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Part 1
What’s Woolworths worth?

In this three-part series, we consider whether Woolworths can avoid the disasters unfolding for its UK peers, before arriving at a valuation.

James Carlisle • 8 December 2014

He gets most of the credit, but it probably didn’t take a genius like Isaac Newton to tell people that what goes up must come down. In finance, the proposition typically gets expressed as ‘reversion to the mean’, which sounds a lot grander but comes to much the same thing; and it’s fair to say that supermarkets in the UK have been doing a lot of it lately.

The legendary Tesco has seen the operating margin at its UK business fall from 6.1% in 2012 to 2.3% in the six months to August – and it’s forecast to get worse before it gets better.

All this has caught investors on the hop, with the share price halving since September last year, to £1.88. Even Warren Buffett has coped a bloody nose, having bought a (now reduced) stake at over £3.

Fellow UK listed supermarket groups Sainsbury’s and Morrisons haven’t fared much better, falling 42% and 39% in the same period. Naturally this has got people wondering whether the same fate could befall Woolworths over here, and it has now fallen around 15% in six weeks in sympathy with its UK peers (it wasn’t helped by a disappointing first-quarter sales update).

OMINOUS SIMILARITIES

There are ominous similarities in a couple of key areas – the rise of discounters like Aldi and the increase in internet shopping. In this three-part series, we’ll look at these problems and consider how they might affect Woolworths (and the Wesfarmers-owned Coles).

We’ll start in this first part by examining the threat from discounters such as Costco and Aldi. In part two, we’ll consider the impact of the internet before returning to the overall level of competition - or lack of it - in the Australian market. Finally in part three we’ll look at what it all might mean for Woolworths’ margins and valuation, and whether it too will end up demonstrating Newton’s law.

Before we start, though, we’ll let slip a little of the punch line, because it’s important to understand the context of the various issues. Despite the similarities, there’s a major difference between the Australian and UK markets in the intensity of competition. Notwithstanding Aldi’s considerable success, the Australian market still operates as a quasi-duopoly. The UK, by contrast, has four players with market shares between 10% and 30% and a clutch more between 5% and 10% (See Charts 1 and 2).

This exacerbates the underlying problems in the UK: the presence of discounters is made worse by a willingness to match their prices; the over-reliance on out-of-town superstores is made worse by the need to earn something from the massive fixed investment; and the rise of the internet is made worse by the reluctance of the majors to extract an appropriate charge for it. We’ll return to this towards the end of Part 2, but for now let’s turn our attention to the discounters.

LAND OF THE GIANTS

Walking into a Costco has been likened to entering the land of the giants. There are relatively few stores, but they are BIG, and everything is sold in BULK – after all, you don’t want to travel all that way too often. With cheap locations and bulk deals Costco is able to offer cheap prices on premium brands, but you have to pay an annual membership and relatively few people have the time or inclination to travel that far not knowing exactly what will be in stock (the company refers to it as ‘the treasure hunt’).

Costco now has seven Australian stores, after opening its first in 2009, but with an estimated $1–2bn in annual sales it’s a small part of the $92bn Australian grocery market and we expect it to remain a niche player. Even in the US, where it has been going for 30 years and has 450 stores, its share of the overall grocery market is only about 5%.

Despite the similarities, there’s a major difference between the Australian and UK markets in the intensity of competition.
PARALLEL UNIVERSE
If entering a Costco is like walking into the land of the giants, visiting an Aldi is like stepping into a parallel universe. The smoked salmon comes in a blue packet with a transparent leaping salmon, but it says ‘almare’ rather than ‘tassal’; the English breakfast tea comes in a crested red box but says ‘Diplomat’ instead of ‘Twinings’; and the diced Australian tomatoes come in black tins with a red and white logo that says ‘Remano’ rather than ‘Ardmona’.

The thing is that Associated British Foods and Coca-Cola Amatil (the respective owners of Twinings and SPC Ardmona) have spent large sums creating these associations with their own products – and that of course is the very reason that they cost so much more (see Chart 3).

Whatever the legal situation (we’d guess that Aldi are sailing close to the wind but have an idea what they’re doing), customers are voting with their feet: given the choice they’d rather not pay the extra to be advertised at. This has propelled Aldi from a standing start in 2001 to over 10% of the local market, according to independent research from Roy Morgan (see Chart 2), overtaking the hapless Metcash/IGA in 2013.

RAMPING UP PRIVATE LABEL
The point has not been lost on Woolworths and Coles, which have been ramping up their own private-label offerings in recent years, with the added twist that they’ve used their existing goodwill to give their labels a jump start. At different price points and in different categories, Woolworths and Coles now offer a range of private-label products, some with much improved packaging from the ‘no-frills’ offerings.

All this isn’t so much of an issue for the fresh produce that contributes around a third of grocery spending. These products don’t lend themselves so well to branding and suppliers have already been beaten down in price. But it has created a major headache for the premium brands, and we’d suggest it’s behind the recent weak performances from the likes of Coca-Cola Amatil and Goodman Fielder.

Woolies and Coles, though, are a step back from the front line; indeed they’re in the same position as Aldi. They just need to make sure they provide products that customers want to buy at prices they are willing to pay – and they’ve made it clear to suppliers that they will do exactly that, whether it be a premium brand backed by heavy marketing or – increasingly – a cheaper brand of their own.

LEADING THE CHARGE
We suspect that many suppliers will continue to struggle to get their heads around this, and that private label will continue its rise. According to IBISWorld, private-label sales have grown from 14% in 2007–8 to around 25% now, and the researcher expects them to reach 35% by 2019–20.

Woolies and Coles will no doubt be delighted to lead the charge because own brands give them higher margins, and/or greater scope to cut prices to compete with the discounters (although they presumably do better out of their mid-priced rather than budget brands).
In fact the increase in private label thus far is a major reason they’ve been able to maintain their combined market share, while increasing margins, despite Aldi marching ahead. In fact most of Aldi’s gains have come at the expense of Metcash’s IGA network and ‘other’ (see Chart 2).

No doubt Metcash/IGA has been pushing its own private-label goods, but it is facing bigger problems, notably its distribution-focused business model and the lack of control over its store network, as we explained in Metcash model is fundamentally flawed on 23 Mar 14 (Avoid – $2.85).

CONVENIENT STORES

Aldi does have one edge over Woolworths and Coles – at least for part of the market – in the smaller footprint of its stores and limited range. Part of the problem in the UK has been a massive misreading of the market a decade or two ago, which led the large chains to build a huge number of stand-alone, out-of-town superstores. These now account for 42% of UK grocery sales, but they’re finding that to lure people to them, they have to be very competitive on price at the same time as carrying huge ranges (you wouldn’t want to have to travel to more than one of them).

Australia has virtually none of these out-of-town superstores, favouring the medium-sized format so often seen in shopping centres, but Aldi nevertheless gets an edge from its more limited range and convenient sites. The former means it can compete hard on price on the stocked items, while the latter means customers are happy to pop in for just part of their overall shop.
Part 2

What’s Woolworths worth?

In the second of this three-part series, we look at the threat Woolworths faces from the internet – and from the re-energised Coles.

JAMES CARLISLE • 10 DECEMBER 2014

Anyone who’s watched Downton Abbey will know that the online ordering and delivery of groceries is nothing new. Where Mrs Patmore (“Do I look like a frolicker?”) once phoned through for provisions for the weekend hunting party, now it’s you and me trying to get the essentials for a busy week.

