Weekly Review

RESEARCH

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Defying expectations, Brickworks is far more than a mere maker of bricks.

BY GAURAV SODHI • INTELLIGENT INVESTOR • 27 SEPTEMBER 2016

Deconstructing Brickworks

It might have one of the dullest names on the ASX, but Brickworks isn't quite as boring as it appears.

Key Points

- ***Building boom has lifted returns***
- ***Don't capitalise peaky earnings***
- ***Complex structure***

BRICKWORKS (BKW) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$13.54	6%	Low	Low–Med

BUY Below $14.00 | HOLD | SELL Above $20.00

$13.54

There are three parts to the business. A building products business makes and sells bricks, timber products and pre-cast cement; a property business develops land used at depleted quarries and spins them into a property trust to provide stable rental income and juicy revaluation profits. There is also a 47.2% stake in **Soul Pattinson**, a diversified conglomerate.

That web of activities increases complexity but enhances security by taming the famously cyclical construction cycle. Uniquely for a building materials business, this is no cyclical pig.

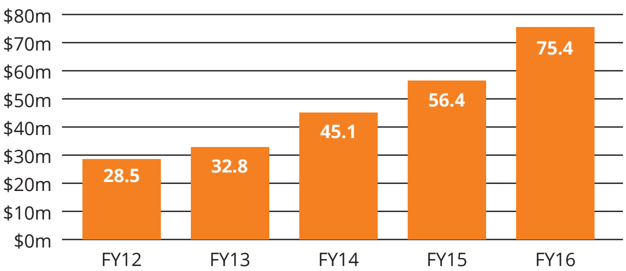
In fact, Brickworks holds one of the more illustrious records on the ASX: it is one of only eight companies that has not cut dividends for 15 years. This is no mere brick business.

Building profits

For most of recent history, the building products business has been the smallest part of Brickworks. That is no longer true (see Chart 1). A tremendous construction boom has transformed the profitability of the materials business and it is now the largest contributor to profits.

Three years ago the building products business generated EBIT of $32m; last year that had risen to $75m thanks to higher prices and higher volumes. It is now the single largest contributor to profit.

Chart 1: BKW's building products EBIT, $m



Source: Company reports

The building boom has helped but so has vanishing competition in the brick market where three competitors have become two. Brickworks has also changed strategy to sell higher margin bricks by treating them much as a retailer treats fashion: turning over inventory quickly and frequently releasing new designs.

Continued on page 2 ...

CONTENTS

IMPORTANT INFO

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Continued from page 1 ...

This has made a mark on returns with a return on tangible assets over 12% – twice what it was a few years ago.

These are, of course, boom time earnings and we don't expect the boom to last forever. But it may be more enduring than many believe.

Construction activity is at record levels but a decade of housing undersupply, between 2003 and 2013, needs to be filled. The supply deficit was estimated to be 108,000 dwellings in 2013 and has now shrunk to 50,000. The boom is making inroads into demand but it could go on for some time yet.

This is not to suggest that investors should pay more for today's peaky earnings – we have not changed our valuation – but it is interesting that the market appears to be sceptical about the construction market. Brickworks is experiencing boom time conditions without a boom time price.

We estimate that the building products business is worth $200m–300m. For a business generating EBIT of $75m that is deliberately conservative. Capitalising cyclically high earnings is a mistake.

Property developments

The property trust, a joint venture with Goodman Group, is well managed and has a long pipeline of opportunities yet to be developed. We expect the $15m in rental income to grow steadily over time as new properties are added to the portfolio.

It should be noted that, of the $73m earned by the property business, over $40m came from revaluations and lower capitalisation rates. If the building boom is aiding the materials business, lower interest rates are doing the same for property.

Even excluding revaluations and redevelopment profits, Brickworks property trust earns a 7% yield on property, a decent sum. We assume book value for the property trust and apply a small discount to book in our low case. To that we add a little for land and development on the balance sheet. The details are shown in Table 1.

Brickworks' holding in Soul Patts is notionally worth around $1.6bn at current prices, by far the largest chunk of Brickworks' $2bn valuation. The calculation is complicated by the fact that Soul Patts itself owns a 44.1% stake in Brickworks. The cross-shareholding needs to be sorted out mathematically and we cannot simply take market prices or we would be valuing Brickworks partly using the market's valuation of Brickworks (confused? See ***The Great Unwinding*** where we set out the detail).

Table 1: Brickworks SOTP valuation

	LOW ($M)	HIGH ($M)
BUILDING PRODUCTS	200	300
PROPERTY TRUST	312	320
OPERATING PROPERTY	245	370
LAND BANK	70	230
SUB-TOTAL	827	1,220
LESS DEBT	(263)	(263)
DTL	(214)	(214)
TOTAL	350	743
SHARES ON ISSUE (M)	147	147
VALUE PER SHARE EXCL. SOL ($)	2.38	5.05
SOL VALUE	2,685	3,929
BKW EQUITY VALUE	1,844	2,982
VALUE PER SHARE ($)	12.54	20.29

Sorting out the cross-ownership, we arrive at a valuation between $13 and $20 a share, shown in Table 1. The low side of that valuation assumes a 30% discount to Soul Patts' sizable market holdings and the high side marks them to market. A fair price is probably in between those two figures and, below $14 a share, Brickworks makes decent buying.

