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THE AUSTRALIAN FINANCIAL REVIEW

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► Shift from property to 'One Belt One Road'

China curbs offshore investment

Angus Grigg and Lisa Murray
AFR correspondents

Shanghai | The Chinese government has moved to halt "irrational" overseas investments by restricting purchases of real estate and entertainment assets, a decision which could dent demand for Australian assets

The move, designed to curb capital outflows and lessen downward pressure on the Chinese currency, also compels mainland companies to align themselves more closely with Beijing's foreign policy objectives.

The State Council said it would encourage companies to invest in the \$1 trillion One Belt One Road infrastructure initiative, which aims to improve China's trade links with Europe, Africa, South-east Asia and the Middle East.

The Turnbull government has not formally signed up to the initiative despite a desire by Beijing to link it with Canberra's \$5 billion Northern Australia Infrastructure Facility.

The new investment guidelines formalised a series of edicts issued by regulators over recent months and included a list of "banned, encouraged and restricted" areas for investment.

Hotels, sporting teams, cinemas and the broader entertainment sector were on the restricted list, while investments in casinos and defence technology were banned.

However, it has encouraged deals in high technology, advanced manufacturing, agriculture, some areas of the service sector and oil and gas.

"This will lead to more rational investments ... after a period of crazy acquisitions at any cost," said Zhang Yansheng, chief economist at the Beijing-based China Centre for International Economic Exchanges.

"In the short term there will be fluctuation in China's investment in Australia, but I'm sure over the longer term there will be a steady increase."

Power plays



China is in transition and not in a good way. What if Xi Jinping seeks not merely to rise to the level of Mao and Deng, but actually surpass them to reflect his grip on power? Carl Milner East Asia Forum

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The move comes at a time of heightened trade tensions between Beijing and Washington, after the Trump administration said on Friday it would formally launch an investigation into China's alleged theft of intellectual property.

China for its part has called on the US to look at the progress made on the protection of intellectual property rights and solve the issue through dialogue.

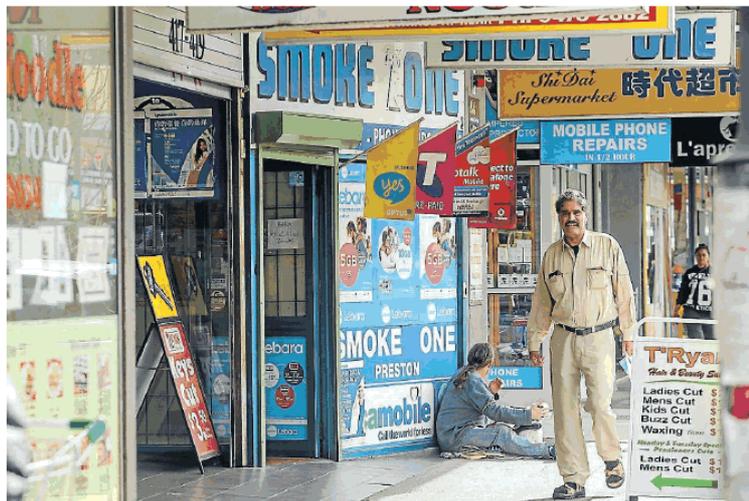
On the investment front Beijing has signalled it is increasingly worried that an acquisition binge by private entrepreneurs in recent years now threatens the stability of its financial system, if loans extended by state-owned banks sour.

Tighter scrutiny of offshore deals over the past six months has already forced the Dalian Wanda Group to restructure its overseas assets, including nearly \$2 billion worth of projects in Sydney and the Gold Coast.

In a statement the country's top economic planning agency, the National Development and Reform Commission (NDRC), accused some Chinese companies of "blindly" going overseas.

"This has resulted in operational difficulties and caused significant losses," it said.

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The streets of Preston, Melbourne, are one place where bargain hunters seek cheap tobacco. PHOTO: PAT SCALA

Brazen illicit tobacco shops mock laws

Duncan Hughes

Retailers and tobacco companies claim that federal and state law enforcers are letting tobacco shops backed by Middle Eastern and Asian crime gangs avoid more than \$4 billion a year in excise taxes.

