ORD MINNETT

PRIVATE WEALTH

June 2019

ORDS MONTHLY

WINNING PERFORMANCE

POLICY CONVERGENCE

"We see potential for the Australian market to continue its outperformance, even as the domestic macroeconomic outlook presents some challenges."

The Australian equity market proved to be a shining light in May, gaining 1.1% in a month when all its developed market peers slid at least 3% and some lost more than 9%.

Souring relationships between the US and most of its major trading partners spurred the poor showing in most markets in May, and we see little sign of improvement in the near term.

That said, we see potential for the Australian stock market to continue its outperformance, even as the domestic macroeconomic outlook presents some challenges.

These challenges have led us to revise our economic growth forecasts to account for both external headwinds and what we now see as a significant boost coming from convergence of fiscal and monetary policy. See our Investment Strategy note on pages 2–3 for our view on how this will develop.

Our corporate coverage this month leads off with a review of the multi-pronged portfolio of the 'Big Australian'.

BHP's strategic approach is very much one of 'make haste slowly', and on page 4 we highlight the company's thinking on its key divisions.

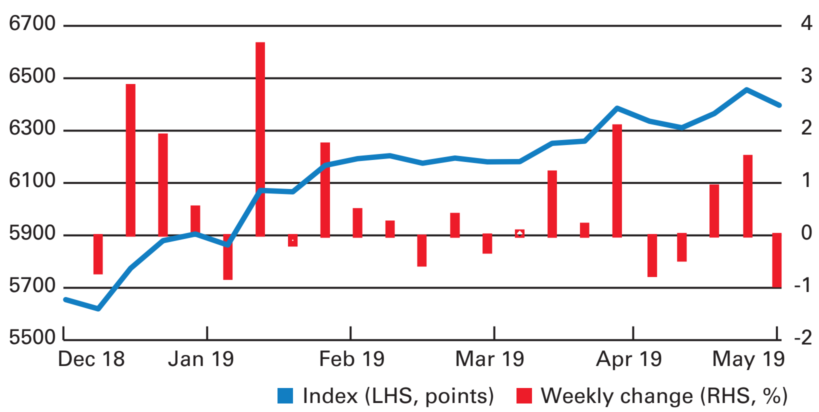
It was a disappointing trading update for the March quarter from **Commonwealth Bank**. Weak revenue trends, rising customer remediation costs and pressure on non-interest income all echoed the issues highlighted in first-half results from Commonwealth Bank's September-balance-date peers last month. See page 5 for our review.

Aristocrat Leisure continues its winning streak as one of the nation's best overseas operators. Strong recurring revenue streams and market share growth in the key North American market propelled the land and digital gaming group to a strong first-half fiscal 2019 result. We continue to see the risk-reward equation as very attractive for Aristocrat and lay out our investment thesis on page 6.

Time is certainly on the side of **Charter Hall Long WALE**, with the property trust's defining characteristic being the extended length of the leases over its low-risk and diversified portfolio. On page 7, we review that portfolio and its exposure to what is, in our view, a material shift in investor demand. Now favoured are long weighted average lease expiry (WALE) assets in a macroeconomic environment of low interest rates.

Lastly, **Fortescue Metals** put a smile on shareholders' faces with an early declaration of its final dividend, courtesy of strong free cash flow from a surging iron ore price. We do not forecast a further payout with the fiscal 2019 results in August, but we do expect returns to shareholders to feature in fiscal 2020. Page 8 has more.

Figure 1: S&P/ASX 200 Index weekly performance in 2019 (to 31 May)



Source: Ord Minnett Research, Iress

INVESTMENT STRATEGY

RATES RETHINK

The Australian stock market has outperformed its developed market counterparts in 2019 so far. It may well continue to do so, although global trade ructions and some domestic weakness have led us to redraw our view of the wider economic picture.

We have recently raised our forecast for cuts to the official cash rate of the Reserve Bank of Australia (RBA) to an additional 50 basis points (bp) of easing in 2020.