This isn't a business that will generate outrageous returns but it is stable, well managed and diversified. The balance sheet, with $270m in net debt and interest coverage of over 15 times, is strong. Brickworks is mildly underpriced and there is nothing dull about that. **BUY.**

Staff members may own securities mentioned in this article.

After the yield story came the growth story. With prices up across the board, what's an investor to do?

BY JOHN ADDIS • INTELLIGENT INVESTOR • 28 SEPTEMBER 2016

What to do when everything looks expensive

Wherever one looks these days, a low digit number is never far away. Every asset class has been affected by the plentiful supply of cheap money. The yield on 10-year Australian Government bonds is just 1.95% while bank term deposits offer around 3%, higher than they were a few months ago but still unappealing. And don't get me started on the real yield on investment properties, if you can find one at all.

Key Points

- ***Opportunities can be fleeting***
- ***Patience rewards***
- ***Perhaps also look for high-quality Holds***

As the prices of supposedly safe asset classes have risen, investors have bounced up the risk curve, attracted by the relatively high yields in blue chips stocks. Take **Sydney Airport**, for example. The price has more than doubled since we upgraded it as part of our '**high yield & safe' mini-portfolio** in February 2013. Back then it offered a pre-tax yield of 6.6%. Today's equivalent figure is 4.5% – not such a high yield and not so safe.

Dropping like Buys

Until about a year ago, anything with a reliable yield, especially stocks juiced up on debt, experienced booming share prices and falling yields. That knocked a bunch of stocks off our Buy List, including **Virtus Health**, **Monash IVF** and **Hotel Property Investments**, as well as the other two stocks from our 'high yield & safe' mini-portfolio, **BWP Trust**, which gained 40% before we downgraded to Sell in August 2015, and **ALE Property**, which is up 87% (on top of some generous distributions).

Then the market woke up to itself, realising that maybe, just possibly, investors had overcooked the yield story. Stocks like **Telstra** and the big banks have since pulled back but the hunt for returns better than term deposits continued apace. Growth stocks were next to get a run. And why not? If you want that additional 3% but aren't prepared to bear the high prices and dividend payout ratios of yield-orientated stocks, organic growth seems like a good bet.

That removed a further swag of stocks from our Buy List, including **Seek**, **ResMed**, **Nanosonics**, **SomnoMed**, **TradeMe**, **Carsales.com**, **Caltex**, which almost doubled before we **downgraded it to Sell** in February 2015, and Hansen Technologies, which has tripled since we **first upgraded it** in October 2014.

The upshot is that the number of stocks on our Buy List has halved in only a few years. If, like us, you're driven by a desire to find cheap stocks with a decent margin of safety, that poses a problem, to which we offer three potential solutions.

Fleeting opportunities

The first is to pursue the challenging strategy of doing nothing at all. Just because there are only 12 stocks on our Buy List now does not imply an absence of opportunities. It only takes a few down days for some stocks to earn an upgrade. Our **Brexit Buy list**, published on the Sunday following the UK's fateful referendum, upgraded four companies with UK exposure to Buy and listed four more as likely upgrades, with a couple of 'possibles' thrown in. Although the UK-related stocks still trade below the buy prices of that time, many of the remaining opportunities quickly disappeared.

That tends to be the way of it: cheap prices come and go quickly. Sydney Airport was on and off our Buy list for six years between 2008 and 2014, earning more than 30 separate Buy recommendations, but **our recommendation to buy** **Reece Australia** in April this year lasted all of 10 days before the price ran away from us and, **late last year**, **Seek** lasted less than a month. The number of stocks on the list reflects the number of Buys at a particular time, but says little about how many Buys we might make over a year. Doing nothing might be difficult but knowing that a few upgrades could be just around the corner should make it easier.

That's especially true given our newly expanded analytical team, now holding more Dragons Dens than ever. As senior analyst James Greenhalgh says: 'Some are smaller stocks but there are a couple of larger, high-quality companies I'm looking at. The important thing to remember is that an upgrade happens when it happens'. That's where the patience comes

> **"But when opportunities are few and far between, as they are now, a fair price for a high-quality business is more easily justified.'**

in, and the ability to act opportunistically when we do upgrade a stock, like when Brickworks joined the Buy list yesterday.

If you don't want to miss out, you need to be a member at the time of each Buy recommendation, because it could be a fleeting opportunity. Then you need to have the courage of your convictions. And while you wait? With inflation running at 1%, a term deposit paying 3% isn't so bad.

Take an overseas trip

The second option – fishing in a bigger pond – is for those that don't want to wait, that want to put their capital to good use now. Since we covered four internationally-focused listed investment companies in International ***LICs take on the world*** in July 2013, more have joined their ranks, including Geoff Wilson's **Future Generation Global Investment Fund**, the **Platinum Asia Investments Fund**, **PM Capital Global Opportunities Fund** and soon-to-be listed Antipodes Global Investment Company.

There are only two rules to follow when buying LICs. Rule 1: always purchase at a discount to fee-adjusted NTA (see **this article** for more). Rule 2: Rule 1 is useless if the assets to which your investment is exposed are overpriced. Only one international LIC meets these criteria right now. If you're tempted, please tuck into **this review**.

