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Lessons from Japan, last month's top rated research and a change at the top.
Greg Hoffman surveys the significant events of the past four weeks.

Already, the tragedy and suffering in Japan are beginning to reveal a few simple truths. For almost 20 years (what is oddly named 'the lost decade'), after the bursting of a massive property bubble, the Japanese economy stagnated. Near-zero interest rates had negligible impact on borrowing; growth remained pitifully weak; and in laughably frequent attempts to kick-start economic activity, government debt ballooned. It now stands at 225% of GDP, not only higher than that of Greece, Portugal or Ireland, but also of Zimbabwe and Iceland.

Then came the earthquake and tsunami. To say that 'life is difficult' seems trite indeed. But the stoicism, dignity and resilience of the Japanese is something to behold; a stirring display of the very best of human nature, so evident in that nation's people, that offer hope and inspiration to us all. The debt is a worry, and it will get worse, as it must if the country is to rebuild, but, as a species, we do recover. And the Japanese will recover quicker than most.

This is an especially pertinent thought when considering how to respond to disaster or the unforeseen in an investment sense; appalling situations get better because human beings make it so. Stock prices almost inevitably follow.

Gone fission

There was a Bonsai-like example of this with the locally-listed uranium stocks. Gaurav Sodhi examined the sector in Gone Fission Part I on 7 Jul 10, following it up with a review of three stocks. In the aftermath of the Fukushima Daiichi plant’s near-meltdown, these stocks suffered a panic-induced fall of an average of 36%; a natural, if not rational, response to an unfolding disaster.

But then, as Gaurav explained in Bunker down in the uranium sector (see issue 316), a more nuanced and rational view superseded the initial, emotive reaction. The developing world has over 60 nuclear plants under construction and almost another 100 being planned. It’s possible they might be put on hold—the Germans quickly abandoned plans to extend the lives of their plants—but unlikely. Coal isn’t a realistic substitute and the continued industrialisation of these countries depends on more power. Demand for uranium is unlikely to fall. Once this perspective had sunk in, the share prices of the three stocks recovered by an average of 25%.

That’s investing history in microcosm; a rapid price fall (or rise), based on an emotive response to news, followed by a calmer, more considered perspective (I acknowledge that in this case it happened quickly; in other cases it can take years). As investors, we need to take advantage of what might be called sentimental price falls by holding a considered perspective during the crisis. That’s when the opportunities arise (although, as Gaurav explains, unfortunately not this time); and it’s our frame of mind that allows us to take advantage of it.

If there’s hope that Japan may now be emerging from its lost decade, the evidence is mounting that the United States might be about to get drawn into a similar void. Corporate profits may be at record levels and the stockmarket has rebounded strongly but in the real world, this is a timid and partial recovery. Unemployment remains high, as do home foreclosures, consumer spending is weak and the carpet bombing of the country with treasury bills appears only to have earned Ben Bernanke an amusing nickname. Japanese members may find these circumstances oddly familiar.

That’s not to say an American future resembles a Japanese past, but it makes sense to acknowledge the possibility. There is a lot that could go wrong...
Blue chip bonanza

Now is not the time to speculate, which is why much of our research has been focused on high quality, defensive stocks offering attractive yields. If you haven’t yet read QBE and IAG head-to-head, Four things you don’t have to worry about Woolies and Metcash’s protective umbrella (all in issue 316), now would be a good time to do so.

I’d also recommend you check out our very popular 24 best buys cage match (see issue 315), where Nathan Bell (more on him later) whittles down our buy list from 24 to 15 stocks. If you’re looking to establish a portfolio from scratch, or make adjustments to an existing one, this is invaluable research at a time when it will pay to be cautious.

But there’s more to our service than making recommendations. Last weekend I was stunned to read a piece titled Super tax penalty needs drastic overhaul by Annette Sampson in The Sydney Morning Herald. In it she cites the case of a woman that received a $69,754 tax bill because of a $10.30 oversight. It seems incredible but investing, and the tax laws that apply to it, is becoming ever more complex, whilst the penalties for contravening them become more punitive.

That may be why Gareth Brown’s research and accompanying spreadsheet on the BHP buyback and the Foster’s demerger plan, plus James Greenhalgh’s work on the Origin capital raising (see issue 316) were so well received. If you own any of these stocks, or hope to do so, I urge you to investigate if you haven’t yet done so.

We’ve also had some good news with Spark Infrastructure and the shenanigans at RHG are perhaps drawing to a close, although you never can tell with Kinghorn et al. And finally, we launched Doddsville, our new podcast where we discuss general economic, investment and portfolio management issues. If you haven’t yet listened to it, please check it out and let us know your thoughts.

Handing over the reins

All up, it’s a nice point to draw to a close my first 10 years at The Intelligent Investor. Yes, it really was a decade ago that I stepped into the role of research director. A few years later I became its largest shareholder and, corny as it may sound, while I own a piece of this company, it also owns a piece of me. This role has given me the opportunity to speak and correspond with thousands of investors around Australia and the globe. It’s been a dream come true.

Many of you have inspired me personally, but also encouraged this business to continue ploughing its own furrow; from Helen in Ceduna who flew hours to come to our Adelaide seminar, Dugald the pilot, Damon in Melbourne, Merv the pharmacist, Jono the hedge fund manager, Brian the dairy farmer, the dearly departed Alison Evans and countless others. I am extremely grateful to have been a very small part of your lives.

Now it’s time to pass the baton to one of our rising stars. Nathan Bell has been a member of our team for almost five years and is one of the most dedicated and reliable people I have ever met. More importantly, he’s a formidable investor with a truly global perspective. From this month, he’ll take full command of the research team. You shall be in good hands.

As for me, I’ll be retaining my shareholding and taking my long-suffering wife on a lengthy overseas trip. I’m looking on it as a psychological hedge against a falling Aussie dollar. We’ll have some fun but I’ll also sneak away from the sightseeing every now and again to pen an article or blog piece for you (don’t tell her but I already have the first planned—a report from this year’s Berkshire Hathaway meeting in Omaha, Nebraska). Think of it more as an ‘adios’ than a ‘goodbye’.

