November 2018

ORDS MONTHLY

CHARTING A COURSE

OFFSHORE EXPANSION

Our forecast in the previous edition of the *Ords Monthly* for a rocky road ahead in the final quarter of 2018 has proven prescient, given the Australian market notched its steepest monthly slide in nearly 10 years in October.

The global sell-off appears to have been prompted by fresh fears the long-running bull market may be nearing an end, potentially sparked by damage to corporate earnings from an apparent continual worsening of trade tensions between the US and China.

Ord Minnett remains alert but not alarmed, and in this issue of the *Ords Monthly* we give readers our guide on how to navigate markets in the wake of October's rout.

In short, we see value emerging on a broader scale, with most markets' valuation multiples below multi-year averages even allowing for the recent bounce from October's lows. Among individual names, we also spy some prime opportunities based on growth or value potential and/or dividend yield on offer. See page 2 for our Investment Strategy note.

In our corporate coverage, we look at **WorleyParsons** post its latest expansionary move – buying the energy, chemicals and resources operations of US-listed Jacobs Engineering for $4.6 billion. The deal creates a global player and doubles earnings at the company founded by chairman John Grill. See page 4 for more.

The expansionary theme continues in our note on **Aristocrat Leisure** on page 5. Besides a burgeoning digital games business, the slot machine and game manufacturer and developer has strong growth options in North American markets in general, and in gaming operations in Native American casinos in particular.

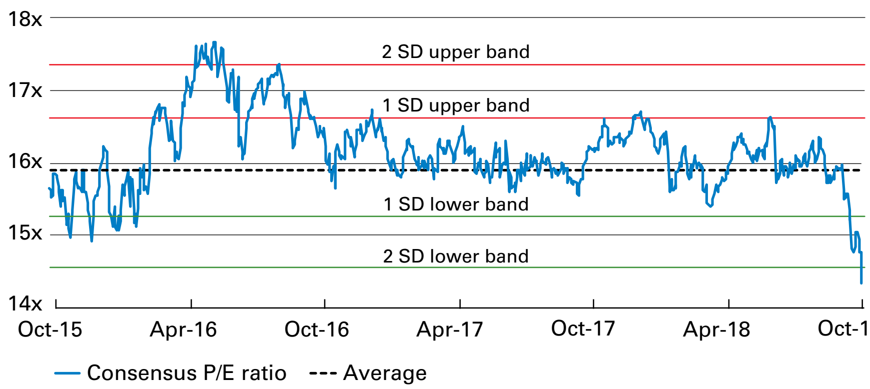
BHP Billiton is splashing the cash now that the sale of its US onshore energy assets is complete. The Big Australian is returning US$10.4 billion to shareholders via a buyback and special dividend. We explain the details and provide a list of key dates on page 6.

Commonwealth Bank surprised many in the market with the sale of its Colonial First State Global Asset Management business to Japan's Mitsubishi UFJ for $4.13 billion, rather than keeping the unit as a keystone of the planned spin-off of the wealth management and mortgage broking businesses. See page 7 for our take on the deal.

> "The Big Australian is returning US $10.4 billion to shareholders via a buyback and special dividend."

Finally, we highlight the growth opportunities for **Caltex Australia** from its convenience retail strategy. Its long-term deal with Woolworths leverages the grocery chain's Metro brand and its buying power, while fast-food offerings such as Boost Juice (and potentially Guzman Y Gomez) will be a key strategic advantage.

Figure 1: S&P/ASX 200 forward P/E and standard deviation (SD) bands



Source: Bloomberg, Ord Minnett Research, data to 27 Oct, 2018.

INVESTMENT STRATEGY

THE WAY AHEAD

Market ructions have once again made October a difficult month for investors, with the S&P/ASX 200 Index's 6.1% fall being the largest monthly decline since January 2010.

Earnings expectations, in stark contrast, actually moved higher this month. As a result, the market's one-year forward price to earnings (P/E) ratio has shed 1.5 points – at 14.0 times in late October it was in line with the 10-year average, a period that includes the depths of the global financial crisis.

