Switzer Super Report

Issue 164, 28 February 2013

The end of the earnings slump

It's official, it really is the end of the earnings downgrade cycle. In our special reporting wrap-up issue our resident economist JP Goldman says so, so it must be so. He also believes that factors are pointing to a boost in earnings that will support the recent market rally. I hate to say I told you so but...I did!

Also in the Switzer Super Report Roger Montgomery finds out who is winning the couch wars between Nick Scali and Fantastic Furniture and small cap fund manager Eley Griffiths Group reveals some of their secrets behind one of their favourite stocks - The Reject Shop. In our question of the week, Paul Rickard gives his opinion on whether or not the government will intervene when it comes to a Graincorp sale.

Sincerely,

Peter Switzer

Inside this Issue

The Magnificent Seven – the banks, TLS, WES and WOW
by James Dunn
04

02 **The worst of the downgrade cycle is over**
by JP Goldman
Earnings improvements to sustain market

04 **The Magnificent Seven – the banks, TLS, WES and WOW**
by James Dunn
SMSF favourites don't disappoint

06 **SMSFs move markets**
by Penny Pryor
Companies focus on dividends

08 **A tale of two settees – Nick Scali versus Fantastic**
by Roger Montgomery
The best furniture company to buy

11 **What we love about The Reject Shop**
by Eley Griffiths
A reject no longer

12 **Question – Will the government intervene with Graincorp?**
by Paul Rickard
What will happen to Graincorp?

switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

Important information: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.

The worst of the downgrade cycle is over

by JP Goldman

It is said that markets are forward looking, and the performance of the Australian share market in recent months is a case in point. It's now clear, in hindsight, that by mid-2012, the market had already priced in weak economic growth and substantial earnings weakness, and was starting to look forward to an expected bottoming out in the earning cycle.

The latest earnings reporting season seems to have confirmed what the market has been telling us all along: this season probably marks the worst in the earnings downgrade cycle.

Better than anticipated

Indeed, with expectations for earnings growth for this financial year having already been beaten down late last year, earnings reports to date have thankfully not been a lot worse than expected. Almost half the companies reporting beat market expectations – the best result in three years according to records kept by AMP Capital Investors.

Note the last significant bottom in the local market was back in early June 2012, and since then share prices have lifted by almost 30%.

Much of this rally has been met with disbelief by investors, particularly as the local earnings outlook still remains quite muted. Indeed, our miners were facing falling world prices for coal and iron ore, while bankers were fretting over persistent weak credit growth despite lower interest rates.

Earnings expectations were progressively revised down over the second half of last year, such that earnings for this financial year are now expected to be broadly flat – rather than rise by the 12% expected back at the market bottom in mid-2012.

But back in June 2012, the market's price to forward earnings ratio was only just over 10, or well below its average of around 13.5 for much of the past decade. Relative to exceptionally low interest rates, the equity market was especially cheap.

What's more, reflecting weak domestic demand and falling commodity prices, forward earnings have been weak for a while – and well below their trend over the past few decades. So the market was cheap at a time when earnings were also cyclically weak.

What's next?

So far so good, but where to from here? Note the biggest driver of the downgrade to earnings last year was weakness in commodity prices – which slashed expected earnings growth among our major mining stocks. A weaker than anticipated pick up in consumer spending and borrowing also dampened financial sector and consumer discretionary earnings.

According to Thomson Reuters estimates, analysts expect earnings to grow by 12% next financial year – driven by a sharp 30% rebound in mining sector earnings and, to a lesser extent, a 10% lift in earnings in the consumer discretionary sector. Financial sector earnings – one third of the market – are expected to

hold steady at around 6%.

Meanwhile, at 14.3 times forward earnings, the market is no longer as cheap as it once was – but not as expensive at it has often become in the past. The PE ratio is a bit above average, which is reasonable if analysts' bullish earnings expectations are closer to the mark in the coming financial year than they were this year. Note also that local and international interest rates remains exceptionally low, and with inflation a non-issue for now, the Reserve Bank has a strong bias to ease interest rates even further should the pick-up in non-mining economic growth falter. An anticipated lift in earnings, low interest rates and a supportive central bank also help justify some premium in share prices relative to current earnings.

Of course, we'll need to see a lift in earnings soon to justify the market's recent optimism. In this regard, the sharp rebound in iron ore prices on the back of firmer growth in the Chinese economy is a positive sign. The tentative upturn in local housing demand is also reassuring, though households still remain cautious in their use of debt. In somewhat mixed news for the economy, many companies this reporting season have also indicated their intent to focus on costs and boost productivity – which is good news for profits, but could add to household caution if the result is also a transitional lift in unemployment.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

The Magnificent Seven – the banks, TLS, WES and WOW

by James Dunn

Another reporting season has shown us the usual gamut of the Good, the Bad and the Ugly.

