

# Fundamentally StockVal

Issue 72 – 24 March 2010

*"Price is what you pay. Value is what you get." — Warren Buffett*

## The online media sector in Australia

By Guy Carson – Clime Asset Management

In recent years online media has been one of the fastest growing sectors in Australia and globally. This growth has been driven by the switch from traditional print and free to air media to the online space. Growing consumer access to the internet has accelerated the growth, as consumers have flocked to websites that offer a new way to transact. The mobile X and Y generations have quickly adapted and also supported the online revolution. Consequently, established and early movers or operators are now controlling individual markets. Full convergence of traditional and online media could make these operators even more powerful in future.

In Australia, the four such early movers are publically listed companies that have all experienced significant share price appreciation since listing on the ASX. They are Seek Limited (ASX:SEK), REA Group Limited (ASX:REA) – better known as [www.realestate.com.au](http://www.realestate.com.au), Wotif.com Holdings Limited (ASX:WTF), and Carsales.com Limited (ASX:CRZ).

Each of the above companies dominates their space, and all have strong brand recognition with consumers. This leads to suppliers wanting a presence on their websites in order to engage with consumers. In turn, this is compelling to consumers as they will always engage in a marketplace where there is abundant supply and access to a range of pricing. Hence a circular effect drives both consumers and suppliers to the same dominant player and creates a premier trading place or hub for these successful first movers.

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Looking across the sector, we can see that all four companies trade at a large multiple of equity and have a high Return on Equity (ROE). The high ROE results from a combination of low start-up costs and, when success is achieved, extraordinary returns. On reflection, this was the initial attraction of the internet bubble of the late nineties. Success would offer wonderful returns. Unfortunately, too many entrepreneurs tried and there were too many flawed business plans. Success took time and was limited to a few key market segments that lent themselves to a new way of transacting and delivering value. Ultimately, however, success did not require significant capital but rather clever capital.

Generally speaking, a company with a higher ROE should trade at a higher multiple of that equity than a company with a lower ROE. This is currently observable across the online sector. Wotif.com and Carsales.com have a higher ROE than the other two and, as a result, trade at over 18 times their book value. Whilst they may deserve to trade at a premium, there is always the risk that these companies will not be able to reinvest their retained earnings at a similar rate to that which has been achieved historically. A declining rate of return on a stable capital base will ultimately cause a company's valuation to fall.

At the other end of the spectrum, SEK has seen its ROE decline in recent years due to an inability to maintain returns on its incremental or retained earnings. This has been due to weaknesses in the employment market, the equity raising undertaken at \$2.60 per share (near the bottom of the market) and the lower returns achieved from the acquisition of education businesses which included "Think". As a result, SEK's Return on Equity has more than halved from over 80% to less than 40%. Clearly the capital raised for the acquisition could not possibly give shareholders a return on equity comparable to SEK's established business. This is a problem which all online companies will confront if they choose to grow through acquisition.

When we look at REA, we see that its ROE has increased over the last 2 years, as it has exited poor performing and loss-making businesses which were acquired overseas. This restructure has refined the focus and improved the quality of the business, and business performance has improved.

If we look at the companies on a valuation basis we see that, despite having a lower return on equity than WTF and CRZ, REA comes out on top. Our valuations are based on a forecast ROE for the next 3 years. The return on equity we have forecast for REA is 53%. This is below our FY10 forecast of 56.6% and well below FY09 at 73.5%.

	Price	Market Cap (\$m)	Equity per share	Equity multiple	Return on Equity FY10 Forecast
Seek Limited	\$ 8.05	\$2,504.8	\$1.00	8.05	34.0%
REA Group Limited	\$11.54	\$1,348.6	\$1.05	10.99	56.6%
Wotif.com Holdings Limited	\$ 7.49	\$1,586.2	\$0.40	18.73	105.8%
Carsales.com Limited	\$ 5.71	\$1,200.9	\$0.28	20.39	74.4%

	Return on Equity Forecast	Required Return	Valuation	Price	V/P
Seek Limited	40.0%	13.4%	\$ 5.38	\$ 8.05	- 33.17%
REA Group Limited	53.0%	13.8%	\$11.71	\$11.54	1.47%
Wotif.com Holdings Limited	90.0%	13.8%	\$ 5.10	\$ 7.49	- 31.91%
Carsales.com Limited	80.0%	13.8%	\$ 2.79	\$ 5.71	- 51.14%

