ORD MINNETT
PRIVATE WEALTH

June 2018

ORDS MONTHLY

US INTEREST RATES

LEADING THE WAY

Interest rates in the world's largest economy are a key driver of global economic momentum and in this issue of the Ords Monthly, we consider the outlook after US 10-year bond yields recently pierced the 3% mark to reach multi-year highs.

We had forecast a rise in US yields over 2018 but the drivers have turned out to be different from what we expected, with the oil price, rather than economic fundamentals, providing the impetus.

At this stage, we don't believe another small increase in US bond yields will dramatically alter economic conditions or presage a recession. We expect, however, more volatility and the pace of equity market rallies to slow, compared with previous years when interest rates were more accommodative. See our Investment Strategy note on page 2 for more.

In the same note, we have also moved to update our list of preferred stocks across various investment categories.

The key addition overall to our list of top choices for 2018 is **Ansell**, which we include in the 'balance-sheet appeal' category. We are positive on the outlook for the global protective wear manufacturer, and lay out our investment thesis in detail on page 4.

The key removal from our lists is **Ramsay Health Care**, which we have cut from both the 'global over local' and 'structural growth' categories.

Recent feedback from private hospital groups suggests there has been little improvement in operating conditions in Australia, meaning Ramsay will have to scramble to meet its profit targets.

Besides Ansell, in this edition we also cover the continued strong performance of **CSL**, with the plasma product and influenza vaccine supplier recently upgrading its earnings guidance for fiscal 2018. See page 5 for more.

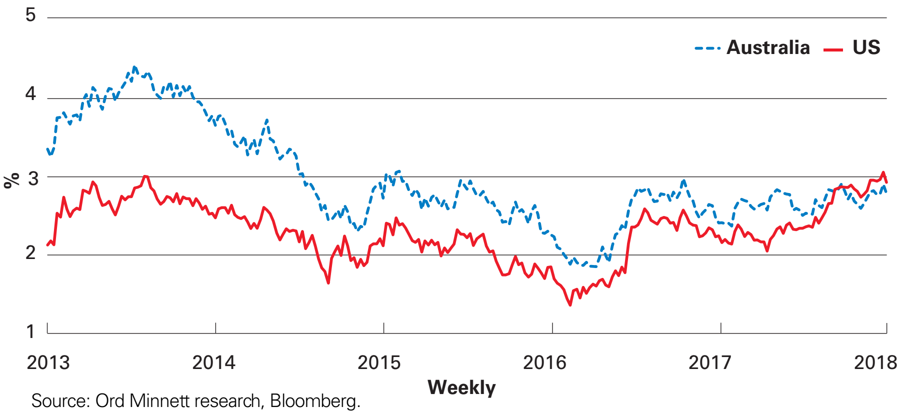
"We are positive on the outlook for the global protective wear manufacturer Ansell"

Meanwhile, **Wesfarmers** has extricated itself from what has proved to be a disastrous expansion of its previously all-conquering Bunnings brand into the UK and Ireland. The new management has engineered the exit for a loss on divestment of $350–400 million, well down on our forecast of circa $1.1 billion. We cover the deal and the outlook for the conglomerate on page 6.

Aristocrat Leisure keeps ringing up the wins, and its latest result continues the streak. Its rapidly growing digital business is posting larger than expected margins and its North American gaming operations just keep on paying out. See page 7 for our views.

Finally, we run the ruler over **Steadfast Group**. At its recent investor day, the insurance broker provided an upbeat view on the likely earnings boost over the medium term from the increasing adoption of its new client trading platform. More on page 8.

Figure 1: 10-year bond yields - Australia versus US



Source: Ord Minnett research, Bloomberg.

INVESTMENT STRATEGY

SELECTING WINNERS

The US 10-year Treasury bond yield has focused our recent attention, with the key interest rate indicator breaking the psychological barrier of 3% to hit a multi-year high.

That US bond yields have risen this year is no surprise, but the drivers of the move have recently deviated from our expectations.

In our view, bond yields would be driven higher over the course of 2018 by a continuation of strong global economic momentum seen in the December quarter of 2017, rising inflation, and more hawkish rhetoric from central banks. This was certainly the case in the first quarter of the year.

In contrast, it appears that bond yields in the June quarter have been influenced more by the rising oil price (see Figure 2) and technical factors, rather than economic fundamentals which, on balance, have been weaker than expected.

