INTELLIGENT INVESTOR
SHARE ADVISOR

10 Best Buys
Share Advisor Analysts' Top Picks

■ EFY 2015 Special Report

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The fine print on top picks

> *Members of your analytical team have value investing in their blood, manage their own money and between them, have over 100 years of real-life investing experience.*

You've got to admit it, the title of this report has an alluring pull. The members of your analytical team have value investing in their blood, manage their own money (few are big on property when it means a smaller share portfolio) and between them, have over 100 years of real-life investing experience.

Who wouldn't want to know what each considered their top two buy ideas right now, especially when cheap stocks are so hard to come buy? Unfortunately, the catchy title is open to misinterpretation. So, before diving into the research, let's address any potential misunderstandings about how it should be used.

The first point to note is that, unlike most *Share Advisor* recommendations, which require a focus on ASX-listed stocks of a certain market capitalisation, what follows is a form of analytical freestyle. No restrictions were placed on the kind of stocks that could be included in this report.

If an analyst wanted to include a foreign stock, no problem. If one chose a fairly priced growth stock and another selected a poor business at a very cheap price (the proverbial cigar butt), again, no problem. Size, quality, location, value; all of it was up for grabs.

This has a number of implications. First, just because a company is covered in this report does not mean we will continue to cover it. Table 1 lists all 10 stocks in this report. Whilst seven will receive ongoing coverage, three won't. If you pursue these recommendations please understand you're on your own.

Second, where we aren't offering ongoing coverage no formal recommendation has been made. Whilst these three stocks offer a close and revealing insight into your analyst's personal styles, they have not been put through our standard analytical processes, which is why we can't formally recommend them. The seven stocks that do have a formal recommendation have been subject to our rigorous internal procedures, which is why we've reiterated the current Share Advisor recommendation.

Lastly, all the usual stuff about diversification and not having too much of your portfolio allocated to speculative opportunities still applies. Please take note of the portfolio weightings and if you purchase any of the three stocks where we haven't offered a figure, please don't get carried away.

Okay, let's get into it, kicking off with James Carlisle's interesting approach to a very interesting sector.

Table 1: Analysts' top picks

COMPANY (ASX CODE)	CURRENT PRICE	MOST RECENT RECOMMENDATION	ONGOING COVERAGE (Y/N)?	MAX. PORTFOLIO WEIGHTING
CARSALES (CAR)*	$10.73	23 Feb 15 (Buy – $10.17)	Y	6%
TRADE ME (TME)*	$3.60	19 Feb 15 (Buy – $3.57)	Y	6%
ICAR ASIA (ICQ)*	$1.00	30 Apr 15 (Spec Buy – $0.97)	Y	2%
AINSWORTH GAME TECHNOLOGY (AGI)	$3.17	2 Mar 15 (Buy – $2.49)	Y	3%
GAGE ROADS BREWING (GRB)	$0.05	N/A	N	NA
APPLUS SERVICES (APPS.MC)	€10.29	15 Apr 15 (Buy – €10.98)	Y (Premium)	3%
BETFAIR (BET.L)	£26.19	N/A	N	NA
AMERICAN INTERNATIONAL GROUP (AIG.NYS)	US$59.23	1 May 15 (Buy – US$56.60)	Y (Premium)	4%
FLEETWOOD CORP (FWD)	$1.44	12 Mar 15 (Spec Buy – $1.34)	Y	4%
MOLOPO ENERGY (MPO)	$0.15	N/A	N	NA

*** These stocks are to be treated as a mini-portfolio with an overall weighting of no more than 10%. The figures shown apply only if you're selecting individual stocks rather than adopting the mini-portfolio approach.**

James Carlisle

With a portfolio approach to a very interesting sector, James offers not one, not two, but three picks.

Once a company establishes a leading market position in the online marketplace, it becomes a very powerful, profitable monopolistic force.

With dominant market positions all but locked in by 'network effects', online classified stocks enjoy many attractive business characteristics. As each additional person lists a car or house to sell on a site, they increase the overall usefulness of that site for everyone.

The more sellers there are, the more useful the site becomes to buyers. And the more buyers there are, the more useful the site becomes to sellers. The **ASX** – also in my portfolio and on our Buy list – benefits from the same kind of forces. Once a company establishes a leading market position in the online marketplace, it becomes a very powerful, profitable monopolistic force.

But it isn't just network effects that make the fast-growing online classifieds sector so appealing. As advertising expenditure moves online, these businesses grow very quickly. And improving technology increases the value of the services delivered, offering the opportunity to increase prices and boost margins. Believe me, these are top quality businesses that I'm very happy to own at a reasonable price.

