Week
28

Stories To Read From FNArena
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Contents

Woolworths Fuels Value

A new deal with Caltex prepares Woolworth's fuel business for sale, but broker responses are mixed.

-Expanded joint venture locks in better wholesale fuel prices for Woolworths Petrol business -Caltex stations will join loyalty scheme and offer discounts on Woolworths dockets -Caltex will open Metro brand convenience stores and buy Woolworths wholesale food

By Nicki Bourlioufas

Woolworths ((WOW)) and Caltex ((CTX)) announced on July 5 they have sealed a 15-year strategic alliance that will expand five aspects of their joint venture: fuel supply, convenience stores, wholesale food, docket discounts on petrol and loyalty rewards. Analysts' reactions were mixed, noting that the deal strengthens Woolworths' Petrol business in readiness for a sale but Caltex has paid handsomely for greater certainty over medium-term earnings.

Woolworths closed at $30.66 after the announcement, in which the company said it would continue to pursue an IPO or sale of its Petrol business. Citi raised its price target to $32.90, but cut its rating from Buy to Neutral given the stock's recent performance. Ord Minnett maintained its Accumulate but raised its target from $31 to $32.50. Morgan Stanley was most pessimistic, rating Woolworths Underweight with a target of $23, arguing that the petrol division could be less attractive as the 15-year term "will limit a future owner's flexibility" and its operating performance "may suffer as the future ownership remains unclear".

Caltex closed at $32.60. Citi maintained its Buy but cut its price target from $37 to $36. Ords maintained its Hold but increased its target slightly to $27.38. Morgan Stanley was again noticeably bearish, rating Caltex Underweight with a target of $26.

Caltex hands over $80m a year to keep fuel supply deal

Woolworths will pocket about $80m a year from the lower margins Caltex charges it on fuel. Caltex will also pay $50m to re-write the deal, which will be amortised over the life of the contract. In return, Caltex gets the removal of "change of control" clauses, which formerly allowed Woolworths to cancel the contract if it sold the business.

Citi says Woolworths' Petrol division is now worth about $2.4bn, compared to the $1.8bn offer that BP abandoned at the end of the 2017. For Caltex, Citi says, the deal is essentially "an expensive insurance policy" that maintains a competitive position in both the wholesale and retail markets. While Caltex will sacrifice $80m a year in wholesale margin, this is less than the $150m loss that was expected if it lost the supply contract.

Convenience stores and wholesale food a neat fit

The joint venture will establish 250 convenience stores at Caltex sites under Woolworths' Metro banner over the next six years, starting with 50 sites over the coming two years. Caltex will fund and operate the stores, and pay Woolworths a royalty for use of the Metro name. Citi estimates the royalty at $20,000 per store per year. Woolworths will supply wholesale groceries to the 250 new stores, as well as Caltex's non-Metro stores.

Citi estimates the sale increase from supplying wholesale groceries to Caltex stores at a relatively small $10m. "The supply chain economics of a convenience store network are more challenging on a unit cost basis due to a higher share of tobacco in the sales mix and smaller delivery sizes to each store." However, the addition of the 700-plus Caltex stores will improve economies of scale at Woolworths Food division, and this will be felt "materially" over time.

Fuel discounts and reward cards entice shoppers into Woolworths' orbit

The deal will add 125 Caltex petrol stations to the network of sites giving a petrol discount of 4 cents per litre. With Woolworths already operating 534 petrol stations, this brings the network of stations offering discounts to 658 sites compared to 1,008 Woolworths supermarkets. This is closer to the ratio enjoyed by Coles, which had 712 petrol stations and 806 supermarkets in the first half of 2018.

The benefits of the fuel discount are also expected to flow through to the Food division, as more motorists fill up at a Caltex station then shop at a Woolworths-supplied convenience store. Citi estimates sales will rise about 3% at the supermarkets located near a petrol station that redeems discounts. The Woolworths loyalty scheme will be expanded to give Rewards points to motorists buying fuel and merchandise at more than 700 Caltex stations across Australia.

FNArena's database shows three Buy (or equivalent), ratings for Woolworths, three Hold and two Sell. The consensus target is $28.48, suggesting -7.1% in downside to the last share price. Targets range from $23 (Morgan Stanley) to $32.50 (Ord Minnett).

FNArena's database shows five Buy ratings for Caltex, one Hold and one Sell. The consensus target is $36.29, suggesting 13.2% in upside to the last share price. Targets range from $26 (Morgan Stanley) to $40.80 (Credit Suisse).

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Nickel Outlook Key To Independence Group

Independence Group is keen to discover more nickel and its quality product from Western Australia is sought after, providing a positive outlook for FY19.

-Ideally placed to benefit from tightening nickel market -Significant cash flow forecast for FY19 -Yet valuation remains an issue for most brokers

By Eva Brocklehurst

FY18 production fell short of Independence Group's ((IGO)) guidance but brokers were not overly concerned and acknowledge the efforts the company is making to expand its nickel profile.

Credit Suisse observes the FY19 exploration budget for the two key assets, Nova and Tropicana, indicate a desire to discover more nickel. This supports the company's intention to invest capital and improve nickel payability (the percentage of the London Metal Exchange nickel price paid for ore).

Independence Group is ideally placed, several brokers suggest, to benefit from a tightening nickel market and higher prices, amid a bullish outlook on the take-up of electric vehicles.

UBS notes the Nova mine has a 10-year life and low costs, while free cash flow suggests a 13% yield for FY19. Ord Minnett expects demand from lithium ion batteries to grow to 205,000t in 2025, from 20,000t in 2017, and account for 8% of global nickel demand.

Despite this outlook, nickel appears to be one of the few commodities that is trading below its long-run real average price, although new sources of supply will be at higher cost and technically challenging.

Ord Minnett expects the nickel market will remain in deficit beyond 2018 as higher prices are required to incentivise new supply. The broker upgrades long-term nickel price forecasts to US$9/lb and is upbeat about the prospect for the nickel market and the strategic position of Independence Group.The company produces high-quality concentrate for a growing market and has an offtake agreement with BHP ((BHP)) to supply feed to the Western Australian Nickel West smelter. A sufficient return on this investment, for BHP, requires the smelter to operate efficiently beyond 2020, when the current offtake agreements expire.

This puts Independence Group and associate Western Areas ((WSA)) in the box seat, as their products are key blending items for the low-quality Mt Keith feed. Both sell 50% of their offtake to Nickel West and 50% to China.

In turn this supports, Ord Minnett believes, the potential for the companies to push for higher payability. The broker resumes coverage of Independence Group with an Accumulate rating.

The main issue for brokers is the valuation of the stock and, hence, UBS retains a Neutral rating. A combination of upside for the nickel price, higher payability and an extension to mine life is considered already factored in.

UBS calculates that assuming a US$10/lb long-term nickel price, 80% nickel payability and a 1.5x NPV multiple on Tropicana, the valuation would only lift to meet the prevailing share price.

Canaccord Genuity, not one of the eight stockbrokers monitored daily on the FNArena database, retains a Sell rating and $4.00 target on valuation grounds, although acknowledges the significant cash flow that is forecast for FY19, which should maintain the appeal for investors that want a low-risk exposure to diversified metal production.

Production

A soft March quarter left a stretched target for the following June quarter at both Nova and Tropicana. Nova production for FY18 was 22,300t, below guidance of 23-27,000t. The main problem was the mill liner at the processing plant but this is being replaced and management does not believe it will be an ongoing issue.

Grades improved in the quarter and mining rates were also above nameplate. This points to better production potential and a sustained performance going forward, UBS assesses. The next catalyst is an update for reserves.

Following an infill drilling campaign the company has been working on optimising Nova, yet nickel, copper and cobalt output were -7%, -4% and -16% lower than Macquarie's forecasts, respectively. The broker cuts earnings estimates for FY18 by -20% while making no changes to FY19.

At Tropicana FY18 gold sales for the company's 30% stake totalled 138,700 ozs. Here production was also lower than Macquarie expected. The softer result versus estimates reflected throughput that was -2% lower and milled head grade that was -3% lower.

Meanwhile, the transition to care and maintenance at Long occurred as planned. Production was 20% above Macquarie's expectations and ceased in May.

Targets

Independence Group has reached an agreement to acquire the Southern Hills tenements in the Fraser range. These tenements are contiguous to the Nova mining lease and the company has identified a number of drill-ready targets.

Independence Group will pay Creasy Group $21m to earn a 70% interest in the tenement and will then fund exploration through to a feasibility study. Dilution rights could mean the interest eventually increases to 95%, although this would require the Creasy Group to withdraw post the completion of the feasibility study.

In May, the company increased its equity interest in Orion Minerals ((ORN)) to 11%. Orion intends to use the proceeds to drill test copper-nickel-cobalt targets in South Africa as well as fast track the re-start of the Prieska zinc-copper project.

The database shows one Buy rating (Ord Minnett), four Hold and two Sell for Independence. The consensus target is $4.84, signalling -4.4% downside to the last share price. Targets range from $4.20 (Credit Suisse) to $5.40 (Ord Minnett).

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Value In Magellan Financial?

Recent acquisitions have supported growth in funds under management for Magellan Financial in the second half of FY18, although brokers disagree regarding whether this is the right time to buy the stock.

-Retail flows return to positive territory, albeit slightly -Near-term outlook driven by market rather than organic contribution -Are more acquisitions needed?

By Eva Brocklehurst

Fund flows are improving for Magellan Financial ((MFG)) and several brokers consider the valuation support is now better after the June quarter. Funds under management increased 20% in the second half, underpinned by the Airlie acquisition, positive markets and net inflows.

Retail flows returned to positive territory in June after three months of outflows. Credit Suisse suspects those outflows were temporary and triggered by investor fatigue as well as the pullback in equity markets in the March quarter, which caused some re-allocation away from equities in the retail channel.

Positive institutional inflows also concealed some outflow from the Airlie product during the half year. Funds under management for the half year to June were $69.5bn with retail sustaining -$56m in outflows and institutional $1.34bn in inflows.

Credit Suisse believes concerns regarding future flows are overstated, as there has been only temporary weakness in retail flows amid further capacity for existing institutional clients. Upside also exists if the company can leverage its distribution and build the Airlie retail business.

