Weekly Review

RESEARCH

– Issue – 23 Sep. 2016

Returning to a stock at higher prices is among the hardest things for an investor to do. We give it a shot.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 21 SEPTEMBER 2016

Caltex: refined and redefined

Picking a decent business at a decent price is hard. When things work out exactly to your investment case, as they did when we first recommended Caltex in ***Caltex: A fuels errand*** back in 2013, it can be tempting to tick the success box and move on. That would be a mistake.

Key Points

- ***Business continues to improve***
- ***Now a distributor/retailer***
- ***Consolidation possible***

CALTEX AUSTRALIA (CTX) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$33.74	6%	Low–Med	Low–Med

BUY Below $32.00 | HOLD $33.74 | SELL Above $42.00

While Caltex is now dearer than our original buy price, the business is also better. The Kurnell refinery, long a sink for capital and a source of low and variable returns, is now closed.

Caltex still operates a small, modern refinery in Queensland – Lytton – which refines mostly premium grade fuels, but it imports most of its fuel from Singapore. No longer a big refiner, the business is largely a distributor of fuel and an operator of petrol stations.

Still sounds dull, doesn't it? That may just be the point. Petrol stations, once maligned as little more than peddlers of gum and source material for comedians have morphed into wonderful businesses.

The improvement in profits has been decades in the making but was obscured for years by Caltex's refining losses. The first time we recommended Caltex it was because the market was ignoring the transformation of the business. We're looking at it again because, even with the transformation complete, the valuation doesn't appear to reflect the improvements.

Who needs a Kwik-E-Mart?

Two big changes have lifted retail profits for Caltex; lower competition and higher margins.

Forty years ago, there were over 20,000 petrol stations to service a population of 12m. Today, there are just 6,000 stations to service twice that many. The car fleet is larger still.

With independents all but gone from the industry, the retail industry is the preserve of consolidated giants and each petrol station is now far more profitable. The same dynamic has occurred along the distribution chain.

Once highly competitive, the petrol distribution business now resembles a cosy oligopoly. The four largest firms account for 90% of industry revenue and high sunk costs along with low margins eliminate the threat of new entrants.

Despite the rise in the car fleet – about 1.2m new cars are sold annually in Australia – absolute petrol volumes have been flat or falling for years as efficiency gains, smaller engines and regulations require less fuel.

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Caltex has offset those volume declines with astonishing margin gains. Margins from the distribution and retail of fuel have more than doubled over ten years. This is no mere cyclical phenomenon. Ten years ago, premium fuels accounted for less than 10% of the fuel mix; they are now a third of all petrol volumes and 35% of diesel volumes.

Engines may be more efficient but that improvement comes at a cost as modern motors need higher octane fuel from which Caltex generates higher margins. Distribution and retail margins of less than 2% have grown to well over 5%. That trend is unlikely to reverse and, in fact, appears to be more entrenched as the car fleet modernises. We don't expect margins to rise much but neither will they fall.

A retail story

Protected by high barriers to entry, the distribution business supplies fuel to about 2,000 sites including petrol, diesel and jet fuel suppliers. The end of the mining boom has made a small dent in diesel volumes but the vast bulk – about 70% – of diesel volumes and almost all growth comes from consumers rather than miners.

Caltex also owns or leases 800 sites itself from which it conducts 3m transactions per week. With sales of over $1bn a year, Caltex is a significant retailer in its own right and has barely tapped its potential.

In Australia, just 20% of sales in the convenience sector come from petrol stations. In overseas markets, that share is as high as 60% so there's an opportunity to lift sales. Caltex is aiming to lift non-fuel revenue through its retail sites by offering new services such as mail pickup, laundry and more food and drink.

New format stores a being rolled out and, while this is a source of potential, management has been careful to limit the downside with experimentation and a slow rollout. We view an expanded retail base as an option rather than a certainty.

Even without success from new formats, profits have been growing at about 5% per year and we expect this to continue for some years. Lifting sales through a high fixed cost base should improve profits over time.

Fair value

We expect Caltex to generate EBIT of around $900m this year and perhaps $950m in 2017. In Table 1, we've outlined a base case valuation and a high case. In the base case, an EBIT multiple of 10 yields a valuation of $32 a share, just below today's price.

Table 1: Caltex valuation

	BASE	HIGH
EBIT ($M)	900	950
MULTIPLE (X)	10	12
EV ($M)	9,000	11,400
NET DEBT ($M)	712	712
EQUITY VALUE ($M)	8,288	10,688
SHARES (M)	260	260
$/SHARE	32	41

In the high case, we assume that higher earnings attract a higher multiple to reflect better quality. On 12 times EBIT, Caltex would be worth over $40 a share.

Net debt has risen to $700m but with operating cash flow covering interest by 15 times last year, the debt load remains comfortable. The business also holds over $1bn in franking credits, so higher free cash flow (there no longer being an expensive refinery to maintain) should support higher franked dividends.

> “Another option for cash is to purchase a competitor.

Another option for cash is to purchase a competitor. Woolworths is apparently looking to sell its petrol business and Caltex is a logical buyer. In New Zealand, consolidation of retail sites has been tremendously profitable. This could happen here too.

It is tempting to upgrade now. With over $1bn in franking credits, strong free cash flow and a dominant domestic position, this is a better, more resilient business than it appears.

Yet we adhere to strict hurdles and demand a discount to fair value. Below $32, we’d likely upgrade. You might consider building a small position now but an official upgrade must wait. For now, **HOLD**.

Staff members may own securities mentioned in this article.

The international expansion has been far from easy but after further acquisitions things are looking up for Iress, especially in the UK.

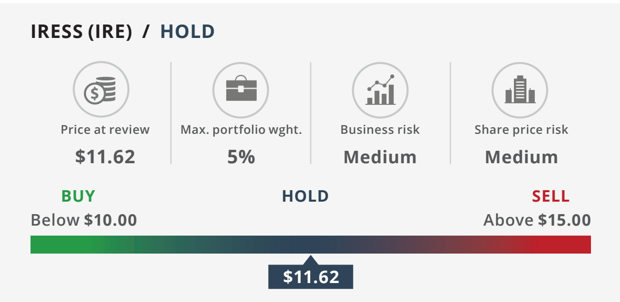
BY ALEX HUGHES • INTELLIGENT INVESTOR • 23 SEPTEMBER 2016

Iress: Going OK in the UK

What happens when Australia's leading financial software business achieves local market dominance but is priced for future growth? That was the situation for Iress in 2010 and explains why it has pursued overseas expansion with vigor since. Thus far the company has built operations in the UK, Canada, South Africa and Asia.

