the extra US$1.3bn in EBIT generated from iron ore came as much from cutting costs as it did from higher prices. Indeed, BHP has stripped an astonishing US$11bn from its cost base over the past four years.

Coal was where prices helped the most, more than doubling over the period and generating industry leading margins.

It is telling that BHP's four commodity groups all made sensational EBITDA margins, with copper the lowest at 46%. This is a function of both higher prices and quality resources.

At a group level, numbers were reminiscent of the boom: EBITDA rose 65% to $US9.8bn, EBIT was up 350% to US$5.9bn and net profit rose almost 700% to US$3.2bn.

Bigger cash flows

As impressive as that sounds, it probably undercooks the level of cash being generated.

BHP is currently depreciating an asset base that was expanded in a high-cost environment but is being maintained in a low-cost environment. It is therefore depreciating more in accounting terms than it is spending in cash terms, so cash flow is far higher than profits: it made operating cash flow of US$7.7bn and free cash flow of US$5bn for the half year, on track for a free cash flow yield of more than 7%.

Table 2: BHP's interim result 2017

SIX MONTHS TO DEC (US$M)	2016	2015	+/(–) (%)
UNDERLYING EBITDA	9,896	5,994	65
UNDERLYING EBIT	5,982	1,342	346
UNDERLYING NPAT	3,244	412	687
UNDERLYING EPS (USC)	61.0	7.7	692
DPS (USC)	40	16	150
CAPEX	2,727	4,368	(38)
NET DEBT	20,000	25,900	(23)

The business may have reported equally high profits over the boom but it always spent the cash. It is now, for the first time in memory, generating copious free cash flows.

Most importantly, it is spending that cash well, electing to pay dividends of US$0.40 per share, part of which is a special dividend. More cash was deployed to lower debt from US$26bn to US$20bn, where it is comfortable if a little high, and some on high returning new projects.

> **The business may have reported equally high profits over the boom but it always spent the cash.**

There was also good news from the petroleum division, which houses the maligned US shale assets. Last period the collection of shale assets lost over US$1bn in EBIT. This year the loss was US$390m, an improvement aided by both higher prices and lower costs.

Different this time?

We have seen high commodity prices and high profits from BHP before but this result was different and suggests a newfound restraint from management. There is fresh capital for exploration and high-returning projects are still being pursued but large acquisitions and the chase for volume have ceased.

It is easy to pursue cuts and follow restraint in the gloom but such dour discipline is hard to maintain when times are good. Times are good again and we shall see if things are different this time. **HOLD**.

*Note: The Intelligent Investor **Growth Portfolio** and **Equity Income Portfolio** own shares in BHP Billiton. 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.

Full-year guidance for the travel retailer always looked a stretch, and so it has proved.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 23 FEBRUARY 2017

Flight Centre: Interim result 2017

We've been very clear in recent reviews that another profit downgrade from Flight Centre was a strong possibility, and today we got it.

Key Points

- ***Full-year guidance downgraded by 7%***
- ***Further downgrades possible***
- ***Nevertheless, stock looks cheap***

FLIGHT CENTRE (FLT) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$29.84	6%	Medium	Med–High

BUY Below $32.00 · HOLD · SELL Above $50.00

$29.84

Alongside the company's interim result, management said it expected underlying profit before tax (UPBT) for the year to June to be $300m–330m, around 7% below the $320m–355m it had previously forecast.

That translates to earnings per share of $2.08–2.29, but when we **upgraded the stock** to Buy back in November, we said it was 'probably more realistic to assume that Flight Centre will earn about $2 a share this year'. On that basis, we wouldn't be surprised to see another downgrade.

Buying anyway

So why have we been happy to buy the stock? Well there are different ways to invest. You can try to second-guess the market's view of likely short-term eventualities, or you can focus on the long term, try to value stocks and buy them at a discount to that value.

As most will know, we take the latter approach. It means that at times you have to put short-term concerns to one side and buy anyway – the idea being that such concerns are likely to be shared by others and therefore reflected in the price.

That appears to be the case here, with the stock closing down only 1.5% today (albeit after an early knee-jerk slump of around 7%).

The reasons for the downgrade – and the 22% fall in UPBT in the first half – are mostly the same ones previously given, notably low ticket pricing by airlines (which makes it hard to meet over-ride commissions), economic uncertainty and currency movements.

The airfare deflation began in the second half of the 2016 financial year and is particularly affecting Australia, the US, India and Singapore.

The currency impact was mostly from translating sterling profits into Australian dollars, with sterling having fallen around 20% since Brexit.

TTV increase

Total transaction value (TTV) across the group rose only 2% to $9.3bn, with a slight fall in margins meaning that revenue slipped 1% to $1,251m. This was exacerbated by a 3% increase in costs – mostly from marketing and higher depreciation from increased capital expenditure in previous periods, although staff costs (about 60% of total costs) were kept flat. Operational gearing saw to the rest, knocking the UPBT down by 22%.

Table 1: FLT interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
TTV ($BN)	9,343	9,182	2
REVENUE ($M)	1,251	1,258	(1)
PBT^ ($M)	113.2	145.9	(22)
NPAT^ ($M)	78.2	105.7	(26)
EPS^ (C)	77.5	104.8	(26)
INTERIM DIVIDEND	54c fully franked, down 25%, ex date 22 Mar		

^ Figures are underlying results

Among the positives were record levels of TTV, in local currency terms, in nine out of 10 regions, and record operating profit, again in local currency terms, in Europe, South Africa and Mainland China. But Australia still contributes five times the operating profit of the next largest region (Europe), so its 13% profit fall dominated the result.

> **Furthermore, we can't say when the current problems might go away.**

Founder and chief executive Graham Turner said he was still concerned about airfare pricing and we'd have to agree. As noted above, we think further downgrades are still quite likely.

Long-term focus

Furthermore, we can't say when the current problems might go away. What we can say, though, is that we have great faith in Flight Centre's ability to generate cash over the long term.

It says a lot about the company that it spends just over a quarter of its half-yearly results presentation pack discussing its 20-year strategy. We won't go into it all here, but it's worth a read and, together with the company's management and legendary culture, it allows great confidence in the future.

And because of the current difficulties, the stock is priced cheaply – at just 15 times our conservative estimate for 2017 earnings per share of $2. With the company typically making most of its earnings as free cash, that equates to a free cash flow yield of almost 7%.

That's decent value for a company of this calibre, even with the potential for further 'disappointments' in the short term. We would, however, still recommend keeping your weighting relatively small at this point – perhaps 3%, or about half our 6% recommended maximum. That's the approach we've taken with our Growth and **Equity Income portfolios** and we'd want to see more bad news priced in before going much beyond that. **BUY**.

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

Staff members may own securities mentioned in this article.

It was a poor interim result for this IVF provider, with market share losses and rising competition.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Virtus Health: Interim result 2017

From the get go, we thought Virtus Health was a superior IVF provider both operationally and financially: it has a bigger market share than **Monash IVF**, better management, a smooth overseas expansion, more diverse revenue streams, and a conservative balance sheet, to tick a few things off the list.

Key Points

- ***Losing market share in declining market***
- ***Genetic testing a bright spot***
- ***Share price undervalued; Buy***

VIRTUS HEALTH (VRT) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$5.21	5%	Med–High	Med–High

BUY Below $5.50 | HOLD | SELL Above $9.00

$5.21

But Virtus's result for the six months to December is starting to strain that theory – especially relative to Monash's, which we covered on Monday.

Total revenue fell 1% to $131m, mainly due to weak volume growth Australia-wide and a loss of market share in NSW and Victoria.

The worst news, though, was lower volumes at its Victorian full-service clinics (see *Virtus disappoints with market share losses*). And, to top things off, the company suffered a 19% decline in volumes at its low-cost The Fertility Centre clinics in NSW. Ouch.

The number of cycles performed in Australia fell 7% to 8,070, compared to a 6% decline for the market as a whole. Virtus lost market share in the eastern states, which declined from 43.8% to 43.2%.

Like a retailer

Before we get to the gore and guts, a 6% market decline is well below last year's growth of 11% and the long-term historical growth rate of 3–4%. This is a reminder that Virtus is a more cyclical business than other healthcare companies, such as hospital operator **Ramsay Health Care**. Having a child is often a high priority, but IVF is expensive and clients have some discretion over when they try. Of all the healthcare stocks on the ASX, Virtus is one of the most likely to be hit by a deterioration in the general Australian economy.

Nonetheless, as we explained in ***Does low-cost IVF threaten Monash?***, IVF is still a largely untapped market. Over the past decade, the average age of first-time mothers has increased by roughly a year to 31 – and that shift in the bell curve means higher rates of infertility. There's no reason to believe the trend for women to delay having children so they can focus on careers and education is going to abate any time soon, so it's a reasonable assumption that infertility will continue to rise in the population.

A growing population plus growing rates of infertility means there will almost certainly be substantially more demand for IVF in 10 years' time than there is today. The number of IVF cycles performed each year has grown at around 3% annually since the Government reduced financial assistance in 2010, and we still think 3–4% market growth is a reasonable long-term assumption.

Table 1: VRT interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
NO. OF CYCLES	9,410	9,781	(4)
REVENUE ($M)	131.4	132.2	(1)
EBITDA ($M)	31.7	36.2	(12)
NPAT ($M)	15.6	18.8	(18)
EPS (CENTS)	18.2	22.1	(18)
INTERIM DIVIDEND	13.0 cents, fully franked, down 8% ex date 30 March		

As fellow analyst Jon Mills recently said to me, it may be best to view Virtus like a specialty retailer, where like-for-like sales figures can be volatile and lead to significant share price movements. If you think the long-term outlook for IVF is good – and we do – then it's these 'troughs' in cycle growth that should be the best times to buy.

> **The company remains the market leader, with economies of scale, healthy returns on capital and it throws off plenty of cash.**

Ireland and diagnostics

Revenue would have declined much more if it weren't for Virtus's other divisions picking up the slack. The Diagnostics division was the real winner this half, with revenue up 7% thanks to a 38% increase in pre-implantation genetic screening services, which is now used in 12% of fresh cycles (up from 8% last year). This compares to a 5% decline in genetic screening for Monash over the period and was one of the few areas where Virtus stole the show. For more on why we think diagnostics is a significant opportunity, see ***Virtus Health's genetic goldmine***.

The company's three clinics in Ireland are also ticking along nicely, with 2% cycle growth leading to a 4% increase in both revenue and earnings before interest, tax, depreciation and amortisation (EBITDA).

Virtus made one large acquisition on the international front during the half, the Aagaard Fertility Clinic based in Denmark. The total price tag of up to $16.5m (dependent on first-year earnings) was funded by cash and debt, which led to a $9.3m increase in net debt to $134m.

Management said that Scandinavia is an attractive market for Virtus due to it having a similar regulatory framework to Australia. The company is on the hunt for other acquisitions in the region as part of its strategy to expand internationally and remove some of the volatility in IVF cycle numbers.

Future pain

Overall, group EBITDA was down 12% to $31m, due to a higher cost base, particularly employee and fertility specialist related expenses, causing a 4.0 percentage point contraction in the operating margin to 30.3% for the Australian division.

Net profit fell 18% to $14.7m, while steady capital expenditure and lower cash flow from operations led to a 26% decline in free cash flow to $11.5m.

Management didn't provide specific guidance for the 2017 financial year but did say that weak cycle numbers in the second half, should they continue, will have a material impact on profits. The company also warned that volumes and margins are likely to face headwinds in Queensland, where **Primary Health Care** has recently opened a bulk-billing clinic.

Although this was a poor result and Monash deserves credit for its much better performance, Virtus still has plenty going for it. The company remains the market leader, with economies of scale, healthy returns on capital and it throws off plenty of cash.

The share price is another attraction. The stock trades on a forward price-earnings ratio of around 15 based on consensus estimates for 2017 earnings, a current free cash flow yield of 8.2% and a fully franked dividend yield of 5.4%. We're sticking with **BUY**.

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

Disclosure: The author owns shares in Virtus Health.

The exchange operator is travelling along well, and the market seems to have taken note.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 17 FEBRUARY 2017

ASX: Interim result 2017

Increased trading activity in both shares and derivatives made up for lower listings in the first half for ASX, allowing revenues to creep up nearly 3% overall to $387m.

Key Points

- ***Trading revenues higher***
- ***Listing revenue down***
- ***Downgrading to Hold***

ASX (ASX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$51.74	8%	Low–Med	Medium

BUY Below $50.00 | **HOLD** | **SELL** Above $70.00

$51.74

The total value of share trading on the ASX in the half rose almost 2% to $539bn. However, a greater proportion came from the higher margin Centre Point exchange, where the value increased 51% to reach 10% of the total, so cash market trading revenue rose 15% to $23m.

Technical Services revenue rose 8%, with increased connections and the number of customer cabinets hosted in the Australian Liquidity Centre (ALC) increasing from 219 to 270. Information Services revenue, however, fell 1.8% due to fee changes. Overall Trading Services revenue rose 5% to $96m.

Within Derivatives and OTC Markets, the nascent **OTC** operations continued to expand rapidly, with the value cleared rising to $2,160bn, from $817bn in the prior corresponding period. Futures contracts traded rose 9%, giving a 5% rise in overall revenues for the division, to $133m.

Although the number of IPOs rose 12% from the prior corresponding period, to 86, there was a lack of really big floats and initial capital raised fell 18% to $11.1bn. Big offerings from those already listed were also notably absent, with total capital raised in the secondary market falling 37% to $25.8bn.

Demonstrating the resilience of this business, though, listing revenue marched up 7% due to fee changes and increases in market capitalisation (bigger companies pay higher fees). Overall, revenue in the Listing and Issuer Services segment fell just 2% to $103m.

