ORD MINNETT
PRIVATE WEALTH

December 2018/January 2019

ORDS MONTHLY

NO GIVING QUARTER
PROFIT FROM YIELD

The Australian equity market unfortunately is on track to snap a decade-long streak of positive finishes to the year, with the S&P/ASX 200 Index down 8.7% so far in the last quarter of calendar 2018.

Absent a Lazarus-like recovery in the remaining trading days of the year, this will be the first December quarter since 2008 – when the market was in the depths of the GFC – that the benchmark index has notched a loss.

Looking on the bright side, the index's retreat has pushed the Australian equity market's forward dividend yield back above 5%, a level that has historically provided support to the benchmark index as investors switch from low-interest-earning cash into assets offering higher returns. In this final edition of the *Ords Monthly* for 2018, our Investment Strategy article starting on page 2 yields some ideas for income-seeking investors.

In our corporate coverage, we review the fiscal 2018 results from the three big banks that balance their books in September – **ANZ Bank**, **National Australia Bank** and **Westpac** – and a trading update for the first quarter of fiscal 2019 from **Commonwealth Bank**.

The bank earnings season contained some common themes. Net interest margins remain tight, squeezed by rising funding costs and competition in the mortgage market, with the pressure most acute in the retail banking businesses.

Asset quality across the sector is high, with bad debt charges near cyclical lows, while all of the big four remain strongly capitalised despite absorbing remediation charges in the wake of the Royal Commission. See pages 4–5 for our wrap of the results.

Coles Group has returned to the ASX boards as a separate company after Wesfarmers spun off 85% of the nation's second-largest retailer to its shareholders. We have initiated coverage with a Hold recommendation and lay out our investment thesis on page 6.

Mineral Resources has crystallised the value of its Wodgina lithium project in spectacular style, selling 50% of the project to US chemicals group Albermarle for US$1.15 billion.

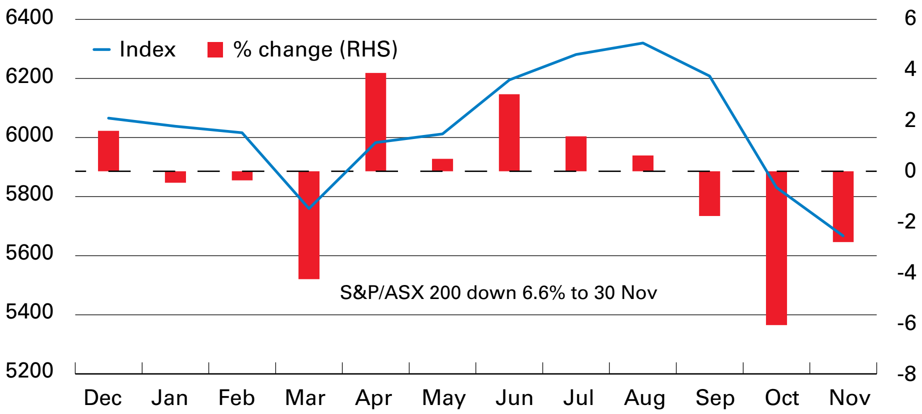
The deal is a good one in our view, and the joint venture structure not only offers the Australian company exposure to value creation from downstream developments, but firmly establishes Wodgina as a world-class tier-1 strategic asset. See page 7 for more.

Macquarie Group turned in a robust profit result for the first half of fiscal 2019, and followed up shortly afterwards with an upgrade to full-year earnings guidance as the sale of Quadrant Energy passed muster with the regulators.

We see valuation multiples for Macquarie as undemanding for such a high-quality financial services company and the asset exposures it offers, and explain why on page 8.

The *Ords Monthly* will return in 2019. In the meantime, we wish all of our readers the compliments of the season and a happy – and profitable – new year.

Figure 1: S&P/ASX 200 Index – 31 Dec 2017 to 30 Nov 2018



Source: Bloomberg, Ord Minnett Research.

INVESTMENT STRATEGY

INCOME EARNERS

A powerful cocktail of trade tensions, geopolitical uncertainty and an unsettled domestic political environment has dragged the S&P/ ASX 200 Index down almost 7% for the year at time of writing.

With capital appreciation lacking, where does an investor go from here? Well, one positive consequence of the pullback in the Australian equity market is that its forward dividend yield has once again lifted above 5%.