In fact, since our global P/E heat map hit the 'red wall' at the end of 2017 with most market multiples scaling cycle highs, the sell-off has driven our heat map into the green, (see Table 1). With the exception of the Small Ordinaries, all key global indices are not far from multi-year lows, even allowing for the post-October bounce.

Many reasons have been offered for the sell-off, and most relate to fears of a cycle peak and imminent economic or earnings recession, spurred by a drawn-out trade war between the world's two largest economies.

In Ord Minnett's view, this lurch downwards is an opportunity as opposed to a portent of more pain.

We see the cycle as maturing, but we do not believe an economic or earnings crisis is on the cards yet and we highlight the following issues:

- **Monetary policy** – This remains accommodative-to-neutral. Interest rates in the US remain accommodative and are not restrictive for growth at this stage. The Federal Reserve could pause its policy tightening if this was a credible risk. In other developed markets, interest rates remain near record lows. Meanwhile, China has also been easing policy, having reduced its bank reserve requirements in recent months.
- **Corporate earnings** – The outlook has not shifted significantly. EPS forecasts for the US S&P 500 Index in 2019 at the time of writing were at circa US$178, as per FactSet, with 74% of companies having reported their latest quarterly numbers. This was little changed through the quarterly reporting season and October's market swoon.

Table 1: Market multiples movement since December 2017

	Price-earnings ratio (x)										
Global	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**
MSCI World	16.2	16.2	15.3	14.8	14.9	14.8	14.6	14.9	14.9	14.8	13.4
MSCI Developed	16.9	16.8	15.9	15.3	15.4	15.3	15.2	15.4	15.5	15.4	14.0
MSCI Emerging	12.5	13.0	12.3	11.9	12.0	11.6	11.3	11.5	11.4	11.2	10.0
Countries/regions											
S&P 500	18.2	17.9	16.9	16.4	16.2	16.3	16.2	16.5	16.8	16.8	15.2
NASDAQ	21.6	22.0	21.2	20.4	20.1	20.9	20.9	20.9	21.9	21.6	19.0
Euro STOXX	14.4	14.7	14.1	13.7	14.2	13.7	13.5	13.9	13.4	13.4	12.2
MSCI China	13.3	14.0	13.0	12.4	12.3	12.5	11.9	11.7	11.2	11.1	9.6
Topix (Japan)	14.8	14.9	14.0	13.5	14.0	13.5	13.2	13.3	13.0	13.5	11.9
FTSE 100	14.7	14.3	13.5	13.1	13.8	13.6	13.3	13.4	12.6	12.7	11.6
Australia											
S&P/ASX 200	16.2	16.0	15.7	14.9	15.3	15.3	15.6	15.8	15.8	15.5	14.0
S&P/ASX 50	15.7	15.5	15.2	14.4	14.9	14.9	15.3	15.5	15.4	15.1	13.7
Small Ordinaries	17.9	17.4	17.3	16.5	16.8	17.0	17.0	16.8	17.6	17.5	15.6

Source: Ord Minnett Research, Bloomberg. Data to 27 Oct, 2018.

Consequently, the US forward P/E ratio for 2019 has improved to 15.6 times, versus a longer-term average (since 1990) of 15.8 times.

Similarly, fiscal 2019 EPS forecasts for the S&P/ASX 200 Index have been resilient at $393, and our forward P/E ratio is around 14.0–14.5 times, versus a longer-term average (since 2000) of 14.3 times).

- **Business and consumer confidence** – The global composite Purchasing Managers Index on business activity inched up 0.2 points to 53 in October, which is consistent with global GDP growth running at a circa 3% annualised pace. The consumer, who drives most growth in developed markets, should be assisted by improving labour markets.

  In Australia, both business conditions and confidence improved in September, although the latter remains near two-year lows. Profitability and employment expectations rose through the month, while trading conditions, capital expenditure and forward orders deteriorated.

  Meanwhile, the labour market has continued to strengthen with the unemployment rate dropping 0.3 percentage points to 5.0%, a six-year low.

- **Asset class contagion** – The sell-off has been mostly contained to equities. Other growth assets are not pointing to as much concern. For example, the iron ore price has increased and is now around US$75 per tonne.

