Switzer Super Report

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# Let's go shopping

The Lowy family's Westfield restructure and asset split has caused plenty of discussion since the shareholder meeting was postponed on May 29. *Switzer Super Report* expert Charlie Aitken is a big advocate of a 'Yes' vote and explains why in his article today.

But SSR director Paul Rickard is not such a big fan, so to balance the argument we also share the views of one of the big institutional investors and 'No' voters - CIO of UniSuper, John Pearce. Although he has been cast as a rebel, today John explains how he is only acting in the interests of his fund members, who are also retail investors.

Sincerely,

Peter Switzer

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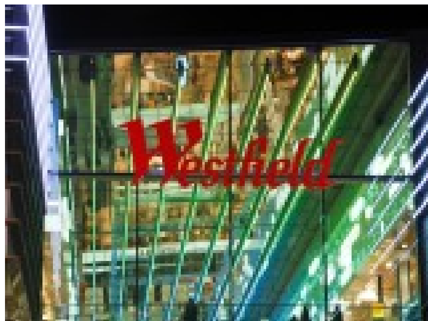


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# The Westfield split – For and Against

by Switzer Super Report

**In favour of the Yes vote – Charlie Aitken**

In recent times I have had questions from retail investors and their advisers about the Westfield split proposal. Today I thought I'd simply put my thoughts on paper ahead of the Westfield Retail Trust "re vote" on June 20.

Firstly I want to make it very clear that myself and Bell Potter have absolutely no role in this Westfield transaction. We shall receive no fees from any outcome. Our only interest is that Bell Potter clients hold around 25 million Westfield Retail Trust (WRT) shares and 40 million Westfield Group (WDC) shares. I think it's important we have an independent view on this large transaction, which potentially has short, medium and long-term ramifications for both Westfield Retail Trust and Westfield Group shareholders.

In my view this Westfield Group/Westfield Retail Trust asset split/simplification always had merit. The recent Westfield Retail Trust meeting failed by a fraction to get shareholder approval, yet 74.1% of shareholders who voted, voted in favour of the transaction. On the Westfield Group side 98% of shareholders voted via proxy in favour of the deal. Those results are somewhat surprising considering it is estimated around 60% of shareholders hold both stocks. You'd think most investors would vote the same way on both sides, but in this case a very public campaign by the ASA and a couple of institutional investors saw the first Westfield Retail Trust vote just fail to get the required 75%.

**Get over the apathy**

Individual Westfield Retail Trust shareholder apathy clearly played a role in the first vote failing to get the required 75%. Of the nearly 100,000 individual Westfield Retail Trust investors only around 9,000 physically voted on the deal. **This is a very important point because what happened at the first vote suggests retail investors being apathetic, yet controlling 10% of the company, actually are holding the cards in this situation**.

One thing I must stress to our Westfield Retail Trust individual investor shareholders is **you need to lose the apathy quickly**. Now that the Lowys have revealed the intention to execute a "Plan B", which would mean Westfield Retail Trust shareholders being left on their own, I think it's very important all Westfield Retail Trust retail shareholders read the Westfield Retail Trust *second supplementary security holder booklet* and the views of the Westfield Retail Trust independent directors. **I also think it's very important you vote because the share price results of apathy could be quite different from the first meeting**.

**The alternatives**

Let me illustrate the two potential alternatives.

**Plan A** sees 100% of the international assets in Westfield Corporation and the Lowy Family owning 8% of Westfield Group. 100% of the domestic/NZ assets are in Scentre Group with the Lowy Family owning 4% of Scentre Group.

| International Assets | Domestic/NZ Assets |
|---|---|
| ↓ | ↓ |
| Westfield Corporation 100% | Scentre Group 100% |
| ↓ | ↓ |
| Lowy Family 8% | Lowy Family 4% |

**Plan B** potentially sees 100% of the international assets in Westfield Corporation and the Lowy Family owning 8% of Westfield Group. 50% of the domestic/NZ assets would be in Newco with the Lowy Family owning 8% of Newco. The other 50% of the domestic/NZ assets would be in Westfield Retail Trust with Westfield Retail Trust paying a management fee to Newco (potentially hundreds of millions pa). The Lowy Family would own 0% of Westfield Retail Trust.

