Surviving Zero Interest Rates

A six-stock mini income portfolio

About Us

With a 20-year track record of beating the market, clear and straightforward language, and an 'open book' approach to stock research and analysis, *Intelligent Investor* offers actionable, reliable recommendations on ASX-listed stocks.

In 2014, *Intelligent Investor* became a part of the InvestSMART family, extending our expertise to even more Australian investors seeking quality analysis and advice.

About the author

John Addis founded *Intelligent Investor* in 1998. Having returned as the editor of *Intelligent Investor* after selling the business in 2004, John now gets to indulge his favourite interests: the shape and form of words; investing psychology; the odd, fascinating and frustrating world of macroeconomics; and great stock opportunities.

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From the author

For a few years now, income investors have been faced with a vexing dilemma; put your money in a term deposit on zero real interest rates or pay up for a better yield and higher risk in stocks. Given the market's rise over the past few years and the absence of real economic growth, many have understandably chosen the latter option.

That dilemma has only sharpened over the past year. As rates have fallen - traditionally a sign of trouble ahead - the prices of real assets have risen. Last year, the ASX All Ordinaries rose by 19%. As a result, not only is our **Buy List** back into single digits but the stocks that do make an appearance are far from the fare of traditional income investors.

Nor is cash much of an option. Over the long term it's a terrible investment. And the effects of record low levels of inflation can still substantially diminish real spending power over time. 'Going to cash' also effectively means trying to time the market, potentially missing the kind of unexpected rise we enjoyed last year.

Building cash reserves as prices rise and the risks of owning shares increase makes sense. But over the long term holding too much cash hurts performance. As for gold, **it's a bad investment even in troubled times**.

There is, however, an alternative approach that we think makes sense. For each recommendation, we set a Buy, Hold and Sell price. These are a guide rather than a precise calculation; an indication of where - all things being equal - we're likely to change a recommendation on a stock.

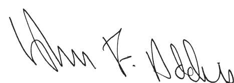
Our Sell price is set around what we estimate is a stock's fair value. In an environment with record low rates it can make sense to buy some stocks with a Hold recommendation.

There may not be as much margin of safety as a Buy but a mildly underpriced stock with a Hold recommendation is more easily justified than either an expensive, high yield stock or a low yield term deposit. Between a Hold and a Buy recommendation exists a grey area more visible in times of low returns.

Investors prepared to pay a reasonable price for a reasonable income, with some growth potential, need not grab a wad of cash and head to the vegetable patch, or the bond or property markets.

That's the background to this six-stock mini-portfolio; a collection of stocks, some of which might not be considered conventional but should do the job just as well, if not better, and without the premium conventional income stocks now command.

COMPANY	PRICE AT 30/1/20	LATEST RECOMMENDATION	MAX. PORT. WEIGHT	SELL ABOVE	FREE CASHFLOW YIELD	FORECAST FY20 DIV. YIELD
360 Capital (TGP)	$1.065	**26 Aug 19** (Buy – $1.11)	5%	$2	N/A	3.8%
Chorus (CNU)	$6.36	**20 Nov 19** (Hold – $5.28)	6%	$9	N/A	3.7%
Link Administration (LNK)	$6.21	**21 Jan 20** (Hold – $6.24)	5%	$9	3.5%	2.7%
Reece (REH)	$11.33	**30 Aug 19** (Hold – $10.00)	5%	$14	2.5%	1.8%
Tabcorp (TAH)	$4.66	**7 Nov 19** (Buy – $4.73)	6%	$7.5	4.6%	4.7%
Woodside (WPL)	$34.64	**21 Nov 19** (Buy – $34.13)	6%	$45	8.7%	4.1%

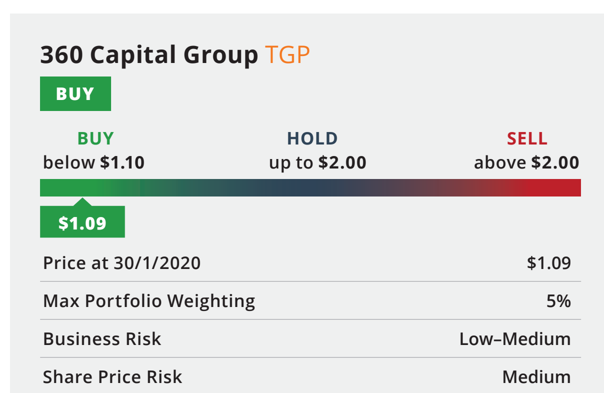


John Addis

Founder and editor of *Intelligent Investor*

360 Capital an AREIT in hiding

This stock is run by a canny operator with a great track record and his own money on the line.



Key Points

- **Shareholder with skin in the game**
- **Large potential in funds management**
- **Current price could prove cheap**

Whichever way you view 360 Capital, income investors might kindly describe it as unconventional. There's a reason for that. Unconventional times have destroyed the attractiveness of conventional income stocks, which now charge a high price for supposed certainty.

360 Capital takes us in a contrary direction, towards a bet on an entrepreneur with an exceptional track record and a counter-cyclical, risk averse mindset. This is about as far from a conventional income stock one can get. For us, that is part of the attraction.

It does require of potential investors, however, an open mind unreliant on the appearance of a regular dividend cheque and a time horizon measured closer to a decade than a few years. If you can't manage these things, this might be one to skip.

360 Capital began life as small AREIT called Trafalgar. Back in 2009, it owned a portfolio of B-Grade office properties and was trading at a large discount to its net tangible assets (NTA).

Tony Pitt, through 360 Capital Management, bought a major shareholding in March 2009, planning to sell the assets one by one to eliminate the discount. A $100,000 stake purchased at the time of Pitt's purchase would now be worth well over $1m, assuming the reinvestment of dividends.

