Weekly Review

RESEARCH

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JB Hi-Fi's high share price and low interest rates make it much easier to justify what is a pretty ordinary acquisition.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

JB Hi-Fi: Good Guys, bad buy?

The media invariably cheerleads for big acquisitions. **They create headlines**, after all. JB Hi-Fi's acquisition of appliance retailer The Good Guys might make financial sense, but whether it's strategically sensible is another thing entirely. Read on if you'd like to know the difference.

Key Points

- ***Makes short-term financial sense***
- ***Strategically much more questionable***
- ***Store management transition a big risk***

JB HI-FI (JBH) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$28.85	4%	Med–High	Med–High

BUY Below $20.00 | HOLD | SELL Above $40.00

$28.85

First, the details. JB Hi-Fi will pay $894m to buy the 101-store chain The Good Guys from the Muir family. A new debt facility of $500m and an equity raising of $394m at $26.20 a share – more on this later – will fund the transaction. The combined business will have more than $6bn in sales and almost $200m in net profit (see Table 1).

JB Hi-Fi will become the Australian market leader in consumer electronics and appliances, with **Harvey Norman** a close second. It's already cleared The Good Guys acquisition with the ACCC during the prolonged courtship, so it's a done deal.

Financially compelling?

At the time of JB Hi-Fi's **2016 results** last month, managing director Richard Murray said the company would only pursue The Good Guys if it made 'compelling financial sense'. Whenever you hear this, it's usually code for 'the transaction will be EPS accretive'.

As Table 1 shows, the transaction will increase JB Hi-Fi's pro forma 2016 earnings per share by no less than 11.6% (169.5 cents divided by 151.9 cents). Whenever a particular transaction results in earnings per share rising, it's called 'EPS accretive' (or 'EPS positive'). Without demonstrating EPS accretion, a management team will usually find it much harder to justify an acquisition to the market.

Table 1: 2016 pro forma EPS accretion

	JB HI-FI	THE GOOD GUYS	INTEREST	COMBINED
SALES ($M)	3,955	2,090		6,045
EBIT ($M)	221	74		295
EBIT MARGIN (%)	5.6	3.6		4.9
NPAT ($M)	152	52	(11)	193
EPS (CENTS)	151.9			169.5

Source: Company acquisition presentation (page 20)

EPS accretion is much easier to achieve when your share price is high – as JB Hi-Fi's is – and interest rates are low. Had JB Hi-Fi needed to raise capital at $20 a share and borrow at 5%, for example, the EPS accretion would have been just 3.4%. But helped by the collapse of Dick Smith – and management's

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IMPORTANT INFO

DISCLAIMER This publication is general in nature and does not take your personal situation into consideration. You should seek financial advice specific to your situation before making any financial decision. Past performance is not a reliable indicator of future performance. We encourage you to think of investing as a long-term pursuit.

DISCLOSURE Staff own many of the securities mentioned within this publication.

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impressive ability to negotiate an average interest rate of 3.1% on the $500m of new debt – the transaction looks financially compelling.

Buying The Good Guys make financial sense in other ways too. Perhaps most importantly, JB Hi-Fi will have greater buying power. Whereas once it sold Samsung laptops, now it will sell Samsung fridges too. JB Hi-Fi expects annual 'synergies' of $15m–20m after a three-year integration period, a figure that seems very conservative.

Strategically weak

For all the financial benefits, though, we're not convinced buying The Good Guys makes strategic sense. Crucial to understand is that a transaction that is EPS accretive in the short term is not necessarily value-accretive in the long term. Indeed, there are some warning signs The Good Guys could end up destroying value.

Selling appliances isn't a great business. It's highly competitive, with Harvey Norman a ferocious rival and consumers more comfortable with purchasing appliances online. That means margins are low – The Good Guys earned a pro forma operating margin of just 3.6% in 2016 (compared with JB Hi-Fi's own 5.6% margin).

It's also cyclical. Appliance sales benefit from strong housing markets, so it's possible JB Hi-Fi is buying The Good Guys towards the end of a cyclical upswing. The fact The Good Guys has increased profit by 64% since 2014 lends weight to that theory. The $894m purchase price looks high next to the 2014 operating profit of $45m.

Most importantly of all, though, is that selling appliances in stores requires motivated salespeople. But there's a big risk here because The Goods Guys' business model has changed dramatically. Prior to 1 July 2016, more than half the stores were owned in joint venture arrangements with store management. This part-ownership arrangement ensured the store managers had an incentive to run their businesses well.

Management transition

In preparation for the sale, the stores became fully owned by The Good Guys. Some former joint venture managers opted to leave entirely, while others agreed to stay on for 12 months as store manager employees. Even if handled well this management transition will be extremely disruptive. At worst, store managers 'may not be sufficiently incentivised under their management agreements' (as the Key Risks section of the acquisition presentation highlights).

No wonder JB Hi-Fi has forecast The Good Guys' sales and earnings to be flat in 2017. With management in transition, even that might prove optimistic.

Then there's the cultural mismatch. The younger, edgier JB Hi-Fi brand sits uneasily next to the daggy, old-fashioned Good Guys. In an attempt to minimise the risks, JB Hi-Fi will retain The Good Guys' head office as well as its managing director. Keeping the businesses separate makes sense, at least during the transition period.

> **Offsetting that is our view that JB Hi-Fi has diluted the quality of its own business with an inferior one.**

So what should shareholders do?

Well, we switched back to Hold in ***JB Hi-Fi: Result 2016*** partly in anticipation of the market looking favourably upon the EPS accretion that The Good Guys acquisition would deliver. If management gets this acquisition right, earnings growth will be assured for a few years and EPS close to $2.00 a share is possible in 2018.

Offsetting that is our view that JB Hi-Fi has diluted the quality of its own business with an inferior one. The stock deserves a lower price-earnings ratio accordingly.

Entitlement issue

The retail entitlement offer – details are in Table 2 – opens on 21 September. We suggest you subscribe for your entitlement (assuming the share price is above the $26.20 issue price), but then sell down to no more than our maximum suggested weighting of 4%. This isn't the time to be increasing your long-term exposure to JB Hi-Fi.

If you wish to sell your entitlement on market, trading begins on 16 September (when JB Hi-Fi shares will also come out of trading halt) and ends on 23 September. If you don't sell or subscribe for your entitlement, they will be sold on your behalf and any funds remitted to you.

Now that The Good Guys transaction has been announced, it's hard to be enthusiastic about it – whatever the EPS accretion. Our suspicion is that the market has already assumed the transaction will take place and, as a result, the reaction on Friday will probably be muted.

Table 2: Entitlement issue

RATIO	1 for 6.6 shares
ENTITLEMENT PRICE ($)	26.20
ENTITLEMENTS TRADING BEGINS	16 Sep
ENTITLEMENT OFFER OPENS	21 Sep
ENTITLEMENTS TRADING ENDS	23 Sep
ENTITLEMENT OFFER CLOSES	30 Sep
NEW SHARES BEGIN TRADING	12 Oct

Of course, we've underestimated this business before and may be doing so again. However, appliance retailing is not what made JB Hi-Fi successful. Indeed, if anything it could be the company's undoing. Subject to our 4% maximum suggested weighting, **HOLD**.

Staff members may own securities mentioned in this article.

