Switzer Super Report

Thursday 20 August 2015

From dusk till dawn

It's been a tough month for Australian equities, but as Charlie Aitken writes today, that's no reason to sell out and move on. It means it's time to get good quality stocks at cheap prices – a message I've been espousing for a very, very long time. Like I said on Monday – we've probably got at least another 12 months to buy on dips.

Also in the *Switzer Super Report* today, we've got four gaming companies to bet on from Tony Featherstone. There's a casino boom going on, which means it's time to take another look at some of these companies.

In *My SMSF,* Stephen Hogg explains why insurance was a big reason for starting up his SMSF, and in *Buy, Sell, Hold – what the brokers say*, Crown, Fortescue and Woodside were all upgraded.

Sincerely,

Peter Switzer

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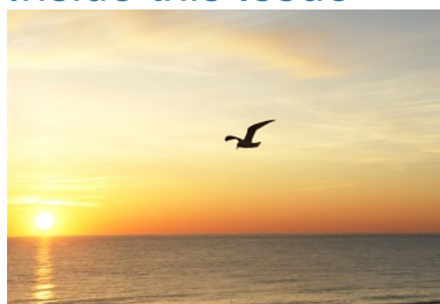

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It's always darkest before the dawn

by Charlie Aitken

Key points

- *At the worst point this month, the benchmark S&P/ASX 200 was down 7%. There have only been five months in the last 15 years when the S&P/ASX 200 has dropped more than that in a single month.*
- *If you want income, there is no answer in cash or fixed interest. You have to take a risk in the right equities.*
- *If we pay too much attention to the index itself we will miss stock-specific opportunities. The index is really just a broad measure of short-term sentiment.*

It's certainly been a very bad month in Australian equities, but I suspect most readers don't realise just how bad.

At the worst point this month the benchmark S&P/ASX 200 was down 7%. To put that in context, there have only been five months in the last 15 years where the S&P/ASX 200 has dropped more than that in a single month.

The move this month is two standard deviations away from the mean monthly return from the S&P/ASX 200 over the last 15 years.

In recent weeks I had warned readers to "keep their powder dry" and wait for a better buying opportunity under 5400. The S&P/ASX 200 saw a low of 5303 on Tuesday afternoon.

Motion sickness

The speed of this month's fall has been staggering. It's been faster and deeper than I forecast and that is why I have been taking advantage of these low prices for my fund this week.

It's fair to say the S&P/ASX 200 has been hit with the perfect storm of negative events this month, but in reality some will prove positive in the medium-term.

I feel more were "liquidity events" rather than "fundamental events", and history has told me to take advantage of liquidity events.

The biggest factor hasn't been China, it's been the ANZ and CBA capital raisings. There is absolutely no doubt in my mind that the vast bulk of the correction in August has been driven by the bank capital raisings, both directly and indirectly.

Obviously equity raisings have a direct effect on the company raising equity and its peers. That's why the ASX Banks Index is down 9.3% this month, more than the grossed up prospective annual yield of the sector.

But the scale of the bank raisings and their weightings in the index has an effect on the ENTIRE market. We have seen clear "funding pressure" right across the market but I now expect that funding pressure to ease.

Find opportunities under pressure

Two stocks I bought for my fund that were clearly under "funding pressure" selling were Telstra (TLS) and Goodman Group (GMG). Both are cum final dividends and both, in my opinion, reported solid full-year earnings. I think both stocks look solid on a 13-month prospective, remembering if you buy them today you get the final dividend and the next two dividends, generating a solid 13-month income return if nothing else.

I've tried to focus on buying ASX stocks that offer dividend growth or dividend reliability during this pullback. That includes the major banks because I

believe the risk to the RBA cash rate remains to the downside and Australian 10-year bond yields are 2.68%. If you want income, there is no answer in cash or fixed interest, you have to take a risk in the right equities.

But where we are now, I see the potential not only for high-dividend streams in the right industrial equities, but also the potential for capital growth.

At the end of the day, while bank capital raisings do cause short-term share price weakness, the ultimate result is stronger banks in terms of capital ratios. That is a good thing. Banks come out the other side of these stronger entities, and that is a point worth remembering.

I was on Peter's TV show on Monday night and we had a good discussion about markets. While I don't think the S&P/ASX 200 is going back to 6,000 in a hurry, I remain of the view this is an opportunity to deploy capital in high-quality industrials at the right risk-adjusted entry prices.

