

Week
45

Stories To Read From FNArena

Friday, 9 November 2018

FNArena
Financial News, Data &
Analysis

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Business Bank Stands NAB In Good Stead

As issues surrounding Australian housing credit growth and tightening lending standards continue to dog the banks, National Australia Bank's FY18 results indicate a weighting to the commercial sector stands it in good stead.

-Challenging capital position and uncertain divestment strategy are potential risks -Leveraged to an improving business credit environment -Can NAB narrow its historical gap to peers?

By Eva Brocklehurst

A focus on business banking is likely to help National Australia Bank ((NAB)) narrow the gap to its peers, as the industry endures the slowing of Australian mortgage growth. The bank reported cash earnings of \$5.7bn in FY18 and an unchanged final dividend of \$0.99.

Issues regarding the slowdown in Australian housing credit growth and tighter serviceability requirements continue to dog the banks, but brokers believe this result should serve to alleviate some concerns.

Momentum in commercial banking means NAB is well placed, in Citi's view, as the implications of the Hayne Royal Commission continue to emerge. Now is a good time to be a commercially-oriented bank, the broker asserts, and NAB's outperformance is likely to be determined by continued execution on its restructuring plans.

Citi believes the current share price offers good risk/reward amid restructuring benefits. However, a challenging capital position and a divestment strategy regarding MLC could be potential risks, the broker concedes.

This was one aspect that displeased Credit Suisse, as uncertainty continues regarding the benefits from divesting MLC and the impact on the dividend. Still, in a deeply-discounted sector delivering a result that is in line with expectations is considered acceptable.

Macquarie recognises significant restructuring carries risks of disruption but, to date, this has not had a material impact on the bank's momentum. If NAB can maintain its performance in FY19, the broker suspects revenue trends should be in line or potentially ahead of peers.

Ord Minnett finds it hard to become excited about the minor underlying revenue growth in the second half, although better revenue trends are expected to become more apparent once the bank reporting season is completed.

The broker believes the valuation is compelling, as the stock is trading at around 11x FY19 forecast earnings. Ord Minnett's Accumulate rating reflects the banks tilt to small business banking, which provides leverage to an improving business credit growth environment and insulates it from the pressures in retail banking.

Morgan Stanley believes the outlook is uncertain and there is an increased probability of weaker revenue growth and a rise in impairment charges. As there is little margin for error on costs, capital or the dividend the broker maintains an Underweight rating. Moreover, a reduction in major bank profitability may be required over the next few years to win back the support of key stakeholders.

Margin

Net interest margin in FY18 was assisted by a five-basis-points improvement in New Zealand and a stable institutional margin. Morgans commends the bank's margin management and discipline, which has meant NAB did not need to increase its variable home loan rates in Australia, unlike other majors.

Loan growth was strong in small-medium enterprises, institutional banking and New Zealand, which the broker considers are significant drivers in the face of slowing home loan system growth in Australia.

Credit Suisse is pleased the result met expectations at a headline level. Yet, the decision not to re-price mortgages potentially leaves the bank at a disadvantage for revenue in the short term, which the broker expects will manifest in an inferior margin outcome in the first half.

Macquarie agrees the main risk is potential underperformance on margins, if management decides not to follow its peers in re-pricing mortgages. However, the broker suspects the bank will eventually re-price mortgages, probably in January, and that would provide \$145m in benefits in FY19.

Furthermore, a decision on mortgage re-pricing will be the key risk to the bank's ability to outperform peers and Macquarie expects NAB will rely on a dilutive discounted distribution reinvestment plan to support its capital position, or it will need to cut its dividend. The bank's credit quality may be sound and arguably better than peers but Macquarie suggests the capital position is at the bottom of the peer group.

Morgan Stanley notes the CEO, Andrew Thorburn, has indicated that variable mortgage rates are only on hold "for now", and he acknowledged that banks need to reconsider the practice of re-pricing the back book and discounting the front book. Morgan Stanley believes this weighs on the outlook for near-term revenue growth and medium-term retail bank profitability.

On the other hand, Ord Minnett asserts, an improved capital position and supportive valuation would mean the bank can narrow its historical valuation gap to peers.

FNArena's database has five Buy ratings, one Hold (Credit Suisse) and two Sell. The consensus target is \$29.31, suggesting 17.1% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 7.7% and 7.6% respectively.

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Is An Earnings Recovery Priced In To Orica?

After a soft FY18 result Orica expects ammonium nitrate volumes will improve. However, uncertainties over the Burrup plant weigh on the outlook.

-Has the market priced in the earnings recovery? -Growth still appears to be a challenge -Burrup not expected to run at full capacity until 2020

By Eva Brocklehurst

Orica ((ORI)) appears at a crossroads, emerging from several years of underperformance with the levers in place to expand. Yet there are reasons to be cautious, as brokers note the Burrup plant is not performing at an optimal level and this is weighing on profitability.

In the company's favour, there is a tightening supply/demand balance in the Australia-Pacific region that is being reflected in improving contract outcomes. The company has guided for ammonium nitrate volumes to increase 3% in FY19. No specific financial guidance was provided but Orica expects growth in revenue and operating earnings will be supported by increased demand and manufacturing improvements.

Expectations for earnings growth over FY19 and FY20 are underpinned by volume growth, stabilised pricing and business improvement initiatives, such as a full year's contribution from GroundProbe, and a recovery in Minova.

Morgans believes the market has largely priced in the earnings recovery and, having to contend with internal challenges and a re-setting of prices, the company's positive leverage to a recovery in volumes has been reduced. Still, the broker believes FY18 should be as bad as it gets.

Deutsche Bank points out the FY18 result was boosted by profit on asset sales of \$17m while cash flow was enhanced by lower tax. Earnings did accelerate in the second half, with an improved contribution from margin/mix and a reduction in costs. However, margins contracted to 11.4% from 12.6% during the year.

The company reported underlying net profit of \$327.2m and operating earnings (EBIT) fell 2.7%, reflecting the impact of unplanned maintenance at Yarwun and Kooragang Island, as well as continued challenges in the cyanide market and cost headwinds.

Regionally the outcome was mixed: Asia-Pacific led the way, while North America was in line and Latin America missed expectations. While Latin America was poor, Credit Suisse notes this was because of factors beyond the company's control and accentuated by adverse currency movements.

Uncertainties Prevail

Credit Suisse upgrades to Outperform from Neutral, although not entirely convinced in the upside case. Still, the company seems to be getting on top of operating issues and the tightening of supply should carry profits higher over the medium term. The reasons to be fearful, the broker acknowledges, include recent history and Burrup.

Morgan Stanley goes the other way and downgrades to Equal-weight from Overweight. There were no major surprises for the broker and the result was better than feared. The environment appears favourable and Morgan Stanley believes a premium to history is warranted at this point in the cycle, but being convinced about the growth profile for 1-2 years hence is a challenge.

Citi observes there was a relief rally in the wake of the result, as operating issues appear largely resolved and cash conversion is recovering. Nevertheless FY19 guidance implies sharp downgrades to consensus expectations and the broker continues to believe the stock is overvalued, maintaining a Sell rating.

Burrup

Utilisation rates at Burrup are likely to be just 20% and the company now expects the plant will not be running at full capacity until 2020. Brokers are still unsure regarding the outcome as Burrup is not running consistently, plagued by technical problems, which will mean higher cost alternative ammonium nitrate supply will be needed for Western Australian iron ore contracts.

Macquarie finds Burrup problematic and believes this is a risk to the downside. Orica has identified more problems at the absorption tower, in addition to the heat exchangers. The broker notes it is costing Orica \$200/t to service

240,000t of Burrup contracts whilst the plant is off-line and there is risk of further costs in the event of delays.

FNArena's database shows one Buy rating (Credit Suisse), five Hold and one Sell (Citi). The consensus target is \$17.56, suggesting -1.4% downside to the last share price. Targets range from \$16.00 (Citi) to \$19.08 (Credit Suisse).

See also, Work To Do At Orica on May 9, 2018.

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Subdued Outlook For Westpac

Another difficult year looms for Westpac and, while mortgage re-pricing should boost first half performance, slower wealth revenues and further customer remediation are likely to weigh.

-Reduction in proportion of interest-only loans but still ahead of peers -Cost guidance the main positive, but step change unlikely until FY20 -Capital position ahead of required benchmark, steady dividend expected

By Eva Brocklehurst

Remediation and funding costs dominated Westpac Banking Corp's ((WBC)) FY18 results and revenue growth was subdued, attributed to sacrificing margin as Australian home loans were re-priced.

The bank is adapting to an environment which features the end of the mortgage bull market, as well as scrutiny of conduct & competition and rising capital intensity in retail banking. Another difficult year looms, and brokers find little support in current trading multiples.

Overall asset quality was sound while non-interest income was softer, largely because of weaker markets income. Market non-interest income was down -17% in the second half. Slower wealth revenues and further customer refunds are expected to weigh on non-interest income. However, if Westpac can replicate its performance in FY19 first half revenue should increase on the prior half, Macquarie suggests.

Cash net profit was \$8.04bn and the full-year dividend was steady at \$1.88. Funding costs appear to have abated in recent weeks and the broker expects, if the trends persist, this will provide the scope for a positive surprise in FY19. Nevertheless, with potentially higher impairment charges, limited earnings growth is envisaged for FY19-20.

Morgans asserts the focus on productivity savings should still underscore cash earnings growth over the next three years. This feature of the FY18 result impressed the broker, as savings were \$173m in the second half and more than offset the increase in business expenses. Westpac is targeting around \$400m in productivity savings in FY19.

Mortgages

Mortgage re-pricing is expected to boost the bank's performance in the first half but the consumer sector is expected to be under pressure going forward because of the composition of the bank's mortgage book.

Net interest margins declined -26 basis points, or -20 basis points excluding customer remediation, but margin pressure is likely to remain in the medium term as Westpac has more exposure to interest-only loans.

This has been a factor weighing on the share price for some time, Morgans observes, although overall asset quality has kept pace with peers. Moreover, when the 30% cap on new interest-only loans was introduced, Westpac's exposure was 50%. The broker points out this has now reduced to 35%.

New interest-only facilities represented 23% of new mortgage limits in the second half and Westpac's share of interest-only loans remains 5-13% above peers. Competition appears to be affecting lending spreads across all loan markets, brokers note, particularly Australian home lending.

