Gold falls, miners plunge
After a brief recovery, the gold price has again plunged taking miners with it. What now for our beleaguered gold portfolio? … (2)

The Reject Shop: The good, the bad and the catalyst
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Gold falls, miners plunge

After a brief recovery, the gold price has again plunged taking miners with it. What now for our beleaguered gold portfolio?

GAURAV SODHI • 12 NOVEMBER 2014

Our bet on the gold price has, so far, not worked out. Gold prices have fallen from highs of US$1,900 an ounce to under US$1,200 an ounce today. It has been the steepest fall in three decades and can be almost entirely explained by changing expectations for American interest rates.

KEY POINTS

- Gold prices and equities keep falling
- Operating leverage creates opportunity
- Northern Star upgraded to Spec Buy

The consensus now expects US rates to rise sooner and more sharply, so investors are changing their behaviour to suit, by selling gold (and to some extent, oil) to buy US dollars. As chart 1 shows, the US dollar has been on a tear, rising over 20% against major currencies over the past year (we’ve used an ETF as a proxy).

Miners have fallen by far more. Our gold mini portfolio, introduced a year ago in AU, check out this gold portfolio is down by about 30%. The fall in the share price of gold miners has been far greater than the fall in the metal because miners have high fixed costs. That operating leverage is why gold miners are cheap now and why, despite being downtrodden, they remain on our buy list. A change in the gold price will never lead to a linear change in profits. Consider, for example, a gold miner that produces 200,000 ounces of gold at a cost of $1,000 an ounce. At a gold price of $1,500, it can generate pre-tax profits of about $100m. If the gold price falls to $1,200 an ounce, however, profits fall to $40m. A 20% fall in the gold prices has resulted in a 60% decline in profitability.

It’s worse if lower prices force lower output. Not only does that reduce volume, but the loss of plant utilisation could raise costs. If it’s large enough, a fall in gold prices alone could conceivably reduce output, raise costs and decimate profitability.

SILVER LAKE RESOURCES

This is exactly what has happened with Silver Lake Resources. Once promising production of 300,000 ounces and costs of less than $1,000 an ounce, changed economics mean that production will fall to less than 200,000 ounces at a cost of about $1,100 an ounce. The share price has been savaged by the deteriorating economics. Why then, does Silver Lake remain a Speculative Buy?

The leverage that creates havoc in the downturn can be a boon as prices rise. If that happens, the miner can deploy additional resources and raise volumes, potentially reducing costs. Under the right conditions, profits could soar.

The falling Australian dollar also cushions the decline in metal prices. As Chart 2 and Chart 3 illustrate, the gold price has fallen far more in US dollar terms than in Australian dollar terms, the currency that matters to local miners.

Silver Lake is certainly struggling. We don’t think it will make much profit at current prices and, if prices fall closer to $1,100 an ounce, output could fall again. But the miner has a solid balance sheet, a robust asset in Daisy Milano and plenty of idle resources to deploy if prices rise.

Silver Lake remains in our mini portfolio not because it is a bargain but because it is an option. Any improvement in prices will have a powerful impact on this miner. For that reason, and with the stock down 42% since Gold miners roundup and results, it remains a SPECULATIVE BUY.
KINGSROSE MINING | KRM
PRICE AT REVIEW $0.32
MARKET CAP. $115m
12 MTH PRICE RANGE $0.32 – $0.67
BUSINESS RISK Very High
SHARE PRICE RISK Very High
MAX. PORTFOLIO WEIGHTING 2%
OUR VIEW SPECULATIVE BUY

RECOMMENDATION GUIDE
Sell Above $1.50
Hold $0.32
Speculative Buy Below $0.60

BEADELL RESOURCES | BDR
PRICE AT REVIEW $0.25
MARKET CAP. $210m
12 MTH PRICE RANGE $0.21 – $0.92
BUSINESS RISK Very High
SHARE PRICE RISK Very High
MAX. PORTFOLIO WEIGHTING 2%
OUR VIEW SPECULATIVE BUY

RECOMMENDATION GUIDE
Sell Above $2.00
Hold $0.25
Speculative Buy Below $0.60

NORTHERN STAR RESOURCES
Northern Star Resources has been the star of the local industry. It has swiftly bought five new mines from retreating international miners, many of which management have worked on before. Production should rise to 500,000 ounces or more and costs have consistently been below $1,100 an ounce. Margins today are skinny but we still expect the business to generate $100m in operating cash flow, enough to justify the company’s $500m market capitalisation.

