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Your Portfolio Partner

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Dear Client

Last year's client letter ended with a warning that the 2015/16 financial year would present mounting investment challenges and unfortunately the year didn't disappoint. By August the Chinese stock market had experienced a 40% downturn; by January crude oil was trading below US$27 a barrel; and by June Britain had voted in favour of Brexit. Actually we weren't warning of those events but rather the vulnerability to low yields and a stock market capitalisation dependent on low interest rates. Despite the challenging year, the positive aspect is that every year the stock market stagnates or declines it helps reduce the risk we warned about.

This financial year the S&P ASX200 total return was approximately 2% with the index finishing negative 4.2%, dividends and franking credits generating 6.2%, while term deposit rates averaged 2.17% across the year. Client accounts have generated superior returns over relevant investor category benchmarks but they are single digit returns. This follows three consecutive years of double digit client returns. Please review your performance report to see your 2015/16 returns.

A review of our holding in Coke (CCL Amatil) is probably due. 70% of CCL's earnings come from the Australian business, so get this right then you get the stock right. CCL's share price pain stems from the operational years of 2013 and 2014 which saw Aust revenue fall 6.4% from $3,018 million to $2,832 million. While revenue only declined $196 million, operating earnings fell $180 million. So how does a 6.4% loss of revenue translate into a near 30% loss in operating earnings? Basically through 2013 and 2014 operating costs fell less than 1% so nearly all the lost revenue ended up as lost profit. In a business where you have to manufacture what you sell it would be reasonable to assume fewer sales imply at least some costs saved. This quandary provides some clue as to the problem CCL was truly facing and brings into question the near universal view CCL's problems rest with declining consumption of sugary drinks.

The problems that came to a head in 2013 and 2014 relate to competitive issues CCL faced through the grocery channel (supermarkets) and non-grocery channel (anywhere else you can buy a coke).

In 2009 Asahi Breweries bought Schweppes (local owners of Pepsi) and the dynamics within the carbonated soft drink (CSD) market subtly changed for the worse. From 2009 through to 2013 CCL's old management let Coke's pricing premium within supermarkets become excessive to Pepsi. This culminated in lost sales volumes, input cost increases not being passed on and additional marketing support to defend market share. Drinking water sold at value prices within the grocery channel also gained market share during this period.

At the same time non-grocery was been impacted by the shift in demand from high margin independent accounts (independent milk bars, pizza shops, service stations etc) to national account chains (7-11, Coles/Woolworths petrol stations etc) and quick service restaurants (Dominos etc). Volumes sold were not impacted but the average selling price was lower because of the bargaining power of the larger customers versus fragmented individual customers.

Some of these issues CCL faced where industry structured problems while others where self-inflicted. Yet, it needs to be remembered that CCL has valuable competitive advantages. Coke outsells Pepsi 6.5:1 in non-grocery channels and 3:1 in the grocery channels while taking market share from Schweppes even with a 40% pricing premium. Is there another product with this pricing power in Australia?

By 2014 CCL had started to make important changes. A new CEO (Alison Watkins) and a new globally experienced head of Australian beverages (Barry O'Connell) were appointed. A new strategy was adopted to exploit product preferences for CCL products and scalability. CCL introduced; lower entry pricing points for products, lower calorie portions, premium packaging and new categories all aimed at increasing transaction occurrences rather than just volumes. CCL also found new and re-engaged dormant independent customers while driving down the cost to service this group through sales automation and reallocated operating costs from support to sales.

Aust operating earnings were flat for 2015 and the key going forward is to watch CCL's transaction growth as the new product offering mix gains traction. CCL has being rebased with revenue stabilized, costs re-allocated, and growth engines reengaged. Once revenue growth resumes the operational leverage that worked against CCL in 2013 & 2014 should start to work for them. The share price will move before it becomes obvious to everyone that the Australian business is rebounding.

Last year in April we sold Woolworths and this year in March we sold Wesfarmers. Last year we shared the following…..

John Maynard Keynes famously said "When my information changes, I alter my conclusions. What do you do, sir?" In response to Keynes question, with regard to Woolworths (WOW), we too alter our opinion when the information changed.

