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Uncertainty Prevails At Link Administration

Earnings uncertainty for Link Administration is heightened and the stock is expected to trade at a discount to valuation for some time.

-Downgrade to FY19 earnings as Brexit uncertainty continues -Lack of clarity on cost impact from superannuation changes -Structural growth story remains intact, FY20 likely trough

By Eva Brocklehurst

Dysfunction in the UK resulting from Brexit and changes to Australian legislation have sideswiped Link Administration Holdings ((LNK)) and earnings predictability has taken a hit. Investors are also concerned about the quality of information provided by the company, and the stock is expected to trade at a discount to valuation for some time.

The company now guides to operating earnings for FY19 in the range of $350-360m, around -9% below prior consensus estimates. Two major aspects contributed to the downgrade, the Brexit overhang on sentiment, which particularly affects Link Market Services and the soon-to-be-disposed corporate and private clients business.

A large portion is also attributed to higher costs and revenue headwinds in funds administration as some superannuation funds are pre-emptively applying regulatory changes occurring from July 1 for account consolidation in FY19.

The delay in Brexit to the end of October appears to have hurt the company in ways it was not expecting and it is unclear if other factors are at play as well. For example, Link Market Services in the UK has won a number of IPO mandates that have subsequently been postponed because of Brexit.

The main impact of the Protecting Your Super legislation, designed to pass inactive accounts to the Australian Taxation Office, was due in FY20 but initial transfers are occurring in FY19 to facilitate early consolidation. There are also further costs from increased call centre activity and client migration activity.

Citi lowers estimates for earnings per share by -12% in FY19 and -16% in FY20. The downgrade was predominantly because of one-off factors and largely outside the company's control, yet, combined with the lack of revenue growth in funds administration, the issues provide cause for doubt and Citi downgrades to Neutral from Buy.

The investment briefing in London on June 18 will more than likely have a positive spin and focus on the potential in fund solutions and opportunities available in UK workplace pension schemes as well as the expansion into Luxembourg, Citi suggests. The company is also expected to emphasise growth opportunities in banking and credit management. Whether this will be enough to sway a sceptical investor base remains to be seen, the broker adds.

Morgans also highlights uncertainty, noting the funds administration impact from client migration activity and higher resourcing costs will not fully roll off until around the end of October.

Cost Savings Critical

A period of elevated costs and reduced visibility is likely. Higher costs are expected to continue until at least October but the company has not been prepared to disclose the level of additional costs incurred so far. Citi accepts there is some reluctance because of difficulties in predicting the levels of member engagement but finds it disappointing nonetheless. Several other brokers agree that some of the reasons behind the downgrade were not explained adequately.

Credit Suisse observes Link Administration is joining a growing list of Australian financial service companies that have downgraded recently, affected by difficult operating environment, elevated costs and regulatory changes. While the magnitude of the impact on earnings is greater than the broker expected, Link Administration is still expected to offer earnings growth if it can successfully achieve its targeted cost savings.

While envisaging significant valuation upside in retaining a Buy rating, UBS acknowledges realising value could take some time and there are concerns around management credibility in setting reliable expectations. While management's disclosure on the size of the cost impact from Australian regulatory changes was quite ambiguous, Morgans still envisages longer-term upside from acquisition synergies, expansion for Link Asset Services and growth in PEXA.

The company will need to engage in renewing contracts with its five largest superannuation fund customers over the next two years, commencing with AusSuper where the existing contract ends in December. While the risk of Link losing contracts outright is low, Citi concedes it will be a source of investor concern until the decks are cleared. The broker suspects the initial market reaction to the downgrade was overly dramatic but points out solid growth in Australian funds administration has failed to materialise.

Long-term Value Remains

Macquarie also recognises the stock is unlikely to re-rate in the near term yet maintains an Outperform rating as there is fundamental value in the stock. The broker forecasts a recovery in Link Market Services revenue growth in FY21 from improved market activity.

Morgan Stanley is disappointed with two downgrades in as many years but considers the stock cheap and the structural growth story intact. The operating environment in Europe appears to be more cyclical than previously considered and the broker does not find the trading update changes its view regarding funds administration.

The funds administration business is currently over-earning, Morgan Stanley assesses, given the number of superannuation accounts is likely to decline by around -30% and because outsourcing businesses are inherently deflationary in the longer term. Yet the FY19 downgrade is largely a 6-9-month pulling forward of the impact of reforms and the broker assumes revenue should trough in FY20.

FNArena's database shows six Buy ratings, one Hold (Citi) and one Sell (Deutsche Bank). The consensus target is $7.18, signalling 24.7% upside to the last share price. This compares with $8.06 ahead of the update. Targets range from $6.00 (Citi) to $8.20 (Morgan Stanley).

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Infrastructure Expenditure Underpins Boral

The outlook for Boral is increasingly reliant on the upside in infrastructure amid a soft residential market.

-Infrastructure, non-residential activity unlikely to offset a decline in residential in FY20 -Benefits from quarrying and asphalt capabilities in Victoria expected -Low probability of further asset sales in current conditions

By Eva Brocklehurst

Brokers heaved a sigh of relief as Boral ((BLD)) provided no changes to FY19 guidance at its investor day. Given March quarter residential activity in both Australia and the US was soft, a result roughly in line with guidance is considered likely to be greeted positively by investors.

The company is targeting additional cost savings to offset softer market conditions. The absence of a downgrade was the most significant news from the investor briefing, in Morgan Stanley's view, noting Boral is currently guiding for FY19 earnings, excluding property, to be similar to FY18.

Still, Deutsche Bank warns that Boral has indicated that outcomes are contingent on a strong June. For the first time, management also conceded that rises in infrastructure and non-residential activity is unlikely to offset a decline in residential business in FY20. Weakness is likely to be particularly acute in NSW, the company's largest revenue region and the one with the highest margin. Typically, infrastructure work has lower margins than residential.

The main bright spot, Credit Suisse notes, is the outlook for asphalt, although this is lower margin than cement/concrete. Yet a poor recent track record and impending cyclical downturn means the broker downgrades to Underperform from Neutral. Credit Suisse expects margins to decline in segments with lower volume, noting a declining outlook for concrete demand in Australia.

Management considers it too early to gauge the traction from price increases in April and Ord Minnett observes the outlook in some market segments, such as south-east Queensland and NSW apartments, is becoming more challenging. Macquarie agrees there are mounting risks in NSW and Queensland and, while a recovery in detached housing demand could be an offset, risks exist if Boral is unsuccessful in securing the WestConnex 3B stage (NSW).

The next phase of the infrastructure story is in Victoria, where the company expects to benefit from quarrying and asphalt capabilities. Margins are likely to be lower in Victoria, Macquarie points out, given the weaker integration across the value chain.

Ord Minnett expects free cash flow will improve materially in FY20 as growth persists in the US and capital expenditure moderates in Australia. While lowering earnings forecasts overall, to reflect a softer outlook for volumes and prices, the broker considers the stock remains attractively priced relative to peers.

The broker acknowledges former expectations for flat volumes through to FY21 appear too optimistic and declines of around -3.5% are now expected in both FY20 and FY21. While the company may be on track to achieve FY19 guidance, favourable weather conditions remain a prerequisite in what is a seasonally important period in the US and Australia, Macquarie asserts.

The company is "rightsizing" the business, UBS believes, as exposure to infrastructure work rose to 46% of revenue, from 36%. Longer term, Morgan Stanley, too, likes the Australian infrastructure exposure and upside from the US, particularly the fly ash business.

Plasterboard JV

The value in the Asian plasterboard JV is becoming clearer, with synergies from plant utilisation and freight noted. Boral's preferred option, to return Australasian business to 100% ownership and expand the JV in Asia with Knauf, has progressed and there is greater clarity on the likely structure, with the company maintaining its preference for funding via debt and asset sales as opposed to a capital raising.

Ord Minnett estimates Boral could pay around $800m without asset sales for the plasterboard business, leaving leverage at the top end of management's target range.

Asset Sales

Macquarie has considered the possible implications of asset sales, assessing there is a preference for selling the remaining elements of the Australian building products operations over anything meaningful from the US portfolio. Boral's Australian building products portfolio generates annualised revenue of around $340m but is experiencing declining profits and higher costs. The US windows business generated annualised revenue of just under US$150m in the first half.

While assessing sale options, the broker asserts that the prospect is a pretty low-probability event. Selling the building products portfolio as a package would be extraordinarily difficult. Market conditions in Western Australia, where these businesses have significant exposure, are far from comfortable. Meanwhile, a review of the property portfolio has led Macquarie to the conclusion that the pipeline is long-dated. The broker increases estimates for average earnings from property to $30m from $20m.

FNArena's database shows five Buy ratings, one Hold and one Sell. The consensus target is $5.77, signalling 8.3% upside to the last share price. The dividend yield on FY19 and FY20 forecasts is 4.9% and 5.1% respectively.

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Appen Highlights Lift In Order Book

Appen has upgraded earnings guidance and indicated a solid order book exists for 2019.

-Expanding sophistication of its artificial intelligence offering -Further upgrade to 2019 may be forthcoming -Figure Eight potentially a material source of earnings upside

By Eva Brocklehurst

Brokers expect customers of Appen ((APX)) will obtain higher-value data as the business expands its sophistication and efficiency. The addition of the crowd management platform of LeapForce and newly-acquired Figure Eight's client portal underpin this view.

The company, which provides data for machine learning and artificial intelligence, has updated 2019 guidance at its AGM, expecting underlying operating earnings (EBITDA) of $85-90m, including the Figure Eight acquisition.

This is an upgrade of 8-9% on the implied range provided at the time of the acquisition in March. As assumptions have not changed (a loss of -$4-6m is forecast for Figure Eight in 2019) this improvement appears to Bell Potter to have been driven by the operating performance in the core operations. Whilst not completely clear, UBS also assesses the guidance includes the $6m investment in technology that is now being spent across other areas of the business.

Order Uplift

The company also indicated that year-to-date revenue, plus orders in hand for 2019 delivery, is $270m, signalling to brokers full year revenue will be over $500m. While this now comprises the contribution from Figure Eight and cannot be directly compared to the $165m for 2018 reported in February it does appear to Canaccord Genuity to represent a healthy uplift in core orders. Either that or a dramatic increase in Figure Eight's recurring revenue.

The broker upgrades estimates to the top end of the guidance range, a 7% increase on previous forecasts. 2020 and 2021 estimates are increased by 6%. Canaccord, not one of the eight stockbrokers monitored daily on the FNArena database, upgrades to Buy from Hold with a target of $29.50.

Canaccord acknowledges a long period with a Hold rating, having been concerned that the expanded earnings multiples could revert to the mean and take the stock price down. However, Appen appears to have retained earnings momentum with positive elements such as this upgrade to guidance for 2019.

Bell Potter forecasts earnings to be above the guidance range, at $93.7m, driven partly by currency. Hence, a reasonable chance of another upgrade can be factored into the second half of the year. The broker, also not one of the eight, maintains a Hold rating with a $25.75 target.

UBS asserts the company is leading the market, while its position has been strengthened with the added capabilities from Figure Eight. Earnings risk is skewed to the upside and the broker considers Appen a strong domestic exposure to global artificial intelligence trends.

UBS maintains a Neutral rating on valuation grounds with a target of $26.20. The broker believes the company's strong language capability should also enable Figure Eight to capture larger scale projects. Figure Eight's video annotation capabilities lead the market and could be a material source of earnings upside in the medium term for Appen.

FNArena's database shows one Buy (Citi, yet to update on the AGM) and one Hold (UBS).