This level has, historically, provided support to the index as investors see an opportunity to switch their funds from poorly returning cash into assets, such as equities, that can generate higher returns.

Highlighting this point is a widening gap between dividend yields and interest rates. The Reserve Bank of Australia (RBA) is likely to leave cash rates on hold for another 12 months, and investors will find it increasingly attractive to source income from riskier assets such as equities rather than leaving it in cash accounts offering only lacklustre returns.

At present, the one-year forward dividend yield on the S&P/ASX 200 is 3.6 percentage points higher than the RBA cash rate – a record differential. See Figure 2. Meanwhile, the gap versus the 10-year bond yield of 2.5 percentage points is similarly attractive, being near previous highs.

Earnings growth is currently forecast at 5% for fiscal 2019, but dividends are expected to grow nearly 8%.

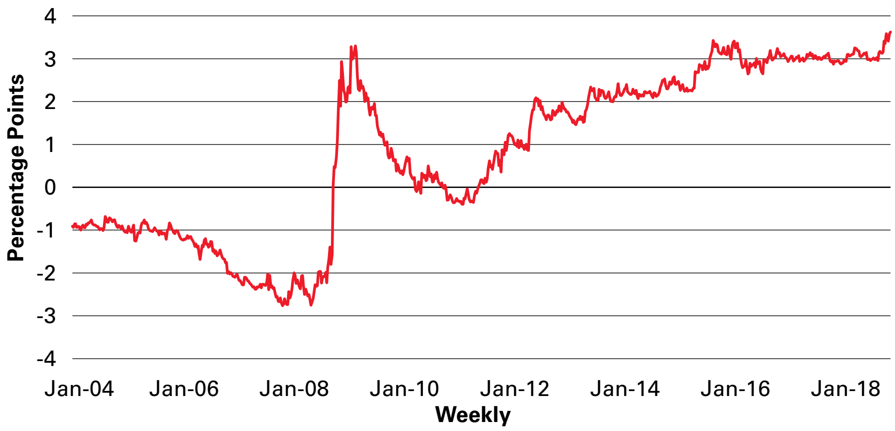
One reason dividend growth is expected to outstrip earnings growth is due to dividend estimates, including special dividends, which generally reflects the distribution of capital rather than earnings.

In the top 20 companies, for example, **BHP**, **IAG**, **Suncorp** and **Woolworths** have special dividends.

There may be some risk that dividend growth will be slower than the circa 8% currently forecast, but we don't see a high probability of dividends declining outright in 2019.

The last time the overall market saw a fall in dividends was around the GFC, in 2009–10. In fact, as per Figure 3, dividends grew even in the face of earnings declines over 2012 to 2016. This stretched payout ratios to around 78% in 2016, although that measure has since improved to circa 73%.

Figure 2: S&P/ASX 200 forward dividend yield (DY) spread to RBA cash rate.



Source: Datastream, IBES, Ord Minnett Research.

One proviso, however, would be a housing correction that turns out to be worse than our base-case scenario, as that could threaten bank dividends.

In the following tables, we list some choices for investors seeking yield.

Table 1 highlights industrial companies on our preferred list. These stocks are not necessarily on our preferred list because of yield, but they do trade with yields of at least 4.5%, have a payout ratio of less than 90%, and are not expected to cut their dividend in 2019.

Table 2 lists preferred industrial companies with strong yields but also higher payout ratios – 90% or more – due to the more defensive nature of their business or, in the case of the infrastructure vehicles, where the payout as a proportion of earnings is not as meaningful given distributions are determined out of cash flow.

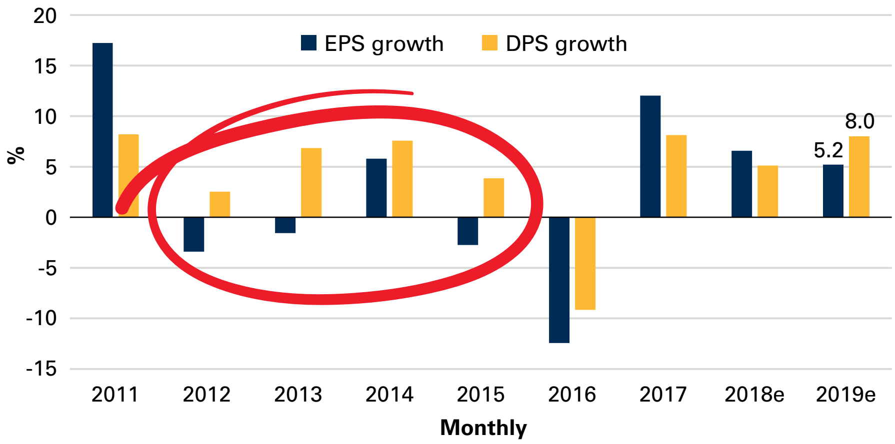
As energy and mining companies face volatility in commodity prices, and their dividends are more cyclical, they tend not to be relied on for yield.