Fred Harrison, chief executive of Ritchies Stores, part of the IGA group, the nation's largest independent supermarket chain, warned illegal tobacco is causing a crime epidemic, funding terrorism and putting legitimate retailers

out of business. "This is a crisis," Mr Harrison said.

Disputes about policing responsibilities between federal, state and local police, regulators, councils and the Tax Office allow the networks to expand.

Smokers are buying illicit cigarettes for a fraction of the recommended retail price at shops and in markets within metres of an inner-suburban Melbourne police station and the electorate office of the Victorian state minister for finance. *The Australian Financial Review* joined smokers in Pre-

ston, about nine kilometres north of Melbourne's central business district, shopping for smuggled and locally grown "chop chop", which is raw tobacco, cigarettes and "shisha", a fluid tobacco smoked through a water pipe.

Victoria Police said the local council was the "first port of call" but councils said the state police were responsible, and the federal police blamed the Tax Office, which said its role was limited.

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► Editorial Smoking them out p38

Australian coal fires for upbeat Peabody

Exclusive

James Thomson and Matthew Stevens

The Australian-born boss of US coal giant Peabody Energy says the group's Australian coal business has become a star of the reborn mining group, which emerged from bankruptcy just four months ago.

Peabody chief executive Glenn Kellow, who was in Australia last week to visit Peabody's coal mines in NSW and Queensland and meet with investors, said the combination of the company's US mines and its Australian operations meant it was unique in the global mining sector.

Surging coal prices helped Peabody's Australian business become the biggest earnings contributor for Peabody on a geographic basis in the June quarter, with margins in the thermal coal business running at a record 44 per cent.

"We look from a market perspective and see both from the metallurgical coal side and the thermal coal side that

BHP to triple dividends



BHP Billiton will deliver a six-fold increase in profit and a three-fold increase in its final dividend on Tuesday, but it is its controversial shale division - key to its fight with activist investor Elliott - that will capture the market's attention. ► Companies p13

these are growing, along with that Asia-Pacific market," Mr Kellow told *The Australian Financial Review*.

"Australia is uniquely placed to service both types of demand." Peabody filed for Chapter 11 bankruptcy protection in April 2016 as it struggled under a debt load of \$US8 billion, a large part of which was associated with Peabody's acquisition of Queensland coal miner Macarthur Coal for \$US4.9 billion in 2011.

The Australian operations were not

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► Matthew Stevens A rare Australian p28

Coalition to pressure Shorten over UK ties

The government will ask the High Court to deal urgently with the citizenship question as it put pressure on Bill Shorten over his own citizenship status. Mr Shorten's father was born in England and while the Opposition Leader insists he has taken all necessary steps to renounce dual citizenship, he has declined to release documentary evidence of this.

Senator Brandis accused Mr Shorten on Sunday of operating a "don't ask, don't tell policy" on the issue.

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Tax rules on residency 'broken', says adviser

Australia's residency rules are "broken", a tax adviser said ahead of a possible overhaul focused on the mega wealthy. Mark Pizzacalla, a partner with BDO in Melbourne, has been leading a Board of Tax working group on residency and high wealth individuals that will soon report to the government. Arnold Bloch Leibler partner Clint Harding has urged the adoption of a simple method: spend 183 days here in a 12-month period and you are an Australian tax resident.

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Markets and politics



So far in reporting season, not enough companies are coming out with better than expected results. Cost cutting is still doing the heavy lifting.

Philip Baker p20

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- Markets Shares set to open flat p20



After last week's roller-coaster ride, markets hope the departure of White House strategist Steve Bannon will mean Trump can devote energy to tax reform.

