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Could Eliwana Reduce Fortescue's Discount?

Development of the higher-grade Eliwana mine should allow Fortescue Metals to transition to a premium iron ore product, which could lift earnings and valuation.

-Eliwana should enable iron grades of 60% ore more -Price realisation remains the key driver of the share price -Eliwana rail spur could open up more potential in Western Hub

By Eva Brocklehurst

Fortescue Metals ((FMG)) is exploring an alternative product strategy in a move to obtain better margins for its discounted iron ore product. To this end, the company has recently approved the Eliwana mine.

The company is also aiming to introduce a new 60% iron product, called Fortescue Premium. This will be sold from the second half of FY19 and sourced from higher grade ore at Firetail and other operations to test the market and potential price premiums, versus the existing blended 58.2% product.

Fortescue has a record for achieving ambitious goals, UBS points out. Leveraging Eliwana to enable a 60% or better iron grade product the broker suspects will be no different. Saleable production of 170 mtpa is expected to be maintained and not require a material lift in operating expenditure or a reduction in the mine life of the assets.

The company will batch process its mined ore to split what is currently a blended product into a higher quality Premium product and increase the tonnage of its Super Special Fines. Adopting this strategy could mean the overall average discount received for its iron ore reduces to around -28% from -34% against the Platts 62% index.

Furthermore, UBS calculates, assuming Eliwana comes on line by FY21 the blending strategy could be expected to lift earnings per share by US$0.14 and valuation by $1.65, relative to a spot scenario.

Eliwana, being of a higher reserve grade at around 59% iron and a lower strip ratio compared to existing operations, should support the transition once production starts late in 2020.

The capital cost of developing the 30mtpa mine is US$1.28bn. Macquarie had already incorporated the mine into its forecasts and makes only modest adjustments, but agrees development should allow the company to improve its product mix over time, although to what level remains uncertain.

Price Realisation

Price realisation remains the key driver for the share price, the broker points out, down currently to 65%, having fallen from 90% in 2015, although, while realisation has remained volatile over the past eight months, the actual realised price has remained stable, at around US$40-45/t.

While iron grade is an important driver, the levels of silica, alumina and phosphorus are also major inputs to price realisation. To date the company has not released product specifications for its Premium product and, therefore, the broker does not incorporate improved price realisation at this stage.

Citi accepts the discounts for lower grade ores are more structural than cyclical but also expects iron ore prices to fade over the next couple of years, towards a long-term price of US$55/t.

The broker emphasises the fact there is no clarity on how much of the future production will be increased to a 60% iron grade or the full operating and capital cost implications of the new strategy.

Capital expenditure for Eliwana is higher than some of the other mine replacement projects currently underway in the Pilbara, Citi notes, as it requires 143km of new rail.

Ord Minnett does not consider the project approval contains any major positives or negatives, although bringing it to fruition will allow other assets in the Western Hub to be exploited, given the addition of the rail line.

The broker believes the rail spur could accommodate significantly more than 30mtpa, noting that Fortescue will build a dry processing facility that appears to be a like-for-like match to Firetail.

Credit Suisse suspects, if discounts normalise back to levels closer to 2016, the company may make a decision to revert back to its existing blend as the primary product, given sensitivities around strip ratios, the life of mines and revenue realisation.

Background

Environmental concerns prevailing in China have affected steel mills, resulting in increased demand for higher grade iron ore. The spread between high and low-grade ore is structural because of this drive for higher productivity at the mills.

Discounts for lower grade products are, therefore, the highest in many years. UBS notes, in the case of Fortescue, the discount to the Platts 62% index was -23% in the March quarter 2015, had reduced to -6% by the March quarter of 2016 and then steadily increased. It is now at -38%.

While Fortescue has pure exposure to the iron ore market, and is considered the lowest-cost iron ore producer globally, its assets are slightly lower grade compared to Vale, Rio Tinto ((RIO)) and BHP Billiton ((BHP)).

FNArena's database shows six Buy ratings and one Sell (Citi). The consensus target is $5.40, suggesting 12.5% upside to the last share price. Targets range from $4.00 (Citi) to $6.10 (Morgans, yet to comment on the Eliwana approval). The dividend yield on FY18 forecasts is 5.2% and 5.4% respectively.

MYOB Calculates Better Future Without Reckon

ACCC concerns regarding the transaction with Reckon have likely led to MYOB deciding, instead, in favour of investing in its own product and client development.

-MYOB will opt for an $80m investment in R&D and sales & marketing -Near-term positive catalysts difficult to envisage -Opportunity to win clients from Reckon but also risk of losing clients to Xero

By Eva Brocklehurst

MYOB ((MYO)) has opted for organic development rather than the acquisition of Reckon's ((RKN)) accountant group assets and will not proceed with the transaction.

The proposed acquisition made strategic sense, although brokers suggest the competition regulator, ACCC, had several issues which were proving insurmountable and likely to have been the main reason behind the decision.

It was evident to Credit Suisse that the proposed acquisition was being used to mask a necessary step change in investment in product development and sales & marketing, now proven to be the case.

MYOB will spend the money intended for the deal, and more, and the broker calculates the planned investment will drop a reported operating earnings (EBITDA) margin to around 40% in 2019/20, versus 46% in 2017.

Credit Suisse downgrades, to Neutral from Outperform, and lowers operating earnings forecasts by -15% because of the reduction in margins and absence of Reckon revenue. The broker finds near-term positive catalysts difficult to envisage and believes investors will remain cautious.

Ord Minnett accepts the reasons for deciding in favour of an $80m investment in R&D and sales & marketing but also questions longer-term revenue growth expectations.

Risks

Near-term delivery risks have increased and the broker's FY22 free cash flow forecast is around -$15m below the company's long-term guidance of over $200m.

Ord Minnet struggles to anticipate why investors would increase positions until free cash flow has either bottomed, in FY19, or there is more evidence about improved returns, and downgrades to Hold from Buy.

UBS was always cautious because of the risk that higher R&D and marketing costs were not been priced in if the Reckon deal fell through. As the stock has fallen more than -8% this concern has faded, somewhat.

The company has an opportunity to win clients away from Reckon, which may struggle to adequately invest in its product as a stand-alone entity, yet Credit Suisse believes this is more than offset by the risk of losing existing clients to Xero ((XRO)) at the lower end, or global operators such as Salesforce and Microsoft at the top end.

Deutsche Bank is not surprised the company is going ahead with elevated expenditure but questions the quantum and downgrades net profit estimates for FY18-20 by -7-21%, to reflect capitalisation of the R&D investment as well as higher interest expenses.

The broker believes the company is pursuing the right strategy, although acknowledges there is a significant level of trust attached to the targets, particularly given they are up to five years away.

Deutsche Bank maintains a Buy rating on valuation but, given the impact of the downgrades on the growth profile and the "trust me" factor, as well as the Bain overhang, suspects it may be hard to witness any near-term outperformance.

Investment

Specifically, the company will invest $50m in R&D over the next two years on new online adviser and SME solutions and bring forward its online platform for accountants, as well as increase adviser sales & marketing by $30m to grow direct SME sales.

The incremental R&D investment will be capitalised and the incremental sales & marketing will be expensed. UBS incorporates higher capitalised R&D into its expenditure forecasts, driving downgrades to free cash flow estimates.

The net result is a -14-15% downgrade to FY19-21 net profit estimates.

The broker considers the stock fairly priced on a free cash flow yield basis and, from a risk/reward perspective, remains incrementally positive because the significant re-investment is now priced in.

Upside risks include accretive M&A and further revenue benefits from the re-investment. On the downside the broker envisages loss of share and further marketing cost pressures because of competition, as well as lower cloud penetration in the longer term.

There is one Buy rating (Deutsche Bank) and four Hold on FNArena's database. The consensus target is $3.31, suggesting 18.1% upside to the last share price. The dividend yield on FY18 and FY19 forecasts is 4.4% and 4.5% respectively.

Strong Sales Dominate Domino's Outlook

Momentum continues for Domino's Pizza, whose technology stands to benefit from continued growth in digital sales and the upcoming FIFA World Cup.

-Competitive intensity seen easing despite expansion of aggregators -Germany, France at the forefront of growth targets in Europe -Franchising inquiry a small short-term risk

By Eva Brocklehurst

Domino's Pizza Enterprises ((DMP)) has sustained momentum in online sales in Australia, which is significant because digital orders account for around 70% of its Australasian sales.

From tracking the company's app rankings and share of downloads, UBS concludes that the growth implied in guidance for the second half may not be all that optimistic. While the company's app ranking fell in Europe recently, where digital accounts for over 40% of sales, the rate of decline was consistent with the first half.

Given the latest app download study and the upcoming FIFA World Cup in Russia, UBS is increasingly confident in the outlook. Domino's Pizza has guided to 20% FY18 net profit growth, implying 33% growth in the second half, and the broker believes the company can grow its share of the Australian takeaway market to 6.2% by FY25, from 5.4% currently.

While there is a large opportunity for aggregators, they only compete across 10% of the takeaway market and UBS observes competitive intensity has eased in the second half ,despite the ramp-up in marketing and the expansion of coverage by aggregators.

The broker also suspects the market has not fully appreciated the challenges that face aggregators, such as coverage and value on offer.

UBS concedes the share price has risen 35% over the last three months despite little change to consensus estimates. Yet, a Buy rating is maintained, with a view that the medium term upside exists to market expectations if the company can achieve its long-term targets.

Europe

Europe remains the key opportunity for the business, although aggregators have eroded much of the company's historical competitive advantage. Hence, while acknowledging the risks around profit growth have increased, UBS assesses that its valuation incorporates the risks.

The broker estimates operating earnings margins in Europe can increase to 25% by FY21. Germany and France are likely to be at the forefront of growth targets as, combined, they are expected to drive 80% of incremental store growth in Europe.

Macquarie recently upgraded the stock to Outperform from Neutral. The broker considers the downside risks to guidance in the Australasian franchising business have lessened, while the outlook for Europe over the medium term has improved. The base is now in place in Europe for scale benefits.

The broker concludes that ,while full year guidance requires a very strong second quarter, the World Cup remains a positive catalyst. The business may longer deliver the growth rates of previous years but also no longer needs to, following a meaningful de-rating in valuation.

Macquarie considers the FY19 P/E ratio of 25x provides the valuation support necessary for a business expected to grow in excess of double digits per annum.

Despite believing that hitting 20% net profit growth in FY18 is still a tall order, Morgans believes any miss will be modest and has upgraded the stock to Add from Hold. The broker believes the company capable of delivering around 15% net profit growth per annum over the next 3-5 years.

Franchise Inquiry

The Senate inquiry into franchising in Australia may present a risk but, as Citi notes, submissions so far emphasise industry-wide issues rather than anything specific to Domino's Pizza.

Compliance costs may rise and store expansion may become more challenging but, in the end, Domino's Pizza has a very good digital platform and superior sales productivity, which validates its business model, in the broker's opinion.

