December 2021

Top 10 Best Businesses

Australia's best businesses uncovered

INTELLIGENT INVESTOR

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About Us

With more than 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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All prices correct as of 3 December 2021.

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Contents

Podcasts

Our series of 6 podcasts from which this report is dervied will be released on the **website** over the Christmas holidays, giving you some content to carry on with while our team takes a short break.

From the author

Determining what makes a great business is inherently subjective. In 2012, we addressed the subject by trying to infuse some science into the art of investing. Employing a series of metrics to find great businesses including dividend per share growth, return on capital employed, return on incremental capital employed and a 'great business index' that ranked companies based on their 10-year dividend growth, we got the basis of our selections.

It seemed like a good idea at the time. You can view the resulting 10 stocks **here**. Although this list featured **BHP**, **Woolworths** and **CSL** - all of which have made the grade in this report - companies like **IRESS**, **Metcash** and **Mondelphous** sat among them. It was a list that didn't sit quite right.

In 2016, we developed a more nuanced approach, asking each analyst to supply their top three durable, high-quality businesses. After that, we argued amongst ourselves for a while. The aim was to establish the best 10 dominant companies that should be bigger and stronger a decade hence.

The **results were more satisfactory**, which is why we repeated the approach this year, albeit with fewer arguments. Only one stock from 2016 - **ASX** - failed to make the list. **Sydney Airport**, meanwhile, was supplanted by **Auckland International Airport** in view of its likely upcoming delisting.

The 2016 report featured seven 'best of the rest' selections. One has made the list this year (**Cochlear**) while another (**Reece**) ran a tight race with **Ramsay Healthcare**. For reasons explained herein, we went with Ramsay.

All up, the commonality is reassuring. Truly great businesses should remain that way for decades on end.

Whilst the process for selecting these businesses hasn't changed, the format in which we present them has. A PDF with 20,000-odd words has its limitations. This year, we recorded interviews with the analyst on each stock. These were then transcribed and lightly edited to remove the waffle and gags that fell flat. Sadly, Nathan's Guns and Roses guitar solo also fell under the knife.

The result is a choose-your-own Christmas adventure. Whether you want to sink into a luxurious couch with a PDF open on your tablet, listen to the interviews whilst watching the grandkids play with the lawnmower or sit at a desk pretending you're working, from podcasts, articles and a PDF, there's an option to suit.

Make no mistake, though – this list is not our 10 best stock picks. Great businesses and great investments are very different things. None of the current selections appear on our **Buy List**.

The best businesses usually command a price premium. The objective is to be prepared. The opportunity to buy the stocks you're about to read about typically occurs when they're going through a tough period. Inevitably, many of them will. With this report, you'll be ready to pull the trigger when the opportunity arises.

Right, let's get into it.

John Addis

Founder and editor of *Intelligent Investor*

Part 1

10 of the best

Sydney Airport, Transurban and Auckland Airport

With stable demand and often Government-protected revenues, infrastructure stocks are some of the most resilient businesses around.

John Addis
Editor & Founder

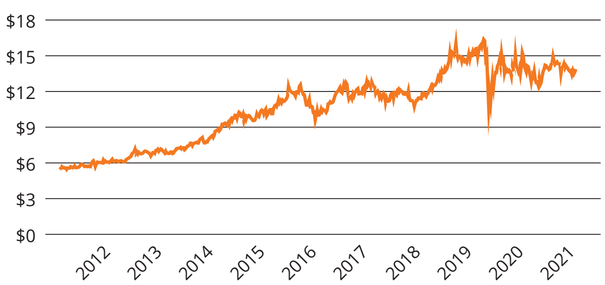
Graham Witcomb
Analyst

Transurban TLC

AVOID

Price at 3 Dec 2021	$13.54
Business Risk	Low–Medium
Share Price Risk	Medium–High

Transurban 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Hi, my name's John Addis, I'm the founder and editor of Intelligent Investor and I have here with me today Graham Witcomb, our infrastructure expert. Good morning, Graham.

Hi, John.

We're here to discuss something we've been chatting about for probably over a month now, which is Australia's top 10 businesses. Graham's here to discuss the first three of them, which are infrastructure stocks. Let's kick off by telling the listeners about the different kinds of infrastructure stocks.

Well, infrastructure falls into three general categories. The first is transport, which covers airports, railways like **Aurizon** and toll roads like **Transurban**. Then there are those that either move or store commodities, things like water and gas pipelines, electricity grids, power lines, that kind of thing. And finally, a new category, companies that move data around through communication towers, data centres, things like that.

And what would you say are the main characteristics of an infrastructure stock?

What grounds them all is their level of predictability. Infrastructure companies tend to be either natural monopolies and/or are heavily regulated. As a result, they often have their pricing regulated but enjoy a steady level of demand because there isn't much competition. When you've got, say, a toll road, there might be little roads around it but most people will take the most direct route. Today's traffic is probably going to match next week's because everyone goes to work on a Monday.

Pandemics excepted…

Yeah, a lot of what we'll be talking about now isn't always applicable but for the most part infrastructure stocks are heavily regulated and enjoy steady demand. There's also a similarity in their cost structures. The assets tend to cost a fortune to build initially but deliver a steady and predictable cash flow after that because they often don't need as much maintenance. Once you've got that bitumen down, that's pretty much it.

> **It usually requires a lot of bad news to get some sort of edge in the pricing of infrastructure stocks.**

This doesn't always apply to data-oriented infrastructure stocks because they need constant renewal to stay up to date, but for things that are like **Sydney Airport** or Transurban or pipelines, there are big upfront expenses and then very low expenses thereafter, which usually produces generous cash flows.

No business is simple to run but are these stocks easier from a managerial perspective than something like BHP or a big bank?

Definitely, for the simple reason that they usually don't have to worry about competition, except in the bidding process. Managing the finances can be a big task but in terms of general operations, maintenance, etc. not much work is required.

With predictable cash flows, does this allow infrastructure stocks to carry substantial levels of debt?

Absolutely. When you've got predictable cash flows, people like to milk it for everything it's worth. The banks are usually jumping over themselves to lend to such companies so, especially now with low interest rates, almost all infrastructure stocks have boatloads of debt.

From an analytical point of view, because the cash flows are predictable and concessions have a limited duration, does that make the job of valuing those cash flows easier?

It does. You can often predict what the revenues are going to be in 10 years' time. Sometimes they're built in by government mandates targeting a particular revenue level, which determines pricing so it is easier to value them. The downside is that it's easier for everyone else, too, which is why they tend to be mostly fairly valued. You don't get huge discounts as you would in something that has more ambiguity to it. It usually requires a lot of bad news to get some sort of edge in the pricing of infrastructure stocks.

So, you rarely get an opportunity to buy these kinds of businesses very cheaply?

That's right, it takes a pandemic sometimes.

Can we talk through some of the macro considerations members should bear in mind when they're thinking about infrastructure stocks?

Sure. The big one is the effect of government action. Usually, because these are monopolies with particular concessions, governments have a strong hand in determining what future returns are going to be. They might be locked in ahead of time but the Government can change its mind; different governments come and go and that can impact returns. That's always a risk for a lot of infrastructure stocks, particularly those where the Government sets the price directly, although that isn't the case with the two we'll be talking about today.

Interest rates are the other big factor, especially as these stocks have picked up a lot of debt over the last decade at low interest rates. Because they're steady assets, they tend to have longer debt terms than most businesses; it's not unusual to find debt with a 10 or 20 year payback period. Interest payments might already consume a fair amount of their income and if those interest rates rise that's going to bite into their future profits.

The other point is that people tend to think about infrastructure stocks as a substitute for bonds. Rising rates might mean you get this double effect of lower profits but people also being less willing to pay up for those profits because, suddenly, bonds and other investments are going to be higher yielding. Falling rates have boosted the share prices of infrastructure stocks; the reverse could take them in the opposite direction.

So the bond proxies stop being bond proxies?

Yeah, it works very nicely when they're going down, but it can cause issues when they're going up.

Given those characteristics, what kind of investors are attracted to these kinds of stocks?

They tend to attract people who are more conservative. If you don't want a lot of risk in your portfolio and especially if you're able to hold for a long period, then often you're not going to get a steadier level of income from any company than an infrastructure stock. That might not always be the case if you're looking out 10 years because of things like the interest rate changes. But if you want to know with certainty – 'okay, I'm going to get this amount of dividends next year' – then infrastructure stocks are pretty hard to beat.

People looking for low-risk stocks also find them attractive, although most tend to be pretty highly-priced now. You're not getting much of a yield, but at least you know that your dividend isn't going to be cut to zero next year if a competitor shows up or something like that.

Okay. Let's now move now into the stock discussion, which is complicated by the fact that Sydney Airport is subject to a takeover offer, which seems likely to go through. We're going to talk about Auckland International Airport as a possible replacement for it but will first discuss Transurban. What assets does it own?

Transurban has a monopoly over toll roads in the eastern states. If you've paid a toll recently, it's almost certainly going to Transurban. It owns the Sydney Orbital Network, the M7, the M5, Melbourne's CityLink and it owns dozens of roads around Brisbane. There are some toll roads that aren't owned by Transurban but most are.

What about the concessions that Transurban has? How long do they own these assets for and what happens at the end of that period?

These days, when the Government is proposing to build a road it usually sells it off to a private firm to build and manage and, in return, gives it an amount of time where it's allowed to toll the users of that road. These concessions usually last decades; the average might be around 30 or 40 years, although some go for much longer. So the company needs to earn all of its money within those 30 years, after which the asset is returned to the Government. The Government might then either resell it to someone else, continue tolling users for its own benefit or remove tolls altogether.

> **They tend to attract people who are more conservative. If you don't want a lot of risk in your portfolio and especially if you're able to hold for a long period, then often you're not going to get a steadier level of income from any company than an infrastructure stock.**

In terms of the ability for Transurban to raise prices, how does that work?

In most cases, it's built into the initial contract. For most of Transurban's roads, they can raise their toll by inflation plus a particular percentage, usually with a lower bound figure. So, it'll be the minimum of, say, 4 per cent or 4 per cent plus inflation – something along those lines.

So inflation protection is built into the business model?

Yeah, and that does make it kind of unique. With the steady demand for toll roads and an inflation hedge, you can be almost certain that the revenues earned next year are going to rise by inflation, plus a bit more. That's a good asset for retirees or those that want to preserve their purchasing power.

And the competitive environment is almost non-existent too, especially after the pandemic where public transport ridership seems to have fallen. Where is the competition in this sector? Does Transurban have it all to itself?

Almost. The roads themselves are generally monopolies. There's not going to be an M7 built down the road. Where competition exists it's usually in that initial bidding process. Transurban has to bid to buy the roads. The returns it can generate will depend on how much it bids. In the end, the company willing to accept the lowest returns usually wins the road.

