Best Buys for income and growth

Intelligent Investor | Special Report | 1 June 2017

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Introduction

Sharemarket investing tests a lot of things, but more than anything, perhaps, it tests your patience. There are times when it pays to be greedy but, just as importantly, there are times to sit on your hands.

One of the main features of our service is to help you tell these times apart – and to help provide the confidence to buy when opportunities abound and the forbearance to wait when they don't.

About a year ago, for example, a trawl through our **Buy List** was an engrossing affair. Featuring between 15 and 20 stocks, from blue chip household names like **NAB**, **Woolworths**, **Perpetual** and **ASX** to enticing growth opportunities like **Virtus Health** and **South32**, there was plenty for investors to sink their teeth into.

Since the beginning of this financial year, though, the S&P/ASX 50 index has risen 14.7% – with no great improvement in earnings prospects. The rise has taken many of our best blue chip opportunities beyond their Buy prices, into Hold territory.

As ever, though, there are a few opportunities; it's just that you have to look a little further afield to find them. While it might be hard to piece together an entire portfolio from scratch, there are opportunities to make improvements around the edges.

A couple of areas remain a bit more prospective than most. First among them is probably the smaller companies. Whilst stocks at the big end of town have shot up, the S&P/ASX Small Ordinaries index has risen a mere 6.4% since 1 July 2016. Needless to say, smaller stocks generally carry more risk than the blue chips, but they can also offer greater reward – and in a few cases we've found enough of the return to justify the risk.

Secondly, growth is probably being priced relatively cheaply, at least when compared with income. For investors willing to trade a per cent or so of yield in exchange for better growth prospects, the pickings are richer.

These themes are reflected in our current Buy List, which has slimmed down to just 11 stocks, of which seven feature in this report. We've separated them into three different categories: our 'Best Buys', which we think are suitable for everyone; our 'Top Income Stocks', which we think are more suitable for those looking for an income (as you'd probably guessed); and our 'Top Small Caps', which we think are more suitable for those that are interested in (wait for it) smaller companies.

We've labelled each stock accordingly, and you see at least one of those badges appear at the top of each report. Two of them (Navitas and Thorn) have two badges and one (Amaysim) has all three.

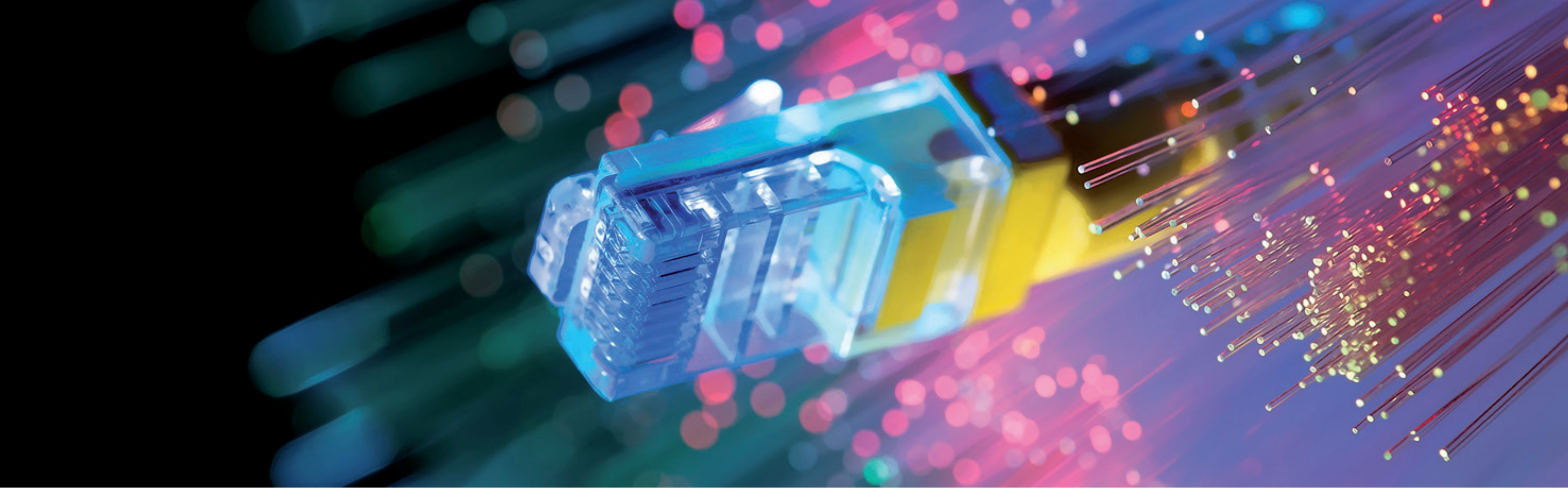
A word on the seven picks themselves: They say in investing that if you're getting three out of five right you're doing well. Our **performance track record** suggests we might be doing better than that. But the point stands regardless – it's quite possible, likely even, that at least one of these opportunities won't work out.

I'd love to be able to tell you which one (or two, or three) that might be but that's not possible. The only sensible response is adequate portfolio diversification. These seven stocks do not constitute a sensible, well balanced and diversified portfolio. So, please take note of the risk ratings and the associated recommended maximum portfolio weighting for each.

You may also want to consider buying your maximum allocation in stages, purchasing small parcels over time. When a stock's price falls further, this will lower your average entry price; when it rises, it will enable you to compare your reasons for purchase with the business performance. The latter may leave you paying a slightly higher average price but it might be worth it to have your thesis confirmed.

Finally, if this all sounds too hard you may like to pay us to do it for you, by investing directly through Intelligent Investor's **Growth** and **Equity Income** portfolios. There's more information if you want it **here**.

Okay, let's get into it.



BEST BUY

This telco's share price has been savaged. Investors may need patience but at these prices it's good value.

Opportunity calls at TPG

We first recommended **TPG Telecom** on 18 Nov 16 (Buy – $7.01). Since then, the price has fallen 20%. One might speculate as to why, but it's safe to assume the company's decision to invest $2bn in developing its own mobile network and the growing presence of the NBN might have something to do with it. Before explaining why these concerns are overdone, let's revisit the original investment case.

Key Points

- ***Margins will fall***
- ***Resources and opportunity to offset decline***
- ***Management matters***

TPG TELECOM (TPM) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$5.61	6%	Med–High	Med–High

BUY Below $6.50 — HOLD — SELL Above $12.00

$5.61

Asset owners typically earn higher margins from broadband services than resellers like iiNet (now owned by TPG) and **Vocus**. The latter generate earnings before interest, tax depreciation and amortisation (EBITDA) margins of 24% compared to broadband margins of 40% and 41% for TPG and Telstra respectively. It is the asset ownership that is the source of those higher margins which, not coincidentally, also explains why iiNet was purchased by TPG.

Because all internet providers will lease network capacity and become resellers on the NBN, these margins will be hit. When everyone uses the same network, advantages are harder to claim and wholesale costs for the NBN are higher than they are for copper access. The future of TPG, and the value of this recommendation, is wrapped up in how the company offsets this margin decline.

There's reason to believe it won't be as bad as the market seems to expect. First, as wholesale access costs rise, scale will become more important because providers can spread all other fixed costs (like marketing and billing) over a larger customer base. Plucky start-ups will still find it hard to compete with industry giants like **Telstra** and TPG. Second, all providers will use NBN fibre but getting on it will require access to their own or third-party wires. As an infrastructure owner, TPG will retain this advantage.

Table 1: TPG Broadband profit estimates*, 2017–2020

	2017	2018	2019	2020
REVENUE ($M)	2,500	2,600	2,800	3,100
EBITDA MARGIN	32%	30%	28%	26%
EBITDA ($M)	800	780	784	806
DA ($M)	150	156	168	186
EBIT ($M)	650	624	616	620

***These figures take no account of TPG's investment into mobile.**

Nevertheless, margins will fall hardest for asset-heavy businesses like TPG. Table 1 shows the impact the NBN could have on its broadband margins. Under our base case assumptions, earnings growth grinds to a halt as margins crumble.

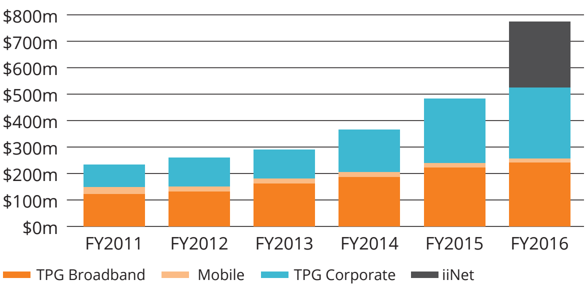
> **"TPG's success is based on a very sound strategy: that of combining asset ownership and scale.**

We've assumed margins will bottom at around 26%, a dangerously precise number that reflects our view that TPG will still make higher margins than resellers but lower margins than today.