Key Points

- ***Australian dominance continues***
- ***Tough overseas but UK is improving***
- ***Iress isn't cheap***



But it hasn't been easy, as Chart 1 shows. With each additional dollar of capital invested abroad, returns on capital have fallen. Is this a case of another high-quality Australian business being diminished by ego-driven thoughts of global domination? It doesn't look that way. Despite numerous market corrections and industry headwinds, Iress has increased revenue every year since 1997. For the six months to June (it has a December year-end) the company increased revenue by 12% and net profit by 15%.

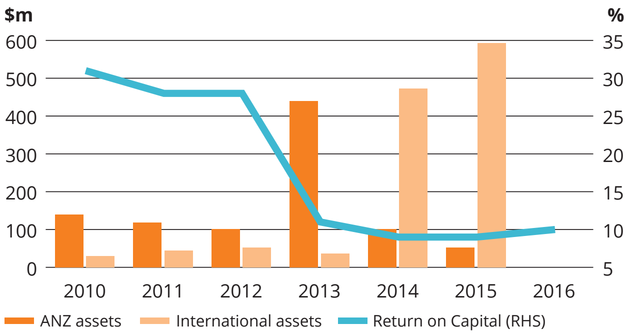
Quality Australian business

The result was testament to the quality of its Australian businesses. The company's wealth management division is taking further market share from number two **Rubik Financial** and producing 47% operating margins, the highest of all the company's businesses. Meanwhile, the ANZ financial markets division enjoyed a flat result and an operating margin of 43%.

Those numbers reflect the grip Iress has on Australian financial planners, institutions and brokers that rely on its business critical software (see ***Iress targets UK wealth*** from April 2015).

For a new financial planner, learning to use Xplan is as important as receiving an RG146 accreditation. And once they've got to grips with it there's little inclination to switch to a competing system. The result is an immensely sticky customer base willing to absorb annual price increases. That has driven high-margin revenue growth for years. If there's one company that can afford to invest in sensible overseas expansion, this is it.

Chart 1: Overseas investment depressing returns

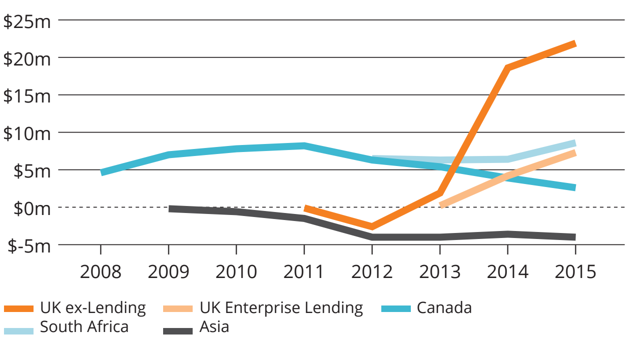


Source: Company reports

Mixed performance overseas

The bigger question for investors is whether that expansion is paying off. Asia continues to lose money and Canada appears destined for a similar fate, with declining year-on-year returns since 2011. South Africa is stable, with growth expected following the recent $14m acquisition of INET BFA, a provider of market data, analytical tools and financial data feeds. But due to its small size, it is yet to move the revenue dial. There's not much encouragement here.

Chart 2: UK growth impressive



Source: Company reports

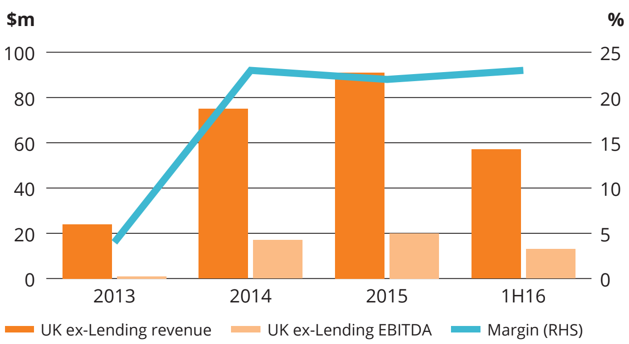
> **"But this figure is misleading because the reported earnings dramatically understate the company's true earnings power.**

But the UK operation is starting to hit its straps, as Chart 2 shows. Iress entered the UK in 2013 through the $360m purchase of Avelo and bolstered its position last year by acquiring Proquote and Pulse for £37.6m.

Part of Avelo's attraction was the opportunity to migrate its existing Advisor Office customers to Xplan and sell more modules. Is it playing out like that? Well, the ex-Lending division (the new name of the combined UK financial markets and wealth management operations) certainly had a good first half with revenue rising 45% and earnings before interest, tax, depreciation and amortisation (EBITDA) rising an impressive 73%.

Xplan demand has indeed been strong, a trend which is expected to continue into the second half. But as Chart 3 shows, UK margins haven't budged. The contribution from the lower margin Proquote and Pulse businesses is partly to blame, but whether Xplan growth can boost margins remains an open question. There is a case, though, that Iress's UK ex-lending division is on the right trajectory. That bodes well for further growth and may arrest the decline in returns on capital.

Chart 3: But can UK margins rise?



Source: Company reports

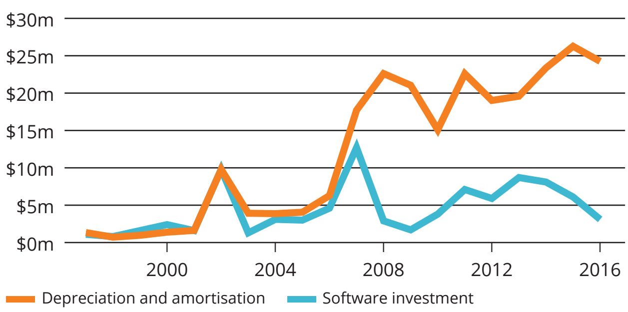
Enterprise lending, the division responsible for originating one in every four UK mortgages, had a weak half-year with revenue down 5% and EBITDA down 43%. Expected losses in the second half mean the division will be barely profitable for the full year. Part of the problem is the shift to a recurring licence model, which is mostly a timing issue. But with management now referring to the division as a 'medium-term' growth opportunity, current challenges are unlikely to be quickly resolved.

