September 2018

ORDS MONTHLY

SEASON'S END
COMMON THREADS

The reporting season ended in a photo-finish, with the proportion of results that exceeded Ord Minnett's expectations coming in at 29%, just pipping those that missed our estimates at 28%. See Figure 1 for a sector-by-sector appraisal of results.

Overall, fiscal 2018 earnings for the S&P/ASX 200 Index rose 7.9%, broadly in line with Ord Minnett's expectations.

Cost pressures and escalating capital expenditure once again provided a common thread across the market, but most notable was the market's infatuation with the high-price-earnings (P/E) multiple, high-momentum stocks such as **CSL**, **Cochlear**, **Altium**, **Wisetech Global** and **Afterpay Touch** – that all hit record highs during August.

Some of these share price rises were difficult to reconcile from an earnings perspective, and unless earnings do improve materially, the risk of a steep slide from those record levels is high.

The outlook for fiscal 2019 is not as certain, with companies' outlook commentary and the incorporation of fiscal 2018 numbers driving analysts to trim current-year estimates in many sectors.

That said, earnings growth forecasts for fiscal 2019 are at a still-robust 7.8%, and certainly higher than we envisaged at the start of this year.

> "Cost pressures and escalating capital expenditure once again provided common threads across the market..."

Our summary of the reporting season, and the outlook, starts on page 2, while all the data you need to know, along with a sector-by-sector summary, begins on page 5.

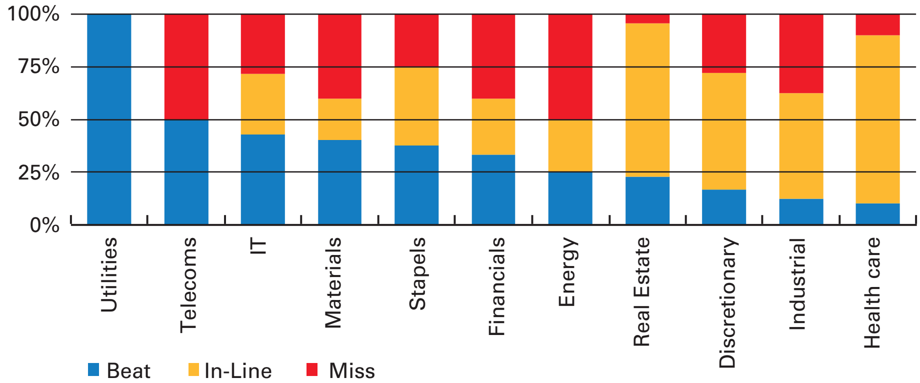
We have also taken this opportunity, now that the numbers for fiscal 2018 are 'in the bag', to review our forecast for the S&P/ASX 200 Index that we set at the end of last year.

Our forecast range is revised higher to 6100–6500 by June 2019, and continues to assume earnings growth in the mid- to single-digits. See page 3 for more details.

Meanwhile, the WestConnex project has found a buyer, with a **Transurban**-led consortium purchasing a 51% stake in the toll-road project for $9.3 billion. Transurban will raise more than $4 billion to fund its share. We lay out our views on page 7.

Finally, the latest strategic plan released by the NBN Co flagged using growth in its fledgling enterprise business – a sector where it is a direct competitor to other telcos rather than simply being a wholesaler – to boost its finances. Having analysed the NBN plan, the impact on **Telstra** is likely to be much lighter than first feared. See page 8 for our assessment.

Figure 1: Beat-miss sector proportions - FY18 reporting season



Source: Ord Minnett Research, Bloomberg

INVESTMENT STRATEGY

DOING THE SUMS

All the results are in and the score card shows fiscal 2018 earnings for the S&P/ASX 200 Index, in aggregate, have risen 7.9%, broadly in line with our expectations.

Outlook commentary and the incorporation of fiscal 2018 numbers have, however, meant cuts to fiscal 2019 estimates for a range of sectors. Nevertheless, earnings growth forecasts for fiscal 2019 are at a still-solid 7.8%, and certainly higher than we expected at the start of this year. See Figure 2 for a sectoral breakdown of forecast growth for fiscal 2019.

The just-finished results season will be remembered for the market's infatuation with the high-price-earnings (P/E) multiple, high-momentum stocks – such as **CSL**, **Cochlear**, **Altium**, **Wisetech Global** and **Afterpay Touch** which all hit record highs during August – while cost pressures and escalating capital expenditure were once again strong themes running through corporate report cards.