Morgans downgrades to Hold from Add, suggesting the retail flows are not reflecting the investment performance and instead reflect lower industry growth, heightened competition and the maturity of the company's traditional distribution channels.

The broker acknowledges the slight outflows of the retail channel, if sustained, are not material to the earnings outlook but may result in a sustained de-rating to the stock's historical valuation.

Growth Outlook

Morgans also cites a relatively low performance fee contribution, believing the near-term outlook is driven by market direction as opposed to organic growth drivers. The broker prefers to accumulate the stock closer to when organic growth returns, or there is any meaningful volatility.

In contrast, Credit Suisse considers the stock is trading at one of its cheapest points since its recent acquisition success. The stock is trading on a 13.7x the 12-month forward earnings per share estimate, and at almost a -17% discount to the market.

Hence, the broker reiterates an Outperform rating and believes the company should benefit over the medium term from a correction in Australia's underweight allocation to global equities.

UBS agrees the stock offers compelling value despite a more mature growth phase. As the key equity and infrastructure funds outperform benchmarks over the second half, the broker upgrades estimates for FY18 earnings by 3.3%.

The company's Global Fund outperformed benchmarks by 1.81% in the half year while the Infrastructure Fund outperformed by 3.01%.

Morgans accepts some growth options exist in the balance sheet along with the recent acquisitions of Airlie Funds and Frontier Partners. Airlie is expected to raise retail funds in the near term and this should add some growth.

Nevertheless, from a "bottom-up" growth perspective the broker believes the US low-carbon strategies need to attract meaningful flows, which requires increased confidence, or maybe further acquisitions are needed.

The database shows two Buy ratings, two Hold and one Sell (Morgan Stanley). The consensus target is $25.61, signalling 6.4% upside to the last share price. This compares with $27.46 ahead of the quarterly update.

Targets range from $20.00 (Morgan Stanley) to $28.00 (UBS, Credit Suisse). The dividend yield on FY18 and FY19 forecasts is 4.4% and 4.8% respectively.

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Uncertainties Put A Brake On Pendal

Several uncertainties prevailing in the June quarter delivered a mixed performance for wealth manager Pendal Group and brokers remain cautious for the year ahead.

-JO Hambro reports third consecutive quarter of outflows -Asia ex-Japan strategies perform particularly poorly -Trade war rhetoric may have affected sentiment

By Eva Brocklehurst

The share price of wealth manager Pendal Group ((PDL)) dived after a mixed June quarter report and brokers expect the stock to remain under pressure in the near term, given several uncertainties and the pending sell-down by Westpac ((WBC)).

Market movements and the performance fees more than offset net outflows and currency movements, Ord Minnett notes, while the JO Hambro division, historically the driver of flows, reported its third consecutive quarter of outflows, not seen in almost seven years of ownership.

The outflows were primarily in the European segment, Global Select and Asian open-ended investment company funds and strong flows have emanated from US pooled funds.Funds under management (FUM) at the end of June were $100bn, an increase of 1% on the prior quarter and 6% on the same period last year. Westpac redemptions were around -$400m, related to the reconfiguration of the MySuper portfolio. Accrued performance fees also deteriorated, with only $6.9m crystallising in June, Credit Suisse observes.

UBS forecasts -$4bn in net outflows for the company in FY18 and envisages significant downside risk to performance fee expectations over FY19-20. Nevertheless, as the stock has de-rated the emerging risks appear priced in and this supports a Neutral rating.

Ord Minnett also expects the share price will trade below historical valuation in the near term, as Westpac has announced an intention to sell its remaining 10% stake in the business.

The master relationship agreement with Westpac, which represents more than $10bn in FUM, is due for fee reviews at the end of the year. The broker is also cautious about the cost base, as branding is transferred to Pendal from BT.

JO Hambro

The -$1.1bn in outflows for JO Hambro disappointed most brokers but the division remains the driver of growth going forward because of its large FUM base that is subject to performance fees.

On a positive note, JO Hambro's retail outflows progressively improved throughout the June quarter and Credit Suisse suspects that the outflows in Europe may have been, in part, driven by an asset class rotation rather than performance.

Conversely, the broker points out the Asia ex-Japan strategies are performing particularly poorly and now experiencing outflows that could continue for some time.

Not only do continued fund outflows pose downside risk to earnings estimates, Credit Suisse suggests this will also prevent a PE re-rating. Hence, despite modest valuation appeal the broker also sticks with a Neutral rating.

Morgans downgrades to Hold from Add and believes a number of uncertainties including the prospect of further outflows, higher costs and potential sell down by Westpac will weigh on sentiment.

The broker agrees the major risks for outflows in the near term stem primarily from Asia ex-Japan, given the continued underperformance, as well as the UK Opportunities Fund, which also underperformed and sustained a change of manager.

There are both opportunities and risks in the domestic business arising from the increased independence of advice firms and while this aspect is relatively balanced at this stage, Morgans is mindful of the FUM managed on behalf of Westpac which previously attracted trailing commissions that have now ceased.

Bell Potter does not believe the current flows are that abnormal in the prevailing environment, nor that a long-term trend is being established. Rather, the broker suspects trade war rhetoric has affected sentiment and positive flows should return at some point in the year ahead.

Meanwhile, the stock is considered historically cheap and the broker, not one of the eight stockbrokers monitored daily on the FNArena database, retains a Buy rating with a $14.80 target.

There are two Buy ratings and four Hold on the database. The consensus target is $10.88, signalling 19.2% upside to the last share price. Targets range from $9.75 (Credit Suisse) to $12.00 (Morgan Stanley). The dividend yield on FY18 and FY19 forecasts is 5.5% and 5.9% respectively.

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Material Matters: Copper, Nickel & Lithium

A glance through the latest expert views and predictions about commodities. Copper; nickel; cobalt & lithium; and coal.

-Tightness expected to linger in copper despite slowing growth -Higher prices likely required for nickel supply to keep up with demand -Oversupply looms for cobalt & lithium. Time for de-stocking? -Market may need to review thermal coal price outlook

By Eva Brocklehurst

Copper

Copper is widely used and hence its sensitivity to growth expectations is high. ANZ analysts point out the immediate effect of the US/China trade dispute was restricted to those metals directly affected by US import tariffs, namely steel and aluminium, but this has now escalated. The dispute now includes the technology and automotive sectors, which raises some concerns.

These developments are taking place amid signs that global growth is slowing. The main drag on ANZ's global growth index comes from the European area. EU manufacturing is affected by protectionism and trade concerns.

Growth has also showed signs of weakening in some of China's sectors. One of these is the power transmission network, a key consumer of copper.

The analysts do not envisage inventory will build significantly but whether this has any material impact on grid investment needs monitoring. China's credit environment is also tightening and this may start to dampen demand from manufacturers of semi-finished copper. Meanwhile, risks of supply disruptions are elevated. Unions are planning a 24-hour stoppage within the next two weeks at the Codelco Chuquicamata copper mine in Chile. At nearby Escondida BHP Billiton ((BHP)) and the unions remain locked in negotiations.

The analysts expect copper markets to record a deficit in 2018 and the tightness to linger into 2019, despite the slower economic growth. A fall in copper scrap imports should also boost demand for imported copper in China, particularly refined metal.

Nickel

Nickel's leverage to the growth in electric vehicles has mushroomed despite it being a mature base metal market. Ord Minnett expects the nickel market to remain in deficit beyond 2018, while higher prices are required to provide the incentive for new supply to keep up with the demand growth.

Nickel is also one of the few commodities that is trading below its long-run real average price and the new sources of supply are expected to be both higher cost and technically challenging. The broker forecasts long-term nickel prices of US$9/lb.

While BHP remains non committal regarding its Nickel West asset, it is investing, the broker observes, to maintain the business and prolong the mine life as well as develop downstream facilities.

A sufficient return requires the smelter to operate efficiently beyond 2020, when the current Independence Group ((IGO)) and Western Areas ((WSA)) offtake agreements expire. The products from these two companies are key blending ingredients for low quality feed to Mt Keith, and the long-term value of Nickel West relies on short-term business risks being resolved.

Ord Minnett believes it imperative that Nickel West secures these offtakes so the two companies are in a position to push for higher payability. Ord Minnett resumes coverage on Independence Group with an Accumulate rating and upgrades its rating for Western Areas to Hold from Sell.

Cobalt & Lithium

Macquarie envisages massive oversupply versus implied electric vehicle demand for both cobalt and lithium. Participants up and down the supply chain are starting to acknowledge that panic-led rallies in both metals have resulted in large stocks being accumulated.

The broker suggests now is the time for de-stocking, as Chinese electric vehicle sales are set to fall sequentially while subsidies are adjusted. Exacerbating this situation is expectations for further rapid growth in mine supply.

Macquarie remains bearish and expects downside for both cobalt and lithium prices in the medium term. The broker suggests discrepancies in demand and supply lie with the timing of metal consumption versus end-use consumption.

Production of electric vehicle batteries is taking place well in advance of deployment into vehicles, and some consultancies have suggested that over a year of lead time is currently factored in to the market.

Too much supply from new and returning mines is set to come to market, putting cobalt into difficulties from next year while lithium should already be in surplus. Hence, the broker observes the price is, deservedly, beginning to respond to the weakening fundamentals.

Coal

Newcastle 6,000cal coal has surged to US$115/t, a record premium of 46% over the 5,500cal high-ash coal price. Credit Suisse is not sure what this premium reflects. The market for high-grade has been tight but probably not so tight for this particular coal.

The broker suspects, somewhere, high-price cargoes have been bought, although this could just be traders caught out trying to meet contracts. While a South African shortfall initiated the rally Newcastle has now run on beyond Richards Bay.

Yancoal and Glencore, having taken control of Rio Tinto's ((**RIO**)) former NSW coal operations, now dominate Newcastle supply. Given their dominance, Credit Suisse questions whether the Newcastle price really reflects supply and demand.

If, as a large Indonesian producer suggested, the Newcastle price is whatever Glencore decides, the price might hold at high levels for longer than it should. Still, the broker interprets the failure of Japanese contract negotiations to indicate this current price is too high.