KEY POINTS

- Online ordering and delivery is nothing new
- Pricing for internet shopping likely to remain rational
- Woolworths’ greatest threat is from revitalised Coles

All that’s changed is the mechanism – and a whole bunch of perception. After retailers worked out that pandering to Mrs Patmore was prohibitively expensive, they started encouraging people to come into their stores – and even fill their own baskets.

Originally known as ‘groceterias’, these self-service stores have grown into the supermarkets we know and love today, but the utility of the internet has pushed some people back to the delivery model. The trouble is that while Mrs Patmore was once happy to pay a premium for this service (not that it was her money anyway), we now seem to think that there should be a discount for ordering online – I mean, everything’s cheaper on the internet isn’t it?

Well, no, it isn’t. As a number of would-be internet grocers have found (such as Webvan and Home Grocer – both now owned by Amazon), the number of items at relatively low price points, often with short shelf lives, limits the effectiveness of the traditional internet model, which uses large centralised distribution centres and regular parcel mail.

So there aren’t many costs to save in the physical distribution network, and there are additional costs in filling trolleys and delivering orders. CLSA suggests that these activities each cost about 2.5% of sales, which is enough to wipe out a typical supermarket’s operating margin, if they take it on the chin as they often appear to in the UK. Waitrose, for example, offers free delivery within a two-hour slot for orders over £60, as does Asda for orders over £45, while Tesco will charge just £1 for people spending over £25.

ORDERLY MARKET

In Australia, the market for online grocery shopping is much more concentrated, with neither Aldi nor IGA offering the service. As a result, the market is more rational. So much so that it’s quite hard to pin down the actual cost of the service, but it appears to be plenty: both Wesfarmers-owned Coles and Woolworths often charge higher prices for goods purchased online (particularly premium brands – see Chart 1), and they then add delivery charges of around $10 for a $150 order.

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it still only covers 70% of the UK population, mostly in the densely populated south-east of England.

Tesco started with a store-based model, but has since found greater efficiency in a middle ground, where it uses ‘dark stores’, some of which are highly automated although they still make use of human pickers (Big W’s distribution centre at Hoxton Park for supplying stores uses similar technology). Waitrose has also opened dark stores and Woolworths started out on this journey recently with its first dark store in Mascot, near Sydney Airport.

We’ll be watching developments closely, but ultimately we expect the internet to remain just another sales channel for Woolworths and Coles – and a relatively small one at that (perhaps 5-10% of the market). We also expect that it will be just as uncompetitive as the rest of the local market, perhaps more so given the additional concentration.

RECIPE FOR DISASTER
The other major impact of the internet is in price comparison. Even if you don’t shop online, you can easily check where your preferred toothpaste will be cheapest; and discount stores like Aldi, while they might not offer online ordering, will happily shout out their prices and help you build a shopping list.

Furthermore, all the major supermarkets in the UK now offer some kind of formal price-matching service. Morrisons will match prices from Aldi and Lidl as well as Tesco, Sainsbury and Asda, while Asda will beat all the majors – including Morrisons – by 10%. Presumably this means that Asda will need to beat Aldi and Lidl by 10%, and Morrisons (not to mention Tesco and Sainsbury) will then need to beat that price. It’s a recipe for disaster and so it has proved.

CHART 2: PROPORTION OF ALL GROCERY DOLLAR SPENT AT EACH SUPERMARKET

<table>
<thead>
<tr>
<th>%</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Woolworths</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coles</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aldi</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IGA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other supermarkets</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Roy Morgan Supermarket Currency Report, Dec 2013

As we hinted in Part One, this goes to the heart of the problem in the UK and demonstrates the differences with the Australian market. While the UK has four players with market shares between 10% and 30% plus a clutch more around the 5-10% mark, Australia has just the two majors and a couple around 10%. Our third-placed competitor (Aldi) is admittedly on the rise, but this is matched by the decline of the number four (see Chart 2).

In such a tight market, it’s almost inconceivable that either Woolworths or Coles will do anything drastic. In fact, Woolworths and Coles each have market shares higher than the UK’s biggest (Tesco) – at 39% and 34%, compared to Tesco’s 28% – so they have that much more to lose and that much less to gain from a price war than a fourth-placed competitor like Morrisons, intent on climbing the tree to gain the scale advantages.

COLES REVITALISED
The most we’re likely to see over here are gentle shifts. Woolworths and Coles will talk it up as tough competition, but don’t be fooled – it will remain a world away from the carnage we’ve seen in the UK.

Even so, gentle shifts can add up over time. Back in the 1980s, Coles led Woolworths, but it became complacent and Woolworths got its act together and, by the time Wesfarmers bought it in 2007, Coles was on its knees. Now Woolworths is the one that looks complacent, while Coles has been revitalised by management forged in the white heat of the UK market.

CHART 3: COLES’ AND WOOLWORTHS’ QUARTERLY COMPARABLE STORE SALES GROWTH

<table>
<thead>
<tr>
<th>%</th>
<th>10Q1</th>
<th>11Q1</th>
<th>12Q1</th>
<th>13Q1</th>
<th>14Q1</th>
<th>15Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Woolies AFL comparable store sales growth</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Coles AFL comparable store sales growth</td>
<td></td>
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<td></td>
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</tbody>
</table>

Source: Company reports

The results have been remarkable. Absenteeism at Coles is down over 30%, staff retention is up 30% and injury rates are down more than 50% – with the result that sales per full-time equivalent employee are up over 20%. In its supply chain, Coles is carrying almost 10% more cartons per full-time equivalent employee are up over 20%. In its supply chain, Coles is carrying almost 10% more cartons per load and the cost per carton has fallen nearly 20%.

The results are also apparent at the till, with Coles beating Woolworths on comparable store sales growth in 19 out of the past 20 quarters, with the other being a tie. Alarming, after the gap closed to nothing during the 2014 financial year, it has now stretched back to almost as wide as it’s been.

The superior growth rates have closed the market share gap from almost 12% to just over 5% – and it’s all been achieved while the food and liquor operating margin has risen from below 4% to 5.3%, suggesting that Coles could fight harder if it felt the need. However, Coles appears confident that it can make further operating improvements, estimating that in key measures such as sales density and cost of doing business it’s less than half-way along the journey from where it was in 2009 to what it considers ‘world class’. In supply chain costs it reckons it’s barely a fifth of the way along.
HOPING FOR LOWER MARGINS

Given the improved operating performance, Coles management is shaping up to be more aggressive on growth, with a target to increase net selling area by 2–3% a year, compared to the 1–2% it’s achieved in the past four years.

Coles is unlikely to ruin all this hard work with a price war, but equally Woolworths can’t just sit back and watch as Coles steals market share. Sooner or later it will have to make some gentle shifts of its own – particularly on price – and the more it delays the greater the pain will be. Some of this will no doubt be achieved by pushing private-label produce but, as we explained in Part 1 (see What’s Woolworths worth? on 8 Dec 14 (Under Review – $30.86)), Coles is also pushing hard in this area, so it will be difficult to gain a relative advantage.

Overall we’d expect – indeed we’d hope – to see some reduction in Woolworths’ operating margin in coming years to boost sales volumes, but nothing like the catastrophic falls seen in the UK. In the final part of this series we’ll put some numbers around this and explain what it means for our valuation of the company.

Note: Our model Growth and Income portfolios hold shares in Woolworths.

Part 3
What’s Woolworths worth?

