Oil and gas sector now in play for mergers

RICHARD HEMMING

SMALL listed oil and gas companies look to be increasingly on the auction block as bigger predators eye takeover opportunities to boost production growth given higher operating costs, a relatively high oil price and increasing domestic gas prices.

This was certainly the case for Karoon Gas Australia, whose shares spiked 46 per cent from $2.54 where it was in late April prior to its suspension of trading due to funding uncertainty. It got to as high as $3.72 this week after Origin Energy lifted the previously cash-strapped oil and gas minnow out of the grave.

Origin is on the hook to buy Karoon's 40 per cent interest in two exploration permits for potentially large offshore gas fields in Western Australia's Browse Basin. The deal delivers Karoon $US600 million ($647m) upfront and payments of up to $US200m if things go well for Origin.

The transaction follows other merger and acquisition activity in the sector, including the Horizon Oil (HZN) and Roc Oil (ROC) merger, the all scrip takeover by Drill Search for Ambassador Oil and Gas (AQO) and the $1.84 billion takeover of US-based oil producer Aurora Oil and Gas by Canada's Baytex Energy.

Canaccord Genuity's oil and gas analyst Johan Hedstrom explains why there is more M&A activity in the sector in comparison to others. He said: "There is more takeover activity in oil and gas because the share prices have fallen, yet the oil price is $US100 plus and gas prices in Australia are rising. This is unlike other commodities like iron ore, copper and gold, which have been under sustained pressure."

Hedstrom predicts that there will be more activity in the sector as big companies go looking for cheap assets, and small companies look for scale:

"There is going to be speculation about more activity because so many companies' prices have become irrelevant for investors. Mergers produce scale which will attract institutions."

Hedstrom says that candidates on the takeover front include Beach Energy (BPT), Drillsearch Energy (DLS) and Senex Energy (SXY) because of their shale gas enterprises in the Cooper Basin.

At the smaller end he includes Cooper Energy (COE) as well as Sundance Energy (SEA) and Lonestar Resources (LNR). He also singles out Karoon (KAR). "This is a huge deal for the company and means it can develop its assets in Peru and Brazil."

Richard Hemming is an independent analyst who edits www.undertheradarreport.com.au He does not own shares in the stocks mentioned.

Decision time for investors

The global economy has reached a fork in the road. Which way?

STIRLING LARKIN
GLOBAL INVESTOR

Deng Xiaoping is widely praised for setting China on a path to 30 years of growth

GREAT fortunes are often built during uncertain times. Uncertainty generates opportunities and risks and differentiating between them is very hard. Global investors know that hard decisions are made with equal parts of rationality and intuition.

They also recognise that we are now in the greatest period of uncertainty in modern times. This is not hyperbole but an acknowledgment that the time is now to decide which fork in the road we follow. Sitting at the crossroads is no longer an option.

For ultra high net worth investors, there is no clear road map in their search for relatively stable yield.

As spreads continue to grind tighter thanks to shrinking volatility, investors will be forced to consider riskier investments.

But the ways in which we assess "risk capital" are being distorted thanks to unconventional, global monetary policies.

The news just in that the European Central Bank cut the deposit rate to minus 0.1 per cent, the main refinancing rate to 0.15 per cent and the marginal lending rate — or emergency borrowing rate — to 0.4 per cent proves that too many elves are tinkering in the toy shop.

Imposing negative nominal rates contradicts the basic tenets of capitalist economics, which our global economy has been based upon since the times of Adam Smith.

Coupled with the continued expansionary policies of the US Federal Reserve, Bank of Japan and Bank of England, this experiment is still only "half baked". And Fed chair Janet Yellen and her cohort have not come this far only to now quit.

As both the US stockmarket and US 10-year Treasury notes reach records highs, Credit Suisse, highlights that the S&P 500 has done the exact same thing for 11 out of 12 days this past fortnight. It has dropped within the first 45 minutes of trading and then rallied towards the end of the day.

Meanwhile the Chicago Board Options Exchange (CBOE) VIX index, which measures the US stockmarket volatility levels, has stayed below a reading of 12, which is a concerning sign. This is a near record low and interpreted as a degree of complacency in the market that hasn't been seen since 2007.

