Switzer Super Report

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Heavy lifting

As the budget hangover starts to settle and markets seem pretty un-phased overall, Charlie Aitken revisits BHP today and explains why he still thinks it could be one of the heavyweights that takes the ASX200 to his long-term 6000 target.

Of course, we have our analysis of what's in the budget for you, our valued *SSR* subscriber, in a video from Paul Rickard, and Tony Negline also breaks down the main changes in his article today.

Also in the *Switzer Super Report today*, funds management guru Geoff Wilson has some lessons from his recent trip to London, and Roger Montgomery examines the health sector and discovers Ramsay is still the golden child.

Sincerely,

Peter Switzer

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BHP Billiton – still on message

by Charlie Aitken

BHP Billiton remains Australia's largest global market capitalisation company yet I continue to feel the cultural and business change under CEO Andrew Mackenzie is under-appreciated by most investors.

There are two reasons for this. The first is that Mackenzie is relatively low profile and goes about his business of running the business. That is a very good thing. The second is when it comes to mining stocks, the market is besotted by commodity prices rather than stock specific internal stories.

To my way of thinking, this is leading to the BHP cost out, productivity, production growth, simplification and capital discipline story sneaking up on investors who are purely focused on the daily spot price of iron ore.

No doubt the falling iron ore price and resilient Australian dollar are macro negatives for BHP (currently 48% of group revenue), yet with their high Fe grades, and place at the bottom of the iron ore cost curve (plus commodity diversity) they are the least affected by falling iron ore prices in Australian dollar terms.

But the iron ore price is a transparent *"known known"* and what I want to focus again on today is the less focused on story of what Mackenzie and his management team are doing at BHP.

Flashback

I first met one-on-one with Andrew Mackenzie last year. Below are a few points I made in these notes about that initial meeting (30 September 2013):

Mackenzie is of Scottish heritage and like all good Scotsman watches the pennies very closely. I believe you can look forward to a period of BHP being run hard, very hard, with a through the business focus on productivity, margins and free cash generation. I wouldn't be expecting any wastage on Mackenzie's watch, in fact I expect the complete opposite.

It's worth noting Mackenzie has even appointed a group "productivity officer" who reports directly to him. The business unit leaders have been given productivity benchmarks and I suspect it's fair to say we all could be underestimating the cost out story at BHP. It's worth noting BHP reduced controllable costs by $US2.7 billion in FY13, with Mackenzie only in control for two full months of FY13.

In summary, under Mackenzie I think BHP is going to be the free cash machine we all hoped it would be. I just don't think you're going to wake up one morning under Mackenzie's leadership and be surprised by a $50 billion tilt at some other company. We might actually be surprised how "boring" BHP becomes, but boring is good when you are the bottom of the cost curve and increasing production, while simultaneously stripping out costs and reducing capex.

Not that it's my role as a lowly stockbroker to give the CEO of BHP Billiton advice, but the only piece of market based advice I gave Andrew Mackenzie when I sat down with him was that whenever anyone from BHP speaks to investors, analysts or the press that they deliver a consistent and clear message.

(You can read the rest of Charlie's report on BHP last year here).

The story today

Fast forward to today and Mackenzie remains *"on message"* and delivering what he said he would.

Earlier this week at a conference in Miami, BHP produced evidence of the business changes under

Mackenzie.

Interestingly, Mackenzie's opening remarks at Miami were *"Today you will hear me repeat a number of things I've said before because maintaining your confidence is about being predictable and consistently delivering on our commitments".*

I think it's worth running through a few of those *"evidence"* slides.

We are delivering on our commitments

bhpbilliton
resourcing the future

Sustainable productivity gains:
US$4.9 billion now embedded ✓
Capital and exploration expenditure:
To decline by 25% in FY14 ✓
Selective investment:
Average rate of return >20%[1] ✓
Portfolio simplification:
US$6.5 billion in two years ✓
Strong free cash flow generation:
Increased by US$7.8 billion[2] ✓
Capital management:
Solid A credit rating and progressive base dividend maintained ✓

Return on capital[3] of 22% in H1 FY14

- Productivity gains to increase to US$5.5 billion by the end of FY14
- Capital and exploration expenditure to decline again in FY15
- Competition for capital has increased the average rate of return of our low-risk, largely-brownfield growth options to >20%[1]
- We will continue to simplify our portfolio in order to unlock additional value
- Our growing base dividend commitment is comfortably covered by internal cash flow
- We will maintain financial discipline

1. Ungeared, post tax, nominal rate of return for our portfolio of major project options.
2. Refers to the increase in net operating cash flows less net investing cash flows, adjusted to exclude proceeds from divestments and sales, in H1 FY14 compared with H1 FY13.
3. Excludes capital investment associated with projects not yet in production.

