INTELLIGENT INVESTOR

5 Best Buys for 2017

SPECIAL REPORT

December 2016

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Prices correct as of 1 December 2016.

Opportunities will arrive next year, and if we had to pick 5 stocks to buy now, here they are.

BY JOHN ADDIS • INTELLIGENT INVESTOR • 1 DECEMBER 2016

Introduction

Let's get one thing out of the way first, shall we? The title of this report is somewhat misleading. We have no idea what might be the best buys of 2017 for obvious reasons. Even in a year's time when we may have added many more stocks to our **Buy list**, we still may not know the best buys of 2017. Only in retrospect, perhaps years down the track, will we have an understanding of which of the many opportunities that will inevitably arise next year were the best.

What we do know with a fair degree of certainty are the five stocks on our Buy List right now that, for a variety of reasons, stand out. That's what this report is all about. Members surveying the 20 stocks on the Buy List might appreciate the direction and focus.

There are a few other points to note. The first is in the nature of the opportunities themselves. Cheap stocks are cheap for a reason. IOOF has endured a financial planning scandal, News Corp is facing disruption in some of its businesses and operational problems in others and we've all read about Crown and the arrest of some of its China-based employees. Even Trade Me, which according to conventional measures is the most expensive featured stock, endured a few years of slow profit growth during which time the market turned away from it.

Humans are herd animals, which means we tend to feel safest when we're doing the same thing as those around us. In investing, it is this herding behaviour that creates the opportunity for value investors like us. But to take advantage of it we must act differently from the crowd. With all of the stocks covered in this report, this demands that you look through the negative media headlines and broker coverage and towards the detail of business performance, valuation and likely future growth. It isn't easy, but you probably know that by now. To generate a return better than the crowd, you have to do something different from the crowd.

Secondly, it's quite possible, likely even, that at least one of these opportunities won't work out. Unfortunately, we're unable to tell you which one it might be. In a nutshell, that's the reason for portfolio diversification. Please take note of the business and share price risk ratings and the associated recommended maximum portfolio weighting.

Many of our analysts like to buy their maximum allocation in stages, purchasing small parcels over time. When a stock's price is falling this can lower the average entry price and in the opposite, may allow you to compare your reasons for purchasing the stock with recent business performance. Obviously, this will require paying a slightly higher average price but having your thesis confirmed might be worth it.

Lastly, with Christmas almost upon us, free time and cold beer beckons. If you haven't conducted a portfolio review lately, now might be a good time to do so. Over the past year many of our former Buy recommendations have risen strongly. Just over a year ago **Gentrack** was added to the Buy List and has risen 89% since. Members who purchased **South32** this year have done extremely well (those that purchased well before that far less so) and **Fleetwood**, **PMP** and many other stocks have risen strongly.

All of this is good news of course, reflected in the performance of our **Growth** and **Equity Income** portfolios over the past 12 months. One of the adverse consequences of a stock doubling in price is that it probably represents a higher percentage of your portfolio than at the time of purchase. So, use the break to take a look at your holdings, reduce your over-exposure to stocks that have risen strongly and put the proceeds to work in one or more of the following opportunities.

Yours sincerely,

John Addis

Editor-In-Chief, InvestSMART

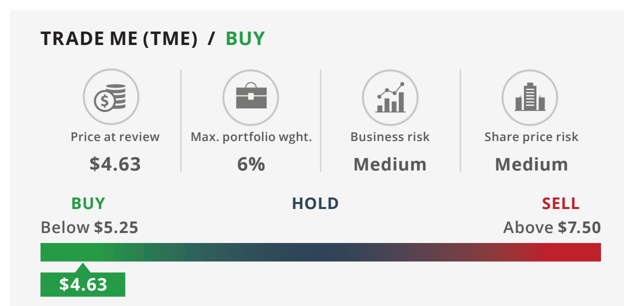
This leading online auction and classifieds business looks expensive but investors should think of the growth.

Trade Me up for auction?

We've had a long history with this online classifieds business, first recommending it on **19 Feb 14** (Buy – $3.54). Trade Me has been on our **Buy list** pretty much ever since for two reasons. The first is that it offers access to a portfolio of high quality businesses with network effects, all under one roof. Think of it as New Zealand's answer to eBay, **REA Group**, **Seek** and **Carsales** rolled into one.

Key Points

- ***Potential from premium products***
- ***Profit growth to accelerate***
- ***Facebook threat overdone***



The second reason is the price. Those aforementioned Australian online classifieds businesses trade on PERs of 33, 27, and 22 respectively. Much as we'd like to own them (and we have recommended all three over the years, most recently Carsales, only **recently downgraded**) their prices make new investments difficult.

But what if you could buy a portfolio of them for a PER of just 22? That's the second reason for Trade Me's inclusion in this report. Despite a 31% increase in price since that first recommendation almost two years ago, it remains reasonable value. In ***Trade Me: Result 2015*** we declared: 'On a 2016 forecast PER of 16, the stock is one of our better buying opportunities'. Today, even at a slightly higher multiple, it still is.

What created the initial buying opportunity were widespread concerns that the company's growing cost base was a hindrance to profit growth. We saw it slightly differently, as an investment in the future. There's now evidence that the latter view was correct. Expense growth is moderating, the company is hiring fewer staff and the 104 employees it put on the payroll in 2015 are starting to earn their keep. Second-half expense growth was 17% but management forecasts a fall to around 10% in 2017, which would mean forecast 2017 profit growth will exceed that of 2016. That's encouraging.