Table 1: Carlisle's classifieds portfolio

COMPANY (ASX CODE)	CURRENT PRICE	MOST RECENT RECO.	ONGOING COVERAGE (Y/N)?	MINI PORT. WGHTG
CARSALES (CAR)*	$10.73	23/2/15 (Buy – $10.17)	Y	40%
TRADE ME (TME)*	$3.60	19/2/15 (Buy – $3.57)	Y	40%
ICAR ASIA (ICQ)*	$1.00	30/4/15 (Spec Buy – $0.97)	Y	20%
OVERALL WEIGHTING				10%

Naturally, the alluring features of internet classifieds stocks haven't escaped Mr Market's attentions. But over the past few months many have fallen sharply in price. **REA Group** is 20% below its 52-week high, **Seek** 11%, **Carsales** has slumped 17%, **Trade Me** is down 6% and tiddlers **iCar Asia** and **iProperty Group** have fallen 45 and 27% respectively.

More's the pity, because directly (Trade Me and iCar Asia) or indirectly (through an investment in **News Corp**), three out of the six stocks I currently own are in this sector. The first two are also on our Buy list, while News Corp – although technically a Hold – has recently slipped back below our Buy price.

The good news about price falls is that they produce new opportunities. Carsales recently made a reappearance on our Buy list and I'm close to restoring it to my personal portfolio. The company enables sellers to upload image galleries and videos (if you pay enough), and provides tools to help dealers create, edit and track their listings. Buyers get to search listings far more easily and see more information about cars they're interested in.

REA Group does the same for property buyers and sellers and, rather than taking the place of property classifieds, will ultimately do much of the work of real estate agents – taking the value of its service up from the tens of dollars per listing to perhaps thousands. Unfortunately, and despite the recent price fall, on a PER of 28 it's a little too expensive to recommend, as is Seek. But both are worth watching for future opportunities.

That leaves us with Carsales, Trade Me and iCar Asia, which I think would make an ideal mini-portfolio for members wanting exposure to this fast-growing sector, increasingly internationalised sector.

Carsales

Carsales now has operations in Brazil, South Korea and, through its stake in iCar Asia, Malaysia, Thailand and Indonesia. These overseas businesses are relatively small, but revenues are rising fast and earnings could grow even more quickly as they pass what is usually a fixed cost base.

Even rapid growth requires minimal funding, so much of the profits generated are available to

shareholders as free cash. These high quality businesses can therefore more easily justify higher earnings multiples.

Compared with the likes of Seek and REA Group, there's a more attractive margin of safety in Carsales – on multiples of 22 for 2015 and 19 for 2016 – and Trade Me, on 19 and coming down to 18.

These lower multiples reflect the slower growth these companies are currently experiencing. But I expect growth to improve eventually. Carsales, for example, is marketing its newly acquired vehicle finance business, Stratton Finance, very forcefully. The company is also investing in its overseas businesses, which are beginning to come into profit, which is why Carsales is a **BUY** below $11.00 for up to 6% of your portfolio.

Trade Me

Trade Me has the advantage of bringing together classified businesses in several areas – property, cars and jobs – along with a general merchandise business. New Zealanders have many reasons to flock to the site, which is why it's always front of mind when they have a car to sell or a house to buy. Trade Me's dominant position in cars and property (and a close second in jobs) is more than enough to compensate for the lack of specialisation.

> ***These high quality businesses can therefore more easily justify higher earnings multiples.***

Recently, the company has been investing in channel development. With more than half the company's traffic coming from mobile devices, Trade Me is expanding its products to make access from a variety of devices a more pleasant experience.

Whilst holding back profit growth now, these new services will makes the sites more attractive to users, extending Trade Me's already considerable barriers to entry. What's more, revenues from classifieds have recently overtaken the much slower growing general merchandise revenue. In future, overall growth should increasingly resemble the former rather than the latter. It's a **BUY** below $4 for up to 6% of your portfolio.

iCar Asia

Those who can stomach a little volatility may want to add iCar Asia to these worthy performers. The company's market-leading car classifieds sites in Malaysia and Thailand are slated to breakeven later this calendar year, although the Indonesian business is locked in a struggle for leadership and will be sucking in dollars for a few more years.

Indonesia has ten times Australia's population and already has more cars, so it's a prize well worth winning. Carsales topped up its stake in the company last year at $1, and we're currently recommending iCar Asia as a **SPECULATIVE BUY** up to that price for up to 2% of your portfolio.

Online Classifieds Recent Reviews

19 Feb 15 *Trade Me: Interim Result 2015*
21 Aug 14: *Trade Me: Result 2014*
31 Jul 14: *Trade Me Backs Down on Property Pricing*
23 Feb 15: *Carsales: Interim Result 2015*
24 Oct 14: *Carsales AGM*
7 Oct 14: *Carsales Upgraded to Buy*
30 Apr 15: *iCar Asia's Road to Riches*

I'd suggest a mini-portfolio approach for these stocks, as shown in Table 1, with the three stocks adding up to no more than 10% of your portfolio overall. But if you don't like the speculative nature of iCar Asia, splitting your mini-portfolio between Carsales and Trade Me makes sense.