Northern Star’s new mines were neglected by previous management and offer only short lives. The company is spending $50m a year on exploration and there are promising signs it can extend mine life. New resource additions will be key to sustaining high output and the risks involved largely explain price falls. Reserve figures probably understate the value of Northern Star’s mines and, with the share price falling 24% since Gold miners roundup and results, we’re upgrading to SPECULATIVE BUY.

KINGSROSE MINING
Kingsrose Mining has confirmed that, following regulatory delays, mining is now underway and it should produce 40,000 ounces of gold next year. That may not sound like much but Kingsrose is one of the lowest-cost miners in the world and remains profitable at any conceivable gold price.

With total costs of about $700 an ounce, the price of gold will not destroy this business. The investment case rests of the returns the miner generates from reinvesting profits into exploration. Kingsrose will deploy cash flow to drill its Talang Santo mine, a system of volcanic rocks that contains high grade veins of gold.

The nature of this mineralisation means the miner chases veins as they are found rather than established reserves upfront. Official reserves likely underestimate the value of the Talang Santo orebody. It appears to be several times larger than its existing Way Linggo mine and Kingsrose is yet to breach its limit.

We expect Kingrose to generate operating cash flow of $20–30m a year at today’s prices. An enterprise value (which adds net debt to the market capitalisation) of just $120m is a decent price for a low-cost operation with an interesting exploration option. The gold price rout has least impacted Kingsrose: the stock is down 19% since Gold miners roundup and results and it remains a SPECULATIVE BUY.

BEADELL RESOURCES
Beadell has been the most troubling of our mini portfolio, with yet another weak quarterly report showing that it is struggling to meet cost and production targets. Output was just 33,000 ounces for the September quarter, down 40% from this time last year while costs more than doubled from $452 an ounce to US$956.

The details tell the story: last quarter, Beadell moved twice as much waste material as a year ago while grades halved and recoveries fell. These are disastrous numbers that will have a major impact on profits. Costs will far exceed stated targets for the full year. We must decide whether they are just a blip or a new normal.

Management says the results reflect stripping of waste material to expose high grade ore at the vital Duckhead deposit. This is backed up by the fact that, despite plenty of material movements, Duckhead contributed just 3,000 ounces of production. The orebody should now be exposed and should contribute to output in the fourth quarter, but production will have to be stellar to rescue an abysmal year for the miner.

In a tacit admission of its own failures, Beadell will now outsource mining. Doing so will release about $40m in cash and we will be watching costs closely for improvements.

The stock is down 41% since Gold miners roundup and results and we’re reducing the prices in our recommendation guide to factor in higher than expected costs, but, with Duckhead now able to contribute high grade ounces to production, we’re willing to show some patience. SPECULATIVE BUY.

After showing glimpses of a recovery (see Gold portfolio shines), our gold portfolio has crashed along with the gold price. Gold miners are extremely unpopular; they are also as cheap as we can remember. For a small part of a risk tolerant portfolio – we recommend a maximum of 5% between them – this bet requires patience and boldness but, if it works, could be satisfying speculation.

Note: Our model Growth Portfolio holds shares in Silver Lake and Northern Star.

Disclosure: The author, Gaurav Sodhi, owns shares in Silver Lake, Northern Star and Kingsrose.
The Reject Shop: The good, the bad and the catalyst

Shareholders in The Reject Shop have had a bumpy ride. What’s changed and is there still a case for investing?

Graham Witcomb  •  11 NOVEMBER 2014

Things looked pretty bad for The Reject Shop when we upgraded the stock earlier this year, with stalling same-store sales growth, intensifying competition, a lower Aussie dollar and a departing chief executive. But with the stock down 40% in the space of two months we saw an opportunity.

