Weekly Review

RESEARCH

– Issue – 27 Jan. 2017

Despite declining revenues and declining profits, Fleetwood's share price rose 60% last year. Does the investment case still stack up?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 23 JANUARY 2017

Fleetwood's asset problem

When Fleetwood reports interim results in February, it will be with a new chairman and several new board members to go with a managing director who's only been in place since 2014. The internal upheaval mirrors the change in Fleetwood's key markets.

Key Points

- ***Progress in RVs***
- ***Poorly performing accessories business***
- ***Downgraded to Hold***

FLEETWOOD CORPORATION (FWD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.91	4%	Med–High	Med–High

BUY Below $1.80 | HOLD | SELL Above $3.50

$1.91

The end of the mining boom has decimated returns from the Searipple mine camp. After the years of easy money, investors' focus has now returned to a deteriorating recreational vehicle (RV) business that is losing significant cash.

From a distance, Fleetwood looks like a basket case with declining profit and declining revenues.

It is in this environment that we upgraded the business yet again in ***Fleetwood: Result 2016***. The business has been on and off our Buy list for several years. It is time to revisit the investment case.

RV revival

Key to that case is the revival of the RV business. At its peak, Fleetwood's two brands – Coromal and Windsor – held a 25% share of an expanding caravan market, consistently generating pre-tax profits over $20m a year.

Old models, however, were not renewed and the dealer network shrank significantly along with sales. At its peak, the RV business delivered almost $200m in revenue; last year it contributed just $30m revenue. Success in mining bred neglect in RVs.

As we noted in ***Fleetwood starts to turn***, Fleetwood has appointed new management and designers and released several new models to arrest the decline. Factory orders are returning with weekly output tripling and orders up 300%.

This hasn't lifted profits yet. Caravan manufacture, unlike car making, is a labour-intensive business and workers take time to train and become productive. With the workforce tripling in quick time, costs remain too high but there is a path to eliminating losses.

That alone will make a huge difference to profitability. RVs have lost almost $16m over the past two years, a time when profits have totaled just $6m.

With two prominent brands, a dealer network and manufacturing facilities, the option to sell the business must also be considered and would likely result in a decent outcome.

Whether it be through a turnaround or a sale, there is a path to redemption for the business.

Continued on page 2 ...

CONTENTS

RECO. CHANGES	FROM	TO
Aurizon	Hold	Avoid
Brambles	Sell	Hold
Fleetwood Corp	Buy	Hold
Macmahon Holdings	Hold	Sell

Continued from page 1 ...

Broken accessories

Of greater concern is the performance of the accessories business. Fleetwood only began separating profits from this division last year and we were surprised by the weak profits.

Over the past two years, accessories contributed pre-tax profits of less than $1m per annum. Compared to losses from the RV unit that might not seem so bad.

Table 1: Segment stats, $m, 2016

	REVENUE	EBIT	EBIT MARGIN	ASSETS	ROA
RV	29.6	-8.1	n/a	15.9	n/a
PARTS ACCESSORIES	82.1	0.9	1.1%	54.8	1.6%
MAN. ACCOMODATION	142.5	3.6	2.5%	97.1	3.7%
VILLAGES	33	7.9	24%	27.7	29%

Yet consider the capital poured into each business. Building RVs, as we have noted, is labour intensive and there is just $16m of assets marked against that business.

Historically, RVs have generated significant profit and, if market share is recaptured and margins restored, it could still generate meaningful profit and excellent rates of return.

That isn't true for the accessories business.

A mighty $55m of assets is used to generate just $1m in profit, a return on assets of just 1.8%. Putting that cash in the bank, even in a low interest rate environment, would have delivered a better outcome.

Margins tell us something about the competitiveness of the business too. A revenue base of $82m yielded less than $1m in profit last year – a margin of just over 1%.

Competition is fierce and, unless volumes rise dramatically, it's hard to see why margins might increase. Fleetwood has moved manufacturing offshore to reduce costs and currency movements make a difference but the fact is that this is a lousy business. Fleetwood should sell it to release capital for better use.