The original thesis behind owning WOW was that it had a competitive cost advantage over its major competitors Coles and Metcash (think IGA supermarkets system) in food and liquor that it could exploit for years to come. That advantage could be expected to result in reliable and meaningful earnings growth leading to higher dividends and higher share prices. While Coles and Woolworths sold groceries for roughly the same gross profit margin Woolworths ran its businesses 15% more efficiently than Coles and 20% more efficiently than the Metcash system. Much of this cost efficiency was reinvested back into the business and that led to Woolworths supermarket being able to grow sales to $41 billion while Coles sales grew to $29 billion over the same time period.

Woolworths and Coles high profit margins in their supermarket business attracted Aldi and Costco to Australia. The emergence of the discount operators could easily have been interpreted as the supermarket industry just fragmenting with the new players carving out a small segment of the market supplying the very frugal. It was fair to assume Woolworths and Coles by only having a small operating cost disadvantage compared to the new discount operators, but with other advantages like broad scale, would keep the new players in check.

While there isn't much disclosed information about Aldi, as it is a private family business headquartered in Germany, we now have an appreciation for Aldi's (and Costco's) operating structure in the same way as the Australian players. Woolworths spends approximately 19 cents of every dollar of sales (Coles 22 cents, Metcash system 24 cents) on the basic operating costs of the business while Aldi spends 11 cents and Costco 12 cents. That is not a large difference, it is an astronomically huge difference and Woolworth, Coles and Metcash have absolutely no hope of getting close to that kind of efficiency, for all kinds of reasons. The massive cost advantage Aldi and Costco have over the Australian operators allows them to sell at lower prices. Woolworths and Coles are greatly impacted on items that have transitionally been large profit margins items such kitchen, laundry and bathroom products. To date (April 2015) Woolworths has simply put more pressure on its suppliers to make up the profit difference thus maintaining profitability, but this won't resolve the growth problem.

Aldi have plans to double store numbers to around 700 stores nationally while Costco want 20+ stores. This means ongoing pricing pressure and Woolworths who have two choices to deal with these challenges. They can lower prices on many more products or increase spending on promoting.

Either way revenue or operating costs are going to be impacted and future earnings growth will be impacted negatively.

Long term Coles is more at risk than Woolworths because they have a higher operating cost base but because 87% of Woolworths profitability comes from food and liquor the challenges will affect them proportionality more. In the UK a similar situation developed and it did not end well for the incumbent supermarket business (the customers did well). Aldi and Costco's will never grow market share to be Woolworths or Coles size but with their materially superior cost advantage they don't have too for there to be serious collateral damage to Woolworths and Coles futures. The operating leverage will take care of that.

We like to find and invest in businesses that are very capable of keeping competition at bay because this is the surest way that revenue growth translates to profit growth which translates to share price growth. Woolworths has been a pin up child for this way of investing in the past. Unfortunately we are no longer convinced that WOW's earnings are near certain to increase in the foreseeable future meaning we don't feel sufficiently confident that the share price will be higher in three or four years. They could be higher but they could also be materially lower. As such it is too much of a guess to remain an investment. As to John Maynard Keynes saying "When my information changes, I alter my conclusions. What do you do, sir?" We sell and look elsewhere……

Since we originally wrote the above note last year Woolworths has lowered shelf prices in an attempt to become more competitive with Aldi which has resulted in lower profits and a share price fall from $30 to $20.

Fast forward twelve months form the decision to sell Woolworths and we have had the same brain wave with Wesfarmers (We can hear you asking what took you so long). For a long time Wesfarmers has been living off the fat in Coles that came from the wasted years of ownership under Coles Myer. The plan for Coles was simple; refurb the stores, improve efficiencies and basically remake themselves in the image of Woolworths. The result being market share gains because now the two players look the same. Given the high price Wesfarmers paid for Coles previously poorly executed strategy these gains shouldn't be seen as surprising. Along with the strength of Bunnings that was the rational for holding Wesfarmers.

When we sold our Woolworths shares it was making 7 cents operating profit for every dollar of sales while Coles made about 4.25 cents. In 2016 both will make about 5 cents. This means the operating gap is closing and market share gains for Coles are going to become more difficult. That isn't the only problem Coles faces. All supermarket chains are increasing their shop floor space by opening new stores and increasing selling space in their existing stores. This is at a greater rate than the population and demand is growing. In effect industry supply is increasing at a greater rate than demand is growing meaning industry costs are going up without extra sales revenue. Industry profitability will be the casualty.

