INTELLIGENT INVESTOR
SHARE ADVISOR

Top Stock Picks

From Australia's best fund managers

■ EFY 2015 Special Report

Intelligent Investor Share Advisor

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Note: The fund managers in this report and their funds own many of the stocks mentioned.

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A letter from the Editor

Dear Intelligent Investor,

This is the third year we've rounded up what we consider to be some of the country's best value-oriented fund managers and asked them to nominate a few stocks. In my (incredibly biased) view, this is the biggest and best report yet.

This year, there were no limitations on what the managers could pick. Many international stocks are featured, from Chinese insurers and NASDAQ-listed subprime lenders to Spanish mining services companies and South Korean banks.

Members that only invest in ASX-listed stocks won't be disappointed, either. There are a dozen local stock ideas for you to investigate and enjoy, including one or two companies that may surprise you. There really is something here for everybody, from deep value local picks to international companies with strong brands and attractive valuations.

Needless to say, none of the stocks referred to constitute an endorsement or recommendation from Intelligent Investor. These are stock ideas from people we respect, to be investigated under your own steam and at your own pace.

Please also bear in mind that whilst these fund managers were asked to pick stocks they'd be happy to purchase at prices around the end of May 2015, they may well have established positions before then, potentially at entry prices quite different from the prices at which they now trade. So, caveat emptor and all that.

One of the themes emerging from this basket of stocks is their international flavour. Even many of the local selections like **Surfstitch** and **GBST** generate large licks of overseas revenue. This reflects the relative valuations available in Australian stocks right now compared with other areas of the world. As members well know, we've been banging this drum for years and over the past six months many others are now singing the same tune. Allocating at least some of your portfolio to overseas markets has gone mainstream.

If you haven't already acted, is it too late? Many international markets aren't as cheap as they once were but plenty of opportunities still exist. Moreover, the sheer volume of stocks listed beyond Australia's shores increases the pool of opportunity. For those that haven't yet invested overseas this report offers much to ponder.

Lastly, I'd like to thank the fund managers for their contributions. Australian investors are lucky to have such a talented bunch of managers. For those investors that don't want to manage their own money or are happy to allocate some of their portfolio to the professionals, you can still get great performance without it costing you the earth.

I trust you enjoy their stock picks.

Yours sincerely,

John Addis,
Founder and editor,
Intelligent Investor Share Advisor

Antipodes Global Investment Partners

Jacob Mitchell

Believing that opportunities arise only when disguised as something else, Jacob Mitchell offers three favourably priced international stocks that are not quite as they seem.

> *Despite recent rises, the structural shift now underway is not yet captured in the company's share price.*

Collapsing energy prices, persistent low growth and policy-induced currency debasements; what is an investor to do in the face of such threats?

Profile

BACKGROUND

Jacob Mitchell was formerly Deputy Chief Investment Officer at Platinum Asset Management and a Portfolio Manager of the flagship Platinum International Fund. Partnering with Pinnacle Investment Management, he launched Antipodes Global Investment Partners earlier this year.

PERFORMANCE

As Portfolio Manager for the Platinum Unhedged Fund between Jan 2007 and May 2014, Jacob achieved 6% per annum outperformance after fees. Between January 2008 and November 2014 as Portfolio Manager of the Platinum Japan Fund, he delivered 10% per annum outperformance after fees.

MORE INFORMATION

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Nippon Electric Glass

Because opportunities naturally arise disguised as something else, the answer is to look beyond the obvious. In the case of my first pick – **Nippon Electric Glass** (5214-JP) – the company's poor operating history is mistakenly embedded as a permanent feature in its valuation. This has been a poorly performing business but the LCD glass industry is now an oligopoly featuring significant barriers to entry, bringing with it the opportunity to transform Nippon's economics and shareholders' returns. I believe the market is missing this point.

The LCD glass industry is dominated by three players; **Corning** (NYSE:GLW) with a 50% share, **Asahi Glass** (5201–JP) with 25% and **Nippon Electric Glass** (NEG) with 20%. Smaller players like LG Chemical, **Saint Gobain** (ENXTPA:SGO) and Schott have struggled to keep pace with falling prices and rising technical hurdles. This, plus two other factors, is good news for the bigger players.

Not only has the market become less competitive but Corning's decision to offer customers guaranteed best prices in return for guaranteed fixed supply removes the incentive for Asahi and NEG to discount to win market share. Indeed, Asahi and NEG now have scope to raise prices knowing that Corning will not undercut them. Less price competition should result.

The third and final factor also raises the prospects of better financial returns for the Japanese glass companies. Whilst the LCD glass industry is denominated in Japanese Yen, the final products in which the glass is incorporated (TVs, notebook PCs, etc) are largely priced in US dollars. During the period of the Yen's strength up until 2013, Japanese suppliers were at a competitive disadvantage. Coupled with rising energy costs after the Fukushima nuclear power plant shut down, NEG suffered a bleak winter. The company is now emerging from this difficult period, assisted by the policy-induced weakness in the Japanese Yen.

With China Inc. now embarking on the next wave of panel production, LCD glass manufacturers are set to benefit from rising demand, higher prices and reduced competition.

So, how much are investors paying for this undiscovered opportunity? Trading at just 0.6 times book value with net cash on its balance sheet, NEG carries the type of asymmetric risk-reward profile we like. The company's recent surprise revision to its margin outlook is evidence of the changing industry dynamics. Despite recent rises, the structural shift now underway is not yet captured in the company's share price.

That explains why NEG is one of the larger positions in our funds. As investors become more comfortable with the idea of sustainably higher industry returns, as has occurred in the DRAM and Hard Disk Drive industries, valuations can and should expand. A mid-cycle earnings valuation of 1.5x book value is well within reach.

Cisco

Once considered one of the four horsemen of the internet, **Cisco**'s (NASDAQ:CSCO) lowly rating suggests the company's best days are behind it. The opportunity is in Cisco capturing significant market share as the transition to software defined networking gets underway.

> ***The company's brand, breadth of solutions and incumbency will make it a difficult competitor to dislodge.***

Let's look at the bear case first. Cisco supplies networking hardware with a software layer that enables network functions like bandwidth provision, security features and user entitlements. The bears believe that software defined networking (SDN) will remove the intelligence from the hardware, collapsing hardware pricing. Meanwhile, OpenFlow software standards will allow multiple software vendors to compete for the profit pool that is now dominated by Cisco.

The bull case revolves around Cisco's response to this competitive threat. The company has quickly secured a strong position with its own SDN software stack. Our recent discussions with marquee Cisco customer **Telstra** (ASX:TLS) suggest that the company's brand, breadth of solutions and incumbency will make it a difficult competitor to dislodge. Whilst there may be some hardware pricing pressure, SDN adoption has the potential to increase demand for switching equipment as the burden of greater functionality puts pressure on antiquated networking installations. The era of big data only adds to this pressure.

We believe Cisco is set to enter the next phase in its evolution, making the company's lowly PER of 11 (net of cash) seem unjustly cautious. In recent years the company has accelerated its buyback program, introduced a dividend and successfully cut costs in a low growth environment. Shareholders are now set to benefit as a new era of software defined networking emerges. With the Nexus 9K+3K – part of Cisco's SDN solution – growing 144% year on year in the most recent quarter, one of the original horseman of the Internet may yet ride again.

KB Financial Group

Our third and final pick is South Korean banking leader **KB Financial Group** (105560-KS), an interesting case study of relative valuations for Australian bank investors. KB is the domestic retail bank market leader in the relatively mature Korean economy, one with high but manageable household debt matched by conservative net government and corporate debt levels.

Since the Asian crisis of the late 1990s, South Korea's banking market has consolidated. Four major private sector players compete in the retail market against disinterested international banks and poorly run government institutions. KB is the leading digital bank in the country with its app downloaded more than any other.

There are three reasons we hold KB shares, the first concerning our favourable view of the Korean economy. GDP growth is averaging a reasonable 3%, inflation is benign and construction activity, which has been falling since 2008, is finally picking up.

With the Korean Government running budget surpluses and the country's world class, export-led tech companies (**Samsung** (5930–KS)) and car makers (**Hyundai** (5380–KS)) doing their bit, Korea's current account surplus is over 6% of GDP.

Bank lending to households is now running at double-digit growth, a rate that can be maintained with lower interest rates. Together with the Government's desire to increase domestic spending, Korea is an environment conducive to rising home prices, with KB a clear beneficiary.

The second issue is company-specific. KB is undergoing a significant restructure. New management, focused on improving efficiency, is offering redundancy packages to about 25% of its workforce. Should half accept, we think this would increase NPAT by around 10%. As KB gains market share as a result of its digital initiatives, there may be further cost savings.

