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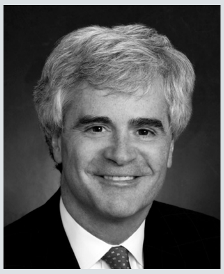

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Warren Buffett begins shopping in Australia

Now that Warren Buffett is shopping for Australian stocks investors are speculating about the next target.

Berkshire Hathaway's recent deal with Insurance Australia Group (IAG AU) means the company will have some $2 billion a year to invest in the Australian market. In the wake of the deal, Mr. Buffett said he plans to buy "four or five" Australian equities over the next two or three years. Further, Buffet said that Berkshire will take one or more positions in Australian banks.

The Big Four Australian banks may be too expensive for Buffett's taste at today's prices. All four are trading at substantially higher valuations than most other large banks. However, investors may be betting that Buffett will take a stake in ANZ given its larger exposure to Asian markets. Buffett watchers believe the IAG deal was attractive in part due to the company's growing Asian presence.

Over the years, however, Buffett has outlined his criteria for acquisitions. When acquiring entire companies (as opposed to taking an equity stake) Buffett prefers large deals with at least $75 million in pre-tax earnings. Berkshire also demands consistent earnings from high ROE companies. No turnaround situations or technology companies need apply.

The smallest company in which Berkshire currently has an equity position is US Gypsum with a $4 billion market cap. As a result, it is reasonable to assume that an Australian target would need to be at least as large.

Berkshire often favors brand name consumer staples over cyclical, capital intensive companies like miners and energy plays. Buffett also is a fan of near-monopolies and wide moats. This was no doubt behind his acquisition of US railroad BNSF. But Buffett may be spoiled by his US railroad experience. BNSF has benefited from the perfect storm of a shale oil boom and limited infrastructure to move energy products to market from certain fields. The result was a boom in rail traffic.

Australian railroads Aurizon (AZJ AU) and Asciano (AIO AU) may be less profitable than most US rails, but Asciano just received buyout bid from Canada's Brookfield Infrastructure Partners. The rails should benefit from an eventual recovery in the Australian mining and resource industry, even without a repeat of the prior commodity cycle.

So what else is likely to peak Berkshire's interest? Probably not airlines. Buffett has called the airline industry a "death trap" after his less than successful foray into the industry in 1989. So Qantas is probably safe.

For an overview of candidates that may attract Berkshire's attention, we screened for Australian based companies with market caps greater than $3 billion. We eliminated companies that delivered a 3-year average return on equity of less than 6% and those that posted negative five-year sales growth. The table below excludes banks, including those discussed above. Also excluded are real estate investment trusts, utilities, and telecom companies as we don't perceive those as being in Berkshire's wheelhouse. Financial services are a core expertise for Berkshire so we included those in the insurance industry despite the arrangement with Insurance Australia Group. The companies are sorted by their Price to Cash Flow ratio.

Companies that may fit Berkshire's desire to gain exposure to faster growing Asian markets could include Brambles and Amcor. While neither derives significant revenues directly from Asia, their containers, crates and shipping supplies should benefit from the increasing movement of goods globally.

Buffett's appetite for recurring revenues might be whetted by Transurban Group (TCL AU), the toll road company operating in Melbourne and Sydney. However, the stock's strong performance has made the relationship between price and cash flow less attractive in recent months. At lower prices this largely recession proof company benefiting from a growing population in Sydney and Melbourne could prove interesting to Buffett.

Given that Coke (KO) is one of Berkshire's four largest holdings, Coca-Cola Amatil (CCL) may hold some appeal. CCL's stock has lagged as competition and consumer aversion to sugary drinks has crimped profits.

Still, the company creates excess cash flow after capex, an attribute Buffett likes. CCL expects to make more headway into Indonesia over the next few years, fuelled by a $500 million infusion from a joint venture with parent KO. Coca-Cola owns a hefty 30% of the CCL and its interest in the bottler's success should prevent KO from negotiating as aggressively with CCL as it has with other bottlers. However, Berkshire has yet to purchase a bottler, and Buffett is on the board of KO, which could present a potential conflict of interest.

