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ORD MINNETT
PRIVATE WEALTH

Ords Monthly

STATE OF PLAY

KEEPING THE FAITH

Volatility is the word of the moment as we publish this issue of the Ords Monthly.

The global market rout, followed by a rally – albeit not back to January's heights – has left many investors around the globe uneasy.

A whipsawing Wall Street and vertiginous volatility notwithstanding, we are constructive on the outlook for equity markets and growth assets. We see the recent nervousness more as a 'digestion' issue for investors as they reconcile the implications of stronger economic growth, and we explain our view in the *Investment Strategy* section starting on page 2.

In our company coverage this month, we lead off with **Boral**. Despite a remarkable run last year – the stock soared 44% in 2017 – we do not believe the company's significant growth potential through to 2021 is fully reflected in the share price. We present our investment case on page 4.

We are also positive on **Treasury Wine Estates**, one of the world's largest wine producers, which is enjoying significant leverage to the booming Asian market. We have raised our earnings estimates following its first-half result for fiscal 2018 and we explain why on page 5.

WorleyParsons has been delivering engineering and project management to the oil industry for more than 60 years, with a blue-chip client list of companies and countries.

"A whipsawing Wall Street and vertiginous volatility notwith-standing, we are constructive on the outlook for equity markets and growth assets."

Signs of an improving outlook for capital expenditure in the resources sector is good news for a pro-cyclical company such as WorleyParsons, and we have initiated coverage with a Buy recommendation. For more details, see page 6.

Been shopping lately? Chances are you've seen the logo advertising **AfterPay** at the checkout.
The company is a major player in the rapidly expanding 'buy now, pay later' space, with a product that allows consumers to receive their goods upfront and smooth their spending over four payments. Ord Minnett has initiated coverage with a Buy recommendation and we explain our reasoning on page 7.

On page 8 we outline the opportunity available in **Pinnacle Investment Management**. The company reported very impressive growth in funds under management in the first half of fiscal 2018 and we see more to come.

Finally, this edition comes out as the December reporting season kicks into high gear, and we list some of the key companies and their reporting dates in Table 1.

Table 1: Major companies still to report results

Date	Company	Results
13-Feb	Transurban	Half-year
14-Feb	IAG	Half-year
14-Feb	Woodside	Full-year
15-Feb	Origin Energy	Half-year
15-Feb	South32	Half-year
15-Feb	Telstra	Half-year
19-Feb	Brambles	Half-year
22-Feb	Alumina Ltd	Full-year
26-Feb	QBE Insurance	Full-year
23-Feb	Woolworths	Half-year

Source: Ord Minnett Research

INVESTMENT STRATEGY

ALERT BUT NOT ALARMED

Global and local equities have suffered a setback after a strong start to 2018, and Ord Minnett believes the latest bout of volatility can be attributed to two main factors:

- **Bond market fears** – A strong run of economic numbers, highlighted by the latest US payrolls data showing an acceleration in American wage growth to 2.9% year-on-year, has reignited fears of an unrestrained rise in inflation and bond yields.

  Bond-market sell-offs – or 'tantrums' as they have become known – are not new, and have become increasingly common since the Federal Reserve sparked the 'taper tantrum' in 2013 by preparing to temper its quantitative easing program put in place in the depths of the GFC.

  Despite the number of tantrums over the years, however, US 10-year Treasury note yields are still within the levels seen in the aftermath of the Fed's tapering more than four years ago, despite the better growth outlook (see Figure 1).

- **Technical factors** – Markets are testing key psychological levels. The CBOE Volatility Index, known as the VIX and often cited as a measure of market fear, had been hovering at very low levels. Our previous research has shown low volatility is usually followed by a short-term pause in US equities. Only twice since 1990 has the VIX dipped below the 10-point mark. In both cases, a 5–10% sell-off occurred over two to three months in US equities, before the market rose again. Investor sentiment also appears stretched when measured by the AAII Bull-Bear ratio, which in early February pointed to net bullishness among investors at its highest levels since 2000 (see Figure 2).

We do not play down the above-mentioned concerns, but view the volatility as more of a digestion risk as the market reconciles the implications of better growth. We also note the falls up to time of writing have only taken the S&P 500 Index back to levels of early December, versus a nearly nine-year bull run from the 2009 lows of the GFC. For the local market, the losses take the S&P/ASX 200 Index back to levels seen in October.

