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A Montgomery White Paper

JANUARY 2013

A head in the clouds?

The continuing growth of technology is disrupting the millon-dollar accounting software market. With a forecasted rise in intrinsic value, Reckon is on the verge of value territory.

By Roger Montgomery

Whoever said accounting was boring has not followed the progress of Xero, MYOB or Reckon in recent times, or considered how technology is disrupting the billion-dollar accounting software market and potentially creating huge winners and losers.

Xero shares have soared almost fivefold this year, capitalising the cloud-based software provider at a staggering $3.7 billion. And like many internet hopefuls, Xero doesn't make any money. It lost $17.1 million in the half-year to September 2013, is yet to have positive free cash flow as it reinvests for growth, and serves 4 per cent of small businesses in Australia. It has some very smart and well-connected backers, including Sam Morgan (he sold TradeMe to Fairfax in 2006), who is, I can say from personal experience, one of the smartest digital-age operators in Australia and New Zealand.

MYOB, on the other hand, has been passed between private equity firms, the last sale for about $1 billion in 2011 - and is a rumoured Initial Public Offering (IPO) for 2014. One wonders whether Xero's nosebleeding valuation might spur MYOB to come to market sooner rather than later.

Then there is Reckon, the subject of today's report, capitalised at $288 million, and under pressure with a one-year total shareholder return (including dividends) of minus 6 per cent. Price falls have put the well-run Reckon on the cusp of value territory and strengthened its case for a prime spot on portfolio watchlists of long-term value investors.

On paper, Reckon looks ideal for this market. Accounting software provides high-margin, recurring revenue and good earnings visibility, and the company has a forecast dividend yield of 4.3 per cent. Such stocks have attracted valuation premiums this year, given earnings uncertainty in many sectors.

Reckon faces three key challenges. Short term, it must overcome the loss of its licensing agreement with Intuit Inc. for QuickBooks and Quicken desktop products, which ends in February. It has rebranded QuickBook to Reckon Accounts, and says there has been no effect on revenue so far.

The medium-term challenge is development reinvestment and heightened industry competition. Reckon used to go head-to-head with MYOB in the lucrative accounting software market. Now, it's up against the impressive Xero, which is growing rapidly off a small base, a larger MYOB, and US accounting software giant, Intuit.

The long-term challenge (depending on your definition of "long-term") is becoming a key player in cloud-based accounting solutions. Reckon has taken its time to compete in cloud-based software, but at least has a product; Reckon One, which is yet to earn revenue and is still in Beta testing.

Cloud-based solutions could seriously disrupt the accounting software market. Consider a micro-business owner with fewer than five employees. Its owner pays hundreds of dollars for accounting software upfront, struggles to understand it, and only uses a fraction of its functionality.

The micro-business then meets its accountant, who reconciles and lodges the accounts, provides retrospective advice and perhaps a few ideas for the coming year. The desktop accounting software means the accounts are kept and maintained by the business, then shown to the accountant - an old-fashioned way to work in an interconnected world.

In theory, with cloud-based accounting solutions, the micro-business pays a small monthly fee and thanks to the internet, discusses the accounts with its accountant in real time via the cloud. The accountant or business adviser can provide strategic advice and potentially earn new fees. Like all great innovations, cloud-based accounting software solves problems for different stakeholders.

For the micro-business that struggles with desktop accounting software, or keeps its basic accounts on an excel spreadsheet, cloud-based accounting has great potential. It's one reason why an investment bank dubbed Xero the "Apple of Accounting" earlier this year; such is its disruptive potential.

The other attraction is market size. With 500,000 micro-businesses (and more than a million small businesses) in Australia thought to be using spreadsheets to maintain their financial accounts, there is scope to grow market share in a large, fragmented business-services market.

The other appeal of cloud-based accounting software is the business model, scalability and sustainability. As an online product, it offers companies a "capital-lite" business model that can be quickly taken to new markets. Xero has already entered the challenging US and UK markets and has less than one per cent share. Even a few percentage points is a big deal given the size of those markets - keeping in mind the price of the shares currently anticipates many millions of customers, which Xero does not yet have.

Sustainability comes through the "stickiness" of accounting software. In terms of a sustainable competitive advantage, it's referred to as switching costs. Larger businesses cannot function without the software and they tend to stick with the same product for longer periods, because of the high-perceived cost and inconvenience of switching to a new provider. The benefit to the business of the customers' inconvenience is the ability to charge rising prices.