I tend not to worry about the index itself, I tend to focus on stocks. It is a market of stocks, not a stock market. If we pay too much attention to the index itself, we will miss stock-specific opportunities. The index is really just a broad measure of short-term sentiment. In reality "index corrections" provide you with stock specific opportunities and that is what I am trying to get through to investors in this period.

Obviously that is what I am doing for my fund too. We came into this period cashed up, we have protected capital, and now it is time to deploy it in the right stocks at the right price.

I want to finish today with exactly the same advice I wrote last week. This advice is probably even more valid than it was last Thursday. There are times in writing investment strategy to repeat yourself. This is one of them.

Still buy in gloom

But we must all remember that the idea is to "buy in gloom". There may well be some more gloom to come in the next few months, but the hardest thing to do is to actually buy in gloom.

The way I approach periods like this is firstly to have some cash stockpiled, but secondly identify individual stock price levels where I would be happy to buy a given stock. Whether that level is based off valuation, PEG ratio or prospective dividend yield, I do like to pick levels where I'd be happy to add to holdings or initiate a new holding.

I think this approach is useful to individual investors/SMSFs as well. The hard bit is actually buying the stock when it gets to the price level you like. I can guarantee you that when the price reaches the level you have identified you will have second thoughts about buying the stock because at the time the world/markets will seem quite ugly.

Yet you will need to be brave and pull the buy trigger. As I say, it's hard to do, but it's the right thing to do for investors with more than a one-day investment horizon.

In the meantime, make sure you take up you your CBA rights. The ONLY question you need to ask yourself about the CBA rights issue is whether you want to buy CBA shares at $71.50. That will turn out to be "free money" just like the NAB rights issue was. Forget the ANZ debacle. That was rushed and mispriced and also included an earnings downgrade. The ANZ post deal performance shouldn't put you off taking up CBA rights. In fact, what the ANZ debacle did to the sector and CBA itself means the CBA rights issue is effectively a discount to a discount.

It's always darkest before the dawn….

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4 gaming stocks to bet on

by Tony Featherstone

Key points

- *As billions of dollars are invested in casino developments, long-term investors who are comfortable with the ethics of gambling should look closer at gaming stocks. Their operational performance is improving and some offer better value after recent price falls.*
- *Crown and Echo Entertainment are the big players, but pokie machine manufacturer, Ainsworth Game Technology, stands out among smaller gaming stocks, principally for its growing overseas footprint.*
- *Donaco International is a small cap stock for the speculators. It owns the Lao Cai International Hotel in Vietnam and has acquired the Star Vega Resort & Club in Poipet, Cambodia.*

"Follow the smart money" is a useful investment maxim. In gaming, that means following the biggest casino development boom in Australian history and positioning portfolios to capitalise on rising Asian and local demand for integrated resorts.

As billions of dollars are invested in casino developments, long-term investors who are comfortable with the ethics of gambling should look closer at gaming stocks. Their operational performance is improving and some offer better value after recent price falls.

The lucky country

Sydney, of course, is leading the casino charge through the massive Barangaroo development on the CBD's western edge. Crown Resort's proposed $2-billion hotel, casino and apartment complex, due to open in late 2019, will be Sydney's second legal casino and create a global international gaming precinct with The Star casino in nearby Pyrmont.

The Star's owner, Echo Entertainment Group, in July pipped Crown for the right to develop the giant Queen's Wharf integrated resort in Brisbane. An Echo-led consortium that includes two Asian companies will develop a project that could add $4 billion to Queensland's economy.

As part of the Queen's Wharf Proposal, Echo is building a Tourism and Hospitality School on the Gold Coast, and a $345-million redevelopment of its Jupiters Casino, which is underway, will be ready for the Commonwealth Games there in 2018.

The Star has had a substantial makeover. An $870-million refurbishment between 2009 and 2013 added new restaurants, bars and event spaces. The pay-off has been The Star's improving operational performance, evident in Echo's latest full-year result.

Skycity Adelaide, owned by New Zealand's Skycity Entertainment Group, is also being expanded as the city is transformed with a larger convention centre and other big developments. The redevelopment is expected to cost about $350 million.

Crown Perth, at Burwood, is getting a $568-million expansion. A new 500-room, six-storey hotel, due in 2016, will give Crown a bigger presence in the west.

