# Five Top Picks for 2019

## Special Report

DECEMBER 2018

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# Letter from the Editor

**Dear Investor,**

Before the month of October, the thought of pulling together this special report filled me with dread. Members pay us for many different reasons but regular buy recommendations are be at the top of their wish list.

Unfortunately, successful value investing often entails simply doing nothing, especially when doing something means chasing expensive stocks ever higher. This isn't the route to investing heaven, which is why our **Buy List** has been shrinking in recent years.

In 2017, as in 2016, the ASX 200 index rose by about 7%. That made the job of uncovering cheap stocks harder. In 2016, 57 companies joined our Buy List, from blue chips like **Woolworths** to less popular second liners like **Reece**, **Gentrack** and, lamentably, **GBST**.

In 2017, only 18 stocks made the grade, many of them smaller companies which necessarily entail more risk.

This year was shaping up in much the same way. In March we published How to build a portfolio from scratch, urging members to be patient and act quickly when those rare buys appeared. At the time there were just nine stocks on our Buy List, a number which soon fell by one.

Then, between 30 August and 25 October the ASX 200 dropped 11% and the upgrades flowed. Despite the recent rebound, at the time of writing there are 15 stocks on our Buy List (including six Speculative Buys), which makes this report more interesting than it might have been a few months back.

The general fall has delivered something for everyone. Income investors might be surprised to learn of the high quality but unloved blue chip paying a yield of 7.8% while value investors might be attracted to the out-of-favour wealth manager trading at around 10 times consensus earnings forecasts for 2020.

And the growth-orientated might like one of our recommendations joining the list in mid-November – the essence of a good business at a fair price. There's even something for the more speculatively inclined with two small stocks from InvestSMART's funds management team.

That's a pleasing haul for a year that started so badly. Let's get into it.

Yours sincerely,

**John Addis**
***Editor-in-Chief***
***InvestSMART***

"BARGAIN SHOPPING IS
ALL ABOUT PRICE
AND VALUE."

# Prices slashed, dividend up at Unibail-Rodamco-Westfield

**Since listing in May at $14.65 a share, the share price has fallen 20%. For income investors this is very good news.**

It's been a case of choose-your-poison for income investors over the past few years: suck up historically low rates with a 2.5% term deposit or get more than twice that in a big bank and run the risk of a(nother) major share price tumble.

## Key points

- **Unibail portfolio even higher quality than Westfield's**
- **Attractive yield and prospect of growing earnings**
- **Opportunity for overseas diversification**

Well, we have some good news. Unibail-Rodamco-Westfield, henceforth referred to as Unibail, offers an impressive dividend yield of 7.8% and trades on a price-earnings ratio of under 12. Since listing in late May the share price has fallen 20%: the result is one of those rare opportunities that should set the pulse racing, even for wary income investors.

Let's begin at the beginning. In May, European shopping centre giant Unibail-Rodamco, headquartered in Paris, completed its $32bn takeover of Westfield. Australian investors understand the strategy behind Westfield's US and London-based shopping centres – URW's European assets not so much. This information gap is the source of the opportunity.

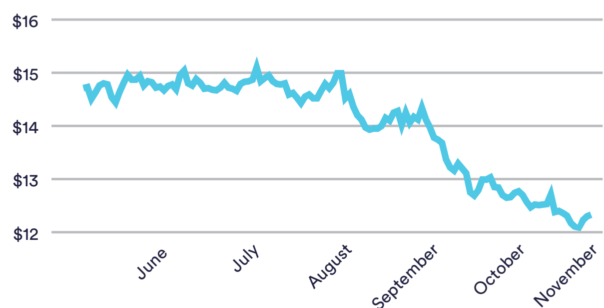
In terms of profile, demography and scale, Unibail's €64bn property portfolio mirrors Westfield's flagship approach. With mainly high-end shopping centre assets generating impressive foot traffic and sales per store across France, the US, UK and Central Europe, it may even be a slightly better example of it.

## Premium retailers

To act on this recommendation is to believe that the growth of online sales will drive premium retailers like Apple and Nespresso to take space only in the most attractive shopping centres, many of them owned by Unibail.

It is also to believe that they'll attract non-traditional tenants like Jaguar Land Rover and Tesla, who want to showcase their brand in the best environments, replacing ageing, dying retailers like department stores. This flight to quality drove our decision to upgrade Scentre Group earlier this year (Buy – $3.94). Much of the same thinking applies to Unibail.

### Share price since listing in June 2018




Source: S&P Capital IQ

Can we be sure the growth of online retail won't affect flagship shopping centres in the same way as it might sub-regional centres and local high streets? Of course not. Even in the most popular centres discretionary retailers still account for a large percentage of the tenant mix. All are subject to threat from online competition.