**KEY POINTS**
- Same-store sales worse than expected
- New chief looks like a good fit
- Margins should improve in 2015

A new chief was then announced and there was room for optimism in the full-year result, despite the anticipated ugly headline numbers. But the company’s latest trading update puts it squarely back in the doghouse and, with its share price now down 18% since our original upgrade, it’s time for a fresh look.

Let’s start with the bad news. The company could have used a break after such a difficult 2014 financial year but it hasn’t got it. An unseasonably warm May-June reduced sales of winter products, which the company was forced to heavily discount later in the season to clear the shelves. For a retailer operating on wafer-thin margins, extra markdowns can mean the difference between profit and loss.

Furthermore, failed competitor Retail Adventures, operator of the Go-Lo and Chickenfeed brands, entered the final stages of liquidation in July and August, undercutting The Reject Shop’s prices and attracting customers away from the 70-odd stores in direct competition. Same-store sales for the first quarter of the 2015 financial year declined 5% – a terrible result given the 4% average growth of the last ten years.

A final curve ball came with the Aussie dollar’s 8% plunge since September. Most of The Reject’s Shop’s products are manufactured overseas so a lower dollar increases the cost of purchasing its merchandise. It will be difficult to pass on the added costs to customers and avoid taking a hit to margins in the short term – especially in an already gloomy retail environment where competition is intense.

So these are clear causes for concern, but are they just temporary setbacks?

**THE GOOD NEWS**

Like most retailers, The Reject Shop uses derivatives to hedge the bulk of its currency exposure, so we don’t expect a volatile dollar to cause any cash flow issues. Over time, however, if the dollar stays low the hedging contracts will be renewed at lower rates and the company forced to raise its prices. But competitors are in the same boat and as you can see in Chart 1 The Reject Shop has maintained a profit margin of around 3–4% over the past ten years, despite the Aussie dollar starting the period at 80 cents, falling to 62 cents by 2008, hitting $1.10 in 2011 and more recently hovering back around the 85 cent mark.

Currency movements won’t matter to long-term shareholders nearly as much as the competitive environment – and there are some positive signs here as well. First of all, the heavy discounting associated with Retail Adventures is only temporary. As its stores are progressively closed over the remainder of the year, the added pricing pressure on the 70 directly competing stores will be removed. In fact, those stores will come out far stronger; in many cases being the only remaining discount variety retailer in town.

We also expect same-store sales to be supported by the company’s changing geographic footprint. One of the major contributors to the poor result was aggressive discounting from large discount department stores. However, in recent years the company has been slowly leaving large shopping centres in favour of regional, stand-alone locations.

Sales from stores outside major centres now account for more than 80% of the total. And, as that shift continues, the competitive pressure from the likes of Kmart and Big W should ease.
MARGIN IMPROVEMENT

All things equal, we still expect the company’s profit margin to improve next year as the accelerated network expansion resumes its normal rate of around 20 stores per year.

The company got lucky in 2012 when creditors pulled the plug on its largest direct competitor, debt-laden Retail Adventures (see Bargain hunting at The Reject Shop from 1 Apr 14 (Buy – $9.89)). The Reject Shop’s management spotted the opportunity to take market share and doubled the rate of store openings in 2013-14. However, as the cost of fitting out new stores is immediately expensed and they typically become profitable only after a year or so, profits are being temporarily depressed.

CHART 2: HISTORICAL SAME-STORE SALES

As the normal opening rate resumes, fit-out costs will fall and profits should rise. Management also expects some margin improvement from store leases being renewed at lower rates, with nearly a fifth of the company’s stores up for renewal in 2015.

We’re still comfortable with The Reject Shop’s business model. If you bought the first 10 items in the company’s latest catalogue, you’ll have saved more than 20% compared to buying them from Coles or Woolies.

The benefits of this model are twofold: competition from online retailers is lower as shipping can prove costlier than the item itself, and during recessions the number of potential customers should expand as people become more price conscious.

The Reject Shop has around 320 stores across Australia, which are usually small and warehouse-style. Staff costs are low and a new store fit-out only costs around $90,000, leading to a return on incremental capital above 20%. Lower fit-out costs also limit the downside if stores are found to be unproductive and give management more flexibility to try new formats and locations.

