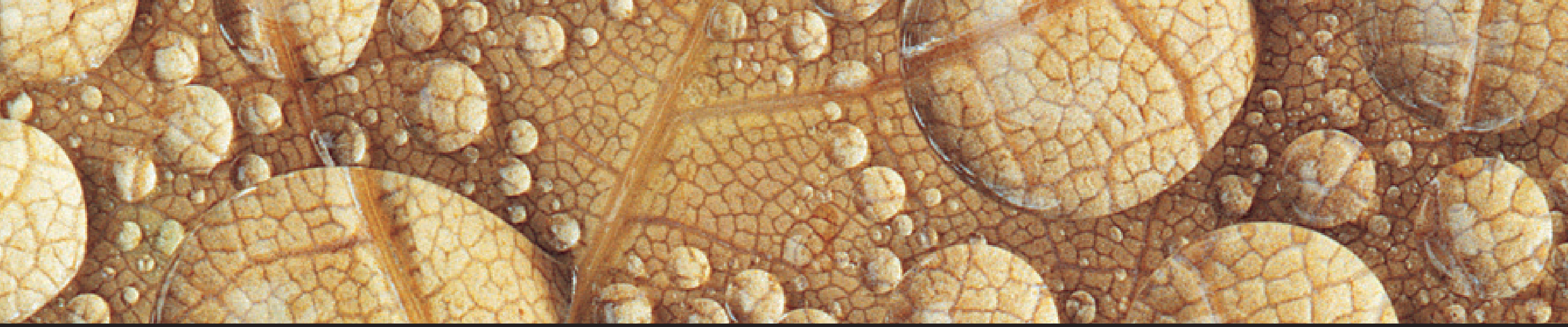
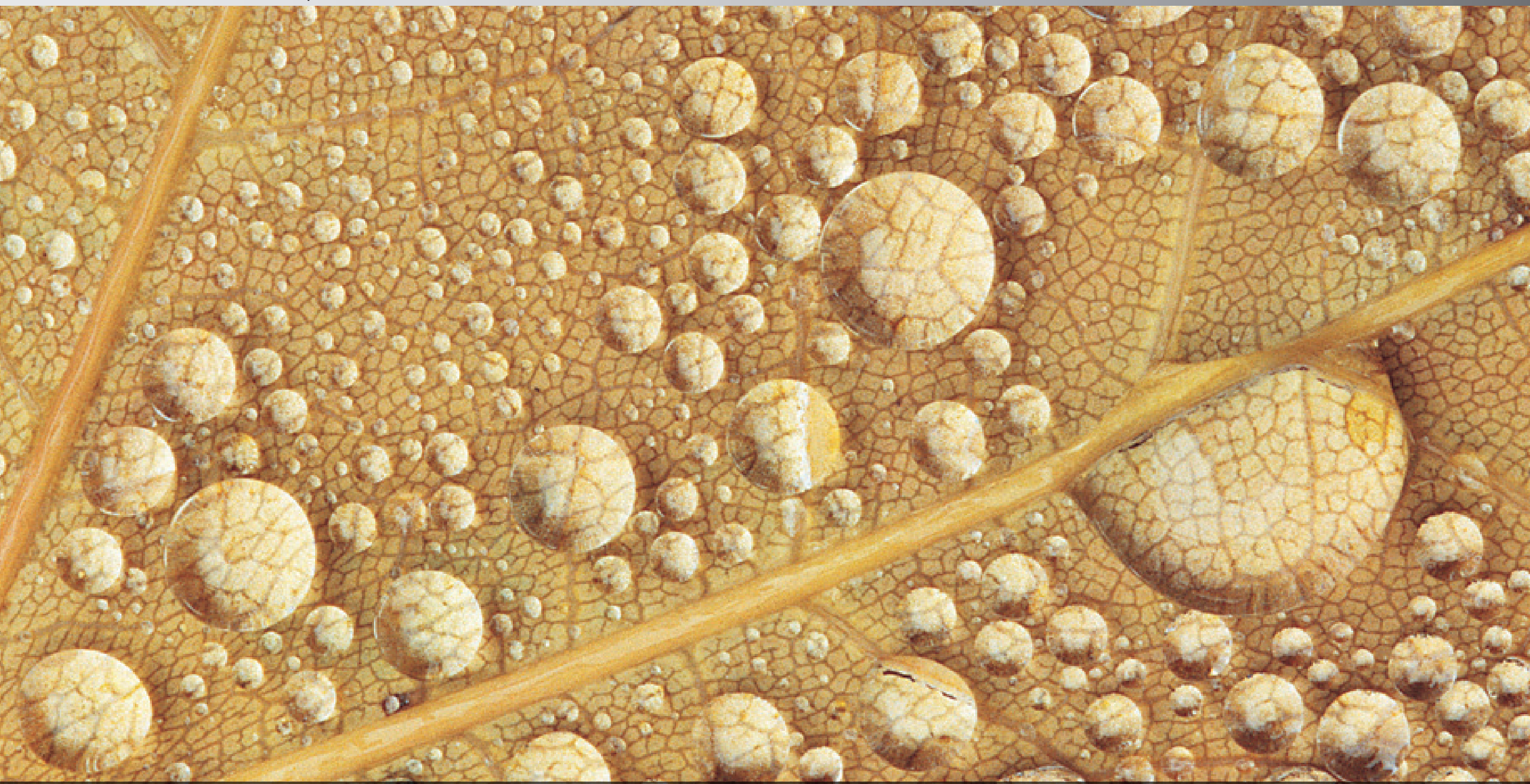


# Stocks to profit from a lower Aussie dollar

INTELLIGENT INVESTOR
SHARE ADVISOR

**SPECIAL REPORT** | JULY 2013



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**PRICES CORRECT AS OF** 2 July 2013

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# Stocks to profit from a lower Aussie dollar

## Introduction

Those with long memories may recall 'the recession we had to have'. But in the 22 years since Paul Keating made that famous remark, we haven't had another one. That doesn't necessarily mean we're due, although consecutive decades of economic growth can mask many sins. But it does seem as if Australia has slayed the business cycle. There have been booms but no real busts.

The result has been an extraordinarily resilient economy with 'safe haven' status. The Global Financial Crisis caused a flight to safety around the world: out of shares and into US Treasury bonds paying next to nothing; to gold; and to Australia, which, like a soaring eagle, looked down on the carnage of the GFC and flew past it, straight into a mining boom. Lucky country indeed.

The Government should also get some credit. The response of Rudd and Co was textbook, the stimulus package so successful that many have forgotten how bad it could have been. Instead, there was a bit of whinging about an insulation scandal and normal service was resumed. The GFC was something that happened somewhere else.

Until recently at least, it really felt as though we inhabited a different economic universe. Policy debates, if that's the right word, revolved around the dangers of debt. When our government debt stands at about 20% of gross domestic product (GDP), compared with 82% in the UK and over 100% in the US, the frivolity was revealing. This is what you worry about when you have nothing to worry about.

House prices had fallen slightly, yes, but there was no collapse. Unemployment has remained low and the government cutbacks that have provoked ugly scenes in European capitals are almost beyond our comprehension. Amid the maelstrom, unless you happened to get to work on Sydney's City Rail, daily life in Australia was rather good.

According to the OECD's Better Life Index, Australia is the world's number one happy country, and not just because far too many people enjoy a little puff. We might loathe our politicians and rail against the size and ineptitude of our public services, but they have done us proud. For the past 22 years, we've had it good.

And the world has taken notice. Who would have thought at the time of Keating's Banana Republic comments that the Swiss equivalent of the Reserve Bank would have been piling into Australian dollars, or the Singaporeans?

Ten years ago, the Australian dollar bought US 60 cents. Despite recent falls, at 93 cents it's still more than 50% higher than back then. Which is of course a signal for the flock gathered at The Church of Pessimistic Tendencies to get a little worried.

Over the past few years, whilst enjoying the performances of our recommendations, we've been covering some of the things that might dent our economic performance—not because we expect these things to occur, but in order to protect our portfolios against the reasonable possibility that they might.

There are four aspects to this argument but they all lead in the same direction: to a lower Australian dollar. That's why we've been banging the drum for international stocks since the publication of our special report *Ripe for the picking: Eight overseas stocks to buy now*, and shown you some of the ways you can go about investing overseas yourself (see pullout box—How to invest overseas).

This report takes a different tack, recognising that many members don't want to leave home in search of cheap US or European stocks. Here, we're going to focus on four local stocks that we believe will be big beneficiaries of a lower dollar. And the lower it falls, the better off they'll be.

