Switzer Super Report

Issue 216, 29 August 2013

Storm clouds gather

As markets worldwide prepare for a potential hit on Syria - a terrible situation that has already produced 1 million child refugees - we are seeing a flight to safety on the markets.

My advice to you though, is to hold tight. Yes things are going to get a bit rocky for a while, but mostly I think we're going to see some buying opportunities presenting themselves. And to help you out when it comes to what to buy, today we have Roger Montgomery talking about a little company they like a lot - Credit Corp Group.

Also in the *Switzer Super Report*, we have Charlie Aitken explaining why Woolworths deserves a bit of love, and when it comes to supermarkets it doesn't have to be one or the other (i.e. Wesfarmers or Woolworths).

Sincerely,

Peter Switzer

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The WOW factor – the market is underestimating Woolworths

by Charlie Aitken

Being a believer in *Peter Lynch theory* (the best investment ideas are the ones you see in your day to day life), today I wanted to have a look at Woolworths (WOW), where I have spent a disproportionate amount of time lately buying nappies!

Over the medium-term, WOW has been one of the greatest total return investments available in large cap Australia. But more recently, the retail sector analysts have turned against WOW, with the current BUY/HOLD/SELL recommendation ratio of 4/5/7 being the most negative on WOW I can ever remember. Similarly, the median price target is $32.83, the most bearish median price target versus current share price I can ever remember for WOW.

The table at the bottom of page charts the WOW share price, median analyst price target and BUY/HOLD/SELL recommendations (green/beige/red) since 1998.

That's why I want to have a look at WOW today because it's rare that great Australian businesses have such a consensus negative view. History suggests when that occurs contrarians should at least have a look.

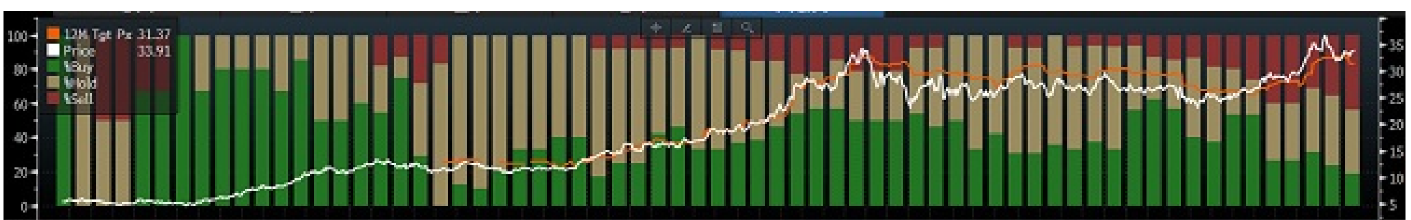
A different view

Firstly, I find it somewhat intriguing that the analysts are so negative on WOW when the chart below shows the company consistently beats consensus EPS forecasts and consensus is for EPS to continue to grow out to FY17. In fact, the compound EPS growth forecast for the next four financial years in WOW is 24%. That's pretty damn good compound EPS growth from the leading player in a defensive industry.

Secondly, WOW just delivered another year of stellar total returns to its 420,000 shareholders, around 50% of whom are Australian "mums and dads". The total return generated in WOW over FY13 was 30%, made up of 25% share price growth and 5% dividends.

The increase in market cap during the year was $8.5 billion. This was despite dividends of $2.1 billion paid during the financial year (final 2012, interim 2013 and SCA Property Group in-specie distribution). You could argue that the shareholder total return was $10.6 billion for FY13 (before any compounding benefit from reinvesting the dividends during the year). On the opening market cap of $32.5 billion, this equates to a return of around 33%. It's also worth noting that SCA itself delivered a total return of 17.6%, from December's IPO date to FY end, as another bonus to WOW shareholders.

The analyst negativity seems to be based around a view on the Masters hardware expansion JV. That view is somewhat justified as the start-up of Masters has been more expensive, slower and less profitable than expected, but, in all reality, it's a pimple versus WOW's food and liquor business and this could easily be another situation where a tail is wagging a share price dog.



remains a powerhouse. I see the Woolworths/Coles supermarkets competition as an “effective duopoly”. But by “effective duopoly” I don’t mean constant exercise of pricing power in terms of price rises to customers. In fact quite the opposite, where Coles and Woolworths use their buying power and scale to extract margin/better terms from suppliers (see the recent Coca Cola Amatil result ?) and then pass part of that on to customers. The customers are winners from what is an “effective duopoly” and you don’t read that in any economics textbook.

