May 2019

ORDS MONTHLY

THE SAGA CONTINUES
TRADE TUSSLE

The end of fiscal 2019 is in sight, but the issues at the top of investors' minds show no signs of being resolved any time soon.

The global macroeconomic picture is dominated by the continuing trade conflict between the US and China. The latest increase in US tariffs on Chinese goods – and the threat of imposing a 25% rate on all US$540 billion of Chinese imports into the US – comes after China's leadership refused to implement trade concessions, agreed earlier, in full.

Global markets are increasingly fatigued amid tit-for-tat threats of protectionist action by the world's two largest economies but so far are only mildly shaken by recent developments.

The consequences of not reaching an eventual deal, however, are serious – not least for the American and Chinese equity markets.

Our Investment Strategy article in this edition of the *Ords Monthly* attempts to quantify this impact, and also considers the key domestic issues – the federal election and the Reserve Bank's thinking on monetary policy after its recent decision to sit pat on interest rates surprised many in the market.

In our corporate coverage, three of the four big banks recently reported first-half earnings for fiscal 2019. For the most part, the numbers from **ANZ Bank, National Australia Bank** and **Westpac** met our expectations.

"One issue all three bank reports highlighted was a tough environment for retail banking"

There were notable differences in the composition of the results, although one issue all three bank reports highlighted was a tough environment for retail banking. See page 4 for more.

Meanwhile, March-quarter earnings from **ResMed**, the world's leading sleep apnea therapy provider, comfortably exceeded Ord Minnett's estimates. Strong mask sales – double-digit growth in all major markets – were a standout in the result, while sleep machine sales again proved robust.

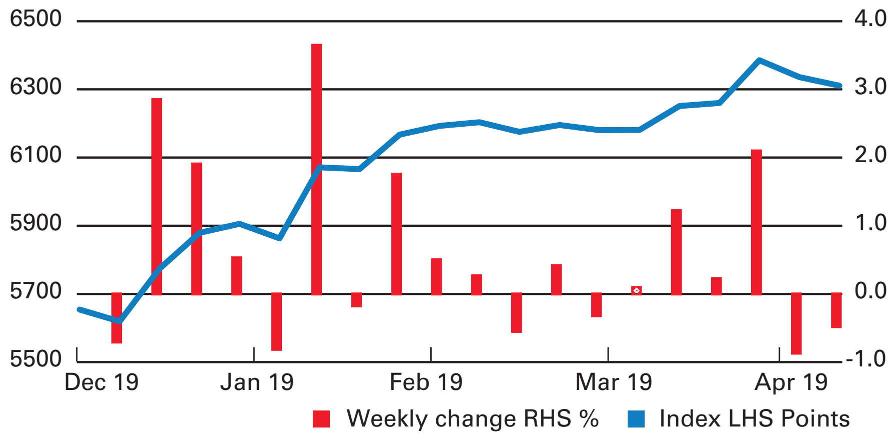
We still have questions about the contribution from its various software operations, however, and note that device reimbursement pressures from US Medicare programs could weigh on future results. See page 6 for the details.

Woolworths' Australian food business again buoyed the retailer's sales in the March quarter, ensuring it continues to lead arch-rival Coles.

The liquor business performance was also heartening, with Endeavour Drinks recording sales growth of 4.3%, a vast improvement on 0.2% growth in a very weak December quarter. Page 7 has the rundown.

Last, we highlight the latest expansionary plans of **Wesfarmers**, with the conglomerate launching a bid for **Kidman Resources** as it seeks greater exposure to lithium, a key ingredient in batteries for electric vehicles. See page 8 for our view.

Figure 1: S&P/ASX 200 Index weekly performance in 2019



Source: Ord Minnett Research, Iress, Data to 10 May

INVESTMENT STRATEGY

HURDLES AHEAD

The Australian and global stock markets have made solid strides in 2019 so far, but a road map for the way ahead shows some obstacles.