Equity Post-Trade Services increased revenue by 4% to $53m, but the composition of that figure reveals where the threat of greater competition hangs. Clearing revenues fell 1% due to a 10% price reduction that took effect on 1 July, while settlement revenues rose 10% due to a 10% increase in dominant settlement messages.

Operating expenses rose 6%, as foreshadowed, due to a 6% increase in average headcount and a corresponding 9% rise in staff costs. A similar increase is expected for the full year.

Table 1: ASX revenue split

SIX MONTHS TO DEC ($M)	2016	2015	+/(–) (%)
LISTING AND ISSUER SERVICES	103	106	(2)
TRADING SERVICES	96	91	5
EQUITY POST-TRADE SERVICES	53	51	4
DERIVATIVES AND OTC MARKETS	133	127	5
OTHER	1	1	0
TOTAL OP. REVENUE	387	376	3

The net effect of all this was a 3% rise in net profit to $219m and a similar increase in earnings per share to $1.13. That puts the company well on the way to making the consensus forecast of $2.28 for the full year (which would be an increase of about 4% on 2016).

Table 2: ASX interim result

YEAR TO DEC ($M)	2016	2015	+/(–) (%)
OPERATING REVENUE	387	370	4
OPERATING EXPENSES	90	86	5
EBITDA	297	285	4
DEP. & AMORT.	22	21	6
EBIT	274	264	4
INTEREST AND DIVS	38	34	11
UNDERLYING PBT	237	230	3
UNDERLYING NET PROFIT	219	213	3
UNDERLYING EPS	113.4	110.2	3
INTERIM DIVIDEND	$1.02 fully franked, up 3%, ex date 9 March		

> **ASX is traveling well and the market seems to be coming round to that view, with the stock rising 26% since our review of last year's interim result.**

Capital expenditure in the half came to $20.3m, down from $31.5m in the preceding half, but up from $18.7m in the prior corresponding period. ASX tends to spend more in the second half of the financial year and that pattern is expected to be repeated with (unchanged) guidance for full-year capex of about $50m.

The interim dividend was raised by 3% to $1.02 (fully franked, ex date 9 March), maintaining the company's target 90% payout ratio.

Management didn't offer much on the proposed replacement for CHESS, save to say that it has been consulting widely and is continuing to do so, including through its '**acceler8**' dedicated demonstration suite that looks like something out of the Starship Enterprise. The company continues to develop its base level equity post-trade system based on distributed ledger technology to help inform a decision expected in late 2017 on the exact technology to use.

ASX is traveling well and the market seems to be coming round to that view, with the stock rising 26% since **our review of last year's interim result**. That gives it a capital return of 73% since we **initially upgraded it in 2012**. On top of that there's been a fully franked yield that amounted to almost 6% when we initially upgraded, but which has now dipped below 4%.

That move has taken the stock above our $50 Buy price and we're therefore downgrading to **HOLD**.

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

Disclosure: The author owns shares in ASX.

iSelect's recovery in the second half of 2016 has continued so far in 2017.

BY JON MILLS • INTELLIGENT INVESTOR • 20 FEBRUARY 2017

iSelect: Interim result 2017

It seems iSelect is well and truly back on a stable footing due the good work of chief executive Scott Wilson since he assumed leadership in October 2015 (see Table 1).

Key Points

- ***Health segment out of recovery ward***
- ***Life insurance a disappointment***
- ***Telco a highlight***

ISELECT (ISU) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.80	**2%**	**Med–High**	**High**

BUY Below $1.40 | **HOLD** | **SELL** Above $2.20

$1.80

In particular, the previously problematic Health segment is out of the recovery ward. After a disastrous first half of 2016 (see ***iSelect: Interim result 2016*** on 29 Feb 16 (Speculative Buy — $0.875)), the improved performance was helped by the return of **Medibank**'s low-cost brand ahm for the full period, better training of employees, and a strategy concentrating on finding customers the most appropriate policy rather than just the cheapest. The latter helped push up the average revenue per sale by 17%, to $939.

However, as premium rates continue to rise far in excess of inflation, affordability remains an issue within the wider health insurance market. This meant that customer leads fell 8%, to 465,000, but iSelect still sold more policies (44,000) than the in the prior corresponding period (43,000).

So, after recording an earnings before interest, tax, depreciation and amortisation (EBITDA) loss of $2.0m in the first half of 2016, the 13% rise in revenue pushed the segment back into profit on an EBITDA basis (see Table 2).

The peak buying periods for health insurance are in March and June as customers try to get in before premium rates and the Lifetime Health Cover loading rise on 1 April and 30 June each year, respectively. This means that iSelect's Health segment has a strong skew towards the second half.

To try to reduce this seasonality, however, the company introduced its Health Cover Check Up marketing campaign but this may have pulled some sales forward into the first half. We'll have to wait until the final result but management still expects the segment to grow in the second half compared to the prior corresponding period.

Life insurance problems

Things were less rosy in the Life & General Insurance segment, where margins were depressed by stronger competition in life insurance due to the Trowbridge reforms, combined with additional marketing and employee expenses.

However, iSelect has already adopted the hybrid commission structure required by Trowbridge (which still hasn't been passed into law). It continues to invest in this business as management believes it will be a good source of growth from 2018 due to iSelect's advantages in acquiring customers compared to competitors.

Table 1: iSelect interim result 2017

SIX MONTHS TO DEC ($M)	2017	2016	+/(–)(%)
REVENUE	78.0	66.2	18
UNDERLYING EBITDA	5.9	(3.6)	n/a
UNDERLYING EBIT	2.8	(6.9)	n/a
UNDERLYING NET PROFIT	2.6	(4.2)	n/a
UNDERLYING EPS (C)	1.1	(1.6)	n/a
INTERIM DIVIDEND	1.5c (up 50%), fully franked, ex date 24 Feb		

By contrast, continued growth in the car insurance segment – Zurich recently joining iSelect's panel – helped segment revenue rise by 8% to $14.4m. Car insurance sales have lower margins, however, so segment EBITDA still fell, by 26%, to $2.5m.

One good consequence of the disappointing life insurance result is that upfront revenue now represents 87% of the total. (iSelect receives commissions from life insurance policies and some health insurance policies over a number of years rather than upfront).

> **One good consequence of the disappointing life insurance result is that upfront revenue now represents 87% of the total.**

As a result, the balance of trailing commissions receivable actually declined in the period, to $101m from $104m at 30 Jun 16. Along with better control of working capital, this helped improve operating cash flow by $15.5m, from a negative $5.7m to a positive $9.8m. However, there remains the risk that iSelect has underestimated the rate of churn in Health insurance in particular – if a customer subsequently moves to another policy, iSelect loses any remaining commissions still to be paid to it.

Telco a highlight

The highlight of the result was its Energy and Telco segment, with both revenue (+39%) and EBITDA (+260%) dramatically improving. Additional investment in employees and marketing helped the number of leads rise 47% but a slight reduction in the conversion of these leads meant the number of sales rose by 'only' 41%.

While the Energy business is more mature, the nbn still has to be rolled out past the majority of Australian households and there should be 8m households connected to it by 2020. As such, this is another business that management believes has significant growth potential – nbn connections now only represent 30% of broadband sales – and with $73m in net cash on its balance sheet, iSelect is well placed to continue expanding to meet expected demand in this and other segments.

It also means it's well placed to continue spending the tens of millions of dollars a year required to generate leads and see off competition such as comparethemarket.com.au.

On the cost front, with one in five customers contacting the company outside normal business hours, iSelect now has over 100 employees in Cape Town, its newest office. In the short term this helps the company extend its hours from 7am to 11.30pm and also on the weekend, but from 2018 onwards it will reduce cost growth due to the lower wages and cost of doing business in South Africa compared to Australia.

In the meantime, however, along with greater headcount, iSelect continues to expand marketing and also invest in various parts of its business. This likely means earnings before interest and tax (EBIT) in the second half of 2017 will be less than in the prior corresponding period.

Table 2: Segment earnings

SIX MONTHS TO DEC ($M)	2017	2016	+/(–) (%)
REVENUE			
HEALTH	35.0	31.1	13
ENERGY & TELCO	24.3	17.5	39
LIFE & GENERAL INSURANCE	14.4	13.3	8
EBITDA			
HEALTH	5.2	(2.0)	n/a
ENERGY & TELCO	1.4	0.4	260
LIFE & GENERAL INSURANCE	2.5	3.4	(26)

Nevertheless, management guided towards 2017 EBIT at 'the upper end' of $21m–24m. Using the midpoint of this guidance would put iSelect on an enterprise value to EBIT multiple of 10.

iSelect shares have fallen 6% since ***iSelect: AGM 2016*** but have still almost doubled since we first upgraded the stock a year ago in ***Is it time to pick iSelect?*** on 29 Jan 16 (Speculative Buy – $0.90). **HOLD.**

*For more on iSelect, please see our recent **BossTalk with CEO Scott Wilson**.*

Disclosure: The author owns shares in iSelect.

Net profit fell 15% for this gaming operator due to fewer large jackpots and increasing competition.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 20 FEBRUARY 2017

Tatts: Interim result 2017

'**Reversion to the mean**' is an important concept, but especially so for gaming company Tatts Group. There were 15 lottery jackpots above $15m in the six months to December, down from a record 24 in the previous corresponding period.

Key Points

- ***Fewer big jackpots depressed sales***
- ***Wagering revenue and turnover decline***
- ***Fixed costs hurt profits***

TATTS GROUP (TTS) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.08	5%	Low–Med	Medium

BUY Below $3.75 — HOLD — SELL Above $6.50

$4.08

At first, that may seem like a good thing – Tatts is the one paying out the jackpots, after all. Unfortunately, though, without the chance to dream big, people are less inclined to buy lottery tickets, and this caused a 26% decline in revenue from the Powerball and Oz Lotto games for the six months to December. Excluding jackpot games, the rest of the division increased revenue 7%.

Overall, revenue for the Lotteries division – which accounts for 75% of operating earnings – fell 8% to $1.0bn, with earnings before interest, tax, depreciation and amortisation (EBITDA) down 11%. Most of Tatts' costs are fixed and that works wonders on margins when the business is growing, but it also means that losses tend to be supercharged, too.

Turning to the company's UBET wagering operation, fixed-odds racing and sports revenue was up 8% thanks to a 3% increase in turnover and a higher win-rate. The company has rebranded its 280 retail wagering outlets under the UBET brand and management said brand awareness among punters has doubled over the year.

This wasn't enough, however, to offset a sharp decline in tote betting. Overall, wagering turnover fell 5%, with revenue down 2.5% and EBITDA down 12% – again due to the large proportion of fixed costs. Management said it had changed its focus to revenue growth, rather than turnover growth, and an improved win-rate of 15.6% – up from 15.2% – suggests that shift is already having an effect.

Not convinced

We have mixed feelings about the switch. On the one hand, a focus on margins over turnover can drive short-term revenue growth, as was the case this half. On the other hand, widening margins means less money in the hands of punters – either the company is offering worse odds or fewer promotional bonuses to customers.

Table 1: Tatts interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	1,425	1,530	(7)
EBIT ($M)	195	228	(15)
UNDERLYING NPAT ($M)	124	146	(15)
UNDERLYING EPS (CENTS)	8.5	10.0	(15)
INTERIM DIVIDEND	9.5 cents, fully franked, (unchanged) ex date 6 March		

As we explained in ***Tabcorp: Result 2016***, the wagering divisions of both Tatts and Tabcorp face an uphill battle against lower-cost online operators. The companies' biggest threat is Australia's largest online wagering outfit, Sportsbet – owned by UK-based Paddy Power Betfair.

Sportsbet already almost invariably offers better odds than Tatts due to its lower-cost operating structure, and customers have been flocking to online providers at the expense of traditional bookies. We can't see how Tatts offering even worse odds under a 'win-rate optimisation' strategy is going to solve that problem. Indeed, Sportsbet grew turnover by 23% in the six months to December, suggesting Tatts is still losing market share to the company.

Net profit fell 17% to $123m due to that nasty base of fixed-cost retail outlets, as well as $10m of expenses related to the **proposed merger with Tabcorp**. Both companies' boards of directors support the merger but it still needs to pass various regulatory conditions, as well as get approval from the courts

> **Tatts has a monopoly position, long licences and is highly cash generative.**

and the wagering and lottery regulators in each state. Tatts' management says it is happy with progress to date and the Australian Competiton and Consumer Commission (ACCC) is expected to make a judgment on 9 March.

Raising price guide

Tatts has a monopoly position, long licences and is highly cash generative. The stock currently sports a forward price-earnings ratio of 23 based on consensus estimates for full-year earnings.

Under the proposed merger with Tabcorp, Tatts shareholders will receive 42.5 cents in cash plus 0.80 shares of Tabcorp, for a total implied value of $3.90 given Tabcorp's current share price (that's in addition to Tatts' 9.5 cent interim dividend). We think the deal undervalues Tatts, particularly given its more reliable Lotteries monopoly (though you wouldn't know it from this result). We aren't in favour of the deal and would rather see Tatts sell its ugly Wagering division to Tabcorp, leaving a standalone Lotteries operation.

Nonetheless, at least $130m of duplicate costs are expected to be cut from the combined businesses, which would add well over $1bn of value for shareholders. There was even a **second deal** on the table until the board knocked it back, so Tabcorp clearly isn't the only party interested. It isn't too late for a better offer to come in.

Although this was a poor result, we're raising our recommended Buy price to reflect the higher odds that a deal will go through. If the ACCC rejects the merger on 9 March, our valuation will decrease and we will again lower our price guide. For now, we're sticking with **HOLD**.

