Switzer Super Report

Issue 236, 7 November 2013

Go your own way

This week is big bank week and the latest of the behemoths to report was Commonwealth Bank - a darling of Charlie Aitken. I also believe it's the pick of the bank bunch, as does Switzer expert, Paul Rickard.

And if you didn't get to pick a winner on Tuesday, you might pick one today. As well as Charlie on CBA, we have Roger Montgomery giving his view on Sirtex.

In *Buy, Sell, Hold - what the brokers say,* retailers David Jones and Billabong get upgrades, while Margaret Lomas has some very common-sense advice on what to do in this hot property market, and Tony Negline explains which court decisions you should be paying attention to.

Sincerely,

Peter Switzer

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Get your head out of the sand on CBA

by Charlie Aitken

And so the battle continues with the Commonwealth Bank of Australia (CBA) ostriches.

CBA confirmed yesterday it has generated a $2.1 billion cash profit in Q1 FY14, and on my forecasts is on line to generate an annual profit of at least $8.25 billion. FY14 EPS will be over A$5.00 a share, it's just a matter of by how much.

What the…

However, CBA remains the most hated of the top 20 Australian stocks by analysts. It makes absolutely no sense. There is actually no top 20 Australian stock with a more negative buy/hold/sell ratio (4/7/6) than CBA, or a consensus price target further below the current share price, than CBA. This is truly stunning as I consider CBA Australia's strongest company (ROE 18%) with the strongest board and a proven, deep management team led by Ian Narev. That was again evidenced yesterday, but here we are and the vast majority of bank analysts still don't get it. They remain in complete denial.

But this has been the case for the last 12 months, as you can see in the graph below. Just to put this in context, on this day 12 months ago, the CBA buy/hold/sell ratio was 2/10/5 and the median 12-month price target was $54.85. That was only wrong by 43% or $40 billion in market cap.

It's not like we are talking about some penny dreadful here, where the woeful analyst forecasting can be excused. This is Australia's biggest bank ($124 billion market cap) and the ASX 200's biggest index weight stock (9.33%). It is also the stock most widely held by the SMSF army. It is Australia's most important stock for a wide variety of reasons, yet the analysis and forecasting of where its share price will be has been highly inaccurate, both relatively and absolutely.

Analysts upgrade earnings

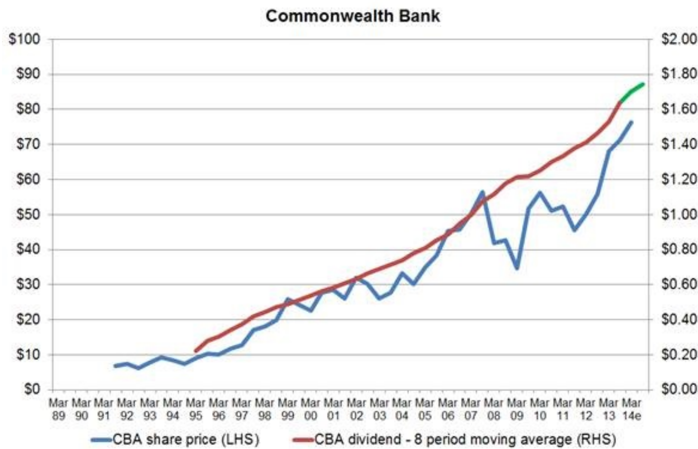
This morning, consensus FY14 EPS and DPS has risen 12c (+2.5%) to 502c, as bad and doubtful debts (BDD) were again overestimated. The Bell Potter forecast is 509c EPS.

Earnings Forecast

Year end 30 June	2013	2014e	2015e	2016e
NPAT (reported) (A$m)	7,677	8,185	8,728	9,225
NPAT (adjusted) (A$m)	7,819	8,231	8,774	9,271
EPS (adjusted) (¢ps)	486	509	541	566
EPS growth (%)	8%	5%	6%	5%
PER (x)	15.8	15.1	14.2	13.6
P/Book (x)	2.7	2.6	2.4	2.3
P/NTA (x)	3.5	3.3	3.0	2.8
Dividend (¢ps)	364	384	410	434
Yield (%)	4.7%	5.0%	5.3%	5.6%
ROE (%)	18.4%	18.1%	18.1%	17.8%
NIM (%)	2.13%	2.11%	2.08%	2.08%
Franking (%)	100.0%	100.0%	100.0%	100.0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

My view remains that CBA's share price, like all Australian banks, tracks its long-term dividend growth. In the chart below, we have extrapolated the next few periods of DPS forecasts and added them to our long-term CBA share price versus dividend correlation graph. That points to a CBA share price in the mid $80s being highly achievable.



