ORD MINNETT
PRIVATE WEALTH

July 2019

ORDS MONTHLY

SURVEYING THE NEW YEAR
INCOME SOLUTIONS

The Australian stock market wrapped up fiscal 2019 with a bronze medal among its global peers, although it took a surprise election result, a surging iron ore price, and the first interest rate cut since 2016 to get the S&P/ASX 200 Index over the line.

The lower interest-rate environment is set to drive sentiment for the moment, spurring a search for yield by income-starved investors as cash product rates fall.

Our **Investment Strategy** note starting on page 2 lays out our suggested stocks to play this theme, and we also highlight the role of hybrid securities in such an environment.

WorleyParsons leads off our corporate coverage this month, with the company's recent investor day reinforcing our positive view on the resources and chemicals contractor.

Our investment thesis is underpinned by an already strong pipeline of work, expectations that resources capital expenditure has bottomed and will steadily improve, and the Jacobs acquisition that increases its footprint in the Americas and diversifies its client base. See page 4 for our view.

Charter Hall Education Trust is the largest childcare centre owner, with 430 centres in Australia and New Zealand, and has the management expertise to back up its role in the sector.

Demand for childcare is likely to remain strong, underpinned by government subsidies, population growth, an increased female workforce participation rate and less use of informal childcare.

The trust trades at a premium to its peers, but we see such a valuation as justified given its strong growth profile, high-quality portfolio, favourable lease terms, and ability to leverage the broader **Charter Hall Group** platform. Page 4 for the details.

Santos is aiming to nearly double its annual output to more than 100 million barrels of oil by 2025 from 57 million.

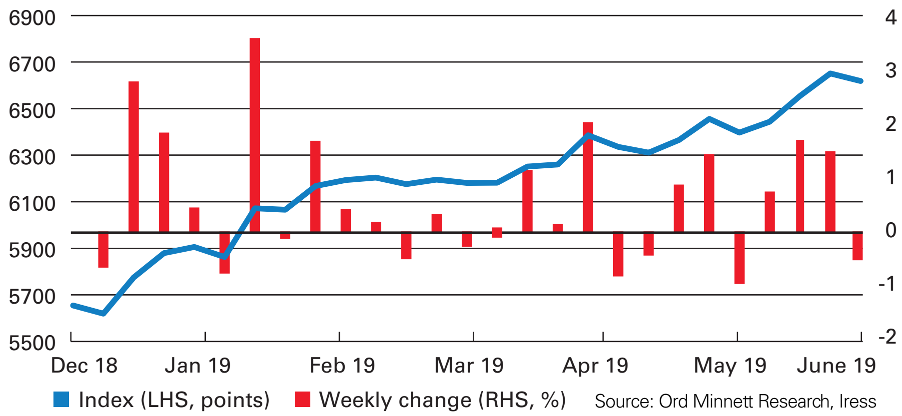
Driving the strategy is the 2018 acquisition of the Quadrant Energy assets and its Dorado oil and gas discovery off the Western Australian coast, which industry analysts are calling the largest Australian discovery this century. Refer to page 5.

BlueScope Steel has downgraded its earnings guidance for fiscal 2019, due primarily to a contraction in steel spreads. The narrowing was more pronounced in its North Star operations in the US than in its Australian arm, although it was still less than we had expected.

We were already downbeat on fiscal 2019 earnings, so our estimate changes for that period are minimal. Our concerns relate more to fiscal 2020 earnings and we explain our thinking on page 7.

Lastly, the strong update from **Alliance Aviation** has served to reinforce our positive view on the carrier, which operates regional services, both corporate and commercial, with its 44-strong fleet of small jets and turboprops. See page 8 for more.

Figure 1: S&P/ASX 200 Index weekly performance in 2019 (to 28 June)



Source: Ord Minnett Research, Iress

INVESTMENT STRATEGY

SEEKING YIELD

The Australian stock market turned in a strong performance in fiscal 2019, with the benchmark S&P/ASX 200 finishing ahead of most developed-market peers. See Figure 2 below.

