Switzer Super Report

Issue 371, 12 March, 2015

A hiccup

In some good news today the local market was up, even though the Dow had a rough night. In another contradiction, European markets had a good night too. I still think the little hiccup we've had lately is the correction we had to have and this year is going to be much better for local stocks.

The Aussie dollar is still going to go down and Charlie Aitken is predicting 68 cents. It might not be good for your overseas holidays but it is great for a bunch of stocks like CSL, Resmed and Charlie's favourite, Servcorp.

Also in the *Switzer Super Report,* Sean Fenton from Tribeca runs the ruler over one of his favourites – Aristocrat Leisure, and Roger Montgomery is a big fan of Ansell.

Sincerely,

Peter Switzer

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The winners when the Aussie hits 68 US cents

by Charlie Aitken

Key points

- *A lower Aussie dollar is good for ASX-listed US dollar industrial earners, ASX-listed offshore fund managers, ASX-listed international equity LIC's and ETFs, and ASX-listed inbound tourism beneficiaries.*
- *Some stocks to watch include Westfield Corporation (WFD), CSL (CSL), Resmed (RMD) and Brambles (BXB).*
- *Servcorp is a classic GARP stock when GARP is getting much harder to find.*

The clear winner of last week's blowout US payrolls number was the US dollar. The US Dollar Index (DXY) at 98.61 is now within sight of my long-held target of 100, a target that will need positive revision in the weeks ahead as more and more global capital flows back to the world's reserve currency, most notably from the euro, yen and Aussie dollar.

US dollar power

I have been and remain a very firm US dollar bull. I believe this is the infancy of a major US Dollar move, which clearly has ramifications for anything denominated in US Dollars.

There should be now no doubt at all that the Federal Reserve will start raising cash rates, albeit slowly, mid-way through this year. The Fed will be the ONLY central bank raising rates globally this year and the ramifications for the US Dollar are large as we have argued in these notes for many years.

Here's some trivia for you all. On which date did the Fed first take the Federal Funds Rate (FFR) to 0%? Answer: 16th of December 2008.

The S&P500 subsequently bottomed on March 9 2009 at 676, and despite the current pullback, is 204% from that point, reminding you of the old adage ***"don't fight the Fed".***

We are into our seventh year of ZIRP (zero interest rate policy). It's actually quite amazing. I don't think many people believed US cash rates would be 0% 7 years later, but here we are and the Fed's policies have clearly worked, with US GDP growth outpacing the world and US employment growth outpacing the world.

Similarly, who would have thought seven years ago that the US unemployment rate would be 1% below the Australian unemployment rate? At one stage in 2009 they were 5% apart in Australia's favour!

I have been bearish on the Aussie dollar since 106 US cents. It's been one of my key macro calls. A few weeks ago I lowered my Aussie/US dollar cross rate target further, from 75 US cents to 68 US cents. I want to reiterate today that I remain extremely comfortable with that 68 US cent Aussie dollar/US dollar target and feel it could be hit far quicker than anyone currently believes. The pure technical target would be 64 US cents, which could also be hit on a rout.

On that basis I am redoubling my strategic focus on ASX-listed US dollar industrial earners, ASX-listed offshore fund managers, ASX-listed international equity LIC's and ETFs, and ASX-listed inbound tourism beneficiaries. I also continue to urge you to "lose the home bias" in terms of overall asset allocation.

Resource bear

One of the reasons I remain bearish on the Australian dollar is falling commodity prices. Unfortunately for commodity prices they are facing the perfect storm. Chinese GDP growth is slowing. The supply response has arrived in all commodities. Commodities are priced in US dollars. Major producers are showing NO signs of curtailing production.

To make it worse, the case for diversification into holding physical commodities has fallen apart and losses in commodity equities are stacking up. You can feel a complete and utter capitulation coming and that is why the ONLY comment I made on Australian resource stocks this year was **warning you NOT to buy them for yield.** You simply don't buy ANY stock for yield when its earnings base is falling. That is just dangerous.