Now, Pitt is at it again. Having sold 360 Capital's last major property to NextDC, 360 Capital is flush with cash and a new, inverted strategy to that employed at Trafalgar.

When emerging from downturns like the global financial crisis, owning equity maximises returns as asset prices recover. At the opposite end of the business cycle, debt can be more profitable and lower risk. Pitt now wants to supply debt, along with cosy covenants, rather than equity. For income investors this should offer some solace.

You don't need to sacrifice returns too much, either. Property development returns have increased due to the withdrawal of Australian banks, which have been forced to ration credit to satisfy regulators as they prepare for lower housing prices and higher bad debts.

Providing debt for a year or two on a small property development typically earns a 10–11% annual return – not bad when interest rates are below 2%, if you get your money back. Anecdotally, those returns have recently been more like 15%.

A typical development for 360 Capital might be a $30m suburban doctor's office. In a worst-case scenario where the developer goes under, leaving the project unfinished, Pitt could take control and complete it. More capital might be required, either directly from 360 Capital's balance sheet or by finding a new developer and/or investor, but that shouldn't be a problem.

How big is small-size property development financing? The market share of commercial real estate debt held by banks is about 80%. According to Goldman Sach research, this figure is expected to fall to about 60% over the next few years. The result is a $30bn lending gap, of which Pitt wants to take a decent slice.

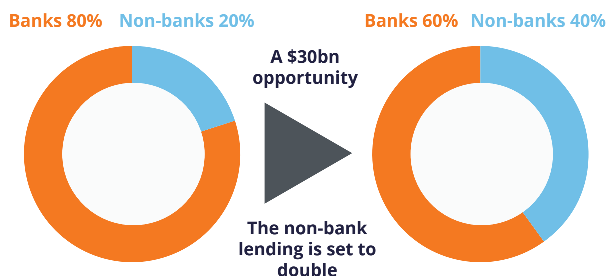
Although such loans are often at the risky end of the capital structure, lenders tend to get more protection than equity investors. This might mean accepting lower returns but the extra protection and short payback periods of 18–24 months make it worth it. Unfortunately, we expect recent annualised returns of around 16% to fall with general interest rates.

From $3.7bn worth of potential deals and $424m of signed term sheets (i.e. offers made to loan money), 360 Capital has lent just $46m recently. Lenders are dropping their standards to win deals in an increasingly desperate chase for yield. Pitt's refusal to do so is the sort of conservative, counter-cyclical approach one hopes for.

Given it's flush with cash, a deep recession would be great for 360 Capital, although Pitt believes any property downturn would be short lived. Sydney's apartment surplus, he believes, would be absorbed in a few years.

Chart 2: $30bn lending gap

Traditional banks are unable to service the demand for real estate lending, creating a funding gap for non-bank lenders[1].



Currently, the market share of commercial real estate debt held by banks is approximately 80%.

It is expected that this share will decline to 60% over time, creating a A$30+ billion opportunity for non-bank lenders[1].

1. Goldman Sachs research 2017

Source: 2018 Annual Results Presentation

Currently, investors are paying around net tangible asset value (NTA) for 360 Capital. The extraordinarily high returns on offer a year or two ago have disappeared as the property market has recovered and interest rates have fallen but, given Pitt's track record, that could still be very cheap indeed.

Although it is difficult to pinpoint the forecast yield, over time shareholders should also receive distributions as if they owned an A-REIT. The value of 360 Capital, meanwhile, would grow as profits are banked from completed projects and reinvested in new ones.

That's pretty good for a company with a shrewd, shareholder-friendly chief executive that owns a quarter of the shares. With an orientation towards leaner times, Pitt can capitalise on higher development returns while they last.

But the story doesn't end here. 360 Capital also owns a 50% stake in a property lending platform called AMF Finance. It earns fees from matching developments requiring capital with investors willing to supply it.

Imagine you're a high net worth individual with $25m to invest over the next few years in our theoretical suburban doctor's office. You plug your details into the AMF Finance system, after which you get a list of projects in which to invest along with the associated terms. You pay a fee for being offered deals on a plate without having to do the dirty work.

As projects mature, 360 Capital can then repackage or 'securitise' this debt for less risk-tolerant investors willing to accept lower returns, releasing cash for 360 Capital's next development. Sometimes, 360 Capital can turn over its capital more than once a year. With the right fee structure, this can be extraordinarily profitable.

The platform only completed $110m of deals in 2018, although the prospects are substantial if investors get the right outcomes. Potential shareholders currently aren't paying much for this potential.

360 Capital is also developing its funds business. The company has **launched three small funds** aimed at yield-hungry investors and added several high calibre executives, including a joint venture with successful telecommunications businessman David Yuile.

Yuile led Nextgen Networks from 2014-15 before selling to Vocus and was chief executive of data centre operator Metronode before it, too, was taken over in 2018. He's renowned for turning around businesses and selling them at large premiums.

The US$250m fund will invest in all manner of modern telecommunications assets, including data

centres and telecommunications towers, aiming to deliver to investors a 10% annual return. It should sell itself in this environment.

But this is only the beginning for 360 Capital's funds management business. And potential investors aren't paying much for it at the current price.

Last year, 360 Capital paid a 5.5-cent distribution but it's unclear what will be paid in future. That may put some income investors off but the bull case should draw them back in.

Tony Pitt is a canny operator with his own money on the line. In a blue-sky scenario, the AMF Finance business could one day be collecting fees on deals valued in the hundreds of millions of dollars along with fees from the new funds yet to be launched.

Even if the funds management business doesn't grow as we expect, at worst you'll own a well-run, entrepreneurial business that's investing in a profitable niche. Pitt excelled during the global financial crisis and we expect nothing less from him during the next downturn.

