Switzer Super Report

Thursday, 23 July 2015

Happy days

It has been a big week for Australian banks with APRA now requiring them to increase capital requirements for residential mortgages. Charlie Aitken says the worst of the tough ride for banks and their shareholders is now over and looks like good value, but he has another surprise overseas sector to reveal.

If you invested in yield stocks in 2011, you might well be pleased with yourself today for having such foresight, but what does the future hold for them? Ron Bewley investigates. In today's *Fundies' Favourite,* what do the lower Aussie dollar and cold weather have in common? They both work to the advantage of Amalgamated Holdings, explains David Aylward.

In *Buy, Sell, Hold – what the brokers say*, with a potential acquisition in the works, brokers downgraded Energy Developments and upgraded the acquirer, DUET. And in *Questions of the Week*, we answer reader queries about the unlisted property sector and reveal three reasons to hold BHP.

Sincerely,

Peter Switzer

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Contrarian value locally and abroad

by Charlie Aitken

No doubt, global and domestic equity markets remain volatile. A nice relief rally on the back of Greece can being kicked down the road again, followed by another pullback driven by US quarterly earnings disappointment.

As I look around global markets for contrarian value, there are two sectors I think look good value and have bottomed. I hope you're sitting down: China H shares and Australian banks.

In a world where value is hard to find and many, many stocks are priced for perfection, I think the deep correction in China H shares and Australian banks is offering a clear contrarian medium-term value opportunity now that the trading knife has stuck.

My fund has started building positions in both China H shares and selected Australian banks, feeling both offer the right risk adjusted value proposition right now. Of course, these sectors won't be without short-term volatility, but we think the very worst of that volatility is behind us in both these sectors.

Today I want to focus on the Australian banks because I suspect they are near and dear to all *Switzer Super Report* subscribers' hearts.

With the big four banks dominating the ASX200 index, they do attract a disproportional amount of broker and financial press commentary. Fair enough, so go the banks so goes the ASX.

This week there was a regulatory development that was genuinely "non-negative" for the Australian banking sector. In fact I believe it was a classic "short-cover the fact" or "buy the fact" event and that is exactly what I did in my fund.

No doubt the key reason for the -20% Australian bank correction was regulatory risk. Markets hate uncertainty and the "certainty" on regulatory capital this week confirmed by APRA was in my view the end of "uncertainty" for the sector. The fact the outcome was "less worse" than every analyst had forecast was an added bonus.

I think it's important I explain exactly what did happen this week.

The Australian Prudential Regulatory Authority (APRA), the bank regulator, confirmed an increase in the capital requirements only for residential mortgages under the IRB approach. However, APRA's announcement of a 25% mortgage risk weight was below analyst expectations of 30% and at the low end of the range recommended by the Financial Services Inquiry (FSI) of 25% to 30%. The outcome appears in line with the Basel Committee's current thinking on global capital adequacy.

The higher risk weight will apply to all residential mortgages other than SME lending secured by a residential mortgage and will come into effect on July 1 2016 to ensure an orderly transition.

The good news for bank shareholders is that, in my opinion, bank share prices were already discounting the 30% increase scenario. That was consensus and fears about capital raisings were weighing on bank share prices. My view remains that Australian banks will not need to raise external capital but will simply fund the extra capital requirements via dividend reinvestment plans (DRP).

NAB post their recent capital raising should NOT require any DRP. We feel ANZ will need just one underwritten DRP to raise $2b (give or take Esanda sale receipts), while WBC recently raised $2b and will most likely raise another $2b via DRP. CBA will confirm at its August result its intentions but again we feel an underwritten DRP (or maximum 2) will see it

raise $4b. All in all, it's a very manageable position for the banks to handle in the medium-term.

For Australian investors who can value franking credits, I believe grossed up yields above 8.00% more than compensate you for taking the risk of owning bank equity. Cash rates are certainly not going up in Australia, in fact I forecast further cuts, which would make these bank dividend yields even more attractive relatively and absolutely.

Below is a summary of current major and regional bank investment arithmetic.

