ORD MINNETT
PRIVATE WEALTH

July 2018

ORDS MONTHLY

SAFETY FIRST
STARTING OVER

The Australian stock market jumped 3% in the final month of the financial year just finished, but its annual price gain of 8.3% proved somewhat of a middling performance – outperforming European peers but not providing a challenge to its US and key Asian rivals.

In this edition of the Ords Monthly, our investment strategists ponder the outlook for the next six months to find a clearer picture for investors.

Broadly speaking, we remain positive on equities given analysts' valuations, earnings growth and robust balance sheets all provide a solid foundation for the next six months. That said, we also suggest adding some protection to portfolios, given the risks around tightening financial conditions and trade wars. Our investment strategy note starting on page 2 lays out the issues needed to fine-tune a portfolio.

Breaking up is hard to do, but **Commonwealth Bank** is giving it a shot, spinning out its wealth management business, most of its financial planning operations and its mortgage broking operations into a new company. CEO Matt Comyn is reshaping the business after a torrid 12 months to deal with a rapidly changing regulatory landscape for financial services in a post-Royal Commission world. See page 4 for more details.

> "We remain positive on equities given analysts' valuations, earnings growth and robust balance sheets all provide a solid foundation"

That need for a new start is also driving the restructure of **Telstra**, although the telecommunications carrier is doing it via a trial separation rather than a divorce, creating a standalone but wholly owned business – InfraCo – to hold its prized utility infrastructure assets. Telstra would consider selling InfraCo in 2022 when the NBN rollout is complete, but our analysts expect the relationship to end before then. See our note on page 6.

Boral has disappointed since the stock nearly hit a 12-year high in February, with a soft interim result and a cut to full-year guidance. It has been an uncertain start for Boral following the Headwaters acquisition in 2017, but we see the stock offering compelling value at current price levels and we explain our investment thesis on page 5.

HUB24 is one of the leaders of a rapidly growing number of independent platform providers that give advisers, planners and investors an efficient way to manage investments. Its recent full-year guidance update disappointed, but the company is winning strong fund flows. Industry trends favour HUB24 and its peers as fallout from the Royal Commission drives advisers from the big players such as AMP to independent licensees. We set out our view on page 7.

This edition finishes with the inventor of the toasted sandwich maker. Starting with radios in 1932, **Breville** is now a global distributor of homeware appliances such as its eponymous jaffle-maker, along with brands such as Kambrook and Ronson. We see accelerating earnings growth in fiscal 2019 that is both self-funded and globally focused. See page 8 for more.

INVESTMENT STRATEGY

DEFENCE MECHANISM

The Australian stock market outperformed its European peers in the financial year just gone, but came up well short of its US and key Asian counterparts. So, where to from here?

The global economy has sustained above-trend growth in 2018, despite weak patches, and Australia's economy has positively surprised. Risks are building, however, and the issues that jangled investor nerves in the first half of 2018 will likely persist in the second half.

Ord Minnett examines these risks in detail later in this note, but overall, valuations, corporate earnings growth and solid company balance sheets still leave us positive on the outlook for equities. We do, however, see sense in ensuring your portfolio has sufficient defensive characteristics, given the risks around tightening financial conditions and trade wars.

