er

# Weekly Review

RESEARCH

6 NAVITAS: INTERIM RESULT 2017 | 8 VIRTUS DISAPPOINTS WITH MARKET SHARE LOSSES | 10 MORE PROJECT DELAYS HIT GBST | 12 OFX WARNS AGAIN AND SACKS CEO

– Issue – 3 Feb. 2017

***To help you navigate the coming company results, John Addis asks the team what they're looking out for.***

BY JOHN ADDIS • INTELLIGENT INVESTOR • 30 JANUARY 2017

## What to watch this reporting season

This from ***The Weekly Times***: 'In the first six months of 2015-16, the company has already earned net revenue of $105.1 million, putting it on track to exceed last year's extraordinary result. With forecasts already blown to pieces, how far can the company's star rise?' A long way, thought the company's CEO: 'We have certainly got to the moon — but we'd like to get out to Pluto.'

The company in question was **Bellamy**'s; the quote, now almost a year old, was from Laura McBain, who has since departed, but presumably not to Pluto. One period's results can only reveal so much. Beyond the superficial metrics, reporting season can offer a guide to how a company is performing, if you know where to look. That's the point of this article – to give you an indication of what to watch out for amid the sea of media commentary that is about to consume us. Here are the thoughts of the analytical team on what they'll be looking for from key sectors and recommendations over the coming weeks.

### James Carlisle, research director

Among the banks, **CBA** reports half-year results while the others offer quarterly updates, which won't say much about dividends, which remain under pressure particularly at **NAB** and **ANZ**. Our focus will be on impairments, which showed a slight uptick last year, and the net interest margin, also under pressure from a combination of lower interest rates and higher funding costs.

At CBA, impairment charges crept up from 0.16% of loans to 0.19% in the 2016 financial year while the net interest margin dipped from 2.09% to 2.07%. The company has **already announced** offsetting exceptional items, being a $275m writedown on capitalised software and a $278m profit on the sale of its remaining stake in Visa. With the share price up above $80 compared to our Buy price of $70, I'm not expecting an immediate opportunity, although you never know.

After a few flat years, **ASX**, currently on our **Buy List**, has returned to growth. I'm expecting half-year numbers that show it's on track to increase earnings by a few per cent in 2017 on top of last year's 7%. It's not much, but you don't need much when there's a 4% fully franked dividend yield on offer. I'll also be keen to hear more about the company's **proposals** to replace the CHESS settlement system.

**Computershare** has had a nice run over the past couple of months, gaining 26% thanks to the rise in long-term bond yields following Donald Trump's election win and earning itself a **downgrade** to Hold. The company earns interest on its sizeable cash balances (US$15.7bn last June) but the impact of rising rates (or the prospect of them) will not be felt immediately. Still, it will be interesting to hear management confirm the likely impact: previously it has indicated that a 1% increase in rates would add about 30% to profits.

***Continued on page 2 ...***

## CONTENTS



**RECO. CHANGES**

| RECO. CHANGES | FROM | TO |
|---|---|---|
| Aditya Birla | Avoid | Coverage Ceased |
| Caltex sub notes | Avoid | Coverage Ceased |
| Cleanaway | Sell | Coverage Ceased |
| Coates Group | Sell | Coverage Ceased |
| Duet Group | Hold | Coverage Ceased |
| GBST Holdings | Buy | Hold |
| Genesis Energy | Hold | Coverage Ceased |
| Gold Road Resources | No view | Coverage Ceased |
| GWA Group | Avoid | Coverage Ceased |
| Highlands Pacific | Avoid | Coverage Ceased |
| iiNet | Hold | Coverage Ceased |
| M2 | Hold | Coverage Ceased |
| Mighty River Power | Hold | Coverage Ceased |
| Navitas | Hold | Buy |
| OFX Group | Hold | Sell |
| Servcorp | Hold | Under Review |
| Silex Systems | Sell | Coverage Ceased |
| Tap Oil | Sell | Coverage Ceased |

**IMPORTANT INFO**



**PORTFOLIO CHANGES**

| PORTFOLIO | COMPANY | BUY/ SELL | DATE | NO. OF SHARES | PRICE ($) | VALUE ($) |
|---|---|---|---|---|---|---|
| Income | Flight Centre | Buy | 1/02/17 | 24 | $30.39 | $729 |
| Income | Monash IVF | Sell | 1/02/17 | 345 | $1.76 | $607 |
| Income | Origin Energy | Sell | 1/02/17 | 60 | $7.24 | $434 |
| Growth | Flight Centre | Buy | 1/02/17 | 24 | $30.39 | $729 |
| Growth | Monash IVF | Sell | 1/02/17 | 407 | $1.76 | $716 |


***Continued from page 1 …***


Chief executive Stuart Irving was pretty exuberant at the full-year results last August despite having little to shout about, so we don't expect him to hold back about these glimmers of hope.

At **IOOF**, I'll be hoping to see another quarter of net platform inflows – which would make it four consecutive calendar years if it happens. This is likely to be offset by margin contraction, though, leaving cost reductions as the primary source of earnings growth. It's good, therefore, that IOOF has such a strong track record in this area.

### Gaurav Sodhi, deputy research director

The market has priced in higher inflation and higher interest rates with remarkable swiftness and certainty. Whilst this is likely I am less sure of it than the market seems to be. Any disappointment from the US could see a rapid repricing. The yield story may not be over quite yet.

This should be a terrific reporting period for miners. **BHP** and **South32**, two former buys in the sector, should both report well, as the market is expecting. At BHP, two things to look for will be the company's use of its free cash flow and comments on the future of the US shale business. It has been a capital sink but, with higher oil prices and better data, will they pour more cash into it?

As for South32, its cash pile is now over $1bn. Dividends should follow but I suspect the market will be disappointed by management electing to hold onto the cash. The sector's history tells us that sense is reserved for the bust while higher commodity prices tend to invite the silly. We shall see.

Coal producers should also fare well and we'll be keeping an eye on energy producers as this could be one area of the market that's still cheap. I'll be particularly interested to see how additional cash flows are being spent.

In telecommunications, customer acquisitions and margin stability will be worth watching. For those that have embarked on acquisitions, margin expansion should be clear as new businesses are integrated. Comments on attitudes towards future spectrum auctions will also be worth noting.

**Amaysim**, currently on the Buy List, may not meet its customer acquisition targets. The last Optus contract review was a year ago and the market has become more competitive since. Another wholesale agreement with Optus should help growth but the investment case is about getting free cash out of the business as much as gaining more customers.

As for **TPG**, I'll be watching closely for margin pressure and NBN customer growth. Most important, though, will be growth in the corporate division. Low expectations exist for the retail business but if the corporate division is traveling nicely, there's the potential for a rerating. Management impresses me with its independence and clarity, unlike **Vocus**, which is the complete opposite.

> “ As retail and consumer stocks haven’t been that strong during the boom, there’s a risk it could turn ugly, although this won’t be evident this reporting season.