And clear accounts are oming out of Beijing and Shanghai this week tell us that the moods in both the business and government sectors are turning very sombre and that growth is clearly slowing. Even though the official purchasing managers' index (PMI) still sits above 50, representing an expansionary bias, tit is known as a lagging indicator meaning it is, by definition, out of date.

But this is not a bad situation as the entire premise of China joining the West in globalisation over tthe past 30 years has been about moving from a manufacturing to a consumption-led economy. China is evolving exactly as hoped and is doing it well.

The timely conversations that *The Australian's* business editors Geoff Elliott and Damon Kitney led last week during the Australia in China's Century Conference emphasised that the Chinese economic car now moves a bit slower as it becomes larger. Those conversations highlighted that 1 per cent GDP growth in 2000 is not the same as 1 per cent today.

Australian house prices have begun to moderate and in the stockmarket, last month saw a notable lack of large capitalisation downgrades — significantly, the first time for the month of May in five years.

Tthe banking sector in May underperformed the ASX 200.

This is significant because the big four banking stocks plus Telstra are regarded as the dividend-yield backbone for our domestic pensioners' community. The decision that the global investor now needs to make is whether we follow the path that leads us to higher grounds or conversely, batten down the hatches for the precipitated storms.

Tthis is not an easy decision. The catch-22 of record price levels across markets, which exhibit tight price spreads combined with low levels of asset volatility plus small trading liquidity, is that if markets about-turn, the exits will become very crowded.

This happened during the GFC, when credit markets imploded and then froze. The US government then pumped iliquidity into the system via the TARP package. Even though this saved the global economy, it set a dangerous precedent and came at a great cost.

If we believe China is evolving, albeit slowly, exactly as prescribed in the model adopted 30 years ago and that Yellen and her cohort will ensure the global economy kickstarts again, we should buy intoo growth opportunities that position us for higher inflation levels.

But if we hold a contrary view that China is waning and that unnconventional monetary stimuli are pumping more liquidity into an already overinflated system, then we should jump to protect capital and employ downside protection strategies.

The reality may also be somewhere in between.

Either way,, there is a growing acknowledgment that the GFC was the tipping point of the 75-year-long build-up in the long-term global debt cycle and, even though the GFC was sharp, it didn't deleverage the system enough.

Reinflating it now may icause a greater crisis down the line. It is, now, without any doubt, decision time.

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Market volatility at near record lows

Chicago Board Options Exchange index

Source: Bloomberg

Domino's aiming for digital delivery

ROGER MONTGOMERY

YOU don't typically associate the pizza industry with innovation. Pizza is one of the most popular meals in the world, with a design that has endured for centuries. Yet innovation is at the heart of Domino's Pizza (ASX: DMP). Such is this focus on improvement that it is being considered more as a technology company than a chain of pizzerias.

You see, Domino's Pizza is a digital leader of food delivery in Australia, with nearly 60 per cent of domestic sales made online. This share is expected to increase, as the company has recently announced that "big technology launches" are planned in the next financial year.

Consider what the future would be like if 100 per cent of Domino's Pizza orders were made online. Could Domino's one day become a truly virtual player, no longer requiring storefronts?

First, we should explore the basics of the traditional pizza industry. Pizza is typically purchased on impulse or for convenience, and is always consumed upon purchase. When you're hungry, waiting an hour for your food can be too long. Pizza chains would service this need by producing pizzas in a central location. A large store network provides scale benefits from the sourcing of ingredients, but the cost of producing the pizzas has stayed high due to the need for localised production.

If all customers eventually become comfortable ordering online, does this present an opportunity to innovate with the traditional storefront model? Could Domino's consolidate its traditional store network into production centres?

Production centres have a lot of cost advantages over a network of small stores. The model would require fewer staff, as all orders would be centrally processed. Rents might be reduced as distribution centres do not need to be in highly visible areas, and with no storefronts the company would not need to invest in furniture and fittings to refresh the brand. This sounds appealing in theory, and may be a viable option to achieve earnings growth once Domino's reaches the limits of it store rollout strategy. But there are two barriers that may limit this new model in practice.

The first is the need to deliver fresh, hot pizzas so drivers have a time limit. While a distribution centre may be able to service a wider area than a local store, distance constraints would still limit consolidation potential.

