Switzer Super Report
Advice you can trust

Thursday 14 April 2016

Bulls and permabears

There's been a lot of talk about China's outlook and certainly the permabears – those who are always negative about markets no matter what – continue to see the downside for both the country and commodities. Today, Charlie Aitken explores the bull case and what it means for stocks like BHP.

Also in the *Switzer Super Report*, Tony Featherstone uncovers good value in the tech space and finds us stocks for the watch list. With new rules to age pension entitlements, Melanie Dunn gives us some strategies to keep your age pension safe.

Sincerely,

Peter Switzer

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Is the worst over for resources?

by Charlie Aitken

I spent the first three days of this week in Perth, seeing investors and West Australian-based companies. It was certainly an interesting time to be there with a major LNG conference on, which attracted many of the CEOs of the world's largest oil & gas stocks, while the Prime Minister and Federal Cabinet were also in town.

In my live TV cross to Peter Switzer from Perth on Tuesday night, I did mention that the most untold story in Australia in 2016 was the positive performance of commodities and commodity stocks (e.g. Fortescue (FMG) has doubled from its January low).

The question is: what is driving it and will it continue?

China, resource stocks and pervasive negativity

Investors have long memories and plenty of scar tissue. As such, dramatic crashes such as the GFC are never forgotten. Similarly, counter trend rallies against a backdrop of pervasive negativity are always viewed with great scepticism. The problem with an entrenched mentality is that it usually blinds you to an opportunity or a trend change.

The growling from the China permabears increased to a loud roar following the $US5 trillion equity meltdown last year. More recently, the devaluation of the Renminbi and rising debt-related bank fears confirmed (or so it seemed) that the Chinese economy was ready to implode.

Set against a background of negative Chinese sentiment and increased supply concerns, commodities have been in a bear market, since peaking in 2011. However, after plumbing multi-year lows in February, resource stocks have found new support. Indeed, since early March, the resource sector has relatively and absolutely outperformed.

Certainly, there is much investor scepticism surrounding the recent resource rally. The consensus view appears to suggest that commodities are rallying with the weakness in the US dollar.

There's no doubt the US dollar has weakened. Gold is a prime example. But what is driving the resource and commodity recovery? Is it just US dollar weakness? Is the current move sustainable or is the rebound merely a bear market rally or a counter cyclical trend?

Signposts and reflection points

A number of data points and events have occurred recently, which, on reflection, could be viewed as turning points for both the Chinese economy and commodities.

Firstly, on March 1, the Peoples Bank of China (PBOC) announced a 50bp cut in the RRR (reserve requirement ratio), the 5th easing in the current cycle. This was a very important event, given the easing came at a time of recent capital outflows and dramatic currency depreciation. The message was clear. The government was re-committed to pro-growth rather than RMB stability.

Secondly, at the National People's Congress on March 5, the Chinese government committed to a 6.5% -70% per annum growth target. This remains consistent with the long-term aim of doubling economic growth from 2010 to 2020. Premier Li Keqiang stated that it was "impossible" to miss this year's growth target. Following the weakest Chinese GDP growth in 25 years of 6.9%, this was very reminiscent of the famous Draghi " whatever it takes" comment.

Thirdly, at the same time, the National Development and Reform Commission committed an extra RMB 600b into the Special Construction Fund, up from the Q1 figure of RMB 400b.This compares to RMB 800b for the 2015 full year. In addition, the government announced an RMB 1.65 trillion road building initiative and an RMB 800b railway program.

Fourthly, after rising from 2.3% to 3% in March, the PBOC announced the possibility that the fiscal deficit-to-GDP ratio could be raised to as high as 5% in order to stimulate growth. It's worth noting that while the economy has grown since the GFC, the fiscal deficit-to-GDP rose to 2.8% in 2009, after the massive RMB 4 trillion stimulus.

Fifthly, it appears that the government has been successful in re-stimulating growth, with a pick up in the trade balance. As a result, after a $US600bn fall in FX reserves last year, recent figures revealed March FX reserves increased by $US10b. While it's early days, the government appears to have stabilised both the falling Renmimbi and the FX reserves outflows. This will allow a further refocus on economic growth.

