ORD MINNETT
PRIVATE WEALTH

April 2018

ORDS MONTHLY

A WINDOW OPENS

OPPORTUNITY KNOCKS

Ord Minnett analyses the stark divergence between prices and earnings so far in 2018 in this edition of the Ords Monthly. We conclude that a window of opportunity has opened, with valuation multiples for most markets and industry sectors now at or near the bottom of their trading ranges over the past 12 months.

That deep compression of price-earnings multiples from a recent peak in January means markets are looking cheap – the S&P 500 is trading on a ratio below its 30-year median, while the Australian market has not been this cheap since 2015.

We explain in our Investment Strategy note, starting on page 2, how a supportive global economic backdrop, combined with ongoing earnings momentum – in particular, a strong US first-quarter 2018 earnings season – keeps us positive on equities.

The most recent beneficiary of this view is energy, where Ord Minnett has upgraded its stance on the sector to Overweight, given it has fallen 5.2% in price terms in 2018 even though earnings forecasts have risen by 24% – the largest sectoral earnings revisions in the Australian market over the past 12 months.

Our preferred exposure in the sector is **WorleyParsons**, a leading global contractor to the oil and gas industry, which is enjoying a growing backlog of work as resource-sector capital expenditure starts to normalise.

Energy – pricing and supply security in particular – is still running strong in the daily news cycle, and we run our ruler over **AGL Energy**, one of Australia's largest utilities. In the short term, AGL faces some margin challenges as new renewable energy supply comes on line, but we see value in the medium term. See page 4 for more details.

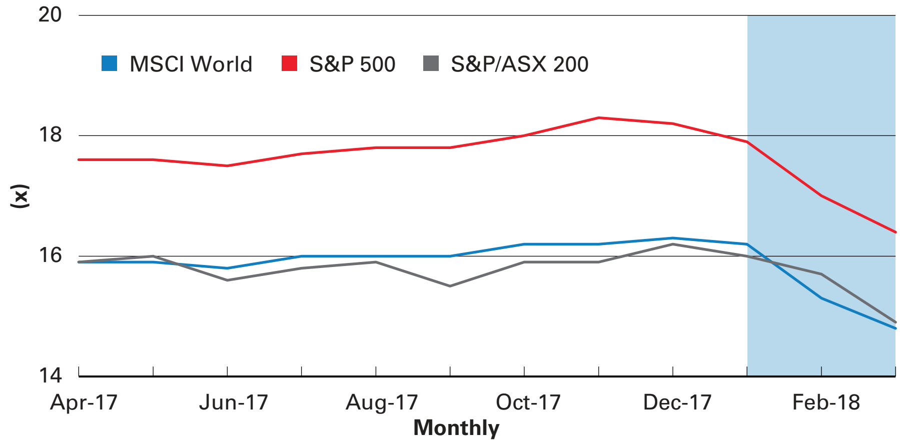
Fortescue Metals has lagged its rivals this year for a variety of reasons but the 25% share price slide since the middle of February has put Australia's third force in iron ore squarely in value territory. We outline our investment thesis on page 5.

Aged care is becoming an even larger part of the market as Australia's population ages. The sector has been through a difficult few years, both in terms of reputation and government funding, but we now see value after a long period of underperformance. **Regis Healthcare** is our key pick. See pages 6–7 for more details.

Finally, we take a look at **Smartgroup**, a provider of salary packaging and novated leases. The company's business model and strong balance sheet add up to an attractive package. See page 8 for our view.

"A supportive global economic backdrop, combined with ongoing earnings momentum, in particular – a strong US first-quarter 2018 earnings season – keeps us positive on equities. "

Figure 1: Market P/E multiple moves over past 12 months



Source: Ord Minett research, Bloomberg, Prospective basis: 12 month forward.

INVESTMENT STRATEGY

VALUE PROPOSITION

Equity markets around the globe have had a tough start to 2018, with almost all major markets booking losses in the year to date.

In stark contrast to stock market performance, however, the earnings revisions cycle remains resolutely positive. Indeed, the ascent in EPS projections that was such a powerful force in equity markets last year has continued into 2018, and the potent cocktail of falling stock prices and earnings upgrades has pushed key valuation multiples lower.