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

There was positive news for this IVF provider on the pricing front, but revenue and volumes declined.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 20 FEBRUARY 2017

Monash IVF: Interim result 2017

Whenever we read a Monash IVF result, there's one number we rush to see: did the company raise prices. As we explained in ***Virtus, Monash and the $30,000 babies***, the two greatest risks facing Monash are government changes to Medicare funding of IVF, and pricing pressure from budget operators, including **Primary Health Care**'s new bulk-billing IVF clinics and **Virtus Health**'s The Fertility Centre.

Key Points

- ***IVF volumes down***
- ***Market share increases***
- ***Genetic screening disappoints***

MONASH IVF (MVF) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.74	3%	Med–High	Med–High

BUY Below $1.50 | **HOLD** | **SELL** Above $2.80

$1.74

With this in mind, it was pleasing to hear that Monash was able to increase prices 2% across all services, leading to a 2% increase in average revenue per patient.

That's significant because it suggests the company is experiencing little pressure on prices, despite budget offerings increasing their market share and the recent entry of Primary Health Care to Monash's home turf of Victoria.

This reinforces our view that the new budget IVF model is akin to a McDonald's opening next door to a fine-dining restaurant – it may expand the overall 'eating out' market by making the pricey procedure available to low-income earners, but there are still plenty of people seeking a premium service.

On the other hand, **Virtus's recent loss of volumes** at its Victorian premium clinics undermines that argument, so this seems to be a period of conflicting information – premium volume loss is bad, little pricing pressure is good. We'll know more when Virtus releases its interim result later this week.

Market decline

Monash reported a decline in IVF cycles of 2.4%, though that was better than the overall market decline of 6.2% and enabled the company to increase its national market share from 22.1% to 23.0%.

Unfortunately, this was accompanied by a 5% volume decline for pre-implantation genetic screening, though this was offset by a 9% increase in pre-natal testing as the company broadened its in-house offering of the service.

We were disappointed to see the decline in genetic screening as Monash lowered prices last year, which promptly doubled volumes. We hoped to see uptake of the procedure continue to grow at the lower price point.

The company's ultrasound division had a poor six months with a 9% decline in volumes, though price rises meant this led to a decline in revenue of just 2%.

Table 1: MVF interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
NO. OF CYCLES	8,895	9,009	(2)
REVENUE ($M)	78.7	79.3	(1)
EBITDA ($M)	25.3	24.5	3
NPAT ($M)	15.2	14.0	9
EPS (C)	6.46	5.95	9
INTERIM DIVIDEND	4.3 cents, fully franked, (up 8%) ex date 2 March		

On the international front, Monash's Malaysian business performed reasonably with a 3% increase in revenue and stable margins. An 18% rise in patient treatments was unfortunately offset by a decline in the Malaysian ringgit.

Interest rate tailwind

Overall, Monash reported a reasonable result with revenue falling 1% to $78.7m for the six months to December, though earnings before interest, tax, depreciation and amortisation (EBITDA) rose 3% thanks to cost-cutting initiatives improving operating margins.

> **We hoped to see uptake of the procedure continue to grow at the lower price point.**

The real bread maker, though, was the refinancing of the company's $93m of net debt on more favourable terms, which caused a 30% fall in interest expenses. That boosted overall net profit by 9% to $15.2m.

Management expects net profit to increase in the 2017 financial year compared to 2016, though it didn't offer specific guidance. Management also noted poor market growth in the first two months of the second half, which could impact the forecast for growth if things don't pick up.

Monash trades on an undemanding price-earnings ratio of 14 and a free cash flow yield of 6%. With economies of scale, decent growth prospects, and plenty of cash flow, we're raising the price guide slightly and continue to recommend that you **HOLD**.

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

Disclosure: The author owns shares in Virtus Health.

It was another flat result for the share registry operator, but management raised guidance for the first time in a while and there should be more to come.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 21 FEBRUARY 2017

Computershare: Interim result 2017

Much has been said about how Computershare should benefit from the anticipated Trump boost to interest rates, but shareholders are going to have to wait a while longer for that to show up as profit.

Key Points

- ***Margin income lower again***
- ***Big jump in UK mortgage service revenue***
- ***Guidance raised***

COMPUTERSHARE (CPU) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$13.70	7%	Medium	Medium

BUY Below $11.00 — HOLD — SELL Above $16.00

$13.70

In the six months to December, margin income (the interest earned on client balances) fell again, to US$66.6m. You have to go back to 2006 to find a half in which Computershare made less margin income. Back then, though, client balances were just over US$6bn, less than half the average for the latest half of US$16.6bn. That, in fact, was their highest for four years, and they'd have been higher still but for the almost 20% fall in sterling, in which more than 20% of balances are held.

Based on current rates in the futures market, though, this year is expected to mark the bottom of the interest rate cycle (see Chart 1). Over the next couple of years achieved yields should rise by about 0.5% from their current low of 0.8%. All things being equal, that should add about US$20m or almost 5% to annual operating profit.

To whet the appetite, management disclosed for the first time the split of margin income between different divisions (see Table 1). On the conference call chief executive Stuart Irving also confirmed that, in renegotiated contracts in its registry business in recent years, the company hasn't been reducing its dependence on margin income.

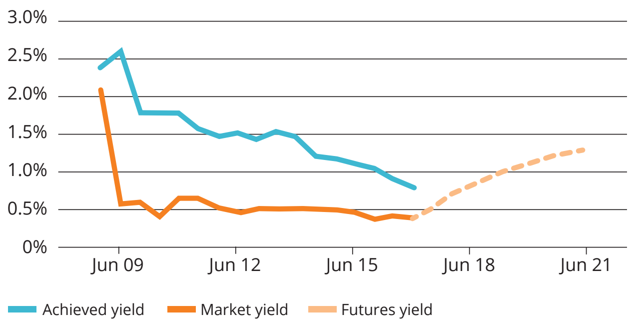
Mortgage services soars

In the meantime, Computershare is moving ever further from its roots, with a 40% increase in Business Services revenue due to the contract with **UK Asset Resolution** (UKAR, the government entity tasked with winding down the mortgage books of Northern Rock and Bradford & Bingley).

That took total Business Services revenue to US$403m, or 40% of the group total, taking it past the traditional Register Maintenance businesses, where revenue slipped 3%, taking its share down to 32%.

The UKAR contract meant that UK mortgage services revenues rose by US$99m to US$140m, overtaking US mortgage services revenues of US$124m. The remaining US$140m of Business Services revenue comes from administering bankruptcies and class actions and providing communications for **utilities**.

Chart 1: Yield on client balances



[1] **Achieved yield** = annualised total margin income divided by the average balance for each reporting period
[2] **Market yield** = avg. cash rate weighted according to the client balance currency composition for each reporting
[3] **Futures yield** = avg. implied rates weighted according to the client balance currency composition at 31 Dec 16

Source: Computershare 2017 Half Year Results

Including UKAR, total revenue rose 7% to US$1.0bn but, without it, revenue was flat. UKAR also accounted for US$87m in additional operating costs – amounting to almost all the 14% group-wide increase. Excluding UKAR and some small additional costs from acquisitions, group costs actually fell slightly.

> **For the past couple of years it's been mostly 'less', particularly in resources.**

Those figures imply that the UKAR business made an operating margin of around 13%, dragging the overall group operating margin down from 25.8% to 24.1%. The integration of the UKAR business, however, is progressing ahead of schedule and the margin will improve.

Table 1: Margin income split

	DIVISIONAL EBITDA (US$M)*	MARGIN INCOME (US$M)*	SHARE OF TOTAL MARGIN INCOME	MARGIN INCOME SHARE OF DIV. EBITDA
BUSINESS SERVICES	81.4	30.8	44%	38%
REGISTER MAINTENANCE				
AND CORPORATE ACTIONS	124.4	30.0	43%	24%
EMPLOYEE SHARE PLANS	26.7	9.1	13%	34%
TOTAL		69.9		

*Constant currency

The UKAR business itself has a finite life – peak profits are expected to be earned in around 2020 – but the plan is to use it as a platform to win more mortgage processing work in the UK. In that regard, it is promising that Computershare has won contracts by three 'challenger banks' who entered the UK mortgage market in the period.

Lower quality

When the US mortgage servicing business reaches full scale (defined as unpaid balances of US$100bn compared to US$57bn currently), management expects it to make a profit before tax margin of 20% and a post-tax return on invested capital of 12–14%.

That's nothing to be sneezed at, but it's not yet in the bag and in any case compares with a level of 15% achieved across the group in the first half. Back in 2011 when we first recommended the stock (see ***Computershare takes the lion's share – part 1*** on 16 Jun 11 (Long Term Buy – $9.32) and **part 2**), when Business Services contributed only 16% of revenue compared to 39% now, the group return on invested capital was 17%.

It makes sense to build the mortgage servicing business, because Computershare can bring to bear the skills it has developed elsewhere. But it's more competitive than the traditional share registry business and it makes lower returns.

That's a tough comparison – Computershare's registry business is one of the best around – but nonetheless the group's overall quality is being diluted. The profits might be going up (at least they should soon) but we won't value them quite as highly.

Employee Share Plans is another decent business, which should benefit from the worldwide trend towards equity-based pay. In the short term, though, it can be pushed around by sharemarkets, which make it more or less attractive for employees to participate.

For the past couple of years it's been mostly 'less', particularly in resources. So with the recovery in markets over the past year, it was reassuring to see this division bounce back with a 9% increase in revenue and an 18% rise in underlying earnings before interest, tax, depreciation and amortisation (EBITDA) in constant currency terms. And that's in spite of a 37% fall in margin income in the division. Ignoring that, EBITDA would have been 42% higher.

Table 2: Computershare interim result

SIX MONTHS TO DEC	2017	2016	+/(–) (%)
REVENUE	1,003	939	7
UNDERLYING EBITDA	241	242	(0)
UNDERLYING EBIT	214	218	(2)
UNDERLYING NET PROFIT	141	144	(2)
UNDERLYING EPS	25.7	26.0	(1)
INTERIM DIVIDEND	17c, 30% franked, up 6%, ex date 24 Feb		

All up, underlying EBITDA was flat at US$241m. Excluding the effect of currency movements, though, it rose 3%, and excluding movements in both currency and margin income, it would have risen 11%. Underlying earnings per share were flat at 25.7 US cents, but rose 4% excluding currency effects.

Guidance raised

The big impact to cash flow in the **2016 interim result** from advances to the US Specialised Loan Servicing (SLS) business was unwound in the **full year result** and the SLS advances totalled just US$12m in this result, or about 7% of the US$173m operating cash flow before advances.

> **"Underlying earnings per share were flat at 25.7 US cents, but rose 4% excluding currency effects.**

Excluding the advances, but deducting maintenance capital expenditure, free cash flow came to US$150m – or slightly more than 100% of management's measure of net profit. As a result, net debt fell by 10% to US$1,017m, even after the payment of US$64m in dividends the repurchase of shares worth A$5m.

That puts net debt at 1.91 times EBITDA, in the bottom half of management's target range of 1.75x to 2.25x. As a result, the interim dividend was raised by 6% to A$0.17 – franked at 30% – but that still represents a payout ratio of less than 50%.

To cap a strong result, management raised full-year guidance from 'slightly up' on last year's 55.1 US cents to a range of 56–58 US cents. That represents growth of 2–5% but, with mortgage servicing margins likely to improve and margin income (probably) on the up, growth over the next couple of years should be closer to 10%.

The market, though, has already cottoned on to this, driving the stock up 58% since a low of $8.66 in early August and 39% since our review of the 2016 result on 11 Aug 16 (Buy – $9.83). That puts it on a multiple of 18 times forecast earnings for 2017 of 74.2 Aussie cents (at the middle of the range and at current exchange rates). **HOLD**.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in Computershare. You can find out how to invest directly in these and other InvestSMART portfolios by **clicking here**.*

Staff members may own securities mentioned in this article.

This minnow of the financial services world is growing its loan pools and investing in its core business.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 24 FEBRUARY 2017

FSA Group: Interim result 2017

Consumer debt levels are at record highs. A prolonged period of low interest rates is lulling many borrowers into large loans and mortgages that they couldn't otherwise afford if interest rates were higher.

Key Points

- ***Services division low growth***
- ***Loan pools rising, arrears improving***
- ***Spec Buy up to 3% of portfolio***

FSA GROUP (FSA) / SPECULATIVE BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.38	3%	High	Very High

SPEC. BUY Below $1.30 — HOLD — SELL Above $2.00

$1.38

This is especially true for interest-only loans, which aren't cushioned by principal repayments. Interest-only mortgages now account for 40% of all approvals, up from around 30% in 2010. These types of loans have always been popular among investment borrowers but now, partly due to affordability, many owner-occupiers are also turning to these loans; one in four owner-occupiers now has an interest-only mortgage. With interest rates at record lows, this is a precarious situation.

If Australia's economy slows and unemployment edges up, a deluge of borrowers will hit the breadline. One of the few companies that benefits from times of crisis is FSA Group – Australia's largest originator of debt agreements and subprime loans.

FSA's revenue notched up 9% to $33.5m for the six months to December, which was surprisingly good given the healthy state of Australia's economy and low interest rates.

Services

The company's Services division, which administers debt and personal insolvency agreements, had a reasonable half with a 2% increase in new clients and the total number rising 4% to 19,553, which lifted revenue 4%.

Pre-tax profit, however, was flat at $6.5m due to an increase in administration expenses as the company lays the foundations for future growth. We're comfortable sacrificing a little profit growth today for a lot more tomorrow – one of our biggest concerns should another financial crisis come along isn't that FSA will go bust, it's that it won't have enough time to hire and train staff to fully take advantage of it, leaving money on the table.

