AUSE01Z01MA - V0

WEALTH

theaustralian.com.au/wealth Edited by James Kirby

POWERED BY eureka report

"The very best businesses, by definition, grow earnings every year, without requiring an additional dollar of capital."
ROGER MONTGOMERY, MONTGOMERY FUND

Medibank Private is feeling a lot better now

TIM BOREHAM
CRITERION

Medibank Private (MPL) $2.22

Retail subscribers to the much-hyped IPO are now comfortably above water after yesterday's post-results share surge pushed the stock well beyond the $2-a-share base-offer price.

But take care: management warns of "challenging industry conditions and slowing market growth", which we didn't read much of in the glossy promos ahead of last November's float.

Spreading its unclipped wings post-privatisation, the health insurer is playing to script by tackling costs and dodgy claims through the "payments integrity" program.

A fatwa on "waste and errors" signals the insurer won't pay for overservicing or doctors' mistakes (the non-fatal ones).

The insurer has also targeted a rump of dubious dentists and here's a suggestion for free: take a look at upsizing optometrists.

"We are confident of more cost improvement to come," says (or threatens) Medibank CEO George Savvides.

While Medibank's full-year revenue of $5.93 billion was up 5 per cent, it fell short of the prospectus forecast of 6.2 per cent. But the 13 per cent net profit rise to $292 million beat expectations, as did the dividend of 5.3c (4.9c was forecast).

The numbers show Medibank's profit margin has improved from 3.5 per cent to 5.5 per cent over the last three years. This is behind the for-profit peer Bupa on a sector-leading 7.2 per cent. The average industry margin fell 4.5 per cent to 2 per cent over this period, with HCF making negative returns. "Our clear ambition is to deliver best-in-class margins," Saviddes says.

He says the insurer remains committed to membership growth. But what's clear is that unlike its mutual cousins, Medibank Private won't chase unprofitable growth and has eschewed the biggest comparison portal, iSelect. We'll wait and see how Medibank's high-profile stoush with Calvary Hospitals pans out. But Savvides says 150 hospitals are not contracted with Medibank "for a number of reasons" and that disputes are routinely settled without media noise.

Negotiations with giants Healthscope and Ramsay Healthcare are yet to come, but Savvides purrs the parties are aligned on the need for a "quality-based approach".

Medibank is in rude health and, more broadly, is slowing the disturbing claims inflation seen across the sector for years.

But investors need to be clear whether they want a health exposure or an insurance exposure. If they want the former, why not just invest in the likes of Sonic Healthcare or CSL?

MyState (MYS) $4.62

It's not every day that we can report that Tasmania is leading the way in an economic sense, yet the island state's more prosperous hue was a standout factor in the bank's robust lending performance.

The product of the 2011 amalgam of Rockhampton's The Rock building society and Tassie's MyState, MyState straddles two regions with different economic traits.

The improvement is partly $A driven, with the lower currency driving tourism and improving agricultural returns.

"We are confident about the economy down here," says MyState chief Melos Sulicich.

MyState's central Queensland catchment is mixed, with beef and coal prices exhibiting positive and negative influences. MyState's loan settlements surged 75 per cent to a record $1bn, although natural run-off of the book translated to a 16 per cent lending growth to $3.6bn. This growth rate is 2.3 times the industry average. However, keen competition reduced interest margins and resulted in a flat underlying net profit of $29.7m.

Sulicich reckons MyState has benefited from enhanced consumer perceptions after it converted to a bank in October last year. This is especially the case with deposits, which grew at 7 per cent. With a $400m market cap MyState is a certified minnow but it's still twice as big as the smallest listed bank, Auswide (ABA, $5.35, formerly Wide Bay Building Society).

Sulicich reckons there will be more consolidation, which is inevitable given the number of small credit unions and building societies that survive. Not surprisingly, MyState intends to be more than an interested bystander. Long-term buy.

Universal Coal (UNV) 14c

Criterion hasn't been the only one to bang on about the unrecognised value in Universal, which is about to open its second South African coalmine with take-or-pay contracts with state utility Eskom.

Well, Germany's IchorCoal has been listening, having plonked a 16c cash offer on the table, a 45 per cent premium to Thursday's close of 11c.

Broker Patersons swiftly decried the offer as too low, citing a 27c/sh valuation. The firm believes management will be able to amass a 10 per cent blocking stake and bid auf wiedersehen to the interlopers.

Universal should generate annualised ebitda of $40m when the New Clydesdale Colliery comes on stream. Apply a multiple of 5.5 times, allow for Universal's $50m and you easily get to a valuation of 34c/sh.

To misquote Winston Churchill, this is only the beginning of the end and we maintain a spec buy call.

The Australian accepts no responsibility for stock recommendations. Readers should contact a licensed financial adviser. The author does not hold shares in the stocks mentioned.