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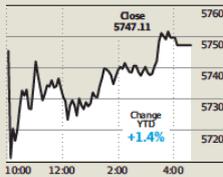
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Market snapshot

S&P/ASX 200 Index (points)



S&P/ASX 200 stocks Friday

Best	Close (\$)	Change (%)
Tatts Grp	4.19	+4.23
Treasury Wine	13.41	+3.47
Tabcorp Hldgs	4.27	+3.39
Cochlear	157.50	+2.93
Domino's Pizza	44.97	+2.86

Worst

QBE Insurance Grp	10.77	-3.58
IPH	4.49	-3.44
Qantas Airways	5.70	-3.39
Beach Energy	62	-3.13
IRESS	12.02	-2.83

Indices

	Close (points)	Change
ASX 200	5747.11	-32.1
Nikkei	19470.41	-232.22
Hang Seng (pm)	27047.57	-347.64
Shanghai A	3423.76	+0.63

Currency

	Change
TWI	66.6 -0.3
SA/USc	78.94 -0.52
SA/£	86.17 -1.20
SA/€	0.6738 -0.003
SA/¥	0.6154 -0.0017

Rates

	Close (%)	Change
Cash rate	1.50	steady
90-day bills	1.73	steady
10-yr bonds	2.616	-0.038

Commodities

	Close (\$US)	Change
Gold (spot)	1284.10	-4.41
Iron ore	77.94	+4.97
Oil WTI	48.51	+1.63

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BHP to deliver six-fold jump in earnings

James Thomson

BHP Billiton will deliver a six-fold increase in profit and a three-fold increase in its final dividend when it announces its full-year earnings on Tuesday, but it is questions over the future of its controversial shale division – the key to its fight with activist investor Elliott – that are likely to capture the market's attention.

After a lacklustre start to the earnings season from many of Australia's blue chip companies, near doubling of earnings from BHP's iron ore division will propel the resources giant to underlying earnings of around between \$US7 billion and \$US7.3 billion based on analyst expectations.

This is a sharp turnaround from 2015-16's result of underlying profit of just \$1.2 billion, and highlights the benefits of better commodity prices (the average price of iron ore in 2016-17 was 33 per cent higher than the previous year) and chief executive Andrew Mackenzie's productivity push.

Predictions of the size of BHP's final dividend vary much more.

A bumper shareholder payout by great rival Rio Tinto – which boosted its interim dividend four-fold earlier this month, and launched a \$US1 billion share buyback – may put pressure on BHP to go further than the minimum payout of 50 per cent of underlying earnings set out in its dividend policy.

"With peer Rio bumping up their buyback at their half-year result the temptation may be to go beyond a 50 per cent payout, but any material jump is unlikely in our view ahead of the chairman elect [Ken Mackenzie] assuming the role effective September 1," said Credit Suisse analysts, who expect a US36¢ dividend in line with the 50 per cent payout ratio.

But the guidance of analysts is for a final dividend of US43¢, up sharply

from last year's final payout of 14¢. Respected Deutsche Bank analyst Paul Young expects a dividend of US46¢, representing a payout ratio of 65 per cent of underlying earnings.

Macquarie analyst Hayden Bairstow expects a dividend of US45¢, and says Rio's higher-than-expected shareholder return may put some pressure on BHP in more than one.

"With Rio also well down the path of portfolio rationalisation pressure will likely continue to be felt by the BHP board to show progress on divestment of the underperforming shale assets."

Both Mr Mackenzie and out-going chairman Jac Nasser have conceded BHP's \$US40 billion shale push has been a mistake and while Elliott said last week that it was "encouraged" by BHP management's comments on the division it is continuing to push for a sale.

Analysts have valued the division at \$US10 billion, so a sale could allow BHP to further increase shareholder returns – another key demand of Elliott.

Privately, BHP management point to rising valuations of shale acreage and argue that they must not compound the shale errors of the past by selling the division too quickly.

The market will want more detail on that argument, and BHP's path towards exiting the shale assets. This may include more detail on how BHP is optimising its current shale portfolio by lowering operating costs and using hedging to maximise and protect returns as it looks for the best way to dispose of the division.