But shopping centre owners have been fighting back, successfully shifting their mix of tenants away from department stores towards food and services, offering people an experiential rather than a functional reason to visit a major centre.

### Portfolio value by type

Source: Company reports

The clincher is that Unibail is further along this path than local property trusts such as Vicinity and Scentre. In Unibail's biggest markets, online retail sales as a percentage of total sales are higher than they are in Australia. In the US, e-commerce sales are expected to hit 9% this year. The UK figure is twice that while the local figure is about 7%.

## Increasing market share

Results suggest that Unibail's strategy of focusing on high-quality shopping centres is helping it to weather the impact and prosper beyond it.

Unibail's European centres enjoyed sales growth of 2.3% in the three months to 30 September compared to the same period in 2017, helped by a 2.0% increase in visits. It's not much, but when compared to a slight fall in retail sales across the European Union over the same period, it's nevertheless impressive.

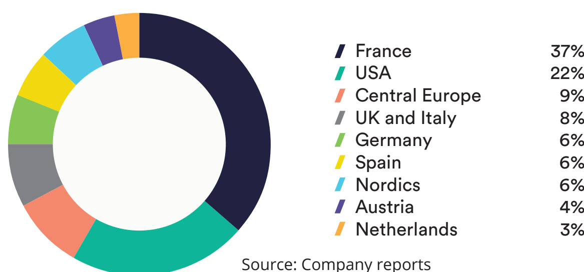
In the US, there was a 5.5% rise in specialty sales per square foot for the 12 months to September 2018, compared to the previous period, well above the national average of 0.5% growth.

Tenant sales growth is important. Profitable tenants renew leases and can pay more in rent as the years pass. Leases are also structured so that owners like Unibail receive base rent for each store plus a percentage of sales.

Management also noted that cost reductions following the Westfield acquisition would have a positive effect on full-year earnings per share and confirmed earnings guidance of €0.637–0.645 (A$0.99–1.00) for each of its ASX-listed securities.

With 67 shopping centres – 57 of which can be classified as high-performing malls – delivering more than a total of 6 million visits a year, Unibail is living proof that shopping has been a central part of human activity for centuries. We think it will remain so.

### Portfolio value by region




Source: Company reports

To justify the current share price, though, Unibail's shopping centres don't need to represent as large a percentage of the economy as they have in the past. In fact, having factored growth of only 2–4% into our valuation, we're essentially accepting that the company's share of GDP will fall. At these prices and yields, that can still deliver an attractive outcome.

## Development potential

There's also a backstop if things don't work out. Most centres have development potential, adding residential apartments as Unibail is doing in London, or conversion to offices or other commercial developments. Both provide a floor to the valuation.

Unibail already owns some office developments and convention centres but these are peripheral to our investment case. This recommendation is really all about shopping centres, and Unibail owns some of the best in the world, delivering higher rental income and lower vacancies.

The company is also building more of them: Unibail's €13bn development pipeline, in addition to the full year impact of new centres such as the World Trade Centre in New York, should continue to deliver increasing earnings and distributions.

In the short term at least, this growth should be assisted by cost savings from the merger. In August management revealed it had already achieved annual cost savings of €74m, ahead of initial guidance of €60m.

## Debt and currency risk

Debt is more of a concern. Boosted by the A$7.4bn cash payment made to Australian shareholders as part of the acquisition, Unibail's gearing of 38% is significantly above the ASX200 AREIT average of 22%.

But it has a big card to play. Thanks to prime locations in Europe and the US, Unibail is able to secure financing at rates well below local property trusts. This makes debt metrics look far better than the absolute level of gearing: average debt maturity is seven years and little is due to expire before 2021; interest cover is seven times; and the average interest rate is 1.5%. Overall debt is also being reduced.

There's also the currency risk. Most of Unibail's revenue is generated in US dollars, sterling and euros. If the Australian dollar weakens, then it would boost earnings and distributions in terms of Aussie dollars – and vice versa.

The flipside is the diversification benefit. Many local investors are poorly diversified, with too much of their money in Australian shares. This recommendation provides an opportunity to rectify some of that imbalance. It means accepting overseas currency exposure, but that's part of the point of diversification.

Unibail is an undervalued and unloved high-quality business with an attractive and sustainable distribution yield of 7.8% and a forward price-earnings ratio below 12. We recommend buying the ASX-listed Chess Depositary Interest (CDI) up to $15 for no more than 6% of your portfolio.

*Note: Not all brokers permit customers to buy the URW CDI. Those that do include Commsec, Bell Direct and Westpac Online Investing; those that don't include Nabtrade, CMC Markets and ANZ Share Trading.*

**“DON’T DISMISS THE POSSIBILITY OF DECENT RETURNS FOR THE FIRST FEW YEARS AS NEW MANAGEMENT DRIVES EARNINGS GROWTH, WHICH, WE SUSPECT, IS WHY WESFARMERS RETAINED A 15% STAKE.”**

# The case for Coles

**The stock price has been weak since listing but the reasons for it reinforce why the company looks great value.**

What goes around comes around. Almost 11 years to the day after its takeover by **Wesfarmers**, Coles Group relisted on the ASX on 21 November, 2018 at a price of $12.49.

