Switzer Super Report

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Keep calm and watch IPOs

In this volatile market, where you could be confused by some of the commentators for thinking the sky is falling, I think we should take the advice of long time financial journalist Barrie Dunstan when he says 'don't panic'. He has some more sage words in his article below that I think we should all heed, if we're not already.

We have a news flash on off-market transfers that should provide a bit of relief and our fundie today is Anna Kassionos from Platypus Asset Management and her favourite is Oil Search. Ron Bewley likes the energy sector with Origin, Santos and Woodside taking his fancy.

Sincerely,

Peter Switzer

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News flash – Off-market transfer restrictions abandoned

by Penny Pryor

Trustees that were considering making off-market transfers of listed securities from related members into their superannuation funds after 1 July, should be able to breath a sigh of relief today, after the government decided to remove the key Schedule that would have restricted such transfers from the Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013.

“The government will be proposing an amendment to remove schedule 4 from this bill. Schedule 4 contains specific rules for trustees and investment managers of self managed superannuation funds in relation to acquiring assets from and disposing of assets to related parties,” Lindsay Bradbury, Assistant Treasurer Minister Assisting for Deregulation said in parliament last night.

“The measure is a response to a recommendation of the Super System Review, which was undertaken in 2010. Since the time of the review, the government has made significant reforms to the superannuation system, including to the SMSF sector. Further consultation with industry has indicated that the concerns the measure is seeking to address are not as pressing as they were at the time of the review.”

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A happy arrival – Virtus Health IPO

by James Dunn

In-vitro fertilisation (IVF) is a life-changing miracle of medical technology for some people; for others, it is an ethical dilemma; for others still it is a career.

Now it is an investment too.

IVF business – make that "assisted reproductive services provider" – Virtus Health Limited is joining the Australian Securities Exchange (ASX) through a $339 million float. It is the first IVF company in the world to float on the stock market.

And it will go off like hot cakes.

The reason why is – as with iSelect, which we looked at last week – unsatisfied demand.

A virtuous shortage

Everyone wanted Virtus shares in the primary market (the issue of shares). The issue was over-subscribed by seven times. Two fund managers' combined bids for shares would have bought the whole lot: but the vendors – Quadrant Private Equity owns 43%, while IVF doctors own about 51% – wanted a wider spread of shareholdings than that, which meant that those who did get shares receive far less than they wanted. That means strong demand in the secondary market (when the shares list).

The joint lead-managers of the float are big hitters – Morgan Stanley and UBS. Broker 'firm' offers close next Friday (June 7) and the shares will hit the ITS screens on Tuesday, 11 June.

Several things have excited the market about the Virtus listing.

Firstly, it is a strong business.

Virtus Health is the largest provider of assisted reproductive services in Australia, with a market share of about 35% of the 39,000-plus IVF cycles performed in Australia last year, from which about 4,000 babies a year are born. It operates 34 fertility clinics, six day hospitals and 39 laboratories across New South Wales, Victoria and Queensland. Assisted reproductive services accounted for 77% of Virtus' revenue in FY12; specialised diagnostics and day-procedures conducted in its hospitals made up the rest.

This means that Virtus slots in with the likes of Cochlear, Primary and Healthscope as a defensive healthcare stock, both recession-resistant and with growth prospects. And it has government subsidies involved: an IVF cycle is typically funded between 42%–59% by the Commonwealth, between 10%–13% by insurers, and from 27%–49% by the patient.

Virtus has demographics in its favour: the female population is growing, and more Australian women are having babies later in life. The social acceptance and awareness of IVF services have increased, as has the accessibility of those services.

A unique proposition

The company has a wide economic 'moat': IVF treatment is a highly specialised business, so while Virtus certainly does not have the field to itself, it is a difficult business for new entrants to gain a significant foothold in.

It has sound growth prospects, in three areas. The first is in bolt-on acquisitions; the second is in its low-cost TFC clinics, established in 2012, which targets a new segment of the market for which fertility treatments were previously unaffordable; and the third is in international expansion. Virtus says the IVF markets in Asia-Pacific, China, India and the Middle

East are very immature and fragmented, and offer attractive opportunities.

