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AUSTRALIA

Lofty Prices Stand Incitec Pivot In Good Stead

Elevated prices for fertiliser and ammonia and an expected recovery in explosives put Incitec Pivot in a strong position despite the impact of Hurricane Ida

- Hurricane Ida to impact Incitec Pivot's earnings for the final month of FY21
- Elevated gas prices supporting ammonia markets globally
- Waggaman needs to run smoothly for some time to instigate a re-rating

By Eva Brocklehurst

As the financial year closes for Incitec Pivot ((IPL)), another difficulty to surmount has come in the form of Hurricane Ida, which is a reminder of the many issues that have plagued operations at Waggaman, the company's ammonia plant in Louisiana.

The plant was shut down on August 28 in anticipation of the hurricane to protect against damage, and the re-start has been awaiting the restoration of high-voltage industrial power.

The total outage is anticipated to be four weeks from the date the plant was shut down, which correlates with the final month of the company's financial year and results in another material downgrade to earnings estimates.



The timing is unfortunate, given the advantage lost from an historically high ammonia price, and Morgans downgrades forecasts for FY21 while keeping FY22-23 unchanged. Macquarie notes the balance sheet is in good shape since a capital raising in 2020 and gearing should have fallen in the second half, consistent with normal seasonal trends.

The broker also suspects the market will look through the interruption, as Waggaman has performed much better recently. The plant has been running at nameplate capacity since the end of May and has not sustained any damage to its structure from the hurricane. Macquarie estimates the last four months (June-September) of

FY21 will have averaged 93% utilisation.

There will be two more turnarounds in the company's plants, at Cheyenne and Phosphate Hill during FY22, after which there will be a breather and the next cycle will not occur until FY25.

Brokers also concludes there is material upside from this point if fertiliser prices hold up and no further manufacturing issues eventuate. The loss in EBIT terms is -US\$28m while the impact on net profit is -US\$21m. Moreover, the plant now needs to successfully re-start hence, as Macquarie points out, there is some residual risk.

Morgans downgrades its estimates to a lesser extent than the headline indicates, to account for higher fertiliser prices. Moreover, there is material upside if prices hold around current levels. For FY22 the broker assumes an average diammonium phosphate (DAP) and ammonia price of US\$470/t and US\$420/t versus spot at US\$632/t and US\$615/t, respectively. As UBS notes, the latter (Tampa spot ammonia price) is up 140% over the year to date.

Fertiliser

The broker observes **most market commentators expect fertiliser prices to remain high until at least the first quarter of 2022, amid strong demand, supply disruptions and rising raw material costs.** Morgans also expects a recovery in Incitec Pivot's Asia-Pacific explosives business and a larger cotton season during FY22 will provide benefits in terms of fertiliser sales.

Gas costs are also surging in the UK and Europe, underpinning the ammonia price. As Macquarie points out, US gas prices may be surging but Europe has risen more because of a very tight LNG market, and this provides a favourable margin spread for US nitrogen producers.

Morgan Stanley adds an observation that urea and DAP prices in the US have increased in the wake of Hurricane Ida while Chinese DAP prices are unchanged. Yet, as UBS reflects, DAP prices in Asia are still up 70% in the year to date.

Re-Rating?

Morgans assesses the fundamentals for Incitec Pivot are attractive compared with the broader market and competitor Orica ((ORI)), yet recognises the Waggaman plant needs to run properly for an extended period of time in order for the market to become comfortable and re-rate the stock.

Macquarie agrees Incitec Pivot is trading at a large discount to Orica on FY21 and FY22 multiples, with the main risks being further problems with manufacturing, or a slump in fertiliser prices.

UBS considers the stock highly leveraged to ongoing strength in global agriculture and believes its forecasts of 30% EBIT growth in FY22 will be underpinned by favourable fertiliser pricing along with a better manufacturing performance and resilient explosives markets.

Tight supply amid a likely reduction in DAP exports from China is also a feature and elevated global gas prices will support ammonia markets in the absence of new merchant ammonia capacity.

FNArena's database has seven Buy ratings for Incitec Pivot with a consensus target of \$3.06 that suggests 11.5% upside to the last share price.

See also, [Incitec Pivot Re-Rating Dependent On Waggaman](#) on May 19, 2021.

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AUSTRALIA

Brambles Has Great Expectations For Plastic

To improve the efficiency of its global pallet operations, Brambles will incur a significant investment over the four years from FY22. Will it be worthwhile?

- A structurally better business could result from the transformation plan
- Key decision on the Brambles/Costco plastic pallets trial expected in H2
- Investment requires capital at a time when expenditure is already elevated

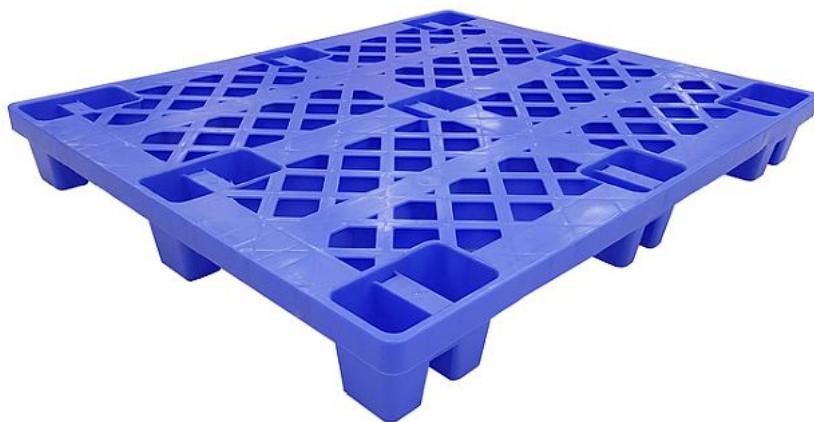
By Eva Brocklehurst

Brambles ((BXB)) has outlined ambitious plans to improve the efficiency of its global pallet operations. This requires a digital transformation, centred on using GPS-tagged plastic pallets to identify sources of pallet losses and unauthorised pallet usage.

The company has used 5000 GPS-tagged pallets in its Irish business and found a tenfold investment return from the use of digital capability. This has spurred the company to focus on extending the digital transformation, particularly with Costco which, as Macquarie alludes, is pushing hard for a plastic pallets solution.

The investment required involves US\$480m of operating expenditure spread across this transformation plan and US\$625m in capital expenditure out to FY25. Brambles is guiding to 5-7% revenue growth to FY25 yet net profit growth of just 1-2% in FY22, which will move to high single digits in FY23-25. Guidance excludes the impact of plastic pallet outcomes.

Macquarie can envisage a structurally better business as a result of the transformation plan, with cash generation that should lead to value creation for shareholders (Brambles is guiding to 10% shareholder value creation) but acknowledges the substantial costs upfront make for caution.



Morgans believes the initiatives make sense but agrees the investment is significant and the key will be the execution over the next few years as well as proving up the returns. Margins will be affected in FY22 by higher transformation and digital costs, although operating leverage should improve over the medium term as these investments are realised.

The opportunity is fairly large should the company be successful and Citi agrees Brambles could become a better business structurally. The re-start of the share buyback should support earnings growth and provide some offset to the higher investment expenditure in FY22.

All up, management has flagged a potential US\$1.1bn four-year investment plan with the offset being a -4% downgrade to FY22, Citi concludes, and the risk of projected returns not materialising from the US\$450m to be spent on the supply chain is low, given US\$235m relates to already-proven technology, US\$60m to continuation of an existing pallet durability program and US\$120m to purchasing new automation technology.

Yet Jarden questions why the transformation decisions are being made now, although understands the company wants to entrench its competitiveness. The broker points out customers are accepting higher prices at present and current conditions are most conducive to profitable growth, as pallet supply remains tight over key markets in CHEP Americas and CHEP EMEA (Europe, Middle East, Africa).

Instead, investors are now faced with a lower earnings growth outlook over the short term and prospects of execution risk at a time when the market is still recovering from the pandemic.

Jarden lowers forecasts to reflect a combination of a lower margin outlook for the US pallets division and incremental costs as well as a step up in the tax rate. Even without this investment decision, the broker believes free cash generation will be constrained going forward and is unlikely to cover any dividends before FY25.

Hence, Jarden, not one of the seven monitored daily on the FN Arena database, downgrades to Underweight from Overweight and reduces its target to \$11.60 from \$12.75.

In order to become more positive, the broker would need to find sustained competitive gains and benefits from the transformation along with operating leverage. Credit Suisse, too, has downgraded estimates following the presentations, reducing FY22-23 forecasts by -5-6%.

Most of this pertains to lower margins in operating segments and the remainder from higher transformation costs. Nevertheless, the broker is still ahead of management's guidance for FY22-24, noting historically the company tends to be quite conservative.

Management has expressed concern that costs may not fully return to pre-pandemic levels while Credit Suisse, suspecting this assumption is included in guidance, envisages no reason why costs cannot return closer to pre-pandemic levels and allow for stronger margins.

Brambles has low penetration in Germany, partly because of the popularity of a competitor's whitewood exchange, but expects higher growth in the future after gaining retail acceptance from the likes of Aldi and Lidl.

While the company has experienced a strong recovery in automotive container demand this has slowed because of a semiconductor shortage. **As many vehicle manufacturers are moving to a higher proportion of electric vehicles Brambles is intent on gaining exposure to parts logistics**. Specialised containers for batteries produced in China are considered another opportunity.

Costco

Management is currently undertaking a trial of plastic pallets with Costco and iGPS. Costco comprises around 10% of the company's volume in the US and a decision is expected in the second half of FY22.

Brambles will not go ahead if the return is less than 10%. Jarden calculates a best case return is 13.8% for plastic pallets, although this fails to account for any network inefficiencies from running a large wooden pallet pool elsewhere in the US.

Credit Suisse also points out, while the plastic pallet loss rate is around -30-50% lower than for wooden pallets, these are typically deployed across low-loss lanes, given the pricing premium.

Plastic pallets cost around three times more to produce than wooden pallets so efficiency is critical, although Macquarie suspects Costco will go ahead regardless of whether Brambles comes to the party.

Besides the return on investment, the company will also require a commitment from Costco to transport collaboration along with acceptance from Costco suppliers. In the event Costco switches to plastic pallets a

three-year conversion timeframe is anticipated.

Morgans considers the future of plastic pallets at Costco comes down to whether the price premium can be justified, noting if Brambles decides not to proceed the lost Costco volumes could take years to replace. On the other hand, the investment will require capital expenditure of US\$450-700m over three years during a period when expenditure is already elevated.

FNArena's database has three Buy ratings and two Hold. The consensus target is \$12.68, suggesting 15.3% upside to the last share price.

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AUSTRALIA

BHP Embarks On The Jansen Era

Approval of Jansen potash has long been heralded as a catalyst and now, with investment details and timeframe, the stage is set for BHP Group's new era

- Jansen products expected to offer lower carbon intensity and higher water efficiency
- Superior automation should put BHP at the forefront of potash mining
- Capital expenditure on Jansen expected to peak in 2025/26

By Eva Brocklehurst

Goodbye petroleum, welcome potash, the new favoured commodity for BHP Group ((BHP)). Shaw and Partners asserts BHP will become a globally significant player in potash within a decade.

The company approved the Jansen potash project last month and has briefed investors on the development, located in Canada's potash basin in Saskatchewan where it owns 37% of the tenements. The formal approval should mean potash production commences around 2027, with initial development delivering an underground mine and production capacity ramping up to 4.35mtpa within two years.

Morgan Stanley assesses the growth parts, stages 2-4, have compelling returns and therefore the company has no need to pursue partnerships. BHP's marketing division has commenced engagement with potential customers, anticipating many potash customers will wish to diversify sources of supply.

There are few supply opportunities in potash available globally and BHP has glowingly described Jansen as "the best greenfield opportunity in the best potash basin". Pricing will be negotiated when agreements become binding.



Memoranda of Understanding have been agreed in China and across Asia, South America and North America. BHP expects to be always able to sell product and make a margin, and sales contracts typically last 3-5 years, so an inventory build will not be part of the marketing strategy.

Jansen's products are expected to offer a lower carbon intensity and higher water efficiency compared with competitors, although, as Morgan Stanley points out, ultimately this advantage depends on how customers value these aspects over time.

The processes are dependent on natural gas which will be difficult to displace and the business is working on carbon capture and storage technology to improve the carbon footprint. Numerous studies have optimised the mine plan and there is increased confidence in a projected 92% recovery rate.

It has been a long journey to arrive at the approval for stage 1, with Shaw noting a lot of prevarication over the past 20 years. Still, the opportunity has arrived and opens up a new growth front.

A New Era

Shaw makes the comparison with Fortescue Metals' ((FMG)) entry into iron ore, disrupting the three existing major operators, Rio Tinto ((RIO)) BHP and Vale. The broker believes the same playbook has been appropriated by BHP with its state-of-the-art potash mining. The broker lauds the decision to go ahead, as this is a future-facing commodity that adds to the company's copper/nickel exposure.

Yet Goldman Sachs continues to believe Jansen is one of the most contentious of the company's growth projects because of the large amount of capital expenditure required upfront, and long-dated market returns and payback, albeit it has the greatest ability to grow value in earnings over the long-term.

The global potash market has blossomed in 2021, Macquarie observes, amid rising demand, strong crop prices and supply-side risks in Belarus. Demand growth of 2.5% per annum is expected to outpace supply and the market swing to a deficit after 2026.

Macquarie's base view allows for Jansen to absorb the forecast market deficit for 2027-31. Beyond 2032 a deficit is expected to re-emerge, even with Jansen expanding to 16mtpa. This implies, in the broker's opinion, BHP could expand Jansen at a faster pace.

Development

For Stage 1, BHP envisages 12-14% returns, at a long-run realised potash price of US\$320/t. Goldman Sachs calculates stage 1 represents 3-4% of group operating earnings (EBITDA) by FY30 with petroleum and around 4-5% without petroleum, and 15% of capital expenditure at its peak with petroleum and 25% without petroleum.

The company advises that stages 2-4 are significantly de-risked because of the shaft capacity in place from stage 1, which is 93% complete. First production from stage 1 is expected in late 2026. Lower capital intensity in stage 2 is also anticipated because of redundancy in the system and infrastructure that is all that already available as part of stage 1.

The company has outlined a US\$5.7bn initial capital investment and has more than 50% of engineering and more than 45% of procurement orders in place. Capital expenditure is expected to peak in 2025/26 and around 85% of total expenditure is in Canadian dollars, currently unhedged.

BHP expects to be the lowest cost producer of potash in Canada with its differentiated mining method that allows for a continuous "one-pass" cut while competitors require two. This results in shorter mining times and efficiency.

Goldman Sachs flags Saskatchewan as one of the most complicated fiscal regimes in the world. BHP will pay royalties from year 1 but is not expected to pay state or federal tax until the mid 2030s. The broker does not rate BHP while Shaw and Partners, not one of the seven stockbrokers monitored daily on the FN Arena database, has a Buy rating with a \$56 target.

The database has one Buy and three Hold ratings (with three brokers restricted on ratings and targets at present). The consensus target is \$47.23, suggesting 15.1% upside to the last share price. The dividend yield on FY22 and FY23 forecasts is 9.7% and 6.9%, respectively.

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COMMODITIES

Gold Outlook Improves: Are Stocks Cheap?