REA GROUP LIMITED		Performance and Valuation						Performance Chart	
Stock Code	REA	Currency	AUD	<input type="radio"/> NROE for last year of review	56.6%				
Sector	Consumer Discretionary		<input type="radio"/> IRR	40.8%					
Last Equity Date	30/06/2010		<input checked="" type="radio"/> Other	53.0%					
Intangibles	54.5		Adopted Profitability Forecast			53.0%			
Total Liabilities	37.4		Distributed			17.6%			
Cash Equivalents	57.8		Reinvested			35.4%			
Interest Bearing Debt	0.1		Investment Value at Required Return			13.8% \$11.71			
Average Funds Employed	96.6		Value/Price Margin at adopted Required Return			0.7%			
Total Shareholders Equity	138.0		'Required Return' to justify market price			13.8%			
Less Minorities	4.0		'Assumed Return On Equity' to justify market price			52.8%			
Less Non Ordinary Equity	0.0		<input type="button" value="Create Adjusted"/> <input type="button" value="Save"/> <input type="button" value="Preview"/>						
Net Ordinary Share Equity	134.0								
	2005	2006A	2007A	2008A	2009A	2010F	Totals	<b>Vital Statistics</b> No. Ordinary Shares (m) 127.3 Market Price at 24/03/2010 \$11.63 Equity per Ordinary Share \$1.05 Year High - Market Price \$11.80 Year Low - Market Price \$4.01 NTA per share \$0.62 Intangibles \$0.43 Liabilities \$0.29 Borrowings per share \$0.00 Net Debt to Equity Ratio 0.0% Normalised Earnings \$0.43 Normalised ROFE 56.5% Dividend per share \$0.10 Dividend Yield 0.9% Grossed Up Dividend Yield 1.2% Equity Ratio 78.2%	
Amortisation of Goodwill		0.0	0.0	0.0	0.0	0.0	0.0		
Abnormal Gains (Loss)		-0.9	-1.9	-1.2	-59.5	-3.2	-66.7		
Net Profit inc. Abnormals less Pref Divs		8.2	15.1	22.3	0.9	49.1	95.6		
Dividends on Ordinary Shares Only		0.0	0.0	0.0	0.0	12.7	12.7		
% of Dividends Franked		0%	0%	0%	0%	100%			
Grossed up Dividends		0.0	0.0	0.0	0.0	18.1	18.1		
Opening Equity		18.8	54.8	66.3	87.4	92.1	18.8		
Retained Profits		8.2	15.1	22.3	0.9	36.4	82.9		
Change in Reserves		0.8	-3.6	-1.2	3.8	-3.2	-3.4		
New Ordinary Share Capital		27.0	0.0	0.0	0.0	8.7	35.7		
Ordinary Capital Buybacks		0.0	0.0	0.0	0.0	0.0	0.0		
Closing Ord. Equity Ex Minorities	18.8	54.8	66.3	87.4	92.1	134.0	134.0		
Normalised IRR Cash Flows	-18.8	-27.0	0.0	0.0	0.0	210.1	164.3		
Normalised Earnings		9.9	13.4	22.3	64.2	54.5	164.3		
Normalised ROE		30.7%	24.5%	33.6%	73.5%	56.6%	43.7%		

