Weekly Review

RESEARCH

– Issue – 9 Dec. 2016

This provider of debt solutions is at its best when the economy is at its worst – and it's going cheap.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 7 DECEMBER 2016

FSA: selling canoes in the Sahara

You may be wondering how I'm going to make an article about personal insolvency paperwork interesting. I've been wondering the same thing. Truth is, though, I don't think I can make the administration of debt agreements sound glamorous – but that might be exactly why FSA Group is undervalued.

Key Points

- ***Debt agreements will spike in bad times***
- ***Low savings, record levels of indebtedness will lead to future clients***
- ***Undemanding valuation; Spec Buy***

FSA GROUP (FSA) / SPECULATIVE BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.21	3%	High	Very High

BUY Below $1.20 — HOLD — SELL Above $2.00

$1.21

Unlike the **Cochlear** and **REA Group**'s of the world, investors are unwilling to pay up for boring stocks, and that creates opportunity. As they say in the north of England: 'Where there's muck, there's brass'.

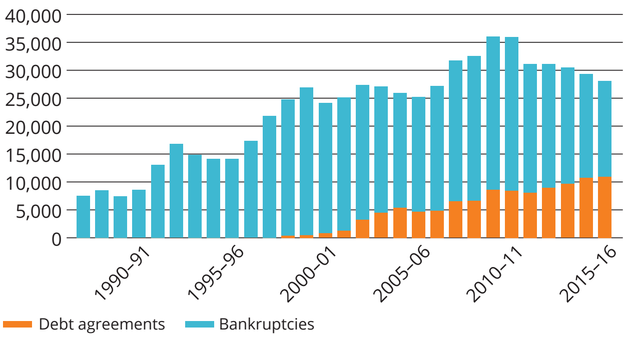
FSA operates in a dull industry and has a market capitalisation of only $150m – it earns in a year what **Commonwealth Bank** earns in a day. But this ugly duckling does have a few things going for it: a dominant market position; good management with a large ownership stake; high margins and returns on equity; and a 5.7% fully franked yield.

What really sets FSA apart from other stocks, though, is a simple fact: perhaps more than any other listed company, FSA Group is genuinely countercyclical.

The business of bankruptcy

FSA is best known for its slightly dodgy looking TV commercials where the company offers budgeting assistance, mortgage refinancing and the promise to 'free yourself from debt'. The big money-spinner, though, is originating Part IX Debt Agreements, which are a way for clients to negotiate with their lenders to settle debts or to freeze repayments until they are more financially secure. It's essentially a version of insolvency for people with modest incomes and relatively little debt.

Chart 1: Total bankruptcy and debt agreements



Source: Australian Financial Security Authority

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Industry-wide, some 12,150 debt agreements were signed in the year to June and that number has grown at around 9% a year over the past decade. The banks love FSA as they reclaim an average of 60–65 cents per dollar of debt, compared to around 10 cents if the debtor declared bankruptcy. FSA may be a small fish, but it has some large sharks as allies.

There are currently 38 registered debt agreement administrators in Australia, but most are one-man shops. FSA dominates the industry with a market share of 41%. Although this is down from 50% last year, management says it was due to 'staffing challenges' that have now been resolved, so we'll be watching the next result closely to ensure it is a temporary issue. FSA has a far larger marketing budget than its competitors, so we expect it to reclaim lost ground.

When bad news is good news

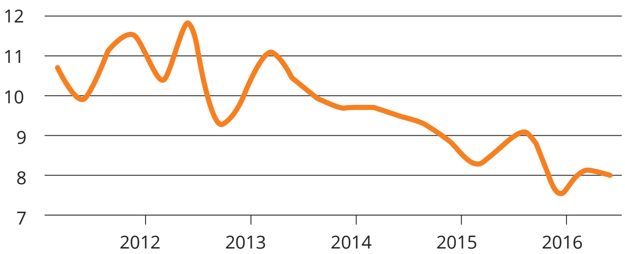
With a strange business model that relies on financially distressed clients, FSA is like a canoe salesman in the Sahara desert. When the sun shines and the Australian economy is growing, fewer people are in financial distress, leaving FSA without clients. The company's underlying net profit fell 5% to $12.3m in the year to June, but what would happen if an economic thunderstorm arrived?

A prolonged period of record low interest rates is lulling borrowers into large mortgages that they couldn't afford if interest rates were higher. This explains the sharp rise in interest-only mortgages, which made up two-thirds of total approvals in 2015 according to the Australian Securities and Investment Commission (ASIC), compared to only around 10% in 2004. Any rise in interest rates is likely to create a deluge of borrowers unable to make their repayments.

And that day may come sooner than you think. Debt levels are at record highs, with average household debt as a multiple of income at 180% – higher than almost all developed countries, such as the USA, Canada and Germany. At the same time, however, the rate of saving is declining (see Chart 2).

We think this all points towards one thing: a gathering number of people are standing on a cliff edge. Any tremor through the economy is likely to cause a significant increase in financially distressed households. Those in distress have only a few options, the main ones being bankruptcy, a debt agreement or refinancing their debt – and FSA is the largest provider of all three solutions.

Chart 2: Australian household savings rate (%)



Source: ABS

That would provide a big jump in earnings. Client numbers for FSA's debt agreement division increased 30% in 2009 – profits doubled – and the Australian economy didn't even go into recession. Since the company's founding in 2000, unemployment levels have never reached much above 6%, yet it has still managed to double revenues over the past decade.

Default risk

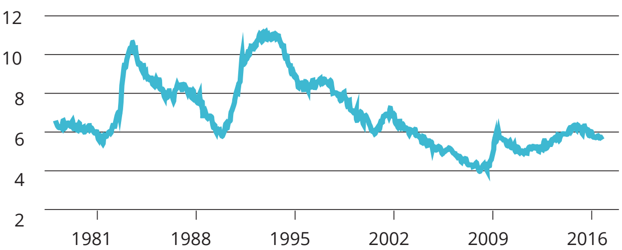
There is one glaring risk, though – the Lending division, which provides mortgages to people in financial difficulty. If unemployment and interest rates rise, it's reasonable to expect a spike in loan defaults. And although the number of new applicants would go up – along with long-term revenues – the company could still face problems in the short term with the existing loan book.

If things really got out of hand, the division could blow up entirely, which would cut earnings by at least a quarter.

> "Until the economy hits a snag, most growth will come from lending.

However, only around 3% of FSA's equity is on the line because the division is in its own separate trust with the debt being non-recourse to the parent company. FSA wouldn't be bankrupt, but the share price may still get hammered until the extra revenue from the Services division begins to flow through (fees are typically spread out over the standard five-year term of the debt agreement).

Chart 3: Unemployment rate (%)



Source: ABS

Refinancing the Lending division could also become an issue, though it's a joint venture with Westpac, which has a 10% equity stake. Westpac also recently increased its debt facility available to the division from $250m to $275m, suggesting its ongoing support – at least until October 2017 when the facility is up for renewal.

Valuation

We expect the debt agreements division to continue to find growth hard to achieve while interest rates and unemployment are low. Until the economy hits a snag, most growth will come from lending.

Management has said shareholders can expect earnings growth of around 10% a year for the next five years, with at least half of net profit paid as dividends. If that growth materialises, FSA's price-earnings ratio of 12 and fully franked dividend yield of 5.7% puts the stock well into bargain territory.

The stock is currently bang on our Speculative Buy price, so if it settles much higher we're likely to downgrade to Hold. However, with good management, economies of scale, and a dominant market share – not to mention being one of the few truly countercyclical companies on the ASX – for now we're sticking with **SPECULATIVE BUY**.

Disclosure: The author owns shares in FSA Group.

Bellamy's has stunned the market with a stinging profit downgrade. We recommend Avoid.

BY PHILIP BISH • INTELLIGENT INVESTOR • 5 DECEMBER 2016

Bellamy's gets creamed

Investors don't like nasty surprises, and they like it even less when they're sent out with a positive spin.

That's exactly what we got from Bellamy's on Friday. Management began its 'business update' with a statement that the company had 'continued revenue momentum' with total revenue up 24% in the year to 20 November.