But here's the thing; we've also assumed revenue growth of 4–7% between now and 2020, by which time all of TPG's broadband customers will have migrated to the NBN.

There are five reasons why we believe revenue will rise. First, average revenue per user (ARPU) will increase as customers switch to the NBN, although not enough to offset higher costs. TPG paid about $15 per user per month to lease copper wires but will now pay closer to $50 per user per month for NBN access.

Chart 1: EBITDA by segment, 2011–2016



Source: Company reports

Between now and 2020, however, millions of households will be forced to switch their broadband service before copper wires are abandoned. With about 7m households switching, this will be the biggest '**churn**' event the industry has ever encountered. Low-cost providers like TPG are best placed to pick up market share and increase revenue.

Second, for the past few years, most of TPG's growth has come from the corporate segment (see Chart 1), where the company has built the largest dark fibre network in the country and one of the largest metropolitan fibre networks.

The company has used this infrastructure to lure businesses to establish direct connections between multiple offices, servers and data centres. Since the purchase of AAPT, TPG has generated most of its EBITDA growth from companies. Before the acquisition of iiNet, corporate accounts generated more than half its profit.

The NBN will not be as disruptive in this area. We expect TPG to continue making inroads into the corporate segment. Building fibre attracts high upfront costs but also generates sensational economics that make new customers extremely profitable. Incremental margins exceed 80%. Competition is also less likely to replicate fibre connections and customer churn is low.

Third, a quirk in the NBN legislation allows fibre owners to extend legacy assets by 1km to connect to buildings. TPG, as one of the largest fibre owners, is exploiting this by building an independent fibre to the basement (FTTB) network that will connect thousands of buildings and many more customers to its own network at roughly half the price of NBN plans, but still delivering superior margins. This will go some way to offsetting expected declines, although the opportunity is limited to about 500,000 households.

Fourth, Vodafone has signed a 15-year deal to underpin the construction of a 4,000km fibre network. Vodafone alone will provide almost $1bn in revenue, and every additional customer TPG attracts to it should provide a very high margin.

Finally, the business has acquired mobile licences in Singapore and Australia.

All these options could potentially offset margin decline but are being ignored in today's market valuation.

TPG's success is based on a very sound strategy: that of combining asset ownership and scale. It has bought or built infrastructure and then filled it with customers at low cost and high incremental margins. That combination

> **With 80% of industry revenue in the hands of the top three providers, we expect more rational behaviour but that is far from certain.**

has provided high returns despite low retail prices. TPG generates the same broadband earnings before interest, tax, depreciation and amortisation (EBITDA) margin as Telstra, while charging about half the price.

The introduction of mobile services will build on this strategy, allowing the business to reduce churn, increase average revenue per user (ARPU) and enter a category that might, one day, challenge broadband altogether. TPG has gone mobile not because of an ambitious expansion but to defend a business upended by external change. This boldness is driven by necessity, not by ego.

Here is the nub of it: TPG will likely lose money on mobile for several years as it builds scale. The mobile business is capital intensive and will require cash to build, cash to scale and cash to maintain. Competitors will fight for customers and prices will be sharp.

Recent Reviews

DATE	TITLE (RECOMMENDATION)
20/4/17	*TPG goes mobile* (Buy – $6.06)
13/4/17	*TPG buys spectrum, raises money* (Hold – $6.66)
22/3/17	*Interim result 2017* (Buy – $6.79)
20/12/16	*TPG's Singapore sling* (Buy – $6.65)
17/11/16	*Opportunity calls at TPG* (Buy – $7.01)

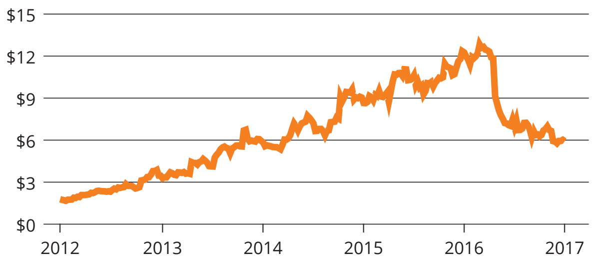
At the end of the struggle, however, if TPG can harness scale, it will have created another revenue stream where low costs and size will generate superior returns. It is, in fact, replicating a strategy that has already worked, and management has proved adept at its execution.

TPG may have to wear losses for several years. The free cash flow we initially envisiged won't appear and the apparent PER will increase as mobile costs grow. It's therefore prudent to include a small negative value for the mobile business as it builds scale; somewhere around minus $400m or about 40 cents per share.

That doesn't mean the mobile venture is a bad idea, though. Over time, this is the right strategy. TPG is playing a long game and investors need to do likewise.

The greatest risk is from competition. An entire industry faced with declining margins could react unpredictably and a price war could erupt as competitors fight for market share. With 80% of industry revenue in the hands of the top three providers, we expect more rational behaviour but that is far from certain.

Chart 2: TPG 5-year share price



Source: S&P Capital IQ

There is also a risk that TPG might try to buy its way back to higher margins and does it badly. Founding chief executive David Teoh owns 34% of the business and has all his wealth tied to it; Soul Patts Chairman and TPG director Robert Milner is also buying shares. We expect that these personal interests will discourage ill-conceived empire-building.

High reinvestment rates combined with uncertain rates of returns mean this recommendation relies to a degree on our faith in management. A splendid track record helps in that regard and, with an **enterprise value to EBITDA** multiple of less than 8, TPG is sufficiently attractive to start building a position. **BUY.**

Staff members may own securities mentioned in this article.

BEST BUY

You can almost ignore News Corp's old media assets these days. The online real estate division has more than justified management's confidence.

News Corp's valuable properties

The thing about tunnels is that it's very dark until near the end. With the release of **News Corporation**'s 2017 third-quarter results, shareholders might not need their headlamps for much longer.

Key Points

- ***Move now sustainably profitable***
- ***Old media assets less important***
- ***Greater confidence in value***

NEWS CORP VOTING (NWS) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$18.79	5%	High	High

BUY Below $20.00 — HOLD — SELL Above $30.00

$18.79

While News Corp's 'old media' assets – including the newspapers and Foxtel – ironically attract the most media attention, they're becoming less and less important to the company's valuation. In fact, the company's Digital Real Estate division might now account for around 80% of its enterprise value.

It shouldn't be a secret. Management has already told the market that Digital Real Estate will become the company's most profitable division (see ***News Corp: Interim result 2017***). Everyone already knows what a great asset News Corp's 62% stake in **REA Group** is but now US real estate business Move is, well, also moving on up.

News Corp's Digital Real Estate division generated earnings before interest, tax, depreciation and amortisation (EBITDA) of US$75m in the third quarter of 2017 (see Table 1), up 92% (or 68% on an underlying basis). This financial year the division should record more than US$300m in EBITDA (although not all of that is attributable to News Corp shareholders).

Move's quarterly earnings turned around by US$22m in the third quarter, which suggest it is now sustainably profitable. Our view is that Move could be generating around US$100m in annual EBITDA by 2019. Move's third-quarter revenues were US$100m – only a little below those of REA Group – and they're now growing faster than its Australian sister company too.

Table 1: Divisional EBITDA ($USm)

3 MONTHS TO MARCH	3Q17	3Q16	+/(–) (%)
NEWS AND INFORMATION SERVICES	123	93	32
BOOK PUBLISHING	37	36	3
DIGITAL REAL ESTATE SERVICES	75	39	92
CABLE NETWORK PROG. (FOX SPORTS)	34	34	–
CORPORATE	(54)	(44)	(23)
TOTAL			
FOXTEL (50% SHARE)	131	144	(9)

We're increasingly confident that Move could be worth close to the US$1.4bn 'high' value in our sum-of-the-parts valuation (see ***News Corp's leap of faith*** from July 2016). Add the US$3bn that the stake in REA Group is now worth to News following the former's share price rise, and that's around 84% of the company's value in this one division.

> **An acquisition of Ten isn't as crazy as it sounds, as it might allow News, Foxtel and Ten to tighten their grip on Australian sports broadcasting.**

Of course, we don't want to get too far ahead of ourselves – the Move chicken is still fighting its way out of the egg.

Turning to News Corp's other businesses, even News and Information Services (NIS) put in a decent quarter (of sorts). For the first time in years, NIS's quarterly EBITDA rose, by 32% to $123m, although much of that was due to one-off benefits – the acquisitions of Wireless Group and Australian Regional Media, as well as some acquisition reversals and timing issues. Excluding these effects, we estimate NIS's underlying EBITDA was flat.

