SPECIAL REPORT

The Dividend Advantage Mini Portfolio:

Five income stocks better than the banks

Investing with an eye on dividend yields is one of the surest ways to earn higher returns.

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About Us

With over 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.

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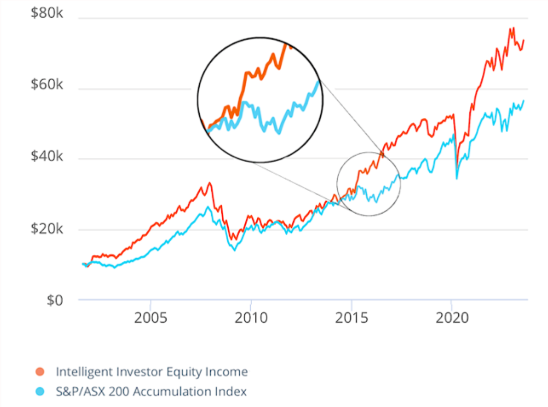
Multiple studies have found that buying a basket of stocks with above-average dividend yields tends to outperform the overall market. The strategy works whether you're talking about individual stocks, funds, or even whole countries.

A dividend focus may also offer the best protection in down markets. In **Contrarian Investment Strategies**, David Dreman compared the effectiveness of several value investing styles. He found that all value strategies outperformed the market during a downturn, but the high dividend yield strategy performed best.

Our own experience weaves a similar tale – our **Equity Income Model Portfolio** has returned 9.92% a year over the past 10 years compared to 8.03% for the overall market. Most of that extra return was earned during the bear market of 2015 and through the recent pandemic slump; the portfolio earned 6.47% a year over the past three years compared to the index's 7.44% (see Chart).

Chart 1: Intelligent Investor Equity Income Model performance



Source: Intelligent Investor

You may notice something else from the chart. The outperformance during rough times is interspersed with mediocre performance during boom times. If a strategy is truly worth its salt, shouldn't it perform well under all conditions?

The short answer is no – dividend strategies are a trade-off, not a way to game the system.

By their nature, dividend-focused portfolios – including our **Equity Income Fund** – own fewer stocks than the market as a whole, which can make them more volatile.

What's more, they tend to home in on large blue-chip companies with steady revenues. The Equity Income Fund, for example, has a 4.6% and 3.5% position in **Wesfarmers** and **Brickworks**, two stocks whose income barely wavered during the pandemic.

This means that when the economy is booming, and the market is on a tear – as it was from 2016 to late 2019 – these steady eddies of the investment universe are often left behind. The cost of stable earnings is stable earnings.

Focusing on stocks with above-average yields isn't an all-season strategy – there will inevitably be periods of underperformance, sometimes lasting years.

Indeed, the Equity Income Fund was listed in June 2018 and it trailed the S&P/ASX 200 Index for its first couple of years due to its limited exposure to growth and glamour stocks.

However, it’s those periods of underperformance that allow for outperformance over the long term. If a dividend strategy worked all the time, everyone would just buy income stocks, pushing up their share prices and killing future returns. The fact that it doesn’t work all of the time is what lets it work over time.

When the pandemic hit – right on cue – investors started clamouring for sturdy businesses with defensive earnings. The Equity Income Fund has returned 14.18% a year since July 2020, clobbering the S&P/ASX 200 by almost 1.81% a year (past performance is no guarantee of future results).

This was an unusual period; returns won’t always be so rosy. Nonetheless, over the long term, investing in a basket of income stocks tends to add a percentage point or so to your yearly return, and for three simple reasons.

The first is that it indirectly selects undervalued companies. Buying for yield isn’t fool-proof, which is why your analysts at Intelligent Investor take many different factors into account when valuing stocks, such as their competitive position, balance sheet strength, growth potential, etc. Not all stocks with high yields are cheap, but cheap stocks do tend to have higher yields.

Secondly, dividend strategies have some major advantages over other selection methods. Dividends are real cash delivered to your bank account, not a mystical earnings figure reported by the company and prone to accounting manipulations. Nor are you relying on intangible assets, which have a habit of evaporating just as you reach for them.