Deregulation and new rent controls make a perfect world for the country's top pathology labs.

BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 15 SEPTEMBER 2016

Sonic Healthcare blessed by regulators

Imagine a conspiracy brewing in corporate Australia: the Government secretly wants to create an all-powerful and obscenely profitable duopoly in the pathology industry. How might the plot unfold?

Key Points

- ***Pathology competition decreasing***
- ***Rent controls will save operators money***
- ***Partially offset by lower Medicare incentives***

SONIC HEALTHCARE (SHL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$20.71	5%	Low–Med	Medium

BUY	HOLD	SELL
Below $18.00	$20.71	Above $30.00

We first noticed **reducing competition in pathology** a few years ago, but since then things have become even more extreme – and a recent Government proposal could mean a significant jump in profitability for the two industry heavyweights, Sonic Healthcare and **Primary Health Care**.

Before we gather our tin foil hats, though, let's set the scene with a few facts and figures. These days, most medium to large medical practices have a space dedicated to the collection of blood or specimens that need to be sent to a lab for testing. These 'collection centres' – often no larger than a walk-in wardrobe – aren't run by the practice; they're leased by a pathology provider.

When a GP refers you to get a blood test, you're technically able to get it done anywhere you like. But let's face it, if you walk out of the doctor's office and there's a collection centre eight feet to your left, you're unlikely to shop around; you'll just hand the script to whichever pathology service happens to be affiliated with that clinic.

In any case, why would anyone bother shopping around: 85% of pathology services are bulk-billed with no out-of-pocket expense for the patient – the highest rebate rate of any medical specialty. There's no financial incentive to choose one provider over another, nor much difference in service quality, so the deciding factor is down to convenience.

David and Goliath

Until 2010, however, there was a limit on the number of collection centres a pathology group was allowed to operate. The idea was that if Australia had too many collection centres it would make the system inefficient and so add expense for Medicare, which essentially funds the whole industry. But here's where the plot begins to thicken.

In 2006, auditor KPMG released a report that said the existing regulatory framework hindered the growth of small operators and recommended that there be no cap on collection centres. Four years later, the Government deregulated collection centre licencing with the expectation that it would increase competition. And it did – but only in the sense that both David and Goliath were unchained at the same time.

Pathology, you see, is an extremely technology intensive business. Tests typically rely on expensive automated equipment and this large fixed cost means that the average cost per test goes down as the volume of tests running through the machine increases. In other words, the operators with the highest turnover earn the highest profits, and this was the main incentive behind all the mergers of the past 20 years.

Collection centre explosion

Deregulating collection centres did two things. The first, as you might expect, is that they started popping up everywhere, especially in the smaller medical practices previously ignored due to the cap on centre numbers. Since 2010, the total number of collection centres has risen from 2,200 to 5,500 today.

But what the Government wasn't expecting, it seems, was how the industry's powerful **economies of scale** would affect prices.

The two dominant players, Sonic and Primary, with their existing efficiency and cost advantages could afford much higher rents for the collection centres than smaller operators.

> **“We don’t really think the Government was conspiring with Sonic and Primary, but it might as well have been.**

Without a cap on the number of centres they could operate, they were now in a position to outbid their competitors.

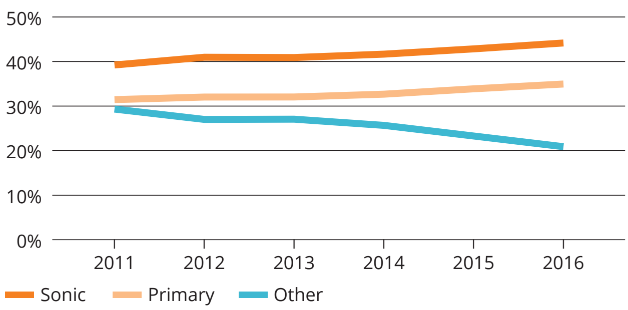
Rents rose dramatically and those little wardrobe sized collection centres now command rents to rival top real estate in Point Piper or Toorak, with many costing thousands of dollars a week ... per square meter.

Lower competition

We don’t really think the Government was conspiring with Sonic and Primary, but it might as well have been. Far from helping the little guys, deregulation and the land grab that followed made pathology an even less competitive environment.

As you can see in Chart 1, Sonic and Primary have been increasing their market share at the expense of smaller operators, which have been progressively priced out of the market.

Chart 1: Pathology industry market share



Source: IBISWorld

To put it in perspective, the Australian Competition and Consumer Commission (ACCC) says that competitive issues typically arise in an industry when the top four firms account for 75% or more of industry revenue, or where one company has more than a 15% share. This threshold is what triggers an investigation into a proposed merger that may be anti-competitive.

Sonic and Primary – two companies, not four – now account for 79% of the pathology industry’s total revenue and Sonic, the largest player, accounts for almost half.

Rent controls

Whether by will or accident, there’s no doubt that the Labor Government’s actions in 2010 concentrated power in the two largest pathology operators.

But here’s where the conspiracy theorists really have something going for them. The current Liberal Government **intends to introduce new provisions** to collection centre regulation that would mean medical practices can only charge ‘fair market value’ rents. That is, rent will now be based on local commercial rates.

It isn’t unusual for a collection centre located inside a practice to pay five times the rent that would be charged were it located separately but nearby.

Morgan Stanley estimates that rent expense has risen from 5% of Sonic’s revenue in 2010 to 15% today. Rising rent costs have been a significant drag on profit growth, so the proposed regulatory changes would be a huge saving for Sonic and Primary and a significant loss of income for medical practices.

Table 1: SHL result

YEAR TO JUNE	2016	2015	+/(–) (%)
REVENUE ($M)	5,052	4,201	20
EBITDA ($M)	876	731	20
NET PROFIT ($M)	451	348	30
EPS ($)	1.09	0.86	27
FINAL DIVIDEND	44 cents, up 7%, 30% franked ex date 8 Sept		

However, as we’ve **explained previously**, the Government is also cutting the $6.00 bulk billing incentive for pathology, which is currently paid to providers who bulk bill certain patients, such as children, concession cardholders or those in rural areas (the latter of which garners a $9.10 payment). Sonic expects this will shave around $50m from revenue, though that loss will still be more than offset by the new rent controls.

> **All things being equal, we expect Sonic and Primary's profit margins to be materially higher a few years from now under the Government's proposed changes.**

Macquarie Securities estimates that the rent caps will save Sonic around $116m at its 2,000 collection centres, leaving the company a good $66m better off if and when all the regulatory and Medicare changes go through. After tax, that would boost net profit by around 10%.

The real benefit, though, will only be seen over many years. A large proportion of Sonic's operating costs are fixed due to the testing equipment mentioned earlier, and, with rents anchored by commercial rates, the company's **operating leverage** will be even greater.

As Sonic continues to grow its market share – and the overall number of tests increases thanks to an ageing population – more of each incremental dollar of revenue will fall to the bottom line. All things being equal, we expect Sonic and Primary's profit margins to be materially higher a few years from now under the Government's proposed changes.

So, we'll ask again, if the Government secretly wanted to create an all-powerful and obscenely profitable duopoly in the pathology industry, how might the plot unfold? First, the Government would deregulate the industry so that the two leading companies could outbid smaller rivals at rent negotiations, thus driving them out of business. Second, when the industry is more concentrated than ever, it would introduce rent controls so that the two biggest players no longer have to pay sky-high rents to medical practices. Economies of scale should take care of the rest.