Key Points

- *Earnings downgraded*
- *Oversupply issues*
- *Switching to Avoid*

BELLAMY'S AUSTRALIA (BAL) / AVOID

Price at review	Max. portfolio wght.	Business risk	Share price risk
$6.44	N/A	High	High

Sounds impressive. Unfortunately, way down on the third page of the announcement, investors were told that the company expected just $120m in revenue for the first half of the 2017 financial year (to December), some 14% below the second half of 2016 (although management chose not to make that comparison). They must have a different understanding of the word 'momentum'.

With revenue for the second half of 2017 expected to be 'similar to the first half', full-year revenue would come to $240m, slightly below the $244m recorded for 2016. That's way short of the 45% growth the market had been anticipating, and the announcement sent the stock down 44%.

Chief executive Laura McBain blamed the lower revenue on 'temporary volume dislocation' in China due to changing regulations. She said that brands that were unlikely to gain Chinese registration were liquidating inventory at discounted prices. But given the positive spin around the rest of the announcement, it's hard to have much confidence in that.

In **our review last month** we noted the danger of oversupply in the organic infant formula market, and our concern – apparently shared by other investors – is that this is the real reason behind the market disruption. It would no doubt look a lot like a 'temporary volume dislocation' from changing regulations, but only time will tell how temporary it is.

A2 Milk recently reported solid revenue growth in Chinese infant formula sales and made no mention of the issues highlighted by Bellamy's. This suggests there may be specific problems with Bellamy's brand, marketing or distribution in China, or in the supply chain relating to organic formula rather than that for A2 milk.

It's also disappointing that there was no mention of any problems at the company's annual meeting in October. The market took this as 'no news is good news', and assumed that if there were any issues they would have been promptly disclosed.

That, however, wasn't the case and it doesn't reflect well on management and the board. If they knew something was up, they ought to have disclosed it; and if they didn't, then they should have.

Is there value?

With forecast revenue of $240m and an operating margin of slightly less than 20% (we'll call it 19%), we get an operating profit of $46m. This translates to a net profit of $32m and earnings per share of $0.32. At the current price, the shares therefore trade on a price-earnings ratio of about 20. That hardly looks cheap, especially given the company's low cash generation.

Bellamy's did say that 2017 included an additional 'investment' of $15m–20m on marketing activities, people capabilities and enhancing the organic supply chain. It's not clear though how much of this expense is really 'one off'.

The bull case for Bellamy's is that the current oversupply will resolve itself within 12 months, Bellamy's will receive its Chinese registration and competition will decrease.

The bear case is that the supply issues run deeper, which would prompt further downgrades. A further tightening of Chinese regulation and the possibility of Bellamy's not receiving Chinese registration add to the risks.

Given the way the management has handled this, we're not inclined to give the company the benefit of the doubt and we're therefore switching our recommendation to **AVOID**.

Disclosure: The author owns shares in Bellamy's.

With only one more year to go, we check in to see how things are going in our triennial '3 for 3' contest – and look at some stocks our analysts would choose if we were starting again today.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 8 DECEMBER 2016

Top 3 for 3: The final stretch

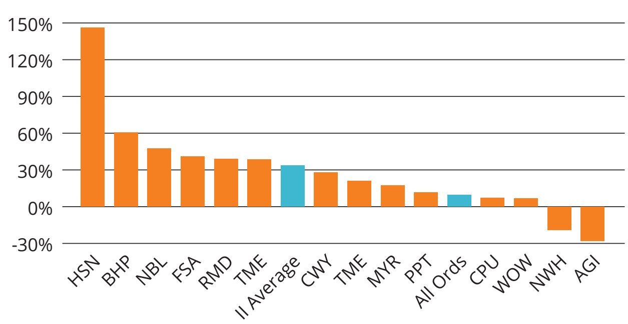
Whether it was Brexit, President Trump or even the success of Leicester City and the Chicago Cubs, it is fair to say that 2016 has been a strange year.

Despite the unpredictability, the All Ordinaries Accumulation Index increased by around 14% since we last checked in on our **Top Three for Three competition** and around 10% since we first started way back in **December 2014**.

With this as a backdrop, the analysts continued to do well with the original competitors generating an average return of 37% since the competition began, and that only drops to around 34% when you add in myself and James Greenhalgh who entered a year later – an outperformance of around 24%.

Firstly, the disclaimer. As always, three stocks are too few for a portfolio to be considered diversified and three years is too short a period to judge performance. Also, with all stocks weighted equally and no ability to buy or sell, the competition is very different to the decisions analysts would make in real life as you will see in their comments. However, with that out the way, let's get into the results.

Chart 1: Total gross return after two years (%)



Source: ASX, S&P Capital IQ

With two years now in the bag and only one year to go, we have asked the analysts to not only comment on their selections but also share their top stock pick if the competition was starting again today.

Gaurav Sodhi

'I'm pretty happy with how the portfolio has performed' says Gaurav. That's not surprising considering he is the current leader with an average return of 71%.

'**Hansen** has performed better than expected but, to be honest, I would have found it difficult to hold this long. I'm a little uncomfortable with the acquisition strategy and it looks fully priced to me.

'I said last year I would have sold **Cleanaway** (formerly Transpacific) and yet it has staged a remarkable turnaround and is now in the black. Was selling a mistake? I'm not sure. Cleanaway looked like a broken investment case and management, installed with great fanfare, left abruptly. I'm certain I would make the same sell decision again.'

Sodhi's Stockpile

STOCK (ASX CODE)	PRICE AT 7 NOV 14 ($)	PRICE AT 7 DEC 16 ($)	GROSS DIVS (C)	VALUE AT 7 DEC 16 ($)	TOTAL RETURN (%)
TPI (NOW CWY)	0.91	1.12	0.046	1.17	28.1
TME	3.60	4.63	0.360	4.99	38.6
HSN	1.56	3.66	0.179	3.84	146.1
AVERAGE					**70.9**

'**Trade Me** is a wonderful business that I would still happily hold. There are cheaper stocks and some tempting ideas – **Flight Centre** and **News Corp** for example – but I have learned to hold quality for longer. Few businesses are as resilient as Trade Me.'

For his top pick today, Gaurav has chosen mining service provider **Austin Engineering**.

'Mining services has been a seductive area for us value hounds and Austin falls into this category. The business makes and sells consumable products like buckets, truck parts and tanks that are used in the mining and construction industry.

'As miners have conserved cash, they have pushed out their maintenance and equipment is now overdue for replacement. Resuming the replacement cycle will help the revenue line while operating changes should ease margin pressure.

'Austin had a terrible balance sheet but several capital raisings have cleaned that up. One risk here, apart from revenues not turning up, is the amount of working capital the business sucks up to fulfill new contracts but there appears to

> **Warren Buffett has said "Buy into a company because you want to own it, not because you want the stock to go up." Hansen fits the bill.**

be enough cash to support growth. It doesn't look particularly cheap but if we assume a normalised revenue line it looks very cheap.'

Disclosure: Gaurav Sodhi owns shares in Austin Engineering.

Graham Witcomb

Next up is Graham, who has dropped down one spot after leading the competition at the one-year mark. His top performer, like Gaurav, was Hansen Technologies which is up 146% since the competition started. However, he has a slightly different view regarding its acquisition strategy.

Witcomb's Winners

STOCK (ASX CODE)	PRICE AT 7 NOV 14 ($)	PRICE AT 7 DEC 16 ($)	GROSS DIVS (C)	VALUE AT 7 DEC 16 ($)	TOTAL RETURN (%)
HSN	1.56	3.66	0.179	3.84	146.1
PPT	48.15	46.65	7.071	53.72	11.6
FSA	1.03	1.25	0.193	1.44	40.8
AVERAGE					**66.1**

'Warren Buffett has said: "Buy into a company because you want to own it, not because you want the stock to go up." Hansen fits the bill. The company continues to shoot the lights out operationally, with captive utility customers providing steady revenues and management's knack for making sound acquisitions. The share price now reflects a lot of the competitive advantages we saw in Hansen a couple of years ago, but to say the stock is overvalued still strikes me as risky. Hansen will almost certainly be a bigger, better company 10 years from now and we're in it for the long haul.