Next month, you’ll see Nathan’s name at the top of this column. But there’s every chance my name will be popping up on my return. Venice is nice but believe me, there’s nowhere in the world quite like Oxford Street, Bondi Junction.

Disclosure: Staff members, including the author, Greg Hoffman, own many of the shares mentioned in this article. For a full list see staff portfolio holdings on page 12. First published online 8 Apr 2011.
The beer and wine demerger is good for shareholders. Demergers can be complicated, we’ve aimed to simplify the process here. We’ll be taking a closer look at both standalone entities over the coming month, to be ready for any opportunity.

Foster's demerger survival guide

There are six vital questions for shareholders considering the Foster’s demerger. This survival guide answers them, and looks at an opportunity that may emerge.

You’d think that a 200-page ‘booklet’, no matter what it concerned, would answer every conceivable question a reader might ask. Not always. The Foster’s Group demerger tome likely prompts as many shareholder questions as it answers.

This survival guide outlines what the demerger means for shareholders. And it also examines the potential opportunities that might spring from the separation.

The basics of the deal are simple: Shareholders will receive one share of Treasury Wine Estates—the new owner of Foster’s extensive wine assets—for every three Foster’s shares they hold.

This isn’t a free lunch. Foster’s shares, which after the demerger will only hold the beer, cider and spirits assets, should fall in price by an amount that corresponds to the value in the wine business. Theoretically, the combined value of your two shareholdings should be much the same as it is today. But we’re hopeful of an opportunity stemming from the fact it may not be.

Let’s get started.

1. Should I be buying before the demerger?

Unless the current stock price falls significantly below $5.50, probably not. The recommendation guide from 15 Feb 11 (Hold—$5.74) shows that, at today’s price, it’s a touch above our Long Term Buy price. It’s not a compelling bargain. Unless you want to own both demerged businesses immediately after the demerger, it makes sense to wait.

After the demerger, income investors will naturally gravitate towards the beer business. Treasury Wine Estates will be the drop of choice for those keen to bet on a wine turnaround. The crossing over of the two natural shareholder groups may throw up an opportunity but no one yet knows.

If you want to prepare yourself in the hope that it might, see Foster’s Group: Splitting heirs of 15 Feb 11 (Hold—$5.74), Cheers to Foster’s demerger (27 May 10) and Put some Foster’s in your cellar (11 Mar 10). These will give you a good background on these businesses and our valuation of them.

2. Should I be voting in favour of the demerger?

Yes. Table 1 offers a list of the pros and cons of the demerger, but the advantages outweigh the disadvantages.

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2. Should I be voting in favour of the demerger?

Yes. Table 1 offers a list of the pros and cons of the demerger, but the advantages outweigh the disadvantages.

Making and selling beer and wine are very different activities. Having them both under one roof never made much sense. It led to a monumental misallocation of capital, a great destruction of shareholder value. Separation will encourage the payment of prodigious beer cash flow to shareholders, rather than to subsidise the wine business, which will now have to stand by itself.

The demerger will also bring clarity and focus to management, and result in far clearer reporting. There’s also an opportunity under the new structure to better align management rewards to shareholder returns. These advantages outweigh the fairly meagre costs and disadvantages of the divorce.

If you can’t make it to the scheme meeting and general meeting in Melbourne on 29 April, simply vote ‘For’ in step 2 of the yellow Scheme Meeting proxy form and ‘For’ in step 2 of the blue General Meeting proxy form. Don’t forget to appoint a proxy in step 1 of both forms, most commonly by crossing the ‘chairman of the meeting’ box.

3. What’s the timetable?

There are several key dates (see Table 2). Get your ‘yes’ vote in well in advance of the scheme and general meetings on 29 April. On 10 May Treasury Wine Estates starts
trading on a deferred basis, at which point Foster’s shares will drop in price accordingly.

4. I’m a small shareholder. Should I sell through the sale facility?

We can’t offer a definitive ‘yes/no’ answer to this question, but we’d lean towards ‘no’. If you own 1,000 or fewer Old Foster’s shares during the demerger, you have the option of participating in the Sale Facility (pink form). This facility will sell your entitlement to Treasury Wine Estates shares on market between 23 May and 10 June, return the cash proceeds by 20 June, and will leave you with only a stake in the Foster’s beer business. Selling through the facility is brokerage free and applications are due by 13 May.

If you aren’t interested in maintaining your holding in Treasury Wine Estates then you might choose to sell through this brokerage-free facility, although you may be selling to other members of The Intelligent Investor at a cheap price (see below). We’re hopeful that institutional selling may provide an opportunity to buy Treasury Wine Estates cheaply in the days after it lists, and that’s the time that the sale facility will be selling your shares.

5. What are the tax implications of the demerger?

We knew you were going to ask that. The best source of information available is on page 18 and pages 114-120 of the demerger booklet.

Demerger tax relief is likely to be available. If you’re an Australian resident shareholder and are able to apply tax relief, you will ‘not realise any capital gain or loss from the demerger and the cost base in respect of (your Old) Foster’s shares will be allocated between (your New) Foster’s shares and (your) Treasury Wine Estates shares.’

As per page 116, the cost base will be apportioned ‘having regard to the market values…just after the demerger’. Foster’s will advise participating Australian shareholders of these amounts after the demerger. When the paperwork arrives later in the year, tuck it away for tax time.

Our understanding is that a certain percentage of your original cost base will be applied as the cost base for New Foster’s, with the smaller remainder applied as the Treasury Wine Estates cost base.

6. Should I buy Foster’s or Treasury Wine Estates subsequent to the demerger?

That’s the $64,000 question. We’re hopeful of an opportunity, but won’t know until it comes.

Let’s deal with the easy bit first. Valuing Foster’s once it has spun off the wine operation should be straightforward. We last provided ‘Cheap’, ‘Reasonable’ and ‘Aggressive’ valuations for the beer business in Cheers to Foster’s demerger (27 May 10). Those still broadly hold.