As a result, the majority of markets and sectors are trading towards the bottom end of their one-year price-earnings ranges (see Figure 1), which underpins our continued positive view on equities on a global and local basis. We discuss our investment thesis in more detail below:

Falling markets...

A triple shot of negative factors has conspired to roil equity markets in 2018:

- Rising bond yields in the US, driven by a quickening pace of US inflation as data shows solid economic growth momentum;
- Trade tensions, both actual and rhetorical, mainly between the US and China but with global implications; and
- A sharp widening of the spread between two key interest rates used in global markets, the London interbank offered rate (LIBOR) and the overnight indexed swap (OIS) rate, in the past two months. The differential between the two rates is viewed as a key indicator of credit risk within the banking sector, and the spike in this measure has raised fears of a looming funding crunch that would inflict financial stress in more indebted sections of the market.

The worst-performed market over 2018 so far is the UK FTSE 100 Index, which has sunk 6.4%. The S&P 500 Index has lost 2.3%, the MSCI World Index in US dollar terms has slipped 2% and Australia's S&P/ASX 200 Index has dropped 4.2%. Hong Kong's Hang Seng Index, up 1% at time of writing, is the only major index to record a gain for the year so far.

Figure 1: Global markets P/E – current vs 1Y range

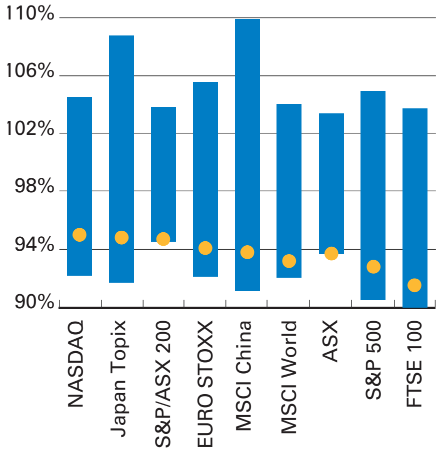
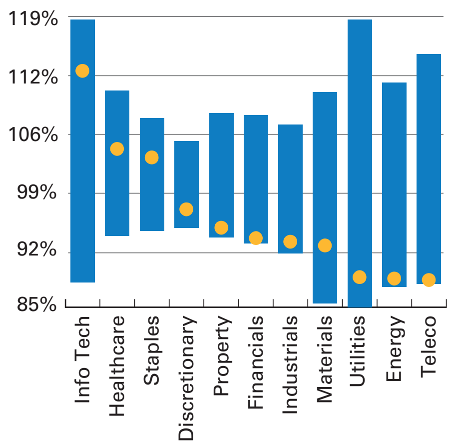


Figure 2: S&P/ASX 200 sectors – current vs 1Y range



Source: Ord Minnett research, Bloomberg.

...and rising earnings...

The uncertainty and nervousness permeating markets in 2018 has had little impact on the trajectory of earnings expectations.

In the year to date, EPS projections for the MSCI World Index have moved 8.1% higher. Expectations for S&P 500 EPS have climbed 10% so far, with US corporate tax cuts providing a significant boost.

Australia is lagging its larger counterparts, but local forecasts for the S&P/ASX 200 Index are still up 3.1% in 2018.

...polish valuations

Earnings upgrades coupled with falling markets have led to deep multiple compression across the globe. After hitting the 'red line' in January, P/E ratios have since retraced markedly, putting a fresh shine on valuation metrics.

The MSCI World multiple is down 1.5 points from January to 14.8 times. Meanwhile, the S&P 500 P/E ratio is also down 1.5 points to 16.4 times, below its 30-year median level, making that market cheap in absolute terms – and even more attractive given low global interest rates.

Locally, the S&P/ASX 200 P/E measure has shrunk 1.1 points from January to circa 14.9 times – the last time this multiple fell below 15 times was in 2015 when China surprised markets with three straight currency devaluations.

Our global economists are confident that economic growth will hold above trend for the remainder of this year and into 2019.

This supportive backdrop, combined with continued earnings momentum, keeps us positive on global equities. In particular, our global research partner expects a strong US first-quarter 2018 earnings season, with results above market consensus.