CATALYST

We see new chief executive Ross Sudano’s appointment as a catalyst to getting the house in order. Without the bias of previous commitments, new chiefs can take an axe to unsound business practices and a fresh look at the supply chain and the choice of merchandise.

The Reject Shop already has the scale, distribution network, executive team and clean balance sheet to keep operations running smoothly. Sudano can focus on the big picture – and we expect a revised marketing strategy to be a significant opportunity.

The Reject Shop’s marketing is still stuck in the 1990s, with junk mail catalogues about the only customer interaction. Sudano, however, ignored traditional mass advertising while building the Little Creatures brand of craft beer. By engaging customers through community events, tasting nights and sponsored local markets, Sudano took the brand from tiny niche to a mainstream product selling 10m litres a year – and nearly tripled profits during his three-year tenure. What’s more, he negotiated the buyout of Little World Beverages by Lion Nathan at a fabulous price for shareholders.

Sudano joined The Reject Shop in September. Since then, he’s noted that ‘comparable sales have improved considerably over the last five weeks [to 15 Oct] as the initial impacts of planned initiatives to address the situation have begun to be felt, with comparable store sales for the first two weeks of October being flat’.

We can’t give too much weight to five weeks’ performance, but it’s nice to see things moving in the right direction again.

ROAD MAP

Let’s think about how things might develop for The Reject Shop. For the reasons outlined above, we still think it’s conservative to assume zero same-store sales growth.

<table>
<thead>
<tr>
<th>TABLE 1: FIVE-YEAR EARNINGS AND 2018 FORECAST</th>
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<tbody>
<tr>
<td>YEAR TO 30 JUNE</td>
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<tr>
<td>STORES</td>
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<td>SAME-STORE SALES GROWTH (%)</td>
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<td>REVENUE ($M)</td>
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<td>GROSS PROFIT ($M)</td>
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<td>OPERATING INCOME ($M)</td>
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<td>STATUTORY NET PROFIT ($M)</td>
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<td>UNDERLYING NET PROFIT ($M)</td>
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<td>UNDERLYING NET PROFIT MARGIN (%)</td>
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<td>UNDERLYING EPS (CENTS)</td>
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*excluding store opening costs, asset writedowns and insurance claims
Management intends to continue the roll-out with 20 new stores per year, which implies The Reject Shop should reach its goal of 400 stores in about four years. With flat same-store sales, total revenue would come in at around $900m. As pricing pressures ease, leases are renewed at lower rates and the store roll-out winds up, we expect a percentage point or so to be added to the profit margin, to give around $30m–35m in net profit. On a conservative price-earnings multiple of 12, the middle of that range would get us to about $400m, or almost $14 a share.

If The Reject Shop is becoming an outdated concept — or, at least, a permanently less profitable one — it will show up first in same-store sales. If they remain negative for an extended period, the company may need to reduce its store network to cut costs, rather than continue the roll-out. If same-store sales keep falling over the next few quarters we’ll downgrade and cut our losses.

We’re reducing our price guide and lowering the portfolio limit to 3% to allow for greater volatility in same-store sales. But with the stock down 12% since The Reject Shop: Result 2014 from 21 Aug 14 (Buy – $9.30) and with reasonable prospects for growth and operating improvements, plus a fully franked dividend yield of 3.7%, we’re sticking with BUY.

Note: Our model Growth Portfolio holds shares in The Reject Shop.

On the scent with iSentia

Our view of iSentia’s business has improved following a meeting with management, but we’d need a cheaper price before buying.

JAMES CARLISLE • 14 NOVEMBER 2014

Walter Schloss was one of the legends of value investing. A former student and employee of Ben Graham and one of the Superinvestors of Graham-and-Doddsville, he racked up 21% a year over 46 years to 2002 – and he did it without hardly ever meeting with companies’ managements.

KEY POINTS

- Visit to iSentia helps us overcome concerns
- High quality company we’d love to own at the right price
- Upgrading to Hold

As his son Edwin explained: ‘You can waste a whole lot of energy running all over the country checking on managements of the companies you own. We only go to annual meetings if they’re within a 20-block radius of the office.’