CBA remains a core member of my high conviction buy list and also has to be a core player in my index target of 6000. Yesterday CBA jumped another small sentiment hurdle but, in the process, steamrolled all the non-believers again.

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Channel 9 is not compulsory viewing

by Paul Rickard

When I think about Channel 9, the Wide World of Sports cricket commentary team always seems to come to mind – Chappelli, Bill Lawry, the late Tony Greig and of course, Richie Benaud. One of Richie's more infamous quotes is "a cricket ground is a flat piece of earth with some buildings around it". Sums up my sense of the much hyped Nine Entertainment IPO – a few things tacked on to a TV network in a flat, low growth market.

Nine Entertainment Company (NEC)

Nine Entertainment, which comprises the Channel 9 TV Network, Ticketek and Allphones Arena (Nine Events) and some digital properties, such as the ninemsn website, will be listed on the ASX following an IPO of approximately 305 million shares. These are priced at a range of $2.05 to $2.35 per share, with the final price to be set via an institutional book build. On completion of the offer, the group will have 931 million shares on issue, with an indicative market capitalisation of $1.93 billion to $2.17 billion. Key offer statistics are as follows:

Key Offer Metrics	
Indicative price range	$2.05 to $2.35 per share
Shares being offered to public	304.7 m *
Total shares after IPO	931.0 m *
Indicative market capitalisation	$1,928 m to $2,168 m
Enterprise value (incl. $602m debt)	$2,530 m to $2,770 m
Forecast PE	13.8 to 15.5
Enterprise value to EBITDA	8.3 to 9.1 times
FY 14 dividend	4.1 c unfranked (1.75% to 2.0% yield)
Retail offer opens	Tuesday, 12 November
Retail offer closes	Friday 29 November
Final price announced	Thursday 5 December
ASX listing (code NNE)	Friday 6 December

** Exact number of shares will depend on final price, as $275 million from sale of new shares is fixed. Calculations based on price of $2.20. Also 6.0 million shares issued to employees and non-executive directors*

Shareholder sell down and escrow

Nine Entertainment (NEC) is partly owned by two private equity firms (Oaktree and Apollo), which collectively own 53.5% of the company. For the IPO, existing shareholders including Oaktree are selling 179.7 million shares of the 800 million shares they own, or 22.5%. And 131 million new shares are also being issued. The offer will raise $670 million, with $390 million being paid to existing shareholders, $199 million used to pay down debt, $50 million for working capital and $26 million for the costs of the offer.

Post the IPO, existing shareholders Oaktree and Apollo have agreed to hold their shares in escrow until the results of the 2014 FY are released to the market – sometime in August 2014. Critically, the other existing shareholders (who will own 281.6 million shares post the IPO) are not subject to any escrow requirements. For potential new shareholders, this means that up to 620 million shares from current shareholders could hit the market in the next nine months.

	Shares Pre IPO	Shares Sold into IPO	Shares Post IPO	% Post IPO	Escrow
Oaktree	222.6m	89.1m	133.6m	14.3%	Till Aug 14
Apollo	205.1m	Nil	205.1m	22.0%	Till Aug 14
Other existing shareholders	372.2m	90.6m	281.6m	30.2%	Nil
New shareholders (via IPO)	n/a	n/a	310.7m	33.4%	Nil
Total	**800.0m**	**179.7m**	**931.0m**	**100.0%**	

Why would you want to invest in Nine?

Well, not for yield. The directors are forecasting the payment of a final dividend for the 2014 FY of 4.1c per share, unfranked. This won't be paid until late 2014. Astonishingly, they have decided to describe this as a yield of 3.5% to 4.1%. Only in the "fine print" is there the disclosure that there won't be an interim dividend for FY 14, making this an outrageous misrepresentation.