However, this is where Transurban has a slight advantage in Australia. With a monopoly over most of the roads, the incumbent has an advantage on bidding for new ones because it can plug in its other roads to the new one. And due to its existing relationships with governments, it has better financial backing and can spread the risk. In the end, there is an advantage that Transurban has for bidding for new roads even though each road individually is a monopoly.

What about population growth? Most of the immigrants who come to Australia tend to end up in Sydney or Melbourne, so isn't there a growth component to this business as well?

Yeah, that's exactly right. Those central roads are irreplaceable. As the population in a region grows, the roads pick up that population growth one for one almost, and sometimes more than that. Something like the Sydney Orbital Network, for example, gets people from well outside Sydney using it.

This is why I think Transurban made the list; it has all of these tailwinds; it's a very reliable and stable business, and it's easy to run. What about Scott Charlton, the CEO? He earns about $5 million a year, do shareholders get good value for that?

No. [Laughs] Not at all. I am stunned…

I think you could do that job, Graham.

I mean, he's being paid something like $15,000 a day to run a piece of bitumen. What is he doing in that office? I don't have an answer for that. There are plenty of CEOs that have more difficult and more value-adding jobs that get paid less than him. I don't want to criticise him too much, but toll roads don't require brilliant management to keep going. The main thing you want is conservative management; someone who isn't going to go on some crazy buying spree paying ridiculous prices for new roads, because that does affect shareholders' returns. In terms of the running of the roads that are there now, they should almost run themselves.

It does seem like the big risk in this business from a managerial perspective is an empire-building mentality.

Yeah, absolutely, I wouldn't say it's the only risk – recessions and pandemics play their part – but it is a big risk if you've got a manager who loves adding roads at crazy prices. And Scott Charlton is close to that mentality, I would think.

> **"In the end, there is an advantage that Transurban has for bidding for new roads even though each road individually is a monopoly.**

You can probably tell from Graham's comments there, we haven't recommended Transurban for quite some time and it does look overvalued, but this isn't about valuation, this is about the quality of the business and this does look like a business that any idiot could run.

Yeah, exactly. This is one of those classic cases of where even the best businesses in the world aren't worth an infinite sum. Transurban is a really phenomenal business, but it's just not worth an infinite amount. You've got to take that into account before you rush out and buy it.

Okay, let's move onto the airports now. We'll start with Sydney Airport. Like Transurban, it's still a strip of concrete, benefiting from population growth and tourism. If you were to put them side by side, in terms of business models which would you prefer?

Sydney Airport, by miles. There is just so much more going for it in terms of its model, its regulatory outlook, and lease terms. Transurban's weighted average lease expiry is around 26 years; Sydney Airport owns its land until 2097 so has a lot longer to make use of its asset. There are many things to like about Sydney Airport.

Sydney Airport SYD

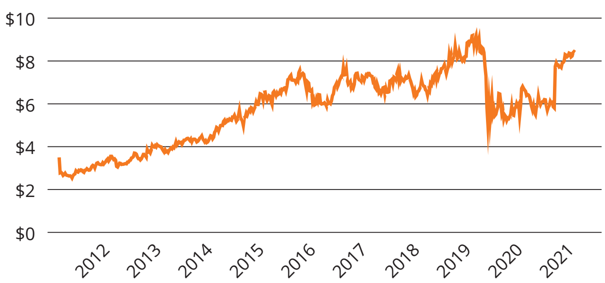
HOLD

BUY	HOLD	SELL
below **$6.00**	up to **$9.50**	above **$9.50**

$8.28

Price at 3 Dec 2021	$8.28
Max Portfolio Weighting	7%
Business Risk	Medium
Share Price Risk	Medium

Sydney Airport 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

History suggests that air travel comes back really quickly after significant events like SARS and 9/11. Do you think this is going to happen this time, too?

There has been no real precedent for any kind of sharp decline in air travel worldwide. Almost every year, traffic was a little higher because of things like rising incomes in developing countries, higher density aircraft and just more disposable incomes which make people want to travel more. Until this pandemic hit and they closed the borders, there was basically no year where there was a material decline in passenger numbers for Sydney Airport. I think the worst was probably 9/11 and that only went down a few per cent or something like that.

But you do have a cost base that's reasonably fixed, so as passenger throughput rises you can get fairly rapid profit growth?

Definitely. Once they've built the terminals, the infrastructure is sitting there. It's such a high throughput kind of business model that the proportion of income that needs to be reinvested into painting the walls or that kind of thing is so small that most of it does come through as free cash flow and also it's able to grow faster than passenger growth. Because costs are mostly fixed, as income increases, profits are going to grow even faster. Over the past decade, you've got passenger growth of 4 per cent or so, but Sydney Airport's profits have grown at around 10 per cent.

And it looks as though the regulatory environment is fairly light touch as well, so there's scope there for the airport to do things that maybe Transurban can't do?

Sydney Airport is so unique as an asset in Australia. It has a clear monopoly and is very lightly regulated compared to most other monopolies. I can't find any other regulatory framework that's lighter on airports than in Australia, although New Zealand is a close second. Australia really lets the airport almost do what it wants. It's able to set its own prices and can negotiate directly with the airlines so there's no government price fixing. The airport has a lot of levers to pull on when it comes to setting its own destiny, which is really important if you have such a monopoly.

Yeah, so we've got a fixed cost base; we've got air travel growing at a rate much faster than GDP over time; we've got a rapid comeback in international travel after major events. There are also some particular characteristics of Sydney Airport that are unusual, like its proximity to the CBD.

Yeah, that's right, and it has a very long lease on its land, which it can use for all sorts of things that add to its development ability. It's not just earning income from the aeronautical fees or passenger fees, there are also car parks, development, retailing, hotel leases. It has a diverse stream of revenues, all dependent on people being allowed to go into the airport, but once they're in there there's lots of levers that Sydney Airport can pull.

> **Sydney Airport is so unique as an asset in Australia. It has a clear monopoly and is very lightly regulated compared to most other monopolies.**

What about the second airport being built in Western Sydney. Is this a big issue?

What really matters is how irreplaceable that central airport is. Western Sydney Airport is being built because air travel is going to increase over time. There is a demand there but for Sydney Airport in particular, what matters is that it's very close to the CBD. Western Sydney is going to be 50km from the CBD and if you've just flown from Tokyo, that's a drag.

Now, the airlines can choose the airports at which they land competitively but if you're flying in from Tokyo and your customers can choose between Western Sydney or landing just down the road from the CBD, they're going to choose the one closest to the attractions they want to visit. What we think is going to happen is that Western Sydney Airport might mop up a lot of domestic travel over time while Sydney Airport focuses on the more lucrative international markets. Passenger fees and retail spending are higher for international travellers so there are benefits to Sydney Airport from having a second airport out west.

And the airport itself is obviously constrained by the number of slots that you have at an airport with a fixed number of runways?

Yes, there are limits, but Sydney Airport has quite a lot to go. There are other airports that have a much higher density of incoming and outgoing flights compared to its land area, so I don't think Sydney Airport will be hitting up against its limits any time soon.

And regional flights that fly into Sydney with 30 passengers could be swapped for an A380 with 550 passengers?

Yeah, that's right. Sydney Airport had a first right of refusal to own any other airport in Sydney and chose not to buy it. That tells you something. It's going to do perfectly fine without it.

Auckland International Airport AIA

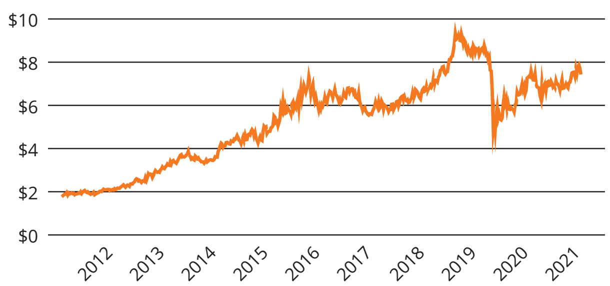
HOLD

BUY	HOLD	SELL
below **$5.50**	up to **$8.50**	above **$8.50**

$7.51

Price at 3 Dec 2021	$7.51
Max Portfolio Weighting	5%
Business Risk	Low–Medium
Share Price Risk	Medium

Auckland Intl Airport 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Let's talk briefly about Auckland Airport because it looks as though Sydney might be delisted, much to our disappointment…

Yeah, vote no if you're hearing this before the vote!

This is Graham's campaign of the day. How does Auckland Airport compare to Sydney? Can you just talk us through some of the differences between Auckland Airport and Sydney.

Auckland Airport is an amazing asset in itself. It might not be the top 10 if we had to pick between Sydney and Auckland, but there's no doubt that this is one of the best businesses on the ASX. It is smaller than Sydney, with about half as many passengers in a normal year. But there are also many similarities. It has a monopoly around Auckland, there's a similarly light regulatory framework so it gets away with setting its own prices and being able to use its assets in ways that a lot of monopolies wouldn't be able to. The main difference between them is that Auckland Airport is much more dependent on international tourism compared to Sydney.

Just before the pandemic, around half of Auckland Airport's traffic was international, where it was just a third or so for Sydney. That does affect the volatility of earnings. Because they're more lucrative passengers, it means that any dip in those passengers is going to have a bigger impact on profits.

And the land that it owns as well, it's not leased is it, as is Sydney Airport?

That's probably the big advantage it has over Sydney. Sydney Airport's lease runs out in 2097, whereas Auckland Airport owns its land freehold and that's an amazing block - 1,500 hectares - larger than Auckland itself - right on the water and very close to Auckland CBD. It's an irreplaceable block of land.

> **Yeah, vote no if you're hearing this before the vote!**

Okay, well thanks very much, Graham, that was really interesting. There's an overview of three businesses, two of which will be on our top 10 list to be published around Christmas. I hope members have enjoyed it and we'll speak to you soon.

Thanks, John.

Thanks, everybody.

Part 2

10 of the best

REA Group, Wesfarmers, Woolworths and Coles

Retail doesn't always make great businesses, but when brand and good real estate come into play, returns can be outstanding.

John Addis
Editor & Founder

James Carlisle
Senior Analyst

REA Group REA

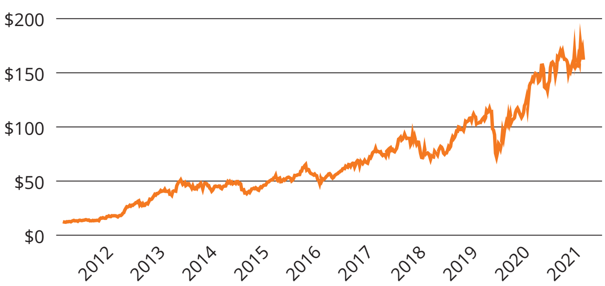
HOLD

BUY	HOLD	SELL
below **$120.00**	up to **$180.00**	above **$180.00**

$161.77

Price at 3 Dec 2021	$161.77
Max Portfolio Weighting	6%
Business Risk	Medium
Share Price Risk	Medium–High

REA Group 10-year share price



Source: Capital IQ; 10 years to 3 Dec2021

Hello, everybody, my name's John Addis, I'm the Founder and Editor of Intelligent Investor, and I'm here with James Carlisle today. How are you doing, James?