Better to wait

The question now is what's Sonic worth? Management expects EBITDA to rise 5% in 2017, with the potential for new acquisitions to add to that. The stock currently trades on a forward price-earnings ratio of around 18, which isn't particularly expensive for a business of this quality.

We're notching up our Buy price to $18, which would put the stock on a forward price-earnings ratio of 16. Conservative, no doubt, but we're mindful of two things and don't want to be caught overpaying. The first is that given the need to constantly upgrade expensive equipment, free cash flow – which can be distributed to shareholders – typically trails net profit. Despite the seemingly low price-earnings ratio, the current free cash flow yield is only 4.4%.

The other thing to note is that Sonic suffers from 'customer risk' as the company essentially has just one customer, and a powerful one at that. The Government, mind you, is a whimsical creature. In December, when it **proposed various Medicare fee cuts to lab services**, Sonic's share price promptly dropped 15%. If Sonic did become super profitable, the Government would have plenty of incentive to whack down Medicare rebates even more to cut costs from the healthcare budget.

Nonetheless, with good management, various competitive advantages and economies of scale, there's plenty to like about Sonic and we hope we get the chance to upgrade sometime soon. **HOLD**.

Staff members may own securities mentioned in this article.

A recovery in mining services is underway but the market is already pricing in plenty of optimism.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 13 SEPTEMBER 2016

Mining services update: FY2016

What a difference a year makes. At the start of the year, what remains of our mining services mini portfolio (see ***Time to buy mining services?***) appeared irredeemable.

Key Points

- ***Mixed results***
- ***Worst appears over***
- ***Debt in some companies remains high***

AUSDRILL (ASL) / HOLD

Price at review **$1.62** | Max. portfolio wght. **1%** | BUY HOLD SELL

BRADKEN (BKN) / HOLD

Price at review **$2.33** | Max. portfolio wght. **1%** | BUY HOLD SELL

MACMAHON HOLDINGS (MAH) / HOLD

Price at review **$0.11** | Max. portfolio wght. **1%** | BUY HOLD SELL

Bradken, mired in debt and rejected by no less than four suitors, languished at just 40 cents per share; **Ausdrill**, also debt heavy and struggling to put its fleet of drill rigs to work, fell below 30 cents. Only **Macmahon**, recapitalised thanks to asset sales and restructured, appeared certain to survive.

Just nine months on, Bradken's share price has leapt five times and Ausdrill's almost six times.

The entire sector, especially the debt heavy, asset heavy minnows in our mix, has lifted as excess capacity is cleared and miners again open their wallets. The gold miners, in particular, have saved the day, buoyed by record gold margins.

Well, that is perhaps a bit strong. The sector in aggregate, and our mini portfolio specifically, remains in the red (not helped by recognising losses on **Emeco** and NRW). But death no longer stalks these businesses.

Bradken, Ausdrill and Macmahon reported mixed results that simultaneously excite and frighten.

Ausdrill

Ausdrill's full-year result was one of the best of the season. Although revenue rose only marginally, net profit rocketed 10 times compared to last year's disastrous outcome; although it looked good on paper this result was built on failures of the past as much as operating improvements.

Lower costs helped lift earnings before interest, tax, depreciation and amortisation (EBITDA) margins to 16% and falling debt lowered interest costs. These were necessary changes that contributed to the better outcome.

Just as important, however, was the impact of several years of impairments and asset sales that have savaged the value of balance sheet assets by 40% over three years. One of the upsides from a shrinking asset base is lower depreciation, which is now half the sum reported three years ago. This helped lift profits as much as operational improvements did.

To be fair, free cash flow was also strong. Operating cash flow actually fell 20% reflecting asset sales over the year, but capital expenditure was slashed by 60% to just $12m. That meant Ausdrill generated free cash flow of almost $80m which was, in addition to $50m received from asset sales, put to work lowering debt.

Debt has now fallen from a peak of $460m in 2013 to $215m. With interest cover of just over 3 times, it is still far too high but repayments aren't due until 2019 and, if cash flow of this scale continues, Ausdrill is likely to be in the clear.

Booming gold margins have lifted revenue, especially in Ausdrill's African unit which generated almost all its profit, but the huge improvement in the share price is the market's reward for no longer being in imminent danger of going broke.

On an enterprise value to EBITDA ratio of just over five times, Ausdrill still looks cheap. It also now trades at a small discount to net tangible asset value and those who have managed to stay the course have done reasonably well. There is no better illustration of the difficulties, perils and profits of distressed investing. We don't recommend it often.

Even though it looks cheap, Ausdrill is still vulnerable to industry deterioration. It is better but not quite fixed. **HOLD**.

> "It has been a painful journey but things appear to be on the mend.

Bradken

Bradken's result was decent simply because the market's worst fears were not realised. A business that supplies both capital and consumable goods to the mining industry, Bradken's revenues have collapsed from $1.5bn in 2012 to just $819m last year as capital goods orders disappeared.

Although revenue declined 15% over the full year, it actually grew slightly in the second half, suggesting a turnaround. Underlying EBITDA, down 20% to $108m, still implies stable margins of 13%.

Net profit was unsurprisingly weak and 13% lower than last year but there was an improvement in the second half of the year, when the business generated $22m in net profits.

Two figures stood out: free cash flow, at $60m, was 57% higher than last year and net debt fell 11% to $352m. That is still a big number and, while the bulk of that debt is due in 2018 and 2019, Bradken isn't out of the woods yet.

Asset sales worth $17m helped lower debt but a refinancing or capital raising is still needed to bring the balance sheet back from the brink. A major restructure should simplify the business to create two broad product groups: consumables and steel castings.

Restructuring has made for messy accounts but asset impairments of about $400m over the past two years should lower future depreciation charges and costs have been slashed by moving production to lower-cost foundries. Capital expenditure, almost $50m last year, fell to just $20m and helped free cash flow generation.

It has been a painful journey but things appear to be on the mend. Yet Bradken's share price reflects the improvements and there is no longer a buying opportunity. **HOLD**.

Macmahon

What was originally one of the scariest stocks in our mini portfolio has turned out to be the most boring. Selling its Mongolian division for an unbelievable sum has repaired Macmahon's balance sheet and the business has shrunk to reflect lower expected revenues.

The result, which we had expected to be a decent one, was one of the disappointments of the season.

Comparisons with prior periods are misleading as Macmahon has drastically shrunk its workforce and asset base. Over the past three years, for example, net property plant and equipment has fallen by over 70% and total assets are just a third of what they were in 2013. The workforce has fallen 60% over the same time.

Naturally, revenues and profits have suffered with revenue halving over the year. EBITDA margins have also fallen and the business generated profit of just over $1m.

The stock appears to be appalling value on a multiple of 125 times earnings. That is also misleading. Excluding a small impairment, underlying profits came to $3m and were affected by contract completions and security problems in the Nigerian business. New contract work is yet to contribute to earnings while high African costs should not be recurring although there is a risk the business might exit Nigeria altogether.