Recent Reviews

DATE	TITLE (RECOMMENDATION)
13/2/17	*Interim result 2017* (Buy – $17.70)
09/11/16	*Weak start for News Corp and REA* (Buy – $16.01)
10/8/16	*2016 result* (Buy – $17.85)
6//7/16	*News Corp's leap of faith* (Buy – $15.78)

Still, flat is a reasonable performance in a division facing as many challenges as NIS. There was even some positive news – at News America Marketing in-store promotions performed well, digital subscribers to The Wall Street Journal rose 34% on a year ago, and cost efficiencies took effect.

While print advertising remains weak, management noted some 'moderation this quarter'. Following the election of Donald Trump, quality newspaper titles have seen a surge in subscriptions. It's possible that marketing budgets are already following the new subscribers, particularly with **recent concerns** that online advertisers have had about their ads appearing next to inappropriate content.

The Book Publishing result was flat, with some new titles off to a weaker start than expected. In Cable Network Programming, revenues were up, due mainly to the acquisition of Sky News, although EBITDA was flat too. Both divisions face fewer challenges than some of News's other divisions and could easily justify News Corp's remaining (non-real estate) valuation.

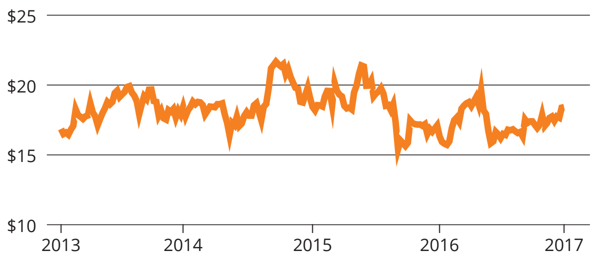
Of course, there's still News Corp's 50% stake in Foxtel. In the third quarter Foxtel's EBITDA fell 9% to $131m on revenue of $591m, showing that it's still a surprisingly profitable business despite the intensifying threats.

Foxtel

If Foxtel is dying – and it probably is – its death will be of the 'thousand cuts' variety. The numbers suggest as much, with average monthly revenue per subscriber falling 2% to A$86 and total subscribers down 1% at 2.8m. At the moment higher sports programming costs are taking a toll on profitability.

Foxtel's sports coverage will protect it from the worst of competition for a few years yet, although it's cold comfort: overseas experience suggests that advantage will erode over time, and Foxtel's margins are likely to fall in the meantime in any case.

Chart 1: NWS share price chart



Source: S&P Capital IQ

In the background looms the government's media industry reforms. If enacted, News Corp is likely to be interested in buying Ten Network (of which Foxtel already owns 14%) – and not just because it might rescue Ten shareholder Lachlan Murdoch from the hole he has dug for himself. An acquisition of Ten isn't as crazy as it sounds, as it might allow News, Foxtel and Ten to tighten their grip on Australian sports broadcasting.

It's frustrating to see REA Group's share price outperform News Corp's by around 15% over the past three months. Since ***News Corp: Interim result 2017*** in February News's

> **Our view is that News Corp's convoluted structure and disparate collection of cross-border assets means it continues to be misunderstood.**

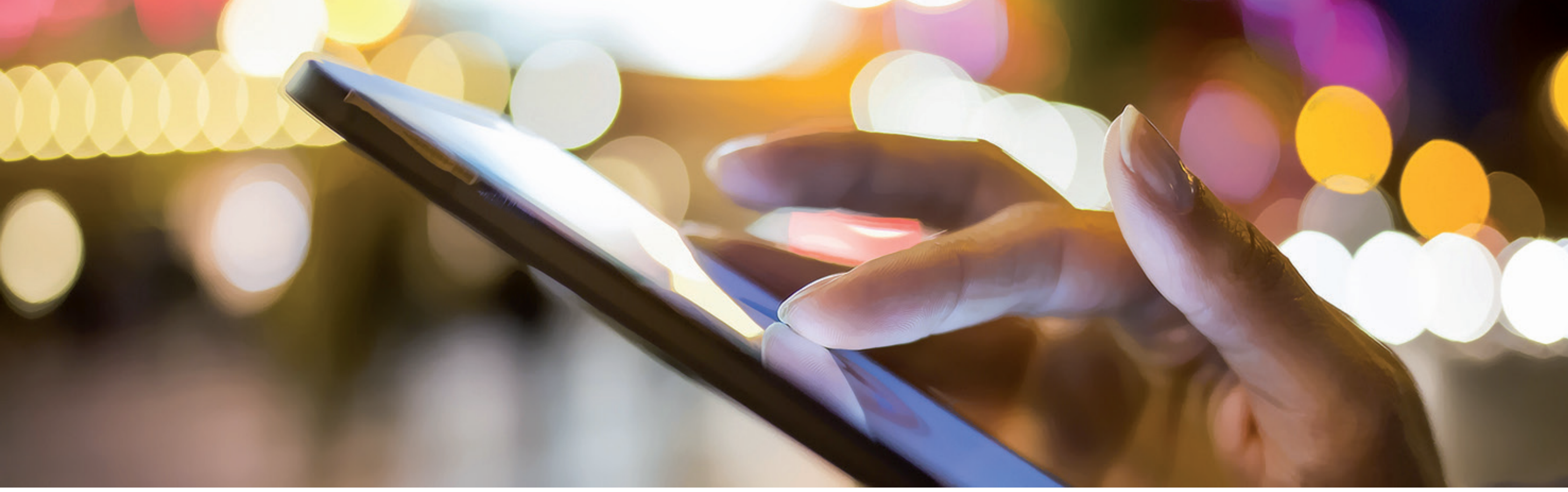
share price has only risen by 6%. The implication is that the market believes the value of News Corp's other businesses is deteriorating as fast as digital real estate is improving.

Whether the old media businesses are really that bad is debateable. Depending on the value you attribute to Move, the non-real estate businesses – with EBITDA totalling more than US$500m – are being implicitly valued at US$1bn–2bn. And that's excluding Foxtel, which you're getting thrown in for free.

Our view is that News Corp's convoluted structure and disparate collection of cross-border assets means it continues to be misunderstood. It's hard to determine when that mispricing will be recognised, but continued growth from the digital real estate division should do the trick eventually.

Despite the lack of share price movement, the light at the end of this tunnel is brightening. **BUY**.

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



This virtual mobile network operator has a misunderstood business model where margins increase even faster than revenue.

BEST BUY
INCOME
SMALL CAP

Misunderstood Amaysim

Most mobile markets are dominated by a handful of mobile network operators (MNOs) which own and operate their own assets along with a slice of mobile spectrum. In Australia, the MNOs are familiar names: **Telstra** accounts for half the mobile market and Optus and Vodafone combine for another 40%.

Key Points

- ***Asset light business model***
- ***Economics improve as sales expand***
- ***Click acquisition increases risks***

AMAYSIM (AYS) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.95	4%	High	High

BUY Below $2.00 — HOLD — SELL Above $3.50

$1.95

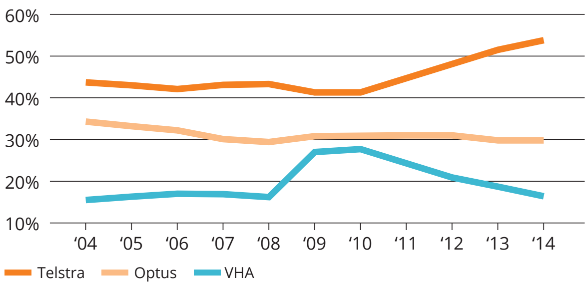
The final 10% of the market is serviced not by asset owners but resellers known as Mobile Virtual Network Operators (MVNO), the largest of which is **amaysim** (yes, that's a small 'a').

amaysim has a contract with Optus to lease a slice of its 3G and 4G mobile networks at wholesale rates, which it then uses to build plans to sell to retail customers. Optus provides the network; amaysim takes care of marketing, billing, top-ups and customer service. The MVNO model is employed the world over and is the fastest-growing segment of the mobile market.

Australia has, in the past, been a graveyard for virtual networks. Moreover, trading on a PER of 18, amaysim doesn't appear obviously cheap. But current earnings understate how profitable this business can be.

MVNOs are attractive for MNOs because they offer a reliable source of high-margin revenue. Optus, for example, doesn't pay a cent to acquire amaysim customers, nor does it have to provide ancillary services like customer service and billing. It simply collects revenues for the use of its network. As with all capital heavy investments, higher utilisation drives higher margins.

Chart 1: Service rev market share by MNO, %



Source: Company reports

MVNOs can also attract different users to those that might use an MNO's core brand. amaysim, for example, targets users that spend $40 or less; other virtual networks chase customers based on ethnicity, employment or demographic factors.

It's difficult for Optus to market to all these niches. By striking deals with MVNOs it can still collect revenues from them. In fact, all the growth in Optus's user base

> **“ amaysim alone has delivered Optus over 1m customers.**

has come from this sector. amaysim alone has delivered Optus over 1m customers.