## Key points

- **High quality business**
- **Earnings currently depressed**
- **Better value than Woolworths**

Wesfarmers' shareholders may have been surprised by the 28% decline in the share price on the day but it simply reflected the demerger of Coles. And, just as we hoped, it listed below our assessment of value and was added to a burgeoning Buy list.

Coles Group now consists of Coles' supermarket operations, as well as Liquorland and First Choice liquor and the Coles Express fuel and convenience business. Unlike 2007, the new version of Coles Group doesn't come with ownership of department store chains Kmart and Target, which have remained with Wesfarmers.

Coles is the slightly weaker supermarket group compared to **Woolworths** but both are high quality businesses. In the very long term our preference would be for Woolworths. But at $12.60, the significantly different sharemarket pricing means Coles is currently the better buy.

Let's examine why.

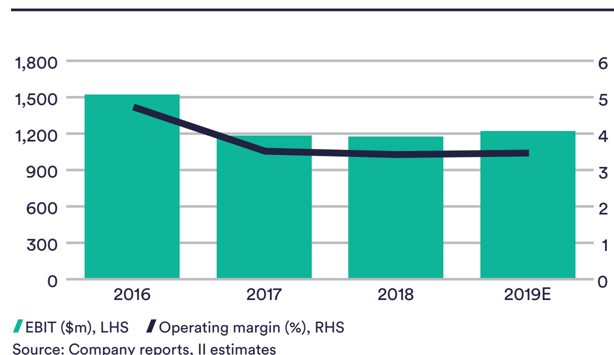
Brokers have been generally unenthusiastic about Coles, reinforcing the negative sentiment around the stock. Perhaps shareholders are buying the line that Coles is a low-growth business, or are worried about Amazon's grocery offer undercutting the major chains.

Then there's the news that Woolworths has apparently regained sales momentum after losing it to Coles' Little Shop promotion in the first quarter. Woolworths has launched its own Christmas cardboard collectibles campaign, and has been particularly aggressive with 'money-off' promotions in the lead-up to Christmas. Coles, by contrast, has trotted out a somewhat tone-deaf re-run of the Little Shop collectibles promotion.

To top it off, chief executive Steven Cain's performance incentive will be measured from the day after the half-yearly results are released in February. He probably doesn't have much interest in talking up the company until then.

These are short term issues that overwhelm a more pertinent point: Coles is at a much earlier stage of its profit recovery than Woolworths.

### Coles supermarkets division



Source: Company reports, II estimates

Coles Group's operating earnings under Wesfarmers' ownership doubled between 2009 and 2017. This is a wonderful business that, along with Woolworths, controls a near 70% share of the Australian grocery market. Both companies' market shares have been remarkably stable over many years, with the emergence of discounters such as Aldi and Costco making nary a dent.

However, Coles' earnings were damaged by Woolworths' price reductions and service investment in 2016, which has in turn driven superior same-store sales growth for

the larger company. Coles Supermarkets lost its seven-year sales growth leadership as a result, with earnings before interest and tax (EBIT) falling from $1.5bn to $1.2bn between 2016 and 2018. The margin took a hit too (see chart).

We're confident that new management will address the problems. The last time Coles Group was separately listed, chief executive John Fletcher admitted he hadn't set foot inside a supermarket in 20 years. Steven Cain, Coles Group's recently appointed chief executive, is an industry veteran.

### Comparative valuation

| | COLES GROUP | WOOLWORTHS |
|---|---|---|
| Share price for calculation ($) | 13.00 | 26.00 |
| No. of shares on issue (m) | 1,334 | 1,313 |
| Market capitalisation ($m) | 17,342 | 34,138 |
| Net debt ($m) | 2,000 | 1,530 |
| Enterprise value (EV) ($m) | 19,342 | 35,668 |
| Sales 2019e ($m) | 40,000 | 63,000 |
| EBIT 2019e ($m) | 1,444 | 2,809 |
| EV/sales (x) | 0.48 | 0.57 |
| EV/EBIT (x) | 13.4 | 12.7 |
| Net profit ($m) | 955 | 1,767 |
| Free cash flow ($m) | 861 | 1,400 |
| PER (x) | 18.2 | 19.3 |
| Free cash flow yield (%) | 5.0% | 4.1% |

As the saying goes, retail is detail. Having run the supermarkets, liquor and fuel businesses – the same ones being demerged from Wesfarmers – back in 2003–04, Cain brings a fresh pair of experienced eyes to the business. The benefits of management change shouldn't be underestimated, particularly as Cain's long-term incentive is largely based on achieving earnings growth.