Costs

Cost guidance was a clear positive from the results, although Credit Suisse suspects a step change is unlikely until FY20 at the earliest. The bank also reported a decline in stressed exposures.

Morgan Stanley was hoping for more on costs but acknowledges it will take some time to realise the benefit of investment in technology and infrastructure. The broker forecasts around 3% growth in expenses in FY19, factoring in another \$275m in remediation costs.

The capital position was strong and the CET1 ratio improved to 10.63%, which compares with the benchmark of 10.5% required by January 1, 2020. Morgan Stanley expects the CET1 ratio to settle around 10.9% without the need for additional dividend reinvestment plans. The broker forecasts the pay-out ratio will stay over 80% in FY19 and FY20, despite management's long-term pay-out ratio target of 70-75%.

Capital management could be on the agenda next year, although Macquarie suggests the scope is limited. Morgans anticipates the strong capital position and asset quality will support the current dividend.

FNArena's database shows three Buy ratings, four Hold and one Sell (UBS). The consensus target is \$30.05, suggesting 11.9% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 7.0%.

Disclaimer: the writer has shares in Westpac.

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ResMed Expands Presence In Home Health

The price ResMed is paying for MatrixCare is rich, although brokers accept the deal will significantly expand its offering in home health data analytics.

-Diversifying revenue streams in home health -Provides scale opportunity in software design -Complements Brightree and HEALTHCAREfirst

By Eva Brocklehurst

ResMed ((RMD)) is building out its position as a provider of software-as-a-service to the US out-of-hospital market. To this end, MatrixCare is the number two operator in long-term post-acute software. ResMed will acquire MatrixCare for US\$750m from the private equity division of OMERS, a Canadian pension plan.

Brokers are concerned the deal is rich, albeit it appears to complement the company's current offerings in home medical equipment and home health, delivered through Brightree and HEALTHCAREfirst. This should help lower risk and diversify revenue streams.

The price equates to 25x current year operating earnings (EBITDA) versus the 19x earnings paid for Brightree, excluding tax. For Ord Minnett, the success of Brightree underpins confidence that the company is ahead of the market with its strategy.

This latest acquisition should provide a large number of customers and patient records providing the scale that often leads to rapid market concentration. It establishes the company's cloud-based connected care that allows for the leverage of data analytics to improve the quality of care, Credit Suisse agrees.

MatrixCare services 15,000 providers across the skilled nursing, senior living and home care industries. It offers referral management, claims processing, payroll and nutrition management. The offering compliments Brightree, which is aimed at durable medical equipment providers, and HEALTHCAREfirst, aimed at hospices and home care.

ResMed estimates 2018 pro forma revenue and operating earnings to be US\$122m and US\$30m respectively. Citi estimates the transaction to be 2% accretive to earnings per share in FY19 and forecasts gearing to increase to 1.1x net debt/operating earnings.

ResMed will fund the transaction with existing debt and suspend its US share buyback. Ord Minnett calculates the acquisition to be earnings neutral in FY19 and around 1% accretive in FY20. UBS assumes that, under a well-resourced owner, investment in growth can be supported and translate to robust revenue and earnings for MatrixCare.

There is only modest crossing over with current offerings other than HEALTHCAREfirst and, in time, Ord Minnett expects operations to be integrated. Credit Suisse agrees the similarity of the MatrixCare and Brightree models provide economies of scale in the design of software solutions.

There is also a longer term opportunity to identify and refer patients who may suffer from obstructive sleep apnoea, chronic obstructive pulmonary disease or other respiratory illnesses.

Morgans believes the acquisition solidifies the company's connected care offering and, when coupled with stable pricing and moderating operating expenditure, supports a solid earnings trajectory. As a result, the broker increases sales assumptions by up to 4.6% and increases net profit by up to 1.8% for FY20 and FY21.

MatrixCare will be operated by existing management and retain its head office in Minnesota. This is the third large acquisition of a software business by ResMed. Given the current market dynamics, Citi now believes it possible ResMed can grow faster for longer. The company could take market share over the rest of FY19 while the mask resupply program drives growth in the US.

FNArena's database shows four Buy ratings, three Hold and one Sell (Macquarie, yet to update on the transaction). The consensus target is \$15.17, suggesting 5.3% upside to the last share price. Targets range from \$13.50 (Macquarie) to \$16.73 (Morgans).

See also ResMed Increases Market Dominance on Oct 29, 2018.

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Soft Retail Outlook Drags On UR Westfield

Unibail-Rodamco-Westfield has reiterated 2018 earnings guidance, with dilution from asset sales countering the accretion from the acquisition of Westfield.

-Sound premium from asset sales despite tough market -Could experience a negative structural re-pricing -De-leveraging could be achieved by retaining more development profits

By Eva Brocklehurst

Global retail property business Unibail-Rodamco-Westfield ((URW)) has signalled a tough outlook for shopping centres, noting conditions for retailers are getting harder, regardless of improving sales growth.

Earnings guidance has been reiterated for 2018 earnings in a range of EUR12.75-12.90 per share. This guidance was provided back in January, ex the integration of Westfield. Yet, the company has also indicated the acquisition of Westfield was accretive in 2018.

Dilution from asset sales completed during the year was greater than Unibail-Rodamco-Westfield expected, while there was a delay in project development and management revenue in London and California.

Macquarie suspects this has dragged on earnings and is the reason why there was no upgrade to guidance subsequent to the Westfield acquisition. Macquarie maintains an Outperform rating and \$16.29 target on the ASX-listed stock.

Meanwhile, the challenging environment for retailers is causing longer leasing discussions and retailers are becoming more cautious about new store openings.

Unibail-Rodamco-Westfield has disposed of eight assets this year with net proceeds of EUR1.79bn. The sales represented a blended net initial yield of 4.5%, sold at a weighted average premium of 8.1% to book value as of June 30, 2018.

Citi believes the operating performance of the business is sound, despite pressures in the retail market and remains reassured by the premium from the sale of these assets. The broker has a Neutral rating with a target price of EUR204.

Morgan Stanley acknowledges the company has a long history of selling assets and selling well, having sold EUR11bn worth of assets at 11%, on average, above book value in the last decade.

For many years, the stock has been a core holding for specialist investors in the property sector but, the broker observes, this has now changed and the shares are underperforming the sector by around 30%.

De-leveraging

The shares are also pricing in a rise in property yields, the broker points out. Higher property yields and, conversely, lower property values, could lead to de-leveraging.

The company, along with many of its peers, has geared against lower property yields and Morgan Stanley believes this could become an issue if the market forces these businesses to unwind that gearing.

Yields on continental malls stand at 4.3%, at the lower end of the 4.3-6.1% range over the last decade. The broker's main worry is that the company's portfolio will experience a negative structural re-pricing because future rental growth is likely to be below past levels.

Yet de-leveraging could also be achieved by the company retaining more of its earnings through development profits, as well as through the positive impact of rental growth. However, most recurring earnings are paid out in dividends currently and, the broker points out, development profits are reduced when yields rise.

Morgan Stanley has an Equal-weight rating and EUR165 target. Assumptions incorporated into the broker's base view include a gradual increase in yields to 30-40 basis points above the current valuation. This should allow the company to sell sufficient assets but also assumes that investment markets remains sufficiently liquid.

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CBA Going Back To Being A Bank

Commonwealth Bank is moving back to being a retail and business bank and brokers welcome the potential for capital management down the track.

-Regulatory and compliance headwinds being dealt with -Outlook still challenging as housing market weakens -Scope for capital management by 2020

By Eva Brocklehurst

Brokers concur that Commonwealth Bank ((CBA)) has made good progress on addressing the concerns raised during the Hayne Royal Commission, simplifying its business and improving credit quality.

Cash net profit in the first quarter was \$2.57bn, benefiting from lower impairment expenses. Revenue momentum appeared weak, with little or no growth in the quarter and, while costs were well managed, Ord Minnett notes there is a timing element because of lower investment spending. The broker was not surprised that net interest income was flat, given the revenue pressures flagged by other banks during reporting season.

Bell Potter observes the transition in the bank's business raises the issue of whether it has retained much of its original identity. Still the broker becomes positive in view of CBA mastering the myriad of changes that have been imposed in the last 12 months. Following the sale of CFS Global Asset Management, Commonwealth Bank should move back to being predominantly a retail and business bank.

The broker downgrades earnings estimates by around -4% from 2020, to exclude the CFSGAM earnings and maintains a \$73 target, with the value offset arising from an expected post-tax gain on sale of around \$1.5bn and the release of around \$2.9bn in CET1 capital. The broker, not one of the eight monitored daily on the FNArena database, maintains a Buy rating as the bank continues its transformation.

Operating income, excluding one-off items, was 1% higher as higher other banking income more than offset flat net interest income. Overall, troublesome exposures remained stable in the quarter, although impaired assets were up, which Bell Potter attributes to "usual mortgage stresses - presumably in WA and Queensland".

Capital Management

Credit Suisse likes the falling operating expenses and considers CBA to be the emerging story of the sector, as many of the regulatory and compliance headwinds have been or are being dealt with. The focus now is on cost reductions and capital. A CET1 ratio of around 11.2% in a dividend-paying quarter indicates capital management could be on the cards and Credit Suisse upgrades to Outperform from Neutral.

Morgans agrees credit quality remains sound and forecasts a CET1 ratio of 11.3% by the end of FY20, agreeing there is scope for capital management, given APRA's unquestionably strong benchmark is 10.5%.

UBS is more cautious about extrapolating quarterly trends but accepts business momentum is continuing. Expenses, while well managed, were aided by the timing of investment expenditure and software impairments in the prior half-year, and the broker expects higher costs will continue in FY19.

Assuming the completion of divestments, the pro forma CET1 ratio will rise by 120 basis points, which the broker suggests will push the ratio towards 11.8% by the first half of 2020, allowing for a \$5bn on-market buyback in its forecasts from late 2019. The outlook is still likely to be challenging, and potentially deteriorate as the housing market weakens.

Still, the core retail franchise is intact, although UBS retains a Neutral rating in the context of an overall cautious view on Australian banks.

Margin

The aspect of the quarterly update that most displeased Credit Suisse was the lower net interest margin, although re-pricing benefits are expected to take effect from the second quarter.