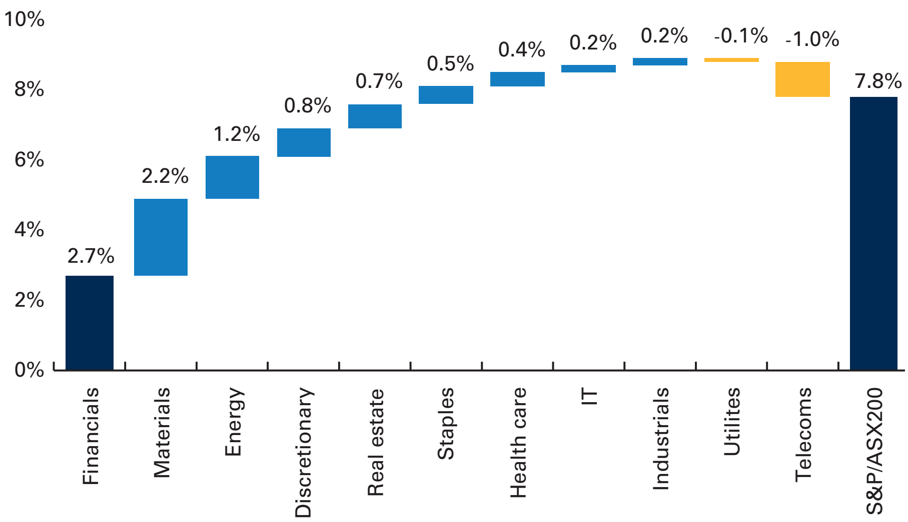
Beats just edged out misses in the end – beats came in at 29%, marginally ahead of the misses at 28%. Utilities generated the highest rate of beats, while healthcare propped up the other end of the table.

That rate of beats is the lowest since the August 2016 reporting season.

- P/E ratio expansion – The rate of growth in this multiple for high-momentum companies, especially technology, was extraordinary in itself, but even more so relative to earnings revisions. Some reratings are difficult to justify, in our view, and, unless earnings trends improve markedly, the risk of a group-wide share price decline is high.
- Costs – Top-line trends were mostly positive through August, with revenue upgrades across the market as a whole of 1.2% during the month. Mining, up 3.5%, and industrials, up 2.9% were two of the stronger sectors.

Most of the revenue upswing, however, was offset by a further move higher in cost expectations. Higher raw material prices dragged on earnings at **Ansell**, **Brambles**, **Rio Tinto** and **Reliance Worldwide**, in particular. Costs are a common headwind, but some companies are handling them better than others, e.g. **Alumina** and **Orora**.

Figure 2: Fiscal 2019 net profit bridge for S&P/ASX 200 (%)



Source:Ord Minnett Research, Bloomberg

Investment Strategy

Transurban Group

Telstra Corp

Escalating costs were evident across a wide range of companies, but weighed heaviest on the materials sector, where most companies reported higher-than-expected rises in a range of costs.

The rise in costs, and the subsequent offsetting of revenue increases, ultimately squeezed the operating earnings margin for the index as a whole.

One-year forward estimates for operating earnings margins for the S&P/ASX 200 Index have now stagnated in the 26–27% range, where they've been stuck since mid 2017. Interestingly, the current level is running exactly at the average of the past five years.

- **Capital expenditure** – The market remains in a capital expenditure upgrade cycle. Forecasts for capital expenditure rose in all sectors bar consumer discretionary, with materials, which includes the miners – up nearly $1 billion over August – and healthcare – up $519 million, almost entirely driven by CSL – leading the uplift.
- **Capital management** – Payout ratios were guided higher by **Magellan** and emerging company **Alliance Aviation**. **Adelaide Brighton**, **Suncorp** and **Qube** declared special dividends, while **Insurance Australia Group** will supplement its dividend with a capital return. **Santos** resumed paying a dividend Meanwhile, **AGL Energy**, **Rio Tinto** and **BHP Billiton** are hinting at future buybacks.
- **Fiscal 2019 outlook** – Analysts have shaved their EPS growth forecast for fiscal 2019 to 7.8% from 8.9% at the end of July.