Be aware, though, that those valuations were enterprise value, not an equity value. We’ll need to adjust for the fact that most of the company’s current debt will remain with Foster’s, as well as making some adjustments for corporate costs. We’ll provide a detailed review of the standalone Foster’s beer, cider and spirits business before the demerger takes effect on 10 May.

Analysis of the beer business involves balancing the cash generating ability of its world-class operations against the threat imposed by the growing power of retailers. Coles and Woolworths (who else?) are positioning for a greater share of Carlton & United Breweries’ 40% EBIT margins.

A recent stoush, where Foster’s pulled its marquee brands from retailers’ shelves, is the most visible battle in what’s been a long running war. Nonetheless, there is significant value in the beer operation, something we’ll explain in our forthcoming review.

But it’s Treasury Wine Estates that will deserve a sharper eye in its first few weeks of listed life. Unwanted spin-offs can provide fertile fields for canny investors, although there’s certainly no guarantee of a bargain (the bible on spin-off investing is Joel Greenblatt’s 1997 classic You Can be a Stock Market Genius).

In essence, the smaller spin-off is usually the one that’s unwanted. That seems the case here. Usually, it’s been poorly managed (check) and gets to start life afresh with better management, clearer focus and little debt (check).

Crucially, in the information vacuum that exists between now and the new entity’s first financial report (due in late August), buyers are typically wary. Motivated and even forced sellers might cause the share price to fall.

In this instance, the sale facility will be forced to sell shares of all participating small shareholders and some foreign shareholders in a 15-day window, and some institutional
investors will sell as the stock drops out of the ASX Top 50 (into the Top 100). Other shareholders will simply associate the wine operation with poor performance and take their money and run.

In percentage terms, the range of potential intrinsic values for the wine business is much wider than it is for the beer business—Treasury Wine Estates is a turnaround in the making with no guarantee of success.

In a forthcoming review in the days leading up to 10 May, we’ll establish what might be a bargain price for these wine assets so that you’ll be ready to pounce if the stock gets walloped.

The (Old) Foster’s share price is little changed since 15 Feb 11 (Hold—$5.74), and our recommendation remains unchanged. But complete the paperwork, and get ready to get ready. HOLD.

Note: The model Income portfolio owns shares in Foster’s Group.

Disclosure: Staff members own shares in Foster’s Group but they don’t include the author, Gareth Brown.

High stakes resource | Gaurav Sodhi

Tap Oil's lucky hand

The share price might be up 31% since our original recommendation but there are good reasons to hang on.

Poker aficionados know that luck plays a part in success but that the best players take advantage of chance and manipulate probabilities to their benefit. Ultimately, poker is a game of skill. Hunting for oil and gas is much the same. Whilst luck may determine the outcome on any individual prospect, over time, the skill of the driller is the more important factor.

Tap Oil hasn’t merely been an unlucky explorer; it’s been a flawed one. Over the last five years, Tap has spent almost $200m trying to increase its reserves without success. The share price has dwindled as a result (see Chart 1).

Those flaws are now being addressed with new management and exploration teams reinvigorating the company. Modest ambition and extreme conservatism—fine in some industries but not in oil and gas exploration—have been replaced with aggression and élan. Tap has so far made two significant acquisitions, ventured into new turf and, most recently, done what many imagined was beyond it; made a new discovery.

What lies beneath

As reported in Tap Oil strikes gas on 17 Feb 11 (Hold—$1.00), the company recently confirmed gas at Zola, a large structure it was drilling with Apache in the Carnarvon Basin. Pre-drill estimates suggest it could hold between 1 and 2 trillion cubic feet (Tcf) of gas. If you’re in any doubt—that’s a lot.

Weather has prevented confirmation of the commerciality and size of Zola and, in the interim, legal woes have held back the shares (see Tap’s legal stoush in the pull-out box). Thus far, the market is valuing Zola at about 30c per share.

According to management, Zola holds reserves at the larger end of pre-drill estimates. But even at 1Tcf it would be worth about 44c per share. A 2Tcf discovery could be worth more than 60 cents. If Zola turns out to be commercial, it will be a genuine company changer that bodes well for other prospective areas in the exploration portfolio.
**Better days**

Tap recently purchased an additional 20% equity in a Carnarvon Basin prospect with the rather dull moniker of WA-351-P. Operated by BHP Billiton, it’s one of the most attractive prospects in the lucrative waters off the coast of Western Australia. High quality seismic surveys and nearby success for US energy giant Hess suggest this is as good as offshore drilling gets. Tap now holds a 40% stake and we rate this as its single most attractive exploration asset.

In Ghana, the company has an attractive new offshore oil prospect off the coast of West Africa where several large discoveries have been made by other firms. With the help of new data, there could be more. The targets are massive—up to 200m barrels of oil—but a good dose of luck and skill will be required to make something of them. Nevertheless, the potential is exciting.

Is it enough to tempt new investors? One has to wonder why the market is discounting Zola when energy prices are soaring. One explanation is that it’s located next door to the giant Gorgon gasfield, where a high level of carbon dioxide has delayed development for 30 years. A similar problem may stifle Zola. Similarly, WA-351-P may look sensational on paper, but Tap’s old foe—luck—will decide the final outcome. Tap’s fortunes might have changed but the laws of risk and reward haven’t.

**Worth buying?**

Table 1 outlines high, low and best guess valuations. The best guess estimate assumes Tap loses its pending court case. As with all stocks that promise excitement, there’s a long way to rise and just as far to tumble. That’s very important to keep in mind.

Tap is in better shape than it has been for years and members who followed our initial recommendation from 21 May 10 (Speculative Buy—$0.85) are sitting on a 31% gain. There’s a reasonable chance that may just be the start. Assuming a favourable outcome at Zola, the share price could go much higher.

If you understand and are comfortable with the risks, there is an argument for buying now. Conservative investors, though, should wait for test results at Zola (expect a review shortly thereafter). Officially, we’re sticking with Hold but have adjusted our recommendation guide to account for the improving outlook.