These days, however, with beefed-up balance sheets and cost control boosting cash flow generation, many resources companies now trade on more competitive dividend yields.

Table 3 provides a ranking of our mining and energy coverage universe rated Hold or higher, ranked by yield. We highlight the major miners BHP and **Rio Tinto**, offer 6% dividend yields on payout ratios of only 60–65%.

Finally, we list the market's 'yield darlings', the major banks. **National Australia Bank** offers the highest yield, while **ANZ Bank** offers a solid 6% yield but on a more conservative payout ratio.

Figure 3: S&P/ASX 200 EPS and DPS growth – it is rare to see DPS cuts, even when EPS declines



Source: Datastream, IBES, Ord Minnett Research. EPS – earnings per share; DPS – dividends per share

Company name	Reccom	Target price ($)	Net yield (%)	Payout ratio (%)	DPS growth (%)
				Fiscal 2019E	
Table 1: Preferred industrial companies – ranked by dividend yield, payout ratio below 90%					
AGL Energy	Accumulate	23.40	6.2	75	0.0
Suncorp	Hold	15.00	5.4	73	0.0
Boral	Accumulate	7.40	5.3	60	1.9
GPT*	Hold	5.20	4.8	81	2.4
Table 2: Preferred industrial companies – ranked by dividend yield, payout ratio 90% or above					
Unibail-Rodamco*	Buy	15.00	7.7	92	2
Viva Energy*	Accumulate	2.35	6.8	100	5
AusNet Services	Hold	1.85	6.3	nm	4
Transurban	Buy	13.25	5.2	90	5
Magellan	Buy	32.00	5.2	nm	11
Table 3: Mining and energy companies – ranked by dividend yield					
Alumina Ltd*	Accumulate	3.10	13.3	97	-15
South32	Hold	4.10	8.0	61	76
Fortescue	Accumulate	5.50	7.7	57	35
Whitehaven	Accumulate	5.40	7.5	50	19
BHP	Accumulate	38.00	5.9	65	13
Rio Tinto*	Accumulate	95.00	5.4	60	10
Woodside*	Accumulate	35.50	5.2	79	14
Table 4: Major banks – ranked by dividend yield					
NAB	Accumulate	31.80	8.0	86	0
Westpac	Accumulate	30.90	7.7	84	1
CBA	Hold	77.60	6.1	79	0
ANZ	Accumulate	32.20	6.0	70	0
Macquarie	Accumulate	132.00	5.2	69	13

Source: Factset, IRESS, OML Research. *December balance date so data refers to fiscal 2018.

BIG 4 BANKS

MARGIN SQUEEZE

ANZ Bank – Recomm: Accumulate Risk rating: Higher Share price: $26.80

Year to September	2018A	2019E	2020E
Profit after tax ($m)	6,487	6,773	7,242
Earnings per share ($)	2.14	2.29	2.52
Price/earnings (x)	12.5	11.7	10.7
Dividend ($)	1.60	1.60	1.73
Dividend yield (%)	6.0	6.0	6.5
Franking (%)	100	100	100

ANZ Bank (ANZ)

Commonwealth Bank – Recomm: Hold Risk rating: Higher Share price: $71.23

Year to June	2018A	2019E	2020E
Profit after tax ($m)	9,233	9,917	10,373
Earnings per share ($)	5.13	5.48	5.85
Price/earnings (x)	13.9	13.0	12.2
Dividend ($)	4.31	4.31	4.31
Dividend yield (%)	6.1	6.1	6.1
Franking (%)	100	100	100

Commonwealth Bank (CBA)

National Australia Bank – Recomm: Accumulate Risk rating: Higher Share price: $24.64