Credit Suisse suspects a reasonable price remains higher than the market anticipates, and perhaps forecasts need to be reconsidered. Consensus for the next financial year is for US$83/t.

The broker understands Glencore headed into the Japanese contract negotiations seeking a three-digit price while Japanese buyers wanted a price below US$95/t. As the contract negotiations failed this signals Japan, being the biggest buyer of 6,000 cal coal, remains willing to pay US$94/t for thermal coal for a year.

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Material Matters: Oil, Gold And Silver

A glance through the latest expert views and predictions about commodities. Oil; aluminium; gold; and silver.

-Political risk premium for oil likely to climb -Little downside risk but significant rebound unlikely for aluminium -Gold benefits from equity weakness although US dollar remains a headwind -Cuts to Chinese solar subsidies bode poorly for silver

By Eva Brocklehurst

Oil

RBC Capital Markets observes proliferating supply outages will make it extremely challenging for OPEC to satisfy President Trump's demand that it puts more barrels on the market. Libya's oil outage rose with the closure of the Hariga and Zueitina terminals and this, the analysts suggest, effectively removed nearly all eastern oil crescent exports from the market. As of last night, Libya is flagging the recommencement of production.

Fears centre on President Trump tapping strategic reserves if oil prices stay firm ahead of the upcoming mid-term elections, triggering a fall in prices. The effectiveness of such a reserve release would be judged by whether refiners could absorb the additional barrels. US Gulf refiners are running at near all-time high levels.

Meanwhile, the analysts suspect the political risk premium for oil will continue to climb, as a first set of sanctions on Iran are put back in place in around a month. The analysts believe it will be nearly impossible for European leaders to offer anything meaningful to Iran in order to retain the nuclear deal, given exposure of their corporates to US markets.

They envisage a real risk of Iran resuming suspended nuclear activities by the end of the northern summer.Aluminium

The imposition of tariffs by US and China across a range of products has coincided with the start of softer demand for aluminium, leaving it vulnerable to a sell-off. Morgan Stanley notes the fall in the price of aluminium has pushed it back to marginal cost at around US$2,100/t from a peak of US$2,541/t during the April disruption related to Rusal.

The broker acknowledges the price weakness might be surprising given the disruption in the markets but points out there has not been a global shortfall this year, and estimates a global market surplus of 1.07mt in 2017. Inventory built up in Russia in April is also now being released to the market and this is further weighing on the price.

Given cost pressures on both smelters and refineries, Morgan Stanley envisages little more downside risk to the aluminium price, although a significant rebound through the weak summer months is also unlikely.

Meanwhile further up the supply chain, alumina refineries are also under pressure, particularly in China, amid plans to cut -770,000 tpa of capacity as the local bauxite price rises following government closures of illegal mines. This reduces the likelihood of a substantial correction in alumina prices in the near term, the broker suggests.

Gold

Both gold and silver stabilised over the past week, ahead of last night, helped by a pause in the US dollar's ascent as some doubts were cast on the hawkish outlook for US official interest rates. However, Macquarie expects imminent inflation data, likely to be firm, could rebuild the hawks' confidence in gold.

RBC Capital Markets observes gold has benefited from both equity weakness and weakness in US interest rates, although the US dollar remains the headwind and a prime mover of the yellow metal. The analysts are beginning to witness some weak upside risk versus forecasts but remain of the view that there needs to be a significant risk-off event to spark a wave of gold allocations.

Meanwhile, Australian gold miners continue their strong quarterly themes, Macquarie noting both St Barbara ((SBM)) and Perseus Mining ((PRU)) produced exceptional production results. The former reported a record result for the June quarter with 119,400 ozs of gold across Gwalia and Simberi. Perseus reported strong preliminary production estimates from both Edikan and Sissingue.

Resolute Mining ((RSG)) is also driving cost savings with automation at the underground sub-level cave at the Syama project. Meanwhile, the ramp up of Dacian Gold's ((DCN)) Mount Morgans is on track. Macquarie expects Mount Morgans to be positive for cash flow over the second quarter of FY19.

Silver

Macquarie observes silver has been knocked to its lowest price in seven months by fears of a trade war and a reduction in Chinese solar subsidies. The broker believes the sell-off has gone far enough, although the case for significant upside has been damaged.

The fears of a trade war took their toll on the market after the US imposed tariffs on US$35bn of Chinese goods in June. While silver did not fare as badly as some base metals it was nevertheless affected.

Another policy decision in June was more specifically bad for silver, the broker asserts. This was the announcement by China of potentially large and comprehensive cuts to its solar subsidy regime. If implemented, this would imply reductions equivalent to about one fifth of total global installations and a large impact on silver demand.

Silver was affected by these two negative factors just as other negatives - an ebbing US dollar rally and the first quarter slowdown in global industrial growth - faltered. Macquarie highlights that, despite the potential and existing threats to industrial demand for silver, the metal is actually maintaining most of the gains it achieved against gold from April to June.

Assuming the US dollar has stabilised, the broker does not envisage more downside for silver and, if trade wars recede, then there should be some upside. However, speculative positioning does not point to an immediate bounce and a strong recovery does not appear imminent to the broker.

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 July 2 to Friday July 6, 2018 Total Upgrades: 6 Total Downgrades: 10 Net Ratings Breakdown: Buy 44.69%; Hold 40.28%; Sell 15.03%

Unsurprisingly, the positive momentum in the Australian share market has triggered more downgrades than upgrades for ASX-listed stocks from stockbroking analysts. For the week ending Friday, 6th July 2018 FNArena registered six upgrades versus ten downgrades.

Four of the six moved to Buy with Atlas Arteria, FlexiGroup, Iluka Resources and Sigma Healthcare all enjoying an extra Buy rating. Four of the downgrades shifted to Sell with Domino's Pizza receiving two of those. The other receivers of a fresh Sell rating were ASX and Magellan Financial Group.

Plenty of positive movements in consensus price targets with Reliance Worldwide grabbing the lead for the week (+6.8%), followed by FlexiGroup, Iluka Resources, and Western Areas. The negative side only contains a small number of stocks, but the negative adjustments are huge. Sigma Healthcare -hardly a surprise- suffered the heaviest blow post loss of a major distribution contract, followed by Aveo Group, then Galaxy Resources.

The table for positive revisions to earnings forecasts is pretty much an all-resources affair with Syrah Resources on top, followed by Western Areas, Newcrest Mining, Orocobre, Santos, and Alumina ltd. The flipside has Perseus Mining receiving the biggest negative adjustment, followed by Sigma Healthcare, Atlas Arteria, and Galaxy Resources.

The local corporate calendar remains thin, but confession season continues to draw out bomb shells in the local share market, predominantly among small caps, with macroeconomic matters dominating in a global risk off environment that ironically has benefited Australian equities over the past two months or so.

Any sector updates on energy or mining should provide ongoing positive momentum to most stocks involved.

Upgrade

ATLAS ARTERIA ((ALX)) Upgrade to Add from Hold by Morgans .B/H/S: 5/1/0

Atlas Arteria, formerly Macquarie Atlas Roads, has made its final performance fee payments to Macquarie Group ((MQG)), from which it was originally spun off. Of the $115m paid, $90m was raised by issuing scrip to Macquarie at a 5% premium to yesterday's close, eliciting exclamation from Morgans. The balance was paid in cash.

Morgans has adjusted for the payment/raising and updated forex forecasts, noting particular exposure to the euro. Target rises to $6.76 from $6.53 and on a 10% plus forecast total shareholder return, the broker upgrades to Add from Hold.

BEACH ENERGY LIMITED ((BPT)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 1/4/1

Beach Energy has reported a "material increase" in its oil and gas reserves and Ord Minnett has taken the view this event clarifies the medium-term production growth profile, hence an upgrade to Hold from Lighten.

From this moment onwards, the company's production volumes are expected to remain around current levels, explain the analysts. Target price lifts to $1.80 from $1.40. Forecasts have received a substantial shot in the arm, but DPS estimates have fallen.

CIMIC GROUP LIMITED ((CIM)) Upgrade to Hold from Sell by Deutsche Bank .B/H/S: 1/3/1

Deutsche believes CIMIC's market valuation has moved to a more realistic level and, given the stock's more balanced risk-reward profile, upgrades to Hold from Sell. CIMIC's 12-month price-earnings multiple has fallen from 22x to 18x and the stock's previous close was $41.68 - just above the broker's target of $40.50, which is unchanged.

FLEXIGROUP LIMITED ((FXL)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 4/2/0

Credit Suisse believes that for the first time in a long time FlexiGroup has a reasonable chance of meeting FY earnings forecasts. FY19 should show flat to modest growth. The broker has thus upgraded to Outperform from Neutral but warns it is not so much of an "upgrade" story as it is "no more downgrades".

Even at a single digit multiple, FlexiGroup is not without its risks, the broker warns. But the Australian card business and cost-outs should prove key earnings drivers. Target rises to $2.45 from $1.85.

ILUKA RESOURCES LIMITED ((ILU)) Upgrade to Buy from Neutral by Citi .B/H/S: 4/1/1

Citi has upgraded Iluka Resources to Buy from Neutral, citing higher production and sales, improved pricing and a weaker Australian dollar.

Estimates for earnings before interest tax depreciation and amortisaton per share rise 9% in 2018 and 24% in 2019.

Target price jumps to $13.70 from $10.72.

SIGMA HEALTHCARE LIMITED ((SIG)) Upgrade to Buy from Sell by Citi .B/H/S: 1/1/2

Citi upgrades Sigma Healthcare to Buy from Sell, after confirmation the Chemist Warehouse contract will not be renewed.

The broker cuts earnings per share estimates across FY19-FY21 (-15%, -34% and -17% respectively) to reflect new guidance arising from the news. Target price falls to 55c from 70c.

The broker notes the share price has already fallen -40%, hence the upgrade. Capital management and acquisitions remain as upside risks given the slowing in the underlying revenue. The broker says Sigma will have to choose carefully.

Downgrade

AVEO GROUP ((AOG)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 3/1/0

Macquarie downgrades retirement village company AVEO Group to Neutral from Outperform, in response to signs of mounting pressure on fundamentals.

The broker notes project completions are and will continue to outpace settlements and that this cash flow gap will exacerbate the risk arising from the weaker property market and compromise its capital position.

