

# The Smart Dividend Portfolio 2020



THE SMART INVESTOR



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# Welcome to the Smart Dividend Portfolio 2020 report from **The Smart Investor**.

Before we begin, please allow us to introduce ourselves. We are the same people who built up The Motley Fool Singapore since its beginnings in 2013.

The Smart Investor is co-founded by David Kuo, Joanna Sng, and Chin Hui Leong.

The doors have closed at The Motley Fool Singapore, but we felt that our work in Singapore was far from complete. When we started out in Singapore seven years ago, our aim was a simple one – to show that long-term investing does work.

We know the approach works. We dare say it with great confidence.

The evidence is sitting in our own personal stock portfolios and in our past stock recommendation services too.



# An ode to investing for the long term ...

The best example we can share is from a service we worked the longest on, Stock Advisor Gold, which was launched in May 2016.

As the doors to the Motley Fool Singapore closed at the end of October 2019, the flagship service scored a return of 30.2% over the Straits Times Index's 7.8% comparable return.

We are proud of the results that were generated by simply picking two stocks each month since May 2016.

What's interesting is that our results actually got better with time.

Take our stock picks from 2016, for instance. Our 16 stock picks had the benefit to mature over the past three years -- and deliver results that are over and beyond our average results above.

Take a look at the summary below ...

## STOCK ADVISOR GOLD'S 2016 STOCK PICKS

*STOCK PICKS*

**16**

*AVERAGE RETURN*

**62%**

*POSITIVE RETURNS*

**88%**

*of stock picks*

*BEATING BENCHMARK*

**63%**

*of stock picks*

*MULTI BAGGERS*

**25%**

*of stock picks*

*STOCKS SOLD*

**12.5%**

*of stock picks*

Data as of 31 October 2019

As we tally up our results, 14 out of 16 stocks were in the green.

The returns of the 16 picks came in at a handsome 62% (on average) with four companies returning over 100% or more (that's a multi-bagger).

So, how did we achieve it?

We submit that the returns were a result of our team's ability to find good companies, followed by our tenacity to hold on to the stocks, regardless of what the market was doing.

We didn't sell very often. Only two stocks out of 16 that we picked in 2016 were sold -- both at a profit of more than 50%, we might add. We held the rest of the stocks all the way through.

It doesn't mean that holding stocks over the past three years was easy.

Barely a month after Stock Advisor Gold launched, Brexit happened. In a surprise vote, the UK chose to leave the European Union, roiling stock markets around the world.

The uncertainty did not end there.

Just before 2016 ended, Donald Trump confounded bookmakers to clinch the US Presidency -- an eventful moment with an impact still felt today.

Between 2017 and 2018, the US Fed started to raise interest rates.

And then, in early 2018, President Trump engaged China in a high-stakes trade war, exchanging blows with the Middle Kingdom in the form of trade tariffs.



***BUT here's the dilemma -- all of the matters and events above remain unresolved.***

The war between the world's two largest economies rages on today. Despite voting to leave the EU, the UK has been unable to come to an agreement on how Brexit should happen.

That means markets have been, and always will be, volatile. That's what all investors will face in the future, and that's what we should expect.

# Welcome to The Smart Investor



## THE SMART INVESTOR

As the doors of The Smart Investor opens, we'd like to welcome you to join us as we teach you how to build your own portfolio.

There are many ways to build a portfolio. Not every way works.

We have demonstrated success with our method. In this exclusive report, we will cover the basics of how to build a Smart portfolio.

In a special collaboration with Share Investor, we will be revealing 3 stocks that we will be purchasing for our Smart Dividend Portfolio in 2020 in the pages ahead.

Beyond this report, for those who wish to learn more of our secrets to building a money-making portfolio, The Smart Investor will soon be launching courses to SHOW you how to build a money-making Smart Portfolio. When you join us for the course, you will get a behind-the-scenes tour of how we build our very own Smart Dividend Portfolio. In the course, you will also get to see which stocks we choose to buy for our own portfolio, how much of our own money we will be putting into each stock, and when we will be buying them. We will explain our rationale behind each buy or sell decision.

But that's for another day.

For now, let's get started with the basics of picking stocks, the basics of how to build a portfolio, and our 3 Smart stock picks.



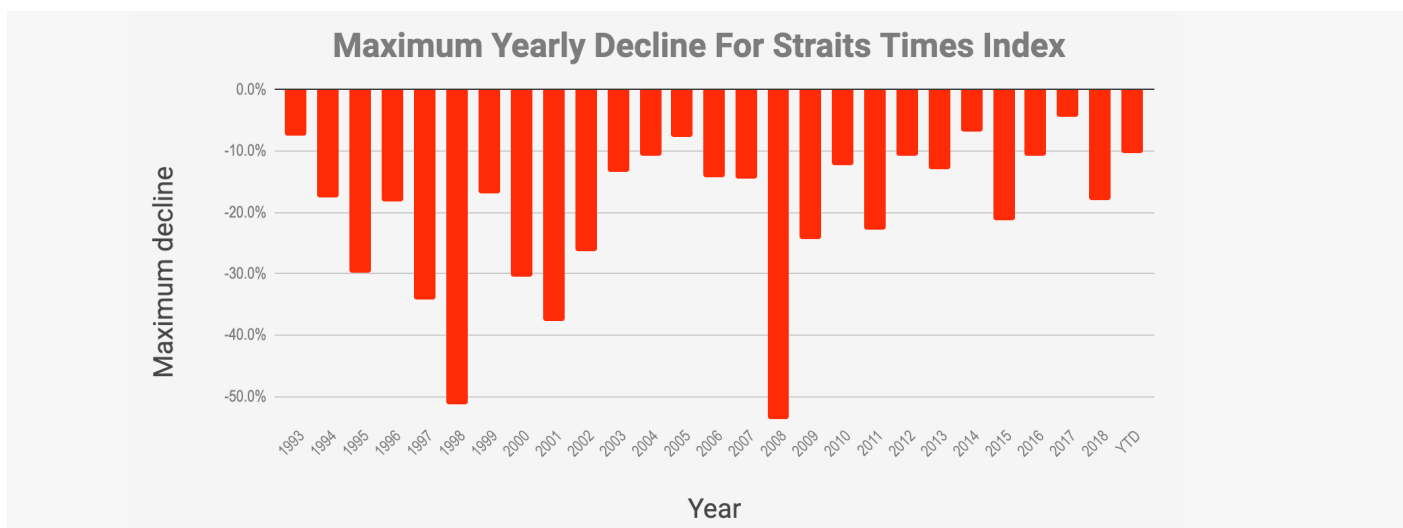
# CHAPTER 1: COMFORTABLY UNCOMFORTABLE

For the year to date, the STI's maximum decline, from peak to trough, is around 10%.



Now, you may feel that a double-digit decline is sizable. But if you zoom out and look at the bigger picture, you'll find that a 10% decline in any one year is pretty normal.

The chart below, which shows the maximum yearly decline for the STI across 26 years, puts 2019's decline into perspective.



Source: S&P Global Market Intelligence; author's calculations

For context: Since 1993, the STI has declined 10% in nine out of every 10 years.

The index has also fallen 20% or more four times in every decade. And larger declines of 30% or more happen around one-fifth of the time. On two rare occasions, in 2008 and 1998, the STI fell by over 50% from peak to trough.

The statistics above clearly demonstrate that market volatility is a normal occurrence. As such, we should come to expect that frequent market swings, whether up or down, are part and parcel of investing.

But it doesn't mean that we should be afraid of what we can't control. Instead, we should learn to embrace it -- let us explain why.

# CHAPTER 2: SIMPLY OUTSTANDING RETURNS

*“A ship in harbour is safe, but that is not what ships are built for.”*

**John A. Shedd**

The past three years, between 2016 and 2019, have been eventful.

And yet, our results at Stock Advisor Gold show that we were able to produce an average return of above 30% despite all the uncertainty and volatility.

***So, here's the BIG secret: there was no grand plan involved.***

Instead, we continued to pick stocks, month in and month out, on a specific date and specific time (for the curious, there was no feng shui involved). Regardless of what was happening in the world at large or where the market was trading at.

The way we see it ...