We recommend 360 Capital for up to 4% of well-diversified portfolios at prices below $1.10. Note, though, that the low-to-medium risk rating currently reflects the company's large amount of cash. Over time, these ratings are likely to increase depending on the investments made.

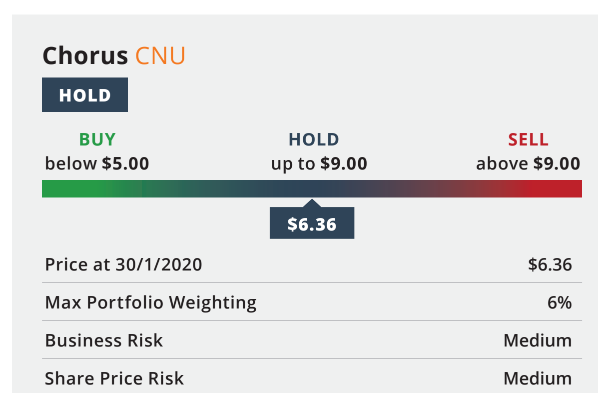
It should also be noted that the stock is relatively illiquid. Be patient when building a position and use limit orders. Please also understand it might be difficult to offload shares in a downturn. If you're not genuinely prepared to own this stock for the very long term you may want to avoid it.

*Note: The Intelligent Investor **Equity Income**, **Equity Growth** and **Ethical** funds own shares in 360 Capital, as do our **Model Income**, **Model Growth** and **Model Ethical** portfolios.*

Disclosure: The author owns shares in 360 Capital.

Chorus: A yield stock without a yield (yet)

New Zealand got its NBN right. Now income investors have a chance to participate in its success.



Price at 30/1/2020	$6.36
Max Portfolio Weighting	6%
Business Risk	Medium
Share Price Risk	Medium

Key Points

- **More information on regulatory outcomes released**
- **Implied WACC of 5.7%, within expected range**
- **Trajectory of outcome is favourable**

Chorus has spent almost ten years and NZ$5bn building New Zealand's Ultra Fast Broadband network (UFB), the Kiwi version of the NBN. The UFB is now active and, like the NBN, it is swiftly churning users of copper broadband into users of fibre broadband.

Unlike the NBN, the UFB achieves astonishing speeds – it is about 20 times faster than the Australian equivalent because the entire network, right to each premise, is built on fibre.

Chorus is the owner of about 75% of that fibre network. The remainder will be built and owned by smaller companies who specialise in specific regions. You might expect the owner of crucial piece infrastructure – a bona fide monopoly – would make a thrilling investment.

Despite spending time and money in spades, ultimate returns from the network remain a mystery. No one knows how much money Chorus can make from its investment, what it can charge or, indeed, how much the network will even be worth. And that is the opportunity.

As a one-time owner of the old copper network, Chorus is used to being a regulated monopoly. As the monopoly owner of the UFB, however, it will soon morph into a fully regulated utility.

That means NZ's Commerce Commission, the national regulator, will decide how to set prices and determine returns. It is currently drafting regulations that will determine the asset base, revenue and ultimate returns that Chorus can earn.

The task should be completed by 2020 or so and the first regulatory period should start from 2022. That is three long years away.

Most investors turn their portfolios over many times over in that period. The uncertainty and required patience is why many investors may not consider Chorus and may avoid it altogether.

That would be a mistake. Take the financial uncertainty out and it's clear that the UFB is a high-quality asset that will generate tremendous value.

The UFB will pass 87% of the population by 2022 and will also be used as backhaul for mobile networks and in commercial applications.

Take up has been strong. Just over 50% of the population is now connected to the UFB and take up rates have accelerated sharply as the rollout matures. Survey results of satisfaction and costs suggests that, after a rocky start, the UFB is popular and effective. No one expects data use to do anything other than surge in the future.

One concern remains mobile broadband. Spark Telecom, NZ's equivalent of **Telstra**, is building a 5G network and many suggest that 5G will take market share from the UFB, potentially decimating returns for Chorus. We think that unlikely (for more on 5G see ***An investor's guide to 5G***).

Data travels far more efficiently, and cheaply, along fibre than on radio waves and fibre will always be cheaper and capable of carrying more data. The UFB is a globally competitive fibre network; 5G won't worry Chorus.

While we don't know the exact regulatory regime, we know the rough approach the Commerce Commission will take and we know how that approach is applied to other businesses.

The regulator has also released a draft report on methods for fibre regulation and it sheds light on what ultimate regulation and returns might look like.

Much like regulated assets from Australia, Singapore and indeed in NZ, the regulator will adopt a building blocks approach. That means it will outline a 'regulatory asset base' (RAB) from which future returns are derived.

As a one-time owner of the old copper network, Chorus is used to being a regulated monopoly. As the monopoly owner of the UFB, however, it will soon morph into a fully regulated utility.

Past capital expenditure will form the bulk of the RAB and a rate of return will be applied that will deliver a maximum allowable revenue. From there, operating costs and taxes will be paid. The remainder can be used to pay dividends or *gulp* to make acquisitions. Depreciation and fresh capital expenditure is tallied in future years.

We know the approach and we can estimate some of the key variables. We must now consider a series of scenarios and what returns might be achieved.

We've tallied up prior UFB spending by Chorus and come to a tangible RAB of NZ$4.2bn. To this we can add more.

Other regulators allow past operating losses and capitalised funding costs to be counted in the RAB calculation. It is unclear how these intangibles will be treated by the Commerce Commission and this will be a major point of contention during the regulatory process.

We estimate NZ$1.5bn of intangibles can potentially be counted, raising RAB to about NZ$5.7bn.