The worst part of the result was weak cash flow. Operating cash flow of just $9m was lousy against EBITDA of $39m and, with capital expenditure higher than last year despite a smaller asset base, free cash flow was in the red. There are two problems: Macmahon has been slow to collect cash from clients and new contract wins have required higher capital expenditure. We'll be watching this figure closely.

The balance sheet is among the strongest in the sector with $57m in net cash compared to a market capitalisation of just $130m. Macmahon appears remarkably cheap on an asset basis (0.6x NTA) and enterprise value to EBITDA basis (EV/EBITDA of 3). The lack of free cash flow is an annoyance but the net cash position does provide some protection.

Despite the cheapness, this isn't a sector to be bought by conservative investors. Some may choose to look again at Macmahon but, recognising the high risk and careful portfolio management needed to curate positions in this sector, we'll decline an upgrade. **HOLD**.

Although we are yet to turn a profit from the space, the turnaround in the entire sector has been remarkable; a reminder that the time to buy a cyclical business is in the teeth of the downturn. Another reminder, which poor returns from our mini portfolio amply display, is that buying in tranches is best, as is exercising patience and vanquishing panic.

Disclosure: The author owns shares in Macmahon.

Staff members may own securities mentioned in this article.

This retailer has enjoyed an impressive ride on Telstra's shoulders, but with the core business firing on all cylinders, future returns may be harder to come by.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 9 SEPTEMBER 2016

Vita Group: Result 2016

Faced with a stagnating business in 2009, telecommunications retailer Vita Group decided to piggyback on Telstra, instead of Apple. Management was optimistic about rolling out Telstra branded stores, whilst simultaneously withdrawing from Next Byte, the independent Apple retailer, but the merit of the strategy was murky at the time.

Key Points

- ***Growth from optimisation***
- ***Expanding outside core competence***
- ***Not a bargain***

VITA GROUP (VTG) / SELL

Price at review	Max. portfolio wght.	Business risk	Share price risk
$5.32	3%	Med–High	Med–High

BUY Below $3.50 · HOLD · SELL Above $5.20 · $5.32

It is now crystal clear. The continuation of Vita's strong results in 2016, led by its Telstra branded stores, provides further validation of the strategy. And with the share price up over 200% over the past 12 months, shareholders aren't complaining.

Making of a Multi-bagger

It's hard to say that Vita Group hasn't been well managed. As Table 1 shows, dramatic improvements have been achieved across all facets of operations.

Telstra stores have inherently better economics than a traditional retailer. It's one of the most inventory-light models you will find, made possible by selling voice, data, subscriptions and bundled packages from Telstra's entire product suite. For context, inventory represents just 2% of sales, compared to 14% at JB Hi Fi.

For each dollar that Vita pays in rent, it makes around $11 in gross profit, a level that rivals some of Australia's best retailers such as Flight Centre.

But while management has done a good job, a lot has gone right for this business. The total telecommunications market has grown as the number of devices per person has increased, and Vita has captured an increasing proportion of this as market share has migrated to Telstra. We are less sure that these tailwinds will continue to blow as hard for Vita in future.

Table 1: 5 year improvements

YEAR TO JUNE	2011	2016	+/(–) (%)
TELSTRA STORES	50	100	100
TELSTRA BUSINESS CENTRES	9	21	133
TOTAL STORES	180	~140	(22)
SALES PER STORE	$2.2m	$4.6m	109
GROSS MARGIN	32.3%	35.8%	11
OPEX/SALES	28.9%	26.6%	(8)
EBITDA MARGIN	3.0%	8.7%	190

Is it sustainable?

It's not often you find a retailer shrinking to greatness. Over 5 years Vita's store network is around 22% smaller, but its profits are up 5.2 times and its share price is up over 20 times. But with a trailing price-earnings ratio of 23 times, investment success requires a continuation of Vita's earnings growth.

This is becoming trickier as Vita is now a highly optimised business, suggesting further improvements will be much harder to come by. Consensus expectations are for earnings per share to grow 12% in the 2017 financial year and 11% in 2018. Still decent, but dramatically lower than has been achieved over the past few years.

Table 2: VTG result 2016

YEAR TO JUNE ($M)	2016	2015	+/(–) (%)
REVENUE	645	542	19
EBITDA	66	50	31
NPAT	35	25	39
EPS (C)	23.4	17.4	34
DPS (C)	14.0	8.0	75
FRANKING (%)	100	100	N/a

*** Final dividend 8.21 cents, ex date 15 Sep**

> **Vita has produced an exceptional return for its investors, up over 200% in the last 12 months, but that means little today.**

As an indication of the approaching maturity of its core retail business, a lot of the future growth is expected to come from enterprise, Vita's new division that sells IT services and support across Vita's existing channels. Expanding from retailing into IT services is not something you see every day (if ever), and this undoubtedly adds to Vita's risks. It is a hotly contested market, where many seasoned businesses compete.

Opportunities elsewhere

Vita has produced an exceptional return for its investors, up over 200% in the last 12 months, but that means little today. It is the prospective return that matters.

With such a high valuation and the company moving outside its core area of competence, we suspect future returns will be much lower and we'd prefer to watch from the sidelines for the time being.

It's still a well-managed business in a decent industry, so we plan to keep our eye on it. However, at prices above $5.20 we recommend you **SELL**.

Staff members may own securities mentioned in this article.

The shopping centre giant continues to spread its brand around the world and shows no signs of slowing down.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 9 SEPTEMBER 2016

Westfield: Interim Result 2016

With its white spiky facade rising out of the grounds of one of the world's most famous locations, the recently opened Westfield World Trade Centre (WTC) is a hard building to miss.

Key Points

- ***Westfield WTC opened fully leased***
- ***Flagship malls continue to perform well***
- ***Regional malls flat, but less important***

WESTFIELD CORPORATION (WFD) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$9.88	8%	Medium	Medium

BUY Below $6.00 | HOLD | SELL Above $12.00

$9.88

Due to its prime location in downtown Manhattan and role as a major transportation hub, Westfield WTC is expected to have more than 300,000 people walk through it every day. Not surprisingly, demand for space has been high and the building opened fully leased.

With Westfield WTC now open and the company continuing pre-development work on its Milan centre, Westfield will soon have flagship properties operating in two of the world's financial capitals, three of the four major fashion capitals as well as the entertainment and technology capitals of the world in Los Angeles and Silicon Valley. It's an impressive feat.

Flagship's commanding performance

With many retailers around the world looking to shrink the amount of stores they have as online retailing becomes increasingly popular, quality locations are an important advantage for shopping centre landlords and Westfield's flagships are about as good as they come. Where those retailers choose to close stores will depend on sales activity and Westfield is leading the way, as is Scentre in Australia.

Westfield's centres generated specialty sales of US$724 per square foot, much higher than centres owned by competitors such as General Growth, Simon Property and Macerich at US$583, US$607 and US$626 per square foot. Even more impressive was the performance of Westfield's flagship centres — 81% of its total portfolio — where specialty sales increased 4.6% to reach US$905 per square foot.

Whilst the flagship malls shine, Westfield's regional malls show the challenges many others face across America. Although total occupancy in regional malls increased to 94%, specialty sales and specialty store rent remained flat. Comparable net operating income for regional malls only increased 2.2% compared to the flagship division at 4.4%. Westfield is looking to offload some of these regional malls, and with development focused on flagship properties, this division will continue to become less important in the years ahead.

