Switzer Super Report

Issue 228, 10 October 2013

Come fly with me

Caught a flight recently? You may have noticed, as Charlie Aitken did, that it was full. Today, Charlie explains why this is a good omen not only for Qantas, but also for business activity in general, and why the Flying Kangaroo's share price could double.

Also in the *Switzer Super Report,* Roger Montgomery turns his attention to the telco space - no, not Telstra - today he looks at a small cap company called BigAir. And Tony Negline reveals the tax issues you need to be aware of when it comes to moving from accumulation to pension phase.

And in today's Question of the Week, Paul Rickard explains what 'long' and 'short' mean when it comes to shares.

Sincerely,

Peter Switzer

Inside this Issue

Come fly with me – a buy on Qantas
by Charlie Aitken
02

02 **Come fly with me – a buy on Qantas**
by Charlie Aitken
Come fly with me – a buy on Qantas

05 **SMSFs and borrowing – time to get worried?**
by Barrie Dunstan
Noise and bluster

07 **Telco sector in focus: is BigAir flying high?**
by Roger Montgomery
Significant growth

10 **On the move: accumulation to pension phase**
by Tony Negline
Tax issues to keep in mind

12 **Buy, sell, hold – what the brokers say**
by Penny Pryor
Banks upgraded

13 **What does 'short' and 'long' mean with regards to shares?**
by Questions of the Week
The long and short of it

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.

Come fly with me – a buy on Qantas

by Charlie Aitken

I remain very, very firm in my belief that you have seen the bottom in Australian GDP growth rates and that any pullback in the prices of the right Australian cyclical equities driven by US political theatre is a buying opportunity. In fact, it could well prove the last buying opportunity before consensus comes around to my view of a clearly recovering East Coast economy.

Every conversation I have had with private Australian business people since the Federal election has confirmed an uptick in activity. The consumer and business confidence readings lift is translating to both consumer and business spending. That won't show up in the ABS data for a few months, but I have to set the domestic investment strategy and stock selection ahead of the confirmation in that official data that will lead to analysts upgrading currently pessimistic FY14 estimates for Australian cyclicals.

Even as recently as Tuesday I saw firsthand evidence of that pick-up in activity on a day trip to Brisbane. As per my day trip to Melbourne last week, on **Qantas (QAN)**, the flights were so full you couldn't even change seats or buy an upgrade to business class using frequent flyer points. The flights were full of people like me wearing suits and there was even a solid traffic jam at Sydney Airport just to get into the car park. I do travel a lot domestically and I can't remember seeing SYD or QAN this busy in years.

QAN to me is one of those deeply cyclical stocks that will benefit the most from a sustained pick-up in consumer and business spending. They even doubly benefit from a pick-up in consumer spending as the credit card companies have to buy more points from them as activity picks up.

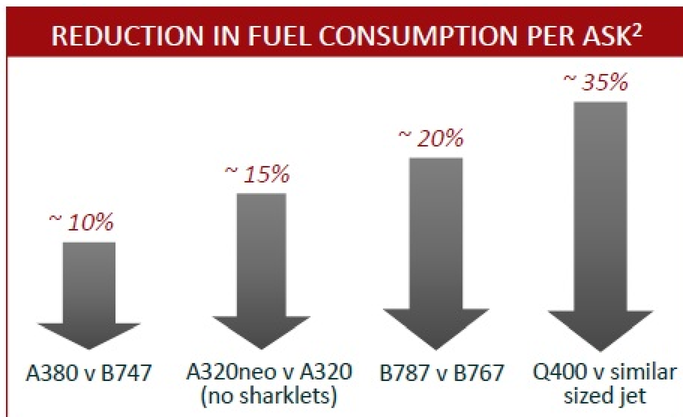
But the good news for QAN is that this recovery in consumer and business spending will be occurring right as their fleet is the most fuel efficient it has been.

Wednesday was a pivotal day for Qantas group with the first 787 Dreamliner arriving at Melbourne Airport wearing the Jetstar livery. To put it in context, that 787 is five years late and is the reason QAN is still flying those ancient 767's on East Coast high traffic routes.

