MARTIN ROTH'S

BEST-SELLING ANNUAL

TOP STOCKS

TWENTY-SECOND EDITION

2016

A SHAREBUYER'S GUIDE TO

LEADING AUSTRALIAN COMPANIES

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Preface

Our stock market is volatile, the currency is weak and there is talk that the country might fall into recession. Yet this new edition of *Top Stocks* presents as many exciting companies as I have seen in 22 years of compiling this book.

Most of these are smaller or medium-sized companies. Some will be unfamiliar to investors. Yet all meet the stringent *Top Stocks* criteria, including solid profits and moderate debt levels.

Here are just five examples, all companies that have never previously appeared in the book. (Interestingly, four are based in Brisbane.)

- *Corporate Travel Management.* A series of offshore acquisitions—with more possible—have transformed this company into a global business. Profits rose 66 per cent in June 2015, and the company's forecast is for a further 25 per cent to 30 per cent increase in the June 2016 year.
- *ERM Power.* In a highly regulated industry, electricity provider ERM is realising solid growth, thanks to an emphasis on reliability and service to its corporate customers. It has moved into the US market and believes it can replicate its success there.
- *GBST Holdings.* Surging British demand for the company's financial software saw profits up 52 per cent, and growth continues.
- *Magellan Financial Group.* Funds management operation Magellan has achieved renown for its international funds, at a time when demand for these is growing among Australian investors. Profits more than doubled in the June 2015 year.

- *Vita Group.* This specialist retailer of mobile phones and computers is enjoying excellent growth as it opens new stores and diversifies into fresh areas of business. Profits more than doubled in June 2015.

As noted above, this is the 22nd edition of *Top Stocks*, and guiding investors towards value stocks has been one of the paramount aims of the book from the very first edition. Indeed, one of the rationales for the book has always been to highlight the truth that Australia boasts many excellent companies that enjoy high profits—and *growing* profits—regardless of the direction of the markets.

Despite the title, *Top Stocks* is actually a book about companies. So right from the start it has been an attempt to help investors find the best public companies in Australia, using strict criteria.

These criteria are explained fully later. But, in essence, all companies in the book must have been publicly listed for at least five years and must have been making a profit and paying a dividend for each of those five years. They must also meet tough benchmarks of profitability and debt levels. It is completely objective. My own personal views count for nothing. In addition, share prices have never been relevant.

Of the 94 companies in *Top Stocks 2016*—two fewer than in last year's edition—fully 64 reported higher profits in the latest financial year (June 2015 for most of them), while 60 achieved higher earnings per share and 63 paid a higher dividend.

Of the 64 companies reporting higher profits, 46 achieved double-digit profit growth, with four companies reporting a triple-digit increase. In addition, 51 of them saw profits growing at a faster rate than revenues, implying that their profit margins were expanding.

Although, as noted, share prices are not relevant for selection to *Top Stocks*, 57 of the 94 companies in the book have provided investor returns—share price appreciation plus dividends—of an average of at least 10 per cent per year over five years. In fact, of these 57 companies, more than half have provided a return of over 20 per cent.

And 11 of them—Corporate Travel Management, Greencross, Domino's Pizza, G8 Education, GBST Holdings, Integrated Research, Magellan Financial, Objective Corporation, Sirtex Medical, TPG and Vita Group—have provided an annual average return over five years of more than 40 per cent.

High dividend yields

With interest rates low, many investors have been seeking stocks offering high dividend yields. These are still a worthy target, as they should offer a degree of protection if the market is falling.

Two years ago, when investors were looking for smaller companies with high dividend yields, I included a list of smaller companies (having a market capitalisation of below $450 million) with a dividend yield of at least 5 per cent.

There were 22 such companies in *Top Stocks 2014*. Repeating the exercise last year produced 15 stocks. In this latest edition of the book there are 16.

Dividend yield: small companies

	Dividend yield (%)
Decmil	12.1
Prime Media	10.0
Acrux	9.7
Finbar	8.5
Beyond International	8.4
DWS	8.1
Countplus	8.0
Mortgage Choice	7.9
Treasury Group	7.6
OrotonGroup	7.0
Cabcharge	6.6
Data#3	6.3
Seymour Whyte	6.3
MyState	6.2
Cedar Woods	5.6
RCR Tomlinson	5.4

Trends in *Top Stocks*

Every new edition of *Top Stocks* unveils trends or themes in the market that could reward potential investors prepared to study more and do their own research.