I could go on with other regional or Asian casino developments. The point is clear – casino operators are getting set for the coming boom in Asian tourism, which the *Switzer Super Report* outlined this month, and for Australian population growth. As Sydney and Melbourne's populations swell, more people will want to live, work and play in the one precinct.

Investors need to ask whether the valuations of Crown, Echo and Skycity (dual listed on ASX) have captured the upside. Or if smaller players, such as Ainsworth Game Technology and Donaco

International, focused on Southeast Asia, offer value.

1) Crown Resorts

Crown is tricky. It has fabulous assets in the Crown Entertainment Complex in Melbourne and Crown Perth; a third interest in the Nasdaq-listed Melco Crown Entertainment, which has assets in Macau; and smaller investments in offshore casinos and online betting.

But it has fallen from a 52-week high of $16.47 to $12.40, principally over fears that China's crackdown on government corruption is hurting the VIP gaming segment in Macau. Crown's debt position and potential pressure on its credit rating is an emerging concern for bond investors, although Crown seems to be managing its debt position adequately.

James Packer's retirement this month as Crown chairman surprised investors, although he remains a director and is expected to retain his executive role.

Crown reported normalised underlying earnings (EBITDA) for 2014-15 of $824.9 million – below market expectation. Beneath the weak headline result was a better-than-expected performance from Crown's Australian operations and better VIP revenues.

Of 12 analysts who cover Crown, five have a strong buy or buy recommendation, six have a hold, and one a sell, according to consensus estimates. A median share price target of $15.50 suggests 25% upside for Crown from the current price.

Crown has excellent long-term prospects and it is likely the market has overreacted to weaker VIP revenues in Macau. However, it is hard to find a short-term re-rating catalyst to turn Crown shares sharply higher this year. Better news from Macau, an obvious catalyst, seems less likely, for now, and the devaluation of China's currency could weigh on outbound tourism.

My sense is Crown will get cheaper before it recovers. But it is approaching value territory. Chartists will watch if Crown holds important price support around $12.

Chart 1: Crown Resorts

Source: Yahoo

2) Echo Entertainment Group

As Crown weakens, Echo has raced from a 52-week low of $3.08 to $5.10. In addition to its flagship The Star and Jupiter's Casino on the Gold Coast, Echo operates the Treasury Casino and Hotel in Brisbane. It divested the Townsville Jupiters Hotel and Casino last year.

Echo's latest full-year result had much to like. Normalised underlying earnings of $520.7 million for 2014-15 were 24% higher than the previous full-year result and ahead of market expectations. All divisions performed well and The Star was a standout, with 26% revenue growth. Echo shares rallied on the result.

Echo has momentum. The Star is benefiting from its big refurbishment, and a better performance from the main gaming floor could further lift performance.

Solid growth in cash flow and lower gearing, always a good sign, gives Echo greater flexibility to develop The Star and other assets, and prepare for Sydney's second casino at Barangaroo.

It is hard to know how much a development of Barangaroo's scale, still four years away, will affect The Star. One certainty is the rise of a global gaming precinct in Darling Harbour/Pyrmont, which should benefit The Star in the long run.

Echo's Gold Coast casino, a smaller contributor to the latest results has good prospects. Its refurbishment and the Commonwealth Games should be big tailwinds. Longer term, a casino-led hospitality

school has great potential. Heaven knows, our tourism industry can do with better service.

Echo has an interesting portfolio of assets: the high-performing The Star that is driving current results, medium-term growth potential from Jupiter's and long-term potential at Queen's Wharf in Brisbane. Like all good poker players, Echo is thinking several steps ahead.

Seven of 12 brokers that cover Echo have a strong buy or buy recommendation, two have a hold and three a sell, consensus forecasts show.

Granted, Echo is not cheap on a forecast price-earnings (PE) multiple of 18 times forecast 2015-16 earnings. Sydney's second casino will be fierce competition; projects in Brisbane and, to a lesser extent, on the Gold Coast have significant execution risk; and Echo has a capital expenditure hump to get over as casinos are built or upgraded.

Nevertheless, Echo is well run, is performing strongly across the divisions, has a good balance sheet, and clear growth prospects in Sydney and south-east Queensland. It can go higher, but is due for a share price pullback or consolidation after recent gains.