The largest cost for amaysim is network charge paid to Optus, representing 60–70% of revenue. Those charges, and hence gross margins, are governed by a ‘Network Supply Agreement’ between amaysim and Optus – set to run until December 2019 – with amaysim having an option to extend for a further five years.

amaysim pays a fixed charge per customer as well as a smaller variable charge depending on data usage. As the number of subscribers grows so do payments to Optus. The other costs incurred by amaysim – billing, marketing, service and activation – are mostly fixed, so unit costs fall as subscribers rise. This means amaysim earns high incremental margins; as it increases revenues, profits tend to rise more rapidly.

Table 1: Amaysim key stats, 2012–2016

($M)	2012	2013	2014	2015	2016
REVENUE	32.5	73.5	128.1	205.7	254
EBITDA	–19.1	–9.2	–2.2	16.4	35.4
EBIT	–20.3	–10.7	–3.8	14.1	30.1
ARPU, $/MONTH	17.04	18.89	20.86	26.12	25.24
SUBSCRIBERS, ‘000	230	400	619	718	966

The network agreement also allows for annual price reviews and a predetermined mechanism to resolve disputes, which means amaysim isn’t a hostage to Optus and pricing is driven by market conditions.

What about business quality? Gross margins of 20–30% must support service and marketing costs. Such businesses are only profitable if these costs can be amortised over a large customer base. This is a scale business where size confers a significant advantage.

By our reckoning, with the possible exception of Optus-owned Virgin Mobile, amaysim is the only MVNO with sufficient scale to be profitable, making the acquisition of competing operators’ customers cheap, profitable and increasingly likely.

amaysim has no stores, only 140 staff and 40% of its activations and 80% of its charges are conducted online. Typically, retail activations are 10 times as costly as those made online, so savings accumulate quickly and are reflected in lower prices.

Then there is the obvious benefit from leasing rather than owning its network. Unlike Optus, which this year expects to spend $1.8bn on network improvements, amaysim doesn’t have to make large capital investments to grow.

The business model itself should generate generous cash flow. Not only does it collect monthly fees from customers, but under the network agreement, Optus pays amaysim an upfront fee for every customer it collects. That fee is then repaid over 24 months from customer billings, granting amaysim a generous cash flow advantage. Optus, rather than banks, fund its growth.

These benefits were reflected in the company’s **most recent result**. Our investment case is based on the premise that amaysim has a scalable business model, a fact under-appreciated by the market, and that more customers should generate higher margins and fatter profits.

Table 2: AYS interim result 2017

SIX MTHS TO DEC ($M)	2016	2015	+/(–) (%)
REVENUE	136.6	117.3	17
UNDERLYING EBITDA	17.3	12.8	38
EBITDA MARGIN (%)	12.7	10.7	19
OP CASH FLOW	11.2	0.7	big
UNDERLYING EPS (C)	4.6	4.6	0
DPS (C)	4.0	3.0	33
SUBSCRIBERS (‘000)	1,025	764	38
INTERIM DIVIDEND	4c, unfranked, up 33%		

At the time of last year’s interim result, amaysim had 760,000 customers with operating expenses of $23m. Now it has over a million customers and its service costs remain the same. Big tick. Gross margins have remained flat, but EBITDA margins grew from 10.7% to 12.7%. More customers *have* led to higher margins. Another tick.

> **“ If the acquisition works out, Click could be hugely beneficial. Sharing technology platforms and lifting average revenue per user (ARPU) will raise margins without forcing prices higher.**

That’s the basis of the model, one now being applied to other utilities. In May 2017, amaysim acquired **Click Energy**. Click locks in fixed price electricity from a generator and then sells it to retail customers. The business earns a gross margin of around 25% from which it pays non-electricity operating expenses. As with amaysim, it needs both scale and low costs.

With just 150,000 customers Click is profitable and generates earnings before interest, tax, depreciation and amortisation (EBITDA) margins of about 7%. With an online only model that mirrors amaysim’s own, costs are low and customer growth has been swift. amaysim’s ultimate aim is to have three products – mobile, NBN and electricity – on a single platform with shared technology to market to a shared user base.

Recent reviews

DATE	TITLE (RECOMMENDATION)
13/4/17	*Amaysim Clicks on power* (Buy – $1.89)
28/2/17	*Interim result 2017* (Buy – $1.83)
30/11/16	*Investor day* (Buy – $17.85)
23/9/16	*Result 2016* (Buy – $2.03)
23/3/16	*Unlocking value in Amaysim* (Speculative Buy – $1.90)

The retail energy market is **ripe for disruption** and looks a lot like telecoms did a few years ago with healthy incumbent margins, marketing complexity and poor service. There’s room for new competitors, unburdened by legacy assets and with lower costs. But a case for Click Energy isn’t necessarily a case for amaysim buying it.

The deal is expensive, for a start. Click has about 155,000 customers, which means amaysim is paying about $775 each. **Origin** has acquired customers in past transactions at about half this cost. More recent transactions have come in at around $500 per customer.

Click does boast a relatively high ARPU at $115 a month and has grown from 20,000 to 155,000 customers in about three years. This isn’t a bargain but it might not be a crazy price, if one assumes the two businesses can cross-sell products, which is becoming increasingly popular internationally.

That had better be the case because without it, it’s hard to see how this acquisition can work. amaysim will pay $40m in equity and another $80m in cash, which will increase its debt. If the deal had been wholly financed with shares at $1.75 a share, it would raise earnings per share by less than 5%. While we aren’t overly enthused by the purchase there is a logic to combining these businesses.

Inexpensive

amaysim, meanwhile, still appears inexpensive. Energy will account for about half of revenues and about a quarter of earnings. If the acquisition works out, Click could be hugely beneficial. Sharing technology platforms and lifting average revenue per user (ARPU) will raise margins without forcing prices higher. If it doesn’t, the base business should be able to repay the debt and the gambit would have failed without existential consequences.

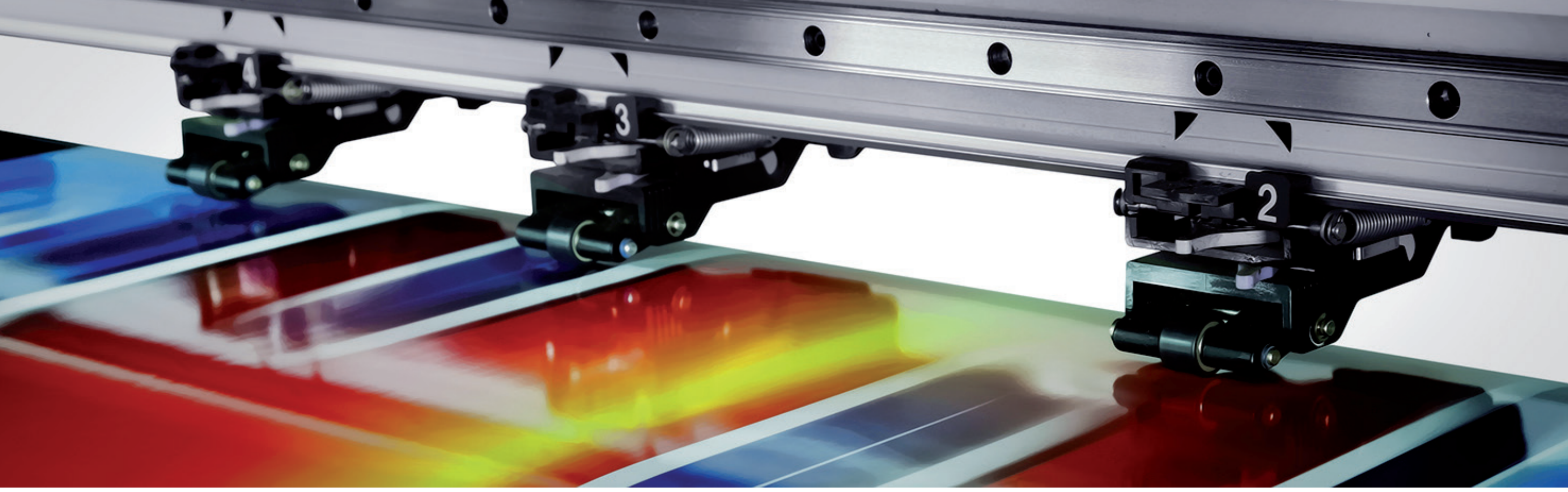
What else could go wrong? Well, a network fault that drove customers away from Optus, as occurred with Vodafone, wouldn’t help. Even for those that are comfortable with more risk, that’s why we recommend a maximum portfolio weighting of just 3%.