LOOSE LENDING SPELLS TROUBLE AHEAD

Interest-only loans flash red

JAMES KIRBY

GLENN BARNES

ASIC chairman Greg Medcraft has warned of risks in interest-only property loans

Perhaps the single biggest unexamined issue in the residential property market is the swing towards interest-only home loans.

As the wider market endlessly examines surging Sydney prices, plunging values in mining towns and the never-ending comparisons with overseas markets, four out of every 10 new home loans across the nation go to people who have generally no intention of paying out their mortgages.

There has always been interest-only loans but they were for very rich investors. Today they are available to just about anyone. In fact they are being made available to many who clearly have not been properly assessed by lenders (more on that later).

The interest-only mortgage business is growing at 20 per cent a year — that's about eight times faster than our GDP growth and should make it plain just how "hot" this lending sector has become.

From a macro-perspective it's patently obvious that this rise in looser lending is going to bring trouble sooner or later. But that day it seems is still some way off, sufficiently far away to consider the investment proposal offered by interest-only home loans.

As my colleague, the economist Adam Carr has suggested more than once: the annual cries of an impending property crash continually fail to materialise. Moreover, while we have a shortage of housing, low interest rates and we come to terms with recent population rises, there is little evidence now that any significant housing downturn is looming.

Indeed a close look at the delinquency rates in the interest-only home loan sector shows they are currently lower than delinquency rates in the traditional "interest and principal payment" sector. But the troubling aspect of this quiet surge in interest-only loans is the manner in which it is being handled by the banks.

ASIC, led by chief executive Greg Medcraft, had this to say earlier this week following a two-year review of the sector:

1. In more than 30 per cent of the files examined there was no evidence the banker had considered whether the interest-only loan met the borrower's requirements

2. In 40 per cent of the cases the clients were given an underestimation on the length of time the lending would last

3. In one in five cases the borrower's actual living expenses were not considered.

So, as an investor the picture is clear — if you want an interest-only loan, it is not hard to get one. But do not in any way trust a bank to look after you interests or give you advice — it is very obvious banks are regularly just signing people up for these loans without sufficient examination of their circumstances.

Separately, the realities of an interest-only loan have to be examined.

The clear advantage of these loans is that you can maximise your exposure to rising property prices. You can also minimise your outgoings in relation to a property investment. From a tax perspective you can improve your negative gearing.

The disadvantages are that with rental yields between 3 per cent and 4 per cent — and mortgage rates in the 4 per cent range — you are depending very heavily on price improvement to make it all work.

You will also have to pay a lot more to service these loans than standard loans once the "interest-free" period ends, which is five years on average. Remember, that though you may have started with the idea of never having to pay any principal ... it might not work out that way.

To put it plainly, if you don't get that price rise in the first five years you invariably have big repayments coming down the line ... that's when you'll know if it all worked out. This is not an area for inexperienced investors.

Just like hedge funds or peer-to-peer lenders (see today's article from Elizabeth Redman) deregulation has make these often exotic products widely available, but that certainly does not mean everyone should jump on board.

Understanding value is key to dodging the landmines

ROGER MONTGOMERY

Reporting season is in full swing and the very large share price reactions following a big proportion of company announcements suggests the results have regularly turned out to be surprising and unanticipated.

It also might suggest that analyst valuations — those relied upon for the final buy/sell recommendations — might be filled with optimistic inputs or inappropriately formulated. Given the number of financial types that read this column, and the investors in the banks, it's worth revisiting the valuation formula.

In assessing the value of a company, the market tends to focus almost exclusively on the outlook for earnings (profits) growth. Indeed during reporting season the market obsesses over it. While important, other variables are crucial in determining whether a company and its business are a good investment.

The value of a share of a business is derived from the future potential cash payments receivable by shareholders. Such a valuation uses these key variables.

- The level of earnings — technically, the valuation requires an estimate of the earnings generated over the next year
- Sustainable earnings growth — the ability not just to make a profit one year, but every year.
- The sustainable marginal return on capital — in other words, the ability of the company to make more money investing in its own business than you might have if you'd put it in the bank.
- The cost of capital — this is the annual return required by an investor for a given investment

Given the extended period of very low interest rates and the corrupting influence this has on investors' sense of risk, I will focus on the third point, the marginal return on capital.

To deliver earnings growth, a company must invest, and more often than not, reinvest. This investment might be in new production capacity, or funds for incremental working capital. It might also be capital for acquisitions. As is the case for an individual, the best kind of investment is the type that requires the lowest upfront outlay and thus produces the highest return. Any rational investor would, for example, prefer a $10 investment that generates $5 a year of return than a $100 investment that also returns $5 a year. The same applies to a company.

A company has a finite amount of capital. It can either reinvest for growth or it can return surplus capital to shareholders in the form of dividends or share buybacks. The higher the return on capital achieved on growth projects, the lower the amount of capital required to be retained to fund a given rate of earnings growth.

