ORD MINNETT

PRIVATE WEALTH

Ords Monthly

Ord Minnett Research
November 2017

LOOKING AHEAD
THE BIG PICTURE

Markets have just passed the halfway mark of the December quarter and the S&P/ASX 200 Index is up around 5% so far since 30 September, only just below its gains over the whole of 2017 to date.

If the gains hold, the index would have notched its largest quarterly rise since the same period in 2015, and extended its winning streak in the December quarter to nine years straight.

That said, the question now is where to from here, and in this note Ord Minnett paints a picture of how 2018 is shaping up in our investment strategy article starting on page 2, along with some of our key stock choices.

We expect the Australian equity market to deliver a total percentage return in the low double-digits in the year ahead, driven by a combination of earnings growth, price-earnings ratio expansion and dividend increases. This would represent a modest acceleration from the 9.4% rise in the S&P/ASX 200 Accumulation Index, which includes dividends, so far in 2017.

The macro-economic backdrop is unlikely to have the lead role in the equity market in 2018. We expect 'more of the same' next year, i.e. unemployment around current levels, unchanged interest rates, and the consumer to be hampered by weak wages growth and household debt.

"This weakness in the local currency will support offshore earners, and this theme supports our key stock choices, for example, Brambles and Westfield."

We expect the Australian dollar to soften across the course of 2018, driven by rising US interest rates. This weakness in the local currency will support offshore earners, and this theme supports our key stock choices, for example, Brambles and Westfield. In addition, any tax cuts or stimulus in the US would also boost both these stocks.

One of the keys to the equity market in 2018 will be the performance of the heavyweight financial sector. The major banks have just completed their reporting season for 2017, leaving us with some mixed conclusions about the trading environment for this key sector.

On the positive side, margins, asset quality and capital all beat expectations, leading us closer to capital management scenarios, such as special dividends or share buybacks (spoiler alert – we believe ANZ will be the first mover). Headline earnings numbers, however, were hurt by weak trading income from markets businesses and provisions related to poor corporate conduct. We examine the results in more detail on page 4.

Looking beyond next year, one of the major structural shifts to occur in the coming decades will be in the automotive sector, as production and sales increasingly switch from fossil-fuelled vehicles towards electric ones.

The numbers in play are large – our global research counterparts forecast electric vehicle sales could rise to 33 million by 2025, from circa 3 million in 2016, giving the electric category a 31% share of the overall vehicle market. There is a lot of excitement about additional demand for materials required to meet the growth in electric vehicles – both for the vehicles and the all-important batteries – and we take a critical view of the opportunities in the article starting on page 6.

Finally, we highlight Incitec Pivot's impressive 2016/17 result. The agri-chemicals supplier keeps delivering growth despite a challenging industry environment and we see more to come.

INVESTMENT STRATEGY

CHARTING A COURSE

Prescience would be the perfect Christmas present for investors as the market heads into the tail end of 2017, and in this note Ord Minnett outlines how our team views the picture for 2018.

Overall, we expect a low double-digit percentage return from the Australian equity market in 2018. This compares with 9.4% rise in the S&P/ASX 200 Accumulation Index, which includes dividends, so far in 2017.

The domestic economic backdrop is unlikely to play a defining role in dividends, which includes equity market outcomes in 2018, a view that hinges on our expectation for the coming year to be 'more of the same'.

Economists at our global research partner expect economic growth to improve to an annualised rate of 2.8% from 2.4%, but they also note the bulk of the improvement stems from LNG exports, which will have little effect on the broader economy.

Unemployment is expected to hold around current levels at 5.5%, albeit with a deteriorating mix as the part-time share of employment rises.

The consumer will stay on the back foot, caught in the uncomfortable grip of low wage growth and high household debt.

The Reserve Bank of Australia will hold its benchmark cash rate steady, staving off the need for balance sheet repair. Historically low interest rates will do little to spur consumption, however, given the debt and wage constraints on households.