Andrew Mackenzie, Chief Executive Officer, 13 May 2014 Slide 3

Maintaining strong momentum within our pillars

bhpbilliton
resourcing the future

- Strong operating performance underpinned by continued productivity gains
- Full-year guidance upgraded for a number of our highest margin products
  - WAIO production guidance increased by 10 Mt[1] to 217 Mt[1]
  - metallurgical coal production guidance increased by 2.5 Mt to 43.5 Mt
  - copper set to deliver against guidance of 1.7 Mt
  - petroleum production guidance rebased to 245 MMboe, albeit with a higher contribution from valuable crude and condensate
- Group production growth of 16%[2] in the two years to the end of FY15 is underpinned by the expansion of our high-margin businesses

Strong outlook for liquids production
(FY14 petroleum production, MMboe)
260
230
200
Initial guidance
Crude oil and condensate
Natural gas and NGL
Current guidance

1. 100% basis.
2. Copper equivalent production growth based on FY13 average realised product prices, as disclosed in the 2013 Annual Report.

Andrew Mackenzie, Chief Executive Officer, 13 May 2014 Slide 7

BHP is controlling the controllables. They can't control Chinese GDP growth or commodity prices but they can control their place on the cost curve, production volumes, productivity, simplicity of their business, and capital allocations.

Simple things, like open pit digger fleet utilisation being up 10%, and truck fleet utilisation rates being 8% are driving BHP's margins and free cash in the right direction.

Focus on the controllables

In the presentation, there is also a clear change to focus on what BHP can control, from macro outcomes they can't control. I think that is a good development for BHP shareholders with the entire market underestimating the margin and free cash flow uplift from BHP sweating their assets harder. Note the comment *"we will grow margins even in the absence of higher commodity prices".*

The other clear message from the presentation is that BHP is going to focus on its four pillars (iron ore, petroleum, coal and copper). It's probably fair to assume the rest is on the chopping block. This is good news as it will increase BHP's ROE and further increase group productivity and margins.

BHP, under Mackenzie, is on its way to be a simpler, more productive and capital efficient organisation. That is a good thing for shareholders.

While I am cautious on iron ore, iron ore pure plays and the broader ASX200 at the moment (absolute value hard to find), it's worth noting that BHP has underperformed the ASX200 sharply over the last two years in particular. This is the largest underperformance I can ever remember of BHP to the benchmark index, of which it represents 9% itself.

I believe this gap will close over the years ahead, as investors come around to my views on the business improvement at BHP under Mackenzie. Investors will start to realise that the sharp improvements in

productivity and production growth will offset falls in spot iron ore prices for this diversified group. They will also realise they will receive a greater percentage of rising free cash flow in the form of dividends and buybacks. All that will lead to medium-term P/E expansion.

On 13 times FY15 consensus earnings, and offering a gross yield close to 5%, BHP remains the core portfolio mining holding in Australia/world. And its growth is essential if the ASX200 is going to get anywhere near my long-term 6000 target.

The point of today's note is that BHP Billiton under Andrew Mackenzie and his management team remains 100% *"on message"*, a message which is not yet broadly appreciated by investors.

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Ramsay passes health check with flying colours

by Roger Montgomery

By now, many readers will be aware of the generational shift that is occurring in Australia. According to the Australian Bureau of Statistics, the population aged 65 years and over is projected to increase from 3.2 million in 2012 to around 5.7 million by 2031.

The shift is being driven by the baby boomers. After a lifetime of hard work, many will be looking to exit the workforce and enjoy their retirement. In order to maintain their health, the generation will require increasingly greater levels of medical care.