'**FSA Group** doesn't have the innate competitive advantages that Hansen has, but it's a well-run company, with this past year a case in point. Management let go of a poorly performing division and is now focused on the company's bread and butter: making loans and arranging debt agreements for people in financial distress. The company is investing heavily in sales and marketing in anticipation of future growth, which would be aided by a faltering Australian economy. With a price-earnings ratio of 12, we believe the market is undervaluing the stock's growth potential and it remains on our **Buy list**.'

For **Perpetual**, Graham notes that 'fund performance has been lacking recently with the Aussie market only up slightly this year. Fund flows are down, though Perpetual is well placed to benefit from a strengthening economy and rising market. We're still long-term believers in the company, which currently sits on our But list.'

As for Graham's current top pick? 'It's hard for me to look past **Virtus Health**,' he says.

'It has its share of risks, but the IVF industry will almost certainly be a long-term growth story due to rising infertility and, with Virtus's dominant position, economies of scale, clean balance sheet and strong brand, we expect the company to do well over time. Virtus is exposed to short-term volatility in cycle numbers, but it churns out cash – and with a free cash flow yield of 8%, investors are getting a good company at a great price.'

Disclosure: Graham Witcomb owns shares in Hansen, Virtus and FSA Group.

James Carlisle

According to Research Director James Carlisle, his selections are a case of 'two steps forward and one step back, with Trade Me and **ResMed** each gaining about a third, and **Ainsworth Game Technology** losing a similar amount'.

'Since I picked Trade Me two years ago at $3.60, it's been down as far as $2.68 and up as far as $5.70, before settling at its current level around $4.63, so who knows what's in store for the final year of the contest.

Carlisle's Crackers

STOCK (ASX CODE)	PRICE AT 7 NOV 14 ($)	PRICE AT 7 DEC 16 ($)	GROSS DIVS (C)	VALUE AT 7 DEC 16 ($)	TOTAL RETURN (%)
TME	3.60	4.63	0.360	4.99	38.6
RMD	6.03	8.06	0.313	8.37	38.9
AGI	3.10	1.95	0.286	2.24	–27.9
AVERAGE					**16.5**

'I'm very happy with the stock, and hold it personally. It has a wonderful position, albeit in a small market, but there's every reason to believe that its classifieds businesses can increase the value that they add to end users, thereby expanding that market. Management is taking all the right steps to achieve that, by investing in its sites, apps and other services.

> **"Ainsworth is another where Jon's personal approach has led to a different result than the competition.**

'I'm less comfortable with ResMed, which I've sold personally and which has also been sold from our **Growth** and **Equity Income Portfolios**. In all three cases, though, the sales were less to do with the stock itself and more to do with better opportunities elsewhere.

'Our relative indifference has mostly been due to its markets being slower growing and more competitive than we anticipated when we **upgraded the stock** to Long Term Buy back in 2013. Add to that a management team that appears to be moving beyond its comfort zone to supplement the lacklustre growth, and the gloss has rubbed off a bit.

'Still, the company adds lots of value, has a strong position in a growing market and generates excellent cash flow. On a multiple of only 21 times earnings expected for 2017 it also doesn't look expensive and it remains a solid Hold – at least if you're not itching to buy something else. There are worse places to be for the final year of this competition.

'One of those worse places might be Ainsworth Game Technology, which has had a pretty terrible run since we upgraded it around the time this contest began in 2014. The big hope back then was for growth in its international business and it has largely delivered on that. The problem is that at the same time its Australian business has crumbled.

'Worst of all, Len Ainsworth appears to have rubbed other shareholders' noses in it by selling his shares about 50% higher than current levels. The stock certainly looks cheap on a price-earnings ratio of about 12, but it looks unlikely to recover the ground already lost'.

If we were starting the competition again today, the first stock on James' list would probably be **GBST**.

'It's had its problems since I first recommended the stock a couple of years ago (admittedly at too high a price), and with the business treading water the market is seeing the glass as half-empty. When its software is installed, though, it's for the long haul, and revenues should grow over the years as transactions and funds increase. In time, I think we'll see this flowing through, making today's share price look cheap. There are risks, though, and I'd therefore probably balance it out with some more reliable performers (the likes of **Seek** and Trade Me come to mind)'.

Disclosure: James Carlisle owns shares in Trade Me, Seek and GBST.

Jon Mills

For Jon, the competition rules highlighted how different the 'Three for three' competition is compared to the reality of investing.

'As well as a 33% weighting in each stock being far too high, the inability to take advantage of volatility and buy (and sell) in stages – as we usually recommend members do – are unrealistic compared to the cut and thrust of everyday investing.'

Millsy's Monsters

STOCK (ASX CODE)	PRICE AT 7 NOV 14 ($)	PRICE AT 7 DEC 16 ($)	GROSS DIVS (C)	VALUE AT 7 DEC 16 ($)	TOTAL RETURN (%
AGI	3.10	1.95	0.286	2.24	–27.9
NWH	0.68	0.55	0.000	0.55	–19.1
TPI (NOW CWY)	0.91	1.12	0.046	1.17	28.1
AVERAGE					–6.3

He pointed to his selection of **NRW Holdings** as a good example. 'Investing in stages has meant that my personal holding of NRW Holdings is up around 33%, even though it almost went bust – and really should have – after Samsung decided to exert its power over its subcontractors after losing $1bn on Roy Hill (see ***NRW ends dispute***). As Gaurav noted then, if it survived, there was generous upside. It did – after tough negotiations with its banks and a timely big contract win – and there was: it has 14-bagged after reaching a low of $0.04 and recently took advantage of its resurrection to raise additional capital to ease its debt burden. It has also been helped by the apparent turnaround in the mining cycle and, with it, sentiment towards the sector.'

Ainsworth is another where Jon's personal approach has led to a different result than the competition.

'Investing in stages and using volatility to my benefit is also why I'm slightly ahead with my personal investment in Ainsworth. Ainsworth has continued to expand successfully overseas – especially in North America – but its Australian performance is currently worse than we expected due to Aristocrat's dominance here. We also retain concerns over Len Ainsworth's **well-timed sale** of most of his stake to Austrian gaming giant Novomatic. However, the company has a strong balance sheet and access to Novomatic's much larger R&D budget and game

> **“My motto has always been ‘Don’t blow yourself up’ rather than ‘Try to blow the lights out’.**

library, so a recovery of Australian market share – and perhaps in its share price – is possible in coming years.

‘Cleanaway too has experienced great volatility, falling 20% from its level two years ago but now being 27% ahead for those that hold it. Despite some management upheaval, its new CEO has successfully reorganised the business, reduced customer churn rates, cut costs and improved margins in all three of its divisions. Lower capital expenditure requirements, reduced remediation spending and the imminent closure of its lower-margin Clayton landfills will also cement the turnaround of this business’.

For his top pick this year, Jon is taking a different approach and focusing on quality after reading the thoughts of grizzled veteran of ‘Three for three’ competitions, James Greenhalgh, in last year’s update who said ‘selecting lower quality companies that are mathematically cheap is risky given the timeframe, the inability to sell and the lack of diversification. It’s far better to select high-quality businesses’. Jon’s selection is New Zealand classifieds business Trade Me.

‘Its share price has fallen due to worries over Facebook’s new Marketplace service but as James notes in ***Trade Me and Facebook square off***, the likelihood is that this service will have minimal effect on Trade Me. Trade Me is a place where Kiwis go to sell stuff whereas Facebook is for social contact. While free – Facebook will make money via advertising – Marketplace lacks many of the features of Trade Me’s service such as facilitating payment and delivery and so serious buyers and sellers are still likely to prefer Trade Me. If history is any guide, it’s likely Facebook retreats like other competitors have in the past in the face of Trade Me’s strong network effects.’

Disclosure: Jon Mills owns shares in Ainsworth, NRW Holdings and Trade Me.