Accommodation and villages

The manufactured accommodation business contributes the largest portion of revenue but lumpy volume means both revenues and margins are volatile.

A consolidation of its customers has benefited Fleetwood, which has won exclusive contracts with larger providers seeking security and scale. The company is also trying to strike similar volume deals with state governments.

Although margins are low, a fixed cost base should mean that higher volumes lead to higher margins.

Operating assets of about $100m appear high for this business. We suspect there is scope to release capital over time perhaps by selling surplus assets.

Perhaps the biggest surprise has been the profitability of Searipple, which generated about $8m of pre-tax profit even though utilisation rates are low.

Some of this profit would have come from managing the relinquished Osprey Village but there is no doubt Searipple remains an excellent generator of cash.

Costs are largely variable which allows the village to remain profitable with high vacancies and the asset has been written down to just $27m. The replacement cost would be far higher.

Patience and price

Looking at Fleetwood's aggregated numbers suggest a business with meagre profitability and meagre prospects tied to a large valuation. It does, after all, make no money and trades on a price-earnings ratio (PER) of well over 100.

A closer examination, however, confirms that this is not a troubled business but a business with a troubled segment and too much capital deployed. Eliminating losses from RVs alone would restore the PER to a more respectable 13 times – and that's without making any other changes.

> **We suspect there is scope to release capital over time perhaps by selling surplus assets.**

There are still ways to release value. It is clear the accessories division should be sold. Surplus assets also appear to be sitting in the manufactured accommodation business and management has hinted that these will be sold off progressively.

The market has recognised that progress is being made and, with its balance sheet repaired, Fleetwood's share price rose about 60% last year. That has taken it above our buy price.

We are content to be patient but we are sticklers for value.

With the investment case on track, we're downgrading Fleetwood to **HOLD**.

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

Disclosure: The author owns shares in Fleetwood.

The conglomerate's Resources business has staged a remarkable turnaround but Coles is losing some sheen.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 24 JANUARY 2017

Wesfarmers' coal curveball

The announcement of a 'First Half Earnings Update' often foreshadows bad news but in Wesfarmers' case it was the opposite. Last week the company announced that its Resources division – which mines coal – would produce operating earnings of $135m–$140m for the first half of 2017.

Key Points

- ***Coal prices helping Resources division***
- ***Woolworths price cuts hurting Coles***
- ***Bunnings entering slower period***

WESFARMERS (WES) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$41.09	8%	Low	Low

BUY Below $38.00 — **HOLD** — **SELL** Above $55.00

$41.09

'So what?' you might think. Well, what's surprising is that back in October Wesfarmers forecast the division would only break even in the first half.

It just goes to show that, especially in the resources sector, forecasting earnings is a fool's errand. If Wesfarmers can't forecast a $140m turnaround in earnings three months out, what hope do the rest of us have? You can see the volatility of earnings from the Resources division in Chart 1.

The turnaround has been driven largely by soaring coal prices as China cuts capacity at its mines. Prices for metallurgical (or coking) coal have been particularly strong. Wesfarmers' flagship coal mine Curragh is a significant producer of high-quality metallurgical coal and, to take advantage of the high prices, it ramped up production during the quarter. Second-quarter metallurgical coal production at Curragh was up 41% on the weather-affected previous quarter, so the timing was fortuitous.

It's impossible to tell where coal prices will go from here, although they have been weakening again lately. The price rise will, however, help Wesfarmers should it decide to sell the coal assets.

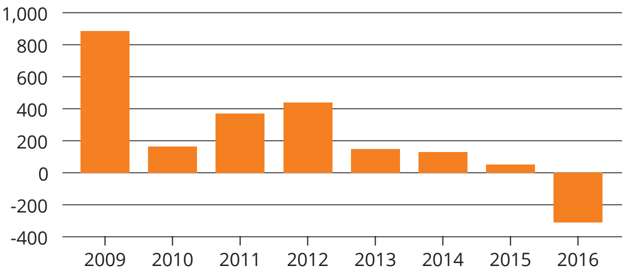
The sum-of-the-parts valuation we outlined in ***Wesfarmers counts on Chaney*** just over a year ago valued the Resources division between $1.0bn and $2.5bn. For the reasons outlined then, even the top end might have been a conservative valuation, which the recent strength in coal prices has helped confirm.

