

Three Best Buys

Special report

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Letter from the Author

Dear Member,

The sharemarket is a hive of activity – never much more so than the past nine months, which have seen the All Ordinaries Index fall 14% before jumping all the way back up. But successful investing isn't about activity, it's about inactivity. It's about waiting patiently for great opportunities to present themselves – and then waiting patiently for them to deliver their value. The people that can't wait are the ones that offer up the opportunities for those that can.

As Charlie Munger once put it: 'It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred gratification-gene, you've got to work very hard to overcome that.'

This is why our Buy list ebbs and flows as opportunities come and go. Before the market stumbled last year it got down to just seven stocks, before swelling to 15 during the downturn. We're now back to nine. This is how it should be.

Pickings might be thin but they have not disappeared altogether. The recent haul has something for everyone.

Income investors might be surprised to learn of the high quality but unloved blue chip paying a yield of 7.1%, while the growth orientated will be attracted to a mining consultancy with a software division transitioning to a software-as-a-service model. As for dyed-in-the-wool value investors, an out-of-favour coal company might fit the bill.


The bigger question is the mindset required to take advantage of these opportunities. Humans are herd animals, which means we tend to feel safest when we're doing the same thing as those around us. In investing, it is this herding behaviour that creates the opportunity for value investors like us.

With the three stocks covered in this report, this demands that you look through the negative media headlines and broker coverage towards the detail of business performance, valuation and likely future growth.

It isn't easy, but to generate a return better than the crowd, you have to do something different from the crowd.

Yours sincerely,

John Addis
Founder, Intelligent Investor
InvestSMART



**“ WITH 67 SHOPPING CENTRES
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YEAR, UNIBAIL IS LIVING PROOF
THAT SHOPPING HAS BEEN
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ACTIVITY FOR CENTURIES. WE
THINK IT WILL REMAIN SO.**

Prices slashed, dividend up at Unibail-Rodamco-Westfield

Since listing in May at \$14.65 a share, this international shopping centre owner has seen its share price fall 25%. For income investors, this is great 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 from shares in a big bank and risk a(nother) major share price tumble.

Key Point

- **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 7.1% and trades on a price-earnings ratio of 13. Since listing in late May last year, the share price has fallen 25%. The result is one of those rare opportunities that should set the pulse racing, even for wary income investors.

Just over a year ago, European shopping centre giant Unibail-Rodamco, headquartered in Paris, completed its \$32bn takeover of Westfield (owner of the eponymous shopping centres in the US and Europe). Australian investors understand the strategy behind Westfield's shopping centres – URW's European assets not so much. This information gap, and much talk of a retail apocalypse, 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 centres 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.

Flight to quality

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 such centres will attract non-traditional tenants like Jaguar Land Rover and Tesla, who want to showcase their brands in the best environments, replacing ageing, dying retailers like department stores. This flight to quality drove our decision to **upgrade Scentre Group** in February last year (Buy – \$3.94). Much of the same thinking applies to Unibail.

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? No. Even in the most popular centres discretionary retailers still account for a large percentage of the tenant mix. All are subject to the threat of 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.

US pain

Unibail's **latest result** suggests that strategy is working, despite struggling US assets and hoped-for synergies not materialising. US retail assets make up 24% of the company's portfolio so performance in this region will affect future returns. It was here that the pain was felt most. In the company's most recent result comparable net operating income in the US fell by 1.6%, inclusive of a –0.3% contribution from 'flagship' properties.

“ 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. ”

But there was no mention of 'like-for-like' sales and the comparison omitted the key Christmas trading period. In the US at least, returning to growth might be difficult. Poor operating performance in the US, project delays, a difficult operating environment in the UK and higher-than-expected costs delivered an additional reduction of €0.50 per share in guidance.

URW has also lowered its targeted loan-to-value (LTV) range (a ratio of its debt to tangible assets) from 35–45% to 30–40%. To bring this about, planned asset sales will increase from €3bn to €6bn, reducing recurring earnings by about \$0.07 per ASX-listed CDI).

