Weekly Review

RESEARCH

– Issue –
4 Nov. 2016

Roc Oil wasn't the most costly recommendation in our long history but it might have been the most valuable, if you could stomach the 60% loss.

BY JOHN ADDIS • INTELLIGENT INVESTOR • 1 NOVEMBER 2016

5 from 15 – Roc(s) in our heads?

Until I met John Doran, former chief executive of Roc Oil, I didn't know what it meant to fall in love with a stock. Along with many other analysts at *Intelligent Investor*, I took the plunge in June 2003, following the advice of our first review (Buy – $1.13). The first few lines summed up the argument: 'Being a small oil and gas company isn't for everyone. But for those willing to take on some risk, we think the stock represents excellent value.'

Key Points

- ***Most investing errors are psychological***
- ***Beware the charms of a humble CEO***
- ***Always learn from your mistakes***

At first, that synopsis was borne out. By July 2006, Roc had risen well above $4, at which point, despite a few Holds on the way up, we doubled down. The company had acquired a stake in a block off the coast of China at what appeared to be a cheap price and all looked good.

History shows that it wasn't, although not due to this acquisition. The Buy recommendation of mid-2006 proved to be the top and we rode the slide all the way down, making 18 further Buy recommendations between July 2006 and March 2009. Eventually, we sold out at a price of $0.45 on 4 Feb 10. From beginning to end we lost members 60% of their stake, but far worse had you followed our advice at the top.

This isn't the biggest loss in *Intelligent Investor* history, as the fourth article in this series, to be published later this month, will show. But Roc was perhaps the most valuable loss, leading to a raft of changes in the way we researched companies and how we made decisions. In the manner of a long-standing relationship creaking before the final break, Roc Oil was a failure that strengthened rather than broke us. Before recounting the lessons, let's push the metaphor over the edge and describe the initial spark of attraction.

In 1992, John Doran, a geologist by training and an 'oil man' by choice, with a devoted focus on shareholder returns, took over Command Petroleum. Although the company's shares were trading at around 30 cents three years' later, Doran had created a much-improved business. Within a year, Cairn Energy recognised that value, taking the company over at $1.40 per share.

After creating a five-bagger for shareholders, Doran founded Roc Oil in late 1996, embarking on what we hoped would be a similar journey. Senior management took 15% of the stock, ensuring the focus was on long-term returns rather than massaging public perceptions. So, good CEO, owner managers, shareholder focus: tick, tick and tick.

Combining production assets with exploration potential, Roc also sported a margin of safety. The UK gas business was exceptional, operating at 75% margins whilst adding to net reserves. We valued this business at $100m plus. The company also had net cash of $45m and a raft of exploration assets in Australia, Equatorial Guinea, Angola, Mauritania and China. With a market capitalisation of $122m, these assets came free. Only one of them would need to pay off for Roc to be worth many multiples of its then share price.

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Our excitement made its way onto the page. Said the first review, this is 'a great opportunity to BUY a quality stock with the potential for huge capital gains. But please, don't expect a quick rise in price just because we have recommended it. This stock will require some patience but we're confident that patience will be handsomely rewarded.'

We were patient alright but the rewards weren't handsome. The mistake was ours and we had to own it. So, dear reader, take a deep breath and join us on the couch (former Roc shareholders will find the tissues to their left). This is how we got it wrong:

1. We lacked expertise

Tom Elder, our then resources analyst, left us suddenly to move overseas, leaving Gareth Brown, an industrials analyst, to fill the hole. At the time of Tom's departure we could have sold out and ceased coverage but we didn't. Along with members, our analytical team was invested in Roc Oil and excited by the opportunity. That probably caused us to psychologically set aside our lack of expertise.

It wasn't until the arrival of Gaurav Sodhi, a dedicated resources analyst, in 2010, that we set things straight. Gaurav got us out of the stock soon after his arrival, explaining that he was 'struck by the absence of industry specific valuation measures like Enterprise Value/Barrels of Oil Equivalent or EV/2p'. He thought we were valuing Roc as an industrial stock rather than an oil business. Had we embarked on the journey with that mindset, Roc Oil would probably have been a Speculative rather than outright Buy.

2. Commitment bias took over

Commitment bias soon took over. This is the tendency to be consistent with previously expressed opinions or views, especially if those views are made public. Our views were public and regularly reinforced. Between June 2003 and March 2009 we issued a total of 44 Buy recommendations on Roc Oil, an average of more than seven a year. With each recommendation, we added to our bias.

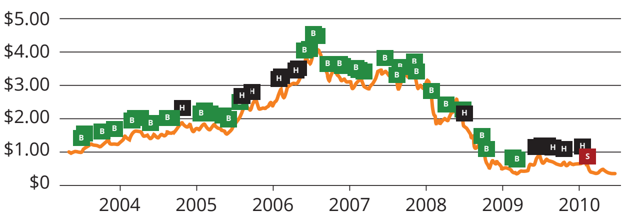
3. Confirmation bias added to the problem

Initially, things went well, too well. In the three years after our initial recommendation Roc Oil's share price almost tripled. That had the effect of vindicating our initial view (even now there's an argument Gareth's research to that point was sound). But the price rise made us overconfident, allowing us to overlook the speculative nature of the business and our unconventional approach to valuing it.

4. We spotted a giant red flag and ignored it

Despite these faults we might still have made money were it not for one fateful decision. In June 2008, Roc announced it was acquiring Anzon Australia and its 53% shareholder, UK-listed Anzon Energy. Gareth recalls the press release announcing the deal and the meeting with John Doran to discuss it. 'From the start I thought this a dumb deal, done for all the wrong reasons. John did his best to convince us the acquisition was his idea but none of us believed it. It looked like it was forced on him by a board worried about the dusters from their drilling in Angola.'

Chart 1: Roc oil, a history of recommendations



Gareth's scathing and insightful review from that period (Don't spoil our Roc Oil!) got everything right except the recommendation. Instead of selling out we downgraded to Hold at a price of $1.73. This was the fateful error, the real cause of the loss, which, in addition to confirmation and commitment bias, had two further sources.

"A research company can do many things to reduce the impact of a series of mounting biases playing into a recommendation.

