ORD MINNETT
PRIVATE WEALTH

August 2019

ORDS MONTHLY

TRADE BRINKMANSHIP
THREATS TO GROWTH

The Australian stock market finally surpassed its pre Global Financial Crisis highs, but has since quickly retreated in the face of an increasingly bitter trade conflict between the US and China that threatens global growth prospects.

The benchmark S&P/ASX 200 Index reached an intraday record high of 6875.5 and a record closing high of 6845.1 on 30 July 2019.

Despite the steep decline since 30 July, we are not yet turning bearish as, in the near term, we see central banks and governments acting to avert a recession.

To put the most recent slide into context, the US S&P 500 Index is still more than 13% higher in 2019 so far, and the S&P/ASX 200 Index is almost 15.3% higher. Ord Minnett's Investment Strategy note runs through the market outlook on pages 2–3.

Our corporate coverage takes to the road with Transurban on page 4. We have recently resumed coverage of the toll road operator with a Buy recommendation. We see the stock as undervalued, with earnings growth and balance sheet capacity forecast to deliver ongoing distribution growth at 6–7% per annum.

National Australia Bank has named Ross McEwan as its new chief to oversee the repair job on the bank's reputation in the wake of the Hayne Royal Commission. The current CEO of Royal Bank of Scotland in the UK and

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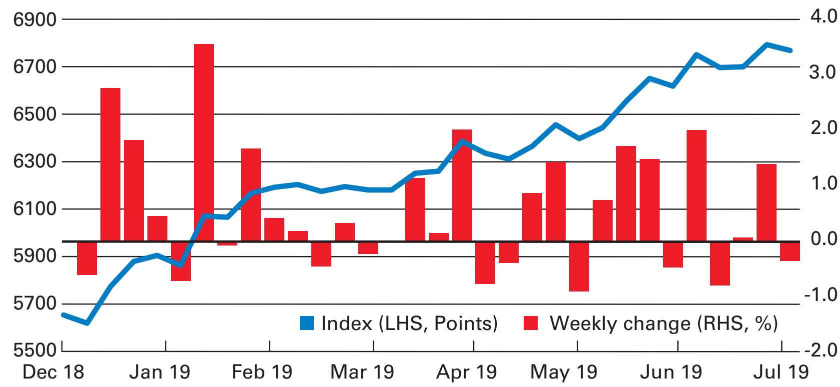
former CBA executive is our preferred choice of the external candidates to replace Andrew Thorburn. McEwan's appointment should give the market additional confidence in NAB's medium- and long-term outlook. See page 5 for the details.

Sydney Airport is a key infrastructure asset, generating good margins, with a positive outlook for all four divisions – aeronautical, retail, property and parking. It is trading on elevated multiples, however, leading us to resume coverage with a Hold recommendation. We outline our investment thesis on page 6.

We all love a special dividend and Rio Tinto delivered again at its first-half calendar 2019 result, with a surprise payout of US$0.61 per share, topping up the US$1.51 interim dividend for a total payout of US$2.12. It wasn't all good news for the diversified miner, however, with another write-down on its Oyu Tolgoi copper-gold project in Mongolia's Gobi Desert. Page 7 has our review of the result.

Lastly, we give Viva Leisure a workout on page 8. We recently initiated coverage of the pre-eminent regional health club operator in Australia with a Buy recommendation. Its attractions include a well-capitalised balance sheet, a differentiated business model and capable management.

Figure 1: S&P/ASX 200 Index weekly performance in 2019 (to 2 August)



Source: Ord Minnett Research, Iress

INVESTMENT STRATEGY

PEAKS AND PRICING

The Australian stock market has finally reached a fresh high, with the S&P/ASX 200 Index recently surpassing its previous intraday peak and closing high struck on 1 November 2007.

By comparison, the US S&P 500 Index took less than six years to pass its pre Global Financial Crisis peak and the Nasdaq Composite took less than four. On the other hand, it has been nearly 30 years since Japan's equity market peaked.

In our *Food for Thought, Rate Cuts – One Down, More to Come* on 7 June 2019, we expected if the Reserve Bank of Australia (RBA) cut rates to 1%, the S&P/ASX 200 Index could trade up to 6600. The benchmark not only reached this level, on 30 July it climbed to a record intraday high of 6875.5 – versus 6851.5 previously – and a record close of 6845.1 – versus 6828.7 previously.