Good thanks, John, how are you?

Yeah, very well thanks. James, you're the analyst for REA. What is it about this business that makes it so good?

Well, it's all about network effects; the platform it has brings together different parties, the buyers and sellers primarily. Platforms come in all shapes and sizes, but what makes this one so valuable is that the value of the asset you're selling is so high relative to the cost of putting it on the website. With Carsales and Seek, the value of each transaction is so much less compared to the value of a home. The value of a house is also readily apparent. It's unlikely to have been in a car accident and got a damaged chassis. Before you buy it, you'll get a survey anyway, but you can see the location and the condition pretty well online, showcased through the platform. It's become the only game in town. You have to get onto REA's website to sell your house. You might also put it on Domain but, as the latecomer, REA stole a lead and has three times the audience.

Yeah, that first-mover advantage is really something. It seems like an almost insurmountable market position that REA has established for itself.

Once you have the buyers, you get the sellers and the two sides combine. Each buyer makes the network more useful to all the sellers and vice versa. If there's a weakness in REA's network it would be that it's slightly two-sided. Everyone on the network could be a buyer or a seller – when you're selling your house, you're looking for a house to buy, everyone's in the market – but the sellers are corralled by agents to a degree and so that side of the transaction is condensed. There's a slight weakness there; it's not like a telephone network where everybody can be a receiver or a maker of the telephone call on the same terms.

> **When you're selling a multi-million-dollar home there's a lot more scope to squeeze in premium products.**

I remember driving around Sydney trying to find places to rent in the 1990s and you'd have the paper on your knee, circling classifieds hoping that the agent turned up. The internet has transformed the user experience of looking for a house or rental for the better.

It's vastly better – and that's the same for all of these platforms. In the newspaper, you had one page that had 100 ads. Online, each house, each car has its own page or more, with video inspections and 3D layouts. It's so much easier to showcase the value of what you're looking at. That increases the value and what you can charge for the service, especially in real estate. When you're selling a multi-million-dollar home there's a lot more scope to squeeze in premium products.

And that technology is developing all the time, allowing REA to improve its offer and charging just that little bit more for it. It's also increasing engagement with home owners in all sorts of other ways. It's recently launched the 'property owner dashboard', which allows you to put your house into the system and get regular emails telling you how much your house is worth, and the recent transactions. As a more engaged property owner, they can then serve you adverts to refinance your mortgage. Having recently purchased Mortgage Choice, they can even sell you the mortgage.

So there's still scope for REA to introduce new products to the agents that will help them do a better job of selling properties?

Well, they've got the agent services business, which they're trying to build and an agency marketplace, whereby sellers can pick an agent. There's all these add-on services REA can provide, enabled by the technologies on the platform.

Do you think REA might cut out the middleman - the agent - and sell properties directly to consumers? Or are they moving in the direction where the agents remain integral to the model?

I don't think you're going to get rid of an agent per se, because you're going to need someone to open the house up when people come and visit. People are still going to need to go to property inspections. You also need someone to advise on how to present a house, whether it's worth giving it a lick of paint, whether it's worth sorting out the garden, that sort of thing. Agents provide a service in that respect. But at the moment they're getting tens of thousands for a property sale and the platform is getting only a few thousand, compared to a few hundred for a classified ad. What I think we'll see is that value shift continuing, with the agents getting a little less and the platform more. Who knows how far that can go but I think it can go a lot further than it has already.

Let's talk briefly about the macro environment. There are some tailwinds that REA benefits from aren't there James?

The obvious thing is house prices, which tend to go up over the long term because wages go up so what people can afford to pay for a house goes up. That's certainly been the case over the last 30 years with interest rates falling, pushing up what people can afford. Either way, over the long term, house prices tend to go up, subject to ups and downs of course.

But you've also got an increasing population through immigration and births exceeding deaths, increasing demand for housing. This increases the market for REA's services.

With those tailwinds - population growth and inflation protection - this sounds like a business that creates pretty high margins.

Yeah, absolutely. The business currently makes an EBIT margin of around 50 per cent and most likely that's only going to go upwards.

REA is currently on a PE well over 50 and it's a long way away from where we'd buy it so this is one for members to understand rather than act on.

So there's network effects and first-mover advantage that's made REA the place to go if you want to buy or sell or rent a property. There's some demographic tailwinds, inflation protection and potentially higher margins from being able to squeeze agents a little bit more. Anything else?

REA is also moving into other areas like mortgage broking, and it has the international side of its business, which for the most part is at an earlier stage of development.

What about those overseas businesses?

With the PropertyGuru merger they're in Malaysia and Hong Kong, but also have 20 per cent of the Move business in the US, with News Corp the other major shareholder.

You don't often get chances to buy these kinds of businesses cheaply though, do you, James?

No, you don't. REA is currently on a PE well over 50 and it's a long way away from where we'd buy it so this is one for members to understand rather than act on. If we get a buying opportunity at some stage in the future you'll be first to know about it.

Wesfarmers WES

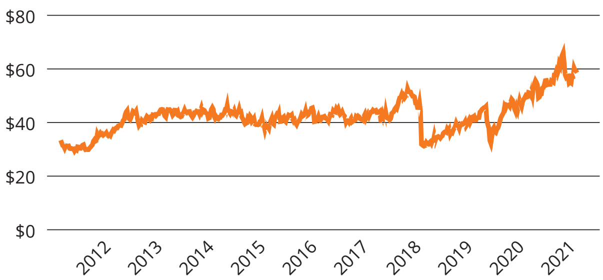
HOLD

BUY	HOLD	SELL
below $45.00	up to $70.00	above $70.00

$57.15

Price at 3 Dec 2021	$57.15
Max Portfolio Weighting	8%
Business Risk	Medium
Share Price Risk	Medium

Wesfarmers 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Let's now move onto an unconventional business. Wesfarmers is a conglomerate, which have been out of fashion for a long time. The world's most famous conglomerate, General Electric, recently announced that it will be broken up. Wesfarmers has managed to make a success of a business model that has fallen out of favour. How did it do it?

It does from the outside look a bit like a dinosaur. I was brought up in the UK very much on the conglomerate model, when it was going out of fashion with companies like Hanson and Tomkins, the guns to buns conglomerate which owned Rank Hovis McDougall and the Smith & Wesson guns business in the US.

Guns to buns, I love that line.

The idea was that they would buy underperforming businesses and work their managerial magic on them. Instead, they ended up with a disparate group of generally quite poor businesses. Like GE, it was a case of empire building. Eventually, the market got wise to the idea and now prefers companies to focus on one thing, letting investors get their own diversification. What I think makes Wesfarmers different is that the incentives aren't about sales growth and growth for the sake of it but return on capital. It's like Berkshire Hathaway in that sense.

> **It's a classic example of a retail business with the right formula which has been rolled out, without much competition, in an area where there's this obsession with property and doing up your home.**

Hanson and Tomkins eventually got themselves into trouble, earnings growth stalled and investors got fed up with them. That hasn't really happened with Wesfarmers. Even with Coles, they made some big early improvements but it got harder and harder. They then made the remarkable decision to just hive it off. Wesfarmers remains a conglomerate but it's not an empire builder. Coles was about a third of their profits when they demerged it, but they were happy to move it along and focus on other areas.

That's quite unusual in conglomerates, which tend to bring things together and keep them there. Is this a key difference in the culture of that business?

Yeah, absolutely, and I think it shows in the incentives. A lot of the old-style conglomerates were incentivised through short-term earnings per share, so they pursued transactions that provided that, which got them into trouble. Wesfarmers management incentives are heavily skewed towards return on equity and have long-term hurdle rates, with shares locked up for five years or more. A lot of the long-term incentives are based on return on equity. This has been built into the company from its very early days and filters through the company.

This is something that's hard to put your finger on but you can see it over time in the decisions made with regards to Coles and probably also in one of its better businesses - Bunnings. Why is this such a good business?

I love going to Bunnings. There's something about wandering around the store and seeing all the wonderful things they have there.

There is. I would go there for breakfast.

Yeah, that's right. It's a classic example of a retail business with the right formula which has been rolled out, without much competition, in an area where there's this obsession with property and doing up your home. Bunnings have been on that curve but they got the formula right from an early stage.

They've got the locations, the range and the brand. Whatever the project you can go to Bunnings and get whatever you need. That's a very powerful thing. There are economies of scale with that as well, to the point where it's almost impossible for someone to compete.

At the moment, it's a monopoly and a wonderful business making great margins. But if a competitor comes in and does a proper job of competing, the ultimate prize is going to be less attractive because it's split between two. That's where Masters was at really.

With Masters, there were site issues but it didn't seem as though it had the product range right, either?

Yeah, I think they were much more about homewares, which is slightly different. They never really won over the tradies. Bunnings gives you the impression when you walk in that anything is possible whereas with Masters – I may be exaggerating a little bit – you felt as though you were redecorating the lounge. I think it was a conscious decision to make it slightly different but that proved to be a mistake and the sharemarket didn't really have the patience with them to make the tweaks. People were screaming for them to get out of it from a very early stage and they did.

The result was that Bunnings got the market to itself. What kind of returns does it make?

Given everything we've said about returns on capital, this is where Bunnings really shines. Return on capital is a remarkable 82 per cent for 2021. It's had a boost the last couple of years because everyone's been tidying up their homes but EBIT margins are pretty decent at 15 per cent. But by generating a lot of sales per dollar of capital, it's able to get that up to a very, very healthy return on capital.

What about its other businesses, James?

Bunnings is almost two-thirds of Wesfarmers profit, a sizable chunk. The other businesses are okay but not brilliant. The idea is that you let management do its thing and let the culture work, and trust them to get rid of things that aren't performing well enough and make acquisitions and investments that will do well.

> **By generating a lot of sales per dollar of capital, it's able to get that up to a very, very healthy return on capital.**

The two main other retail businesses are Kmart and Officeworks, which have good brands but make half the margin of Bunnings. Officeworks makes about 20 per cent return on capital, Kmart's up at 50 per cent.

They're good businesses with strong market positions but nothing like as strong as Bunnings. That's about another quarter of the profits and then the final eighth or so comes from Chemicals, Energy and Fertilisers, CEF, which supplies things like ammonia nitrate, gas and now lithium – it's investing heavily in the Mount Holland Lithium Project. That's another example of management seeing attractive returns and making the investments. Where they see returns, they're very happy to make those investments so that's what's happening there.

The tiniest bit of the group, 2 per cent of EBIT is the industrial and safety division. It only makes a return on capital of 6 per cent, which is way below par. It makes you wonder why they keep it in the group and I don't have an answer for that. It might lend a little credibility to Bunnings in a funny sort of way, having those sorts of businesses in the group.