5. We fell in love with a CEO

John Doran wasn't given to dramatic overstatement and lilly-gilding. Born in Llanelli, Wales and educated in Sheffield, England, he was a salt-of-the-earth type, with liberal doses of intelligence, humility and wit (sadly, he passed away suddenly in 2008). When we met to discuss the Anzon deal, we were susceptible to his charms. Had he been a puffed-up blowhard, it would have been easier to walk away. But he wasn't, and so we hung on.

6. We suffered from groupthink

A research company can do many things to reduce the impact of a series of mounting biases playing into a recommendation. Unfortunately, in July 2008, we weren't doing enough of them. Each analyst would make their own call on a stock and, although they might seek input from others, were not required to do so. Gareth was out on his own, bearing the weight of expectation of staff and members.

Moreover, by this stage his investment in the company was underwater, a potential source of loss aversion bias (if you've thought you'll just hang onto a stock until it gets back to the price you paid for it, that's it). Gareth was surrounded by other analysts, many of whom had also met Doran and owned Roc shares but couldn't claim any real expertise. In this way, any dissenting opinions were self-censored out of the discussion. We became a victim of groupthink.

The rest, as they say, is history. In five short years the Anzon deal managed to turn $600m into $1m, proving Gareth's instincts right. Gaurav cleaned up the mess and we made some important changes to our internal processes – Dragon's Dens in particular – that have since served the business well, proving that it's one thing to make a mistake but a far bigger error not to learn from it.

Staff members may own securities mentioned in this article.

The company's financial services division, acquired in 2014, is suffering due to problems at a major lender. Was the acquisition a lemon?

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 2 NOVEMBER 2016

Carsales' Stratton splutters

Diversification into 'adjacent areas', as they're sometimes called, carries risk. At its recent annual meeting, management announced that Carsales' core business, 'Online Advertising', was performing well. Another double-digit increase in revenue is expected in 2017, partly driven by price increases for its dealer customers.

Key Points

- ***Profits to fall in finance division***
- ***Core business still performing well***
- ***Other concerns prevent upgrade***

CARSALES.COM (CAR) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$10.42	6%	Medium	Med–High

BUY Below $10.00 — **HOLD** — **SELL** Above $15.00

$10.42

But Carsales' financial services business, Stratton, has hit a pothole. Management announced that first half revenue and profit would be 'substantially below' the 2016 result.

Carsales acquired a 50.1% stake in Stratton in 2014. It arranges finance for car buyers through a panel of lenders. Apparently the 'temporary volume capacity reductions' at a major lender experienced late last financial year – see Carsales: Result 2016 – have turned out to be less temporary than expected.

Carsales' disclosure leaves something to be desired but, after some digging, we've pieced together the story. It appears that an unnamed lender on Stratton's panel – one that accounts for an incredible 40% of the loan book – was having 'some challenges with ASIC'. We've already seen that ASIC is investigating the car finance and insurance market – see Automotive Holdings: Result 2016 – so the industry seems to be experiencing some regulatory turbulence.

Stratton seems to have received volume bonuses for using this particular lender too. So with the lender's volumes being affected by the ASIC investigation, the downturn in Stratton's revenues has been amplified.

Originally management expected volumes to recover in the first quarter of this financial year but that's no longer the case. It now appears that Stratton was too heavily reliant on one lender and our suspicion is that, if ASIC is investigating that lender, those volumes might not return at all.

To keep things in perspective, Carsales owns just 50% of Stratton, the division is small compared to the core Online Advertising business, and there's no suggestion of wrongdoing by Stratton itself. The combined effect is that, while Stratton's 2017 earnings could be 50% below 2016 levels, this will only knock about 3% off forecast earnings per share. We're now expecting around 48 cents this year, placing the stock on a forecast PER of 22.

Normally we'd consider temporary difficulties at a quality business a good reason to upgrade. Presumably, Stratton will be able to redirect its volumes to other lenders in time. But we have other concerns too, some of which were mentioned in Carsales: Result 2016 (since then the share price has fallen 22%).

Gumtree growing

Chief among our concerns is that Carsales' recent earnings growth has been disappointing. What growth has come has been mainly due to imposing price increases on dealers, a strategy which might end up backfiring. Gumtree has also been aggressive in chasing market share, which we think is limiting pricing power in the private listings market. The last time Carsales increased its standard ad price (from $60 to $65) was in December 2013.

We also believe Carsales has been a beneficiary of the strong housing market in the eastern states. Classifieds businesses are cyclical and will suffer in any downturn. In our opinion Carsales has less pricing power than **REA Group**, and much less international diversification than **Seek**, yet it trades on similar multiples to those stocks.

Carsales remains a very high quality business. But with a few problems at its finance division and some evidence of rising competition, we're now looking for a higher margin of safety. We'll look to upgrade the stock should it dip below $10.00, as explained in Carsales recommendation guide a few days ago. **HOLD**.

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

Staff members may own securities mentioned in this article.

Woolworths' supermarkets business is growing again – just.

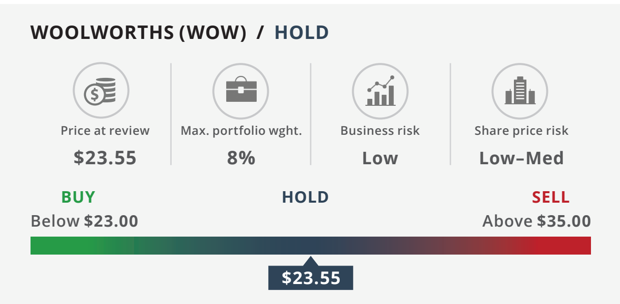
BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 31 OCTOBER 2016

Woolworths accentuates the positive

Last week's poor sales results for Coles were an indication that Woolworths' own results – delivered on Friday – would show some improvement. They were indeed better than expectations, with Woolworths' supermarkets business reporting first-quarter same-store sales growth of 0.7%. It might not sound like much but it was the first positive number for 18 months.

Key Points

- ***Return to positive sales growth for supermarkets***
- ***Petrol division on the block***
- ***Big W to report another loss this year***



It narrows the gap between Woolworths and Coles, to be sure, but let's not get carried away. Woolworths' supermarket business has invested $1bn in price over the past 18 months, which explains why the operating margin fell from 8.2% in 2015 to 4.9% in 2016. Customers were bound to notice lower prices and improved service eventually, and some have switched from Coles as a result.