When Holds can be Buys

The third strategy requires some flexible thinking. Clearly, a Hold recommendation is not a Buy. But there's a grey area somewhere between the two that becomes a little more visible in times like these. All our Hold recommendations show some value relative to cash or a term deposit. If they didn't, we'd recommend you Sell rather than Hold.

As research director James Carlisle says: 'The point at which you buy to a large extent comes down to how greedy you want to be. When great opportunities are plentiful, you probably want to be very greedy, demanding a cheap price and a big margin of safety. But when opportunities are few and far between, as they are now, a fair price for a high-quality business is more easily justified.'

That's a sound basis for trawling through our Hold recommendations and picking out a few high-quality stocks near our Buy price. Here's the list, with the stocks listed at the top being James's preferred picks, not so much because of their proximity to our Buy price, but more on the basis that 'if you're going to allow your margin of safety to shrink, it probably makes sense to stick to higher quality stocks, which should produce fewer nasty surprises'.

Table 1: Holds near our Buy prices

	CURRENT PRICE	BUY PRICE	PREMIUM / (DISC.) TO BUY PRICE (%)
CLOSE TO BEING BUYS			
TOP HOLDS			
BHP	21.39	20.00	7
CARSALES	11.83	11.00	8
CBA	73.15	70.00	5
SEEK	15.71	14.00	12
TRADE ME	5.34	5.25	2
WOOLWORTHS	23.00	23.00	0
OTHERS WORTH CONSIDERING			
NAVITAS	5.22	5.00	4
OIL SEARCH	6.51	6.50	0
PLATINUM ASSET MGMT	5.03	5.00	1
SOUL PATTS	16.15	15.00	8
TATTS GROUP	3.86	3.50	10
VIRTUS HEALTH	7.83	7.00	12
WOODSIDE	26.52	27.00	(2)
CLOSE TO BEING SPEC BUYS			
MYER	1.17	1.25	(6)
PMP	0.62	0.60	3

As ever, it's also generally a good idea to buy in stages, so that if better opportunities come along you will be able to take advantage.

Finally, note that a couple of the stocks are already below our Buy prices. We generally wait for a bit of clear space before upgrading (to avoid flitting around too much as much as anything else), but some new additions to our Buy list could be just around the corner.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in many of the stocks mentioned – but sadly not Reece, because we were being too greedy. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Disclosure: The author owns shares in many of the stocks mentioned.

This high-quality business is priced as steeply as ever, but its prospects are also as good as ever.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 26 SEPTEMBER 2016

ARB shifts back into gear

Hanging on to top-performing stocks can be just as hard as ditching the poor performers. Just one twitch of nerves can see you part with a great stock and it can be years before it comes back into range for buying – if it ever does.

Key Points

- ***Share price very steep***
- ***But prospects as good as ever***
- ***Raising price guide; Hold (just)***

ARB CORPORATION (ARB) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$18.07	6%	Low–Med	Med–High

BUY Below $13.00 | **HOLD** | **SELL** Above $20.00

$18.07

We twitched with ARB **when we recommended selling it** in 2013 at $13.49. We were fully aware what a great business it was, having made almost four times our money since we **first recommended buying it** in 2004. But, with concerns that demand might slow as mining demand collapsed, we just couldn't stomach the price-earnings ratio of 22.

Our concerns have in fact largely been borne out. Australian sales of 4WD utility vehicles have fallen slightly since 2013, from 138,000 to 134,000, and although SUV (sports utility vehicle) sales have continued their rise, going from 335,000 to 408,000, about two-thirds of these are smaller SUVs that don't tend to be accessorised (see Chart 1).

The top line has been kept moving by overseas sales, which have more than doubled (see Chart 2 over the page), but a fall in the group operating margin from 18.7% to 16.7% means that earnings per share have remained broadly flat.

Conundrum

You'd think flat earnings over three years would be a bad look for a highly priced growth stock but, such is the market's admiration for ARB, its share price has actually risen 33% since our Sell recommendation, to put the stock on a price-earnings multiple of 30 times for the year just completed.

This poses a conundrum: how come ARB is being rated at its highest ever despite growing at its slowest ever?

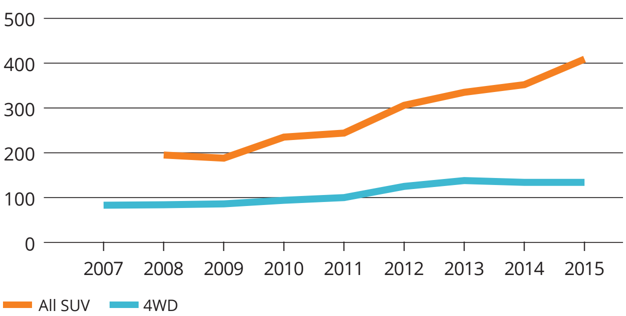
That rating is even higher when you look at the cash flow, which is ARB's one slight weakness. The company has grown quickly in the past, but it has had to invest hard to do so. As a result, it has had to keep back about 40% of net profit over the years, so that only about 60% is released as free cash flow. That means the price-earnings ratio of 30 represents a free cash flow yield of only 2%.

