Switzer Super Report

Issue 253, 16 January 2014

Bouncing cats

It was almost like a dead cat bounce, but in reverse. Our very healthy cat - the Dow Jones - dived this week in the US when investors got spooked, and sold off. But our feline friend, aka the market, was very much alive again and shot back up, when investors realised they had over-reacted.

Like I've said all along, we're going to be seeing a bit of this in the weeks and months ahead, so use it as an opportunity to buy. Today in the *Switzer Super Report*, we have buying ideas from James Dunn in the consumer discretionary space. The sector, for the most, had a good 12 months, but there's still life in it yet, with the likes of Oroton and Nick Scali.

We go global in *Short 'n' Sweet* this week, and Tony Negline examines when a kitchen renovation is a super contribution for your SMSF. In *Questions of the Week*, Paul Rickard dares not compare himself to Warren Buffet, but does dare to provide some advice on Orora and Fortescue.

Sincerely,

Peter Switzer

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Three must-haves in the consumer discretionary jungle

by James Dunn

One of the big domestic investment themes posited for 2014, is the handing of the economic-growth baton from the resources sector to the non-resources sector. But judging by the stock market, that process well and truly got under way last year.

The star of the show

In particular, the consumer discretionary stocks sector was star of the stock market in 2013, up 36.3%, powered by the sub-sector of specialty retail.

Gradually, the prevailing record-low interest rates and housing market recovery are supporting a recovery in consumer confidence, and retail sales are strengthening. On the most recent Australian Bureau of Statistics (ABS) figures, Australian retail spending rose by 0.7% in November, beating economists' expectations of a 0.4% rise.

That was the seventh consecutive monthly rise for retail sales, and took the figure to a level 4.6% higher than a year ago, with the all-important Christmas numbers to come. Given that as recently as June 2013, annual retail sales growth was running at a near-record low of 1%, consumers have clearly begun to unlock their wallets.

But this is not a uniform trend. In November, department-store sales actually fell over 12 months, down 1.2%. In contrast, clothing specialists lifted sales by 10.5%, while restaurant turnover was up 8.3% on a year ago. Spending on household goods rose 4%. Deutsche Bank reckons retail stores have continued to do well over Christmas and into the New Year; Commonwealth Bank economist Gareth Aird says “increased wealth is being transferred to a lift in consumer spending.”

The big guns

The stellar performance of the consumer discretionary stocks as a group was driven by some extremely strong gains, but there were some big losses as well, as is obvious in the following table.

	Symbol	12-month return (share price gain plus dividends)
Kathmandu Holdings	KMD	93.0%
Nick Scali	NCK	79.0%
Domino's Pizza	DMP	78.0%
Harvey Norman	HVN	69.0%
Breville Group	BRG	46.0%
Specialty Fashion Group	SFH	39.0%
Gazal Corporation	GZL	37.0%
David Jones	DJS	33.9%
Super Retail Group	SUL	32.0%
Myer	MYR	31.4%
Premier Investments	PMV	30.0%
Funtastic	FUN	-25.6%
Webjet	WEB	-28.3%
Oroton	ORL	-34.2%
Fantastic Furniture	FAN	-36.2%
Wotif.com	WTF	-47.4%

Source: Stock Doctor – 13 January, 2014

Better for some than others

Clearly, the last few years have been more of a struggle for some retailers than others. The rejuvenated Australian consumer and the lower A$ should help the sector: in particular, the weaker $A should bring some respite to those retailers who compete against products bought online from overseas, which is a less-attractive transaction than it would have been a year ago, with the dollar near or above parity with the US dollar.

However, a lower Aussie dollar is not a panacea for the likes of Harvey Norman, JB Hi-Fi, David Jones, Myer and Premier Investments, because it both increases the landed costs of the goods they bring in from overseas, and makes it easier for the Zaras, Top

Shops, H&Ms, Forever 21s and Uniqlos of the world to expand into the Australian market.