Locally, our year-end target for the S&P/ASX 200 Index of 6300 implies potential price upside of circa 7%.

On a sectoral basis, the key beneficiary is energy, where we have upgraded our stance to Overweight, given it has fallen 5.2% in price terms even as earnings forecasts have been raised by 25% over the past 12 months.

Key to this is the resilience of the oil price, with US crude up nearly 5% in 2018 even as global equity markets went the other way.

Our preferred exposure to the sector is WorleyParsons, on which we have a Buy recommendation.

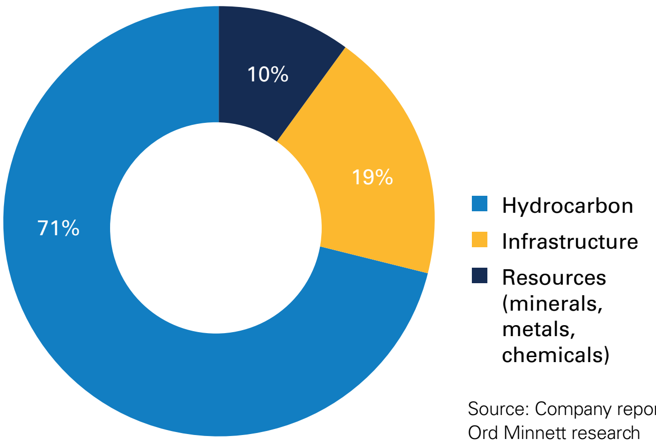
WorleyParsons is a leading provider of professional services to the energy and resources sectors around the globe. Its key operations are in oil and gas, as shown in Figure 3 below.

Our positive view on the company is primarily driven by an improving global business capital expenditure cycle, which we believe will lead to consensus upgrades. Resources company capital expenditure is still below its historical average, but has started to rise.

WorleyParsons noted at its recent result that market conditions have improved, driving an increase in its backlog of work (see Figure 4), with many of its customers indicating a return to capital and operational expenditure growth.

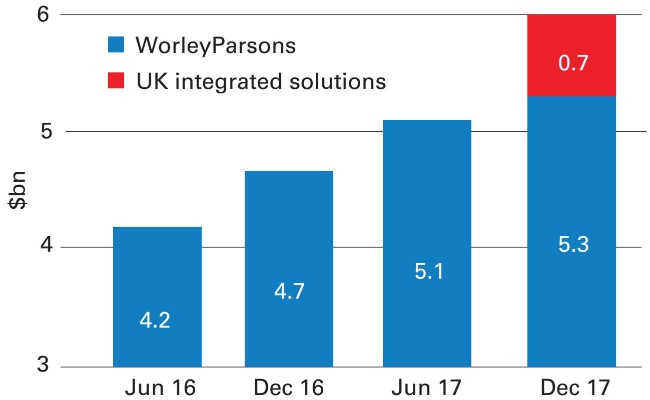
We forecast EPS growth of 28%, 29% and 13% in fiscal 2018, 2019 and 2020, respectively, and believe the market will need to upgrade its earnings forecasts, which should act as a positive catalyst for the stock. Our target price of $16.90 implies potential upside of more than 20% from current share price levels.

Figure 3: WorleyParsons FY17 revenue by segment



Source: Company reports, Ord Minnett research

Figure 4: WorleyParsons pipeline of work



Source: Company reports. UK integrated solutions is AFW acquisition

AGL ENERGY

POWER PLAY

Sector: **Energy** **Recomm:** **Accumulate** **Risk rating:** **Low** **Share price:** **$20.63**

Year to June	2017A	2018E	2019E
Profit after tax ($m)	802	1,007	1,124
Earnings per share ($)	1.20	1.54	1.71
Price/earnings (x)	17.2	13.4	12.1
Dividend ($)	0.91	1.13	1.28
Dividend yield (%)	4.4	5.5	6.2
Franking (%)	80	80	80

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

AGL Energy (AGL) share price

Source: IRESS

AGL Energy is one of Australia's largest vertically integrated utility businesses and is, in fact, Australia's largest private owner, operator and developer of renewable generation assets.