Chart 2: Echo Entertainment Group

Source: Yahoo

3) Ainsworth Game Technology

The pokie machine manufacturer, Ainsworth Game Technology, stands out among smaller gaming stocks, principally for its growing overseas footprint.

Ainsworth reported a full-year result that was ahead of market expectation. Underlying earnings rose 20% to $107.6 million in 2014-15, boosted by currency gains and stronger international sales. After jumping 40 cents this week to $3.21, Ainsworth is still below the 52-week high of $3.79.

Offshore growth is the key to Ainsworth and a reason it is among the market's more interesting small-cap stocks. Always look for small-caps that have a global footprint, or potential to build one. Australia's size means growth options can quickly expire.

Ainsworth's international revenue rose 46% to $147.6 million. The division now contributes 61% of total profit. Its American revenue is growing strongly and partly offsetting a slowing domestic market and greater competition.

Ainsworth expects the launch of new products to lift its Australian operations and says strong momentum in the international operations has continued in the first quarter of this fiscal year. It affirmed expectations for "strong organic sales and profit growth in 2015-16".

Five of six brokers that cover Ainsworth have buy recommendations and one has a hold. Ainsworth has plenty of potential, but suits experienced long-term investors comfortable with higher-risk stocks.

Chart 3: Ainsworth Game Technology

Source: Yahoo

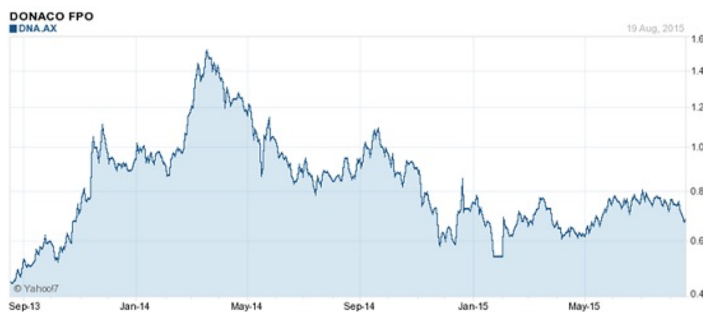
4) Donaco International

Speculators might consider Donaco International. It owns the Lao Cai International Hotel in Vietnam (the Vietnamese Government is a 5% owner) and this year acquired the Star Vega Resort & Club in Poipet, Cambodia.

Southeast Asia has exceptional long-term growth prospects as hundreds of millions of people move into its middle-class. Vietnam, in particular, has arguably the most promising outlook within the region, given its fast-growing, urbanising young population.

Donaco has been well supported by Asian equity funds that hold smaller companies, but conservative investors should stick with larger gaming stocks, Echo in particular.

Chart 4: Donaco International



Source: Yahoo

• *Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at August 19, 2015.*

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My SMSF – better insurance plus performance

by Stephen Hogg

Name: Stephen Hogg
Age: Mid thirties
SMSF members: My wife and myself

How long have you had your SMSF?

Three years

Why did you start it up?

We started it up mainly for insurance purposes and also our superannuation balances combined had reached critical mass to warrant an SMSF.

With insurance we wanted to lock in the pricing – for life and TPD (total and permanent disability) – so it would be easier to keep premiums lower in the future and to have the security of an adequate amount of insurance cover.

How big is it?

Less than $500,000

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

Because I'm in the industry, it's pretty much as I imagined it. The big unknown factor is how much time you want to spend on investment strategy. I guess there is a lot of sporadic enthusiasm on my part, but I haven't seen the pay off in being more or less passive or active at this stage.

Are you glad you have it?

Yes it helps me understand some of the issues that my clients with SMSFs might be going through and also I was really happy to lock in the insurance.

Are you pleased with its performance?

Yes in terms of keeping costs down, we've definitely saved on fees. I think lower fees, in and of themselves, can obviously improve performance.

In terms of overall performance we've done pretty well. I believed we could beat the index and we've done that.

What is your asset allocation?

We probably have around less than 5% in cash, 30 to 40% in international equities and the rest in domestic equities.

I don't invest directly in international – I don't think it's warranted unless you've got serious money to mitigate currency fluctuations – we invest through managed funds like Magellan and Vanguard. I looked for good managers with low Management Expense Ratios. We don't have any property. I think that most Australians are probably overexposed to property through the mortgages on their family homes.