Worst of all, there are signs that ARB's returns are being diluted. Its return on capital employed (ROCE) has almost halved over the past five years, from 51% in 2011 to 26% in 2016. That's still an excellent return, but the rolling five-year return on incremental capital (ROIC – the additional operating profit earned on the extra capital committed over five years) has fallen from around 100% to just 7% (see Chart 3 over the page).

Investing hard

These are just numbers, though. ARB is one of the best-managed business on the ASX and, with plenty of opportunities for long-term growth, the company has continued to invest even though earnings have been flat. Other companies could learn from this, but it will obviously bring down returns in the meantime.

Chart 1: Aust 4WD and SUV sales ('000s)



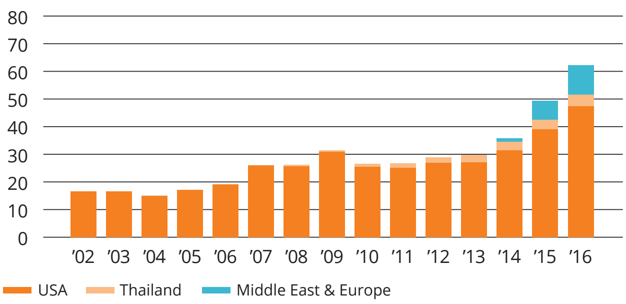
Source: Company reports

Recent investments include a substantial investment in property – in the factories in Melbourne and Thailand, and in warehousing facilities in Brisbane, Sydney, Adelaide, Prague and Jacksonville, Florida. These investments will provide capacity in years to come but are not yet earning a full return.

> ARB is one of the best-managed business on the ASX and, with plenty of opportunities for long-term growth, the company has continued to invest even though earnings have been flat.

Heavy investment is also partly responsible for the flat earnings performance, with a 134% increase in research and development expenditure since 2013, to $6.8m, accounting for about half the fall in the operating margin. Adjusting for the property and holding R&D expenditure at 2013 levels would push the ROCE up to 31% and the ROIC up to 13% – not too shabby for a company facing some significant headwinds.

Chart 2: ARB overseas revenue ($m)



Source: Company reports

This is all hypothetical, but it does shift everything down the track. It'll be a few years before we know how good the recent performance has been and few companies have a better track record at turning investments into profits.

Opportunities

So what about those long-term opportunities? For starters, it's hard to see mining demand going backwards from here, so we'd expect to see 4WD sales picking up over time. The future for SUVs, though, is less positive. In 2009, three '**passenger vehicles**' were purchased in Australia for every SUV, but some time next year that's likely to hit parity.

Whether this trend continues will probably have as much to do with definitions as tastes, but as SUVs become dominant in the market, they're less likely to be accessorised with, say, an **ARB Air Locker** (although an **ARB Portable Fridge Freezer** might be just the thing for Saturday sport). So we'd expect any tailwinds from this segment of the market to reduce, although its continued growth may have a knock-on effect on 4WDs, which are much more likely to carry ARB parts.

The real opportunity for ARB, though, is overseas. Despite quadrupling over the past 15 years, sales abroad still represent just 17% of ARB's total, and a tiny fraction of the available market.

Sales to the Middle East and Europe, in particular, have exploded from nothing to $11m over the past three years – 3% of the group total – and could add that much again in a couple of years. A sales and distribution centre is being set up in Dubai to complement a similar facility established in Prague in 2014.

Chart 3: ARB return metrics

Meanwhile, sales in the US have jumped 75% over the past couple of years (to $47m, 13% of the total), helped by the falling Australian dollar and a new distribution centre in Jacksonville, Florida, to complement the one in Seattle, Washington. Management also notes that it now manufactures bull bars for the three big truck makers in the US – Chevrolet, Dodge and Ford – and that 'the opportunities for this range in the future are substantial'.

We don't doubt it. The company also stands to take a greater share of any sales, thanks to the proposed expansion of its manufacturing facilities in Thailand, where it has bought about 55,000 square metres of land near its existing 27,000 square metre factory. With the average wage in Thailand around a tenth of that in Australia, this will no doubt provide a boost to margins.

> **Other companies could learn from this, but it will obviously bring down returns in the meantime.**

Controlling the twitch

All this leads to an answer for the conundrum we posed earlier. ARB is being rated at its highest ever because its prospects are as strong as ever. Given its track record, investors are backing it to make good on those prospects. Unfortunately for us, though, that means that much of the potential is already priced into the shares.

The consensus forecast is for the company to increase earnings per share by about 10% in the current year to 66 cents, putting the stock on a forward price-earnings ratio of about 27. That's nowhere near cheap enough to buy, but we're going to try to keep our nervous twitches under control this time and hold back from selling.

All things equal, we'd be interested in buying ARB on a forward multiple of about 20 (meaning the Buy price moves from $9 to $13) and we'd likely be uncontrollably twitchy on a forward multiple of about 30 (meaning the Sell price rises from $14 to $20). **HOLD**.

Disclosure: ARB was the first ASX-listed stock the author ever owned. Uunfortunately he twitched in 2008 at a mere $3.83. He says he had other things to buy, but it's not much consolation.