This further easing is on top of the widely expected 25bp cut delivered at the bank's June meeting and would leave the benchmark interest rate at 0.5% by the middle of calendar 2020.

At the local level, these changes largely reflect explicit recognition by RBA governor Philip Lowe that an unemployment rate below 5% can be sustained and, in fact, needs to be actively pursued to hit the central bank's inflation target band of 2–3%.

A broad rule of thumb is that an easing of 50bp should reduce the unemployment rate by 0.15 percentage points over the subsequent 12–18 months.

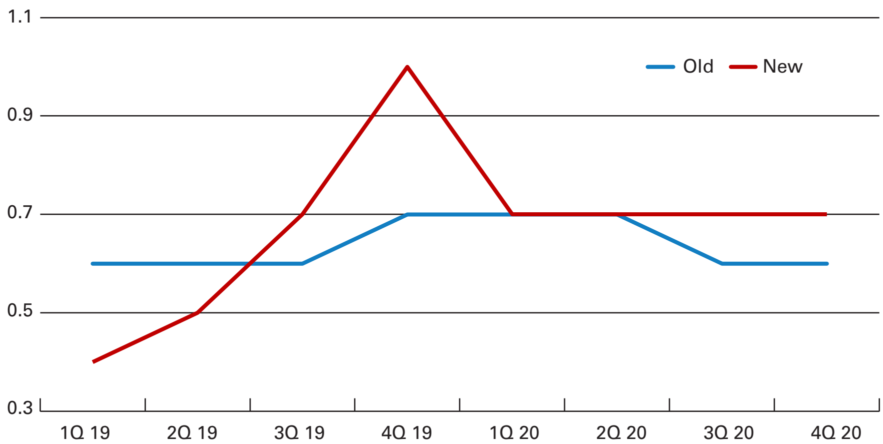
Assuming a starting level of 5.2% for the unemployment rate, our previous estimate of 50 bp of easing were inadequate to deliver the macro-economic outcomes necessary to achieve a pick-up in inflation, hence our forecast revisions.

More widely, we also highlight the cross-currents of a deteriorating global economic backdrop amid trade conflicts, along with more dovish policy from other central banks, and domestic fiscal policy easing.

Reflecting these expectations, we have also revised our estimates for economic growth. Our forecast for gross domestic product (GDP) growth in calendar 2019 is now 1.9%, down from 2.1% previously, while our estimate for GDP growth in 2020 has been increased to 3.0% from 2.7% previously.

As Figure 2 below shows, we have factored in some short-term weakness before the impact of looser monetary policy and expansionary fiscal policy kick in.

Figure 2: Economic growth forecasts post changes in interest rate expectations (%)



Source: Ord Minnett Research

In the near term, the dominant forces are the weak March-quarter GDP numbers and an increasing drag from trade in the June and September quarters.

It is worth highlighting here that so far global trade ructions have not threatened the federal government's coffers. This is because a surge in key commodity prices, and iron ore in particular, has driven the value of our exports higher even as export volumes have drifted lower, at least partly in response to tariffs.

The strong trade performance means the first stage of fiscal policy easing – the low- and middle-income tax offsets – is still in train and likely to be passed into law soon. This boost to household income will underpin second-half GDP growth, with most of the benefit coming in the December quarter as Figure 2 shows.

The aforementioned trade conflicts show no sign of abating, with the White House recently imposing a 5% tariff – increasing to as much as 25% – on all goods imported from Mexico. The move is designed to force America's southern neighbour into tightening its borders to stem the flow of illegal immigrants into the US.

"This boost to household income will underpin second-half GDP growth, with most of the benefit coming in the December quarter."

Meanwhile, the relationship between the US and China remains strained, with China threatening to blacklist what it calls 'unreliable' foreign entities in retaliation for bans on Huawei.

Further mooted retaliatory measures include 'weaponising' its dominant position in rare earths production – China is responsible for 80% of global production of the materials which are used in everything from smartphones to nuclear armaments.