What does this mean? By lowering the LTV ratio, management is effectively saying that the book value of some of URW's assets may be overstated. That would explain why the stock is trading at a 37% discount to reported net tangible assets. This may be especially true of its US assets, where the 'risk premium' (the additional return earned from holding a risky asset) incorporated into its capitalisation rate appears low.

More encouragingly, rents on newly leased space in the US rose 7.5% while total tenant sales increased by 7.0%. This metric is especially 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.

European gloss

The gloss in the result was in Europe, where like-for-like net rental income rose 4% and footfall increased 1.8%. Tenant sales, meanwhile, increased 3%, re-leasing spreads (the difference between the rent on new leases compared to old leases for the same space) were 1.3% and occupancy rates edged up 0.2% to 97.6%.

Such numbers are not the stuff of a retail apocalypse, proving that flagship properties can adapt to a new retailing, entertainment-based environment. 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%. Results suggest that Unibail's strategy of focusing on high-quality shopping centres is helping it to weather the impact and prosper beyond it.

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.

Having cut the distribution to €10.80 (or about \$0.86 per CDI), the stock now offers a distribution yield of 7.1 per cent, although the distribution is unlikely to grow this year.

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 economic output will fall. At these prices and yields, this can still deliver an attractive outcome.

Valuation backstop

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

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.

“ THIS RECOMMENDATION PROVIDES AN OPPORTUNITY TO RECTIFY SOME OF THAT IMBALANCE AT THE COST OF ACCEPTING OVERSEAS CURRENCY EXPOSURE. ”

Debt remains a concern, however. Boosted by the A\$7.4bn cash payment made to Australian shareholders as part of the acquisition, Unibail's gearing of 37% is significantly above the ASX200 AREIT average of 22%.

But the company 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; the average interest rate is 1.5%; and interest cover is seven times. Overall debt is also being reduced.

Diversification benefit

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

The flipside of this 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 at the cost of accepting overseas currency exposure.

Offsetting those attractive qualities are lower earnings per share, falling book values, reduced confidence in management and reporting that lacks transparency. These are the reasons the market has punished Unibail since listing.

But if one looks beyond these concerns there exists an undervalued and unloved high-quality business with an attractive valuation and sustainable distribution yield. We recommend Unibail as a **BUY**, via the ASX-listed Chess Depositary Interest (CDI), up to \$12 a share 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.

Disclosure: The **Intelligent Investor Equity Growth Fund** and the **Intelligent Investor Equity Income Fund** own shares in URW, as do our **Model Growth** and **Model Income** portfolios.

**“ THERE PROBABLY ISN'T
ANOTHER COAL MINER IN THE
INDUSTRY WITH A BETTER
RECORD OF BUYING AND
SELLING ASSETS TO EXPLOIT THE
CYCLICAL NATURE OF MINING.**



New Hope a new opportunity

Opportunities emerge alongside fear and uncertainty and one is building right now in this coal miner.

Investors pursue gains in different ways. Some follow growth and others prices. Some measure momentum and others chase charts. When it comes to losses, however, all investors look alike. They avoid loss at almost any cost..

Key Point

- Coal market shenanigans impacting share price
- Key regulatory ruling due this year
- Good assets with excellent management

This often means uncertainty gets mispriced. Probabilities cease to be thought about and decisions are made from frustration and fear. The tendency to avoid uncertainty means it can be a wonderful source of opportunity.

Enter New Hope Corporation. This long-time coal miner with a stellar track record has recently been admonished for its product and suffered regulatory uncertainty – leading to a plunging share price and an interesting opportunity.

There probably isn't another coal miner in the industry with a better record of buying and selling assets to exploit the cyclical nature of mining.

[Editor's note: If you have an ethical bent this may not be enough to persuade you. This is a matter of personal choice and one we respect. It is our role to uncover opportunities and your decision whether you pursue them. If a coal investment is not for you, the third opportunity – RPMGlobal – may be more to your liking.]

Bulls eye

In 2006, New Hope bought a \$48m stake in Arrow Energy which it sold to Shell for \$650m just four years later. In 2008, it sold the New Saraji coal mine to **BHP Billiton** for \$2.5bn after purchasing it for a pittance years earlier. Unlike most miners, New Hope understands that this is a cyclical business.

