Weekly Review

RESEARCH

– Issue – 25 Nov. 2016

Successful investing is as much about avoiding losers as it is picking winners. This is how we avoided the iron ore crash.

BY JOHN ADDIS • INTELLIGENT INVESTOR • 24 NOVEMBER 2016

5 from 15:
The myth of stronger for longer

For decades, the price of iron ore chugged along like a slow moving train, never rising much above US$15 a ton. That was as it should be. The planet does not suffer from a lack of iron ore. In places like the Pilbara, it's right beneath your feet, accessible with a sharp pull of the heel.

Other than dealing with the arduous process of getting it to the customer – iron ore is more about logistics than mining – the big producers enjoyed a predictable life. Demand met supply at pretty much the same place, year after year, and so the price of ore exhibited a tranquil equilibrium.

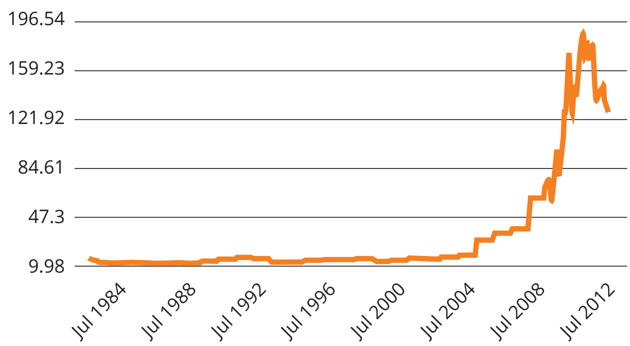
Then something remarkable happened. In July 2004, a metric ton of iron ore cost US$14, much the same as it did in July 1991. But by February 2011, it was selling for $US187. The reason for this 1,236% rise was a huge increase in Chinese demand.

As analyst Gaurav Sodhi wrote in ***Iron ore: It's (not) different this time*** on 15 Nov 10, 'In return for legitimising the authoritarian rule of the Communist Party, the people of China have been wrenched from grinding poverty and heaved towards a prosperous new future.'

At the heart of this modernisation was a huge and growing demand for steel. Iron ore was the key ingredient, along with coking coal and manganese. By 2009, China accounted for 50% of the world's crude steel output and was producing more than four times the volume of steel it had been making a decade earlier.

But there was a problem. Ore supply had been locked up by three of the world's biggest producers – Vale, **BHP Billiton** and **Rio Tinto** accounted for 60% of global ore output – and China didn't much like paying sky-high prices for it. The country set about promoting new global supply, including mining its own resources. That changed the dynamics of the industry. In the Pilbara and Carajas, Brazil, producers did not bother with grades of less than 55% iron but, in China, miners worked with a shovel to recover grades as low as 20%.

Chart 1: Iron ore price, 1982–2011 (US$/metric ton)



Source: smh.com.au

The measures had the desired effect. In 2010, it was estimated that Brazil and Australia produced just under 400 mtpa of iron ore. Meanwhile, Chinese domestic production had risen to 900 mtpa. That huge increase by Chinese miners was about to have a global impact.

As Gaurav said in his review of the sector: 'Chinese authorities understand what many iron ore investors don't: that there is a finite ceiling to how high iron ore prices can go before

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IMPORTANT INFO

PORTFOLIO CHANGES

PORTFOLIO	COMPANY	BUY/ SELL	DATE	NO. OF SHARES	PRICE ($)	VALUE ($)
Growth	South32	Sell	22/11/16	113	2.58	292.00
Growth	BHP Billiton	Buy	22/11/16	14	24.23	339.00
Income	South32	Sell	22/11/16	101	2.58	261.00
Income	BHP Billiton	Buy	22/11/16	13	24.23	315.00

Continued from page 1 ...

plentiful low grade resources become viable. We believe we are now at such a threshold. The only thing standing between hungry steel mills and a flood of new supply are the logistics to get the lower-grade ore into the mills.'

With average returns on equity of just 3.5%, Chinese steel making was a woeful business but the authorities didn't much care about that. They wanted to get the price down and understood what was necessary to do it. Eventually, the huge increase in supply hit the iron ore price.

Table 1: Iron ore miners in trouble

COMPANY (ASX CODE)	RECO/ PRICE AT 15/11/10	PRICE AT 23/11/16	% CHANGE
BC IRON (BCI)	Avoid – $2.51	$0.18	–93.0%
IRON ORE HOLDINGS (IOH)	Avoid – $1.89	Taken over	N/A
FORTESCUE METALS GROUP (FMG)	Avoid – $6.82	$6.30	–7.6%
SUNDANCE RESOURCE (SDL)	Avoid – $0.31	$0.00	–99.4%
GINDALBIE METALS (GBG)	Avoid – $1.18	$0.03	–97.6%
ATLAS IRON (AGO)	Avoid – $2.97	$0.02	–99.3%

Local miners soon hit trouble. After reaching a high of US$187 in 2011, by July 2015 the iron ore price had crashed through US$50. In Australia, the effects of the fall were being felt before then.

In late 2014, **BC Iron** took over Iron Ore Holdings in a cash and shares deal that valued the stock at $1.59 a share. As the table shows, that deal didn't much help. **Sundance Resources** is currently facing bribery allegations and is all but gone while the others are shadows of their former selves. Only **Fortescue Metals**, which slashed its cost base with alacrity, survived in a meaningful way.

As for the bigger miners, we advised members to Take Part Profits on BHP Billiton on **19 Jan 05**, and stuck with that recommendation as the price rose for the next three years. With Rio Tinto, we held throughout the boom and much of the subsequent bust, eventually selling out on **29 Nov 10** (Sell - $83.65). Rio's stock last traded at $58.13.

In both cases, the buy/sell decision was more complicated. These are both huge, diversified miners with high quality assets. It was the smaller miners, where most of the excitement was being generated, that we were most keen to avoid. So, what can we learn from the great iron ore boom and bust?

1. When the music's playing, you don't need to dance

In early 2005, Atlas Iron was trading at 29 cents a share. By May 2008, it had hit almost $4 (the shares subsequently crashed but the second leg of the boom kicked in and Atlas's shares did break $4 in August 2011). Price rises like that get attention. The media writes about them, sceptical analysts respond to clients' demand for research, and confidence floods a market that doesn't need much encouragement.