Net profit rose 40% to $7.4m, though most of the growth was due to unrealised gains on derivatives.

In 2015, FSA entered into two interest rate swap agreements, which effectively locked $80m of its funding at a fixed rate for 5 years. Rising bond yields during the half increased the value of these swap agreements to the tune of $1.6m before tax, though this is unrealised and doesn't affect cash flow.

Excluding the gain from derivatives, the company's underlying net profit still rose a healthy 12% to $6.2m.

Lending

Services accounts for around two-thirds of the company's underlying net profit, but it was FSA's Consumer Lending division that contributed the growth – pre-tax profit for the division rose 31% to $3.3m, which was helped by a decrease in bad debts.

Table 1: FSA interim result

SIX MONTHS TO DEC ($M)	2016	2015	+/– (%)
FEES FROM SERVICES	25.8	24.9	4
NET FINANCE INCOME	7.5	5.9	29
REVENUE	33.5	30.7	9
UNDERLYING NPAT	6.2	5.6	12
UNDERLYING EPS (C)	4.99	4.46	12
INTERIM DIVIDEND	3.0c (unch), fully franked, ex date 3 Mar		

Total loan pools were up 20% to $309m, making FSA the country's largest provider of home loans where the borrower doesn't meet standard lending criteria. These are known as subprime or non-conforming mortgages and are used to consolidate a client's debts. FSA's mortgage loan pools recorded a 14% increase, while personal loans almost tripled.

> **“ FSA intends to grow total loan pools to $500m over the next three years.**

What most caught our attention in this result was a sharp decline in the number of home loans where payments are more than 30 days overdue. The 30-day arrears rate fell from 2.67% to 1.30%, which is unusually close to the 1.16% rate for prime mortgages. Given FSA is lending to people bankrupted or close to it, a higher rate of arrears is to be expected, but the company clearly has a knack for cherry-picking the best borrowers – the arrears rate for subprime mortgages is typically 4–5%.

The company increased its home loan facility with Westpac from $250m to $275m during the half and its personal loan facility from $20m to $30m. FSA intends to grow total loan pools to $500m over the next three years.

The Lending division carries significant risk due to its leveraged nature and, if the economy worsens, we expect a painful uptick in arrears. A worst case scenario could see the division wiped out entirely.

The debt is, however, non-recourse to FSA, sitting in its own separate trust, so a spike in client defaults wouldn't cause the company to go bust – just 3% of FSA's equity is at stake. Nonetheless, FSA would stand to lose nearly a third of its earnings, so the share price could still get hammered.

Management says underlying net profit should rise 10–15% in the 2017 financial year, with earnings per share between 10.85 cents and 11.33 cents. That puts the stock on a forward price-earnings ratio of only 12 or so, with a fully franked dividend yield of 5.1%. FSA certainly carries its share of risks, but we're being well compensated for them.

The stock has risen 42% since we upgraded it a year ago on **26 Feb 16** (Speculative Buy – $0.96) and we're pleased with the company's progress. We're raising our (Speculative) Buy price to $1.30, but that means the stock stays a **HOLD**.

Note: With several substantial shareholders, FSA Group's stock is highly illiquid with a large spread between the bid and offer prices. To ensure you aren't caught overpaying, it's important that your buy orders have a limit price and are not made 'At Market'.

Disclosure: The author owns shares in FSA Group.

This online education company's steady progress is hidden behind non-cash writedowns.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 24 FEBRUARY 2017

3P Learning: Interim result 2017

3P Learning's first-half results, the first with Rebekah O'Flaherty at the helm, had that 'new-CEO' look about them. Business closures, writedowns and cost cutting made for a messy result, and a statutory loss of $8.8m. That figure understates the progress in key areas. Underlying operating profit (before depreciation and amortisation) actually rose 19% to $8.3m.

Key Points

- ***Underlying EBITDA up 19%***
- ***Mathletics impairments concerning***
- ***BUY up to $1.00***

3P LEARNING (3PL) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.00	3%	High	High

BUY Below $1.00 — HOLD — SELL Above $2.00

$1.00

There was also much less 'sizzle' than in the company's prospectus from June 2014, which featured dazzling investments in software-as-a-service (SAAS) start-ups. It may be back to school time for students but it's back to basics for 3P Learning.

The all-important Asia-Pacific division saw revenue rise 7%, due to a 1% increase in licences and a 6% increase in average revenue per user licence (ARPU). Operating earnings (before depreciation and amortisation) increased 18% to $8.6m.

Despite little licence growth, it is satisfying to see the company use its pricing power, a core pillar of our initial investment thesis in ***3P Learning: A textbook case*** (Buy – $1.04) back in November last year. Management expects to pull this lever harder in the future, segmenting Mathletics by school years and charging higher prices for the segments with the highest demand. Beyond that, public students, who pay half or a third of the price of private students, may face across-the-board price increases.

Licences in Europe, the Middle East and Africa (EMEA) increased 18% and ARPU increased 3%, leading to 21% revenue growth in constant currency terms. However, the depreciation of the UK pound reduced this to minus 6% in Australian dollars. Despite that, EBITDA increased 62% to $1.3m.

By contrast, the Americas result was mediocre. Licence growth was stagnant and the business suffered an 8% decline in ARPU in constant currency terms, although prudent cost control kept the EBITDA loss flat at $1.6m. We initially liked the opportunity for US growth but this now appears a long way off.

Table 1: 3PL interim result 2017

SIX MONTHS TO DEC ($M)	2016	2015	+/(–) (%)
REVENUE	25.1	22.9	10
APAC EBITDA	8.6	7.3	18
EMEA EBITDA	1.3	0.8	(62)
AMERICAS EBITDA	(1.6)	(1.6)	0
STATUTORY NPAT	(8.8)	3.2	(375)
OPERATING CASH FLOW	(4.7)	(4.7)	0

The difficulties of a model in which licence fees are received at the start of the school year were also revealed this half. The operating cash inflow was $4.7m as receivables rose to $24m, requiring a $13m increase in debt to keep the lights on. This figure is $10m less today than it was in December, but for a company that wants to portray itself as a SAAS business, dropping jargon like '**CAC**' and '**LTV**' into its presentation, it's quite a stretch. SAAS businesses have predictable monthly revenues, not working capital tides like this.

New hand on the tiller

We're now six months into Rebekah O'Flaherty's rule and she's leaving her mark. 3P will cease enrolling students in its science product IntoScience, resulting in a $2.9m impairment. The investment in Desmos was also impaired by $4m. An Indian development office was closed, resulting in total employee numbers continuing to fall, to 250 by June 2017, down from 338 in June 2016. The US division was moved to a lower cost telesales approach, as is used in Canada. And the office footprint is under review. All up, the changes are expected to save $2m annually.

> **“When a company like 3P capitalises a lot of development, many expenses bypass the profit and loss statement.**

None of this is a matter for huge concern – but the $8.4m impairment of intangibles associated with Mathletics and Spellodrome might be. With a new version of Mathletics, built on a different code base, set for release shortly, new management considered the old code base impaired. This move highlights how EBITDA can be inflated easily.

When a company like 3P capitalises a lot of development, many expenses bypass the profit and loss statement. EBITDA is higher as a result. Imagine, for example, that the investment was initially expected to have a five-year life but actually became obsolete after three. That would produce a ‘non-cash write down’. But if we spread the true cost of the development over its three-year useful life, it would result in much lower actual EBITDA.

It’s too early to say whether this is the case with 3P Learning but it’s something we’ll be watching. The company will invest $10m this financial year and, while all of it will be capitalised, the company has taken a conservative step by reducing the useful life from five to three years.

Despite a few bruises, we think our investment case has survived the company’s first reporting period on our Buy list, although we have reduced our Buy price to $1.00 from $1.20 as a precaution, just to add in a slightly higher margin of safety. That puts the stock right on the new Buy price – and we’ll stick with **BUY** for now.

Staff members may own securities mentioned in this article.

Two very different results from these private health insurers suggest one has the better strategy.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 21 FEBRUARY 2017

Medibank & NIB: Interim results 2017

Earlier this month, the Minister of Health approved 2017 average premium increases of 4.8% across Australia's private health insurers – the lowest in more than a decade, and down from 5.6% last year. Medibank Private, Australia's largest private health insurer, received approval for a 4.6% increase, while smaller competitor NIB was allowed a 4.5% rise in prices.

Key Points

- ***Significantly better result from NIB***
- ***Operating margins moving in opposite directions***
- ***NIB also attracting over-55s***

MEDIBANK PRIVATE (MPL) / HOLD

Price at review **$2.83** | Max. portfolio wght. **5%**

BUY Below **$2.00** | HOLD | SELL Above **$3.50** | **$2.83**

NIB HOLDINGS (NHF) / HOLD

Price at review **$5.18** | Max. portfolio wght. **5%**

BUY Below **$3.50** | HOLD | SELL Above **$7.00** | **$5.18**

This tells us a couple of things. Firstly, if the trend is for premiums to rise more slowly, it means Medibank and NIB will be increasingly reliant on growing their number of policyholders. Secondly, raising premiums at three times the rate of inflation isn't a great way to do that. Declining affordability makes attracting new customers a bigger challenge every passing year.

Or, at least, it has been for Medibank. A whole stadium full of customers – 29,000 of them – left the company in the six months to December. And it's easy to see where they're going: just over 11,000 signed up to NIB.

Indeed, NIB accounted for 50% of total industry growth in the first half of the financial year, despite having a market share of just 8.2%. NIB's strategy of targeting young people by offering cheaper products with lots of exclusions has increased its market share for 17 consecutive years.

Market share is a big deal in the health insurance industry. Medibank has 3.8 million members, while NIB has just over a million. Just two companies, however – **Ramsay Health Care** and **Healthscope** – control nearly half of Australia's private hospitals. Medibank's loss of market share undermines its negotiating position with the hospitals, while NIB's gain strengthens it, which ultimately feeds back into better service prices and lower claims inflation.

Interim results

As you might have guessed, NIB reported a strong interim result – roughly a bazillion times better than Medibank's – with premium revenue increasing 7% to $995m, compared to revenue growth of just 1% for Medibank.

As you make your way down the companies' income statements, the disparity only grows: management expenses rose 8.2% for Medibank compared to 7.6% for NIB, and the overall gross margin went in opposite directions – Medibank's fell from 17.2% to 16.9%, while NIB's grew from 15.1% to 17.3%.

Net profit rose a modest 2% to $232m for Medibank – despite a 6% decline in operating profit – thanks to a jump in income from the company's investment portfolio. The company has been increasing its allocation to growth assets, such as shares and property. That's good when asset prices rise, as they did this period, but Medibank's 26% allocation also makes for more volatile results than NIB's 19% allocation.

Table 1: MPL interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	3,397	3,380	1
OPERATING PROFIT ($M)	250	267	(6)
NPAT ($M)	231	228	2
EPS (CENTS)	8.4	8.3	2
INTERIM DIVIDEND	5.25 cents, fully franked, up 5% ex date 4 March		

NIB, on the other hand, achieved a 65% increase in net profit to $71m, driven by fewer claims in Australia, a strong result from its small New Zealand operations, and a turnaround in the inbound international health insurance division. The 7% increase in premium revenue was matched by a modest 3.5% increase in claims expense, which led to a 43% jump in operating profit.

> **People still want health insurance, they just can't afford the bells and whistles anymore.**

Baby boomers

Interestingly, NIB's sales to over-55s saw the greatest uptick during the period, with total policyholders in this demographic rising 5%, compared to no growth in the under-40s.

Table 2: NHF interim result

SIX MONTHS TO DEC	2016	2015	+/–(%)
REVENUE ($M)	965	903	7
OPERATING PROFIT ($M)	95	66	43
NPAT ($M)	71	43	65
EPS (CENTS)	16.4	9.9	66
INTERIM DIVIDEND	8.50 cents, fully franked, up 48% ex date 2 March		

NIB's ability to grow this demographic at the expense of Medibank is impressive, as it has historically been the latter's domain; Medibank has a strong focus on service and benefits over price. That older demographics are switching from Medibank to NIB suggests affordability is becoming an issue all the way up the income ladder. People still want health insurance, they just can't afford the bells and whistles anymore.

Unfortunately, Medibank's cheaper 'ahm' brand didn't gain much from the changing consumer preferences, with total policyholders for the brand increasing a modest 4%. NIB is clearly doing something right on the marketing front, too.

NIB's management expects underlying operating profit of $140-150m for 2017. Although declining affordability is undoubtedly a growing issue for the private health insurance industry, the higher churn rates seem to have benefited NIB so far given its cheaper products. We're increasing NIB's price guide and, with a forward price-earnings ratio of around 20, we continue to recommend you **HOLD**.

Medibank's management expects an underlying operating profit of $490m in 2017. 'Customer experience, value and outcomes are all improving, but it will take time to turn around the historical market share trajectory,' said management. We expect NIB to continue to outperform Medibank on both the customer acquisition front and in terms of earnings growth. With this in mind, Medibank's lower price-earnings ratio of 18 isn't enough to tempt us and we're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

Telstra's result caused its shares to tumble, but was it really that bad?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 21 FEBRUARY 2017

Telstra: Interim result 2017

Is this a utility or a tech business? Telstra has long struggled with its dual identity but this result highlighted that it remains both, in an unflattering combination: it retains the sluggish growth of a utility but combines it with all the change and uncertainty of a tech business.