Ben Clearly, a portfolio manager at Tribeca Global Natural Resources Fund, which has also been critical of BHP's shale play, is one looking for details on its investment.

"What we would like to see is some guidance as to how the development of

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Chris Prunty and Tony Waters have formed QVG Capital. PHOTO: BROOK MITCHELL

Micro-cap duo say size enemy of performance

Monday fundies QVG wants companies in the low-risk growth phase.

Jonathan Shapiro

The mantra of micro-cap stock-picking duo Chris Prunty and Tony Waters is that "size is the enemy of performance".

The pair have united for the fourth time in their careers to launch their own "micro-cap" fund and are telling prospective investors they will limit the size of their fund to ensure returns don't become a victim of a fund that's too big.

"That story is really resonating, so the fact that we have been so explicit about the target is unusual and been well received," Prunty says.

Prunty and Waters recently left Aus-bill Dexia, where they ran the micro-cap fund, to form QVG Capital – which stands for Quality Value Growth.

Their stated target is to raise \$300 million from investors to invest in stocks outside the S&P/ASX 100. The \$300 million is a "soft close", but ultimate capacity of their strategy is \$600 million.

Waters and Prunty first joined forces at esteemed broker CCZ Statton in 2008. They reunited at small-cap fund manager Confluence, where Prunty had followed the footsteps of David Paradise and David Fleming to work under Campbell Boag.

The pair then worked together at Investors Mutual in 2008. And at Aus-bill they teamed up to manage one of the sector's top-performing funds in

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Could Westpac steal CBA's crown as Australia's premier bank?

Due Diligence



James Frost

You wouldn't think so given the headlines, but things are surprisingly good in bank land. And they are getting better.

A pair of quarterly updates and a full-year net profit from three of the big four banks have painted a robust picture of health.

Lower bad and doubtful debts, improving margins thanks to higher mortgage rates and good cost control have been the key themes to emerge.

Westpac, however, has escaped the limelight on account of its decision to ditch the rigmarole of quarterly updates back in 2012 under former chief executive Gail Kelly.

Westpac will make some disclosures on Monday morning around capital



Westpac CEO Brian Hartzler's zeal for an improved branchland experience is evident. PHOTO: MICHELE MOSSOP

levels and credit quality, but investors will have to wait until full-year results are delivered on Monday, November 6, to get a more detailed look at the bank's

performance. While it's tempting to simply extrapolate conditions at the other banks to Westpac, history has shown that nuances between the banks can have a significant impact on returns.

As CLSA analyst Brian Johnson notes, decade-long super cycles in the Australian banking sector have driven excess returns for shareholders.

Investors who held NAB from 1992 to 2002 were handsomely rewarded. Likewise investors who have held Commonwealth Bank from 2002 to 2012.

Not owning Westpac in the lead-up to its near-wipeout in 1992 was a good idea. It was an equally good idea to avoid NAB when CBA was in its heyday.

There's little to suggest that there is anything to be gained from singling out

Westpac as the sector's only sell, but is it in the right shape to become the nation's premier banking franchise?

From a valuation perspective, Westpac is about average. That is not criticism.

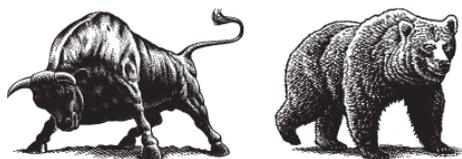
It has one-year forward price-to-earnings ratio of 13.2 times and a price-to-book ratio of 1.9 times. Its average-ness is merely a reflection of where the bank sits in a sector with four dominant players. Just behind rival Commonwealth Bank but well ahead of ANZ and NAB.

From a capital level perspective, Westpac reported a Common Equity Tier 1 ratio of 10.0 per cent as of March 31. Again, average.

CET1 capital is defined as the strongest, or most resilient, of a bank's

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InvoCare one for the bottom drawer: analysts

Bulls & Bears

Simon Evans

Australia's largest funerals operator is assured of a long-term steady stream of customers and has fundamental strengths that make it a good "bottom-drawer" investment, says stockbroking house Morgan Stanley.