But before we get into the stocks themselves, let's recap the reasons why we believe the Australian dollar is set to fall.

*“Ten years ago, the Australian dollar bought US 60 cents. Despite recent falls, at 93 cents it's still more than 50% higher than back then.*

**FURTHER READING: HOW TO INVEST OVERSEAS**

- Why now is a great time to invest abroad
- Overseas stock opportunities—Part 1
- Overseas stock opportunities—Part 2
- Ripe for the picking: Eight overseas stocks to buy now

## #1: The mining cliff

Let's start with the big one, iron ore. Way back in November 2010, Gaurav Sodhi wrote an article titled Iron ore: It's (not) different this time. Here's one of the key passages:

*'Chinese authorities understand what many iron ore investors don't: that there is a finite ceiling to how high iron ore prices can go before plentiful low grade resources become viable. We believe we are now at such a threshold.'*

At the time iron ore prices stood at about $150 a tonne. Ten years ago a tonne of iron ore changed hands at $30 a tonne. Now it's $125. The performance of the stocks quoted in that article (see Table 1: Iron ore wipe out), tell the story.

### TABLE 1: IRON ORE WIPE OUT

| COMPANY | ASX CODE | PRICE AT REVIEW | CURRENT PRICE | CHANGE SINCE REVIEW | RECO AT TIME |
|---|---|---|---|---|---|
| BC IRON | BCI | $2.51 | $3.28 | +31% | Avoid |
| FORTESCUE METALS | FMG | $6.82 | $3.07 | –55% | Avoid |
| GINDALBIE METALS | GBG | $1.18 | $0.132 | –89% | Avoid |
| IRON ORE HOLDINGS | IOH | $1.89 | $0.70 | –63% | Avoid |
| SUNDANCE RESOURCES | SDL | $0.31 | $0.073 | –76% | Avoid |
| ATLAS IRON | AGO | $2.97 | $0.772 | –74% | Avoid |

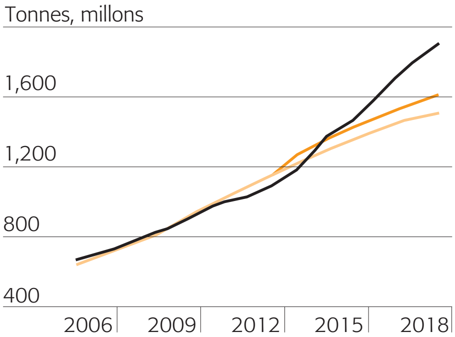
Forget about Chinese demand for a moment (we'll get to that). There's a bigger picture that goes something like this: there is no shortage of iron ore. In many places around the world you only have to scrape the soil to find it. The tricky bit is in getting it to where it's needed. Iron ore is a logistics business, and an expensive one at that, which is why three companies (**Vale**, **Rio Tinto** and **BHP Billiton**) account for 60% of global supply.

But as prices rise, lower grade ore becomes more economic to mine and big companies have every incentive to increase supply. In Mauritania for example, a massive new iron ore province looks a lot like the Pilbara did 40 years ago. And Chinese firms are funding infrastructure all over Africa to increase global supply.

Now ask yourself this question: how many industries can sustain historically high prices—the iron ore price has increased 1,500% in the eight years to 2011—while massively increasing supply?

This is basic economics. As explained in The coming iron ore glut, in the first of three stages of a mining boom, prices rise. In the second, miners invest heavily in new supply to capture greater profits from the price rises. Finally, as new mines begin to ship greater volumes, prices fall.

### CHART 1: GLOBAL SEABORNE IRON ORE




Source: MacroBusiness

David Llewellyn Smith of MacroBusiness described in that article how the mining cycle is playing out in textbook fashion:

*'In the early phases of the mining boom, Australian miners were sceptical of the sustainability of Chinese demand and moved only slowly to expand supply. Later, convinced of the boom's durability, they aggressively invested in supply. Australian miners shipped about 270m tonnes of iron ore in 2005.*

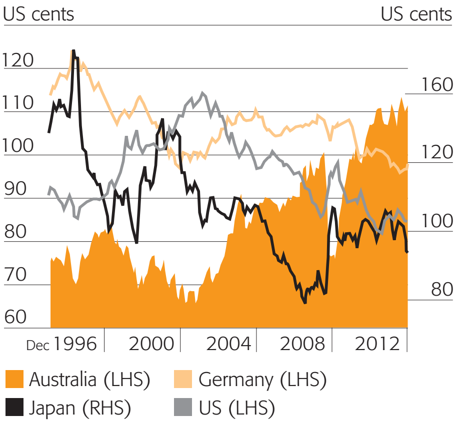
*Australian capacity is forecast by Morgan Stanley to reach 950m by 2018. And that is only in Australia. Global seaborne iron ore shipments were 650m tonnes in 2005 and are projected to rise to a capacity of 1,880m tonnes.*

*In short, current mining expansion plans have dramatically overshot demand growth because China has suddenly changed its steel consumption pattern from growth of 8-10% per year to just 2–3%.'*

Capacity expansion by the likes of Rio Tinto, BHP and **Fortescue** over the next three years is already committed. Australian miners will account for some 250m tonnes of the planned 300m tonnes of new seaborne capacity coming online in the next three years. As Chart 1 shows, that will mean that for the first time iron ore supply will exceed demand.

The effects of this activity on the exchange rate are direct and substantial. The income flows from the boom have driven up the local dollar, leaving non-mining export businesses exposed and the costs of doing business relatively more expensive. Australia now has some of the highest asset prices in the world and equally high levels of household debt.

### CHART 2: AUSTRALIA'S REAL EXCHANGE RATE AS OF 31 DEC 2012




Source: Bloomberg

Our relative competitiveness has declined as a result. Chart 2 shows how Australia's real exchange rate, which includes currency and wages, has increased hugely compared with that of Germany, Japan and the United States.

The RBA is all too aware of the problem, which is one of the reasons it has consistently lowered interest rates.

But there's another factor to consider: implicit in all commodity booms is an increase in supply that drives down the prices that produced it. That's what's happening with iron ore, thermal coal and, to a lesser extent, coking coal right now. In three years time, LNG may well be in the same position. An increase in production produces a glut and what was a shortage becomes a surplus. Commodity prices crash, taking the exchange rate with them.

So here we are, teetering on the edge of the mining cliff. There's a growing acknowledgement that the so-called super-cycle is at an end. Production increases are already locked in but planned projects that will add to an increase in supply are being cancelled.

In *Recession risk? Pt 2*, David Llewellyn Smith explained how mining investment as a percentage of GDP has grown exponentially but is now being withdrawn. No one really knows the pace and pitch of this decline but there's a clear recession threat because of it.

> *Mining investment as a percentage of GDP has grown exponentially but is now being withdrawn.*

The RBA is trying to head off that threat by rapidly lowering interest rates—by 2% in two years. It wants to compensate for the withdrawal of mining investment by stimulating the economy, and making money cheaper and exports relatively more attractive is the best chance of doing it.

But for that it needs a lower Australian dollar. And the lower it falls, the greater the chance of avoiding recession, which is why the RBA is praying that the US economic recovery will gather pace. One way or another, the RBA wants to see the dollar down.

## #2: A China slowdown

Let's for a moment assume that everything in the mining sector is hunky dory: that commodity prices will remain stable and, in a historical sense, relatively high; that production increases won't outstrip demand; that the recession risk in Australia is negligible; that there is no such thing as the mining cliff; and that the RBA doesn't need to lower interest rates. What then?

Shanghai 1990: Behold, a city park

Shanghai 2010: Where did the greenery go?

Without all these factors pushing the exchange rate down, there remains one key fact: that the challenges Australia faces are miniscule compared to those of China.

Our special report *The coming China crash* was published in December 2011. Its main premise was that developed economies rely largely on consumption rather than investment. The trouble with China is that these factors are inverted. Much of Chinese economic growth over the past few decades has been driven by investment rather than consumption, and that can't last. Countries do not get and stay rich by speculating in property and building high-speed rail. At some stage, ordinary people need enough money in their pockets to sustain themselves and a developed economy.

At the time, we deliberated over the report's title, thinking it a little too predictive and catastrophic. China was an economic miracle, a model for Western growth, and few really questioned the underlying view that China would lift the west from its post-GFC funk. Now the title seems apposite. Fears over a China crash have gone mainstream (see Table 2).