Key Points

- ***Declining revenues and profit***
- ***Mobile business generating strong margins***
- ***Borrowed to pay dividends***

TELSTRA (TLS) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.83	**7%**	**Low**	**Medium**

BUY Below **$4.00** | **HOLD** | **SELL** Above **$5.50**

$4.83

Everyone knows the NBN will cut into broadband margins. Until now, Telstra has owned all its infrastructure and earned stunning margins because of that ownership.

It has also been able claim superior network quality in fixed broadband. That will all change when NBN provides standard fibre used by all competitors and Telstra moves from being an asset owner to a reseller. Margins will fall.

That fact, as well as the loss of billions in annual earnings before interest, tax, depreciation and amortisation (EBITDA) from the closure of the shrinking but still lucrative copper wire business, has largely been responsible for the negativity surrounding Telstra and a large chunk of its share price decline.

Strong market share

Yet the migration to NBN is progressing well. Telstra's market share from NBN services remains high at 51% as it added 290,000 new connections – despite charging higher prices for the use of the same infrastructure.

Customer inertia is, so far, proving to be more powerful than competition.

Telstra is also being compensated for the loss of its copper network and will receive about $11bn in payments over the next few years. The company will also receive about $1bn a year for over 30 years from NBN Co for access to equipment like ducts and exchanges.

Telstra must maintain these assets, of course, but this will be a valuable annuity stream that, amid all the talk of decline, gets neglected.

Mobile decline

Despite gaining 200,000 new subscribers, mobile EBITDA fell 3% to $2bn for the half-year. Average revenue per user (ARPU) fell slightly but remains far above peers at over $67 per user per month.

Competition is intensifying in the mobile business. Higher inclusions, more churn and lower penalty fees are all hurting but Telstra maintains market dominance and, at 41%, some of the highest EBITDA margins in the world. Those margins have held steady despite aggressive competition.

Table 1: Telstra interim result

SIX MONTHS TO DEC	2017	2016	+/(–) (%)
REVENUE ($BN)	13.7	14.2	(3.5)
EBITDA ($BN)	5.2	5.3	(1.6)
EBIT ($BN)	2.9	3.2	(9.5)
NPAT ($BN)	1.8	2.1	(14.4)
CAPEX ($BN)	2.1	2.1	(1.1)
EPS (C)	14.8	17.2	(14.0)
DPS (C)	15.5	15.5	Nil
INTERIM DIVIDEND	15.5c, fully franked, ex date 1 March		

Telstra is spending madly to upgrade its network and maintain margins. Capital expenditure rose to $2.1bn or 16% of sales and the business will commit about 18% of revenues to capital expenditure next year as it seeks to develop new 5G technology.

It is hard to say whether this is an aggressive use of cash to entrench dominance or a deeply defensive strategy that recognises waning strength.

> “The combination of flat revenue, high dividends and high capital expenditure might raise an eyebrow.

Away from mobiles, both the fixed line and data business reported lower EBITDA but Network Applications and Services (NAS, which is a collection of cloud services) again grew swiftly, increasing EBITDA by 330% to $117m.

It is notable that NAS profit growth came from a mere 18% jump in revenues. That suggests the business is highly scalable but also the focus on EBITDA exaggerates growth.

Unsurprisingly, Telstra is optimistic that growth in NAS as well as investments in new healthy technologies and media will offset declines elsewhere in the business. In our view, Telstra is better thought of as a stagnating business than a growing one.

Follow the cash

The combination of flat revenue, high dividends and high capital expenditure might raise an eyebrow.

Operating cash flow of $3.2bn is used primarily to fund capital expenditure of $2.2bn. The remaining $1bn of free cash flow isn't enough to cover the generous dividend of $1.9bn. Telstra borrowed almost $1bn to maintain its dividend, increasing net debt by 5%.

Net debt appears high at $14.8bn but Telstra generates plenty of cash and can handle some debt. Interest coverage, a measure of debt-servicing stress, sits at a comfortable 14 times.

Is the dividend sustainable? For at least the next two years, probably. Payments from NBN are lumpier than expected and are tied to NBN completions but they should be enough to meet the cash shortfall. In our view, however, dividends should be cut and the cash should be reinvested.

We've been critical of Telstra in the recent past even as its share price has soared. A dismal view has now become consensus and expectations have lowered considerably.

It is possible the negativity has gone too far. Despite intense competition and unfavourable regulatory rulings, the mobile business is performing well and the NBN business has been strong. This result wasn't as bad as it appeared.

The stock's price-earnings multiple of 16 doesn't appear particularly cheap, but depreciation has risen to reflect higher capital expenditures and recent acquisitions. An EV/EBITDA multiple of less than 8 suggests Telstra is fairly priced, but some way from a level at which we'd be interested in buying. We'd cutting our Buy price down to $4 and our Sell price to $5.50. **HOLD**.

Staff members may own securities mentioned in this article.

The domestic online employment classifieds business saved the day this half but Seek has more aces to play.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 21 FEBRUARY 2017

Seek: Interim result 2017

It's difficult not to get excited listening to Seek's management. When you hear managing director Andrew Bassat say things like 'we're believers in doing things right rather than quickly', you know he just gets it. With management thinking a decade ahead, it almost seems sacrilegious to review a financial result that covers just six months.

Key Points

- ***Good result from domestic employment***
- ***Weak economies hurt overseas businesses***
- ***Education still has potential***

SEEK (SEK) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$15.52	6%	Medium	Medium

BUY Below $14.00 · HOLD · SELL Above $22.00

$15.52

Of course it's our job to provide regular analysis, though, so here you are. While Seek's revenue growth for the six months to 31 December grew just 2%, that figure understates the performance of the business. Removing the negative effects of Aussie dollar strength and the **evaporation of the Seek Learning business**, underlying revenue growth was 12%.

Excluding significant items, earnings before interest, tax, depreciation and amortisation (EBITDA) fell 5% as **early stage venture losses** ramped up.

Particularly pleasing was the 'ANZ Employment' division, which contains Seek's domestic online classifieds business in Australia and New Zealand. When we upgraded the stock in ***Seek finds success overseas*** in September 2015, we were enthusiastic about the classifieds businesses spending money on growth initiatives and to 'widen the moat'. Those investments – though by no means complete – are now showing up in the results, with revenue and EBITDA from ANZ Employment up 13% and 10% respectively.

In the 2016 interim result the International division was the star, but it dimmed a little this period. Despite a 4% increase in revenue (or 11% excluding foreign exchange movements), EBITDA from the company's four main international businesses fell 3%.

The New York Stock Exchange-listed Chinese-based Zhaopin was the exception, with EBITDA increasing 8%. Excluding foreign exchange movements, though, EBITDA jumped 20% and Zhaopin is without question one of Seek's most promising investments.

Fight club

Earlier this week management announced that Seek had joined a private equity consortium that proposes to privatise Zhaopin at a price of US$18 per **ADR**. Seek intends to maintain a stake similar to its current 62% holding in Zhaopin although the consortium might have a fight on its hands. The takeover price doesn't seem particularly attractive and several high-profile Australian investors in the Chinese company have started pushing back.

Table 1: Seek interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
REVENUE ($M)	492	482	2
EBITDA ($M)	184	193	(5)
NPAT ($M)	84	93	(10)
EPS (C)	24.2	27.1	(11)
INTERIM DIV. (C)	23c fully franked, up 10%, ex date 28 Mar		

Elsewhere, other International businesses were less positive. Weaker economies in Malaysia, Hong Kong and Singapore hurt Seek Asia's results, although that was offset by continued growth from the less mature markets of the Philippines and Indonesia. Overall Seek Asia's revenues and EBITDA fell slightly, although, as we mentioned in ***Seek's Learning difficulties*** last November, there's a risk economies in the region might deteriorate further.

Results from the Americas were even worse. The Brazilian economy has now suffered under its 10th consecutive quarter of economic contraction. On an underlying basis EBITDA fell 16% and there's no end in sight. While the 27% plunge in EBITDA from Mexico sounds terrible, this business is considerably smaller than Brazil and the decline was mainly due to cost increases as Seek invests for growth.

> **"Don't get hung up on the swings and roundabouts in any result.**

Crash diet

Having been forced to slim down by regulatory changes, Seek's Education division suffered during the first half. The decision to close Seek Learning's vocational business incurred $16m in one-off costs. Management gave more details about the new education start-up on the conference call, but it's unlikely to be anywhere near as profitable as Seek Learning's first incarnation.

Elsewhere in Education, the Online Education Services business (formerly known as Swinburne Online) is producing fantastic results with EBITDA up 21% in the half. It looks like management renamed this business with the intention of launching other online education offerings. Given the success of Swinburne Online, there's enormous potential here.

The early-stage ventures produced losses in line with expectations at $11m, although they'll be higher in the second half. Management likes to exclude these to show the underlying performance of the business and, if you do that, Seek's net profit rose 11% to $114m. The company is on track to meet the higher end of profit guidance: around $220m for the full year (or earnings per share of 63 cents).

We prefer to deduct the various losses and the significant items, though, as they're in the ordinary course of business. Using our preferred measure, net profit fell 10% to $84m.

Don't get hung up on the swings and roundabouts in any result. Seek's underlying revenues, earnings and, of course, dividends have been rising nicely over time. While economic conditions could cause some upsets occasionally, this is a management team you want to back for the long term.

We remain hopeful of another buying opportunity, even if the one we got almost 18 months ago at around $12 a share (see ***Seek finds success overseas*** on 8 Sep 15 (Buy – $12.06)) now seems an increasingly distant prospect. For now, **HOLD**.

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

Disclosure: The author owns shares in Seek.

Is the turnaround finally here?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Fleetwood: Interim result 2017

To those unfamiliar with our investment case, Fleetwood's half year result didn't sound too impressive. Net profit of just $3.6m on revenues of $153m suggests a low margin business, while abysmal return on capital numbers suggest poor quality to boot.

Key Points

- ***Another profitable half***
- ***Turnaround under way***
- ***RV profits expected next year***

FLEETWOOD CORPORATION (FWD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.12	4%	Med–High	Med–High

BUY Below $1.80 — **HOLD** — **SELL** Above $3.50

$2.12

Yet we have recommended Fleetwood for the business it could be rather than one that it is currently. Adding to its attraction, Fleetwood has been cheap for a long time.

With that said, let's look at the result a little more closely.

Earnings before interest and tax (EBIT) was small but meaningful because it was the second consecutive underlying profit recorded after years of losses.

It is still a small number, though: $5.5m represents an EBIT margin of just 3.6%. Return on capital remains lousy too. However, with capital employed falling and profits rising, the turnaround appears to be on track.

Turnaround in caravans

Crucial to that process have been changes to the recreational vehicles (RV) business, which manufactures and sells caravans.

In ***Fleetwood starts to turn*** last May, our visit to a trade show suggested that the RV product range had improved considerably as new manufacturing facilities, new dealers and new designers were all installed. That work has paid off with revenue from the division up almost 90% compared to the same period last year.

Although losses from RV have narrowed to $3m over the period, they haven't been eliminated.

It appears that new staff hired to complete more orders aren't yet generating the productivity of more experienced staff so higher volumes haven't yet been accompanied by higher margins.

Over time we expect manufacturing costs to fall as productivity improves. We should see profits from the RV business – for the first time since 2013 – next year.

Another positive is the expanded dealer network. Encouragingly, management expects that half the network will return to exclusive distribution agreements, a key plank for success during the business's halcyon days. All in all, the injured RV business does appear on the mend.

Sell accessories please

The parts and accessories business was less impressive. We argued in ***Fleetwood's asset problem*** that Fleetwood should sell the business as it consumes huge amounts of capital and spits out little cash. That view remains.

The manufactured accommodation business shrugged off the mining decline and now supplies the education and affordable housing segments. Revenue rose 16% but it can be lumpy from period to period. EBIT rose substantially, to $5.9m, as scale benefits and lower costs increased margins. This has been the key driver of better profitability.

Table 1: Fleetwood interim results

HALF YEAR TO DEC ($M)	2017	2016	+/(–) (%)
RV EBIT	(3.0)	(3.9)	24
ACCESSORIES EBIT	0.6	(0.6)	n/a
ACCOMMODATION EBIT	5.9	(0.8)	n/a
VILLAGE EBIT	3	4	(24)
TOTAL EBIT	5.5	2.8	96
OP CASH FLOW	(7)	52.9	n/a

Occupancy of Searipple, a managed village at Karratha, returned to low levels of about 30%. At this level, there is little profit but at least it doesn't generate losses or consume much cash. Searipple will need higher occupancy to generate meaningful profit but remains a cheap option within the business.

> **Dividends were again not paid but, with the recovery still early, this is prudent.**

Changing cash flow

For the second time, we have noticed poor cash generation. This is unusual as the business has historically delivered excellent cash flows. Management claims the usual things such as higher working capital and delayed payment terms and that all will be well next time.

We suspect, however, that the cash dynamics of the business have changed along with the revenue mix.

Fleetwood has historically enjoyed strong cash generation but, as its revenue shifts from village operations to modular accommodation and RVs, the business will need to spend money upfront and collect it at a later stage, increasing working capital requirements. This is likely a permanent change.

This isn't a huge problem but we should recognise that reorientating the business away from mining exposure, while vital for continued profitability, has come at a cost.

Dividends were again not paid but, with the recovery still early, this is prudent. We expect dividends to recommence next year. It didn't look like it from the headline numbers but this was an excellent result and our investment case is well on track. **HOLD**.

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

Disclosure: The author owns shares in Fleetwood.

A welcome improvement in Australia was offset by a surprise – albeit likely temporary – decline overseas.

BY JON MILLS • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Ainsworth Game: Interim result 2017

In what long-suffering shareholders might describe as an understatement, Ainsworth Game Technology chief financial officer Mark Ludski admitted that 'game development is obviously key to the future' on today's conference call.