  Similarly, credit markets do not appear to be under stress, nor is liquidity drying up. There are pockets of concern, e.g. Italy and Turkey, but broadly, global credit spreads have barely moved.

- **China** – An anticipated lift in fixed asset investment failed to materialise in China's latest activity data, but our economists still see fiscal stimulus triggering a recovery in infrastructure investment.

From a global perspective, we see the downdraft as overdone. In Australia, we maintain our June 2019 target range for the S&P/ASX 200 Index of 6100–6500, implying potential upside of 4–11% from current levels.

We have run the ruler over our coverage universe, screening for stocks that had fallen more than the market; offered at least 20% upside to our target price; paid a gross dividend yield of more than 6.5%; or which still met our growth at a reasonable price theme, i.e. a PE multiple to earnings growth (PEG) ratio of 1.5 times or less.

In companies that meet at least two of the criteria, **WorleyParsons** – covered in this *Ords Monthly* – features in three of the four categories, having underperformed the market, offering potential target price upside of 35% and a PEG ratio of 0.5 times.

Aristocrat Leisure – also covered in the following pages – features in the same three categories, and offers potential 28% price upside and a PEG ratio of 0.6 times.

We note **National Australia Bank** meets all four criteria at the time of writing – offering 23% upside to our target price, a gross dividend yield of circa 11.4% and a PEG ratio of 0.8 times. NAB and **ANZ Bank** are our top choices in the financials.

See Table 2 below for more of our preferred choices or contact your adviser for more information.

Table 2: Highlights from Ord Minnett preferred stock list

Company	Potential upside to target price (%)	Gross yield (%)	Performance vs market 31 Aug-7 Nov (ppts)	PE/EPS growth (PEG) (x)
Afterpay Touch	77	0.0	28	0.4
WorleyParsons	35	2.8	-20	0.5
AGL Energy	29	8.6	-13	na
Aristocrat	28	2.5	-14	0.6
Reliance	25	2.6	-7	0.3
Alumina Ltd	23	16.7	-13	0.1
NAB	23	11.4	-9	0.8
ANZ Bank	22	8.5	-10	1.6
Magellan	18	7.8	-3	1.2
Rio Tinto	16	6.7	12	1.7

Source: Ord Minnett Research, Bloomberg. Data to 7 Nov, 2018.

WORLEYPARSONS

GOING BIG

Sector: Energy Recomm: Buy Risk rating: Higher Share price: $15.54

Year to June	2018A	2019E	2020E
Profit after tax ($m)	171	358	543
Earnings per share ($)	0.63	0.87	1.04
Price/earnings (x)	24.7	17.8	15.0
Dividend ($)	0.25	0.43	0.61
Dividend yield (%)	1.6	2.8	3.9
Franking (%)	-	-	-

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

WorleyParsons (WOR) share price

Source: IRESS

WorleyParsons has paid $4.6 billion to buy the energy, chemicals and resources (ECR) business of US-listed Jacobs Engineering in a deal that creates a global engineering group.

Ord Minnett is positive on the deal as the assets are complementary to its existing businesses and make strategic sense. That said, ultimate success will depend on the point in the capital expenditure cycle. The larger scale and scope of the new WorleyParsons should be positive, in our view, if the cycle continues to improve as we expect.

The acquisition will be funded with $3.7 billion in cash and a further $895 million in new debt via a bridging loan. The equity funding was completed through a $2.9 billion 1-for-47 entitlement offer and the issue of $985 million in new WorleyParsons stock to Jacobs.

The new Jacobs shares will be escrowed for six months post completion of the deal – expected in the first half of 2019 – or until 31 August 2019, whichever is later.

This is WorleyParsons' largest transaction to date, and follows the $300 million acquisition in 2017 of the oil and gas operations of UK-listed Amec Foster Wheeler to give the Australian company a foothold in the North Sea.

The combination of WorleyParsons and the Jacobs ECR business will double the size and scale of the current business. It expands WorleyParsons' geographical footprint to include the US, Canada, and Europe, where Jacobs ECR has a strong presence, and will lift overall revenue by 93%. See Figure 3 for old and new company revenue split.

