Switzer Super Report

Thursday 9 April 2015

# Money for God's sake!

I'd just like to make one thing clear, I don't do this for fun or to fill pages (although of course I do enjoy investing). My primary reason for writing for the *Switzer Super Report* and *Switzer Daily*, and setting them up in the first place, is to make money and to tell you how to invest to make money! That's why you need to read my article today – and every other day.

You also need to read Tony Featherstone's article today on 6 small caps that were born global – smart companies that knew they had to focus on the rest of the world from the very beginning.

Also today, Tony Negline has a call to arms for SMSF trustees and some great tips on how you should be lobbying to make sure the government leaves super alone. Roger Montgomery tells you how to spot a dud retailer, and Platypus Asset Management senior analyst, Anna Kassianos, explains what's so great about Sydney Airports.

*Buy, Sell, Hold – what the brokers say*, has upgrades for ASX and Resmed and *Questions of the Week* further examines the possibility of super changes and euro currency forecasts.

Sincerely,

Peter Switzer

## Inside this Issue

6 Aussie small caps reaping the benefits of being 'born' global

by Tony Featherstone

02


02 **6 Aussie small caps reaping the benefits of being 'born' global**
by Tony Featherstone

06 **I do this to make money, so read this!**
by Peter Switzer

09 **Buy, Sell, Hold – what the brokers say**
by Switzer Super Report

10 **Why you need to fly away with Sydney Airport**
by Anna Kassianos

12 **Trustees united will never be defeated!**
by Tony Negline

14 **How to spot a dud retailer**
by Roger Montgomery

16 **The likelihood of super changes getting up**
by Questions of the Week


switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

*Important information: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.*

# 6 Aussie small caps reaping the benefits of being ‘born’ global

## by Tony Featherstone

***Key points***

- *Domino’s Pizza and Slater & Gordon have shown how an international outlook can boost growth.*
- *Owner of Mathletics, 3P Learning, and Smiggle, Premier Investments, have worked out a global focus is essential.*
- *SomnoMed and IMF Bentham are also in on the game.*

Investors chasing the next hot small company often assess management, the balance sheet, product and myriad financial metrics. Less considered is the company’s global footprint, capacity to expand rapidly offshore, and skill in entering new markets.

Expect to see more “born-global” small caps on the ASX in coming years as technology blurs market boundaries and as investors pay a higher valuation premium for companies that can scale their products or services into much larger offshore markets.

Consider the outstanding Domino’s Pizza Enterprises. About a quarter of its revenue is earned in Europe and 44% in Japan, after an astute investment in 2013. Or fast-growing law firm Slater & Gordon and its $1.2 billion acquisition last month of Quindell plc’s professional service division, making it the United Kingdom’s largest personal-injury law firm.

There are good reasons to prefer small caps with a global focus from the get go. Longer term, this market is too small for companies that focus on niche industries. After expanding rapidly in the domestic market, their growth plateaus, then stagnates. By the time they look overseas, it is too late.

A weakening Australian dollar also strengthens the case to buy born-global small caps. As commodity prices and the official cash rate fall this year , it’s a safe bet that the Australian dollar’s recent slide has further to run. In many instances, that means higher earnings for companies with offshore operations as profits are translated into Australian dollars.

Another benefit of owning born-global small caps is enhanced diversification. An Australian retailer with divisions in the United States, the UK, Asia and Australia, for example, has spread its operating risk much better than another with only domestic operations. That diversification and potential to grow in larger markets should lead to higher valuation premiums for such companies over time.

Below are six small-cap companies with interesting global growth prospects that are still reasonable value at current prices for long-term investors.

**1. 3P Learning**

The education-technology company, best known for its popular Mathletics, Reading Eggs, Spellodrome and IntoScience games, still trades below the $2.50 issue price from its 2014 IPO, despite exceeding prospectus forecasts and market expectations in its latest interim result.

About five million children, through 17,000 schools in more than 200 countries, use its products. More students in the UK now use Mathletics than in Australia and 3P has strong growth prospects in the US, a market where it is expected to make more investments or acquisitions. About a third of its revenue is earned offshore.

3P is a classic example of an Australian small cap that thought about global markets early in its lifecycle and will reap the rewards in the coming decade as it

rolls its product suite into new markets. It looks better value than most tech stocks and is a high-quality, well-run business.