In the global backdrop, markets are focused on the latest manoeuvres in the protracted trade war between the US and China – the world's two largest economies – and the potential impact on global growth.

At the time of writing, tariffs on US$200 billion of Chinese goods imported into the US have been raised to 25% from 10%. China reacted swiftly, imposing higher tariffs on imports of US products.

The latest move comes as recent talks in Washington ended in a stalemate, with no new negotiations scheduled, although both sides say further talks are possible.

Heightening the situation, US negotiators told their opposite numbers that China had four weeks to agree to a deal. If no deal is reached, additional tariffs of 25% would be imposed on a further US$325 billion of goods imported from China.

This raises the prospect of all of China's goods exports to the US – valued at circa US$540 billion in 2018 – being hit with new imposts.

Our global research partner estimates the increase in tariffs could lop 0.2 percentage points off US economic growth in 2019.

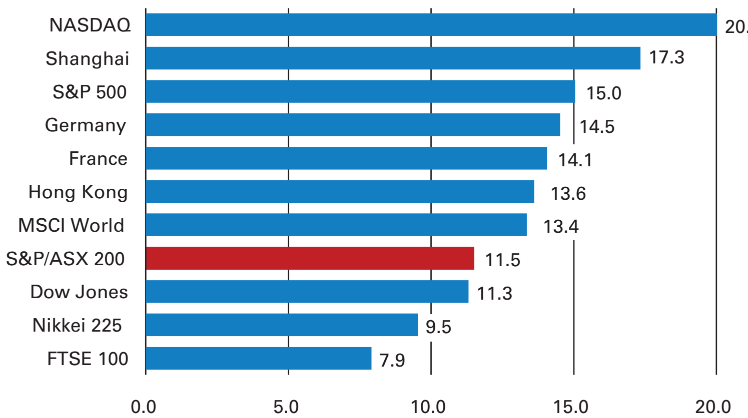
These tensions also threaten to reverberate to other markets – not only from an impact on supply chains, but also via the question mark it places over trade talks under way between the US and Europe and the US and Japan.

That said, we have endeavoured to put some numbers around the potential risks to market valuations in the US and China – the two strongest-performing equity markets this year (see Figure 2) – should a resolution of the trade dispute not be reached.

In our *Food for Thought: Quantifying the Risks* article on 14 September 2018, we noted that the US raising tariffs, along with retaliatory responses from China, could reduce the S&P 500 Index's earnings per share by US$8–10.

A reduction in market EPS of that size, assuming no derating in the current price-earnings (PE) multiple, would equate to a fall of around 5%.
A reduction in earnings, and a one-point derating in the PE multiple, would take another 5–6% off the value of the S&P 500 Index.

Figure 2: Global markets performance in 2019



Source: Ord Minnett Research, Iress.

Meanwhile, for China, our global research partners estimate that without a trade deal, corporate earnings growth in 2019 could ease to around 10% from 15% currently.

Assuming no derating in the MSCI China Index's PE multiple, this would equate to a circa 4% fall in the index, while one-PE-point derating would take the index down a further 8%.

The immediate market reaction to the latest developments was muted – after all, markets have had to play this game for some time now – but we remain neutral on equities generally given the delicate situation.

We see a recession as being unlikely this year given current conditions. There will, however, need to be some certainty in key areas – i.e. trade negotiations, growth momentum, US fiscal outlook, Brexit and domestic policy changes post the election (more below) – before we regain some conviction.

Should trade tensions persist and/or escalate, we expect the more defensive sectors – e.g. utilities, consumer staples, healthcare and property trusts – to outperform cyclical sectors, while gold and reserve currencies – such as the Japanese yen and US dollar – would rise.

On the home front, the federal election on 18 May heads the list of issues. The Coalition has narrowed the gap to the Opposition since the turmoil of 2018, but polls still show the ALP as likely to occupy the government benches after the poll.