Upside surprise?

It's now hard to imagine Wesfarmers selling its Resources division for less than $3bn although it might take a haircut simply to remove the reputational risk that comes with owning coal mines. Management has valued the assets at significantly more than $3bn in the past and, assuming the sale takes place, the eventual figure could surprise the market.

While Wesfarmers' Resources division was last year's ugly duckling – Target was a close second – that moniker may pass to Coles in calendar 2017. Management has apparently been telling broking analysts that its sales growth is being affected by **Woolworths**' investment in price. Christmas trading for Woolworths was also better than at Coles.

Chart 1: Wesfarmers Resources EBIT ($m)



Source: Company reports

Coles, then, is expected to report anaemic same-store sales growth for the December quarter. Indeed, its sales growth is expected to be below Woolworths for the first time in years. This isn't quite as bad as it sounds for Coles – same-store sales for the December 2015 quarter was a strong 5.3%, which makes it a tough comparison to beat.

> **We've long wanted to buy Wesfarmers and 2017 may be the year.**

We've long wanted to buy Wesfarmers and 2017 may be the year. With Coles slowing and Bunnings' growth also likely to tail off, there's some chance of disappointment. Bunnings' John Gillam has stepped down and it's possible managing director Richard Goyder might choose to move on sooner rather than later too. All in all, it could be a year of disruption for Australia's largest retailing conglomerate.

Flagging these changes will help us be prepared. For now we're waiting and watching but this is definitely a company we'd like to own. **HOLD**.

Staff members may own securities mentioned in this article.

ResMed has announced another quarter of decent sales growth failing to translate into earnings.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 25 JANUARY 2017

ResMed margins disappoint (again)

We have mixed feelings about ResMed's financial result for the three months to December. On the one hand, revenue grew an impressive 9%, excluding acquisitions and the effect of currency fluctuations. Including those items, sales were up 17% to US$530m thanks to strong sales in the Americas.

Key Points

- ***Sales and new product release a bright point***
- ***Gross margin continues to disappoint***
- ***Watch portfolio weighting***

RESMED (RMD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$8.87	7%	Medium	Medium

BUY Below $6.00 — HOLD — SELL Above $10.00

$8.87

Management also noted approval by the US Food & Drug Administration (FDA) for its new AirMini continuous positive airway pressure (CPAP) machine, which is the smallest CPAP machine on the market. Given that CPAP devices tend to be bulky and inconvenient, the smaller size is a major selling point and makes the product ideal for the travel market. That bodes well for future sales.

On the other hand, the company's gross margin was unchanged at a lacklustre 58% – its lowest point in some 20 years. Management said that cost cutting on the manufacturing side was offset by fewer sales of high-margin products and lower prices across several product ranges. This is a trend that has been running for a good three or four years now, with mask prices – in particular – being cut to remain competitive with the highly popular range released by **Fisher & Paykel Healthcare**.

Costs growing faster

What's more, operating costs grew faster than revenue so the perfectly respectable sales growth didn't translate into higher earnings, with net profit down 20% to $76.7m. Administrative expenses increased 18% in constant currency terms, or 10% excluding acquisitions.

Even after removing several one-off expenses – including litigation costs and those related to the **2016 acquisition of Brightree** – underlying earnings per share were dead flat.

On the bright side, part of those higher costs were due to a 28% increase in research spending. Assuming that translates into a few cutting edge product releases over the next few years, it's better to consider research as an up-front investment in future growth. And given declining prices and a strong product line-up from F&P Healthcare, this is one expense we're happy to see increase.