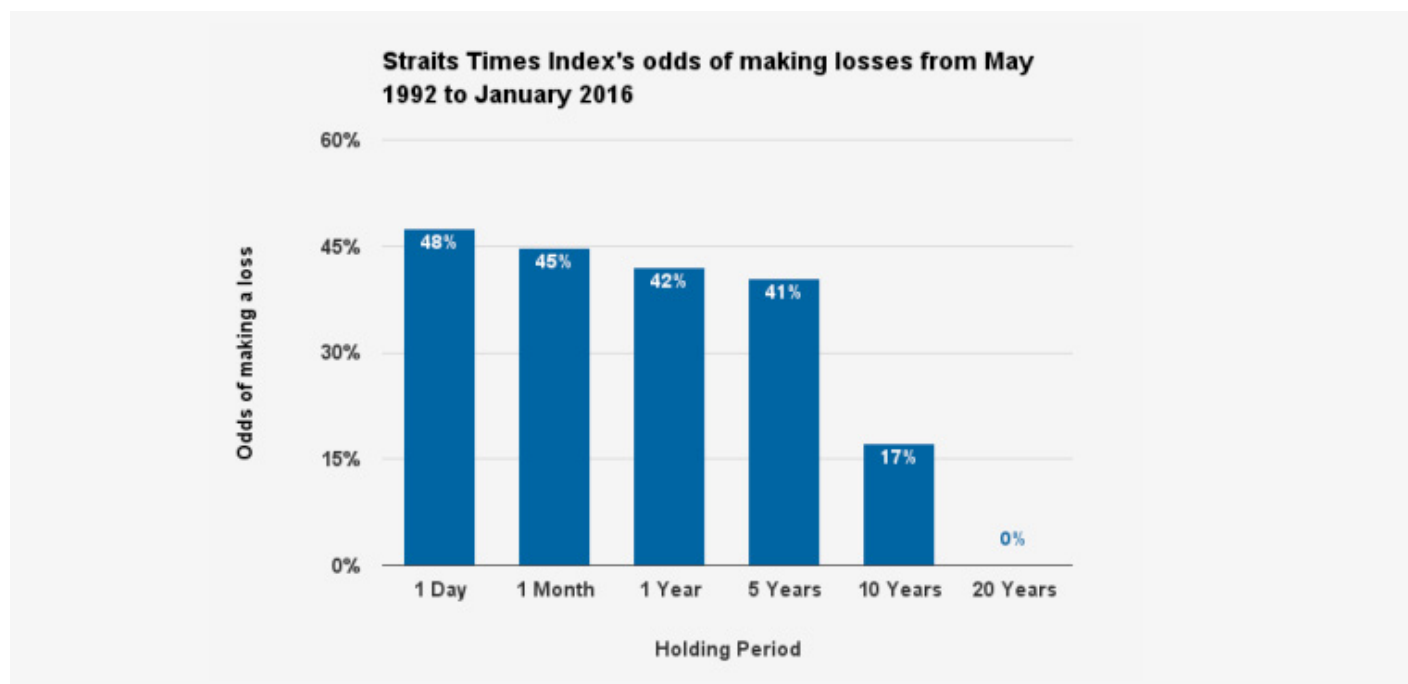
***Time in the market matters more than timing your entry into the stock market.***

We have shown that our 2016 stock picks have delivered 62% in returns because we gave the companies we chose time to mature.

Our experience is not unique. It happens on the broader scale as well.

# CHAPTER 2: SIMPLY OUTSTANDING RETURNS

The chart below shows the odds of making losses in the STI from 1 May 1992 to 12 January 2016 for different holding periods (the returns do not include dividends and inflation).



Source: S&P Global Market Intelligence

As you can see from the above, from one day to the next, our chances of earning a positive return are not much better than a coin flip.

The probability of obtaining a positive return sharply increases at the 10-year holding mark. And from there, Singapore's STI delivered positive returns in all scenarios if it was held for 20 years.

***The statistics back our belief that the best returns come from simply holding for the long haul.***

As such, instead of fearing volatility, we have to learn how to brave through the inevitable rough seas.

That's because holding stocks for the long term is where the best returns can be found.



# CHAPTER 3: BE FEARLESS

*“Everybody has a plan until they get punched in the face.”*

**Mike Tyson**

As a first step, we should always leave our emotions out of investing. But that’s easier said than done. Market crashes can be unsettling, and challenge you in unexpected ways.

Consider this scenario: A recession happens -- and with it, a major stock market decline.

Now, a typical recession comes with lower business activity. That occurrence can put pressure on your financial position whether you own a business or are holding on to a job.

Reduced business activity could lead to lower revenue profits for business owners. With it, there might be fewer jobs to go around or smaller salary increases for employees.

But that’s not the end of it.

Because stock market downturns tend to accompany recessions, our stocks are likely to decline. Selling them to raise cash, at that very moment, would be a bad choice.

The situation could get a lot worse if we lose our business or our job at that very moment, thereby putting our finances under stress. Under these unfortunate circumstances, we might be forced into making decisions that harm our long-term financial health.

The scenario above, while unsavoury, is very possible.

So, let’s talk about something real you can do for yourself.

On our side, we think that every investor will benefit from creating their own personal zone where they can invest fearlessly.

And how can you create a fearless zone? You can start by getting the basics right.

# CHAPTER 4: PLAY SMART, GEAR UP



Starting with the basics: an emergency fund.

Simply said, an emergency fund is a sum of money that you set aside for rainy days. The key here is to park these funds in a place you can access when you need it most.

Examples include a bank savings account, a fixed deposit account, or even in Government bonds.

Now, don't expect too much returns from these emergency funds. Returns might even lose out to inflation. But extracting returns is not the goal for these funds.

These accounts act as safe harbours -- as close as a guarantee that you can get that your money will all be there when you need it the most.

In short, the emergency fund is there for your own financial protection, not gain.

## **On your mark, get set ...**

Hold on there, partner. We're not done gearing up.

# CHAPTER 4: PLAY SMART, GEAR UP

Let's lay three simple but powerful ground rules that will help keep you out of trouble.

## **Rule #1**

Any cash that you need to use in the next five years should NOT be in stocks. Period. Because we are planning to hold our stocks for five years or more, we shouldn't put any short-term cash needs at risk.

## **Rule #2**

As a follow on to Rule #1, any money you don't need within the next five years can be considered as a candidate for the stock market.

## **Rule #3**

Once you have identified the spare cash that you don't need for the next five years -- then, it is the right time to dip your toe into the stock market. At this juncture, it is imperative to exercise restraint, and not pour all your cash into the stock market at one go.

The rules above are simple and doable. More importantly, our experience from decades of investing informs us that simple rules work are the most effective.

With the rules in place, let's get to work on building our portfolio.



# CHAPTER 5: HOW TO BUILD THE PORTFOLIO OF YOUR DREAMS

In our view, constructing a portfolio is like building a sturdy house to last a lifetime. You start from the bottom -- and build your way up.

You can start with a foundation of steady income shares at the base. From there, you can layer in a group of dividend-paying stocks that offer growth too. And at the peak, if you like, you can add stocks that have a touch of speculation involved -- but that stock should still pay a dividend.

## Introducing the Smart Portfolio Builder

Here at The Smart Investor, we recommend that you build your portfolio like a pyramid.

We call this our Smart Portfolio Builder.

Here is what our Smart Portfolio Builder is about.

A Smart Portfolio would resemble a pyramid shown below.



A balanced smart portfolio should have more income than growth, and more growth than speculative shares.

For those who would like to build their own portfolios using this concept, you can follow this simple guide.

A simple guide to the Smart Portfolio Builder	
Smart Income Stocks	60%
Smart Growth Stocks	30%
Smart Speculative Stocks	10%

For a better understanding of the Smart Portfolio Builder...



# CHAPTER 5: HOW TO BUILD THE PORTFOLIO OF YOUR DREAMS

## 1. The Smart Income Segment

The foundation of the Smart pyramid should be filled with reliable producers of income for your lifetime.

Companies that fall under the income category are usually leaders in their industry or own a dominant position in their niche. Their business is likely to be entrenched and well protected, making it hard for competitors to dislodge them.

For us, **Singapore Exchange** (SGX: S68) or SGX exemplifies the characteristics of a Smart Income segment stock.

## 2. The Smart Growth Segment

**Mapletree Industrial Trust** (SGX: ME8U) is our candidate for a Smart growth segment stock.

Unlike the Smart Income segment, the Smart Growth segment's role is to provide an ongoing boost to your stream of income.

Let's be clear. Having a reliable dividend is still important, but for the growth segment stocks, our priority is the dividend growth that these companies can offer.

As these companies increase their revenue and profits, we will be looking for larger dividend payouts year after year.

## 3. The Smart Speculative Segment

The speculative segment is for riskier stocks. But we are not asking you to run wild while picking this set of stocks.

We should still have an investment thesis backing it. And remember, our objective is to build a Smart dividend portfolio. Therefore, a dividend is still a must-have.

For us, **HRnet Group** (SGX: CHZ) is the kind of stock we would file under the Smart Speculative segment. The company offers a nice dividend. Yet, there are challenges that the company is facing that make the case of investment less clear.

# CHAPTER 5: HOW TO BUILD THE PORTFOLIO OF YOUR DREAMS

## Remember, it's YOUR pyramid

Our suggested allocation of 60% in Smart Income, 30% in Smart Growth, and 10% in Smart Speculative only serve as a rough guide for you.

You can, of course, adjust the three components to suit your own needs.

As you map out your plan, keep a few key tips in mind...

1. Don't get too caught up with the definition of what a Smart Income, Smart Growth or Smart Speculative stock is.
2. The key here is about balancing the risk and reward to achieve what you want.
3. The Smart Segment allocation provides the guide rails so that you don't inadvertently overload on any one segment.
4. Remember to keep the Smart Income segment higher than the Smart Growth segment, and the Smart Growth portion larger than the Smart Speculative tip.
5. Be strict on the percentage of speculative stocks in your portfolio.

As you grow older and your goals in life change, you can consider tweaking your portfolio allocation to suit your needs.

In summary, take your time to find the right mix.

# CHAPTER 6: TAKING ACTION

The next step is to put your plans into action.

Start building in order to fill up the Smart Pyramid with stocks. To help you with that, we'll go through two main strategies:

## 1. Sizing your stock position: how much to buy

As a general rule, when it comes to buying stocks, consider starting with small amounts and slowly build up your position.

A good guide for what a “small amount” means would be any amount that you feel comfortable holding for five years, without selling the stock at the first sign of trouble.

