Would Warren Buffett buy this stock?

When the Oracle of Omaha, Warren Buffett, goes after a stock he looks at a number of markers. Over subsequent months I intend to take a number of companies and assess them according to these markers to try and answer this question: Would Warren Buffett buy this stock? A former market darling caught out by the Brexit drama is the first company to sit my test.

It’s important your SMSF is compliant and one area attracting attention lately is a fund’s investment strategy. What’s your investment objective and how will it support your retirement plans? In order to check yours, Paul Rickard gives his 4 steps to pitch yours against to see if your SMSF strategy stacks up.

Sincerely,

Peter Switzer

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Would Warren Buffett link himself to this stock?
by Peter Switzer

A few weeks ago I pointed to a stock the analysts thought had plenty of upside. It was a former darling of the market but had seemingly been caught out by the Brexit drama. Recently the company reported better than expected and it enjoyed a marking up by those who do the form on listed businesses.

The company in question is Link Administration Holdings (LNK) and I’m going to make this the first company to sit my test: Would Warren Buffett buy this stock? I intend to occasionally make numerous companies sit this test — those companies that analysts believe are under-priced.

The following charts tell the story for LNK. The first chart captures the fall from grace where Brexit was seen as the prime culprit for the company’s price decline.

On January 2018, LNK was nearly a $9 stock but it suffered along with most stocks, copping a sell off with the trade war and the fear of a Fed raising interest rates. This took stocks down in the second-half of that year. Then in late May, the stock market revised their view on LNK, as shown by the steep fall in the chart above.

Here’s what Motley Fool reported at the time:

“The Link share price plunged 30% on Friday, May 31 this year after providing the market with a trading and earnings update that downgraded the company’s FY19 earnings outlook.

“Link sighted a lack of finality regarding the Brexit outcome in the UK and regulatory changes in the superannuation sector as key influences on second-half earnings due to lower revenue activity. Link management also announced that the company’s full-year FY19 results will be released to the market on Thursday, 29 August 2019.”

The AFR agreed, with Misa Han reporting: “Australia’s largest superannuation administration company, Link Group, has fallen casualty to Brexit, posting lower-than-expected earnings due to the negative business conditions in Europe.”

One of the big issues is the Brit business — Capita’ which it bought for $1.5 billion in 2017. This business lost some IPO opportunities because of the Brexit uncertainty, but you’d have to think one day this Brexit disaster will end.

The company copped a Federal Government curve ball from the Protecting Your Super package, which was going to add to costs for LNK. However, the Hayne Royal Commission is bound to be good for its biggest customers — Australian Super, HESTA, Hostplus and Cbus.

It looks like this company’s problems are more short-term than long-term (or permanent). Industry super funds are in a growth phase and, as I say, Brexit has to get sorted, eventually! And since reporting, the market has reassessed its negative view on LNK, as this chart shows.

LNK (one month)
The recent share price move has been from $4.96 to the $5.67 close on Friday.

The latest FN Arena assessment is a target price of $6.71, which would be an 18.3% upside, if these guys are right. The stock has a 3.64% yield and at last count was 100% franked. But when the UK businesses start producing positive results, I guess that will change.

I reckon the story so far says this is a company that has potential but what would a Buffett test find?

When Warren Buffett goes after a stock the following markers are looked at:

1. Does the company have consistent earning power?
2. Does it have a good return on equity (ROE)?
3. Does it have capable management?
4. Is it sensibly-priced?
5. How has the company performed?
6. What’s its debt position like?

**Does the company have consistent earning power?**

Buffet puts a lot more into his assessment to work out a company’s intrinsic value than I will but let’s just see how LNK measures up on these general Buffett measures.

On consistent earnings power, LNK has a solid business locally, which explained its near $9 share price. But it has been brought undone by the Brexit problem. Eventually, the new business should add to earnings.

**Does it have a good return on equity (ROE)?**

The statistics experts say a ROE between 15-20 is good and LNK comes in at 14.3, while the industry has a benchmark of 11.83. And while on measures you might want to know about, its Price/Earnings ratio is 10.12, which makes it price attractive but it’s not saying that the market is confident that the company is going to have a really good run. That said, the P/E assessment can be more short term and can lack a longer term take on a company’s potential. Here are some more figures on the company.