Make no mistake, a 0.7% lift in same-store sales isn't adequate. On the results conference call, management was probed about what same-store sales growth would avoid operating deleverage (read 'falling margins'). Somewhere between 2% and 3% was the answer, which won't be easy to achieve as Aldi gains traction in South Australia and Western Australia.

To give Woolworths' management its due, though, growth of 0.7% is a start. It does show the turnaround is making progress. Our view was that Woolworths' wounds were self-inflicted, so it's reassuring that managing director Brad Banducci has been adept at applying Band-Aids.

Liquored up

Elsewhere, the liquor business – now called Endeavour Drinks Group – reported same-store sales growth of 1.8%. Again, nothing to write home about but at least its taking market share from Coles.

The New Zealand supermarkets business went the other way, reporting that same-store sales declined by 0.7%. It looks like a one-off, with the previous period boosted by heavy promotional activity.

With Target falling in a heap in the September quarter (see Target toys with Wesfarmers), Big W's performance was always going to be interesting. Same-store sales fell 5.7% – on top of an 8.0% decline in the same quarter last year – but next to Target's 22% swan-dive it seemed modest. Big W benefited from Target's toy sale stuff-up but apparel sales seem to be in a market-wide slump (Take note **Myer** shareholders).

Table 1: Woolworths 1Q17

FIRST QUARTER 2017	SAME-STORE SALES GROWTH +/(–) (%)
AUST. FOOD (SUPERMARKETS)	0.7
PETROL	(13.0)
ENDEAVOUR DRINKS	1.8
NZ FOOD	(0.7)
BIG W	(5.7)
HOTELS	2.1

What's clear is that the long lead times in the department store business – merchandise is ordered more than six months ahead – mean that Big W's turnaround will take time (as will Target's). Big W is likely to report another loss in 2017 because directly sourced and newly designed product won't hit stores until well into the second half of 2017.

> **Hang tight. It's still early days in Woolworths' turnaround but at least management is focused on Retail 101.**

Bye-bye bowser

Management refused to be drawn on the petrol division, which has apparently been put up for sale. Caltex has expressed an interest (see Weighing up Caltex) and, while it's the most logical buyer, a transaction isn't guaranteed. With the ACCC having nobbled the ability of the supermarket chains to offer big discounts on fuel, there's less strategic merit in Woolworths retaining the business.

So what should you do from here?

Hang tight. It's still early days in Woolworths' turnaround but at least management is focused on Retail 101. Christmas will be crucial but management is determined not to repeat the silly mistakes of last year, when it didn't have enough seasonal stock on the shelves when shoppers wanted it.

On a price-earnings ratio of 20, Woolworths' share price already includes a premium for its nascent recovery. With that in mind, there may well be setbacks yet. We're maintaining our Buy price at $23 and the stock is a **HOLD**.

Note: The Intelligent Investor Equity Income Portfolio *owns shares in Woolworths. 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.

Macquarie Group's interim result beat expectations, however, this was partly supported by one-off factors.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 31 OCTOBER 2016

Macquarie Group: Interim result 2017

It was a case of swings and roundabouts in Macquarie Group's interim result on Friday. But while the 4% decline in earnings per share was about 5% ahead of the consensus forecast, the shine was taken off because it was supported by one-off factors and a lower tax rate.

Key Points

- ***'Annuity-style' profits fall***
- ***Market-facing profits flat***
- ***Guidance maintained***

MACQUARIE GROUP (MQG) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$81.76	7%	Med–High	High

BUY Below $60.00 — HOLD — SELL Above $100.00

$81.76

The biggest loser was Macquarie Asset Management, the group's largest division with 37% of profits, which saw profits drop 25% to $857m due to a 73% fall in performance fees from $610m to $165m. That's as expected, though, and the underlying performance was good, with base fees and expenses broadly in line with last year, but increased gains on the sale of investments (such as the partial disposal of Macquarie Atlas Roads).

Corporate and Asset Finance, however, was disappointing, with a profit decline of 15%. The AWAS and Esanda businesses bought in calendar 2015 are performing in line with expectations, but their increased contributions were more than offset by a higher impairment charge and reduced lending income. Chief financial officer Patrick Upfold suggested this was partly a timing issue, so hopefully we'll see an improvement in the second half.

The upshot is that profits from Macquarie's supposedly stable 'annuity-style' businesses fell 15% even though the (relatively small) Banking and Financial Services division managed a 54% increase. That was boosted by gains on the disposal of Macquarie Life, however, and the underlying result was broadly flat, with increased impairments offsetting business growth. Growth was particularly strong in business banking, where the loan portfolio grew 8% and deposits rose 11%.

Software write-off

The growth contrasts with others in the sector and reflects investments made over the past few years, so hats off for that. But there's a cost to it, and that fact was underlined by the write-off of $40m of previously capitalised software costs due to a 'narrowing of the eligibility criteria for capitalisation in connection with the Core Banking platform'.

Table 1: Macquarie interim result

SIX MONTHS TO SEPT	2016	2015	+/(–) (%)
DIVISIONAL PBT			
MAM	857	1,139	(25)
CAF	521	611	(15)
BANKING & FS	261	170	54
MAC. SECURITIES	18	240	(93)
MAC. CAPITAL	205	170	21
COMMOD. & FM	472	282	67
TOTAL DIV. PBT	2,334	2,612	(11)
CORP. COSTS	(846)	(1,012)	(16)
GROUP PBT	1,488	1,619	(8)
TAX	(438)	(530)	(17)
NET PROFIT	1,050	1,070	(2)
DILUTED EPS ($)	3.12	3.25	(4)
INTERIM DPS* ($)	1.90*	1.60	19

***45% franked, ex date 8 Nov**

Among the markets-facing businesses, the big loser was Macquarie Securities, whose profit contribution fell 93% to just $18m partly because last year's 'very favourable conditions' in Asia were not repeated. That sounds like a weak excuse for such a big fall, but this division is highly volatile – it made losses in 2012 and 2013 – so we'll take what we can get.

Macquarie Capital enjoyed a profit increase over a year ago of 21%, with increased investment income (including profits from associates, gains on disposals and interest and trading income) and a lower impairment charge more than offsetting a fall in fee and commission income.

