Switzer Super Report

Issue 222, 19 September 2013

The big picture

It was a little bit of a surprise, but overnight the Fed chairman Ben Bernanke decided not to ease the easing program, that means the tapering caper hasn't started yet. If you know me, you know I'm not too bothered about the easing of the Fed's buying up bonds anyway, as when it does happen, it will be because the Fed thinks the economy is strong enough to handle it. But in the meantime, our market, along with most others, has had a boost today.

But as all good *Switzer Super Report* subscribers know, there are always opportunities if you know where to look, and today to help you out with those decisions we have Charlie Aitken talking about "nation builders" like Leighton and Lend Lease. Ron Bewley finds some surprises in the listed property sector and Geoff Wilson explains why property business Villa World could be a good investment.

Sincerely,

Peter

Peter Switzer

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Buy a nation builder

by Charlie Aitken

The biggest frustration with living in Sydney is its inadequate arterial road and motorway network. It is retarding Sydney's productivity.

And I'm sure it's not that much different in the other capital cities.

Infrastructure is always playing catch up to demand, which further reduces productivity during road upgrades.

I believe we are entering a new period for Australia, where federal and state funds are committed to critical infrastructure projects that reap economic rewards well beyond the current election cycle.

I also believe we are entering a period of renewed federal and state cooperation in terms of infrastructure projects.

Federal and state political leaders are clearly working out the greatest sustained GDP multiplier you can generate from allocation of taxation dollars is via infrastructure upgrades, but particularly roads. You get a shorter-term GDP multiplier lift in the construction phase, and a longer-term GDP multiplier lift in the completion phase, via productivity gains. This is another reason I believe Australian GDP growth is bottoming right now.

Money to burn

At the same time, the superannuation system is flush with funds looking at long life projects to meet obligations, which can't be met with 4% bond yields (1.5% real). More importantly, Canberra is looking at the hundreds of billions of dollars held in unproductive cash and looking at ways of using this to fund infrastructure through tax efficient bonds inside the super/SMSF system.

Sydney's current arterial road and motorway network remains a patchwork of inefficiency, with major motorways starting and ending at two lane roads, motorway tunnels that are two lanes, federal roads meeting state roads, numerous 3:2 merges and clear missing links. One oversize truck going into a tunnel causes hours of gridlock!

The solution

Critical upgrade projects I would build over the next decade to vastly improve the road transport infrastructure of Sydney and its economic efficiency/productivity include:

- M1 (F3) –M2 missing link tunnel (8kms)
- Westconnex 33kms from M4 East to Anzac Bridge and M4 East to M5 at Beverly Hills (not 90210)
- Widening of the Eastern Distributor to three lanes each way
- Widening of the M5 tunnel to three lanes each way
- Construction of the M6 "Shire Motorway" from the M5 at Kogarah to the F6 at Heathcote
- Construction of the M8 "inner ring motorway" from the M2 cross M4 to M5 at Bankstown

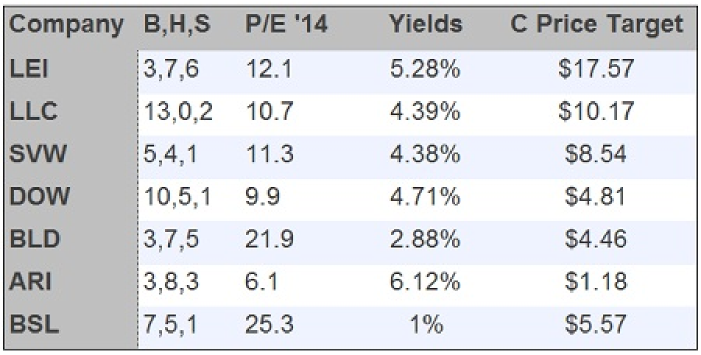
These are massive multi-year infrastructure projects that will require tunnelling expertise, road building expertise, civil works, concrete, slab steel, reinforcing bar, heavy equipment and manpower. As the mining capex boom peaks over the next few years, the re-mobilisation of skilled labour and equipment will head East.

The opportunities

I am only using the Sydney basin motorway example above, but you can be certain that a renewed national political focus will be on infrastructure upgrades and innovative ways of funding them (buy Macquarie Group).