That said, winning the election does not mean carte-blanche for Labor and its election platform, given it will likely fall short of a clear majority in the Senate.

Any government would thus require the support of the Greens, and possibly some of the other minor parties, to progress its policies.

With more politicking to come, we caution investors not to confuse what is promised in the campaign with what is eventually delivered in government.

The election is being fought on markedly different issues. The Coalition is emphasising its economic credentials in returning the Budget to surplus, while warning of higher taxes under Labor.

Meanwhile, Labor's promises are broadly aimed at improving wage growth and essential services, such as education and healthcare, and promoting renewable energy.

The more contentious issues, such as reforms to franking credit rebates and changes to penalty rates, will be subject to more rigorous debate in the Senate. It would be wise, therefore, to see what amendments are made in these areas before reacting.

Nevertheless, we generally expect banks, financial services, residential property developers, hybrids, health insurers, utilities and labour-intensive sectors to be disadvantaged under Labor government policies. Some select domestic healthcare and telecommunication companies may benefit.

Due to the nature of its policies, a Labor government is likely to be more of a headwind for markets. That said, much of the negative rhetoric is already priced in.

The other issue for investors is the outlook and positioning of the Reserve Bank of Australia (RBA).

Somewhat surprisingly, the RBA kept its benchmark cash rate steady at 1.5% at its May policy-setting meeting, despite weak inflation and economic momentum.

Clearly, the hurdle for the central bank to cut interest rates has been raised. The RBA stressed employment as the key factor, implying a deterioration in the labour market is a necessary condition for rate cuts.

> "The more contentious issues, such as reforms to franking credit rebates and changes to penalty rates, will be subject to more rigorous debate in the Senate"

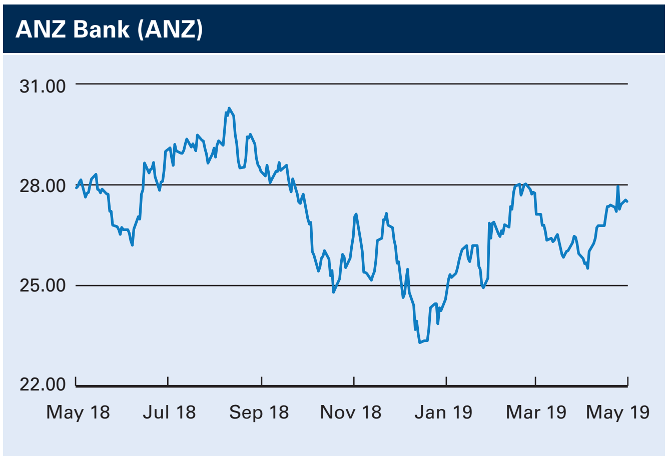
Our expectation is that economic growth in Australia will remain below trend this year, and possibly slow further if trade threats escalate. This outcome would likely deliver a modest rise in the unemployment rate and further easing of core inflation.

This implies the bias is still for at least one rate cut this year. Again, this would seem to support the same areas that also are relatively better off in a trade-war situation: defensive stocks – typically with high sustainable distribution yields – gold and the US dollar.

BIG BANKS
REPORT CARDS

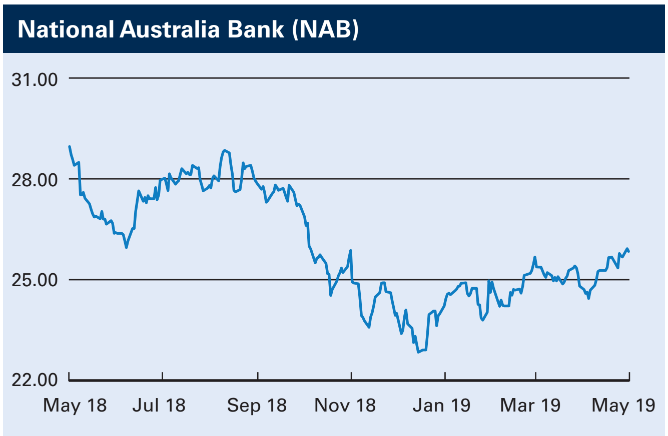
ANZ Bank – Recomm: Hold Risk rating: Medium Share price: $27.50

