Switzer Super Report

Thursday 8 October 2015

The golden goose

Some stability seems to have returned to the market in the past few days. I still think we'll see some more volatility but the chances of a Santa Claus rally may be rising!

In the *Switzer Super Report* today, Charlie Aitken explains why he recently bought a stock that is highly leveraged to the newly cashed up Chinese consumer. Tony Featherstone argues the case for buying more legal stocks, and in *Buy, Sell, Hold – what the brokers say*, both Cochlear and Resmed were upgraded.

Questions of the Week answer queries on the Origin rights and calculating capital gains on Westfield group shares, and you can catch up on last week's webinar here.

Sincerely,

Peter

Peter Switzer

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Finding the next golden health stock

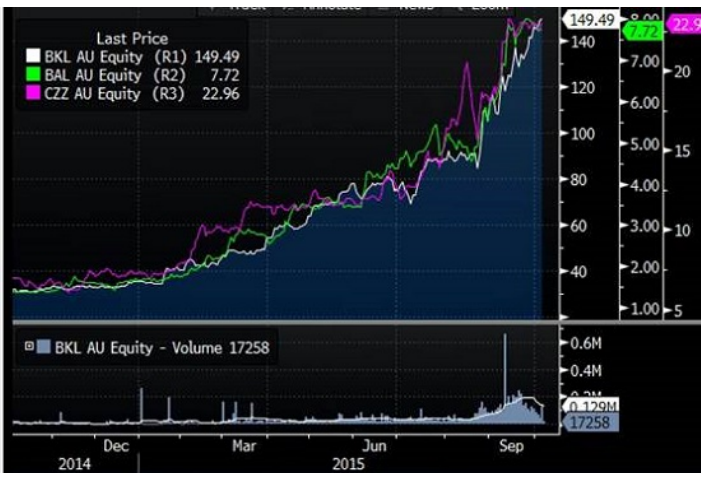
by Charlie Aitken

My fund recently supported a new IPO called Vitaco Holdings (VIT), which successfully listed on the ASX. My fund has bought more VIT shares on market and today I will explain the investment case behind our decision and why we see VIT as a genuine growth stock when growth is very hard to find.

Chinese prepared to pay for quality

There should be absolutely no doubt the Chinese consumer is paying a premium for “provenance”. By provenance I mean security, quality and reliability of supply. This is particularly relevant to agricultural/food products and health products, with Australia and New Zealand superbly positioned to continue to benefit from this structural growth trend.

You can clearly see the trend already in the performance and earnings upgrades from Blackmores (BKL), Bellamy’s (BAL) and Capilano Honey (CZZ). In fact, owning these three “provenance” plays has been, and will most likely continue to be, rewarding. You can see they basically track each other as a basket and my view is VIT will join this basket over the next few months.



Stories of Chinese tourist buses pulling up outside chemists and supermarkets are rife. What happens is Chinese tourists walk in with large empty suitcases and walk out with them filled with vitamins, baby formula and honey. This isn’t a joke.

Similarly, broker analysts and investors from Asia on Australian road shows have been known to ask where the nearest chemist is to fill requests from relatives for all of the above.

After the numerous scandals in China about baby milk powder and all sorts of substituted products, you can absolutely understand why Chinese visitors pay a premium for Australian and New Zealand sourced product.

According to Citi Research, the growth in demand from China has been rapid and only recent for many Australian and New Zealand health food companies. The trend really only began in 2014, which reflects the expansion of free trade zones. The free trade zones have facilitated cross-border e-commerce.

The new China story

China is transitioning to a consumer-led economy. This is leading to growth in incomes and increasing consumption of “Western” products. Chinese wages growth has averaged 12% over the last five years and Beijing’s income distribution plan aims to double household income in real terms from 2010 to 2020.

There is a strong correlation between Chinese wages growth and retail sales growth. Over the past five years, Chinese retail sales growth has averaged 16%.

Adoption of the Internet and smartphones in China has also driven growth in e-commerce.

However, to truly capture the Chinese consumer opportunity, you need a brand profile. The brand needs to be reliable, well known, and endorsed by friends or celebrities.

Similarly, the product needs to be available. That means you need to have a presence across major e-commerce platforms and a degree of prominence in the brand.