Central bank governor Philip Lowe underlined this view in a recent speech where he noted *"there is not a case for a near-term adjustment in monetary policy"*.

We expect the Australian dollar to slide across the course of 2018 as the US Federal Reserve raises its fed funds rate four times and the RBA stands pat.

Further weakness in the currency will support offshore earners, as well as overall economic activity, and this key theme supports a number of our stock preferences, for example, Brambles and Westfield. (See Table 1 on page 3 for our full list.)

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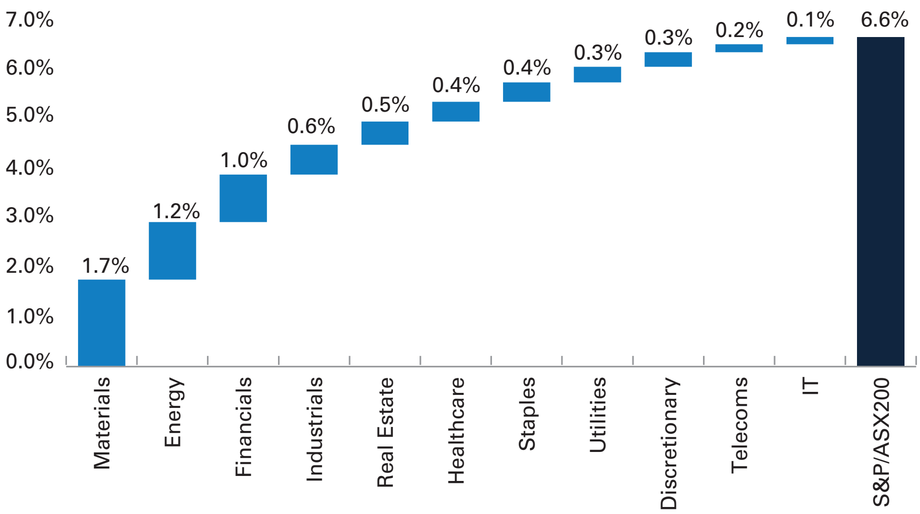
Figure 1: Sector composition of FY18E earnings growth for S&P/ASX 200



Source: Ord Minnett Research

Earnings

The strong reflationary drivers that underpinned global earnings growth in 2017 have mostly been absent in Australia. Looking to 2018, however, we see earnings per share growth of 7%, with dividend growth running at a slightly faster rate of 8%, although we note these estimates are two percentage points above the consensus forecast. (See Figure 1 for our forecast contributions to earnings growth by sector.)

Notwithstanding underperformance so far in 2017, earnings momentum across the S&P/ASX 200 Index has turned positive over the past three months – bank earnings have stabilised, except for National Australia Bank, while momentum remains positive for the materials sector.

Given that materials and financials account for more than 40% of the broader market, we expect these sectors to do the heavy lifting for the overall market. For materials, a sharper-than-expected slowing in China, and a subsequent downturn in base and bulk commodity prices, are the key risks to our view.

For financials, credit growth is a key swing factor. We do expect credit growth to slow in 2018, but not so much that it stymies growth for the banks. More recently, we note the prospect of an early election and associated political uncertainty that could affect the banks, in particular, given the opposition and cross bench support for a royal commission into banking and financial services.

Best of the bunch

The majority of our favoured stocks are positively geared to a weaker Australian dollar.

Brambles is the standout, offering the highest potential upside of our large-capitalisation coverage, with a still-supportive structural growth story.

In our view, investor concerns surrounding CHEP USA (circa 35–40% of group earnings) are overdone. We acknowledge there was a slowdown in 2017 revenue growth which is likely to extend into 2018, but we believe the factors driving this are largely cyclical and will revert over time.

Pallets remain an essential part of the fast-moving consumer-goods supply chain and, within that, pooling continues to stack up as the best economic solution for both manufacturers and customers.