Year to September	2018A	2019E	2020E
Profit after tax ($m)	6,487.0	6,891.5	6,925.1
Earnings per share (¢)	213.90	229.80	235.50
Price/earnings (x)	12.9	12.0	11.7
Dividends per share (¢)	160.00	160.00	173.00
Dividend yield (%)	5.8	5.8	6.3
Franking (%)	100	100	100



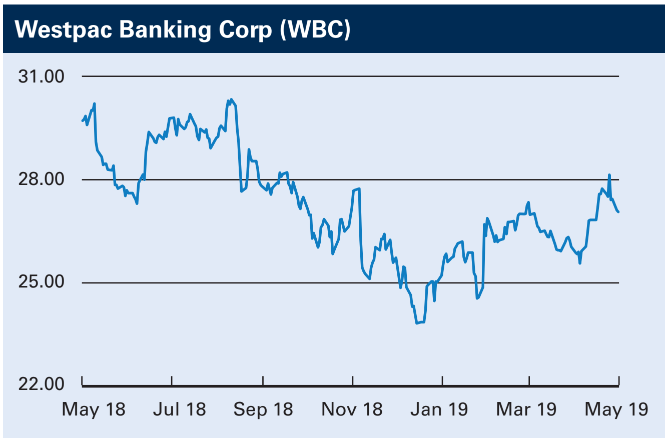
National Australia Bank – Recomm: Accumulate Risk rating: Medium Share price: $25.84

Year to September	2018A	2019E	2020E
Profit after tax ($m)	5,702.0	6,003.4	6,852.1
Earnings per share (¢)	202.40	204.40	226.30
Price/earnings (x)	12.8	12.6	11.4
Dividends per share (¢)	198.00	166.00	166.00
Dividend yield (%)	7.7	6.4	6.4
Franking (%)	100	100	100



Westpac – Recomm: Hold Risk rating: Medium Share price: $27.06

Year to September	2018A	2019E	2020E
Profit after tax ($m)	8,065.0	7,318.8	8,159.3
Earnings per share (¢)	229.30	204.00	224.30
Price/earnings (x)	11.8	13.3	12.1
Dividends per share (¢)	188.00	188.00	188.00
Dividend yield (%)	6.9	6.9	6.9
Franking (%)	100	100	100



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

The first-half results for fiscal 2019 confirmed a challenging environment for retail banking businesses, although there were differences in the divisional performances of the three major commercial banks that rule off their books on 30 September. Note that **Commonwealth Bank** has a 30 June balance date and had not reported its March-quarter update at time of writing.

- **ANZ Bank** posted a first-half fiscal 2019 result that was very close to Ord Minnett's forecasts at every line, although the composition of the result was skewed more to the institutional business than we had expected. This institutional strength saved the blushes of an underperforming Australian retail banking division.

  The bank's cash earnings of $3.564 billion were broadly in line with our estimate after adjusting for lower-than-forecast remediation costs and higher-than-expected gains on asset sales, while the interim dividend of $0.80 a share, fully franked, was right in line.

  The sharp share price rise on the day of the result likely reflected management's target of a cost base of $8 billion by fiscal 2022 – implying much better cost control than we had forecast – and low market expectations.

  On the positive side, the institutional operations delivered a return on equity of just below 11%, a figure that we expect to improve further. In our view, however, it will take longer than we had expected to turn the retail bank around and, although the capital surplus is healthy, ANZ faces greater exposure than its peers to proposed higher regulatory capital requirements in New Zealand.

  These factors, along with execution risk and the recent strong share price run, led us to cut our recommendation to Hold from Accumulate and our target price to $29.50 from $31.20.