Are gold equities cheap? Several brokers assess the Australian gold sector, while affected by cost pressures, offers value

- Cost pressures prevail for Australian gold stocks
- Yet the majors benefit as gold price forecasts are raised
- Several mid-small tier gold stocks hold value

By Eva Brocklehurst

Gold equities have underperformed the broader mining sector and several brokers are now reassessing the outlook. Morgans notes sentiment softened recently and moved away from defensive sectors such as gold.

Yet Shaw and Partners points to a gap that opened up between the US dollar gold price and US real rates after the US Federal Reserve's "taper tantrum" in mid-June, and believes the gold price should be trading closer to US\$2000/oz compared with US\$1800/oz.

As a result, gold appears cheap to the broker and, while acknowledging the long-term price will be influenced by money supply, asserts **gold equities are offering value and in absolute terms trading at or near cycle lows.**



In addition, the current price of gold signals to Macquarie there is considerable ongoing scepticism about the US Fed's ability to execute on its desired liquidity tapering and subsequently raise official rates.

The broker suspects the path for gold prices going forward will be heavily dependent on data such as US payrolls. Macquarie has upgraded its gold price outlook by 4-5% for 2021-22 and 3-6% for 2024-26 and now expects gold prices to average US\$1750/oz in the fourth quarter of 2021 and US\$1625/oz in 2022.

Australian gold stocks have also been affected by cost pressures and this is a key theme in brokers' analysis of

the FY21 results. Border closures in Western Australia and the strength of the iron ore sector have created labour shortages.

Morgans expects this cost pressure will likely continue until the end of the year. The main issue is the increasing shortage of technical staff, which in turn will affect long-term planning.

Citi notes the ASX gold index has underperformed the ASX300 metals index since early December 2020 despite the gold price outperforming iron ore substantially over the last month. The broker considers gold valuations on a broad base remain elevated, with the exception of **Newcrest Mining ((NCM))**.

Major Golds

While no two gold miners are alike, Morgans takes account of the scale of production, the jurisdiction and a number of operations into its valuations and concludes the larger miners provide a safer option as production is spread across several operations.

The broker also notes the majors - **Newcrest Mining, Northern Star Resources ((NST)) and Evolution Mining ((EVN))** - all have plans for large capital investments in coming years to support growth in production.

Newcrest stands out in terms of annual production and its reserve base, although Northern Star is edging closer to that stock's bellwether status. Still, Newcrest enjoys high margins and has a benefit of strong **copper** credits which provides some of the lowest production costs across the group.

On this point Macquarie notes a 10% move in copper price forecasts can shift earnings for Newcrest by 12-14% while sensitivity to copper for Evolution Mining is lower at 5-8%.

Macquarie's changes to gold price forecasts drive material upgrades to the outlook for the major gold miners. The broker continues to prefer Northern Star over the other two for ASX100 gold exposure.

The broker's improved pricing outlook has boosted the rating for Newcrest, upgraded to Outperform, and Evolution Mining, upgraded to Neutral. Evolution Mining has a stronger growth profile, with a five-year production growth rate of 10%.

Northern Star has been the most consistent, in Macquarie's view, delivering the strongest overall share price performance, largely attributed to the completion of the merger with Saracen Minerals.

Citi prefers stocks that offer volume growth, free cash flow generation and have positive upcoming catalysts. The broker considers Northern Star has potential for a re-rating as it delivers a turnaround at assets and is the second largest producer after Newcrest with production expected to ramp above 2m ounces in FY25.

FY22 production guidance from both Northern Star and Newcrest was ahead of Citi's expectations, while Evolution Mining's guidance was largely in line, although its capital expenditure plans to achieve growth production at Lake Cowal and Red Lake is higher than anticipated.

Mid-Small Caps

While smaller producers may offer more leverage to the gold price or upside from discoveries they are relatively high risk, and Morgans emphasises no metric generates a ranking that fully captures the valuations.

The broker classifies 500,000 ounces as the threshold that separates the majors - Newcrest, Northern Star, Evolution Mining - from the mid tier stocks and assesses **valuations are quite flat across the mid tier**.

Regis Resources ((RRL)) is just outside the major category, Morgans observes, and while investors weigh up the price paid for Tropicana and the permit risk at McPhillamys, the broker considers the stock is undervalued given its production profile.

Macquarie upgrades four mid-tier stocks on the back of stock weakness and the increases to its gold forecasts, including Regis Resources and **OceanaGold ((OGC))**, upgraded to Outperform, **St Barbara ((SBM))** upgraded to Neutral and **Dacian Gold ((DCN))** a double-upgrade from Underperform to Outperform.

Ramelius Resources ((RMS)) remains a top pick in the Morgans stable for those looking for near-term exposure to the gold price. The broker generally considers annual production below 100,000 ounces as a junior producer.

Another small stock, **Red 5 ((RED))** is building momentum as it develops the King of the Hills project in Western Australia, and the share price has begun to turn, with the next 6-12 months being critical.

Morgans notes gold stocks tend to experience a lift in share prices on first gold production at a project, yet flags Red 5 as a high-cost producer on an AISC (all-in sustainable cost) basis at the Darlot operation. At the other end **West African Resources ((WAF))** is the lowest cost producer.

Junior producers **Silver Lake Resources ((SLR))**, **Bellevue Gold ((BGL))** and **Aurelia Metals ((AMI))** are Macquarie's preferred Australian small-cap producer stocks while **Perseus Mining ((PRU))** is preferred from a West African standpoint.

Incorporating upgrades to the gold price forecast is positive across the board for the small cap sector, the broker adds. Macquarie singles out **Gold Road Resources ((GOR))** as having only modest leverage to the gold price while Bellevue Gold has no exposure until it commences commercial production in FY24.

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COMMODITIES

Lithium Market Losing Track Of Fundamentals?

Demand for lithium is being driven by the surging take-up of electric vehicles and supply is tight so prices in China have soared. Yet has the lithium market reached its zenith?

- Chinese lithium prices soar, triggering a supply response
- Yet have stocks overshot the fundamentals?
- Should investors take profits in lithium stocks now?

By Eva Brocklehurst

A tight market in lithium has caused a sharp rally in Chinese prices but has the market now lost track of the fundamentals? Credit Suisse suspects so. The broker anticipates further price support in the short term may stem from momentum trades and remains cautious around extrapolating too much from the current dynamics.

Demand for lithium is being driven by the take-up of electric vehicles, with total sales for the year to date almost the same as for the whole of 2020. Macquarie notes sales of pure electric passenger vehicles were up 149% in the year to July.

Europe has dominated sales overall with 63% market share while China has been the leader in 100% EV with a 53% market share. Macquarie expects total EV sales to hit 5.83m vehicles in 2021, representing 6.5% of global vehicle sales.



A rally in spodumene, with realised prices reaching US\$950/t, has triggered the same for lithium carbonate and Macquarie continues to expect the price will be supported in the short term as downstream processors source lithium carbonate to feed smelters in China.

A tight market in lithium may continue, as increasing battery demand has been met by limited supply, yet Morgan Stanley believes prices in China are way too high and this signals downside.

In China, lithium carbonate and hydroxide prices have risen to above US\$18,000/t and although other markets are on a positive trend the broker notes carbonate import prices in Japan and South Korea remain below US\$10,000/t and hydroxide between US\$11-12,000/t.

The broker believes supply is already responding to higher prices that should lead to a lithium surplus in 2022. This should drive prices down, probably in the second half of that year, when Morgan Stanley forecasts carbonate prices to reach US\$8000/t.

The broker also believes new policies under discussion by left-wing parties in Chile will also affect perception of the risk profile of lithium production in that country and the continuity of the SQM operations in Atacama.

Spodumene prices will go higher given the tightness in supply and the potential margin that can be captured and Credit Suisse has outlined a “blue sky” lithium price scenario that envisages lithium carbonate reaching US\$21,000/t and spodumene reaching US\$1700/t in the short term, yet this then could impede battery competitiveness and temper enthusiasm for any upside.

The broker's base case price calculations imply margins close to 40% for Chinese factories that are processing lithium carbonate and hydroxide from spodumene. This appears implausibly high for a conversion process, and is not sustainable as the industry has no barriers to entry, while such margins will attract competitors.

Moreover, lithium miners are building hydroxide plants in Australia and there are more Chinese factories under construction. Credit Suisse believes **the conversion industry will subsequently lose its pricing power and surrender its margins to miners upstream**, where the real tightness lies, and slightly softer carbonate and hydroxide prices will advantage cathode/battery makers downstream.

The broker has a preference to buy sectors where all news flow appears negative and the stocks are trading at discounts to valuation, taking profits in sectors where all momentum is positive, suspecting the latter situation may now have approached for lithium.

Lithium Producers

Are equity valuations disconnected from the industry? Even assuming its blue sky projections, Credit Suisse struggles to justify much upside to equity valuations on a discounted cash flow (DCF) basis.

There may be price support on a multiples basis, should spot prices continue to rise and if contract pricing follows suit, but the broker believes DCF fundamentals should still matter and if there is no DCF upside from this blue sky scenario then investors should be wary.

Credit Suisse anticipates the next big move up in value for **Pilbara Minerals ((PLS))** and **Orocobre ((ORE))** could be to use their expensive scrip to enlarge their footprint via scale and/or geographical expansion, or even into potential future battery supply chain disruptors.

Still, making sure that existing strategies are not disrupted in the process would be key for Pilbara Minerals, in particular, to retain market trust. The broker has recently downgraded both Pilbara Minerals and Orocobre to Underperform on valuation grounds.

Even the best managed businesses have a price limit and Credit Suisse believes this these two have exceeded that. A correction should ensue but the timing and catalysts are hard to identify.

Credit Suisse retains a preference for Pilbara Minerals over Orocobre given its track record and above-ground risk profile while, in contrast, Ord Minnett flags Orocobre as its top lithium stock.

Macquarie's preference is for Australian-based producers of lithium with Pilbara Minerals as the top pick as it offers strong production growth. **Mineral Resources ((MIN))** is also a preferred stock with exposure to the broader resources sector while Orocobre offers unique exposure to both lithium brine in South America and spodumene production in Australia.

Macquarie emphasises the **Liontown Resources' ((LTR))** Kathleen Valley is one of the largest development projects with offtake available to third parties.

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COMMODITIES

Is Aluminium Pivoting Towards A Structural Bull Market?

While demand for aluminium is on a tear due to disruption and power-related restrictions, there's growing concern that a breakdown in the supply of bauxite from Guinea could lead to a deficit

-Jury's out on whether bauxite supply can sustain Guinea's military coup

-ANZ sees the global aluminum market recording a major deficit in 2021

-Citi's base-case is for cash aluminum price to repeat all-time highs of mid-2008

By Mark Story

A string of Chinese supply challenges together with a constrained physical market beyond China, plus rising energy prices, have culminated in the London Metals Exchange (LME) cash aluminum prices hitting ten-year highs of US\$2,777/t on September 9th, after rallying 40% from the start of 2021.

While the strong price rally over the past year, broadly in line with the global cyclical upswing, would typically unwind owing to a supply response, Citi believes the constraint in aluminum supply is sufficient to sustain higher prices for years to come.

ANZ Research estimates that over 1m tonnes of aluminium smelting capacity were curtailed in second quarter FY21 due to China's aluminum smelters being hampered by power restrictions. However, ANZ notes the bigger impact on output is yet to come, with plans for new capacity in Yunnan now expected to come online more slowly than originally forecast.

Beyond China, other supply issues include structural damage to one of Alcoa's ship unloaders at its Alumar refinery in Brazil which is forcing a reduction in alumina output to about 7,000 t/day. Then there's Jamalco, an alumina plant located in Jamaica operated by Noble Group, which sustained damage in a major fire on 23 August.



Guinea Uncertainty

Political unrest in Guinea has also significantly heightened the risk of disruption to the output of bauxite, the key feedstock in the production of aluminium. However, Citi has not identified any firm impact on Guinea's bauxite exports, given that the leader of the military coup has urged miners to operate as usual and suggested he will honour existing mining agreements and re-open ports.

However, ANZ Research notes that while Guinea's pipeline of bauxite-related projects is solid - with the potential to expand output by at least 50% over the next three to five years - the risk of disruption to future supply is thought to be high. ANZ reminds investors that Guinea supplies China - the world's largest aluminium producer -- with nearly half of its bauxite imports.

ANZ notes since buying 2% of Guinea's exports in 2015, China consumed around 15% in 2020, and suspects that could rise to 60% by 2040. But while Guinea was expected to overtake Australia as the world's largest bauxite supplier by 2022, ANZ believes the coup raises serious doubts over how many of the planned projects will come to fruition.

With India's aluminium industries also suffering from a surge in power demand, ANZ sees the global aluminium market recording a deficit in 2021 of around 750kt.

Meanwhile, Citi has revised down global aluminium demand growth to better reflect the recent slowing down in Chinese economic growth and global supply chain challenges. However, the broker believes bullish supply impacts outweigh the bearish demand factors.

As a result, Citi has updated supply/demand balance estimates to reflect a significantly larger global deficit in 2021 than the broker had previously projected.

Due largely to a series of Chinese supply losses, Citi envisages 2021's global deficit reaching 1.1mt and foresees China's refined aluminium output rising 3.8% year-on-year in 2021, lower than the earlier projected 6.6% year-on-year increase.

Citi expects supply issues to persist, resulting in 2022/23 projected global deficits bigger than previously projected.

As a result, Citi's revises up aluminum price forecasts to an average of US\$2,475/t in 2021 and US\$3,010/t in 2022 and expects spot aluminium prices to nudge US\$2,900/t in 0-3 month and US\$3,100/t in 6-12 months.

Citi's base case, to which the broker attributes 60% indicative probability, is for the LME cash aluminium price to repeat its all-time highs of US\$3,271/t reached in mid-2008 and for real "all-in" aluminium prices to hit cyclical highs of US\$3,464/t by 2023.

Citi also expects existing and anticipated supply disruptions - plus rising bauxite and caustic soda prices -- to help keep alumina prices, (Australia FOB) which have surged US\$20/t since late August to US\$322/t, at elevated levels during the remainder of 2021. The broker has revised up alumina price forecasts to an average of US\$310/t for third quarter 2021 and US\$340/t for fourth quarter 2021.

After simmering away for the past few weeks, Shaw and Partners notes that alumina prices rose 15% on 9 September, which the broker notes, adds to the price inflection off \$300/t on 1 September.

The price lever aside, Shaw notes that over the past six months the alumina price has been tracking the China import parity price higher, and expects freight charges to at some stage see the alumina price (ex-Australia) up \$20-25/t. The broker also expects the near-term inflection to be the latest supply curtailment challenge.

While Shaw is not advocating a price spike similar to that experienced in 2018-19 - following a partial closure at the world's largest alumina refinery - the broker will be watching the price response closely.

Meanwhile, Shaw has a Buy or both Alumina Ltd ((AWC)), target price \$2.20, and South32 Ltd ((S32)), target price \$3.60, with the broker adding that the latter gets even more sizzle with met coal at an all-time high.