Of course, experts have been predicting a China crash for decades. How could a centrally planned economy with no established property rights (see what happened when this family refused to vacate their home for a freeway) or independent legal system be so successful in the first place?

**TABLE 2: TABLES TURN ON CHINA'S MIRACLE ECONOMY**

| |
|---|
| UK Guardian 21 Apr 13: *Chinese downturn fuels fears crisis is spreading east* |
| Forbes 23 Feb 13: *Why a China crash may be imminent* |
| SMH.com.au 4 Jun 13: *PMI pullback adds to China slowdown fears* |

And yet each time China faces a slowdown or a crisis like the GFC, it has emerged from it, lifting millions over and above the poverty line and delivering astronomical increases in health and education. Take a look at the images of Shanghai to the right—one from 1990 and the other 20 years later—to see the visual impact of this transformation.

The statistics remain impressive. In January this year, exports and imports were 25% and 29% higher respectively than a year earlier. In the third quarter of 2012, Chinese GDP increased by 7.4%. In the fourth that figure was 7.9%. New bank lending also increased massively.

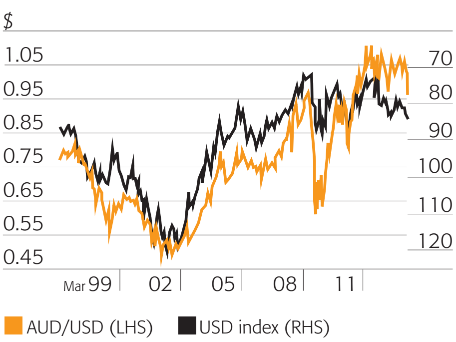
Let's take the credibility of these numbers for granted for a moment. If they're false, it's a problem. If they're not, that's also a problem. Why? Because GDP growth per se isn't a good measure of economic health.

Remember how, prior to the GFC, Western economies were pumping along? Well, all that debt-fuelled growth quickly disappeared in the crash. There was a reckoning; the growth was illusory, showing up in the figures before being subtracted from them. There's a strong case that investment led, debt-fuelled GDP growth in China will take a similar path.

In 2009-10, the Chinese embarked on a huge trillion-dollar stimulus program, fuelled almost exclusively by debt. This covered up bad bank loans and got the economy going again, but not through consumption. Infrastructure and property investment were the drivers.

Even government officials now admit this was a mistake. And yet they're repeating it, albeit with a twist. In September last year a US$160bn infrastructure package was announced and there are reports that local governments have embarked on unofficial packages of ten

**CHART 3: AUD/USD EXCHANGE RATE MOVEMENT**




Source: www.GlobalFX.com.au

times that figure. If you're wondering how those credit financing figures from January have ballooned, there's your explanation.

Since December 2008 when total loans and social financing amounted to 140% of nominal GDP, that figure is now approaching 200%. And most of this financing is coming from the 'shadow banking' sector.

In the US prior to the GFC, $4 to $5 in debt was needed to create $1 of GDP. Twenty years ago in China the figure was less than half that. Now about $6 to $8 of debt is required to create $1 of GDP. The conclusion offers up a bare face: Chinese investment returns are declining.

Quoted in Forbes, famed China bear Jim Chanos says the country is on 'a treadmill to hell'. Australia, along with other resource economies like Canada and South Africa, is sitting in the back seat, hoping the driver has a map. These are the countries most exposed to the risk of a China crash.

What might happen to the Australian dollar should that risk eventuate?

Recent salutary experience offers us a clue. Remember that trillion dollar Chinese stimulus, triggered by fears of a China crash? Chart 3 plots the Australian US dollar exchange rate over the past five years. See that dip between late 2008 and early 2009 when iron ore prices crashed? Back then the local dollar plummeted and was buying US60 cents.

We're the first to admit that forecasting currencies is a mug's game, only for the brave and the foolish and all that. But this has happened before, and not in completely dissimilar circumstances to the position China and Australia now find themselves. Only this time resource production has increased and we're perched on the edge of the mining cliff.

A fall of this magnitude is far from a certainty, but it's also a very real possibility.

## #3: Housing prices

Now we've set your pulse racing, let's take a look at the ultimate sacred cow, fatter than the resources supercycle and juicier than the Chinese miracle economy: Australian property prices.

There's nothing that lifts the spirits of your analytical team more than a good long bleat about the unsustainable level for Australian housing. So satisfying are these collective moans that we've indulged in them regularly over a decade or more. See, for example, *What's your house really worth?* and *Is your bank going broke?* from April 2007 (the answer was 'no').

Long-term members have heard it all before, which is why we recently asked David Llewellyn-Smith of MacroBusiness what his team thought of the local property market. This was a bit like getting The Stranglers to cover Dionne Warwick's *Walk on by*—the same words but punked up with a hard edge.

It takes just 10 minutes to read *A property price bubble?* (see issue 364) and, if you haven't yet invested that time, we suggest you do so. But here's the basic thread: although housing affordability has improved since the GFC, most measures suggest that Australian housing remains expensive by global standards.

> *"Although housing affordability has improved since the GFC, most measures suggest that Australian housing remains expensive by global standards.*

Prior to 2004, increasing debt drove up the price of Australian homes. Since then, they've been kept high by the rising incomes delivered by the commodities boom. As Macro's Leith van Onselen, formerly of the Australian Treasury and Goldman Sachs, argues:

*Australia could experience a severe housing correction in the event that commodity prices experienced a protracted downturn, brought about by the slowing Chinese economy or an increase in global commodity supplies. That could quickly cause a sharp reduction in incomes, jobs and government revenues as the terms-of-trade deteriorates and planned mining investments are cancelled.*

The key risk is in whether the banks can refinance their borrowings from offshore. In the event of a huge commodity price slump and a China crash, Australia's status as a safe haven would be threatened. If the banks could refinance their offshore borrowing they'd probably pay more to do so. If not, credit would be rationed and the housing sector would be very hard hit.

The other aspect to this argument concerns what the banks themselves might be hiding. We really only get to find out whether the banks have been writing stupid loans when people can no longer afford to pay them back.

In the US, that occurred when the poor, sick and destitute were illegally sold adjustable rate mortgages in the run up to the GFC. When their monthly repayments effectively doubled a year or two after they'd signed up, defaults started to flood in, accompanied by jingle mail as borrowers sent back their house keys.

That's unlikely to occur in Australia, where a more traditional source of default is more likely—unemployment. That's not to say this will happen, but if China crashes and Australia stumbles atop the mining cliff, there's a far greater chance of it.

Either way, a severe house price correction would prompt international investors to look at Australia in a different light. The safe-haven status would be lost and the currency would fall.

## #4: Sovereign debt crisis

A sovereign debt crisis occurs when a country can no longer afford to pay its debts. There are only three ways out: grow the economy in order to increase tax revenues to pay down the debt; inflate the debt away by increasing the money supply, encouraging inflation and weakening the currency, thereby reducing debt held by foreigners that have to convert it back into their own currencies; or default, a path chosen by Russia in August 1998 and Argentina in 2001.

Austerians believe there's another way out of a debt crisis: by cutting back on government expenditures and increasing taxes, thus attracting the confidence fairy to sprinkle her magic and get investment going again. We'll leave the recent history of the UK to speak for itself (see *Does austerity work?*). All the evidence points to this not being a serious option for getting out of a debt crisis. In fact, Joseph Stiglitz claims 'there is no instance of a large economy getting to growth through austerity'.

What then are the risks of a sovereign debt crisis and how might they affect the Australian dollar?

The answer to the first part of that question is straightforward, at least compared with the answer to the second. Since the GFC, total central government debt as a percentage of GDP has ballooned. In effect, much of the private bad debt held by the banks has been transferred to the taxpayer.

Add this to burgeoning transfer payments (unemployment benefits etc.) typical of a deep recession and the stimulus packages undertaken to get a country out of a slump and you've got the three main ingredients for increasing government debt (for the US, the costs of two wars are a separate and rather large component).

Chart 4, which uses OECD data to show the level of government debt as a percentage of GDP, clearly shows how the risk of sovereign default has increased since the GFC.

Higher debt limits a country's policy options. For the euro-zone countries, the restrictions are like a noose. Without their own currencies, they cannot inflate the debt away or pump prime their economies with printed paper because it's not theirs to print.

If these countries want to stay within the euro zone, austerity becomes pretty much their only option, especially when 'the troika' makes it a condition of future loans. If those countries don't want to face that option, then leaving the euro-zone becomes that much more attractive. Either way, higher government debt means a greater chance of default and a higher probability of inflation.