See also, Appen Enhances Scale With Figure Eight on March 12, 2019.

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China Plans Self-Sufficiency In Milk Formula

Will China's self-sufficiency action plan for infant milk formula have a detrimental impact on imports?

-Lack of clarity on achieving the goals, given no timeframe -Action plan has weighed on sentiment but local brands still struggle -A2 Milk may be well positioned, with flexible distribution channels

By Eva Brocklehurst

China has announced a plan to improve confidence in domestic infant milk formula. The intention of the National Development and Reform Commission (NDRC) is to obtain a higher market share for domestic brands and a 60%-plus self-sufficiency rate.

The plan envisages support for domestic dairy processors to acquire, or set up, bases overseas for milk supply and to encourage foreign dairy firms to invest in China. No new regulation or changes to existing regulations are proposed.

While the policy appears favourable to domestic players, Morgan Stanley notes a lack of clarity on how the government intends to achieve its goals, given no time frame. For a2 Milk ((A2M)) and Bellamy's Australia ((BAL)), the broker believes there are risks that the addressable market may shrink and a focus on traceability could lead to a crackdown on the daigou, suppliers that are based outside China, to which a2 Milk is heavily exposed.

Changing consumer perceptions of domestic products is the key challenge for the government, Macquarie asserts, as local brands have been selling foreign-manufactured goods in China for some time but have struggled to build share. A preference for imports was triggered by the 2008 contamination, where melamine was found in domestic formula, while the number of brands operating in China has been reduced significantly since 2018.

Hence, Macquarie assesses manufacturing and providence do not seem to be the limiting factors in consumer acceptance. The broker considers it unlikely the government will reduce access to imported formula, given consumer sensitivity.

UBS assesses domestic brands make up less than 60% of the aggregate share, which means some market share risk for international brands in the longer term. The broker also notes China's government has previously sought to promote domestic brands, the last time in 2013.

Three-year targets have also been set for establishing a research database, safety monitoring system and a new round of inspections on production facilities. The broker does not believe there is a significant issue for international companies as these often have greater flexibility, in that they can produce locally or import.

Infant Formula Stocks

Macquarie considers this a buying opportunity for a2 Milk, as the action plan as it stands has limited near-term impact. The company continues to have a partnership with China State Farms and a flexible multi-channel distribution structure.

Bell Potter is not so sure, as a2 Milk is still largely dependent on cross-border e-commerce entities and the daigou trade, and any disruption through a tightening of e-commerce regulations may disrupt revenues in FY20-21.

The broker, not one of the eight monitored daily on the FNArena database, retains a Sell rating on a2 Milk with an $11.50 target. The database has two Buy ratings, four Hold and one Sell (Morgan Stanley) for a2 Milk. The consensus target is $14.40, signalling 7.1% upside to the last share price.

Nevertheless, Macquarie asserts, while a2 Milk is a fast-growing and trusted consumer brand in China, increased support for domestic players could mean competition intensifies and requires additional investment in sales and marketing.

Bell Potter also continues to envisage a risk from the transition in the sales mix to lower-margin China direct sales at a time when ingredient costs are rising and sector-wide demand in China is slowing.

Synlait Milk ((SM1)), meanwhile, has come under pressure because of the uncertainty around its Pokeno site and Munchkin putting its US FDA application on hold, the latter which entails a gap in filling capacity. At present a2 Milk makes up almost all Synlait Milk's infant formula production. Therefore, should China's latest announcement affect volumes for a2 Milk it would have a corresponding impact on Synlait Milk.

Macquarie has an Underperform rating for the stock, reflecting a view on the medium to longer term margin sustainability as well as the uncertainties referred to above. On balance, Bell Potter finds China's announcement underscores the strategic value of Synlait Milk's manufacturing footprint, a positive, and retains a $12.50 target with a Buy rating.

Fonterra Shareholders Fund ((FSF)) has a small exposure to infant formula in China and the main impact, Macquarie suggests, would be further strength in Beingmate's share price (Fonterra has a 19% stake) relative to this action plan. Macquarie notes the company is looking to potentially divest its stake in Beingmate as well as two farming hubs in China.

Bell Potter flags the dependence of Bellamy's Australia on e-commerce sales in China, and suggests any more rigid enforcement of e-commerce laws, may have a detrimental effect. Given delays, the broker has removed China-direct organic label sales from its forecasts, as this remains subject to China's market regulator approval.

The broker also reduces the probability of the company achieving its $500m revenue target. Bell Potter's Hold rating is maintained with an $8.05 target. On the database, there are three Hold ratings for Bellamy's Australia and the consensus target is $9.78, signalling 22.0% upside to the last share price.

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RBA Rate Cut Just The Job

How many more RBA rate cuts ahead? Opinions vary, but it will all depend on a fall in unemployment and subsequent rise in inflation.

-Unemployment the critical factor for RBA -Regulatory and fiscal measures play their part -Will further cuts even help?

By Greg Peel

It's not about a falling housing market, it's all about jobs, and subsequently inflation.

After a surprisingly weak CPI result for the March quarter the RBA flagged a rate cut ahead. The only point of debate was whether it would be as soon as May, but given the election in May, June seemed more likely, and so it has come to pass.

A falling housing market and the possibility of increased mortgage defaults seemed like justification to cut the cash rate to stem the tide, but yesterday the RBA statement noted, in relation to housing, "Conditions remained soft, although in some markets the rate of price decline has slowed and auction clearance rates have increased".

This graph tells the tale:

The housing market is far from irrelevant, nevertheless. The graph is signalling a bottom in house price declines is possibly not far off, and that's before APRA formerly lowers its mortgage serviceability rate requirement and yesterday's announced mortgage rate cuts from the banks have their impact.

The main issue with falling housing prices is not as much of mortgage default risk as it is of the "wealth effect". Even though a mortgaged homeowner may have no desire or need to sell into a falling market, the usual response is to hold off on discretionary spending. In rising housing markets people feel "rich" and go out spending. In falling housing markets the opposite is true.

And that keeps a lid on consumer price inflation. But the signs are improving for the housing market, yet the RBA saw reason to cut. While the board gave a nod to the risks inherent in an all-out global trade war, the primary concern is weak wage growth, which is the result of so-called "spare capacity" in the labour market.

While a 5% unemployment rate was once considered "full employment", in today's world that "neutral" rate is lower. The RBA wants to see the unemployment rate fall. And it wants to see the underemployment rate fall. A lot of the "spare capacity" is down to those with part-time jobs wanting either full-time jobs or at least more hours.

A reduction of that spare capacity is required to lift wage growth. Growing wages allow workers to spend, and spending supports higher inflation. The RBA cut its cash rate to an historical low 1.25% yesterday with the specific intention of reducing unemployment. This is the remaining weak factor in an economic outlook that hasn't otherwise much changed.

Will it work? Clearly few economists believe so. For starters, rate cuts take many months to flow through the system and have their impact. The RBA remains hopeful, but recent labour market indicators suggest otherwise. Consensus has it that a second cut as early as next month would be forthcoming but for a lack of data in the lead-up, and the RBA has suggested in not so many words it is now data-dependent.

As I write, Australia's March quarter GDP result has just come in at 0.4% growth, slightly below consensus expectation, but 1.8% annual growth, in line with expectation. That's the slowest annual rate since the GFC.

Within the number, government spending contributed the most to growth, and strong iron ore prices did their part. But the key for inflation expectations is household consumption, which slowed to a growth rate of a mere 0.1%.

The result, while reflecting conditions as far back as January, supports further rate cut. Economists nonetheless agree a more critical data release will be the June quarter CPI result, which will not be delivered until after the July RBA meeting. While headline inflation will likely rise on higher oil prices in the period, core inflation is not expected to improve from the weak march quarter result.

Hence consensus has it that August is as much as a lay-down misere for a second rate cut as June was for the first.

Indeed, the bulk of economist responses to the rate cut were published after the statement release but before RBA Governor Philip Lowe spoke last night. Before the speech economists were in disagreement about whether the nuances of the statement suggested a more dovish tone. But last night he said:

“That the Board has not yet made a decision, but it is not unreasonable to expect a lower cash rate. Our latest set of forecasts were prepared on the assumption that the cash rate would follow the path implied by market pricing, which was for the cash rate to be around 1 per cent by the end of the year.”

So bake in August. The question then is: How many more? Here, opinions differ.

Other factors

The RBA has made it clear that monetary policy alone cannot be expected to stimulate economic growth, and the lower rates go the less the incremental benefit of cuts. What is required are “unconventional tools” and fiscal policy support.

As to “unconventional tools”, APRA has already come to the party. A reduction in the mortgage serviceability rate is not going to send house prices and mortgage demand flying back up again, but it does help to improve confidence.

Last week the Fair Work Commission granted a 3% increase to the minimum wage. Given this is close to twice the current rate of inflation, it is somewhat “unconventional”, and will add to the spending power of lower-income workers.

On the fiscal side, it’s a matter of what won’t happen as much as what will happen now the Coalition has been returned to power.

Negative gearing will not be restricted, which is supportive of a return to confidence in housing and increased investor demand. Cash refunds for dividend franking will not be scrapped, meaning many Australians can now rely on (and thus spend) significant income streams.

The Coalition is set to deliver across-the-board tax cuts. CBA economists have noted that substantial income tax rebates will flow to around 10m low-to-middle income earners from as early as mid-July. In total around $7.5bn in rebates will be received in FY20 which, CBA calculates, is equivalent to 0.6% of disposable income or 50 basis points in interest rate cuts.

Lastly on the fiscal front, albeit totally out of the government’s control, is the impact of the surging iron ore price. Spot iron ore is currently bouncing around the US$100/t mark and may well go higher in the short term. When the Coalition delivered its budget ahead of the election, and promised a swift return to surplus, its iron ore price assumption was US$55/t.

Currently, the market is pricing in a risk that the RBA cash rate will fall below 1% in 2020, and beyond that there is a risk “unconventional” monetary policy will be required, which basically suggests quantitative easing. “Our view,” says CBA, “is that such an outcome would require an economic scenario that is considerably more bearish than our own forecasts”.

CBA sits at the more “hawkish” end of expectations.

Range of expectations

JP Morgan believes the RBA statement was more dovish than the market appreciates at present, and “at present” was before Philip Lowe spoke last night. Specifically the final sentence:

“The Board will continue to monitor developments in the labour market closely and adjust monetary policy to support sustainable growth in the economy and the achievement of the inflation target over time.”

How much “adjustment”? JPMorgan sits at the opposite end of consensus from CBA, expecting a rate cut in August and two more in the first half of 2020.

Morgan Stanley is another expecting an August rate cut, but then expects the RBA to remain on hold. The reason being it takes some time for the impact of cuts to flow through the economy and the board will need to see how things play out. It will also want to see what impact the APRA cut and income tax cuts bring about.

However, as exciting as all these stimulatory measures may be, Morgan Stanley expects rate cuts to provide only limited stimulus to the economy, and “little” in the near-term. MS economists don’t see much of a pass-through to spending and are sceptical that a significant pick-up in credit growth will follow.

“Animal spirits will need to be rekindled to see a more effective and sustained monetary stimulus”.

UBS believes the RBA's GDP forecasts remain "optimistic" and will be downgraded by August. UBS has booked in an August cut but sees risk of more easing below 1%.

Potential triggers to this would be weak consumption within the March quarter GDP result (which we now know is the case), unemployment failing to improve, June quarter underlying CPI inflation failing to lift from the March quarter historic low, and the risk of the global trade war escalating.

The latter risk was also flagged as an issue in the RBA statement.

