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# Stock pickers' guide to value

Opportunities The market's bull run has made identifying gems harder than ever, writes **Max Mason**.

**Finding value in the** Australian sharemarket is becoming increasingly like walking a wild path in the Amazon jungle with a machete – there's a lot to cut through to find El Dorado. The Spanish conquistadors may never have found the city of gold but there is still a glimmer of hope for local investors – if they look hard enough.

After a stellar year in 2013, when the S&P/ASX 200 surge more than 15 per cent and the All Ordinaries jump 14.8 per cent, markets have taken their foot off the gas slightly in 2014.

There are lots of moving parts for investors to keep an eye on, such as the United States Federal Reserve, interest rates and bond yields – not to mention company fundamentals.

Long-term low rates and bond yields mean that stocks perceived to be expensive aren't necessarily that overvalued because of high yields, says Credit Suisse analyst **Damien Boey**. "You can look at price-earnings ratios and all those metrics, and that will give you some insight into what's cheap or not – but, of course, earnings can change."

Consensus is hard to come by, even at the big end of town where the serious money decisions are made. Platypus Asset Management chief investment officer **Don Williams** says major miners **BHP Billiton** and **Rio Tinto** are overvalued, with the price of iron ore expected to fall further over the next few years.

"We think, at best, BHP and Rio will go sideways for a number of years," Williams says. "BHP is trying to add some value for shareholders, but just splitting the company in two doesn't necessarily add anything, unless one of the bits gets bid for."

But Philo Capital head of listed equities **Hugh Dive** reckons shareholders will be rewarded by the big miners as added capacity forces smaller players out of the market.

Domino's moves into Japan and Europe have put it at the top of some investors' shopping lists.
PHOTO: ISTOCK

Dive says once BHP and Rio stop adding capacity, there is room for returning cash to investors.

"Once [there are no] mega projects in the near future, their stock prices will be strongly supported for the next five years by a steady stream of dividends," Dive says.

## Undervalued

One stock that doesn't look cheap using the PE model is **ResMed**. With a forward PE of 20.22 times, it look a little pricey – until you dig a bit deeper.

Tribeca senior fund manager **Sean Fenton** reckons ResMed has adjusted after battling through uncertainty around price pressure, with the US cutting competitive bidding, and its new range of sleep masks will help profitability.

"The balance sheet is extremely strong, with a lot of excess cash – if you adjust for that and look at where they're trading relative to the rest of the healthcare sector and their long-term growth profile, it's probably the best-value stock within the sector," he says.

**Domino's Pizza** has been riding high in recent times; so much so that it could be argued it's likely to cool off. But Platypus's Williams says the company is making the right moves to keep growing. Strong advances into Japan and Europe are laying the groundwork for exponential growth.

"In Japan, they'll be rolling out high double-digit store numbers for years, so we see a lot of growth there that isn't fully reflected in the share price."

Adding to the theme of global expansion, **Carsales.com**'s recent acquisition of iCarAsia gives the car listing website the perfect base from which to launch into Asia, Motley Fool adviser **Scott Phillips** says.

"They're following the Seek model of going overseas for growth and buying into businesses," Phillips says. "It makes sense to take Australian engineering and know-how and partner with foreign best-in-class or existing players to magnify their reach in those local markets."

Looking at one-year PE ratios is missing the point because Carsales is a five- to 15-year story with plenty of growth left in the Australian market in terms of pricing power, he says.

## Overvalued

Mining stocks, which look cheap on a PE basis, pose significant risk to investors. Tribeca's Fenton singles out **Mineral Resources**, with a forward PE of 13.36, as one in a group of mid-tier miners that look pricey.

"The further you go down into the junior iron ore stocks, the higher the cost base. They look pretty stretched," Fenton says.

"Mineral Resources is quite a high-cost producer; its leverage to the iron ore price is quite high. Cash costs are materially higher than the bottom-quartile producers."

Prices could be going down for Coles's parent company **Wesfarmers**, and Bank of America analyst **David Errington** is extremely disappointed with the conglomerate's strategy. Wesfarmers' earnings were in line with expectations but growth is missing, he says. The company announced a $1 billion return of cash to investors, but Errington says Wesfarmers should be looking to reinvest in growth areas.

"We are least attracted to companies that sell businesses and return the capital to shareholders – due to, presumably, a lack of investment or growth opportunities," Errington says.

"In the 2014 financial year, four Wesfarmers businesses went backwards in earnings – and in the 2015 financial year, combined with the elimination of insurance earnings, three businesses are forecast to go backwards. For a conglomerate to deliver above-market growth in earnings, to justify a premium valuation, we believe none of its businesses should post negative growth."

Warring airlines may be great for consumers wanting to travel, but the battles have left **Qantas** bruised and battered, Motley's Phillips says. "Qantas is a woeful business in a very tough category. It's not going to make investors rich over any significant length of time."

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> David Errington, Bank of America

Some analysts predict the airline's losses will top $1 billion this financial year, and Phillips says there are no signs the business can deliver long-term for investors.

Overcapacity is chronic in the airline industry, keeping prices low.

"**Alan Joyce** is doing a fantastic job running that business to keep it at a reasonable level, but he's got to run a million miles an hour just to stay still," Phillips says.

Philo Capital's Dive has personal experience in the risks of investing in insurance companies. "I unfortunately was a large shareholder in **IAG** during 2008-2011. During those periods, people priced them as if the catastrophes were never going to end, and during the great periods they price them like [the good times] are never going to stop."

"I'd be very concerned about buying into general insurers, like IAG and **Suncorp**. I think they look quite overvalued, notwithstanding a good headline number. If we have a particularly nasty catastrophe year, which could be around the corner, that could easily evaporate."