Common sense yields rich returns

We're held back by red tape and lack of realism about China

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GLOBAL INVESTOR

MANY people ask why Australian ultra-high net worth investors typically invest more of their wealth in foreign markets compared to others.

The answer may be found in a small Dutch town called Drachten, where a road death happened on average every three years. In 1999, the local municipality decided to remove all traffic lights and signs, hoping people would pay more attention to the road and not fixate on rules and regulations. Since then there has not been a single road death.

This suggests that allowing more room for common sense yields better results. It may also illustrate the perils of too many rules and not enough ingenuity.

Even in light of the recent wave of long overdue reforms, Australia is still the OECD's most over-regulated, red-taped, bureaucratic economy. Bureaucracy of this scale has not only stifled productivity growth — arguably the most important engine of genuine economic growth — but has also subdued common sense.

UHNW investors — unlike many other investment communities in Australia that are prescriptively mandated to invest heavily domestically — have often chosen to seek opportunities abroad where, they believe, rules, ingenuity and opportunities are better matched.

They believe that until Australia is clear about what are the best goods and services it should produce and which trading clients have longevity, the better opportunities are often found abroad. As mentioned in last week's column, this community has recently sought opportunities in North American equity markets, Chinese corporate credit spreads and regional currency pair trades (we'll discuss the yen and Abenomics in columns to come), to name but a few.

The Robert Ringer makeable deal theory posits that it is far more efficient to work hard on finding a few makeable deals than to work hard on an endless number of unmakeable deals which have little possibility of closing or yielding an attractive return. This theory is deeply grounded in common sense. An intelligent person can find any number of unmakeable deals but only those who enjoy good judgment have the common sense to pursue and acquire makeable deals.

Australia has many potential makeable deals but has done a miserable job of connecting resources, ingenuity and capital. It could well be argued that all we need to do is value the importance of rediscovering common sense.

Last year's Nobel economic sciences laureate Robert Shiller says "we seem to be at the mercy of our narratives", and this aptly reflects Australia's position. Our groupthink surrounding the plight of China and our belief that it has an obligation to purchase our iron ore is irrational and lacks all sense, let alone common sense.

Even though we are explicitly told demand for iron ore is waning and our mining capital expenditure is rapidly diminishing, too many Australians remain over-allocated in mining shares and commodity exposures.

We get angry at an economy that has more than a billion people because its headline growth marginally slows, even though it is still four times as high as ours, and because it no longer seems to want to buy as much of a product it no longer requires — at least not in the same quantities as before.

Australian UHNW investors see the lack of common sense in this thinking and have moved on, while many others remained fixated on an old story. These UHNW investors are out there scouting for the makeable deals of 2014, not the redundant and unmakeable ones of 2010.

What's more concerning is that many still fail to understand the China story, and China's and Australia's roles in the triumph of globalisation.

The concept of globalisation is not a new one, although the stars finally aligned for this paradigm only when Ronald Reagan and Margaret Thatcher led the world aggressively down a new path of economic liberalisation, market reforms and genuine reductions in tariffs, oversight and bureaucratic overreach during the 1980s.

Aligned with this renaissance in economic remodelling was an unprecedented push for economic globalisation, especially between the then developing and developed worlds. Whether it was in Latin America, Asia or eastern Europe, the developing nations were strongly sold on the idea of participating in globalisation.

In essence, the pitch was that as they became the developed world's outsourced manufacturing hubs (as the "invisible hand" deemed them better suited at that point to manufacture due to their then cheaper labour costs), they would export these manufactures back to the developed world.

By doing so, they would slowly but incrementally become richer, and in due course they would become affluent and evolve into a consumer-led economy just like the developed nations.

Countries such as China that, coincidentally at that same time, were looking for a new market-led model, tacitly accepted this accord and championed it with zeal.

Jumping forward 30 years to present-day China, this economy has reached that mature stage of the globalisation paradigm and is ready to progress to the next level of becoming a consumer-driven economy itself. The Chinese kept to their end of the bargain (from 30 years ago) and now understandably want what they were promised: a developed, prosperous consumer economy.