*Note: The **Premium Portfolio** owns shares in Trade Me, the **Growth Portfolio** owns shares in Carsales and Trade Me, as does the **Income Portfolio**.*

Disclosure: James Carlisle owns Trade Me, iCar Asia, News Corp and is itching to buy Carsales.

Jonathan Mills

What these two picks – a pokie manufacturer and a brewer - say about the most recent addition to our analytical team is anyone's guess, but the stocks themselves deserve sober inspection.

If Ainsworth is to really deliver on its promises it must grow offshore. My belief is that the company is successfully doing just that.

As noted in the preamble to this report, it's difficult deciding on one or two stocks that are 'top picks' because it contravenes the basic principle of diversification over concentration. Why is this important? With a diversified selection of stocks, mistakes in analysis or simple bad luck won't lead to permanent capital loss. With a concentrated portfolio they may well. Nevertheless, the rules are the rules.

Ainsworth Game Technology

My first pick is pokie machine manufacturer **Ainsworth Game Technology**. Founded by Len Ainsworth – who also started competitor **Aristocrat Leisure** – Ainsworth has grown dramatically in recent years, increasing market share in Australia and expanding into the Americas.

The allure and potential pushed the price up to a high of $4.79 in October 2013. Then disappointment set in. Earnings growth wasn't keeping up with expectations and then a profit warning was issued at the November 2014 AGM. Before Christmas 2013 the stock price had declined to just $2.06, although it has been recovering since.

Chart 1: Ainsworth Revenue Breakdown

Source: Company reports

Driving the recovery have been new game releases in Australia, including its first multi-game cabinets which appear to be having success in the NSW hotel market. The issue for investors is that the number of pokie machines is capped locally. If Ainsworth is to really deliver on its promises it must grow offshore.

My belief is that the company is successfully doing just that. Ainsworth continues to expand into new jurisdictions within the United States and is growing market share in the country. To assist with this push it's spending $30m building a new Las Vegas HQ, which should be finished next year.

Unfortunately, with the American economy growing only slowly, gambling revenue hasn't been increasing at a pace that might encourage casinos to increase the rate at which they're replacing old machines. As a result, Ainsworth is increasing its 'recurring revenue' by leasing machines to casinos, rather than selling them outright, in return for a percentage of their daily takings.

Recent consolidation within the sector has left a few large companies that could cut prices to make life for small players like Ainsworth more difficult. But I think that's an unlikely prospect. In one strange respect the pokie market is like the market for airliners; dominated by a few big players and a host of smaller ones serving niche markets, customers spread their purchases to avoid being dictated to by the large suppliers.

With AGI's US market share in the low single-digits, the company has a lot of potential to increase this figure in coming years, particularly if the US economy starts growing strongly.

As well as increasing its business in the rest of the Americas, Europe and Asia, the other significant revenue opportunity lies in online social and real money gaming. AGI has admitted that it was slow to pick up on this opportunity and is playing catch up. Yet it recently released its Players Paradise Social Casino mobile phone app and will soon start distributing some of its most popular games to UK online casino platforms. There's a good chance AGI will have similar success to Aristocrat in this arena.

Spending about 11% of revenue on research and development, the company will need to continue producing games that punters like to play. This has not been a problem in recent years but is

obviously something that will have a big influence on future returns.

With Len Ainsworth a sprightly 91 and still actively involved in operations, his departure from the company is an obvious risk The company would certainly miss his unparalleled experience and contacts within the industry but should have enough highly skilled employees to successfully continue.

Ainsworth Recent Reviews

2 Mar 15 Ainsworth Interim Result 2015
20 Nov 14: AGM 2014
6 Nov 14: Ainsworth Spins the Wheel in Vegas

Having used up all its prior year tax losses, Ainsworth recently started paying franked dividends, although the level of future franking will depend on the proportion of Australian earnings. Still, the current 3.1% dividend yield isn't bad for a company that should grow at a respectable clip. Members should note, however, that the uneven release of games and the low free float (Len Ainsworth still owns about half the company) means the stock is likely to be volatile. We don't recommend chasing the price up, but Ainsworth is a **BUY** below $3.30 for up to 3% of your portfolio.

Uneven release of games and the low free float means the stock is likely to be volatile.