- **National Australia Bank** posted first-half fiscal 2019 cash earnings of $2.954 billion, in line with Ord Minnett's expectations. The stronger-than-expected income from its markets division helped offset challenging conditions in the retail banking and wealth management operations, but the 16% cut in its interim dividend stole the headlines.

  NAB lowered its interim dividend to $0.83 per share from $0.99, a more severe cut than we had expected (our dividend forecast was $0.90 a share). We had argued for some time that the bank needed to rebase its dividend, and the consequent 70% underlying payout ratio leaves NAB well-positioned to deal with further customer remediation costs and build capital to meet higher New Zealand regulatory capital requirements.

  The underlying result demonstrated why we prefer NAB in the bank sector, i.e. good growth and margin outcomes in the small- and medium-sized enterprise lending operations, the New Zealand business, and the corporate and institutional banking division, that more than offset challenges in the smaller consumer banking and wealth business.

  We have cut net profit forecasts by around 3% across our forecast period, but we see NAB as screening attractively versus its peers in what is a very difficult Australian retail banking environment. Our target price has fallen to $28.60 from $29.80.

- **Westpac** reported first-half FY19 cash earnings of $3.296 billion, just 1% below Ord Minnett's forecast, and declared a fully franked interim dividend of $0.94 per share, as expected.

  The trends evident in Westpac's result were a little different from ANZ and NAB, however, with a better retail banking performance but poor treasury and insurance income, and underperformance in its business banking operations.

  To this point, Westpac missed our non-interest income forecast by a material 7%. Most of this reflected higher general insurance claims costs, as well as further pressure on fees and commission income.

  Assuming it continues, a recent improvement in the bank bill swap rate versus the overnight indexed swap rate – a key measure of funding costs – should provide a tailwind of 4.0 basis points to Westpac's net interest margin in the second half.

  We note Westpac is more leveraged to this metric than ANZ or NAB, and the benefit should come through more quickly. That said, we expect this benefit to be more than offset by ongoing competition and lower earnings on the capital/deposit hedge position.

  Subdued trends are likely to continue in the medium term, with only modest action on cost savings relative to its big bank rivals.

  We are increasingly concerned about the sustainability of returns in retail banking, a segment to which Westpac is heavily exposed. In addition, its book mix – with greater exposure to interest-only and investor lending than its rivals – will further hamper its performance in the near term. Our target price has fallen to $27.40 from $27.90.

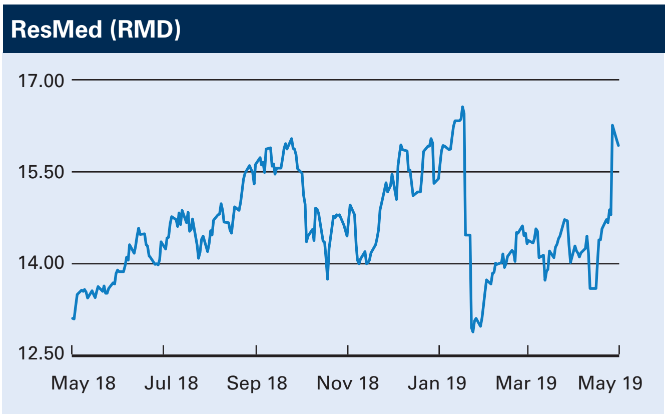
RESMED

SLEEP ON IT

Sector: Healthcare Recomm: Hold Risk rating: Medium Share price: $15.93

Year to June	2018A	2019E	2020E
Profit after tax ($m)	653.7	721.6	829.5
Earnings per share (¢)	45.41	49.92	56.51
Price/earnings (x)	35.1	31.9	28.2
Dividends per share ¢)	18.32	21.00	23.26
Dividend yield (%)	1.1	1.3	1.5
Franking (%)	0	0	0

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



Source: IRESS

ResMed is a global player in the market for sleep apnea treatment and in health management software via its Software as a Service (SaaS) operations.

