Roll-ups make national sense

Dogs, kids and dentists put some smiles on investors' faces

ROGER MONTGOMERY

CONSIDER for a moment how long in advance you need to book to see your dentist or how long it takes to get your child on to the waiting list at your closest childcare centre, or how often you take your pet to the vet for a check-up.

I'm sure that as you thought about this a local operator came to mind for each category. But it was only a local business, not a national brand.

In these sectors there's no name synonymous with dentists, vets or childcare centres. There's no Woolworths, Coles, Pepsi or Coca-Cola in these categories, yet each of these services is in constant, high demand.

This is the environment conducive to roll-ups.

A roll-up is the term used to describe the acquisition of many smaller and similar businesses by a company. In theory, roll-ups reduce costs through economies of scale and attract more revenue through better branding and awareness.

When launching a roll-up strategy, one of the more important considerations is industry stability. And on that basis the three aforementioned industries are particularly well suited to consolidation.

Three listed companies are vying to become the national brand, one in each sector.

G8 Education is a company that has emerged from the wreckage of ABC Learning. As an aside, ABC Learning is the classic example of what can go horribly wrong with a roll-up model that takes on too much debt to fund the acquisitions.

G8 has been careful to not replicate ABC Learning's failings by financing most of its expansion through equity rather than debt.

The highest offer management will make to purchase a local operator is four times its earnings before interest and tax; publicly listed companies will usually trade on multiples of five to six times earnings. This strategy is proving effective, with G8 earning a 25 per cent return on invested capital.

Aside from the forces of demand and supply that make the market attractive, there is another element of the childcare market that G8 Education is particularly focused on to drive its consolidation strategy.

Increasing government regulation is beginning to overwhelm single-centre operations. G8 is carefully acquiring those centres that are profitable but do not have the capacity to stay abreast of changing regulations. The company has much potential to grow, as its network accounts for only 3 per cent of the long-care market.

Our next roll-up hopeful is Greencross, which is consolidating veterinary clinics. The veterinary industry has become conducive to roll-ups thanks to two dramatic shifts in recent years. Until recently, ownership of veterinary businesses was limited to veterinary professionals. Regulations have since changed to allow non-veterinarians to become shareholders, and Greencross has been the first company to launch a land grab.

The second shift is the standard of care that pet owners are providing for their "significant others".

Veterinary services were traditionally used on a reactive basis. If the family dog was sick in the middle of the night you would rush down to the local vet. Of course in rural Australia a completely different and much cheaper approach is often adopted. But pet owners have become proactive in their care. This means high demand for preventative medicine and loyalty programs. With customers paying for services in advance annually, Greencross is receiving a considerable cash float that it can use to fund further acquisitions.

This is a critical element of Greencross's long-term strategy as so far it has been funding acquisitions with uncomfortable levels of debt.

The net-debt-to-equity ratio is at 80 per cent, but management believes gearing will trend below 65 per cent as the business network matures.

As an aside, a common feature of veterinarian clinics is that they usually serve as the owner's residence. This is an added consideration for Greencross management during negotiations, though it shouldn't impede the growth plans of one to two acquisitions a month.

The final roll-up is 1300 Smiles, which provides dental surgeries to self-employed dentists.

Essentially, the dentists pay a management fee in return for the rooms, facilities and staff, while the head office takes care of the administration. The revenue is typically divided 60 per cent to the head office and 40 per cent to the dentists.

The company has a lot of scalability — it has 24 sites, all located in Queensland. However, management has refrained from making any new acquisitions since the end of last year after the federal government suddenly withdrew funding for the Chronic Disease Dental Scheme.

The CDDS was the biggest client in the dental industry, providing payments of about $1 billion, or 20 per cent of total industry revenue. It is very rare for an entire industry's revenue to suddenly decrease by 20 per cent (unless of course you dig iron ore out of the ground). 1300 Smiles is well positioned to act once the dust settles; the balance sheet has no debt and lots of cash.

Meantime, management is launching a program to get more people to the dentist; 70 per cent of people do not visit the dentist regularly.

Having more people going to the dentist will not only help the company's bottom line but also ease the pressure on Australia's health system.

So there you have it: three companies attempting to become national icons in their respective fields. With any luck they just may build a brand as big as roll-ups themselves.