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COMMODITIES

Material Matters: Base Metals, Zircon, Iron Ore

A glance through the latest expert views and predictions about commodities: base metals; coal; iron ore; zircon; oil & gas

- High demand, subdued supply underpinning momentum in base metals
- Coking coal prices surge in China, reduced traffic on Chinese/Mongolian border
- Pick-up in infrastructure activity in December quarter may arrest iron ore price decline
- Tight supply of zircon sends prices sharply higher
- Substantial incentive for shale gas suppliers to ramp up production

By Eva Brocklehurst

Base Metals

Momentum keeps on keeping on in the electric vehicle market, benefiting **nickel**. Macquarie notes, while non-nickel/cobalt batteries are gaining share in China, they are still only a quarter of the global market. Orders for batteries with higher nickel content are still strong, boosting nickel usage.

Meanwhile, lower **zinc** production and higher **copper** output in Peru was recorded in July, and in Chile copper production was down -3%, primarily because of lower output from Chuquicamata.

Macquarie prefers **OZ Minerals ((OZL))**, **29 Metals ((29M))** and **Sandfire Resources ((SFR))** for copper with **Chalice Mining ((CHN))** the preferred stock in exploration. 29 Metals has a strong production trajectory and provides unique exposure to zinc within the broker's coverage. **Sunrise Energy Metals ((SRL))** offers exposure to Macquarie's long-term bull case for **cobalt**.

The coup in Guinea has put China's **aluminium** raw material supplies at risk, Longview Economics notes, with aluminium prices breaching another multi-year high. Guinea supplies over 50% of Chinese **bauxite** requirements.

The analysts also note the **microchip** shortage shows little sign of easing and the order backlog from Renesas, the Japanese supplier where the plant was set on fire in March, is now four times greater than it was before the pandemic.



Coking (metallurgical) coal prices have reached new highs in China's domestic market, equivalent to US\$497/t, while Macquarie notes Australia's F.O.B. index has reported prices at A\$279/t. This indicates an arbitrage opportunity, in the broker's view, or at the very least provides support for Australian coal miners.

Macquarie cites a Reuters report that China's NDRC has recently banned a coal trading firm from publishing price assessments in an effort to manage hefty pricing.

The broker notes, too, the the Chinese/Mongolian border has been closed again after one week of operation. Macquarie's commodities team estimates daily crossings could be constrained at 180-200 trucks per day after the reopening, which compares with 800-1000 pre-pandemic.

Iron Ore

After a strong first half, Chinese **steel** production has slowed significantly through July and August. JPMorgan suspects the drop is related to general economic weakness that has been influenced by tightening controls on pollution and relatively low steel mill profitability.

Weakness through the September quarter leads the broker to reduce 2021 steel production growth estimates to 4.0% from 6.5% and demand growth to 0.8% from 2.8%.

After hovering around US\$220/t in June and July JPMorgan notes **iron ore** has corrected to US\$120/t. This is on the back of a significant change in sentiment combined with lower Chinese steel output and has led to a cut in its forecasts for 2021 and 2022 to US\$165/t and US\$125/t, respectively.

As a result, JPMorgan lowers earnings estimates by -10-35% for **BHP Group** ((BHP)), **Rio Tinto** ((RIO)), **Fortescue Metals** ((FMG)) and **Mineral Resources** ((MIN)), downgrading the latter to Neutral on wider iron grade spreads and lower free cash flow.

The broker assesses the other three are generating impressive cash flow at current prices, supporting capital management potential. JPMorgan acknowledges, on the upside, China could address weak GDP growth through increased infrastructure expenditure, which may provide a positive fillip for iron ore prices.

Exports from Australia are down -4% over the year to August while Brazil's exports are up 3%, highlighting a lack of growth in supply from the major miners despite the strong price.

JPMorgan also points out Vale has maintained 2021 guidance although lowered 2022 capacity targets to 370mt from 400mt. Negative sentiment is likely to continue over the short term while a pick-up in the fourth quarter in infrastructure activity may help arrest the decline in prices.

Longview Economics believes the bull run in iron ore has come to an end with several developments in China weighing on prices. This includes weakening Chinese construction activity, tighter housing regulations and measures to reduce air pollution ahead of the 2022 Beijing Winter Olympics.

On the supply side, Longview assesses production from the main four iron ore miners is starting to accelerate, noting Fortescue and BHP reached record highs in production earlier in the year and Rio Tinto has highlighted the potential for a re-acceleration in production later in 2021.

Zircon

Morgan Stanley observes a sharp increase in high-grade **zircon** prices, driven by the news of a shutdown at Rio Tinto's Richards Bay Minerals operations during the June quarter. Operations have restarted in August but as there are few sources of additional zircon supply the market is expected to remain tight for the next three months.

China's high-grade zircon price is currently US\$2570/t and Morgan Stanley calculates the price could rise a further US\$230-385/t as a result of tight supply. Demand for **Iluka Resources** ((ILU)) product is strong and the broker notes China's ceramic factories have reduced levels of inventory, with the number holding inventory for more than two months decreasing by -30%.

Intermediaries are also sustaining low inventory and most have reported a shortage of raw materials. China's domestic supply is unchanged and there is no new policy anticipated that will impact production.

China's main sources of high-grade **mineral sand** remains Australia, South Africa and Indonesia with low grades sourced from Australia, South Africa, Mozambique and Sierra Leone.

Oil & Gas

Hurricane Ida has disrupted the **oil & gas** market, with over 80% of production in the Gulf of Mexico shutting down for a week. Prices have subsequently diverged with oil returning to August levels and natural gas prices

rising 18%.

The issue is whether this is a natural break in the correlation of the two or a temporary event. Going forward, factors that Longview Economics considers will be key to the outlook included the prospect of a heavily oversupplied oil market by 2022 amid a significant increase in OPEC et al supply over coming months.

On the other side, natural gas prices are observed to be technically overbought and Longview flags the futures curve as the most backwardated - pricing in tightness - since 2008.

Over the medium term, the analysts suspect a supply response will be forthcoming given the high price of gas, noting rig counts are low compared to 2018 highs and the incentive for shale gas producers to increase production is substantial.

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COMMODITIES

Material Matters: Coal, Iron Ore And Oil

A glance through the latest expert views and predictions about commodities: coal; iron ore; and oil

- Tight seaborne coal market underpinning robust prices
- Volatile iron ore prices, yet miner cash flow remains solid
- Will OPEC move to balance the market in 2022?

By Eva Brocklehurst

Coal

The seaborne **coal** market has tightened significantly. Demand is surging as global power consumption recovers along with steel production. Supply challenges in South Africa, China and Mongolia as well as Australia relating to the pandemic have aided tightness.

Hence, Goldman Sachs upgrades benchmark price forecasts for both thermal and metallurgical (coking) coal. Benchmark thermal coal is expected to hit US\$190/t in the December quarter and average US\$137/t in 2022 while metallurgical is expected to average US\$230/t in the December quarter and US\$175/t in 2022.

Specifically, thermal coal exports from key producers were up 8% on average in May and June, largely because of a rebound in exports from Indonesia, yet as Goldman Sachs points out, Australian exports set the benchmark and exports from Australia, South Africa and Colombia were down. Meanwhile, on the import side, volumes were up 16% in June amid demand from South Korea, Japan and China.



For metallurgical coal the rally in prices have been driven by a decline in China's domestic production along with lower exports from Mongolia, Australia and the US. Demand has strengthened in Japan, Taiwan, India and South Korea. Goldman Sachs expects metallurgical coal prices will ease back in the December quarter as China makes cuts to its steel production and supply recovers in Australia.

The broker retains a Buy rating for **Whitehaven Coal ((WHC))** and pure metallurgical coal operator, **Coronado Resources ((CRN))**, as well as diversified miner **South32 ((S32))**. **New Hope Corp ((NHC))** is downgraded to Neutral on valuation.

Iron Ore

Following maintenance during July and August at Port Hedland, Australian weekly shipments of **iron ore** have increased. Volumes for **BHP Group ((BHP))** increased 15% while **Rio Tinto ((RIO))** rose 8.4%. Macquarie notes this offset sequentially by lower volumes from **Fortescue Metals ((FMG))**.

The combined shipping rate for the three in September to date has rebounded above the 800mtpa level. On the other side of the Pacific, Macquarie notes shipments from Vale have trended lower because of low throughput at one of its mines along with port maintenance work.

The broker notes the iron ore price has been volatile, having recently breached the US\$130/t low point registered in mid August. Yet the miners are still enjoying bumper cash flow and at spot prices free cash flow yields for the majors remain in double digits.

Meanwhile, **steel** prices have increased as the market contemplates additional production cuts in China and Macquarie assesses the current strength in seasonal demand is likely to continue into October.

The broker is positive on those stocks with iron ore exposure because of the cash flow and the potential for upgrades. Rio Tinto is the preferred large exposure while the broker is also positive on both Fortescue and BHP.

Mid-cap picks include **Mineral Resources ((MIN))** and **Champion Iron ((CIA))** as both offer leverage to the price

of and expenditure cycle in iron ore. **Deterra Royalties ((DRR))** also offers exposure to iron ore via its royalty derived from BHP's production at Mining Area C.

Oil

While most market participants are anticipating oil market balances will weaken in 2022 as new volume from OPEC and US shale enters the market, Morgan Stanley suspects OPEC will move to slow production.

The broker acknowledges valid reasons exist for a deterioration in market sentiment as consensus GDP forecasts have been pushed lower and all the main agencies have lowered their forecasts for 2022 oil demand. Importantly, a large volume of supply is expected to enter the market.

[This week OPEC significantly raised its 2022 oil demand forecast to above pre-pandemic levels - Ed]

Yet, the calls for Brent to fall back to US\$55-60/bbl are considered overly pessimistic and Morgan Stanley suspects OPEC will not increase production by 400,000 b/d through 2022.

The broker explains that previously, OPEC often had to trade off the oil price against the long-term prospects for market share but the fundamentals have now changed. The reason why OPEC did not cut production in late 2014 was because shale production was growing strongly at the time and if OPEC had cut its supply, growth in US supply would have continued unchecked.

Hence, if long-term prospects for market share are still strong, balancing the market is the optimal choice. Morgan Stanley suspects the cartel will be quite willing to balance the market in 2022, which should support Brent prices in the mid-US\$70/bbl range.

Why? Inventory drawdown is signalling a tighter market than previously estimated. It appears that all excess inventory build in 2020 has been eroded. An aggregated view of global inventory suggests that in some areas, observable stocks are now below 2019 levels.

What is even more significant is the draw-down has been regular, with Morgan Stanley noting global stocks are effectively being drawn down at a "remarkably" stable rate of around 1.74m b/d.

As supply data tends to be more accurate, the broker believes this implies upside to estimates of demand. Moreover, refinery outages have largely dissipated while an improvement in mobility statistics is a supportive trend for oil consumption.

The broker expects US shale production will still grow in 2022, at around 600,000 b/d, but will not stage a recovery like that seen in 2016-18. Rystad data in the US shows that in the last three months both the number of active fracking spreads and the commencement of new fracking jobs have actually declined.

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ESG Focus: Linked finance the next big thing - Part 2

Borrowers and investors will confront a range of penalty mechanisms - both in type and size - as sustainability-linked finance floods the market

- Take your pick of type and size of penalties
- More stick than carrot
- Investors and the two-step shuffle

By Sarah Mills

Sustainability-linked finance (SLF) is forecast to rise at a compound annual average growth rate of 98.32% to US\$17trn within five years, according to Knowledge Sourcing Intelligence, and this article on SLF penalties is the second in a series on the subject.

Investors and borrowers can take their pick of a variety of penalties, ranging from step-up coupons to charitable donations.

Not all penalties are created equal and some present more risk to investors than others.

A quick recap on SLF

Sustainability-linked finance has been developed to support the green transition and broader social and environmental objectives.

To date, the bulk of ESG finance has comprised use-of-proceeds (UOP) loans such as green and social bonds.

Because UOPs funds were earmarked for specific projects, they lacked flexibility and played to a select few - mainly the energy and materials industries.

They were unsuitable for the vast majority of borrowers that might want to build sustainability into their operations in a more general way.

SLF is best understood as an incentivisation structure: a “pay for success”, “penalise for failure” vehicle that provides funds that can be used for a broad range of social and environmental projects alongside traditional, operational purposes.

SLF borrowers can access these general purpose funds, so long as they meet a set of pre-agreed sustainability key performance indicators (KPIs) and (SPTs).

So for example, a green mortgage is just like a traditional mortgage but a condition of the loan might be that insulation and solar panels be installed, or that the design has a certain carbon quotient, or that water tanks be installed.

If borrowers fail to meet the KPIs and SPTs, penalties apply.

There are two main aspects to penalties: type and magnitude.

Types include step-up and step-down penalties, charges, or obligations to purchase carbon offsets or make charitable donations - and more may develop.



Step-up coupons

The most common penalty type is a one-time coupon/rate step-up applicable to all remaining interest payments on the loan after the first time a borrower misses a target, introducing a time component within the charge.

So it is important that KPI and SPT assessment is conducted at least annually, otherwise the issuer could announce a failure towards the end of loan with no penalty.

At the moment, penalty step-ups tend to range between 10bp and 75bp.

Step-down coupons have also been proposed for outperformance, but the debate to date suggests this is unlikely.

Step-ups and step down coupons mean that sustainability-linked bonds more closely resemble a loan than a bond in that they essentially carry a floating interest rate.

The concept more naturally relates to traditional variable rate loan markets.

Global Capital notes that this structure offers a strong incentive to borrowers to meet targets, but doesn't incentivise ambitious goal-setting.

Global Capital doubts a step down would be effective in incentivising outperformance given SLBs are, at the moment, already comfortably priced - ditto for sustainability-linked loans.

Some observers believe this could change as the market and pricing matures, to the point that step-downs could represent stretch targets.

The straight-out charge

The next most common penalty type is the “fine” or penalty charge for missed targets.

On the penalty front, this could vary from a fee at the six-monthly/annual assessment of a loan to a one-time payment.

The most common form of penalty for missing SLB targets is the payment of a penalty at maturity.

For example, if an issuer misses a target it must repay more than it borrowed; for example, 100.5% of the principle.

However, there is nothing at this stage stopping a lender from setting a range of fees and penalties over the period of the loan.

Purchase of carbon offsets

Borrowers can choose to mitigate misses by purchasing carbon offsets but this is generally viewed unfavourably for a number of reasons.

For example, it may provide a transitioning “out” for some companies.

Also, carbon offsets could be set, or purchased in advance, and underestimate the necessary amount to make up for the failed SPT.

The Climate Bonds Initiative (CBI) does not consider carbon-offset purchases favourably and this is likely to set the tone for investors and issuers when structuring SLBS.

Charitable donations

Some issuers are already writing charitable donations into their contracts, possibly taking advantage of the demand-supply imbalance in the market.

But charitable donations are also viewed unfavourably by the powers that be because they are not considered material penalties, particularly given the less than altruistic nature of some charities.

It also can be used as a greenwashing tool for the issuer, distracting attention from the more material miss.

And let's not forget the tax advantages to be gained (an increase in interest expense also creates a tax shield).

An example of what not to do

Morgan Stanley's report Sustainability-Linked Bonds: Materiality is the Missing Link refers to the recent ANA Holdings' (a Japanese transportation services company) SLB issuance as an example of what not to do.

It is also an interesting example of what can be done.

ANA Holdings' SPTs pertain to the environment, human rights, diversity and inclusion, and regional revitalisation.

