Weekly Review

RESEARCH

– Issue – 24 Mar. 2017

Are all general insurers created equal? Here we put the country's two largest, IAG and QBE, head to head.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 22 MARCH 2017

Which is Australia's best insurer?

When it comes to insurance, competition is everything. Insurance is different to many industries in that managers can make decisions today that only have consequences decades from now. Companies often get themselves into trouble by underpricing policies to boost short-term growth, but that can result in an excess of claims down the road. This slowly chips away at shareholder equity, and sometimes not so slowly. Knowing the good insurers from the bad is paramount to making sensible investments in this sector.

Key Points

- ***QBE has more diverse products and geographies***
- ***IAG run more efficiently***
- ***Both offer fair value; slight preference for IAG***

(IAG) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$5.95	6%	Below $4.50	$5.95	Above $7.50

QBE INSURANCE GROUP (QBE) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$12.92	4%	Below $8.50	$12.92	Above $17.00

The Australian general insurance landscape is dominated by three insurers – **QBE Insurance**, **Insurance Australia Group** (IAG), and **Suncorp**. Here we'll focus on the two standalone general insurers, QBE and IAG. While Suncorp is the second largest insurer in Australia, half its income is from banking and life insurance, which is a completely different ballgame.

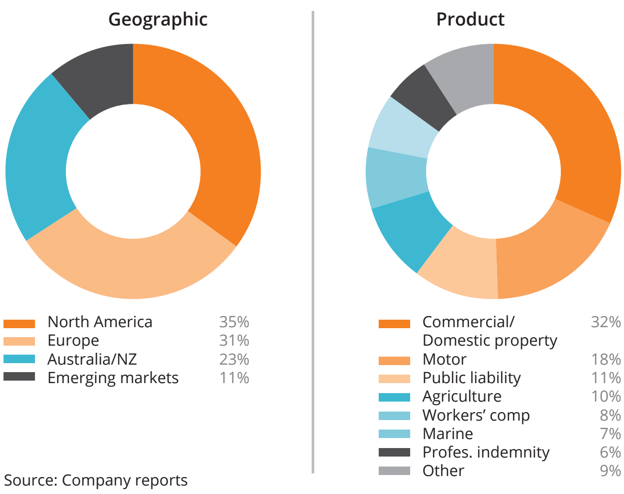
Let's use three criteria to compare IAG and QBE – operational differences, financial performance, and relative valuation.

Operational differences

The general pitch of financial advisors is that diversification is your friend. And when it comes to diversity, no insurer does it better than QBE.

With operations in North America, Europe, Asia, Australia and New Zealand – 37 countries in all – QBE is one of the world's 20 largest insurers (see Chart 1).

Chart 1: QBE geographic and product divisions



Source: Company reports

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RECO. CHANGES	FROM	TO
Myer	Hold	Sell
Goodman Group	Avoid	Hold
Lend Lease	Avoid	Hold

PORTFOLIO CHANGES

PORTFOLIO	COMPANY	BUY/ SELL	DATE	NO. OF SHARES	PRICE ($)	VALUE ($)
Equity Income	Amaysim	Buy	16/03/17	486	1.74	846

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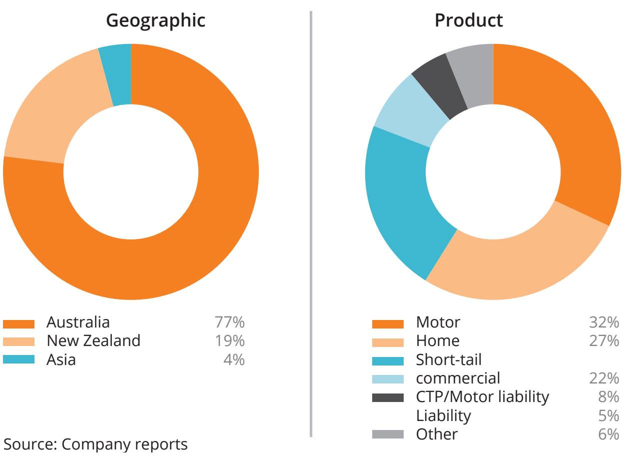
IAG, on the other hand, holds the dominant market position in Australia and New Zealand – with a market share of 27% – but it is almost entirely focussed on these mature markets (see Chart 2). Around 4% of the company's gross written premium (GWP) – an insurer's measure of revenue – is from Asia, but its **investments overseas have been patchy** at best.

Chart 2: IAG geographic and product divisions



Source: Company reports

Both companies' strategies have merit. IAG's focus on one particular region means stronger brand recognition, which translates into slightly more pricing power and less exposure to offshore risks. But QBE's diverse geographic operations mean a natural disaster in one particular area will be less disruptive.

As for product diversity, QBE again wins out – but it's a double-edged sword. QBE will insure just about anything, with product lines running from simple car insurance to covering cargo ships against the risk of being captured by pirates.

Nearly all of IAG's business, however, is from less complex (and less risky) insurance, such as home and motor lines. These are known as 'short tail' policies, where losses are known and paid soon after the event – a car crash or house fire, for example.