I don't think we are at the bottom in commodity prices yet or the bottom in terms of sentiment towards resource stocks. We haven't seen the baby thrown out with the bathwater yet.

I am watching all this closely, however, falling commodity prices and our collapsing terms of trade are key to my domestic interest rate view (2.00% or lower) and bearish Aussie dollar view. In terms of commodity equities I am basically letting the knife fall strategically and waiting for the capitulation moment when the momentum knife sticks in the deep contrarian value floor. I do not think that is yet because that event requires complete analyst capitulation at the consensus forecasting level and as you can see in the table below, **the consensus view on major Australian resource stocks remains positive in terms of BUY/HOLD/SELL ratios and 12-month price targets.**

	BUY	HOLD	SELL	PRICE TARGET
BHP Billiton	12	9	1	$34.48
Rio Tinto	11	7	1	$68.69
Fortescue	5	14	5	$2.64
Woodside	4	6	4	$37.37
Santos	8	5	2	$10.96
OilSearch	13	4	2	$9.22
Origin	10	3	2	$13.51

The price targets above have been a "death buy a thousand cuts" as earnings get revised down monthly. To put this in context, the current BUY/HOLD/SELL ratio on Telstra is 5/12/4 and the median 12-month price target is $5.94. In an iron ore crash there is only one sell recommendation on Rio Tinto versus four sell recommendations on Telstra. Enough said.

Who knows, we might be three years into a 10-year bear market in commodities. From the resource companies, through to the analysts, everyone is throwing darts. Nobody has a clue what comes next. Nobody predicted that iron ore would have a "5" handle and oil a "4" handle, that is why I think setting an Aussie dollar/US dollar target of 68 Us cents is not even a big call. It's just a matter of how quickly it gets there.

The winners

If I am proved right on my Aussie dollar/US dollar bearishness then these below stocks will be the winners. Winners keep on winning in that scenario. Currency cycles are long cycles.

US dollar leverage

- Westfield Corporation (WFD)
- Servcorp (Servcorp)
- CSL (CSL)
- Resmed (RMD)
- Brambles (BXB)
- Macquarie Group (MQG)
- Mesoblast (MSB)
- Treasury Wine Estates (TWE)
- Platinum Asset Management (PTM)
- Magellan Financial Group (MFG)

Inbound tourism

- Crown Resorts (CWN)
- Sydney Airport (SYD)
- Auckland Airport (AIA)
- Air New Zealand (AIR.NZ)
- Sealink Travel Group (SLK)
- For the highly risk tolerant Virgin Australia (VAH) is arguably worth a punt

Servcorp

In August 2014 I wrote a note on Servcorp titled "Boutiquefication Leverage" and set a $6.50 price target. Servcorp shares were around $5.00 then and we've collected the 11-cent final FY14 dividend and 11-cent interim FY15 dividend. It's been a solid total return mid-cap industrial idea. It's given us the leverage I hoped for.

Today I want to update that note to include analysis of the FY15 interim result.

Servcorp (Servcorp) delivered **one of the best results of the reporting season.** These earnings and dividend trends will continue in the years ahead. Just have a look at this slide: most industrial companies would be very pleased to print this set of numbers.

Operational Highlights

H1 FY 2015

- Revenue of $129,863,000, up 10%
- NPBT of $19,618,000, up 30%
- NPAT of $16,039,000, up 36%
- Like for like NPBT of $21,193,000, up 39%
- Operating cash flow from operations of $29,246,000, up 61%
- Unencumbered cash and investment balances of $94,199,000
- NTA backing of $2.19 per share, up 7%
- EPS of 16.3 cps, up 36%
- Reaffirm guidance of not less than 15% NPBT growth for FY 2015
- Interim dividend 11.00 cps, declared for H1 FY 2015, 20% franked
- Forecast H2 FY 2015 dividend of 11.00 cps, 30% franked
- Approx. 80% of revenue and profits earned offshore

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Servcorp is a leveraged play on the global structural trend to "boutiquefication". Ok, that's not a word, but it means the trend of professionals learning their trade in a big incumbent firm then branching out in early middle age to start a boutique business. The vast majority of the working world has worked out you can't get rich in a big firm and you can't control your destiny.