The franchise inquiry is a short-term risk but Morgans agrees, having viewed the terms of reference, the company's submission and that of one franchisee, that any risks should be contained, and there is more negative implications for competitors in the industry, which should potentially benefit Domino's Pizza in the medium to longer term.

The broker believes the company is also unlikely to launch into any new category/territory without there being material accretion on offer and this creates an upside risk catalyst. Morgans believes the trading multiple is not out of place for what is still a growth stock.

There are four Buy ratings, three Hold and one Sell (Deutsche Bank) on FNArena's database. The consensus target is $48.64, suggesting -5.9% downside to the last share price. Targets range from $36.00 (Deutsche Bank) to $57.50 (UBS).

A-REITs Still Finding Solid Support

Brokers suggest A-REITs are likely to continue finding support amongst the global investment community, given an increasing need for annuity income and scarcity of investment-grade real estate.

-Valuations and relative performance main reasons for A-REITs appeal -Most concerns centre on the retail segment -Capital markets still viewing Sydney's office segment favourably

By Eva Brocklehurst

May was a strong month for Australian real estate investment trusts (A-REITs) as they outperformed the broader ASX 200 equities index as well as most major global REIT indices, with the exception of the US.

Shaw and Partners notes, over the month, yields tightened and geopolitical issues were in focus as investors took refuge in safe havens, such as the US, and defensive stock, such as REITs.

The broker believes A-REITs screen cheaply relative to direct real estate investment in Australia and the M&A cycle has not yet reached its conclusion.

Hence, the predictability of earnings and increasing need for annuity income, as well as an increasing scarcity of investment-grade real estate, should provide support for good-quality A-REITs.

Shaw and Partners' sector forecast total shareholder return is 7.5%, including a 5.1% yield. Support in the short term is expected to emanate from the reinvestment of proceeds from the Westfield transaction, along with most A-REITs going ex-dividend in late June, and lower 10-year bond yields in the US and Australia.

Morgan Stanley agrees the international investment community finds A-REITs relatively attractive, although concerns are heightened regarding the residential and macro environments. This is the broker's conclusion after meetings with investors in the US, Europe and Asia.

Valuations and relative performance were cited as main reasons for the increase in appeal, while the biggest debate centres on retail. The discussions with investors underscored the broker's preference for office over retail and, within retail, self-help over perceived quality and developers over aggregators.

The broker also highlights that many investors were surprised by the level of capital expenditure required to maintain sales growth, or conversely the deterioration in sales growth in retail assets that are left undeveloped.

Morgan Stanley highlights they were also interested in the momentum in the Lend Lease ((LLC)) development & investment management businesses.

Retail

Morgan Stanley observes the use of company voluntary arrangements (CVA) to negotiate store closures and rent reductions, a UK insolvency process, is accelerating. The process allows a company to review and restructure leasing obligations.

If 75% of all creditors vote for, and less than 50% of non-connected investors vote against, then the company's proposal is approved and implemented. Morgan Stanley observes this not only adds uncertainty to current lease commitments but is starting to reshape future income visibility.

While this CVA legislation does not exist in Australia the broker also observes recent trends in the UK reveal a global shift in the balance of power towards tenants and away from landlords.

Internationalisation of retail could mean such methods of dealing with lease commitments flow through to Australian shopping centres.

The broker finds growing evidence of Australian retailers successfully negotiating store closures/rent reductions such as Sumo Salad and Specialty Fashion ((SFH)).

Therefore, increasing variability in specialty lease structures could change the value proposition of shopping centres and signal lower, more volatile and less transparent operating income growth as well as require much higher capital expenditure.

Consequently, Morgan Stanley is cautious regarding shopping centres and prefers Vicinity Centres ((VCX)) and Stockland ((SGP)) over both Scentre Group ((SCG)) and Mirvac ((MGR)) if investors need exposure to shopping centres.

Office

Mirvac has exercised its pre-emptive right to acquire a 50% stake in 275 Kent Street Sydney for $721.9m and will assign the rights to an existing capital partner.

The company sold the stake in 2014 for $435m, retaining the remaining 50%. The 2018 sale price implies a 30% premium to book value at a yield of around 3.9%, in Macquarie's calculations.

Given Sydney office rents have increased by around 40% since Westpac ((WBC)) signed a 15-year lease across 75% of the building in 2015, the broker suggests the acquirer has probably factored in positive leasing spreads in outer years.

While earnings leverage to improving Sydney office market is taking time to flow through to free cash flow, Macquarie believes capital markets are still viewing the segment favourably.

With upside risk to asset valuations the broker remains positively disposed to Sydney's office segment and retains Outperform ratings on Dexus ((DXS)), GPT ((GPT)), Mirvac and Charter Hall ((CHC)).

Wesfarmers Opts For A Tighter Strategy

Wesfarmers is taking on more disciplined approach to future capital deployment and brokers believe management is signalling a preference for a smaller, better-returning base.

-Target contracting to a smaller, more focused fashion business -Opportunities in industrial segments may be underappreciated -Capital returns considered less likely until divestments are sorted

By Eva Brocklehurst

After offloading its loss-making venture with Homebase, Wesfarmers ((WES)) has emphasised capital discipline at its strategy briefing. Brokers welcome the change of focus, as management watered down expectations that further M&A may be imminent.

Deutsche Bank is pleased that a disciplined approach is being applied to future capital deployment, noting the CEO has signalled the existing businesses represent the best opportunity to invest.

The focus will be on shareholder returns and the broker is left with the impression that management would be content with running a smaller, better-returning capital base if the right M&A opportunity does not present.

A -20% reduction in Target floor space is planned over the next five years as well as the ramping up of private label products and refurbishments at Coles. Morgans believes management is doing a good job repositioning the portfolio and re-weighting it towards stronger growth and higher-returning businesses.

The CEO has signalled his main priorities, since taking over as managing director, are making a decision on Homebase, improving the performance of department stores and re-weighting the portfolio. The de-merger of Coles and the sale of Homebase are viewed as consistent with this strategy.

Macquarie points to a further emphasis on big data and FlyBuys. Wesfarmers and Coles will each have a 50% stake in FlyBuys post de-merger and have opened an analytics centre in Melbourne with a view to support best-practice data analytics.

Credit Suisse downgrades to Neutral from Outperform, given the recent appreciation in the share price and despite the near-term catalysts. Still, the broker envisages no lack of attractive internal opportunities to support improving returns.

As Target contracts to a smaller, more focused fashion business the capital deployed should reduce in parallel with improved profits. The scale of Kmart will be hard for other entrants to the market to overcome, while the broker suggests talk of offshore expansion in the long-term is likely to come to nothing.

Credit Suisse further suggests the opportunities in industrial segments are underappreciated. Chemicals are likely to come off peak earnings in FY18 but declining gas costs present opportunities in ammonia production, while changes to market structure could be a catalyst for further development of downstream capabilities.

UBS agrees with the interpretation that Wesfarmers is not afraid to shrink in order to deliver superior returns and the growth outlook for the business, ex Coles, is stronger than previously thought.

The broker is now more positive on Bunnings too, expecting margins to continue widening in the near term and share gains to offset any moderation in housing.

Challenges Continue

Despite the bold action by new management in regard to the exit from the UK and the reduced scale of Target, Ord Minnett downgrades to Lighten from Hold, believing the risk/reward equation is no longer compelling.

Challenges also exist at Bunnings from the external environment, i.e. consumers and housing, and this should moderate sales growth and earnings margins, the broker asserts.

On the industrial side, the oversupply in ammonium nitrate is weighing on the company's business, and Ord Minnett also suspects that the fashion-led strategy will be difficult to achieve at Target because of tough competition.

In the end, there is a lack of valuation support, given the share price performance, and Coles is also challenged in regard to sales growth and cost pressures. The outlook for Coles appears more negative, UBS agrees, as capital expenditure is expected to rise by 20% into FY19.

Morgan Stanley also points out Coles faces headwinds from produce deflation, the new enterprise bargaining agreement and lower Coles Express earnings, while it intends to push further into private labelling, targeting 40% penetration by 2023.

Capital Returns

The company is continuing to work on the sale of its 40% stake in Bengalla and media has speculated on a sale of Kmart Tyre and Auto Services as well as a deal involving the pubs business. Macquarie points out the company has indicated these potential transactions are immaterial to the group.

Morgans suggests, if all these deals are completed, then Wesfarmers will have significant funds to invest in existing business, pursue acquisitions or return capital to shareholders.

The company is likely to wait until these divestments and the re-weighting are finalised before embarking on any M&A or capital management, the broker suspects. UBS concurs the likelihood of a capital return from the proceeds of Curragh has increased, relative to M&A.

Citi speculates that, following the Coles de-merger, Wesfarmers could undertake a $3.5bn buyback and remain in keeping with credit rating thresholds. The broker envisages a staged buyback is most likely.

Nevertheless, with the stock trading at its highest level in over three years, as investors put a premium on capital returns, the broker considers the risk of a de-rating is more imminent than earnings accretion from capital returns and retains a Sell rating.

As is the case with Citi, Morgan Stanley is not overwhelmed by the prospects and does not believe the strategy briefing changes the investment thesis. The broker believes investors will be disappointed by the lack of specific capital management and clarity over the Coles balance sheet.

FNArena's database shows four Hold ratings and three Sell. The consensus target is $43.32, suggesting -6.8% downside to the last share price. Targets range from $39 (Morgan Stanley) to $47.34 (Morgans). The dividend yield on FY18 and FY19 forecasts is 4.7% and 4.9% respectively.

See also, Wesfarmers Exits Homebase, Where Next? On May 28 2018.

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Material Matters: Nickel, Copper, Oil & Coal

A glance through the latest expert views and predictions about commodities. Nickel; copper; oil; and thermal coal.

-Speculative demand for nickel is pushing increased use of NPI in stainless steel -Credit Suisse forecasts copper surplus until 2022 -Oil fundamentals seen supporting longer-term rally -China's demand/policy underpinning thermal coal prices

By Eva Brocklehurst

Nickel

Morgan Stanley observes there is little regard for the realities of the stainless steel sector, which is 70% of the demand for nickel, as speculative buying pushes the base metal to US$15,000/t. The speculative demand is in anticipation of electric vehicle industry growth.

Furthermore, The broker suggests the sharp fall in exchange inventory, in both Shanghai and London, appears to be partly driven by hoarding rather than demand. Nickel is forecast to record another deficit in 2018.

The high nickel price is encouraging greater demand for forms of stainless steel which use less nickel. Stainless steel oversupply in China, along with the higher nickel price, is squeezing margins for mills and encouraging output reductions and the increased use of cheaper nickel pig iron (NPI).China's NPI output climb 21% in the year to April. This suggests to Morgan Stanley NPI volumes will continue to rise, with China's imports from Indonesia hitting 1.37mt in March and Indonesia's domestic output continuing to expand.

While these are bear points for nickel heading into the second half, the fall in inventory has tightened the market considerably and the broker suspects the nickel price could stay supported as a result.