Despite the performance of its regional malls, the future actually looks bright for Westfield. It currently has US$2.6bn worth of development activity under construction and another US$6.9bn in pre-development. The company expects these projects to yield between 7% and 8% and should provide a boost to distributable profit once completed.

A growth story

Westfield expects total distributions of US$0.251 (unfranked) for the full year which, assuming an exchange rate of $1.31 for every US dollar, means the stock is trading on an unfranked yield of 3.4%.

Table 1: Westfield interim result 2016

SIX MONTHS TO JUNE ($M)	2016	2015	+/(–) (%)
RENTAL INCOME	378	415	(9)
BORROWING EXP.	(100)	(85)	18
DISTRIBUTABLE PROFIT	342	380	(10)
DPS (C)*	12.55	12.55	0
GEARING (%)**	28.4	25.3	12
NTA PER SHARE ($)	4.55	4.48	2

*12.55 cents unfranked, ex-date already past
** Net debt / (total tangible assets – cash)

> **With its sizeable development pipeline in major cities, Westfield actually has strong growth prospects.**

With retailers looking to reduce the number of their stores and shopping centres shutting across America this might sound expensive. However, all malls are not created equal and we expect Westfield's flagship properties to be largely unaffected.

With its sizeable development pipeline in major cities, Westfield actually has strong growth prospects. Although we only expect distributable profit to grow between 3% and 4% in 2016, long-term growth should be a little higher – perhaps 3–6% (the wide range being due to the added risk of currency fluctuations).

Adding that to the current yield gives a total expected return of around 6–9% before tax. Note, however, that you will only get this return if our assumptions are correct and you hold forever. The sooner you sell before then, the more your actual return will be affected by changes in the price the market puts on Westfield's stream of income. If interest rate expectations increase, then the stock's yield will surely increase them, meaning that its price will fall.

We'd need to see a higher potential return for us to recommend Westfield as a Buy for all members, but for those happy to accept relatively low total returns in exchange for a high-quality stream of distributions and international diversification, the stock might make sense at a little above our Buy price. We also wouldn't make the stock an outright Sell until the yield fell to below 3%. As a result, we're decreasing our Buy price to $6.00 and raising our Sell price slightly, to $12. **HOLD**.

Staff members may own securities mentioned in this article.

A dip in sales growth at the end of the year made for a slightly disappointing result – and a tough start to 2017.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 16 SEPTEMBER 2016

Myer: Result 2016

The number 'seven' is lucky (or so some say). For Myer you'd hope so, because the company has now reported six straight years of declining earnings.

Key Points

- ***Result reasonable rather than good***
- ***Sales growth needs to improve***
- ***2017 another difficult year***

MYER (MYR) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.26	3%	High	High

BUY Below $1.25 — **HOLD** — **SELL** Above $1.80

$1.26

Myer's slick managing director Richard Umbers plans to interrupt the trend. Reporting the company's 2016 results yesterday, he promised that underlying net profit would grow this year. For what it's worth we believe him, although that particular number is pretty easily to manipulate.

We weren't expecting miracles in 2016 and the result was acceptable rather than exceptional. Helped by an extra week in the year, Myer's sales grew 3% to $3.3bn while underlying net profit fell 11% to $69m (see Table 1). Profit was in line with the company's guidance but don't put too much faith in that number; net after-tax implementation costs associated with the New Myer strategy of $9m knocked the bottom line down to $60m. Expect more implementation costs in 2017.

As expected, the **gross margin** fell 1.6% to 38.7% as Myer introduced more concession stores (sales up 22%) and de-emphasised private label brands (sales down 7%). While management has said it is being more efficient in rostering staff, we can't help thinking its costs should be rising rather than falling at this point in the turnaround. Instead the company's **cost of doing business** fell 0.9% to 32.5%.

Return to dividends

Myer's strong cash flow was a key reason for recommending the stock in ***Is Myer still a pariah?*** in November 2015. Thankfully Myer didn't disappoint here, with excellent operating cash flow of $149m and **free cash flow** of $98m. Another of the milestones we were looking for was delivered, with a return to dividends during the year. A fully franked final dividend of 3 cents was declared.

The apparent delay to Myer's capital expenditure program, however, has been a little surprising. After promising to spend $100m-120m in 2016, it spent just $59m in the period. Management explained that the cash figure didn't include capital already committed, and that the program would ramp up in 2017. Net debt of $102m is therefore likely to rise from here.

Table 1: Myer result 2016

YEAR TO 30 JULY	2016	2015	+/(–) (%)
REVENUE ($M)	3,290	3,196	3
EBITDA ($M)	206	223	(8)
NPAT ($M)	69	78	(11)
EPS (C)	8.8	13.2	(33)
DPS (C)	5.0	7.0	(29)
FRANKING (%)	100	100	N/a

*** Interim dividend 3 cents, ex date 28 Sep**
Note: Figures are underlying results

Included in the 2016 capital expenditure program were refurbishments of the Werribee store, which opened in July, and the Warringah store, which will open in November. Both will be tailored to local demographics, with the Warringah 'premium' store the first to showcase the New Myer strategy. Refurbishments will also commence at a further seven (lucky?) stores in 2017, including the Sydney and Melbourne flagship stores.

As we explained in ***Is Myer still a pariah?***, the New Myer strategy was as much about where it won't spend money as where it will. To that end, the company announced that it will close the Logan store in Brisbane in 2018 and will not proceed with the Darwin store it announced in 2012.

> **Sales growth was in fact the weakest element of Myer's result.**

Selling space contracting

It's all about focusing on areas where Myer can earn the greatest return. With its selling space contracting, sales per square metre rose 5.6% in 2016.

As we said in March, though, in ***Myer: Moribund no more***, reducing selling space is a low-quality way of improving sales density. What we're really hoping for is decent sales growth.

Sales growth was in fact the weakest element of Myer's result. Same-store sales rose 2.9% for the year to 30 July, which seems like a reasonable result given the headwind of a warm winter. Yet, David Jones grew same-store sales by 7% over the year to 26 June.

What's particularly concerning is that Myer had a very weak July. Management blamed it on the election and clearance activity – which makes some sense – and it's just one month after all. But it's concerning that the focus for 2016 was on introducing 'wanted' brands and – just at the time shoppers should be getting excited about the changes – sales dipped.

The first quarter of 2017 looks like another difficult one. The corresponding quarter was a strong period and this year the company will need to clear aged inventory from winter. These are short-term concerns, yes, but same-store sales growth below 3% will make the turnaround much tougher.

Slow start to 2017

With a slow start to the year – and the refurbishment program proving potentially disruptive – 2017 is unlikely to be a stellar year. Of course, a lot will depend on Christmas. But at this stage it looks like the decent profit growth we were expecting might be less than 10%.

The good thing is you're not paying for high expectations. The market isn't counting on a significant turnaround so if Myer manages to produce anything better than 5–10% profit growth over the next few years then the stock looks good value below our Buy price. As it stands, Myer is trading on a 2017 forecast enterprise value to earnings before interest, tax, depreciation and amortisation multiple of 5.8 and a price-earnings ratio of 14. The stock is not expensive.

All that said, this remains a speculative recommendation. Success depends on management being able to turn around a business that has been a perennial underperformer. There's a reasonable chance of a decent return from here but our Buy price needs to incorporate the risks.