At this moment in time, Chinese consumers have a low consumption per capita of vitamins and supplements. According to Euromonitor, overall consumption is $US12 versus US$86 in Australia and New Zealand. However, products aimed at health and beauty, not simple nutrients, tend to be more popular in China.

The Vitaco story

Vitaco is not simply a vitamins story. The company is also in the Sports Nutrition business. The two key brands are Aussie Bodies and Musashi. The gym junkies reading this note would know those brands well, but clearly sports nutrition products are making their way into mainstream retail via supermarkets and petrol stations.

Sports nutrition products are well-placed, due to an ageing demographic (60 is the new 50) and greater overall sports participation. You could also argue that the proliferation of social media has made the world more vain. The entire world seems to worry about what they look like in a "selfie" nowadays.

Vitaco's sports nutrition brand is adding new products and gaining shelf space in supermarkets. This could be a source of revenue surprise for VIT in the year ahead.

As I mentioned above, genuine growth is hard to find in Australian equities. Yes, there has been some cost-out growth, but genuine top-line revenue growth is very hard to identify. If anything, analysts are consistently revising down aggregate S&P/ASX 200 EPS forecasts for FY16.

What this leads to is the handful of stocks that offer genuine top line revenue growth trade at significant PE premiums to the broader market. The market is industry agnostic where it allocates that PE premium for growth and I suspect that to continue in a low growth/low inflation environment, where pricing power is hard to find.

This is why I have bought VIT for the AIM Global High Conviction Fund despite the short-term multiples seeming high. In genuine structural growth stocks, the near-term PE multiples are almost always "high", but so too is the prospective EPS growth.

Price to growth versus price to equity

My preferred approach is price to growth, or PEG ratio analysis. As long as the PE is lower than the forecast EPS growth, i.e. the PEG ratio is less than 1x, I have no issue paying a high forward P/E.

I think this is what a lot of analysts and investors get wrong. Not all PE's are created equal, just as not all companies are created equal. I'd rather pay up a little for growth than be stuck in a "cheap" stock with no growth prospects. To consistently make money as an investor, you need to be in companies that can grow. Grow earnings and grow dividends. Those few stocks are ALWAYS more "expensive" than growth less value stocks.

If you can find the combination of sustainable revenue growth, margin growth and ROE growth, you will almost certainly also see structural earnings and dividend growth. That is exactly what we see in VIT and why we have bought it on a "high" near-term PE multiple. Below is a table of VIT forecasts for the next three financial years.

	FY16	FY17	FY18
Sales	$220m	$253m	$286m
Sales Growth	27.8%	15.2%	13.3%
EBIT	$22.5m	$30.6m	$37.5m
EBIT Margin	10.2%	12.1%	13.1%
Core NPAT	$14.4m	$19.5m	$24.1m
Core EPS	10.1c	13.8c	17.1c
EPS growth	28.7%	36.5%	23.5%
P/E	26.7x	19.5x	15.8x
PEG Ratio	.93x	.53x	.67x
ROE	11.3%	15.6%	18%

The above are all forecasts/estimates that I believe will prove conservative through time. Only time will tell.

VIT has only been listed for a month but it has started very well as a listed company. The stock opened around 20% above its $2.10 IPO price and hasn't looked back. An IPO performance like this is more than often a good signal of future performance.

VIT is only a small cap stock at $377 million market cap, and has very little broker research coverage. As a newly-listed small cap stock, there are obviously risks and if you buy VIT, you must own it in the right risk-adjusted size for your portfolio.

However, I believe the potential reward significantly outweighs the risks. This is a well-run small company with a strong board and global opportunity.

At this moment in time, on our modelling, we can see value in VIT up to $3.00. That means we wouldn't buy more above $3.00. However, if VIT follows the Blackmores, Bellamy's and Capilano script, then the upside multi-year price target would be well ahead of those levels.

Anyhow, if you're looking for a small cap growth stock in your portfolio that has leverage to the Chinese consumer and a structural growth segment, I recommend you have a look at VIT, at current prices.

Disclaimer: the AIM Global High Conviction Fund owns VIT shares.

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The case to buy legal stocks

by Tony Featherstone

Slater & Gordon's dramatic fall this year has cast a shadow over listed professional-service firms and created an opportunity for contrarians to pounce on undervalued stocks, such as Queensland-based law firm Shine Corporate.