*Source: ASX*

**2. SomnoMed**

The maker of oral devices to treat sleep apnoea, a potentially life-threatening disease, is growing rapidly overseas. About 48% of revenue is earned in the US, 41% in the UK, and the rest in the Asia Pacific. SomnoMed offshore growth is quickening.

SomnoMed is not cheap, at least on domestic valuations, having rallied from a 52-week low of $1.37 to $2.75 after another strong half-year report. But it trades on a revenue multiple below similar medical-device companies in the US, despite having a rapidly expanding global footprint.

Sleep apnoea is a long-term growth market as higher rates of obesity cause more sleep disorders and breathing problems. Non-compliance with continuous airway pressure machines, made by ResMed and others, is also lifting demand for more comfortable oral devices.

*Source: ASX*

**3. IMF Bentham**

As the market frets about the price tag of Slater & Gordon's UK acquisition, it is easy to overlook the prospect of another law-related stock, litigation funder IMF Bentham. It funds class actions, a complex growth market with bigger barriers to entry than widely realised.

IMF Bentham now earns about half of its revenue in the giant US market, the global home of shareholder and consumer class actions.

It has plenty of growth options in the US. It opened a subsidiary in New York in 2011 and a Los Angeles office in 2013. Eighteen cases have been funded, of which five have been successful. Although competition for litigation funding is high, the company believes the US market knowledge of this type of specialist finance is at an early stage.

IMF Bentham has had more muted sharemarket gains this year than Slater & Gordon, Shine Corporate and booming intellectual property lawyer IPH, which listed last year. IPH's growing footprint in Asia, which will need more intellectual property services, is also worth watching.

A Federal Court ruling in April that favoured ANZ Bank in the long-running bank-fees litigation brought by IMF Bentham has crunched the stock in recent weeks. An opportunity to buy the impressive litigation funder is emerging (there is some price support in its chart at $1.70).

*Source: ASX*

Source: ASX

**4. Premier Investments**

Solomon Lew-backed Premier Investment owns the Just Jeans, Jay Jays, Portmans, Jacqui E, Dotti and Peter Alexander retail chains. But it's the outstanding Smiggle chain and its offshore growth prospects that have put a rocket under the share price.

Kids in Australia, and increasingly the UK, cannot get enough of its brightly coloured stationery. Premier's target is 200 stores and revenue of $200 million in the UK over five years. UBS estimates Smiggle will have around 450 stores by FY25, possibly many more if its store rollout in Western Europe and Asia succeeds.

Premier has rallied from a 52-week low of $8.01 to $13.36 after its recent half-year result exceeded market expectations, and was among the better-quality profit reports. It is fully valued. Ten of 15 brokers have a hold or sell recommendation, and five a buy, consensus estimates show.

But Premier is definitely one to watch on any market pullback or correction. Few mid-cap companies have a product with as much offshore growth potential as Smiggle.

**5. Retail Food Group**

As the market cheers for Domino's, one can underestimate the global prospects of its nearest listed rival, Retail Food Group. It owns the Donut King, Brumby's Bakery, Michel's Patisserie, bb's café, Esquires, The Coffee Guy, Pizza Capers Gourmet Kitchen and Crust Gourmet Pizza, and last year bought the Gloria Jean's and Di Bella Coffee chains.

Retail Food Group is rapidly transforming into a global franchisor and coffee wholesaler, thanks to transformative acquisitions such as Gloria Jean's. It and the Cafe2U system give the company more than 500 international outlets.

About 10% of revenue in the latest half-year result was earned offshore, but watch that figure grow rapidly in coming years as Retail Food Group takes its popular franchise systems to China and western markets, and builds on its US footprint. Coffee and gourmet pizza are standout food businesses and likely to be in much higher demand as the number of middle-class consumers in Asia booms over a decade.

Retail Food Group has soared from a 52-week low of $3.67 to $6.90. Like some others on this list, it is best bought on price weakness during an inevitable market pullback.

*Source: ASX*

**6. Austal**

The ship builder slumped after the GFC as demand for its military and commercial vessels sank. But it is recovering nicely from the 2012 lows amid strong contract wins from the US Navy, a rapidly growing order book, and greater global recognition of its product.

Austal has excellent growth prospects in the US and capacity to build a much bigger base of recurring earnings from maintenance and vessel upgrades. There was plenty to like about its latest contract win – two more Littoral Combat Ships for the US Navy and the option of a third.