The best case scenario, attracting a 9% cash flow yield, could see the share price double. It could fall if the bear case emerged.

To that RAB, the regulator will apply an allowable rate of return. The return will ensure that Chorus, as a monopoly, does not exploit its market power.

After comparing allowable rates of return in similar industries – **Spark Infrastructure** earns returns of about 5.6% – and across international peers – Singapore's Netlink, which owns similar fibre assets, is allowed to earn 7% – we think a fair rate of return will fall between 5% and 7%.

It's now time to put our propeller hats on and crunch the numbers in a few different scenarios to see what potential outcomes might look like.

Table 1: Regulatory scenarios, 2022 est.

SCENARIO	CASHFLOW YIELD
Include intangibles in RAB, 7% rate of return	9%
Include intangibles in RAB, 5% rate of return	5%
Tangible assets only in RAB, 5% rate of return	3%

We look at three scenarios. In the first two, the regulator allows intangibles to be rolled into the RAB. We run both a 5% and 7% rate of return. In the third case, we assume tangible RAB only and a 5% rate of return, a combination that forms the bear case. The results are shown in Table 1.

It should be noted that Chorus doesn't operate a trust structure as many of its peers do. Inside a trust, all free cash flows must be paid out to investors. Chorus can choose how to allocate cash, which introduces capital allocation risk.

Our yield numbers in Table 1 count cash available for distribution and might not reflect actual dividends.

In the best-case scenario, Chorus could generate distributable cash flow of 9%; in our low case, we expect distributable cash flow of 3%. In an environment where interest rates are low (and seem to be heading lower) and appetite for yield is insatiable, these are decent outcomes. The best case scenario, attracting a 9% cash flow yield, could see the share price double. It could fall if the bear case emerged.

Table 2: Earnings based valuation, 2022 est.

	$NZ	$A
Fibre connects, m	1.1	n/a
ARPU, $/month	50	n/a
Fibre revenue, $m	660	617
Copper revenue, $m	100	93
Total rev, $m	760	710
EBITDA margin, %	65	65
EBITDA $m	494	462
DA (20% rev)	132	123
EBIT $m	362	338
Interest $m	–120	–112
PBT $m	242	226
Tax $m	68	63
Distributable cash flow $m	174	163
CF/share	0.4	0.37
Yield		7%

To check that these numbers are in the ballpark, we also estimate earnings using traditional metrics and compare them with regulated outcomes. We've done that in Table 2 using assumptions laid out.

Our earnings-based valuation suggest Chorus can generate an earnings yield of 7%, bang in between our bear and bull cases.

We still don't know the outcome in front of Chorus but at least we have an idea of the range of outcomes we will likely face.

Risk is a scary word for investors. We spend a lot of time identifying it and plenty of effort avoiding it. That is usually a sensible course of action. Occasionally, however, risk can work in our favour. We can exploit it.

Here is a situation laden with obvious risk. No one knows the returns this asset base will generate in a few years time. However, as explained in ***Chorus a step closer*** (Hold – $5.28), the regulator's draft report implies a weighted average cost of capital (WACC) of 5.7%, within our expected range of 5–7%.

Compared to previous releases from the regulator, this report illustrates that changes are being made in favour of higher returns. The Commerce Commission and Chorus still don't see eye-to-eye on everything, but the gap has narrowed.

For portfolios seeking income and lower risks, which is what this mini-portfolio is all about, Chorus remains attractive.

This has reduced the uncertainty of the situation but also pushed up the price since the time of our original Buy recommendation on **18 Sep 19** (Buy – $4.86). That increase shouldn't dissuade income investors. Despite downgrading Chorus on **20 Nov 19** (Hold – $5.28), the situation is now less risky than it was, although not risk-free.

For portfolios seeking income and lower risks, which is what this mini-portfolio is all about, Chorus remains attractive.

Please note that New Zealand-based companies attract a 15% withholding tax. ***This PWC paper*** *might help explain what that means. As for dividend imputation, this* ***ATO fact sheet*** *may be useful.*

Note: The Intelligent Investor ***Equity Income***, ***Equity Growth*** *and* ***Ethical*** *funds own shares in Chorus, as do our* ***Model Income***, ***Model Growth*** *and* ***Model Ethical*** *portfolios.*

Disclosure: The Intelligent Investor Model Income and Model Growth portfolios owns shares in Chorus.

Link faces time bombs, looks ahead to better future

The company's Retirement and Super Solutions division is set for a difficult year. Beyond that, though, the outlook is brighter.

Link Administration Holdings LNK

HOLD

BUY	HOLD	SELL
below $5.50	up to $9.00	above $9.00

$6.21

Price at 30/1/2020	$6.21
Max Portfolio Weighting	5%
Business Risk	Medium
Share Price Risk	Medium-High

Key Points

- **Retirement division to weaken this year**
- **Earnings to recover from 2021**
- **Reasonable price for good business**

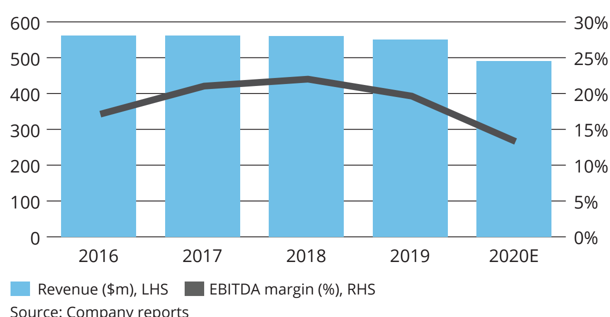
In ***One Up on Wall Street***, legendary investor Peter Lynch suggested categorising companies into six types: slow-growers, stalwarts, fast-growers, cyclicals, asset plays and turnarounds. Lynch didn't have much time for slow-growers, but he felt that stalwarts – large businesses with middling growth prospects – could be attractive if bought cheaply enough, and fast-growers, well, Lynch's career returns tell that story.