### James Greenhalgh, senior analyst

With the housing cycle looking long in the tooth, it will be important to think about what happens when house prices (in the eastern states) stop rising or start falling. As retail and consumer stocks haven’t been that strong during the boom, there’s a risk it could turn ugly, although this won’t be evident this reporting season.

For the grocery retailers, same-store sales are the stat to watch. For the first time in years, **Woolworths** looks like it will overtake Coles in this area, largely due to Coles dropping back than Woolworths surging ahead. But it does show that Woolworths’ price cuts are making a difference, which might provoke a tit-for-tat price reduction program. That would be good for shoppers and bad for shareholders.

Among the online classifieds companies, profit growth will be an interesting comparison. While growth was once common across the sector, it’s now more stock-specific, suggesting the structural tailwinds are over. From here, growth will be more about management and capital allocation decisions.

**REA Group** and **Carsales** are still increasing prices to customers but listing volumes could be an issue for the former and non-core business problems an issue for the latter.

I’ll be looking for some acceleration in profit growth at **Trade Me**. After years of cost investment, profit growth should start to accelerate slightly. If there’s a slowdown in revenue growth, this could be an issue. It’s probably too early to determine the effect of Facebook Marketplace but management may make some commentary.

Overall, I’m not expecting any cyclical effects in these results but, as advertising businesses, cyclical downturns could have an impact. As most of the classifieds companies have spent time and money on overseas expansion, I’ll be watching the progress of these businesses, which could be a source of risk, especially those exposed to emerging markets.

I’ll also be watching three other stocks with great interest. At **News Corporation** a continued erosion of advertising revenue is expected. Whether this is speeding up or slowing down will be key. Thus far, the trend has been worse than we’ve expected and, while management is cutting costs, the advertising businesses have been deteriorating quickly. Foxtel’s performance will also be worth watching given the rumours of a float, and to see whether the trends in this business (eg average revenue per user or ARPU) are weakening or holding up in the face of competition from Netflix and Stan.

Cost growth will be the metric to watch at **Flight Centre**. It’s been rising for a few years now but, with revenue growth slowing, cost growth should be slowing, too. If not in evidence this reporting season it will be something to watch for next year. Management seemed a little over-optimistic about a recovery in the second half when it downgraded earnings in November. But even if there’s some short-term downside in the share price, it’s cheap enough and it may provide an opportunity to top up holdings if it’s worse than expected, although the market already expects the company to miss second-half guidance.

### Graham Witcomb, senior analyst

Because it isn’t as exposed to swings in the economy, results in the healthcare sector tend to be less volatile than others. One thing to watch will be how hospital operators **Ramsay** and **Healthscope** are coping with a surge in lapses and policy downgrades at **Medibank** and **NIB**, which has made these companies more aggressive in price negotiations.

The IVF sector is also struggling with slower growth in cycles and increased competition, particularly in NSW where **Monash IVF** has entered the market. I’ll be watching its results and those of **Virtus**, looking for signs that it isn’t losing too much market share to Monash. The contribution from their international operations is now an important diversifier so I’ll be checking to see that these expansions are on track.

Now to a company recently returning to our **Buy List** rather than a former feature of it. With **Sydney Airport**, the result will be less important than management commentary (and reading between the lines) on where it stands on the Government’s formal offer to build the second airport. A decision is required by April. Management doesn’t seem enthusiastic and neither are we.

**FSA Group**, a current Speculative Buy, will be interesting to watch as its debt agreement business is a barometer for the general economy. And as a subprime lender, any increase in bad debts could be a leading indicator that financial distress is increasing in the economy.

> **“ At this stage I’d be happy with continued growth in all three divisions’ revenue, if not EBIT.**

Finally, I’ll be watching for more theatrics from **Nanosonics**, where the CEO was formerly head of marketing at Cochlear. The company flip flops between presenting performance figures based on the directly preceding quarter or last year’s corresponding period, depending on which looks best. We’d prefer more consistency.

### Jon Mills, senior analyst

**Crown** and **The Star Entertainment Group** are both benefitting from rising non-VIP Asian tourism (especially Chinese). I’ll be looking to see whether this has been offset by any slowdown in the Australian economy (if one believes the last GDP result). After China’s clampdown on Crown we’ll also get more details from Star Entertainment in particular about the effect on VIP revenue.

At **iSelect**, the 2016 interim result featured turmoil in the health insurance division so I’m expecting improvements this half along with continued growth in its other divisions (Energy and Telco, and Life and General Insurance). Competitor comparethemarket continues to advertise heavily so I’ll be looking for any impact on iSelect’s business. However, iSelect has a better service and far greater resources to generate leads so I think it’s unlikely that comparethemarket will seriously dent iSelect’s business.

Australia has been a disaster for **Ainsworth Game Technology** due to **Aristocrat**’s strong performance but I’m hoping for some improvement as its new A600 cabinet (hopefully) gains traction and the company releases more games for it. Overseas, the second half is bigger than the first half due to American casinos operating on a calendar year basis (and so incurring more of their capital expenditure in the early part of the calendar year); but continued good performance in North and Latin America, plus an update on early benefits from Novomatic transaction would be nice. Management still tends to talk big then underdeliver. I’d prefer it if the results were left to speak for themselves.

As for current Buy recommendations, **Reckon** operates on a calendar year end so this period will cover the 2016 result. Practice Management – its best business – should do well so hopefully no surprises there. I’ll be interested to see if Document Management is still rapidly growing revenue but, even if it is, the investment in moving to the cloud will probably mean minimal earnings. The Business division that houses its small business accounting software (Reckon One), competing against Xero and MYOB et al, has been showing ‘exponential growth’, albeit from a very low base. At this stage I’d be happy with continued growth in all three divisions’ revenue, if not EBIT.

### Alex Hughes, senior analyst

The original investment thesis for **3P Learning**, currently on the **Buy List**, is that the Australian and New Zealand division underwrites the current market value, leaving growth from overseas as a free option. I’ll be focused on evidence of the local operation holding up (licence retention and pricing) and overseas licence growth to see if the reality backs up our thesis.

It’s also the first reporting cycle for the new CEO, Rebekah O’Flaherty (she was appointed 11 July, so she communicated the last results, but didn’t influence them). I’ll be watching for any changes in the reporting and accounting style, communication detail and where the focus is placed. Management has billed this year as one to establish the global operating platform and that’s what we should be measuring them against.

The Buy case for **RungePincockMinarco** was even simpler to make than 3P’s: this was a software business priced like a lousy mining advisory business. This year should be transformational. The two big things to watch are licence sales growth and the integration of iSolutions, a large and recent purchase that offers great cross-selling opportunities. Profitability in the advisory business, due to cost-cutting in previous years and rising commodity prices recently, will also be worth watching. If the metrics start to pick up there’s a chance this business could be sold, making the company a pure software play.

Finally, to **GBST**, which has the greatest market share of the UK platform market. The potential for growth in assets under management renders it cheap. The company has been full of excuses for a year now – and we’re expecting more again this time as the company waits for the Cofunds work to ramp up. GBST has been bullish in the past so I’ll be looking for

> **“Results from the listed property sector should be fascinating. Almost every form of property (residential, retail, commercial and industrial) has found the past few years very profitable.**

any changes in tone, along with comments on the progress of the Aegon/Cofunds integration and the future direction of their software architecture.