The barriers to entry are enormous in terms of capital, logistics and sites. Both players are consistently squeezing more and more out of their suppliers/supply chain to improve the perception of value to their customers, which in turn drives greater market share into the duopoly from smaller competitors, who can’t match their prices/service/range/buying power/loyalty programs etc. WOW reduced average prices by -2.9% in FY13. This average price reduction is smart business for a whole host of reasons, not least of which is consumer regulatory oversight.

I suspect some of the analyst negativity on WOW is driven by the perception that you can’t recommend WOW and WES. It’s a classic broker thing to like one and not the other, or vice versa, to attempt to drive investors to switch between the two. But in this case, I think comparing WOW to WES, and vice versa, is broadly useless. They should be looked at on their own merits, particularly as one is a genuine industrial conglomerate that owns everything from Bunnings to supermarkets and coal mines, and the other is a supermarket and hotel operator with a start-up hardware business.

WOW really is about Australian food and liquor. For the FY13 year, Australian food, liquor and petrol delivered $2.9 billion of the $3.54 billion group EBIT. That’s 84% of group EBIT that grew by 6.7% (normalised) in FY13. The crucial “gross margin” rose 30 basis points to nearly 25%. ROFE (Return on Funds Employed) rose 294 basis points to 76.7%, confirming the Grant O’Brien led management team has done an excellent job tweaking the business model and extracting extra economic value from $46 billion of sales.

Customer numbers increased by 3.6% per week to a weekly average of 28.4 million, with the now 7 million strong Everyday Rewards loyalty scheme driving higher average basket sizes and further customer loyalty.

Australians ‘hate a drink’ and “liquor” is in structural growth mode. Ditto hotels, where the gross margins are huge.

This combined to drive 22.8% EPS growth for WOW in FY13 (4.8% normalised) and a total of $2.2 billion returned to shareholders in various means.

The tail

Regarding Masters, which appears to be the tail currently wagging the share price dog, WOW believes they are at peak start-up losses right now.

Loss leading start-ups that require reasonably large capex have a history of weighing on share prices. However, as the market becomes more comfortable that the start-up losses are peaking and therefore the overall effect on group financial metrics are peaking, it will become more comfortable with the concept and most likely move back to analysing and pricing the WOW food and liquor powerhouse.

Yet despite the larger than anticipated losses at Masters and the effect on group free cash flow, WOW shareholders received the equal largest total distribution from the company. Even after that, the good news is that WOW is sitting on an absolute mountain of franking credits, meaning the likelihood of buybacks and special dividends is high, once the Masters free cash flow and EPS impact reverses. This is a very important point, considering WOW’s retail investor dominated share register. WOW is feeding its loyal retail shareholders “yield”.

In terms of forward guidance, WOW said when announcing its results, “We expect another year of profit growth with FY14 NPAT from continuing operations to increase 4% to 7%.”

WOW is currently cum the 71c fully franked final FY13 dividend. Consensus is for the annual dividend to grow to $1.41 in FY14. That equates to a prospective 13-month yield from WOW of 6.0% fully

franked, or 8.6% grossed up. I think that yield support alone is enough to support WOW in the year ahead around current prices, but what interests me more is what P/E the market will pay for this stock.

P/E improvement on the cards

The consensus FY14 EPS forecast is $2.00 (inc Masters' losses). On the guidance given, that seems about right. Yet P/E has been taken off WOW for the near-term uncertainty of the Masters strategy and I have a feeling it will be added back on, as the market becomes more comfortable that the losses from the strategy have peaked.

I am certainly not in the camp that Masters is going to be some giant ongoing stuff up. I don't even need it to be a wonderful success, because at the end of the day, WOW really is all about food, liquor and petrol retailing. My view is stability in Masters = P/E being added back to WOW. It's a pretty simply view that the dog will revert to wagging the share price tail, not vice versa.

In the year ahead, I see WOW P/E heading back to 19 times FY14. That equates to a $38.00 share price. Making a couple of bucks and collecting a couple of bucks in fully franked dividends over the next 13 months in WOW is a nice return from a defensive business.

I think the analysts are too down on WOW at the peak of Masters' losses and the low point of group P/E. High class, well-run, massive barriers to entry, high sustainable ROE businesses are rarely cheap and I think WOW should be added to portfolios.