At a time when the "buy and hold" strategy is increasingly coming under fire because of sharp volatility in sharemarkets and digital disruption, which is up-ending traditional business models, InvoCare is one company that may be worth sitting on for a long time.

Morgan Stanley analyst James Bales said InvoCare was a long-term structural growth story of consistent multi-decade volume growth, with rational pricing power and a market share opportunity as it ploughed through a \$200 million investment program. It is spending up to revitalise and modernise its 250-strong network of funeral homes and crematoriums in Australia to ensure it adapts to a shift in the industry, where families are now wanting more of a "celebration" of the dead person's life.

InvoCare, which runs brands including White Lady Funerals, Simplicity Funerals and Tobin Brothers, delivered a 50.1 per cent rise to \$4.7 million in the first six months of calendar 2017, with a large chunk of the increase coming from booming investment returns from the \$508 million investment portfolio it

has as people pre-pay for future funerals. The strong results announced on August 16 received a generally warm response from analysts.

Morgan Stanley's Mr Bales said InvoCare lost 130 basis points of market share in Australia largely because of fierce price competition at the low-cost end of the market and the retirement of some former vendors in the business. Market share slipped to about 32 per cent. But the fact that it was still able to

InvoCare is a rarity in the 'emerging leaders' segment of the ASX.

Macquarie analysts

upgrade its profits demonstrated the quality of the business, he said.

He said it wasn't the cheapest small-cap stock but its fundamental strengths made it a "bottom-drawer investment for long-term oriented investors".

Morgan Stanley has a price target of \$16.50 on the stock and an "overweight" recommendation. The shares are hovering around \$15. Mr Bales said the capital investment program meant there was an attractive risk versus reward scenario built around organic growth, which was more compelling than previous strategies at the company. Pre-paid contracts were also a driver of future market share.



InvoCare is revitalising its 250-strong network of funeral homes and crematoriums. PHOTO: CATHRYN TREMAIN

UBS analyst Tim Plumbie is a bit more circumspect and has a "neutral" rating on InvoCare. He said solid cost control had offset "subdued" revenue growth. He is optimistic about the market share growth opportunity from the \$200 million capital spending under the "Protect and Grow" strategy but with the stock trading on a one-year forward looking price-earnings multiple of 26.7 times, he believes the upside is largely priced in. Mr Plumbie has a 12-month price target of \$14.70.

He said the standout of the result was cost control, with total operating expenses down 0.7 per cent compared with last year.

There had also been a big focus on squeezing out extra procurement benefits from areas such as travel, information technology and funeral vehicles. Running such a big network enabled some tough negotiations with suppliers. That also stemmed to the basics of the funeral business, with a new coffin provision contract signed late in the June half, with the benefits to flow through in the second half.

InvoCare chief executive Martin Earp said on August 16 the company would wait until the peak winter season had passed before really stepping up the investment spending, with the winter months the busiest for funeral services.

Macquarie Capital has a 12-month price target of \$15.31 on InvoCare and said it was a rarity in the "emerging

Death and taxes, two of life's certainties

InvoCare share price, daily (\$)



SOURCE: BLOOMBERG

leaders" segment of the ASX because of its stable, defensive earnings growth outlook and favourable long-term demographics. It has an "outperform" rating on the stock and said there was "significant opportunity" through the Protect and Grow strategy to unlock value from the company's network of assets, which have been requiring additional investment for a long time.

Capital spending on the program this calendar year was expected to be \$80 million, spent on a refresh of funeral homes, chapel facilities and fitouts of new shopfronts, together with new vehicles and digital technology.

Macquarie said "online price discovery" by price-conscious shoppers and the fierce competition

from lower-cost operators was "still a threat" to InvoCare in the low-end of the market. The company had rolled out nationally a "value offering" for cremations that was reported to be picking up lost volumes against the low-cost operators.