Depending on your definitions, we went about 15 blocks to visit iSentia Group last week, so we’re hoping that Schloss would have been OK with it. In truth, though, we suspect we’re just that bit keener to get out of the office.

Chief executive John Croll and chief financial officer Nimesh Shah can’t do much about the last one of those, but we were hoping they might allay our other concerns. Before we get onto that, though, let’s have a quick recap on iSentia’s business.

SIMPLE ROOTS

From simple roots as a press clippings service in the 1980s, iSentia has developed into a diverse media intelligence business, gathering media content from print, broadcast, online news and social media sources, packaging it up, summarising it, analysing it, and supplying it to customers in real time, mostly through its award-winning Mediaportal platform.

These days stories can break without warning on social media and companies need to be able to react quickly, with an understanding of the way in which their customers are reacting. This means catching the story early and then following it as it moves through different media channels. The breadth of the iSentia’s media coverage also puts it in the perfect position to provide ‘added value services’,...
helping companies communicate with the outside world and evaluate their effectiveness in doing so.

All of this combines to form the modern ‘media intelligence’ industry and iSentia is far and away the market leader in this neck of the woods, with 90% of revenues in Australia and New Zealand (ANZ) and 28% in the whole of the Asia-Pacific, compared to just 6% for the nearest competitor. In contrast to iSentia’s leadership at home, the Asian market is still dominated by small regional operators and in-house services, so it’s ripe for the picking, with a growing trend towards outsourcing.

iSentia is far and away the market leader in this neck of the woods, with 90% of revenues in Australia and New Zealand (ANZ) and 28% in the whole of the Asia-Pacific, compared to just 6% for the nearest competitor.

The market in the Asia-Pacific grew at 16% a year between 2009 and 2013, to $344m, and is forecast to grow at 9% overall between 2013 and 2016, to about $500m. Either side of this figure, we’d expect growth in Australia of around 5–8% and growth in Asia of 10–15%, but we’ll come back to that when we consider valuation. For now, let’s return to our other three concerns.

BARRIERS TO ENTRY

With respect to supplier relationships, Croll and Shah described the range of deals they have with different media businesses. The biggest media companies do indeed band together to negotiate deals with iSentia, but it has thousands of other sources, in print, online and broadcast media, with a variety of arrangements. Crucially – particularly following iSentia’s acquisition of AAP’s media monitoring business earlier this year – iSentia is the only game in town, at least in Australia and New Zealand. So the media companies are faced with taking some revenue from iSentia (at close to 100% margins) or not taking any at all – and these days media businesses tend to be pretty happy to take what they can get.

So, rather than supplier relationships representing a threat, it seems more likely that they create a major barrier to entry, which brings us to our second concern.

Excellence in business quality translates into excellent financial performance. Perhaps the most notable feature is that with a relatively fixed cost base and low capital expenditure requirements, additional revenue flows efficiently into profits and cash. This is reflected in its earnings before interest, tax, depreciation
and amortisation (EBITDA) margin rising from 22% in 2011 to an expected 33% in 2015. The company also boasts a return on capital (excluding acquired goodwill and customer contracts) of around 41%.

That brings us to the share price, which is that much harder to stomach after rising almost 50% in five months since the float. For the year to June 2015, the company expects to achieve EBITDA of $41.3m and a net profit of $12.8m. To that net profit, however, we need to make a couple of adjustments, one positive and negative.

The first is for the amortisation of acquired customer contracts. Given iSentia’s track record at retaining customers we don’t see this as a genuine business expense, so we’ll add it back – all $5.5m of it in 2014 and an expected $6.1m in 2015. (The company must, however, keep investing in its software, so this is a real cost and we do include the amortisation of capitalised software.)

The second adjustment is for the relatively low tax rate the company has enjoyed (and which is expected to continue for 2015 at least), due to research and development offsets and lower tax rates in some Asian countries. Our inclination is generally to take the conservative approach and assume that the ATO eventually gets its hands on 30%, although in this case that’s probably a little pessimistic.

After making these adjustments, we get a conservative net profit figure of about $22m for 2015, or earnings per share of about 11 cents (though the statutory numbers will be about 10% lower and the figures excluding all amortisation will be about 20% higher).