Gage Roads Brewing Co

My second pick is Gage Roads Brewing, a Western Australian craft brewer of beers including Atomic Pale Ale and Sleeping Giant IPA. Woolworths – which has guaranteed the company's $9m debt and recently renewed its commitment to purchase a minimum of 1m cartons per year until 30 June 2017 – owns 25% of the company's stock, although this hasn't assisted Gage's share price stability.

Reaching a high of 29 cents in October 2013, a fault in production in April the following year led to 140,000 cartons being destroyed, an event that pained investors and a certain former Australian leg spinner in equal measure. Two months later the company revealed that the recovery from the production fault would reduce production by another 125,000 carton equivalents. Making matters worse, insiders had fortuitously sold large amounts of stock in the mid-to-high 20 cents range.

The share price trudged along in the mid-teens until the company updated investors in January this year, announcing an 8% decline in revenue for the first half of 2015 compared to the corresponding period. The shares naturally plummeted and have settled at around 5 cents since.

Yet despite the evident disorganisation, the investment case that colleague Greg Hoffman first outlined in July 2013 (see ***5 small stocks set to shine***) remains valid (as do the risks he noted). While the company's high fixed costs mean that lost production can be painful, the opposite also applies. Gage Roads is a participant in a craft beer market growing at 11% per year. The company has a good shot at making decent profits as it expands production to just under 3m carton equivalents a year by 2017, particularly if it is successful in cutting in half its operating costs per carton.

A new warehouse means the company now has inventory on its premises rather its customers', resulting in Woolworths and others reducing their sales to run down their inventory. This should be a short-term issue, but possibly one to watch.

Unfortunately, the company's contract brewing business is also not performing as well as previously due to the products of a number of customers losing popularity and market share. That needs to change.

Table 1: Key financials

	2011	2012	2013	2014	1H2015
REVENUE ($M)	15.8	19.7	22.6	27.4	14.5
EBIT ($M)	0.6	1.2	1.9	-0.1	0.6
NPAT ($M)	0.1	0.5	0.9	-0.4	0.3
EPS (CPS)	0.03	0.13	0.22	(0.10)	0.07
CARTON EQUIVALENTS (M)	1.0	1.3	1.4	1.7	0.9

Gage Roads has also been expanding its distribution of draught beer in its home market of Western Australia with the intention of expanding nationally in coming years. It has also commenced exports to Japan and Singapore and is also looking at selling to China and the United Kingdom.

So while there are risks – the main one being that Woolworths decides it no longer needs Gage Roads' products – I believe they are more than outweighed by the opportunity to gain multiples of the current share price if the company is successful.

*Note: The **Premium Portfolio**, the **Income Portfolio** and **Growth Portfolio** also own shares in Ainsworth Game Technology.*

Disclosure: Jon Mills owns shares in Ainsworth Game Technology and Gage Roads Brewing.

Nathan Bell

With the oil price plummeting, Nathan picks a Spanish company well placed to profit from a recovery. Best of all, it's also potentially very cheap.

> *In this area of the industry it doesn't make sense to skimp on costs.*

Applus Services

Busted floats can be a great source of opportunity, and Spanish certification and testing company Applus Services qualifies on the basis that its share price has fallen 35% since listing on the Madrid Stock Exchange in May last year.

Applus hasn't suffered from all the usual problems you'd expect of a float following seven years of ownership by private equity. Unrealistic growth expectations, an overblown float price and underinvestment remain potential risks but there's little evidence of them thus far.

So why is Mr Market running scared? Because the company's largest customers are oil titans struggling to cut costs in response to lower oil prices. That's curtailing the need for Applus's testing and certification services. Around half of Applus's revenue and profits (see Chart 1) come from testing and certifying the major assets of oil and gas companies, and checking that suppliers and service providers are complying with strict agreements.

At around 7–8%, operating margins aren't high and there are plenty of competitors, although few offer Applus's international scope. The company's major advantage is that oil giants like Shell prefer to stick with a reliable partner like Applus, usually signing long-term contracts with them. It makes sense. The cost of Applus's services are nominal compared, for example, with the expense of a major explosion at an oil refinery. In this area of the industry it doesn't make sense to skimp on costs.

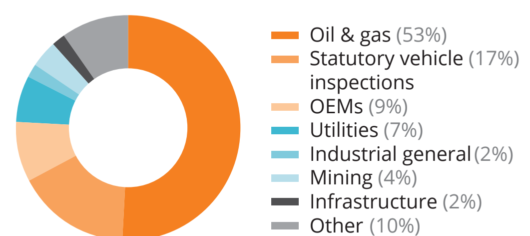
The company's revenues are split evenly between regular checks of existing assets, which provide recurring revenue, and the testing of new plant and equipment. Mr Market is currently concerned that profits from the latter will slump as oil and gas companies slash development expenditure in the wake of the sharp drop in the price of oil.

