ORD MINNETT

PRIVATE WEALTH

May 2018

ORDS MONTHLY

CATCHING UP

BANK REPORT CARDS

Ord Minnett sums up the recent big bank reporting season in this issue of the Ords Monthly, with some common industry themes showing up across the results, but also some stark differences.

On the broader level, of course, the report cards were delivered against a backdrop of regulatory inquiries across the financial services industry, which has caused significant damage to reputations, and which may yet mean substantial changes to business models.

There are two key headwinds facing the sector: firstly, the costs of funds; and secondly, increasing pressure on retail margins as mortgagors switch from interest-only loans to interest and principal loans and competition in the home-loan market intensifies.
We examine the results on page 5.

Our investment strategy update this month focuses on the recently handed down federal budget which – if the numbers stack up – suggests the country may be finally on a path to surplus after a decade of deficits. Our report begins on page two.

The seemingly indefatigable Frank Lowy may have finally called full-time on his **Westfield** empire, with the family agreeing to sell their stake to Unibail-Rodamco, a major European player. See page 6 for how we see the pros and cons of the deal.

Demand for infant formula, particularly in the booming China market, has driven the performance of a number of companies in recent years (think **Bellamy's, A2 Milk**). **Clover Corporation** looks set to ride that same wave as a key member of the infant formula supply chain. We recently initiated coverage of Clover and explain our investment thesis on page 7.

Woolworths recently posted its March-quarter sales, which showed Australia's largest grocer continued to outpace arch-rival Coles as the former's food business strengthens. See page 8.

Taking a broader view, and we concede it is early days, it appears the Australian stock market may be finally turning the corner – outperforming its developed market counterparts by 3.6 percentage points in the last month – after lagging for some time.

The S&P/ASX 200 Index underperformed the MSCI Developed Markets Index by some 6.0 percentage points over the past year, partly thanks to currency effects but due mainly to a moribund earnings outlook. The local market generated positive earnings revisions of 4.9% over the last 12 months, well behind the 18.6% gain notched by developed markets.

As we have noted previously, however, we see Australia closing that gap in 2018 and this view appears to be coming to fruition, with positive earnings revisions of 1.1% in the past month outpacing the developed markets upgrades of 0.3%.

Current 12-month EPS growth is forecast at 7.1%. Assuming mid single-digit growth can be sustained, and based on a multiple of around 15.5 times, means a valuation for the S&P ASX 200 Index of circa 6300. We take a slightly more cautious tack, and recommend accumulating on the dips, as we see the benchmark as likely to trade in a 5800–6300 range. See Figure 1 for the comparison and Figure 2 for the sectoral contribution to the local market's recent outperformance.

Figure 1: Key global markets/indices over the past month (%)

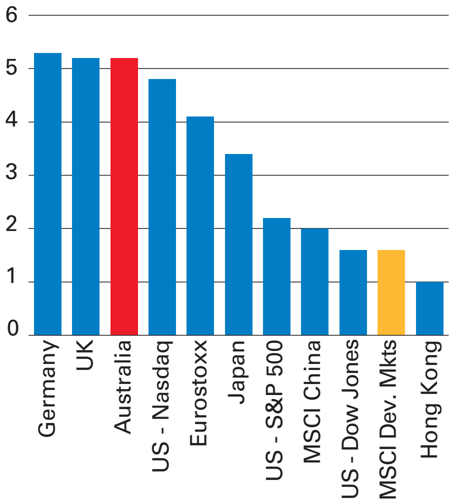
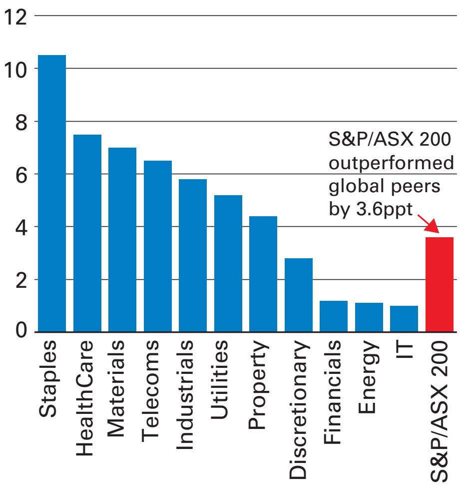


Figure 2: Composition of S&P/ASX 200 outperformance over past month (ppts)



Source: Ord Minnett research, Bloomberg.