Understated earnings

IRESS doesn't look cheap either, on a price-earnings ratio of around 25 based on the consensus forecast for full-year earnings per share of 46 cents. But this figure is misleading because the reported earnings dramatically understate the company's true earnings power.

When Iress buys a business, it records a portion of the purchase price as software and customer accounts, both intangible assets amortised under accounting standards. For example, when Iress purchased Visiplan in 2007, 76% of the $49m purchase price was recorded under these balance sheet items. As a result, Iress was required to amortise 76% of its Visiplan investment over future years, under the (incorrect) assumption that customers would leave as the software drifted into obsolescence. This couldn't be further from reality. The Visiplan acquisition solidified Iress's leadership in Australian wealth management, delivering high customer retention and ever improving financial returns since.

Chart 4: Misleading amortisation



Source: Company reports

As Chart 4 shows, the actual investment to maintain Iress's software is far lower than indicated by the company's amortisation charges, meaning free cash flow consistently exceeds reported earnings. Iress may trade on a PER of 25 times but the free cash flow multiple is in the high teens. That's reasonable for a business of Iress's quality and growth profile, and a more useful indicator of value.

We're raising our price guide to Buy below $10 (from $9) and Sell above $15 (from $13). **HOLD**.

Staff members may own securities mentioned in this article.

The listed property sector is relatively straightforward to analyse, but the valuation is highly personal. We're shifting our emphasis on the sector a little, in a bid to make our coverage more useful to members.

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 20 SEPTEMBER 2016

Getting a Hold on property trusts

We're a greedy lot at *Intelligent Investor* and we make no bones about it. Before we put a Buy on a stock, we look for a wide margin of safety, either through a cheap price or a strong business position, or more usually a combination of both.

Key Points

- ***Have been negative on listed property since before the GFC***
- ***Many trusts have improved their quality***
- ***Acknowledging this by moving more stocks from Avoid to Hold***

In the bull market that preceded the global financial crisis, **property trusts fell short on both fronts**, with high prices, excessive gearing and some questionable forays into funds management. We did well to recommend that members sell or avoid most of the sector. Over the next few years, many formerly mighty names were **brought to their knees**.

Stung by this experience, perhaps, many property trusts have spent the past few years getting their, er, houses in order. The sector now offers a bunch of stocks that do what property trusts ought to do, owning decent properties, collecting rent, perhaps doing a little development on the side, but keeping debt at manageable levels.

We've even found room for some Buys in the more niche areas, such as with **ALE Property Group**, **Hotel Property Investments** and **BWP Trust**. These have done well for members and **our portfolios**, and the only pity is that we haven't been able to find more of them.

Sadly, as is often the case in even a faintly efficient market, prices in the sector have raced away from us, reflecting the improvement in quality and leaving little margin of safety. As a result, we've kept many of the bigger stocks in the sector on Avoid, but we must now acknowledge that this doesn't provide much help for members.

Keeping it simple

The fact is that property trusts, when they're doing what they're supposed to do – mostly collecting rent and paying it out – make pretty simple investments, and it's pretty simple to assess the returns on offer.

You take the yield and add the growth in distributions you expect over the years (averaged out on a time-weighted basis to be precise, although this is not a precise science). That should give you an idea of the total returns on offer. Note, however, that you'll only get that return if our assumptions are right and you hold forever; the sooner you sell, the more of your actual return will be determined by the fickle nature of the market and the value it places on the income being generated. If interest rate expectations rise over your period of ownership, then it's likely the market will pay less for the income, which may at the same time be reduced due to a higher interest bill.

You can then decide whether the 'expected' return is acceptable to you based on the underlying quality of the trust, incorporating such things as location, usage, occupancy, lease length, lease terms (eg who pays for maintenance), diversity of location and tenant, and of course debt.

Making it personal

The key word in all of this is 'you', because the return that members will consider acceptable from a particular trust will be highly personal. If you're 80 years old, with no dependents and in need of a steady income, it's not for us to say that you should spurn the 4.4% (unfranked) yield available from **Scentre Group**, for example, growing at perhaps 3–5% a year over the long term.

Scentre is in fact already a Hold, for exactly these reasons, as are the likes of **Dexus**, **Westfield**, **Vicinity**, as well as ALE and HPI. But in this review, we're belatedly bringing **GPT**, **Stockland** and **Mirvac** back into the fold, as well as updating on one or two others.

The form we'll take with this and future reviews is to explain where each particular trust sits on the quality spectrum, and why, as well as giving the current yield and our estimation of the likely long-term distribution growth. Note that we will almost certainly be wrong about the latter, because it will depend on a bunch of factors, not least economic growth. But it's impossible to say whether these stocks are attractive without having a stab at it.

Based on this information we'll provide a price guide, which will in most cases be pretty wide, reflecting the personal nature of the investing decision and our greedy nature. We'll only make a stock a Buy if we think most members should consider buying it, and we'll only make it a Sell if we

> " Many of its office properties are considered premium or A-grade properties that are located in the middle of the Sydney CBD.

think almost all members should be shot of it. There's a lot of room in between and, given the nature of the market and the relative simplicity of these stocks, this is where most of them will sit.

BWP Trust (BWP)

Although not BWP Trust. Investors got a sharp reminder of the importance of tenant diversity a few weeks ago when Bunnings announced it would be vacating up to seven of BWP's properties and moving to ones formerly occupied by Masters. This followed news that Bunnings had already left up to four properties during the 2016 financial year. As a result, the stock has fallen more than 15% since we reviewed its **full-year result** on 5 August and reiterated our recommendation to Sell.

The problem for BWP is that its properties are constructed to meets the needs of Bunnings and when they leave, there are few other businesses out there who have a use for big-box retail properties without needing to spend money redeveloping the site. Also, the existence of a financially strong tenant such as Bunnings/Wesfarmers is a major driver in demand and therefore any property without them attached would likely fetch a lower price on the open market leading to lower property values.

BWP's tenant risk, as well as its relatively low-quality properties and long-term distribution growth we estimate conservatively at only 2–3%, means we will continue to take a conservative approach. We're nudging down our Buy price to $2.20 and our Sell price to $3.00. **SELL**.