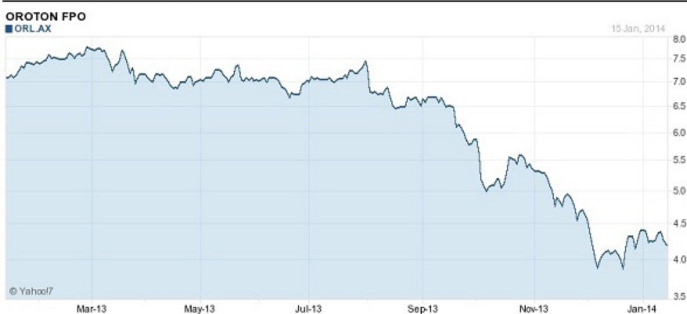
Many of the retailers are pinning their hopes on the online playing field being evened somewhat by having the Australian goods and services tax (GST) applied to overseas purchases worth less than $1,000, but even there, the fact is that the large international retailers, especially those from the US, can simply offer much lower prices because they have lower labour costs and better buying prices. Even the costs of shipping to Australia are largely offset by the lower costs of the big online retail sites.

The must-haves

So while consumer discretionary is a tough business, the share price performance of many (not all) of the participants has belied this to a significant extent. And the strong returns posted by the sector index and the even better returns generated by many of the constituents raise the obvious question – is there any value still to be found?

The answer appears to be yes – even in some of the stronger performers.

1. Oroton (ORL)



Source: Yahoo

Oroton is considered to have 15% upside to the target price, and a 5.3% fully franked yield. Clearly, many investors were tempted to mark Oroton down last year on the back of two seemingly-big negatives: the resignation of the highly regarded Sally Macdonald as chief executive officer and the severing of the company's 23-year relationship with Ralph Lauren, which expired in June 2013. The exclusive Ralph Lauren licensing agreement represented 45% of Oroton's sales and 35% of net profit: not surprisingly, Oroton has forecast a 30% drop in earnings for 2013-14.

But if you look closer, the company – under new CEO Mark Newman, who worked closely with Macdonald – has freed-up capital to expand its own brand into Asia, and can grab opportunities from which it was barred while working with Ralph Lauren.
The perfect example is the 10-year joint venture agreement announced in August 2013 with US fashion brand Brooks Brothers that will see Oroton – which has 51% of the joint venture – open four to eight Brooks Brothers stores and department store concessions this financial year, the first Brooks Brothers' outlets in Australia. Oroton expects revenue from the joint venture to reach $50 million in five years. This is while Oroton opens its own stores in China and the Middle East

The Brooks Brothers deal was followed in October by an exclusive 10-year franchise agreement with Gap Inc. to develop the Gap brand in Australia and New Zealand, with first rights to develop the Banana Republic brand in these countries, and the potential opportunity to develop the Old Navy brand as well. Who needs Ralph Lauren?

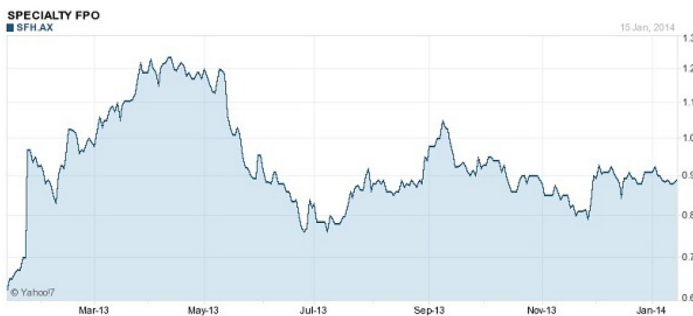
2. Nick Scali Furniture (NCK)

Source: Yahoo

Nick Scali Furniture looks even better, with about 19% of potential upside and a 4.8% fully franked yield (FY14) – the caveat there is that NCK is a

lightly-traded stock. With a housing recovery well under way, Nick Scali is well positioned for its plans to move into the Perth market this financial year, with New Zealand the next target. The company says its strategy is to increase its store numbers from the current 38 to 80, in both the main brand and the lower-priced Sofas2Go brand, although it has not given a time frame. That should flow through to improved profitability, although the company's main challenge is to maintain its margins, as a weakening A$ makes its stock more expensive to import.