But if you want to cut to the chase, another Western is a more appropriate theme – the Magnificent Seven.

For retail investors – particularly income-oriented investors like SMSFs – interest in reporting season hones in on the big yield plays: the four major banks, Telstra, Wesfarmers and Woolworths, which have led the 2012-2013 bull market.

Key bank stocks hold strong

In bank land, only CBA of the big four reports at this time of year. National Australia Bank, Westpac and ANZ use 30 September as their end-of-year balance date, meaning that their interim reports – for the half-year ended March 31 – come out in May. But the trio do bring out trading updates in the February half-year reporting season for the companies with June-December periods.

CBA certainly did not disappoint, with cash earnings – which excludes one-off costs and gains – up 6% to $3.78 billion. The net margin fell two basis points over the year to 2.1%, but that disguised a much better performance in the December half, in which the margin rose by four basis points. Investors were also pleased by a 20% increase in the bank's interim dividend, to $1.64 a share.

The shares hit a record high of $67.15 on the result, before trading downward into the ex-dividend date. Now nudging $67 again, it trades at a consensus expected FY14 yield of 5.5%, equivalent to 6.7% to an SMSF in accumulation mode and 7.8% if the fund is paying a pension.

Despite also showing a 6% increase in cash profit – albeit unaudited, and only for the first quarter of its financial year – ANZ's shares fell after its trading update, before moving higher. There was no improvement in the net interest margin, but in fairness, it was only one quarter – and there was good growth from the bank's operations in Asia – but the update did not impress investors as CBA's result did, mainly because the shares had been pushed higher leading into the announcement.

However, the bank looks to be on track to achieve its forecast of $3.08 billion in cash profit for FY13, barring any unseen events. ANZ is priced at the same FY14 yield of 5.5%.

Big-four laggard NAB's first-quarter trading update did not shoot the lights out – revenue was up 3%, cash earnings rose 4% and the bank's bad and doubtful debts fell by 10% – but the market liked the update, pushing NAB shares over the following days through $30, a level they have not broached for more than three years.

NAB still faces big problems extricating itself from its troubled UK operations, but at $30.30, it is priced on an alluring 6.4% FY14 forecast yield, equating to 7.8% to an SMSF in accumulation mode and 9.1% if the fund is paying a pension.

Westpac is yet to give its first-quarter trading update, but at $30.83 it is priced by the market at an expected FY14 yield of 5.8%, equating to 7% to an SMSF in accumulation mode and 8.3% if the fund is paying a pension.

Telstra confirms guidance

Telstra's result for the December 2012 half-year was in line with market consensus expectations, with operating earnings up 3.7% to $4.99 billion, and net profit up 8.8% to $1.6 billion, on the back of what the market took to be strong growth in its mobile

business, in which revenue rose 4.6% to $4.56 billion. 607,000 new domestic mobile customers were added to the billing book, bringing the number to 14.4 million.

Telstra announced a 14 cent fully-franked interim dividend, representing a $1.7 billion return to shareholders, and the market liked chief executive David Thodey's comment that Telstra's full-year earnings would be at the top end of previous guidance for the full year – which implies profit growth in the low single digits.

After going ex-dividend, Telstra trades on a 6.3% FY 14 yield, which corresponds to 7.6% to an SMSF in accumulation mode and 9% if the fund is paying a pension.

Retailers performing well – mostly

At Wesfarmers, half-year net profit rose by 9.3% to $1.28 billion, largely on the back of an excellent performance from Coles – where pre-tax profit jumped by 15% to $755 million – and a 25% jump in earnings from Kmart, to $246 million. Bunnings lifted its contribution by 6.8%, while Target reported a 20.4% fall. Insurance lifted its earnings, but lower coal prices and the high $A dampened the resources division's profits.

Wesfarmers spread the largesse, lifting its interim dividend by seven cents, or 10%, to 77 cents. At $40.74, Wesfarmers is yielding 4.7% for FY14, translating to 5.7% for an SMSF in accumulation mode and 6.7% for a fund paying a pension.

Finally, of the high-yielding defensive plays that have driven the market, supermarket giant Woolworths boosted net profit in the six months to December 31 by 19% to $1.15 billion, and raised its interim dividend by three cents to 62 cents. At $35, Woolworths is priced at a 4.1% yield for FY 14, equivalent to 5% to an SMSF in accumulation mode and 5.9% for a fund paying a pension.