Revenue, meanwhile, continues to motor upwards – by 9% as you can see from Table 1. The company's classified businesses produced 13% revenue growth in 2016, with the growth in 'premium' revenue especially pleasing. In Trade Me's three classified segments of Property, Motors and Jobs, premium revenue grew 51%, 56% and 36% respectively. This kind of growth maybe just the beginning.

Trade Me is well behind its Australian classified contemporaries in charging like wounded bulls. Differences in business models and industry structure explain some of that difference but there's almost certainly significant upside for Trade Me Property, Motors and Jobs to lift prices and develop more premium products.

Table 1: Trade Me result 2016

YEAR TO 30 JUN (NZ$M)	2016	2015	+/(–) (%)
REVENUE	218.0	199.7	9
EBITDA	140.5	134.4	5
NPAT	83.0	80.1	4
EPS (C)	20.9	20.2	3
DPS (C)*	16.8	16.2	4

*** 9 cent final dividend ($NZ), 100% franked (NZ only), ex date 8 Sep. Aust. shareholders also receive a 'top-up' dividend equating to c. 1.588 NZ cents, or c. 10.588 NZ cents in total.**

The laggard has been its General Items division (the New Zealand equivalent of eBay), although it too is stirring. Second half revenues rose 7% – the first decent growth in three years – as product improvements drove listing volumes up 27%. While General Items is unlikely to produce growth anywhere near Trade Me's classifieds businesses, the nascent recovery shows what a bit of management attention can do.

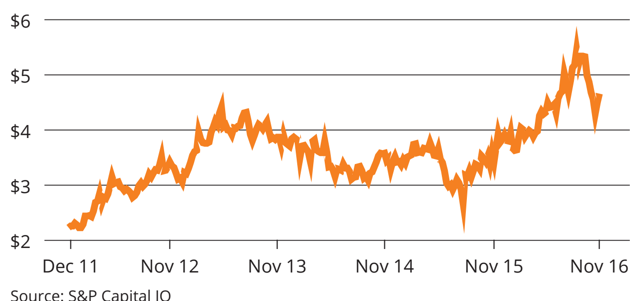
What could go wrong? All the usual risks. A New Zealand recession or even a minor economic downturn could see listings contract. Trade Me's Jobs business is probably most exposed but all Classifieds businesses would be affected.

> **When compared with other online classifieds, it still looks comparatively cheap for such a high quality business.**

The company could also score an own goal with one of its new ventures. For example, it has invested in New Zealand peer-to-peer lending group Harmoney. It's a great name but start-up ventures often end up consuming more capital than originally envisaged no matter what they're called. A blow-out of losses here – from $1.6m in 2016 – wouldn't be a surprise.

Then there's the ever-present risk that a deep-pocketed new or existing competitor tries to take market share. That might explain the recent price weakness. In September, the stock passed $5.50 a share, causing us to **downgrade it**. But it has since fallen well under $5. In October, we published ***Trade Me and Facebook square off*** (Buy – $4.94), examining how the news of Facebook launching its Marketplace product in New Zealand might affect Trade Me.

Chart 1: TME 5-year share price



Source: S&P Capital IQ

The conclusion was that Marketplace isn't likely to become a direct revenue-generation tool. Instead, user activity – including what is bought, sold and viewed – will be used to sell advertisements. (Remember: If the product is free, you're the product.) Facebook Marketplace is designed to keep you within the Facebook ecosystem for the purpose of gathering better data, not to become the next Trade Me. Marketplace is free and will attract some stingy sellers and tyre-kickers; Trade Me costs a small amount and is more likely to attract serious buyers and sellers.

Even after taking that threat into account, Trade Me is attractive. The market has (again) taken a different view, pushing the company's share price down since that review. But with an EBITDA forecast of close to NZ$160m in 2017 and the long-term potential to push premium pricing higher, we're comfortable paying up to 12 times 2017 prospective EBITDA.

Yes, this is a high multiple – equating to a prospective price-earnings ratio of 21 – but we expect profit growth to accelerate. When compared with other online classifieds, it still looks comparatively cheap for such a high quality business.

Remember, too, that our Australian dollar Buy price of $5.25 a share equates to a historical free cash flow yield of 4.5%. Trade Me is by no means the bargain it was but still offers good long-term value.

If you're new to the stock, we recommend starting with only half our suggested maximum portfolio weighting of 6%, which will allow you to top up if a better opportunity appears. Existing shareholders from past recommendations should sit tight, although bear in mind the 6% maximum weighting. **BUY**.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in Trade Me. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

Disclosure: Staff members own shares in Trade Me.

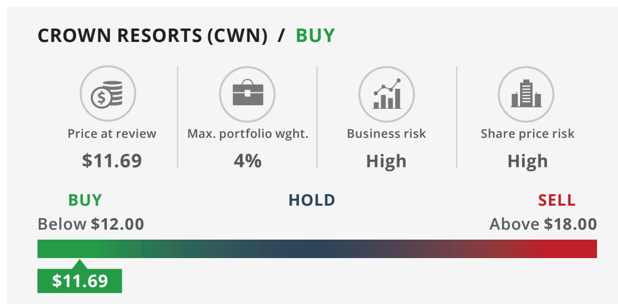
This company has been in the news for all the wrong reasons, which is the source of the opportunity.

Crown chips a crown jewel?

