ORD MINNETT
PRIVATE WEALTH

October 2018

ORDS MONTHLY

FINAL APPROACH

BOATS, PLANES AND PALLETS

Escalating trade tensions, domestic political uncertainty, Royal Commission revelations over bank misbehaviour – and the potential impact on earnings – and divergent monetary policy outlooks all signal a rocky road in the final quarter of 2018.

The S&P/ASX 200 Index is currently on track to snap its winning streak of nine straight December-quarter gains, albeit it is very early in the period.

The impact from the above-mentioned cocktail of influences has led Ord Minnett to further cut its forecast for the Australian dollar against the US dollar into 2019.

In this edition of the Ords Monthly our investment strategy piece, starting on page 2, lays out our thinking on the currency and lists the non resources stocks that, in our view, will benefit most from prime exposure to the greenback.

We also touch on the banks following the release of the Royal Commission's interim report, and set out some of the challenges facing the sector.

The first of our individual stock notes is **Brambles**, which has fallen a long way from its highs in 2016 above $13.00.

Pallets remain integral to the supply chain, however, and offer the best solution for customers. Ord Minnett runs the ruler over Brambles on page 4, and highlights how solving a pallet reuse problem could boost revenue and earnings.

"The S&P/ASX 200 Index is currently on track to snap its winning streak of nine straight December-quarter gains, albeit it is very early in the period."

Sydney Airport offers exposure to an attractive asset class, with attributes such as high barriers to entry, limited effective substitutes, and an end-market that has proven resilient.

The latest deal for the owner of Kingsford Smith, the nation's largest airport, is with the NSW state government to use airport land to build the $2.6 billion Sydney Gateway Motorway, which will connect the airport to the major WestConnex toll road project. See page 5 for more.

Austal continues to kick goals in the US, with the Western Australia-based shipbuilder winning a contract with an implied value of more than US$1 billion to build another two littoral combat ships for the US Navy. See page 6 for the details.

McMillan Shakespeare is one of the largest providers of salary packaging and novated leases in Australia. It is a low-capital business with strong organic growth fundamentals.

The company's strategy and business model are very attractive and we have initated coverage with a Buy recommendation. Page 7 runs through our investment thesis.

Finally, we highlight the improving outlook for the Patrick stevedoring arm of **Qube Holdings** after the surprise decision by rival operator DP World to substantially increase its charges. Qube appears expensive by some metrics, but we forecast significant longer-term earnings contributions from the Patrick business and the Moorebank logistics hub development. See Page 8.

Table 1: Key dates

Bank reporting dates		Major AGM dates	
ANZ Banking Group	31 Oct	IAG	26 Oct
National Australia Bank	1 Nov	CBA	7 Nov
Macquarie Bank	2 Nov	BHP Billiton	8 Nov
Westpac Bank	5 Nov	Wesfarmers	15 Nov
Commonwealth Bank*	7 Nov	Woolworths	21 Nov

* Trading update. Source: Company updates, OML Research

INVESTMENT STRATEGY

FOREIGN AFFAIRS

The clock is ticking as markets head into the final quarter of 2018 and in this edition Ord Minnett notes some recent changes to our forecasts for the Australian dollar and the best choices to exploit this theme.

We also revisit the banks – a key component of the local market with the big four accounting for circa 20% of the $1.8 trillion S&P/ASX 200 Index.

The Australian dollar has continued its fall against the US dollar this year.

The decline has been precipitated by weakness across emerging markets as fears of a US-China trade war intensified.

This has not been the chief reason behind our view of Australian dollar weakness, however; rather, it is a widening in interest rate differentials with the US.

Our revised outlook still sees a further, but more modest decline for the Aussie against the greenback.

The local currency is second only to the Swedish krona as the worst-performing G10 currency against the US dollar in 2018, with even the Chinese yuan**, down circa 6%, faring better despite concerns over the impact of trade imposts on growth in the world's second-largest economy.

