February 2020

ORDS MONTHLY

FIRST SIGHT
FLYING START

The Australian equity market raced out of the gates at the start of 2020, with the S&P/ASX 200 Index rising 5% in January.

Where to from here is now the key question, and the investment strategy note starting on page 2 in this edition of the *Ords Monthly* provides a rundown on the broader macroeconomic outlook and lists our preferred stock choices for 2020.

BHP Group kicks off our corporate coverage this month. The world's largest mining company's production report for the December quarter was mostly weaker against our forecasts, with the exception of its Escondida-driven copper division.

Maintenance affected volumes at its main business – the West Australian iron ore operations – although the achieved iron ore price was ahead of our estimate.

BHP's operations are still generating plenty of cash, however, and we forecast the Big Australian to pay out circa US$4 billion to shareholders at its first-half fiscal 2020 results in February. Page 4 outlines our view.

Origin Energy delivered a somewhat soft December-quarter result, with sales volumes, revenues and realised gas prices all below Ord Minnett's estimates.

The result highlighted an emerging theme of headwinds in east coast gas markets, although Origin's gas prices lagged those of its peers in any case.

We note the weak signals from the quarterly report, but Origin's strong cash generation and the potential for higher dividends maintains the stock's attraction. See page 5 for more information.

Link Administration has quickened the pace of its expansion in Europe, buying the loan servicing business of KKR-owned Pepper Group for up to $322 million.

The acquisition will add scale to Link's UK and Ireland loan-servicing operations and offer cost savings, while the entry into Spain, Greece and Cyprus provides growth opportunities. See page 6 for the details.

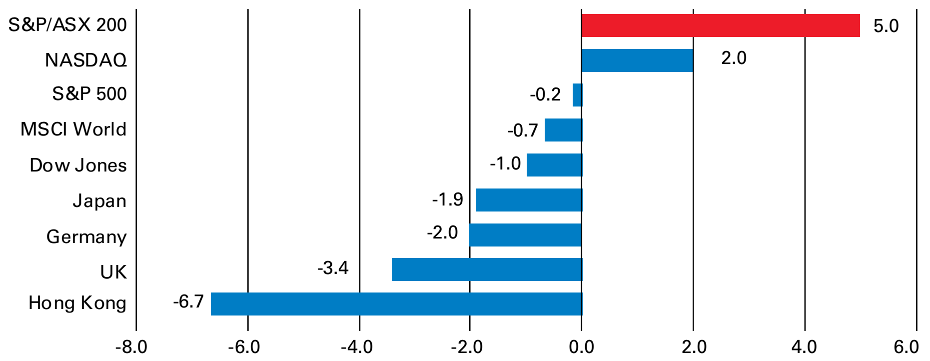
The December-quarter production report from **Fortescue Metals** again highlighted the No.3 iron-ore miner's best-in-class operational performance, with shipments running close to record levels and costs comfortably below Ord Minnett's estimates.

Fortescue, as with its larger rivals BHP and Rio Tinto, is offering attractive shareholder returns as its operations generate strong free cash flow. Page 7 has more.

Treasury Wine Estates disappointed with a weak first-half fiscal 2020 result, blaming challenges in its US business, and downgraded fiscal 2020 earnings growth guidance to 5–10% from 15–20%.

The company is taking steps to remedy the issues in the American operations, but for now, we have cut our recommendation and target price as it faces headwinds in its two largest markets – the US and China. See page 8.

Figure 1: Global markets performance to 31 Jan 2020 (price basis, %)



Source: IRESS, Ord Minnett Research.

INVESTMENT STRATEGY

2020 VISION

The first weeks of 2020 have borne all the hallmarks of 2019, in that long-end bond yields are in decline, US yield curves are flattening, American equity markets are outperforming and the greenback is strengthening.

The persistence of these trends into 2020 is at odds with the global and domestic prognostications of Ord Minnett and its research partner – we see US treasury yields rising and yield curves steepening; emerging markets and euro-zone equities overtaking Wall Street; and a flat-lining US dollar.

In this note, we review the Australian economic outlook and that of corporate earnings, and detail our high-conviction calls for 2020.

