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BTN Thursday Thoughts

Jeff Middleswart
btnresearch.com

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Contents

This is will be our first of many potpourri-style *BTN Thursday Thoughts* where we update several prior thoughts and reports as well as address some new areas that may generate some more in-depth research in the future.

Travel Growth in New Zealand

"It's a dangerous business, Frodo, going out your door.
You step onto the road, and if you don't keep your feet,
there's not knowing where you might be swept off to."

-J.R.R. Tolkien, *Lords of the Rings*

Among the things we want to identify at Behind the Numbers are some long-term stories of growth or decay to have a macro tailwind for investment ideas. One area we see solid growth potential is in travel. Millennials like to travel. As people age and have fewer family commitments, they often start to travel more. As people earn higher wages, they also tend to spend more money on travel. Currency rates also play a role- to some countries with strong currencies, other places look like bargains and that drives travel too.

After spending Christmas in New Zealand, it was obvious that there is considerable growth potential still coming there. We identified some investment options and some potential problems. We need to do more work on them before formally recommending them, but here are some of our anecdotal observations:

1) *Considerable new infrastructure is being built.* The Auckland Airport recently expanded its International terminal and has signs posted about more construction in the form of a new runway, more customs clearing capacity, hotels, and a modernized domestic terminal.

2) *Tourist shopping after Christmas was intense*. We passed several stores like Prada, Coach, Louis Vuitton, etc. with security guards outside the door to limit the number in the store at any given time. The line to get into most of these stores was at least 40-50 people. There is more retail construction starting in the area also.

3) *Lord of the Rings may be more popular than the Kiwi birds*. The South Island in particular markets the various locations where *Lord of the Rings* was filmed, and getting people to those areas has become a large part of the job base along with new wine regions.

4) *Potential Property Bubble*. The first tour we did in Queenstown, the driver noted that his friend bought a home for under NZ$200,000 about 10-years ago which is now valued at over NZ$1.2 million. The second tour we did, the driver himself bought a house recently for NZ$565,000 and by the time the paperwork process was complete, it was valued at over NZ$700,000. His previous job was a customer service phone rep for Lego. Based on the fee of the tour for 6-people at about NZ$1,000 and the 16 people who work for his company, vans, gasoline, etc., I could not get my guesstimate of his pay above NZ$200 for the day. He has kids as well, along with a sizeable mortgage. The chairman for Mainfreight, a freight company in New Zealand, noted in his 2017 annual report letter that the rising home prices are a considerable, recent change for the country. Historically, home prices were about 3x annual incomes of home buyers- now they are above 10x.

5) ***Underutilized commercial property***. Queenstown in particular has a town center that still houses numerous T-shirt shops selling low-priced trinkets, 40 places booking tours, and upholstery repair shops along the lakefront. If the value of real estate is that high and tourism is growing, much of this can be repurposed and perhaps add more stories to the buildings. We saw similar activity in Auckland near the harbor as well.

Looking more closely at some of the figures for New Zealand, the growth is becoming more pronounced. The government's website for Tourism New Zealand reported that for 2017, international tourism had reached NZ$14.5 billion and total GDP is about NZ$235 billion. The growth rate has been strong for years:

# Passengers	Intl	Domestic	Transit
2017	9,742,980	8,601,841	675,752
2016	8,779,566	7,902,059	578,706
2015	8,124,435	7,198,595	493,756
2014	7,687,836	6,911,689	462,560
2013	7,317,324	6,760,537	438,354
2017Gr	11.0%	8.9%	16.8%
2016Gr	8.1%	9.8%	17.2%
2015Gr	5.7%	4.2%	6.7%
2014Gr	5.1%	2.2%	5.5%

These are passengers who flew on international flights, domestic flights, and landed on an international flight, which connected to another one without leaving the airport. The growth rates have been impressive and are showing signs of accelerating. Moreover, New Zealand has only a little over 4 million citizens, so the number of people traveling is already very pronounced. These figures are from the Auckland Airport annual reports. They do not include people who arrive by cruise ship.

Growth also appears to be fairly untapped from some key markets with higher populations:

# Passengers	USA	China	India
2017	267,037	356,315	52,301
2016	203,573	359,270	49,284
2015	186,257	292,435	45,755
2014	168,437	226,994	34,484

The growth is coming from each of these countries with 300 million to 1 billion in population. However, the US is still only 5.5% of passengers, China 7.3% and India 1.1%. Compare that to Australia at nearly 18% of New Zealand's passengers with a population of only about 24 million. Sydney and Melbourne are still over 3-4 hours away from Auckland by plane.