Its KPIs included:

- listing on the DJSI World and Asia Pacific indices;
- listing on FTSE4Good Index;
- the MSCI Jan ESG Select Leaders Index; and
- a company rating of A- or above on the CDP (a company that administers carbon disclosure ratings).

Morgan Stanley argues that investors aren't protected against failure in this structure and this type of issuance could prove costly.

Firstly, it had no SLB framework, meaning less transparency, and less comparability with the materiality of its sustainability choices to its core business strategy.

“ANA's KPIs and SPTs are largely binary and three of the four targets do not appear to be material to the credit in the short or long term,” says Morgan Stanley.

The investment bank prefers internal metrics (particularly those historically reported on) because softer metrics make performance more difficult to quantify.

Also ANA's penalty for missing the SPT is to donate to charity, which Morgan Stanley decries as irregular, unfavourable to investors, and unlikely to prove a material incentive to the borrower to improve its sustainability.

Similarly, there is poor transparency on the amount donated, so the company may face no consequences for missing targets.

Magnitude of penalty - it must be material

The other key aspect of SLF penalties is that of magnitude.

The magnitude of the penalty is also an important consideration when structuring SLF contracts.

At the moment, 25 basis points is a common number.

But the materiality of such penalties varies according to the underlying coupon.

For example, a 25 basis point penalty on a 1% coupon is more significant than on a 2% loan.

Borrowers with solid sustainability and credit ratings are likely to attract lower relative penalties than underperformers.

Over time, Morgan Stanley expects the pricing on this should tighten according to credit rating and

sustainability performance.

Until then, Morgan Stanley offers the following three main considerations to help investors navigate concerns about quality of ESG KPIs and incentives to achieve those targets:

- *“Do KPIs reflect a material issue to the credit within the tenor and call structure of the bond?;*
- *“Is the magnitude of the financial penalty for missing a KPI material within the context of the number of coupon payments post-assessment, size of penalty as a proportion of initial coupon, and sensitivity of the issuer to interest expense?;*
- *“Does the issuer have a track record of corporate reporting and transparency with respect to financials and ESG? ”*

Investors are also advised to develop a triple scorecard for environment, social and governance performance of a company or organisation.

Another scorecard monitoring water useage, carbon intensity and circularity would make sense.

And as always, be sensitive to greenwashing.

Step down argument

“*You wouldn’t praise a fish for swimming*”, is one quote being widely bandied around in relation to the concept of step-down coupons.

Step-down coupons are one of the more hotly contested topics in the SLF markets.

They refer to a situation in which a borrower is rewarded for sustainability out-performance by a reduction in the coupon on loan rate.

Step-down supporters say that for issuers, the SLF format offers the prospect of punishment without reward, which could dampen appetite and hold the market back.

They argue that step-down coupons provide an incentive to go above and beyond the KPIs and SPTs outlined in the loan contract.

Supporters also note that without the risk of a step-down, investors might buy weak performers hoping for step-ups, undeservedly lowering cost of capital.

They say that the prospect of step downs should manage that propensity.

Detractors argue that issuers should not be rewarded for doing what they should be doing anyway - hence the fish analogy - and that borrowers are already benefiting from “greeniums” given demand far outstrips supply.

Supporters counter the greenium argument, pointing out the greenium is just a couple of basis points, nothing near the 25bp penalty.

Detractors note that overachieving on the sustainability front would yield cost savings, attracting equity and fixed-income investors, thereby lowering the cost of capital (or raising it on the flipside), or at least prevent it from rising more than that of peers.

This combined with a reputational sheen should provide sufficient incentive to improve environmental credentials.

Detractors argue that step-up coupons without a counterbalancing step-down would not lead investors to favour poor performers, as they would be cutting off their nose to spite their face.

They note that bondholders in particular are more likely to sell out of SLBs that consistently miss targets, rather than hold out for an additional coupon, particularly given missed targets can reflect on broader operational, financial and reputational problems and possible ratings issues.

“It is difficult to make the case that the coupon step-up resulting from not being able to deliver on your ESG commitment is separate from your credit standing as an issuer,” notes Rahul Ghosh of Moody’s ESG Solutions says in Global Capital.

Ghosh notes that trust guidelines may also preclude them from holding consistently underperforming assets, resulting in bond sales at a loss, and the investment fund’s reputation could also take a hit.

“Over time, a failure to hit targets could constrain an issuer’s ability to raise additional ESG financing and have material financial implications above and beyond the 25bp,” says Gosh.

“As that differentiation becomes more apparent in the market, you’ll start to see more variability ex-ante in some of the pricing of the structures.”

Social impact bonds

Meanwhile, the most likely application of a coupon step-down will be in the social impact bond (a form of SLB) market, given investors will be seeking to encourage companies to lean into impact.

Observers point to the development of supercharged impact indices that allow the inclusion of step-down bonds.

Investors will need to learn the two-step shuffle

Life was simple once upon a time - at least simpler.

Accounting for step-ups and step-downs, penalty types and magnitudes is enough to send investors’ head spinning.

It’s a whole new dance - step up, step down, turn around, don’t fall down.

Those with deep pockets are likely to manage these gymnastics with greater ease than the minnows, leaving the latter very much in the position of using sustainability reputations as a guide, turning their focus to greenwashing.

The SLF design was intended to help counter greenwashing, which we discuss in a later article.

Frictions in smaller private markets are also expected to favour subject matter experts with a deeper knowledge of the risk and potential surrounding investments.

Over time, credit ratings agencies and sustainability ratings agencies are likely to create a numerical value, which will be attached to corporations and other borrowers to ease the process.

This could extend to specific categories like water, carbon, diversity, safety, given the materiality of KPIs differ from industry to industry and company to company.

In our next article, we turn our attention to the sustainability-linked bond market.

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Big End Of Town Eyes SLBs

Major corporations are using sustainability-linked bonds to fill their coffers to fund their green transitions, which is set to kick off in earnest in 2022.

- A servant to many masters
- Issuers frameworks paramount to investors
- Materiality and pricing

Sustainability-linked bonds (SLBs) are one of the more innovative products to hit ESG markets and are aimed at the big end of town.

SLBs are an odd bird in the fixed-income world in that they can carry a floating rate, via a step coupon, rather than the traditional fixed rate.

One of the main reasons for this state of affairs is that SLBs were developed, in part, to incentivise the transition with penalties.

This means SLBs fall under both the transition finance (TF) and sustainability-linked finance (SLF) umbrellas.

Given the likely scale and impact of SLBs in transition finance, we will address that aspect in a separate article.

We will also examine social impact bonds and development impact bonds (often both SLBs) in a separate article on impact investing.

This article is divided into two halves and examines the broader applications and challenges of SLBs.

The first half examines the lay of the land, dealing with issues of materiality and covers some of the ground mentioned in our introductory article on sustainability-linked finance (see link below).

The second half examines the pros, cons and pitfalls of the market; its challenges and future; and early Australian issuance.



The new kid on the block

Sustainability-linked bonds (SLBs) only recently hit the market but issuance is expected to rocket as borrowers avail themselves of the cheap covid-19 funds flooding the world, filling their coffers to fund the green transition which starts in earnest in 2022.

Morgan Stanley's report *Sustainability-Linked Bonds: Materiality Is The Missing Link* estimates the total SLBs issued since the market's inception in 2019 to be US\$57.7bn as of June 30, 2021, with 2021 issuance making up for than 75% of the total.

SLB turnover rose roughly 185% in the month of June alone and Morgan Stanley expects another \$30bn will be issued by year-end, and another US\$200bn within a few years.

This compares with the vanilla bond market's US\$3.8trn a year pre-covid (now at US\$2.8trn - a figure that could continue to face erosion as ESG markets gain traction).

The first SLB was issued by Italy's ENEL (one of the world's largest energy companies) in 2019.

While SLBs are targeted squarely at the big end of town, smaller players that struggle in vanilla markets are likely to benefit from excess demand in the market's early phases.

The SLB market is well diversified sectorally and is dominated by financials, utilities and REITS, all of which account for one third of total issuance; after SSAs (sovereign, supranationals and agencies), which represent more than half of issuance.

About 55% of SLBs issued to date are from private companies. When traced to the ultimate parent, that figure tops out at 15%.

The European Central Bank (ECB) announced it would buy SLBs at the start of 2021, which should further fire demand.

A servant to many masters

SLBs were designed to compensate for shortcomings in the green, social and sustainable (GSS) use-of-proceeds (UoP) markets in supplying transition finance and broader sustainability funding.

GSS activity was largely confined to green infrastructure projects, given green assets are easier to ring-fence than social and sustainability assets.

This in turn meant issuance in social and sustainability UoP markets suffered liquidity constraints.

SLBs have a broader application than UoP bonds and can be used for any general corporate purpose, any sector, and can be directed to either social or green endeavours.

SLBs permit this unrestricted use-of-proceeds for general purposes on the proviso a good percentage of funds are allocated to pre-specified sustainability initiatives that align with the United Nations Sustainable Development Goals (SDGs).

SLB projects can include: transitioning (reducing the carbon intensity of emissions and the broader business); water management (mainly reducing water withdrawal intensity); diversity; circularity; health; housing; infrastructure; industrial waste reduction; plastic-waste reduction; petroleum derivatives reduction; education; diversity; board diversity; and inclusion (ethnic diversity as a percentage of the workforce) - just to name a few.

SLBs carry penalties for failure to meet agreed sustainability measures such as step-down and step-up coupons - a typical carrot-and-stick incentive (see our previous article on sustainability-linked penalties in the link below).

The penalties are designed to encourage borrowers to meet targets and, in part, to compensate investors for lower transparency, as qualifying projects are not easily ring-fenceable.

The system is also designed to attract more borrowers and boost liquidity in ESG markets, to enrol the rest of the world in the sustainability drive.

SLBs also help entities embed their public sustainability commitments into their debt capital strategies.

Once the market matures, SLBs are forecast to offer greater flexibility, comparability/fungibility and accountability compared to UoP ESG bonds.

SLBs are particularly useful for transition financing given they incorporate measurable, forward-looking key performance indicators (KPIs) and sustainable performance targets (SPTs) into the structural and/or financial aspects of the bonds based on a standardized benchmark of carbon intensity.

Regulation and frameworks

The International Capital Markets Association (ICMA) published the sustainability-linked bond principles in June 2020, sparking a flurry of issuance.

These voluntary guidelines highlight five core components:

- selection of KPIs;
- calibration of sustainability performance targets (SPTs);
- bond characteristics;
- reporting; and
- verification.

The selected KPIs should be highly relevant to the issuer's core business strategy and core sustainability challenges. They must be measurable, externally verifiable and benchmarkable.

They need to be under management's influence, consistently quantifiable, and able to be verified by an independent third party.

Investors are likely to favour borrowers with frameworks that align to ICMA's principles, forcing the system into self-regulation.

Borrowers are expected to provide:

- up-to-date information on KPI and SPT performance based on meaningful baselines;
- inclusion of a verification assurance report relative to the SPTs (the report should outline the borrower's performance against the SPT and the impact and timing of SPT on the bond's financial and/or structural characteristics); and
- any information enabling investors to monitor the level of ambition of the SPTs, such as a sustainability strategy, KPIs, and ESG governance.

At this stage, bond contracts tend to select metrics included in annual sustainability reports so investors can gauge progress.

Alternatively companies can provide relevant historical data for the past three years.

General characteristics of SLB issuance

Morgan Stanley estimates total SLBs issued since the market's inception in 2019 to be US\$57.7bn

European Union-domiciled issuers dominate the market given Europe is the ahead of the curve and is the current centre for ESG issuance.

Euros and US dollars are the currencies of choice for SLB issuers. Chinese yuan rolls in at a distant third.

No one sector dominates issuance of the SLB markets (unlike UoP markets), which may appeal to those seeking to diversify through sectors.

For example, SLBs offer investors exposure to more carbon-intensive sectors such as Materials, Energy and Industrials as they decarbonise.

As an example of non-energy sector issuance, fashion retailer H&M's launched a E500m 8.5 year SLB in February 2021.

The SLB terms require the company increases its share of recycled materials as inputs to 30% from 0.5%; reduce Scope 1 and Scope 2 emissions by 20%; and reduce selected Scope 3 emissions by 10% against a 2017 baseline by 2025.

Issuers' frameworks paramount to investors

The quality of an issuer's sustainability frameworks will likely determine their ability to curry investor favour.

A corporation's frameworks should comply with both the ICMA principles, and the United Nation's SDGs.

The framework should also drive the three legs of ESG and include environmental, social and governance KPIs that are relevant to the core business; are measured from a baseline to avoid overstatement or double counting; and reflect the company's geography and specific sustainability challenges.

For example, Morgan Stanley criticises a recent Enbridge Gas SLB, noting the company should have included a Native American on the board given the nature and geography of the business. General board diversity would be considered a less impactful KPI for Enbridge's situation.

The inclusion of second-party opinion in frameworks is considered another key signal of quality, depending on the opinion provider, and, is likely to become best practice and ubiquitous.

Regular external verification of SPTs and KPI is a must and auditors or environmental consultants are expected to verify performance against these at least annually.

These expenses are expected to be paid by the issuer.

Moody's ESG Solutions says investors should examine an issuer's interim goals, historical KPI performance, science-based measurement criteria, level of transparency and ambition on scope and coverage; and ensure a limited reliance on carbon offsets.

"Robust commitments in these areas can strengthen the credibility of targets," reports Moody's.

To date most KPIs have been environmental; followed by multi-purpose KPIs. Social KPIs comprise a fraction of the total.

Structuring the bond and framework

Delving deeper into the ICMA principles, the association says an issuer's framework should include:

Bond characteristics: financial/structural impact involving trigger events such as a coupon step-up between 10-75 basis points; or a premium/penalty payment. More innovative penalty clauses may develop.

Reporting: Issuers publish, at least annually, progress against the KPIs; verification assurance on performance impact; and information that enables investors to monitor SPT ambition.

Verification: Issuers need independent and external verification of their performance against each SPT for each KPI.

Calibration of SPTs: Issuers should provide regular disclosure on progress, just like any other significant information.

The framework should be ambitious and strategically aligned.

Keep an eye to credit ratings, and a few extra guidelines

Investors seeking the best performers and to avoid greenwashers should look for the following qualities in an SLB.

A pre-defined timeline should be set before issuance and the timeline must match the bond's tenor and call structure.

For example, it is not ideal if the SLB is callable before the first measurement date.

Investors should also check whether the issuer is subject to regulations that may make the SPT redundant as well as geopolitical risk and geographical alignment.

Strong geographical alignment enhances the chances of an SLB's outperformance.

Market observers also recommend investors engage in peer-to-peer comparisons, noting that the sustainability frameworks of some SLBs may not be as rigorous or ambitious as the sustainability frameworks of some companies issuing conventional vanilla debt.

Ideally KPIs should be material not just for the business but the issuer's credit.

Investors should also check the credit rating of the issuer as there is usually a strong relationship between rating and a company's long-term sustainability.

For example, if a company fails on ESG metrics, its credit rating could be downgraded, which would affect its conventional debt regardless, thereby reducing the incentive to rely on the call to avoid the step-up provision.

Morgan Stanley notes that investment grade issuers in low-BBB ranks will sometimes include provisions for coupon step-ups in the case of rating agency downgrades - generally 25bp per notch.

