Switzer Super Report

Issue 275, 3 April 2014

On the right track

All the talk in market circles today is of NAB's announcement that chief executive Cameron Clyne will be leaving later this year. Many are saying it could be a game changer for NAB but it didn't seem to bother stocks too much. Financials were down slightly in morning trading but the rest of the market was up, following a good night on Wall Street.

CEOs are very important, but so are business models. Today, Charlie Aitken explains why you should always buy the tracks - i.e. Telstra - over the train, particularly when the trains are looking a little expensive.

Also in the *Switzer Super Report*, we have Gary Stone's technical analysis of Suncorp - which could be set to go higher, Roger Montgomery's view on upcoming IPO Japara Healthcare and in *Buy, Sell, Hold - what the brokers say*, Tatts and Independence Group get upgrades.

Sincerely,

Peter Switzer

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Telstra on track for $6.00 target

by Charlie Aitken

I remain a structural bull on mobile data growth driven by "internet 2.0" meeting next generation smartphones and 4G mobile networks.

Mobile data addiction (MDA), which I can admit I definitely suffer from, remains the key driver of my still bullish Telstra (TLS) recommendation.

But judging by the smartphone penetration rates in Australia, I am not alone with my MDA.

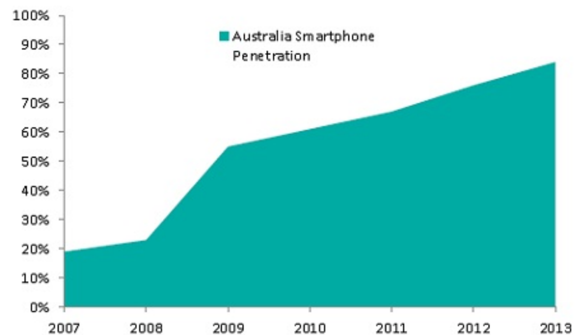
In Australia, at the end of 2013, smartphone penetration is now above 80%. This is one of the highest penetration rates in the developed world.

More interestingly, from a mobile internet/data usage perspective, smartphone penetration is the highest in the 16-39 age group, with over 90% of this demographic, which I recently left, owning a smartphone.

Mobile internet usage requires the use of a smartphone rather than a traditional mobile phone, so it is the level of smartphone penetration that is relevant rather than the number of SIM cards in active service.

It's also worth noting that Neilson estimates that this calendar year, globally, mobile internet usage will overtake desktop internet. Obviously, Krudd didn't read that report when he decided to spend $70 billion on the NBN.

Part of this will be driven by companies like Microsoft offering operating systems like Office for tablets.



SOURCE: AUSTRALIAN INTERACTIVE MEDIA INDUSTRY ASSOCIATION (AIMIA)

A need not a want

My argument remains that smartphones are a consumer staple, not a consumer cyclical. I also believe demand for mobile data will grow exponentially and drive Telecommunications sector revenue growth.

Telstra has the 4G network advantage in Australia and remains my large cap way of playing the structural growth in mobile data. Telstra remains in an earnings and dividend upgrade cycle.

In fact, I suspect most people who read this note today read it on a smartphone using the Telstra 4G network.

Interestingly though, I remain in the minority recommending Telstra shares. However that has been the case for the last three years.

As of yesterday, there are five buy recommendations, nine hold recommendations and five sell recommendations on Telstra. The median 12-month price target of those analysts is $5.08, i.e. most of them think it's going nowhere. Again, this has been the case for a few years, as the table below of consensus price target (yellow line) and share price (white line) confirms. The green/grey/red shading represents buy/hold/sell recommendations.

Click here to enlarge image.

The track or the trains

The aspect that amazes me is the same tech/telco analysts have universal buy recommendations over Australian internet-based business models (REA Group, Domino's Pizza, Seek, Carsales.com.au, etc.) which are heavily reliant on Telstra's 4G network to carry their product and grow their business, yet most of the analysts are neutral to negative on Telstra. To me, that's like recommending the trains and not the train track. Sure, the trains are moving at a faster pace than Telstra right now, in terms of top-line revenue growth and efficiency (ROE), but the P/E differential already strongly reflects that fact.

It's also worth remembering Telstra owns 65% of US Listed Autohome (ATHM US$4.2 billion market cap), which translates to a value of 22c per Telstra share. ATHM is twice the size of Carsales.com and you could argue that 22c of value is not reflected at all in Telstra's share price.