If an interim dividend for FY 2015 is paid, perhaps the yield for 2015 will be in that range – however, the yield for investors over the next 12 months is only 1.75% to 2.0%. Investors should also note that the directors don't expect to be able to commence franking until the final dividend for FY 2015, and that there are overriding restrictions on the payment of dividends under NEC's borrowing facilities.

If it's not for yield, then it must be for growth – or a better bet than its nearest rivals, Seven West Media or TEN. Let's deal with the "growth" perspective.

Of NEC's total revenue, 89% comes from advertising (a small component comes from ticketing and events). The Australian advertising market has grown at a CAGR (compound annual growth rate) of 3.6% over the last 10 years. Television's share of this has been steady at 27% to 30%, and according to NEC, is currently sitting at 29.3%.

Online media has experienced strong growth, and is now attracting 25% of advertising expenditure. However, growth has been strongest in 'search and directories', which accounts for 54% of the category. NEC is not in this segment. Rather, NEC through ninemsn and other properties (known as Mi9) is mainly in the 'online display' segment, which accounts for 26% of this market.

So, on a macro level, is NEC positioned in a "growth" industry? Well, a CAGR of 3.6% is interesting, however, it is not great – and while NEC has some exposure to the online market, it is still largely a TV business.

Peering into the company's pro-forma financial results confirms that while there is some growth, it doesn't really set the world on fire. As the following table shows, NEC's revenue CAGR from 2011 to 2014 is 3.4%, and even allowing for perhaps an improvement in 2014, the increase on 2013 is only a modest 4.8%.

	Proforma Historic			Proforma Forecast
$ million	FY 11	FY 12	FY 13	FY 14
Revenue	1,415.4	1,392.7	1,493	1,565.9
Expenses	1,068.5	1,083.7	1,199.9	1,264.3
EBITDA	350.1	313.4	297	305.0
EBIT	313.6	270.0	250.1	252.1
NPAT	172.3	144.8	137	139.5

Not an impressive set of numbers (particularly the EBIT deterioration), and not really a "growth" story either. And that's without considering the risk that internet TV and other technologies pose to NEC's core free to air TV business.

And is NEC worth buying over Seven West Media? The argument being advanced is that NEC has "pure" exposure to the "higher" growth TV and online markets, and doesn't carry Seven West's exposure to the "negative growth" magazine and newspaper divisions.

While there is obviously something in this, television accounts for 67% of Seven's revenue and 69% of EBIT. For NEC, the 9 Network is 79% of revenue and 79% of EBITDA.

In the market, Seven West is trading on a forecast PE for 2014 of 10.3, and is forecast to pay a fully franked dividend yield of 4.9%. It also has had a pretty good year on the market, rising from $1.64 to $2.41. That said, it still looks considerably cheaper than NEC, which at the indicated price, is forecast at a multiple of 13.8 to 15.5.

Bottom line

Avoid. It is not a buy for yield, the growth story rings a little hollow, and given the pricing premium, there is no compelling case for it over Seven West. And that's without worrying about all that stock held (or more realistically, not held), in escrow.

If you do want to invest, you will need to go through a broker and secure a firm allocation. That shouldn't be too difficult, as many of the major brokers are involved in the deal and getting paid to promote it, including Bell Potter, CommSec, Deutsche, Macquarie, Morgan Stanley, Morgans, Nomura and UBS.

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Sirtex – medical success offers investment opportunity

by Roger Montgomery

Sirtex Medical Limited (SRX) is perhaps not a business you are familiar with. But we believe it's a real success story, with bright prospects.

Source: Bloomberg

A new treatment

This Australian medical business's core product is SIR-Spheres, which deliver a highly focused radioactive dose directly to liver cancers (Hepatocellular Carcinoma – HCC).

Approximately 600,000 cases of liver cancer are diagnosed each year, including 19,000 in the US, 54,000 in Europe and 390,000 in China, Korea and Japan.

Chemotherapy has been the gold standard in treatment for many decades, but its combined use with SIR-Spheres is growing.

Whilst it's early days, it is hoped that the focused nature of the treatment, which delivers a radioactive dose several times the potency of standard chemotherapy, will be enough to shrink cancer tumours to a size at which they can be removed.

