ORD MINNETT
PRIVATE WEALTH

Ords Monthly

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FUTURE VIEW

INVESTMENT THEMES IN 2018

In this final edition of the Ords Monthly for 2017 we shift from the wider market and industry viewpoint of our November issue to focus on the themes that generate our investment ideas for 2018.

We noted the macroeconomic environment was unlikely to play the lead role in equity markets in 2018 and this remains the case.

Ord Minnett still sees the Australian dollar falling against the US dollar, with the local economy remaining on a 'steady-state' path in terms of monetary and economic policy. This keeps our twin themes of 'declining A$ versus US$' and 'global over local' at front of mind when looking for places to invest in 2018.

We have added two new themes – 'inflation beneficiaries' and 'balance-sheet appeal' – to our process.

Overall, there are five new faces among our preferred choices.

Coming up trumps is **Aristocrat**, with the slot machine and game supplier now making about 80% of its revenue from offshore markets. The company is also capitalising on the move to online gaming. Aristocrat joins our 'global over local' list, and we examine the company in greater depth on page 6.

Meanwhile, **QBE Insurance** and logistics group **Qube** come into the 'inflation beneficiaries' list.

Qube is in a position to push through higher port charges, boosting revenue for its Patrick's stevedoring business.

Meanwhile, QBE is set to benefit from both rising global insurance premiums following the recent northern hemisphere hurricane season and global bond yields.

Alumina Ltd joins our new 'balance-sheet appeal' category, given it is under-geared relative to its peers and is exposed to aluminium, our top choice in the base metals complex.

Last but not least, **Austal** joins our 'structural growth' category. The shipbuilder has major defence contracts in the US and Australia, along with a thriving commercial ferry business.

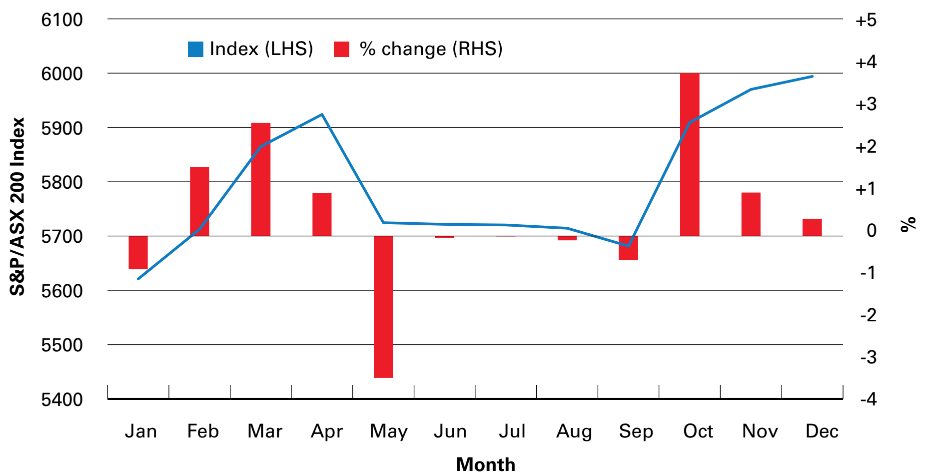
Elsewhere in this edition, we highlight **Amcor** and the packaging giant's ability to create value from its acquisitions, while **ASX Ltd** features as the exchange operator goes to the cutting edge of technology to find a replacement for its ageing CHESS clearing system.

We also take a look at **Ramsay**, where a boost to funding for the UK's National Health Service bodes well for the multinational hospital operator.

Finally, we cast our eye over **Service Stream**, the prime contractor to NBN Co, and maintain our positive view on the company, despite the travails of its major client.

The Ords Monthly will return in 2018 – in the meantime, we wish all our readers the compliments of the season and a happy – and profitable – new year.

S&P/ASX 200 Index over 2017



Source: OML Research, IRESS (End of month data, Dec @ 8 Dec). Index is on a price basis.