**Does it have capable management?**
On management, its CEO John McMurtrie is a highly-regarded manager who has been with the business for 18 years. McMurtrie took the operation to listing. I don’t think Warren Buffett would have many issues with the chief executive of LNK.

The AFR’s Hans Van Leeuwen recently reported that McMurtrie is hopeful of a rebound once Brexit is resolved. “London will still perform valuable functions as a global financial centre under any sort of Brexit scenario. The IPO market will come again, M&A will come again, capital raisings and returns of capital will come again. But it is true that those have been a bit subdued.”

Is it sensibly-priced?

The next issue concerns the sensible pricing of LNK. If the FNArena analysts can be believed, you’d have to think, on a long-term basis, that the current price is on the low side and isn’t sensible. Also, when the share price is still 37% below its all-time high, it does look like an attractive long-term punt. That’s especially so if you can trust McMurtrie, who I know to be a pretty straight bat player. (He was a cricketer of Shield standard as a youngster!)

How has the company performed?

On company performance, you’d have to say that until recently it has been a stellar performer. The EBITDA story shown in this WSJ chart is a positive one.

A good ROE over time is a pretty good guide for a company and recently the team at Simply Wall Street actually looked at LNK and its recent ROE performance. They showed the recent ROE is close to the industry standard for IT businesses around 13%. These very numerate types also looked at the company’s debt in relation to its ROE.

This was their conclusion: “Link Administration Holdings has a debt to equity ratio of 0.40, which is far from excessive. The combination of modest debt and a very respectable ROE suggests this is a business worth watching. Conservative use of debt to boost returns is usually a good move for shareholders, though it does leave the company more exposed to interest rate rises.”

(Interest rate rises are less likely in the modern setting, I’d say.)

What’s its debt position like?

So on the final Buffett test of debt, we can pretty well conclude that it’s not an issue, provided McMurtrie’s call on the future, post-Brexit, is right. The non-excessive borrowings of LNK leaves it in a fairly attractive position to be an improver.

I suspect LNK might make the shortlist as a company that Warren Buffett would look at. I think it has real potential because Brexit is giving it a bad assessment now, but, in the long term, the company’s true potential is likely to be acknowledged by the market.

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Is your investment strategy up to scratch?
by Paul Rickard

You can review a sample strategy here (https://switzersuperreport.com.au/smsf/sample-investment-strategy/). Alternatively, work through these steps for developing an investment strategy, and see how you stack up.

**Step 1: Set investment objectives**

What’s your investment objective and how will it support your retirement plans? Start by answering some key questions, such as:

- How old are the SMSF’s members? Are they in accumulation or pension phase? If the former, how many years until they retire?
- What assets do the fund’s members have both inside and outside the fund?
- How much income will you need in retirement?
- What level of investment risk are the members prepared to accept?

The answers to these questions should help you determine the investment objectives, which should be measurable, achievable and able to be communicated to the members of the fund. Examples of these objectives could be a simple statement, such as: “The fund will outperform inflation by 3% per annum over the long term,” or a more complex statement, such as: “The fund will keep pace with inflation while avoiding a negative return in any one year.”

**Step 2: Define asset weightings**

You’ll need to decide where to invest your assets in the same way professional fund managers carefully determine how to allocate funds across the various asset classes. The investment plan should clearly state the types of asset classes you want to invest in – like equities, cash, fixed interest and property – as well as the percentage weightings (that is, the percentage of the fund that will be invested in that asset) and benchmarks for each asset class.

Different SMSFs will choose different asset class weightings based on their member’s investment timeframe, their level of risk, their need to protect capital, and potentially, their medium-term investment perspective. A fund that is prepared to take on more risk and has a longer investment timeframe is more likely to have a higher proportion of ‘growth’ oriented assets, such as equities and property, while a fund where capital protection is important will most likely have a higher proportion of ‘income’ oriented assets such as cash and fixed interest securities.