Morgans believes the bank is offering good value at the current share price and points to the net interest margin boost from the recent increase to all Australian variable home loan rates of 15 basis points. Household deposit growth was also strong in the quarter, at 8.9% annualised and the main driver was transaction deposits.

The broker also believes there are signs that front book home loan discounting in Australia has peaked and this is positive for the margin outlook. Deutsche Bank assesses the 3% growth required in the second quarter to meet its first half cash net profit forecasts is achievable, giving the upcoming benefit from mortgage re-pricing.

FNArena's database shows two Buy ratings, five Hold and one Sell (Morgan Stanley). The consensus target is \$73.95, suggesting 5.9% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 6.2% and 6.3% respectively.

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Is Domino's Guidance Becoming Stretched?

Sales momentum at Domino's Pizza slowed over the first weeks of FY19 while the numbers of stores being opened appear significantly behind schedule.

-Shares are trading as if the company will beat FY19 guidance -Strong second half skew required for new store openings to reach target -Question of whether profitability in France, Germany can be lifted sufficiently

By Eva Brocklehurst

Sales momentum has slowed for Domino's Pizza Enterprises ((DMP)) recently, particularly in Australasia, although trends are expected to improve as the benefits of a new menu are savoured.

Same-store sales for the first 17 weeks of FY19 were up 2.91% compared with over 5% growth previously. Japan slowed sharply to growth of 5%, with 12% growth over the first five weeks implying just 2.1% in the last 12 weeks.

Morgans suspects the upper end of underlying operating earnings (EBIT) guidance of \$227-247m is looking stretched. New menus may assist, particularly in Australasia, but the broker wants more clarity on top line momentum in order to be more confident regarding guidance. As the stock is trading over 10% above the target, Morgans downgrades to Reduce from Hold.

Citi, too, suggests the shares are trading as if the company will beat FY19 guidance and remains to be convinced. Macquarie continues to forecast significant earnings growth and believes the FY19 guidance range is conservative. The broker was pleased with the performance in Europe, given the parent company noted that region was negative in the three months to September as demand was affected by the hot summer.

Domino's Pizza can still grow its share of Australian takeaway, UBS asserts, forecasting market share of 5.9% by FY25 from 5.4% currently. This is despite the opportunities for aggregators, as these compete across only 10% of the takeaway market.

Morgan Stanley points out the company has signalled that higher food costs ensuing from the Australian drought will affect the business during the second half after benefits from lower cheese prices in the first half. Ord Minnett believes Domino's Pizza faces challenges given the slowing sales growth and the impact of Australia's drought on food costs.

Regional Divisions

In a departure from a trend of the last several years, no separate disclosure was provided for Australasia and Europe and Deutsche Bank wonders why the company was only providing more detail on the smallest division, Japan.

While Japan was singled out, Ord Minnett notes it was an undemanding comparable and there is a risk extrapolating trends, given infrequent pizza consumption in Japan versus other markets such as Australia.

UBS downgrades, to Neutral from Buy. The broker trims forecasts to reflect a greater skew to the second half. By division, the broker expects Japanese sales to be up 2%, Australasia to be flat and European sales down -3%. UBS continues to believe this is a good business with a strong earnings outlook but the latter is priced into the stock.

UBS also estimates European margins will not reach the target 25% by FY21, although the outlook is strong given the scale and industry consolidation potential. Germany and France will be key to hitting targets, as they are expected to drive around 80% of incremental store growth.

Store Targets

The company retains an expectation for rolling out 225-250 new stores in the current financial year. A strong second half skew is expected for new stores. Stores have increased by 36 so far, but management has noted that openings are more concentrated towards December and June.

Conversions of Hallo Pizza are ahead of expectations. Still, Citi believes the risks are building that new store roll-outs will be late in the fiscal year and make a smaller contribution to earnings.

Credit Suisse looks at the updates from the parent and other franchises that have indicated zero same-store sales growth in Europe. While European region has a volatile history, the broker is yet to find enough evidence that

profitability for franchisees in France and Germany can be lifted sufficiently to incentivise new store openings commensurate with targets.

As there are few competitor acquisitions available, targets need to be achieved almost entirely by organic means. The broker retains forecasts for new stores that are well below the company's target and points out, ultimately, it is store numbers the drive profitability.

Ord Minnett believes there is a higher risk is for negative same-store sales growth in France, a market where the potential may be significant but the execution difficult.

FNArena's database shows two Buy ratings, one Hold and five Sell for Domino's Pizza. The consensus target is \$49.09, suggesting 0.3% upside to the last share price. Targets range from \$36 (Deutsche Bank) to \$65 (Morgan Stanley).

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The Hottest Metal In The World Right Now

By Marin Katusa, Katusa Research

One of the trendiest metals on the tip of investors' tongues right now is vanadium.

The metal is named after Vanadis, a Norse goddess. Vanadium is very ductile, malleable and corrosion-resistant.

It's rare for vanadium to exist as a free element and it's usually found in minerals such as vanadinite, carnotite and magnetite. Thus, metallurgy is the key question when you find a large amount of vanadium.

Vanadium has incredible properties which increase the strength of alloys containing it, such as rebar which is heavily used in construction. China has just raised their steel rebar limits. Vanadium is also used in everything from jet engines to dental implants.

This past weekend I was down at the Katusa/Cambridge House Gold and Silver Summit in San Francisco. The main theme was precious metals, but I couldn't escape questions about vanadium.

Here's why...

Below is a chart which shows the price of vanadium over the past 3 years.

I've seen this type of small sector hype many times before. And so have you with lithium and cobalt.

Like those two niche metals, many "vanadium" stocks have spiked in price, returning doubles and triples in a short time. And some have even become 5 baggers in the month of October alone. Those kinds of gains are enough to hit everyone's radar screens. Traders, investors and "me-too" companies alike will start piling on the momentum train.

Here's what you need to know about Vanadium

Vanadium is a small, niche sector. In 2017, global consumption was roughly 95,000 tonnes (209 million pounds).

For comparison, in 2017 the world consumed roughly 23 million tonnes of copper (50 billion pounds). Below is a chart which shows annual vanadium consumption since 2007.

Vanadium is mainly used as a stiffening agent in steel. Around 90% of annual vanadium production is sold to the steel sector. This makes the 2 industries highly correlated. The majority of vanadium production comes from 4 countries: China, Russia, South Africa and Brazil.

So why is everyone getting excited?

There are a few reasons why the vanadium sector has been exploding.

Vanadium Excitement Reason #1: Steel demand and changes to Chinese building codes

The steel sector itself is correlated to the health and strength of economies around the world.

As economies expand and develop they need vast amounts of new infrastructure. A lot of this infrastructure requires steel, which in turn requires vanadium.

Building codes in China are edging closer towards building codes in places like the U.S. and Europe.

For example, in the U.S., you'll find steel has about 0.1 kilograms of vanadium (3.4 ounces) per tonne of steel. Whereas in China, you'd find a tonne of steel contains about 0.05 kilograms (1.7 ounces) of vanadium.

One of the main catalysts that spiked interest in the metal is new steel regulations that China will be imposing in November 2018.

The new Chinese regulations are phasing out Grade 2 rebar which uses no vanadium in favour of grades 3, 4 and 5. Each of these new rebar grades requires vanadium. The higher the grade, the more vanadium that is required.

Vanadium Excitement Reason #2: Utility scale battery storage

Renewable energy projects are springing up around the globe.

But the biggest issue with renewable power is that it is intermittent.

You can't generate much in the way of solar electricity in the middle of the night. That's why battery storage is so crucial to large scale renewable power. Think oil production before pipelines and rail takeaway. This is going to happen and will be a major game changer for electricity generation dynamics.

Vanadium flow batteries are now being pilot tested as a solution to industrial scale battery storage issues. But it is still very early stage.

If vanadium flow batteries do become a go to metal for utility size energy storage, it would open up a huge amount of new demand for vanadium.

Dirty Secrets in the Vanadium Sector

Just because the vanadium sector is small, doesn't mean that vanadium is rare.

Vanadium is actually fairly common, and can be found as a secondary metal in many types of deposits.

Most of these secondary deposits contain low grade vanadium mineralization. But at current vanadium prices, those marginal deposits become economic. Which opens up a plethora of new potential supply. This is very similar to the crappy/low grade copper and nickel projects which magically turned into cobalt projects last year.

You will see many crappy uranium projects now be touted as vanadium stories. It's neither cheap nor easy to produce a radioactive material. Buyer beware.

The second dirty secret is that there is actually a sizable amount of production capacity which is currently offline.

Total production capacity in the vanadium market is around 150-160 thousand tonnes per year. But right now, production is only around 95,000 tonnes.

A large amount of vanadium is produced through Chinese co-production facilities, which produce both steel and vanadium. Some of these facilities are currently shutdown or operating at lower capacity rates.

It's no secret China has a huge pollution problem. To curb some of these effects the government has forced the closure of several large steel and vanadium facilities.

Katusa's Vanadium Outlook and Play

I believe that both steel and battery manufacturers will want to secure a long-term supply of low cost, metallurgically recoverable (metallurgy that actually works) vanadium production in a non-AK47 nation that is friendly to mining.

I do like commodities that don't just depend on continued growth in China.

Vanadium has the benefit of growth demand from China. But the reality is, 30-40% of global vanadium demand is directly correlated to the Chinese rebar market. If Chinese rebar demand slows down or contracts, vanadium prices will pull back significantly.

In these niche markets it's important to not get too over exposed.

Be careful and invest only with speculative capital that you can truly afford to lose 100% of.

I've been looking for years for the right vanadium project. I have a database of every single deposit globally.

Do not invest in any projects that are using anywhere near current spot prices in their economics. I specifically asked a large producer of vanadium if he could get an off take at \$25 per pound, while vanadium was \$32 per pound and he couldn't lock in a hedge or off-take.

So, if you are going to play a niche market like vanadium, make sure you are using say \$15 per pound not the current \$30+ per pound spot price.

Also, make sure you invest with a management team that not only understands the niche metal markets, but have direct success in the niche markets. Just because you know how to finance or build a mine, doesn't mean you understand the complexities of the niche markets.

Niche markets are very different than the large commodities such as copper or gold.

katusaresearch.com

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Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday October 29 to Friday November 2, 2018 Total Upgrades: 22 Total Downgrades: 6 Net Ratings Breakdown: Buy 43.98%; Hold 42.30%; Sell 13.72%

If there is one conclusion that can be drawn from the week past it is that stockbroking analysts overwhelmingly see opportunities emerging in a shocked and beaten down Australian share market. October has been brutal on multiple accounts, but at least analysts are responding by issuing far more recommendation upgrades than downgrades for individual ASX-listed stocks.