Yet the 787 did arrive and I think it's little understood how young QAN's fleet now is and how fuel-efficient it has become. QAN is in the process of a major simplification of fleet, even reducing configurations to one standard seating configuration per jet type.

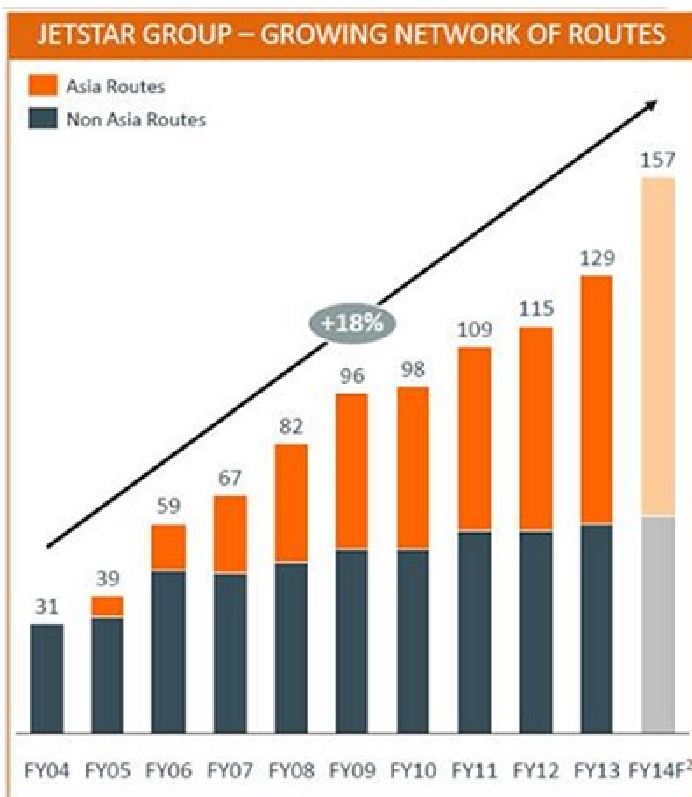
On Monday, QAN released a chart pack titled "***Fleet, efficiency & engineering***". With a public holiday in NSW it most likely slipped under the radar (pardon the pun), but I though there were some very interesting slides in the pack, which confirm QAN is an investment case where the top down and bottom up are both arriving concurrently. Here are a couple of key charts.

Aircraft type	Configuration changes FY11-Current (seats)	Seat change
B744[4]	307 / 353 → 364	19%
A380	450 → 484	8%
B717 (single class)	115 / 117 → 125	9%
A320	177 → 180	2%



In simple terms, QAN is reducing the number of types of planes it flies, reducing the average age of the fleet, reducing the number of seating configurations, reducing fuel costs, reducing heavy maintenance costs and, at the same time, increasing the number of seats on planes. They are also ensuring the right plane is on the right route.

The other angle on QAN is you are picking up the high growth Jetstar brand for "free" inside the QAN group share price.



I believe legacy losses in the QAN International business mask the value in Jetstar, QAN Domestic and the Frequent Flyer programme. As QAN international losses slow quickly under the Emirates JV, I think the investment community will focus on the value of Jetstar, the 65% market share domestic business, and the powerful and highly profitable FF programme. You will even see analysts start thinking about "spin offs".

It's worth noting, to emphasise this point, that in FY13 Jetstar contributed $138m EBIT to QAN group, QAN domestic $365m and QAN Loyalty (FF Programme) $260m. Freight also contributed a handy $36m of EBIT. That was offset by a $246m EBIT loss in QAN international.

$M	FY13
Qantas Domestic	365
Qantas International	(246)
Jetstar	138
Qantas Loyalty	260
Qantas Freight	36
Corporate/Unallocated	(185)
Eliminations[1]	4
Underlying EBIT[2]	372

So let's look forward and assume QAN international reverts to a breakeven result. QAN domestic, under my macro and pricing scenarios, could make $500 million in EBIT (it made $463M in FY12), Jetstar makes $200m (it made $203 million in FY12) and QAN loyalty makes $300 million. That sees QAN EBIT at $1 billion up from $372m in FY13.