Table 1: RMD Q2 result

THREE MONTHS TO DEC	2016	2015	+/(–) (%)
REVENUE (US$M)	530	455	17
EBIT (US$M)	96.9	108.0	(10)
NPAT (US$M)	76.7	95.6	(20)
EPS* (US CENTS)	5.4	6.8	(20)

***US cents per ASX-listed CDI**

ResMed trades on a price-earnings ratio of 27 and an unfranked dividend yield of 2.1%. While revenues continue to grow, costs are rising faster, which has brought earnings growth to a standstill. We'll leave the price guide unchanged for now, but a price-earnings ratio in the high 20s is becoming harder to justify without that trend reversing and, consequently, margins improving.

If ResMed has become a large proportion of your portfolio, you should consider taking some chips off the table in favour of the better opportunities on our **Buy list** but, for now, our recommendation remains **HOLD**.

Staff members may own securities mentioned in this article.

Australia's largest rail freight operator uses too much capital and there's not much growth on the horizon.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 27 JANUARY 2017

Aurizon lacking a gravy train

Modern railways are prodigiously efficient: trains can move one ton of cargo some 200km using just a litre of diesel fuel. And if there's one thing all good businesses possess, it's efficient operations.

Key Points

- ***Capital intensive business***
- ***Iron and coal contracts pose a headwind***
- ***No margin of safety; Avoid***

AURIZON (AZJ) / AVOID

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.97	N/A	High	High

Sold by the Queensland Government as QR National in 2010, Aurizon is Australia's largest rail freight operator. It's a vital cog in the country's resources supply chain, has world-class facilities and some considerable competitive advantages – no-one is going to build a competing network any time soon.

Unfortunately, all the glossy terminals and operating efficiency in the world isn't enough to make Aurizon a great business. The problem isn't a matter of fuel consumption, though; it's a matter of capital consumption. And on this measure, Aurizon fails miserably.

Over the past five years, Aurizon earned $2.6bn in underlying net profit, for a margin of 14%. If we were confined to the income statement, we might mistake this for a decent business.

The company's cash flow statement, however, tells a different story. Aurizon generated $5.8bn in operating cash flow over the past five years, yet needed to spend $4.7bn maintaining its network. That left just $1.1bn in free cash flow, which can be distributed to shareholders, used to repurchase stock or pay down debt. In other words, more than half of the company's net profit needed to be ploughed back into the business to keep things running.

We love companies that can reinvest earnings, but only if the money can be put to use at high rates of return. Unfortunately, Aurizon's **return on capital** over the past five years has averaged 8.8%. That's not terrible, but it's also nothing to write home about, especially given the risks.

Show me the money

Unlike cash-generative businesses like **REA Group** or **Virtus Health**, Aurizon has significant capital expenditure needs to maintain all those locomotives, tracks, bridges, and terminals. This large base of fixed assets requires continuous investment, which is only loosely related to how many tons of cargo are being transported in any given year.

In good years, such as 2016, free cash flow can match net profit almost one-for-one. In bad years, such as 2012, more cash goes out the door than comes in, with the company needing to take on debt to make up the difference.

For such a capital hog to earn decent returns, it needs to maintain a high profit margin. Here, Aurizon has a few things going for it but there are still points of concern.

On the bright side, around half of the company's earnings before interest, tax, depreciation and amortisation (EBITDA) is from its Network division, which operates the Central Queensland Coal Network.

Like other monopoly assets, such as **Sydney Airport**, the network could – at least in theory – charge through the nose for access. The rail operators that use it (Pacific National and BMA) would have little choice but to accept whatever terms Aurizon lays down. The company has significant pricing power.

In practice, though, the asset is heavily regulated with access pricing determined by the Queensland Competition Authority to guarantee a fair – but not extreme – return for shareholders. This ensures reliable revenues and a stable EBITDA margin above 60%.