The final reason is valuation. At 0.6x tangible book value and a 2015 PER of 9 (8 if we factor in the restructuring), today's buyers don't need a consolidating market that should increase margins, a strong economy, double-digit household lending growth, rising house prices or a successful restructure to do well.

We doubt everything will work out perfectly but, in a country where the 'smart money' is averse to borrowing for a house for fear of losing on the investment, KB offers a reassuring margin of safety with plenty of potential for share price growth at current prices.

Ausbil Investment Management

Chris Prunty

When Amazon is so dominant in so many categories but remains unprofitable, who can make money in online retail? Chris Prunty believes this locally-listed global company can.

> *If a customer wants to buy it online, there's a good chance Surfstitch is the customer's only option.*

Surfstitch Group

Being the leading pure-play online Action Sports retailer globally, **Surfstitch Group** (ASX:SRF) doesn't have any physical stores. What it does possess is a dominant market position in online action sports retailing in Australia, a rapidly growing business in Europe and an emerging business in the US.

Profile

BACKGROUND

Chris Prunty is a Fund Manager at Ausbil Investment Management. He and colleague Tony Waters have responsibility for the award-winning Ausbil Micro Cap fund. The fund is currently ranked first versus all micro, small and mid-cap peers over 1, 3 and 5 years on the closely-watched Mercer survey. Chris was previously at Investors Mutual and was a small company broker at CCZ Equities. He is CFA qualified, holds a Bachelor of Commerce and Bachelor of Arts from ANU and in 2013 was named one of the top 14 buy-side analysts in the world by SumZero.

PERFORMANCE

The Ausbil MicroCap Fund has returned 31% per annum since inception in February 2010.

MORE INFORMATION

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Surfstitch sells 700 brands and 30,000 products in over 125 countries. Trading under the Surfstitch brand in Australia and Asia, the Surfstitch and Surfdome brands in the UK and Europe and Swell in North America, the group is forecast to generate $200m of revenue in FY15.

Until recently the company was 49% owned by **Billabong** (ASX:BBG). With the purchase of Billabong's stake and the acquisition of Swell in the US, the company now has control over its destiny. Freeing itself from Billabong control has allowed the company to renegotiate supply deals to improve gross margins, boost inventory to improve stock positions and make acquisitions like Surfdome in the UK.

Almost half of the company's product range is exclusive to it. With the decline of independent bricks and mortar surf retailers, Surfstitch showcases brands and ranges that simply cannot get exposure elsewhere. If a customer wants to buy it online, there's a good chance Surfstitch is the customer's only option.

Surfstitch also benefits from servicing a niche but global audience. Its usually young, male customers don't find Amazon or any mass merchant cool and as a full priced retailer Surfstitch's brands don't get trashed by excessive discounting.

This approach shows up in the figures. Surfstitch's gross profit margins are close to 50%, comparing favourably to the 20–25% for most online discount retailers. Once the company matures, 10–15% EBITDA margins are within reach.

Despite impressive management, compelling customer experience and industry-leading online metrics, the company's IPO wasn't well understood. The market struggled to value a company that listed with a $214m market cap but just $5m of EBITDA, underestimating the growth potential in this business.

As shareholders with a 10% stake in the business, we're taking a longer view. If the company can grow revenues at 25% per year for the next few years it'll be generating more than $300m of sales in FY17. Assuming EBITDA margins of 10–15%, Surfstitch could be making $30–45m in two to three years' time. With a current enterprise value of less than $350m, that's very attractive.

A good software business generally makes for a high quality stock.

Altium

Because they have a number of similarities, my second pick concerns two companies rather than one. If you like cheap stocks, stop reading now because software businesses **Altium** (ASX:ALU) and **GBST** (ASX:GBT) are not obviously 'cheap'. But with net cash on their balance sheets, high levels of growth and recurring revenues, what they lack in cheapness they make up for in quality.

Due to high switching costs, software businesses tend to have sticky revenues, very high cash conversions and conservative accounting. A good software business generally makes for a high-quality stock.

Altium makes software for printed circuit board designers while GBST makes software for stockbrokers and wealth managers. Both are generating most of their earnings and growth offshore. This global outlook is appealing, especially while the domestic economy struggles to grow and the Australian dollar is likely to be in a long-term downtrend.

Altium first listed on the ASX in 1999. The stock peaked at over $6 in the euphoric dotcom era but was small and in its early stages, too early to be listed in fact. The stock price fell to less than 10 cents per share, partly due to management problems.

As with many small technology companies, Altium was led by its founders, technical people that had built a great product but weren't especially focused on money. Over the past few years new management has shifted away from technical development to commercialisation.

As well as a great product, Altium now has disciplined research and development and sophisticated marketing and distribution. To be closer to customers its headquarters have been moved to San Diego and new distribution partners have been appointed to help sell more product. As a result, we think FY16 consensus earnings are too low. With almost A$80m of net cash, this is also a business well-placed to make accretive acquisitions to drive further earnings upgrades.

GBST Holdings

GBST is another interesting story. We think about it in three parts; a flat-to-declining Australian capital markets (read: stockbroking) business via an aging software platform called SHARES; an unprofitable but highly prospective International capital markets business with a product called Syn; and an excitement machine in the form of rapidly growing wealth management software Composer.

Composer is benefiting from regulatory change in the UK, which has forced wealth managers to undergo a once-in-a-generation refresh of their technology platforms. GBST's international wealth management business grew revenue over 40% in the first half. Longer-term, we'd expect further regulatory change in markets such as the US and Asia to stimulate the adoption of Syn.

But this is no cigar butt. Instead of a classic margin of safety, our approach is to buy 80c for $1 with the view that future intrinsic value will be around $1.20. This smaller margin of safety is offset through attractive features like net cash, a high return on invested capital, growth, annuity earnings and a strong market position.

Ausbil Investment Management believes Altium, GBST & Surfstitch are all 80c dollars. We think it's more likely than not they'll grow to $1.20 via organic growth, with the potential to turbocharge this through sensible mergers and acquisitions.

Should you rush out and buy them? Probably not. Value in all these businesses is dependent on the growth coming through as expected. And that requires a higher-than-usual level of monitoring and competitor due diligence. Something, perhaps, best left to the professionals.

Cadence Capital

Simon Bonouvrie & Chris Garrard

Simon picks out a cheap US anti-viral pharmaceutical company from his buy list while Chris nominates one of Australia's biggest miners as a short sell.

As the world's leading anti-viral company Gilead holds strong market positions in some very lucrative markets.

About 12 months ago, Cadence Capital began investing in non-ASX listed stocks. Our rationale wasn't solely due to the limited nature of local stocks, heavily weighted as they are to banks and resources, although that was part of it. We also thought the Australian dollar was overvalued and that the end of the mining boom meant more challenging economic circumstances. We moved away from stocks exposed to the local economy and toward countries emerging from recession.

Profile

BACKGROUND

Chris joined Cadence Capital in 2007 as a Portfolio Manager and has over 10 years finance and financial services experience, first as a financial analyst at IBM and as Portfolio Manager for the Garrard Geared Australian Share Fund. Simon joined Cadence in 2013 as a Portfolio Manager, prior to which he was a Portfolio Manager at Platypus Asset Management. Simon started his career in banking and has over 15 years of financial services experience including 10 years in funds management.

PERFORMANCE

Since inception in October 2005 to 30 April 2015, Cadence Capital (ASX:CDM), a listed investment company, has returned an annualised gross performance of 18.52%, compared to an increase in the All Ordinaries Accum. Index of 6.8%. Over the last five years CDM has paid an annualised historical distribution yield of 6.9%.

MORE INFORMATION

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Excluding our picks from last year – **Macquarie Group** (ASX:MQG) and **Henderson Group** (ASX:HGG) – both of which have substantial offshore revenues, about 28% of our portfolio is now allocated to non-ASX listed companies, mostly in the United States. In fact, of the 40-plus stocks in our portfolio, 12 are listed in the US and I'm choosing one of them as my first pick.

Gilead Sciences

Gilead Sciences (NASDAQ:GILD) is a US biotech specialising in antiviral drugs to treat patients suffering from HIV, hepatitis C, influenza and other conditions. In Australia 'biotech' has a poor reputation. Don't let it put you off; Gilead is more like a conventional pharmaceutical company than a speculative Australian biotech. In 2014 it generated about US$25bn in revenue and currently has a market capitalisation of US$165 billion. As the world's leading anti-viral company Gilead holds strong market positions in some very lucrative markets.

Take Harvoni and Sovaldi, new drugs developed by Gilead used for the treatment and cure of hepatitis C (Harvoni being the newer version of Sovaldi). In the company's latest quarterly report (for the period ending 31 March 2015), company product sales totaled US$7.4 billion. That compares very favourably with the previous year's corresponding quarter sales of $4.9 billion. Harvoni and Sovaldi explain much of that revenue growth.