Year to September	2017A	2018E	2019E
Profit after tax ($m)	5,702	6,662	7,076
Earnings per share ($)	2.02	2.31	2.42
Price/earnings (x)	12.2	10.7	10.2
Dividend ($)	1.98	1.98	1.98
Dividend yield (%)	8.0	8.0	8.0
Franking (%)	100	100	100

National Australia Bank (NAB)

Westpac – Recomm: Accumulate Risk rating: Higher Share price: $25.97

Year to September	2018A	2019E	2020E
Profit after tax ($m)	8,065	8,453	8,686
Earnings per share ($)	2.29	2.36	2.40
Price/earnings (x)	11.3	11.0	10.8
Dividend ($)	1.88	1.99	2.13
Dividend yield (%)	7.2	7.7	8.2
Franking (%)	100	100	100

Westpac (WBC)

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

Fiscal 2018 and second-half results from the big three banks that rule off their books on 30 September were largely as Ord Minnett expected. Revenue growth proved subdued but still very close to our estimates, while there were some encouraging signs in productivity programs.

Cash earnings were in line, while at the pre-provision level, earnings met our expectations or were marginally below.

Top-line growth will likely remain subdued, although we note business lending growth has strengthened. In addition, the short-term funding cost pressures should not recur, and mortgage repricing will support net interest margins.

Despite modest growth outlooks, risks around house prices, slowing mortgage growth and issues from the Royal Commission, we see **ANZ Bank**, **National Australia Bank** and **Westpac** as attractively valued, with capital management an emerging theme, and they remain our preferences in the sector.

Commonwealth Bank, with a balance date of 30 June, is our least preferred choice in this sector. CBA's trading update for the first quarter of fiscal 2019 fell short of our expectations and we examine the September-quarter performance of Australia's largest bank later in this report.

Interest margins

Net interest margins in the second half of fiscal 2018 came under pressure due to short-term funding costs and mortgage competition. Retail banking margins fell significantly, although margins in business lending, institutional and New Zealand all expanded in the half.

NAB managed net interest margins best in the period, which meant it did not have to follow its peers in repricing mortgages.

ANZ's cautious approach weighed on its result, and its conservatism was reflected in lower growth in retail and unsecured lending. Despite this, risk-adjusted returns continued to improve and the bank again led the sector in cost savings.

ANZ acknowledged it had probably been too cautious in its approach, and we do anticipate some moderation in that caution. That said, we expect ANZ to remain at the conservative end of the risk spectrum.

Business lending

NAB's margin performance was supported by low deposit growth and a better customer mix, i.e. a bias towards business lending rather than retail. The growth in business lending has generated debate about the risks that NAB is taking, but we find little evidence that it is taking undue risk.

Business lending growth overall rose to 6% on a year ago, but we note the strength was concentrated in institutional lending – reflecting support from M&A activity and infrastructure investment – rather than the small and medium-sized enterprise (SME) loan book.

SME lending has been held back by political uncertainty, although NAB outperformed in this segment – a trend we expect to continue.

Mortgages

Data in Westpac's result showed tighter lending standards had not led to a decline in average loan size, but fewer applications – we suspect flows are shifting to non-bank lenders with less onerous requirements.

Interest-only loan balances continue to shrink in size with a modest impact on credit quality. We expect an ongoing impact on net interest margins from interest-only switching to principal and interest loans for some time.

Asset quality

Yet again, asset quality looked very clean across the sector. Impairment expenses were mostly below our estimates and close to cyclical lows. Lead indicators also looked stable to positive.

New and increased impaired assets mostly fell as a share of gross loans, while stressed assets as a share of total exposures also fell.

Perhaps the most positive aspect of the reporting season was the capital generation, with efficiencies continuing to be realised by the banks despite headwinds from one-off charges, i.e. customer remediation costs.

The major banks are well capitalised, albeit to varying degrees, although our capital management forecasts are largely unchanged post this series of results.

Commonwealth Bank

CBA delivered a soft trading update for the first quarter of fiscal 2019, relative to what we expect for the first half of fiscal 2019. We estimate no revenue growth in the quarter and, while costs were well-managed, there appears to be a timing issue due to lower investment spending.

On the plus side, impairment expenses were very low – as with its peers – while capital performance was slightly ahead of our forecasts.