Copper

Credit Suisse has revised copper forecasts, reducing second half estimates but raising estimates for 2019 and beyond to a cost support level. The broker expects the copper market to be in surplus to the tune of 135,000t this year.

No tightness appears to exist and the broker suspects the market is hoping for disruptions to mine supply from strikes in Chile. Yet, few disruptions are actually expected because the strong copper price incentivises mines to settle with the unions. Escondida negotiations are occurring this month.

Credit Suisse expects a settlement to be reached and forecasts the copper price to drop below US$3/lb. Going forward, the broker forecasts a copper surplus until 2022.

While there are fewer mine expansions underway, equally important is the slowing consumption growth. China's consumption of copper is expected to grow less than 1% by 2021. Grid expenditure, housing, infrastructure and appliances all look softer than in 2017.

Oil

Shaw and Partners acknowledges there are reasons to be cautious in the short term regarding oil but believes fundamentals are supportive of the longer-term rally. A dramatic rise over the last month was driven by two factors, including improved supply & demand fundamentals and geopolitics.

Nevertheless, the broker is concerned that quick moves up can reverse just as quickly as traders take profits. Demand forecasts from various market operators, such as OPEC and the International Energy Agency show a downward revision to estimates and, while small, this is the first reduction in six months.

The softening in expected 2018 growth is largely attributed to the negative effects on consumption of higher oil prices.

Supply in the US is also plateauing but Shaw and Partners suspects this will be temporary. Higher oil prices should stimulate US supply once again, amid continued erosion of OPEC output and the dire straits of the Venezuelan oil industry.

The broker estimates OPEC output needs to be around 32.6 mmbopd to balance the market and May's estimates were slated at 31.6 mmbopd, suggesting market is currently in undersupply and de-stocking is underway.

Shaw and Partners has a preferred exposure for Woodside Petroleum ((WPL)) in this scenario, noting many smaller companies have had good rallies and caution should prevail.

Thermal Coal

Seaborne thermal coal prices have lifted to the highest level since March 2012, Commonwealth Bank analysts note. Supply and demand factors in China have largely contributed to the rise.

Electricity output has lifted 7.7% in the year to April, supported in part by thermal power generation which accounts for around 76% of total electricity output. On the supply side China's environmental issues have maintained subdued levels of domestic output.

Coal import restrictions have also weighed, exacerbating the domestic shortage. As a result, it is no surprise to the analysts that China's coal stockpiles have dwindled at both ports and utilities.

They suggest that both seaborne and China's domestic coal prices will eventually fall as policy takes effect. Yet, a downward price correction to US$77/t may take longer than forecasts currently suggest.

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Lithium Chile, A Perfect Storm

[Editor's note: While the following highlights lithium opportunities in Chile, and one Chilean-based, Canadian-listed lithium miner in particular, the article is nevertheless informative for those interested in the wider lithium market and Australian-listed lithium stocks.]

By Richard (Rick) Mills Ahead of the Herd

As a general rule, the most successful man in life is the man who has the best information.

Remember the scene in that Tom Cruise movie, Jerry Maguire, when Cruise's sports agent character gets a call from Arizona Cardinals wide receiver Rod Tidwell, played by Cuba Gooding Jr? Shirtless in his kitchen, Tidwell implores Jerry Maguire to shout "Show me the money!" loudly and with feeling, which he does, to the distress of his buttoned-down office co-workers.

The saying has become a bit of a cliche, but it's an apt summary for an attractive lithium brine project whose stars have aligned to the point where suitors are bound to come a knockin', and management could soon be shouting the same thing as Tom Cruise: "Show me the money!"

Lithium Chile (TSX: LITH) has spent the last few years quietly amassing a huge collection of properties in the "lithium triangle" of Chile, Argentina and Bolivia - where about 75% of the world's lithium comes from, given its abundance and high quality. Chile is currently the second largest producer of the main ingredient of lithium-ion batteries installed in electric vehicles, behind only Australia, home to the Greenbushes hard rock lithium and tantalum mine owned by Talison Lithium.

The small-cap lithium junior holds 152,900 hectares across 14 salars and one "laguna" (lagoon in Spanish), surrounding the world's most important lithium reserves in the Salar de Atacama. LITH's land package is the largest privately-owned lithium amassment in Chile.

One of the hottest, driest, windiest and most inhospitable places on Earth, the Atacama is ideal for lithium mining because the lithium-containing brine ponds evaporate quickly and the solution is concentrated into high-grade lithium products like lithium carbonate and lithium hydroxide used in EV batteries. Mining lithium in the salars of Chile and Argentina is much more cost-effective than hard-rock mining where the lithium is blasted from granite pegamite orebodies containing spodumene, apatite, lepidolite, tourmaline and amblygonite.

It's a perfect jurisdiction to be in, with two of The Big Three lithium producers - US-based Albemarle and SQM, Chile's largest lithium producer - controlling nearby ground. Moreover, Chile has become recognized as an excellent mining country, with a low risk of resource nationalism (resource nationalism is the tendency of people and governments to assert control, for strategic and economic reasons, over natural resources located on their territory), a new mining code, and clear permitting rules - all major pluses for mining and exploration companies hoping to do business there. But it wasn't always this way.

Chile opens up to investment

In December 2017 Chile elected a new President, Sebastian Pinera. The billionaire businessman, who was President between 2010 and 2014, campaigned on a pro-growth, pro-mining platform. In January 2018 Pinera made good on that promise by having his right-leaning government issue the first new lithium production and export license in decades. The pro-mining mandate also meant sweeping changes to the mining code, regulation and permitting - facilitating low-cost acquisition and fast exploration. The Chilean government continues to change the rules regarding lithium production and exportation such that foreign public companies, other than the two majors, Albemarle and SQM, are being granted licenses.

Lithium Chile's ability to acquire all the strategic properties it holds came about because of a perfect storm, brought about by a change in government. Before Pinera was back on the scene, a centre-left coalition ruled the country, and the economy was bleak. The mining, producing and exporting of lithium was restricted by an old government decree based on its use in nuclear fuels. At the same time, Argentina had eased foreign capital restrictions, elected a pro-mining, right-wing government and supported lithium exploration. Foreign investment went to Argentina, while in Chile, companies and capital stayed away.

Low-cost land acquisitions

Except for Lithium Chile. While most lithium explorers were buying up ground in Argentina, Lithium Chile turned to geologist Terry Walker. Their man in Chile had 26 years of experience in the country, not to mention a Chilean wife and children. Walker also had access to something that would prove extremely valuable: a database of the salars first done in the 1960s and updated in the 90s. The survey for the Chilean government contained information on salar chemistries and grades, and Walker used it to identify the best properties for staking. Unbelievably, Walker was able to pick up highly prospective land blocks for not much more than $3 a hectare.

By comparison, Millennial Lithium entered Argentina in 2016 and bought its first project, Pastos Grandes (PG) at $2,000 a hectare. This project had $4.5 million in previous exploration drilling. Within six months of acquisition and additional exploration, adjoining ground at PG was selling for $3,000 a hectare. Following the realization that PG contained a mineral resource that could be mined, Millennial bought adjoining ground at closer to $9,000 a hectare (2,600 hectares for USD$22.6 million).

Now, prospective lithium blocks in Chile are going for $1,000 a hectare; not only that, the low-hanging fruit is gone, along with rock-bottom prices. Any more available land is held by Chilean corporations or families, and it is not going cheap. The possibility of replicating what LITH has accomplished in assembling its land package would, in your author's opinion, be impossible today. The cost alone would be staggering, Lithium Chile has a land package totaling 152,900 hectares, at today's price of $1,000.00 per hectare to assemble the same size package would cost over $150,000,000.00.

4 key prospects

With nearly 150,000 hectares under its control, Lithium Chile went exploring in 2016. Since then, the company has completed surface and near-surface brine and salt sampling programs on six salars: Coipasa, Ollague, Helados, Atacama, Turi and Talar. Geophysical surveys on five properties have also been done, with reconnaissance drilling planned for later this year.

Of the six identified salars, four have been prioritized according to three criteria: grade, size and access. All four properties - Coipasa, Ollague, Helados, and Atacama - are accessible by paved highways - so the difference really comes down to size and grade. Surface and auger sampling returned grades ranging from 580 milligrams per liter (mg/l) at Salar de Turi, to 1,410 mg/l at Salar de Coipasa. Surface and near-surface sample grades on the four above-mentioned properties were north of 1,000 mg/l.

To put that in perspective, average lithium production grades in Argentina are 600 mg/l.

In brine lithium mining, size is important because you need large evaporation ponds. Anything less than 3,000 hectares is too small. Lithium Chile's Coipas and Helados salars size up at a respective 11,000 and 30,000 hectares - making them suitable for building a lithium production facility in the future.

A few highlights:

Helados - At over 150 square kilometers, Salar de Helados is Lithium Chile's largest prospect. The property contains a large laguna - 6 kilometers long and 65 meters deep. The grades on the edge of the laguna are about 1,100 mg/l. On an extension of the salar and salt cap, samples brought back grades of 1,200 mg/l.

Atacama - At Salar de Atacama, the company has seen grades beyond 1,300 mg/l.

Coipasa -The Salar de Coipasa straddles the Chile-Bolivia border, meaning that a third of the salar is in Chile, and two-thirds is in Bolivia. While this could create a conflict of ownership, with Bolivia producing no lithium right now, there is nothing stopping Lithium Chile from draining the salar on both the Chilean and Bolivian sides, according to the company. LC's highest grade sample was taken here at a meter below surface. At 1410 mg/l this is by far the best sample Lithium Chile encountered.

100% salar ownership

A company should have 100% control over the production from their salar. It's possible an aquifer can become diluted - over-producing can impact the brine's salt concentrations and chemical compositions - or deplete it by too many wells sucking up more brine than should be produced.

If two or more companies have straws (wells) into the same salar, legal battles might result over the sharing of the resources.

However in Lithium Chile's case they have attempted to control the majority of the land in their most prospective targets. For example they control over 70% of the Salar de Coipasa.

Another important point about Chile is that unlike other mining jurisdictions, claims ownership does not come with a work obligation, meaning companies don't have to worry about regular expenditures to keep their claims current.

There are also no additional option payments to make, and no net smelter royalties to be paid to the government.

Low contaminants

A common industry axiom says that the ratio of magnesium to lithium in brines must be below the range of 10:1 to be economical. This is because the magnesium has to be removed by adding slaked lime to the brine. The slaked lime reacts with the magnesium salts and removes them from the water.

The higher the magnesium to lithium ratio, the costlier it is to produce a tonne of lithium.

According to Lithium Chile most of the samples they've taken so far are running at around a 4:1 ratio. This is significantly lower than brine-magnesium ratios in Argentina, which run between 5:1 and 10:1. Millenial Lithium, with its above-cited Pastos Grandes project in Argentina, has about a 6:1 ratio.

Shallow extraction

Most of the samples taken by Lithium Chile have been taken at or near surface. The exploration targets, judging by the conductivity, are between 20 and 300 meters deep. This is in line with most of Chile's lithium, which is found around 30-35 meters below surface - significantly shallower than Argentina's lithium where the lithium-bearing zones run between 300 and 500 meters. Why is this important? Because the deeper the target, the more brine needs to be pumped to the evaporation pond - adding costs and time.