Nation building – you are going to hear those words used a lot more over the years ahead and you need to own a few “nation builders”. Leighton (ASX Code: LEI), Lend Lease (LLC), Seven Group (SVW) through Caterpillar/ Coates Hire, Downer EDI (DOW), Boral (BLD), Arrium (ARI) and Bluescope Steel (BSL) are the most obvious “nation builders”.

The buy/hold/sell ratio on each of those stocks is below, with the current consensus P/E for FY14, yield and price target. You can see there is very little optimism in the share price targets and clearly no acknowledgement (yet) of the above. The majority of P/E’s also look bottom of the cycle. FY15 could be huge for these names as what I write about unfolds.



Company	B,H,S	P/E '14	Yields	C Price Target
LEI	3,7,6	12.1	5.28%	$17.57
LLC	13,0,2	10.7	4.39%	$10.17
SVW	5,4,1	11.3	4.38%	$8.54
DOW	10,5,1	9.9	4.71%	$4.81
BLD	3,7,5	21.9	2.88%	$4.46
ARI	3,8,3	6.1	6.12%	$1.18
BSL	7,5,1	25.3	1%	$5.57

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Getting the cycle right - Villa World

by Geoff Wilson

A perusal of the BRW Rich 200 list will provide ample motivation for any ambitious young entrepreneur to dive into the property development game. It appears that the property industry has made more people wealthy than any other in Australia.

The pre-GFC property boom that we experienced was perhaps not as extreme as previous property booms, such as the one that crashed at the end of the 1980s, which brought the mighty Westpac to its knees (along with many others). However, the excessive lending and high inflation did result in a speculative bubble in property that ultimately led to many, many property business failures when the banks finally called in their loans. As Warren Buffet likes to say, “We don’t find out who is swimming naked until the tide goes out.” Well, as with all booms, it finally busted and those swimming naked got blown-up.

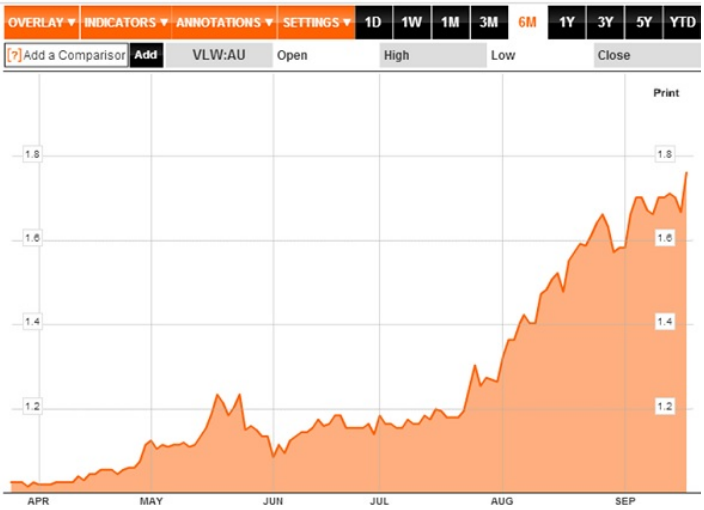
The exception

One small listed residential property developer that rode this rollercoaster is Villa World Limited (ASX: VLW). Villa World has been listed since 2004, but started life back in 1986, so the company has been around the block, so to speak. It had residential development projects in Queensland and Victoria.

At its peak back in December 2005, the stock price reached $6.30. During the post-GFC period the stock fell all the way to about 30 cents – ouch! What a painful reminder of what often happens to cyclical businesses when the party stops.

We started buying Villa World early this year at around $1.20. At the time, it had net tangible assets (‘NTA’) of $1.76 and had gone some way towards cleaning up its balance sheet, and the mess left behind by the GFC and the indiscretions committed during the boom.

Stock Chart for Villa World Ltd (VLW)



Source: Bloomberg

We took the view that the long-term bear market in residential building would start to improve, based on interest rate cuts and a significant under supply of residential property. We also liked the buffer provided by the discount to NTA.

In Villa World’s recent pre-release update, we were encouraged to see that the balance sheet is well on the way to being cleaned-up (although debt remains high) and demand for the company’s affordable home packages continues to firm, particularly in the Queensland market where the company is based.

It’s encouraging to see the NTA edging up too, the last report pegged it at $1.85. While Villa World’s underlying business is profitable, it is still experiencing non-recurring losses due to balance sheet clean-up. Its underlying profit for the 2013 year of $11 million is around a third of its ‘peak of cycle’ earnings back in 2005. It may be a long road back, but potential upside is clearly substantial.