James Greenhalgh

With his previous advice influential in Jon’s selection of Trade Me, how did he do in his first year back?

‘Having participated in four ‘Top 3 for 3’ competitions, my motto has always been ‘Don’t blow yourself up’ rather than ‘Try to blow the lights out’. Thankfully I haven’t blown myself up for the one year I’ve been in the competition (I re-joined Intelligent Investor mid-2015, so my version is a ‘Top 3 for 2’).

‘**Computershare**’s business looks becalmed but the stock still doesn’t look expensive, despite our recent downgrade to Hold. With Donald Trump winning the US presidency, fears of inflation are stoking long-term interest rate rises, which might eventually benefit Computershare’s business’.

‘While my Trade Me pick entered the competition at a higher price than I envisaged, the improvement in the business has become more evident since last year. The stock is not as cheap as it was but Trade Me has pricing power and it’s still on our Buy list’.

Greenhalgh’s Gems

STOCK (ASX CODE)	PRICE AT 15 DEC 15 ($)	PRICE AT 7 DEC 16 ($)	GROSS DIVS (C)	VALUE AT 7 DEC 16 ($)	TOTAL RETURN (%)
CPU	11.36	11.76	0.413	12.17	7.2
TME	3.98	4.63	0.184	4.81	21.0
NBL	0.95	1.40	0.000	1.40	47.4
AVERAGE					**25.2**

‘**Noni B** was an unusual (that is, risky) pick for me in this competition but it has been my star performer. With the company making a substantial acquisition, the stock is no longer under-priced and I have been selling down my significant personal holding. I’m concerned Noni B could be my undoing in the final year of the competition, as things can change quickly year-to-year’.

‘My top pick right now is **Crown Resorts**. Looking out three years, not only should the business have shrugged off its current woes, but the demerger is likely to have realised significant value’.

Disclosure: James Greenhalgh owns shares in Computershare, Trade Me, Noni B and Crown.

Andrew Legget

Rounding out the competition participants is myself who, along with James Greenhalgh, joined in the second year of the competition.

‘Myer has been a roller coaster, as you would expect for a discretionary retailer in the middle of a turnaround. Its share price has regularly risen above $1.20 but also just as often fell back below $1.10. In fact, only a few weeks ago, its share price was as low as $1.03. I expect this volatility to continue, but

> **Although it appears to have put a line through its Masters headache, a new one has arrived in the name of Big W which continues to underperform.**

am happy to continue holding it as one of my three selections. Ever since the strategy update last year, more signs have shown that its new strategy is working ending in November where sales grew faster than old enemy David Jones for the first time in a while. Also, after visiting its first new-format store in Sydney's Northern Beaches I am finally seeing signs that Myer is getting its act together.

Legget's Legends

STOCK (ASX CODE)	PRICE AT 15 DEC 15 ($)	PRICE AT 7 DEC 16 ($)	GROSS DIVS (C)	VALUE AT 7 DEC 16 ($)	TOTAL RETURN (%)
MYR	1.13	1.26	0.071	1.33	17.4
WOW	22.49	22.91	1.100	24.01	6.8
BHP	16.27	25.73	0.399	26.13	60.6
AVERAGE					**28.2**

'The same can't be said for **Woolworths**. Although it appears to have put a line through its Masters headache, a new one has arrived in the name of Big W which continues to underperform. Its supermarkets also continue to face aggressive competition from Coles and Aldi. One issue that has been resolved is the appointment of a new chief executive in Brad Banducci which at least gives the company some stability at the top. Despite the issues, the company still has one of the best supply chains and store networks and I still consider this a quality company and one I'm happy to hold.

'Finally there is **BHP**, which was my top performer of the year and ironically a company I would usually avoid due to my dislike of resources companies. However, that is also the reason why I am not surprised at the result, as it would take a really cheap price and high quality to tempt me in the first place. Despite the 2016 headline loss of US$6.4bn, the mining operations have continued to perform well and the recovery in some commodity prices such as iron ore have helped bring investors back to the sector. The swings in its share price doesn't change the fact it is one of the highest quality miners in the world'.

Foy my top pick, I am echoing Graham Witcomb and choosing Virtus Health.

'With people waiting longer to have kids leading to higher infertility rates, more people will need assisted reproductive services. With surrogacy laws in Australia still quite strict, this leaves IVF as a major option for potential parents. That's not to say there are no risks in Virtus, it is in a well-regulated industry and low-cost providers are taking market share. But the numbers such as its free cash flow yield, as mentioned by Graham, make me comfortable in taking the chance.'

Finally, we have our newest additions to the analyst team in Alex Hughes, Mitchell Sneddon and Phil Bish. Rather than make them attempt the impossible and choose 3 stocks for one year, we have decided to be fair and instead asked them to share only their top picks.

Alex Hughes

Alex has kept to his favoured small caps sector and chosen a software company whose market cap is only $16m – **Techniche** – which he calls a 'profitable software company valued as a cigar butt'.

'Techniche owns two businesses. The first is European based ERST, which provides secure data transfer for 10,000 European fuel stations. Next is Urgent, a facilities management application used by 30,000 retail sites in 16 countries, and finally Statseeker, a 50% owned SAAS network monitoring tool used by numerous fortune 500 companies.

'With an enterprise value around 4x earnings, it's superficially cheap and the dividend yield isn't bad either. Techniche also has $15m in tax losses which could add value by reducing future tax bills.

'However, the situation has enhanced recently following a $10.6m takeover bid for Urgent. If the deal proceeds, Techniche's cash pile will expand, and when you deduct its excess cash from its market cap, its enterprise value falls close to zero. The remaining businesses, ERST and (50% owned) Statseeker are expected to generate earnings of around $2m going forward.'

'So, assuming the Urgent sale proceeds, you are buying 1.5 software businesses for around 1x earnings. If it doesn't you are paying around 4x. Both are too cheap in my opinion.'

'Such a low share price suggests the market believes the businesses are near worthless, or that management will destroy value with bad acquisitions. (I think the real reason

> **"So, assuming the Urgent sale proceeds, you are buying 1.5 software businesses for around 1x earnings. If it doesn't you are paying around 4x.**

is that Techniche is small so it is unknown or off the radar of most investors). I think both assertions miss the mark.

'ERST has been around since 1996, and since Techniche bought it in 2008, it has been consistently profitable with earnings up 57% since. Its software is embedded into the daily operations of many fuel stations, so it's not easily replaced, but it does have customer concentration risk to BP. Statseeker has big markets and some big customers, and has been growing at a good clip. It recently reached profitability, and if growth continues, it could make a meaningful contribution going forward. These are not world class software businesses, but they're far from worthless.

'Also, Techniche's history with capital allocation has been decent. For example, ERST paid itself off in a matter of years and Urgent has produced an IRR of around 14%. Management and the board own a lot of stock, so interests are aligned, and communication and governance have improved under the new CEO.

'Being such a small company, Techniche comes with added risks (and I would never put 100% of my portfolio into it, as this competition implies), but I think a low entry price, a strong balance sheet, and aligned management bode well for a decent future.'

Disclosure: Alex Hughes owns shares in Techniche.

Mitchell Sneddon

'My background has been in managed investments and specifically listed investment companies (LICs) for the *Eureka Report*. If I had to pick one from the near 100 out there to stick in the bottom drawer and pull out in three years and be pleasantly surprised it would have to be Thorney Opportunities Limited. Led by Alex Waislitz, **Thorney Opportunities Limited** is a highly concentrated portfolio of small ASX listed companies. At first glance most investors would look elsewhere to a more undervalued LIC. Thorney isn't undervalued at all. It's sitting approximately at value right now. But what Thorney has shown over its short life is the team's ability to create value through careful stock selection and using the experience that sits within the LIC to play the role of an activist investor when needed.'

Phillip Bish

Finally, Phil Bish has gone a tastier route and selected **Retail Food Group**.

'Retail Food Group is a food and beverage company that owns a large number of food franchise systems, including Gloria Jeans, Michel's Patisserie, Donut King and Brumby's. It is also in the coffee business owning four coffee roasting facilities and a number of coffee franchises.