That's possible in the short term but we expect the oil price to at least recover to the marginal cost of production (our estimate is US$70–80 per barrel) over the next few years. Applus customers like BP and ExxonMobil will eventually start spending again, without any risk that they'll go broke in the interim.

That's important because the company's largest client within this division represents 7% of revenue, and the largest three clients contribute 15%. Eighty per cent of the company's work is also repeat business so losing any of them would be painful. But given the company's excellent reputation we'd expect this division to grow over time as oil and gas production increases.

What if we're wrong? Well, Applus could still justify its current valuation as it has two other businesses delivering steady profits. The first is a highly profitable vehicle inspection division, which provides certificates of roadworthiness. Spain still accounts for a third of revenue, but over the years the company has grown internationally. It now owns a monopoly in Ireland, for example, which delivers 24% of revenue.

Chart 1: Revenue by end-markets



Source: Company prospectus, 2014

Operating profit margins are around 26%, and while the division provides 17% of Applus's total revenue, it generates 34% of profits because most jurisdictions allow Applus to charge a fixed price for a specified period of time with limited, if any, competition.

The hard part is extending contracts at similar prices. On average Applus's contracts have eight to nine years left to run, but given Ireland and the Catalonia region of Spain account for 42% of the division's revenue losing such highly profitable contracts would be impossible to replace.

Over the past decade, though, Applus has only lost three contracts, while extending nine and winning nine more. With regulations tightening around the world as more and more vehicles hit the road, there should be incremental opportunities to grow profits.

The other major division performs automotive testing and engineering, and provides 10% of profits. Applus owns 80% of the business with the Spanish government owning the rest. This isn't a huge business and won't grow quickly, but it should provide valuable cash flow should the RTD division's profits dry up over the next year or two.

Table 2: Applus interim result

ANNUAL RESULT	2014	2013	+/–(%)
REVENUE ($M)	1,619	1,581	2.4
UNDERLYING EBITDA ($M)	205	200	2.5
UNDERLYING NET PROFIT ($M)	88	43	102
UNDERLYING EPS (C)	67	n/a	
PER (X)	17	n/a	
DIVIDEND (C)	13	n/a	
DIVIDEND YIELD (%)	1.1	n/a	

Over the past decade Applus has only lost three contracts, while extending nine and winning nine more.

Of course, there's plenty that could go wrong in addition to the oil price staying low. The company is highly acquisitive, and grew rapidly despite the GFC due to Carlyle's debt-fuelled acquisition frenzy. That's left an Everest-sized quantity of goodwill and intangible assets sitting aloft a large pile of debt. While interest costs are currently below 3%, the company has recently written off some assets and there's the possibility of more. And yet with Applus's share price falling so far there's already a decent margin of safety.

There are two ways to look at Applus's valuation. If we assume profits from newly constructed oil and gas projects fall 50% and stay flat forever, that would deliver a price-earnings ratio for the stock of around 20. That seems fair for a company with multiple recurring revenue streams.

But if we assume that revenues recover in a few years' time and the rest of the business enjoys a little bit of growth, we'd be paying less than 10 times earnings. That's attractive, especially compared with multiples of 20 or more for rivals like US-listed Mistras.

*Applus Recent Reviews**

4 Feb 15 *Mr Market gives Applus a C-minus*
6 Mar 15: *Result 2014*
12 Apr 15: *Applus Share Price Drops 10%*
*Premium service only

You don't need to be creative to conjure disaster scenarios but the most likely outcome for Applus is that earnings suffer over the next year or two before recovering as the oil price increases, rendering today's price very cheap. We still want a large margin of safety, as things are likely to get worse before they get better. But Applus is a **BUY** up to €11 for up to 3% of your portfolio.

Note: Nathan's second pick was, like Jon's, Ainsworth Game Technology. He had nothing further to add to Jon's comments. Consider this two votes for 91-year old Len rather than one.

Disclosure: The Premium Portfolio owns shares in Applus Services.

Graham Witcomb

Could there really be a betting exchange with a monopolistic market share that takes a 60% cut of its biggest customers' winnings? You bet there could.

> ***Betfair is to gamblers what the ASX is to investors.***

Betfair

As far as analysts go, I don't have a typical background. I started my career as a professional gambler and have bet on a good 20,000 horse races in my time [Graham shows remarkably few visible signs of ageing, which is surprising given this fact – Ed]. Without getting too side-tracked about the surprising overlap with value investing, one company was central to my daily life: UK-based Betfair (LSE: BET). This is my first pick, and one with which I am intimately familiar.

Betfair is unique in the gambling world: it operates an exchange that matches punters that wish to back a horse with those that think the horse will lose. It is to gamblers what the **ASX** is to investors.