**Performance Chart:**  
**realestate.com.au Limited (ASX:REA)**

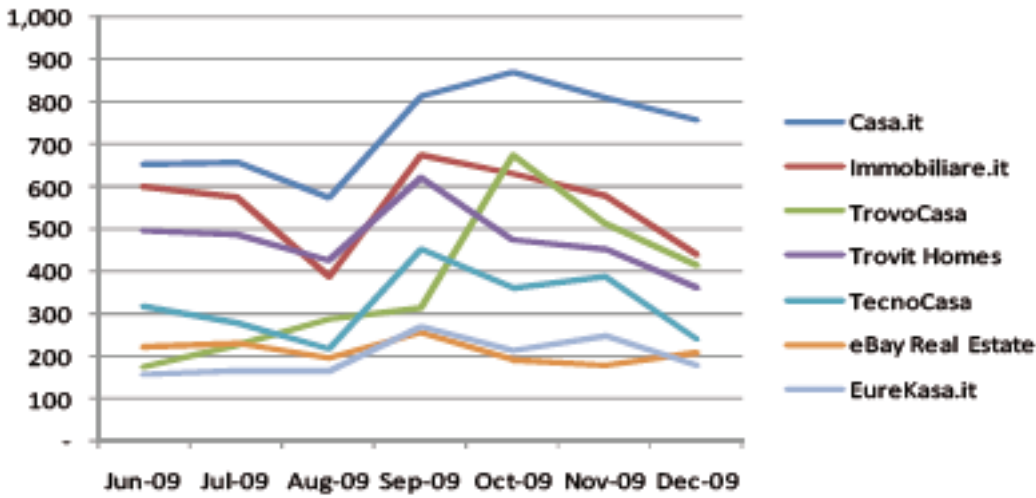
Source: www.stockval.com.au

If we look at REA’s history, we see that ROE has improved in FY09. Why is this? In recent years, REA has had an aggressive offshore expansion strategy. This strategy was not successful as they struggled to reproduce their Australian success in other countries. This was due to being the second or sometimes third player into offshore markets and therefore not having that first mover advantage. In FY09 REA restructured and either sold out of or exited loss making businesses in the UK, New Zealand, UAE and Belgium. The focus came back to the highly profitable Australian business and the business in Italy. The restructure has refined the focus and improved the quality of the business.

Subsequent to the restructuring, the results of the business have improved significantly. The recent first half result showed a substantial improvement and saw a half year net profit after tax of \$23.4 million up from \$6.8 million in the prior corresponding period. Revenue grew by 15% despite a subscription price freeze for real estate agents in Australia over the period. The management has now flagged price increases of 8 – 10%, which should support earnings growth over the remainder of FY10 and into FY11.

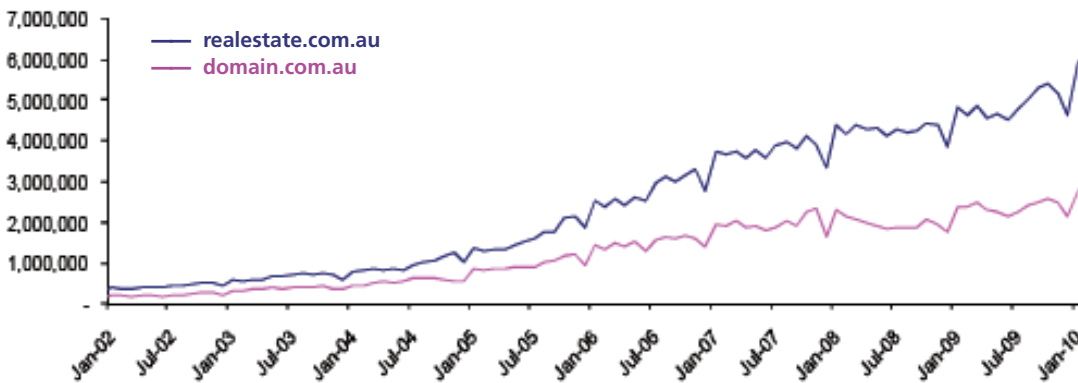
The company has begun to pay fully franked dividends and these should increase in line with earnings.

The Australian business continues to be the dominant player in the online real estate sector. Unique browsers to the site over the period were 5.4 million more than twice that of the closest competitor domain.com.au.



**Unique Browsers for casa.it**

Source: REA Group Limited Presentation



**Unique Browsers for realestate.com.au**

Source: REA Group Limited Presentation

The number of paying agents is currently 9,239. This was flat over the period and REA estimates it constitutes approximately 95% of the market.

In Italy, REA’s real estate site casa.it continues to grow. Subscribing Italian agents increased by 1,087 during the first half to 9,140. Traffic in terms of unique browsers increased from 0.83 million to 1.56 million making it the clear market leader in Italy. This led to revenue increasing 36% to €2.2 million.

The last 18 months have been a period of transition for REA and the company has come out in better shape. The Australian site, realestate.com.au, is the clear market leader and continues to exert its dominance over domain.com.au. It continues to generate large amounts of cash which are being both distributed to shareholders and re-invested into a growing business in Italy. We value the shares at \$11.71 and believe it to be a good long term investment around current levels.

## Silver Chef Limited

By Leo Sek – Clime Asset Management

Silver Chef Limited (ASX:SIV) has been providing commercial restaurant and catering equipment finance since 1986. SIV provides financing through its Rent Try Buy product. This is a 12 month rental contract, through 400 hospitality equipment dealers nationwide. There is a minimum total asset value of \$2,000 on each contract and the average loan size is \$10,000.