The local market has retreated sharply since scaling those peaks, sliding more than 5% to below 6500 at time of writing on 6 of August. That swift reversal comes as the trade war between the US and China enters a more antagonistic phase after Washington slapped a 10% tariff on another US$300 billion of Chinese goods imported by American companies and consumers.

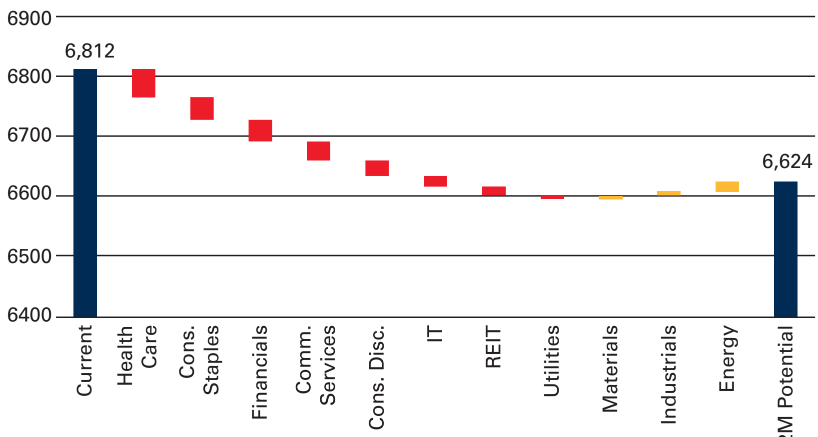
China retaliated by allowing its currency, the yuan, to fall to the lowest level against the greenback in more than a decade – making its exports cheaper – and telling state-owned enterprises to halt purchases of US agricultural exports.

That, in turn, led the US Treasury Department to formally label China as a currency manipulator, and threaten to engage with the International Monetary Fund to eliminate what it described as China's unfair competitive advantage. The action by Treasury is the first such event since president Bill Clinton's administration in 1994 and had bipartisan support in Congress.

US president Donald Trump's latest move comes just days after the Federal Reserve cut interest rates for the first time in ten years. Trump is likely hoping the US can exert pressure on China without significant consequences, as the Fed will act as a backstop – cutting interest rates to support the economy and limit market volatility – the so-called 'Fed put'.

This may work but it is a high-risk tactic given stagnating manufacturing activity, only middling global corporate earnings momentum, and a (still) sharp rise in valuations.

Figure 2: Valuation of S&P/ASX 200 implied by 12-month forward price targets



Source: OML Research. As at 31 July 2019

To put this into context, the S&P 500 Index remains more than 13% higher in calendar 2019 so far, and the S&P/ASX 200 Index remains 15.3% higher, despite the most-recent ructions.

China, on the other hand, is expected to pull several more levers to support its economy. Our global research partner now expects the following stimulus from Beijing:

- Increased fiscal spending via higher funding of local governments;
- The People's Bank of China to announce another two cuts to the reserve requirement ratios for banks in the next six months (up from one cut previously);
- Lending rates to be tweaked, including changes to benchmark lending rates and a 10-basis-point cut to the open market operations policy rate; and
- Allow the yuan to depreciate, with the US$–yuan rate expected to finish 2019 at 7.10 from 7.05 now.

We remain neutral on equities generally (and also fixed income). Following two rate cuts by the RBA, our fair value for the S&P/ASX 200 is currently 6600.

Figure 2 opposite shows that even using a bottom-up valuation methodology – adding up our price targets on each stock covered and weighting them by market capitalisation – produces an index value of about 6600.

We are not yet turning bearish given the likelihood in the near term that central banks and governments can act to avert a recession.

Furthermore, one of the key signals we use in forecasting a major market correction has been US yield curves. These have flattened, and some have inverted, indicating we are late in the cycle. That said, we also observe that the peak in the S&P 500 Index doesn't usually occur unless all four yield curves we analyse have inverted. As at 6 August, only two of the four curves had inverted.

External threats aside, whether the market can resume its rise is, in part, dependent on further RBA rate cuts – which we do not see as likely until early-to-mid 2020 – and the upcoming earnings reporting season.

Prior to recent slides, the S&P/ASX 200 was already trading on a 12-month forward price-earnings multiple of 16.5 (Figure 3), near 10-year highs, and near record highs excluding the dot.com boom in the early 2000s.

The forward earnings per share outlook has improved, but this largely reflects upward revisions to earnings in the resources sector. If we exclude resources, valuations are already looking far more stretched. (Figure 4).

