ORD MINNETT
PRIVATE WEALTH

November 2019

ORDS MONTHLY

HEAT IS ON
WINNERS AND LOSERS

The Australian equity market lagged its global counterparts in October – the S&P/ASX 200 Index dipping 0.4% versus the MSCI World Index's gain of 3.3% – to record underperformance of 3.7 percentage points for the month.

A stronger Australian dollar – up 2.7% against the greenback over the month – played a part in the underperformance, although the greater drag was from weakness in the banks – down 5.1% – and the miners – down 2.2%. For the year so far, the local market is up a solid 17.9% in price terms, albeit running towards the middle of the pack in a global context as Figure 1 below shows.

Drought has dominated news headlines for many months now, and the latest one appears to be particularly onerous. In this edition of the Ords Monthly, we examine the impact on sectors and stocks from the big dry. See pages 2–3.

Our corporate coverage kicks off with **Lendlease**. The company has a development pipeline of around 20 projects with an end-value of $100 billion, which augurs well for the property group for the next 20 years. A key development underpinning the outlook is its Barangaroo South project, and we explain why this has driven double-digit increases in our EPS estimates on page 4.

Cleanaway Waste Management disappointed with its recent guidance for the first half of fiscal 2020, and the market will be sceptical of the company's expectation of a second-half earnings recovery. That said, we see medium-term industry trends as positive for large-scale players such as Cleanaway and outline our views on page 5.

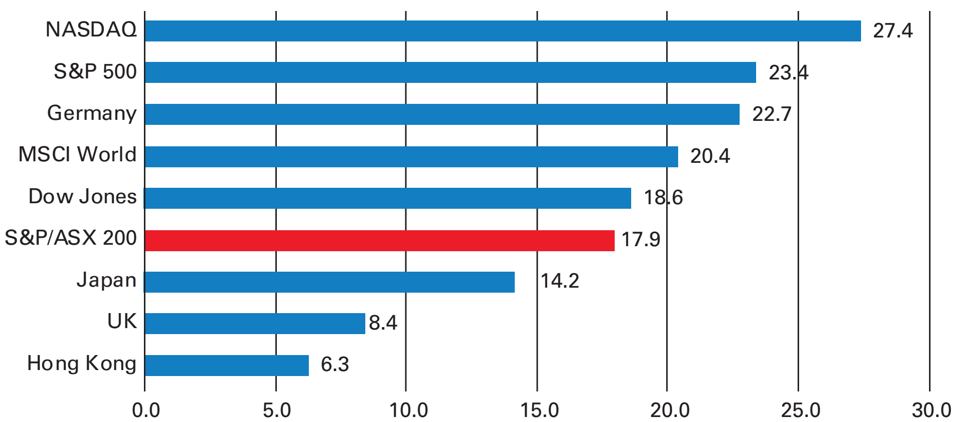
> Fortescue Metals continues to report impressive operating metrics, particularly in free cash flow which finds its way back into the hands of shareholders via capital management.

The **Rio Tinto** Pilbara iron ore operations performed solidly in the latest quarter, as did its copper division via the Kennecott copper mine in Utah and the part-owned giant Escondida mine in Chile. Increasing cost pressures will be an issue in 2020 but we still prefer **Rio Tinto** over BHP Group and we lay out our investment thesis on page 6.

Fortescue Metals is one of our key picks in the mining sector. The No.3 iron ore producer continues to report impressive operating metrics, particularly in free cash flow which finds its way back into the hands of shareholders via capital management. The balance sheet is strong, bolstered further by a recent refinancing, and we see record operating earnings margins in fiscal 2020. See page 7 for more.

Lastly, **Insurance Australia Group** has sold its stake in its Indian joint venture for $600 million, with an expected profit of at least $300 million. The move will boost the insurer's capital position and we expect returns to shareholders once the sale is completed. See page 8.

Figure 1: Global markets performance to 1 Nov 2019 (%)



Source: IRESS. Price index basis.

INVESTMENT STRATEGY

DRY ARGUMENT

Drought has long been a characteristic of the Australian landscape, but the current arid weather is taking a particularly onerous toll with little relief in sight.

Lower-than-average rainfall is apparent across a wide swathe of the country (see Figure 2). In turn, areas in drought – deemed as having rainfall in the lowest 10% band on record for three months or more – now cover most of NSW and South Australia, along with parts of Queensland and Western Australia (see Figure 3).