—

**The Ideas Lab | James Greenhalgh**

**iSoft bid bolsters Oceania sale**

A takeover for one of Oceania’s investments is some rare good news. But the 42% rise in the share price means it’s time to get out, as James Greenhalgh explains.

Woeful timing is something one occasionally experiences in the sharemarket. A takeover of iSoft, Oceania Capital Partners’ second largest investment, was something we canvassed in Private equity hopes for QR success on 24 Sep 10 (Hold—$1.405). But also possible, and looking increasingly likely, was that iSoft would fall into receivership, as its ‘going concern’ audit qualification last year prefaced.

We reduced our valuation of iSoft to zero as a result on 24 Feb 11 (Sell—$1.55) and recommended you sell Oceania. Five weeks later, though, US-listed company Computer Sciences Corporation (CSC) announced a takeover bid for iSoft at 17 cents per share (well above iSoft’s last trading price of 4.3 cents). Oceania’s share price has risen 42% since that downgrade and 54% since The Ideas Lab: Pulling the pin on private equity from 17 Mar 11 (Sell—$1.425).

You can see an updated valuation for Oceania in Table 1 (over the page). The second

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**TAP’S LEGAL STOUSH**

Tap Oil, as an equity partner in the Harriet Joint Venture (HJV), is being sued by customers for not supplying contracted gas following the Varanus Island gas explosion in 2008. The HJV declared that it was legally allowed to halt deliveries of gas but customers—Alcoa most prominently—argue that the HJV must pay compensation. An unfavourable outcome will see the HJV liable for at least $158m. Needless to say, Tap’s share price has responded badly to the news.

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**TABLE 1: ESTIMATING TAP’S VALUE**

<table>
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<th>HIGH</th>
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<tr>
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<tr>
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<td>LEGAL LIABILITY</td>
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<tr>
<td>CORPORATE COSTS</td>
<td>0.16</td>
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</tr>
</tbody>
</table>

**TOTAL VALUE PER SHARE**

| 1.98 | 0.55 | 1.22 |

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**TAP RECOMMENDATION GUIDE**

| SPECULATIVE BUY | Up to $1.00 |
| HOLD            | Up to $1.50 |
| SELL            | Above $1.50 |

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**OCEANIA CAPITAL PARTNERS | OCP**

| PRICE AT REVIEW | $2.20 |
| REVIEW DATE     | 7 Apr 2011 |
| MARKET CAP.     | $202m |
| 12 MTH PRICE RANGE | $1.20—$2.72 |
| FUNDAMENTAL RISK | 3.5 |
| SHARE PRICE RISK | 4 |
| OUR VIEW        | SELL |
The Intelligent Investor

column shows the prior valuation from 24 February, while the third column provides a valuation at the takeover price of 17 cents (iSoft is currently trading at 15 cents).

There have been rumblings that 17 cents may be insufficient to secure iSoft, and that alternative bidders are waiting in the wings. So the fourth column values Oceania assuming someone pays 22 cents for iSoft and Oceania sells its stake at that price (although Oceania may choose to sell earlier for reasons of certainty).

With many factors at play, there is no guarantee iSoft will be sold for a higher price (indeed, the market isn’t expecting a higher bid). Given iSoft’s precarious situation, there’s a risk that the 17 cent bid will fail.

The updated valuation suggests upside from Oceania’s current price of $2.20 is not hugely significant, even in the case of a higher bid for iSoft. This makes sense, as three-quarters of Oceania’s value should soon be in cash. Conservatism can be costly—as with our initial downgrade—but there’s not much to be gained by holding on.

While the iSoft takeover may have a few twists and turns yet, we prefer a bird in the hand.

**Sell.**

Note: The original article valued the iSoft convertible notes at the value provided by Oceania on 28 February ($21.1m). The value following the takeover announcement should be the full face value ($39.7m). The table has been adjusted but, while the discount has increased, it does not change our view materially.

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**Investor’s College | Gaurav Sodhi**

**Financial Ratios**

**Perplexed by PERs? Part II**

You’ve learnt how to calculate a PER; but when and how should you use it and where can it lead you astray?

After reading part I of this two part series, perhaps you’ve calculated a few PERs. Cochlear, for example, trades on a PER of 30; Tabcorp’s is 10; and IAG’s 80. Are these high or low and how can you tell? Let’s find out.

Analysis is an inexact science. So, like the medical student practising on dead bodies before being let loose on live ones, let’s start with a theoretical example (as a refresher, check out the simple PER calculation in part I).

Let’s look at Mature Inc., a business that makes exactly the same profit (earnings) year after year. Because it’s the very essence of predictability, it pays out all earnings as dividends, which happens to simplify our calculations (companies normally ‘retain earnings’ to reinvest in the business, something we’ll get to).

Let’s now assume that you have in your head an idea of the sort of return you’d like to make from an investment. You can use this figure to establish what PER the company would need to trade at in order for you to make your required return. Note that this is not the same PER as what Mature Inc. currently trades at. Table 1 shows you the calculation.

In the first scenario, Mature Inc. makes $5 profit per share (EPS) every year. With a required return of 10%, the value per share is $50 ($5/0.10). In scenario 2, $5 in annual profit per share with an 8% required return delivers a per share valuation of $62.5 ($5/0.08).

What’s all this got to do with PERs? We can calculate a required PER for Mature Inc. using what you learnt in part I. Simply divide the valuation per share by the earnings per share. That delivers a PER of 10 under the first scenario ($50/$5) and 12.5 ($62.5/$5) under the second. These PERs provide a ‘required PER’; a yardstick to compare other companies.

So what is the actual PER, rather than the figure you need to deliver the required return? That depends on Mature Inc.’s share price. Assuming the share price is $55, Mature Inc.
would be trading on a PER of 11, above the required PER of 10 when our required rate of return was 10%. In this case, we wouldn’t be interested in purchasing. But if our required return was 8%, Mature Inc. trades below our required PER of 12.5 and we’d be more inclined to purchase.