Technical reasons for the rise in bond yields include growing Treasury supply as the US federal government ramps up spending. At the same time, demand from US companies is waning as cash is repatriated from overseas and used instead to buy back shares and make acquisitions.

Our global research counterparts now expect US 10-year bond yields to reach 3.30% by December 2018, up from a previous forecast of 3.15%.

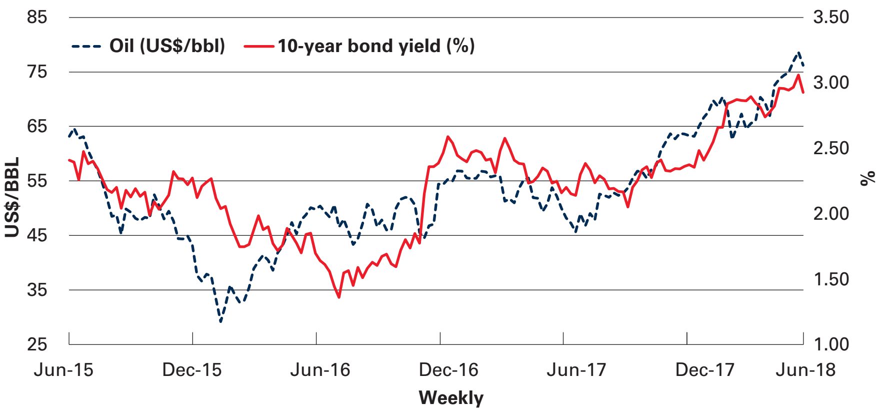
This forecast suggests a slower rate of increase in the second half of 2018, given the implied 30 basis points in the next six months compared with a 60 basis points rise in the year to date.

We contrast this with Australian 10-year bond yields, where we expect a more modest rise to 2.95% by December, given the fiscal deficit has been kept under control and the Reserve Bank is more likely to keep its benchmark rate on hold this year.

At this stage, we don't believe another 30 basis points increase in US bond yields will dramatically alter economic conditions or presage a recession, but we expect more volatility and the pace of equity market rallies to slow compared to previous years when interest rates were more accommodative.

We would watch developments in the yield curve and the level of real

Figure 2: Oil price versus US 10-year bond yield



Source: Bloomberg, Ord Minnett Research

interest rates – nominal interest rates adjusted for inflation – for any bearish signals.

So far, the yield curve has flattened – where the gap between short- and long-term yields narrows – but hasn't inverted – where short-term rates are higher than long-term rates, a scenario often viewed as signalling a pending recession. We note also that real interest rates are still well below levels seen before previous US recessions.

Nevertheless, the anticipation of a further, gradual increase in US bond yields suggests staying underweight fixed income assets and being more selective on bond-like equities, while gaining leverage to a strengthening US dollar against the Australian dollar. We highlight these ideas in further detail below, where we update our preferred stocks.

Portfolio Themes

- **Declining Australian dollar**

  We still forecast a decline in the Australian dollar against the US dollar, although given the unwinding from a peak of nearly US$0.81 since January, our forecast implies a more modest weakening to US$0.74 by the end of 2018, then US$0.73 by March 2019. The main driver of our view is the divergence in monetary policy between the US and Australia, which will see US interest rates rise at a faster pace. For exposure to this theme, we suggest the Betashares US Dollar ETF (USD.AXW) exchange traded fund.

- **Global over local**

  Ramsay Health Care has been removed from this list as recent feedback from private hospital groups, including Healthscope, suggests there has been little improvement in operating conditions in Australia. We see subdued industry conditions continuing, which means Ramsay has to work harder on efficiencies and savings to meet its guidance of 8–10% EPS growth this year.

  We believe Ramsay shares may see further downside before recovering. Our preferred global-focused stocks are **WorleyParsons, Aristocrat Leisure** and **Boral**.

- **Balance sheet appeal**

  The key addition overall to our list of top choices for 2018 is **Ansell**. We are positive on the outlook for the global protective wear manufacturer, and detail our investment thesis on page 4.

  In this same category, we remove **Rio Tinto** as a preferred stock – note that we still recommend holding the stock as the business is in great financial shape, but we are hitting the limits on valuation at present share price levels.

  Our other preferences in this list remain **Alumina Ltd, ANZ Bank, Orora** and **Service Stream**.

- **Inflation beneficiaries**

  We have made no changes to this list. Our choices remain **AGL Energy, QBE Insurance, Oil Search** and **Qube Holdings**.