Woolworths WOW

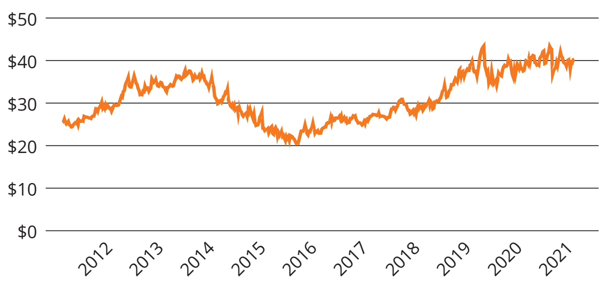
HOLD

BUY	HOLD	SELL
below $30.00	up to $45.00	above $45.00

$39.84

Price at 3 Dec 2021	$39.84
Max Portfolio Weighting	7%
Business Risk	Low
Share Price Risk	Low–Medium

Woolworth's 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Let's move from one retail-orientated stock to Woolworths and Coles. We're going to talk about these as a pair because of the obvious similarities.

Yeah, but Woolworths is really the superior business. Both are strong but Woolworths is a bit bigger, has slightly better economies of scale and locations.

Are these retailers where they work on volume at a very low margin or is there something else going on there?

There's something else going on. The big idea behind both is to make themselves indispensable to consumers, so the focus is on the customer and getting them into the store for a regular shop. Having the most convenient locations and a range of essential and frequently-purchased items is central to that. Once you've got them in the door you can sell them a whole heap of things and that's where they play around with price and margins. The margins on some products are much greater than others.

Things like milk, for example. They put it right at the back of the store and sell it cheap and don't make much margin. But it gets customers in the store and they pass everything else to get it. That's the nuts and bolts of the business model.

Coles Group COL

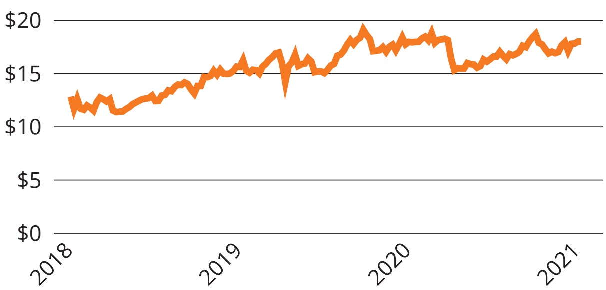
HOLD

BUY	HOLD	SELL
below **$14.00**	up to **$22.00**	above **$22.00**

$17.76

Price at 3 Dec 2021	$17.76
Max Portfolio Weighting	7%
Business Risk	Low–Medium
Share Price Risk	Low–Medium

Coles Group 4-year share price



Source: Capital IQ; 4 years to 3 Dec 2021

I remember when Aldi was expanding rapidly in Australia and there were concerns about it eating the lunch of Woolies and Coles. That didn't really happen. How important Is the idea of bringing people into the store central to the defence of these traditional supermarket businesses?

Fresh fruit and veg is key. It's essential, frequently purchased and customers want quality produce, which means going to a store. A convenient location means customers will tend to get all their other stuff at the same time. This is where the UK went wrong recently. The big supermarket groups opened these huge out-of-town stores to encourage a bigger but less regular shop. That's not what people wanted. There's a large body of people who will shop more frequently when given the opportunity with the right locations.

Aldi's got a different business model and does fine but it only has, I think, about 4,000 items on its shelves, whereas Woolworths and Coles is up towards 30,000. You just can't get by with only buying at Aldi. There are things that you need to go to Woolworths and Coles for.

The interesting thing about the strategy of getting people into the store is that you minimise the threat of online businesses. Are these businesses concerned about big online retailers disrupting their model?

I think it's a concern and that's partly why they're doing it themselves to compete. The convenience of online is slightly overrated, though. You might buy your toilet paper or dishwasher liquid online but, if there's a Coles or a Woolies nearby, you may as well get those items when you're getting the fresh food. The customer gets what they want immediately, often doing their own bagging, picking them off the shelves, scanning their own items and then driving them home. That's a big cost saving for the established chains, which is why it's often more expensive buying online. As long as they're in good locations, there's an efficiency and convenience in having the stores over online.

> **It's not like other businesses where some competitor steals their lunch; they can reset and repair themselves and that's really what they've done.**

You wouldn't ordinarily contrast a supermarket chain with online classifieds, but online classifieds transform the user experience while online retail, at least in terms of supermarkets, degrades it.

That's right. It goes back to convenience. With online, you have to give yourself a window. If it's delivered within two hours you've got to pay more but a four-hour window means you have to be home for the period. And you don't get to see the specials or pick the goods for yourself.

Are these the kind of businesses that any idiot can run or are they complicated?

Woolies was famously pushing its margin too hard a few years ago, got itself into trouble and had to reset. New management came in and almost halved the margin overnight. Coles is even more classic because when Wesfarmers took it over there was a whole layer of senior and middle management cut from the business. Over the years it had become very complacent. Remember Fletcher, a former Coles CEO who said he hadn't been in a supermarket for years?

Yeah, he was the former CEO of Brambles. He did his first interview, I think, with the media and said, "Oh, my wife normally does the shopping."

It was a remarkable admission. They've both got themselves into trouble but are incredibly resilient businesses. It's not like other businesses where some competitor steals their lunch; they can reset and repair themselves and that's really what they've done.

Woolies and Coles can also look to the US and Europe and see the innovations that are taking place there and pick and choose the ones that they want. That's an advantage too, isn't it?

That's right. It's largely how Coles reset after Wesfarmers took it over. They got Archie Norman from Asda, who was the king of grocery retailing in the UK. He helped them pick the management team to do the job, many of whom were also ring-ins from the UK. The chief executive, Ian McLeod, did a great job and, I think, for a few years was paid more than Goyder. It shows how Coles were prepared to make those sorts of decisions.

Okay, well that was a very interesting discussion of these three great businesses. I want to thank you for your time and thank you to the members for listening in.

Part 3

10 of the best

Cochlear and CSL

Competitive advantages don't get more embedded than having a company's product surgically implanted in your head and being locked into upgrades.

John Addis
Editor & Founder

Graham Witcomb
Analyst

Cohlear COH

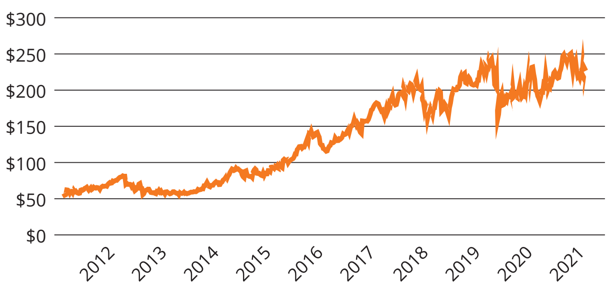
HOLD

BUY	HOLD	SELL
below **$150.00**	up to **$260.00**	above **$260.00**

$214.00

Price at 3 Dec 2021	$214.00
Max Portfolio Weighting	7%
Business Risk	Medium
Share Price Risk	Medium–High

Cochlear's 10-year share price



Source: Capital IQ; 10 years to 1 December 2021

Good morning, my name's John Addis, the Founder/Editor of Intelligent Investor and I have with me here today, Graham Witcomb. Good morning, Graham.

Hi, John.

Graham is our healthcare specialist and we're going to talk about two of the three healthcare stocks that have made it to our top 10 businesses list. Graham, we seem to do a good job of creating innovative healthcare companies in Australia. Any idea why?

Different countries have their little niches and Australia seems to do well at healthcare. We've got about 0.3 per cent of the world's population but around 3 per cent of its medical patents. We really do punch above our weight in biotech and healthcare.

Maybe it's got to do with the specialisation of labour, which keeps on perpetuating. Once you have big companies like CSL, Cochlear and ResMed, there's a pool of talent to build more such businesses. We've also got good research universities, which feeds this dynamic. And maybe it's easier to start new businesses here. But I don't have a firm answer.

What do you think is required to make a successful healthcare business?

It starts off with a big market. The world's healthcare industry is worth $10 trillion a year, one of the biggest expenditures of any country. You can't be a jack of all trades in healthcare because it's just such a large market. There's always going to be someone who's got more economies of scale. To succeed, you have to focus on one thing and just do it really well.

Does that imply high R&D focused on one particular niche?

Most healthcare businesses depend on their research capabilities, but the industry has a slightly different model to a lot of others. In the tech industry, innovations occur in-house and are typically commercialised that way, too. In healthcare, a lot of research is carried out in universities or in tiny start-ups where it's just a lone researcher who's gone off and done some study and then gradually built a team around it.

> **It's one of the few companies that you could really say built an industry from scratch. Cochlear implants weren't the first hearing device, but they were the first to electrically stimulate the cochlear nerve rather than amplify sound.**

Then the larger companies with their economies of scale, distribution networks and the rest of it, come in and buy these small start-ups or licence the research from universities directly. These bigger companies are good at getting the products to market and getting past all the regulatory issues, so there are some unique specialisations there.

So innovation largely comes from small companies and the marketing and distribution is done by big pharma?

That's exactly right. The big pharma businesses are really good at doing clinical trials, so when you see these huge numbers in the pharmaceutical companies they're spending on R&D, most of that isn't on the real innovation. There's rarely a eureka moment where someone is cracking a new molecule or something like that. Much of this money is in trying to get an initial idea with promise past the regulators through clinical trials, which can cost tens of millions to conduct.

Let's now move on to the two companies that have made the list. We first recommended Cochlear in July 1998 at a price of $6.38. It's now over $230 dollars, although we have sold along the way regrettably. Want to make a comment on that, Graham?

That's one of my biggest mistakes at Intelligent Investor probably. I remember putting a sell on it four years ago at around $120 dollars and it's of course doubled since. There was a good lesson out of that, which is why you may not have spotted me making the same mistake twice. Not yet anyway. Selling these really high-quality businesses can lead to very big mistakes.

With a business like Cochlear and the other one we're going to talk about, CSL, you do want to allow a big margin for these kinds of companies to get things right.

I think that's exactly right. James Carlisle once put it to me that you should leave a margin of safety on the upside as well, because high-quality businesses tend to surprise you nicely. The crappy businesses tend to deliver nasty surprises. So yes, you want to leave room for them to surprise you in positive ways; give them the benefit of the doubt and don't sell too quickly.

What problem does Cochlear solve for its customers?

It's one of the few companies that you could really say built an industry from scratch. Cochlear implants weren't the first hearing device, but they were the first to electrically stimulate the cochlear nerve rather than amplify sound. Normal hearing aids will just take the sound in and make it louder. Cochlear implants directly stimulate the cochlear nerve inside your inner ear.

Are you saying that the electrical stimulation that the implant creates is the same as the electrical stimulation that the nerve would create when it hears a sound in a normal fully functioning ear?

Yeah, exactly. It doesn't replace the nerve itself so you do need that nerve to still be there but it can kind of bypass that mechanical element of sound inside your ear and go straight to the nerve itself by releasing little impulses.