These developments have driven downgrades to China and US growth forecasts, and could now see the US central bank cut its federal funds rate this year. In fact, at time of writing, St Louis Federal Reserve president James Bullard was suggesting a cut in interest rates *"may be warranted soon"* to support inflation and offset economic risks from escalating trade conflicts.

From an asset allocation perspective, we are neutral on equities and bonds, with a slight overweight in cash to absorb market volatility as global trade conflicts play out. Against this backdrop, we see potential for the Australian stock market to continue to outperform its developed market counterparts. See Figure 3 for the comparison over 2019 so far.

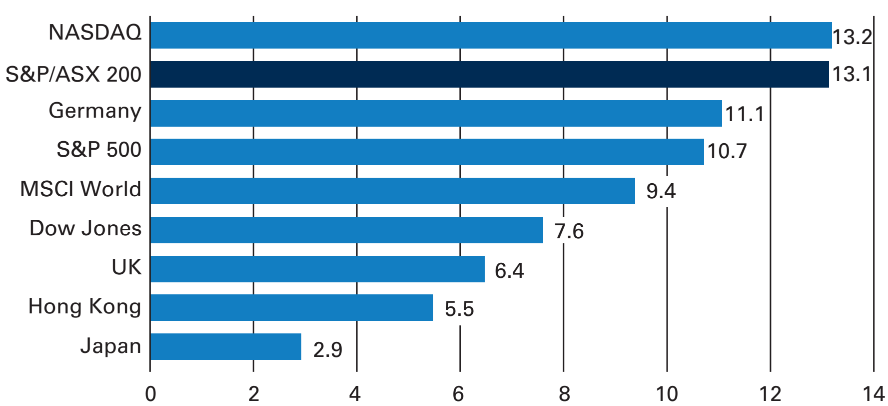
Within equities, defensive sectors, such as healthcare, and yield stocks are the focus. Yield stocks are likely to remain relatively attractive given expected interest rate cuts from the RBA and the possibility of easier monetary policy by the US Fed if trade tensions persist.

Some of our preferred yield ideas include **AusNet Services**, the operator of electricity and gas distribution networks in Victoria, and **Charter Hall Long WALE**, a property trust focused on long-dated leases. See page 7 for more on Charter Hall Long WALE.

We also suggest adding some gold exposure. Gold does not pay an income, but it tends to do well late in the cycle, when real rates stay low, and in times of uncertainty it acts as a safe haven. We prefer a pure play exposure to the gold price via **ETFS Physical Gold (GOLD)**.

Our expectation of steeper interest rate cuts in Australia, coupled with some linkages to China weakness, also puts pressure on the Australian dollar against its US counterpart. Our forecast is for the currency to be closer to US$0.66 by year end, with the **Betashares US Dollar ETF (USD)** being one way to benefit from this.

Figure 3: Global markets performance in calendar 2019 (%)



Source: Ord Minnett Research, Iress

BHP GROUP

STEADY SHIP

Sector: Metals & Mining Recomm: Hold Risk rating: Higher Share price: $37.76

Year to June	2018A	2019E	2020E
Profit after tax ($m)	11,523.1	14,260.6	17,768.3
Earnings per share (¢)	216.5	281.9	351.3
Price/earnings (x)	17.4	13.4	10.7
Dividends per share (¢)	152.2	344.4	246.8
Dividend yield (%)	4.0	9.1	6.5
Franking (%)	100	100	100

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

BHP (BHP) share price

Source: IRESS

BHP Group, the world's largest resources company by market capitalisation, recently provided an update on its portfolio strategy and Ord Minnett highlights the key divisions below.

WA iron ore

BHP has no desire to expand its Western Australian iron ore operations in the Pilbara in the near term, and it would take several years to put through a meaningful expansion in any case.

The company expects the currently curtailed production from Brazil's Vale (due to tailings dam failure) to return to the market around the time that BHP could deliver a potential expansion, so it is challenging to justify such an expansion.

Copper

BHP does not plan another large-scale expansion of the Escondida project in the Atacama Desert in northern Chile until the end of the 2020s, when grades of the red metal at the world's largest copper mine are expected to decline to 0.6% from 0.9–1.0% currently.

