Bringing the shell back to life ...

UNDER THE RADAR

RICHARD HEMMING

THIS time last year, the market for ASX-listed shells was dead.

Today, the business is thriving, with some lucky investors making five times their outlay in a matter of days. Or not.

Shells are not just home to marine molluscs, but are also financial organisms. A shell company is one whose main asset is its ASX listing. These companies are used as vehicles by sectors where demand is running hot to gain a listing.

Private investor Andrew Brown has been involved in a number of "backdoor" listing situations and says the emergence of cloud-based hosting systems in Australia has been the catalyst for bringing the shell back to life.

"A year ago you couldn't give shells away. The IT boom being experienced overseas wasn't permeating to Australia. Shells have predominantly been used for mining, but people couldn't raise money easily.

"Now mining companies provide the shells and we've seen four or five in the past six months on IT/cloud speculation."

The pricing of shells is the premium paid over net assets and is a good indicator of speculative fervour in the market. A good shell has cash backing of about $1.2 million and trades at a discount to this. Brown tracks 580 such companies which trade on the ASX.

A recent example of a backdoor listing is Bulletproof (BPF), which describes itself as an "Australian cloud provider". The shell it used was Spencer Resources (SPA), which prior to the deal traded at 4.5c a share, a big discount to the 7.8c worth of cash on its balance sheet.

Last January, it announced it was acquiring Bulletproof and issued shares at 27c to raise just over $2.8m. This implied a value of 19.2c per SPA share, effectively locking in a profit for SPA investors of 455 per cent only two days after the announcement.

Bulletproof's shares are trading at 30c, so maybe it has legs.

But it raises the question of why companies come to the ASX through a shell when they generally have to issue a prospectus, anyway. Brown says a backdoor listing facilitates quick selling of shares by insiders once the target company has listed.

In situations where a shell isn't used and a company lists on the ASX, the shares issued to the vendors of the assets are often escrowed for a period. For this reason, investors must be wary when they buy into such backdoor listings.

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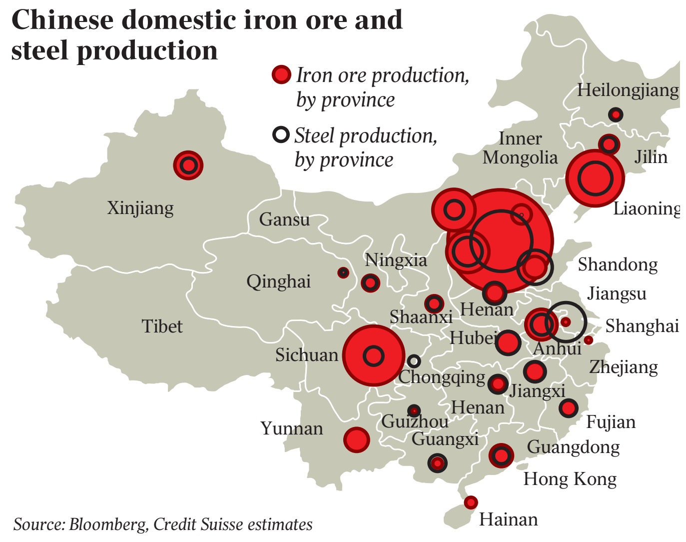
The iron laws and oily rags of the commodity complex

We must not only collect all the dots, but also connect them

STIRLING LARKIN
GLOBAL INVESTOR

Chinese domestic iron ore and steel production



Source: Bloomberg, Credit Suisse estimates

THERE are huge dissimilarities emerging and a possible disconnect between the conversations that Australian ultra-high-net-worth wholesale and retail investors are having on the investment themes of China, iron ore, oil and global energy.

These parallel narratives do not complement each other and the divergent views are grossly out of step with one another.

It has now become imperative for all Australian investors to better inform themselves about how others are approaching the investment challenges of risks versus rewards. As the Norwegian prime ministers Kjell Magne Bondevik said, "Knowledge of other people's beliefs and ways of thinking must be used to build bridges, not to create conflicts".

On one side of this debate, when discussing Chinese steel production and Australian iron ore supply, retail-focused commentary in Australia has heavily relied upon the opinions and forecasts provided by the iron ore suppliers. In contrast, UHNW and wholesale commentaries have attempted to gauge the demand by consumers — namely the Chinese steel manufacturers.

It is illogical and self-contradictory to ask in the public domain a supplier where they believe their clients' demands and price points will be heading. Common sense would suggest that on every occasion these participants would take the opportunity to talk up the demand for their product and say that there was "price elasticity" at all levels of output. This is not to suggest we should not involve suppliers in the conversation, but rather that we should not solely base the conversation on their assertions, as appears is currently practised in Australia.