Globally, up to 200 million people are living with chronic hepatitis C, including 4 million in the United States. Gilead owns the best-in-class drug in this market, launched in October last year with very promising results. Harvoni is a one-pill anti-viral combination taken daily for 8–12 weeks. With almost no side effects it has a cure rate of over 90%. Of the four million people in the US with hepatitis C only 260,000 have been treated with either Harvoni or Sovaldi, which shows the extent of the opportunity.

Through partnerships with health insurers and government agencies, Harvoni and Sovaldi have established a high market share in the United States. Although the headline treatment costs about $80,000, the total cost of treatment is far cheaper than former maintenance therapies, which had

lower cure rates and left many patients eventually facing a liver transplant. The actual cost for the treatment is much less than the headline rate suggests as health insurers have negotiated better cost outcomes with Gilead.

Gilead also has the world's leading position in HIV treatment which generates a third of company revenues. Of US HIV patients, 81% use a Gilead drug. The company also develops treatments for diseases in the areas of oncology, cardiovascular and respiratory illnesses.

For investors, the real attraction is the valuation. Thanks to the revenue from its hepatitis C and HIV treatments, Gilead currently trades on a PER of 11 times forward earnings. Given the huge market opportunity for treatment of these two diseases, company revenue and profits are forecast to grow strongly over the next several years.

Of the world's four biggest producers, Fortescue has the highest cash costs and the lowest grade ore.

So why is it apparently cheap? First, Harvoni is a new drug and it appears the market hasn't fully factored in the extent of the global opportunity. Many investors are worried about what might be called 'peak sales' from its hepatitis C drugs. From a financial point of view, a product that cures patients after only eight weeks of treatment isn't as good as one that keeps the virus at bay for years through a daily maintenance pill.

Second, competing products already exist (one from **AbbVie** (NYSE:ABBV), for example) and more are on the way. Third, investors are concerned about the negative reaction from politicians and health insurers over the cost of treatment with Gilead's hepatitis C drugs, and the subsequent potential for downward pressure on pricing. Gilead's hepatitis C drugs currently make up more than 50% of company revenue so any effect on the outlook for these products will influence the stock valuation.

My view is that these concerns are overdone. Harvoni has already established a very strong foothold in this huge and growing market. This is a best-in-class anti-viral drug that lowers the cost of treatment to health insurers and agencies, which is why it has maintained a very high market share and is the leading choice for physicians.

The company also has a full and growing suite of treatments in influenza, HIV and other areas. The company has very strong free cash flow and is in a position to extend its foothold in oncology treatments through acquisitions. On 11 times forward earnings with solid earnings growth combined with a strong balance sheet, Gilead is an excellent opportunity. For Cadence Capital's second pick – a short no less – I'll hand over to fellow analyst Chris Garrard.

Fortescue Metals

Fortescue Metals (ASX:FMG) is the third-largest producer of iron ore in Australia and a stock we're currently shorting, having first established a position in September last year at a price of $3.84. There are two main reasons for our belief that Fortescue's share price will fall further.

Until 2005, the iron ore price traded below US$20 a tonne, then peaked at around US$190 in early 2011 before falling to about US$60 now. In commodity cycles, this pattern tends to repeat. As the ore price has fallen we have seen a small drop in iron ore production by some mining companies but the price needs to fall further to cause a meaningful decrease in iron ore supply.

The second reason is that of the world's four biggest producers, Fortescue has the highest cash costs and the lowest grade ore. Without reducing costs, Fortescue would currently be making a pre-tax loss of around US$14.5 per tonne of ore. The company recently claimed cost reductions would take it from a breakeven price of US$76.50 in the first half of this financial year to a breakeven price of US$45.50 in 2016. That would be an amazing achievement. However, it's only beneficial if other iron ore miners cannot reduce costs in the same way.

We believe the strong downtrend in iron ore prices will continue until we see significant mine closures, which we expect to occur at a price between US$30 and US$40 per tonne. We expect Fortescue to make a loss in the short to medium term and are comfortable with our current short position.

*Editor's note: Shorting is a practice best left to the professionals and is not recommended to Share Advisor members. For our reasons why, please see our recent special report **Jim Chanos Masterclass: The fundamental short seller**.*

Ganes Capital

Wayne Jones

Wayne picks two local stocks, the first an internationally focused LIC and the second a growing distributor of medical supplies.

For investors looking for international diversification without the hassle of purchasing overseas stocks, this Templeton fund is worth a look.

Templeton Global Growth Fund

Templeton Global Growth Fund (ASX:TGG), my first pick, is a listed investment company (LIC) with an international portfolio. But unlike most LICs, its primary exposure is to Europe, where it has 44% of the fund invested across a diversified portfolio with large weightings in the financial and healthcare sectors.

Profile

BACKGROUND
Ganes Capital Management was founded by Dr Clive Gaunt and Wayne Jones, the Portfolio Manager, as a privately- owned boutique fund manager, specialising in the management of investments in the Australian equities markets.
PERFORMANCE
The Ganes Focused Value Fund has returned 9.9% per annum over the past five years and averaged 12.6% per annum over the past 12 years.
MORE INFORMATION
Website: ganescapital.com Phone: 1300 766 916

Templeton believes there are 'compelling absolute and relative valuations' on offer in Europe, and that company profit margins and earnings have significant potential to increase. I'd agree with that sentiment, so for investors looking for international diversification without the hassle of purchasing overseas stocks, this Templeton fund is worth a look.

With roughly 100 stocks in the portfolio and the top 10 holdings accounting for less than 20%, this is a highly diversified portfolio, managed according to value investing principles, with a proven track record. Over the past 3 years it has returned 24.3% p.a. compared with the benchmark MCSI index return of 23.3% p.a.

At end of March, after-tax NTA was $1.47, in line with the current share price. That means investors aren't paying a premium to access this fund. With its diverse portfolio and unhedged currency approach, TGG offers an opportunity to gain from international economies in very different sectors to Australia and a potential lift if the Australian dollar weakens further.

Lifehealthcare

My second pick, **Lifehealthcare** (ASX:LHC), distributes medical supplies and high-end equipment to hospitals and surgeons specialising in orthopaedics, cardiology, neurology and the spine. The company has beaten its IPO forecasts and upgraded its profit forecasts for 2015.

The key metrics to watch are the number of surgeons using Lifehealthcare's equipment and the amount each is spending. On both measures the company is performing far better than I had anticipated at the time of the float in December 2013. Having added another three surgeons in the latest half, the company now has nearly 100 'active' surgeons using their product, a figure that has grown at around 10% per annum for the past few years. As for the spend per surgeon, it's increased 56% over the same time frame. The company clearly has a skilled salesforce, an important consideration given it is purely a distributor at this stage.

My forecast is for the company to earn $8.5m NPAT (20c per share) on almost $100m revenue in 2015. With a return on equity of nearly 20% it should continue to grow at a double-digit rate for at least the next few years, particularly as new surgeons come on board. If the company can grow earnings at 10% per annum for the next few years and deliver a dividend

> ***It should continue to grow at a double-digit rate for at least the next few years.***

yield of over 4% then investors should achieve an attractive return on investment.

The short-term risks mostly lie around growth stalling if the company fails to attract more doctors. More likely, and more difficult to manage, are the currency risks associated with further falls in the Australian dollar. All the equipment and supplies are imported on a fixed price schedule. An increase in cost of goods sold could impact profit margins, at least in the short term.

A larger, long-term risk is that distributors are somewhat at the mercy of suppliers and their supply agreements. **OrotonGroup** (ASX:ORL), for example, suffered tremendously when it lost the exclusive distribution agreement for Ralph Lauren after 23 years of building the business. As Lifehealthcare is seeking to expand into other specialities, management is presumably acutely aware of the issue and are addressing it through diversification.

Given the company's growth prospects and a reasonable multiple of 15 time earnings (plus a dividend yield of 4.5%), Lifehealthcare should deliver a very good return for shareholders.

Lanyon Asset Management

Erik Metanomski

Erik picks not one but two stocks that look like the epitome of a bad business. But with new management and turnarounds already underway, two attractive stories are emerging.

> *This is a turnaround that's gathering pace and the market has yet to catch on.*

PMP

My first pick may surprise some readers: a commercial printing, letterbox delivery, digital pre-media, and magazine distribution service in Australia and New Zealand. As I commented in 2013's version of this report, '**PMP** has been a horrible business for a long time.'

Profile

BACKGROUND

Erik Metanomski is chairman and portfolio manager at Lanyon Asset Management. He previously managed the Value Growth Trust for MMC Contrarian.