This issue – i.e. as grades decline more ore needs to be processed to produce the same amount of metal – is also a factor at the Spence operation, also located in the Atacama Desert.

Olympic Dam

The brownfield expansion concept designed to take production at the giant copper-gold-silver-uranium miner in South Australia to 330,000 tonnes per annum has been reduced in scope to 240–300,000 tonnes, as the ore body is not as contiguous as first thought.

BHP expects a final investment decision to be made by mid to late 2020.

Metallurgical coal

The BHP Billiton Mitsubishi Alliance in Queensland is planning a 12–16 million-tonne expansion. BHP is confident the market can take the additional tonnes, and sees low-capital-intensity expansions at Black Water and Caval Ridge projects.

Metallurgical coal, also known as coking coal, isn't just a China story – there is growth in steel output in India, which produces no local metallurgical coal.

BHP also sees reserve depletion across the industry, and believes new supply coming on is largely inferior in quality to the product coming from the Bowen Basin.

Thermal coal

BHP may close its thermal coal arm in the early 2020s once tax losses are used up. These losses are around US$600 million for the Hunter Valley Mt Arthur mine, an amount seen as material when considering the after-tax value for shareholders.

An exit will be easier once these tax losses are utilised in the early 2020s – a spin-off has been considered in the past but is complex, and a trade sale would be simpler.

Oil

BHP sees the oil outlook as very attractive into the 2020s, with demand peaking in the 2030s, and a 4-percentage-point gap between demand growth and supply – i.e. 1% demand growth with a 3% decline in supply. This leaves demand in a state of inducement economics – with an oil price that provides incentive for new supply – continuously over that period.

COMMONWEALTH BANK OF AUSTRALIA

INTERESTING TIMES

Sector: Financials Recomm: Hold Risk rating: Medium Share price: $78.51

Year to June	2018A	2019E	2020E
Profit after tax ($m)	8,915.0	8,590.6	9,344.6
Earnings per share (¢)	495.7	470.1	512.0
Price/earnings (x)	15.8	16.7	15.3
Dividends per share (¢)	431.0	431.0	431.0
Dividend yield (%)	5.5	5.5	5.5
Franking (%)	100	100	100

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

Commonwealth Bank (CBA) share price

Source: IRESS

Commonwealth Bank delivered a trading update for the third quarter of fiscal 2019 that was weak across the board. The update featured soft underlying revenue trends, much higher-than-expected remediation provisions and deteriorating asset-quality trends.

Overall, the result highlighted that while CBA has an enviable position in the industry, it is not immune to challenges facing the broader banking market.

This was particularly evident in the additional remediation, regulatory and compliance provisions in the quarter, as well as ongoing pressures on non-interest income.

Underlying cash net profit of $2.215 billion was 9% below the quarterly average of the first half of fiscal 2019, struck on 4% lower revenue.

This was partly due to timing effects on net interest margins and higher insurance claims, but even so, we still estimate revenue was 1.1% lower in the quarter despite significant benefits from full-period mortgage repricing.

Non-interest income headwinds were particularly acute, with this category falling 10% on a headline basis. We note the rebasing of fees and commissions is expected to have a permanent impact, and there are some residual effects to come in the June quarter.

CBA topped up its provisions for remediation, regulatory and compliance programs by $714 million. This included $334 million of aligned advice remediation costs, bringing the total to $534 million.

There was also $156 million of 'other program costs', which the other banks appear to have treated as 'business as usual' costs, and $152 million of banking customer refunds.

CBA's asset-quality metrics deteriorated over the quarter. Bad and doubtful debts increased to $314 million, equating to 17 basis points (bp) of gross loans and acceptances (GLA), up from 15bp in the first half.

Consumer arrears were higher in all segments, with housing arrears rising 4bp on the first half to 71bp of GLA.

Total accounts in negative equity came in at 3% for the group, with approximately three-quarters located in Western Australia and Queensland.