Finally, income strategies may tap into a ‘**quality effect**’ – an extra splash of return delivered by companies with high returns on capital, stable earnings, and pricing power. A portfolio focused on dividend stocks will naturally gravitate towards businesses that can afford to pay out their profits as dividends – and high-quality businesses are more likely to have that capacity than low-quality businesses.

If you can stomach the inevitable periods of underperformance, income-focused strategies might be one of the closest things to a free lunch in investing - you get higher-quality stocks, better sleep during down markets, the chance at above-average returns over time, and you get to enjoy regular cash payments along the way.

How to build an income portfolio

Establishing an income portfolio or fine-tuning it for maximum performance requires some basic principles. These are less about focusing on yield as a number and more about the mentality you bring to the exercise in the first place.

1. Think of Holds as potential buys

All our Hold recommendations are undervalued to an extent, but not by as much as Buy recommendations, where the margin of safety is necessarily greater.

For income investors, this need not matter as much as it might first appear. The longer your view and the more diversified your portfolio, the less you need to rely on a large margin of safety.

The Sell price we place on a stock generally represents fair value. In environments where Buys are scarce, it can pay to buy appropriate stocks with a Hold recommendation. There may not be as much margin of safety as a Buy, but a moderately underpriced stock with a Hold recommendation might be better for your portfolio than the alternatives. (See **Holds as buys mini portfolio** from earlier this year.)

2. Don't focus solely on yield

Focusing solely on the dividend yield is a good way to land yourself in trouble. For one thing, the dividend yield is a historical measure. When you buy a stock, though, the only thing that matters is what will happen in the future.

Another issue with dividend yields is that they tell you nothing about the underlying risk of investing in a stock. The dividend yield is unrelated to a company's ability to grow. A high payout ratio could indicate a company has fewer opportunities to reinvest profits into growth projects. Sometimes a falling payout ratio is a good sign if it reflects management allocating more capital to operations or acquisitions.

3. Beware of overpaying for income or growth

Over the last few years, we have experienced an incredible period. Leading into the pandemic, interest rates were at long-term historical lows. The rebound from it produced rapid and multiple rate increases that changed the game for income investors.

For the first time in many years, as the equity risk premium was compressed, cash became a viable option. Now, as inflation falls and rate rises have abated, the stage is set to change again.

This is not a world where overpaying for income stocks makes sense, especially if those stocks don't also produce strong growth. Doing so could severely dent your returns. This is always the case, but especially so as the investing environment changes.

4. Sell down to boost your income

For decades, Warren Buffett has told Berkshire Hathaway shareholders it's better to sell some shares over time as the share price increases than have a wonderful business pay dividends to investors when that money can be reinvested to grow earnings in the business.

As portfolio manager Nathan Bell says, this is a 'far more sensible and sustainable strategy than buying stocks with high starting yields but no earnings growth to increase dividends over time'.

However, it does have a few caveats. First, the approach necessarily involves tilting your portfolio more towards growth. Second, it's only feasible for those with a longer time frame, where you can ride out the bumps along the way. If you meet those two criteria, it's worthy of consideration, **as discussed further here**.

5. Be patient

No income investor wants to sit on cash. That, though, is the price of convenience and the opportunity to act quickly when conditions turn in your favour.

This is not a time to lose your nerve and chase prices in stocks that wear an attractive yield but lack the ability to sustain it. Markets are likely to be more volatile over the next decade than they have been in the past 10 years. As the world adjusts to higher interest rates, there will be opportunities. There's nothing wrong with waiting.

6. Watch out for the banks

It was once common to hear of income-orientated members with more than 50% of their portfolio allocated to the major banks. A more standard industry weighting a few years back might have been half that. Our income portfolio has a 20% weighting to financials but includes no banks.

Banks aren't the intoxicating source of capital gains and income growth they once were. Whilst their dominance remains, banking is inherently riskier than a conventional industrial business and the sector is under increasing threat from online digital-only businesses. **Macquarie Group**, meanwhile, is giving the big four a run in mortgage lending.