All of the gains came in the second half, however, as investors applauded the surprise re-election of the Liberal-National coalition government and iron ore prices rocketed above US$100 a tonne. Meanwhile, the Reserve Bank of Australia (RBA) came to the party late, bowing to the weight of weak data and cutting interest rates for the first time since 2012.

By sector, banks and miners did most of the heavy lifting for the broader market – banks by virtue of the federal election result as fears of harsher regulation and restrictions abated, and iron ore producers thanks to supply issues and strong demand from Chinese steel-makers that squeezed the price of the key commodity to more than five-year highs.

The RBA may have arrived late to the party, but it is clearly on a mission to spark lacklustre growth in the domestic economy. Following the June meeting, it also cut the cash rate at its July meeting, to 1% from 1.25%.

This marks the first consecutive cuts by the bank since 2012 – suggesting a little more urgency in the current easing cycle than those in 2015 and 2016.

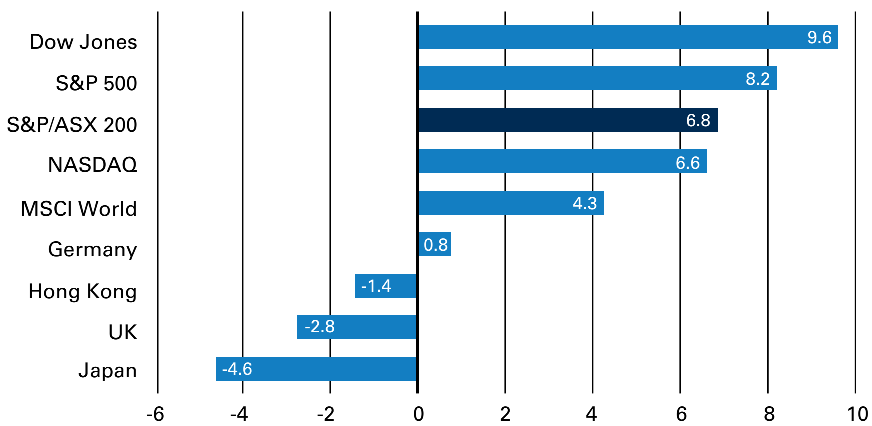
As with the June easing, the July cut is designed to support employment growth and provide greater confidence that persistently weak inflation will be eventually return to the RBA's 2–3% target range.

Parsing the commentary, however, suggests it may now be prepared to wait for further evidence before moving again. This does not mean the RBA has shut the door on more easing, but that further rate cuts will be contingent on economic growth, labour market and inflation data missing the bank's current forecast.

That said, the statement was still more dovish than we have usually seen after a 0.5-percentage-point easing in recent years, so we should assume that the bank will respond to weaker growth and/or inflation data.

Our research partner continues to forecast a further 0.5 percentage points in cuts by the June quarter of 2020, bringing the cash rate to 0.5%, with the risk being the RBA moves earlier rather than later.

Figure 2: Global markets performance on fiscal 2019 (%)



Source: OML Research. Price basis in local currency terms

The themes of falling interest rates, both locally and globally, and the (now passed) $158 billion in income tax cuts are set to drive the market in the months ahead.

Rate cuts tend to be stimulatory for most sectors of the market, from cyclical stocks, e.g. consumer discretionary, industrials, and miners, to companies with higher gearing, such as utilities, infrastructure and property trusts, which benefit from lower interest costs.

More specifically, we expect to see a noticeable and sustained benefit from lower interest rates to higher-yielding equities.

Term deposit rates are set to stay low, driving investor preference for higher-yielding assets in the search for income. In **Table 1** below, we list the higher-yielding companies on our preferred lists, with a minimum 4% dividend yield for inclusion.