As the Chart 4 shows, there is no risk of an Australian default because our debt is minimal. So where does the threat to the Australian dollar lie?

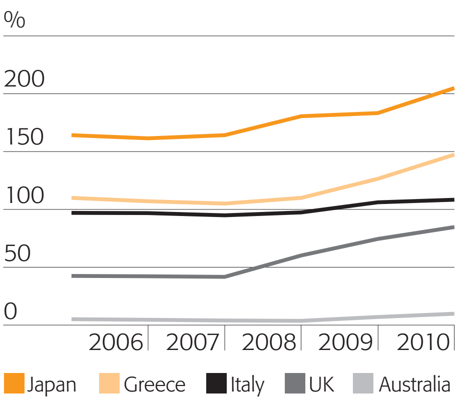
The answer is somewhat paradoxical. Imagine that Greece, Ireland and Portugal withdrew from the euro zone, triggering a European crisis. Given Australia's strong economic performance, sturdy currency, and low debt, you'd imagine that all those investors scared witless by another crisis would pile into Australian dollars.

That may be rational but it probably wouldn't happen quite like that. Australia exists at the periphery of global financial markets. In times of crisis, money travels from the outer edges to the centre—to the perceived safe havens of US dollars and financial assets. That may not make much sense but it's exactly what happened in late 2008 when the GFC hit.

At the time, commodity prices fell and the banking crisis went global. Australia's relative health didn't make much difference; one Australian dollar purchased 97 US cents on 21 July 08 but exactly four months later it had fallen to 61 US cents.

> *A severe house price correction would prompt international investors to look at Australia in a different light. The safe-haven status would be lost and the currency would fall.*

**CHART 4: DEBT AS A % OF GDP**



The greater problem is in the interconnectedness of the system, where problems are quickly exported, like bad blood moving from one part of the body to another. With Australia running a current account deficit, we need to borrow money from abroad. And trouble for our lenders means trouble for us, stuck out on the edge of the world. The chances are that another GFC-like event would see the local dollar collapse.

## Four stocks to profit from a lower dollar

When we started working on this special report, one Aussie dollar purchased US$1.03. By the date of publishing on 3 July, it had fallen to US$0.93, a drop of 10%. Drat. We've been waiting for this for years but when it actually happens, it's about two weeks too early.

Timing has never been our specialty. Still, the seemingly dramatic fall does not mean it's too late to act. Historically the local dollar has purchased between US$0.65–0.70. A reversion to the mean suggests it could fall further yet.

*“Historically the local dollar has purchased between US$0.65–0.70. A reversion to the mean suggests it could fall further yet.*

The remainder of this report deals with how to profit from a lower dollar. Specifically, four high-quality stocks that we believe will serve you well whether the dollar falls or not, but if it does, should do particularly well.

Before getting into them, a few words on one obvious selection that doesn't feature in this report: **BHP Billiton**.

BHP Billiton reports in US dollars but that doesn't mean currency movements are irrelevant. Far from it, in fact.

Along with iron ore, the USD/AUD exchange rate is the most important price affecting net profit because Australian operations incur AUD costs but production attracts USD prices. It's a combination for spectacular currency exposure.

For every 1 cent change in the US dollar against the AUD, BHP's net profit rises or falls by about US$110m. If nothing else changed, BHP could make an extra US$2.7bn in net profit should the AUD return to its long term average of 70 US cents.

That's a remarkable but misleading sum. In reality, the value of the AUD responds to commodity prices. A fall in the Australian dollar is likely to coincide with a fall in commodity prices.

At best the currency acts as a cushion. As commodity prices soar, a higher local currency holds back the full extent of the rise. But as commodity prices fall, the currency effect cradles the blow.

That's why BHP Billiton doesn't feature in this report—there are no easy ways to profit from currency falls with the Big Fella. But there are four high quality stocks that do offer this potential.

# Breathe easily with ResMed

**We have great confidence in the long-term growth of this quality business, with or without a lower dollar. But the lower it falls, the better off shareholders will be.**

Australia lacks global brands. There is no Australian McDonald's, no P&G or Toyota. But there is a specialised global niche where Australia punches above its weight: global healthcare.

Alongside remarkable growth stories **CSL**, **Cochlear** and **Sonic Healthcare** sit two of the world's leading sleep apnoea machine manufacturers; **Fisher & Paykel Healthcare** and **ResMed**. Both are highly profitable, cyclically immune, growing businesses and exactly the type of blue chip stocks you should aim to own, although for reasons that will become clear, ResMed is our favoured pick.

Obstructive Sleep Apnoea (OSA) is a collapse of the throat during sleep which causes the sufferers to wake. Linked with stroke, hypertension and heart attacks, it affects an estimated 20% of the population. In a recent study by Harvard and McKinsey, the global costs associated with the condition are at least $50bn a year. This is no small problem, and no small market.

There are three primary ways to treat OSA; surgery, mandibular splints and 'Continuous Positive Airway Pressure' (CPAP) machines. It's in this area that ResMed has carved out very lucrative businesses. CPAP machines deliver constant air pressure through a facial mask, keeping the throat open during sleep.

One sufferer, George, explained on an apnoea support website after using a CPAP machine for the first time, 'The results were amazing! I slept through the night from day one. My blood pressure went down. My energy level went up, and I stopped snoring.'

The concept is simple enough, but the complexity of the technology shows up in the price people like George are prepared to pay for it, and the margins machine manufacturers like ResMed make.

Pumps cost between $1,500–$2,500 and rarely need replacing. But the masks and tubes cost between $100 and $400 and require replacement at least every year. That makes for a satisfying business model; a fat sale up front and high margin ancillary sales for as long as the patient lives.

Best of all is the company's growth potential. As new chief executive Mick Farrell explained in a conference call in April, ResMed's main obstacle isn't competition but the lack of understanding and awareness of OSA among healthcare professionals.

Farrell estimates that around 5%–15% of the company's core sleep-disordered breathing market has so far been reached, 'meaning that 85%-95% of the opportunity in our core business is still in front of us'. Healthy competition can be a positive in such a market because all market participants are working to educate the market, thereby boosting overall growth.

ResMed also enjoys a number of competitive advantages, especially through its brand and relationships with distributors and healthcare professionals, and its technological edge in variable pressure machines and data collection.

These are the product of the company's huge research and development (R&D) spending, which has been running at about $10m a month so far this year, equivalent to more than half of third-placed FPH's entire OSA-related revenue.

R&D spending has also taken ResMed into neighbouring markets, such as chronic obstructive pulmonary disease (COPD), for which the company announced a new FDA-approved machine alongside its third-quarter result

This is a highly attractive market, and not just because it's the third most common cause of death in the developed world (after heart disease and stroke). COPD is very expensive to treat. ResMed estimates that the US market for its COPD machines could be around $100m and it expects to get 'more than its fair share' of that.

A longer-term opportunity is in heart-failure patients, who often suffer from central sleep apnoea, in which a neurological malfunction can interrupt breathing. In addition to the usual problems of sleep deprivation, central sleep apnoea can be fatal.

## KEY POINTS

- ResMed is growing rapidly
- The company has US$672m of net cash
- Buy below $5

## RESMED | RMD

| | |
|---|---|
| PRICE AT REVIEW | $4.94 |
| REVIEW DATE | 2 July 2013 |
| MARKET CAP. | $7.7bn |
| 12 MTH PRICE RANGE | $2.95–$5.27 |
| BUSINESS RISK | Med–High |
| SHARE PRICE RISK | High |
| MAX. PORTFOLIO WEIGHTING | 7% |
| OUR VIEW | BUY |

## TABLE 1: RMD VALUATION SCENARIOS IN 2017

| | PESSIMISTIC SCENARIO | MIDDLING SCENARIO | OPTIMISTIC SCENARIO |
|---|---|---|---|
| 2013 FORECAST EPS ($US) | 2.15 | 2.20 | 2.25 |
| FORECAST 2013–2017 EPS GROWTH RATE (% P.A.) | 10 | 12 | 15 |
| 2017 FORECAST EPS ($US) | 3.15 | 3.46 | 3.94 |
| ASSUMED HISTORIC PER IN 2017 | 16 | 20 | 25 |
| IMPLIED US$ SHARE PRICE IN 2017 | 50.37 | 69.23 | 98.38 |
| A$/US$ EXCHANGE RATE (NOTE 2) | 1.03 | 1.03 | 1.03 |
| IMPLIED ASX SHARE PRICE IN 2017 | 4.89 | 6.72 | 9.55 |
| CURRENT ASX SHARE PRICE (A$) | 4.94 | 4.94 | 4.94 |
| SHARE PRICE APPRECIATION (% P.A.) | −0.3 | 8.0 | 17.9 |
| APPROX. AVERAGE DIVIDEND YIELD ON PRICE NOW (%) | 2 | 2 | 2 |
| TOTAL RETURN (% P.A.) | 1.8 | 10.0 | 19.9 |