The Australian stock component is mostly in the S&P/ASX 20. It's a fairly conservative strategy. I don't invest in any speculative stocks. Investing in Australian dividend payers – like the banks and Telstra – is still a very tax-effective strategy for SMSFs paying 15% tax in accumulation and 0% in retirement phase.

What are your favourite investments/stocks and why?

One of my least favourite investments was ABC Learning, but that was before I established the SMSF. One of my favourite investments has been CSL. Of course it's all relative to when you invested but we've had that in our SMSF since the beginning.

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

No, just the BGL software.

Is there anything else you'd like to say about SMSFs?

I think one of the major benefits often overlooked with establishing SMSFs is the insurance. The earlier you do this, the easier it will be to get better rates during major life events.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

UBS upgraded Ardent Leisure (AAD) to Buy from Neutral. Buy/Hold/Sell 1/4/0 FY15 results were broadly in line with expectations and the broker expects Main Event to make up over half of FY16 earnings and over 70% of group earnings by FY20. UBS no longer expects a falling oil price to have a materially negative effect on Main Event over FY16-17.

Morgan Stanley upgraded Bank of Queensland (BOQ) to Overweight from Equal-weight. Buy/Hold/Sell 2/4/2 Morgan Stanley believes the bank leads in dividend and earnings growth in FY16 estimates, given upside risk from home loan re-pricing. The broker expects expanded mortgage distribution and home loan re-pricing to drive around 9.0% revenue growth in FY16. An absence of one-off costs and underlying expense growth around 3.0% should allow the bank to offset higher amortisation and limit growth in reported expenses to just 1.0% in FY16.

Citi upgraded Crown Resorts (CWN) to Buy from Neutral. Buy/Hold/Sell 4/3/1 FY15 results were below the broker's expectations because of higher corporate costs. Still, Crown Melbourne impressed Citi with growth of 17.8% in earnings. The broker upgrades to Buy from Neutral following an increase in valuation as a result of changes to methodology.

Macquarie upgraded Fortescue (FMG) to Outperform from Neutral. Buy/Hold/Sell 2/3/3 The broker suggests material reductions in operating costs have significantly improved the earnings outlook for Fortescue. Tailwinds from the A$ could see costs fall further, such that the company's iron ore breakeven price could fall to US$37/t. Fortescue is generating sufficient cash flow to service near-term debt, but if iron ore prices remain lower for longer, latter obligations could be supplemented by minority sales in the company's mines.

UBS upgraded Seek (SEK) to Neutral from Sell and Morgan Stanley upgraded to Equal-weight from Underweight. Buy/Hold/Sell 4/4/0 FY15 results were in line with expectations but UBS finds the FY16 outlook a little disappointing. The company expects FY16 earnings to grow 5-8%. UBS considers the stock valuation undemanding against the potential growth profile, aware that management is investing for the long term. The company's FY15 results were ahead of the Morgan Stanley's forecasts, mainly due to positive exchange movements and new distribution agreements in China. The Asian market is expected to continue growing and the broker has lifted FY16 and FY17 earnings estimates by 22% to reflect this.

Deutsche Bank upgraded Treasury Wine Estates (TWE) to Hold from Sell. Buy/Hold/Sell 0/4/4 The FY15 result was solid and earnings were ahead of Deutsche Bank's expectations. The company is less reliant on Penfolds, with a reinvigorated marketing campaign across the portfolio.

Morgans upgraded Woodside Petroleum (WPL) to Hold from Reduce. Buy/Hold/Sell 2/3/3 The first half earnings and dividend declined, as expected, because of lower oil prices and production. Despite the diminished returns, the share price fall has reduced the downside potential to forecast returns. Morgans considers the business well run, but short on yield and growth appeal and a lack of near-term catalysts.

In the not-so-good books

JP Morgan downgraded Coca-Cola (CCL) to Underweight from Overweight. Buy/Hold/Sell 3/3/2 The downgraded follows a detailed review of the Australian beverages operations, the core of the

business. Target price has been reduced to $8.00 from $11.17. As shown by the significant reduction in target, the analysts see many challenges impacting and little, if any, valuation support for the stock. Too much fizzy drink and too many health concerns probably sums it up best.

UBS downgraded QBE to Neutral from Buy. Buy/Hold/Sell 5/3/0 UBS found the first half result had a lot to like although margins were lower than expected as was cash profit. UBS reduces forecasts for 2015 and 2016 by 4% and 7% respectively. The build up to 2016 is suggesting to the broker that a lot needs to go well for a high 10% margin to be achieved.