Coal and iron contracts

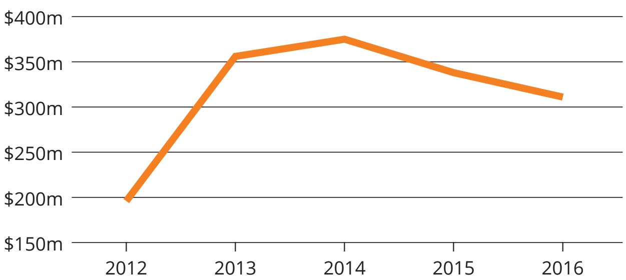
Unfortunately, the other half of EBITDA is from so-called 'above rail' operations – hauling coal, iron ore and freight. This is a much more dicey outfit exposed to the booms and busts of the resource industry. Contracts can be lengthy – the weighted average length of current contracts is around 10 years – but when they reset, they depend on the current state of the mining industry.

> **Around 65–75% of Aurizon's operating costs are fixed, such as labour, track access expenses and repairs.**

Prices can swing wildly depending on forecasts made at the time of the reset. If the coal and iron ore markets stay where they are, we expect contracts to be gradually renewed on less favorable terms as they roll off.

Iron ore contracts, in particular, could be a significant headwind to earnings growth. Aurizon currently earns around $311m a year from transporting iron ore.

Chart 1: Revenue from iron ore contracts



Source: Company reports

The trouble is that 90% of those earnings are from just two customers – Cliffs Natural Resources and Karara Mining. And the Cliffs contract, accounting for roughly half of iron ore revenue, expires in 2020 when the mine is due to close. The Karara contract expires two years later. We expect iron ore revenue to fall materially over the next few years.

Valuation

Around 65–75% of Aurizon's operating costs are fixed, such as labour, track access expenses and repairs. The **operating leverage** inherent in a business with mostly fixed costs means that when revenue is growing and costs are stable, margins improve and profits grow even more quickly.

Sadly, it works both ways. For the year to June 2016, a 4% decline in the volume of transported material led to a 9% decline in revenue to $3.5bn. After deducting expenses, underlying net profit was down 16% to $510m.

Turning to the balance sheet, Aurizon has $3.5bn of net debt and a further $211m of non-cancellable operating and property leases. We're never fans of debt; however, in this case, interest expense is covered a good six times over by operating earnings so the debt should be manageable given the steady and recurring revenues from the company's Network division.

Management expects revenue of $3.35bn–3.55bn in 2017 and underlying earnings before interest and tax of $900m–950m, with operating expenses falling despite relatively flat revenue due to an efficiency drive that management expects to eliminate $100m of costs this year.

Aurizon has its share of competitive advantages and the regulated portion of its business is attractive. However, a forward price-earnings ratio of around 19 and a partially franked dividend yield of 4.9% leave little room for error.

We commend management for the cost-cutting initiatives, but this is still a company whose financial fortunes are tied to factors outside its control – such as volatile commodity prices – and where free cash flow is typically well below profits due to the company being a glutton for capital. Throw in the risk that current coal and iron ore contracts will be renewed at inferior rates, and we recommend you **AVOID**.

Staff members may own securities mentioned in this article.

Things keep getting worse for Bellamy's with IMF Bentham today announcing it will fund a proposed class action against the infant formula maker.

BY PHILIP BISH • INTELLIGENT INVESTOR • 23 JANUARY 2017

Bellamy's faces class action

If newly appointed **Bellamy**'s CEO Andrew Cohen didn't already have enough on his plate, he certainly does now after litigation funder **IMF Bentham** today announced it will fund a proposed class action against Bellamy's. The proposed class action will be conducted by **Slater & Gordon** and has been launched on behalf of current and former Bellamy's shareholders.

While it's still possible the class action won't proceed, the market responded negatively to the announcement, pushing Bellamy's shares down 4%, to close the day at $3.85.

This is the first of what may be several class actions against Bellamy's, as Maurice Blackburn is also looking to proceed with a class action.

According to IMF Bentham, 'the claims relate to alleged misleading or deceptive conduct and an alleged breach by Bellamy's of its continuous disclosure obligations, in connection with its trading prospects and future earnings performance during the period between 14 April 2016 to 9 December 2016'.