QBE has many more 'long tail' contracts, where the eventual losses may not be known for many years. These policies – things like workers' compensation or public liability – are much harder to predict and often need to be settled in court.

Done well, long tail insurance lines can be more profitable, as we'll see in a moment, and the complexity adds a barrier to new competitors. Warren Buffett's Berkshire Hathaway has made tens of billions from ultra long tail policies that can span decades. Nonetheless, complex long tail policies carry an extra dose of risk; QBE wrote off US$600m of goodwill in 2013 largely due to underpriced long tail policies coming back to bite long after they were written.

Financial performance

When you take out an insurance policy, you pay a premium up front but generally only make a claim months or years later. In the meantime, the insurer gets to hold onto the money – which is known as 'float' – and can invest it for the benefit of shareholders.

IAG and QBE have $6bn and US$15bn of float, respectively. Could this be another win for QBE? No. Over the past 10 years, QBE's float has shrunk 8%, while IAG's has grown 12%. Growth in float is one of the three main forces driving shareholder returns – the others being underwriting prowess and investment income, which is largely down to interest rates.

Float is only valuable to shareholders if its cost is consistently below the cost of obtaining alternative sources of funding. If an insurer pays out more in claims each year than it earns in premiums – an underwriting loss – then that difference can be considered the cost to hold onto and invest policyholder money.

In analyst speak, the 'combined ratio' is how we measure the cost of float. If the insurer has a bad year and pays out $105 in claims and related administration expenses, but takes in only $100 in premiums, it will have a combined ratio of 105%. That is, it made an underwriting loss.

> **"Competition in the insurance industry is so strong that any level of profitability is rare, with most insurance operations being loss-making.**

If the company is making money from its insurance business – before adding the investment income earned on its float – then it will have a combined ratio below 100%.

Competition in the insurance industry is so strong that any level of profitability is rare, with most insurance operations being loss-making. The industry as a whole had a combined ratio of 105% over the past 15 years. As such, most insurers rely on investment income from their float to turn a profit.

So how do IAG and QBE score? Though there are peaks and troughs that coincide with high claims and bad weather, the Australian insurance oligopoly is surprisingly – or perhaps unsurprisingly – profitable.

IAG's combined ratio has averaged 96% over the past 15 years, while QBE managed an even more impressive 93%. Even after accounting for the large writedowns in 2013, QBE still has had an above-average level of profitability.

Not to be outdone, however, IAG has another ratio going for it. Pricing of risk is the single most important thing an insurer needs to get right but, in an industry as competitive as this one, running a tight ship is a close second.

To measure an insurer's efficiency, we turn to the expense ratio – the percentage of a company's premiums that went to underwriting expenses, including salaries, broker commissions, and marketing. Here, IAG takes the crown with an expense ratio of 26%, compared to 31% for QBE. Over the past five years, the difference has averaged almost 7% in favour of IAG, suggesting management has a keen eye for keeping expenses to a minimum.

Relative value

Even the best insurer will make a poor investment if you pay too much for its stock. As this notoriously cyclical industry has too many ups and downs to make any one year's earnings of much value, it's important to assess IAG and QBE's average earnings power.

Over the next five years, we expect IAG's dominant market position to generate a respectable return on shareholders' equity, which currently stands at $6.8bn. Management targets a return on equity (ROE) of 15% 'through the cycle', but, for the sake of conservatism, let's knock that down to 11%, which is the company's 10-year average. That would equate to a normalised profit of $750m, or around 32 cents per share (consensus estimates are for the company to earn 35 cents per share in 2017).

At today's price of $5.95, that's a normalised price-earnings ratio of around 19 and 2.0 times book value, which also happens to be the stock's 10-year average. So you won't be surprised that we consider IAG to be fairly valued at current levels.

QBE has a book value of US$10.3bn and a long-term return on equity target of 13–15%. Here, though, the term 'target' is used particularly loosely – the last time QBE actually achieved that return on equity was in 2010; QBE only managed an ROE of 8% in 2016.

Let's assume QBE's ongoing US$350m cost-cutting program brings the company's ROE back up to its 10-year average of 10%. If that's the case, normalised net profit is around $1.3bn given current exchange rates, or around 98 cents per share (consensus estimates are for 82 cents in 2017).

That puts QBE on a normalised price-earnings ratio of 13 and price-to-book ratio of 1.3. A steal, right?

Not so fast. Remember those riskier insurance policies mentioned above? Profitability can be much more volatile and QBE's exposure to large natural catastrophes means any investment deserves an extra dose of caution. What's more, given its riskier polices, QBE invests 90% of its portfolio in cash and short-term fixed interest securities, which only earn a pittance given today's low interest rates. That reduces the value of QBE's float.

Ultimately, IAG's less risky policies, efficiency-focused management, and dominant – and growing – market share in the stable Australian market are worth paying a premium for. Both companies trade within our range of fair values, though IAG is slightly closer to our recommended Buy price of $4.50 than QBE is to its Buy price of $8.50. For both companies, we continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

TPG's interim result was a strong one but spending is likely to rise.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 22 MARCH 2017

TPG Telecom: Interim result 2017

It's still too soon to make it official but TPG's interim result went some way towards validating our investment case (outlined in ***Opportunity calls at TPG***).