This has profound implications for the healthcare sector. While a growing market certainly makes for a favourable investment dynamic, it does not in itself guarantee profitability or sustainable returns. Investors who want exposure to this sector shouldn't be allocating capital in a scattergun approach. Rather, investors should be targeting those companies with the best fundamentals, prospects and value for money.

Quality scorecard

The healthcare sector is classified by a number of segments, including biotechnology, equipment manufacturers, pharmaceuticals and service providers. Many healthcare companies are exposed to the favourable tailwind presented by the ageing population, yet the underlying quality varies considerably. Let's explore the quality of the following companies by comparing Return on Equity (ROE), Gearing (Net Debt to Equity) and Profit Margins (Net Profit After Tax / Sales).

Code	Company Name	Industry Name	ROE (%)	Net Debt to Equity (%)	Profit Margin (%)	Market Cap ($mill)
CSL	CSL LTD	Biotechnology	36	30	25	33,647
SRX	SIRTEX MEDICAL LTD	Biotechnology	25	(59)	19	957
MSB	MESOBLAST LTD	Biotechnology	(12)	(50)	(338)	1,544
COH	COCHLEAR LTD	Health Care Equipment	21	33	19	3,401
RMD	RESMED INC-CDI	Health Care Equipment	19	(36)	20	7,745
ANN	ANSELL LTD	Health Care Equipment	16	30	10	2,799
RHC	RAMSAY HEALTH CARE LTD	Health Care Providers	21	64	6	9,358
VRT	VIRTUS HEALTH LTD	Health Care Providers	8	61	5	623
SHL	SONIC HEALTHCARE LTD	Health Care Providers	13	60	10	7,327
SIP	SIGMA PHARMACEUTICALS LTD	Health Care Providers	9	(12)	2	793
PRY	PRIMARY HEALTH CARE LTD	Health Care Providers	6	39	10	2,412
API	AUSTRALIAN PHARMA INDUS LTD	Health Care Providers	4	20	1	261
MYX	MAYNE PHARMA GROUP LTD	Pharmaceuticals	7	23	6	502
SPL	STARPHARMA HOLDINGS LTD	Pharmaceuticals	(20)	(73)	(623)	189

Source: *Bloomberg, Latest Applicable Financial Year, Market Capitalisation as at 13 May 2014*

The segments with the highest quality according to these metrics are biotechnology companies and equipment manufacturers. You'll note that CSL, Sirtex, Cochlear and Resmed each have a return on equity above 19%, high profit margins and strong balance sheets.

Control over valuable intellectual property helps explain each company's financial position. Resmed specialises in sleep, Cochlear provides hearing to the deaf, CSL produces life-saving vaccines, while Sirtex is showing promising results in the treatment of liver cancer – these are all treatments that customers pay a premium for.

Considerable time and investment is required to generate these profit margins. You will note that Mesoblast, a developer of biological therapies for regenerative medicine, is unprofitable. Yet the company has a market capitalisation of $1.5 billion, which is 2.4 times greater than its book value of equity.

High profit margins generally attract competitors, and this means substantial reinvestment is required to maintain strong positioning and pricing power. Cochlear, in particular, has recently experienced considerable pressure in this regard.

Best providers

Looking at the healthcare providers, the quality operators are Sonic Healthcare, which focuses on pathology, Ramsay Health Care, a builder and operator of hospitals, and Virtus, the owner of fertility clinics.

We regard Ramsay Health Care as one of the highest quality companies on the ASX. You may wonder why, given it has a high return on equity but low profit margins and high gearing. Operating hospitals is a difficult game, evidenced by the lower profit margins. But Ramsay is very good at it.

Because of this reputation, Ramsay is favoured over many of its competitors when tendering for projects or pursuing acquisitions. This dynamic makes for a very strong value proposition, given the sheer scale of domestic and international opportunities. This is demonstrated by the company's recent announcement that it has entered into exclusive discussions to acquire a majority stake in Générale de Santé, one of the France's leading Private Healthcare Service Groups.

When companies do not control intellectual property, it tends to be difficult to generate value. This is the case with Sigma Pharmaceuticals and Mayne Pharma, manufacturers and distributors of generic products through wholesale and pharmaceutical networks. Companies that handle generic products have little pricing power, and this translates to both modest margins and returns on equity.