All of the major banks look inexpensive relative to historical multiples, but we prefer the more business-exposed banks – where we see greater margin and return-on-equity resilience – to CBA, which has far greater mortgage exposure.

COLES GROUP

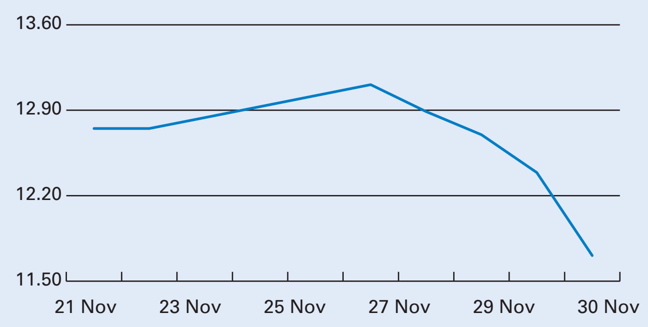
INCONVENIENCED

Sector: Consumer Staples Recomm: Hold Risk rating: Medium Share price: $11.71

Year to June	2018A	2019E	2020E
Profit after tax ($m)	914	941	982
Earnings per share ($)	0.70	0.72	0.75
Price/earnings (x)	16.7	16.3	15.6
Dividend ($)	-	0.34	0.61
Dividend yield (%)	-	2.9	5.2
Franking (%)	-	100	100

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

Coles Group (COL) share price



Source: IRESS

Ord Minnett has initiated coverage of **Coles Group** – which has relisted as a separate company after being owned by **Wesfarmers** for the past decade – with a Hold rating and a target price of $13.25. We need to see greater clarity on the company's food strategy, along with an end to the declines in convenience-business earnings, before taking a more positive view.

The food retail outlook appears more balanced and is improving. Food deflation is moderating in dry grocery, and the fruit and vegetable category has recently turned inflationary after making a deflationary contribution for some time. The changes in management and focus at Coles suggest it will not be the driver of deflation.

Fresh food remains an area of market share headroom for Coles and Woolworths. Dry grocery share between the two majors is circa 70–75%, but in fresh food categories it is only around 50–60%.

The Coles liquor business is poor in comparison with Woolworths, in our view. It has a weak big box format, sells too little wine and too little private label product, and it also lacks overall scale in sourcing and broader fixed-cost leverage.

Earnings growth from the Coles units will be greatest from the liquor business as private label and network optimisation continue, but our expectations are modest given the inherent limitations in the Coles offering.

Significant cost savings flagged by Coles are long-dated, and need food inflation to drive earnings growth. The reliance on food inflation is due to Coles facing some hurdles that Woolworths does not, or at least not to the same extent. The Coles store network is well-pruned, but Coles lacks quality at the upper end, with fewer stores than Woolworths that achieve sales of $2 million or more per week.

In addition, supply-chain cost savings for Coles are somewhat modest compared with the savings from automated distribution centres that Woolworths will enjoy from the first quarter of fiscal 2020.

Supply chain savings do partly help in fiscal 2019 and 2020, but automated distribution centres savings do not flow through until fiscal 2022 and 2023.

Convenience earnings continue to fall. Coles has endured declining total and like-for-like fuel volumes in recent years since the change in ownership of alliance partner Shell to Viva Energy.

Viva is charging Coles higher supply prices as it focuses on dollar profitability rather than the volume strategy that Shell employed. This has led Coles to charge customers a significant premium.

The fall-out is declining fuel volumes and site productivity now well below Woolworths, despite Coles having far superior site quality.

Overall, Coles provides an earnings stream that is somewhat defensive – but not as defensive as that of arch-rival Woolworths. Valuation support for the stock is also lacking, given it trades on a high-teens forward price to earnings multiples and offers only a sub-5% dividend yield, in fiscal 2019.

MINERAL RESOURCES

LITHIUM LEAP

Sector: Metals and Mining Recomm: Accumulate Risk rating: Higher Share price: $15.25

Year to June	2018A	2019E	2020E
Profit after tax ($m)	265	227	346
Earnings per share ($)	1.42	1.21	1.84
Price/earnings (x)	10.8	12.6	8.3
Dividend ($)	0.65	0.43	0.64
Dividend yield (%)	4.3	2.8	4.2
Franking (%)	100	100	100

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

Mineral Resources (MIN) share price

Source: IRESS

Mineral Resources is a major supplier of contract mining services to some of the world's largest resources companies and also has its own operating assets, including iron ore operations at Iron Valley and Yilgarn and its Mt Marion and Wodgina lithium projects.