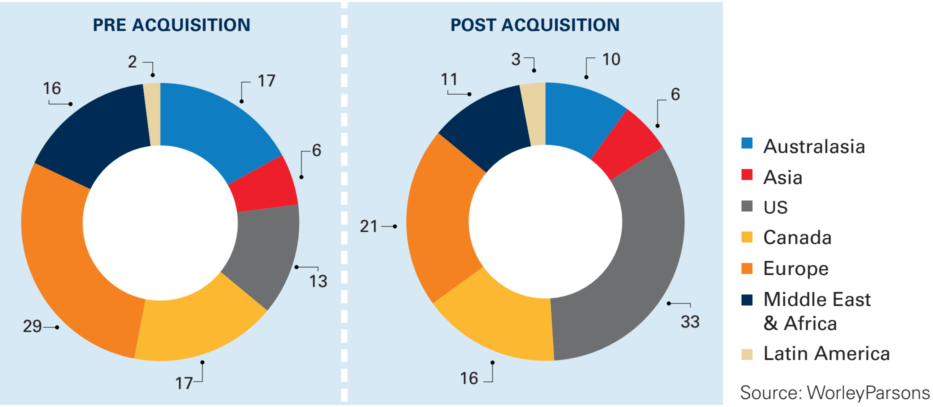
Our net profit forecasts have increased by close to 100% after incorporating the acquisition into our model.

Our EPS estimates are broadly unchanged, however, with the higher net profit offset by a greater number of shares on issue.

It is worth noting that one of the previous investment considerations with WorleyParsons was the potential for the company to be taken over.

Dubai-based Dar Group, which had previously bid for full control of WorleyParsons, will take up its full allocation to maintain its circa 22% stake. While Jacobs will become the second largest holder at 11%. John Grill, WorleyParsons' founder and chairman, will hold circa 10%. These changes, and the increased market capitalisation, suggest a takeover is now less likely.

Figure 3: Proforma fiscal 2018 revenue split by geography (%)



Source: WorleyParsons

ARISTOCRAT LEISURE

GAME ON

Sector: Consumer Services Recomm: Accumulate Risk rating: Higher Share price: $27.31

Year to September	2017A	2018E	2019E
Profit after tax ($m)	546	768	877
Earnings per share ($)	0.85	1.20	1.37
Price/earnings (x)	32.0	22.7	19.9
Dividend ($)	0.34	0.49	0.59
Dividend yield (%)	1.2	1.8	2.1
Franking (%)	70	100	100

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

Aristocrat Leisure (ALL) Share price

Source: IRESS

Aristocrat Leisure is a slot machine and game maker with operations in Australasia, the Americas and elsewhere, as well as a fast-growing digital division.

We recently reviewed the company's North American strategy and market growth opportunities after our global research partner hosted an investor tour through the US state of Oklahoma. The state is an important segment of the Native American gaming market and home to nearly one-third of the nation's American Indian population.

Oklahoma has more casinos than any other state, with around 130 tribal gaming operations. Oklahama City, the state capital, takes in circa US$2.3 billion per annum in gross gaming revenue, according to the National Indian Gaming Association, with a total of 69 operators alone.

We see Aristocrat generating net profit growth of more than US$202 million in new land-based markets by fiscal 2021, based on 4,400 slot machine shipments in Oklahoma expansions and at least 9,500 extra machines across other new market segments.

The annual addressable North American market for Aristocrat can be split between sales of 75,000 machines, and leasing – also called participation or gaming operations – of 160,000 machines, across both Class 2 and Class 3 machines.

Class 2 machines are non-taxable and are only available in tribal casinos. They offer games such as bingo and cards, where players compete against each other rather than the house. Class 3 machines are traditional slots offering wagering games or electronic versions of games played against the house, such as roulette and blackjack, and are taxable by the states.

Oklahoma casino expansions will grow the market by 10,000 machines, with Aristocrat set to win 4,400 slots, given its 65% market share in Class 2, and a strong list of Class 3 titles.