Global

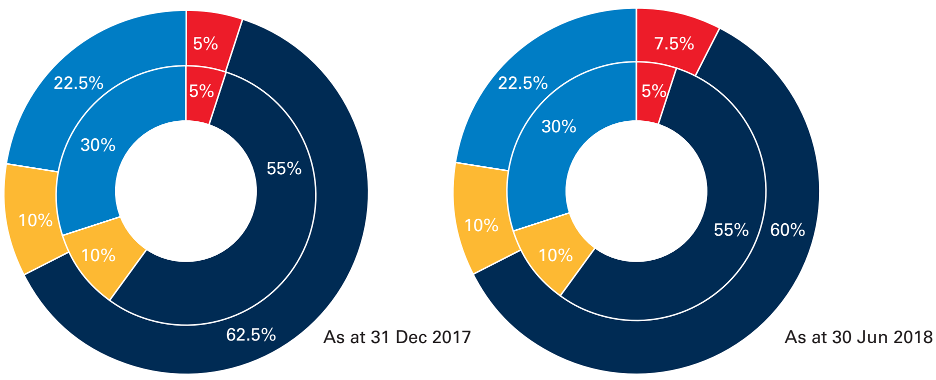
Despite some patchy data in Europe, upgrades to the outlook in the US and China have helped the global economy sustain a healthy, above-trend pace of growth so far this year. The Composite Global PMI, an indicator of manufacturing and services activity, has averaged 54 this year. This is still in expansionary territory above 50, and consistent with GDP growth annualising 3.0–3.5%.

Regional view – We see global growth slowing modestly to an annualised rate of 3.2% from 3.6% currently, so still an above-trend rate. The slowing growth will be mostly policy-induced, in our view. Stronger growth in the US and euro zone is being limited by central banks gradually removing stimulus, while trade tariffs will shave some growth off China.

We assume the euro zone and US will maintain a 2.5% annualised GDP growth, while China's growth is forecast to ease to circa 6.3% by year end from 6.6% currently. Emerging markets are also forecast to slow as they face reverberations from the direction of US policy, that is, trade tensions and relative interest rates.

Macro picture – We are constructive on the outlook for US and euro-zone consumers. Unemployment rates are at their lowest levels since the Global Financial Crisis in these regions, and consumer sentiment is strong. A modest pick-up in business capital expenditure is also forecast.

Figure 1: Changes to our balanced asset allocation in the past six months – tactical weight to equities now 60%, cash weight lifted to 7.5%



Source: Bloomberg, Ord Minnett Research

Investment Strategy 2

The key risk, however, is political – specifically, how the policies of populism-driven coalitions in Germany and Italy evolve. An escalation in trade conflicts, for example, risks unravelling an otherwise robust economic picture.

Inflation – Global inflation should accelerate to 2.5% by year end from a combination of protectionist policies, prolonged strength in commodity prices and a continued recovery in wages as labour-market slack diminishes.

Interest rates – Major central banks remain confident, leading the US Federal Reserve to raise rates twice this year and the European Central Bank (ECB) to target an end to its bond purchase program in December 2018.

Our base case is for the US Federal Reserve to raise rates twice more in 2018 – a quarter of a percentage point both times – and US 10-year bond yields to rise to 3.2% by year end.

We see ECB commentary turning more hawkish, but they will stop short of lifting rates until late 2019. Likewise, Japan will keep monetary policy steady this year given little evidence of inflation pressures. Indications for China, however, are that monetary policy will be eased further in response to the heightened external risks.

Australia

Australia's economy has tracked better than forecast so far this year, largely due to net exports and government spending. Households remain key to sustaining confidence in the economy's underlying strength, however, and there is little evidence of improvement.

Domestic view – There has been no significant change to our economic outlook for Australia, which assumes economic growth remains below potential at 2.5% annualised by year end. This reflects fading contributions from net exports and still-subdued household spending.

If anything, risks are skewed to the downside, as our anticipated slowdown in housing credit growth to 4% from 6% over 18 months gains more conviction following the Royal Commission and calls from regulators for stricter lending criteria. This adds to the list of constraints on consumers – along with high levels of indebtedness, low savings rates, low wage growth, and a smaller wealth effect from housing.

Macro picture – Business expenditure should improve as the drag from the mining investment downturn fades, while non-mining construction spending and public infrastructure projects will contribute positively.

The key for Australia in the second half is how much consumers will trim spending if pressure on household finances is not alleviated. We see spending growth in 2018 being lower than in 2017.

Inflation – Commodity price pressures, including higher food prices, may see inflation pick up. A lack of wage growth given excess capacity in the labour market, however, means inflation should still stay towards the low end of the 2–3% target band of the Reserve Bank of Australia (RBA).