DEXUS (DXS)

Table 1: DEXUS result 2016

YEAR TO 30 JUNE	2016	2015	+/(–) (%)
DISTRIB. PROFIT ($M)	413.9	369.8	12
DISTRIBUTION (CPS)*	43.5	41.00	6
GEARING (%)**	32.0	28.4	13
NTA PER SHARE ($)	7.53	6.68	13

***Unfranked, ex date already past**

****Gearing defined as net debt / (total tangible assets – cash)**

Tenant risk and property quality is something that DEXUS, owner of office and logistics properties, doesn't have to worry about as much. Many of its office properties are considered premium or A-grade properties that are located in the middle of the Sydney CBD. Also, no industry makes up more than 15% of its total rental income.

Trading profits and fee income from its funds management business were the key drivers that led to distributable profit increasing by 12% in its full-year result last month.

We expect DEXUS to be able to grow distributions around 2–5% (the large range is due to the potential for trading profits), which when combined with a forward unfranked distribution yield of 5%, suggests a total pre-tax return of between 7% and 10%. We will be moving our buy price up to $6.50 and pushing out our sell price to $11.00. **HOLD**.

GPT Group (GPT)

Table 2: GPT Interim result 2016

SIX MONTHS TO 30 JUNE	2016	2015	+/(–) (%)
DISTRIB. PROFIT ($M)	208.1	197.1	6
DISTRIBUTION (CPS)*	11.5	11	5
GEARING (%)**	24.4	29.9	(18)
NTA PER SHARE ($)	4.38	4.21	4

***Unfranked, ex date already past**

****Gearing defined as net debt / (total tangible assets – cash)**

GPT's interim result highlighted the benefit of owning high-quality CBD properties. Like-for-like income from its office properties increased 6% and properties located in Sydney were valued 11% higher, exceeding the 4% achieved in Melbourne and no increase in Brisbane.

Despite this, distributable profit growth was dominated by a one-off performance fee from its funds management business. When you remove this and also adjust for capital expenditure, distributable profit only increased around 3%.

GPT currently trades on a distribution yield of around 5%, resulting in a total implied pre-tax return of 7–9% when you factor in our long-term growth expectations of 2–4%. We're upgrading to Hold, with a Buy price of $3.50 and Sell price of $5.50. **HOLD**.

> **Such properties tend to have a harder time keeping existing tenants and finding new ones.**

Mirvac (MGR)

Table 3: Mirvac result 2016

YEAR TO 30 JUNE	2016	2015	+/(–) (%)
DISTRIB. PROFIT ($M)	500	468	7
DISTRIBUTION (CPS)*	9.9	9.4	5
GEARING (%)**	22.9	25.0	(8)
NTA PER SHARE ($)	1.92	1.74	10

***Unfranked, ex date already past**

****Gearing defined as net debt / (total tangible assets – cash)**

Mirvac residential had a good year in 2016 settling a record number of lots with a default rate of less than 1%. If this default rate continues, the residential division should continue to be a big driver of distributable profit considering the company has also secured more than $3bn in pre-sales. The great result from residential was probably a good thing as like-for-like operating income from the office properties was largely flat.

Mirvac owns a diverse portfolio of quality properties spanning office, retail, logistics and residential throughout Australia. These properties are also extremely popular with occupancy across the portfolio over 95% making it one of the higher-quality property portfolios in the sector.

However, this quality currently comes at a price with an unfranked distribution yield of under 5%. Along with expected long-term growth of 2–4%, that suggests a total pre-tax return of between 7% and 9%. We're upgrading to Hold, with a Buy price of $1.50 and a Sell price of $2.50. **HOLD**.

Stockland (SGP)

Table 4: Stockland result 2016

YEAR TO 30 JUNE	2016	2015	+/(–) (%)
DISTRIB. PROFIT ($M)	740	657	13
DISTRIBUTION (CPS)*	24.5	24	2
GEARING (%)**	21.6	20.1	7
NTA PER SHARE ($)	3.82	3.68	4

***Unfranked, ex date already past**

****Gearing defined as net debt / (total tangible assets – cash)**

Residential sales were also a big driver for Stockland, with its residential communities operating profit increasing 39%. This helped increase total distributable profit by around 13%.

Stockland, however, lacks the quality commercial property that Mirvac has with its shopping centres predominately located in regional areas and office towers outside the CBD placing more importance on the riskier residential development activity. Such properties tend to have a harder time keeping existing tenants and finding new ones.

Stockland is trading on an unfranked distribution yield of 5.5% which implies a total pre-tax return of between 7.5% and 9.5% when you assume long-term growth of 2–4%. We're upgrading to Hold, with a Buy price of $3.30 and a sell price of $5.50. **HOLD**.

Arena REIT (ARF)

Table 5: Arena REIT result 2016

YEAR TO 30 JUNE	2016	2015	+/(–) (%)
DISTRIB. PROFIT ($M)	25.6	22.1	16
DISTRIBUTION (CPS)*	10.9	10.0	9
GEARING (%)**	26.0	27.9	(7)
NTA PER SHARE ($)	1.49	1.28	17

***Unfranked, ex date 29 September 2016**

****Gearing defined as net debt / (total tangible assets – cash)**

We first covered Arena REIT in the article ***Can smaller property trusts boost your income?*** on 30 May and liked its exposure to childcare and medical centres and long-duration triple net lease terms that mean it doesn't need to pay for maintenance.

A key driver in Arena's profit is development activity, with $19m of development activity completed in 2016 and a future development pipeline of $52m. Development typically results in higher yields than acquiring existing properties.

Currently Arena is trading on an unfranked distribution yield of about 5.7% and we expect long-term growth of around 2–4%. We will be initiating formal coverage on Arena with a Buy price of $1.50 and a Sell price of $2.50. **HOLD**.

Staff members may own securities mentioned in this article.

In the strange world of corporate reorganisations, two plus two may well equal five.

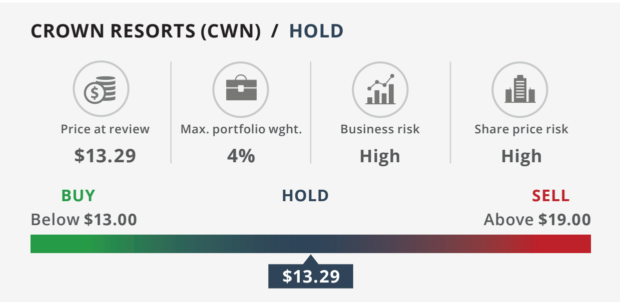
BY JON MILLS • INTELLIGENT INVESTOR • 22 SEPTEMBER 2016

Crown demerger: enhancing value?