Banks are likely to be sought for their yield, but we highlight that rate cuts are generally harmful to banks in operational terms. Cuts put downward pressure on net interest margins to the extent that mortgage rates fall, interest income earned on excess capital falls, and banks are unable to lower deposit costs commensurately, particularly on non-rate-sensitive (low-cost) deposits.

We thus have a narrow set of preferences in the bank sector, namely National Australia Bank and ANZ Bank, which have a higher proportion of business banking relative to consumer banking business.

Worth highlighting here are hybrid securities. They should remain supported as official interest rates continue to fall, and offer an attractive solution for yield-starved investors, particularly retirees who have traditionally relied on term deposits.

As term deposit rates approach 'floor rates', it is likely many investors will pry their money from deposits and deploy it in the hybrids market, although hybrids have a higher risk profile. **Table 2** below provides our preferences.

In our view, the recent rally in hybrid securities over the past month is justified. At current levels, however, we are cautious that valuations are stretched. This leads us to recommend a greater focus on security selection and capital preservation over capital appreciation.

Table 1: Preferred companies in the S&P/ASX 200 Index with net dividend yields above 4% (excluding resources)

Company	Code	Recomm.	Risk	Target Price ($)	Close ($)	Dividend yield (%)		Payout ratio (%)	
						FY19E	FY20E	FY19E	FY20E
National Australia Bank	NAB	Accumulate	Medium	29.60	26.72	6.2	6.2	81	74
Perpetual	PPT	Hold	Higher	40.00	42.24	5.8	5.8	97	94
ANZ Bank	ANZ	Hold	Medium	29.40	28.21	5.7	6.1	70	75
Viva Energy REIT	VVR	Hold	Medium	2.40	2.60	5.6	5.8	100	100
Charter Hall Long WALE	CLW	Buy	Medium	5.25	5.01	5.4	5.8	100	100
Boral	BLD	Accumulate	Higher	6.00	5.12	5.3	5.3	62	62
APA Group	APA	Hold	Medium	10.00	10.80	4.3	4.8	nm	nm
GPT Group	GPT	Hold	Medium	5.50	6.15	4.3	4.4	81	83

Source: OML Research, IRESS, Factset

Table 2: Preferred hybrid securities

Key theme	Investment thesis	Implementation
Capital preservation	Shorter-dated notes offerw price stability as these securities will benefit from 'pull to par'.	NABPB, BENPE, WBCPF, CGFPA
Income	Mid-dated notes offer an attractive combination of capital price stability and income, although valuations look stretched and investors should expect to pay a premium for the high distributions these securities offer.	WBCPG, NABPD, ANZPG, CBAPE, IAGPD, AMPPA, CGFPB
Reducing reinvestment risk	Longer-dated notes offer marginally higher returns, although term premiums remain skinny. Investors at this end of the curve should expect to hold these notes to maturity if credit spreads widen and prices are adversely impacted.The benefit of holding longer-dated notes is that, should rates fall further reinvestment risk is reduced.	ANZPH, NABPF, CBAPG, CBAPH, WBCPI

Source: OML Research

WORLEYPARSONS

PLAYING ON THE GLOBAL STAGE

Sector: Energy Recomm: Buy Risk rating: Higher Share price: $14.71

Year to June	2018A	2019E	2020E
Profit after tax ($m)	171.4	282.3	469.1
Earnings per share (¢)	62.8	63.9	90.3
Price/earnings (x)	23.4	23.0	16.3
Dividends per share (¢)	25.0	29.5	53.0
Dividend yield (%)	1.7	2.0	3.6
Franking (%)	0	0	0

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

WorleyParsons (WOR) share price

Source: IRESS

WorleyParsons management recently hosted an upbeat investor day, clearly focusing on the opportunities presented by the recent acquisition of Jacobs Engineering's energy, chemicals and resources division, and the positive outlook for the business.

There was nothing to change Ord Minnett's positive view on the stock, although near-term growth appears a little more anaemic with customers displaying caution given the recent trade dispute between the US and China.