On Bloomberg consensus data for the current year, Telstra trades on 15.2x earnings. REA Group is on 49x, Seek 18.7x, Domino's 48x, and Carsales.com.au 28x.

I am certainly not a guy who thinks all P/E's should be equal. Far from it, but I just think we have got to the point where the trains are a bit ambitiously priced versus the track that carries them and I'd rather own the track (TLS).

That doesn't mean I foresee some collapse/tech wreck 2 in the share prices of highly priced tech growth stocks. I think we could see a near-term trading/valuation correction after the huge run they have had and money being rotated to Telstra.

To me, Telstra gives you leverage to many of the same mobile data themes at a significant P/E discount and significant fully-franked dividend yield advantage, a dividend that is now advancing in absolute terms after eight years of stagnation.

Call it train and track or hare and tortoise, but I prefer the tortoise from here.

Dividend plus

I think Telstra lifting the interim dividend from 14c to 14.5c was a major event for the company. We should get another 14.5c or even 15c fully-franked at the 2H FY14 result in August, which means the company is well on the way to paying 30c fully-franked in dividends in FY15.

If you buy Telstra today and hold it for the next 16 months, you should collect a minimum of 44.5c fully franked (14.5c +30c), putting the stock on a prospective 16-month fully-franked yield of 8.7% or 12.5% grossed up. With EPS growth driving that DPS growth, rather than simply a higher payout ratio, I think the downside risk in TLS shares is very limited.

With Telstra nearly 50% owned by Australian mums and dads in their SMSFs, dividend growth is vitally important to the direction of Telstra shares. I simply can't see the SMSF army abandoning their Telstra shares when the fully franked dividend is rising in absolute terms.

Similarly, it would take a very large rise in domestic cash rates for bank term deposits to compete with Telstra shares as a source of investment income. Again, I don't see a scenario of aggressive cash rate rises in the near-term.

Telstra management, under CEO David Thodey, has done a great job of taking costs out, which translates relatively modest headline revenue growth into high single-digit EPS and EBITDA growth. First half FY NPAT rose 9.2%, EPS rose 8.7%. There is more cost to take out, and I continue to believe the consensus view is UNDERESTIMATING forward EPS and DPS for Telstra. I think the stock will remain in an upgrade cycle, which is important to my bullish view on the stock.

KEY FINANCIALS			PRODUCT REVENUE			CUSTOMER GROWTH
TOTAL INCOME	↑	4.1%	MOBILES	↑	6.4%	739,000 NEW DOMESTIC RETAIL MOBILE CUSTOMER SERVICES
EBITDA	↑	7.0%	FIXED VOICE	↓	-7.3%	
NPAT	↑	9.7%	FIXED DATA	↑	6.0%	75,000 NEW RETAIL FIXED DATA CUSTOMERS
EPS	↑	8.7%	NAS	↑	29.3%	
DPS	↑	3.6%	INTERNATIONAL	↑	28.3%	117,000 NEW CUSTOMERS ON A FIXED BUNDLE

WE ARE ON TRACK TO MEET FY14 GUIDANCE

- WE HAVE DELIVERED REVENUE, PROFIT AND CUSTOMER GROWTH
- WE HAVE INCREASED THE DIVIDEND FOR THE FIRST TIME IN EIGHT YEARS
- CONTINUED INVESTMENT IN OUR CORE BUSINESS
- CONTINUED FOCUS ON NEW GROWTH INITIATIVES
- WE ARE ON TRACK TO MEET FULL YEAR GUIDANCE

To conclude, just keep in mind the 20-year chart of Telstra shares below. In tech boom part 1, they got above $9.00 as they were priced as a technology growth stock. I therefore think it is not an ambitious call to stick by my long held price target of $6.00 for Telstra over the next few years. At $6.00 paying a 30c fully franked annual dividend the stock will still yield an attractive 5.00% fully franked.

100% of Charlie Aitken's fees for writing for the Switzer Super Report *are donated to The Sydney Children's Hospital Foundation.*

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IPO opportunity in Japara Healthcare

by Roger Montgomery

In recent weeks, we have analysed no less than 10 individual prospectuses for IPOs and out of those, two have passed our filters for quality, and possess what we believe to be identifiable competitive advantages and bright future prospects. Importantly, and despite a hot market generally, they also passed our 'value' test.