Strong growth in sales has lead Sirtex to undertake a Phase 111 trial (now underway) and we expect the results to be announced in early 2015.

Positive trial results may lead to an increase in demand for SIR-Spheres. A number of smaller trials have shown excellent outcomes when compared to the use of chemotherapy alone, and we anticipate that the Phase 111 trial will result in much broader adoption of SIR-Spheres.

Growth focus

Sirtex is currently expanding its sales teams and US and German manufacturing facilities in anticipation of strong, future demand from a growing market, and it is continuing to update shareholders on how dose sales are tracking.

The following statement is from Sirtex's most recent quarterly disclosure, on 4 October 2013:

"Sirtex Medical Limited (ASX: SRX) today announced sales of its SIR-Spheres® microspheres targeted radiation therapy for liver cancer, grew 4.1 per cent for the quarter ended 30th September 2013 compared to the previous corresponding period. Sirtex has now recorded 37 consecutive quarters of positive growth."

While we don't encourage focusing on quarter-to-quarter growth, the update seemed to disappoint and the share price subsequently declined, so for context, let's compare the past 12 quarterly disclosures.

SIRTeX

	Quarterly Dose Sales Growth				
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Average
2014	4%				
2013	37%	25%	6%	13%	20%
2012	11%	22%	34%	26%	23%
2011	16%	17%	21%	23%	19%

We suspect the negativity is due to the growth rate being low compared to exceptional historical performance.

Four per cent growth as the new normal would be concerning for the future prospects of SIR-Sphere dose sales, as it may imply the outlook for the business has faded. Is the business's growth profile as attractive as it once was?

In the same period last year, a record 37% in Dose Sales growth was achieved. The September 2013 quarter numbers were therefore 'cycling' off a very high base.

We therefore view the market's reaction to the recent disclosure as an overreaction at this stage. Perhaps more important to focus on was the following sentence:

"Dose sales increased in the Americas by 6.6% and 10.2% in APAC (Asia Pacific). EMEA (Europe, Middle East and Africa) declined 5.1%."

While US and APAC growth impressed, EMEA is potentially a very large addressable market for SIR-Spheres, so it's important to understand what caused the 5.1% contraction.

Funding schemes

One of the key risks to Sirtex's business model is whether hospitals and practitioners who use SIR-Spheres have access to an adequate level of 'reimbursement'.

This is a fundamental driver of all medical device use. Should reimbursement ever become unavailable, demand would simply decline.

Across major markets in the UK, US and APAC, there are diverse funding schemes. In the UK, SIR-Spheres were, until recently, captured under the UK Cancer 'Drug' Fund reimbursement system.

SIR-Spheres, however, are a device, not a drug. And when this was picked up, it was promptly removed.

For a large portion of the September 2013 quarter, Sirtex's SIR-Spheres transitioned into a new scheme, 'Commissioning through Evaluation' (CtE). This was expected to finish in July, but due to delays in approval, it has been delayed until November 2013.

During this period, reimbursement for the device is effectively in limbo, and this has resulted in a significant reduction in dose sales in the UK, the third largest region in EMEA by dose sales. This is clearly a short-term negative, but, in time, will potentially benefit sales.

Like any growing business, there are likely to be bumps along the way. The road is never smooth, especially in the medical device industry.

Relatively few Aussie inventions have ever improved the quality of lives of patients all over the world. Cochlear's hearing devices are one example of a product that has. Seeing current Sirtex management in action gives us confidence that, in time, SIR-Spheres will be recognised as another.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

Brokers were much more positive this week with retailers like David Jones and Billabong getting upgrades, after some improvements in sales by the department store and a new debt facility for the surfwear company. DJS first quarter numbers took a couple of brokers by surprise.

In the good books

Citi upgraded Billabong (BBG) to Neutral/High Risk from Sell/High Risk after Billabong announced it had secured a $360 million term loan from Centrebridge and Oaktree. The company has also sold Canadian retail chain West 49. The sales feedback from some customers is mixed, with weaker trends in the Americas. Billabong is not expected to generate meaningful earnings until FY16, given the proposed recapitalisation.

