Weekly Review

RESEARCH

– Issue – 3 Mar. 2017

iSentia's profit result was one of the worst of the 2017 interim reporting season. Does a halving of the share price make a difference?

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 25 MARCH 2017

iSentia: Interim result 2017

They say there's never just one cockroach in the kitchen. One scuttled through iSentia's house in November – see ***iSentia's King loses its crown*** – but five or six more darted out in last week's interim result.

Key Points

- ***Significant profit downgrade***
- ***Remains a very good business***
- ***Takeover target***

ISENTIA (ISD) / BUY			
Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.57	4%	Med–High	Med–High

BUY Below $1.70 | HOLD | SELL Above $2.50

$1.57

In November the creepy-crawly was dud acquisition King Content. King's performance has since worsened but, more worryingly, the problems have spread to the core Australia and New Zealand media monitoring business. No wonder the share price has plummeted 34% since then.

iSentia's problems mean management has issued another significant downgrade to profit guidance. At the time of our review last July – ***Risks rising for iSentia*** – market expectations were for earnings before interest, tax, depreciation and amortisation (EBITDA) of around $59m for 2017. Last week management said EBITDA would be closer to $45m, a 12% decline from last year. When 'growth stock' and 'market darling' meet 'falling earnings', it's never pretty.

So is this an opportunity? We've often said that iSentia is a very good business. It has a 90% share of the Australia and New Zealand media monitoring market. Replicating its full-service model would be difficult. More than 5,000 government and corporate clients rely on iSentia to tell them what the media – and, these days, 'mummy bloggers' and the like – are saying.

Let's analyse the two issues. As we said in our most recent review, we were sceptical King Content would turn around as quickly as management indicated. It admitted as much last week, explaining that King would lose $3m this year compared to its previous forecast of breakeven.

Throne down

We disliked King Content from the start – see ***iSentia's unfriendly trends*** from March 2016 – and continue to think it's a dud. At least management put 'earn-outs' in place that mean the vendors have received only $34m rather than the $48m originally envisaged. If you're wondering why statutory interim net profit rose 83% to $18.7m, it's because expected payments for King were reversed. The headline profit isn't representative of iSentia's underlying performance.

The second issue is more worrying. Management said that the 10% price rise pushed through last June – see ***iSentia's social skills*** from October 2016 – hadn't worked. This price rise had been partly designed to offset higher copyright costs, which the company must pay to distribute media content and which rose 39% in the half.

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Main competitor Meltwater – with a 6% share of the market – apparently absorbed these higher costs. As a result some iSentia clients pushed back late in the year, suggesting there's a limit to the company's pricing power. More concerningly, iSentia lost share in social media, which is Meltwater's strength. iSentia's management admitted on the conference call that its social product is uncompetitive at the moment.

Poor half

It all added up to a poor first-half result. Revenues rose 5% but just 3% in the core Australia and New Zealand media monitoring division. With higher costs and King Content underperforming, underlying net profit fell 17% to $12.4m.

Table 1: iSentia interim result 2017

SIX MONTHS TO 31 DEC	2016	2015	+/(–) (%)
REVENUE ($M)	79.6	75.8	5
EBITDA ($M)	20.5	23.5	(13)
NPAT# ($M)	12.4	14.9	(17)
EPS# (C)	6.2	7.4	(17)
DPS* (C)	3.1	3.7	(16)
FRANKING (%)	100	50	N/a

*** interim dividend 3.1 cents, 100% franked, ex date 8 March**
 # before the amortisation of acquired intangibles

Credibility has also taken a hit. Management has been far too optimistic about King Content as well as 2017 guidance. It should also have known costs were much higher and that the price rise wasn't holding well before it announced those facts to the market on 22 February. The savage share price reaction shows the profit decline and accompanying downgrade was clearly market sensitive information.

iSentia has all the hallmarks of yet another private equity disaster. We'd been sceptical about the company because of its heritage, even though we never downgraded to Sell (we got close in ***iSentia's unfriendly trends***). That, then, is the bad news.

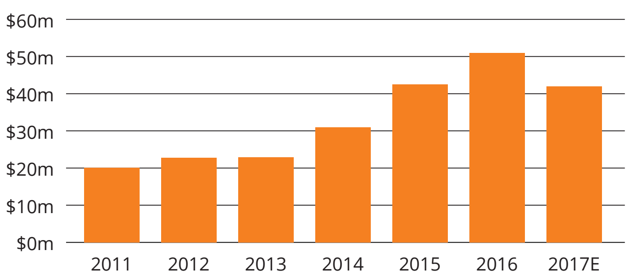
A share price that's down by more than 50%, though, has to be tempting. This remains an above-average business. So what's the other side of the story?

Well, the price rise didn't stick partly because management didn't launch any major product improvements at the time. Since then, a new version of its customer interface, Mediaportal, has been released to 'really good feedback'.

The full story

More importantly, iSentia has been working on a product enhancement it calls Storyview, which will be 'shipped' in the fourth quarter of 2017. Whereas clients previously viewed content by source, Storyview will allow them to see it by story. All clients will receive bundled mainstream media and social/online content, whereas previously social content was a chargeable add-on. Meltwater, which is not a full-service provider, will have trouble competing.

Chart 1: iSentia EBITDA



Source: Company reports

What's more, the stock now looks inexpensive. We have some doubts about management's 2017 EBITDA forecast for obvious reasons but, based on our analysis, $42m seems achievable – and possibly more. At the current price, that means iSentia is trading on a forecast enterprise value to EBITDA multiple of 9 and a price-earnings ratio of 12.6. These are inexpensive numbers for a good business with potential for improvement in 2018.

> iSentia must also be a takeover target. The global 'media intelligence' industry has been consolidating quickly.

iSentia must also be a takeover target. The global 'media intelligence' industry has been consolidating quickly and US-based Cision, for example, is presumably interested. Cision could easily save $8m a year by selling King Content and cutting head office costs. Even at $2.40 a share Cision would be getting a bargain.

iSentia isn't without risks. If Meltwater steps up its aggression, then things could get ugly. As a full-service player iSentia only has so many costs to cut. And, with a 90% market share, any erosion will be painful. Nevertheless, such extreme market dominance traditionally favours the incumbent.

Given these risks, we're lifting our business risk rating to Medium-High, which indicates iSentia isn't suitable for conservative investors. Our 4% maximum portfolio weighting remains the same. This is a small company, even if it dominates its market.

The stock, however, looks inexpensive, even accounting for management credibility issues and the risks of another profit downgrade. The cockroaches might be running rampant at the moment but our view is they can be controlled down the track. We're upgrading to **BUY** up to $1.70.

Staff members may own securities mentioned in this article.