### Andrew Legget, analyst

In funds management, the major metric to watch is funds under management (FUM), particularly with regard to capital flows. Already, we know that the two big international fund managers – **Platinum Asset Management** and **Magellan Financial Group** are having different years. Platinum started back in July with FUM of around $23.4bn but by December it was only $23.2bn. Magellan meanwhile grew funds from $41.5bn to $46.5bn, an increase of 12%. It will be interesting to hear from Kerr Neilson and Hamish Douglass as to the reasons for the discrepancy.

**Perpetual**, for its part, has already reported a decent second quarter with funds under management increasing 3.9% to $31.9bn, the highest since March 2014. Most of the gains were from market performance rather than flows – in fact, there was a $0.1bn outflow in equities – but we’ll take what we can get.

Results from the listed property sector should be fascinating. Almost every form of property (residential, retail, commercial and industrial) has found the past few years very profitable. Low interest rates made debt cheaper, driving property valuations and share prices higher as investors chased yield. But with bond yields rising the market has started to turn.

I’ll be looking for any signs of trouble in the big listed property companies, especially those with residential development businesses such as **Stockland** and **Mirvac**. Things to look out for include movements in capitalisation rates and valuations, vacancies and defaults.

This reporting season will also be the first chance for investors to gauge the impact of last October’s accident at Dreamworld, resulting in the deaths of four people. We already know that **Ardent**’s theme park division has seen revenues fall 63% in the key month of December and no revenue at all during November when the park was closed.

But the impact has spread beyond Ardent. **Village Roadshow**, which operates *Warner Bros. Movie World*, *Wet’n’Wild* and *Seaworld* on the Gold Coast, has seen visitations from local Queenslanders (60% of total attendances) drop by more than 12% since the Dreamworld accident. This wasn’t helped by well-publicised ride malfunctions at their own parks. How management presents the results, especially after the disastrous response to the initial incident, will be illuminating.

*Note: Our **Growth** and **Equity Income** portfolios own shares in CBA, ASX, Computershare, IOOF, BHP, South32, Amaysim, TPG, Woolworths, Carsales, Trade Me, News Corp, Flight Centre, Virtus Health, Monash IVF, Sydney Airport, Nanosonics, Crown, Ainsworth Game Technology, GBST and Perpetual. You can find out how to invest directly in these and other InvestSMART portfolios by **clicking here**.*

**Disclosure: Staff members own shares in CBA, ASX, Computershare, IOOF, BHP, South32, Amaysim, TPG, Woolworths, Carsales, Trade Me, News Corp, Flight Centre, Virtus Health, Monash IVF, Sydney Airport, FSA Group, Nanosonics, Crown, Ainsworth Game Technology, Reckon, iSelect, 3P Learning, RungePincockMinarco, GBST and Perpetual.**

***Legacy issues dogged university college operator Navitas in the first half but, never fear, growth should return in 2018.***

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 2 FEBRUARY 2017

# Navitas: Interim result 2017

Earlier this week education provider Navitas reported record interim earnings of $53m for the half year to 31 December. And yet the share price fell 6% on the day, taking the decline since the July 2016 high to more than 25%. Is this our long-awaited opportunity to buy Navitas?

### *Key Points*

- ***Result somewhat disappointing***
- ***Very good business***
- ***Growth to return this half***

NAVITAS (NVT) / BUY

| Price at review | Max. portfolio wght. | Business risk | Share price risk |
|---|---|---|---|
| $4.40 | 5% | Medium | Medium |

BUY Below $5.00 — HOLD — SELL Above $8.00

$4.40

The record result was thanks to a one-off gain which, ironically, highlighted a weakness in Navitas's new joint venture model (more on that shortly). Excluding the gain, net profit actually fell 14%, while revenues declined 8% (see Table 1).

Navitas's 2017 year is probably best described as 'transitional'. As discussed in ***Navitas: Result 2016***, the effects of the closure of the Macquarie and Curtin Sydney colleges continued into the first half of 2017. The end of these agreements – combined with some unfavourable foreign exchange movements – were behind the poor result.

The two colleges previously generated almost $30m in earnings before interest, tax, depreciation and amortisation (EBITDA) for Navitas. That the company's University Programs division will essentially report flat EBITDA over the three years to 2017 proves the underlying growth the remainder of the business is delivering. Universities Programs' EBITDA fell 5% to $70m in the first half but, excluding the two colleges, earnings would have risen 8%.

### Longstanding relationship

During the half, the University Programs division renewed its agreement with one university and converted its longstanding agreement with Edith Cowan University to a joint venture. This gave rise to a one-off non-cash gain in the half, which effectively represents a transfer of $21m of value to Edith Cowan University. It looks a little like the university held a gun to Navitas's head – who said academics weren't commercially-minded? – so it's a risk we'll watch as other partnerships come up for renewal.

SAE, Navitas's second division, also reported a weaker result, with EBITDA falling 10% to $13m. The turnaround of this business, which Navitas acquired in 2010, has been ongoing, with the result affected by the closure of four sub-scale colleges. SAE is Navitas's weakest business but Australian results have been strong and new courses in the USA should support earnings from next financial year.

Professional and English Programs – the third division – is a grab bag of English courses and vocational training colleges. EBITDA fell 3% to $11m in the half but the division has produced decent revenue and earnings growth over the past five years. The Australian Migrant English Program is a Navitas-taught government contract that is up for renewal shortly but, as the company has been involved with the program since 1998, it is confident of winning the tender.

So that's the interim result. What about the future?

**Table 1: Navitas interim result 2017**

| SIX MONTHS TO 31 DEC | 2016 | 2015 | +/(–) (%) |
|---|---|---|---|
| REVENUE ($M) | 478.1 | 517.5 | (8) |
| EBITDA ($M) | 76.6 | 82.8 | (8) |
| NPAT ($M) | 39.0 | 45.1 | (14) |
| EPS (C) | 10.6 | 12.0 | (12) |
| DPS* (C) | 9.4 | 9.4 | 0 |
| FRANKING (%) | 100 | 100 | N/a |

*** ex date 28 Feb**
**Note: Figures are underlying results**

While the result looked poor and was poor, it feels like Navitas is turning the corner. The University Programs division should resume growing in the 2018 year after several difficult years. Chart 1 shows this is a growth company; it's just that the closure of the Macquarie and Curtin colleges interrupted earnings growth between 2015 and 2017.

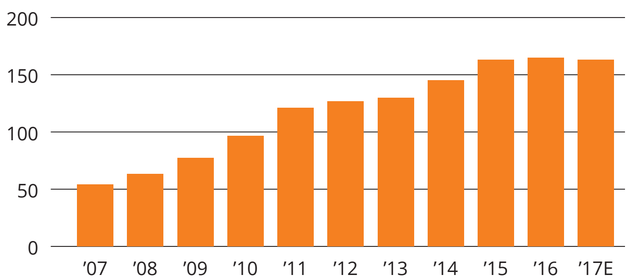
> “Reassuringly, management disclosed that it was in negotiations with about a dozen other universities, so there's still a growth pipeline.