Go Australia, Charlie.

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Credit Corp Group – a stock to consider

by Roger Montgomery

This week I bring to your attention a little business that is both relatively easy to understand and is also currently enjoying a little time in the sun. It is a company we have held since inception. The business is Credit Corporation Limited (CCP).

What does it do?

Irrespective of whether it's a bank, utility or telecommunications company, a business without the specialised skills or teams required to deal with large numbers of accounts in arrears will turn to a company like CCP to fill the gap.

CCP turns accounts receivable into cash today and reduces the amount ultimately written off as bad debts later.

Problem payers with specific age and maturity profiles, for example accounts that are 180 days in arrears, are rolled into a single vehicle known as a 'Debt Ledger'. Thousands of credit cards, gas, electricity and mobile phone customers, who have not kept up with their payments, are bundled together and marketed for sale to debt collection businesses.

CCP analyse the ledger, the type of debts, the age and profile of the non-payers and what return they believe they can make by taking it on. Provided their required return can be met, CCP will bid a few cents in the dollar, and if they are selected as the preferred bidder, the newly acquired ledger becomes another part of the core assets of the business, which includes the many ledgers purchased before it.

Known in the company's language as PDLs or Purchased Debt Ledgers, CCP educate and manage the underlying, newly-acquired accounts to ensure payments are brought back on track. Debt management is what they do best, simple.

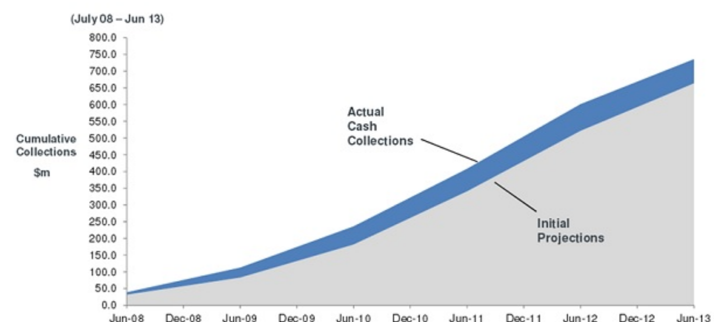
Keep it simple

We prefer simple businesses. The easier a business is to grasp, the lower the risk of an unforeseen 'event'. With that in mind, CCP management really only has to get two things right.

Because the main assets on the balance sheet are PDLs, the first thing to get right is rationally forecasting the returns that each ledger will generate to ensure the company does not overpay/overbid. A general rule in investing is the lower the price you pay, the higher your return. Naturally, therefore, you'd expect management to be as conservative as they can here, but balanced against competitive forces.

Secondly, in order to hit the return target initially forecasted, the business as well as actual collections from the ledgers must be run efficiently. As Fig 1 shows, this has been the case in recent years.

Fig 1.



Over a number of years, CCP has built market leading systems and processes, as well as a team of 964 people to help deliver consistent, and importantly, scalable business outcomes. This includes a significant move to 'offshoring' collection teams in order to make purchasing lower balance accounts, such as utility and phone bills, economical.

A focus on income

CCP is also lowering their earnings risk by shifting their revenue mix to a 'recurring' nature, with 72% of all PDL collectables now on regular payment arrangements. Some of the best investment attributes that spill out from a larger recurring revenue base are business stability, the ability to forecast future cash flows with a greater level of confidence, clarity of the businesses financial metrics and higher returns to shareholders.

Since 2008, CCP's intrinsic value has grown steadily from $2.33 to our forecast range of $9.50 to $10.00. And if you believe Benjamin Graham's observation that in the long run, the market is a 'weighing machine', then you would agree that prices eventually follow valuations. And indeed, that is precisely what has happened in CCP's case.

CCP, however, can't grow forever, and while there is always the temporary risk that rising unemployment could make it harder for the company's customers to pay back their smaller debts, at some point the business will, more permanently, mature in Australia. When it reaches that point, other growth engines will be needed, and already management is focusing on the future, with two paths to extending the winning streak of shareholder returns.

The future

CCP has commenced a new business line providing personal loans to customers for whom they obviously have detailed knowledge of a reasonable credit history.

The typical loan is $3,500 and the company has built a $20 million book funded from its own cash flow, earning 40% (yes, F-O-R-T-Y) interest rates and below-industry defaults. The potential is a total loan book of $70 million with a target after-tax return on equity of 16%. The incremental profit potential here is therefore approximately $4.2 million.