I genuinely believe QAN can be a $1 billion EBIT company again by year end FY15 and, if that proves right under transformation above, then the current market cap of $3.1 billion is ridiculously undervalued. To put this all in context, the current QAN FY15 EBIT forecast is $550 million.

Yes, it's an airline and it's inherently volatile, but there is so much hidden value in this stock, hidden by the current losses in International.

QAN fits every macro and micro theme I believe in. It is a play on consumer confidence, business confidence and rising inbound tourism. But, even more importantly, it is becoming a far more efficient company and exiting its historic legacy businesses and inefficient aircraft.

I also expect load and yield traffic data to be strong from September on.

The company has 47 million shares left to buy on market, a buyback that confirms the Board sees the equity as undervalued. They are completely right in my view.

It's not often I would recommend a stock with no dividend yield and consensus forward P/E of 26x, but in this case I think current multiples are not the way to look at QAN because they are representative of the past, not the future.

Over the next few years I think QAN shares can double as they execute all of the above and interestingly around $3.00 is where multi-year technical resistance lies.

QAN is a strong buy under $1.50.

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 and borrowing – time to get worried?

by Barrie Dunstan

SMSF investors shouldn't panic about stories on property spruikers and housing bubbles, but it would be foolish to completely ignore the warning signs.

Most trustees of SMSFs have the experience to avoid inappropriate, get-rich-quick offerings; it is perhaps less experienced people running smaller funds who might be at risk.

So, while most of the media talk has been inappropriately linking SMSFs' ability to borrow to buy property with anticipation of a possible bubble in housing, the underlying concern is the relatively recent policy of allowing SMSFs to gear into property (and equities). Since borrowing was allowed, the growth in SMSFs has been rapid, shifting the balance of power in the superannuation industry.

The ability of SMSFs to borrow money to buy properties, which many have used to invest in their own business's property, gives them an advantage over larger funds. This accounts for the recent comments by the new Assistant Treasurer, Senator Sinodinos, about the need for a level playing field across superannuation funds.

The Cooper Review

This, in turn, reflects inaction by the previous government, after the recommendations in mid-2010 from the Super System Review, chaired by Jeremy Cooper, that the government review the provisions allowing borrowing. On this timing, a review might have begun in 2012 and, by now, could have ventilated the topic. It might also have cooled the rise in borrowing, which attracted property spruikers trying to sell loans and property to wide-eyed SMSF trustees.

As for any action, both major parties have pledged not to make major or adverse changes to super in the next three years. If the Coalition maintains this stance – and the Prime Minister Tony Abbott has already re-committed to this statement – it's difficult to see gearing by SMSFs becoming a factor for perhaps three years or more.

Nevertheless, for all but six of the 20 years of superannuation legislation, super funds couldn't borrow. When the SIS Act set out the rules in 1993, it prohibited funds from borrowing. The September 2007 changes, which initially allowed SMSFs to gear, were introduced to help many investors who had borrowed to buy Telstra shares in the 2006 T3 issue of shares, when the Howard government successfully used the structure of instalment receipts to encourage investors to buy.

In its final 2010 Report, the Cooper committee argued the original policy of no borrowing was "…simply that leverage for asset acquisition amplifies both gains and losses and this was seen as placing members' retirement savings at too much risk."

The game at hand

Now, of course, a much larger and more sophisticated SMSF movement might claim that members are experienced and capable of assessing the risks of leverage for their own retirement savings. But prudential regulators, charged with ensuring the security of the trillions of dollars of savings, can't ignore any risks to what is now a third of all super savings.

On the level playing field argument, cited by Senator Sinodinos, the big institutional super funds argue that they are disadvantaged by SMSF funds being able to borrow to finance the purchase of property associated with the funds' members – in essence, getting the advantage of gearing within an already tax-advantaged structure, especially in pension

mode.

In reality, the main problem has arisen because of the lack of control over dubious sales tactics, which can lead unwary investors into trouble with property investments when the temperature starts rising. This lack of control is a long-running story and goes beyond super funds. Despite the losses racked up in each property boom and bust, it seems no government is prepared to put controls on property sales similar to those on other investments marketed to the public.