In past editions I have a number of times put the spotlight on the steady rise of the healthcare sector within the book. At one time the only healthcare-related company in *Top Stocks* was F.H. Faulding, a drugs manufacturer and distributor. In this edition we find eight companies, one up from last year. Some have been growing strongly, though few offer high dividend yields.

Top Stocks 2016: healthcare companies

	Year-on-year after-tax profit growth (%)	Dividend yield (%)
1300 SMILES	31.9	2.7
Acrux	–60.2	9.7
Ansell	26.3	2.5
Cochlear	55.6	2.2
CSL	15.2	1.8
Greencross	76.6	3.1
Sirtex Medical	69.0	0.6
Sonic Healthcare	–5.6	3.5

Something similar has been happening with high-tech stocks. There was a time when the only technology-related company in the book was Computershare. In this edition there are 11 companies from the information technology sector, up from nine last year. (There is also just one from the telecommunication services sector, down from four last year.)

Top Stocks 2016: information technology companies

	Year-on-year after-tax profit growth (%)	Dividend yield (%)
Codan	36.0	4.0
Data#3	40.9	6.3
DWS	–19.4	8.1
GBST Holdings	52.2	2.3
Hansen Technologies	14.5	2.1
Infomedia	7.8	4.4
Integrated Research	67.9	3.3
IRESS	109.0	4.5
Objective	–21.4	2.3
SMS	34.4	3.8
Technology One	14.8	1.8

Another noteworthy trend is the growth of non-bank, non-insurance financial companies, some of them showing excellent growth. In the early years of *Top Stocks* the only such company in the book was Lend Lease. Later Perpetual came along. Nowadays there are well over a dozen.

Each has its own characteristics, and it is difficult to point to a common theme in their rise, though certainly the powerful locomotive that is the Australian superannuation industry is a key factor.

Lend Lease and Perpetual remain strong. Two other large companies are ASX and IOOF. Fund managers are prominent, including BT Investment Management, Magellan Financial and Platinum Asset Management. Other companies include Austbrokers, Mortgage Choice and Money3.

And do not forget two interesting IT companies that specialise in financial software, GBST Holdings and IRESS.

Note, though, that many of these companies are exposed in various ways to financial markets and could be hurt by any lengthy period of market weakness.

Another trend that has certainly become evident in recent editions of *Top Stocks* is companies that appear to be achieving success as they expand overseas.

Investors have on occasion been sceptical about Australian companies taking a big plunge into overseas markets, believing that such moves would invariably fail. These doubts have sometimes proven correct. Some local corporations, successful at home, have done poorly abroad. But others have performed very well. Examples include Cochlear and CSL.

With the Australian dollar weak, and possibly set to fall further, astute investors will certainly wish to consider companies that have a large overseas presence. Here are companies in *Top Stocks 2016* that generate a substantial amount of their revenues abroad. Do note, however, that this does not automatically mean that they are beneficiaries of a weaker dollar. Some have in place a hedging program—or some other arrangement—that limits the potential gains from the weak dollar.

- Acrux sells its Axiron testosterone drug in half a dozen countries, with the US the major market.
- ALS maintains active laboratory analysis services in 65 countries, with overseas revenues more than 60 per cent of the total.
- Ansell is a global leader in safety and healthcare products, with 85 per cent of sales abroad.
- Beyond International is a prominent producer and distributor of television programming, with more than 40 per cent of sales to overseas buyers.
- Breville Group sells its home appliances in more than 50 countries, with foreign revenues making up about 55 per cent of the total.
- Coca-Cola Amatil has significant business operations in New Zealand, Indonesia, Fiji and Papua New Guinea.
- Cochlear sells its products in over 100 countries, and overseas business represents more than 90 per cent of its revenues.
- Codan sells its metal detectors and high-frequency radios to more than 150 countries, representing 80 per cent of company turnover.

