ORD MINNETT

PRIVATE WEALTH

March 2019

ORDS MONTHLY

SCOREBOARD

A WET SEASON

The Australian stock market and its developed-market counterparts have maintained their recent strong momentum, with the local benchmark standing 10% higher this year at time of writing.

The gains in equity markets have come despite some lacklustre economic data and wary comments from key central bankers on the prospects for global growth in 2019.

In Australia, the S&P/ASX 200 Index marched higher despite a disappointing corporate results season, with an end-of-season beat ratio, i.e. the proportion of earnings that exceeded our expectations versus the proportion of earnings that fell short of our forecasts, of just 28% being the weakest in more than five years.

Key themes from the season included further price-earnings (P/E) multiple expansion; the emergence of structural pressure in some sectors; and a slew of special dividends, as companies went on the front foot ahead of a potential change in the dividend franking rules post the upcoming May federal election. Our scorecard and key statistics from the February season start on page 2.

Brambles, best known for its CHEP pallets, is our preferred choice in the transport sector. The key business unit is CHEP USA, and we view the first-half fiscal 2019 result and outlook comments as confirmation that an expected turnaround has begun. See page 6 for details of our investment thesis.

Santos has undergone a difficult and protracted restructuring journey in recent years, but is now one of our preferred energy stocks.

The stock has a number of attractions, including a strong balance sheet and cash flow, a low break-even cost hurdle, and exposure to both east and west coast gas prices. We outline our most recent Santos analysis on page 7.

Lastly, we detail our investment view on **Sydney Airport**. The operator of Kingsford-Smith Airport offers exposure to an attractive asset class, while parking revenue and one of the most productive retailing spaces in the country add to its appeal as an investment option. See page 8.

Post the results season, it is appropriate that we revisit some of our preferred investment themes for 2019.

We have made no changes to our choices in the 'Oversold Cyclicals' category. Our base case is that a global recession is unlikely in 2019. Some cyclical stocks, in our view, have unduly derated on this concern, such as Reliance Worldwide, Aristocrat Leisure and Origin Energy.

Sonic Healthcare and the GOLD ETF have been added to the 'Volatility Vigilant' bucket, while **Newcrest Mining** has been removed and **AusNet Services** has been transferred to our new 'Yield Leaders' category (see **Food for Thought**, *Ords Weekly,* 8th March).

A late, but not end-of-cycle, stage is usually characterised by higher risk and higher volatility, which warrants having some relatively defensive exposures, e.g. **Viva Energy REIT** and Sonic. It is also worth considering companies that could perform well if macro economic conditions that challenge consensus views develop, e.g. **Austal**. We continue to favour gold as a hedge against certain events, but have swapped Newcrest out for a pure exposure to the commodity.

We now forecast that the Reserve Bank of Australia will cut interest rates this year and see the dividend yield theme regaining prominence as a result. Some stocks that fit well into the new 'Yield Leaders' group include AusNet, **National Australia Bank** and Sydney Airport.

We have also added Sonic to our 'Election Tailwinds' category. As the federal election approaches, we expect more focus on expansionary and nation-building policies, with potential winners in health care, e.g. **Integral Diagnostics** and Sonic Healthcare; infrastructure, e.g. **Boral** and **Qube**; and those exposed to renewables, e.g. **Service Stream**.

Tabcorp joins our 'Risky Business' group following its downgrade to Lighten. Others in this category include **Goodman**, **DuluxGroup**, **Steadfast** and **Domino's Pizza**.

INVESTMENT STRATEGY

MISSING A BEAT

The February 2019 results season will be best remembered for the unusual combination of a very strong equity market performance against the backdrop of a moribund set of corporate earnings numbers.

A large part of the S&P/ASX 200 Index's 5.2% gain over February was driven, in Ord Minnett's view, by three factors extraneous to results, i.e. the big bounce back by the financial sector (up 8.1%); a rallying resources group (up 6.1%); and the offering interest rate posture of the Reserve Bank of Australia.

Our track of rolling post-result earnings revisions was negative at -1.0%, while aggregate weighted revisions for the month were positive at +0.3%, thanks largely to the materials sector.