'The company listed in 2006 at $1.00 per share and has seen a steady rise in both its profits and share price over the last 10 years. The shares are currently trading at $6.23. With earnings per share at around $0.41, the company has a price-earnings ratio of around 15. With the recent acquisition of Hudson Pacific Corporation, the company expects underlying profit growth for 2017 of 20%.

'The company has a long history of successfully acquiring and integrating franchise systems. It has also bought food and coffee roasting businesses that it uses to supply the various franchise systems, enabling vertical integration and lower costs.

'As the company is in the food and coffee business, I believe Retail Food Group will be very resilient in the event of an economic downturn, and with management constantly looking for new opportunities should continue to grow well into the future.'

Disclosure: Phil Bish owns shares in Retail Food Group.

Along with a change in chief executive, the company is expanding into new markets.

BY JON MILLS • INTELLIGENT INVESTOR • 5 DECEMBER 2016

Aristocrat Leisure: Result 2016

Since Jamie Odell began as chief executive of Aristocrat Leisure on 1 Feb 2009, the company's share price has risen from $3.73 to $15.35, giving an annualised return of 19.8% before dividends.

Key Points

- ***Jamie Odell to retire***
- ***Another strong result***
- ***Expanding into new markets***

ARISTOCRAT LEISURE (ALL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$14.94	5%	Med–High	High

BUY Below $10.00 | HOLD | SELL Above $18.00

$14.94

After a job well done, Odell will retire in February 2017 to be replaced by Trevor Croker, who is currently responsible for the company's global product portfolio including the all-important development of popular games. Croker also led the Australasian business for six years during which it regained its dominant market position in Australia, so it seems he is well suited to the role.

Aristocrat's 2016 result was another cracker (see Table 1). It was even better than it looked, in fact, considering it includes an additional $25m – or around 2.7 cents per share after tax – in depreciation in relation to its machines leased to casinos in return for a share of the daily winnings. The company has assumed shorter useful lives on the basis that these machines will be replaced more quickly, hopefully by newer Aristocrat cabinets.

Led by various versions of its phenomenally successful Lightning Link game, Aristocrat's games make up 30 of the top 50 in NSW and 14 of the top 20 in Queensland.

This explains why the company sold 31% more machines in Australia in 2016 and, with the help of **operating leverage** and a 2% increase in average selling price to $20,903, segment earnings before interest and tax (or EBIT) increased by 49% to $169m.

However, the company now dominates an Australian pokie market limited by regulation to around 200,000 machines, so further growth will be harder to come by. The success of Lightning Link, though, means higher margin conversions – where existing Aristocrat machines are upgraded – rose 73% in 2016, and this remains a potential source of growth.

Rising in US

By contrast, EBIT growth in North America was a more subdued 28%. Outright sales of the company's Class III machines (see *Shoptalk*) rose 19%, to 11,503. Here too the company was able to increase its average selling price by 8% to US$18,104 due to the strong performance of its Arc Single and Helix cabinets.

Even more impressively, its installed base of Class III machines on participation – those leased to casinos in return for a share of the daily winnings – rose a staggering 39%, to 13,675 from 9,808. Strong sales of its Arc Double, Behemoth and Helix cabinets along with top performing games Lightning Link, Buffalo Grand, Britney and Game of Thrones all contributed.

Lightning Link is being rolled out in North America but is at a much earlier stage of market penetration than in Australia.

> ***Shoptalk***
>
> Class III games include slot machines that you generally find in Australia and around the world in casinos where a random number generator determines whether a player wins. Class II games are generally games of chance known as bingo linked to a central server that determines which player wins.

For its part, the Class II machines (see Shoptalk) owned by its subsidiary Video Game Technologies increased by a more sedate 4% to 21,427. Centered in Oklahoma, the company continues to see little effect on demand despite the economic impact of low oil prices on the region.

The company doesn't break out the average fee per day between Class II and Class III machines but overall fee per day rose a respectable 13% to US$48.19.

> **Management believes Aristocrat remains a 'growth stock' and so further acquisitions – including in digital – are possible should they make sense.**

While Aristocrat's Lightning Link and Buffalo Grand games were voted the number one games in the US premium leased and outright sales segments respectively, with it also holding the second position in each of these segments, the company expects more moderate growth in 2017. However, it still expects to sell more Class III machines and increase its Class III and Class II machines on participation.

Digital growing too

Driven by the continued growth of its Heart of Vegas app on Facebook, iOS and Android, EBIT from Aristocrat's digital segment rose 127% to $114m. A moderation in the cost of acquiring new customers, increases in the number of daily average users (to more than 1.26m at year-end) and a rise in the average revenue per daily average user to US$0.42 from US$0.38 all contributed.

Consistent with its multi-app strategy, the company has recently released a second app named Cashman Casino to keep its digital business growing.

The result of all this was free cash flow of $488m, a 64% increase on 2015, which enabled the company to repay US$270m in debt while also significantly increasing its dividend (see Table 1).

Table 1: Aristocrat 2016 result

YEAR TO 30 SEP	2016	2015	+/(–) (%)
REVENUE ($M)	2,129	1,582	35
EBITDA ($M)	806	523	54
U'LYING EBIT ($M)	673	431	56
U'LYING NPAT ($M)	398	236	69
U'LYING EPS (C)	62.4	37.1	68
DPS (C)	25*	17	47

*** Final dividend of 15 cents, unfranked, ex date 5 Dec 16, no DRP**
Note: 2015 figures include VGT from 20 Oct 14

With Aristocrat's earnings before interest, tax, depreciation and amortisation (or EBITDA) rising 54% to $806m, the net debt to EBITDA ratio is now a much more comfortable 1.2 times (compared to 2.6 times in 2015 and 3.6 times when VGT was acquired (see ***Odell bets his reputation***)).

Management believes Aristocrat remains a 'growth stock' and so further acquisitions – including in digital – are possible should they make sense. The company is also expanding into new markets where it currently has very little presence, including the Class III Stepper, Class II Video and the North American Video Lottery Terminal (VLT) markets.

The Class III Stepper market is a 15,000 to 20,000 units per year opportunity, with another 10,000 leased. The Class II video market totals around 28,000 machines while there are around 100,000 VLTs in the US and Canada.

We think this makes sense as Aristocrat can leverage its existing infrastructure, intellectual property and customer relationships to maximise its chances of making such an expansion a success.

Increasing price guide

Although growth will likely slow – perhaps a reason for Odell's departure – the company's excellent performance earns it an increase in our price guide, with our Buy price rising to $10 (from $8) and our Sell price rising to $18 (from $16).

Even so – if you ignored our premature **downgrade to Sell** – we recommend trimming your holding to keep it within our recommended portfolio maximum. While Aristocrat is undoubtedly a better business than before Jamie Odell took over, management change can involve risk. There's enough reason to **HOLD**, but Aristocrat's history of upsets suggests it's wise to keep your weighting below 5%.

Staff members may own securities mentioned in this article.

A spurned takeover bid earlier this year highlights that there might be value in this laboratory services company.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 6 DECEMBER 2016

ALS: testing the waters

What does laboratory services provider ALS Limited and **Treasury Wine Estates** have in common? Hopefully not much, because scientists and alcohol don't mix – at least not at work. Red wine's hell to get out of a white coat too.

Key Points

- ***Takeover bid highlights value***
- ***Chequered acquisition history***
- ***High margin but cyclical business***

ALS (ALQ) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$6.22	5%	Medium	Medium

BUY Below $5.50 · **HOLD** · **SELL** Above $8.00

$6.22

But ALS and Treasury Wine share one other characteristic – both have been the subject of failed private equity bids. Since Treasury Wine rejected KKR's bid in 2014, its stock has more than doubled. Say what you want about private equity (and we've said a few unflattering things) but they know a bargain when they see one.

In June this year, Advent International and Bain Capital bid $5.30 a share for ALS, valuing the company at $2.7bn. The company rejected the bid – correctly, we think – and since then the stock has jumped to more than $6.00. Is there still value here?