We’ve presented the figures in Table 1, along with a couple of possible scenarios for five years from now: one based on the bottom of the growth ranges we mentioned earlier, of 5–8% in ANZ and 10–15% a year in Asia, and one based on the top (in reality, the company may beat Asian market growth if it can take market share). Between these two scenarios, we get a pretty ordinary investment, with a total return of 8% a year, and a standout, with an annual return of 18% – which demonstrates the sensitivity to small differences in revenue growth.

On that basis, we don’t think the current share price overvalues the company, but we’d want a bigger margin of safety for a purchase – something closer to $2.60, which would amount to about 24 times our conservative 2015 earnings number.

For the time being, though, if you ignored our advice on the float then – whilst noting our recommended maximum portfolio weighting of 4% – we recommend you HOLD.

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**TABLE 1: ISENTIA FINANCIAL DATA AND SCENARIOS**

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<td>18</td>
<td>8</td>
<td>18</td>
<td></td>
<td></td>
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</tbody>
</table>

* excludes amortisation of acquired customer contracts
** Targeted payout ratio of 40–60% of net profit before all amortisation; add about 1% if using FCF yield
**Stock updates**

**ARB CORP**

**GRAHAM WITCOMB**

<table>
<thead>
<tr>
<th>ARB CORP</th>
<th>ARP</th>
<th>RECOMMENDATION GUIDE</th>
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<tr>
<td>MAX. PORT. WEIGHTING</td>
<td>6%</td>
<td>Buy Below $9.00</td>
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<td>OUR VIEW</td>
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**ARB Corporation** has declared a fully franked special dividend of $1.00 per share to be paid on 5 December (ex date 17 Nov). The distributor of four wheel drive accessories will distribute $72.5m to shareholders and a significant portion of the company’s accumulated franking credits. This is a savvy move, as the Federal Government has proposed reducing the corporate tax rate from 30% to 28.5% from July 2015, and the lower franking rebate would apply to any retained earnings paid out after 1 Jul 15 regardless of when the profits were earned.

Shareholders can elect to receive all or part of the dividend as shares rather than cash as the company has temporarily recommenced the Dividend Reinvestment Plan (DRP) and the Bonus Share Plan, but it only applies to the special dividend. The applicable share price will be the lower of $11.35 (ex the special dividend); or a 5% discount to ARB’s average share price during the five trading days after and including 17 Nov 14.

Chairman and founder Roger Brown said, ‘Please note that any previous participation that shareholders may have had in the Plans is no longer operative. Accordingly, if shareholders wish to participate in the DRP and/or BSP with respect to this Special Dividend, shareholders must complete the Election Form (which will be enclosed with the Information Booklet) according to the instructions on the form and return it to the share registry … by 5pm on 21 November 2014.’

However, with the share price up slightly since ARB Corporation: Result 2014 from 25 Aug 14 (Hold – $12.97) and just 6% below our Sell price, we’d prefer to take the cash and invest it in cheaper opportunities on our Buy list. We still love the company despite the headwinds it faces as the resources boom deflates, but due to its high valuation we’re sticking with HOLD.

**SOMNOMED**

**GRAHAM WITCOMB**

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The share price of SomnoMed jumped more than 4% yesterday after announcing its mouthguards to treat sleep apnoea are now being used by more than 200,000 patients. Some 50,000 were fitted over the past 12 months – double what the company sold just three years ago.

This follows an excellent full-year result where revenue rose 40% to $26m thanks to strong sales in Europe. The company now operates in 26 countries and has a distribution network of more than 4,000 dentists.

In an accompanying presentation, management noted that a significant driver of the company’s rapid growth has been higher levels of patient comfort compared to continuous positive airway pressure (CPAP) treatments from the likes of ResMed and Fisher & Paykel Healthcare. The small ‘oral appliances’ are also less costly and more durable than CPAP.

Chairman Dr. Peter Neustadt said: ‘Whilst 200,000 SomnoDent devices fitted to patients is an important milestone, we believe it is only the beginning of our long-term growth. We expect this sales trend to continue with sales growth driven by a growing acceptance among medical specialists, increased levels of reimbursement by insurers and expansion into new markets.’