Although this was a poor result, industry consolidation should see returns improve.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 28 FEBRUARY 2017

PMP: Interim result 2017

PMP's interim result was a reminder that, although there is much to like about the investment case, this remains a difficult business in a difficult industry.

Key Points

- ***Poor result***
- ***Higher savings and higher costs confirmed***
- ***Could still be cheap***

PMP (PMP) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$0.70	4%	High	High

BUY Below $0.75 · HOLD · SELL Above $1.00

$0.70

Revenue appeared strong but reflected the consolidation in the magazine distribution business. PMP's core Australian business, its largest division, reported a concerning 20% decline in revenue.

Competition in the period has been fierce and PMP has not replaced lost contracts. Management suggests customers have been reluctant to sign deals until industry consolidation is over.

If true, that suggests that the latest result might be an aberration but, more worryingly, it could also signal that benefits from the merger will ultimately be competed away.

Tough conditions

This will never be an industry that generates higher than average returns on capital but, today, all participants make sub-normal returns, so higher returns are possible though that will require a change in industry structure.

The Australian division lost $4.8m with print volumes falling 16% and distribution volumes down 12%. We'll be watching the second-half result carefully for improvement.

Free cash flow, a key metric for the business and vital to the investment case, was its weakest in years. This mostly reflected lower earnings before interest, tax, depreciation and amortisation (EBITDA) as margins were crunched from over 7% last year to just over 2%.

This should improve as more volume is pushed through the asset base and industry structure improves. Higher print volumes and rational competition will be vital for restoring margins.

Excluding $9m in one-off costs, trading cash flow was alarmingly weak: just $6.6m compared to $18m in the previous period.

Merger benefits

An update of the merger provided mixed news. Projected synergies are expected to be $55m, ahead of the previous forecast of $40m, but the cost of achieving them has risen from $65m to $80m.

It is convenient that cost rises are perfectly offset by synergy gains. We have previously noted that the synergy gains appeared undercooked; it looks as though PMP has brought forward some of those gains to cover higher redundancy and restructuring charges.

Table 1: PMP interim result

SIX MONTHS TO DEC	2017	2016	+/(–) (%)
REVENUE ($M)	496	390	27
EBIT ($M)	(1.8)	14.8	n/a
OP CASH FLOW ($M)	(2.2)	15	n/a
NET DEBT ($M)	9.8	10.4	(6)

The enlarged group is expected to generate between $90m and $100m in EBITDA, a slight downgrade from earlier estimates of just over $100m, which was our base case all along. We are bullish on merger synergies but realistic about the difficulties faced by the core business.

Yet at today's price, PMP still appears cheap.

Still cheap?

In ***PMP merger gets green light***, we argued that $100m in EBITDA would be worth about $500m in enterprise value for the combined group. Adjusting for restructuring charges and dilution would suggest a value for PMP of about $270m, or about 85 cents per share.

> **This will remain a competitive business but overcapacity will at least be corrected and margins should rise.**

We regard that as a base case and think higher cost savings might push the value towards $1 a share.

Dividends won't be paid for the next 12 months to provide cash for restructuring. PMP should be able to shut excess capacity, lift utilisation rates and increase margins and cash flow as the deal is completed. This probably won't be a growing business but efficiency and scale should lift profits while strong cash flow will be paid as dividends.

As this result highlights, PMP remains a fragile business but the catalogue niche still generates decent cash flow and better industry structure should help offset industry decline.

An industry dominated by four large competitors, each with low margins and high fixed costs competing fiercely will be replaced by two large competitors each lowering capacity.

This will remain a competitive business but overcapacity will at least be corrected and margins should rise. The market is still clearly sceptical about PMP's and that presents an opportunity. We're increasing our Buy price to $0.75, and that means an upgrade to **BUY**.

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

Disclosure: The author owns shares in PMP.

A strong result should get stronger as amaysim launches broadband products.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 28 FEBRUARY 2017

amaysim: Interim result 2017

With both Telstra and Optus warning of a hyper-competitive mobile market there was some nervousness before the release of amaysim's interim result.

Key Points

- ***Strong profit result***
- ***ARPU below expectations***
- ***Broadband launch should help margins***

AMAYSIM (AYS) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.83	4%	High	High

BUY Below $2.00 — HOLD — SELL Above $3.50

$1.83

It was unwarranted. The business – which continues to forsake capital letters – released pleasing results.

A 34% rise in subscribers fed higher revenue and higher earnings before interest, tax, depreciation and amortisation (EBITDA). Last year's statutory numbers were muddied by the acquisition of vaya (again no capital letter) but, on an underlying basis, EBITDA rose 38% $17.7m for the half year.

Our investment case, outlined last year in ***Unlocking value in amaysim*** was that a scalable business model was not recognised by the market and more customers would generate higher margins and fatter profits. That is happening.

This time last year, amaysim had 760,000 customers and its operating expenses were $23m. It now has over a million customers and its service costs remain the same.

Gross margins have remained flat, but EBITDA margins have grown from 10.7% to 12.7%. More customers have led to higher margins.

Switching plans

Yet margins remain slightly lower than we had originally thought. The change has occurred at the average revenue per user line (ARPU) which fell 15% to just over $22 per month. We had expected ARPU between $26 and $27 per month at this stage.

Why has ARPU fallen especially as Telstra has increased its ARPU over the past few years? Competition is the short answer, but the long one is more interesting.

This is a fiercely competitive market and amaysim's customers tend to be more price sensitive than Telstra's. Rather than hack away at prices directly to chase customer growth, amaysim has allowed customers to switch plans at any time with no penalty.

Unsurprisingly, customers are choosing cheaper plans when needed. This has lowered ARPU but it has also contributed to lower churn, which has almost halved over two years to just 2%.

Improving cash flow

In broadband and fibre, we have been cheerleaders for asset ownership but, in mobile, leasing assets can generate better returns. This is clear from cash flow.

Table 1: AYS interim result 2017

SIX MONTHS TO DEC ($M)	2016	2015	+/(–) (%)
REVENUE	136.6	117.3	17
UNDERLYING EBITDA	17.3	12.8	38
EBITDA MARGIN (%)	12.7	10.7	19
OP CASH FLOW	11.2	0.7	big
UNDERLYING EPS (C)	4.6	4.6	0
DPS (C)	4.0	3.0	33
SUBSCRIBERS ('000)	1,025	764	38
INTERIM DIV.	4c, unfranked, up 33%, ex date 20 March		

Last year's weak cash generation – amaysim generated less than $1m in the prior period – was reversed as the business bought in more than $11m in operating cash flow, and that is after counting a $10m repayment to Optus for vaya's liability to the network.