Not so simple

Trouble is, you won’t find a Mature Inc. listed on the ASX. No company earns the same amount each year and pays all of it out as dividends. Profits fluctuate. Companies also keep (retain) some of their earnings to reinvest in their business. This is where the PER model sets its first trap.

A high quality business with strong growth potential will often retain more of its profits to reinvest for growth. Being very profitable, it can usually make a bigger return on the retained portion than a typical required return. It therefore warrants a high PER.

Scratching your head? Don’t worry; let’s go through an example. Quality Corp makes widgets. With strong growth potential, it needs more factories to make more widgets. It hangs onto profits to pay for it, rather than pay dividends. With new factories, profits grow much faster than our required rates and shareholders are better off than if they’d received dividends.

So, what kind of PER would we pay for Quality Corp? It makes sense to pay more than the required PER for Mature Inc. That’s because Quality Corp is growing profits at a giddy rate, while Mature Inc.’s are flat. The hard part is determining how much more to pay; there’s a multitude of factors to consider.

Cochlear is an example of a real life business akin to Quality Corp (see Here’s to Cochlear, see issue 273). As Table 2 shows, the PER is very high but so is profit growth. Cochlear retains earnings because it reinvests them very profitably. Poor quality businesses retain profits just to help keep the doors open. In such cases, shareholders would be better off if they received dividends as they could be reinvested at a rate higher than that delivered by the company.

That’s why businesses like Fairfax Media (read more in Fairfax optimism presents an opportunity, see issue 303) trade on traditionally lower PERs. The key is to know the quality of the business; something that can only be the result of diligent research.

Pitfalls

Some PERs aren’t just misleading, they’re a fundamental illusion. Cyclical or complex businesses, such as insurers, top this list. Volatility in earnings leads to a highly mobile PER, as Table 3 shows. To overcome this problem, ‘normalised’ earnings, a measure of long-term average earnings capability, is used instead. Our estimate of IAG’s normalised earnings is 25 cents per share (see Adding to IAG, issue 297, for a derivation of this number), placing it on a PER of 14; a far cry from the 80 using reported profit.

Tabcorp highlights another trouble spot. Profits have grown at a healthy clip for most of the past decade making the current PER of 10 look attractive. But it’s a business facing challenges including, in 2012, the loss of its lucrative Victorian poker machine licence (see Tabcorp’s year of living dangerously, see issue 288). That’ll dent future profits. So what initially looks cheap is actually a reflection of reality.

As surgeons consider each patient’s circumstances, investors need to do likewise with each stock. Remember, the PER is a proxy for valuation and nothing more. In some cases it’s a downright misleading proxy. That said, it’s still a very useful ratio but only as an indicator of potential value. There really is no substitute for thorough research.

Disclosure: Staff members own shares in Cochlear and IAG, but they don’t include the author, Gaurav Sodhi.
Stock updates

ASX | James Greenhalgh

Treasurer Wayne Swan, acting on the advice of the Foreign Investment Review Board, yesterday advised that he was 'disposed' to reject the merger between ASX and Singaporean exchange SGX on national interest grounds. While some adjustments to the proposal are possible, the fast decision suggests the merger is probably dead.

This is a disappointing outcome for ASX shareholders. The high price offered was attractive, with SGX getting the poorer end of the deal (as today's 4% bounce in SGX's share price attests). ASX's share price has now declined 13% since 17 Feb 11 (Hold—$38.64).

It's doubly disappointing because the government has thrust competition upon ASX at home, but won't let it compete in the fast-consolidating global exchange market. At some point, the government will realise isolationist policies aren't appropriate, and ASX will be absorbed into a larger exchange group.

At the current price, shareholders should stick with this business. While the ASX faces competitive threats, they're less significant than those faced by many overseas exchanges. Indeed, the commencement of competition later this calendar year might provide a buying opportunity. HOLD.

Cellestis | James Greenhalgh

A 51% profit is a great result in eight months, you might think. But today’s announcement that Cellestis has agreed to be acquired by German biotech company Qiagen NV is tinged with disappointment. The friendly takeover bid is pitched at $3.55 a share, a 51% premium to the price in Cellestis passes the biotech test on 2 Nov 10 (Speculative Buy—$2.35).

But value investors hate having companies acquired out from under them at a price that doesn't reflect full value. That’s the case here. The 'Sell' price in our original recommendation guide of $5.00 is closer to what we were hoping Cellestis might achieve in a takeover (although that’s unlikely now).

We said then that ‘in this industry, takeover prices can be mind-boggling because the acquirer can use its existing distribution system to ramp up sales’. Interestingly, though, distribution synergies don’t seem to be Qiagen’s main rationale for acquiring Cellestis. Rather, it believes the company’s QuantiFERON technology is ‘highly complementary to our portfolio’.

The scheme booklet is due to be posted around 31 May, so there’s unlikely to be much news before then. The scheme meeting to approve the takeover is scheduled for late June but, as it stands, we're likely to recommend you vote against the proposal unless the price is improved. A competing takeover is another source of potential upside, although Cellestis has agreed not to solicit alternative bids (a standard, but hardly shareholder friendly, clause in takeover agreements these days).

The stock is up 26% since 14 Feb 11 (Hold—$2.75) and, for now, there's nothing to do but HOLD. We'll make further comments once the scheme booklet is released.

QBE Insurance Group | Nathan Bell CFA

QBE’s recent annual meeting reaffirmed 2011 forecasts at the higher end of those provided in the full-year results presentation. Insurance profit is expected to grow at least 30% although dividends are likely to remain unchanged. The market responded enthusiastically to this update, but the truth is they were within expectations.
QBE's record as one of the most profitable insurers in the world makes it stand out. For every dollar of premium received, QBE has paid out less than 90 cents in claims and expenses over the past five years. But low interest rates aren't helping the returns on its US$26bn investment portfolio, which is invested largely in fixed income and cash. When interest rates rise, as seems almost inevitable at some point, higher returns will boost QBE's profits.