Australian economy outlook

Our economists expect consumption to recover in 2020, thanks to a higher starting savings rate, as well as fiscal policy (tax cuts brought forward) and monetary policy (two Reserve Bank of Australia rate cuts plus quantitative easing) support.

At the time of writing, the central bank had left the benchmark cash rate unchanged at 0.75% at its first meeting for 2020.

In his commentary, governor Philip Lowe noted the outlook for the global economy remained “reasonable" despite unsettled US-China trade differences, while the economic impact of the bushfires and coronavirus was expected to prove only a temporary drag on domestic growth.

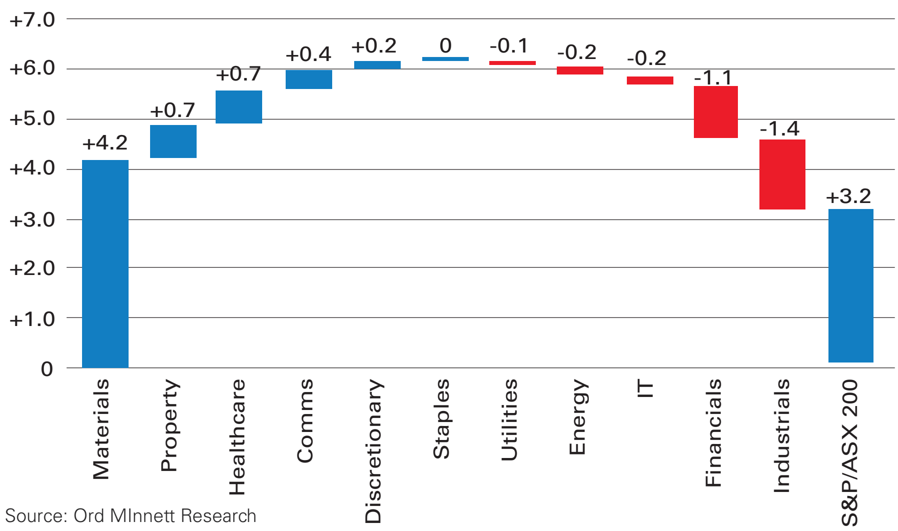
GDP growth is forecast to rise to 2.8% this year from 2019's pedestrian rate of 1.8%.

Despite the likelihood of stronger private consumption gains in 2020, the government’s contribution to growth is still likely to be greater. Public demand’s share of GDP growth has risen consistently in recent years, and we forecast the sector to again contribute the lion’s share of growth in 2020.

Corporate earnings outlook

Upgrade breadth – the ratio of positive earnings revisions to negative revisions – in January was running well ahead of historical averages, which points to a reporting season that will have to improve markedly on August 2019’s dismal showing to meet expectations.

Figure 2: Fiscal 2020 net profit bridge for OML coverage in S&P/ASX 200 Index



Source: Ord MInnett Research

The 'corporate growth' gap between Australia and the globe widened in 2019, with the gap set to widen further based on an aggregation of our team's company forecasts.

Adjusting our forecasts coverage to an aggregated 12-month period to June 2020 points to a pedestrian 3.2% lift in net profit, with growth to be negative once materials are excluded, with industrials, financials and IT sectors dragging on the overall market. See Figure 2 opposite.

We turn now to our preferred stocks for 2020. Our choices are screened on three criteria – the stock must be a key sector pick for 2020; it must offer material potential upside to our price target; and our earnings forecast must be above the market, either in the current year and/or on average over the next three forecast years. See Table 1 for the key metrics.

CIMIC

The company provides construction and engineering services to customers in the mineral and metals, oil and gas, telecommunications, power, transport, water and property sectors.

As the largest listed construction firm in Australia, we see it as well-placed to benefit from large infrastructure investments. Industry consolidation could involve CIMIC as well.

For the full report on any of these companies please contact your Ord Minnett adviser.

Lendlease

As a global leader in the property, infrastructure and urban regeneration space and with a backlog of around 20 development projects, we see Lendlease as well-positioned for the next 10–20 years.

Barangaroo South in Sydney and TRX in Kuala Lumpur are the key projects over the next three years, with Barangaroo South providing a strong profit contribution to FY23E and FY24E.

