O'Kane Investment Services Pty Ltd
Portfolio Management
ABN 66 101 935 737
OKIS.COM.AU

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Key takeouts from the reporting season and other portfolio observations.

Half Financial Year Company results for 2012/13 for the most commonly held stocks across portfolios.

Platinum Asset Management (PTM $5.05, was $3.60 last report): The 1st Half (1H) dividend was 8 cents (fully franked), the same as last year's 1H dividend. Profit was down 7.4% compared to the same six month period last year while the stock price is up 40% since I last reported in September 2012. How can profit be down but the share price be up? Remember PTM is a simple business to understand with revenue and profit directly linked to the funds under management (FUM) held by Platinum Asset Management. At the start of the 2013 financial year, on the 1st July 2012, there was $14.8 billion of FUM and by 1 January 2013 there was $16.6 billion of FUM. Now in March 2013 FUM stands at $17.7 billion.

PTM has grown FUM predominately from positive investment returns on the money already invested and is now starting to attract new customers. With FUM trending higher expectations are now for higher profits and given the market is a forward looking beast the price has moved up in anticipation of those higher future profits. Of course my question is if the market is such a good forecaster of the future why did it let the share price go down so much in the first place?

One year ago I noted the 'The ASX has a market capitalization of $1,200 billion dollars while there is approximately $500 billion in term deposits sitting on the sideline' and six months ago I wrote 'in the context of our portfolios it is important to own businesses like PTM for this exact leverage impact'. Well, with the past six months price rally we got our recompense. Platinum now yields 4.2% full franked and thus requires only modest growth to do well from here. Importantly Platinum does well when investors lose their fear and start to get greedy and there is a good chance that is what we have started to see.

Telstra (TLS $4.52, was $3.80 last report): The 1H dividend was 14 cents (fully franked) unchanged from last year. Over the period income increased 1.7% and operating costs decreased 0.3% resulting in a profit increase of 9.7%. While it is great to see Telstra controlling costs (the secret to its future success) such profit growth, as just experienced, should not be relied upon moving forward.

Nearly 70% of Telstra's $25 billion revenue comes from either PSTN (think land lines, home broadband etc) or Mobiles. In 1H 2013 revenue from mobile increased $200 million while revenue from land lines etc decreased $150 million. For Telstra it feels like one step forward and one step backwards and I fear long term profit growth rates starting to reflect revenue growth rates. This is fine when we are buying at a 10% fully franked yield but a risk when holding for a 6.2% yield with capital gains in your back pocket. Naturally the question needs to be asked what else we could do with the funds if not invested in Telstra for yield. I don't have a good enough answer to that question yet but I am mindful that every bubble originates from what was in the beginning a sound idea.

Level 7, 1 Collins Street Melbourne 3000
Email jjokane@okis.com.au Ph 03 9016 8989 Mob 0403 857 290 Fax 03 9016 5939
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230238) are Authorised Rep of PGW Financial Services (AFS 384713)

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Brambles (BXB $8.52, was $6.80 last report): The 1H dividend will be 13.5 cents (30% franked) up 4% from 13 cents compared to last year. Brambles pooling of wooden pallets and reusable plastic containers (RPC's) occurs in more than 50 countries and earns profits in multiple currencies. For the sake of consistency it reports its overall results in US dollars and in the 1H 2013 financial year revenue rose 4% and profit rose 26%. Key to this improvement was 1. The USA pallets business where revenue grew 9% and operating profit grew 23% and 2. The RPC's (think fresh food containers used at Woolworths) where revenue grew 5% and underlying operating profit grew 26%. These two divisions represent 55% of Brambles profitability and the key competitive positions in of their respective markets are the reason we own the stock.

Management continues to strive for a more efficient, leaner and focused business that enhances its scale advantage to become more relevant to more customers. This business is getting stronger every six months.

Invocare (IVC $10.60, was $8.45 last report): The full year dividend paid was 34 cents (fully franked) up 14% from last year's 29.75 cents. Over the period revenue grew 13.7% and earnings per share (profit measure adjusted for the issue of shares) grew 12.5% as the merger between Invocare and Bledisloe took effect.