While this is a broad overview of what to look for when diagnosing the well being of health care companies, it should go some way to demonstrating that a favourable industry tailwind does not automatically translate to favourable returns. Of course, further research is required if you were to consider any of these companies as investment prospects.

The Montgomery Funds own CSL, Ramsay Health Care, Resmed and Sirtex Medical.

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UK uptick good news for News, Brambles and QBE

by Geoff Wilson

I recently returned from a trip to the UK where I spent time meeting with fellow Listed Investment Company (LIC) fund managers, research houses, stockbrokers and various LIC industry participants to discuss industry trends and insights into the market more broadly.

As quite an aside, in my travels I was fortunate enough to bump into actor James Nesbitt (star of Cold Feet and The Hobbit) out at a restaurant. You may be interested to know that amidst a wide-ranging discussion covering acting and rugby, James said his favourite Australian restaurant is Catalina's in Rose Bay, Sydney.

Below are my four main observations investment observations from the UK and what they could mean for the Australian share market.

1. New economics manifesto taking Europe by storm

A new book by French economist Thomas Piketty is taking Europe by storm. From London's financial district to Westminster, the city is abuzz with discussion of Piketty's *'Capital in the Twenty-First Century'*, which discusses wealth and income inequality. Piketty shows that the return on wealth is greater than the growth in income in a capitalist system. The book was published in English just last month, (after being published in French last year) and is already on top of Amazon's Best Sellers list.

2. Legislative changes to be major benefit to UK LICs

Until recently, British pensioners were required to invest their savings in annuities. Legislative amendments announced by Britain's finance minister George Osborne, as part of the March Budget, are set to change this policy so that pensioners have the ability to invest in a range of investments. The move has been disastrous for companies with annuities businesses but a boon for other investment products, including LICs, which offer investors exposure to a diversified portfolio of growth shares and a running yield.

3. Housing market hot

Britain's housing market has been incredibly strong, not only in London but across the country, driven by interest rates at around 2%. Recent figures show median house prices jumped 8.5% over the last year and are up around 12% since the market's low of June 2009.

4. UK economy strong

The UK economy has launched a strong recovery over the last 12 months, with British GDP predicted to grow at 2.9% this year. Due to falling unemployment and low inflation, the IMF's recent World Economic Outlook report forecasted the UK to be one of the fastest growing of Europe's advanced economies. Added to this, the outlook for the nation's manufacturing industry is the best it has been for 40 years and the sector is expected to grow at 3.8% this year.

What does this mean for Australian shares?

Effectively, Britain's economy was in a terrible mess for some time. However, there are clear signs that because they've 'taken their medicine' their economy is improving. It appears the UK economy is now following the same growth trajectory as the US.

If these two countries continue to progress in this positive direction, the policy imperative for stimulating their economies diminishes. Already, we have seen the US Federal Reserve cut their stimulatory

bond-buying program from US$85 billion per month to US$45 billion per month.

This leads us to believe we are edging closer to an interest rate tightening cycle globally. We anticipate this process to start first in the US and the UK before Australia and, when this happens, we expect the Australian dollar will fall back to 80c or below.

This development would, of course, be welcome news for export-focused businesses and companies with a significant amount of their earnings offshore such as: News Corporation (ASX: NWS), Brambles (ASX: BXB), QBE Insurance (ASX: QBE) and Resmed (ASX: RMD).

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My SMSF – stellar performance

by Maurizio Zappacosta

Name: Maurizio Zappacosta
Age: 52
Other members of the SMSF: My wife

How long have you had your SMSF?

Around a decade but only really started focussing on it in the last five years.

Why did you start it up?

To prepare for my retirement and control my future. I think if you're a business person and own your own business, you should have an SMSF. But they're not for everybody. If you have less than $250,000 or $200,000 it's hard to balance the cost.

How big is it?

Approximately $860,000.

Is it more or less difficult to manage than you thought it would be?

No, as long as you have good book keeping and record keeping systems in place. Being an accountant, a lot of it is what I do anyway.

Do you enjoy managing it?

I don't necessarily enjoy doing it. It's another thing to do.

Are you pleased with its performance?

Yes.

Can you give us some numbers around performance over the last few years?