While this debate may lie in the future, SMSF trustees should ensure that they stick strictly to the existing borrowing rules and other requirements for in-house assets. The recent statements by the various regulators are a signal that the authorities are aware of rising pressures, especially if interest rates start rising.

SMSF investors should also realise future events might cause a change in government policy – after all, superannuation now has a long history of legislative change – but the “no adverse change” policy should ensure that, as always, any change would not be retrospective.

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.*

Telco sector in focus: is BigAir flying high?

by Roger Montgomery

The subject of telecommunications advances and the companies that make up the telco sector are regular topics of discussion at Montgomery Investment Management.

The group's stalwart is of course Telstra, but despite its popular acceptance as a 'blue chip' company, we have tended to avoid investment and preferred, and still own, a number of the second tier competitors.

A few might criticize a process that steers its operators and funds away from Telstra, but a simple comparison is all that is needed to see that Telstra doesn't "stack-up" against the other incredibly attractive opportunities on offer.

Remembering that we believe there is a strong correlation over the long term between a business's economic performance and its share price performance, you might be interested in the following comparison of the capital movements (excluding dividends) of a number of listed Australian telecommunication companies, since October 2008. Where would you have preferred to invest?

Company Name	ASX Code	Market Capitalisation (A$b)
Telstra	TLS	61.2
Telecom Corp NZ	TEL	3.7
TPG Telecom	TPM	3.4
M2 Telecommunications	MTU	1.1
iiNet	IIN	0.97
Amcom Telecommunications	AMM	0.468
BigAir Group	BGL	0.144

As they say, a picture tells a thousand words and several much smaller telecommunication stocks have had stellar gains in the past few years.

Booming internet demand

Demand for internet connectivity (what we refer to as "the internet of everything") and mobile telephony is booming and smaller players are eating into the market share of the incumbent. For this reason, Telstra ranks poorly on absolute growth and market share growth metrics.

Gains have been especially strong for TPG (ASX Code TPM), BigAir (BGL), M2 Telecommunications (MTU), Amcom (AMM) and iiNet (IIN) as each company continues to consolidate a highly fragmented industry – and the market rewards their relatively stable, predictable and recurring revenue streams.

As an aside, if you had built a portfolio replete with such businesses, would it matter if this week we woke up to discover that the US had defaulted on its debt? If anything, the ensuing volatility should provide a temporary opportunity to buy these businesses at

even more attractive prices.

Every month, more than $100 is direct debited from the bank accounts of millions of Australians to fund their telephony and internet appetites. Just knowing that revenue can be relied upon to come in the door each month, each quarter, and each year, despite any ‘external shock’ enables a business to accurately budget, reward staff consistently and plan expansions with fewer surprises and greater focus.

Investors who have acquired higher quality telco stocks have benefitted from their earnings visibility and “defensive growth” characteristics. They have been well rewarded, and we expect that this is likely to continue.

Let’s focus on just one of these companies. While not the best performing stock in the sector over the past five years, BigAir Group Limited (BGL) is one of the better performing small capitalisation telcos we have surveyed. Interestingly, it remains one of the sector’s lower profile stocks.

Source: Bloomberg

BigAir in focus

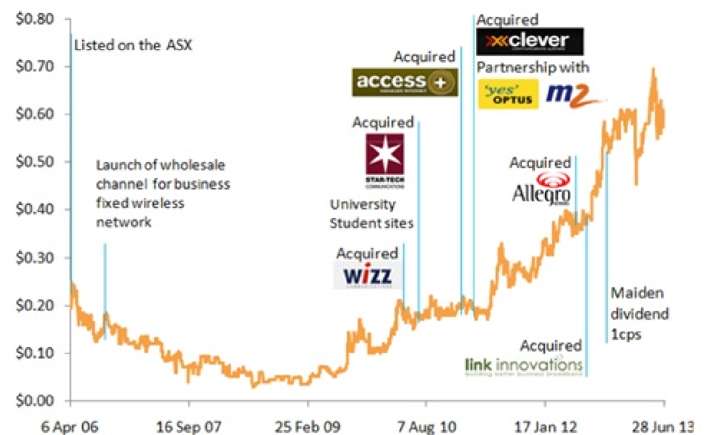
BigAir owns and operates Australia’s largest metropolitan business fixed wireless broadband network providing fixed wireless internet services to businesses in capital cities as well as some regional towns.