Fig 1: US 10-year notes – Yields are still within the range set since Jan 2013

Source: Bloomberg, OML Research

Ord Minnett remains constructive on the outlook for equity and growth assets for the following reasons:

- **Alignment with our base case** – Our base case is for inflation to pick up this year and global bond yields to rise as growth improves and spare capacity diminishes. Recent data is consistent with these views. If higher interest rates are a consequence of higher growth rates, then this should not hinder equities – at least not at this point. Rather than seeing these bond tantrums as a cause for panic, we view them as more of a validation of our views around good global economic momentum.

- **Fundamentals are improving** – Global macroeconomic data remains robust and supportive of equities. Since the start of the year, our global research counterparts have been upgrading their growth forecasts such that global GDP growth in 2018 is now expected to hit 3.5%, up from 3.2% previously.

Earnings remain another key support for markets. Fourth-quarter earnings in the US have proven to be robust so far, with 81% of S&P 500 companies beating earnings estimates, the highest level in seven years. Similarly, in Australia, forecasts for fiscal 2018 earnings have been revised higher in recent weeks, largely focused on the resources sector.

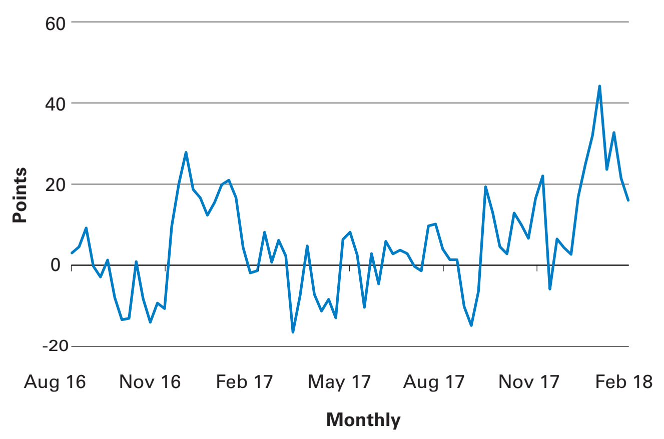
Real interest rates remain in the low-to-negative zone, which is stimulatory for economic growth. With the US benchmark fed funds rate in a target range of 1.25–1.5% and core inflation at 1.8%, real cash rates remain negative. Similarly, US bond yields adjusted for inflation are at low levels. We suggest real cash rates would need to rise to by one to two percentage points before unnerving investors.

"Global macroeconomic data remains robust and supportive of equities."

Locally, similar stimulatory settings apply, with the Reserve Bank leaving its benchmark cash rate at 1.50% at its February meeting, compared with core inflation of 1.8% based on the central bank's preferred measure.

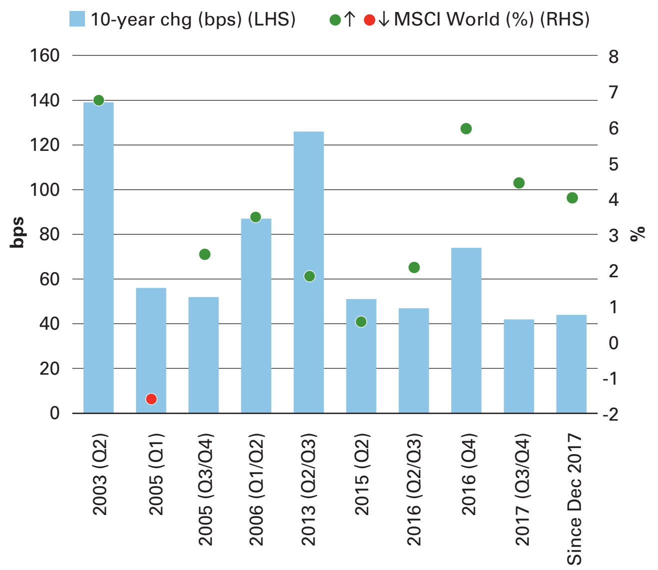
We also note equity market declines do not necessarily endure when bond yields rise. See Figure 3, which plots the performance of global equities during 10 episodes when US 10-year yields rose about 50 basis points, to highlight the stockmarket's resilience.