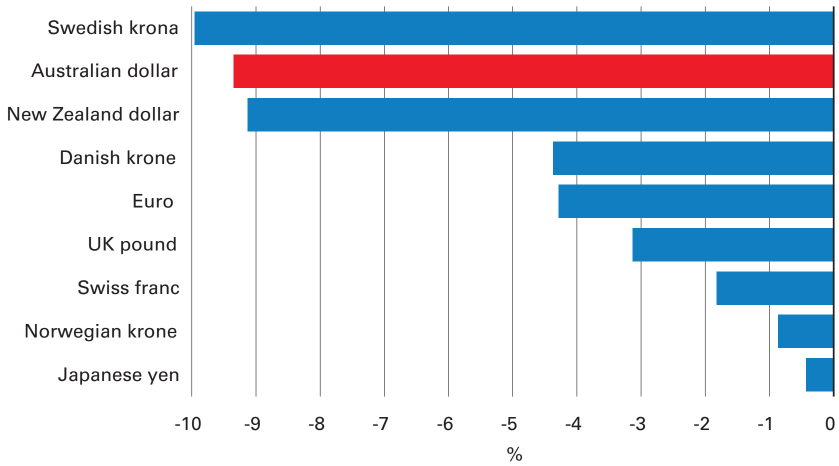
The latest slide in the Australian dollar came as the US threatened to raise tariffs on another US$200 billion of imports from China, which sent the price of base metals lower.

An easing in the trade rhetoric, and Standard and Poor's (S&P) upgrade to the outlook for Australia's AAA rating from negative to stable, allowed some recovery from around US$0.71 to almost US$0.73. This was short-lived, however, as the trade war tensions ratcheted up again, sending the Aussie down below US$0.71 at time of writing.

We doubt this marks the end of its decline, although the weakness should be more gradual from here.

Our currency forecasts now see the Australian dollar reaching US$0.70 by the end of 2018 and US$0.68 by the middle of 2019.

Figure 1: Performance against US$ in year to date (%)



Source: Ord Minnett Research, Bloomberg

** Refers to the offshore-traded yuan. In theory, the value of this version of the yuan is set by foreign currency markets, although the massive influence of the Chinese central bank means it frequently trades within a modest range of the onshore-traded yuan.

The primary reasons for this outlook are as follows:

- Australia-US interest rate differentials – We forecast the Federal Reserve to deliver further interest rate rises – around 0.25 percentage points per quarter into 2019 – while the Reserve Bank of Australia stays on hold. This means that by mid-2019 the US federal funds rate could be 3%, versus Australia's benchmark cash rate at 1.5%, or 1.5 percentage points below the US.

  The last time cash rates in Australia were below those in the US was around 1999–2000, when the Australian dollar averaged US$0.60.

- Tax gap – Australia has one of the highest corporate tax rates globally, particularly among Organisation for Economic Co-operation and Development countries. The US, for example, recently cut its federal corporate tax rate to 21%, compared with Australia's 30%.

  All else being equal, this should contribute to a lower Australian dollar as capital shifts away from higher-taxed countries.

- Economic convergence – Real GDP growth in Australia should slow to 2.5% in 2019 from 3.2% in 2018 as the incremental contribution from mining exports fades, while consumer spending and housing growth slows. This would see growth largely on par with the US.

To put our views into context, the currency has already declined over the past seven years by more than 35% from its peak just above US$1.10 in 2011.

If US$0.70 is reached by the end of 2018, it would mark a 10% decline in the currency this year, putting it in the vicinity of one of the largest annual percentage declines since the dollar was floated in 1983.

Sentiment is already quite negative, as indicated by the net speculative short positions in the Australian dollar, which are close to their most extreme level since late 2015.

The two key risks to our thesis for the local dollar are as follows:

- Australia's fiscal position – Elevated iron ore prices and strong employment growth mean the government is now targeting a surplus one year earlier than initially projected.

  As a result, S&P recently reaffirmed its AAA credit rating on Australia, and raised its outlook from negative to stable. It did, however, note a sharp fall in house prices was a key risk.

- China stimulus – We expect China to undertake some mild stimulus to mitigate the risks around US trade tariffs, but more aggressive stimulus could mean greater upside for the Australian dollar.

Table 2 lists our preferred non-resources companies with sensitivity to the Australian dollar versus US dollar exchange rate.

Investors could also gain exposure to the currency directly through an exchange-traded fund, such as the Betashares US Dollar ETF.