If new management is part of the case for Coles, then so is a potential earnings recovery.

Broking analysts appear to be pricing the business on 2019 earnings, which are arguably still depressed.

Coles' earnings have been dragged down by Woolworths, whose own earnings only began recovering in 2018 after a 38% slide between 2014 and 2017. With Coles' former management having done the hard work to stabilise the business – earnings in the second half of 2018 rose slightly – Cain is positioned to benefit from the upswing.

While Woolworths' 2019 earnings will be up more than 20% from their 2017 nadir, Coles is still bouncing along the bottom. On a pro forma basis, we're expecting Coles Group's operating profit to rise by only 2% this financial year.

You can see some comparative valuation statistics for Coles and Woolworths in the table, based on share prices of $13 and $26 respectively (being our Buy prices for both stocks).

Based on $13 a share, Coles Group's valuation statistics are superior to Woolworths on most measures (with the $26 Buy price for Woolworths 10% lower than the market price in any case). Coles also trades at a lower enterprise value to sales multiple, with the discount increasing if we adjust for Woolworths' fuel business, which is for sale, and loss-making department store Big W.

**WEIGHT WATCHING**

**Don't forget to also review your portfolio exposure to the retail sector. Following the demerger we've recommended a lower maximum weighting of 8% for Wesfarmers and 7% for Coles Group. However, both are effectively retail stocks and a 15% total exposure to both is probably on the high side.**

**Also, if you own Woolworths, it might not be prudent to consider buying Coles as well. More active members might consider switching from Woolworths to Coles given the valuation relativities (although this is not a recommendation).**

**Remember to consider any other retail stocks you own, too. If your total exposure to retail is 20% or higher, then you should probably consider trimming overweight or more expensive positions.**

Coles also trades at a better free cash flow yield of 5%. Both companies are investing heavily at the moment but even with the additional capital expenditure, Coles should generate close to $1bn a year in annual free cash flow over time.

Coles Group does, however, trade at a slight premium to Woolworths at the moment, in terms of price-earnings and enterprise value to EBIT. This makes sense because Coles' earnings are still bouncing along the bottom whereas Woolworths' have already begun to recover. While Coles' supermarket margins won't return to previous highs – above 5% – there's upside from the current 3.9%.

At the current price of $12.60, Coles is trading on a 2019 prospective PER of 17.6, an attractive metric given its quality and profit turnaround potential.

While the market is underestimating the potential for earnings recovery, Coles won't be a high-return stock. If your hurdle is for double-digit returns over the long term, then you might look elsewhere.

But don't dismiss the possibility of decent returns for the first few years as new management drives earnings growth, which, we suspect, is why Wesfarmers retained a 15% stake. Management didn't want to own Coles forever. But it also understands the market was likely to undervalue the stock until earnings growth resumed.

This is a relatively low risk stock with a risk rating of Low-Medium and a maximum portfolio weighting of 7% (but please see Weight Watching box before acting). **BUY**.

*Disclosure: The author owns shares in Wesfarmers and Coles Group.*

*Note: This recommendation replaces IOOF, which was originally one of the five stocks selected for this report. A few hours after publication, APRA issued proceedings against IOOF senior management, provoking a share price fall and a downgrade to Hold. As per John Lennon, "Life is what happens to you while you're busy making other plans."*

**"CARSALES' SYSTEMS ARE EMBEDDED IN DEALERS' BUSINESSES, AND IT'S LIKELY TO REMAIN THE GO-TO SITE FOR THE VAST MAJORITY OF QUALIFIED BUYERS."**

# Carsales and the canary in the car yard

**With a share price down 25% in the last three months, this dominant automotive classifieds website is beginning to look cheap.**

If you're as old as I am, you might remember scouring the classifieds section of the newspaper for a job, car or house (probably in that order). Advertisements were small, detail was lacking, and photos were non-existent.

## Key points

- **Downgrade to 2019 expectations**
- **Some cyclical risk emerging**
- **Stock reasonable value again**

Yet these tiny classified ads were so important to newspaper group Fairfax Media in the 1990s that they generated revenue of more than $1bn a year. The ads were the liquid in Fairfax's famed 'rivers of gold'.

As the Internet bloomed a decade later, few print groups saw the writing on the wall, let alone the computer monitor, which is where that revenue went. Classified ad revenue has now migrated almost entirely online in western countries, to the point that Carsales.com recently announced that profit growth this year would be just 'moderate'.

Popping that into our management-speak translator, it means net profit for the online car classifieds company will grow by perhaps 4–5% in 2019. Management also said growth would be 'weighted towards the second half', so don't expect much in the current half.