INVESTMENT STRATEGY

TAKING A POSITION

Ord Minnett recently outlined its views on the big picture for the Australian market in 2018, and in this issue we home in on the key investment themes that drive our preferred portfolio choices.

One of the observations from our macro outlook is that some of the trends from 2017 should continue into 2018. In particular, Australia is expected to remain out of sync with other developed markets from an economic and monetary policy perspective. Hence, the 'declining Australian dollar versus the US dollar' and 'global over local' themes remain relevant. New themes we are introducing include 'inflation beneficiaries' and those with 'balance sheet appeal'.

Additions to our preferred lists this year include **Aristocrat Leisure** (global), **QBE Insurance** and **Qube** (inflation), **Alumina Ltd** (balance sheet) and **Austal** (structural).

Portfolio themes

- **Declining A$ vs US$** – We continue to see the Australian dollar versus US dollar exchange rate declining, to US$0.72 by the end of calendar year 2018. Many of the reasons for forecasting a lower local currency in 2018 are familiar – narrowing interest rate differentials between the US and Australia, a further modest slowing in China's growth rate, and our expectation that most commodity prices will track sideways to lower over the year.

  Another factor could be widening corporate tax differentials with the US, if the US government is successful in legislating tax reforms. For pure currency exposure, we suggest an exchange-traded fund such as the **Betashares US Dollar ETF (ASX code: USD)**.

- **Global over local** – The global economy is expected to sustain above-trend 3.2% real GDP growth in 2018. Compositionally, this assumes better growth in emerging markets excluding China (primarily India and Latin America), a modest slowdown in China's growth, and a steady Europe and US.

By comparison, economic growth in Australia is set to come in at a below-average pace of 2.8%. Corporate earnings growth overseas is also forecast to be double that available in Australia over the next 12 months, at 10% versus 5%.

Based on our currency views, regional earnings growth forecasts and outlook for offshore equity markets, we suggest having some global exposure still makes sense.

Slot machine maker **Aristocrat** is a new addition, with around 80% of revenue sourced offshore, primarily in the US but also in Asia and Europe. The company is also diversifying its revenue sources by investing in the high-growth digital space as consumers shift towards online gambling channels. The acquisitions of Plarium and Big Fish will make Aristocrat the second-largest social casino publisher globally by revenue, and will raise its pro forma recurring revenue as a share of total revenue to 65% from 57%. (See more on Aristocrat on page 6)

Other options for exposure to offshore growth include **Boral**, which is leveraged to US construction and rebuilding activity, as well as local infrastructure works, and **Ramsay Health Care**, a hospital operator with a strong balance sheet to strengthen its existing presence in Europe. (See page 7 for more on Ramsay)

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- **Balance sheet appeal** – Given economic risks in Australia, and the patchy track record our market has had in meeting earnings expectations, it is hard to go past companies with sound balance sheets. Our view is these companies should offer some defensive protection in the event economic risks increase, but still have flexibility to pursue earnings accretive strategies, such as acquisitions or buybacks.

  ANZ is our preferred bank given it has one of the stronger capital ratios of the major banks, with its common equity tier-one ratio at 10.6%, opening up the possibility of capital management early in 2018.

  Rio Tinto and **Alumina Ltd** are our preferred resources exposures given the companies' relatively under-geared balance sheets, valuation upside, and exposure to our preferred base metal, aluminium.

  Service Stream is currently in a net cash position, which it is likely to use for bolt-on acquisitions, supplementing its revenues from the NBN rollout, but giving it flexibility for capital returns as well.

  Similarly, **Orora** has capacity under its net debt/operating earnings target of 2.0–2.5x to pursue further bolt-on acquisitions.

- **Inflation beneficiaries** – It is anticipated global inflation will rise to 2.2% from 2.0% in 2018, driven by input cost pressures – namely energy prices – and tightening labour markets. Yet the scene in Australia is different, with spare capacity in labour markets and rising competition creating the risk of disinflation.

  We seek companies that can hedge against both outcomes – that is, those with the ability to push through price increases that can either offset local disinflationary pressures or absorb the risks emanating from rising global inflation.