Your maths teacher might not like it, but in the strange world of corporate reorganisations and spin-offs two plus two can potentially equal five. Herein lies the potential attraction of the proposed Crown Resorts restructure aimed at 'enhancing shareholder value'.

Key Points

- ***Most international holdings demerged***
- ***Crown Resorts to keep Australian casinos***
- ***Potential IPO of Australian hotels too***



As noted in ***Crown spins off international ops and hotels*** on 16 Jun 16 (Buy — $12.75), Crown Resorts intends to demerge most of its international operations into a separate company.

The spin-off – InternationalCo – will hold a 27.4% interest in **Melco-Crown Entertainment**, a majority interest in the planned Alon casino in Las Vegas and other smaller assets (see Table 1).

Existing shareholders will retain their shares in Crown Resorts while also receiving new shares in InternationalCo proportionate to their existing holdings.

Crown Resorts – we'll tag it 'OzCo' to avoid confusion – will retain full ownership of Crown's Australian casinos in Melbourne and Perth, the future Crown Sydney, Crown Aspinalls in the United Kingdom and the company's fast-growing wagering and online gaming businesses.

The company is also considering floating a 49% interest in its Australian hotels (except for Crown Towers Melbourne) by way of a listed property trust. The proposed trust will own more than 2,300 hotel rooms and lease them to OzCo on long-term leases.

The demerger and proposed initial public offering (IPO) are still subject to final sign-off from the Board and ratification by shareholders and various regulators. However, by spinning off InternationalCo, the goal is for the strong performance of Crown Resorts' Australian assets to become more visible to the market and hopefully more highly valued as a result. In that way, OzCo and InternationalCo should be worth more in total as separate entities than combined under the one banner as they are now.

Table 1: Assets held by OzCo & InternationalCo

OZCO	INTERNATIONALCO
Crown Melbourne	Melco Crown Entertainment (27.4% interest)
Crown Perth	Alon Las Vegas
Crown Sydney	Nobu (20%)
Crown Aspinalls (UK)	Aspers (50%)
Wagering & Online	Caesars

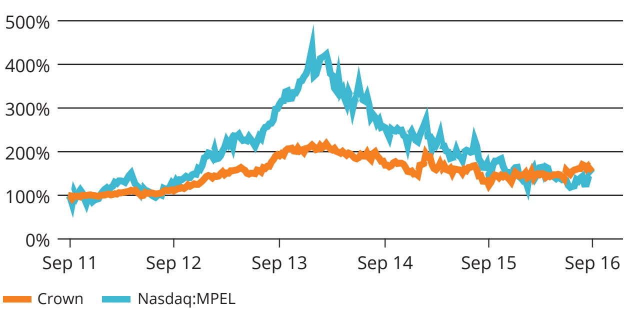
Note: OzCo may also float 49% of most of its Australian hotels

To see whether this is a reasonable goal, let's analyse the proposed reorganisation, starting with OzCo.

Australia

Management claims that 'Crown Resorts' share price has been highly correlated to the performance' of Melco-Crown and the share price charts back them up (see Chart 1).

Chart 1: Share prices over past 5 years



Source: Capital IQ

The demerger will mean shareholders in InternationalCo will now have to deal with concerns over Macau's future due to the Chinese government's corruption crackdown and the stuttering Chinese economy. As such, OzCo's share price should more closely track the performance of its monopoly casinos in Melbourne and Perth.

> **“This should also help support OzCo’s share price in this era of very low interest rates and the resulting search for yield.**

Although its greater geographical concentration means OzCo will be even more affected by any future Australian economic downturns, we’d expect growth in earnings to at least match economic growth over the long term (see ***Betting on Crown – part 1*** on 20 Apr 15 (Buy — $13.15)).

Crown Resort’s equity accounted profit from its Melco-Crown investment fell 64% in 2016 and its Australian casinos in Melbourne and Perth now generate around 83% of net profit. So it isn’t surprising that Crown Resorts recently amended its dividend policy to pay out 100% of normalised profit excluding profits from associates but including dividends from associates (due to the volatility arising from the large amounts VIPs bet, casinos adjust their earnings to reflect theoretical rather than actual win rates from VIPs). This should also help support OzCo’s share price in this era of very low interest rates and the resulting search for yield.

OzCo also has attractive growth prospects, not least from its $2bn Crown Sydney casino now under construction but also from its fast-growing (albeit currently barely profitable) wagering and online gaming businesses. Freed from exposure to Macau, this could also help OzCo trade on higher multiples. On the downside, Crown Sydney could prove more expensive than expected to build and/or the company could receive less than the $500m expected from the sale of apartments included in the Crown Sydney building.

Hotel REIT

InternationalCo’s status as a holding company means it’s unlikely to be able to support much on-balance sheet debt, so most if not all of Crown Resorts’ existing $2.3bn in gross debt is likely to remain with OzCo.

This is another reason why further value may be realised should Crown Resorts (and hence presumably OzCo) proceed with the IPO of 49% of its Australian hotels except for Crown Towers Melbourne.

Crown is clearly taking advantage of high property prices – and, in particular, foreign investor demand for Australian hotels – and will be able to use the cash raised to help fund capital expenditure and/or reduce its debt burden.

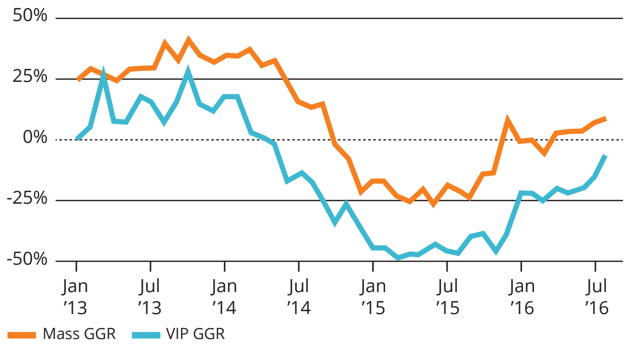
Importantly, not only will Crown Resorts/OzCo likely earn top dollar from the IPO, it will also profit from the difference between what it pays in leasing costs and the hotels’ earnings. Australian hotels are currently much sought after due to increasing occupancies and revenue earned per room as a result of rising numbers of foreign visitors and the dearth of new hotels being constructed.

As for the IPO, it may be of interest to members depending on its price, yield and lease terms and your personal situation and return expectations (see ***Getting a Hold on property trusts*** for more on our recent slight shift in emphasis on listed property trusts).