> **Overall, the profit before tax contributed by the various divisions fell 11%.**

Brexit boosts forex business

The knock-out performance, though, came from Commodities and Financial Markets, which increased profit by 67%. The more settled conditions in commodity markets led to lower impairments, which more than offset the reduced demand for commodity-related risk management, financing and inventory management products. The financial markets side of the business was helped by volatility around Brexit and US interest rate uncertainty.

Overall, the profit before tax contributed by the various divisions fell 11%. Corporate expenses, though, fell 16%, partly due to reduced impairments on legacy assets held at the group level, and the tax rate dropped from 33% to 29%, so the group net profit fell only 2% to $1.05bn.

Earnings per share, however, fell 4% due to the shares issued to buy Esanda in October 2015, although that was still slightly around 5% higher than the consensus forecast. The dividend was increased by a whopping 19% to $1.90, but the 61% payout ratio remains at the bottom of the 60–80% target range.

Guidance maintained

Management maintained its guidance for a flat full-year net profit, and with the increased share count, that would lead to slightly lower earnings per share, from last year's $6.00 to perhaps $5.80. Given the better than expected first half and management's reputation for caution that's probably on the low side, but it makes sense to tread carefully given the fickle nature of financial markets.

The stock is up 14% since our update on the final result in May, and 37% since we upgraded to Buy in February. That puts it on a forward price-earnings ratio of around 14 and a dividend yield of 5.3% for the past 12 months (42% franked). **HOLD**.

Dividend cuts aren't off the table yet but this was a reasonable result nonetheless.

BY JON MILLS • INTELLIGENT INVESTOR • 4 NOVEMBER 2016

ANZ: Result 2016

New ANZ Chief Executive Shayne Elliot has held the position for just 307 days but is rapidly moving the bank away from the Asian-focussed strategy of his predecessor.

Key Points

- ***Wealth business likely to be sold***
- ***Institutional business improving***
- ***Payout ratio still above target***

ANZ BANK (ANZ) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$27.35	8%	Medium	Medium

BUY Below $22.00 — **HOLD** — **SELL** Above $36.00

$27.35

After the recent sale of its retail and wealth businesses in five Asian countries, at its 2016 result presentation (see Table 1) the bank announced 'possible strategic and capital market' options in relation to its Wealth business, including the potential sale of its Australian life insurance, advice and superannuation and investments businesses.

ANZ is also looking to exit its remaining retail and wealth businesses in Asia as well as its minority stakes in four Asian banks, worth around $5bn, allowing it to concentrate on improving the profitability of its institutional business in the region.

As we've noted previously, due to its strong Australasian institutional business, it makes sense from a strategic perspective to keep its Asian institutional business, facilitating regional trade and capital flows.

So far the bank has been successful in winding down unprofitable businesses, with the international business's net interest margin (NIM) rising from 1.39% to 1.79% over the past year (see Chart 1). In fact, despite also reducing the number of unprofitable Australian institutional customers in the second half of 2016, improvements in the international business were the reason why the company's institutional business NIM rose from 2.06% to 2.20%.

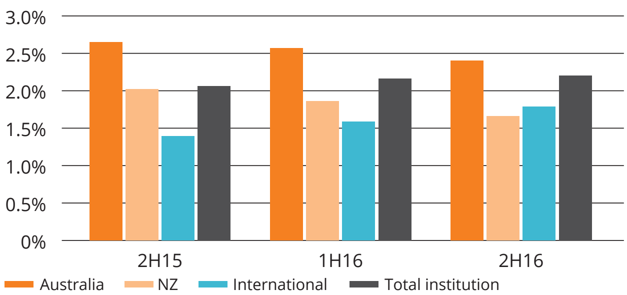
Ignoring the 0.02% reduction due to the sale of its Esanda finance portfolio to **Macquarie Group**, ANZ's overall NIM fell slightly, from 2.02% to 2.00%. Rising funding costs, including strong competition for deposits in Australia, and discounting of home loan rates, have affected Australian margins.

Otherwise, it was a fairly mundane result, albeit one significantly affected by one-off charges. For example, operating expenses increased 11%, with around half the increase due to a more conservative software capitalisation policy and the 'accelerated amortisation' (read: writedown) of previously capitalised software costs. As with other one-offs this year, these are real costs, although they should assist future earnings growth.

Provisions levelling off

Provisions were increased by 49%, from $695m to $1,038m, compared to the second half of 2016, although $150m of that increase relates to the bank's settlement of litigation with the Oswal family. Exclude that and the increase was a more reasonable 28%, little changed from the first half of 2016.

Chart 1: Institutional NIM



Source: Chart recreated from ANZ Full Year Results presentation, 3 Nov 2016

Management believes provisions are now 'levelling out', with low interest rates and moderate economic growth – plus, no doubt, a recovery in commodity prices – helping out. At 0.34% of average gross loans and advances, they're still towards the lower end of what we'd expect over the cycle.

Ignoring the various one-offs, underlying earnings fell a more reasonable 3%, giving the bank a return of equity (ROE) of 12.2%. That doesn't sound so bad, except when compared with **Commonwealth Bank**'s market-leading ROE of 16.5% in 2016 (see CBA: Result 2016).

> **Adding to these are increasing capital requirements and rising compliance and regulatory costs.**

Headwinds

Management also noted the various headwinds faced by the sector. These include slower credit growth due to moderate economic growth; slowing house price growth; provisions close to cyclical lows; and the effect of low interest rates on NIM.

Table 1: ANZ result

YEAR TO 30 SEP ($M)	2016	2015	(%)
NET INTEREST INC.	14,616	15,095	3
NON-INTEREST INC.	6,474	5,434	(16)
TOTAL INC.	20,529	21,090	(3)
OPERATING EXP.	10,422	9,378	11
CREDIT IMPAIRMENT	1,929	1,179	63
PROFIT BEFORE TAX	8,178	10,533	(22)
CASH EARNINGS	5,889	7,216	(18)
U'LYING EARNINGS	6,966	7,145	(3)
EPS ($)	2.38	2.44	(2)
DIVIDEND ($)	1.60*	1.81	(12)

*** 80 cent final div, fully franked, ex-date 14 Nov, DRP (no discount)**

Adding to these are increasing capital requirements and rising compliance and regulatory costs. As a result, bank earnings and dividends are likely to grow at a slower pace, even without a major economic or housing downturn.