Fig 2: AAII Bull-Bear ratio – Net bullishness reached elevated levels at the start of February



Source: Bloomberg, OML Research

Fig 3: Stocks vs bonds – Global equity markets rarely decline during major bond market sell-offs



Source: OML Research

BORAL

AMERICAN PIE

Sector: Materials Recomm: Accumulate Risk rating: Higher Share price: $8.00

Year to June	2017A	2018E	2019E
Profit after tax ($m)	352	470	572
Earnings per share ($)	0.37	0.40	0.49
Price/Earnings (x)	21.5	20.0	16.4
Dividend ($)	0.24	0.26	0.29
Dividend Yield (%)	3.0	3.2	3.6
Franking (%)	75	60	90

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

Boral (BLD) share price

Source: IRESS

Boral is an integrated heavy construction materials producer and building products manufacturer, with its key operations in Australia and the US and significant interests in Asia and the Middle East.

Boral led the sector with its performance in 2017, as investors became comfortable with the Headwaters acquisition in the US and its strong earnings growth outlook.

We have refreshed our view on Boral and upgraded our recommendation to Accumulate from Hold. Despite a remarkable run last year – Boral stock soared 44% in 2017 – we do not believe the company's significant growth potential through to 2021 is fully reflected in the share price.

The key driver of earnings growth for the company in the coming years will be its North America division.

After a restructure, we see a compound annual growth rate in operating earnings for the division of 18% over 2017–21.

The explicit drivers of this forecast are as follows:

- **Headwaters synergies –** Boral bought Headwaters, a major North American building products manufacturer and fly ash marketer, for US$2.6 billion in 2016. The fly-ash business now forms part of the construction materials division, while Headwaters' other operations are now in the building products division. We have incorporated the full US$100 million of forecast benefits into our estimates;
- **Meridian –** The formation of the Meridian bricks joint venture created the leading US brick producer and this exposure should be a meaningful driver of earnings in the coming years. We expect benefits of US$25 million by 2021, even with only modest operating leverage;
- **Construction materials –** This newly created unit comprises a market-leading fly-ash (used as a cement substitute in concrete) business, block assets in Texas and Louisiana, and Boral's legacy Denver Ready-mix business. The key driver over 2017–21 will be its fly-ash business, buoyed by both top-line growth and wide margins;
- **Building products –** This business consists of four key products – roofing, stone, light building products and windows.

Our estimates factor in a US$55 million rise in operating earnings over 2017–21, before synergies. This improvement is largely due to sales growth in line with its end-markets, predominantly new residential construction.

Boral's North America division will be the key earnings driver for the group, but the Australia arm also looks set to be a key contributor. In particular, we expect market demand, pricing dynamics and margins to be supportive.

On the demand front, the east coast (particularly NSW and Victoria) remains especially robust, underpinned by growth in non-residential investment and infrastructure.

Lead indicators suggest residential construction will slow in coming years. Data on construction work done, however, has yet to show this in Victoria and NSW – the faster-growing states – and Boral has significant exposure to both of these markets.

TREASURY WINE ESTATES

A GOOD DROP

Sector: Consumer Staples Recomm: Accumulate Risk rating: Higher Share price: $17.12

Year to June	2017A	2018E	2019E
Profit after tax ($m)	299	346	441
Earnings per share ($)	0.41	0.47	0.61
Price/Earnings (x)	42.2	36.2	28.2
Dividend ($)	0.26	0.29	0.41
Dividend Yield (%)	1.5	1.7	2.4
Franking (%)	25	75	75

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

Treasury Wine Estates (TWE) share price

Source: IRESS

Treasury Wine Estates is one of the world's largest wine producers, selling more than 36 million cases annually. The company, which has a portfolio of more than 70 brands ranging from Yellowglen to Penfolds, recently posted a first-half result for fiscal 2018 that again showed the Asian market as the key driver of growth for the vintner.

Earnings before interest, tax and SGARA* rose 25% to $283.3 million, broadly in line with Ord Minnett's forecasts, due to strong margin expansion across all divisions and despite lower-than-forecast sales growth.

Following this result, we have raised our EPS forecasts by 9.4% in fiscal 2018 and 17.7% in fiscal 2019.