Note: Assumes constant exchange rate of A$1=US$1.03

### TABLE 2: RMD VALUATION SCENARIOS IN 2017 AT A$/US$ OF $0.93

| | PESSIMISTIC SCENARIO | MIDDLING SCENARIO | OPTIMISTIC SCENARIO |
|---|---|---|---|
| BASE 2013 FORECAST ($US) | 2.15 | 2.20 | 2.25 |
| FORECAST 2013–2017 EPS GROWTH RATE (% P.A.) | 10 | 12 | 15 |
| PROJECTED 2014 US$ EPS AT SCENARIO GROWTH RATE | 2.37 | 2.46 | 2.59 |
| PROJECTED 2014 US$ EPS AT SCENARIO GROWTH, WITH A$ AT US$0.93 | 2.60 | 2.71 | 2.85 |
| 2017 EPS WITH A$ AT US$0.93 | 3.46 | 3.81 | 4.33 |
| ASSUMED PER IN 2017 | 16 | 20 | 25 |
| IMPLIED US$ SHARE PRICE IN 2017 | 55.40 | 76.16 | 108.22 |
| A$/US$ EXCHANGE RATE IN 2017 | 0.93 | 0.93 | 0.93 |
| IMPLIED ASX SHARE PRICE IN 2017 | 5.96 | 8.19 | 11.64 |
| CURRENT ASX SHARE PRICE (A$) | 4.94 | 4.94 | 4.94 |
| SHARE PRICE APPRECIATION (% P.A.) | 4.8 | 13.5 | 23.9 |
| APPROX. AVERAGE DIVIDEND YIELD ON PRICE NOW (%) | 2 | 2 | 2 |
| TOTAL RETURN (% P.A.) | 6.8 | 15.5 | 25.9 |

Note: Assumes constant exchange rate of A$1=US$1.03

### FURTHER READING

*ResMed: Breathe deeply and buy*
29 Apr 13 (Buy—$4.56)

*ResMed's dream run continues*
25 Jan 13 (Long Term Buy—$4.52)

*How to profit from sleep apnoea*
11 Oct 12 (Hold—$3.91)

### RMD RECOMMENDATION GUIDE

| | |
|---|---|
| BUY | Below $5.00 |
| HOLD | Up to $8.00 |
| SELL | Above $8.00 |

ResMed will soon complete enrolment on a two-year trial to test a machine specifically designed for heart failure patients. With an estimated six million people suffering from heart failure in the US alone, it's a huge opportunity. The company is 'cautiously optimistic that the data [is] going to show ResMed's proprietary technology can save both lives and money'.

Already, this is a wonderful-sounding business. But price insensitivity, growth potential and high margins are meaningless to investors if they don't deliver higher returns on capital. Let's look at that.

With a net cash balance of about US$672m, its post-tax return on equity of 16% is even more impressive than it sounds. Most companies achieve these kinds of figures with large licks of debt; ResMed manages it without.

The cash balance also makes for a more stable and lower risk business. If either company were required to fund a product recall—as Cochlear did in 2011—ResMed would be well placed to manage it.

Table 1 sets out a rough guide to what ResMed might be worth in 2017, under three different scenarios, and the returns the shares might deliver in the meantime. The company has increased earnings per share by a compound average of about 28% a year since 1995, but let's play devil's advocate and opt for 15% in an optimistic scenario, 10% in a pessimistic scenario and 12% in the middle. Note also that the consensus earnings forecast in the first line is in US dollars and relates to the US-listed shares, which have 10 times the economic interest of the ASX-listed stock.

Assuming historic PERs of 16, 20 and 25, the scenarios deliver ASX-listed share prices of A$4.89, A$6.72 or A$9.55 respectively in 2017.

Those figures compare favourably to the current share price of $4.96. Adding in an average dividend yield of about 2% on today's price delivers a total annual return of almost 2% for our pessimistic scenario, 10% for our middling scenario and 20% for our optimistic scenario.

Now take a look at the row that says A$/US$ exchange rate. See how that line says '$1.03'. Yes, this table, originally published on 25 Jan 2013 shows very attractive future valuations with the Aussie at US$1.03 cents. But since then it has fallen by about 10% to US$0.93. If it stays at this level, it will have an important and positive impact on ResMed's future results.

Why? Because ResMed made about 55% of its 2012 sales in the US, 13% in Germany, 10% in France, only about 3% in Australia and 19% elsewhere. However, most of the company's manufacturing and research and development is conducted in Australia. In fact, a third of its workforce in 2012 was based here.

The company reports in US dollars, but because its Australian cost base is proportionately so much higher than its Australian revenues, it has a natural exposure to the Australian dollar—with underlying profits benefiting from a fall in the A$ and hurt by a rise. Taking this into account, a 10% fall in the A$ to US$0.93 would increase underlying profits by about 10%. You can see the effect of this at the top of Table 2, where we've estimated what 2014 earnings per share might be assuming the same scenario growth rates, but now with the A$ at US$0.93. We've then taken these earnings forward to 2017 and translated them at a rate of 0.93.

So, by only changing the exchange rate to its current level and making no other changes to our assumptions, the implied ASX share price for our middling scenario in 2017 rises from A$6.72 to A$8.19 and our total return increases from 10% to around 15%. For the optimistic scenario, the implied 2017 price rises from $9.55 to $11.64 and the total return goes from 20% to 26%; and for the pessimistic scenario, our implied 2017 share price goes up from $4.89 to $5.96 and the total return increases from 2% to 7%.

Even at a price that has increased 10% since we upgraded the stock on 25 Jan 13 in *ResMed's dream run continues* (Long Term Buy—$4.52), ResMed would remain a **BUY** without any positive currency impacts simply because it's a first class company trading at a reasonable price. If the dollar stayed at current levels or even fell further, it would become more attractive.

*Note: Our model Growth portfolio owns shares in ResMed.*

# Cochlear loud and clear

**Cochlear's performance has more than justified its premium price tag over the past decade. In hindsight, today's lofty price will appear reasonable.**

This hearing implant manufacturer has consistently justified its place as one of the largest holdings in our Growth Portfolio. And long-time members that have followed our recommendations have shared in its success.

Today, Cochlear's speech processors are commonly mistaken for hearing aids. Twenty years ago they resembled ham radios. In contrast to the rapid changes in technology, though, the question for investors remains the same; can Cochlear's future business performance justify its current premium price tag?

Dr Graeme Clark, a professor at The University of Melbourne, got the inspiration for winding an electrode around a patient's cochlea, the inner ear, after threading a blade of grass around the circular interior of a turban sea snail shell.

The electrode is lined with sensors that receive vibrations from a speech processor hooked behind the outer ear, like a common hearing aid, which the brain interprets as sound. As seashells are about as scientific as we get, here are the bare essentials about Cochlear implants:

1. They're a nifty piece of gadgetry that brings hearing to the profoundly deaf;
2. Major surgery is required for them to be implanted in the inner ear;
3. They're not a substitute for hearing aids, which are used by those with residual hearing;
4. Patients of any age can benefit from them;
5. The cost to patients is often subsidised by governments;
6. They contain technology that is difficult to replicate and cost as much as a new Ford Falcon;

Following the first successful Cochlear implant surgery in 1978, medical device company Nucleus (then a division of conglomerate Pacific Dunlop) released a commercially available implant in Australia in 1982.

By 1990 Cochlear implants were accepted in more than 70 countries. By 1994 10,000 recipients had received implants and last year's installed base was about 200,000.

Following the acquisition of Swedish-based hearing-loss specialist Entific Medical Systems in 2005, Cochlear is no longer a one trick pony, either. Entific manufactures Baha, or bone anchored implants, which are embedded in the skull behind the ear. They don't compete with Cochlear implants, but instead overcome many of the drawbacks associated with hearing aids, such as ear infections. It's a brand new market for the company.

With treatments failing to meet demand, Cochlear's growth prospects speak for themselves. But as we saw in 2002 and on a few occasions since, paying a high forecast price-to-earnings ratio carries a significant degree of risk.