InternationalCo

By contrast, InternationalCo will be dominated by its investment in Melco Crown Entertainment. Adding in its likely mediocre yield and it’s possible that investors will quickly dump InternationalCo, perhaps giving those who aren’t currently shareholders in Crown an opportunity.

Chart 2: Macau gross gaming revenue – VIP & mass



Source: Reproduction of chart in Deutsche Bank Crown Resorts company update, 12 Sep 2016

As we noted in ***Betting on Crown – part 1***, though, there are many reasons to think that Macau will overcome its present difficulties over the medium to long term. More recently, in **Crown: 2016 result** on 18 Aug 16 (Hold — $13.82) we noted that the decline in Macau’s gross gambling revenue (GGR) may have bottomed and more recent evidence supports this view (see Chart 2).

> **Total visitors to Macau, visitors staying overnight and gaming spend per visitor are all rising too.**

As you can see from Chart 2, the more profitable mass market GGR has finally started to increase, albeit helped by recent casino openings including Melco Crown's still-ramping-up Studio City. Total visitors to Macau, visitors staying overnight and gaming spend per visitor are all rising too. Whilst still early, this suggests that the increase in supply of hotel rooms and tables from recent and future casino openings may be absorbed over the medium term, particularly as various infrastructure improvements are completed (see *Betting on Crown – part 1* for more).

We'll have to wait for final details on the proposed demerger and IPO before determining whether the sum of the parts will in fact be greater than the whole. We suspect they will be, but like any recommendation, our views will depend on the relationship between price and value. In the meantime, we recommend you **HOLD**.

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

Staff members may own securities mentioned in this article.

One-off work has made payment processor Touchcorp look cheap, but we are not convinced it's sustainable.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 19 SEPTEMBER 2016

Staying out of Touchcorp

At first glance, global payment software business Touchcorp is a screaming bargain. To explain why, you need to know only two basic facts.

Key Points

- ***At first glance, company looks cheap***
- ***However, we have some concerns***
- ***Not initiating formal coverage***

TOUCHCORP (TCH) / NO VIEW

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.98	N/A	N/A	N/A

Assuming you had a spare $240m lying around and purchased Touchcorp outright, you'd receive $16m in annual operating earnings (before depreciation and amortisation). That's not a bad start. Then there's the fact that included in that $240m purchase is a $142m investment in fast-expanding retail payments solution **Afterpay**. Exclude that from the valuation and you're paying five times operating earnings for Touchcorp's core business.

Intriguing right? We thought so too, which is why we took a closer a look. Unfortunately, Touchcorp is not as cheap as it seems but, if a much lower price emerged, we might be tempted. To arm you for that possibility, here's a summary of the analytical legwork.

The nuts and bolts

Retailers use Touchcorp's software to facilitate the sale of non-physical products like mobile phone credit, iTunes cards, Medicare payments and even fishing licences. By installing Touchcorp's software on point of sale systems (EFTPOS) retailers can sell over 600 products, in return for which Touchcorp takes a small slice.

Now 16 years old, Touchcorp's network extends to more than 56,000 retail locations, although Optus, 7-Eleven and European convenience retailer Valora still make up half of transactional revenue. Customer concentration is a big risk. But when you consider the long-standing relationships, and the fact that the retailer pays nothing for ongoing use, there's not much incentive to change. Indeed, Optus recently extended its agreement with Touchcorp to 2021.

In the first half of calendar 2016, the company generated $44m in transactional revenue (on an annualised basis, as illustrated in Table 1). The potential for this figure to grow dramatically is what got us interested. Touchcorp software is compatible with almost any hardware and operating system, which makes it a product with global potential.

Table 1: Summarised financials

YEAR TO 31 DEC ($M)	2011	2012	2013	2014	2015	2016F
TRANSACTIONAL REV.	–	16.0	17.8	24.0	26.8	–
DEVELOPMENT REV.	–	1.1	1.3	0.8	15.5	–
TOTAL REV.	6.8	17.1	19.1	24.8	42.3	44.0
GROSS PROFIT	5.4	13.8	15.8	19.3	35.3	–
EBITDA	(6.3)	2.6	4.4	5.8	13.2	16.2
EBIT	(6.8)	2.1	3.9	4.9	12.0	–
NPAT	(7.0)	1.8	4.1	13.5	9.4	12.7
OPERATING CASH FLOW	0.5	1.7	7.7	3.2	(3.4)	–

In the last two years the company has struck agreements with European convenience retailers Retain and Once, both bigger than 7-Eleven's Australian operations. Its contract with Valora is also being extended and further agreements with Cornercard and Changeup, two financial services businesses, adds to the growth profile.

Having your cake and eating it too

What of Afterpay, a recent ASX entrant? Last year it contracted Touchcorp to provide the payment backbone for its buy now/pay later business. Afterpay was a start-up at the time and lacked capital. So instead of paying cash, it gave Touchcorp most of its development fee in the form of Afterpay equity ($10m in value in fact). What happened next was incredible good fortune.

Afterpay has become a huge hit with retailers, growing its network from 100 to 600 outlets in less than seven months. Touchcorp benefits from the growing transactional revenue, which it doesn't have to pay to generate, and the growth in Afterpay's market capitalisation. Since listing at $1 a share in May 2016, Afterpay's share price has tripled. Touchcorp's original $10m stake is now worth about $142m.

Despite '14-bagging' in around a year, it's too early to call this the investment of the century. Touchcorp cannot sell its Afterpay shares until May 2018, so today's price means very

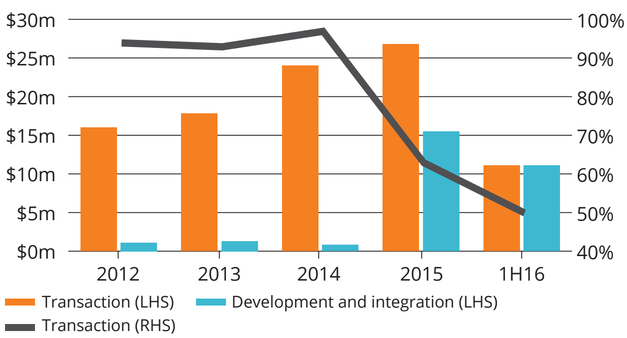
> **Recent earnings growth, and the higher share price it has provoked, is due to one-off development work.**

little. With a market cap of $467m but just $1.4m in revenue last financial year, Afterpay has a long way to go before its market value stands up.