For **Westfield**, we continue to believe earnings expectations are far too subdued. The company has a highly accretive US$5 billion pipeline of active retail developments and we estimate a circa 50% return on cost for these iconic projects, which further increases Westfield's weighting to premium malls. We expect this will drive strong earnings and NTA growth over the 2018–20 period.

Closer to home, **AGL Energy** is the key beneficiary of higher wholesale prices, which are set to ratchet higher as the electricity market tightens over summer.

At the other end, our least-preferred stock is **Qantas Airways**. Many in the market expect the carrier's domestic division margins to match the 15–20% enjoyed by US full-service airlines, but we see this as unlikely given lax discipline on capacity and faltering passenger yields. Moreover, the international business has already seen the peak and pressure on earnings will only increase from here.

Table 1: Key choices for 2018

Company	Code	Recomm	Last trade ($)	Target price ($)	Upside/downside (%)
Most preferred					
Brambles	BXB	Buy	9.87	12.65	+22.0
Westfield Corporation	WFD	Accumulate	8.28	10.30	+19.6
AGL Energy	AGL	Accumulate	24.55	30.15	+18.6
Least preferred					
Qantas Airways	QAN	Sell	5.77	4.55	-26.8

Source: Company data, Bloomberg, Ord Minnett estimates.

BANKS

CAPITAL IDEAS

First, the good news on the bank reporting season: margins, asset quality and capital for the majors beat expectations, which has led us, unexpectedly, a step closer to capital management, such as special dividends or buybacks, from the market's dividend darlings.

Now, the bad news: weak trading income from markets businesses and provisions related to poor corporate conduct made for an overall disappointing bank reporting season at the headline level, even though the underlying performance was a little better.

We note here for clarity that ANZ Bank, National Australia Bank and Westpac all reported results for the year to 30 September 2017, while Commonwealth Bank, which rules its books off on 30 June, released a trading update for the September quarter of the 2017/18 financial year, rather than a complete set of profit and loss numbers.

Margins

The major banks reported better-than-expected net interest margin expansion in the second half of 2016/17, with margins at NAB and Westpac rising six basis points half-on-half, excluding the markets business.

ANZ lagged, notching an increase in net interest margin of just two basis points, even excluding its market business and the sale of its Asian retail assets. CBA registered revenue growth of 4% in the September quarter on the second half of 2016/17, which appeared to be driven by margin expansion given only modest loan growth and mixed trends in non-interest income. Reading between the lines of the bank's commentary, we now forecast six basis points of margin expansion for the first half of 2017/18 for CBA.

The widening gap reflected lending margin expansion – mainly mortgage repricing – and funding cost benefits, which more than offset the impact of the federal government's bank levy.

Holding the headline revenue line back, however, was weaker markets income, which was down by 16–35% and meant revenue growth was limited to just 0.3% half-on-half, on average. Excluding this, average revenue growth would have been stronger at 3.1%. We note here that a key surprise from CBA's update was the resilience of its markets (trading) income, which the bank said was flat over the quarter, a result that compared favourably to its rivals.

Costs

The ability of the banks to manage costs in an environment of lower revenue growth remains an area of debate. ANZ cut an impressive 1.5% from its underlying costs, although its expenses outlook was less reassuring than previously. NAB and Westpac reported cost rises of 2.6% and 1.9%, respectively, and only NAB achieved the holy grail of 'positive jaws' – that is, where the income growth rate exceeds the expenses growth rate – for the full year. That said, we were disappointed by NAB's productivity program – we forecast 2019/20 costs to remain unchanged despite a 12% reduction in full-time employee numbers over next three years. CBA and Westpac retain a focus on reaching 'positive jaws'.

Capital

Asset quality was strong across the sector, averaging a second-half bad and doubtful debts to loans ratio of 14 basis points, down four basis points half-on-half. CBA's equivalent result in the September quarter was 11 basis points, which the bank attributed to a *"substantially lower"* corporate charge and seasonally lower arrears in the consumer business.