For the week ending Friday, 2nd November 2018, FNArena registered no less than 22 upgrades and only six downgrades, with multiple stocks receiving multiple upgrades. Medium cap mining conglomerate Independence Group received three upgrades during the week, of which two went to Neutral/Hold.

Equally worth pointing out is that upgrades are coming thick and fast for ongoing "growth" stories in the share market, countering the narrative that has been dominating the Australian share market for weeks that the future is now all about "value" stocks outperforming in the face of rising global bond yields.

Beach Energy, Boral, Carsales, nib Holdings, and REA Group all received multiple recommendation upgrades during the week.

The six downgrades went to one automotive dealer, two gold producers, one wealth manager, an owner of shopping centres and one troubled engineering firm currently under threat of falling 100% into Belgian ownership. Maybe the double representation of gold is a sign in itself?

Target prices, they didn't move much on the upside during the week, with Northern Star and ResMed enjoying increases of 3.4% and 2.85% respectively, but others not worth mentioning. A clear negative is, however, the observation there are far more and deeper cuts to take note of on the opposing side of the ledger.

Biggest casualty for the week is the consensus price target for AMP, which fell yet another -24%. Apart from this well-known, idiosyncratic train wreck, Blackmores' target fell by -19%, followed by Lovisa Holdings on -9.99%, Boral on -5.68% and Automotive Holdings on -5.24%.

There was more encouraging news from changes in estimated earnings with the positive side equally showing large numbers. Top for the week goes to Alacer Gold, whose forecasts enjoyed a boost of 67% during the week, handsomely beating AMP (yes, you read that correctly), Perseus Mining, National Australia Bank (yes, indeed), ANZ Bank (idem), and Beach Energy.

Independence Group's three upgrades were countered by a -18% reduction in EPS estimates, followed by Orocobre on -12.3%, Northern Star, Senex Energy, Mineral Resources, and Wagners Holding Co.

With AGM updates ongoing, and the out-of-season financial reporting season heating up locally, the week ahead should see plenty of changes yet again, amidst ongoing events on the macro-calendar.

Upgrade

BLACKMORES LIMITED ((BKL)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/2/2

Share price weakness has brought the stock closer to fair value and Credit Suisse upgrades to Neutral from Underperform. The broker reduces the target to \$115 from \$130, given China's consumer sector has de-rated.

Critical to the broker's valuation is the assumption that direct Chinese sales growth in FY19 decelerates to 15% through to FY23, from 20%.

Sales in the first quarter were ahead of expectations while operating earnings (EBITDA) growth of 11% was close to the projected growth rate.

BORAL LIMITED ((BLD)) Upgrade to Buy from Neutral by Citi and Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 5/2/0

Citi observes Boral shares have sharply underperformed the broader market, largely because of concerns over the US housing cycle and disruptions caused by wet weather.

The company remains bullish on demand conditions. Boral has also reiterated a preference to fund a possible acquisition of USG's 50% stake via asset sales and debt.

Citi believes the stock is oversold and upgrades to Buy from Neutral. Target is clipped to \$7.00 from \$7.50.

A laundry list of weather events contributed to a weak performance in the September quarter yet Credit Suisse believes, weather-related delays aside, the opportunities in the Australian business remain strong.

The order book is robust and price increases are coming through in concrete and aggregates. Nevertheless, despite unchanged guidance, the company's task is becoming more difficult because of a moderation of the US housing market.

Credit Suisse upgrades to Neutral from Underperform, although maintains the view that a discount to fair value is justified because of the moderating end market outlook. Target is reduced to \$5.80 from \$6.40.

BEACH ENERGY LIMITED ((BPT)) Upgrade to Buy from Hold by Ord Minnett and Upgrade to Neutral from Underperform by Macquarie .B/H/S: 2/1/1

September quarter production growth and higher commodity prices generated strong cash flow and helped reduce debt in the September quarter. Ord Minnett calculates the company is trading on an annualised free cash flow yield of 17%.

FY19 guidance is reaffirmed, signalling the business is trending towards the upper end of the guidance range for production and earnings. Rating is upgraded to Buy from Hold. Target is steady at \$2.10.

The company reported stronger production and sales in the September quarter, offset by hedging losses and weaker pricing. Production is expected to come in at the upper end of FY19 guidance.

Macquarie upgrades to Neutral from Underperform and, at current levels, believes the stock is fair value, despite expecting a beat on production and earnings in FY19. Target is raised to \$1.65 from \$1.60.

CARSALES.COM LIMITED ((CAR)) Upgrade to Outperform from Neutral by Macquarie and Upgrade to Buy from Neutral by UBS .B/H/S: 6/1/0

The company has reported a slowing for Display and Stratton which has caused a softer financial performance in the first quarter.

The bias to the second half for earnings from the Display business signals to Macquarie that an improvement should be expected, although the basis for the assumption is not apparent. The second half bias for Stratton is based on operating improvements.

Macquarie, while aware of the near-term macro concerns, upgrades to Outperform from Neutral, envisaging broad-based earnings drivers including increased take up of premium/promote products. Target is \$13.90.

UBS makes modest earnings downgrades after the AGM update, which suggests FY19 core revenue growth is expected to be more moderate.

UBS reduces domestic core earnings growth forecasts to 6% but, with the benefit of the SK Encar acquisition, still expects the company to deliver headline earnings growth of 14%.

Nevertheless, the broker considers the valuation now undemanding and upgrades to Buy from Neutral. Target is reduced to \$13.50 from \$14.00.

CSL LIMITED ((CSL)) Upgrade to Accumulate from Hold by Ord Minnett .B/H/S: 4/4/0

Ord Minnett believes Seqirus, the company's flu vaccine, will be able to price Flucelvax at a premium to egg-based vaccines. This opportunity has come after CSL gained regulatory approval for its new manufacturing process that should deliver a doubling of output in FY20.

The broker believes the vaccine business will deliver FY20 EBIT comfortably in excess of the US\$200 guidance. Rating is upgraded to Accumulate from Hold and the target is raised to \$215 from \$201.

INDEPENDENCE GROUP NL ((IGO)) Upgrade to Buy from Neutral by Citi and Upgrade to Neutral from Underperform by Credit Suisse and Upgrade to Neutral from Underperform by Macquarie .B/H/S: 2/3/1

Citi acknowledges that downside risk is ongoing for nickel and copper in the face of US-China trade tensions but this is partly offset by gold's re-emerging sensitivity to geopolitical risk. Nova production was soft in the Sep Q, leading to a target price cut to \$4.70 from \$5.00, but the broker believes there is clear upside potential from Nova exploration.

Citi considers a -13% sell-off for Independence is overdone, and upgrades to Buy from Neutral.

September quarter production was in line with expectations. Credit Suisse notes there were no changes to FY19 budgets while a stronger second half for Nova should deliver lower unit costs.

Management has indicated its dividend policy is up for a review with a possible switch to a free cash flow pay-out from the first half of FY19.

The broker upgrades to Neutral from Underperform because of weakness in the share price. Target is steady at \$3.95.

Macquarie incorporates an underground development of Boston Shaker into its forecasts for Tropicana. Adjustments to grade profile means cuts of -1% and -10% to FY19 and FY20 production estimates.

The move underground will extend the life of the Tropicana project and improve the potential for exploration success at depth.

Rating is upgraded to Neutral from Underperform. Target is raised to \$4.30 from \$4.20.

IRESS MARKET TECHNOLOGY LIMITED ((IRE)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 2/3/0

The share price has fallen -15% in October and Ord Minnett now believes the valuation is compelling enough to warrant an upgrade to Buy from Hold. The broker now considers IRESS one of the cheapest stocks in the sector.

First half results were ahead of expectations and the commentary at the time suggested growth in the UK would accelerate in the second half. Target is reduced to \$11.73 from \$12.36.

LOVISA HOLDINGS LIMITED ((LOV)) Upgrade to Add from Hold by Morgans .B/H/S: 3/0/1

The trading update revealed a softer start to FY19 with like-for-like sales down -0.9%. Morgans suggests the volatility and weakness is likely to persist over the balance of the year but believes the rolling out of stores has potential as a positive driver of the business.

The broker believes 2019 will be the year the company takes a more assertive stance on the pilot market footprint. Rating is upgraded to Add from Hold.

The broker remains unconcerned about the short-term sales blip and emphasises the global growth potential and growing cash position. Target is reduced to \$8.06 from \$10.93.

MONADELPHOUS GROUP LIMITED ((MND)) Upgrade to Neutral from Sell by Citi .B/H/S: 1/3/1

Citi continues to envisage downside risk to FY19 earnings but upgrades to Neutral from Sell because of the improving outlook for core markets. Target is raised to \$13.95 from \$12.70.

The broker expects investors will look through the decline in FY19, anticipating earnings growth in FY20 and beyond. The maintenance division is expected to benefit from increased demand as LNG projects ramp up production.

The broker also believes Monadelphous will be able to capitalise on an expected increase in iron ore construction work in Western Australia, yet envisages risk to FY19 given any potential iron ore contract will contribute materially only in FY20, and competition remains in tense.

NANOSONICS LIMITED ((NAN)) Upgrade to Add from Hold by Morgans .B/H/S: 1/0/0

Because of market volatility and the resultant fall in the share price, which is down - 20% from its peak, Morgans upgrades to Add from Hold.

The broker expects new products to be launched over the next 18 months which will drive substantial growth in profit. Target is unchanged at \$3.32.

NIB HOLDINGS LIMITED ((NHF)) Upgrade to Add from Hold by Morgans and Upgrade to Neutral from Sell by UBS .B/H/S: 2/5/1

The company has upgraded FY19 profit guidance by 5.5% because of a benign claims environment. Morgans suggests previous guidance was always conservative and upgrades forecasts by 4-7% over FY19-20.

The recommendation is moved to Add from Hold. The broker believes the recent sell off in the shares has been overdone, particularly in light of the upgrade. Target is reduced to \$6.49 from \$6.77.

The company now believes net margins can be sustained at FY18 levels in FY19 despite lower premium rate increases.

