

FLOAT
WATCH

Helping to ward off hack attacks

Tesseract

ASX CODE: TNT
SHARES ON OFFER: 35 million
LISTING PRICE: 20c
MARKET
CAPITALISATION: \$20.5 million
LISTING DATE: February 19

SIMON HERMANN

In 2013, Scandinavia's largest independent research organisation, SINTEF, reported that 90 per cent of today's data has been created in the past two years. Software giant Oracle projects that data available to consumers will grow at a 40 per cent compound annual rate, reaching almost 45 zettabytes by 2020. With more and more businesses shifting to the cloud, consumer protection becomes increasingly important. No wonder then that concerns surrounding the privacy and safety of personal data abound.

While this trend provides opportunities for cloud computing and technology companies, one of the fastest-growing industries is cybercrime. These cyber-criminals have become an everyday part of the industry.

Software companies across the world are developing ways to counteract these criminals and protect data. Several technology and software companies offer cyber security as a service.

Tesseract is the first pure play internet security company to list on the ASX. Tesseract aims to capitalise on the increasing volume of cybercrimes.

Tesseract has more than 190 clients in 11 countries and achieved total revenue of \$3.7 million during the 2015 financial year. The company seeks to raise up to \$7m in the initial public offer scheduled to conclude in February. The proceeds will be used to repay existing debt, fund domestic and international expansion as well as for general working capital.

Although the company is profitable, its reliance on external capital has not yet been completely eliminated. Directors have not declared a dividend for the current financial year as profits will be reinvested. The internet security industry is highly competitive and there is no guarantee Tesseract will maintain or lift market share.

The offer appears well balanced in light of the revenue and earnings growth trajectory as well as management track record. The recurrent nature of its income and high degree of fixed costs provides strong operating leverage to incremental contract wins. With competition and funding being the main hurdles, IPO participants can gain exposure to the international cybersecurity market.

Simon Hermann is an analyst at wise-owl.com.

Changing times bring new opportunities for savvy investors

DAVID WALKER



Looking ahead to 2016, investing in the Australian market will be about the index's composition, not its level.

The index is going to be restrained by two of the same drags as 2015:

1. A lack of value due to low bond yields inflating equity prices.
2. Underperformance by mining stocks, which accounted for 11 per cent of the ASX 200 by market weight on September 30, but will shrink to a single-digit weighting next year.

What's more, at current levels the index is fully valued and we expect only a single-digit return in 2016.

Other than by picking the right IPOs, the best returns on the ASX next year will come from picking the stocks and sectors that increase their weighting as resources continue to decline in relevance.

The winners will either have exposure to Australian dollar depreciation (US dollar earnings), as we expect the local currency to resume its slide, or to the strengthening non-mining economy.

In our article a fortnight ago in *The Australian*, "Stocks to watch as shifting economy heads for upswing", we presented the ASX stocks and sectors that benefit as the domestic economy grows: Among the stocks listed there were: ABC Brighton, Amcor, Qan-



Tourism-related stocks such as Mantra are ready for an upswing

tas, Ten, Mantra, IAG, Qube, Telstra and Wesfarmers.

So you should "sell beta and buy alpha". This means avoiding index investing (investing in a way that mirrors the major weightings in the market), which will deliver only mediocre returns. Instead, it's time to choose active management, which in 2016 will be the only path to earnings returns that compensate for the risks of equity investing. Indeed, it could be argued this has been the case for the past nine years, as the index remains at levels of late 2006.

Banks are set for modest rallies. All of the four major banks are still undervalued — ANZ, CBA, NAB and Westpac — and, barring further difficulties imposed by new global rules for capital process, bank stocks can rally as mortgage lending continues to grow and business lending accelerates.

My first-choice bank stock for 2016 is NAB for its sector-leading exposure to business lending and the tailwinds to return on equity from divestment of the troubled British operations. Corporates have plenty of room to regear.

CBA is a second choice for its diversification, superior record of low-volatility earnings growth and strategic execution.