When James Packer's Crown Resorts announced it was bringing a casino to Sydney in 2019, Echo Entertainment's (now called **The Star Entertainment Group**) shares were hit by concerns over the impact the new casino would have on its main asset, The Star casino. But the reaction looked overblown and we upgraded the stock in ***Echo is worth a shout*** on 23 Sep 13 (Buy – $2.68). Members who followed that recommendation made a 53% return in around a year, although unfortunately **we sold too soon**, as we tend to do.

Key Points

- ***Capital intensive, complex business***
- ***Developments & Macau to drive future returns***
- ***Investor concerns overblown***



Now investors are fretting over how Crown will pay for its fancy new Sydney casino, on top of a bunch of other developments, as well as concerns over the impact of a Chinese corruption crackdown on its 27% stake in Nasdaq-listed Melco Crown Entertainment (MPEL), and the highly publicised arrests of Chinese-based staff. No wonder the share price has fallen 31% since January 2014.

As with Echo, though, the market is obsessing over the negatives, which is creating an opportunity for those prepared to look beyond them. With Crown recently making a return to our Buy list after **members of its staff were arrested in China** (and after adding it to our **Equity Income Portfolio** and increasing our holding in our **Growth Portfolio**), let's try and establish what Crown is really worth.

As with any valuation, we've made a number of assumptions in each scenario (see Table 1). Some are intended to reduce the complexity, others to increase our margin of safety. Conservatism is the watchword in this analysis.

First, although we believe the **proposed demerger** of most of Crown's international investments and the IPO of four of its hotels will deliver some value, we're not assuming any in either of our three scenarios. Nor have we ascribed any value for Crown's fast-growing Wagering & Online business.

Table 1: CWN sum of the parts (SOTP)

	2016 EBITDA: BEAR / BASE / BULL ($M)	MULTIPLES: BEAR / BASE / BULL	BEAR CASE ($M)	BASE CASE ($M)	BULL CASE ($M)
CROWN MELBOURNE	572 / 619 / 673	7/9/11	4,004	5,571	7,403
CROWN PERTH	221 / 239 / 260	7/9/11	1,547	2,153	2,860
CROWN SYDNEY	n/a	n/a	226	226	1,119
CROWN ASPINALLS	26 / 26 / 26	7/9/11	182	234	286
ALON LAS VEGAS	n/a	n/a	372	372	372
WAGERING & ONLINE	(5)	n/a	–	–	–
OTHER *	n/a	n/a	283	283	283
CORPORATE	(98)	10/10/10	(980)	(980)	(980)
TOTAL			5,634	7,859	11,344
LESS: NET DEBT			(1,812)	(1,812)	(1,812)
TOTAL EQUITY VALUE			3,823	6,048	9,532
SHARES (M)			728.4	728.4	728.4
VALUE PER SHARE ($)			5.25	8.30	13.09
MELCO CROWN VALUE PER SHARE (PER SOTP ANALYSIS IN TABLE 2) ($)			2.43	3.37	6.29
MELCO CROWN VALUE PER SHARE (BASED ON CURRENT SHARE PRICE) ($)			4.59	4.59	4.59
TOTAL VALUE (USING MELCO CROWN SOTP VALUE) ($)			7.68	11.68	19.37
TOTAL VALUE (USING MELCO CROWN SHARE PRICE) ($)			9.83	12.89	17.67

*** Nobu, Ellerston, Aspers & Queensbridge hotel JV**
***Note prices correct as at 14 November 2016**

Crown's 27% investment in **Melco Crown Entertainment**, which owns casinos in Macau and The Philippines, including the majority-owned Studio City Macau and City of Dreams Manila which are still in their infancy, only adds to the

> **“ Our estimate of Crown Sydney’s value is its expected $1.5bn cost discounted to today.**

complexity. Two valuation options are provided in the table, one that simply uses the market value of Crown’s stake in NASDAQ-listed Melco Crown Entertainment while the second ascribes our own sum-of-the-parts valuation.

As Melco Crown’s earnings are likely to grow faster than those of Crown’s Australian casinos, we’ve used higher multiples of earnings before interest, tax, depreciation and amortisation (EBITDA). Moreover, with the bulk of Melco Crown’s capital expenditure behind it, free cash flow should rise at a decent clip, further justifying higher numbers.

To our base case. After the recent arrest of its employees in China, **Crown has said** around 12% of its revenues come from mainland Chinese VIPs, although they account for ‘substantially less than 12%’ of Crown’s profits (margins on VIPs are lower than ordinary punters due to the freebies and commissions used to attract them). Our Base case assumes Crown loses all mainland Chinese VIP business, amounting to around 8% of 2016 EBITDA for its Australian casinos.

Our estimate of Crown Sydney’s value is the capital expenditure invested to date and Alon Las Vegas’s value is Crown’s total equity investment to date.

For Melco Crown, we’ve annualised its casinos’ results for the first nine months of the 2016 calendar year. With two new casinos recently opened in Cotai and more to follow, plus infrastructure improvements such as the Hong Kong to Macau bridge and light rail being delayed, again, we think this is conservative. That is, we’re not adjusting for Studio City and City of Dreams Manila still ramping up, nor for any cyclical upturn in Macau.

In the bear case we’ve assumed that EBITDA for Crown’s Australian casinos declines by 15%, whether due to the loss of mainland Chinese VIP revenue, a downturn in revenue from ordinary punters or a bit of both.