Those liabilities are now more than half paid and, after the final payment is made early next year, cash flow will be stronger still.

Because there is no network to maintain, most of the cash earned by the business is free for reinvestment or distribution.

> **amaysim has grown to become the fourth largest mobile provider with 5% market share**

This allows for generous dividends and the interim dividend was raised from 3 to 4 cents per share and the business is forecasting full year dividends of 10 cents, suggesting a yield of about 5.5% partially franked.

Broadband ahead

amaysim will soon launch a suite of broadband products that will lease fibre from the NBN.

We don't expect broadband to contribute significant standalone revenue but it does allow the business to offer bundles, which helps to support margins.

Although network costs are variable, other operating costs of providing both mobile and broadband are fixed so, by bundling both services and increasing ARPU, amaysim should be able to increase margin without increasing price.

The trade-off evident in this result – between customer growth and price – need not be so dominant and amaysim could conceivably chase both customer growth and decent margin.

Broadband is an attractive move, but we think it will supplement mobile margin rather than be a significant profit generator in its own right.

Strong result

This is a decent result that validates the business model. In quick time, amaysim has grown to become the fourth largest mobile provider with 5% market share and, among mobile virtual network operators, or asset leasers, it is the clear market leader with about 50% market share.

Its 1 million subscribers are now a strategic asset that Optus cannot afford to lose to a rival network, which makes it valuable and aids wholesale negotiations.

We expect full year EBITDA of $40m and, with net cash on the balance sheet, amaysim trades on an EV/EBITDA multiple of 8 times, a modest price. We're downgrading prices slightly to account for lower than expected ARPU but amaysim remains a **BUY**.

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

Disclosure: The author owns shares in amaysim.

A strong result from American farm insurance helped QBE deliver a good full-year result.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 28 FEBRUARY 2017

QBE Insurance Group: Result 2016

Warren Buffett didn't have a lot of nice things to say about insurance in **his annual letter** this past weekend: 'Competitive dynamics almost guarantee that the insurance industry, despite **the float income all its companies enjoy**, will continue its dismal record of earning subnormal returns on tangible net worth as compared to other American businesses.'

Key Points

- ***Strong result from US crops***
- ***Pricing pressure still evident***
- ***Rising investment income and yields***

QBE INSURANCE GROUP (QBE) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$12.23	4%	Med–High	Med–High

BUY Below $8.50 — **HOLD** — **SELL** Above $17.00

$12.23

QBE Insurance didn't get the memo. Net profit rose 16% to US$844m for the year to December, after excluding the effect of currency fluctuations.

Gross written premium (GWP) – an insurer's measure of revenue – increased 1% to US$14.1bn on a constant currency basis. Intense competition and a reduction in premium rates meant GWP growth eluded all of the big insurers this year, including **IAG** and **Suncorp**.

The North American division – QBE's largest, accounting for 29% of revenue – posted a strong result with an improvement in margins and doubling of profits despite an uptick in catastrophe claims. The result was attributed to a good year for the company's crop insurance operations, which insure farms and agricultural land against poor weather.

QBE's local operations had a more difficult time, with a significant deterioration in claims as a proportion of premiums. This follows several years of price reductions, despite rising claims, in an effort to maintain market share (maybe Buffett has a point). Underwriting profit fell 13% to US$250m.

To fix the problem, the company rolled out a host of changes to the Australian business, including: raising premium rates; revising terms and conditions in contracts; greater emphasis on salvage recoveries; and tightening managerial control over claims by removing various delegated authorities.

Management said the improvements are already starting to flow through, with the second half claims ratio being materially better than the first half's.

Rising investment yields

Income from QBE's US$24bn investment portfolio rose 12% to US$746m. Management said it has been shifting the fixed income exposure of the portfolio towards longer-dated securities so as to more closely match the duration of claims. Almost 90% of QBE's portfolio is invested in assets such as corporate and government bonds, cash, or other short-term fixed income securities. The company said rising bond yields since the US election will mean investment income should rise again in 2017.

Table 1: QBE full-year result

YEAR TO 31 DEC	2016	2015	+/(–) (%)
GWP (US$M)	14,395	15,092	(5)
INSURANCE PROFIT (US$M)	1,075	1,031	4
NET PROFIT (US$M)	844	687	23
EPS (US CENTS)	60.8	49.8	22
FINAL DIVIDEND	33 cents, (up 10%), 50% franked ex date 9 Mar		

Overall, QBE produced a decent profit margin of 9.7%, up from 9.0%, which was in the upper end of management's target range of 8.5–10%.

The company's debt-to-equity ratio was stable at 34% and QBE achieved a return on equity of 8.1%, up from 7.5%.

Management met its target of US$150m of expense savings this year and said shareholders could expect another US$150m of costs to be stripped from the business by 2018, with at least half of its US$200m target for savings from claims fraud to be achieved by the end of 2017. These cost-cutting initiatives are expected to support management's long-term goal to achieve a return on equity of 13–15%.

> **QBE's turnaround is on track and the company is leaps ahead of where it was a few years ago.**

The board announced a US$1bn share buyback over the next three years, which should reduce the share count by 7–8% at today's prices. We think the buyback in addition to the board's decision to raise the dividend payout ratio to 65% is a decent use of cash flow given the company's limited growth opportunities and clean balance sheet.

Management expects gross written premium to be largely unchanged in 2017 due to the tough premium pricing conditions. The stock sports a price-earnings ratio of around 16, with a partially franked dividend yield of 4.3%. QBE's turnaround is on track and the company is **leaps ahead of where it was a few years ago**. We're raising the price guide slightly and sticking with **HOLD**.

Staff members may own securities mentioned in this article.

Perpetual's advisory business stole the show in its latest result, and management has ambitious targets for it.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 28 FEBRUARY 2017

Perpetual: Interim result 2017

You'd forgive Perpetual Private – the group's wealth advisory business – for feeling a bit like the perennial bridesmaid. Contributing only a fifth of Perpetual's total profits, compared to three-fifths for Perpetual Investments, it's the latter that gets all the attention around results time.

Key Points

- ***Strong performance from Perpetual Private***
- ***EPS growth likely to return this year***
- ***Downgrading to Hold***

PERPETUAL (PPT) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$51.61	6%	Medium	Med–High

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

$51.61

This time around, though, Perpetual Private was firmly in the limelight, with a 9% increase in profit before tax, compared to just 3% for Perpetual Investments (and 1% for the Corporate Trust business). The business added 46 net new clients, with an average of $2.8m of funds under advice (FUA), giving over $0.1bn in net flows. That makes it seven halves in a row that these markers have both been positive, with a cumulative 283 new clients and $1.05bn in flows.