Link Administration Holdings, a private equity spin out that listed at $6.84 a share in October 2015, competes with **Computershare** in share registry services. It is also Australia's largest provider of fund administration services to super funds. The odd thing

about Link is that it's a stalwart masquerading as a slow-grower, but with a fast-grower thrown in.

In **March last year**, we wrote that Link was *"an interesting business in a mundane industry. If the price fell 20% or so, we'd love to get it on the Buy List."*

Retirement and Super Solutions division



Source: Company reports

We didn't have to wait long. In May, the company announced trouble in a number of business units, but especially Link Asset Services, which was **struggling in Europe**. A profit warning saw the price tumble.

Deeper research led to an upgrade on **12 Jun 19** (Buy – $5.47) but the bad news continued. In ***Link's lean retirement*** (Buy – $5.67) on **27 Nov 19**, James Greenhalgh explained the reasons for two years of falling earnings.

The division responsible for the most recent decline is Funds Administration, or Retirement & Super Solutions (RSS) as it is now known. Management has said RSS will produce earnings before interest, tax, depreciation and amortisation (EBITDA) of $60m–70m in 2020. At the midpoint, that represents a divisional earnings decline of 40% from last year's $108m.

Link's RSS division is its flagship, accounting for 37% of group revenue. Providing administration services to mainly industry superannuation funds such as AustralianSuper and REST, the chart shows it has had trouble growing revenues for a few years.

Some of this year's earnings weakness is outside Link's control, and temporary. As we said when we **upgraded the stock**, the government's 'Protecting Your Super' changes have reduced the number of super accounts Link administers and created significant costs in dealing with the member queries they have prompted. Some of these additional costs will be short-lived and should reduce in 2021 and beyond.

More worrying is the contract renewal risk in the RSS division. This was one reason why we weren't willing to pay 29 times earnings for the stock four years ago.

While Link renewed 10 client contracts in 2019, securing more than 50% of divisional revenue, it has lost some small clients in recent years to competitor Mercer. Of the 10, the most important were AustralianSuper and REST, Australia's largest and third largest superannuation funds respectively.

Link probably had to sharpen the pencil to re-contract these two big super funds. Management recently explained that these funds wanted their administrator to invest in the business but were keen to ensure Link makes an economic return. So whilst 20%-plus margins were too high, their probable fall doesn't signify a race to the bottom from here.

"Some of this year's earnings weakness is outside Link's control, and temporary

While contract renewals will remain a risk, the outlook for RSS beyond 2020 looks better. The costs associated with the Protecting Your Super reforms will tail off, while Link – as the lowest-cost provider in the industry – could win other administration contracts. But as the revenue bar in the chart indicates, it's been more about renewals than wins thus far.

The odd thing is that, despite declining earnings in RSS, management is forecasting the company will produce flat operating EBITDA in 2020 (excluding businesses that have been sold). In other words, it's expecting to make up RSS's lost earnings elsewhere.

Cost cuts will help but other divisions will need to take up some of RSS's slack. One which should pull its

weight will be Technology & Operations. This division, which is essentially an IT services division that supports Link's other operations and external clients, was the star performer of 2019. Revenues rose 12% while EBITDA rose 9%.

There's an interesting incentive at work here. As a business-to-business service provider, it makes sense for Link to charge internal divisions like RSS and Corporate Markets as much as possible for technology-related services and projects. It helps reduce margins in those divisions – making them less obvious to clients – but boosts the Technology & Operations segment . It's a clever aspect of the business model and we suspect this division will lift earnings in 2020 once again.

> **There remain numerous growth opportunities for Link, including expansion into the UK pension market, which is currently implementing a superannuation system that resembles Australia's.**

If management says operating EBITDA will be flat in 2020, presumably that means net profit will be flat too? Well, not exactly.

We're expecting underlying earnings per share to fall sharply – from 38 cents in 2019 to about 31 cents this year (dividends should be around 17 cents, slightly lower than last year). The culprit is mainly a large increase in depreciation and amortisation expense as past investments hit the income statement. As a technology-driven business, Link has also flagged that capital expenditure is likely to exceed 6% of revenue for the time being.

A few time bombs have hit the company in 2019 and this year might not be so different. Some have come straight out of the private equity playbook, with higher depreciation and amortisation and capital expenditure to hit earnings and free cash flow.

Beyond this year, however, earnings growth from 44%-owned property settlement platform PEXA should begin to kick in. And there remain numerous growth opportunities for Link, including expansion into the UK pension market, currently implementing a superannuation system like Australia's. Link recently acquired a stake in auto-enrolment platform Smart Pension to gain a foothold in the UK and other acquisitions are possible.

There remain risks to 2020 earnings, particularly as management has trotted out the old 'earnings will be stronger in the second half' chestnut. The accounts could be messy too, with new reporting segments and AASB 16 accounting changes set to kick in (the latter affects all listed companies).

But even if we take a haircut to our PEXA valuation, remembering it is yet to contribute to earnings, Link's price looks reasonable. Excluding the PEXA investment, Link is trading on 16 times expected earnings.