The percentage ranges for the various asset classes should be set wide enough to allow for day to day market variation, although not so wide as to render them useless as a monitoring tool.

**Step 3: Detail any other specific rules**

After the asset allocation has been set in a way that will best meet your investment objectives, the final step is to detail any other investment rules or restrictions you wish to impose on the Fund. These rules can be used to foster diversification, manage risk, maintain adequate liquidity, or strengthen the probability of delivering strong after-tax returns.

Examples of these rules could be:

- “For the Australian equities portfolio, the trustees must ensure that there are at least five different securities from different sectors in the portfolio.” (Diversification)
- “No single asset or security in the fund will..."
represent more than 20% of the fund’s total assets.” (Single asset risk)

- “The Fund will ensure that, at all times, it has at least $10, 000 in a cash deposit with an Authorised Deposit Taking Institution available within 24 hours’ notice.” (Liquidity)
- “The Fund will look to take advantage of dividend imputation by having a preference for companies that pay fully franked dividends.” (Tax efficiency)
- “The Fund will not invest in collectibles such as works of art, rare coins, stamps etc. or other assets where a market value cannot be readily established.” (Defining what assets the Fund can’t invest in).

Investing in ‘in-house assets’ (as defined by the Act), this should be specifically referenced in your investment strategy.

If you propose to invest in a very material asset such as business real property or in “exotic” assets such as artworks or collectibles, a written strategy will assist in demonstrating that the relevant issues have been considered and that the investment is not ad hoc or reckless. Minutes should be kept recording the decision, and can also be used to document that the decision was reached after consideration of the relevant issues, including:

- The expected return from the asset;
- The need for diversification given the investment timeframe and level of risk of the asset;
- The need for liquidity given the age of the members and the expected time when benefits would start to be paid; and
- The Fund’s ability to meet ongoing operating expenses from the investment income on the asset.

**Step 4 : Insurances and minutes**

Since 2015, you are required to consider whether the Fund should take out insurance cover for one or more of your members. Insurances could be life cover, TPD (temporary or permanent disability) or income protection.

This requirement doesn’t mean that your Fund needs to take out insurance – it just means that you need to consider whether to do so or not. If you decide not to take out any insurance covers, it is probably a good idea to formally record this decision in a trustee minute every year, the same minute you make after reviewing the adequacy of your investment strategy.


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4 biotech candidates
by James Dunn

Biotech is a hugely interesting and potentially lucrative hunting ground for investors on the ASX but it comes with big caveats – the news flow in biotech stocks can giveth and taketh away, in nerve-racking falls and heart-pumping rises. The sector can potentially turn world-class research and biochemical discoveries into big dollars, and should be on the radar of any investor, in the speculative, high-risk area of the portfolio, where a small proportion of funds are put aside for an informed (hopefully!) punt that could pay off big-time. Here are 4 candidates – that all come with the standard warnings.

1. Biotron (BIT, 7 cents)
Market capitalisation: $42 million
One-year total return: 288.9%

In September-October last year, Sydney-based infectious diseases specialist Biotron showed just how speculative the biotech industry can be, when its shares rocketed from 2 cents to as high as 45 cents – a 2,150% surge – in just three weeks. The trigger was Biotron announcing that its flagship drug candidate, BIT225, was “having a unique effect in patients, over and above viral suppression seen with current anti-retroviral drugs” in patients suffering from HIV, in phase 2 trials.

With BIT225 showing potentially beneficial immunological changes not achieved in the current anti-retroviral treatment – which do not kill or cure HIV, but are used to prevent growth of the virus – the trial results grabbed world attention, not least because Biotron said at the time that the test results were “a major step to the ultimate goal of curing HIV-1 infection.”

The share price has eased from those heady days, but nothing much has changed: BIT225 is still in clinical development, the company sees a potential role for the drug in improving patient health outcomes “as well as in future HIV-1 eradication strategies,” and Biotron is talking all the time to potential development and commercialisation partners. In July, Biotron wrote to shareholders to remind them that the global drug development process takes its time.