For some companies, our conviction is high. For other companies, we may have less conviction. As such, we can always choose to buy more of our high-conviction companies, and less of companies that merit less confidence.

As we outlined above, our conviction in SGX is higher than HRnet Group. As such, when we invest, our allocation for SGX will be higher compared to HRnet Group.

## 2. Pacing yourself: when you should add to the stock

Beyond sizing your position, another factor within your control is how often you invest in the stock.

Again, you can tie the pace of your investing to the risk profile of the company.

Using the same comparison between SGX and HRnet Group, we can choose to add to SGX over shorter intervals (say, six months). But for HRnet Group, we can choose to wait longer (a year or two if we have to) before committing more money.

### ***Bonus Tip: diversify, diversify, diversify***

We think that a diversified portfolio of 15 to 25 stocks is what you should aim for. Bottom line, we don't want you to pour all your money into just a handful of companies.

# CHAPTER 6: TAKING ACTION

## Get Smart: The Final Word

Our blueprint to building a Smart Dividend Portfolio 2020 should bring clarity on the steps that need to be taken to build a dividend-paying machine that can feed you for life.

Your life, that is.

In the end, it falls back to what you want to achieve. Ultimately, a successful portfolio is one that meets your needs.

For us, investing is a lifelong pursuit. And we are honoured to be a fellow traveller with you.

Do keep a lookout for future free and paid content from The Smart Investor. We hope that we will be able to accompany you on this journey.

Onward,

*The Smart Investor Team*



# INCOME STOCK CANDIDATE:

## Singapore Exchange (SGX: S68)

Headquarters	Singapore	Revenue (TTM)	S\$948.5
Market Cap	S\$9,590	Earnings (TTM)	S\$414.2
Recent Price	S\$8.95	Cash / Debt	S\$786.5 / S\$0
Yield	3.4%	Free Cash Flow	S\$391.6

TTM = trailing twelve months; figures in millions except recent price; data as of 18 December 2019

## Why We Like Singapore Exchange (SGX)

Today, investors can access any stock market around the world at the click of a mouse.

Most Singapore investors will recognise SGX as the only stock exchange in the Lion City. But there are other stock exchanges around the world where you can buy or sell stocks. As such, it is important to know how the Singapore-based company can remain relevant at the global stage.

### 1. Finding its niche in the world

On stocks, SGX has found its niche as Asia's largest international REIT platform, attracting listings such as **ARA US Hospitality Trust** (SGX: XZL), **Prime US REIT** (SGX: OXMU) and **Eagle Hospitality Trust** (SGX: LIW) in FY2019.

In October, **Lendlease Global Commercial REIT** (SGX: JYEU) also debuted on the local bourse.

Passive investing is catching on too. According to PwC, passive investing in Asia Pacific is expected to reach US\$5 trillion by 2025.

To tap on this trend, SGX has partnered **Factset Research Systems** (NASDAQ: FDS) to launch thematic indexes covering Asia healthcare, global cybersecurity, global robotics, Asia technology, and global robotics and artificial intelligence (AI). These indexes can then be licensed to ETF providers.

Beyond stocks, SGX also excels as Asia's largest listing for international bonds, with over 5,000 listed securities by 1,500 issuers from more than 50 countries in 20 different currencies.

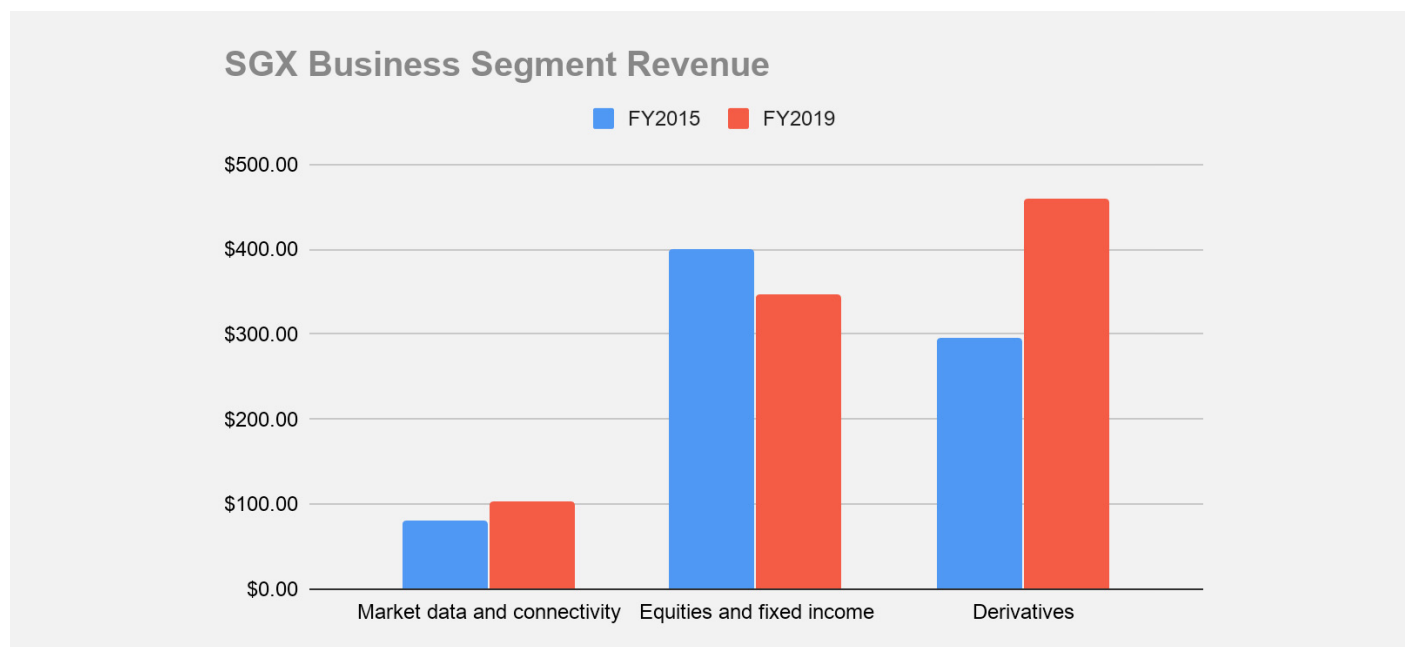
The company's bond issuance business is significantly larger than its equity listing business. For context, there were 1,066 bond listings worth S\$451.7 billion in FY2019 compared to equity listings which raised S\$6.4 billion through new and secondary listings. Notable bond listings in FY2019 include the Temasek Retail Bond and the Astrea private equity bond.

With global interest rates still relatively low, companies might prefer to issue debt rather than equity.

## 2. Growth from derivatives

SGX has three key business segments: market data and connectivity, equities and fixed income, and derivatives.

The biggest growth driver is its derivatives business. Between FY2015 and FY2019, the bulk of the company's growth came from this segment.



Source: SGX annual reports

Unlike equities, which rely on IPOs to broaden the market offerings, SGX can design and add more derivative products for institutional customers in the future.

For its part, SGX has positioned itself as a provider of pan-Asian derivatives for risk management, focusing on equities, currencies and commodities.

The company's forays into single-country equity indexes, commodities and currencies have yielded a number of highly traded derivatives.

In FY2019, six products accounted for 87% of the derivative volume traded on its platform, namely SGX FTSE China A50 Futures, Japan Nikkei 225 Index Futures, Nifty Derivatives, MSCI Taiwan Index Futures, Iron Ore Derivatives, and foreign exchange (FX) futures.

We will be looking to the company to capitalise on its market position in different sectors, including the Baltic Exchange, to deliver more from this business segment.

Meanwhile, SGX has also signed a memorandum of understanding with the Industrial and Commercial Bank of China (ICBC) and the China Central Depository and Clearing Co. (CCDC) to promote a suite of ChinaBond-ICBC RMB-based bond indices.

### 3. New geographies and new businesses

Strategically, SGX is positioning itself as a trusted partner operating a multi-asset exchange.

The company has expanded its presence to 17 cities worldwide while partnering other stock exchanges in China and India to bring new products to investors worldwide.

Meanwhile, SGX has also invested in new ventures including Trumid, a US-based electronic bond trading platform, and BidFX, a specialised trading platform for global FX markets. Other notable investments include Freightos, a digital freight platform and CapBridge, a private securities exchange built on a public blockchain.

Speaking of new technologies, SGX has also filed for a patent for automating the delivery versus payment processes using smart contracts which are built on blockchain technology.

### 4. Free cash flow machine

There is an inherent attraction to SGX's business as a platform. As its business grows, the company's operating cash flow grows, but its capex moderates over time, leading to higher free cash flow.

In FY2019, SGX was able to turn every dollar of revenue earned into more than S\$0.40 of free cash flow.