Benefits are likely to be short lived, however, in the broker's view, as wider margins will add to mounting political pressure for lower premium rate increases.

Rating is upgraded to Neutral from Sell, as the broker envisages limited downside. Target is reduced to \$5.95 from \$6.10.

PERPETUAL LIMITED ((PPT)) Upgrade to Neutral from Sell by UBS .B/H/S: 0/7/0

The shares are down -31% in the year to date and UBS believes the downside is now limited, upgrading to Neutral from Sell.

The Corporate Trust and Perpetual Private divisions are on track and represent 58% of operating earnings versus 38% five years ago, as the company has diversified away from its stagnant Perpetual Investment earnings.

While net outflows will continue to affect the latter, the broker expects earnings elsewhere to grow by around 5% per annum.

As a result, UBS believes the stock offers fair value and the cash on the balance sheet provides strategic options. Target is reduced to \$33.50 from \$41.50.

REA GROUP LIMITED ((REA)) Upgrade to Accumulate from Lighten by Ord Minnett and Upgrade to Neutral from Sell by UBS .B/H/S: 4/3/0

Ord Minnett notes the share price has fallen -23% since peaking in August following the weak update from Domain ((DHG)). This formed the basis for a Lighten rating, exacerbated by global de-rating of technology stocks.

Ord Minnett now believes the correction has run its course and there is greater-than-expected growth in depth penetration, amid a soft property market.

While lowering first quarter estimates because of a steeper decline in listings, the broker envisages potential upside to its numbers. Rating is upgraded to Accumulate. Target is steady at \$79.

UBS reduces earnings estimates because of slower Premiere growth, particularly in NSW, as well as a view that house prices will decline around -10% from peak to trough.

FY19 and FY20 estimates for earnings per share are reduced by -2% and -4% respectively. Still, despite the reductions to expectations the broker believes REA Group is more resilient as the number one player, despite the soft housing environment.

Rating is upgraded to Neutral from Sell. Target is reduced to \$75 from \$80.

RESMED INC ((RMD)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 4/3/1

First quarter results were strong, with operating earnings up 28% and 13% above Credit Suisse estimates.

The broker believes growth in both the US and the rest of the world for flow generators stems from the company's connected care strategy and the data capabilities on its AirView and Brightree platforms.

Credit Suisse upgrades to Outperform from Neutral. Target is raised to \$15.10 from \$14.30.

WISETECH GLOBAL LIMITED ((WTC)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 2/2/0

The share price has fallen -27% in October, reflecting a broader sell-off in technology stocks. This is the opportunity Ord Minnett was waiting for.

Earnings have recently been upgraded and, while the stock still trades at a substantial premium to software peers, it is now modestly below the broker's valuation.

The broker believes the volatility presents an opportunity to take a stronger view on the growth story and the rating is upgraded to Buy from Hold. Target is raised to \$17.87 from \$17.00.

Downgrade**AUTOMOTIVE HOLDINGS GROUP LIMITED ((AHG)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 1/4/2**

Morgan Stanley has lowered forecast earnings for AP Eagers ((APE)) by -5-10% and for Automotive Holdings by -14-17% due to lower commissions, lower organic growth expectations based on falling vehicle sales, and sentiment around wealth effects. The broker sees house prices declining -10-15% from their peak, and thus vehicle sales -6%.

Morgan Stanley prefers AP Eagers to Auto Holdings and notes previous periods of falling house prices and vehicle sales have led to a de-rating for Auto Holdings, which the market is underestimating. The balance sheet is more constrained this time around. Downgrade to Underweight from Equal-weight, target falls to \$1.55 from \$2.50. Industry view: In line.

EVOLUTION MINING LIMITED ((EVN)) Downgrade to Hold from Add by Morgans .B/H/S: 3/5/0

Morgans observes gold production in the September quarter, if annualised, would be at the top of the projected range for the year. At the flagship Cowal mine work continued on the tails leach project with some success with high-grade exploration reported.

Meanwhile, treatment of stockpiles will continue at Mt Rawdon with a focus on the stage 4 pit cutback. The board has also approved the underground mine development at Mt Carlton.

Rating is downgraded to Hold from Add, given the rise in the share price. Morgans envisages the primary risk to valuation comes from the gold price, with the copper price less significant. Target is raised to \$3.28 from \$3.17.

OCEANAGOLD CORPORATION ((OGC)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 4/2/0

Credit Suisse expects production is on track to deliver on full year guidance, supported by a surprise contribution in the September quarter from the previously-unknown high-grade breccia ore.

This, in all likelihood, was added to the Didipio production schedule to offset the weaker-than-expected result from Haile.

The broker retains a positive outlook but downgrades to Neutral from Outperform on valuation. Target is raised to \$4.00 from \$3.80.

PENDAL GROUP LIMITED ((PDL)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 2/3/1

Weak equity markets are expected to affect growth in funds under management and could potentially affect industry flows to equities. Credit Suisse notes Pendal Group is overweight equities.

The broker downgrades to Underperform from Neutral because of these near-term headwinds. Hambro performance fees are likely to be lower for longer, the broker suspects.

Earnings forecast for FY19-20 are lowered by -12-14%. Target is reduced to \$7.10 from \$9.00.

SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP ((SCP)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 0/3/2

The stock has re-rated, Ord Minnett believes, because of its superior operating results compared with other retail portfolios, as well as relatively predictable earnings growth.

Pricing on the assets acquired from Vicinity Centres ((VCX)) was also favourable. The broker continues to believe the portfolio is well-positioned with an attractive return on capital and relatively low risk.

As the stock is trading in line with the target, steady at \$2.70, the rating is downgraded to Hold from Accumulate.

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

Watpac has received an off-market takeover bid from BESIX, which currently has a 28.1% stake. The board has unanimously recommended the offer and it has been deemed fair and reasonable by an independent expert.

Morgans had suggested previously that an earnings-led recovery in the share price would take time and, therefore, believes shareholders should accept the offer. A superior offer, while possible, is considered unlikely.

The broker downgrades to Hold from Add. The target is raised to \$0.92 a share, in line with the offer price, from \$0.86.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 BEACH ENERGY LIMITED Neutral Sell Macquarie 2 BEACH ENERGY LIMITED Buy Neutral Ord Minnett 3 BLACKMORES LIMITED Neutral Sell Credit Suisse 4 BORAL LIMITED Buy Neutral Citi 5 BORAL LIMITED Neutral Sell Credit Suisse 6 CARSALES.COM LIMITED Buy Neutral Macquarie 7 CARSALES.COM LIMITED Buy Neutral UBS 8 CSL LIMITED Buy Neutral Ord Minnett 9 INDEPENDENCE GROUP NL Neutral Sell Macquarie 10 INDEPENDENCE GROUP NL Buy Neutral Citi 11 INDEPENDENCE GROUP NL Neutral Sell Credit Suisse 12 IRESS MARKET TECHNOLOGY LIMITED Buy Neutral Ord Minnett 13 LOVISA HOLDINGS LIMITED Buy Neutral Morgans 14 MONADELPHOUS GROUP LIMITED Neutral Sell Citi 15 NANOSONICS LIMITED Buy Neutral Morgans 16 NIB HOLDINGS LIMITED Buy Neutral Morgans 17 NIB HOLDINGS LIMITED Neutral Sell UBS 18 PERPETUAL LIMITED Neutral Sell UBS 19 REA GROUP LIMITED Neutral Sell UBS 20 REA GROUP LIMITED Buy Sell Ord Minnett 21 RESMED INC Buy Neutral Credit Suisse 22 WISETECH GLOBAL LIMITED Buy Neutral Ord Minnett Downgrade 23 AUTOMOTIVE HOLDINGS GROUP LIMITED Sell Buy Morgan Stanley 24 EVOLUTION MINING LIMITED Neutral Buy Morgans 25 OCEANAGOLD CORPORATION Neutral Buy Credit Suisse 26 PENDAL GROUP LIMITED Sell Neutral Credit Suisse 27 SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP Neutral Buy Ord Minnett 28 WATPAC LIMITED Neutral Buy Morgans Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 BPT BEACH ENERGY LIMITED 25.0% -25.0% 50.0% 4 2 IGO INDEPENDENCE GROUP NL 8.0% -42.0% 50.0% 6 3 CAR CARSALES.COM LIMITED 86.0% 57.0% 29.0% 7 4 REA REA GROUP LIMITED 50.0% 21.0% 29.0% 7 5 BLD BORAL LIMITED 64.0% 36.0% 28.0% 7 6 NHF NIB HOLDINGS LIMITED 13.0% -13.0% 26.0% 8 7 LOV LOVISA HOLDINGS LIMITED 50.0% 25.0% 25.0% 4 8 WTC WISETECH GLOBAL LIMITED 50.0% 25.0% 25.0% 4 9 IRE IRESS MARKET TECHNOLOGY LIMITED 40.0% 20.0% 20.0% 5 10 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 70.0% 50.0% 20.0% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 NST NORTHERN STAR RESOURCES LTD -43.0% -7.0% -36.0% 7 2 OGC OCEANAGOLD CORPORATION 58.0% 75.0% -17.0% 6 3 AVN AVENTUS RETAIL PROPERTY FUND 33.0% 50.0% -17.0% 3 4 PDL PENDAL GROUP LIMITED 17.0% 33.0% -16.0% 6 5 EVN EVOLUTION MINING LIMITED 31.0% 44.0% -13.0% 8 6 AHG AUTOMOTIVE HOLDINGS GROUP LIMITED -21.0% -8.0% -13.0% 7 7 SCP SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP -40.0% -30.0% -10.0% 5 8 ALL ARISTOCRAT LEISURE LIMITED 79.0% 81.0% -2.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 NST NORTHERN STAR RESOURCES LTD 8.157 7.886 3.44% 7 2 RMD RESMED INC 15.080 14.662 2.85% 8 3 MND MONADELPHOUS GROUP LIMITED 14.365 14.157 1.47% 6 4 WTC WISETECH GLOBAL LIMITED 18.600 18.383 1.18% 4 5 CSL CSL LIMITED 215.325 213.575 0.82% 8 6 OGC OCEANAGOLD CORPORATION 4.667 4.633 0.73% 6 7 BPT BEACH ENERGY LIMITED 1.885 1.873 0.64% 4 8 EVN EVOLUTION MINING LIMITED 3.029 3.015 0.46% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 AMP AMP LIMITED 2.853 3.791 -24.74% 8 2 BKL BLACKMORES LIMITED 113.000 140.000 -19.29% 4 3 LOV LOVISA HOLDINGS LIMITED 9.953 11.058 -9.99% 4 4 BLD BORAL LIMITED 7.113 7.541 -5.68% 7 5 AHG AUTOMOTIVE HOLDINGS GROUP LIMITED 2.317 2.445 -5.24% 7 6 AVN AVENTUS RETAIL PROPERTY FUND 2.227 2.315 -3.80% 3 7 PDL PENDAL GROUP LIMITED 9.650 9.967 -3.18% 6 8 IGO INDEPENDENCE GROUP NL 4.392 4.533 -3.11% 6 9 CAR CARSALES.COM LIMITED 15.519 15.889 -2.33% 7 10 SFR SANDFIRE RESOURCES NL 7.440 7.597 -2.07% 7 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 AQG ALACER GOLD CORP 3.260 1.949 67.27% 4 2 AMP AMP LIMITED 23.157 20.200 14.64% 8 3 PRU PERSEUS MINING LIMITED 3.580 3.280 9.15% 3 4 NAB NATIONAL AUSTRALIA BANK LIMITED 228.543 210.214 8.72% 8 5 ANZ AUSTRALIA & NEW ZEALAND BANKING GROUP 232.750 217.486 7.02% 8 6 BPT BEACH ENERGY LIMITED 22.333 20.900 6.86% 4 7 FMG FORTESCUE METALS GROUP LTD 39.259 36.744 6.84% 8 8 OGC OCEANAGOLD CORPORATION 29.869 28.665 4.20% 6 9 NHF NIB HOLDINGS LIMITED 77.368 76.117 1.64% 8 10 ILU ILUKA RESOURCES LIMITED 76.936 75.836 1.45% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 IGO INDEPENDENCE GROUP NL 20.828 25.432 -18.10% 6 2 ORE OROCOBRE LIMITED 13.824 15.766 -12.32% 8 3 NST NORTHERN STAR RESOURCES LTD 55.383 60.685 -8.74% 7 4 SXY SENEX ENERGY LIMITED 1.620 1.760 -7.95% 5 5 MIN MINERAL RESOURCES LIMITED 140.733 152.033 -7.43% 3 6 WGN WAGNERS HOLDING COMPANY LIMITED 15.770 16.837 -6.34% 3 7 WSA WESTERN AREAS NL 15.670 16.580 -5.49% 7 8 SFR SANDFIRE RESOURCES NL 72.757 76.413 -4.78% 7 9 LOV LOVISA HOLDINGS LIMITED 38.020 39.920 -4.76% 4 10 IFL IOOF HOLDINGS LIMITED 65.600 68.800 -4.65% 5 Technical limitations