Yet with 65% of handsets now out of contract and the MVNO sector generating strong growth, amaysim’s telecoms business boasts attractive economics and strong profit potential. In two years, the company could be generating about $500m in revenues and about $60m in EBITDA.

With an adjusted enterprise value (EV) of about $480m, a forward EV/EBITDA ratio of about eight offers reasonable value. **BUY**.

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

Disclosure: Staff members may own securities mentioned in this article.



SMALL CAP

Despite two years on our Buy List, PMP remains a cheap stock in a difficult, but improving, industry.

Future brightens at PMP

When we first upgraded **PMP** in June 2015 (Speculative Buy – $0.525), revenues had declined for a decade; profit margins had been negative for five of the previous six years and the printing and distribution industry was widely acknowledged to be structurally impaired. Yet over the previous three years, its share price had more than tripled.

Key Points

- ***A reformed business***
- ***Debt falling, free cash flow rising***
- ***Industry has consolidated***

PMP LIMITED (PMP) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$0.70	4%	High	High

BUY Below $0.75 — HOLD — SELL Above $1.00

$0.70

While the stock had soared over a three-year period, it had been pummeled for more than 20 years before then, at which point it was worth 80% less than it was in 1995. Few businesses could boast a worse performance without going bust.

The improvement in the share price reflected improvements to the business. Industry conditions were still diabolical (see below) and returns on capital still woeful. Yet debt had been paid down, costs had been slashed and the asset base restructured. Death no longer stalked PMP. It even promised decent cash flow and, perhaps, a better future.

The investment case rested on three planks. First, the balance sheet had been repaired and the business would soon be in a position to pay dividends. Second, the company's printing assets had been updated to reflect a new business model: this is not the business it was or is often assumed to be. And third, it was cheap, with additional option value.

The old and new

To understand what makes the new-look PMP attractive, we must first understand why the old PMP almost failed. The tale begins with Rupert Murdoch, when **News Corp**'s acquisition binge of the early 1990s left it with a huge debt burden and forced it to demerge its print and publication arm into a new listed entity.

The new business was richly endowed with magazine titles, publishing deals, newspaper and directory printing and its own marketing business. In the early 1990s, these appeared fine assets. Over time, it became clear that they weren't. The magazine stable was sold in 2002; the newspaper printing business was sold in 2005 and the directory print business was felled last year. A disparate empire of publishing, graphic arts, marketing and property has all been shut or sold and, today, PMP is a pure print and distribution business.

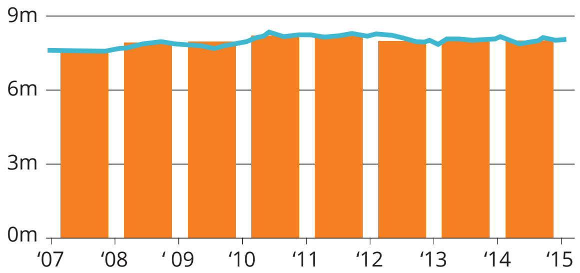
Although it still retains a substantial New Zealand print operation and a tiny magazine distribution business, 80% of PMP's earnings now come from the print and distribution of catalogues, a business which is more attractive than you might imagine.

www.intelligentinvestor.com.au info@intelligentinvestor.com.au 1800 620 414

> **“ The real upside, though, was in the deployment of that cash flow because it gave management the opportunity to acquire struggling competitors.**

Catalogues are often placed alongside newspapers as a once mighty industry in irreversible decline. And yet as Chart 1 indicates, since the GFC catalogue volumes have risen at about 2% a year. The world may have outgrown the newspaper but it still clings lovingly to catalogues.

Chart 1: Industry volumes by distribution



Source: Australasian Catalogue Association industry report, Mar 2015

Catalogues now reach more people each week than free-to-air TV, radio and newspapers, which is one reason retailers continue to use them (see Table 1). They're also very effective. Marketing studies suggest that half the people who peruse a catalogue subsequently visit the store to make a purchase. The catalogue business hasn't been disrupted in the way that magazine, directories and newspapers have.

Table 1: Weekly audience numbers, 2014, m

CATALOGUES	20
NEWSPAPERS	16
FTA TV	14
MAGAZINES	14
PAY TV	10
RADIO	8

Source: ACA 2015

Still, the number of pages in each catalogue depends on economic conditions so, for printers, there is some cyclicality; in recent years, weak retail conditions have stifled profits. And catalogue runs are highly seasonal with the bulk of work coming over the Christmas period. That means cash flows are likewise seasonal and the success of two months trading largely determines profits for the year.

PMP has locked 85% of its catalogue customers onto rolling 2–4 year contracts, an arrangement that provides some revenue stability, albeit likely at the expense of margin. But print margins remain woefully low because of an industry-wide oversupply. With utilisation rates of just 60%, no-one is generating acceptable returns and capacity must be cut. It is here where the greatest profit potential lies (more on that later).

Over the past seven years PMP has spent about $200m on capital expenditure, primarily acquiring new printers. The asset base is new, efficient and capable of larger volumes but average utilisation rates are low. As a result, net profit margins languish.

Free cash flow

PMP's fancy new printers have a lifespan of 20–30 years and, while they will likely be replaced earlier and require maintenance, there's little need to spend cash in the near term even though the business must depreciate assets on its accounts. That has important implications for free cash flow.

In our **original recommendation**, we believed PMP would be able to generate net profit of $20m in 2017. On a cash flow basis, we expected results to be even better with free cash flow of over $30m.

The real upside, though, was in the deployment of that cash flow because it gave management the opportunity to acquire struggling competitors. Doing so would mean PMP could lift its own utilisation rates and its own margins.

With a high fixed cost base, the business is highly sensitive to margin changes. Raising profit margins from 2% to 3% – an undemanding task from a successful acquisition – could increase earnings by about 30%, lifting our valuation by a similar amount.

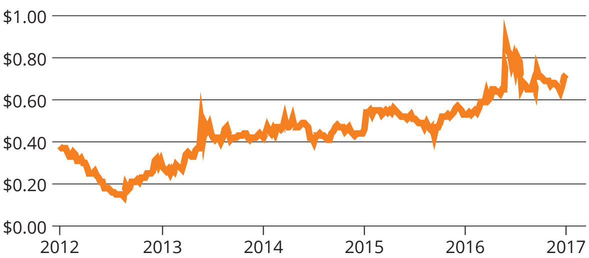
Fast forward a year or so and that is how it's playing out. In October 2016, PMP announced the $120m purchase of privately owned rival IMPG which owns the Hannanprint, Inprint and Offset Alpine businesses. Although the ACCC

> **The merger is a big deal, allowing more work to be run through an efficient fixed asset base. That should lift margins.**

initially expressed concerns over the deal, it ultimately approved it.

The ACCC made specific mention of **IVE Group**, a listed print business that has grown by acquisition, as a major competitor that would restrain the merged group. However, a smaller number of larger market participants should show supply restraint and could lead to industry profits rising. IVE itself trades on an enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) multiple of 9 – high for this kind of business. PMP, in contrast, trades on EV/EBITDA of under 4.

Chart 1: PMP 5-year share price



Source: S&P Capital IQ

The merger is a big deal, allowing more work to be run through an efficient fixed asset base. That should lift margins. The new group will sell under-utilised printers and work to reduce chronic oversupply.

The Hannan family received board representation as well as 37% equity in the combined group. At less than 6 times EBITDA, this doesn't appear dirt cheap but, including the benefit of synergies, the price falls to a third of that.

The new PMP is expected to generate between $90m and $100m in EBITDA. We are bullish on merger synergies but realistic about the difficulties faced by the core business.

In ***PMP merger gets green light***, we argued that $100m in EBITDA would be worth about $500m in enterprise value for the combined group. Adjusting for restructuring charges and dilution would suggest a value for PMP of about $270m, or about 85 cents per share. We regard that as a base case and think higher cost savings might push the value towards $1.

Dividends won't be paid for the next 12 months to provide cash for restructuring. PMP should be able to shut excess capacity, lift utilisation rates and increase margins and cash flow as the deal is completed. This won't be a growing business but efficiency and scale should lift profits while strong cash flow will be paid as dividends.

Recent reviews

DATE	TITLE (RECOMMENDATION)
28/2/17	*Interim result 2017* (Buy – $0.70)
28/2/17	*PMP merger gets green light* (Hold – $0.73)
30/11/16	*Patience pays at PMP* (Hold – $0.85)
23/9/16	*Result 2016* (Hold – $0.64)
23/3/16	*PMP back from the brink* (Speculative Buy – $0.525)

PMP remains a fragile business but the catalogue niche still generates decent cash flow. A better industry structure should offset industry decline. Four large competitors, each competing fiercely, with low margins and high fixed costs, will be replaced by two large competitors each lowering capacity. The market is still clearly sceptical about PMP and that presents an opportunity. **BUY**.