Roger Montgomery is the author of Value.able: How to Value the Best Stocks and Buy Them for Less Than They're Worth, available at www.rogermontgomery.com

TAXING SUPERANNUATION WILL RAISE PENSION COSTS

Short-term fix too costly

ANDREW MAIN

A SENIOR consulting actuary has questioned Treasury and the federal government's numbers on which they based last week's announcement about taxing payments made to some retirees, calling the existing tax system "sustainable".

David Knox, senior partner at superannuation consultants Mercer in Melbourne, describes the methodology behind the changes as "a flawed approach" because it uses superannuation tax break figures without considering the savings the government would make in reducing age pension payouts.

"The changes improve sustainability, but only slightly — assuming there's no change in the behaviour of the people facing the new tax," Dr Knox said.

He isn't critical of the federal government so much as what he sees as the misinformation that has been bandied around, such as the so-called $32 billion and growing "Treasury number" of tax concessions being given to superannuants.

"The problem with that number is that the estimate of the cost to government of superannuation tax concessions is only part of the story. These savings are totally ignored in the commonwealth Treasury tax expenditure figures.

"With the inevitable increasing costs associated with an ageing population, age pension costs and savings must also be included in any reasonable debate about Australia's retirement savings and income system."

He said time was an important dimension in the relationship between the super tax breaks and the age pension savings. "That time factor spans generations. Simply put, as the super industry matures, the age pension savings will increase. This is especially important as our population ages and other cost pressures build. At the moment, the age pension savings are modest because many retirees had very limited super. That won't be the case in future years."

He made it clear a lot of the noisy debate in recent weeks about superannuation and tax had been focused on the short term, adding that "Australia's three pillar retirement savings and income system of compulsory super, voluntary contributions to super and the age pension really does provide equitably for all in their retirement".

Dr Knox said it would be of major importance to make sure the superannuation system interacted with the age pension to produce the best outcome for retired people and for the federal budget.

He produced a graph showing when average income earners worked for 40 years and retired for 20 thereafter on their own superannuation (which has yet to happen because the superannuation savings of people retiring now are usually not big enough to do that) "it is clear the accumulated superannuation benefit reduces future age pension payments at a significant saving to government". And although our super system is still a work in progress because of the existing lack of savings, "in the future we will have fewer people receiving the full pension, as the super system gets bigger".

"Age pension savings to the government in the next 20 to 30 years will also get bigger, and that's what is being ignored" by people who saw the system as unsustainable, he said.

Looking at Australia's position globally, he said that our age pension costs were regarded as "quite moderate" because we didn't have the social security network of countries such as Britain and many European countries.

"We have an ageing population but, unlike a lot of countries with zero population growth, we have net immigration and our situation is nowhere near as bad as in many parts of the world."

On the issue of superannuants with balances as high as $10 million potentially skewing the system, he said the present system of caps for concessional ($30,000 a year) and non-concessional contributions ($150,000 a year) would make it hard for such balances to be built up in the future.

But it would be important for tax concessions to be retained to encourage saving into super.

"Tax concessions to superannuation are an investment in the future because they mean there will be less pressure on future budgets," he said.

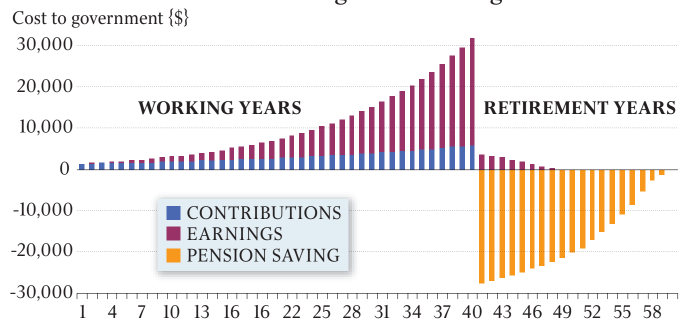
If super tax concessions were removed, then the equivalent amount of money would flow into government coffers was a misconception.

"This is not the case," he said. "Treasury acknowledges behaviour would change and the potential revenue gain would be much lower than the quoted value of the tax expenditure."