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Uranium Week: Producer Power

Cameco's guidance on intended purchases prompted another step-up in the uranium spot price last week.

-Cameco reveals buying intentions -Spot price rises yet again -Forward curve narrowing

By Greg Peel

Canada is the world's second largest producer of uranium and Canadian-listed Cameco is the world's largest corporate producer of uranium. Or at least it was, until the company temporarily but indefinitely slashed production in the face of non-commercial prices.

Rather than producer uranium at a loss, Cameco has spent the year buying uranium on the spot market to satisfy delivery contracts. The company's September quarter earnings report, released last week, showed a year on year drop in uranium production of -52% to 1.5mlbs U3O8, but a 15% increase in sales volumes to 10.6mlbs. Sales averaged US\$30.18/lb or -7% less than last year.

Producer purchases, along with investor interest, has driven the uranium spot price up 27% above the 2017 average price, with the impact more noticeable in past weeks. The question is: How long will Cameco and others keep buying in uranium for before the price is sufficient to restart production?

Cameco has not revealed that price, but it did reveal at its result release that it intends to buy another 1-3mlbs in the spot market through to year-end and a further 10-12mlbs in 2019.

The spot market was quiet for most of the week as market participants attended the annual International Uranium Fuel Seminar in Boston, and industry consultant TradeTech's spot price indicator remained unchanged. Right up until Friday, when Cameco released its report.

TradeTech's weekly spot price indicator closed up US80c on Friday at US\$28.80/lb on 2mlbs of U3O8 equivalent changing hands during the week, most of it on Friday.

Flattening Curve

The month of October ended Wednesday, at which point the spot indicator was US\$28.00/lb, up from US\$27.65/lb at end-September. A total of 47 transactions were recorded in the month, representing 6mlbs U3O8 equivalent.

Increased activity in the spot market has come at the expense of the term markets. The bulk of requests at present is for 2019 delivery, which counts as spot, or mid-term delivery, while interest in longer term delivery has gone quiet, TradeTech notes. There are term market tenders out there but last month saw little action.

The result is the gap between spot and term pricing is continuing to narrow. TradeTech's end-October mid-term price indicator of US\$30.00/lb remains unchanged from end-September, and spot is closing the gap fast, while the consultant has lowered its long-term indicator to US\$30.00/lb as well, down from US\$31.00/lb.

At this rate, the market will be in backwardation by next year. That might spark up some utility interest.

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The Short Report

Guide:

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

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

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

Summary:

Week ending November 1, 2018

Last week began with the ASX200 still correcting, but then came the sharp bounce.

In the prior couple of weeks, as the correction played out, I had noted that the plunging market had sparked little in the way of profit-taking on short positions. Well it appears the shorters were either expecting more downside, or were poised to cash in on any sign of a turnaround, or both.

There is an awful lot of green on the table below, and some big moves in percentage point terms.

The stocks with the biggest short reductions include JB Hi-Fi ((JBH)), BWX ((BWX)), Super Retail ((SUL)), all of which held AGMs last week, and IOOF Holdings ((IFL)), which provided a quarterly update.

Other big movers, for which there was no specific news last week, include Inghams Group ((ING)), Nine Entertainment ((NEC)) and CSR ((CSR)). CSR's earnings result came out earlier this week. Yesterday Ingham's announced a capital return.

All these stocks rate as "Movers & Shakers" for the week, and I will highlight the actual short position changes below. Those holding AGMs did see direct market responses, good or bad, but in the context of the market in general bottoming out, we might assume it was a rush to lock in profits before it was too late that drove most of the short-covering.

As an aside, we note AMP ((AMP)), which fell -25% at the beginning of last week, saw only a slight short reduction, to 5.5% from 6.3%.

We might also note that while Corporate Travel Management ((CTD)) has been under siege recently from a short-side hedge fund, its short position was recorded last week as only 4%.

Weekly short positions as a percentage of market cap:

10%+

ORE 16.5 GXY 15.8 JBH 15.8 SYR 15.8 IVC 12.0 DMP 11.6 MYR 11.1 BWX 10.6 NXT 10.2

Out: ING, MTS

9.0-9.9

GEM, MTS, SDA

In: MTS Out: CSR, IFL, NEC, SUL, NUF, HVN 8.0-8.9%

HVN, NWS, NUF, BAL, LYC, NAN, KDR, GXL

In: HVN, NUF, KDR

7.0-7.9%

PLS, MND, FLT

In: FLT Out: KDR, BOQ, AAC

6.0-6.9%

AAC, MLX, HT1, SUL, IFL, RSG, BKL, IGO, MSB

In: SUL, IFL, AAC, BKL Out: FLT, AMP, BIN, SIG, SEK

5.0-5.9%

GMA, BIN, SIG, BGA, KAR, AMC, ING, VOC, APT, CGF, CCP, A2M, AMP, CLQ, CSR, CAB, MOC, PTM, RCR, ASL, RFG, ALX, NEC, AHG, CQR

In: ING, CSR, NEC, AMP, BIN, SIG, ASL, RFG, CQR

Out: BKL, NWL, GNC, MYO, SGM

Movers & Shakers

JB Hi-Fi shorts fell to 15.8% from 19.8%. AGM trading update was positive.

BWX shorts fell to 10.6% from 12.3%. Trading update was negative.

Super Retail shorts fell to 6.5% from 9.3%. Trading update was negative.

IOOF shorts fell to 6.4% from 9.9%. Broker responses to a trading update were mixed. We might note IOOF is basically a share market proxy.

Inghams shorts fell all the way to 5.8% from 13.1%. Last month the company appointed a new CEO. Yesterday a capital return was announced. No news last week.

CSR shorts fell to 5.5% from 9.9%. Last week saw brokers tweaking forecasts ahead of this week's earnings result, which was a net miss of broker forecasts.

Nine Entertainment shorts fell to 5.0% from 9.7%. The company does not have to worry about poor cricket ratings but it is in the process of merging with Fairfax Media ((FXJ)). It was last month when Nine provided more details of merger expectations.

ASX20 Short Positions (%)

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

IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

Often large short positions can be attributable to a listed hybrid security on the same stock where traders look to "strip out" the option value of the hybrid with offsetting listed option and stock positions. Short positions may form part of a short stock portfolio offsetting a long share price index (SPI) futures portfolio - a popular trade which seeks to exploit windows of opportunity when the SPI price trades at an overextended discount to fair value. Short positions may be held as a hedge by a broking house providing dividend reinvestment plan (DRP) underwriting services or other similar services. Short positions will occasionally need to be adopted by market makers in listed

equity exchange traded fund products (EFT). All of the above are just some of the reasons why a short position may be held in a stock but can be considered benign in share price direction terms due to offsets.

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

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

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

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

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

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The Wrap: Health, Housing, Auto And PRRT

Weekly Broker Wrap: health insurers; housing; automotive dealers; airlines; PRRT; Security Matters; and Netwealth.

-Catalysts ahead in private health insurance carry downside risk -Household de-leveraging expected to restrain spending growth into 2019 -Headwinds persisting for automotive dealerships -Woodside most affected by changes to PRRT

By Eva Brocklehurst

Health Insurers

The private health industry is facing substantial challenges, with Macquarie assessing that over 85% of funds could have insufficient excess capital in order to sustain two consecutive years of a 2% price cap.

Margins in the largest states are improving but premiums per policyholder are increasing more in states where participation is slipping the most. The earnings gap between the for-profit and not-for-profit funds almost doubled in FY18, which the broker suggests raises the chances for different capital rules to be imposed.

The next catalysts for the industry carry material downside risks, Macquarie believes. These include the April 2019 price increases, first half earnings results and the outcome of the federal election, due by May 2019.

