



StockVal informer

Issue 18 - October 2008

"Man's mind, once stretched by a new idea, never regains its original dimensions" - Oliver Wendell Holmes



all about the **FORUM**

This issue of StockVal Informer features the most topical threads from StockVal's Forum. Normally reserved exclusively for StockVal members, StockVal's online Forum has almost 250 members and includes around 60 topics and 300 posts. The Forum is a place for StockVal members to share thoughts and discuss investment ideas.

NEWTOPIC*

Australia's Best Listed Businesses

The following Forum topic was created by **StockVal analyst Russell Muldoon** on Thursday 31 July.

To view this topic online visit
www.stockval.com.au/view_forum.php

With over 2000 companies on the Australian stock exchange, choosing a handful of top notch companies is a daunting task for many DIY investors. With that in mind, in this thread I would like people to share with other members their top 10 listed businesses (you can only choose 10). A discussion as to why would also be useful in helping others build knowledge. I will share mine at a later date to avoid influencing others decisions. After a few posts I will consolidate everyone's ideas and choose the companies most selected.

This will make a great watch list.

Russell

POSTREPLY ↙

by **NeilEQLDjun08** on Fri Aug 01, 2008 1:01 pm

BHP, COH, WOW, QBE

They all have the following attributes in common:

1. High ROE
2. High Market Cap. Which means to me stability, economy of scale, strength over their competitors
3. Modest debt levels
4. Earnings growth

Plus one thing that appeals to me, they're all optionable. So I can get a modest income from them writing covered calls on them.

BHP and WOW have the added appeal of diversification. They earn money in a number of different areas, so they're not as vulnerable to a downturn as a one product company. (Being a one-product company is the only reservation I have about COH).

POSTREPLY ↙

by **IanPQLDmar08** on Wed Aug 06, 2008 12:36 pm

This could be an interesting thread to watch, if only to see the "strategies" other StockVal members might be using, or consider important in defining great businesses in Australia. I look forward to seeing Russell's list too.

Just two of the smaller cap ones I think are great businesses are PME (cap approx \$116m) and WWA (\$75m). REH is NOT a small cap, just too tightly held to be included in the S&P/ASX200 index.



PME: just look at the high NROE (>60%) AND high net profit margin (around 50%), sustained for many years (ie the very definition of a STRONG FRANCHISE). Managers have a high personal stake in the business. Only recently started using options as payment. zero, zip, nada, no long term debt. Tied into the "ageing population needs more health care" theme. Not only has no requirement for new equity for many years, but doesn't need to retain profits to achieve growth e.g. more than doubled profits in 5 years, and still paid out 85% of profits

REH: sustained ROE for many years (not outstanding, but solid, around 30%). Managers have high personal stake in the business. No requirement for new equity for many years. No options as payments. Reasonable long term debt. Perhaps perceived risk with forthcoming change of senior management?

WWA: sustained NROE for many years (40-60%). Growing Net Profit margin in a highly competitive field (implies some pricing power?). Managers have high personal stake in the business. No requirement for new equity for many years. No options as payments. zero, zip, nada, no long term debt.

Footnote for REH: they own about half of their stores, but land and property is counted at depreciated cost in book value. If the current value were to be included in equity, this would reduce apparent NROE by a few per cent. BUT this under reporting of assets in equity ADDS an element to the "safety" of the business as an investment (of course they report the current value in the notes, but property (land and buildings) is counted in equity at depreciated cost)

NB none of these are currently screaming bargains.

POSTREPLY ↙

by **JeffWVICmay08** on Thu Aug 07, 2008 1:40 pm

My two cents worth on your selections...

PME: Seems solid on most fundamentals but overpriced according to StockVal by 25%! The dividend policy seems bizarre, if they can't reinvest profits at near ROE (reinvestment rate only 6.2%) then this is a concern. A patient investor is required because their share price performance over 5 years isn't impressive. Not a stock I would be looking at for now unless you have a dividend income focus.