It's a mind-bending idea to think that could work but it's created an incredible business. Why is it so good?

Well, it's a kind of razor and blades model...

This is the Gillette thing?

Yes, you can sell the razor fairly cheaply and people will keep coming back to buy the blades, which cost a fortune. Cochlear works on a similar principle. You get the implant - the razor - surgically implanted into your head; you can't get it out. Then you're locked into the brand and, every four years or so, you upgrade the external sound processor to take advantage of new features and smaller size.

> **By connecting the cochlear implant's processor to your iPhone or another Bluetooth-enabled device, music can be streamed directly to the processor and then to the implant that stimulates the nerve.**

It's a special kind of brand loyalty, there's really nothing like it...

The ultimate brand loyalty. It's often implanted in kids' heads as they have the most to benefit from learning how to hear for the first time. That's a potential 70-year revenue stream.

Wouldn't the upgrades have a kind of declining rate of return in terms of performance?

In terms of incremental performance, they do. But the key element is that the patient rarely pays for the processor. Instead, the insurer pays and they usually have this rule that every four or five years you're allowed a new one.

What kind of margins does that lead to?

Very, very good ones. In terms of a profit margin, it's around 20 per cent or so and, before the pandemic, it was earning 40 per cent returns on equity. It's a phenomenal business.

Whenever Cochlear gets a new CEO it's striking how I've never ever heard of them because they recruit internally. How much does that feed into the management quality of the business?

We prefer businesses that hire internally but it's especially important for Cochlear because it's a complex industry and product. Internal appointments have the knowledge acquired from being with the company for so long. It's a much better transition as they're usually groomed for the position over many years. Current CEO Dig Howitt took over in 2018 but has been with the company for over 20 years.

Would you say that Cochlear has reached a point where it's become a natural monopoly?

Almost. Cochlear started as a natural monopoly but Advanced Bionics got in along the way. Cochlear has a 60 per cent share of the market now and Advanced Bionics about 25 per cent. Then there's a small third player called MED-EL with about 10 per cent. They don't tend to fight on price, preferring to compete on design and function instead.

Often a cosy duopoly is better than a clear monopoly because it doesn't attract regulatory attention.

Yeah, I think that's right. It's still a highly regulated industry but not in the sense of Sydney Airport or Transurban where a lot of oversight exists. Having three players in the sector seems to work well; they all earn pretty good returns. Cochlear could earn higher margins with its pricing power but it doesn't take advantage of that, keeping margins and returns on capital reasonable.

In regards to R&D, can you tell us about this new functionality that allows you to hook up your iPhone to the implant?

I was just blown away when it was explained to me by the company's management a few years ago. By connecting the cochlear implant's processor to your iPhone or another Bluetooth-enabled device, music can be streamed directly to the processor and then to the implant that stimulates the nerve. What that means is that sound is being streamed directly to your brain without it ever hitting the air.

Cochlear first looks like it's a device company, but there's a strong service component. What effect does that have on the business?

It's increasingly a service business. The implant is a huge portion of revenue each year but around 30 per cent is from sales of upgrades, batteries, repairs, things like that. As the customer base grows, more people need to keep coming back for these additional services. We expect that proportion to grow over time. This makes the company more stable.

I'm sure you'd love to get a chance to upgrade this business, Graham. At what price do you think that might happen?

Well, it's tough. It is a really good business but even the best businesses aren't worth infinite prices. We've got a buy up to $150 at the moment with a sell at $260. So, unfortunately, it's closer to being fully valued than undervalued. But this is a business that we would love to get our hands on again.

Isn't it normally the case with such high-quality businesses that something needs to go wrong to get a buying opportunity?

It'll probably take a product recall or something like that to really shake investors' confidence in the company. Investors who recognise Cochlear's intrinsic qualities and can look past those short-term news items might then get a chance to buy. Hopefully, we'll be among that group.

That's something to wait for. Let's now move along to CSL. We first recommended it in 1998 at a price of $9.60, it's now over $300 dollars. Again, we've had some sells along the way…

But it paid for the membership…

It definitely paid for the membership, no doubt about that, probably more than a few years. It was listed in 1994, I think, at $2.30, but this has been around a long time, hasn't it, Graham?

It was started in 1916 as Commonwealth Serum Laboratories as a vaccine maker for the Government and spun off much later, as you said, in 1994.

What problem does CSL solve?

It has two main business lines. Around 17 per cent of its sales are from vaccines but the other 83 per cent are from plasma-derived products – things like antibodies, haemophilia factor proteins, a few other bits and pieces like albumin. It's a critical company for the world's healthcare system in that it helps treat many rare immune system and blood diseases that don't have many treatment options. You can't get these antibodies from other sources; you have to get them from plasma.

CSL CSL

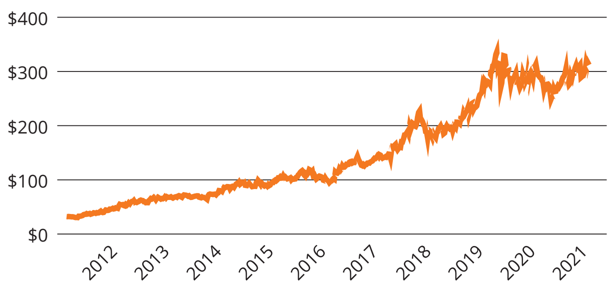
HOLD

BUY	HOLD	SELL
below **$230.00**	up to **$360.00**	above **$360.00**

$309.65

Price at 3 Dec 2021	$309.65
Max Portfolio Weighting	7%
Business Risk	Medium
Share Price Risk	Medium–High

CSL's 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

You can't make them synthetically?

No, although there are developments in the pipeline. Listeners will have heard about the latest vaccines around COVID-19 and how they're being developed in different ways. CSL develops its vaccines largely through chicken eggs - the old school way - but new methods are emerging.

How does CSL source its blood plasma?

It comes almost exclusively through the US and Germany. Any plasma products sold in the US have to be sourced in the US so the plasma makers decided that was going to be their primary source of extracting plasma, just to comply with this one regulation. Germany and the US, unlike other countries where donations are voluntary only, allow for paid donations of plasma. It ends up being mainly poorer people who give their blood but they're providing a really useful service to the world and they're being paid for it.

I remember a critical Four Corners episode on this subject. But if CSL stopped collecting blood in this manner I'm not sure that would improve their lives in any way.

> **It's usually taking an already invented or discovered molecule, or a new therapy or use case and taking it to market, via all of the different regulatory hurdles.**

CSL's caught in a tricky position. If the US banned pay-for-donations, plasma supply would drop tremendously. The world would then just run out of antibodies and factor proteins for haemophilia and all kinds of things.

And then presumably we'd start incentivising blood donation by paying for it?

Yeah, it would probably just move overseas to even poorer countries than the US, so it's a hard problem to solve. CSL is caught in a tricky position, but if someone's willing to sell their plasma for $30 and they're saving a life by doing so, it doesn't seem controversial to me.

What makes this a good business?

Well, CSL is a very large company with economies of scale and low capital requirements. Once it's built factories and fractionation plants there's a very low cost to putting more plasma through. As volumes rise, it gets more and more profitable. It's that fixed cost element that is important.

One of its unique qualities is it has the largest network of donation centres, Grifols and Shire being the other two. That gives CSL a unique advantage in that it's able to have a much more reliable supply of plasma. And it gets it cheaper than the others because of those economies of scale in its collection network.

There's quite a lot of competitive advantages there. If there was a shortage of blood products then CSL could pay more to secure a bigger supply?

The company uses all sorts of incentives like loyalty programs and lotteries to encourage donation but the government regulates how much people can give per month. The competition is more about collection rather than on-selling therapies.

So that shows up in good margins and returns on capital?

Definitely. CSL has a profit margin of 20 per cent or so and a return on equity of about 30 per cent. It's a very profitable business because of those protections combined with the economies of scale.

CSL seems to spend a lot more on R&D than its competitors.

It spends around a billion a year on research and development, with much of that tied up in clinical trials. It's usually taking an already invented or discovered molecule, or a new therapy or use case and taking it to market, via all of the different regulatory hurdles. It's not doing much initial innovation; many such initiatives are purchased from third parties, universities, start-ups, that kind of thing.

So this isn't the traditional pharma model that we were talking about earlier?

Yeah, it buys a lot of its research basically and then it does most of the development.

And it has got quite a long history of acquisitions as well, hasn't it?

Yeah, it does acquire a lot of these licences and has purchased a few large companies. Seqirus, its vaccine maker, was a combination of the vaccine maker bought from another competitor combined with CSL's own vaccine operation. Recently, it bought a gene therapy called AMT 61, which replaces the missing gene in haemophilia patients.

There's been a lot of innovation in haemophilia research recently and CSL has been falling behind. As a result, it has these earnings holes coming up. Purchasing a gene therapy like AMT 61 might end up replacing the gene inside the individual so the person can produce their own factor IX protein, bypassing future therapies.

What about management?

We're lucky in that all of the big healthcare companies in Australia are pretty well managed. Paul Perrault's been the CEO of CSL since 2013 and he's done a really good job. He inherited a very large, very old company and he still managed to double profits and revenues in his time.

Okay, well I think that's a great overview of two fantastic businesses, Graham. Thanks very much for outlining why they're such good businesses and here's hoping we get a chance to buy them at some stage in the future.

Yeah, I hope.

Thanks, Graham.

Thanks, John.

Part 4

10 of the best

BHP Group

Economies of scale are paramount in the resource sector, and no company manages them better than BHP.

John Addis
Editor & Founder

Gaurav Sodhi
Senior Analyst

BHP Group COH

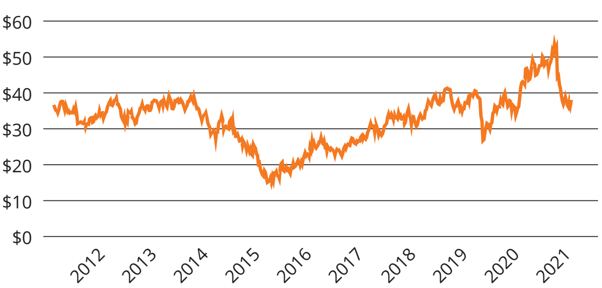
HOLD

BUY	HOLD	SELL
below **$25.00**	up to **$50.00**	above **$50.00**

$40.01

Price at 3 Dec 2021	$40.01
Max Portfolio Weighting	8%
Business Risk	Medium
Share Price Risk	Medium

BHP's 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Hello everyone, my name's John Addis, founder and editor of Intelligent Investor, and I have with me here today, Mr Gaurav Sodhi, the andalyst for BHP and all things resources. How are you doing, Gaurav?

Hey, John, very nice of you to refer to me as mister, it's much more respect than I'm used to getting around here.

This is the problem with young children, you get no respect.