Before we knew it, 'stronger for longer' had become gospel. We had entered a new era, or so we were told. Obviously, partaking in such a boom entertains the risk of a crash. But in an exuberant environment investors tend to forget about that, coming to believe that the risk is in not being a part of the exuberance.

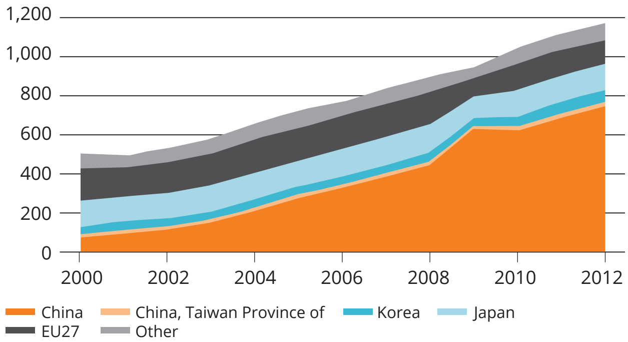
To be successful at investing, you have to be prepared to miss out on huge price rises if that also entails avoiding the bust. For investors at least, Citigroup's Chuck Prince was wrong: if the music's playing, you don't have to get up and dance.

> Despite recently hitting a two-year high, the iron ore price is only back to where it was in 2009.

2. Challenge the dominant narrative

Standing aside while everyone else makes money on the way up isn't easy. Chinese demand *had* fundamentally changed market dynamics, paving a path for small miners to become huge, profitable concerns, if only temporarily. But the narrative obscured a more fundamental truth, visible only to those prepared to look at the market dynamics with a sceptical, independent eye and challenge the dominant narrative.

Chart 2: Global iron ore imports



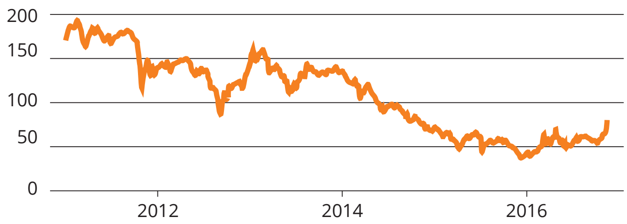
Source: Chart recreated from IntierraRMG presentation; UNCTAD, Raw Materials Data Iron ore, 2013

3. Supply and demand matter

Whilst Chinese demand had risen massively, the fundamental interaction between supply and demand had not. Even among Western producers, it was clear that higher prices would eventually lead to increased production, which is exactly what happened.

As for the Chinese production, the largely irrational nature of it – at least as conceived by Westerners – added to the dynamic. The huge increase in production has bought down prices, just as an analysis of supply and demand would suggest. The Chinese understood this; many investors in Australian iron ore stocks did not. Despite recently hitting a two-year high, the iron ore price is only back to where it was in 2009.

Chart 3: Iron ore price, 2011–2016 (US$/metric ton)



Source: www.tradingeconomics.com, OTC

4. A crash brings opportunity

In September 2012, in ***Iron ore: Trumpets and warning bells***, Gaurav wrote: 'Although lower iron ore prices will mean lower profits for the likes of BHP and Rio in the short term, there is a rust-coloured lining. Lower prices strengthen the position of the big three by ensuring high cost projects get canned. Competition will be killed off.' He concluded that 'BHP and Rio are now on our radar'.

Although we didn't purchase Rio Tinto, we did upgrade BHP on **27 Jan 15** (Buy – $28.91). Admittedly, that decision has yet to work out, but it does make the point. If you can avoid a boom, there are often bargains to be found in the bust. It's better to be looking in the wreckage than be a part of it.

Staff members may own securities mentioned in this article.

Helped by a fresh new format, Myer's 2016 annual meeting was the latest evidence that the New Myer strategy is making a difference.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 21 NOVEMBER 2016

Myer: AGM 2016

If marketing was the only thing that mattered for retailers, then Myer's sales would be roaring. The company's annual general meeting was a slick production but, for the record, the new format made for a refreshing change (you can watch the **webcast online** if you're interested).

Key Points

- ***Sales growth better than expected***
- ***Further evidence New Myer is working***
- ***Excellent annual meeting format***

The company's directors sat in comfy armchairs rather than behind a forbidding desk and, with the chairman Paul McClintock interviewing them Michael Parkinson-style, each outlined their take on the New Myer strategy. The meeting not only humanised the directors, but gave shareholders a feel for their expertise. More companies should follow the format if they want shareholders to understand what directors bring to their roles.

Of course, Myer's sales aren't roaring, with the company reporting same-store sales growth of just 1.6% for the first quarter of 2017. But it was again pleasing to see same-store sales growth at flagship and premium stores – where Myer is devoting most attention – at 2.8% over the same period.

It's a measure of just how low expectations were that Myer's share price jumped 14% on the day. Most retailers are still reporting difficult conditions, which follows on from our comments last month in ***Myer upgraded***. Shareholders were obviously relieved that Myer is holding its own, while the fact that same-store sales growth exceeded that of David Jones helped lift excitement levels.

As managing director Richard Umbers said, though, the company is just one year into a five-year turnaround. It's still early days, but the meeting gave a strong sense that a lot had been achieved over that first year. We're now the most comfortable we've been that management can make the New Myer turnaround – first outlined in ***Is Myer still a pariah?*** – work.

The first major store to be refurbished as part of the New Myer strategy – at Warringah Mall on Sydney's Northern Beaches – also opened last week. As McClintock said at the meeting, the store 'reinforced my confidence in Richard and the rest of the management team and their ability to execute'.

Small but perfectly formed?

By all accounts, Myer Warringah is a smaller but much, much better store. Look out for colleague Andrew Legget's **blog piece** on his store visit (he's keen, having already been twice since it opened). If you've visited, let us know your thoughts in the comments section below.

Myer shares continue to look reasonable value, with expectations that the company will report earnings per share of around 9-10 cents this financial year. We currently expect that earnings growth should accelerate into the 2018 year. On a historical free cash flow yield of 10%, the stock remains worth buying.