Falling electricity forward prices have worn heavily on the stock recently, with AGL down 13.3% in the year to date versus a 4.2% fall in the S&P/ ASX 200 Index.

In the short term, Ord Minnett expect AGL's margins and free cash flow generation to decline, driven by lower wholesale electricity costs as new renewable capacity comes online.

On a medium-term view, however, we believe the stock looks attractive, with key valuation metrics at historical lows.

We do see some risks around market earnings estimates – particularly if wholesale prices continue to deteriorate – but we note the AGL price is already factoring in 20% downgrades.

AGL is trading on a multiple of 12.4 times fiscal 2019 forecast EPS and 11.7 times fiscal 2020 EPS estimates, based on Bloomberg consensus forecasts.

These multiples are at the bottom of the company's historical trading range and 10% below the S&P/ASX 200 Index. Historically, AGL has traded at a 5% premium to the index.

If we assume AGL's historical average price-earnings multiple of 15.4 times, then the current stock price is implying 20–25% downgrades to fiscal 2019 earnings estimates.

The share price is also at a 14% discount to our revised discounted cash flow (DCF) valuation of $24.50 per share.

The key variable in our valuation is our long-run wholesale electricity price estimate of $75 per megawatt hour (MWh), noting that a $5/MWh change in the wholesale price impacts our DCF valuation by circa 10%.

The biggest risk to our positive view on AGL is the potential for negative catalysts that could drive downgrades to market earnings forecasts.

These are likely to be the retail standing offers for fiscal 2019 being made in NSW, South Australia and Queensland in July 2018, or in 2019 profit guidance at AGL's 2018 result in August.

Retail standing offers in the electricity market are a base price plan offered to customers, somewhat analogous to the standard variable home loan rate of the mortgage market.

Last July, retailers in the above states made increases of 15–20% in the fiscal 2018 standing offer. The decline in wholesale electricity prices since then, however, means standing offers for fiscal 2019 will likely come down.

More important, however, is fiscal 2019 guidance at the full-year result in August, given the current consensus estimate is for 15% net profit growth next year.

FORTESCUE METALS GROUP

MAGNETIC MARGIN

Sector: Metals & Mining Recomm: Accumulate Risk rating: Higher Share price: $4.54

Year to December	2017A	2018E	2019E
Profit after tax ($m)	2,773	1,433	1,179
Earnings per share ($)	0.89	0.46	0.38
Price/earnings (x)	5.1	9.9	12.0
Dividend ($)	0.45	0.23	0.20
Dividend yield (%)	9.9	5.0	4.4
Franking (%)	100	100	100

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

Fortescue Metals (FMG) share price

Source: IRESS

Fortescue Metals Group is an iron ore miner operating in the Pilbara region of Western Australia, and is the country's third-largest producer behind Rio Tinto and BHP Billiton.

Ord Minnett recently raised its recommendation on Fortescue to Accumulate from Hold, following share price weakness that places the stock well in value territory.

This lower entry point enhances our investment view, with Fortescue offering exposure to long-life operations that should generate attractive margins over the foreseeable future.

Fortescue stock slid more than 25% from mid February to early April, versus a fall of just 1.7% in the benchmark S&P/ASX 200 Index, and more than double the losses of 10.5% for Rio Tinto and 8.7% for BHP.

An important difference between Fortescue and its larger rivals is the grade of the ore mined, with Rio Tinto and BHP's output being mainly higher-grade benchmark 62% Fe (iron) product while Fortescue's production is generally lower-grade 58% Fe ore.

Now the 62% Fe iron ore price – which Fortescue is most correlated to despite its ore being the lower 58% Fe grade – has fallen about 20% in a month, iron ore is back at fair value levels with an overhang removed.

The price fall has also provided a disincentive for marginal supply to restart.

We cut our 58% Fe price forecasts by 5% to US$43 a tonne in calendar 2018 and 8% to US$45 a tonne in calendar 2019, reflecting a discount to the 62% Fe index of 35% and 31%, respectively.

Low-grade iron ore discounts have remained higher than average for more than a year now, and even since the end of winter heating season in China – where steel production ramps up and steel spreads narrow – discounts have not closed.