PERFORMANCE

As at 31 May 2015, the Lanyon Australian Value Fund had returned 15.4% a year since inception in July 2010, net of all fees, compared to 10.8% a year for the All Ordinaries Accumulation Index. Over this period average cash levels within the fund have been about 50%.

MORE INFORMATION

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Back then, my reasons for selecting the stock were that new management was successfully cutting costs, reducing very high capital expenditure and paying back debt. PMP might never be a great business but back then it was priced as a permanently terrible one, at a time when management was well on the way to improving it. Since then, the share price has more than doubled. I believe it could double again.

PMP has been re-engineered by new management and is now a far better business than it was two years ago. This is a turnaround that's gathering pace and the market has yet to catch on.

Let's start with the financials. By selling property and leasing it back, reducing capital expenditure (down from $30m in 2012 to just $5m in 2014) and the sale of excess printing presses, debt has fallen from $147m on 30 Jun 2012 to $44m on 31 Dec 2014. The company aims to be debt free by June 2016. With no requirement to purchase any expensive equipment for many years, PMP should generate free cash flow of $35m–40m per year in coming years, a position not yet appreciated by the market.

The company has also successfully repositioned itself. An overcapacity in the Australian printing market together with reduced demand for printed material meant this *was* a horrible business. The aggressive price competition was unsustainable and, with some companies leaving the market, margins are improving. In addition, PMP isn't renewing negative margin contracts and print prices have stabilised. The company has exited its directories business, leaving pre-digital, catalogues – which account for about 80% of PMP's EBITDA – and magazine and book printing and distribution.

Moreover, new management has taken the company's focus away from general print and towards printed catalogues for the big retailers, a market where volumes have been stable for years. In fact, the catalogues business is growing with GDP and is less competitive. Combined with digital marketing and its distribution business, PMP now has a very attractive offer for retailers, some of whom are switching from competitors like **Salmat** (ASX:SLM).

As for valuation, with a $139m market capitalisation and free cash flow of $35m–40m the quality of this business is far better than its current price suggests.

BSA Limited

My second pick is equally unloved and disregarded. Whereas PMP is valued as a poorly performing printer, **BSA Limited** (ASX:BSA) is viewed as a poorly performing construction business. Again, things aren't quite as they appear. With inept management, poor tendering and undisciplined accounting controls, there's no doubt BSA was once the proverbial train wreck. But even then, underneath the mess and chaos were some pretty good businesses. Now they're coming to the fore.

The first – Technical Design and Construction Projects – accounts for about half of group revenue. This division installs heating, ventilation and air conditioning systems in commercial, industrial and large residential developments. This business was a source of provisions and writedowns last year but with these legacy contracts rolling off and improved management, margins should increase over coming years.

The company's second division – Technical Maintenance Services – generates annuity-style revenues that are currently undervalued by investors. After installing, say, air conditioning equipment in a hospital, this division frequently wins the maintenance and servicing contract. Revenues from such contracts formerly constituted about 30% of group revenue. That figure has now reached 50% and management is aiming for more, capitalising on the trend to outsourcing and extending the life of an asset rather than replacing it. These are growing, dependable revenues that should be valued at a far higher multiple than a low margin construction business.

"These are growing, dependable revenues that should be valued at a far higher multiple than a low margin construction business.

The company's third business, Technical Field Force Solutions, provides communication, installation and maintenance services to the telecommunications and broadcast media industries. Again, these are annuity-style, long-term contract revenues from long-standing clients like Optus and Foxtel. Management has improved the efficiency of delivering its services in this area and is winning additional business.

The big upside rests in the growing volume of NBN and Telstra-related work up for grabs over the next decade. BSA is one of the few specialists in this area and one of its prime competitors, **CIMIC Group** (AKA Leighton Holdings) (ASX:CIM), appears to be struggling. I expect BSA to capture at least its fair share of this work, which should have a positive impact on the company's overall financial performance.

Of course, none of the potential in this company will be captured without sensible, capable management. New CEO Nick Yates, who used to run one of **Transfield**'s (ASX:TSE) most profitable businesses, joined BSA in March last year, bringing with him a new CFO. Both have had experience in turning around similar businesses and their recent track record suggests they can achieve with BSA what they have elsewhere.

With 2016 forecast revenue of $500m, forecast EBITDA of $20m and a current market capitalisation of $72m, BSA trades on a forecast PER of 7 with net cash of $5m on the balance sheet. Eventually, the market will catch on and rerate this business at a price it deserves.

Disclosure: Lanyon Asset Management owns 15% of BSA.

Leyland Private Asset Management

Charles Leyland

Charles nominates two local stocks with dominant market positions and great growth prospects. Best of all, they're both cheap.

There's a big opportunity for Challenger in the growth of this asset class.

The attractive economics of businesses servicing Australia's rapidly ageing population has made stocks like **Primary Healthcare** (ASX:PRY), **Healthscope** (ASX:HSO) and **Invocare** (ASX:IVC) anything but cheap. But what if it were possible to gain exposure to this lucrative sector without paying a premium for it?

Profile

BACKGROUND

Founded in 2003, Leyland Private Asset Management is an independent value investing firm specialising in managing and administering Australian share market and fixed income portfolios through a discretionary portfolio service.

PERFORMANCE

In the 10 years from 2004–2014 Leyland Private Asset Management returned an average aggregate gain (after fees) of 13.1% per annum vs. the ASX200 accumulation index of 9.8% per annum.

MORE INFORMATION

Website: leyland.com.au
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Challenger Limited

Enter our first pick, **Challenger Limited** (ASX:CGF). Challenger is an investment management company operating two core divisions, Annuities Life, which accounts for 91% of revenue, and Funds Management, which delivers the balance.

Challenger is the Australian market leader in providing retirees with annuity income streams. If you're not sure what that is, consider it a financial product akin to a pension. Companies selling annuities take in a lump sum and, in return, deliver a steady cash flow during retirement (naturally, they invest it and charge a fee in the process).

If you're worried about outliving your savings and want a predictable income in retirement, annuity products can help. In the US they're a huge business but in Australia account for just 2% of total superannuation savings. From an investment perspective this is an important point: annuity-style products are likely to become more popular, which may well attract competition from other providers.

But Challenger believes that the potential for growth is so substantial that it will more than offset any loss of market share. Indeed, the company believes increased competition will actually increase market awareness of the availability and value of annuity products, which is currently quite low.

At the 1H15 results presentation, CEO Brian Benari put the potential for growth in context when he said: 'Retail annuity sales have continued to grow strongly yet we're only four years into the 20-year retirement phase of Australia's four million plus Baby Boomers. As the wealthiest generation in history, the Boomers have a lot to lose, so place a very high value on capital preservation, as reflected in the size of our average annuity sale, which has grown from $80,000 to $200,000 over the last decade.' The recent update highlighted the resilience of sales growth (and Benari's point), especially during periods of low interest rates. There's a big opportunity for Challenger in the growth of this asset class.

What about valuation? At a current PER of 11 (versus Bloomberg's 21 for the ASX200) Leyland's view is that Challenger is appealing, especially when compared with other companies exposed to an ageing population. Consider also that in the past five years the interim dividend has almost doubled and dividends are now franked to 70%. Based on current expectations, the board expects the final 2015 dividend to be 100% franked.

Challenger is not a healthcare provider so its earnings aren't as defensive as stocks like Invocare and Primary Healthcare. But for investors seeking exposure to our ageing population it's an attractive alternative.

Smartgroup Corporation

Our second pick is **Smartgroup Corporation** (ASX:SIQ), which listed in July last year and is a leading player in the outsourced Australian salary packaging and fleet management services market.

"Whilst the political risk remains, it is more than compensated for in Smartgroup's share price.

Salary packaging is an Australian Tax Office-approved process that enables users, usually public service employees, to buy a range of everyday items using a portion of their salary that hasn't yet been taxed, thereby lowering their taxable income. Smargroup's service offers salary packaging, administration, salary packaging software and employee benefit cards, which accounts for about 90% of total revenues (the remainder comes from fleet management).

With an EBITA margin of 33.9%, this is a very profitable business. The company's biggest client is the Australian Defence Force. There are an estimated 550,000 employees using salary packaging and about 120,000 of them use Smartgroup. Along with **McMillan Shakespeare** (ASX:MMS), Smartgroup dominates this market.

Part of the reason for the company's strong position is its emphasis on staff engagement and customer experience. The company was accredited as a Best Employer by Aon Hewitt in 2013 and 2014 and was ranked by BRW Magazine as one of Australia's 50 most innovative companies in 2013.

Much of this success is due to an innovative program introduced in August 2012. ZEST, an acronym for Zeal, Engagement, Satisfaction and Trust, is a program that the company believes will 'sort the wheat from the chaff' and lead to a higher level of workforce commitment and customer experience.