Link financials

	2017	2018	2019	2020E
Revenue ($m)	780	1,198	1,404	1,240
Underlying EBITDA ($m)	219	335	356	320
Underlying EPS (c)	33	42	38	31
Dividends (c)	14	20.5	20.5	17

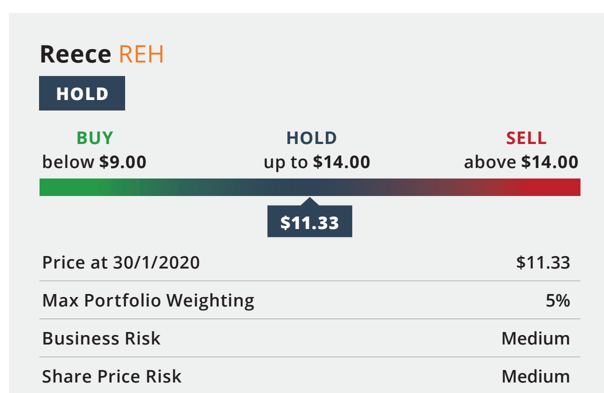
For a reasonably high-quality business with a forecast yield of 2.7%, that's attractive, especially as we're confident Link's earnings growth should resume in 2021 as the temporary drags on earnings dissipate.

*Note: The Intelligent Investor **Equity Income**, **Equity Growth** and **Ethical** funds own shares in Link Administration Holdings, as do our **Model Income**, **Model Growth** and **Model Ethical** portfolios.*

Disclosure: The author owns shares in Link Administration Holdings.

Reece spreads its wings

Having conquered the Australian plumbing supplies market, Reece has shifted its attention to the United States' most prospective region.



Key Points

- **High quality business with great track record**
- **Recently added to our model portfolios**
- **Extending market share lead in Aust/NZ**

In 2016, James Greenhalgh wrote in our upgrade of **plumbing supplies company Reece**, "*What idiot would buy a plumbing supplies business near the peak of a housing boom? Well, this idiot, for one. We've waited a long time to recommend Reece which is, without question, one of Australia's best businesses.*"

Reece dominates the plumbing supplies market, fending off competition from Tradelink, Bunnings and Mitre10. Its customers are mainly plumbers who prefer not to cart heavy materials around in their utes: an account with Reece allows them access to more than 100,000 items from almost 500 outlets around Australia.

This mix of range, service, convenience and buying power enables Reece to earn margins consistently above 10% in its home market of Australia.

Management is able to invest capital – usually very profitably – in the business. Wholesalers working on lower margins inevitably are denied this opportunity, leaving Reece to improve and extend its business, each time improving its competitive position.

The company's potential to take market share in the heating, ventilation, air-conditioning and refrigeration industry (which goes by the acronym HVAC-R) is a good example. In January 2014, Reece acquired Actrol, the largest independent wholesaler in the sector.

HVAC-R wholesaling market is much more fragmented than plumbing supplies. Reece brought professionalism and capital, as well as independence from manufacturers, to the sector, taking market share from other players, just as it has done in plumbing supplies.

Reece's 2018 acquisition of Morsco, in the southern United States, is another example. The purchase was a big bite, increasing net debt to $1.6bn. But with plans to roll out more stores – only nine were rolled out across Australia and the US during 2019 – Reece has taken the time to learn more about the business before ploughing more cash into it. It's the kind of approach sensible owner-managers tend to take.

Table 1: Reece result 2019

YEAR TO JUNE	2019	2018	+/- (%)
Revenue ($m)	5,464	2,689	103
EBITDA ($m)	522	378	38
EBIT ($m)	380	324	17
Net profit ($m)	238	225	6
EPS (cents)	42.4	44.6	(5)
DPS* (cents)	20.25	20.25	0
Franking (%)	100	100	n/a

*** Final div of 14.25 cents, fully franked, unchanged, ex date 8 Oct**
Figures are underlying results

With the Wilson family controlling 63% of the company's stock, they manage Reece for ultra-long term performance. The results speak for themselves; net profit has more than doubled over the past decade. Although Morsco's performance needs watching, the company's owner-management team and outstanding track record has earned the right to a little leeway.

What about the downsides? Perhaps the biggest issue is the health or otherwise of the housing construction sector. A cyclical downturn could have a big impact on profits.

Last August, for example, **Adelaide Brighton** revealed a massive 25% profit downgrade, partly because of its exposure to the high-rise apartment market. Reece wasn't quite so affected as its exposure is at the far end of the cycle. Dwelling completions matter more and they actually peaked in 2019. For Reece, this financial year marks the start of a potential downturn.

Reece's sales jumped 103% in 2019 due to the acquisition of Morsco. Underlying earnings before interest, tax, depreciation and amortisation (EBITDA) increased 38% to $522m. But a couple of strange accounting issues meant underlying net profit was lower than expected at $238m.

Free cash flow was good, but it looks like Reece is keeping a tight rein on capital expenditure. If it wants to expand organically by opening more branches, investment spending will need to rise. Indeed, Reece has confirmed its intention to roll out more branches in the US – as well as make acquisitions – over time.

Nevertheless, the earnings outlook is uncertain. While we've allowed for this in our valuation and price guide to some extent, there's a risk the downturn gets ugly, although recent reports suggest activity is returning to the housing sector.

Everyone knows that Reece is a high quality business, one of Australia's best. Buying opportunities such as we found in April 2016 are rare, and often occur only when the company is going through a rough patch.

In 2016, when the housing boom had peaked we got our opportunity. Almost four years later, we might soon get another one.

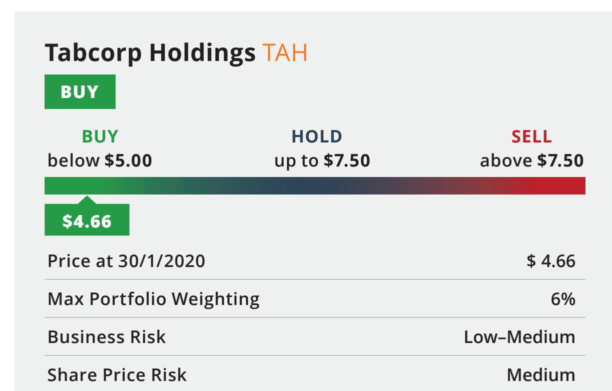
Reece might not be on the Buy List just yet but we have been enthusiastic enough to add to our positions in the InvestSMART Ethical Share Fund and Intelligent Investor model income and growth portfolios just before Christmas. This remains a wonderful owner-managed business trading at a fair price and a forecast 2020 yield of 1.8%.