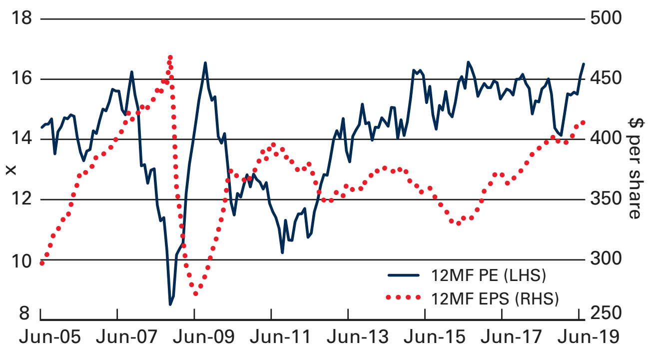
Within equities, our key investment themes for this year remain balanced across the following themes:

- Oversold cyclicals, i.e. stocks that have unduly derated on concerns of a global recession;
- Volatility vigilance, including relatively defensive exposures as a counterweight to market volatility;
- Yield leaders, on expectations that interest rates will fall; and
- Election tailwinds, i.e. beneficiaries of government spending in Australia.

Our price targets also currently indicate more potential upside in the energy (e.g. **WorleyParsons),** materials (e.g. **Rio Tinto)** and industrial sectors (e.g. **Transurban)**.

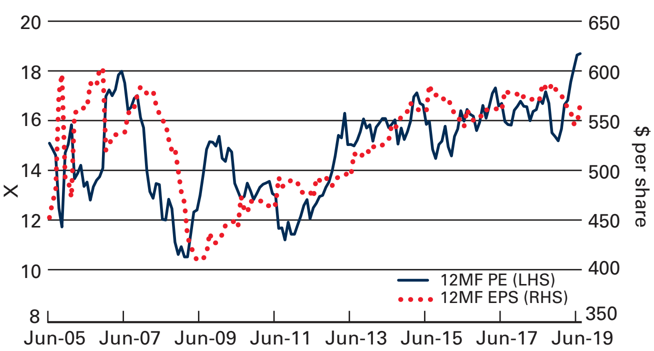
Not surprisingly, most sectors face downside in the current environment, although we flag that price targets will likely be refreshed as companies report their results in August.

Figure 3: S&P/ASX 200 12-month forward PE



Source: OML Research, Bloomberg. As at 31 July 2019.

Figure 4: S&P/ASX 200 12-month forward PE ex resources



Source: OML Research, Bloomberg. As at 31 July 2019.

TRANSURBAN

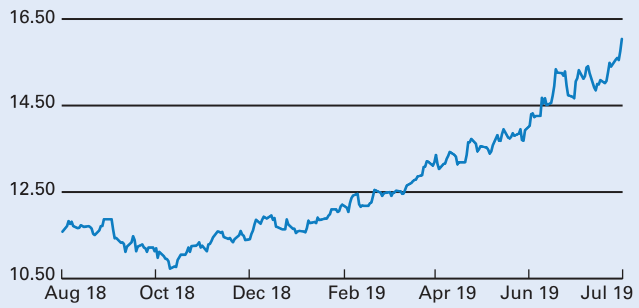
ROAD TRIP

Sector: Transportation Recomm: Buy Risk rating: Medium Share price: $16.04

Year to June	2018A	2019E	2020E
Profit after tax ($m)	529.0	191.5	169.7
Earnings per share (¢)	24.7	7.2	6.4
Price/earnings (x)	nm	nm	nm
Dividends per share (¢)	56.0	59.0	62.0
Dividend yield (%)	3.5	3.7	3.9
Franking (%)	10	10	10

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

Transportation (TCL) share price



Source: IRESS

Transurban is an Australia-listed company that builds, owns and operates toll roads in Melbourne, Sydney and Brisbane, as well as in the greater Washington DC area in the US and Montreal in Canada.

It has the largest portfolio of toll roads in Australia. Its relatively predictable traffic growth has historically outpaced growth in gross state product (GSP), i.e. economic growth in the states where its assets are located.

Ord Minnett recently reinstated coverage of Transurban with a Buy recommendation and a target price of $16.75. We see Transurban as undervalued, and our analysis suggests it has the earnings growth and balance sheet capacity to deliver ongoing distribution growth at 6–7% per annum.