*Note: The Intelligent Investor **Equity Income portfolio** owns shares in PMP. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Disclosure: Staff members may own securities mentioned in this article.

INCOME

SMALL CAP

The threat of a class action and an ASIC fine have led to a share price slump but the company is rising above it, offering investors an attractive return.

Thorn Group rises above regulatory stoushes

The weather report is always 'cloudy with a chance of regulatory reviews' in the subprime leasing market. **Thorn Group**, the owner of Radio Rentals, is the latest to find itself caught in a storm, this time around ASIC penalties and an impending class action.

Key Points

- ***A consumer leasing leader***
- ***Lower price unrelated to sustainable earnings power***
- ***Speculative Buy up to 3%***

THORN GROUP (TGA) / SPECULATIVE BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.30	3%	High	High

SPEC. BUY Below $1.40 | HOLD | SELL Above $2.00

$1.30

Ordinarily, we view leveraged businesses with great scepticism, especially those that profit from less financially sophisticated consumers. It's an area most investors avoid, and for good reason; just writing those sentences was enough to send shivers down my spine.

But that's the point. This sector is hated so widely that it throws up the potential for bargains, especially when regulatory clouds are at their darkest. This is where Thorn finds itself today. As a result, the company trades around book value. For a market leader capable of sustaining returns on equity of 15–20%, that's cheap.

The source of those impressive returns is Thorn's crown jewel, Radio Rentals, which dominates Australian consumer leasing. Radio Rentals began financing radio purchases in the Great Depression and now offers a wide range of credit options for the purchase of everyday items like electronics, furniture and whitegoods. Over 70% of the company's customers say it's the only way for them to access essential goods and 92% rate it as affordable, in sharp contrast to the claims that Thorn's leasing practices are predatory.

Attractive business

This is a business with a clear, established niche, one often (and mistakenly) compared with unsecured lenders like Cash Converters. Whilst there is some customer overlap there are two differences that make Thorn a more attractive business.

First, Cash Converters makes unsecured loans that can be used for other everyday expenditures like poker machines and cigarettes. Radio Rentals only finances equipment purchases with collateral. Should the lease go unpaid, the asset can be seized and re-rented, reducing arrears.

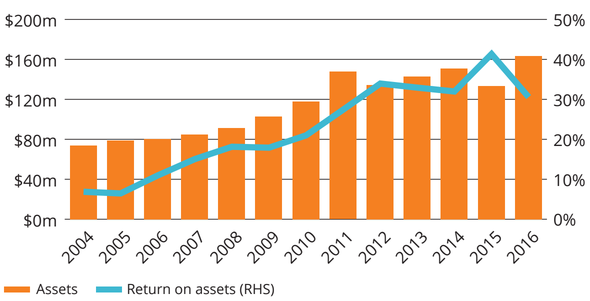
This service is used by customers who are unable to purchase everyday items outright but can manage smaller ongoing lease payments. Most are low-income earners and many are Centrelink clients. Credit Suisse estimates that half of Radio Rentals' revenue is received directly from Government, bypassing customers' accounts altogether.

> **“With an estimated market share twice that of nearest competitor Walker Stores, it enjoys economies of scale that smaller competitors can’t match.**

This is the second crucial difference. If a Radio Rentals customer chooses to use the Centrepay service, Radio Rentals is paid *before* the Centrelink client receives their payment, reducing the risk of funds being misspent. That reduces bad debts but adds regulatory risk, a point we’ll get to.

After 80 years of operation and with 83 stores and more than $163m of assets, Radio Rentals is the clear market leader. With an estimated market share twice that of nearest competitor Walker Stores, it enjoys economies of scale that smaller competitors can’t match, especially in equipment procurement, finance and marketing. Thorn can charge lower prices and still earn higher returns. It may not be a watertight competitive moat but it’s not far from it.

Chart 1: Consumer leasing assets and ROA



Source: Company reports

Take the example of a 65-inch smart UHD LED TV, which costs $35.28 a week at Radio Rentals and $66.85 at Walker’s RT Edwards stores. Radio Rentals’ country-wide network meanwhile dwarfs competitors that only operate in particular geographic pockets, enabling higher returns. If regulations were tightened this may benefit the biggest player as the impact would fall more strongly on smaller competitors.

Chart 1 shows just how good a business Radio Rentals is. As it grows, so do the returns, although an economic downturn would set progress back a few years.

Results for the year to March 2017 show Thorn continues to invest in lower prices in its Radio Rentals business, backed by an increased marketing spend, to entrench its competitive advantage and increase market share (more on this below).

Thorn’s other businesses have been recently pared back. The consumer loans division is in run off and will generate small profits until $27.6m of net receivables are returned. Thorn also sold its debt collection business to **Credit Corp** for $22.6m in September last year. Aside from Radio Rentals, the business finance division is all that remains.

Business future

This is the part of Thorn we least like. From a standing start in 2012, by March 2017 the business, which funds a diverse range of equipment purchases and debtor finance for small businesses, had grown to $180m in assets, with operating profits increasing by 83% over 2016.

By targeting an area underserviced by the major banks it has carved out a profitable niche. Unlike Radio Rentals, however, there’s nothing special about it. The return on assets is a shadow of its illustrious sibling.

So why would management direct half the company’s assets to its lowest-returning business? Perhaps the institutional imperative for growth has taken hold. We would prefer to see Thorn sell or run down business finance and focus exclusively on Radio Rentals. Yes, investors would have to accept lower growth but they’d be compensated with a high yield. And management could deal with regulatory clouds with aggressive share buybacks at cheap prices.

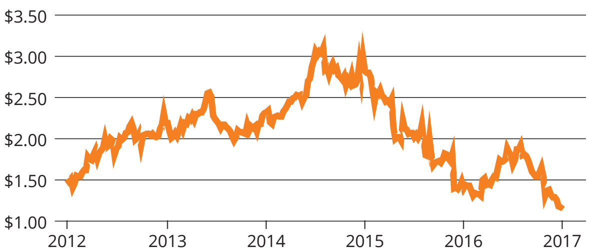
That said, business finance has been growing and returns are improving with scale although the business is yet to be tested in a recession. Thorn is protected to a point by its ability to confiscate equipment in the event of default, but economic conditions are likely to be influential on the returns from business finance.

What about those regulatory risks? Well, just when investors thought one issue had been put to rest, two more have emerged.

> The fear of a $10m one-off penalty has knocked $50–100m from its market capitalisation and that has provided investors with an opportunity.

In a consumer leasing review in April 2016, the Government recommended caps on the interest rates lessors can charge and restrictions on the total value of leases an individual consumer can enter. If implemented, these restrictions would reduce costs to consumers and therefore the value of a single lease (or customer) to Thorn. Naturally, this would reduce earnings. To stand still, Thorn would need to write more leases.

Chart 1: TGA 5-year share price



Source: S&P Capital IQ

Although the recommendations haven't yet passed into law, Thorn has already adopted them, recognising that, as the lowest-cost operator, by reducing costs to consumers it could further increase market share at the expense of smaller competitors. We suspect it has already done so. With competitors struggling, further industry consolidation seems likely.

Still, capped lending rates with market-driven borrowing costs introduce the possibility of margin compression from rising interest rates. However, both dynamics have been known, and therefore priced into the share price, for some time.

What's new are ASIC penalties and a class action. This all came to the fore after an internal review showed Thorn had overcharged some customers owing to a technology glitch. The company promptly notified ASIC and has since improved internal processes to rectify the issue, although this hasn't prevented an ASIC review and a subsequent class action.

Thorn had already provided for penalties but needed to increase them by a further $4m in March this year. The stock responded by falling 25% in ten days, to levels last seen in 2010, and it has drifted lower since.

Here's the good part. These recent woes have little to do with Thorn's earnings power. The fear of a $10m one-off penalty has knocked $50–100m from its market capitalisation and that has provided investors with an opportunity.

We also don't think the class action is a major issue. Settlements are often funded by insurers and the actions themselves can take years. With the leasing review just completed, the risk of further regulatory change is low and the lower share price offers sufficient compensation.