- Corporate Travel Management, following several acquisitions, conducts a majority of its operations abroad.
- CSL derives 85 per cent of company revenues from overseas sales of its blood products and vaccines.
- Domino's Pizza Enterprises operates in Japan, New Zealand, France, Belgium and the Netherlands, which between them now account for 70 per cent of total income.
- Flight Centre gets around 45 per cent of its income from its overseas branches.
- GBST Holdings derives 55 per cent of total turnover from foreign revenues, following rapidly growing demand overseas for its financial software products.
- Hansen Technologies is rapidly expanding its overseas billing services, which now represent more than two-thirds of total income.
- Infomedia sells most of its electronic car parts catalogues outside Australia.
- Integrated Research's specialised performance monitoring software is mainly sold abroad.
- IRESS derives nearly half the income from its financial software from overseas, following a big British acquisition.
- Lend Lease, a financial giant that operates around the world, draws more than 40 per cent of its revenues from outside Australia.
- Macquarie Group derives nearly two-thirds of its income from abroad, including nearly one-third from the US.
- Mineral Resources, a big iron ore exporter, collects 60 per cent of income from abroad.
- Navitas, a top-performing education provider, gets more than a third of its income from overseas operations.
- Orica makes more than two-thirds of its industrial explosives sales to customers abroad.
- Rio Tinto is a major global supplier of minerals.
- SAI Global, a large specialist corporate consultancy, obtains more than half of its business overseas.
- Seek, Australia's leading online jobseeker service, is growing rapidly thanks to its overseas businesses, which now represent more than 60 per cent of total company turnover.
- Servcorp, the serviced office space provider, has more than two-thirds of its business offshore.

- Sirtex Medical sells its liver cancer treatment around the world and derives most of its income from overseas buyers.
- Sonic Healthcare's fast-growing overseas pathology businesses now account for more than half of total revenues.
- Wellcom Group's corporate design services are enjoying increasing demand outside Australia, with overseas business jumping from 17 per cent to 29 per cent of total revenues in June 2015 and expected to rise further, thanks to more offshore acquisitions.
- Woodside Petroleum is a major global supplier of liquefied natural gas and oil products.

Who is *Top Stocks* written for?

Top Stocks is written for all those investors wishing to exercise a degree of control over their portfolios. It is for those just starting out as well as for those with plenty of experience but who still feel the need for some guidance through the thickets of around 2200 listed stocks.

It is not a how-to book. It does not give step-by-step instructions to 'winning' in the stock market. Rather, it offers an independent and objective evaluation of leading companies, based on rigid criteria, with the objective of yielding a large selection of stocks that can become the starting point for investors wishing to do their own research.

A large amount of information is presented on each company. Another key feature of the book is that the data is presented in a common format, to allow readers to make easy comparisons between companies.

It is necessarily a conservative book. All stocks must have been listed for five years even to be considered for inclusion. It is especially suited for those seeking out value stocks for longer-term investment.

Yet, perhaps ironically, the book is also used by short-term traders seeking a good selection of financially sound and reliable companies whose shares they can trade.

In addition, there are many regular readers who buy the book each year, and to them in particular I express my thanks.

What are the entry criteria?

The criteria for inclusion in *Top Stocks* are strict:

- All companies must be included in the All Ordinaries Index, which comprises Australia's 500 largest stocks (out of around 2200). The reason for excluding smaller companies is that there is little investor information available on many of them and some are so thinly traded as to be almost illiquid. In fact, the 500 All Ordinaries companies comprise, by market capitalisation, more than 90 per cent of the entire market. (Note that one company in the book, Beyond International, is no longer in the All Ordinaries Index. However, it was in *Top Stocks 2015*, so for continuity purposes it has been included in the present book.)

- All companies must have been publicly listed since at least the end of 2010, and have a five-year record of profits and dividend payouts, each year.
- All companies are required to post a return-on-equity ratio of at least 10 per cent in their latest financial year.
- No company should have a debt-to-equity ratio of more than 70 per cent.
- It must be stressed that share price performance is *not* one of the criteria for inclusion in this book. The purpose is to select companies with good profits and a strong balance sheet. These may not offer the spectacular share-price returns of a biotech start-up or a promising gold miner, but they should also present far less risk.
- There are several notable exclusions. Listed managed investments—as defined by the ASX—are out, as these mainly buy other shares or investments. Examples are Australian Foundation Investment Company and all the real estate investment trusts.
- Also excluded are the foreign stocks listed on the ASX. There is sometimes a lack of information available about such companies. In addition, their stock prices tend to move on events and trends in their home countries, making it difficult at times for local investors to follow them.