Iress buys superannuation software business Financial Synergy for $85m.

BY ALEX HUGHES • INTELLIGENT INVESTOR • 27 SEPTEMBER 2016

Iress's super acquisition

Another day, another acquisition for Iress. With the ink still drying on the INET BFA acquisition announcement, Iress is at it again with the $85m acquisition of Financial Synergy. The purchase will be funded by an institutional placement and share purchase plan at $11.35.

IRESS (IRE) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$11.88	5%	Medium	Medium

BUY Below $10.00 — HOLD — SELL Above $15.00

$11.88

If you were hoping for a game-changing acquisition, you won't find it here. Financial Synergy, like INET BFA before it, barely moves the needle and doesn't change the price guide we set out last week in ***Iress: Going OK in the UK***.

The acquisition does, however, give Iress a strong platform in the superannuation market. Financial Synergy began life in 1978 as an actuarial firm, but after finding success internally developing software, it switched to providing software and services to superannuation funds and their administrators. Its Acurity product helps superannuation members to view and manage their investments, as well as with reporting and compliance. It's now a significant business, managing 12.5% of Australia's $2 trillion superannuation industry (by assets). The acquisition adds $27.5m in revenue and $8m of EBITDA to Iress's coffers.

Financial Synergy seems like a very decent business. Since it started, it's yet to have a customer leave and 50% of revenue is recurring. Its 29% EBITDA margins trump Iress's, and that's using the lower EBITDA figure derived using Iress's more conservative accounting policies. It also didn't come at a bargain multiple with a price tag of 10.6x EBITDA.

Like any business, Financial Synergy has risks. The most notable is its customer concentration, with its top three customers contributing half of revenue. And like any acquisition, joining two organisations always brings integration and cultural risks.

That said, Iress is undoubtedly excited about the mandated growth of the superannuation industry, which is projected to grow to $9.5 trillion of assets by 2035. With such rapid growth in assets, it seems logical to assume that the superannuation administration software market will follow a similar trajectory, supporting Financial Synergy in turn. But in reality, growth is unlikely to be this certain or predictable.

For instance, industry structures tend towards oligopolies over time in Australia. We have four big banks, two large supermarkets, and after **Vocus**'s roll-up of the sector, just a handful of telecoms providers. It seems likely that the superannuation industry will follow a similar path over time.

For Financial Synergy, the winds of industry consolidation could blow both ways. If its clients buy out competitors, it would be a big benefit as their acquired members are migrated onto Acurity. But if competitors do the consolidating, Acurity's customer numbers could stagnate.

At this stage, Financial Synergy looks like a decent acquisition, but we look forward to future presentations to learn more about it. In the meantime, **HOLD**.

Staff members may own securities mentioned in this article.

Growth by acquisition can lead companies astray, but this packaging maker knows how to do it right.

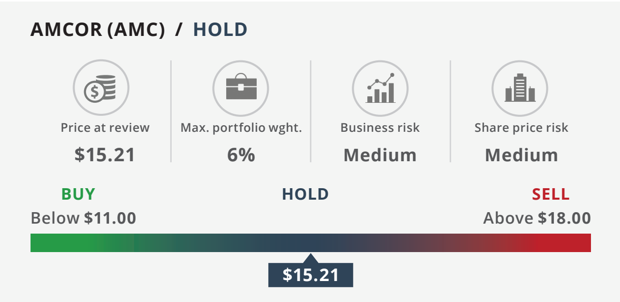
BY GRAHAM WITCOMB • INTELLIGENT INVESTOR • 29 SEPTEMBER 2016

Amcor: buying big and getting better at it

Nothing boosts a company's charm like the perception that it's growing profits and cutting costs.

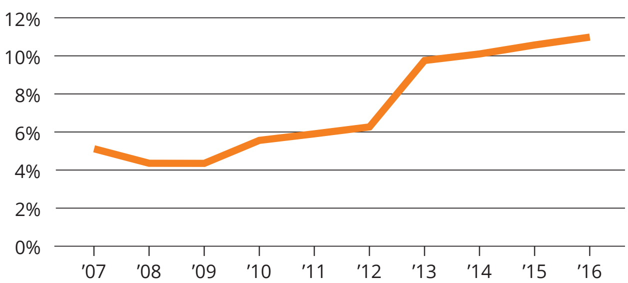
Key Points

- ***Scale reduces costs, boosts profits***
- ***Sonoco deal looks attractive***
- ***Cost cutting at acquisitions is improving***



Take Dick Smith, for example, which forecast that operating earnings would triple in the year after its 2013 float due to various 'efficiency programs' and 'growth initiatives'. When the company listed, the intoxicating combo led investors to pay five times the price at which **Woolworths** had sold the business just a year earlier. We saw through the smoke and mirrors and recommended members **avoid the float** – and thankfully sidestepped the company's collapse in 2015.

Chart 1: EBIT margin



Source: Company reports

But in a world of accounting shenanigans and dodgy marketers, **Amcor** is the real deal. The plastic containers and packaging maker has been genuinely cutting costs and improving its operating margin one percentage point at a time (see Chart 1).

What's more, the company seems to be getting better at it, as we'll explain shortly, and that comes down to one thing: **economies of scale**.