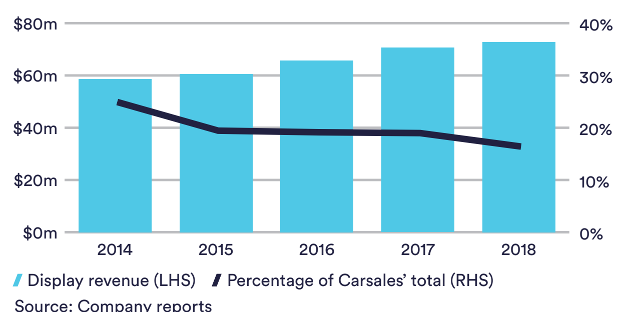
Investors had become used to management predictions of 'solid' growth of 8–10%, so the announcement was seen as disappointing. As a consequence, the stock has fallen from more than $16.00 in August to less than $12.00 now.

Management said there were two main reasons for slower-than-expected growth: display advertising 'has experienced disappointing trading' and its Stratton finance business has been 'impacted by credit tightening'.

## Falling new vehicle sales

Let's put the announcement into context. First up, the new vehicle market is contracting. Australian new vehicle sales fell for the seventh consecutive month in October, dropping 5.3%. The decline seems to be accelerating too, particularly in states where house prices are falling. October new car sales fell 9.2% and 4.2%, respectively, in New South Wales and Victoria. The 2018 calendar year is shaping up as the first decline in the new vehicle market since 2014.

### Display advertising revenue




Source: Company reports

So how do new vehicle sales affect Carsales, which operates a website that mainly advertises used cars?

Well, 16% of Carsales' revenue still comes from display advertising – things like banner ads on websites. The company has the highest proportion of display advertising revenue of any of the online classified

companies we cover. New car manufacturers, insurers and finance providers all pay to advertise on Carsales' sites.

But display advertising is a little old hat. Used by advertisers to promote their brands or highlight offers it's not well-targeted or suited to mobile devices. It's also the first type of marketing that gets cut if advertisers start feeling the pinch. That's probably what's happening here – new car manufacturers are curtailing ad spend as vehicle sales weaken.

## Credit tightening

The second issue highlighted by Carsales was credit tightening. Following the Royal Commission into the financial services sector, credit has become harder to obtain. As around 90% of car buyers use some type of finance, difficulty in obtaining loans appears to be affecting new and used car sales.

It's worth noting the connections between these markets and how they might affect Carsales. Weak housing markets and difficulty in obtaining credit make people less likely to buy a new or used car. Fewer people buying new cars also means fewer used cars will be traded in.

What we haven't yet seen – but which is certainly possible – is a downturn in used car buyer enquiries. Carsales operates a 'leads' model for its dealer customers, slightly different to the 'listings' models of other online classifieds companies. Dealers have to pay Carsales a fee (currently $48) every time the Carsales website delivers a buyer enquiry about a car. Fewer buyer enquiries – whatever the cause – would mean less revenue for Carsales.

What's also been affecting market sentiment is the announcement that Facebook will extend Facebook Marketplace to car dealers. Trade Me shareholders will be familiar with Facebook Marketplace – see *Trade Me and Facebook square off* – which has caused the kiwi company to lose a little market share in recent years.

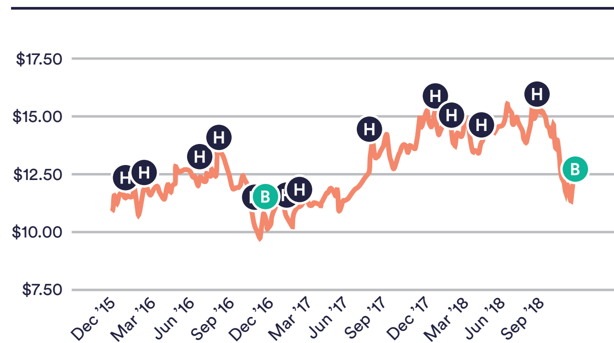
Facebook will allow car dealers to upload their vehicle inventory onto Facebook Marketplace for free. As with Trade Me, Carsales is likely to lose some market share, particularly if dealers somehow encourage buyers to head to Facebook for their inventory (where they wouldn't need to pay Carsales for leads).

## Embedded systems

Still, we're not particularly concerned. Carsales' systems are embedded in dealers' businesses, and it's likely to remain the go-to site for the vast majority of qualified buyers, with Facebook Marketplace and Gumtree offering a 'no frills' experience.

The more significant question is whether the decline in display advertising and credit tightening presages a more significant downturn for Carsales. The answer is: it's possible.

### Recommendation history over the past two years




Source: S&P Capital IQ

Carsales should be considered more cyclical than it once was. The print-to-online structural shift has played out and common sense tells you that advertising is linked to the economy and consumer confidence. A sustained decline in the vehicle market would certainly be reflected in weaker sales and earnings for Carsales.