## Another lonely day?

Nevertheless, the risk of universities going their own way remains. Here we were reassured by management on the conference call. They implied that Macquarie's decision to go it alone hasn't been particularly successful, which is dissuading other universities. Management is confident about renewing the agreements with Deakin and Curtin universities at the end of the year under the royalty model.

Navitas has also signed a partnership with the University of Idaho (under the royalty model), its first North American agreement since August 2014. Reassuringly, management disclosed that it was in negotiations with about a dozen other universities, so there's still a growth pipeline.

**Chart 1: Navitas EBITDA ($m)**




Source: Company reports

The North American market is proving harder to crack – and there is greater competition – but there's enormous potential there given its immaturity. Only 4% of students in the USA are international, compared with 18% in Australia and the UK. If the Trump administration decides to take a hard-line attitude towards international students – and there have been rumblings in recent days – then Navitas management believes Canada and Australia will be the beneficiaries.

Returning to our original question, is it time to buy Navitas? Well, notwithstanding the disappointments of the past two years, this is a very good business. A high **return on capital employed** (of 37%), a negative working capital model whereby Navitas receives fees upfront and pays its teachers later, and long-term industry tailwinds mean the stock should trade at a premium.

## Priced for moderation

And it does. Navitas trades on a 2017 forecast price-earnings ratio of 19 and an enterprise value to EBITDA multiple of 11 times. However, current earnings do not reflect the long-term potential of Navitas. The market is currently pricing the company as if it will achieve only moderate growth. That outcome will produce decent returns from this price but stronger growth would provide upside.

Navitas's negative working capital model means it also produces strong free cash flow (although not in the first half of 2017, due to college closures and investment in several campuses). Removing the effects of various one-offs, we conservatively estimate the stock trades on a free cash flow yield of around 5.0%. Again, no bargain but reasonable enough for a quality business.

Debt has crept up recently but mainly due to a share buyback. Over the past year management has bought back 17m shares at a cost of $86m – an average of about $5.00 a share. Notwithstanding the error in acquiring SAE in 2010, we believe management has a keen sense of value and that the buyback reflects its belief the stock is underpriced.

We're mindful of what we said in ***Navitas's school of hard knocks*** back in February 2016 (which also provides more detail about the business and the risks than we have space for here). And that's there might be disappointments occasionally.

Navitas could lose the Adult Migrant English Program contract in March. Deakin or Curtin universities might not renew their agreements later this year, or they might do so on less favourable terms – as happened with Edith Cowan University. Changes to immigration and student visa policies remain an ongoing risk.

But international students will continue to want quality educations in English-speaking countries, and Navitas has shown itself to be a leader in facilitating relationships with universities. Consistent with our view in ***Navitas: Result 2016***, the current price represents reasonable value for a very good business. We're upgrading to **BUY**.

**Staff members may own securities mentioned in this article.**

***Virtus has lost market share in its key state, but there are other things to like about this IVF provider.***

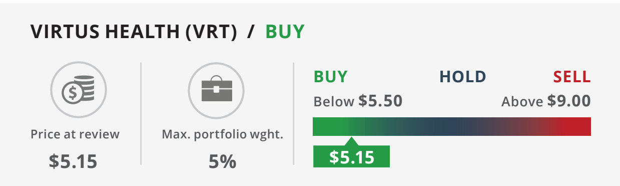
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 31 JANUARY 2017

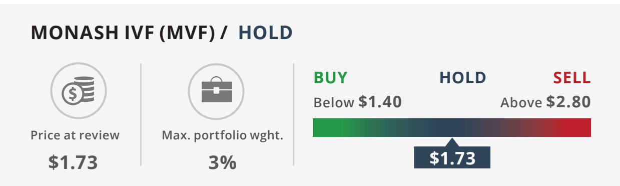
# Virtus disappoints with market share losses

IVF provider **Virtus Health**'s share price has fallen more than 15% after revealing that the number of fresh IVF cycles undertaken has fallen 7.2% in the six months to December 2016, slightly worse than an overall market decline of 6.0%. The company said this would likely have a 'material impact' on the full-year result, though said it was too early to tell how bad it would be.

### *Key Points*

- ***Full-service volumes decline***
- ***Overall market decline down to ebb and flow***
- ***Lowering price guide; raising risk ratings***




The company outlined three reasons for the poor result: weak volume growth Australia-wide; a loss of market share in NSW, with volumes at the company's low-cost The Fertility Centre clinics falling 19%; and, most disturbingly, market share losses in Victoria due to lower volumes at its full-service clinics.

The poor result in NSW was to be expected given the presence of **Primary Health Care**, which operates a bulk-billing Sydney clinic, and the recent entrance of **Monash IVF**. A fall in volumes of 19% is far worse than we expected, however, and suggests the new low-cost competitors are clearly doing something right to poach Virtus's customers.

More worrying, though, is the loss of market share in Victoria. Until now, the entrance of low-cost competition hasn't affected Virtus's high-margin full-service clinics, with volumes being relatively stable and prices actually increasing slightly. It appeared the low-cost operators were expanding the overall market by making IVF available to lower income families, rather than poaching customers from full-service clinics.

### Shaken, not broken

This announcement shakes that theory, though it's still too early to tell whether this is a short-term anomaly or the beginning of a long-term trend. A prospective couple are working to a biological clock and don't have time to waste. We expect many will still choose the premium services of Monash and Virtus, where the focus is on quality and success rates rather than price. It's unclear where market shares will settle, but Virtus will still have a place and, more than likely, continue to dominate the premium market.

Nonetheless, this announcement is a reminder that IVF is a volatile industry and the introduction of budget offerings is shaking things up. The impact has been greater than we had anticipated at this stage – margin declines seem increasingly likely and, if volumes don't pick up, revenue growth will also be difficult. To give ourselves a greater margin of safety, we're lowering Virtus's Buy price from $7 to $5.50 and our Sell price from$11 to $9. We're also increasing our risk ratings. Similarly, we're lowering our Buy price for Monash IVF from $1.80 to $1.40 and our Sell price from $3.30 to $2.80.

There's no doubt that this announcement is bad news, but there's still plenty to like about Monash and Virtus if we stay focused on the long term. As we explained in ***Does low-cost IVF threaten Monash?***, IVF is a huge untapped market and increasing rates of infertility make it hard for us to imagine a world where there is not substantially more demand for IVF in 10 years' time than there is today. The number of IVF cycles performed each year has grown at around 3% annually since the Government reduced financial assistance in 2010, despite significant volatility year-to-year. We think 3–4% market growth is a reasonable long-term assumption, with the 7% growth achieved last year and 6% decline this past half being blips on a long-term trend.

For Monash, we are happy to continue to **HOLD**.