As the number of punters using the exchange increases, so too does the value on offer, because the extra volume reduces the 'spread' between prices (i.e. you get better odds). This in turn attracts more punters and is known as a '**network effect**' – the same type of moat that defends eBay, Facebook and James Carlisle's picks in this report.

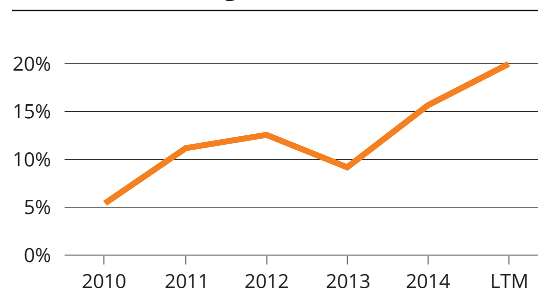
The benefit of Betfair's competitive advantage is best seen through an example. The company makes money by charging a 2–6.5% commission on winning bets. In most cases, the more you bet, the less you pay. But in 2008 the company introduced a 'Premium Charge' for punters that won consistently, which essentially set their commission rate at 20% of profits.

Unsurprisingly, the punters were horrified. But, with a 90% share of the betting exchange market, Betfair has no legitimate competitors. The gambling syndicate I worked for was by far the company's largest customer, accounting for more than 20% of turnover when I left in 2010. Even it had to just suck it up. When there's only one bridge that gets you to work in the morning, you pay the toll whatever it is.

Still not convinced of Betfair's pricing power? In 2011, the company raised its commission rate to 60% of winnings for its biggest customers. Can you imagine the ASX saying it will tax your capital gains at 60%?

But there was nothing anyone could do: this is an unregulated monopoly. If the company did lose any customers during this period it was imperceptible as far as betting volumes were concerned.

Chart 1: EBIT margin



After this episode, several customers practically threw money and 'seed liquidity' at Betfair's main competitor, Betdaq, in an effort to get it off the ground as a viable alternative. Those efforts came to naught. After years of trying, nothing could dislodge Betfair's grip. Betting volumes continue to grow.

Betfair's last remaining challenge is to convince punters that exchange-based betting is as good or better than the bookie and tote system at the racetrack. Exchanges are more intimidating but they are gaining in acceptance.

What got me excited about Betfair as an investment opportunity was its introduction in 2014 of new features called 'Price Rush' and 'Cash Out', which subtly linked the sportsbook to the exchange and took advantage of some clever psychology.

People would place a fixed bet at, say, 10:1, but the Price Rush feature would then secretly look on the exchange for better odds. Where they existed, the customer would automatically receive the better deal. Imagine buying a lottery ticket to this week's $15m prize and then being told after your purchase that – just for you – the prize would be $20m and you've got the idea. It was an example of **operant conditioning**. Recreational punters could now get

> A PER of 30 isn't ridiculous for a highly cash generative company with no debt, powerful network effects.

the superior odds on the exchange, but with a user-friendly interface.

What's more, Price Rush was (unbeknownst to players) feeding a growing pool of 'mug' punters onto the exchange and increasing the number of profitable opportunities for sophisticated bettors. So the large customers that account for most of the company's liquidity and earnings are now more hooked than ever.

The strategy is working. My jaw dropped when Betfair released its most recent quarterly result – the number of active customers rose 50% and revenue was up 27% in its main markets.

Being a website, the company's costs are mainly fixed so incremental revenue falls quickly to the bottom line. A 41% increase in revenue quintupled net profit over the past five years and management expects operating earnings to increase 24–29% in 2015.

Betfair won't appear on any traditional value investor's radar. I've never owned a stock this pricey on statistical measures. But I've seen the power of Betfair first-hand and I'm confident that it will be a bigger, stronger company in 10 year's time, especially if it can crack the traditional sports betting market.

Worldwide, the total sports betting industry is worth over $100bn. I couldn't take myself seriously if I used a number with 11 zeros in my calculations, so let's focus on the tiniest, most immediate opportunity – traditional online bookmaking for recreational punters in the UK, a £500m+ market growing at 7% or so a year.

Betfair has roughly a 10% share, but it's almost inconceivable that it will not grow that figure over the next few years with its new exchange linked sportsbook. The exchange typically offers 10-20% better odds than the bookies, meaning Betfair's sportsbook will beat competitors on price in most cases (it's a nice website, too).

If Betfair increases its share by a further 10%, that's £50m of incremental revenue. About half of that should fall to the bottom line (don't forget that lovely operating leverage), adding 30% to net profit. Worldwide, online sports betting industry revenues are about $6bn, growing at 10% a year. There's plenty of room to grow here.