Key Points

- ***Strong interim result***
- ***Broadband margins will fall***
- ***Watch mobile capex***

TPG TELECOM (TPM) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$6.79	6%	Med–High	Med–High

BUY Below $7.50 — HOLD — SELL Above $14.00

$6.79

Yes, broadband margins are being pinched but the acquisition of iinet, build-out of independent fibre, growth in the corporate business and potential ventures in mobile all go some so way towards offsetting margin decline.

In aggregate, revenue grew 9% while earnings before interest, tax, depreciation and amortisation (EBITDA) grew 28%. Some of this increase was due to expanding margins from bringing iinet customers onto TPG infrastructure, but cost-cutting was also significant. iinet now generates an EBITDA margin of 26%; before being bought by TPG it made just 18%.

By contrast, TPG's consumer business generates an EBITDA margin of 38%. With lower levels of service, we expect that TPG's margin will always outstrip iinet's, but the two should continue to converge.

Corporate jewel

The corporate business continues perform strongly, increasing revenue by 4%, EBITDA by 7% and expanding the EBITDA margin from 40.6% to 41.8%. We've highlighted previously that this is arguably the best bit of TPG and the margin should continue to increase as more customers are placed onto TPG-owned fibre. As a reminder, the corporate business, which accounts for about a third of EBITDA, won't be impacted by the NBN.

Table 1: TPG interim result 2017

SIX MONTHS TO 31 JAN	2017	2016	+/(–) (%)
REVENUE ($M)	1,234	1,153	7
EBITDA ($M)	418	369	13
NPAT ($M)	208	162	28
EPS (CENTS)	24.5	19.6	25
DPS (CENTS)	8	7	14
INTERIM DIVIDEND 8.0c fully franked, up ex date 13 April			

The corporate business enjoys high incremental margins because of the low marginal cost of signing customers on to existing fibre services. It has helped that customers are choosing to leave low-margin voice services and signing on to higher-margin fibre services.

TPG's greatest threat comes from NBN. Subscriber numbers are still modest – NBN represents less than 15% of total broadband customers – but that will grow as NBN access increases. ADSL margins of 40% will be replaced by NBN reseller margins that are much lower.

Margin offset

TPG is growing its fibre to the basement business (FTTB) product, a clever idea that bypasses the NBN and earns splendid margins, but that opportunity is limited to about 500,000 households.

To date, FTTB has successfully offset margin decline and TPG reported surprisingly high broadband EBITDA margins of 40%. That will fall as the take-up of NBN accelerates. We expect margins to eventually fall towards the mid-20% range. The FTTB business is exposed to some regulatory risk with regulators threatening to increase charges and limit the range of its NBN competing infrastructure. This would certainly crimp profits from the venture but, in our view, there is little justification for changes. We will be watching regulatory outcomes.

TPG completed its Singapore spectrum acquisition at a cost of $100m. Building the physical network will cost another $200m–300m, cash that should come from operating cash flow. Returns from Singapore will be small, but money may not be the main motivation.

> **High reinvestment rates combined with uncertain rates of returns mean this recommendation relies to a degree on our faith in management.**

Singapore is a test tube where the business can learn how to run a mobile business in a competitive market with strong incumbents, while the small coverage area should keep start-up costs low. Ultimately, TPG has designs on running an Australian mobile business.

Mobile future

TPG already owns some spectrum and will likely be a bidder for upcoming spectrum that the regulator has ruled cannot be bought by Telstra. Its fibre network could be used to support a mobile business as well, but it will still need to spend up to $2bn building a physical network.

That hasn't yet been confirmed by the company but it is, in our view, the most likely outcome and will come attached to new risk.

Capital expenditure will remain high. In the short term, constructing fibre for the Vodafone contract is now incurring costs without generating revenue; Singapore expenditure will soon follow and, if TPG fulfils its mobile ambitions, capital expenditure could rise again. Capital expenditure for this business has a high discretionary component but that might not matter if TPG goes all out chasing growth.

High reinvestment rates combined with uncertain rates of returns mean this recommendation relies to a degree on our faith in management. A splendid track record helps in that regard and, with an ***enterprise value to EBITDA*** multiple of less than 9, TPG is attractive enough to start building a position. **BUY**.

*Note: The Intelligent Investor **Growth Portfolio** owns shares in TPG. Find out how you can invest directly in this and other Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Staff members may own securities mentioned in this article.

We survey the latest results from the listed property sector.

BY HUGH DIVE • INTELLIGENT INVESTOR • 24 MARCH 2017

Property: Interim result 2017 round-up

For several years until the middle of last year, listed property has been one of the top performing sectors on the ASX. While other sectors have faced concerns about a rising and then falling Australian dollar, volatility in commodity prices, euro-zone issues, near zero interest rates and bank capital raisings, listed property sailed serenely on.

That all changed in the second half of 2016, when 'safe', yield-generating stocks such as property and infrastructure stocks were routed as investors priced in expectations for higher interest rates.

During the recent interim reporting season, Australia's leading property trusts had the opportunity to address investor concerns about the rates and their ability to grow distributions in a higher inflation environment. Their success in this is reflected in the sector's 7% recovery since the lows reached in November 2016.