We were comforted by the indication that further M&A is likely on hold until the Jacobs acquisition is fully integrated. The company did, however, indicate a successful track record of acquisitions and said WorleyParsons would remain opportunistic in terms of inorganic growth in future.

WorleyParsons is set to benefit from the improving capital expenditure cycle, which could see strong earnings growth in the medium term.

It is leveraged to the global energy transition and expects significant increases in conventional oil and gas investment. This should drive the hydrocarbons business, increases in global primary chemicals production, and higher metals and minerals production to support growth in renewables and electric vehicles.

The Jacobs acquisition has changed the structure of WorleyParsons, with chemicals now its largest exposure. **See Figure 3** for the sectoral split.

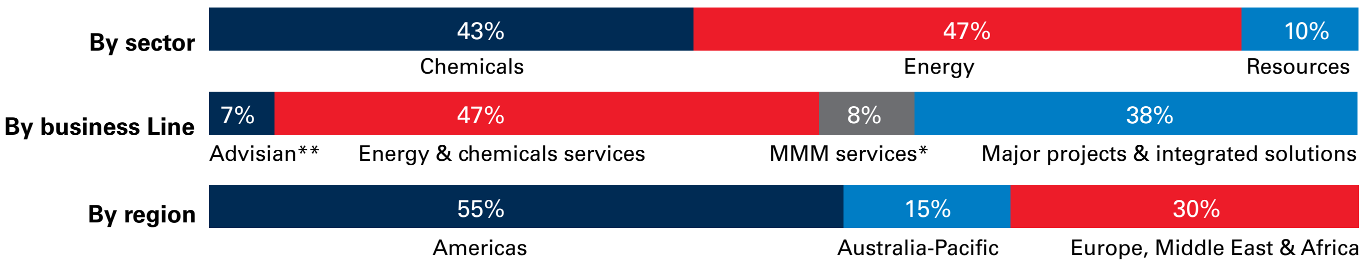
The acquisition has also driven a big rise in the company's contract backlog, with the chemicals sector now the largest component of the overall backlog by value. This has stabilised at $18 billion.

Staff utilisation levels, the key leading indicator for reimbursable business (which accounts for 83% of revenue, versus 17% from lump-sum or fixed-price work), continue to rise.

The company also raised its cost-savings target from the Jacobs acquisition to $150 million per annum from $130 million, with 60–70% to be achieved on a run-rate basis in the next 12 months.

Our positive view on WorleyParsons is driven primarily by its already strong pipeline of work, expectations that resources capital expenditure has bottomed and is steadily improving, the Jacobs acquisition that increases its footprint in the Americas and diversifies its client base, and the presence of key strategic shareholders, such as Dubai-based Dar Group, on the register.

Figure 3: Business profile post Jacobs acquisition (%)



* Metals, mining and minerals ** Advisian is WorleyParsons' consultancy arm. Source: Company data

CHARTER HALL EDUCATION TRUST

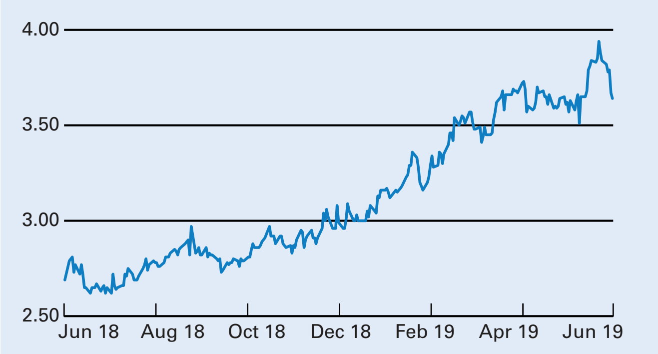
CLASS ACT

Sector: Real Estate Recomm: Hold Risk rating: Medium Share price: $3.64

Year to June	2018A	2019E	2020E
Profit after tax ($m)	41.9	44.2	54.5
Earnings per share (¢)	16.5	16.5	18.0
Price/earnings (x)	22.1	22.1	20.2
Dividends per share (¢)	15.1	16.0	16.6
Dividend yield (%)	4.1	4.4	4.6
Franking (%)	0	0	0

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

Charter Hall Education Trust (CQE) share price



Source: IRESS

Charter Hall Education Trust is a social infrastructure real estate investment trust with a $1.18 billion portfolio of childcare centres and a robust development pipeline.