Evidence of clean-up

The stock is under-owned by institutions, and the company has done very little marketing while it has focussed on getting its ‘house in order’.

For us, it’s a classic counter cyclical play and while some bought the stock earlier in its recovery, we wanted to wait until we saw evidence of the recovery and sale of non-core assets before buying. As we have said before, we wait until we can identify re-rating catalysts for a cheap stock before venturing in.

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REITs now look cheap and attractive

by Ron Bewley

In my previous review on the 7th March 2013, I reported that forecast capital gains for the property sector over the next 12 months were a negative 0.5%, and so it could only reasonably be considered as a dividend play. As it turns out, the capital gain over the last six months for the sector was a negative 1.4%, compared to an ASX 200 gain of 1.4%. When dividends – but not franking credits – are reinvested, the sector would have returned 4.7% compared to 7.3% for the broader index.

Only two stocks, Westfield Retail Trust (WRT) and Dexus Property Group (DXS), made the cut for High Conviction stocks, with Westfield being preferred to Dexus. That is, they were in the top 100 and met my '2.5' broker recommendation status (please see here for details).

From Table 1, both Westfield and Dexus lost ground, but the sector also lost ground overall and the highest capital gain was 4.1% for Abacus Property Group (ABP). Over the period since my last review, Westfield's recommendation has improved from 2.25 to 2.10, and Dexus has improved from 2.58 to 2.20. On that basis, there would be no need to change my preferences for this sector but there are now four more stocks that are worthy of consideration: Mirvac Group (MGR), Stockland (SGP), Investa Office Fund (IOF) and Federation Centres (FDC). In particular, Investa and Federation have particularly strong recommendations. Only Charter Hall Group (CHC) in the small caps group attracts attention.

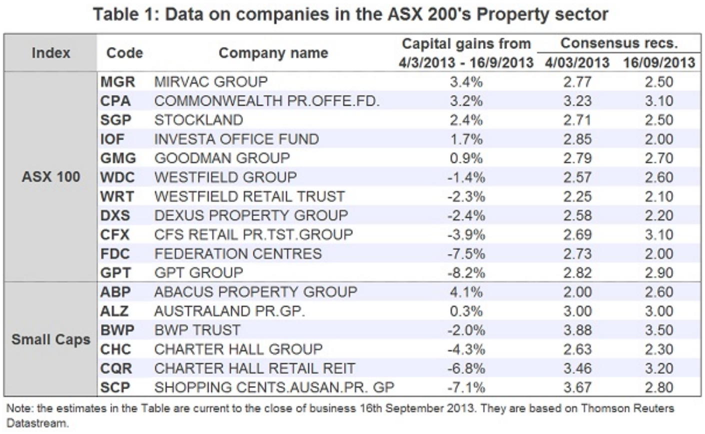


Table 1: Data on companies in the ASX 200's Property sector

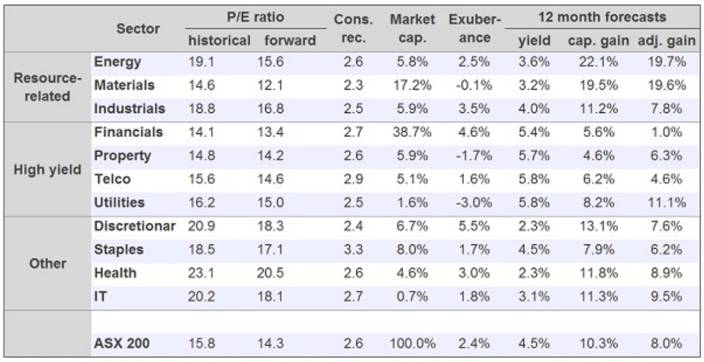
Index	Code	Company name	Capital gains from	Consensus recs.	
			4/3/2013 - 16/9/2013	4/03/2013	16/09/2013
ASX 100	MGR	MIRVAC GROUP	3.4%	2.77	2.50
	CPA	COMMONWEALTH PR.OFFE.FD.	3.2%	3.23	3.10
	SGP	STOCKLAND	2.4%	2.71	2.50
	IOF	INVESTA OFFICE FUND	1.7%	2.85	2.00
	GMG	GOODMAN GROUP	0.9%	2.79	2.70
	WDC	WESTFIELD GROUP	-1.4%	2.57	2.60
	WRT	WESTFIELD RETAIL TRUST	-2.3%	2.25	2.10
	DXS	DEXUS PROPERTY GROUP	-2.4%	2.58	2.20
	CFX	CFS RETAIL PR.TST.GROUP	-3.9%	2.69	3.10
	FDC	FEDERATION CENTRES	-7.5%	2.73	2.00
	GPT	GPT GROUP	-8.2%	2.82	2.90
Small Caps	ABP	ABACUS PROPERTY GROUP	4.1%	2.00	2.60
	ALZ	AUSTRALAND PR.GP.	0.3%	3.00	3.00
	BWP	BWP TRUST	-2.0%	3.88	3.50
	CHC	CHARTER HALL GROUP	-4.3%	2.63	2.30
	CQR	CHARTER HALL RETAIL REIT	-6.8%	3.46	3.20
	SCP	SHOPPING CENTS.AUSAN.PR. GP	-7.1%	3.67	2.80