Economists across the board land somewhere between one and three more rate cuts ahead. BIS Oxford Economics suggests two more to 0.75%. Franklin Templeton is backing three to 0.5%. Janus Henderson so far sees just the one cut in August. ANZ Bank has moved a prior forecast of another rate cut in November forward to August but believes a move below 1% is "not imminent".

While it is the US Federal Reserve that made the expression "data-dependent" a buzzword, the same now is explicitly true for the RBA. The RBA will need to assess the data, and see how other measures (APRA, government fiscal policy) play out. As to how long the RBA will allow for such an assessment is unclear, and as to whether the board believes a cut below 1% is going to help at all is also not certain.

It does appear certain nonetheless, as far as economists are concerned, that another cut is coming in August.

Technical limitations

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WorleyParsons Gains Enhanced Global Scale

Brokers agree WorleyParsons is well placed to capture a large slice of work in global resources engineering but some concerns linger over the outlook for oil & gas.

-Upgraded synergy targets for Jacobs ECR acquisition -Near-term growth in E&P engineering somewhat soft, customers cautious -Excess low-cost gas in the US may be an opportunity

By Eva Brocklehurst

A diverse business mix has been further enhanced and WorleyParsons ((WOR)) is positioned to capture a greater amount of work as it integrates Jacobs ECR. Pending a smooth integration, the new scale will provide wide exposure, covering upstream oil & gas, chemicals and mining.

Brokers note the integration of Jacobs ECR is continuing to track ahead of expectations and there is upside risk from the acquisition from both the revenue and margin perspectives. Management has put further M&A on hold, a fact which pleases Ord Minnett, given a two-year integration program for Jacobs ECR.

Morgan Stanley points out Jacobs ECR has a history of refining work but is building a greater weighting in chemicals. While there was no guidance on refining capex, WorleyParsons expects chemical capex to grow at 3% to 2024.

Synergies Highlighted

Cost synergy targets for Jacobs ECR have been upgraded by 15%, with 60-70% of the synergies to be delivered in the first 12 months. This a good sign, in Macquarie's view, as it comes after only five weeks of ownership. The company has also highlighted the margin opportunity via shared services and global integrated delivery.

Revenue opportunities include the likes of the lithium project for Orocobre ((ORE)). Moreover, while WorleyParsons has no presence in Argentina Jacobs ECR does. Macquarie asserts, combining this with WorleyParsons' lithium expertise, this is a good example of the leverage available to the merged group.

UBS upgrades the stock to Buy as it now appears more attractive on a valuation basis, given the share price has fallen -15% over the last three months. The broker forecasts earnings (EBIT) growth of 96% in FY20 and 13% in FY21 supported by Jacobs ECR synergies.

While the backlog over the past six months has improved, and Morgan Stanley is unconcerned, there is the undisputed inference that industry activity is not surging ahead. This compares with 2017-18 whether backlog grew sequentially quarter by quarter. Meanwhile, there appears to be no momentum on WorleyParsons' four large receivables and the broker wonders whether some of this will be written off over time.

Ord Minnett assesses near-term growth is a little anaemic, while customers are cautious about the current macro economic environment. Nevertheless, the broker believes WorleyParsons can benefit from an improving cycle. Macquarie also notes a more measured pace of top-line growth, and the number of contract awards has slowed from very strong levels. Still the balance sheet is in good shape. Importantly the company's commercial model has not changed post the acquisition of Jacobs ECR, so the risk profile remains similar.

Citi expects the company to continue leveraging global delivery capabilities in India and China. In the medium term, earnings are likely to be softer as further capital expenditure is required for additional investment in the modernisation of systems.

Oil & Gas Outlook

WorleyParsons is leveraged to the global energy transition, yet expects significant increases in conventional oil & gas investment. Global primary chemicals production is also expected to increase materially, while higher metals and minerals production will lead to resources growth in renewable power and electric vehicles.

The main risk Morgan Stanley perceives is the deflationary outlook for oil & gas. This is driven by the resilience of shale production in North America, which is growing at close to the growth rates of global oil demand, and there is significant resources in place to underpin the trend. This also suggests OPEC (Organisation of Petroleum Exporting Countries) is ceding market share and this is rarely good for oil prices.

Morgan Stanley wonders whether countries outside of the US will consider lowering taxes on oil projects to compete for capital and notes, in terms of WorleyParsons, its upstream business has very little exposure to shale.

Macquarie highlights the multifaceted growth in petrochemicals, believing excess low-cost gas in the US creates opportunities. US shale as a petrochemical feedstock, albeit far away from markets in China, can be exported economically and Jacobs ECR has experience in a range of US crackers on the Gulf of Mexico coast.

UBS considers the global oil & gas cycle is in the early stages of a recovery and remains constructive on the medium-term outlook. Still, there is a high correlation of WorleyParsons shares with oil prices and this is a key downside risk. Downside risk comes with any deferral of energy expenditure as a result of oil price declines.

The main prize in the merger with Jacobs ECR is revenue, Credit Suisse asserts. The broker observes project and capital expenditure across resources is being moved out a little and it is unlikely WorleyParsons will lose its leverage to the oil price any time soon. Still, for items that can be controlled, the business appears well situated. Overall, Credit Suisse identifies the risks to the upside, albeit near-term catalysts are hard to identify.

Morgan Stanley alludes to management's frustration at the lower share price and agrees that the correlation to oil prices is unlikely to disappear quickly, as there are limited oilfield service companies in Australia, or even regionally, for investors. While envisaging some valuation upside, the broker maintains its Equal-weight rating.

FNArena's database shows six Buy ratings and one Hold (Morgan Stanley) and the consensus target is $18.32, suggesting 39.4% upside to the last share price. Targets range from $16.00 (UBS, Morgan Stanley) to $21.48 (Macquarie).

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Afterpay Touch Steams Into The US

Payment provider Afterpay Touch has steamed into the US, with stellar growth in sales similar to that experienced when the business started up in Australia.

-US margins may be negative and market needs to watch carefully -UK roll-out more subdued versus US -AUSTRAC investigation adds regulatory risk

By Eva Brocklehurst

Customer growth rates in the US appear to be going gangbusters for Afterpay Touch ((APT)), the "buy now pay later" payment provider. The company is on track to add one million US users in the second half of FY19 and will be closing in on 1.7m active US users by the end of June.

Afterpay Touch, which merged with Touchcorp in 2017, has been upgrading revenue forecasts for around two years now and, while growth is at a slower pace in more mature markets, relatively it remains stellar, brokers assert. The US business has performed very strongly, as sales, merchants and customers rose 115-135% half on half to the end of May, and sales totalled $531m in the first five months of 2019.

US net transaction margins improved, although Wilsons suspects this is in negative territory, supported by merchant fee income and stabilising losses as the business gains scale. While not explicitly clear, the broker assumes, on a reported basis, that US margins are negative and asserts the market needs to continue scrutinising US margins.

US trading was slightly below expectations, although Wilsons acknowledges progress is still "great" and moves forecasts up marginally to reflect momentum. The broker remains attracted to the long-term market opportunity across the US, UK and Australia yet notes the cost to execute globally is substantial and earnings margins will face headwinds in the near term.

Average expenditure in the US is similar at this point in time to what it was when operations started in Australasia and Bell Potter expects average expenditure to increase as more merchants are added and the US moves to in-store offerings to complement the online experience.

Bell Potter, retaining a Buy rating and $29.28 target, upgrades underlying active customer estimates by 2-2.9% and increases earnings estimates on the back of higher growth expected in total transaction value.

In the UK an initial 50 merchants provided a firm start in that market. Morgans notes the UK entry, launched as Clearpay, may appear subdued relative to the US but management has signalled a more phased roll-out in that country.

All up, initial progress in the US is encouraging and upside to the share price is likely if offshore roll-out plans can be successfully executed. Hence, Morgans has an Add rating and $25.96 target.

Australasia Maturing

Morgans considers the implied second half sales growth of 10% in Australia is “reasonably solid”. Growth rates in Australia are trending lower as the business matures, although sales growth of 100% is still expected in 2019.

Australian sales of $1.9bn in the second half imply the company will reach $2.2bn by the end of the half to June. Meanwhile, the investigation by AUSTRAC, Australia's financial intelligence agency, will at the very least, Morgans suspects, involve costs in order to improve processes to better comply with regulation. AUSTRAC has indicated it intends to review a range of international platforms for compliance, including Facebook.

Wilsons also notes AUSTRAC has raised some issues pertaining to anti-money laundering compliance and the company remains in dialogue with the regulator. Wilsons believes this has added a further dimension to the regulatory risk that has consistently affected the company and maintains a Hold rating and $21.85 target. This position reflects strong execution, with a valuation that discounts material market share in the online US market.

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ESG Focus: Global Shipping, Disrupted Disruptor

FNArena's dedicated ESG Focus news section zooms in on matters Environmental, Social & Governance (ESG) that are increasingly guiding investors preferences and decisions globally. For more news updates, past and future: https://www.fnarena.com/index.php/financial-news/daily-financial-news/category/esg-focus/

ESG Focus: Global Shipping, Disrupted Disruptor

-International Maritime Organisation slashes sulphur limits in shipping fuel by 85% -Shipping, oil refineries, aviation, road transport and coal will be hardest hit -Domestically, Australian LNG and coal exports to feel the repercussions

By Sarah Mills

“It’s life Jim but not as we know it.”

These iconic words from Star Trek’s Mr Spock could easily apply to the investment environment over the next two decades as environmental, social and governance (ESG) considerations bite.

ESG has, up until now, been a largely abstract concept, with the exception of sharply deteriorating funding for the coal industry.

But the world is about to feel the first shock of environmental regulation when the International Maritime Organisation’s (IMO’s) new limits on sulphur in shipping fuel come into effect on January 1, 2020.

Limits on sulphur fuel in ships slashed 85%

Under MARPOL Annex VI regulation 14.1.3, IMO has mandated an 85% reduction in sulphur levels in shipping fuel to 0.5% weight from the existing 3.5% weight.

IMO has also banned the carriage of non-compliant fuel after March 2020, to stop ships switching fuel at sea. Ships will be inspected going in and out of port.

It is the largest sulphur reduction undertaken in one step in the transportation sector’s history.

Global impact

Global shipping has long been a sink for dirtier crudes, and the implications will be far reaching.

The shipping industry is responsible for half of global high-sulphur fuel demand, according to Forbes; and accounts for 80% of international trade, at least 3% of global emissions and 10% of global transportation oil demand, according to HSBC.

The bad oil

Shipping fuel is an extremely dirty, high polluting fuel, containing high levels of sulphur oxides.

Sulphur oxide is a potent greenhouse gas, and is also responsible for acid rain.

Sulphur levels in shipping fuel are roughly 3,500 times greater than standard road fuels in Europe, and one container vessel consuming 80 tonnes a day of high-sulphur fuel emits the equivalent in sulphur oxides of 46m light-duty diesel vehicles.

Limited preparation means concentrated impact

The major players have been aware of the coming changes since 2008. While some maneuvering has been taking place, most have taken a wait-and-see approach given it is difficult to know when disruption strikes, where and when to invest until the situation resolves itself.

For example, there is already talk that the sulphur levels could be cut further (another 80% to just 0.1% weight), which would change the game again.

This means preparations will begin in earnest from July 1, concentrating the bulk of the fallout into a narrow timeframe of roughly 18 months to two years.

Limited preparation means the industries will most likely opt for quick-fix expensive options as they scramble to comply before long-term capital investment restores the balance.

The regulators

The International Maritime Organisation is the United Nations body responsible for the safety and environmental performance for the shipping sector.

