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ValueLine: Asciano

By Roger Montgomery

PORTFOLIO POINT: Does Asciano's sharp price drop and bright outlook make it good value? Well no, if you consider the headwinds the company faces.

I only looked at a few companies over the holiday break, in between sitting in the shade of palm trees and losing fights with the surf that left me sorry and sore. How silly of me not to have spent more time analysing companies as inevitably there are overpriced stocks to warn you about or underpriced stocks to consider for the portfolio. There are also rogue waves that can be avoided.

This year I commit to offering my thoughts on a broad range of companies, as I consider them for the portfolio or the rubbish bin. Regardless of whether they are rejected or included, each will have a value-investing beacon shone on it and a valuation offered.

An unexpected candidate this week is a company that in 2008, on the brink of collapse, supposedly offered many investors a golden opportunity to acquire its irreplaceable assets.

Asciano (AIO) is a spin-off from Toll Holdings (TOL), which was listed in 2007 and comprises Pacific National's rail assets along with Patrick's ports and stevedoring business.

The company has a short but chequered history on and off the field. Rumours of corporate activity lurk in the background and significant shifts in the competitive landscape are on the horizon. Fascinating as these things are, they pale into insignificance when you consider the 97% plunge in value the stock suffered between June 2007 and February 2009.

This decline in the share price is in the past and investor returns are based on the future performance of the business. The company, however, offers several hurdles for the value investor. The first is the balance sheet, the second is the uncertain competitive landscape and the third the valuation.

Of course none of this is relevant to the hot-blooded corporate "investor" or industry "player" who is attracted to assets of national importance but disregards debt and net profits because interest is paid out of EBITDA … which incidentally is funded by the tooth fairy.

Recently Asciano announced it had refinanced its debt and proudly declared that it had no debt due for two-and-a-half years. With three children I can tell you that 30 months comes around quickly and, as the 97% decline in the share price shows, things can change a lot in 30 months.

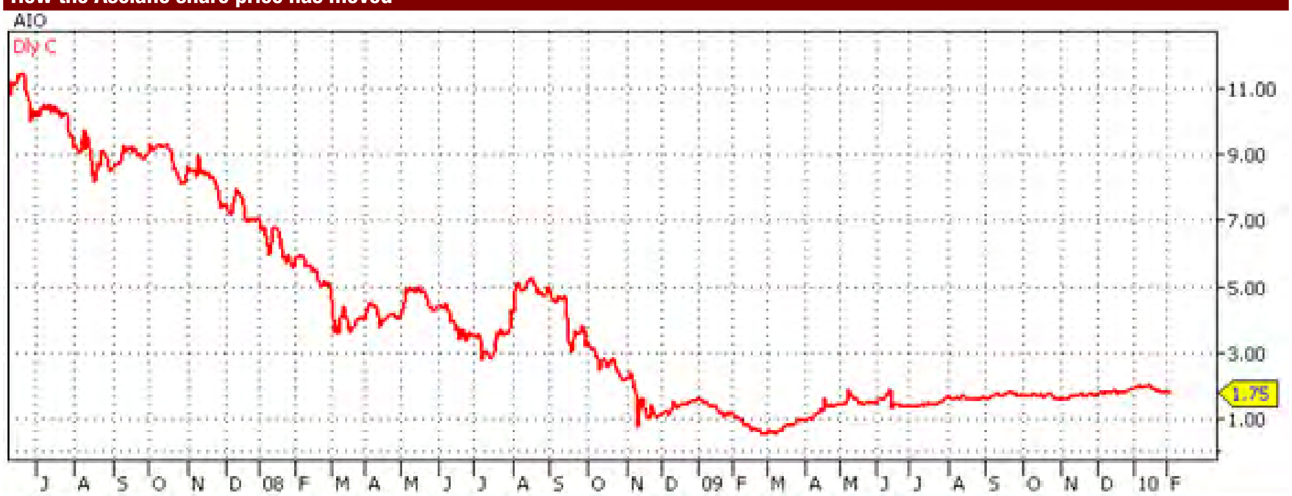
The balance sheet is not something for those who wish to sit dreaming under palm trees; reports of the company's debt-free status are incorrect.

A capital raising and debt refinancing has still left the company with a debt of $2.9 billion and $300 million in cash. That's like you taking out a $2.9 million mortgage to buy a $3.2 million house. Total forecast liabilities of $3.9 billion should be compared to equity of $4.2 billion, which in turn includes intangibles/goodwill of $3.9 billion.

The debt and the goodwill suggest investors are paying a lot for the irreplaceable port and rail assets.

Analyst forecasts for the next three years also have a hockey-stick look to them but thanks to improving imports helping the ports business and continued growth in coal haulage the optimism seems justified. NPAT is expected to grow from the $71.8 million reported in 2009 to $205 million in 2010, $263 million in 2011 and $320–400 million in 2012.

How the Asciano share price has moved



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These projections have significant risks, not merely because of the time scales involved but because of the second hurdle I referred to above: the competitive landscape.

The Port of Melbourne Corporation has indicated thatit would like to a third operator to join Asciano and DP World's P&O (which, incidentially is considering listing on its own later this year) on Melbourne's wharves. The Victorian government would move Asciano's car import operations from Webb Dock East ahead of the expiry of its lease in 2017. Asciano will argue that its lease has been breached and indeed the latest reports suggest it will sue for $25 million, but this is chickenfeed compared to the $1 billion the government will spend on the upgrade.

In addition to a shakeup of the east coast port duopoly, there are the proposed changes to the ownership of Queensland Rail (QR). The QR freight business consists of two parts and one of these, the rail track unit, is a monopoly infrastructure asset. The other, the rail freight business, is subject to competition. Under new, non-government ownership QR will have the incentive to "do a Telstra" on its competitors, especially Asciano, by charging more for the use of its network so it can offer lower prices to its own rail freight customers.

Until 2007, QR had an absolute monopoly on the rail freight business in Queensland. Now Asciano, having moved into the state's coal haulage business, has about 10% of the market. QR's new owners won't want to see this market share expand further and could restrict access to the rail track or even slacken off on maintaining the rail network, some insiders say.

Happily for those hoping for a better Asciano share price, the coal industry, with about $40 billion revenue last year and strong growth projected, has some clout and big coal companies will not be happy if their deliveries are held up.

Leaving aside the fact that Premier Anna Bligh would be doing her state a favour from a competition and infrastructure investment standpoint by "functionally separating" QR before it is privatised, the fact is that instability around the Asciano's competitive landscape means it is imprudent to be optimistic when valuing the company.

And that brings me to the final hurdle.

Asciano will report its half-year results on February 24; most analysts expect it will show the company's first ever December-half profit. If we assume that the profit projections are conservative and have taken into account lower prices in Melbourne's ports and on Queensland's rail network, the returns on equity – which others don't care too much about – will average 7% for the next three years. This is unspectacular.

No dividends are expected in 2010 but a payout ratio of 65% is expected for the subsequent two years. Taking all of this into account and adopting a 9% discount rate – the lowest I have ever given for any company – I get a valuation of 73¢.

The valuation rises for the next few years but goes nowhere near the current price of $1.70 or the brokers' target prices of about $2.

Of course, valuing a company is not the same as predicting its price and in saying that I feel as silly as I did when I said Telstra was worth $3 when it was trading for $9 or when I said ABC Learning was worth less than $3 when it was trading well over $8.

But value investors know the safest place to be is always under the palm trees with a good book, rather than out in the surf with the ever present danger of being crushed by the rocks. ◆

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