Note: the estimates in the Table are current to the close of business 16th September 2013. They are based on Thomson Reuters Datastream.

Turning to Table 2, the property sector is slightly cheap (exuberance is 1.7%) and the adjusted capital gain is 6.3%. With a predicted yield of 5.7%, this sector is now very attractive indeed. Property is currently a viable alternative to financials, as that sector is quite overpriced with exuberance at 4.6%.

It should be noted that no sector is sufficiently overpriced to warrant alarm, but discretionary (5.5%) and financials are getting close to that zone. The capital gains' forecast for the broad index has slipped since the start of the August reporting season – but only by about one percentage point. The adjusted gain forecast is only 8.0%. While that is a good number compared to long-run returns, it is not as exciting as many of the forecasts we made earlier in the year. However, we have reason to believe that the broker forecasts of dividends and earnings on which my calculations are based may soon be revised upwards.

Table 2: ASX 200 sector statistics



	Sector	P/E ratio		Cons. rec.	Market cap.	Exuber-ance	12 month forecasts		
		historical	forward				yield	cap. gain	adj. gain
Resource-related	Energy	19.1	15.6	2.6	5.8%	2.5%	3.6%	22.1%	19.7%
	Materials	14.6	12.1	2.3	17.2%	-0.1%	3.2%	19.5%	19.6%
	Industrials	18.8	16.8	2.5	5.9%	3.5%	4.0%	11.2%	7.8%
High yield	Financials	14.1	13.4	2.7	38.7%	4.6%	5.4%	5.6%	1.0%
	Property	14.8	14.2	2.6	5.9%	-1.7%	5.7%	4.6%	6.3%
	Telco	15.6	14.6	2.9	5.1%	1.6%	5.8%	6.2%	4.6%
	Utilities	16.2	15.0	2.5	1.6%	-3.0%	5.8%	8.2%	11.1%
Other	Discretionar	20.9	18.3	2.4	6.7%	5.5%	2.3%	13.1%	7.6%
	Staples	18.5	17.1	3.3	8.0%	1.7%	4.5%	7.9%	6.2%
	Health	23.1	20.5	2.6	4.6%	3.0%	2.3%	11.8%	8.9%
	IT	20.2	18.1	2.7	0.7%	1.8%	3.1%	11.3%	9.5%
	ASX 200	15.8	14.3	2.6	100.0%	2.4%	4.5%	10.3%	8.0%

Note: the estimates in the Figure are current to the close of business 16th September 2013. They are based on Thomson Reuters Datastream and Woodhall Investment Research's analysis of that data.

The data from China has been so strong and unexpected by many that these results must surely have positive repercussions for the materials sector forecasts. Also, the boost in confidence following the general election, combined with some interesting movements in the household savings ratio and household personal loans, leads me to believe there might soon be a boost to the broader economy. If discretionary stocks are upgraded, that could be sufficient to erode the current high overpricing.

In conclusion, the property sector is looking good so sticking with Westfield Retail Trust and Dexus seems reasonable, but supplementing those holdings with Investa and Federation could pay dividends, as all four stocks have yields above 6%!

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FUNDIE'S
favourite

A soaring small cap for your portfolio

by Ben Griffiths

How long have you held Auckland International Airport (AIA)?

Initiated position in July 2013.

What do you like about it?