This is to compensate investors in the event of a downgrade, particularly to high-yielding debtors, and given it can affect the investment mandate.

Issuers downgraded from investment grade to high yield often experiencing widening spreads of 100-150bp over the year preceding and after the downgrade.

So they investors should have warning and the downgrade should be largely priced in then the compensation mechanism should kick in to offset losses, leaving the investor no worse, reports Morgan Stanley.

A criticism of ESG-labelled debt is that investors may have to pay a premium for features not associated with credit risk - but market observers say this comes down to the bond structure, which is where investors should keep their focus.

Morgan Stanley argues that the greenium shouldn't be enough to cancel out the penalty mechanism.

Liquidity is also an issue. Observers point out that given demand for ESG debt is so high, many SLBs have been issued by relatively small companies without liquid capital structures.

Engagement is critical in emerging markets.

Materiality and pricing

Materiality is critical for SLBs.

For SLBs to gain investor support, they must offer a meaningful mitigation of credit risk, or an incentive. For a discussion on penalties, see the link below.

Morgan Stanley in its report *Sustainability-Linked Bonds: Materiality Is The Missing Link* says investors should focus on SLBs with KPIs that are material to the credit of the issuer to better align the investment with its credit risk and incentivise quality ESG targets.

"We view the SLB financing concept as fundamentally sound and believe it holds significant potential in financing decarbonisation and addressing other sustainability challenges," says Morgan Stanley.

"We see a 5 basis point greenium emerging among highly liquid investment grade names in primary markets but the trend is less clear among high-yield issuers.

"We have not identified a consistent SLB premium in secondary markets."

Morgan Stanley expects liquidity eventually to be in line with non-SLB structures.

The analyst advises against expecting consistent premium discounts. While greeniums are still achievable, these are likely to abate over time. Already, many SLBs are trading in line with conventional bonds.

Morgan Stanley reports the SLB structure has the potential to be more material in the high-yield market where issuers are more sensitive to interest costs and are more exposed to credit-material ESG risk.

The analyst reports that in fixed-income, it is notoriously difficult to pinpoint the fair value of a security.

When ESG is added to investment mandate, it affects factors such as ratings, sector and duration, further

complicating the endeavour.

Not much can be taken for granted. SLBs can trade at a greenium in the secondary market but not always.

High-yield companies tend to have higher emissions than investment-grade companies so investors are likely to see higher yields, and lower ratings within the SLB market as a proportion of overall issuance.

Morgan Stanley estimates that only half the issuers are investment grade but says those that are investment grade are likely to gain a slight greenium of about 5 basis points.

Whether a greenium will apply in the high-yield non-rated space has yet to be tested but Morgan Stanley says it is a distinct possibility.

Linked Finance The Next Big Thing Part 1

(<https://www.fnarena.com/index.php/2021/09/07/esg-focus-linked-finance-the-next-big-thing-part-1/>)

Linked Finance The Next Big Thing Part 2

(<https://www.fnarena.com/index.php/2021/09/13/esg-focus-linked-finance-the-next-big-thing-part-2/>)

FNArena's dedicated ESG Focus news section zooms in on matters Environmental, Social & Governance (ESG) that are increasingly guiding investors preferences and decisions globally. For more news updates, past and future:

<https://www.fnarena.com/index.php/financial-news/daily-financial-news/category/esg-focus/>

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WEEKLY REPORTS

Weekly Ratings, Targets, Forecast Changes - 10-09-21

Weekly update on stockbroker recommendation, target price, and earnings forecast changes.

By Mark Woodruff

Guide:

The FN Arena database tabulates the views of seven major Australian and international stock brokers: Citi, Credit Suisse, 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 September 6 to Friday September 10, 2021

Total Upgrades: 8

Total Downgrades: 8

Net Ratings Breakdown: Buy 52.93%; Hold 39.31%; Sell 7.77%

For the week ending Friday 10 September, there were eight upgrades and eight downgrades to ASX-listed companies covered by brokers in the FN Arena database.

In the only material adjustment to target prices by brokers for the week, City Chic Collective had the largest percentage rise in the database, after a positive market update by US peer Torrid. Citi feels this bodes well, given City Chic derives some 39% of its sales from the US. It also reconfirmed to Macquarie that the female plus-size market is underpenetrated.

Orocobre had the largest percentage rise in forecast earnings in the FN Arena database last week as brokers react to a beat for FY21 results. After combining the Orocobre and Galaxy Resources accounts, Citi generates a lift in forecast earnings for Orocobre in FY22 and FY23 of 139% and 55%, respectively.

The next largest rises in forecast earnings went to Coronado Global Resources and Whitehaven Coal. This comes as Macquarie strategists consider the outlook for coal continues to be positive, even after thermal and met-coal prices have more than doubled in 2021. The broker notes equities have lagged the increase in coal prices and predicts material upside, with greater leverage to metallurgical coal prices favoured via Coronado.

Despite Qantas having the largest percentage decrease in earnings forecasts by brokers in the FN Arena database last week, UBS believes the company will return as a stronger airline post pandemic. Nevertheless, the recovery is sensitive to higher vaccination rates, cooperation on borders and increased traffic from pent-up demand.

Coming next was Mayne Pharma, following a miss in broker expectations for FY21 earnings. Macquarie highlights falling gross margins from increased competition. However, Citi believes the company is transitioning to branded products from generic drugs as the largest segment. The analyst lifted the rating to Buy from Neutral soon after the initial downward share price reaction to the FY21 result.

Finally, Northern Star Resources also appears on the list for the largest percentage fall in forecast earnings last week. Despite this, Citi retains its Buy rating and expects Kalgoorlie District Milling synergies.

Total Buy recommendations take up 52.93% of the total, versus 39.31% on Neutral/Hold, while Sell ratings account for the remaining 7.77%.

Upgrade

APA GROUP ((APA)) Upgrade to Buy from Accumulate by Ord Minnett .B/H/S: 3/2/0

Following results season, Ord Minnett prefers APA Group within the Utilities sector due to its strong free cash flow generation, and opportunities for organic and inorganic growth.

The broker increases its rating to Buy from Accumulate on valuation. The price target of \$10.75 is unchanged.

DEXUS ((DXS)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/2/1

Macquarie assesses Dexus has been able to improve cash flow by recycling capital, and earnings have grown despite a challenged environment. Office markets form the base and asset valuations are resilient. The broker expects earnings growth in excess of 6% in both FY23 and FY24.

There is also upside from funds management. The business has \$23bn in funds under management making it the fourth largest under the broker's coverage with unlisted and listed funds in the platform.

While Macquarie does not assume it is all blue sky, generating a track record of growth in this area could mean the multiple expands. Rating is upgraded to Outperform from Neutral and the target is raised to \$11.67 from \$11.11.

FLIGHT CENTRE TRAVEL GROUP LIMITED ((FLT)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 1/4/1

The large exposure to Australasian sales, particularly the international outbound component, has made Flight Centre the least preferred in Credit Suisse's coverage.

Yet, with progress on vaccinations and a better break-even opportunity, the rating is upgraded to Outperform from Neutral and the broker's new stock travel pick.

The broker assesses the corporate division has been steadily gaining market share and remains a high-quality business. Target is raised to \$19 from \$18.

FORTESCUE METALS GROUP LIMITED ((FMG)) Upgrade to Buy from Neutral by Citi .B/H/S: 3/2/2

Citi upgrades Fortescue Metals to Buy from Neutral and reduces the target to \$18.50 from \$19.50. The broker suspects iron ore could hold at levels over US\$100/t for longer than the market is currently factoring.

Longer-dated market concerns regarding large-scale iron ore exports from Guinea now look much less certain. Moreover, China's leading indicators are stabilising and have headed higher from recent lows.

G.U.D. HOLDINGS LIMITED ((GUD)) Upgrade to Buy from Neutral by Citi .B/H/S: 3/1/0

Citi is increasingly concerned about the sustainability of the current new car sales momentum given industry articles indicate new car orders are down significantly in lockdown areas. Also, auto manufacturers continue to be impacted by semi-conductor supply issues.

The broker upgrades to Buy from Neutral, as this should be a tailwind once lockdown restrictions are lifted. The target price remains at \$12.30. Following a recent share price decline it's thought the significant discount to peer Bapcor ((BAP)) is excessive.

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

While no specific reason was given, BGH Capital has withdrawn its proposed takeover of Hansen Technologies, with all formal proceedings relating to the takeover now terminated.

The broker notes Hansen's recent cash flow track record has been excellent and estimates the company now has a debt capacity of around \$350m.

Ord Minnett expects the company to focus on M&A, where it has an excellent track execution and integration record, especially once global travel opens up in 2022.

The company reiterated its FY25 targets of \$500m revenue at an earnings margin of 32-35%, and the broker's earnings forecasts are unchanged.

Ord Minnett upgrades Hansen Technologies to Buy from Hold and the target of \$6.50 is unchanged.

IMDEX LIMITED ((IMD)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 2/0/0

Macquarie considers the earnings outlook is positive given the latest data that show a continuation of favourable industry inputs. Rating is upgraded to Outperform from Neutral.

The main risks to the rating include a material downturn in gold and copper prices or disruptions caused by the pandemic to operations in Australia and North America. Target is raised to \$2.65 from \$2.56.

MINERAL RESOURCES LIMITED ((MIN)) Upgrade to Buy from Neutral by Citi .B/H/S: 3/0/1

Citi suspects decisions around the Ashburton development and re-start of Wodgina will be outlined on or before the AGM that is scheduled for November 18.

The share price is down -15% from the recent high in July as benchmark iron ore prices have dropped. The broker believes an upward trend in the lithium market will largely offset weakness in iron ore and the growth outlook is unaffected.

Rating is upgraded to Buy from Neutral and the target is steady at \$65. The company has completed the acquisition of 40% of the Red Hill joint venture which further supports Ashburton.

Downgrade

CORPORATE TRAVEL MANAGEMENT LIMITED ((CTD)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 5/2/0

Credit Suisse assesses the market is increasingly close to reflect Corporate Travel's synergy and efficiencies target. Yet, delays to office timelines limit the full sales potential for the business.

Additionally, the share price has continued to rise and while still envisaging upside, the broker suspects this is likely to take longer than previously anticipated. Hence, the rating is downgraded to Neutral from Outperform. Target is \$23.

JUPITER MINES LIMITED ((JMS)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/0/1

Jupiter Mine's 49.9%-owned Tshipi manganese mine in South Africa has announced a dividend well below Macquarie's expectation.

The lower distribution is due to Tshipi being cautious on depressed lower-grade manganese prices and higher shipping and transport costs, while also maintaining cash to fund FY22 capital expenditure, the broker notes.

While this leads to only a -2% downgrade to the broker's FY22 earnings forecast, increased risk has the broker increasing its weighted cost of capital assumption and lowering its forecast enterprise multiple. Target falls to 22c from 30c,

Downgrade to Underperform from Neutral.

LENDLEASE GROUP ((LLC)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 3/2/1

Over the next 6-12 months the business may lack upside, Morgan Stanley asserts, as the company takes its development work-in-hand towards a target of around \$20bn, so that its target for \$8bn per year in completions from FY24 can be realised.

Beyond FY24 the broker finds it unclear if production targets are sustainable or adequately funded.

Rating is downgraded to Underweight from Equal-weight as FY22 and FY23 estimates are revised down -20% and -12%, respectively, to reflect reduced cost reductions at the group level. Target is reduced to \$11.40 from \$13.00. Industry view is In-Line.

MACQUARIE GROUP LIMITED ((MQG)) Downgrade to Hold from Add by Morgans .B/H/S: 2/2/1

Morgans upgrades FY22 and FY23 estimates for earnings per share by 8% and 3%, respectively, to reflect Macquarie Group's more positive outlook. Macquarie Group expects first half net profit to be only slightly lower compared with the prior half's strong performance.

The business is exposed to structural growth areas and capitalising well on the current environment, with the broker noting some value accretive acquisitions.

Yet, with the stock running hard and now trading on 20x FY22 PE it is close to fair value and the broker downgrades to Hold from Add. Target is raised to \$181.10 from \$172.30.

NOVONIX LIMITED ((NVX)) Downgrade to Hold from Add by Morgans .B/H/S: 0/1/0

It is Morgans' view that while the company looks promising, much of its future success is already reflected in

the share price and the rating is therefore downgraded until further detail on the Samsung quality audit and gross margin expectations are confirmed.

The rating is downgraded to Hold from Speculative Buy and the target price increases to \$5.68 from \$4.49.

QUBE HOLDINGS LIMITED ((QUB)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 2/3/0

Qube Holdings has announced the acquisition of the Newcastle Agri Terminal for -\$90m. Credit Suisse notes that although this is a small deal for the company, it allows Qube to provide grain export services through the Port of Newcastle.

The broker also notes that Qube is set to receive \$1.3bn in initial proceeds from the Moorebank sale, which is likely to generate \$200-300m in tax payments and \$600m in capital management.

Accounting for the acquisition, Credit Suisse upgrades earnings per share forecasts by 0.5% and 2.0% for FY22 and FY23, respectively.

The rating is downgraded to Neutral from Outperform and the target price increases to \$3.55 from \$3.30.

TECHNOLOGY ONE LIMITED ((TNE)) Downgrade to Neutral from Buy by UBS .B/H/S: 1/3/0

UBS resumes coverage with a downgrade to Neutral from Buy and \$11.70 price target, transferring coverage to another analyst.

The broker forecasts 14% growth in pre-tax profit in FY21-26 and half of this growth is likely to be driven by the migration of the majority of existing customers to the SaaS platform.

The broker is more cautious on the remaining uplift, which is likely to be driven by product/mix and UK expansion. While the recent acquisition of Scientia should assist the UK expansion, UBS does not believe it will provide substantial upside.

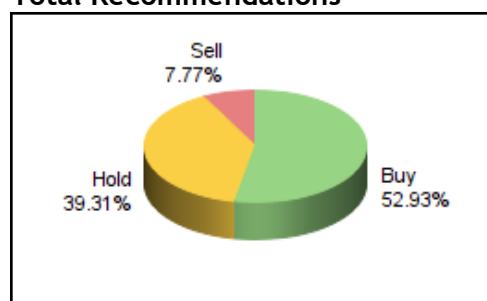
WEBJET LIMITED ((WEB)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 3/4/0

Credit Suisse envisages material upside to consensus estimates if Webjet can achieve its -20% cost reduction target. Nevertheless, the broker is cautious about fully modelling the upside.

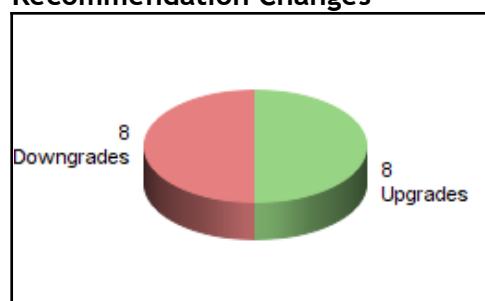
Improvement is expected in the primarily domestic Australian B2C division into 2022. There was limited opportunity, given the resurgence in the pandemic, to fully capture the northern hemisphere summer in the bed bank division.

Credit Suisse now has a preference for Flight Centre ((FLT)), likely to be a key beneficiary for Australia's re-opening. Credit Suisse downgrades to Neutral from Outperform and raises the target to \$5.70 from \$5.20.