Table 2: Preferred non-resources stocks with exposure to US$

Company	Rating	Risk	Target price	US$ revenues (%)†
Aristocrat	Accumulate	Higher	$33.50	60%
Ansell	Hold	Medium	$25.10	44%
Austal	Accumulate	Higher	$2.10	84%
Boral	Accumulate	Higher	$7.80	36%
QBE Insurance	Accumulate	Higher	$12.25	28%
Reliance Worldwide	Accumulate	Higher	$6.20	68%
Unibail-Rodamco-Westfield	Buy	Medium	$19.00	30%
WorleyParsons	Buy	Higher	$19.40	33%

† May also include Canadian revenue. Source:OML Research, company reports

Banks

We note the release of the interim report from the Kenneth Hayne-led Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. We also point out the banking sub-index looks set to record a fourth-straight year of underperformance against the broader market in 2018.

Heading into the banks' results season, valuations look inexpensive, which might support a short-term bounce. This may not be sustainable, however, given myriad challenges to profitability remain.

At time of writing, three of the big four banks – Westpac, ANZ Bank and Commonwealth Bank – had issued warnings on earnings, driven by charges related to the Royal Commission. Furthermore, a number of events, such as the federal election, are likely to weigh on sentiment.

Overall, our view is that portfolio exposure to Australian banks should be neutral at best.

BRAMBLES

POLICING PALLET PIRATES

Sector: Industrials Recomm: Buy Risk rating: Higher Share price: $10.94

Year to June	2018A	2019E	2020E
Profit after tax ($m)	846	922	1,035
Earnings per share ($)	0.53	0.58	0.65
Price/earnings (x)	20.6	18.9	16.8
Dividend ($)	0.30	0.29	0.30
Dividend yield (%)	2.7	2.7	2.7
Franking (%)	30	30	30

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

Brambles (BXB) share price

Source: IRESS

Brambles has fallen a long way from its highs in 2016 above $13.00, driven mainly by concerns over its key CHEP USA business.

In our view, investor worries over CHEP USA are overdone. We concede the slowdown in fiscal 2017 revenue growth extended into fiscal 2018 but we see the factors driving this as largely cyclical rather than structural. Given this, revenue growth should revert to historical levels over time.

Pallets are an essential part of the fast-moving consumer-goods supply chain, and within that, pooling still stacks up as the best economic solution for customers.

Finding a solution to the reuse of pallets by its US retail customers' businesses, however, could unlock significant value for shareholders.

Exact figures are hard to come by, but we estimate at least 30% of the pallets in the CHEP USA pool are reused.

Retailer reuse leads to higher pallet losses for CHEP (OMLe 17%) and replacement capital expenditure, along with higher pallet damage rates (OMLe 80%) and repair costs. It also means lost revenue opportunities (OMLe US$250 million).

Usually, a retailer will sign a participating distributor deal with CHEP, which means it agrees to return the famous blue pallet once the original load has been removed from the pallet at the retailer's distribution centre, rather than sending it down to the store level, or using it for some other purpose. Unique to the US pallet market, however, is a reuse agreement with a large retailer or distributor.

Under such an agreement, the retailer can reuse inbound pallets from a CHEP customer – product manufacturers such as Pepsico, Procter & Gamble, Coca-Cola or Nestle, for example – by reloading the same pallet with other products and either sending it within the retailer's network, or simply storing it within one of the retailer's distribution centres or stores.

In the case of those retailers that illegally reuse CHEP's pallets, Brambles is seeking compensation.

What to do in the case of retailers that legally reuse pallets is another issue. One solution might be the creation of an internal (closed-loop) captive pallet pool to be used within the retailer's network.

The following scenario illustrates the potential benefit of capturing revenue from pallet reuse. If CHEP generates US$115–250 million per annum from stopping a retailer reusing its pallets, and it costs US$76–144 million per annum to reissue them, then CHEP is saving some US$104–165 million a year from lower damage costs.

This implies potential for additional operating earnings of US$143–271 million per annum, equivalent to a 10–15% increase in our estimate of fiscal 2019 operating earnings. See Table 3.

There are difficulties in crystallising these benefits – we see the hardest aspect as ensuring adherence to the agreed lower dwell time for its blue pallets, such as down to 45 days from 120. This is not impossible to our mind, but it is undeniably challenging and probably costly.