Pricing of funerals is a sensitive issue. A rival company, Propel Funeral Partners, is scrutinising a potential ASX listing and has about 70 properties in its network across Australia and New Zealand, with a large regional focus.

A company called gatheredhere.com is increasingly focused on delivering more transparency in funeral pricing for people who are looking for funeral services at a time when they are distraught and racked with grief.

From page 13

Micro-cap duo say size enemy of performance

2010. The micro-cap fund they managed returned more than 26 per cent per annum from inception until the end of March, according to disclosures.

As QVG gets off the ground they're sharing an office with rising long/short fund Totus Capital at 139 Macquarie Street, Sydney, a building that has become the city's unofficial capital of small-cap investing.

The fund will focus on finding companies that they believe have evolved into the "low-risk growth" phase.

"These are companies that have hit some critical mass and there is real evidence that the business is scalable and about to hit an inflection point in growth," Waters says. Prunty adds: "We don't like going early and taking business-model risk. We are more prepared to leave the first 100 to 200 per cent returns to someone else."

Examples, he says, are Harvey Norman in the 1980s, Flight Centre in the 1990s and JB-Hi-Fi over the past decade.

"They all had proven business models at the start of those decades. They



QVG Capital says JB Hi-Fi was an example of a low-risk company.

were making money, had systems in place and the critical mass to penetrate their markets with relatively low risk," Prunty says.

Waters believes they've benefited from owning companies that graduate from the S&P/ASX 300 index to the 200 index as their growth puts them on the radar of more investors.

Companies with similar business models have a two to three percentage point valuation uplift by moving from the edge of the 300 index to the 200 space. Moving into the S&P/ASX 100 is a "far more challenging graduation" -

although Waters says there's a "bubble effect" in the 50 to 150 area where growth stocks are on extreme multiples.

Any lessons learnt over the years?

"Beware roll-ups ... run by young CEOs," Prunty says. A "roll-up" is an all-too-familiar creature in Australian capital markets. They are companies, typically listed, that deliver earnings growth through acquisitions but eventually succumb to market pressure to do one deal too many.

Roll-ups often start out on the right track, Waters says, as they extract the private to public multiple arbitrage

(Investors tend to value the earnings stream of a public company more than a private one. So a public company can appear to create value by acquiring the earnings of a private company).

Eventually roll-ups become victims of their own success.

"To move the needle they need to make a big acquisition. And by that stage they're large so they can get debt funding to borrow heavily," Prunty says.

The increased leverage makes the company more vulnerable to a slip in earnings. "You need an escalating share price each step of the way for your supporting equity holders to keep coming back. As soon as you do a raising at a discount to the last one your ability to raise further equity is impaired," Waters says.

But there are companies that can expand responsibly and effectively via acquisitions. One of the fund's favourite stocks in this regard is Hansen Technologies.

Waters says they're wary of valuations of certain industrial stocks, particularly after a multi-year period of declining interest rates.

But there are future winners out there. Another favoured stock, which Prunty presented at a recent Livewire conference, is mobile phone software company MNF Group, a rare bright

spot during this reporting season. They're also looking at some mining stocks, although Prunty admits "most small-cap managers get dragged kicking and screaming to look at resource stocks".

Waters says the fund looks at "small resources stocks with the same financial metrics as we do industrials".

"We are looking for good balance sheets and improving return on invested capital," he says.

QVG's efforts may be helped by the fact that many of the top small-cap managers have closed their doors to new money because they're aware of the adverse impact on performance when operating above capacity.

But that's happened as more money in aggregate has come out of the small-cap sector as some funds have wound down while larger institutions have reallocated to large-cap stocks.

Some estimate \$4 billion to \$5 billion has come out of the small-cap sector in the last 12 months.

With less money hunting for opportunities in the smaller end of town, it's better for those starting out.

"It would be easy to bang the table and say 'this is a great time to be small-caps,'" Waters says. "But we can say with conviction that it's a better time than it was 12 months ago."

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