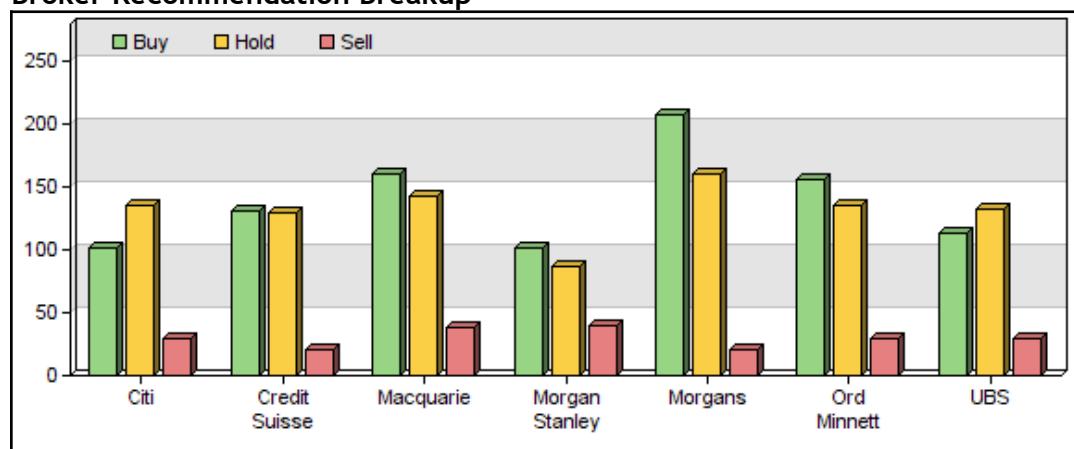
Total Recommendations



Recommendation Changes



Broker Recommendation Breakup



Broker Rating

Order	Company	New Rating	Old Rating	Broker
Upgrade				
1	APA GROUP	Buy	Buy	Ord Minnett
2	DEXUS	Buy	Neutral	Macquarie
3	FLIGHT CENTRE TRAVEL GROUP LIMITED	Buy	Neutral	Credit Suisse
4	FORTESCUE METALS GROUP LIMITED	Buy	Neutral	Citi
5	G.U.D. HOLDINGS LIMITED	Buy	Neutral	Citi
6	HANSEN TECHNOLOGIES LIMITED	Buy	Neutral	Ord Minnett
7	IMDEX LIMITED	Buy	Neutral	Macquarie
8	MINERAL RESOURCES LIMITED	Buy	Neutral	Citi
Downgrade				
9	CORPORATE TRAVEL MANAGEMENT LIMITED	Neutral	Buy	Credit Suisse
10	JUPITER MINES LIMITED	Sell	Neutral	Macquarie
11	LENDLEASE GROUP	Sell	Neutral	Morgan Stanley
12	MACQUARIE GROUP LIMITED	Neutral	Buy	Morgans
13	NOVONIX LIMITED	Neutral	Buy	Morgans
14	QUBE HOLDINGS LIMITED	Neutral	Buy	Credit Suisse
15	TECHNOLOGY ONE LIMITED	Neutral	N/A	UBS
16	WEBJET LIMITED	Neutral	Buy	Credit Suisse

Recommendation

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	GUD	G.U.D. HOLDINGS LIMITED	75.0%	40.0%	35.0%	4
2	UMG	UNITED MALT GROUP LIMITED	75.0%	50.0%	25.0%	4
3	CCX	CITY CHIC COLLECTIVE LIMITED	88.0%	63.0%	25.0%	4
4	SCP	SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP RE LIMITED	40.0%	17.0%	23.0%	5
5	REG	REGIS HEALTHCARE LIMITED	67.0%	50.0%	17.0%	3
6	DXS	DEXUS	33.0%	17.0%	16.0%	6
7	FLT	FLIGHT CENTRE TRAVEL GROUP LIMITED	-7.0%	-21.0%	14.0%	7
8	NST	NORTHERN STAR RESOURCES LIMITED	80.0%	67.0%	13.0%	5
9	EVN	EVOLUTION MINING LIMITED	-17.0%	-29.0%	12.0%	6
10	APX	APPEN LIMITED	50.0%	40.0%	10.0%	4

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	IGO	IGO LIMITED	-38.0%	-10.0%	-28.0%	4
2	MQG	MACQUARIE GROUP LIMITED	10.0%	30.0%	-20.0%	5
3	EBO	EBOS GROUP LIMITED	40.0%	60.0%	-20.0%	5
4	VRT	VIRTUS HEALTH LIMITED	33.0%	50.0%	-17.0%	3
5	LLC	LENDLEASE GROUP	33.0%	50.0%	-17.0%	6
6	CTD	CORPORATE TRAVEL MANAGEMENT LIMITED	71.0%	86.0%	-15.0%	7
7	WEB	WEBJET LIMITED	43.0%	57.0%	-14.0%	7
8	AWC	ALUMINA LIMITED	20.0%	33.0%	-13.0%	5
9	AZJ	AURIZON HOLDINGS LIMITED	20.0%	33.0%	-13.0%	5
10	CSL	CSL LIMITED	17.0%	29.0%	-12.0%	6

Target Price

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs

1	CCX	CITY CHIC COLLECTIVE LIMITED	6.663	5.938	12.21%	4
2	MQG	MACQUARIE GROUP LIMITED	174.820	161.860	8.01%	5
3	MIN	MINERAL RESOURCES LIMITED	64.025	59.520	7.57%	4
4	SCP	SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP RE LIMITED	2.676	2.528	5.85%	5
5	TNE	TECHNOLOGY ONE LIMITED	10.100	9.567	5.57%	4
6	ORE	OROCOBRE LIMITED	8.884	8.520	4.27%	5
7	REG	REGIS HEALTHCARE LIMITED	2.360	2.270	3.96%	3
8	SFR	SANDFIRE RESOURCES LIMITED	7.952	7.673	3.64%	6
9	ING	INGHAMS GROUP LIMITED	4.350	4.200	3.57%	4
10	SHL	SONIC HEALTHCARE LIMITED	43.830	42.397	3.38%	6

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	APX	APPEN LIMITED	13.775	14.920	-7.67%	4
2	RRL	REGIS RESOURCES LIMITED	3.230	3.383	-4.52%	6
3	CGC	COSTA GROUP HOLDINGS LIMITED	3.750	3.920	-4.34%	4
4	A2M	A2 MILK COMPANY LIMITED	6.290	6.525	-3.60%	6
5	AZJ	AURIZON HOLDINGS LIMITED	4.360	4.508	-3.28%	5
6	NST	NORTHERN STAR RESOURCES LIMITED	11.790	12.108	-2.63%	5
7	LLC	LENDLEASE GROUP	12.692	12.958	-2.05%	6
8	CSL	CSL LIMITED	305.317	308.843	-1.14%	6
9	MYX	MAYNE PHARMA GROUP LIMITED	0.307	0.310	-0.97%	3
10	DRR	DETERRA ROYALTIES LIMITED	4.950	4.970	-0.40%	4

Earning Forecast

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	ORE	OROCOBRE LIMITED	10.500	8.717	20.45%	5
2	CRN	CORONADO GLOBAL RESOURCES INC	3.707	3.081	20.32%	3
3	WHC	WHITEHAVEN COAL LIMITED	45.262	39.224	15.39%	6
4	HLS	HELIUS LIMITED	31.332	27.383	14.42%	6
5	DRR	DETERRA ROYALTIES LIMITED	28.658	25.726	11.40%	4
6	MQG	MACQUARIE GROUP LIMITED	911.260	833.680	9.31%	5
7	EHE	ESTIA HEALTH LIMITED	8.533	7.900	8.01%	3
8	OZL	OZ MINERALS LIMITED	167.317	156.414	6.97%	6
9	MIN	MINERAL RESOURCES LIMITED	675.775	638.760	5.79%	4
10	SFR	SANDFIRE RESOURCES LIMITED	115.083	108.929	5.65%	6

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	QAN	QANTAS AIRWAYS LIMITED	-36.077	-24.243	-48.81%	6
2	MYX	MAYNE PHARMA GROUP LIMITED	-1.043	-0.783	-33.21%	3
3	NST	NORTHERN STAR RESOURCES LIMITED	25.780	33.950	-24.06%	5
4	WSA	WESTERN AREAS LIMITED	2.725	3.336	-18.32%	5
5	UMG	UNITED MALT GROUP LIMITED	12.393	15.143	-18.16%	4
6	EVN	EVOLUTION MINING LIMITED	15.228	16.767	-9.18%	6
7	RRL	REGIS RESOURCES LIMITED	24.943	27.237	-8.42%	6
8	APX	APPEN LIMITED	34.885	37.868	-7.88%	4
9	WEB	WEBJET LIMITED	-6.514	-6.060	-7.49%	7
10	NCM	NEWCREST MINING LIMITED	131.125	141.146	-7.10%	6

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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WEEKLY REPORTS

Uranium Week: Price Surge Continues

Speculative activity has now pushed the uranium spot price to its highest level since 2014.

By Greg Peel

The Sprott Physical Uranium Trust (SPUT) has lit a fire under the spot uranium market, sending industry consultant TradeTech's spot price indicator up 39% in the last four weeks - a record in percentage terms. That's a US\$12/lb gain since mid-August.

Having turned over 3.7mlbs U3O8 equivalent the week before last, the spot market last week saw a further 3.8mlbs change hands in four trading days. TradeTech's weekly spot price indicator rose to US\$42.50/lb from US\$39.00/lb the week before.

The last time the spot uranium price was above US\$40/lb was in November 2014.

SPUT is purely a speculative vehicle which raises money to buy physical uranium, betting on increased demand as the world steps up its efforts to reduce carbon emissions. Last week SPUT filed an amendment to its original prospectus to increase its funds by a further US\$1bn.

SPUTs thesis received a boost last week when the state government of Illinois approved a financial support package to head off Exelon Energy's proposed early closure of its two-unit Byron nuclear plant, and to prop up the company's financially challenged Braidwood and Dresden plants.

Where are the utilities?

The recent spot price surge has been driven primarily by traders, financials (such as SPUT, which is not the only investment vehicle) and intermediaries, TradeTech reports. Traders and producers are the primary sellers.

While supply remains plentiful to meet spot demand, sellers have been backing off their offers in order to retain supply ahead of any further increase in prices.

Utilities - the actual end-users of uranium - have simply been watching spot market developments. But they haven't been sitting on their hands.

Utilities have been active in off-market transactions. On the Friday of last week, 940,000lbs changed hands in the off-market following the Illinois news. TradeTech reports one reason driving utilities to stay out of the spot market is the willingness of sellers to show more competitive offers to utility buyers, especially if there is a possibility for securing a new client or increasing their market share.

Sellers are not exhibiting the same willingness to extend such terms to speculators.

Utilities also prefer to secure material on term contracts so as to lock in a price and avoid spot market volatility, and producers also prefer to sell that material on term contracts for the same reason.

Still not high enough

But the problem producers face is the speculative spot market bubble has pushed the uranium market into backwardation. TradeTech's current spot price indicator is US\$42.50/lb while its term price indicators are US\$35.75/lb (mid) and US\$35.00/lb (long).

While the time value of money suggests backwardation (lower prices further out in time) is a natural state for commodity markets, it's only been since the speculative surge that term prices have fallen behind spot prices. Current term prices remain below the cost of production for many.

So, does a producer wait and hope to be able to secure higher term prices ahead, or continue to sell at below cost to ensure it doesn't lose customers?

Little has been heard recently from Cameco, which in the prior couple of years has supported spot market prices by buying in the market to cover legacy contract obligations rather than producing to sell at a loss. Most

recently, Cameco's hand has been forced by covid-related production shutdowns.

A restart of full production at Cameco might just be the pin that could burst the current bubble.



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WEEKLY REPORTS

The Short Report - 16 Sep 2021

See **Guide** further below (for readers with full access).

Summary:

Week Ending September 9, 2021.

Last week opened with the ASX200 falling below 7500, but only because of Fortescue Metals' ((FMG)) dividend, and the index soon spun around. But by week's end, the 7500 level finally gave way and sparked a technical sell-off.

As is evident in the table below, and with the August result season now behind us, there was very little movement in short positions.

The exception is AGL Energy ((AGL)), which appeared in the table last week at 6.2% shorted from below 5% previously. See below.

Weekly short positions as a percentage of market cap:

10%+
FLT 10.6

No changes

9.0-9.9

WEB, Z1P, EOS, KGN

In: **KGN**

8.0-8.9%

PLL, MSB, ING

Out: **KGN**

7.0-7.9%

COE, RBL, TGR, RSG

In: **RBL**

6.0-6.9%

AMA, A2M, MTS, AGL, TPW

In: **AGL, TPW** Out: **RBL**

5.0-5.9%

BHP, PNV, IVC

Out: **TPW, BGL**

Movers & Shakers

Downstream electricity and gas utility AGL Energy has lost more than half its value in 2021, and -79% in five years. The difficulties facing the company were emphasised in early August when it and rival utility Origin

Energy ((ORG)) both issued profit warnings.

AGL had already suspended its dividends in June. Utility companies are supposed to be sources of reliable yield.

The warnings off significant reductions in earnings in FY22 were largely based on falling wholesale power prices, to an extent driven by Australia's record take-up of solar power, and a government push to regulate lower prices. The overriding issue has been investors, particularly institutional, shying away from fossil fuels from an ESG perspective.

AGL's biggest problem is its legacy coal-fired power stations. Origin, in contrast, is as much an upstream energy company as downstream given its interest in the APLNG facility in Queensland. LNG is still a fossil fuel, but less "dirty" than coal.

To address the issue, AGL has decided to split the company into two entities, one comprising of AGL's renewable energy interests, and other the legacy coal-fired operation. With the split not expected to be completed until year-end, investors have been quietly abandoning AGL.

While part of the demerger plan includes an executive shake-up at the top, AGL fell another -7% yesterday on news the company's head of technology and commercial strategy has left for a Sydney-based solar start-up. Presumably Simeon Baker-Finch was not an executive AGL wanted to lose.

But the overarching question for investors, regarding the merger, is who in this day and age will want to buy a legacy coal power business?

AGL shorts last week rose to 6.2% from below 5%.

ASX20 Short Positions (%)

Code	Last Week	Week Before	Code	Last Week	Week Before
ALL	0.2	0.1	MQG	0.2	0.1
ANZ	0.6	0.5	NAB	0.6	0.6
APT	1.2	1.1	NCM	0.1	0.1
BHP	5.7	5.3	RIO	0.3	0.4
BXB	0.3	0.3	TCL	0.5	0.5
CBA	0.5	0.4	TLS	0.2	0.2
COL	0.5	0.4	WBC	0.5	0.5
CSL	0.2	0.2	WES	0.2	0.2
FMG	1.7	1.6	WOW	0.3	0.3
GMG	0.1	0.1	WPL	1.6	1.6

To see the full Short Report, please [go to this link](#)

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.