REH: Steady average business performance whose stock price has only just recently (last 6 months) come down from the stratosphere. Still 17% overvalued though and a prudent value investor would have sold out last year when its value/price margin told you the market price was highly irrational and not based on business performance or potential growth.

WWA: Another company with good fundamentals (ROE 62% and no debt!) and a bizarre dividend policy. Share price went ballistic in 2007 and returned to earth with a thud so far in 08. Again, a value investor would have sold out last year when the V/P margin became very distorted. Definitely worth an entry in the watchlist.

It's truly unfortunate that so few Australian companies follow Warren Buffett's lead and reinvest all profits, foregoing dividends. Time and again I see Australian company directors of top performing businesses capitulate to the pressure to increase dividend payout ratios. Just a shame and quite frankly gutless if profits can be reinvested at greater than 25% ROE.

POSTREPLY ↙

by **IanPQLDmar08** on Fri Aug 08, 2008 12:45 pm

Jeff,

Thanks for your 2c. You make some interesting points.

I am intrigued by your focus on price and price movements, but I concur with your "...a patient investor is required..", although I'm tempted to suggest (rather tongue in cheek) that without patience one can hardly be called an investor :-)

I was focusing on what I consider good businesses: high, sustainable ROE, no (or little) debt, management invested, no requirements for new capital. Note, no reference to PRICE (other than to say they aren't currently bargains, and I should say that I almost always have some adjustments to the standard StockVal valuation (eg adjust REH equity incorporating actual land valuations lifts valuation closer to current market price).

As for dividend policies of WWA and PME: the managers of these companies have identified that they do NOT NEED to retain profits (let alone ask punters for more capital) to fund their ongoing activities and growth. If they don't need it (no matter how high their ROE), then RETAINING capital would be the bizarre thing to do, as it would lead to reduced ROE. Retaining cash they don't need might also lead to temptation to expand into something they're not familiar with! That these companies have stuck to what they know without being tempted to rule the world or go empire building with their free cash speaks volumes of the calibre of management to me. (To paraphrase Warren Buffett (I think), we want managers who have integrity, intelligence, and who work hard - without the first, we don't want them to have the second two qualities).

I would also suggest that although Buffett and Berkshire never distribute dividends, surely the companies they invest in are ones that can grow with



limited requirements for new cash (ie can turn a dollar of retained earnings into more than a dollar of market value, I think he said), and can pay their excess cash to Berkshire to allocate. See also his discussion of See's Candy in the 1991 and 2007 Berkshire letters (www.berkshirehathaway.com/letters/letters.html). On back of the envelope calculations, in the years cited by StockVal, PME has retained \$4.9m to generate an increase in profit of \$4.3m (94% return on retained funds), WWA has retained \$8.2m to generate \$4.1m (50% return), compared with COH, WOW, and QBE generating 48%, 18% and 20% respectively on retained/new capital.

I look forward to seeing other people's favourite "top 10 listed businesses" and what factors others consider most important in a top business, regardless of what price Mr Market is currently attributing to them.

POSTREPLY ↙

by **JeffWVICmay08** on Fri Aug 08, 2008 5:17 pm

Hello Ian,

An interesting reply and, not wanting to hijack this thread by straying to far off topic, I will try and be brief in reply.

You should not be intrigued by my comments on price. The value investor focuses on valuation as a starting point for the investment decision. Price comes into play as part of an investment strategy when deciding an entry and exit rule base. Value investors do SELL shares when the V/P margin is irrational and for other reasons. I could site many examples and there is no virtue in being a buy at whatever price and hold forever investor. The "Concise Guide to Value Investing" by Brian McNiven is an excellent read and has a good chapter on "When to Sell".