We’ve also used a lower EBITDA multiple of seven. For reference, both Crown and **The Star Entertainment Group** have traded on an average EBITDA multiple of 11 since they listed in 2008 and 2011 respectively.

For Melco Crown, the only adjustment to our base case is to use a lower EBITDA multiple of eight. This is higher than our multiple for the Australian casinos because Macau is likely near a cyclical low and Studio City and City of Dreams Manila are still ramping up.

In the bull case we’ve assumed that Crown Melbourne and Crown Perth maintain their 2016 EBITDA, perhaps through minimal losses to VIP revenue being offset by increases in other income. This could be helped by a doubling in hotel rooms at Crown Perth when Crown Towers Perth opens in December. Our estimate of Crown Sydney’s value is its expected $1.5bn cost discounted to today.

Table 2: Melco Crown sum of the parts

	2016 EBITDA: BEAR / BASE / BULL (US$M)	MULTIPLES: BEAR / BASE / BULL	BEAR CASE (US$M)	BASE CASE (US$M)	BULL CASE (US$M)
CITY OF DREAMS MACAU	738 / 738 / 800	8/10/12	5,904	7,380	9,600
ALTIRA	2 / 2 / 30	8/10/12	16	20	360
MOCHA	24 / 24 / 30	8/10/12	192	240	360
STUDIO CITY (60%)	79 / 79 / 240	8/10/12	632	790	2,880
CITY OF DREAMS MANILA (69%)	107 / 107 / 182	8/10/12	856	1,070	2,184
CORPORATE	(110)	10/10/10	(1,100)	(1,100)	(1,100)
TOTAL			6,500	8,400	14,284
LESS: NET DEBT *			(1,582)	(1,582)	(1,582)
TOTAL EQUITY VALUE			4,918	6,818	12,702
CROWN’S SHARE (US$M)			1,333	1,848	3,442
AUD/USD			1.33	1.33	1.33
CROWN’S SHARE (AU$M)			1,773	2,457	4,578
SHARES (M)			728.4	728.4	728.4
VALUE PER SHARE (AU$)			2.43	3.37	6.29

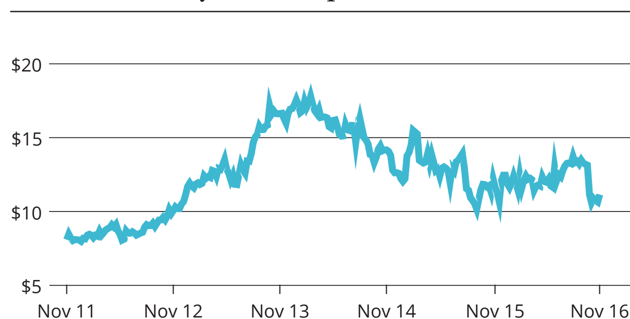
*** Melco Crown’s proportionate share of cash and non-recourse debt held by its majority-owned subsidiaries**

We’ve also estimated normalised earnings for Melco Crown, assuming a fully operational Studio City and City of Dreams Manila and recovery in Macau. It’s possible that Studio City won’t meet its financial covenants in calendar 2017, which could lead to its debtholders taking ownership and rendering the equity worthless to Melco Crown. However, as Melco Crown’s proportionate share of Studio City’s net debt (the debt is non-recourse) is around $1bn, this would actually increase the value in our Bear and Base cases but reduce our Bull case valuation by around $1 per share.

> **With the share price closer to the bottom of that range, the upside reward potential is greater than the downside risk.**

As you would expect, an investment in Crown offers a wide range of outcomes, from a bear case of just below $8 to a bull case of above $19. With the share price closer to the bottom of that range, the upside reward potential is greater than the downside risk.

Chart 1: CWN 5-year share price



Source: S&P Capital IQ

Members should tread carefully. Bear in mind our high risk ratings and the 4% recommended maximum portfolio weighting. It might make sense to start a bit below this level, to allow room to buy more if a better opportunity emerges. Our **Growth** and **Equity Income** portfolios, for example, currently have weightings of 3.2%–3.3%. **BUY.**

Note: The Intelligent Investor ***Growth*** *and* ***Equity Income*** *portfolios own shares in Crown Resorts. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by* ***clicking here****.*

Disclosure: Staff members own shares in Crown Resorts.

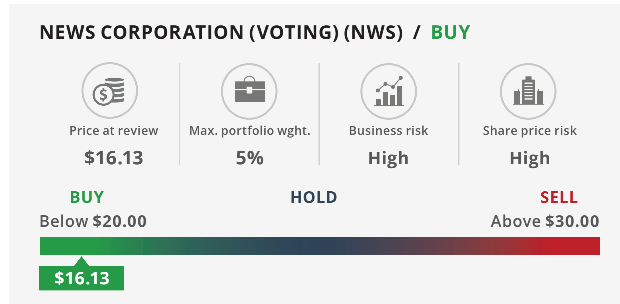
It's difficult to find a company less loved than this one. But whatever way we dice it, it looks cheap.

News Corp's leap of faith

News Corporation is cheap but it requires a leap of faith. Quite a big leap, in fact. You're betting that Rupert Murdoch and the intelligent people he employs (plus those that aren't) are right and that the market is wrong.

Key Points

- ***Digital real estate a wonderful business***
- ***Other assets facing challenges***
- ***Compelling value***



So far the market is winning. Since we upgraded the stock in ***The not-so-bad News*** a year ago, it has fallen 19%. The decline would have been worse had the share price of its largest investment, the 62%-owned **REA Group**, not risen 18% over the same period.