All that said, Myer's ultimate earnings performance over the next four years will depend to some extent on consumer confidence. This Christmas will be important, but so will the one after that – and the one after that. Our thesis could be demolished by a recession or management mistake, so we're sticking with the speculative tag.

As always, we continue to recommend you buy on bad news but wouldn't be surprised if sentiment towards the stock improves in the short-term as analysts become more comfortable with the New Myer strategy. We're not far away from a downgrade to Hold again but the recommendation remains **SPECULATIVE BUY**.

Staff members may own securities mentioned in this article.

This logistics company's profits overstate reality. Here we explain Brambles' free cash flow problem and why it matters.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 23 NOVEMBER 2016

Brambles: A pallet of poor returns

I can't help but feel a little sorry for Brambles. Its pallet pooling operation, CHEP, is at the centre of world trade, helping to move goods from suppliers to customers. The company made a net profit of US$557m this year – a 10% profit margin and a return on equity of 20%. Not bad at all. Yet, still, Brambles is about as popular among the analyst team as singers who mime at concerts.

Key Points

- ***Capex exceeds depreciation***
- ***Dominant position; low free cash flow***
- ***Downgrading to Sell***

From a distance, the company looks like a high-quality business with a commanding market share, earning decent margins and returns on capital. Up close, though, you realise that Brambles doesn't distribute its earnings to shareholders as cash. It pays them in pallets.

Brambles made US$3.3bn in cumulative net profit over the past five years, yet only paid US$1.8bn in dividends. What's more, the company needed to raise US$448m in additional capital in 2012. So where did the extra US$1.9bn of retained earnings and fresh capital go?

Every last cent needed to be reinvested into the business for it to maintain its operations. We can't even say that the money was spent growing the business – underlying earnings per share are still 8% below where they were in 2012.

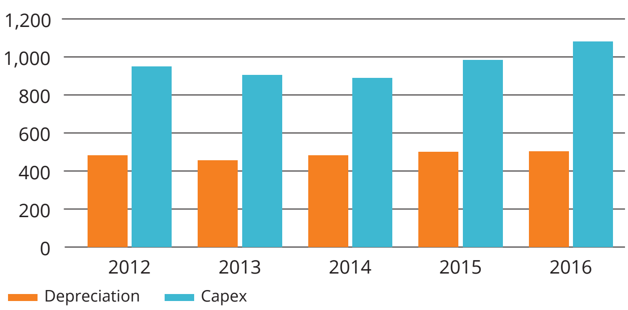
A losing game

We're not being entirely fair: Brambles used a bit under US$400m paying off debt, which we like to see – though there's still around US$2.6bn of net debt on the balance sheet. And around US$700m evaporated due to the translation of earnings and assets at foreign subsidiaries back to the US dollar while the currency strengthened.

That still leaves an earnings gap, and Chart 1 shows you where the profits went – or, to be more accurate, why they were never really there to begin with.

Brambles currently owns 550 million pallets worldwide but, in a typical year, around 1-in-10 are either lost, damaged or otherwise deemed 'irrecoverable'. Of these, only around half garner any compensation from the customer, so Brambles is usually left footing the bill. It must constantly buy new pallets just to maintain a steady level of stock.

Chart 1: Capex vs depreciation ($m)



Source: Company reports

Last year Brambles wrote off US$75m of lost pallets – with a further depreciation expense of US$373m for the battered survivors – but the company spent US$620m replacing all the irrecoverable and scrapped stock. The difference will eventually flow through the income statement as higher depreciation in future years, but the cash is still out the door today.

Bad renters

Why does this matter? Imagine you want to earn a little extra income each month and so decide to rent out part of your home. One of your neighbours offers to pay $50 a month to rent a car space on your driveway, and another neighbour pays $100 a month to rent a granny flat in your backyard for their teenage son.

At the end of the month, the cash comes rolling in – but there's a problem. When you inspect the teenager's granny flat, it looks like he drove a forklift through the living room

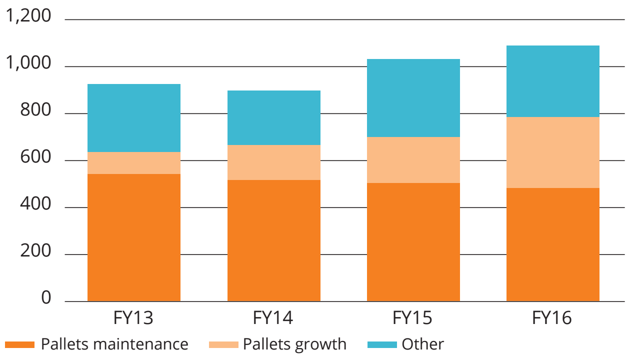
> "Despite Brambles' earnings per share going absolutely nowhere since 2012, the share price has almost doubled.

before hitting a landmine in the bedroom. You'll need to spend at least $100 on repairs. In contrast, the car space is still sitting there in the same condition you left it.

Here, the car space is considered 'capital light' as it doesn't need constant reinvestment, whereas the granny flat is considered 'capital intensive' as you need to spend lots of cash to maintain it. On paper, the granny flat is earning more in rent, but, in reality, the car space is producing more 'free cash flow'. And whether it's an investment property you own or a business, free cash flow is what matters.

Brambles produced US$1,167m of operating cash flow in the year to June, but needed to spend US$1,081m – 19% of revenue and more than double depreciation expense – on replacing old pallets and buying more to grow (see Chart 2). That leaves just US$86m of free cash flow.

Chart 2: Capital expenditure ($m)



Source: UBS Research

Even if we add to this the US$104m received from the sale of old pallets to third parties, the company still only has free cash flow of around US$190m – a far cry from the US$557m in statutory net profit.

Still, Brambles does have a few things going for it. Pallets are an important cog in global trade and the company dominates its industry – a position we expect it to maintain for decades to come. The business enjoys significant economies of scale, which is a formidable competitive advantage. And although growth hasn't been stellar, there will almost certainly be more goods shuffled around the world economy in 10 years' time than there are today, so Brambles at least has a little wind in its sails.

This isn't a high-quality business the likes of **Cochlear** or **REA Group**, but we would still be happy to recommend buying the stock – if the price is right.