Price-earnings (P/E) multiples expanded throughout February, with the top quintile of companies still in ascendancy with an increase of 15%, but with the fifth quintile rebounding with a 10% rise.

Other key themes included structural, rather than cyclical, pressures in some sectors, in particular, the consumer staples category.

Meanwhile, as expected, the release of franking credits also featured as a range of companies pre-empted a potential post-election change in dividend franking policy by paying out special dividends or increasing their ordinary dividends.

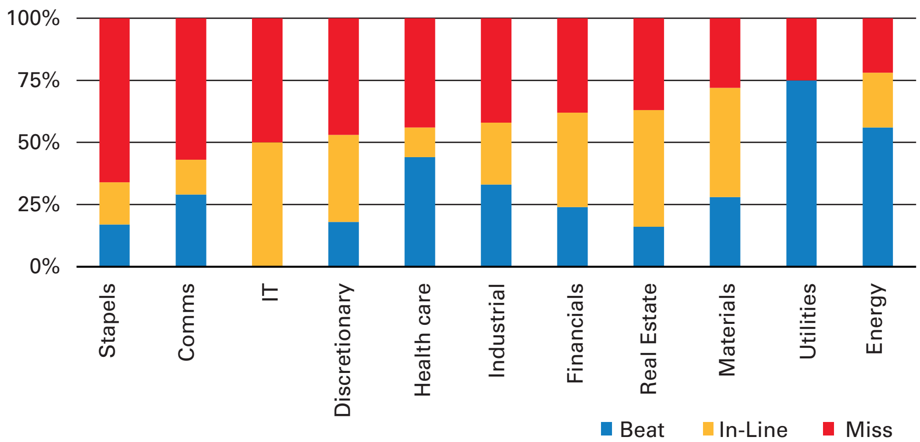
It was a disappointing season on the beat/miss front, with the end-of-season ratio being the weakest in more than five years.

The overall proportion of beats at 28% was the lowest since the August 2016 profit season, with only two sectors – energy and utilities – above 50%.

The overall miss rate of 40% was the highest in recent years, with consumer staples languishing at a lacklustre 65% rate. See Figure 1 below.

The reporting season was marked by a step down in costs, a stark contrast to the trend observed over the past three seasons.

Figure 1: Beat/miss ratio by sector for first-half FY19 (%)



Source: Ord Minnett Research, Bloomberg

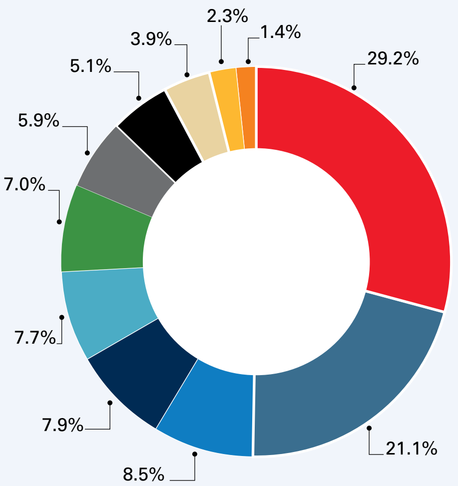
Investment Strategy

By sector, declining costs were most evident in utilities (down 2.8%), property trusts (down 2.4%), and communication services (down 2.1%).

A 5.2% lift in EPS projections for the materials sector underpinned a modest 0.3% rise over the season in the EPS estimate for the S&P/ASX 200 Index.

The conclusions emanating from the regular poll of our analyst team show the potential for consensus EPS upgrades has increased, capital expenditure is still on the rise and capital management prospects are set to decline in the wake of February's bounty.

Figure 2: First-half FY19 net profit contribution by sector (%)



Materials	29.2%	Comms.	5.9%
Financials	21.1%	Staples	5.1%
Discretionary	8.5%	Energy	3.9%
Real estate	7.9%	Utilities	2.3%
Health care	7.7%	IT	1.4%
Industrials	7.0%		

Source: Ord Minnett Research, Bloomberg

Multiple expansion

Across the globe, multiples have been expanding in the year to date, with the one-year forward P/E ratio of the MSCI Developed Markets Index rising more than 1.5 points over January and February.