Earnings per share estimates are revised up 8%, 8% and 20% across FY18 to FY20 to account for higher completions. The target price falls to $2.65 from $4.15 and is set at a discount to the broker's valuation of $3.26 to reflect ongoing headwinds.

ASX LIMITED ((ASX)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/2/6

Even though they see the risk for any disappointments as low in the short term, Citi analysts cannot get past the fact ASX shares seem expensively priced. For this reason, the rating has been downgraded to Sell from Neutral. Target price lifts to $58.40 from $57.85.

COSTA GROUP HOLDINGS LIMITED ((CGC)) Downgrade to Neutral from Buy by UBS .B/H/S: 2/2/0

UBS downgrades Costa Group to Neutral from Buy on a valuation basis, noting the stock is trading at roughly 27 times the broker's FY19 earnings-per-share estimate.

Triggers to the upside would include a surprisingly strong FY18 result, an upgrade to China guidance or further M&A activity in the avocado business. UBS reduces near-term earnings-per-share forecasts by -2-3%, noting the positive tailwinds of FY18 are likely to wane in 2019.

Target price rises to $8.40 from $7.50 to reflect a higher return on investment capital in the international business and a one-year roll forward of the broker's discounted cash flow valuation.

DOMINO'S PIZZA ENTERPRISES LIMITED ((DMP)) Downgrade to Sell from Neutral by Citi and Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 3/2/3

It was only three weeks ago that Citi upgraded to Neutral, which has been acknowledged in today's research update, but the analysts have nevertheless decided it's time to once again downgrade to Sell.

Two reasons for the reversal: a sharp rally in the share price plus the realisation operations in Japan are not meeting expectations. Citi believes market consensus forecasts are due for a downgrade. Price target lifts to $46.30 (was $44.60).

Credit Suisse has downgraded Domino's Pizza Enterprises to Underperform from Neutral, citing structural risks.

The broker believes the negatives: the franchise industry inquiry, rising labour costs, aggregator expansion, franchisee attrition, huge growth needs in Europe and uncertainty in Japan; make it difficult to back the market's sentiment on the stock.

Credit Suisse lowers network forecasts yet again and observes organic store openings appear to be lagging guidance. Target Price falls to $36.76 from $42.47.

INGHAMS GROUP LIMITED ((ING)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 1/5/0

Credit Suisse downgrades to Neutral from Outperform while maintaining a constructive long-term view. However, in the short-term input price pressures (predominately feed) challenging market conditions in New Zealand and a one-off taxation charge point to a muted FY19 EPS outlook.

Of the -11% reduction to forecast FY19 EPS, operational changes account for 6% and a higher tax rate 5%. Target reduced to $4.10 from $4.30.

MAGELLAN FINANCIAL GROUP LIMITED ((MFG)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 3/1/1

Morgan Stanley downgrades Magellan to Underweight from Equal-weight, contrary to consensus, on a persistent slowdown in retail funds flows. Inflows have slowed for the past months and risk turning negative, the broker suggests.

Magellan also charges above-peer fees, suggesting these may come under pressure. Given the fund manager is maturing as a business, there are fewer growth options than previously, the broker notes. Target unchanged at $27. Industry view: In-Line.

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

Nanosonics has hit Morgans target price so the broker downgrades to Hold from Add, remaining a long-term fan of the stock. The $3.12 target price is retained.

Meanwhile, Canadian and European clearances have been received for the second generation Trophon2 device and the broker expects a launch in early FY19, although a lag would drag on the share price.

VIVA ENERGY REIT ((VVR)) Downgrade to Accumulate from Buy by Ord Minnett .B/H/S: 3/0/0

Ord Minnett downgrades Viva Energy Reit to Accumulate from Buy on valuation grounds.

The target prices is steady at $2.35, the broker noting news on the capital management front (two institutional 8-10-year term loans totalling $60m and delayed-start interest rate swaps totalling $368m) has done little to change valuations.

WOOLWORTHS LIMITED ((WOW)) Downgrade to Neutral from Buy by Citi .B/H/S: 3/3/2

Citi sees the renewed distribution agreement with Caltex ((CTX)) as a positive; it explains why the price target moves by 8% to $32.90. Operationally, the analysts continue to forecast Woolworths will outperform peer Coles ((WES)).

Alas, the recent share price rally cannot be ignored, and thus the recommendation is being pulled back to Neutral from Buy. A better pricing in the new agreement means the JV with Caltex will lead to higher profits from petrol sales.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ATLAS ARTERIA Buy Neutral Morgans 2 BEACH ENERGY LIMITED Neutral Sell Ord Minnett 3 CIMIC GROUP LIMITED Neutral Sell Deutsche Bank 4 FLEXIGROUP LIMITED Buy Neutral Credit Suisse 5 ILUKA RESOURCES LIMITED Buy Neutral Citi 6 SIGMA HEALTHCARE LIMITED Buy Sell Citi Downgrade 7 ASX LIMITED Sell Neutral Citi 8 AVEO GROUP Neutral Buy Macquarie 9 COSTA GROUP HOLDINGS LIMITED Neutral Buy UBS 10 DOMINO'S PIZZA ENTERPRISES LIMITED Sell Neutral Citi 11 DOMINO'S PIZZA ENTERPRISES LIMITED Sell Neutral Credit Suisse 12 INGHAMS GROUP LIMITED Neutral Buy Credit Suisse 13 MAGELLAN FINANCIAL GROUP LIMITED Sell Neutral Morgan Stanley 14 NANOSONICS LIMITED Neutral Buy Morgans 15 VIVA ENERGY REIT Buy Buy Ord Minnett 16 WOOLWORTHS LIMITED Neutral Buy Citi Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 SIG SIGMA HEALTHCARE LIMITED -25.0% -75.0% 50.0% 4 2 FXL FLEXIGROUP LIMITED 67.0% 50.0% 17.0% 6 3 ILU ILUKA RESOURCES LIMITED 50.0% 33.0% 17.0% 6 4 WSA WESTERN AREAS NL -17.0% -33.0% 16.0% 6 5 ALX ATLAS ARTERIA 83.0% 67.0% 16.0% 6 6 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 63.0% 50.0% 13.0% 4 7 ORE OROCOBRE LIMITED 75.0% 71.0% 4.0% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 CGC COSTA GROUP HOLDINGS LIMITED 38.0% 63.0% -25.0% 4 2 AOG AVEO GROUP 63.0% 88.0% -25.0% 4 3 MFG MAGELLAN FINANCIAL GROUP LIMITED 40.0% 60.0% -20.0% 5 4 VVR VIVA ENERGY REIT 83.0% 100.0% -17.0% 3 5 ING INGHAMS GROUP LIMITED 17.0% 33.0% -16.0% 6 6 GXY GALAXY RESOURCES LIMITED 60.0% 75.0% -15.0% 5 7 WOW WOOLWORTHS LIMITED 6.0% 19.0% -13.0% 8 8 ASX ASX LIMITED -75.0% -63.0% -12.0% 8 9 CSL CSL LIMITED 50.0% 56.0% -6.0% 8 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 5.203 4.870 6.84% 4 2 FXL FLEXIGROUP LIMITED 2.115 2.015 4.96% 6 3 WSA WESTERN AREAS NL 3.258 3.128 4.16% 6 4 ILU ILUKA RESOURCES LIMITED 11.667 11.258 3.63% 6 5 CGC COSTA GROUP HOLDINGS LIMITED 7.773 7.548 2.98% 4 6 WOW WOOLWORTHS LIMITED 28.488 27.786 2.53% 8 7 ALX ATLAS ARTERIA 6.702 6.540 2.48% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 SIG SIGMA HEALTHCARE LIMITED 0.488 0.768 -36.46% 4 2 AOG AVEO GROUP 3.230 3.605 -10.40% 4 3 GXY GALAXY RESOURCES LIMITED 3.580 3.775 -5.17% 5 4 ING INGHAMS GROUP LIMITED 3.917 3.950 -0.84% 6 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 SYR SYRAH RESOURCES LIMITED 0.452 -0.032 1512.50% 5 2 WSA WESTERN AREAS NL 8.865 7.865 12.71% 6 3 NCM NEWCREST MINING LIMITED 70.122 66.206 5.91% 8 4 ORE OROCOBRE LIMITED 12.192 11.589 5.20% 8 5 STO SANTOS LIMITED 33.450 32.074 4.29% 6 6 AWC ALUMINA LIMITED 27.383 26.335 3.98% 5 7 ILU ILUKA RESOURCES LIMITED 70.608 67.942 3.92% 6 8 AOG AVEO GROUP 26.225 25.300 3.66% 4 9 MFG MAGELLAN FINANCIAL GROUP LIMITED 132.160 129.560 2.01% 5 10 MQG MACQUARIE GROUP LIMITED 788.620 776.220 1.60% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 PRU PERSEUS MINING LIMITED 0.315 0.735 -57.14% 4 2 SIG SIGMA HEALTHCARE LIMITED 4.750 5.230 -9.18% 4 3 ALX ATLAS ARTERIA 27.830 30.608 -9.08% 6 4 GXY GALAXY RESOURCES LIMITED 12.183 12.960 -6.00% 5 5 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 15.775 16.150 -2.32% 4 6 RRL REGIS RESOURCES LIMITED 31.750 32.500 -2.31% 7 7 EVN EVOLUTION MINING LIMITED 16.381 16.612 -1.39% 8 8 CTX CALTEX AUSTRALIA LIMITED 235.914 238.814 -1.21% 7 9 QBE QBE INSURANCE GROUP LIMITED 69.373 70.183 -1.15% 8 10 AZJ AURIZON HOLDINGS LIMITED 26.537 26.837 -1.12% 7 Technical limitations

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

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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 July 5, 2018

Last week saw the ASX200 continue to consolidate before a sudden rush up to a new high, albeit briefly, this week.

There was not a lot of action among the most shorted stocks last week, but there were definitely some moves to highlight.

Just how much of a threat is Amazon to Australia's two incumbent retail leaders JB Hi-Fi ((JBH)) and Harvey Norman ((HVN))? Analysts, for the most part, suggest not as much as the market fears but that has not stopped shorts from quietly building in both.