Table 3: Impact of preventing pallet reuse (US$m)

	Low case	High case
New revenue	115	250
Less: pallet reissue costs	76	144
Net revenue gain	39	106
Plus: lower damage expenses	104	165
Potential earnings benefit	**143**	**271**

SYDNEY AIRPORT

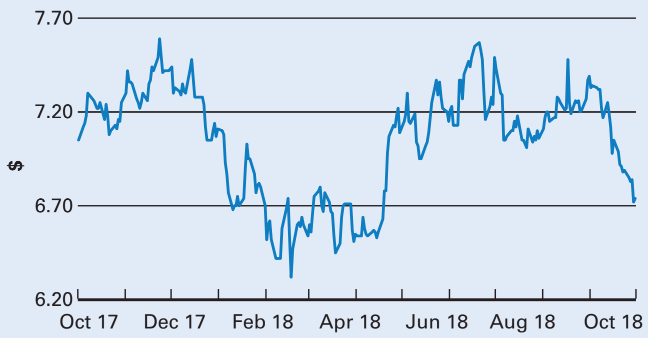
TICKET TO RIDE

Sector: Transportation Recomm: Buy Risk rating: Medium Share price: $6.74

Year to December	2017A	2018E	2019E
Profit after tax ($m)	350	376	410
Earnings per share ($)	0.16	0.17	0.18
Price/earnings (x)	43.5	40.4	37.0
Dividend ($)	0.35	0.38	0.42
Dividend yield (%)	5.1	5.6	6.3
Franking (%)	-	-	-

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

Sydney Airport (SYD) Share price



Source: IRESS

Sydney Airport has cut a deal that allows the NSW state government to use part of the airport's land to build the $2.6 billion Sydney Gateway Motorway – which will connect the airport to the WestConnex toll road project – in return for $170 million in three years' time.

This development allows the Sydney Gateway project to proceed to the next stage, with the opening targeted for the end of 2023.

Ord Minnett views this as a critical piece of infrastructure that should improve airport accessibility in the long term. Sydney Airport plans to use the funds to improve road and rail access to the domestic and international terminals.

The government has been granted an easement over 9.8 hectares (ha) of Sydney Airport's northern lands to support road alignment, while 1ha will be used temporarily for construction activities.

According to Sydney Airport's 2039 Master Plan, the northern lands precinct amounts to about 27ha.

Part of that land will now be used for the Sydney Gateway connection – a link from the St Peters interchange to the airport precinct

A significant parcel of land remains for potential future airport logistics, such as car parking for staff and/or pick-up and drop-off areas, and freight development. We note Sydney Airport handles about half Australia's international air freight.

Industry talk had suggested a compensation figure closer to $250–275 million. In our view, however, the deal does take into account likely state funding for connections over Airport Drive, Alexandra Canal and the existing railway. As well, there may be opportunities to partner with the NSW government on other transport projects.

Sydney Airport plans to invest the compensation into transport solutions for the airport. This could include increasing the number of rail and bus services with a new metro link to Kingsford Smith. We estimate rail has grown its share as a means of transport to the airport to more than 20% from about 10% in 2010.

Such concessions could help to grow and diversify the company's earnings in the longer term.

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

More specifically, the stock offers exposure to the following key drivers:

- Significant leverage to the strength in international passenger growth;
- Capacity additions by airlines;
- A probable easing in air traffic movement restrictions;
- Exposure to one of Australia's most productive retailing precincts;
- A car parking operation that generates margins in excess of those earned by its airport peers and non-airport operators; and
- A reliable revenue source in property leasing, which will be boosted by its new hotel offer.

We note that initial construction work on the second Sydney airport at Badgery's Creek has recently started, but there is no impact on our earnings forecasts for the foreseeable future.