In the meantime, we're 'looking through' to QBE's long-term earnings power. Our estimate for this figure is around US$1.40 per share, so today's buyer is paying an underlying PER of 14. A forecast dividend yield of 6.7% (mostly unfranked) also looks attractive, although it has been underwritten in the past. The stock price is up 7% since QBE and IAG head-to-head on 28 Mar 11 (Buy—17.72) and it remains a BUY although we are on the cusp of a downgrade (as you can see from the recommendation guide).

Disclosure: The author, Nathan Bell, owns shares in QBE Insurance, as do other staff members.

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**QBE RECOMMENDATION GUIDE**

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**Doddsville blog | Gaurav Sodhi**

Are pessimists wiser?

A diversity of opinions is a healthy thing. It makes life more interesting for one. And when it comes to financial markets, you need dissenters to weigh their bets in order to profit. The best investors—the Buffetts, Lynchs and Granthams of the world—therefore owe the opinionated uninformed a lot.

Among the cacophony of views, some opinions are clearly weightier than others. But even so, has anyone else noticed that pessimists get an easier ride than optimists?

An optimist explaining how things have improved or how they’ll get better is often dismissed as naive or ignorant of the risks. Get Steve Keen or Nouriel Roubini on the couch however and, despite doomsday scenarios proving wrong for years, their opinions are considered more thoughtful.

As value investors we are inclined to ‘look down before looking up’ as a colleague of mine might say. But being too pessimistic has its costs and these are too often ignored.

At the trough of the bear market in 2009, how many people said things were going to get worse? Or that the depression would be back and America maligned for decades? Whoever listened to the ‘wise pessimist’ missed out on one of the most powerful rallies in a generation.

And it’s not just in financial markets you see this reverence for the glum. The Japanese nuclear disaster brought onto our TVs a heap of nuclear experts, almost all of whom were solemn figures with multiple degrees and uniform views; things would get worse.

Thinking about risk and worrying about risk aren’t necessarily the same thing. We should, of course, consider what could go wrong, but that doesn’t mean we should always expect it to. Perhaps knowledge is the burden. If smarter people who know more are prone to expect the worst, here’s to not knowing too much and hoping for better.

Pessimists aren’t smarter or wiser. In fact, I’m going to make an uninformed opinion of my own; over time, the optimists have it right.

First published online 5 Apr 2011 at our [Doddsville blog](http://example.com).
Below is a list of this week's article links posted by our analyst team to our Twitter page.

Think the US can't default? Well, it can and will, says Bill Gross, but not in the way you might expect.
Zimbabwe effectively nationalises its mining industry. With energy woes in S.Africa, expect higher platinum prices.
Michael Mauboussin explains the ‘coffee can’ approach to investing—doing nothing at all can be very profitable.
Announcement at 5.27pm today—Kinghorns can’t vote in the RHG Group buyback! It will now be voted down. Board stoush to follow.
Shennanigans in the Chinese copper market make copper a very high risk exposure.
PLQOTD: ‘Any idiot can run this business’ is one characteristic of the perfect company, the kind of stock I dream about.
John Burbank discusses US economy, banks and Saudi Arabia in this interview.
An impressive DFS from Extract Resources although capital costs a tad high. A takeover target surely.

Below is a list of podcasts published to the website during the past week

Doddsville | Profit margins, margin loans and the case for cash

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PLQOTD: ‘Spinoffs of divisions or parts of companies...often result in astoundingly lucrative investments’. Will this apply to Fosters?
If you can stand the annoying CNBC interviewer, Jim Grant is always worth listening to.
Ask the Experts

Please note that the member questions below have undergone minimal or no editing and appear essentially as they do online.

**Starpharma doesn’t meet biotech criteria**

Your November article ‘Biotechs: More than a horror story’ was very useful. How do you rate Starpharma (SPL) on the criteria for evaluation of biotechs that James laid out in that article? Peter H

**James Greenhalgh:** Hi Peter. In short, Starpharma doesn’t rate on our criteria in *Biotechs: More than a horror story*. It does not have regulatory approval for VivaGel or any other product (yet), therefore it has no revenues or profits.

This doesn’t mean Starpharma won’t achieve regulatory approval, or that the stock won’t go up, but it is at too early a stage for us to consider reviewing. While the company seems to be attracting quite a bit of attention, the market capitalisation looks on the optimistic side. Getting a product to the commercialisation stage almost always takes longer than expected, and delays can be very detrimental to the share price if this reality sets in.

**MAp Group: rival airport**

Hi Guys I have been reading today about the recent push for a second airport in Sydney—fulled by leaked reports on the inadequacy of the current layout for future growth. (Not that we needed leaked reports to work this out). I know a second airport has been on the agenda for some time, however this was not listed as a risk in MAp: A classic capitalisation buy. Would you agree this is a potential risk, and something we should be wary of? I would only assume overflow/minimal flights would be directed to the new location, as it couldn’t be in as an ideal location as Kingston smith? Could it? Aaron C

**Gareth Brown:** Hi Aaron, we’ve talked about this a lot but the difference between politicians talking about a new airport and actually building one that will get used is huge. The new airport would be far less convenient, as it wouldn’t be connected to the rail system or be as close to the city, and it might not even handle larger aircraft provided the community even wanted another airport.

Though we would never rule out another airport, further regulation could be just as detrimental to MAp. MAp is exposed to many low probability, high impact risks, such as SARS or a terrorist attack, which is why the current portfolio limit isn’t higher.

**Tap review coming up**

Hi Gaurav, I was interested in what you think of Tap or are you still waiting for more drilling information on Zola. Bernie R

**Gaurav Sodhi:** Hi Bernie. Weather has delayed the Zola results but there will be an update on Tap tomorrow. Hopefully it answers your questions.

**Mayne Pharma**

Do you guys have any thoughts on Mayne Pharma? I understand they have a patent defence case coming up in June concerning their biggest selling generic, which will have a material effect on their revenue if they lose, but it looks like a reasonably priced, profitable biotech company without a lot of hype (and there’s not a lot of them around). Its trading about 12x earnings/5x EBITDA. If the patent holds up in court they have it until 2022, and they are developing a number of other revenue streams and have clearly defined growth markets particularly in Europe as well as a partner with an established distribution network. You guys don’t seem to like the healthcare sector much outside the really established players but I thought this stock may fit into your investing philosophy. I’d be keen to get your initial thoughts.