Low costs

Lithium prices will fluctuate, so it's important for a would-be lithium producer to be able to handle lower prices. In this respect, Chile is by far the safest place to weather a lithium price correction, given it's the lowest-cost jurisdiction in the world for mining lithium. While it's too early for Lithium Chile to publish expected production costs, a couple of examples prove the point. When Lithium Power International did a PEA on its 50%-owned Maricunga salar lithium project in Chile, the predicted cost of producing a tonne of lithium carbonate equivalent (LCE) was between $2,600 and $2,700 a tonne. Over in Argentina, Millenial Lithium has their PEA set at $3,200 per tonne. Neo Lithium, also in Argentina, is around the same, $3,300 a tonne. Chilean lithium production is therefore about 25% cheaper than Argentina's. To put that in perspective, it costs about $6,000 per tonne to convert spodumene to lithium hydroxide - which is done in China from Talison's Greenbushes mine in Australia. The lithium carbonate conversion is about $500 higher.

Exploration program

As mentioned one of the criteria for identifying priority targets was, obviously, grade. Steve Cochrane, president and CEO of Lithium Chile, said "the richest, lowest-cost lithium mine in the world is the SQM/Albemarle Atacama property. And their production grade right now is 1,500 milligrams per liter. So having that 1,410 on an auger sample is very encouraging."

Cochrane, who joined Ahead of the Herd in a wide-ranging interview, also noted that lithium grades in Chile are twice those of Argentina, the chemistry of the brines is significantly better, and the magnesium content is lower.

"Even things like evaporation rates are two to three times what they are in Argentina because of precipitation, so there's a real advantage to Chile."

We asked Cochrane what the plan is, as far as next exploration steps. How will Lithium Chile go about delineating the LCE tonnage of what could be a high-grade lithium deposit?

"The ultimate goal is to first all prove that you have a lithium-bearing aquifer on your property and then move that discovery to a resource," he said, noting there are four steps toward that objective.

The first two - sampling and transient electromagnetics (TEM) - have already been completed. "What that data indicated on our four properties is that we have a large conductive area over Coipasa, Ollague, Helados, and Atacama that would certainly be indicative of a liquid or a salt-rich prospect."

Steps three and four are to identify drill targets (already done) and then to file for permits. Drilling permits have been issued but the company is waiting on land-access permits. Assuming those arrive, the next step will be to drill reconnaissance holes and perform pumping tests, to get an idea of flows.

While exploration is still early-stage, Cochrane said he likes what he sees; it's just a matter of confirming it with the drills.

"We just really don't know, I mean the bride hasn't been undressed," he quipped. "We've got some great looking geophysics, some unbelievable surface samples, and we've got no competition in these salars."

As a comparison, consider that Millenial Lithium only needed 11 holes to prove up a resource of 2.1 million tonnes measures and indicated lithium carbonate equivalent. If Lithium Chile can do something similar, the market is sure to take notice, as well as potential acquirers.

"Suffice to say, I think the targets that we're looking at are substantial for all the properties, and as a standalone prospect, I think any company would be pleased to have one of them, let alone four," said Cochrane.

The right project at the right time

We've written extensively on lithium demand and supply, and most recently, how predictions of a supply glut are unlikely to come to fruition, despite the best guesses of analysts. Perhaps the most obvious evidence of the lithium bears being wrong is that lithium prices have not budged at all since those predictions came out. What that indicates is that demand is still strong - certainly not being overwhelmed by supply.

So Lithium Chile is entering the market at a great time, in terms of lithium demand. Remember, in 2016, Chinese carmakers sold 28.03 million cars. If China follows through on its promise to go 100% electric that's a minimum 28.03 million lithium-ion battery packs for EVs per year. Add in the UK's 2.7 million car sales in 2016 and France's 2 million car sales in 2016. That's 32.73 million electric vehicles all requiring lithium-ion battery packs, without counting electric buses (a big deal in China, and going to be in India as well) or annual growth rates in auto sales.

We also wrote about the take-out of Lithium X by Chinese company NextView. We calculated the value of the lithium in the ground, of that project in Argentina, to be $132 per tonne. Now, while we think that NextView overpaid for LIX, it's intriguing to imagine what the market might pay for Lithium Chile - which has four high-grade (based on samples and geophysics) targets, in a far more attractive, and lower-cost, jurisdiction.

Then there's the point about scale. For the first time ever, automakers are actually negotiating with mining companies, so important is the need to secure components of electric vehicles. For example Volkswagen and Apple are both reportedly talking to major producers in order to secure cobalt - another key ingredient in EV batteries. It's all about security of supply. These companies are looking for large deposits - of lithium, cobalt, copper - not small ones, because having to go to several suppliers for feedstock is inefficient, and expensive. That's why Tesla is looking to source its lithium from Chile, not North America, where the mines are just too small.

We think that investors are underestimating the sea-change that is taking place from internal combustion engine vehicles to EVs. Why is that? Because it hasn't been made necessary. But some countries are forcing people to change their mindset. China, India, France, and the UK are among countries that have promised to end the sale of gasoline and diesel vehicles. If they actually do it, by passing laws, we may be looking at a tsunami of battery-metal demand.

A million electric cars produced in North America means 45,454,000 kg/ 100,000,000 pounds or 45,454 tonnes /50,000 tons of lithium carbonate equivalent (LCE) has to be mined just for Tesla's North American electric vehicle production. And it's not just about the US. China is also building lithium-ion megafactories, and by 2020 these are expected to grow global production capacity by six times. Think about those global 32,730,000 lithium battery packs. If each used the same amount of lithium carbonate as Tesla's electric vehicles, that's 1.487 billion kilograms/ 3.273 billion pounds or 1,487,727 tonnes /1,636,500 tons of new lithium carbonate demand. Current annual production of lithium carbonate equivalent (LCE), for all purposes, stands at about 230,000 metric tonnes.

Consider; in 2014 the Benchmark Mineral Intelligence lithium battery megafactory tracker listed only three planned plants. Today 26 battery cell plants that are either in production and due to expand capacity or new operations due to be in production by 2021 are being tracked!

How on earth are we going to fill the gap between supply and demand? The answer lies in companies like Lithium Chile that can bring on more supply, quickly.

Chile Lithium Capital share structure:

Insider ownership 51%

Public ownership 49%

Total shares outstanding 101,000,000

Fully diluted 110,800,000

Treasury $8,800,000.00

"The mining industry just can't keep up to the change that's coming. People are trying to find fast ways to get lithium out, but that's not going to happen. It works at bench scale, it does not work at big scale," said Andy Bowering, a Lithium Chile director. "The tried and true approach is brine evaporation. Take any metal out of any rock, you've gotta reduce it to a liquid at some point, regardless of the metal. In Chile, and Argentina, and Bolivia, nature's done it for you."

Conclusion

A confluence of factors - the perfect storm - is meshing for Lithium Chile in what is arguably the best place in the world for mining what some have dubbed "white petroleum" for its potential to accelerate a sea-change in our global transportation system. The company has accumulated over 150,000 hectares of prospective land blocks in the Salar de Atacama of the "lithium triangle," where the majority of the world's lithium is produced.

Lithium Chile has four properties, each with multiple drill ready targets. The drills are expected to start turning soon. But Lithium Chile isn't just a property owner. LITH has deep exploration and development expertise that will enable it to advance their projects to a maiden resource, PEA and beyond - giving it the option either to be a lithium miner or to hive off one or more of its projects to a major like SQM or Albemarle, a battery supplier, or even an automaker wanting to lock up a long-term lithium supply.

Demand for lithium will continue to outstrip supply, meaning prices are likely to remain strong well into 2025 and beyond. Governments are promoting a shift to EVs in a top-down approach that could eventually mean the demise of gas and diesel-powered vehicles.

For all of these reasons, I've got LITH on my radar screen.

[Note: Among Australia's major listed lithium miners, Galaxy Resources ((GXY)) and Orocobre ((ORE)) own projects in Argentina, while Mineral Resources' ((MIN)) and Pilbara Minerals' ((PLS)) lithium resources are in Australia – Ed]

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If you're interested in learning more about the junior resource and bio-med sectors, and quality individual company's within these sectors, please come and visit us at www.aheadoftheherd.com

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

The FNArena database tabulates the views of eight major Australian and international stock brokers: Citi, Credit Suisse, Deutsche Bank, Macquarie, Morgan Stanley, Morgans, Ord Minnett and UBS.

For the purpose of broker rating correlation, Outperform and Overweight ratings are grouped as Buy, Neutral is grouped with Hold and Underperform and Underweight are grouped as Sell to provide a Buy/Hold/Sell (B/H/S) ratio.

Ratings, consensus target price and forecast earnings tables are published at the bottom of this report.

Summary

Period: Monday May 28 to Friday June 1, 2018 Total Upgrades: 6 Total Downgrades: 13 Net Ratings Breakdown: Buy 44.98%; Hold 39.87%; Sell 15.15%

The month of May has been rather two-faced: full of buoyancy at first, troubled next and barely keeping a positive return at the finish line. The closing week endured most pressure to the downside, but that did not stop stockbroking analysts from issuing more downgrades than upgrades for individual ASX-listed companies.

For the week ending Friday, 1st June 2018, FNArena counted six upgrades and 13 downgrades. Spark New Zealand contributed the sole upgrade that did not go all the way to a Buy recommendation, whereas Domino's Pizza attracted two upgrades during the week.

On the flipside, REA Group was downgraded twice, following a strong performance, while ERM Power's disappointing market update attracted no less than three downgrades. Both downgrades for REA Group moved to Sell, while ERM Power only received one new Sell rating.

Meanwhile, the gap between total Buy ratings versus Neutral/Holds and Sells remains noticeably wide: 44.98% versus 39.87% and 15.15% respectively. History shows this can mark a tough time for the domestic share market but in the present context it most likely also signals a heavily polarised share market, seldom as bifurcated between the "Haves" and the "Have Nots".

The week saw some hefty increases to consensus price targets, with APN Outdoor on top, enjoying a boost of 17%, followed by Aristocrat Leisure (+15%) and Reliance Worldwide (+7%). Reductions were heaviest for ERM Power (-9%), MYOB Group (-6%) and Monadelphous (-4%).

Market bulls can draw confidence from the fact increases are more significant than reductions, and the former are larger in numbers too.

The table for positive revisions for earnings estimates similarly shows a positive current with ALS ltd grabbing honours for the week, enjoying a boost of 32%. Equally noticeable gains were booked by Fisher & Paykel Healthcare, APN Outdoor and Aristocrat Leisure.

Here the flipside looks equally impressive with medium sized miner Independence Group's forecasts suffering -27% following the sale of an underperforming asset, followed by -15% for ERM Power, and -10.5% for Galaxy Resources.