The market expected a smaller order and the fact that the US Navy preferred Austal over larger rivals says a lot about its product and growth potential offshore. The company is trading near fair value after recent price gains and best bought on price weakness. But there is potential for a higher valuation multiple and further medium-term price gains as Austal wins contracts with other navies and builds it maintenance income.

Source: ASX

*- Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at April 9, 2015*

***Important**: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# I do this to make money, so read this!

by Peter Switzer

I don't write all this stuff here in the *Switzer Super Report*, in our *Switzer Daily* website and on my TV show to end up being used for newspaper to wrap up fish and chips! Yeah, I know this is an anachronistic metaphor, as I now write and broadcast electronically and the fish n' chip story relates back to when it was all newspapers for business and finance. And it was when fish and chips were wrapped in newspaper, not plastic bags!

But my point is clear: I don't write and broadcast to fill time and space. I'm in it for education, for insights and for helping you (and me) make money.

**Back to the future**

These thoughts came to me after receiving an email from an academic (who'll remain nameless), who is a subscriber. Let's call him The Prof because he is a Professor of Economics and I respect that achievement.

This is what his current email said: "One thing of which you might not be aware is the strong negative relationship that has been found between the sentiment of "pros and experts" and the subsequent performance of the market. Indeed, it is one of the numerous contrarian signals used by many technical analysts."

That's a great insight. I am in the insight collection business, though being right is a higher priority.

This followed my pointing out that there was a big divergence between what the expert newsletter gurus were predicting and what moms and pops surveys of the market were saying in the US.

But wait there's more. Below the current email was one The Prof sent me on 13 September, 2012, which went like this: "One thing that is evident is that I read what you write! Further, I envy you to the extent that you seem to be a person who sees good in everything and everyone. However, I am compelled to comment on your rather colourful article on the likely advent of QE3, where you see good in Obama (an obviously wonderful but ineffective person) and Bernanke (who is running Greenspan a close race in being the worst head of the Fed).

"Of course, we do not know where we would have been without QE1 and QE2 but what they did was use most of the Fed's firepower with no improvement in the economy and with a stock market that has not moved in five years (nor this millennium). I would back those who say that QE1 and QE2 were ineffective over your rose-coloured assessment."

"You are right about animal spirits and the positive decision about QE3 will cause a jump in the market largely driven by scribes telling the market what a good thing that it is…"

The rest of the email was missing but you get the gist of what The Prof was saying. I think his anti-Fed views then have been trumped by what's happened on the stock market since 13 September.

**The brighter picture**

Let's have a look at them and make some conclusions. Here they are:

- The closing level on the S&P 500 was 1459.99 and as I write, it's now 2081.9, a 42% gain, leaving out dividends.
- For the Aussie market, our S&P/ASX 200 index has gone from 4339.4 to 5960.7. That's a 37% gain. If we threw in dividends and franking credits (and we were conservative) then the gain would be over 50% for 31 months!

- That's an annualized return of 19.3%!

So if my optimism and my support for Obama's interventionist policies and the Fed's QEs that helped avoid a Great Depression re-run has also had the payoff of a 50% improvement in the index that we all benchmark off, then I say thank God for my positivity.

I'd also add (and I want The Prof to know this) that I don't like everyone and I'm not always positive. I think the unions need to get real about penalty rates. I think international companies are having a lend of us, with their profit-shifting to low tax regimes. I hate the plethora of negativity, spread by a lot of my colleagues in the media. I know many of them are doing it for front page headlines with their by-lines and ultimately to be used, if not for fish and chip wrapping, then to make baby disposable nappies more acceptable in the kitchen tidy!

**It's all in the timing**

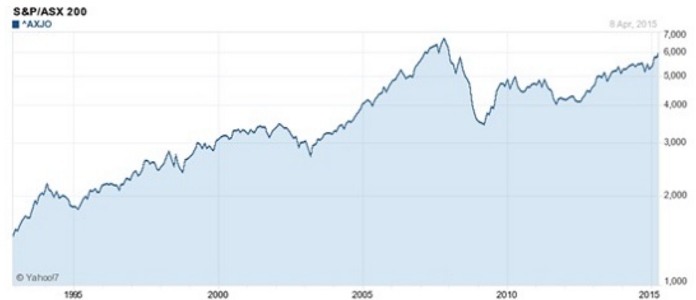
I keep saying that one day I'll turn negative. I hope for you and me I get the timing right. I do buy stocks that I'd be happy to ride a crash with and that I'd be happy to buy more of when their prices slump. But I did come across some interesting research this week from the team at Perennial Value.