In our view, there are two reasons to expect the growth to continue beyond the demographic impact of people traveling more. The first is airline, airport, and hotel capacity to and from New Zealand is still expanding. And second, the tourism bureau is investing more in touting New Zealand as a destination on a number of fronts.

Infrastructure capacity should continue to build. We are going to outline what a few companies are reporting for the last year and future:

Boeing – The 787 plane has the range to cross the Pacific from Los Angeles or Japan. It is cheaper to operate in terms of fuel and because it is smaller, it is profitable on fewer seats being sold. That opens up more routes rather than focusing only on major cities with larger planes. The 787 makes it possible for people to connect through Auckland for other international flights and is a reason the transit figures are rising so rapidly as noted above.

Boeing is increasing its production of 787s from 12 to 14 per month. So far, 625 planes have been delivered with another 675 on order. As more of these planes become available, it should allow more flights into New Zealand from places like India, China, SE Asia, etc. This helps remove a bottleneck when New Zealand didn't have enough traffic to fill 747s, 777s, and Airbus 380s. Those planes were also more costly and airlines therefore allocated them to the most profitable routes which resulted in many travelers to New Zealand needing connecting flights. The 787 should continue to boost direct travel options.

Auckland Airport – Has been expanding and redesigning its property primarily through 2022. Upgrades include adding more international gates – some of which are already open. Expanded security and customs screening and upgrading the check-in area are planned. New airport lounge-clubs and easier road transportation to and from the airport are being added. A new domestic terminal will come online in 2022 and a second runway is scheduled for 2028. An anecdotal observation here as well – while I have not been to every international airport in the world, getting through customs to enter and to leave Auckland was the fastest I've ever had, and that's before much of this new work is completed. The airport is also adding hotel capacity onsite for 2020.

Air New Zealand – The fleet has been upgraded and more of that will continue as 787s arrive in 2018 and 2019. The company recently added non-stop service between Auckland and Houston, Buenos Aries, Tokyo and just added a second Tokyo airport. There is a focus on boosting fly-through travel from smaller cities in Australia to the United States via Auckland. It has partnered with several other world airlines like Singapore Airlines, Cathay Pacific, and United to drive connecting travelers to the Air New Zealand routes. Also, many international passengers may arrive on a different airline, but it is likely if they want to visit other New Zealand cities, they will transfer to a domestic flight on Air New Zealand. The company has also upgraded its domestic fleet and route system.

Accor Hotels – This is a French company that operates several levels of hotel brands around the world. Sofitel, Swissotel, Fairmont, Novotel are some of their brands. The company operates 583,000 hotel rooms and is adding 171,000 more. While New Zealand is not broken out specifically, Asia/Pacific is where 44% of those new rooms are being added. Accor is in a joint venture with the Auckland Airport to build a hotel there.

Tourism New Zealand is the government tourist bureau set up in 1991. New Zealand has recognized that tourism plays a big part in its economy and has set up branch offices in large cities such as Buenos Aries, Rio, Los Angeles, London, Tokyo, etc. Here is their annual report. On page 20, they show that international tourism is the fastest growing area of the New Zealand economy.

The group has been very active in touting New Zealand stories on social media and TV shows. To some degree, it sounds like the old Paul Hogan/Crocodile Dundee advertisements and Steve Irwin/Crocodile Hunter TV shows that touted Australia as a tourist destination, or when every other show on cable was pushing Las Vegas hotels and how to visit for $10/day.

Tourism New Zealand is touting New Zealand movie tie-ins like *Lord of the Rings*, Disney's *Pete's Dragon* and local movie icons like James Cameron. It has set up outdoor adventure shows from New Zealand on the Nat Geo channel with Bryce Dallas Howard. They are touting the proximity to Antarctica and the new wine regions in the country.

We understand that every country and many cities have tourism bureaus to help draw in visitors so it's a competitive area. But, it caught our eye how well many of the moving parts work together. For example, Air New Zealand recently announced non-stop flights from Buenos Aries at the same time Tourism New Zealand opened an office there. The same happened with cities in India and China as air routes opened. Also, Tourism New Zealand is working to not only grow the number of visitors, but also boost spending per capita. Spending per person can be sporadic at times, and they believe foreign exchange can play a role. It appears to us that in both situations, there is considerable room to expand. Auckland Airport had some stats in its Investor Day presentation that China visitors coming on group packages, which are lower cost, have basically been flat since 2013. However, free-traveling Chinese tourists are up 400% since 2013.