Amcor has significant fixed costs, such as manufacturing equipment, sales staff and head office expenses. That means that as more boxes and bottles are churned out of its machines, the average cost per unit goes down.

Commodity types

Amcor is one of the largest packaging manufacturers in the world and is the market leader in many of its product categories, such as flexible plastic containers for the food industry or paper packaging for tobacco products.

Packaging is known as a 'commodity type' business because there's little to distinguish one plastic bottle from another. This makes the industry especially competitive as price is about the only lever companies can use to make a sale.

Amcor's size, however, ensures it can remain profitable at prices that would leave smaller competitors losing money, which is a significant barrier to newcomers trying to enter the market.

Extra bottles = extra profits

The company's size also means it can push back on suppliers, which – together with its lower average fixed cost base – helps to explain a profit margin of 7%.

That's nothing spectacular, to be sure, but still reasonable given the intensity of competition in this industry. For comparison, the second largest plastic packaging maker, Sealed Air Corp, has a margin of just 5%; the fourth largest, Coveris Holdings, hasn't turned a profit in five years.

What's more, packaging companies need to reinvest in capital equipment to maintain their factories. But with more packages being churned out of its machines, Amcor's capital expenditure is spread across a higher volume of sales – capital expenditure came to 31% of operating cash flow over the past three years, compared to 40% for Sealed Air Corp.

The flipside of lower capital expenditure is that more of the net profit flows through as free cash flow: Amcor had

> **Amcor isn't a high-quality business but there's still plenty to like at the right price.**

US$750m of free cash flow in 2016, a margin of 8%. This may not be a great business, but there's still plenty of free cash flow that can be returned to shareholders as dividends – or used for acquisitions.

Hey big spender

Given the benefits of being big in this industry, Amcor's management rightly loves to acquire smaller competitors. In addition to the US$2.0bn mega-purchase of Alcan Packaging at the height of the global financial crisis, Amcor has spent a further US$1.6bn since then buying more than a dozen bite-sized companies.

Earlier this month, Amcor agreed to buy the rigid plastic moulding operations of Sonoco Products for US$280m. The Sonoco operations generate US$210m in sales and include seven production sites in North America.

The new facilities are a welcome addition as they beef up Amcor's specialty food and personal care segments. When it comes to a commodity-type industry like plastic packaging, the more specialised the niche, the better, as it usually comes with hints of pricing power. Indeed, the Sonoco assets generate an earnings before interest, tax, depreciation and amortisation (EBITDA) margin of 17% compared to Amcor's overall margin of 15%.

Amcor also expects to remove US$20m of costs following the purchase by cutting out duplicate expenses in the supply chain and, with the economies of scale mentioned earlier, we expect the company will have no trouble doing so.

But here's the kicker: the purchase price of eight times EBITDA already looked quite reasonable – Amcor itself currently trades on a multiple of 12 – but the cost cuts reduce the price to just five times EBITDA.

Better than ever

More interesting still is that the Sonoco transaction suggests a budding trend: not only is Amcor cutting costs with each acquisition, it seems to be getting better at it.

When Amcor bought Alcan Packaging in 2010, cost-cutting 'synergies' amounted to around 5% of Alcan's sales. The purchase of Aperio in 2012, then Alusa earlier this year, both came with cost-cutting targets of 7% of sales. And now, with Sonoco, management expects synergies of around 10% of sales.

When you consider that these businesses typically come with profit margins in the single digits, the ability for Amcor to remove this much in duplicate costs is a huge deal. It's conceivable that the Sonoco assets will make double the profits under the Amcor umbrella than with its previous owner.

Bad balance sheet

The global plastic packaging market is worth a good US$300bn, with hundreds of manufacturers. We expect many more opportunities for Amcor to make sensible purchases and add a few percentage points to its organic growth of around 3%.

Table 1: AMC result

YEAR TO JUNE	2016	2015	+/– (%)
REVENUE (US$M)	9,421	9,612	(2)
EBIT (US$M)	1,055	1,053	0
U'LYING NPAT (US$M)	671	680	(1)
U'LYING EPS (US CENTS)	58.0	56.6	2
FINAL DIVIDEND	22.0 US cents, unfranked, (up 5%), ex date 6 Sept		

Unfortunately, with net debt of US$3.8bn – and interest expense consuming nearly a fifth of operating earnings – Amcor already carries an uncomfortably large chunk of leverage. If the company tries to make any more large acquisitions, we expect it will need to tap shareholders for money. However, even after paying dividends, Amcor still has around US$280m of free cash flow, which is ample to make a few smaller bolt-on acquisitions each year.

Amcor isn't a high-quality business but there's still plenty to like at the right price. The stock has an underlying price-earnings ratio of 20 and unfranked dividend yield of 3.7%. That isn't ridiculous, but nor is it enough to whet our appetite given that we only expect earnings to grow in the mid-single digits over the long term.

We're increasing our recommended Buy price from $8.50 to $11 and the Sell price from $14 to $18 to reflect an improving outlook. For now, though, we're sticking with **HOLD**.

Staff members may own securities mentioned in this article.