Virtus has an impressive record of growth in revenue and EBITDA (earnings before interest, tax, depreciation and amortisation). On pro forma numbers, consolidated revenue is forecast to grow at a compound annual rate of 9.6% between FY12 and FY14, to $206 million, with EBITDA growing at a compound annual rate of 10.5% over the same period, to $63 million. Cash flow generation has been strong, running at 89% of EBITDA to free cash flow in FY12.

No dividend will be paid for FY13, but the prospectus says the company intends to start paying dividends at the December 2013 half-year. The implied dividend yield for FY14 at the $5.68 issue price is 4.6%, based on the current intended dividend payout ratio of 65% of what the company calls its statutory NPATA (net profit after tax and after adding back the tax-affected amortisation expense) in FY14.

Beyond FY14, Virtus says it intends to target a payout ratio of between 50%– 70% of statutory NPATA. It expects that “all future dividends will be franked to the maximum extent possible.”

Delicate pricing job seen as fair

And importantly for a private equity sell-down, the market thought the final price for the shares – although it was at the top end of the indicated range – was fair. Quadrant Private Equity, which bought into Virtus in 2008 for $33 million, sold out entirely, after originally flagging that it might stay in with 10%. Doctors and staff will own about 23% of the company.

The market has good reason to be wary of private equity IPOs. Everyone knows that private equity firms are hard-nosed and they use IPOs to exit investments. If they are perceived to be too greedy – as they were in floats such as Myer, Emeco Holdings and Boart Longyear – it leaves a bad taste in the mouth of the investors who take the stock off their hands. Quadrant has done well out of Virtus – it will make more than three times its money from the share sale – but the $5.68 share price, equating to 14.4 times FY14 forecast earnings and a 4.6% dividend yield was largely seen by the market as fair to the vendors and buyers. Earlier in the year, the vendors reportedly hoped to get up to $6.82 a share for Virtus.

The maintenance of government subsidies is a risk for the business. A 2012 report by the Australian Institute of Health and Welfare showed that the number of women using IVF fell 13% in the year after the caps on IVF use were introduced in 2011, doubling the cost of an IVF cycle from about $1,500 to $3,000. That was the first fall in the number of IVF treatments in Australia in almost 30 years.

A happy arrival

But what Virtus really has going for it, is that its product is not really subject to discretionary spending – demand for it is driven by one of the most basic, but strongest, human needs. In effect, Virtus sells hope.

Usually the stock market is wary of unique investments, because there are not ready comparisons able to be made, but we think Virtus is different.

With pent-up market demand for IPOs that are not related to mining, heavy unsatisfied demand for this particular issue, and a strong niche position in a booming health sector, Virtus looks a good bet for both a successful float, and a new life on the stock market.

Fundie's favourite – Oil Seach

by Anna Kassianos

How long have you held Oil Search?

We initiated our position in December 2010. We then topped up in 2011 and 2012 in advance of outperformance on its PNG oil operations, and more importantly as the PNG-LNG project derisking milestones were being achieved.

What do you like about it?

We like Oil Search for upcoming delivery of the $19 billion world-class, long-life, and nearly fully contracted PNG-LNG processing trains T1 & T2 development, by its operating JV partner Exxon.

Oil Search management is guiding a fivefold lift in operating cashflow from onshore PNG-LNG, with first saleable cargo targeted early 2H 2014, and full production in 2015.

Furthermore, it is pleasingly balanced with exciting, but riskier, exploration in onshore Kurdistan and offshore Gulf of Papua with its other JV partner Total.

But of greater importance is the exploration and appraisal program taking place around its LNG project, and existing oil operations in PNG. We see potential for incremental cashflow expansion.

Another important anecdote is that the PNG government is very supportive of PNG-LNG given its significant contribution to GDP. The government seems to be very pragmatic and considers it better for future oil and gas development activities to be potentially consolidated and integrated into PNG-LNG.

Source: Bloomberg

How is it better than its competitors?

It stands out amongst the pack with a targeted fivefold lift in operating cashflow of $1.3 billion to $1.5 billion, and a 40%-50% net profit after tax (NPAT) payout ratio in 2015.

Return to shareholders is reasonable, even with the range of growth options available in the kitty. Furthermore, we see potential for these other opportunities to be progressively commercialised over the longer term. Its ASX listed oil and gas peers fail to compete on these metrics of commerciality, and globally it's one of the sector's best.