Ord Minnett is of the view that part of the 58/62% Fe spread is cyclical – our long-term discount remains 20%, or a US$40 per tonne price versus 62% Fe at US$50 per tonne – but we acknowledge there will be some who see this issue as wholly structural.

Despite concerns about persistently high discounts for low-grade iron ore, the absolute price of US$40 a tonne still provides an operating earnings margin of nearly 40%.

We estimate all-in sustaining costs for Fortescue of US$30 a tonne, which at a spot price for 58% Fe ore of around US$40 a tonne provides a US$10 a tonne margin, or cash flow of US$1.7 billion based on 170 million tonnes of shipments annually.

Fortescue now screens as one of the cheapest stocks in our coverage, with a price to net present value measure of 0.86 times and a one-year forward enterprise value to operating earnings multiple of 4.5 times.

Fortescue also sports a free cash flow yield of 9% and a dividend yield of circa 5%, adding to the value on offer.

There is no visible catalyst to see Fortescue re-rate over the short term, but we believe the market will eventually become more comfortable with wider low-grade ore spreads, and will start to focus more on the attractive financial and valuation metrics displayed by Fortescue.

AGED CARE SECTOR

GREY POWER

Regis Healthcare - Recomm: Accumulate Risk rating: Higher Share price: $3.71

Year to June	2017A	2018E	2019E
Profit after tax ($m)	61	58	58
Earnings per share ($)	0.20	0.19	0.19
Price/earnings (x)	18.2	19.3	19.3
Dividend ($)	0.20	0.18	0.19
Dividend yield (%)	5.5	4.9	5.2
Franking (%)	100	100	100

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

Regis Healthcare (REG) Share price

Source: IRESS

Estia Health - Recomm: Hold Risk rating: Higher Share price: $3.37

Year to June	2017A	2018E	2019E
Profit after tax ($m)	40	44	45
Earnings per share ($)	0.18	0.17	0.17
Price/earnings (x)	19.0	19.8	19.8
Dividend ($)	0.08	0.16	0.17
Dividend yield (%)	2.4	4.8	5.1
Franking (%)	100	100	100

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

Estia Health (EHE) share price

Source: IRESS

Japara Healthcare - Recomm: Lighten Risk rating: Higher Share price: $2.00

Year to June	2017A	2018E	2019E
Profit after tax ($m)	25	20	21
Earnings per share ($)	0.09	0.08	0.08
Price/earnings (x)	21.2	26.3	24.9
Dividend ($)	0.11	0.08	0.08
Dividend yield (%)	5.7	4.1	4.1
Franking (%)	90	80	100

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

Japara Healthcare (JHC) Share price

Source: IRESS

Ord Minnett recently initiated coverage of the aged-care sector. Value has emerged in the listed residential care providers after a long period of underperformance following funding reforms first unveiled by the federal government in 2015.

The aged-care industry has been through a difficult few years as it has endured multiple funding cuts. The pressure on earnings will continue as the past reforms roll through, but we believe the level of funding has bottomed with the May federal budget likely to include supportive measures.

Given this near-term positive, along with attractive demand dynamics, the industry outlook is improving. We believe there are now opportunities for investors to gain exposure to a sector with demographic tailwinds at a reasonable price.

An estimated 75,000 more places are forecast to be required to meet demand for residential aged-care services by 2026, representing an increase of circa 3% per annum from current levels. We believe the listed providers are well positioned to supply a disproportionate share of the needed supply, thus supporting above-industry earnings growth.

The ongoing headwind from the Aged Care Funding Instrument reforms will limit earnings growth from existing facilities in the absence of any federal budget support.

We see, therefore, a strong development pipeline as crucial to delivering meaningful earnings growth. New developments will be the key source of expansion in the number of aged-care places over 2018–20.

The important opportunity here is that development can be funded by refundable accommodation deposits (RADs), or bonds, from residents.

Cash inflow from these accommodation bonds may be used as a source of capital to fund greenfield and brownfield construction projects. The funding from RADs is interest-free and, to date, incoming residents have paid higher RADs than those refunded, generating an additional cash flow for the provider that is tax-free.

Growth will also come from acquisitions, with the highly fragmented aged-care industry providing opportunities for consolidation. Based on data from June 2016, of the 949 providers, 65% were operating only one facility while only 8% operated seven or more.