- **Structural growth**

  We have removed **MYOB** after it abandoned the acquisition of Accountant Group assets from Reckon. MYOB will instead accelerate its spending on product development. Investors will need more patience with the business, as the company forecasts its R&D costs as a percentage of revenue will be higher than usual over the next three years, while underlying earnings margins will decline over the same period. We believe this is too much of a leap of faith, especially given it is contending with rapid growth from its competitor Xero.

- **Risky business**

  This list outlines companies where we see downside risks developing.

  Bendigo & Adelaide Bank has been added to this list. The stock is still trading above our estimate of fair value and does not reflect our caution around higher bad debts and ramifications to credit growth from the Royal Commission, as well as risks to net interest margins from higher funding costs.

  We also add **TPG Telecom** to the list. The junior telco's growth aspirations represent some risk to its balance sheet. TPG is currently spending $1.9 billion to build a fourth Australian mobile network and $200–300 million on a Singapore network. Our analyst forecasts the ratio of net debt to operating earnings to rise to circa 3 times and interest coverage to fall to 3.4 times in fiscal 2020. It is also likely TPG will participate in 5G spectrum auctions in October as well, which would add further pressure to debt levels or precipitate a capital raising.

  We have removed **Metcash** and **Bank of Queensland** from the list, given both stocks have fallen 5–10% to underperform the S&P/ASX 200 Index since they were added to the list in March.

ANSELL

TEAM EFFORT

Sector: Healthcare Recomm: Accumulate Risk rating: Medium Share price: $26.25

Year to June	2017A	2018E	2019E
Profit after tax ($m)	195	194	220
Earnings per share ($)	1.33	1.35	1.57
Price/earnings (x)	19.8	19.5	16.7
Dividend ($)	0.57	0.62	0.66
Dividend yield (%)	2.2	2.4	2.5
Franking (%)	-	54	-

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

Ansell (ANN) share price

Source: IRESS

Ord Minnett is increasingly confident in the outlook for protective wear manufacturer **Ansell** due to solid economic conditions, stable input prices and the potential for the company to deliver sustained market-share gains, as its new approach to its distributor network bears fruit.

Earnings will also be boosted by a transformation program, and there is potential for M&A given its underutilised balance sheet. A more aggressive buyback has been promised if acquisition opportunities are not found.

Expenses related to the transformation program will continue to weigh on reported results, but promised savings should become apparent with underlying fiscal 2018 results.

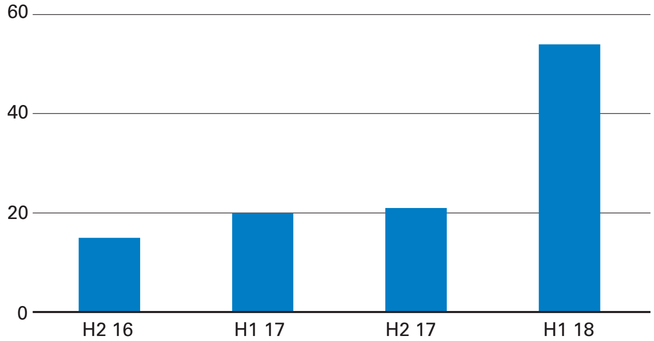
Market share growth is the clear opportunity for Ansell. Despite having a leading share in key hand protection categories, Ansell's overall market share position is modest – based on company data, it has a circa 10% share across the main industrial glove categories. We expect the company's share to lift materially over the next couple of years, noting management's aspirational market share target of 25%.

Ansell's partnership approach to its distributors is a key foundation of our expectations for increased market share and revenue growth (see Figure 3). The company has been rapidly expanding the number of distributor deals, with more than 50 reported in February, up from 21 at the end of fiscal 2017 (see Figure 4). Much of this increase involves smaller European groups, but also a couple of large new US distributors. Combined, these should support a solid lift in market share over the next couple of years.

The partnership strategy is a clear divergence from Ansell's past behaviour, where it had a transactional relationship with distributors and a relatively poor reputation for service.