A fall from glory

Slater & Gordon could seemingly do no wrong when it soared from $4.50 at the start of 2014 to a 52-week peak of $8.07 in April this year. The market applauded its acquisition of Quindell's Professional Services Division (PSD) for $1.25 billion in March 2015 – a deal that would make it the United Kingdom's largest personal-injury law firm.

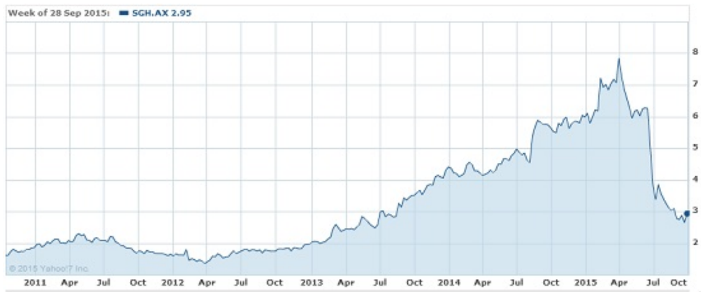
Then hedge funds struck. They queried its audit relationship with Pitcher Partners and upped their bets against Slater & Gordon through short selling.

Investment bank reports that questioned the price Slater & Gordon paid for Quindell's were picked up in financial newspapers and negative sentiment towards the law firm escalated.

A selling frenzy followed when Britain's Financial Conduct Authority announced in June an investigation into Quindell Plc's financial accounts, and when Slater & Gordon said it had contacted the Australian Securities and Investments Commission (ASIC) about an accounting error that related to differences between UK and Australian accounting standards and had no effect on its profitability and cash flow.

Slater & Gordon tanked to $2.65 in September, wiping $1.8 billion off its valuation in a few months. The former market darling was being death-ridden by hedge funds that believed it had paid too much for PSD, conducted insufficient due diligence and that there were flaws in PSD's accounting process to book revenue from work-in-progress for cases.

Chart 1: Slater & Gordon



Source: *Yahoo!7 Finance, 8 October 2015*

Late last month, Slater & Gordon released its audited 2014-15 financial accounts, after appointing Ernst & Young to audit its UK business. The review identified a range of minor accounting adjustments that had a modest effect on earnings. The review eased some concerns about Slater & Gordon's financial accounts, and confirmation of the value of the firm's work-in-progress was a good sign. But the share price has barely moved as the market awaits ASIC's impending review of the firm's accounts.

The company's sceptics still outweigh the true believers, judging by the steady state of short-selling interest: Slater & Gordon remains the market's third-most shorted stock. Some hedge funds believe the PSD transaction has destroyed rather than created value in Slater & Gordon and have valued its stock at $1, according to recent newspaper reports. ASIC's review, taking longer than expected, has made the market nervous, but not everybody expects a damning review from the corporate regulator.

Macquarie Equities Research wrote in late September: "The release of the audited accounts with significantly more disclosure should go a long way to settle any lingering concerns in Slater &

Gordon's financial accounts. For us, the auditor's confirmation of the value of work in progress indicates the business remains well supplied with cases – a very good indicator of future revenues. We are still awaiting formal conclusion to the ASIC review, albeit remaining confident there will be no adverse findings."

Those hoping for a quick recovery will be disappointed. Slater & Gordon had some justification when it argued it was the subject of rumourtage, market manipulation and false stories being leaked to the media about the extent of its problems. Still, the accounting errors, the ASIC problem, and scandals this year at Quindell Plc, the crisis-ridden UK insurance firm and PSD's former parent, have dented confidence.

Value territory

But every stock has it price. Slater & Gordon is trading at a two-year low and its valuation is back to the level before the transformative Quindell's PSD acquisition. Effectively, the market is giving no value to a $1.25 billion acquisition that gives Slater & Gordon the top position in the fast-growing, lucrative UK personal-injury law market. At $3.04, Slater & Gordon is capitalised at $1.08 billion.

Using consensus analyst forecasts, Slater & Gordon trades on a forecast Price Earnings (PE) multiple of less than 6 times 2015-16 earnings and is expected to yield 3.9%, partially franked. The stock had an average PE of 13 in 2014-15. The market must believe the company's earnings are heading sharply lower, but there was no sign of that in the UK audit.