The price is wrong

Despite Brambles' earnings per share going absolutely nowhere since 2012, the share price has almost doubled. Investors are paying a good 90% more per dollar of earnings today than a few years ago, despite very little change in the long-term outlook.

A price-earnings ratio of 25 and free cash flow yield of 1.4% simply doesn't provide adequate compensation for the risks.

In 2016, the Americas pallets business – where Brambles has a 40% market share – increased earnings before interest and tax (EBIT) by 2.5% to US$428m. The Europe, Middle East and Africa pallets operation did slightly better at 3% EBIT growth to US$355m.

That's reasonable given Europe's current economic woes – and management forecasts revenue growth of 7–9% in 2017 – but it's still nowhere near enough given the low yield on offer. And we haven't even touched on the potential effect of Donald Trump's proposed scrapping of various US free trade agreements (hint: it's not a positive).

A final point of concern is the recently announced retirement of chief executive Tom Gorman, which is to take effect in February 2017. A new chief financial officer also came on board last month. If we know one thing about business, it's that new managements like to work with a clean slate. This coming year's financial results would be a perfect time to air any skeleton-filled closets, write off extra pallets, and catch up on any delayed capital investment. We don't necessarily expect bad news, but new managements tend to crystallise it.

We're reducing our maximum portfolio weighting from 8% to 5% and, even though the stock is just above our recommended Sell price of $12, we're disinclined to give it much leeway. We're downgrading to **SELL**.

Staff members may own securities mentioned in this article.

All the news is focussed on the Gold Coast, but Ardent's future lies closer to Texas. Is the 25% fall in its share price enough to warrant a buy?

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 21 NOVEMBER 2016

Will Dreamworld take away from Ardent's Main Event?

The tragic accident that occurred at Ardent Leisure's Gold Coast theme park Dreamworld stunned the nation.

Many of us have been to Dreamworld and quite likely been on the very ride whose malfunction led to the death of four people. Even if we haven't, the idea that people could lose their lives at a place synonymous with family fun and laughter seems so unfair.

Key Points

- ***Theme park results uncertain***
- ***However, increasingly less important***
- ***US business is now main focus***

ARDENT LEISURE (AAD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$2.02	4%	Med–High	High

BUY Below $1.10 — HOLD — SELL Above $2.20

$2.02

Compared to the loss the victims' families must be feeling, a 25% fall in the company's share price is of no consequence. However, it's been more than three years since our last review on this stock, it was already on our list for an update, and all we can do is try to assess the company's value as things stand today.

Theme Parks

Alongside the 25% fall in the share price, the most obvious new factor is that Dreamworld is still to re-open following the accident, with management waiting until 'every ride has undergone a thorough safety check'.

Considering the high fixed costs involved in theme parks (and any leisure business) this is likely costing the company a lot of money but it's necessary to minimise the risks of further accidents and to reassure the public. As much as the closure is hurting the business, what matters more is how many people will queue up when the gates are eventually reopened.

The history of theme parks that have suffered serious accidents is mixed, with some never opening their gates again and others continuing to trade as if nothing ever happened.

The Alton Towers theme park in the UK is the most recent example where four people were seriously injured in 2015. According to the Themed Entertainment Association's 2015 Theme Index, the park suffered a **25% fall in attendance after the accident**.

Table 1: Ardent value using 2017 theme park estimate

($M)	LOW EBITDA	HIGH EBITDA	LOW VALUE	HIGH VALUE
THEME PARK	15	40	120	320
MAIN EVENT	61	80	488	640
INDOOR ENTERTAINMENT	19	25	114	150
CORPORATE COSTS	(16)	(14)	(128)	(112)
BUSINESS VALUE			594	998
NET DEBT			(308)	(308)
EQUITY VALUE			286	690
VALUE PER SHARE ($)			0.61	1.47

Consensus estimates are that Dreamworld is likely to suffer a similar fate in 2017, with many predicting a fall in attendance of around 20%. We estimate this would lead to operating profit (before rent, depreciation and amortisation) falling by about 45%, to just under $20m.

Table 2: Ardent value using normalised figures

($M)	LOW EBITDA	HIGH EBITDA	LOW VALUE	HIGH VALUE
THEME PARK	35	84	280	672
MAIN EVENT	61	80	488	640
INDOOR ENTERTAINMENT	19	25	114	150
CORPORATE COSTS	(16)	(14)	(128)	(112)
BUSINESS VALUE			754	1,350
NET DEBT			(308)	(308)
EQUITY VALUE			446	1,042
VALUE PER SHARE ($)			0.95	2.22

The other part of the equation is how much is spent by those that do visit the parks. In response to its accident, Alton Towers froze the price for 2016 family tickets while

> **The company's major focus is on its chain of Main Event family entertainment centres (FECs) dotted across the USA**

only increasing single tickets by around 3% (all prices were increased by double digits in 2015).

This would have hit the average revenue per guest. As well as the impact of lower attendance, each percentage point fall in average revenue will knock another 2.4% or so from Ardent's operating profit. All these figures also ignore any significant items related to legal costs, insurance and compensation that might be payable.

The best case scenario for Ardent is that any effect will be consigned to 2017, with the business reverting back to normal thereafter. However, if crowds continue to stay away, the business will be worth much less.

To try to cover both scenarios, we're valuing the business twice using our low and high estimates of earnings before interest, tax, depreciation and amortisation (or EBITDA). In our first valuation (see Table 1) we assume that the theme park division will suffer long-lasting effects from the accident and use our estimate of 2017 EBITDA. In the second (see Table 2), we use estimates of normalised EBITDA to reflect that the business suffers no long-term effect. A multiple of eight times is used in both scenarios.

Main Event

The positive for Ardent, however, is that the theme park division is increasingly less important to it — in fact, it brings in the lowest revenue of all three divisions (see Chart 1). The company's major focus is on its chain of Main Event family entertainment centres (FECs) dotted across the USA.