Interest rates – We expect the RBA to stay on hold, rather than risk a credit crunch by raising interest rates.

The market is already undertaking some tightening on behalf of the RBA – with banks raising lending standards and some increasing rates on some products to offset wholesale funding cost pressures.

Currency – The Australian dollar has fallen 5% this year versus the US dollar, but given monetary policy in Australia lags the US – along with less upside to iron ore prices – the currency should stay in the low US$0.70s range.

Our view is the above-mentioned risks will keep markets choppy and limit returns. We still see the S&P/ASX 200 Index as still likely to trade within our previously forecast 5800–6300 band into the end of 2018.

This outlook does not necessitate turning bearish, but it is worth giving your portfolio a health check to ensure it is sufficiently robust to mitigate the near-term risks.

First, speak to your adviser to determine if you should trim your exposure to certain stocks or sectors as a method of enhancing your portfolio's defensive qualities.

Second, adjust your portfolio to, in effect, stay short the Australian dollar. As a commodity currency, the Australian dollar, given its greater economic reliance on Asia, would suffer comparatively more if trade conflicts escalated and threatened global growth. This strategy can be implemented indirectly, through increasing exposure to stocks with predominantly US-dollar earnings, or directly, via an exchange-traded fund such as the BetaShares US$ ETF.

We still keep an overweight bias to equities and our balanced asset allocation recommends a 60% tactical/shorter-term weighting in equities via a combination of Australian and international shares. See Figure 1. This is above the recommended strategic/longer–term allocation of 55%, although this was fine-tuned from 62.5% in March as we saw increased volatility ahead potentially presenting opportunities.

COMMONWEALTH BANK

CLEARING THE DECKS

Sector: Banks Recomm: Hold Risk rating: Medium Share price: $75.67

Year to June	2017A	2018E	2019E
Profit after tax ($m)	9,881	9,421	10,578
Earnings per share ($)	5.56	5.24	5.82
Price/earnings (x)	13.6	14.4	13.0
Dividend ($)	4.29	4.30	4.34
Dividend yield (%)	5.7	5.7	5.7
Franking (%)	100	100	100

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

Commonwealth Bank (CBA) share price

Source: IRESS

Commonwealth Bank will spin off its wealth management and mortgage broking operations, ditching a long-running vertically integrated business model in favour of a strategy to become what CEO Matt Comyn calls a *"simpler and better bank".*

The largest part of the new company, known as CFS Group, will comprise Colonial First State Global Asset Management – with $207 billion in funds under management – and the Colonial First State superannuation platform – with $135 billion in funds under administration.

The new company will also own the Count Financial and Financial Wisdom financial advice businesses, the Aussie Home Loans mortgage broking operations, and minority shareholdings in **CountPlus** and **Mortgage Choice**.

CBA will also undertake a strategic review of its general insurance business, including considering a potential sale.

The spin-off will not affect CBA's 20-year strategy distribution partnership with Hong Kong-based AIA Group in relation to life products.

Comyn said the CFS Group made a pro-forma net profit of more than $500 million in fiscal 2017 and would have a "*strong capacity to pay franked dividends*", while the bank itself would benefit from being a simpler business focused on its core Australasian market.

CBA will keep its salaried financial advice business, Commonwealth Financial Planning, which will form part of its consumer financial services business. This unit will sit in the retail banking services division.

CBA also made a series of senior appointments: Nigel Williams as chief risk officer, David Cohen as deputy CEO, Angus Sullivan as head of retail banking services, and Andrew Hinchliff as head of the institutional banking and markets division.

Only the group CFO role is yet to be filled in the executive leadership team, and an appointment is expected after the full-year result.

Separately, CBA received Australian Prudential Regulation Authority (APRA) endorsement for its plan to fix shortcomings in governance, risk management and accountability found by a regulatory inquiry into the bank.