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 FN Arena unqualified as a service to subscribers. FN Arena 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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WEEKLY REPORTS

The Wrap: Global Rebound, Oz Telcos, Oz Property, Energy M&A

Weekly Broker Wrap: Patchy global recovery ahead, telcos tipped for special dividends, REIT upside realigns with fundamentals, Woodside to emerge as favoured MergeCo

By Mark Story

- Global indebtedness and wealth inequality have been reignited by the pandemic
- Proceeds of Telstra/TPG infrastructure sell-downs to return to shareholders
- Reopening story for large-cap mall landlords already priced in
- Post-merger, Credit Suisse expects Woodside's Top 10 independent O&G status to attract global investors

Global economic recovery: Future rebound no longer in sync

While inflation fears and the delta variant have commanded the market's attention recently, Oxford Economics' research suggests there are four key themes set to steer financial markets in coming months.

Firstly, while the onslaught of the pandemic set in motion the most synchronised global downturn and subsequent recovery in recent history, the forecaster expects the next phase of the recovery to be markedly different.

Oxford expects the patchy nature of the path to full recovery across western, Asian, and emerging markets to be exacerbated by ongoing disruption to supply chains.

Overall, Oxford expects supply constraints to contribute to the volatile nature of the recovery. The forecaster notes while supply issues have been a feature of past recoveries, they have not been on the same scale as the current disruption and foresees further disruption, especially if Asian countries struggle to cope with more covid waves.

Oxford also points to bloated global savings that have remained a present reality since the pandemic surfaced. While the pandemic has only galvanised policymakers' desire for growth, the forecaster suspects the flipside to an eventual depletion of households' excessive savings, will see a reversion to a grinding pace in 2023.

While an extended, rapid recovery from the pandemic may convince some that the market has unshackled itself from secular stagnation concerns, the savings glut remains embedded within the forecaster's baseline assumptions.

The forecaster subscribes to the contrarian view that the long-term factors - indebtedness, demographics, and wealth inequality - that have depressed growth and inflation have in fact been reignited by the pandemic.

Thirdly, in the near term, the forecaster expects excess savings to underpin high asset price valuations. Oxford admits there's limited likelihood of multiple expansion dampening returns. But barring a broader downturn, the forecaster suspects the risk of a significant correction in prices is low.

Regardless of central bank tapering, Oxford expects abundant liquidity that has supported valuations, to remain intact. The ensuing quest for yield and the high levels of capital looking for a home should keep valuations elevated relative to fundamentals.

Lastly, Oxford believes reduced living standards from high inflation, unemployment, and income inequality, together with the need to withdraw public sector support to address mounting debt, will lead to geopolitical risk. This risk will surface in the form of populist policies, especially within advanced economies and emerging markets.

Over time, Oxford expects the burden of fiscal adjustment hoisted on many countries by the pandemic, may well worsen the volatility of the recovery.

In conclusion, Oxford suspects economic underperformance in the years ahead only galvanises the base case for more combative international economic policies designed to source advantage from trade relationships. The forecaster's analysis also suggests that the implications for decoupling on trade and productivity would be more detrimental for China than the US or other western economies.

Oz telcos: Two pending infrastructure divestments

The mouth-watering valuations achieved by both the sale of Vocus Group in its entirety, and a 49% stake in Telstra's ((TLS)) TowerCo, has spurred companies across the sector to review the telecommunications infrastructure within their portfolios, with a view to boosting shareholder value.

In light of these developments, JPMorgan assesses two potential transactions currently under review: Firstly, Telstra's InfraCo asset, which operates passive infrastructure assets including FibreCo, and Ducts & Fixed Network Sites (DNFS) which reported earnings of \$1.47bn, over six times that of TowerCo.

Based on the part-sale of TowerCo, JPMorgan values InfraCo at \$31.7bn, representing a 21.6x multiple, and estimates a 49% sell-down would generate \$14bn in value, after capital gains tax, which could be used to reduce debt and buyback stock.

The broker expects the likely timing of a potential transaction to occur late FY22 or early FY23, following the completion separating legal entities of the group. If the recent sale of TowerCo is any proxy, JPMorgan expects 50% (\$6.8bn) to go to debt reduction, with the remaining proceeds from the transaction being returned to shareholders.

Based on the current share price, the broker estimates a \$6.8bn buyback - assuming 49% sale after capital gains tax - would be up to 10-11% earnings per share (EPS) accretive while gearing would also decline to 16%.

Following the 49% divestment of TowerCo and InfraCo the broker estimates Telstra would need to buy back 1.4bn shares (12% of the register) to be EPS neutral in FY23. At current market prices, the broker notes this would result in \$5.4bn allocated to share buybacks with the remaining \$2.8bn being allocated to a special dividend.

Due to mobile margin improvement, cost reductions driving stronger fixed earnings, and potential for further asset monetisation, Telstra remains JPMorgan's preferred stock and the broker maintains an Overweight rating and price target of \$4.50.

Then there's sell-down of TPG Telecom's ((TPG)) own tower assets, which JPMorgan believes could net the telco \$1.3bn. Due to a higher tenancy ratio, JPMorgan expects TPG's value per tower to be slightly higher than TowerCo and working backward from the average earnings per tenant from Telstra and Optus of \$29,000, forecast overall earnings to be \$63 million.

Assuming the transaction proceeds, the broker expects it to occur in 2022 following the review into the tower assets.

Given that TPG has recently completed a merger with Vodafone, JPMorgan expects the company to favour debt reduction and/or the return of proceeds to shareholders, over further M&A activity.

Based on JPMorgan's numbers, the \$1.32bn proceeds from the sale of the towers would be sufficient to purchase 11% of the register. Under this scenario, JPMorgan forecasts EPS to be 0-7% accretive and 11% accretive to the broker's fair value.

Despite cost synergies from the merger with Vodafone, JPMorgan notes TPG continues to experience covid headwinds, NBN margin erosion, plus concerns around its mobile with subscriber decline and average revenue per user decline. As a result, the broker retains a Neutral rating and target of \$6.85.

Oz property: Back to reality for retail REITs

Macquarie believes the recent share price movement of retail malls in the UK, EU, and US highlights outperformance based on announcements or expectations of re-openings, as opposed to the physical re-opening itself.

As a case in point, while US-based Retail REIT Simon Property Group significantly outperformed industrial REIT Prologis in January/February, up 32%, since then Simon Property Group has underperformed Prologis by -19%. The broker notes that this outcome was experienced despite heavily populated states like California, New York, Florida, and Texas all re-opening throughout this period.

REITs in the EU had similar experiences. For example, in the 30 days post the announcement of the UK roadmap, EU retail REITs UR Westfield ((URW)) and Klepierre) outperformed industrial REIT landlord SEGRO by 19%. Similarly, the retail REITs outperformed SEGRO for the 30 days after the announced French roadmap to

re-opening in May.

However, 60 days after the full reopening of retail, retail REITs underperformed SEGRO by just under a third (-29%).

Closer to home, there could still be some upside in valuations for large-cap mall landlords once the physical opening of non-essential retail resumes in October/November.

However, in light of the offshore experience, the broker views this eventuality as more limited given Scentre Group ((SCG)) - Underperform and target price of \$2.60 -- and Vicinity Centres ((VCX)) -- Neutral and target price of \$1.66 -- have already rallied on the back of a roadmap to re-opening provided by NSW, Victoria, and the federal government.

From here, Macquarie suspects outperformance will rely more closely on fundamentals, which in the broker's view, will remain challenging. For example, Macquarie notes gravitating from pandemic to endemic means learning to live with the virus, which the broker suspects result in additional challenges for retail landlords.

Energy M&A: Will Woodside emerge as Australia's favoured energy exposure?

While the proposed mergers of Woodside Petroleum ((WPL)) and BHP Group's ((BHP)) Petroleum division, and Santos ((STO)) and Oil Search ((OSH)), will transform Australia's listed energy equity landscape, Credit Suisse's analysis concludes that post-merger, Woodside may resurface as a viable alternative for energy exposure in Australia versus Santos.

As a result, the broker maintains an Outperform rating on Woodside (target \$27.65), and Neutral ratings on Santos (target \$6.98), and Oil Search (target \$4.38).

The broker suspect both entities may reposition as a differentiated LNG weighted and Asia Pacific-exposed 'mini majors' on the global stage. However, Credit Suisse believes even more M&A may be required to properly compete in the international leagues.

But considering that it is likely to take greater prominence on a global level given the company's scale, the broker suspects Woodside may present a more favourable proposition on valuation, political risk and ESG fronts. Credit Suisse data indicates Woodside has more favourable ESG metrics compared to Santos: -40% lower emissions intensity, and a -30% emissions reductions target by 2030 versus -26-30%.

As a result, Credit Suisse suspects there's a risk of overall register churn from Santos into Woodside which may have greater appeal to yield investors.

Credit Suisse sees value in both MergeCos, but more so with Woodside given the company's more favourable position across key metrics, plus the beaten up starting base relative to Santos, in which more upside is already priced in.

While register overhang poses near-term risk for both Woodside, and to a lesser degree Santos, Credit Suisse reminds investors of the potential ESG de-rating of the sector. Given that this appears to be undermining a strong LNG and oil price backdrop, the broker suspects it could trigger further register churn.

However, assuming the market's appetite for oil exposure over the coming 12 months is not going to improve, the broker sees a potential zero-sum game playing out between Woodside and Santos MergeCos for investors' incremental investment dollars from later in 2022.

Despite the scale and ESG headlines, Credit Suisse sees joint venture alignment at Scarborough for Woodside, and Papua LNG for Santos, as the key merger drivers, potentially presenting value in excess of market expectations.

The broker suspects synergy upside is yet to be fully factored into share prices and sees scope for accelerated 'energy transition' themed investment - by Woodside in particular - post mergers, as balance sheet room becomes available.

While Woodside is pursuing a carbon farming-driven strategy to help establish a foothold in the hydrogen gas market, the broker notes that Santos has already embarked on a carbon capture and storage (CCS) dominated strategy.

But despite these 'energy transition' ambitions, Credit Suisse is reluctant to ascribe too much value to the carbon farming/CCS or hydrogen/renewable deployments, given what the broker regards as questionable economics under the current market conditions.

Based on what it knows right now, Credit Suisse believes Woodside's merger synergy target of US\$400m per annum provides more upside than Santos's US\$95-\$115m pa. The broker also sees Woodside as presenting

marginally better valuation than Santos, with a stronger balance sheet -- 12% versus 30% gearing - a slightly higher earnings margin of 58% versus 56%, and a more favourable enterprise value multiple.

Credit Suisse also expects the consensus 2021 dividend yield of 6% for Woodside versus 2% for Santos and 3% Oil Search to also favour the Woodside MergeCo, assuming Woodside maintains a similar yield.

In summary, post-merger Credit Suisse expects Woodside to stand out again to international investors as the only top ten independent oil and gas company, which is heavily LNG and Asia-Pacific weighted. The broker suspects this could provide a favourable point of difference versus global peers.

By comparison, the broker is less confident that the Santos MergeCo will be able to attract significantly more additional international attention given Top 20 versus Top 10 scale, higher concentrated political risk, greater carbon intensity, and limited yield

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TREASURE CHEST

Treasure Chest: Scale Beckons Peter Warren

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Peter Warren Automotive is navigating NSW lockdowns cautiously, yet the re-opening recovery along with acquisition potential may indicate an opportunity

- Major upgrade to guidance could be forthcoming
- Is the forward order book decreasing?
- Acquisitions could scale up the business substantially

By Eva Brocklehurst

The fortunes of Peter Warren Automotive ((PWR)) have been underpinned by strong demand even as supply constraints created by the pandemic impede deliveries of new motor vehicles.

Morgan Stanley has now become more bullish on the stock and assesses, even if its bear case estimates for sustainable pre-tax profit of \$50m prove correct, the market is factoring in an undemanding \$60m pre-tax profit in FY23.



The main catalyst for the stock is the re-opening of NSW, from where 50% of its base is located, and a return to more normal car purchasing markets. The company appears to assume lockdowns in NSW extend beyond the current government setting for the end of September and this made guidance provided at the FY21 results appear very conservative.

Yet even with the potential for re-opening NSW in late October, Morgan Stanley notes the factors supporting the outlook are many. **Housing wealth effects are intact and there will be no competition from international travel for some time while the preference for personal over public transport continues.**

No update to the prospectus forecast for first half FY22 pre-tax profit of \$28m was provided at the results, as company remains mindful about the impact of lockdowns in NSW, and to a lesser extent Queensland, combined with supply chain constraints.

At the time of the results in August, Peter Warren Automotive was exposed to lockdowns in NSW and Queensland and Morgans suspects prospectus forecasts for the first half were simply reiterated, as would represent a -43% contraction versus the second half profit of \$48.8m in FY21.

Moelis accepts management has been very conservative in its forecasts and the roll-out of the vaccine in NSW leading into the December/January holiday period should mean vehicle demand recovers strongly, and may mean FY22 guidance is upgraded.

Yet the broker has a niggling suspicion the order book could be decreasing. There will also be a couple of months lead time before new orders for cars can be delivered and this may create an earnings hole.

Moelis estimates Peter Warren has 2-3 months worth of sales in its order book that should be delivered during the first quarter. Still, the order intake in Sydney is likely to remain subdued during the lockdown and deliveries are unlikely to be replenished with new orders. Moreover, constrained supply will mean deliveries will not happen immediately once restrictions are eased.

Yet Morgans disagrees, assessing the forward order book is strong and lockdowns are simply delaying earnings rather than causing cancellations. Jarden considers the risks are about the cyclical nature of the industry, which means **Peter Warren Automotive is exposed to changes in consumer sentiment as well as macro factors that constrain discretionary expenditure**.

Margins

The main positive in FY21 was elevated gross profit margins, with Moelis noting operating cash flow was \$85m. Gross profit margins improved to 18.3%. The Queensland business has also bounced back strongly after lockdowns in July, demand for cars remains robust and supplies constrained, so Moelis expects this margin will continue in FY22.

Service income is also affected by the lockdowns albeit partially offset by cost reductions. Around -40% of the business is locked down, Moelis calculates, and service income in affected areas is down -20%. Should this continue for the rest of the first half the broker estimates this would produce a -\$2.2m net impact of pre-tax profit as the company can reduce staffing costs to mitigate some lost income.

Moelis has upgraded estimates for FY22-23 by 16-20% to reflect the elevated margins, albeit slowly reducing, as well as the recent acquisitions, and applies a 20% probability weighting to an assumption that Peter Warren Automotive can internalise the family-owned Toyota business.

Acquisitions

The company has recently acquired several assets which are not included in Morgan Stanley's forecasts as there was little detail disclosed, albeit they should still provide some tailwind. The four dealerships include three in NSW and one on the Gold Coast and were acquired in June/July.

While pointing out little value is being attributed to organic growth, the broker makes comparisons, in terms of the acquisition outlook, with the trajectory of Eagers Automotive ((APE)) which gained substantial scale after the merger with Automotive Holdings.

Hence, the broker takes a long view on the growth trajectory, although acknowledges market concerns about the current shape of demand in the wake of the pandemic. Moelis agrees there is a long trajectory for growth available as the industry consolidates and a enlarged dealer group can benefit from scale.

The broker also notes ongoing discussions around further acquisitions and there is \$42.9m in net cash on the balance sheet. Morgans suspects the company is intent on a larger "prize", such as acquisitions with \$400-600m in turnover, and agrees sizeable acquisitions have the potential to change the profile of the stock considerably.

Jarden has a target of \$4.32 with a Buy rating and Morgans an Add rating with a \$4.09 target. Moelis has a \$4.79 target and Buy rating while Morgan Stanley retains an Overweight rating and \$4.60 target.