Key Points

- ***Interim dividend cancelled***
- ***Some good news locally, finally***
- ***Decline overseas likely temporary***

AINSWORTH GAME TECHNOLOGY (AGI) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.69	2%	Med–High	Very High

BUY Below $1.50 | **HOLD** | **SELL** Above $3.00

$1.69

Ainsworth's failings in Australia in this area are why this recommendation is down 44% (or 38% including dividends) since we first upgraded the stock in ***Ainsworth spins the wheels in Vegas*** on 5 Nov 15 (Buy — $3.03), despite generally good performance overseas.

Dividend cancelled

To speed up game development, research and development was cranked up by 29%, to $18m. Along with increased marketing and administration costs, and poor sales, this led to a poor profit performance.

Operating cash flow also declined, by 59% to $7m, albeit helped by a $15m increase in inventory due to management expecting higher sales in the United States in the second half as is usually the case.

All this explains why the Board cancelled the interim dividend and hasn't yet made a decision on the amount of the final dividend, if any.

However, net debt remains reasonable at around 0.6 times the last twelve months' earnings before interest, tax, depreciation and amortisation (or EBITDA) and current assets – one-third of which is inventory – are more than four times current liabilities.

As such, unless this suggests management is worried about other problems (such as South American receivables potentially being at risk), we suspect Novomatic's influence is the major factor.

If we're correct, we agree with its long-term perspective to grow the business at the expense of dividends. And if the lack of dividends drives down Ainsworth's share price and perhaps gives Novomatic the opportunity to mop up the rest of the company more cheaply, the company's founder and his wife still hold a blocking stake of more than 10%.

Despite the dividend cut, however, there are some positive signs – finally – in Australia.

Dawn down under?

In its recent profit warning, management noted that sales had then fallen 'approximately 30%' compared to the prior corresponding period. However, first half sales of 1,483 represent a decline of 'only' 23% and, even better, are more than 55% higher than in the second half of 2016.

Table 1: Ainsworth interim result 2017

SIX MONTHS TO 31 DEC	2017	2016	+/(–) (%)
AUST. REVENUE ($M)	41	50	(18)
INT. REVENUE ($M)	82	92	(11)
TOTAL REVENUE ($M)	123	142	(13)
FOREX GAINS ($M)	5	10	(50)
UNDERLYING EBITDA ($M)	30	45	(33)
UNDERLYING EBIT ($M)	16	35	(54)
UNDERLYING NPAT ($M)	11	25	(56)
UNDERLYING EPS (C)	3.2	7.4	(57)
DPS (C)	–	5	(100)

This is encouraging given **Aristocrat**'s recent dominance in Australia – 80% of pokie sales relate to its very successful Lightning Link series of games. Even more so in that Ainsworth appears not have to chased volume with lower prices, increasing average selling prices by 5%, from $21,300 to $22,300.

There is also some good news on the game front: some of Ainsworth's new games have been performing at 30–40% above the house average. Although this is still below the

> **Despite the disappointing result and dividend cut, there were positive signs in this result.**

Lightning Link series, this supports Ainsworth in upcoming negotiations with ALH, 75% owned by **Woolworths** and the owner of some 12,000 pokies in Australia.

Whisper it, but we may have reached the cyclical bottom in Australia.

'Temporary' declines overseas

By contrast, performance overseas was disappointing. As in Australia, the transition to new cabinets including the A600 and A640 was part of this and, unfortunately, delays in regulators approving the new hardware and software also contributed.

This meant sales of Class III machines (see Shoptalk) in North America fell 26%, to 988, but picked up late in the half after the necessary approvals were received.

What growth that occurred primarily came from Class II machines, with the number 'on participation' (ie rented to casinos in return for a share of the daily winnings) rising 10% to 1,187. Class II machines on participation have now risen 27% since the acquisition of Nova (see ***Ainsworth enters new market with Nova***) and this will likely continue as Ainsworth releases more Class II-based games.

The company still expects substantially higher sales in the second half due to American casinos skewing their capital expenditure to the first half of the calendar year. Of course, if management is wrong, then inventory may have to be written down.

New gaming taxes

In Latin America, the transition to the A600 was again a culprit but was joined by new gaming taxes being imposed in Mexico and Argentina. The decline in the peso on fears the new US President will renegotiate trade agreements also contributed.

While outright sales of machines fell 12%, to 1,228, the number of machines on participation rose 19%, to 2,172, and the average revenue per day earned on these machines remained steady at US$16 per day.

Class III games include slot machines that you generally find in Australia and around the world in casinos where a random number generator determines whether a player wins. Class II games are generally games of chance known as bingo linked to a central server that determines which player wins.

We tend to agree with management's view that these declines in the Americas will prove temporary. Ainsworth still only has a 4% market share across South and Central America while its market share in most US jurisdictions is also below 4%.

Ainsworth also has a number of games in both North America and Latin America that perform above the house average. 15 brands perform between 1.0x and 2.2x the house average in North America while a similar number perform even better in Latin America, at between 2.1x to 3.0x the house average.

No doubt this is one reason why it was able to increase its average selling price in both parts of the Americas, albeit helped by the transition to the more-expensive A600.

While we still have concerns about the tie-in with Novomatic (see ***Ainsworth Game Technology: Result 2016***), game development is one area in which Ainsworth should benefit greatly from this arrangement.

Six Novomatic games are already being adapted for Ainsworth's machines and more should follow after the transaction completes (currently projected for September 2017).

Still a HOLD

So despite the disappointing result and dividend cut, there were positive signs in this result.

The company has guided to 2017 profit before tax of 'at least $56m' which puts Ainsworth on a PER of around 14. **HOLD**.

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

Disclosure: the author owns shares in Ainsworth Game Technology

Shoptalk

Class III games include slot machines that you generally find in Australia and around the world in casinos where a random number generator determines whether a player wins. Class II games are generally games of chance known as bingo linked to a central server that determines which player wins.

Dose sales are slowing but there was good news on the R&D front for this radiotherapy maker.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 23 FEBRUARY 2017

Sirtex Medical: Interim result 2017

Give a capuchin monkey a piece of apple, and you have a happy monkey. But give it two pieces and then take one away and **the monkey throws a fit**. Although both conditions have the same outcome, the sense of loss that follows something being taken away can be overwhelming, for capuchin monkeys and investors.

Key Points

- ***Dose sales slowing***
- ***Australian hospital expansion***
- ***Cutting non-core R&D***

SIRTEX MEDICAL (SRX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$16.39	3%	Very High	Very High

This interim result was the worst in years, but mostly on a relative scale. Sirtex Medical has now posted 50 consecutive quarters of sales growth. That dose sales of Sirtex's main product – a radiotherapy for liver cancer known as SIR-Spheres – only increased 6% to 6,047 units was disappointing, but mainly because we're used to double-digit growth. So, let's not be monkeys about it.

Sirtex's share price has more than doubled since we first upgraded it in ***Sirtex enters remission*** on 8 Nov 10 (Speculative Buy – $5.90). That's an 18% annual return, with dividends on top. The recent share price fall is unfortunate, but what matters more is where the company stands today.

Treatment centre expansion

The number of treatment centres using SIR-Spheres worldwide increased 10% to 1,060 in the six months to December. Sales in the US – which accounts for 80% of total revenue – rose 6% and prices were stable at around US$15,000 for a 5ml dose. Unfavorable currency movements, however, meant that when revenue was translated back into Australian dollars, sales were flat.

The company blamed some of the slowdown in dose sales on lower insurance reimbursement rates and clinicians waiting for overall survival data from the main ongoing clinical trial, which is to arrive later this year.

As we explained in ***Sirtex Medical: The bull and bear case***, a big driver of the slowdown in sales was also competition from a new drug, Lonsurf. It isn't a direct competitor, though, in that it's an oral medication.

Lonsurf is undoubtedly more convenient to administer and has little risk of complication. Doctors are willing to use Lonsurf earlier in the 'treatment ladder', which is what caused the dip in sales. Patients that would have been given SIR-Spheres were put on Lonsurf, which delayed them buying from Sirtex. That delay was enough to cause dose sales to slow, but we expect this to normalise next year when Lonsurf will have had a full year on the market.

Table 1: SRX interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
DOSE SALES (UNITS)	6,047	5,728	6
REVENUE ($M)	112.8	112.6	0
NPAT ($M)	20.8	25.9	(20)
EPS (CENTS)	36.1	45.4	(21

Asia Pacific sales thankfully picked up some of the slack and the company managed to grow dose sales 10% in the region, with Australia pulling most of the weight. The number of hospitals in the region certified to use the SIR-Spheres treatment increased by 9% to 144.

Up-front investment

Net profit fell 20% to $20.8m, mainly due to an 8% increase in operating expenses. Marketing expenses grew 7%, while administration expenses were up 14% as the company builds its sales team and the infrastructure necessary for continued growth.

More marketing spending impacts short-term profitability, but we're more than happy to accept lower profits today in exchange for higher growth tomorrow, given the company's ability to reinvest at high rates of return – Sirtex's return on equity and net profit margin both consistently hover above the 20% mark.

> “The four projects added nothing to our valuation of Sirtex and were arguably detractors.

Sirtex spent $10m this half on clinical studies that it hopes will further improve acceptance for SIR-Spheres among doctors. It was also extremely pleasing to hear management say that it will wind down non-core research and development and will end three of four main side projects: a special anti-oxidant that makes healthy tissue less sensitive to radiation; and two separate programs researching nanoparticles.

As for the fourth project, Sirtex will finish a Phase 1 clinical trial for the compound, which treats sepsis (the ‘Histone Inhibition Program’), and then consider its commercial viability.

All four projects had only a small probability of working out and we are glad that management intends to focus all of its energy on developing the SIR-Spheres product, which already has regulatory approval and has done well commercially.

The four projects added nothing to our valuation of Sirtex and were arguably detractors. All costs associated with them were expensed in the income statement, rather than being capitalised, so their closure should improve profitability. Management is targeting $7m of cost savings, which are expected to show up in the 2018 financial year.

Management expects earnings before interest, tax, depreciation and amortisation (EBITDA) of $65–74m in 2017, putting the company on a price-earnings ratio of 19 based on consensus estimates for 2017 earnings. That’s not enough to consider an upgrade and, as a one-product company, Sirtex remains a high-risk stock. It’s important to keep your portfolio weighting below our recommended maximum of 3%.

Nonetheless, with continued sales growth, net cash of $99m, and plenty of potential from its ongoing clinical trials, there’s still every reason to **HOLD**.

Staff members may own securities mentioned in this article.

Chief executive Chris Kelaher was surprised by the market's reaction to IOOF's result, and he has a point, but we're nonetheless sticking with our reduced price guide.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 23 FEBRUARY 2017

IOOF takes its lumps

When we saw IOOF management on Friday last week, they were clearly surprised by the reaction to last week's interim profit announcement – although chief executive Chris Kelaher did suggest he was getting used to it.

Key Points

- ***Net operating margin expected to rise in second half***
- ***Fund flows positive***
- ***Sticking with new price guide***

IOOF HOLDINGS (IFL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$8.44	6%	Medium	Medium

BUY Below $8.00 — **HOLD** — **SELL** Above $12.00

$8.44

As we explained in our update following the result, the stock fell almost 10% after the company reported a fall in its gross margin to 0.58%, from 0.62% in the preceding half, and a fall in the net operating margin to 0.30%, from 0.32% in the preceding half.

In that review, we said that the gross margin fall 'would be fine if customers were simply migrating to cheaper, more efficient platforms, because it should push operating costs down' but then noted that costs were flat.

In fact, management has been at pains to point out that this is exactly what has happened – it's just that the gross margin impact of customers switching is immediate, whereas the cost impact has been delayed. In this case customers of Bridges (one of **IOOF's advice businesses**) have **been moved** from The Portfolio Service to the flagship Pursuit platform.

That has enabled them to reduce their fees – driving down the gross margin – but it will also enable IOOF to reduce costs by about $5m–6m a year, although little of that was seen in the December half. It should all be flowing now, though, with the result that all things being equal the net operating margin should tick back up by around 0.01% in the second half.

Chris Kelaher is of the view that the net operating margin is only one of the numbers to look at when judging IOOF's performance and the transfer of Bridges clients supports this point. Not only is there a timing difference between gross margin and costs savings, but he also expects it to drive future fund flows and ultimately support profits. 'Pursuit is a far more contemporary, far more flexible platform for those [Bridges] clients,' said Kelaher, 'and we expect funds to grow significantly in response to that'.

Impressive flows

Fund flows were certainly a highlight of the result, with $401m of net platform flows (compared to $383m and $147m in the preceding two halves). That contrast with experience elsewhere in the sector, with **AMP reporting disappointing flows** in its latest result and Morningstar suggesting that, industry-wide, platform flows fell 40% in the year to September 2016.

Flows into the advice business were also impressive, with a net $865m flowing in, compared to $542m and $741m in the preceding two halves. Management put that down to 'high adviser retention and attraction', noting 'record levels of interest in IOOF advice groups', including '30 applications from new advisers from other institutional licensees'.

And this comes after AMP revealed it had lost 570 (or 16%) of its advisers in the December half. It's fair to say that Chris Kelaher was unconvinced by the excuses given by AMP (of the reclassification of some advisers and the retirement of others).

Advisers, he said, were 'leaving the big guys above us', attracted by the flexibility offered by IOOF's open architecture (whereby advisers can offer other non-IOOF platforms) and its less bureaucratic nature. This obviously bodes well for future fund flows, but we'll have to see if it translates into a higher net operating margin.