Last week saw JB Hi-Fi shorts rise to 18.8% from 17.5%. Harvey Norman has snuck back into the 10% plus shorted club with a small increase.

We also welcome debutant Inghams Group ((ING)) into the club. See below.

Making their debuts into the 5% plus shorted table last week were nickel-cobalt-scandium miner cum water purifier Clean TeQ ((CLQ)) and embattled pharma distributor Sigma Healthcare ((SIG)). See below.

Weekly short positions as a percentage of market cap:

10%+

SYR 21.1 JBH 18.8 DMP 15.3 GXY 14.5 ORE 13.3 VOC 12.2 MYR 12.1 ING 11.6 MTS 11.4 AAC 11.2 GXL 10.8 IVC 10.6 NWS 10.4 NAN 10.1 HVN 10.0

In: ING, HVN

9.0-9.9

GEM, MLX

Out: ING, HVN, IGO 8.0-8.9%

HT1, IGO, BIN, IFL, CSR, MYX

In: IGO Out: MLX

7.0-7.9%

NSR, FLT, BGA, GMA, PLS, CCP, RFG, IPH

In: CCP Out: SFR, KAR

6.0-6.9%

MOC, SFR, SIG, BKL, NEC, KAR, TNE, SEK, APT, BAP, RSG, AAD, MYO, BEN, WEB

In: SFR, KAR, SIG Out: CCP, BEN, WEB

5.0-5.9%

BEN, WEB, TPM, QUB, NUF, SUL, JHC, MSB, BWX, CLQ ALX, TGR

In: BEN, WEB, BWX, CLQ Out: ALX, TGR

Movers & Shakers

Poultry producer Inghams Group ((ING)) plunged in share price last month on the announcement the company's well regarded CEO would be stepping down earlier than expected. On that news alone, Macquarie downgraded its rating to Hold (Neutral), foreseeing a drag from management uncertainty.

Otherwise Macquarie saw value as "undemanding", which is not the opinion of peers. Earlier last month Morgans downgraded to Hold citing emerging headwinds. Last week Credit Suisse downgraded to Hold (Neutral) citing rising input costs. And this week, UBS downgraded to Sell, suggesting the market is overestimating the company's capacity to cut costs.

Inghams' share price had been recovering from the plunge in June, but has headed south again on this succession of downgrades. Inghams shorts last week increased to 11.6% from 9.9%.

Last week Sigma Healthcare ((SIG)) announced it had lost its wholesale pharma supply contract to Chemist Warehouse. The contract previously provided for 40% of revenues. Sigma downgraded FY18 guidance by -40%, and on the day the share price fell by, you guessed it, -40%.

Sigma did not previously appear on the 5% plus shorted table, hence there would not have been a lot of shorts to possibly cover as the share price plunged. Rather, Sigma has now debuted at 6.8% shorted.

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: Franchises, Banks & Software

Weekly Broker Wrap: franchising; regional banks; software; Rhipe; debt purchasing; and FE Investments, Scottish Pacific & CML Group.

-Inquiry into franchising could extend consumer law protections and increase ACCC powers -Deficiencies in regional banking sets it up for consolidation -Ord Minnett considers software sector increasingly important for small cap investors -Is the debt purchasing sector ripe for consolidation?

By Eva Brocklehurst

Franchising

Credit Suisse highlights the developments taking place with regard reform of the franchising industry as a result of the final hearing of the parliamentary committee inquiry. The broker concludes that the scale of evidence began to impact the committee's thinking as the inquiry unfolded and it is now looking at addressing structural imbalances.

Of interest to the broker were the number of items taken on notice including: the number of stores earning less than $60,000 in operating earnings; the proportion of the 799 store total where shift trimming had occurred; and the number of stores that were bought back to resolve disputes.

In the broker's view policy is likely to address the imbalances in contractual arrangements through extending Australian consumer law protections, increasing ACCC powers and codifying good faith provisions under the franchise code.

These reforms would imply major structural headwinds for Australian franchising and, in combination with increased labour costs, raise significant questions regarding the profitability of franchisees. In turn, this may lessen the attraction of the industry for new franchise investors.Regional Banks

Citi believes declining retail banking returns and consumer preferences have exposed the deficiencies in the regional bank business models. This has created an urgency to act. In other markets, similar banks have turned to consolidation to solve deficiencies or, in some cases, private equity sponsors.

The broker believes it is time for a similar type of consolidation to occur in Australia. Regional banks appear to have an over-reliance on branch-based banking, be underweight broker distribution and lack omnichannel presence, with insufficient size to adequately invest in digital.

The main consolidation prospect, in the broker's opinion, is a Bank of Queensland ((BOQ)) and SunCorp ((SUN)) bank merger. The broker observes the bleak retail banking headwinds continue for both Bendigo and Adelaide ((BEN)) and Bank of Queensland, with these stocks down -3% and -17% in the year to date respectively.

Software

Software represents around $15bn of market capitalisation and 7% of this Small Industrials index and Ord Minnett notes the sector is performing strongly. The broker makes a detailed comparison of the sector leaders, believing software is increasingly relevant for small cap investors.

The broker has initiated coverage of Technology One ((TME)) with a Buy rating and $5.45 target, believing the company offers both attractive growth and improving earnings quality.

Altium ((ALU)) has a Sell rating and $16.54 target, as Ord Minnett cannot reconcile the current valuation with the level of recurring revenue. The broker believes the stock is heavily exposed to up-front licence sales and its recurring revenue is the lowest amongst peers.

Ord Minnett also initiates coverage on WiseTech Global ((WTC)), with a Hold rating and $14.96 target, believing it offers investors leverage to a global software story in its early stages. Following a substantial re-rating over recent months Ord Minnett plays the long game and intends to wait for a more attractive entry point.

Finally, Ord Minnett considers IRESS ((IRE)) offers investors a relatively low risk exposure to software while promising double-digit growth and higher recurring revenue. A Hold rating and $11.24 target are in place.

Rhipe

Rhipe Ltd ((RHP)) provides cloud-based subscription software service licences to a growing number of IT providers across the Asia-Pacific region. The company also provides consulting, marketing and support to its network.

Bell Potter considers the cloud services market a growing opportunity and the company is well-positioned to gain exposure to the structural trend. Moreover, management appears able to build out its presence and maintain strong earnings momentum. Bell Potter initiates coverage with a Buy rating and $1.25 target.

Debt Purchasing

In reviewing the debt purchasing sector Canaccord Genuity questions whether the industry is ripe for consolidation. And will comprehensive credit reporting even the playing field? Amid conflicting industry rhetoric the broker suggests access to capital is the key determinant of returns.

In this regard Credit Corp ((CCP)), Pioneer Credit ((PNC)) and Collection House ((CLH)) are all considered to have plenty of funds going into FY19. Credit Corp has an opportunity to plough capital into the US market and Pioneer Credit has commenced personal loan origination in its own right.

Heading into reporting season, the broker suggests Credit Corp is typically the most explicit about return hurdles and this makes it most likely to pull back on domestic purchasing if pricing does prove to be stretched. Meanwhile, Pioneer Credit has a most momentum in the near term in its cash collections. The broker maintains a Buy rating on these two.

Canaccord Genuity has a Hold rating on Collection House, choosing to maintain a neutral stance ahead of the results while acknowledging the shares have fallen -13% since the end of May.

FE Investments

FE Investments ((FEI)) provides SME lending and micro-financing. The company has created a successful franchise in New Zealand which it aims to replicate in Australia over the next 12 months. PAC Partners initiates coverage on the stock with a Buy rating and target of $0.18.

Loan growth and net interest margin expansion are expected to drive strong upside to earnings. The company has a large addressable market in Australian SME lending, estimated to be a $20bn opportunity. PAC Partners believes the company can leverage technology to significantly scale its lending activities.

Scottish Pacific

Scottish Pacific ((SCO)) has reported strong growth in invoice turnover and reaffirmed guidance regularly throughout FY18. Canaccord Genuity suggests it may have erred conservatively in order to restore market confidence following a surprise downgrade in its maiden year of listing.

The broker believes high single-digit earnings growth is comfortably achievable. Favourable economic conditions are driving strong turnover growth across the client base and the UK should deliver an improved contribution. The broker considers the stock cheap relative to the outlook and maintains a Buy rating and $3.42 target.

CML Group

CML Group ((CGR)) has upgraded FY18 operating earnings (EBITDA) to $17m from $15.5m, and reaffirmed FY19 guidance for $19.5m. Canaccord Genuity expects this will ultimately prove to be conservative versus its forecasts.

Guidance may not fully capture the contribution from the Thorn Group ((TGA)) debtor finance book let alone any additional organic growth. Canaccord Genuity has a Buy rating and $0.70 target.

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Oz Dollar Likely To Falter, Uncertainty Prevails

In an environment of increasing volatility and waning risk appetite the Australian dollar is unlikely to rally, while the US/China trade uncertainty is clouding the outlook for commodity prices.

-Risk sentiment likely to determine flows until late September as trade tariffs feature -US earnings season may trigger volatility in US currency as guidance turns more pessimistic -Widening interest-rate differentials with the US likely to depress Australian dollar

By Eva Brocklehurst

Supportive price action in the Australian dollar over recent days has been underpinned by a reduction in risk aversion, although analysts suspect this is unlikely to last.

Sentiment is rotating towards the US/China trade war, with a subsequent increase in volatility, while US economic data and Federal Reserve commentary remain to the fore and have reinforced a stronger trend in the US dollar.

AxiTrader's Greg McKenna believes the strength of the US economy and the fact President Trump appears to be cruising through his global meeting agenda are providing support for the greenback. Hence, the Australian dollar is likely to be sold on any rallies.ANZ analysts agree that any forthcoming weakness in the US dollar is likely to be contained, as data has started to perform better than consensus expectations.

Typically, the US dollar does not weaken extensively when global growth is weakening so, while catalysts for strength are becoming harder to find, the upshot is likely to be consolidation rather than outright weakness.

The analysts are also not convinced that any weakness in the US dollar will automatically provoke a rally in the Australian dollar, as risk sentiment should determine flows and is likely to feature until late in the September quarter.

Additional tariffs on China from the US are set to start in September and the analysts consider the Australian dollar a "sell on strength" currency.