ANZ and Westpac rank last. ANZ screens as the cheapest bank but this is deserved, as the Asian expansion has not delivered any value that we can see. Bank returns on equity from Australian mortgage lending were higher throughout ANZ's expansion in Asia, but ANZ is now expanding in Australian home lending at the peak of the cycle and by price discounting, which is a concern.

In contrast, Westpac expanded the most aggressively in NSW and Victoria investor lending so it has the most to lose from the current slowdown in these markets. Westpac needs more capital for this

reason and because it raised \$3.5 billion of new equity but then paid most of it out again in dividends.

I've singled out these stocks because of the following macro-assessments:

- There will be no housing collapse and that underpins our confidence in banks. House price growth will slow down but continue because interest rates remain very low. The theme is stagnation/cooling, not collapse. We do not expect the Reserve Bank to (lift rates until mid to late next year.
- The upside risks to world in-

flation are in the tightening US labour market (and Britain to a much lesser extent) and the stability in oil around \$US40-\$US50. The heaviest falls in oil were a full year ago, so these falls will soon drop out of annual comparisons.

Oil will rally. To preserve profitability and dividends, oil producers have slashed capital expenditure too far for the industry to meet demand growth in coming years, especially given that the US's much-vaunted shale oil wells have short production lives and need replacement sooner than traditional wells.

As the futures market realises this, oil prices should rally modestly next year, giving the industry incentive to resume exploration and development of new reserves. Low prices will be their own cure. Note the outlook for oil differs from the bearish outlook for iron ore and coal.

Australian dollar weakness will resume as bulk commodity prices continue to head lower on rising supply and weaker Chinese demand. BHP and Rio Tinto are both bearish on iron ore in 2016. Gina Rinehart's Roy Hill just started exporting, adding to the surplus in the seaborne iron ore trade. Major miners continue to drive costs lower by increasing supply in an effort to drive out higher-cost production and in-

crease market share. We also expect the foreign exchange market will start to pay more attention to Australia's worsening foreign debt position. High gearing and commodity exposure do not go well together.

The great opportunity for Australia is inbound tourism, especially from China. Australia has world-famous tourism assets when outbound Chinese tourism is compounding rapidly and the cheaper dollar makes an Aussie holiday more affordable. We urge our politicians to lead a national conversation on this and how the country can best benefit from it.

This Christmas is shaping up as a good one for retailers, but working capital pressures in retail will grow in 2016 as Australian dollar hedges at US\$80c roll off and retailers pay more for imported inventory. Any retail that cannot pass this on to consumers could disappoint investors.

Finally, the building sector is experiencing the highest levels of residential construction in a decade but the market has fully factored this in. It's time to ease out of residential construction stocks during share price strength. We recently sold the Brickworks position in our model portfolio.

David Walker is senior equities analyst at StocksInValue.com.au.

Free to borrow SMSFs, must tread carefully

TONY NEGLINE



One of the key developments in superannuation this year should not go unmarked: Thankfully common sense has prevailed and the Government will continue allow super funds to borrow money. This is a key decision, it goes against what was recommended in the Murray Inquiry and it should mean investors can now make plans with some confidence.

But investors needs more than confidence, they need to be very careful. To date most super funds that have leveraged their investments have been Self Managed Super Funds and the majority of that activity has been in the residential property market.

It's only a matter of time before APRA regulated super funds begin looking at this option for their members. There is no doubt that some of their members will move to SMSFs if this option remains unavailable in larger funds. Some bigger funds will provide

a half way solution by offering an investment option that internally contains gearing. Some retail super funds already have this alternative. Later some funds will allow members to put in place a gearing arrangement over specific assets including the member's preferred gearing level just like SMSFs.

Borrowing to invest always increases risk and it never ceases to amaze me how some don't understand this aspect or how to assess it. Take the example of someone I spoke to recently. This investor was in an employer sponsored super scheme. She has about \$100,000 that can be moved out of this fund and currently salary sacrifices about \$15,000 into super each year (or \$13,500 after contributions tax).

She was thinking of transferring the \$100,000 super balance to a SMSF that she would set up and have the fund borrow \$900,000 to purchase a residential property.

My first response was to do some back of the envelope maths. Suppose the interest rate on the loan was 6 per cent which means that each year at least \$54,000 (6 per cent of \$900,000) would be payable. I say "at least" because of the way most lenders calculate the amount of interest owing.