The S&P/ASX 200 Index joined in, with the index P/E multiple rising 1.4 points to 16.1 over the past two months – the second-largest back-to-back move in the past five years.

The Small Ordinaries Index saw a very sharp 2.2-point multiple expansion across the first two months of 2019, with that sector's earnings slide of 4.3% in February a key factor.

Structural pressures

A rising tide of concern regarding the pressures of structural change appeared to permeate this season. This is the case across multiple sectors and companies, and appears to us to have been more acute than in recent years.

Retail banking

Headwinds in this lending category were particularly evident in the CBA result, where the retail banking services net interest margin fell 17 basis points in the last 12 months.

The difficult environment isn't expected to improve any time soon, and we expect the strong returns on equity still being earned by the majors in retail banking to fall from here.

Pressure in this section of the market underpins our preference for **National Australia Bank** and **ANZ Bank** – given their greater relative exposure to business lending than retail lending – over **Commonwealth Bank** and **Westpac**.

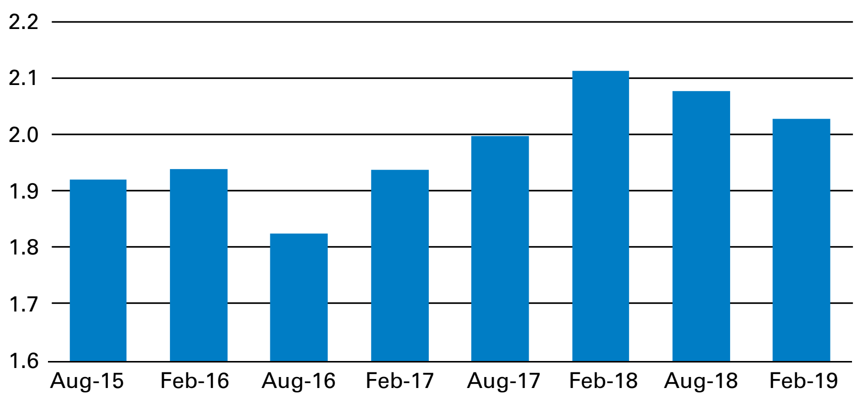
Consumer staples

This category endured a tough season, with the sector delivering the worst on-day performance – a fall of 7.1% – across all the industry sectors this season.

It was also at the bottom of the EPS revisions table, with cuts of 2.2% across the sector.

The travails of **Coles** were a key factor. The first result since splitting from **Wesfarmers** highlighted the challenges facing the retailer.

Figure 3: Trends in capital management ($bn)



Source: Ord Minnett Research, Bloomberg

Like-for-like sales growth in the key food division is proving elusive in the absence of key programs such as ‘Little Shop’, while earnings are suffering as growth in costs of doing business outpaces sales growth.

Casinos

First-half fiscal 2019 earnings from both **Star Entertainment** and **Crown Resorts** missed our forecasts, due primarily to weakness in their VIP operations. The Australian VIP market recovery has potentially stalled and we now forecast combined second-half VIP turnover for the two casino operators of $51 billion, a drop of more than 14% on the second half of fiscal 2018.

Franking credits

As expected, a range of companies accelerated capital returns in the form of off-market buybacks and special dividends in advance of a potential change in government and possible subsequent changes to the rules over refunds of franking credits to shareholders.

