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Value Line: Transurban? No thanks

By Roger Montgomery

PORTFOLIO POINT: Transurban might have an impressive collection of assets; but the figures are not so persuasive.

I have long refrained from buying shares in businesses that have never made any money, those that have significant amounts of debt, that pay dividends despite earning nothing and those whose return on equity is forecast to remain below the rate of return available on a government-guaranteed bank account.

I am particularly fearful of any company that displays all these characteristics at once.

How foolish of me not to realise that someone – evidently much brighter than me – would want to pay billions for such an "irreplaceable collection (of assets)".

And so it seems that I am missing something rather attractive about Transurban (TCL). The bid of $5.25 per share by the Canadian Pension Plan Investment Board (CPPIB) and the Ontario Teachers Pension Plan (OTPP) proves it.

When the Singaporean sovereign wealth fund Temasek, ploughed $US270 million into ABC Learning Centres at $7.30 per share I was made to feel equally silly. How could my valuation of ABC Learning be under $3 when the stock had just traded at $8 and a "sovereign wealth fund is buying"? Something must be wrong with your valuations, Roger!

When the same sovereign fund went on to lose money investing in casinos, Barclays, Merrill Lynch and Standard Chartered, when churches and councils around the world borrowed to lose billions investing in mortgage backed securities and when some of the world's biggest mutual funds lost money in Enron, Worldcom and the world's largest automaker, GM, these were all one-offs or someone else's fault. And yet history is replete with so many examples.

To make myself absolutely clear, I am not saying that Transurban is a business on the edge of collapse. The point I do want to make, however, is that smart people don't always make smart investment decisions.

Transurban isn't going to make any significant money for the next two years and it may actually lose money. According to the research department of a very large bank, it will have raised an additional $1 billion in equity by 2012. Further, on top of the $2.9 billion it borrowed in 2005, it plans to load up an additional $1.6 billion of debt.

The ValueLine portfolio, as at November 17, 2009

Company	Buy price	Price today	Est value	Margin of safety	Shares bought	Invested ($)	Capital value ($)	Divs rec	Total return	Total return
JB Hi-Fi	14.8	22.59	25.76	12.3%	845	$12,500	$19,079	0.29	$6,824	54.59%
Cochlear	56.36	61.28	56.3	-8.8%	102	$5,744	$6,245	0.95	$598	10.42%
CSL	31.81	32.1	32.87	2.3%	163	$5,197	$5,245	0.4	$113	2.17%
Woolworths	26.16	28.4	26.85	-5.8%	206	$5,377	$5,838	0.56	$576	10.70%
Reece	17.8	23.16	14.83	-56.2%	236	$4,209	$5,477	0.33	$1,346	31.97%
Platinum Asset Mgt	4.06	5.58	3.95	-41.3%	854	$3,467	$4,765	0.12	$1,400	40.39%
Commonwealth Bank	46.51	52.64	52.81	0.3%	215	$10,000	$11,318	0	$1,318	13.18%
Since July 1										
Security Value										$57,967
Cash Value										$56,635
Total Value										$114,602
Total Return ($)										$14,601.69
Return Invested (%)										30.25%
Total Return (%)										14.60%
All Ordinaries change										20.30%
Outperformance of invested portion										9.95%
Outperformance of total portfolio										-5.70%
Negative watch										
Company	**July 1 price**	**Price today**	**Est value**	**Margin of safety***						**Total Return**
ISOFT	0.635	0.78	0.19	-310.5%						-22.83%
Amcor	4.79	5.74	3.63	-58.1%						-19.83%

What we have here is toll-road-owning enterprise with $10.3 billion of assets and yet $7.9 billion of those assets, 77%, are intangible. Intangible toll roads perhaps?

No, they represent among other things, goodwill on the acquisition of the Sydney Roads Group (to the relief of Macquarie Group) and the Hills Motorway Group as well as the Transurban's right to "design, build, operate and maintain" the CityLink tollway and construction costs including materials and labour to upgrade and improve for example, the Monash–CityLink–Westgate Greenway Corridor (M1).

To create these accounts and metrics must either be challenging or risky because the auditors are paid almost $3 million a year to report them and management and the directors received $18.5 million in 2009 to produce them.

Despite these confidence-inspiring factors, analysts believe that the Canadian pension funds could and should offer more than the $5.25 they have bid, partly because the dividend-distributions of Transurban have been increasing, and partly because the Canadians participated in a $659 million capital raising at $5.49 in June last year.

The perennial change-of-control premium argument has also been trotted out to justify expectations of a higher bid, as has CPPIB's willingness to offer 22 times EV/EBITDA for the Auckland Airport between July and December in 2007. Their propensity to make offers at large premiums to the traded price is also apparently a reason to expect them to pay $5.75–6 this time.

There is a vast difference between investing and speculating, however, and the bulk of the discussion about higher bids falls into the latter category even though it may prove to be correct.

Orchardists must truly regret their career choice. If they produce 500 apples per tree, they cannot deliver five times more or 2500 per tree. Transurban has evidently discovered a way to do this while simultaneously paying down the debt and eventually handing some of its roads back to governments unencumbered.

According to forecasts, Transurban will generate earnings per share of 5¢ (or 5 apples per tree) in 2010, 2¢ in 2011 and 6¢ in 2012 while paying dividend-distributions of 24¢ (24 apples per tree), 26¢ and 28¢ respectively.

This front-loading of distributions relies on all the stars lining up; debt costs mustn't rise, the debt itself must be able to be refinanced and cash flows must rise significantly to allow the ongoing servicing of the increasing debt obligations and distribution expectations.

There is no doubt that telling your dinner guests that you own Melbourne's CityLink and Sydney's M2, M4, M5 and Eastern Distributor would produce jaw-dropping responses of the envious variety but great assets don't always make great investments.

The business generates operating cash flow of $380 million but after upgrades, maintenance, replacement of plant and equipment and the like, the business breaks even at best and loses money at worst.

Then in an example of the revolving door method of cash management, it pays dividend-distributions, which obviously must be funded by borrowings or capital raisings. The first funding source increases risk and the second dilutes your ownership. And I haven't even talked about return on equity or the valuation.

Return on equity of –1% in 2009 is forecast to "rise" to less than 0.5% in 2010 and 2% in 2011. For my liking, the debt is too high, the return on equity is too low, distributions are unfunded by the after-maintenance-and-upgrade cash flows of the business and if someone wants to pay $5.25 they can have it, provided of course the roads aren't some great Australian icon that is in the national interest to keep. ◆

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