PME and REH are overpriced according to the default StockVal valuation (admittedly conservative). I think the current market and global credit situation requires a value investor to be conservative. The quality of the business may be excellent but if it can't grow by reinvesting a large percentage of profits at or near NROE then the value investor should be concerned. How else are value, price and business growth generated? By either reinvesting profits, borrowings or issuing new capital to expand the business. For the value investor, reinvesting profits is by far the best solution if it can generate a return on reinvested profits of greater than 20% (my rule base). If the business is not growing in profitability with increasing ROE on low debt don't expect the price to go anywhere (except for speculation, takeovers etc) and we do invest to make money do we not?

As for dividend reinvestment policy (most companies have no stated or explained dividend policy BTW), I

am in good company in being critical of companies with high ROE paying out high dividend ratios for questionable reasons, Roger Montgomery and Warren Buffet to name a few notables. I will publish my favourite businesses here shortly.

POSTREPLY ↙

by **ChrisQLDjul06** on Thu Aug 14, 2008 10:40 am

I agree with Neil's selections (BHP, COH, WOW, QBE), and hold each of them.

I'd like to add the following for consideration:

CSL - good and steadily-increasing NROE, high rate of reinvestment, low debt. They are a well-managed business, and have a habit of surprising on the upside. Stockval has consistently regarded CSL as grossly overvalued, and therefore you might expect a big drop in share price when market moods darken. In fact though, the share price has been very resilient during the last 12 months. Maybe StockVal's missing something??

LEI - a dominant player locally and has a significant presence in Asia. Leightons will continue to benefit from rebuilding Australia's infrastructure, the ongoing demand for Australia's resources and continuing development in the Asian region. NROE is around 40% with significant reinvestment.

FAN - NROE seems to have stabilised at over 40%, reinvestment is substantial and they have low debt. They've been able to fund recent acquisitions without increasing borrowings. Now available for less than StockVal's valuation.

TRS - I'm surprised no-one has mentioned Reject Shop, for all the reasons comprehensively covered in Fundamentally Stockval issue 4 (https://www.stockval.com.au/stocks/eneews_download.php?id=27). Also now selling at less than valuation.

NEWTOPIC *

Billabong International Limited (ASX:BBG)

The following Forum topic was created by **JasonSWAmar07** on Thursday 10 July.

To view this topic online visit
www.stockval.com.au/view_forum.php

Just wondering if anyone has conducted any research on Billabong and/or would like to comment on it? Looks to be a well run business on the surface with a well-recognised brand globally. I'm not sure about management and need to search for any information on them... The



accounts seem reasonably clean without anything unusual.

POSTREPLY ↙

by **RussellMuldoon** on Fri Jul 25, 2008 5:30 pm

Hi Jason,

Just some quick thoughts RE: BBG. You might want to consider that the business has significant exposure to the US consumer, coupled with significant US currency dominated profits.

A slow down in consumer spending will affect sales revenues. Assuming they can't adjust costs in line with that decrease, margins will be squeezed, lowering after tax profits. \$USD profits need to be translated into \$AUD equivalents. With the depreciating \$US and with our \$AUD appreciating, it will take more after tax profits to make the same impact in the businesses financial reports - hence ROE's are likely to come down.

Saying all this, your comments are correct. A great business, just cyclical in nature.

POSTREPLY ↙

by **WesHQLDsep08** on Sun Aug 10, 2008 10:44 am

This might be a somewhat superficial comment, but wander out on the street and see which is the most popular brand - Billabong, RipCurl or Quicksilver. If you're in a heavily populated area it won't take long to find your answer. Maybe it's different overseas, but the answer is plainly obvious in Australia. So, which is it?

NEWTOPIC*

Durable Competitive Advantage

The following Forum topic was created by **TimIQLDjun08** on Monday 7 July.

To view this topic online visit
www.stockval.com.au/view_forum.php

Value Investing Comrades,

I've read a few books and Buffett letters to shareholders on value investing, as well as attend various StockVal seminars. One of the often-mentioned elements of a wonderful company is its durable competitive advantage. This is often expressed in terms of brand name recognition, ease through which the company can increase production without the need to invest large amounts of capital or a unique system/advantage it has over its competitors.