INVESTMENT STRATEGY

NUMBERS GAME

Higher tax receipts and lower welfare payments have combined to boost Australia's fiscal position in a big way over the past few months, with federal treasurer Scott Morrison's budget predicting a deficit of $14 billion in 2018–19, some $6 billion below the forecast in December's mid-year economic and fiscal outlook.

In addition, the government expects a return to a modest surplus in 2019–20, a year ahead of its previous target, suggesting a decade of deficits may soon be coming to an end (see Figure 3).

This provides some room for the government to be a little more generous, especially ahead of a federal election in 2019. Overall, we estimate this budget is net-neutral for the economy, compared to recent budgets which have been a fiscal drag.

Winners include low- to middle-income earners who will receive a modest personal tax cut as well as an additional tax offset; senior citizens as well as those delivering retirement income products; and logistic and construction companies benefitting from the commitment to improve Australia's infrastructure.

Losers will be superannuation administrators, life insurers, the black economy and migrants.

We provide an overview of the main features of this budget, and point to some likely winners and losers:

- **Personal tax cuts**

  The government has outlined a seven-year plan to reduce personal income tax.

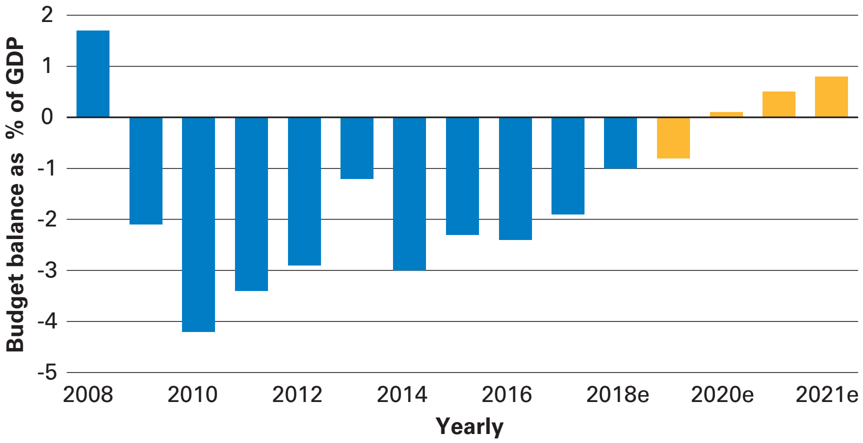
  Low- and middle-income earners are set to benefit initially, while higher-income earners will have to wait until at least 1 July 2022 for some relief.

  These measures may boost consumer confidence and household discretionary incomes, and could be an election winner for the government, but we don't see this translating into materially stronger consumer spending, given the near-term savings will mostly be used to offset cost of living pressures, while the more significant cuts are longer-dated.

- **Superannuation reforms**

  Exit fees on all super accounts will be banned. The Australian Tax Office (ATO) will also be tasked with reuniting inactive super

Figure 3: Forecast path of federal budget balance



Source: 2018-19 Government Budget Papers, Ord Minnett Research. Fiscal year end.

accounts with balances below $6,000 to a member's active account. Together, these measures will likely drive the consolidation of multiple super accounts with low balances.

The government will also introduce a 3% annual cap on passive fees charged by super funds on accounts with balances of less than $6,000, and will stop super funds from automatically charging for life insurance for members under 25 years of age, with balances of less than $6,000, or whose accounts have not received a contribution in 13 months.

Overall, we see financial services companies, such as **AMP** and **Link**, as being more negatively affected by these changes. Link has already said the plan may have a material impact on the number of accounts and members to which it provides administration services. AMP will face some fee pressure with the banning of exit fees and consolidation of small accounts, as well as not being able to automatically charge certain cohorts for life insurance. An unintended consequence of these reforms, though, is that other members may see increases in their fees or life insurance premiums as providers such as AMP seek to claw back some lost revenue.