It is estimated that the number of people over the age of 75 will double in Australia over the next 20 years. This 'Grey Market' (or the 'Generational Avalanche' as we have been referring to it at Montgomery for a number of years) is going to fundamentally and dramatically reshape Australia's economic landscape and a number of opportunities will emerge to excite investors.

There are a number of quality Australian healthcare companies that are perfectly positioned for this growing market. Several are listed and many more are not.

On the listed side, we have Cochlear Limited; at the forefront of hearing aid devices, Ramsay Health Care Limited; the leading private hospital operator, CSL; on the cutting-edge of biological advances, and Sirtex Limited with their potentially game-changing SIR-Spheres for inoperable liver cancer.

Japara Healthcare

To this select group, we would also like to add Japara Healthcare Limited, which should be listed shortly. We currently believe Japara is a high quality business that's being offered at a price we consider not overly expensive when compared to its peers. It's also a business with excellent tailwinds.

According to the japara.com.au website, the company operates 35 aged care facilities and five retirement complexes throughout Vic, SA, NSW and Tas. In total, it manages 3,075 patient beds and is the fourth-largest provider in Australia, caring for elderly Australians, specifically those who can no longer live independently. Somewhat sadly, as those in such situations have an average longevity of 2.5 years, Japara provides a service to a growing need.

Although Japara does not provide private hospital services, the majority of revenue is generated from providing services not dissimilar to the private hospital system. We believe the businesses' assets and revenues are quality.

Fees are charged based on a variety of living arrangements, amenities, services, meal plans, social activities and care options, for example for those requiring respite, dementia and Alzheimer- related care.

Potential risks

The government currently provides the majority of funding to the industry. Around 70% of Japara's fees are predominantly sourced through a prescribed fee schedule termed ACFI, which bases reimbursement on the acuity (acuity represents the resident's dependency and the level of care required to match it) of residents.

The balance of Japara's fees generally comes from wealthy residents, who may opt for higher standards of care. With higher standards of service levels comes higher associated costs, and therefore, higher fees.

These fees are regulated by the government and are indexed to CPI. There's no pricing power but government funding providing some certainty of recurring revenue (not earnings).

The economics of age care benefit from 'bonding'.

Bonding essentially provides the business with capital at zero cost and these funds can be used for a multitude of investment purposes but not the payment of dividends.

In addition to a lack of pricing power, however, the industry employs unionized labour and approximately 80% of Japara's expenses are wages. Limits to fee growth, amid scheduled wages increases, can impact profit margins and a heavy reliance on fixed costs means any drop in occupancy can lead to quick margin compression.

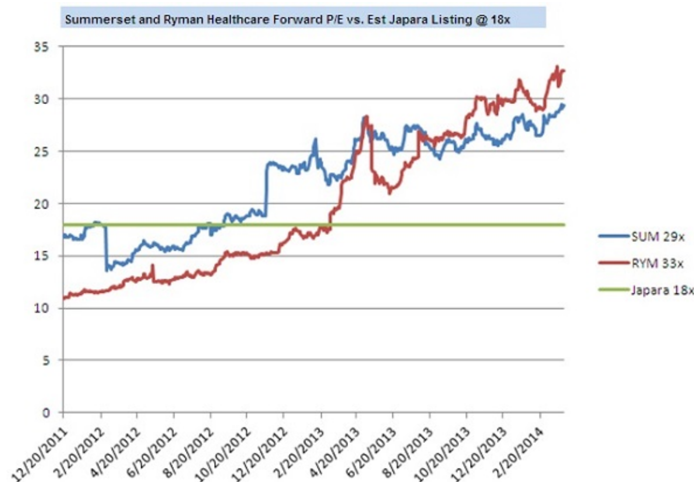
Offsetting all this is the compounded 9.2% annual growth in government funding – well in excess of wage cost growth. In the last two years, the government has reigned in funding, inflation and fee growth has declined slightly to 7.2% – still in excess of wage growth in a normal year. Importantly, training an increasing number of nurses could cap salary growth but it could also embolden unions representing a larger cohort of constituents.

Another potential negative stems from government regulated growth in the total number of beds – currently about 1.9% per annum.

The potential upside

But these negatives have to be measured against the quality of the business's assets, the certainty of its revenue and the rising demand for their services. There is also plenty of room for acquisitions in a highly fragmented industry with 186,000 beds, and the occasional brownfield development provides potential upside.

The company's shares are being offered at 18 times forecast earnings, well below the multiples commanded by other recognised listed quality operators in similar spaces.