Our analysis of Transurban's traffic data shows it has grown well above GSP growth across Sydney, Melbourne and Brisbane, which together represent 85% of Transurban's business.

On a normalised basis, removing the effects of road widenings, extensions, etc, we estimate it has averaged 1.3 times GSP growth.

Against this backdrop, we forecast Transurban's traffic growth will average about 3% per annum. A key reason we see this as achievable is that 90% of the group's assets have unconstrained flow due to surplus capacity.

Over the fiscal 2019–25 horizon, we forecast free cash flow will grow by 8% per annum and Transurban's distribution will increase by 6–7% per annum.

A key factor underpinning distribution growth is capital releases as Transurban rebalances leverage levels subject to key milestones.

These milestones are typically based on cash flow generation and/or refinancing events. Our forecasts include circa $100 million of capital releases funded in the second half of fiscal 2019, and a further $1 billion over fiscal 2020-23.

We also forecast tax expense to normalise from fiscal 2023, which will create a drag on earnings.

Our forecasts show Transurban's serviceability declining with the funds from operations to debt ratio falling from about 7% in fiscal 2019 to 6.5% over the next two years.

That said, relatively strong growth in earnings should see serviceability ratios quickly restored and its investment-grade credit rating maintained.

Transurban's Australian network is a strategic collection of assets, as opposed to stand-alone motorways. In our view, this positions Transurban to undertake road widenings, extend concession lengths or fund developments through price adjustments, cross-subsidisation and/or early renegotiation. It also allows Transurban to pursue transactions in state government unsolicited processes in typically less competitive situations.

Transurban's investment proposition also stacks up versus our broader coverage of real assets such as Sydney Airport (SYD), with toll roads having less regulatory risk than airports and less cyclicality than real estate.

NATIONAL AUSTRALIA BANK

NEW BROOM

Sector: Financial Services Recomm:Accumulate Risk rating: Medium Share price: $28.51

Year to September	2018A	2019E	2020E
Profit after tax ($m)	5,702.0	5,993.0	6,788.8
Earnings per share (¢)	202.4	204.1	224.3
Price/earnings (x)	14.1	14.0	12.7
Dividends per share (¢)	198.0	166.0	166.0
Dividend yield (%)	6.9	5.8	5.8
Franking (%)	100	100	100

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

National Australia Bank (NAB) share price

Source: IRESS

National Australia Bank has named Ross McEwan as its new CEO, filling the vacancy left by the exit of Andrew Thorburn's exit in the wake of the Hayne Royal Commission report.

McEwan is currently the outgoing CEO of Royal Bank of Scotland Group (RBS) in the UK. Prior to joining RBS, he was Commonwealth Bank's (CBA) head of retail banking services arm.

We had viewed McEwan as the preferred of two main likely external candidates for the role, and his appointment should give the market additional confidence in NAB's medium- and long-term outlook.

An external appointment also allows a fresh look at what needs to be done to improve NAB's culture.

McEwan has a wealth of directly relevant banking experience. He has been CEO of RBS in the UK since 2013, having joined the group as head of its UK retail business in 2012.

Prior to that, he was CBA's group executive responsible for retail banking services for five years.

Before leading its retail arm, McEwan was in charge of CBA's branch network, contact centres and third-party mortgage brokers.

He has also had experience with ASB Bank and other entities in the New Zealand banking and financial services market.

McEwan will commence as CEO once his obligations to RBS have been discharged, no later than April 2020 or one year following his resignation from RBS.

Interim CEO Phil Chronican – who also took the top board role when predecessor Ken Henry left following the Hayne report – will transition from interim CEO to chairman in November. The board will then put in place other interim management arrangements suitable to the Australian Prudential Regulation Authority (APRA) if required.

McEwan pledged to *"protect and accelerate"* the transformation program as the bank rebuilds its reputation. He also flagged areas where NAB could extend its lead, such as in business banking, agriculture and health.

We note McEwan led RBS through a period of complex change and has dealt with many of the issues currently facing the Australian banks, including an increasingly tough revenue environment.

McEwan will be paid a fixed remuneration of $2.5 million per annum. He also has the potential to earn between 0% and 150% of fixed remuneration in an annual variable reward, paid half in cash and half in performance rights and vesting evenly over four years.

The new CEO is also entitled to an annual grant of up to 130% of fixed remuneration, paid in performance rights, with vesting subject to performance testing at the end of a four-year period. This will be measured against customer scores and financial metrics based on relative total shareholder return.