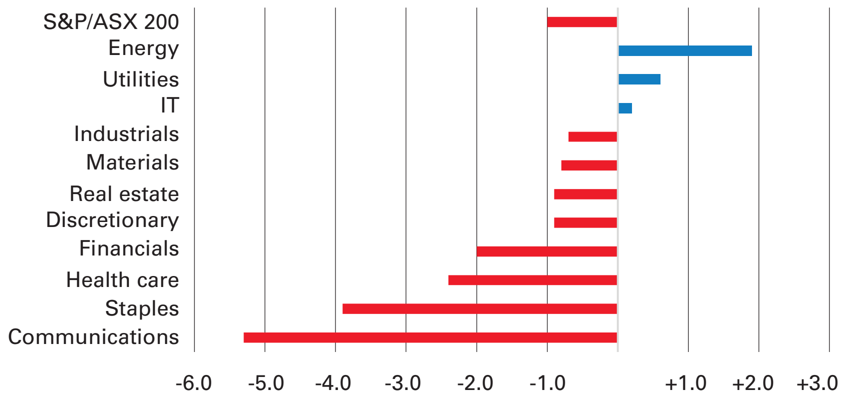
Among those handing back cash, **Fortescue Metals** declared an 11 cents per share special dividend in addition to a regular interim dividend of 19 cents, with management flagging the increased payout was to accelerate distribution of franking credits.

Flight Centre declared a special dividend of $1.49 per share on top of its interim payout of $0.60, while South32 set a special of 1.7 cents per share in addition to its interim dividend of 5.1 cents.

Table 1: Recommendation changes during February

	Recommendation		
Stock	**Old**	**New**	**Risk Rating**
Upgrades			
Altium	Sell	Hold	Higher
AP Eagers	Hold	Accumulate	Higher
Charter Hall Long WALE	Lighten	Hold	Medium
GUD Holdings	Hold	Accumulate	Higher
Insurance Australia Group	Hold	Accumulate	Higher
IDP Education	Hold	Accumulate	Higher
Link Administration	Hold	Accumulate	Higher
Moelis Australia	Accumulate	Buy	Higher
Netwealth Group	Hold	Buy	Higher
Northern Star	Hold	Accumulate	Higher
Sonic Healthcare	Hold	Accumulate	Lower
Treasury Wine Estates	Hold	Accumulate	Higher
Downgrades			
AMP	Accumulate	Hold	Higher
Breville	Buy	Accumulate	Higher
Caltex Australia	Buy	Hold	Medium
Charter Hall Group	Accumulate	Hold	Medium
Coles Group	Hold	Lighten	Medium
Costa Group	Hold	Lighten	Higher
Huon Aquaculture	Buy	Hold	Higher
Integral Diagnostics	Buy	Accumulate	Higher
IRESS	Buy	Accumulate	Higher
Pushpay Holdings	Buy	Hold	Higher
Rio Tinto	Accumulate	Hold	Higher
Senex Energy	Buy	Hold	Higher
Spark Infrastructure	Accumulate	Hold	Medium
Stockland	Accumulate	Hold	Higher
Technology One	Buy	Hold	Higher
Treasury Wine Estates	Accumulate	Hold	Higher
Westpac	Accumulate	Hold	Medium
Wisetech Global	Buy	Hold	Higher
Woodside Petroleum	Accumulate	Hold	Higher
Initiations			
Viva Energy Group	Initiation	Accumulate	Higher

Table 2: First-half FY19 post-result EPS revisions by sector (%)



Source: Ord Minnett Research

Table 3: Earnings outcome by sector

Sector	No. of cos. reported	Beat (%)	In line (%)	Miss (%)
Staples	6	17	17	66
Communications	7	29	14	57
IT	4	0	50	50
Discretionary	17	18	35	47
Health care	9	44	12	44
Industrials	12	33	25	42
Financials	13	24	38	38
Real estate	19	16	47	37
Materials	18	28	44	28
Utilities	4	75	0	25
Energy	9	56	22	22
Market	**118**	**28**	**32**	**40**

Source: Bloomberg, Ord Minnett Research

"As expected, a range of companies accelerated capital returns in the form of off-market buybacks and special dividends in advance of a potential change in government... "

Telstra's special dividend fell short of our expectations – the telco paying a special dividend of 3.0 cents per share, versus our forecast of 5.0 cents, and an interim dividend of 5.0 cents.

Our analysts see an element of conservatism in the dividend payout from Telstra, hampered as it is by weak free cash flow and a high net leverage constraint.

Meanwhile, Wesfarmers posted a surprise special dividend of $1.00 a share, in addition to a regular interim payout of $1.00.

After what has been a protracted period of elevated capital management activity, we now see deceleration in such action. See Figure 3, page 3 for recent trends.