The market remains sceptical about Myer's turnaround but there's some chance it will surprise on the upside – just not in 2017. We'll upgrade again if Myer falls much below our $1.25 buy price, but for now the stock remains a **HOLD**.

Staff members may own securities mentioned in this article.

AMA's purchase of Gemini dominated its 2016 result.

BY JON MILLS • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

AMA: Result 2016

AMA's purchase of the Gemini Accident Repair Centres business dominated a much improved 2016 result (see Table 1). Along with a number of abnormal and one-off expenses, this means comparisons with 2015 are fairly meaningless.

AMA GROUP (AMA) / COVERAGE CEASED

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.14	N/A	N/A	N/A

Due to the Gemini acquisition and others, AMA's Panel division – which operates in the vehicle panel repair industry in Australia and New Zealand – now represents more than 81% of the company's revenue, up from 46% in 2015. With Gemini owned for only nine months of 2016, this figure should rise again in 2017 absent any acquisitions in other divisions.

So far at least, AMA is resisting pricing pressure from insurers **Suncorp** and **IAG** – which control around 85% of vehicle smash repair volume.

AMA's consolidation of the industry is helping in this regard, while also giving it more power when negotiating with its suppliers. The latter is of particular importance given the high percentage of raw materials sourced from overseas and hence subject to exchange rate movements.

Pressure from insurers and the benefits of economies of scale are encouraging the smaller groups and independent operators to sell to the likes of AMA. There's still scope for further consolidation of the panel repair industry and we'd expect AMA to purchase additional smaller operators in coming years, although growth is likely to be slower.

AMA's Protection division (which sells vehicle protection products and accessories) and its Component division (which remanufactures automotive components) also grew in 2016, increasing their sales by 3% and 20% respectively.

By contrast, the Electrical division (which sells automotive electrical and cable accessories) suffered a disappointing 7% fall in sales. Whilst these divisions are much smaller than the vehicle repair division, AMA hopes to expand each of these businesses too.

Table 1: AMA result 2016

YEAR TO JUNE	2016	2015	+/(–) (%)
REVENUE ($M)	264.3	93.2	184
UNDERLYING EBITDA ($M)	31.9	14.2	125
UNDERLYING EBIT ($M)	25.1	12.9	95
UNDERLYING NPAT ($M)	17.6	9.0	96
UNDERLYING EPS (C)	3.6	2.7	33
DPS (C)	2.2*	1.7	2.9

*** 1.7c final div, (no change), fully franked, ex date 14 Sep**

AMA's shares have trebled over the past three years, putting them on a multiple of 29 times 2016 earnings and 21 times those expected for 2017. With growth likely to be slower in coming years, we think there is now better value elsewhere and we're **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

Advertising and marketing production agency Wellcom reported a good 2016 result.

BY JON MILLS • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

Wellcom: Result 2016

Advertising and marketing production agency Wellcom reported a good 2016 result (see Table 1), with its three segments each recording rising revenue and earnings before interest and tax (EBIT).

WELLCOM GROUP (WLL) / COVERAGE CEASED

Price at review	Max. portfolio wght.	Business risk	Share price risk
$5.38	N/A	N/A	N/A

The company still earns more than half its net revenue from Australasia. Ignoring the $345k lost on **Dick Smith** entering administration, $500,000 in foreign exchange fluctuations and other one-offs, this segment's margin improved in 2016.

However, most of Wellcom's 20% increase in net revenue was due to continuing growth in its UK and US businesses, driven by the purchase of Dippin' Sauce and Additive Pixel in these two countries respectively.

Despite an impressive 39% increase in net revenue, to $28m, higher costs meant the US segment only reported a 17% increase in EBIT. By contrast, the expansion of Wellcom's partnership with advertising agency Bartle, Bogle & Hegarty in the UK resulted in the partnership performing the marketing production for car manufacturer Audi and UK supermarket giant Tesco, helping segment EBIT rise more than seven-fold.

Foreign revenue as a percentage of total revenue should continue to grow as Wellcom looks to expand further overseas, with management considering both complementary acquisitions and further strategic partnerships.

Wellcom's advertising and marketing agency partners are responsible for coming up with the advertising ideas, campaigns and media strategies, whereas Wellcom performs the more mundane work of producing content such as videos, animations, artwork and so on. As such, Wellcom operates in a competitive industry where the lowest cost producer is in prime position, which explains why it has many of its production staff based in Malaysia.

Table 1: Wellcom result 2016

YEAR TO JUNE	2016	2015	+/(–) (%)
NET REVENUE ($M)	103.4	85.9	20
EBITDA ($M)	19.1	16.1	19
EBIT ($M)	16.4	13.9	18
NPAT ($M)	11.1	9.8	13
EPS (C)	28.3	24.9	14
DPS (C)	22.5*	20.5	10

*** 13.5c final div (up 13%), fully franked, ex date already past**

Wellcom has risen 35% over the past year. That's a nice return for an ordinary business which, on a PER of 19, is now selling for a high price. **CEASE COVERAGE.**

Staff members may own securities mentioned in this article.

Telstra's share buy-back is a sensible way of returning cash, but whether you should participate will depend on your circumstances.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 13 SEPTEMBER 2016

Your guide to Telstra's share buy-back

Share buy-backs – especially big ones like Telstra's – do a lot to stir the pot of public debate. To some they're a case of Santa come early, showering gifts on shareholders; to others they're a sign of a company down on its luck, bereft of imagination and opportunities for growth; and to still others, they're a way of making a balance sheet 'more efficient' to somehow conjure up additional returns.

Key Points

- ***Telstra will buy-back $1.5 billion worth of shares***
- ***Only makes sense for certain shareholders***
- ***Use Telstra's calculator and/or seek advice***

The truth is more prosaic. A share buy-back is simply a means of giving shareholders back a chunk of their own money, and whether it makes sense or not depends on whether it's best for shareholders to have the money or for the company to keep it.

The effect of a share buy-back is almost identical to that of a dividend, except that instead of returning cash to all shareholders and all shareholders maintaining the same interest in a slightly reduced pie, the cash is only returned to those shareholders that wish to take part, whose share of the pie is proportionately reduced.

Herein lies the magic, if there is any. Because all shareholders are different – particularly in terms of tax – it makes more sense for some to get their money out than for others, and an off-market share buy-back enables them to do this. For those not participating, they will maintain their investment, which will be a slightly larger share of a slightly less valuable company.

It gets even better when the buy-back is conducted off-market via a tender, because the keener some shareholders are to take part, the bigger the discount they'll accept, and the more the non-participants will see their proportionate share increase. So the tender process should spread the benefits on offer more fairly among all shareholders.

But we're getting ahead of ourselves. Before we consider whether it makes sense to stay or to go, let's run through what's actually happening.

What's happening?

With its recent sale of Autohome shares for $2.1bn and continued strong free cash flow, Telstra now has surplus capital that it wants to give back to shareholders.

In addition to paying out around $3.8bn in dividends this year, management has decided to return another $1.5bn by buying back shares. This is comprised of a $1.25bn off-market share buy-back, followed by a $250 million buy-back of shares on the market.