What of the risks? Smartgroup has lost only two clients of greater than 1,000 packages in the past 15 years. Whilst this track record does not remove the risk of losing major customers in the future, it does minimise it. But there remains the threat of increased competition in the salary packaging and novated leasing industry, loss of key personnel and suppliers, and potential failures and breaches of information technology systems. From meetings with Smartgroup's CEO, we feel the company has these issues well in hand but, again, some are beyond its control.

The biggest risk is political. A plank in Kevin Rudd's 2013 Federal Election campaign was to abolish the tax benefits associated with salary packaging and novated leasing. This saw Smartgroup's main competitor McMillan Shakespeare's shares plummet from $15 to $9 in one day's trading. Had Smartgroup been listed at the time its share price would likely have suffered a similar fate.

The fortunes of McMillan and Smartgroup were quickly restored with the election of the current Government, which appears disinclined to make any major changes to the current system. Still, purchasing either of these companies now assumes that as the number of people benefiting from this loophole increases the political will to change the rules will diminish. Whilst the political risk remains, it is more than compensated for in Smartgroup's share price.

Trading on an undemanding 2015 PER of 10.1x with an attractive dividend yield expected to be 7.7% in 2015 (fully franked), Smartgroup is all but debt-free and sports a forecast return on equity of 26.5% and return on assets of 17.4%. With significant growth prospects through winning new business and further acquisitions on the agenda, this is an attractively priced stock.

Disclosure: Leyland Asset Management is a shareholder in Australasian Wealth Investments (ASX:AWI), owners of Intelligent Investor Share Advisor.

Maple-Brown Abbott

Andrew Maple-Brown

The rush to yield has left local infrastructure looking very expensive. Andrew Maple-Brown discusses two alternatives, with lots of profitable growth ahead of them.

> *The outlook for growth in infrastructure investments is as strong as we have ever seen it.*

Intelligent Investor Share Advisor members have had some profitable experiences with listed infrastructure plays over the past few years, including **Spark Infrastructure**. (ASX:SKI) My two picks come from the same sector and feature similar characteristics to stocks like Spark, but with a twist.

Profile

BACKGROUND

Andrew Maple-Brown is Head of Global Listed Infrastructure at Maple-Brown Abbott. Together with Lachlan Pike, Steven Kempler and Justin Lannen, Andrew manages the Maple-Brown Abbott Global Listed Infrastructure Fund.

PERFORMANCE

As at 30 April 2015, the Maple-Brown Abbott Global Listed Infrastructure Fund had returned 28.8% per annum since inception on 18 December 2012.

MORE INFORMATION

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Global listed infrastructure has performed well over the past 12 months, broadly in line with global equities, albeit with lower volatility. But with fundamentals for the sector still strong, good opportunities remain. Two US-listed stocks in particular offer similar characteristics to comparable companies in Australia, but with stronger growth and at still attractive prices.

Atmos Energy Corp

Driven by the need to update and improve essential infrastructure around the world, the outlook for growth in infrastructure investments is as strong as we have ever seen it, especially when compared to other asset classes. Hence my first pick, US-listed **Atmos Energy Corp** (NYSE:ATO), an almost fully regulated owner and operator of US natural gas pipelines.

The attractions of a regulated business like this depend on three factors; the returns that the regulator permits; the ability for the company to earn these returns; and the potential to make further investment in their networks, building new assets at an attractive rate of return. Atmos scores well on all three factors.

In addition to an intrastate pipeline network, about two-thirds of Atmos' business is as a Local Distribution Company (LDC), where further investment is almost guaranteed. Triggered by a series of pipeline explosions and the need to lower methane leakage from the current network, pipeline integrity has become a critical issue for US regulators. And thanks to falling gas prices, demand is increasing, especially in residential heating, leading to further investments in new connections.

With the cost of new pipe almost always far higher than its original historical cost, Atmos benefits from robust growth in the value of the company's rate base, which in turn supports future earnings. This factor in particular will result in a durable, strong investment profile for the North American LDC companies.

With operations in Texas, Louisiana, Mississippi, Kentucky and Tennessee, Atmos serves over three million customers, making it one of the largest US LDC businesses. With an average Allowed Return on Equity of 10.3% this company is well placed to deliver impressive long term returns.

Despite a rate base forecast to grow over the next few years at a rate of 9–10% per annum, one of the highest we see in any utility globally, Atmos is replacing its pipe network at less than 1% per annum. As a consequence, this high level of investment will be required for many years (or perhaps decades) to come.

On all three counts Atmos is an attractive regulated business. The regulator allows LDC companies to make a relatively high rate of return on their asset bases and Atmos in particular has great potential to grow the size of its asset base, with demand and supply factors driving further investment.

What of the share price? In recent months the company has traded at valuation multiples similar to regulated electric utilities. With a vastly superior growth profile and far lower long-term asset redundancy risk, Atmos is attractively priced in our opinion.

Crown Castle International

My second pick, **Crown Castle International** (NYSE:CCI) owns, operates and leases towers and other infrastructure for wireless communications. CCI offers significant wireless coverage to 98 of the top 100 US markets, owning and operating about 40,000 US sites.

With high margins all but unaffected by changes in economy-wide activity, these earnings are highly predictable.

Strong earnings growth for the sector comes from the significant capital expenditure required by the major mobile phone companies to expand and improve network coverage and quality, particularly in high density areas. This results in additional equipment being deployed on new and existing sites, generating additional returns for infrastructure owners.

The growing use of smartphones and the more data-intensive applications they permit is driving the exponential growth in wireless data usage. So great is the demand that governments are releasing additional spectrum to support it.

Cisco estimates that, based on 2014 levels, US mobile data consumption will grow by more than seven times by the end of the decade. Whilst this sector growth is attractive to investors, the optionality of a portfolio of towers owned and operated independently from the wireless carriers is even more so. Most of these towers can support additional tenants (wireless operators) at very little additional cost, and most of the additional revenue from adding more tenants drops to the bottom line.

CCI's current earnings are supported by long-term contracts. With high margins all but unaffected by changes in economy-wide activity, these earnings are highly predictable. But the growth will come from increasing data usage and tenancy rates.

There are three other factors that make CCI attractive. First, unlike many of its peers, it's not an aggressive acquirer of foreign assets, focusing instead on growing its footprint in the United States where it has the expertise, experience and stakeholder relationships. This is a conservative, sensible strategy likely to deliver better long-term returns.

Second, CCI's board and management collectively own more than US$200m in CCI stock. Senior management also has appropriately structured pay packages with a significant proportion allocated to long term incentives. And, unlike many US companies, the CEO and chairman roles are split and, with the exception of the current (and arguably former) CEOs, the entire board is independent.

With a track record of hitting targets and expectations, and an extended history of accretive and well structured bolt-on acquisitions, this is a top rate management team genuinely aligned with the interests of shareholders.

Finally, CCI sports an attractive price. Whilst currently trading on a more expensive EV/EBITDA than many of our other investment opportunities, CCI has more tangible earnings growth. And its US REIT structure means those future earnings are tax free. The company also offers a very defensible 4% dividend yield, which could increase at a rate of 6–7% or more per annum. If that sounds implausible, consider the fact that two years ago CCI didn't even pay a dividend.

Perpetual Global Share Fund

Garry Laurence

Garry issues a warning on the Australian banking sector and offers a handful of financial stock picks that are, in his view, cheaper and less risky.

> *Australian banks are late to the party in raising their capital levels, with global banks having taken their medicine years ago.*

While global banks seem to be very cheap and attractive opportunities, Australian banks are quite the opposite. The Australian market has finally realised that Australian banks are undercapitalised relative to global banks and that the risks to earnings is to the downside, when bad debts are at all-time lows, and certain metropolitan property markets seem to be entering bubble territory.

Profile

BACKGROUND
Garry joined Perpetual in March 2008 as an Analyst and now holds the title of Global Equities Portfolio Manager. He has been managing the Global Share Fund since its inception in January 2011, prior to which he was co-portfolio manager of an Asian fund. Garry has a Bachelor of Commerce and a Bachelor of Laws from the University of New South Wales.
PERFORMANCE
The Perpetual Global Share Fund (Class W) has returned 29.6% per annum, net of fees, compared with the MSCI World Net Total Return ($A) of 24.2% pa.
MORE INFORMATION
Website: perpetual.com.au Phone:1800 022 033

I start to worry when I read about 300sqm knockdowns in Sydney selling for $2.7m, $1m over the reserve. Investors in Australian banks should worry, too. Sydney house prices are now over 50% above the pre-crisis level and since 1984 the size of a mortgage has increased two times greater than income.