Gross impaired assets and those classified as 'Corporate Troublesome' both rose quarter-on-quarter.

Following the result, we have reduced our cash net profit forecasts by 7% for fiscal 2019 and by 4% over the fiscal 2020 to fiscal 2021 period, due to lower revenue.

Based on our revised numbers, CBA is trading at 15.3 times fiscal 2020 forecast earnings, which in our view places it in the fair- to full-valuation camp.

We also note, however, the strong capital position that should emerge over the next 12 months, along with potential cost savings and capital management in the medium term.

ARISTOCRAT LEISURE

A GOOD BET

Sector: Consumer Services Recomm: Buy Risk rating: Higher Share price: $29.12

Year to September	2018A	2019E	2020E
Profit after tax ($m)	729.6	850.3	1,002.3
Earnings per share (¢)	114.1	133.3	157.1
Price/earnings (x)	25.5	21.8	18.5
Dividends per share (¢)	46.0	55.5	69.0
Dividend yield (%)	1.6	1.9	2.4
Franking (%)	100	100	100

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

Aristocrat Leisure (ALL) share price

Source: IRESS

Aristocrat Leisure is a slot machine manufacturer with operations in Australasia, the Americas and other international segments, as well as a fast-growing digital gaming division.

The company has strong recurring revenues and has been consistently gaining market share in an overall flat North American market. It recently posted a first-half fiscal 2019 net profit of $422.3 million, up 16.8% on a year ago and ahead of our $410.0 million forecast. A fully franked interim dividend of $0.22 per share was also declared.

Sustained growth in North America was in line with our projections, and operating earnings growth of 27.3% in the Americas land-based business was strongly encouraging for the second-half outlook. In addition, the digital business is primed to showcase the benefits of its global design and development platform in fiscal 2020.

Aristocrat's markets in Oregon, Washington state and Canada accounted for 80% of the growth in first-half platform sales.

The second half will continue to see growth, albeit with reduced average selling prices.

We forecast second-half platform sales of 1,987-plus, made up of 250 bar-top machines, circa 1,000 machines across two video lottery terminal networks, further Washington casino data systems and about 500 organic churn sales, with the remainder coming from sales of its RELM stepper cabinet and the like.

Native American gaming operations had an installed base of 24,681 machines in the first half, with additional 5% growth to 25,477 forecast for the full year.

The traditional poker machine installed base grew 18.5% to 21,695 units in the first half, in line with our estimate of 21,965 units. We expect these premium products to continue expanding, driven by the *Dragon Link* title and RELM content adoption. We forecast another 14% increase in the installed base, to 22,930 units, in the second half of fiscal 2019.

The digital division delivered a better-than-expected result, with a profit margin of 30%, above our 28.9% estimate.

Ord Minnett expects margins to vary in the 30–35% range in the digital business as the portfolio continues to undergo changes, with higher margins expected in the long term.

We also see potential upside to digital forecasts as Aristocrat's ecosystem has scale, unique cross-company knowledge-sharing, dedicated live operations studios, and good land-based content supporting its online casino growth.

Aristocrat is methodically executing a digital strategy to derisk title development for land-based slot machines via its digital platforms.

Growth potential still exists in both digital and land-based markets through fiscal 2020, with capital management opportunities also available.

Coupling this with solid execution by management, strong free cash flow and a well-capitalised balance sheet, we still find the risk-reward equation on Aristocrat attractive.

CHARTER HALL LONG WALE REIT

PLAYING A LONG GAME

Sector: Real Estate Recomm: Buy Risk rating: Medium Share price: $4.91

Year to June	2018A	2019E	2020E
Profit after tax ($m)	58.4	71.1	83.2
Earnings per share (¢)	26.4	27.0	28.9
Price/earnings (x)	18.6	18.2	17.0
Dividends per share (¢)	26.4	27.0	28.9
Dividend yield (%)	5.4	5.5	5.9
Franking (%)	0	0	0

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

Charter Hall Long WALE (CLW) share price

Source: IRESS

Charter Hall Long WALE REIT holds a high-quality, low-risk diversified property portfolio, with the key investment feature being the extended length of its weighted average lease expiries (WALE).