A refundable security bond of an amount equal to 13 weeks rent is required upon signing the rental agreement. A document fee of \$195 also applies. The security bond is refunded when the customer exercises the purchase option or if the equipment is returned at the end of the contract.

The customer may purchase the equipment at any time during the first 12 months and receive a 75% rebate of rent paid. We believe the rental rebate serves to encourage customers to take up the purchase option so that SIV can receive cash earlier and reinvest to maintain a high level of profitability or return on equity.

At the end of the 12 months, customers have the option to:

- return the equipment if it is no longer required
- continue to rent and the rental payments deducted from the purchase price
- upgrade the equipment.

An example lease is presented below:

Should rent assets be valued at \$10,000, by choosing the Rent-Try-Buy Solution, you could look forward to:

### Combi Steamer Oven

Low weekly rent of	\$115.38
Purchase price at the end of one year	\$6,500.00
Total net Rent-Try-Buy Payments	\$10,700.00
Rental cost of ownership	\$700.00
Nett % rental cost of funding	7%

\*\*Nett rent after-tax savings plus purchase price.

Source: Silver Chef Limited website:

[www.silverchef.com.au/rent-try-buy/how-does-it-work](http://www.silverchef.com.au/rent-try-buy/how-does-it-work)

Based on this example, a customer pays \$6,000 in rent over the first year and \$6,500 to purchase the equipment at the end of one year. Therefore, SIV receives \$12,500 gross for assets valued at \$10,000, providing \$2,500 gross profit. From this, SIV would have to deduct interest and administration expenses to arrive at its net profit.

Equipment comes with a manufacturer's warranty, after the warranty expires, the customer pays for any repairs and maintenance.

In July 2008, SIV launched a new division, GoGetta, to provide commercial equipment leasing for uses such as trucks, trailers, health, bakery, compressors and industrial equipment. GoGetta operates under the same Rent Try Buy model.

GoGetta operates through 85 vendors and 47 finance brokers. The average deal size is \$45,000.

### Key Issues

Currently, SIV has a funding line from BankWest. The \$38.5 million facility matures in July 2011, with \$30 million of the facility fixed at 6.46% p.a. Management is trying to diversify and lower its funding risk by negotiating to create a second bank syndication.

If the recent Flexigroup Limited (ASX:FXL) capital raising is anything to go by, there is a risk that banks may require SIV to contribute more equity into the business. Management appears to be cognizant of this, announcing a dividend reinvestment plan and flagging a capital raising to follow its October 2009 raising. The downside is that this increased capital may result in lower returns on equity. SIV is a leveraged business and by increasing the capital employed, ratio will result in a lower return on equity.

SIV's credit risk assessment of its clients appears sound. Bad debt levels have averaged less than 2% of rental income over the past 5 years. Further, SIV now draws upon 24 years of financing experience.

SIV is a volume driven business, largely dependent on the fortunes of the hospitality industry. Rising interest rates and Australian dollar are headwinds for this business if inbound travel declines. However, improving Australian consumer sentiment with low unemployment and rising house values is supportive of the clients of SIV.

Noteworthy is that SIV performed strongly during the global financial crisis, growing its finance book from circa \$64 million in FY08 to \$84 million in FY09 despite the downturn in credit markets. Possibly businesses moved away from banks to the smaller financiers like SIV.

The business displays interesting revenue streams as the average contract life is 29 months and 74% of FY10 income was written in FY09. Approximately 80% of customers continue to rent beyond the initial 12 month term, producing a 30% return on capital employed. The remaining 20% of clients are split between returning and purchasing the equipment at the end of 12 months.

The purchase option generates a 30% return on capital employed while returns of equipment generate a lower 12% return.

SIV owns the equipment and so bears the risk of obsolescence or replacement. Despite this risk, 95% of assets are currently generating income. The risk is mitigated in the GoGetta business through a vendor remarketing agreement that obligates vendors to remarket equipment if returned within an agreed timeframe.

SIV is not a very liquid stock as the founder, Allan English, owns around 40% of issued capital and daily turnover averages less than 20,000 shares.

Founder Allan English will retire on 1 July 2010 after 24 years of service, replaced by Charles Gregory, who has been Chief Operating Officer since July 2008. Succession planning has been underway for two years. Mr English intends to allocate 100 days a year, for an unspecified period of time, to support Mr Gregory. Mr English has no intention to reduce his holding in SIV.