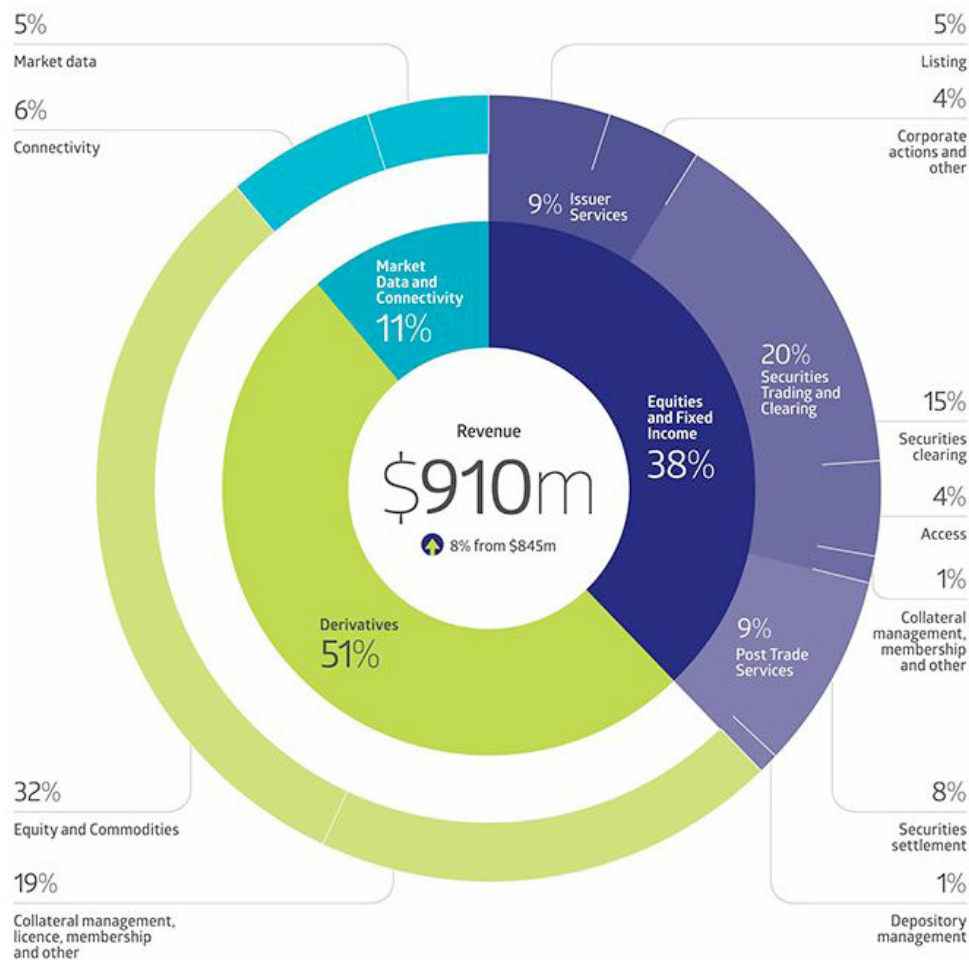
The company's free cash flow acts as fuel for dividends or expansion to new areas.

*With our reasons outlined above, let's take a deeper dive into understanding SGX's business, financial track record, management, risks, and valuation.*

# Understanding the business of SGX

SGX has three key business segments: market data and connectivity, equities and fixed income, and derivatives.

The split in revenue for FY2019 is shown below.



Source: SGX's FY2019 annual report

## 1. Equities and fixed income

This segment, which accounts for 38% of total FY2019 revenue, can be further divided into three sub-segments, namely, issuer services, securities trading and clearing, and post trade services.

Singapore investors should be familiar with the securities trading and clearing segment. For every trade done on the SGX platform, brokers will pay the company clearing fees.

Revenue depends on the trading volume of stocks, real estate investment trusts (REITs), business trusts, exchange-traded funds (ETFs), daily leverage certificates, American depository receipts (ADRs), and structured warrants.

As such, if trading volumes go up during volatile times, SGX would earn more.

For issuer services, SGX earns a fee on every IPO and secondary offering. The company also earns an annual fee from every entity that is listed on the exchange (read: recurring revenue).



## **2. Derivatives**

Derivatives is SGX's largest revenue segment, contributing 51% of total sales.

The majority of the revenue from this segment is tied to the volume of derivatives traded. Derivative trading in equities and commodities accounted for 64% of the segment's total revenue, with the rest coming from collateral management, license, membership and other.

Revenue is dependent on the trading volume of derivatives contracts and the average fee of the contracts.

## **3. Market data and connectivity**

SGX also licenses its market data. The company provides colocation services and connectivity subscriptions.

This segment produces relatively stable and recurring revenue. Connectivity solutions accounted for 6% of FY2019 while 5% was contributed by market data solutions.

# Financial track record

When it comes to financials, SGX is a picture of consistency.

Fiscal Year	Revenue (\$\$, million)	Profit to Shareholders (\$\$, million)	Diluted Earnings Per Share (cents)	Operating Cash Flow (\$\$, million)	Capital Expenditure (\$\$, million)	Free Cash Flow (\$\$, million)	Cash (\$\$, million)	Debt (\$\$, million)
FY2009	\$594.8	\$305.7	\$0.29	\$278.8	\$35.4	\$243.4	\$645.4	\$0.00
FY2010	\$639.7	\$320.1	\$0.30	\$375.1	\$46.1	\$329.0	\$685.3	\$0.00
FY2011	\$660.7	\$294.9	\$0.28	\$348.9	\$55.2	\$293.7	\$693.3	\$0.00
FY2012	\$647.9	\$291.8	\$0.27	\$345.3	\$50.8	\$294.5	\$697.7	\$0.00
FY2013	\$715.1	\$335.9	\$0.31	\$418.8	\$27.6	\$391.2	\$763.3	\$0.00
FY2014	\$686.9	\$320.4	\$0.30	\$358.6	\$71.8	\$286.8	\$757.4	\$0.00
FY2015	\$778.5	\$348.6	\$0.33	\$429.0	\$82.4	\$346.6	\$850.9	\$0.00
FY2016	\$818.1	\$349.0	\$0.33	\$423.5	\$73.8	\$349.7	\$867.0	\$0.00
FY2017	\$800.8	\$339.7	\$0.32	\$377.7	\$60.1	\$317.6	\$797.0	\$0.00
FY2018	\$844.7	\$363.2	\$0.34	\$426.8	\$78.6	\$348.2	\$854.3	\$0.00
FY2019	\$909.8	\$391.1	\$0.36	\$417.5	\$47.3	\$370.2	\$692.2	\$0.00

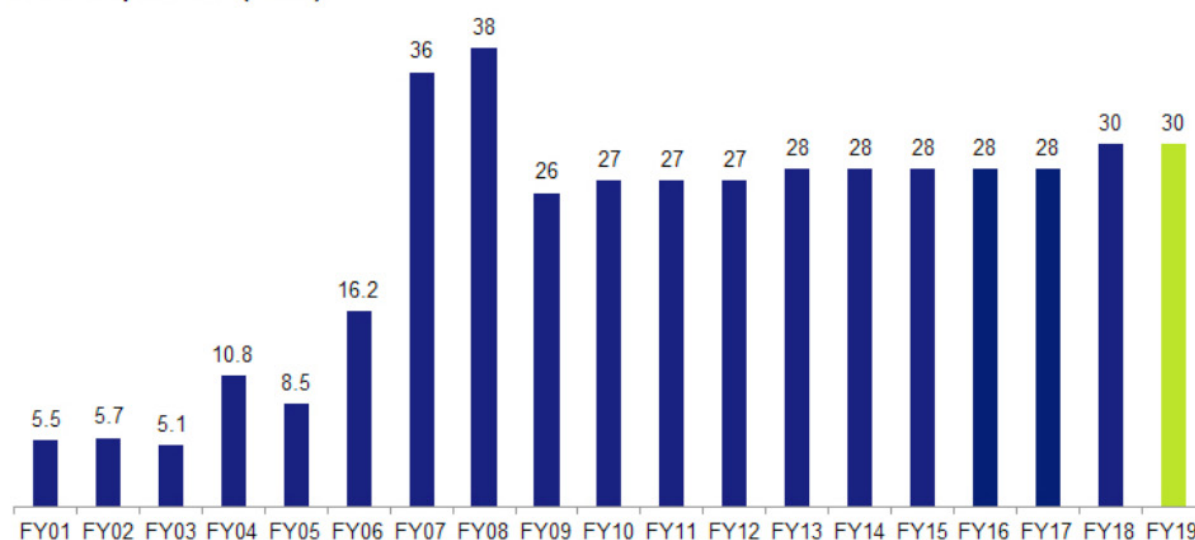
Source: S&P Global Market Intelligence

Between FY2009 and FY2019, a period of 10 years, SGX was able to grow its topline by 4.3% per year and profits by 2.5% per year.

Free cash flow also grew by 4.3% per year with its annual free cash flow margin (free cash flow as a percentage of revenue) over the same period coming in at 44.3%.

The bourse operator's ability to generate strong free cash flow has provided the fuel for its growing dividend, which grew from S\$0.26 in FY2009 to S\$0.30 in FY2019.

Dividend per Share (cents)



- i. Dividend per share includes proposed final dividend
- ii. Excludes special dividends paid in FY03 and FY05
- iii. Commenced payment of one-tier tax exempt dividend from 3Q FY05

Source: SGX website

Beyond free cash flow, SGX's balance sheet had S\$786.5 million in cash and equivalents, as of 30 September 2019, adding a significant buffer to its ability to fund its dividend.

## Ownership and Management Team

Singapore's Temasek Holdings owns 23.4% of SGX and is the company's largest shareholder.

CEO Loh Boon Chye has led SGX since July 2015. Notable developments during his tenure include the reduction of the lot size from 1,000 shares to 100, the acquisition of the Baltic Exchange, and the broadening of SGX's derivatives products.

Senior management remuneration consists of a fixed and variable component.