By contrast, ANZ's common equity tier one capital ratio of 9.6% means it should still satisfy ASIC's requirement that it (and other major banks) remain 'unquestionably strong'. Global banking regulators are finalising the latest round of regulations but at this stage it doesn't appear Australian banks will be forced into more major capital raisings once the new regulations apply.

Nevertheless, despite ANZ's full year dividend declining 12%, this still amounts to a payout of around 67% of adjusted cash profit. As ANZ's new target payout ratio is 60-65%, there remains the possibility of further dividend cuts but despite that, and consistent with our recommendation of 28 Oct 16 (Hold - $27.63), ANZ remains a **HOLD**.

**Please note our recommended maximum portfolio weightings of 8% for ANZ individually and 20% for the banking sector as a whole. More conservative investors and those with other exposure to the property market should use lower limits.*

Note: The Intelligent Investor Equity Income Portfolio *owns shares in Commonwealth Bank. 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 glove and condom maker's success depends on two competitive advantages. What are they, and why do they matter?

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 3 NOVEMBER 2016

Ansell's two competitive advantages

It's easy for investors to fixate on a company's numbers: its margins, profit growth or price-earnings ratio, for example. We all like dealing with things that are easy to measure, so figures and charts get a lot of attention.

Key Points

- ***Strong brands improve margins***
- ***Economies of scale add barriers to entry***
- ***Volatile earnings due to industrial exposure***

ANSELL (ANN) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$21.13	7%	Low–Med	Medium

BUY: Below $18.00 | HOLD: $21.13 | SELL: Above $30.00

However, it's usually on the more touchy-feely level of competitive factors that we can truly separate the good companies from the bad.

For a business to earn outsized profits over the long term, it needs what Warren Buffett calls a 'moat' – a sustainable competitive advantage. A company's moat generally comes in one of four shapes: high customer switching costs; network effects; economies of scale; or intangible assets, such as brands or patents.

Were it only down to the first two categories, Ansell's moat would look more like a kiddie pool. It's in the last two – economies of scale and intangible assets – that the company has some decent competitive advantages.

What's in a name

Ansell manufactures industrial, medical and single-use gloves as well as condoms and a few other protective clothing products. The company has dozens of brands and sub brands, many of which you may be familiar with.

Brands have value for a couple of reasons. A brand is ultimately about trust – it's a manufacturer's promise that when you buy this product instead of another one, you can expect a consistent level of quality.

Imagine that you're an oil rig worker in need of gloves with a specialised chemical resistance to keep you safe. The first product that will come to mind is probably Ansell's NEOX line, which has been in every engineer's mind since the 1950s. Are you going to try something new and on sale, or stick to the product that kept your father safe, and his father before him? Some of Ansell's brand names have been in continuous use for more than 100 years.

The added trust and brand recognition means that Ansell can often charge a little more than competitors selling generic products. This, in turn, explains Ansell's gross margin of 41% – well above the industry average, where four of the top six glove makers don't break 30%.

Pays to be big

In analyst-speak, making gloves and condoms is known as a 'capital intensive' industry because of its heavy reliance on manufacturing equipment and factories, rather than labour.

The benefit of this is that a significant proportion of Ansell's costs are fixed – only 15% of the total cost to produce a condom, for example, is variable (such as raw materials and latex). This means that as more condoms are made, the average cost per 'unit' decreases because the fixed expenses are shared across higher volumes of output. Sales, therefore, can grow at a faster rate than costs.

In the gloves segment, Ansell is more than twice the size of its nearest competitor, Malaysian-based Top Glove, and it's the second largest condom manufacturer (albeit a distant second).

Chief executive Magnus Nicolin would be the first to tell you that size matters.

More sales and lower average fixed costs ensure Ansell earns above average margins. More importantly, perhaps, is that the company can remain profitable at prices that would leave smaller competitors losing money, which is a significant barrier to new operators trying to enter the market.

> **In 10 years' time, you can bet your boots that those three manufacturers will still be on top.**

Table 1: Sales, margins and market position

	INDUSTRIAL	MEDICAL	SINGLE-USE	SEXUAL WELLNESS
SALES ($M)	$654m	$396m	$302m	$220m
SHARE OF TOTAL SALES	42%	25%	19%	14%
EBIT MARGIN	14%	13%	21%	14%
GLOBAL MARKET POSITION	#1 (2X No. 2 player)	#1 (1.1X No. 2 player)	#1 (3X No. 2 player)	#2 (No. 1 player 5X Ansell)

The top three condom makers – Ansell (Lifestyles), Church & Dwight (Trojan), and Reckitt Benckiser (Durex) – account for 90% of the condom market. In 10 years' time, you can bet your boots that those three manufacturers will still be on top.

Volatile earnings

Despite Ansell's collection of well-recognised brands, its large and entrenched distribution network, and significant economies of scale, the stock still has its share of risks. The first is the company's exposure to volatile commodity prices, such as rubber latex, as well as its exposure to industrial demand.

Cyclical industries – such as mining, oil and gas, automotive, and chemical – account for around 40% of sales (the balance being from less cyclical industries such as medical, food processing, and condoms).

What's more, emerging markets represent around a quarter of Ansell's sales, and their more volatile currencies add another layer of risk. As the company found in Russia earlier this year, a plunging rouble made the importation of Ansell's products more expensive. Sales fell 31% as droves of customers turned to local competitors.

Between commodity prices, currencies, and exposure to emerging markets and cyclical industries, Ansell's profits are prone to boom and bust. With this in mind, the company's net debt of US$419m is a turn-off, but with operating earnings covering interest payments 10 times over, it's manageable.

Valuation

Ansell generated sales of US$1.5bn in the year to 30 June and a net profit of US$159m, or US$1.05 per share. Excluding acquisitions, organic growth has been lacklustre in recent years and it's only reasonable to expect sales to increase in line with the general economy.

Management expects revenue to rise 2–4% in 2017 and underlying earnings per share to increase by 2–17% (before taking into account the sale of Ansell's small Onguard footwear business). That would bring 2017 earnings per share to between US$0.98 and US$1.12, putting the stock on a forward price-earnings ratio of around 15 at the midpoint of the range.

Assuming organic growth of 2–3% over the long term, with room for sensible acquisitions to add to that, total annual returns could come in around the high single digits. Ansell isn't going to shoot the lights out, but it's still a decent company going for a fair price. The stock has risen 36% since we upgraded it to Buy nine months ago, and we're sticking with **HOLD**.