Sixthly, the economy officially edged back into expansion with the March PMI manufacturing index rising to 50.2 from 49.4 in Feb. This followed a slump to as low as 47 last year.

Seventhly, Chinese iron ore import data for March of ~86mln tons, +17% month-on-month & 7% year-on-year (yoy).

Lastly, the property sector accounts for 15% of Chinese GDP growth. As such, it's an easy policy move to stimulate housing in order to support growth. In this regard, new housing construction in Feb spiked to 13.7% yoy growth. The latest figures show that new home prices in 70 cities rose by 2% in February, the third month of rises after 15 straight months of declines. It appears that housing is recovering. This is a big positive.

New commodity bull market?

Despite the negative sentiment and doomsday scenarios, China seems to have averted yet another crisis. It appears that the lowest economic growth in 25 years was the inflection point for a government policy change from reform to growth. Make no mistake, this is an important development.

To be sure, China faces many economic difficulties, which will continue to create further uncertainty. But there is no denying the government has the firepower to stimulate growth. Clearly, growth through fixed asset investment and the housing market continues to be a priority. This is very positive, given both remain very commodity-intensive sectors.

There's little doubt that at $15, with BHP Billiton (BHP) as a proxy for the sector, resource stocks were priced for a Chinese meltdown and recession. Maybe just the hint of a rebound in economic growth rather than a recession is enough to see new resource sector inflows money rather than short covering.

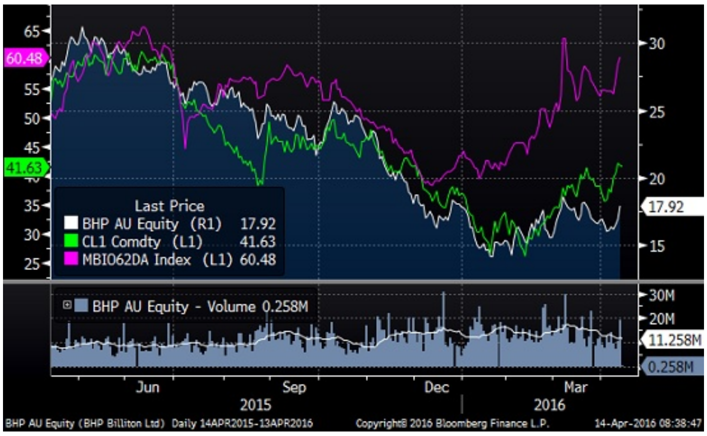
However, it's not just a rebound in Chinese growth, which is improving the outlook for commodities and the resources sector. There are other positives.

The dramatic fall in commodity prices has already resulted in a significant cutback in exploration budgets. The result will be lower future production and, ultimately, a supply deficit in some commodities. This is already being reflected in a rise in consensus forecasts.

In addition, the huge cutbacks in cap-expenditure and expansion plans by the major resource companies have improved cash flows and supported balance sheet repair. Similarly, a reduction in dividend payments has further improved the outlook for industry profitability. Further, significant cost-out programs have been implemented to offset falling revenues. Lastly, valuations are at multi-decade lows.

It's difficult, if not impossible, to determine in real time whether resources have entered a new bull market after a five-year downturn. Time will tell. Meanwhile, both the micro and macro outlooks are improving. That could be enough for further relative outperformance, particularly with the headwinds facing the banking sector.

Obviously, the key large cap Australian stock in this debate is BHP Billiton. Even despite this week's bounce, BHP is lagging its two key commodities iron ore (pink) and oil (green) (see chart below). That suggests BHP has further to run to the upside and my old friend Peter Switzer was right when he thumped the table on BHP down at $15.00. My advice would be to continue to hold BHP as you have already taken the pain: from here could well be gain. The knife has stuck in the deep value floor.



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3 tech stocks to watch

by Tony Featherstone

WiseTech Global's strong debut on the Australian Securities Exchange (ASX) this week buoyed technology bulls and potentially paved the way for other tech companies to list in a tough float market.

WiseTech's market capitalisation hit $1.13 billion when its $3.35 issued shares rallied to $3.89 within days of listing. The logistics software provider is FY16's third-largest listing, after CYBG Plc and Link Administration Holdings.