Bottom line performance

Net profit growth for the season came in at 2.5%, led by IT, up 58.3%, and energy, up 47.7%. Excluding these sectors, we estimate that the rate of growth drops to only 0.7%. In the former category, **Link Administration** and **Computershare** were the biggest movers, while **Beach Energy** and **Origin Energy** recorded the highest profit growth in the energy sector.

Four out of the 11 industry sectors saw profits decline over the year. Financials, which constitutes a large proportion of overall market earnings, proved a major drag as profits fell 1.2%. Excluding financials, we estimate market-level profit growth of circa 3.6%. See Figure 2, page 3 for the sectoral contribution.

BRAMBLES

EYES ON THE (AMERICAN) PRIZE

Sector: Industrials Recomm: Buy Risk rating: Higher Share price: $11.94

Year to June	2018A	2019E	2020E
Profit after tax ($m)	846	919	1,004
Earnings per share ($)	0.53	0.58	0.63
Price/earnings (x)	22.3	20.6	18.8
Dividend ($)	0.30	0.30	0.28
Dividend yield (%)	2.5	2.5	2.4
Franking (%)	30	50	30

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

Brambles (BXB) share price

Source: IRESS

Brambles is a worldwide logistics group best known for its ownership of the ubiquitous CHEP wooden pallets used in the fast-moving consumer goods (FMCG) industries.

The company counts most of the world's major retailers among its customers, but the CHEP USA pallet pool operation is the key division.

Ord Minnett sees investor concerns over the CHEP USA business as overdone. A slowdown in revenue growth in recent years is the result of largely cyclical factors, in our view, and we expect a return to growth over time.

There is also no escaping the fact that pallets remain an essential part of the FMCG supply chain and, within that, pallet pooling continues to stack up as clearly the best economic solution for Brambles' customers.

Brambles reported an underlying net profit of US$326.7 million for the first half of fiscal 2019, 6.7% above Ord Minnett's forecast, and declared a 65%-franked interim dividend of 14.5 cents per share.

More importantly, we were pleased by operating trends across the key businesses and the outlook commentary – in particular, an easing of input-cost inflation in the second half of fiscal 2019 and beyond.

We now expect the worst is over for cost inflation and estimate that spot rates for US lumber and transport peaked in June 2018. This should start to filter through into contract rates in the second half and beyond. Brambles also expects a moderation in its US-European transport costs.

Outside CHEP USA, the CHEP Europe, Middle East and Africa unit again exceeded expectations, with strong volume gains in Europe – which accounts for circa 87% of divisional revenue – from market share gains and modest like-for-like volume growth.

We highlight that pallet growth in Europe is still largely a function of broader macro-economic conditions, as well as growth in the beverage and grocery sectors across the continent.

CHEP Asia-Pacific posted earnings above our estimates, driven by a one-off government infrastructure grant in Asia, a successful reusable plastic containers contract renewal in New Zealand and volume growth in south-east Asian automotive business.

Post the result, Brambles sold its IFCO Systems reusable plastic containers business for US$2.5 billion. Brambles plans to use the proceeds to return cash of about US$300 million, or 29 cents per share, as a capital return as well as an unfranked dividend. The company will also launch an on-market buyback of up to US$1.65 billion, equating to about 10% of issued shares.

Brambles is our key pick in the transport sector and we maintain our Buy rating with a $12.55 target price.

We see the recent loss of the Aldi contract in Australia as immaterial. Investors should remain focused on the main prize – turning around the performance of CHEP USA – and the first-half result and associated commentary have demonstrated that this is already under way.

SANTOS

WELL-DEVELOPED

Sector: Energy Recomm: Buy Risk rating: Higher Share price: $6.95

Year to December	2018A	2019E	2020E
Profit after tax ($m)	972	950	1,071
Earnings per share ($)	0.46	0.45	0.51
Price/earnings (x)	14.9	15.3	13.6
Dividend ($)	0.13	0.06	0.06
Dividend yield (%)	1.9	0.9	0.8
Franking (%)	100	100	100

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

Santos (STO) share price

Source: IRESS

Ord Minnett's recent analysis of Queensland coal seam gas (CSG) has led us to reiterate our positive view on Santos.