An 8% increase in net profit seems to have reassured the market but declining revenue in Australia is inescapably bad news.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 27 SEPTEMBER 2016

Coca-Cola Amatil: Interim result

Coca-Cola Amatil's half-year results, released last month, contained a 3% increase in revenue and an 8% increase in net profit, but those figures disguised some worrying trends.

COCA-COLA AMATIL (CCL) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$10.05	5%	Medium	Med–High

BUY Below $7.00 · HOLD · SELL Above $11.00

$10.05

The 8% profit lift might sound OK, but much of it was due to lower finance charges (due to lower interest rates and reduced debt thanks to The Coca-Cola Company's investment in the Indonesian business), cost reductions and a minor recovery in Indonesia.

Meanwhile, the worrying trends – which we described in ***Coca-Cola Amatil's Big headache*** in July – accelerated. In Australian Beverages, the company's largest and most important division, revenues fell 4%. Particularly concerning was that the volume of sparkling beverages fell 6% in the first half (after being flat in the year to 31 December 2016). That people are drinking much less Coca-Cola is now indisputable.

Thankfully management managed to slash costs, containing the operating profit decline in the Australian Beverages division to 2%. Had costs been flat, earnings would have fallen 22%. There is only so much cost-cutting a company can do – eventually declining revenues will crunch profitability.

At the moment, cost-cutting and earnings growth from smaller divisions are supporting Coca-Cola Amatil's overall profitability. But, with the stock gaining 9% since our July review, we're concerned the market is too focused on the 8% half-yearly earnings increase and not paying sufficient attention to the worrying trends in Australian Beverages. Perhaps Indonesian growth will offset weakness from Australian Beverages in the years ahead but we don't want to count on it.

Table 1: CCL interim result 2016

HALF-YEAR TO 1 JULY	2016	2015	+/(–) (%)
REVENUE ($M)	2,517	2,450	3
EBIT ($M)	327	317	3
NPAT ($M)	198	184	8
EPS (C)	26.0	24.1	8
DPS (C)	21*	20	5
FRANKING (%)	75	75	N/a

*** Interim dividend, ex date 1 Sep**
Note: Figures are underlying results

The stock is trading on a 2016 prospective price-earnings ratio of 19, which is starting to look expensive given the potential earnings downside if Australian revenues keep declining. We're approaching a downgrade to Sell but the stock remains a **HOLD** for now.

Staff members may own securities mentioned in this article.

Despite what we might prefer, an entitlement issue isn't necessarily the best solution for a small company that requires additional funds.

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 27 SEPTEMBER 2016

Directors walk a capital raising

A renounceable entitlement issue is the fairest way to raise capital (see ***Capital raisings: Time for a fair share***). So why did **iCar Asia** recently choose a placement, the least fair method?

It's galling that many existing shareholders – retail investors, in particular – were unable to participate. Several members expressed their anger in the comments section of ***iCar Asia finds the funds***.

But it's a misunderstanding of directors' duties to think that they owe a fiduciary duty to particular groups of shareholders. Rather, their duty is to the company as a whole.

Sometimes the best thing for the company might even involve favouring certain groups of shareholders over others, as in iCar Asia's case here. Of course, we don't have to like it.

Cash crunch

iCar Asia needed more capital. The company was due to run out of cash by the middle of next year. It was therefore necessary that directors raised capital with the least amount of risk. But entitlement issues are the riskiest way of raising capital because they take time.

It's also likely that, had iCar Asia launched an entitlement offer, the issue price would have been 25 cents, or perhaps even 20 cents a share. A much larger number of shares would have been issued, making it more akin to a recapitalisation than a capital raising.

In the end, iCar Asia's decision to issue shares to institutional investors, existing large shareholders and certain directors was – as much as it pains me to say it – probably the best decision. The 32-cent issue price was at a discount of only 10% to the share price, meaning dilution to existing shareholders was just 2.5%. The raising was also wrapped up within days, minimising the risk that it might fall over.

Risking administration

Had iCar Asia launched a failed entitlement issue – due to an untimely market crash, for example – it might have risked administration (although big brothers Catcha Group and **Carsales.com** would probably have prevented this). Directors chose to advantage a small group of shareholders for what might be called 'the greater good'.

This is not a defence of iCar Asia's board or (former?) management. It probably should have realised the company had insufficient capital much earlier. And it should have launched a raising well before the market began panicking. The raising was conducted from a position of weakness rather than strength.

Be that as it may, it could have been worse. Unfortunately start-ups require a lot of capital, sometimes at inopportune times. It's yet another risk to take into account when dabbling in this sector.

Note: I'm not a lawyer, so if I've misunderstood something about directors' duties, feel free to correct me in the comments.

Takeover bid for SAI Global

BY JAMES GREENHALGH • INTELLIGENT INVESTOR • 26 SEP 2016

SAI GLOBAL (SAI) / HOLD

Price at review **$4.67**

Max. portfolio wght. **4%**

BUY Below **$3.50** · **HOLD** · **SELL** Above **$5.00**

$4.67

We've been ambivalent about standards publishing and compliance group SAI Global for some time. Our concerns centred mainly on its publishing licence with Standards Australia, which will need to be renewed over the next year. As its relationship with Standards Australia is strained – to put it mildly – the renewal is a significant risk.