	Mkt Cap	Price / Book (x)		PE (x)		Yield		ROE		EPS growth	
	($bn)	2015e	2016e	2015e	2016e	2015e	2016e	2015e	2016e	2015e	2016e
BANKS											
ANZ	90.7	1.7	1.6	11.9	11.3	5.7%	5.9%	15%	14%	4%	5%
CBA	143.2	2.7	2.5	15.8	15.1	4.8%	5.0%	18%	18%	4%	4%
NAB	90.2	1.6	1.5	12.4	13.1	5.8%	5.8%	14%	13%	26%	-6%
WBC	110.1	2.0	1.9	13.8	13.3	5.4%	5.7%	16%	16%	2%	4%
BEN	5.9	1.2	1.1	13.4	12.9	5.4%	5.7%	9%	9%	5%	4%
BOQ	5.0	1.4	1.3	13.6	12.6	5.6%	6.0%	11%	12%	10%	8%
DIVERSIFIEDS											
MQG	27.9	2.3	1.8	16.6	15.7	4.0%	4.2%	14%	13%	31%	6%
SUN	18.2	1.3	1.3	15.3	13.1	6.9%	7.1%	9%	10%	-9%	16%

Click here for larger image

FY16 price to book ratios and dividend yields appear attractive to me and the greatest share price upside lies in ANZ and NAB in my opinion.

Not many people have noticed, or perhaps they have, but industry leader CBA has bounced $7.00 (+9%) off recent capitulation lows. CBA will pay their final dividend in August, while the other three banks will pay dividends in October/November.

Personally I think the chart below tells you that ANZ and NAB will now start playing performance catch up to CBA.

The last few months have been a tough ride for Australian banks and Australian bank shareholders. My view is now the worst of that is over and it's time to pick up the vibrating knife, which has stuck in the value and yield support floor.

My final point is the hedge fund community has been short the major Australian banks and the Australian dollar. For the first time in many, many years that short Australian bank trade worked in Australian dollar terms. I believe that this successful short has now run its course in Australian banks and I expect to see some short-covering over the next few weeks as it becomes a more consensus view that the worst is over for the sector due to regulatory certainty arriving.

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Yield stocks will continue to yield but further capital gains might be limited

by Ron Bewley

Key points

- *A person who invested $100 in an index made up of 'high-yield' stocks at the start of 2011 would have made just over 40% more than a person who invested only in an index made up of all other stocks.*
- *But going forward, the future for high-yield stocks might not be as good as the historical long run.*
- *An investment in overseas equities – via the unhedged ETF representing the S&P 500 (IVV) – has paid off over the past six months.*

Following the February/April bubble in the four high-yield sectors (financials, property, telcos and utilities), the relative outperformance to the seven other sectors fell by nearly 5% points.

High-yield delivers to date

However over the long-term, they are still well ahead and I conducted the following experiment with indexes to illustrate.

To construct Chart 1, I made up two new indexes (one for 'high yield' and one for 'other') from the 11 sectors using market cap weights. I did the exercise for both the standard price index and also the accumulation index – which includes re-invested dividends but not franking credits. I then took the ratio of the two price indexes and then the two accumulation indexes scaled to be 100 at the beginning of 2011.

Chart 1: Relative outperformance of ASX 200 High-Yield sectors

Source: Thomson-Reuters Datastream & Woodhall Investment Research

The accumulation index ratio in red is just above 140, meaning that a person who invested $100 in the 'High-Yield' index at the start of 2011 would have made just over 40% more than a person who invested only in the 'Other' index. At the right hand side of the chart, you should see that, after peaking at just above 140, the red line fell to just over 135. This fall represents a relative loss for High Yield compared to the Other index.

However, the High-Yield index has rallied back to take the red line very close to the recent peak. In other words, investors who had held their ground in recent months made a sensible decision.

Other sectors might perform better from here

But going forward, it follows from Table 1 that my usual broker-based sector forecasts suggest that the future might not be as good as the long-run trend in Chart 1 indicates. With exuberance at +1.1% (over-priced by 1.1%), the High-Yield index is very close to fair pricing. The forecast yield is good at 5.1%, excluding franking credits, but the forecast capital gains (adjusted for exuberance) are only +3.6%.