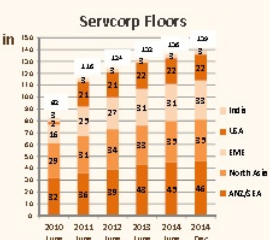
You need to "hang your own shingle out" if you want a private jet. This is a structural trend, aided by technology, that will continue. Servcorp is superbly placed to provide a variety of services to small and medium sized entrepreneurial businesses.

The trick to any start up business is to look stronger than you are. Servcorp, via offering small scale serviced offices on high floors in the world's most premium office buildings, clearly facilitates that ability to look stronger than you are at competitive rents and without the long tail liability of extended leases/make-goods etc that come with direct office leasing. Servcorp clearly does offer "the world's finest service offices". The slide below summarised Servcorp's global footprint.

The Servcorp Footprint

H1 FY 2015

- Opened 57 new locations since 2010
- 4 new floors opened and 3 floors were expanded in H1 FY 2015
- We plan to open 7 floors and expand 3 existing floors in H2 FY 2015
- Office capacity expected to increase by no less than 10% in FY 2015
- As at 31 December 2014 there were 139 floors in 52 cities in 21 countries



6 SERVCORP

In terms of earnings/dividend growth total floor space, occupancy rates and margins are all heading in the right direction ie up. With head office/management costs stringently watched, the leverage to revenue growth and cash flow conversion is very strong.

The office of the future

Growth is also starting to come from ***"virtual office".*** To my way of thinking "virtual office" is a low cost growth option of Servcrp with the technology required simply piggybacked onto the existing office hardware/software backbone. Clearly the EBITDA margins in "virtual office" are highly attractive.

Back to the core business and Servcorp has more than doubled in size over the last 5 years, signing long-term floor leases when conditions post GFC were very favourable. Now, as the world economy starts recovering, they fill those floors and reap the revenue and margin harvest.

But the growth doesn't stop here for Servcorp with intentions to open a further nine floors and expand three existing floors in FY15, which will add approximately 10% to group office capacity. In terms of earnings and valuation I think Servcorp is an undervalued structural global growth stock.

The yield is a nice bonus but to me, Servcorp is about GROWTH. With the usual caveats about "unforeseen circumstances", Servcorp has guided to net profit before tax (NPBT) to "improve by NO less than 15% in FY15". No less than 15% NPBT growth vs. the ASX200, which offers prospective EPS growth of 5% in FY15 at the aggregate level.

Servcorp ticks all my boxes. Organic global growth in a structurally supported sector, earnings growth, extremely strong balance sheet, strong management, dividend growth, tight register and clear valuation support. It's a classic GARP stock when GARP is getting much harder to find.

It's also a great example of an Australian company getting offshore expansion right. I continue to rate Servcorp a high conviction mid-cap buy and reiterate the 12-month price target of $6.50.

Go Australia, Charlie

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Getting a handle on Ansell

by Roger Montgomery

Key points

- *Having aggressively pursued acquisitive growth in the past three years, Ansell is now beginning to see the benefit.*
- *The shift towards lean manufacturing resulted in $10 million of annual savings in FY11, but $20 million in annual savings in FY14.*
- *Ansell's share price and prospects offer a sufficient margin of safety to warrant a position.*

The share market has rallied sharply since the start of the calendar year, driven by investors demanding higher income. During this time however, we have maintained relatively high weightings to cash in The Montgomery Fund and The Montgomery [Private] Fund. One advantage of a higher cash weighting is the ability it affords to be an opportunist.

During reporting season, for example, we were quick to build a new position – that is already profitable – in one company after seeing a much stronger result than we had previously forecast.

Ansell develops intellectual property

The new addition is Ansell (ASX: ANN). Ansell is a global manufacturer of protection solutions, primarily gloves for customers in the industrial, automotive and life sciences sectors. Having aggressively pursued acquisitive growth in the past three years, the company is beginning to see the benefits that sometimes accrue to the largest player in a market.