As ever, though, the message was subtly different between the different sub-sectors: retail, office, residential and industrial.

Retail

Discretionary retailers continue to face challenges from online competition, slower inbound tourism and – over the past year or so – a higher Australian dollar. That has put pressure on profit margins in the sector, particularly in clothing and footwear.

Weaker retail sales restrict the ability of shopping centre operators such as Scentre and Vicinity to raise rents and typically a rental contract will include a percentage of store sales. New clothing retailers such as Zara continue to take sales away from department stores, which is important given department stores are typically the largest rent payer in a shopping centre. Additionally, over the past year shopping centre landlords saw several major tenants depart due to insolvency, including Payless Shoes, Howard Storage and Pumpkin Patch.

Whilst the outlook for retail looks difficult, we expect shopping centres to continue to have an important role to play, but they will need to evolve by favouring tenants that offer services that can't be delivered online such as personal grooming and dining.

Office

In contrast to shopping centres, the Australian CBD office market looks to be pretty healthy for owners of office towers such as DEXUS and Investa Office. Vacancy is the best measure of health in the office sector, as empty floors leave a nasty hole in rental income.

Overall the market looks stable, but the picture across Australia is quite divergent, with vacancies remaining very low in Sydney and Melbourne, but hitting a 23-year high in Perth. Sydney and Melbourne have benefited from the conversion of office towers into apartment buildings, which reduces supply, while Brisbane and Perth face excess supply from towers built towards the end of the mining boom.

Residential

Unsurprisingly, the buoyant residential market in Sydney and Melbourne boosted the results of major residential developers Mirvac, Lend Lease and Stockland. We have some concerns that these developers may face defaults from buyers that have paid deposits for apartments (particularly in Melbourne).

A buyer may refuse to complete a sale (thus forfeiting their deposit) if after completion the value of the property has declined or the buyer has had trouble obtaining finance. The recent reporting season suggests that it's so far so good, with developers reporting minimal defaults and healthy forward sales.

Industrial

Whilst industrial assets continue to be priced higher, the underlying fundamentals for the sector have deteriorated with vacancies rising. Unlike office towers which are relatively homogenous assets – where an accounting firm, for example, might take space vacated by an advertising agency (after they've removed the basketball hoops and foosball tables of course) – industrial sites are often configured for a particular tenant.

That's the challenge being faced by BWP Trust in filling sites vacated by its key tenant Bunnings.

More positively, industrial trusts have continued to generate profits from rezoning industrial property to residential. In

> **Their success in this is reflected in the sector's 7% recovery since the lows reached in November 2016.**

October Goodman sold an industrial park in Sydney's north west for $200m to apartment developer Meriton Group.

Arena REIT (ARF)

Social infrastructure (child and healthcare) landlord Arena had a decent six months, reporting an increase in its weighted average lease expiry (WALE) to 10.6 years, a 13% rise in profit, and a 9% jump in its distribution.

Table 1: Arena REIT interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)	14.2	12.6	13
DISTRIBUTION PER SHARE (C)	5.85*	5.35	9
GEARING (%) (SEE NOTE)	27.0	25.0	8
NTA PER SHARE ($)	1.74	1.54	13

*** 2.95c second quarter dividend, unfranked, ex date already past, DRP (1.5% discount)**

Note: gearing = net debt / (total tangible assets less cash)

Arena's portfolio is leased to high-quality tenants on attractive terms where, unlike office or shopping centre trusts, the tenants are responsible for almost all operating expenses, including repairs and maintenance. This allows Arena to pay out a greater percentage of earnings in the form of distributions.

As a result of the rental increases and completed developments over the past 6 months, Arena upgraded its full-year distribution guidance to 12 cents per security. That would amount to growth of 10% over 2016's distribution. Since listing in 2013 Arena has delivered 10% compound growth in distributions per security, an enviable record in the listed property sector. **HOLD**.

BWP Trust (BWP)

BWP reported a reasonable result with both profit and distributions up 4% and stated that its portfolio was almost fully leased. The problems for BWP investors, however, lie in the future, with major tenant Bunnings seeking to take advantage of Woolworths' hardware debacle to relocate a number of stores to more desirable vacant sites.

Bunnings has so far vacated five of BWP's properties (although it is still paying rent on them) and it has plans to vacate another over the next three years.

Around 23% of BWP's portfolio is coming up for expiry over the next three years and it may struggle to find other big-box retailers to take over these leases without significantly discounting rent.

Table 2: BWP interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)	55.5	53.3	4
DISTRIBUTION PER SHARE (C)	8.63*	8.29	4
GEARING (%) (SEE NOTE)	27.5	29.0	(5)
NTA PER SHARE ($)	2.60	2.52	3

*** Unfranked, ex date already past, no DRP**

Note: gearing = net debt / (total tangible assets less cash)

We see big risks to BWP's guidance that distributions will increase about 3% per annum, and it's even possible we'll see a distribution cut over the next three years. **HOLD**.

DEXUS Property Group (DXS)

Australia's largest office tower landlord had a good result, buoyed by rising rents and increasing asset values. Demand for office space in the Sydney and Melbourne CBDs allowed DEXUS's portfolio to remain almost fully leased with rental income up +3%.