So as investors, when we see Chinese export numbers normalising or even declining, we should not see an economy in decline but more an economy progressing and evolving exactly as scripted a generation ago. As investors, especially here in Australia, we need to change our thinking with the times. No longer should we think of China as solely an exporter but also now more and more as a consumer economy ready to import all the developed goods and services an advanced economy such as Australia could offer.

There are now more than 1.5 billion of our northern neighbours who want all the consumer staples we have been enjoying. This new reality bodes well for Australian businesses and investment communities.

It is time to take heed of the pioneering efforts of many UHNW investors and to take action on engaging China beyond selling it our resources, wines and ugg boots. Rediscovering the importance of common sense is an intelligent start.

Larkin Group is a wholesale wealth advisor focusing on high-yield regional investments. Contact Stirling Larkin via email at stirling.larkin@larkin.org.au

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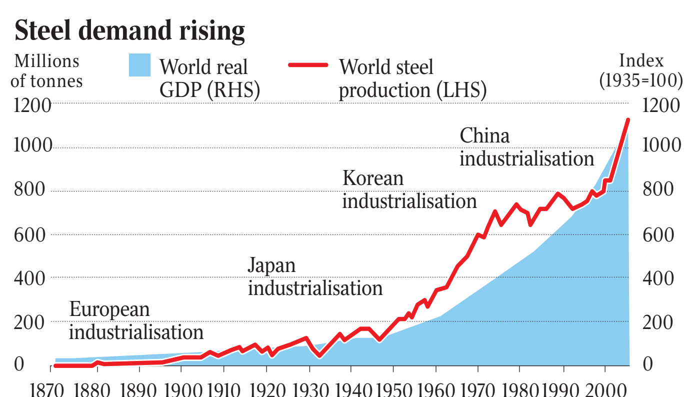
Nobel economic sciences laureate Robert Shiller says 'we seem to be at the mercy of our narratives'

Steel demand rising



Distributor set for a healthy future

ROGER MONTGOMERY
VALUE INVESTING

LAST year saw the Montgomery Funds participate in and support several floats. At first blush you might wonder how such activity fits with our preference for businesses with "demonstrated track records". Just keep in mind that a new float isn't always a new business.

Perhaps the least covered float, and one we supported, was that of medical device distributor LifeHealthcare.

LifeHealthcare is no speculative biotech dreamer, nor is it a business replete with patented intellectual property. Unlike a Cochlear or ResMed, it does not research, design or build hi-tech devices. It mostly distributes them for others.

LifeHealthcare raised $76.6 million through an IPO and listed in December. With so many other notable listings, it was easy to overlook. Its shares initially fell below the $2 issue price, thanks to what we believe to be its small size and the quick trigger fingers of institutions that were looking for a quick flip. The shares are now at $2.16.

LifeHealthcare's biggest selling points are leverage to the defensive healthcare sector, rising demand for medical devices, and a strong industry position and record. Its position as a large, independent distributor of medical devices is deceptively complex. Its advantage is, I believe, built on three sources. The most important is the 62 highly trained sales representatives, often with medical backgrounds, who form relationships with surgeons, specialists and hospitals. The depth of this team — and its relationships — are valuable assets.

The second plank of its competitive advantage is customer relationships. Surgeons are the key customers for LifeHealthcare's devices. In FY13, LifeHealthcare provided implantable devices to 300 surgeons in Australia and New Zealand who were responsible for 91 per cent of revenue from its large implantable device division. A key metric is the number of "active surgeons", which LifeHealthcare defines as those generating more than $50,000 in annual revenue. The company's first-half FY14 earnings presentation showed 91 active surgeons and it is on track to meet the FY14 forecast of 97.

The third plank of competitive advantage — supplier relationships — is just as vital. This is a fiercely competitive and lucrative market. LifeHealthcare has to continue sourcing the latest products from the best suppliers to satisfy customers. As it adds more "active surgeons", suppliers are attracted to LifeHealthcare's leadership in its key markets. Suppliers know that if they want to get their products into the hands of key surgeons, they need distributors that have the relationships. LifeHealthcare has deepened the supplier relationship through a range of services. For example, it works with suppliers in areas such as regulatory affairs and clinical education.