Ord Minnett recently initiated coverage of the trust with a Hold rating and a $3.65 target price.

Demand for childcare is likely to remain strong, underpinned by government subsidies, population growth, an increased female workforce participation rate and less use of informal childcare.

The trust is the largest childcare centre owner, with 430 centres in Australia and New Zealand, and has expertise in the sector with capability in asset selection, development and portfolio optimisation.

Formerly known as Folkestone Education Trust, Charter Hall Education is the latest addition to the **Charter Hall Group** stable of listed vehicles. This should give improved access to transaction markets and opportunities to expand and diversify.

This should, in turn, drive strong EPS growth over the next three years.

The portfolio is based on triple net leases with the tenant responsible for all outgoings on 15-year terms.

The trust does not pay incentives or capital expenditure and is moving away from CPI-based rent rises to fixed annual reviews, further de-risking rental income. See **Figures 4 and 5** for a split of rental income.

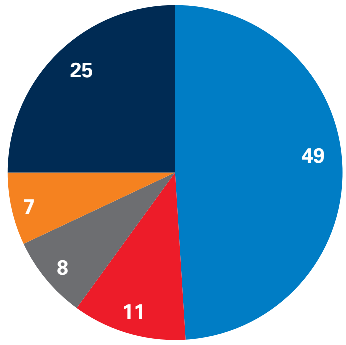
Management has a strong track record in acquisitions and developments, having more than doubled the portfolio value over the past four years, leading us to forecast the trust will deliver a three-year EPS compound annual growth rate of 5.7%.

Following a $120 million capital raising in March, it has the ability to debt-fund its strategy for the next two years. We forecast this will drive earnings growth of more than 9.2% in fiscal 2020 and more than 5.6% in fiscal 2021, well above peer averages of 5.8% and 1.5%, respectively.

Charter Hall Education is trading on a forecast fiscal 2020 price-earnings ratio of 20 times, with a 4.6% distribution yield, representing a premium to other small-capitalisation REITs.

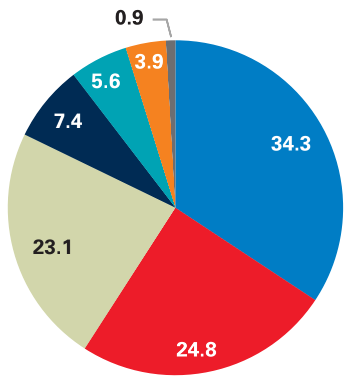
We see this valuation as justified, given the trust's strong growth profile, high-quality portfolio, favourable lease terms, strong management and ability to leverage the broader Charter Hall platform.

Figure 4: Rent by tenant (%)



Goodstart Early Learning
Only About Children
G8 Education
Best Start
Other

Figure 5: Rent by geography (%)



Queensland
NSW/ACT
Victoria
New Zealand
South Australia
Western Australia
Tasmania/NT

Source: Company data

SANTOS

ROAD TO EL DORADO

Sector: Energy Recomm: Buy Risk rating: Higher Share price: $7.08

Year to December	2018A	2019E	2020E
Profit after tax ($m)	972.4	1,140.9	1,256.4
Earnings per share (¢)	46.4	54.4	59.9
Price/earnings (x)	15.3	13.0	11.8
Dividends per share (¢)	13.0	9.2	8.6
Dividend yield (%)	1.8	1.3	1.2
Franking (%)	100	100	100

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

Santos (STO) share price

Source: IRESS

Santos is an energy producer with a strategy to double its annual production to more than 100 million barrels of oil equivalent (mmboe) by 2025.