The fixed wireless division contributes to the majority of the business’s revenue, while its community broadband division, which offers internet services to the student accommodation market, provides the rest.

Companies use BigAir’s services for direct high-speed internet access and to extend their local area networks to wider areas, and connect their outlets, employees, customers and suppliers nationwide.

The company has grown significantly since it first floated in 2006, raising $7 million at 25 cents a share, and since 2009 when, after a string of acquisitions, its shares were trading at just 3 cents and its future was uncertain.

However, under the guidance of CEO Jason Ashton, the business began to build a very strong base, achieving strong organic growth and delivering the cash flows needed to continue funding smaller, shrewd acquisitions.



As illustrated above, BigAir has embarked on a significant growth-by-acquisition strategy, buying competitors since listing and extending its footprint in key regional markets, its fixed wireless reach in cities and its share of the fast-growing tertiary student market for internet services.

When integrated under one roof, they have given the group the scale and efficiencies needed to create the highly profitable business it is today. But that’s not where the story ends.

BigAir enjoys significant tailwinds. As acceptance of fixed wireless as a reliable, high-speed service rises, more businesses are demanding wired and wireless internet services to ensure uninterrupted web access, as they take advantage of innovation, such as cloud computing.

BigAir's expanding reach in regional markets also offers new opportunities, as do student accommodation internet services, which could grow faster than the market currently expects as international student enrolments recover on the back of a lower Australian dollar.

The risks

A key risk for BigAir is how the National Broadband Network (NBN) rollout and implementation will affect demand for its services. Another risk is increasing competition. TPG, with their recent acquisition of 2×10 MHz spectrum in the 2.5 GHz band, will be able to offer innovative and value-adding products to its customers that are similar to those offered by BigAir, particularly in the increasingly important wireless broadband market.

BigAir believes that the NBN will create opportunities and that there will be pent-up demand for super high-speed broadband as hype builds. Interestingly, BigAir's network can deliver NBN speeds today.

BigAir has carved out a competitive position in the business wireless market and it is racing towards the point where greater scale will produce even higher returns on equity, and greater free cash flow generation and value-add for shareholders. This is all being reflected in its increasing share price.

As BigAir enjoys organic growth and continues to focus on exploiting synergies from acquisitions, we are cautiously optimistic it will be a bigger business than it is today in years to come, while maintaining high levels of profitability.

If the basic recipe for success is bigger equity and bigger returns on equity, then we believe BigAir meets the grade. Value investors however will need to consider the price value equation and ensure that a sufficient margin of safety is available. And that's a subject for another column.

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.*

On the move: accumulation to pension phase

by Tony Negline

Moving from the accumulation phase to the pension phase generates a number of tax issues at the super fund level that you need to understand.

One of the benefits of the pension phase is that all capital gains – even those earned during the 15% taxed accumulation phase – are tax-free.

The super system is never quite this easy, so here I'm going to explain how the system works.

To understand how the tax system taxes pension assets, it's essential to appreciate the difference between segregated and unsegregated assets.

I dealt with this particular issue a few weeks ago, but it's worth repeating the basic difference.

Your super fund will have segregated pension assets if it specifies certain assets as being exclusively for the payment of pensions. The unsegregated assets approach is the exact opposite – that is, one or more of your fund's assets are used to pay pensions and for pre-retiree assets.

If your fund is only used to pay one or more pensions, then this issue is of academic interest.

If you use the unsegregated approach, then each year you need to get an actuarial certificate. The certificate is a legislative overhang from the late 1980s when the super system was very different to what it looks like now.

In reality, these certificates are a waste of time and money and don't tell you anything you can't calculate yourself. (The Abbott Government reckons it wants to remove useless regulations – well, here's one it could get stuck into. No doubt the actuaries will be happy about losing a handy revenue source removed from their businesses. Boohoo, I say.)