The downgrades have been widespread across the sectors, which we think reflects some earnings being brought forward into fiscal 2018 year, and outlook statements from companies generally not generating much in the way of upward revisions to forecasts.

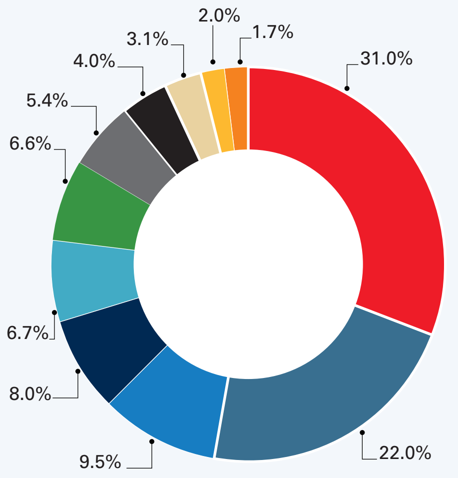
Overall, we see downside risk to consensus earnings expectations, a continued escalation in capital expenditure, a slight downshift in capital management activity and industry conditions that remain challenging for many companies.

- **Index view** – Over the month of August, the S&P/ASX 200 Index returned nearly 2% (including dividends) and is now trading at the top end of our 5800–6300 trading range, which we set at the end of last year. As such, we take the opportunity to revise that range higher to 6100–6500.

The new range continues to assume mid- to single-digit earnings growth, but off a higher earnings base than when we formed our initial views.

It also assumes the P/E multiple ranges in a band of 14.5–15.5 times, versus the current forward multiple of 16 times. Our target band, however, is more in line with the five-year average of 15.3 times. We also assume the index still trades at a circa 4.5% forward dividend yield.

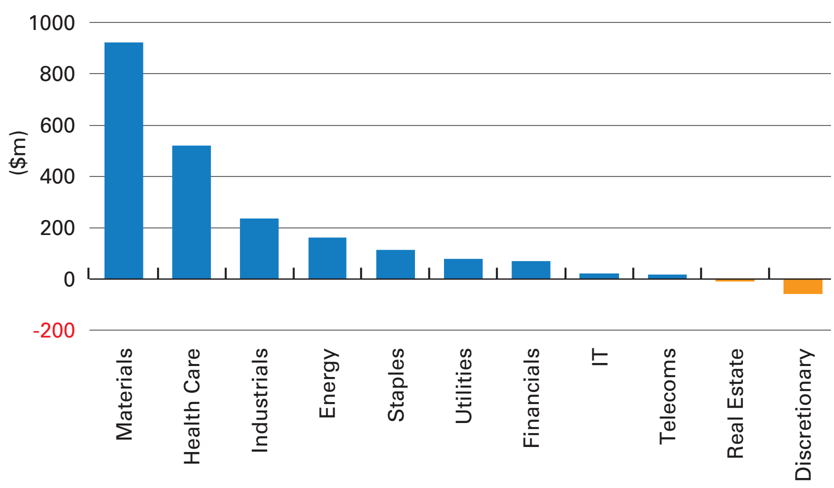
Figure 3: Fiscal 2018 net profit contribution by sector (%)



Materials	31.0%	Telecoms	5.4%
Financials	22.0%	Discretionary	4.0%
Real estate	9.5%	Energy	3.1%
Staples	8.0%	Utilities	2.0%
Industrials	6.7%	IT	1.7%
Health care	6.6%		

Source: Ord Minnett Research, Bloomberg

Figure 4: Increase in capex expectations (12M, Consensus)