DAVID GERAGHTY

David Knox says the government's figures were flawed because they did not include the cost of pensions

The calculated costs and savings for an average income earner



Source: Mercer

Super tax proposal 'a political stunt'

ANDREW MAIN

OPPOSITION superannuation spokesman Mathias Cormann is in an unusual situation: he's dumping on the federal government's proposed tax changes to super, announced on April 5, but says they have "no status" because they won't be legislated before the election in September that he and his Coalition colleagues hope to win.

He says the purpose of the announcement by Wayne Swan and Superannuation Minister Bill Shorten is "to declare those supposed savings as revenue to be included in the budget, and spent, but they won't legislate it".

Cormann, who has never been one to hold back, describes the announcement as "a political stunt by a desperate government to get people off its back".

He hasn't formally declared his policy positions on the announcement, probably because he doesn't sign off on the policy and it will all be subject to the state of the budget if the Coalition wins the election.

He also says the Swan has not ruled out making further changes to super when the Treasurer hands down the budget next month.

But Cormann and his colleagues firmly reject the 15 per cent tax on earnings from pensions and other such structures for the over-60s that is designed to raise $350 million over four years.

They object to the tax, ostensibly to be levied on people earning more than $100,000 from their pensions in retirement, for two reasons. The first is political, regarding it as a breach of the Labor government's promises made in 2010 and in February not to tax the payments made to the over-60s.

"That is 100 per cent a broken promise," Cormann says, noting that there are currently no taxes on earnings or payments in relation to the over-60s.

The other reason, of much more practical interest to the super industry, is that he does not believe the tax system on super is as unsustainable as is being made out by the government. What's more, any move to increase taxes on people's super savings, or to remove the incentive for people to save for their old age, "is merely going to make more people dependent on the age pension, which we don't want".

He picks on the Treasury number of the supposed "$32 billion" of tax breaks that the Australian tax office has been giving to super savers in 2012-13, rising to $44.8bn in 2015-16. The numbers have been discredited for being gross rather than net, for instance ignoring the impact on age pension payments, but Cormann says the misleading number wasn't Treasury's fault.

"It is the government that imposes assumptions that they have to work with," he says, sounding a lot like a man preparing to work more closely with Treasury after September.

His overall line is that "the Coalition will not make any detrimental unexpected changes to super over the next term of parliament". But he has a number of points that indicate clearly which way he's headed, even via the prism of the "no status" announcement from Swan and Shorten last week.

One is that he doesn't want to see any move to discourage Australian workers from saving for their retirement and sees the notion of a tax break as integral to that philosophy.

"The reason that people pay less tax (currently 15 per cent across the board) on their contributions is that they have to agree in exchange to lock their money up for what might be 20 or 30 years," Cormann says.

Another is that some policies, such as the extension of concessional tax treatment of deferred lifetime annuities (DLAs), are worth looking into but on a wider basis than that proposed.

"What the government has proposed is one possibility, for one product," he says.

DLAs are currently not offered because the buyer has to pay tax on the annuity's earnings even if the annuity's payout period, often starting around aged 80, has not yet begun.

"Let's make one arrangement apply and see what the providers plan to offer if that happens," Cormann says.

He says other types of annuity could be devised.

He made similar comments about the proposal to tax excess concessional contributions to super at a lower rate than the swingeing 46.5 per cent rate.

While he says a Coalition government would consider the proposal favourably, "the announcement doesn't touch on the penalties ruling on non-concessional contributions on which tax has already been paid".

He says any move on excess contributions should look at non-concessional as well as concessional contributions and that "surely the government can't be basing its revenue on the basis of people making inadvertent errors".

Market may have peaked for now

MICHAEL GABLE
A CHARTIST'S VIEW

OUR market has peaked and last month's high may not be surpassed for several weeks.

That is what the charts are telling us. Since November our market gave us 16 consecutive weeks of "higher highs" and "higher lows"

If the definition of an uptrend is a series of higher highs and higher lows, then this particular one was as good as it gets.

Since peaking last month, the uptrend has broken and a downtrend has begun.

You will remember that during this uptrend, the pullbacks in the market were very shallow. There was no "panic selling".

However, on February 21, the ASX 200 index fell nearly 118 points in one day.

In my opinion, that was panic selling and represented an inflection point in investor sentiment. My advice since then has been that the markets will take a breather for at least several weeks.