AUSTAL

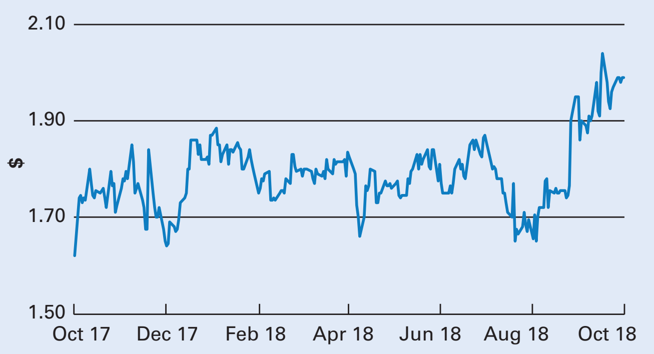
SHIP IT IN

Sector: Capital goods Recomm: Accumulate Risk rating: Higher Share price: $1.99

Year to June	2018A	2019E	2020E
Profit after tax ($m)	39	42	47
Earnings per share ($)	0.11	0.12	0.13
Price/earnings (x)	17.8	16.7	14.9
Dividend ($)	0.05	0.06	0.06
Dividend yield (%)	2.5	3.0	3.0
Franking (%)	-	-	-

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

Austal (ASB) share price



Source: IRESS

Austal designs and manufactures customised aluminum defence and commercial ships, and counts many of the world's leading ferry operators and defence forces among its customers.

The US Navy recently awarded a contract to Austal to construct two additional 'Independence class' littoral combat ships (LCS). The new ships will be the sixteenth and seventeenth vessels in the class to be built by Austal, and have been designated as LCS–32 and LCS–34.

Littoral combat ships are designed for close-to-shore operations rather than the open-sea capabilities of larger, more heavily armoured vessels. Key design principles for LCS include shallow draft, excellent manoeuvrability and high speed.

Construction of LCS–32 is scheduled to begin in 2019 and delivery of LCS–34 to the US Navy is scheduled for mid FY23.

As was the case in 2017, the contract was awarded through a limited competitive process between Austal and US-based Lockheed Martin. According to the latest contract award, Austal is to build two vessels and Lockheed Martin will build one vessel.

The exact value of the contract award has not been disclosed as the information is considered source-selection sensitive, given Austal and Lockheed Martin are, in effect, in a competitive tender process for the contracts.

That said, the LCS program faces congressional spending caps with each vessel to cost less than US$584 million, which gives some indication of the total value of the contract award.

The 127-metre, frigate-sized vessels were originally designed by Austal at its Henderson shipyard in Western Australia, but are being constructed in the company's shipyard in Mobile, Alabama.

The Mobile shipyard has made strong productivity improvements and is streaking ahead of Lockheed Martin in the dual-track construction process.

The Australian company's construction profile has reduced sharply as the company has moved through the program, with LCS–18 taking just 794 days from keel-laying to delivery, versus 1,427 days, on average, for LCS–2, LCS–4 and LCS–6.

This compares to Lockheed Martin where the latest three ships it delivered to the US Navy – LCS–9, LCS–11 and LCS–13 – took an average of 1,495 days to construct.

At the end of August 2018, Austal had delivered its ninth LCS vessel to the US Navy, while Lockheed Martin had delivered only its sixth and seventh vessels.

Congress reduced the original LCS program to 32 vessels from 55 in July 2017. All of those 32 contracts have now been awarded – 17 to Austal and 15 to Lockheed Martin.

The other 20 vessels will be built under a modified guided-missile format design known as Future Frigate FFG(x), with the US Navy intending to purchase the first vessel under the new format in 2020.

MCMILLAN SHAKESPEARE

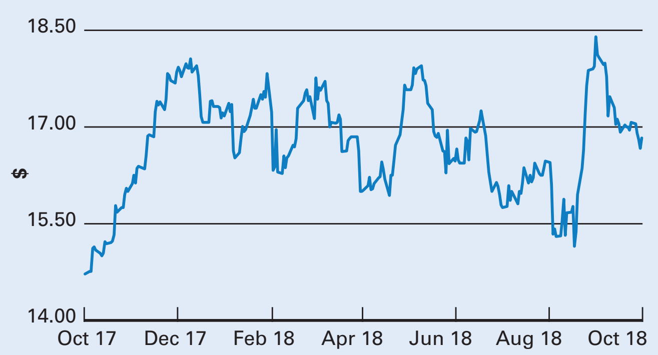
SALARY EXPECTATIONS

Sector: Commercial & prof. services Recomm: Buy Risk rating: Medium Share price: $16.83

Year to June	2018A	2019E	2020E
Profit after tax ($m)	94	101	112
Earnings per share ($)	1.13	1.21	1.35
Price/earnings (x)	14.9	13.9	12.5
Dividend ($)	0.68	0.76	0.84
Dividend yield (%)	4.0	4.5	5.0
Franking (%)	100	100	100

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

McMillan Shakespeare (MMS) share price



Source: IRESS

McMillan Shakespeare has one of the largest salary packaging and novated leasing operations in Australia, along with an asset management division and a growing UK presence.