This, along with good capital efficiency stemming from the institutional divisions, allowed strong organic capital generation. Common equity tier-1 (CET1) ratios beat our forecasts by about five basis points on average, although Westpac excelled at 20 basis points above our forecast.

We expect ANZ to address its capital management options such as special dividends or buybacks early in 2018, with Westpac likely to be next off the block. NAB will likely be the laggard on capital management, with none factored into our numbers, nor any material dividend growth, over FY17–20.

Table 2: Equity ratings and price targets

Company	Recomm	Last trade ($)	Target price ($)	Upside/ downside (%)	Div Yield FY18E (%)
ANZ Bank (ANZ)	Accum	29.33	31.50	+6.9	5.6
Commonwealth Bank (CBA)	Hold	80.58	78.50	-2.6	5.4
National Australia Bank (NAB)	Hold	30.03	31.50	+4.7	6.6
Westpac (WBC)	Hold	31.90	33.00	+3.3	6.0

Source: IRESS, OML Research

The situation is somewhat more complicated for CBA. Australia's largest bank reported a pro-forma CET1 ratio of 10.8%, which included an estimated 70 basis points from the sale of its insurance operations. Excluding this, CBA's CET1 ratio was unchanged over the quarter at 10.1%, despite the payment of the final dividend and an eight-basis-point drag from Colonial debt roll-off. This outcome was aided by low levels of risk-weighted asset growth and a strong take-up of its dividend reinvestment plan.

We forecast a 10.4% CET1 ratio (or 11.1% on a pro forma basis given its June balance date) for CBA in the first half of 2017/18, and such a strong ratio obviously raises the question of capital management. Until the legal action brought by the Australian Transaction Reports and Analysis Centre is settled or completed, however, we believe it will be difficult for CBA to consider returning capital to shareholders in any meaningful size. This is reflected in our forecasts, with the CET1 ratio rising above 11% in 2018/19.

Outlook

The major banks are trading at an average 26% discount to the industrials group, around 4% cheaper than the 10-year average. Despite only modest growth prospects, we expect reasonable total returns over the next 12 months of around 9%, driven mainly by an average prospective dividend yield of around 6%.

Our key preference in the sector is ANZ, which we rate as an Accumulate, while our least preferred is CBA, which we rate as a Hold. For a complete list of recommendations and target prices, see Table 2.

