

ALAN KOHLER: HOW TO BE A BETTER INVESTOR

Money

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\$50
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PLUS

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right exposure

SUPER GAP

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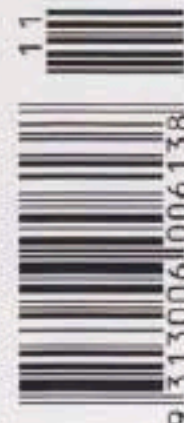
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QR NATIONAL FLOAT: WHY IT'S NOT A GOOD BUY

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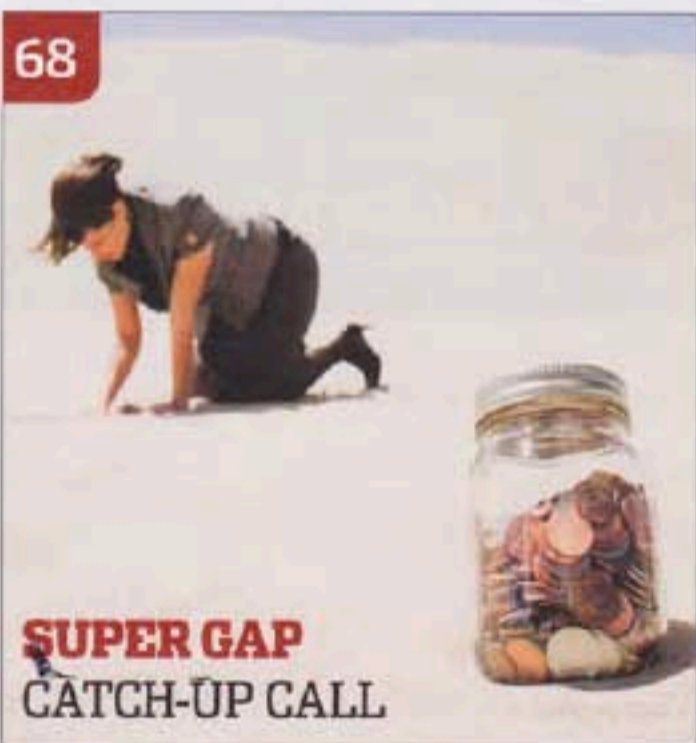
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Numbers game

Roger Montgomery has his doubts about a big new float

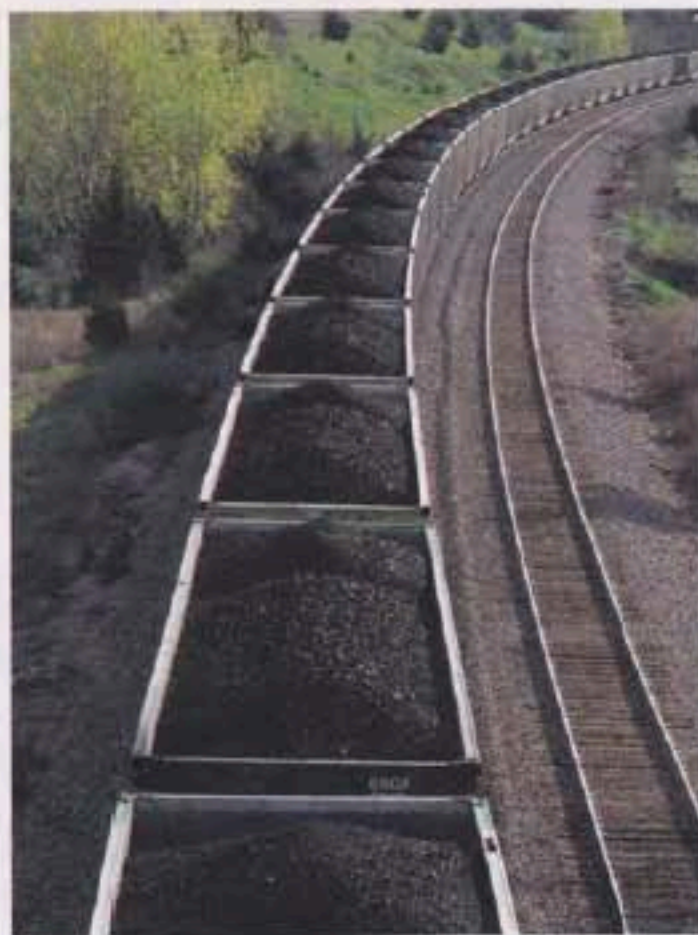
WHAT'S THE IQ OF AN investment in QR? QR National is a business you would be unlikely to have heard of just a few months ago and today it's a loss-making rail track and coal haulage business that everyone wants you to buy. The prospect of easy money can make new floats, or "IPOs", very exciting. And when the vendor's marketing machine begins its work, the company being sold can go to being a household name in just a few weeks.