North America, the Eurozone and China are all on board and account for 90% of global shipping fuel demand. UAE is the only major non-signatory.

The initiative also has the support of major shipping companies through the Trident Alliance.

Oils aint oils

Given oil's pivotal economic role, its repercussions will reverberate across the globe.Total global demand for major petroleum product is still expected to continue to grow between 1m to 14m barrels a year.

However, the usage of oil types is expected to change sharply and impact pricing for better and for worse across oil spreads.

Internationally, prices for middle distillate oil are forecast to rise, affecting the aviation and road transport industry, asphalt markets, petrochemical and feedstocks markets, bringing supranormal short-term profits for producers.

Shipping and oil refineries first in the firing line

The shipping and oil refinery industries will face a period of restructuring as players adopt a variety of survival strategies. As with all disruption, the regulation represents both threats and opportunities.

Starting with shipping, fuel represents 15% of total costs so upgrading global fleets to more expensive distillates will have a material financial impact.

The shipping industry only has three options. It can: switch to more expensive marine gas oil (adding 15% to fuel costs); install scrubbers to clean sulphur from the fuel; or invest in new ships designed for LNG, or renewables mixes.

It is expected that the market will opt primarily for marine-gas oil in the short-term, as installing scrubbers is expensive (about $3m to $5m per ship) and involves several months lead time and at least two months in dry-dock, resulting in a loss of revenue.

IMO had forecast that 3,800 ships (from the main global fleet of 60,000) would install scrubbers but pundits now estimate that figures could be as low as 1,000-1,500, according to Lloyds.

The installation of scrubbers also involves expensive operational, logistical, technical, regulatory and commercial issues.

This means that depending on the age of the ship, in many cases it will be more sensible to buy a new high-spec boat, including boats designed to run on liquid natural gas (LNG) or a renewable energy mix.

New ships cost roughly $120m to $160m, and the average life cycle is 20-25 years. Depending on which way the industry leans, this lifecycle could be reduced to as low as seven-12 years at considerable expense.

LNG vessels cost 15%-20% more than traditional bunker fuel vessels but there are concerns about its availability as a bunker fuel within the next five years. About 25 ports are equipped with LNG facilities and this is forecast to grow.

Meanwhile, ship-builders and scrubber installers and producers are likely to find themselves suddenly very busy. The shipbuilding sector should experience strong demand particularly for high-spec energy efficient vessels.

Scrubbers are expected to experience a 15% to 30% increase in cumulative incremental capital intensity (cici), according to Lazard.

An LNG retrofit of a vessel is expected to cost between $15m and $25m and have a 40%-80% cici. A new LNG vessel is likely to cost between $160m and $170m at 15%-20% cici.

The good oils

As neither scrubbers nor new ships are immediate fixes, the industry will have to use alternative fuels in the short term, which also have another short-term advantage.

Given shipping freight prices are at historical, cyclical lows (Lazard analysts estimate freight rates account for less than 5% of total goods shipped), it is expected that a high percentage of the fuel costs at least, can be passed on to consumers, at least until the cycle shifts.

Marine gas oil and diesel are the two main options, with LNG being a possibility for new-build ships. LNG is not available at all ports, and this is a major drawback, although many new LNG ships will allow for long hauls without refueling. LNG represents just 3% of marine fuels market and the cost of switching is high, and not all ports are equipped for it.

Marine gas oil uses the same hydroprocessing steps as low-sulphur fuel, which makes it attractive. However, straight diesels blend better with other diesels, which is important should a ship find itself in a situation where it needs to blend fuel. The oil refineries will keep a keen eye on which way the shippers lean.

The oil refinery shuffle

Next in line are the oil refineries.

As ships shift to marine gas oil (an extra 1m barrels per day) and other fuels, the more complex refineries will benefit from the sharp uptick in demand, leading to higher margins and profits.

Of these, those with deep conversion (mainly listed refineries) are forecast to experience strong margins and supranormal profits, and medium conversion refiners should also improve margins to a lesser extent.

It is estimated that there are insufficient refineries with the necessary equipment to produce higher value distillates, which means those that can, will be running at high utilisation rates, which increases costs.

While there is a huge incentive across the board to upgrade distillate facilities, and this will be a feature over the next decade given increased oil consumption, prices for higher value distillates may start subsiding temporarily within two years as the initial impact of the shipping regulation subsides, so the mid-term return on expenditure is less certain.

Oil refineries are multi-million pound long-term investments. Refineries can take up to five years to come on line (well after the peak demand is forecast) and they often experience building delays. So any projects now would miss the peak IMO run regardless.

Global shipping trade is forecast to continue climbing but given the international commitment to cut carbon and technological advances in alternative energy sources, the future of such investments is increasingly uncertain.

So there is unlikely to be relief from the oil refining quarter.

Then there is the problem of what to do with all the heavy sulphur-laden fuel. Shipping used to be a sink for high-sulphur fuels often left over in the distillation process. It is estimated the surplus will be at least 2m barrels a day. About 1m barrels may be used as refinery feedstock but refinery demand will be insufficient to destroy all the high sulphur fuel.

Basic refineries will also lose of their biggest markets almost overnight. As this stock hits the broader market, an oversupply is expected to send prices spiraling downward.

This will also be an issue for more complex refiners who usually still have heavy crudes in the mix, placing further upward pressure on the middle distillates to enable them to recoup losses from weak high-sulphur products.

Some will turn high-sulphur fuel into products such as asphalt and petroleum coke for industries such as construction.

Volatility for oil commodities

Oil commodities markets are also bracing for widening spreads between crude mixes. Up to 290m tonnes of compliant fuel could be needed by next year, according to IMO.

Volatility is also expected to feature given small changes in supply and demand of as little as a few hundred thousand barrels are day can have major affects on price.

As noted, the shipping industry is responsible for half of global trade fuel demand. But marine gas oil, the higher value distillate, which is likely to attract that demand, only represents 5% of overall global oil demand.

Higher demand for gas oil will have to be met by higher crude runs placing upward pressure on global crude prices, distillate premiums to other fuels and refining margins in general.

Lloyds expects cracking margins for European Brent to rise US$3 a barrel. Markets expect sharp widening in the spreads between marine gas oil, crudes and even other distillates, creating a situation of contango in 2020.

Diesel prices to rise

HSBC predicts pressure on middle distillates means diesel demand will rise 5.2% by its 2020 peak, before returning to balance in 2025.

Lloyds says the spread between gasoline and diesel has traditionally been about US$4-US$6 a barrel. When diesel demand rises relative to gasoline, the spread rises to US$12, which the broker forecasts for 2020, before declining between 2021 and 2023.

Distillate inventories are already below the five-year average, which is expected to exacerbate price rises. Observers believe higher prices could hinder compliance.

High-sulphur fuel prices to tumble

Meanwhile, prices for high sulphur fuels are tipped to fall.

Traditionally, high-sulphur fuel is used in competition with natural gas in the power generation market, where it is used as feedstock. However, the dumping of shipping oil stocks could overwhelm this market, allowing it to compete with even lower-value coal in the Asian power sector.

This would mean it could fall to as low as US$15 a barrel, (from US$40), but demand would provide a floor at that level. Saudi Arabia has already signaled its intent to use high sulphur fuel to power its desalination plants, and Bangladesh is also a potential market.

Downstream industries feel the ripples

The global economy pivots around the oil price and the ripples of the IMO regulations will be felt across industries. Energy markets and industrial activity are expected to feel the brunt with petrochemicals buyers expected to be the worse off. Industries dependent on long-distance haulage are also vulnerable.

The aviation and road haulage industries are the largest buyers of middle distillates, and all things equal, are expected to face higher costs over 2020-21.

Agriculture also relies on low freight costs, which means prices could rise at the checkout. Higher freight costs are likely across most raw materials industries.

Certain metals industries are also expected to experience tighter supply of anode coke, which accounts for 10% to 15% of aluminium manufacturing. It is estimated this could add an extra 1% to 2% to costs on top of increased freight rates.

As noted above, the coal industry could suffer if the price of high-sulphur fuels drops low enough to make it competitive with coal. Oil has lower carbon-dioxide emissions than coal plus offers 50% more energy per unit.

Power generators could benefit from the regulations if more high-sulphur fuel finds its way into the feedstock market. Will ESG fund some of this? Talk to Tim Buckley. Shipping is one of the highest polluters in the transport sector, leaving it highly vulnerable to a carbon tax.

Australia caught in the cross fire

At a local level, Australia will suffer as low-quality crudes compete with coal in power generation markets. Exported LNG prices are also expected to take a short-term tumble before recovering post 2020.

This anti-intuitive state of affairs reflects the fact that Asian LNG contract prices are indexed against a basket of heavy crudes, the Japanese Crude Cocktail.

As the price of the cocktail falls and the spread against Brent crude widens, it should equate to a drop in LNG prices of about US$18 a tonne, according to The Australian Financial Review. Wood Mackenzie estimates the impact on the Australian LNG market at US$2.7bn.

The export prices of iron-ore and coal, representing 17% and 14.5% respectively of Australian export sales, could also be affected. Given both these markets are subject to other demand and supply forces which are outside the scope of this article, it is difficult to determine the net effect.

Countries with skin in the game

Countries most adversely affected will be producers of heavy crudes in Canada, Mexico, Venezuela, followed by Russia and Middle East. Winners are expected to be those producing medium weight low-sulphur crudes – north-west Africa, Brazil and North Sea.

Big investments will also be required in US and European refineries.

Compliance – to be or not to be

Many industry observers find it hard to imagine immediate and full compliance, but all agree 2020-2021 will pack a punch.

Wood Mackenzie estimates global compliance in 2020 will be 80%, while BP's CEO, Bob Dudley, expects 50% non-compliance – quite a disparity. Many participants are reluctant to move given the possibility of further regulation.

Uncertainty reigns

Discussions are under way regarding the European Emissions Control area, which would include Mediterranean shipping to consider imposing an even more stringent 0.1% weight for marine fuels across European waters.

This would further tighten middle distillate supply. Some IMO members are also considering banning the use of fuel oil in the arctic where marine traffic is expected to rise.

A carbon tax remains on the agenda, as does ESG funding decisions down companies' supply chains. IMO's greenhouse gas strategy may hold back interest in LNG bunkering beyond the 2020s. Adopted in 2018 and to be revised in 2023, it aims for a fast peak in emissions and then a halving by 2050, despite rising traffic.

This means zero green-house-gas emission vessels need to come into service at commercial scale in the 2030s, making investment in LNG ships less certain as new energy sources come on line, such as biomass, wind powered rotor technology, batteries or solar.

There has also been talk of slow steaming regulations – effectively speed limits that would incentivize adoption of zero carbon fuel. This would be of particular concern for perishable goods. Many decisions will likely hinge on future carbon-tax and emissions-regulation estimates.

Coal has a carbon intensity of about 1,000g CO_2/kWh, oil is 800g CO_2/kWh, natural gas is about 500g CO_2/kWh, while nuclear, hydro, wind and solar are all less than 50 g CO_2/kWh, according to the Renew Economy website.

Then again, perhaps it will be IMO that backs down and provides an extension, a distinct possibility a year or two into the regulatory period if the situation does not resolve itself satisfactorily.

The industry is literally "at sea".

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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FNArena is proud about its track record and past achievements: Ten Years On

Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday May 27 to Friday May 31, 2019 Total Upgrades: 8 Total Downgrades: 17 Net Ratings Breakdown: Buy 40.33%; Hold 43.20%; Sell 16.47%

For the week ending Friday, 31st May 2019, FNArena registered 17 downgrades in recommendations for individual ASX-listed stocks against only eight upgrades.