The company recently posted net revenue of US$662.2 million in the March quarter, around 2% above Ord Minnett's forecast, driven by strong growth in sales of machines and masks in the core sleep business.

Operating profit increased 15% on a year ago and beat our estimate by 7%, due largely to lower-than-expected R&D and interest expenses.

Net income was also strong at US$128.1 million, some 11% above our forecast, while the quarterly dividend met our expectations.

ResMed reported double-digit growth in mask sales across all of its major markets, which we attribute to both share gains and strong market dynamics (noting that rival Philips also reported double-digit growth in mask sales).

The 13% growth in US mask sales was attributed to new product launches, which supported share gains in key market niches, as well as positive resupply trends.

Outside the US, the 12% growth in mask sales was supported by new product launches and fleet upgrades in France and Japan, which tend to boost compliance and thus mask sales.

Sleep machine sales were robust, especially given the March quarter included a large fleet renewal sale in France.

ResMed's SaaS operations doubled their sales contribution to US$80 million, due to the recent acquisitions of MatrixCare and HEALTHCAREfirst, companies that supply software for long-term and post-acute care providers, home health care agencies and hospices.

The Brightree business, another supplier of healthcare management software, showed improved revenue growth but remains some way off the double-digit target.

We have made only relatively small positive revisions to our forecasts after the strong quarterly sales result. Our changes are supported by cuts to expected interest expense, consistent with new management guidance.

Despite the strong result from the core sleep business, we are cautious of fully extrapolating this trend in our forecasts given the volatility of historical results.

We note that management commentary indicated the usual confluence of strong sales across most major markets in the March quarter, but provided only limited evidence that the Brightree franchise has recovered after the unexpected slowdown in the second quarter.

There is also the potential for reimbursement pressures on US durable medical equipment suppliers due to the introduction of new rules for the 2021 round of bidding by the Centers for Medicare and Medicaid Services, the government agency that manages federal healthcare programs such as Medicare in the US.

In addition, investment in the joint venture with Alphabet's Verily – a provider of health data analytics – and the acquisition of Propeller – a digital therapeutics company that monitors patients with chronic obstructive pulmonary disease and asthma – should reduce net income by about US$40 million, or 7%, in fiscal 2020 before making a contribution to group earnings.

WOOLWORTHS

FOOD GLORIOUS FOOD

Sector: Consumer Staples Recomm: Hold Risk rating: Medium Share price: $32.35

Year to June	2018A	2019E	2020E
Profit after tax ($m)	1,604.8	1,736.6	1,802.7
Earnings per share (¢)	123.00	133.30	143.10
Price/earnings (x)	26.3	24.3	22.6
Dividends per share (¢)	104.00	96.00	100.00
Dividend yield (%)	3.2	3.0	3.1
Franking (%)	100	100	100

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

Woolworths (WOW) share price

Source: IRESS

Woolworths' March-quarter sales showed continued strong momentum in the key Australian food division, with like-for-like (LFL) sales growth of 4.2% comfortably ahead of Ord Minnett's forecast of 2.8%.

This also implies sales momentum accelerated in the second half of the March quarter, given Woolworths indicated at its first-half fiscal 2019 result in late February that sales were up 2.7% in the period so far.

Commentary regarding a possible end to dry grocery deflation should also be a positive for the industry.

The Endeavour Drinks division posted LFL sales growth of 4.3%, a strong recovery from very weak December-quarter growth of 0.2%.

Endeavour's range curation program, known as 'Customer 1st' ranging, is a tailored range of products for every store based on the local customer base and locally sourced products, such as craft beers.

The program was introduced at its BWS stores two years ago and has contributed to its growth, and was identified at the first-half result as being required at its Dan Murphy's stores.

Dan Murphy's has already run the Customer 1st ranging program in chardonnay and sauvignon blanc, with red wines being the current focus.