Excluding the Bledisloe acquisition the rest of the business continued on with its regular performance. Comparable revenue (i.e. excluding the Bledisloe acquisition) was up 6.3% driven by average revenue per funeral increasing 4.3% and the number of funeral services performed increasing 1.5%. Invocare's fully franked dividend yield of 3.3% means today's price remains full, but with the Australian mortality rate due to peak in 2033 and the ability to raise prices annually, the time to exit this stock is not now.

Ramsay Health Care (RHC $31.75, was $23.50 last report): The 1H dividend was 29 cents (fully franked), 13.7% higher than last year's 25.5 cents. Over the half year revenue grew 5.2% and profit grew 12.3%. This uneven growth happens because the further development of existing hospitals (known as Brownfield developments) sees each additional dollar of revenue more profitable than average as some hospital costs don't change at the same rate as the hospital expands.

To justify the current share price RHC has to achieve long term profitability growth of around 8% per annum from here, or put another way, double profitably over the next 9 years. If you check the last September letter when the share price was $23.50 I wrote those numbers needed to 7% growth and 10 years. Unless we get abnormal jumps in revenue and leveraged profitability the higher the share price goes the more difficult those numbers become to achieve. Thankfully Ramsay has been producing some abnormal growth and guidance for 2013 is now for 13%-15% profit growth. RHC is an A grade stock with a B- grade share price (in case you are wondering that is a better proposition than a C grade stock with an A grade share price).

Westfield Group (WDC $10.10, was $8.91 last report): The 1H dividend will be 24.75 cents (unfranked) up 3% from last periods 24 cents. Every day Westfield Group is collecting rent from established retail complexes while at the same time developing further shopping complexes. Net property income grew in the USA

(3%), Australia/NZ (3%) and the U.K (1%) with specialty retail sales growing strongly in the US (9%).

In an environment where online shopping is threatening to flood traditional bricks and mortar retailing, as an owner of shopping complexes, you want to own all the high ground because that is where everyone will retreat to. Westfield owns the some of the best centres globally and with a further $10 billion pipeline is developing further complexes.

Harvey Norman (HVN $2.00, was $2.03 last report): The 2H dividend will be 4.0 cents (fully franked) making the full year dividend 9 cents (fully franked) down 25% from last year's 12 cents. The key to analysing HVN is the franchise operating margin (being the percentage of Australian store sales it keeps after paying for advertising, warehousing and other expenditure on supporting franchisees). The margin for 2011/12 was 2.63% on $4.83 billion in sales compared to 5.01% on $5.08 billion on sales this time last year. This negatively impacted operating profit by $127 million explaining 86% of the company's profit drop of this year. HVN always spends more money supporting franchisees when operating conditions are tough and the ongoing price deflation (less profit per unit sale) and the resulting competition are hurting the whole industry.

Traditional retailing is a business that is relatively easy to enter as all that is required is premises to sell from, a sales system, maybe warehousing and access to inventory to sell. Yet traditional retailing is a very difficult business to exit from, especially if you have had success in the past. Shops need to be closed and leases paid out, inventory needs to be sold down and losses taken while remaining assets like sales systems become worthless, it is a very expensive exercise to leave the industry. It reminds me of a lobster trap – easy to get into the pot but impossible to get out of. Today's industry participants in household goods retailing that are leaving the industry are causing further industry stress on top of deflation as they create further short term over supply, but eventually these competitors will be gone. Why wouldn't HVN compete aggressively for market share in such circumstances? In 2011/12 revenue collected from HVN franchisees was only 8.6% (or $80 million) lower than the previous year yet HVN earned 50% less from franchisees ($127 million). Not only did HVN not cut expenditure they raised it another $47 million assisting franchisees to take market share. I can't see how HVN won't come out of this a bigger more aggressive operator with fewer competitors than before. In retail, no short term pain equals no long term gain.

Woolworths (WOW $28.80, was $25.20 last report): The 2H dividend will be 67.0 cents (fully franked) making the full year dividend 126 cents (fully franked) up 3% from last year's 130 cents.