*Note: The Intelligent Investor **Equity Income**, **Equity Growth** and **Ethical** funds own shares in Reece, as do our **Model Income**, **Model Growth** and **Model Ethical** portfolios.*

Disclosure: The author owns shares in Reece.

Tabcorp a rational bet

There aren't many stocks paying a reliable 4.6% yield plus potential share price growth. Tabcorp is that rare opportunity.



Key Points

- **Synthetic lottery ban reinforces monopoly**
- **Interest rate movements the big risk**
- **Long term growth; wide moat**

If you're a company trying to maintain a stable dividend, it certainly helps when half of your business is the next best thing to the Australian Mint. Tabcorp has a monopoly over all the major lotteries in Australia. That provides a stable base of earnings. But changes in Tabcorp's other division – Wagering – could add significant value to the company over the next few years.

There are signs Tabcorp now has the upper hand, for a number of reasons. First, the long-serving chief of Sportsbet's parent company, Ireland-based Flutter Entertainment, left early last year. Breon Corcoran was, in our opinion, the most astute executive of any wagering business worldwide. We don't think his replacement is of the same calibre.

Next, the merger of Tabcorp and Tatts is expected to produce cost savings of $130–145m by 2021, with $64m of that already bagged in 2019. In theory, these should flow through to punters as better odds and promotional offers, which would narrow the

advantage Sportsbet currently has (see ***Tabcorp: Result 2019***).

Third, the introduction of 'point of consumption' taxes affect the top line of all operators, replacing variable taxes based on where bookmakers held a licence. The old system favoured online bookies, which typically registered in the low-tax Northern Territory, leaving Tabcorp paying higher taxes in most states due to separate licences. The new set-up levels the playing field.

> **The bottom line is that it's hard to imagine the Lotteries division ever losing money over an extended period.**

The company's 2019 **full-year result** gave us the first piece of evidence of the impact of these factors. For the six months to June, Tabcorp's digital turnover grew 7% compared to Sportsbet's 12%. Sportsbet is still gaining market share but the rate of gain has declined and we expect it to continue to do so.

Whilst the outlook for the Wagering division is improving the Lotteries division, which accounts for 55% of operating profits, is the company's real financial powerhouse.

Lotteries has an exclusive licence to operate all the lotteries in Australia except in WA. With a capital-light business model and a fixed margin built into its games, the division has never turned a loss in more than 25 years (after that we stopped counting).

The biggest risk to the division was the emergence of synthetic lotteries. These allowed players to bet on the outcome of a lottery draw, instead of participating in the draw itself. In January last year, synthetic lotteries were unsurprisingly banned – almost half of Lotteries' division revenue is deposited into government coffers as taxes.

Tabcorp's state lottery licences will eventually expire and need to be renewed but that's a long way off. Around 75% of profits are from licences with more than 35 years to expiry. It's only the Victorian licence – which expires every 10 years – that investors need worry about, and it was most recently renewed in 2018.

And even when licences come up for renewal, it's hard for competitors to muscle in on Tabcorp's monopoly. Governments usually get the best deal by sticking with the incumbent.

The bottom line is that it's hard to imagine the Lotteries division ever losing money over an extended period. Growth isn't guaranteed, but outright operating losses are unlikely. Lotteries provides a solid floor to the dividend and Tabcorp's valuation, as we'll soon see.

Major licences and expiry

LICENCE	EXPIRES
Lotteries licence – VIC	2028
Lotteries licence – NSW	2050
Race wagering licence – QLD	2098
Sports wagering licence – QLD	2098
Sports bookmaker licence – NT	2020
Major betting operations licence – SA	2100
Inter-hotel linked gaming system licence – NSW	2019
Race and sports wagering licence – TAS	2062

Ironically, the lottery division's predictable cash flows mean the real risk in valuation comes mostly from interest rate changes rather than volatile profits or competition.

The best we can do is value Tabcorp's Lotteries business using its probable long-term earnings under the current interest rate environment, and then build in a margin of safety to account for the inevitable errors in forecasting.

We can't know the direction of interest rates but with the bond yield halving over the past year, a stable earner like Lotteries is significantly more valuable now than a year ago.

Tabcorp's Lotteries division earned $2.9bn in revenue for the year to June, an increase of 23% compared to last year, and operating profits of $425m, up 37%.

It would be unwise to project that level of growth into the future. There were far more jackpots in the last 12 months than in the prior period. Big jackpots attract more punters – a few of whom might become regular players – and they also stimulate a wave of free advertising. But luck can swing the other way just as quickly. It's reasonable to expect a lean year for every supercharged one.

After evening out the ebb and flow, lottery turnover has grown at around 4% a year over the past 20 years. We expect something around that mark to be sustainable for the long term. Better yet, the division is relatively immune to swings in the economy – even during the peak of the last financial crisis, turnover only dipped 10%, then hit a new high the following year.

With many competitive advantages and a decent yield growing in the mid-single digits, there's a reason why Tabcorp is one of our few current Buys.

The Lotteries division could make $230–250m in net profit as a separate company and a similar amount of free cash flow (after adjusting for the division's share of Tabcorp's $3.4bn of net debt).