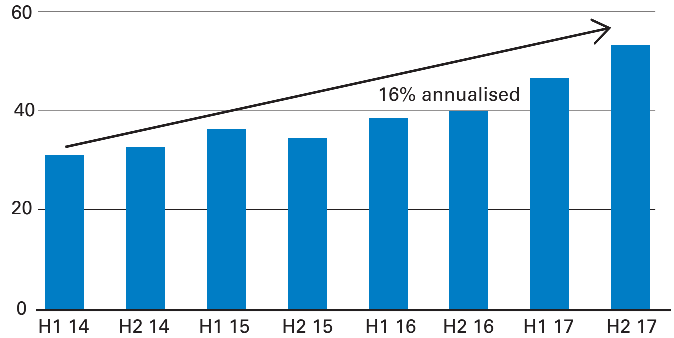
Industry feedback suggests Ansell previously focused on its end customers, often to the detriment of distribution partners. The new deals are tailored to each partner, with both parties agreeing to a clear set of performance criteria, and are designed to deliver gains to both parties.

Figure 3: Number of distributors signed up



Source: Company data

Figure 4: Sales at newly signed distributor accounts



Source: Company data, Ord Minnett estimates

CSL

BLUE-BLOOD STOCK

Sector: Healthcare Recomm: Accumulate Risk rating: Medium Share price: $185.85

Year to June	2017A	2018E	2019E
Profit after tax ($m)	1,742	2,292	2,644
Earnings per share ($)	3.83	5.07	5.85
Price/earnings (x)	48.6	36.7	31.8
Dividend ($)	1.77	2.25	2.55
Dividend yield (%)	1.0	1.2	1.4
Franking (%)	-	-	-

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

CSL Ltd (CSL) share price

Source: IRESS

Pharmaceutical group **CSL** recently raised its net profit guidance for fiscal 2018 to US$1.68–1.71 billion, up from US$1.55–1.6 billion, with the company attributing the upgrade to the timing of costs and a maiden profit from the flu vaccine division.

Ord Minnett, however, also sees the rise in guidance as confirming the prescience of CSL's aggressive investment in plasma collections and fractionation capacity.

Robust plasma demand is expected to continue and there is strong margin support from the group's market-leading therapies – Idelvion, used to treat haemophilia B; Haegarda, a treatment for hereditary angioedema; and Hizentra, for treating primary immune deficiency – leaving us sanguine about CSL's outlook.

The new guidance implies an upgrade of 9.5%, in effect, when a currency tailwind of US$30 million is included, and gives a range of US$1.71–1.74 million.

The company noted the stronger than anticipated result was due to a *"confluence of positive outcomes",* implying some good fortune and timing came into play.

Most notably, the recently-formed Seqirus vaccine benefited from the strong northern hemisphere flu season.

Meanwhile, R&D costs came in below expectations due to delayed dosing in trials of the much-anticipated CSL 112 trial drug. This treatment, designed to rapidly remove cholesterol from the arteries and stabilise lesions at risk of rupture, reduces the high incidence of early recurrent cardiovascular events in the days and weeks following an initial heart attack.

The company will provide profit guidance for fiscal 2019 when it reports its fiscal 2018 result in August.

Despite the strong conditions, we expect CSL to retain its usual conservatism given the uncertainty arising from impending product launches and the flu season. This may see management's guidance fall short of our own profit forecast.

We have raised our earnings estimates by 4% for fiscal 2018 and 2019 following the guidance upgrade.

The positive factors mentioned above are also expected to support further gross margin expansion, confirming a multi-year trend. Operating margins should lift in fiscal 2018 given the phasing of expenses, although we expect this trend to moderate in fiscal 2019 as R&D costs rise.

The key risk to CSL's haemophilia franchise remains competing gene therapies to treat haemophilia B. Progress on this was reported at the recent World Federation of Hemophilia World Congress, but given the uncertainties around such therapies and the fact they are still some years away, we have left our forecasts unchanged.

We reiterate our Accumulate recommendation and have raised our target price to $195 from $171.

WESFARMERS

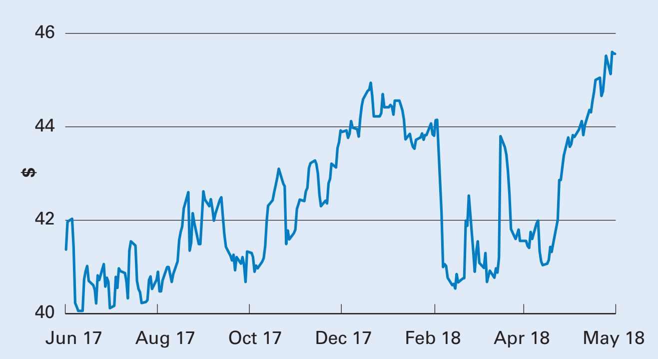
REFOCUSING

Sector: Consumer staples Recomm: Hold Risk rating: Medium Share price: $45.56

Year to June	2017A	2018E	2019E
Profit after tax ($m)	2,859	2,721	2,964
Earnings per share ($)	2.53	2.40	2.61
Price/earnings (x)	18.0	19.0	17.4
Dividend ($)	2.23	2.25	2.30
Dividend yield (%)	4.9	4.9	5.0
Franking (%)	100	100	100