| International Assets | Domestic/ NZ Assets | Domestic/NZ Assets |
|---|---|---|
| ↓ | ↓ | ↓ |
| Westfield Corporation 100% | Newco 50% | WRT 50% |
| ↓ | ↓ | ↓ |
| Lowy Family 8% | Lowy Family 8% | Lowy Family 0% |
| | | ← mgt fees to Newco |

In my view Plan B would make Westfield Retail Trust very difficult/almost impossible to takeover, yet Plan A makes both Westfield Group and Scentre Group clean potential takeover targets in the future. That is also a point worth considering. Plan A also sees Scentre Group enter the ASX20 Leaders Index (XTL) and all the broad index money/ETF money support that brings.

I don't think Westfield Retail Trust shareholders "going it alone" with 50% of the domestic asset base and a management agreement with "Newco" is a good idea. It would also mean the Lowy Family had no direct interest in Westfield Retail Trust shares which would be far from ideal as they have nothing to lose and everything to gain by ramping up those management fees to Newco. I suspect some of the independent Westfield Retail Trust Board members would resign too after recommending the deal, while neither Newco nor Westfield Retail Trust in this form would be members of the ASX20 Leaders Index (XTL). That is the alternative Westfield Retail Trust shareholders face if the 2nd vote fails to get 75%.

It's fair to say the independent directors of Westfield Retail Trust realise this is a material change from the first proposal. It clearly increases the share price downside risk of a no vote and puts Westfield Retail Trust in a strategic bind corporately.

At the second Westfield Retail Trust shareholder vote on June 20 you are faced with a very clear choice: a future with the Lowy Family or a future without the Lowy Family.

For all the institutional noise about valuations, merger ratios, advisor fees, gearing levels, development pipelines and management agreements that institutional investors quibble about, the simple summary of the situation in this 2nd Westfield Retail Trust vote for retail investors is if you want the Lowys with you?

Clearly in my mind and through history that question answers itself. And to me, it's the ONLY question that needs answering and voting on.

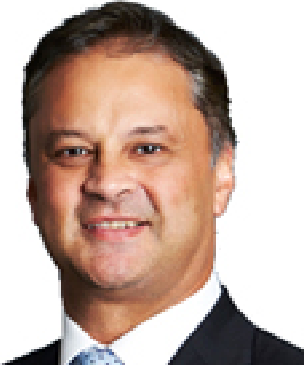
I encourage all Westfield Retail Trust shareholders to vote either via proxy (by 18th of June 10am) or at the meeting on the 20th of June. In this case the all too frequently used words "*your vote is important*" are extremely accurate. You, the individual shareholders of Westfield Retail Trust will decide this outcome.

My advice is to vote "yes", stay aligned to the Lowy Family and the Westfield management team, and then hold on for the day in the future when both Westfield Group and Scentre Group are taken over at significant premiums to NTA.

*Frank-ly, you should give a damn*

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

### In favour of the No vote – John Pearce



John Pearce is chief investment officer of UniSuper and looks after nearly $40 billion for over 450,000 members in the higher education and research sector super fund. UniSuper's growth option has returned 16.04% for the financial year to date as at June 10 and the high growth option 17.59%.

In response to the argument that institutional investors vote or act differently to retail investors, Pearce stresses that "we are representing retail investors" and all investment decisions are made in their best interests.

His publically stated view is that the proposal is not in the best long-term interests of investors. Pearce and UniSuper were relatively quiet about their position until the first vote on May 29.

"I think the events of May 29 changed that for us because…at the meeting shareholders were basically being warned if they don't vote for this they are going to be up against this really competitive vehicle [Newco]," he explains.

"We basically want to balance up the discussion a bit," he says.

Pearce does not believe Newco would be a big competitor as it would be "debt-laden" and would operate under the same competition restrictions around buying more shopping centres that Westfield does.

Pearce also points out that if the entities were two totally independent companies – and didn't have the same level of common ownership that Westfield Retail Trust and Westfield Group have – the vote would have got no where near the 74% in favour on May 29.

"I think we are blurring the real picture," he says.

The following is an edited extract from a June market update UniSuper sent to members.

**Why are we rebelling against the proposal?**

At a high level, one can see that Scentre is a fundamentally different proposition to WRT. We bought into WRT because it was a lowly geared landlord, earning steadily growing rental streams, which ultimately convert into growing dividends.