Exceptional companies should never be written off

The experience of other industries - print media is a good example - shows the damage technology-based insurgents such as Xero can inflict on incumbents like Reckon over time. The insurgent typically has an early-mover position that is hard to catch, and vastly lower, costs. Strong cash-flow growth lets it reinvest heavily to accelerate growth and consolidate market position.

The fear is that the accounting software industry will eventually boil down to two players: a market leader that has a significant gap between it and the number two player, which is light years in front of the third. Several other industries disrupted by web-based rivals have developed this way. With four strong competitors, the number one and two spots in accounting software will be hotly contested.

Understanding these industry dynamics is critical when assessing Reckon. Backing incumbent companies in industries that are increasingly digitalised can be a high-risk strategy. And with so much competition on the way, investors should ask: are Reckon's best days behind it?

Reckon has plenty of challenges, but exceptional companies should never be written off. The key questions are whether its valuation reflects these changing industry dynamics, and if market noise surrounding cloud-based computing and Xero has created a buying opportunity in Reckon.

There is still a lot to like about Reckon. Its A1 quality rating reflects growing Return on Equity (ROE) from 23 per cent in FY05, to almost 40 per cent in FY12. Reckon has been A-rated for a decade, and its performance judged exceptional for most of that time.

The balance sheet is strong: net-debt-to-equity was 20.7 per cent at the end of FY12 and considered low risk. The number of issued shares fell from 132 million in FY11 to 128 million in FY12 after a share buyback. At least Reckon believes its shares are underpriced.

The market expects Reckon's high ROE to continue. A consensus of eight analysts has the ROE dipping to 35 per cent in FY13, then rising to 41 per cent in FY14 and FY15 - still an exceptional return, and a belief that Reckon can defend its market position while maintaining high returns on shareholder funds. Of course, it pays to remember that analysts are, as a group, overly optimistic.

Reckon's market position will be hard to shake. As mentioned earlier, small and medium-size enterprises usually take a lot of convincing to change service providers - and the SME market can be a deceptively hard one to crack. That Reckon has so far suffered no revenue fallout from the Reckon Books rebrand, shows the strength of its customer relationships and brand as a whole.

Moreover, it has 600,000 registered business customers, 100,000 repetitive customers who buy a range of solutions annually, and it partners with more than 6,000 accounting practices. Far from being crunched by cloud-based computing, Reckon could deliver an internet-based software package, assuming it gets its product right, to a large existing customer base - and target new markets.

Its software is popular with established small and mid-size enterprises. Cheaper cloud-based accounting software might have more appeal for micro-businesses with a founder and perhaps a few staff, which are a key target market for Xero. The same market might be limited in terms of what they can afford to pay, which, in turn, could limit that company's pricing power.

Skaffold forecasts Reckon's intrinsic value will rise from $1.51 in 2013 to $2.10 in 2014, and $2.31 in 2015. Always seek companies with large forecast increases in intrinsic value, for the share price usually follows it higher over time.

At $2.11 (after meaningful share price declines), Reckon is right on value territory. Long-term investors may want to wait for even lower prices to ensure a sufficient margin of safety, and carefully assess the intensifying industry competition.

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XKOAI	ASX 300 Accumulation Index	26.23%	12.72%
XTLAI	ASX 20 Accumulation Index	35.80%	3.15%
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DuluxGroup has attractive traits, but well beyond value territory

Renovation and housing-construction uncertainty paints a hazy picture.

By Tony Featherstone

Who would have thought choosing paint could be so difficult, that so many shades of white exist, and that the virtues of the colour Antique White USA would be dinner-party conversation? Or that we could become obsessed with home maintenance and decoration - and home-improvement reality-TV shows?!

The growing complexity and sophistication of paint is good news for DuluxGroup and other key paint manufacturers in what is still a commoditised, price-driven market. As consumer tastes evolve, paint brands will become more important, and pricing power should, in theory, improve.

But that trend, welcome as it is, is dwarfed by the housing cycle. Like other companies that provide housing-related products, DuluxGroup is leveraged to the strength of housing construction, although less so than many think, given that most of its paint sales are for existing homes.

The company has some attractive traits: a well-known brand, an enviable position in a concentrated market, good distribution through hardware chains and a high return on equity (ROE). Also, it's lifting its market share in a flat industry, which is usually a sign of sustainable competitive advantage and a good management team.

But DuluxGroup's stretched valuation more than accounts for these characteristics and has arguably factored in too strong a recovery in housing construction and the broader economy in 2014. High debt, partly due to the acquisition of Alesco Corporation this year, dampens company quality.