BHP loses CEO, but key divisions humming

Lastly, of the popular stocks that drive the market, BHP is not a high-yield play, but many SMSFs hold the stock for resources exposure. BHP's underlying earnings before interest and tax (EBIT) for the half-year came in at US$9.8 billion – well ahead of consensus of US$9.5 billion – while net profit met the consensus estimate, at $5.7 billion. The dividend was in line with expectations, at US57 cents a share.

The shares were sold off, however, seemingly because of a fall in net profit, on the back of lower commodities prices and global demand, but that should have been factored in by the market. (There was also the minor detail of CEO Marius Kloppers stepping down early as CEO, but again, that was not a huge surprise to the market. See our story about that here.)

BHP is expected to earn about US$13.9 billion for the full-year. With the iron ore and petroleum divisions – which account for 80% of the company's earnings – performing strongly, there is no reason to doubt BHP's ability to meet that expectation.

So while there was a lot of noise and colour coming out of the half-year reporting season, the bottom line is that there was nothing to dissuade an SMSF proprietor from continuing to hold the group of stocks that form the backbone of long-term portfolios.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

SMSFs move markets

by Penny Pryor

Interim reporting season is almost over and even if the results across the board haven't been that earth-shattering, one of the things that companies have been trying to do is preserve dividend payments.

They know that in this lower interest rate environment, a large percentage of their investors are probably SMSF trustees seeking yield.

"I think the big story generally for companies is, if they want to maintain their investors, they have to try as much as possible to maintain their dividends," Assyat David director at strategy advice group Strategy Steps says.

Income seeker

Anecdotally some analysts are saying that SMSFs may be behind the recent rise in the share market past 5000 and we all know trustees are always on the lookout for a good yield stock.

SMSFs now account for 31.5% of total superannuation assets of $1.5 trillion so their influence is not insignificant, and with a large percentage of assets under management sitting in cash up until the end of last year, it wouldn't be surprising if they had managed to move markets, so to speak. CoreData recently conducted some research for Russell Investments and the SMSF Professionals Association of Australia (SPAA) and they found that trustees had cash allocations of 33.9% in 2012 compared to only 25.6% in 2011.

"What's actually happening is a lot of SMSFs – the majority of them – are thinking about getting into the market again," David says.

"They are being attracted to some of the yields you can get in shares. I think that high yield attractiveness story has been around for a couple of years."

Trustee habits

CoreData also asked trustees with cash allocations of 10% or more for their reasons for their current allocation. The majority still said they were waiting for a better investment option – 45.7%, or they wanted to reduce their risk – 32.4%, but those percentages were down on previous years. In 2011 those numbers were 44.3% and 48.9% respectively and in 2010 they were 52% and 47.6%.

The volatility of equities was an important factor in 2011 at 32.4% but not so much in 2012 when it had dropped to 21.8%.

What was interesting, and which may also be indicative of more SMSFs about to increase their equity allocations, was the percentage of people who said "I haven't had time to invest my cash but I plan to do so over the coming year". That was 6.3% in 2011 but had risen to 15.4% in 2012.

SPAA's director of education and professional standards, Graeme Colley, says that at least anecdotally they are hearing of more SMSFs boosting their equity allocations.

"From what we know and talking to our members, mums and dads are getting back into the market," he says.

But he also points out that SMSFs have large allocations to shares anyway.

According to the ATO SMSF data for December last year, SMSFs had 31.6% of their assets in listed Australian shares, or $150.1 billion. That was up on the 29.3% of assets, or $119.9 billion the previous December.

The ASX's market capitalisation today is $1.4 trillion, which means that SMSFs account for over 10% of the market – a not insignificant force to be reckoned with.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

A tale of two settees – Nick Scali versus Fantastic

by Roger Montgomery

We have been fortunate through this season's half yearly reports. Our two largest positions – Seek and The Reject Shop (see Eley Griffith's view on this stock below) reported incredible results and their shares surged. And while we'd love to own every extraordinary company for our clients, limited pockets prevent us from doing so. This is a tale of one extraordinary company that we haven't purchased and another, in the same industry, which many think is extraordinary.

Playing house

Australians love their homes and they love buying them. Indeed, so ingrained into our culture is the purchase of a home that it is as much a right of passage as turning 21. In response, homemaker centres have been popping up everywhere, catering to the great Australian dream. Build it – large warehouses on cheap industrial land, filled with furniture and decorations – and people will come.