The other is the business's expansion overseas into the United States. The US expansion plan is very important, as this would become the business's next big source of growth. And the opportunity is large.

The US collections market is currently dominated by Managed Investment Schemes (MIS) and private equity players, who are known to purchase books, squeeze them as quickly as possible (collect the easy money) to get their money back, and then flip the remaining books for a riskless profit. It's estimated that 90% of the market participates in such activities but new legislation has effectively stamped out this practice.

Sellers of PDLs (Citigroup, American Express, JP Morgan, Chase etc.) now have to ensure that books are being sold to reputable organisations that will manage their books and NOT resell. According to CCP, a large portion of the US collection market will be impacted by the structural change to a collection 'servicing' model. This appears to play directly into CCP's strengths and it opens the door to a large opportunity. CCP can take market share while other participants scramble to get their houses in order.

Like any business strategy or investment however, it's not without its execution risks. While we currently rate CCP management very highly, we are watching this development with interest.

Until our view changes, which of course can occur at any time, the outlook appears to be bright. CCP remains a business that is quietly doing what it does best and a business that we will happily hold in our funds at Montgomery.

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My SMSF – in control of my destiny

by Super Report Subscriber

Name: Peter
Occupation: Strategic policy, energy industry
Age: 63
Other members of your SMSF: My partner is a trustee. However, she has her superannuation in a government employee Defined Benefit Scheme. We recently considered moving her investment account into the SMSF, but decided to use that money to purchase additional years of service for her defined scheme.

How long have you had your SMSF?

I established the SMSF in June 2012. For about eight years prior to that, I had a financial advisor handling my superannuation, and before that I was in a mixture of government and private superannuation.

Why did you start it up?

I have always had an interest in finance and investing and my advisor was moving to another position about a year or so ago. That provided me with the impetus I needed to make the decision to do it myself. I also have a background in economics and finance.

How big is it?

Currently, it's about $850,000. It was somewhat larger before the GFC, and I'm happy that I have, to date, been able to slowly build it up again. I often feel that, if I had control of my investments before, during and after the GFC, I would have taken a different tack to the one taken by my previous advisor. However, hindsight is a wonderful thing.

Is it more or less difficult to manage than you thought it would be?

I have been pleasantly surprised at the ease with which it all fell into place. It is definitely easier than I expected, despite the fact that I still work full-time. I actually don't mind the occasional administrative tasks associated with it, and I certainly love the challenge of looking for new investments and re-balancing my portfolio on the odd occasion.

Are you glad you have it?

Yes, I like the idea of having control of my own destiny, and not having advisor or trailing commission fees to pay.

Are you pleased with its performance?

So far I am happy with the way it has gone. In the year to June 2013, I managed a return of about 23.5% (that includes contributions through salary sacrifice arrangements). I am cognisant of the fact, however, that the period was one of good overall returns across the board. That will not always be the case, and the next challenge for me is to learn how to hedge against market corrections, when or if they occur.

What is your asset allocation?

I currently hold Australian shares directly (51%), Australian shares through a managed fund (10%), international shares through a managed fund (7%), listed property through a managed fund (5%), Westpac Capital Notes (5%) and cash (11%). The remainder is held in the form of assets in an ATM investment scheme.

I hold almost 50% directly in financials, banks and insurance, which I may re-balance soon, as I think that is now overweight. The other half of the direct equities covers the top 20 "blue chips" such as Telstra, Woolworths, Wesfarmers, BHP, Rio, Woodside, CSL, CCL etc. I also reserve a small amount for small caps and a very tiny amount for

'speculatives', just for fun. The overall portfolio covers the range of sectors, including telcos, materials, energy and health. I am currently 90% in large companies and 10% in medium and small caps.

What are your favourite investments/stocks and why?

Definitely direct investment in Australian shares of good quality. My favourite stocks have been Telstra, Seek, Integrated Research and CSL. I have currently taken a risk and bought a small quantity of Billabong shares with the hope that this company will be successful again.

What investments do you have outside of superannuation?

My partner and I own our house. We also have two investment properties that we manage outside the SMSF, as well as a $100,000 ATM investment (separate from the one in the SMSF), financed by an investment loan. We also have about $25,000 in ANZ and Telstra shares held in trust for my partner's daughter. My partner purchased those when her daughter was born.