  AGL Energy is favourably exposed to higher electricity prices – one of the few sources of inflation in Australia – having pushed through price rises to retail customers in the past year.

  Another beneficiary of higher energy prices is **Oil Search**. Oil prices have risen as OPEC extends its output cuts to the end of 2018, while LNG prices have risen since regulation was introduced to restrict Australian exports. Oil Search is one of the few producers able to take advantage of this pricing environment, given it is producing above nameplate capacity and is able to sell the additional tonnage on spot markets.

  We may be a little early on **QBE**, with the possibility the new CEO may re-base guidance, but in our view the share price could be nearing a bottom. Our analysts think there is an increased chance that global insurance premiums will rise following the September-quarter losses sustained by the industry. Further, higher global inflation will induce higher bond yields, which would benefit QBE's investment yields.

  Finally, we see **Qube** pushing through higher port infrastructure charges following a move by one of its key competitors, creating some revenue upside in its Patrick stevedoring division. We expect this could also increase the appeal of its Moorebank project, helping it to lock in further tenancy agreements next year.

- **Structural growth** – These are companies that may not deliver earnings upside in the near term, but we are willing to be patient around the investment thesis given leverage to longer-term structural trends – such as the ageing population, growth in superannuation assets, infrastructure and renewables. This category includes AMP, APA, Ramsay and MYOB.

  One new addition to this list is **Austal**, a shipbuilder. Our positive view is based on the company being well positioned to benefit from a strong pipeline of opportunities in the defence sector, especially given the geopolitical climate.

New Faces - Additions to preferred stocks for 2018

	Recomm.	Risk	Last Trade* ($)	Target price ($)
Global over local				
Aristocrat	Accumulate	Higher	$23.02	$24.20
Balance-sheet appeal				
Alumina Ltd	Accumulate	Higher	$2.23	$2.50
Inflation beneficiaries				
QBE Insurance	Hold	Higher	$10.70	$10.95
Qube Holdings	Buy	Higher	$2.62	$3.00
Structural growth				
Austal	Accumulate	Higher	$1.69	$2.00

*Closing price on Friday, 8 December Source: IRESS, OML Research

AMCOR

THE COMPLETE PACKAGE

Sector: Containers & Packaging Recomm: Accumulate Risk rating: Medium Share price: $15.72

Year to June ($A)	2017A	2018E	2019E
Profit after tax ($m)	913	1,004	1,131
Earnings per share ($)	0.79	0.87	0.98
Price/Earnings (x)	19.9	18.1	16.1
Dividend ($)	0.56	0.59	0.63
Dividend Yield (%)	3.6	3.8	4.0
Franking (%)	-	-	-

Source: Company report, Ord Minnett Research. Profits are on a normalised basis.

Amcor (AMC) share price

Source: IRESS

Amcor is a global packaging company providing products and services for use in food, health care, tobacco, consumer and industrial applications.

Ord Minnett recently raised its recommendation on Amcor to Accumulate from Hold in response to some share price weakness that followed media reports the company was considering buying US-based rival Bemis, and soft outlook commentary provided by management at the AGM.

We believe a deal with Bemis is unlikely at current share price levels, however, given Bemis has soared nearly 10% since mid November when sale speculation resurfaced.

In addition, the trading headwinds for the first half of fiscal 2018 flagged at the AGM are likely to be only temporary. Management pointed to higher input costs, soft conditions in North America beverages and weak demand in emerging markets.

We have incorporated these dynamics into our model, but we believe the impact should dissipate through the second half of fiscal 2018, as storm-related resin premiums unwind and consumer demand recovers in emerging markets. Recent data releases and commentary from industry participants support this view.

Notwithstanding any Bemis deal, a primary source of value creation for Amcor through the years has been its ability to source and successfully integrate acquisitions. In our view, the stock price does not fully factor in the value the company is likely to generate from deploying free cash flow into value-accretive deals.