It is surely a tribute to the strength and resilience of Australian corporations that, despite the volatility of the past few years, so many companies have qualified for the book.

Changes to this edition

A total of 21 companies from *Top Stocks 2015* have been omitted from this new edition, including BHP Billiton, as its return-on-equity figure slid to around 9 per cent.

Four companies were acquired during the year and delisted:

- Amcom Telecommunications
- iiNet
- Toll Holdings
- Wotif.com

Many companies took advantage of low interest rates to expand their borrowings, and six companies saw their debt-to-equity ratio rise above the 70 per cent limit for this book:

- Aristocrat Leisure
- CTI Logistics
- McMillan Shakespeare
- My Net Fone
- Ramsay Health Care
- Reckon.

The remaining 11 excluded companies had return-on-equity figures that fell below the required 10 per cent:

- BHP Billiton
- Caltex Australia
- Cardno
- Euroz
- MaxiTRANS Industries
- MMA Offshore (formerly known as Mermaid Marine Australia)
- NRW Holdings
- RCG
- Slater & Gordon
- STW Communications
- WorleyParsons.

There are 19 new companies in this book (although five of them appeared in earlier editions of the book but were not in *Top Stocks 2015*). One of these, interestingly, is Coca-Cola Amatil, one of Australia's largest manufacturers, which had previously always been excluded for its high debt levels.

But not yet back in the book is Wesfarmers, which has so much goodwill on its balance sheet after acquiring Bunnings and Coles that—despite growing profits—its return-on-equity ratio remains below 10 per cent. I have had several emails from readers enquiring how a book that calls itself *Top Stocks* can exclude Wesfarmers. That is the reason.

Also excluded is Telstra, due to its high level of borrowings and a debt-to-equity ratio well above 70 per cent.

The new companies are:

- Acrux*
- Amalgamated Holdings
- BT Investment Management*
- Coca-Cola Amatil*
- Codan
- Corporate Travel Management*
- Countplus*
- CSR
- Decmil Group*
- ERM Power*
- Fantastic Holdings
- GBST Holdings*
- Harvey Norman Holdings
- Magellan Financial*
- Objective Corporation*
- REA Group*
- Seymour Whyte*
- Sirtex Medical*
- Vita Group.*

* Companies that have not appeared in any previous edition of *Top Stocks*.

Companies in every edition of *Top Stocks*

This is the 22nd edition of *Top Stocks*. Just three companies have appeared in every one of those editions:

- ANZ Banking
- Commonwealth Bank of Australia
- Westpac Banking.

Once again it is my hope that *Top Stocks* will serve you well.

Martin Roth
Melbourne
September 2015

Introduction

The 94 companies in this book have been placed as much as possible into a common format, for ease of comparison. Please study the following explanations in order to get as much as possible from the large amount of data.

The tables have been made as concise as possible, though they repay careful study, as they contain large amounts of information.

Note that the tables for the banks have been arranged a little differently from the others. Details of these are given later in this Introduction.

Head

At the head of each entry is the company name, with its three-letter ASX code and the website address.

Share-price chart

Under the company name is a five-year share-price chart, to September 2015, provided by Alan Hull (www.alanhull.com), author of *Invest My Way*, *Trade My Way* and *Active Investing*.

Small table

Under the share-price chart is a small table with the following data.

Share price

This is the closing price on 1 September 2015. Also included are the 12-month high and low prices, as of the same date.

Market capitalisation

This is the size of the company, as determined by the stock market. It is the share price (again, as of 1 September 2015) multiplied by the number of shares in issue. All companies in this book must be in the All Ordinaries Index, which comprises Australia's 500 largest stocks, as measured by market capitalisation.

Price-to-NTA-per-share ratio

The NTA-per-share figure expresses the worth of a company's net tangible assets — that is, its assets minus its liabilities and intangible assets — for each share of the company. The price-to-NTA-per-share ratio relates this figure to the share price.