Scentre has much higher levels of gearing, and also adds risk associated with property development management fees. In simple terms one could say we bought an apple, and now we are being asked to accept an orange.

Since the time of our initial investment, we have been very clear in our communication to WRT management in relation to corporate strategy.

The other major sticking points for us revolve around cost and price. The big winners from restructures are invariably the lawyers, bankers, and other 'experts' and this proposal is no exception, with the bill estimated to be around $75 million plus a further $350 million of refinancing costs. WRT will therefore be asked to pick up a huge tab for something we didn't want in the first place.

The difference between the proportion of assets WRT is contributing to Scentre (69%) and the ultimate ownership (51.4%) is effectively payment for management rights that WDC will relinquish to Scentre. The independent expert has deemed this to be a fair price, but we strongly disagree. The valuation ascribed by the independent expert implies a level of property development management fees, *in perpetuity*, which we simply cannot reconcile. The property experts we speak to agree. Suffice to say that we are far apart in terms of fair valuation.

In our view this deal simply represents a transfer of value from Westfield Retail Trust (WRT) to Westfield Group (WDC).

**The extraordinary events of 29 May 2014**

The meeting itself provided an extraordinary twist to the story. The proposal was destined for defeat because, in our view, there were insufficient votes on-the-floor to change the outcome from the proxy votes lodged before the meeting. That is, until the chairman made the extraordinary decision to postpone the meeting. The reason given was that information presented by Westfield Group chairman, Frank Lowy in the morning was deemed to be new information, and that this new information was material. In the chairman's view, the information was considered material enough that Westfield Retail Trust investors would need more time to consider their decision, or indeed change their decision if they had already voted.

The new information appears to have been Westfield's *'Plan B',* in the event that the proposal was not approved by security holders. Plan B involves the establishment of a new company (for this update let's call this 'Scentre B') housing the Australasian assets spun off by Westfield Group. Furthermore, it was made clear to members that Scentre B would be a very attractive company competing with WRT (the "ugly sister" according to one journalist) in the marketplace for capital and assets. In other words it could be viewed as a thinly veiled warning to potential 'against' voters.

We hope that WRT security holders see through this. In our view, Scentre B [now known as Newco] will not be the attractive sister to WRT – indeed we think quite the contrary. Scentre B, after incurring the costs of a restructure, will be highly geared and be forced to sell assets as investors demand lower debt levels. This would in itself be a great outcome for WRT given that it has pre-emptive rights (i.e. first right of refusal) to purchase the properties.

The bottom line is that we are not at all concerned about the so-called 'Plan B'. Under this scenario WRT will continue to be the attractive, lowly geared, rent collecting landlord we bought in the first place. Therefore our response to Plan B is: "bring it on".

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# Buy, Sell, Hold – what the brokers say

by Staff Reporter

In a short week, companies in health care and retail stood out. Pacific Brands was upgraded on expectations of future value and a visit to a sleep conference in the US, put Macquarie at ease with regard to Resmed.

**In the good books**

Citi upgraded Pacific Brands (PBG) to Buy from Neutral. The company has issued a profit downgrade for FY14 and, based on Citi's revised forecasts, earnings will fall 25%, despite sales growth. The broker believes that, despite the difficult outlook, the core brands will hold value for others and places a 25% probability on a break up of the company. This potential for a break up, which could achieve a valuation of 74c per share, drives the broker's upgrade to Buy from Neutral.

JP Morgan upgraded Resmed (RMD) to Overweight from Neutral. The broker attended the Minneapolis Sleep Conference and was surprised by the issue of bundling, which appears more benign than first thought. Discounting remains rife and this leaves brand, product launches, credit terms and systems capability as the potential drivers of market share, in the broker's view. While discounting is a concern, the reduced risk around bundling will go a long way to destabilising the short interest in the stock.

**In the not-so-good books**

Macquarie downgraded AGL Energy (AGK) to Neutral from Outperform. Warmer than usual weather is dampening the outlook. Macquarie notes AGL relies on one month of winter and a cooler autumn to lift gas demand and electricity usage. Macquarie has also deferred timing of both the Diamantina power station and QCLNG gas demand in refining the outlook for the company. The broker thinks there is some premium attached to a potential MacGen acquisition and upside for investors centres on realisation of the 50% interest in ATP1103. Still, the risk of softness in electricity prices and reduced profitability in base load generation contributes to a lowering of the recommendation.