The increase in production will be driven by acquisition and by development of its prospective fields, in particular, the Dorado field offshore Western Australia that came with its 2018 purchase of Quadrant Energy for US$2.15 billion.

Santos is also running drilling campaigns in the Cooper Basin in South Australia and in Queensland.

The company is due to make a final investment decision (FID) on its offshore Northern Territory Barossa project to supply gas to the Darwin liquefied natural gas (LNG) project in early 2020.

To this end, Santos recently entered exclusive talks with the Darwin LNG joint venture to settle on a processing services deal and a tariff before FID.

Management has bedded down the acquisition of the Quadrant Energy assets and had success in lowering costs in the core business.

The Dorado field, which industry analysts describe as the largest Australian oil find this century, is highly prospective. It will be a key driver, along with the other Quadrant Energy assets, of the targeted rise in production to more than 100mmboe by 2025 from 57mmboe in 2018. See **Figure 6** for each asset's proportional contribution.

Recent drilling results from the Dorado-2 appraisal confirmed a large oil and gas resource intersecting multiple reservoirs. The key positive was confirmation that all reservoirs are in pressure communication, which enables more accurate estimation of reserves, at the same intervals as the earlier Dorado-1 well.

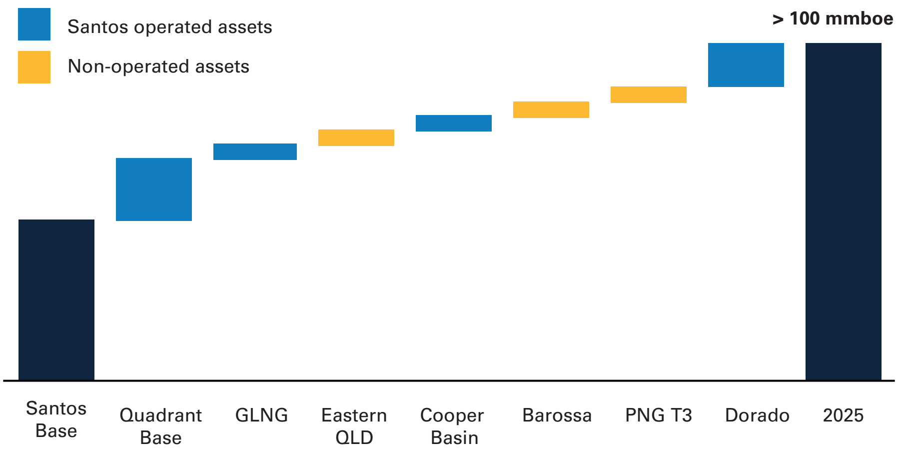
This suggests the resource size could be significantly larger than earlier drilling had indicated, and goes a long way to de-risking the project.

In Ord Minnett's view, the positive results show potential upside to the current estimate of 50,000 barrels per day gross, or 15 million barrels per annum.

In addition, the production forecast does not include any output from the condensate-rich gas that has also been delineated at Dorado.

Santos offers fully funded growth, a strong balance sheet and cash flow, with estimated breakeven at US$35 a barrel, and exposure to both east and west coast gas prices.

Figure 6: Santos medium-term production guidance



Source: OML, Company data

BLUESCOPE STEEL

NORTH STAR DIMS

Sector: Metals & Mining Recomm: Accumulate Risk rating: Higher Share price: $12.05

Year to June	2018A	2019E	2020E
Profit after tax ($m)	826.0	937.6	390.8
Earnings per share (¢)	148.6	174.1	73.3
Price/earnings (x)	8.1	6.9	16.4
Dividends per share (¢)	14.0	14.0	14.0
Dividend yield (%)	1.2	1.2	1.2
Franking (%)	10	0	0

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

BlueScope Steel (BSL) share price

Source: IRESS

BlueScope Steel is a global steel products manufacturer with operations predominantly in Australia, New Zealand, North America and the ASEAN region.