Japara Healthcare currently appears to us to be a quality company with bright prospects, providing a quality level of care, bolstered by the tailwinds of an ageing population. We cannot say at this early stage whether we will be allocated any shares but over time we expect to do well investing in high quality and rationally priced IPOs.

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SUN may be set to rise

by Gary Stone

Suncorp Group (ASX: SUN) is a $16.5 billion Top 50 ASX listed company that provides banking, insurance, superannuation and funds management products and services to the retail, corporate and commercial sectors.

During the 2008 bear market, Suncorp's share price suffered far more than the major banks and the two other regional banks when it was down by 78%, compared to the others ranging between 60% and 68%. But since the bottom of the 2008 bear market in March 2009, only one of the six other banks in Australia has outperformed Suncorp and that is CBA.

Flag pattern at the half way mark

The weekly chart below dates back to early 2007, when SUN reached its all-time high. It is important to show this period to provide perspective of where Suncorp's share price currently is, relative to the decline that it suffered during the 2008 bear market.

The main area on the chart that I am interested in right now is the middle blue line, which is the 50% retracement level, or half way mark, of the decline in 2008. Technically, a 50% retracement is a key support and resistance area for price action. It took Suncorp's share price four years from March 2009 to reach this level in April 2013 and has spent nearly a year oscillating above and below this $12.50 area.

Combine this situation with another technical pattern, the flag, and a fairly high probability opportunity may be presenting itself. The flag can be seen at the middle right side of the chart and is depicted by the two red declining parallel lines. A flag is a continuation pattern – this putting the odds in favour of a price rise, if Suncorp's share price breaks out above the upper declining trend line.

The breakout out of the flag pattern occurred on 21 March and Suncorp is still trading above the declining trend line.

Source: Beyond Charts

The outlook

From here, Suncorp could continue to rise to challenge its recent high of $13.67 reached on 25 November. But before that occurs, one should expect a short-term retracement to retest the 50% retracement zone at around $12.50 and to meet the declining upper trend line.

If Suncorp is set to rise, then support should be found at the levels mentioned above, and from there, Suncorp's price should rise above its recent high and on to its first target around the $14.40 area, which is the 61.8% retracement zone, the upper blue line on the chart.

On the downside, one's risk should always be managed and the downside protected. A stop loss must always be placed to limit loss in the event that an unforeseen event occurs that affects price negatively. A prudent place to set a stop loss would be just below the recent low of $12.24 on 26 February. A wider stop could be set below the previous low of $11.82 reached on 5 February, to allow a trend to develop.

Gary Stone is the founder and managing director of *Share Wealth Systems*.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

It has been a much busier week in broker world so far, with mining and resources companies drawing attention as expectations for commodity prices wax and wane. Credit Suisse, in particular, moved on a number of companies based on better expectations for nickel, gold and copper prices.

In the good books

Credit Suisse upgraded Independence Group (IGO) to Neutral from Underperform, following a revision in outlook, given upgrades to nickel and gold price forecasts. There's a strong balance sheet so the broker thinks the issue is what to spend cash flow on. Expanding Tropicana will depend on further exploration success, as will the mine lives of Long and Jaguar.

Credit Suisse upgraded Oz Minerals (OZL) to Outperform from Underperform. The broker is bearish on the copper price but for those with gold exposure, there are compensatory risks.

UBS upgraded Sonic Healthcare (SHL) to Buy from Neutral. UBS considers the risk of offshore reform is moderating and Australia's reform risk is contained. Historically, the company's model delivers over 30% in incremental margin on new volume but this leverage was reduced or diluted by unrelenting reforms and cuts.

BA-Merrill Lynch upgraded Tatts Group (TTS) to Buy from Neutral. The broker observes a market downgrading of Tatts because of re-licensing concerns, the macro headwinds and a capex burden looming in wagering. This is driving a new Buy rating for the broker, upgraded from Neutral. Merrills considers Tatts a high quality defensive investment with credible growth opportunities.

Credit Suisse upgraded Western Areas (WSA) to Outperform from Neutral, its second rating upgrade in less than a month, on the back of Credit Suisse's increasing confidence that nickel prices are on the way up. Joint ventures with cash-strapped base metal juniors and M&A speculation are also in focus again.

In the not-so-good books

JP Morgan downgraded Seven Group to Neutral from Overweight and Macquarie downgraded to Underperform from Neutral.