National Australia Bank

Given NAB's exposure to small- and medium-sized business enterprises, we see the bank as positively leveraged to an improving credit growth environment and expect it to enjoy greater margin resilience than its peers.

Structural cost savings are expected to be made in 2020 as new CEO Ross McEwen sets out his strategic agenda.

NAB also faces fewer competitive pressures in the mortgage lending market relative to its peers and, along with reduced costs, this will set the bank up well for the future, in our view.

Rio Tinto

The diversified miner stands out for its best-in-class balance sheet and shareholder payout potential.

Coupled with an attractive dividend yield and cash flow, Rio Tinto is also slightly cheaper than BHP. In addition, iron ore prices are expected to remain elevated in 2020.

Reliance Worldwide

The company designs, manufactures and supplies a range of water flow and control products for the plumbing industry.

Early signs of improvement in Reliance's UK demand will assist the company in continuing its long track record of penetration into the push-to-connect fittings market.

Management has also flagged that it is reinvesting in its commercial teams, R&D and operational capability.

Worley

The global project delivery and consultancy to the resources and energy sectors is expected to grow over the next two years, as indicated by business cycle capital expenditure surveys.

Rising staff utilisation levels, contract award wins and an increased dividend payout further underpin our positive view.

Woodside Petroleum

The largest operator of oil and gas production in Australia has been successful in improving the returns from key growth projects in Western Australia by increasing the resource base and lowering its capital costs.

A substantial de-risking of the Scarborough growth project and upcoming catalysts from its Browse projects are key elements of our Accumulate recommendation.

Table 1: Our preferred stocks for 2020 and key metrics

Company	Code	Recommendation	Target price ($)	Last price ($)	Implied total return (%)	Price-earnings ratio (x)	Dividend yield (%)	Franking (%)
CIMIC	CIM	Buy	40.00	29.29	39.2	11.5	2.6	100
Lendlease	LLC	Buy	21.00	18.12	19.0	16.4	3.1	40
NAB	NAB	Accumulate	29.70	25.86	21.3	11.8	6.4	100
Reliance	RWC	Accumulate	4.80	4.50	9.2	19.8	2.6	100
Rio Tinto	RIO	Accumulate	112.00	98.77	18.8	12.0	5.4	10
Woodside	WPL	Accumulate	40.25	34.73	20.8	16.2	4.9	0
Worley	WOR	Buy	17.60	15.24	19.9	16.6	4.4	100

Source: IRESS, Ord Minnett Research.

BHP GROUP

CASH RICH

Sector: Metals & Mining Recomm: Hold Risk rating: Higher Share price: $39.40

Year to June	2019A	2020E	2021E
Profit after tax ($m)	13,231.8	16,306.4	15,639.1
Earnings per share (¢)	261.7	322.3	309.1
Price/earnings (x)	15.1	12.2	12.7
Dividends per share (¢)	328.5	226.4	216.7
Dividend yield (%)	8.3	5.7	5.5
Franking (%)	100	100	100

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

BHP Group (BHP) share price

Source: IRESS

The December-quarter production report from **BHP Group** showed output as generally soft versus Ord Minnett's estimates, with volumes in the key iron ore division hampered by car dumper maintenance.

Production guidance for fiscal 2020 was unchanged across the various business, although the petroleum division is tracking to the lower end of the range due to North West Shelf platform maintenance, lower seasonal gas demand and cyclones in the Gulf of Mexico.

Iron ore shipments ran at an annualised rate of a 276 million tonnes per annum (Mtpa) in the quarter, versus fiscal FY20 guidance of 273–286Mt, despite the impact of the car dumper maintenance.

We note production in the current March quarter is typically weak due to the cyclone season in the north-west of Australia.

The first-half fiscal 2020 achieved iron ore price was US$78 a tonne on a free-on-board basis, some US$3 more than we had expected. We view this as a good outcome given lower grades at the Jimblebar operation.

Ore grades are expected to improve in the June quarter, returning to more than 60% iron (Fe) content.

Overall, the better iron ore price has offset lower-than-expected production, and we have raised our EPS estimates for fiscal 2020 and 2021 by 2%.

