Switzer Super Report
Advice you can trust

Thursday March 17 2016

Playing the megatrends

There are some big growth themes playing out and for investors it's about understanding what these themes are and the types of companies that will benefit from this growth.

Today, Charlie Aitken revisits the Chinese consumer growth story and picks one stock set to benefit from China's demand for wine. I'll drink to that! Also in the *Switzer Super Report*, Tony Featherstone uncovers some sustainable opportunities in the clean energy theme, while Graeme Colley gives us the ins-and-outs of the sole purpose test and why you may need to revise your investment strategy.

Sincerely,

Peter Switzer

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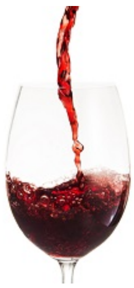

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The China growth opportunity

by Charlie Aitken

I want to continue today on the theme of ASX listed beneficiaries of the rising Chinese consumer spending.

Rising wages and incomes lead to changes in diet. In alcoholic beverages that leads to marginal dollars being spent on wine over beer.

The major China-facing ASX-listed beneficiary of this structural growth theme is Treasury Wine Estates. TWE is more recognisable as the “Penfold’s” business spun out of Fosters a few years ago.

TWE’s key brands include Penfold’s, Wynn’s, Wolf Blass, Lindeman’s, Rosemount and Rawson’s Retreat. I’m sure we all know one or two of those brands. Under CEO Michael Clarke, TWE is a genuine growth stock. The company has consistently upgraded earnings forecasts then beaten those forecasts. That happened again this year when TWE upgraded forecasts to 1HFY16 EBIT of between $140m and $150m, and then delivered beyond the mid-point of that range when confirming 1H results in February.

What most analysts and I found encouraging was the quality of the results, which was cash realisation of 126% and all businesses delivering margin and EBIT growth. This is encouraging as TWE have been reinvesting current earnings back into future sales growth initiatives, reminding you life isn’t all about dividends.

To put this reinvestment in growth in context, TWE increased its selling and marketing expenses by +$40m in the 1H. This is a major increase in TWE’s investment in its current and future sales. It’s clear this is working to drive sales with 1H sales growth +10% in constant currency and +20% in reported currency. In a world where top line sales growth is hard to find, these are excellent numbers.

Since the 1H result we have seen analysts upgrade forward year forecasts significantly, taking the correct view that, in the years ahead, TWE earnings will benefit from the combination of strong sales growth, cost of goods sold being materially lower and economies of scale in marketing spending to increase. The company has strong internal momentum, which shouldn’t be underestimated.

The other development worth not underestimating is TWE’s opportunity in China. Changes to TWE’s distribution in China have helped drive very strong North Asia volume growth (+149% yoy). Part of this was driven by a fivefold lift in marketing spend in China and a higher allocation of luxury wine. But to put this in context, TWE is only a small player in the Chinese domestic wine market at this stage. Therein lies the opportunity over the years ahead.

TWE’s share of the 219m unit case Chinese market is just 0.6%. This accounts for 2% of Chinese wine imports. While this is up from 0.2% in FY08, analysts estimate that TWE’s China markets share is far less than in developed markets (2-4%) and peer Asian countries (2-5%). On that basis, TWE looks underexposed in China when compared with other developed and emerging countries. This is partly because China previously hasn’t been as large a focus as it’s become now for TWE, while previously Australian wine was viewed as expensive in China, leading to lower than achievable sales growth.

However, consumption of wine in China, especially high-value wine, is significant in China. Overall consumption is growing at +4%, with Australian wine exports to China rising by +66% in the 12 months to December 2015. Higher value wine is growing at even faster rates.

Looking forward, it is estimated that should TWE achieve 4% of the Chinese market, in line with peer markets, that Asian EBITs could reach $300m. That would be a threefold rise from current levels. All things being equal that would equate to around $3.00 a share in value being added to TWE just on the China growth angle.

This Chinese growth opportunity is presenting itself as TWE's America's business is turning the corner. It's worth noting that TWE's America's business reported a +67% increase in EBIT. This growth should continue as US imports of Australian wine increase and the weak 2015 Californian vintage leads to a more balanced US domestic wine market.

The world's major premium wine companies all attract multiples associated with "luxury brands". That's fair enough because they are true "luxury brands" linked to rising wealth and consumption. Let's look at current and future multiples for TWE's global peer group.