As with BWS, however, the benefits from the Customer 1st program are expected to be longer-dated in delivery.

Big W's LFL sales growth of 7.4% was strong, albeit below our forecast of 7.9%, while guidance for a fiscal 2019 loss of $80–100 million at the earnings before interest and tax (EBIT) line was reiterated.

That guidance includes the loss-making Big W stores and incorporates the high rents that are driving Woolworths' plan to close around 30 of its 183 Big W stores.

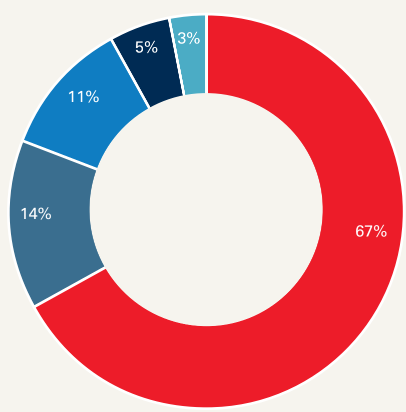
Growth in Big W's online sales was a positive and only a modest negative for earnings margins, with circa 65% of online sales being 'click & collect'. The key constraint on online earnings margins is the skew away from higher-margin apparel.

More broadly, the driver of the Big W guidance for fiscal 2019 has been the slower recovery in higher-margin apparel sales and ongoing challenges with stock loss.

We have raised our EPS forecast for fiscal 2019 by 1.7% post the result, driven by higher Australian food LFL sales growth and wider earnings margins.

Our forecasts for fiscal 2020 and 2021 are broadly unchanged. We see higher costs of doing business in the Australian food arm being offset by increased earnings from the Endeavour Drinks division and smaller losses in the Big W business.

Figure 3: Woolworths sales split by division (%)



Australian Food	67%
Endeavour Drinks	14%
NZ Supermarkets	11%
Big W	5%
Hotels	3%

WESFARMERS

NO KIDDING

Sector: Consumer Disc. Recomm: Lighten Risk: Medium Price: $36.00

Wesfarmers (WES) has advanced its strategy of increasing minerals exposure in its portfolio with a friendly takeover offer for **Kidman Resources** (KDR, Speculative Buy), developer of the Mt Holland lithium project.

The $1.90 a share offer, valuing Kidman at around $776 million, follows Wesfarmers' hostile bid in March for rare earths producer **Lynas Corp** (LYC, Not Covered) at $2.25 a share, or circa $1.5 billion.

Ord Minnett sees Kidman as the most attractive acquisition target among Australian lithium producers. This is due to its vertically integrated business model, its joint venture partnership with Sociedad Quimica y Minera de Chile (SQM) – a world leader in the global lithium industry – and signed offtake contracts with customers such as Tesla, LG Chemical and Mitsui.

The Kidman deal would be EPS-accretive for Wesfarmers – but slightly dilutive in terms of return on capital – in fiscal 2022, when first refinery production occurs.

Wesfarmers' interest in Kidman does not stop it making a Lynas bid – the company could fund both from existing cash flow – but Kidman is the preferred target.

The approach of Wesfarmers, now classified as consumer discretionary post the **Coles** (COL, Lighten) spin off, is focused on the long term. This approach may not win favour in all of the investment community, but management is willing to use the strength of its balance sheet to pursue investments in new energy assets even if they have a long gestation period.

That said, we are concerned by the willingness of Wesfarmers to dilute the high returns on capital from its key Bunnings division with this proposal.

Despite the support of major shareholders, we are not convinced a transaction will occur at this price.

Due diligence is a risk, and the bid price is well below our target price of $3.00, which assumes dilution from a $150 million equity raising at $1.10 per share as part of project financing. If we were to assume the project was 100% debt-funded, our valuation would lift to $3.60 a share. In addition, no deal has been struck with SQM on any JV changes.

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

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

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

Mackay
45 Gordon Street
Mackay QLD 4740
Tel: (07) 4969 4888

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