There's certainly more value in ALS than when we **shone the spotlight on mining services** in March 2013. At the time the stock had fallen from a peak of around $13 to $10. By late 2015 it was under $4.00 and the company had launched a capital raising at $3.35 a share.

Life's good

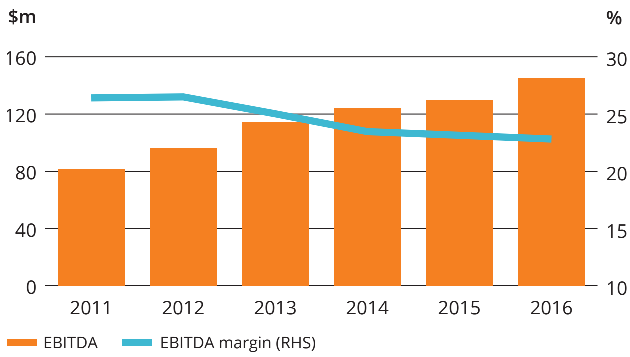
It's been a painful ride for shareholders but it's now a mistake to see ALS purely as a 'mining services' stock. In fact, private equity was probably most interested in ALS's Life Sciences division, which has little to do with mining.

Rather, ALS's Life Sciences division is the global leader in environmental testing. If you turn on a tap in Sydney, for example, you can rest assured that the water from the Warragamba Dam catchment area has been monitored by ALS. If you're renovating your house, ALS can tell you if that unidentified substance is asbestos.

Chart 1 shows why private equity wanted ALS. The Life Sciences division's profit growth over the past six years has been excellent, with (EBITDA) margins consistently above 20%.

It's no surprise then that the company is now increasingly focused on Life Sciences. Management is making acquisitions in the food safety area, with the intention of having around $250m of food safety and pharmaceutical testing revenues by 2018 (up from $105m in 2016).

Chart 1: Life Sciences division



Source: Company reports

An example is the recent acquisition of UK-based ALcontrol for $49m. After integrating it into ALS's existing operations, management expects the business to produce $10m in EBITDA. Management says other acquisitions are imminent.

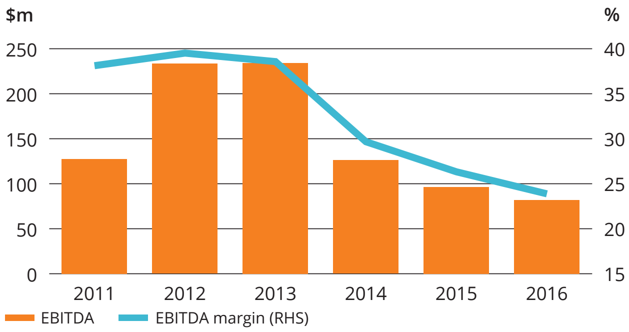
Testing turnaround

There's another reason why private equity wanted ALS: a looming turnaround in its Minerals business. This division provides analytical and testing services for the mining and exploration industries. If you need to know how much gold is in a sample of rock, for example, ALS Minerals will run tests to tell you.

> **If Life Sciences and Minerals are the 'good' of ALS, its Energy division is the 'bad'.**

Chart 2 shows that margins and profitability in the Minerals division have suffered as the mining boom has petered out. While the chart isn't pretty, management has cut 28% from divisional costs since 2012, meaning the margin remains at a relatively healthy 24%. Cyclical or no, Minerals is a decent-enough business.

Chart 2: Minerals division



Source: Company reports

The market is already anticipating a recovery in the Minerals business, which partly explains why ALS's 2017 forecast price-earnings ratio is a hefty 30. A turnaround is coming, though, with early evidence that miners and explorers are starting to spend again. This year's commodity price reversal will also help.

The good, the bad and the ugly

If Life Sciences and Minerals are the 'good' of ALS, its Energy division is the 'bad'. Within Energy, ALS's oil and gas business is truly ugly, having incurred $13m of losses in the first half of 2017 (another reason why the price-earnings ratio is artificially high).

It's here that management gets a rap over the knuckles. The US$533m supposedly '**EPS accretive**' acquisition of oil and gas services provider Reservoir Group from private equity in 2013 – the top of the boom – turned out to be a disaster (fancy that).

In 2015, a $290m writedown of its oil and gas assets was followed by a $325m capital raising. At the release of the 2017 first-half results last week, management announced it would sell this business. If the company gets $100m, it would be a good result.

You can see our preliminary sum-of-the-parts valuation for ALS in Table 1. There's one division – Industrial – which we haven't spent much time on in this review. Suffice to say it's mainly a small but reasonable LNG and resources-related maintenance business that's had consistent-enough margins over the years.

So what's the verdict?

While cyclical, ALS is a good business that we'd like to recommend at some point. Despite being somewhat capital intensive, it has produced decent free cash flow over the years. ALS has some similarities to the pathology industry because it's a scale business – higher volumes result in better labour and asset utilisation, which in turn generates better margins. In the recent 2017 first-half results, management confirmed that margins were below par but that they should improve from here.

Table 1: ALS sum of the parts valuation

	2016 EBITDA ($M)	LOW MUL-TIPLE	HIGH MUL-TIPLE	LOW VALUE ($M)	HIGH VALUE ($M)
LIFE SCIENCES	145.1	12	18	1,741	2,612
MINERALS	81.7	12	18	980	1,471
ENERGY	13.8			100	200
INDUSTRIAL	30.9	8	10	247	309
CORP. COSTS	(28.2)	10	10	(282)	(282)
NET DEBT				(438)	(438)
LAND AND BUILDINGS				163	200
EQUITY VALUE				2,512	4,072
SHARES ON ISSUE				504	504
VALUE PER SHARE				**4.98**	**8.08**

On the other hand, management's acquisition record has been poor. It was caught up in the resource boom – witness the Reservoir Group disaster. Whilst management is contrite, we're not convinced that lessons have been learned.

> **Weighing it up, there's some chance of disappointment.**

Over-optimistic?

It's possible that management is being over-optimistic about its ability to improve the returns from acquisitions like ALcontrol. International competitors are also looking for acquisitions in the less cyclical food and pharmaceutical testing space so bargains will be rare.

Weighing it up, there's some chance of disappointment – perhaps from acquisitions that don't work out, delays in the turnaround of the Minerals division, or an inability to sell its oil and gas business.

But we think the company is better value than the current price-earnings ratio and the relatively high multiples in the sum-of-the parts valuation in Table 1 suggest. Laboratory services can be a very profitable business through the cycle, as the company's margins indicate.

ALS's larger international competitors – such as SGS and Bureau Veritas – also trade at premium multiples of between 11 and 14 times forecast EBITDA. The company is almost certainly a takeover target for one of these big players, or private equity might return with another bid.

Given the risks though, we don't see a sufficient margin of safety to recommend the stock at the current price. We're commencing coverage, though, with the intention of becoming more familiar with the business over time. So we'll be ready to pounce if the stock falls back towards the bid price. **HOLD**.

Staff members may own securities mentioned in this article.

The government plans to halve the daily cash withdrawal limit in Macau to reduce capital flight.

BY JON MILLS • INTELLIGENT INVESTOR • 9 DECEMBER 2016

Crown falls on further UnionPay restrictions

Crown shares have fallen 6% today after **Melco Crown Entertainment**, in which it has a 27% stake tumbled 14% overnight. Melco Crown owns casinos in Macau and The Philippines and fell due to reports that China will halve the amount of money Macau gamblers can withdraw daily using their UnionPay cards.

CROWN RESORTS (CWN) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.29	4%	High	High

BUY Below $12.00 — HOLD — SELL Above $18.00

$11.29

Although there are other ways to bring funds into Macau, the restrictions will likely affect gross gambling revenue and hence casino profits in the short term. As such, it's a setback to the apparent cyclical upturn in Macau, where gross gambling revenue has been increasing in recent months, albeit helped by the opening of new casinos such as Wynn Palace and Las Vegas Sands' Parisian.

With another, MGM Cotai, due to open next calendar year, it may also result in greater competition among the Macau casino concessionaires to lure punters to their properties.