Moreover, Morgan Stanley points out a global trade war and potential economic weakness means those currencies from countries with large current account surpluses are likely to gain, as weakness in risk assets prompts a repatriation of funds. In this case the Japanese yen is the natural candidate followed by the Swiss franc.

Conversely such an environment of declining global liquidity, rising volatility and waning risk appetite means currencies such as the Australian dollar are likely to underperform.

Volatility is likely to be heightened and investors in crowded positions should remain wary, Morgan Stanley suggests. Moreover, liquidity continues to deteriorate and this amplifies price action.

The upcoming US earnings season may provide a trigger as earnings guidance turns increasingly pessimistic in the wake of tariffs and slowing earnings growth.

Morgan Stanley also believes US growth is poised for a pullback, as almost half of the second quarter's GDP growth estimate is driven by inventory and trade, and this is likely to have been boosted by stockpiling ahead of the implement station of tariffs.

The high degree of foreign ownership of US assets suggests to Morgan Stanley that an initial safe-haven rally in the US dollar may be followed by weakness as these assets are liquidated.

There is also a risk that central banks, such as the Bank of Canada, may be tightening policy going into a weakening environment, which will be bearish for that currency as it plays out.

Commodity Prices

St.George analysts expect a great deal of uncertainty as fundamentals such as commodity prices and interest rates are not providing a clear picture for the direction of the Australian dollar. Also, the inclination for President Trump to backflip on policies underscores the uncertainty on the global stage.

Recent trade tensions have put pressure on some commodity prices, as this scenario implies downside risk to global growth, although most have held up reasonably well.

Over 2018 the relationship between commodity prices and the Australian dollar has broken down somewhat and St.George analysts believe the likely explanation is that financial market sentiment has renewed its focus on inflation and rising interest rates.

Yield Differential

The widening interest-rate differential between Australia and the US, which has posed downside risk for some time, could be having more of an impact and dampening the Australian dollar, St.George analysts suspect. The US economy is performing relatively strongly versus others and this has propped up the US dollar.

The US Federal Reserve is expected to lift its funds rate further this year, while the Reserve Bank of Australia is not expected to lift official interest rates any time soon. Australia's unemployment rate has held within the range of 5.4-5.6% for 13 consecutive months and this suggests ongoing spare capacity within the labour market.

Financial markets have pushed out the timing for the first rate hike from the RBA and indicate little chance of one this year. The St.George analysts now expect the Australian dollar to end 2018 at US74c and 2019 at US76c.

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FY19 Should Be Less Disruptive For Class

Software service provider, Class, posted a weak June quarter but brokers remain positive on migration to the cloud.

-FY19 expected to be less disruptive -Year-on-year growth still in double digits -90% of SMSF accounts expected on the cloud in 3-5 years

By Eva Brocklehurst

Changes to superannuation, implemented by the Australian government last year, have affected the portfolio of software service provider Class ((CL1)). The company reported a weak June quarter as changes to accounting requirements wrought disruption.

Additional work is required of accountants and administrators to implement capital gains tax relief for clients. This has meant end-of-year tax lodgements have been delayed which, in turn, affects the ability of prospective customers to evaluate software purchases.

Hence, account growth disappointed. While net new accounts totalled 4,526 during the quarter this appears to have been supported by slower migration of the AMP-based accounts. As FY19 is expected to be less disruptive for the industry, brokers suspect migrations will now accelerate.UBS forecasts the remaining 8,300 AMP-based accounts will transition from Class over FY19. This could be offset by faster industry migration to the cloud as a result of regulatory changes at the Australian Taxation Office.

Moelis takes a conservative approach to growth expectations across FY19-21. FY19-20 estimates for earnings per share are reduced by -5-10%. The June quarter update was disappointing, although a more stable environment going forward should support the company's strong customer retention and cash conversion.

Meanwhile, the company's scalable platform provides an attractive investment opportunity over the medium term. Moelis, not one of the eight stockbrokers monitored on the FNArena database, maintains a Buy rating and a target of $2.70.

Morgans also downgrades forecasts to reflect a slightly lower starting base for paying subscribers at the end of the June quarter and a lower number of new account additions in the first half of FY19 because of logjams in the workload. The broker considers the shortfall in SMSF subscribers is not that dramatic as year-on-year growth is still in double digits.

While the growth rate in the second half of FY18 was below expectations, paying accounts grew by 16% Morgans points out, and in the financial year Class grew its share of SMSF accounts on platform to 26%.

Perceived earnings risks include a failure to grow customer accounts at the rate expected by the market, as well as regulatory changes that slow new SMSF formations.

Morgans maintains a positive view on the stock and believes sustained double-digit earnings and free cash flow growth should continue. As the stock trades at a discount to valuation an Add rating is maintained. Target is $2.73.

Headwinds

Extensive changes were made to superannuation regulations in the federal budget in 2017. There was little time provided for changing systems and administrators of SMSF platforms are struggling to cope with the workload. Class has noted that, as of June 21, 35% of the former financial year tax returns have not been filed.

Traditionally, the September and December quarters of each year are the best time for Class to sign up new customers, as the former year's tax and statutory accounts have been lodged and there is an opportunity for accountants to consider switching to a new platform.

Signing new clients was also made harder by main rival, BGL, offering 12 months of free use of its new cloud-based SMSF system. Morgans suggests this allowed accountants, who may have been tempted to switch to Class, to defer a decision for 12 months. The broker also points out that BGL is a private company and short-term earnings are less important than defending market share.

UBS factors in the "fee holidays" to its forecasts and acknowledges competition remains intense. Still, the possibility of a faster-than-expected transition to cloud-based software for SMSFs supports a Buy rating for Class, in the broker's view.

Morgans notes, of around 600,000 SMSFs, 57% are claimed by one of the two main cloud-based administration platforms. The remainder are up for grabs over the next three years. To support the broker's current valuation Class needs to win an additional 84,500 net new accounts between now and June 30, 2022.

UBS expects around 90% of accounts will be on the cloud over the next 3-5 years and this may accelerate should non-cloud accounts find it difficult to comply with the Australian Taxation Office reporting requirements that begin in the September 2018 quarter.

The database shows three Buy ratings (Ord Minnett is yet to update on the quarter). The consensus target is $3.06, signalling 39.1% upside to the last share price.

Find out why FNArena subscribers like the service so much: "Your Feedback (Thank You)" - Warning this story contains unashamedly positive feedback on the service provided.

Subdued Outlook For Michael Hill

Michael Hill reported a soft fourth quarter with same-store sales growth deteriorating across core markets. The main positive for brokers is the fact that FY18 marks the full exit from Emma & Roe and the US business.

-Slowdown in fourth quarter sales growth may be caused by the distraction of closing businesses -Weak consumer environment in Australia may also be having an adverse impact -Additional investment may be required in marketing to reinvigorate momentum

By Eva Brocklehurst

Jeweller Michael Hill ((MHJ)) is fronting a cleaner outlook for FY19, having disposed of its loss-making enterprises. Nevertheless, several brokers suggests it is too early to become overly optimistic regarding growth in the core business.

The most notable aspect of the company's trading update for Credit Suisse was a sequential deceleration in the same-store sales growth in Australia, New Zealand and Canada. Admittedly, both Canada and Australia were cycling tough prior comparable periods.

The broker found management commentary light and no earnings guidance was provided. Credit Suisse continues to believe Michael Hill offers attractive value, and FY19 will not be hampered by the earnings drag from the loss-making Emma & Roe and US business. The broker expects the remaining business to deliver 6% compound earnings growth over the next three years.

Citi suspects the slowing in implied like-for-like sales growth has been caused by the distractions associated with closures in the US and Emma & Roe, as well as a new promotional strategy that focuses on reducing the amount of price discounting. While the FY19 PE multiple is undemanding, the broker needs to observe a path to improved execution before recommending the stock.

Competition in Canada and a weak consumer environment in Australia may also be having an adverse impact. The broker suggests Michael Hill may be losing share to the key Canadian brand Peoples as sales momentum for Peoples has been improving.

Morgans remains cautious regarding the performance of the core business and believes there is a requirement for investment in the near to medium term that could further curtail margins. Organic growth potential is considered subdued, given the lack of same-store sales momentum and potential for increased investment.

Morgans, too, would need to witness a sustained period of growth in same-store sales before becoming more positive on the stock, given the extent of the earnings downgrades over the past 18 months.

Sales

For FY18 the company reported total store sales of $599.7m, up 3.3%, and opened seven new stores over the year, closing two and bringing the total store count to 171. Group same-store sales growth was 0.4%. In Australia, revenue was up 1.1% for FY18 while the June quarter revealed a -3.3% decline in same-store sales growth. Management did not provide commentary regarding the sales performance only to acknowledge challenging retail conditions in Australia.

New Zealand revenue was NZ$125.1m, up 2.5%. Same-store sales growth was 2.2%. Similar to the Australian market, New Zealand recorded a sequential slowing into the fourth quarter but, Credit Suisse suggests, unlike Australia this did not reflect a challenging prior comparable but rather a continuation of the slowing momentum seen over FY18.

Sales growth in Canada was up 15.5% year-on-year, reflecting the rolling out of eight new stores. Same-store sales growth was 3.5%. Management did reiterate previous commentary that the pace of further store opening in Canada would be dictated by the availability of suitable locations and satisfactory lease terms.

Morgans makes additional downgrades to FY18 forecasts to reflect the more subdued update on the fourth quarter. The broker suspects taking share in what has become a somewhat tired category may require additional investment in marketing, loyalty and systems.

FNArena's database shows two Buy ratings and two Hold. The consensus target is $1.09, suggesting 13.2% upside to the last share price. The dividend yield on FY18 and FY19 forecasts is 6.2% and 7.2% respectively.

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SMSFundamentals: Women Fall Short On Super

SMSFundamentals is an ongoing feature series dedicated to providing SMSF trustees with valuable news, investment ideas and services, in line with SMSF requirements and obligations.

For an introduction and story archive please visit FNArena's SMSFundamentals website.

Women plan to retire later, but still have less in super than men

Women are working for longer but compared to men, are looking at a lot less super on retirement.