Further adding to the somewhat lopsided picture is that only three of the upgrades moved to Buy with five upgrades stopping at Hold/Neutral. The three fresh Buy rating all came from stockbroker Morgans and went to Costa Group, Genex Power and OZ Minerals.

Vocus Group was the sole recipient of two upgrades during the week, after the company received take-over interest. Both upgrades moved to Neutral.

Then again, only five out of the 17 downgrades moved to Sell. BlueScope Steel received two downgrades, of which one to Sell, and so did QBE Insurance, with both downgrades moving to Neutral.

With exception of Vocus Group, not much is happening with positive revisions to valuations and price targets. There's only a bit more action on the negative side where BlueScope Steel, Domino's Pizza and GUD Holdings might be worth investor attention.

A similar picture emerges for changes to earnings estimates. On the positive side, Fisher & Paykel Healthcare stands out (following profit update), while on the negative side Costa Group's most recent profit warning makes its impact felt, followed by reduced forecasts hitting Xero, and Freedom Foods Group.

Upgrade

BLACKMORES LIMITED ((BKL)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 0/5/1

Reports suggest Australia's flu season is extensive and well ahead of any of the previous five years at this early stage. Morgan Stanley believes this will translate into strong support for sales in the fourth quarter of FY19 and first quarter of FY20.

There is also greater confidence in the cost reduction program, which should support near-term earnings growth. Morgan Stanley upgrades to Equal-weight from Underweight and raises the target to $84 from $75. Industry view is: Cautious.

COSTA GROUP HOLDINGS LIMITED ((CGC)) Upgrade to Add from Hold by Morgans .B/H/S: 4/1/0

It was a litany of disaster for Costa in May. Variable harvest conditions for Moroccan blueberries, not cold enough for mushroom demand, crumbly raspberries and a fruit fly spotted in one of the companies seven citrus orchards. Morgans has "materially" rebased its FY20-21 forecasts as a result of the profit warning.

The broker remains concerned about fruit fly, as a breakout could result in millions per annum to treat the entire citrus crop. But otherwise the broker remains attracted to Costa's portfolio approach, geographic diversity and protected cropping techniques. Taking on board fruit fly risk Morgans upgrades to Add from Hold following yesterday's sell-off, anticipating normalisation from a month best forgotten.

Target falls to $4.77 from $5.68.

See also CGC downgrade.

COLES GROUP LIMITED ((COL)) Upgrade to Neutral from Underperform by Credit Suisse .B/H/S: 0/6/1

Credit Suisse believes Coles can accelerate sales growth over the medium term as it develops digital capability and addresses weakness in its fresh and convenience product range.

A lag in supply chain modernisation is the central competitive risk, in the broker's view, and costs are likely to be above Woolworths ((WOW)) for several years.

Rating is upgraded to Neutral from Underperform and the target raised to $11.83 from $10.81.

GENEX POWER LIMITED ((GNX)) Upgrade to Speculative Buy from Hold by Morgans .B/H/S: 1/0/0

Morgans is confident the K2-H project will go ahead although warns investors they need to be aware that, as the bulk of the stock's value comes from this project, this increases the risk.

Management has targeted June 2019 for financial close on both this project and Jemalong. The broker also updates assumptions for the K2-Solar and K3-Wind projects.

Morgans upgrades to Speculative Buy from Hold and raises the target to $0.29 from $0.25.

OZ MINERALS LIMITED ((OZL)) Upgrade to Add from Hold by Morgans .B/H/S: 4/3/1

Morgans believes the stock's retreat of nearly -20% since early April is overdone. The broker suspects sentiment is the culprit because of ongoing US/China trade uncertainty.

The broker suspects marginal investors use OZ Minerals as a proxy for the outlook for both the copper market and global growth, given its status as the largest and most liquid ASX-listed pure copper play.

The broker marks down copper prices for 2019-21 and raises gold assumptions for 2019. Overall, earnings forecasts improve by 6% over 2019-20 but are -12% lower for 2021.

Rating is upgraded to Add from Hold, as the current valuation is a key buy trigger, Morgans suggests. Target is reduced to $11.27 from $11.40.

SIGMA HEALTHCARE LIMITED ((SIG)) Upgrade to Neutral from Sell by Citi .B/H/S: 0/1/3

Since its FY19 result, Sigma has entered into a new community service obligation deed with the Commonwealth government which has provided some certainty around payments until at least June 2020.

Also, the company has provided more clarity around the cost reductions in relation to the loss of a major contract. Finally, with the re-election of the Coalition this suggests the government will be more supportive of existing regulations around the pharmacy distribution industry.

Citi now upgrades to Neutral/High Risk from Sell/High Risk while the target is steady at $0.52.

VOCUS GROUP LIMITED ((VOC)) Upgrade to Neutral from Underperform by Macquarie and Upgrade to Neutral from Sell by UBS .B/H/S: 1/6/0

The company has confirmed the receipt of a non-binding, indicative proposal at $5.25 a share. Macquarie believes the offer from EQT Infrastructure assumes strong execution on the strategic turnaround at Vocus on the back of recent and ongoing initiatives.

The broker upgrades to Neutral from Underperform and raises the target to $4.70 from $3.25. Should the due diligence not lead to a binding offer, and in the absence of other offers, the broker expects the stock price to return to around $4.15.

The company has received a non-binding indicative proposal at $5.25 a share from EQT Infrastructure, a Scandinavian private equity group.

UBS observes several factors have led to an increase in price versus previous bids, including improved free cash flow conversion and a new management team.

The broker upgrades to Neutral from Sell and raises the target to $4.60 from $3.10.

Downgrade

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

The company has updated on prospectus forecasts and now expects FY19 revenue to be over $50m. Pro forma operating earnings (EBITDA) of $1.4m are expected. Morgans assesses the business is gaining traction on new products, particularly as it expands into more consumer oriented business.

The broker downgrades to Hold from Add, following strong share price appreciation. Given the scalable manufacturing operation, the broker points out that additional partnerships can move the dial in terms of revenue/earnings uplift. Target is raised to $1.42 from $0.90.

ANSELL LIMITED ((ANN)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 3/5/0

Raw material pricing trends have been favourable and there are incremental benefits from the transformation program, Macquarie observes. Yet weaker macro economic trends present downside risk to near-term earnings.

Despite an undemanding valuation, the broker downgrades to Neutral from Outperform because of reduced confidence in the macro economic outlook. Target is lowered to $26.90 from $28.20.

BLUESCOPE STEEL LIMITED ((BSL)) Downgrade to Underperform from Outperform by Macquarie and Downgrade to Neutral from Buy by UBS .B/H/S: 2/4/1

Input costs are putting pressure on spreads and global conditions are turning down, overcoming easing risks in Australian end markets, Macquarie observes.

An altered US tariff regime, ongoing trade issues with China and softening economic indicators are posing risks to the outlook. The broker believes there is a high probability of negative earnings revisions in coming months.

Rating is downgraded to Underperform from Outperform and the target is lowered to $10.15 from $14.60. FY20 and FY21 net profit estimates are downgraded by -14% and -15% respectively.

The removal of Canadian & Mexican steel tariffs and high iron ore prices as well as softening demand for housing in Australia all conspire to put pressure on the business, UBS believes. Rating is downgraded to Neutral from Buy.

FY20 and FY21 estimates for earnings are cut by -36%. Despite weakening US spreads, the broker believes the company will still push ahead with the expansion of North Star as this is the right strategy for the long-term. Target is reduced to $13 from $16.

COSTA GROUP HOLDINGS LIMITED ((CGC)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 4/1/0

The company has sharply downgraded 2019 guidance, now expecting profit growth in a range of 1-17% as opposed to 30%. Macquarie reduces estimates for 2019 and 2020 earnings per share by -23% and -22% respectively.

Conditions have changed abruptly since early May, with a late season in Morocco putting pressure on prices while, locally, poor quality fruit has led to a large amount of wastage. Macquarie downgrades to Neutral from Outperform. Target is reduced to $4.05 from $6.03.

See also CGC upgrade.

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

Citi observes the shares have strongly outperformed this year, amid easing alumina cost concerns and the boost in housing market sentiment. The stock has now priced in the rally and the broker downgrades to Sell from Neutral. Target is $3.50.

The broker believes the recent court decision in Brazil to lift production restrictions at Alunorte should help improve supply but this may not be of help to CSR. CSR recently secured a new contract for half of its alumina requirements at around 18-18.5% linkage to the LME aluminium price.

DOMINO'S PIZZA ENTERPRISES LIMITED ((DMP)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 1/4/2

Softer same-store sales growth and fewer store openings lead Morgan Stanley to lower forecasts, believing earnings risk has increased. While the broker still envisages great opportunity in Europe, execution needs to improve to sustain a re-rating.

Morgan Stanley downgrades to Equal-weight from Overweight and lowers the target to $41 from $50. Cautious industry view.

After over 10 years of strong double-digit growth the Australasian business is also slowing. The broker agrees a greater focus on franchisee health is the right strategy but is likely to affect growth in the near term.

DOWNER EDI LIMITED ((DOW)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 4/0/1

The company's partner in the Murra Warra wind farm project, Senvion GmbH, has filed for self-administration in Germany. Despite Downer's minor share in the project it is jointly and severally liable under the contract.

Downer has indicated it has substantial bank guarantees from Senvion. Credit Suisse suspects the catalyst for the market update is the court-appointed custodian may be attempting to offload the cost of completing the project to Downer and the bank guarantee may be insufficient to cover the liability.

Downer is assessing any impact on guidance for FY19. Rating is downgraded to Underperform from Neutral and the target lowered to $7.10 from $7.40.

ESTIA HEALTH LIMITED ((EHE)) Downgrade to Neutral from Buy by UBS .B/H/S: 0/4/0

The company has downgraded underlying earnings guidance by -6% at the mid point for FY19, as occupancy deteriorates. The company now expects like-for-like EBITDA to be $86-88m.

UBS notes the share price has risen 27% since the beginning of 2019 despite the weakening outlook and pressure on staff costs.

With the possibility of a more favourable policy environment under a Labor government now removed, and meaningful sector reform unlikely until the final report from the Royal Commission is tabled, the broker believes the operating environment in the near term is challenging.

Rating is downgraded to Neutral from Buy and the target lowered to $2.85 from $3.00.

G.U.D. HOLDINGS LIMITED ((GUD)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 4/1/0

Channel checks of the auto market conducted by Credit Suisse suggest after-market growth is trending lower and competition is increasing among part suppliers. The broker notes that while GUD has an excellent track record of navigating through increased competition in the past, its relative reliance on auto is now greater than it ever has been.

Credit Suisse has not changed forecasts but sees sufficient downside risk emerging to warrant a pullback to Neutral from Outperform. Target falls to $12.00 from $13.35.

KIDMAN RESOURCES LIMITED ((KDR)) Downgrade to Hold from Buy by Ord Minnett .B/H/S: 0/1/0

Ord Minnett reduces forecasts for global supply of lithium by -8% in 2020 and -14% in 2021, although continued market surplus is still considered likely.

The broker lowers battery-grade price expectations for the next two years by -10%, to US$11,500-12,000/t of lithium carbonate equivalent, and concentrate pricing by -14% to US$550/t.

Rating is downgraded to Hold from Speculative Buy and the target reduced to $1.90 from $3.00.

METCASH LIMITED ((MTS)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 3/1/3

Credit Suisse believes the widening digital capability gap is another headwind for independent food retailers. While making no changes to forecasts, the broker downgrades Metcash to Underperform from Neutral because of the recent appreciation in the share price.