The off-market buyback will be conducted via a tender process, and holders of shares bought on or before August 17 will be eligible to take part. The forms will need to be received back by the company's registrar (Link Market Services) by 7pm on Friday 30 September. Tenders can also be lodged online via **Telstra's buyback page** (when you click you'll need to go through a brief verification process).

Under the tender, shareholders can submit a price at which they'd be prepared to sell their shares. The offers will be accepted from the bottom up, until the $1.25bn target is reached, so that those accepting the biggest discounts are more likely to have their offers accepted.

You can also select a minimum price at which you'd be prepared to sell your shares, and/or you can opt to have your shares bought back at whatever is the final price that would make that possible.

The price paid by Telstra will be the same for all shares bought back and will be the lowest price at which it can buy-back shares worth $1.25bn, taking all the different tenders into account.

Should you take part?

So should you take part? Here's where it gets difficult because, as we've noted above, everybody is different (particularly in terms of tax) so there is no one-size-fits-all answer. The way it works is that the price eventually paid for the shares is split between a capital component (which the Australian Taxation Office has indicated will be $1.78) and a dividend component (the rest of the price).

> **“And, of course, the lower the discount on the buy-back price, the more attractive the deal will be.**

On the dividend component, you'll pay tax at your marginal rate offset by a full franking credit, as with a regular dividend; and on the capital component you'll be subject to capital gains tax (CGT) on the difference between the cost of the shares and $1.78 per share plus an adjustment based on the difference between the market price and the final buy-back price (see section 4.1 of **Telstra's Buy-Back Booklet**). The CGT discount will be available if you've held the shares for more than a year and if you make a capital loss then it can be used against capital gains in the current year or carried forward to future years.

So the buy-back is likely to be more attractive to people (or super funds) on low tax rates, and/or who stand to make a capital loss on the shares and can make good use of it against gains elsewhere. And, of course, the lower the discount on the buy-back price, the more attractive the deal will be.

All of this is explained in greater detail in Telstra's Buy-Back Booklet, available from **its website**. In particular, in Section 4.6 (on page 19) there's a table setting out how the proposal might pan out for people on different tax rates. We've reproduced parts of this in Table 1, but with the market price lowered to near-current levels ($5).

It's important to note that the prices and some other details will change, but it provides a good basis for working through the various possibilities. Telstra also provides (via the same link given above) a buy-back calculator, which you can use to test different scenarios.

Road-testing

Bear in mind that it might also be worth participating even if you don't want to reduce your holding, because you can always buy the shares back on the market, but this is likely to be less attractive for most situations as you'll have to absorb the discount. There are also risks to this approach as the price may change between the Buy-Back and when you replace the shares.

There is also a risk that the ATO might classify such a transaction as a 'wash sale' – where shares are bought and sold within a short period for the main purpose of obtaining a tax benefit. In such circumstances, the tax office might disregard the transaction and any tax benefits might be lost. So if you're considering such an approach, make sure you consult with your tax advisor.

After extensive road-testing of **Telstra's Buy-Back Calculator** and while noting that we're not able to provide personal advice, we'd say it's hard to find scenarios where those on the highest tax rates will benefit from participating. At the other end of the spectrum it looks like super funds will benefit in most situations at least as compared with selling on market, and even when repurchasing the shares as long as the discount isn't too big. In the middle, things get more marginal.

Everybody is different, though, so we'd recommend having a play with the calculator yourself, running through the methodology in Section 4.6 of the Buy-Back Booklet, and/or speaking to your personal tax advisor.

Table 1: Illustrative examples

ASSUMING MARKET PRICE = $5.00; DISCOUNT = 10%; COST BASE = $4*	0%	SUPER FUND (15%)	21%	34.50%	39%	49%
BUY-BACK PRICE ($)	4.5	4.5	4.5	4.5	4.5	4.5
AFTER-TAX PROCEEDS OF BUY-BACK ($)	5.67	5.25	5.03	4.62	4.49	4.18
AFTER-TAX PROCEEDS OF SALE ON ASX ($)	5	4.9	4.9	4.83	4.81	4.76
PROFIT/(LOSS) FOR BUY-BACK AND REPLACING SHARES ON MARKET	0.67	0.25	0.03	(0.38)	(0.51)	(0.82)
PROFIT/(LOSS) FOR BUY-BACK VS SELLING ON MARKET	0.67	0.35	0.14	(0.21)	(0.32)	(0.57)

* This also assumes zero brokerage, that the Telstra shares have been held for more than a year, and that capital losses can be used against gains held on shares that have also been held for more than a year.

** Note that thes are illustrative examples only, based on Telstra's buy-back calculator; we recommend making your own calculations and/or speaking to your tax adviser.

ASX getting cheaper

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 15 SEPTEMBER 2016

ASX (ASX) / BUY

Price at review **$47.19** | Max. portfolio wght. **8%** | BUY Below **$50.00** | HOLD | SELL Above **$70.00** | **$47.19**

The share price of ASX has fallen almost 10% since we **downgraded to Hold** last month, taking it well below our Buy price. As a result, we're upgrading back to **BUY**.

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

Disclosure: The author owns shares in ASX.

Platinum announces buy-back

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

PLATINUM ASSET MANAGEMENT (PTM) / HOLD

Price at review **$5.51** | Max. portfolio wght. **6%** | BUY Below **$5.00** | HOLD | SELL Above **$8.00** | **$5.51**

Platinum Asset Management has announced plans to buy back up to 10% of its total shares on-market over the next 12 months, commencing on 4 October. Shares will only be bought back if the stock 'trades at a significant discount to its underlying value' although 'no target price has been set' (or at least announced).

The full 10% would amount to 59m shares, worth about $300m; and given that around 60% of the stock is held by insiders (including 53% by managing director Kerr Neilson and his ex-wife), it amounts to around a quarter of the remaining shares. It's also equivalent to around 15% of the annual trading volume. It's unlikely that Platinum will be able to buy that many back without pushing the price beyond what it's prepared to pay – which is presumably around current levels else it would have started sooner.

It's a clear indication, though, that Kerr Neilsen thinks Platinum is cheap – and the stock has accordingly jumped more than 10% today. We don't disagree with that view, but we'll continue to look for a greater margin of safety before we upgrade to Buy (as reflected by our $5 Buy price). **HOLD.**

Staff members may own securities mentioned in this article.

Ridley: Result 2016

BY JON MILLS • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

RIDLEY CORP (RIC) / COVERAGE CEASED

Price at review **$1.28** | Max. portfolio wght. **N/A** | BUY | HOLD | SELL

Ignoring one-offs such as profits on the sale of surplus land and its Dry Creek salt field in South Australia, animal feed and nutrition supplier Ridley Corporation reported a flat 2016 result (see Table 1).

More than half the company's total sales still come from its Barastoc poultry feeds (tagline: 'Hens aren't just pecky, they're picky too'). The company is benefitting from increasing demand for white meat, helped by Australia's growing population.

Table 1: Ridley result 2016

YEAR TO JUNE	2016	2015	+/(–) (%)
REVENUE ($M)	912.6	907.6	1
UNDERLYING EBITDA ($M)	53.5	51.0	5
UNDERLYING EBIT ($M)	42.1	38.8	9
UNDERLYING NPAT ($M)	24.1	24.1	–
UNDERLYING EPS (C)	7.8	7.8	–
DPS (C)	4*	3.5	14

*** 2.5c final div (up 25%), fully franked, ex date 25 Oct**

Elsewhere, its dairy feeds performed well in 2016. However, sales slowed towards the end of the year as reductions in milk prices paid by milk processors such as Murray Goulburn (as shareholders in **MG Unit Trust** could painfully attest) and expectations of lower prices created uncertainty over the winter calving season.