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

Disclosure: The author owns shares in Ansell.

We look at three more companies from the 7th annual Microcap Investment Conference.

BY JON MILLS • INTELLIGENT INVESTOR • 28 OCTOBER 2016

Microcap Conference 2016: Part 2

Following on Part 1 earlier this week, here are three more companies that piqued our interest at the 7th annual Microcap Investment Conference. Please note that they haven't been fully researched and aren't formal recommendations. However, they may prove fruitful if you're prepared to do your own research.

Gage Roads Brewing (GRB)

The travails of Gage Roads will be familiar to long-time members (see here and here). Management recently changed tack to concentrate on growing sales of its higher-margin proprietary craft beer range while gradually reducing its contract brewing business.

A recent capital raising means it now has no net debt while it also repurchased **Woolworths**' stake, albeit at the cost of losing Woolworths' debt guarantee. Nevertheless, it will still contract brew for Woolworths over the next three years, with volumes reducing over that time to accommodate the hoped-for rise in proprietary sales. Woolworths has also committed to purchasing minimum volumes of Gage Roads' craft range.

Chart 1: Australian beer market*

*Source: IBISWorld

Chart recreated from Gage Roads ASX announcement, 30 Aug 16

Gage Roads can also now access the 54% of the retail market not controlled by Woolworths (see Chart 1). It's also hoping to gain more of the 'on-premise' market (ie hotels, bars and restaurants) which makes up 31% of the Australian beer market. New distribution agreements signed recently mean initial signs are positive, while it's also cranking up sales and marketing expenditure to expand further on the east coast.

If successful, margins should rise: draught beer has gross margins of 83–89% compared to 70% for bottled beer sold in independent retailers and 65% for cases sold to Woolworths.

The company's premium Little Dove New World Pale Ale continues to win awards and, after 'refreshing' its craft beer range recently, sales rose 83% in 2016 and now represent 2.5m of the 11m litres brewed each year.

The Australian craft beer market has grown at 16% a year over the past five years and, at 9% of the total beer market compared to 18% in the US, there's still plenty of room for further growth.

The long-term goal is to earn $1 in earnings before interest, tax, depreciation and amortisation (EBITDA) per litre or $11m in total EBITDA, which would compare favourably to the Gage Road's current enterprise value of $35m. After spending $25m on its brewery in recent years, minimal capital expenditure means much of these earnings should flow through as free cash.

Corporate governance remains a concern but the generous incentive shares awarded to insiders at $0.05 per share and the sub-underwriting of the capital raising means insiders' incentives are now more aligned with shareholders.

Should its new strategy prove successful, Gage Roads may be targeted by bigger brewers – as the likes of Byron Bay Brewing and Little Creatures have been in the past. If it fails, however, Gage Roads could share the same fate as many of the ships that sailed through the sea channel between mainland Western Australia and Rottnest Island and after which it is named.

Smart Parking

Smart Parking designs, develops and manages car parking solutions. Anyone who has struggled to find a cark park and pay for it knows there is a large opportunity to make this process more efficient worldwide.

The company's Management Services division operates solely in the UK and manages off-street car parks on behalf of customers. It recorded $5.3m in EBITDA in 2016 and long-term contracts mean revenue is fairly stable.

Drivers are identified using number plate recognition technology. This means they can pay their parking charges electronically – but it also enables the company to access the driver's details on the UK government's website and automatically send them a fine if needed.

> **Cyclopharm is one of those rare breed of biotechs that is profitable, generating cash, paying dividends and has net cash.**

By contrast, despite revenue increasing by 40% to $5.6m in 2016 – over 34% of which was recurring – the Technology division recorded an EBITDA loss of $2.5m. This division uses a cloud-based system and in-ground sensors and tags to identify empty car spaces – thereby saving drivers time and money while reducing congestion – or cars that have outstayed their allotted time. It then sends the information to drivers and parking officers.

Drivers can also pay for their space via a mobile app rather than fiddling with cards or cash. Customers range from the City of Westminster in London, **Stockland** and the ACT government in Australia, and Auckland Transport.

The company is continuing to gain market share in the UK while also gaining from rolling out its Technology products around the world.

As you'd expect, this is a competitive industry but the company's suite of products encompassing both hardware and software provide a more complete solution than its competitors. For instance, Cisco tried and failed to enter the industry in recent years.

Management guided to overall EBITDA 'grow[ing] significantly' in 2017 despite the fall in sterling since the UK voted to leave the European Union (90% of its revenue comes from the UK).

Even so, and before taking into account the losses in Technology, it currently looks expensive but may be worth adding to your watch list, particularly if driverless cars take longer to dominate the roads than some are predicting.

Cyclopharm

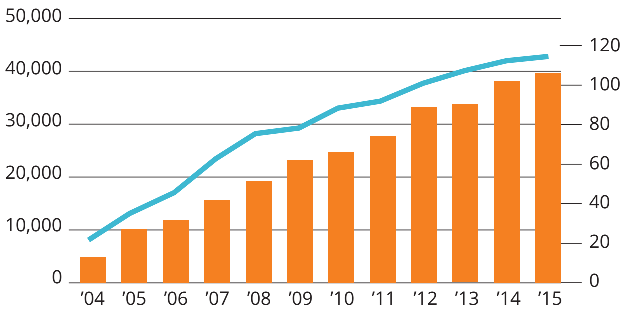
Cyclopharm is one of those rare breed of biotechs that is profitable, generating cash, paying dividends and has net cash.

Its Technegas product is used in the diagnosis and monitoring of lung diseases and is the world leader in lung ventilation imaging. Using a 'razor and blade' business model, Cyclopharm sells its Technegas Generator equipment to hospitals and then earns recurring revenue from the single use patient sets used to administer the tests. Sales of these sets represent 84% of total sales, with gross margins above 80%.

The Technegas generator is patent protected until at least 2026 and has been approved to test for pulmonary embolism or blood clots in the lungs in 55 countries. As such, more than 80% of Cyclopharm's revenue is from overseas.

Once approved in Canada, Technegas quickly displaced a xenon-based test Xe133 (see Chart 2) due to more accurate imaging results. Canada is now Cyclopharm's largest market.