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Retained Profits	0.7	0.3	0.9	1.8	2.7	6.4																																																																																																															
Change in Reserves	0.0	0.1	0.0	0.0	0.0	0.1																																																																																																															
New Ordinary Share Capital	3.2	1.6	1.5	0.4	6.4	13.1																																																																																																															
Ordinary Capital Buybacks	0.0	0.0	0.0	0.3	0.0	0.3																																																																																																															
Closing Ord. Equity Ex Minorities	4.9	8.8	10.8	13.2	15.1	24.2																																																																																																															
Normalised IRR Cash Flows	-4.9	-1.6	0.4	0.9	2.5	22.6																																																																																																															
Normalised Earnings	2.3	2.4	3.4	4.4	7.4	19.9																																																																																																															
Normalised ROE	34.9%	25.0%	29.7%	33.0%	40.5%	32.6%																																																																																																															

Performance Chart – Silver Chef Limited (ASX:SIV)

Source: www.stockval.com.au

## Valuation

We see a history of sustained profit and return on equity (ROE) growth in the above performance chart, a characteristic of a good investment. A policy of paying out 60%–70% of profit after tax as fully franked dividends provides investors with a robust income stream and allows SIV to retain money to fund organic growth.

The quality of reported profit is high with operating cash flow exceeding profit after tax from the period FY06 to first half FY10.

A downside to this business is its high gearing, with net debt to equity of 165%. This is to be expected as SIV is a financing company with little equity capital requirements.

For this reason, as well as SIV's funding risk, low liquidity and changes in management, we have adopted a relatively high required return of 16.1%.

The market currently requires 27% profitability (APF) to justify the current price. We prefer to be more conservative given the rising interest rate environment and the potential for further equity to be raised, which may dilute ROE. Therefore, we have adopted 25%.

We believe the stock is trading around fair value and would look for a conservative margin of safety or discount to our valuation before acquiring this stock.

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- The difference between profit and profitability
- How StockVal's analysts derive Required Return and how Required Return relates to StockVal's risk colour coding
- How to choose an APC
- Why adjustments to historical financial statement figures are necessary.

### 2010 StockVal Introduction Training Dates

CITY	DATE	VENUE	TIME
<b>Melbourne</b>	Tuesday, 30 March	Vibe Savoy Hotel	10am – 12pm
<b>Sydney</b>	Wednesday, 14 April	StockVal Sydney Office	10am – 12pm
<b>Canberra</b>	Wednesday, 21 April	Crown Plaza, Canberra	11am – 1pm
<b>Wollongong</b>	Wednesday, 28 April	Novotel, North Beach	11am – 1pm
<b>Newcastle</b>	Wednesday, 5 May	Crown Plaza Hotel	11am – 1pm
<b>Brisbane</b>	Tuesday, 8 June	Holiday Inn, Brisbane	10am – 12pm
<b>Adelaide</b>	Tuesday, 15 June	Hotel Grand Chancellor	11am – 1pm
<b>Perth</b>	Thursday, 17 June	Holiday Inn, City Centre	10am – 12pm
<b>Sydney</b>	Tuesday, 22 June	StockVal Sydney Office	10am – 12pm

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<b>Melbourne</b>	Tuesday, 30 March	Vibe Savoy Hotel	3pm – 5pm
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<b>Canberra</b>	Wednesday, 21 April	Crown Plaza, Canberra	3pm – 5pm
<b>Wollongong</b>	Wednesday, 28 April	Novotel, North Beach	3pm – 5pm
<b>Newcastle</b>	Wednesday, 5 May	Crown Plaza Hotel	3pm – 5pm
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**Getting Started with StockVal** is available online to guide you through the process of using StockVal to assess businesses and identify investment opportunities. The guide introduces the five segments of StockVal's Valuation screen and teaches you how to adjust StockVal's valuations to suit your own risk level and investment style by adjusting the Adopted Performance Criterion and the Required Return.

Log into StockVal then navigate to the Support Centre tab and select **Getting Started with StockVal** from the drop down menu to download the PDF document or click the following link:

[StockVal - Getting Started Guide 2010](#)

## Feedback

We welcome any comments or feedback you may have about **StockVal** or **Fundamentally StockVal**. Email [members@stockval.com.au](mailto:members@stockval.com.au) or call 1300 136 225.

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