The proposed class action follows a torrid two months for Bellamy's after it shocked the market in early December with a surprise revenue and profit downgrade. Shortly after, the company requested a month-long trading suspension in order to renegotiate an onerous 'take or pay' supply agreement it has with **Fonterra** (NZX:FCG).

Bellamy's emerged from the trading suspension to reveal that inventory levels had ballooned to between $105m and $110m, and that it would be required to pay around $12m a year in shortfall payments to its suppliers including Fonterra. The company also further downgraded its 2017 estimated profit.

The company also faces the uncertainty of an Extraordinary General Meeting scheduled for 28 February. Shareholders who own 35% of Bellamy's shares want to remove four board members and replace them with their own representatives. These shareholders include Jan Cameron (co-founder of **Kathmandu** and the mysterious Black Prince Private foundation.

With the continued level of turmoil at the company and all the associated risks, it is hard to see any light at the end of the tunnel for Bellamy's.

Brambles lowers profit forecast

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 23 JAN 2017

BRAMBLES (BXB) / HOLD

Price at review **$10.42**

Max. portfolio wght. **5%**

BUY Below **$7.00** | HOLD | SELL Above **$11.00**

$10.42

When we **[downgraded Brambles to Sell](#)** back in November, we observed that '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 [due to the recent change in management].'

That theory seems to be playing out. Brambles now expects revenue growth of 5% and underlying net profit growth of 3% for the six months to December 2016. Management said the poorer than expected result was due to higher transport and plant costs as US retailers required fewer pallets. The company also noted pricing pressure in its recycled pallet business.

This has dragged down the company's expectations for the full year, with the final result expected to be 'below' prior guidance for constant-currency revenue growth of 7–9% and profit growth of 9–11%. Management said it would provide new earnings guidance on 20 February when the company reports its interim result.

The stock has fallen 15% today but, with the price-earnings ratio still at 22 times 2016 earnings and a paltry free cash flow yield of 1.6%, there still isn't enough value to whet our appetite. We're lowering our price guide; however, with the stock down 13% since we downgraded it on **23 Nov 16** (Sell – $12.05) and a new Sell price of $11, we're upgrading to **HOLD.**

Staff members may own securities mentioned in this article.

Macmahon's takeover offer

BY GAURAV SODHI • INTELLIGENT INVESTOR • 24 JAN 2017

MACMAHON HOLDINGS (MAH) / SELL

Price at review **$0.145**

Max. portfolio wght. **1%**

BUY | HOLD | SELL

CIMIC, formerly Leighton Holdings, has made a takeover offer for Macmahon Holdings, a member of our **mining services mini portfolio**. CIMIC is offering 14.5 cents for each Macmahon share in an unconditional bid.

That's a 30% premium to Macmahon's previous traded price and values the business at $170m, a near 20% discount to the company's net tangible assets. Ordinarily, we would expect such a modest bid to be met with resistance or a rival bidder but this might be an exception.

Still recovering from a debt-induced implosion and near collapse, Macmahon has been through several managers. The board is considering the bid and hasn't yet made a recommendation, but it could make sense to sell out while commodity prices are high.

As CIMIC already has a 20% equity stake in the business, a rival bidder is unlikely to disrupt proceedings either. CIMIC itself cannot increase the offer unless a rival bid is made.

For the moment, this is the best price on offer even if it does value Macmahon at less than six times earnings before interest, tax, depreciation and amortisation (EBITDA).

The business is hardly a growth engine but it does hold over $50m in net cash, has several secure contracts and many of its clients are again opening their wallets. It's a shame to let the stock go so cheaply but options are limited. We're also cognisant that several recent bids have failed – **Ozforex** and **Bradken** shareholders are still bruising heavy losses after takeover bids fell through.

Macmahon is a fragile business in a volatile industry. It's probably not worth risking a large fall for a slight gain especially when the share price matches the offer price. **SELL.**

Disclosure: The author owns shares in Macmahon.