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

Wesfarmers (WES) share price



Source: IRESS

Diversified business operator **Wesfarmers** has extricated itself from the struggling Bunnings UK and Ireland (BUKI) business, selling out to UK-based restructuring specialist Hilco Capital for a nominal amount and taking a loss on sale of £200–230 million ($352–405 million).

Under the deal, Hilco will acquire the Homebase brand, store network, property, leases and inventory, for £1. Wesfarmers will be entitled to 20% of any equity proceeds on a further sale by Hilco.

Wesfarmers will book the loss on sale in its fiscal 2018 results, with the transaction expected to be completed by 30 June.

Including prior writedowns, the BUKI foray destroyed shareholder value of £1.3 billion ($2.3 billion), equal to almost a year's worth of dividends.

The problems were a function of due diligence as well as execution, factors that Wesfarmers management has frankly acknowledged.

That said, final exit costs were much lower than we expected.

Our forecast was for a loss on divestment of £631 million, so the end result reflects well on the business development team, led by newcomer Ed Bostock, a former Kohlberg Kravis Roberts executive.

Following the sale, we have increased our EPS forecasts by 8.7% for fiscal 2019 and 6.3% for fiscal 2020, and the deal should also improve Wesfarmers' gearing metrics.

Wesfarmers has reiterated its intention to grow at a faster rate and is interested in exploring organic or inorganic growth. This is likely to accelerate once the Coles supermarket business is spun out, as the company will be reduced in size. This means future smaller acquisitions – for example, of circa $500 million in enterprise value – would make a material contribution to the group.

Wesfarmers maintains offshore M&A ambitions and has learned from the BUKI experience, but we suggest this will be treated with significant scepticism by the market, not to mention intense scrutiny of any deal.

Locally, Bunnings should continue to perform well following market consolidation and its strong position in Australia and New Zealand.

Coles, under new leadership, could leverage undemanding comparable numbers and margins to drive performance, although Woolworths (WOW, Accumulate) has momentum, with the demerged Coles business needing capital investment.

The industrial divisions have improved due to cost savings and better commodity pricing, although revenue growth remains difficult.

Department stores are increasingly led by Kmart, which remains a strong earnings contributor, while earnings ambitions for Target have been reduced.

New CEO Rob Scott is driving bold change at Wesfarmers, addressing challenged divisions and share price underperformance.

Overall, however, the outlook for Wesfarmers is somewhat mixed and we see a lack of valuation support, leading us to maintain our Hold recommendation.

ARISTOCRAT LEISURE

ENTER THE DRAGON

Sector: Consumer discretionary Recomm: Accumulate Risk rating: High Share price: $30.04

Year to September	2017A	2018E	2019E
Profit after tax ($m)	546	735	808
Earnings per share ($)	0.85	1.15	1.26
Price/earnings (x)	35.2	26.1	23.8
Dividend ($)	0.34	0.46	0.54
Dividend yield (%)	1.1	1.5	1.8
Franking (%)	69	100	100

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

Aristocrat Leisure (ALL) share price

Source: IRESS

Gaming machine operater **Aristocrat Leisure** recently posted an impressive first-half profit for fiscal 2018 of $361.5 million, up 32.5% on a year ago and well above Ord Minnett's forecast of $327.1 million. A fully franked dividend of 19 cents per share was declared, also above our forecast of 18 cents per share.

The result was driven by strong growth in Aristocrat's burgeoning digital business and in its key North American gaming operations.

A focus on higher-quality daily average users drove higher than forecast margins across the digital business, even as average bookings per daily user were below forecasts.

Within digital, the growth was driven by outperformance in the Product Madness arm due to growth in *Cashman Casino* and the launch of *FaFaFa Gold* in the period, while strength in the Big Fish unit was due to the expansion of *Cooking Craze*.

In terms of outlook, Aristocrat is launching new games across multiple genres and many of these will take time to fulfil their monetisation potential.