1Á^æ¦Á8% pa
GÁ^æ¦•Á7.5% pa
3Á^æ¦•Á5.5% pa
5Á^æ¦•Á6% pa

What is your asset allocation?

89% commercial property (my accounting office), with the balance in cash and fixed interest.

What are you favourite investments and why?

I stick to property, as I understand it. I haven't played with equities yet but in the next few years I'll be looking to diversify more and have a more balanced portfolio. I'll use a financial planner to help with that.

What investments do you have outside of superannuation?

A couple of rental properties.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

There wasn't much in the way of good news from brokers in the first half of the week, with most of the news being dominated by downgrades. Seven West Media was the only upgrade worth highlighting.

In the good books

UBS upgraded Seven West Media (SWM) to Buy from Neutral. Seven trampled on its TV rivals in April, which included the long Easter break. The network scored 42% share and the broker calculates the market is factoring in an expected 36% average in FY14, based on the SWM price. The shares have underperformed on fears Nine (NEC) is trying to fight back, but the broker feels this is leaving SWM undervalued.

In the not-so-good books

Citi downgraded Incitec Pivot (IPL) to Neutral from Outperform, following its interim result, citing a subdued second half outlook from management. IPL is beholden to DAP fertilizer prices and the Australian dollar and it appears the rally in DAP fertilizer prices has now petered out at the end of the Indian buying season.

UBS downgraded Dexus Property Group (DXS) to Neutral from Buy. UBS thinks investors will increasingly focus on office fundamentals and Dexus may be stuck, or used as a funding source given the key catalyst, the Commonwealth Property transaction, has passed. UBS also thinks underlying earnings growth may be soft in the FY14 results.

Macquarie downgraded Orica (ORI) to Neutral from Outperform. The first half result was soft, but in line with Macquarie's expectations. The company is embarking on further cost cutting and efficiencies and the benefits of the review should be revealed at the FY14 results, according to the broker. Still, earnings momentum is negative and there are risks around the second half.

JP Morgan downgraded UGL (UGL) to Underweight from Neutral. JP Morgan thinks shareholders would be best served by a structural separation of DTZ and engineering but keeping the two businesses under one corporate umbrella. Nevertheless, management seems set on selling DTZ or pursuing a full de-merger in the broker's view.

The above was compiled from reports on FNArena, 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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The Budget breakdown for your SMSF

by Tony Negline

This year's Budget contains many changes that impact all investors directly or indirectly over the next several years.

Here's a brief summary:

Superannuation

1. Excess non-concessional contributions (excess NCCs)

You will be permitted to withdraw contributions made after June 2013 that are deemed to be excess NCCs and any earnings applicable to those contributions and have them taxed at your marginal tax rate. This new policy will come into effect after the end of the 2013/14 financial year and after you and your super fund have submitted 2013 tax returns and super contribution details.

To enable this to happen, your fund's trust deed will have to permit the refund of these contributions and their associated earnings. I doubt many deeds will currently allow for this. There's no specific power for this in the super laws and I don't think it will be inserted into those laws.

2. Excess contributions and benefit payments above relevant thresholds

From 1 July 2014, those with taxable income of more than $180,000 will pay a 2% levy. This levy will apply to excess contributions. It will apply to excess NCCs that are not withdrawn from your super fund (refer above) and will apply to excess concessional contributions if your taxable income is more than $180,000.

3. Superannuation guarantee

From 1 July 2014, SG rate will increase to 9.5%. This will remain until 2018 and then increases will be by 0.5% each financial year until 12% is reached. The new table is as follows:

Financial Year	Minimum Superannuation Guarantee Rate
2013/14	9.25%
2014/15	9.50%
2015/16	9.50%
2016/17	9.50%
2017/18	9.50%
2018/19	10.00%
2019/20	10.50%
2020/21	11.00%
2021/22	11.50%
2022/23	12.00%

4. Contribution limits increased

Due to indexation, the contribution limits will be increased on 1 July 2014. The general concessional cap will increase from $25,000 to $30,000, and the non-concessional cap will increase to $180,000. The Government made no announcement in this year's Budget about changing this policy.

Centrelink pensions

1. Clean energy supplement

This payment (currently $13.50 for a single person and $21.00 for a couple combined and indexed every six months) won't be indexed for the 2015, 2016, 2017, 2018 and 2019 financial years.