- **Assistance for the ageing population**

There will be an extra 14,000 high-level home care packages and 13,500 residential aged care places. **CSL's** *Fluad* influenza vaccine is also being listed on the National Immunisation Program from 1 July 2018 for people aged over 65 years. Those on the age pension may benefit from changes to the pension work bonus and the pension loans scheme.

Superannuation trustees will be required to formulate a retirement income strategy for fund members, including offering comprehensive income products for retirement. The pension means-test rules have also been amended to encourage the development and take-up of lifetime retirement income products.

This budget has been more supportive of the healthcare providers than usual, but won't have a meaningful impact on our forecasts for healthcare stocks. The additional residential aged care places represent a circa 5.6% rise in total allocated residential care places. This is roughly in line with the required 3.5% per annum growth required to meet forecast demand.

The addition of CSL's *Fluad* influenza vaccine to the immunisation program was anticipated and should provide a modest contribution to its Seqirus unit revenues. For financial services firm **Challenger**, its annuities business should benefit from the requirement for trustees to incorporate retirement products into their plans, as well as the new means-test rules that provide more clarity on the treatment of retirement products in qualifying for the pension.

- **Infrastructure**

There was quite a bit of excitement around the mention of $24.5 billion in new infrastructure projects in the budget, but we note this forms part of the government's earlier commitment to spending $75 billion in transport infrastructure over the next decade. Therefore, we don't see the announcement as new in terms of its overall scale, but we view it as a strong commitment from the government to levels of infrastructure spending over the coming years, with more detail on specific projects.

There will be around $400 million allocated to duplicate rail lines at Port Botany. This should see rail receive a larger share of container traffic at the port and boost activity at nearby intermodal terminals. We see **Qube**, which is building a freight hub at Moorebank, as a beneficiary of this development.

- **Tougher stance on welfare for migrants, the black economy and holders of vacant land**

From 1 July 2018, the waiting period for new migrants to access certain welfare payments will rise to four years from three years, saving circa $203 million over five years.

As part of a broader crackdown on tax loopholes, the government will introduce a $10,000 limit for cash payments made to businesses for goods and services from 1 July 2019. This means transactions over this limit will now need to be made via electronic payment systems or cheque.

From 1 July 2019, the government will also deny deductions for expenses associated with holding vacant land. This is expected to lift revenues by $50 million over the forward estimates.

BIG 4 BANKS

AT THE MARGIN

ANZ Bank – Recomm: Accumulate Risk rating: Higher Share price: $27.95

Year to September	2017A	2018E	2019E
Profit after tax ($m)	6,809	6,981	6,916
Earnings per share ($)	2.33	2.43	2.51
Price/earnings (x)	12.0	11.5	11.1
Dividend ($)	1.60	1.61	1.66
Dividend yield (%)	5.7	5.8	5.9
Franking (%)	100	100	100

ANZ Bank (ANZ)

Commonwealth Bank – Recomm: Hold Risk rating: Higher Share price: $71.41

Year to June	2017A	2018E	2019E
Profit after tax ($m)	9,881	9,510	10,168
Earnings per share ($)	5.56	5.29	5.59
Price/earnings (x)	12.8	13.5	12.8
Dividend ($)	4.29	4.30	4.34
Dividend yield (%)	6.0	6.0	6.1
Franking (%)	100	100	100

Commonwealth Bank (CBA)

National Australia Bank – Recomm: Accumulate Risk rating: Higher Share price: $28.72

Year to September	2017A	2018E	2019E
Profit after tax ($m)	6,642	5,955	6,767
Earnings per share ($)	2.40	2.12	2.37
Price/earnings (x)	12.0	13.5	12.1
Dividend ($)	1.98	1.98	1.98
Dividend yield (%)	6.9	6.9	6.9
Franking (%)	100	100	100

National Australia Bank (NAB)

Westpac – Recomm: Accumulate Risk rating: Higher Share price: $29.75

Year to September	2017A	2018E	2019E
Profit after tax ($m)	8,062	8,398	8,657
Earnings per share ($)	2.31	2.39	2.44
Price/earnings (x)	12.9	12.5	12.2
Dividend ($)	1.88	1.88	2.11
Dividend yield (%)	6.3	6.3	7.1
Franking (%)	100	100	100