In our golden age of fast communications, it has become relatively easy for the UHNW investment community to listen to and hold meaningful dialogues with Chinese consumers who do not hasten to share their frank insight into real demand and price expectations. No doubt they, too, talk down demand and price expectations, but what participants on either side of the conversation say should always be taken with a grain of salt.

All being considered — as previously discussed here — China appears to be successfully transitioning from a manufacturing to a consumption-driven economic model, where steel is not required in such large quantities for the foreseeable future.

The irrational viewpoint of the current Australian commentary, which purports that the Chinese must continue to buy our iron ore at high prices when they no longer require as much, shows our narrative has become disconnected, uncommercial and has lost its way.

Under the proposition of globalisation that we sold to them, they are progressing to the next stage of their development.

Under our current thinking, we are now complaining they are no longer buying a product from us that they no longer need, at prices that were always profiteering.

The UHNW wholesale investment community has emphatically rejected this mindset and instead directed their focus on the "price discovery" process that market forces provide. Then, balancing this information with the tilted comments of both the demand (Chinese) and supply (Australia and Brazil) sides, they attempt to extrapolate and forecast where iron ore spot prices will be heading.

During the middle-most phases of China's focus on manufacturing, steel production was ramped up for both infrastructure components and manufactured products. Sino capacity soared from about 100 million tonnes in 1995 to about one billion today.

This denary increase represented a doubling of the global steel output, a sevenfold increase of what Japan, the then largest producer, was galvanising and a tenfold increase compared to the US. However, as China matured and began its transition towards the next phase of its development, which required less steel, the global investor observed that Chinese consumers reduced their demand for imported higher-grade iron ore.

They noted that, even though steel was being purposely over produced in certain provinces of China, and there was stockpiling occurring as pseudo-collateral for credit financing of real estate assets in the daylight and shadow banking markets, that, all being considered, aggregate demand was on the way down. The iron ore spot price, now pushing below the resistance level of $US90 a tonne, is down 34 per cent since December last year.

Also, there is no sign of restocking in the period preceding the Chinese New Year, which is a first in recent years.

Shanghai "rear" (reinforcing steel used as rods in concrete) prices are at near-record lows while Chinese iron ore port inventories hit record highs, reflecting oversupplied imports and subpar steel production. Coupled with this, as the seaborne supply of iron ore from Australia and Brazil moves towards a structural surplus in coming months, continued pressure will push the spot price towards $US80 a tonne by 2015.

> The consumers' demand is, without a doubt, declining

This continued fall is further exasperated by existing project ramp-ups in Australia and Brazil.

Regardless of the supplier's margins and capacity to cut costs from their tier-one assets, the consumers' demand is, without a doubt, declining. However, the global investor takes comfort in the view that this is a good outcome for them as well as for the Chinese. This is because as China's economy progresses, and as their markets open up ever faster to the world, newer and more sophisticated opportunities will present themselves to the astute global investor. Rather than fretting over the "normalisation" of iron ore within the global commodities mix, we should be seeing this transition as a welcome development, as a new, more mature market of more than one billion consumers who now want all the same goods and services that we have been enjoying since the end of World War II.

Equally, this dynamic mindset can be used when facing the alarming geopolitical events currently afoot in Iraq and Syria. Within this mindset, we would recognise that, separating the humanitarian implications of ISIS's coup, their influence over global oil production is marginal at best. This is because their occupied territory in northern Iraq accounts for only 10 per cent of Iraq's oil exports and the rest is still well garrisoned against future attacks. Also, as discussed in our May 31 article, the world's largest consumer, the US, is quickly becoming energy independent — thanks to the shale gas and tight oils revolution.

It is fundamental that all investment conversations involve input from demand and supply participants and that we not only collect all the dots, but also connect them.

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A worker in Wuxi in China's southern Jiangsu province ... consumers have reduced demand for imported higher-grade iron ore

STIRLING LARKIN

Just when you thought it safe ...

ROGER MONTGOMERY

THREATS to every industry from new technology and new competitors mean that no industry is safe any more and your retirement savings are at risk.

At Montgomery Investment Management, we are naturally attracted to businesses that are highly profitable and operate in an industry with tailwinds, allowing both high rates of returns on existing capital and the potential to deploy large amounts of incremental capital at equally or more attractive rates. The problem, of course, is that such characteristics don't only attract fund managers. They tend to attract a lot of competition for the business, too. To be a successful investor, it's important to understand not only what the competitive landscape looks like now, but what it might look like in the future.

And, as you are about to discover, even if your retirement savings are invested in what appears to be the safest and most stable of industries, they might just be at risk from a garage-based start-up.

The old strategy of a buying a blue chip, shoving it in the bottom drawer and living off the genius is no longer safe.