Source: Ord Minnett Research, Bloomberg

Table 1: Recommendation changes during August

Stock	Recommendation Old	Recommendation New	Risk Rating
Upgrades			
ALS	Lighten	Hold	Higher
James Hardie Industries	Lighten	Hold	Higher
Northern Star Resources	Lighten	Accumulate	Higher
Regis Resources	Lighten	Hold	Higher
Sims Metal Management*	Hold	Buy	Higher
St Barbara	Hold	Accumulate	Higher
Tabcorp Holdings	Lighten	Hold	Higher
Tourism Holdings	Hold	Buy	Medium
Wesfarmers	Lighten	Hold	Medium
Western Areas	Hold	Spec Buy	Higher
Downgrades			
Adelaide Brighton	Hold	Lighten	Medium
Ansell	Accumulate	Hold	Medium
Ardent Leisure Group	Hold	Lighten	Higher
Blackmores	Accumulate	Hold	Higher
Carindale Property Trust	Hold	Lighten	Medium
Charter Hall Group	Accumulate	Hold	Medium
Corporate Travel Management	Buy	Hold	Higher
Costa Group	Accumulate	Hold	Higher
Cromwell Group	Hold	Lighten	Higher
Dexus Prop	Accumulate	Hold	Medium
Domino's Pizza Enterprises	Hold	Lighten	Higher
Elanor Investments Group	Accumulate	Hold	Higher
GPT Group	Accumulate	Hold	Medium
Growthpoint Properties	Hold	Lighten	Higher
Hotel Property Investments	Accumulate	Hold	Lower
Link Administration	Hold	Lighten	Higher
Monadelphous Group	Hold	Lighten	Higher
Origin Energy	Accumulate	Hold	Higher
Primary Health Care	Accumulate	Hold	Medium
RCR Tomlinson	Buy	Lighten	Higher
Sims Metal Management*	Accumulate	Hold	Higher
Super Retail Group	Buy	Hold	Higher
Webjet	Buy	Hold	Higher
Initiations			
Midway	Initiation	Buy	Higher
Volpara Health Technologies	Initiation	Buy	Higher
Xref	Initiation	Buy	Higher

* The recommendation for Sims Metal Management was downgraded to Hold from Accumulate on 10 August. Subsequently, the recommendation was upgraded to Buy from Hold on 27 August.

Source: Ord Minnett Research

Table 2: Fiscal 2018 net profit growth by sector

Sector	FY17 ($bn)	FY18 ($bn)	Change (%)
Consumer discretionary	2.435	2.510	+3.1
Consumer staples	4.839	5.054	+4.4
Energy	1.347	1.945	+44.4
Financials	14.309	13.948	-2.5
Health care	3.495	4.214	+20.6
Industrials	3.375	4.221	+25.1
IT	0.868	1.072	+23.5
Materials	17.332	19.655	+13.4
Real estate	5.764	6.121	+6.2
Telecoms	4.026	3.427	-14.9
Utilities	0.992	1.263	+27.4
S&P/ASX 200	58.782	63.430	+7.9

Source: Bloomberg, Ord Minnett Research

Table 3: Earnings outcome by sector

Sector	No. of cos. reported	Beats (%)	In-line (%)	Misses (%)
Discretionary	18	17	56	28
Staples	8	38	38	25
Energy	8	25	25	50
Financials	15	33	27	40
Health care	10	10	80	10
Industrials	16	13	50	38
IT	7	43	29	29
Materials	24	42	17	42
Real estate	22	23	73	5
Telecoms	2	50	0	50
Utilities	4	100	0	0
Market	**134**	**29**	**43**	**28**

Source: Bloomberg, Ord Minnett Research

"A net beat ratio of -25% showed a disappointing season for energy, which had its second-straight season where misses outnumbered beats. "

Sector by sector

Consumer discretionary

This sector fell short of our expectations, with only 17% of our covered companies registering beats. This season's net beat/miss ratio – measured as the percentage of beats minus the percentage of misses – of -11% is the lowest since February 2017.

The market cap-weighted earnings surprise, however, was just in the black. This highlights stronger results from the larger-capitalisation stocks in the sector, such as **Crown Resorts**, **Star Entertainment** and **Tabcorp**.

In addition, **JB Hi-Fi**, **Harvey Norman** and **Super Retail** – three retail bellwethers – exceeded our expectations. Those that fell short included **Domino's Pizza Enterprises** and **Flight Centre**.

Consumer staples

This group delivered another positive net beat/miss ratio of 13%, which represents the sixth consecutive season in positive territory.

Three companies underpinned the sector's performance – **Wesfarmers**, **Coca-Cola Amati**l and **Treasury Wine Estates**, which all rose sharply on the day of their respective results.

Energy

A net beat ratio of -25% showed a disappointing season for energy, which had its second-straight season where misses outnumbered beats.

Only two stocks – **Oil Search**, with a solid result despite the impact of the Papua New Guinea earthquake – and **Whitehaven Coal**, with a special dividend – outdid our expectations.

The two largest stocks in the sector – **Woodside Petroleum** and **Origin Energy** – fell well short of our projections and accounted for a large proportion of the negative earnings surprise.

Sector by sector (cont...)