Combined with market movements, funds under advice in Perpetual Private rose 4% to $13.3bn over the period and averaged $13.0bn. A stable margin of 0.85% meant that Perpetual earned $55.7m of 'market-related' revenue on those funds (up 3%). Meanwhile, 'non-market related' revenue (from things like tax, accounting and property services) rose 9% to $30.9m, giving total revenues of $86.6m (up 5%).

Expenses grew at the slower rate of 4% (including depreciation, amortisation and equity remuneration), leading to the 9% profit increase.

Ambitious targets

The 9% increase in non-market related revenue was primarily due to the Fordham advisory business, which focuses on providing advice to business owners, and which expanded into NSW last year with the addition of seven new partners, taking the total to 16.

The business was bought for $35m in 2010, with around 14 partners generating $22m in revenue. Initially it disappointed, with revenue falling to $16m in 2013. A recovery over the past three years, however, has seen revenue recover to $20m – generated by the business's nine partners in Victoria – and management says it believes there is the potential to treble this to $60m by 2020.

Table 1: Perpetual interim result 2017

SIX MONTHS TO DEC ($M)	2016	2015	+/– (%)
PERP. INV. REV.	113.8	110.0	3
PERP. PRIV. REV.	86.6	82.3	5
PERP CORP. TRUST REV.	44.5	42.4	5
OTHER REV.	7.5	6.0	25
OPERATING REVENUE	252.4	240.7	5
EXPENSES	160.7	152.8	5
UNDERLYING PBT	91.7	87.9	4
UNDERLYING NET PROFIT	65.7	63.5	3
UNDERLYING EPS (C)	140.7	137.3	2
INTERIM DIV.	130c, fully franked, up 4% ex date 1 March		

To achieve that goal, it's aiming to increase partner numbers from the current 16 to 'over 30', with revenue per partner of 'over $1.5m'. Simple arithmetic would suggest that one or both of those will need to be 'well over' to make $60m.

If that target is achieved, it would add about 24% to Perpetual Private's revenue – and 8% to the group total – on its own, and there would be additional benefits for the rest of the group through referrals. It's an ambitious target, though, and we'll be taking it with a pinch of salt for the time being.

> **"The main driver of profits will remain the funds management business, Perpetual Investments, and here the news is less rosy.**

Poor (recent) performance

The main driver of profits will remain the funds management business, Perpetual Investments, and here the news is less rosy. Net flows of zero in the half included an outflow of $0.2m from the higher margin retail channel and $0.4m from equities. Market movements, however, meant that funds under management (FUM) rose $2.5bn to $31.9bn, compared to June 2016. Average FUM rose 2% to $30.7m.

The good news was that, despite the outflows in equities and retail, the underlying revenue margin was relatively stable at 0.72%, which increased to 0.74% with the inclusion of performance fees. That gave a 3% rise in revenue compared to the prior corresponding period and a 3% increase in profit before tax.

The concern for this business is that performance has been poor for the past few years, with only 44% of flagship funds in the first and second quartiles over one and three years. Generally speaking we wouldn't be too fussed about such short-term performance (over five and ten years, 87% and 85% of flagship funds are in the top two quartiles), but there have been some personnel changes over the past few years so it's something that we'll be watching.

Growth returning

The final piece of the jigsaw is the Corporate Trust business, which produced a solid result, with funds under administration rising 7% to $644bn over the year. Some of that increase is yet to translate into revenue, which grew only 5%, and a 6% cost increase due to continued business investment meant that profit before tax grew only 1%.

Overall, underlying profit before tax increased 4% and a slightly higher tax rate and a few more shares on issue meant that underlying earnings per share increased only 2% $1.407. Even so, that's a little more than the market was expecting and supports the hope we expressed in our review of **Perpetual's 2016 result**, that 2017 might see a return to earnings growth.

Something around $2.85–2.90 would represent growth of 3–5% and would put the stock on a price-earnings ratio of 18. That's not expensive for a quality cash-generative business but, with the stock now past our Buy price*, we're downgrading to **HOLD**.

* We note that the stock is due to trade without entitlement to its $1.30 interim dividend on 1 March and this might bring the stock back to around our Buy price. We'd want to see a bit of space below this level, however, before upgrading again.

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

Disclosure: The author owns shares in Perpetual.

Australia's two largest hospital networks had very different results this half – and it pays to be big.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 2 MARCH 2017

Ramsay & Healthscope: Interim results 2017

You know you've done a decent job as chief executive when, on news of your retirement, some $800m is wiped from your company's valuation. This was the case for Australia's largest hospital operator, **Ramsay Health Care**, at its latest result when chief executive Chris Rex announced he would be leaving the company later this year.

Key Points

- ***Ramsay posts good result in all divisions***
- ***Healthscope losing market share; not for long***
- ***Economies of scale boost margins***

RAMSAY HEALTH CARE (RHC) / HOLD

Price at review **$68.87**
Max. portfolio wght. **7%**
BUY Below **$45.00** · HOLD · SELL Above **$100.00**
$68.87

HEALTHSCOPE (HSO) / HOLD

Price at review **$2.21**
Max. portfolio wght. **7%**
BUY Below **$1.80** · HOLD · SELL Above **$3.50**
$2.21

Ramsay's earnings have risen a good five times over since he took the reins nine years ago. There's no doubt Rex added value for shareholders and his act will be a tough one to follow.

Besides this bit of bad news, Ramsay posted a strong result for the six months to December: revenue rose 4% to $4.3bn, or 8% after removing the effect of currency fluctuations, mainly due to strong growth in Australia, the UK, and France.

The Australian business in particular had a good half with revenue up 9% to $2.4bn (56% of the total), mainly due to admissions growth as an ageing population boosts hospital occupancy rates, as well as some recent expansion projects.

The company's French operations performed well, with revenue up 6% to €1.1bn despite a second year of reduced government funding to the private hospital sector. Management said strong admission growth, cost management and small acquisitions helped support revenue and earnings.

Pays to be big

Ramsay's underlying earnings before interest and tax (EBIT) increased 9% to $464m, while net profit rose 13% to $268m – both of which underscore Ramsay's impressive economies of scale. A large proportion of Ramsay's costs are fixed, so the strong admissions growth this half meant Ramsay's expensive equipment and operating theatres could be used more efficiently, with additional revenue quickly falling to the bottom line.

Table 1: RHC interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	4,319	4,173	4
UNDERLYING EBITDA ($M)	649	607	7
UNDERLYING NPAT ($M)	268	237	13
UNDERLYING EPS ($)	1.29	1.14	13
INTERIM DIVIDEND	53 cents (up 13%), fully franked ex date 7 March		

Ramsay's size also gives it the muscle to negotiate better rates for care when dealing with private health insurers, as well as cost advantages when buying medical consumables – such as bandages or prosthetics – which account for around a quarter of operating costs.