Upgrade

APA GROUP ((APA)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 4/2/2

Macquarie upgrades earnings estimates for FY18 by 1.8% and FY19 by 2.8%. The broker believes the drag from the regulatory threat has run its course.

The regulator risk discount is removed and the broker believes the US is emerging as an attractive growth option. Rating is upgraded to Outperform from Neutral. Target is raised 11% to $8.67.

DOMINO'S PIZZA ENTERPRISES LIMITED ((DMP)) Upgrade to Outperform from Neutral by Macquarie and Upgrade to Add from Hold by Morgans .B/H/S: 4/3/1

Macquarie estimates the downside risk to Australasian franchising and FY18 guidance is less than previously thought. Meanwhile, the upside for Europe appears greater and there is potential now to drive scale benefits.

While FY18 net profit guidance for growth of 20% requires 35% growth in the second half, a challenge the broker acknowledges after a soft first half, headwinds are reduced and the upcoming World Cup should support business.

Macquarie upgrades to Outperform from Neutral. Target is raised to $55 from $45. The broker believes the stock has valuation support for a business that is expected to grow in excess of double digits per annum.

Morgans continues to believe that 20% net profit growth in FY18 will be a tall order, although any miss is likely to be modest. The broker expects the company can deliver around 15% net profit growth per annum over the next 3-5 years.

The broker also notes potential upside from further acquisitions and suspects the company will not launch a new category/territory without material accretion being on the cards. Rating is upgraded to Add from Hold. Target is raised to $51.51 from $50.39.

GALAXY RESOURCES LIMITED ((GXY)) Upgrade to Outperform from Underperform by Macquarie .B/H/S: 2/2/0

The company has entered a non-binding agreement with POSCO to sell 28% of its Sal de Vida resource for US$280m. This is a better outcome than Macquarie envisaged as the company is now able to sole fund the development.

In the longer term, the delivery of a substantial brine project, that has proved challenging for others, in an expansionary environment becomes a key catalyst for the stock.

Rating is upgraded to Outperform from Underperform. Target is raised to $3.90 from $3.00.

SPARK NEW ZEALAND LIMITED ((SPK)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 2/2/1

The company has confirmed the acceleration of its Quantum program, bringing forward implementation costs of $25-30m in FY18. Macquarie observes competitive pressures remain but cost reductions provide an offset.

The broker envisages modest earnings growth in the next two years. Rating is upgraded to Neutral from Underperform. Target is raised to NZ$3.60 from NZ$3.50.

VICINITY CENTRES ((VCX)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 4/2/0

Macquarie reviews the mixed use opportunity for the business as well as the Chatswood Chase development. Near term catalysts in the business strategy suggest the valuation is attractive.

An in specie distribution of second-tier retail assets is still considered to be on the agenda and presents potential upside.

The broker upgrades to Outperform from Neutral. Target is steady at $2.92.

Downgrade

AMP LIMITED ((AMP)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 3/4/1

The Productivity Commission has published a draft report assessing the superannuation system and recommending a radical overhaul.

On balance, the broker believes the report's major proposals pose a threat to the retail sector, to both corporate super and fees on choice products.

The practical detail of what is proposed will be difficult to achieve, the broker suggests, and the politics are also unclear.

This leads the broker to downgrade its recommendation to Hold from Accumulate. Target is reduced to $4.20 from $4.84.

DOMAIN HOLDINGS AUSTRALIA LIMITED ((DHG)) Downgrade to Neutral from Buy by UBS .B/H/S: 2/2/2

As the stock is trading near fundamental valuation, UBS downgrades to Neutral from Buy. The broker believes the company is on track to meet FY18 expectations.

Admittedly, since the May 1 update, there has been a softening of new listing volumes but the broker suggests there are offsets to manage the earnings impact. Target is raised to $3.30 from $3.20.

ERM POWER LIMITED ((EPW)) Downgrade to Hold from Add by Morgans and Downgrade to Hold from Buy by Ord Minnett and Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/2/1

The company's business update indicated domestic operations are performing well but the loss-making US venture is less profitable than previously expected. Morgans materially reduces expectations for the US retail business.

The broker downgrades to Hold from Add, given the outlook for total returns. Target is reduced to $1.64 from $1.93.

The company has guided to lower sales volumes and margins in its US business, the second downgrade since the beginning of 2018. Ord Minnett understands the reasons but believes this reduces the market's confidence in the outlook for the US retail business.

Ord Minnett now values the US business at $34m, equivalent to less than 9% of the overall discounted cash flow valuation. The broker downgrades to Hold from Buy and lowers the target to $1.69 from $1.75.

The company has lowered its FY18-19 outlook and guidance for US gross margins but reiterated its expectations for Australia. Macquarie observes the company has a buyback, which will reduce liquidity and slow the weakness, but considers the fundamental value remains stretched.

Cash flow is attractive but another disappointment in the US suggests predictability is low. Target is reduced to $1.39 from $1.51, but the broker believes there is potential upside to $1.50 if management divests the US operation. Rating is downgraded to Underperform from Neutral.

HANSEN TECHNOLOGIES LIMITED ((HSN)) Downgrade to Hold from Buy by Ord Minnett .B/H/S: 1/1/0

Ord Minnett observes the share price is now 15% higher since the February result. The broker upgrades FY18 operating earnings estimates by 1% but downgrades to Hold from Buy on valuation.

Forecasts imply a margin of 27.4%, consistent with company guidance. While the broker leaves some room for the company to outperform, it suspects the share price is now factoring in a bigger upgrade than is likely. Target is raised to $4.54 from $4.47.

MONADELPHOUS GROUP LIMITED ((MND)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 0/3/2

Macquarie now forecasts a -16% decline in the company's FY19 construction revenue, given the low level of wins this year and the time lag for new work flowing through to revenue. The Ichthys work should largely be completed by June 30 and the focus is now on the replacement of around $300m in revenue run-off in FY19.

Macquarie downgrades to Neutral from Outperform. Target is reduced to $15.87 from $19.18. The broker estimates 28% revenue growth in construction in FY20, assuming the company wins its share of upcoming work from the major miners.

MYOB GROUP LIMITED ((MYO)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 3/3/0

MYOB has abandoned its planned acquisition of Reckon's ((RKN)) Accountant Group assets due to ACCC concerns, choosing to pursue organic growth instead using the money it had allocated. Credit Suisse has lowered earnings forecasts by -15% to reflect the lost opportunity.

The hit to earnings per share is less due to interest savings and an acceleration of the buyback now the acquisition is off, but the broker has cut its target to $3.00 from $3.75 and downgraded to Neutral from Outperform.

REA GROUP LIMITED ((REA)) Downgrade to Lighten from Hold by Ord Minnett and Downgrade to Underperform from Neutral by Macquarie .B/H/S: 2/3/2

The company has received approval from the ACCC to proceed with its planned acquisition of Hometrack Australia. The acquisition is considered neutral to Ord Minnett's discounted cash flow valuation.

Nevertheless, the broker downgrades its rating to Lighten from Hold because of weaker real estate listings data, weaker third-quarter earnings and overall valuation. Target is $78.

Macquarie considers the valuation stretched at current levels and downgrades to Underperform from Neutral. While operating momentum is strong the broker envisages a risk that future growth in earnings will be absorbed by a relative de-rating.

Listing volumes are down moderately, the broker observes, but price/mix remain the key drivers of the stock. Target is raised to $86 from $74 after the rolling forward of valuation.

STOCKLAND ((SGP)) Downgrade to Sell from Neutral by UBS .B/H/S: 4/2/1

UBS expects house prices will fall by -5% or more in 2019 as lending standards tighten and higher living expenses limit borrowing capacity. The broker downgrades Stockland FY20 and FY21 earnings estimates by -3% and -8% respectively on lower residential settlements.

UBS does not believe the company is able to achieve the operating profit margin of 23% that is required to deliver 4% growth in earnings. Rating is downgraded to Sell from Neutral. Target is reduced to $4.08 from $4.20.

SMARTGROUP CORPORATION LTD ((SIQ)) Downgrade to Hold from Add by Morgans .B/H/S: 4/2/0

Morgans suggests Smartgroup has sufficient debt capacity to fund an acquisition, although given the remaining salary packaging businesses are small, it would likely have to be in a adjacent sector. This means lower synergies and greater capital investment, the broker notes.

The market is already pricing in growth through acquisition, but it would be more prudent to wait to see what and how it goes. Morgans pulls back to Hold from Add for now. Target unchanged at $11.60.

WESFARMERS LIMITED ((WES)) Downgrade to Sell from Neutral by Citi .B/H/S: 1/4/2

Wesfarmers has announced the sale of Bunnings UK & Ireland. The 24 Bunnings pilot stores will revert back to the Homebase brand following completion of the transaction.

Wesfarmers expects to recognise a -GBP200-230m loss on disposal in its FY18 results. While the acquisition was a poor one, Citi observes the costs of exit are much better than expected and remove a risk hanging over the stock, improving the balance sheet.