Drier-than-average conditions are forecast to continue until December, with a less than 30% chance that most of the mainland will exceed the median rainfall.

Even if conditions ease in early 2020, several months of above-average rainfall are required to end the challenging conditions.

We estimate the drought has added 0.4 percentage points to food inflation and presented a 0.15–0.20% headwind to economic growth.

In our view, below-average rainfall presents downside risks for agriculture, banks, fertiliser producers, transport companies and selected industrial manufacturers.

On the other hand, the lack of rainfall is supportive, or even beneficial, for construction activity, general insurers (lower claims costs), and supermarkets (due to food inflation).

We examine the potential impact from the 'big dry' in more detail below.

Looming negatives…

Agriculture – lower livestock or crop yields

We currently do not cover any agricultural companies but note that companies such as **Costa** (impacted by water costs and food quality), as well as **Tassal** and **Huon Aquaculture** (warmer sea temperatures impact salmon numbers) are negatively affected.

Banks – loan impairments

We estimate around 1–4% of the major banks' loan portfolios are exposed to Australian agriculture, with **National Australia Bank** and **ANZ Bank** at the higher end of the range.

Bendigo and Adelaide Bank has more meaningful exposure, with around 16% of its cash earnings and circa 10% of credit exposure in agribusiness. Around 8% of **Suncorp**'s lending portfolio is to agribusiness.

Fertilisers – less demand for crop protection or fertilisers

The drought reduced fiscal 2018 and 2019 sales and earnings in **Nufarm**'s Australian segment, and is expected to have an impact on fiscal 2020 as demand for crop protection stays subdued.

Incitec Pivot is Australia's largest supplier of fertilisers. It recently downgraded FY19 earnings ahead of its result on 12 November. We estimate its Asia-Pacific fertiliser division represents circa 19% of group earnings before interest and tax and a strategic review of the business is under way.

Wesfarmers operates CSBP Fertilisers in Western Australia. Fertiliser earnings are not disclosed separately, but the chemicals, explosives and fertilisers unit made up 15% of group earnings in fiscal 2019.

Packaging – reduced demand due to lower agricultural production

Pact Group provides packaging for the consumer-goods industry including food, dairy and agricultural products. It has been affected by lower demand from packaging volumes from these sectors. In fiscal 2019, 56% of Pact's packaging revenue came from the food, dairy and beverage sectors.

Transport – lower grain and livestock volumes

We have limited coverage of transport companies, but we note the impact of lower grain export volumes on haulage, storage and/or handling facilities at **Aurizon** and **Qube**.

Balanced risks, but negative if drought worsens…

Resources – if water availability restrains commodity output

At this stage, we see the run of dry weather as more favourable as it reduces processing downtime and the risks of mines being flooded.

We don't anticipate a significant impact, unless a stronger El Niño pattern forms, perhaps forcing restrictions on water usage. We note commodities such as coal (**Whitehaven Coal**), coal seam gas (**Santos**), nickel, copper and gold (**Newcrest**); all have relatively high water intensity.

Utilities – lower hydro output but electricity prices supported

The initial impact will be negative for those operating hydro assets, as low dam levels prevent these assets from operating at capacity. **AGL Energy**'s hydro assets represent 8% of its overall generation capacity versus 3% at **Origin Energy.**

Over the medium term, however, lower supply and higher electricity demand during a warm summer could put upward pressure on electricity prices.

Furthermore, coal-fired power generators use large amounts of water, but we don't anticipate a significant impact unless governments specifically apply water restrictions to the industry.

Beverages – yield versus quality

Treasury Wine Estates' yields would suffer from a hot summer, but this needs to be balanced against what is likely to be a higher-quality vintage, which should attract higher prices from customers.

Supportive or beneficial…

Construction – drier weather reduces delays

A longer run of dry weather will allow construction companies to complete projects faster, or on time, and within budget, benefiting the likes of **Boral** and **Lendlease**.