**James Greenhalgh:** It’s interesting to see this company change its name from Halcyen to Mayne Pharma, given the Mayne name was ‘big’ in healthcare a few years ago (until it was dismembered). Also interesting is the appointment of Roger Corbett as chairman, not that he has covered himself in glory at Fairfax.

I think Mayne is a little small for us to look at, with a market cap of around $100m. I also noticed 50% of their revenue comes from one product, so the business definitely falls into the ‘high risk’ category.

I’ve published this for other members who want to do their own work, but it’s probably too small and speculative for us.

**Oceania after the iSoft takeover**

Hi—Any comment on OCP & the recent iSoft takeover offer of $0.177? I know you had a sell on OCP but I’m sure many members (including myself) did not sell in time for the latest trading halt. With a bit more certainty in this stock is it worth another look? Cheers. Rowan W

**James Greenhalgh:** Hi Rowan. With the proposed takeover of iSoft the valuation of Oceania changes somewhat. We’ll look to update our most recent review later this week. As Oceania is a now-completed recommendation, we’re unlikely to cover it on an ongoing basis. But with the situation somewhat different than before, we’ll update our view for members who still hold it.

**RHG activism**

Surely the only fair action for all shareholders in RHG is a distribution of a special dividend of 87c (plus franking credits) which gives us the benefit of the current cash plus still participating in possible upside and requires no judgements about today’s value. If shareholder activism is to be effective, shouldn’t we push for this outcome? Tony R

**Gareth Brown:** We have pushed for a different deal, Tony, but we don’t control the agenda here, and we’ve got zero chance of winning a bunfight with both institutions and the Kinghorns. Fairness, unfortunately, rarely drives the agenda. For us, it’s a choice between imperfect but effective shareholder activism and a perfectly fair plan that will prove ineffective in garnering the support needed to stop Kinghorn.

The new plan, if it gets up, is far superior in that at least shareholders
have a real choice about whether to participate or not in the buyback. We're quite happy about the proposal, although we argued hard for something else.

From our point of view, the ideal outcome would be a well-pitched buyback (at a higher price), which has the potential to create value for all shareholders, much like with the BHP off-market buyback. If a buyback was done at a higher price, but still a lower price than intrinsic value, then the buyback would deliver franking credits to those who find them most valuable (low tax rate investors), delivering them an amount more than intrinsic value, while still generating value for remaining shareholders. The value created from the current buyback is too lopsided towards remaining shareholders, but at least we know that information and can choose to ignore the buyback and wait around for a future stream of fully franked dividends. Kinghorn didn’t give us that option.

If RHG paid a dividend to everyone, not just to selling shareholders, it would need to be lower than 88 cents—the company will still need resources to operate. By the way, there was an interesting announcement last night that the Kinghorns won’t be able to vote on the buyback. So the existing buyback will be voted down easily, and it will all come down to the board challenge in a few months.

**Arbitrage in RHG? I wouldn’t call it arbitrage**

RHG—unless I am missing something here, only those shares which have not been traded since the ex-entitlement date have value in terms of the buy back. In my mind, there are essentially 2 classes of shares—one that only has the currently listed price of about $1, and those where this applies with the choice of cashing in on the dividends. Is there not the option of double dipping now as an arbitrage and for those who have the money, take the dividend payout down the track, but buy shares now on sale at about $1 and wait for the next round of benefits to roll on down the track? If the value is about $1.70 and I can get this on the $1 shares plus the 1.20–1.30 in dividends, I get the best of both worlds? David M

**Gareth Brown:** Your reasoning seems valid to me. But, and it’s a big but, the stock you might buy on market today doesn’t have the same downside protection as older stock (entitled to the current buyback) in the instance that Kinghorn wins this battle. There are certainly no guarantees of the rebellion winning. Those shares you buy today might end up stuck in an unlisted company with Kinghorn. Or you might have to sell them on-market in a month at who knows what price. That risk shouldn’t be overlooked. Perhaps it’s worth $1.70 (to low tax payers, not necessarily to everyone) in the instance of success, but if RHG gets delisted it’s worth substantially less because of the so-called agency problem, in that you’re completely at the whims of the chairman. That’s not a situation we’d be comfortable with.

**Why cease coverage on Monadelphous?**

This is a comment, not a question. If you say at one moment that MND is as good as you did recently, then something is radically wrong with your methodology if you turn around a few months later and say ‘cease coverage’. By all means say it is a sell—but that is not a reason to cease coverage.

**Gaurav Sodhi:** This is an important point to raise and I’m glad you’ve done so. While ‘Coverage Ceased’ means we won’t be publishing regular updates, it doesn’t mean we ignore the stock. As the analyst on Monadelphous I can assure you I’ll still be reading announcements and watching presentations. I just won’t be writing about it.

We’ve made a judgement that our time is probably better used finding you new opportunities and covering existing ones rather than writing about a stock which we have recommended you dispose of. That doesn’t mean we ignore it though, and if it gets back into our target price range, we would certainly let everyone know about it. One of the lessons I’ve learnt from the GFC is that it pays to get to know the highest quality stocks and have a target price in mind so if things turn, you can pick up a bargain. That’s what we aim to do with Monadelphous.

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**Macquarie Group on the borderline**

Hi, I am a long term buyer and have some spare money and I was wondering what your thoughts where on mqg is it time to buy or wait a bit. Michael M

**Nathan Bell CFA:** Hi Mick. Macquarie Group’s share price is currently right on the borderline between Hold and Long Term Buy, so it’s not a screaming bargain. Our view of the company hasn’t changed, though, and we’re comfortable with the prices in the current recommendation guide that you can see in past reviews.

We’ve published a virtual library of reviews on this company over the years, which analyse how the company has changed. For Macquarie, the future will look quite different to the past now that it’s much larger and expanding aggressively overseas.

