Switzer Super Report

Issue 237, 11 November 2013

Steady as she goes

Last week we saw some good numbers come from the banks, which have many asking "have the big four run too hard?" James Dunn looks at this today, and finds some could still be worth adding to your SMSF.

Also in the *Switzer Super Report* today, I argue why a melt-up is more likely than a meltdown, as there's still plenty of money on the sidelines waiting to get into stocks.

Elan Miller from Pengana Capital writes our Fundie's Favourite today on Drillsearch Energy. Pengana bought Drillsearch in May this year and the stock has returned 20% in that time. Despite the run, they still see the stock as representing great value.

In *Buy Sell Hold - what the brokers say,* the banks are the centre of attention, with CBA getting an upgrade while Macquarie and Westpac both saw downgrades. And the auction scene continues to dazzle, with stellar results in Sydney and Melbourne.

Sincerely,

Peter Switzer

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Could a correction be KO'd by a market melt-up?

by Peter Switzer

Regular readers know I've been wrestling with the history of stock markets, which suggests a correction or pullback is overdue. However against this, last week I argued, with great trepidation, that "this time is different!"

Despite my bullishness since March 2009, these are the kinds of words someone like me, a cautious investor, fears ever uttering, let alone writing or believing!

I ran my theory that the differences of today — QE3 in the USA, Draghi's monetary stimulation in Europe, stimulatory Abenomics in Japan and the resilience of the Chinese economy — makes this stock market we are dealing with very different.

The biggest blast from the past is wrapped in a cliché that old heads have argued — "don't fight the Fed". Against this, however, you have the history of people eventually laughing at those who, at various times, have said: "This time it is different."

So, let me get it on the record by saying that this excessive money supply expansion will, one day, cause problems, such as inflation, big budget deficits, etc. and this could lead to gold spiking and stock markets falling – but this happens anyway. In a decade, you expect one market slump, sometimes two market slumps, as we did in the 'noughties', with the dot.com bust and then the GFC.

Right now I'm heartened that Macquarie's head of equity strategy, Tanya Branwaite — a serious economist, who gets stocks and that's why the millionaire's factory looks to her — is tipping a slow grind higher for the world and local economy.

So that underpins my optimism that this monetary stimulation policy can translate into economic improvement, and this should underwrite stocks heading up.

Goldman Sachs' Richard Coppleson is predicting a 9% plus rise to June 30, while Bell Potter's Charlie Aitken is banking on 6,000 by the end of 2014.

The weekend spike in stocks, with Wall Street sending the Dow into record territory with the index up 167.8 points to 15,761.78, keeps reminding me that there's still a lot of money on the sidelines and not in stocks. In fact, the numbers are "very different" than the usual stats on those usually invested in risky equities.

One thing I know for sure is that a correction or two or three will come before we see another crash — that's what usually happens. In 2007, there was at least two big sell-offs but it was the one between July and September, where the 14,000.4 level was left behind with the Dow dropping to 13,113, that was the warning for what eventually happened in November.

By October 10, the index went to 14,164.5 and the rest was downhill from there.

I think we are a long way from this kind of scenario and that's despite Marc Faber of The Gloom, Boom and Doom Report telling CNBC that the global financial system is "in a worse position than we were back then" in 2008.

Why? He says China did not have the debt issues it has now. That's true, but it doesn't mean we have a debt challenge like the sub-prime mess, which not only endangered the world financial system but effectively blindsided too many key players, from the big banks (which did not know their exposure) to the credit ratings agencies, who misrepresented the dangers to the regulators and who might have over-relied on the likes of Standard & Poor's and Moody's.

As I argued last week, this time it's different, and while I know I will one day be warning you that "this correction looks serious enough for me to change my 'buying the dip' strategy," now is not that time!

We're still in the scepticism stage of the bull market, and if I add Branwaite's slow grind upwards to where our stock market is — still below its all-time high even if I adjust for the mass capital raisings post-GFC, which might have taken the 6800-level down to 6300 — then I'm not for quitting stocks yet.

I think there's a good chance of the market melting up for some time, as David Darst of Morgan Stanley suggested on CNBC. But as he said, if that should happen, then I might become a little cautious and take some profit.