DuluxGroup was spun out of Orica Group in July 2010 through an ASX sharemarket listing. Key brands include British Paints, Berger, Dulux, Cabot, Feast Watson, the Selleys handyman range, and Yates garden products. Alesco expands the product line into garage doors, cabinets and other construction products.

In some ways, DuluxGroup exemplifies the dangers of buying stocks on simplistic top-down trends. Media talk of a "property boom" usually refers to rising prices for established dwellings in capital cities. The housing-construction cycle is a different matter and there are cycles within cycles.

Almost two-thirds of the company's 2013 revenue came from the maintenance and home-improvement market: individuals and tradesmen using its paint to spruce-up a home or renovate it. Only 16 per cent of sales were for new houses; another 16 per cent was for commercial applications.

DuluxGroup will benefit from stronger housing construction, probably later in the cycle when more homes are constructed and paint is finally applied. What matters most is how inclined consumers are to purchase paint for established homes ñ or pay thousands to tradesmen to do it for them.

The home-maintenance and improvement market is more defensive than most housing-related segments. Paint eventually needs to be reapplied and high housing prices can encourage more people to stay put and invest in a renovation, rather than upgrade to a new home.

But paint is still a discretionary product; easily deferrable when times are tough and consumers more fearful. Consumer sentiment hit a five-month low in December, according to the Westpac Melbourne Index of Consumer Sentiment. On balance, consumer sentiment is still more positive than negative, but the confidence boost from the Federal election and rising house prices was short-lived.

More troubling is Westpac's Unemployment Expectation Index in its consumer sentiment survey. It shows a sharp increase in fears about job security, which is hardly conducive to a renovation and home-maintenance boom. Headlines about mounting job losses in 2014 will not help. These are not great signs of demand for discretionary housing products.

And the housing-construction cycle, while improving, is not nearly as strong as expected; given record-low interest rates and an unemployment rate just below 6 per cent. Strong growth in dwelling approvals and housing finance has not yet translated into a hefty upswing in residential housing construction. Moreover, first-home buyers, typically eager painters, are harder to find in this housing cycle.

The housing-construction cycle should accelerate in 2014 as interest rates stay low or are cut again because the economy is weaker than forecast. But the key question is whether valuations for housing-related stocks have priced in too strong a housing recovery.

DuluxGroup has a one-year total shareholder return (including dividend reinvestment) of 42 per cent. GWA Group is up 28 per cent, and Brickworks and Adelaide Brighton have delivered about 22 per cent each. Several residential property-development stocks have rallied this year.

These are big gains in an economy that grew at a disappointing 2.3 per cent in the year to September 2013. Australia's gross domestic product, less than economists forecast, is decidedly sluggish and likely to remain below trend-growth rates in 2014 as the resource investment boom cools.

Long-term forecasts for paint demand are equally sombre. Business forecaster IBISWorld predicts the paint and coating manufacturing industry will grow at 1 per cent annually between 2014 and 2019. That follows annualised negative growth of 1.2 per cent over the five years to 2014.

IBISWorldís industry definition also includes demand from car manufacturers, the printing industry and industrial companies. It notes that increased housing-construction activity in 2014 is an opportunity for paint manufacturers, yet still predicts modest growth.

The renovation market should do better. The Housing Institute of Australia forecast in August that spending on housing renovation will rise by 3.5 per cent in FY14. Total investment in housing will rise by 1.4 per cent - still a tepid recovery in housing-related activity.

Longer term, structural industry challenges could pose problems for paint manufacturers. IBISWorld estimates DuluxGroup has a 19.5 per cent share of the painting and coatings manufacturing market, followed by PPG Industries Australia (14.2 per cent) and Valspar Paint Holdings (13.3 per cent).

That dominant position gives DuluxGroup excellent distribution through Bunnings and Woolworths' emerging Masters hardware chain. As the big chains expand, especially Masters, DuluxGroup should benefit from even stronger distribution channels and higher market penetration.

The risk, however, is that Bunnings and Masters eventually stock more home-brand paint, just as Coles and Woolworths have allocated extra shelf space to generic products. Should this happen, DuluxGroup and other brands could face greater pricing pressure and shelf-space competition.

Another threat is greater competition from global paint manufacturers that have the scale to compete aggressively with DuluxGroup to lift market share. Highly competitive, commoditised, mature markets can be treacherous when growth slows and industry incumbents slug it out through discounting.