The Digital Real Estate division, which includes REA and Move, is the only one that isn't troubled. Here we'll concentrate on the ones that are, but remember that digital real estate accounts for almost US$3.8bn of value in our base case valuation (see Table 1). Not only is it News Corp's best asset, it's worth a truckload.

News and Information Services (NIS) is perhaps the most troubled of all. It's a vast, global business, with revenues of more than US$5bn, including all News' Australian, British and American mastheads, the News America Marketing insert and coupon business and Dow Jones, which owns the *Wall Street Journal* and a suite of professional and market information products.

NIS is suffering as advertising revenues shift away from old media. In the most recent quarter, they declined 11%. Continuing weakness means 2016 divisional earnings before interest, tax, depreciation and amortisation (EBITDA) was around US$494m, down 47% since 2012. That's certainly worse than expected, so it's little wonder the stock has been weak.

But NIS's management isn't forsaking old media. Quite the contrary; it's actually making acquisitions. NIS recently acquired APN News and Media's regional newspaper business for US$27m, or just two times EBITDA. The recent US$290m takeover of UK radio group Wireless Group plc is harder to fathom on a seemingly pricey 19 times EBITDA, although earnings will grow as recently launched stations mature.

Table 1: NWS sum of the parts

DIVISION	2016E EBITDA FOR VALUATION (US$M)	MULTIPLES: LOW / BASE / HIGH	LOW VALUE (US$M)	BASE CASE (US$M)	HIGH VALUE (US$M)
NEWS AND INFORMATION SERVICES	494	3/5/7	1,482	2,470	3,458
FOXTEL (50% SHARE)	302	4/6/8	1,208	1,812	2,416
CABLE NETWORK PROG. (FOX SPORTS)	124	4/6/8	496	744	992
BOOK PUBLISHING	185	6/8/10	1,110	1,480	1,850
DIGITAL REAL ESTATE SERVICES					
REA GROUP STAKE		$A40/$50/$60	2,434	3,043	3,651
MOVE/REALTOR.COM			0	762	1,400
BUSINESS VALUE			**6,730**	**10,311**	**13,767**
CORPORATE	(183)	10	(1,830)	(1,830)	(1,830)
BUSINESS VALUE AFTER CORP. COSTS			**4,900**	**8,481**	**11,937**
CASH			1,737	1,737	1,737
OTHER INVESTMENTS			394	394	394
LESS SHARE OF FOXTEL DEBT			(888)	(888)	(888)
LESS OTHER LIABILITIES			(394)	(394)	(394)
TOTAL VALUE			**5,749**	**9,330**	**12,786**
AVERAGE PER NWS SHARE ($US)			9.88	16.03	21.97
AVERAGE PER NWS SHARE ($A)			**13.17**	**21.37**	**29.29**

These acquisitions may seem incongruous but they fit within News Corp's strategy. Management will presumably cut costs at APN but, more importantly, use community and regional newspapers for real estate advertising. Wireless Group has the radio rights to the Premier League and owns talkSPORT, the leading UK sports radio network, which NIS can cross-

> **Foxtel's decision to unbundle its subscription options mean it is gaining subscribers (albeit slowly).**

promote in *The Sun*. Both real estate advertising and sports broadcasting are core markets for News Corp.

NIS management certainly isn't ignoring the shift to digital. At Dow Jones, digital revenues account for more than 50% of the total, and 45% of *Wall Street Journal* subscribers are digital-only. Over the past year the division has acquired digital coupon company Checkout 51 and video distribution platform Unruly. Both will help make its existing marketing and media businesses stronger.

Our base case in Table 1 suggests NIS is worth US$2.5bn but in a break-up it would be significantly more. Dow Jones might fetch that much alone. Like NIS, Foxtel and Fox Sports are similarly challenged as customers seek out content elsewhere. We'll consider them as one business as they're inextricably linked. Indeed, rumours persist that **Foxtel and Fox Sports will be merged** ahead of a combined 2017 public float.

Overseas, sports network ESPN – owned by the Walt Disney Company – is struggling. Subscriber numbers peaked at 100m in 2011 and are expected to slide to 88m by the end of 2016. However, Foxtel's decision to unbundle its subscription options mean it is gaining subscribers (albeit slowly).

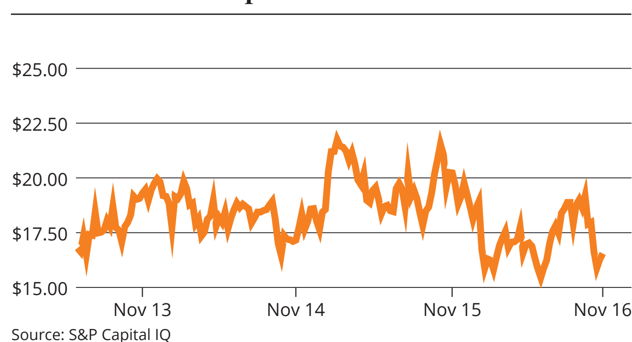
Foxtel and Fox Sports remain very profitable. Together, they will generate more than US$400m in EBITDA for News in 2016*. Yes, there's uncertainty, especially in how Foxtel/Fox Sports will recoup the US$1.6bn it will pay to the NRL and ARL for broadcasting rights over the 2017–2022 period. As we said in ***News Corp on the Move***, though, Rupert Murdoch didn't acquire the rights to lose money. In our base case, we've allowed for Foxtel and Fox Sports to be worth a combined US$2.5bn. In the event of a public float they should be worth at least that much (consistent with other valuations we've seen).