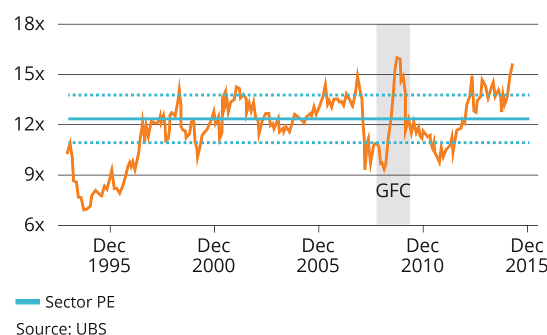
When interest rates eventually rise, this will be a problem for Australian banks as bad debts will probably start rising, hitting their earnings. However, due to elevated levels of household debt in the system, credit growth has slowed to mid-single digit levels now. Bad debts over loans for **Commonwealth Bank** (ASX:CBA) are at 16 basis points and will now drift higher (30 basis points is probably closer to a more normalised level). These two impacts mean that earnings growth will be much slower over the next 10 years.

BBVA and Lloyds Bank

Furthermore, Australian banks are holding much lower capital levels than global banks. We own banks like **BBVA** in Spain (BME:BBVA) and **Lloyds Bank** in the UK (LON:LLOY). Lloyds has a core tier 1 ratio (equity over risk weighted assets) of 13.4%, and BBVA is at 12.7%.

This compares to **National Australia Bank** (ASX:NAB) at 8.8% (prior to its capital raising). NAB has just finished undertaking a $5.5bn rights issue – the largest in Australian corporate history – to get its capital levels on a par with global banks. This raising will dilute earnings and reflects the fact that Australian banks are late to the party in raising their capital levels, with global banks having taken their medicine years ago.

Chart 1: Australian Banking Sector PER



Australian banks are also expensive. Chart 1 shows the PER of the Australian banking sector over the past 20 years. The average has been about 12.5x.

> ***We feel much more comfortable investing in more attractively valued financials globally than local banks.***

Commonwealth Bank however is currently trading on a PE of 15x. This compares to Lloyds Bank (the largest retail bank in the UK) on 11x and Wells Fargo (one of the largest and best run retail banks in the United states) on 14x.

We feel much more comfortable investing in more attractively valued financials globally than local banks. About 25% of our fund is allocated to financials, but with very different dynamics to Australian banks.

Banks sell commodity-like products, and therefore you want to own the lowest cost manufacturer that is being run well. Banks we own that fit this criteria include **Wells Fargo** (NYSE:WFC), **Lloyds Bank** (LSE:LLOY), **BBVA** (BME:BBVA) (in Spain), **Julius Baer** (SWX:BAER) (a private bank in Switzerland) and **Bank of America** (NYSE:BAC).

Wells Fargo is the poster child of American banking; the Commonwealth Bank of America. It has 12% market share of loans and 12% share of deposits, being the leader alongside Bank of America. Despite its size, Wells continues to grow its loan book consistently and prudently (loans up 7% in the last quarter) with a healthy balance sheet with core tier 1 above 10%. Its bad debts/loans is at normalised levels, of around 30 basis points. But what makes Wells Fargo unique is its high levels of customer satisfaction and ability to cross sell products to its customer base.

Net interest margin is another driver of a bank's revenue, alongside loan growth. When rates start rising Wells' net interest margin will start rising with it, driving earnings growth. Despite all these positive drivers of earnings, over the next few years, Wells Fargo still only trades on a PER of 14 and a Price/book of 1.5.

As for Lloyds Bank, it's the largest retail bank in the United Kingdom with over 20% market share of loans and deposits. The UK is in a very similar situation to Australia with household debt levels being high, relative to the rest of the world. However, at least the UK equity market is realistic in pricing in the growth prospects for the bank.

Lloyds is trading on a low PER of 11 and price to book of 1.2 despite a very strong balance sheet and underlying profit growing by 20% year-on-year in the past quarter. Its core tier 1 ratio stands at 13.4% and we expect the bank to start to return more capital to shareholders over the coming years.

Peters MacGregor

Michael Haddad

Michael seeks out esoteric opportunities, including a New Zealand jewellery chain with global ambitions and a mispriced sub-prime auto lender based in Florida.

With our homes, jobs and well-being correlated with the Australian economy, the concept of 'risk mitigation' through investing abroad is in vogue.

With global interest rates near zero, risk premiums have compressed. The result has been soaring real estate prices and a chase for yield in equities, regardless of quality. Money has been, in a word, easy.

Profile

BACKGROUND
Established in 1999, Peters MacGregor manages concentrated portfolios of undervalued, quality equities on behalf of clients. Clients may access its services via a retail unit trust, an individually managed account service or a separately managed account offer.
PERFORMANCE
The Peters MacGregor Global Fund has returned 15.6% per annum over the past five years (versus 13.3% for the MSCI benchmark) and 8.5% since inception in September 2004, compared with 6.9% for the benchmark index.
MORE INFORMATION
Website: petersmacgregor.com Phone: 02 9332 2133

The next decade is likely to be very different. Avoiding the most overvalued and precarious business models will be paramount. Keen stockpicking will help drive respectable absolute returns. With the 25% decline in the local currency against the USD over the past few years, smart investors are increasingly reaching for foreign asset exposures. With our homes, jobs and well-being correlated with the Australian economy, the concept of 'risk mitigation' through investing abroad is in vogue.

Michael Hill International

That's as it should be, although perhaps for the wrong reasons. Contrarians and cynics may argue that the fall in the local currency means that, once again, the easy money has been made. But the larger point is that proper global diversification makes sense in its own right, to say nothing of the fact that against major currencies other than the USD, the AUD has barely moved. There remain many attractive opportunities abroad, which brings me to my first pick, **Michael Hill International** (NZE:MHI).

New Zealand-listed Michael Hill is the largest jewellery retailer in New Zealand, a major player in the Australian market, and which over the past decade has built a substantial Canadian business that has now reached an inflection point in its profitability. With truly global aspirations embedded in the company's DNA and a fledgling US operation, this is a growing, internationally-diversified business available at about 13 times earnings.

Listed since 1987, Michael Hill now has 280 stores and is one of the best performers on the NZX. Its consistent profitability over the years is a testament to its internal controls and brand power. But perhaps the best thing about it is how the market appears to be mispricing the value of future growth. In fact, it may be ignoring it altogether.

Current profitability reflects small losses on its fledgling US operation and sub-normal margins from its Canadian division. Now that critical mass has been achieved, head office costs and marketing spend are leveraged across a larger store base and the company has a stronger bargaining position with landlords. That's why the company is enjoying increasing margins as well as continued store expansion and same-store-sales growth.

This is a wonderful flywheel that will likely deliver respectable group-wide profit growth in the years ahead. An interesting quirk for Australian investors is that whilst Michael Hill is listed in New Zealand its substantial Australian earnings mean it is able to pay franked dividends – currently a yield of 5.6%.

Nicholas Financial

To a very different kind of business, one where the mispricing has a structural rather than psychological explanation: **Nicholas Financial** (NASDAQ:NICK) is a well-run subprime auto 'micro-cap' based in Florida. The company has a loan book approaching $300m and, until recently, an equity base of $155m supporting it.

Debt funding is provided by a syndicate of major banks at a cost of 4.5% while loans are made at around 24%. The spread seems high but NICK deals with a segment of the consumer market where losses can be high so it's necessary and appropriate. The company has a 25-year history of profitable growth and a plain vanilla business model, if there is such a thing in the finance industry.

NICK writes all its own business and keeps what it writes, which means securitisation, the process by which loans are bundled up and sold in a game of pass-the-parcel that contributed to the global financial crisis, is off the table.

The company also has a proprietary credit scoring system, developed over many years through its network of 60 branches. Whilst every financial business makes grandiose claims about its risk management and watertight internal assessment, NICK has never recorded an annual loss (including through the Global Financial Crisis). Further, while loss provisions were substantially increased during the downturn, management was shown to be conservative. Much of the additional provisioning had to be reversed in subsequent periods.

"Whilst every financial business makes grandiose claims about its risk management and watertight internal assessment, NICK has never recorded an annual loss (including through the Global Financial Crisis).

Towards the end of 2013 an agreement was reached whereby NICK would be acquired by another (larger) listed company at a price of $16 per share, a 45% premium to its then book value. The deal eventually fell over, but not before a number of merger arbitrage funds had acquired significant shareholdings. When the deal failed these specialised funds no longer had a mandate to hold the stock and dumped it indiscriminately. NICK's share price fell 30% to a low of $11 per share.

The company capitalised on this overhang and by early 2015 had repurchased 38% of its outstanding stock via a tender offer at $14.85 per share. Unappreciated and neglected, the stock is today back to around $13 per share, trading on an estimated multiple of just seven times earnings and a slight premium to book value. The market appears to be overlooking the very substantial earnings accretion NICK has enjoyed in repurchasing 38% of itself.