Management says a current plan to squeeze out savings when purchasing consumables should cut $40m of expenses over the next 12 months.

These economies of scale have flowed through as ever-widening margins – Ramsay's EBIT margin rose from 10.2% to 10.7% over the past year and, all things being equal, we would expect margins to keep expanding as the company grows.

Ahead of schedule

Smaller competitor Healthscope increased revenue 4% to $1.2bn, though the hospital division only increased revenue 3% due to poor admissions growth. The overall Australian private hospital market grew 5% in the period – and Ramsay increased revenue 9% – so the implication is clear: Ramsay is increasing market share at Healthscope's expense.

> "With economies of scale and a well executed international growth strategy, Ramsay is one of Australia's top healthcare companies.

Nonetheless, we expect Healthscope to claw back some of that ground over the next few years. Various expansion projects are expected to add almost 1,000 new beds and 50 theatres to Healthscope's network – a 20% increase in capacity – between now and 2018, which should ensure faster revenue growth than Ramsay's local operations on completion (see ***Will the aging population rejuvenate Healthscope?***).

Table 2: HSO interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	1,192	1,147	4
UNDERLYING EBITDA ($M)	217	206	5
UNDERLYING NPAT ($M)	91	97	(7)
UNDERLYING EPS (CENTS)	5.2	5.5	(7)
INTERIM DIVIDEND	3.5 cents (unchanged), fully franked, ex date 8 March		

What's more, Healthscope's management said the new billion-dollar Northern Beaches Hospital is three months ahead of schedule, with construction of the external physical structure now complete.

The company's New Zealand pathology division recorded a strong result with revenue increasing 16% to $123m and EBIT up 31%. This was attributed to increasing utilisation of community pathology, and cost savings from equipment upgrades.

Healthscope's overall EBIT increased 1% to $161m, though net profit fell 7% to $91m, mainly due to a significant uptick in interest expense as the company takes on debt to fund the expansion projects. Net debt increased 12% to $1.4bn, though operating profits still cover interest expense a healthy six times over, so we aren't concerned.

Healthscope's management expects growth to continue to be slow in the second half of the financial year with the Hospital division likely to achieve EBITDA growth similar to the first half (up 2.2%). The company has several competitive advantages, though is arguably more risky than Ramsay due to most of its earnings being exposed only to the Australian market and regulators, rather than being diversified geographically. Still, with decent growth prospects and a price-earnings ratio of 22, Healthscope is a comfortable **HOLD**.

Ramsay's management expects underlying earnings per share to grow 12–14% in 2017, up from previous guidance for growth of 10–12%. With economies of scale and a well executed international growth strategy, Ramsay is one of Australia's top healthcare companies. The stock sports a forward price-earnings ratio of around 27, but that premium to Healthscope is justified. We're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

iCar Asia's full-year result was a bloodbath, as expected, but management is hoping for an improvement in 2017.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 1 MARCH 2017

iCar Asia: Result 2016

As expected, the red ink was flowing thick and fast in iCar Asia's 2016 profit and loss account. All but two lines (revenue and interest income) were negative, and most of them significantly more so than 2015.

Key Points

- ***Heavy losses for 2016***
- ***Operating metrics still improving***
- ***Management bullish; but risks remain***

ICAR ASIA (ICQ) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$0.25	2%	Very High	Very High

Advertising and marketing expenses increased 38% to $6.9m, while employee expenses only rose 8%. This shows that the big ramp-up in expenses has been less about investing in the product and more about selling it.

Overall, operating expenses rose 14% to $21.8m and that was offset by a mere 6% increase in revenue to $6.7m (in constant currencies the increase would have been 10%). Give or take, the difference produced the net loss of $15.0m (up 20%).

The full-year revenue was barely half the $11m–12m expected a year ago and the second-half revenue of $3.5m (up 10% on the first half) was below the range of $3.6m–4.6m given at the time of the half-year result (and just ahead of the capital raising).

Overoptimistic

The problems stem from an overoptimistic plan to monetise its websites running headlong into various negative factors, including weak Asian car markets (new car sales declined in Malaysia and Thailand and grew only slowly in Indonesia), adverse currency movements and the death of King Bhumibol of Thailand (which significantly impacted Thai business activity in the final quarter).

When we reviewed ***iCar Asia's 2015 result*** we wrote that: 'Any upsets – and we can imagine a few – could result in disappointment', but we must admit we didn't contemplate that last one.

So that's the bad news. On a more promising note, it does look like the extra marketing spend has had an impact, with operational metrics improving across the group (see Table 1). A range of depth products have also been introduced (whereby customers pay more for additional features).

Table 1: Operating metrics

	MALAYSIA	THAILAND	INDONESIA
LISTINGS GROWTH (%)	35	11	7
AUDIENCE (UNIQUE VISITOR) GROWTH (%)	90	22	2
LEADS GROWTH (%)	14	17	50

Management is very confident about the company's prospects for 2017, citing a number of factors: moves by its major competitors (**mudah.my** in Malaysia, **kaidee.com** in Thailand and **olx.co.id** in Indonesia); signs of an uptick in new car sales; a TV advertising campaign across all markets; and new products, including chat functionality in all markets.

Table 2: iCar Asia 2016 result

YEAR TO DEC ($M)	2016	2015	+/(–) (%)
REVENUE	6.7	6.3	6
EXPENSES	(21.8)	(19.1)	14
OP. LOSS	(15.1)	(12.8)	18
NET LOSS	(15.4)	(12.7)	21
NET CASH	26.6	18.0	48

Needless to say, though, a sharp improvement will be required if the group's $27m in cash (at the year-end) is to be sufficient to get it through to profitability, and investors will be forgiven for taking little on faith.

Speculation

The stock has risen 25% since the result, but that probably has less to do with the company's underlying performance and other developments. For starters, founder Patrick Grove (who controls 27% of iCar's shares) stepped down as chairman last Thursday, being replaced by Georg Chmiel.

Chmiel has an impressive track record, including time as managing director of iProperty Group and six years as chief

> **There's too much risk for us to recommend a Buy, but there's reason enough to hang on at current prices.**

financial officer and General Manager International at REA Group. Grove will remain as a non-executive director, but conspiracy theorists will wonder if he's paving the way for some corporate activity.

We doubt it. More likely is that Grove is just very busy. Pouring fuel onto any takeover speculation, though, is the announcement by the currently suspended LatAm Autos, iCar's South American equivalent, that it has received proposals for various of its country-specific businesses. It's unlikely that this would directly affect iCar Asia, but it does suggest that people are interested in loss-making car classifieds businesses.