Examples given of companies with this highly sort after "durable competitive advantage" include Coca-Cola, Amex, Nike and a raft of other US-based corporations.

I was wondering what listed Australian companies would have a durable competitive advantage. To be honest, not many sprung to mind. Whether this is due to our smaller market, the cultural might of the US advertising industry or my lack of attention when it comes to Australian brands I do not know. Names like Hills Hoist, Victa, Arnotts and Leyland come to mind, however they have been bought out or folded due to ugly, dangerous products (sorry P76 lovers). BHP may be the Big Australian, but branding hardly matters when it comes to buying coal or iron ore. Macquarie certainly is well known, but does it have an identifiable advantage over its international competitors other than gifted financial management?

So, I thought I'd put the question out there:

What Australian listed companies do you think hold a durable, competitive advantage within their market?

POSTREPLY ↙

by **JasonSWAmar07** on Mon Jul 07, 2008 4:25 pm

I've often thought of this as well and had trouble thinking of any ASX listed companies that match this criteria... However - if a business has a great return on equity over many years (with reasonable level of debt) - does this imply that the business does have a durable competitive advantage?

POSTREPLY ↙

by **TimIQLDjun08** on Mon Jul 07, 2008 5:40 pm

Jason

I don't necessarily think so, if you stick to the pursuit definition (I'll call durable competitive advantage DCA to make things easier to type).

Take BHP: As I said before, BHP has a great ROE and has been a solid performer for the last 5 years. However, its primary business is mining and selling commodities, which by and large are bought based on cost rather than brand or origin. This alone should discount it from having a DCA, let alone the cyclical nature of resources. However, it is the largest mining company in the world and to an extent can influence world commodity prices (especially in the current sellers market with China). So does its size engender a certain competitive advantage? Maybe in determining prices, but small mining companies start up all the time and some even make it big (Macarthur Coal, Nathan Tinkler etc). This line of reasoning would lead me



to believe that, even though BHP's ROE might be high and consistent, I would say it cannot have a DCA due to its commodity-type products.

So, that knocks out resource companies. But it still leaves the rest of the market. One security I thought of for DCA candidacy is the Just Group. I know Fundamentally StockVal examined the Just Group in Issue 15, Oct 2007 and had positive things to say about them. They own a swath of brand name clothing retailers (Just Jeans, Portmans, Dotti etc). I would tentatively say that the collection of brands under it's banner would amount to a competitive durable advantage - every one knows Just Jeans, Portmans, Dotti etc. They also have ROE's exceeding 90%. They took a battering recently due to a lower than expected 2008 EPS, but that's good news for investors hunting for value.

Maybe Just Group is a wonderful company we should be watching closely, to see if it dives further as discretionary spending continues to drop in the months ahead.

POSTREPLY ↙

by **JasonSWAmar07** on Mon Jul 07, 2008 6:11 pm

Hi Tim,

I agree with your thinking re: ROE and Resource companies... Maybe it should be: "if a business has a great return on equity over many years (with reasonable level of debt and is NOT a commodity business) - does this imply that the business has a durable competitive advantage?"

POSTREPLY ↙

by **RhettMNSWoct06** on Tue Jul 08, 2008 9:01 am

no

a whole sector or many participants in it may have a high ROE - has nothing to do with a competitive advantage

an example could be a cafe or a consulting company.

POSTREPLY ↙

by **JasonSWAmar07** on Tue Jul 08, 2008 10:16 am

... but if that whole sector or group of companies has an enduring high ROE as described above - then surely that is a great sector or group of companies to invest in, given the other conditions that value investors such as Buffett look for (i.e. Management, etc)? Remembering it is your predictions that this high ROE will continue into the future which matters. For a business or sector to have a sustainable high ROE I think that proves that somewhere it has

a sustainable competitive advantage - if this was not the case it would not be able to command the high ROE. i.e. an "enduring" high roe and a sustainable competitive advantage go hand in hand.

