Switzer Super Report

Issue 303, 10 July 2014

Glass half full

So good news is bad news and bad news is good news? Clear as mud? Yeah, me too. A strong performance by Wall Street overnight is still good news for the local market. That uptick offshore followed the release of the US Fed's meeting minutes but I'm really not surprised. You know I'm firmly entrenched in the bull camp.

To help you leverage all available opportunities today *Switzer Super Report* director and expert, Paul Rickard, picks through the details on the Healthscope float and discovers that it might be slightly overpriced.

We also have Roger Montgomery on ARB Corporation, Jo Heighway gives you five tips for your audit, and in *Buy, Sell, Hold – what the brokers say,* QBE Insurance and NAB both get upgrades.

Sincerely,

Peter Switzer

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IPO Watch – Healthscope is no Ramsay

by Paul Rickard

The case for being an investor in Australia's health system is pretty strong. A growing and ageing population, increasing wealth per capita and increasing medical treatment capabilities are strong growth drivers. Between 2002 and 2012, overall health expenditure in Australia grew at an impressive compound annual growth rate of 8.3% – and this doesn't include the impact of the 'baby boomer' generation ageing ever more gracefully.

Private hospital operators play a key role in the provision of health services. Although they only account for 33% of the total number of hospital beds, they perform a higher share of elective surgery and total hospital separations, and are growing in market share compared to public hospitals. The two largest operators are Ramsay Health Care (ASX Code RHC) with 68 hospitals, and Healthscope, with 44 hospitals.

Healthscope also has an Australian pathology business (6% of operating EBITDA), which has a market share of 12%, compared to Primary (PRY) with 37% and Sonic Health Care (SHL) of 33%, and an international pathology business. The latter business brings in 12% of EBITDA, and is mainly based in New Zealand and Malaysia.

Through an IPO, which involves Healthscope's current private equity owners (TPG and Carlyle) selling down, investors are being offered the opportunity to invest in Australia's second largest private hospital operator. An obvious question is – how does this opportunity stack up against Ramsay Health Care? Before we come back to this question, let's review the IPO.

The Healthscope IPO

The IPO is seeking to raise approximately $2.4 billion from new shareholders, which will be used principally to pay down debt (approx. $1.7 billion) and repay the current owners (approx. $0.63 billion). Following the completion of the offer, the current owners TPG and Carlyle, through their vehicle CT Healthscope Holdings, will still own at least 25% of Healthscope, and potentially as high as 40%. This holding will be subject to a voluntary escrow, which will last until the announcement of the FY15 results (in approximately 13 months' time).

The offer involves a retail component (broker firm and priority), institutional component and an exchange offer to holders of Healthscope Notes. An indicative price range of $1.76 to $2.29 has been set, with the final price to be determined by way of an institutional book build. Applicants in the retail offer will apply for a fixed "$ value" of shares.

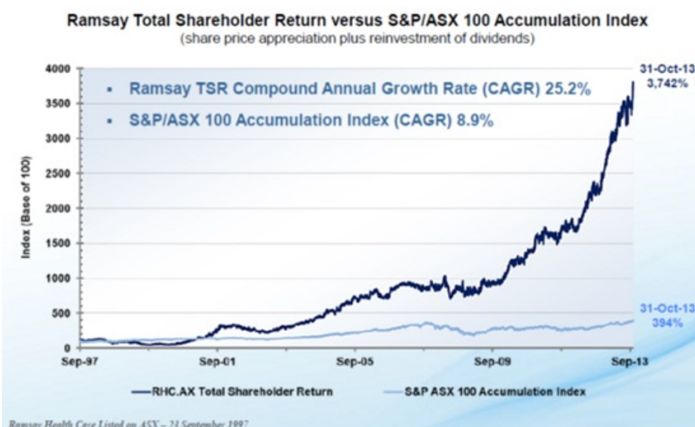
At a price of $1.76 per share, the company is priced on a multiple of forecast FY15 earnings (PE ratio) of 20, and at the top end of the range of $2.29, at 23. The forecast dividend yield is between 3.0% and 3.5%. The company does not expect to be able to frank any dividends at least until FY18.