Do you use an advisor or any kind of service provider?

I have no formal advisor, but I subscribe to the *Switzer Super Report* and three other subscriptions. I also keep up with market and international events by reading the financial sections of the newspapers every morning.

I selected E-Superfund as my SMSF platform to look after the taxation, financial and audit side of the SMSF requirements, and they handle that side very efficiently.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

It's still all about earnings reports for the brokers. Billabong had a shocker, and although it wasn't entirely unexpected, it still scored four swift downgrades. Next week, things might get back to 'normal', with most companies having reported by the end of this month.

In the good books

After announcing a bumper financial year result last week – net profits tripled to $776 million – JP Morgan was the last broker to move on Insurance Australia Group (IAG), and upgraded, where others had downgraded. Earlier downgrades were based on the expectation that things will get tougher from here. But JP Morgan believes fundamentals remain supportive and expects momentum on premium rates into the first half of next year, upgrading it to Neutral from Underweight. IAG currently has four Neutral ratings and four Underperform ratings from the eight major brokers.

Although Crown (CWN) reported a 22.9% fall in net profit to $395.8 million, due to the $70 million loss on its investment in Echo Entertainment, the result was mostly in line with broker expectations. Credit Suisse upgraded the company to Outperform from Neutral after upgrading its earnings forecasts, based on expectations for higher Macau earnings.

Credit Suisse also upgraded McMillan Shakespeare (MMS) to Neutral from Underperform. The company's results were largely in line with expectations, although no final dividend was declared. McMillan is clearly an election play that was sold off on the Rudd Government's FBT announcement, and is picking up momentum as an Abbott victory looks more and more likely.

In the not-so-good books

Brokers were disappointed with Boart Longyear's (BLY) interim results of a net loss of $US329 million. The contract driller has been hit hard by the mining slowdown. Credit Suisse and CIMB both downgraded it to Underperform from Neutral, and Macquarie to Neutral from Outperform.

Although a potential debt restructure could help the company's fortunes, Macquarie warned that it came with no guarantees and debt levels could remain high for some time.

Credit Suisse upgraded Caltex (CTX) following its results to Outperform from Neutral, while Macquarie downgraded it to Underperform from Neutral and UBS to Neutral from Buy. Its result was in line with expectations and Credit Suisse says the value is the firm's infrastructure, which makes the company compelling value at these levels. Macquarie was more concerned about the tougher outlook, and UBS thinks the share price is fully valued, which is why they chose to downgrade.

It appears that most brokers agree Billabong's brand is worth zero, after it announced a loss of $895.5 million for last financial year. Citi, Deutsche Bank, JP Morgan and UBS all downgraded it to Underperform or Sell from Hold or Neutral, except in Citi's case, which previously had it as a Buy. Potential restructuring activity and an uncertain outlook for the group, seemed to bother the brokers most.

The above was compiled from reports on the FNArena database, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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Some long-sought clarity on pensions from the ATO

by Tony Negline

Over the last couple of years, a draft ATO tax ruling about superannuation pensions has had a big impact on how all retirees use pensions.

This ruling has now been finalised and many of the nasties in the draft have been taken out.

For example, the ATO originally said that CGT is payable on super fund assets before funds paid any lump sum death benefits. To solve the potential claim that the government had surreptitiously introduced death duties, the tax laws were amended in May 2013 to remove this impost for death benefits paid as soon as possible after June 2012.

So what does the ATO's finalised ruling actually say? It primarily deals with two main issues – when a pension commences and when it ceases or is deemed to have ceased. Both these issues impact when a super fund pays 0% tax on its pension income. Here are five key issues you need to know relating to the ruling (TR 2013/5).

1. A pension can't commence until all capital is in the fund

You can't commence a pension until a super fund has all the capital for that pension. Suppose you intend to contribute money into your SMSF and those contributions will be used to pay you a pension. The pension can't start until you've actually made all the contributions you want to use in the pension and they are physically assets of the super fund. A similar issue applies with transfers into your super fund from other super funds.

2. Must have documentation

A pension can only commence if it has been specifically documented before it starts. A good way to solve this problem is to only commence a pension when you have completed application forms.

For several decades, it's been quite common for this documentation to be completed long after the end of a financial year in which a pension commenced. SMSF trustees and administrators will face a big change because this will no longer be acceptable.

Your super fund won't get an exemption from income tax for its pension assets, unless you can show a member was eligible to receive a specific pension and, if required, you can also show the member wanted the pension.