By stock, we have initiated coverage of Regis Healthcare with a Buy recommendation, Estia Health with a Hold and Japara Healthcare with a Lighten. These are discussed below.

- **Regis Healthcare** is one of the largest aged-care providers. It has circa 6,500 places across 58 facilities located in Victoria, Queensland, Western Australia, NSW and South Australia, and also operates 550 independent living units across five retirement villages which are co-located with its aged-care facilities.

  Regis, in our view, has the highest-quality portfolio and business among the listed providers with valuation attractive at the current price. The company's robust development pipeline, track record of project execution and facilities located in higher socio-economic areas support our expectations of superior earnings growth versus the other listed providers, and these factors underpin our Buy recommendation.

- **Estia Health** is the fourth-largest residential aged care operator in Australia in terms of number of places (just over 6,000), and operates facilities located throughout Victoria, South Australia, NSW and Queensland.

  Estia owns and operates high-quality aged-care facilities primarily in above-average socio-economic catchment areas with the potential to generate demand from residents. The quality of Estia's portfolio and the efficiency of its business model are demonstrated in strong operational metrics, such as occupancy levels above industry average and earnings per resident well above other for-profit providers.

  Following a turbulent period that saw an overhaul of management and a capital raising, Estia is getting its house in order. We are confident the company now has an effective management team with the right strategy in place, but the modest development pipeline limits its potential for growth in earnings and free cash flow compared with its peers. Estia represents fair value at the current price, hence our Hold rating.

- **Japara Healthcare**, founded in 2005 and listed in 2014, runs 44 facilities located in Victoria, NSW, Queensland, South Australia and Tasmania. Japara also operates 180 independent living units across five retirement villages located adjacent to its aged-care facilities.

  Differentiating its service offering by providing a superior level of care is one of Japara's key strategies. A high-care-focused operating model has been put in place in order to facilitate 'ageing-in-place' by supporting residents with complex care needs and providing specialised services for residents with dementia.

  We consider Japara the most challenged operator by funding reforms and rising debt is a concern. A 12% drop in underlying operating earnings in the first half of fiscal 2018 reflects its higher-cost model, while gearing is set to rise to more than 3.5 times operating earnings in fiscal 2019 as it funds developments.

  At a time when funding reforms are placing pressure on the revenue line, Japara's high-care model – and its higher costs per operating place per day compared with its listed peers – leave the company more vulnerable to earnings deterioration given fixed-cost leverage.

  Japara's current share price does not adequately compensate for the risk in its model, in our view, hence we have initiated with a Lighten recommendation.

SMARTGROUP

THE SMART MONEY

Sector: Support Services Recomm: Buy Risk: Medium Price: $10.84

Smartgroup (SIQ) is a leading salary package and novated leasing provider, with an attractive business model and a strong balance sheet that leaves it well-equipped to take advantage of acquisition opportunities.

Ord Minnett recently raised its recommendation on Smartgroup to Buy from Accumulate, and its target price to $11.55 from $11.40, following a recent pullback in the share price.

The company's business model is attractive as it is largely a 'clip the ticket' structure, taking no residual vehicle risk and resulting in strong cash conversion, typically around 100% of adjusted net profit.

Smartgroup's recent $78.4 million capital raising was a surprise given we were already comfortable with its calendar 2018E gearing metrics. It does mean, however, the company is very well capitalised for any acquisition opportunities that may emerge, particularly in the private sector.

Announced acquisitions from 2017 are poised to deliver an additional $15 million of operating earnings in calendar 2018 based on our estimates, in addition to $6.5 million of organic earnings growth.

On the organic growth side, our channel checks indicate that retail demand for novated leases remains reasonable, especially in the government and not-for-profit sectors. We forecast organic growth in novated leases for calendar 2018 of circa 2,900, up 5.1% year-on-year (YoY).

On the salary packaging side, we forecast growth in salary packages of 9,400 over calendar 2018, a rise of about 2.9% YoY.

The outlook for Smartgroup appears bright, with a combination of organic and acquired growth likely to keep earnings growth in double-digits over the medium term.

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

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