Competitive landscape analysis is not an exact science. As a result, our focus is regularly drawn to answering another simple question. How easy is it for new entrants to enter a market?

Heightened competition can increase the supply of a product, the servicing capacity and produce efficiency gains without any increase in consumer demand. These economic forces can negatively impact margins and valuations.

The degree of threat from new entrants to an industry is partly determined by the extent or numbers of barriers to entry.

Economies of scale (supermarkets), significant upfront capital investments (mining) and high switching costs for consumers (banking) are all barriers to entry. Highly differentiated products or well-known brand names, access to favourable locations and proprietary technology also decrease the threat of entry.

The global healthcare diagnostic market (think blood samples and pathology centres) is an industry we have hitherto considered to be attractive. It's a $60 billion market, growing fast as an ageing population takes advantage of new technology to seek more and new tests.

Many investors have gained exposure to this market through the ASX-listed Sonic Healthcare (SHL) — a Sydney-based company that provides laboratory, pathology and radiology services.

Sonic is the largest pathology company in Australia and Germany, and the third largest in the US, with laboratories also in Switzerland, Belgium, and Ireland. The businesses generated $3.5 billion in revenue and $340 million in net profit after tax in 2013 and employs more than 500 pathologists and thousands of medical scientists and technicians.

You wouldn't think a company like Sonic in such a stable industry could be at threat. Then along comes 19-year-old chemical engineer Elizabeth Holmes and Theranos — the biggest blood diagnostic company you've never heard of.

A recent $400m venture capital raising effectively gave the company a $US9bn valuation — eclipsing Sonic Heathcare's capitalisation of $6.8bn. It's more than a start up and its run by a young woman with that "change-the-world zeal" seen in the likes of Steve Jobs and Bill Gates.

Watch out.

Theranos's technology is highly disruptive, offering multiple, simultaneous blood-diagnostic tests from just a few drops. Replacing the discomfort of a syringe and intravenous blood draw into multiple, 13cm vials is a barely noticeable finger prick and a nano-vial. Results are available in a few hours, not days, and the equipment fits in a small locker rather than requiring dedicated labs. Expect them to be in every corner pharmacy.

Perhaps most alluringly, the total cost of the tests is less than half what the US Medicare and Medicaid now pay to providers for conventional tests. It is estimated these two bodies alone could save $200bn over 10 years by switching to the technology. Theranos's technology has the potential to change diagnostics forever, if not life as we know it. And the switching costs are low. In other words, sticking with the incumbents could be just as painful as the blood tests they offer. Still, Theranos is in its infancy and its rollout will take time, but your retirement savings are on notice.

Roger Montgomery is the founder of Montgomery Investment Management

Bring out your dead: time to revisit past glories that are now gory

CRITERION
TIM BOREHAM

WITH the local bourse set to close about 15 per cent higher for the financial year, hopefully readers are sitting on some realised capital gains.

With the taxman eyeing his cut of the spoils, now is the time to clean out the cupboard of dormant stocks, or those worth more to an investor for capital losses.

The trouble is, if the stocks aren't trading any more, it's hard to crystallise a loss.

The online disposal facility deListed Australia cites 166 stocks it estimates are of little, if any, value. Of these, 110 have been suspended and the rest delisted.

And what a sad list of past glories it is: names such as the hapless BrisConnections, girlie club owner Planet Platinum, ballistics innovator Metal Storm, (miss) managed investment scheme Timbercorp, car stereo mob Strathfield Group and, more recently, private-equity spin-off Penrice Soda Holdings.

Run by former Australian Shareholders Association chief Tony McLean, deListed will buy the shares for a peppercorn $1 and a $150 fee.

McLean says many companies are still included in ASX share tables with a last quoted price. "Don't be misled," he says. "Your company may have been suspended from quotation for years.

Helpfully, the administrators of Apex Minerals, Arafura Pearls, Australian Rural, Ultrapay and Forge Group made loss declarations during the year.

The final act is the "burial" itself: deregistration. At this stage, investors who haven't claimed a loss can do so.

Polling Indonesia

AUSTRADE lists 400 Australian companies active in Indonesia but only a handful of listed ones. Our chief Asiaphile, ANZ Bank, is rumoured to be selling its stake in Panin Bank.

Still, corporates are not oblivious to Indonesia's potential, making the July 9 presidential poll more closely watched than usual.

AT Kearney's Jakarta-based Asian head John Kurtz says both the reformist dark horse Joko Widodo and protectionist former general Prabowo Subianto are preaching homegrown messages to their constituency. "It's way unclear who to root for," says Kurtz.

Listed industrials with a meaningful Indonesia presence include Ramsay Health Care, Coca-Cola Amatil, Origin Energy, BlueScope Steel and Pacific Brands.

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