Biotron also has a promising pre-clinical program for hepatitis B virus (HBV), as well as several earlier-stage programs designing drugs that target a class of virus protein known as viroporins, which play a major role in the virus life cycle of a very broad range of viruses, many of which have caused worldwide health issues such as Dengue, Ebola, Middle East Respiratory virus, Influenza and Zika viruses.

The return-to-earth of the Biotron share price could offer a welcome opportunity for investors to enter this highly promising story.

2. ResApp (RAP, 20 cents)
Market capitalisation: $139 million
One-year total return: –14.9%
Analysts’ consensus price target: 28 cents

ResApp is an e-health company that has developed a smartphone-based diagnostic test for several major respiratory conditions, including primary upper respiratory tract disease, lower respiratory tract disease, asthma and reactive airway disease, acute paediatric respiratory disease, and obstructive sleep apnoea (OSP). Last month, the test, called ResAppDx-EU, received CE Mark certification as a Class IIa medical device, meaning that the tool can now be sold in the European Union for use in acute paediatric respiratory disease.

EU approval is the first such step for ResApp, which has also lodged applications with the US Food and
Drug Administration (FDA), under the FDA’s “de novo” pathway for novel medical devices to advance safe, effective, and innovative treatments for patients, as well as with the relevant authorities in Australia, Canada and Singapore.

RAP’s differentiation in the market is that ResAppDx-EU is a “software-only solution” that can accurately diagnose lower respiratory tract disease, croup, pneumonia, asthma/reactive airway disease and bronchiolitis by using machine learning algorithms that analyse a patient’s cough sounds to make a diagnosis. It is far less intrusive than existing diagnostic aids, such as stethoscopes, imaging, and blood and sputum tests, and stands a chance replacing these processes.

The company’s study/trial data has been very strong, demonstrating that ResApp’s software is highly accurate in diagnosing the presence of the conditions it targets. ResApp also intends to move into the hardware area to back its software: in May, the company that it was working with a British medical device consultancy to develop customised hardware and wearable devices capable of running ResApp’s machine learning algorithms.

RAP is an e-health stock with an exciting future.

3. Mesoblast (MSB, $2.02)
Market capitalisation: $1 billion
One-year total return: 13.5%
Analysts’ consensus price target: $5.08

We looked at Mesoblast in October 2016 as a promising stem-cell stock when it was trading at $1.16, and again in January 2018 as one of four promising biotechs (can we link to SSR 8 Jan 2018), when it was priced at $1.475: the stock has moved to $2.02, and looks to be only getting started.

Mesoblast specialises in regenerative medicine, using its proprietary stem-cell technology platform, which is based on specialised cells known as mesenchymal lineage adult stem cells. From this platform it is developing treatments for inflammatory ailments, acute graft-versus-host disease, cardiovascular disease and chronic back pain – and it is the latter application that has pricked investors’ ears lately.

Earlier this month, Mesoblast struck a strategic partnership to develop and commercialise a stem cell treatment for chronic lower back pain. The partnership, with Grünenthal, a German company that specialises in pain management treatment, will see the companies work together to commercialise the MPC-06-ID treatment, a Phase 3 stem cell therapy used to treat chronic low back pain caused by degenerative disc disease. Mesoblast says the therapy would be applied to patients who have “exhausted conservative treatment options.” The company is currently completing a phase 3 trial of MPC-06-ID in the US, the results of which are expected in 2020.

Under the Grünenthal deal, the German company will have exclusive commercialisation rights to MPC-06-ID for Europe and Latin America. Mesoblast says it will receive up to $US150 million in upfront payments prior to product launch: the company expects to receive about $US$45 million of that in the next 12 months, including a $US$20 million payment upon receiving regulatory approval to begin a confirmatory phase III trial in Europe.

Further out, MSB told the stock market that cumulative milestone payments could exceed $US$1 billion depending on the final outcome of Phase III studies and patient adoption. Mesoblast will also receive “tiered double-digit royalties” on product sales. What most impressed investors was that the Grünenthal deal is exactly the kind of transaction MSB has talked about in its strategy, which is “to team up with best-in-category commercial leaders to maximise market access for our innovative cellular medicines.” The deal should give investors confidence in Mesoblast’s ability to strike similar partnerships.