There were other factors depressing this result. For one thing, this was the first period that took the full impact of the lower pricing on MySuper. Non-core disposals also reduced underlying net profit by $3.3m compared to the prior comparable period.

> **Full details of the sale process for this business are due by the end of February and Kelaher is clearly champing at the bit.**

Champing at the bit

So IOOF continues to drive efficiency from within, albeit with lumpy results and no obvious increase in earning power, but management is obviously very keen to make another large acquisition. There have 'never been more [merger and acquisition] opportunities' for IOOF, enthused Kelaher, before singling out ANZ's wealth business as a particularly juicy target. Full details of the sale process for this business are due by the end of February and Kelaher is clearly champing at the bit.

In regard to funding, he noted IOOF's current net debt of just $15m. That represents about 7% of underlying earnings before interest, tax, depreciation and amortisation, but the company would be comfortable with that ratio up as far as 150% (suggesting net debt of around $300m).

Kelaher explicitly stated, though, that for a deal the size of ANZ Wealth, the company would need to use a mix of debt and equity. We'd be fine with that – for the right deal at the right price, and Kelaher has a first-class record of making and integrating acquisitions – but it certainly adds some risk.

When we **first upgraded IOOF** on 23 June 2014 (Buy – $8.28) – with a Buy price of $9 (the same as before the latest announcement) – we felt the company offered 'mid to high single-digit annual growth prospects'. So far, over three years, based on the new consensus forecast of 54 cents for the current year, we'll have got earnings growth of about 1% a year.

That's not a disaster for a stock churning out a fully franked dividend yield of around 6%, but it's also not what we'd hoped for. We agree that this result wasn't as bad as the market seemed to think, but we're nevertheless happy with our lowered price guide and will stick with that. **HOLD**.

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

Staff members may own securities mentioned in this article.

As expected, this was a poor result. But over the long term Crown is well placed.

BY JON MILLS • INTELLIGENT INVESTOR • 23 FEBRUARY 2017

Crown Resorts: Interim result 2017

Former Packer employee Bill Lawry is renowned for shouting 'it's all happening here at the MCG!' during the cricket, especially when a fellow Victorian was providing the entertainment. We're not sure what he'd make of Crown Resorts but there's been a lot happening all right.

Key Points

- ***Poor result, as expected***
- ***New dividend policy, special dividend & buyback***
- ***Hotel spin-off ditched***

CROWN RESORTS (CWN) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$12.29	5%	Med–High	Med–High

BUY Below $12.00 — HOLD — SELL Above $18.00

$12.29

After warning before Christmas of a dramatic reduction in VIP revenue after 18 Crown employees in China were arrested (see ***Crown cashes in on Melco*** on 15 Dec 16 (Buy— $11.37)), the result was in line with our expectations. Normalised* VIP revenue (-45%) fell as expected, main gaming floor revenue (-1%) was flat and non-gaming revenue (+4%) rose nicely. The 9% fall in normalised* earnings before interest, tax, depreciation and amortisation was to be expected. Table 1 has the headline details.

We're not too concerned about this decline. Crown Melbourne and Crown Perth remain monopoly assets and should continue to throw off cash in coming decades, as first noted in our initial upgrade on 20 Apr 15 (see ***Betting on Crown – part one*** (Buy — $13.15)).

We also expect VIP revenue to eventually recover, especially given increasing Chinese wealth and a growing desire for international travel. Furthermore, the 'VIP-only' Crown Sydney should prove nicely profitable once built (at this stage in 2021) – see ***Crown reveals potential VIP impact*** on 21 Oct 16 (Buy — $11.10).

There are of course risks relating to the $2bn cost of Crown Sydney. These could potentially blow out and the planned $500m proceeds in apartment sales might be lower than hoped.

New CEO

More worrying are the regular changes in strategy. We'd like to see the company concentrate on making its major assets – the casinos in Melbourne and Perth, and eventually Sydney – more profitable. The return of James Packer to the board is a step in that direction.

Having a majority shareholder isn't a guarantee that minority shareholders will benefit – see Ainsworth, Len – but Packer has emphasised that, if it wasn't before, Crown is now focussed on 'maximising returns' from its Australian assets. You'd think that would also mean 'maximising returns for shareholders'.

Table 1: Crown interim result 2017

SIX MONTHS TO 31 DEC	2017	2016	+/(–) (%)
REVENUE ($M)	1,701	1,864	(9)
EBITDA ($M)	403	424	(5)
EBIT ($M)	258	284	(9)
UNDERLYING NPAT ($M)	186	206	(10)
EPS (C)	25.5	28.3	(10)

Note: figures are normalised rather than actual, 30c interim div & 83c special div, both 60% franked, ex date 1 Mar

And while former CEO Rowan Craigie has done a fine job, new CEO John Alexander is just the man to cut costs and improve the profitability of the business. He is generally credited with helping James Packer sell his interests in the Nine Network to private equity for a tremendous sum.

We expect a razor-like focus on costs, especially in the VIP business if revenue remains depressed. While there were 'some good days' during January's Chinese New Year, VIP visitors and associated spending is still down in the second half thus far.

> **"The Board hasn't yet decided what to do with the remaining 11.2% stake in Melco Crown Entertainment.**

Like its counterpart at **The Star Entertainment Group**, management is being cautious and waiting for the Chinese authorities to deal with the company's still-imprisoned employees before resuming VIP marketing in the region.

Dividend policy changed

Starting with its 2017 interim dividend, Crown now intends to pay a dividend of 60 cents per year, likely 60% franked, which represents a 4.9% yield or 6.1% grossed-up. Crown will also pay a special dividend of 83 cents – also 60% franked – along with the upcoming interim dividend.

The Board hasn't yet decided what to do with the remaining 11.2% stake in Melco Crown Entertainment. Just under half of this is hedged but the company hasn't disclosed the duration of the contracts.

Crown will also shortly commence a buyback of up to $500m of its ordinary shares and proposes to buyback potentially all of its $530m in **Crown Subordinated Notes**. These were subject to call in September 2018 in any case but they are an expensive form of debt and it makes sense to buy them back earlier using surplus funds.

Hotel listed property trust ditched

Finally, the last of the transactions proposed in June 2016 (see ***Crown spins off international ops and hotels***) has been ditched. The company will not proceed with the spin-off of a 49% stake in four of its hotels in Melbourne and Perth into a listed property trust. The company no longer needs the money and the recent rise in long-term rates probably meant lower proceeds from this transaction than initially expected.

Today's 8% increase has taken the stock past our $12 Buy price, so we're downgrading to Hold for the time being. All things being equal, when the stock goes ex-dividend on 1 March it'll fall by $1.13; we'll likely adjust our price guide by a similar amount and change our recommendation if appropriate. **HOLD**.

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

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

Disclosure: the author owns shares in Crown Resorts.

IAG experienced an unexpected jump in home and auto insurance, but the Asian division had a poor half.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 24 FEBRUARY 2017

IAG: Interim result 2017

Insurance Australia Group (IAG) has posted a decent interim result despite net profit for the six months to December falling 4% to $446m. Gross written premium (GWP) – an insurer's measure of revenue – was up 5% to $5.8bn, predominantly due to improved pricing on commercial and personal lines.

Key Points

- ***Taking market share from SUN***
- ***Good Personal and Business result***
- ***Asian division hit by competition***

INSURANCE AUSTRALIA GROUP (IAG) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$6.13	6%	Med–High	Med–High

BUY Below $4.50 — HOLD $6.13 — SELL Above $7.50

The increase in GWP was considerably better than management's prior expectation for no growth, with good performances from Motor and Home lines, up 6% and 8% respectively.

It was a different story at competitor **Suncorp**, where Motor and Home lines both increased only 2% (for more, see ***Suncorp: Interim result 2017***). IAG has been nipping away at Suncorp's market share, despite already accounting for 27% of the general insurance market compared to Suncorp's 21%.

IAG's underlying insurance margin was 12.6%, down from 14.2%, due to slightly worse than expected natural peril claims. On the bright side, management said there are signs that commercial pricing has likely passed the bottom of the cycle, which bodes well for margins in future years.

Business strength

IAG's Business division also achieved a respectable result. Excluding the sale of the Swann Insurance motor dealership operations, GWP rose 4%. Management noted retention levels were above expectations at higher average rates. A decline in underlying margins from 10.7% to 8.8% was the result of poor rates and volumes in previous years flowing through.

IAG's New Zealand business continued to deliver strong profitability, with an underlying margin above 15%, despite higher claims. GWP increased 5%, or 1% after removing the effect of currency fluctuations. Good premium growth in personal lines was offset by a decline commercial business.

And that's where the good news ends. Unfortunately, IAG experienced a marked decline in the Asian division, where GWP fell 8% due to growing competition in Thailand and unfavorable foreign exchange movements. The contribution from the developing markets of India, Vietnam and Indonesia improved, but this was more than offset by higher claims in Thailand and Malaysia.

Investment pain (and pleasure)

IAG's $13bn investment portfolio took a battering too, with total investment income falling 33% to $142m due to rising bond yields causing capital losses on the company's fixed income securities. This was partially offset by strong performance from equity markets. Rising bond yields cause pain in the short term, but benefit shareholders over the long haul as they eventually flow through as higher returns from IAG's portfolio (see ***Can IAG float our boat?***).

Table 1: IAG interim result

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
GWP ($M)	5,802	5,543	5
INSURANCE PROFIT ($M)	571	610	(6)
NET PROFIT ($M)	446	466	(4)
EPS (CENTS)	17.9	18.6	(4)
INTERIM DIVIDEND	13 cents (unchanged), fully franked ex date 28 Feb		

Management said it is making progress in its drive to cut $250m in costs from the business over the next three years and grow earnings per share at 10% a year. We admire the ambition – the trouble is that IAG's major competitors are also scraping around for savings: Suncorp has earmarked

> **IAG's New Zealand business continued to deliver strong profitability, with an underlying margin above 15%, despite higher claims.**

$170m in cost cuts over the next two years, while **QBE** has a US$700m cost-cutting plan underway. Unfortunately, the industry is extremely competitive on price, so we expect most of the savings will wind up in the hands of customers, not in the pockets of shareholders (see ***IAG: Cutting costs to stand still***).

Management raised its forecast for GWP to 'low single-digit growth' in the 2017 financial year, up from 'relatively flat'. It also expects an insurance margin of 12.5 – 14.5%, with consensus estimates for earnings per share of 36 cents. That puts the stock on a forward price-earnings ratio of around 17, with a fully franked dividend yield of 4.2%. IAG is a leading insurer, with strong brands and economies of scale, which is why we're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

With its asset sale programme now complete, Scentre is focussing on making its already high quality properties even better.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Scentre Group: Result 2016

If there was one message Scentre Group wanted to emphasise during its 2016 result, it's the quality of its portfolio.

SCENTRE GROUP (SCG) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.42	5%	Medium	Medium

BUY Below $4.00 — HOLD — SELL Above $7.00

$4.42

That's understandable. Scentre arguably owns the highest quality retail assets in Australia, with 16 of its 34 shopping centres in the top 25 by annual sales.

With the sale of Casey Central in Victoria and WestCity in New Zealand for a combined total of $368m, and the acquisition of David Jones's Market Street property in Sydney in 2016, its portfolio is now even better.

Asset sales complete

Casey Central and WestCity were the last of nine smaller, slower-growing properties that were targeted for sale after Scentre was created following the Westfield restructure in 2014.

These asset sales have been a drag on the company's performance since and 2016 was no exception. Fewer properties meant net property income fell around 1% in 2016 (Scentre has a calendar year end). While distributable profit increased 3%, this figure would have been around 5% if the impact of transactions is excluded.

By contrast, Scentre benefitted from the $665m in developments completed in 2016. These projects were forecast to yield around 7% on cost but instead generated 7.5% initial yields. With attractively-priced properties hard to find, development activity will continue to be a key driver of growth at Scentre: it has a development pipeline of around $3bn, with $700m in activity planned for 2017.

Distribution growth

Distributable profit will likely be relatively unaffected by asset sales from 2017 onwards, which is why management is forecasting distributable profit growth of 4.3% in 2017.

Distributions are also forecast to grow, albeit at a more moderate 2%. The estimated 2017 total distribution of 21.73 cents per share means Scentre shares offer an unfranked distribution yield of around 4.9%.

With specialty leases mandating rental increases of either 2% or 3% above inflation (5% fixed in Victoria) over at least five years and a strong development pipeline, we expect the company to be able to grow distributable profit over the long term between 3–5% per year. This results in an implied pre-tax return of 8% and 10%.

Table 1: Scentre result 2016

YEAR TO DEC ($M)	2016	2015	+/(–) (%)
RENTAL INCOME	1,810	1,825	(1)
BORROWING EXP.	(462)	(499)	(7)
DISTRIBUTABLE PROFIT	1,238	1,199	3
DPS (C)*	21.3	20.9	2
GEARING (%)**	34	35	(3)
NTA PER SHARE ($)	3.72	3.37	10

***10.65 cps final div, unfranked, ex-date already past**

**** Net debt / (total tangible assets – cash)**

Note, however, that you'll only get that return if our assumptions are right and you hold forever. If you sell before then, then the sooner that is the more your total return will be determined by changes in the price the market puts on Scentre's returns. If long-term interest rates start to rise, the market will doubtless put a lower value on the stock. At current prices, we continue to recommend members **HOLD**.

Staff members may own securities mentioned in this article.