The hard part is determining if that roe will continue into the future and for how long (i.e. the APC in StockVal), just as the hard part is finding a company with a sustainable competitive advantage that you speak of.

POSTREPLY ↙

by **RhettMNSWoct06** on Tue Jul 08, 2008 11:20 am

No. High sustained ROE is not enough (and does not imply a moat) it could easily mean a business with low equity.

POSTREPLY ↙

by **JasonSWAmar07** on Tue Jul 08, 2008 12:05 pm

A business with fantastic returns with little equity - sounds pretty good to me... why would that be a bad thing?

POSTREPLY ↙

by **RhettMNSWoct06** on Tue Jul 08, 2008 12:19 pm

It might be good. But its not relevant - the question was attempting to link ROE to a moat and in my view there is not a direct link.

NEWTOPIC *

Macquarie Group Limited (ASX:MQG)

The following Forum topic was created by **NeilDSAaug07** on Wednesday 17 September.

To view this topic online visit

www.stockval.com.au/view_forum.php

With Macquarie Group's rapid decline should we decide that this is a case of fear and panic in the US causing indiscriminate selling in an entity deemed to be the same but not?

I think that from what we have seen in the U.S. that when it comes to failing companies, size offers no protection - but does value? Or could the rapidly falling share price cause a self fulfilling prophecy in that if the company needs to raise funds, it's two options, debt or equity, are currently unattractive.

Debt because no one is lending without a hefty premium and equity (if the valuation is correct) in the



form of new shares issued at a price below valuation would dilute the ROE and current shareholder value.

So, is MQG a bargain that in 5 years we shall be looking back and saying, gee if only I could have bought at that price, or will it decline further and we will be glad we stayed clear of it.

Taking a stand against the trend is one of the toughest calls.

Regards

Neil

POSTREPLY ↙

by **RhettMNSWoct06** on Thu Sep 18, 2008 10:35 am

So what do others know that we dont? ie what haven't they announced yet?

What did Alan know???

I'm guessing the ROE will be lower than history suggests...
Rhett

POSTREPLY ↙

by **AngeloDVICjul08** on Thu Sep 18, 2008 12:08 pm

Today the price moved another -17% but all I hear from management is that the company is well funded and the media reports are false.

So the big question is: Is MGQ Value or Avoid?

Angelo

POSTREPLY ↙

by **NeilDSAaug07** on Fri Sep 19, 2008 11:15 pm

Well, by now we should have all stocked up on MQG at those huge discounts to the valuation unless we were paralysed like a 'roo in the headlights of the credit squeeze juggernaut.

Who would have believed these kind of movements in stock prices down 20%+ then up 37%. It looks like a market in complete confusion.

I had hoped to buy some more yesterday but my funds had not cleared and by the time the order was placed the stock had taken off, I will not chase a stock higher.

Interestingly, on the Thursday I glanced at the market depth screen on MQG and there was 1 seller of 35,000 shares at \$27 before the open. This is what effectively

thumped it down so fast.

What is interesting is this. Someone who holds that many shares would be regarded as an investor of some wealth or sophistication. Was this just a sign of capitulation as normally one would sell a line of stock slowly so as to get the best price, not thump them all off in one go? It couldn't be a short seller as the uptick rule would have to apply. One must only think this person is now spitting chips with the 'miraculous' reversal.

Neil



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Wednesday 22 October	Ballina	Ballina Beach Resort
Tuesday 28 October	Melbourne	Vibe Savoy Hotel
Monday 10 November	Perth	Somerset St Georges Terrace
Wednesday 19 November	Orange	Orange Ex-Services' Club
Wednesday 26 November	Killara	Killara Golf Club
Tuesday 2 December	Double Bay	Stamford Plaza Double Bay
Tuesday 9 December	Adelaide	Mercure Grosvenor Hotel

Seminars commence at 6pm and are followed by light refreshments and snacks.



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