But this hasn't happened yet. This is now, and while I think Faber will be right one day — he has warned of market doom in 2010, 2012 and 2013 — if you had listened to him you would have missed out on a lot of moneymaking opportunities since March 2013.

The S&P/ASX 200 index has gone from 3145.5 to around 5400, which is 72% plus five years of dividends, which would put those optimists back in the black on a total return basis.

Let's see a correction before we start worrying about a crash!

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Digging for value with Drillsearch (DLS)

by Elan Miller, Pengana Capital

How long have you held Drillsearch (DLS)?

We have held Drillsearch (ASX Code DLS) since May 2013.

What do you like about it?

Drillsearch is a focused Cooper Basin oil play with strong oil production, which has continued to surprise on the upside, potential wet gas production, an active expansion program and long-term exposure to unconventional gas. The company has substantially increased its reserves, is well run, has delivered on its stated goals and scores well across our earnings and value factors.

How is it better than its competitors?

Drillsearch is focused on one region, namely, the Cooper Basin, with a three pronged business strategy centred on oil, wet gas and unconventional gas. Drillsearch scores very well across our earnings, value and quality factors within our model, and screens exceptionally well relative to the stocks within the energy sector.

What do you like about its management?

Management has a proven track record of delivering solid growth and remains focused on their long-term strategy. Management is proactive with assets and continuously maintains focus on reserves, production and cash flow.

At what point would you sell it?

We would consider selling it on relative valuation grounds when other stocks within the energy sector start displaying more favourable scores across our fundamental model. This may be as a result of a setback in production, poor drilling results and high CAPEX requirements for the unconventional drilling program.

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

We have held the stock since May 2013, and it has returned over 20% in six months, providing a solid gain to the long side of the portfolio.

Where do you see the value?

The stock scores very favourably on upward earnings revision and profit growth, as Drillsearch's oil production guidance remains conservative and its wet gas commercialisation will be accelerated through the Santos JV. Drillsearch trades at a deep discount to its intrinsic value and provides exposure to the long-term potential of Drillsearch's unconventional gas program. As a result, Drillsearch scores well across earnings, intrinsic value and relative value in our model.

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Which Banks are still a buy?

by James Dunn

To say that the big four banks had a belter of a year in 2012-13 is an understatement. Let's just recap on the headline numbers:

ANZ – year ending September 30:

- Record cash profit, up 11% to $6.5 billion
- Record net profit up 11% to $6.3 billion
- Total dividend of 164 cents a share, up 13%

Westpac – year ending September 30:

- Record cash profit, up 8% to $7.1 billion
- Record net profit, up 14% to a record $6.8 billion
- Total dividend up 5% to 174 cents.

NAB – year ending September 30:

- Record cash profit, up 9% to $5.9 billion
- Record net profit, up 33.6% to $5.45 billion
- Total dividend up 5.5% to 190 cents.

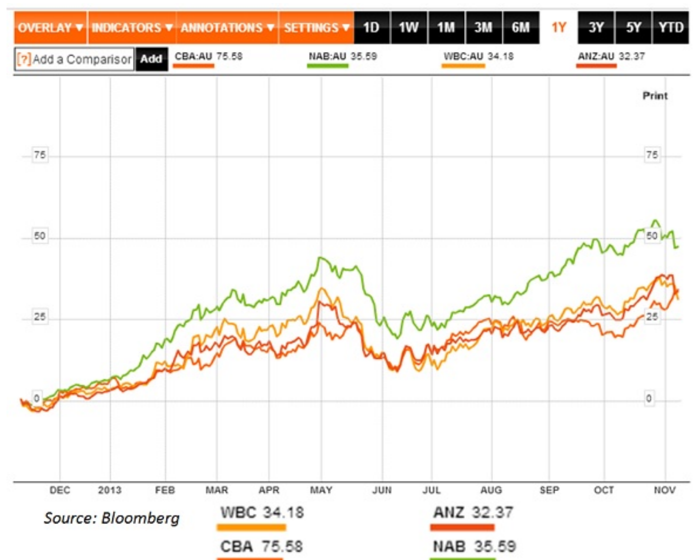
CBA – year ending June 30:

- Record cash profit, up 10% to $7.8 billion,
- Record net profit, up 8% to $7.68 billion,
- Total dividend up 9% to 364 cents.