The fixed portion is tagged to the 50th percentile of Singapore's banking and financial services industry.

For the variable portion, up to 50% of the compensation is deferred over a period of three to four years to keep the management team aligned to the company's long-term goals.

## Risks

Every company comes with risk. If you do not see any risk in a company that you are studying -- well, look harder.

The most obvious risk, in our view, is the decline in trading volume in its securities business and the lack of major IPOs. In FY2019, daily average traded value (SDAV) fell 17% year on year. Meanwhile, new equity listings raised S\$1.7 billion, down from S\$6.2 billion in FY2018.

At the same time, SGX was not able to attract local gaming hardware maker **Razer** (SEHK: 1337) which chose to list in Hong Kong instead.

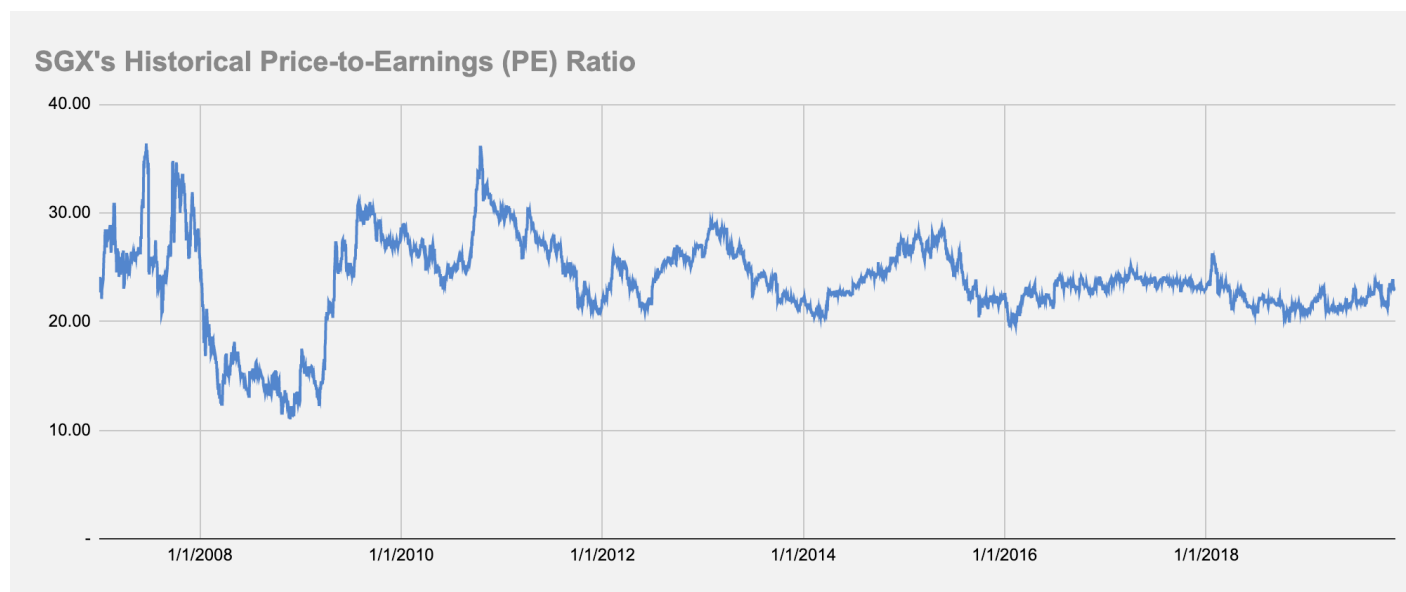
Another risk is concentration. As we mentioned earlier, most of its derivatives trades come from six products.

To be fair, SGX can still expand its product range in the future. But until then, if any of its key products fall out of favour with investors, the segment's revenue could be greatly affected.

Elsewhere, SGX has established a S\$1.5 billion debt line that it can tap to fund future acquisitions. Due to the size of the debt programme, investors should be looking at how the company puts the cash to use.

## Valuing SGX

Since 2007, shares of SGX has traded at an average price-to-earnings (PE) ratio of around 23.7 times.



Source: S&P Global Market Intelligence

Today, SGX shares are slightly cheaper at 23 times earnings, suggesting that the current share price is a fair one.

Getting the stock at a PE ratio of around 20 times would be ideal but the stock price might not always trade at where we want it to be. As such, when we are faced with a situation like this -- the better move, given what we know, would be to buy a little and add more if the stock trades lower.

## Get Smart: Your Personal ATM Machine

SGX can serve as the ideal anchor to any dividend investor's portfolio.

The dividend growth might not excite investors but the fortress-like balance sheet and copious amounts of free cash flow make the company a candidate to buy and hold for the long haul.

# GROWTH STOCK CANDIDATE:

## Mapletree Industrial Trust (SGX: ME8U)

Headquarters	Singapore	Revenue (TTM)	S\$394
Market Cap	S\$5,546	NPI (TTM)	\$305.6
Recent Price	S\$2.52	Gearing	29.2%
Yield	4.8%	Interest coverage	6.6

TTM = trailing twelve months; NPI = net property income  
 Figures in millions except recent price; data as of 18 December 2019

Mapletree Industrial Trust went public in October 2010, coinciding with the third quarter of its financial year ended 31 March 2011 (FY10/11). Today, the REIT owns 87 industrial properties in Singapore, along with a 40% stake in 14 US-based data centres.

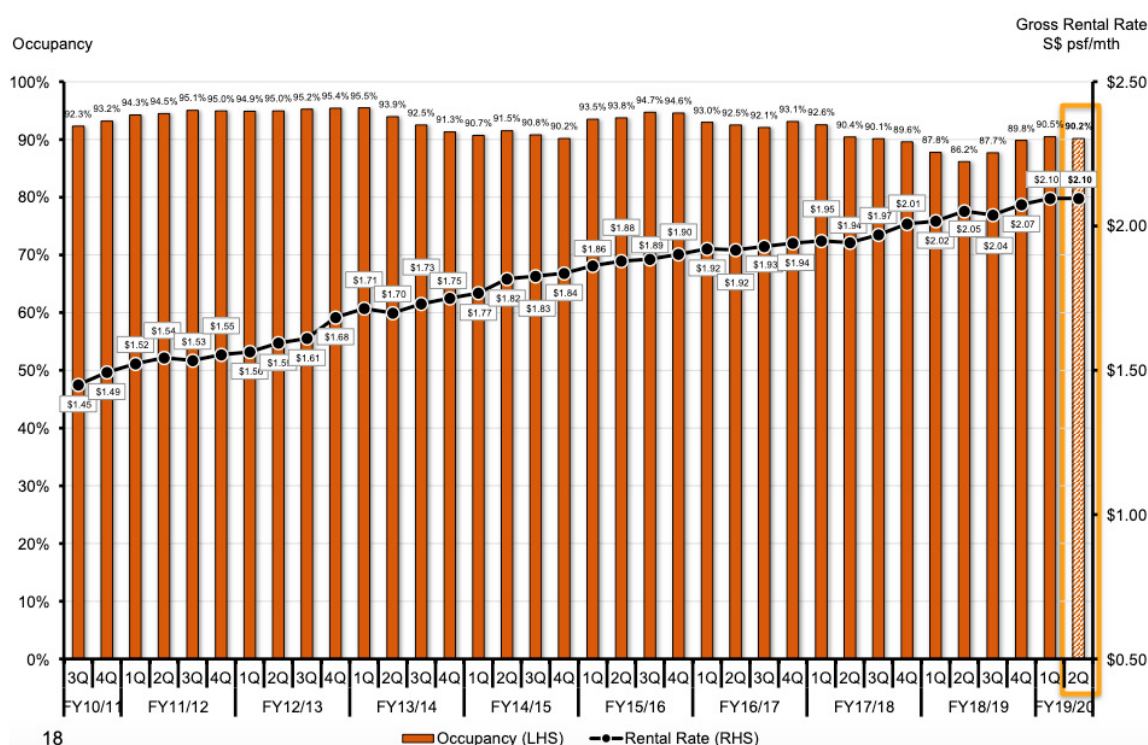
## Why We Like Mapletree Industrial Trust (SGX)

### 1. Strong property portfolio

We think that Mapletree Industrial Trust has a strong property portfolio for the following reasons:

1. For the Singapore portfolio, its underlying land leases have a weighted average lease expiry (WALE) of 37.2 years at the end of 2019's first quarter. Meanwhile, its US portfolio is on freehold leases.
2. The REIT's tenant profile is diverse with 26 different trade sectors with no single sector accounting for more than 21% of its gross rental income (as at the end of FY19/20's second quarter).
3. In addition, the majority of the REIT's tenants, or 64.5% to be exact, have remained with its properties for at least four years.
4. Mapletree Industrial Trust has been able to increase the gross rental rates of its Singapore portfolio steadily over time, illustrated by the chart below (observe the thick black line). From its IPO to the second quarter of FY19/20, Mapletree Industrial Trust has grown its rental rate by 4.4% per year from S\$1.45 per square foot per month (psf/mth) to S\$2.07 psf/mth.
5. Despite the rental increases, the REIT has maintained a solid occupancy rate above 86%.





Source: Mapletree Industrial Trust FY19/20 second-quarter investor presentation

## 2. Strong track record:

Mapletree Industrial Trust's stable of properties has delivered solid results since its IPO. Between FY11/12 and FY18/19, Mapletree Industrial Trust's distribution per unit (DPU) has grown by 5.4% per year from S\$0.0841 to S\$0.1216.