M&A focus and market opportunities

	Flexible packaging		Rigid plastic speciality containers	Closures
	Americas	Asia		
Amcor sales	US$1bn	US$1bn	US$750m	US$400m
Estimated total market	US$25bn	US$20bn	US$15bn	US$25bn
Estimated market growth	3%	5%	3%	6%

Source: Company report, Ord Minnett Research estimates

Similarly, our earnings estimates incorporate only announced transactions. As such, it seems likely that earnings estimates (including our own) would be revised as deals are announced.

Amcor has frequently noted that its key acquisition targets are in flexibles packaging in America and Asia, rigid plastic specialty containers (PET containers) and closures.

These segments have attractive fundamentals, including overall market growth rates, and provide opportunities for Amcor to offer a differentiated product and scope for market share gains via either organic growth or acquisitions. Given Amcor's low share of revenue (6% or less) in these highly fragmented markets (see table at left), we believe there are plenty of acquisition opportunities.

Amcor stands out from other industrials in our coverage, with the stock trading on a forward price-earnings multiple of circa 18 times with an EPS compound annual growth rate of 9.3% over the 2017 to 2020 period.

ASX LTD

NEXT MOVE

Sector: Diversified Financials Recomm: Hold Risk rating: Higher Share price: $56.25

Year to June ($A)	2017A	2018E	2019E
Profit after tax ($m)	431	452	467
Earnings per share ($)	2.23	2.33	2.41
Price/Earnings (x)	25.2	24.1	23.3
Dividend ($)	2.02	2.09	2.16
Dividend Yield (%)	3.6	3.7	3.8
Franking (%)	100	100	100

Source: Company report, Ord Minnett Research. Profits are on a normalised basis.

ASX Ltd (ASX) share price

Source: IRESS

ASX Ltd is Australia's primary securities operator, running both equity and futures markets, along with clearing and settlement services.

The exchange has recently announced plans to replace its ageing post-trade clearing house electronic subregister system, known as CHESS and launched in 1994, with a system using distributed ledger technology. The decision follows feasibility testing over the past two years, with the timeline for transition to the new technology to be released to the market at the end of March 2018. Implementation will not occur until after 2019.

A distributed ledger is a type of database that is shared, replicated and synchronised among members of a network, rather than stored in a central location. The distributed ledger records the transactions, such as the exchange of assets or data, among the network participants.

Distributed ledger technology is particularly useful for financial transactions. **It cuts inefficiencies and offers a secure way to create a tamper-proof log of sensitive activity, such as international money transfers or shareholder records.**

It is worth noting that a blockchain is just one type of distributed ledger; not all distributed ledgers employ block or chain transactions.

In fact, the new ASX system will operate on a secure private network where users are known and have been 'permissioned' for access. The system will be designed without barriers to other market operators, or clearing and settlement facilities.

It also gives customers a choice as to how they use the ASX's post-trade services. They will be able to connect in a similar way to now, or they can interact directly with the distributed ledger.

We believe this method of implementation will be a positive for ASX as it will continue to control the settlement system and ownership data, but it also allows the exchange to leverage the technology's benefits by making the ledger free of barriers to market operators, other clearing facilities and regulators.

Digital Asset Holdings, founded by former JP Morgan Chase executive Blythe Masters and in which ASX has an 8.5% stake, will build the new system.

The transition to the new technology will be a multi-year process. Most of the work on the transition will begin in fiscal 2019 and there might be a slight rise in capital expenditure from fiscal 2019 onwards, although this is largely in our forecasts.

The benefits from the new system, however, are likely to provide a medium-term tailwind for ASX. This will be through additional revenue from the technology potentially replacing other IT infrastructure in the banks, settlement and custody functions, as well as the potential to capture richer data on share ownership, which could be used for new sources of data-related revenue.

ARISTOCRAT LEISURE

PLAYING THE GAME

Sector: Consumer Discretionary Recomm: Accumulate Risk rating: Medium Share price: $23.02

Year to September ($A)	2017A	2018E	2019E
Profit after tax ($m)	546	600	703
Earnings per share ($)	0.85	0.94	1.10
Price/Earnings (x)	26.9	24.5	20.9
Dividend ($)	0.34	0.40	0.47
Dividend Yield (%)	1.5	1.7	2.0
Franking (%)	69	30	30

Source: Company report, Ord Minnett Research. Profits are on a normalised basis.