Seven Group has entered a merger agreement with Nexus Energy (NXS), taking advantage of a strong balance sheet to make an oil and gas play. The broker has doubts about this as the company has no operating history with oil and gas, relying entirely on CEO Don Voelte's experience in the sector.

Macquarie thinks Seven Group's total spend to acquire Nexus (NXS) is likely to be $450m for long dated assets, which may ultimately be valuable but will provide limited earnings in the short term.

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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Short 'n' Sweet – the right Internet exposure

by Penny Pryor

Today, Charlie Aitken writes about the importance of prioritising the tracks over the train and potential "ambitious valuations" of the Internet darlings like Carsales.com.au.

These companies might look expensive, but with retail spending set to improve – the RBA isn't considering interest rate rises because we're slowing down – there could still be some upside in these well developed business models. It just means you need to wait for a market dip to buy them.

And if you'd got in when we first mentioned them in this report, you could well be streets ahead already.

If you had bought REA Group, owner of Realestate.com.au, back in January when Jelena Stevanovic from Platypus Asset Management wrote about it for a *Fundie's Favourite*, your $41.21 investment would now be worth over $48 – that's an increase of over 16% in three months.

Roger Montgomery recently wrote about one of his favourites – Carsales.com.au. Montgomery Investment is a big fan of the company's offshore expansion plans and points out that it might be hard for a company that's exposed to growing vehicle sales to lose money.

"According to VFACTS, in 2010 nearly one million new cars were sold in Australia. In 2013, this figure has climbed to over 1.1 million, which means amongst Australia's 20 million adult population, 5.5% buy a new car every year. That's a lot of turnover.

"One also suspects that just as many, if not more, second-hand cars are turned over as well, and the dominate online player that is leveraged to this industry without having to buy stock, lease a showroom or pay the wages of mechanics is Carsales.com.au (CRZ)."

Last week, Manny Pohl from EC. Pohl & Co. wrote about Domino's Pizza in a *Fundie's Favourite* and how its internet strategy is also making it a game changer.

But these aren't the only IT companies exposed to the consumer discretionary sector. On Monday, James Dunn will look at those companies set to become the next Seek, Realestate.com.au and Carsales.com.au.

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When all SMSF members die – individual trustees

by Tony Negline

Two weeks ago, I wrote about the control of an SMSF with a corporate trustee when all members die at the same time.

I'm now going to look at this issue when individual trustees run an SMSF, as control is worked out very differently.

For an SMSF with corporate trustees, the terms of the company's constitution are critical. Also *The Corporations Act* – and some of the default provisions that are found in there – are also sometimes very handy. For corporate trustees, the fund's trust deed is important but in most cases takes a back seat until the issue of who can be appointed directors of the trustee company are sorted out.

But what happens when all members of an SMSF with individual trustees die at the same time?

Key documents

It's still essential to confirm that death has actually taken place and then key documents need to be located.

The key documents aren't the various super or tax laws. The key documents are the fund's trust deed and the *Trustee Act* in the State or Territory in which the fund is based.

Let's assume we have a fund with two members.

When it's unclear which member died first, it's assumed that the older member died first. At this point, we need to tell the ATO that the deceased trustees no longer fulfil this function because of their death (there is an ATO form for this). The ATO will want to know who now controls the fund. The initial response has to be that this is being sorted out according to the fund's trust deed.

Legal personal representative

We need to examine the fund's trust deed to see if the deceased's Legal Personal Representative (LPR) is automatically appointed as a director.

If this is the case, then we need to make sure the LPR can actually be appointed as a trustee. In effect, this means we need to confirm that the LPR isn't disqualified from being an SMSF trustee for some reason, for example, an undischarged bankrupt.

Once the LPR has been appointed by the court after probate has been granted, or Letters of Administration have been issued, then they can be appointed as an SMSF trustee. This appointment needs to occur according to the rules of the fund and the LPR would sign the ATO trustee declaration. The ATO need to be informed about the appointment.

If the LPR isn't automatically appointed, then we can ignore these requirements./assets/3.4.14-Consensus-and-Share-Target-Chart.jpgDeath benefits guardian (DBG)

Some SMSF trust deeds allow a DBG to be appointed. Some of the powers given to DBGs can be:

- Consent or veto to how death benefits will be distributed;
- Remove trustees;
- Consent to trust deed amendments.

Obviously, you'll want to carefully review your fund's trust deed to work out if this applies to you.

I'm not a great fan of DBGs but I will deal with this in another article.

Who appoints replacement trustees?