Over the medium to long term, however, the prospects for Macau remain positive. Improved transportation infrastructure, the Chinese cultural attachment to gaming, rising living standards in China and the ongoing diversification of both Macau and nearby Hengjin Island's economies into non-gambling businesses all bode well for Melco Crown (see ***Betting on Crown – part I***).

So far at least there's been no change to the UnionPay withdrawal limits overseas, including in Australia. This is a potential risk to Crown's Australian casinos too given that mainland Chinese represent a substantial percentage of the international visitors that provide one-third of Crown's revenue.

As today's news and the **arrest of Crown's staff in China** show, even if our investment case proves correct, there will be setbacks and Crown's share price likely won't increase in a straight line.

As we noted in ***Crown: adding up the chips*** on 14 November, Crown is a complex company with a wide range of potential outcomes. So it makes sense to start a bit below our maximum recommended portfolio weighting of 4% to allow room to buy more if a better opportunity presents itself. **BUY.**

*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.

Rising commodity prices and new wins for its enterprise software have improved the prospects for this mining software provider.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 8 DECEMBER 2016

Runge on the mend

When we brought Runge to your attention in ***Runge pivots from mining to software***, we liked its leading software business, used by miners to better help them manage their mining and production assets.

Key Points

- ***Advisory business now profitable***
- ***Large software contract secured***
- ***Software acquisitions likely***

RUNGE PINCOCK MINARCO (RUL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$0.505	3%	High	High

BUY	HOLD	SELL
Below **$0.50**	$0.505	Above **$0.90**

The drawback was the 'drag of a poorly performing advisory business'. This used to be Runge's main profit centre, but as commodity prices fell it became a millstone. Rising commodity prices have recently lifted that weight.

The advisory business derives most of its revenue from the coal industry. With the coal price rising from below US$80 per ton to nearly US$300 for coking coal, the business is showing signs of recovering, especially with mine sales and merger and acquisition activity picking up. We understand November was one of the division's busiest months in years. Operating conditions for GeoGAS, which provides mine gas consulting and laboratory testing to eastern coal markets, have also improved.

After cutting costs over the past few years, the advisory business should turn a small profit in 2017, making our initial estimate of a neutral contribution from the advisory and GeoGas businesses look conservative.

This doesn't change the fact that the consulting business remains a lousy one. Although we'd prefer to see it sold, at least the bleeding has stopped. Now management attention can turn to growing the software division, which is where the real money will be made.

Ka-Ching at Kazzinc

Higher commodity prices have improved the prospects for this division, too, by boosting the coffers at the large mining houses that use it. As an example, Runge recently signed up Kazzinc, a Glencore subsidiary, for its full suite of enterprise products.

It's an important win. Kizzinc is a substantial operation, comprising four underground and two open pit zinc mines that contribute about 20% of Glencore's operating earnings. By revenue, it's about as big as Santos. More interesting is the big picture potential; success at Kazzinc could lead to wider adoption across Glencore's businesses.

Still, it's going to take more than a few good months to see a meaningful improvement in software spending by the miners. But the additional licence and implementation revenue is a step in the right direction for our profit estimate this financial year.

Another acquisition?

In other news, Runge also raised $14.5m in September, which is probably an indication of its acquisition intentions. The last time the company raised capital, two software acquisitions followed. With cash on display to potential vendors, Runge can move quickly if required, although the company is not trigger happy. It took 10 months after they last raised capital to buy the Flexsim software and 21 months before iSolutions was purchased. We're not anticipating immediate acquisitions but do expect them within the next few years.

With the advisory division returning to profit, we're increasing our buy price from $0.40 to $0.50 – very close to the current price. For the moment we're sticking with **HOLD**, but would probably upgrade if the price settled much lower.

Disclosure: The author owns shares in RungePincockMinarco.

A downgrade to full-year dose sales doesn't change our long-term view, but it's a black mark against management.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 9 DECEMBER 2016

Sirtex smashed on lower growth

For sharemarket investors, there aren't many words more annoying than 'Trading update'. The share price of radiotherapy maker Sirtex Medical has fallen 40% following today's update, which revealed that sales growth in the first half of the financial year would be below expectations.

Key Points

- ***Dose sales to slow***
- ***Issue no longer seems temporary***
- ***Still plenty to like***

SIRTEX MEDICAL (SRX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$15.17	**3%**	**Very High**	**Very High**

First-half dose sales in the Americas and Europe, Middle East, and Africa (EMEA) is expected to be a lacklustre 4–6%, well below last year's 16%. Chief executive Gilman Wong said the result is due to insurance reimbursement restrictions, increasing competition and the approval of a new drug that competes with SIR-Spheres – a last-resort treatment for liver cancer.

Earnings before interest, tax, depreciation and amortisation (EBITDA) is expected to be in the order of $30m–32m, a decline of 9–16% compared to the prior period, though a lower EBITDA figure was expected due to an increase in research costs as the company prepares for a major clinical study next year. Management expects a better second half and that full-year dose sales will increase 5–11%, with EBITDA of $65m–74m – a decline of 0–12%.

What bothers us most about this update is that the company also warned of slowing growth prior to the 2016 full-year result but assured investors that it was due to temporary factors. Sirtex is a well-managed company, but two downgrades in seven months is a black mark – either it was generous with the word 'temporary' or overly optimistic.

Treading carefully

These situations must be handled delicately. On the one hand, we're increasingly suspicious that Sirtex's growth may be slowing, particularly if ongoing clinical trials don't boost SIR-Spheres to first-line treatment status. Management's actions around the last two downgrades also add a slightly uncomfortable edge.

On the other hand, as we explained in ***Is Sirtex's $20,000 teaspoon enough?***, there's plenty to like about Sirtex. The company has an approved product, $100m of net cash to fund its clinical trial and research programs, and a huge untapped market for SIR-Spheres if trials are successful in giving it first-line status. Sales growth of 5–10% is well below that achieved over the past five years, but it's still nothing to sneeze at.

Even if growth has permanently slowed, the sharp fall in the share price could mean we're being adequately compensated for it with a lower valuation and price-earnings ratio of 16. Whatever the case, this update is a reminder that one-product companies are high risk. We'll look more deeply into the situation in case it presents an opportunity, but for the time being we're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

Today we look at the fascinating world of asset writedowns. Try to control your excitement.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 6 DECEMBER 2016

Getting writedowns right

In the comments section of our recent article ***Carsales core business motoring***, member Reece R asked:

Hi James, could you please elaborate on why 'writedowns can be an issue for asset-light businesses like Carsales'? How are writedowns treated in the books? Is the amount treated as an expense in one year rather than being depreciated, and is it a tax deductible expense in that year?

These are interesting questions, at least for those of us who get our jollies delving into the nitty-gritty of company accounts. I'll try to answer them here as best I can (it's a complicated area and, while I have accounting training, I'm neither an accountant nor a tax expert).

Companies such as **Carsales.com**, whose business depends on technology or intangible assets rather than physical assets, are sometimes informally described as 'asset-light'. In fact, all the online classifieds companies, including **Seek** and **REA Group**, could be described this way.

Let's (not) get physical

This means there are few physical assets on the balance sheet. For Carsales you can see this in Table 1, with the 'Before' column showing an abridged version of the company's 2016 balance sheet (see page 50 of the annual report). The company has only $6.6m in property, plant and equipment on its books.

Table 1: Carsales hypothetical writedown

BALANCE SHEET	BEFORE ($M)	WRITEDOWN ($M)	AFTER ($M)
TOTAL CURRENT ASSETS	74.5		74.5
INVESTMENTS	267.0		267.0
PROPERTY, PLANT AND EQUIPMENT	6.6		6.6
INTANGIBLE ASSETS (INC. GOODWILL)	191.6	(56)	135.6
OTHER	6.1		6.1
TOTAL NON-CURRENT ASSETS	471.3		415.3
TOTAL ASSETS	**545.8**		**489.8**
BORROWINGS	226.9		226.9
OTHER LIABILITIES	58.5		58.5
TOTAL LIABILITIES	**285.4**		**285.4**
TOTAL EQUITY	**260.4**	**(56)**	**204.4**

Its major assets are 'Investments', which includes its stakes in overseas businesses in South Korea and Brazil, as well as its stake in the ASX-listed **iCar Asia**. Its 50.1% stake in finance provider Stratton is mainly recorded within the 'Intangibles' asset category, because the purchase price was mostly goodwill ($56m of goodwill out of the $59m purchase price).