At the moment rental yields where her preferred property is

located are running at about 3.5 per cent or about \$35,000 each year. She would need a real estate agent to manage this property which would charge about \$3,000 per year. Rates, maintenance, insurance and other costs would be about \$6,000 every year. Net rent is therefore approximately \$26,000 pa.

All up she would have \$39,500 (\$26,000 in net rent and the \$13,500 net salary sacrifice super contribution) to cover her super fund's interest cost which means

she's short at least \$14,500 each year.

I asked her what she would do if interest rates increased by 2 or 3 per cent per annum? Paying 8 per cent interest each year would see her interest cost increase by 33 per cent or an additional \$18,000 each year. Nine per cent per annum interest cost sees her paying 50 per cent more in interest each year.

I also asked what would happen if her tenant left and she had

to wait for an unknown period of time before a new one moved in?

My final question was what would happen if she lost her job for whatever reason and there was no salary sacrifice super contribution going into the fund?

This strategy fails because of insufficient annual cashflow even allowing for the fact the super fund would pick up a tax break on the annual loss because the investment is negatively geared. The problem is the tax break is only worth about \$2,200 inside the fund.

There is another basic problem with her idea — lenders operating in the super fund arena typically only loan up to 70 per cent of a property's purchase price.

Clearly she needs to take a deep breath, re-evaluate her strategy and consider how it might all fall apart and what her finances would look like.

This situation feeds perfectly into all the hysteria about super funds borrowing money. Namely, property spruikers preying on unsuspecting investors who then lose all their retirement money by borrowing too much money to buy a questionable property.

Tony Negline is the author of *The Essential SMSF Guide 2015-16* published by Thomson Reuters

Getting to know your DIY parties

MONICA RULE



The issue of "related parties" is often misunderstood in the self-managed superannuation fund (SMSF) space: One of the most common misconceptions is that superannuation law does not allow people who operate a business together to invest together.

While this assumption is correct for people who operate a "partnership" business together, it does not apply to businesses operated under a "company" structure. This is because it is an individual's shareholding in the company that determines whether they can invest with the other shareholders of the company.

Under the superannuation law, where an SMSF member operates a company with other people who are not related to them by blood or by marriage, and each of the directors of the company holds no more than 50 per cent of the shareholdings in the company, then the company is not treated as a related entity of the member of the SMSF. The direct-

ors are also not treated as related parties to each other. The above misconception is caused by the wording in the superannuation law that describes who is a related party or which entity is a related entity of a member of an SMSF.

Under the superannuation law, if a member of an SMSF is in a "partnership" relationship, then the other individual in the partnership would become a related party of the member.

This means, people who operate a "partnership" business together would be treated as a related party of each other under the superannuation law. It also means that if two people operate a joint bank account that derives bank interest, or invest in a property that derives rental income, then these people will become a related party of each other.

This is even if the two people are not related to each other by marriage or by blood. This is because, the term "partnership" is defined in taxation law as an association of persons carrying on a business as partners or in receipt of ordinary income or statutory income jointly.

So how does the Taxation Law affect the superannuation law?

Well, the revision of the in-house asset rules in superannuation law was made with the passing of the Superannuation Legislation Amendment Bill (No

4) 1999. The Government's policy objective was explained in the explanatory memorandum (EM) to the Bill. The EM refers to partners in the sense that the taxation law considers the partnership as taxpayers. Therefore the superannuation law's "view" of partner and partnership does not mean partner in the sense of domestic partner or business partner but a partner of a partnership.

So, if you and two other people operate a business together under a company structure, and provided all three of you are not in a partnership relationship with each other, then the three of you are not in a partnership under the superannuation law and therefore are not treated as a related party of each other. Although the three of you are directors of the company where you operate a business together, you are not partners of each other, nor are you partners of your company.

What this means is that if you and the other directors of your company do not hold a controlling interest in the company (where none of you hold more than 50% of the shares); and, provided you do not have a partnership relationship of any sort, then the superannuation law allows you to pool your SMSFs' money and invest together.

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