While having a market value of just $100m, NICK highlights the sort of esoteric opportunities we're able to uncover for investors. Despite a highly challenging and precarious environment, there remain plenty of exciting opportunities for diligent stock pickers.

Platinum Asset Management

Clay Smolinski

Clay introduces one of the biggest insurers in one of the world's largest and fastest growing markets, with a valuation comparable to local insurers that aren't growing at all.

The People's Insurance Company of China

Imagine a country with almost 1.4 billion people, one where only seven in a hundred own a vehicle and one in five are uninsured. Now compare that with Australia, where vehicle ownership is 10 times higher and insurance is compulsory, or Japan, where 60% of the population own a vehicle. Consider also that in this under-insured country with low rates of car ownership, the auto insurance premium base is increasing at about 20% a year and vehicle ownership is growing at 15% a year.

"The regulator is deregulating the industry for a select few insurers and keeping a tight lid on the rest.

Profile

BACKGROUND

Clay joined Platinum in January 2006 having worked as an accountant for Grant Thornton. In May 2009, he became portfolio manager of the Platinum European Fund. He is also the sector leader for financials and services and in June 2014 became portfolio manager of the Platinum Unhedged Fund. Clay also remains co-manager of the Platinum European Fund.

PERFORMANCE

Since inception in June 1998 to 30 April 2015, the Platinum European Fund has returned 12.2% pa, net of fees and costs, compared with the benchmark MSCI Europe Net Index (in A$) return of 2.7% pa. Since inception in January 2005 to 30 April 2015, the Platinum Unhedged Fund has returned 12.1% pa, net of fees and costs, compared with the MSCI World Net Index (in A$) return of 6.6% pa.

MORE INFORMATION

Website: platinum.com.au
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These are mouthwatering figures, diminished only by the fact that they concern China. But what if I said this strengthened the investment case, that investing in a large auto insurer in China right now might be preferable to, say, an investment in **IAG (ASX:IAG)**?

To explain why, a bit of history; Between 2005 and 2009 the Chinese insurance market – one where foreign companies are banned – became intensely competitive. Price discounting was rife, premiums collapsed and regulations were flaunted. The result was an unprofitable, chaotic industry unable to meet the needs of its customers.

The regulator stepped in, enforcing rules, standardising discounting and clearing the industry of weaker players. Emerging from the chaos were three companies, two of whom were state-owned enterprises, that came to dominate the market. Determining that insurance was a social good, the regulator had chosen market stability over irrational price competition, to the great benefit of the big insurers that had survived the period.

The People's Insurance Company of China (2328.HK) is one of China's three largest insurers, generating 70% of its business from auto insurance. It's also well placed to expand into other lines like home and contents insurance, which account for just 5% of premiums in China compared with 25% in the West. Best of all PICC is cheap, for reasons we'll shortly examine.

The chaos of 2009 didn't just upend the entire industry, it prompted a top-down reassessment of PICC's business. New management was installed, including a chairman that is a 20-year insurance industry veteran that emphasises profitability over market share. PICC also upgraded its IT systems. The company can now centrally underwrite and price policies while management has ready access to product line profitability.

PICC can also sell more policies directly to consumers. In 2009, just 15% of all policies were sold

The regulator is prescribing a system that ensures the powerful and profitable remain that way.

direct; now that figure is 40%. Cutting insurance agents out of the picture has increased profitability and improved cross-selling opportunities. None of these factors eliminate the cyclicality of the industry but they do make PICC a stronger, more profitable business capable of capitalising on the opportunities before it.

The financial impact was rapid. In 2009, PICC suffered a combined ratio (the sum of incurred losses and expenses divided by earned premiums, a key industry ratio) of 103%. Within two years that figure had improved to 94%.

So why is it cheap? Well, here's the twist. Having saved the industry in 2009, the regulator is now letting the market set prices – deregulation, in effect – trialling a new scheme in six provinces where insurers can determine policy terms and rates. This has investors spooked, worried that the bad old days will return.

But things are not quite as they seem. Only those companies that meet strict solvency criteria, which have a combined ratio of less than 100% over the past two years, can control their policy terms and pricing. The remainder have to price as per the regulator's stipulation; at the industry average loss ratio plus a 35% expense loading. The result is that just six companies, including PICC, will be allowed to set their own prices and policy terms. In effect, the regulator is deregulating the industry for a select few insurers and keeping a tight lid on the rest.

This delivers a number of advantages to bigger companies like PICC. In 2009, the regulator established a national insurance claims database which logs every insurance claim, mapped to car licence plate and driver's licence. Previously, poor risks were miscategorised and priced too low. Now insurers can view an individual's claims history and price risk accordingly.

All this is ominous for the smaller insurers. PICC can cherry pick the best drivers and boost its profitability, leaving the small fry to compete for high-risk drivers. In so doing, these businesses will almost certainly face lower levels of profitability, removing the prospect of them ever emerging from the regulated sector to compete with the likes of PICC.

The central database also gives the regulator a tool to police the market, restricting a desperate insurers' ability to discount a policy for the short-term cash sugar hit at the expense of long-term profitability. Used sensibly by the regulator, the system ensures that a deregulated market need not lead to irrational price competition.

In effect, the regulator is prescribing a system that ensures the powerful and profitable remain that way. This is a version of deregulation that works to ensure market stability, via large insurers' profitability, at the expense of excessive price competition and instability.

Unfortunately, the market is beginning to catch on. In mid-2014 PICC was priced on a PER of eight times last year's earnings. That figure is now about 13. But compared with, say, Insurance Australia Group, which trades on a PER of 11, PICC, with a good record of corporate governance and dividend history, features a return on equity of 20% and should grow at 15% a year for many years to come. Despite the recent price increase, this remains a great growth business trading at a cheap price.

Editor's Note: Clay's second pick was Applus, a Spanish oil and gas services company covered by our Premium service. Members wishing to learn more about the company can read our latest review in the recent special report, Bargains in the Oil Patch, in the Appendix.

Wilson Asset Management

Geoff Wilson

Geoff picks two local stocks, one expanding into Asia and the other performing well since its recent IPO.

> *After visiting Blackmores' Asian office earlier this year, we're confident the company's management team has the skills to capitalise on this growing market.*

Blackmores Limited

Our first pick, **Blackmores Limited** (ASX:BICL), is one of Australia's largest vitamins and supplement producers. Having operated in Australia for 80 years it will be well known to many investors. What makes it interesting is how successfully it has expanded into Asia, and the future growth this is likely to deliver.

Profile

BACKGROUND

Geoff Wilson is founder and chairman of Wilson Asset Management. Wilson Asset Management manages more than $1 billion across one unlisted fund (WAM Equity Fund), three listed investment companies (WAM Capital, WAM Research, WAM Active), and the recently created Future Generation Investment Company.

PERFORMANCE

WAM Capital has returned 15.2% pa over the past five years and 18% pa since inception in 1999, before costs, compared to 8.2% and 8.7% a year respectively for the All Ords Accumulation Index.

WAM Research has returned 19.6% a year since the change in investment strategy in July 2010, before costs, compared to 10.8% a year for the All Ords Accumulation Index.

WAM Active has returned 10.4% a year over the past five years and 12.5% a year since inception in 2008, before costs, compared to 8.2% and 2.9% a year respectively for the All Ords Accumulation Index.

WAM Equity Fund has returned 17.4% a year over the past five years and 20.1% a year since inception in 1998, before costs, compared to 8.2% and 9.2% a year respectively for the All Ords Accumulation Index.

MORE INFORMATION

Website: wamfunds.com.au, futuregeninvest.com.au
Phone: 02 9247 6755

In the recent third quarter update, sales grew by 42% to a record level, with earnings before interest and tax rising 104% on the same period last year. We expect the company to post a strong full year profit of $42 million with earnings per share growth of over 60%.

Whilst the domestic market remains strong, Blackmores' push into China, Hong Kong, Korea, Malaysia, Singapore, Taiwan, Thailand and Kazakhstan, where a growing, health conscious and brand-aware middle class is emerging, will drive future growth. After visiting Blackmores' Asian office earlier this year, we're confident the company's management team has the skills to capitalise on this growing market.

Blackmores is well positioned to continue to increase sales in Australia as well as to expand throughout Asia, reduce costs through greater economies of scale and consolidate its customer base through e-commerce. Our analysis suggests Blackmores can grow its earnings over 60% this year, putting it on a PER of 30. The company's dividend yield is currently 2.1%. We forecast Blackmores PER will then fall to 25 with 25% earnings growth next financial year.