The trust has 38% of its assets in the industrial segment, 26% in office, 25% in retail/hotels and 11% in the Inghams chicken processing facilities.

Ord Minnett recently reviewed Charter Hall's portfolio, which highlighted its exposure to what we see as a meaningful shift in demand for long lease expiry assets in Australia.

We anticipate a capital flight to high-quality assets with long-term leases and structured growth in a low-interest-rate environment.

Based on transactions of assets with a 10–15 year WALE, we value the Charter Hall portfolio in our sum-of-the-parts valuation using an ungeared internal rate of return of 6.25–6.50%, based on an inflation rate of 1.5% per annum.

These metrics support our thesis of capital flowing to long-WALE assets with rent increases, albeit with lower assumed inflation and nominal income growth.

Our global comparison of triple net lease (where the tenant pays non-capital outgoings as well as the rent) or long-WALE peers in the US and the UK – spanning some $75 billion in market capitalisation – suggests Charter Hall's return on capital is relatively high.

Based on our estimates, the group is trading at an above-average implied capitalisation rate with higher rental increases. Its unleveraged internal rate of return of 7.0–7.5% is a 550–600 basis-point spread to the long bond yield, the highest among its REIT peers.

The trust offers a one-year forward distribution yield of 5.9%, with an annual distribution growth rate of 3–4% for the next three years, based on our forecasts, underpinned by a predominance of fixed rent increases.

We estimate Australian REITs are trading on an average one-year forward distribution yield of 5.3%, with a 2.8% EPS compound annual growth rate for the next three years.

This makes Charter Hall's near-6% distribution yield and 4% annual EPS growth attractive given its limited exposure to lower inflation and/or lower GDP growth.

The key leasing risk is the REIT's Metcash facility in Perth, an asset we consider to be materially over-rented, i.e. the current rent is above prevailing market rates.

Metcash leases about 100,000 square metres (sqm) of gross lettable area with about 4.5 years remaining, and we forecast rent will fall by around $50/sqm when it is re-leased after expiry.

Our preference is for the risk to be mitigated by selling the asset. That said, it is one of the better-located sites of its kind in Perth and has development potential. We expect the lease to be extended and e-commerce user demand to improve.

FORTESCUE METALS

EARLY PAYOUT

Sector: Metals & Mining Recomm: Buy Risk: Higher Price: $8.05

Fortescue Metals (FMG) recently surprised the market with the early declaration of its dividend for the second half of fiscal 2019, setting a payout of $0.60 per share – a touch higher than Ord Minnett's $0.57 estimate.

The payment, in addition to the first-half dividend of 30c, brings the full-year payout to $0.90 per share. This equates to a 73% payout ratio, versus guidance for 50–80%, and a total shareholder return of about 12% in fiscal 2019.

Our forecast fiscal 2019 dividend was $0.87 per share, above the Bloomberg consensus of $0.82.

Fortescue hasn't ruled out a further payment with its full-year result in August, although we do not expect anything further.

The announcement accelerated dividend payments to shareholders given strong cash flows from a buoyant iron ore market. It also reflected a desire to distribute franking credits ahead of expected, but now moot, policy changes if the Labor Party had won government at the federal poll in mid May.

Iron ore markets remain tight, with Fortescue's spot achieved price estimate remaining at US$82 per tonne at the time of the dividend announcement.

That price implied a spot free cash flow yield of 26%, even before the recent run higher to more than US$90 a tonne for Fortescue's main product – the lower-specification 58% iron content product – and to around US$110 per tonne for the benchmark 62% iron product.

We expect more returns to be a feature of fiscal 2020, and forecast a full-year dividend of $1.09 per share.

Fortescue offers exposure to long-life operations and should generate solid margins in the near future. We maintain our Buy rating on Fortescue, with the stock screening as good value based on our positive view of the iron ore market.

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

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