Proceed with caution

Roger Montgomery runs a market darling through the Harbour Bridge test

AT THE MONTGOMERY FUND WE are more than a little enamoured with a measure of economic performance known as return on equity. A business that can generate a high rate of return on retained profits and incremental equity is tantamount to reinvesting the interest of a bank account at a very high rate. You would never want to withdraw your money from such an account.

To be able to sustain such a feat, a company needs to have more than just a warehouse, shelving and a production line. It needs something that typically cannot be replicated easily: a competitive advantage And the most valuable one is the ability to raise prices.

Now, think about what you need to charge a customer whatever you liked; the only toll bridge in town is perhaps the simplest example – owning Sydney Harbour Bridge would make you incredibly wealthy. So, too, are the long-term shareholders of REA Group (ASX REA), which owns www.realestate.com.au – another toll bridge.

REA just reported another half-year of growth with revenue up 30% and both net profit and earnings per share rising 37%. Its Australian business accounts for 78% of all minutes spent online on local property portal sites. That's equivalent to 78% of all the cars in a country crossing your bridge every day. And more cars are likely to cross if property prices go higher.

Of course, one needs to be satisfied that cars will continue to drive across the bridge and, ideally, in increasing numbers; that the bridge isn't deteriorating and requiring costly repairs; that there isn't a superior bridge being built next door; and that not too much is paid for the construction or purchase of any other bridges. And a new owner needs to know if the price they pay is reasonable.

In REA's case the answers are mixed. While the recent result blew away all claims that it is a mature business, investors are left with the question of how many more cars can cross the bridge, whether prices can be increased and whether the bridges bought overseas will be as successful as the one it built here. Unless you can positively answer these questions, it may be that new investors cannot justify buying at today's prices.

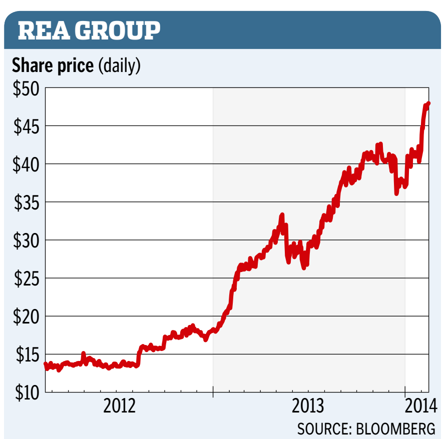
It seems the opportunity to build more market share here is limited. But growth in revenue and profits can come from raising prices – thanks to its monopoly position –

> REA is priced as though nothing could go wrong

or offering ancillary services. Indeed, REA has noted that the value it delivers is well in excess of what it charges, which indicates both scope and intention to raise prices.

It could also charge for services, including generating leads for mortgage providers removalists and other service providers and REA believes that the total scale of the property transaction market is very large.

Internationally, REA is No. 1 in the Italian market, with an average monthly unique audience 1.4 times that of the nearest competitor. The structure there, however, is different, as the agent, not the vendor, pays for the advertising of the property. While REA doesn't enjoy the sort of dominance in Italy that it enjoys here – partly the result of lower internet penetration – it may over time and a population of 70 million is a large opportunity. REA is also No. 1 in Luxembourg and Hong Kong and, while the regions contribute little at present, there is significant potential upside.



Every investment has its risks and for REA these include an expensive local housing market, the ever-present risk of losing dominance and, perhaps most alarmingly, that it seems to be without a long-term solution to the departure of both its CEO and chief financial officer. Finally there is the risk of paying too much. At 40 times estimated earnings for full-year 2014, there is no doubt REA is being priced as though nothing could ever go wrong.

At Montgomery we can obtain a range of valuations from $26 to $40, depending on assumptions. If we assume return on equity of 40%, a cost of equity of 8.5% and a reinvested capital rate of 21%, we end up with a valuation of just $26.50. But REA has been able to reinvest about 50% of its profits and it's tempting to assume this will continue indefinitely (producing an estimated value of $40). The reality is that as it retains more and more cash, a larger proportion of its asset base will earn just 3% and the residual assets will have to dramatically increase their profitability above already extraordinary rates. We'd be delighted if they achieved this but, at current prices, we aren't prudently managing our investors' money if we speculate that the company will.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*