**TABLE 1: COCHLEAR'S BIGGEST PRICE FALLS**

| DATE | PRICE FALL (%) | REASON |
|---|---|---|
| 16/12/03 | –23.6% | Profit warning due to renewed competition from Advanced Bionics and tight US health budgets |
| 12/09/11 | –20.3% | Recall of the Nucleus 5 implant |
| 03/06/13 | –18.1% | Profit warning due to weak US sales, market share losses and slowdown ahead of N6 launch |
| 12/03/04 | –16.3% | Request for information from the US Department of Justice. |
| 14/09/11 | –14.6% | Recall of the Nucleus 5 implant |
| 26/07/02 | –11.3% | Scare over meningitis in implant recipients |

This year Cochlear suffered two one-day falls of 9% (on 5 February after its interim result suggested pressure on margins) and 18% (after the profit warning on 3 June). There have been five other occasions since 2000 when the stock has fallen by more than 10% in a day and seven when it has risen by more than the same amount.

This sort of volatility is just what you'd expect from a highly priced growth stock. Small changes in people's assumptions about future growth have a big impact on their assessment

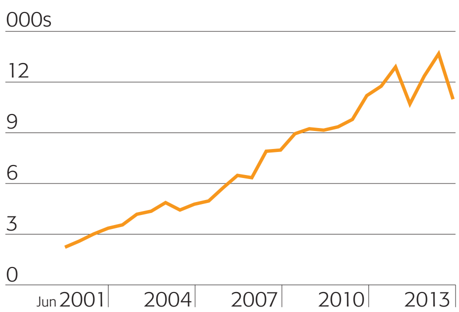
**KEY POINTS**

- Profits under pressure from market share losses and impending product launch
- Nucleus 6 and lower A$ should help sales
- Looking for another opportunity to Buy below $55

**COCHLEAR | COH**

| | |
|---|---|
| PRICE AT REVIEW | $61.70 |
| REVIEW DATE | 2 Jul 2013 |
| MARKET CAP. | $3.5bn |
| 12 MTH PRICE RANGE | $52.84–$82.45 |
| BUSINESS RISK | Med–High |
| SHARE PRICE RISK | Med–High |
| MAX. PORTFOLIO WEIGHTING | 7% |
| OUR VIEW | HOLD |

**CHART 1: COH HALF-YEARLY UNIT SALES**




Source: Company reports

## TABLE 2: COH HALF-YEAR RESULT

| | H1 2013 | H1 2012 | CHANGE (%) |
|---|---|---|---|
| UNIT SALES | 13,672 | 10,724 | 27 |
| REV ($M) | 392 | 388 | 1 |
| EBIT* ($M) | 108 | 109 | n/a |
| NET PROFIT* ($M) | 77.7 | 80.1 | –3 |
| EPS (CENTS) | 137 | 141 | –3 |
| DPS (CENTS) | 125 | 120 | 4 |
| FRANKING (%) | 40 | 60 | –33 |

* Adjusted for recall expenses of $138.8m before tax and $100.5m post tax

## TABLE 3: IMPACT OF A LOWER DOLLAR

| | EARNINGS PER SHARE IN A$ | | |
|---|---|---|---|
| | STATUS QUO OF US$1.03 | A$ AT US$0.90 | A$ AT US$0.70 |
| 2013 UNDERLYING EARNINGS PER SHARE | 1.89 | 2.59 | 4.18 |
| 2013 EARNINGS PER SHARE AFTER HEDGING | 2.33 | 2.51 | 3.30 |

> *Cochlear can generate around a fifth of its revenue and a larger portion of its profits just by selling upgrades.*

## FURTHER READING

*Cochlear cops an earbashing*
24 Jun 13 (Hold - $60.43)

Cochlear brief
3 Jun 13 (Buy - $53.58)

*Cochlear Interim result 2013*
6 Feb 13 (Hold - $70.00)

*Shining a light on Cochlear*
12 Aug 11 (Hold - $69.10)

## COH RECOMMENDATION GUIDE

| | |
|---|---|
| BUY | Below $55.00 |
| HOLD | Up to $90.00 |
| SELL | Above $90.00 |

of value. That begs the question: How much is Cochlear worth?

On 6 Feb 13, James Carlisle analysed the company's interim result, which came at a time after the company was emerging from the recall of the Nucleus CI500 range. That prompted another of those gut-wrenching price falls; the share price fell 40% to a low of $45.75. But the stock quickly recovered in 2012 when the share price approached near-record highs above $80. Now it's back down to $61. Why?

Cochlear's current problems hark back to the recall of the Nucleus 5 implant in September 2011 (see 13 Sep 11 (Hold—$57.50)). Competitors seized the opportunity to build market share. In early 2011 Cochlear held 75% of the bionic ear market; now it's about 60%.

The most significant beneficiary has been market No. 2 Advanced Bionics. But Cochlear's problems have been compounded by the launch of the Nucleus 6 processor, approval for which has already been granted in Canada and Korea, is imminent in Europe and is expected later in the year in the US.

Customers have been delaying implants and processor upgrades until the new model is available. This isn't unusual. Ahead of the launch of the Freedom system in the second half of the 2005 financial year and the Nucleus 5 system in the first half of the 2009 year, unit sales slowed. Each time, they recovered with the launch of the new model.

There's every reason that pattern will be repeated with the Nucleus 6. It appears to be another big step forward in processor technology and management is extremely upbeat about it.

The new processor should also drive a recovery in processor upgrade sales. In the four years after the Freedom system launched in 2005, $250m was generated from upgrade sales, but the installed base of implant recipients—at about 200,000—is now more than three times as large as it was back then.

Following the launch of the Nucleus 5 processor upgrade in 2011, upgrade sales reached almost $100m in the first half of the 2012 financial year before fading away to not very much in the current half. Upgrades to the Nucleus 6 won't come in a sudden rush but it's not hard to imagine upgrade sales hitting $200m a year over the next few years.

This demonstrates one of Cochlear's key strengths; it can generate around a fifth of its revenue, and a larger portion of its profit, just by selling upgrades to people that have already received its implants. And this installed base is still increasing by more than 10% a year.

Which brings us back to market growth. Of particular concern is the slow sales growth in developed markets, particularly the US. Whilst offset in part by growth in the Asia-Pacific region, margins here are about 22% (including a share of central costs), compared with about 30% for Europe and the Americas. These customers are also likely to upgrade less frequently, especially in China, where sales are made on large Government tenders.

But who wouldn't be happy with margins of 22% in their weakest markets and a return on capital employed of around 50%?

These figures show how Cochlear remains a very high quality business. All that's missing is some top-line growth. That should come over the next few years with the Nucleus 6 on its way, the US economy recovering and, most likely, a lower Australian dollar.

With the Aussie dollar at US$0.93, underlying 2013 earnings per share would be around $2.50, giving a PER of about 24. Assuming some organic revenue growth in 2014, the underlying PER would fall to around 22.

Despite having more than 90% of its revenues and over 50% of its costs denominated in overseas currencies, Cochlear prepares its accounts in Australian dollars.

That means you don't get a translational effect from converting US$ earnings into $A, but a weaker A$ would mean relatively higher revenues from overseas markets, as measured in $A. Overseas costs would also increase, but because overseas revenues are proportionately higher than overseas costs, the overall effect is higher profits from a lower $A.

Table 3 shows the impact of a lower dollar on Cochlear's earnings per share according to the recent guidance from management. Under the two scenarios of an Aussie dollar buying US$0.90 and US$0.70, underlying profit increases of about 37% and 120% respectively could be expected.

However, Cochlear also undertakes extensive hedging, the impact of which reduces over a period of three years to leave us in the underlying position.

So Cochlear is two stories in one; another clear beneficiary of a lower Australian dollar, but also a justifiably highly priced growth stock going through one of its traditionally challenging periods.

Each time it has emerged in rather good shape and we expect it will do so again. Whilst Cochlear is currently a **HOLD**, any price fall to below $55, as occurred just a few weeks ago, would likely prompt an upgrade to Buy.

*Note: Our model Growth portfolio owns shares in Cochlear*

# CSL way out in front

**CSL enjoys attractive economics and exemplary management. It's one of Australia's best businesses.**

Since floating in 1994 at $2.30 a share (the equivalent of 77 cents today, following a three-for-one share split in 2007) blood products manufacturer CSL's share price has risen nearly 8,000% to $61.82. Shareholders have also banked over $6 a share in dividends. This success has been no accident.