Following recent share price appreciation, Citi downgrades to Sell from Neutral. Target lifts to $41.50 from $40.10.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 APA GROUP Buy Neutral Macquarie 2 DOMINO'S PIZZA ENTERPRISES LIMITED Buy Neutral Morgans 3 DOMINO'S PIZZA ENTERPRISES LIMITED Buy Neutral Macquarie 4 GALAXY RESOURCES LIMITED Buy Sell Macquarie 5 SPARK NEW ZEALAND LIMITED Neutral Sell Macquarie 6 VICINITY CENTRES Buy Neutral Macquarie Downgrade 7 AMP LIMITED Neutral Buy Ord Minnett 8 DOMAIN HOLDINGS AUSTRALIA LIMITED Neutral Buy UBS 9 ERM POWER LIMITED Neutral Buy Morgans 10 ERM POWER LIMITED Sell Neutral Macquarie 11 ERM POWER LIMITED Neutral Buy Ord Minnett 12 HANSEN TECHNOLOGIES LIMITED Neutral Buy Ord Minnett 13 MONADELPHOUS GROUP LIMITED Neutral Buy Macquarie 14 MYOB GROUP LIMITED Neutral Buy Credit Suisse 15 REA GROUP LIMITED Sell Neutral Macquarie 16 REA GROUP LIMITED Sell Neutral Ord Minnett 17 SMARTGROUP CORPORATION LTD Neutral Buy Morgans 18 STOCKLAND Sell Neutral UBS 19 WESFARMERS LIMITED Sell Neutral Citi Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 SPK SPARK NEW ZEALAND LIMITED 20.0% -25.0% 45.0% 5 2 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 50.0% 13.0% 37.0% 3 3 GXY GALAXY RESOURCES LIMITED 50.0% 20.0% 30.0% 4 4 DMP DOMINO'S PIZZA ENTERPRISES LIMITED 38.0% 13.0% 25.0% 8 5 VCX VICINITY CENTRES 58.0% 42.0% 16.0% 6 6 APO APN OUTDOOR GROUP LIMITED 33.0% 20.0% 13.0% 6 7 ALL ARISTOCRAT LEISURE LIMITED 81.0% 69.0% 12.0% 8 8 TLS TELSTRA CORPORATION LIMITED 25.0% 13.0% 12.0% 8 9 APA APA GROUP 25.0% 13.0% 12.0% 8 10 CWY CLEANAWAY WASTE MANAGEMENT LIMITED 67.0% 60.0% 7.0% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 EPW ERM POWER LIMITED -33.0% 67.0% -100.0% 3 2 MND MONADELPHOUS GROUP LIMITED -40.0% -20.0% -20.0% 5 3 REA REA GROUP LIMITED -6.0% 13.0% -19.0% 8 4 MYO MYOB GROUP LIMITED 50.0% 67.0% -17.0% 6 5 SIQ SMARTGROUP CORPORATION LTD 67.0% 83.0% -16.0% 6 6 SGP STOCKLAND 36.0% 50.0% -14.0% 7 7 FPH FISHER & PAYKEL HEALTHCARE CORPORATION LIMITED -67.0% -60.0% -7.0% 3 8 AMP AMP LIMITED 25.0% 31.0% -6.0% 8 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 APO APN OUTDOOR GROUP LIMITED 5.575 4.762 17.07% 6 2 ALL ARISTOCRAT LEISURE LIMITED 34.159 29.645 15.23% 8 3 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 4.870 4.533 7.43% 3 4 CWY CLEANAWAY WASTE MANAGEMENT LIMITED 1.713 1.656 3.44% 6 5 DMP DOMINO'S PIZZA ENTERPRISES LIMITED 48.635 47.245 2.94% 8 6 GXY GALAXY RESOURCES LIMITED 3.563 3.480 2.39% 4 7 REA REA GROUP LIMITED 83.458 81.958 1.83% 8 8 APA APA GROUP 8.735 8.629 1.23% 8 9 TLS TELSTRA CORPORATION LIMITED 3.380 3.355 0.75% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 EPW ERM POWER LIMITED 1.573 1.730 -9.08% 3 2 MYO MYOB GROUP LIMITED 3.707 3.948 -6.10% 6 3 MND MONADELPHOUS GROUP LIMITED 15.224 15.886 -4.17% 5 4 AMP AMP LIMITED 4.289 4.369 -1.83% 8 5 SGP STOCKLAND 4.483 4.500 -0.38% 7 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 ALQ ALS LIMITED 34.890 26.395 32.18% 6 2 FPH FISHER & PAYKEL HEALTHCARE CORPORATION LIMITED 34.291 30.689 11.74% 3 3 APO APN OUTDOOR GROUP LIMITED 32.952 29.684 11.01% 6 4 ALL ARISTOCRAT LEISURE LIMITED 116.457 107.443 8.39% 8 5 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 16.150 15.825 2.05% 3 6 NHC NEW HOPE CORPORATION LIMITED 28.367 27.890 1.71% 3 7 SVW SEVEN GROUP HOLDINGS LIMITED 99.500 97.975 1.56% 5 8 SGR THE STAR ENTERTAINMENT GROUP LIMITED 27.200 26.929 1.01% 8 9 CWY CLEANAWAY WASTE MANAGEMENT LIMITED 4.817 4.800 0.35% 6 10 S32 SOUTH32 LIMITED 31.089 30.995 0.30% 7 Negative Change Covered by > 2 Brokers Order Symbol

Company New EF Previous EF Change Recs 1 IGO INDEPENDENCE GROUP NL 9.464 13.044 -27.45% 6 2 EPW ERM POWER LIMITED 8.367 9.867 -15.20% 3 3 GXY GALAXY RESOURCES LIMITED 12.680 14.180 -10.58% 4 4 OZL OZ MINERALS LIMITED 73.200 75.629 -3.21% 6 5 BBN BABY BUNTING GROUP LIMITED 7.675 7.925 -3.15% 4 6 NWS NEWS CORPORATION 57.803 59.407 -2.70% 6 7 MTS METCASH LIMITED 21.535 22.047 -2.32% 7 8 SPK SPARK NEW ZEALAND LIMITED 19.662 19.949 -1.44% 5 9 MYO MYOB GROUP LIMITED 18.400 18.658 -1.38% 6 10 ANZ AUSTRALIA & NEW ZEALAND BANKING GROUP 229.243 231.043 -0.78% 8 Technical limitations

If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

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Uranium Week: Is This A Breakout?

Near record spot market activity in May and a 14% year on year increase in the spot price are the result of increasing uranium market uncertainty.

-Third highest monthly volume on record -Spot price up 14% year on year -Uncertainties dominate both sides of the market

By Greg Peel

Uranium spot market activity increased considerably in May, industry consultant TradeTech reports. A total of 36 transactions representing 7.4mlbs U3O8 equivalent marks the third highest monthly volume on record and more than double the prior monthly average in 2018.

Utilities featured among the buyers, as did producers buying in to fullfil delivery contracts, but the bottom line is 75% of May's volume was attributable to traders and speculators on the buy-side.

TradeTech's spot price indicator closed the month at US$22.70/lb, 8.1% above the end-April price of US$21.00/lb and almost 14% above May 2017's US$19.95/lb. The month ended on Thursday, and on Friday a further increase saw TradeTech's weekly spot price indicator rise to US$23.00/lb, up US15c on the prior week.

The market remains beset with an inventory overhang but growing uncertainty on various fronts has encouraged buyers to chip away at the excess.

The temporary suspension of US Department of Energy stockpile sales is both a positive driver of prices and a source of uncertainty as it is unclear how long "temporary" will last and whether further extensions are imminent.

US trade laws are proving a persistently fluid proposition as the world attempts to figure out whether Donald Trump is simply applying Art of the Deal tactics to force concessions with trading partners or whether tariffs, under the justification of "national security", are here to stay.

Speculators, Not End Users

Producers continue to cut back supply in the face of uneconomical prices while the wold's largest nuclear power industry, America's, is threatening significant shutdowns in the face of non-competitive generation prices.

The speculators are betting on the assumption something has to give and it is unlikely to result in lower global uranium prices. Yet this is not the first time in recent years the spot price has shown encouraging signs of breaking away from an apparent floor price of US$20/lb, only to slide back down again as the real end-users fail to come to the party.

To that end, TradeTech notes the term uranium market was decidedly less active in May than the spot market. Three transactions totalling less than 1mlbs is barely worth reporting.

Nonetheless, Trade Tech's monthly mid-term price indicator has risen US$1.00 to US$26.50/lb, while the long-term indicator remains at US$28.00/lb.

For US utilities, the outcome of the pending section 232 decision (national security) with regard imported uranium is discouraging term delivery commitments. If the petition is approved, US utilities will be forced to buy 25% (or some proportion) of their uranium from local producers and that will mean a higher net price. Yet reactors are already non-commercial amidst an abundance of cheap US gas even at the "cheap" prices being paid for foreign uranium imports.

The US government is keen to maintain a nuclear power industry to ensure a diversified energy for the sake of – you guessed it – national security.

If you ask to get out of flying more missions on the grounds of insanity you can't possibly be insane.

The Short Report

Guide:

The Short Report draws upon data provided by the Australian Securities & Investment Commission (ASIC) to highlight significant weekly moves in short positions registered on stocks listed on the Australian Securities Exchange (ASX). Short positions in exchange-traded funds (ETF) and non-ordinary shares are not included. Short positions below 5% are not included in the table below but may be noted in the accompanying text if deemed significant.

Please take note of the Important Information provided at the end of this report. Percentage amounts in this report refer to percentage of ordinary shares on issue.

Stock codes highlighted in green have seen their short positions reduce in the week by an amount sufficient to move them into a lower percentage bracket. Stocks highlighted in red have seen their short positions increase in the week by an amount sufficient to move them into a higher percentage bracket. Moves in excess of one percentage point or more are discussed in the Movers & Shakers report below.

Summary:

Week ending May 31, 2018

Last week saw the ASX200 bottom out under 6000 before beginning a choppy recovery this week.

While the prior week saw quite a lot of movement on the short table, last week saw very little at all. Only one stock saw a move of one percentage point or more, being APN Outdoor ((APO)), which fell to 7.1% from 9.7%. See below.

Beyond that, special mention goes to Metcash ((MTS)), which saw shorts rise to 8.7% from 7.9% after issuing a profit warning.

We'll also note BWX ltd ((BWX)) has dropped to 6.6% from 7.3% in the wake of its takeover offer.

AMP ((AMP)) Watch: 3.7% last week from 3.5%.

Weekly short positions as a percentage of market cap:

10%+

SYR 19.7 DMP 16.3 JBH 15.5 GXY 14.5 MYR 13.3 NAN 12.4 AAC 11.9 ORE 11.9 VOC 11.8 GXL 11.2 IVC 10.9 IGO 10.7 NWS 11.2 HT1 10.0

In: IGO Out: HT1

9.0-9.9

GEM, HT1, MYX

In: HT1 Out: IGO, APO 8.0-8.9%

MTS, BIN, AAD, HVN, MLX, IPH, PLS

In: MTS Out: RFG, GMA

7.0-7.9%

GMA, FLT, TPM, WEB, BGA, IFL, BKL, QUB, SFR, RFG, APO

In: APO, GMA, RFG Out: MTS, BWX

6.0-6.9%

RSG, ING, TGR, CSR, BWX, SEK, KAR, MOC, BAP, PRY

In: BWX

5.0-5.9%

ALX*, SUL, NSR, AHG, MYO, BEN, CCP, NUF, IMF, JHC, NXT, BOQ, GTY

In: GTY

Movers & Shakers

Last week APN Outdoor upgraded its FY18 earnings guidance in a rare "confession session" anti-warning. The share price quickly shot up 13% and given short positions fell to 7.1% from 9.7%, short-covering was clearly involved.

The upgrade suggested that the damage done to APN's earnings prospects after having lost the Yarra Trams contract has now been overcome with new business.

APN Outdoor is currently in a bidding war for HT&E's ((HT1)) outdoor advertising business, Adshel, along with rival oOh!media ((OML)). APN has gazumped oOh!media's $470m bid with $500m, but not all cash. Brokers suggest HT&E would prefer a cash bid, which would likely require APN to raise capital.

And no doubt HT&E is waiting to see if oOh!media comes back again.

The irony is that up until 2013, what are now known as HT&E and APN Outdoor were both part of the same company, APN News & Media.

We note shorts in HT&E fell to 9.4% last week from 10.0%.

oOh!media did spend some time on the 5% plus shorted table but has not been spotted for many weeks.

ASX20 Short Positions (%)

* Replaces WFD for the moment

To see the full Short Report, please go to this link

IMPORTANT INFORMATION ABOUT THIS REPORT

The above information is sourced from daily reports published by the Australian Investment & Securities Commission (ASIC) and is provided by FNArena unqualified as a service to subscribers. FNArena would like to make it very clear that immediate assumptions cannot be drawn from the numbers alone.