Table 3: DEXUS interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)*	287.7	260.6	10
DISTRIBUTION PER SHARE (C)	21.71**	23.05	(6)
GEARING (%) (SEE NOTE)	27.1	32.0	(15)
NTA PER SHARE ($)	8.05	7.25	11

*** Excludes trading profits**

**** Unfranked, ex date already past, no DRP**

Note: gearing = net debt / (total tangible assets less cash)

However, investors in DEXUS saw a decline in their distribution, by 6%. This reflects the large amount of trading profits the company made in the six months ending December 2015. A trust makes trading profits when, for example, it sells an industrial site to a residential developer for an amount above the value it is held at on the balance sheet. Investors should be wary of profits from this source, as they evaporate in market downturns.

> **Goodman continues to be a beneficiary of increasing online sales, developing the distribution centres across Australia, Asia and Europe that aid the flow of goods to consumers.**

Looking ahead DEXUS has guided to distribution growth between 3.5% to 4.5% per unit. Whilst this is expected to be achieved if current market conditions persist, investors should be aware that this is not backed solely by collecting rents, but rather includes both assumed trading profits and development fees. **HOLD**.

Goodman Group (GMG)

Industrial property investor and developer Goodman had a good first half, with profit and distributions up over 7%. The trust reported rental growth of 2.6%, high occupancy of 96% and a $3.5 billion development pipeline across 81 projects in 14 countries.

Table 4: Goodman interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)	388.0	356.6	9
DISTRIBUTION PER SHARE (C)	12.7*	11.9	7
GEARING (%) (SEE NOTE)	33.4	34.7	(4)
NTA PER SHARE ($)	4.24	3.90	9

* Unfranked, ex date already past, no DRP
Note: gearing = net debt / (total tangible assets less cash)

Goodman continues to be a beneficiary of increasing online sales, developing the distribution centres across Australia, Asia and Europe that aid the flow of goods to consumers.

Investors will recall that Goodman performed very poorly in the global financial crisis, falling 90% as high levels of debt forced the trust to raise equity at deeply discounted prices. Management appears to have learned some lessons from this near-death experience and has kept debt at a lower level by using funds from partners (on which Goodman earns management fees) to develop industrial properties.

In February Goodman upgraded its guidance for full-year distributions to 26 cents, an 8% increase over 2016. We're upgrading from Avoid to Hold in line with the thoughts expressed in ***Getting a Hold on property trusts*** last September. The stock is not cheap, however, on a distribution yield of 3.3% and, with a Sell price only 10% higher than the current price, it wouldn't take much to see a downgrade. **HOLD**.

Lend Lease (LLC)

International property and infrastructure group Lend Lease delivered one of the best results of the recent reporting season with profit up 12% and distributions up 10%. The clear highlights of the period were the operational completion of three office towers in Sydney's Barangaroo, the sale of 628 apartments and the significant reduction in gearing.

Table 5: Lend Lease interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)	394.8	353.8	12
DISTRIBUTION PER SHARE (C)	33.0*	30.0	10
GEARING (%) (SEE NOTE)	5.1	12.1	(58)
NTA PER SHARE ($)	10.2	9.25	10

*** Unfranked, ex date already past, DRP (no discount)**
Note: gearing = net debt / (total tangible assets less cash)

Ahead of the result we were concerned that the residential developer may report an increase in investors failing to complete on apartment purchases. In the event, though, less than 1% of the 628 apartments delivered in the half were not fully completed by buyers.

Lend Lease currently has a construction backlog of $20.5 billion that should support distributions from 2017 to 2019. However, we're mindful that Lend Lease has been a major beneficiary of the current housing boom and that, as a developer, its profits and distributions are more volatile than the more stable rent-collecting property trusts.

We're upgrading from Avoid to Hold in line with the thoughts expressed in ***Getting a Hold on property trusts*** last September, and the stock sits close to the middle of our Hold range of $12 to $20. **HOLD**.

Mirvac Group (MGR)

Diversified property trust Mirvac is in good shape, with profit were up 25% and distributions up 4% in the first half, although this reflects the timing of residential settlements.

> **Unlike Mirvac's residential business, Stockland's business is focused on house and land packages, properties that generally attract less speculative interest from investors.**

Table 6: Mirvac interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)	167.0	134.0	25
DISTRIBUTION PER SHARE (C)	4.9*	4.7	4
GEARING (%) (SEE NOTE)	27.0	22.9	18
NTA PER SHARE ($)	2.01	1.83	10

*** Unfranked, ex date already past, no DRP**
Note: gearing = net debt / (total tangible assets less cash)

Mirvac owns a diverse portfolio of office, industrial and residential development assets across Australia. In the six months to December, the trust completed $348m of commercial developments and settled on 977 residential properties.

As with Lend Lease, we're concerned that buyers might fail to complete on apartment purchases, particularly as Mirvac is more heavily weighted to the lower end of the market. However, Mirvac reported defaults on only 23 properties, 70% of which were resold at a profit. This performance was helped by Mirvac's decision to limit pre-sales exposure to foreign buyers to 30%.