Seven of 11 broking firm that cover Slater & Gordon have a buy recommendation, two have a hold and two have a sell. Broker estimates ranging from $2.94 to $8.73 reflect the uncertainty in its outlook. The lowest valuation estimate is in line with the current price and a median price target of $5 suggests significant upside. Much could still go wrong. However, Slater & Gordon's valuation offers a reasonable margin of safety for prospective long-term investors who can withstand short-term volatility, provided no nasty gremlins emerge in the financial accounts or ASIC review.

Slater & Gordon was one of Australia's great professional service companies and can be again once the market is assured the UK problems are behind it. It has the management and board strength to get back on track quickly. Amid all the controversy, it's easy to forget why Slater & Gordon bought PSD in the first place, and paid a higher-than-usual valuation multiple for it. The UK legal market is ripe for consolidation – it has more than 10,000 law firms, with almost two-thirds of them owned by one or two partners. Regulatory change in the UK is expected to drive greater industry consolidation, and by paying up for PSD, Slater & Gordon has done most of its acquisitions in the UK in one transaction.

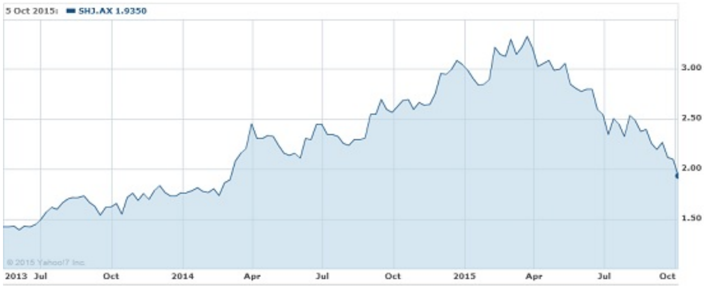
Shine Corporate

Shine Corporate was affected by sentiment towards Slater & Gordon and it too may have been the target of short selling, given it has a similar business model. The Brisbane-based personal-injury firm dropped from $3.36 in March – just as Slater & Gordon's problems emerged – to $1.93.

Shine listed on ASX in May 2013 after raising $45 million at $1 a share, in a weak market for initial public offerings (IPOs). It earns most revenue from personal-injury litigation services, in areas such as workers' compensation, motor accidents, medical negligence and public liability claims. It also has an emerging practice in product liability, professional negligence, class actions and other areas. Shine's market capitalisation of $345 million is about a third that of Slater & Gordon.

After soaring in 2014, Shine was a candidate for profit taking during the share market correction in August and September this year. A tougher year for the personal injury market, more aggressive competition, and changes to Queensland WorkCover rules weighed on Shine's full year earnings. But its after-tax net profit still grew 37.8% in 2014-15.

Chart 2: Shine Corporate



Source: *Yahoo!7 Finance, 8 October 2015*

Shine has good long-term growth prospects, is well run, and unlike the much larger Slater & Gordon, is focused on the Australian market – its strategy relies mostly on growing outside Queensland. Shine's acquisitions are modest by comparison, and there is less risk – although less upside – compared with Slater & Gordon's UK business. All five broking firms that cover Shine have a buy or strong buy recommendation, according to Thomson/First Call consensus analyst forecasts. Price targets range from $2.77 to $3.65 and the mean forecast is $3.50 – a 57% premium to the current share price. The leading share valuation tool, Skaffold, values Shine at $2.90 over one year.

On balance

Of the two stocks, Shine is the lower-risk play to capitalise on ongoing consolidation in Australia's legal industry and growth in personal-injury claims. Like Slater & Gordon, it looks undervalued and suits experienced long-term investors comfortable with small-caps.

Slater & Gordon offers a lot more upside – and risk. My sense is the market has over-reacted at the current price, and that Slater & Gordon's due-diligence processes on the PSD acquisition and management strength will see it recover. It's not every day that a dominant firm in the Australian and UK personal-injury legal market trades on a PE below 6, with a near 4% yield. Plenty of crappy industrial companies that are constrained to this market trade on higher multiples.