Large tech listings in Australia have been rare since 2010, despite growing hype about the sector and the strong collective performance of US tech stocks. Most tech listings on the ASX have been for micro-cap companies and many have chosen so-called "backdoor listings" and vended their assets in listed shell companies, in preference to an IPO.

MYOB stands out among larger recent tech IPOs

WiseTech, Link and accounting software provider MYOB Group are among the few tech listings large enough for long-term portfolio investors.

Link has had a good start after raising $943 million in an IPO and listing in October 2015. Its $6.37 issued shares peaked at $7.99 and trade at $7.66. Link's maiden result as a listed company impressed, with revenue tracking slightly ahead of first-half guidance, and full-year prospectus forecasts maintained. But it looks fully valued for now.

MYOB Group has not fared as well after raising $739 million through an IPO and listing in May 2015. Its $3.65 issued shares, considered a touch expensive at listing, have fallen to $3.25 after almost touching $4. MYOB's fiscal 2015 result slightly bettered prospectus forecasts amid good momentum in its cloud-based services.

MYOB, a high-quality company, looks slightly undervalued after recent price falls. The market has mixed views: two broking firms that cover it have a buy, three have a hold and one has a sell. A median price target of $3.29, based on consensus analyst estimates, suggests MYOB is fully valued. But I believe it can do better than the market expects as demand for cloud-based accounting software grows.

Accounting software is a fascinating industry; something has to give with four big players in Xero, MYOB Group, Reckon (nominated as a takeover target in the *Switzer Super Report*) and Intuit Group, maker of Quicken software. I expect Xero and MYOB to dominate the market over time, but the others, particularly Reckon, will not go without a fight.

Chart 1: MYOB Group

Source: Yahoo!7 Finance

WiseTech's attractions include a strong global footprint and deep integration in the logistics industry. Transport operators use its CargoWise One technology to move and store goods – a growth industry if ever there was one.

WiseTech forecasts its pro forma after-tax net profit will grow from an expected $14.3 million in FY16 to $26.1 million in FY17. That puts it on a forecast FY17 Price Earning (PE) multiple of about 43 times – too rich for my liking, even though WiseTech has good long-term prospects. As with most floats, I'd prefer to wait until it has more history as a listed entity.

This brief analysis of tech IPO shows how hard it is to find tech stocks of sufficient size and quality on ASX for portfolio investors, and how the scarcity of large tech stocks on the ASX leads to higher valuations compared with similar companies offshore.

Watch the portals

Of course, much depends on one's definition of "tech" these days. A broader definition brings billion-dollar star stocks such as Seek, REA Group and Carsales.com into play. It wasn't so long ago that the "internet portals" were considered emerging tech stocks.

One of my best strategies over the years was to buy the internet portals during market sell offs and corrections. It was obvious Seek (SEK), REA (REA), CarSales.com (CRZ), Webjet (WEB) and Wofit.com Holdings (WTF) (another stock identified in the *Switzer Super Report* Takeover Portfolio that was acquired) had good growth prospects. But nose-bleeding valuations made them hard to buy.

Investors can mistakenly overlook REA, Seek and Carsales.com, believing they have had their big gains and now as blue chips in their own right have lower growth prospects. They still have terrific long-term outlooks, particularly offshore.

Seek has had a rare negative total return (including dividends) over 12 months, REA is up 13% (low by its standards) and Carsales.com has delivered 23%. Each looks fully valued at the current price, with REA offering slightly better value than its peers.

Another portal, Trade Me Group, looks more interesting from a valuation perspective. The New Zealand provider of online auction and marketplace services demerged from Fairfax Media over 2011-12. It has disappointed over the past three years with an annualised return of 2%, amid losses in online property advertising and market concerns about its required capital expenditure.

Trade Me's turnaround potential is reflected in its rally from \$2.70 in July 2015 to \$3.87. The market has a habit of underestimating how much capital is required to fix up businesses that demerge from larger companies. Non-core businesses often struggle to compete for capital within the parent company and take a few years to repair as standalone companies. The bulk of Trade Me's investment program is over, meaning it can get on with the job of growing market share and earnings.