Chart 2: Technegas growth – Canada



The company hopes to repeat this feat in the US which, for various reasons, it has struggled to enter until now. Xe133 had US$47m in sales in 2015, which compares very favourably to Cyclopharm's total sales of $13m in 2015. The US Food and Drug Administration (FDA) approved phase 3 clinical trials are ongoing, with approval targeted by December 2018.

At US7m, these trials aren't cheap but with decent cash flows from its existing business and around $7m on the balance sheet, a capital raising is not on the horizon at the moment.

The real attraction is over the longer term if the company can obtain approval for Technegas to be used in testing for other diseases. First up is testing for chronic obstructive pulmonary disease (COPD), which causes difficulty in breathing and is 30 times more common than pulmonary embolisms. Preliminary trials in China suggest that Technegas can indeed be used to test for COPD. The company also has plans to expand its use into the asthma market.

Cyclopharm should also begin sales of its patented Ultralute technology in 2017. Ultralute extends the life of nuclear isotopes by up to 50% and so saves 30–40% of the costs in the manufacture of radiopharmaceutical Tc99m. This is also used for imaging purposes when testing for various diseases and is manufactured on location at hospitals and clinics, many of which are existing customers.

Unfortunately, a recent price spike means the company's growth potential is now more priced in but this is also one to keep an eye on.

Disclosure: The author owns shares in Gage Roads Brewing. Staff members may own securities mentioned in this article.

What happens when you don't try to improve your product? As Twitter has found, nothing good.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 2 NOVEMBER 2016

Twitter's sale fail shows problem of complacency

Some Twitter employees are about to find out that working in Silicon Valley isn't all vacation days, celebrity visits and unlimited kombucha. CEO Jack Dorsey recently announced the social media company will sack around 8% of its workforce.

The fact the news only came after Twitter failed to sell to either **Alphabet** (NASDAQ:GOOGL), **Salesforce** (NYSE:CRM) or **The Walt Disney Company** (NYSE:DIS) is revealing. For a long time, many observers thought Twitter's strategy was to get acquired rather than find a business model that actually worked.

This latest move appears to back up that view, as does the spending of more than US$3bn on R&D since 2010, little of which has led to a user experience that might attract more, err, users. It wasn't until last year's return of Dorsey — who is said to have been against a sale — that Twitter's biggest changes occurred, which happens to be a move into live streaming.

The company has acquired the digital rights to broadcast one NFL game a week with major league baseball and hockey beginning next year. This could fundamentally change the business, perhaps helping Twitter to become a kind of live-**Netflix** (NASDAQ:NFLX).

Twitter has always had the bones of a potentially great company but its lack of innovation and complacent management limited that potential. The move into live sports streaming could push the company into a better place.

There are lessons here for Australian businesses. Few can afford to rest on their laurels and expect the good times to continue, no matter how strong that industry once was.

A recent look at the media industry indicates this better than most, with the likes of **Fairfax** (ASX:FXJ), **Nine Entertainment** (ASX:NEC) and **News Corp** (ASX:NWS) turning (belatedly?) to digital businesses, some with more successes than others.

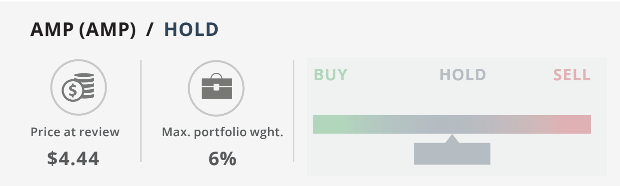
Twitter's business model hasn't yet been disrupted but it does show that even new-age tech businesses can find themselves in strife. **Facebook** (NASDAQ:FB), in comparison, has been adding new features (and making acquisitions) for years and is as profitable and popular as ever.

Right from the beginning, Twitter has disappointed investors, showing that even some of the world's best-known brands aren't above competition. If you own stocks in your portfolio exhibiting similar complacency, they may be heading for trouble.

Disclosure: The author owns shares in The Walt Disney Company

AMP on the rocks

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 2 NOV 2016



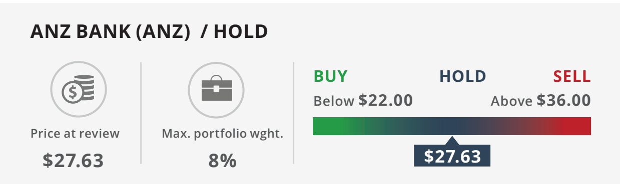
After having negative recommendations on AMP for more than ten years, we put AMP back on Hold after its interim result in February, with its prospects seemingly on the up. It turns out our timing was peccable, though, and it's been downhill ever since, with a run of bad news culminating in last week's writedowns in its wealth protection business.

The stock has now fallen below the Buy price we set back in February but, given the business deterioration, our valuation has also fallen. Where to is hard to say for such a complex business, so we're going to remove the price guide pending a more detailed review. We should note, however, that AMP is not near the top of our list of likely opportunities. **HOLD**.

Staff members may own securities mentioned in this article.

ANZ reduces Asian retail exposure

BY JON MILLS • INTELLIGENT INVESTOR • 31 OCT 2016



ANZ today announced the sale of its retail and wealth businesses in five countries in Asia at a $110m premium to book value. These businesses are just too small to be run efficiently, particularly with the increasing regulatory requirements since the global financial crisis, and so the decision to sell was an easy one.

Representing only $50m in net profit, these businesses are minor in the scheme of things: ANZ made over $7.2bn in cash profit in 2015.

Its remaining non-institutional businesses in Vietnam, Laos, the Philippines and Cambodia are 'still under review' but these too are likely to be sold for similar reasons.

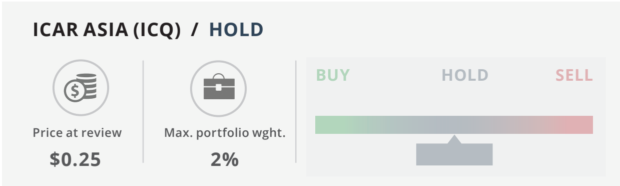
By contrast, the bank remains committed to its institutional business in Asia on the basis that, as the leading institutional bank in Australia and New Zealand, this helps support its customers in Australasia. However, as we noted in ANZ: Interim result 2016, it is gradually extracting itself from the less profitable parts of this business.