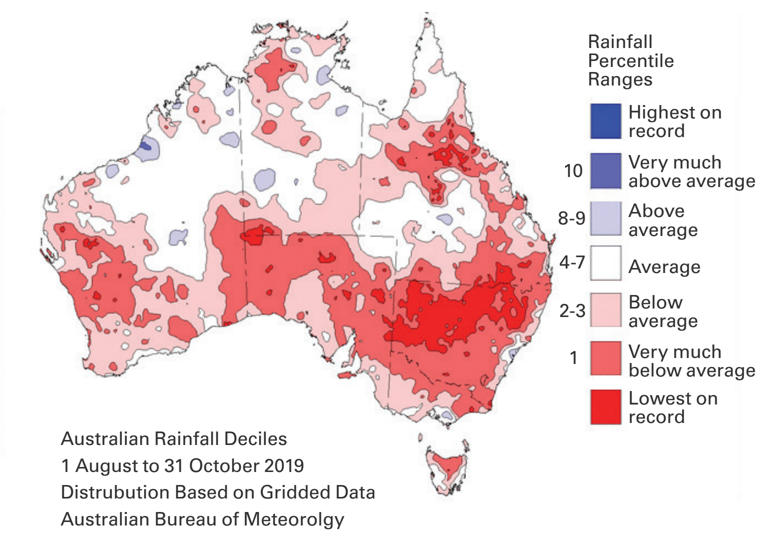
General insurance – lower claims

Insurance Australia Group, QBE Insurance and Suncorp could see an improvement in margins as reduced rainfall results in lower motor accident rates. Furthermore, flooding tends to be more costly for insurers, so the reduced chances of floods could see below-budget catastrophe costs.

Supermarkets – food inflation

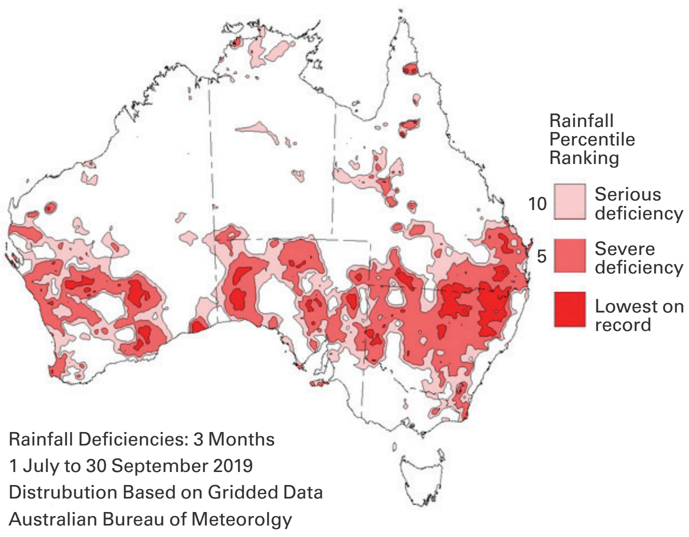
Food inflation, which drives sales revenue and margin expansion, is likely to be more meaningful for **Woolworths** and **Coles** revenues, as fresh food, e.g. fruit and vegetables and meat, represents roughly 20% of their supermarket sales versus 5% at **Metcash**.

Figure 2: In the red – rainfall remains below average across Australia (July to September 2019)



Source: www.bom.gov.au

Figure 3: Areas of Australia in drought (i.e. rainfall in the lowest 10% band on record)



LENDLEASE GROUP

BARANGAROO BOOST

Sector: Real Estate Recomm: Buy Risk rating: Higher Share price: $18.95

Year to June	2019A	2020E	2021E
Profit after tax ($m)	467.5	782.8	670.3
Earnings per share (¢)	82.4	138.8	118.9
Price/earnings (x)	23.0	13.7	15.9
Dividends per share (¢)	42.0	69.0	60.0
Dividend yield (%)	2.2	3.6	3.2
Franking (%)	–	–	–

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

Lendlease (LLC) share price

Source: IRESS

Lendlease Group is a contruction and property development group and a global leader in large-scale mixed-use urban regeneration projects.

Following a series of major project wins, the company now has a development pipeline of around 20 projects with an end-value of circa $100 billion, which positions the business well for the next 10–20 years.

One such project that underlines the strong outlook for Lendlease is its Barangaroo South project in the Sydney CBD's western corridor.

Ord Minnett has conducted a comprehensive analysis of the Barangaroo South development and we estimate it will underpin earnings growth of 30–40% over the next three-to-five years for the company.