The original Trade Me business in online auction is going okay and the online classified advertising business in jobs and property has excellent growth prospects. The market seems to have lost some interest in Trade Me, despite it trading on a forecast FY17 PE multiple of 16 times, based on the consensus of a small number of analyst forecasts. By internet portal standards, the PE is modest for a company that dominates its market.

Chart 2: Trade Me Group

Source Yahoo!7 Finance. Based on Australian prices

Tech companies with an eye on Asia

This column has identified several ASX-listed technology companies benefiting from growth in Asia. iProperty Group (taken over by REA Group) and iCars Asia (ICQ) were both nominated in the Switzer Takeover Portfolio at different times. The online advertising companies, from the Catcha Media stable, are targeting huge South East Asian markets.

Freelancer (FLN) is another I have favoured for its offshore exposure. The micro-jobs site is essentially a play on wage arbitrage between Western and Eastern labour markets: companies in developed markets outsourcing work to cheap labour in emerging markets via Freelancer's platform.

Freelancer has more risk than other technology stocks mentioned in this column and suits experienced investors comfortable with speculation. It is yet to make a profit, is reinvesting surplus cash flow in the business, and has been an occasionally volatile stock since its 2013 listing at 50 cents a share.

Nevertheless, the micro-job market has excellent long-term prospects and rapidly rising internet penetration in developing markets is connecting Western companies to cheaper labour. It's hard to fault Freelancer's execution or acquisition strategy so far.

Freelancer shares spiked this week after investment bank UBS initiated coverage with a buy recommendation and $1.85 price target. If all goes to plan, Freelancer will be worth a lot more within 3 to 5 years, but is close to being fully valued for now.

Vista Group International (VGL) is another promising Asia-focused tech stock. The New Zealand-based company, dual-listed on the ASX, provides cinema-management software, film-distribution software and customer-analytics software in the global film industry.

Vista delivered 39% growth in revenue to NZ$65.4 million for FY15 and grew underlying earnings (EBITDA) by 60% to NZ$15.1 million. Both results exceeded prospectus forecasts.

Vista last month announced the sale of its Chinese subsidiary into a new venture owned by Vista and Weying Technology. Weying's online ticking App is integrated into WeChat, the giant Chinese App that more than 600 million people use. About three-quarters of movie tickets in China are sold online through Apps, and Weying is thought to have a 15% share in this market.

The deal should give Vista a stronger position in the soaring Chinese cinema market, which is expected to be the world's largest box-office revenue earner by 2017. The boom in Asian middle-class consumption, covered extensively in this column, is driving stronger demand for Western-style entertainment, such as action movies. Chinese cinemas are superbly placed to benefit.

Macquarie Wealth Management estimates the deal is worth about $1 a share to Vista, which is not included in 12-month price target of A$5.39 (NZ$6) – a reasonable safety margin to Vista's A$4.85 share price.

Vista is due for share-price consolidation after strong price gains since its $83-million IPO in August 2014 at $2.15 a share. But the combination of software, entertainment and China focus makes Vista among the market's more interesting companies for long-term investors, who understand the risks of investing in thinly traded small caps.

Chart 3: Vista Group International

Source: Yahoo!7 Finance

– Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at 13 April 2016.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

BT Investment Management (BTT) Upgrade to Add from Hold by Morgans B/H/S 3/2/1

March quarter funds under management were down 3.1%, largely because of the drag from the British currency, Morgans observes. JO Hambro reported net inflows of $1.1bn.

The broker considers the structural growth drivers are intact and the company is executing well. Rating is therefore upgraded.

On a longer-term view, the broker expects certainty around Britain's exit, or otherwise, from the European Union should alleviate currency concerns and the stock can re-rate towards the target.

In the not-so-good books

Alumina (AWC) Downgrade to Neutral from Buy by UBS B/H/S 4/2/1

The share price is up 13% in the year-to-date, supported by a 25% rebound in the spot alumina price, UBS observes. Still, despite the price improvement in the March quarter, the broker believes 40-50% of the alumina refining industry remains loss making.