'Moderate' growth in earnings this year implies Carsales will achieve earnings per share of 56–57 cents. However, vehicle sales and/or advertising markets may weaken further because of house price declines and credit tightening. We wouldn't be totally surprised to see earnings per share of 50 cents next year in this scenario.

## Reasonable price

Picking economic cycles, however, is notoriously tricky. The stock has already fallen more than it did ahead of our last upgrade – at $9.93 in 2016 – and, based on management guidance, it's trading on a forecast 2019 price-earnings ratio of 20. That's very reasonable for a business of this quality that should produce 5–10% annual profit growth over the long term.

Further profit weakness would likely lead to a lower share price in the short term, but Carsales is once again offering a decent discount to our valuation. It's perhaps not a standout opportunity just yet, particularly given our view that it's the weakest of the three major online classified stocks.

But with the stock facing a barrage of bad news and having returned to a reasonable price, it's certainly good enough to upgrade. We recommend buying gradually, and we'd need cheaper prices to encourage us to go near our 6% maximum weighting. But below $12 it's offering a rare opportunity. **BUY**.

> **"IF THE STORY ENDED HERE, YOU'D CURRENTLY BE PAYING NTA FOR 360 CAPITAL. GIVEN PITT'S TRACK RECORD THAT COULD BE VERY CHEAP INDEED."**

# 360 Capital a bet on the downturn

**This company, says Nathan Bell, is filling a niche left by the retreat of the big banks from commercial property lending. And it comes with a free option.**

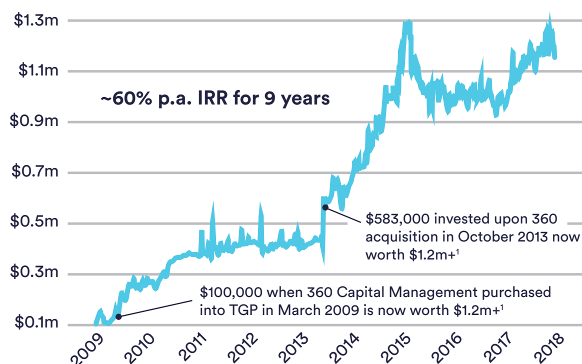
In 2009, as I was sifting through the ruins of the commercial property sector, a friend urged me to look at a small A-REIT called Trafalgar. Like every A-REIT at the time, its portfolio of B-Grade office properties was trading at a large discount to its net tangible assets (NTA).

## Key points

- **Shareholder friendly management**
- **Growth opportunity as banks ration credit**
- **Upside from lending platform**

What distinguished Trafalgar was a man named Tony Pitt, who'd bought a major shareholding and planned to sell the assets one by one to eliminate the discount. Over a few years he delivered on his promise much to shareholders' benefit (see chart below).

### TPG's total return post 360 Capital Management involvement




1. On a total return basis assuming dividends were reinvested. Since 360 Capital's initial strategic stake in Trafalgar (ASX: TGP), through which 360 Capital later listed.

Source: 2018 Annual Results Presentation

I then sold my shares, thanked my friend for the recommendation, paid my tax, and moved on to 'better' opportunities, missing the huge share price gains as Pitt reversed his strategy and began making acquisitions. Renaming the company 360 Capital, he kept buying undervalued property and rode the recovery in commercial property prices.

## Clean slate

Now, Pitt is again starting with a clean slate. Having recently agreed to sell 360 Capital's last major property to **NextDC**, which also happens to be the tenant, 360 Capital is flush with cash and a new strategy.

When emerging from downturns like the global financial crisis, owning equity maximises your returns as asset prices recover. At the opposite end of the business cycle, which is where I believe we are now, Pitt wants the extra protection of supplying debt with covenants rather than equity.

You don't need to sacrifice returns too much, either. Property development returns have increased due to the withdrawal of Australian banks, which have been forced to ration credit to satisfy regulators as they prepare for lower housing prices and higher bad debts.

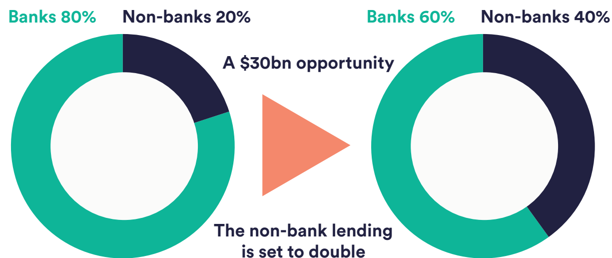
## Big opportunity

This market opportunity can be quite lucrative. Providing debt for a year or two on a small property development typically earns a 10–11% annual return. Not bad when interest rates are below 2%, if you get your money back. Anecdotally, we've learned those returns are more like 15% right now.

The chart below, which shows the (expected) falling market share of Australia's banks for property lending, is a visual description of the size of the opportunity.