-Women's average super balance is 57.3% of men's average -Men's and women's intended retirement ages converge on 62 -Later retirements increase savings period, easing pressure on age pension

By Nicki Bourlioufas

Women are working until they are older but still leaving the workforce with less money in their superannuation funds than men have, according to new findings by Roy Morgan. Women planning to retire in the coming 12 months have an average of $177,000 in their super accounts, compared to an average of $309,000 for men, the research found.

Comparisons with Roy Morgan's 2008 survey of retirement expectations show that, while super balances for both sexes have more than doubled in the past decade, the gender gap has narrowed only slightly. In 2008, females held an average of $79,000 in super, or 55.2% of the male average of $143,000. By 2018, the women's average had grown to 57.3% of the men's.

Superannuation Balance of Intending Retirees Male vs Female

Source: Roy Morgan Single Source (Australia), Australians 14+, 12 months to April 2008, n = 52,051 and 12 months to April 2018, n = 50,067. Base: Australians 25+ intending to retire in next 12 months.12 months to April 2008, n = 2,632 and 12 months to April 2018, n = 2,214

The findings come from the latest Roy Morgan Single Source survey, released on July 1. This annual survey brings together data from in-depth, face-to-face interviews conducted with more than 50,000 Australians in their own homes, including 2,200 people who plan to retire. An estimated 415,000 people intend to retire in the coming year.

Other findings from the Single Source survey, released on March 15, show that men and women are both putting back retirement, but the rise in women's planned retirement age is most dramatic. The average age of women intending to retire this year is 61.8 years, an increase of 6.3 years since 2008. By contrast, men are planning to retire at 62, an increase of 2.9 years since a decade ago. This makes the average retirement age for men and women almost identical at just under 62.

Source: Roy Morgan Single Source: 12 months ended December 2008, n= 515; 12 months ended December 2017, n= 459. Base: Australians 14+ intending to retire in the next 12 months 1. Next 12 months

The decision to defer retirement and work until they are older suggests women are sensitive to the need to save more, especially given they have greater life expectancy than their male counterparts. But the persistent lag in women's super balances, coming despite considerable publicity given to the issue in recent years, shows it would take many years of saving – not just an increase in awareness – to catch up with men.

Roy Morgan's industry communications director, Norman Morris, said women's lower average super balance reflected their lower levels of employment, lower pay, less full-time work and more broken careers.

"Despite real gains in employment for women over the last decade, they still lag males in terms of full time and overall employment levels," he said.

"This has been one of the major reasons that overall female income levels are around 25% lower than males, which obviously in turn leads to lower superannuation contributions and balances when compared to males."

Women's lower average income, and the likelihood that they will have more interrupted employment patterns, explain why they have been unable to close the gap and "generally show inadequate superannuation for retirement", he said. "It is likely to take some considerable time and changes to superannuation conditions for females to achieve an adequate level of superannuation more equivalent to their male counterparts."

Morris said the more rapid increase in the age of females intending to retire compared to males over recent years is "a positive trend" since is enables women to increase their savings potential as they head into retirement. The Australian Government faces twin financial pressures on funding the age pension, from an increase in life expectancy on one hand and inadequate personal retirement savings on the other.

"Given this situation, it is a positive finding in this research that there has been a gradual increase in the age of intending retirees," he said. "This results potentially in a longer period of paying tax, increased savings and as a result less time on the pension, possibly at a reduced level. However, one drawback of delayed retirement is that it may increase unemployment, with older workers occupying positions that younger people might otherwise have filled."

Technical limitations

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

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The Triumph Of Quality

In this week's Weekly Insights (published in two parts):

-The Triumph Of Quality -Share Market Sweet Spot -Conviction Calls -Rudi On TV -Rudi On Tour

The Triumph Of Quality

By Rudi Filapek-Vandyck, Editor FNArena

By now, most investors would be well aware Australian shares have not kept up with the equities bull market in the US since March 2009; that Australian banks have had a horrible few years during which elevated dividend yields were not enough to compensate for capital erosion; that large cap stocks have noticeably lagged the performance of smaller caps; that value investors have found the going much tougher with investor focus almost solely concentrated on new economy growth stocks, and in energy and mining sectors over the past 18 months.

What is not often mentioned is that investor appetite has equally made a big switch towards higher quality businesses, which is a rather moot point among investors. Everybody likes to think he/she owns the best of breed when it comes to long term holdings. Irrespective, 'quality' is one of those labels that, whilst frequently used, has no strict definition or even commonly agreed upon definition.

For some, Australian banks are 'high quality'. Others use the same term for BHP and for Rio Tinto, at times including Fortescue Metals. I even hear the occasional reference to Telstra and/or TPG Telecom, still, despite years of falling share prices. Management at Mineral Resources is believed to be of 'high quality', but then so is the team at Wesfarmers and they went terribly wrong venturing into the UK.

In my own market analysis, I try to combine generally accepted characteristics of quality, such as a lowly geared balance sheet, sector leading products and services plus a solid track record, with less tangible factors such as industry dynamics and longevity/sustainability of cash, profit growth and margins.

Combining such elements has in the past led me towards global market leaders CSL ((CSL)), ResMed ((RMD)) and Cochlear ((COH)) with the added observation all three share prices have been extremely strong outperformers in years past. But then I also selected Ramsay Health Care ((RHC)) and here loyal shareholders have had a rough experience since 2016.

For a number of years I have been referring to CSL as "probably the highest quality, most successful growth story in Australia". Judging by the share price moving from below $30 to nearly $200 it's probably fair to assume few are today prepared to dispute that statement, but many would be asking the question how much upside is there still left, and should we now not worry more about potential downside?

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Within this context, I observe Lazard fund manager Warryn Robertson recently visited Australia, confiding to the Australian Financial Review his fund currently owns 25 stocks, of which none are listed on the ASX. Lazard includes in its concept of 'quality' the ability to forecast the future with above-average certainty (I consider this characteristic as vital myself) and as such the London-based international funds manager is keeping a keen eye on the three healthcare champion stocks I mentioned earlier, as well as on Ansell ((ANN)).

Lazard doesn't own them, but would like to, at the right price. Instead, companies like Qualcomm, Medtronic, Intel, Oracle, ADP, Unilever and Procter & Gamble currently sit among the 25 stocks held in portfolio.

For Australian investors I think the message here is clear: don't fret about short term risk of a weakening share price. Longer term potential is still very much embedded in these high quality business models. If you are as yet not on board, maybe adopt the same strategy as Lazard: treat weakness as an opportunity with a confident eye into the future.

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Another proponent of investing in high quality companies are the fund managers at Morgan Stanley responsible for the Global Quality fund and the Global Franchise/Brands fund. Even though many of the equities currently held in these funds are trading at a premium to the overall market, the responsible managers don't seem overly worried, instead arguing their investment philosophy about 'quality' includes "resilience".

The latter is seen as a key ingredient for inclusion. Say the managers: companies in portfolio are the ones that keep the lights on, rather than shooting them out. They have been described as get rich slowly schemes. The companies in portfolios are less likely than the market to disappoint significantly on earnings because of their inherent stability.

Nine years into a very strong bull market, and with investor concern likely to increase about interest rates, economic growth and corporate profits, these fund managers believe their funds remain well-protected to the downside because the inherent resilience in the companies owned means less chance for sustained de-ratings on the back of significant disappointment in earnings delivery.

Equity analysts at Morgan Stanley dedicate part of their global research efforts on what they label "Global Best Business Models"; consider this a close nephew of the Champion stocks or the All-Weather concept (whatever label we like to use). Here last week's update by the team of responsible analysts can provide investors in Australia with some valuable insights.

Since December 2016, a selection of 37 "global best business model" equities has generated an equal-weighted total return USD performance of 31.4% between December 2016 and June 30, 2018; well above the MSCI ACWI (widely used as a benchmark for global equities) which "only" generated 23.1% and certainly more than widely used benchmarks such as the Dow Jones Industrial Average, the S&P500 and the S&P/ASX200 in Australia.

The 'Best Business Model' concept tries to distinguish quality from the wannabes in each sector on a global scale. Apart from quality inputs about profits, management and the balance sheet, Morgan Stanley equity analysts also include quant modeling, specific top-down strategies as well as Environmental, Social and Governance (ESG) inputs.

Here the interesting observation is that, according to a study released by the Responsible Investment Association Australasia (RIAA), investment funds implementing core responsible investment strategies (i.e. they incorporate ESG in their portfolio inclusion choices) are outperforming peers both in Australia as well as internationally over most time horizons.

Is this maybe because quality companies led by quality management teams simply score high on governance as well?

Increasingly, professional fund managers are separating quality from lesser quality companies by paying attention to corporate culture. Wall Street legend Paul Tudor-Jones recently explained this as follows: "If you have a motivated workforce that you pay and treat well, you produce a high quality and low-cost product that has some benefit, and you treat your customers throughout with respect, this is a winning formula and these companies are outperforming those that don't."

Now cue the many embarrassing revelations at the Royal Commissions into Banking, Superannuation and Financial Services and into Franchising. Or think about the current situation at Aurizon Holdings where management is operating in open conflict with both regulators and key customers. Should investors be genuinely surprised that Telstra and AMP have lost -70%-80% off their value since the late 1990s?

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Morgan Stanley's selection of Global Best Business Models spans 37 companies, spread over 33 industries across four different regions, but unfortunately, none of the selected companies are listed on the ASX. I think the fact that Australia only represents 2% of equities worldwide probably has a lot to do with this.

Instead, the selection contains companies such as Anheuser-Bush InBev from Belgium, Accenture, Amazon, Boeing and Facebook from the USA, Iberdrola from Spain, LVMH from France, Nestle from Switzerland, Sinopharm Group from China, and TSMC from Taiwan.

Performance for the twelve months to June 30 has been 11.8%, indicating performance overall is slowing, but still good enough to beat the 10.6% achieved by MSCI ACWI. Of equal importance is the observation that 29 of the 36 stocks have performed positively, but seven inclusions thus far are performing negatively. Only twenty of the stocks have outperformed the MSCI ACWI.

Even though Morgan Stanley equity analysts work off a more liberal methodology than myself or the aforementioned fund managers, the underlying basic observation still holds its value for all investors elsewhere: even good companies can at times underperform expectations, the broader market, and their inherent potential.