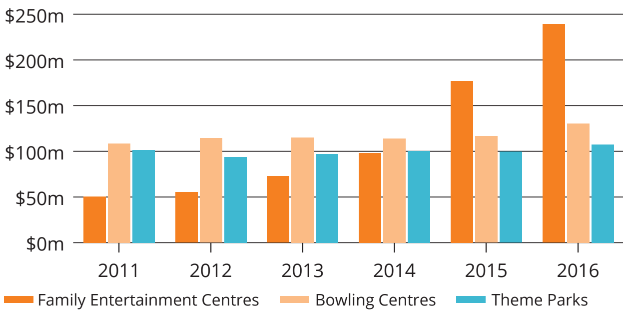
From nine centres in Texas in 2010, Main Event now has 27 venues (including 15 outside of Texas) and more are on the way. The company expects another 11 centres to open in 2017 and for its Main Event division to continue to grow by around 30–40% per year. Ardent has identified around 200 locations as opportunities.

So far this roll-out has been quite successful, with operating profit (before depreciation and amortisation) increasing by around 20% each year since 2010 and each new centre is expected to generate a return on investment of greater than 30%.

A new centre costs around US$7m to open and, with an aggressive rollout planned, capital expenditure is considerable. There were fears that the impact on Dreamworld might reduce earnings and harm the company's ability to fund the Main Event expansion but this should be fine in the short term. The proceeds from the $260m sale of its health clubs division and the impending sale of its marina assets allow the company to meet its funding needs in the short term without increasing debt.

Notwithstanding Main Event's success, however, it operates in a very competitive industry with large chains like Dave & Busters, AMC Entertainment and Chuck.E.Cheese as well as independent venues dotted across the American landscape. Ardent's store rollout is already leading to what it calls 'conscious cannibalisation' where new centres reduce the profitability of old ones. But when the alternative is to lose the incremental business to a competitor, this strategy makes sense.

Chart 1: Revenue by segment



Source: S&P Capital IQ

In valuing this division, we assume that each centre generates about US$6.5m in revenue and the division generates an operating profit (before depreciation and amortisation) of between $61m and $80m when translated back into Australian dollars. We have also used a multiple of 8 when valuing this business.

> “How much it is worth, though, depends a lot on what happens with Dreamworld over the coming years.

Indoor attractions

The final part of the jigsaw is the group’s Australian indoor entertainment businesses. This division operates bowling alleys such as the AMF and Kingpin bowling brands.

After a few flat years between 2012 and 2015, where profitability remained stable, the business came back firing in 2016 with operating profit (before depreciation and amortisation) increasing by 30% to $18.2m.

The company has focused on turning these venues into multi-attraction entertainment venues including bowling and electronic games and is also improving the food and beverage options. Management hopes these changes will continue to improve the customer experience and increase margins as more people visit the centres and spend more money.

In valuing this business we have assumed operating profit of between $19m and $25m and a multiple of six.

Is there an opportunity?

With the sale of its health clubs and marina businesses and the proceeds being used to fund the growth of its Main Event business, Ardent is a much better business than it used to be.

How much it is worth, though, depends a lot on what happens with Dreamworld over the coming years. If it suffers a significant and lasting fall in attendance over many years then Ardent is likely to be worth between $0.60 and $1.50. However, if business quickly reverts to normal at Dreamworld, Ardent’s value could be much higher – we’d estimate between $1.00 and $2.20.

With a forecast dividend yield of around 6%, we don’t see any reason for investors to panic and recommend members **HOLD**.

Staff members may own securities mentioned in this article.

A move to Mexico is reducing costs and a growing top line has pushed this healthcare stock to record profits.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 22 NOVEMBER 2016

F&P Healthcare: Interim result 2017

Fisher & Paykel Healthcare has released good numbers for the first half of the financial year, with revenue growing 12% to NZ$425m – though it increased a more hearty 16% after removing the effect of currency fluctuations. Net profit rose 26% to NZ$78m, or 30% in constant currency terms.

Key Points

- ***Masks market share is growing***
- ***Cost cutting is helping margins***
- ***Positive oxygen therapy clinical trial results***

F&P HEALTHCARE (FPH) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$8.29	4%	Medium	Med–High

BUY Below $5.50 — **HOLD** — **SELL** Above $10.00

$8.29

Revenue for the Hospital division – which sells respiratory humidifiers and accessories – increased 23% in constant currency terms, aided by a 35% lift in sales for new products and devices used in non-invasive ventilation.

Management singled out strong demand for the company's Optiflow nasal high flow and AIRVO systems. Positive clinical trial results were released earlier in the year showing that high flow oxygen therapy (Optiflow) was as effective as conventional oxygen therapy, which supported the brand's popularity among clinicians.

F&P Healthcare's other major division, Homecare – which sells masks and continuous positive airway pressure (CPAP) machines for sleep apnea – performed decently. Revenue increased 8% in constant currency terms, with mask sales up a respectable 14%.

Growing market share

Importantly, management noted the company is increasing its market share of masks. As larger competitor **ResMed** recently announced revenue growth for masks of 9% for the year to June, we can guess where some of that share was taken.

What's more, the overall CPAP device market is growing at around 7–8% a year so it's a reasonable guess that F&P Healthcare is at least maintaining share in the device market too – which is nothing to be sniffed at when you consider that ResMed has a research budget more than double that of F&P Healthcare.

CPAP and other respiratory device sales are important because as the installed base grows, so too does the proportion of recurring earnings from selling masks, accessories and other consumables. The proportion of revenue that is considered 'recurring' from these sales rose from 83% last year to 86%.

Innovation is essential in this industry so it was pleasing to see research and development spending rise by 16% to NZ$42m. The number of patent applications has more than tripled since 2012, suggesting a strong pipeline of future product releases.

Margin improvement

F&P Healthcare's gross margin increased 157 basis points to 64.9% (or 307 basis points in constant currency terms). The gross margin has risen from 55% a mere three years ago, which is an impressive feat. The improved margin has been due to increased sales of higher-margin products and cost cutting initiatives throughout the supply chain.

Table 1: FPH's Interim result

SIX MONTHS TO SEP.	2016	2015	+/(–) (%)
REVENUE (NZ$M)	425	381	12
EBIT (NZ$M)	111	95	16
NET PROFIT (NZ$M)	78	62	26
EPS (NZ CENTS)	13.8	11.1	24
DPS (NZ CENTS)	8.25	6.7	23

Over the past two years, the company has significantly reduced manufacturing costs by shifting manufacturing from Auckland to Tijuana, Mexico, where wages are lower. A further benefit of the move has been to reduce F&P Healthcare's reliance on foreign exchange hedges by diversifying the cost base. The company recently purchased

> **F&P Healthcare is a high-quality company, with a mouth-watering return on equity of 31% and a profit margin of 19%.**

an additional 15 hectare site in Mexico on which it plans to build a second factory to further increase production capacity in the region.