This doesn't spell the end of banks as suitable places for income investors, but it does add more risk, which is best managed through portfolio allocations.

7. Count your blessings

Senior analyst Graham Witcomb doesn't invest specifically for income but he does receive dividends from stocks domiciled in different countries. He reckons 'Australia has the fairest set-up regarding tax treatment by far – our franking credit system means you're never double-taxed, nor is there an incentive for companies to hoard cash'.

It's worth remembering when you're doing your taxes this year and checking the interest paid on those term deposits.

In summary,

1. keep your capital safe;
2. invest it in high-quality, undervalued companies; and
3. target companies that offer a suitable yield and decent growth prospects.

Here are five stocks that meet that criterion right now.

Introducing the income mini-portfolio

Five stocks to give your income a boost.

The following five stocks embody the features and approach described in our introduction. Chorus, Woolworths and Endeavour aren't particularly cyclical, but each faces their own risks. The reviews that follow will make you aware of them.

For one reason or another, these stocks are all on the nose, which is why they've made our **Buy List**. In addition to the yield on offer, if each can fix the issues outlined, there should be decent capital growth as well.

Eagers, the country's largest car dealer, has performed well through every downturn but there is always a risk that fewer car sales mean lower profits. This fear has knocked the share price down more than it deserves.

As for coal stock New Hope, its fortunes are tied to coal prices. These can bounce around, but with the share price down 25% since its recent peak, there's the potential for strong gains if and when coal prices recover. It's an unusual pick for an income mini-portfolio but embodies the approach – these are all stocks available for reasonable and, in some cases, cheap prices that offer attractive yields and the potential for capital appreciation.

Company	Last review	Price @ 26 Jul 24	Current Yield	Buy Below	Sell Above	Max. Port Weight
Endeavour Group (EDV)	15 Jul 24 (Buy - $5.16)	$5.36	4.1%	$5.00	$7.5	3%
Eagers Automotive (APE)	27 Jun 24 (Buy - $10.38)	$10.39	6.9%	$12.00	$20	5%
Woolworths (WOW)	20 Jun 24 (Buy - $33.09)	$34.21	3.1%	$35.00	$50	7%
Chorus (CNU)	16 Apr 24 (Buy - $6.75)	$6.94	5.6%	$7.00	$9.00	6%
New Hope (NHC)	4 Apr 24 (Hold - $4.66)	$4.73	7.8%	$4.00	$9.00	4%

Raise a glass to Endeavour

This liquor giant won't shoot the lights out, but there's plenty of value on offer.

Key Points

- **Steady liquor returns**
- **Industry-leading scale and margins**
- **Pokies add regulatory risks**

In 1944, with World War II in full swing, Nobel Prize-winning economist Paul Samuelson predicted trouble. He warned that a Depression would engulf the world when the war was over. Instead, a new phase of economic growth began that would be the largest and longest in history.

It would be a stretch to suggest that **Endeavour**'s situation is anything like World War II. Our point is that calamities reduce expectations, making it easier to beat those expectations. Turnarounds always start with a surprise.

Endeavour has had a lousy six months. A long-running spat between the company's management and its largest shareholder, Bruce Mathieson — who owns 15% of the stock — culminated in both Endeavour's chairman and Mathieson's son giving up their board seats earlier this year.

Then there's the company's performance. In the three months to March, same-store sales for Endeavour's flagship brands BWS and Dan Murphy's were dead flat. Cost of living pressures are encouraging customers to shop more selectively and focus on promotions.

This feeds into the bigger picture we explained in ***Endeavour: less booze, more bucks***. Alcohol consumption peaked in the mid-1970s and has declined around 30% since then to 9.3 litres per capita per year. If Endeavour has a Buy case, it's off to a wobbly start.

Call us optimists but we think the market is overreacting to temporary setbacks. The decline in alcohol consumption has levelled off and there was no material change between 2019 and 2023. We wonder whether the trend might even reverse due to the ageing population and wave of retiring baby boomers: people aged over 70 are twice as likely to be daily drinkers as people in their 50s. Happy hour starts late.