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RUDI'S VIEWS

Rudi's View: Appreciating The Mighty All-Weathers

In this week's Weekly Insights:

- Appreciating The Mighty All-Weathers
- Conviction Calls
- Research To Download
- FN Arena Talks

Appreciating The Mighty All-Weathers

By Rudi Filapek-Vandyck, Editor FN Arena

One of the most persistent errors made by investors, on my observation, is a too stringent application of the 'Buy Low, Sell High' principle, usually translated as: only buy stocks that are trading on a below-average valuation and don't hold on to them once the PE ratio is much higher.

It has been one of my long-standing favourite market observations: contrary to popular share market folklore, a stock with an above average valuation does not by definition become a Sell, and neither is the opportunity gone for a great investment return over many years into the future.

Recently I was again reminded by these facts by an excellent piece of research (see further below) involving ResMed's ((RMD)) return over the past ten years. As most of you would be well aware, ResMed has been identified as an All-Weather Stock through my own research and the shares are firmly held by the All-Weather Model Portfolio.

This week ResMed entered the ASX50, but preceding this milestone has been a return of no less than 1262% over the past decade. Even for a long standing close observer like myself, that is quite the eye-catching number. Unfortunately, the All-Weather Portfolio is only in its seventh year running, so not all of these returns have been captured, but then again, I don't see this success story coming to an end anytime soon either.



What mostly happens when such a piece of research has been published, is that your typical value-oriented stock picker or share market analyst tries to relegate the share price achievement to the past. One of the obvious ways to do so is by pointing out that back in 2011, this stock was trading on a PE of around 25x while today the forward looking PE is around 46x. Hence, the underlying suggestion then becomes: Sell, there no longer is further opportunity for PE expansion.

While this PE-expansion assessment might be correct, it is but one factor that has contributed to the extraordinary return since 2011, and it by no means prevents this company from achieving many more rewards for loyal shareholders. I also think investors are missing the bigger picture by only comparing the PEs of today and 2011.

A more correct assessment, I believe, is by comparing ResMed's valuation in 2011 with the broader market, which back then was trading on an average PE of below 15x. In other words: ResMed shares ten years ago were valued at a substantial premium versus most other ASX-listed stocks.

When asked the same question ten years ago, today's value-oriented nay-sayers would not have recommended ResMed shares as an excellent Buy-opportunity. Because at such a market premium, the shares did not look "cheap".

Yet, over the following ten years the return from those seemingly "overpriced" shares has been nothing but phenomenal. I haven't done the numbers, but I don't think any of the "cheaply" priced alternatives back then has managed to generate anything remotely close to the reward that has befallen loyal ResMed shareholders over the period.

As a matter of fact, when I think of those stocks that have equally generated outsized returns over the period, the same basic characteristics apply as ResMed's; think CSL ((CSL)) and Cochlear ((COH)), REA Group ((REA)), Seek ((SEK)) and Carsales ((CAR)), but also ARB Corp ((ARB)), Ansell ((ANN)) and TechnologyOne ((TNE)).

In contrast, last week I was dragged into a discussion on social media about the merits, or otherwise, of the proposed merger between BHP Petroleum and Woodside Petroleum ((WPL)). I think Woodside desperately needs this deal. As I looked up the share price, I noticed it is at the same price level as it was back in 2004 - 17 long years ago.

Throughout most of that period, in particular post-2011, Woodside shares have mostly looked "cheap" and "great value", also offering an outsized dividend yield, but that has not generated much in terms of sustainable returns for shareholders (luckily they do pay a dividend).

Certainly, there have been rallies, and at times Woodside looked in a sweet spot, temporarily, but it'll only take a few more years for its shareholders to look back and conclude history doesn't consist of just one, but of two lost decades. So much for the "cheaper" entry!

I am certain all of us can add many more (apparently) cheaply priced examples: AMP ((AMP)), QBE Insurance ((QBE)), Humm Group ((HUM)), Slater & Gordon ((SGH)), and many, many more. Sure, at some stage they'll have a rally and outperform ResMed and the likes, but great long-term investments they have not been, and why would they be in the future?

The answer does not lay in the low or high PE ratio.

When investing in the share market, investors have roughly two main types of risk to deal with: the risk of overpaying for exposure -your typical share price risk- and the risk not all is well with the company, or that management cannot fulfill its plans and ambition and falls short of expectations; the operational risk.

The first type of risk is usually settled through generalised numbers -PE, dividend yield, relative discount/premium, etc- while the second type is much more difficult to assess and to establish, which is why most financial commentary and analysis focuses on the first part. Much easier. And it works.

Sort of.

If it really were the superior method to uncover opportunities and avoid value-traps, wouldn't we all have owned ResMed shares over the past decade (as well as the other All-Weathers) instead of getting caught into the next downdraught at Myer ((MYR)), Mesoblast ((MSB)) or The Reject Shop ((TRS))?

I do know it's not quite that simple. Not every market participant has the same horizon or objectives, but the message remains the same: instead of ignoring the second risk and predominantly taking guidance from the first assessment, I am advocating long-term investors should practice the exact opposite: start with the second assessment and relegate the first risk to a secondary consideration, at most.

If we start with the companies -and by extension: the sector- behind the numbers and the share price, we soon discover some invaluable insights, such as:

- Some companies (and sectors) have a multi-year growth path ahead of them that is relatively predictable;
- Some companies (and sectors) can grow virtually independently from the economic cycle;
- True market leaders hold the lead in new products, innovation and developments;
- True market leaders can expand their local dominance well beyond Australia's borders;
- Sustainable success requires constant investing, both in the business as well as into new products, markets, geographies, etc
- Quality corporate culture cannot be measured, but you'll recognise it when you see it;
- Quality companies don't need to be convinced about ESG or better practices (they score highly already);
- Great management has a relatively easy job at hand when at the helm of a quality market leader in a sustainably growing industry

The most important take-away is, however, that once the market sniffs out that a company such as ResMed has all of the above characteristics, plus some, it will price its stock accordingly. So no need to wait until the PE ratio is below 15x or something similar; that simply will never ever happen, unless the company's story starts to unravel.

Judging from the latest indications, including the company's investor day last week, investors are wasting their time if their strategy is to position for the end of the ResMed growth story. If anything, most analysts returned from the investor day with the impression the company might yet again surprise on the upside next year, as major competitor Philips is struggling with a product recall.

Underlying, however, the ResMed growth story is much more powerful. It is about management correctly anticipating future trends and direction and thus investing in innovation and product expansions that not only solidify the global leadership, but also set up the company for larger market share, a closer relationship with patients and care providers, and possibly a technological moat around its leadership.

See, the odd thing that happens in our human brain is that from the moment we realise what's going on inside this high quality business, and how truly exciting the future might be, we feel excitement flowing through our veins and the urge to become part of it. If only ResMed shares were not publicly listed; we would stand hours in a queue to invest in it!

The best way to invest in a stock like ResMed is by using market volatility to your own advantage, while taking a multi-year view and realising that a "cheap" valuation is something of a short-term nature. Imagine, you'd be struggling with the same dilemma in 2011. Shall I buy around \$6? Or \$5.50 maybe? Maybe I get another chance below \$5?

Ten years later the shares are changing hands above \$40.

The focus of my own research and analysis is on the ASX and this means I am fishing in a relatively small pond. Australia doesn't have many companies of the quality and caliber of ResMed, which, strictly taken, has become more of a US enterprise with its official headquarters now in San Diego, California but still ASX-listed.

As a direct result of the limited selection in comparable All-Weathers, I tend to be quite sanguine about the valuation and entry-price to obtain exposure to such high-quality performers. One of my favourite quips is: if one pays too much for an All-Weather, one might have to wait six months or so to get in the black, but if we do the same for a low quality cyclical, we might have to wait forever and a day!

Last week, I had the pleasure of attending an online presentation by funds manager Claremont Global and while the team over there doesn't use the same vocabulary, their methodology and approach shouts "All-Weathers" from the left to the right and again from the bottom to the top, and back.

The key difference here is, Claremont has a global focus and thus the team can be more stringent and choosy when it comes to valuations and entry-points, for the simple fact there are so many more options to analyse and to consider. But, underlying, the similarities are striking; no mining, no oil&gas, no banks, no insurers, no heavily government regulated industries; and nothing that cannot be forecast with a fair degree of certainty.

Claremont only owns a maximum of 15 companies at any given time. Its preferred entry point is -20% below intrinsic valuation and the stock is usually sold above 20% over-valuation. The aim is to outperform its international benchmark by 2-4% per annum and Claremont has done exactly that by owning the likes of Nike, Microsoft, Alphabet, Aon, Lowes, Automatic Data Processing, Agilent Technologies, Diageo, Ross Stores and Sherwin-Williams.

Viewed through an Australian lens, one can see the equivalents of Bunnings ((WES)), DuluxGroup (alas, no longer ASX-listed), Steadfast Group ((SDF)), Nanosonics ((NAN)), and others.

In the words of portfolio manager Bob Desmond, all companies that will grow faster than the market average in the years ahead and that allow investors to sleep comfortably during a market downturn. I am less certain whether any of these companies are high on the list of managers and investors who focus solely on 'valuation' and 'cheap' PEs.

I discovered the Claremont website offers some interesting views and topics, not only explaining why certain stocks are held, but also, for example, to answer a question like: why would you sell a great business in order to buy a mediocre alternative?

<https://www.claremontglobal.com.au/our-insights>

Claremont Global was spun out of Evans & Partners.

The research mentioned earlier in the opening sentences of my story was by TMS Capital's Ben Clark, which, by the way, showed that ResMed's return over the decade past was eclipsed by competitor Fisher & Paykel Healthcare ((FPH)) having returned no less than 1754% over the period.

Ten years ago, Fisher & Paykel Healthcare shares were trading on a PE below 20x (well above market average). Today, the forward looking multiple on FN Arena's consensus forecasts is 50x and 49x for FY22 and FY23 respectively.

<https://www.livewiremarkets.com/wires/two-stunning-healthcare-stocks-hint-it-s-not-cs1>

Conviction Calls

It remains **Macquarie's** recommendation that investors seek (more) exposure to **offshore earners** on the ASX, providing superior earnings growth and additional benefit from a weaker Aussie dollar.

Macquarie has applied a three-year out filter and selected the following favourites: Computershare ((CPU)), Link Administration ((LNK)), Boral ((BLD)), James Hardie ((JHX)) and Ramsay Health Care ((RHC)) inside the ASX100. Outside of the Top 100, the broker's Best Buy ideas are News Corp ((NWS)), Nufarm ((NUF)), Codan ((CDA)), EML Payments ((EML)), Bravura Solutions ((BVS)), Janus Henderson ((JHG)), and United Malt Group ((UMG)).

In addition, Macquarie highlights Webjet ((WEB)) and Flight Centre ((FLT)) with both having been negatively impacted by covid (and that's an understatement) and still ranking among the most shorted stocks on the local exchange.

Macquarie has also selected several Sell-ideas: a2 Milk ((A2M)), Xero ((XRO)), Reece ((REH)), Altium ((ALU)), Domino's Pizza ((DMP)), ARB Corp ((ARB)), and Zip Co ((Z1P)).

Healthcare sector analysts at Citi have updated their preferences post August reporting season; Ansell ((ANN)), Ramsay Health Care, CSL ((CSL)), and Integral Diagnostics ((IDX)).

With exception of Ansell, all companies mentioned should experience an acceleration in growth following negative impact from covid, predict the analysts. Ansell should struggle for growth post covid-boost, and Citi is forecasting a decline in earnings per share, but the share price is nevertheless considered too cheap.

Earlier, peers at **Macquarie** had expressed their sector preferences for Ramsay Health Care, Cochlear ((COH)), Healius ((HLS)), Virtus Health ((VRT)), and Monash IVF Group ((MVF)).

Mining sector analysts at Ord Minnett have used their latest number crunching exercise -otherwise known as general update on data, numbers and price forecasts- to nominate South32 ((S32)) as one of their sector favourites, even as the share price has already had a good run. South32 sits high on the preference rankings, alongside BlueScope Steel ((BSL)) and Rio Tinto ((RIO)).

Ord Minnett still retains a positive view on the lithium sector, with Orocobre ((ORE)) its favourite, while among ASX-listed gold producers the preference sits with Northern Star Resources ((NST)), above Newcrest Mining ((NCM)) and Evolution Mining ((EVN)).

Peers at **Macquarie** very much prefer OZ Minerals ((OZL)), 29Metals ((29M)), Sandfire Resources ((SFR)), and, among explorers, Chalice Mining ((CHN)).

In the local **retail sector**, **Jarden** continues to prefer global reopening plays Premier Investments ((PMV)), Flight Centre, and City Chic Collective ((CCX)) alongside those companies busy building a longer term moat; Woolworths ((WOW)), Wesfarmers ((WES)), and Temple & Webster ((TPW)).

Jarden is cautious regarding Nick Scali ((NCK)), JB Hi-Fi ((JBH)), Harvey Norman ((HVN)), and Super Retail ((SUL)).

Earlier, in a sector report published immediately post the August results season, Jarden had also expressed its positive view on Lynch Group ((LGL)), Beacon Lighting ((BLX)), and Kathmandu Holdings ((KMD)) among leading market positions with growing audiences.

Post-August, stockbroker **Morgans** has expanded its **Best Ideas** with Universal Store Holdings ((UNI)), Beacon Lighting, Hub24 ((HUB)), MoneyMe ((MME)), PTB Group ((PTB)), and Panoramic Resources ((PAN)).

Morgans' list of Best Ideas now consists of 47 names, including Macquarie Group ((MQG)), BHP Group ((BHP)),

ResMed ((RMD)), NextDC ((NXT)), Incitec Pivot ((IPL)), Lovisa Holdings ((LOV)), Karoon Energy ((KAR)), TechnologyOne ((TNE)), Ramelius Resources ((RMS)), and Whitehaven Coal ((WHC)).

Market strategists at **Wilsons** have re-weighted their **Focus List** towards the reopening trade with enlarged exposures to Qantas Airways ((QAN)), Silk Laser Australia ((SLA)), Santos ((STO)) and James Hardie while both Worley ((WOR)) and Transurban ((TCL)) have been removed.

Bell Potter's key picks for investing in the domestic **technology sector** are now, in order of preference: Nitro Software ((NTO)), Infomedia ((IFM)), and Life360 ((360)).

Equally noteworthy: the broker currently has no Sell rating in the sector.

Morgan Stanley analysts have nominated Life360 as one of their key picks out of the August reporting season.

Research To Download

IIR on Assetline First Mortgage Debt Fund No 1:

<https://www.fnarena.com/downloadfile.php?p=w&n=72F145F3-0640-3907-10C9988E1F1098C5>

IIR on Magellan Future Pay:

<https://www.fnarena.com/downloadfile.php?p=w&n=72E57601-0FD3-A04B-BD43DA656858E384>

IIR BKI Review:

<https://www.fnarena.com/downloadfile.php?p=w&n=72E9CC7D-A541-DE5B-E716C44A077AA7A3>

FNArena Talks

Last week, I was interviewed by Peter Switzer on the current cycle and the prospect for 'Value' stocks to regain their mojo:

<https://youtu.be/V1nXDOHpdnc?t=90>

(This story was written on Monday 13th September, 2021. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website).

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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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