A ratio of one means that the company is valued exactly according to the value of its assets. A ratio below one suggests that the shares are a bargain, though usually there is a good reason for this. Profits are more important than assets.

Some companies in this book have a negative NTA-per-share figure — as a result of having intangible assets valued at more than their remaining net assets — and a price-to-NTA-per-share ratio cannot be calculated.

See Table M, in the second part of this book, for a little more detail on this ratio.

Five-year share price return

This is the total return you could have received from the stock in the five years to 1 September 2015. It includes reinvested dividends, bonus stock, rights issues and capital gain from the stock's appreciation. It is expressed as a compounded annual rate of return.

Dividend reinvestment plan

A dividend reinvestment plan (DRP) allows shareholders to receive additional shares in their company in place of the dividend. Usually — though not always — these shares are provided at a small discount to the prevailing price, which can make them quite attractive. And of course no broking fees apply.

Around a third of all large companies seem to offer such plans. However, they come and go. When a company needs finance it may introduce a DRP. When its financing requirements become less pressing it may withdraw it. Some companies that have a DRP in place may decide to deactivate it for a short time.

The information in this book is based on up-to-date information from the companies. But if you are investing in a particular company in expectations of a DRP, be sure to check that it is still on offer. The company's own website will often provide this information.

Price/earnings ratio

The price/earnings ratio (PER) is one of the most popular measures of whether a share is cheap or expensive. It is calculated by dividing the share price — in this case the closing price for 1 September 2015 — by the earnings per share figure. Obviously the share price is continually changing, so the PER figures in this book are for guidance only. Many newspapers publish the latest PER for every stock each morning.

Dividend yield

This is the latest full-year dividend expressed as a percentage of the share price. Like the price/earnings ratio, it changes as the share price moves. It is a useful figure, especially for investors who are buying shares for income, as it allows you to compare this income with alternative investments, such as a bank term deposit or a rental property.

Sector comparisons

It is sometimes useful to compare a company's price/earnings ratio and its dividend yield with those of its sector.

Figures used in this book are those of the S&P/ASX sectors from September 2015.

Company commentary

Each commentary begins with a brief introduction to the company and its activities. Then follow the highlights of its latest business results. For the majority of the companies these are their June 2015 results, which were issued during July and August 2015. Finally, there is a section on the outlook for the company.

Main table

Here is what you can find in the main table.

Revenues

These are the company's revenues from its business activities, generally the sale of products or services. However, it does not usually include additional income from such sources as investments, bank interest or the sale of assets. If the information is available, the revenues figure has been broken down into the major product areas.

Earnings before interest and taxation

Earnings before interest and taxation (EBIT) is the firm's profit from its operations before the payment of interest and tax. This figure is often used by analysts examining a company. The reason is that some companies have borrowed extensively to finance their activities, while others have opted for alternative means. By expressing profits before interest payments it is possible to compare more precisely the performance of these companies. The net interest figure—interest payments minus interest receipts—has been used for this calculation.

EBIT margin

This is the company's EBIT expressed as a percentage of its revenues. It is a gauge of a company's efficiency. A high EBIT margin suggests that a company is achieving success in keeping its costs low.

Gross margin

The gross margin is the company's gross profit as a percentage of its sales. The gross profit is the amount left over after deducting from a company's sales figure its cost of sales: that is, its manufacturing costs or, for a retailer, the cost of purchasing the goods it sells. The cost of goods sold figure does not usually include marketing or administration costs.

As there are different ways of calculating the cost of goods sold figure, this ratio is best used for year-to-year comparisons of a single company's efficiency, rather than in comparing one company with another.

Many companies do not present a cost of goods sold figure, so a gross margin ratio is not given for every stock in this book.

The revenues for some companies include a mix of sales and services. Where a breakdown is possible, the gross profit figure will relate to sales only.

Profit before tax/profit after tax

The profit before tax figure is simply the EBIT figure minus net interest payments. The profit after tax figure is, of course, the company's profit after the payment of tax, and also after the deduction of minority interests. Minority interests are that part of a company's profit that is claimed by outside interests, usually the other shareholders in a subsidiary that is not fully owned by the company. Many companies do not have any minority interests, and for those that do it is generally a tiny figure.