> **There's no doubt that this announcement is bad news, but there's still plenty to like about Monash and Virtus if we stay focused on the long term.**

Despite a declining market share, Virtus is still the market leader with economies of scale, a clean balance sheet and excellent returns on capital. We'll review the company in detail when it releases its interim result later this month. The stock now trades on a price-earnings ratio of around 13 and free cash flow yield of 9%. The road has proved bumpier than we expected and the risks are higher, but we're being well compensated for those risks. **BUY**.

*Note: Intelligent Investor's **Growth** and **Equity Income** portfolios own shares in Virtus Health and Monash IVF. Last week we gave instructions to sell our holdings in Monash IVF and this trade is still in the process of being completed. We continue to believe that Monash is undervalued, but we chose to sell it to make way for a purchase of Flight Centre. We are also happy to reduce our large exposure to a sector that is more volatile than we had anticipated. Details of the trade will follow when it has been completed. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

**Disclosure: The author owns shares in Virtus Health and Monash IVF.**

***Soft services revenue in the UK is GBST's latest undoing.***

BY ALEX HUGHES • INTELLIGENT INVESTOR • 2 FEBRUARY 2017

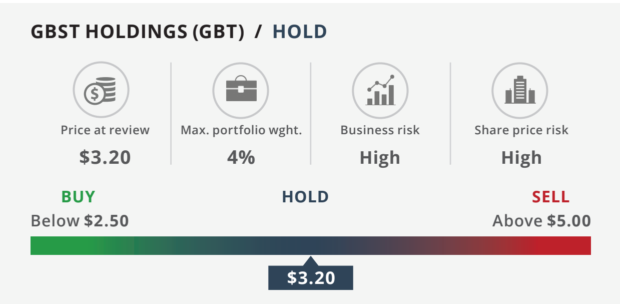
# More project delays hit GBST

Yesterday's market update is a case of bad news becoming worse for GBST.

The financial software business now expects to report operating earnings (before depreciation and amortisation) of $8m for the first half, and just $12m for the full year. That's a 30% decline on the $17.2m reported in 2016, and a long way from the strong profit growth we envisaged when we first upgraded the stock almost two years ago at $5.75.

### *Key Points*

- ***FY17 EBITDA downgraded 30%***
- ***Soft UK services revenue***
- ***Downgrade to HOLD***




Another red flag was the resignation of non-executive director Ian Thomas the day before the downgrade. Never a reassuring sign.

That leaves us with a stuttering profit engine, concerning director departures, and a 17% lower share price from two days prior.

## Soft services

You may be wondering how this can happen. To explain, let's revisit GBST's earnings model.

In an overly simplified sense, GBST is made up of four moving parts: Software revenue; Services revenue; research and development (R&D) expenditure and operating expenditure. When these variables are favourably aligned, GBST can produce strong profits. But if revenue undershoots, or if costs overshoot, the performance can take a battering.

Software revenue, the largest component representing 65% of the total, is the most predictable, as it is recurring in nature and derived from customers who cannot easily change to other providers.

But Services, such as development and integration which makes up the remaining 35%, is much less predictable. New work takes a long time to secure and is subject to changes in both scope and timing by the client.

This makes profits lumpy and we've had more of the bad kind lately. Not only that but with hindsight, it looks like we were seduced into our original upgrade by one of the good ones.

## Con(ference) call

Another weakness – not just in GBST's model but in all on-premise software businesses – is that if a client cancels a big development project, profits go and this forces difficult decisions with the cost base.

This was the story behind GBST's downgrade, with UK wealth management services revenue falling short of expectations.

On the conference call, we learned that 5 projects from 3 clients were put on hold, for reasons, at least per GBST management, that were outside their control.

The Aegon/Cofunds merger also completed later than expected (just before the champagne corks were popped on New Year's Eve), delaying services revenue for the integration. This all comes in a year of elevated R&D investment, which is expected to exceed 2016's $16m before normalising to around $10m in future years.

This marks the second disappointing downgrade due to the UK's wealth management division in as many years.

## Earning's engine intact

The big question now is whether this reflects timing issues amidst an uncertain macroeconomic world, or intrinsic problems within GBST? Despite having egg on our face from recommending GBST at much higher prices, we continue to think it is the former. GBST's earnings engine remains intact.

There is some evidence to suggest the mantle of best software provider has shifted to GBST's competitor, Bravura. They claim they have won every head to head battle for new clients over the last 18 months. Cofunds did choose Bravura over GBST initially (before it was acquired by Aegon and consolidated on GBST's platform), as we explained in Enter Bravura: GBST's biggest competitor, which adds weight to Bravura's claims of software superiority.

> **On top of overpaying, there are a few risks we haven't given enough weight to in the past.**

We also think Bravura's software model is likely to prove more efficient over time, as a single line of code is easier to maintain, and the effectiveness of development is maximised by allowing all customers to benefit from the expenditure of a single client. This all may be a moot point, however, as having the best software does not guarantee victory in this industry.

GBST's clients are unlikely to change, and it has a sufficient base to be a very profitable business. With today's lower price, the thesis herein becomes less about winning new clients and more about maximising profitability from the existing book.

## Increasing risks

On top of overpaying, there are a few risks we haven't given enough weight to in the past. With a smaller number of customers now contributing a large portion of revenue, the risk of deferrals is higher than it once was. It's a painful reminder of the danger in paying high multiples for businesses with significant earnings risk.

We should have required a greater margin of safety and – belatedly – we're going to put that right by lowering our buy price to $2.50. The Sell price falls to $5, but note that this is as things stand at the moment; if there are signs of improvement then we'll move it higher (and, of course, vice versa). We're also increasing our fundamental risk rating a notch and reducing our maximum recommended portfolio weighting from 5% to 4%. Sadly we suspect that market movements will have made this a non-issue for people who stuck to our prior limits. **HOLD**.

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

**Staff members may own securities mentioned in this article.**

***OFX has lost patience with CEO Richard Kimber; and we've lost patience with it.***

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 2 FEBRUARY 2017

# OFX warns again and sacks CEO

OFX Group chairman Steve Sargent joined the board six months ago and only became chairman in November, so he's probably a good person to allocate the blame for the company's latest profit warning – and he wasn't pulling his punches.

### *Key Points*

- ***Second half profits to undershoot by 20%***
- ***CEO replaced***
- ***Downgrading to SELL***

**OFX GROUP (OFX) / SELL**

| Price at review | Max. portfolio wght. | Business risk | Share price risk |
|---|---|---|---|
| $1.27 | 3% | High | High |

BUY Below $0.80 — HOLD — SELL Above $1.20

$1.27

'We feel good about the things ... we're working on,' he explained in yesterday's conference call, 'but the execution against that was often coming up short'.

Ouch. Apparently the board decided around the half-year result in November (about the time that Sargent took over) that chief executive Richard Kimber would need to be replaced if OFX had another bad quarter, and so it has.

Kimber will leave the company just 19 months after joining. He will be replaced by John 'Skander' Malcolm, who has 23 years' experience in the financial services industry in Australia, NZ, the US and the UK, most recently as CEO of Australia and New Zealand for GE Capital (where he worked alongside Sargent).