Copper production of 455,000 tonnes was ahead of Ord Minnett's forecast by 4%, with the key highlight being record concentrator throughput at Escondida – the world's largest copper mine – in Chile.

Meanwhile, costs in this division are tracking below guidance due to strong gold by-product credits.

In other operations, metallurgical and thermal coal output rose 16% and 9%, respectively, on a quarter-on-quarter (QoQ) basis after a maintenance-affected September quarter, but sill missed our estimates.

Petroleum divison production fell 3% QoQ to 29 million barrels of oil equivalent, short of Ord Minnett's forecasts by the same magnitude.

We maintain our preference for Rio Tinto over BHP in the diversified mining sector due to the former's cheaper valuation metrics.

That said, there is little to differentiate the investment case for the two stocks, as both have strong balance sheets and similar free cash flow yields of about 6%.

In addition, there is upward pressure on consensus earnings estimates given the strength in iron ore markets, and the solid returns accruing to shareholders in the form of higher, and special, dividends and share buybacks.

We estimate BHP will return about 70% of earnings to shareholders in February (circa US$4 billion).

Our expectation for the structure of the BHP payout is a US$0.55 interim dividend, along with a US$1.1 billion share buyback.

ORIGIN ENERGY

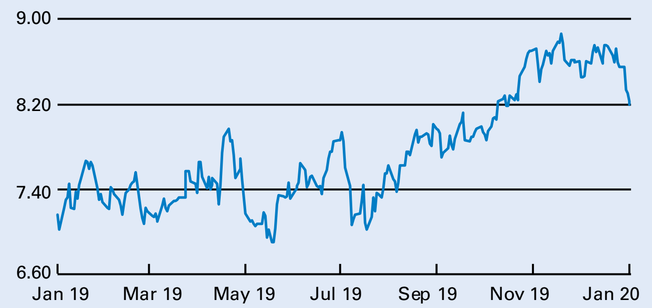
EAST COAST BLUES

Sector: Energy Recomm: Accumulate Risk rating: Higher Share price: $8.20

Year to June	2019A	2020E	2021E
Profit after tax ($m)	1,028.0	1,106.8	1,211.1
Earnings per share (¢)	58.4	63.1	69.0
Price/earnings (x)	14.0	13.0	11.9
Dividends per share (¢)	25.0	24.0	38.0
Dividend yield (%)	3.0	2.9	4.6
Franking (%)	100	100	100

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

Origin Energy (ORG) share price



Source: IRESS

Origin Energy delivered a somewhat soft December-quarter result, with sales volumes and revenues below Ord Minnett's estimates.

The result was affected mainly by lower domestic gas revenue as a result of lower sales and much lower-than-expected realised gas prices, which highlights an emerging theme of headwinds in east coast gas markets.

Origin has pointed to lower seasonal demand, and lower short-term liquefied natural gas (LNG) contract volumes as key drivers of the result.

There were also some concerning trends in the energy markets business, with electricity volumes hurt by market share losses.

In LNG, Origin's share of output from its 37.5% owned Australia Pacific LNG (APLNG) plant near Gladstone was 908,000 tonnes, up 10% on the previous quarter and 2% above our estimate.

We estimate that LNG production at the APLNG facility was operating at 107% of nameplate capacity over the quarter.

LNG sales were also higher, but domestic gas sales of 15 petajoules (PJ) were 18% below the previous quarter and our estimate.

Origin's realised domestic gas prices declined 16% from the previous quarter to their lowest level since late 2017.

The realised price of $4 per gigajoule (GJ) compares unfavourably with peers, with Beach Energy at $7/GJ and Santos at $6.04/GJ.

APLNG net cash distributions for the first half of fiscal 2020 came to $520 million, in line with guidance.

The energy markets division reported lower retail sales volumes in the quarter, with electricity down 6% and gas down 11% on a year ago.

The division's electricity volumes declined 5% on the prior quarter and gas volumes dropped 26%, owing largely to seasonality, partially offset on the gas side by increased gas sales to generation.

Gas volumes were also affected by contract expiries from business customers and lower internal generation (noting the Mortlake gas plant was down for the period), which more than offset higher mass-market customers.