Company	FY16 P/E	FY17 P/E	FY16 EV/EBITDA	FY17 EV/EBIDTA
Brown-Forman	27x	25x	18.5x	17.2x
Constellation Brands	22.8x	20x	15.2x	13.4x
Davide Campari Milano	20.2x	19.2x	12.5x	11.6x
Diageo	19.4x	17.8x	15.2x	14.1x
Pernod Ricard	17.5x	16.6x	13.7x	13x
Remy Cointreau	25.4x	22.7x	16.1x	14.6x
TWE	23.9x	20.2x	12.8x	10.9x
Average	22.3x	20.2x	14.9x	13.5x

While TWE commands similar P/E multiples to its peers, those P/E multiples are unfair on TWE as they are currently reinvesting heavily in the branded business as mentioned above. On EV/EBITDA multiples, TWE is very cheap versus its global peers and I think that is the valuation measure to look at.

The other point to focus on is GROWTH. I believe current consensus analyst forecasts for the next few years will prove conservative. That has been the case for the last two years and will continue to be case in my opinion. Below are my forecasts for EPS for TWE v. current analyst consensus.

	FY16	FY17	FY18
Aitken forecast	32c	41c	47c
Consensus forecast	29c	36c	41c

If my forecasts prove right then you can see TWE EPS will have more than doubled from FY15's 22c by FY18. What this also means is TWE will be in a structural earnings upgrade cycle and attract a P/E premium for that structural growth. I'd also be very surprised if TWE's EV/EBIDTA multiple didn't expand to the global peer group or beyond.

I believe TWE is a classic example of a structural growth stock. I believe the macro tailwinds for Australian export wine will remain strong and TWE has the management team to deliver on the China opportunity. All things being equal, TWE should be a core portfolio holding for the next three to five years as it delivers way above market (asx200) EPS growth and gets re-rated to a true global luxury brand stock.

I'd be using this period of a slight bounce in the AUD/USD cross rate to accumulate TWE shares. I don't think the AUD/USD rally will be sustained beyond 76 US cents and therefore any underperformance of Australian exporters is a buying opportunity. TWE fits into my broader high conviction theme of the rising Chinese consumer. If this goes according to plan, and so far it has, TWE should be re-rated to a mid-teens share price over the years ahead and could also become a takeover target by another global major.

The AIM Global High Conviction Fund owns TWE shares.

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5 ways to buy the growing clean energy sector

by Tony Featherstone

Few sectors are more promising and frustrating for investors than clean energy. The world needs to reduce its reliance on fossil fuels and a "tipping point" for renewables will one day create vast wealth. But it has been a long time coming.

That makes it is easy to overlook Australian clean-tech stocks. Their collective long-term performance has been poor and ASX is not endowed with large, investment-grade clean-tech stocks across the solar, wind, waste, water, biofuels, energy storage, wave and geothermal sub-sectors.

The combined market capitalisation of 62 stocks in the Australian Clean Tech Index, a unique barometer of clean-tech performance, was $16.2 billion in January 2016. Put another way, the sector's combined worth is about an eighth the size of Commonwealth Bank.

By volume, the sector is littered with micro-cap stocks that are too small and illiquid for most investors. A handful of stocks in the index, such as New Zealand electricity providers Mighty River Power and Meridian Energy, Sims Metal Management and Cleanaway Waste Management (formerly Transpacific Industries Group) suit conservative investors.

I could go on with other reasons to beware the Australian listed clean-tech sector. But the share market has a habit of surprising investors who ignore sectors and base investment decisions on history and generalisations. The listed clean-tech sector has renewed energy.

The Australian Clean Tech Index had a cumulative return of 30.6% over three years to January 2016. The S&P/ASX Small Ords Index lost 13.1% in that period. Over 12 months, the Clean Tech Index lost 1.6% and the Small Ords lost 10%. After years of underperformance, the Clean Tech Index is beating the broader market.

Of course, care is needed with index returns. The performance of the Australian Clean Tech Index, weighted by market capitalisation, can be skewed by a few of its biggest constituents. Also, the index can be volatile and it had several years of heavy losses until about 2013.

But offshore indices also highlight the sector's improving performance over the past few years. The S&P Global Clean Tech Index, which includes 30 of the world's largest clean-tech companies, has a three-year annualised return of almost 8% to February 2016.

That's a decent result, given sector headwinds in the past 12 months. Falling oil and gas prices have made some renewables less competitive and crunched global clean-tech stocks this year. The S&P Clean Tech Index is down almost 20% over 12 months and 7% this calendar year.