Management expects ‘annual growth rates of 20% to 30%’ over the next few years; however, our expectations are at the lower end of that range. SomnoMed’s share price has risen 42% since SomnoMed: Result 2014 from 25 Aug 14 (Hold – $1.88) and is up 101% since we upgraded the stock nine months ago in SomnoMed: A future mini-ResMed? (Speculative Buy – $1.33). HOLD.
ASX CEO Elmer Funke Kupper knows that setting a good example is vital. With its regulatory function, the behaviour of ASX sends a signal to other listed companies. So the announcement mid-last year that the company would raise $553m of capital in the fairest way possible—via a renounceable entitlement offer—deserves credit.

Unfortunately, few companies meet this standard. Many share issues diddle small shareholders at the expense of the big end of town. So how do you recognise if you’re being short-changed?

A renounceable entitlement offer—originally called a ‘rights issue’—is the fairest way to raise capital because it’s pro rata; shareholders are entitled to acquire new shares in proportion to their existing holding. And because it’s renounceable, shareholders can usually sell their entitlement on market. But they require you to do something. If you’re on holiday, or otherwise unable to take up your entitlement, it lapses.

Shareholder-friendly companies like the ASX avoid this problem by selling lapsed entitlements into a bookbuild. The proceeds are then sent to the shareholders that failed to take up their entitlement.

So why don’t all companies use renounceable entitlement offers?

Because the Corporations Act requires a prospectus for each offer, they’re slow and expensive. It can take six weeks or more to conduct an entitlement issue, exposing the company to market declines. This usually means a significant price discount is required. The ASX’s $30 issue price, for example, was a 16% discount to the price before the announcement.

A non-renounceable offer is the same as a renounceable offer, except that shareholders cannot sell their entitlements on market. It’s a ‘use it or lose it’ principle and much less fair system. If you’re unable to take up your entitlement, or don’t have the cash available, your shareholding will be diluted.

A Share Purchase Plan (SPP) avoids the need to issue a prospectus but because it’s limited to no more than $15,000 of shares per existing shareholder in a 12-month period, it too is fundamentally unfair.

The amount is too small if you have a large shareholding and too large if you have a small one. In fact, a shareholder with only $500 worth of shares could acquire a much larger holding at a significant price discount through an SPP.

But the most galling aspect that there’s often a heavy scale back if demand is high. In 2012, QBE Insurance launched a $150m SPP in conjunction with an institutional placement at a price of $10.70. Most small shareholders received a tiny fraction of the shares applied for, making the whole process somewhat pointless.

To the third option; a placement. This is an issue of shares to one or more large shareholders (existing or otherwise). As investment banks typically control which clients receive stock—as well as the issue price—it’s the least transparent of all the capital raising methods and can be used as a way of handing out favours at small shareholders expense. But hundreds of millions of dollars can be raised in little more than an afternoon—particularly useful when making acquisitions, takeovers, or repaying debt.

The same problem exists, though. Placements tend to be dilutionary to small shareholders because institutions get to buy new shares at a discount and small shareholders don’t. While some companies try to overcome this by combining an institutional placement with an SPP, it’s simply combining two inadequate capital raising mechanisms. The option remains the poor cousin of the renounceable entitlement issue.

So what’s the way forward? Well, ASIC could improve Australia’s capital raising regime by removing the requirement to issue a prospectus. It’s absurd to require prospectuses for entitlement offers and not for share purchase plans, particularly when investors buy shares on market every day without them. Surely a two-page ‘capital raising summary’ could suffice for secondary share issues?

The new ASX Bookbuild service has the capacity to be fairer and more transparent because it runs like an auction, where price drives allocation. But too many companies prefer not to use it because it doesn’t allow them to exercise control over who gets shares and who doesn’t.

So be wary of companies making placements, particularly when there’s no share purchase plan attached.