Near-term growth has been strong, too: In FY19/20's first half, Mapletree Industrial Trust's DPU increased by 3.7% compared to a year ago. The REIT's DPU growth has been supported by rising gross revenue and net property income, as shown in the table below.

Year	Gross revenue (S\$, million)	Net property income (S\$, million)	Distribution per unit (Singapore cents)	Aggregate leverage ratio
FY11/12	246.4	171.3	8.41	37.8%
FY12/13	276.4	195.4	9.24	34.8%
FY13/14	299.3	214.7	9.92	34.4%
FY14/15	313.9	228.6	10.43	30.6%
FY15/16	331.6	245.1	11.15	28.2%
FY16/17	340.6	256.8	11.39	29.2%
FY17/18	363.2	277.6	11.75	33.1%
FY18/19	376.1	287.8	12.16	33.8%

Source: Mapletree Industrial Trust annual reports and earnings updates

### 3. Prudent use of debt:

On top of that, Mapletree Industrial Trust has been able to grow without the use of excessive debt. For context, the Monetary Authority of Singapore (MAS) requires REITs to keep their leverage ratio (i.e. the ratio of debt to assets) below 45%.

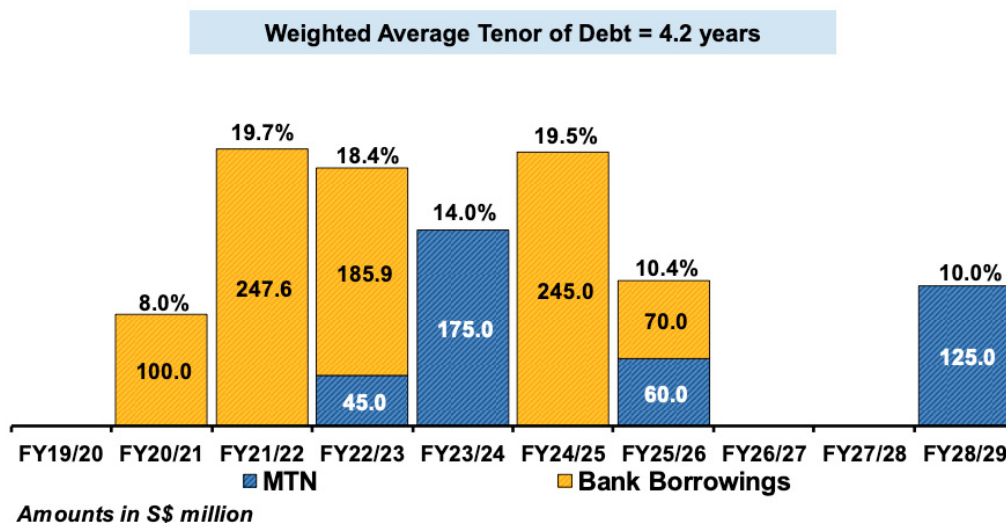
From FY11/12 to FY18/19, Mapletree Industrial Trust's average aggregate leverage ratio was less than 32.7%, substantially lower than the 45% limit.

At the end of the FY19/20's second quarter, the REIT's debt profile looks healthy with:

1. An aggregate leverage ratio of 29.2%.
2. A high-interest coverage ratio of 6.6.
3. A reasonable interest rate of 2.9% on its borrowings.
4. A well-staggered debt maturity profile, shown in the chart below.

#### DEBT MATURITY PROFILE

As at 30 September 2019



Source: Mapletree Industrial Trust FY19/20 second-quarter earnings presentation

### 4. Near-term growth

Mapletree Industrial Trust has visible catalysts for growth in the near term:

1. 7 Tai Seng, which was completed in early July 2019, has been leased to data-centre provider, **Equinix** (NASDAQ: EQIX) for the initial term of 25 years, and comes with annual rental escalations.
2. The REIT also acquired 18 Tai Seng, a mixed-use industrial property linked to the Tai Seng MRT, in February 2019. The property has a committed occupancy rate of 95.1%.

## 5. Data-centre contribution on the rise

Mapletree Industrial Trust has been making a strong push into the data-centre space which is projected to grow worldwide by 5.2% per year from 2017 to 2022.

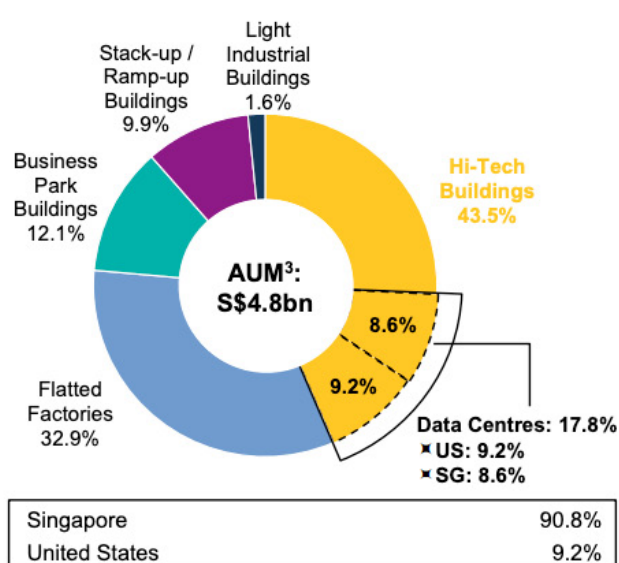
The REIT's current portfolio of 14 US-based data centres offers attractive characteristics, and could act as a key driver of its long-term growth:

1. The land tenure for this portfolio is freehold.
2. The occupancy rate is high at 97.4% while the WALE is 4.5 years (by gross rental income) as of 30 September 2019.
3. Data centre leases are based on a triple-net structure where the tenant covers costs such as maintenance, taxes, and insurance.
4. Mapletree Investments has granted the right of first refusal on its 60% stake in the 14 data centres to the REIT.

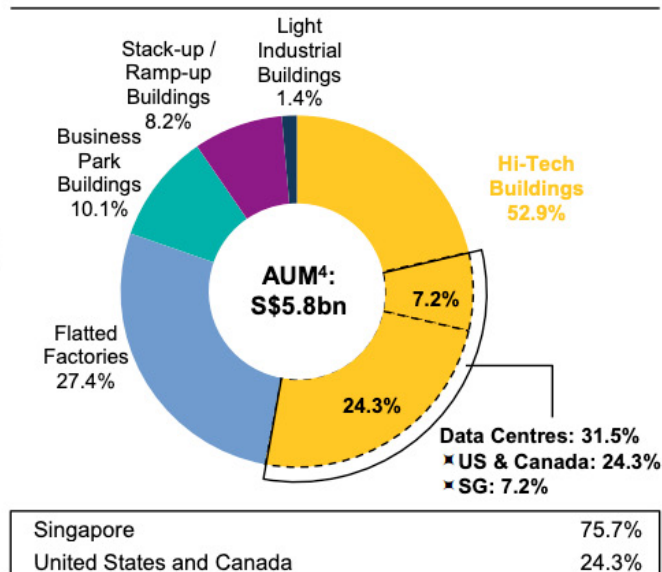
The contribution from data centres is set to rise further as Mapletree Industrial Trust has partnered Mapletree Investments and the US-listed Digital Realty Trust (NYSE: DLR) to acquire an additional 13 data centres in the US.

When completed, the data centres will contribute 31.5% of the REIT's assets under management (AUM), as shown below (see dotted lines).

**Pre-Acquisition: Portfolio Breakdown<sup>3</sup>**



**Post-Acquisition: Portfolio Breakdown<sup>4</sup>**



Source: Mapletree Industrial Trust's FY19/20 second-quarter investor presentation

The deal includes 10 data centres in a 50-50 joint-venture with Digital Realty Trust and another 3 data centres in an 80-20 proportion between the Mapletree duo and Digital Realty Trust.

The 13 data centres offer the same attractive characteristics as the REIT's existing 14 data centres:

1. The vast majority of its underlying land, or 94.1% to be exact, is of freehold tenure.
2. WALE (weighted average lease expiry) of 9.1 years.
3. Fixed annual escalations of 2% or more for 92.2% of its leases.

When completed, Mapletree Industrial Trust's mix of freehold buildings is expected to rise to almost 38% while its overall WALE is expected to increase to 4.1 years.

The deal is expected to be accretive to the REIT's DPU and book value per unit. Beyond that, Mapletree Industrial Trust will be able to tap on the expertise of Digital Realty Trust, which is the second-largest data centre REIT in the US.

*Beyond the reasons why we like Mapletree Industrial Trust above,  
let's delve a little deeper into the make-up of the business, its management and sponsor,  
valuation and risks involved.*



# Understanding Mapletree Industrial Trust's portfolio

Mapletree Industrial Trust owns industrial properties in Singapore and data centres in the US.

To get a better sense of the REIT's Singapore portfolio, we can look at the five types of properties that it has, namely flatted factories; hi-tech buildings; business park buildings; stack-up / ramp-up buildings and light industrial buildings.

The description of the buildings are below:



## FLATTED FACTORIES

High-rise multi-tenanted industrial buildings with basic common facilities used for light manufacturing activities.



## STACK-UP/RAMP-UP BUILDINGS

Stacked-up factory space with vehicular access to upper floors. Multi-tenanted space suitable for manufacturing and assembly activities.