3. Speciality Fashion Group



Source: Yahoo

Specialty Fashion Group, at 89 cents, has 16.9% potential upside to the consensus target price of $1.04.

In November 2013, for a seemingly bargain-basement price of $5 million, Specialty Fashion picked up the Rivers chain, with its 160 stores and $180 million turnover. SFH says Rivers could expand to 220 stores, by leveraging off the group's database of seven million customers and maximising economies of scale.

If it gets the Rivers integration right, Specialty Fashion will have paid a pittance for an asset that moves it out of its specialty women's fashion market, and into the footwear and men's and children's clothing markets, in the 'value' segments. The company says the material benefits from the Rivers acquisition will flow through from FY2015.

Specialty has reacted to the big challenges facing apparel retailers by investing in its design team, to differentiate the range from the foreign invaders, and has also boosted its online retail presence, which now accounts for about 4% of revenue.

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REA Group – a good little earner for your fund

by Fundie's Favourite

How long have you held the REA (REA) Group?

We have held it since the 14th of February 2013. REA is a digital advertising business focused on real estate – the operator of 13 websites such as realestate.com.au

What do you like about it?

We feel that the value creation in the migration from print to digital business models still has a long way to go. REA Group is less mature than their Australian-listed peers, which have a more mature domestic market. REA should continue to create shareholder value, owing to their move from subscription pricing to depth-based listing products (products which offer an extra layer of tailored service to users).

How is it better than its competitors?

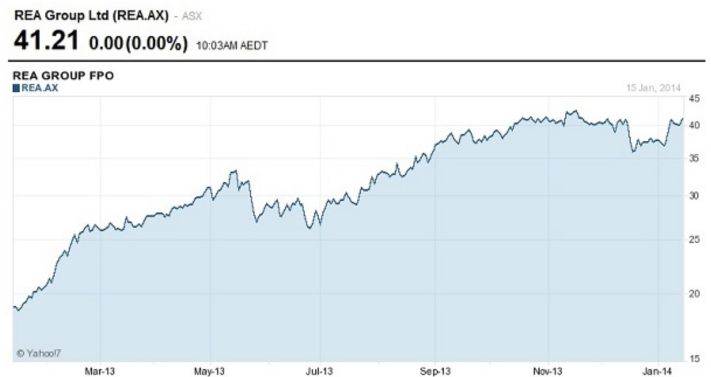
REA's main competitor, Domain.com.au, is less well funded and management hasn't delivered the market share gains that REA has. REA continues to dominate the market in terms of average monthly unique visitors, and average number of minutes spent on the site.

What do you like about its management?

The CEO has done such a good job. He was head-hunted by a large international player from Germany. The next CEO is likely to continue the current strategies.

What is your target price on REA Group?

$50.



Source: Yahoo

At what point would you sell it?

When we feel it is fully valued relative to the market.

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

It has been a substantial positive contributor to performance.

Is it a liquid stock?

Yes, it is a liquid stock now, despite the free float being small.

Where do you see the value?

We believe sell-side analysts have underestimated the value creation that could come from the migration of all clients to depth products. We believe the stock will continue to deliver positive earnings surprises.

Jelena joined Platypus as an analyst in October 2008 from Deloitte where she worked in Corporate Finance as a Valuations Senior Analyst; Jelena had been with Deloitte since 2005.

Orora the one to watch in a mediocre bunch

by Ron Bewley

Only one stock from this sector, Nufarm (NUF), did not make a capital gain (Table 1ĚĄÏ) in the period since my last review (25th June 2013). Indeed, only two stocks, Nufarm and Incitec Pivot (IPL), did not outperform the ASX 200 over the period!

So, while this sector performed very well in recent times, a number of these companies suffered during the GFC. However, with the US economy seemingly getting back into shape, and our dollar having fallen back to around US 90 cents , a closer look at this sector is now appropriate.