The Native American Class 3 tax rate in Oklahoma is set to rise to 10% from 6%, which will benefit Aristocrat's Ovation offering – a non-taxable Class 2 product with similar playing characteristics to a Class 3 machine.

The Oklahoma market is currently 40% Class 2 machines and 60% Class 3. That mix is likely to invert as tribal casino operators turn to Aristocrat's VGT arm, a key provider of leased Class 2 machines to the tribal market, and its Ovation product to maintain margins.

In our view, Aristocrat can sell an additional 9,500 machines in other new markets. These include Washington state's central determining system – a very large database of predictable, determined outcomes that are distributed to gaming machines in advance, similar to a scratch Lotto ticket game; the bar-top market – literally machines in bars; video lottery terminals; and the state of Illinois, where video gaming was only legalised in 2012.

Besides North America, we see further digital growth and capital management opportunities. Coupled with strong execution by management, and earnings growth despite a challenging structural decline in slot machine spending, the Aristocrat risk/reward equation looks attractive.

BHP BILLITON

SPLASHING THE CASH

Sector: Diversified Resources Recomm: Accumulate Risk rating: High Share price: $33.39

Year to June	2018A	2019E	2020E
Profit after tax ($m)	11,523	13,901	12,579
Earnings per share ($)	2.16	2.61	2.36
Price/earnings (x)	15.4	12.8	14.1
Dividend ($)	1.52	1.83	1.65
Dividend yield (%)	4.6	5.5	4.9
Franking (%)	100	100	100

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

BHP Billiton (BHP) share price

Source: IRESS

BHP Billiton has concluded the sale of its US onshore assets and announced details of how it intends to return the US$10.4 billion of proceeds to shareholders.

The company will use US$5.2 billion ($7.3 billion) for a buyback of the Australian-listed Ltd stock, while the remaining US$5.2 billlion will be returned via a special dividend. There will be no onmarket buyback of the UK-listed Plc stock. Please see Table 3 below for a list of key dates:

The capital return was well flagged by the company, although Ord Minnett was surprised by the large special dividend component and the lack of a Plc buyback.

Our preference would have been a larger buyback although we note the form of return is likely a function of investor feedback.

Overall, the capital return has increased our FY20 EPS forecast by 4.0% and is 1.6% accretive to our net present value (NPV) measure under BHP's payout plan.

The special dividend, to be paid after completion of the buyback, equates to a 5% return on top of the ordinary dividend of a 5% yield.

The US$5.2 billion buyback of Ltd stock represents 3.2% of issued capital and lifts our EPS forecasts by 4.0%. BHP intends to complete this process by 17 December 2018.

Under this scenario, our NPV would rise 1.6%, with the stock purchased around 10% below our NPV.

BHP is now at the lower end of its US$10–15 billion targeted net debt range, i.e. circa US$10.9 billion as at 30 June.

Strong cash flow continues for the resources giant, and we see a high likelihood of further capital management in the medium term.

In our view, future returns will be more likely to be in the form of share buybacks, in accordance with the company's recent history of capital management.

Table 3: Timetable for share buyback and special dividend

Nov-2018		Dec-2018		Jan-2019	
1	Last day shares could be acquired to be eligible for franking credit entitlements under off-market buyback	14	Buyback tender period closes	9	Last day to trade cum special dividend (ASX, LSE, NYSE)
5	Last day shares could be acquired to be eligible to participate in the off-market buyback	17	Announcement of final buyback price and any scale back	10	Ex date for special dividend
6	Share quoted ex-entitlement to participate in the off-market buyback	17	Special dividend determined and announced	11	Record date for special dividend
7	Buyback record date: Determination of eligible shareholders entitled to participate in the off-market buyback	24	Dispatch/crediting of buyback proceeds to participating shareholders	30	Payment date for special dividend
15	Distribution of buyback tender documents to shareholders				
19	Buyback tender period opens				

Source: BHP Billiton, Ord Minnett Research

COMMONWEALTH BANK

LOSING APPEAL

Sector: Financial Services Recomm: Hold Risk rating: Medium Share price: $69.25

Year to June	2018A	2019E	2020E
Profit after tax ($m)	9,233	9,917	10,373
Earnings per share ($)	5.13	5.48	5.85
Price/earnings (x)	13.5	12.6	11.8
Dividend ($)	4.31	4.31	4.31
Dividend yield (%)	6.2	6.2	6.2
Franking (%)	100	100	100

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

Commonwealth Bank (CBA) share price

Source: IRESS

Commonwealth Bank will sell its Colonial First State Global Asset Management (CSFGAM) business to Japan's Mitsubishi UFJ Trust and Banking Corporation (MTUB) for $4.13 billion, with the transaction expected to complete in mid 2019.