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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When should you update a trust deed?

by Penny Pryor

The trust deed for a self-managed superannuation fund (SMSF) is arguably the fund's most important document. But it isn't a static document and trustees should never "set and forget" it.

There is no legal requirement to update a deed every year, or even every other year, but it is in every SMSF trustee's interest to do so regularly – and at least once a year, particularly if legislative changes allow SMSFs to do more with their fund.

Legislation and fund circumstances

The two key areas that may necessitate updates to a trust deed are changes to legislation or changes in the circumstances of the fund.

For example, Limited Recourse Borrowing Arrangements are now permitted under law but can't be entered into unless a trust deed specifically provides for them. So before an SMSF trustee borrows to buy a property, they need to get their trust deed ready.

Recent changes that required SMSF trustees to report asset value at market value may have also required some trust deeds to be updated if they specified how assets were to be reported.

Another thing SMSF trustees need to be on top of is whether a member might be moving from accumulation to pension phase, or if a new member will be joining the fund. Often these things happen at the beginning of a financial year, or even if they don't, it's a good time to consider whether any of these changes will be happening during the coming financial year.

If a member is moving into pension phase, from accumulation phase, a trust deed needs to be able to allow for an account-based pension and if there is a new member, they have to sign the relevant trustee declarations and also be added to the trust deed.

If you're updating your estate planning, you may need to update your trust deed as well.

Binding death nominations are a useful tool for estate planning to make sure a trustee's wishes are followed if they pass away, but trust deeds need to allow for this. Trustees may want to consider visiting a solicitor to work this out.

The investment strategy

An SMSF's investment strategy needs to be in alignment with the trust deed and needs regular reviews as well. If a member is moving into pension phase within the fund, as well as being able to pay the pension, the trustee needs to make sure the investment strategy supports paying that pension.

This may involve increasing the focus on yield investments or liquid investments in order to be able to pay the pension on a regular basis.

There is also a minimum pension payment that has to be paid each year and there are penalties for not paying that minimum.

And if the fund will be investing in new asset classes – like borrowing to invest in property – then the investment strategy document may also need to be amended so it allows for this.

If the property is going to be a major investment for the fund, trustees would be well-placed to make a note of the single asset risk in the fund and how the benefits of holding the property will outweigh those potential risks.

So while there's no set time to update a trust deed, take advantage of the beginning of a financial year to ensure it, and other relevant documentation, is up to date.

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ANZ and FlexiGroup – buy or sell?

by Questions of the Week

Q: As a long-term holder of each of the big four banks, I am wondering whether I should reduce (or possibly exit) ANZ?

This is mainly because of press reports of the alleged difficulty in realising on the capital invested in its various Asian assets (if that becomes necessary in addition to its announced capital raising).

Are these assets trading profitably anyway?

A (By Paul Rickard): ANZ remains my least-preferred major bank.

My rating is:

1. NAB
2. CBA
3. Westpac
4. ANZ

The CEO will definitely go soon (and the chairman should probably follow suit as well). And in my mind, the strategy around Asia remains confused.

That said, they are now the cheapest – on FY 15 multiples, PE of 11.3, dividend yield 6.2% compared with NAB at 12.8 and 6.1% and WBC at 13.2 and 5.8%.

At these levels, I wouldn't be selling – banks are now attractively priced and despite not being keen on the ANZ, there is probably some value to be found here.

Q2: I currently hold 20,000 shares in FlexiGroup and recently purchased 4,000 – have I made an error?

I believe the stock was oversold on fear and innuendo resulting from departing senior executives.

A2 (By Paul Rickard): FlexiGroup (FXL) fell approximately 16% following the shock departure of its CEO. It has rallied back a little following the release of its second half report.

Two brokers have also upgraded their ratings – Citi to Buy from Neutral, and UBS to Neutral from Sell.

According to FN Arena, the consensus target price is now $3.03 and sentiment is fairly positive at +0.5 (scale -1.0 is most negative to +1.0 most positive).

It is a high yielder, guidance for FY 16 is tight, and barring any blow out in bad debts – looks reasonably priced. This being the case, a rally back to $3.00 is not out of the question.

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Don't miss this!

In this Super Sessions update, we talk about how healthy our health care stocks really are!