Ansell

Source: Yahoo!7 Finance, 12 March 2015

Scale benefits are enormously important for manufacturers to remain competitive. With greater size comes greater bargaining power with suppliers, and higher volumes means greater economies of scale – leveraging a large fixed asset base.

Ansell is not a manufacturer of a generic commodity. While you may consider that one glove is like any other, Ansell has developed considerable intellectual property to set its products apart and that allows it to charge a premium. Gloves are not a material expense for most companies, yet hand injuries sustained by employees can be very costly. A few extra cents does not seem much to improve the safety of a company's workforce.

We are particularly attracted by Ansell's focus on its core brands. Companies are shifting away from niche applications, and are instead demanding products that are useful in any part of a plant. By rationalising non-core products, the company can better leverage its manufacturing facilities, while the sales force can deliver a stronger brand to the end user. Recall Henry Ford's iconic offer that you could buy the T-model Ford in any colour as long as it was black.

Strong leadership

And it's not just inorganic growth that is driving the company's improved performance. Since assuming

the position in 2010, the CEO has had a keen focus on operational efficiency and new product development. These initiatives have a long lead-time but are now bearing fruit. For example, the shift towards lean manufacturing resulted in $10 million of annual savings in FY11, but $20 million in annual savings in FY14, and this saving rate is expected to double again in the next three to four years. Sales of new products in the Industrial division have doubled in past 12 months.

We also expect Ansell will achieve margin expansion in coming years. This will primarily be driven by operational efficiencies and technological innovation, as the company continues reinvesting around $60-$70 million each year.

When Ansell announced the first-half 2015 results, management commented that cash flows have been stronger than expected. This is largely due to a smooth integration of Ansell's largest acquisition, BarrierSafe Solutions, which sells the leading single-use glove in the United States.

Unlike Ansell, Barriersafe outsources manufacturing, which provides the company with new initiatives to optimise the supply chain. BarrierSafe's sales have also been isolated to the United States market, which means that meaningful revenue synergies can be provided through Ansell's global sales force.

While Ansell is well positioned and amply funded to pursue acquisitions, management has noted that they are not dependent on them to grow.

The outlook

As with any investment there are caveats. At the first half results briefing, the company maintained full-year 2015 guidance, but warned the world had become even more uncertain over the previous quarter. While we currently believe Ansell has sufficient global diversification to weather shocks in major economies, we are watching the 25% of Ansell's sales that are denominated in euros.

With the market continuing to favour quality companies, it is rare to find investments that are trading at deep discounts to our estimates of intrinsic value. Ansell is not an exception to this dynamic, however it's share price and prospects offer a sufficient margin of safety to warrant a position.

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Aristocrat Leisure – the sky's the limit

by Sean Fenton

How long have you held the stock?

Since late 2011

What do you like about it?

Exposure to the US economy and the gaming sector globally. The US economy is the one real bright spot for growth in the world and the $US earnings are increasing in value along with the currency. They have invested strongly in research and development in recent years and that is now paying off with popular game releases and increasing market share as well as having a deep library of older games. The recent acquisition of gaming company VGT is quite accretive for them and increases their proportion of recurring revenues. The concentration of VGT to Oklahoma might temper growth here, due to the weakening oil price and its impact on regional economic activity, but the broad uplift to the consumer and gaming, in particular, from increased disposable income across the rest of the US and Australia will more than compensate.

How is it better than its competitors?

It has taken the lead in recent years in new game development following the investment in R&D and acquisition of new talent. Ship share has been growing strongly at the expense of the competition.

What do you like about its management?

Jamie Odell helped to turn the business around by focussing on its core strengths. This included the inherent value in its library of games and how to best exploit and monetise them. He identified the importance of the recurring revenue segment as being more valuable in driving consistent earnings.

What is your target price on Aristocrat?

$8.50, but that would move higher if the Australian dollar continues to fall.

At what point would you sell it?