Details of the offer are as follows:

Indicative price range	$1.76 to $2.29 per share
Shares available under offer	$1.12bn to $1.28bn
Total proceeds under offer	$2.25bn to $2.57bn
Shares on issue following offer	$1.67bn to $1.89bn
Indicative market capitalisation	$3.3bn to $3.8bn
Net debt	$866m
Enterprise value	$4.2bn to $4.7bn
Forecast FY15 EBITDA (pro forma)	$387.3m
Forecast FY15 NPAT (pro forma)	$166.1m
Enterprise value/FY 15 EBITDA	10.8x to 12.1x
FY15 forecast PE	20.0x to 23.0x.
Forecast dividend yield	3.0% to 3.5%, unfranked
Offer closes	22 July
Bookbuild	23 to 24 July
Final price announced	25 July
Commencement of trading on ASX	28 July (ASX Code: HSO)

How does Healthscope stack up against Ramsay?

There aren't too many companies that can boast a chart like the one below.



***Source:** Ramsay Health Care 'FY13 Year in Review'*

While it is a few months out of date, the overall trend has continued into 2014. It is no wonder that those pricing the IPO for Healthscope are looking over their shoulder at Ramsay and saying this is a similar business, and hence considering "Ramsayesque" pricing.

Ramsay is an expensive stock – and deservedly so. According to FN Arena, it is trading at a multiple (PE) of 27.9 for FY14, and with forecast earnings growth, a multiple of 23.4 for FY15. On the other hand, Healthscope is pitched at a multiple in the range of 20 to 23 for FY15.

Following Ramsay's recent move to acquire 83% of the French hospital operator Générale de Santé, the two companies are starting to look a little different. The French business will now account for 40% of Ramsay's revenue, with Australia/Asia falling to 52%.

In the directly comparable area (Australian hospitals), Ramsay has grown both revenue and margin at faster rates than Healthscope. For the first half of FY14, Ramsay grew revenue at 10.2% while Healthscope grew revenue at 5.5%. EBIT for Ramsay increased at 13.2%, while for Healthscope, it managed a 10.1% increase.

In a "whole of business" comparison, the 'track records' also tell quite different stories. Profit growth at Ramsay is running at a compound rate of growth of around 17.7%, at Healthscope, it is around 11.9%.

	Profit Growth 2013 to 2011 (CAGR)	Profit Growth 2014 (F) vs 2013	Profit Growth 2015 (F) vs 2014 (F)	Profit Growth 2015 (F) vs 2011 (CAGR)
Healthscope[1]	10.6%	13.2%	13.3%	11.9%
Ramsay[2]	15.9%	19.8%	19.3%	17.7%

[1] Based on Healthscope pro forma historical and pro forma forecast NPAT
[2] Based on Ramsay 'Core EPS' (historical), and forecast EPS from FN Arena

Our view

You don't get to be a "Ramsay" overnight, and while the management team at Healthscope looks like they are doing a good job, it is too early to put them in this class. Healthscope hasn't yet demonstrated the impressive growth rates that Ramsay has been able to sustain, and hence doesn't deserve the same premium price.

Given that pretty well all the major broking firms are involved in the deal, you are probably not going to hear anything too negative about it and there is no doubt it will find a home.

However, it is an expensive IPO at a multiple in the twenties and with a voluntary escrow that comes off in only 13 months, it is not for us. No thanks.

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Credit Corp – still a bargain

by Fundie's Favourite

How long have you held Credit Corp (ASX Code CCP)?

We've held it for almost five years. Our weightings have been quite different over that time. We call it the gift that keeps on giving. When we originally bought it, it was about $2 on a multiple of just under 10 times earnings. It's now $8.70 and its earnings multiple is still only just over 10 times earnings. This is in spite of paying large fully-franked dividends and growing its earnings every year in excess of 20%. The stock has barely been re-rated.

Credit Corp (CCP)

Source: Yahoo charts

What do you like about it?

Essentially it has two businesses now, where it used to have only one. It buys and collects purchased debt ledgers from the banks and it has a very sophisticated system for doing this. It's the biggest in the industry and one of the most efficient.