Fragmented decision-making in relation to investment and implementation of digital strategies are likely to be significant structural barriers, Credit Suisse adds. Target is steady at $2.69.

NRW HOLDINGS LIMITED ((NWH)) Downgrade to Neutral from Buy by Citi .B/H/S: 0/2/1

Demand in the company's core markets continues to improve and Citi envisages upside risk to forecasts from further contract gains and better-than-expected margins. However, the broker considers the stock fairly valued and downgrades to Neutral from Buy.

A key concern is the credit risk associated with the $55m per annum Dalgaranga project. The company provided a $12m working capital facility in December 2018 and also had to support a capital raising by the project owner. Target is raised to $3.01 from $2.52.

PILBARA MINERALS LIMITED ((PLS)) Downgrade to Lighten from Hold by Ord Minnett .B/H/S: 2/0/0

Ord Minnett reduces forecasts for global supply of lithium by -8% in 2020 and -14% in 2021, although continued market surplus is still considered likely.

The broker lowers battery-grade price expectations for the next two years by -10%, to US$11,500-12,000/t of lithium carbonate equivalent, and concentrate pricing by -14% to US$550/t.

Ord Minnett lowers its rating to Lighten from Hold. Target is unchanged at $0.65, as falling concession prices add pressure for improved operating rates in order to deliver positive cash flow.

QBE INSURANCE GROUP LIMITED ((QBE)) Downgrade to Neutral from Outperform by Macquarie and Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 5/2/1

Macquarie notes some regions in the US have now passed final crop planting dates and this is expected to trigger claims on some crop insurance policies. US crop is QBE's largest exposure and with downside risk growing Macquarie downgrades to Neutral from Outperform.

The broker believes US crop risks are poised to de-rail the company's FY19 results. Industry articles are recommending farmers do not plant crops at all and instead submit insurance claims for their maximum coverage.

Should the attritional loss ratio for QBE's US crop portfolio deteriorate -5%, Macquarie estimates this could result in a -5.8% hit to cash earnings in FY19. Target is reduced to $12.90 from $13.20.

The share price has outperformed the market over the past three months and moved close to the target. Credit Suisse reviews the earnings outlook and key drivers for the next leg up in the share price.

While the company is benefiting from favourable premium rates and early-stage expense efficiency, it also faces a slowdown in the important lender mortgage insurance division, as well as increased volatility from adverse weather claims.

Rating is downgraded to Neutral from Outperform. Target is steady at $13.

TELSTRA CORPORATION LIMITED ((TLS)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 3/2/3

Telstra has updated guidance around restructuring costs and asset impairment. Management now expects -$800m of restructuring costs to be incurred in FY19 and has also guided to a further -$350m post FY19.

The company also plans to write down the carrying value of its legacy IT systems by -$500m. Ord Minnett downgrades to Hold from Accumulate based on valuation. Target is unchanged at $3.55. FY19 and FY20 earnings estimates are unchanged.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 BLACKMORES LIMITED Neutral Sell Morgan Stanley 2 COLES GROUP LIMITED Neutral Sell Credit Suisse 3 COSTA GROUP HOLDINGS LIMITED Buy Neutral Morgans 4 GENEX POWER LIMITED Buy Neutral Morgans 5 OZ MINERALS LIMITED Buy Neutral Morgans 6 SIGMA HEALTHCARE LIMITED Neutral Sell Citi 7 VOCUS GROUP LIMITED Neutral Sell Macquarie 8 VOCUS GROUP LIMITED Neutral Sell UBS Downgrade 9 ANSELL LIMITED Neutral Buy Macquarie 10 ATOMOS LIMITED Neutral Buy Morgans 11 BLUESCOPE STEEL LIMITED Sell Buy Macquarie 12 BLUESCOPE STEEL LIMITED Neutral Buy UBS 13 COSTA GROUP HOLDINGS LIMITED Neutral Buy Macquarie 14 CSR LIMITED Sell Neutral Citi 15 DOMINO'S PIZZA ENTERPRISES LIMITED Neutral Buy Morgan Stanley 16 DOWNER EDI LIMITED Sell Neutral Credit Suisse 17 ESTIA HEALTH LIMITED Neutral Buy UBS 18 G.U.D. HOLDINGS LIMITED Neutral Neutral Credit Suisse 19 KIDMAN RESOURCES LIMITED Neutral Buy Ord Minnett 20 METCASH LIMITED Sell Neutral Credit Suisse 21 NRW HOLDINGS LIMITED Neutral Buy Citi 22 PILBARA MINERALS LIMITED Sell Neutral Ord Minnett 23 QBE INSURANCE GROUP LIMITED Neutral Buy Macquarie 24 QBE INSURANCE GROUP LIMITED Neutral Buy Credit Suisse 25 TELSTRA CORPORATION LIMITED Neutral Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 VOC VOCUS GROUP LIMITED 14.0% -13.0% 27.0% 7 2 SIG SIGMA HEALTHCARE LIMITED -75.0% -100.0% 25.0% 4 3 ILU ILUKA RESOURCES LIMITED 75.0% 58.0% 17.0% 6 4 BKL BLACKMORES LIMITED -17.0% -33.0% 16.0% 6 5 OZL OZ MINERALS LIMITED 38.0% 25.0% 13.0% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 BSL BLUESCOPE STEEL LIMITED 7.0% 50.0% -43.0% 7 2 QBE QBE INSURANCE GROUP LIMITED 44.0% 69.0% -25.0% 8 3 MGR MIRVAC GROUP -30.0% -8.0% -22.0% 5 4 FPH FISHER & PAYKEL HEALTHCARE CORPORATION LIMITED -80.0% -60.0% -20.0% 5 5 GUD G.U.D. HOLDINGS LIMITED 70.0% 88.0% -18.0% 5 6 PLS PILBARA MINERALS LIMITED 50.0% 67.0% -17.0% 3 7 DOW DOWNER EDI LIMITED 42.0% 58.0% -16.0% 6 8 MTS METCASH LIMITED -7.0% 7.0% -14.0% 7 9 CSR CSR LIMITED -43.0% -29.0% -14.0% 7 10 DMP DOMINO'S PIZZA ENTERPRISES LIMITED -19.0% -6.0% -13.0% 8 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 VOC VOCUS GROUP LIMITED 4.249 3.643 16.63% 7 2 MGR MIRVAC GROUP 2.748 2.678 2.61% 5 3

BKL BLACKMORES LIMITED 86.042 84.542 1.77% 6 4 ILU ILUKA RESOURCES LIMITED 10.558 10.458 0.96% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 BSL BLUESCOPE STEEL LIMITED 14.307 15.586 -8.21% 7 2 DMP DOMINO'S PIZZA ENTERPRISES LIMITED 43.271 44.396 -2.53% 8 3 GUD G.U.D. HOLDINGS LIMITED 13.282 13.603 -2.36% 5 4 DOW DOWNER EDI LIMITED 7.830 7.880 -0.63% 6 5 AGL AGL ENERGY LIMITED 20.401 20.486 -0.41% 8 6 QBE QBE INSURANCE GROUP LIMITED 13.070 13.108 -0.29% 8 7 WOW WOOLWORTHS LIMITED 29.905 29.975 -0.23% 8 8 OZL OZ MINERALS LIMITED 11.209 11.225 -0.14% 8 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 FPH FISHER & PAYKEL HEALTHCARE CORPORATION LIMITED 40.012 33.901 18.03% 5 2 SXY SENEX ENERGY LIMITED 0.702 0.682 2.93% 6 3 ALL ARISTOCRAT LEISURE LIMITED 132.150 129.583 1.98% 7 4 SYR SYRAH RESOURCES LIMITED -4.148 -4.219 1.68% 5 5 BKL BLACKMORES LIMITED 349.417 346.583 0.82% 6 6 OZL OZ MINERALS LIMITED 63.497 63.069 0.68% 8 7 SKI SPARK INFRASTRUCTURE GROUP 6.704 6.664 0.60% 7 8 ANN ANSELL LIMITED 147.149 146.306 0.58% 8 9 AWC ALUMINA LIMITED 25.448 25.395 0.21% 5 10 SDA SPEEDCAST INTERNATIONAL LIMITED 32.678 32.610 0.21% 4 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 CGC COSTA GROUP HOLDINGS LIMITED 19.228 23.908 -19.58% 6 2 XRO XERO LIMITED 12.435 13.834 -10.11% 6 3 FNP FREEDOM FOODS GROUP LIMITED 8.267 8.933 -7.46% 4 4 SUN SUNCORP GROUP LIMITED 73.429 74.714 -1.72% 8 5 BSL BLUESCOPE STEEL LIMITED 181.550 184.117 -1.39% 7 6 DOW DOWNER EDI LIMITED 49.644 50.218 -1.14% 6 7 SIQ SMARTGROUP CORPORATION LTD 57.988 58.532 -0.93% 6 8 ILU ILUKA RESOURCES LIMITED 92.135 92.852 -0.77% 6 9 OML OOH!MEDIA LIMITED 27.480 27.626 -0.53% 5 10 CTD CORPORATE TRAVEL MANAGEMENT LIMITED 94.670 95.170 -0.53% 6 Technical limitations

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

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Uranium Week: Paying Up For Certainty

Buyers are paying more for uranium that does not come from sources facing possible US restriction but falling demand is still sending prices lower.

-Uranium price discrepancy opens up -Trend remains down -IEA rails against premature reactor shutdowns

By Greg Peel

An interesting dynamic opened up in the month of May in uranium markets with regard the uncertainty surrounding the US president’s pending decision on section 232, which may force US utilities to buy at least 25% of their uranium supply from US producers. Presumably that uncertainty is exacerbated every time Donald Trump pulls a new tariff rabbit out of his hat, given tariffs are also a matter of “national security” under section 232.

A wide price discrepancy has opened up based on origin of material. Buyers are now willing to pay higher prices for deliveries specifically not from Russia, Kazakhstan or Uzbekistan, which are potential US trade restriction targets. Buyers who do not specify origin of material are enjoying “considerably” lower prices, industry consultant TradeTech reports.

Transactions involving delivery at Canada’s Cameco, which for many months commanded a premium over other delivery locations, showed little to no price premium over other locations in May but this has been attributed to the general decline in demand.

Uranium spot market transactions totalled just over 2.4mlbs U3O8 equivalent in May – the lowest monthly total since December 2017. A total of 20 transactions was also under the year to date monthly average, as it was in April.

TradeTech’s weekly spot price indicator closed the week, and the month, at US$24.00/lb, down -US30c for the week and -US$1.15 from end-April. The weekly price indicator is now -2% below the average price traded in 2018 of US$24.56/lb.

Only two transactions were concluded in uranium term markets in May, reflecting an even greater unwillingness to commit to term delivery contracts amidst 232 uncertainty. TradeTech’s monthly mid-term price indicator has fallen -US$1.15 to US$27.35/lb and the long-term price indicator has fallen -US$2.00 to US$30.00lb.

Fading Fleet

Only serving to weaken demand further is ongoing shutdowns of legacy US reactors in the face of cheaper gas-fired electricity production and subsidised renewable production. Last Friday Entergy's Pilgrim plant in Massachusetts closed its doors after 47 years of service.

The closure marks the eighth US nuclear plant to be closed prematurely since 2013 and 11 more are scheduled for closure between this year and 2025. Nuclear plants in some states have also failed to gain credit for producing zero-carbon electricity, as is afforded to renewable energy.

The shutdowns are alarming the International Energy Agency, which last week warned the world risks a “steep decline” in nuclear power in advanced economies which could result in billions of additional carbon emissions.