What's more, rising prices and a shift towards premium alcohols have kept drinks spending at 2% of disposable incomes despite declining consumption. We see no reason why, over the long term, Endeavour's sales shouldn't keep up with inflation and population growth. The company has been increasing its market share and while zero same-store sales growth for the start of the year was disappointing, it was at least ahead of **Coles** Liquor's 3% decline.

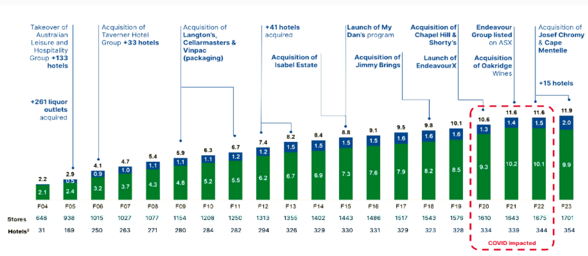
If you believe there's money to be made in alcohol, Endeavour will be the one to make it. The company is Australia's largest liquor retailer with a 45% share of the retail liquor market, dwarfing the industry's number two, Coles Liquor with a 15% share. Endeavour has unrivalled negotiating power in procurement, which is necessary to face large suppliers like **Diageo**.

Profitability is glazed further by some vertical integration. Endeavour's Pinnacle Drinks division owns various private label brands, which allows it to quickly launch new products based on demand shifts spotted in stores. **Amazon** is known to front-run third-party sellers with in-house products and Endeavour has successfully adopted the same strategy: Pinnacle accounts for around 18% of liquor sales and is growing faster than the segments it emulates.

Endeavour also has one of the largest loyalty programs in Australia, with 5.4 million active members. This program personalises online ads and promotions based on prior buying history, making marketing dollars go further.

Endeavour's vertical integration, marketing superiority, and economies of scale deliver far better margins than competitors: last year, the retail operations earned $9.9bn in revenues and $658m in operating profits, a 6.6% margin against Coles Liquor's 4.3%. For a business selling commodity-style products like beer and wine, that's a major difference.

Chart 1: History and revenue ($bn)



Source: H1 financial report

We also like Endeavour's return on capital, which measures how well it uses its money to make more money.

This is where the Hotels division steps up. With 350 hotels and pubs, Endeavour has a 20% market share. Hotels account for just 17% of sales but contribute 40% of profits.

Don't let the name fool you, though — accommodation is a side hustle. The division's profitability is fed in two ways: first, by piggybacking a liquor store on each hotel, the company can share resources such as marketing, property costs, and licences. This increases profitability and returns on capital.

Gaming is an even bigger honeypot. A typical Endeavour hotel has around 40 pokie machines — this nook of flashing lights is responsible for most of the Hotel division's operating profits and, we estimate, roughly a third of the company's total profit. Endeavour is effectively running 350 micro casinos, with an operating margin triple that of the retail business and returns on capital above 20%.

Despite impressive financials, the Hotels division also holds the biggest risks. Regulators love to tinker with pokies, and governments see them as cookie jars.

Endeavour's pokie risks come in three forms: those that increase costs, those that decrease revenue, and one-off disruptions.

On the cost side, stricter harm minimisation and anti-money laundering laws seem to perpetually chip away at margins. An example is NSW's requirement for 'responsible gambling officers' in venues with more than 20 machines, which will affect most of Endeavour's venues and increase staff expenses.

On the revenue front, restrictions to lessen problem gambling inevitably discourage regular gamblers, too. In recent years, NSW and Victoria have lowered cash input limits and imposed stricter ID requirements, cashless play, and mandatory pre-commitment limits. All anchor revenue growth.

Finally, shareholders get the thrill of navigating black swan events, like surprise tax hikes or hefty penalties for compliance breaches.