They have also started a lending business. This business has exceeded growth expectations and at the same time has demonstrated management's competence and conservativeness in terms of profitability. I don't think any value is being placed on that business.

How is it better than its competitors?

I think its systems are better. Its management has corporatised the process for tracking down and collecting, thereby monetising the purchased debt ledgers (PDLs) in an efficient manner. Importantly management has also shown real discipline in terms of the prices they pay for the PDLs.

What do you like about its management?

Chief executive officer Thomas Beregi has been very good at corporatising the knowledge that is involved in debt collecting. The systems allow the people to be more productive. The board and management team have also been disciplined in the way they apply capital, while at the same time actively looking for growth options.

Under Thomas, the business has been a lot more disciplined. If they can't buy legers at the right price, they just won't buy them

What is your target price?

We prefer to buy businesses that can feed us with a decent after tax cash earnings yield. As long as this is at an acceptable level, then we would like to own the business indefinitely. Currently, Credit Corp is on a 9% after tax cash earnings yield with no debt and a large bank of franking credits. This represents a "Good Deal" for our investors

At what point would you sell it?

If our calculation of the after tax cash earnings yield fell to 6 or 7% (either because sustainable earnings fall or the share price rises) then we would look to sell it.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Financial services and education drew analysts' attention this week. A major contract loss for education provider Navitas was not all bad news though, as two brokers believe the sell off has been overdone and upgraded it after the price fall.

In the good books

Citi upgraded Navitas (NVT) to Buy from Neutral following the announcement that Macquarie University will take pathway courses in house from 2016. Citi notes this is the first pathway contract loss for Navitas and its most significant program. The broker downgrades FY16 earnings forecasts by 7% but despite the loss, thinks university program earnings will be sustained by a recovery in Australian and UK programs and ongoing growth from North America. UBS also upgraded to Neutral from Sell. It thinks the announcement questions the company's core business model but the 31% fall in the share price is a little overdone (see downgrade).

BA-Merrill Lynch upgraded NAB to Buy from Neutral. Recent earnings trends may be poor but the broker is comforted by the fact that earnings expectations have been re-based. The stock now looks attractive and Merrills expects that meeting lower estimates will be enough to drive outperformance. Merrills observes the price/earnings discount to peers has been greater over the past 20 years but only when NAB was in a pickle, such as with Homeside, FX options and UK credit.

Citi upgraded QBE Insurance Group to Buy from Neutral. There are still some risks for QBE but the broker thinks market fears are overdone. The share price fall since the FY13 result means the stock is now reasonably attractive on a 12-month view. The leverage to interest rates remains significant and, under certain circumstances, a 1% rise in rates could add nearly 40% to earnings. The precise timing is hard to call but the broker's global team suspects rate hikes could be close at hand in the UK and within a 12 month timeframe in the US.

In the not so good books

Macquarie downgraded Coca Cola Amatil (CCL) to Underperform from Neutral. Macquarie is of the opinion that the soft drink industry is a major target for heath authorities in the obesity epidemic. The company has few offsets, although water is benefitting from the consumer switch from carbonated soft drinks, and Macquarie thinks volumes will remain subdued for some time. The price of the stock does not reflect the extent of the challenges.

Macquarie downgraded Navitas (NVT) to Neutral from Outperform following the pathway course contract loss. The agreement with Macquarie University will end in 2016, a material loss for Navitas in the broker's opinion. No details on the financial impact were provided but Macquarie has downgraded FY16 earnings forecasts by 7.6%.

Credit Suisse downgraded Insurance Australia Group (IAG) to Underperform from Neutral. Credit Suisse has reviewed the sector and expects minimal growth in the near term. IAG's business is in good shape and personal lines are well positioned to defend a dominant market position, while the acquisition of

Wesfarmers' (WES) underwriting business offers a growth option but brings downside risk and overweight exposure to Australasian commercial lines. The broker's downgrade is premised on the share price hitting the target rather than a negative view of the company.