Could this be a buying opportunity in global clean-tech stocks? It is hard to see oil prices going much lower from here, as supply cutbacks help restore equilibrium in that market. And the long-term story for renewable energy, particularly in emerging markets, is firmly intact.

Reducing global energy poverty remains one the world's great challenges. About 1.3 billion people, mostly in sub-Saharan Africa or developing Asia, cannot access electricity and 2.6 billion are without clean-cooking facilities, International Energy Agency (IEA) data shows.

Power helps bring sanitation, education, internet connectivity and commerce – and opportunity for global companies, particularly those in renewable energy, that can build infrastructure or supply power to Third World countries.

It is likely that developing countries, such as India, will quicken their use of renewables as they leapfrog the traditional hub-and-spoke model of energy infrastructure – much like India's telco sector bypassed expensive infrastructure for mobile telephony.

Another 3.1 billion middle-class consumers by 2030, two thirds of them Asian, on OECD forecasts, will also drive higher demand for renewable energy in the region.

As the market focuses on renewable technologies, the catalyst might come from discoveries of new and advanced materials. In a Sydney briefing I attended this month, the World Economic Forum described advanced materials as one of five technologies that will shape the "fourth industrial revolution", which is just starting. It builds on the ongoing digital revolution that began in the 1970s. (The other technologies were artificial intelligence, neurotechnology, 3D printing, and precision genome editing).

Lighter, stronger and more energy-efficient materials, such as graphene, will drive a new generation of products that require less power and make renewable energy more viable. Advanced materials, in my view, and the lighter products that result, could be the next greater driver of renewable energies. The two go hand in hand.

Whatever happens, there is a good case to expose portfolios to alternative-energy companies and benefit as one the great investment megatrends unfolds in the coming decade.

Here are five ways to play the trend:

1. Go global, go passive

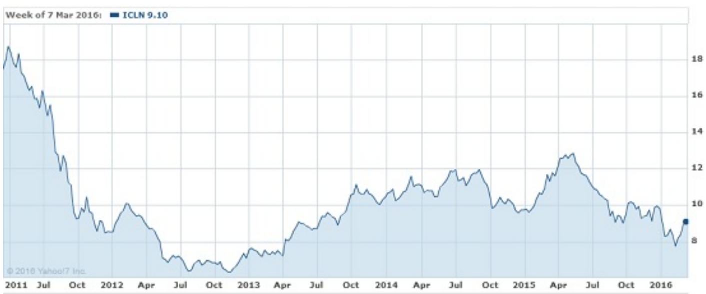
Investors wanting exposure to large renewable-energy companies that dominate their markets need to look overseas. Solar companies, for example, are well represented on the NASDAQ but only a handful of micro-cap solar providers exist on the ASX.

Using an exchange-traded fund over clean-tech stocks makes sense for investors who want long-term sector exposure. The iShares Global Clean Tech ETF, listed on the NASDAQ, aims to replicate the price and yield performance of the S&P Global Clean Tech Index.

It provides exposure to big names such as First Solar Inc in the US, Gamesa in Spain, and Enel Green Power in Italy. The ETF, in US dollar terms, has a three-year annualised total return of 13.7% to December 2015. Over five years, it has lost 6.4% annually.

Half of the index is invested in large US and Chinese clean-tech companies. It looks a good way to gain exposure to the world's biggest and best clean-tech stocks, but comes with additional currency risk for Australian investors.

Chart 1: iShares Global Clean Energy ETF



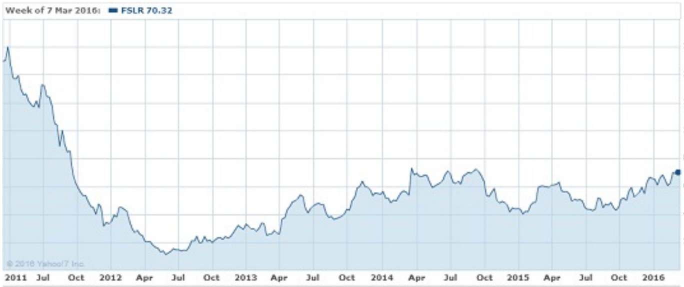
Source: Yahoo!7 Finance. ETF is listed on Nasdaq

2. Go global, go active

Those seeking direct stock exposure should consider US solar companies. Solar has some of the best long-term prospects within the clean-tech space and equipment providers, such as First Solar Inc, SunPower Corporation and JA Solar, are an interesting way to play the trend. Several solar stocks have tumbled this year amid the sector's broader sell off.