What do you like about its management?

Despite Exxon becoming an operator of the PNG-LNG development in more recent times, Oil Search management have played a large part in community, health and environmental aspects of successfully operating in the PNG Highlands over their greater than 80 years in the country.

The social licence to operate in another country's backyard is sometimes ignored, but we see management have been very successful in paying due attention to this area. It is also regarded by OXFAM's Publish What You Pay as a "stand-out company", being one of the very few ASX-listed entities to have adopted Extractive Industry Transparency Initiative (EITI) disclosure, despite it not being a requirement.

What is your target price on Oil Search?

Our target price is over $11.00 a share. However, it has the opportunity to be refreshed from the inferred value of the various PNG transactions (including Interoil tenements and HZN farm-down) to be potentially announced in the very near term. In the longer term, a final investment decision (FID) on further PNG-LNG processing trains could push out our target further.

At what point would you sell it?

We would consider selling in the event of a big downgrade in PNG-LNG production and consequential escalation in the extremely competitive operating cost base of $10-12/BOE (barrel of oil equivalent) targeted.

We see downgrade risk as low probability. Furthermore, we see the PNG-LNG project delivery is largely derisked, with around 15% left as at end April 2013. It is pleasing that gas pipeline commissioning is scheduled to commence in 2H 2013, providing ample time to iron out any issues.

A further sell event trigger from a growth perspective is if the exploration and appraisal program taking place around PNG-LNG project isn't big enough to justify further incremental capex for processing trains T3 (most likely) and T4 (if further discovery upside and global LNG demand allows).

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

Detracted 26 basis points performance over past 12 months.

Is it a liquid stock?

Liquidity in the stock is fairly good, with an average of 15 million shares traded per week in the last 12 months.

Is there anything else you would like to say about Oil Search?

Last, and by no means least, around 10% of sales volume (total sales volume of 6.9Mtpa guided) is uncontracted from PNG-LNG, and also an earlier start date is now targeted relative to the formal contract. There is therefore significant opportunity for leverage to spot market sales. The formal contract start date is end 2014 for 6.2Mtpa, but first cargo sale is anticipated for early 2H 2014, providing a six-month window of opportunity for early sales. Both opportunities work in very well with the limited supply available on the spot market.

The energy sector – ORG, STO and WPL outperform

by Ron Bewley

I last reviewed this sector for the Switzer Super Report in November 2012 using data up to the close of 5 November 2012.

After now having been through the cycle of reviewing all sectors of the ASX 200, it is time to assess how our analysis performed over the last six months and suggest any new directions.

At that time I argued that the high conviction part of a superfund portfolio should focus on the biggest of the top 100 companies – but excluding those with a consensus rating of 2.5 or worse – that is better than a hold (1 is a buy, 3 a hold and 5 a sell). I excluded Worley Parsons and Caltex due to their being better classified as Industrials. I excluded Paladin and Whitehaven Coal because of undue risk. Since my last review, Paladin has fallen from the top 100 to the bottom half of the 200. Linc Energy left the top 200 to be replaced by Maverick Drilling

The stocks in the Energy sector of the ASX 200 are listed in Table 1 together with the capital gain – or change in stock price – and the consensus recommendation at the last review.

In the last review, we identified three stocks as fulfilling our requirements of being the biggest in the top 100 of the energy sector and with a rating better (lower) than 2.5. They were Woodside (WPL), Origin (ORG) and Santos (STO). Based on their then current recommendations and their one-year histories, I favoured them in the following order as STO, WPL and ORG.

The index for the sector grew by 5.9% over the same period – far less than the ASX 200 but a well-diversified portfolio often requires exposure to all sectors. Five stocks beat the index – Caltex (CTX), ORG, STO, Oil Search (OSH), and WPL. None of these were in the bottom half of the ASX 200. Since we have been through a testing time in equity markets, it is not surprising that smaller cap stocks performed relatively poorly. Since we excluded CTX on classification grounds, that leaves four outperforming stocks and all three in our 'selection universe' were in that set. Of course, there is an element of chance in the performance of stocks from my selection process but the methodology is designed to help the chosen set to outperform the index as a group and on average – not each time.