In the absence of the automatic appointment of a deceased's LPR as a trustee, we need to see if the trust deed confers a power to appoint a replacement trustee. In many cases, this power is given to the existing surviving trustees. However, as all fund members are dead, this provision doesn't help us in this case.

It may be that this power is given to the LPR of the last surviving trustee – in our case, the younger member.

At this point, reference could be made to your SMSF's State or Territory *Trustee Act*. For example, the *NSW Trustee Act* gives the LPR of the last surviving trustee a statutory power to appoint a replacement trustee.

This legislation also allows a court to appoint a replacement trustee. Clearly, this might be a safer option if managing the deceased's affairs are controversial and you want to avoid future hassles.

Fund assets

For SMSFs with individual trustees, all fund assets have to be in the name of all trustees.

What happens now that all trustees are dead? Who controls the assets?

There are three potential issues here:

- Owned as joint tenants – ownership transfers to the younger trustee automatically; this means the younger trustee's LPR controls and owns the fund's assets; their job is to protect the fund's asset and, in time, transfer ownership of the asset when the fund's replacement trustees are appointed.
- Owned as tenants in common – each trustee's interest transfers to their respective LPR; these LPRs jobs are to protect and, in time, transfer ownership of the asset when the fund's replacement trustees are appointed.
- Solely by one trustee and not the other (that is, incorrectly) – these assets are transferred to the deceased trustee's LPR, whose job is to protect and transfer the asset at the appropriate time.

When the LPR doesn't become a trustee

It's important to realise that a deceased's LPR doesn't automatically become a trustee of an SMSF. This is a very common misconception, as the super laws allow for this but don't mandate this rule.

As noted above, they can become a trustee but this happens because of a specific provision in a fund's trust deed.

If the LPR isn't a trustee, then they can't exercise any SMSF trustee powers and have no rights under the trust deed.

Once the replacement trustee has been appointed

These requirements are very similar to those for a corporate trustee. They are:

- Value assets to determine the size of the death benefit;
- Claim any death insurance proceeds;
- Determine if any anti-detriment death benefit augmentation (that is, return of contributions tax) can be made;
- Determine any succession rule applying to the benefit (for example, if a pension is to be paid, then will another person receive that benefit if the initial pensioner dies?).

Conclusion

I have long been an advocate for corporate trustees for SMSFs. Comparing what happens in multi-member SMSFs when all members die adds further weight to my argument.

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Seven Group outlook and SG queries

by Questions of the Week

Question: On March 6, Charlie strongly recommended Seven Group Holdings (SVW). Having a lot of respect for Charlie's knowledge and having read the article, I concurred and bought the share at $9.26. Since then and in the space of three weeks, it has dropped like a stone and is currently down over 11%. Can Charlie give me some insight on this recommendation as it now approaches a stop/loss point?

Answer (by Charlie Aitken): The shares have fallen from the recent high for two reasons. One, the stock went ex the 20c fully franked interim dividend on March 24 and also suspended the on market buyback ahead of a deal announcement.

That deal, a merger with Nexus Energy, has now been announced and I expect the buyback to recommence. Speculation of the deal in a period of no buyback and ex-dividend caused most of the share price damage.

I remain a believer in the company.

Question 2: As a recent retiree, mainly due to illness, I retired with around 14 weeks long service leave and two to three weeks of accrued annual leave.

On the ATO website it states: "The following types of payments are not included in the minimum amount that SG contributions are calculated on….accrued annual leave, long service leave and sick leave paid as a lump sum on termination Redundancy payments."

My former employer has taken that to mean that on retirement I was not entitled to the 9.25% and thus I was deprived almost $3,000. As the 9.25% is included as part of my salary package I was shocked that this clause is in place. In hindsight (and with some friendly advice) I should have stopped work in December 2013 (as I did) but not resigned until all my long service and annual leave had been used up, sometime in April 2014.

Are you aware of this clause? If it is correct that my former employer is entitled to deprive me of that 9.25%, then this seems very unfair.

Answer 2 (by Tony Negline): Yes, the SG isn't payable on your accrued annual leave, long service leave or sick leave.

It might have been payable if you were employed under an industrial agreement or award.

Unfortunately, sometimes the law and logic are two different things. Your circumstances are a bad way to find this out, I have to say.

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Did you know?

What does it mean if a company is on the short selling list? Should you give it a wide berth? I sat down with Paul Rickard during the week to discuss that very dilemma. Watch the video here.