### $30bn lending gap

Traditional banks are unable to service the demand for real estate lending, creating a funding gap for non-bank lenders[1]




Currently, the market share of commercial real estate debt held by banks is approximately 80%.

It is expected that this share will decline to 60% over time, creating a A$30+ billion opportunity for non-bank lenders[1]

1. Goldman Sachs research 2017

Source: 2018 Annual Results Presentation

Let's now look at how this might unfold in practice. A typical development for 360 Capital might be a $30m suburban doctor's office. Because of the small size, in a worst-case scenario where the developer goes under, leaving the project unfinished, Pitt could take control and complete it. More capital might be required, either directly from 360 Capital's balance sheet or by finding a new developer and/or investor, but that shouldn't be a problem.

If the story ended here, you'd currently be paying NTA for 360 Capital. Given Pitt's track record that could be very cheap indeed.

Over time, shareholders would receive distributions as if owning an A-REIT. The value of 360 Capital, meanwhile, would grow as profits are banked from completed projects and reinvested in new ones.

That's pretty good for a company where a shrewd, shareholder-friendly chief executive owns a quarter of the shares and which is orientated towards leaner times, but has the potential to capitalise on higher development returns while they last.

## Lending platform

But the story doesn't end here. 360 Capital also owns a 50% stake in a property lending platform called AMF Finance, which earns fees from matching developments requiring capital with investors willing to supply it.

Here's how it works. Let's say you're a high net worth individual with $25m to invest over the next few years in our theoretical suburban doctor's office. You plug your details into the AMF Finance system, after which you get a list of projects in which to invest along with the associated terms. You pay a fee for being offered deals on a silver platter, without having to do any of the dirty work.

As projects mature, 360 Capital can then repackage or 'securitise' this debt for less risk tolerant investors willing to accept lower returns. This releases cash for 360 Capital's next development. Sometimes, 360 Capital can turn over its capital more than once a year. With the right fee structure, this can be extraordinarily profitable.

These are early days. The platform has only completed $111m of deals in the eight months to 30 June, although the potential is substantial, if investors get the right outcomes. Potential 360 Capital shareholders aren't currently paying anything for this potential.

Last year, 360 Capital paid a 5.5-cent distribution but it's unclear what will be paid in future.

The bull case is clear. Tony Pitt is a canny operator with his own money on the line. In a blue-sky scenario, the AMF Finance business could one day be collecting fees on deals valued in the hundreds of millions of dollars.

Just as importantly, Pitt has prepared the business for leaner times. Even if AMF Finance is worthless, you're not paying much, if anything, for it. At worst, you'll own a well-run, entrepreneurial business that's investing in a profitable niche. Pitt excelled during the global financial crisis. We expect nothing less from him during the next downturn.

We recommend 360 Capital for up to 3% of well diversified portfolios at prices below $1.05. Note, however, that the stock is relatively illiquid, so we recommend being patient when building a position and using limit orders.

*This stock review is provided by InvestSMART senior portfolio manager Nathan Bell.*

*The Intelligent Investor Equity Growth Portfolio and the Intelligent Investor Equity Income Portfolio own shares in 360 Capital.*

**"GIVEN HOW PROFITABLE A DOMINANT ONLINE CLASSIFIED BUSINESS CAN BE, ONE WINNER IS ALL THAT FRONTIER MIGHT NEED TO BE A RESOUNDING SUCCESS."**

# An international play on online classifieds businesses

## With 15 investments, one of which may already be worth more than Frontier itself, this company has a decent shot of hitting the big time

When local online real estate classifieds business REA Group entered the Italian market in 2007 it looked unstoppable. After conquering Australia's real estate market, attracting 89% of agents and gaining a handy lead over Domain, acquiring Italy's biggest property website, Casa.it, should have been a breeze.

### Key points

- **Investor in 'frontier' online classifieds markets**
- **Take only minority stakes with portfolio approach**
- **9 of 15 investments set to breakeven next year**

It wasn't. After being overtaken by once distant competitor immobiliare.it, REA sold out of Italy in 2016. The loss of a seemingly insurmountable lead has been put down to the travails of corporate bureaucracy.

REA shareholders' loss is Frontier Digital Ventures' (FDV) gain. FDV acquires stakes in emerging online classifieds. By mimicking the successful parts of REA Group and dropping the mistakes – a classic second mover advantage – Frontier has a decent shot of hitting the big time. With the benefit of hindsight, REA's failed Italian jaunt was the wet stone that honed its model.

Founded in 2014 by Shaun Di Gregorio, a general manager of REA's Australian business for eight years and former iProperty chief executive, Frontier lacks the value sucking management contracts common in other investment vehicles, such as Macquarie Group's former satellites.

Instead, Di Gregorio receives a market-based wage and upside via a large stake in the company – alongside renowned Asian classified investor, Catcha Group. It's reassuring that both are aligned to the interests of minority shareholders.