The quote

Berkshire often favors brand name consumer staples over cyclical, capital intensive companies.

Macquarie Group operates in the financial services industry and does some business in Asia. Its varied businesses segments offer a relatively diversified revenue stream.

Buffett, of course, also puts a high weight on management quality and tenure, business "moat" and other intangible factors.

While Australia offers opportunities to invest in large hotels and travel related businesses, Buffett does not own positions in any such business currently. That may be a deliberate aversion, or perhaps Berkshire is waiting for the right opportunity in the right market. FS

Table 1. Potential Buffett targets in Australia

Ticker	Name	Market Cap	Industry	Price/ Cash Flow	3Yr Avg ROE	*Net Debt to EBITDA	Free cash flow Yield
MQG AU	MACQUARIE GROUP	20,983	Capital Markets	2.2	10%	NA	NA
AZJ AU	AURIZON HOLDINGS	8,593	Road & Rail	9.5	6.5	2.1	2.4
AIO AU	ASCIANO LTD	5,080	Road & Rail	9.8	8.5	3.7	0.2
BXB AU	BRAMBLES LTD	13,102	Commercial Services & Supplies	10.6	31%	1.9	2.4
WOW AU	WOOLWORTHS LTD	26,292	Food & Staples Retailing	11.4	25%	0.7	3.1
CCL AU	COCA-COLA AMATIL	5,506	Beverages	12.1	14%	2.0	4.8
WES AU	WESFARMERS LTD	34,964	Food & Staples Retailing	12.3	9%	1.1	3.3
AMC AU	AMCOR LTD	13,129	Containers & Packaging	12.7	22%	2.3	5.7
CWN AU	CROWN RESORTS	7,194	Hotels, Restaurants & Leisure	13.6	13%	3.0	1.4
CPU AU	COMPUTERSHARE	5,291	IT Services	14.5	14%	3.1	6.9
SHL AU	SONIC HEALTHCARE	6,654	Health Care Providers & Services	15.1	12%	2.9	4.6
FLT AU	FLIGHT CENTRE TR	3,382	Travel Agency	15.3	23%	-1.1	6.5
SUN AU	SUNCORP GROUP	13,532	Insurance	17.3	5%	NA	5.7
SEK AU	SEEK LTD	3,848	Professional Services	17.4	37%	1.4	5.6
ASX AU	ASX LTD	5,981	Stock Exchange	17.5	11%	-2.0	5.3
HVN AU	HARVEY NORMAN	4,154	Multiline Retail	17.9	8%	1.3	4.1
RHC AU	RAMSAY HEALTH	9,598	Health Care Providers & Services	19.2	21%	3.6	2.4
PTM AU	PLATINUM ASSET	3,477	Capital Markets	21.5	53%	-0.4	4.8
CSL AU	CSL LTD	31,506	Biotechnology	21.5	37%	0.6	3.7
ALL AU	ARISTOCRAT LEISU	3,747	Gaming machines	22.8	22%*	3.7	2.6
REA AU	REA GROUP	3,996	Media	26.4	43%	-0.2	3.5
COH AU	COCHLEAR LTD	3,573	Health Care Equipment & Supplies	27.5	35%	0.9	3.3
QBE AU	QBE INSURANCE	14,570	Transportation Infrastructure	40.5	4%	NA	1.8
TCL AU	TRANSURBAN GROUP	14,824	Transportation Infrastructure	46.9	4%	10.6	1.6
AMP AU	AMP Ltd	14,080	Insurance	NA	10%	NA	NA
MPL AU	MEDIBANK	4,405	Insurance	NA	NA	NA	NA

As of 7/1/15. Source: Ranger International, LP; Bloomberg. *Negative net debt to EBITDA figures indicates more cash than debt on the balance sheet.
*Figure represents 1 year normalized ROE.