The total cash earnings of the big four banks for FY13 was $27.3 billion. Four years ago, coming out of the GFC, they earned $16.3 billion in total.

And CBA has raced out of the blocks in the current financial year, reporting last week a $2.1 billion cash profit for the September quarter, up 14% from the equivalent period last year, and potentially putting the bank on track for a profit of $8.3 billion to $8.4 billion this year.

Now there is talk of big US hedge funds lining up to short-sell the over-valued Australian banks; and also of CBA splitting its shares, on the grounds that a share price close to $80 is too large and off-putting.



Well, it's not too large or off-putting if you own them: especially if you have owned CBA shares since the float at $5.40 in September 1991, and have received a total of $38.67 in dividends along the way.

But $80 just might put you off buying CBA shares if you don't already own them – and that goes for all of the big four banks, because they are virtually priced for perfection.

On the FNArena database, the broker analysts' consensus target price for ANZ is $32.85 – it is trading just 14 cents below that.

At $79.10, CBA is actually trading 5% above the consensus target price of $75.05.

NAB, at $34.78, is 2.7% short of the consensus target price of $35.73; while Westpac, at $33.28, is also short of its consensus target price of $33.50.

The big four banks are still phenomenally strong generators of hefty fully franked yields, which make them the cornerstone holdings of many self-managed super fund (SMSF) portfolios.

On consensus estimates, the big four are expected to return the following over the next 24 months:

Consensus estimated yields

	Dividend in cents		Yield	
	FY14	FY15	FY14	FY15
ANZ	171.5	183.3	5.2%	5.6%
CBA	384.9	397.8	4.9%	5.0%
NAB	202.9	214.3	5.8%	6.2%
WBC	190.8	189.8	5.7%	5.7%

But, as always, these nominal yields have to be placed in the context of how the franking credit rebates to an SMSF augment these yields, firstly if the shares are held in a fund in accumulation phase, and secondly for a fund in pension phase.

To an SMSF in accumulation mode, ANZ is priced to offer an FY14 yield of 6.32%, rising to 6.8% in FY15; CBA should yield 5.95% in FY14, and 6.07% in FY15; NAB is projected to pay 7.05% in FY14, and 7.53% in FY15; and Westpac looks like offering 6.92% in FY14 and FY15.

If the fund that holds the shares is paying a pension, ANZ is priced to offer an FY14 yield of 7.43%, rising to 8% in FY15; CBA should yield 7% in FY14, and 7.14% in FY15; NAB is projected to pay 8.28% in FY14, and 8.86% in FY15; and Westpac is effectively offering 8.14% in FY14 and FY15.

Of course, many of the shareholders will do substantially better than these yields, because they bought the shares at lower prices. For example, had your fund bought CBA five years ago, at $32.10, the FY15 projected yield would be a nominal yield of 12.4% – rising to 15.05% for a fund in accumulation phase, and 17.7% for a fund in pension phase.

Or had your fund bought ANZ five years ago, at $13.78, the FY15 projected yield would be a nominal yield of 13.3% – rising to 16.2% for a fund in accumulation phase, and 19% for a fund in pension phase.

You can see why many SMSFs are very reluctant to part with their bank shares.

The FY13 results were assisted by lower-than-expected charges for bad and doubtful debts (B&DD), which more than offset weakness in revenue and costs.

But analysts say it is difficult to see the banks' profitability – as measured by return on tangible equity (ROTE) – expanding from current levels. The outlook for ROTE is at best flat, which influenced Goldman Sachs to estimate that bank forward earnings needed to be about 10% higher to justify the sector's current price-to-net tangible assets (NTA) multiple versus industrials.