### Aspirational goal

Kimber's plan to double revenues by 2019 (to $200m) has also gone by the wayside, now being described by Sargent as an 'aspirational goal', which 'will not materialise within the timeframe previously outlined'.

Looking shorter term, the statutory net profit for the year to March 2017 is now expected to be 'at least $19m', compared to the prior guidance of slightly more than last year's $21.8m. That in turn means the company is expecting the second half to deliver something similar to the (disappointing) first-half net profit of $9.7m, instead of the $12m previously anticipated. The new profit figure is taken after an undisclosed cost of sacking Kimber, but it's still a big downgrade.

The performance hasn't been helped by the dislocation following the Brexit referendum back in June. Not only has the British pound fallen by 20% against the Australian dollar, but there have also been fewer large value transactions originating from the UK. All told, the average revenue on such transactions fell by about 35% in the December quarter. As a result, fee and commission income will now be $3m less than anticipated for the year to March.

The company denied that competition had exacerbated the impact, but it's hard to have much faith in that given the track record of missing targets.

### New client problem

The UK weakness looks like it accounted for most of the downgrade, but the company also revealed that it had signed fewer new clients than expected in Australia during the third quarter. On the call, chief financial officer Mark Ledsham explained that this was because the company's investment in programmatic display advertising was taking time to implement effectively.

Programmatic display advertising automates the buying of online display ads to specifically target a company's most likely leads. It's an iterative 'test and learn' process and Ledsham suggested it was beginning to show results, just more slowly than expected.

But if that's the case, then it seems a bit premature to sack Kimber. Perhaps the implementation has been found wanting; or perhaps Sargent just wanted his man in the job.

Or perhaps competition is taking a toll despite Ledsham's assertion that it didn't 'pose a significant issue'. Barriers to entry (in terms of gaining licences and banking relationships), he said, were keeping new entrants at bay, while the size of the market meant that existing players were working to grow the market and take business from the banks as opposed to from each other.

Maybe he's right, but in that case, how come the company has found it so difficult to sign new clients, ever since it **first disappointed on this metric** in May 2014, just seven months after **floating**.

> **“Strong cash generation on its own does not make a great business.**

Active clients (who have transacted in the past 12 months) stood at 152,000 in September 2016, compared to 151,000 a year earlier and 130,000 in September 2014 (below the prospectus forecast for 140,000).

As a result, the expected earnings per share for the year to March 2017 of about 8 cents will be less than the underlying 8.6 cents recorded in 2014. That's not great for a supposed growth stock that first traded with a prospective price-earnings ratio of about 30.

### Investment case broken

Like Sargent, we also want to be clear about where we lay the blame for this recommendation – entirely with ourselves. We put too much faith in the underlying financial dynamics of the business – most particularly its cash generation.

But strong cash generation on its own does not make a great business. For that you need competitive advantages and, while OFX has carved out a niche undercutting the big banks on international payments, its looking increasingly hard for it to maintain and grow that niche.

With the stock now on a prospective price-earnings ratio of around 16, we're calling it quits. UK transaction values could recover and the Australian marketing could start to sing, in which case selling now will compound our original mistake. The network of licences and is also of some value and could attract another takeover offer. But this is not the quality growth stock we once thought and we're not going to hang on in hope. Our investment case is broken and we're heading for the exits.

We're reintroducing our price guide with a Buy price of 80 cents and a Sell price of $1.20. **SELL**.

** OzForex holds significant amounts of client cash while waiting to settle deals. As a result, interest forms an important part of its operating profit, so it uses 'earnings before tax, depreciation and amortisation' as a reporting measure rather than the more common 'earnings before interest, tax, depreciation and amortisation'.*

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in OFX but, depending on price movements, expects to Sell them. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

**Staff members may own securities mentioned in this article.**

***This Asian online classifieds start-up reported cash flows in line with expectations and, for once, some positive news.***

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 1 FEBRUARY 2017

# iCar Asia's bright side

iCar Asia reported its fourth quarter cash flows yesterday. Trying to put a positive spin on things, management headlined with 'iCar Asia reports 2016 year to date cash flows up 20% on prior year'.

**ICAR ASIA (ICQ) / HOLD**

| Price at review | Max. portfolio wght. | Business risk | Share price risk |
|---|---|---|---|
| $0.245 | 2% | Very High | Very High |

We think the company means 'cash receipts' rather than 'cash flows' but whatever. Annual cash receipts were up 20% it's true, but all the growth came in the first half. Second half cash receipts were flat on the previous year. Combined with the higher spending required to defend the business, zero revenue growth in the second half forced last year's capital raising (see ***iCar Asia finds the funds*** from September).

The bright side is that the numbers were in line with the guidance management gave in August (see ***iCar Asia warns on losses***). As the Malaysian ringgit has been weak over the past six months, that's relatively good news. The company's Malaysian operation – its most advanced business – generates almost 60% of revenue.

Assuming the operational statistics management chose to disclose are indicative of broader performance, they were also reassuring. For example, in Malaysia paid accounts were up 26% for the year, while listings grew 35%. This isn't a business that's going backwards.

The reality, though, is that iCar Asia is a capital hog. Had the company not raised capital in September, it would have run out of cash in the current quarter. On current spending rates, iCar Asia will need to raise capital again in 2018.

With our thesis on iCar Asia broken – due to losses blowing out and **Carsales withdrawal** – there's a case to sell out. 'Hope is not a strategy', as they say, and iCar Asia remains highly speculative.

But we knew that when we went in, and the stock should be a very small part of your portfolio. There's downside from here (including to zero) but our suspicion is that the major shareholders will want to resolve the situation rather than continually tipping in capital every year. Assuming you can tolerate a potential wipeout, iCar Asia is a **HOLD**.

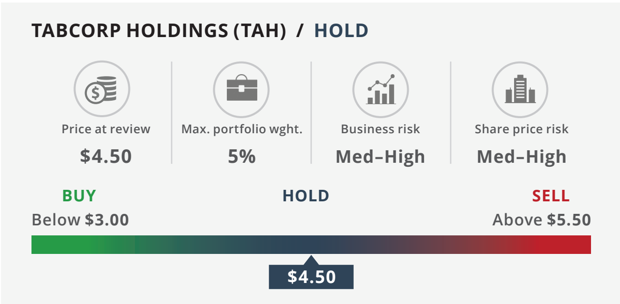
*Note: The Intelligent Investor **Growth Portfolio** owns shares in iCar Asia. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

***While growing, Tabcorp continues to lose market share to online competitors but the Gaming division earned a new contract.***

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 2 FEBRUARY 2017

# Tabcorp: Interim result 2017

Gambling giant Tabcorp has released a mediocre interim result for the six months to December, with revenue growing a paltry 2% to $1.2bn, although it did manage a 14% increase in digital turnover (wagering through the company's website and apps).




As we explained in ***Tatts: the lottery that always pays***, the company faces increasing competition from online operators that don't have to maintain a costly base of retail outlets. Larger online competitor Sportsbet – owned by UK-based Paddy Power Betfair – increased Australian turnover by 23% in the six months to December, suggesting Tabcorp is still losing market share to the company.