A lower amount of capital required to fund growth leaves a greater amount of capital available to be returned to shareholders. The very best businesses, by definition, grow earnings every year, without requiring an additional dollar of capital.

Historical returns provide a guide, but not an answer

The ability to repeat the reinvestment in growth at a high rate of return is what defines an exceptional company due to the impact of compounding returns.

Below is the standard formula for valuing a company using the 4 variables. If we assume a 10 per cent annual return is required by shareholders, we can calculate combinations of earnings growth and marginal return on capital that generate the same valuation. For example, the value of 5 per cent a year growth at a 50 per cent marginal return is the same as 6 per cent growth at a 21.4 per cent return and 7 per cent growth at a 15.2 per cent return.

The importance of the marginal return on valuation highlights why it is important to understand the source of a company's future growth. Historical returns provide a guide, but not an answer.

Organic earnings growth is generally higher return than earnings growth from acquisitions. This is because the net investment for acquisitions includes a payment for the value the previous owners generated above the value of the investment they made in the business themselves. This reflects a payment for goodwill, which reduces the marginal return on capital for the acquirer.

Acquisition growth also tends to be higher risk because the vendor is more informed about the business than the buyer.

Looking at Amcor as an example. The acquisition of Alcan's packaging assets in 2009 delivered strong earnings growth at a very high marginal return on capital through cost reductions. However, with the majority of the benefits from that acquisition having been realised, and organic growth in the packaging industry remaining weak, future growth must be driven by acquisitions of small competitors.

The company targets a 25 per cent pre-tax return on acquisitions, but this is likely to represent a lower marginal rate of return than the company has generated over the last five years. While Amcor has remained disciplined in walking away from deals if the returns don't meet its minimum requirements, rising asset prices invariably mean there are fewer available opportunities. This negatively impacts both the growth and marginal return outlook for the company relative to its recent history.

Another example is the impact of APRA's decision to increase mortgage risk weightings for the major banks. Effectively, the major banks will be required to hold 55 per cent more equity on mortgages from July 2016, diluting the return on equity for mortgages by 36 per cent. Estimates of the dilution to bank ROE resulting from increased capital requirements range from 1.5 to 2 percentage points, reducing both the earnings base as well as the future return on new mortgages written.

Therefore if the banks do not reprice products to increase profits, their stock values should not only fall due to the dilution of EPS from the capital railings, but their PE ratios should also fall due to lower marginal return generation in future periods. If they raise prices to compensate for the increase in equity capital, then their competitive position will be negatively affected relative to other lenders in the market.

Whichever way you look at it, an understanding of value will enable you see opportunities and avoid the landmines.

Roger Montgomery is chief investment officer of the Montgomery Fund. www.montinvest.com

THE COACH

I received an inheritance from my grandmother's estate of $60,000. The money has been earmarked for my children's education. It has been recommended I invest in insurance bonds. My children are eight, six and two. What is an insurance bond and why is this option attractive?

An insurance bond is a "tax paid" investment issued by an insurance company on the life of an individual investor. Earnings derived on investments held within the bond are subject to tax at the life insurance company tax rate of 30 per cent. However, the effective tax rate within the fund can be lower; for example, if the assets held within the bond include shares paying franked dividends.

From a tax perspective, they are ideally suited to those on higher taxable incomes as the tax paid internally (that is 30 per cent) would be less than the individual's marginal tax rate. However, it should also be noted that capital gains derived from investments held within the bond will not receive any CGT discount (whereas investments held individually generally will).

Another advantage of insurance bonds is the simplicity of the investment. You are not required to report investment earnings in your tax return unless the bond is redeemed, and even then:

- The growth on insurance bonds held for more than 10 years is tax-free.
- If the bond is redeemed in the 10th year, only one-third of the growth is assessable.
- If the bond is redeemed in the ninth year, two-thirds of the growth is assessable.
- If redeemed in under eight years, all growth is assessable.

Any assessable growth amounts will be taxed at the individual's marginal tax rate at the time but will also attract a 30 per cent tax offset based on the tax already paid internally.

Insurance bonds can be attractive investments for minors who may be subject to quite high marginal tax rates on their investment income. A minor is defined as an individual under 18.

There are insurance bonds available in the market that provide investment options ranging from a very conservative investment mix through to 100 per cent growth.

I suspect insurance bonds have been recommended to you for the longer-term investment timeframe you are looking for and the amount you are looking to invest. The insurance bond most likely would be owned by you or the executor of the estate depending on the terms of your grandmother's will. If you nominate a child as the life insured and an adult as the policy owner, then ownership of the bond can be transferred to the child at a nominated age, generally between 10 and 25, without any capital gains tax payable. Until the nominated age is reached, the trustee has control.

Visit the Wealth section at www.theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.