This year will likely see Wesfarmers begin to refurbish the first of the original Coles stores previously refurbished after the takeover. Coupled with Aldi gearing up in South Australia and Western Australia Coles is facing headwinds.

Since 2012 all of the earnings growth Wesfarmers has generated from successfully running Coles and Bunnings has been offset by what Wesfarmers no longer generates in its Coal and Industrial/Safety businesses. Wesfarmers basically earns the same money it did three to four years ago despite great gains in the Coles and Bunnings/Officeworks divisions over those years. Future earnings growth in the Coles business is likely difficult and shouldn't be assumed while Bunnings has been growing above trend and is at risk of slowing down. Given Wesfarmers trades at a forecast 19X earnings, a multiple usually reserved for growth stocks, the impact of a slowing Coles business could be large on the share price. The inevitable slowdown in Coles earnings means Wesfarmers share price will always be at risk.

The next time someone starts warning you to sell a stock because of an economic disaster event unfolding let them know what really erodes share prices are competitive forces that cause business to sell less items for lower prices while incurring higher operating and capital costs. Fear an "Aldi" more than "Brexit".

Here is an investment idea that so far hasn't made it onto the buy list. It is a shame as researching a stock idea can take weeks and even months. Still, it should provide an insight into the investment process undertaken before a stock is recommended as an addition to portfolios.

Regis Healthcare is a residential aged care company, which is different from a retirement living company. Residential aged care services are typically provided to people who can no longer live unassisted and include clinical care services, daily living services, and accommodation services. This is distinct from the retirement village industry where operators normally offer little to no care services but rather accommodation on a user pays basis.

Besides Regis Healthcare there are two other ASX listed Aged care providers, Estia and Japara. Add another 1,000 not for profit and for profit operators spread across the country and the industry is highly fragmented with approximately 63% of operators operating single facilities, 29% operating between two and six facilities, and 8% operating seven or more facilities. The three ASX listed operators are among the most commercial in the industry generating roughly $20,000 operating profit per resident per year. Meanwhile the bottom third of all industry operators are unprofitable.

In addition to the prospect of industry consolidation the aged care industry is perceived as an attractive growth sector because of the Australia's ageing population. The greatest demand for services is from people aged 85 years or over, with approximately 58% of permanent residents in this age category. Australia's population aged 85 years and over is projected to double by 2032 and double again by 2046. On face value the growth story for the aged care industry sounds highly promising as does the prospect of industry consolidation.

The key to understanding Regis as an investment prospect is to understand the economics of the business; the revenue drivers, the major operating costs, the amount of capital needed to fund the growth and the competitive forces within the industry that impact those variables.

Regis's annual revenue is a function of the total number of operational beds, the occupancy rate of those beds and revenue earned per bed. Seventy percent of Regis's revenue comes from the Australian government; making it Regis's single largest customer. This can be a plus and a negative but more on that later.

Regis earns revenue by providing three key services to residents; a) there is a daily living service fee covering the essential non-clinical care needs of residents such as cleaning, laundry and meals, b) a clinical care service fee ranging from minimum levels of dependence on staff and care, through to 24 hour care by registered nurses and care staff and c) an accommodation service fee covering the provision of physical accommodation, furnishings, and bedding.

The daily living fee is set at 85% of the basic aged pension at approximately $48 a day or $17,600 a year. The clinical care service fee comes from a complex funding model and is a function of the Aged Care Funding Instrument (ACFI). Regis generates revenue in excess of $150 Per Resident Per Day (PRPD) or $55,000 annually from providing these services. The more acute the care required the higher the daily clinical care service charge (max $220 prpd). Both fees are means tested but a resident's contribution towards clinical care services is capped at $25,000 annually or $60,000 over a lifetime. Resident's accommodation costs can be met in three ways. First they can lodge a Refundable Accommodation Deposit (RAD) which is returned in full to the estate. Regis gets full use of the funds in the meantime. Alternatively the resident is charged a Daily Accommodation Payment (DAP) which equals 6.3% annually of what the RAD would have been. This is also means tested and can be government funded.

According to Regis's last financial report it received $70,000 of funding per resident from the government and $27,000 directly from residents, totalling $97,000. After operating expenses Regis generated an operating profit of $20,000 per resident making it a very lucrative business.