4. Cynata Therapeutics (CYP, $1.595)
Market capitalisation: $163 million
One-year total return: 31.8%
Analysts’ consensus price target: $2.50

Cynata Therapeutics was also one of our promising stem-cell stocks in October 2016, when it was trading at 71 cents: CYN has also hit the headlines this month, announcing a deal with Japanese company Fujifilm by which the latter will exercise its option to license one of Cynata’s stem cell-based treatments
coming out of its Cymerus mesenchymal stem-cell technology platform.

Mesenchymal stem cells, or MSCs, are found in the body’s bone marrow and connective tissue. They have immune-suppressive and immune-regulatory activity, and migrate to sites of affected tissue to control local inflammation. In 2015, Cynata achieved a world-first breakthrough of manufacturing MSCs to therapeutic standards using induced pluripotent stem cells: prior to this breakthrough, manufacturing MSCs required a continuous supply of new tissue donations, but CYP’s technology using induced pluripotent stem cells gives it an effectively limitless starting material.

The Fujifilm deal was ready for the green light earlier this year, but in March, the two parties announced a six-month delay: that caused a 40% slump in CYP’s share price, but all is forgiven now on the part of skittish investors.

Fujifilm will license CYP-001, Cynata’s treatment for graft-versus-host disease (GvHD), a rare but potentially lethal complication from bone-marrow transplants, including for leukaemia. GvHD happens when immune cells from a transplant (the graft) see the recipient’s cells (the host) as foreign, and attack them, causing inflammation throughout the body. Usually, severe cases of GvHD are treated with high-dose steroids and immune-suppressants, but in about half of cases the patient fails to respond to treatment – and the consequences are usually fatal.

However, CYP-001 treatment, involving an infusion of millions of stem cells, appears to work to control and mediate the immune response. A Phase I clinical trial in 2018 showed that 14 out of 15 GvHD patients treated with CYP-001 showed improvement, with 8 of 15 having their GvHD signs and symptoms “completely resolved.”

Cynata will receive $US3 million from Fujifilm as an up-front fee, and stands to get up to $US43 million more in future milestone payments, as well as 10% royalties if the drug is successfully commercialised.

Cynata is also working to develop stem treatments for osteoarthritis and critical limb ischemia, a reduction of blood flow to the extremities that can lead to amputation and death. The company is preparing Phase II trials for its stem cells in relation to both conditions.

In July, Cynata received a $200 million takeover proposal by Japan’s Sumitomo Dainippon Pharma, at $2 a share. The company says it will update the market about the approach shortly: obviously, its response will have a significant impact on whether CYP will stay independent long enough to attain where analysts see its price as potentially heading.

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My “HOT” Stock – I like A2 Milk (A2M)
by Maureen Jordan

Like

Michael likes A2 Milk (A2M). “Analysts were unimpressed by last week’s Investor Day but the numbers still add up, he says.

“With long-term growth above 15% and a price-to-earnings ratio around 30x, the 25% share price pull back looks like an opportunity,” he adds.

Dislike

Michael doesn’t like Collin’s Food (CKF). “Its share price is boosted by its addition to the S&P ASX200 index,” he says.

“However, at close to $10, the share price is at all-time highs, on a P/E ratio around 24x.

“The KFC and Taco Bell franchise holder would need spectacular growth to justify this sort of multiple,” he adds.

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Buy, Hold, Sell – What the Brokers Say
by Rudi Filapek-Vandyck

In the good books

MAGELLAN FINANCIAL GROUP LIMITED (MFG) was upgraded to Neutral from Underperform by Macquarie B/H/S: 0/2/5

Following a recent de-rating in the share price along with relative outperformance, Macquarie upgrades to Neutral from Underperform. Target is $50. The company’s $275m capital raising in isolation would result in just under -3% dilution, the broker calculates. Offsetting this, the proceeds will be used to launch the Magellan High Conviction Trust as well as a new retirement product and seed new investment strategies.