The simple reality however is if you don't bother to get the certificate, your pension's gains and income will be taxed.

Non-arm's length income

If your fund earns any non-arm's length income, then this will be taxed at 46.5% if the assets are being used to pay a pension (this includes any capital gains).

Capital gains and losses with segregated pension assets

In simple terms, you ignore any capital gains and losses made by your fund's pension assets.

You cannot offset a capital loss made with your pension assets against gains made by all your fund's other assets. That is, the losses made by the pension assets never have any economic value.

Losses on non-pension assets can be carried forward and used at a later date to offset gains made by those assets (assuming they haven't been made pension assets in the meantime).

Capital gains and losses with unsegregated assets

Your pension's capital losses can be carried forward and used in later income years against assessable capital gains.

Your fund's net capital gain is its capital gains less capital losses (from all assets). This capital gain is then included in a fund's assessable income before an actuary tells you how much income is exempt from tax.

Carried forward tax losses

This is another important but often-overlooked topic.

Suppose your fund has tax losses (not losses on the sale of assets but losses from having tax deductions higher than assessable income).

In these situations, your losses are used to reduce your funds net exempt pension income (that is, pension income after allowing for relevant expenses).

Only the remaining losses can be used to reduce assessable income this year.

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.*

Buy, sell, hold – what the brokers say

by Penny Pryor

It was a very slow week on the upgrades and downgrades front, with brokers apparently still stuck in long weekend mode. There were three upgrades and just one downgrade since our last update on Tuesday, with no new recommendations above a hold.

In the good books

Deutsche Bank upgraded Newcrest (NCM) to Hold from Sell, following the announcement of a succeeding CEO when Greg Robinson leaves the company in the second half of FY14. Incoming CEO, Sandeep Biswas will be initially appointed as chief operating officer in January next year.

Deutsche Bank thinks the change will be greeted favourably by investors, and could be the start for further strategic decisions in the next couple of years.

JP Morgan upgraded Bendigo Bank (BEN) from Underweight to Neutral. The broker previously preferred Bank of Queensland (BOQ) over Bendigo & Adelaide in the regional banking sector, but believes that the relative valuation gap has closed.

JP Morgan also upgraded CBA to Neutral from Underweight, again citing closing gaps in relative valuation among the major banks. The broker said the banks have ground away the 15% correction that was seen in May and June and have now returned to levels of six months ago. The upgrade was given despite the broker seeing the banking sector as fully valued.

In the not-so-good books

The only downgrade of the week went to Hillgrove Resources (HGO), with JP Morgan downgrading the company to Neutral from Overweight. The broker cited the recent capital raising, and lower copper price assumptions in their decision.

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.

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 does 'short' and 'long' mean with regards to shares?

by Questions of the Week

Question: *Thanks for very interesting and educational webinar. I find them very helpful in managing our SMSF.*

I would like to know what 'short' and 'long' mean with regards to shares. Kindly, explain.

Looking forward to the next webinar.

Answer (By Paul Rickard): Thanks for the question.

Like most industries, there is a lot of jargon in finance – and sometimes we make the mistake of assuming that everyone else is familiar with the jargon. Our apologies.

'Long' and 'short' are a little like "buy" and "sell" – they are opposites.

If you are "long", you own it. If I am long 100 shares, I own 100 shares.

"Short" or "short sold" is the exact opposite to "long". If I am "short" something, I don't own it – in fact, I have sold something I don't own. If I am 'short 100 shares', I have sold 100 shares I don't own.

Going 'long' means that you profit when the price goes up.
Going 'short' means that you profit when the price goes down.

How do you sell something you don't own? You "borrow" the shares from someone else, and then return the shares to the lender when you buy them back.

So, you:

1. Borrow the shares from the lender.
2. Sell them in the market at price A.
3. Buy the shares back in the market at price B.
4. Return the shares to the lender.

If B<A, then you make a profit (less any borrowing costs).

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?

I recently spoke with Lance Lai to find out what his charts are telling him about the outlook for global markets. Don't miss his views on Super TV.