Macquarie downgraded Ramsay Health Care (RHC) to Neutral from Outperform. Macquarie has updated forecasts to include the acquisition of Generale de Sante. The acquisition increases Ramsay's presence in France to 113 hospitals from 38. The broker is confident in Ramsay's ability to deliver, but the French market is challenging and the ramping up of a presence in France will be a material headwind to growth.

Credit Suisse downgraded The Reject Shop (TRS) to Underperform from Neutral. The company has downgraded FY14 profit expectations by 15%, reflecting a downturn in sales at the end of May and beginning of June. Credit Suisse suspects the weakness in trading was felt across the industry and, as such, represents downside risk to other retailers. With a new CEO yet to be appointed and the product offering under review, the broker remains cautious on long-term sales growth assumptions.

*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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# My SMSF – how to focus on yield

by Jo Heighway

**Name:** Jo Heighway

**Age**: 36

**Members:** My SMSF has four members including my spouse and parents. I have 3 children who aren't members of the fund

**Where do you live?**

Gold Coast QLD

**How long have you had your SMSF?**

12 years

**How big is it?**

$400-$500,000

**Why did you start it up?**

To invest in commercial property leased to my business at the time

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

I love having my own SMSF. It's great to have control over your family's retirement savings and it makes me more active in putting away extra money whenever possible for my future. The admin can be time consuming, and its' important that investment decisions are happening regularly. But well worth the extra effort to know I have control over where my super is invested.

**How has it performed?**

Performance for 2013 calendar year was 15.70%

**What is your asset allocation?**

Asset allocation is 56% growth and 44% defensive assets – all in all this is a balanced risk profile. The current portfolio generates a gross yield (incl. franking credits) of 5.9% pa. I believe the yield is important, especially if your fund is paying pensions (my parents are members and currently taking transition to retirement pensions).

The breakdown is as follows:

- 46% Australian equities (higher profile due to higher yield and franking credits on offer from Aussie companies).
- 4% International equities (this is a bit low at the moment but note that many Aussie companies have exposure to overseas markets/ operation internationally).
- 6% Listed property (typically pays a high yield and using property companies listed on the stock exchange (ASX) provides liquidity, easy to exit/sell whereas there are still property funds floating around which are frozen).
- 36% Fixed interest (includes term deposits and capital notes/preference shares which for compensation for the higher risk profile pay a higher income than term deposits).
- 8% Cash (have recently sold into strength to ensure we have funds available to take advantage of any potential stock-market weakness)

**What are your favourite investments/stocks and why?**

Favourite investments have been high-yielding blue chip companies- ANZ, NAB, Telstra, Westpac, Woolworths and Woodside Petroleum.

Also Ardent Leisure stock has more than doubled

since buying in November 2012.

**Do you use an advisor or any kind of service provider?**

I use an adviser who is at Morgans Financial. The benefits include award-winning research, ease of management with complete portfolio management service and access to corporate offers – new issues/ IPOs – such as Burson Group IPO and capital notes/ preference shares in ANZ, NAB, Bank of Queensland and Suncorp. I prepare the financial records myself but of course use an independent specialist SMSF auditor annually.

**What investments do you have outside of superannuation?**

Mainly just term deposits and my business interests. I have recently bought a new home on the Gold Coast and I am focusing most of my spare cash on repaying the mortgage as fast as possible.

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# The resource service sector headwinds

by Roger Montgomery

Recently the Bureau of Resources and Energy Economics (BREE) released their biannual Resources and Energy Major Projects reportÂ and it is not good reading if you are a shareholder in a business servicing the Australian resource service sector.

According to BREE the amount of committed project work dedicated to the resources and energy sector has declined by $40 billion, or 15%, to around $230 billion over the past year. I now think this decline is likely to be the tip of the iceberg.

There are some enormous projects, particularly in the energy sector, that are shifting in status from construction to production over the next few years, from which Australia will benefit enormously, with export value of LNG expected to grow fivefold over the next five years to $65 billion.

For example, five projects moving into production over the foreseeable future with a combined volume of 50 million metric tonnes per annum of LNG, include Curtis Island CSG to LNG, Gorgon LNG project, Gladstone CSG to LNG, Australia Pacific CSG to LNG and Wheatstone LNG.