We like a number of things about Auckland International Airport (ASX Code: AIA). First, it is a concentrated portfolio of a monopoly, 24 hr airfield in Auckland (~74% of all international visitors arrive/depart here) as well as three, 25% stakes in Queenstown (NZ), Cairns and Mackay airports. Approximately half the group's revenues (aeronautical charges) are subject to regulator influence, with the balance being revenues from retail, carparking and property development activities.

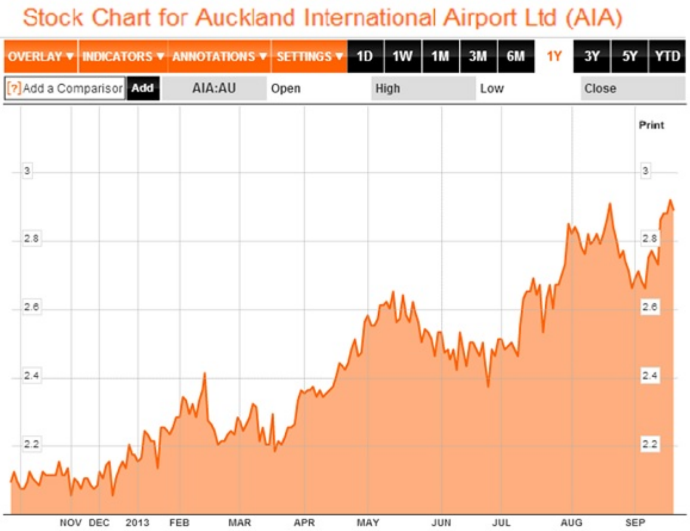
Second, AIA owns the Auckland airport freehold, and within the 1,500 ha title there is ample scope for ongoing commercial/industrial developments.

Third, Auckland airport continues to enjoy exceptional passenger growth numbers (Compound Annual Growth Rate of 4.7% since 2000) with services from Asia the obvious growth avenue for the group. Management has advised that FY14 passenger growth to 25 August is up 7.9%.

Fourth, the NZ economy continues to perform strongly, emerging from its funk hole in 2012, on rallying consumer and investment confidence. This looks set to continue.

How is it better than its competitors?

Effectively, it has no competitors. Auckland is the nation's predominant gateway and regional Queensland cities of Mackay and Cairns only have one airfield, which aims to capture holiday/business travel to these regions. There is zero risk of new entrants.



Source: Bloomberg

What do you like about its management?

The senior management team is high energy and well regarded. The CEO comes with a strong retail/commercial pedigree from Telecom NZ. There is a clear 'sweat the assets' culture within the group, and we would expect productivity dividends to feature going forward.

What is your target price?

We don't set price targets, preferring our investment process to reflect relative valuation metrics. We have been a recent accumulator of stock.

At what point would you sell it?

When our process suggests there are better relative value investment candidates. That's unlikely in the short term.

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

The stock has rallied since purchase, and has given us a 15.8% return, including dividends, since purchase.

Is it a liquid stock?

AIA is very liquid with turnover value at $233 million on a 6-month rolling basis. It will shortly be added to the ASX300 index.

Where do you see the value?

Despite its solid share price performance to date, we see the strong likelihood of continuing share price appreciation as inbound travel, chiefly from Asia, swells and the group's assets are leveraged to maximise returns.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

At the tail end of reporting season, one company managed to draw opposite reactions from brokers, and banks got a good going over by BA-Merrill Lynch, which acted on three of the Big Four.

In the good books

BA-Merrill Lynch upgraded Commonwealth Bank (CBA) to Neutral from Underperform. The broker likes that CBA is the least leveraged to institutional lending of its peers. BA-Merrill Lynch believes the company is positioned to deliver attractive returns, despite growth in credit, given its ability to manage revenue and cost outcomes.

National Australia Bank (NAB) was also upgraded by BA Merrill Lynch – from Underperform to Buy – on forecasts of a UK exit by the group (which now only accounts for 12% of NAB equity). This provides for a major re-rating opportunity, not shared by the other Big Four and NAB is now the broker's favourite.

Regis Resources (RRL) was upgraded to Overweight from Neutral by JP Morgan, after the company announced an increase in profit after tax for the financial year just ended of 168% to $200.7 million. But JP Morgan's upgrade followed a review of all gold stocks, with Regis winning out on quality. Two brokers retained Neutral or Hold ratings on the stock after the results announcement, with another keeping it at outperform, however Credit Suisse saw fit to downgrade (see below).