F&P Healthcare is a high-quality company, with a mouth-watering return on equity of 31% and a profit margin of 19%. Growth has also been remarkably steady, with revenue increasing at a compound rate of 11% over the past five years and earnings per share compounding at 19%.

Management said its 'longstanding objective is to double our constant currency operating revenue every five or six years' and it expects net profit of NZ$165–170m in 2017, with revenue around the NZ$880m mark.

The share price is up some 14% over the past year and currently sports a forward price-earnings ratio of around 29. The question now is this: can F&P Healthcare meet the growth expectations embedded in its lofty current share price?

We don't want to underestimate ResMed's research team – it would only take a couple of new blockbuster products to quickly put F&P Healthcare on the back foot. Nonetheless, given the business's growing market share, highly popular range of masks, economies of scale and expanding low-cost Mexican plant, we think the company has a decent shot at meeting management's ambitious five-year goal to double revenue.

We're notching up our price guide to reflect the growing business and continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

This billing software maker had a strong year of growth and is ramping up for more.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 25 NOVEMBER 2016

Gentrack: Result 2016

The financial media loves to focus on a company's net profit, but this figure isn't always what it seems. Accountants decide how to report profits; it's a product of fiddly adjustments and sometimes unreasonable rules.

Key Points

- ***Addition of four new customers***
- ***Excellent free cash flow***
- ***Net profit is understated***

GENTRACK GROUP (GTK) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$3.25	3%	Medium	Medium

BUY Below $2.70 · HOLD · SELL Above $5.00 · $3.25

A case in point is billing software maker Gentrack's statutory net profit of NZ$9.6m for the year to September, which significantly understates the company's underlying earnings power.

A management buyout in 2012 (prior to Gentrack's listing) added a wad of goodwill and intangibles to the balance sheet, and those intangibles are now being amortised as an expense through the income statement – even though the event that crystallised them didn't change the economic output of the company in any way.

Gentrack's statutory net profit was calculated after expensing NZ$2.0m of non-cash amortisation charges. But as they are just an accounting measure, we need to add back NZ$1.4m (after-tax) to reach Gentrack's underlying net profit of NZ$11.1m – 16% higher than the headline number.

Furthermore, underlying net profit rose a meagre 2% in 2017, but this was mainly down to NZ$1.4m of foreign exchange losses due to a strengthening New Zealand dollar. Some 75% of these losses were non-cash, unrealised changes in the value of hedging contracts and loans made by one Gentrack division to another (so-called 'intercompany loans').

Cash flow fountain

What really matters to shareholders is how much cash the company generates after all its bills, taxes, and capital expenditures (CAPEX) have been paid. This 'free cash flow' was up a more vigorous 16% to NZ$14.8m and can be used for paying dividends, making acquisitions and reducing debt.

Again, though, this figure isn't all that it seems. When a customer wants a new billing system they pay for it upfront. This shows up as NZ$8.5m of unearned revenue on Gentrack's balance sheet, which reduces the company's working capital needs. Unearned revenue rose NZ$3m this year due to a bumper year of new customers (see below). Although we expect Gentrack to add new customers each year, to be on the conservative side, we'll deduct this amount from free cash flow to reach a 'normalised' free cash flow figure that's on par with the underlying net profit figure above.

Table 1: GTK's full-year result

YEAR TO SEP.	2016	2015	+/(–) (%)
REVENUE (NZ$M)	52.7	42.1	25
EBITDA (NZ$M)	16.7	14.5	16
UNDERLYING NET PROFIT (NZ$M)	11.1	10.8	2
EPS (NZ CENTS)	14.8	14.8	0

As you might expect given this fountain of cash, Gentrack's balance sheet is squeaky clean and the company had net cash of $19m as of September, up from $12m last year. The business has more cash than it needs, which is why the board upped the final dividend by 7%.

Good growth

Revenue increased 25% to NZ$52.7m for the year. Most of that growth came from project services, which we'll get to in a moment, but it was still pleasing to see 12% growth in revenue from recurring annual fees and support services.

All up, about 56% of the company's revenue is recurring and it comes from a broad spread of utilities and airports around the world, so has limited exposure to the economic cycle.

> “Management expects ‘to continue to deliver long-term revenue growth and EBITDA growth of 10%+’.

That recurring revenue streams grew 12% is particularly impressive because growth tends to be driven by price escalations built into contracts – which are typically only in the low single digits – or the odd new customer.

As we’ve **explained previously**, it’s difficult to remove Gentrack’s complex billing software once it’s installed. That gives the company plenty of pricing power – but it also means that it’s hard for Gentrack to pry new customers away from competitors. With this in mind, that Gentrack signed up four new customers during the year is actually a pretty good showing.

Revenue from one-off projects – which accounts for around a third of total revenue – was up an impressive 61%. However, this portion of revenue is discretionary and more sensitive to the general economy than annual fees and support services. It’s prone to boom and bust.

Margin squeeze

Earnings before interest, tax, depreciation and amortisation (EBITDA) rose 16% to NZ$16.7m and the EBITDA margin narrowed from 34.4% to 31.6%. Normally, narrowing margins are a bad sign, but, in this case, it’s nothing to lose sleep over.

Gentrack increased its headcount by 60 people, leading to a 29% jump in employee costs (which make up two-thirds of total expenses). The sharp increase is due to an upfront investment in staff and development as the company sets itself up for future growth. Management sees scope to double its Australian operations (half of total revenue) over the next five years, which would increase total revenue by at least 50%. And to that you can add contractual price increases for existing customers.

Management expects ‘to continue to deliver long-term revenue growth and EBITDA growth of 10%+’. The stock has risen 80% since we **upgraded Gentrack to Buy** a little over a year ago, putting it on a price-earnings ratio of 23. Nonetheless, the stock isn’t expensive given its improving growth outlook – especially when compared to larger competitor **Hansen Technologies**, which has a price-earnings ratio of 29.