Current valuations appear supportive but the broker does not believe all the catalysts are completely priced into consensus estimates and maintains a Neutral rating for both Medibank Private ((MPL)) and nib Holdings ((NHF)).

While UBS assesses the insurers are in good shape it cannot say the same for consumers or hospitals. A soft claims environment appears to have continued into FY19, positively skewing the risk to margins in the near term, although the broker acknowledges the conditions are unsustainable over the medium term.

Medibank Private has made progress in stemming its market share losses but this could prove challenging, in the broker's opinion, should the tailwind from taking share from Bupa moderate. UBS retains a Sell rating on the stock with a Neutral rating for nib Holdings.

More broadly, the sustainability challenge is highlighted by the virtual absence of any growth in policy numbers. The broker also questions whether the historical margin cap of 5.6% will prove irrelevant in a soft claims environment.

Housing

While the broader economic impact of sliding house prices has been limited to date, Morgan Stanley believes household de-leveraging will restrain spending growth into 2019. National house prices are now down -4.6% in the year to date, nationally, and auction clearance rates and sentiment have also weakened sharply.

Surveyed house price expectations have now fallen to record low levels. Meanwhile, construction appears to be responding to weaker prices and tighter credit, with a declining trend in both apartments and detached houses.

A further consideration is the proposed changes to negative gearing and capital gains tax discounts being mooted by the ALP ahead of next year's federal election. Morgan Stanley assesses the policies as positive for affordability and negative for prices and turnover.

The broker considers the decline in house prices a catalyst for de-leveraging and a meaningful headwind for bank revenues and consumer spending. However this is not necessarily recessionary while global growth and public expenditure are supportive.

Automotive Dealers

Australian car sales fell -5.3% in October 2018. All states deteriorated besides Tasmania. Passenger car sales continued to lead the decline, down -24% and partly offset by an 8% rise in sports utility vehicles.

UBS believes reductions in house prices are continuing to affect new car sales. When adjusting sales by each dealership over the 12 months, in each state, the broker estimates new car volumes over July-October, combined, were down -8.8% for Autosports Group ((ASG)) and -6.6% for Automotive Holdings ((AHG)).

The broker believes it will be difficult for Autosports to grow like-for-like volumes because of the macro outlook although, given the improving earnings and minimal exposure to flex commissions, estimates new car revenues could fall -5% and still hit FY19 estimates.

Meanwhile, Automotive Holdings has headwinds from its exposure to the slightly faster rate of decline in new car sales in Western Australia as well as the ongoing effects of regulatory changes that, UBS estimates, could reduce finance commissions by -25%.

Wilsons believes WA held up reasonably well in the latest figures as it cycled strong growth, albeit remains cautious about the near-term outlook for Automotive Holdings as there are no notable catalysts for a recovery in consumer activity in WA.

The broker downgraded its outlook for dealerships following the July figures and believes the latest three months justifies the revised outlook. Wilsons assesses conditions remain more favourable for AP Eagers ((APE)).

Airlines

Domestic passenger growth for airlines slowed in September, with Sydney Airport ((SYD)) reporting a decline of -0.5%. Ord Minnett calculates, using bookings data from Travelport, that yields for Qantas ((QAN)) across key international routes were down -1.9% in August from a year ago. The broker notes Qantas reported domestic passenger yields increased by just 3.6% in the first quarter versus 7.0% in the prior corresponding quarter.

The broker admits the analysis focuses on just a handful of routes but believes both Qantas and Virgin Australia ((VAH)) are facing headwinds and a challenging operating environment a missed increased competition, weak demand, excess capacity and higher fuel costs. The broker has a Sell rating for Qantas and Lighten rating for Virgin Australia.

PRRT

The Australian government has responded to the Callaghan review of the Petroleum Resource Rent Tax (PRRT), reducing uplift rates over the next 10 years to Long-Term Bond Rate (LTBR) +5% from the current LTBR +15% for all production licenses granted after July 1, 2019. Historical exploration will continue to be uplifted at the prior rate and switch on July 1, 2019 to the new rate.

The government will also remove the obligation for all onshore projects. Companies had been using onshore credits to reduce PRRT on profitable offshore projects. A 12-18 months review on how LNG projects use transfer pricing to reduce PRRT obligations will also be conducted.

Macquarie envisages Woodside Petroleum ((WPL)) will be most affected by the changes, as Scarborough could potentially lose -15% of its value and the impact could be even larger for Browse, as a compounding effect of the tax shield will be diminished with the project being further away from first production.

The bigger concern is the gas transfer pricing review, which could delay projects and potentially reduce future earnings. Oil Search ((OSH)) is unaffected by the changes as its operations are in PNG and the US.

The changes are relatively modest compared to what the industry feared, Credit Suisse points out. The broker envisages a negligible impact on Woodside's earnings, for the next five years at least, and no impact on the North West Shelf. The impact on Pluto/Wheatstone is expected to be limited and there is modest impact for Scarborough and Browse.

The changes do not materially affect the broker's base case valuation. Credit Suisse concurs that the transfer pricing review into integrated LNG projects remain a more material risk to the value of existing LNG projects.

Security Matters

Security Matters ((SMX)) has a technology which can be used to mark products during the packaging and production process. Such products can be tracked throughout the supply chain to the end customer.

TMT Analytics suggests, by invisibly marking branded products and packaging, product authenticity can be guaranteed by retailers, noting losses from counterfeiting alone are in excess of US\$500bn globally. The company, an Israeli B2B business, recently listed on ASX and TMT Analytics values the stock at \$1.13 a share, initiating coverage with a Speculative Buy rating.

Netwealth Group

Wilsons was concerned that the trading multiples of Netwealth ((NWL)) would not accommodate a broadening of price-led competition after BT Panorama cut platform administration fees.

However, the broker is increasingly of the view that incumbent platforms will need to open up to external providers to appease the Hayne Royal Commission. This would significantly increase the addressable market for Netwealth. Removing previous discounts leads Wilsons to double upgrade to Buy from Sell. Target is \$8.49.

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Wagners Anticipates Flat Earnings In FY19

A gap in major projects in the first half has meant earnings for concrete business Wagners will be skewed to the second half and likely to be flat over FY19.

-Market may have over-reacted to the reference to "challenges" -Main concerns centre on ability to secure concrete work with higher margins -Significant customer will be lost in FY20

By Eva Brocklehurst

The weather has played havoc with the performance of Wagners Holding Co ((WGN)) and, hence, expectations for FY19. The company has downgraded forecasts at its AGM, citing gaps in project work in its key state of Queensland.

Few major new projects getting off the ground means first half earnings will be down and a stronger second half will simply lead to a more balanced or 'flat' FY19. Projects such as Sydney's cross-city tunnel are still committed, although the timing is uncertain.

Credit Suisse believes the market has seemingly over-reacted to the company's reference to "challenges" which is likely to refer principally to the commencement of the Southern Cross cement import terminal, which is well understood and theoretically priced in to the stock.

The continuation of the sell-off in the share price, Morgans suspects, is partly attributable to the lack of visibility on FY20 trading. While major projects will be forthcoming, competition is also increasing. Still, the broker finds it hard to envisage Wagners is ex growth.

Revenue growth is being sustained from increased contributions from lower-margin divisions and Morgans emphasises the lumpy nature of infrastructure projects that are prone to delays. Ultimately, the broker believes Wagners is well placed as a low-cost producer in south east Queensland and can achieve earnings growth in FY20.

Macquarie is more cautious about the outlook, as there is limited visibility on the pipeline of projects and the potential for margin compression. Given peer trading multiples, the broker envisages potential for further de-rating. The main concerns centre on the ability to secure the concrete work that attracts higher margins.

The slow recovery in Queensland for infrastructure and a tight fiscal position in that state indicates that volumes could remain somewhat challenged. This in turn reinforces the broker's concerns regarding the top line and earnings certainty.

Wilsons found the trading update rather ambiguous and was surprised by the lack of quantitative guidance, as the end of the first half is less than two months away. The broker's revised forecasts reflect a first:second half split of 60:40%.

Wilsons estimates concrete products and precast concrete are the most affected divisions and there are some lingering concerns regarding medium-term earnings. This is largely emanating from sector concerns regarding infrastructure delays and the increasing costs of cement grinding. The company also faces the loss of a significant customer, Neilson Group, in FY20.

Beyond Neilson

Credit Suisse models the loss of the entire 100,000t of cement volumes supply to the Neilson Group. Yet, the company has a growing base and there are several upside opportunities that may drive a step change to earnings in coming years.

The most immediate is the Anadarko LNG, targeting an investment decision in the first half of 2020. This alone could almost double the company's operating earnings (EBIT), providing annual revenue of over \$100m and margins above 30%.

Wagners did not provide an update on the Mozambique project. Revenue of \$200m is expected with operating earnings' margins of 30-50%. Whilst margins appear attractive, Wilsons suspects this project may involve a high degree of risk.

The broker, not one of the eight monitored daily on the FNArena database, points out contractor-derived earnings are increasing while construction materials-derived earnings are declining, and this will be particularly evident in

FY20. Moreover, this is not factored into current valuation multiples.

Wilsons maintains a Sell rating and \$2.95 target. FNArena's database has two Buy ratings and one Sell (Macquarie). The consensus target is \$3.60, suggesting 3.8% upside to the last share price.

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Treasure Chest: Treasury Wine Oversold

FNArena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Several brokers point out there is more to Treasury Wine than just China and the recent sell-off may be overdone.

-US market changes may be a significant growth opportunity -US should receive more luxury wine, boosting margins
 -Acquisition opportunities abound in the US

By Eva Brocklehurst

Slowing demand in China has preoccupied investors recently but Treasury Wine Estates ((TWE)) boasts more than just China among its earnings drivers, and these may be under-appreciated.

Morgan Stanley believes the sell-off on the back of growth concerns emanating from China is overdone. China has been the greatest contributor to the company's earnings growth recently so, when macro economic indicators weaken, investors become, understandably, cautious.

One of the drivers for Treasury Wine, Morgan Stanley observes, is the lift in the price of the Penfolds range. The increase in the median recommended retail price was 11.1% at the annual launch in October.

The broker also expects Maison de Grand Esprit margins may be approaching those of Penfolds and expects this brand to continue expanding as the company secures greater supply. A similar opportunity is also expected with the new Italian portfolio that was launched in September.