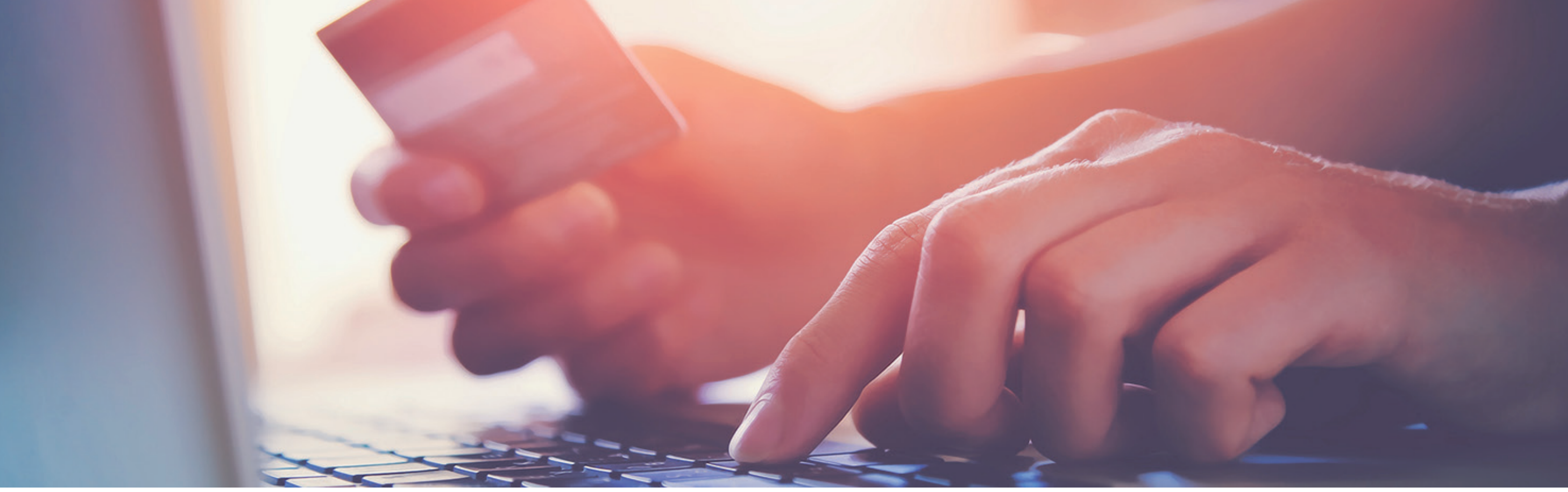
Recent reviews

DATE	TITLE (RECOMMENDATION)
15/8/17	*Thorn Group: Result 2017* (Speculative Buy – $1.24)
6/4/17	*Regulatory fears snag Thorn Group* (Speculative Buy – $1.36)
23/8/16	*Stock Trek video – The importance of scalability* (No recommendation)
15/8/16	*The Thorn Identity* (No recommendation)

Thorn is unlikely to rise by multiples of its current share price but an attractive return is quite possible as regulatory fears subside. Even after the final dividend was cut, the company trades on a 6.2% fully franked yield. That's a sound foundation for future returns.

Still, Thorn is only suitable to investors prepared to accept higher risks and, even then, we'd recommend limiting it to a maximum portfolio weighting of 3%. **SPECULATIVE BUY.**

Disclosure: Staff members may own securities mentioned in this article.



BEST BUY

After more than three years of heavy investment, this online classifieds business is delivering the profit growth we anticipated, with more to come.

A jack of all trades

We've had a long history with this online classifieds business, first recommending it on 19 Feb 14 (Buy – $3.54). **Trade Me** has been on our Buy list pretty much ever since for two reasons. The first is that it offers access to a portfolio of high-quality businesses with network effects, all under one roof. Think of it as New Zealand's answer to eBay, **REA Group**, **Seek** and **Carsales** rolled into one.

Key Points

- ***Potential from premium products***
- ***Profit growth to accelerate***
- ***Facebook threat overdone***

TRADE ME (TME) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.99	6%	Medium	Medium

BUY Below $5.00 — HOLD — SELL Above $7.50

$4.99

The second reason is the price. Those aforementioned Australian online classifieds businesses trade on PERs of 32, 36, and 26 respectively. Much as we'd like to own them (and we have recommended Seek and Carsales over the years) these lofty valuations make new investments difficult.

But what if you could buy a portfolio of them for a PER of just 25? That's the second reason for Trade Me's inclusion in this report. Trade Me remains a high quality, growing business available at a reasonable price – in spite of a 41% rise since our original recommendation.

Widespread concerns that the company's growing cost base would restrict profit growth created the initial buying opportunity. We didn't doubt it, but we took a longer view, and expected the investment to support the various businesses' competitive positions and ultimately support profit growth. It's still early days, but recent results support that view.

This year's interim result, covering the six months to 31 December 2016, saw cost growth slow to just 5% (temporarily – it will be higher in the second half). After under-investing for a few years, we're hoping this reinvestment phase isn't over. Certainly, Trade Me has taken on enough new staff to continue product development. This result saw that investment starting to pay off.

Table 1: Trade Me interim result 2017

SIX MONTHS TO 31 DEC. (NZ$M)	2016	2015	+/(–) (%)
REVENUE	114.9	105.6	9
EBITDA	74.3	66.3	12
NPAT	44.7	38.5	16
EPS (NZC)	11.3	9.7	16
INTERIM DIV. (NZC)	8.5c, up 9%; 100% franked in NZ; 'Top-up' div of 1.5 NZc for Aust holders		

With first-half revenues rising 9% to NZ$115m, margins are finally expanding after several years of decline. Underlying earnings before interest, tax depreciation and amortisation (EBITDA) rose by 12%, while underlying net profit rose by 16% (see Table 1).

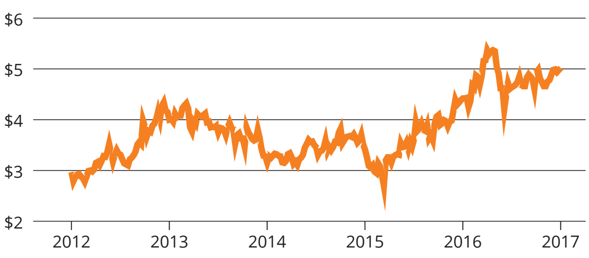
The previously stalled Marketplace business was a standout. Listing volumes rose 21% and management

> **There's significant upside for Trade Me Property, Motors and Jobs to lift prices and develop more premium products.**

said it had seen little effect from Facebook thus far (see ***Trade Me and Facebook square off*** from October 2016). New services like 'Buyer Protection' and 'Book-a-courier' will help differentiate it from the interlopers.

In Classifieds, the best division was Jobs, where a strong economy saw revenue increase 23%. Property was weakest but, while revenues rose only 5%, the division took market share. Across the division, premium revenue continues to grow but still accounts for just 10% of the total. There's still plenty of potential for Trade Me to charge like wounded bulls in the manner of its Australian classified contemporaries. Differences in business models and industry structure explain some of the difference but there's significant upside for Trade Me Property, Motors and Jobs to lift prices and develop more premium products. No doubt some of the new staff are tasked with doing exactly this.

Chart 1: TME 5-year share price



Source: S&P Capital IQ

What could go wrong? All the usual stuff. A New Zealand recession or even a minor economic downturn could see listings contract. Trade Me's Jobs business is probably most exposed but all its classifieds businesses would be affected.

The company could also score an own goal with one of its new ventures. For example, it has invested in New Zealand peer-to-peer lending group Harmoney. It's a great name but start-up ventures often end up consuming more capital than originally envisaged regardless of nomenclature. A blow-out of losses here – from $1.6m in 2016 – wouldn't be a surprise.

Then there's the ever-present risk that a deep-pocketed new or existing competitor tries to take market share. Facebook Marketplace is designed to keep you within the Facebook ecosystem for the purpose of gathering better data, not to become the next Trade Me, but that may not be the case with an Amazon or eBay, should they decide to set up in the Shaky Isles.

We set this financial year's aspirational EBITDA target at NZ$160m. The company may struggle to reach that target but a prospective price-earnings ratio of 22, which sounds expensive, really isn't when you account for the likely acceleration in profit growth. Trade Me still lags its Australian peers when it comes to premium product revenue and there's a lot of upside as new staff start making their mark. When compared with other online classifieds, Trade Me still looks comparatively cheap for such a high-quality business.

The company also generates excellent cash flow, so that the current price – just below our $5 Buy price – equates to a historical free cash flow yield of 4.7%. Trade Me is by no means the bargain it once was, but still offers good long-term value.

Recent reviews

DATE	TITLE (RECOMMENDATION)
25/2/17	*Interim Result 2017* (Buy – $1.36)
12/10/16	*Trade Me and Facebook square off* (Buy – $4.94)
19/8/16	*Result 2016* (Buy – $5.15)

If you're new to the stock, we recommend starting with only half our suggested maximum portfolio weighting of 6%, which will allow you to top up if a better opportunity appears. Existing shareholders from past recommendations should sit tight, although bear in mind the 6% maximum weighting. **BUY**.

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

Disclosure: Staff members own shares in Trade Me.

BEST BUY
INCOME

This troubled sector is emerging into the light, with Navitas, a high quality stock at a reasonable price, leading the way.