When coal prices reached their nadir in 2016, New Hope mobilised its vast cash balance to buy a 40% stake in the Bengalla mine in NSW. Shortly afterwards, it purchased another 40% stake.

Those acquisitions, from **Rio Tinto** and **Wesfarmers** respectively, consolidated ownership of Bengalla, in which New Hope has an 80% stake with a customer retaining a 20% share.

Bengalla is a modestly sized mine producing about 9m tonnes per annum (mtpa) of high-quality thermal coal. But it comes with a permitted mine life of more than two decades, approved plans for expansion and is one of the simplest operations you'll ever see.

A visitor would be underwhelmed. The site is just a big hole in the ground that hosts one giant piece of machinery that works relentlessly – all day, every day. This simplicity helps explain the outstanding economics. The mine boasts production costs of about \$40 a tonne and produces premium coal perfect for Asian markets demanding inputs for new, efficient thermal generators.

Best of all, it was purchased from counterparties who simply wanted out of the thermal coal business. Wesfarmers' and Rio's decision to sell had little to do with price or value.

Opportunity knocks

We've explained much of this in our [past coverage](#) of New Hope. We mention it again now because one big thing has changed: in a few days in March, New Hope's share price fell more than 30%.

This was the opportunity we had been waiting for. Before explaining why, let's first give some consideration to why the price has fallen.

Australian thermal coal prices have dropped from \$120 a tonne to less than \$90 as global thermal coal benchmarks have climbed. The swiftness of these price falls, along with the fact they appear to be isolated to Australian coal, suggests something fishy is going on.

Media reports have suggested that Australian coal is being delayed at Chinese ports to allow deeper environmental testing. Australia exports the world's highest quality coal so this explanation seems strange. But if it incentivises buyers to switch suppliers it would explain the fall in the Newcastle benchmark price.

“WITH DISDAIN FROM INVESTORS AND PRODUCERS ALIKE, FEW NEW COAL MINES ARE LIKELY TO COMMENCE, AND HIGHER COAL PRICES PROBABLY WON'T BE MET WITH A WALL OF SUPPLY. LEGACY PRODUCERS FACE THE BEST COMPETITIVE ENVIRONMENT IN YEARS.

Some have suggested that Australian coal is being specifically punished by authorities as a muscle-flexing exercise, or perhaps for banning a cherished local firm, Huawei, from Australia. Whatever the explanation, we doubt price falls are rooted in changes to supply and demand.

Coal remains a vital source of energy in Asia, which has invested in ultra-critical thermal power stations that burn coal at high temperatures to reduce the pollution they cause. These power stations must be powered by the best-quality coals and generate up to 50% less waste than conventional coal generators.

Restricted supply

We needn't fear an expansion of supply either because, for both lenders and investors, coal is a dirty word. Banks will no longer lend to coal projects and miners themselves don't want to mine it. Glencore is but the latest to publicly state it won't expand thermal coal production.

With disdain from investors and producers alike, few new coal mines are likely to commence, and higher coal

prices probably won't be met with a wall of supply. Legacy producers face the best competitive environment in years.

We shouldn't be flippant about the challenges coal faces. Demand from China and elsewhere is falling. Fewer coal plants are being built. Yet a fleet of existing generators needs to be fed and high-quality, low-cost coal under the stewardship of excellent managers still makes sense.

We've outlined a valuation in the accompanying table that shows how most of New Hope's value derives from Bengalla.

Bengalla should, on average, generate free cash flow of \$250m–300m each year for about 20 years. We're comfortable using the higher end of that range to capture likely production increases and lower costs from consolidating the ownership structure of the mine. All up, New Hope's stake could be worth up to \$3bn, assuming long-term coal prices of \$100 a tonne.

Table: New Hope sum-of-the-parts valuation

ASSETS	VALUE (\$BN)	WEIGHTED PROBABILITY	ADJUSTED VALUE (\$BN)
Bengalla	3	1	3
New Acland	0.2	1	0.2
New Acland S3	1.5	0.6	0.9
Port	0.2	1	0.2
Other mines	0.2	1	0.2
Land bank	0.1	1	0.1
Debt	(0.355)	1	(0.355)
Corporate	(0.08)	1	(0.08)
Total			4.165
Shares on issue (m)	831		
\$/share			5.01

New Acland, the company's existing mine, will close by 2020 if extension permits aren't granted. That battle has been raging for a decade. If granted, an expansion of New Acland could be worth over \$1bn to New Hope. If denied, the mine will generate no more cash after 2020.