That inquiry followed court action against CBA by the Australian Transaction Reports and Analysis Centre (AUSTRAC) for breaches of anti-money laundering regulations.

APRA had already imposed a $1 billion additional capital requirement on CBA following its report, and CBA only reached a settlement with AUSTRAC in mid June, paying a civil penalty of $700 million and $2.5 million in AUSTRAC's legal costs.

The so-called Remedial Action Plan outlines changes to improve the way the bank runs its business, manages risk and works with regulators.

Measures in the plan include cutting senior executive remuneration by more than $60 million and the reduction in fees for non-executive directors announced in August 2017.

Our Hold recommendation reflects a further deterioration in CBA's return on tangible equity as it digests regulatory capital headwinds. However, we believe these headwinds are now adequately reflected in CBA's valuation metrics.

BORAL

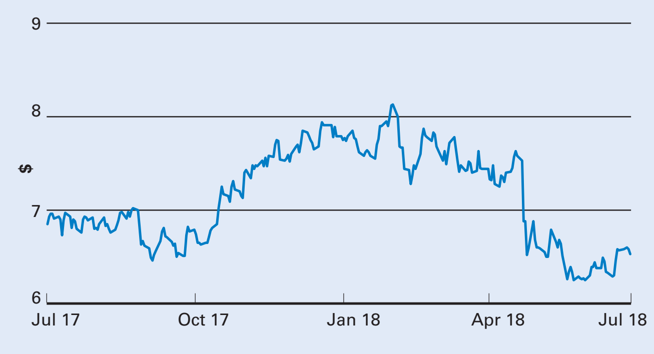
CONTRARIAN VIEW

Sector: Materials Recomm: Accumulate Risk rating: Higher Share price: $6.56

Year to June	2017A	2018E	2019E
Profit after tax ($m)	352	506	551
Earnings per share ($)	0.37	0.43	0.47
Price/earnings (x)	17.6	15.2	13.9
Dividend ($)	0.24	0.26	0.28
Dividend yield (%)	3.7	4.0	4.2
Franking (%)	80	50	100

Source: Company reports, 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 supplier in Australia and the US, and holds a 50% share in a plasterboard joint venture with USG Corp in Asia, Australia and the Middle East.

Shares in Boral nearly hit a 12-year high of $8.13 on 2 February 2018 ahead of the first-half fiscal 2018 result. Since then, however, the company has disappointed the market with a weak first-half result and a downgrade to its full-year guidance. Boral shares plumbed depths as low as $6.29 in mid June – a slide of more than 20% from the February high – before recouping some losses to end June at $6.53.

Ord Minnett concedes it has been an uncertain start for Boral following the Headwaters acquisition in 2017, but we see the stock offering compelling value at current price levels.

The key issues concerning the market seem to be security of supply of fly ash in the US – given the ongoing closures of coal-fired power plants – and the performance of the Australian operations during the robust construction activity seen in recent years.

We address both issues below, but point out that sentiment has turned too negative, in our view, and we are comfortable with our adjusted EPS compound annual growth rate (CAGR) projection of 13% over FY17–20. We have maintained our Accumulate recommendation and target price of $7.70.

- **US fly ash supply**

  Fly ash is a by-product of coal-fired power plants and has cement-like properties that allow it to be used as a substitute for Portland cement in the production of concrete.

  Boral is tackling supply issues following the closure of coal-fired power plants in Texas. This dynamic will clearly continue, but we note it is not a new headwind faced by either Headwaters or Boral.

  Some 190 coal-fired power plants were shut down in the US over 2011–17, but we estimate pro-forma fly ash volumes for Boral and Headwaters combined grew at a CAGR of 2% over the same period.

  At the same time, Headwaters' fly-ash margin expanded by 6.3 percentage points (Boral did not separate fly ash earnings over this period).

  Importantly, fly ash prices – at circa US$62/tonne in 2018 – are at a steep discount to Portland cement – US$90–130/tonne – despite fly ash having superior environmental and physical properties to cement.