The company's Keno division had a mediocre year, with revenue up 2% to $112m. However, the Gaming Services division – which supplies pokies machines and services to various gambling venues – performed well with revenue up 14% to $60m, and a new contract was signed in NSW with Panthers Group.

Net profit fell 28%, though most of that decline was due to one-off items including legal expenses and start-up costs for a new UK betting platform called Sun Bets. On an underlying basis, net profit increased 5% to $103m.

This will be a big year for Tabcorp thanks to the **proposed combination with Tatts Group**. If the deal goes through, the company will gain many new markets and should be able to cut costs significantly thanks to extra scale – not to mention get one of Australia's best businesses, Tatts' Lotteries monopoly. Management said it was making progress with the various regulatory approvals necessary to get the merger across the line, with completion expected mid this year.

The company's chances were helped when, in December, Tatts' board rejected a rival takeover offer from a private consortium. The competing bidder hasn't ruled out sweetening the deal.

Tabcorp's stock currently trades on an underlying price-earnings ratio of around 20 and we continue to recommend you **HOLD**.

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

***Expensive chocolates can teach us a lot about how companies price their products – and what it means for investors.***

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 31 JANUARY 2017

# The truth about pricing power (and chocolate)

I think a lot about **Haigh's Chocolates**. Not only because I get a dopamine rush every time I unwrap one, but because I think the 102-year-old company is one of Australia's best businesses.

Why do I say that? Because I, like thousands of others, seem willing to line up outside their store each Christmas in the scorching heat to buy their chocolatey gifts – and cheerfully brush off the inevitable annual price increase.

As an experiment, I decided to compare the company's current prices with those displayed on an **archived version of their website from January 2012.**

The price of most boxed chocolate options has risen by around 20–25% over the past five years, implying an annual increase of around 4%. General inflation over that time has been around 1.9%, or 10% cumulatively. Put another way, customers are paying a good 10–15% more today in real terms for Haigh's chocolates than they did in 2012.

This kind of pricing power is a wonderful thing. It means that revenue can grow faster than volumes and – more importantly – revenue can grow faster than costs, which supercharges profit growth. If a company has an operating margin of 10% and raises prices by 2% above its cost inflation, that 2% turns into 20% growth in earnings.

Haigh's is a private company so we don't have specific data, but I'm willing to bet that margins and returns on capital are substantially higher today than they were 10 years ago (or 100 years ago for that matter).

## Think like a miner

But here's the thing: the term 'pricing power' is often bandied around as if it's an inherent quality of a business. It isn't. Having a great brand and product, as Haigh's does, may allow the company to increase prices faster than costs for a period of time, but that can't go on forever. Eventually the price will hit a ceiling equal to what the product is worth to the customer. Haigh's may be able to charge $30 or $40 for a box of chocolates. Maybe $100, who knows. But a box of chocolates isn't worth an infinite sum, and that means that raising prices faster than inflation and wage growth will eventually end. Pricing power is a finite resource.

It's easy to look at Haigh's and say 'wow, this company has been increasing prices much faster than inflation, it must have lots of pricing power, what a terrific business'. But when I look at Haigh's, I think 'what a great brand – but just how much pricing power does it have left?'. Pricing power is like a mine; your job is to work out how much has been extracted already and how much is still left in the ground.

Companies tend to be very good at figuring out what their customers are willing to pay for their product and so usually don't leave money on the table. Finding stocks with unused pricing power is actually quite rare, but these can make the best investments.

If you want to buy companies backed by pricing power, rather than looking for those that have consistently raised prices above inflation over the past five or 10 years – which could mean they are starting to overprice their product – you may do better looking for companies with good products but a *lack of price increases*. The gap between the current price of a product and its underlying value to the customer is what matters, not historical price rises.

# Equity Income Portfolio trades

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 1 FEB 2017

**FLIGHT CENTRE (FLT) / BUY**

Price at review $29.84 | Max. portfolio wght. 6%

BUY Below $32.00 | HOLD | SELL Above $50.00

$29.84

**MONASH IVF (MVF) / HOLD**

Price at review $1.72 | Max. portfolio wght. 3%

BUY Below $1.40 | HOLD | SELL Above $2.80

$1.72

**ORIGIN ENERGY (ORG) / HOLD**

Price at review $7.19 | Max. portfolio wght. 4%

BUY Below $4.50 | HOLD | SELL Above $12.00

$7.19

The ***Intelligent Investor Equity Income Portfolio*** has sold its holding of about 2.8% in Monash IVF at an average price of $1.76 and its holding of about 1.8% in Origin Energy at $7.24. The money has been used to buy a 3% stake in Flight Centre at $30.39.

We still think Monash IVF offers reasonable value – as described in **yesterday's update** – but we're keen to take advantage of what we consider to be a better opportunity in Flight Centre. Given that we also have a Holding in Virtus Health, we also wanted to reduce our overall exposure to the IVF sector.

We also continue to see value in Origin Energy (and our **Growth Portfolio** continues to hold a small stake) but we decided to sell it in this portfolio following its decision to axe its dividend.

*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.**

# Growth Portfolio trades

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 1 FEB 2017

**FLIGHT CENTRE (FLT) / BUY**

Price at review $29.84 | Max. portfolio wght. 6%

BUY Below $32.00 | HOLD | SELL Above $50.00

$29.84

**MONASH IVF (MVF) / HOLD**

Price at review $1.72 | Max. portfolio wght. 3%

BUY Below $1.40 | HOLD | SELL Above $2.80

$1.72

The ***Intelligent Investor Growth Portfolio*** has sold its holding of about 3.3% in Monash IVF at an average price of $1.76 and used the money to buy a 3% stake in Flight Centre at $30.39.

We still think Monash IVF offers reasonable value – as described in yesterday's update – but we're keen to take advantage of what we consider to be a better opportunity in Flight Centre. Given that we also have a holding in Virtus Health, we also wanted to reduce our overall exposure to the IVF sector.

*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.**

# Servcorp takes a tumble

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 30 JAN 2017

**SERVCORP (SRV) / UNDER REVIEW**

Price at review $6.01 | Max. portfolio wght. 5%

BUY | HOLD | SELL

Servcorp has announced that it expects profit before tax in the year to June 2017 of about $47m — around 4% less than 2016 and 16% lower than the bottom of the previous guidance range of 'not less than $56m'. However, the company also announced that it expects to pay interim and final dividends of 13 cents a share compared to last year's 11 cents, giving a total of 26 cents a share for the year. Franking levels remain uncertain, but are expected to be similar to last year's level of 50%.

The profit downgrade is principally due to the 'unsatisfactory' performance of the company's USA and South East Asia operations. Senior management will now take on a greater role in these two divisions with chief operating officer Marcus Moufarrige relocating to New York for the remainder of 2017 and the South East Asia region coming under the supervision of chief executive officer and founder Alf Moufarrige.