In the final part of our series on Woolworths, we pull all the strands together to produce a valuation and a new price guide.

JAMES CARLISLE • 11 DECEMBER 2014

Charlie Munger once said that for all Warren Buffett’s talk of discounted cash flow valuations, he’d never actually seen him do one, to which Buffett replied that there are certain things a gentleman only does in private.

KEY POINTS

- Valuation highly sensitive to margin assumptions
- Middling scenarios more likely since margins offset growth
- Downgrading to Hold

Well, gentlemen can evidently afford certain luxuries that aren’t available to us. Quite reasonably you expect us to explain how we reach our valuations and sometimes that means baring our spreadsheets.

Our valuation of Woolworths isn’t technically a discounted cash flow, but it’s similar and we’re very aware that it’s just as dependent on the assumptions that go into it. That’s why we’ve spent parts one and two of this series providing some background to the most important ones (the growth and margins in the Australian supermarkets business). We’re also providing you with our valuation spreadsheet, and we encourage you to take it somewhere private to test your own assumptions.

Woolworths is a good example of why many prefer to keep these things close to their chest. One specific problem is that while we’ve penciled in 8% operating or EBIT (earnings before interest and tax) margins as our ‘bullish’ scenario for 2019 – unchanged from 2014 – we’d probably be disappointed if it happened, because it would mean that management was still failing to face up to the challenge from Coles.

At the other end of the spectrum, while a fall in the food and liquor operating margin from 8% to 5.8% would on the face of it be disappointing, it would more than likely be accompanied by improved long-term prospects.

GIVE AND TAKE

In other words, while we’ve combined a low margin with a low growth rate in our bearish scenario and vice versa for the bullish case – as we need to in order to place some outer limits on our valuation – we think that such combinations are relatively unlikely in practice. In reality there’s likely to be some give and take between margin and growth, leading to outcomes closer to the middle, but how the company ends up there will make a difference as to how it’s placed beyond 2019.

On the whole, if some medicine needs to be taken (and we think it does), we think it’s probably better done sooner rather than later. The valuation problem could be overcome by taking the forecasts further into the future, but even we are not prepared to play with specific longer-term forecasts in public.

It’s also worth stressing that our bearish and bullish cases don’t reflect the worst and best possible outcomes. It’s possible that the margin could fall to 4% or rise to 10%, but the chances are remote and it doesn’t help frame a picture of the valuation. It makes more sense to stay realistic but acknowledge the additional risks.

PICKING THE NUMBERS

The spreadsheet (you can download it here) is split into sections for each of Woolworths’ operating businesses. There are yellow boxes in each for you to enter an annual revenue growth rate for 2014-19 and EBIT margins for 2019, for bearish, neutral and bullish scenarios.
We’ve further refined the inputs for the Australian food and liquor business, because this is the one that matters most, contributing 87% of underlying EBIT in 2014. For this division, you can break down the margin between the gross margin (what’s left after paying the direct costs of each product – most of all the cost of buying or making the product) and the cost of doing business (the EBIT margin amounts to the gross margin minus the cost of doing business).

By changing the assumptions you can come up with different EBIT outcomes for each division. At the bottom, you can then enter estimates for central overheads, the net financing costs (for Woolworths’ net debt which amounted to $3.4bn at the end of June 2014), tax and the profit deducted for minority or ‘non-controlling’ interests.

Finally, you can enter assumptions for shares on issue to give earnings per share figures for 2019, payout ratios to give dividends per share figures and price-earnings multiples to give implied future share prices and your total return given a specified buy price.

So how should you go about picking the numbers? Well, the obvious first point to make is that we’re looking into the future, so you need to be careful to avoid getting ‘anchored’ to past performance. But the past can also inform about what’s likely to happen in future (indeed it’s all we’ve actually got so it would be wrong to discount past results entirely.

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The other fundamental point is to know when to use help from external sources. We could spend weeks trying to estimate Australia’s future population growth rate, but we’d still probably come up with a worse number than the Australian Bureau of Statistics and the time would be better spent trying to understand the threats and opportunities facing Woolworths’ businesses. Make sure, though, that you consider whether data providers might suffer from any bias (forecasts provided by an industry group, for example, may be optimistic).

**REVENUE ASSUMPTIONS**

With all that in mind, let’s consider our revenue assumptions for Woolworths. The basic factors affecting Woolworths’ revenue are how many people there are, how much food and groceries they need or want, how much it all costs and how much of it they get from Woolworths.

‘How many people there are’ is relatively straightforward: the [ABS’s central case](#) is for population growth to slip from 1.7% in 2012 to 1.0% in 2045, so for 2014–19 something around 1.6% seems fair and matches predictions made by IBISWorld (see Chart 1).

What about the need and desire for food and groceries, and how much it costs? There are two elements to the first part of this: the needs and the wants. The needs are fairly constant, but the wants – whether you buy the gourmet sausages or the homebrand – will fluctuate with consumer sentiment. On top of this, though, you need to consider how much people are eating out: reduced sentiment means fewer meals in restaurants and more demand for supermarkets, so to some extent the economic sentiment balances out.

So as a rough guide, at least over the short term, you’d expect people to continue to spend the same proportion of average wages on groceries, and that’s expected to rise by around 3% a year (see Chart 2) – but over longer time scales you need to consider that we’re getting more efficient at producing food, leaving more room for other areas of expenditure.

They placed a greater emphasis on the daily feed than their entertainment budget in the Stone Age, for example, and the trend still holds for the 1980s. According to the ABS, from 1986 to 2006 household spending on ‘communications services’ rose 8% a year and spending on ‘goods for recreation and culture’ rose by 7% a year, while spending on food only rose by 0.4% a year. All of which is to say that over time we’d expect spending on food and groceries to lag economic growth and the increase in average wages.

**CHART 2: REAL HOUSEHOLD DISPOSABLE INCOME**

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**CHART 3: FOOD PRICE INFLATION ACCORDING TO DIFFERENT MEASURES**

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**CHART 1: AUSTRALIAN POPULATION GROWTH**

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What about the need and desire for food and groceries, and how much it costs? There are two elements to the first part of this: the needs and the wants. The needs are fairly constant, but the wants – whether you buy the gourmet sausages or the homebrand – will fluctuate with consumer sentiment. On top of this, though, you need to consider how much people are eating out: reduced sentiment means fewer meals in restaurants and more demand for supermarkets, so to some extent the economic sentiment balances out.

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They placed a greater emphasis on the daily feed than their entertainment budget in the Stone Age, for example, and the trend still holds for the 1980s. According to the ABS, from 1986 to 2006 household spending on ‘communications services’ rose 8% a year and spending on ‘goods for recreation and culture’ rose by 7% a year, while spending on food only rose by 0.4% a year. All of which is to say that over time we’d expect spending on food and groceries to lag economic growth and the increase in average wages.

**CHART 3: FOOD PRICE INFLATION ACCORDING TO DIFFERENT MEASURES**

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As you can see from Chart 3, ‘Food and non-alcoholic beverages’ inflation has averaged a little over 2% over the past few years (according to the ABS), although it’s been over 10%, following the floods in 2011, and as low as minus 3%. Woolworths’ average shelf prices before the cost of promotional activity have followed the trend, though in muted fashion, as they have after the effects of increasing promotional activity, although in this case they’ve tended to be several percentage points lower. Since 2012, food price inflation has recovered back to around the average and we’d expect that to continue, but we’d also expect Woolworths’ price growth to remain some way below this, after promotional activity, partly funded by gross margin reductions (as we’ll come to shortly).