NAB remains our preferred bank among the big four. We see potential upside to the current share price given NAB's attractive valuation and the likelihood of greater revenue resilience than peers against a challenging banking backdrop.

SYDNEY AIRPORT

LEVEL FLIGHT

Sector: **Transportation** **Recomm:** **Hold** **Risk rating:** **Medium** **Share price:** **$8.68**

Year to December	2018A	2019E	2020E
Profit after tax ($m)	372.5	386.8	421.7
Earnings per share (¢)	16.5	17.1	18.7
Price/earnings (x)	52.6	50.8	46.4
Dividends per share (¢)	37.5	39.0	40.5
Dividend yield (%)	4.3	4.5	4.7
Franking (%)	0	0	0

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

Sydney Airport (SYD) share price

Source: IRESS

Sydney Airport is a key infrastructure asset generating good margins, with a positive outlook for all four divisions – aeronautical, retail, property and parking.

Ord Minnett recently resumed coverage of Sydney Airport with a Hold recommendation and a target price of $7.90.

We expect the group to deliver strong and growing cash flows into the future with good investment opportunities to enhance returns. It is trading on elevated multiples, but its relative pricing looks attractive versus other Australian defensive assets, global infrastructure and Australian industrials stocks.

Passenger numbers obviously play a key role in the generation of revenue at Kingsford Smith Airport and within this, the international passenger cohort is key.

A large proportion of aeronautical revenue is directly linked to passenger numbers, as are retail sales, particularly in the international terminal. International passengers are estimated to account for circa 70% of passenger-driven revenues and they generate five times more revenue than their domestic peers.

This makes international passenger growth far more important for driving revenue than domestic passengers.

International passenger growth was very strong in 2016 and 2017, boosted by Asian passengers. These growth rates normalised in 2018 and have slowed further in the first half of 2019 to the lowest levels in four years, i.e. 3.1% in the year to June.

We see some improvement in the second half and 4–5% annual growth out to 2023 driven by Asian demand.

Sydney Airport's aeronautical business is well-positioned as it is the only international airport in Australia's largest city. We expect the upcoming International Airline Agreement to deliver 2.5% per annum growth in charges per passenger, lower than the existing 3.8% contract, but this should be offset by lower required capital expenditure.

Sydney Airport owns the most productive retail space in the country, with international terminal sales productivity estimated at $40,000 per square metre.

Its property business is fully let, delivering solid annual increases with opportunities to improve rents. Hotel rooms are being added and its car-parking business delivers good margins, albeit the growth outlook is modest.

Sydney Airport's credit metrics have improved each year since 2015 and should continue this trend in the short term.

In addition to slowing international passenger growth, challenges for Sydney Airport include becoming a tax-paying entity in fiscal 2021–22, which we estimate will restrict its dividend compound annual growth rate to 4% versus 7% previously.

The opening of Western Sydney Airport will also likely restrict passenger growth around its expected opening in 2026.

Catalysts for Sydney Airport include a potential rebound in international passenger growth and the possibility of spreading aircraft movement caps over a longer time period at the curfew-constrained airport.

RIO TINTO

SPECIAL SURPRISE

Sector: Metals & Mining Recomm: Hold Risk rating: Higher Share price: $94.77

Year to December	2018A	2019E	2020E
Profit after tax ($m)	11,781.7	16,870.5	16,527.4
Earnings per share (¢)	710.3	1,039.5	1,018.5
Price/earnings (x)	13.3	9.1	9.3
Dividends per share (¢)	735.7	817.5	707.8
Dividend yield (%)	7.8	8.6	7.5
Franking (%)	100	100	100

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

Rio Tinto (RIO) share price

Source: IRESS

Rio Tinto recently reported its first-half calendar 2019 result, with a surprise special dividend but also another write-down on its Oyu Tolgoi copper-gold project in Mongolia.

The interim result was clean, matching consenus across the key P&L and balance sheet items. Underlying operating earnings of US$10.3 billion, net profit of US$4.93 billion and net debt of US$4.9 billion were all within 3% of our estimates and consensus.

The key surprise was the special dividend of US$0.61 per share, topping up the US$1.51 per share interim dividend for a total payout of US$2.12 per share.

We viewed this as a positive surprise, but we note it is, in effect, a pull-forward of returns we were expecting with the full-year calendar 2019 result.