Despite strong recent growth, it appears that New Zealand is still growing off a low base. Las Vegas had 43 million visitors in 2016. Johannesburg had 20 million passengers at its airport in 2016. New Zealand is not only behind those areas in gross numbers, the World Bank noted that it only ranks 61st in visitors per capita at only 0.8x. Other smaller countries that are beating it include Austria at 3.1x ranked 20th, and Croatia at 3.0x ranked 22. New Zealand could double its per-capital visitors and still be half what those countries are doing.

Possible Investment Ideas Related to this Theme:

These are not fully fleshed out ideas so do not consider these companies completely researched by us at this point. We will do more work on a few of these that seem more promising in the future. At this time, treat these as some simple outlines of why they could be appealing:

Auckland Airport (AIA.NZ, AUKNY) – We noted above the expansion at Auckland Airport that has been ongoing for a couple years and will be largely completed by 2022, other than the second runway expected to open in 2028. What is of further interest is the company owns 24.99% of the Queenstown airport on the South Island of New Zealand which is where *Lord of the Rings* was filmed. There are also many other types of outdoor activities including rafting and skiing. The company also has a 24.55% interest in both Queensland, Australia airports, which are the gateway to the Great Barrier Reef. All four airports should benefit from more tourism and create a company with a very high operating margin as it collects fees from planes landing and taking off, and collects rent from tenants operating restaurants, stores, Duty Free, airport lounges, parking, etc.

The company saw revenues rise 9.7% and income rise 26.9% last year. The dividend of 20.5 cents produces a yield of 3.1%. The dividend grew 17% last year and is a 73% payout of EPS. Debt-to-EBITDA is 3.4x. The cash flow looks unsustainable now because the capital spending is elevated as the airport is enlarged. So, the cash flow from operations with dividends from affiliates (basically the other airports it invests in) is NZ$327 million, the total capital spending and investments is NZ348 million, and the dividend is NZ$211 million. The company's basic plan is to pay the dividend with earnings. It then devotes the depreciation shield from earnings to new capital spending, which is NZ$78 million and the dividend reinvestment program adds another NZ$15 million. Other cash flow left over after dividend payments also is earmarked to capital spending and the airport borrows the rest. The view is that by focusing on areas for rapid growth such as adding more gate capacity to draw more planes and adding more routes, revenues and cash flow rise and the debt-to-EBITDA figures remain solid. Auckland Airport has an A- credit rating. This works as the airport has a 75% margin, so higher revenues generate higher cash flow very quickly.

Air New Zealand (AIR.NZ, ANZFF) – This one benefits from rising tourism, not only on its own international routes, but also from other carriers' passengers flying Air New Zealand domestically within the country. This company is further along in rolling out new capacity, retiring older planes, and launching some new routes where it faces little competition, such as Houston and Buenos Aries to Auckland. Its capital spending was very high in 2015 and 2016 and is now decreasing as cash flows rise. It has more planes to add in the next 3 years, but has already reduced operating costs per km by about 50-cents. It also has been able to boost capacity by 22% and only added 6% to employee totals. They also operate with more premium seats than many competitors, which boosts revenue.

This is still an airline, so there can be seasonality as well as changing fuel prices that impact short-term results. It also has high fixed costs, so filling less or more of the plane by a few additional seats can impact margins rapidly. If there are 250 passengers instead of 300 – they don't fly without a co-pilot or take 2 flight attendants off for example. However, it is an airline with an investment-grade rating. This was seen in 2017 as capacity was added faster than they could fully sell seats, and thus revenues declined slightly by 2.3% but earnings fell 17%.

The company grew the dividend by 5% in 2017, and noted that it views the dividend in a longer-term light rather than quarterly results. The dividend provides a 6.9% yield and the 21 cents was 63% of the 33.5 cents in EPS. Again, the cash flow does not look as strong during another period of high capital spending. Cash from operations was NZ$904 million and the company did sell NZ$60 million of old equipment as it updated with NZ$853 million of capital spending. That only leaves NZ$111 million and the dividend is NZ$240 million. What makes this look much more comfortable is the airline has NZ$1.4 billion in cash to handle the shortfall. It also means that net debt is only NZ$1.1 billion and less than 60% of equity. Debt is also only about 1x EBITDA too, which is very low for an airline.

Mainfreight (MFT.NZ, MFGHF) provides freight transportation within New Zealand, Australia, and other international markets. New Zealand is about 26% of revenues and 46% of EBITDA. Total revenue growth was 2%, while New Zealand growth was up 8%. Profit for both New Zealand and the full company was up 17% in 2017.