We're here to talk about BHP, a business I've never owned because it seems to me it's reliant on iron ore and China, which probably grates with the Chinese, and has a history of failed acquisitions…

Spectacularly failed … it doesn't fail small, it fails big.

It really goes big. There was Billiton, Chesapeake Energy, Petrocorp, Magma Copper, Samarco. Have there been any more?

There's a long list.

And it seems to buy at the top and sell at the bottom.

Famously.

Why is this one of Australia's best businesses? It sounds terrible.

It does and if you're looking at the numbers it hasn't looked great for most of its history, but the superficial numbers hide its quality. When you look at core earnings and not the accounting profits, it's never made an operating loss.

Consider the crazy price cycles and how many wild events have occurred over the past 80 years and that's remarkable. It goes to the quality of those assets. The mistakes the company has made have not been operating errors but errors of capital allocation.

We had BHP on the top 10 list in 2016 when its recent history was more in question. We may have been premature but the company now has a five or six-year history of outstanding capital allocation. There's a genuine commitment to better capital allocation not just from BHP, but across the industry. This has been a big change brought about by a historic collapse in commodity prices. BHP's been at the forefront of that change.

So, you feel as though there's been a change in managerial attitudes and the cultures within these businesses as a result of the collapse in iron ore prices?

I do. BHP has always held excellent quality assets and allocated capital atrociously. The asset quality has improved. It's shed some of its weaker assets and bulked up on its best assets. The business has been simplified.

This is the best BHP that's ever existed, and maybe the best mining company that I've ever seen. I think you'll see a much better performance through the cycle now, which is already visible in the numbers. Commodity prices have not been booming but the returns have been colossal. I think you'll see more of that in future.

Let's go through each division then. We'll maybe do this on a commodity basis. Iron ore is BHP's biggest commodity and has produced astonishing returns. How is it that something that's so readily available can deliver such amazing profitability?

Iron ore is not a mining operation but a logistics business. It's taken a long time for people to understand this. The reason why it delivers such high profits and why outsiders have not been able to break into the enormous profit pool of the incumbents is because you have to invest maybe hundreds of billions of dollars of infrastructure to build out the transport network. This dirt needs to travel vast distances. Once you've built out the infrastructure to do that, any incremental increase in supply really comes from your own sources.

There are two big mining hubs for iron ore, one is in Brazil and the other is in the Pilbara. Most of the incremental increase in supply comes from those two sources simply because that's where the infrastructure is. Iron ore is so profitable because it relies on a vast volume of fixed cost infrastructure to support the movement of low-value dirt.

“

Despite booms in the iron ore price, over the past 50 years only one miner of scale has emerged anywhere in the world.

So being the lowest cost producer isn't really enough, it's the lowest cost when you deliver it to the customer at the other end?

Yes, but you also have to consider the different grades. Presently, Fortescue and BHP vie for the position of lowest cost producer but Fortescue probably gets 30 to 40 per cent less revenue per ton of iron ore than BHP because it lacks the grade to match international benchmarks. Fortescue is a good quality, well-run business but would never make a list like this is because it doesn't have the grade.

A lot of very smart investors disregard miners because they don't have control over the prices of their products. But they do have an absolute lock on a natural endowment. Marry that with a vast logistics network and that's an almost impregnable moat. Despite booms in the iron ore price, over the past 50 years only one miner of scale has emerged anywhere in the world.

Let's look at the demand side of the equation. Is there a danger in that Chinese demand for iron ore might reduce as the movement from rural areas to the city slows?

It's certainly possible. If you go back 20 or 30 years, the major customer for iron ore was Japan. Chinese demand didn't take off until the early-2000s when rural migration took off in earnest. If you take China out of the picture, it's true that the iron ore demand profile looks weak, but we can look at Japan's pattern of consumption to get clues about what might happen in China now that Japan is a fully developed, wealthy country.

> **BHP's copper business is high quality with lots of internal expansion options.**

Japan still consumes decent levels of iron ore, as does Korea. Once you've built an infrastructure base you still need steel to maintain it. All those people who move into the cities don't just require houses, they require cars and a whole lot of items that require aluminium and steel. I think the demand profile has permanently changed. I don't think it's going to go back to what it was 20 or 30 years ago.

So this is a defensive, high-profit business that isn't as cyclical as it appears. It's well-positioned in that sense.

And it doesn't require booming iron ore prices. If iron ore prices went back to being $50-60 dollars a ton, BHP will still make 20-30% returns on capital in its iron ore business. BHP and Rio together are probably the best mining assets in the world.

BHP has been a long-term coal producer. What's happening in their coal businesses?

BHP has traditionally specialised in metallurgical coal which is a really high grade, high energy coal that you throw into a furnace, burn it off and get concentrated carbon that you add to the steel making process.

Australia has the best endowment of metallurgical coal in the world. Over in the Bowen Basin in Queensland, we get 30- to 300-metre-thick coal seams, whereas in the rest of the world you'd be lucky to find three-metre coal seams. Nothing compares to it. This is controlled by BHP, with a logistics network established over decades to match.

Like iron ore, coal is a low-value product that requires transportation. You don't have to move as much bulk as you need to move with iron ore, but it still requires a large logistics operation. BHP used to have a large thermal coal business but has sold almost all of its thermal coal mines. They've made a decision not to do thermal coal anymore and to focus on metallurgical coal.

And why is that?

They say it's because of ESG reasons, and there has been investor pushback on the issue. It's quite unattractive for investors and banks but it's probably more rational than that. Thermal coal is a declining commodity. In 20 years it's hard to see a lot of volume coming from thermal coal mines. BHP has got out at reasonable prices. It's another surprising example of good timing and management from the company which we're not used to.

What about the petroleum business? There are some big changes there, too.

The petroleum business is not world-class but the company is probably a top-20 oil producer with a similar-sized operation to Woodside, perhaps slightly better. It generates lots and lots of cash flow. BHP has made the decision to hive the entire oil business off to Woodside. Again, some claim this is for ESG reasons but it also makes a lot of business sense.

Electric cars are coming and transportation is a huge user of oil. There's no doubt that demand for oil is going to fall over the next 20 years or so. This is another example of BHP trying to protect its business by hiving off oil assets which were arguably some of the weakest assets in its suite.

In the decarbonisation process, copper and nickel are central to the electrification of everything. What about these two businesses?

BHP is such a high-quality copper producer, operating Escondida in Chile, the world's biggest copper mine in a joint venture with Rio and another party. It's an extraordinary resource, almost too good in fact. A mine that's so profitable often ends up with too many stakeholders trying to take bits and pieces of it. At Escondida, the Chilean Government, unions and other stakeholders have probably taken a higher stake of the profits than in other copper mines BHP runs. But there's still excellent copper mines elsewhere in the empire.

Copper is what they call a future-facing commodity. It's needed for electric vehicles and is central to economic development. It's needed to electrify grids and modernise economies. BHP's copper business is high quality with lots of internal expansion options.

Where they are looking to grow is nickel and potash. In 10 years' time, they'll be much more important parts of BHP.

What is it about potash that's so attractive?

There are a couple of industry characteristics that are super-attractive. Again, it's like iron ore, a digging operation superficially but a logistics operation in practice. You have to move a lot of dirt and install a lot of rail and port infrastructure.

BHP is doing that at Jansen, its potash mine, over the next decade or so, investing probably $8bn to $10bn and maybe more. In stage two it'll probably have to double that investment again. This is a huge commitment to potash, a global oligopoly with a couple of basins in the world that control supply.

And this is used primarily as fertiliser, right?

Yes, that's correct. Let me get this right, it's potassium I think it adds to the soil. I think that's right – I did agriculture in high school and I used to know all this stuff …

You kept that quiet.

I've forgotten all of that now. But, yes, potash is vital as a fertiliser and this kind of hard rock potash is particularly valuable. The industry structure is a cartel. The great attraction for BHP is that this mine is huge and world-class. If they can get it into production, they can take advantage of cartel-like prices without having to abide by cartel rules. The returns are potentially quite impressive.

So they're trying to do with potash what they did with iron ore?

Exactly. They're not just building a mine, they're trying to establish a potash basin in Canada and building infrastructure to support a 100-year operation. A lot of these moves show a level of long-term thinking that had been sorely lacking at BHP, and other miners for that matter. BHP has a plan and it may be the first time in a long time that they're working diligently and in a disciplined way towards it.

It seems unusually long-term orientated for this business.

Yeah, it is. BHP has been richly rewarded by the market for good management and for running these assets really well. There's been a cultural change in the business, which you can see from the procurement side. To be a supplier to BHP used to be wonderful; now it's akin to being a supplier to Woolworths, a low-margin hassle that helps with volume and little else.

> **BHP's been an unlucky business for most of its existence. This is the first time I've seen them being kind of lucky.**

That's interesting. What about nickel then, how is it used in modern economies?

Nickel traditionally has been used in the steel business to coat steel to create stainless steel. Now it's a key component in batteries. There are two different types, a sulphide which is a rock nickel and very easy to process and laterite nickel, which is trapped in rock. You have to do all sorts of magic and trickery to get the nickel out.

Most of the nickel being mined is laterite, which is really a chemical endeavour rather than a mining one. Due to the complex processing, a few years ago BHP actually tried to offload its nickel division but because nickel prices were weak at the time, no-one wanted to buy it. Then they realised that if they hang onto it and maybe grow it a bit, they're really well set up.

If BHP can expand this operation it could be very profitable because nickel demand is changing from being steel to battery orientated. I hesitate to say this out loud, but BHP's been an unlucky business for most of its existence. This is the first time I've seen them being kind of lucky.

Let's just talk about Olympic Dam, which feels like an orphan child, but it also has some potentially long-term interesting assets, right?

> **They haven't cracked the processing puzzle but if they do Olympic Dam could be an absolute bonanza.**

BHP picked up Olympic Dam when it took over Western Mining. It's been predominantly a nickel-copper mine for about 20 years or so and has really underwhelmed. It doesn't get much analyst attention because it's not a huge part of BHP in terms of profits, but if you look at this as an orebody, it's one of the top-two in the world.

The best without a doubt is the Norilsk Mine, a copper-platinum-silver mine in Russia. I don't know how many billionaires have been minted from that business but it's astonishing. Olympic Dam is probably the next most valuable orebody that I've seen. The reason it hasn't been profitable is that the separation is really devilish, the metallurgy is really hard and it also contains a heck of a lot of uranium. When you have uranium mixed in the ore it's quite hard to deal with. But it contains 25% of the world's known uranium volumes. So Olympic Dam is one of the world's top-five copper bodies, top-five gold orebodies and the top uranium resource in the world.

And uranium has been out of fashion for a while, but you can see things are getting to the point where we might have to start using more nuclear power. Is that why they're hanging onto it?

I think so. They haven't cracked the processing puzzle but if they do Olympic Dam could be an absolute bonanza. You can see BHP being the world's biggest supplier of uranium in 15 years and it will certainly add to its gold and silver and copper resource as well. It's potentially another profit pool on its own if they can crack it. We should remember that as another leg of super-profitability for BHP if they can get it right.