FALLING MARKET SHARE

As you can see, from the relative certainty of population growth, the waters are getting murkier and it gets worse still with ‘how much of it they get from Woolworths’, otherwise known as market share.

This will be directly affected by how much Woolworths is prepared to compete on price, although there will be a lagged effect. It takes time for perceptions to change around ‘price leadership’ and the longer Woolworths lets Coles get ahead on this, the harder it will be to turn it around.

Even with heavy promotional activity, we’d expect Woolworths to continue to lose market share at least for the next few years, which is to say that its comparable store sales growth will continue to lag Coles (see Chart 4) until perhaps recovering towards the end of the five-year period if it takes the necessary action.

Even with heavy promotional activity, we’d expect Woolworths to continue to lose market share at least for the next few years, which is to say that its comparable store sales growth will continue to lag Coles (see Chart 4) until perhaps recovering towards the end of the five-year period if it takes the necessary action.

As a result, our growth assumptions centre on the 3% target for growth in selling area, with 2% in the bearish case and 4% in the bullish, but as already mentioned we think it’ll be hard to meet these assumptions without reducing the gross margin.

For all this hard work, then, we come up with a revenue growth range of 2–4% a year, which again emphasises Woolworths’ defensive nature.

MARGIN PRESSURE

The bigger impact will be felt in the margin assumptions. This is where it gets really murky, because it’s impossible to say how much you need to reduce prices in order to change perceptions and get people to come into your store. You can fast-track the process by shouting out price-matching guarantees but, as they’ve found in the UK, this can be a dangerous approach. And of course, it’ll only do you any good in the long run if quality is maintained while making any price cuts.

It can make things easier to break the EBIT margin down into the gross margin and cost of doing business (CODB), because the latter is harder to shift for a company that’s already operating efficiently. Technology may provide some gains in the supply chain through the use of things like radio frequency pallet tagging, and there may be further gains to be had from things like self-service checkouts. In our neutral case, though, we’ve stuck with the current CODB, and edged 0.1% higher in our bear case and 0.1% lower in the bull case.

That takes us to the gross margin, where the real battle will be fought. We outlined in part two of this series why we think Woolworths will need to be more proactive on pricing, but part of this can be achieved through increased private label offerings and/or lower supplier costs (as explained in part one).

In our bullish scenario this is enough and we therefore assume no change in the gross margin, but in the neutral case we take 1% off, and in the bear case we deduct 2%. These approximate to fully self-funded price cuts of a similar magnitude and, combined with private label and reduced supply costs, they would give Woolworths considerable ammunition for a gentle price skirmish – in the bearish scenario particularly. This in turn would almost

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**Even with heavy promotional activity, we’d expect Woolworths to continue to lose market share at least for the next few years.**
Certainly lead to improved growth rates although, as we’ve noted, they may take a little while to appear.

The resulting EBIT margin is 5.8% in the bear case, which is still higher than Coles (which managed 5.3% in 2014), much higher than the 4% average for the world’s largest 30 food retailers (according to CLSA) and much much higher than the ‘no more than’ 2.3% guidance for the year to February 2015 given yesterday by Tesco.

**OTHER ASSUMPTIONS**

We go through a similar process for each of the other operating divisions, but we won’t spell out the detail here, because the valuation is overwhelmingly influenced by the assumptions for Australian Food and Liquor and we don’t want to confuse matters. Further thoughts on Masters can be found in Woolworths still learning with Masters from 13 Aug 14 (Buy – $35.74).

Notable features are that we assume slightly better growth for the NZ business, some fairly disastrous results for Big W and a break-even result for Masters in 2019 even in our bullish scenario.

**CHART 6: FREE CASH FLOW AS % OF NET PROFIT**

![Chart 6: Free Cash Flow as % of Net Profit](image)

In the bear case we’ve assumed that Lowe’s has finally exercised its put option on the Masters joint venture – adding about $50m to the annual interest bill for the cost of buying it out and increasing minorities because Lowe’s is no longer shouldering some of the losses.

The minority interests represent the profit share on the 25% of ALH that Woolworths doesn’t own (assumed to be $50m), offset by Lowe’s share of losses from Masters (which is assumed to be nothing in the bull case due to it breaking even, nothing in the bear case due to it being bought out and a $25 post-tax loss in the neutral case).

In addition to the possible increase in debt to buy out Masters, we’ve assumed net debt rises by up to about $1bn from the current $3.5bn (adding around $50m to finance costs), reflecting the fact that Woolworths’ free cash flow has been lagging its targeted dividend payout ratio of 70% (see Chart 6).

**TOTAL RETURNS**

This leaves the share price, which you can enter in the green highlighted cell. At the current price the stock is on a price-earnings ratio (PER) of about 15 reflecting the fact that we’re not the only ones who think the 8% food and liquor margin is at risk. By putting in PERs for 2019, the spreadsheet will give you an approximate total return for the 2014–19 period (approximate because, to keep things simple, it doesn’t discount the dividend payments individually according to when they are received). We’ve opted for 2019 PERs of 14, 17 and 20 for the three scenarios, which would mean total annual returns ranging from minus 4% to plus 13% at the current price, and minus 2% to plus 16% at our proposed new Buy price of $27.

As regards Australia’s other listed food retailers, we’d continue to AVOID Metcash for the reasons given in Metcash model is fundamentally flawed from 21 Mar 14 (Avoid – $2.85). Wesfarmers is more interesting, but the situation is confused by its higher price (a PER of 19) and other businesses, some of which aren’t going so well. We’re planning to have a good look at it in the new year, but for the time being it remains a HOLD.

And that’s going to be Woolworths’ new recommendation as well. When we upgraded the stock a couple of years ago in Put some Woolies in your basket on 23 Oct 12 (Long Term Buy – $29.20), we were anticipating growth in the mid-single digits with a reasonable degree of confidence. Not only does that outcome now look optimistic, but the risks have also increased, particularly in light of the worsening sales performance over the past two quarters.

We’ve been slow to adapt our thinking, but we’re not going to compound that error by clinging to our past valuation when the facts appear to have changed.
‘The internet will soon go supernova and, in 1996, it will catastrophically collapse’, proclaimed Robert Metcalfe in 1995. Metcalfe was no fool. As the inventor of the Ethernet, he was an early internet pioneer and part of the intellectual establishment. His ludicrous prediction tells us two things about prognostication.

KEY POINTS

- Price fall is supply led
- Shale output depends on credit conditions
- Most shale output uneconomic today

Firstly, the worst predictions don’t come from lunatics on the fringe; they are announced by experts and accepted by insiders. Secondly, predictions should be made sparingly and with humility.

We note the above as we embark on a prediction of our own. Oil prices have sunk 40% in a matter of weeks and the share price of energy producers has tumbled. Before we can assess whether those stocks are good value now, we must establish a view on the oil price. Are today’s prices simply a short term tumble or is this the end of the great oil price boom?

CHART 1: WTI PRICE, 2014 USD

Crude oil price (US$/bbl)

<table>
<thead>
<tr>
<th>Year</th>
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<tr>
<td>120</td>
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<tr>
<td>20</td>
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Source: Infomine

While the speed and ferocity of the price fall has surprised (see Chart 1), the causes of the decline are classic. Too much supply is chasing too little demand.