We wouldn't be pinning our hopes on any activity involving iCar Asia, though it is certainly possible. For those shareholders grimly hanging on, the more important thing will be whether – and how quickly – we see the hoped-for operational improvements. In this respect, it does at least look like a vote of confidence for Chmiel to have taken the chairman's role. As we've said before, though, improvements will need to come quickly if the company is to reach breakeven without requiring further capital.

On that basis, there's too much risk for us to recommend a Buy, but there's reason enough to hang on at current prices. **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**.*

Disclosure: The author owns shares in iCar Asia.

A good result from the Jetstar division wasn't enough to compensate for overcapacity on the international front.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 1 MARCH 2017

Qantas: Interim result 2017

Qantas Airways has reported a 25% fall in net profit to $515m for the six months to December, though this is largely due to last year's inclusion of a $201m gain from the sale of Qantas's T3 terminal at **Sydney Airport**. Underlying profit before tax of $852m was down 'only' 8%, with revenue 3% lower at $8.2bn.

Key Points

- ***Growing competition internationally***
- ***Jetstar remained profitable***
- ***Capital intensive business***

QANTAS AIRWAYS (QAN) / AVOID

Price at review	Max. portfolio wght.	Business risk	Share price risk
$3.73	N/A	Very High	Very High

Qantas continues to battle many factors beyond its control, including volatile fuel prices, a declining Australian resource industry, and intense competition from government subsidised Middle Eastern and Asian airlines.

'The international market is tough because of capacity growth and lower fares, and Qantas International is not immune from those pressures. But the work we've done on removing costs and making the business more efficient means Qantas International is outperforming its peers in the region,' said chief executive Alan Joyce.

Thankfully, the company's budget Jetstar division (29% of underlying earnings before interest and tax, or EBIT) picked up some of the slack and managed to increase EBIT by 5%. The result was attributed to better-performing international routes and an improvement in the operating margin of 1.1 percentage points to 14.8%.

New Dreamliners

Qantas added three new Fokker F100 aircraft during the period to replace larger planes in its resource sector operations, which has experienced dwindling demand. The company also said it expects the arrival of its first two Boeing 787-9 Dreamliners in late 2017 to replace retiring 747s, which are increasingly costly to maintain.

The new Dreamliners will allow the airline to service the international market better by adding more ultra-long range routes – including the first direct connection between Europe and Australia from March 2018.

Management expects a 1–2% increase in capacity during the rest of the financial year, with a 3% increase for the International division being offset by a decline in the local operations. Management didn't provide specific profit guidance.

All up, this was a decent result, and management was quick to point to Qantas's return on invested capital of 22% on a rolling 12-month basis.

Nonetheless, a broken clock is still right twice a day – intense competition and a capital-intensive business model will make it hard for the company to maintain such figures over the long haul. We're mindful that – notwithstanding the last year – Qantas only generated free cash flow of around $1.8bn in the 10 years to 2016, despite tying up around $5bn in average shareholder equity over that time. A 10-year average return on equity in the low single digits isn't anything to write home about. We expect this figure to be about as much as shareholders should expect over the long term.

Table 1: QAN interim result

SIX MONTHS TO DEC	2016	2015	+/– (%)
REVENUE ($M)	8,184	8,463	(3)
UNDERLYING EBIT ($M)	949	1,031	(8)
NPAT ($M)	515	688	(25)
EPS (CENTS)	27.3	31.9	(14)
INTERIM DIVIDEND	7 cents, 50% franked, ex date 7 March		

The stock's price-earnings ratio of only 9 and dividend yield of 3.8% are attractive on the face of it, but we don't think they compensate for the risks. **AVOID**.

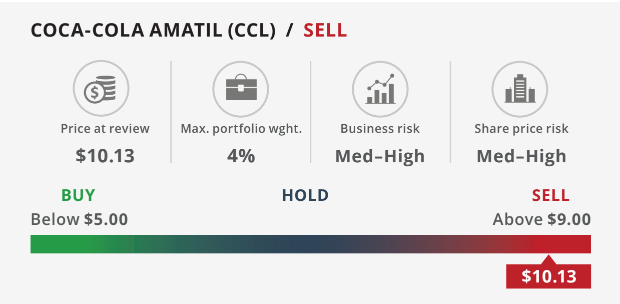
Staff members may own securities mentioned in this article.

Management is pulling out all stops to meet short-term growth targets. But will earnings turn ugly in 2018?

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 1 MARCH 2017

Coca-Cola Amatil: Result 2016

Coca-Cola Amatil's 2016 full-year result came with a generous helping of 'share buyback'. With the company's strong cash flow delivering what the broking analysts might call a 'lazy' balance sheet, management has decided to acquire $350m worth of shares on market starting this month.



Unfortunately Amatil's management is a little too fond of smoke and mirrors. The proposed share buyback is just one example of financial shenanigans that will help this under-pressure company deliver the not-very-exciting target of 'mid-single digit' earnings per share (EPS) growth.

Another decision that will end up making this target easier was the $217m writedown of assets at food business SPC. Lower depreciation expense will be the result, boosting future profits. Property sale gains can also be used to massage current and future earnings; in this result management said they were immaterial to earnings and, while that might be so, it's less clear if they were immaterial to the growth in earnings.

The reason why earnings might need massaging is, as we've said before, that the Australian beverages business is deteriorating. While management thinks it can cost-cut its way to greatness, we remain sceptical. Cost-cutting managed to contain a 3% decline in Australian beverages revenue to a 2% fall in earnings, but what happens when costs can't be cut further?

In 2016, Amatil managed to eke out a 1% lift in overall revenue mainly because the much smaller New Zealand, Indonesia and Alcohol and Coffee businesses all improved their performances. Earnings rose for all three as well, helping to offset the weakness in Australian beverages, which has failed to meet management's targeted 'low single digit' growth in earnings before interest and tax (EBIT) for two years now. Diversification and lower interest costs helped to deliver underlying net profit growth of 6%.

Table 1: CCL final result 2016

YEAR TO 31 DEC	2016	2015	+/(–) (%)
REVENUE ($M)	5,151	5,094	1
EBIT ($M)	683	661	4
NPAT ($M)	418	393	6
EPS (C)	54.7	51.5	6
DPS* (C)	46.0	43.5	5
FRANKING (%)	75	75	n/a

*** Final dividend 25 cents (75% franked), ex date 27 Feb**

Note: Figures are underlying results

Nothing in this result changes our view from ***Last drinks for Coca-Cola Amatil*** last month. As cost-cutting opportunities recede – and admittedly there's room for a bit more yet – weaker Australian volumes and revenues will start hitting earnings hard.