That's the case for BHP being one of Australia's top 10 businesses, it's got some fantastic high-margin commodity-based assets but there are some sleeper assets there as well that might be worth a lot more in the future as economies start to shift towards a different kind of energy base that they've had in the past.

And all BHP has to do is not stuff it up.

It's been a fantastic overview of the business, Gaurav, I'd like to thank you very much. I hope the members have enjoyed it. That's the case and thank you very much.

Always happy to talk BHP, John.

Part 5

10 of the best

Commonwealth Bank

Banking is a century-old business, but with sticky customers and rock-solid brands, Australia's banks can be highly profitable over the long term.

John Addis
Editor & Founder

Nathan Bell
Research Director

Commonwealth Bank CBA

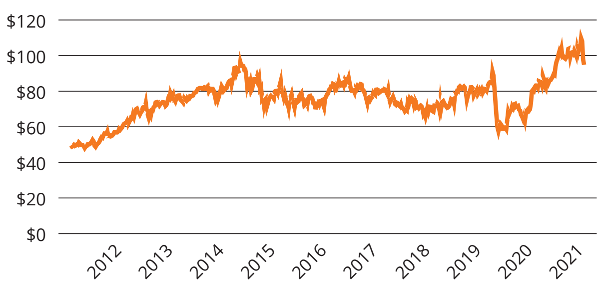
HOLD

BUY	HOLD	SELL
below **$60.00**	up to **$120.00**	above **$120.00**

$93.91

Price at 3 Dec 2021	$93.91
Max Portfolio Weighting	8%
Business Risk	Medium-High
Share Price Risk	High

CBA's 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Good morning, everybody. My name's John Addis. I'm the founder and editor of Intelligent Investor and I have with me here Nathan Bell, our research director and fund manager, to talk about Commonwealth Bank, one of our 10 best businesses. Nath, can we start off by telling the listener how banks make money?

I think when people look at banks, particularly for the first time, they look complicated. The simple fact is that a bank makes money by earning a spread margin between the amount it charges for the loans it makes, for things like mortgages and credit cards, and what it pays depositors. Customer deposits are about 70-80% of their funding source, with the remainder raised in US and European credit markets.

That difference is what we call the net interest margin. That's the money they get to keep after they've made all their loans, minus the cost of raising the money to make them. It doesn't take into account any bad debts or anything like that, or expenses, just pure revenue if you like. If you understand only one thing about banks, the net interest margin is it.

If you could only choose one metric to evaluate a bank, that would be it?

Yeah. Interestingly, if you go back 15 years, the net interest margin for the big banks was over 4%. It's since collapsed to below 2%. Part of that is because you can't reduce deposit rates any further than zero. Although they could be negative, that hasn't happened so far. This has squeezed their margins. There's also been increasing competition but the important point is that the return on equity of the banks has come down from where it used to be.

It hasn't collapsed to single digits as it has in places like Europe but it is much lower. Lending volume has offset this decline. Over the past 30 years, consumer debt in all its forms has risen. So that volume has offset the decline in the net interest margin. There's been market consolidation as well. Ironically, given the attention fintechs get, it's a less competitive market than it's ever been.

> **CBA has the largest customer base, and banking is a game of scale. If you are the biggest bank with the most customers, you can offer the best prices and still make the most profit.**

We'll get onto that. There's a lot of news media around digital finance, but not much evidence in the bank's results that they're having much impact. Can we first talk about the macro factors that investors need to consider? What about recessions? We seem to have abolished them.

We saw in the bear market last year how governments stepped to support the banks. There's more government intervention in banking markets than there's ever been. During the GFC, the RBA and the government got together and allowed the banks to use the government balance sheet to support their businesses. This is what I personally dislike about the government's behaviour towards the banks; they take on all the risk but there's no penalty for doing so when it goes wrong.

That's kind of good for CBA shareholders, isn't it?

Absolutely, it is. There's a couple of other advantages as well. CBA has the largest customer base, and banking is a game of scale. If you are the biggest bank with the most customers, you can offer the best prices and still make the most profit. That's really powerful. Then there's the unwillingness of customers to change their banks because it's such a pain.

You can refinance your mortgage somewhere else, but you're likely going to continue to get the best rate by sticking where you are and renegotiating. That's how the biggest bank can retain customers without affecting its profits.

This is an interesting point. Commonwealth Bank, as the biggest home loan lender, is able to negotiate better rates on those funding sources.

Absolutely. The Achilles heel of the Australian banks is their overseas borrowing and the funding mismatch. They're lending long and borrowing short, and that never goes away. What we've seen recently is the government has no appetite for a bank run or for anyone to really pay for bad lending. They step in every time something even looks like it's about to go wrong.

Let's talk about the competitive environment. The fintech sector is getting a lot of publicity. How is Commonwealth responding to those potential threats?

Commonwealth is well ahead of the other majors in terms of offering more modern services. Most recently they've offered cryptocurrency services, which makes perfect sense to me because it helps retain customers. The key to being a really profitable bank is not selling a customer one service but selling them a third or fourth service.

The other reason I've been quite sanguine on the competition from the sort of newer finance businesses is that there's a huge regulatory hurdle. Anyone that wants to lend a lot of money has to hold lots of capital on the balance sheet to make the loans. It's all well and good for a small, neo-finance company, as we've seen in the UK, to start lending a bit of money and make some profits.

The problem is if they are really successful with a great product or service, they need a big balance sheet to facilitate growth. This puts the major banks in a great position because they have deep pockets and are friends with the regulators.

That's right. APRA probably prefers a small number of big banks over lots of small ones. What about these new fintech start-ups? The big four seem deeply involved.

I think one of the biggest issues they have is the culture. We're seeing billions of dollars get spent every year to upgrade decades-old IT systems. This is where these incubators are quite good. But the majors have the marketing and distribution heft behind them. They can buy them out or invest in them and run them as separate operations when they got to a point where they pose a threat.

I think the parallel here is News Corp. When they saw how classifieds were moving online, they took stakes in the online classifieds businesses to protect their existing franchise. This could be a similar strategy for CBA?

People probably don't know that a lot of these new finance companies are backstopped by the banks anyway. A recent recommendation of ours is **MoneyMe**, an online lender. It offers an excellent, quick way to get auto loans, for example, but the financing, I think, comes from Westpac.

> **There's not much management can do to boost profits. Banks are at the mercy of credit growth in the general economy to increase their profitability.**

You can see a future where these start-ups are the front end for the big four's loan book?

It's fairly similar to the big telcos, which white label their networks to other carriers. It's similar in that the big banks want volume; they don't necessarily need to go out and advertise directly to customers if they're funding all of these new start-ups. The margin may be lower but the volume should compensate.

Let's talk about Commonwealth Bank's management. They seem to be doing a good job in responding to these competitive threats.

I'll get one thing off my chest first. I get frustrated when people still talk about banks as great investments. There was a time where they were incredible. I'd say that probably ended about seven years ago. Up until that point, if you'd owned Commonwealth Bank in particular, since it floated in the early '90s, you've made a 14.5% annual return, excluding franking credits. The share price today is much as it was in 2015, despite a rampant credit boom.

Now people are focused on the dividend. That's important because CBA has had the least managerial problems and adverse media headlines than the other big three. But over the last seven years, shareholders haven't done that well. Alternative investments like Apple or Google, probably two of the biggest and safest businesses in the world, have shot up. It demonstrates how mature the banks are.

There's not much management can do to boost profits. Banks are at the mercy of credit growth in the general economy to increase their profitability. You can switch the price or pull the price levers a little bit, but managers are really just trying to keep costs low and minimise things like bad debts and adverse media headlines.

This is an important point in how members think about these 10 best businesses. We're not saying they're the 10 best investments. We're saying they're really high quality, predictable, reliable franchises, and Commonwealth Bank is most certainly that. But it tends to trade at a premium, whether it's earnings or dividends or price to book, because of that quality. Most brokers have a sell on it currently, which is unusual. It's important for people to understand the difference between the quality of a business and the price at which it trades.

That's certainly true. Commonwealth Bank's share price fell about 15% after its result. One of the reasons was its premium to the other banks but now people are starting to realise there's only so much the bank can do. The competition's heating up in the mortgage market, and that's showing up in lower net interest margins and lower return on equity, which is how most banks are valued.

In the UK after the GFC, the competition for mortgages was intense. It was really tough going and still is. Even though they looked statistically cheap back then, they've stayed that way. We're starting to see this in Australia now. There are only so many loans to make in Australia. I mean, who's left that hasn't got a loan yet?

> **It really eats me up that I have to hold any banks, particularly CBA at the current price. But we're way underweight the banks with, I think, about 5% of the portfolio in the sector compared to 17 or 18% for the index.**

Probably half of them work in the offices of Intelligent Investor, including myself. For the rest, there's the bank of Mum and Dad, which I think is the fifth-biggest bank in the country. There's not much a bank can do now and competition is increasing. You've got Macquarie, for example, coming in and taking a cut. They're happy to earn less because they're smaller and don't have these huge expectations from shareholders.

What kind of environment can you imagine where we get a chance to upgrade Commonwealth Bank?

I know one of our members was very frustrated with the fact we didn't upgrade the banks during the bear market last year, and the banks are up a lot since then. I was quite happy that we didn't upgrade the banks and instead upgraded 20+ stocks that have gone up anywhere from two to five or six times since. The banks were simply not worthy of a place among our best ideas.

This member was looking at the returns since the bear market but our perspective is longer than that. We're looking at future returns over the next five years and that counted the banks out. The banks have really nowhere to go and no-one's expecting any growth. The only reason earnings are growing at the moment is because they're replacing or winding back all those bad debt provisions. You shouldn't really expect much more than the dividend yield, because they're priced so highly.

They're old, they're huge and we've had the biggest credit bull market in history, and yet the returns have still been poor over the last seven years. You really need to pay a cheap price to get decent capital gains on the banks. And that's usually when we're going through a really deep bear market when there are so many other better opportunities.

In my last presentation for our income fund, I covered a company that had grown dividends really fast and was now trading on the equivalent of a 9% yield, had you bought the stock nine or 10 years ago. The price had also risen tenfold compared to the banks' gains of 40 or 50%. That was CSL versus CBA, so tell me, which is the better income stock?

This is a really important point. Because banks have been such a good investment for the last 25 years, it's created this mentality that it's always going to be like that. It's important for members to understand that the future probably doesn't look much like the past for the reasons that you've described. Whilst we like the quality of Commonwealth Bank's franchise, and its ability to hold onto customers, and be a source of funding, in terms of the opportunity cost of investing in something like a bank, that's something that members really should consider. I've never owned a big bank stock, and it's really not hurt my performance at all and it's probably taken away a little bit of risk.