They have created a LIC, which has derivatives connected to it to reduce the impact of a big sell-off, called Wealth Defender Equities while attempting to beat the index on the upside.

What John Murray, the MD, and his team have shown is that if you invested $1,000 for 30 years between 1982 and 2012 and you'd simply stayed in the market, you made $22,972 or 11% per annum. If you had perfect timing, your $1,000 went to $262,370 or a return of 20.4% per annum. But if you got out three months earlier, your $1,000 rose to $86,613 or 16% a year. If you got out three months later, your nest egg ends up at $90,804 or a 16.2% return!

So getting out late before a crash can be OK but it does mean you have to be able to work out the difference between a crash and a correction. That's another difficult part of my job description and your task as a DIY fund manager.

This chart shows there were some signals before the big crash of 2008 and there was a window after the first leg down in November 2007, where you could've got out with a smaller loss.




*Yahoo!7 Finance, 9 April 2015*

On November 1, 2007 the S&P/ASX 200 index had its highest close of 6828.7 and by November 23 it was at 6330.2, which was a 7% slide. You could have easily stayed in thinking this was another correction. By January 22, the index was at 5186.8 and you might have lost 24% and that's when you should have cut your losses, with hindsight or could you have hung in there?

Well, if you were really smart or courageous, you could've waited until April 28, 2008 when the index went to 5602.7, where your loss was only 17.9%.

In fact, if you could've hung in there until 19 May, the index went to 5949.40 and your loss was only 12.8%. If you missed this, it was all downhill from there until 6 March 2009, when the index stopped falling at 3145.50. That was a 53% loss of portfolio value, if your stocks match the index but it could've been worse!

That 24% loss by late January would've made you sick when you saw the 12.8% loss by May but after that, the 53% loss certainly made the 24% loss look positively loveable.

**Someone has got to do it**

Timing the market is hard. You're often out on the best days and in on the worst. Trying to work out whether a crash is a correction or not can be very expensive.

That's a part of my brief to help you. My preference

is to be out early and pocket my profit. Even doing that can be costly, as this bull market, because of the unusually low interest rates, could be a long one.

I know there are some crazy things going on with economies and interest rates but it has powered markets up and I couldn't afford to be wrong on what stocks could do for the right economic reasons. Many 'gurus' have done this and people have lost money, which I can say has not been the case with my calls since March 2009.

Being as right as I can be is my difficult brief, but hell, someone has to do it!

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Buy, Sell, Hold – what the brokers say

by Switzer Super Report

Analysts had a quiet short week, with only a few actions, including an upgrade for the ASX on the back of improved activity.

**In the good books**

**Credit Suisse upgraded ASX (ASX) to Neutral from Underperform.** Buy/Hold/Sell 0/5/3 March quarter stats show a strong result for ASX trading, with equities and derivative activity solid and rate cut expectations driving volumes, the broker notes. March is usually a quiet quarter for raisings but activity was solid in that space as well. Strong cyclical activity is providing a tailwind for ASX volumes at present and given dividend and valuation support, the broker has upgraded its rating to Neutral. But the broker continues to believe ASX faces structural headwinds over the next 2-3 years.

**Citi upgraded Oil Search to Neutral from Sell.** Buy/Hold/Sell 6/2/0 The recent underperformance in the share price means the stock is now trading below the broker's target and, as such, the rating is upgraded to Neutral from Sell.

**Credit Suisse upgraded Resmed (RMD) to Outperform from Neutral.** Buy/Hold/Sell 6/2/0 Credit Suisse has reviewed margins for the past three years and estimates the constant currency margin reported in the second quarter of FY15 was the highest in three years. With stronger volume growth forecast on the back of successful product launches the broker expects ongoing improvement in this margin.

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

**Macquarie downgraded Aristocrat Leisure (ALL) to Underperform from Neutral.** Buy/Hold/Sell 5/0/2 The broker likes Aristocrat's market leading products, recurring revenue and favourable A$ exposure, but the stock has run up too far. The broker sees headwinds in the form of a tepid US market, a greater than anticipated capex requirement and a fight-back from the competition.