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**Foster’s demerger—multiple articles coming over the next month**

Hello, I received the Fosters demerger paperwork in mail. I am guessing I will be reporting on it in the near future. As mentioned in your recent article on FGL that smaller sibling could get dumped initially, I am hoping the sell and then buy back in at cheaper price but would like to hear your comments. Nilang S

**Gareth Brown:** Well-timed question Nilang! There’s an article to be published Monday that details most of the important questions shareholders are likely to have about the demerger—should I vote in favour of it, how do I vote, what is the timetable, what are the tax consequences etc.

Then, closer to the actual demerger in early May, we’ll be publishing detailed reviews of the two standalone entities—the beer, wine and cider-focused Foster’s Group and the wine-focused Treasury Wine Estates.

As you’ve suggested, there’s a chance that Treasury Wine will be initially dumped, and we want to be prepared in case that happens. I don’t really understand your strategy to sell and buy back Treasury Wine though. If there is a dumping, it’ll happen in the early days of listed life, and we certainly won’t be selling into that if that happens. Small shareholders who use the Share Sale Facility will have their shares sold on the market, which could be at the time it’s depressed, it’s not at a set price. Hopefully all will be clearer after Monday’s article. But if you have any further questions after that then please let us know.

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**Aristocrat management**

Hi Guys, any comments on Aristocrats management given the recent reports on remuneration for Jamie Odell?

**James Greenhalgh:** We’ve certainly said that Aristocrat’s board and management leave something to be desired, so this sort of thing isn’t ideal. But there are different points of view—I probably take a less hard line view on management remuneration than some of my colleagues, for example.
I think it’s important to understand exactly what a managing director can achieve, and over what time period. Odell can’t really be blamed for Aristocrat’s current woes—they are a result of past mismanagement as well as market conditions. I don’t really think current management should be penalised for past management’s misdeeds, and shareholders need to provide some incentive to fix the problems (but that doesn’t mean we think share options are the way to do it).

There’s also a timing issue. It’s very easy for shareholders to forget that turning around a mismanaged business takes years, not months. So, again, it’s maybe a bit early to be too critical of him. Odell is really only part of the way through what’s a particularly difficult turnaround. And the financial results are often at their worst at the very time a business is finally making some underlying progress, which appears to be the case here (although I’ll admit there have been a few false dawns already).

**Thinksmart**

Hey Guys Wanted to know your take on Thinksmart (TSM). From the brief read through I had of their latest financial presentation, they seem to have fantastic Operating Margin (64%) and EBITDA Margin (42%), EBITDA has been growing at a CAGR of 17% last 4 years. Minimal Debt (approx. 17% D/E ratio), and sitting on good cash balance. Although Market cap is 112 mill, not sure if it falls within your radar.

James Greenhalgh: It’s on the small side, although looks potentially interesting. I was initially wary of Thinksmart because it looked like it was involved in some sort of equipment/consumer financing. These sorts of businesses tend to have high margins but they’re also high risk, because they are finance companies (i.e. engaged in borrowing and lending).

I haven’t spent much time on it, but am having trouble getting my head around the business model. It looks interesting because it doesn’t seem to have much debt on balance sheet, but makes most of its revenue via commissions. If anyone else knows more about this business model, please feel free to enlighten me. I’ll put it on the list to look at down the track, although it’s not high priority given the company’s small size.

**Spark Infrastructure’s growth and management internalisation**

Nathan and the team, Firstly, I have been a member for almost a year now and really enjoy the service you offer. I have found it difficult in the past to find a professional subscription service with a similar value investing philosophy. So I am glad that I found the team at The Intelligent Investor. I have been reading your reviews on Spark Infrastructure and have a few questions;

1. In relation to the RAB, Nathan mentioned in his review on the 2/11/10 that the RAB annual growth should fall between 6.9% and 9.2%. However, in his next review on the 22/2/11, he said that Sparks investment in the RAB will be approx. 14% per year. Could you please clarify...

2. For arguments sake, If the investment in the RAB increases by 10% per year, how much of this increase will fall through to the bottom line and thus distributions?

3. Finally, if there comes a scenario where the RAB needs to be sold, what are the chances that the price paid for the assets will be less then the stated value of the RAB? Looking forward to your response. Elliot J

Nathan Bell CFA: Thanks for the kind words Elliot. The underlying electricity asset companies expect to grow the regulatory asset base (RAB) by ’8%’ per year, which is consistent with the previous review that you have referred to. But due to its financial leverage, Spark’s actual investment in the underlying RAB is expected to increase by a healthier 14% per year.

I thought about being consistent with the past review and quoting the 8% figure, but I expect securityholders like yourself are more interested in the expected returns Spark actually expects to make, rather than the underlying asset companies themselves. I expect distributions will only increase gradually as the underlying asset companies need to retain cash in order to expand the electricity networks, so I expect profits will grow faster than distributions. But expanding the asset base (or the RAB) is real value being created which is why we expect the stock to produce healthy dividends and capital gains.

In answer to the final question I can only speculate, as it would take another credit crisis to bring about asset sales and who knows what price Spark might achieve as a desperate seller. The need for asset sales is a very low probability event in our view. Banks love to lend to companies producing reliable and regulated profits like Spark, particularly having agreed regulatory terms for the next five years. Securityholders have also received further good news this morning with management announcing that it will internalise the management structure.

**QBE vs IAG**

Just read your QBE & IAG Head to Head article and well written except for the product diversity issue which in my view is simply incorrect as the IAG short tail commercial would cover many of the product classes explicitly mentioned by QBE. In my mind the split between short & long tail is the real risk area as prior mispricing can seriously hurt insurers. IAG is substantially “shorter” than QBE—do you agree? Dennis F

Nathan Bell CFA: Hi Dennis, you’re spot on that IAG’s ‘short-tail commercial’ would cover product classes split out in the chart by QBE, but QBE is still a more diversified insurance business in virtually every way, including by product line. It’s a shame IAG doesn’t break out the figures like QBE does.