People are careful about what enters their body. Why else would we pay four times as much for Panadol when generic paracetamol does the same job? This is especially true with blood products where viral infections such as human immunodeficiency virus (HIV) and hepatitis can easily spread without careful control. That gives companies operating in this market strong pricing power.

CSL also enjoys two main barriers to entry. First, strict licensing regulations make it costly for would-be competitors to enter the industry. Second, even if a new entrant passes the first hurdle, it has to sustain large losses until volumes reach a point where it can compete with the incumbents (this is an industry with substantial economies of scale). Most companies don't make it, which explains why the market is equally divided among three big operators.

The story gets even better. As countries become wealthier, they spend more on healthcare. With two thirds of CSL's potential consumer base located in emerging markets, it's almost certain that its market will continue to grow.

Usage is increasing for other reasons, too. Up until the 1970s, haemophilia treatments were rudimentary and life expectancies low. Now, thanks to new treatments, sufferers live long enough to have children of their own, some of whom inherit the disease. This has significantly expanded CSL's market.

Lastly, as is common in healthcare, new uses are found for existing products, which goes some way to explaining why CSL's return on incremental capital employed has exceeded 50% a year for the past decade.

These factors alone make CSL an attractive investment proposition. The quality of its management is really icing on the cake. Management hasn't let success breed complacency and has been adept at identifying and capitalising on industry consolidation through a series of shrewd, strategic acquisitions and then managing the integration of new businesses with exceptional finesse.

Each year, the company becomes more efficient. With the assets-to-sales ratio falling from 1.6 to 1.0 over the past decade it now uses fewer assets to produce each dollar of sales.

Shareholders aren't treated as patsies, either. When the proposed buyout of Talecris (since acquired by Spanish-based Grifols) collapsed in 2009, it swiftly announced a share buy-back instead of splurging on an ill-conceived acquisition. This is a management team with its collective ego in check.

What of the competitive environment? The industry is split equally between Baxter, CSL and recently merged Grifols-Talecris. New competition is unlikely but continued exceptional profitability relies on these players competing rationally, which means not too competitively.

There's always a risk that landmark discoveries might create wholesale changes in industry dynamics but, thus far, R&D expenditure is producing incremental rather than revolutionary change.

Another potential threat to profitability comes from governments cutting back on healthcare spending. Evidence from the US (CSL's key market) suggests these cuts will allow only modest price increases but the risk of more dramatic impacts remain. Finally, there's the operational risk of contamination of a product batch that could result in products being banned from sale.

The strength of CSL's franchise and its profitability mean it can carry these low probability, high impact risk with relative ease. This is a company not subject to the whims of the economic cycle; it enjoys growing demand that should see earnings rise by around 5% a year; and it can fund continued share buy backs from operating cash flow, further boosting earnings per share.

Expenditure on R&D also lends support to a positive view. In 2013 CSL will spend over $400m on R&D, more than the company's revenue in 1997 and ten times its then R&D budget.

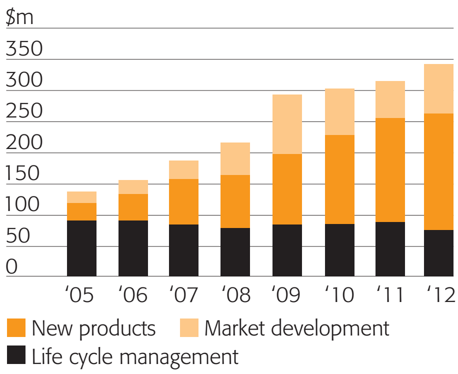
**KEY POINTS**

- A genuine world class business
- New CEO poses a risk
- Earnings to rise over 10% with lower dollar


**CSL | CSL**

| | |
|---|---|
| PRICE AT REVIEW | $61.82 |
| REVIEW DATE | 2 Jul 2013 |
| MARKET CAP. | $32bn |
| 12 MTH PRICE RANGE | $38.50–$64.58 |
| BUSINESS RISK | Low |
| SHARE PRICE RISK | Medium |
| MAX. PORTFOLIO WEIGHTING | 7% |
| OUR VIEW | HOLD |

**CHART 1: CSL R&D SPENDING MIX**




Source: Bell Potter

The cervical cancer vaccine Gardasil demonstrates what's possible. It cost CSL around $10m to develop but has generated more than $650m in licensing fees, most of which is profit.

Whether current expenditures pay off depends largely on management. With long-standing CEO Brian McNamee recently replaced by Paul Perreault, the former head of CSL Behring, this month, that's a risk. But this is a company with sound internal systems and processes. It should deal with McNamee's departure with ease.

As reported on 13 Feb 13, the half-year result was impressive. Revenue increased 11% in constant currency terms to US$2.5bn (it changed to US dollar reporting last year), while net profit rose 25% to US$627, again in constant currency terms. Earnings per share leapt even further, rising 31% to 124.7 US cents thanks to CSL's ongoing share buyback.

Driving this growth was CSL Behring, CSL's plasma products business, which continues to outgrow the market by winning market share and selling premium products. Meanwhile, the ruthless pursuit of manufacturing efficiencies has helped expand earnings before interest and tax margins.

CSL remains in sound financial health. Although the company now carries nearly US$400m of net debt due to its current share buyback, the company is producing nearly US$1bn of annual free cash flow meaning it can easily support this modest debt burden.

The impact of a falling Aussie dollar on the company isn't as strong as it is for Cochlear or Computershare but it does offer some potential. With 85% of CSL's business outside Australia, it would become more valuable in Aussie dollar terms if the dollar were to fall further.

All things being equal, and using forecast 2013 earnings of US$1,200m (EPS of $2.50, adjusted for the current share buyback) a 1% fall in the Aussie dollar would boost net profit by around $10m. If the Aussie fell to 90 cents against the US, earnings would rise to around $1,350m (or EPS of $2.75) and a fall to 70 cents against the US would see earnings jump 25% to around $1,500m or EPS of around $3.10.

Although this exercise focuses on a falling Aussie dollar, it's the US dollar/Swiss Franc paring that can impact operations. CSL sources most of its plasma inputs for its products from the US (in $USD) and processes in Europe. This means swings in the US dollar/Swiss Franc impacts margins.

Either way, 2013 looks like being another successful year with full-year net profit pegged to rise 20%. The company's share price has continued its march upwards as the market better appreciates its quality but there's still plenty of room for more growth.

CSL is an exceptionally high-quality business. Although we're a long way from an upgrade, it remains a classic **HOLD**.

*Note: Our model Growth portfolio owns shares in CSL.*

## TABLE 1: IMPACT OF A LOWER DOLLAR

| | EARNINGS PER SHARE IN A$ | | |
|---|---|---|---|
| | STATUS QUO OF US$1.03 | A$ AT US$0.90 | A$ AT US$0.70 |
| 2013 UNDERLYING EARNINGS PER SHARE | 2.50 | 2.75 | 3.10 |

## FURTHER READING

*CSL: Interim result 2013*
13 Feb 13 (Hold - $57.74)

*Lessons from CSL's R&D day*
12 Dec 12 (Hold - $54.54)

*Why CSL is a top 10 business*
10 Apr 12 (Hold - $35.62)

## CSL RECOMMENDATION GUIDE

| | |
|---|---|
| **BUY** | Below $40.00 |
| **HOLD** | Up to $70.00 |
| **SELL** | Above $70.00 |

# Computershare cheaper than it looks

**Two years ago we set out four things that could provide a kicker to Computershare's profits. Now three of them are falling into place.**

Industries dominated by a single firm are easy to spot. The winner has the highest margins, even when charging a similar or lower price; it enjoys a dominant market share, often over 50%; and it has higher returns on capital.

That dominance frequently creates a virtuous circle whereby a large market share delivers the cash flow that can be used to further strengthen the company's competitive advantage. The Coca-Cola Company and Gillette are famous US examples, as is Cochlear closer to home.

Computershare, the world's largest share registry business, can now be added to this illustrious list.

Computershare manages the share registers of listed companies across the globe, managing records, legal titles and dividend payments on behalf of its clients' shareholders. It also takes queries and phone calls from shareholders and manages complex employee equity plans. These activities generate handsome, stable recurring revenues.

At key points in the stockmarket cycle, other lucrative but irregular revenue kicks in; the back end processing of capital raisings, mergers and takeovers, stock splits and other one-offs, for example.