This result was clear evidence of a business under pressure. Amatil might be meeting short-term targets now but, absent volume recovery in Australia, achieving them will get much harder. We firmly reiterate our **SELL** recommendation.

Staff members may own securities mentioned in this article.

The market wants to know how it will plug an upcoming earnings hole and Caltex has obliged. Is it sensible?

BY GAURAV SODHI • INTELLIGENT INVESTOR • 1 MARCH 2017

Caltex: Result 2016

Caltex has released another splendid full-year result. Headline profit fell 17% to $524m but the decline was entirely due to refining margins from the Lytton refinery returning to average following a dramatic spike last year.

CALTEX AUSTRALIA (CTX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$28.28	6%	Low–Med	Low–Med

BUY Below $27.00 · HOLD · SELL Above $40.00

$28.28

The fuel supply and retail business increased earnings before interest and tax (EBIT) by 9% to $709m. In 2013 it generated EBIT of just over $500m so, even in a mature market, Caltex continues to find efficiency gains and expand margins.

That task has been aided by the continued growth of premium fuels, which now represent 33% of fuel sales and 35% of diesel sales.

That growth, which has placed a rocket under margins, is driven by car manufacturers' requirements for higher octane fuel to meet tighter emission standards. It is unlikely to reverse.

Encouragingly, non-fuel income continues to rise, contributing $177m to profit. It is a relatively small part of the business, but management has big plans for its network of 1,500 petrol stations.

They generate over $1bn in sales on their own and make Caltex a significant retailer. Caltex will push more fresh food and services through these sites to lift revenue, a strategy that has been successful overseas but is untried in Australia.

Interestingly, Caltex owns almost 500 sites and reports book value of $1.2bn for its retail network, a sum which reflects historic costs. The true value of these sites is likely multiples of book value. The business also boasts a franking balance of over $1bn so there is scope for higher returns.

For now, Caltex will pay a fully franked final dividend of 52 cents per share, giving a total for the full year of $1.02 and a payout ratio of just over 50%.

Caltex made two acquisitions over the year (of retail sites in Melbourne and in New Zealand) and, while we agree with management that overpaying for Woolies' retail sites would be worse than losing the supply deal, it is convenient that lost business should be replaced so quickly.

If we assume an EBIT margin of 2 cents per litre and include efficiency losses, the loss of the Woolies contract might cost around $80m a year in EBIT. The new businesses will contribute about $50m.

Table 1: Caltex 2016 result, $m

YEAR TO DEC	2016	2015	+/(–) (%)
EBIT ($M)	813	977	(17)
NPAT ($M)	524	628	(17)
EPS ($)	1.99	2.33	(14)
DPS ($)*	1.02	1.17	(13)
OP. CASH FLOW ($M)	928	885	5
CAPEX ($M)	353	454	(22)

*** Final dividend of 52c per share, fully franked, ex date 7 March**
Note: Profit figures are calculated on a replacement cost basis

Caltex already generates strong returns on capital and has articulated a credible strategy to generate higher sales from an underutilised retail base. This is a better quality business than many imagine and we don't mind eyeballing it.

We are within whiskers of upgrading but we do worry whether acquisitions have been made merely to plug an obvious earnings hole or whether they represent genuinely good opportunities. That uncertainty is enough to reduce our price guide slightly. For now, **HOLD**.

Staff members may own securities mentioned in this article.

Reece's results are nothing if not solid, even if this one indicated growth is slowing.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 28 FEBRUARY 2017

Reece: Interim result 2017

You won't hear much from Reece from one profit announcement to the next. The management team just gets on and, well, manages. When you have a business that's performed this well, you don't need to say much.

REECE AUSTRALIA (REH) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$43.36	5%	Low–Med	Medium

BUY Below $36.00 · HOLD · SELL Above $55.00

$43.36

The interim result was another solid set of numbers. Revenues rose 6% to $1,211m while net profit increased a little more, to $96m. The result was driven by building activity which remains at high levels, although it varies significantly across the country. New South Wales and Queensland have been strong, but activity has been weakening elsewhere).

Reece opened a distribution centre in Sydney during the half, which will help improve service levels to customers. This is presumably partly behind the 10% increase in inventory during the period, which in turn resulted in operating cash flow falling a little.

The company has been slowing its branch opening program, which isn't really surprising. The network is largely mature in Australia. Only four new branches were opened in the half, taking the total to a little over 580. Reece is, however, undertaking a heavy branch refurbishment program, with capital expenditure rising 20% during the period.

Management didn't say much about the outlook for the building industry. Others have been less reticent, with **Boral**'s chief executive Mike Kane recently saying that he thought residential construction would remain strong for another two years. Nevertheless, Boral noted that housing starts fell 4% in the first half, while the Housing Industry Association forecasts that starts will fall 13% this calendar year.

Table 1: Reece interim result 2017

SIX MONTHS TO DEC	2016	2015	+/(–) (%)
REVENUE ($M)	1,211	1,141	6
EBITDA ($M)	164	155	6
EBIT ($M)	140	132	7
NPAT ($M)	96	90	7
EPS (C)	96.6	90.3	7
INTERIM DIV.	29c, fully franked, up 7%, ex date 15 March		

Because profitability has risen since we upgraded the company in ***Reece: Three reasons*** in April 2016, the stock trades on similar 2017 forecast multiples to last year. But with the housing cycle more advanced – and the stock up 27% – we're not inclined to push our luck.

At some point we expect a weakening of building activity to affect Reece, but the business has been resilient in the past. Our recommendation remains **HOLD**.

Staff members may own securities mentioned in this article.

Following the 'smart money' makes sense. Except when it no longer cares about the same things you do.

BY JOHN ADDIS • INTELLIGENT INVESTOR • 28 FEBRUARY 2017

Facebook and the problem of 'smart money'

One of the clarifying aspects of modern capitalism is the absence of argument about its purpose. Yes, laws must be adhered to, or, with the help of a lobbyist or two, changed. And a company cannot flout generally held standards of acceptable conduct, except perhaps with regards to tax.

These exceptions aside, from board and senior management down to staff and shareholders, we can all agree that everyone's in it for the money.

This is the best insurance policy investors have got. If management is incentivised correctly – a big 'if', I'll admit – you don't have to worry too much about chief executives, founders and their boards wandering off the reservation.

In fact, it's widely accepted that the bigger the stake a founder or senior management team has in a business, the better off investors will be. What's good for the goose is good for the gander and all that.

Well, maybe. Following the smart money, as this investing approach is sometimes called, certainly has merit, as early investors in **Harvey Norman** (ASX: HVN), **JB Hi-Fi** (ASX: JBH) and **News Corp** (ASX: NWS) might attest. What is less appreciated are the dangers of backing owner-managers. Two recent examples reveal the nature of the problem.