It is wrong to assume that short percentages published by ASIC simply imply negative market positions held by fund managers or others looking to profit from a fall in respective share prices. While all or part of certain short percentages may indeed imply such, there are also a myriad of other reasons why a short position might be held which does not render that position "naked" given offsetting positions held elsewhere. Whatever balance of percentages truly is a "short" position would suggest there are negative views on a stock held by some in the market and also would suggest that were the news flow on that stock to turn suddenly positive, "short covering" may spark a short, sharp rally in that share price. However short positions held as an offset against another position may prove merely benign.

Often large short positions can be attributable to a listed hybrid security on the same stock where traders look to "strip out" the option value of the hybrid with offsetting listed option and stock positions. Short positions may form part of a short stock portfolio offsetting a long share price index (SPI) futures portfolio - a popular trade which seeks to exploit windows of opportunity when the SPI price trades at an overextended discount to fair value. Short positions may be held as a hedge by a broking house providing dividend reinvestment plan (DRP) underwriting services or other similar services. Short positions will occasionally need to be adopted by market makers in listed equity exchange traded fund products (EFT). All of the above are just some of the reasons why a short position may be held in a stock but can be considered benign in share price direction terms due to offsets.

Market makers in stock and stock index options will also hedge their portfolios using short positions where necessary. These delta hedges often form the other side of a client's long stock-long put option protection trade, or perhaps long stock-short call option ("buy-write") position. In a clear example of how published short percentages can be misleading, an options market maker may hold a short position below the implied delta hedge level and that actually implies a "long" position in that stock.

Another popular trading strategy is that of "pairs trading" in which one stock is held short against a long position in another stock. Such positions look to exploit perceived imbalances in the valuations of two stocks and imply a "net neutral" market position.

Aside from all the above reasons as to why it would be a potential misconception to draw simply conclusions on short percentages, there are even wider issues to consider. ASIC itself will admit that short position data is not an exact science given the onus on market participants to declare to their broker when positions truly are "short". Without any suggestion of deceit, there are always participants who are ignorant of the regulations. Discrepancies can also arise when short positions are held by a large investment banking operation offering multiple stock market services as well as proprietary trading activities. Such activity can introduce the possibility of either non-counting or double-counting when custodians are involved and beneficial ownership issues become unclear.

Finally, a simple fact is that the Australian Securities Exchange also keeps its own register of short positions. The figures provided by ASIC and by the ASX at any point do not necessarily correlate.

FNArena has offered this qualified explanation of the vagaries of short stock positions as a warning to subscribers not to jump to any conclusions or to make investment decisions based solely on these unqualified numbers. FNArena strongly suggests investors seek advice from their stock broker or financial adviser before acting upon any of the information provided herein.

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The Wrap: Wealth, Agriculture & Aged Care

Weekly Broker Wrap: wealth management; agriculture; infrastructure; private hospitals; and aged care.

-Less certain outlook for wealth management sector -Poor start to winter crop season entails more bearish view of agriculture sector -Citi questions sustainability of distribution pay-out at Transurban -Private hospital patronage seen ebbing on affordability issues -Operating headwinds in aged care not expected to ease in the short term

By Eva Brocklehurst

Wealth Management

UBS expects enhanced education standards, coming into effect from January 2019, could transform the wealth management industry. The broker estimates the average existing adviser will need to undertake 642 hours of study by January 2024. Based on the new minimum education standards that are proposed, planners would also need to pass a national exam by January 2021 to continue practising.

As a result, given the average age of advisers is around 55 years, UBS suspects at least 25% will call it quits from the industry over the next five years. More attrition may occur should grandfathered commissions be abolished.

AMP ((AMP)) and ANZ Bank's aligned dealer groups that are due to be acquired by IOOF ((IFL)) appear most exposed. The broker does not believe vertical integration will be outlawed, although structural separation is a tail risk that should be factored into views on stocks.

Bell Potter argues the business models used by AMP and IOOF are broken, and until it is clear how the adjustment to the new environment will take place believes the stocks demand a lower PE multiple rating. This is based on earnings outlook being weaker and less certain.

Bell Potter currently has AMP on and FY19 PE of 13x and IOOF on 16x. The broker suggests the main beneficiaries of the trend will be Praemium ((PPS)), Onevue Holdings ((OVH)) and Netwealth ((NWL)). The broker recently downgraded Netwealth to Hold from Buy because of strong share price action and, until such time as there is greater clarity on how much traction the business will get with the shift to independence, prefers Praemium and Onevue.

Agriculture

Bell Potter is incorporating a more bearish view across the agricultural sector given a weak start to the winter cropping season. This view is also incorporated in derivative commodities such as livestock.

Stocks considered most exposed include Elders ((ELD)) , for which expectations are downgraded given the poor start to cropping amid reduced forecasts for the value of livestock turnover. The impact is a -10% reduction in FY18 net profit estimates and -4% in FY19.

Graincorp ((GNC)) is a late-cycle exposure leveraged to the harvest rather than the inputs so a softer 2018/19 east coast harvests affects its FY19 result. Bell Potter's Sell rating is maintained.

Nufarm ((NUF)) generates around 21% of revenue and 15% of operating earnings (EBITDA) in the Australasian business but this percentage will shrink as recent European acquisitions are consolidated. The broker downgrades the FY18 season and assumes a heightened competitive environment in FY19-20. Rating is also downgraded to Hold in light of recent share price strength.

The outlook for the cropping season also merits a downgrade to estimates for Ruralco Holdings ((RHL)). Bell Potter reduces net profit estimates by -15% for FY18 and -5% for FY19-20. Buy-rated Australian Agricultural Co ((AAC)) is still expected to sustain operating earnings improvements from the closure of the Livingstone processing facility and the internalisation of its supply chain.

Infrastructure

In analysing Australasian infrastructure, Citi finds a preference for Auckland International Airport and Sydney Airport ((SYD)) over Transurban ((TCL)). Balance sheets, debt metrics and the credit cycle are leading the broker to question the sustainability of distribution pay-out ratios. Citi reinstates coverage of Sydney Airport with a Buy rating and Transurban with a Sell rating.

Earnings certainty remains high across the sector and there is upside risk to consensus expectations for airports. While overall valuation metrics appear fair in a low interest rate environment they are not compelling, in the broker's opinion.

The broker expects strong international passenger growth in both Auckland and Sydney, with a multi-year retail tailwind for the latter Airport as terminals are progressively upgraded. The broker's less favourable investment view of Transurban is driven by an expected reduction in the pay-out ratio from FY23 as balance sheet pressures mount.

Private Hospitals

Credit Suisse asserts that the recent deterioration in Australian private hospital industry growth is a structural issue. Affordability pressures have stretched the elasticity of demand for private health care in a market where there is a viable public hospital substitute.

The broker believes the market is underestimating the long-term downside to Ramsay Health Care ((RHC)) and Healthscope ((HSO)). Several factors are driving patients to the public system, including funding incentives for public hospitals to admit more private patients, a deterioration in private health hospital cover and increases in out-of-pocket surgery costs.

While accepting that Ramsay Health Care has underperformed the market by around -15% in the last 12 months the broker continues to envisage downside risk in the medium term and downgrades to Underperform. Credit Suisse retains a Neutral rating for Healthscope but considers the underlying valuation implies material downside to the current share price even if an M&A deal does not eventuate.

Aged Care

Operating headwinds in the aged care sector are unlikely to ease in the short term and Macquarie suggests offsetting initiatives carry higher execution risk. Costs of care are outgrowing revenues, caused by downgrades to the industry subsidy.

The broker's top-down analysis suggests the growth outlook is not attractive. Budget estimates imply little relief in funding per bed for aged care operators and there are unlikely to be any regulatory changes that will result in positive inputs before the next federal election.

The broker's preferred stock in the sector is Estia Health ((EHE)), upgraded to Outperform, which provides a three-year growth rate of 7.4% on a 5.5% forward yield. Japara Healthcare ((JHC)), with a Neutral rating, carries the highest execution risk, Macquarie believes, as it has material capital commitments to support the workbook.

Meanwhile, Regis Healthcare ((REG)), downgraded to Underperform, is expected to sustain declines in earnings per share in FY19. The business is currently at a point in the cycle where a material investment is required and distributions are in decline.

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Treasure Chest: Takeover Appeal In Newcrest?

Buying Newcrest may be a better option for a large-cap gold producer, rather than trying to discover and define gold resources, Citi suggests.

-Value relative to replacement cost provides a high takeover appeal -Since 2000 gold equities have underperformed a rising gold price -Tailings issues remain a challenge for the company

By Eva Brocklehurst

Would it be cheaper to buy Newcrest ((NCM)) than build it? Citi believes so. The stock is trading at a -71% enterprise value/reserve discount to its peers because of, in the broker's opinion, temporary issues with its operations as well as the concentration of production at key assets.

Hence, buying the company could be a better option than trying to discover and define gold resources. The value relative to replacement cost provides a high takeover appeal. The broker's calculations centre around the cost to find gold and the required capital expenditure for production.

On average it costs US$45/oz to find gold and around US$90/oz in capital to reach production. Citi surmises that it could cost 107% of Newcrest's enterprise value to develop the company from scratch.

A global production shortfall is looming and many miners do not have development options available. The broker estimates, further, that it would require US$130bn of capital to sustain gold output globally until 2026, which could require dubious projects to be given the green light.

Moreover, since 2000, gold equities have underperformed a rising gold price. Hence, the broker considers Newcrest is the answer for any large-cap gold producer. Furthermore, the in-ground multiples fundamentally undervalue the company.

It would not be possible, Citi believes, to reconstruct a company with as much gold as Newcrest has for anywhere near its market valuation. The broker estimates the company's replacement cost is US$28.5bn.

Cadia East, Lihir, Telfer and Gosowong are in production. Wafi Golpu and Fruita del Norte are gold discoveries and require just the cost of discovery to be replaced, although Citi notes this would undervalue completed studies and construction.

Ord Minnett, with an Accumulate rating, is the only other stockbroker monitored daily on the FNArena database that is positive about the value in the stock.

The broker is relieved that Cadia is now full steam ahead after its earthquake-related issues and positive about the company's target of 550-600,000 ozs from the asset for FY18.

Alternative View

Credit Suisse has a Neutral view on a valuation basis, as Newcrest emerges from reliability issues at two of its core operations, Cadia and Lihir.

Tailings have emerged as a challenge for the company in several respects, notably Cadia's dam failure, while Lihir uses submarine tailings disposal (the same as proposed for Golpu) and this, in the broker's opinion, makes the company un-investable for many ESG (environmental, social and governance) funds.

Credit Suisse also suggests that Lihir and Cadia are losing too much gold to tailings from lower metallurgical recoveries. Meanwhile Gosowong is depleting fast and there appears to be no incentive to recapitalise the mine.

Macquarie awaits catalysts such as the Cadia East pre-feasibility and plant expansion studies in August. The broker, which rates Newcrest Underperform, notes several developments over coming days have potential to impact gold and gold equities. These include the upcoming US Federal Reserve and European Central Bank meetings as well as political developments in Europe and Korea.

FNArena's database shows two Buy ratings, four Hold and two Sell for Newcrest. The consensus target is $21.07, suggesting 0.3% upside to the last share price.