Aristocrat Leisure (ALL) share price

Source: IRESS

Aristocrat Leisure is a manufacturer, developer and distributor of slot machines, online gaming content and casino management software.

The company recently posted an underlying net profit of $546 million for the year to 30 September, up 37% on a year ago and above our forecast of $534.7 million, with strong profit growth across all divisions. A fully franked final dividend of 20.0c per share was also declared.

The company's digital business was the star of the show – digital daily active users (DAU) and average revenue per DAU were above our forecasts, driven by Cashman Casino's expansion to Apple's iOS platform, spurring a 37% jump in digital revenue.

Aristocrat has also broadened its digital reach, acquiring Seattle-based game developer Big Fish for US$990 million, allowing Aristocrat to expand into the casual gaming genre.

Big Fish's games include the likes of *GummyDrop* and *Sir Match-A-Lot*.

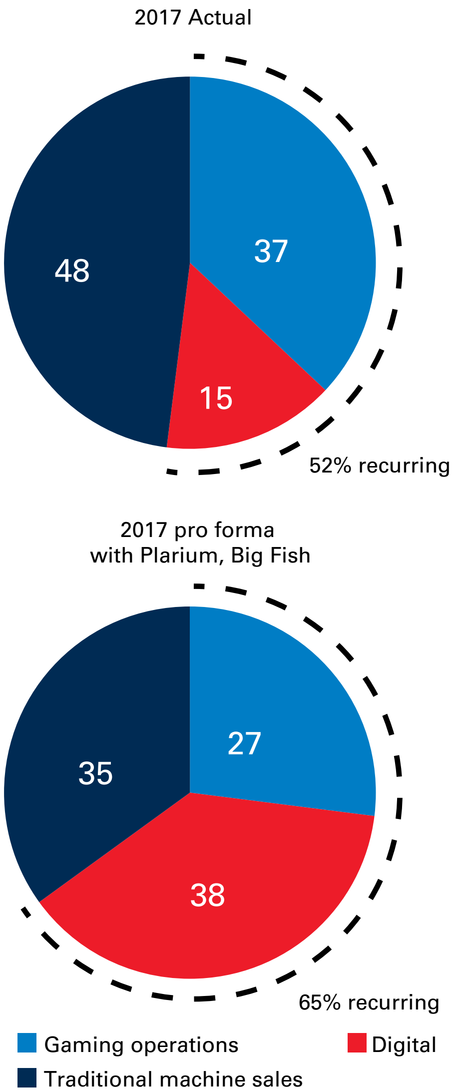
The latest purchase follows the acquisition in August of Israeli gaming company, Plarium, whose games include *Vikings: War of Clans* and *Sparta: War of Empires*, for US$500 million.

The digital segment is expected to be the largest single revenue contributor for Aristocrat after incorporating pro-forma revenue from the acquisitions. These moves also highlight the group's change in focus, with recurring revenue on a pro forma basis now making up 65% of total revenue, reducing Aristocrat's reliance on cyclical outright sales of hardware and equipment. (See charts at right)

Aristocrat continues to develop titles for both land-based and digital platforms. Further digital growth and capital management opportunities are available, with strong execution by management and the scarcity of earnings growth in the market – despite a challenging and structural slot expenditure decline. We recently cut our recommendation on Aristocrat to Accumulate from Buy following a strong run-up in the share price since its September lows, even incorporating the nearly 7% fall on the day of the result.

We believe the risk/reward balance remains attractive, however, and we are optimistic on the company's growth prospects.