Ord Minnett recently initiated coverage of McMillan with a Buy recommendation and a target price of $20.50.

Our investment thesis is driven by strong organic growth in its packaging and leasing business – which accounted for 67% of fiscal 2018 earnings – and margin expansion driven by its 'Beyond 2020' business improvement program.

In addition, there are growth opportunities in its UK business and the potential for material earnings growth in its Plan Partners joint venture that offers administration plans to members of the National Disability Insurance Scheme (NDIS).

McMillan is the equal-largest provider, alongside Smartgroup, of salary packaging and novated leases in Australia. It is a low-capital business with strong organic growth fundamentals. We estimate McMillan has circa 35% of the externally managed salary packaging market and 23% of novated leases in Australia. We forecast a compound annual growth rate (CAGR) of 7.4% for novated leases and 4.3% for salary packaging over fiscal 2018 to 2021.

The Beyond 2020 program is an investment designed to improve service, sales and efficiency in the salary packaging and novated leasing business. McMillan is targeting a 33% increase in novated lease sales conversions, and a lift in operating earnings margin to 60% from 47% in fiscal 2018. This equates to an additional $20–25 million per annum over the next three years.

The company's UK asset management and finance business operates in a highly fragmented sector. This provides opportunities to buy businesses in this segment at attractive multiples. At its fiscal 2018 result, McMillan outlined ambitious goals – it is targeting more than £1 billion of finance to be arranged in that division by fiscal 2021, up from £500 million in 2018. This will likely be achieved via a combination of organic growth and acquisitions.

McMillan's entry into the NDIS administration sector is via a joint venture – Plan Partners – with Disability Services Australia. The business, in which McMillan has a 75% stake, was launched just over 12 months ago.

We see Plan Partners benefiting from McMillan's expertise in large-scale payment administration. Management expects this business to be profitable during fiscal 2019, and we anticipate it adding $3 million to operating earnings in fiscal 2021, with further growth thereafter.

Finally, we highlight the strong management team. The CEO, Mike Salisbury, has spent 10 years with McMillan, including four years as CEO, while CFO Mark Blackburn has been with the company for seven years.

Salisbury and Blackburn have continued to manage an organisation that has consistently delivered strong organic growth, while building and expanding its UK presence.

QUBE HOLDINGS

THE SHIPPING NEWS

Sector: Transportation   Recomm: Buy   Risk: Higher   Price: $2.66

The outlook for the Patrick stevedoring arm of **Qube Holdings** (QUB) continues to improve after the recent surprise decision by rival operator DP World to substantially increase its charges.

DP World will raise infrastructure access charges by an average of 70% for road and rail operators at its West Swanson Terminal in Melbourne, its Fisherman Island's Terminal in Brisbane and its Port Botany Terminal in Sydney. These charges are in addition to those paid by shipping companies for quayside loading and unloading.

It is worth noting the industry's overall return on assets has fallen from 29% in 2011–12 to just 8% in 2016–17. It would now seem that after years of pressure on stevedoring rates from merged and/or larger shipping lines, new industry entrants, required infrastructure investment (e.g. automation), and rising operating costs, (e.g. terminal rents post privatisation and taxes), the operators are saying enough is enough.

The increased charges could help DP World turn around its estimated 7% decline in calendar 2017 operating earnings.

The move leaves Patrick with options. It could leave its charges unchanged so as to win market share if customers shift freight to vessels calling at its terminals rather than those of its rival.

Alternatively, it could increase its own charges, potentially raising revenue by up to $50 million, a rise of circa 8%. On previous occasions, Patrick has followed DP World's lead and raised charges rather than play a market-share game.

Qube appears to be relatively expensive, based on its above-market price-earnings multiple. In our view, however, this metric fails to capture the likely significant earnings contribution in the longer term from the Patrick business and the Moorebank logistics hub development.

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

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