QR National is the second biggest float in Australia's history and raising billions requires a multitude of public relations and promotional teams, messages and devices. How you respond should depend only on the quality and prospects of the business and the value at which it is being offered.

Our focus is extraordinary businesses, purchased at discounts to intrinsic value, so this month I'll cut through the spin and talk of "icons" associated with the float of QR National, to bring you the numbers I believe matter.

QR National is described as having two businesses, the "above rail" business, which is the operation of rolling stock for freight haulage, and the "below rail" business, which covers operation and management of rail track. The above-rail business commands a 52% market share by revenue and its nearest competitor is Asciano with 35%. The below-track business is a monopoly but, despite this and the fact that coal hauled has quadrupled since 1985, QR Limited reported a loss of \$37 million in 2010.

The explanation offered for this is that a state government has owned the company and consequently the cost structure was inefficient, while business development resulted in long-term contracts written with customers, such as BHP Billiton, on terms that were uncommercial for QR National.



A company-wide restructure combined with customers rolling off old contracts and onto new, more commercial ones as well as continued growth in coal haulage volumes, is expected to result in a profit of \$369 million in two years' time.

The restructure, however, is not as clean-cut as it may first appear. The company will receive \$150 million from the state government in 2011 and \$148 million in 2012 and the government will continue to own 25% to 40% of the company for roughly the same period – three years – as its employment guarantee for 9500 staff. Let's put this to one side and concentrate on the numbers that have been provided.

Following the float, QR National will have a balance sheet with about \$6.8 billion of equity, representing the funds that have been put in and left in by the owners. It is against this number you should measure the optimistic profit forecasts. If QR National hits its targeted 2011 and 2012 profits, that equity will grow to \$7.3 billion, excluding any profits retained through the proposed dividend reinvestment plan. And if QR National hits its 2012 profit forecast, return on average equity will equal 5.1%. This return compares unfavourably with the returns available from government-guaranteed bank accounts and term deposits. Indeed, selling the entire operation for one times the equity and then banking the proceeds will generate a higher return.

At the prospectus launch, the chairman was quoted as saying: "We offer outstanding prospects in terms of profitability." In

light of the 5.1% return, one wonders if he might have been referring to some other company. And the low returns on equity make you wonder why management will receive millions in remuneration over two years – to run a business forecast to generate a lower return than a bank account.

Perhaps most importantly, the business's capital-intensive nature means the company will be cash-flow negative – and that's before dividends are paid. Between 2008 and 2012 QR National will have expended \$7.2 billion on capital and to fund the future gap (pardon the pun) in cash flow, it will need to borrow a couple of billion dollars.

Recently QR's chief executive said agreements signed with iron ore producers would see iron ore volumes trebling in the next few years. To put this in perspective, 95% of the country's iron ore exports are transported on above-rail assets owned by BHP, Rio Tinto and Fortescue Metals.

It has been claimed that QR National is difficult to value because, for example, a \$1.1 billion capital investment in the development of additional below-rail assets means there is a lag between investment and returns. But this is true of virtually all investing and, in any event, when the GAPE tracks are fully utilised they will return \$170 million before interest, tax, depreciation and amortisation or by my estimate, \$60 million after tax, interest and depreciation. This 6% return on funds employed (all debt) is nothing to write home about and will have a minor impact on the overall returns on equity.

I estimate QR's shares have an intrinsic value of between \$1.09 and \$1.50 – in 2012 that is! This is a long way from the \$2.40 to \$2.80 price you are being asked to pay now and, while it's not a prediction of where the price will trade, it is enough below the price being offered for me to conclude that little or no margin of safety exists.

Valuing a company is not the same as forecasting its price and, while the price may rise substantially – there are plenty of devices being employed by the promoters to make sure it doesn't slump – you won't find it in my portfolio.

ROGER MONTGOMERY

Roger Montgomery is a value investor and fund manager. His book, *Value.able*, is available at www.rogermontgomery.com