

From the Editor, Issue 16. 25/02/10

## Four Potential Surprises for 2010

When market volatility drops to medium-term lows, the greatest potential emerges for a volatility increase. At these times it can help to have a few outside bets up your sleeve - here are four of them.



One of the best ways to make money in the market is to get ahead of the rest of the investing community and predict trends which have not quite emerged. We thought that a valuable exercise would be discussing four potential eventualities that would really surprise the market and reward those investors who got on the right side of the bet early. We are not suggesting these outcomes will occur, but wish to bring up the possibilities as food for thought.

### 1. JB Hi-Fi (JBH) receives a hostile bid from Woolworths (WOW)

The timing of our first 'maybe' is appropriate considering recent events, the first of which is the recent sales numbers for WOW and the second of which is the retirement of long term JBH CEO Richard Uechtritz.

In the wake of WOW's recent sales numbers and the Wesfarmers (WES) interim result, there has been widespread disappointment at the fact that, firstly, WOW is clearly losing market share to a resurgent Coles brand in its supermarket division and, secondly, there is clearly a lack of growth options left in Australia for its largest retailer. WOW has always been priced as the dominant retailer with rock solid earnings growth and market share, but the market has started to question this, in our view correctly.

So what options does WOW have? Well, it can try to hold off

the rampaging Coles, which it will no doubt try to do. It is also looking at moving into the hardware sector, which has been the cornerstone of WES' retail excellence; a wise move, but one that will be capital intensive and take years to make any inroads. Or it could try to grow by acquisition. With an astute board that knows full well how sceptical the market would be to overseas expansion, what real targets of any scale are there left in Australia?

We think JBH makes total sense for WOW, and the timing could not be better for them. Firstly, its consumer electrics division (Dick Smith) has lost market share to JBH, and that trend looks like it is not slowing. WOW has approached JBH in the past, so clearly the interest is there, but could not get the board on side. With the very popular CEO stepping down, this is the first time for some period that the market is questioning JBH's future, and now would be the perfect opportunity to strike while there is uncertainty. There are no major shareholders standing in the way, and we feel that JBH's future is assured as ever with new CEO Terry Smart, who has been along for the JBH ride since the beginning. And needless to say that if WOW decided it wanted JBH, shareholders would be richly rewarded.

### 2. Wesfarmers Begins its Transformation

One of the highlights of the interim reporting season, as we have mentioned above, has been **Continued** ➤

## Four Potential Surprises for 2010. cont...

the standout performance of WES, but in particular its retail businesses. Ever since WES bought Coles Group at what was near the top of the market, WES' future was always going to be about how it handled retail.

WES management had an excellent resume in retail with its hardware division Bunnings, which in our view is the best run retail business in Australia, but its ability to turn around a struggling brand in Coles was questioned from the start given the amount of capital needed. After some initial hiccups, the most recent results demonstrate across the board improvements, and the WES management is getting the plaudits once again.

But the question now really is, what does the future hold? There is still more work to be done and more capital to be deployed, and the diversity of WES' conglomerate structure always meant that if some divisions were struggling, others would make up for it. But with retail now dominating over 75% of the group's earnings, is there a real point? The WES board has avoided selling its businesses in peak conditions for the reasons mentioned above, but with some of them peaking now, there is an argument to suggest the conglomerate model is no longer necessary.

And if WES began selling off assets at strong prices and returned the capital to shareholders, WES shareholders would likely benefit in a big way.

**3. Mass Property Mergers & Acquisitions**  
Last year was the year of the capital raising, and we saw almost all large property trusts raise new discounted equity to repair balance sheets that had been damaged by sagging property prices and unavailable credit. Enter 2010 and the picture is vastly different. Property prices and capitalisation rates are stabilising, and now most property groups are finding themselves with too much capital.

At the same time, share price recoveries have been lacklustre, and many property trusts trade at prices below NTA (net tangible asset backing) when only two years ago, many traded at a premium. And this is with NTAs that are potentially at their long term bottom if you listen to sector experts.

With excess liquidity and low asset prices, unless the sector starts moving soon, we would not be surprised to see large

scale merger and acquisition activity. The market's pricing suggests this is not currently expected, but by the end of the year, the picture could have changed dramatically, and shareholders will be duly rewarded for a tough few years.

**4. The Government's New Resources Rent**  
This is the first potential outcome that could be a nightmare for shareholders, and we're not sure this is factored into share prices, which is concerning. There has been much speculation as to the outcomes of the Henry Tax Review, and one such rumour is that there is to be a new

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rent on resource companies, one which would dramatically alter the tax landscape for the mining industry.

It is believed that the Henry review wants to substitute a 40% tax, charged on the profit margins of operating mines, for the mining royalties collected by state governments. Analysts have suggested the tax could cost mining giants BHP Billiton (BHP) and Rio Tinto (RIO) a combined \$US5bn in annual earnings.

While we would be surprised if there were to be such a change, clearly this is not factored into share prices, and is a concern. Beyond affecting many resource companies' earnings, it also changes the dynamics of the industry in Australia and will deter future investment in Australian mining, considering the unfavourable tax regime. This ironically would affect future royalties from lower mining activity, so we think there are enough negatives to keep the current tax regime largely unchanged.

Still, if the Henry review goes as far as the rumours suggest, then resource company shareholders better watch out!

Good investing,



**Shannon Rivkin**  
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