The ones to watch

While Sims (SGM) and Orica (ORI) have acceptably good consensus recommendations – being less than 2.5 on a scale of 1 (buy) to 5 (sell) – both ratings have slipped over the period. On the other hand, Bluescope (BSL) and Incitec Pivot have improved their ratings into this range. Bluescope's price has been on an upward trend since it was beaten down in 2012. Incitec reversed its year-long downward price trend in early December 2013. Perhaps it would be worthwhile watching Incitec for a little while longer with a view to getting on board.

Orora (ORA) is also worth watching, but with only four analysts following the stock – against double figures for the other top 100 stocks – a bit more support from brokers would be needed to attract me at this stage.

The sector analysis in Table 2ĄÇÏ D paints a solid, but not spectacular future for both the sector and the index. With exuberance for the sector at 3.4%, these stocks as a group look cheap. However, with there being no specific index for non-mining, it is not clear whether the under-pricing is uniformly across both sub-sectors.

The broader index is only a little under-priced. But the sector to watch is industrials. There is more in common between industrials stocks and non-mining stocks compared to the companies in the two subsectors of materials. Not only does the industrials sector have a great forecast of capital gains for the next 12 months at 22.3%, this forecast has been steadily upgraded over recent months, while that for materials and the ASX 200 have been slipping.

So my conclusion is that there is a better comparable sector to watch than materials – i.e. industrials – but Orora is one to spend a little time on as a potential for good returns in 2014.

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Table 1: Data on companies in the ASX 200's Materials (Non-mining) sector

Index	Code	Company name	Capital gains from 21/6/2013 - 13/1/2014	Consensus recs.	
				21/06/2013	13/01/2014
ASX 100	ARI	ARRIUM	103.2%	2.83	3.30
	JHX	JAMES HARDIE INDS.CDI.	36.4%	3.62	2.70
	BSL	BLUESCOPE STEEL	22.4%	2.36	2.30
	SGM	SIMS METAL MANAGEMENT	19.1%	2.07	2.40
	ORI	ORICA	18.7%	2.06	2.30
	AWC	ALUMINA	18.5%	3.64	3.50
	AMC	AMCOR	17.3%	2.69	2.70
	BLD	BORAL	15.4%	2.93	3.10
	ABC	ADELAIDE BRIGHTON	12.7%	2.93	3.10
	IPL	INCITEC PIVOT	2.5%	2.63	2.50
	ORA	ORORA			2.00
Small Caps	BCI	BC IRON	49.1%	1.80	2.50
	DLX	DULUXGROUP	33.2%	2.83	2.70
	CSR	CSR	28.2%	3.29	2.80
	FBU	FLETCHER BUILDING (ASX)	19.6%	2.14	2.30
	NUF	NUFARM	-2.7%	2.50	2.90

Source: Thomson Reuters Datastream and Woodhall Investment Research – 14 January, 2014.

Table 2: ASX 200 sector statistics

	Sector	Index Weights	Exuberance	12 month forecasts		
				yield	cap gain	adj gain
Resource related	Energy	5.5%	-6.5%	3.7%	21.0%	28.8%
	Materials	17.3%	-3.4%	3.4%	9.7%	13.3%
	Industrials	5.9%	-2.2%	4.2%	19.7%	22.3%
High yield	Financials	39.9%	0.1%	5.5%	5.8%	5.6%
	Property	5.9%	-2.8%	5.9%	3.9%	6.8%
	Telco	5.5%	3.8%	5.5%	3.4%	-0.5%
	Utilities	1.6%	-1.9%	5.8%	10.6%	12.6%
Other	Discretionary	4.1%	-0.4%	3.5%	13.6%	14.1%
	Staples	8.6%	-0.9%	4.6%	8.4%	9.4%
	Health	4.8%	0.6%	2.3%	12.2%	11.5%
	IT	0.8%	0.5%	3.1%	11.8%	11.3%
	ASX 200	100.0%	-1.4%	4.6%	8.9%	10.4%

Source: Thomson Reuters Datastream and Woodhall Investment Research – 14 January, 2014.