Furniture retailers in particular helped drive this model as people rushed to upgrade their houses and then proceeded to spruce them up. But ultimately, furniture is a cyclical industry, sensitive to the economy and dining settings seemed to be the furthest thing from consumers' collective minds following the global financial crisis.

As demand for furniture 'faded' (pun intended), so did the number of retailers in the market. In fact the furniture market reportedly contracted by 6.8% from July to December 2012.

Two furniture retailers that have survived and even grown are Nick Scali and Fantastic. But over the years their performance has differed. This can best be seen by looking at the charts of their intrinsic values – Figure 1 and Figure 2. If you can plot and forecast intrinsic values, you can get a pretty good handle on where the share price is going to go. You don't really need to bother forecasting shares prices at all, because over the long run, prices tend to follow valuations.

As you can see from Figure 1 and Figure 2, Nick Scali's intrinsic value has risen at the rate of about 4% per annum, but is forecast to rise by over 20% in the next couple of years. Fantastic, on the other hand, has seen its intrinsic value rise at less than 1% over the last decade and is forecast to rise by about 10% over the next two years.

Figure 1. Nick Scali Intrinsic value line. (Click to enlarge)

Figure 2. Fantastic Furniture Intrinsic value line. (Click to enlarge)

As the 2013 half-year reporting season approached, the situation looked bleak, particularly for leading furniture retailers such as Nick Scali and Fantastic Furniture. But it is during the tough times – when the tide is going out – that you see who is swimming naked. The latest results from these two players make for a very interesting tale.

The best place to sit

Nick Scali is a family run business that is held in high regard within the industry. The company primarily operates two brands. Nick Scali Furniture caters to the middle market with a focus on quality products, while Sofas2Go is tailored to budget conscious customers. Nick Scali customers pre-order the majority of the furniture selected off the floor and this helps the company maintain a gross profit margin of more than 60%.

Fantastic Furniture, on the other hand, is known as the 'Package Deal King' and the company focuses on value-for-money 'bundles'. It operates a different business model to Nick Scali. Its stores are located in industrial centres in order to appeal to a value-conscious consumer and to sell on a larger scale at lower margins. The company also sells higher margin sofas through its Plush brand, mattresses through the Original Mattress Factory and designer furniture through Dare Gallery.

Nick Scali was the first of the two companies to report its HY13 results, increasing sales by 17% – a simply remarkable result in the context of a weak retail environment. The growth can be largely attributed to the company increasing its store network from 32 to 36 during financial year 2012.

What was more surprising was like-for-like sales growth of 4.7% (like-for-like sales excludes new stores sales, helping to assess the performance of existing stores). While management expect this growth to normalise at around 2% over the remainder of 2013, they did note that sales orders in January were very strong, which augurs well for the second half of the year.

With their results on fire, Nick Scali laid down the gauntlet for Fantastic Furniture, and several analysts and brokers on our panel expected robust results.

The other side of the couch

Fantastic Furniture increased its store count from 128 to 133 during 2012 but the results were anything but fantastic. Sales increased by 2.5%, while like-for-like sales increased by just 1.8%. Plush, Fantastic Furniture's second largest division, experienced a decrease in like-for-like sales of 6.1%. What's more, the company only added one store to its network during the half-year period.

Management uncovered a range of issues from inventory through to the structure of support functions, and there is a very real risk that the company will be forced to scale back Plush. Even Fantastic's outlook statement starkly contrasted Nick Scali's. Management reported that sales for January and early-February were slightly below the prior corresponding period.

The ability of Nick Scali to produce such impressive results amid an industry consolidating is a testament to the quality of the company. While Nick Scali is hoping to use this momentum to support future growth, investors should be aware that this growth is unlikely to be repeated. Management at Nick Scali are very thorough when it comes to identifying new store sites, and they have commented that finding suitable locations is getting tougher and tougher. In a population of just 22 million people, maturity and old age comes early for retail businesses.

The future for furniture

The furniture market remains weak and management are cautious about the outlook.

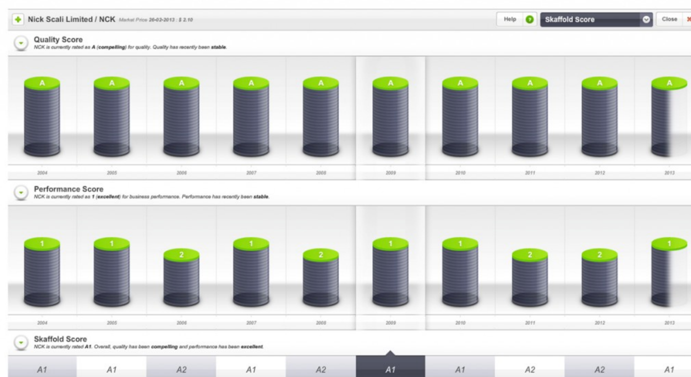
The moral of this tale is that investors should be focussed on companies that can generate sustainable value growth during any stage of the economic cycle. Fantastic Furniture has actually been

a good performer these past few years, and it is likely to bounce back after confidence returns to the property market. Many will buy the shares and do very well. But momentum is not our caper.