Book Publishing is less structurally challenged than the other divisions. People are still reading printed books and e-book sales are much more profitable than print in any case (see ***Old Murdoch, new News***).

In 2016 Book Publishing generated around US$185m in EBITDA, down 16%. That's mainly a function of the strong publishing year that was 2015 and what is likely to be a temporary industry-wide downturn in e-book sales. We've allowed US$1.4bn for the Book Publishing division but, when you consider News Corp paid US$414m for romance publisher Harlequin alone, it's probably on the low side.

Ignoring but not forgetting Digital Real Estate, as we mentioned earlier, News Corp's dwindling cash pile is also causing market concern. Litigation isn't helping, with the company winning a US$117m legal settlement from Zillow but paying out US$280m to settle litigation at News America Marketing.

Chart 1: NWS share price chart



Source: S&P Capital IQ

We've deducted the latter in our valuation but the US$290m acquisition of Wireless Group will reduce the 'Cash' figure again. The market remains sceptical about the various acquisitions because the long-term benefits are being obscured by their absorption into much larger divisions.

The sum-of-the-parts valuation in Table 1 is derived from earnings. As those earnings have fallen, so do the valuations at the bottom (compared with the table in ***News Corp on the Move***). For that reason we're adjusting our price guide numbers down slightly. Do not be unduly concerned. A break-up or asset-based valuation would produce higher figures. And management will not stand idly by while earnings erode to zero.

Even if it did, we can afford for one or even two divisions to be worth nothing without this recommendation being a disaster. If NIS was worth zero in our base case, our valuation would be $15.70 a share. If Foxtel and Fox Sports were *also* worth zero, our valuation would be $9.90. A wipe-out of all three divisions is difficult to imagine and yet, even in that dire scenario, the valuation would be only 37% underwater from the current share price.

> **Structural challenges remain for subscription television and REA Group might be in for a period of slower growth.**

News Corporation's wonderful Digital Real Estate business, together with its cash, effectively justifies more than 80% of the company's market capitalisation. You get the remaining businesses – with revenues of around US$7bn – for not much more than US$1bn.

Yes, buying structurally challenged businesses is difficult, a point made clear in the **latest result**. The first quarter looked dire but the rest of the year shouldn't be so bad. Book Publishing seems to have a pipeline of new releases, Fox Sports will benefit from strong audience numbers, and Move's growing profitability should become more obvious with time.

As for the negatives, the NIS division looks troubled and cost cutting will become increasingly harder without damaging content quality. Structural challenges remain for subscription television and REA Group might be in for a period of slower growth.

But there's clear value in this unusual conglomerate. At this stage, we're comfortable with our valuation but there's an argument for knocking a few dollars off our price guide if the year fails to improve. It depends somewhat on whether the performance of Move steps up next year, as well as movements in the REA Group share price. But at less than $16 this is a compelling opportunity. **BUY**.

**Note that Foxtel is 50% owned, so News has no direct interest in its cash flow.*

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in News Corporation. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

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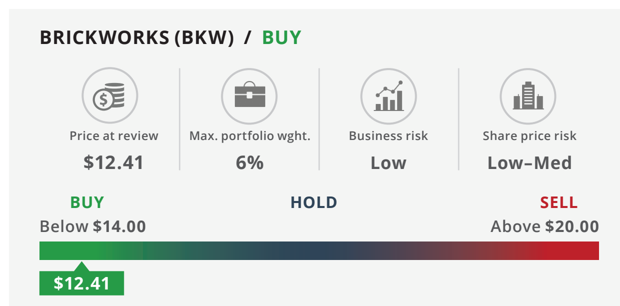
The boom time earnings won't last forever but they may endure longer than many believe.

Brickworks hits the boom time

It might have one of the dullest names on the ASX, but Brickworks isn't quite as boring as it appears. There are three parts to the business. Building products makes and sells bricks, timber products and pre-cast cement; a property business develops land used at depleted quarries and spins them into a property trust to provide stable rental income and juicy revaluation profits. There is also a 47.2% stake in **Soul Pattinson**, a diversified conglomerate.

Key Points

- ***Building boom has lifted returns***
- ***Don't capitalise cyclically high earnings***
- ***Complex structure***



That web of activities increases complexity but enhances security by taming the famously cyclical construction cycle. Uniquely for a building materials business, this is no cyclical pig. In fact, Brickworks holds one of the more illustrious records on the ASX: it is one of only eight companies that has not cut dividends for 15 years. This is no mere brick business.

For most of recent history, the building products business has been the smallest part of Brickworks. That is no longer true (see Chart 1). A tremendous construction boom has transformed the profitability of the materials business and it is now the largest contributor to profits.

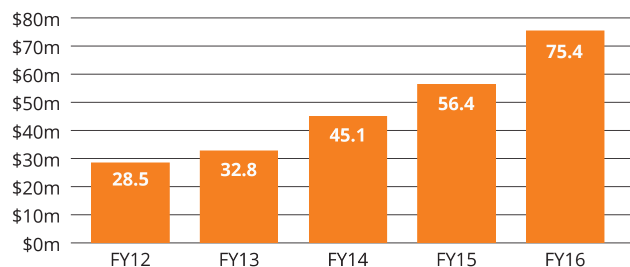
Three years ago the building products business generated EBIT of $32m; last year that had risen to $75m thanks to higher prices and higher volumes. It is now the single largest contributor to profit. The building boom has helped but so has vanishing competition in the brick market where three competitors have become two.