The key to analysing Woolworths is to watch the Australian and NZ Food and Liquor businesses – which contribute about 90% of all operating profits. Here sales grew 3.8%, operating profit grew 5.3%, market share increased, customer numbers increased, basket size increased and items sold increased - and all this despite an industry fighting deflationary pressures.

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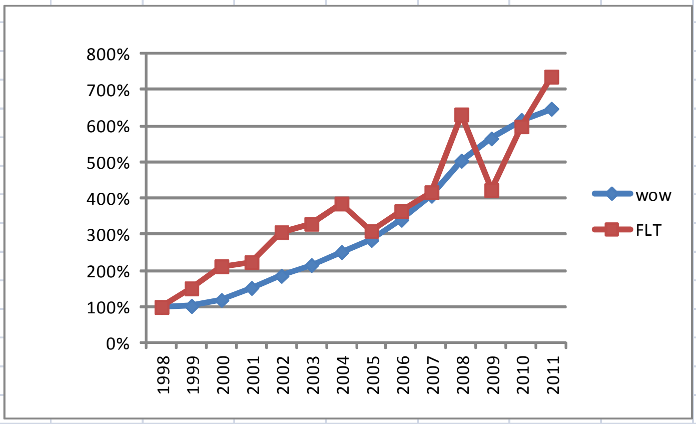
Macquarie Group (MQG $29.30, was $26.70 last report): The 2H dividend was 75.0 cents (unfranked) making the full year dividend 140 cents (unfranked) down 25% from last year's 186 cents. Macquarie Group has six business units separated into annuity style earnings and market linked earnings. The three annuity style businesses continue to prosper while the three market facing businesses suffered, Macquarie Securities and Macquarie Capital (think institutional brokering and investment banking) being the worst culprits. Another market facing businesses, FICC - Fixed Income, Currency and Commodities did have a strong contribution in the second half of the year. Coupled with the promised cost cuts from all operating divisions it could be that Macquarie is poised for better earnings results.

Earlier when analysing Platinum Asset Management I referenced the need to own businesses within the portfolio that offered leverage. Alongside Platinum, both Macquarie Group and Harvey Norman offer that leverage. The idea being when the circumstances change for the finance and retail industries these businesses will find earnings momentum and prosper rapidly with their stock prices running two to the one of the market. When coupled with steadier businesses like Woolworths, Invocare, Ramsey and Telstra etc it should facilitate a portfolio for all seasons. We do ok as the market flounders and we don't miss out when the market runs. The key to getting this strategy right is to only own businesses with competitive positions capable of outperforming competitors, either in their stable environments or in the cyclical environments. I repeat the key is not that all the businesses perform all the time but that when it is their time they perform. Remembering that "Our goal as investors should simply be to purchase at a rational price a part interest in an easily understandable business whose earnings are virtually certain to be materially higher 5,10 & 20 years from now" WEB. So the question I ask of PTM, MQG and HVN is not 'when' will your earnings improve but how 'certain' am I that they will improve. Below is a graph I made in 2011 of Flight Centre and Woolworths earnings per share going back to 1998. Both have different business styles and face different customer demand cycles but both have one important factor in common: they are the dominant market players in industries where scale matters (think low cost strategy). Their earnings took very different paths but ended in the same place - the key is they were both capable of reaching that place.

	FLT		WOW	
1998	23.2	100%	26.5	100%
1999	35.1	151%	27.2	103%
2000	49.2	212%	31.6	119%
2001	51.8	223%	40.4	152%
2002	71.1	306%	49.3	186%
2003	76.4	329%	57.2	216%
2004	89.4	385%	66.6	251%
2005	71.9	310%	75.4	285%
2006	84.5	364%	90.3	341%
2007	96.6	416%	107.8	407%
2008	146.5	631%	133.5	504%
2009	98	422%	149.7	565%
2010	138.8	598%	163.2	616%
2011	170.8	736%	171.5	647%



Cochlear (COH $68.00, was $58.58 last report): The 2H dividend will be $1.25 (35% franked) making the full year dividend $2.45 (50% franked) up 8.8% from last year's $2.25 dividend. Over the year revenue fell 11% while profit fell 12% as a result of the product recall. The similar decline in revenue and profits obscures the fact operating costs increased as research and development (R&D) costs accelerated while tax incurred materially declined because of the write off's associated with the product recall.