Note: Exuberance is a measure of mispricing (negative is underpriced) and cap(ital) gain is adjusted for exuberance. Cons. Rec. is the consensus recommendation from Thomson Reuters. 1 is a buy, 3 a hold and 5 a sell

Short 'n' sweet – going global

by Penny Pryor

Although SMSF asset allocation data suggests that SMSF trustees don't have much of an interest in international shares, we still get a lot of questions from subscribers about this very thing.

"I am wondering whether you would be inclined to invest money in a global fund or buy shares with global exposure. Could you also recommend any global equity funds or shares with global exposure and maybe suggest what percentage of a typical SMSF you would invest in such funds or shares," is just one such question.

In response, *Switzer Super Report* director, Paul Rickard, said: "While there is always a debate about how much to allocate to overseas markets, with an expectation of a falling Aussie dollar and recovering global economy, I think there is still some value in allocating money to these markets.

"The standard portfolio allocation models have a lot higher weighting to overseas equities than we prefer for SMSFs, mainly because they don't consider the tax advantages from franking credits. Accordingly, we typically recommend around 10% to 20% of your total fund rather than some models that are as high as 35%. Clearly, different funds have different needs to meet for their members and different expectations about risk and return – so there is no normal."

It makes sense

Australia represents less than 3% of the entire global share market. So, for true diversification, it makes sense to go offshore. But what's the best way to go about it? Do you use a managed fund, an ETF or buy directly yourself?

Barrie Dunstan wrote about the importance of including international shares in your portfolio late last year. He also touched on how you can access global markets through exchange-traded funds or ETFs.

If you want to do it yourself, some online brokers now allow it, and costs have come down.

CommSec offers rates of around $US65 per trade (or 0.75% which ever is great), while E*Trade is $59 per trade (or 0.59% whichever is greater).

Check out the costs here.

Tax implications

If you are buying US shares directly, and will receive income from those investments, tax is usually deducted and withheld at a rate of 15%. You will generally be able to claim an offset in Australia for the tax that has been withheld.

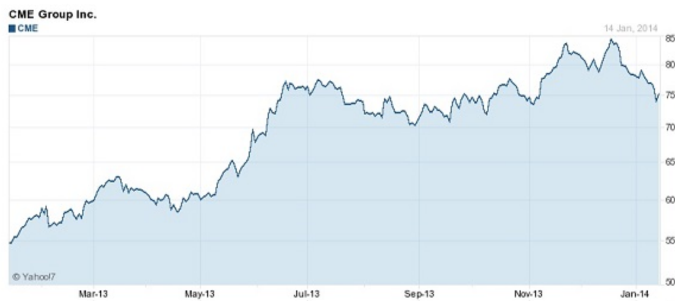
You need to complete the W-8BEN form – a form from the US Department of Inland Revenue, which certifies you're not a US resident – extra tax will be deducted, so make sure you complete this before you start trading.

We've also covered funds that offer good international exposure if you don't like picking the stocks yourself.

But if you are more of a DIYer with your shares, here are what the professionals think of three global stocks.

Chicago Mercantile Exchange Group

CME Group Inc. (CME) - NasdaqGS
75.76 +0.47(0.62%) 08:00 | After Hours : 75.76 0.00 (0.00%) 09:27

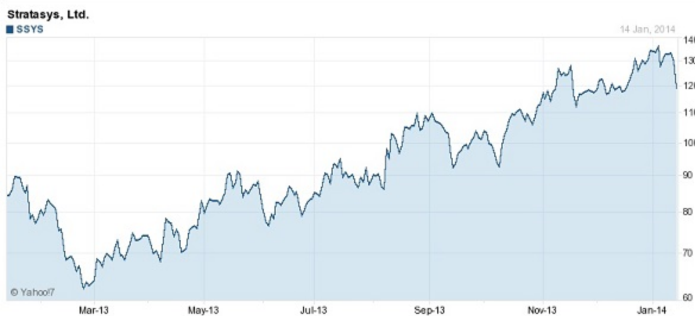


Source: Yahoo

"Chicago Mercantile Exchange Group has a near monopoly position and faces no viable competition in the medium to long term, which, combined with an intrinsically high return business model, makes it an attractive long-term investment," fund manager at PM Capital Uday Cheruva said in a November Fundie's Favourite.