We’re increasing the price guide to reflect the growing business and, with captive customers, a clean balance sheet and plenty of free cash flow, we continue to recommend you **HOLD**.

Note: With several substantial shareholders, Gentrack’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 your purchase orders have a limit price and are not made ‘At Market’.

Disclosure: The author owns shares in Gentrack and Hansen Technologies.

Roving* analyst Andrew Legget shares his thoughts on Myer's first 'new strategy' store, which opened on Sydney's Northern Beaches recently.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 22 NOVEMBER 2016

What's new about 'New Myer'?

I'd only just walked through the doors of **Myer**'s (ASX:MYR) new store at Sydney's Warringah Mall when I heard someone say 'Myer looks amazing'. This would've been music to the ears of chief executive Richard Umbers, as would the sight of upbeat shoppers leaving with Myer shopping bags in their hands.

Thanks to a $310m redevelopment by **Scentre Group** (ASX:SCG), the department store icon was given a blank slate for the relaunch. Myer, which was located in a previously desolate area of the mall, now has all **walkways leading towards it**.

The new store is impossible to miss. But it's on the inside where the success of the new format will be judged. At the core of Myer's new strategy is a focus on creating a wonderful shopping experience for its high value, fashion conscious and affordable fashion customers.

The approach encompasses giving these shoppers more of the brands they want and introducing an improved shopping experience in a more visually appealing store. From the moment one walks in, the strategy is clearly on show.

The first thing that stands out are the numerous concessions, stores-within-stores where a brand essentially rents floor space from Myer, erecting its own signage and store fittings as if it were a stand-alone boutique.

This makes the overall feel of the store more visually appealing, as well as making it easy for customers to find the brands they like. Whilst concession sales are typically at lower margins (Myer only gets a cut rather than full sale price), they are attached to popular brands and **often lead to higher sale volumes**.

The new format stores will also be more interactive and experience-led. Throughout the Warringah Mall store are areas that allow the customer to do more than shop, including interactive displays, a café, full-service barber and live, in-store events. In the menswear section shoppers can play table games like fussball and air hockey while the womenswear section features vintage photo booths.

On the page, this may sound ludicrous. Who wants to play air hockey in a department store? But with bricks-and-mortar retail using experiences to combat the online threat, Myer should be rewarded for effort at least. Nor would these developments be done on a whim. If they cause shoppers to spend more time in-store enjoying themselves, increased sales, as the latest results indicate, may not be so far away. Such novelties may be symbolic more than anything else, but from a differentiation point of view they could be important.

Add the above to a more modern appearance, better lighting, luxurious fitting rooms and staff that were not only easy to find but extremely helpful, what was once a dull and dark embodiment of everything that was wrong with Myer (and bricks-and-mortar retailing in general) has long gone.

Of course, it's early days. The store (and the wing of the shopping centre it is located in) is still less than a week old but the Northern beaches community's reaction to it, as well as the retailer's latest sales update, is a promising sign that the company's turnaround is on track

Just over a year ago when we recommended Myer as a Speculative Buy (when the price was $0.94), the new strategy was no more than a presentation. Many thought the retailer's days were numbered. There's still a long way to go - **see our latest update here** - but so far, so good.

**Roving might be a bit of a stretch. But considering Andrew lives on the Northern Beaches where any trip that takes longer than 5 minutes is considered long distance we'll let him have it.*

Carsales recommendation downgraded

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 24 NOV 2016

CARSALES.COM (CAR) / HOLD

Price at review $10.63 | Max. portfolio wght. 6%

BUY Below $10.00 | HOLD | SELL Above $15.00 | $10.63

There's been no substantial news since we upgraded our recommendation on Carsales.com last week in ***Carsales' core business motoring***. Only that the company is not 'currently considering' selling its stake in **iCar Asia**, or launching a takeover. One presumes the former position could change instantly if it was approached.

As we've said before, though, we doubt Carsales will buy iCar Asia any time soon. To do so would require Carsales fund that company's losses well into the future.

Our current downgrade to our Carsales recommendation is purely price-related. **HOLD**.

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

iSelect: AGM 2016

BY JON MILLS • INTELLIGENT INVESTOR • 21 NOV 2016

ISELECT (ISU) / HOLD

Price at review $1.90 | Max. portfolio wght. 2%

BUY Below $1.40 | HOLD | SELL Above $2.20 | $1.90

After a horror first half of 2016, iSelect's **2016 result** suggested the business had stabilised in the second half and the good news from iSelect's recent AGM is that this appears to have continued into 2017.

The company's previously problematic Health division is performing better so far in 2017 compared to the prior period, although it's still experiencing some affordability issues in certain segments of the private health insurance market. Nevertheless, management expects this division to grow at two-to-three times the industry growth rate.

Management also expects the Energy & Telco and Life and General Insurance divisions to be drivers of growth in the near term. So far at least the results are also encouraging: Energy & Telco and Life and General Insurance grew revenue 34% and 33%, respectively, in 2016 and the 'early indication [so far in 2017]...is that this growth is continuing'.

Over the longer term, we think iSelect has potential to substantially increase its share of industry commissions in each division while also expanding into other markets. For example, it has recently expanded into credit cards and mobile phone plans.

Management reaffirmed guidance of 2017 earnings before interest and tax (or EBIT) of between $21m and $24m but now expects EBIT to be at the 'upper end' of this range assuming no deterioration during the remainder of 2017. Along with further evidence that the business has stabilised, this means we're increasing our price guide. Our Speculative Buy price moves to $1.40 (from $1.20) and our Sell price also rises, to $2.20 (from $2.00). **HOLD**.

Staff members may own securities mentioned in this article.

Send back SAI Global paperwork

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 23 NOV 2016

SAI GLOBAL (SAI) / HOLD

Price at review $4.69 | Max. portfolio wght. 4%

BUY | HOLD | SELL

By now you should have received your Scheme Booklet for the proposed takeover of SAI Global. You'll need to send back your paperwork so it arrives by 2 December for your vote to count.