We see this as a catalyst for price-earnings multiple expansion, recently leading us to raise our recommendation on Lendlease to Buy from Accumulate and our target price to $22.50 from $17.50.

The Renzo Piano-designed Barangaroo South comprises three buildings, spanning 808 units over 106,000 square metres (sqm) of gross floor area and 93,000sqm of net saleable area, based on our estimates.

Our analysis suggests Barangaroo South will deliver $4.05 billion in revenue, some $1.3 billion more than our previous forecast, at a 21% post-tax margin on cost. We estimate this would generate $630 million of post-tax profits in fiscal 2023 and 2024.

To reflect Barangaroo South and the broader backlog, we have lifted our forecast EPS by 44% in fiscal 2023, 58% in fiscal 2024 and 46% in fiscal 2025.

Forecast annual EPS for fiscal 2023–25 of $1.85–2.00 equates to a 30–40% cumulative increase on our fiscal 2020 EPS estimate of $1.39.

We assume Lendlease will fund 50% of the Barangaroo South construction cost through a capital-efficient funding mechanism to manage cash flow and gearing.

In effect, this would be a forward sale of presold revenue.

Based on this, we forecast gearing will peak at 18–19% (near the upper end of the group's 10–20% target), although we expect cash settlement revenue to reduce net debt by about $2.25 billion and cut gearing to 0–5% by fiscal 2024.

In our view, Lendlease would prefer to retain balance sheet flexibility. Besides a capital-efficient funding structure, it could introduce a joint venture partner to the project, or raise $0.5–1 billion in capital if it can resolve the fate of its problematic engineering and services business.

The division is up for sale, with several companies having lodged their interest with Lendlease, although no deal has yet been announced.

We estimate a $1 billion raising, or about 10% of market capitalisation, would dilute EPS by 5%, but would reduce peak gearing to 12% and position Lendlease with no net debt on completion of the Barangaroo South development.

CLEANAWAY WASTE MANAGEMENT

WASTED OPPORTUNITY

Sector: **Commercial Services** **Recomm:** **Accumulate** **Risk rating:** **Higher** **Share price:** **$1.84**

Year to June	2019A	2020E	2021E
Profit after tax ($m)	140.0	138.9	157.0
Earnings per share (¢)	7.4	7.3	8.2
Price/earnings (x)	24.9	25.2	22.4
Dividends per share (¢)	3.6	3.6	4.9
Dividend yield (%)	2.0	2.0	2.7
Franking (%)	100	100	100

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

Cleanaway (CWY) share price

Source: IRESS

Cleanaway Waste Management is an integrated waste management and recycling group that has historically grown through acquisitions.

Following the sale of its New Zealand operations and non-core divisions, the business has reduced leverage and is now focused on growing its presence in Australia, with a particular focus on landfill assets and truck-in collections businesses.

The company provided guidance at its recent annual meeting for first-half fiscal 2020 earnings to be flat on a year ago, driven by lower volumes and commodity prices and the impact of the Queensland levy introduction on its post-collections business.

Ord Minnett found the guidance disappointing on several fronts.

We expected the company would still be seeing incremental cost benefits from the acquisition of Toxfree Solutions as well as the annualisation of benefits realised in fiscal 2019.

In addition, the company's new joint venture with ResourceCo disappointed in the second half of fiscal 2019, although it was expected to contribute in the first half of fiscal 2020.

We concede slowing volumes in Cleanaway's end markets and softer commodity prices are outside its control, but the company has also cited lower local Queensland landfill volumes following the implementation of the levy.

The levy was flagged well in advance of its introduction, however, and Cleanaway should have had the ability to mitigate this to some degree, or at least not be surprised by the resulting impact.

Given the different pricing mechanisms in the market, the soft volumes would have affected post-collections earnings first. This is because post-collections are charged based on a price-per-weight basis, while standard collections are charged based on a price-per-lift basis.

The company expects to offset the lower volumes and commodity prices through cost-saving initiatives and price rises in the second half of fiscal 2020.

Ord Minnett expects the market to remain sceptical about the delivery on these, however, given the poor fiscal 2019 result and this latest reduction in earnings guidance for fiscal 2020.

Cleanaway's management has a strong track record of focusing on the company's cost base, but achieving price rises has been a challenge for the industry for some time.