Of course, while they face common issues of net interest margin pressure, interest rate risk, market risk, operational risk, funding risk and potential regulatory change, the big four are different beasts, and can't be viewed the same. The differentiation is marked by ANZ's Asian expansion strategy; CBA's greater exposure than the others to stock market moves, through its proportionally larger funds management/wealth arm; NAB's UK presence, which it has not fully exited, and its ongoing core banking system replacement, which carries significant execution risk; and Westpac's greater reliance than its peers on wholesale funding, because it lags in deposits.

Broker Citi, for example, rates the banks in order of preference as CBA, WBC, ANZ, and NAB – with preferences following profitability. CBA ranked top dog because of its strong deposit franchise and higher returns, but Westpac is narrowing the gap with CBA on funding and asset quality. With credit growth strengthening, term funding costs falling, and stability in housing and small-to-medium enterprise (SME) loan margins, Citi expects mid-single digit earnings-per-share (EPS) growth in FY14, with banks still "in a very sweet spot in the cycle."

For its part, Goldman Sachs says the sector's valuations are ignoring a "deteriorating trajectory" in profits (before provisions). Goldman Sachs would only buy NAB, saying that over the next two years it

forecasts NAB to deliver the best EPS growth of the group, and to be the only major bank to increase its ROTE. Goldman Sachs is neutral on ANZ, but says it's time to sell CBA and Westpac.

Baillieu Holst last week gave its clients the "top 10 reasons to take some profit in banks."

1. Valuations are stretched;
2. Upgrades were priced in before the result;
3. Great run since May after bank sector pull-back;
4. Currency higher than most analysts expected;
5. US tapering worries are back with latest strong growth data;
6. Three of the big banks go ex-dividend early in November;
7. Majority of the investor universe has been 'long' the banks for a while;
8. Brokers have mostly moved to 'hold' recommendations with limited upside;
9. IPO line up pre-Christmas needs funding vehicle; and
10. US Hedge funds are looking at Australian banks, like in May.

Remember, though, that these views are not meant to be that of the SMSF investor, holding the bank stocks for yield. Whether the bank share prices have gone into over-valued territory is not necessarily an argument that concerns SMSF investors: to them, the dividend flows and the yields those represent are always the most important numbers.

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Buy, Sell, Hold - what the brokers say

by Rudi Filapek-Vandyck

Stockbroker upgrades and downgrades are pretty much in balance during this quiet period. The past week saw a general re-assessment of David Jones (see our mid-week broker update here), which led to no less than three brokers upgrading their rating to Neutral for the stock. This has pushed the face value numbers in favour of more upgrades. As such, FNArena recorded 11 upgrades and 8 downgrades.

All in all, changes in stockbroker ratings seem devoid of any strong themes. Most are simple responses to profit warnings or to re-appraisals, as share prices rise on low volumes.

Upgrades

Code	Company	Old Rating	New Rating	Broker
BBG	Billabong	Sell	Neutral	Citi
CBA	Commonwealth Bank	Neutral	Buy	JP Morgan
DJC	David Jones	Sell	Neutral	CIMB Securities
DJC	David Jones	Sell	Neutral	Credit Suisse
DJC	David Jones	Sell	Neutral	Deutsche Bank
DOW	Downer EDI	Neutral	Buy	UBS
FLT	Flight Centre	Neutral	Buy	Deutsche Bank
FMG	Fortescue Metals	Neutral	Buy	UBS
PNA	Panaust	Neutral	Buy	Credit Suisse
QBE	QBE Insurance	Neutral	Buy	CIMB Securities
TTS	Tatts Group	Sell	Neutral	JP Morgan

In the good books

Commonwealth Bank (CBA) was upgraded to Overweight from Neutral by JP Morgan. CBA's quarterly earnings beat the broker on lower provisioning expense and the result was compositionally solid, the broker suggests. Margins declined slightly but FUM growth was strong. Business loan growth was absent but mortgage growth was above system for the first time in three years. Importantly, CBA was able to generate capital in a low earnings growth environment, leading the broker to increase its dividend forecast. With peers going ex-div, CBA is well positioned for upside, the broker suggests.