Westpac (WBC)

Source: IRESS, Company report, Ord Minnett Research. Profits are on a normalised basis. Pending ex dividend dates as at time of writing: ANZ–14 May; NAB–15 May; WBC– 17 May

- **ANZ** posted first-half fiscal 2018 cash earnings of $3.493 billion, 3% below Ord Minnett's forecast, due to softer-than-expected income from the markets unit. The $0.80 per share interim dividend was below our forecast of $0.82.

  The bank showed good progress on the key tenets of our positive view, i.e. risk-adjusted returns, cost control and a strong capital ratio.

  Net interest income as a ratio of risk-weighted assets, excluding markets, rose 5.0 basis points in the half and improved in all units.

  Expenses fell 2%, mainly due to a big fall in premises costs. Staff costs were flat, but the second half will likely see a material fall with benefits from the $78 million restructuring program in the first half.

  ANZ's common equity tier-one (CET1) ratio was a very strong 11.0%, or 11.8% on a pro forma basis when divestments are completed. Given the large buffer to minimum regulatory capital requirements, we expect $6 billion of buybacks over the next three years.

  We estimate ANZ will deliver strong EPS growth of 5% over the next three years, supported by buybacks and an attractive valuation. **We maintain our Accumulate recommendation on ANZ**.

- **CBA** reported a weak third-quarter fiscal 2018 trading update, with cash net profit of $2.35 billion and pre-provision profit of $2.53 billion, both 9% below the quarterly average, for first-half fiscal 2018.

  The main culprits were non-interest income, which fell about 8%, and operating expenses, which rose 3%.

  Asset quality was strong but a CET1 ratio of 10.1% was lower than forecast, due to weaker earnings and higher risk-weighted asset growth. CBA flagged second-half capital headwinds, including maturity of the final tranche of Colonial debt; the adoption of new accounting standards; and the APRA-imposed $1 billion rise in regulatory capital.

  Accounting for these, we expect CBA's second-half CET1 ratio to fall below 10%, which would see the bank lagging its peers – that are already looking at capital management – by some way.

  We have cut our cash EPS forecasts by about 2% over the next three years. CBA's price-earnings premium to its peers has closed somewhat. Given the earning regulatory issues, however, **we maintain our Hold recommendation**.

- **NAB** delivered a first-half fiscal 2018 cash net profit of $2.759 billion, 1% below our estimate of $2.795 billion, with the key business banking operations showing strong growth and a solid outlook. An interim dividend of 99.0 cents per share was declared.

  Net interest income was slightly below our forecast, as was revenue.

  We note concerns about NAB's wide 5–8% target range on cost growth in fiscal 2018 and the lack of detail on how costs would be kept flat in fiscal 2019–20.

  Nonetheless, we see NAB as well-positioned, given it has less exposure to the margin-pressured retail banking sector, which accounts for only 25% of group profit and 21% of risk-weighted assets. NAB's key business and private banking franchise, which generates 42% of group profit, offers leverage to any recovery in business credit growth, and shelter from the margin pressure in retail banking given business banking customers tend to be 'stickier' and less price-conscious.

  NAB's CET1 ratio of 10.2% was slightly below our forecast of 10.3%. NAB has a path to 10.5%, however, and will be less affected than peers by regulatory changes to the capital rules. As such, we see the dividend as safe, absent a major change in industry fortunes, and the 7% yield looks attractive. **We keep our Accumulate rating.**

- **Westpac** posted a first-half fiscal 2018 cash net profit of $4.251 billion, ahead of our $4.223 billion estimate, due to a bigger-than-expected rebound in markets and low provision costs. The interim dividend was $0.94 per share versus our $0.95 forecast.

  The highlight of the result was a strong net interest margin, which rose 3.0 basis points to 2.05%. Expense growth slowed to 1% in the half, despite a material rise in group expenses, driven by regulatory and compliance costs.