In the not-so-good books

ANZ was downgraded to underperform from Buy by BA-Merrill Lynch. The broker believes returns offshore are now under pressure and would prefer a focus at home. A competitive Asian market could be difficult for the bank.

UBS downgraded Downer EDI (DOW) to Neutral from Buy, which means the broker now has no Buy recommendations in the sector. It believes that the operators/miners are a more attractive leverage to commodity price strength.

JP Morgan downgraded Computershare (CPU) to Neutral from Overweight on the back of the expected internalisation of customer management systems by a major client – Australian Power & Gas. The ACCC approved AGL's bid for Australian Power & Gas (AGK), which currently outsources to Computershare.

Credit Suisse downgraded Regis Resources (RRL) to Underperform from Outperform. The FY13 result was in line with the broker's estimates, but the rating was downgraded on the back of the rally in the share price.

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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What ETFs and healthcare stocks do you like?

by Questions of the week

Question 1: *I am new to investing. Do you have any recommendations for International exchange traded funds (ETFs) to invest in, like Vanguard or iShares hedged or unhedged? There are so many different ETFs and I am not sure which one would be good long-term. Do you have any suggestions for long-term health sector shares or any shares with growth potential other then bluechip shares?*

Answer (by Paul Rickard): As ETF managers, Vanguard and iShares (Blackrock) are both fine – they are global providers.

I would consider the following:

iShares Core S&P 500 (ASX Code IVV) or the Vanguard US Total Market (ASX Code VTS) for exposure to the US Market. Both unhedged, very low management fees.

There is an argument when it comes to international shares that hedged or unhedged doesn't matter over the long term. In the short term, however, I feel that the Australian Dollar is still more likely to weaken – so I would prefer to be unhedged.

For exposure to the rest of the world, consider Vanguard's All World ex US Shares ETF, ASX Code VEU.

On the health sector, I prefer companies like CSL and Ramsay. There is also a global heathcare ETF – from iShares, S&P Global Health Care – ASX Code IXJ.

Question 2: *Can you pay yourself a benefit out of your super fund with an asset of the fund instead of using a cheque, cash or electronic funds transfer? For example, your super fund might own a house and you or your relatives want to live in the house during retirement, so you decide to take a lump sum out of your fund equivalent to the value of the home.*

Answer (by Tony Negline): I'm going to call this transaction an in-specie benefit payment.

The short answer is yes this can be done, but there are a number of issues that have to be considered including the following.

1. It can only be for lump sum benefits, not for pension income payments. It's long been held by the super regulators (ATO and APRA) that pension income payments have to be made using cheque, cash or EFT; many super lawyers don't agree with this view but I don't know if anyone has been prepared to mount a challenge to the regulator's restrictions in the Administrative Appeals Tribunal.
2. Your fund's trust deed – some older SMSF trust deeds don't allow benefits to be paid using fund assets; you need to check that your fund permits such transactions.
3. Preservation – benefits can only be paid when you meet a condition of release. Retirement is the most common reason investors can access their super monies. Make sure you satisfy at least one of these rules. If you're receiving a Transition to Retirement pension, then you won't be able to access any lump sum benefits unless you satisfy the super law retirement definitions.
4. Capital gains tax – if you or other members of your fund aren't receiving a pension from your fund, then when your fund disposes of the asset – by transferring its ownership to you as a benefit payment – the fund will have to pay any CGT owing. Depending on the asset you want to own in your personal name, there might be other transaction costs such as legal and state taxes to pay.
5. Deal at arm's length – the super laws demand that super fund trustees must make sure that with every transaction the super fund

gets a good deal. At the very least, you have to make sure the super fund ends up no worse than it would if it were dealing with an arm's length transaction. For example, you can't pay a super fund asset worth $1 million as an in specie benefit and say that a $200 super lump sum benefit has been paid.

6. Value assets using market value – the ATO demands that all super assets be valued at market.
7. Tax components – when any benefit is paid from your super fund, it needs to be split between taxable and tax-free components. If the taxable component has tax payable when the benefit is paid, then your fund will need to retain this tax and would need to registered as a pay as you go collector.
8. Lump sum paper-work – your fund needs to provide you with a payment summary when the benefit it paid.
9. Restrictions on super fund asset sales and acquisitions – this policy was going to be put in place by the Gillard Government but was dropped just before the 2013 election; it's unclear if the new Government will proceed with this policy.

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