Hall pass

Just before Christmas, famed ethical value investor Peter Hall **sold half** of his controlling 44% shareholding in Hunter Hall for a dollar a share. On the day the sale was announced the shares had traded as high as $3.10.

Logic, at least of the financial kind, does not explain this decision. Why would Hall sell his stock for less than a third of its market value?

Psychology offers a better explanation. When a person has built a successful business, perhaps viewing it as their life's work, they come to care about it in a way that investors do not.

Shareholders think mainly about the money but founders, especially those with more than enough of it, think of legacies, reputations and purpose. Hall wanted, quite literally, to get out at any price. There could be no greater misalignment of interests.

A related situation is developing at Facebook, where Mark Zuckerberg's grip on the business through a headlock shareholding must be giving shareholders the willies.

Facebook is one of greatest money-making machines the world has ever seen. But instead of putting his feet up and buying a massive boat like everyone else in the Valley, our Mark is getting all worked up about purpose and legacy.

Here's a few choice quotes from his recent **6,000 word screed**:

'Today we are close to taking our next step. Our greatest opportunities are now global — like spreading prosperity and freedom, promoting peace and understanding, lifting people out of poverty, and accelerating science.'

And this:

'Our greatest challenges also need global responses — like ending terrorism, fighting climate change, and preventing pandemics. Progress now requires humanity coming together not just as cities or nations, but also as a global community.'

Things go better...

It reads like that Coke ad from the '60s, or a scene from the TV show ***Silicon Valley***, where every start-up wants to 'make the world a better place'. It's all very noble and admirable, but it's probably not why most shareholders bought in.

This is where following the smart money as a strategy breaks down. Founders like Zuckerberg and Hall have enough influence over the businesses they've created to take it in a direction that is not solely about maximising profit. Some might want to walk away at a price that stuffs the shareholders; others might simply want to change the world using the business they've created.

Shareholders in companies with dominant owner-managers have as much reason to be wary as encouraged by recent events. Following the smart money isn't always smart.

Crown goes ex-dividend

BY JON MILLS • INTELLIGENT INVESTOR • 1 MAR 2017

CROWN RESORTS (CWN) / HOLD

Price at review **$11.53**

Max. portfolio wght. **5%**

BUY Below **$11.00** · **HOLD** · **SELL** Above **$17.00**

$11.53

At the time of writing, Crown's shares have fallen $1.13, or 9%, today – exactly the amount of the dividends to which the stock has lost entitlement, being an interim dividend of $0.30 and a special dividend $0.83, both of them 60% franked (see ***Crown Resorts: Interim result 2017***).

The special dividend represents part of the proceeds from the company's recent selldown of its interests in Melco Crown Entertainment — which owns casinos in Macau and The Philippines. The remaining proceeds will potentially be used to buy back up to $500m of its ordinary shares and potentially all of its $530m in Crown Subordinated Notes.

With the stock shedding $1.13 of its value, our Buy price falls to $11 (from $12) and our Sell price falls to $17 (from $18). **HOLD.**

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

Disclosure: the author owns shares in Crown Resorts.

Trading rules for smaller companies fund

What will be/are the trading rule for the small caps fund? Given, per the podcast, there is staff and company money in the fund, will the staff trading rules apply? Will it have to wait until research is published to trade on the recommendation? Will its holdings be disclosed in reviews? Can it trade against a recommendation? For a company that is otherwise pretty strong on transparency, I don't think I've seen much info about the fund online ...

2 Mar 2017 – **James Carlisle**: We haven't disclosed details about the smaller companies fund because it's still in its formative stages – at the moment it only has company money invested in it. You can be sure, though, that there are tough rules about staff trading – particularly because of the sensitivity around smaller companies and their lower levels of liquidity.

For one thing, staff members have to get authorisation for any purchases (as currently) and that won't be given if any of the portfolios has an interest in buying the stock. It goes further for the smaller companies fund, because staff also won't be able to buy stocks that are held by the fund – if they want exposure to them, then they'll need to invest directly in the fund.

In terms of the buying and selling by the fund, the universe of stocks that it invests in can be split into those that might be suitable as recommendations to members (ie the larger more liquid stocks, probably those close to $200m or above), and those that would be too small to recommend. For the former, the same rules will apply as for the current Growth and Equity Income portfolios, in that we have to recommend the stock first before we can then buy them for the portfolios. For the latter, the fund can just go ahead and buy them.

We'll still disclose our holdings for the smaller companies fund from time to time (probably quarterly), but given the liquidity constraints and the fact that stocks may need to be bought gradually, we won't be so quick to disclose our every move as we do with the Growth and Equity Income portfolios.

Portfolio weightings for banks

I have holdings in all the 'big four' banks. in looking at your research you have a maximum holding in a portfolio of a total of 38% in these four banks, if looking at your individual research on each bank. What do you consider to be the maximum total percentage holding in these banks for an income/growth portfolio in both a private company and a superannuation fund? Many thanks for your very informative updates of the various companies you cover.

2 Mar 2017 – **James Carlisle**: Good question! We don't tend to specify sector weighting limits, but we make an exception for the banks because they're such a large proportion of the market and our experience is that many investors have what we would regard as too much exposure to the sector. It's important to remember that they all have similar risk exposures, and in a financial crisis, they will all suffer together. The other point is that banks are highly geared investments in and of themselves – they do go bust (and/or need recapitalising) from time to time (eg in Europe and the US during the GFC).

On the basis of all that, we specify a 20% maximum for the banking sector, but note further that more conservative investors should use lower limits – probably closer to 10%. We try to remember to put a note to this effect at the bottom of our reviews on bank stocks – **eg here** .

Value Investor club in Melbourne?

I'm in my early 30s and have been with II for over 2 years. I really enjoy the value investing approach applied by II and have really expanded my knowledge both in the stock analysis and psychological shortfall we all have in our investment decision. However, I found it very difficult to find people with similar value investing approach with I can interact in my surrounding social circles as they all seem to treat the sharemarket like a casino. Do you know any value investor club in Melbourne with people that have similar value investment philosophy?

2 Mar 2017 – **Jon Mills** I'm glad you enjoy our service and find it useful. Although I'm not aware of any Value Investor clubs or groups in Melbourne, I'm sure there are some so I'll open it up to members. Please let us know either in a follow-up Q&A or via email at info@intelligentinvestor.com.au (addressed to me) and I'll update this response accordingly.

UPDATE: based on feedback received so far, it appears there isn't a Value Investing club / group in Melbourne. However, one member has volunteered to try to get one up and running so please contact me and I'll put you in touch with him.