The risks to gaming are real but we think Endeavour is well placed to manage them. The NSW Government earns more than $2bn a year in pokies tax revenue from pubs and hotels; despite harm minimisation plans, the Government is incentivised to keep the industry ticking along, and there's more political sensitivity to disrupting community entertainment than casinos.

Regulation is mostly at the state level, so Endeavour's diversification across states and relatively high margins will help dampen any shocks.

The company's balance sheet is in good nick, with $1.9bn of net debt being around 1.1 times earnings before interest, taxes, depreciation and amortisation (EBITDA). All debt adds risk but the current level is reasonable given the stable earnings from the liquor business. Endeavour has a substantial real estate portfolio worth around $1bn as well as $1.3bn in undrawn facilities to steady any short-term cash flow concerns.

Consensus forecasts are for earnings per share of 29 cents in 2024. Management is targeting 'high-single-digit EPS growth' in the medium term, though we have a more conservative expectation for growth of around 5% a year.

With a forward price-to-earnings ratio of around 18 and a fully franked dividend yield of 4.1% Endeavour trades at a 20% discount to other blue chip retailers like **Woolworths** and Coles, reflecting its higher risk but similar growth prospects.

While Endeavour's drinks business is top-notch, the one-third of profits derived from pokies is exposed to sudden shocks. To reduce our downside, we've decided to lower Endeavour's recommended portfolio limit from 5% to 3%.

We're not banking on a total return above 10% a year but for investors looking to own a high-quality blue chip with a decent yield of 4.1% and steady growth in the mid-single digits, it's worth considering. A lower portfolio weighting of 1-2% might be appropriate at the current share price, particularly if you already own gaming giant **Aristocrat**.

The company has an unmatched market position in both alcohol retailing and hotels, it has economies of scale, returns on capital of 15-20%, and decent growth prospects. The current share price is slightly above the Buy price of $5.00, but that isn't going to make a material difference to the investment outcome. **BUY**.

Eagers Automotive a quiet achiever

The country's largest car dealer is far better than it seems.

Key Points

- **Better business than it appears**
- **Credible options for growth**
- **Strong track record**

Everyone knows car dealers are rich. In 2019, four economists studied the richest Americans and concluded that car dealers typically generated personal income measured in millions of dollars per year. They were among the most reliably rich in the country.

Families like the Warrens, the Suttons and the Pagents have made generational fortunes from selling cars in Australia. So, if everyone knows car dealers make money, why does Australia's largest car dealership group look like such a lousy business?

Eagers Automotive controls more than 10% of the local market, about five times that of its nearest rival. Last year, one of the best in its history, it generated net profit margins of less than 3%, return on assets of just 7% and held $2.4bn of net debt against a market capitalisation of $2.8bn.

With numbers like that, it's no wonder the market isn't interested; Eagers trades on a price-to-earnings ratio (PER) of less than 10 and is viewed as cyclical, capital-intensive and low-quality. But Eagers is a better business than it appears, and it's worth buying now.

Founded in 1913, Eagers is among the oldest businesses listed on the ASX. From the start, the company has habitually bought rivals and new franchises. It was listed on the ASX in 1957 and has paid a dividend every year since.

The consistency and longevity of dividends are one clue that business quality is better than it appears. For others, we need to examine the balance sheet in greater detail.

At first glance, it doesn't look good. Last year, the business generated net profit of about $300m from $4.7bn of assets and $1.8bn of debt. The accusations of being capital-intensive seem to hold up. Yet several balance sheet items need adjustment: inventories, debt and intangibles.

The easiest to adjust are the intangibles. When Eagers pays for acquisitions, it records goodwill on the balance sheet. That goodwill sits like a stone, sinking returns. It isn't amortised and continues to grow with purchases.

Acquisitions are real costs; we aren't trying to argue otherwise. Yet permanently inflating assets will record permanently lower returns.

If Eagers were to write off its goodwill one morning, nothing in the business would change, but asset returns would be dramatically higher. This is a dance of the spreadsheets, not a reflection of reality.

The high debt and inventory numbers are intertwined, part of the industry specific floor financing arrangements used by all dealership groups. We need to understand this, too.