Taken together, these competitive advantages provide the seeds of a powerful network effect. Having the best people with the best relationships selling your products becomes a formidable barrier to entry for new players.

The best measure of competitive advantage is returns on equity over long periods. As shareholder equity builds, and the return on that equity rises, the company's intrinsic value increases. LifeHealthcare's ROE has risen from 20.3 per cent in FY10 to a whopping 41 per cent in FY13. Net debt of $23.3m in first-half FY14 implies a net debt/equity ratio of 56.5 per cent. The debt should fall over time given its surplus cashflow and ability to fund growth internally. The business has clear growth opportunities. The implantable devices market enjoyed compound annual growth of 7.7 per cent in Australia and 12 per cent in New Zealand over the five years to 2013. That will surely rise as the population ages.

There is a lot to like about LifeHealthcare. But the market is well aware of its strengths — at least for now — judging by recent price gains. We estimate LifeHealthcare's intrinsic value to be $1.97 a share, rising to $2.03 in two years. At $2.16, LifeHealthcare is fair value, but not a bargain.

Roger Montgomery is the founder of Montgomery Investment Management.

Fortune could favour investors willing to test their mettle on Capral

UNDER THE RADAR

RICHARD HEMMING

CAPRAL'S stock is wallowing at 14c and reflects the massive forces working against this Australian manufacturer of aluminium products, but there could be riches for the brave.

One who has a record of bravery, in an investment sense, is the high-profile value investor Simon Marais, whose $4 billion-strong fund Allan Gray announced last month that it had increased its holding in Capral from 18.4 per cent to 19.3 per cent.

Marais acknowledges that it will be a struggle for the company, which competes with foreign importers who get more bang for their home buck when it comes to selling aluminium products in Australia, where the domestic currency is still very strong.

But he also sees the rewards that can come from investing in a company that has massive operating leverage, which refers to its high gross profit margins once its fixed costs are covered.

"It could go bankrupt. That is the risk for equity investors. On the other side, it could easily get to 50c if its volumes rise. It doesn't have any debt, and it's washing its face (covering its costs), so the potential is there," he says.

Allan Gray typically invests in stocks that are "unappreciated" by most investors, and this can easily be said of this struggling manufacturer.

Less than 10 years ago when Capral's stock traded at more than $17 and it had a market cap of $270 million, there were virtually no imports of aluminium extrusion into Australia. Today, its market cap is $69m and reflects that imports represent 40 per cent of the domestic market.

Not helping the situation is that much of the foreign imports come from China, whose companies are subsidised heavily by the state. In contrast, Australian companies are given little protection. Imports are taxed at 6 per cent, which is easily absorbed. Contrast this with the US, where imports receive a 40 per cent impost. Despite this, the company is experiencing a significant tailwind in rising dwelling construction, which at the housing level is climbing at about 8 per cent a year in terms of numbers, according to a BIS Shrapnel report released last month.

There will be a delay in the positive impact, says Capral chief executive Tony Dragicevich.

"There is a three to six-month lag between our products going into buildings and the start of construction activity. We are definitely starting to see an increase in housing market flow through to manufacturing volumes."

Capral also has going for it its bigger distribution capabilities following the acquisition late year of One Steel Aluminium, which puts the company on track to more than double its earnings before interest, taxes, depreciation and amortisation for fiscal 2014, if the volume in housing construction translates to its bottom line.

In calendar year 2013 Capral reported an underlying EBITDA of $4.1m and it has given guidance for the current year of between $8m and $10m. One broker forecasts EBITDA to climb as high as $15.5m over the next two years, but we imagine such forecasts are based on a continued weakening of the dollar.

No doubt, Capral shareholders all hope for this to occur, but what would be more meaningful is a tougher stance by Australia's government on import dumping.

Richard Hemming is an independent analyst who edits undertheradarreport.com.au, which provides investment opportunities in Small Caps. The author does not own shares in any of the stocks mentioned.

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