  We factor in flat volumes, strong but moderating price increases and steady underlying margins for the business through to our forecast horizon. Sentiment towards the business has turned too negative, in our view.

- **Australian performance**

  A view held by some investors is that Boral's Australian performance has been underwhelming, given robust construction activity in recent years, and that peak earnings for those operations could have been reached.

  We disagree – concrete volumes for the division have kept pace with broader activity since 2011, and there has been a substantial improvement in margins and divisional returns.

  Ord Minnett sees modest volume and price rises over fiscal 2017–21, complemented by margin expansion following fixed-asset upgrades and contributions from the proposed Geelong mill.

TELSTRA

REBOOTING

Sector: Telecommunications Services Recomm: Accumulate Risk rating: Higher Share price: $2.80

Year to June	2017A	2018E	2019E
Profit after tax ($m)	3,889	3,147	2,343
Earnings per share ($)	0.33	0.26	0.19
Price/earnings (x)	8.6	10.7	14.5
Dividend ($)	0.31	0.22	0.18
Dividend yield (%)	11.1	7.9	6.4
Franking (%)	100	100	100

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

Telstra (TLS) share price

Source: IRESS

Telstra used its recent strategy day to reveal a change in tactics designed to reignite the dominant carrier's stuttering performance in a fiercely competitive telecommunications market.

A key plank of the plan is the creation of a wholly owned standalone business unit, known as InfraCo, comprising Telstra's prized fixed-network infrastructure. This business, which will sell services to Telstra, wholesale customers and NBN Co, will include data centres, copper lines, international subsea cables and exchanges, but not mobile network assets such as spectrum, radio access equipment or towers.

InfraCo will also hold Telstra's NBN Co commercial works activities and the wholesale unit, with a workforce of around 3,000. The new business will have assets valued at about $11 billion, while annual revenue and operating earnings are expected to be $5.5 billion and $3 billion, respectively.

Management flagged that InfraCo could be spun off after completion of the NBN rollout in 2022.

Our view, however, is that a structural separation of InfraCo is the best option, and much could develop between now and 2022 that may spur Telstra to sell the business before then.

The second plank is an aggressive cost-cutting plan and the sale of $2 billion in assets to bolster the balance sheet. Productivity gain targets have been increased by $1 billion to $2.5 billion in a bid to cut core fixed costs by the latter amount by 2022. This means a net reduction of 8,000 in headcount and the removal of several layers of management.

The company also plans to dramatically simplify its product offerings – more than 1,800 consumer and small business plans will be slashed to just 20 core plans – while larger mid-market and enterprise customers will migrate to a completely new technology framework, allowing Telstra to ditch its legacy systems.

In the nearer term, Telstra also used the strategy day to lower guidance for operating earnings to $8.7–9.4 billion for fiscal 2019.

This was well below our estimate at the time of $11.4 billion and the then-consensus expectation of $10.5 billion. We have since reduced our forecast for fiscal 2019 operating earnings to $9.1 billion.

Given the drastic rebasing of earnings, we also expect the dividend to be cut to 18 cents per share over the fiscal 2019–20 period, and to 15 cents from fiscal 2021, implying dividend yields of 6.4% and 5.4%, respectively, based on prices at 6 July.

Telstra has one of the most recognisable and valuable brands in Australia, similar to incumbent telecom operators in other countries. We expect its dominance in the local market to continue, but recent structural changes to the industry from the NBN and the entry of **TPG Telecom** as a fourth mobile operator could pressure growth and profitability in the near term.

That said, current valuation levels are attractive – the stock is fairly valued on a dividend yield basis, but we see more than 20% potential upside from an eventual structural separation of the company's businesses.