Stratasys

Stratasys Ltd. (SSYS) - NasdaqGS
122.88 +3.51(2.94%) 08:00 | After Hours : 123.30 +0.42 (0.34%) 10:48 - Nasdaq Real-Time Price



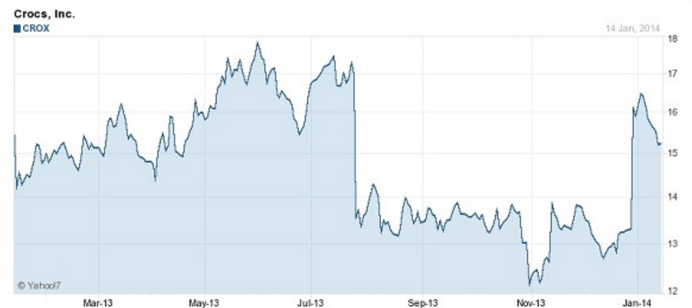
Source: Yahoo

Stratsys manufacturers and distributes 3D printers and earlier this year Australian Ethical portfolio manager Nathan Lim said: "Through a combination of strong organic growth and strategic acquisitions (most recently MakerBot, which now secures Stratasys' position in both the commercial and retail market), the company has the potential to maintain double-digit growth rates for several years."

The company's share price has risen steadily since he said that in June.

Crocs Inc

Crocs, Inc. (CROX) - NasdaqGS
15.27 +0.02(0.13%) 08:00 | After Hours : 15.27 0.00 (0.00%) 09:22



Source: Yahoo

In April, we had a Fundie's Favourite from Morphic Asset Management founder Jack Lowenstein on Crocs Shoes, and although the company had a big dive on poor results in August, it has since rebounded, following the announcement that CEO John McCarvel will step down, and Blackstone Group has taken a $US200 million stake in the group.

"Given that it has been close to five years since Crocs fell from grace, we believe it is time for investors to start paying more attention to the turnaround story," Lowenstein said then.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

Brokers aren't easing into the first month of the year by any means, as this week saw plenty of activity. Many are using the slightly slower period to review and revise overall forecasts and predictions for individual sector growth and commodity price direction.

In the good books

Macquarie upgraded education-provider Navitas (NVT) to Outperform from Underperform, following a change in the analyst for the company. The previous analyst believed the company was expensive and considered FY14-15 earnings already well priced in. The new analyst sees a company exposed to population growth in Asia and a growing demand for higher education from the likes of China and India.

CIMB Securities upgraded Suncorp (SUN) to Buy from Neutral. Suncorp is CIMB's preferred pick following sweeping upgrades of first-half profit forecasts for the domestic general insurance sector. Suncorp has a greater than 10% upside to its target price on a total return basis, and CIMB predicts a firm first half in 2014 could deliver a $300 million special dividend in the second half.

Macquarie upgraded Challenger (CGF) to Outperform from Neutral, ahead of the 2014 interim this week. A strong operation performance in the December quarter, combined with solid September-quarter growth and a narrowing of credit spreads (reducing risks), contributed to the upgrade.

In the not-so-good books

JP Morgan downgraded Regis Resources (RRL) to Neutral from Overweight. A weaker-than-expected December quarter, accompanied with revised production estimates and guidance, triggered the move. This is the second guidance downgrade in six months.

Credit Suisse downgraded Graincorp (GNC) to Underperform from Neutral, following a weaker-than-expected receivables update from Graincorp. Hot weather across the country is impacting on summer crop potential and the broker has reduced forecast earnings by 15% and 14% in FY14-15. GNC remains a long-term value play, but short-term momentum is missing.

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 you can and can't do with SMSF real estate assets

by Tony Negline

If you're one of the thousands of SMSF investors who owns some sort of real estate in your fund, and you want to develop the property or maintain it yourself, then you need to understand what that work means for your super fund.

Here are some common questions and answers around what you can and can't do to your property.

A key issue for you will be how will the development or maintenance work you personally perform be valued by your super fund. This is important because the value of the work will be deemed to be a contribution.

Why a contribution?