Inventory isn't paid for by Eagers; an external finance business, usually an arm of a car manufacturer, finances it. Toyota's finance arm is the largest provider of floor finance, for example.

The finance company charges interest on debt backed by individual vehicles. Eagers pays the interest rate for the vehicle while it sits on the lot. When the car is sold, the receipts pay the finance on the vehicle. Eagers makes its retail margin and makes room for another car.

In this transaction, Eagers has paid only the interest on the loan. The sale of the car has repaid the debt. It earns its margin from a relatively small capital base.

Accounting rules for floor finance (known as bailment finance) force the asset to be recorded as inventory and the debt to be recorded as a liability. However, as we have seen, that doesn't reflect reality.

If we exclude floor financing, net debt moves from $1.8bn to just $260m. This isn't a deeply indebted business at all. We should also remove inventory since it is paid for by the finance company rather than the dealer.

From an initial asset base of $4.7bn, $3.2bn relates to the business's inventory, goodwill and property.

That means Eagers generates $300m in profit (a bit less if we add lease expenses to counter-owned property) on a much smaller tangible asset base of $1.5bn. This is a much more profitable business once we adjust the balance sheet for common sense.

This is a decent quality business with a long history of profits and dividends, where insiders own about 35% of the equity. But can it grow?

There are four sources of future growth. The first is to continue adding dealerships to the network. Eagers currently operates more than 250 dealerships around Australia and New Zealand, but it does add more when operators are prepared to sell. That will continue.

We also note that Eagers tried to acquire novated lease operator **Smartgroup** a few years ago and has taken an equity stake in **McMillan Shakespeare**.

Novated leases offer a good deal for customers but suffer from low take-up rates. Eager wants to raise participation. Leases and finance generate high-margin fee income for Eagers and remain an untapped opportunity.

Eagers runs a joint venture with BYD, the largest electric car maker in the world. BYD has been a sales sensation in China. As a vertically integrated car maker, it boasts lower costs than almost anyone and is aggressively rolling out in Australia. Eagers already generates $1bn of revenue from the venture and it should contribute profits in future.

Perhaps the most promising growth path, though, is the creation of a new car retailing concept, the Automall.

Eagers has been the first dealership in the world to introduce the idea. It consolidates seven or eight brands onto one property to lower costs and raise productivity. Eagers currently runs two Automalls and has planned an additional seven.

Each typically occupies a 21,000-square-meter lot, larger than the usual 6,000-square-meter car yard but smaller than the land needed across seven. Service and parts are shared across all brands, and, so far, lower property costs, higher inventory turnover, and more sales per worker have almost doubled margins at Automalls compared to traditional yards.

Eagers won't be a fast-growing business but we think it can generate 7-9% earnings growth for decades. It's worth noting that a decade ago, Eagers made just $63m in net profit; last year, it made $300m. The business has been growing consistently for years.

Today, Eagers can be bought on a price-to-earnings ratio of less than 10 and a fully franked yield of 7%. That cheapness is, in our view, because the business is misunderstood as poor quality and cyclical. We have made the case it isn't poor quality but it does remain cyclical.

The market is expecting a slowdown – Eagers has already warned of one - and has priced low expectations into the stock. Yet past slowdowns have recovered swiftly, and the structural growth from more dealerships and higher margins will continue.

Eagers is a high-quality business with competent and aligned management, trading at an attractive price. It is the essence of intelligent investing, with an attractive yield to match. **BUY**.

Disclosure: The Intelligent Investor Equity Growth Fund and the author own shares in Eagers Automotive.

Add Woolies to your income portfolio shopping list

Woolworths offers good value at today's price despite short-term concerns.

Key Points

- **Slight loss of market share to Coles**
- **Long-term advantages remain**
- **Upgrading to Buy**

In 2021, **Woolworths** was faring well against other grocers. Sales were increasing, and margins expanding. The company had just split from **Endeavour** and announced a $2bn share buyback, both of which would benefit shareholders (see ***Woolworths: Result 2021***).