**The headwinds**

I have recently attended a Wood Mackenzie presentation entitled "Changing of the guard in energy markets" kindly hosted by Deutsche Bank, and I am convinced the "second phase" of Australian LNG capacity expansion is off the agenda until further notice due to global competition from North America and East Africa as well as a lack of cost competitiveness.

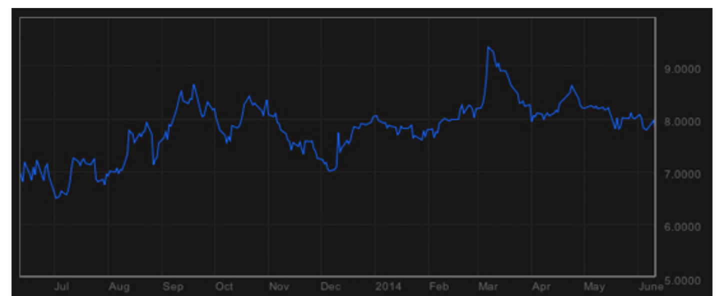
Now back to those worrisome forecasts. The Australian Bureau of Resources and Energy Economics estimates the combined value of "committed and likely" resource projects will decline by 75% from the current $228 billion, to an estimated $55 billion in the four years to 2018. The crucial point from the resource service company sector viewpoint is that the production phase relative to the construction phase of these enormous energy projects requires relatively few people and very little servicing.

So for those companies whose prime focus is servicing the Australian resource sector – whether that is via civil works, construction, accommodation or processing – they should expect to face a very stiff headwind over the next few years.

**WesTrac and Seven**

While there are over two-dozen ASX listed companies and some hundreds of unlisted companies in this category, I thought I would touch on WesTrac Australia, a wholly owned subsidiary of Seven Group Holdings Limited (ASX: SVW), the industrial services, media and Investments conglomerate. At the current $8.00 share price, its market capitalization is $2.44 billion, and with $608 million of net debt at 31 December 2013, its enterprise value is $3.05 billion. Kerry Stokes controls 68% of the issued capital.

**Seven Group Holdings**




WesTrac Australia operates as the sole Caterpillar

dealership in Western Australia, NSW and the ACT, and supplies new and used machinery to the construction, mining, forestry and quarrying industries. The last three six-month periods have seen a severe decline in revenue – from the $2.38 billion peak in the December 2012 half-year to $1.73 billion in the June 2013 half-year to $1.26 billion in the December 2013 half-year. Earnings before interest and tax (EBIT) has fallen even faster – from $275.4 million to $209.1 million to $88.7 million, respectively. EBIT to sales margins have come down from 12% to 7%, and it looks to me like there is worse to come.

Recently released data from Caterpillar Inc., a company with 2013 revenue of US$55.7 billion, does not auger well for the June 2014 half-year. For example, the months of February, March and April 2014 have seen Caterpillar Inc's Asia/Pacific machine sales record a year-on-year decline of 17%, 20% and 25%, respectively. Furthermore, Caterpillar Inc's sales to the Asia/Pacific Resource Sector for February, March and April 2014 declined by 55%, 65% and 70%, respectively!

While the business has done an excellent job in growing the product support component of their revenue, we believe the hit to sales in the Asia/ Pacific region by Caterpillar Inc and the headwind from the Australian Resource Sector is likely to see WesTrac Australia's revenue and earnings line deteriorate somewhat further.

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# Be ready for raised caps on 1 July

by Tony Negline

The indexing of super contribution caps and benefit thresholds on July 1 will be particularly welcome this year as it's effectively the first time these caps have been indexed since 2007.

However if you want to make super contributions, especially non-concessional contributions in the near future then you will need to plan carefully. Non-concessional contributions are mainly personal super contributions not claimed as a tax deduction.

**Concessional contribution caps for 2014/15**

If you're aged at least 49 on 30 June 2014 you'll have a concessional contribution cap of $35,000 in the 2014/15 financial year.

Everyone else will have a concessional contribution cap of $30,000 for that year.

Concessional contributions are primarily personal contributions claimed as a tax deduction and all employer contributions.