Iluka Resources (ILU) Downgrade to Sell from Neutral by UBS B/H/S 1/1/5

Year-to-date, the share price has been volatile, UBS observes. The broker considers the outlook is subdued, although potential upside could come from tightening of global supply, particularly rutile, or if demand recovers.

UBS downgrades earnings forecasts for 2016 and 2017 and drops the rating to Sell from Neutral, given concerns that the stable pricing regime of the last three years is coming to an end.

Platinum Asset Management (PTM) Downgrade to Underperform by Credit Suisse B/H/S 0/3/1

March quarter funds under management were down 8%, affected by outflows and weak market movements. Credit Suisse downgrades earnings estimates for FY16 and FY17 by 3% and 4% respectively.

Rating is downgraded, as retail outflows appear to be accelerating. The broker observes, historically, outflows can extend many months and remains cautious.

Changes are coming: Is your Age Pension safe?

by Melanie Dunn

The assessment of age pension entitlements is changing soon and for some self-managed superannuation fund (SMSF) trustees this could mean an immediate loss of benefits.

The age pension is determined based on the outcome of an Assets Test and an Income Test. For SMSF couples, it is often the Assets Test that will determine the age pension entitlement. Under the Assets Test, a homeowner couple will currently be entitled to a part Age Pension where they have assessable assets (which excludes the family home) of less than $1,163,000.

Many SMSF retirees will currently fall within the rules for receiving at least a part age pension, and in fact, even $1 of age pension entitles retirees to the Pensioner Concession Card. This provides additional concessions such as reductions on rates, energy bills, and vehicle registration, as well as concessions on medicines and health services, which can significantly reduce living expenses in retirement.

From 1 January 2017, the Assets Test assessment is changing in two ways, and here's what it means for you.

A good change – increasing the asset threshold for the full Age Pension

The first is a good change. This is an increase in the amount of assessable assets you can have and still receive a full Age Pension entitlement. This means that some retirees currently on a part Age Pension will actually receive an increase in their Age Pension entitlement at 1 January 2017. A homeowner couple with assessable assets below $286,500 will currently receive the full Age Pension of $34,252. From 1 January 2017, this couple could have more assessable assets, up to $375,000, and still receive the full Age Pension under the Assets Test. Unfortunately, a second means test, the Income Test, may kick in, leading to an entitlement that is higher than prior to this change but below the full rate.

If you have been drawing down on your capital, and fall within these wealth thresholds, you may see a boost in income from the Age Pension in 2017 due to this change. Indeed, if you are a homeowner couple with assessable assets of less than $451,500 you can expect to receive a higher pension.

The big one for SMSF retirees – reducing the asset threshold for the part Age Pension

The second change is to the rate at which Age Pension entitlement drops away under the Assets Test and is likely to be more significant for SMSF retirees.

Currently for every $1,000 in assets above the full Age Pension threshold, you lose $1.50 a fortnight in Age Pension. From 1 January 2017, this happens faster, you will lose $3 a fortnight in pension for every $1,000 in assets above the threshold.

The amount of assets you can hold and still receive a part Age Pension is reducing. For a homeowner couple, the new Assets Test threshold will be $823,000. This is likely to affect you if you have assessable assets that sit between the current Assets Test threshold of $1.16m and the new threshold of $823,000.

It means a homeowner couple today, who is currently receiving an Age Pension entitlement of around $13,500 p.a. with assessable assets just above $823,000, will lose their Age Pension and Pensioner Concession Card on 1 January 2017. There is no grandfathering of the old rules.

If you lose your Age Pension but are currently over age 65, you may still receive the Commonwealth Seniors Health Card, which continues to provide you with concessions on medicines and health services. A loss of Age Pension may also impact the future Centrelink treatment of account-based pensions under the Income Test in your SMSF.

It's not all bad for SMSF retirees

This change does mean that once you do receive a part Age Pension, you will head towards the full pension more quickly as you consume your capital in retirement. Under the Assets Test, for every $100,000 in assets you spend, you will receive an extra $3,900 per annum in Age Pension. From 2017, this doubles to $7,200, so you may see your Age Pension increasing more quickly as you spend your assets.

If you think you might be negatively impacted by the upcoming Assets Test changes, then there are strategies you can consider prior to 1 January 2017 that may reduce the value of your assets assessed by Centrelink.