As mentioned in ***Carsales core business motoring***, both iCar Asia and Stratton are now struggling. Accounting standards generally require that assets be written down if their values, or the cash flows they are expected to generate, have deteriorated.

According to that review (and ignoring any changes in value since then), it's possible Carsales might need to make writedowns of $68m related to both iCar Asia and Stratton. The former would be because Carsales' stake in iCar Asia is no longer worth what it paid, and the latter because the goodwill related to Stratton has been 'impaired'.

Stratton stacks it

Focusing just on the potential Stratton goodwill writedown of $56m, it would be taken through the income statement as an 'expense' in the year it was impaired (which is why a company will sometimes report a loss when it makes a writedown). So why can this non-cash impairment be a problem for asset-light businesses?

Well, Carsales will reduce the value of the Intangibles asset (specifically, goodwill) by $56m and, because the writedown also feeds into lower retained earnings, it effectively reduces shareholders equity by the same amount. The hypothetical 'After' column in Table 1 shows this effect (ignoring any iCar Asia writedown).

This might in turn have other implications. If Carsales then had insufficient retained earnings, it might have to skip a dividend (as dividends must be paid from earnings). Also, depending on its banking covenants, the company might even be forced to raise capital. In the hypothetical example shown, Carsales' debt-to-equity ratio has jumped from 87% to 111% because of the goodwill writedown.

> **Without much in the way of hard assets to cushion the blow, writedowns can hit equity hard and in turn affect dividend payments and balance sheet leverage ratios.**

At this point it's important to clarify that we actually *prefer* asset-light businesses like Carsales. They tend to produce strong cash flow and high returns on equity. In 2016 Carsales ROE was 44%, for example.

One thing leads to another

But they do have downsides. Without much in the way of hard assets to cushion the blow, writedowns can hit equity hard and in turn affect dividend payments and balance sheet leverage ratios. If something goes seriously wrong, there can be significant downside.

We don't expect dividend cuts or capital raisings at Carsales but recent share price weakness is, in our view, related to concerns around Stratton and iCar Asia. Both assets are small and relatively insignificant to Carsales, but they increasingly look like dud investments (we've all made them).

As to Reece's enquiry about the tax deductibility of writedowns, it's a complicated area with which I'm not particularly familiar. Goodwill writedowns, however, are not tax deductible. Other types of writedowns might give rise to deferred tax assets, but any cash tax refunded will usually occur at a later date than the writedown itself.

You'll often see management label a writedown as non-cash, which is best described as accurate but not truthful. It's simply a timing difference. Value has been eroded; the writedown is just the crystallisation of an earlier erosion.

So while writedowns don't destroy value of themselves, they can have secondary effects on the balance sheet once they're made. Whilst complicated, understanding how they can affect various balance sheet items will make you a better informed investor.

Disclosure: The author owns shares in Seek. This is not a recommendation.

BWP Trust share price falls

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 5 DEC 2016

BWP TRUST (BWP) / HOLD

Price at review **$2.84**

Max. portfolio wght. **6%**

BUY Below **$2.20** **HOLD** **SELL** Above **$3.00**

$2.84

BWP Trust has fallen around 3% since the US election and 8% since we recommended selling in ***Getting a Hold on property trusts*** (Sell — $3.08) on 20 September 2016.

BWP is not alone, with long-term bond yields rising on the back of Donald Trump's election victory. Listed property stocks have been under pressure with the ASX 200 A-REIT index down approximately 2% compared to the general market's increase of almost 4%.

As a result of the fall, BWP's share price is now below our recommended Sell price of $3.00. With no material news relating to the company and a forecast dividend yield of 6% that we expect to grow between 2%-3% annually, we are upgrading our recommendation for BWP Trust to **HOLD**.

Staff members may own securities mentioned in this article.

Bonds/cash in portfolios

Many value investors talk about investing in bonds as well as shares and having a percentage kept as cash. Neither of your portfolios do this. Do fixed interest products and cash have a place in a portfolio made up of your recommendations?

9 Dec 2016 – **James Carlisle**: We're unable to provide personal advice, so my comments need to be general – but most advisers will recommend having some of your assets in cash and/or bonds to provide diversification. Personally I'm not convinced by the arguments for this – at least with truly long-term investments – because there are good reasons to think that shares (and other real assets) will ultimately prevail (as they have over long periods in the past).

If cash and bonds outperformed the real productive elements of the economy (eg shares and property) over 100 years, say, then it's hard to see where the money would come from to pay the interest on the bonds and cash. So it's little wonder that over periods of two or three decades or more, history has shown that if shares do badly then they lose out to cash/bonds by a little, but if they do well then they hit them out of the park.

Of course bonds and cash will reduce the volatility of your overall asset pool over shorter periods of time, but that comes at a cost over the very long term. If we're talking about truly long-term investments, then the reduction of volatility becomes less important and the long-term cost becomes more important. This is why people recommend a higher proportion of shares for younger people. It also gives regulators and advisors a quieter life to recommend more bonds rather than less – because if shares have a bad ten years (as they have recently in fact), then people are inclined to forget that they were originally in it for the long haul.

Anyway, none of that is really relevant to your question (it's a lazy Friday afternoon and I got a bit carried away) because it concerns the very personal matter of asset allocation and is therefore somewhat beyond my remit. Our job is really to advise on the shares element of people's overall asset pool, whatever percentage that may amount to. That's also the remit of our Growth and Equity Income Portfolios. The idea is that people can use them for the shares element of their overall asset pool, and can make their own personal decisions about how much bonds and cash to hold as well.

There's more on (my view of) how much cash to hold in **this article**.

Investing in stages

I have recent receive a sizeable amount of cash from a property sale. I already have some shares and intend to invest this new cash into shares now also. How would you generally suggest investing larger sums? I was thinking to buy some of the current recommendations and then add more as they come out over the next year to average the entry point out. What would be a rough guide for breaking up a 8% 'buy' recommendation into multiple purchases? Are 2% lots too small?

9 Dec 2016 – **James Carlisle**: First of all, please bear in mind that we're not able to provide personal advice since, amongst other things, we know nothing about your personal circumstances, so you'll need to interpret our general advice to suit your particular situation.

That said, the best way to go from zero per cent invested to fully invested with a large sum, generally speaking, is gradually. There are a couple of reasons for this: first you smooth out your entry points to avoid the market's peaks and troughs; and second you can be patient as the best opportunities appear to build your portfolio.

The second point is probably the key to it. If you just went out and bought all our Buy recommendations right now, or all the stocks that you personally thought looked undervalued, then you'd end up with a very unbalanced portfolio. The better bet is to be patient, see what opportunities appear and build a portfolio over time.

In that respect, it's less about buying small chunks of investments now, in the expectation of buying more later, and more about being picky with the stocks you buy. If and when something looks attractive, then you might as well buy the entire starting stake that you'd want for a portfolio.

Note, however, that this doesn't mean buying up to our 'maximum recommended portfolio weighting' straight away. That is deliberately stated to be a maximum, so with most investments, we suggest starting well below that level – around half in many cases – to give some scope for the holding to grow before breaching the maximum if things go well, or to purchase more if the price falls and the stock becomes more attractive (which aren't necessarily the same thing).

Brickworks

Building approvals fell sharply in October, down 12.6% compared with market expectations for a modest 2.0% rise and followed a revised 9.3% contraction in September. I understand that the building products division is only ~10% of the Brickworks valuation but do these figures change the valuation at all?

5 Dec 2016 – **Gaurav Sodhi**: We havent counted the boom in our valuation. As you can see from **our last valuation** of BKW, we've been very conservative with valuing the building materials arm, using much lower sustainable earnings than what the business generates today.