Figure 2: Second-half FY17 performance versus consensus forecasts

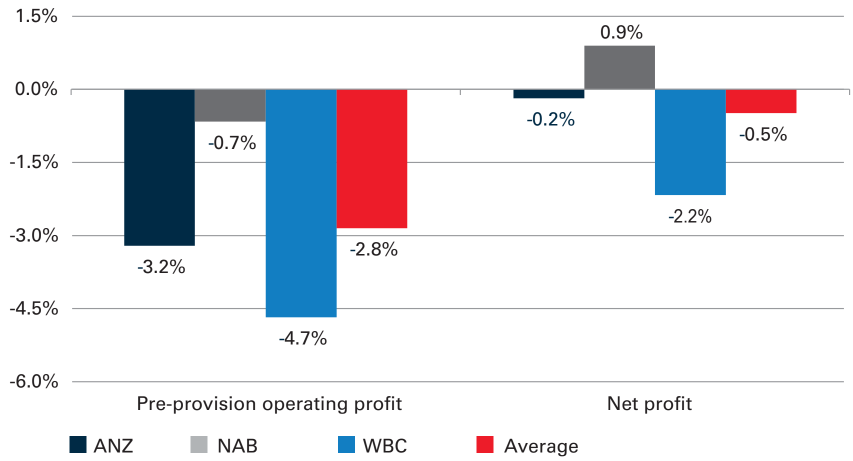


Figure 3: Consensus EPS changes post FY17 results

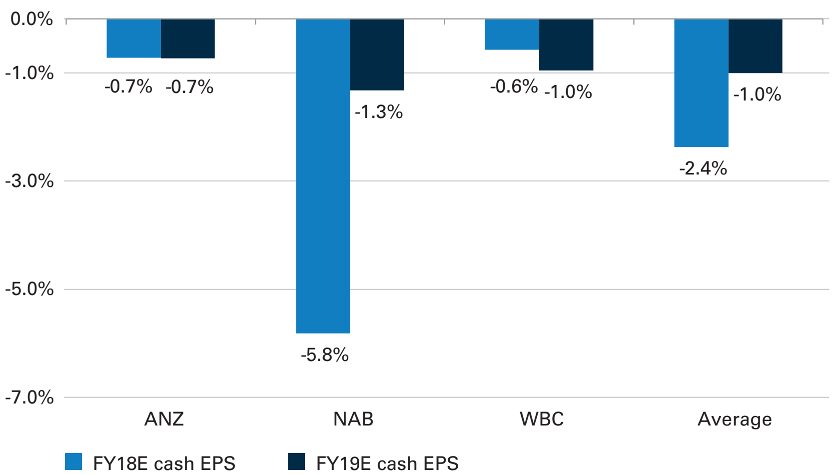
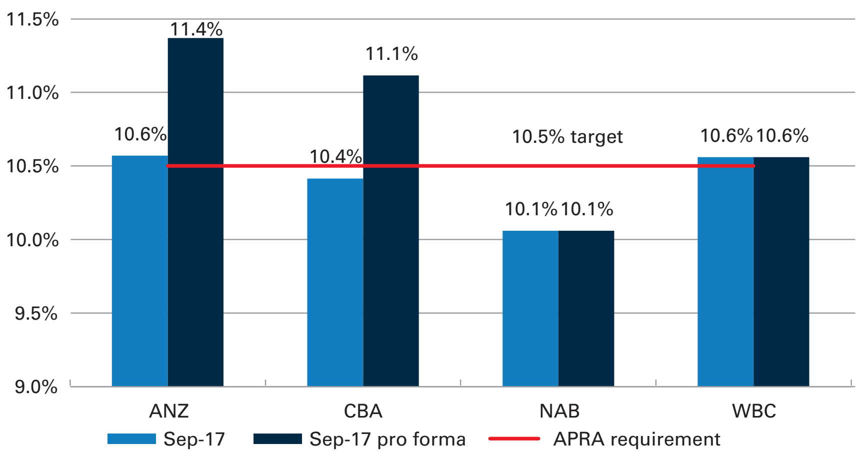


Figure 4: Capital levels – common equity tier -1 ratios



Source (Figures 2-4): OML Research, Bloomberg

ELECTRIC VEHICLES

DRIVER'S SEAT

One of the major structural shifts to occur in the coming decades will be in the automotive sector, as production and sales increasingly transition from fossil-fuelled vehicles towards electric ones.

Governments of various stripes around the world are promoting the production of electric vehicles, with the aim of phasing out diesel- and oil-fuelled engines entirely.

Among the major western countries, France and the UK have said sales of fossil-fuelled vehicles will be banned by 2040. A number of other countries have set targets, with India aspiring to have only electric vehicle sales by 2030. China, meanwhile, requires automakers to have electric vehicles make up least 12% of production by 2020, and is said to be preparing a timeline for an eventual ban on fossil-fuelled vehicle sales.