If you are planning to spend some of your savings in the near future, perhaps for a holiday or home improvements, then bringing this expenditure forwards can be a way to reduce assets now before the 1 January 2017 changes. Similarly, if you are looking to help out family members, then the 'gifting' rules allow you to gift up to $10,000 in a financial year or $30,000 over a rolling 5-year period, without those assets counting towards the Assets Test. Although remember that assets gifted in excess of these limits will still be counted as assessable under the Assets Test.

Some other options to consider include:

- purchasing a funeral bond;
- superannuation fund contributions on behalf of a spouse who is below the Age Pension age;
- purchasing an annuity; and
- for aged care residents, paying a refundable deposit instead of a daily payment for accommodation.

It is very important however to ensure that these are considered in light of your entire financial situation and goals. We recommend that you seek appropriate professional advice before making any financial decisions.

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Professional's Pick – Spark Infrastructure

by Jason Teh

What do you like about the business?

Spark Infrastructure owns regulated electricity transmission and distribution assets. We like Spark Infrastructure because of the company's ability to pay sustainable dividends and, importantly, it offers good value.

The company owns monopoly assets, which offer low risk and stable cash flows.

How can you determine whether this stock has the ability to pay sustainable dividends?

We look at three factors when identifying whether a company can sustain its dividends. This includes the level of recurring earnings, balance sheet strength and the payout ratio.

Spark Infrastructure owns monopoly assets and as highlighted earlier, recurring earnings from these assets are high.

The company's balance sheet is not highly leveraged and the business has been deleveraging steadily over the last five years. In terms of its payout ratio – the company has sensibly paid out a conservative percentage of its earnings in dividends – around 50%. This allows the company to reinvest in the business, ensuring future growth in the business.

What do like about its management?

We really like the management behind the business, particularly their ability in operating the assets and their attitude in regards to capital allocation. They have been prudent with using the cash generated in the business to fund their large capex program. This conservatism has ensured that the company can deliver sustainable shareholder returns.

How long have you held the business?

We initiated a stake in the business 12 months ago. We were attracted to the business because the company was good value and was approaching the end of their de-leveraging period. This meant that the business was in a position to significantly raise their dividends in the future.

At what point would you sell it?

Based on current share prices, the company is good value as it is trading around 10x free cash flow multiple.

We would probably look at exiting the stock when there is less value, which would most likely be around $2.60.

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

In context of the market that has fallen more than 10% over the last year, Spark's defensive qualities have avoided the market carnage.

The share price has been flat at around $2 a share but has delivered a 6% dividend yield over the last 12 months.

Spark Infrastructure

Source: Yahoo!7 Finance

Jason Teh is a senior portfolio manager with Investors Mutual.

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Duet and selling the banks

by Questions of the Week

Question: What is your view on buying into the Duet (DUE) retail rights issue?

Answer: (Paul Rickard): Duet provides solid, but not spectacular income and income growth opportunities. It has reaffirmed guidance for a distribution of 18c per unit in FY16, rising to 19c by FY18 and potentially, an unfranked yield of 8.0 to 8.5%.

In terms of the security purchase plan (SPP), retail investors will pay the lesser of $2.20 (the price paid by institutions), or a 2.5% discount to the weighted average trading price over the period 22 April to 29 April.

The acquisition (the remaining 20% in the Dampier pipeline) makes sense, and while the SPP is no bargain, the degree of risk with this stock is low to moderate.

Question: I am holding a fair share of my portfolio in the big four banks, which are paying good dividends for my SMSF. With the price dropping, do you feel I should sell part of my bank share portfolio or, as suggested by Paul Rickard, hold onto them?

Answer (Peter Switzer): It’s very hard for me to advise you to sell your banks stocks as:

a) I don’t know how overweight you are; and
b) I don’t know what the tax implications are.

I am not selling my bank stocks at the moment as I am with Paul and think, in time, the market will see the value. However, they are on the nose at the moment – and I think it will take a while (read some pretty positive news) to change sentiment. So, probably, some pain to come – and if you aren’t up to this, you may wish to consider your exposure.