CIMB Securities and Credit Suisse both upgraded David Jones (DJS) to Neutral from Underperform after it announced improved sales in the first quarter. CIMB upgraded expectations by 4% in FY14 and 1% in FY15. The improvement was assisted by a warm start to Spring. Although the stock's valuation is considered excessive, relative to the discretionary stocks, CIMB has taken the opportunity to raise the rating to Neutral from Underperform.

Credit Suisse analysts were also pleased with the company's Q1 update, citing "solid sequential improvement in like-for-like sales". Credit Suisse believes the risks associated with owning equity in the upmarket retailer have shifted into neutral territory, hence the upgrade in rating.

UBS upgraded Downer EDI (DOW) to Buy from Neutral, after upgrading earnings forecasts. The increase of 6-8% in FY14-16 estimates is largely a result of upward revisions to mining margin estimates, and incorporating the $400 million contract at Wheatstone LNG, as well as some small road maintenance contracts. The broker finds the stock compelling value at its current FY14 price/earnings of 10 times.

UBS upgraded Fortescue Metals (FMG) from Neutral to Buy after the company hosted a site visit. While market confidence in China is high, the company sees near-term iron ore price risks. Earnings are expected to ease by 4% in FY14 and 13% in FY15 as a result of higher depreciation and amortisation. Despite this, UBS expects iron ore prices to average above US$100/dmt for the next 18-24 months. This underpins cash flow and should enable de-gearing.

In the not-so-good-books

Credit Suisse downgraded Investa Office Fund (IOF) to Neutral from Outperform, as UBS downgraded the fund to Neutral from Buy. Credit Suisse was disappointed with the price the fund got for its minority interest in Dutch Office Fund. The main positive, in their view, is that IOF is transforming itself into an Aussie-only office REIT.

UBS says the sale price of EUR155 million for Dutch Office Fund reflects a discount to the net asset value of 24% and a 15% discount to the carrying value. Pricing was below UBS's expectations and the sale has come earlier than expected but, ultimately, it will be what the company does with the proceeds that will be of interest. On UBS estimates, acquisitions of $400 million in Australian assets could offset the earnings dilution.

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With property it pays not to follow the crowd

by Margaret Lomas

If you're a property investor who keeps their eye on the market, then you would've noticed that many of our major property markets are on the move.

You'd have to be either asleep or out of the country not to have seen the news plastered all over the press depicting some of our capital cities as too hot to handle and, possibly, you're just becoming alert to what appears to be a fading opportunity to get into the market, and fast!

Recently, we've been seeing some pretty impressive figures released in terms of house price growth, with most capital cities having experienced some of the best growth they've seen for a while. Last year, investors were incredibly bullish and stayed out of most of the inner ring suburbs, while this year they're racing each other to the finish line, creating demand that's outstripping supply.

When you think about it, it makes no sense to stay out of a decent market just because no one else is buying there, and then rush in when you experience an emotion my children seem to know very well – FOMO. FOMO simply means Fear of Missing Out, and everywhere I look today I see property buyers bidding as if the world is coming to an end and property is about to blast off into the stratosphere, where it will never be affordable again.

Affordability is still relative

I recall at 21 years of age being pressured by my father to buy a property before it was too late. I purchased a modest one-bedroom unit in Cabramatta for $28,000. My wage at that time was $5,700 per annum and so I was paying roughly five times my wage to buy this property. This same property would sell for around $220,000 today, and with the average wage around $1,200 a week, well, it's just as affordable now as it was then.

And so it would seem that once you take out the highs, created during times of buyer frenzy, and the lows, when everyone is too frightened of something going awfully wrong in the property market to buy anything, things remain pretty much the same and affordability, though it ebbs and flows, seems to remain relative most of the time.

And so to my point – if we take from history the lesson that property buyers will buy property that is affordable to them given their wage level, and property is pretty much going to remain at a price where it will continue to change hands, then what we should be able to see is that market timing is everything and is, as it has always been, the most critical part of buying property well.

Get that market timing right, and you can buy before an area becomes a hotspot, and enjoy the benefits that solid growth can bring. Get it wrong, and you'll likely join the ranks of those who claim that you can't make money from property (failing to see that it was actually you who didn't make the money, because you didn't do it well!).

