Three Darling Stocks to Sell

We don’t own many great businesses. Our portfolio is full of asset plays, turnaround stories and okay businesses trading at dirt-cheap prices. Don’t get me wrong. We like good businesses. Dental aggregator **1300 Smiles** has been one of our investments. It’s just that the prices for Australia’s good businesses are too darned expensive.

Perhaps it’s the Warren Buffett influence: “It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.” Perhaps there is less risk to fund manager reputations in buying supposedly high quality shares. But, whatever the reason, the ‘good business’ pond is heavily fished in this country.

There are those where I agree with the general sentiment. **Cochlear**, **CSL** and **Coca-Cola Amatil** are businesses we’d love to own at the right price. But it’s hard to see much margin of safety at current prices.

More dangerously, there are those that look like great businesses but aren’t. “You can’t make clay out of turds”, Charlie Munger told us at the 2008 Berkshire AGM. But you can make turds look like clay for a while.

Paying too much for a good business that really is a good business usually means you end up with, say, a 6% return instead of the 10% you were hoping for when you bought it. A familiar experience, perhaps, for those who paid $80 for their Cochlear shares in 2007.

But paying a big price for a business that you think is a clay, and then finding out that it’s actually a turd, now that’s where you can lose significant cash.

On that somewhat smelly note, here are my top three overrated businesses.

McMillan Shakespeare

A friend of mine has managed to get his tax rate down close to zero. Every time we go out for a meal he keeps the receipt and claims it against his tax. He does that often enough and with enough people to get deductions against the vast majority of his income – and there’s nothing dodgy about it. There is a specific piece of legislation that allows public health sector employees to incur all sorts of expenses including, according to McMillan Shakespeare’s website, one’s “mortgage, rent, school tuition fees, private health insurance or even a personal loan repayment”.

McMillan Shakespeare’s role in the world is to manage these schemes on behalf of public health employers. For its part, the company sports a market capitalisation of almost $1bn. It’s well managed. The economics are wonderful. And it’s been able to grow earnings consistently for a very long time. But the business is a leach on the economy.

The government pays the employees below market salaries. The employees take advantage of a loophole to claim all sorts of absurd deductions, such that their post-tax salary is more like market. What the government takes with one hand, it gives back with the other. The only problem is the $300m of revenue that falls out of the merry-go-round and into McMillan's lap.

The share price got hammered two years ago when the Henry Review of taxation recommended shutting down the loophole. Along with most of Ken Henry's other sensible suggestions, the government ignored it after pressure from vested interests. But those paying 18 times earnings are taking a huge regulatory risk.

Flexigroup

This is another well-managed business that runs rings around its peers. But the products it sells are a rip-off for its customers, and ASIC should do something about it.

Flexigroup's main product, Flexirent, enables you to lease new computers and the like for a weekly or monthly fee. Using the calculator on their website, they'll lease you a $2,000 computer for three years for just $101.60 per month. Sound attractive?

Probably not, to you. Three years at $101.60 a month is $3,675.60. You don't need a financial calculator to work out how obscenely expensive that is for a $2,000 computer, but for those who are interested, the implicit cost of finance is roughly 45%. And that's before considering the residual value of the computer.

Flexigroup generated $241m of "interest" income last year and wrote $801m of new business. Either a lot of people desperately need TVs and have no other way of buying them, or they have no idea how badly they are getting ripped off.

My guess is the later feature prominently. Which is why you don't see the cost of finance anywhere on Flexirent's website.

All ASIC needs to do is force these companies to inform the client of the implicit cost of finance, and business would halve.

There's no sign of that on the horizon. ASIC is too busy telling people not to buy agribusiness schemes five years after investors learned that lesson the hard way. But Flexigroup's shares trades on 18 times last year's earnings. For mine, that's a big price for a business with product of dubious value.

Blackmores

And finally, there's Blackmores. There is a lot to like about this company's financials. Over the past five years, this nutritional supplement business has grown revenue 9% per annum, earnings per share 10% per annum and fully franked dividends 9% per annum. Its return on assets was 16% last year. Return on equity a very healthy 34%. It's not hard to see why people are prepared to pay 19 times earnings for it.

But it's those same stupendous metrics that have me worried. High returns on capital represent one of two things: either a beacon to investors that highlights a wonderful business with a sustainable competitive advantage; or a beacon to competition that there are juicy returns to be had.

Blackmores has had a dream run since the collapse of its main competitor, Pan Pharmaceuticals, in April 2003. It has had the market to itself for the best part of a decade. Its relationships with traditional chemists have been very strong – read financially prosperous for both parties – and market dominance led to wonderful margins.

That is all changing. Firstly, competition has returned with financial backing to boot. Swisse and Nature's Own are both pouring millions of dollars into gaining a foot hold in the market. That is crimping sales growth – from double digits to nothing on a comparable basis.

Worse, Blackmores is having to spend more on marketing itself. As a percentage of revenue, promotional expenses have increased from 12% four years ago to 19% as of the latest results.

Secondly, Coles, Woolworths and Chemist Warehouse have changed the game on the distribution side. All three have become big players in the market for nutritional supplements – and they play tough. Blackmores' average days receivables – the average time it takes to collect from its customers – blew out from 58 days in 2009 to 68 days today. Average days inventory outstanding was 83 days. Now it's 118. And, on the other side of the equation, the average days Blackmores takes to pay its bills has fallen from 51 to 47 over the same period.

That's all horrible for working capital, and has meant that while earnings have been growing, cashflow hasn't. Cash from operations grew only 3% in 2011 and *fell* 10% in 2012.

Evidence is mounting that Blackmores' moat is not wide enough to protect its wonderful recent margins. Given today's $30 stock price, that should be serious cause for concern.