Revenue split by product segment (%)



RAMSAY HEALTH CARE

HEALTHY OUTLOOK

Sector: Health Care Recomm: Accumulate Risk rating: Medium Share price: $70.41

Year to June ($A)	2017A	2018E	2019E
Profit after tax ($m)	543	592	658
Earnings per share ($)	2.61	2.86	3.18
Price/earnings (x)	26.9	24.6	22.1
Dividend ($)	1.35	1.44	1.59
Dividend yield (%)	1.9	2.0	2.3
Franking (%)	-	100	100

Source: Company report, Ord Minnett Research. Profits are on a normalised basis.

Ramsay Health Care (RHC) share price

Source: IRESS

Ramsay Health Care is a global hospital group operating 235 hospitals, day surgery centres, treatment facilities, rehabilitation and psychiatric units, and a nursing college across six countries.

The bulk of the company's facilities are in France (119), Australia (73) and the UK (35), with minor facilities in Malaysia (4), Indonesia (3) and Italy (1).

Ord Minnett acknowledges Ramsay's ability to generate solid earnings growth, augmented by the group's ongoing brownfield development program, potential for acquisitions and procurement savings.

The company has a proven track record of generating operating leverage through its brownfield redevelopments, and with what we estimate at $100 million of available procurement savings, we believe it will continue to deliver margin expansion.

Private hospitals are backed by supportive industry fundamentals domestically and in the other countries where Ramsay operates, which supports a robust earnings outlook and our Accumulate recommendation.

We note Ramsay is one of our preferred portfolio choices for 2018, with the company slotting into both the 'global over local' theme, with its offshore exposure, and the 'structural growth' category, where the above-mentioned supportive fundamentals provide leverage to longer-term structural trends.

The recent UK budget included an additional £2.8 billion of funding for the National Health Service (NHS) over the next three years for day-to-day spending, including surgeries. The additional funding appears to be specifically targeted to reduce ballooning NHS waiting lists.

In Ord Minnett's view, this bodes well for Ramsay's UK operations, which are heavily reliant on NHS patients, especially in light of the limited capacity of NHS hospitals over the winter months.

The political aim of the additional funding appears to be to improve patient waiting times and reduce waiting lists. There has been a clear slowdown in NHS patient numbers since April due to funding pressures and the associated downgrading of referral to treatment targets.

We expect the funding boost to result in an improvement in NHS patient bookings following the recent slowdown.

The bigger picture in the UK also provides more opportunities for private operators like Ramsay. With the NHS waiting list now more than 4 million people, and estimates of 7–8 million by 2022 under current funding proposals, the private sector is increasingly likely to be seen as an alternative to the stretched public system.

The fact that the extra government funding was less than half the £4 billion requested for 2019 highlights the budgetary pressures facing the NHS and its ability to meet waiting list targets.

SERVICE STREAM

STREAM STILL FLOWING

Sector: Industrials Recomm: Buy Risk: Higher Price: $1.26

Service Stream is an engineering and network services contractor to the water, energy and telecommunications industries. Its largest –and most high-profile – client is the National Broadband Network Co (NBN Co), which recently suspended all new orders over its hybrid fibre-coaxial (HFC) network (principally pay-TV cable) so it could perform network testing and remediation work to improve the quality of existing services.

Despite suspending new orders, however, NBN Co confirmed it was still on target to connect eight million homes by 2020. Given this, we see the delay in HFC activations as being short-lived and we expect only a minimal impact on Service Stream's fiscal 2018 result. In fact, it is possible any impact may be offset by additional remediation work.

Service Stream also recently noted HFC technology work makes up only 27% of its activations, suggesting the majority of its work for NBN Co will be unaffected by the suspension.

Further, it said it did not expect the suspension of HFC new orders to have a material impact on the earnings outlook for the current financial year or beyond.

Service Stream's share price has sunk 10% since NBN Co's announcement, but we still see this as a good operating environment in which to be a high-quality contractor, and we find no reason to change our earnings estimates at this stage. We forecast EPS growth of 22% in fiscal 2018 and a further 7% in fiscal 2019.

Service Stream is Ord Minnett's preferred exposure to the NBN rollout and its ongoing maintenance. We reiterate our Buy recommendation and our target price of $1.54, which offers potential upside of more than 20% from current share price levels.

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