Mirvac expects to pay a distribution of 10.2–10.4 cents, 3–5% more than 2016. **HOLD**.

Stockland (SGP)

Stockland reported a healthy 8% growth in profit for the six months to December, with gains in retail and retirement living offsetting weakness in office assets. Stockland's shopping centres saw 99.5% occupancy and rental growth, although tenant sales growth was only 0.4%, which is likely to constrain future rental increases.

Unlike Mirvac's residential business, which is weighted towards medium density apartments, Stockland's business is focused on house and land packages, properties that generally attract less speculative interest from investors. Stockland's residential development business unsurprisingly benefited from continued strong eastern seaboard price growth and has 5,807 contracts on hand from buyers, with 3,635 expected to settle in 2017.

Table 7: Stockland interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
DISTRIBUTABLE PROFIT ($M)	369.0	342.0	8
DISTRIBUTION PER SHARE (C)	12.6*	12.2	3
GEARING (%) (SEE NOTE)	23.9	23.1	3
NTA PER SHARE ($)	4.0	3.87	3

*** Unfranked, ex date already past, DRP (1% discount)**
Note: gearing = net debt / (total tangible assets less cash)

The record level of residential deposits provides investors with a degree of confidence that Stockland will be able to grow its distribution above 5% per annum in the medium term. **HOLD**.

Staff members may own securities mentioned in this article.

Myer's profit was in line with expectations but sales growth is proving inadequate at this stage of the turnaround.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 21 MARCH 2017

Myer: Interim result 2017

In Myer's recent interim results, management marked a milestone: 'We are 18 months into our five-year transformation'. Many of the things we expected when we first upgraded the stock in ***Is Myer still a pariah?*** on 11 Nov 15 (Speculative Buy – $0.943) – shortly after management announced the New Myer strategy – have in fact happened.

Key Points

- ***Interim profit supported by cost cutting***
- ***Sales growth weakening***
- ***Outlook much less favourable***

MYER (MYR) / SELL

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.10	3%	High	High

BUY Below $0.65 **HOLD** **SELL** Above $1.00

$1.10

Earnings declines have abated, while strong cash flow has resumed. Dividends have also recommenced. In fact the 2017 interim dividend was lifted by 1 cent to 3 cents per share, making a total of 6 cents for the past year.

Unfortunately, though, weak sales growth in the result looked like a setback – and it's a big one. One of the key tenets of management's New Myer strategy from 18 months ago was the introduction of a range of new 'wanted' brands. This merchandising overhaul has to a large extent been implemented (although brand management is an ongoing process).

Eighteen months on, the introduction of new brands should have boosted sales growth. But it simply hasn't happened to the extent expected – in fact second-quarter same-store sales growth fell 0.5% (see Chart 1). After a decent-enough Christmas, sales fell in a hole in January during Myer's Stocktake Sale. While concession sales rose 25% in the half, private label and wholesale brand sales fell 12% and 4% respectively.

This can all be explained away. Apparel sales are going through a tough period, as recent retail collapses have shown; Myer can't be immune. The company's ownership of sass & bide was also a drag in the period as consumers walked away from premium brands. And management's strategic decision to cease heavy discounting – consistent with its move upmarket – cost it 'affordable fashion' customers during the Stocktake Sale.

Damage contained

Myer managed to contain any damage with cost-cutting. A 0.8% improvement in its cost of doing business meant that earnings before interest, tax, depreciation and amortisation (EBITDA) rose 3% to $142m in the half. Lower interest costs boosted net profit by 5% to $63m (see Table 1).

Table 1: Myer interim result 2017

SIX MONTHS TO 28 JAN	2017	2016	+/(–) (%)
REVENUE ($M)	1,785	1,795	(1)
EBITDA ($M)	142	139	3
NPAT ($M)	63	60	5
EPS (C)	7.7	7.3	5
DPS* (C)	3.0	2.0	50
FRANKING (%)	100	100	N/a

*** Interim dividend, ex date 24 Mar**
Note: Figures are underlying results

But the sales numbers the company is now delivering simply aren't good enough. When we originally upgraded the stock in November 2015, we'd expected that sales growth would be significantly better at this stage in the turnaround (similar to the boost David Jones experienced after its change of ownership, even if it seems to have lost its way more recently). This partly formed the basis for our statement that 'from 2017, earnings should stage a recovery'.

Myer's earnings should rise this financial year. But it won't be by much, and earnings are being driven by cost-cutting rather than sales growth. From our original expectations of 10–11 cents in 2017, the company is unlikely to produce much more than 9 cents this year. Our longer-term aspirational

> **With the company's sales growth actually deteriorating in recent months, we hate to think what might happen as housing prices ease or interest rates increase.**

target for earnings per share of 20 cents looks too optimistic given this lack of sales growth. Management's own sales growth target of an average of 3% a year between 2016 and 2020 also looks optimistic.

There's some downside risk to profit guidance in 2017 too. Management confirmed that net profit should increase this year, with the caveat that the dire conditions experienced in January and February do not return. As headwinds are par for the course in the department store industry, this is perhaps a risky assumption.