The stock responded to the news by falling more than 20%, to around $5.80, but it has since settled at around $6. That's well below our previous Buy price of $6.50, but given the new information we're placing the stock **UNDER REVIEW** and will aim to provide a further update later this week.

**Staff members may own securities mentioned in this article.**

# Sirtex slapped with legal action

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 1 FEB 2017

**SIRTEX MEDICAL (SRX) / HOLD**

Price at review 14.92

Max. portfolio wght. 3%

BUY HOLD SELL

Sirtex Medical has been threatened with legal action by a shareholder alleging that the company breached continuous disclosure obligations when it said in August that it would achieve double-digit sales growth in 2017, only to downgrade that guidance a few months later. This follows the recent firing of chief executive Gilman Wong after he sold roughly a fifth of his holding in the company last October, just two days after he confirmed the August forecast for double-digit growth in sales.

The company said it would 'vigorously defend' the proceedings and is seeking legal advice. It's too early to tell how this will play out and judging the financial repercussions – if any – is next to impossible. We will keep you updated as things progress, but for the time being we're sticking with **HOLD**.

**Staff members may own securities mentioned in this article.**

# Sonic acquires German lab

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 30 JAN 2017

**SONIC HEALTHCARE (SHL) / HOLD**

Price at review $21.35

Max. portfolio wght. 5%

BUY Below $18.00 HOLD SELL Above $30.00

$21.35

Sonic Healthcare has announced the purchase of two large pathology laboratories in north-west Germany for €63m (around $89m) with a mix of cash and debt. Founded in 1961, Medical Laboratory Bremen has 275 staff. The company has €30m of revenue and is expected to increase Sonic's earnings per share by 2% following the acquisition, which implies a net profit of around €6.3m. That suggests a profit margin more than double Sonic's, which is impressive and probably due to Bremen focusing on higher-margin specialty testing.

Sonic already owns several other labs in Germany and the small size of this acquisition means it should be easy to manage. We also expect Sonic to be able to cut costs as duplicate expenses are removed, which bodes well for future earnings growth. Test volumes may increase too if Sonic adds ancillary medical services that are available at its larger labs.

In recent years, the German government has gradually reduced the insurance reimbursement funding pools to curb runaway healthcare costs. We expect this funding pressure to benefit Sonic at the expense of smaller operators, which are then encouraged to sell to a larger network to benefit from economies of scale. The Bremen acquisition seems to be a case in point. Sonic is due to report its interim result on 15 February and we continue to recommend you **HOLD**.

Staff members may own securities mentioned in this article.

# Trimming our coverage list

BY GAURAV SODHI • INTELLIGENT INVESTOR • 30 JAN 2017

January provokes strange behavior. People join gyms, eat healthier, drink less and forgo smoking all because the new year marks an easy path to a new start. Our equivalent is to run through our coverage list and shorten it.

Throughout the course of each year, we pick up new businesses to investigate, some of which are added to our coverage list. To make our stock universe manageable, we need to cull stocks to make room for new ones.

Here's a list of the stocks we've culled. Most of them are just too small and illiquid to continue coverage: **Silex**, **Tap Oil**, **Highlands Pacific** and **Carnarvon** fall into this category.

Then there are businesses that have been taken over or that we are unlikely to ever recommend because of quality concerns. Here belong copper miner **Aditya Birla**, gold miner **Gold Road**, **Coates Group**, **iiNet**, **M2** and **Duet Group**.

The trickiest group are larger stocks that sit on the coverage list but receive little coverage. Here we find Dragons Den reject **GWA**, **Cleanaway** and **Caltex** sub notes. Kiwi power pair **Genesis Energy** and **Mighty River Power** also join this list.

This clean-up will allow better opportunities to receive the attention they deserve.

**Staff members may own securities mentioned in this article.**

## 3P Learning

*With regards to your recommendation for 3P Learning as buy, I can see the broker consensus says strong sell. Just wondering about the conflicting advice and if you guys are still recommending to buy 3P with the recent share price fall? I have read the financials and also agree there may be potential for the business to do well in the future, however by examining the share price fluctuations I am unsure if this is the share you should trade with rather than invest for long term. Do you think it is better to wait till 23 February for the half year results or consider before then?*

30 Jan 2017 – **Alex Hughes**: We have not changed our recommendation on 3PL.

Remember, 3PL is a small cap where share price volatility is heightened compared to large caps. A few substantial shareholders (FIL, Denver) have been reducing their positions recently as well, which may have contributed to the fall in price.

It is normal for members of the financial community to have differing opinions. That's what makes a market. I am more interested to know if any of the bearish arguments from the brokers have merit. Please send them through if so.

I cannot comment about whether you should wait until the result to buy. Buying before the result obviously incurs the risk of any negative news, but it also brings the opportunity for good news as well. However, we are not playing the game of predicting short term business results, and the resulting share price action.

are looking to identify businesses that will do well over the longer term.

## Blackrock shareholding in Wesfarmers

*Why has the Blackrock Group bought and sold a large number of Wesfarmers shares on several occasions recently, with only a few days between each transaction?*

27 Jan 2017 – **James Greenhalgh**: Your guess is as good as mine I'm afraid! The main thing I can see in this case is that it looks like Blackrock has just exceeded the 5% substantial shareholding notification limit in Wesfarmers, then dipped back under it (so therefore they cease to be a substantial shareholder – they haven't bought and sold 5% each time). Blackrock is, I understand, partly an index fund manager, so it might have something to do with movements in their index funds.

Generally we don't pay much attention to fund manager substantial shareholder notices (with a few exceptions). Blackrock is certainly not one of the managers I pay any attention to, partly because they're index managers. Fund managers buy and sell for all sorts of reasons that are impossible to determine from the outside, so it's probably not worth spending much energy on.

## Touchcorp getting cheaper

*Touchcorp has halved since your last review of it in Sep. Has it become more attractive at the present price?*

31 Jan 2017 – **James Carlisle**: Yes, we having been watching this one and it has got more attractive at the cheaper price. The trouble is that at current prices it's also got a bit too small for us to formally recommend due to liquidity contstraints. With a small and tight limit on portfolio weightings - it is definitely a risky situation - it might provide an opportunity for those interested in smaller companies (including perhaps our own forthcoming smaller companies fund), so we'll continue to monitor the stock, but it's unlikely we'll start formally covering it.

## 3P Learning

*I purchased 3pl @$1.1157 3% of my portfolio, It is now down to $0.97. What is known of the fall in Price, and should I add to my holding?*

27 Jan 2017 – **Alex Hughes**: Unfortunately, I can't give you personal advice about topping up.

I can provide some general comments about 3PL. The short answer is I have no idea why the price is lower. I don't spend much (if any) time trying to comprehend price action.

I can reiterate that we haven't seen anything that suggests our initial thesis (found here) has changed.

It is worth remembering that the first half of financial year 2017 has now completed. Some investors concern themselves with short-term profit results, and you can see some volatility around these periods when actual results differ from expectations. This can have a pronounced effect on the price, especially for a relatively illiquid stock like 3PL.

We will be providing an update on 3PL after their 1H17 results are released on Feb 23.