Just in the past few weeks, though, the weekly chart of the ASX 200 finally gave us the ominous reversal signal that many analysts were looking out for.

If we look at a candlestick chart, we can see what is referred to as an "evening star formation".

Candlestick charts are a method of showing price movements within a given timeframe.

On this weekly chart, each candlestick represents a week's price action. If the candlestick is white, it means that the market closed the week higher compared to where it opened on Monday morning. If it is black, the market closed lower than where it opened.

The vertical lines at the top and bottom of each candle show the intra-week extremities in price action. The evening star formation is a combination of three candles.

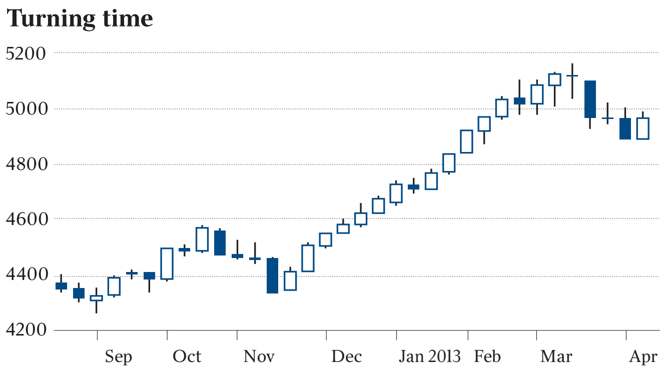
At the end of a trend, you see the market closed quite a bit higher than where it opened. The following week we can see that it closed about the same level where it opened, even though during the week it traded lower at some points, and higher at others.

The fact it settled back to the same level means there has been indecision in the market. Are we heading higher or lower? That was resolved the following week when the market opened lower and then finished the week much lower again. These three candles create the evening star formation and tell us that the uptrend has reversed and we should expect a period of weakness in the market.

I was anticipating the ASX 200 would initially fall into support around 4880. Now that it has done so and rallied above 5000 again, it will be critical to see if we can go to a new high.

Michael Gable is a private client adviser at Novus Capital.

Turning time



US hedge fund out to lure Aussies

KATHERINE JIMENEZ

US hedge fund Blue Mountain Capital Management has made its first foray into Australia after securing its first institutional mandate, wealth management group MLC.

Blue Mountain managing director Jay Bryant confirms that after a four-year search it has secured a "significant" investment from MLC for its flagship fund, the $5.7 billion Blue Mountain Credit Alternatives.

"We are pleased to have our first Australian investment. It's a big deal," says Bryant, who has high hopes for the Australian market.

The main appeal is Australia's $1.5 trillion superannuation system. "From a US manager's perspective there is a large amount of money in the hands of some pretty sophisticated investors, who in some cases recognise the value of specialised managers and are prepared to pay fees to get," he tells Weekend Wealth.

"The reason that everybody from New York is showing up in Sydney and Melbourne is because we think that we have a product that fits . . . We think we have a product that makes sense for this market.

"You are probably not going to see many beta-driven managers here . . . (but) you are going to see a lot of people who have demonstrated that they can make money across market cycles . . . because this market wants that."

The 10-year-old group, which is best described as a relative value multi-strategy credit fund, has $15bn in funds under management. It is also partly owned by global asset management group Affiliated Managers Group, which has stake in the hedge fund.

AMG has equity investment stakes in several investment managers around the world.

What separates Blue Mountain from its peers is its "relative value" investment approach to credit.

"For most of the rest of the market, credit investing still means directional and beta-driven (strategies)," says Bryant.

"But really that strategy only works until it doesn't (and) when there are big market reversals you have to give back a lot of what you have made."

> 'There is a large amount of money in the hands of some pretty sophisticated investors'
>
> JAY BRYANT
> BLUE MOUNTAIN

Relative value investing in credit means that Blue Mountain rarely takes out outright directional views on the market. Essentially, it makes money by "trading related sets of instruments that diverge from fair value or contract."

For example, within the BMCA fund there are three strategies.

One is fundamental credit, which encompasses a long and short strategy. The other two are structured credit and index arbitrage, a strategy that aims to profit from temporary mismatching between the prices of credit default swaps or derivative comprising an index and the price of a futures contract on that index.

Bryant sees its goal in Australia as being "when Australian super investors think about credit, I want them to think about Blue Mountain".