Mining services has long been the company's core business, but it is now unlocking significant value in its lithium assets.

The latest step in this process is the sale of a 50% stake in the Wodgina project in Western Australia to US-listed Albemarle Corporation for US$1.15 billion in cash. The price equates to $8.50 per Mineral Resources share, or more than 50% of the current share price.

Under the deal, Albermarle and Mineral Resources have signed an exclusivity agreement to create a 50/50 joint venture to own and operate the Wodgina lithium mine and co-develop integrated lithium hydroxide (LiOH) facilities onsite. Lithium is used in everything from mobile phones to grease and car batteries.

Albemarle buys a 50% interest in all mineral rights, excluding iron ore and tantalum, at Wodgina, which is located in the Pilbara, all fixed infrastructure and utility assets, the concentrate plant and mobile mining equipment.

Importantly, the agreement includes participation in the downstream project where Albemarle brings significant intellectual property and engineering expertise given its existing chemicals business.

The venture will start work on a 50,000 tonnes per annum (tpa) LiOH plant as soon as necessary licences and regulatory approvals are in place. The second stage of the downstream project is subject to market conditions, but would add another 50,000tpa of LiOH capacity and fully consume all of Wodgina's output of spumodene concentrate.

Spodumene is the most important mineral containing lithium due to its higher grade. A typical run-of-mine ore can contain 1–2% lithium, while a typical spodumene concentrate will grade at around 6–7% lithium.

Albermarle already owns 49% of Greenbushes, the world's largest and highest-grade producer of spodumene ore, located south of Perth.

Ord Minnett valued Wodgina at $2.3 billion (US$1.64 billion or US$820 million for 50%), but this included only 50,000tpa of LiOH capacity, not the 100,000tpa target that has been flagged as part of the Albermarle deal.

If we add another 50,000tpa of downstream capacity, our valuation of Wodgina rises to $3.2 billion (US$2.3 billion, or US$1.15 billion for 50%), in line with the agreed price.

In our view, this is a clean and fair deal. By partnering with a global lithium leader, Mineral Resources has galvanised the value of the downstream option and cemented Wodgina as a tier-1 strategic asset.

Not only does this transaction deliver a cash windfall for Mineral Resources, but also it confirms the strategic value of upstream lithium assets that can be developed into long-term supply sources of battery-grade lithium.

MACQUARIE GROUP

SILVER DONUT STILL SHINES

Sector: Financials Recomm: Accumulate Risk: Higher Price: $114.42

Macquarie Group (MQG) is a global investment bank with strong market positioning in niches such as commodities, infrastructure and green energy, and a keen focus on risk management.

The company recently raised its guidance for growth in fiscal 2019 net profit to 15% from 10%, following the competition regulator's approval of the sale of Quadrant Energy – in which Macquarie has a 22% stake – to Santos.

Ord Minnett previously estimated the Quadrant sale gain would be worth 2–3% to net profit versus the company's apparent guidance to a 5% contribution. Macquarie will receive the proceeds from the sale in the second half of fiscal 2019.

The latest upgrade to guidance follows another strong first-half result from Macquarie, driven largely by an 85% rise in earnings from its commodities and global markets division.

This division is a market-facing business and thus inherently subject to volatility. Macquarie's commentary, however, suggested the strength in the commodities business is likely to remain in place for some time.

Pleasingly, the strong first-half result was achieved without relying upon a significant boost from performance fees or gains on sale. Indeed, these 'volatile items' equated to 13% of total revenue – in line with the 10-year average.

We note consensus is factoring in 13% revenue growth at the mid-point, which suggests there is potential for consensus earnings upgrades.

Macquarie is currently trading on a one-year forward price-to-earnings (P/E) multiple of 13.3x. This is above the major banks, but we see Macquarie as unlikely to be affected by some of the headwinds facing the big four and their earnings post the Royal Commission. We also see Macquarie facing less regulatory pressure.

In our view, the forward P/E multiple looks undemanding for such a high-quality financial services company that offers leverage to the key themes of infrastructure, green energy and commodities.

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

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