An extensive store network in highly visible locations also allows Domino's to remain front-of-mind for impulse purchases. While customers may order online, in many instances this sale is generated by visual cues. How many times have your dinner decisions been influenced by what you've seen on the commute home from work? As such, the potential cost savings from production centres would have to be considered against the potential loss of "walk-in" sales.

The second barrier could be the mindset of consumers. Australians have been comfortable with the takeaway model for decades, but this has always been based on a clear understanding of where the pizzas come from. While customers who receive deliveries do not make contact with the pizza store, they know they can visit the nearest store and see the pizza being made. This level of trust is important, and is a key reason why Domino's moved its "pizza make line" to the front of the store.

If Domino's was to become a pure online player customers would need to be comfortable ordering from a production centre. There must be complete trust that the products will be prepared to the highest of standards. While the quality may improve in these centres where the environment can be more controlled, it may be a tough ask for the public to trust what goes into their bodies without a physical presence for confirmation.

At Montgomery Investment Management, we consider that Domino's rightly trades as a technology company to reflect its growth opportunities. The company has been successful in transforming the buying patterns of its customers, and more sales are made online than via the physical store presence. For this innovative pizza maker, it is certainly an interesting future to consider.

Roger Montgomery is the founder of Montgomery Investment Management.

THE COACH

Q. My mother is 84 and, while relatively fit, she realises she needs to move into aged care. As a result, we have sold the family home and are assessing options. Our preferred option has a bond of $400,000, and care fees of around $24,000 a year. I am aware of changes to assessment criteria of fees for aged-care facilities that take effect on July 1. Are we better off waiting until after July 1 or should we make the move now? Mum was previously on the full aged pension of about $22,000 p.a. She has $680,000 from the sale of the family home and $30,000 in the bank.

A. Making the decision to move into aged care is often difficult and stressful and this can put a terrible load on the family. To compound your problems, there are major changes to the way in which the aged-care system operates that commence July 1 that will have significant financial consequences for your mother.

Under the current rules, aged-care residents pay an Accommodation Bond as a lump sum to the facility on admission. Accommodation Bonds are assets test exempt for Social Security purposes. The cost of the bond will vary from facility to facility and usually can be negotiated depending upon the availability of suites. On death the Accommodation Bond is refunded within 14 days and guaranteed by the government. Facilities are entitled to keep a retention payment of $331 per month per resident up to a maximum of $19,860 over five years.

As you have sold the family home, the net proceeds after paying the Accommodation Bond will be assessed by Centrelink for assets test purposes. So your mother's entitlement to the age pension will most likely reduce.

Your mother will pay a daily care fee. The maximum daily care fee is $46.50 per day. She will also be asked to pay an income-tested fee in addition to the daily care fee. This is calculated at 41.67 per cent of her total assessable income above $951.20 per fortnight.

The Department of Health and Ageing determines the fees on a quarterly basis. The maximum fee is $73.86 per day. A facility can charge additional amounts for extra services provided by negotiation with the resident.

The major changes that occur from July 1 relate to the treatment of the accommodation bond and the income-tested fees. For new residents from July 1 the Accommodation Bond will be replaced by Accommodation Payments. Residents will have the choice to pay a lump sum Refundable Accommodation Deposit (RAD), a periodic payments known as a Daily Accommodation Payment (DAP) or a combination of both.

The incomes-tested fee will be replaced by a means-tested fee. The key difference being that your mother's assets as well as her income will now be taken into consideration in determining her daily care costs. The fee is calculated on 50 per cent of her income above $22,701, plus 17.5 per cent of the value of assets between $40,500 and $144,500, plus 1 per cent of the value of assets from $144,500 to $353,500, plus 2 per cent of the value of assets beyond this. The value of the RAD is also included. The fee is capped at $25,000 annually or $60,000 over the resident's lifetime.

In your mum's case, depending on how the net proceeds of the property sale are invested, her fees could rise by about $9000 if you wait until July 1. If you are in a position to make a decision now, you should seriously consider acting before July 1. But please seek advice from a financial planner to optimise the outcome.

Visit the Wealth section at www.theaustralian.com.au to send your questions which will be answered by Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions. Follow him @andrewheavenFP

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