Table 1: 12-month-ahead sector forecasts of exuberance, yield and capital gains

	12-month forecasts			
Sector	Exuberance	Yield	Adjusted cap. gain	Index weight
High-Yield	1.1%	5.1%	3.0%	58%
Other	-3.1%	3.6%	15.1%	42%
ASX 200	-0.9%	4.5%	8.3%	100%

Source: Woodhall Investment Research; at close 20th July 2015

On the other hand, the other sectors are quite cheap (-3.1%) and the adjusted capital gains are very strong at +15.1%. The ASX 200 is close to a simple average of these two aggregated sectors since they are now similarly sized (58:42).

These relativities in forecast capital gains and yield forecasts explain in part why my latest Hybrid Yield-Conviction portfolio system selected five of the 12 stocks from the 'Other' sectors – Santos (STO), CSR (CSR), Sydney Airport Holdings (SYD), Transurban Group (TCL) and Tatts Group (TTS). Except for CSR, I hold these 'other' stocks in my portfolio that I last rebalanced in March.

Of course, the August reporting season may tell a lot about the appropriateness of this allocation when it comes to my next six-monthly rebalance in September.

The offshore view

For my own SMSF, I am considering raising my investment in overseas equities – specifically in an unhedged ETF representing the S&P 500 (IVV). I first invested in IVV in early December 2014 – an allocation of 18% – and raised my stake to 38% in March, based on my analysis and expectations of a weak Australian dollar.

My early December 2014 tranche has made a capital gain of about 15% in just under eight months and the March tranche has gained about 6.5% in five months. My latest analysis suggests my raising my stake in IVV even further – and that work does not take into account certain reputable forecasters pencilling-in end of year forecasts of 62c to 70c – would greatly add to my gains if these currency forecasts are even remotely correct!

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

UBS upgraded DUET Group (DUE) to Buy from Neutral. The prospect of DUET's acquisition of Energy Developments (ENE) are positive in the broker's view. Not just financial synergies but gearing metrics should improve. DUET will inject around $150m in cash, which should lift Energy Developments credit rating to investment grade, in the broker's opinion. UBS lifts distributions to management's guidance and expects cover should improve post the acquisition.

In the not-so-good books

Credit Suisse downgraded Energy Developments Limited (ENE) to Neutral from Outperform rating. DUET (DUE) has offered $8 a share and entered into a scheme of arrangement. Credit Suisse considers the bid is a good price after a strong 12 months and there is a high probability of it succeeding.

Macquarie downgraded iSentia Group Limited (ISD) to Neutral from Outperform. The broker expects iSentia to beat its FY15 prospectus forecast through a strong performance in Australia and New Zealand, with Asian earnings remaining in line. Strong cash flow will reduce net debt and the broker expects a final dividend increase above the interim. iSentia has nevertheless strongly outperformed the ASX Small Industrials over the past 12 months so while raising its target to $3.81 from $3.50, the broker pulls back to Neutral.

Deutsche Bank downgraded Transfield Services Limited (TSE) to Hold from Buy. Deutsche Bank continues to believe in the company's transformation and expects a strong FY15 result but downgrades its recommendation to Hold from Buy. Target is lowered to $1.56 from $2.03. Downside risks are envisaged to FY16-18 forecasts and the broker is concerned the amount of cost savings that will fall to the profit line. FY16-18 forecasts are downgraded 1-4%.

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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A night out with Amalgamated Holdings (AHD)

by David Aylward

Key points

- *The lower Australian dollar, which will help in-bound tourism, is an important tail wind to Amalgamated Holdings' collection of leisure and accommodation assets.*
- *It has a no-nonsense managing director in David Seargeant.*
- *Tribeca Investment Partners' valuation sits at around $14 but if the A$ were to fall further, this may well go up.*

David Aylward is managing director and portfolio manager at Tribeca Investment Partners.

What do you like about it?

Amalgamated Holdings (AHD) has a fairly diverse range of business units, each of which we see as being competitively well placed within their sector, either through being a market leader, or operating as a significant and innovative player within a market niche. The large film exhibition business is specifically benefiting from a more appealing crop of content that has got people going back to the movies for a night out. Within the hotel brands, there are some new offerings within the suite of brands coming online and we think these will be well received. However from a more macro perspective, the lower Australian dollar will positively impact on in-bound tourism and we see this as an important tail wind to Amalgamated Holdings' collection of leisure and accommodation assets. Finally, the recent blast of cold weather we have had should benefit this firm's investment in the Thredbo Ski Resort.