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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Big bumper opportunities for ARB Corporation

by Roger Montgomery

Going global is, at times, a recipe for trouble – and relatively few Australian firms have been successful in achieving their international ambitions. Many industries in Australia are dominated by oligopolistic structures, and the management of businesses that enjoy large domestic market shares often suffer from a false sense of security when looking at global opportunities.

The issue for these companies is incumbency – there are no free kicks when trying to break into a foreign market. What Australian consumers like, international customers may not – and this is not exclusive to dining. What fancies the palate can also vary in products and services, such as financial services, groceries, packaging, right down to how we accessorise our vehicles.

Going bush

Which brings us to ARB Corporation Limited (ASX: ARP) and its expansion into the United States. ARB Corporation is one of Australia's largest providers of aftermarket automobile accessories, and is most famous for their bull bars, air lockers and Old Man Emu 4×4 suspension systems. ARB has a national network of 50 stores, and their products are sold globally in over a thousand independent distributors.

ARB Corporation (ARP)

Source: Yahoo charts

The value proposition for ARB is simple. Farmers and adventurers looking to brave the harsh rural and outback conditions only want the best gear on their 4WD – getting stranded due to inferior equipment just isn't worth it. Other brands are good competition; however ARB holds its status as the market leader due to years of research and development and consumer engagement. These latter factors are valuable intangible assets that have lead to many years of profitability and returns for shareholders.

To take an example, a $1,000 investment in ARB a decade ago would this week be worth approximately $3,385.20, plus dividends of $712.60. Compared this to Telstra (ASX: TLS), which has turned your $1000 investment into $1,076.66, with dividends of $627.21 – and you can see one of the reasons why we at Montgomery Investment Management monitor this company so closely.

Going global

A 50-store national network in Australia is a good asset, however for growth to continue, the firm must look for new market opportunities overseas. To this end, ARB has been building its sales infrastructure in the United States for several years now. This comprises several warehouses, relationships with national distributors and a large network of independent dealerships. The key to sustainable success however, is to develop products that US consumers are willing to buy en masse. Unfortunately, ARB US performance has been well below that of Australia. For example, US sales have been going backward at the rate of 1.5% per annum over the past five years. In comparison, total group sales have increased by an average of 8.8% per annum over the same period.

A matter of taste

Numbers are one thing, but our interest lies in what drives the current result and what changes management is making for the future. Our research indicates that the issue may be one of taste in that the Sports Utility Vehicles (SUVs) that ARB products are currently designed for, may not be what potential US customers want to buy.

It appears that US consumer tastes are orientated towards larger SUVs, as opposed to the smaller and medium-sized models preferred by Australian and Asian consumers. ARB has responded with a commitment to develop bull bars with the necessary specifications to suit US consumer tastes, and this will be a space we will watch very closely.

In addition, the company has recently established a new distribution centre in Jacksonville, Florida. This will enable more timely deliveries of bull bars and other equipment to their customers on the East Coast and Central North America, as well as South America.

We expect further growth to be derived from Asia and Europe. In the former, ARB conducts sales through a subsidiary (Off-Road Accessories Limited) and has found strong demand for the ARB Air Locker and other smaller accessories. On the latter, ARB has recently established a warehouse in Prague, which we believe to be the start of a much more comprehensive sales network throughout Europe.

Sure bets are a rare – if not mythical – concept in financial markets. In reality, each business has its own risks and ARB is no different. However, should it be able to continue to deploy incremental capital at rates of return of at least 20%, as it has been doing in the past, we would expect a bright future for ARB shareholders.

Montgomery Investment Management does not own shares of ARB Corporation Limited (ASX: ARP).

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How to buy into the big investment trends

by Peter Switzer and Paul Rickard

As we head into a new financial year, it's a good time to look at the trends that will be driving the markets over the next 12 months. Here is an extract from a limited edition *Switzer Super Report* eBook on five investment trends for the new financial year. Email us at **subscriber@switzer.com.au** if you want a copy of the publication.