Aside from a left-field management stuff-up, the only real threat is Betfair's success. Gambling profiteers like Betfair, casinos and lotteries have always been a honeypot for government's wishing to raise taxes. Betfair's monopoly position may eventually lead to regulatory issues. The company's operating profit rose 17% this past quarter but it would have risen 51% had the UK not introduced a new gambling tax during the same period.

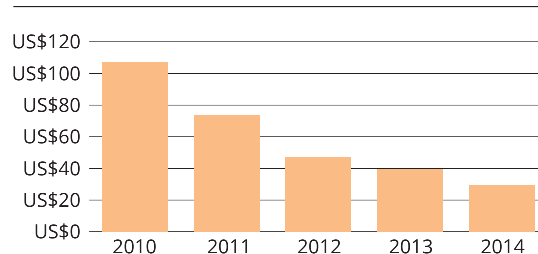
There are also some underground betting exchanges operating in China that have a lot of liquidity. If they eventually gain legitimacy they could pose a viable alternative, although their customer interface is ugly and complicated. Recreational punters will be steering well clear of it.

When I bought the stock last year on a PER of 16, the case to buy was clear-cut. But, with a current PER of 30, a lot of future growth is now built into the share price. Buying today would certainly be speculative, but a PER of 30 isn't ridiculous for a highly cash generative company with no debt, powerful network effects, few competitors and a large, growing market. By continuing to hold at these prices, I risk feeling pretty stupid if the story doesn't play out as I expect. But I'm willing to take a punt.

AIG

My second pick is **AIG**, one of the most complex businesses in the world. Following its collapse during the global financial crisis – and $185bn government bailout – AIG sold off enormous parts of the company in order to pay back the government. Its derivatives book, which got the company into trouble in the first place, has been completely excised and AIG has improved its balance sheet – debt-to-equity has come down from 331% in 2008 to 29% today (see Chart 2).

Chart 2: Net debt ($USbn)



Source: Company reports

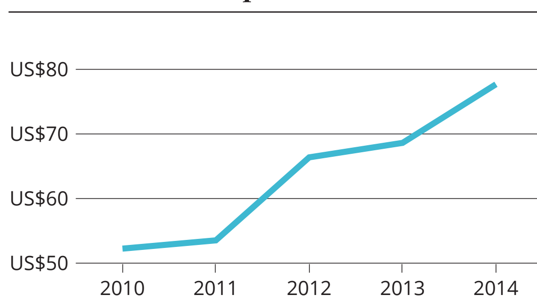
What remains is a simplified company with two main components: a global property and casualty insurer (previously named Chartis) and a US-based life insurance business (previously named SunAmerica). Both businesses have tremendous brand recognition, with tens of millions of customers worldwide, and both came through the financial crisis relatively

Improving the underwriting result by letting go of unprofitable business will be necessary and is the heart of future shareholder returns.

unscathed. AIG is still the largest underwriter of commercial insurance in the US.

Though lagging peers, AIG's underwriting result has been improving with a combined ratio for commercial lines improving from 98.9% to 97.1% in the most recent quarterly result; however, the consumer business deteriorated slightly from 103% to 103.2%. Improving the underwriting result by letting go of unprofitable business will be necessary and is the heart of future shareholder returns. If and when interest rates rise, the company will also have a tailwind in investment returns on its massive 'float'.

Chart 3: Book value per share



The company earned a 7.8% return on equity last year, helped by a large stock repurchase program. Management has a long-standing target of 10% ROE and the board approved another $3.5bn buyback for 2015.

That's great news because the stock trades on a PER of 10 and a 25% discount to book value. AIG's peers, meanwhile, are trading above book value (typically 1–1.4X BV). If AIG can keep buying back stock at depressed levels, earnings per share and book value should disproportionately grow.

The company has increased book value per share at 9% a year over the past five years (see Chart 3). With book value currently at about $80, if AIG continues to increase this metric at this rate the book value per share will be around $123 in 2020.

AIG Recent Reviews*

16 Nov 14: *Three US stocks to buy now*
13 Feb 15: *AIG: Annual Result 2014*
1 May 15: *AIG : 2015 Q1 result*
*Premium service only

Slowly but surely management is cutting costs and improving underwriting results. If it meets its goal of 9% ROE the share price should eventually trade at or above book value, in line with peers making similar returns. In that case, investors at today's price of $59 will earn a 16% return.

But there are still significant risks. AIG is an insurer exposed to freak natural disasters – earnings in 2012 collapsed due to the Fukushima tsunami. It is also highly leveraged with equity sitting at just 20% of assets.

For investors wanting to increase the risk/reward ratio, there are also AIG warrants, which allow the holder to purchase the stock at $45 in 2021. If AIG does trade at $123 in 2020, the warrants would be worth $78 – three times their current price, for a 25% annual return. The warrants expire in 2021 and could conceivably expire worthless if AIG's stock is below the $45 strike price. If you choose this option, a much smaller portfolio weighting is warranted. They add risk, but are a leveraged way to buy the upside for more aggressive investors. As for the ordinary shares, they're a **BUY** for up to 4% of your portfolio.

