

ValueLine: Reece Australia



By Roger Montgomery

PORTFOLIO POINT: All the figures are strong for Reece Australia. If only the share price would drop below its intrinsic value ...

Legend has it that Warren Buffett, the world's greatest living investor, was so resentful of the Efficient Market Theory's hold on his Columbia University alumni that he refused to donate money to the university, telling the business school dean, John C Burton, that he didn't think business schools were teaching things he wanted to support.

Financier and political activist George Soros in his book *The Alchemy of Finance* (yes I have begun my summer reading) says the [Efficient Market] Theory "is manifestly false". (The theory says all market participants receive and act upon all available information; in other

words, share prices perfectly reflect reality.)

There is one point on which Buffett, Soros and the academics can agree, however: there are conditions during which markets are inefficient. In particular poorly understood, new or under-researched markets are more likely to produce periods of inefficiency that the investor can take advantage of.

Australian plumbing supply chain, Reece Australia Ltd (in which ValueLine holds shares), is covered by just two analysts: Ivor Ries of Baillieu Stockbroking and Robin Morgan of Taylor Collison. I don't know of any others who have produced research on one of Australia's shining examples of superior business economics.

Understandably large brokers don't cover companies that cannot produce large amounts of brokerage and the fact that Reece's free float amounts to less than 30% of its issued capital further increases the prospect pricing inefficiencies.

Australia's home improvement sector, worth about \$24 billion, is dominated by the Wesfarmers-owned Bunnings hardware chain, which has an 18% market share. (To read more about Bunnings, click [here](#).)

Among the remaining participants, which include Mitre 10 (soon to become part of Metcash), Crane Group's Tradelink and Woolworths' Danks. Reece commands 8% of the market

The ValueLine portfolio, as at December 15, 2009

Company	Buy price	Price today	Est value	Margin of safety	Shares bought	Invested	Capital value	Divs rec	Total return	Total return
JB Hi-Fi	14.8	22.57	25.76	12.4%	845	\$12,500	\$19,063	0.29	\$6,807	54.46%
Cochlear	56.36	65.2	56.3	-15.8%	102	\$5,744	\$6,645	0.95	\$998	17.37%
CSL	31.81	30.75	32.87	6.4%	163	\$5,197	\$5,024	0.4	-\$108	-2.07%
Woolworths	26.16	27.01	26.85	-0.6%	206	\$5,377	\$5,552	0.56	\$290	5.39%
Reece	17.8	23	14.83	-55.1%	236	\$4,209	\$5,439	0.33	\$1,308	31.07%
Platinum Asset Mgt	4.06	5.15	3.95	-30.4%	854	\$3,467	\$4,398	0.12	\$1,033	29.80%
CommBank	46.51	52.84	52.81	-0.1%	215	\$10,000	\$11,361	0	\$1,361	13.61%

July 1 - Today

Security Value	\$57,481
Cash Value	\$56,635
Total Value	\$114,116
Total Return (\$)	\$14,116.00
Return Invested (%)	29.25%
Total Return (%)	14.12%
XAO Change	18.20%

Outperformance of invested portion x

11.05%

Outperformance of total portfolio

-4.08%

Negative watch

Company	July 1 price	Price today	Est value	Margin of safety	Divs rec	Total return
ISOFT	0.635	0.705	0.19	-271.1%		-11.02%
Amcor	4.79	6.17	3.63	-70.0%		-28.81%

and is by far the dominant participant in the plumbing services sector.

In the past decade equity has risen from \$160 million to a forecast \$580 million in 2010, revenues have tripled to \$1.5 billion as have profits (to a forecast \$113 million) and not a single share has been issued to fund that growth!

HJ Reece, established in 1919 and listed in 1954, for almost 90 years provided a dedicated service to plumbers. In 1969 the Wilson family bought into the business and renamed it Reece Australia in 1987. Reece's 3500 staff, 400 stores and dominant position in supporting refrigeration, ventilation, air conditioning and heating contractors, as well specialised services to the industrial, irrigation, and civil engineering sectors, have produced something of a moat that is reflected in the company's profitability and lack of debt.

Return on equity for the past decade has been relatively stable, averaging 22.8% but perhaps more importantly, returns on net fixed assets – a measure of capital intensity – have averaged 45.6% over the decade. By way of comparison, Qantas' average return on net fixed assets over the past decade has been just 4.9% and was less than 1% last year.

With returns like these it should come as no surprise that debt does not feature on Reece's balance sheet. With just over \$500 million of equity, the company's long-term debt has never exceeded \$5 million in the past 10 years (although there is a short-term obligation of \$48 million, but even this amounts to less than 6% of total assets and is exceeded by cash in the bank).

Boring old toilets, taps, pipes and hot water systems aren't as sexy as biotechnology and gold but the returns have

arguably been far more attractive.

Ignoring a five for one share split in 2002 – no doubt motivated by some banker spuriously arguing about liquidity – the intrinsic value of Reece has risen from about \$3.30 in 2001 to about \$15 today.

This is impressive and it was a reason for Reece's original inclusion in the ValueLine portfolio.

Unfortunately, the pricing inefficiency discussed earlier has not been to the downside for Reece. The price has remained stubbornly above intrinsic value for some time and today the extent of that truth is confronting. But opportunities to acquire more shares are likely to present themselves if Reece continues to grow its equity faster than its profits.

Ultimately what I am interested in, is a business with a demonstrated track record of superior economics, bright prospects and a cheap price. Although the cheap price is missing today, value investors should nevertheless hope for a rainy day on the market and remember Reece when it rains.

Postscript: These little postscripts ... they can pack a punch. Last week's cautionary note about MMS was timely with the stock subsequently falling 11%. This week probably won't be as powerful but will nevertheless be just as valuable. The IATA, which represents 230 airlines carrying 93% of international traffic, has forecast airline losses in 2010 will total \$5.6 billion, 47% wider than an earlier forecast and "happily" just half the \$11 billion deficit IATA predicts for this year. These losses are despite revenue of \$478 billion. Shares in airlines? You have been warned. Again. ♦

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How Reece Australia's share price has moved