## HI-TECH BUILDINGS

High specification industrial buildings with higher office content for tenants in technology and knowledge-intensive sectors, including data centres. Usually fitted with air-conditioned lift lobbies and common areas.



## LIGHT INDUSTRIAL BUILDINGS

Multi-storey developments usually occupied by an anchor tenant for light manufacturing activities.



## BUSINESS PARK BUILDINGS

High-rise multi-tenanted buildings in specially designated "Business Park zones". Serve as regional headquarters for MNCs as well as spaces for R&D and knowledge-intensive enterprises.

Source: Mapletree Industrial Trust FY19/20 second-quarter investor presentation

For the US-based data-centre portfolio, the properties are located in nine states.

Mapletree Industrial Trust owns a 40% stake with other 60% stake owned by the REIT's sponsor, Mapletree Investments.

## Ownership, Management and Sponsor

Mapletree Investments, the sponsor for Mapletree Industrial Trust, is a real estate conglomerate that is controlled by Temasek Holdings.

The REIT's parent had property assets worth S\$55.7 billion as of 31 March 2019 and acts as the REIT's manager and major unitholder too.

Mapletree Industrial Trust's manager, Mapletree Industrial Trust Management (MITM), is a subsidiary of Mapletree Investments.

MITM has been led by CEO Tham Kuo Wei since its listing.

In terms of remuneration, MITM earns a base fee of 0.5% per year on the value of the REIT's properties, and a performance fee of 3.6% per year on the REIT's net property income.

It's not the best compensation structure as we prefer to see DPU growth as a measure, as opposed to absolute net property income growth.

That said, the REIT's track record in DPU growth supersedes these concerns, in our view.

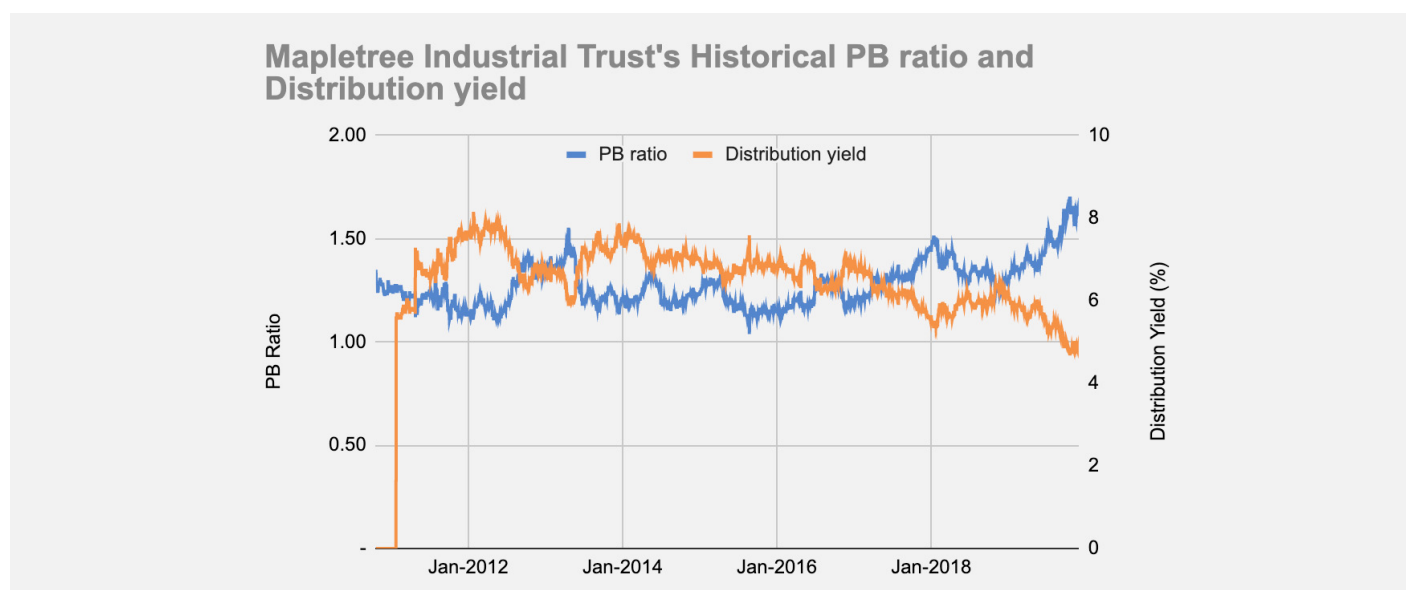
Elsewhere, the remuneration plans for MITM executives look reasonable to us. Around 83% of Tham's FY18/19 compensation was based on variable bonuses with a distinct long-term component.

We also think that MITM has made some smart decisions in allocating capital. As an example:

1. Since its IPO, the REIT has been involved in five build-to-suit projects which tend to have tenants who are willing to sign long-term leases that can provide stability.
2. The move into data centres has been accretive to DPU and book value per unit. The key aspects of the REIT's portfolio such as tenant distribution, WALE, and freehold composition have improved as a result.

# Valuing Mapletree Industrial Trust

Mapletree Industrial Trust's historical price-to-book (P/B) ratio and distribution yield are shown below.



Source: S&P Global Market Intelligence

Based on Mapletree Industrial Trust's share price of S\$2.52 as of 18 December 2019, units have a P/B ratio of 1.63 and a distribution yield of 4.8%.

For context, since its IPO, the REIT's historical average P/B ratio was 1.27 and the average distribution yield has hovered at 6.45%.

Compared to its historical trading range, units of the REIT are not cheap.

Situations like these are not uncommon for investors. Of course, if we were given a choice, we would prefer to invest in the REIT at cheaper value points. That is one approach investors can take.

However, given the positive catalysts, we would prefer to start with a smaller position and hope to add at more attractive valuations in future. That way, if the stock does well, we will benefit. But if share prices do fall, it opens up opportunities for us to add more.

## Risks

Though there is a lot to like about Mapletree Industrial Trust, there are still some risks that investors need to take note of:

1. The largest tenant – **Hewlett Packard** (NYSE: HPE) – accounted for 9.1% of its total gross rental income as of 30 September 2019. If this key tenant decides to exit, Mapletree Industrial Trust could be hurt.
2. The vast majority of the Mapletree Industrial Trust's portfolio value is based in Singapore. If our local economy stumbles, it is likely the REIT could be adversely affected too.
3. At the same time, Mapletree Industrial Trust will be subject to the demand and supply of factory space in Singapore.
4. Like any other REIT, Mapletree Industrial Trust will have to contend with the rising cost of debt. At the moment, the REIT has its interest payments well-covered. However, it is always important to keep an eye on debt levels, since the REIT intends to pursue growth in the data centre space.

## Get Smart: Growth at a cost

You will never get everything that you want when it comes to investing. At least, that rarely ever happens.

Mapletree Industrial Trust is a great case study on how a REIT might have many of the desirable traits that we want as an investor -- yet, all good things come at a hefty price tag.

As investors, we should be aware that the share price that we pay is just one factor of many that we can control.

While we strive to pay as low a price as we can, it is also possible to start off with small positions and then build up a larger position over time. That way, we get to participate if the share price performs unexpectedly well. And if it doesn't, we will have room to add more as the share price falls.



# SPECULATIVE STOCK CANDIDATE:

## HRnet (SGX: CHZ)

Headquarters	Singapore	Revenue (TTM)	S\$427.7
Market Cap	S\$619.3	Earnings (TTM)	S\$49.1
Recent Price	S\$0.62	Cash / Debt	S\$239 / S\$0
Yield	4.5%	Free Cash Flow	S\$54.9

TTM = trailing twelve months; figures in millions except recent price; data as of 18 December 2019

## Why We Like HRnet

Simply said, HRnet Group is in the business of helping other companies hire people. The HR recruitment firm has two main business segments:

1. Professional recruitment services where it owns brands such as HRnetOne, PeopleSearch, SearchAsia, HRnetRimbun and REForce.
2. Flexible staffing solutions with its Recruit Express, RecruitFirst and Career Personnel brands.

As a whole, the recruitment industry is fragmented with low barriers to entry. That means there are a host of competitors, big and small.

To that end, HRnet Group will need to differentiate itself from the pack. Here's why we think they can stand out.

## **1. Ownership culture**

Staff recruitment is a labour-intensive task. As such, getting the most out of its employees is the key to outpacing its competition.

At the end of June 2019, the company had a large sales force, with 777 employees.

Given the size, getting everyone on the same page to contribute to the company requires a strong structure.

Starting from the top, each of HRnet Group's key personnel (think segment business leaders) has a minority stake in their respective subsidiaries, formalised under its 88GLOW program.

If the leader's subsidiary does well, HRnet Group has the first-right-of-refusal to acquire back these minority stakes over an eight-year period starting from 2020. The price paid is dependent on the subsidiary's performance.

The setup encourages its leaders to act like owners, rather than just employees.

On a broader scale, HRnet Group has a co-ownership scheme called 123GROW.

Under this scheme, select employees will be offered the opportunity to subscribe to HRnet Group shares and the chance to be awarded additional shares if they meet their productivity goals.

The programme results are tangible.

In 2019's third quarter, an impressive 85% of the 123GROW cohort brought in gross profit that is at least three times their annual payroll (HRnet Group considers this metric as a productive headcount or PHC).