We question a meaningful recovery in earnings in the second half, although we remain positive about the medium-term structural trends for large-scale operators in the waste management industry driven by potential public policy and regulatory changes.

RIO TINTO

SHIP IT IN

Sector: Metals & Mining Recomm: Buy Risk rating: Medium Share price: $90.49

Year to December	2018A	2019E	2020E
Profit after tax ($m)	11,781.7	14,596.4	12,998.8
Earnings per share (¢)	710.3	899.8	801.3
Price/earnings (x)	12.7	10.1	11.3
Dividends per share (¢)	735.7	698.4	556.4
Dividend yield (%)	8.1	7.7	6.1
Franking (%)	100	100	100

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

Rio Tinto (RIO) share price

Source: IRESS

The September-quarter report from **Rio Tinto** showed solid performance from the company's iron ore and copper operations, with the aluminium division the only disappointment.

Iron ore shipments by the nation's No.1 producer of the steel-making ingredient ran at an annual rate of 341 million tonnes per annum (Mtpa) in the quarter.

This was 8% above our forecasts, which we had set conservatively to allow for rail maintenance issues. In the end, maintenance affected less than two weeks of the quarter. Rio Tinto did sell 6.7Mt of 'alternative' lower- grade products, which reflects stripping issues, in our view.

Guidance was maintained for shipments of 320–330Mt of iron ore in 2019, at a cash cost of US$14–15 a tonne.

Copper production was 13% higher than our forecast, driven by a bounce in grades at the Kennecott Utah Copper mine and a strong quarter of throughput at the Escondida copper mine, the world's largest, in northern Chile.

The company noted that grades at Kennecott would remain volatile until the pushback of the south wall of the underground mine was completed.

The aluminium unit fell short of expectations, with downgrades to 2019 bauxite production guidance to 54Mt from 56–59Mt and a cut in alumina guidance to 7.7Mt from 8.1–8.4Mt. Weather and rail issues were cited for the downgrades.

This business accounts for just 5% of our 2019 forecast for earnings before interest and tax, so we do not view it as a material issue.

At its strategy day in early November, the company provided guidance for 2020 Pilbara iron ore shipments of 342Mt, in line with forecasts.

Cost guidance was not provided, but costs are under pressure and we expect them to rise in 2020 due to general inflation across the sector.

Given this, the company increased its estimate of US$1.5 billion for sustaining capital expenditure in the Pilbara operations, versus US$1 billion historically.

Based on guidance for 2020 shipments, that equates to circa US$3.40 a tonne, in line with our estimate.

Rio Tinto also confirmed it would not be able to reach its targeted annual run rate of 360Mtpa until the 43Mtpa Koodaideri mine comes online in 2021.

Rio Tinto has pushed US$500 million in spending out to 2020 from 2019 and provided new 2022 capital expenditure guidance of US$6.5 billion (with about US$1 billion as yet unapproved).

This was higher than our US$4.5 billion estimate for approved projects only, due mainly to ongoing iron ore division spending.

Rio Tinto is our preferred choice over BHP based on its cheaper valuation metrics, with a price to net present value multiple of 0.91x versus 0.97x for BHP, and a 2020E enterprise value to operating earnings multiple of 4.9x versus 6.1x for BHP. We are also attracted to the mark-to-market upgrades in iron ore, returns of excess capital and a strong dividend yield.

FORTESCUE METALS GROUP

CASH FLOWING

Sector: Metals & Mining Recomm: Buy Risk rating: Higher Share price: $9.00

Year to June	2019A	2020E	2021E
Profit after tax ($m)	4,454.8	5,732.0	3,831.6
Earnings per share (¢)	144.7	186.1	124.5
Price/earnings (x)	6.2	4.8	7.2
Dividends per share (¢)	112.8	110.7	73.6
Dividend yield (%)	12.5	12.3	8.2
Franking (%)	100	100	100

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

Fortescue Metals (FMG) share price

Source: IRESS

Fortescue Metals Group reported a solid September-quarter result, with positive surprises in net debt and realised price metrics and an in-line iron ore production outcome.

Net debt of US$500 million was the lowest since 2006 prior to the company's first production.

This was down from US$2.1 billion in the June quarter and beat Ord Minnett's forecast, due to a working capital release and lower than forecast tax and capital expenditure.