How is it better than its competitors?

Being something of a mini conglomerate, the answer here differs from business to business. However, as an overriding observation, it is the combination of keen property acquisition, management and development skills that are combined with a very customer centric understanding of what is expected in the offerings that are ultimately taken to the market. A key example of this is the way they have skewed the cinema offering towards a premium experience.

What do you like about management?

David Seargeant is a fairly no-nonsense Managing Director. His tenure in the position is quite long and in this instance, we like the experience this brings in allocating capital across, and leading, a somewhat diverse range of brands. Importantly, the team working with David has demonstrated a keen understanding of their various customer sets.

Price target

Our valuation sits at around $14 but if the A$ were to fall further, this may well go up.

At what point would you sell?

Beyond significant price appreciation beyond our valuation, there is an element of key person risk among the very senior executive team so material changes here would be cause for concern.

How much has it added?

The stock has added 23 basis points to portfolio performance in excess of the market over the last 12 months.

Is it liquid?

Liquidity can be an issue as it is quite tightly held. That said, with a patient approach and realistic price objective, stock can be moved.

Where do you see value?

It is a stock that tends to fly under the radar a little. While they are clever with their branding operationally, they don't focus too much on promoting the stock price. We like that and it means that as results continue to be posted, the stock price will be rewarded for consistent growth. We believe much of the untapped value lies in the fact that most of the hotel assets are in the books at cost. With well-targeted reinvestment, the real worth of these assets is likely considerably greater than is indicated in the accounts. Finally, there is an attractive dividend yield that is covered by cash earnings.

Amalgamated Holdings (AHD)

Source: Yahoo!7 Finance, 23 July 2015

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The unlisted property sector, and three reasons to hold BHP

by Questions of the Week

Question: What is the justification for holding BHP shares? I have had these for quite a significant time and have lost money? Why should I continue to hold these?

Answer (by Paul Rickard): This is a really good question, particularly following yesterday's BHP operational review. This foreshadowed production decreases in FY16 in four key commodities:

1. Petroleum by 7%
2. Copper by 12%
3. Metallurgical Coal by 6%
4. Energy Coal by 2%

Iron Ore is forecast to grow by 6%, with BHP's share of production in FY 16 rising to 247m tonnes.

Why keep BHP? I think there are three reasons to consider:

1. History shows that commodity cycles, in particular the extent and duration of the upswings or downswings, are largely unpredictable. Clearly, we are in a downswing in commodity prices at the moment – how much further this goes, and how long it lasts, is the $64 question. Keeping some exposure to BHP now offers this upside potential.
2. Of the commodity majors (and in Australia, it is really only a choice between BHP and RIO), my preference is BHP, due to a broader mix of commodities (RIO earns more than 90% of its revenue from iron ore – I think this has material over-supply issues); and
3. BHP has made a commitment to pay a sustainably increasing dividend. If commodity prices continue to fall, this commitment may be seriously challenged – so take this into account, however on paper, BHP will be yielding around 6.4% – fully franked! A possible income stock!

Question: One of your readers recently reported on her SMSF investment strategy, which includes >50% in unlisted property trusts. Our advisers have recommended we buy commercial property, but we don't have the time or expertise to do this.

We do have some shares in the listed property sector, but these are obviously subject to the vagaries of the market, hence in principle, unlisted property seems like a good option for us.

Have you had any recent short reviews/recommendations/suggestions of the unlisted commercial property sector, and if not, can you please do one soon?

Answer (by Paul Rickard): Thanks for the question.

Most of the unlisted property trusts are building or property specific, and are close ended. That is, they raise the money for a property upfront, and then are closed to any further subscriptions.

In theory at least, unlisted property trusts are subject to the same vagaries of the market as listed property trusts – they just aren't as transparent and there is no observable market price.

Typically, unlisted property trusts will be priced at a discount to listed property trusts (higher capitalisation rate and higher distribution yield), because there is no or very limited liquidity, and usually, you have single asset risk. Listed property trusts tend to have multiple assets.

If you are interested in unlisted property trusts, I would get on the mailing lists of some of the larger managers – and then consider opportunities as they arise. Consider managers such as Centuria, Charter

Hall, Stockland etc.

I have attached a link here for an earlier review for a fund for Centuria (now closed).

Hope this helps.

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