There's another difference between FDV's and REA's approaches to acquisitions. Instead of buying entire businesses, Frontier takes minority stakes in local market leaders, keeping founding entrepreneurs at the helm, suitably incentivised.

This means it keeps local expertise. If needed, though, Frontier will provide guidance to help the businesses entrench their leadership positions (which is often why an owner sells to Frontier in the first place); otherwise it stays out of the way. Again, it's a better alignment of interests.

What about the markets in which Frontier operates? Well, the name says it all. 'Frontier' markets are even riskier than 'emerging' markets, but the opportunity for rapid growth is perhaps greater.

Countries like Pakistan and the Philippines  have large populations – 197m and 105m respectively – and rates of internet and online advertising penetration are quickly catching up with more developed economies. The allure of Frontier is the potential of owning a market leader, protected from competitors by network effects, with decades of growth ahead of it.

Unfortunately, the comparison with owning, say, REA or US-based Zillow in its formative years is misplaced. Frontier operates in countries with less stable economies, governments and currencies. That means these businesses are exposed to greater risks than their western counterparts.

To soften this risk, Frontier takes a portfolio approach. It currently has 15 investments, with most focusing on property in the Asian region. Of these 15 investments, we'd expect five to wind up worthless, more than that to muddle through and a small handful to be successful.

Given how profitable a dominant online classified business can be, one winner is all that Frontier might need to be a resounding success. An investment in Frontier is therefore much closer to venture capital investing than typical equity investing.

And, as luck would have it, Frontier might have stumbled upon a winner with its very first investment.

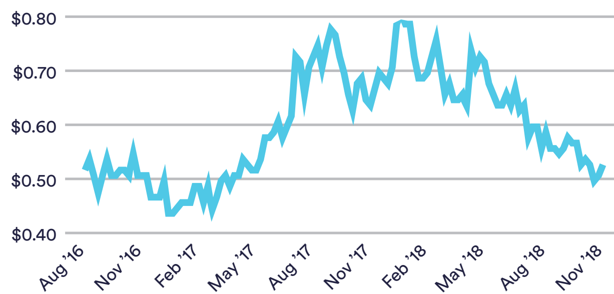
In 2014, Frontier acquired a 30% stake in Zameen, the leading property portal in Pakistan. At the time this valued the business at US$4m. After adopting Frontier's suggestions, Zameen's market leadership widened and its growth accelerated. In May this year, Zameen was valued at US$220m. You read that correctly. Frontier's stake is now valued at 55 times its purchase price.

How can this be? Well, maybe it's not. The valuation was conducted privately between two parties, both with an incentive to overstate the value to validate their business models.

Either way, Zameen's revenue is almost doubling every year. And with the valuation representing a lower multiple of sales than many listed comparables, it may not be outlandish. There's a chance that Frontier's Zameen stake is worth more than its market capitalisation of $127m, meaning shareholders would get 14 free lottery tickets in the form of its other investments.

Zameen also has the potential to 'get closer to the transaction', which may increase its value further. In many frontier markets, websites garner a higher degree of trust than in the West. This may allow them to facilitate transactions rather than merely advertise them. Zameen could be even more important in Pakistan than REA Group is in Australia.

### Share price since August 2016



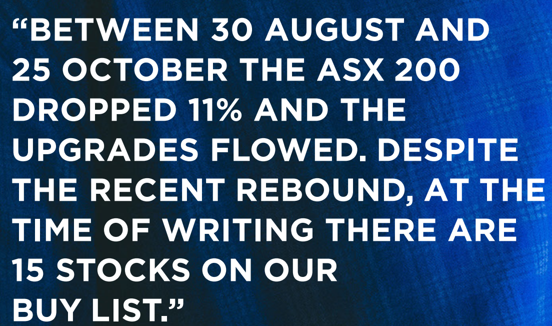

Source: S&P Capital IQ

Frontier's currently burning cash at a rate of $7m each year. But with $20m in the bank it has a few years before passing around the hat. But with nine of its investments expected to breakeven by the end of calendar 2019, it may not need to.

We recommend FDV for up to 2% of well diversified portfolios at prices below $0.55. Note, however, that the stock is relatively illiquid, so we recommend being patient when building a position and using limit orders.

*This stock review is provided by InvestSMART portfolio manager Alex Hughes.*

*The Intelligent Investor Equity Growth Portfolio and the InvestSMART Australian Small Companies Fund own shares in Frontier Digital Ventures.*


"BETWEEN 30 AUGUST AND
25 OCTOBER THE ASX 200
DROPPED 11% AND THE
UPGRADES FLOWED. DESPITE
THE RECENT REBOUND, AT THE
TIME OF WRITING THERE ARE
15 STOCKS ON OUR
BUY LIST."

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