ANZ reports its 2016 result later this week and we'll have a more complete update then. **HOLD**.

Staff members may own securities mentioned in this article.

iCar Asia's lower inflows

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 1 NOV 2016



iCar Asia announced its third-quarter cash flow figures recently – and the market hated them. The stock fell 12% yesterday and is now down 30% since iCar Asia finds the funds in September.

The problem seems to be that the quarterly cash inflow figure of $1.7m was the lowest for five quarters. We're not entirely sure why that surprised the market, as management had already indicated revenues would be weaker than expected this year (see iCar Asia warns on losses in August).

The quarterly cash flow statement also provided a forecast of greater spending for the fourth quarter – around $7.0m of cash expenses compared to $5.4m in the third quarter. Both revenue and expenses look consistent with the guidance management has given for 2016.

That said, we're getting impatient with management's positive spin on the numbers but lack of detail and consistency. New managing director Hamish Stone announced that 'the company's strategic direction has been clearly defined' and yet there's been no clarity for small shareholders. Nor was any management commentary released to the ASX at the recent annual meeting. We consider that poor form.

It's sometimes the nature of small companies going through rough patches that the information flow to shareholders deteriorates. Unfortunately that seems to be the case with iCar Asia. Otherwise nothing fundamental has changed since iCar Asia finds the funds; the market is just losing patience. Don't forget the warnings in the latest review but the stock remains 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.

Staff members may own securities mentioned in this article.

Trouble at Vita

BY ALEX HUGHES • INTELLIGENT INVESTOR • 2 NOV 2016

VITA GROUP (VTG) / COVERAGE CEASED

Price at review **$3.55**

Max. portfolio wght. **N/A**

BUY HOLD SELL

In VitaGroup: Result 2016, we recommended members SELL, because we had concerns that this telecommunications retailer was moving outside its core area of competence.

Running Telstra's branded stores had been very lucrative, but with maturing stores and a new strategy to expand into IT services, we felt ongoing success would be much harder to achieve. Our concerns have only intensified since.

Get this: at last week's annual general meeting Vita announced it had started selling men's clothing. This was a shock to shareholders, who had no idea that they already owned a business called SQD Athletica, with two Queensland stores.

More concerning, however, is this week's news that Telstra is seeking to renegotiate its "remuneration construct" with its resellers. This is CEO-speak for "our profits in our main business will reduce". It's unlikely Telstra wants to pay its resellers more. Compounding these factors is the sale of 10m shares worth $49.5m by CEO Maxine Horne.

With questions around the future profitability of the core business, an illogical strategy and significant insider selling, we recommend members that haven't yet sold do so. As for future reviews, there won't be any, at least for the foreseeable future. We're **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

Growth or income?

We are a share group that has been investing for 20 years. We are all in our late 50's and women. Should we be looking for capital growth or income?

2 Nov 2016 – **James Carlisle**: I'm afraid I'm unable to give personal advice, so you'll need to interpret my general comments to suit your own situation. I think the question of whether to invest 'for growth or income' puts the cart before the horse – what matters is to invest 'for value'. Each company provides returns in terms of income (dividends) and capital growth (which, over the very long term, is ultimately determined by how much the income grows) – and what matters is that the combination of these provides sufficient returns to justify the price you pay.

That said, at any point in time, you might have several opportunities in prospect, and if you're struggling to choose between them, then you might decide to pick the one with the higher growth potential or the higher income generation, depending on what suits your situation (including tax - note that income and capital gains are taxed differently - you don't have to pay tax on the latter until you sell and if you hold for many years you're effectively getting a loan of the amount of any tax from the taxman).

It's for a combination of these reasons that our Growth and Equity Income portfolios have 20 or so stocks in common out of 25 holdings in each - but the other 5 in each have a higher dividend generation in the Income Portfolio and greater growth potential in the Growth Portfolio. This gives the Income portfolio a slightly higher overall dividend yield (3.9% compared to 3.2%), but I wouldn't expect either to outperform the other over the long term in overall terms, because they're both picked on the basis of value.

Watermark Global Leaders Fund

I would be interested to hear any thoughts on the upcoming IPO of the Watermark Global Leaders fund.

4 Nov 2016 – **Jon Mills**: Justin Braitling and the team at Watermark are fine investors with a good long term record.

The Watermark Global Leaders Fund will invest internationally via a 'market-neutral' strategy: as well as buying shares hoping they rise (or going 'long'), it will also short sell with the idea of keeping the total long and short positions at around the same size to hedge out market risk or the influence of market movements on the portfolio. If successful, this means the returns of the portfolio will be entirely dependent on the stock picking skills of the manager. As it will be investing globally, the portfolio will also hold long and short positions in a range of foreign currencies and hence the foreign exchange risk will be largely hedged too.

While we're generally in favour of listed investment companies (LIC), the problem with buying LIC IPOs is that you immediately lose a part of your investment (in this case, around 2%) to fees and costs. In recent times, LICs have tried to compensate investors for this by issuing 'free' options in the IPO. However, this just means the potential gains from investing in the IPO will be diluted if these options end up being exercised.

We prefer to buy listed investment companies at a discount to post-tax net tangible assets to compensate for the impact of fees - in this case a 1.20% management fee plus a performance fee - on shareholder returns. See An Introduction to listed investment companies for more.

Replicating the portfolios

I have recently become a member and am interested in replicating the income and growth portfolios. I was wondering about the timing of establishing those portfolios. Seems to me that there is no good or bad time to start but rather a matter of correctly replicating the portfolio's so to maintain the underlying stock specific weightings and to ensure sufficient diversification. Your thoughts please?

2 Nov 2016 – **James Carlisle**: First of all, I must stress that I'm not able to give personal advice, so you'll need to adapt what I say to suit your own circumstances. As a general rule, though, it's fundamental to our philosophy that you can't time the market. On that basis, if and when you've decided that a portion of your savings should be directed towards equities, then any time is a good time. There is a school of thought that it's best to drip feed money into the market over a period of months or even years, to ensure that you don't hit any high points – but the trouble is that in the meantime your money is in something else that you'd previously decided wasn't as good - and if markets can be at a peak for a day, they can also be at or close to a peak for months or even years! Bear in mind also that the portfolio pages only update overnight, so you won't necessarily be able to buy or sell at the same prices that the portfolio does - although that should probably iron out over the long term.