Even since, we've been talking about upgrading Woolworths below $30 a share but the price never quite scraped past that threshold. For income investors in particular, at current prices, that need not be a problem.

Woolworths offers a rare blend of stability, growth potential, and reliable income, making it a potential addition to any type of diversified portfolio. We've decided it's worth stretching for.

Woolworths' stable growth and 'market darling' status created high expectations through the pandemic, so it's been doubly punished by a recent run of poor results. The stock is down around 20% since August 2021.

Some of that is justified. Over the past two years, **Coles** has grown sales by around 11% while Woolworths' Australian food division only managed 8%. It's clear Woolies has lost some market share. The main anchor seems to be its premium branding, which hasn't fared well as cost of living pressures squeeze household budgets.

Let's think about the wider context. The company still commands a 37% slice of the Australian supermarket industry against Coles' 28%. Its extensive scale and distribution network allows it to maintain competitive pricing and superior operating margins compared to Coles and others.

Over the long term, we expect its premium strategy to pay off, as it has historically been a source of growth and improved profitability. But in the short term, expect bad news.

Margins may fall next year due to a large investment in automation and supply chain improvements, which is expected to add $90m-100m a year in costs over the next few years. If any large projects run over budget, it will lower profitability and probably whip up media negativity.

However, these projects should yield substantial cost savings by 2028, reinforcing Woolworths' competitive edge. They're worth the risk.

What's more, Woolies recently sold 5% of its 9% stake in Endeavour at $5.22 per share, raising $468m. The company has said it intends to return the proceeds to shareholders, potentially through a buyback or special dividend, with further details expected when it releases its full-year results in August. The proceeds add up to around 38 cents per share, though given the value on offer at the current share price, we'd be in favour of a buyback.

With a price-to-earnings ratio of 25, Woolworths should be capable of delivering a long-term return of 8-11% or so. It may be worth penny-pinching at the store checkout, but a similar philosophy applied to investing can lead to major missed opportunities when dealing with stocks of Woolworths' quality. They're rarely on sale.

We're increasing our Buy price from $30 to $35. Our portfolio limit remains at 7%, but we don't recommend filling your wheelbarrow in one hit — with recent management changes and the pressure from Coles, there's still room for bad news that could lead to a better buying opportunity.

Whatever the case, Woolworths remains one of Australia's best retailers, with top-notch brand recognition, relatively stable earnings, and economies of scale. With a fully franked dividend yield of 3.2%, we're upgrading Woolworths to **BUY**.

Note: The Intelligent Investor *Equity Income Fund* and *Equity Growth Fund* own shares in Woolworths.

Chorus tuned to deliver

Higher interest rates will feed into higher returns for Chorus.

Key Points

- **Higher rates feed higher returns**
- **RAB has risen**
- **Higher yield likely**

Valuation is a mysterious art, or it appears that way. Valuing stocks is simpler than the academic papers written on the subject suggest — take future cash flows generated from a business and discount them to today's value. That's it.

Most investors spend a lot of time considering cash flows and profits. Little thought is given to interest rates and when it is, the verdict is universal; as they go up, prices go down. That is true enough, most of the time.

Chorus is an exception. The monopoly owner of New Zealand's fibre network is a newish regulated monopoly. We first upgraded the stock in 2019 in **Chorus: A yield stock in hiding**, arguing that the market had not correctly recognised how the business had changed. The share price has jumped 48% since, while also paying attractive dividends.

This was the first opportunity preceding its first regulatory period. With the second regulatory period, due to start in 2025 and conclude in 2028, there is another.

Over each regulatory period, the NZ regulator, the Commerce Commission, determines Chorus's revenue potential. It does this by determining a regulated asset base (RAB) and allowing the business to earn a rate of return on that asset base.

The RAB established during the first period was NZ$5.4bn and the allowable rate of return was 4.72%. The risk-free rate, a key variable in the returns calculation, was just 0.51% and inflation, used to revalue assets, was just 1.8%.

