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 a better explanation than what you will read in the financial press.

Full Financial Year Company results for 2011/12 for the most commonly held stocks across portfolios.

Platinum Asset Management (PTM $3.60, was $3.70 last report): The 2nd Half (2H) dividend will be 13 cents (fully franked) making the full year dividend 21 cents (fully franked) down 16% from last year's 25 cents. Over the year revenue fell 14.5% and profit fell 16%. PTM is a simple business to understand with revenue and profit directly linked to the funds under management (FUM) during the period. At the start of the financial year there was $17.8 billion of FUM, by 1 January 2012 FUM was $15.1 billion and at 30 June 2012 there was $14.8 billion of FUM. The bleed of FUM in the 2H was lower than the 1H.

PTM can grow and lose its FUM from either having positive/negative investment returns on the money already invested or by attracting/losing customers. The earnings and therefore the share price are leveraged to the general market and Platinum's investment performance. In 2011/12 the market fell 11% and Platinum's investment results were poor by historical standards. Despite this and in the context of our portfolios it is important to own businesses like PTM for this exact leverage impact. I'll expand on this thought a bit later in the report.

Telstra (TLS $3.80, was $3.32 last report): The 2H dividend will be 14 cents (fully franked) making the full year dividend 28 cents (fully franked) unchanged from last year's 28 cents. Over the year revenue increased 1% and operating costs increased 1% while profit increased 5%. This means the profit growth occurred outside of general operations i.e. due to lower finance costs.

In 2008 Telstra earned $6.7 billion revenue from PSTN (think land lines, local calls etc) and $6.4 billion revenue from mobile. In 2012 PSTN revenue was $4.8 billion and mobile revenue was $8.7 billion, the trends are clear. It is true that PSTN revenue is more profitable than mobile revenue but PSTN revenue will only fall so far while mobile revenues potential is unknown. Throw in the NBN compensation and it is unclear whether the race Telstra is losing will cost more than the race they are winning. What is certain is in a business that depends on scale you want to be on the side of the biggest player. Management are forecasting more low growth this year so nothing exciting or unexciting is anticipated and in the meantime we are being paid a 40 cent gross dividend ($.28/0.7) to watch the economics unfold.

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

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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 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.

Brambles (BXB $6.80, was $7.20 last report): The 2H dividend will be 13 cents (30% franked) making the full year dividend 26 cents (25% franked), a flat result 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 2011/12 revenue rose 20% and profit rose 20%. The bulk of the increase is attributable to the acquisition of IFCO (German based RPC leader) and the continued improvement of the traditional wooden pallets business in America. All of this was expected.

The modern focused Brambles is a business I am impressed with. Scratch the surface of the results and a combination of multi currency, multi pooling businesses with continuing/discontinuing operations will keep an analyst busy for a month. Yet such analysis is a distraction from what really counts – the inherent attractive economics of a leading pooling business. In basic terms a wooden pallet costs about $18 and can be rented out three times a year for about $5 each time or $15 per year. The annual cost to rent out a pallet is about $11 leaving $4 of profit per year or a 22% return on investment. The more pallets Brambles rents out the lower the average cost of the two largest components become, being distribution/transport and repair costs. The efficiency gains are passed to the customer so more customers are attracted to Brambles thus creating a self fulfilling advantage. The misfortune of Brambles not being able to sell Recall during the year was $2 billion of capital isn't available to expand the pooling businesses. The opportunity won't go away because no one else has the scale Brambles does.

Invocare (IVC $8.45, was $8.04 last report): The 1H dividend will be 15 cents (fully franked) up 11% from last periods 13.5 cents. Over the period revenue grew 24% and earnings per share (profit measure adjusted for the issue of shares) grew 15% as the merger between Invocare and Bledisloe took effect.

Excluding the Bledisloe acquisition the rest of the business continued on with its regular performance. If I could only own one business on the ASX this would be the one and I suspect it's also the one Warren Buffett would want as well.

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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While today's share price is fully justified this isn't the price I would be willing to buy the lot at.

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.

Ramsay Health Care (RHC $23.50, was $18.32 last report): The 2H dividend will be 34.5 cents (fully franked) making the full year dividend 60 cents (fully franked) up 15% from last year's 52 cents. Over the year revenue grew 6% and profit grew 14.5%. 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 be precise occupancy costs increased 2.4%, service costs increased 3.4% and medical consumables and supplies increased 3.8% (these three representing 40% of all costs) versus hospital revenue increasing 6%. In a business where cost is king the war is won by what you don't spend.

To justify the current share price RHC has to achieve long term profitability growth of around 7% per annum from here, or put another way, double profitably over the next 10 years. While this is achievable it isn't a slam dunk – so I'm cautiously optimistic of the price movement from here rather than excited. 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%).

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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.

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%

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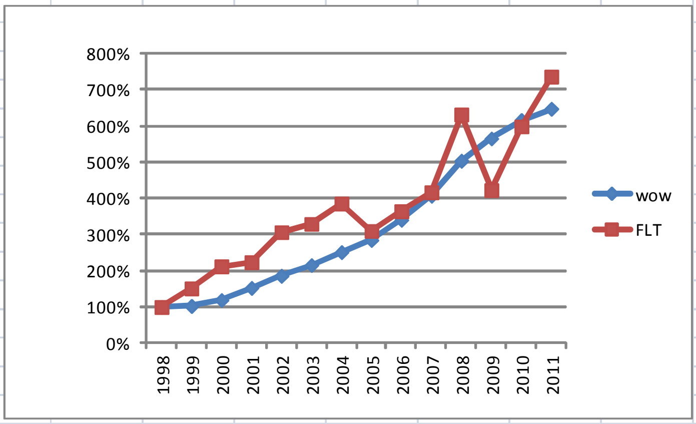
from last year's 186 cents. Macquarie Group has six business units separated into annuity style earnings and market linked earnings. The three annuity style businesses continue to prosper while the three market facing businesses suffered, Macquarie Securities and Macquarie Capital (think institutional 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%



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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.

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