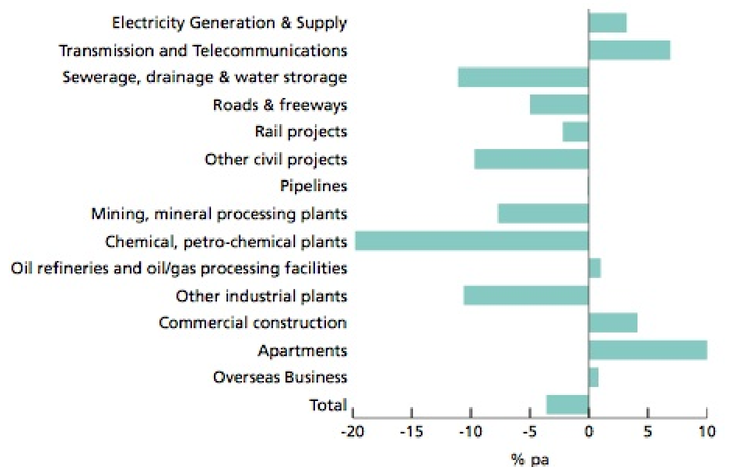
Construction

The end of the mining boom means there will be a drop off in engineering related construction, but that is likely to be picked up by residential and commercial property construction and, to some extent, road and transport projects.

The Australian Industry Group Construction Outlook for May shows the sectors that are expected to do well (see graph), and apartments and commercial (non-residential property) construction can expect robust growth rates in 2014, and the trend to continue in 2015.

Like shares, the property market has enjoyed a good year, but it takes a while for demand to filter through to construction for new properties, which means supply – and the construction that necessitates – of new residential homes and apartments will come on the market over the next 12 months.

The Australian Industry Group is forecasting apartment construction growth of 10% in 2014 and 9.6% in 2015.



Recent government announcements around spending on new roads and transport projects will start to filter through to actual construction in 2015, and the NBN will see ongoing growth in transmission and telecommunications construction.

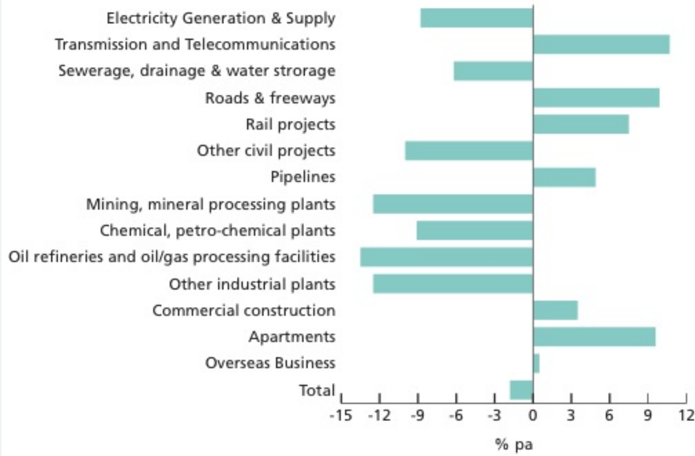
The listed companies in this sector most likely to be able to leverage this growth, and who are less exposed to mining construction (which is forecast to fall), include the likes of Leighton Holdings (LEI), Downer EDI (DOW) and Boral (BLD).

For Leighton Holdings, mining contracting only accounts for 24% of operating revenue and construction-contracting revenue is growing. But potential investors need to keep an eye on how controlling shareholder Hochtieff (and its Spanish parent ACS) restructures and sells off parts of the business.

Downer EDI has more exposure to the infrastructure sector but also has operations in rail. Mining accounts for a smaller percentage of revenue. It has been undergoing an efficiency drive and appears to be dealing with declining revenue in mining.

Boral and CSR don't operate in mining services and are pure construction plays. Boral has just signed a JV with USG in gypsum that is expected to help its outlook, and CSR's building products are performing well, with a slight drag in the glass and aluminum divisions.

2015 FORECAST ANNUAL PERCENTAGE CHANGE (CURRENT DOLLARS)



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Five tips for a top audit

by Jo Heighway

As we kick off with a new round of SMSF audits for the 2014 year, we have a new set of tips for how you can prepare early for a quick and easy audit.