The best way to track Cochlear's underlying performance is by tracking the yearly change in implant unit sales. Implants for the year reached 25,387 (including 2,300 unpaid procedures) up from 24,661. Cochlear is not without its challenges in 2012/13 i.e. additional tax to be paid and less favourable FX contracts impacting profit but it goes into 2012/13 with minimal market share loss and a growing global footprint. If those two situations where reversed we wouldn't own the stock. To justify today's share price annualised long term profit growth of around 6.5% is required from Cochlear. This seems an awfully low growth hurdle for a company with such a strong competitive position in its market.

Coca-Cola Amital (CCL $13.50, last report was $11.90): The 1H dividend will be 24 cents (fully franked). First half trading revenue increased 8.9% while profit increased 5.6%.

It is a pleasure owning this business and I only wish I understood it better five years ago. If Invocare is the best business on the ASX then it is possible the Australian bottling operations of CCL is the best division of a business in Australia. Today's share price implies long term earnings growth of 6.5% is needed to justify the price. This looks plausible but again we have an A grade business with a B grade stock price.

Billabong (BBG $1.35, last report was $3.00): There will be no 2H dividend making the full year dividend 3 cents (unfranked) down 90% from last year's 29 cents.

ARB Corp (ARP $9.70, was $8.70 last report): The 2H dividend will be 14 cents (fully franked) making the full year dividend 25 cents (fully franked) up 8.7% from last year's 23 cents. Over the year revenue grew 6% and profit grew 2%. The key to ARB is the growing number of 4WD/SUV sales on an absolute basis and as a percentage of total vehicles sold. As highlighted in the March letter Asian 4WD vehicle manufacturing was severely impacted by natural disasters and this impacted ARB because they supply accessories to these vehicles. Global 4WD supply has returned and so it is expected ARB will experience meaningful revenue and profit growth in 2012/13. On the downside there is market fear that the slowdown in mining activity may impact demand for 4WD's as mining and exploration companies postpone activity. It is unclear how important this impact is.

ARB's valuation is a conundrum. What can be observed based on basic valuation metrics like return on equity (25%), average payout ratio (70% taking into account bonus dividends) and estimated growth rates (derived from return on equity and retained capital) is that ARB should trade at a higher price. But

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this undervaluation has persisted for nearly as long as we have owned the stock. I suspect the reason is the anticipation that ARB's business should act like a cyclical stock but hasn't yet – thus making ARB a bit of an economic miracle, like Australia not having had a recession in 20 years. This constant threat makes ARB difficult to newly buy but impossible to sell.

Flight Centre (FLT $23.85, was $22.18 last report): The 2H dividend will be 71 cents (fully franked) making the full year dividend 112 cents (fully franked) up 33% from last year's 84 cents. The key to analysing FLT is to watch the growth in TTV or total transaction value (i.e. every dollar of sales) and the income margin or percentage they keep of the TTV. In 2011/12 $13.2 billion of travel was sold at a 13.8% margin resulting in a record profit. Global sales staff numbers grew by 6% to 12,130 and are expected to grow a further 6-8% next year. If 12,000 people get the chance to talk to 7 customers a day, 5 days weekly over 50 weeks a year that is well over 20,000,000 chances to close a deal. Makes you feel sorry for someone who only has a website.

Flight Centre like ARB Corp is not as widely held by recent client accounts as stocks such as BXB, IVC, WOW, MQG etc as the valuation conundrum discussed in the ARB review exists with FLT as well. For FLT the unknown is how important is the high Australian dollar to company profitability. This makes FLT difficult to be newly purchased given higher prices but difficult to sell with such low growth expectations in the price. Without a margin of safety in an originating purchase price it is best to err on the side of caution.

Level 7, 1 Collins Street Melbourne 3000
Email jjokane@okis.com.au Ph 03 9016 8989 Mob 0403 857 290 Fax 03 9016 5939