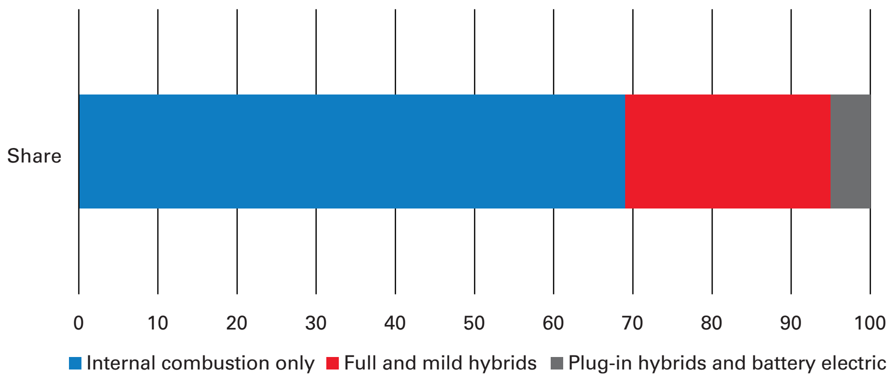
The numbers in play are large – our global research counterparts forecast electric vehicle sales could rise to 33 million per annum by 2025, from 3 million in 2016, giving the electric category a 31% share of the overall vehicle market. (See Figure 5 below.)

The main area of growth within this will be in conventional hybrid electric vehicles where both an internal-combustion engine and electronic motor are used. These models cannot usually be plugged in and recharged; instead, their batteries are charged by capturing energy from braking, converting kinetic energy into electricity. Production of this type of vehicle, typified by previous versions of Toyota's Prius (the current model has a plug-in variant), is expected to rise to 26 million from 2 million annually.

Meanwhile, combined production of plug-in electric vehicles and battery-electric vehicles is expected to rise to more than 5 million per annum from 1 million currently. Plug-in electric vehicles, such as the BMWi8 and the now-discontinued Holden Volt, are similar to conventional hybrids except that their batteries can also be recharged from plugging into the grid.

Battery-electric vehicles, however, such as the Tesla S and the Nissan Leaf, are charged from the grid and have no other power source.

Figure 5: Global light vehicle sales market share 2025E (%)



Source: Ord Minnett Research

We are circumspect about becoming too positive on the longer-term implications. After all, history has shown us that innovation and response mechanisms can easily alter the outlook. Recall, for example, predictions of peak oil, which continue to be pushed back as new alternatives emerge, technology improves extraction rates and energy intensity reduces.

Similarly, while there has been a lot of excitement about additional demand for materials required to meet the growth in electric vehicles, markets are likely to adjust accordingly through technological advances, substitution and capacity additions.

Nevertheless, commodities that should benefit the most from the shift towards electric vehicles include aluminium, copper, cobalt, graphite, lithium, nickel and manganese, from being used in either the lithium-ion battery or the electric vehicle infrastructure.

We stick with large-capitalisation companies, such as Rio Tinto and Alumina Ltd, as our preferred, lower-risk options that offer good value in this area. (See Table 3 for a list of miners with exposure to the main metals associated with the electric vehicle market.)

Demand for **nickel**, primarily used in batteries, is expected to grow nearly ten-fold to 136 million tonnes per annum (Mtpa) in 2025 from around 14.5Mtpa at present. That said, we do not expect a serious or sustained shortage of nickel supply over the next decade, partly because stainless steel growth is forecast to slow in coming years.

Aluminium is likely to replace steel usage in cars, given it is a lighter material, helping automakers cut the weight and improve the efficiency of the vehicle. Our analysts forecast aluminium demand could grow by 4.3% per annum between 2016 and 2025.

Electric vehicles also require more **copper** than a fossil-fuelled car, with copper being used in the battery's foil and in the electrical infrastructure (including charging ports). It is estimated that including demand from the charging infrastructure and cabling within the vehicles, additional copper demand for electric vehicles will grow to 770,000 tonnes per annum by 2025 (or 3.5% of current annual refined copper production), although this incremental demand is likely to be offset by reduced demand from China for traditional uses, keeping copper demand steady overall.

It is worth noting that while lithium has been seen as the 'poster child' of the electric vehicle industry, demand growth for this metal will be slower. This is because lithium is only used in the battery, and even then accounts for only a small percentage (less than 5%) of the battery's weight. The rapid rise in lithium prices has been more due to constrained supply that should ease over time.