When we’re looking for quality companies, we prefer those with management that embrace the challenges and solve the issues. We cannot say it better than Anthony Scali; “Nick Scali Furniture does not believe standing still is the right approach. Complaining or demanding protection from government does not address the issues or lead the way for the future of retail. By embracing these challenges and looking to the retail trends of the next decade, not the last, Nick Scali Furniture has refused to stand still.”

This attitude is also reflected in the company’s quality and performance scores. As I regularly discuss on Switzer TV on Sky Business, ranking companies in terms of quality from A1 for the best and C5 for the worst, using a proprietary selection of ratios really helps us identify the best businesses. Figure 3 reveals Nick Scali, despite having limited opportunity and a tough retail environment, has produced an enviable track record of business quality and performance.

Figure 3. Nick Scali’s historical Quality and Performance Scores. (Click to enlarge)



The final step for any investor when building a portfolio is to purchase these high quality businesses when they are at substantial discounts to their estimated intrinsic values. As Figure 1 revealed, that is not the case just yet.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

What we love about The Reject Shop

by Eley Griffiths

How long have you held TRS?

We own 4.9% of the company and returned to the share register in late 2011. We reduced our holding in the aftermath of the Ipswich floods in anticipation of a significant dislocation to the company's Qld-NSW supply chain. We added to our holdings again in Aug-Sep 2012.

What do you like about it?

A simple, high-performance retailing story, with a strong record of execution. The company has a big store roll-out ahead of it and is presently reviewing the store portfolio of competitor, Retail Adventures, for potential acquisitions. The stock enjoys a high PE rating but this reflects the growth trajectory and growing perceptions that a revival in consumer confidence is now under way.

How is it better than its competitors?

Financial metrics such as an ROE of 33%, with sustainable EPS growth of 10%+ per annum, to start with. Net debt is actually reducing and inventory management is improving. Its strength of brand and reputation in discount variety retailing.

What do you like about its management?

Management is a seldom-seen combination of business-builders and risk managers. They are experienced in discount variety, from store formatting through to offshore inventory sourcing. Management is Argus-eyed on return on investment and optimising the businesses operational leverage through the cycle.

What is your target price on TRS?

We never set target prices for stocks, preferring to assess the company's relative valuation and qualitative aspects versus other small companies on an ongoing basis. Some stocks 'value' improves despite its share price advancing. Setting exit prices for stocks means you are nearly always selling too soon or too late.

At what point would you sell it?

Not soon. Maturing of the growth profile or if we perceive valuations are too stretched.

How much has it added to your overall portfolio over the last 12 months?

It has added 0.62% to our portfolio performance over the past 12 months (portfolio +15.9%)

Where do you see the value?

Stock has run very hard into and immediately after its interim result. I had hoped it may have paused to afford a buy point.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Question – Will the government intervene with Graincorp?

by Paul Rickard

Q. *Do you think the Australian Government will be ok about a sale of Graincorp? It's a bit like selling off Qantas after it divided into Qantas and Jetstar, isn't it? The Government stepped in then and stopped the sale, didn't they? If Graincorp play [Archer Daniels Midland has made a bid but talks have stalled] begins again I presume the Government will step in and stop it?*

A. I don't think that they are going to be keen to step in with Graincorp. They won't do anything until they get the Foreign Investment Review Board recommendation – and if the FIRB says "yes", it is a very brave government that goes against this (I will stand corrected – the last one I can recall is Shell's bid for Woodside – Costello said no).

I am not sure that you are right about Qantas in that under the original privatisation legislation of 1995, the Act prohibited foreign shareholdings of greater than 50%. That remains in place today. As I recall it – they didn't actually "step in" or make a decision – they just didn't agree to change the legislation. Maybe I am splitting hairs, however I think they are quite different actions.

Also, have a look at the market price. While the Board says that the company is 'undervalued', if the market really believed that the Government would say "no", I think it would be unlikely that the share price would be sitting around the offer price.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Did you know?

Last night on my Switzer program on Sky News Business Channel I spoke to Sinclair Taylor from Westpac about insurance in your superannuation fund. This is something the government wants more SMSF trustees to 'think about'.