Despite lower sales in the quarter, Origin reiterated fiscal 2020 operating earnings guidance for the energy markets business unit of $1.4–1.5 billion, versus our $1.402 billion estimate.

The majority of Origin's earnings and valuation comes from the energy markets arm, although it is also exposed to oil prices via APLNG.

We note the weak signals from the quarterly report, but Origin has strong cash generation and the potential for higher dividends towards the top of management's policy of paying out 30–50% of free cash flow.

We estimate the company currently trades on an 8–10% free cash flow yield and, with the stock trading below our net present value measure, we reiterate our Accumulate recommendation.

LINK ADMINISTRATION HOLDINGS

WIDENING THE NET

Sector: Software & Services Recomm: Accumulate Risk rating: Higher Share price: $6.81

Year to June	2019A	2020E	2021E
Profit after tax ($m)	319.0	66.4	130.0
Earnings per share (¢)	37.4	28.2	38.4
Price/earnings (x)	18.2	24.1	17.7
Dividends per share (¢)	20.5	16.7	19.5
Dividend yield (%)	3.0	2.5	2.9
Franking (%)	100	100	80

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

Link Administration (LNK) share price

Source: IRESS

Link offers a range of products designed to simplify the administration processes of financial services companies.

These products include a banking and credit management (BCM) operations division, a share registry, a fund administration platform and superannuation management services.

The company has accelerated the European expansion of its BCM business with the acquisition of Pepper European Servicing (PES) from the KKR-owned Pepper Group for up to €200 million, or $322 million.

The price will be split between an upfront cash payment of $266 million, with a further $56 million contingent on performance hurdles over three years.

PES provides end-to-end loan servicing across the loan cycle from origination through to settlement and arrears management, and asset management and advisory services, including portfolio due diligence, valuation services, panel management and real estate advisory.

Overall, the PES operations are complementary to BCM's business, and creates a leading pan-European asset servicer and manager.

There is a much similarity between the services of BCM and PES, but the asset management services (at the very least, real estate advisory) appear to be additional services BCM could cross sell to its clients.

PES operates in the UK and Ireland, with operations in Spain, Greece and Cyprus, while BCM currently operates in Ireland, the UK, the Netherlands and Italy.

PES will add scale to Link's UK and Ireland operations and offer cost saving options, while opportunities in Spain, Greece and Cyprus that PES provides will be a benefit to BCM and provide growth.

Link estimates annual cost savings of about $16 million and a one-off integration cost of circa $2 5 million from the acquisition. The integration and run rate cost savings are expected to be realised by the end of fiscal 2021.

We note that the cost savings are about 14% of the cost base of the target, which we consider a reasonable objective.

The acquisition is subject to regulatory approvals, which are expected to take six months but could take longer.

The deal seems highly accretive as presented by Link, particularly if the targeted savings and revenue gains are achieved.

In our view, however, it is unclear whether the high margins of PES are sustainable, due to performance fees, or if the growth in new markets, such as Greece, will offset the run-off from non-performing loans in BCM's current markets, such as Ireland.

Link will fund the acquisition via existing cash and debt facilities, suggesting net debt will increase by $300 million to circa $911 million, implying a net debt to operating earnings ratio of 2.6 times, above guidance of 1.5–2.5 times.

This increased leverage suggests to us there is a significant risk of the share buyback being put on hold or cancelled.

FORTESCUE METALS GROUP

NO ORDINARY QUARTER

Sector: Metals & Mining Recomm: Hold Risk rating: Higher Share price: $11.39

Year to June	2019A	2020E	2021E
Profit after tax ($m)	4,454.8	6,196.5	4,027.7
Earnings per share (¢)	144.7	201.2	130.8
Price/earnings (x)	7.8	5.6	8.6
Dividends per share (¢)	112.8	119.5	71.5
Dividend yield (%)	10.0	10.6	6.3
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 posted a strong production report for the December quarter, leading Ord Minnett to lift its earnings estimates for fiscal 2020 by 4%.

It was hard to fault the report. Shipments were close to record levels, some 7% above our forecasts, and running at an annualised rate of 184 million tonnes per annum (Mtpa).