IT’S SUPPLY, STUPID

As oil bears point out, oil demand from the OECD (a club of rich countries) has fallen seven years in a row. Yet this is more than offset by growth in developing economies. In aggregate, oil consumption has been growing – albeit slowly – at about 1.5% per year. The world now consumes more than 90m barrels of oil a day. Demand, although not strong, isn’t to blame for lower prices. For that, we turn to the supply side. American oil production, in decline since the 1970s, has almost doubled in the past few years to 9m barrels per day. Shale producers have drilled more than 20,000 wells in the past five years, more than 10 times the level of Saudi Arabia. As a result, about 90% of the worlds additional output has come from America, almost all of that from shale basins (see Chart 2).


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<th>Year</th>
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<td>'08</td>
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<tr>
<td>'10</td>
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<td>'13</td>
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Barrels per day (m)

| 1.0  |
| 0.8  |
| 0.6  |
| 0.4  |
| 0.2  |
| 0    |

Source: The Economist; IEA

Whether the oil price remains at today’s lows depends on the sustainability of the American shale revolution. Our prediction on oil depends on the predicament of shale.

SHALE SHOCK

Shale production involves different economics to conventional production because initial output is high but falls away quickly. Whereas conventional reservoirs will decline steadily about 5–6% per year, shale production can fall 60–70% in the first year before tailing off more gradually. Maintaining production requires continuously drilling new wells.

To illustrate the different production characteristics, imagine production of 1m barrels of oil a day. To extract this volume from a conventional reservoir would require a producer to sink perhaps 50 wells in total. That same volume from shale would require about 2,000 wells. Sustaining the shale revolution requires copious amounts of cash and constant drilling. There are two threats to production: lower oil prices and access to cash. Let’s take each in turn.
**LOWER PRICES HURT**

Two years ago, we estimated that the marginal cost of shale production required prices of about US$90 a barrel (see Is there still a case for oil?). That number needs updating because drillers are getting more productive and lowering costs.

In the Permian Basin, drillers increased output per rig by 20% last year by tweaking their method. Productivity per well in the Eagle Ford Shale is similarly up 20% as drillers get better at their art. Production costs in the best basins can be as low as US$30 and, in less productive ones, as high as US$90.

Wood Mackenzie, a consultancy, estimates that the median shale producer requires an oil price of US$75 to break even. Over time, we should expect supply to adjust to around US$80 (higher than the breakeven price to allow a rate of return) but there are reasons why production might lag prices.

Tens of thousands of previously drilled wells are still producing declining amounts of oil and, because capital has already been sunk, they incur almost no cost. A long tail of existing capacity will continue to flow and could keep prices down for a while.

Many producers also use futures and derivatives to hedge prices so prices may not immediately impact output. Pioneer Natural Resources, for example, has 65% of its output hedged at US$85 so is under no pressure to adjust volumes.

These are merely lags that delay an inevitable supply response. If oil prices stay low, output will fall. Wood Mackenzie suggests that, at prices of US$60, investment would fall by 50%. Since maintaining output requires additional wells to be drilled, falling investment is sure to lower output.

This has already begun. The number of rigs drilling the most productive shale areas – the Bakken and Permian basins – has fallen by 10% in a month. Applications to drill in the Bakken and Eagle Ford shale have fallen 30% and capital expenditure budgets are now been slashed.

These are early signs that shale output is adjusting to lower prices and we expect to see less drilling activity lead to lower output over time.

**THE CASH CRUTCH**

While the shale revolution was born because of specific technical breakthroughs, it has thrived because of zero interest rates, easy credit and enthusiastic investors.

Last year, shales accounted for 20% of global investment in the oil industry despite accounting for less than 5% of output. In aggregate, hundreds of billions of dollars have been spent increasing shale output over the past decade yet few (we’re aware of none) producers generate free cash flow.

Shale producers have accumulated enormous levels of debt. Debt for listed US producers stands at a quarter of a trillion dollars (see Chart 3) and producers rely on bond markets to fund production growth.

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**CHART 3: US SHALE DEBT**

<table>
<thead>
<tr>
<th>Leverage of US independent energy companies</th>
<th>$bn</th>
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<tbody>
<tr>
<td></td>
<td>3.0</td>
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<tr>
<td></td>
<td>2.5</td>
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<thead>
<tr>
<th>Debt to gross cashflow</th>
<th>2005</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
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<td>Debt to gross cashflow</td>
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Prices of about US$90 are needed to allow the median US shale producer to cover their capital expenditure from cash flow. At lower oil prices, output is at risk from the whims of banks and bond markets.

**HAIL, SHALE**

Earlier this year in Siberia, the single most expensive hole ever sunk was completed. It cost US$700m and took two months to drill. A shale producer with $2m and a drill on the back of a truck could start producing oil in a matter of days. The world’s incremental supply of oil is likely to come from shale rather than capital intensive deepwater wells.

Bulls and bears need to adjust their expectations. If shale is the source of marginal supply, prices above US$80 will be met with new output. The opposite is true today. Prices at US$60 will, in time, force out production. Too many firms are making too little money for prices to be sustained at current levels.
Decoding the strategic review

Strategic reviews are rarely a pleasant experience. Here are the warning signs.

JAMES GREENHALGH  •  8 DECEMBER 2014

The phrase ‘strategic review’ sounds harmless enough. What company’s strategy doesn’t need a good, solid review?

KEY POINTS

- A strategic review suggests something is wrong
- Expect a new managing director to launch a strategic review
- Fundamentally challenged companies are a risky proposition

But as Warren Buffett said of expense reductions: ‘The really good manager does not wake up in the morning and say “this is the day I’m going to cut costs” any more than he wakes up and decides to practice breathing’. Nor does a good manager wake up and decide to review strategy – it should be an ongoing process.

So the term ‘strategic review’ is a type of management code. Something’s gone wrong – and it needs to be fixed. For shareholders, the announcement should be an ‘uh-oh!’ moment. Because when a company needs to be fixed, the measures management takes to fix it can be a little unpleasant.

Before turning to what you should watch out for, let’s consider a definition.

In simple terms, a strategic review is a management investigation of the business. Management (sometimes with the help of external consultants) will usually analyse all aspects of the company, including goals, costs and – importantly – its capital structure. Occasionally management will undertake a ‘strategic review’ of a particular division with a view to demerger or sale (see Hop on the demerger express). Here we’ll focus on strategic reviews of the entire company.

So what should you watch for?

STRATEGIC REVIEWS USUALLY FOLLOW MANAGEMENT CHANGE …

Capitalism isn’t known as ‘creative destruction’ for nothing. Companies and industries change, often very quickly. While shareholders expect their management teams to adapt, the evidence is that it’s usually difficult. Consider Fairfax Media, which had numerous opportunities to overhaul its business, ignored them, then watched its ‘rivers of gold’ evaporate.

When something’s seriously wrong, it’s difficult for existing management to tackle the problems. Often the management team is psychologically committed to its strategy. While the board might be just as culpable, it’s easier to let the managing director become the fall guy.

A new managing director acts as both a circuit-breaker and a catalyst for change. With no baggage, he’s free to question the prevailing orthodoxy and previous decisions. So watch out for new management. At the very least it will cause a strategic re-evaluation, which brings us to the next point.