RAMSAY HEALTH CARE LIMITED (RHC) was upgraded to Outperform from Neutral by Macquarie B/H/S: 2/5/0

Macquarie expects contributions from Australian brownfield projects will support above-industry hospital growth in the near to medium term, although reduced participation in private health insurance presents a headwind for hospital volumes in Australia. The outlook for the UK and France has also improved. Valuation appears undemanding at current levels and the broker upgrades to Outperform from Neutral. Target is steady at $71.50.

In the not-so-good books

BEACH ENERGY LIMITED (BPT) was upgraded to Hold from Buy by Ord Minnett B/H/S: 0/5/0

Post a share price rally of 50% in the past month (!), Ord Minnett has decided it’s time to downgrade this stock to Hold from Buy. The target price remains at $2.55 but is now below the share price. The broker remains positive on the company’s outlook and cites further strengthening potential for the oil price as a key risk to its decision. A further US$10/bbl rise in the oil price would translate into a 20%-plus lift in forecasts.

CENTURIA METROPOLITAN REIT (CMA) was downgraded to Neutral from Buy by UBS B/H/S: 0/2/0

The company has acquired two assets for $380.5m, funded with a $273m equity raising. UBS increases the valuation, raising the target to $2.82 from $2.74, after incorporating the transaction, but downgrades to Neutral from Buy on valuation grounds. The company has acquired 8 Central Avenue Eveleigh, Sydney, and William Square, Northbridge, Western Australia. UBS assesses the overall transaction is neutral or marginally dilutive to free funds from operations (FFO). The company expects FFO in FY20 to be 18.7c per security.

DACIAN GOLD LIMITED (DNC) was downgraded to Underperform from Neutral by Macquarie B/H/S: 0/1/1

Net profit in FY19 was stronger than Macquarie expected, largely because of the better depreciation expense. Mount Morgans continues to be essential to meeting guidance in FY20. Macquarie downgrades to Underperform from Neutral because of recent share price strength. The broker notes the processing plant
needs to perform well in excess of nameplate, given the recently revised life of mine plan. The company is also relying on continuing improvements from the Westralia underground mine. Target is steady at $1.20.

KATHMANDU HOLDINGS LIMITED (KMD) was downgraded to Neutral from Outperform by Credit Suisse B/H/S: 0/3/0

FY19 net profit was at the top end of guidance and above forecasts. Credit Suisse found the results solid, reflecting the full year impact of the Oboz acquisition as well as operating efficiencies. The company expects Oboz to continue delivering double-digit growth and this should largely offset the FX impact on gross margins in the core retail business. Same-store sales growth in FY20 to date has been strong, up 6.1%. While continuing to believe Kathmandu has attractive medium-term growth options there was nothing in the result to drive a materially higher valuation, in the broker’s view. Rating is downgraded to Neutral from Outperform. Target is raised to NZ$3.15 from NZ$3.00.

Earnings forecast

Listed below are the companies that have had their forecast current year earnings raised or lowered by the brokers last week. The qualification is that the stock must be covered by at least two brokers. The table shows the previous forecast on an earnings per share basis, the new forecast, and the percentage change.

The above was compiled from reports on FNArena. The FNArena database tabulates the views of seven major Australian and international stock brokers: Citi, Credit Suisse, Macquarie, Morgan Stanley, Morgans, Ord Minnett and UBS Important: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regard to your circumstances.
My “HOT” Stock – I like Smart Group (SIQ)
by Maureen Jordan

Like

Smart Group (SIQ) provides salary packaging and fleet management services. In the August result, Smart Group saw strong earnings resilience in the face of weak consumer trends.

“With strong cashflow, there’s the possibility of acquisitions or capital management to help boost returns,” she says.

“This is a company that could see upgrades over the next 18 months,” she adds.

Source: Google

Dislike

With weak retail conditions prevailing globally, Julia doesn’t like GPT.

“Shopping centres around the world continue to feel the bite of a weaker consumer and structural shifts to online. And Aussie retail REITs are no different,” she says.

“Here in Australia, we’re seeing major brands decreasing footprint and speciality sales continuing to slow down.

“Reports from GPT and the sector suggest there’s more weakness to come and we could see further negative revisions to the valuation of shopping centre landlords,” she adds.

Source: Google

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