Aussie Equities: Where Is True Value?

In this week's Weekly Insights:

-Aussie Equities: Where Is True Value? -No Weekly Insights Next Week -Rudi Talks -Rudi On TV -Rudi On Tour -At The AIA Conference

Aussie Equities: Where Is True Value?

By Rudi Filapek-Vandyck, Editor FNArena

And after all that was said and done, the Australian share market entered the final month of financial year 2018 with a total gain (incl dividends) of less than 1% for the first five months of calendar 2018.

Most investors, I have little doubt, would prefer a larger bonus given the risks, the headaches, the uncertainties, and the volatility that has kept the world on edge since global equities (seemingly) peaked in late January.

As illustrated by the excellent graph below from Blue Ocean Equities' strategist Mathan Somasundaram, this year's sideways moving pattern is far from the first "correction" period since this global bull market was born in early March 2009.

The prior time Australian equities went sideways for an excruciating number of months occurred last year, and that period doesn't even feature in the graph below because US equities simply soldiered on.

As is the custom in financial markets, the longer these sideways patterns persist, the more doubt creeps into our collective mindset. Could it be that we are witnessing the final chapter before this raging bull gets kneecapped and experiences a face plant?

On my observation, the number of expert calls for more caution and predictions of potential heavy weather ahead is much larger this year than all of last year. At face value, this makes a lot of sense given the Federal Reserve is now a couple of rate hikes further in its normalisation process, while the shine has come off the global synchronised growth story, plus the global bull market for equities is yet another year older.

There is plenty to worry about ranging from pending inflation in the USA, structural problems inside the eurozone, rising bond yields, and the darker side of the Trump presidency, including growing opposition to the US slapping trade tariffs on selected imports. That list is by no means complete.

Locally, Australians are now facing the prospect of weakening house prices, amidst an ongoing squeeze on household budgets, with average wage increases near all-time lows, while Royal Commissions into franchises and the finance sector continue to unwrap corporate scandal after scandal. Meanwhile, the digital disruption and transformation of yesteryear's economies goes on unabated.

The direct result of all of the above is a share market that has rarely looked as polarised as it is today. Most investors are well aware of the sharp dichotomy between the "Haves" and the "Have Nots" in the share market, but they also have found it difficult to obtain full benefit from it.

This is because Australian investors, be they seasoned fund managers or self-managing SMSF operators, are in large majority "value" investors. They buy low and assume this will guarantee them positive outperformance in the long run. But it's not just Vocus Communications, iSentia and Telstra that have inflicted a lot of damage to investment portfolios, it's the popular top end of town, sometimes referred to as "blue chips", that has kept a lid on the performance of many a value-centric investment strategy.

Consider, for example, that while the broader Australian share market has failed to keep up with international peers in years past, the ASX200 Accumulation Index still returned 7%+ per annum on average over the past 5.5 years. The ASX Top20, however, has only managed some 6% p.a. over the past five years, and no more than 3% p.a. all-in over the past three years.

Now consider the fact that CSL ((CSL)), whose share price has more than doubled since a temporary dip in December 2016, is also included in the ASX20, as are BHP, Rio Tinto and Woodside Petroleum - all part of the resources sector which, as a group, rallied some 150% since the low point in early 2016. These numbers highlight how tough life has been for investors whose strategies do not include cyclical resources and/or high growth companies.

Experts like to point towards global synchronised growth as to why miners and energy producers have regained positive momentum over the past two years, but equally important have been greener policies in China, and elsewhere, infrastructure bottlenecks in the US and a sharp reduction in sector capex overall. Most importantly, these sectors are widely considered "late cycle", implying today's outperformance shall be followed by a much less conducive environment at some stage. Also, prior to early 2016 investors in the sector had to endure five long years of sheer misery.

Nobody likes to highlight it, but value investing has generated more disappointments than successes post 2013. This because the reasons as to why share prices weakened were of a longer lasting, if not permanent nature. Think increased competition. Downward pressure on consumer spending alongside changing spending patterns. Increased government intervention and regulatory scrutiny. We can now also add softer dynamics for house prices.

Buying into cheap looking stocks assumes that whatever is depressing the share price today is of temporary, non-structural origin and shall disappear over time, allowing the share price to resume a firm, sustainable up-trend.

Instead, many an Australian household name has been found unprepared for present day challenges, either because of boardroom and C-suite hubris, or because of structural underinvestment to retain a juicy dividend for shareholders, or because of both.

Such has been the painful truth uncovered at the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, but the same machinations have become apparent elsewhere.

Investors need not look any further than Telstra, reportedly the most widely owned stock outside the banks among Australian investors. Its share price more than halved since February 2015 and that 22c dividend looks equally unsustainable as the dry weather in inner Sydney last month.

As for the banks, it seems likely, if not probable, that on a five year horizon today's share prices are offering cheap entry points for patient investors, but with weakening house prices, all-time high household indebtedness, the uncertain consequences from the Royal Commission, plus a potential credit crunch looming, it also remains possible, if not probable, share prices will fall deeper within the next 1-2 years.

That's the real challenge for investors today: identifying which risks are the least dangerous to take on board. Is it the cheap looking stock that is facing structural change and the ongoing potential for more bad news; or is it the glamorous "Winner Takes All"-Champion stock that is being managed by top notch, experienced management but whose share price by now is priced accordingly?

The answer, I believe, lays not necessarily with the individual companies but probably more so with the general corporate climate investors should expect for the remainder of 2018 and the 1-2 years that follow next.

If we do see the Australian economy suffer under too much debt, too little wage increases, banks rationing credit and slowing economic growth internationally, then I don't see a fertile environment for institutional investors to start throwing overboard their investments in high quality, solid growth stalwarts such as CSL, Macquarie Group ((MQG)), Aristocrat Leisure ((ALL)), and others.

If, on the other hand, a more positive scenario were to unfold, one that sees the operational environment for large swathes of today's share market laggards improve much quicker and much more decisively than is currently anticipated, then the risk rises for a repeat experience of the second half of calendar 2016 when money rapidly flowed out of the strong (and defensive) performers at that time and into share market laggards which at that time where cyclical resources and financials, including the banks.

Contrary to general commentary elsewhere (mostly expressed by value-oriented, highly frustrated experts and investors) I do not see a "bubble" in growth stocks. Instead, I believe many of such warnings are based upon one-sided, biased and incomplete analyses.

Most of the strong gains achieved by CSL, Macquarie, Aristocrat & Co over the year past have been underpinned by equally large jumps in corporate profits. But this remains only part of their success story. The failure of AMP, Telstra, the banks, and the likes to offer a positive alternative has equally played an important role.

Herein lies the fundamental dilemma for share market investors as we approach the middle of 2018: are you sticking with what has worked thus far or are you positioning for a decisive break in the trends that have defined performance in the Australian share market over the past five years?

Yes, indeed, it doesn't have to be 100% black and white, and there certainly is room to hedge one's outlook, but when it comes to carrying an overweight bias, I suggest investors do more of what has worked, and less of what hasn't.

All-Weather Model Portfolio

Certainly remarkable in a broader context wherein many calls have been made about an unsustainable bubble in growth stocks, but the FNArena Vested Equities Model Portfolio achieved one of its best monthly performances in May, adding 2.15% between the 1st and the 31st of the month.

The S&P/ASX200 Accumulation Index gained 1.09% over the period. The ASX20 all-in performance was 1.17% during a period when most banks and out-of-season reporters paid out half-yearly dividends, for an 11-month financial year to date total performance of 7.02%. Comparable performance for the ASX200 Accumulation Index is 9.44% and for the All-Weather Portfolio it is 14.62%.

As we have been anticipating a more challenging environment, the portfolio has been increasing cash, which in the short term means we have been sacrificing some upside from the portfolio's performance, in order not to get caught out later on.

No Weekly Insights Next Week

Next week starts with a public holiday on Monday (June 11) and, for me, an interstate flight ahead of presentations to investors and members of the Australian Shareholders Association (ASA) on the Gold Coast and in Brisbane on Tuesday and Wednesday. I will also participate in an online seminar for ASA members on the Thursday.

Hence there won't be a Weekly Insights next week. Next edition shall be written and published on Monday, 18th June 2018.

Rudi Talks

Audio interview about falling share prices and when do we, investors, get rid of disappointing underperformers in portfolio:

http://boardroom.media/broadcast/?eid=5b0cc86f7a67720d3fe99acb

Rudi On TV

This week my appearances on the Sky Business channel are scheduled as follows:

-Tuesday, 11.15am Skype-link to discuss broker calls -Thursday, from midday until 2pm -Friday, 11am, Skype-link to discuss broker calls

Rudi On Tour

-Presentations to ASA members and guests Gold Coast and Brisbane (2x), on 12 & 13 June -ATAA members presentation Newcastle, 14 July -AIA National Conference, Gold Coast QLD, June 29-August 1 -ASA Presentation Canberra, 3 August -Presentation to ASA members and guests Wollongong, on September 11 -Presentation to AIA members and guests Chatswood, on October 10

At the AIA Conference

As stated in the overview above, I will be presenting at the AIA National Annual Conference at the Marriott Resort and Spa Surfers Paradise, from 29th July til 1st August 2018.

This year's theme is SYNCHRONICITY, Identifying opportunities in a world growing in sync...

For the first time in over a decade, the world's major economies are growing in sync.

What does a world that is structurally awash in capital look like?

What will it mean for investors?

http://www.investors.asn.au/events/aia-national-investors-conference/

(This story was written on Monday 4th June 2018 and published on the day in the form of an email to paying subscribers at FNArena, and again on Wednesday as a story on the website).

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

In addition, since FNArena runs a Model Portfolio based upon my research on All-Weather Performers it is more than likely that stocks mentioned are included in this Model Portfolio. For all questions about this: info@fnarena.com or via the direct messaging system on the website).

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- The AUD and the Australian Share Market (which stocks benefit from a weaker AUD, and which ones don't?) - Make Risk Your Friend. Finding All-Weather Performers, January 2013 (The rationale behind investing in stocks that perform irrespective of the overall investment climate) - Make Risk Your Friend. Finding All-Weather Performers, December 2014 (The follow-up that accounts for an ever changing world and updated stock selection) - Change. Investing in a Low Growth World. eBook that sells through Amazon and other channels. Tackles the main issues impacting on investment strategies today and the world of tomorrow. - Who's Afraid Of The Big Bad Bear? eBook and Book (print) available through Amazon and other channels. Your chance to relive 2016, and become a wiser investor along the way.

Subscriptions cost $420 (incl GST) for twelve months or $235 for six and can be purchased here (depending on your status, a subscription to FNArena might be tax deductible): http://www.fnarena.com/index2.cfm?type=dsp_signup

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P.S. I - All paying members at FNArena are being reminded they can set an email alert for my Rudi's View stories. Go to My Alerts (top bar of the website) and tick the box in front of 'Rudi's View'. You will receive an email alert every time a new Rudi's View story has been published on the website.

P.S. II - If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

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