Table 1: Change in stock price and consensus recommendation since last review

Relevant index	Code	Company	Price growth 5/11/2012 to 27/5/2013	Consensus recs. 5/11/2012	Consensus recs. 27/05/2013
ASX 100	CTX	Caltex	25.2%	3.3	3.4
	ORG	Origin Energy	20.2%	2.1	2.4
	STO	Santos	11.7%	1.9	2.0
	OSH	Oil Search	9.1%	1.8	1.9
	WPL	Woodside Petroleum	7.6%	2.4	2.5
	BPT	Beach Energy	-14.9%	2.3	3.0
	WOR	WorleyParsons	-18.2%	2.8	2.2
	AUT	Aurora Oil & Gas	-22.2%	2.8	2.3
	WHC	Whitehaven Coal	-24.6%	1.7	2.3
Small Caps	HZN	Horizon Oil	2.6%	1.4	2.1
	KAR	Karoon Gas	1.5%	1.6	1.8
	AWE	AWE	-9.7%	2.2	1.9
	AQA	Aquila Resources	-12.5%	2.1	2.5
	SXY	Senex Energy	-12.6%	1.8	2.3
	PDN	Paladin Energy	-15.1%	2.3	2.4
	DLS	Drillsearch Energy	-29.4%	2.2	1.9
	BRU	Buru Energy	-43.3%	1.7	1.7
	MAD	Maverick drl. & exp.	-61.6%	1.0	1.5
	CPL	Coalspur Mines	-66.5%	1.5	2.4

Ranked by constituent index and price growth

Source: Thomson Reuters Datastream

As it happened, ORG finished above STO and WPL but an important maxim for investing is that one does not need to choose all of the best stocks – but just try and avoid the bad. There is nothing in the current data that makes me want to change my selection process for the next half year. But if I wanted to add a stock, OSH would now interest me with its new top rating in the top 100.

Going forward, it can be noted from Table 2 that the energy sector has the second highest (adjusted for current mispricing) forecast for growth over the next 12 months (22.3%) from Woodhall's analysis. Currently the energy sector is rated as cheap; exuberance (or mispricing) is negative (-1.2%). The forecast yield is moderate at 4.0%.

At this moment, the market is a little 'fearful' by our Fear Index contained in our Woodhall Weekly. As a result, it may not be a good time to buy but, if the sector forecasts remain strong for energy, a buy might be appropriate as soon as the level of fear falls to back to normal levels.

Table 2: Variation in consensus recommendations for selected stocks

Sector	P/E ratio historical	P/E ratio forward	Forecast yield	Forecast cap. Gain	Consensus rec.	Exuberance	Market cap.	Adj. cap. Gain
Energy	17.9	15.0	4.0%	21.1%	2.38	-1.2%	5.7%	22.3%
Materials	13.4	10.3	3.5%	26.9%	2.23	-14.9%	17.3%	41.8%
Industrials	16.0	13.7	4.5%	15.7%	2.66	-5.3%	5.9%	21.0%
Discretionary	17.9	15.0	2.7%	17.5%	2.46	0.5%	5.1%	17.0%
Staples	18.3	17.0	4.6%	7.7%	3.15	-0.5%	8.6%	8.3%
Health	21.8	19.4	2.4%	11.9%	2.74	0.4%	4.6%	11.4%
Financials	13.4	12.7	5.7%	5.5%	2.79	2.0%	38.7%	3.4%
Property	16.0	15.2	5.3%	5.2%	2.79	4.4%	6.3%	0.8%
IT	19.7	17.3	3.2%	13.2%	2.67	3.9%	0.7%	9.3%
Telco	16.1	15.6	5.7%	3.2%	2.97	7.6%	5.5%	-4.4%
Utilities	16.3	15.2	5.6%	7.2%	2.68	-2.6%	1.8%	9.9%
ASX 200	14.9	13.3	4.7%	11.8%	2.68	-1.7%	100.0%	13.5%

Note: the estimates in the Table are current to the close of business 27 May 2013. They are based on Thomson Reuters Datastream data and Woodhall Investment Research's analysis. Exuberance is a measure of mispricing with +6% our reference point for calling a possible correction or prolonged sideways movement. Cheap sectors (negative exuberance) can become cheaper! The capital gain for the following 12 months and the adjusted gain factors in the current level of exuberance.