A less considered threat is how much appetite for substantial home renovation exists, given Australia experienced an almighty renovation boom in the previous decade. The huge sum spent on renovations is one reason prices for many established dwellings are so high these days.

The upshot is that DuluxGroup faces twin threats: the short-term risk that expectations of a strong housing recovery could be dashed if the economy weakens; and the long-term threat of a slow-growth industry that relies heavily on Woolworths and Wesfarmersí distribution channels.

An obvious response in this scenario is to add scale, improve efficiencies, and take share off other small paint manufacturers that, combined, have 45 per cent of the market, according to IBISWorld.

To this end, DuluxGroup is doing a good job. Its FY13 after tax net profit was better than the market expected, up 18.2 per cent to $94.1 million. Revenue growth of 5.5 per cent was solid in a flat market. The Paints Australia business benefited from market-share gains and improved margins.

Sales and underlying earnings at the Selley Yates business were up about 3 per cent in a mildly improving market. Dulux's FY14 guidance was non-committal: it expects profits to be higher than FY13. Perhaps it is managing market expectations so it can exceed them.

Analysts might have hoped for more bullish guidance, given expectations of a stronger housing recovery and because the acquisition of Alesco - a maker of garage doors and openers, construction equipment, and cabinet and window products - should be fully bedded down.

Even so, DuluxGroup's FY14 ROE is forecast at almost 40 per cent, based on the consensus of 12 stockbroking analysts, down from 44 per cent in FY13. That's an excellent ROE for any company, let alone one faced with a sluggish housing market in recent years. The ROE is expected to hover in the mid-30s in FY15 and FY16, after peaking at 88 per cent in FY11.

It's always a good sign when management engineers a high ROE in tough markets. A hallmark of strong companies and great executive teams is an ability to deliver a consistently high return on each dollar of shareholder funds invested, in good and bad markets.

It also gives some confidence that DuluxGroup can put its high debt to good use. A net debt-to-equity ratio of 173 per cent at the end of FY13 is a concern, although it is partly due to the Alesco acquisition and DuluxGroup has good cash flow and an ability to pay down debt quickly. Still, companies with no or low debt - typically a net debt to equity ratio below 40 per cent - are always preferred to those with high debt.

At the current price of $5.22 per share, DuluxGroup does not look to offer compelling value. Even so, DuluxGroup deserves a spot on portfolio watchlists: housing stocks could be among the first to tumble should Australiaís housing cycle disappoint and if there is a signifant sharemarket correction, which, in turn, could present a buying opportunity in FY14.

DuluxGroup might be better buying later in the housing cycle, when the Alesco acquisition starts to boost earnings growth and there is more confidence in the strength of the housing-construction recovery and renovation demand.

Yes, it seems counter-intuitive to buy a cyclical stock later in the cycle, for its price will usually be much higher. But this housing cycle is a lot more sluggish - and less certain - than previous varieties. Investment patience seems the best strategy, given DuluxGroup's current valuation.

With plenty of volatility possible, DuluxGroup will be a lot more interesting than watching paint dry - or obsessing about a slight difference in shades of white.

Tony Featherstone is a former managing editor of BRW *and* Shares *magazines. This column does not imply stock recommendations. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at December 12, 2013.*

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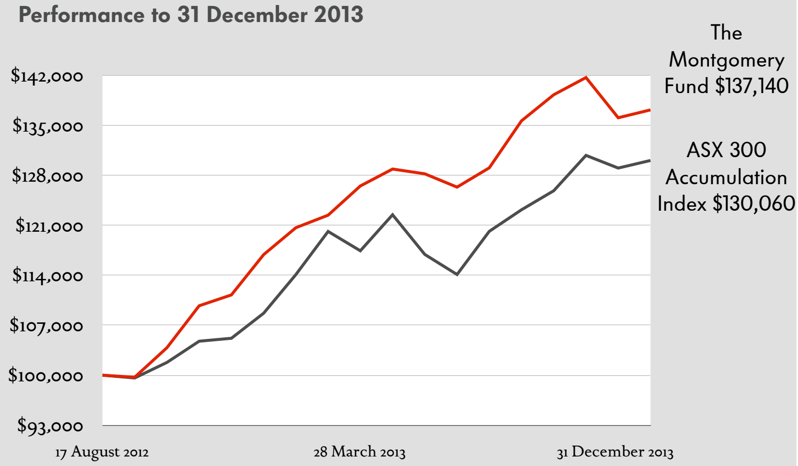

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