What seems interesting about Mainfreight is it should benefit from more tourists buying things while in New Zealand – especially wine – and shipping them home. Every place we visited offered Mainfreight shipping for products purchased. Mainfreight should also benefit from all the new airplane routes coming into New Zealand. Those planes have cargo bays to fill with tourist purchases, as well as shipping fruit and other perishables quickly to other markets.

For a logistics company, Mainfreight looks conservatively capitalized with debt-to-equity of only 33% and debt-to-EBITDA of essentially 1x. It does have some sizeable capital spending, and it spends heavily on software too, and thus has hefty depreciation. The dividend is only about 40% of EPS and is covered 1.6x by free cash flow. The yield is only about 1.6%, but it did grow 11% last year.

Port of Tauranga (POT.NZ, PTAUF) provides land and ocean freight transportation options as well, and has agreements with Maersk – the largest containership company in the world with the lowest operating costs. The port also serves cruise ships, so it sees tourists as well. The revenues rose by 4% and income by 8%.

The company has a debt-to-equity of 40% and debt-to-EBITDA of 2.5x. The policy is to grow the dividend along with earnings, and it was up 4% last year and yields 3.2%. The dividend figures do not look as safe at 130% of earnings, and on a free cash flow basis, last year's free cash flow only covered 40% of the dividend. This company would require more work to get comfortable with the situation, but the basic story touted by the company is it has completed some heavy capital spending to dredge the shipping lanes to allow larger ships to enter, as well as invest in equipment to service larger ships. The expectation is that capital spending will decline and the revenues and cash flow will expand as more traffic is handled by these large fixed-cost investments. Also, by allowing larger ships, it effectively lowers the shipping cost per unit out of their ports and stimulates demand. In addition, cruise ships add a new form a business as well. So, it is possible the company can grow to more easily support the dividend.

If the property situation is as overpriced on the surface as it appears to be, some of the banks may have potential as short ideas. We have not looked at those yet, and would need to do much more than a cursory look to even start talking about potential pitfalls. Loans by market may turn out to be very divergent in terms of loan-to-value and whether the local economy is more tourist-based or local commodity-based. New Zealand is still a large exporter of wool, timber, and meat.

Ocean Yield (OCY.NO, OYIEF) Update

When we wrote Ocean Yield as a long recommendation, we noted that the company typically signed long-term, flat-rate charters for its ships. This means that earnings growth and dividend growth require the fleet to expand. It also requires existing ships to either be sold (and the capital recycled) or to obtain a new charter for an existing ship when a current charter expires. There is news in both areas:

We noted that a couple months ago, Ocean Yield had no order backlog for new ships. Three new oil tankers have been purchased and will be delivered in 2Q, 3Q, and 4Q of 2018. Each will have a 10-year charter with Nordic American Tankers, which is a high credit quality counterparty. The company announced last week that it is in negotiations to acquire several more ships as well. Terms are not known yet, but growth in 2018 and 2019 appears to be coming.

At the time of our initial report, the *Lewek Connector* was the one idle ship at Ocean Yield. It had been running through a series of short-term hires. That ship has received a new 120-day contract that begins on March 1. The most important risk factor was a new contract for the *Dhurrabai-1* vessel. While there is not news on that front yet, we expect an update when 4Q earnings are released in mid-February.

The Transformation of Physical Retail Was a Recent Topic from *Thursday Thoughts*

With the continued string of news focusing on more out-of-date retailers closing stores due to e-commerce, we believe the contrarian view is that e-commerce requires a ton of physical space. Several stores have lower distribution costs than Amazon and more convenient locations for customers to order/pick-up/exchange on-line purchases. The WSJ noted in late December that Best Buy has been succeeding by both matching prices at Amazon and making it more convenient for customers to receive products at rapid speeds.

Barry Sternlicht at Starwood Property Trust has talked in recent conference calls about how retail has been in constant flux for decades, with poor competitors in crowded areas vanishing and that space being redesigned for other forms of retail. He has gone as far as to rattle off lists of companies that vanished before Amazon was ever a threat, such as Mervyn's, Zody's, McDuff Electronics, etc. Stephen Moore addressed this too, talking with the owner of Bellevue Square near downtown Seattle. The commentary is very straightforward that the US retail sector is likely overbuilt, but that real estate still has value. Moreover, nearly 90% of retail purchases are not occurring online. The path to success is adding more entertainment, restaurants, and stores with greater service along with a mall that has many draws such as these instead of simply offering 8 places to buy jeans.

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