Whilst the company is also involved in other businesses, like issuing speeding fines in Victoria and managing tenant security bonds in the UK, we're recommending you buy Computershare for its share registry activities, where it enjoys a dominant market share.

Since opening its doors in 1978 in Melbourne, Computershare now operates in 20 countries, services 30,000 customers and millions of shareholders. In most major markets, it's the biggest player.

This dominance shows up in the figures. Computershare operating profit margins and return on equity are typically well above 20%, all from an operation that appears to be a commodity-like business but is anything but.

For several years we've been banging on about the potential for Computershare's earnings to rocket. Finally, three of the four potential profit boosters we wrote about in *Computershare takes the lion's share Pt2* on 22 Jun 11 (Long Term Buy—$9.19) appear to be falling into place.

### Profit boost 1: Lower Australian dollar

With Australia accounting for just 15% of Computershare's earnings, there aren't many local companies that will benefit more from the fall in the Australian dollar.

The company reports in US dollars, so that 15% of its earnings will shrink proportionately in the case of a lower Australian dollar. But the much bigger effect is in converting the US dollar earnings per share figure into Australian dollars.

Overall, for every one US cent the Aussie dollar falls, earnings per share will rise by about 1%, and vice versa. So, given the 12 US cent fall in the Aussie dollar over the past few months, we can now look forward to earnings per share about 12% higher.

Full-year guidance given at the interim result was for earnings per share of about US$0.55. That would have been worth about A$0.52 with an exchange rate of 1.05, giving a price-earnings ratio (PER) of 20. But at 0.93 it would be worth A$0.59, a PER of 17.

### Profit boost 2: Higher interest rates

Fed chairman Ben Bernanke's 'road map' for the tightening of US monetary policy has freaked the bond market and sent stocks back to where they were at the beginning of the year. But with US$16.7bn in its coffers at 31 December, Computershare will be a big beneficiary of the tightening.

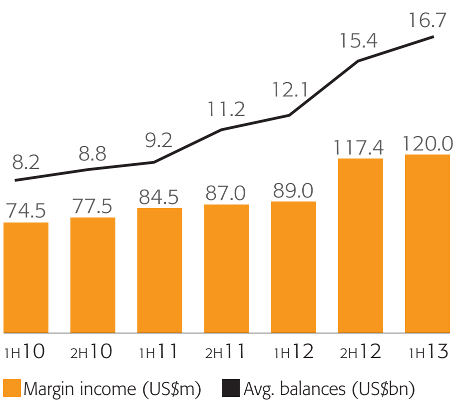
**KEY POINTS**

- A lower $A and higher interest rates could easily add 20% to earnings
- Shareowner Services integration progressing well
- Increased corporate activity would add the cream


**COMPUTERSHARE | CPU**

| | |
|---|---|
| PRICE AT REVIEW | $10.29 |
| REVIEW DATE | 2 Jul 2013 |
| MARKET CAP. | $5.7bn |
| 12 MTH PRICE RANGE | $7.31–$11.33 |
| BUSINESS RISK | Low–Med |
| SHARE PRICE RISK | Medium |
| MAX. PORTFOLIO WEIGHTING | 8% |
| OUR VIEW | BUY |

**CHART 1: MARGIN INCOME ANALYSIS**




Source: Computershare half-year results, Dec 12

This is money Computershare holds on behalf of clients but it's entitled to the interest on much of it. For the six months to 31 December, it made US$120m on an average balance of US$16.7bn, giving an annualised return of about 1.4%.

We'd estimate that about a third of the US$240m margin income is due to hedging gains, so the underlying level at current rates is probably around US$150m a year.

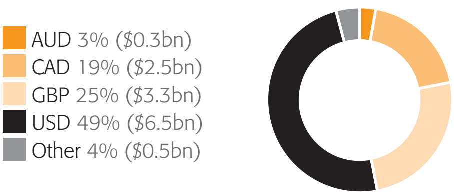
Of the funds exposed to interest rates, about half are in US dollars (current rate of less than 0.25%), about a quarter in British pounds (0.5%). Most of the rest are in Canadian dollars (1.0%).

For every 1% we add to these rates, across the board Computershare should earn an extra US$130m (in a year or two, after the effects of hedging rolls off). Adding that to the underlying margin income would give us an extra US$40m for a 1% rise in rates and an extra US$170m for a 2% increase. That's about 5 US cents and 20 US cents in earnings per share respectively.

So, if interest rates had been 1% higher (and unhedged) during the 2013 financial year and the Aussie dollar had been at US$0.93, earnings per share would have been about A$0.65, giving the stock a theoretical PER of 16. If rates had been 2% higher, those figures would rise to A$0.80, delivering a PER of 13.

> *With Australia accounting for just 15% of Computershare's earnings, there aren't many local companies that will benefit more from the fall in the Australian dollar.*

**CHART 2: TOTAL EXPOSED FUNDS**




Source: Computershare half-year results, Dec 12

### Profit boost 3: Merger with BNY Mellon Shareowner Services

The third profit boost from Computershare takes the lion's share—the acquisition of BNY Mellon Shareowner Services—is already mostly baked into current forecasts. However, there was more good news at the interim results, with synergies ahead of target in time and value. A further US$42m of synergies are now expected in 2014 and 2015, about US$3m more than originally budgeted and equivalent to about 5 US cents per share.

The real benefits of this acquisition, though, should be seen over the longer term. This will allow Computershare to use its 60% market share to cross-sell its range of services and bring operational efficiency to what has previously been a fragmented and antiquated market (US share ownership is still based on paper certificates).

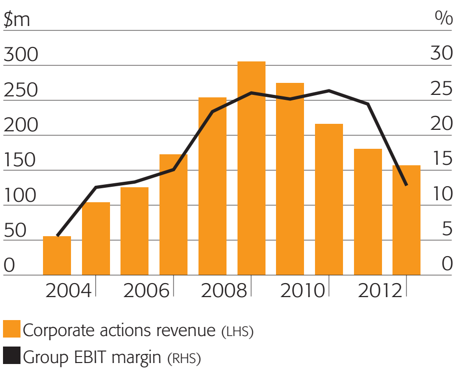
At the interim result, management said that major clients were re-signing with Computershare; that client losses were 'within acquisition assumptions'; and that they were seeing 'encouraging new business outcomes' across the combined US business, 'winning the majority of IPOs and several competitive tenders'. It's early days and we'll be looking for further reassurance as time goes on, but it all helps.

### Profit boost 4: Increase in corporate activity

The one thing that's missing is an increase in corporate activity—the mergers and acquisitions and IPOs on which Computershare has traditionally made its highest margins.

After making US$90m from corporate actions in the first half, the company is set to beat last year's US$156m. Since that was Computershare's lowest result in this area of its business since 2005, that might seem like scant consolation. But it will at least be the first time it has risen since 2008, as you can see in Chart 3.

**CHART 3: CPU CORPORATE ACTIONS REVENUE AND GROUP EBIT MARGIN**




Source: Company reports

It's hard to know what counts as normal for corporate activity. It could be that current levels are way below par, but it could also be that the period from 2006 to 2009 was way above par. Either way, following the Shareowner Services acquisition, it's not hard to imagine revenues in this area getting back to US$300m when activity picks up a bit.

The significance of these revenues is hard to overestimate, as you can see in Chart 3—group EBIT margins closely follow corporate actions revenue. Not only do corporate actions have high margins but activity in this area feeds through into other areas as well.

Ignoring that trickle down effect, though, and estimating an EBIT margin of 50% for corporate actions, it's easy to imagine this area adding an extra US$40m to net profit, or about seven cents per share.

Putting it all together, and assuming interest rates 1% higher across the board, we can imagine earnings per share of US$0.72, or A$0.77 based off a US$0.93 exchange rate, giving a (very) theoretical PER of 13. With interest rates 2% higher, underlying earnings per share might be as much as A$0.95, giving a PER of only 11.

Of course, all this works both ways. But it's hard to see interest rates getting much lower, it's hard to imagine the Australian dollar back above $1.05 any time soon, and it's hard to imagine corporate activity getting much slower.

The stock price is flat since Computershare: The ducks start to line up from 27 Jun 2013 (Buy—$10.54) and we're sticking with **BUY**.

*Note: Our model Income and Growth portfolio own shares in Computershare.*

**CPU RECOMMENDATION GUIDE**

| | |
|---|---|
| **BUY** | Below $12.00 |
| **HOLD** | Up to $18.00 |
| **SELL** | Above $18.00 |

# Notes

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