Any contribution made above these caps is taxed at your marginal tax rate and next year the Temporary Budget Repair Levy (TRBL), if it becomes law, will also apply.

Maximising super contributions next year (rather than this year) might help you reduce the impact of the 2% TBRL. This levy applies to taxable income, which means you might want to consider increasing your salary sacrifice contributions, to lower your taxable income.

**Increase in the non-concessional cap**

The non-concessional contribution cap is set at six times the standard annual concessional contribution cap. As this standard cap will increase to $30,000 for 2014/15, the non-concessional contribution cap will increase from $150,000 to $180,000.

Because of this increase, the three year bring forward non-concessional contribution cap goes up from $450,000 to $540,000 after June 2014. This bring forward amount is available to anyone under age 65 at the start of a financial year.

I wrote about using the bring forward rule in September 2011. You can read that article here.

Any contributions above these non-concessional contribution caps are taxed at 46.5%. The Abbott Government has proposed (in this year's Federal Budget) to tax these contributions at your marginal tax rate and these amounts can also be removed from super before retirement. We'll have to wait and see legislation before knowing how these proposed rules might work.

A three-year bring forward period begins in the financial year you first make non-concessional contributions above the cap for that financial year.

If the bring forward rule was started in the 2013 financial year then the 2014 and 2015 financial years are covered by the 2013 non-concessional contribution bring forward cap ($450,000).

The increase in the bring forward cap (ie to $540,000) that applies from 1 July won't be available if you've made a non-concessional contribution larger than $150,000 before then.

But if you were to commence a three year bring forward period after 30 June 2014 then you can access a cap of $540,000 for three financial years.

Let's look at an example. Suppose Mary will turn 65 in April 2015 and before 1 July 2014 she makes a

$175,000 contribution.  She's now locked into the $450,000 three-year bring forward rule for the 2014, 2015 and 2016 financial years combined. To avoid excess non-concessional contribution tax she's limited to $450,000 in non-concessional contributions in those years.

If Mary had made a non-concessional contribution of less than $150,000 (the annual cap) in the 2013/14 financial year she could have accessed the $540,000 bring forward non-concessional contribution limit in the 2014/15 financial year and maximised her entitlements.

**Super lump sum tax-free withdrawals indexed**

Finally, on 1 July 2014 the limit for the maximum taxable component you can withdraw from super tax free, if you're aged between 55 and 60, has been increased from $180,0000 to $185,000.

This increased threshold might come in handy if you're seeking to withdraw money from super and re-contribute it back into super as non-concessional contributions. Be aware that if you were born before July 1960 then access to super when aged at least 55 but under 60, is restricted to those who can declare that they're fully retired and have no plans to return to work.

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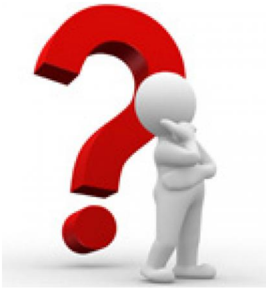

# Hybrids and bank shares

## by Questions of the Week

**Question 1:** Are hybrids a good investment and how safe are they for your self managed super fund as they pay a better interest rate than term deposits?

**Answer (By Paul Rickard):** Firstly, I don't think of hybrids as a "share" – I think of them as a floating rate "corporate bond" or an "interest rate security". As the interest rate is re-set every three months, it is a bit like investing in a "corporate" term deposit that is rolled over every three months.

So, the question of whether they are a "good investment" means (for me) are they good compared to a term deposit, or a corporate bond?

How good are they? Well, they were a lot better some nine to 12 months back when they were priced at more attractive margins. In the search for yield, the spreads have been compressed and they are now less attractive. That said, they are still somewhat attractive compared to a government-guaranteed term deposit.

Safety? I think that with the bank issued hybrids, you can be reasonably comfortable. They are not riskless – so diversify and spread your risk – take exposure across a number of issues.

**Question 2:** Which bank do you favour for the five to seven year term for both growth and income?

**Answer 2 (By Paul Rickard):** Five to seven years is a long, long period, however I am going to stick with my "form guide" (see here).

But if the new CEO of the cheapest bank, NAB (Andrew Thorburn), gets that bank into shape, who knows what it might do.

Bottom line – I wouldn't just invest in one bank (they are too big), and I would certainly review any selection on a periodic basis.

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