Other than a significant appreciation in the share price, an unexpected downturn in US growth and the US dollar would see us lighten. Regulatory changes, while unanticipated, in key selling regions would also be a negative catalyst. Also a loss of product momentum and ship share would be a time to sell.

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

It has added over 1% to portfolio performance in excess of the market.

Is it a liquid stock?

Yes, it is in the top 100 largest stocks listed on the ASX and turnover recently has been in excess of $10 million per day.

Where do you see the value?

It has technology leadership in a growing market. It has a relatively stable earnings base from participation games with blue sky potential from an eventual replacement cycle in the US market and further growth in mobile and online gaming apps.

Aristocrat Leisure

Source: Yahoo!7 Finance, 12 March 2015

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Brokers are decidedly more positive now interim reporting season is practically over. There haven't been too many actions in total this week but there seem to be more upgrades than downgrades overall.

In the good books

Morgans upgraded iiNet (IIN) to Add from Hold. Morgans has taken a closer look at the telco and expects margin expansion and subscriber additions will lead to a re-rating in the second half. For contrarian investors, the broker considers the current share price weakness represents an opportunity to buy a quality company on undemanding metrics. Buy/Sell/Hold 3/2/3

UBS has upgraded Sirtex Medical to Buy from Neutral. The company is about to release its key results on the SIRFLOX study, which is designed to determine whether SIR-Spheres can be elevated to a first line therapy in liver cancer. Other data in the lead up to the study has been positive and UBS is encouraged by its review of previous trial findings. Buy/Sell/Hold 1/1/1

Macquarie upgraded Westpac to Neutral from Underperform. Macquarie considers new technologies could enable the major banks to grow small-medium enterprise banking. This opportunity should offset mortgage regulatory pressures for Westpac. Macquarie upgrades on the basis that the bank has an opportunity to increase its penetration in SME banking. Buy/Sell/Hold 2/4/2

In the not-so-good books

Morgans downgraded Ardent Leisure (AAD) to Reduce from Hold. The retirement of the company's highly respected CEO surprised the broker. The timing of leadership change is considered less than ideal, with a major change in strategy underway in health clubs. Morgans notes the CEO replacement, board member Deborah Thomas, has a lack of operational leisure experience which engenders a cautious response, although acknowledges her wealth of marketing and event management expertise. Buy/Sell/Hold 0/1/4

Deutsche Bank downgraded Crown Resorts to Hold from Buy. Deutsche Bank has reduced earnings forecasts again, to reflect a lower contribution from the Melco JV. The broker now expects the Macau market to decline by 30% in 2015 following a weaker-than-expected Chinese New Year. There has also been an adverse mix change with low end players replacing the high end. Buy/Sell/Hold 4/1/3

Morgan Stanley downgraded Scentre Group to Underweight from Overweight. Morgan Stanley used a tactical trading idea to announce it has downgraded the rating for Scentre Group to Underweight from Overweight. The stockbrokers is of the view lower funds from operations (FFO) and Net Asset Value (NAV) growth will drive a gradual de-rating for the securities. Buy/Sell/Hold 1/3/3

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 biggest issue with SMSFs and commercial property

by Tony Negline

Key points

If you've failed to pay business real property rent to your SMSF you could be breaching:

- *The sole purpose test*
- *Prohibition on lending money or providing financial assistance to members or their relatives*
- *Arm's length dealings*
- *In-house asset test*

Business real property can be a great investment for self managed superannuation funds but there is one big potential problem that you need to be on top of.

Let's assume your SMSF owns commercial property and rents this to your business, which is run by you personally. (Your business affairs aren't conducted via a company or through a partnership.)

Suppose that for a period of time business hasn't been great and to solve the cash flow issues you have failed to pay rent to your super fund.

The rules breached

This is a fairly common scenario and one that needs some careful analysis to determine the extent of the problem.

Potentially under the super laws the following rules may have been breached:

- Sole purpose test
- Prohibition on lending money or providing financial assistance to members or their relatives
- Arm's length dealings
- In-house assets

Let's look at each of these rules in turn:

Sole purpose test – this says that your super fund must be primarily run to provide its members with retirement benefits or your beneficiaries with benefits on your death. Any benefit from the assets of the fund prior to retirement or death must be incidental to either of those two objectives.