Note: The ***Premium Portfolio*** *owns shares in AIG.*

Disclosure: Graham Witcomb owns shares in Betfair and AIG.

Gaurav Sodhi

After trawling through the entrails of the mining sector, Gaurav picks one stock from our Buy List and another that you've probably never heard of.

This is an average business with some very ugly warts, which is why it's completely neglected and unloved.

Fleetwood

For a time, Fleetwood was one of the best performing stocks on the ASX. Year after year, it clocked sensational returns as its flagship asset – the Searipple accommodation village in Karratha – benefited from the resources boom, attracting high occupancy and rates.

The caravan division was also profitable, albeit less spectacularly so and, in aggregate, it appeared as though the company could do no wrong. Sensibly, management used boom time profits to pay extraordinary dividends so, unlike almost every other mining business, shareholders actually benefited from the boom.

Today, things could not be more different. Searipple, with occupancy of around 40%, is a shadow of its former self. Rates have collapsed to the point where it probably only just breaks even. Meanwhile, after several years of neglect and increasing competition, the caravan business now loses millions of dollars a year. In aggregate, profits have collapsed from over $50m in 2012 to absolutely nothing now.

Is Fleetwood a basket case? Not quite. The company has successfully grown a business in manufacturing accommodation for governments and caravan operators that now accounts for most of the company's revenue. This division generates $15m a year in operating profit.

Whilst Searipple is unlikely to ever earn the outsized returns of the boom years, it's still a decent asset that's fully depreciated with very low cash requirements. Even a small turnaround in occupancy will lead to a significant lift in returns. A recently signed agreement with **Rio Tinto** increases the odds of that happening.

A second accommodation village, Osprey, was built for the WA government and comes complete with government guaranteed revenues for 10 years. The business has taken on debt to complete construction and pricing terms have been in dispute but, with a resolution near, the most likely outcome will see Fleetwood earn a large lump sum payment that could entirely pay down its debt. By year end, the business could be debt free, lifting value for equity holders and lowering risks.

Table 1: Fleetwood's sum of the parts valuation

	LOW		HIGH		BASE CASE	
ASSET	$m	cps	$m	cps	$m	cps
OSPREY	55	0.90	65	1.07	55	0.90
SEARIPPLE	18	0.30	90	1.48	42	0.69
RV	40	0.66	80	1.31	80	1.31
OTHER MA	35	0.57	64	1.05	64	1.05
DEBT	−63	−1.03	−63	−1.03	−63	−1.03
CORP COSTS	−10	−0.16	−10	−0.16	−10	−0.16
TOTAL		1.23		3.70		2.75

The caravan division remains deeply unprofitable but this is, to some degree, by choice. Management has deliberately maintained high productive capacity in the hope that previous sales volumes would return. If they do, profitability will improve; if they don't, there is ample opportunity to cut costs and eliminate losses. The division commands about 20% of the RV market and holds some strategic value, especially on the west coast.

Fleetwood Recent Reviews

12 Mar 15: Fleetwood: A Better Buy
29 Aug 14: Results 2014
30 Jun 14: Fleetwood Going for a Song

This is not a Buffett-style, good business, decent price situation. This is an average business with some very ugly warts, which is why it's completely neglected and unloved. Fleetwood trades at just 50% of net tangible asset value and its largest asset isn't even on the balance sheet.

It's a classic cigar butt, a play on the breakup value of the business only.

We think the business is worth, in the base case, about $2.75 a share (see Table 1) and another dollar or so more with more bullish assumptions. On a risk-reward basis, this is an attractive **SPECULATIVE BUY** below $1.90 for the patient, but we don't recommend allocating more than 4% of your portfolio to it.

Molopo Energy

My second idea requires little explanation. After selling oil and gas assets, Molopo Energy currently has about $67m of cash on its balance sheet, no debt and no assets. The share price today values the company at just $37m.

Two investment funds - Bentley Capital and Keybridge Capital - own almost a quarter of the shares and are pressuring management to return cash to shareholders and potentially close the company down. They now have seats on the board and a reasonable chance of achieving that ambition.

This is an interesting situation that could yield decent returns. It's a classic cigar butt, a play on the breakup value of the business only. Should the investment funds be unsuccessful in their ambition and the company instead uses the cash to purchase operating assets, the opportunity falls away. We have no idea how it will unfold but there is enough potential here to keep a very close eye on it.

Note: The Growth Portfolio owns shares in Fleetwood.

Disclosure: Gaurav Sodhi owns shares in Fleetwood.