While reflecting slower growth in China in its forecasts, Morgan Stanley still expects 18% compound growth in earnings per share from FY19-21. The broker envisages little risk to FY19 guidance for 25% growth in operating earnings (EBITS) and upgrades to Overweight from Equal-weight, with a target of \$20.

On the other hand, Citi wonders whether earnings risks are building. The value of Australian bottled red wine exports to China fell -24% in the September quarter versus growth of 106% a year ago. Citi suggests the large growth numbers in the prior year imply the outlook is flat at best. This is a growth business, the broker acknowledges, but that growth and margin expansion is expected to moderate.

Deutsche Bank points out that the data signalling exports to China slowed materially is based on Wine Australia's report, and the Chinese business of Treasury Wine constitutes a large portion of that data. Citi concurs, in this respect, that demand for wine in China has largely been driven by a switch to imports not by per capita consumption growth.

US Wine

Macquarie is increasingly convinced about the margin improvement that is likely in the US. This is a significant growth opportunity for Treasury Wine, as changes to the route to market will deliver control over around 25% of its US distribution. Successfully executing distribution changes will deliver margin upside of around 2-2.5% in FY20, on the broker's calculations.

While execution risk is high in the mandated US three-tier distribution structure, recent feedback from the industry implies that Treasury Wine has laid a strong foundation for success. In comparing Treasury Wine with Constellation Brands, Morgan Stanley is confident that the company can lift its margins in the Americas over the long-term. Constellation Brands makes 20% more profit per litre than Treasury Wine, despite achieving a 12% lower average selling price per litre.

US wine distributors make margins of 16-20% on average and occasionally as high as 30%. Macquarie calculates a reinvestment rate of 50% would allow Treasury Wine to build the business and invest in assets & branding. The broker believes, as the business already has a sales, marketing & distribution team, reinvesting half of the distributor margin is realistic.

Along the same lines Morgan Stanley suggests, as Treasury Wine benefits from its investment in winemaking and luxury conversion capabilities, the US business should receive a greater allocation of luxury wine and this, in turn, should boost margins. The company also has an ability to build new brands in the US such as 19 Crimes, which in FY18 was a 2m case per annum brand.

Meanwhile, the stock has underperformed the market by -12% in the three months to October 30 and its multiple has de-rated to a five-year low, Macquarie points out. The broker also expects the company to remain on the acquisition trail, with the principal focus on the US.

While a deal is unlikely until the route-to-market changes are finalised, the broker estimates an acquisition of the likes of Ste Michelle, owned by Altria, would be around 6% accretive to earnings, assuming a 15:85% debt:equity funding structure. A combination of the recent sell-off and increased confidence leads Macquarie to upgrade to Outperform from Neutral, raising the target to \$18.22.

FNArena's database shows four Buy ratings, two Hold and one Sell (Citi). The consensus target is \$18.40, suggesting 16.2% upside to the last share price.

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When Uncertainty Is The Only Certainty

In this week's Weekly Insights:

-When Uncertainty Is The Only Certainty -Rudi On Tour

When Uncertainty Is The Only Certainty

By Rudi Filapek-Vandyck, Editor FNArena

"There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again." [Jesse Livermore, legendary speculator]

After an unusually savage October sell-off, the subsequent bounce-back rally has been rather mild and unconvincing in character, raising the obvious question: is there a message in there somewhere about the future direction of risk assets?

To some with a negative mindset, and on my observation there is a growing number of bears out there, the answer is unequivocally affirmative. The weak bounce, these expert voices argue, is but another bad omen for what the future holds for global investors in risk assets.

I am not yet convinced by this argument, as there simply is too much uncertainty out there to allow for a quicker and bolder move upwards. Within this context, I'd suggest it would have been rather surprising if equity markets by now had rallied strongly at a time when corporate results in the US are rather lukewarmly received, while stress is rising in Europe, the Federal Reserve is about to provide an update, bond yields are on the rise (again), and all eyes are on deteriorating indicators for the Chinese economy.

We also have mid-term congressional elections in the US this week and here the short term outlook is actually positive. Below is a chart released by Tracey McNaughton, global strategist at Wilsons this week. It shows that, irrespective of the outcome, US equity markets have always rallied post the mid-term elections; at least going back as far as 1950.

Hence if history repeats we should see the return of positive momentum later in the week, which no doubt is what short term traders are looking forward to. For investors looking beyond this week, however, there is no certainty but for the fact that uncertainty remains a key ingredient for financial markets, and is likely to remain exactly that for the weeks ahead.

In Australia, the banks' financial results have been "encouraging", at least for the short term, but for the fact they were not worse than feared, but these results are not good enough to trigger a sharp rally, potentially dragging the rest of the market along. Banks are the most and closest researched sector of the local market, by a long way, thus hoping for something substantially better than what the crowd is already anticipating almost never pays off.

Share prices of domestic banks look cheap, yes they do. But a lot more is needed to re-rate the sector and within the present context that simply does not seem feasible. Investors should note the best the Big Four can do under the circumstances is keep costs contained and pay out a flat dividend. In contrast, Macquarie Group ((MQG)) has no such operational restraints, again lifting guidance for the full year with analysts confident guidance for 10% growth can still be beaten.

Compare the pair, and draw your own conclusions. But I'd add: if you ever wonder why "value" investors are having such a hard task at hand, the evidence is right in front of us. Macquarie versus ANZ/CBA/NAB/WBC/BOQ/BEN. The riddle to solve is only too difficult for those who refuse to see.

Meanwhile, profit warnings from the likes of Wagner Holding Co ((WGN)) are yet more evidence it isn't easy for local investors to position for the boom in infrastructure spending that will underpin domestic GDP in the next three years, while investors are visibly truly uncomfortable with the outlook for housing, and the flow-on effect for Australian households' spending next year, and possibly beyond.

Note the yield on ten-year US Treasuries only fell marginally as equities tanked in October, and it's back to 3.20% alongside the relief rally. The threat of more mayhem because of rising bond yields is not going away in a hurry.

For investors (as opposed to short term speculators) the general context is that calendar year 2018 remains on course for the worst annual performance since the GFC for many an investor across the globe. US equities have become the last asset holding up, whereas others have faltered along the way, and even US indices are finding it tough to remain in positive territory as the end of year beckons, with a smaller number of stocks providing positive support.

Investors in Australia like to bemoan the fact local shares seldom are able to keep up with the US, but they certainly would not like to swap with peers in Germany, Italy, Hong Kong or China, to name but a few (far) less attractive alternatives. Global equities ex-USA peaked in the first quarter of 2017 already and the number of positive performances since has gradually reduced.

This development has escaped most investors in Australia because the local share market remained until recently among the few ongoing up-trending share markets. The trend was brutally broken during the October sell-off, which also pushed year-to-date performance, including dividends, into the negative, albeit only marginally.

Now consider the stats published by Deutsche Bank this week. Of the 38 assets monitored, only four (4) managed to escape a negative performance in October. Gold, UK government bonds, German government bonds and one share market: the Bovespa in Brazil, as investors welcomed the new strongman as the country's freshly elected president on the perception he'll put in place business friendly policies.

All this implies, of course, that just about everyone has been losing money in October, regardless whether portfolios were tilted towards US treasuries, credit, commodities, energy or equities. The only real saviours turned out to be cash and gold. US bonds, including high yielding corporate bonds, only helped to stem losses through lesser negative returns, but returns for the month were still negative regardless.

October's sell-off also pushed an additional five assets into negative return year-to-date with the total in assets still positive now reduced to nine, in local currency terms (see table below). Year-to-date Australian equity markets are down -0.5% on a total return basis (meaning: in local currency, including dividends, as at the end of October) while Australian 10-year government bonds are up 2.65% (all through coupons), the main credit bond index is up 2.64%, and the AUD has fallen -9.4% against the USD. Again: not too bad on a relative comparison.

In light of the public debate about whether October's sell-off is but the opening salvo for the next emerging bear market, or not, maybe the better question to consider is whether the global bear market for risk assets already started sometime back in 2017, and a shrinking group of assets, including equities in Australia and in the US, are only now starting to fall in-line with the rest?

Even if the answer to that question turns out positive, with hence negative consequences for the Australian share market, this need not automatically become a repeat experience of 2008, but I suggest keeping an open mind, preparing for potential scenarios to both upside and downside from here onwards seems but the prudent strategy to employ right now.

In terms of the shorter term outlook for the Australian share market, a study by Longview Economics into share market corrections of at least -10% since May 1928 might provide us with a blueprint of sorts of what to expect in the weeks, if not months ahead.

Longview's analysis has over the period identified 19 such "crashes" and only one (April 1937) did not follow the pattern of a severe sell-off, followed by a relief rally, subsequently followed up by another sell-off so the underlying message here seems clear: be prepared for another leg to the downside, exact timing unknown.

Equally interesting, and I am sure you'll all agree with me on this one, is there's more than a 50% chance the second sell-down might go deeper than the first, but usually the extra percentages to the downside remain quite limited, with Longview setting the range between -0.1% & -3.9%. In a small number of cases, there is another rally higher, which then is followed-up by yet another test of the earlier lows established during the two prior sell-offs.

While history seems to provide a pretty straightforward pattern (with one exception to date), there is no guidance on timing or duration for the various stages or the full process. Sometimes the relief rally is only short and selling resumes within a few days, whereas in 1962 it took the US market 85 trading sessions (circa four months) to revisit the low point of the first sell-off.

Special note: Longview excluded from its analysis the heavy sell-offs that led to protracted bear markets further down the road.

Readers who missed my recent updates might also like to read:

-What Beyond The Rally

-Could This Be The Start Of Something Different

-Out With The Garbage

-Investing Used To Be So Much Easier

Alternatively, paying subscribers can simply visit Rudi's Views on the website; the archive goes back more than ten years.

Rudi On Tour

-ASA Parramatta, on November 14, 5.30-7pm

Rudi On Tour In 2019

-ASA Inner West chapter, Concord, Sydney, March 12 -ASA Sydney Investor Hour, March 21 -ASA Toowoomba, Qld, May 20 -U3A Investor Group Toowoomba, Qld, May 22

(This story was written on Tuesday 6th November 2018. It was published on the Tuesday in the form of an email to paying subscribers at FNArena, and again on Thursday as a story on the website).

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