Today, the risk-free rate in NZ is 5.5%, higher than the returns locked in for Chorus in its first regulatory period. If today's risk-free rate and inflation were plugged into the regulator's calculation, the rate of return would rise from 4.72% to 8.32%.

The RAB has also grown as maintenance spending and inflation-based revaluations are rolled into the number. It is currently NZ$5.7bn.

The next regulatory period, beginning in 2025, will be decided this year and it's clear that, with higher RAB and interest rates, allowable rates of returns will be higher.

Chorus is also spending less money on maintaining the old copper network and building new fibre. Cash outflows ought to fall, leaving a larger surplus to be paid in dividends.

As a regulated utility, Chorus carries a decent whack of net debt, NZ$3bn at last count, but 70% of it is fixed for the next three years. The business will benefit from higher interest rates while being protected from its costs.

Management has confirmed dividends of NZ47.5 cents for the full year, a current yield of almost 6%. We think this could increase as rates of return rise from next year and cash outflows fall.

The yield could rise to 8% over the next regulatory period. That's not bad for a regulated, low-risk return.

The prospect of higher returns from higher interest rates hasn't gone unnoticed. Chorus's enterprise value (market cap plus net debt) of NZ$6.9bn is higher than the RAB, reflecting expectations of higher returns. However, it's not high enough.

As noted above, we expect rates of return to climb significantly higher and dividend growth to continue. An EV/RAB ratio of 1.1 times is attractive against likely returns.

Chorus isn't without risk, especially over the long term. Fibre is being challenged by wireless technologies in some markets, and there is even an investigation underway to decide whether the monopoly fibre owner ought to be a regulated utility. These are long-dated concerns, and the opportunity is before us now.

Returns are about to rise. Cash flows and dividends will increase over the next four years and decent returns are available at little risk. This is an ideal scenario for conservative investors, especially those with an income focus. **BUY**.

Disclosure: The Intelligent Investor Australian Equity Income Fund (Managed Fund) (ASX:INIF) owns shares in Chorus.

New Hope: Interim result 2024

Coal prices have fallen, but cash flow and dividends persist.

The coal boom isn't over. **New Hope**, at its out-of-cycle interim results, reported a net profit of $252m and operating cash flow of $130m. This is at a time of sinking coal prices, down almost 60% compared to the same period last year.

Nevertheless, thermal coal prices still sit over US$130 a tonne, well above long-term averages. They are likely to stay higher for longer. High prices have failed to incentivise enough supply, and demand remains steady.

New Hope did benefit from hedging, which added $61m to profit, but the economics of the Bengalla mine are mouth-watering without it. Bengalla is one of the lowest-cost mines in the country, with cash costs of just $68 a tonne, selling coal at almost $200 a tonne.

%, fully franked, for the full year.

This is a base case outcome. Coal prices are seasonally low and susceptible to supply shocks and price spikes. New Hope has also been investing heavily in expanding output – it spent over $300m in the period – which will result in higher output and, ultimately, higher dividends. New Hope should generate low-to-mid-double digit returns for years while taking little risk.

The balance sheet remains pristine, and management suggests it will retain at least $300m in net cash as a buffer.

Expansion comes from three sources. Bengalla, which was producing 8mtpa a few years ago, will increase to 10mtpa (New Hope has an 80% stake); New Acland, which began production this year, will raise output to 5mtpa by 2027; and a 19.9% stake in Malabar Resources will yield 1mtpa of low-cost coal as it begins production over the next three years.

Overall, New Hope — the most conservative, dull coal miner on the market — will double its output by 2027.

Those tonnes will be high quality and low cost, generating more cash flows to pay higher dividends while carrying a net cash balance sheet and doing nothing silly.

There aren't many miners we would be happy holding for the long term, but New Hope is an unlikely candidate. It is a great example of a stock with a **HOLD** recommendation that income investors should think of buying.

Disclosure: The Intelligent Investor Australian Equity Income Fund (ASX:INIF), Intelligent Investor Australian Equity Growth Fund (ASX:IIGF) and the author owns shares in New Hope.