It was another bumper result for this manufacturer of 'oral appliances', but new sleep clinics make us nervous.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 23 FEBRUARY 2017

SomnoMed: Interim result 2017

SomnoMed posted a good result for the six months to December, underpinned by strong growth in Europe and Australia. Revenue increased 12%, to $23.8m, compared to the prior corresponding period and total unit sales of SomnoMed's custom-made mouthguards (or 'oral appliances', as the company likes to call them) for the treatment of sleep apnoea came to 33,309. Operating earnings grew 57%, to $1.4m, excluding the start-up costs associated with Renew Sleep Services (RSS).

SOMNOMED (SOM) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$3.14	2%	Very High	Very High

RSS is the company's foray into a direct sales model, whereby it opens sleep clinics that will advertise to potential customers, help with insurance reimbursements, and use in-house dentists to diagnose patients and fit the mouthguards. The company plans to open five before the end of the financial year and a further 10 clinics in 2018.

The trouble is that SomnoMed is now competing with its own distributors. Management said sales in the US were lower than anticipated due to 'a reaction of some SomnoMed customers to the perceived channel conflict between their own sales and RSS'. It's early days, so it's hard to know how the clinics will perform and whether the negative reaction by existing customers will be long lasting. **We've been wary of the new business model from the get-go**, so will be watching the next few quarterly results closely.

Unit sales in Europe were up an impressive 18%. The company noted that France, Belgium and Germany are all reviewing reimbursement policies for SomnoMed's dental products due to the higher cost and lower compliance associated with competing devices, namely continuous positive airway pressure (CPAP) machines.

This was a good result and SomnoMed's business is growing rapidly, but there's no getting around the fact that operating sleep clinics is a large, untested shift in the company's strategy. The stock has more than doubled since we upgraded the company in ***SomnoMed: A future mini-ResMed?*** on 5 Feb 14 (Speculative Buy – $1.33) and it may have become an unreasonably large portion of your portfolio. We're happy to hold SomnoMed for the long term but we highly recommend gradually taking profits to maintain a maximum portfolio weighting of 2%. **HOLD**.

Staff members may own securities mentioned in this article.

Iress's acquisition of Financial Synergy could be the solution to its growth problem.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Iress: Result 2016

Iress and Australia's financial markets go together like peas and carrots. After the office lights, Iress products are often the first to be turned on, and the last to be turned off, at many Australian fund managers and wealth advisors.

IRESS (IRE) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.62	5%	Medium	Medium

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

$11.62

But Iress's dominance of Australia's mature market has meant growth has been hard to come by, and the 2016 financial year reflected that. Group revenue increased 7.8% for the year, to $390m, but after stripping out the contributions from acquisitions, the core business is barely growing. Earnings per share increased a respectable 5%, largely a result of a few hundred million dollars in acquistions over the past few years.

We have often wondered how Iress will revive organic growth, outside of a boost that a bull market usually provides. It has been unclear. But following the acquisition of Financial Synergy, which we consider to be a great strategic move, it is becoming clearer.

Synergies from Financial Synergy

Iress dominates the Australian and New Zealand wealth management market. Well over half of all advisors are customers of its flagship XPLAN product and this contributes the lion's share (34%) of Iress's operating earnings. If margins are any indication, this is the strongest business in Iress's stable.

Here, customers are highly sticky, which is both gift and curse. It makes for very resilient revenue, but it's also hard to poach your competitor's clients. Despite having a greatly inferior product, Coin, owned by **Rubik Financial**, recently re-signed two of the big four banks and **AMP** in multi-year contracts.

Out-innovating Coin is not working, so Iress needs to find another approach. This is where Financial Synergy comes in.

Iress paid $90m for Financial Synergy in September 2016, as discussed in ***Iress's super acquisition***. Its flagship product, Acuity, is the core registry system for industry and retail super funds and third party administrators. Collectively, its customers serve 4 million members that hold $250bn of combined assets.

Iress's strategy is to integrate XPLAN, its flagship wealth management product, into Acurity. This will allow tailored, scaled advice to be provided through these superannuation platform channels.

The acquisition made sense in itself. Acurity contributed $4.4m of revenue in 2016 from a few months of ownership. A full contribution in FY17 should see it closer to the $27.5m of revenue and $8m of operating earnings (before depreciation and amortisation) expected at purchase. But by offering XPLAN to Acurity customers on a modular basis, successful cross-selling could see growth return to Iress's high-margin wealth management division.

Table 1: Iress results

YEAR TO DEC ($M)	2016	2015	+/(–) (%)
ANZ WM REVENUE	93.8	80.3	16.8
APAC FM REVENUE	113.5	111.1	2.1
UK REVENUE	136.8	123.9	10.4
OTHER REVENUE	45.7	46.1	(0.8)
EBITDA	103.5	104.9	(1)
NPAT	59.5	55.4	7.0
EPS (CENTS)	37.0	35.2	5.0
DPS (CENTS)	44.0	42.7	3.0
FINAL DIVIDEND	28 cents, ex date March 8		

We think the acquisition of Financial Synergy could improve Iress's growth prospects. However, we would need to see some evidence of this before we upgraded our recommendation guide. We are not interested in buying at current prices, but this could change if the stock fell below $10. **HOLD**.

Staff members may own securities mentioned in this article.

Despite profit falling 20%, this fund manager is looking forward to a better and greener future.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 20 FEBRUARY 2017

Magellan Financial Group: Interim result 2017

At its latest interim results presentation, Magellan Financial Group chief executive Hamish Douglass was eager to talk up its new 'low carbon' strategies, but investors were much more concerned with current performance.

MAGELLAN FINANCIAL GROUP (MFG) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$23.74	5%	Med–High	High

BUY Below $20.00 — **HOLD** — **SELL** Above $30.00

$23.74

Although Magellan's average funds under management rose 10% to $42.9bn in the six months to December 31, total revenue was down 16% to $154m as the recent underperformance in the company's funds led to a 92% fall in performance fees.

The company was quick to point out that performance fees fluctuate from period to period and that outside of performance fees the company has been doing well, with underlying profit before tax and performance fees up 9% to $110m.

Indeed, it appears there is still evidence that Magellan's funds remain a popular choice for investors, with the company reporting retail and institutional inflows of $1.2bn and $1.8bn respectively.

With existing funds getting closer to reaching capacity (which management views as A$53bn for global equities and A$20bn limit for global listed infrastructure), Magellan is looking to take advantage of what it believes is a market of institutional investors worried about carbon exposure.

Table 1: MFG's interim result

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
TOTAL FUNDS ($BN)	43	39	10
REVENUE ($M)	154	182	(16)
EXPENSES ($M)	40	39	3
NET PROFIT ($M)	87	109	(20)
EPS (C)	53.1	68.1	(22)
DPS (C)	38.4	51.3	(25)

Douglass believes this has the capacity to become a trillion-dollar market, with a theoretical capacity limit of A$40bn for Magellan. It's starting off with three new funds – a Global Low Carbon fund, a US Low Carbon fund and an International (non-US) Low Carbon fund.

The stock fell falling around 5% following the results, but it still trades on a price-earnings ratio of more than 20. **HOLD**.

Staff members may own securities mentioned in this article.

Property revaluations and a one-off capital distribution masked what was a typical result for HPI.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 24 FEBRUARY 2017

Hotel Property Investments: Interim result 2017

It seems demand for places to share a drink with friends remains strong in Queensland.

HOTEL PROPERTY INVESTMENTS (HPI) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.78	4%	Medium	Medium

BUY Below $2.50 — HOLD — SELL Above $4.00

$2.78

There are few signs that the market for pubs leased to subsidiaries of Coles, owned by **Wesfarmers**, and **Woolworths** is weakening. During the six months to December, all of Hotel Property Investment's (HPI) properties were independently valued, with the company's average capitalisation rate falling to 6.5% from 7.3% at 30 Jun 2016.

Table 1: HPI interim result 2017

SIX MONTHS TO 31 DEC	2017	2016	+/(–) (%)
RENTAL INCOME ($M)	22.3	21.8	2
BORROWING EXP. ($M)	5.4	5.2	4
DISTRIB. PROFIT ($M)	14.7	13.6	8
DISTRIBUTION (CPS)	22.2*	9.0	nm
GEARING (%)**	36.4	41.9	(13)
NTA PER SHARE ($)	2.56	2.07	24

***9.7c distr. & 12.5 cent capital distr., both unfranked, ex date already past**

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

This pushed the value of HPI's pubs up $56m, with its net tangible assets (NTA) per share also rising, by 12%, from $2.28 at June 2016 (see ***Hotel Property Investments: Result 2016***). The increase in its NTA per share occurred despite HPI selling one property during the first half.

HPI will pay 22.2 cents per share in total distributions, comprising a 9.7 cent interim distribution and a one-off capital distribution of 12.5 cents. The listed property trust is making the capital distribution because it wants to raise gearing to its target level of between 40% and 50%.

Ignoring the one-off capital distribution, HPI is currently trading on an unfranked distribution yield of around 7.1%.

Add in expected long term distribution growth of around 3% and investors are currently getting an implied pre-tax yield of around 10%. As such, we continue to recommend that you **HOLD**.

Staff members may own securities mentioned in this article.

Strong Trophon sales shows the way to a recurring future for this medical device world leader.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 20 FEBRUARY 2017

Nanosonics: Interim result 2017

The first half of the 2017 financial year was another cracker for Nanosonics. Sales were up 132% to $36m for the six months to December, while the company made its first operating profit of $10.3m. Free cash flow was a healthy $8.2m, up 19% on the prior half. The result depicts a growth company in the early stages of a long-term roll out.

NANOSONICS (NAN) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.82	2%	Very High	Very High

With the result already foreshadowed in ***Nanosonics posts strong sales***, let's instead recap the company's strategy, which is like the razor/razor blade model pioneered by Gillette.

The first step in this approach is to establish a large installed base of razors (or Trophon units in Nanosonics' case), which locks the customer into ongoing purchases of consumables.

Nanosonics is doing exactly that with great success. Its installed base increased by 60% over the year to reach 12,300 units. North America has been the first target with 87% of the current installed base, but now the company is increasingly focusing abroad. Next on the hit list is the UK, Germany, and France, followed by Japan and the Middle East. In these new markets, Nanosonics is in various stages of building awareness and establishing its sales channels, which will form the basis of its medium-term growth aspirations.

Trophon units are a decent outlay for the medical department, costing around USD$13,000 depending on the sales channel. Nanosonics currently derives around two-thirds of its revenue from these one-off sales, a high yet normal proportion for a company early in a roll out.

As the installed base grows, we expect the proportion of sales from consumables to increase. This provides greater levels of recurring revenue. But with global adoption still in its infancy, it will be a slow road.

Nanosonics continues to trade at lofty multiples, but that might be justified given its potential for growth. We continue to recommend you take profits if and as the share price rises to a keep a maximum portfolio weighting of 2%. **HOLD**.

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

Suncorp wants to buy a smaller NZ competitor to grow its market share.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 22 FEBRUARY 2017

Suncorp expands in New Zealand

Suncorp has announced that its New Zealand subsidiary, Vero Insurance, has purchased just over 11% of the stock in Tower Limited, a local competitor. The company has also proposed to the board of Tower that Suncorp acquire the remaining 89% of the company at a price of NZ$1.30 per share, or around NZ$219m.

SUNCORP GROUP (SUN) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$13.10	7%	Medium	Medium

BUY Below $8.00 · **HOLD** · **SELL** Above $16.00

$13.10

That's ahead of a deal already on the table – and supported by the board – to sell the company to Canada-based insurer Fairfax Financial for NZ$1.17 per share.

Suncorp's New Zealand insurance division had a rough six months to December, as we **outlined at its interim result**. Net profit more than halved to $36m due to the Kaikoura earthquake last November and residual reinsurance costs from the 2011 Canterbury earthquake. Premiums grew 5% thanks to growth in Home and Motor lines, though the underlying insurance margin was a pitiful 3.8%.

'The proposed acquisition would consolidate Suncorp's position in the New Zealand general insurance market, creating a business with gross written premiums of NZ$1.6 billion. The combined business would generate significant shareholder value through cost efficiencies, as well as reinsurance and technology synergies,' said Suncorp New Zealand chief executive Paul Smeaton.

Tower has roughly a 5% share of the New Zealand general insurance market, making it the fourth largest insurer – behind Suncorp, IAG and QBE – and we expect a business combination would lead to margin improvement through a reduction in duplicate costs.

It's early days; the board of Tower could reject the bid or Fairfax Financial could raise its offer price. We'll keep you posted as things play out. Suncorp's stock trades on a price-earnings ratio of 16 and a fully franked dividend yield of 5.4% and we continue to recommend that you **HOLD**.

Staff members may own securities mentioned in this article.

Tassal has reported a pleasing result but it's time to focus on better opportunities.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 23 FEBRUARY 2017

Tassal: Interim result 2017

Aquaculture company Tassal Group has announced a pleasing result for the six months to December. Revenue fell 3% to $219m, but for good reason – a longer growth season for its salmon and the company directing sales away from retail towards higher margin wholesale customers.

TASSAL GROUP (TGR) / COVERAGE CEASED

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.80	N/A	N/A	N/A

We're happy to trade revenue growth for higher profitability. The shift – combined with various cost-cutting initiatives – lifted operating earnings 7% to $53m and net profit was up 10% to $27m. The board declared a fully-franked interim dividend of 7.50 cents.

Tassal experienced 'extraordinarily adverse environmental conditions' during the 2015/2016 summer season, which impacted fish growth and harvests. Thankfully, growing conditions improved in the 2016/2017 summer season and pricing has been favourable in wholesale and export markets, which management expects to continue into 2018.

As we explained in ***Tassal and the agriculture boom***, the company has many risks associated with weather and disease, and only modest free cash flow and returns on capital. With a price-earnings ratio of 14 and dividend yield of 3.3%, there are much better opportunities on our current **Buy list** and we are **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

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