Sales deteriorating

Also weighing on our minds is that Myer, unlike furniture and appliance retailers, does not seem to have benefited much from the house price boom in the eastern states. With the company's sales growth actually deteriorating in recent months, we hate to think what might happen as housing prices ease or interest rates increase.

If sales aren't likely to grow, neither are earnings. And if earnings per share are unlikely to approach 20 cents by the end of the current decade, then there's insufficient margin of safety at this price given the risks. Our recommendation of the stock was based on New Myer delivering good sales and earnings growth, which now looks less likely. Of course, this is the nature of a speculative recommendation.

The fact we purchased the stock cheaply in the first place has protected us to some extent, but our various Myer recommendations (including at up to $1.25) look like mistakes. The earnings upside we envisaged in any turnaround looks unlikely, which means our investment case is broken. There's insufficient reason to maintain a holding without this potential upside.

We're therefore downgrading the prices in our price guide significantly. This also implies a downgrade of the recommendation to **SELL**.

Staff members may own securities mentioned in this article.

This 4-wheel drive parts manufacturer delivered a rare disappointment in its interim result, and we're almost getting excited.

BY JAMESCARLISLE • INTELLIGENT INVESTOR • 20 MARCH 2017

ARB: Interim result 2017

Depending how you look at it, ARB Corporation's interim result last month was either somewhat disappointing or highly gratifying. On the one hand, revenue rose only 6.1% compared to forecasts of a couple of per cent more; on the other hand, it has caused the share price to fall around 6%.

ARB CORP (ARB) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$14.66	6%	Low–Med	Med–High

BUY Below $13.00 | **HOLD** | **SELL** Above $20.00

$14.66

Australian Aftermarket sales (which contribute 68% of the total) grew a modest 5.0%, with above-average sales in Victoria and NSW offsetting a flat performance elsewhere and a decline in Western Australia. The performance was also affected by wage negotiations at the company's factory in Thailand, which 'severely disrupted' production in November and December.

Exports (25% of the total) grew 12.1%, helped by the new sales and distribution facility in Dubai, which began operating in June 2016 and 'is already providing useful sales'.

Original equipment sales direct to vehicle manufacturers (7% of the total) fell 2% – which is somewhat worse than management's forecast last August that growth would slow from the 12.2% achieved in 2016. The company is 'working on a number of new contracts' with original equipment manufacturers (OEMs) that should improve sales in this category in the 2018 financial year.

A slight improvement in the operating margin, from 17.0% to 17.3%, meant that pre-tax profit grew 8.2%. This was offset by a higher tax rate – due to a higher proportion of profits being earned in higher-tax countries – so that net profit only rose by 5.6%. Management expects the tax rate to 'moderate' in the second half.

Operating cash flow of $28m was almost double its level in the first half of the 2016 year, but slightly lower than the $30m seen in the second half of 2016. The first half of 2016 was affected by a $13m increase in inventories due to warehouse expansion and the introduction of new products; $4m of that was unwound in the second half of 2016, while the first half of 2017 saw a $1m increase.

Capital expenditure jumped to $16m – the same as was spent for the 2016 full year – as the company continued to work on its new warehouse in Keysborough, Victoria. As a result, free cash flow was just $12m, or about half of net profit. As we explained in ***ARB shifts back into gear*** on 26 Sep 16 (Hold – $18.07), though, ARB has a fantastic track record and we're more than happy to see it investing.

Table 1: ARB interim result

SIX MONTHS TO DEC ($M)	2016	2015*	+/(–) (%)
REVENUE	186.2	175.5	6
PROFIT BEFORE TAX	32.2	29.8	8
NET PROFIT	23.4	22.1	6
EPS (C	29.5	27.9	6
INTERIM DIV. 16c fully franked, up 10%, ex date 6 April			

* Underlying

There are few stocks we'd relish buying more than ARB and, with the price now down 19% since our September update, we're daring to dream. For the time being, though, we continue to recommend that you **HOLD**.

Staff members may own securities mentioned in this article.

Downer's management believes it can improve Spotless's performance – but we have our doubts.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 22 MARCH 2017

Downer dreams of Spotless miracle

Everyone wants to have a go at sorting out **Spotless Group** (ASX: SPO) and you can see why. With razor thin margins, it doesn't take much imagination to see how profitability can be improved – and business managers aren't known for a lack of imagination, at least where their own management skills are concerned.

As Warren Buffett explained in his **1981 shareholder letter**: 'Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad's body by a kiss from a beautiful princess. Consequently, they are certain their managerial kiss will do wonders for the profitability of Company T(arget) ... We've observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses.'

So it goes with Spotless Group, which was taken private by Pacific Equity Partners in 2012, refloated in 2014 and is now the subject of a takeover offer from **Downer EDI** (ASX: DOW).

To be fair to PEP, they evidently did have some doubt as to the potency of their kisses, as they refloated the company at $1.60 in May 2014 with the job half done, as we explained in ***Spotless misses the mark***. Prior to PEP's involvement, Spotless's operating margin had contracted from 4.3% to 3.2% and PEP got it back to 4.0% in the year before the float and was forecasting an improvement to 8.4% in 2015.

And to be even fairer, the floated company actually pulled it off, duly chalking up an operating margin of bang on 8.4% in 2015 – before it tumbled back down to 6.6% in 2016.