A total cash return of US$3.5 billion, including the US$1 billion special dividend, beat our estimate and took the total payout ratio to 70%.

Rio Tinto impaired the carrying value of Oyu Tolgoi by US$800 million to US$5.9 billion (34% share).

The Oyu Tolgoi development has been hampered by stability risks, leading Rio Tinto to redesign the underground mine. This could affect the outcome of the grade profile and unit costs.

There was no further update on the ramp-up or production schedules, and studies won't be finished until the second half of calendar 2020, but the company noted the following in its June-quarter production report:

- A capital expenditure blowout of US$1.2–1.9 billion, taking the budget from the original US$5.3 billion to US$6.5–7.2 billion; and
- A delay in first production of 16–30 months versus 2016 guidance, to between May 2022 and June 2023 depending on final design (a nine-month delay has already been announced).

In iron ore, the company acknowledged operational performance was not up to scratch.

This was primarily due to delays in waste stripping, with the issues appearing to be poor fleet performance and with labour market tightness.

Measures are being taken to increase waste stripping in calendar 2020–21. Production will increase in the second half, although management wouldn't be drawn into providing an estimate of 2020 volumes.

Overall, we don't expect the result to influence investors' view on the stock, or lead to material changes to consensus earnings.

Rio Tinto's share price has weakened following a change in market sentiment due to Vale restarts, and modestly higher iron ore and steel inventory in China.

Given the strength in steel production in China – up 9% year-on-year in June – we believe iron ore markets are likely to remain buoyant in the near term. On this basis, we would look to review our recommendation if Rio Tinto's share price continues to fall.

VIVA LEISURE

NO SWEAT

Sector: Consumer Services Recomm: Buy Risk: Higher Price: $1.13

Ord Minnett recently initiated coverage of Viva Leisure – the pre-eminent regional health club operator in Australia – with a Buy recommendation and $1.50 target price.

Viva's attractions include a well-capitalised balance sheet, a differentiated business model and capable management.

Viva commenced operations in Canberra in 2004, with the aim of facilitating the fitness goals of customers through the Club Lime brand. Over the past 15 years, the company has expanded within the ACT, and regional NSW and Victoria.

Viva had circa 54,000 members at the end of fiscal 2019 and, through new clubs roll-outs and acquisitions, expects to have close to 65,000 members and $47 million of revenue in fiscal 2020. We do not expect Viva to pay dividends until fiscal 2021.

Performance is running ahead of prospectus expectations for member numbers and club openings, which bodes well for fiscal 2020.

Unlike its larger rivals, which use a 'one size fits all' approach, Viva tailors its new clubs to each region's demographics, driving rapid breakeven and strong long-term club economics.

Technology provides further efficiency gains, with the 24/7 access model active at all but its largest club. These should combine to drive operating earnings margins of 24% in fiscal 2020 and strong operating leverage.

The fitness market remains highly fragmented – IBISWorld suggests more than 40% of clubs operate outside the large groups – which provides significant scope for consolidation.

Management continues to under-promise and over-deliver, which is important for a recently listed small-capitalisation stock.

As the market comes to appreciate the quality of Viva's management and the strong operating metrics of well-run health clubs, we expect the stock's valuation multiples rerate higher.

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

Ord Minnett Head Office

Sydney
Level 8, 255 George Street
Sydney NSW 2000
Tel: (02) 8216 6300
ords.com.au

National Offices

Adelaide
Level 5, 100 Pirie Street
Adelaide SA 5000
Tel: (08) 8203 2500

Brisbane
Level 31, 10 Eagle Street
Brisbane QLD 4000
Tel: (07) 3214 5555

Buderim, Sunshine Coast
1/99 Burnett Street
Buderim QLD 4556
Tel: (07) 5430 4444

Canberra
101 Northbourne Avenue
Canberra ACT 2600
Tel: (02) 6206 1700

Gold Coast
Level 7, 50 Appel Street
Surfers Paradise QLD 4217
Tel: (07) 5557 3333

Mackay
45 Gordon Street
Mackay QLD 4740
Tel: (07) 4969 4888

Melbourne
Level 7, 161 Collins Street
Melbourne VIC 3000
Tel: (03) 9608 4111

Newcastle
426 King Street
Newcastle NSW 2300
Tel: (02) 4910 2400

International Office

Hong Kong
1801 Ruttonjee House
11 Duddell Street
Central, Hong Kong
Tel: +852 2912 8980
ords.com.hk