We found the Gladstone liquefied natural gas (GLNG) plant, which Santos operates and owns a 30% stake in, is under-utilising its compression capacity. Now Santos is less capital-constrained post its strong debt reduction, we see investment in developing wells allowing higher gas production to feed the plant, offsetting declining third-party purchases of feed gas.

Santos is expected to spend US$200 million on its share of a 350–400 CSG well program in calendar 2019 – notably at Roma East and Arcadia in western Queensland.

The development of these assets, and better well performance, means GLNG output could rise 6% per annum to above 300 petajoules by calendar 2026.

Our analysis also suggests there is unlikely to be a shortage of east coast gas as higher Queensland gas production offsets any declines from traditional southern sources.

Depending on economics, Queensland gas could be displaced by imports, particularly in southern states.

As well productivity falls over time, however, the cost of extraction will increase. By calender 2025, we estimate more than 25% of Queensland CSG wells will need prices above $12 per gigajoule in order to meet the cost of capital, including full capital expenditure.

Santos reported a record underlying net profit of US$727 million for calendar 2018, some 4% ahead of our estimates. Free cash flow for the year (excluding acquisitions and divestments) of US$1 billion was also a record, and underpinned a fully franked full-year dividend of US9.7 cents per share. We estimate the dividend equates to a payout ratio of 21%, in line with the 10–30% of free cash flow policy.

Management indicated the strong result was supported by both higher commodity prices and continued operating performance from assets, with unit production costs down 6% to US$7.62 per barrel of oil equivalent (boe).

Calendar 2019 guidance for production costs was in line with this figure, while production guidance of 71–78 million boe was reiterated, as was sales volume guidance of 88–98 million boe.

Guidance for capital expenditure of US$1.1 billion was down US$100 million on our prior forecast, with the bulk of spending allocated to the Western Australian assets, where a key development will be the drilling of appraisal wells at Dorado.

Santos remains one of our preferred stocks in the sector despite a recent surge in its share price – Santos is up 27% in the year to date versus a rise in the S&P/ASX 200 Index of circa 10%.

The company offers fully funded growth, with production expected to exceed 100 million boe by calendar 2026; 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.

SYDNEY AIRPORT

CAPTIVE AUDIENCE

Sector: Transportation Recomm: Buy Risk: Medium Price: $7.36

Sydney Airport (SYD) offers exposure to an attractive asset class with high barriers to entry, limited effective substitutes, and an end-market that has demonstrated resilient growth in the face of numerous exogenous shocks.

The operator of Kingsford-Smith Airport recently reported calendar 2018 operating earnings of $1.283 billion, in line with Ord Minnett's forecast and up 7.2% on a year ago. An unfranked final distribution of 19 cents per share was declared, in line with expectations.

We have trimmed our operating earnings forecasts by 1–4% for 2019 and 2020 due to our slightly lower passenger growth forecasts.

The slowdown in passenger growth has been noticeable, e.g. international passenger numbers rose 4.2% in 2018, down from 7.2% in 2017.

Sydney Airport is trying to combat the slowdown – and a potential 0.5% cut in capacity by international airlines in the first half of 2019 – by targeting a higher frequency of existing services, as well as opening up new routes.

Despite the slowing in passenger growth, we still see upside potential in the stock and maintain our Buy recommendation on Sydney Airport.

We continue to see a number of significant growth opportunities in non-aeronautical business areas.

Sydney Airport offers exposure to one of Australia's most productive retailing precincts, for example, with room for expansion at Terminal 2 (T2) and Terminal 3 (T3), along with brand upscaling, and a car parking operation that generates margins well in excess of its airport peers and non-airport operators.

It also has unutilised land that can be used for support facilities, and a reliable revenue source in property leasing, a theme bolstered by plans for a 430-room hotel at T2 and T3.

Sydney Airport also offers income appeal, with a forecast distribution yield of 5.3% in fiscal 2019, rising to 5.6% in fiscal 2020.

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