## **2. Efficient scale: A large employee contingent**

HRnet Group is one of Asia's largest recruitment firms.

At that scale, the company is able to organise itself into specialised teams that serve over 2,000 clients, ranging from financial, retail, manufacturing, life sciences and more.

With its workforce, HRnet Group is also able to offer services for hiring permanent and temporary staff. This factor is important as companies around the world are increasingly turning to temporary staffing.

We think that HRnet Group's flexible staffing business is particularly strong in Singapore.

In 2018, the Lion City was the company's largest revenue contributor with 73.7% of the total pie with a high percentage from flexible staffing. As the flexible staffing business tends to be recurring in nature, it's a solid base to build on.

We think that HRnet Group's services are valuable to its customers. At the end of June 2019, its top five customers had an average tenure of 17 years.

### 3. Growing addressable market

According to research firm Frost and Sullivan, Singapore's market for professional recruitment and flexible staffing was S\$1.4 billion in 2016 and is expected to grow at a compound annual growth rate (CAGR) of 4% between 2016 and 2021.

HRnet Group's 2018 Singapore revenue was around S\$316 million, which implies that there is room to expand.

There is a bigger opportunity beyond the shores of Singapore.

The North Asia market, defined as Hong Kong, Taipei, Guangzhou, Shanghai, Beijing, Tokyo, and Seoul, for professional recruitment and flexible staffing in 2016 was S\$46.3 billion. It is expected to expand at a CAGR of 11.5% per year up till 2021.

The market size for the rest of Asia (comprising of Kuala Lumpur and Bangkok) was S\$3.6 billion in 2016, growing at 12.4% per year for the same period.

### 4. Healthy free cash flow and financials

HRnet Group has a short history in the Singapore stock market, having debuted in June 2017.

	Revenue	Profit	Diluted Earnings Per Share (cents)	Operating Cash Flow	Capex	Free Cash Flow	Cash	Debt
Q2'17	\$97.44	\$7.33	0.72	\$5.07	\$0.35	\$4.72	\$279.24	\$0.00
Q3'17	\$97.48	\$10.70	1.05	\$5.75	\$0.05	\$5.71	\$276.47	\$0.00
Q4'17	\$101.66	\$23.31	2.79	\$24.41	\$0.50	\$23.90	\$289.09	\$0.00
Q1'18	\$106.96	\$16.29	1.60	\$12.92	\$0.21	\$12.72	\$292.08	\$0.00
Q2'18	\$108.01	\$13.01	1.28	\$11.91	\$0.64	\$11.27	\$271.00	\$0.00
Q3'18	\$105.01	\$12.60	1.23	\$14.43	\$0.47	\$13.96	\$275.37	\$0.00
Q4'18	\$108.51	\$6.28	0.65	\$12.35	\$0.41	\$11.94	\$281.81	\$0.00
Q1'19	\$103.96	\$19.31	1.92	\$18.07	\$0.11	\$17.96	\$304.47	\$0.00
Q2'19	\$108.51	\$11.52	1.14	\$10.13	\$0.35	\$9.78	\$274.44	\$0.00
Q3'19	\$106.74	\$11.98	1.19	\$15.86	\$0.60	\$15.26	\$238.70	\$0.00

Source: HRnet's earnings report; numbers in S\$ million except for diluted earnings per share

After exhibiting topline growth in 2018, growth has stalled at HRnet Group.

However, the company has demonstrated that it is very cash flow generative with minimal capital expenditure. The company's balance sheet is also flush with cash, which enables the company to expand into new cities in Asia and buy stakes in other companies.

Recently, HRnet Group invested a sizable S\$55.3 million for a 30% stake in Staffline Group, a UK-based market leader for blue-collar flexible staffing and workforce training.

For 2019, Staffline Group has forecasted that it will make around £20 million in adjusted earnings before interest and taxes (EBIT). Based on the projection, HRnet Group paid around 5.2 times adjusted EBIT, which looks like a low price. Note: more discussion on Staffline Group in the risk section.

## 5. Attractive valuation

In our view, there are two key figures that make HRnet Group's valuation compelling.

### a. HRnet Group's cash position versus market cap

HRnet Group had S\$238.7 million in cash and equivalents at the end of September 2019, accounting for 39% of its market cap. Note: S\$100 million of its cash position has been earmarked for working capital.

### b. HRnet Group shares offer a well-covered dividend

HRnet Group paid out S\$0.028 per share in dividend over the last 12 months, which amounts to 57.1% of its trailing net profit and 52.6% of its trailing free cash flow.

In short, HRnet Group's trailing dividend is well-covered. If the company can maintain the current dividend, that would give investors a solid 4.5% dividend yield.

# Ownership and Management Team

HRnet Group is owned by the Sim family.

In 1992, Peter Sim founded HRnetOne, the precursor to HRNet Group. He remains as the chairman today. JS Sim, his brother, is the CEO of Recruit Express and an executive director. Adeline Sim, Peter's daughter, is the company's chief legal officer and an executive director.

The three executives, together with other family members, own almost 75% of HRnet Group as of 19 June 2019, making them the majority shareholder.

When it comes to remuneration, we noted that its business leaders have been awarded more than its own chairman on more than one occasion. It's a sign that compensation is performance-based and not based on family ties.

That said, the Sim family holds considerable influence over all its major decisions and developments. As such, investors interested in the company will have to be comfortable with the Sim family at the helm.

## Risks

The key risks, in our view, is as follows:

1. **Recessions:** HRnet Group relies on clients hiring more people. During economic or industry downturns, its customers may cut back, which could result in sharp drops in profit.
2. **Competition:** HRnet Group has scale. But so does some of its Asian-based competitors, such as Temp Holdings, Technopro Holdings, **Meitec Group** (TSE: 9744), and **JAC Recruitment** (TSE: 2124) and companies outside of Asia such as **Hays** (LSE:HAS), **Pagegroup** (LSE: PAGE), **Heidrick & Struggles** (NASDAQ: HSII), and **Robert Walters** (LSE: RWA).
3. **Recruitment service alternatives:** HRnet Group will also have to contend with job-matching sites such as the US-based Upwork or China's 51Job. Artificial intelligence (AI) and automation could also be potential threats that replace headcounts and reduce demand for recruitment services.
4. **No official dividend policy:** The company has outlined its dividend practice (not policy) as a payout ratio of 50% of its net profit. As such, there is a possibility that HRnet Group may choose to cut its dividend.
5. **Regulation and data protection:** HRnet Group has to comply with government regulations in the countries that it operates in, including getting the relevant licences. The company also holds confidential information on job seekers that are regulated under Singapore's personal data protection act (PDPA). If there is a major hacking or non-compliance, the loss of confidence could translate into business losses.
6. **Government subsidies:** HRnet Group received S\$5.8 million in government grants for 2018, which is around 12% of its total profit for that year. The grants are received are expected to continue until 2021, albeit a lower payout.



## Extra section: The Dacey Staffline Group Situation

We added an extra section for the Staffline Group acquisition as the move was a major one, and deserves some commentary. It also introduces a speculative element into the investment thesis.

As of 2 August 2019, Staffline Group became an associate company to HRnet Group.

Depending on the schedule of the UK Group's earnings, it will start contributing to HRnet Group's bottom line either by the fourth quarter of 2019 or the following one. Adeline Sim will be appointed as a non-executive director.

As such, the impact on HRnet Group's bottom line could be positive or negative.

Notably, Staffline Group reported losses of £6m in the first six months of 2019. The company has been beset with problems since the start of 2019.

On 29 January 2019, an anonymous email tipped off Staffline Group's auditors, PwC, alleging that the company had not been complying with the UK's Working Time and National Minimum Wage (NMW) regulations.

In response, Staffline Group organised an independent legal investigation while instructing PwC to expand its scope of work.

The investigations were complex, causing a five-month delay in the company's 2018 earnings release. At the same time, Staffline Group shares were suspended for six weeks.

As a result of the investigation, Staffline Group took a £15.1 million charge for non-compliance for 2018 and admitted to lapses in its procedures.

Despite the actions taken, the company continues to face challenges.

On 1 August 2019, PwC resigned as Staffline Group's auditor, adding further doubt. In the background, the economic rumblings by Brexit is triggering customers to hire fewer workers.

We think that the Staffline Group acquisition will work out, but at the same time, we are keenly aware that the investment could turn out to be a bad one. HRnet Group does have the balance sheet to withstand the financial hit, as its balance sheet is still flush with cash.

## Get Smart: Cloudy with a touch of speculation

To use an analogy, the weather forecast for HRnet Group today is cloudy.

But as the cloud clears up, we think there is a potential for capital gains and dividend increases.

It's not a given, of course.

When downturns occur, HRnet Group's profit is likely to decline, leaving less money for dividends. The lack of a dividend policy could mean that the dividends could be cut in favour of reinvesting into the business, acquiring other businesses or conserving cash.

HRnet Group has signalled that it is going to ramp up on acquisitions.

In its latest earnings report, the company referred to its home market of Singapore as "matured" while suggesting that Staffline Group could be the first in more acquisitions to come.

As HRnet Group taps on its balance sheet and cash flow to grow the company, investors should look for prudence in spending and watch the management's appetite in maintaining the dividend.

That's the speculative portion investors have to acknowledge.

In the context of a portfolio, we think that HRnet Group should be in the speculative segment until such time we have more clarity in developments at Staffline Group and its acquisition plans in the future.