A verdict on New Acland is imminent and the value of the business will change depending on the outcome. If denied, New Hope's value probably falls to closer to \$4 a share.

Ripe for mispricing

Bengalla strikes us a mine ripe for mispricing. For years, it's been buried within a complex ownership structure and overshadowed by larger assets in larger businesses. New Hope itself has never reported results from its full 80% stake which it only recently finalised. There is a chance, therefore, that the asset is underappreciated and perhaps mispriced.


Add that to the shenanigans in coal prices, a vital upcoming regulatory ruling and the general disdain for coal and it's easy to see why New Hope is unloved.

Yet for many years this has been a great business. New Hope now boasts an excellent asset base with strong economics and arguably the best management in the coal industry. We note three directors buying shares lately, among them Rob Millner from Soul Patts, whom we regard highly.

New Hope won't be for everyone. It reeks of uncertainty and its industry is under genuine threat. Yet this is how opportunities emerge; they are often signalled not with a halo but must be scavenged, unpolished and dirty, from the disdain of others. **BUY.**

Note: Investors holding Soul Pattinson and Brickworks already have indirect exposure to New Hope. For some, this diversified exposure may be sufficient.

Disclosure: Our **Model Growth** and **Model Income** portfolios own shares in New Hope.



**“ THE SOPHISTICATION
ON DISPLAY AT THE BEST
MINES IS BEING REPLICATED
AND DEPLOYED ACROSS THE
INDUSTRY AND RPMGLOBAL
AIMS TO PLAY A PART IN THIS
REVOLUTION.**

RPMGlobal: The Microsoft of mining

**Think mining and software don't belong together?
This obscure software business might change your mind.**

In popular myth, miners are like Neanderthals, mindlessly digging their rudimentary tools into the earth to extract riches they neither own nor understand. The truth couldn't be more different. Modern-day miners still dig holes, but where and how they do this is far more complicated than many imagine.

Key Point

- **Improving capability**
- **Slowly expanding its moat**
- **Numbers don't reflect progress made**

When a big miner dispatches a piece of heavy machinery, software has already divided the orebody into minable blocks and directs equipment to the optimal blocked section to mine.

The software will consider dozens of variables including grade, density, volume and geometry before giving directions. The machines doing the work may well be digging thoughtlessly, but a lot of smarts go into deciding what and where to dig.

Software is used to optimise grade and output, to figure out the best way to access ore or, perhaps, to find the best gradient to roll huge trucks. Assets are managed over decades, simulations are run, and reserves are counted with software.

Mining isn't about digging with shovels any longer; it is about solving thousands of problems, often with the help of technology.

The sophistication on display at the best mines is being replicated and deployed across the industry and RPMGlobal aims to play a part in this revolution.

Consulting past

The business houses two divisions. One is a typical advisory business that sends consultants to far-flung mining projects to help solve specific problems. This is the origin of the company and, in one form or another, RPM has been doing it for decades.

The advisory arm carries a particularly storied reputation in the coal industry, and its fortunes are intimately tied to coal prices; no-one hires advisors and consultants when mining coal is barely worth it. So a pick-up in thermal and coking coal prices should ensure an excellent 2019 result for this business.

This division was savaged in the commodities bust and the company may choose to sell it as its software business matures. For the moment, though, advisory remains an important cash generator that has helped pay for much-needed investment into software.

Software future

The advisory business is where RPM got its start but it's the software business that will determine the future of the company.

RPM's dalliance with software was minor until Richard Matthews took the helm as managing director in 2012. Matthews, with a decent record of building (and selling) software businesses, spent years painstakingly building a software product suite during the bust.

Mining software isn't like payroll or accounting software. Some parts, such as asset maintenance, can be single products that are sold to many customers. Most products, especially those used at the production end, are specifically designed for a specific commodity or mining method.