Let's look at two examples. Firstly, after turning 65, you asked your SMSF trustee to pay you a pension. In these cases, you will have to submit a pension application form to the trustee, who will then check to see if you're allowed to receive a benefit, and also that you're allowed to take it as a pension. Once they have completed that work, they can put the pension in place.

Secondly, your spouse is recently deceased and they had completed a binding death benefit nomination that specified you would be paid a part lump sum and part pension. In this case, the trustee confirms you're the former member's spouse and pays you the lump sum and then puts the pension in place. As you're a pensioner beneficiary, you would have to become a member and trustee of the super fund, if you don't already hold those positions.

3. Commuting a pension

You'll only be permitted to take a lump sum out of a super pension if the pension's documentation allows you to ask that some, or all, of a pension's account balance can be taken out as a lump sum and not as pension payments. (Thankfully this is a relaxation of the rules contained in the 2011 draft ruling.)

4. All super pension laws must be satisfied throughout the year

The ruling says that a super fund must satisfy all the super pension laws during an income year. A failure to follow these rules will mean that a pension hasn't been paid throughout a financial year. In simple terms, this means the fund will pay 15% income tax on the pension's earnings. The ATO says that if a pension is paid in subsequent years, it'll be deemed to be a new pension.

The minimum income requirements are the rules that are most frequently broken. The minimum income is based on your age, and is worked out each 1 July using your pension's account balance, where the assets are valued at prevailing market prices.

For example, in the 2013/14 financial year, the minimum payment for those aged at least 65 but under 75 with a pension in place on 1 July, 2013 is 5% of the account balance on that date.

In January 2013, the ATO announced a minor concession for breaches of this minimum income rule, however this concession can only be used once and only for small breaches of up to 8.3% of the required annual minimum.

5. Pension ceases on death, unless reversionary specified

The ruling says that a pension ceases immediately a pensioner member dies, unless income payments automatically continue to be made to a nominated beneficiary.

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Bond buyer beware in choppy markets

by Gavin Madson

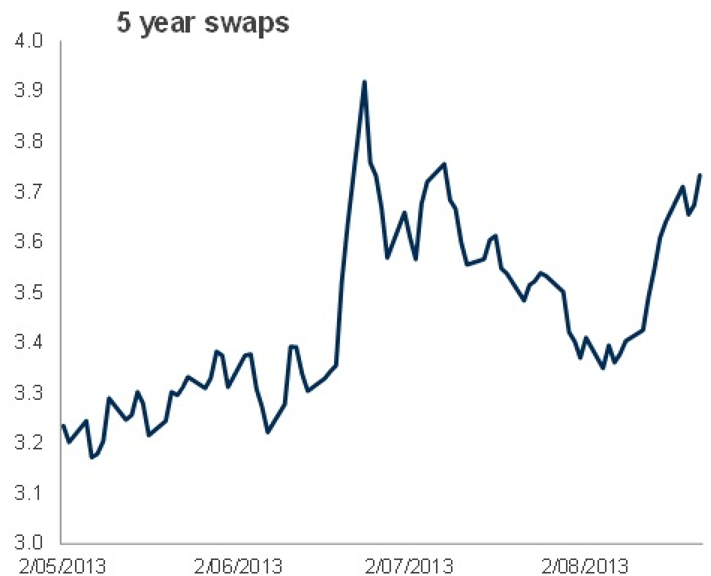
The last three months have seen some dramatic movements in the markets. Following Ben Bernanke's comments in June that the Fed would be reviewing its quantitative easing (QE) program with the view of easing the US$85 billion per month bond buying program, global markets sold off dramatically as investors switched out of 'risk assets'.