Keep calm and carry on

by Barrie Dunstan

The sudden change in the investment climate shouldn't cause SMSF trustees to panic. Rather, they should see it as a chance for a useful check on how well their investment strategy is working.

Steady as she goes

First, there's a chance that the worries about the world economies and the role of central banks will prove overdone. The sharp reaction by uneasy markets to Ben Bernanke's comments was inevitable – any indication on the possible ending of quantitative easing was bound to provoke concern.

Second, no one can actually be sure where the stock market is headed or the likely exchange rate of the Australian dollar. Those who claim they do know are over-stating their competence; those who believe the economic commentators are forgetting their past history of forecasting.

In short, there's probably no case for a drastic change to investments. Fleeing from the stock market in fear of a possible drop may mean SMSFs are protecting their capital. But this could be at the expense of lower immediate income (there's now less comfort in term deposit rates) or capital losses (bonds and fixed interest securities still appear set up for a market fall).

Asset allocation still key

Instead, investors should rely on the most basic tenant of their investment strategy – diversification. A mix of shares, bonds, cash and property is essential; the debate should be about the likely best mix, rather than rash decisions to dump large holdings.

Remember, falling share prices don't necessarily mean lower dividend income if the portfolio is invested in companies with well-covered dividends. Over all but the short-term, good companies' dividends keep rising; the lesson from the GFC setback is a case in point.

And because most experts are unable to forecast accurately things like inflation, interest rate movements and exchange rates (and, more importantly, to get the timing spot on), investors simply must ensure they have a diverse mix of assets, which will provide some hedge to future events.

Don't be a trend follower

Investment literature abounds with studies showing that investors – both the professionals and amateurs – suffer from switching at the wrong time. There now is so much noise around the markets that it's hard to identify real signals, and bitter experience tells us that it's far easier to read signals correctly after the event.

There's also the danger that, once burned, investors will learn the wrong lesson; ie, assume a particular asset class is no good rather than what's wrong is buying or selling at the wrong time. Many investors abandoned real estate investment trusts (REITS) completely after their sell-off, missing the subsequent recovery.

Similarly, there's a danger that investors will decide to forget about gold after its fall from grace. Without embracing some of the more extreme views, investors still might consider a modest gold holding (up to 5% – at lower prices) in their portfolio as a precautionary hedge against a really nasty outbreak of inflation from the world's continued money printing.

Overall, investors need a healthy dose of scepticism in treading a safe path through the investment market. Just as they seem, increasingly, to disregard the investment managers' claim to add value (above their fees), they also need to be aware of the sort of big picture trends, which inevitably affect their investments. This means keeping an eye on share price/earnings levels to guard against buying too high. It also means watching interest rates like a hawk to avoid over-commitment to fixed interest securities when, inevitably, interest rates rise and trigger falling prices.

Not to mention watching the dangers of "fashionable" investing, such as a large, unwieldy, single property investment, along with a level of spruiking for such investments, which has attracted the attention of the SMSF regulators.

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Don't get caught – fraud and SMSFs

by Penny Pryor

Fraud headlines are everywhere, from Chinese espionage to big billion dollar security breaches at major banks, and it's only a few months since the government handed down its report on Trio Capital. That report found that some SMSF trustees were unaware that they wouldn't be entitled to compensation for their savings to the same degree as those in major superannuation funds.

The crimes

David Lacey was executive director, Australian Crime Commission when he gave a speech at the SMSF Professional Association of Australia (SPAA) conference on this topic in March this year and says that after that speech he was inundated with inquiries from SMSF trustees who had been affected by fraud.

"The number of victims who came forward after that conference sort of took things to a new level," he says.

Lacey has since left the Commission but is still working on fraud solutions that could help all victims, including SMSF trustees.

"In some cases, SMSF accounts have run dry, leaving a devastating impact on those who have just lost their life savings," he says.

There are many ways that SMSFs can become victims of fraud and they are not limited to investing in schemes like Trio. If an SMSF trustee becomes the victim of identity theft, then the investments of their SMSF and those of all other trustees in the fund, become vulnerable.