Tatts Group (TTS) was upgraded to Neutral from Underweight by JP Morgan. The broker is upgrading to Neutral from Underweight because the stock has underperformed this year. The recent trading update suggests lotteries are doing well and the investment in the brand and marketing and wagering technology should deliver benefits. Forecasts for FY14 have been increased and the target price is raised to $2.95 from $2.80.

In the not so good books

Ausdrill (ASL) was downgraded to Neutral from Overweight by JP Morgan. JP Morgan has downgraded the rating to Neutral from Overweight. The price target is reduced to 97c from $2.28. The broker considers the company's strong link to mine production increases is broken. Ausdrill is required to make major changes to reset earnings and reduce gearing. After a trading halt, the company has provided initial quantitative guidance and now expects normalised profit to be down 60% in FY14. Management has stated the weakness is widespread, including its core drilling and blasting services in Australia and Africa. JP Morgan suspects the need to lower gearing will make the process of rebuilding challenging.

Downgrades

Code	Company	Old Rating	New Rating	Broker
ABC	Adelaide Brighton	Buy	Neutral	Deutsche Bank
ASL	Ausdrill	Buy	Neutral	JP Morgan
HVN	Harvey Norman	Buy	Neutral	UBS
IOF	Investa Office Fund	Buy	Neutral	UBS
IOF	Investa Office Fund	Buy	Neutral	Credit Suisse
MQG	Macquarie Group	Buy	Neutral	Deutsche Bank
ORI	Orica	Buy	Neutral	JP Morgan
WBC	Westpac	Buy	Neutral	Deutsche Bank

UBS downgraded Harvey Norman (HVN) to Neutral from Buy. First quarter sales were up 2.7% and in line with the broker's expectations. Franchisees slowed, as did like-for-like sales in New Zealand. This confirms the challenging environment is still in place. The broker has lowered first half profit forecasts by 10.2% and FY14 by 7%. The stock has outperformed over the quarter and is now trading in line with the broker's price target (lowered to $3.20 from $3.30) so the rating is downgraded to Neutral from Buy.

Orica (ORI) was downgraded to Neutral from Overweight by JP Morgan. Volume growth is softening but what has caught JP Morgan by surprise is the impact of the shift in the mix towards lower margin regions. This has resulted in reduced profit per tonne for mining services. The broker thinks consensus earnings estimates for FY14 are optimistic and the fundamental valuation is no longer supportive. FY13, FY14 and FY15 earnings forecasts have been downgraded by 0.2%, 6.2% and 4.7% respectively. The rating is downgraded to Neutral from Overweight and the price target remains at $21.20.

Deutsche Bank downgraded Macquarie Group (MQG) to Hold from Buy. Deutsche Bank thinks that while earnings growth and returns will increase significantly over the medium term, the share price will take a breather. The first half showed strong growth in all franchises with both annuity and market-leveraged business contributing. The next upside leg is seen in FY15 and the valuation is looking full on FY14 earnings expectations, amidst the potential for negative sentiment around the tapering of QE in the US. The broker does stress that this is a valuation and timing call rather than revealing concerns around the business model and growth. The rating is downgraded to Hold from Buy and the price target is steady at $56.20.

Westpac Banking Corp (WBC) was downgraded to Hold from Buy by Deutsche Bank. The FY13 result was solid but Deutsche Bank, looking into FY14, finds it difficult to envisage the bank delivering top growth among peers. Initiatives are likely to take some time to show. Further special dividends are expected, but valuation now looks challenging following a 26% increase in the share price since June. Hence, the rating is downgraded to Hold from Buy. The target price is raised to $35.90 from $34.80.