In wind-power equipment, Denmark's Vesta Wind Systems, Germany's Nordex and Gamesa stand out. US waste-to-energy provider Covanta Energy is well regarded. Focusing on equipment providers in the clean-tech space, rather than speculative-technology developers, has less risk and more long-term upside.

Chart 2: First Solar, Inc



Source: Yahoo!7 Finance. First Solar, Inc listed on Nasdaq

3. Go local, go active

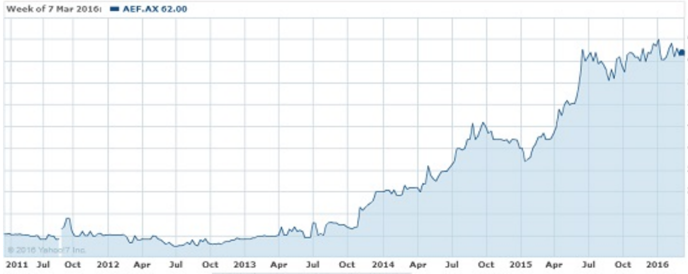
Few Australian managed funds specialise in listed clean-tech stocks. Arguably, the real action, through clean-tech venture capital funds, is in unlisted clean-tech companies.

Listed fund manager Australian Ethical Investment specialises in environmental and socially responsible investments. Australian Ethical has been a cracking performer: the one-year total return is 48% and over three years it is 51%. Due for share-price consolidation after such strong gains, it has good medium-term prospects.

The micro-cap company is enjoying strong funds inflows after consistent top-quartile investment performance. Assets under management grew 35% in the first half of FY16 to $1.4 billion and underlying profit leapt 55%. Who said ethical investing does not pay?

Australian Ethical's managed funds have a strong focus on clean energy, but its mandate covers sectors from responsible banking to healthcare, aged care and medical solutions. Its unlisted International Shares Fund focuses on smart energy companies and suits investors seeking clean-tech companies through a well-run local fund.

Chart 3: Australian Ethical Investment



Source: Yahoo!7 Finance

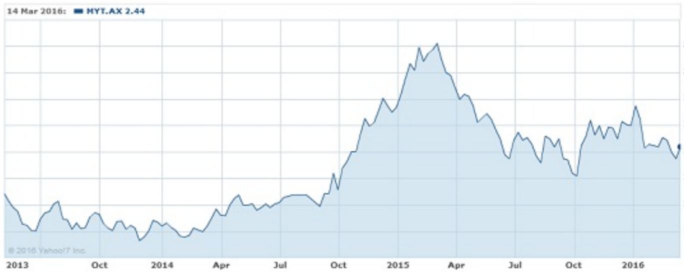
4. New Zealand energy providers

The New Zealand Government privatisation process brought several well-performing electricity companies to the ASX through the Initial Public Offering market. Mighty River Power and Meridian Energy, dual listed on the New Zealand Stock Exchange, are examples.

Mighty River Power, included in the Australian Clean Tech Index, has been one of my preferred mid-cap yield plays in the last few years. After listing on ASX in a $1.3 billion IPO in May 2013, its $2 issued shares peaked at $3.27 last year before falling to $2.40. Downgraded earnings guidance, due to drier weather conditions that affected its hydro-generation, weighed on the outlook.

Mighty River has significant renewable assets, a strong brand in New Zealand, and is the lowest-cost electricity provider in its sector. Macquarie Wealth Management has an outperform recommendation and a NZ$3.27 (A$2.91) 12-month share-price target. It believes retail electricity pricing in New Zealand has bottomed. Mighty River's expected dividend yield of about 5%, unfranked, is another attraction.

Chart 4: Mighty River Power



Source: Yahoo!7 Finance

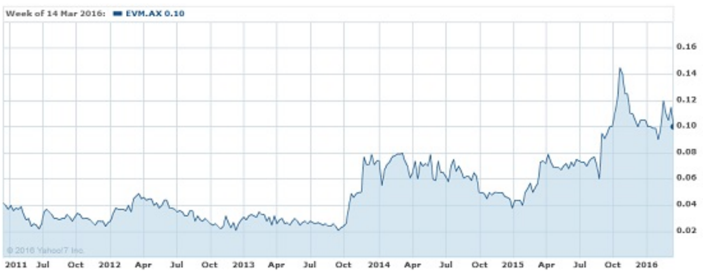
5. Speculative stocks

Day traders and active investors looking to capitalise on renewed momentum in clean-tech stocks should focus on the solar and storage and fuel-cell sub-sectors. Australian Clean Tech index analysis, provided to the *Switzer Super Report*, shows both sub-sectors have starred.