Eclipx Group

Another favourite is vehicle fleet leasing, fleet management and diversified financial services company **Eclipx Group** (ASX:ECX), which listed in April. The company's management team is highly respected and, given its track record at **Flexigroup** (ASX:FXL), should perform well in their new roles. Eclipx has three divisions; Australian Commercial; Australian Consumer; and New Zealand Commercial. Their primary revenue model is to fund, lease and manage motor vehicles on behalf of a diversified customer base.

Driven by its superior technology, IT platform and new product innovation, over the coming years Eclipx should continue to win market share, lower the cost-to-income ratio and increase margins. The regulatory risk, which adversely affected **McMillan**

The company remains on target to exceed its prospectus forecast.

Shakespeare (ASX:MMS) when the Rudd government introduced changes to fringe benefits tax (FBT) on cars (since reversed), has subsided. In particular, the recent Federal budget made no material negative changes to FBT on cars and instead offered the immediate deduction for small business expenses of up to $20,000.

Driven by strong growth in revenue and a reduction in costs, Eclipx recently delivered an interim net profit after tax (NPAT) of $23.8m. The company remains on target to exceed its prospectus forecast of $47.0m in financial year 2015. Next year, we expect further organic revenue growth, growth in receivables, slightly lower cost of funds and an improved cost-to-income ratio. We also expect to see further synergies from acquired businesses and growth in the commercial equipment financing start-up business.

Key risks include used car deterioration, financing and regulatory risk. For example, over a third of earnings before interest, tax and amortisation is derived from end of lease income after impairments. Any deterioration in residual car prices will be detrimental to Eclipx's profits.

At the time of writing, Eclipx shares were trading at $3.19 having climbed 39% from the offer price of $2.30. We participated in April's IPO and have acquired more shares since, confident that the company will continue to perform in coming years. We expect the company will grow its net profit by 37% this year, which puts it on a PER of 14. Eclipx's forecast dividend yield for the 2015 financial year is 2.4%.

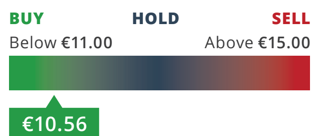
Mr Market gives Applus a C-minus

We've been searching for a safer way to profit from the fall in the oil price. We think we've found it in Spanish company Applus Services.

Applus Services (APPS:MC)

PRICE AT REVIEW	€10.56
MARKET CAP.	€1.4bn
12 MTH PRICE RANGE	€7.53–€17.51
BUSINESS RISK	Med–High
SHARE PRICE RISK	Med–High
PORTFOLIO WEIGHTING	3%
OUR VIEW	BUY

Recommendation guide



**Article initially published on 4 Feb 2015, all values quoted in Euros.*

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 43% since listing on the Madrid Stock Exchange in May last year.

Key Points

- **Applus sin-binned due to low oil price**
- **Large margin of safety**
- **BUY for up to 3% of a diversfied portfolio**

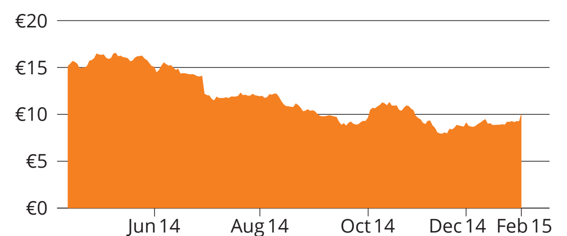
Applus hasn't suffered from the problems you'd expect for a float following seven years of ownership by private equity firm The Carlyle Group: unrealistic growth expectations; an overblown float price; and underinvestment. So often a Cinderella business described in the glossy pages of a prospectus magically turns into a pumpkin, often following write-offs due to lousy acquisitions.

These are still clear and present risks, but Mr Market is running scared because the company's largest customers are the same oil titans that are in a race to see who can cut development spending the most in response to lower oil prices, curtailing the need for Applus's testing and certification services.

Dirty deeds

Around half of Applus's revenue and profits (see Chart 2) 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. That might mean using ropes to drop men into giant storage tanks to check for corrosion or potential leaks, or checking the welds and nuts and bolts on an interstate gas pipeline.

Chart 1: Applus share price



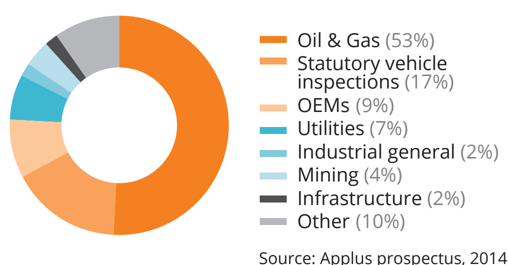
Source: S&P Capital IQ

Operating margins aren't high, at around 7–8%, as there are plenty of competitors, though few offer Applus's international scope. There's a bit of technical know-how and ingenuity involved, but Applus's major advantage is that oil titans like Shell prefer to stick with a reliable partner like Applus and often sign

long-term contracts. As the cost of Applus's services are nominal compared to the expense of a major explosion at an oil refinery, for example, it doesn't make sense to risk skimping on costs.

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 oil price.

Chart 2: Revenue by end-markets



Source: Applus prospectus, 2014

As the cost of Applus's services are nominal compared to the expense of a major explosion at an oil refinery, for example, it doesn't make sense to risk skimping on costs.

That's possible in the short term but, as we explained in recent reviews of **Origin Energy** and **Santos**, 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 two years or so. Applus's customers like BP and ExxonMobil are household names, and eventually we expect they'll 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 still expect this division to grow over time as the world demands more oil and gas.

Duster

Even if we're wrong Applus could still justify its current valuation as it has two other major businesses that provide steady profits.

The first is a highly profitable vehicle inspection division, which essentially provides certificates of roadworthiness. It's like getting a pink slip in New South Wales. Spain still accounts for a third of revenue, but over the years the company has stretched around the world. It has a monopoly in Ireland, for example, which delivers 24% of revenue.

Operating profit margins are around 26%, and while the division provides 17% of Applus's total revenue, it generates 34% of profits. That's 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 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. Unlike in Australia where virtually any mechanic can perform a check of roadworthiness on your car, many foreign regulators have little interest in liberalising their market, which could reduce prices and Applus's market share. With regulations tightening around the world as more and more vehicles hit the road, there should be incremental opportunities to grow profits.

Das Auto

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.

Applus's customers read like a who's who of the automotive world, including Audi, Ferrari and BMW. While Applus performs all manner of vehicle testing, from seating comfort to engine and exhaust noise, it also helps car manufacturers to comply with foreign automotive standards to expand in new markets. The wide range of services means it's cheaper for them to use Applus's world-class facilities than to develop and maintain their own.

It's not 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.

Risks

With so many divisions 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.

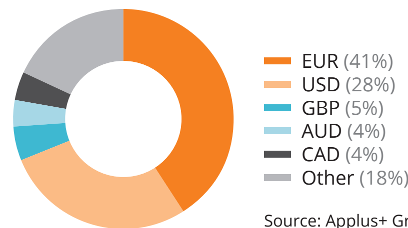
> *We usually have a three-year moratorium on buying floats at Intelligent Investor, as it allows time for any skeletons to appear, but with Applus's share price falling so far there's already a decent margin of safety.*

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.

We usually have a three-year moratorium on buying floats at Intelligent Investor, as it allows time for any skeletons to appear, but with Applus's share price falling so far there's already a decent margin of safety.

Applus has diversified into the US and its currency exposure is broad (see Chart 3). Although currency fluctuations should wash out over time, they could hamper our returns in the short to medium term.

Chart 3: % Revenue by actual currency



Source: Applus+ Group Results Presentation, First Half 2014

Lastly, management gets paid well, but the potential value it could bank from options is egregious. It doesn't ruin our investment case, but it's definitely a black mark against the board and management.

Margin of safety

There's 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, we'd get a price-earnings ratio for the stock of around 20. That seems fair for a company with multiple recurring revenue streams.

If we assume that revenues recover in a few years' time and the rest of the business enjoys a little bit of growth, perhaps as the Spanish economy recovers, then we could be buying the company on less than 10 times earnings compared to multiples of 20 or more for its rivals, such as US-listed company **Mistras**.

Donning our bullhorns, if Applus uses the current malaise to increase its market share by acquiring smaller or niche players at attractive prices the stock could double or more. Alternatively, Applus may be an attractive takeover target itself.

In the current environment 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 too low.

We still want a large margin of safety, as things are likely to get worse before they get better, and unfortunately the stock price surged 9% last night. Still, we're initiating coverage with **BUY** up to €11 for up to 3% of a well-diversified portfolio. We'd likely only consider a higher portfolio limit once our investment case started working out.

*We're starting with a 2% position in the **Premium Portfolio**, leaving room to add to the position if the share price falls significantly. To do so, we're converting US$1,498.15 into €1,316.90 and purchasing 130 shares of Applus at €10.13 each.*