**UBS downgrade BT Investment Management (BTT) to Sell from Neutral.** Buy/Hold/ Sell 1/2/2 While the March quarter flows and upcoming first half results should prove to be strong, UBS now believes earnings forecasts need to be re-based to realistic levels. Equity markets, currency and flows have driven the share price 47% higher in the year to date, outperforming Australian and UK peers by more than 20%.

*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.*

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Why you need to fly away with Sydney Airport

by Anna Kassianos

*Anna Kassianos is a senior analyst – materials and energy – with Australian equities manager Platypus Asset Management.*

**How long have you held Sydney Airport Holdings (SYD)?**

We initiated our position in November 2013 post Macquarie Bank's distribution of its Sydney Airport position to its shareholders (we have maintained a Macquarie Bank position since April 2013), and associated Sydney Airport Trust restructure. We topped up our position in May 2014 in anticipation of further RBA cash rate cuts and expectation for relaxation of the China-Australia flight caps under the new bilateral agreement.

**What do you like about it?**

We like Sydney Airport for continued international passenger growth, particularly from the large scale emerging opportunities of China and India, and increased patronage from up-gauging of flights to A380s. For example, post the free-trade deal between the Chinese and Australian governments, the new aviation agreement signed in January will enable tripled capacity on routes between China and Australia over next three years. Sydney Airport management is guiding 6.4% growth in distributions, with 100% coverage by net operating receipts. We are expecting 30% growth in net operating receipts by end 2017. Furthermore, Sydney Airport has successfully taken advantage of the low interest rate environment globally, and completed the last portion of bank debt refinance last year, with debt now 100% covered by bonds.

Sydney Airport also takes a very low risk approach to investment; spending $1.2bn capex over the next five years, with no single project more than 5% of the capex program, and it can be deferred in line with demand, if required.

**How is it better than its competitors?**

Its ASX listed airport infrastructure peer, Auckland International Airport (AIA) fails to compete on commerciality metrics. Further, in Asia Pacific Sydney Airport stands out as the best, with 82% EBITDA margin in 2014, while its peers trail at 23-53%. It has a 14.4% ROCE (return on capital employed) in 2014 against its peers at 6.9 to 12.7%.

**What do you like about its management?**

Sydney Airport management have got the balance right, with a focus on delivering growth by offering an enhanced passenger experience, but not compromising shareholder distribution growth or balance sheet strength. Management is focussed on sustainable growth, and recently committed to the Global Reporting Initiative's G4 guidelines, becoming the first Australian airport to commit to annual sustainability reporting, despite it not being a requirement.

**What is your target price?**

Our target price is $8.50 a share. However our valuation has the opportunity to be refreshed if Sydney Airport exercises its right to participate in Sydney's second airport to be located in Western Sydney's Badgerys Creek. Despite several iterations, bipartisan support is now clearer for a Western Sydney airport versus 10 years ago. We see management trying to add value during the current consultation phase with the government, and at the same time make sure there is no cannibalisation of Kingsford Smith Airport patronage; focusing on appropriate charges to ensure sufficient demand, but balanced out against cost recovery.

**At what point would you sell?**

Given Sydney Airport is committed to EBITDA growth ahead of passenger growth; a decline in EBITDA growth would be considered a reason to sell. We see downgrade risk as a low probability, with 2.1% year-on-year international growth in February 2015, and 1.7% International passenger growth to date in CY15. A further risk is participation in a sub economic development of Sydney's second airport – which is low probability, given we don't expect management to breach their internal ROI hurdles which has supported their historical growth and balance sheet strength. More importantly, we will continue to monitor the threat of rising cash rates globally, as we expect this will push investors to shift away from yield investments. We see this risk continues to be more skewed toward a standstill or easing bias globally, given the poor US payroll numbers out on 3 April 2015, but also RBA's surprise easing in February 2015 and the strong likelihood for follow-up by a further cut or cuts, respectively.

**How much has it added (subtracted) to your overall portfolio over the last 12 months?**

It has added 20 basis points performance over past 12 months, to end March 2015.

**Sydney Airport**

*Source: Yahoo!7 Finance, 9 April 2015*

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Trustees united will never be defeated!

## by Tony Negline

***Key points***

- *There are enough SMSFs in Australia to change the outcome of an election. We need to use our collective power to get a fair outcome.*
- *Spend 30 minutes to write to the Prime Minister, the leader of the opposition, and your Federal member.*

The time has arrived. I have to admit that the attacks have happened sooner than I expected and action must be taken.