Growth in the electric vehicle market is likely to have an impact on other sectors of the Australian market as well. Fuel efficiencies have already led to a decline in oil demand over the past decade in western markets. This, and the shift towards electric vehicles, is expected to contribute to further falls in demand from western markets, offset by growth in demand from emerging markets, leaving global oil demand flat, at best, over the next 20 years.

Natural gas has better prospects, given cars still need to be powered, suggesting companies with low-cost gas assets, such as Oil Search, still offer value.

The wider use of electric vehicles should result in higher electricity consumption. Some of this increase will undoubtedly be offset by advances in technology that reduce energy intensity levels, but a 33 million electric vehicle production level by 2025 would still translate to only 0.5% of estimated global power demand.

Nevertheless utilities such as AGL Energy could have a role to play not only in the supply of electricity, but also in managing charging stations and profit sharing agreements with electric vehicles owners on electricity supply and demand.

More negatively, automotive accessory retailers may need to restructure their product offering, implying further capital expenditure. The longer life expectancy of electric vehicles may also see reduced spending on maintenance services.

An example of a business that would need to adjust is Super Retail, where around 40% of revenue is derived from its automotive business, principally the Supercheap Auto brand. GUD Holdings also generates around 60% of its revenue from its automotive division, where products include automotive filters and replacement parts.

Table 3: Producers exposed to metals used in electric vehicles

					Minerals as a share of revenue (%)			
Name	**Code**	**Recommendation**	**Last trade ($)**	**Target price ($)**	**Aluminium**	**Copper**	**Nickel**	**Manganese**
Alumina Ltd	AWC	Accumulate	2.24	2.50	100*			
BHP Billiton	BHP	Hold	27.23	29.00		22	<2	
OZ Minerals	OZL	Hold	8.17	7.70		88		
Rio Tinto	RIO	Hold	71.10	75.00	27	5		
Sandfire	SFR	Hold	6.21	6.30		88		
South32	S32	Buy	3.33	3.40	45		5	11
Western Areas	WSA	Hold	3.12	2.50			100	

*Alumina does not split revenue so the figure used is a combination of revenue from alumina, aluminium and bauxite operations, based on the last annual report.
Source: Ord Minnett Research

INCITEC PIVOT

WAGGAMAN CATALYST

Sector: Chemicals Recomm: Buy Risk: Medium Price: $4.01

Incitec Pivot posted an impressive 17% rise in earnings before interest and tax to $501 million in the year to 30 September, with strong cash generation, record earnings growth at its Americas division, and the first contribution from its new ammonia plant in Waggaman, Louisiana, being the highlights.

The global supplier of fertilisers, industrial chemicals and explosives also unveiled a $300 million share buyback, thanks to its strengthened balance sheet.

The key driver of the result was a 46% surge in earnings from its Americas division, underpinned by cost savings and benefits from its 'Business Excellence' program. Growth in the quarry and construction sector, and an initial earnings contribution from the Waggaman plant also boosted the numbers.

For its Dyno Nobel explosives business, Incitec expects continued growth in the quarry and construction sector to benefit the Americas business. In Asia Pacific, recent coal, base and precious metals price moves have been encouraging, and the long-term production outlook has improved, particularly for coal from Queensland's Bowen Basin.

In industrial chemicals, earnings are expected to grow as Waggaman continues to increase production, although earnings are dependent on movements in global ammonia and natural gas prices. The Waggaman operation remains key to group earnings growth as volumes are expected to reach nameplate capacity in 2018.

The fertilisers business will continue to be dependent on global fertiliser prices and the A$/US$ exchange rate, both of which remain headwinds for this unit at present.

We see Incitec entering a period of earnings growth and strong cash flow generation. Productivity benefits from the 'Business Excellence' scheme have supported divisional margins in recent periods, and the company continues to grow despite challenging industry conditions. We reiterate our Buy recommendation.

For a full copy of the report please contact your Ord Minnett adviser.

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