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Ask the Experts

BUILDING A PORTFOLIO
I am a recent subscriber and am currently underweight in shares. In order to build a share portfolio would you recommend selecting shares from the Growth and/ or Income Portfolios (avoiding the speculative ones if you are a conservative investor) or alternatively wait for new Buy recommendations to occur (such as occurred yesterday with AGI)? If the former, would you tend to buy broadly (say all the non-speculative shares), focus on more recent Buy recommendations or some other approach? The latter approach (waiting for new recommendations) would mean building a portfolio over a much longer timeframe depending on how quickly new Buy recommendations are made. Regards

7 Nov 2014 – Graham Witcomb: welcome to the II family! Let me start by saying we can’t give personal advice so it is important to take your own situation into account before acting on our recommendations.

Diversification is a fine balancing act with no hard and fast rules. On the one hand you want to be concentrated in your best ideas so they make a meaningful contribution to performance, but on the other you want to reduce the risk that you will be hurt by those investments that turn against you (note that speculative situations should generally only be a small portion of your portfolio – no more than 10% cumulatively). In any case, it’s those stocks with the least downside, not the greatest potential upside, that should form the core of most portfolios.

When determining which shares to buy, the newest recommendations will be the most up to date but our existing recommendations are still meaningful guides if you also pay close attention to the price guide, portfolio limit and then check the ASX page for the relevant company to see if any material news has been announced since our last article that we may be analysing behind the scenes but are yet to comment on.

Some members follow the model portfolios religiously, others not at all. It really depends on your personal style and how large your portfolio is. Two articles you might find helpful can be found here and here and remember that when building a portfolio there’s no need to rush. Take it slow as you get more comfortable with buying shares and familiar with value investing principles. Let me know if you have any other questions and good luck!

CHALLENGER LOOKS PRICEY
Any plans for some updated research on CGF? It’s getting positive press re its annuity products & our ageing demographic, but your ever-cautious rational views are always welcome...

7 Nov 2014 – James Carlisle: I’d be careful not to confuse a good product with a good company. I’ve had some great flights with Qantas (well they’ve got me from A to B anyhow) and I’ll happily buy Tassal’s salmon for the family, but I wouldn’t invest in either stock. That’s not to say that Challenger is a low-quality business, but it is hard to estimate its value. As I wrote a while ago, its profit number is the small difference between two very large numbers which are themselves hard to estimate. So far it’s been able to build its annuity business with little competition, but it wouldn’t take much for a big financial institution to take market share - annuities are just formulas backed by some assets after all. Of course it could carry on confounding us for years, but it’s hard to see a competitive advantage and, along with the difficulties over valuation, we’d want a big margin of safety and with the share price at slightly more than twice tangible book value, there isn’t one at the moment – at least not one that’s obvious to me! As a result, we’re inclined to focus on better opportunities. Sorry not to be more help.

VEDA ON THE WATCH LIST
What is it’s view on Veda (VED)? It has been almost a year since it’s last review on Veda, it has metrics that meet the criteria of a high quality business. However, I’m more concerned about the threat of the global competitors as credit files is really a commodity and Veda require to compete on price aggressively.

7 Nov 2014 – James Carlisle: I’m not sure it’s a commodity business – there are real barriers to entry from the network effects – more data = more customers = more data ... as you say, though, there is a credible threat from overseas in the form of Experian and it’s hard to say how this impacts the valuation. With the stock on a price-earnings ratio of 25 there is little room for slip-ups. Anyway, as you say, it’s a high-quality business and we’ll be keeping an eye on it, but I’m delighted to say that there are a few other stocks on the watch list at the moment, so I can’t promise a review in the near future.

LISTED INVESTMENT COMPANIES (LICs)
Can you tell me what LIC’s are “flavour of the month” right now as far as II is concerned? (And where would I search for this info without asking here?)

6 Nov 2014 – Jonathan Mills, CFA: Please note that I can’t give you personal advice and so I can’t suggest which LICs you should invest in. There aren’t any LICs currently on our Buy list but you can find a list of them along with information including their NTAs, expense ratios and so on here. More information on each LIC can be found on their websites - doing a Google search of the LIC should bring up their websites.

There is also an article discussing the analysis and valuation of LICs on our website here.

BLOG ARTICLE LINKS
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More proof QE is driving asset prices higher
Will peer-to-peer lending kill the banks?

TWITTER LINKS
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