Multiple products

RPM, for example, has developed different products for open-cut and steeply dipping coal mines; it has something for underground metal mining and for open-pit diamond mining. Since the industry is rich with variability, so must the software be.

That diversity means RPM won't scale in the sensational way that Xero does, but it also puts competitors at a disadvantage because adding value to customers means building not one product but a dozen. Software that doesn't integrate with other software won't sell.

“RPM CAN NOW CAPTURE REAL-TIME DATA FROM DRILLING SENSORS WHICH FEED INTO SCHEDULING AND PRODUCTION SOFTWARE AND INTEGRATE INTO FINANCIAL SYSTEMS. FOR A MINER STILL DOING THESE TASKS SEPARATELY, THIS IS A REVOLUTION.”

RPM is, uniquely, building an integrated product suite that can do everything from design a mine pit, plan and schedule production, simulate variables, make financial plans and maintain assets. And it can do that for about 10 different commodity groups, making it perhaps the most comprehensive software provider in the industry. For mining houses – the big budgeted BHPs of the world – integration with the enterprise is crucial.

RPM can now capture real-time data from drilling sensors which feed into scheduling and production software and integrate into financial systems. For a miner still doing these tasks separately, this is a revolution. Slowly and deliberately, RPM is building out its moat.

A large team of developers, bold and well-priced acquisitions, a wide product suite and industry-best integration all form a formidable competitive advantage. The business boasts impressive capability and potential for its relatively minor \$120m market capitalisation.

Revenue shift

If the moat is so grand and the product so great, where are the profits?

Not on the income statement, that's for sure. Measure RPM from its reported numbers alone – a task that most large investors have probably done – and there is little to impress.

Table 1: RUL segment revenue

REVENUE (\$M)	2015	2016	2017	2018
Advisory	28.8	23.5	23.6	28.5
Software	37.4	33.4	50.2	44.7
Total	66.2	56.9	73.8	73.2

Last year revenue actually went backwards and, over four years, it has increased by just 10%. If raw numbers were all that mattered, it'd be easy to understand why RPM might fall off the radar.

Yet those numbers deserve unpacking. We must first recognise the cyclical nature in the advisory business. A period of low commodity prices has only recently ended, and revenue should pick up this year. Advisory isn't a great business but it's probably underearning.

Table 2: RUL software revenue

\$M	2015	2016	2017	2018
Licence sales	15.9	11.8	23.4	13.6
Subscriptions	n/a	n/a	0.5	0.8
Maintenance	13.7	15.0	17.3	19.6
Consulting	7.8	6.6	9.0	10.7

The software business is also changing, from recognising revenue from perpetual licences, which attracts large, upfront cash payments, to smaller but longer lasting subscription revenue. RPM, like many software firms before it, is turning to a 'software as a service' (SaaS) model and that means passing the dreaded revenue cliff.

Currently, revenue comes from lumpy perpetual licence sales and ongoing maintenance revenue. Those revenue streams tend to result in stronger revenue recognition in early years.

A SaaS model recognises lower revenue upfront – a single year’s subscription is smaller than one perpetual licence sale – but the lifetime value of the customer is higher. And, with RPM now offering software in the cloud, customers benefit from the lower costs associated with cloud offerings.

RPM is taking a short-term hit to its revenues while it builds a subscription business that will benefit in the long term.

Table 2 illustrates this by breaking down software revenue. Licence sales and maintenance revenue will fall while subscription revenue rises. This is starting to happen, but the business is still at the start of the transition.

RPMGlobal recently announced that annual recurring revenue had risen from \$800,000 to over \$3m in the first quarter of 2019. The transition to a subscription model appears to be gathering pace.

Even if the advisory arm is worth just \$20m – and it’s potentially worth more than that – then the \$100m valuation attributed to the software business doesn’t reflect how large or profitable it’s on track to become. The messy accounts and the changing revenue model mean the numbers don’t yet reflect the progress being made. In time, though, they will and we’re happy to be patient. RPMGlobal is a **SPECULATIVE BUY** for up to 3% of your portfolio.

Disclosure: Our **Model Growth Portfolio** owns shares in RPMGlobal.

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