What am I talking about? Anyone involved in SMSFs must man the barricades and let the political class and the fourth estate know that we're not going to take tax hikes or other nasties.

There seems to be a ground swell against the tax-free nature of super post age 60 and a readjustment of the aged pension income and assets tests. The vast majority of people impacted by the floated changes are middle income earners who have paid tax throughout their working lives.

**The attack**

Recently ASFA – an industry lobby group that mainly represents large super funds – produced information about the estimated 200,000 who have superannuation account balances of more than $1 million.

ASFA argues that "Once a person has accumulated enough superannuation savings to generate an income that will fund a comfortable lifestyle in retirement [which ASFA estimates at December 2014 at $58,000 for a couple per annum] it's arguable that they no longer need the same tax incentives in place to incentivise them to accumulate further savings and to support the achievement of adequate retirement savings."

It argues that account balances in excess of $2.5 million that are in pension phase, "should be the starting point for discussions around ensuring the future equity and sustainability of the system."

In other words the return of Reasonable Benefit Limits that Costello's Better Super changes removed!

What is ASFA's data source? Primarily the ATO's SMSF data because equivalent data for APRA regulated funds isn't easily obtainable. I'm sure ASFA wouldn't want to be accused of targeting SMSFs.

**The action plan**

So what's to be done?

At its simplest you only need to spend 30 minutes.

Here's what I encourage you to do – write short simple messages or emails to the following:
1. Prime Minister
2. Opposition Leader
3. Treasurer
4. Shadow Treasurer – chris.bowen.mp@aph.gov.au
5. Assistant Treasurer
6. Your local Federal Member – simply search for them on the internet

Keep your note short and simple. Here are some ideas that you need to put into your own words:

- You run a SMSF – there are over 1 million

members of SMSFs throughout Australia most of them are adults [yes they'll read between the lines that you mean voters]
- If you're still working – you're working hard to save for your retirement in the government's appointed savings vehicle (superannuation) so you have as little impact on the government's finances when you retire. To do this you're foregoing spending money now. You have paid considerable tax all your working life and will do so until you retire. Once you retire your pension will be spent directly in the productive economy
- If you pay the higher income earners super contribution tax – mention that your super contributions face an additional 15% tax which the media never talks about but this must be factored in any decision the government makes
- If you're retired – you worked hard and saved to be as independent of the government as possible. You paid taxes all your working life. Pension income paid from your super fund goes directly to the productive economy
- Most important point – you're a voter and any adverse changes made to SMSFs, super in general and unfair adjustments to the age pension income and assets tests will help determine how you vote.

Please don't expect anyone else to do this work for you. There are enough SMSFs in Australia to change the outcome of an election. We need to use our collective power to get a fair outcome.

The forces against those who have saved and worked hard are powerful. We need to act together!

**Some strategies to improve your position**

Finally all these policy ideas about penalising account balances above a certain limit tells me that you need to be working on splitting your super with your spouse (if you have one).

I think taking action now would be a sensible idea and I'll present some ideas to achieve this objective next week.

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# How to spot a dud retailer

by Roger Montgomery

A discretionary retailer has a life cycle that is reasonably (but not 100%) predictable. This allows investors to form a view of the future, and hence, determine a valuation. The complexity of some businesses on the share market would make any projections meaningless, and when you are unable to make confident assumptions, how can you confidently invest?

With this in mind, retailing as a business model is really dependent on just a few key metrics. How many stores does the business have open? How many stores can be opened? How much can sales grow within each store? And, can margins be maintained?

This may seem simple, but understanding these main drivers of a retailer can be powerful in forming investment decisions. When these key metrics align positively, it often translates into strong earnings and hence a positive share price response. The reaction can be just as powerful in reverse, due to high fixed costs and operational leverage. Carefully watching these metrics can therefore help an investor capture the upside and potentially avoid the downside.

**The Kathmandu example**

An ideal case study to demonstrate this framework is Kathmandu (ASX: KMD), the specialty retailer of outdoor gear and clothing.

Over 12 months ago, Kathmandu was operating 139 stores in Australia and New Zealand. The first-half of 2014 was tracking very well – sales in existing stores were up 5.4% in constant currency terms, the gross margin had expanded to 63.9% and management upgraded the store rollout target from 170 to 180.