<table>
<thead>
<tr>
<th>TABLE 1: STRATEGIC REVIEWS</th>
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<tbody>
<tr>
<td>Are associated with management change</td>
</tr>
<tr>
<td>Aren’t always called ‘strategic reviews’</td>
</tr>
<tr>
<td>Often involve capital raisings or dividend cuts</td>
</tr>
<tr>
<td>Are usually painful for businesses facing fundamental problems</td>
</tr>
<tr>
<td>Aren’t always bad news</td>
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… BUT THEY AREN’T ALWAYS CALLED ‘STRATEGIC REVIEWS’.

It’s a mistake to think new management always flags a ‘strategic review’ to the market. Indeed, it’s best to simply assume that a new managing director will launch one.

It’s an important lesson learnt from QBE Insurance. When John Neal replaced Frank O’Halloran as managing director, he had a mandate for change. A complicated business that had undertaken dozens of acquisitions was bound to have a few skeletons lurking, and they soon came tumbling out of QBE’s closet.

At Toll Holdings Brian Kruger took over from the respected but acquisitive Paul Little in early 2012. While the transition appeared seamless, Kruger has spent several years making writedowns, selling assets, and re-organising divisions.

EXPECT CAPITAL RAISINGS OR DIVIDEND CUTS

A strategic review usually involves a re-assessment of a company’s balance sheet. A new managing director, hoping for a fresh start, might well be uncomfortable with asset values and debt levels.

Perhaps he’s risk averse or wants greater flexibility to make acquisitions himself. Although a more sinister motive might be to lower earnings for remuneration purposes (see Management motives: A tricky business). Writedowns and share issues can reduce earnings per share, resetting the baseline from which management pay is measured.

In recent years, Aristocrat Leisure, Billabong International and Stockland Group announced
capital raisings shortly after appointing new managing directors. New chief financial officers also dislike starting with a stretched balance sheet and frequently instigate capital raisings.

Nor is capital raising the only risk; dividend cuts are normal too. Even before he had announced the results of the strategic review, Ian Morrice, the new managing director of Metcash, had cut the dividend and reinstated the dividend reinvestment plan.

**BEWARE BUSINESSES FACING FUNDAMENTAL CHALLENGES**

Worse was to come for Metcash. Companies facing fundamental problems with their strategies take time to turn around – if they ever do. Metcash is caught between two large well-funded competitors and will struggle for years.

Pacific Brands is in a similar situation. With its wholesale business evaporating as retailers prefer to source private label merchandise directly from overseas, radical surgery is required. While a strategic review might last less than six months, its ramifications can persist for years.

Shareholders of Aristocrat Leisure understand this point well. When Jamie Odell took over as managing director in 2009, the company had long taken its near-monopoly position in Australia for granted. To stem the decline, Odell began investing heavily in game design and development, although it took three years before the benefits became apparent. Other strategic review commitments, such as doubling Aristocrat’s US market share and selling 50,000 games a year in Japan, simply haven’t happened.

**STRATEGIC REVIEWS AREN'T ALWAYS 'BAD'**

Of course, while a ‘strategic review’ might be code for 'something’s wrong', few companies actually enter a death spiral. While some companies face fundamental challenges, others have problems that can be easily fixed.

Take Perpetual. The company’s costs had been too high for quite some time and several managing directors seemed unable to fix the problem. Geoff Lloyd however not only identified $50m of costs to strip out but has even managed to exceed the target.

In other cases, new managing directors simply use the strategic review as a convenient means to jettison their predecessor’s indulgences. In May last year Stockland Group’s Mark Steinert made it clear that the ‘3Rs’ strategy of Matthew Quinn was destined for the dustbin. So don’t become too enamoured of contrived strategies like Quinn’s – they’re invariably the first casualty of management change.

So what’s the key message to take away?

Don’t worry about management change if your company is performing well and has a sound balance sheet. But if it’s showing signs of stress, and a new managing director has been parachuted in to address the problems, it’s time to look more closely.

Think of the ‘strategic review’ as a little like a lighthouse. There’s danger in the vicinity but, with careful navigation, you’ll avoid foundering on the rocks.

*The author, James Greenhalgh, owns shares in Aristocrat Leisure. Staff own shares in QBE Insurance.*
Stocks in Brief

**BHP BILLITON**

**GAURAV SODHI**

**BHP BILLITON | BHP**

| PRICE AT REVIEW | $28.88 |
| REVIEW DATE     | 10 Dec 2014 |
| MAX. PORT. WEIGHTING | 6% |
| OUR VIEW        | HOLD |

The headline says it all. Iron ore and petroleum are BHP’s two largest divisions in terms of both asset size and profit. The long decline in iron ore price and the short, vicious decline in oil prices are a painful combination for the world’s largest miner. Although the price is now below our previously stated buy price, we are in no rush to upgrade. Iron ore returns are still terrific at today’s price but BHP’s enormous shale oil and gas portfolio is under stress. Returns will fall and valuations deserve to be cheaper. We are sticking with HOLD but are looking at BHP closely. We will restate a price guide following a more detailed review.

**TRANS PACIFIC INDUSTRIES**

**NATHAN BELL, CFA**

**TRANS PACIFIC INDUSTRIES | TPI**

| PRICE AT REVIEW | $0.90 |
| REVIEW DATE     | 9 Dec 2014 |
| MAX. PORT. WEIGHTING | 4% |
| OUR VIEW        | BUY |

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<tr>
<td>Sell Above $1.50</td>
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<tr>
<td>Hold Buy Below $1.15</td>
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Transpacific’s share price has fallen 2% after announcing that grounding its fleet following a fatal crash involving one of its trucks (see Transpacific grounds its fleet from 20 Aug 14 (Buy – $0.93)) will cost around $20m. Truck repairs cost about $7m, with the rest due to ‘ancillary matters, such as roadworthy inspections, subcontracting costs, lost revenue and vehicle write-offs’.

As the intrinsic value of a business is the sum of its future discounted cashflows, this one-off cost hasn’t changed our view of the company. What would worry us is if the slow down in the resources sector savaged revenues and margins, the company had sweated its fleet over the past five years requiring a major investment in addition to the recently announced landfill remediation costs, or if the company started making rash acquisitions to boost growth because it wasn’t able to reclaim lost market share at decent margins. A deep recession or a price war would also make buying at today’s price a mistake, at least in the short term.

We’ll explore these themes in more detail when the company announces its results in February, but we’re encouraged that some overseas owners of Transpacific’s local rivals are potential sellers. Transpacific may or may not be a bidder, as chief executive Bob Boucher is focused on buying landfill sites (which don’t come cheap) and it would be a hard to justify buying a rival on an enterprise value to EBITDA (earnings before interest, tax, depreciation and amortisation) ratio of 10 or more (the likely price one of these businesses would fetch) when your own company trades on a multiple of below six. But like the recent sale of its New Zealand waste business (see Five reasons to buy Transpacific from 23 Jul 14 (Buy – $1.085), a transaction might be another sign that Transpacific is cheap. Transpacific may even be a takeover target itself for a large foreign player given its low debt levels.

As we said in past reviews it might still pay to stagger your buying, and we highly recommend sticking to the recommended portfolio limit of 4%. Despite having many long-term contracts, Transpacific’s higher margin work is sensitive to the economy, which could slow quite significantly as the major LNG projects are completed. Boucher’s strategy (which we’ve discussed in past reviews) also won’t show results for at least a couple of years, so the share price is likely to bounce around in the interim even if it eventually pays dividends.