We do note a catch-up tax charge of US$600 million and a US$500 million dividend payment are still to come in the December quarter, and we expect net debt to rise to US$1.1 billion as the company meets these obligations.

Iron ore shipments were as expected, a rate of 167 million tonnes per annum (Mtpa), with costs of US$12.95 a tonne and revenue of US$85 a tonne. Shipment guidance for fiscal 2020 was maintained at 170–175Mt.

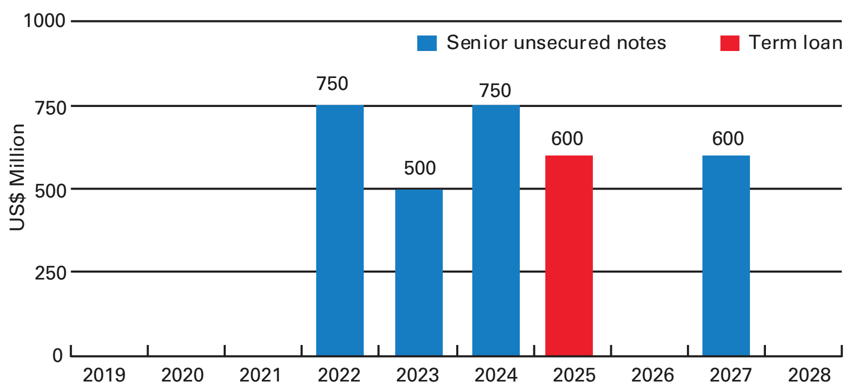
Fortescue's average contract realisation for its lower-grade ore improved to 89% of the benchmark 62% iron content ore price in the quarter, slightly higher than expected.

Fortescue maintained guidance for fiscal 2020 shipments of 170–175Mt. Cash costs were expected to be US$13.25–13.75 a tonne.

The balance sheet remains robust, aided by the US$600 million senior unsecured notes issue and the subsequent repayment and refinancing of the term loan facility. See Figure 4 for the new debt maturity profile.

At spot iron ore prices, we estimate Fortescue would generate US$7.9 billion in operating earnings versus consensus forecasts of US$6.9 billion in fiscal 2020 – a 14% variance – and US$4.6 billion in fiscal 2021 – a 72% difference.

Figure 4: Fortescue debt maturity profile



Source: Company reports

We forecast a 12% FY20 dividend yield, with the stock trading on enterprise value to operating earnings multiple of 2.8x at an average realised price of US$75 a tonne.

Fortescue offers attractive valuation metrics, exposure to long-life operations and strong shareholder returns over the medium term, in our view.

We also expect a record operating earnings margin in fiscal 2020.

The key downside risks are centred on lower iron ore prices, although we expect the stock to show some resilience, in our view, given it hasn't fully tracked higher spot prices.

INSURANCE AUSTRALIA GROUP

EXIT FROM INDIA

Sector: **Insurance** **Recomm:** **Hold** **Risk:** **Higher** **Price:** **$7.90**

Insurance Australia Group (IAG) recently flagged the sale of its 26% interest in its State Bank of India joint venture, SBI General Insurance Co, to Napean Opportunities LLP – part of the family office of Indian IT billionaire Azim Premji – and US private equity investor Warburg Pincus LLC, for more than $640 million.

The transactions need regulatory approval, but the sale is scheduled to be completed by 30 June 2020. The deal is expected to generate a post-tax profit of more than $300 million for IAG.

The impact on the income statement is likely to be a boost to net profit of more than $300 million and strengthen its regulatory capital position by more than $400 million.

This equates to an extra 17 basis points to IAG's core equity tier one ratio, or a surplus of around $250 million to the mid point of its target capital ratio range.

Ord Minnett has included the sale in its earnings forecasts, assuming it will complete in the second half of fiscal 2020. We see capital management as highly likely after that, although this is not yet incorporated into our forecasts.

We have also not included capital management in our IAG earnings estimates as it is unclear what form it would take. That said, we see a share buyback as the most likely option.

IAG appears fully valued. For the moment, however, we see the market as still happy to pay up for a company with perceived earnings certainty.

We have more confidence in IAG's guidance for fiscal 2020 than we have in Suncorp meeting consensus forecasts, and there is also the aforementioned prospect of capital management.

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