The company's strategy of selling surplus property (such as the recently disposed Dry Creek and Dandenong properties) and investing the proceeds into the higher yielding animal nutrition segments makes sense.

However, we note that Ridley has increased earnings before interest and tax (EBIT) from its Agriproducts segment by 93%, from $28m to $54m, over the past three years.

This is an impressive achievement for what is a cyclical, highly competitive and low margin industry. The stock is priced on a multiple of 16 times 2016 earnings per share and we see little margin of safety at current prices. **CEASE COVERAGE.**

Staff members may own securities mentioned in this article.

Better value at Vocus

BY GAURAV SODHI • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

VOCUS COMMUNICATIONS (VOC) / HOLD

Price at review **$7.04** | Max. portfolio wght. **5%**

BUY Below $6.00 | HOLD | SELL Above $9.00 | $7.04

We aren't interested in collecting good businesses, we are interested in cheap stocks. That was our declaration earlier this year when we slapped a Sell on market darling Vocus Communications.

While the business was doing all the right things strategically, the valuation didn't add up. The market appears to agree, with Vocus shares falling more than 20% over the past four months.

An optimistic view of earnings, outlined in ***Time to hang up on Vocus?*** suggests earnings per share of about 50 cents by 2018 if everything goes to plan. That makes today's price of just over $7 – a PER of just 14 times – rather attractive. That is, of course, if the best possible outcome occurs. While there is now upside with Vocus, there isn't a margin of safety.

Acquisitions are hard to integrate, management make mistakes and business is unpredictable. For all those foibles we demand a lower price. We would consider buying around $6 but, for now, the price fall is enough to earn an upgrade to **HOLD**.

Staff members may own securities mentioned in this article.

XTD: Result 2016

BY JON MILLS • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

XTD (XTD) / COVERAGE CEASED

Price at review **$0.20** | Max. portfolio wght. **NA%**

BUY | HOLD | SELL

XTD operates digital advertising screens on the Melbourne and Brisbane metro railway networks, which it leases from the rail operators in return for a share of advertising revenue. XTD subcontracts the provision of advertising content to **APN Outdoor**, so that XTD ends up with about half the advertising revenue from its screens.

There is a risk that XTD loses its existing concessions when they come up for renewal in 2021 and 2022, but the company is countering this with attempts to expand into metro rail networks throughout Asia and the United States. To that end, the recent announcement of a trial of the company's system on the New Delhi metro rail network is a positive sign. If it proves successful, it could lead to substantial increase in XTD's revenues and profits.

The stock remains highly speculative and, while **we've expanded our coverage of small cap stocks**, XTD's $22m market capitalisation makes it far too small for us to cover, as members following our recommendations will likely have an undue influence on its share price. We'll keep monitoring the stock but, for now, we're **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

G8 Education

Do you think G8 Education is worth doing more work on? PEs are no longer the lofty 30 odd times but now lower than the market. Perhaps not at $3 today based on your previous research but at what point do you think it gets interesting?

13 September 2016 – **Jon Mills**: Gaurav Sodhi wrote a **blog on G8** which is well worth a read. As you note, G8 Education is now more reasonably priced after falling 30% since then.

However, there are a number of things that still make us uncomfortable. Firstly, G8's former chief financial officer now prefers developing and selling new childcare centres to G8, despite the greater risk involved compared to purchasing and managing established centres.

We also have concerns over management's disclosure of occupancy figures: like for like peak occupancy for G8's centres purchased in 2014 and earlier either remained steady or declined based on the company's 2015 result presentation but the like for like average occupancies disclosed in the presentation accompanying its 2014 result painted a rosier picture. Now occupancy figures have disappeared altogether from its latest presentation. Unsurprisingly, industry data suggests they deteriorated in the first half of calendar 2016.

Although the second half of the calendar year tends to leads to higher occupancy levels, occupancy may come under further pressure as the supply of childcare centres increases faster than demand. However, the impact will vary depending on the fundamentals in each local market.

Importantly, the $360m in net debt on its balance sheet and $490m in off-balance sheet leases mean the company doesn't have a lot of wiggle room should it encounter trouble. In sum, despite the price falls and seemingly attractive yield, we're still not comfortable recommending this stock to members and prefer to watch from the sidelines.

Virtus and Monash's funny classifications

I wonder if you can help me understand why VRT and MVF have different GICS Industry group classifications when they seem to be in the same industry? It's no big deal as I can easily adjust when looking at the 'industry' ratio of my portfolio as I have about 35 companies in my portfolio however it is curious why they are in different industry groups. In this case I have set a VRT plus MVF combined portfolio weighting of 7% and am currently sitting at 6.3% having sold a few VRT recently. It just makes me wonder if there are other similar apparent anomalous groupings in, diversified financials or software, etc. I 'pull' this data along with prices and dividends (using .iqy in my little Excel file) from the ASX website to help track of my portfolio.

15 September 2016 – **Graham Witcomb**: That's an interesting question and something I hadn't actually noticed. I don't pay much attention to official groupings, it's something that can often lead investors astray due to them pigeonholing companies. In the case of Monash and Virtus, both companies are very much in the same industry, though they do have some slight differences (namely that Virtus gets 12% of its revenue from operating day hospitals and a further 7% from diagnostics, while Monash gets around 12% from ultrasound/imaging services for women). I think it is Monash that is mislabeled, I can't see how it can be classified as a biotech or pharmaceutical company rather than a healthcare services business. As for whether there are other odd groupings, I'm sure there are. One that just jumped out at me as I scanned down the coverage list was that Star Casino is grouped in 'Customer service'. I'm not sure the casino is doing its customers any favours.

Financials weightings in portfolio

With regard to financial stocks and portfolio limits. I think in the past you have recommended holding no more than 20% of a portfolio in financial stocks. Apart from the three banks, which other stocks in the income portfolio are considered financial stocks.

15 September 2016 – **James Carlisle**: The 20% that we've mentioned in the past is actually the recommended maximum for banks stocks, with more like 10% being recommended for conservative investors. We don't tend to give specific maximums for financials generally and other sectors for reasons **discussed here**. I mention in that post that perhaps a third of your portfolio might be considered a limit for all financials, but it starts to become hard to define what is a financial – Computershare, for example, is more of an IT company and ASX is really a marketplace.

Stocks in our Equity Income Portfolio that might be considered financials are ASX (6.1%), CBA (5.2%), GBT (4.6%), IOOF (4.5%), CPU (4.2%), PPT (3.9%), WBC (3.8%), OFX (3.5%) and MQG (3.2%), making a total of 39%. However, as I've said, I think it's a bit of a stretch to include some of those as financials. A tighter definition would cut out CPU and GBT for starters, which would get the weighting down to 30% or so, and excluding ASX would take you down to 24%.

I suppose the question is whether 'financial' is even a useful definition when it includes so many diverse stocks. I certainly wouldn't see them all as being exposed to the same risks (except to interest rates, but all stocks are exposed to those).

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