In fact, a report into serious and organised investment, released by the Crime Commission in July last year, found that the typical victims of fraud were:

- Middle-aged to older persons (often over 35 years old but usually over 50 years old);
- Male;
- Small business owners;
- Self funded retirees;
- Individuals who have previously made investments in other companies and were considered 'financially literate';
- Victims who are on share holder registers;
- Socially isolated individuals – geographically or otherwise.

The Australian Bureau of Statistics also found in a survey last year that personal fraud cost Australians $1.4 billion in the 2010-2011 year.

What can you do to prevent it?

The first thing to do is you need to understand your vulnerabilities.

Switzer expert Paul Rickard stresses: "You are largely on your own – there is no compensation scheme available to trustees if an investment promoter does something illegal or fraudulent – other than your normal rights under common law."

The table below, from the Review of the Trio Capital Fraud and Assessment of the Regulatory Framework released by Treasury earlier this year explains what you are covered for.

Spectrum of Regulatory Intensity

CATEGORY	APRA REGULATED SUPER FUNDS	MANAGED INVESTMENT SCHEME	SMSF
Responsibility for investment decisions	Trustee	Responsible entity	Members (also trustees)
Prudential regulation (by APRA)	Yes	No*	No
Consumer protection regulation (by ASIC)	Yes	Yes	Yes
Redress and compensation against fraud	Yes through industry levied post funded scheme	May seek redress for misconduct by the AFSL	No compensation scheme for SMSFs. May seek redress for misconduct by the AFSL if it has provided services to the SMSF

*In general, the answer is no however there are a small number of entities that are regulated by both APRA and ASIC.

It is important to maintain the normal checks and balances that you would to prevent identity theft, such as the following:

- Protect passwords and change them regularly;
- Secure your physical mail i.e. lock your letterbox;
- Destroy or shred important information;
- Install virus protection;
- Check your SMSF statements and relevant documents regularly for out of the ordinary transactions.

When it comes to investments, be inquiring and make sure you use accredited professionals like those with SPAA recognition. Always remember if something sounds too good to be true, it usually is.

“As an SMSF trustee, you have to be increasingly knowledgeable about the information being given,” SPAA chief executive officer Andrea Slattery stresses.

“If you’ve gone with someone who is competent and knows what they are doing, they are working towards best practice and those best practice processes will allow people to have information and knowledge and security around some of the compliance processes,” she says.

If you do get caught

For investment fraud, if the losses were a result of negligent advice from a licensed advisor, you can seek redress from the advisor’s Australian Financial Services Licence (AFSL) and be compensated via their public liability insurance. You can try the courts for basic fraud and theft but this can be an expensive and lengthy process as many Trio investors have found.

If you get caught up in an identity theft, you could be encouraged by a public and private initiative that David Lacey, in his new role as a research fellow at the University of Sydney and partner at Pario Solutions, is now involved in.

He is driving a feasibility study that will look at how organisations across both the public, private and not-for-profit sectors are orientated towards assisting victims and will look at establishing a trans-Tasman support network – called iDcare – that would be the first port of call for anyone, including SMSF trustees, who has become a victim of theft.

“It’s important that whatever iDcare becomes, it’s a partnership between industry and government to support the community. The feasibility study to be conducted needs to listen and learn from the experiences of Australian and New Zealanders, who have had to go it alone to recover from these criminal acts,” Lacey says.

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Question of the week – income replacement

by Paul Rickard

Q: *Paul, we took your advice and sold Woolworths. What is the next buy for the income/growth portfolio? Are bank prices too high and mining stocks and mining related stocks in for a downgrade?*

A: We have had a pretty good sell off with the financials – CBA this morning is off 9% from its high, ANZ and NAB 14%, and Westpac 17%. Included in the ANZ, NAB and Westpac price falls is the impact of going ex-dividend.

I agree with Peter and see some value in the materials sector, mainly BHP. That said, they are not the ideal stock for an income portfolio and I would be careful to ensure that I don't get overweight in the materials sector.

On a trade/replacement basis, I think financials offer marginally more value and prefer them to consumer staples.

Keep checking back to this page for the latest on our income portfolio.

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Did you know?

Last week I spoke to Ron Bewley, of Woodhall Investment Research and Switzer expert on Switzer TV. Watch here if you want to see more on his market outlook.