Clearly the non-payment of the rent means your business – and therefore indirectly you – have obtained a commercial benefit. The issues to consider are the dollar value of outstanding rent, the time period for failing to pay, any action you as trustee have taken to recover the unpaid money and the existence of a written lease agreement between you as tenant and the super fund as owner.

Prohibition on loaning money or providing financial assistance to members or their relatives – as the commercial property is leased to you as an individual then is the unpaid rent a loan and therefore a breach of the super laws?

Typically unpaid rent isn't a loan as we normally understand it. It's often seen as a normal commercial debtor and creditor arrangement.

However the longer the period of unpaid rent the harder it would be to maintain that some form of loan, by default, hadn't been created.

Most property leases, including commercial leases, require that a bond be paid. If a bond has been paid then some of it could be used to cover for the unpaid rent.

In addition, if the trustee has done nothing to recover the unpaid rent then this may be seen as some sort of financial assistance.

Arm's length dealings – the super law arm's length dealing rule says that when two parties are involved in a transaction, then the super fund must receive at least the same that someone dealing at arm's length would obtain.

Clearly unpaid rent means this isn't a normal commercial relationship. A larger arm's length dealing problem will occur if either or both of the following has occurred:

1. No bond has been paid.
2. The super fund trustee has done nothing to recover rent or apply penalties for non-payment as maybe provided for in the lease agreement.

In-house assets – this rule prohibits more than 5% of a super fund's assets, valued at prevailing market values, from being invested in related parties of the super fund. You as a fund member are a related party. Real estate that satisfies the business real property test is exempt from this test. Is this rule activated by the unpaid rent?

If there is a loan or some other financial assistance then this would be an in-house asset and a test would need to be run to see if the value of that assistance is greater than the 5% permitted limit.

How do you solve this problem?

Much depends on the time period for non-payment and the action the trustee has taken to recover the unpaid money.

If your super fund's auditor finds any super law breaches they will be reported to the ATO under the following circumstances:

- If your super fund is less than 15 months old, then any breaches valued at more than $2,000 must reported it to the ATO by your fund's auditor.
- If the same breach occurred in the current financial year and a previous financial year.
- If your fund had a breach in a previous financial year and you didn't fix it.
- If you breached a super law that has a statutory time limit (for example your auditor requested a document about your fund which you are expected to provide within 14 days) and you take more than 14 days, then your SMSF auditor will need to report that to the ATO.
- If the total value of all super law breaches is greater than 5% of a fund's total assets.
- If the total value of all breaches is over $30,000.

In my view, the best way to solve this problem is, ideally, not to let it happen in the first place. But if it has occurred, then the best bet is to fix it promptly and ideally before your auditor reviews your fund.

Alternatively, you will need to work with your fund's auditor and promptly implement any requirements they stipulate so that they can tell the ATO about the breach, but also say that it's under control.

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Magellan's global fund and consolidating super

by Questions of the Week

Question: We have been given a research paper on Magellan Global Equities Fund (MGE). We already hold Hunter Hall Global (HHV) in our super fund, and have made $7000 on it, so would appreciate your views on the future of both.

Answer (By Paul Rickard): Magellan Global Equities is a new ASX listed version of the Magellan Global Fund.

Magellan has had a great run – they are the form manager when it comes to international equities.

They are an active manager with a pretty unique style.

This new traded fund will be well supported.

Question 2: My Hesta fund is earning YTD15.99% on International shares and last year I had it in Australian shares and earned 16.8%. I have several hundred thousand to put into super and a reputable financial adviser wants me to offload my Hesta into an SMRF with my husband. Hesta returns look too good to offload in my opinion. What do you think?

Answer 2 (By Peter Switzer): I like the idea of consolidating your super – to save on administration and other fees.

As for asset allocation – that is another matter. There should be no reason why you can't have exposure through your SMSF to international shares.

Sounds like you probably should get a second opinion.

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