Our concerns

Excluding the value of its Afterpay investment, Touchcorp is trading on an enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) multiple of 14 times. That could turn out to be very cheap if the new European contracts make a meaningful contribution. What concerns us is the sustainability of core earnings.

Chart 1: Revenue composition



Source: Company reports

In its 2015 prospectus, Touchcorp claimed it derived almost all its revenue from recurring transactions. That's no longer the case. After the large contracts with Afterpay and Changeup, only half today's revenues are recurring, as Chart 1 shows. Recent earnings growth, and the higher share price it has provoked, is due to one-off development work.

Operating earnings (before depreciation and amortisation) were $8m in the first half, but they would be significantly lower without the same volume of development work. A future lull in this area would create a large earnings hole, making it hard to justify Touchcorp's current share price.

These concerns aren't allayed by the decline in transactional revenue in the first half of 2016 (see Table 2). Touchcorp's presentations suggest the contrary, but we cannot verify this claim using the reported figures. Something doesn't add up. Add to that concern a short listed life and a Bermudan incorporation, both of which have the potential to turn up nasty surprises.

Table 2: Declining transactional revenue

	1H15	2H15	1H16
TRANSACTIONAL REVENUE	12.9	13.9	11.1
DEVELOPMENT & INTEGRATION REVENUE	5.5	10.0	11.1

Touchcorp does have some very attractive features but we'd need more evidence of the sustainability of earnings growth in its core business before we could consider recommending it. Plus a lower share price. So, close but no cigar. We won't initiate formal coverage at this point but it's one for the watch list perhaps.

Staff members may own securities mentioned in this article.

Analysts don't get it. Now that The Great Boom is over, the two big miners are much more profitable than they look.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 20 SEPTEMBER 2016

BHP and Rio are understating profits

The big miners are commonly considered disasters for good reason. A quick glance at long term performance doesn't flatter the businesses or, especially, management teams.

'This time is different' is always the catchcry and never the truth and that goes for the propensity of management to sensibly allocate capital. Too often – perhaps always – management over-commits to acquisitions and expansion at the worst possible time.

That propensity for waste could be a source of mispricing today.

Old tricks

One of the oldest tricks to inflate profit, especially for asset-heavy businesses like miners, is to underinvest in the asset base.

This involves lowering capital expenditure to the bare minimum and reporting higher free cash flows as a result. Liberated cash can then be used to lower debt or to pay dividends to appease investors.

A telltale sign of this is to compare capital expenditure with depreciation. A wide and growing gap between the two sums can suggest underinvestment in assets. This is a dangerous game as it lowers long term returns from the asset base and, more commonly, simply defers spending from one period to the next. Fiddling, in other words.

Many analysts accuse **BHP Billiton** and **Rio Tinto** of engaging in such tactics right now. A look at the numbers might suggest they have a point. Both BHP and Rio report spending far less on capital expenditure than they are depreciating. Is this another fiddle?

Different world

In my view, no. High depreciation levels from both miners are a result of past capital allocation decisions.

Over the past five years, BHP spent about US$80bn on capex; Rio spent about US$60bn. 'Property, plant and equipment' on both miners' balance sheets is a little less than it was in 2015 (because of writedowns) but a lot higher than it was in 2011 or 2012.

Both miners are depreciating an asset base that was inflated in both volume and cost terms because of The Great Boom.

Yet they will maintain that asset base in entirely different conditions, when the price of equipment and labour is significantly cheaper and when efficiency gains release additional output.

Capital expenditure should be well below depreciation for the foreseeable future. In other words, BHP and Rio are understating profits at the moment.

OFX hits the skids

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 23 SEPTEMBER 2016

OFX GROUP (OFX) / HOLD

Price at review **$1.87** | Max. portfolio wght. **3%** | BUY HOLD SELL

OFX Group (formerly OzForex) has hit the skids lately, falling around 25% since it peaked at around $2.51 last month and 16% this week. Last month's high came shortly after the company's annual meeting on 3 August, where it triumphantly reported how its systems had held together while others had struggled amid the violent currency swings caused by the UK's Brexit referendum.

There's nothing obvious to us that could justify the fall. Volatility has been low in its key currencies and the Aussie dollar has strengthened a bit. These things won't help but they're just short-term swings and roundabouts and hardly worth a 25% share price fall.

Then there's the news that **Commonwealth Bank has hooked up with Barclays** in the UK to offer international payments via the latter's Pingit app. Pingit is available UK-wide, even if users don't have a Barclays account, and has around 3 million users. This was followed by **comments from the RBA's new governor Philip Lowe** about the New Payments Platform, a collaboration between the RBA and the payments industry which is intended 'to modernise key parts of our electronic payments system'. The platform will enable people to make instant payments between mobile phone numbers and email addresses, and should be available from late 2017. Of course this is intended for local transfers, but it might point the way for the future and may have contributed to investors' concerns.

Banks, though, already provide international payments and they have done for centuries. There's more to doing this than just transferring money – they involve the purchase of currencies in the market, and what matters is whether the banks can give their customers access to this more efficiently than OFX Group. So far that hasn't been the case, and there's no obvious reason why that should suddenly change.

Competition from peer-to-peer payments providers, such as TransferWise, has also been increasing – even though trade suspensions at the height of the Brexit volatility highlighted some of their flaws. This will no doubt continue, but nothing appears to have changed in this regard over the past few weeks.

That said, sharp share price falls are sometimes more unnerving where there's a lack of information, because it makes you wonder if there are others that know something you don't. That may be the case here, particularly given that the company's half-year ends in a week's time. It also needs to be remembered that this is a speculative situation.

On that basis, we're not minded to upgrade again at this point and we're going to remove the price guide to avoid any confusion. We'll provide a full update alongside the interim results in early November or earlier if new information comes to light. **HOLD**.

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

Disclosure: The author owns shares in OFX Group.

Ceasing coverage on Orica

BY GAURAV SODHI • INTELLIGENT INVESTOR • 19 SEPTEMBER 2016

ORICA (ORI) / COVERAGE CEASED

Price at review **$14.51** | Max. portfolio wght. **N/A** | BUY HOLD SELL

We've had sparse coverage of Orica in recent years for one simple reason: the boom times aren't coming back.

Orica generates most of its revenue selling explosives and associated services to major miners. This should be a terrific business as explosives occupy a fraction of mining costs but a disproportionate amount of regulation and headache. As the dominant provider globally, Orica should be able to exert pricing power and generate strong returns.