I've been talking about this for 12 months now but I think people have to think harder about the dividend stocks they're going to own. Obviously, I'm picking out the best stock here but it makes the point. Pinnacle has been a key stock for our income fund. It got down to $2.50 during the bear market and has gone up about five times. Net profit and dividends have grown around 50% a year for the last four or five years and I expect that to continue. I'd much rather get a starting 1 or 2% yield in a business that can grow its dividend by 50% a year for the next five to 10 years than get 3.5% starting yield that's almost the best it can do.

You've got Commonwealth Bank in the Intelligent Investor Income Fund. Are you happy to hang onto it for income purposes?

It really eats me up that I have to hold any banks, particularly CBA at the current price. But we're way underweight the banks with, I think, about 5% of the portfolio in the sector compared to 17 or 18% for the index. The Income Fund has performed extremely well recently but the dividends have been low for the last 12 or 18 months. That's because a lot of the businesses we've been buying have been cheap but have cut their dividends.

I want to keep some banks in the fund because we're getting the dividends and it is an income fund, not another growth fund. Westpac looks a bit cheaper now but CBA is still the premium pick. NAB's share price hit $26 but until recently it'd been trading around $20. I remember buying shares in NAB at $19.50 when I was 18 years old. Commonwealth Bank is the only one that's stayed out of trouble and stuck to its knitting.

That's a perfect place to finish. Nathan. Thanks a lot for your time.

Thanks very much, John. It was a pleasure.

Part 6

10 of the best

Ramsay Health Care

Australia's largest private hospital operator didn't have it easy during the pandemic, but scale, barriers to entry, and real estate will ensure a long life ahead.

John Addis
Editor & Founder

Graham Witcomb
Analyst

Ramsay Health Care RHC

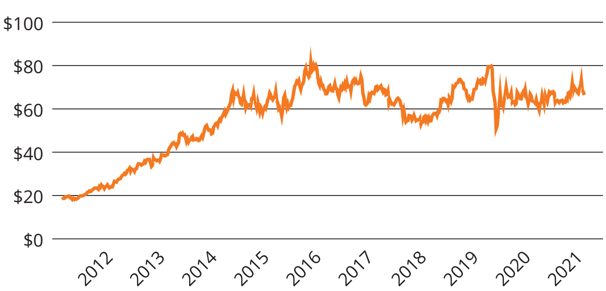
HOLD

BUY	HOLD	SELL
below $50.00	up to $90.00	above $90.00

$66.84

Price at 3 Dec 2021	$66.84
Max Portfolio Weighting	7%
Business Risk	Medium-low
Share Price Risk	Medium

Ramsay Health Care's 10-year share price



Source: Capital IQ; 10 years to 3 Dec 2021

Good morning everybody, my name's John Addis, I'm the founder and editor of Intelligent Investor and I have with me here today, Graham Witcomb.

Hi, John.

Graham's here to talk about the third healthcare stock on our list of top 10 businesses. There was some controversy over whether we should go with Ramsay or Reece, which got about 10 or 15 more votes. In the end we decided on Ramsay, although it doesn't get much coverage. Why is that Graham?

Yeah, it is an interesting one. It's a company that lots of people will interact with but, because you're not necessarily thinking about its brand or anything, it doesn't get the same limelight as a business like Reece.

What does Ramsay actually do?

Ramsay is a private hospital operator. Around 35 per cent of Australia's hospitals are private, the other 65 per cent are public. Ramsay is the largest operator of private hospitals, dealing mainly with elective surgeries.

I've never had private healthcare insurance. What is elective surgery?

It's non-emergency surgery. If it's not being done immediately and the doctor is giving you a choice, then that's elective surgery.

And that's a money-spinner?

Yeah, hospitals are able to charge higher margins on it compared to their other offerings.

And they got quite a few hospitals offshore as well?

Most of Ramsay's hospitals are now offshore after it recently purchased more overseas. Traditionally, Ramsay has been Australia's largest operator but it also has a strong presence in France, where it's been many years, and it also has a large network in the Nordic countries.

Running a hospital network is vastly different to the two other healthcare stocks on the list, Cochlear and CSL. What's a good way to think about hospitals in terms of their business model?

The first thing that comes to mind would be something like infrastructure. Hospitals are a social necessity and have stable revenues and demand. None of that changes much unless you've got a pandemic, as we've learned.

They're also similar in things like utilisation rates as a means to improve margins. Hospitals could also be thought of being like restaurants or property developers, where the main goal is to improve utilisation of a particular space to earn better returns on capital.

There are huge upfront costs of building a hospital and so in order to make that a reasonable investment, you need throughput.

What about managerial skills in such a business?

Hospitals operate on fairly thin margins so there can be big differences among competitors based on how good they are at negotiating with insurers and suppliers, that kind of thing. Hospitals don't require much managerial oversight as hyper-competitive sectors like retail, for example.

And there are demographic tailwinds as well in this industry?

We're all aware of the ageing population, which increases the demand for treatments. There's also a counter-demographic change, in that people are using private health insurance less because the costs keep going up. Although the population is rising and ageing, if new arrivals end up without private health insurance they go to public hospitals, not Ramsay's.

Where is the interplay between the public and private sectors? The overlap is there somewhere, but it's hard to see it.

The public health system takes care of more mental health issues and emergencies whereas there's a bias towards elective surgeries for the private operators. They do compete but that's mainly down to whether people take out private health insurance. Once they've got the insurance, they generally go to a Ramsay hospital. The customers don't pay Ramsay though, they pay their insurer, which then pays Ramsay. The decision between using a public and private facility depends on availability, location and whether the patient has private health insurance.

> **Many of Ramsay's hospitals are regional monopolies. The main competition is in attracting doctors and staff.**

So there are some geographic protections here in that hospitals tend not to be located next door to each other?

Yeah, you're right. Ramsay's the largest operator with 25 to 30 per cent of the private market. Brookfield, which purchased Healthscope, is the next largest with maybe 15 or 20 per cent. They don't overlap geographically too much. Many of Ramsay's hospitals are regional monopolies. The main competition is in attracting doctors and staff. This has become a huge issue since the pandemic as there's a lot of staff shortages, particularly in the French hospitals. Attracting staff will be an increasingly important way that they compete, but they don't compete on prices or even the direct to consumers too much, I think.

So the private sector is dominated by the big two, there's lots of competition for doctors but not much else. What about operational leverage in this sector?

The upfront construction costs are huge, probably higher than any building, I would think, on a per square metre basis. Hospitals need to amortise those costs over time so you don't see the operating leverage show up instantly in the financials because those costs aren't flowing through at the same rate, but they are there.

Would a good comparison be airlines, where you have this high upfront capital cost and then your job is just to make sure you sell the seats?

Yeah, there probably would be some of that. Ramsay has different models. Hospitals are either leased, rented or owned outright. There is a similarity with those it owns.

> **"Ramsay's been one of the biggest pandemic losers because the lockdowns prevented people from getting elective surgeries.**

And as Ramsay gets bigger, I imagine, there are more opportunities there for efficiencies and more negotiating power with the insurers?

That's right. As it gets bigger, it has a lot more purchasing power for things like bandages, which it can buy in bulk. On the other side are insurers, which is perhaps more important. Every few years it renegotiates with the different private health insurers for the different line items and overnight stays and all the rest of it. As it grows, its negotiating position strengthens.

Okay. Is it possible Ramsay could get more competition from offshore?

Well, Australia is a pretty mature market already. It's not a fragmented industry in the way of some European countries, or even in the US. I would assume that if there's competition chasing that kind of aggregation model, they're going to do it in one of those countries before targeting Australia.

So Ramsay's got Australia sewn up?

Pretty much. The only thing it has to worry about is the falling private health insurance uptake.

So, there are large barriers to entry, little competition and revenue should grow over time with the demographic tailwinds?

Exactly. Even though declining participation in private health insurance is a challenge, ultimately people have to get treated somewhere. As participation declines, fewer people will be using Ramsay's hospitals, which leads to longer wait times at public hospitals. How does the Government do to respond to that? They then start outsourcing more work to Ramsay, which we've seen through the pandemic. The States have been buying capacity from Ramsay to keep them open. Even if there's a further decline in participation, I think Ramsay's beds will still be filled, it'll just be under a different model to what it's done in the past.

Well, if there's this huge upfront cost to build a hospital but there's another one over there running at 80 per cent capacity, you'd imagine governments would buy that additional 20 per cent?

Absolutely. As utilisation rates fall because of the decline in participation, Ramsay is going to become more agreeable to whatever rates the Government offers to fill those beds. There's no point having an empty bed in Australia when you've got wait times as they are.

What about COVID and its impact on the sector and Ramsay in particular?

Well, it has been one interesting show to watch over the past 18 months. Had you asked me two years ago, who benefits the most from a pandemic, hospitals would have been top of my list. But it's been the opposite. Ramsay's been one of the biggest pandemic losers because the lockdowns prevented people from getting elective surgeries. In addition, the Government effectively forced the private hospital operators to reserve capacity for any increase in need from the pandemic, but those arrangements were made at cost. So, although Ramsay had to isolate part of its hospitals for the Government, it was not earning any return.

Using the restaurant example, it was like slashing the floorspace and then only being able to charge diners for the cost of the food. Profits were basically halved.

Are there any signs of that bouncing back yet?

Yeah, there have been. Just in the last couple of quarters, you've seen that underlying demand return since the lockdowns ended.

> **There's something to be said about those quiet achievers that just keep compounding slowly year to year and one day you wake up and realise you've doubled your money.**

Let's talk briefly about the growth options. This international expansion, how well has that gone?

Pretty well. There isn't a great history of Australian companies expanding overseas and doing well but Ramsay has, especially in Europe. Management deserves credit for that because hospitals don't have the same kind of operating efficiency or economies of scale as you might get with something like Sonic Healthcare where there are benefits to growing within regions. In France, for example, about 15 per cent of the market are charitable hospitals. It's hard enough competing against the likes of Healthscope, let alone operators that don't even try to make money. I think they do well.

What about management? Does it have a good track record in acquiring these businesses and getting these foreign operations up and running?

Yeah, definitely. Craig McNally, the current CEO, has been around since 2017, but he was the Chief Operating Officer before that. He's been at the company since the 80s. We always like to see managers rising through the ranks, proving themselves at every step of the way before reaching the top. It's a much lower risk proposition than trying to hire some glamorous guru CEO from outside.

Is there anything else?

Well, it's hard to say that Ramsay flies under the radar as it's one of the largest businesses in the country but there isn't much press about it. Maybe that's because it's a reliable business with predictable margins and revenues year to year. There just aren't those big surprises that make news.

I think this is one of the central points about this list. Most of the businesses on it are reliably improving each and every year and have very few things that can bring them undone.

Yeah, there's something to be said about those quiet achievers that just keep compounding slowly year to year and one day you wake up and realise you've doubled your money, without some massive event or product release.

Okay, Graham, I think we'll end it there. Thanks a lot for your time.

Thanks very much, John.

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