Treasury signalled it was *"aligned"* with consensus estimates of $524 million for fiscal 2018 earnings and flagged growth of 25% in fiscal 2019.

We suggest the growth outlook to fiscal 2020 is skewed to the upside.

We maintain our Accumulate recommendation on Treasury and have raised our target price to $18.50 from $15.00.

- **Asia** – Earnings growth remained strong in the first half. Volume growth of 44% also impressed and, along with product mix, drove margin expansion to a strong 39.3%.

- **Americas** – Growth in this market slowed. Volumes fell due to changes in the portfolio and, along with changes to its distribution arrangements, weighed on earnings. Margins expanded, however, due to tight cost controls across the business.

The move to own distribution rights in California and Washington state and a hybrid model in Florida, along with a change in distributor in 20 other states, gives Treasury control over more than 25% of its distribution. The company made the changes as its previous arrangements were unable to deliver the growth that Treasury is seeking as it shifts from its 'fix' mode in the US to 'growth' mode.

- **Australia and New Zealand** – Growth in volumes and net revenue per case was modest, but margins widened due to supply chain benefits aiding costs per case.

Treasury is executing on its strategy well, with a focus on fewer brands, 'premiumisation' (where the average quality of the brands in the portfolio is pushed up the scale), leveraging its scale in marketing and innovation, flexible sourcing, and optimising distribution to the market. The company is also well exposed to the structural growth drivers of Asian wine demand, especially from China, and growth in luxury and masstige wine, and has a disciplined approach to capital with strong cash flow generation.

These attributes should support strong earnings growth on a multi-year basis, despite some near-term disruption from the US distribution changes. Once completed, however, these changes provide further growth potential.

* SGARA, or self-generating and regenerating assets, is an accounting item used to adjust for changes in the value of the company's grapes and vineyards.

WORLEYPARSONS

RIDING THE CYCLE

Sector: Energy Recomm: Buy Risk rating: High Share price: $14.92

Year to Dec	2017A	2018E	2019E
Profit after tax ($m)	123	173	225
Earnings per share ($)	0.50	0.63	0.83
Price/Earnings (x)	29.3	22.9	17.6
Dividend ($)	-	0.30	0.49
Dividend Yield (%)	-	2.1	3.4
Franking (%)	-	100	100

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

WorleyParsons (WOR) share price

Source: IRESS

WorleyParsons is a provider of professional services to the energy, resources and complex process industries.

The company offers a broad scope of services across the full spectrum of an asset's lifecycle, providing design and project services for evaluating the feasibility of new developments, establishing the asset and providing support to maximise the returns from the asset over its life.

WorleyParsons is a pro-cyclical company with its revenue strongly correlated to commodity prices. Ord Minnett has initiated coverage with a Buy recommendation, based on the recent stabilisation in commodity prices.

Weakening commodity prices saw global mineral exploration and production, and metals and mining capital expenditure fall substantially in recent years, with the down-cycle deeper and longer-lasting than most in the market and industry had expected.

There is now evidence of a stronger outlook, however, with the market forecasting single-digit increases in capital expenditure over 2017–20, while the backlog of development work at WorleyParsons has risen to more than 20% and staff utilisation rates are rising. All of these factors are positive for near-term earnings growth.

In addition, our earnings estimates are at the top end of consensus, and we expect the stock price to benefit as others upgrade their forecasts in response to the turn in the cycle and a growing pipeline of work.

We also note the potential for corporate activity in what is a consolidating industry sector. The company's largest shareholder is Dubai-based Dar Group, a privately owned international professional services firm, which controls 23% of the register. Dar Group has previously looked to acquire WorleyParsons and it could return with a firm bid.

WorleyParsons currently has 106 office locations in 42 countries worldwide and employs 23,000 people. Its business is organised into three broad customer sector groups: hydrocarbons, which combines oil and gas, refining and petrochemicals; minerals, metals and chemicals; and infrastructure, which includes power, water and developments.

Most of WorleyParsons' revenue and earnings – some 71% and 83%, respectively – are from the hydrocarbons group, which is its core competency.

The company has been delivering engineering and project management services to the global hydrocarbons industry for more than 60 years, and has long-term relationships with numerous government-owned oil companies and international oil companies, including ConocoPhillips, Chevron, BP, Woodside, Shell and Saudi Aramco.