Financials

The overall tally was negative, with the net beat ratio coming in at -7%. The average earnings surprise was strong at 2.7%, however, with this outcome underpinned by significant beats from **QBE Insurance**, **AMP** and **Suncorp**.

Disappointing results from **IAG** and **Challenger** propped up the bottom of the financials ladder, with both stocks falling sharply on the day of their respective results.

Healthcare

The overall healthcare beats/miss ratio of 0% was an improvement on recent seasons, but belied the fact that only 10% of our coverage exceeded expectations in August. The average negative surprise was -1.0%, but CSL, the sector's largest stock by some considerable margin, delivered a result that met our expectations but pleased the market more, with the stock rising 6.1% on the day of its result.

Elsewhere, there was sharp disappointment from stocks such as **Ansell**, **Primary Health Care** and **Ramsay Healthcare**, all of which underwhelmed with their results.

Industrials

A weak net beat/miss ratio for this sector of -25%, which was back towards the August 2016 low. The average earnings surprise was -1.5%, although the on-day share price reaction was comfortably in positive territory, registering at 1.9%. We note though, that this was underpinned by some very strong on-day moves from just three stocks, i.e. **Qube**, up 9.0% on the day of results; **Seven Group**, also up 9.0%;, and **Brambles**, which jumped 6.4%.

Information technology

This sector turned in another strong net beat/miss ratio of 14%, with 43% of the sector exceeding our expectations. The overall earnings surprise was positive at 1.1%, which was driven at the top-end by a strong beat of 14% from **Domain Holdings**. The on-day performance was very strong, with the average rise coming in at 5.4% – second only to telecommunications across the season as a whole. The two leading on-day performers were **IRESS**, up 11.4%, and **carsales.com**, up 11.2%.

Materials

Despite an in-line net beat/miss ratio for the season, i.e. 42% of companies beat Ord Minnett expectations and 42% of companies missed our forecasts – the materials companies were, on average, a disappointment. The negative earnings surprise was 2% and on-day share price performance was -1.1%. The latter result was dragged down by a series of sharply negative reactions, with the 22.4% savaging of **Pact** marking the season's worst on-day price performance. Other steep on-day falls included **Adelaide Brighton** and **Sims Metal**, both down 6.8%, and **Iluka Resources**, down 7.7%.

Property

REITs delivered one of the best net beat/miss ratios of the season at positive 18%, as only 5% of the companies in the sector missed our expectations. The earnings surprise was positive at 0.9%, with on-day performance just in the black at 0.2%. **Goodman** was an important driver of the latter outcome, jumping 5.1% on the day of its result.

Telecommunications

There was a sigh of relief in the telecommunications sector with the first season of positive earnings surprise for some time, albeit from a tiny sample of two companies. The sector also posted the strongest on-day performance across the market of 6.8% – a first for telcos in our collection of this data. **Telstra** underpinned the positive earnings surprise of 1.9%, as well as having a very strong on-day performance, rising 5.9%.

Utilities

This group scored a perfect beat ratio of 100% across the season, with on-day performance running at a positive 2.8%. The positive average on-day share price reaction was skewed, however, by the two smallest stocks in the sector – **ERM Power**, up 12.9%, and **Infigen Energy**, up 3.7%. This was in stark contrast to the negative on-day performance of the sector's largest stock, **AGL Energy**, which dropped 4.6% on the day of its result.

TRANSURBAN GROUP

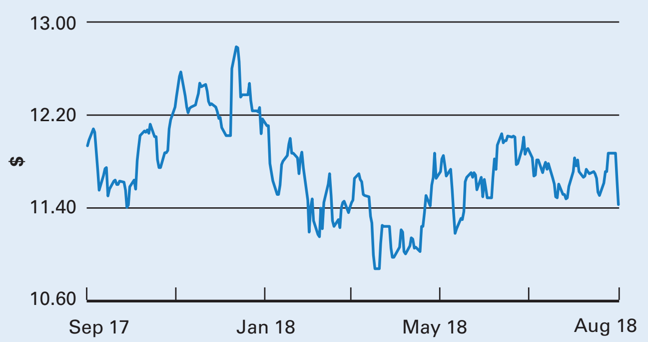
ON THE ROAD AGAIN

Sector: Industrials Recomm: Buy Risk rating: Medium Share price: $11.44

Year to June	2018A	2019E	2020E
Profit after tax ($m)	529	256	399
Earnings per share ($)	0.25	0.10	0.15
Price/earnings (x)	46.3	119.2	76.3
Dividend ($)	0.56	0.59	0.62
Dividend yield (%)	4.9	5.2	5.4
Franking (%)	10	10	10

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

Transurban Group (TCL) share price



Source: IRESS

Sydney Transport Partners, a consortium led by **Transurban**, has won the bidding for a 51% stake in the NSW state government's WestConnex project with a $9.3 billion offer.