The company’s share price has increased 7% since The ‘good growth & okay yield’ mini portfolio from 13 Oct 14 (Buy – $0.845), but as it’s fallen 17% since Five reasons to buy Transpacific we’re sticking with BUY.

**VIRTUS HEALTH**

**GRAHAM WITCOMB**

**VIRTUS HEALTH | VRT**

| PRICE AT REVIEW | $7.31 |
| REVIEW DATE     | 8 Dec 2014 |
| MAX. PORT. WEIGHTING | 5% |
| OUR VIEW        | BUY |

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<td>Hold Buy Below $8.00</td>
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Virtus Health, Australia’s largest network of IVF clinics, has acquired a 70% stake in Tasmanian-based provider TaslVF for $16m, funded by cash and $8m in bank debt.

TaslVF was founded in 1983 and has delivered more than 2,500 babies over the past 30 years. Its main laboratory and day hospital is in Hobart, with additional consulting clinics in Launceston and Devonport (the birthplace of our research director, who was reportedly conceived naturally).

TaslVF brings the total number of specialists under the Virtus banner to 91, following the company’s purchase of IVF Sunshine Coast in Queensland and 70% of Sims Clinic in Ireland earlier this year. A Virtus-branded fertility clinic in Singapore is also expected to open by the end of 2014. The company has stated that ‘for the year to 30 June 2014, TaslVF normalised earnings would have increased
Virtus’s basic earnings per share by approximately 1.24 cents’, implying TasIVF earned around $1m for the year and an acquisition price of 16 times earnings. The price looks fair, especially when you consider there are likely to be administrative cost savings once the clinics are integrated into Virtus’s network and that Virtus itself trades on a PER of 19.

The acquisition will increase Virtus’s net debt from $118m to a still comfortable $134m, leaving the company with plenty of ammunition to make further acquisitions. Virtus also has the option to buy the remaining interest in TasIVF in 2017 and 2019.

The share prices of Virtus and competitor Monash IVF have been hit hard recently due to a surprise dip in the number of IVF cycles throughout the industry, though management still expect ‘low to mid-teens per cent growth in earnings’ for 2015. The stock is flat since Virtus Health and Monash still buy (Buy – $7.46) and we’re sticking with BUY.

Estia IPO: good for Quadrant, not for you

JONATHAN MILLS, CFA • BLOG ARTICLE • 9 DECEMBER 2014

Despite Japara Healthcare Limited (ASX: JHC) and Regis Healthcare Limited (ASX: REG) suffering share price falls since listing earlier this year, investors still think they can cash in on aged-care floats. Private equity group Quadrant floated Estia Health Limited (ASX: EHE) last Friday. The shares listed at $5.75 before falling 18% and recovering slightly to $4.80.

As usual, the only winner here seems to be Quadrant. Quadrant initially invested in Estia in October 2013 before greatly expanding the business in July 2014 through the acquisition of unlisted aged-care operators Padman and Cook Care.

Quadrant’s original investment in Estia totalled $90m. $40m in equity was combined with a $50m loan note where Quadrant collected interest payments of 15%. The Padman and Cook Care acquisitions were highly geared even by private equity standards, with only $19m of the $316m combined purchase price being funded with cash. Quadrant’s share would have been $11m based on its 58% stake in Estia.

So if we assume Quadrant’s total equity investment was $51m ($40m + $11m), in just over a year the company has made a 116% return after selling 19m shares at $5.75 in the IPO for $110m. Not to mention it banked $8m of interest from the $50m loan that was redeemed, and the company still owns 30.8m shares in Estia currently valued at around $150m. All in, Quadrant has potentially tripled its money in a year. Not bad when you consider the All Ordinaries Accumulation Index has returned 7.8%.

NOT FINISHED YET

That’s not the end, though. In private equity investments, third-party investors in private equity funds are called ‘limited partners’, or LPs. These are usually pension funds and the like getting charged ‘two and twenty’ i.e. an annual base fee of 2% of assets under management plus a 20% performance fee.

Theoretically to align their interests with those of their clients, staff also get to invest in deals. They’re called ‘general partners’, or GPs.

GPs only usually invest small amounts, however. It was 1% at my former employer. But the deals become seriously lucrative for GPs if they earn performance fees – usually 20% of gains above the minimum return they promise their LPs (usually 8% per annum).

The success of the Estia deal means Quadrant will be entitled to its 20% performance fee. After subtracting the $8m minimum return payable to their LPs, Quadrant staff have potentially turned a mere $1m investment into $42m (20% of $209m).

Unfortunately only Quadrant knows the exact numbers, but in addition to their base pay and other bonuses perhaps Australia’s retail sector isn’t dead yet.
Ask the Experts

BUSINESS ADVENTURES – KINDLE VERSION
For your information, Amazon has a kindle version of *Business Adventures – Twelve Classic Tales from the World of Wall Street* which was republished in July this year. Thanks for the Special Reports, always an interesting read.

11 Dec 2014 – Jonathan Mills, CFA: Thanks for letting us know. We’re glad you enjoyed the Special Reports.

QANTAS
In your last review of Qantas you were calling for Alan Joyce to be sacked. When are you updating your thoughts? I’ve bought back in, how about you? I appreciate that the crash in oil price has helped but yesterday’s announcement of first half earnings of $250–$300M confirm a big turnaround. Paul H

9 Dec 2014 – Nathan Bell, CFA: As long as I’m research director I doubt you’ll ever see Qantas on our Buy list. To quote Charlie Munger a turd with raisins is still a turd, so we’ll leave Qantas to the speculators. For more thoughtful details on why we’re unlikely to ever own an Australian airline you can check out our past reviews. PS. Qantas should still sack Joyce for the reasons laid out here. It’s only been the falling oil price and the reversal of some his strategies that’s improved things.

USD ETF
Thanks for the ETF report. I’ve owned USD for awhile and have never received a distribution while the report in the break out box (page 5) advises (edited for space): ETF Profile: USD Name: BetaShares US Dollar ETF Distributions: Semi-annual. Have I been missing something or is this a mistake?

08 Dec 2014 – Nathan Bell, CFA: I obtained that distribution information directly from the product information on the Betashares website. I thought it was a little un usual too, because I can’t imagine how a ‘currency’ would pay distributions. What I decided, though, was that the US dollar funds are invested in a bank account that pays interest. If the interest from the bank account was ever enough to exceed the management fees, then the product would pay a distribution. So in theory it pays income semi-annually but in reality it is probably unlikely unless interest rates rise sharply.

VEI MANAGEMENT
The recent banning of the Chairman of the Vision Eye Institute (VEI) Board, Michael Wooldridge, as a company director for his role in the collapsed Prime Trust has raised some questions of trust in respect of VEI management. Benjamin Graham was of the view that it was very important to be able to trust the management of a company. This is a view which you at TII have often echoed in your stock analyses. I would appreciate your thoughts about how this might affect your recommendation on VEI.

7 Dec 2014 – Graham Witcomb: I can’t say I’ve met Michael Wooldridge and don’t have any special insight into his case, though I note he’s appealing the judgment and the Vision board supports his continued position as a director. I have spoken to both CEO Brett Coverdale and CFO Anne McGrath in the past and no red flags were raised as to their integrity. I think they’ve done a good job turning the business around over the past couple of years (though I’m a little cautious of their ambitions to move into ‘other healthcare’). Unless something more serious comes to light, the news of Dr Wooldridge doesn’t affect our recommendation.