Brickworks has also changed strategy to sell higher margin bricks by treating them much as a retailer treats fashion: turning over inventory quickly and frequently releasing new designs. This has made a mark on returns with a return on tangible assets over 12% – twice what it was a few years ago.

These are, of course, boom time earnings, and we don't expect the boom to last forever. But it may be more enduring than many believe. Construction activity is at record levels but a decade of housing undersupply, between 2003 and 2013, needs to be filled. The supply deficit was estimated to be 108,000 dwellings in 2013 and has now shrunk to 50,000. The boom is making inroads into demand but it could go on for some time yet.

This is not to suggest that investors should pay more for today's peaky earnings – we have not changed our valuation – but it is interesting that the market appears to be sceptical about the construction market. Brickworks is experiencing boom-time conditions without a boom-time price.

Chart 1: BKW's building products EBIT, $m



Source: Company reports

We estimate that the building products business is worth $200m–300m. For a business generating EBIT of $75m that is deliberately conservative. Capitalising cyclically high earnings is a mistake.

The property trust, a joint venture with **Goodman Group**, is well managed and has a long pipeline of opportunities yet to be developed. We expect the $15m in rental income to grow steadily over time as new properties are added to the portfolio.

It should be noted that, of the $73m earned by the property business, over $40m came from revaluations and lower capitalisation rates. If the building boom is aiding the materials business, lower interest rates are doing the same for property.

> **This isn't a business that will generate outrageous returns but it is stable, well managed and diversified.**

Even excluding revaluations and redevelopment profits, Brickworks property trust earns a 7% yield on property, a decent sum. We have assumed book value for the property trust and applied a small discount to it in our low case. To that we add a little for land and development on the balance sheet. The details are shown in Table 1.

Table 1: BKW sum of the parts

	LOW ($M)	HIGH ($M)
BUILDING PRODUCTS	200	300
PROPERTY TRUST	312	320
OPERATING PROPERTY	245	370
LAND BANK	70	230
SUB-TOTAL	827	1,220
LESS DEBT	(263)	(263)
DTL	(214)	(214)
TOTAL	350	743
SHARES ON ISSUE (M)	147	147
VALUE PER SHARE EXCL. SOL ($)	2.38	5.05
SOL VALUE	2,685	3,929
BKW EQUITY VALUE	1,844	2,982
VALUE PER SHARE ($)	12.54	20.29

Brickworks' holding in Soul Patts is nominally worth around $1.5bn at current prices, by far the largest chunk of Brickworks' $1.9bn valuation. The calculation is complicated by the fact that Soul Patts itself owns a 44.1% stake in Brickworks. The cross-shareholding needs to be sorted out mathematically and we cannot simply take market prices or we would be valuing Brickworks partly using the market's valuation of Brickworks (confused? See ***The Great Unwinding*** where we set out the detail).

Sorting out the cross-ownership, we arrive at a valuation between $13 and $20 a share, shown in Table 1. The low side of that valuation assumes a 30% discount to Soul Patts' sizable market holdings and the high side marks them to market. A fair price is probably in between those two figures, below $14 a share, Brickworks makes decent buying.

Chart 1: BKW 5-year share price

Source: S&P Capital IQ

This isn't a business that will generate outrageous returns but it is stable, well managed and diversified. The balance sheet, with $270m in net debt and interest coverage of over 15 times, is strong and with a yield of 3.5%, Brickworks is a **BUY** for up to 6% of your portfolio.

Staff members may own securities mentioned in this article.

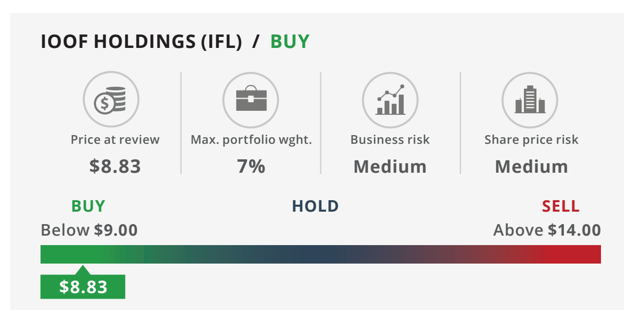
Wealth management fees are coming down but IOOF is fighting back by leading industry consolidation.

IOOF leading charge to consolidate

There's no better way to gain exposure to the broad sweep of the wealth management industry than IOOF Holdings, which clips the ticket on savings as they pass through the hands of financial planners, wrap accounts, fund managers and trust administrators.

Key Points

- ***Margins fell sharply in second half***
- ***Good cost control***
- ***Driver of industry consolidation***



The company splits itself into four divisions – Financial Advice and Distribution, Platform Administration, Investment Management and Trustee and Estate Services – and, while the funds under advice, administration, management or supervision (FUMAS) are split fairly evenly between them, Platforms is the biggest profit contributor by far.