Tip 1 – Appoint your auditor early to get your tax refund faster

Many SMSFs are entitled to tax refunds due to refundable imputation credits – especially super funds paying pensions to their members. Your SMSF tax return cannot be lodged until the auditor has issued their audit opinion. So engage with an auditor early in the financial year to ensure a quick turnaround of your audit and tax refund. Better in your pocket than the ATO's!

Tip 2 – Investment strategies

There have been recent changes to SIS Regulation 4.09 Investment Strategies. The new Operating Standard now reads:

The trustee of the entity must formulate, *review regularly*, and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:

1. the risk involved in making, holding and realising, and the likely return from, the entity's investments, having regard to its objectives and expected cash flow requirements;
2. the composition of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification;
3. the liquidity of the entity's investments, having regard to its expected cash flow requirements;
4. the ability of the entity to discharge its existing and prospective liabilities;
5. *whether the trustees of the fund should hold a contract of insurance that provides insurance cover for one or more members of the fund.*

A pro-active review of your investment strategy to ensure it is current and considers *insurance* will ensure you keep your auditor happy this year.

Tip 3 – Current market valuations of your assets

The rules now require an annual valuation of all assets owned by your SMSF. This is to ensure the financial reports for your fund correctly reflect the current value of your retirement benefits.

If your SMSF has assets, such as real estate property, collectibles, shares in unlisted companies or trusts, loans etc., you can proactively prepare for your annual audit by obtaining independent market valuations of these assets now. Valuations need not be formal valuations in most instances, but ideally they should be in writing from an independent source.

Tip 4 – Take action to fix all breaches from last year

If your auditor notified you of any breaches of the SIS rules in their last audit report, read that report again and make sure that you have fixed all outstanding issues prior to having your fund audited again this year.

The ATO looks much more favorably on trustees who don't ignore breaches, so it's really important to show your auditor that you are taking your role as trustee seriously and have fixed any issues identified by the auditor.

Tip 5 – Make sure your records are complete

Nothing slows down an annual audit more than

missing documents! Ask your advisor or auditor in advance for a list of documents they will require to complete your super fund reports and audit for the 2014 financial year. If in doubt, more records are much better than less.

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Best funds for income and small caps

by Questions of the Week

Question: I am thinking about investing in the BT Balanced Equity income series offering 7.5% plus franking. My understanding is that the risk is low as they only invest in the ASX 200 and cover the index with a put to ensure the fund is not severely impacted with a substantial correction.

Is this low risk and a good investment for income verses a term deposit? Are there other risks I haven't thought through?

Answer (By Paul Rickard): I wrote about this product last year. My concerns at the time were to do with BT's then investment performance, and the management fee.

Over the last 12 months, BT has lifted its game and the performance has improved. According to their last performance report (end May), the fund's performance since inception is spot on with its benchmark.

It is important to note that the benchmark is 40% shares, and 60% bank bills. Accordingly, the fund only returned 9.36% (total return) in the year to 31 May, compared to around 17% for the S&P/ASX 200.

In answer to your questions, I think it is largely a sound investment. It is not low risk – however, it is lower risk than an outright investment in the share market.

Question 2: We have $30,000 invested in the Vanguard MSCI Australian Small Companies ETF (ASX code VSO) in our SMSF and it has not performed well. Are there any other funds, ETFs or LICs that focus on small caps and are better targeted to provide both yield and growth in the current investment climate?

Answer 2 (By Paul Rickard): Overall, smaller companies have done relatively poorly on the ASX over the last 18 to 24 months, so it is not surprising that an index-based ETF like VSO has not performed that well.

There are a number of alternatives.

Firstly on the ETF side, iShares IVO, which tracks the Small Ordinaries index (stocks from the S&P/ASX 300 ranked 101 to 300 by market cap). Again, the performance here hasn't been that great – +12.47% for the 12 months to June, however -1.60% for the last six months.

With the LICs, you can see a full list here. While many of these are large cap, such as Argo (ARG) or AFIC (AFI), many have a small cap focus. Have a look at Geoff Wilson's WAM or WAX, and Mirrabooka's MIR.

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