  We expect things to get tougher from here, given pressure on retail margins from interest-only loan switching and mortgage competition, but we think recent stock weakness has more than discounted this.

  A criticism of Westpac by some is its lack of cost flexibility, with expenses growth set to be stuck in the 2–3% range for some time. Westpac has less capability to cut cost than ANZ although we do see medium-term cost savings once the customer services hub is rolled out – but it is a longer-term story.

  Westpac's CET1 ratio fell to 10.5%, with management flagging headwinds in the second half from further model changes, although the conversion of preference shares to ordinary shares will provide a partial offset.

  We have reduced our cash earnings forecasts by 1.4% on average across fiscal 2018–20 to reflect our trimmed housing growth forecasts and lower non-interest income. Our EPS forecasts are largely unchanged given less dilution from capital instruments. **We maintain our Accumulate recommendation.**

WESTFIELD CORPORATION

END OF AN ERA

Sector: Real Estate Recomm: Hold Risk rating: Low Share price: $9.16

Year to December	2017A	2018E	2019E
Profit after tax ($m)	848	881	969
Earnings per share ($)	0.41	0.42	0.47
Price/earnings (x)	22.4	21.6	19.6
Dividend ($)	0.33	0.33	0.34
Dividend yield (%)	3.6	3.6	3.7
Franking (%)	-	-	-

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

Westfield Corp (WFD) share price

Source: IRESS

Westfield Corporation security holders will soon have to decide how to handle the largest takeover deal in Australian corporate history, if the proposed offer from **Unibail-Rodamco** (Unibail) is approved.

Westfield's owners are being offered a combination of cash and scrip which, based on the Westfield and Unibail closing prices on 9 May 2018, values Westfield at $9.47 per security.

The last day of trading in Westfield shares would be 30 May, with deal implementation in early June.

Unibail may be less well-known to Australian investors, but it is Europe's largest listed commercial property company, and over the past 20 years it has developed an enviable track record of business performance.

It has also delivered returns that are superior to most real estate companies – a US$1,000 investment in Unibail shares in 1998 would now be valued at around US$14,000, while the same investment in the FTSE EPRA/NAREIT Developed Markets index of real-estate companies would be worth circa US$5,000.

In general, we think Unibail shares are a reasonable alternative to holding Westfield in the property sector, given it offers a significant development pipeline while still satisfying our 'global over local' theme.

Overall, we see benefits in the deal, and while there are risks we see these as mostly manageable, so we favour approval of the Unibail offer.

Benefits

The combined group would have a portfolio with a market value of €62 billion, plus a €13 billion development pipeline. Westfield holders would have more exposure to retail mall assets – 102 versus 35. Asset diversity is also boosted with the combined portfolio having 88% of its asset value in shopping malls, but the balance in office and convention centres rather than only retail.

The new group fits well with our 'global over local' theme, which prefers companies that have offshore operations benefitting from the recovery in global growth. Westfield's portfolio is weighted to the US, but assets in the new group would be primarily tilted to Europe, representing 70% of asset value.

Westfield's assets are in two countries – the UK and US – but the combined group's assets would be spread across 13 countries – primarily France, but also Spain, Germany and the Netherlands. We see Europe as being on a recovery path, like the US, with positive drivers such as historically low interest rates and a falling jobless rate.

Risks

Shareholders would also receive shares in Westfield's OneMarket, a start-up retail technology platform. This early-stage and higher-risk business may not suit everyone, in which case their OneMarket shares could be sold via a sale facility, using the form provided in the offer documentation.

The combined group's gearing would be higher than that of Westfield at around 42% versus 31%, although a lower average cost of debt means interest cover remains stable at about 6 times.

Only partial capital gains tax rollover is being provided and the timing of distributions may be too long-dated for some, while broader risks include the impact of Brexit and the negative correlation of REITs to bond yields.