The company recently downgraded its earnings guidance and Ord Minnett has updated its estimates accordingly.

BlueScope now expects fiscal 2019 underlying earnings before interest and tax (EBIT) of $1.35 billion, versus previous guidance for $1.4 billion – a downgrade of 4%. We note, however, that this implies a 9% downgrade to second-half EBIT.

The company highlighted that better-than-expected steel spreads (i.e. spreads did not fall as far as forecast) were offsetting weaker-than-expected domestic volumes from its Australian Steel Products division.

BlueScope did not discuss this in detail, which leads us to be somewhat cautious that the company could be foreshadowing some impact in fiscal 2020 from a shifting sales mix.

To date, the company has highlighted it has been largely insulated from declines in home construction, with exposure to alterations and additions and only limited multi-residential exposure.

Our concern, however, is that the late-cycle nature of its building products, such as roofing, means there could be a delayed impact into fiscal 2020.

The earnings downgrade from BlueScope was not unexpected given our observations of declining spreads in the US. The downgrade to US spreads of US$150 a tonne half-on-half (HoH), however, is a better outcome than the US$161 a tonne fall we had forecast.

This outcome means we have actually increased our fiscal 2019 EBIT forecast by 1% to $1.33 billion from $1.32 billion.

Our estimate for fiscal 2020 EBIT, however, has been cut by 20% to $621 million from $780 million, due mainly to the steep decline in US steel spreads that impact its North Star plant in Ohio.

We forecast US spreads of US$230 per tonne for fiscal 2020, noting that just 10 months ago spreads were at US$560 per tonne and BlueScope was evaluating a North Star expansion.

To put this into context, due to the steep spread declines, we now estimate EBIT of $56 million from North Star in the first half of fiscal 2020, versus the $412 million result in the first half of fiscal 2019.

We have been supporters of a North Star expansion in the past, but sanctioning of the project in the present environment, with spreads below levels of viability and concerns of US oversupply, would be received negatively by the market.

A better outcome would be to defer the project and instead buy back shares.

The downgrade notwithstanding, BlueScope is trading well below our June 2020 discounted cash flow valuation of $15.00 a share, leading us to reiterate our Accumulate recommendation.

ALLIANCE AVIATION SERVICES

REACH FOR THE SKY

Sector: Transport Recomm: Buy Risk: Higher Price: $2.58

Alliance Aviation operates a variety of regular services, fly-in fly-out operations for the resources industry, commercial services for Virgin Australia and ad hoc charters.

The airline's recent positive trading update that highlighted a business with earnings in an upswing. It expects fiscal 2019 profit before tax to be *"in excess of"* $32.5 million, a record full-year result for the company, and also implies a company half-year record of at least $18 million.

The business is well-positioned from a fundamental perspective, with its industry-leading on-time performance rating of 95%. Recent news flow has highlighted further expansion of its relationship with Virgin Australia in Queensland.

The company has also confirmed the addition of six more planes to its fleet, taking the number of active aircraft to 44 by the end of 2019.

The fleet will comprise 25 Fokker 100 jets (seating 100 passengers), 14 Fokker 70 jets (80) and five Fokker 50 turboprop aircraft (50).

Alliance offers both wet leasing services (where it provides a fully crewed and serviced aircraft) and dry leasing (where only the aircraft is provided). It also provides spare parts supply, and engine sales and leasing services.

Alliance has demonstrated an ability to not only deploy recent aircraft additions productively, but also to do it at increasing rates of profitability per aircraft.

The company also offers an attractive yield of 6.6%, based on a forecast dividend per share of 17 cents, fully franked, for fiscal 2020.

Furthermore, the acquisition by Qantas Airways of a 19.9% stake in Alliance (subject to regulatory approval) underscores the strategic value of the Alliance business and its ability to continue 'delivering the goods'.

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