Navitas: Dux of the education sector

Education, you might be surprised to learn, earnt Australia more than $22bn in export revenue in 2016, up 18% according to Government data. That makes it Australia's third-largest export industry behind coal and iron ore. The verdict is in – international students already think Australia is the clever country.

Key Points

- ***Australian enrolments surging***
- ***Targets set for 2020 are conservative***
- ***Vocational education expansion likely***

NAVITAS (NVT) / BUY

Price at review	Max. portfolio wght.	Business risk	Share price risk
$4.36	5%	Medium	Medium

BUY Below $4.70 | HOLD | SELL Above $7.50

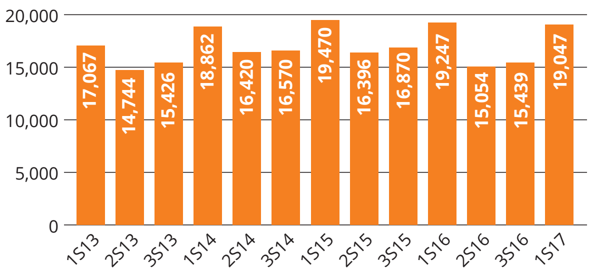
$4.36

The weakening of the dollar since 2013 means Australia is now better value for studying, but that's not all. Our high-quality universities, laidback lifestyle and reputation for safety make for an attractive destination, especially now you-know-who is in the White House.

Navitas, one of only two listed companies in the higher education sector, partners with universities in Australia and overseas, preparing international students for their degrees. The universities get access to a steady flow of international students, while the students are eased into university life at their chosen destination.

University Partnerships, as the company's main division is known, partners with **27 universities** around the world to prepare students for degrees at those institutions. Navitas typically operates an on-campus curriculum for students which, should they pass, feeds them straight into the second year of a university degree. The company charges fees of more than $20,000 per student per year, and pays out around 30% of its revenue as royalties to partner universities.

Chart 1: Navitas enrolments by semester



Source: Company reports

If you're looking for evidence that students want to attend Navitas's university pathway colleges, simply review the company's enrolment figures. Three times each year – the latest being on 30 March – the company publishes the number of students enrolled in a Navitas course. With just over 19,000 enrolments, semester one of the 2017 year was the third-highest number ever (see Chart 1).

> **“Funnelling students to campuses with additional capacity should help lift margins over time.**

This semester is typically the company’s largest student intake, reflecting the start of the Australian university year, which accounts for 53% of Navitas enrolments. But this year’s figure was impressive for two reasons.

First, it offered evidence of the underlying growth outlined in ***Navitas: Interim result 2017*** (Buy – $4.40). Second, Australian and New Zealand enrolments were up a whopping 14% in semester one. At the company’s recent ‘Investor Day’, management attributed this to two things – an increase in domestic students, and Australia being the beneficiary of a less certain migration climate in the UK and US. Management expects both trends to continue in the short term.

The enrolment figures for other destination countries confirmed that story. Enrolments grew by 4% in North America, driven by Navitas’s two university partnerships in Canada. UK enrolments grew by just 1% as Britain’s restrictive visa environment continued, although there are some early signs the rules for students might be relaxed.

Table 1: Management targets

	BY 2020
REVENUE GROWTH (GROUP) P.A.	3%*
EBITDA MARGIN (GROUP)	18%
EBITDA MARGIN (SAE)	20%
ENROLMENTS (UP) P.A.	5%
NEW AGREEMENTS (UP)	5

*** 5% excluding AMEP reduction**

So, if underlying enrolments in its University Partnerships division are growing by 8%, why is management aiming for a much lower 5% annual target out to 2020? This was just one of the so-called ‘key performance indicators’ provided at the recent Investor Day.

Like a lot of Navitas’s other targets, we suspect it’s conservative. Indeed, managing director Rod Jones admitted as much. But with Navitas having produced a few disappointments in recent years, conservative targets are better than aggressive ones. Also conservative – we believe – is the goal for the University Partnerships division to sign five new agreements by 2020. With the company in negotiations with about a dozen US institutions, five doesn’t seem a stretch.

Potential investors, though, are not reliant on this working out. Navitas has plenty of capacity with existing university partners, with a couple of exceptions: its older campuses in Australia are generally approaching full capacity, as are its two colleges in Canada. Like Australia, Canada has a policy of welcoming international students, so new agreements are a priority there.

Funnelling students to campuses with additional capacity should help lift margins over time. This was another of the targets outlined at the Investor Day – management intends to lift the group earnings before interest, tax, depreciation and amortisation (EBITDA) margin from 16% to 18% by 2020.

Achieving that margin will be a little more difficult following the loss of some of the Adult Migrant English Program (AMEP) contracts, which fell under Navitas’s Professional and English Programs Division. The ending of these contracts from July 2017 will cause Navitas’s EBITDA to fall by $12m–14m a year.

Even so, an 18% group EBITDA margin by 2020 looks within reach. What might be a little more difficult is lifting SAE’s margin from 14% to 20%. Management has done a lot of work with this division – which offers courses in creative media – but there’s more to do. In the US, some campuses are woefully underutilised. Increasing student numbers is a priority.

With the Professional and English Programs division being eviscerated by the loss of some AMEP contracts, Navitas has taken the decision to merge the division with SAE. Called Careers and Industry, the new division will be restructured to be mainly a provider of employment-related educational courses.

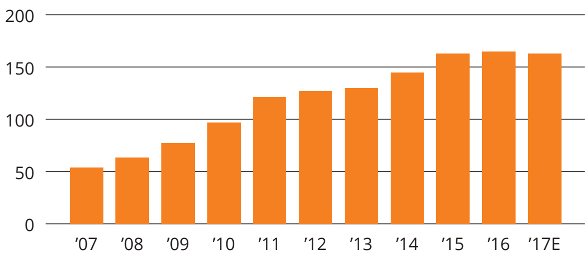
The division will initially consist of existing Navitas colleges such as SAE (creative media), ACAP (psychology, counselling and youth work), NCPS (criminology and

> **"The market is currently pricing the company as if it will achieve only moderate growth. That outcome will produce decent returns from this price but stronger growth would deliver a lot more.**

justice) and HSA (nursing and aged care). With the shake-out in the vocational education continuing, Navitas might make acquisitions, with the company's size and reputation offering much-needed stability to the sector, something we imagine the current government would support. We can envisage a time when Navitas is the largest private alternative to TAFE colleges.

The final major announcement from the Investor Day was the establishment of Navitas Ventures, which management says will investigate 'next generation education focused initiatives'. This is not a venture capital fund, although the company might allocate $10m a year to any opportunities that arise. It's too early to tell whether this is a flight of fancy or a way to keep on top of industry developments, but you can see some of the issues management is thinking about on the **Navitas Ventures blog**.

Chart 1: Navitas EBITDA ($m)



Source: Company reports

We're mindful of recent disappointments. Following the loss of the AMEP contracts, Navitas will report another year of flat EBITDA in 2018 (the company's fifth in a row). The long-term partnerships with Deakin and Curtin universities are also up for renewal this year and, while management is confident of retaining them, the loss of one or both would cause the share price to drop. Changes to immigration and student visa policies are another ongoing risk.

The company's negative working capital model, however, means it produces strong free cash flow (although not in the first half of 2017, due to college closures and investment in several campuses). Removing the effects of various one-offs, we conservatively estimate the stock trades on a free cash flow yield of around 5.0%. Again, no bargain but reasonable enough for a high-quality business.

The same can be said of the multiple of 19 times forecast 2017 earnings per share the enterprise value to EBITDA multiple of 11. However, current earnings do not reflect long-term potential. The market is currently pricing the company as if it will achieve only moderate growth. That outcome will produce decent returns from this price but stronger growth would deliver a lot more.

Debt has crept up recently, due primarily to a share buyback. Over the past year management has bought back 17m shares at a cost of $86m – an average of about $5.00 a share. Notwithstanding the error in acquiring SAE in 2010, management has a keen sense of value. The buyback reflects management's belief the stock is underpriced.

Recent reviews

DATE	TITLE (RECOMMENDATION)
11/4/17	*Navitas target practice* (Buy – $4.40)
2/2/17	*Interim result 2017* (Buy – $4.40)
4/8/16	*Result 2016* (Hold – $5.62)
3/2/16	*Navitas school of hard knocks* (Hold – $4.70)

International students continue to seek out high-quality educations in English-speaking countries and Navitas has demonstrated leadership in facilitating relationships with universities to bring this about. This is a top-notch business with some very favourable tailwinds, notwithstanding occasional contract losses and a difficult international migration climate. The assertion that the market is underpricing the stock, discounting the company's long-term potential whilst concentrating on the likelihood that 2018 will be the fifth year of flat earnings, earns the company a **BUY** recommendation.

Disclosure: Staff members may own securities mentioned in this article.