A handful of micro-cap ASX-listed solar companies, notably EnviroMission, Quantum Energy and K2 Energy, have produced strong returns over the past 12 months, albeit off a low share-price base. In energy storage, Eden Energy, Galaxy Resources and Neometals have delivered good gains over 12 months. As speculative stocks, they suit investors comfortable with higher risk.

Those seeking more established industrial companies could consider the well-performing Beacon Lighting Group in energy efficiency, and Cleanaway Waste and Tox Free Solutions in the waste sub-sector.

Chart 5: EnviroMission



Source: Yahoo!7 Finance

Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations. Readers should do further research of their own or talk to their financial adviser before acting on themes in this article. All prices and analysis at March 16, 2015.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Beadell Resources (BDR) Upgrade to Neutral from Underperform B/H/S 1/2/0, Evolution Mining (EVN) Upgrade to Outperform B/H/S 3/1/1, St Barbara (SBM) Upgrade to Outperform from Neutral B/H/S 1/1/0 by Macquarie.

Macquarie is examining its approach to gold miners as the share prices rally. The broker's methodology favours those with strong and sustainable cash flow. Beadell Resources is upgraded.

Evolution Mining is upgraded as it generates strong cash, despite receiving a lower multiple given a shorter forecast mine life. Macquarie expects the significant debt on the balance sheet will be aggressively paid down in the near term. Barbara's rating is also upgraded as the company has the strongest forecast cash flow in the broker's coverage and the highest multiple, given Gwalia's seven-year reserve life.

The Reject Shop (TRS) Upgrade to Equal-weight B/HS 2/1/0

Morgan Stanley analysts admit the operational turnaround has occurred much quicker than expected. They have now gained sufficient confidence in that positive momentum is sustainable. They do, however, have a problem with the share price, hence why the broker upgrades the business.

In the not-so-good books

BHP Billiton Downgrade to Underperform by Macquarie B/H/S 4/2/2

Following an updated commodities price deck and amid recent sentiment-driven share price movements, Macquarie adjusts its outlook. Aside from marking-to-market, the most significant changes are an upgrade to near-term lead forecasts, upgrade to medium-term semi-soft coking coal and a cut to long-term copper forecasts. The broker does not believe the modest improvement in fundamentals supports the price movements. Prices have moved well ahead of underlying demand assumptions. Hence, the broker downgrades the miner.

Dexus Property Group (DXS) Downgrade to Underperform from Neutral by Credit Suisse B/H/S 0/2/2. The stock has performed strongly over the past month, despite delivering the worst relative performance at the results, in Credit Suisse's view. The broker attributes the recent rally to increased probability on Dexus walking away from the Investa Office (IOF) bid. This would be a positive outcome for Dexus unit holders. Emerging details suggest there is minimal earnings upside for Dexus in terms of Investa's existing management and fee arrangements, the broker notes.

Rio Tinto (RIO) Downgrade to Equal-weight by Morgan Stanley B/H/S 4/4/0. Morgan Stanley has updated its views on iron ore, from London (UK), and reportedly decided to downgrade Rio Tinto as a result. The general revision has led to a 15% cut in the projected average price for iron ore in 2016 & 2017 to US$38/tonne.

Investment strategy and serving the sole purpose test

by Graeme Colley

Believe it or not, one of the more obscure and less well-known parts of the superannuation legislation is the sole purpose test.

In my opinion, the sole purpose test has two arms, which are interlinked. The first relates to the benefits provided by the fund and the second relates to the manner in which the fund makes its investments.

The first arm of the sole purpose test is about the provision of benefits to members and their dependants. This is covered by section 62 of the *Superannuation Industry (Supervision) Act (SIS Act).* The types of benefits that can be provided by the fund are divided into core purposes and ancillary purposes. One core purpose is required to be satisfied, such as retirement, meeting a specified age (65) or death. A fund may choose to provide one or more ancillary benefits but there is no obligation on the fund to have any ancillary benefits.

Examples of ancillary purposes include benefits for ill-health, disability and those approved by the Regulator, such as hardship or compassionate grounds. The governing rules of most superannuation funds will be established with powers to provide all of the core and ancillary benefits.

These benefits link broadly with the preservation standards in *Regulation 6* and conditions of release in *Schedule 1* of the *SIS Regulations*.