Then a profit warning sliced the share price in half – to $1.06 – in a matter of days. The company's latest interim result showed an operating margin of just 4.5%, causing the stock to tumble all the way to 72 cents before Downer EDI came along, pouting, with yesterday's bid of $1.15.

Downer's management is clearly confident of the potency of its kisses, devoting a whole slide in the takeover presentation to explaining its specific techniques: 'detailed risk management processes', 'maintaining focus on customers and business performance', 'identifying and delivering synergies'.

Well, we wish them luck, but it's hard to escape the conclusion that we've been here before.

We like a fairy tale as much as anyone, but we also know that most toads turn out to be toads not princesses.

IAG's regulations, portfolio and performance

With respect to IAG (or for any Insurance companies for that matter) are there rules about how much, in percentage terms, the company must hold in preparation for insurance payouts and, when holding such amounts, are there any rules regarding where and how they can invest them. Are there any standards as to what percentage return the companies should get for these investments. I hold shares in IAG and am wondering how to assess their performance through their financial statements. It seems to me that they have no control over the claims that may come their way and little control over their investments when the equities market is flat. I bought them because I don't care for the banks and because I thought that the establishment of Warren Buffett''s name and some money into the organisation may help provide some Asian growth in the near future. Any comments would be appreciated.

24 Mar 2017 – **Graham Witcomb**: So it seems like your questions revolve around two main issues: what are IAG's capital requirements and portfolio management rules, and how do you assess an insurer's performance.

In terms of capital requirements, the best source is **APRA's General Insurer Prudential Standards**. Here you'll find the bazillions of pages that regulate insurers. General insurers have two main capital requirements: They need to maintain assets in Australia (excluding intangible assets like goodwill) that equal or exceed their Australian liabilities. Put another way, they always need to have a positive tangible book value.

Insurers also need their total regulatory capital (CET1 and CET2) to exceed the **Prescribed Capital Amount** (PCA), which is quite a detailed calculation based on various 'risk charges', which themselves **are calculated by APRA's balance sheet stress tests**. To be frank, I don't know the details of how APRA actually comes up with the Prescribed Capital Amount, it just spits out a number each year and the insurer has to dance to it. In IAG's case, its targeted benchmark is for a total capital position that's 1.4–1.6 X the PCA, compared to APRA's requirement of 1.0 X. IAG's total regulatory capital was 1.72X the PCA in 2016.

The other requirement is to have capital classed as 'Common Equity Tier 1' (CET1) of at least 0.6 X the PCA. CET1 capital is that which is considered permanent, unrestricted and which ranks behind the claims of depositors and other creditors if things go belly up. It's mainly composed of common stock and retained earnings. IAG's targeted range is 0.9–1.1 X and its CET1 multiple in 2016 was 1.06 X – well above APRA's requirement of 0.6 X.

You can find a breakdown of IAG's different levels and components of capital, including CET1, as well as the Prescribed Capital Amount, on page 62 of IAG's **2016 annual report**.

As to the investment portfolio's composition, the Institute of Actuaries of Australia **has this to say**: "Regulated General Insurers, Health Insurers and Life Insurers in Australia are not subject to direct regulatory controls as to their investments (nevertheless, there are different capital related consequences which are associated with the holding of different classes and amounts of particular investments). Australian insurers essentially have "complete freedom of insurer action in relation to investments, with appropriate additions to solvency where this action results in additional risk".

They can technically hold whatever they like, but tend to play it fairly safe. In IAG's case, 88% of its portfolio is in fixed interest assets and cash, with the rest in equities or other investments. In terms of how to assess an insurer's overall performance the main measures to look for are: 1. **The combined ratio**. A number below 100% means the company made an insurance profit by writing policies (excl. returns from the investment portfolio.) Something below 95% is good, below 90% is damn good. IAG's combined ratio was 91.3% in 2016 (see page 88 of the annual report). This is important as, like you said, claims are outside an insurer's control. What they can control, however, is pricing – good insurers will let go of business if they can't get a premium that more than compensates for the risk of loss. You want an insurer that consistently makes good bets, and that is reflected in a combined ratio that is consistently below 100%.

The other measures of performance are: 1. Return on equity. Anything above 10% is ok, above 15% is what I like to see – IAG achieved an ROE of 13% in 2016; 2. Premium and policyholder growth. Ideally, this will be at least the low single digits and above competitors, suggesting they are taking market share, as was the case this year for IAG; and 3. Growth in earnings per share to ensure you aren't being diluted with capital raisings. With general insurers, though, it's important to look at this figure over long stretches, say 5 years or more, as earnings can be quite volatile due to natural disasters and swings in investment income. This last factor is where the red pen comes out for IAG. Earnings per share haven't grown in 10 years, despite a significant increase in gross written premium.

Time to revisit Downer EDI?

Ceased coverage of DOW in December 2015. Is it maybe time to revisit?

23 Mar 2017 – **Gaurav Sodhi**: After making a baffling takeover for Spotless, absolutely not. I cant figure out how this fits into any sensible strategy or how they can justify the price but we will see, maybe it works for them. There is certainly not enough in it to make an attractive investment.