AFTERPAY TOUCH

GOODS IN HAND

Sector: Diversified Financials Recomm: Buy Risk rating: Higher Share price: $7.05

Year to June	2017A	2018E	2019E
Profit after tax ($m)	1	18	47
Earnings per share ($)	0.01	0.08	0.20
Price/Earnings (x)	n/m	93.5	36.3
Dividend ($)	-	-	-
Dividend Yield (%)	-	-	-
Franking (%)	-	-	-

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

Afterpay Touch (APT) share price

Source: IRESS

Afterpay Touch is a major player in the rapidly expanding 'buy now, pay later' space, with a product that allows consumers to receive their goods upfront and smooth their spending over four fortnightly payments. In turn, participating retailers benefit from higher sales.

Afterpay was founded in 2014 and listed in June 2017, and had more than 1.5 million customers and a total (annualised) transaction value of more than $2.2 billion at the end of December 2017. About 11,500 merchants offer the Afterpay product.

Ord Minnett has initiated coverage on Afterpay with a Buy recommendation. Our investment case is based on the following drivers:

- **Market-leading position** – The company now facilitates circa 9% of all online sales in Australia;
- **High take-up rate** – The network effect continues to drive more retailers to offer the product, which allows more consumers to use it more frequently;
- **Scalable business model** – The company has enormous market potential, especially as Afterpay diversifies geographically;
- **Well funded** – Afterpay's existing debt facilities can handle annualised sales of $4.4 billion; and
- **Strong management team** – The company is led by its two co-founders, Anthony Eisen and Nicholas Molnar, each of whom holds a significant stake.

Afterpay's point-of-sale financing, both online and in-store, allows consumers to repay the funded amount over eight weeks, charging no interest or fees other than late fees.

Revenue is earned from a merchant fee, which ranges from 3% to 6% and averaged 4.1% in fiscal 2017, up from 3.7% in the previous year.

The rapid repayment cycle –less than 30 days on average – means every $100 in capital employed generates $57 of revenue over 365 days.

Most of Afterpay's funding comes from bank financing at wholesale interest rates, although it could also fund extra sales by using its own cash flow.

In the short term, Afterpay's earnings will be driven by further penetration into online retail in Australia and New Zealand, a market valued at $18.4 billion excluding take-away food and groceries.

Currently, around 30 new merchants per day are joining the platform, a monthly rate of circa 930, and Afterpay estimates there are more than 50,000 online merchants in Australia.

Over the longer term, Afterpay's plan to expand into the US, where it has partnered with venture capital firm Matrix Partners, has enormous potential given the US$500 billion-plus online retail market in that country.

PINNACLE INVESTMENT MGT

TOP OF THEIR GAME

Sector: Diversified Financials Recomm: Buy Risk: Higher Price: $4.38

Pinnacle Investment Management (PNI) is an investor that currently holds minority equity stakes in seven Australia-based boutique fund managers. Beyond simply owning equity stakes, Pinnacle offers support via seed funding for both working capital and fund investment, distribution to retail and institutional markets, administration services and operational support.

Pinnacle has been successful in fostering growth at its boutiques, with all seven currently profitable and holding $32.4 billion in combined funds under management (FUM) as at December 2017. Unlike other multi-boutique investment firms, Pinnacle provides support services to all of its boutiques, indicating close relationships with its managers and reflecting its philosophy of 'supported independence'.

The FUM outcome of $32.4 billion for the first half of fiscal 2018 was above Ord Minnett's estimate for the full year, leading us to raise our fiscal 2018 FUM forecast to $35.9 billion.

This result, and the benefit of Pinnacle's strong operating leverage, led us to raise our EPS forecasts for fiscal 2018 and fiscal 2019 by 24% and 29%, respectively, and increase our target price to $4.88 from $3.60.

We expect this operating leverage to remain a key feature of our Pinnacle investment case, and we continue to rate the stock as a Buy following material upgrades to our forecasts.

Pinnacle has significant growth options in new seed boutiques, fresh boutique investments and potential acquisitions – none of which are being priced in by the market.

The company has displayed impeccable manager selection and operates a highly effective distribution network, which we believe will provide further opportunities for investment in high-calibre fund managers.

For the full report on Pinnacle, please contact your Ord Minnett adviser.

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