2. Age pension

• From 1 July 2025, the age pension access age will increase by six months every two years, which means it'll hit 70 on 1 July 2035:

Financial Year	Minimum Age Pension Age
2025/26	67.5
2026/27	67.5
2027/28	68.0
2028/29	68.0
2029/30	68.5
2030/31	68.5
2031/32	69.0
2032/33	69.0
2033/34	69.5
2034/35	69.5
2035/36	70.0

Those born before 1 July 1958 are not impacted by this change.

- The age pension's income and asset test thresholds will be frozen for three years from 1 July 2017. That is for the 2018, 2019 and 2020 financial years.
- From 20 September 2017, indexation of the age pension, veteran's pension, disability support pension and the carer payment will be by CPI, not by higher of Male Total Average Weekly Earnings or Pensioner Cost of Living Index.
- Deeming – from 20 September 2017, the deeming thresholds will be "reset" to $30,000 for singles and $50,000 for couples. The higher deeming interest rate will be applied to these reduced thresholds. There is no announcement on the indexation of these thresholds from the date of this change

Commonwealth Seniors Health Card (CSHC) and Concession Card changes

1. Concessions provided to concession cardholders

The Commonwealth government will cease funding of various pensioner concessions provided by State and Territory Governments:

- Pensioner Concession Card holders currently receive concessions for land tax, water and sewerage rates, electricity, gas and vehicle rego.
- Commonwealth Seniors Health Card & Pensioner Concession Card holders currently receive discounted public transport.

2. Commonwealth Seniors Health Card (CSHC)

There are a number of changes here:

- The income thresholds will be indexed by CPI for 2014, 2015, 2016, 2017 and 2018 financial years.
- Account-based pensions that commence after December 2014 will have an income payment (determined using the deeming rules) under CSHC incomes test. Pensions that commence before January 2015 will be exempt from this test.
- The CSHC supplement (currently $876.20 for singles and $1,320.80 for a couple combined) will be abolished from 20 Sept 2014. However, the CSHC Clean Energy Supplement will remain.

Tax Offsets

1. Dependent Spouse Tax Offset – abolished from 1 July 2014.

2. Mature Age Worker Tax Offset – abolished from 1 July 2014.

3. Private Health Insurance Tax Offset – income thresholds will not be indexed in 2016, 2017 and 2018 financial years.

Company tax rate reduction

From 1 July 2015, the company tax rate will be reduced to 28.5%. Large taxpayer companies will pay a 1.5% levy for the new Paid Parental Leave Scheme bringing their effective tax rate back up to 30%. At this stage, it's expected the dividend imputation rate will be 28.5% – that is, the Paid Parental Leave Levy will not be a frankable tax payment (because it is a levy not a tax).

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Outlook for Newcrest and Dexus Property Group

by Questions of the Week

Question: My financial advisor has recommended I add some Dexus Property Group to my SMSF. What are your thoughts on this investment please?

Answer (By Paul Rickard): I quite like Dexus Property – it is in my high-income portfolio and has done pretty well, up almost 11% this calendar year.

At its current price of $1.11, it is probably a touch expensive (the NTA at 31 March was $1.06, with gearing at 34.6%).

According to FN Arena, broker sentiment is positive at +0.4 (scale -1.0 most negative, +1.0 most positive), and the target price is $1.13. Forecast distribution is 6.26c per unit – a yield of 5.6% on a price of $1.11.

I wouldn't be rushing to pay up for the stock – however, at the right price, I think it could add some value to a portfolio.

Question 2: Does your expert panel have any comment on Newcrest mining? I have some shares and have been sitting at a loss for a while and wondering if there is any upside to NCM or the gold price.

Answer 2 (By Paul Rickard): To be honest, I cannot get excited about the gold price (I am a gold bear), or Newcrest for that matter.

As for the brokers, according to FN Arena, the consensus target price is currently $10.31 – very close to where NCM is currently trading. Sentiment is negative at -0.3, on a scale where -1.0 is most negative, +1.0 is most positive.

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Budget Update

Paul Rickard gives the low down on the major changes in the Budget and what they might mean for SMSF trustees. Watch his take on things here.