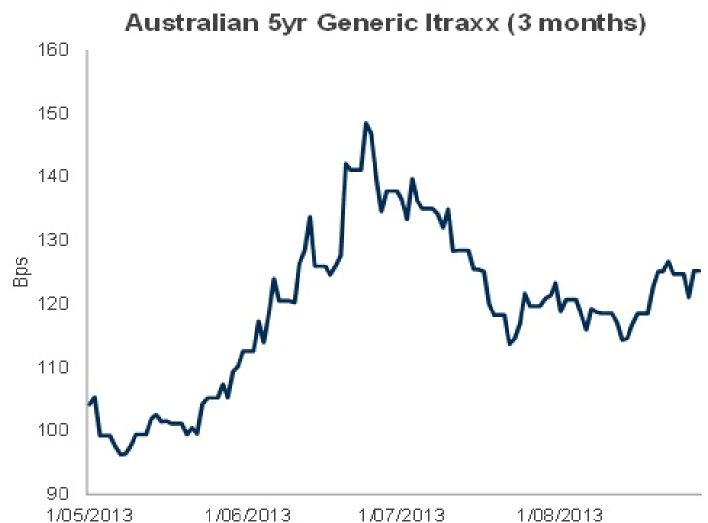
Further to this, the Federal Open Market Committee (FOMC) minutes showed members were described as being "broadly comfortable" with Bernanke's plan to start reducing bond buying later this year, if the economy improves. The latest public comments however, which came after the July FOMC meeting, have shown an increasing willingness to commence the taper as soon as September.

Taper me this

In response, large movements were seen in equity, currency and bond markets, the latter impacted by the realisation that a very larger buyer of bonds will no longer be there when QE is removed, therefore reducing demand. The market reaction was a fall in government bond prices and an increase in yields (given the inverse relationship between fixed rate government bonds and yields).

The following graphs show the movement in 5-year AUD swaps and the iTraxx Credit Default Swap (CDS) index (which is an indicator of credit risk – the lower the spread, the lower the perception of credit risk).

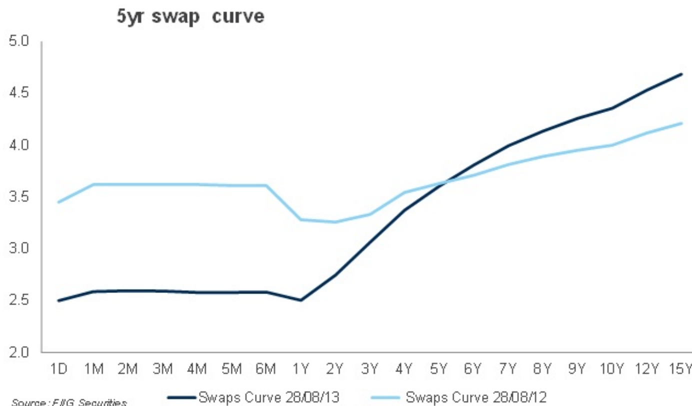




We can see both measures have increased over this period, most notably the spike in late June when Bernanke first made his comments. In regard to the Itraxx, since index lows in May, spreads have widened some 30 basis points, primarily as expectations firmed regarding the Fed's scale back of monetary stimulus.

Swap curve steepening

If we look at the change in the 5-year swaps curve from 12 months ago compared to today, we can see the dramatic effects of recent market movements.



The pale blue line shows the curve 12 months ago. At that time it represented a shallow ‘U’ shape, indicating that there was value on offer in the short-dated market, which for most investors is the term deposit market. In fact, the curve was offering better returns for 30 days than it was for 3 years. The curve has now flattened in the short end and steepened at the long end. This suggests there is now better value on offer further out along the curve.

So where to invest?

The widening of credit spreads combined with the steepening in the yield curve presents opportunities for investors. While widening credit spreads lead to better yield for investors at all maturities, the steepening adds additional return at long end of the curve. So for investors holding fixed income securities, the message is to consider moving out of shorter dated securities and move into longer dated maturities. Or look to take advantage of the volatility and buy on the wider spreads.

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Question of the week – Melbourne CBD property

by Questions of the week

Question: *I have a question relating to a one-bedroom apartment that I bought off the plan in the Melbourne CBD. Is property in the Melbourne CBD (Flinders St) a good investment proposition for an SMSF?*

Answer (By Paul Rickard): I understand that the short-term outlook for near Melbourne CBD residential property (in particular, Docklands) is still weak with some supply overhang. In the long term, the overhang should clear and provided the economy (and the city) grows, CBD residential property will probably do ok.

In terms of whether a property in Flinders Street is going to be a good investment for your SMSF, the questions you should consider are:

1. What is your intended holding period – will you hold it long enough to see the market improve?
2. Will you hold the property long enough to get it into a "capital gains tax free state" (ie: the asset will be supporting the payment of a pension)?
3. What is the expected net rental return on the property?
4. How much of your fund does it represent (how much 'single asset' exposure is there)?
5. What is the "opportunity cost" in investing in this property? What other investment opportunities will you miss out on if you invest in this?

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.*