The directors recommend you vote in favour of the scheme of arrangement. While we're reluctant to let go of decent businesses – and we don't view the $4.75 bid price as particularly favourable – we suggest you vote in favour too. Management's confrontational approach to do with the Standards Australia publishing licence means there's considerable risk around the licence renewal.

If the scheme is approved at the meeting on 5 December, then it will be implemented on 23 December. You might want to make sure the share registry (Link Market Services) has your bank accounts details so you'll be paid the consideration that day, given the likely delays to receiving and banking a cheque over the Christmas period.

Generally we recommend you send back your paperwork late in the process to give yourself maximum flexibility, so note the deadline in your diary if you're going to wait any longer. This is likely to be the last time we mention SAI Global and the recommendation remains **HOLD**.

Disclosure: The author owns shares in SAI Global.

Portfolios trade

BY JON MILLS • INTELLIGENT INVESTOR • 22 NOV 2016

BHP BILLITON (BHP) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$24.86	8%	Below $20.00	$24.86	Above $35.00

SOUTH32 (S32) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$2.65	7%	Below $1.90	$2.65	Above $3.50

On 21 November, the Intelligent Investor **Growth** and **Equity Income** portfolios reduced their weighting in South32 at $2.58, using the proceeds to increase their weighting in BHP at $24.23.

The Growth Portfolio sold 1.4% of its holding in South32, which now represents 4.5% of the portfolio, with its weighting in BHP increasing to 4.6%. Similarly, the Equity Income Portfolio reduced its weighting in South32 by 1.3%, to 4.0%, while its weighting in BHP increased from 2.7% to 4.0%.

The trades were made to equalise the portfolios' weighting in each stock. We still believe that South32 offers reasonable value; but so does BHP and we think it no longer makes sense to have a much higher weighting in South32 than in BHP.

Find out how you can invest directly in these and other Intelligent Investor and InvestSMART portfolios by ***clicking here***.

Staff members may own securities mentioned in this article.

Market crashes and hedge funds

We are looking for the best investment options and recently a financial adviser suggested to keep our money in cash and wait because he thinks that there will be a crash in the market in the following year. I have two questions, first of all what do you think about the market crash and secondly, is there any hedge fund that you recommend? I am asking this question because as far as I know, the hedge funds can use short selling in the market and even if the market crashes, they still can make a profit.

23 Nov 2016 – **Jon Mills**: firstly, I'm not a financial advisor and I'm unable to give personal advice. Even so, I'm highly sceptical of your financial advisor's ability to accurately predict a market crash – I certainly have no idea when one will occur.

As such, I think it's more useful to concentrate on finding ideas such as those on our **Buy list** while maintaining an adequately diversified portfolio. If a crash does occur, then most investors' portfolios are likely to be affected – although there will also be a lot more bargains on offer – but investors who stay 100% in cash until an expected market crash can't take advantage of the inevitable Buy ideas that arise from time to time. Moreover, the longer they wait for the hoped-for crash, the more they're penalised by their cash earning low returns in the bank compared to the higher returns on offer through investing in quality companies.

While there are many types of hedge funds, the traditional 'long-short equity' hedge fund has the ability to short sell stocks as well as buying them – or going 'long' – hoping to make capital gains.

We can't recommend any hedge fund but you may be interested in the listed investment companies Mitchell Sneddon discusses **here**. Since then, Watermark has launched an IPO of its Global Leaders Fund, which will invest globally and also pursue a 'market-neutral' strategy (click on the **link** for a definition of this term).

Italian referendum

How much of an impact do you believe a NO vote in the Italian referendum and the burgeoning bank crisis will have on our stock market?

23 Nov 2016 – **Jon Mills**: As we've seen after the Brexit vote - where the British economy seems to be travelling far better than the experts predicted - trying to predict the effects of macroeconomic events is extremely difficult. Another example is the market's reaction to the surprise victory by Donald Trump in the US Presidential election. These are still recent events of course but the supposed experts have been wrong so far so why should we assume they'll be correct over the longer term?

Or to put it another way, as Peter Lynch said: 'Nobody can predict interest rates, the future direction of the economy, or the stock market. Dismiss all such forecasts and concentrate on what's actually happening to the companies in which you've invested'.

So to answer your question, who really knows?

Should the referendum fail, perhaps the market will decline on fears that the euro will break up and that our banks may have exposure to euro-denominated government bonds which may now be repaid in devalued lira or francs. If so, hopefully we'll get some more Buy opportunities.

The commentators at the Financial Times and the like seem to think that greater fiscal and economic union is the answer to the EU's problems and they're still suggesting this as a response should the referendum fail. According to this logic, apparently forcing Europeans into ever more closer union and ignoring their concerns over loss of sovereignty and economic depressions caused by the Euro will solve everything. I have my doubts, particularly as Brexit, Trump and the rise of populism suggest that the EU's traditional attitude of ignoring the wishes of its citizens if they disagree with their rulers may not be viable anymore. But we'll have to wait and see.

Correlation between financials

I currently hold positions in IFL PPT MCQ and CBA making up about 18% of my total portfolio. I am currently considering adding Platinum Asset Management but hold concerns about being too concentrated within the Financial Services sector. I understand you cannot offer individual advice but can you offer any comments around the risks common to these companies and any natural diversification between them.

22 Nov 2016 – **Andrew Legget**: You are correct that as financial companies they will all have similar risk factors such as the movement of movements in stock markets, interest rates and general economic activity etc. One difference between the likes of CBA, Platinum and Perpetual are their major focuses. CBA makes a lot of its money from loans whilst Platinum and Perpetual are fund managers. Even with Platinum and Perpetual there are some differences with Platinum more focussed on international markets (specifically Asia) while Perpetual is focussed more on the local market.

For what it's worth, I have calculated the correlation between daily share price movements over the past 1 and 5 years. As is the custom with a purely statistical look, there is a lot of noise so I wouldn't read too much into them.

However, in case you were interested, over 1 year there is a correlation between CBA and Platinum of 0.77, CBA and Perpetual of 0.08 and Platinum and Perpetual of –0.16. Over five years, there is a much higher correlation (which is probably a better reflection considering the larger sample size) with a correlation between CBA and Platinum of 0.92, CBA and Perpetual of 0.94 and Platinum and Perpetual of 0.87.

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