WestConnex is a major $16.8 billion investment in Sydney's road infrastructure, and is the largest urban road project currently under construction in Australia.

The consortium comprises Transurban with 50%, AustralianSuper with 20.5%, the Canada Pension Plan Investment Board with 20.5% and the Abu Dhabi sovereign wealth fund, Tawreed Investments, with 9.0%.

Approvals from the Australian Competition and Consumer Commission and the Foreign Investment Review Board have already been granted.

Transurban's equity share of the purchase price is $4.1 billion, to be funded via a 10-for-57 rights issue at $10.80 a share, and placements at $10.85 a share to AustralianSuper and Tawreed Investments to raise $450 million and $150 million, respectively.

In Ord Minnett's view, the Transurban-led consortium is the natural owner of the WestConnex stake given: 1) its existing interests in the M5 motorway and the broader Sydney toll-road network, which create likely revenue benefits and cost savings; 2) its accumulated proprietary knowledge of the Sydney metropolitan network, e.g. traffic and pricing data and tolling systems, etc.; and 3) its proven track record of working with industry and government partners to deliver critical infrastructure.

That said, we are somewhat surprised by the price paid for the asset.

Based on the WestConnex tolling regime – and assuming it can achieve operating earnings margins similar to Transurban's existing Sydney network (a margin we estimate at around 80%) – we forecast traffic forecasts would need to be almost 50% higher than the NSW government's projections in order to generate a return greater than Transurban's weighted average cost of capital.

Despite this, investors should, in our view, have confidence in Transurban's traffic expectations given the enviable track record of its 40-strong team of forecasting experts – historically, such confidence has been well-rewarded.

The difference in forecasts may also be due to the state government's conservatism – which may not have included the benefits of future projects – and Transurban may have a more optimistic view of the take-up of automated vehicles, as well as Sydney's economy more generally.

Infrastructure remains an attractive asset class for many investors, providing access to relatively predictable, growing cash flows, and within this asset class Transurban is a top-quartile performer.

Transurban's significant development pipeline and management initiatives should allow it to continue growing toll revenue and operating earnings in the near term at a rate in excess of the local economies where it operates.

TELSTRA CORP

LOOKING DOWN THE LINE

Sector: Telecommunications Recomm: Accum Risk: Medium Price: $3.13

Ord Minnett has updated its earnings estimates for **Telstra** (TLS) following a guidance update from the company that incorporates the revised NBN Co corporate plan.

Given the NBN Co's lower-than-expected subscriber payment of $1.8 billion in fiscal 2019, Telstra has cut its revenue guidance by $300 million and its estimate of one-off NBN payments by $200 million.

Telstra's guidance for fiscal 2019 operating earnings was cut by $100 million, at the bottom end of our estimated $100–200 million range.

We have lowered our one-off NBN payment amount by $200 million to $1.7 billion for fiscal 2019, resulting in a corresponding fall in revenue and operating earnings to $27.5 billion and $9.1 billion, respectively.

We highlight that this is simply a deferral of revenue and operating earnings from fiscal 2019 to fiscal 2020 and 2021.

Subsequently, our revenue and operating earnings estimates increase by $100 million and $300 million, respectively, for both of fiscal 2020 and 2021.

We now estimate fiscal 2019 EPS of $0.202, down from $0.214 previously, but maintain our dividend estimate of $0.18 per share.

Telstra's dominance in the Australian telecom market will continue, even as recent structural changes to the industry – due largely to the advent of the NBN – puts pressure on margins in what is a very competitive industry.

Telstra is fairly valued on a dividend yield basis, but we see potential upside of more than 20% from an eventual structural separation of the business into infrastructure and services companies.

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

Caloundra, Sunshine Coast
79-81 Bulcock Street
Caloundra QLD 4551
Tel: (07) 5491 3100

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