Uncertainty about the licence was behind the failure of SAI Global to auction itself off in 2014. That process had been initiated after private equity firm Pacific Equity Partners bid for the company at a price between $5.10 and $5.25 earlier that year.

Our concerns have led us to sit on our hands since ***SAI Global: Result 2015***. The stock has looked like reasonable value recently, but we couldn't get comfortable with the risks or management's strategy.

Today the decision has been made for us. SAI Global has agreed to be acquired by Baring Asia, another private equity fund, for a price of $4.75 a share. Presumably Baring Asia has done its due diligence and is comfortable with the licence renewal issue. Perhaps it thinks a different approach than SAI Global's current management has taken will win over Standards Australia.

As we've not had a positive recommendation on SAI Global, we've not given it much time and won't start now. If you hold the stock, however, we recommend you continue to do so. Baring Asia might encourage other private equity firms to renew their interest (although probably not).

Absent further developments, we'll comment closer to the shareholder vote, which is planned for early December. Until then, **HOLD**.

Disclosure: The author owns shares in SAI Global.

LICs

I am on the prowl for reputable listed investment companies (LICs) trading at a discount to net tangible assets (NTA). Are there any available on the ASX that provide a long short option (that is, buying stocks and also short selling them) to cushion market volatility? Your thoughts would be much appreciated.

29 Sep 2016 – **Mitchell Sneddon**: I think you might be on the prowl for some time. The most reputable LICs are predominantly trading at a premium to NTA right now. As far as LICs that use a long/short strategy, most short sell to generate performance just like they do when buying an individual stock they want to own. They might short sell a stock they believe is overvalued or is too indebted or that doesn't have a viable business model.

The bulk of these LICs don't use their ability to short sell as a 'market neutral' strategy. Investors following a market neutral strategy attempt to hedge against movements in the market as a whole (represented by major indices such as the ASX 200). The goal here is to reduce or eliminate the impact of movements in the market on their portfolio so that its performance is solely determined by how successful their individual stock picks – both long and short – are.

However, there are two LICs that come to mind that do use the ability to short as a hedging strategy and they're run by the same team. They are Australian Leaders Fund (ALF) and Watermark Market Neutral Fund (WMK). Currently ALF is trading at a 12% premium to post tax NTA and WMK is a shade above its NTA with a 2% premium. We don't cover either of these LICs.

One thing investors need to keep in mind when looking at LICs with investment strategies other than the traditional buy and hold strategy are the costs associated with them. Alternative strategies can involved a higher cost of doing business and in many cases are managed by an external manager too therefore having managed-fund style fees. There is nothing wrong with this, but investors should demand a bigger discount to NTA to compensate for the additional fees. Please see ***An Introduction to Listed Investment Companies*** for more.

Lidl's threat to Woolworths

Please, what are your views on WOW now that Lidl has applied for trademarks as reported yesterday in the Herald. Fat Prophets says WOW will get to $10 before the price/company turns around. Then there is the affect of Aldi. All very worrying.

28 Sep 2016 – **James Greenhalgh**: We covered these issues in Woolworths: Competition cuts in Part 1 and Part 2 in June. In Part 1 we mentioned that Lidl was applying for trademarks, as it has done for some time (i.e the Herald article is old news). My understanding is that Lidl is looking very long term in any case. It is focused on the US at the moment and is considered unlikely to enter Australia before 2020.

That's if it ever does – I'm not convinced there's room for another Aldi lookalike in Australia (although their strategies are slightly different). Aldi's success will make it that much harder for Lidl to gain a foothold.

Remember that Aldi took 15 years to go from zero to a 12% market share. These things happen very slowly and by that time the market will have grown (and changed) substantially. By that time, Woolworths, Coles and Aldi might have taken more share from IGA/Metcash/independents rather than the discounters taking significantly more share from Woolworths or Coles. Or the pendulum might have swung back so that Coles is struggling compared to Woolworths.

Have a re-read of the articles above if you're concerned. We may be wrong of course, so it's important to make up your own mind. But remember that retailing – including grocery retailing – is a competitive business. There will always be new threats for local retailers to tackle and shareholders to worry about. In the end we need to weigh up price and value and our view is that the worst of the damage to margins has already occurred. I hope that helps.

Push Pay

I know you don't normally review IPO's but I was wondering if had any general comments to make on Push Pay?

29 Sep 2016 – **Alex Hughes**: With a market cap of $578m, against just $15m in revenue and no earnings, a lot of growth has already been factored into Push Pay.

Generally speaking, I think it is difficult to make money from such situations, unless you have superior insight into why this company will go on to meet or exceed the high expectations.

Aged care sector sustainable?

Have you got any opinion on Estia and the sustainability of its earnings?

28 Sep 2016 – **Graham Witcomb**: Let me start by saying we can only offer general advice, so please take your personal situation into account before acting on our recommendations. Having said that, we don't actively cover Estia but aren't big fans of the aged care sector in general - it's highly capital intensive, heavily regulated, and supply is likely to exceed demand for several years, despite the steadily ageing population. You can read more about our distaste for the sector in Aged care reform spells trouble for providers. The retirement village and aged care industry is littered with failed operators, which speaks to the competitiveness and difficulty getting things to work. Even at today's prices, the risks are many and we're happy to steer clear.