It actually gets better for Regis. Since July 2014 the Australian government has required any new resident to put up a deposit (RAD) for their accommodation or make a daily accommodation payment. The dollar size of the deposit usually reflects 65% of the average house price within the location of the aged care facility. Regis tends to operate in areas where housing prices are high so it has access to large amounts of capital at zero interest, currently $700 million. The idea behind the RAD is for current and future residents to effectively fund the development and maintenance of aged care facilities. This is a major positive for Regis as it allows them to recycle their capital. As new facilities are finished and populated the RAD replaces the debt incurred in building the facility and Regis can start on a new facility. In theory this should result in Regis being able to grow facilities/beds at very high returns on their capital.

The most significant operating cost Regis incurs is employee expenses which run at 65% of revenue, similar to other aged care operators. There do not appear great cost advantages through having economies of scale from running multiple facilities. In fact there are 140 single facility operators just as profitable per resident as Regis. If scale is not an advantage then industry consolidation is not the profit opportunity many people think it is. From what I've noticed the acquisition advantage for larger operators appears to come from them buying less sophisticated players, sending in their ACFI specialists and then claiming higher ACFI payments from the government!

As you can see the business of aged care is very lucrative for Regis with huge growth opportunities and cheap funding available to fuel the growth. It seems an ideal situation but we see one important problem. Charlie Munger, Warren Buffett's long term business partner, had some advice when confronting a wonderful business, "Frequently, you'll look at a business having fabulous results. And the question is, 'How long can this continue?' Well, there's only one way I know to answer that. And that's to think about why the results are occurring now – and then figure out the forces that could cause those results to stop occurring."

Australian government aged care spending currently sits at over $10 billion annually (or 2.5% of all Australian government spending) for the care of 200,000 people. Government spending is anticipated to grow at 5% to 6% in the next few years but as the ageing population accelerates so too must the spending rates. You can bet your bottom dollar that the government is cognisant of these trends. In fact much of the basis of my research into the aged care industry came from a June 2015 Australian Government Aged Care Financing report titled "Factors Influencing the Financial Performance of Residential Aged Care Providers". It is quite a document and as the name suggests the government is very keen to analyse the profitability of aged care providers. When the top 40% of the industry have an annual operating profit of between $15,000 and $25,000 per resident it is a safe bet to presume the Aged Care Financing Authority is conjuring up ways to get more bang for government spend. It is difficult to see industry profitability going unchecked let alone allowed to continue as aged care demands grow.

Michael Porter in his book Competitive Strategy warned about the danger a company faces when it has powerful customers (and the government is a powerful customer); the pathology industry understands this well. Powerful buyers compete with the industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other – all at the expense of industry profitability. Where the buyer has full information about demand, actual market prices, and even supplier costs, this usually yields the buyer greater bargaining power than when information is poor.

Subsequent to the completion of our industry analysis a major stockbroker in June released a report estimating listed aged care providers would lose $24 prpd or $8,760 annually in ACFI revenue by 2019. This is a serious risk to industry profitability and is the threat we perceived.

This brings us to why we focussed on Regis. One way for an industry player to survive or even continue to prosper is to be able to pass the lost revenue across to the residents as increased costs. The residents most likely to afford the additional cost transfer are likely to come from affluent areas. Not by coincidence Regis facilities are predominantly situated in what real-estate agents like to call blue chip areas. Assuming a resident contributes a RAD in full, the remaining fully means tested annual out of pocket spend by a resident is approximately $42,600, and for 24/7 quality care this strikes me as a bargain. There is significant room for a resident with the means to contribute more to their aged care. In fact Regis did add an $18 prpd ($6,570 p.a.) fee increase in April to any resident who had put up a RAD instead of paying the daily accommodation fee, so it can be done.

Despite Regis being best placed to survive the threat of rationed government spending, it is not possible to have a high level of certainty that earnings growth will materialise. Without certainty of earnings growth there is not a sufficient margin of safety to buy the stock. So we do nothing and wait for more pieces to the puzzle because the certainty of growth is more important than just buying at a cheaper share price.

What we have shared isn't exhaustive of our analysis but it does showcase what it takes to make an informed investment decision on a stock.

When the stock market corrected this year the largest capitalised stocks were hit hard, more so than the mid-caps. Even though the share prices of many stocks we favour corrected the attractiveness or value was still limited. This created a conundrum as the general market looked cheap but our preferred kind of purchases offered only moderate value.