HUB24

PLATFORM PLAY

Sector: Financials Recomm: Buy Risk rating: Higher Share price: $11.59

Year to June	2017A	2018E	2019E
Profit after tax ($m)	5	9	17
Earnings per share ($)	0.08	0.14	0.26
Price/earnings (x)	143.8	82.6	44.5
Dividend ($)	-	0.07	0.17
Dividend yield (%)	-	0.6	1.5
Franking (%)	-	-	-

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

HUB24 (HUB) share price

Source: IRESS

HUB24 is an independent platform provider that allows investors to centrally and efficiently manage a range of investments through an adviser or planner – including shares, term deposits, managed funds and dealer model portfolios – with functionality that rivals the industry's largest players such as AMP and the major banks.

The company recently provided fiscal 2018 operating earnings guidance for its platform operations of $11.8 million, in line with Ord Minnett's forecast of $11.6 million, but also flagged a break-even result for its software business, making a miss versus our (and consensus) estimate of $800,000.

The tone of HUB24's market release and recent trade articles lead us to believe the company is investing in sales and technology resources at a faster-than-anticipated pace, so we have pared our fiscal 2019 earnings per share (EPS) estimates by 9% despite a part-year benefit from the recent Fitzpatricks Private Wealth deal.

The Fitzpatricks deal will include the transition of $700 million of managed discretionary accounts to the HUB24 platform.

Fitzpatricks' accounts are set to transition to HUB24 by the end of the first half of fiscal 2019. We expect the funds will be on a lower fee than the average fee charged by HUB24, given the book's size.

In its first full year, the deal's benefits should more than offset the added costs, boosting forecast fiscal 2020 EPS by 3%.

The broader Fitzpatricks group has more than $7 billion of funds under administration, suggesting a potentially substantial opportunity to expand beyond the initial deal.

We are encouraged by HUB24's ability to sign such a large deal in what is a competitive market, and expect that the platform's technology, service, customisation and fees were all important drivers of the win.

HUB24's funds under administration finished fiscal 2018 at $8.3 billion versus our forecast of $8.15 billion, implying June-quarter net inflows of circa $220 million per month, up 10% on the March-quarter run-rate and up 20% on the first half of the fiscal year.

This strong flow momentum leading into the new financial year and the Fitzpatricks' transition of at least $700 million lead us to raise our fiscal 2019 estimate of funds under administration by 12% to $12.62 billion.

Industry trends continue to shift in favour of HUB24 and its peers, with the Royal Commission precipitating an accelerated exodus of advisers from the banks and AMP into independent licensees.

Despite the near-term earnings hiccup, we see sufficient long-term upside – our target price implies potential upside of nearly 20% from its 6 July closing price – to retain a Buy recommendation on HUB24.

BREVILLE GROUP

TOASTIE CHOICE

Sector: Consumer discretionary Recomm: Buy Risk: Higher Price: $11.95

Breville Group (BRG) is a global distributor of homeware appliances that started life in 1932 making and selling radios, and went on to create the iconic toasted sandwich maker in 1974.

Besides the Breville name, the company's other well-known brands include Kambrook and Ronson and, more recently, Sage by Heston Blumenthal.

We see Breville as well-positioned to accelerate earnings growth in fiscal 2019. The most attractive feature of this growth, in our view, is that it is self-funded and globally focused, with Breville poised to enter Germany, Europe's largest coffee market, to sell its own brands.

The threats by the White House to impose tariffs on goods made in China, as much of Breville's product line is, do not appear at this stage to pose a major problem.

We note that based on the first and second lists of affected products, the majority seem to be industrial goods. In addition, some of the commercial food-focused items from the original list were removed in the subsequent list released by the administration.

There are a several items that potentially could have affected companies such as Breville, but these products are either non-consumer or immaterial, in our view.

Overall, we expect no significant impact on Breville's earnings from the proposed tariffs. That said, a ramping up of trade tensions could harm the stock due to the negative impact on investor sentiment, as China has made it clear it will respond to any US action.

Our forecast for the fiscal 2019 dividend is 40 cents per share, 60% franked, offering a yield of 3.3%. We acknowledge Breville shares are trading at a premium to the market, but our forecasts are above consensus and we project upside to our valuation of $15.60 a share.

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

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