Nuclear power is currently the second-largest global source of low-carbon power, accounting for 10% of global electricity production. Hydro power accounts for 16%. Without policy changes, advanced economies could lose as much as -25% of their nuclear capacity by 2025, the IEA warns, and as much as two-thirds by 2040. The lack of further lifetime extensions of existing nuclear plants and new projects could result in an additional 4bn tonnes of CO2 emissions.

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FNArena is proud about its track record and past achievements: Ten Years On

The Short Report

Guide:

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

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

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

Summary:

Week ending May 30, 2019

Last week saw the gloss come off the election/APRA/RBA story as focus returned to the macro and trade wars, starting a pullback for the ASX200.

Not a lot of action last week in short positions until we get to the bottom of the table, where we note no less than six stocks crossed over into the 5% plus range for either the first time or a return visit.

They are debt retrievers Collection House ((CLH)), oil & gas company Senex Energy ((SXY)), outdoor advertiser oOh!media ((OML)), lithium/iron ore miner and mineral processor Mineral Resources ((MIN)), which several years ago resided for a very long period at the top of the table, plus travel agents Corporate Travel Management ((CTD)) and Flight Centre ((FLT)).

Not a lot of correlation.

Two stocks saw short potions movements of one percentage point or more last week. Domino's Pizza ((DMP)) shorts rose to 9.5% from 8.3% and Costa Group ((CGC)) returned to the table at 6.8% from below 5%.

See below.

Weekly short positions as a percentage of market cap:

10%+ ING 17.6 SYR 16.8 JBH 15.9 NUF 15.6 NXT 15.1 GXY 14.6 BAL 14.5 ORE 13.7 BWX 11.7 BIN 11.4 MTS 11.1 SDA 10.0 IFL 10.1

Out: IFL

9.0-9.9

RWC, IFL, SUL, DMP, PLS, SGM, HVN, KGN, PPT, CSR

In: IFL, DMP Out: BKL 8.0-8.9%

HUB, BKL, IVC, BGA, MYR

In: BKL Out: DMP

7.0-7.9%

AMC, BOQ, AMP

No Changes

6.0-6.9%

CGF, CGC, WSA, NEC, RSG, SEK, MSB

In: CGC, RSG, GMA Out: MSB

5.0-5.9%

MSB, COE, CLH, SXY, MLX, OML, MIN, CLQ, CTD, HT1, BEN, FLT

In: MSB, CLH, SXY, OML, MIN, CTD, FLT Movers & Shakers

Domino's Pizza provided an update two weeks ago and brokers have since mulled over signs of slowing same-store sales growth and fewer store openings ahead. Last week Morgan Stanley downgraded the stock to Equal-weight to leave only one Buy rating among four Holds and three Sells in the FNArena database.

Macquarie retains Outperform, having faith in growth in Japan, but the broker has not updated its view since April so that one probably comes with an asterisk. Domino Pizza's shorts have risen to 9.5% from 8.3%.

Fruit & veg grower Costa Group also updated the market last week, posting a major profit warning. May brought a litany of disaster for the company, which suffered everything from adverse weather to spoilt fruit and fruit fly across its global network. The share price promptly fell -30%.

The fact Costa seemed to be a do-no-wrong company prior to successive warnings suggests the stock had become overbought by overenthusiastic investors. Macquarie pulled its rating back to Neutral but Morgans upgraded to Add on the share price fall to join three other database brokers with Buy ratings.

It was probably blueberries all round at Ord Minnett, who downgraded to stock to Lighten in February.

ASX20 Short Positions (%)

Code Last Week Week Before Code Last Week Week Before AMC 7.5 7.8 RIO 4.9 4.5 ANZ 0.8 0.8 S32 0.8 1.0 BHP 3.2 3.3 SCP 0.9 1.0 BXB 0.3 0.2 SUN 0.3 0.3 CBA 1.4 1.4 TCL 1.1 1.3 COL 1.4 1.4 TLS 0.6 0.5 CSL 0.4 0.2 WBC 1.7 1.8 IAG 0.6 0.8 WES 1.9 1.9 MQG 0.6 0.6 WOW 2.1 2.6 NAB 0.9 0.8 WPL 0.6 0.7 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: Housing, Banks & Online Classifieds

Weekly Broker Wrap: housing; banks; and online classifieds.

-Large obstacles to a turnaround in Australia's housing market -With further official cuts on the cards, bank interest margins are under pressure -UBS observes improved execution by online classifieds

By Eva Brocklehurst

Housing

Australia's housing market has been weak. Despite the easing of lending guidelines and official rate reductions by the Reserve Bank of Australia, difficulties continue. Baillieu analysts consider oversupply, record leverage and elevated valuations, as well as high investor exposure, are among the obstacles to a turnaround.

They assess that the -30-35 basis points coming off mortgage rates in the near term is a much smaller increment than the -200-385 basis points that have driven the last three recoveries in housing.

In the US, early indications suggest a recovery is underway as broad fundamentals are supportive. In contrast to Australia, there is a growing undersupply of housing, low leverage and reasonable valuations.

The analysts believe this skew to the US for housing growth supports companies such as James Hardie ((JHX)), Boral ((BLD)) and Reliance Worldwide ((RWC)), which have US exposures of 67%, 35% and 53% of sales, respectively. Moreover, all have been materially de-rated and are trading at the lower end of valuation ranges.

Morgan Stanley notes Australian house prices nationally fell -0.4% in May, to be down -10.1% from the peak in late 2017. Detached housing fell more than apartments over the month. While sentiment has improved materially in Australia over the past few weeks, with the return of the Coalition government signalling no change to negative gearing in the near term, fundamentals are still providing pressure.

Despite sharp falls in building approvals, housing supply is elevated and likely to remain ahead of new demand until late 2020, the broker believes. Economic growth is also likely to remain below trend for the rest of the year and the labour market is softening. This will put further pressure on incomes and offset some of the serviceability benefits of rate reductions.

A worsening outlook for the global economy also increases the downside risk. While there is likely to be less chance of a break through the floor of a -10-15% peak-to-trough decline in house prices, now the RBA is on the case, Morgan Stanley does not believe sentiment will allow prices to go materially higher.

UBS also expects a near-term bounce in the housing market following the election and rate reductions, but suspects the impact on credit growth will be muted and offset by mortgage holders increasing the paying down of principal.

Banks

As a further easing of the RBA's cash rates is on the cards, major bank interest margins are coming under pressure. UBS believes it is increasingly difficult for the banks to maintain their retail net interest margins in an ultra-low interest rate environment.

While the sharp compression of the BBSW-OIS (bank bill swap rate-overnight indexed swap) spread provides some near-term support for net interest margins, the global environment is challenging and Australian bond yields are at historical lows.

As bank hedges run off, the yield on the major banks' free floats will drop and UBS estimates this could reduce earnings by -6-8% over the next three years. In the event the RBA cuts the cash rate below 1% or initiates quantitative easing, the broker envisages further downside to earnings and dividends.

UBS expects regulators will pursue whatever it takes to avoid a hard landing in the economy but also wonders whether the “treatment is worse than the disease” if further stimulus is required.

Macquarie calculates that the -25 basis points reduction in the term structure of interest rates reduces major bank profitability by -2-3% and regional banks by -4-7%. However, the next forecast -25 basis points cut would have a cumulative negative impact on earnings of -5-7% for the majors and over -10% for the regionals.

The broker agrees falling interest rates are detrimental to profitability, predominantly because of margin squeeze related to deposit pricing elasticity. Bendigo and Adelaide Bank ((BEN)) is considered the most affected, given an overweight position in low-cost deposits and limited benefit from structural hedges.

Macquarie notes banks, historically, have been successful in re-pricing mortgage portfolios but this is likely to provide only short-term reprieve. While the outlook for banks is adversely affected by falling interest rates, the rationale for reductions to the cash rate reflects the challenges in the broader economy. In the longer term, the broker agrees, if rates continue to decline, banks are likely to deliver sub-optimal returns and trade at an elevated discount to the market.

Bell Potter believes recent changes at the board level for Suncorp ((SUN)), Bank Bendigo & Adelaide Bank and Bank of Queensland ((BOQ)) will lead to strategic reviews, and consolidation could go a long way to addressing some of the performance disparities.

A changing of the guard could also set aside some of the historical animosity over mergers. Bell Potter continues to envisage merits in a merger for Bendigo & Adelaide Bank and Suncorp Bank in terms of geographic diversity, regional market understanding and multi-brand distribution channels. In contrast, a merger between the two Queensland-based entities would concentrate risk.

The broker suspects the persistence of operating headwinds as well as recent changes at board level adds to the urgency for Suncorp to divest its bank and become a pure general insurer. Bell Potter remains comfortable with Hold ratings for Bendigo & Adelaide and Bank of Queensland, in anticipation of valuation upside from regional M&A activity. The broker retains a Buy rating for Suncorp.

Online Classifieds

UBS lifts long-term forecasts and price targets to factor in improved execution by REA Group ((REA)), Seek ((SEK)) and Carsales.com ((CAR)). Residential listings will remain the key value driver for REA Group and the broker expects Agent Edge will support longer-dated growth.

Meanwhile, for Seek the shift to a dynamic pricing model and the potential in the Chinese market are likely to underpin revenue. The opportunity in Carsales.com lies with lifting depth contributions closer to its peers and growing its international business.

While UBS lifts long-term forecasts and price targets to factor in improved execution, the market appears to be already pricing in success. Hence, Carsales.com is downgraded to Neutral from Buy while a Neutral rating is maintained for REA Group and a Sell rating for Seek on valuation.

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FNArena is proud about its track record and past achievements: Ten Years On

Glimmer Of Light Visible For EclipX

As expected, EclipX delivered a very weak first half, posting losses in four out five of its adjacent businesses. Yet brokers believes upside has emerged if the focus can return to the core operations.

-Novated leasing the stand-out performer in the first half -Potential suitors could be encouraged by current valuations -Debt re-financing expected to conclude by the end of 2019

By Eva Brocklehurst

Light is appearing at the end of the dark tunnel for EclipX ((ECX)), as new management separates out its core business of novated leasing and fleet management. On the market are Grays, Right2Drive and commercial leasing, a substantial disappointment in the first half results. Of the company's five adjacent businesses four were loss-making and only Grays profitable.

Novated leasing stood out, with written new business up 10%, financed assets up 12% and fleet volumes up 14%. While the core fleet business felt the impacts of a softer cycle and distractions, operating earnings (EBITDA) rose 2%. However, overall, net profit was sharply below broker estimates. The result included $118m of goodwill impairments related to Grays and Right2Drive, in line with guidance.

Morgan Stanley believes the decision to separate the performance of the core business will allow the market to have more conviction in the trajectory and assign a multiple that is more representative of the quality of the business. UBS agrees the market will begin to ascribe value to the core holdings and, in light of a softer economic backdrop and corporate sentiment, expects mid single-digit growth for the fleet and novated segments in FY19-21.

Citi was pleased with the candid nature of new CEO Julian Russell's presentation, noting that the upside is tangible even if EclipX "just turns off" CarLoans.com.au and AreYouSelling. This ability to shut down loss-making segments and extract asset value if a sale is not possible provides greater confidence, UBS agrees. These two businesses collectively lost -$2.4m because of lower appetite for credit and low-yielding aged stock.

Potential Suitors?

While there was no clarity regarding progress on the proposed divestments, Citi notes that value is present in the core business, and potential suitors could be strongly encouraged at current valuations levels.

Macquarie likes the articulation of a simpler business going forward and assesses the progress of re-setting corporate debt facilities is an indicator that the flagged asset sales could be at or near completion in the next four months. To be able to meet the company's timeframe, this implies interested parties are already in sight.