While the purpose of the superannuation fund to provide various types of benefits may seem relatively clear, there's a catch. That catch is the second arm of the sole purpose test, which relates to the provision of indirect benefits to members, dependants and others who usually have some relationship with the superannuation fund. A fund that provides these indirect benefits or uses the fund for purposes other than the sole purpose of providing superannuation benefits will place itself at risk in gaining the relevant taxation concessions.

A breach of the sole purpose test would include funds making investments, loans or leasing assets to anyone who has a direct or indirect relationship with the fund trustees or members. These transactions then have a link to whether the particular transaction is commercial and the taxation implications for the fund where it is not on a commercial basis. In addition to the sole purpose test, the *SIS legislation* imposes standards on arrangements that are considered not to be at arm's length. For example, benefits must be paid strictly in accordance with the preservation rules, loans cannot be made to members or their relatives and the in-house assets must be limited to no more than 5% of the fund's assets.

Case law

In the modern context, we have seen a number of court cases where the majority of the fund's money found its way back to the contributing sponsor with no intention of providing any benefits to members. During the last decade, we have seen a number of cases where trustees and members of SMSFs stripped money from the fund with reckless abandon to support a business, helping to settle a divorce or pay for mortgages.

In many of these cases, the desperate attempt to pay a personal or business expense has seen good money go after bad and be lost forever. The courts and the Australian Taxation Office have taken a dim view of any trustee who takes money or investments from the fund well in advance of the time permitted by the legislation and penalties have been imposed, ranging from financial penalties to disqualification as a trustee. We are yet to see any gaol sentences imposed but it seems only a matter of time, as one case in the past two years came very close to a trustee going to prison.

The payment of a benefit to a member before time or a superannuation fund set up for the purpose of never paying benefits to members is a clear illustration of a breach of the sole purpose test. In addition, actions that may not be as clear could pose a compliance risk to the fund because of the link between the superannuation fund and its investment strategy.

Re-thinking the investment strategy

There are many things surrounding the fund's investment strategy that need to be understood and whether particular investments will result in the fund being maintained solely for superannuation purposes. All superannuation funds are required to have an investment strategy, which takes into consideration the risks associated with the fund's investments, their returns, diversification, liquidity, taxation consequences and the need for insurance to name but a few of the requirements.

Many trustees may couch the wording of the fund's investment strategy very widely and allow for a very broad range of investments, however, they need to understand that some of these investments may provide indirect benefits to members that could result in a breach of the sole purpose test.

One example is the fund acquiring shares in a public company where discounts are provided to shareholders. This is not a problem if the discounts are offered to fund members for no cost to the fund. However, if the fund is required to pay for the discount card to enable the purchase to take place the sole purpose test could be breached as members are receiving a benefit that is not solely for superannuation purposes.

The sole purpose test requires that any investments that the trustees make on behalf of the superannuation fund must be used exclusively, absolutely and solely directed towards providing benefits to members or their beneficiaries.

It should be ensured that the investment strategy of the fund takes into account the risks, returns, diversification etc. as well as ensuring that the investments made by the trustees are consistent with the investment rules of the legislation, as well as the strict requirements of the sole purpose test.

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National Australia Bank’s UK demerger deal

by Questions of the Week

Question: CYBG has appeared in our Growth Portfolio. Not too sure what strategy to do here. Do we sell (exit the position) or do we carry it as part as a de-facto NAB share for now?

Answer (Paul Rickard): CYBG Plc shares (CYB) were issued in February, following the demerger from the National Australia Bank (NAB). It’s the old Clydesdale and Yorkshire Banks. 75% was distributed on an in-kind basis to NAB shareholders on a 1:4 basis, with 25% sold via an IPO into the market.

I am holding because the shares are very cheap. Essentially, it is a play on a new management team; free from the NAB head office in Melbourne, taking this bank forward.

However, it is such a small investment and probably won’t make any difference to the portfolio return.

Question: My question is in relation to the demerger of CYBG Plc from National Bank. Could you please advise if possible what was the cost base deduction for NAB ? I understand that is something to do with the trading price for the week of the 8th February 2016?

Answer (Paul Rickard): The cost base is $4.01 per share, with a deemed acquisition date of 8 February 2016. If you acquired your NAB shares after 20 September 1985, then you will reduce the cost base for your NAB shares by the CYBG cost base (i.e. effectively $4.01 times the number of CYBG shares you were issued).

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