Rio Tinto

A few years ago I purchased Rio Tinto shares for $73.15 each. I have been sitting on them for sometime now with the hope that the mining sector will turn around. For the last few days, the market showed some of these signs with the share price of RIO closing at $62.87. As such, my question is: when do you think will be a good time to sell? That is, should I continue to hold the shares in the hope of selling the shares greater then $73.15 or should I be willing to sell them at a lower price.

23 Jan 2017 – **Gaurav Sodhi**: This is going to sound harsh but it is crucial: forget about your purchase price. It doesnt matter. The only thing that matters is the price today and the value today. Anchoring to your own purchase price obscures both those things. The price has risen a long way but that is because iron ore prices have risen a long way so profits when Rio reports will be strong. With lower costs and higher prices, the business should report bonanza margins from iron ore. We have a Hold upto $75 and think Rio is fair value where it is. If iron ore prices stay where they are we should expect value to increase. I cant give you personal advice but we have a Hold on Rio for the moment and, even though I expect iron ore prices to fall, the current valuation appears fair.

Transurban capital raising

I own shares in Transurban. There has been some commentary that the current negotiations with the state government concerning the Western Distributor will lead to a capital raising to the tune of $1billion later this year and possibly further capital raising relating to other projects in the pipeline. i would appreciate your thoughts on the implications for Transurban and its share price. Also if interest rates rise further in the US, is this a negative for the stock price.

25 Jan 2017 – **Graham Witcomb**: Let me start by saying we can only offer general advice, so it's important that you take your personal situation into account before acting on our recommendations. Having said that, there is potential for a capital raising and given the stock's lofty valuation I'm sure it is something management would consider over adding more debt. Without knowing the details of any potential capital raising, though, it's difficult to say what the effect would be on the share price, but if it is to the tune of $1bn it probably won't make that much difference given the current market cap is around $21bn. You touch on a much larger issue - the prospect of rising interest rates. This would be a big drag on the share price as it would do two things: increase the company's finance expenses (around 1% higher interest on Transurban's debt would shave around 10% from earnings once hedges roll off) and it would also probably lead to investors paying a lower multiple for the stock. Lower earnings plus a lower multiple could lead to some large share price falls. We're not necessarily forecasting that as we don't know where interest rates will be in the future, but it's a risk to consider.

Sydney Airport and Atlas Iron

Just wanting to see your thoughts on the 2 stocks below SYD (Sydney Airport Holdings) and AGO (Atlas Iron) on a medium to long term view. Where do you see the iron price heading with demand from china decreasing slightly.

23 Jan 2017 – **Gaurav Sodhi**: Iron ore is more complex than it appears. There is little doubt that there is a steel surplus and we expect lower steel volumes from China which suggests lower iron ore demand and hence lower prices. However, China is also pursuing a policy of consolidation and forcing steel mergers to improve the productivity and profitability of its steel sector. As small, inefficient operations close, larger mills will demand higher quality ores so high grade iron ore prices may well stay higher than we originally expected. Current prices still appear too high but earlier expectations of $30-40/t ore are probably too low.

Soul Patts

Any thoughts on SOL's proposed off market takeover of HHL at $1.00 per share?

23 Jan 2017 – **Gaurav Sodhi**: What an amazing story and what an amazing purchase. It would be pretty hard to do badly at that price. SOL has indicated they would move to takeover the entire business and, although they will probably have to pay a higher price for the rest of it, their average price is likely to be attractive. This is a smart use of capital and another example of the shrewd management.

Franking account balance

Franking credits are valuable. How do you find out/work out a company's franking account balance?

25 Jan 2017 – **Jon Mills**: A company's franking account balance will be disclosed in the notes to its financial statements, usually in the Dividend section. Using Crown Resorts as an example, if you scroll to page 95 of its 2016 Annual Report you can see that Crown had just under $210m in franking credits available for distribution to shareholders at 30 June 2016. All things equal, this gives the company the ability to pay $490m in fully franked dividends, for example.

INTELLIGENT
INVESTOR