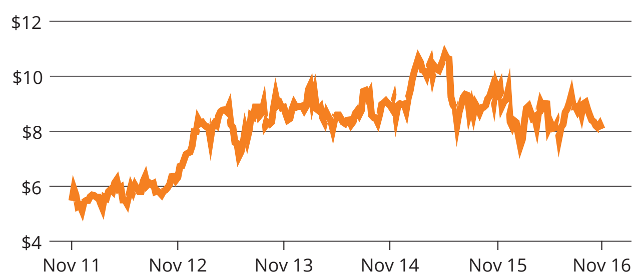
Platforms allow money managers to take huge licks in fees for seemingly small percentages of funds under management. Without a platform that runs the various '**wrap accounts**' that house customers' investments, the wealth management gravy train doesn't leave the station.

Wrap accounts work by collecting money from lots of people, to whom they offer extensive investment options – managed funds investing in a wide range of assets, both locally and overseas, as well as direct shares. By aggregating customers, wraps can wield greater power with fund managers, thereby pushing costs lower. They also take some of the administrative burden away from planners, enabling the good ones to focus on giving good advice and the bad ones to do what they do.

In return, the wrap takes a fee, now quite a lot higher than those charged by planners and fund managers. That said, fees are under pressure because there are scale benefits from administering more money, and the competitive environment is doing its job in delivering a chunk of these back to customers.

With its track record at acquiring and consolidating platforms, IOOF is leading the way, driving fees lower but counteracting this by attempting to grab a bigger slice of the market. While the gross margin percentage has been coming down due to the pressure to reduce fees, the profit margin (profit before tax as a percentage of the gross margin) has been going up.

Chart 1: IFL 5-year share price



Source: S&P Capital IQ

In the latest result IOOF recorded a flat profit for the year, about 90% of which came through as free cash, helping it reduce net debt to $20m. Across the group, the gross margin (GM), which is net fees as a proportion of average funds under management, administration and advice (FUMA), fell to 0.51%, from 0.53% in 2015. However, a 2% fall in operating costs meant the net operating margin (NOM – operating profit as a proportion of FUMA) fell only half a basis point, to 0.23%.

The biggest source of margin compression was the company's platform business, where the GM fell from 0.66% to 0.64% and the NOM fell from 0.37% to 0.35%. There was a particularly sharp fall in the second half, though, which saw the GM slump to 0.62%, from 0.65% in the first half, and the NOM fall from 0.37% to 0.32%.

> **Given the low interest rate environment, any kind of long-term growth would make the stock look attractive given its free cash flow yield of around 6%.**

About half the second half fall in GM was due to customers preferring newer platforms with lower fees, but also with lower overheads. This effect would have been exacerbated by platform consolidation, from which the full cost efficiencies won't be seen until 2018. The introduction of the government-mandated MySuper product also had a negative impact, with the final tranche of member transfers occurring in February. These had a higher average customer balance which has a disproportionate impact on margins due to MySuper's mostly flat administration fees.

The result reveals the essence of IOOF's strategy – to lead the consolidation in the wealth management industry and use scale to make it more efficient and competitive with lower cost options. In recent years customers have seen most of the benefit, but the company is hanging in, helped by the acquisition of Shadforth in 2014 and continuing consolidation, with the move **from three flagships to just two** in June.

Table 1: IFL 2016 result

YEAR TO JUNE	2016	2015	+/– (%)
AVG. FUMA ($BN)	103.8	100.2	4
NET FEES ($M)	534	535	(0)
OTHER REVENUE ($M)	39	42	(7)
UNDERLYING OP. PROFIT ($M)	240	238	1
UNDERLYING NET PROFIT ($M)	173	174	(1)
UNDERLYING EPS	57.8	59.9	(4)
DPS	54.5	53.0	3
FINAL DIVIDEND26c (down 7%), fully franked, ex date 29 Sep			

If IOOF is able to increase profits a little in 2017, it would bring the dividend further back into its targeted range. There's a chance of this, since FUMA averaged $103.8bn in 2016, but ended the year at $104.1bn, with markets rising since then. All things being equal (which of course they won't be) this would provide a higher base from which IOOF can earn its fees – although much of any increase is likely to be offset by a continued decline in margins.

Management also pointed to the 'complementary' performance of Advice, which now matches the Platform business for size (combined, they contributed 81% of profits) and which was able to increase its NOM from 0.21% to 0.24% thanks to further synergies from the acquisition of Shadforth.

That's good to see, although we fail to understand how margin movements in Platforms and Advice would naturally offset each other. More importantly, the integration of Shadforth is complete, meaning further improvements call for another acquisition. Management is clearly on the lookout. Chief executive Chris Kelaher wouldn't be drawn on where he was looking but it clearly includes 'fintech' and 'roboadvice'.

In the absence of any big moves, continued margin compression will likely offset most of the benefits of any rise in FUMA, so we don't expect much if any profit growth in 2017. Longer term, though, IOOF should continue to play a leading role in the consolidation of the wealth management industry, earning its share of an increasing flow of money into superannuation.

Given the low interest rate environment, any kind of long-term growth would make the stock look attractive given its free cash flow yield of around 6%. IOOF doesn't need much growth to deliver an acceptable return and, with the cash flow supporting a fully franked dividend yield of a similar amount, the company may choose to reduce its dividend slightly to provide more firepower for acquisitions. In our view, that would deliver even more long term value. **BUY**, with a maximum portfolio weighting of 7%.

*Note: The Intelligent Investor **Growth** and **Equity Income** portfolios own shares in IOOF Holdings. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios by **clicking here**.*

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