For many years it did just this, aided by a mining boom characterised by ever lower mining grades that forced the greater use of explosives and the consumption of higher volumes of ammonium nitrate. Now, at the end of the boom, volumes have fallen.

Worse still, a large chunk of revenue – 50% of the Australian business – comes from coal where volumes are likely to be permanently lower. Iron ore volumes are similarly likely to stagnate and, thanks to cheap gas in the US, ammonium nitrate supply has expanded. All this spells trouble for Orica's margins at a time when its balance sheet isn't exactly rock solid.

Over $2bn in net debt is a large number considering the structural problems facing the business. Orica remains a decent business and we would look at it again at lower prices (under $11) or if the balance sheet was repaired. A capital raising or asset sales may be needed for this to happen. Until that happens, we're **CEASING COVERAGE**.

Staff members may own securities mentioned in this article.

Staying steady on Servcorp

BY ANDREW LEGGET • INTELLIGENT INVESTOR • 22 SEPTEMBER 2016

SERVCORP (SRV) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$7.95	4%	Below $5.00	$7.95	Above $8.00

We note that Servcorp has breached our $8 Sell price during the past couple of days. We'll typically give a stock a little leeway before changing our recommendation after it passes through one of our price triggers to save too much chopping and changing if it moves about that level. That's particularly the case in this instance, because Servcorp is a high-quality company and we're reluctant to let it go. The stock is on our list for a detailed review, which should be published in the next few weeks and may involve a change to the price guide. In the meantime, we recommend that you **HOLD**.

Staff members may own securities mentioned in this article.

TPG falls

BY GAURAV SODHI • INTELLIGENT INVESTOR • 20 SEPTEMBER 2016

TPG TELECOM (TPM) / HOLD

Price at review	Max. portfolio wght.	BUY	HOLD	SELL
$9.68	6%	Below $8.00	$9.68	Above $15.00

TPG reported full year results this morning and, although profits rose over 70%, forward guidance was lower than expected. Higher capital expenditure and higher costs are mostly to blame as TPG acquires more spectrum and extends its fibre network.

As we outlined in **TPG's biggest byte**, the business was being richly valued and today's 15% plus price fall isn't necessarily an opportunity. This is not a call to action. We will go through the results in more detail in an upcoming review. For now, **HOLD**.

Staff members may own securities mentioned in this article.

The meaning of risk

Of the many topics you write about your comments on risk management always catches my eye. I have a PhD in Engineering from Cambridge University and while I am now retired I spent a good deal of my life managing risk in Engineering Design ...

What worries me is that everything I have ever read about risk management in the financial area is so unbelievably simplistic and childish that I even wonder if the writers even know what the term means. It is no good saying that risk management associated with money is more complicated than engineering because it involves the instincts of people and how they react which can never be codified because this is simply not true. There are far more imponderables in a nuclear reactor design than will ever exist in the money department.

My question is this: is there anyone writing and thinking about managing risk with investments that has even got to the first rung of the risk management ladder? I have never read or seen anything that gives me the feeling that anyone knows what they are talking about. Or do the money people not know that this subject is a mature discipline and because of their ignorance think they have to start again. Or maybe there are people working with risk management associated with investments but what they write and talk about is of no practical value? In engineering design sometimes this divide happens where the mathematicians drift off and up into the blue sky. But there are others that do make and have made very real contributions.

Please tell me how you react to my thoughts

22 Sep 2016 – **James Carlisle**: Great questions! It reminds me of a story our former research director Greg Hoffman tells about explaining the concept of margin of safety to one of his friends. The friend turned out to be an engineer and started lecturing him right back!

I hesitate to say it, because you're clearly more knowledgeable about this than I am, but it seems to me that risk is essentially uncertainty – but uncertainty appears in many different forms and how best to deal with it will depend on the context.

In engineering, it might mean the (hopefully very small) chance of a bridge falling down, or of a nuclear reactor blowing up. But in investment it just means the chances of an investment not providing your expected (mean) outcome (over any particular timescale).

This reveals some key differences – in engineering (at least in the examples I've given) you're dealing with relatively bipolar outcomes. The bridge falls down or it doesn't; whereas an investment could fall 20% below what you expect or 50% (or return 20% or 50% above), so the risk is more of a continuum.

The risks for a bridge are also pretty catastrophic and can't be diversified away. If you hold a portfolio of 100 stocks you won't much care if one of them comes in 50% below your expectations. But if a bridge collapses, then it won't be much consolation if there are 99 that didn't.

Finally, the cost of adding further 'margin of safety' to a bridge may be relatively small. After all the design and labour, adding some extra concrete, or steel (or whatever it takes) might be a small cost but might reduce the risks by a huge amount.

The same idea in investment, however, can have a very significant cost. One way to reduce risk – at least as against an index – is to replicate that index (buy an index tracker) and it's a great approach if you keep your costs low – but it means giving up any hope of doing better. If you are trying to do better, then you might try to reduce your risk of a bad outcome by buying a stock more cheaply – building in a large margin of safety – but if you ask for too much, then you'll never find any investments and you'll be left in cash, which over the long term has been a very poor investment.

This last point is crucial, because in financial markets (securities and insurance), the risk is actually something that's bought and sold – and/or factored into the price – so you can never entirely divorce it from the value. The aim of course is to maximize returns for a given level of risk (or vice versa) but it's not easy to do and generally involves taking a view that's different from the market, which introduces the risk that you might simply be wrong.

So that's probably a somewhat simplistic description – and is probably what you're complaining about! There are some very smart people playing around with the idea of risk in financial markets, but it's not something most people write too much about because it mostly goes over our own heads as well as our audiences!

Harry Markowitz and the 'modern portfolio theory' (MPT) that won him a Nobel Prize is probably the place to start. If you want to go further than that, then it might be an idea to contact the Institute of Actuaries and ask them if they have anything. As you suggest, though, I think this kind of stuff is of limited practical value for most people. It might be great if you're figuring out how much money is needed to back a defined benefit pension scheme (and how to invest it), but for most people wanting to contribute to their own savings, the answer is generally just 'more' ('and diversify, keep costs low and, if you're really keen, focus on long-term value'.)

Probably a much better recommendation would be to get hold of a book called *Against the Gods: The Remarkable Story of Risk* by Peter L Bernstein. It's been recommended to me by a lot of very reliable sources, although I'm sorry to say I haven't actually read it yet. Thanks for the question, though, because you might have inspired me to do so!

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