Stay away from the heat

Which leads me to my next point! Now may not be the right time to be buying in markets, which are buckling under the weight of buyer activity, achieving impossible to sustain sale prices and building into a pressure cooker likely to blow sooner or later.

I am not suggesting that buying today in Sydney, Perth and Brisbane won't make you money – the upward trend is far from over, and while you won't make as much money as you would had you bought last year (when I suggested time was right to buy), you may still see some growth.

The problem is that you are unlikely to get out of that

market before it has its correction – it will either be too short a period for you, you cannot sell quickly enough or you just won't see it coming. Again, this may not be a problem if you can ride the downturn and wait for the next upswing, but if your individual investing timeframe requires selling in the foreseeable future, then I'd be staying out of these overheated markets.

As with all investments, it all comes down to your capacity to withstand loss and the period of time after which you will need to liquidate to access funds for retirement. If you have a long time period in which to invest, then jumping into a buyer frenzy may be acceptable, as a correction can be ridden through until the next upswing.

But if your time frame is more prescribed, stick with predictable markets, where there are fewer buyers pushing up prices and creating a stampede of people experiencing FOMO. Find areas where families are moving, where infrastructure is ramping up and where diversified employment opportunities exist, and go for low-priced housing in strong communities. Such property usually has a far less volatile performance and often shows a better overall growth in the medium term.

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Lessons from the courts for your SMSF

by Tony Negline

During the past 18 months, there have been a number of interesting cases brought before the Courts, which provide good lessons on how you can deal with your financial affairs.

Following is a brief summary of the three most relevant cases for trustees of a self managed superannuation fund.

1. Interhealth Energies

In this case, the trustees of a super fund signed an enforceable undertaking with the Tax Office to correct a number of problems with their fund. One of the problems involved a benefit payment to a member of the super fund but the trustee didn't have clear title to a property it owned. This meant they couldn't sell the property and therefore make the benefit payment. The key lesson from this saga is, if your fund gets into trouble and you sign an agreement with the ATO, make sure you can fully carry out the transaction.

2) Shail Super Fund

This is a well-known case and often used as an example of the possible benefits of corporate trustees over individual trustees. Mr Shail illegally took several million dollars from his super fund and transferred it to bank accounts in Turkey. The Tax Office removed the complying status of the super fund and imposed a penalty on the super fund trustees. In total, several million dollars were owed to the ATO. Mr Shail absconded and left his estranged wife, Mrs Shail, to sort out the mess. Although she complained about the penalties, the Administrative Appeals Tribunal found for the ATO.

Key message: insist that all trustees have to authorise payments from super fund bank accounts. If the fund had had a corporate trustee instead of individual trustees, the fund members, as shareholders in the corporate trustee, may have only been liable for the company's assets.

3) Pamela Dowling

John Dowling withdrew $294,000 out of his super in 2008/09 as a lump sum and contributed this money into his wife's super fund. The contribution was classed as a non-concessional contribution or NCC.

Before performing this transaction, Mr Dowling received verbal advice from a Centrelink Financial Information Service Officer as well as a financial planner associated with the super fund he was using at the time.

In the 2010/11 financial year, Mrs Dowling withdrew $240,000 from her super account and contributed $200,000 of this amount back into her super fund. She did this to reduce the tax payable on death benefits paid to her non-dependant adult children. She decided on this by reading a newspaper article but didn't seek any advice.

The 2011 financial year was the last year in Mrs Dowling's three-year contribution period. Over this period, her total contributions were $494,000 or $44,000 more than the $450,000, which is allowed to be contributed over three financial years.

The Tax Office assessed the $44,000 as an excess NCC and asked for 46.5% tax. Mrs Dowling objected to this and claimed special circumstances. The case ended up in the Administrative Appeals Tribunal (AAT), which found the $294,000 contribution made in 2008/09 shouldn't be counted as an NCC for excess contributions tax purposes. The result – the excess tax problem disappeared. The Tax Office appealed this case to the Federal Court, which has been heard. Judgement can be expected soon.

Cases such as the above are important because if a similar situation applies to you and your SMSF, you can use the above examples as a guide, and also the determinations as a precedent, if you own case ever goes that far.

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