CLOVER CORPORATION

NOT FISHY AT ALL

Sector: Agricultural products Recomm: Buy Risk rating: High Share price: $1.36

Year to June	2017A	2018E	2019E
Profit after tax ($m)	4	8	10
Earnings per share ($)	0.03	0.05	0.06
Price/earnings (x)	54.0	29.5	22.9
Dividend ($)	0.01	0.02	0.03
Dividend yield (%)	0.7	1.5	2.2
Franking (%)	100	100	100

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

Clover Corp (CLV) share price

Source: IRESS

Clover Corporation is a key member of the infant formula supply chain, with its strong position in the encapsulated tuna oil market being due to the high quality of its product.

The key ingredient is docosahexaenoic acid (DHA) – an omega-3 fatty acid crucial for brain health, in particular, but also important for heart and eye health – which is mostly derived from tuna oil, although more than 30% of sales stem from sources such as algae.

A number of oils are used interchangeably by formula manufacturers to introduce omega-3 and omega-6 content, but DHA is the most essential as it assists in replicating the properties of natural breast milk.

Clover's short- to medium-term outlook is compelling and **Ord Minnett has initiated coverage with a Buy recommendation.**

Growth in Chinese infant formula demand is driving revenue, while contract talks and other initiatives will lift gross margins.

In addition, European Union (EU) regulations require a doubling of DHA content in infant formula by 2020.

Clover sells powdered tuna DHA to most major infant formula brands, but with brand-specific risks diversified across more than 50 clients.

The company's key product strength versus rivals is the quality of its encapsulation process – this minimises the 'fishy' smell and taste that can come with other fish oil products while still ensuring maximum nutritional value is delivered. This is achieved through exclusive use of a microencapsulation process developed in conjunction with the CSIRO – and licensed to Clover until 2027 – and ongoing, patented product development techniques.

These drivers deliver an expected EPS compound annual growth rate of 28% over fiscal 2018–21.

Demand – The global market for infant formula is estimated at circa US$40 billion by Euromonitor and is expected to grow at a rate of 5% per annum over 2016–2021. The Chinese market is valued at circa US$20 billion and is anticipated to expand 5–10% per annum over the same period. Most countries will see continued increases in demand for formula, but rapid growth in China is grabbing the majority of headlines.

Margins – We expect gross margins to widen to more than 30% by 2021 from around 24% currently. Key to this is Clover buying its own spray dryer, rather than renting drying time from other manufacturers, which currently accounts for around 35% of cost of goods sold (COGS). Clover's product is high-quality but also very expensive, and such an investment gives the company the option to pass some of the COGS savings on to customers while retaining margin benefits.

EU regulations – These new rules should lead to increased demand for oils and powders as brands increase their DHA content. Clover's EU sales are currently low, but this is a key growth area as it is quite a strict regulatory environment.

WOOLWORTHS

LEADING THE WAY

Sector: Consumer staples Recomm: Accum Risk: Medium Price: $28.56

Woolworths (WOW) recently reported sales numbers for the March-quarter that showed solid evidence of the ongoing turnaround in food, with like-for–like sales growth of 4.3% beating Ord Minnett's forecast of 3.7% and comfortably outpacing arch-rival Coles' 1.3% result.

Combined food and liquor sales (via the Endeavour Drinks business) growth of 4.2% was lower than in recent quarters, but still strong, with the business capturing further market share.

Investment in NZ supermarkets across online, price and service also boosted sales, although that investment will also have a negative impact on fiscal 2018 earnings.

Big W disappointed, however, with comparable sales at the discount department store slipping 1.2% versus our expectations for a rise of 1.4%.

Our fiscal 2018 earnings estimates are largely unchanged post the March-quarter data, although we have made modest upgrades in fiscal 2019 and 2020.

The food turnaround continues and sales growth remains strong, although the pace will moderate as the retailer cycles tough comparable numbers in the rest of 2018.

We are confident that investments in the cost of doing business – via online, offering and service – will improve operating leverage. In addition, lower stock losses should enable gross margin expansion, which in turn will support further sales growth and sustain the turnaround.

We see earnings as having toughed in Big W and see it as positioned well for a recovery in profit, although we note the retail industry backdrop is challenging on many levels.

Valuation support exists with double-digit earnings growth supporting the price-earnings multiple. This leads us to reiterate our Accumulate recommendation on Woolworths and raise our target price to $31.00 from $29.00.

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

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