We see this sale as a mildly positive outcome – CFSGAM accounted for just 3% of CBA's fiscal 2018 group earnings – and it should provide further certainty around CBA's capital position.

CBA expects to recognise a post-tax gain on sale of around $1.5 billion, including these costs. Net of these costs, about $100m, we estimate the deal was struck on a multiple of 17.1 times fiscal 2018 earnings.

The sale should add $2.9 billion to CBA's core equity tier 1 (CET1) capital, lifting its CET1 ratio by more than 60 basis points. This comprises mainly the post-tax gain on sale, plus a reduction in capital deductions from accounting goodwill and investment in net tangible assets.

The bank did not provide any specific guidance on possible capital management initiatives, although management commented that it would provide further guidance to the market on possible initiatives following completion of announced divestments.

Given the global nature of the CFSGAM business, regulatory approvals are required in a number of jurisdictions.

The spin-off of CBA's remaining wealth management and mortgage broking businesses as a separate company is still expected to proceed, albeit at a reduced scope following the sale of CFSGAM.

Colonial First State, Count Financial, Financial Wisdom, Aussie Home Loans and CBA's minority shareholdings in ASX-listed companies CountPlus and Mortgage Choice will comprise the new company.

The omission of CFSGAM from the new company will make the demerged entity less attractive to investors, in our view.

Underpinning the commitment to press ahead with the spin-off of the remaining business, CBA made executive appointments to the new company, including Jason Yetton as CEO and Andrew Morgan as CFO.

Yetton joins the new company after spending two years as CEO of peer-to-peer lender SocietyOne.

He also has more than 20 years' experience working at Westpac and BT Financial, including as group executive of retail and business banking.

Morgan is an internal appointment and is currently CFO for wealth management at CBA.

Prior to this, Morgan was CFO for the business and private bank and Bankwest at CBA.

He has more than 25 years' experience in the financial services and property sectors, including at LendLease, NAB, Radian and Perpetual.

CALTEX AUSTRALIA

FOOD AND FUEL

Sector: Energy Recomm: Buy Risk: Medium Price: $27.13

Caltex Australia recently hosted an investor day where it reiterated expectations of an extra $120–150 million in earnings from the expansion and revamping of its convenience retail operations.

The drivers of future performance include faster shop sales growth than the industry but also new markets beyond traditional convenience, e.g. fast-food offerings and labour cost savings.

The timing of the uplift, however, has been extended to 2024 from 2022–23 and previously exuberant commentary on upside potential has been moderated.

The partnership with Woolworths provides significant opportunities via access to the Metro brand and Woolworths Rewards loyalty program, and lower cost of goods sold through Woolworths' buying power.

Its food offerings are a key differentiator, with the Boost Juice Bars chain as part of a long-term deal, while the Guzman Y Gomez Mexican food chain is still in a pilot agreement.

Caltex is undergoing significant change and is starting to land some strategic initiatives. The Woolworths deal reduces risks around fuel volumes and the convenience retail strategy, which had weighed on the stock.

We like the plan to sell some retail sites to a partner, but it is not the enabler of capital management and return of $1 billion in franking credits for which many investors had hoped.

The transition from a franchise to corporate operating model is a challenge, but the cost has been well-flagged and is an enabler of the new convenience strategy.

The core business is robust, although falling volumes and margins are a near-term headwind. We are confident, however, that the industry structure will support rational competition. Refiner margins should remain robust, if a little volatile, and growth options remain, led by Ampol Singapore volumes, Gull New Zealand and SEAOIL.

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

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