With potential sales growth of 30% from store openings alone, the market was forecasting a bright future, implied by a rising share price.

Fast forward to today, and a profile of the company has completely inverted. At the most recent half-year result, gross margins had declined to 59.3%, sales within stores are declining, and management has lowered the store rollout plan. With the share price subsequently halving, what could you have done to pick up the signs of an impending decline?

The issues appear to have emerged when Kathmandu announced in 2014 that its winter promotional campaign was weaker than expected due to warmer, drier and sunnier weather. As a specialist seller of outdoor clothing, Kathmandu is not immune to seasonal fluctuations, and in isolation the performance could be viewed as cyclical.

It's important to understand that a poor promotional campaign may not be isolated to a particular period. If a retailer is forced to discount aggressively to clear excess stock, this can draw forward demand from future periods. The flow-on effects from the weak-winter period were well-publicised by management in the subsequent full-year result. From the surface, it would have been difficult to determine if the underperformance was more than cyclical.

**The signs**

It was a trading update in December 2014 that indicated the problem was more than cyclical. Not only had the winter promotion disappointed, but the Christmas promotion in Australia was below expectations. At this point, the red flags have well and truly been raised. One poor season is not enough to make a trend, but subsequent periods of underperformance should necessitate a review of the operating assumptions.

The most important consideration for any retailer is the value of its brand. Kathmandu's business relies on pricing quality products high, then offering discounts during key trading periods. If poor inventory

management or intensifying competition forces Kathmandu to pursue more aggressive pricing strategies, then Kathmandu may lose the connection with its core market that are happy to pay a premium. This could result in lower store growth, lower sales growth, lower margins or a combination thereof.

Kathmandu went on to report a disappointing first-half 2015 result, but it was the commentary by management that was most troubling. Management was unable to confirm if the falling sales were cyclical or structural, and commented that consumers appeared to be waiting for more aggressive discounting before making a purchase.

It is an inopportune time for Kathmandu to assess its business model because its currency hedges are beginning to roll off. Kathmandu purchases the majority of goods in US dollars and while earnings have been protected for the past 12 months, it will be difficult for the company to pass on higher costs to the consumer while resolving its discounting strategy.

An intimate understanding of a retailer's operating metrics can afford investors with the confidence to value a company's prospects. But these metrics can change quickly, and unless you have a keen awareness of a company's performance and its drivers, the share price may not work in your favour. Which is why first and foremost, it pays to stick to simple businesses that we can understand readily.

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# The likelihood of super changes getting up

by Questions of the Week

**Question: What do you think the chances are of Scott Morrison's support for a tightening of pension entitlements getting up? My understanding is that both ACOSS and Morrison think a couple with $800,000 in assets outside the home is "wealthy," whereas such a couple may well be earning less than the pension. How does such an approach encourage people to sacrifice now in order to build up their superannuation for the future?**

**Answer (By Paul Rickard):** I think there is a good chance that there will be changes. It seems to have broad political support – and can probably be done without antagonizing too many voters. It is also such a complex area – very hard for the public (and media) to follow the debate and implications.

3 areas are being considered:

a) the exempt amount before the asset test starts (for both homeowners and non- homeowners);
b) the taper rate – currently $1.50 for each $1,000 – however was $3.00 back in 2007;
c) as a corollary to (b), the threshold at which any entitlement to a part pension ceases.

My guess is that (b) is a starter – not sure whether they want to cut that hard into the exempt amount and jeopardise some pensioners losing their entitlement to a full pension.

Also, it is very unclear as to a possible start date (post next election?) and/or grandfathering for existing pensioners. (See Tony Negline's article today for what SMSF trustees can do about talked about changes.)

**Question 2: I have Euro funds in Europe. I want to bring the funds back to Australia in the next few months. Do you think the Euro rate will improve against the A$, or should I bring the funds in now?**

**Answer 2 (By Paul Rickard):** In the medium term, I think the Australian dollar will weaken against most currencies. It is holding up very well against the Euro – however, this has been due to Euro weakness arising from the QE programme.

I would expect a re-test of the 0.70 Euro level (1 A$ buys 0.70 Euro). In the short term, it is hard to forecast, but err on the side of expecting Aussie dollar weakness.

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# Don't miss this!

Paul Rickard and I give you the latest monthly market wrap for March in this Super Sessions update.