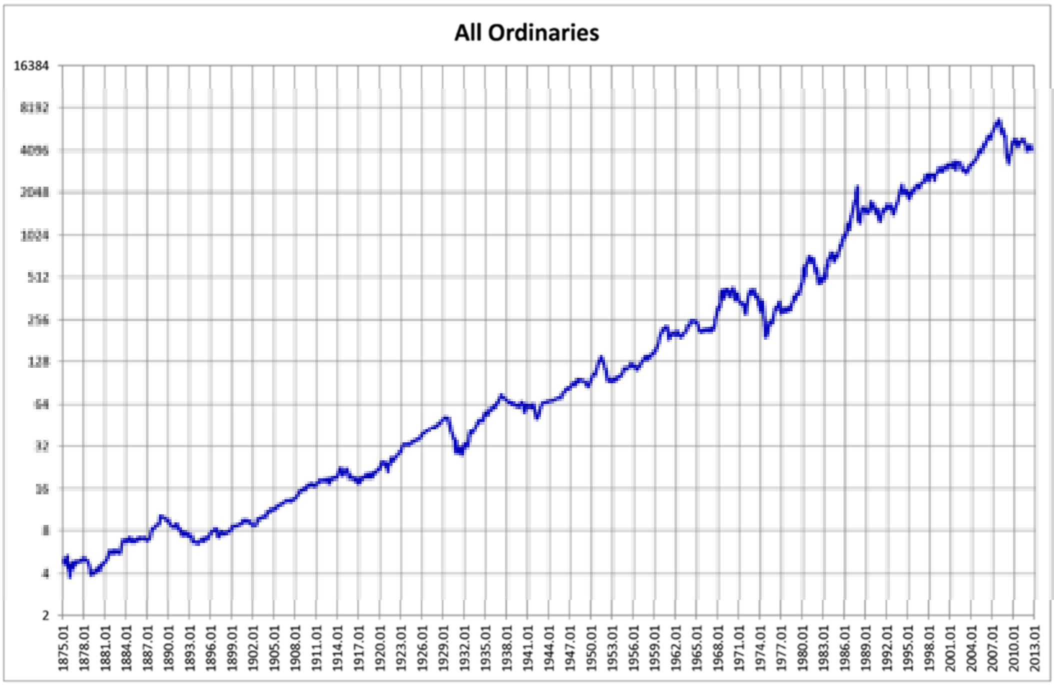
When it comes to using an index fund (e.g. STW, VAS) to buy the overall market there tends to be opposing schools of thought. The pro camp think picking individual stocks is useless as the market is efficient so they always buy the index. The anti-index side can't perceive value in a benchmark they are trying to beat, so they never invest in the index. So one side refuses to recognise that the index can offer value and the other side refuses to calculate the value.

Wesfarmers is branded a conglomerate with 11 major operating divisions made up of many companies while Berkshire Hathaway is now deemed a conglomerate with over 70 different operations. Could an index like the S&P ASX 200 be considered a synthetic conglomerate? Call it Stock Australia with major operations in banking, mining, energy, telecommunications, healthcare, utilities, and consumer and industrial activities. Would assessing the value of a synthetic conglomerate really be that different from understanding other conglomerates?

A synthetic conglomerate may even have a couple of advantages over a real one. An index adds capital to the sectors/companies performing well while reducing exposure to the poorly performed operations. Also an index never faces the prospect of losing value through corporate mortality as its value never ends.

If we intend to assess the index for the purpose of finding value then we need to apply the same principles of value that we do to a single stock. In simple terms we need to know about today's dividend and the growth rate we should expect. This will enable us to establish purchase levels capable of generating a satisfactory total investment return (dividends plus growth).

The index was first measured for the Australian stock market in 1938. In 1979 the All Ordinaries was established at 500 points and in 2000 the S&P ASX200 was introduced. The first chart below (1875-2012) is an estimate of what the All Ordinaries would have looked like before its official introduction and then after. The compound growth of the index from 1938 through to 2016 is 5.7% and from 1979 through 2016 is 6.5%. The second chart is a graph for the All Ordinaries from 1982 to the present period, being the longest history Thomson Reuters has in its data base. The green line trending up is a line that fits the price action during the period, it isn't the only estimate that could be used but it feels roughly right; the growth rate is 5.1%.