Positive Change Covered by > 2 Brokers						
Order	Code	Company	Previous EF	New EF	Change	Recs
1	NAB	National Australia Bank	252.338	269.475	6.79%	8
2	DLS	Drillsearch	22.600	24.025	6.31%	4
3	MQG	Macquarie Group	305.057	322.700	5.78%	7
4	WBC	Westpac	224.275	231.750	3.33%	8
5	FXJ	Fairfax	5.263	5.438	3.33%	7
6	TPI	Transpacific Industries	5.318	5.485	3.14%	6
7	DJS	David Jones	15.618	16.018	2.56%	7
8	AWE	AWE Limited	8.429	8.629	2.37%	6
9	EVN	Evolution Mining	10.095	10.312	2.15%	5
10	AMC	Amcor	68.679	70.148	2.14%	8
Negative Change Covered by > 2 Brokers						
1	QAN	Qantas	1.150	0.475	-58.70%	8
2	ASL	Ausdrill	25.700	18.543	-27.85%	7
3	GUD	G.U.D. Holdings	50.850	44.467	-12.55%	6
4	AQG	Alacer Gold	11.547	10.913	-5.49%	6
5	AUT	Aurora Oil and Gas	29.508	28.381	-3.82%	6
6	CCL	Coca-Cola Amatil	70.000	67.425	-3.68%	8
7	ORL	Orotongroup	32.094	31.106	-3.08%	4
8	BLD	Boral Limited	19.738	19.399	-1.72%	8
9	IOF	Investa Office Fund	24.224	23.810	-1.71%	7
10	RRL	Regis Resources	30.083	29.583	-1.66%	6

The FNArena database 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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Record weekend as auction market reaches boiling point

by Penny Pryor

A "one-in-100 year perfect storm of auction conditions". That's the way Andrew Wilson, senior economist at Australian Property Monitors described the auction market this weekend, and the APM numbers certainly back the claim up.

448 properties made it to auction in Sydney, with 83.7% of those selling. After two weeks of 'Super Saturday' in Melbourne, the Victorian capital continued to power ahead, with a clearance rate of 73.1%.

Almost $670 million worth of property changed hands in Sydney and Melbourne over the weekend. While Sydney had the higher median value, Melbourne had the most expensive property sold, when a two-bedroom house in Toorak went for $3.02 million.

Adelaide and Brisbane remained lackluster, with clearance rates of 57.7% and 55.2% respectively.

Table 1: This Saturday, 9 November 2013

	Clearance Rate%	Number Listed	Number Reported Auctions	Number Sold	Number W/drawn	Total Value Sold ($million)	Auction Median Houses	Auction Median Units
Sydney	83.7%	802	448	394	23	$353.0	$967,000	$585,000
Melbourne	73.1%	977	692	511	7	$315.9	$718,750	$522,750
Adelaide	57.7%	59	22	15	4	$8.2	$620,000	SNR
Brisbane	55.2%	110	29	16	0	$5.0	$452,500	SNR

Source: APM

Last week was similarly strong, with clearance rates in Sydney, Melbourne and Adelaide all above 73%. The properties that were selling were more valuable, with the median house price value for Sydney over $1 million.

Table 2: Last Saturday, 2 November 2013

	Clearance Rate%	Number Listed	Number Reported Auctions	Number Sold	Number W/drawn	Total Value Sold ($million)	Auction Median Houses	Auction Median Units
Sydney	77.4%	728	638	526	42	$514.3	$1,040,000	$611,000
Melbourne	73.1%	117	102	76	2	$43.0	$610,000	$440,250
Adelaide	73.1%	74	65	49	2	$25.2	$570,000	SNR
Brisbane	60.5%	93	36	23	2	$12.1	$595,000	SNR

Source: APM

Looking back 12 months, the property market is unrecognisable. None of the top four cities managed to clear more than 60% of properties at auction, with Brisbane selling a measly 28.1%. Looking at this, Brisbane's 60.5% figure from last week actually looks pretty strong.

Table 3: Saturday, 20 November 2012

	Clearance Rate%	Number Listed	Number Reported Auctions	Number Sold	Number W/drawn	Total Value Sold ($million)	Auction Median Houses	Auction Median Units
Sydney	57.2%	529	422	287	80	$242.6	$850,000	$635,000
Melbourne	58.4%	763	656	387	7	$225.9	$666,500	$441,000
Adelaide	43.1%	60	46	25	12	$16.8	$530,000	SNR
Brisbane	28.1%	87	49	16	8	$9.9	$608,500	SNR

Source: APM

Despite the booming market, talk of a 'bubble' is still far-fetched. All markets have ups and downs, and at the moment we're in the midst of one very strong up on the Sydney and Melbourne property scene.

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