Credit Suisse has upgraded to Outperform from Neutral in the wake of the results, largely as risk appears to have swung to the upside. A stable core business should be able to maintain current earnings and the broker is increasingly comfortable that the balance sheet can be repaired.

The company floored investors earlier this year after flagging a sharp fall in profits for the first half and, then, McMillan Shakespeare ((MMS)) took its merger proposal off the table.

Macro conditions could still pose challenges and Credit Suisse remains wary of a lack of financial oversight in various areas of the business which came to light recently. Still, while high risk, the core business is now a lot more “salvageable” and corporate interests could re-emerge, providing upside risk, in the broker's view.

Debt Risk Reduced

UBS believes medium-term growth will be driven by the improved operating performance and cost optimisation, while the probability of breaches to the debt covenants have materially reduced. This has come from the refinancing of corporate debt facilities, expected by the end of the year and greater confidence in the non-core asset sale program.

Morgan Stanley also expects risks to the balance sheet will ease, although net debt/EBITDA was 2.68x and uncomfortably close to covenants at 2.7x. Management has indicated net debt should fall below 2x after the disposal of Grays, Right2Drive and the commercial equipment business, which implies a value of $90-130m for these assets.

Morgan Stanley retains an Equal-weight rating, as pressure was observed in the end-of-lease profits per vehicle over the half-year, which could indicate risks around residual values. Management has attributed this to the mix but the broker awaits further confirmation.

FNArena's database shows four Buy ratings and one Hold (Morgan Stanley). The consensus target is $1.44, signalling 7.5% upside to the last share price. This compares with $ Targets range from $1.29 (Citi) to $1.66 (Macquarie). The dividend yield on FY20 forecasts is 6.3%.

See also, EclipX Rising Or Eclipsed? on April 1, 2019.

Disclaimer: the writer has shares in the company.

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US Bonds Warning Versus RBA Rate Cuts

In this week's Weekly Insights:

-The One That Got Away From Morgan Stanley -No Weekly Insights Next Week -Conviction Calls -High PE Stocks Versus Hyper PE Contenders -Rudi Talks -Rudi On Tour

By Rudi Filapek-Vandyck, Editor FNArena

The One That Got Away From Morgan Stanley

Part Two of last week's Weekly Insights carried a chart by Morgan Stanley illustrating how, adjusted for QE and QT by the Federal Reserve, the US bond market had been in inverted yield curve mode since November last year.

For those who are less familiar with what this actually means: "inverted yield curve" refers to the rather unusual situation whereby US government bonds with an expiry date in ten years from today are offering a lower yield than shorter duration bond yields, like three months for example.

As everybody will understand, this instinctively doesn't make much sense as longer dated loans (which is what a bond effectively is) should offer higher yield than a short term loan.

In financial parlance this then translates into the US bond market is predicting an economic recession lies ahead, which is why all the talk is about recession this month.

In practical terms it means the Federal Reserve tightened at least one time too much late last year. The bond market is now signalling to the Fed thou shalt need to be loosening monetary policy, and sooner rather than later.

When looking at the raw economic data, this can get confusing because recent data might be signalling a slowing down for the US economy, but a recession? As per always, recessions don't show up in data until after they are in place, and financial markets are forward looking.

US investors are most likely to take further guidance from proprietary downturn indicators, such as Morgan Stanley's (below). When I had to make a decision which chart to include in Weekly Insights last week, I chose the inverted yield curve chart. So this week I am adding the US Cycle Indicator by Morgan Stanley.

As the asset strategists who oversee this modeling pointed out, for the first time in over a decade, the Cycle Indicator is now pointing towards a downturn taking shape for the US economy. And this downturn, on Morgan Stanley's assessment, started before trade talks between the Trump administration and China broke down and turned nasty.

No Weekly Insights Next Week

Next week starts with a public holiday across Australia (Queen's birthday) and I will be in Adelaide to present to the local chapter of the Australian Investors Association (AIA) the next day, so there will be no Weekly Insights for that week.

Weekly Insights will resume in the week Monday June 17 - Friday June 21.

Conviction Calls

Inverted bond yield curves are a rather rare phenomenon. They occur more often in Australia than in the US, where they are widely considered a fairly reliable signal for much tougher times ahead for the US economy and by extension US and global equities.

History shows extended inversions have only happened just seven times over the past 50 years and on every occasion the occurrence was followed up by an economic recession. Not necessarily because bond markets never fail when making forecasts, but because banks stop providing loans as the dynamic between long and short bonds, which is their key source for funding, no longer works in their favour.

Taking guidance from history, Wilsons' head of asset allocation, Tracey McNaughton points out some of the statistics that come with an inverted US bond curve. On average, it takes about eight months after the inversion takes place before the Federal Reserve delivers its first rate cut.

Regardless, an economic recession usually follows between 5 and 16 months after the bond market signal. The big unknown is that the impact/consequences for equities are not as clear cut, though it remains an indisputable fact that deeper recessions correspond with sharper declines, in particular when equity valuations were on the more expensive side to begin with.

As such, five of the last seven inversions have been associated with US recessions; 1969, 1973, 1981, 2001 and 2007.

"This", concludes McNaughton, "makes the inversion of the yield curve a valuable early warning signal and suggest a more defensive investment state of mind is required."

Wilsons' own positioning is Overweight cash and bonds and underweight equities, in particular the US and Europe.

See also Part Two of last week's Weekly Insights, published on the FNArena website as "Rudi’s View: Citadel, Stockland & Expert Warnings".

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This week's update on Wilsons' selective list of Conviction Calls revealed two deletions and one new inclusion with Arq Group ((ARQ)) and Citadel Group ((CGL)) no longer included and ReadyTech ((RDY)) as the newcomer.

Wilsons Conviction Calls have a long history of outperforming both the Small Ordinaries and the Small Industrials indices, but the past six months have proven much harder than usual with both indices mostly performing better. May in particular has not been kind to Wilsons' Conviction Calls, probably exacerbated by the profit warning cum sell-down in Citadel Group shares.

Remainers on the Conviction recommendations list are Bravura Solutions ((BVS)), EML Payments ((EML)), Collins Foods ((CKF)), ImpediMed ((IPD)), EQT Holdings ((EQT)), Pinnacle Investment ((PNI)), Noni B ((NBL)), Ausdrill ((ASL)), Mastermyne ((MYE)), and Whitehaven Coal ((WHC)).

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Macquarie market strategists continue to advocate investors' portfolios to have exposure to Australian housing related stocks. Macquarie's own model portfolio owns shares in REA Group ((REA)), Nine Entertainment ((NEC)), National Australia Bank ((NAB)), Westpac ((WBC)), James Hardie ((JHX)), CSR ((CSR)), and Stockland ((SGP)).

Macquarie's portfolio is underweighted bond proxies (yield stocks that move in accordance with bond yields) as the strategists believe the downward move in bonds looks overdone and the months ahead will likely see higher instead of lower bond yields. Thus far, this forecast has proved horribly wrong.

Assuming improving dynamics for housing in Australia continue to manifest themselves, Macquarie continues to highlight the improving outlook for domestic cyclicals in Australia. Macquarie thinks house prices could be up by 5% at least by end 2020 and banks and construction materials stocks should be among the main beneficiaries.

The RBA well and truly delivered on Tuesday when Phillip Lowe & Co announced the widely anticipated -25bp cash rate cut but the more cautious wordings in the accompanying statement is now attracting increased expectations for one additional cut in August, if not a third cut later this year. Earlier, JPMorgan had built a case for a total of four rate cuts spread over this year and next.

Here's the response from BIS Oxford Economics shortly after the rate cut announcement:

"The statement also suggests that more cuts will materialise in the near term, with the Board noting that they will adjust monetary policy in order to hit the inflation target over time. Given the shift in stance we now expect to see a second 25bps cut in August. And with global conditions deteriorating markedly and the US heading for a sharper than anticipated slowdown as a result of disruption caused by the tariffs imposed on China and Mexico (which will feed through to services exports and business confidence), we think it’s likely that they will cut for a third time this year in November, taking the cash rate to 0.75%."

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Over at stockbroker Morgans, the strategists have removed Reliance Worldwide ((RWC)) from their High Conviction Calls. Reliance Worldwide issued a profit warning in May and was subsequently downgraded by the stockbroker to Hold. Morgans remains concerned about the potential impact from the downturn in multi-res buildings in Australia, as well as the increase in US tariffs on imports from China.

In its place comes OZ Minerals ((OZL)), sold down heavily since early April and now worth buying with conviction, according to Morgans. Prime minister-related troubles in PNG have not deterred the broker and Oil Search ((OSH)) remains on the High Conviction list, alongside ResMed ((RMD)), Sonic Healthcare ((SHL)), Westpac, Kina Securities ((KSL)), Senex Energy ((SXY)), and Australian Finance Group ((AFG)).

High PE Stocks Versus Hyper PE Contenders

A most interesting share market observation was released by JPMorgan/Ord Minnett in the week past, with the analysts observing there has been a notable switch in market momentum inside the group of companies broadly defined as High PE Stocks.

Whereas most of the traditional High PE names such as CSL ((CSL)), REA Group ((REA)), Blackmores ((BKL)) and Domino's Pizza ((DMP)) have found the going a lot tougher in 2019, with only a small number managing to continue to outperform the broader share market, no such loss in momentum has shown up for what the analysts label the "Hyper PE Technology Sector Contenders".

Here stocks like Nearmap ((NEA)), Pro Medicus ((PME)) and Appen ((APX)) still gained more than 100% between January 1st and May 29th, when the analysis was concluded.

The analysis identifies twelve names that fit under this label, and only Hub24 ((HUB)) and TechnologyOne ((TNE)) did not significantly outperform year-to-date. Other members are Afterpay Touch ((APT)), Altium ((ALU)), Bravura Solutions ((BVS)), IDP Education ((IEL)), Netwealth ((NWL)), WiseTech Global ((WTC)) and Xero ((XRO)) for an average return of 54% over five months.

The suggestion made is whether the traditional group of High PE companies has become too mature to continue trading on an elevated market premium, with growth hiccups triggering a de-rating for companies including Blackmores, Cochlear and Domino's Pizza. The analysts do point out the February reporting season proved disappointing for most of these companies, hence it may yet be too early to draw a definitive conclusion.

The analysis offers an interesting fresh insight, but it doesn't cover enough ground, in my opinion, to answer all questions that should be asked by astute investors, including where does this leave non-technology related newcomers such as Bubs Australia ((BUB)) and a very much technology-related NextDC ((NXT)) whose stock equally has found significant outperformance elusive in 2019.

There is no denying companies like Blackmores, Domino's Pizza and Bellamy's ((BAL)) have run into strong headwinds, but whether this means the end of the High PE road is also near for champion stocks including CSL, ResMed, and others remains yet to be seen.

Five months including a disappointing reporting season seems a bit short to draw such far-reaching conclusions. In particular given the likes of Aristocrat Leisure ((ALL)) and Iress Technologies ((IRE)), to name but two examples from the old version High PE stocks, continue to exhibit strong growth and the ability to find new ways to improve the path forward.

To be continued.

Rudi Talks

Recent audio interview about investing in high quality stocks in the Australian share market:

https://www.youtube.com/watch?v=f9pTAV4TPJA&t=16s

Rudi On Tour In 2019

-AIA Adelaide, SA, June 11 -AIA National Conference, Gold Coast, Qld, 28-31 July -AIA and ASA, Perth, WA, October 1

(This story was written on Tuesday 4th June 2019. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website).

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