We forecast margins to fall to 30% in fiscal 2018, but increase thereafter due to synergies and better monetisation. We are optimistic on this score as monetisation can be improved via portfolio mechanics and targeted user acquisition spending, and Aristocrat has managed this well so far.

In North America, the Class III installed base – traditional casino-style poker machines – grew 19.5% to 18,304 units, in line with our forecast. This was a strong performance in what was a flat market overall, based on the quarterly results from Aristocrat rivals Scientific Games Corp and International Gaming Technology.

The Class III gaming machine installed base remains our 'litmus test' for land-based (as opposed to online or digital) performance, with additional growth of 18% forecast for the second half of fiscal 2018.

Aristocrat's *Dragon Link* game – a bank of slot machines that offer both linked progressive jackpots and standalone payouts – was a key driver of the North American operations.

We estimate *Dragon Link* has been adopted by more than 50% of casinos that have its predecessor product *Lightning Link* already installed. *Lightning Link* was Aristocrat's first progressive machine range, and was wildly successful at home and globally.

We expect *Dragon Link's* growth to slow in the second half of fiscal 2018 and into fiscal 2019, however, as the product's market penetration peaks.

Aristocrat has increased its digital exposure to 26% of first-half earnings in fiscal 2018, up from 13% in fiscal 2017, and continues to develop titles for land-based and digital platforms.

We see further digital growth and capital management opportunities for Aristocrat. Combining this with management nous, **we believe the risk-reward equation for Aristocrat remains attractive**. This will offset a challenging and structural decline in slot-machine expenditure decline.

STEADFAST GROUP

PLATFORM PLAY

Sector: Insurance Recomm: Accum Risk: Higher Price: $2.80

Steadfast Group recently hosted an investor day where the insurance brokerage business painted a positive picture for medium-term earnings from the expected increasing uptake of its Steadfast Client Trading Platform (SCTP).

The company is aiming to place 80% of its network gross written premium through SCTP within five years. Our numbers currently do not include any earnings upside from SCTP, but earnings sensitivities imply a $34 million boost to annual pre-tax profit if the targets are hit from higher commission rates and M&A fees. This equates to a 20% rise in forecast 2022 pre-tax profit.

Steadfast will provide more details on the expected contribution from SCTP at its 2018 full-year results, but has noted the platform should result in additional benefits from improved broker efficiency and possibly, in our view, by charging underwriters for data from SCTP.

We note all the large insurers have already signed up to the SCTP's business pack – with the only exception being CGU – which should improve take-up among brokers.

Steadfast also noted performance from its underwriting agencies had been strong, driven by early traction with its London 'super' binder on SCTP, pricing cycle tailwinds and aligning agency product with distribution.

Steadfast's earnings stream is highly defensive with strong free cash flow generation. We see the possibility of profit growth exceeding 10% per annum in the medium term, driven by organic premium growth, efficiency improvements through back-office automation and broker practice consolidation, and future acquisitions of small brokers on accretive terms.

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

Ord Minnett Head Office

Sydney
Level 8, 255 George Street
Sydney NSW 2000
Tel: (02) 8216 6300
ords.com.au

National Offices

Adelaide
Level 5, 100 Pirie Street
Adelaide SA 5000
Tel: (08) 8203 2500

Brisbane
Level 31, 10 Eagle Street
Brisbane QLD 4000
Tel: (07) 3214 5555

Buderim, Sunshine Coast
1/99 Burnett Street
Buderim QLD 4556
Tel: (07) 5430 4444

Caloundra, Sunshine Coast
79-81 Bulcock Street
Caloundra QLD 4551
Tel: (07) 5491 3100

Canberra
101 Northbourne Avenue
Canberra ACT 2600
Tel: (02) 6206 1700

Coffs Harbour
Suite 4, 21 Park Avenue
Coffs Harbour NSW 2450
Tel: (02) 6652 7900

Gold Coast
Level 7, 50 Appel Street
Surfers Paradise QLD 4217
Tel: (07) 5557 3333

Melbourne
Level 7, 161 Collins Street
Melbourne VIC 3000
Tel: (03) 9608 4111

Newcastle
426 King Street
Newcastle NSW 2300
Tel: (02) 4910 2400

International Office

Hong Kong
1801 Ruttonjee House
11 Duddell Street
Central, Hong Kong
Tel: +852 2912 8980
ords.com.hk