ETF INVESTOR PROTECTION
Hey team, thanks for the special report on ETFs. I was wonder if you have an opinion regarding investing in only one ETF company? Everyone seems to comment that ETFs provide a high level of diversification but what are the risks of only investing in stay State Street ETFs. Is there a risk that they could fold? Or be subject to fraud or complete financial mismanagement and all my investments be lost? Should I be diversifying between the financial institutions that provide ETFs? Andrew B

5 Dec 2014 – Graham Witcomb: Please be aware we can’t provide personal advice, so please take your own situation into account before acting on any of the following recommendations.

ETF’s are regulated by ASIC as Managed Investment Schemes which carry strict compliance criteria. An example is that the money you give to an ETF is held by a third-party custodian and separate to their own accounts. In theory, that should mean that if the fund provider’s business goes bankrupt, your assets are safe and a new manager/custodian would be appointed to either continue managing them or organise their return to you. There are also safeguards against the fund manager saying they’ll invest only in bonds for you, but then buy a Chilean llama farm. You might find this (lengthy) report on the legal side of managed investment schemes, and the protections the structure offers, helpful. Personally, I never like to have all my eggs in one basket, even if there are hundreds of regulatory protections.

SHORTING FMG?
Is FMG a short? William M

5 Dec 2014 – Gaurav Sodhi: We dont short stocks, it's a completely different skill set to buying that takes years to cultivate and incurs a different set of risks. We have recently done a special report on Jim Chanos, the most famous shorter in the world (see here) and you can read our views on FMG here. We have a Sell on the stock, but that doesn’t mean we recommending shorting it.

SELLING PTM TO BUY PPT
PTM vs. PPT My trigger finger is getting itchy. After not selling PTM early this year around the $7.50 mark, I can feel that itch to sell building and building again. I see PTM recently lost a portfolio manager, and Kerr Nielsen can’t last forever. Although I thought that about Warren Buffet 15 years ago, but I digress. What are your thoughts on selling PTM to buy PPT? Assuming appropriate limits and non-personal advice etc. James R

8 Dec 2014 – James Carlisle: I can beat 15 years. I first thought of buying BRK in 1995 but decided against it owing to Buffet’s advancing years and have never got around to it. I guess I was in my twenties then so anyone over 50 seemed old – of course that’s looking like a pretty young age now, but I digress …

As you note, we’re not able to provide personal advice, but you can get a general idea about how we’d compare the two companies’ valuations using our recommendation guides. Platinum is a Hold, being 32% above our buy price and only 9% below where we’d Sell, while Perpetual is 4% below our Buy price and 32% below where we’d Sell.

Using the middle of the Hold range (although I should stress that this doesn’t equate to fair
value, because we’re generally looking for a margin of safety even to hold a stock, Platinum is 8% above and Perpetual is 20% below. The risk of Kerr Neilson leaving is a key reason our price guide isn’t a bit higher.

Of course there’d be a case for holding both stocks, to add diversification in what can be a volatile sector, but that’s something you’d have to consider yourself, within the confines of your portfolio and your personal circumstances.

SANTOS’ DEBT

Just a follow up on Santos – they have hinted at a capital raising – has this already been guessed at by the market and factored into the price? There was no big share price drop today when I read this story

5 Dec 2014 – Gaurav Sodhi: Santos were looking at refinancing debt using hybrid instruments (Origin has done something similar). The fall in oil has postponed those plans. Santos doesn’t really need the money – it carries over $2bn in cash and, although it has plenty of debt, none of it is due soon and will be paid back from LNG cash flows. I don’t expect the company to raise equity but they may try to refinance debt again at some stage.

REEF CASINO TRUST

RCT pays a dividend of about 8% – and has fallen of late – any view?

8 Dec 2014 – Nathan Bell, CFA: The stock price fell after acquisition talks were at least temporarily halted. It’s a nice little business but unfortunately it’s too illiquid for us to cover, though I think someone (Greg perhaps) might’ve discussed it in one of our small cap special reports a year or two ago.

PUNTING ON AIRLINES

Qantas, this is more a comment than a question in relation to Nathan Bell’s observation on 9th December. I listened to a super intense (and smart fund manager) once and he said in relation to airline stocks “they are one of the great value destroyers for shareholders”. He worked out the amount of capital raised over time made nearly every airline stock an absolute disastrous long term investment proposition…speculating is not investing … hence airlines should be avoided.

11 Dec 2014 – Gaurav Sodhi: We will release updated views on the major oil producers. First up will be Santos and Origin. Both stocks will go through our internal review process again, a step usually reserved for new ideas. I better get back to it!

JIM CHANOS SPECIAL REPORT

Really liked the Jim Chanos report. One of the best pieces I have seen from him in a while. Best wishes, Fred Woolillard. Fred W

08 Dec 2014 – Nathan Bell, CFA: I think if we gave Johnny another couple of weeks he could’ve written his memoirs.

INCOME STOCKS

I was just looking at the Sell prices for some of your property recommendations ABP, HPI and LEP for example. Some of these are close to or have just passed the sell price. Are you able to give us an update? Should we be getting ready to pull the pin on these positions? Andrew B

4 Dec 2014 – Nathan Bell, CFA: Jon is working on Abacus right now, so look out for a review in the next week or two. Can’t believe how long it took that stock to work out. I’d virtually given up on it, even though I expect Kirsch will acquire it eventually.

Jon will then update the two pub landlords. I expect interest rates are heading down in Australia, potentially further than anyone is talking about, so I’m in no rush to sell those businesses.

BUY SELL SPREAD

What is the buy sell spread?

11 Dec 2014 – Jonathan Mills, CFA: Hi, the buy sell spread is the difference in price between the highest price that a buyer is willing to pay for a share and the lowest price for which a seller is willing to sell it.

For example, let’s assume you want to buy Telstra (TLS) shares. Checking your online brokerage account, you see that the highest price someone is currently willing to buy TLS shares for is $5.65 while the lowest price that someone is willing to sell them for is $5.66. In this case, the buy-sell spread is $0.01 ($5.66 – $5.65).

The buy sell spread is always positive and is usually smaller for big, highly liquid companies like TLS but larger for smaller, less liquid companies. For example, Noni B (NBL) currently has a market cap of $18bn and a buy sell spread of $0.03.

BRADKEN TAKEOVER OFFER

Any comments on the recent acquisition offer made by Pacific Equity Partners and Bain Capital to acquire 100% of Bradken shares. Their SP jumped 33% last Friday and since then has been inching around. Just wondering if this time they may be looking in sealing a deal? Arpit S

11 Dec 2014 – Gaurav Sodhi: I’ve been occupied with oil so haven’t had a chance to look at this in detail. The gap between the offer price and the share price is interesting. On first glance, we would accept the bid. No news on how management will respond or whether other bidders are sniffing around. I will do an update on this next week.

BLOG ARTICLE LINKS

Woodside a winner from the oil price slump

GP co-payment changes benefit Medibank, NIB and Sonic Healthcare

Vote Down the ThinkSmart Buyback

Estia IPO: good for Quadrant, not for you

Bank cartel sharpens its claws

MULTIMEDIA LINKS

Stock Take podcast: The Cartel edition:

Woolies, oil and the banks

TWITTER LINKS

Bill Gates’ five favorite books of 2014

Regarding moat/network effects, Uber looks more like Groupon than Facebook. $40bn seems an awful high valuation:

Wasn’t Platinum saying this for a decade?

>> Why it’s time for fund managers to buy Japanese shares