The long term growth trend could be considered a line of capitalism for which market prices can deviate but not escape. The trend line could be set higher or lower but that isn't the point. Extracting the exact rate of growth from the past isn't as important as recognising that there has been a discernible trend. What is vital is the fundamental explanation of why a growth rate of near 5% has occurred for an extended time.

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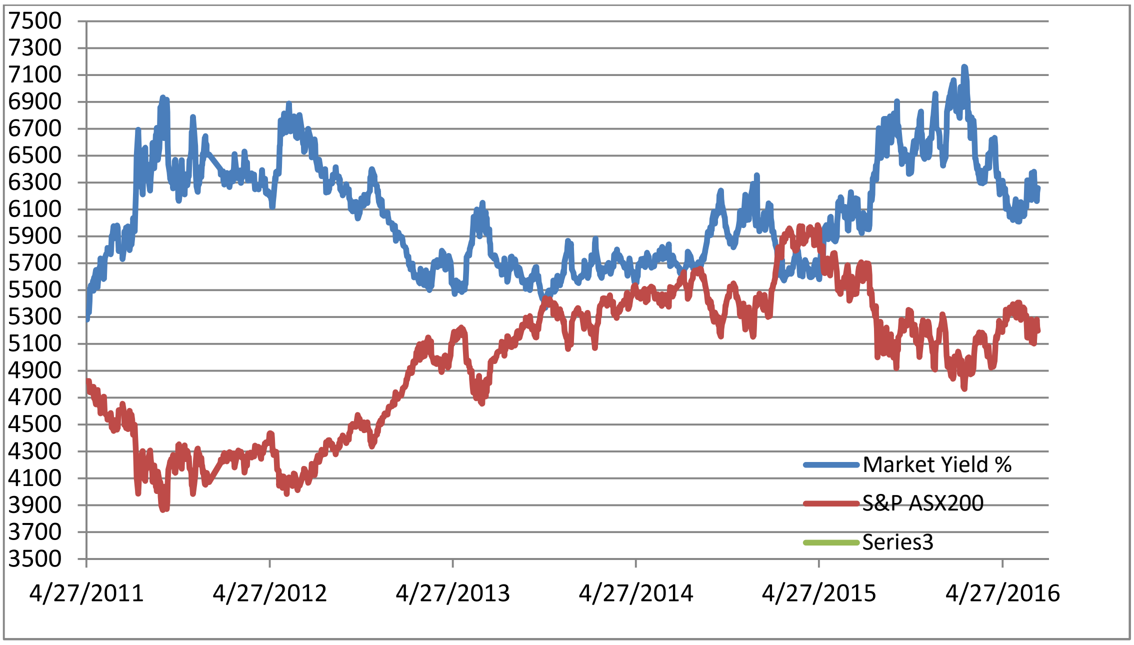
One explanation is that listed stocks on average retained around 33% of profits earnt and reinvest back into their businesses on average at about 15% return on investment. This approximates for the 5% growth rate and confirms slowly but surely the stock market is a saving and compounding machine. The other explanation is that average inflation and economic growth sum to around 5%. This confirms the broad economic picture of the country bears a relationship with the growth in market value.

An important word of caution; appreciating the long term rate at which intrinsic value is accumulating tells you nothing about what the market is going to do in the short or even medium term. We aren't predicting the index movements, rather assessing its value.

Dividend growth for the index is reasonably stable and this is the point most investors miss. In individual stocks we seek for a stream of ever increasing dividends, yet here is the index doing exactly that. Bought at the right yield the index can represent value just as any other investment. It doesn't require an investor to 'pick' the direction of the market to make money from owning the index if purchased for value. The chart below shows the yield (blue line, 6900 = 6.9%) on the ASX 200 since 2011.



We are not advocating the index as a first choice investment, or if purchased that it be held forever, far from it. We much prefer individual business with good prospects of applying capital at higher incremental rates of return bought at a good price. But every now and then, under certain market circumstance an index, seen through the prism of a conglomerate paying dividends and reinvesting for growth, can offer the prospect of decent total investor returns. A gross yield near 7% plus underlying intrinsic growth around 5% sounds like a value investment to us.

Please review the account records enclosed and let us know if you have any questions or would like to discuss any aspect of the report.

Thank you for your support over the past year and we look forward to the coming year.

Yours Sincerely

Justin O'Kane, CFA   William Allen