While we're on legal-related stocks, litigation funder IMF Bentham also looks interesting after recent share-price falls. More on that in a later column.

– Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at Oct 6, 2015.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Deutsche Bank upgraded Cochlear (COH) to Hold from Sell. Given subdued market growth and probable peaking of sales of upgrades in FY16, Deutsche Bank expects only single digit earnings growth from FY17. Nevertheless, a strong boost from the weaker Australian dollar is now expected to push earnings growth in FY16 into the mid teens. This in turn leads to a lift in the price target to $82 from $71 and an upgrade in the rating.

Deutsche Bank upgraded Resmed (RMD) to Hold from Sell. The company faces a difficult second half, with a competitor product launch and the roll out of competitive bidding in the US. Still ResMed is trading closer to Deutsche Bank's valuation after recent share price weakness. The strengthening of the US dollar against the key cost currencies should provide a material boost to earnings.

Macquarie upgraded Xero (XRO) to Neutral from Underperform. Since the broker initiated coverage on Xero, subscriber growth in Australia and New Zealand has been greater than expected but not as fast as Macquarie's US-UK market forecasts. Xero remains the fastest growing software-as-a-solution business under coverage but following the market pullback, no longer trades at a significant premium.

In the not-so-good books

Morgan Stanley downgraded CSR to Equal-Weight from Overweight. Macroprudential regulation is causing a tightening in the Australian housing cycle, argue analysts at Morgan Stanley. They have reduced their projections in response. A reduction in construction activity, in particular for multi-dwellings, has now been incorporated. Industry view is In-Line. Further downgrades to aluminium price forecasts have further impacted on estimates.

Citi Group and UBS downgraded Veda (VED) to Neutral from Buy. Equifax has upgraded its offer to $2.825 a share from the initial offer of $2.70. The board has agreed to recommend the revised offer, subject to the independent expert's opinion and assuming it results in a binding offer. Veda's stock had weakened prior to the offer, Citi observes, because of the collective effects of lower FY16 guidance and an unclear outlook in terms of the path to critical mass.

The above was compiled from reports on FNArena 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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Origin rights and Westfield split

by Questions of the Week

Q: What is your opinion on the make-up of the Origin rights?

A: (By Paul Rickard): Arguably, the market forced Origin into the capital raise – at a heavily discounted price of $4.00 – so it's not surprising that the institutional part of the issue went so well and the shares are now trading around $6.40. Of course, a rally in the oil price has also helped.

What to do? Well, you can sell your rights (issued on a 4 for 7 basis), which are currently trading under ASX stock code ORGR, until Monday 19 October (last day of trading), or take up the rights by Monday 26 October. If you take no action, then your rights will effectively be auctioned to the institutional market and any premium over $4.00 will be rebated to you.

Although I think there is some value in Origin for the long-term holder, my sense is that oil prices won't rebound quickly and that the current rights premium (of approximately $2.40) looks pretty attractive.

Question 2: I am hoping you can assist me to determine the cost base of my current holdings in SCG 4,328 and Westfield Corporation 2,000.

I purchased 2,000 Westfield Group ord/unit stapled securities back on 14 May 2009 at $9.65 for a total cost, including brokerage, of $19,332.95 and have held on through all the mergers and demergers etc.

I'm totally confused regarding what the cost base should be. Any help would be much appreciated.

Answer 2 (By Paul Rickard): Capital gains tax calculations on Westfield securities can be a nightmare – one of the reasons I don't sell mine!

Here is the Westfield guide that deals with the creation of Westfield Corporation (WFD) and Scentre Group (SCG) out of the former Westfield Group (WDC). This occurred with effect on 30 June 2014 – for every 1,000 shares in WDC, shareholders received 1,000 shares in the new WFD and 1,246 shares in SCG.

While the process is more involved (as per the attached sheet), because the securities are stapled, you would apportion 36.3821% of your original cost base (including any incidental acquisition cost like brokerage) to the SCG securities, and 63.6179% to the WFD.

The number of shares that you mention doesn't tally with the number of shares in the split – so there may also have been another split that I don't have details of, or you acquired separately some Scentre Group.

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Don't miss this!

If you weren't able to tune into our webinar last week, don't worry you can still listen to it here. James Dunn and I shared our forecasts for the next few months.