As a group, higher quality companies are most likely to deliver sustainable rewards for shareholders. Traditionally, their true value starts shining during periods of distress, as also highlighted by the responsible managers for the Morgan Stanley funds, but outperformance has equally occurred for the years past.

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The equity analysts note 17 of the stocks included are rated Overweight by their respective sector analysts (that certainly is "only" 17) with the equally weighted price target upside 17%, +11.7% for the median, with FY18 dividend yield estimated at 2.8%. Some of the best performers seem to have rallied well past intrinsic value (Ferrari) but most are projected to simply add further upside.

Some of the laggards are trading well below Morgan Stanley's price target, such as Brazil's Kroton and Phillip Morris in the USA. Which takes me to two laggards of my own selection of All-Weather Performers here in Australia. One is TechnologyOne ((TNE)) and the second one is Ramsay Health Care ((RHC)).

When I was asked last week to nominate one stock tip for the financial year ahead, I nominated TechnologyOne. My reasoning is that overall sentiment towards the stock has turned too negative, despite the odds remaining in favour of the company continuing to grow at double-digits. Company management even suggested they'll probably be in a position to lift their guidance for annual growth in the not too distant future.

My personal view was backed up on Monday with stockbroker Ord Minnett initiating coverage on four small cap software companies in Australia, and TechnologyOne is the only one starting off with a maiden Buy rating. In line with my own assessment, Ord Minnett sees attractive growth and improving earnings quality. Even on projections that are below company management's long term guidance, Ord Minnett still sees 29% upside from today's share price.

As for Ramsay Health Care, investor sentiment is possibly even worse, which makes Monday's update by CLSA even the more remarkable. Having taken another view into industry dynamics and projections, CLSA remains of the view (with conviction) that today's share price looks way too low on a longer term horizon.

On the stockbroker's observation, public hospitals are not investing in beds, and thus waiting lists will continue to build. This will redirect patients into private hospitals.

Among private hospitals, Ramsay seems to be the only one who is still investing in expansion. Ramsay is planning 13 new operating theatres in 2019 and historically there is a well-established relationship with subsequent EBIT growth one year later. CLSA does not see operating theatres becoming less profitable in Australia.

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As for the FNArena/Vested Equities All-Weather Model Portfolio, total return for the financial year ending on June 30th ex-costs has been 16.59% whereas the ASX200 accumulation index stopped at +13%. The portfolio performance overall was weighed down somewhat by the fact we increased cash levels in anticipation of the risk off environment that, ironically, has actually benefited the Australian share market thus far.

The latter shows up through the fact the Model Portfolio added 1.72% in June, while the index added no less than 3.27%, most of it in the final two weeks of the month. Window dressing by funds managers and profit taking by investors further widened the gap towards the end of the financial year.

Without wanting to sound alarmist, but we think investors should adjust their expectations for the year ahead downwards. If tougher times do announce themselves, we remain as confident as the experts cited earlier that the quality and the resilience of the stocks held in the portfolio will continue to serve their shareholders' best interest, which shall also be reflected in the All-Weather Model Portfolio's performance.

Rudi On TV

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

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

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Rudi's View: CYBG, Link Admin & Treasury Wine

In this week's Weekly Insights (this is Part Two):

-The Triumph Of Quality -Share Market Sweet Spot -Conviction Calls -Rudi On TV -Rudi On Tour

Share Market Sweet Spot

By Rudi Filapek-Vandyck, Editor FNArena

One of the persistent misconceptions among Australian investors is that better investment returns await those who venture into small caps, but no such conclusions have ever been drawn from thorough data analysis.

It wasn't that long ago that I compared the performance of various fund managers specialising in large and small caps, and that (admittedly rough) comparison generated similar results as putting raw share prices together.

In contrast to, say, the USA, there is no consistent outperformance of small caps over large caps in Australia. The share market does have its periods when one is very much favoured over the other. And unless you have been living under a rock lately, we are currently in a period when large caps are the laggards, and many investors have redirected their attention to small cap stocks in response.

But are smaller cap stocks the best location for achieving superior returns? What about the higher risk profile?

Turns out, the sweet spot in the Australian share market is situated between positions 51-100 of the ASX200. Throughout the years of reading copious volumes of market research and data analysis, I have come across this conclusion a number of times. Analysts at Citi (if my memory serves me correctly) highlighted this not so long ago, and last week it was the turn of Colonial First State, which is also responsible for the chart below.

We can clearly see how large caps (ASX50) performed considerably better than small caps (Small Ords) over seven and ten year horizons, but the three and five year performances are in favour of small caps, in particular the past three years. But no matter what time horizon we choose, the outperforming market segment is always the ASX Mid Cap 50, which translates into numbers 51-100 of the ASX200 index.

This should come as no surprise. Strong performers including BlueScope Steel ((BSL)), a2 Milk ((A2M)), Seek ((SEK)), Challenger ((CGF)), WiseTech Global ((WTC)), Orora ((ORA)), and Reliance Worldwide ((RWC)); they are all part of this group, as are a number of stocks that haven't performed so well lately, including Harvey Norman ((HVN)), Link Administration ((LNK)), and Fletcher Building ((FBU)).

Investors who'd like to study the apparent sweet spot in the Australian share market in more detail can send an email to info@fnarena.com and we'll send you a list of the current numbers 40-120 of the ASX200. One should always treat such research in a dynamic fashion as market cap and index weight rankings move and evolve on a constant basis.

Stocks like REA Group ((REA)) and James Hardie ((JHX)) were still included only a few years ago, but ongoing success has now pushed them into the top 50. Similarly, Mineral Resources ((MIN)), Altium ((ALU)) and Corporate Travel ((CTD)) are currently not in the sweet spot basket, but it'll only take one more excellent year and they can be.

There will be losers too, of course. This is why a dynamic approach seems best. And as per always, none of the above suggests that every single stock in this particular segment will prove an excellent investment, no matter what horizon.

Conviction Calls

As mentioned in the first part of this Weekly Insights, CLSA analysts are convinced that whoever buys Ramsay Health Care ((RHC)) shares in the lower $50s shall be richly rewarded over time. Less than three weeks ago, the analysts published a sizeable update on the private hospitals operator and the title of that report pretty much gives it away, despite the rhetorical question mark at the end: Darkest before the dawn?

CLSA keeps a Buy rating for the stock with a price target of $72.35. While the target is not the highest in the market, it does suggest plenty of upside, implied, for investors with stamina and patience.

CLSA is also very keen on Treasury Wine ((TWE)) -note: different analyst- with proprietary research involving 45 wine wholesalers across 14 cities in China supporting the ongoing positive view, contrary to media reports about import and inventory problems in the country.

In light of the weakening share price, and a lot of negative press labeled as "noise", CLSA happily sticks to its Buy rating, in combination with a $21 price target and, equally showing off the analyst's conviction, above market consensus forecasts.

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The same passion-with-conviction is becoming apparent at Morgan Stanley with regards to Link Administration. While acknowledging risk remains for the operations in Australia, Morgan Stanley analysts are super-enthusiastic about the outlook for the acquired Link Asset Services (LAS) in the UK. The forecast is for 10% per annum ebitda growth over FY19-21 on a combination of rising revenues and higher margins. This will take care of any small headwinds in Australia, forecast the analysts.

Also, Link is well placed to capitalise on the outsourcing trend in the UK, plus expansion into Luxembourg should add yet another leg of growth. Morgan Stanley is therefore convinced the market is overly focused on the current headwinds and risks in Australia, and thus missing the fact that Link is grabbing the opportunity to build a leading European asset servicing franchise, potentially opening up an earnings upgrade cycle.

Morgan Stanley rates the stock Overweight in conjunction with an In-Line sector view and $9 price target.

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Now that we've mentioned Link Administration, those responsible for the Balanced Model Portfolio at stockbroker Morgans have been buying Link shares recently, arguing the stock looks oversold and has probably weakened a lot more because of frustration from investors who signed up for the capital raising at $8 per share, with the $300m raised un-deployed thus far.

The fund has trimmed USD earners CSL ((CSL)), Macquarie Group ((MQG)), Corporate Travel ((CTD)) and Orora ((ORA)), likely as a weighting rebalance following recent outperformance. All four remain core holdings for the fund, the managers state. Existing holdings in the major banks have been topped up.

The stockbroker's Growth Model Porfolio has equally been buying Link Administration shares, while accumulating additional bank shares, and trimming the position in Reliance Worldwide (profit taking).

Morgans' Cross Asset Income Model Portfolio has sold half its position in APA Group ((APA)), built a new position in AusNet ((AST)) and is watching Stockland ((SGP)) and Mirvac ((MGR)) for an opportunity to replace Peet Retail Bonds.

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Equity investment manager DNR Capital is focusing on a possible reduction in credit in Australia and has decided its portfolio requires less bond proxies and less higher PE stocks. DNR is worried that a period of reduced credit growth will have a negative impact on consumers as well as on the housing sector.

DNR remains underweight consumer stocks and banks, preferring mining and infrastructure spending exposure instead. The investment manager has been building positions in Woolworths ((WOW)), CYBG ((CYB)), and Woodside Petroleum ((WPL)) recently.

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Martin Crabb, chief investment officer at Shaw and Partners, has been warning the stockbroker's clientele it might be time to start selling some shares as the share market in general has performed well, on basically nothing but sentiment and thin air, and with no support from earnings estimates (have not risen accordingly).

Crabb uses a rigorous fair value methodology based on consensus price target forecasts for the ASX100. With the share market rising throughout June and July (up until last week), the suggested further upside potential from this model is only a fraction on top of the prospective 4.45% in dividends. Not enough to start accumulating, in a general sense.

Overall conclusion: "Australian earnings risk seems pretty low, but valuations look full. Global earnings risk looks even lower and valuations are much better. Overweight global equities over local."

His warning is further supported by the observation the Australian share market is trading nearly one standard deviation above its long term PE average.

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(This story was written on Monday 9th and Wednesday 11th July 2018. Part One was published on the Monday in the form of an email to paying subscribers at FNArena, and again on Wednesday as a story on the website. Part Two shall be published on the website on Thursday).

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