In Tax Ruling 2010/1, the ATO says that anything done to increase the value of a super fund, with the purpose to benefit one or more members of the fund, will be deemed to be a contribution. The only exception to this rule will be when the super fund invests its existing money, and makes a capital or income return (i.e. as is the case with most SMSF investments in equities, bonds etc.).

Recently the following scenario was proposed to the Tax Office. A related party of a super fund, for example, a fund member, renovates the kitchen of a residential property owned by a superannuation fund, including supplying all materials and labour for no cost. The cost of the materials is $12,000, the cost of the labour is assessed to be $13,000 and the market value of the property, after completion of the construction of the kitchen, is assessed to have appreciated by $40,000.

The initial point to note about this question is the materials. As the fund's related party has supplied the materials, the super fund would be deemed to be acquiring an asset from the related party. The problem here is that building supplies aren't items that can be sold, or given, to a super fund by any of the fund's related parties.

The exemptions that are allowed for this acquisition rule, such as listed shares and business real property, don't cover building materials.

So the only way around this initial hurdle is for the super fund to buy the materials.

In its response to this question, the ATO notes that in this scenario, the improvement to the fund's asset has occurred for little or no cost to the fund, or at best, for less than market value of those costs. Moreover, once the work is complete, the capital value of the fund will have increased.

In the ATO's view, the key action is the improvement to the fund's assets and overall capital value and therefore the "contribution" would be deemed to be the $40,000.

Are these kinds of contributions included in the contribution caps?

The short answer is, yes. In most of these cases where you work on your fund's property, it would be defined as a non-concessional contribution. However, if you perform the work through your business entity, then it might be deemed to be a concessional contribution.

What is the difference between maintaining an asset and improving it?

In very general terms, improving an asset involves adding new or substantial features or rights to an asset, which substantially increases the asset's value or functional efficiency.

On the other hand, repairing an asset means the act of making good defects, damage or deterioration including the renewal of parts. It doesn't imply a total reconstruction. It may involve improvement to an asset but only to a minor and incidental extent.

As you can probably gather, the difference between maintaining and improving assets can become a remarkably complex issue at a tax and legal level.

What if the property is owned via a holding trust?

Finally, if your super fund owns property that sits inside a holding trust because your fund took out a non-recourse loan to buy the asset, then there are further restrictions on what you can and can't do with borrowed money – you can't improve it, for example (see an earlier story on that here). You can maintain and repair it however, or improve it with other monies.

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Warren Buffett, insurance and new holdings

by Questions of the Week

Question: *I have to ask for your view on the following comment in a recent report by Paul Rickard – "I don't like insurance as an industry". How does this square with a certain Warren Buffet's well-publicised affection for this industry?*

Answer (By Paul Rickard): I don't in any way dare put myself up against Warren Buffet. Let me point out a couple of differences:

1. He is an investor, who either takes a material position in the company, or gets involved in managing the company – I am a tiny, insignificant investor with no influence on the management; and
2. I am not sure the US insurance industry is like the Australian industry.

My experience of the Australian general insurance industry is broadly the following cycle:

Catastrophe – Premiums rise – New players enter – Competition drives premiums down below economic value – Catastrophe

Even with re-insurance (all sourced internationally), not a particularly attractive business cycle.

Where are the local success stories?

Question 2: *One of the stocks you recommend puzzles me: Orora (ORA). It seems like a very recently-listed company, no history of dividends, but doing well in the current downturn. Can you tell me more about why you recommend it? Also how do you like Fortescue? I bought some a while back because the Switzer guests say go for cyclicals. So far it has been a bit disappointing.*

Answer 2 (By Paul Rickard): In regards to Fortescue, it is a pure play iron ore exposure. I have no issues with the company (Charlie Aitken is a huge fan). I just feel BHP provides a more diversified exposure and is lower risk than Fortescue.

With Orora, it is a spin out from Amcor. While it is a new company, it is not a new business – it is essentially the old Amcor's beverage and fibre packaging business. Very detailed information was published with the demerger and Greg Fraser wrote about it some detail for the Switzer Super Report in November.

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.*