A business of this quality with that sort of income and a steady growth rate of 4% could easily command a valuation of $7.0–8.0bn to a private buyer. That would offer a total return of around 7%. The Lotteries division might be worth $3.50–4.00 per share to shareholders were it ever spun off (in a demerger, for example).

Here's where declining interest rates really make a mark, though. Holding all other variables steady, if we assume that interest rates remain low and your required rate of return falls from 7% to 6%, then the division's valuation shoots from $8bn to nearly $12bn.

We still think Lotteries is worth closer to $8bn, but that sensitivity is important to appreciate. Steadily growing businesses with wide moats, as Tabcorp's Lotteries division enjoys, can become extremely valuable as interest rates decline. The flip-side is that if interest rates were to return to 2010 levels, our valuation would almost halve due to the higher opportunity cost.

Adding the Lotteries and Wagering divisions together, Tabcorp is worth around $14–15bn, or a bit over $7.00 per share.

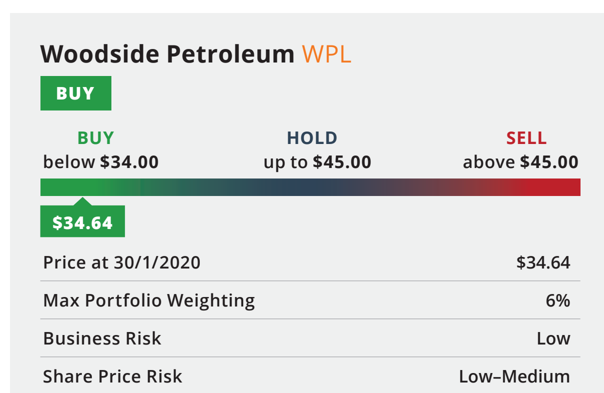
The stock offers a fully franked dividend yield of 4.6% and it's likely that management will increase the dividend next year given the ongoing cost-cuts following the merger with Tatts. With many competitive advantages and a decent yield growing in the mid-single digits, there's a reason why Tabcorp is one of our few current Buys.

*Note: The Intelligent Investor **Equity Income** and **Equity Growth** funds own shares in Tabcorp, as do the **Model Income** and **Model Growth** Portfolio.*

Disclosure: The author owns shares in Tabcorp.

Woodside's grand plan

Another unconventional income stock asks investors to sacrifice dividends in the short term for higher returns in the years ahead.



Key Points

- **Production growth to come**
- **Growth with lower capital intensity**
- **Dividend likely to be cut**

Woodside isn't your typical growth stock, much less a standard income play. Production has stalled for years and the company has only recently reversed a decline in reserves. Revenue growth has come exclusively from changes in commodity prices rather than output growth.

Woodside is partly an energy business and partly an infrastructure one. Raw gas resources are turned into LNG using an enormous fixed asset base that has taken decades and tens of billions of dollars to construct. Even if the gas molecules run out, above-ground infrastructure stands ready to continue processing fresh gas. The value of Woodside can't be measured by resource volume alone.

Yet the market has obsessed about Woodside the energy business but largely ignored its infrastructure qualities. For income investors, this is where the hidden value lies.

At Woodside's investor day it was clear that plans to integrate its infrastructure with its resources into a seamless operating hub are advancing. The value of Woodside's infrastructure will be hard to ignore in the future.

Woodside wants to link the Karratha gas plant and Pluto processing plant via pipeline to create direct access to a swathe of stranded gas assets in the Carnarvon and Browse Basin. The company also plans to link the long idle Browse gas project back to Karratha for processing while also linking the Scarborough project back to Pluto.

By creating a giant, integrated processing hub, Woodside could effectively grow output without replicating facilities that cost tens of billions of dollars. That means lower cost development and higher profit margins. If only the Queensland coal seam gas producers had thought so clearly a decade ago.

The big obstacle, and a key reason the market is ignoring these grand plans is that they require agreements from nine separate parties, each with their own priorities and agendas. Progress is being made slowly.

The value of Woodside can't be measured by resource volume alone.

BHP has finally agreed to a tolling agreement that will see Scarborough gas being processed through Woodside's facilities. This is an outstanding outcome for Woodside and an excellent use of assets with enormous sunk costs. Woodside will earn high-margin tolling fees linked to volume while also sharing profits from LNG sales. A similar deal is being sought for Browse. Each will make the business a more stable, predictable generator of cash. That will be music to the ears of income investors.

Assuming Scarborough can get going by 2024 and Browse by 2026, Woodside should be able to raise output from 90m barrels of oil equivalent (mmboe) to over 150mmboe by 2028. That growth will come at high margin and cost less than US$8 a barrel to develop - about 50% less than previous developments.

Once initial capital expenditures are paid, we expect terrific free cash flows, underpinned by a resource base that continues to expand. Woodside recently announced a 50% upgrade to resources in the Scarborough field to over 10tcf (trillion cubic feet of gas; if you're in any doubt, that's a lot).

Woodside has articulated a clear and considered growth path that will raise output and profits with less capital intensity than in the past.

Here's the catch. To fund this growth, today's high dividends will be cut. Woodside's growth program, while cheaper than in the past, will still cost about US$20bn. That sum should shrink as the company sells project equity but there is no doubt that capital expenditure over the next few years will rise.

Long term investors shouldn't mind. Woodside has articulated a clear and considered growth path that will raise output and profits with less capital intensity than in the past.

Yes, this may be another unconventional income play and there is still widespread scepticism about this new approach to project development. But that's an opportunity for the patient investor that can live with some dividend cuts in the short term. The pay-off is a higher share price and dividend cheques down the track. Woodside remains slightly above our buy price but we won't quibble over a few cents.

*Note: The **Intelligent Investor Equity Income fund** owns shares in Woodside, as does our **Model Income Portfolio**.*

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