Fortescue is now pointing to the upper end of its guidance range of 170–175Mt for fiscal 2020.

Meanwhile, cash costs fell almost 4% quarter-on-quarter to US$12.50 a tonne, some 6% lower than our forecast, due to stronger volumes.

Fiscal 2020 cost guidance was lowered by US$0.50 to US$12.75 to US$13.25 a tonne.

The company reported net debt of US$700 million as at 31 December, well below Ord Minnett's US$1.1 billion estimate due to lower capital expenditure and higher sales.

We note that net debt remains near the lowest level in more than a decade, despite the US$500 million dividend payout and US$700 million tax payment.

Interestingly, Fortescue noted that due to a solid operational performance at the mines, the port bottleneck had now shifted to the railway.

This means that streamlining the railway presents a productivity opportunity for the company, particularly as the Eliwana mine ramps up in December 2020 and the Firetail mine is still producing.

Fortescue announced a further US$450 million of capital expenditure on the energy business, bringing the total to US$700 million. This investment will include building solar power to feed into the Chichester Hub and Iron Bridge operations.

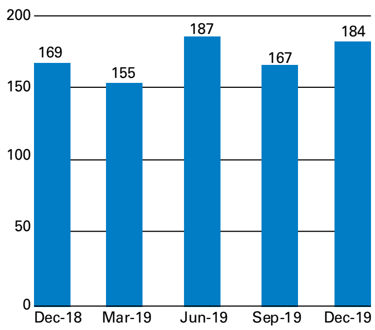
This should see a cost benefit to Fortescue over the long term. We have added the spending into our model and lowered estimated costs slightly. This makes it an net present value (NPV)-neutral investment, although this could be conservative.

Fortescue continues to offer best-in-class operational performance, attractive shareholder returns and unstretched valuation metrics.

The company offers exposure to long-life operations and should generate solid margins over the near future.

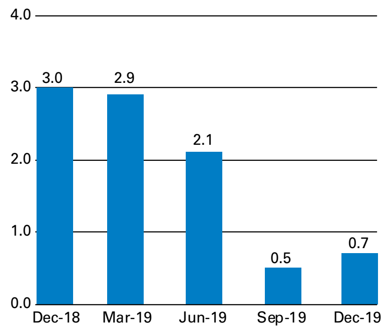
That said, we also see risks to China growth due to the coronavirus which could prevent a near-term rerating of the stock. In addition, the share price has approached our NPV measure, leading us to maintain our Hold recommendation.

Figure 3: Annualised shipment run rate by quarter (Mtpa)



Source: Ord Minnett

Figure 4: Net debt by quarter (US$bn)



TREASURY WINE ESTATES

SOUR GRAPES

Sector: Staples Recomm: Hold Risk: Higher Price: $13.03

Treasury Wine Estates posted a weak first-half fiscal 2020 result, citing challenges in its US business, an outcome which led Ord Minnett to cut its recommendation to Hold from Accumulate and its price target to $15.00 from $20.00.

Underlying earnings before interest, tax (EBIT) were $366.7 million, well below our $398.6 million estimate.

The vintner also cut its guidance for fiscal 2020 EBIT growth to 5–10% from 15–20% and offered fiscal 2021 growth guidance of 10–15%.

The company blamed commercial challenges in its US division for the result and weak guidance, specifically management change, private-label growth and a higher cost of goods sold. A strategic review has been initiated to accelerate change in its US commercial operations.

The Australia and New Zealand, corporate, and Europe and Middle East divisions were ahead of our estimates. Asia was strong again, albeit below our forecast.

We note the lowered guidance from Treasury does not factor in any coronavirus impact, with the risk that softer demand could weigh on industry volumes and margins generally.

We have cut our normalised EPS estimates by 15% for fiscal 2020 and 23% for fiscal 2021 following the result and guidance.

We note still-strong earnings growth, but also a lack of valuation support and uncertainty around the impact of the coronavirus.

Treasury has executed admirably over many years now, applying fast-moving consumer goods thinking, leveraging scale in marketing and innovation, diversifying global supply and optimising the route to market in China and the US to wine.

It now faces headwinds in its two most important divisions, however, which will temper earnings growth for now.

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

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