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AUSTRALIA

High Expectations For Rio Tinto Cash Flow

Record iron ore prices mean strong cash flow and dividends are anticipated from Rio Tinto, outweighing a difficult quarterly production outcome

- Soft production aside, market remains focused on spot iron ore prices
- Mined copper and bauxite production expected at the low end of 2021 guidance
- Any lengthy risks to operations could be of concern when high prices subside

By Eva Brocklehurst

As iron ore prices tower at record highs the greatest risk for Rio Tinto ((RIO)) will come when they fall, although prices are expected to stand the company in good stead in the second half of 2021 and into 2022.

Enduring high prices have mitigated subdued volumes as rain, the pandemic and technical problems impeded mine production in the second quarter. The company had to contend with shutdowns for tie-ins, cultural heritage issues and a tight labour market, which all impacted iron ore volumes in the Pilbara.

Shipments are now expected to be at the lower end of guidance of 325-340mt for 2021 although UBS notes this still requires a run rate of 342mt in the second half. Macquarie also highlights the risk of a miss on iron ore volumes and retains forecasts at the bottom end of the guidance range.



Cost inflation has also meant unit cost guidance for the Pilbara has been lifted 6%. This has stemmed from higher labour and diesel costs as well as heritage management and the pandemic.

Morgans was particularly disappointed with the Pilbara outcome as quarterly output was the slowest since 2015, and material tightness in the Western Australian labour market along with heightened inflation add risk heading into the second half.

That said, the broker acknowledges the market is keenly focused on the ongoing spot price for iron ore.

Morgans sticks with a Hold rating, as long-term investors can still enjoy high-quality earnings, but **remains sensitive to the capital that is at risk from the market's confidence in record iron ore prices.**

Macquarie notes the iron ore division accounts for 65% of revenue and 80% of earnings (EBIT) in its forecasts for the first half. Hence, Rio Tinto is highly leveraged to iron ore's performance and there is upside to earnings forecasts of 38% and 120% in 2021 and 2022, respectively, in a spot price scenario.

Around 90mt of iron ore replacement projects are on track to be completed this year yet Ord Minnett questions why so much is being replaced at the same time. Commissioning of the 43mt Koodaideri mine will be later than expected because of labour shortages yet ramp-up is still expected in early 2022.

Mined copper and bauxite production are expected to be at the low end of the guidance range at 500-550,000t and 56-59mt, respectively. Rio Tinto attributed the lower bauxite volumes in the quarter to heavy rain on Australia's east coast.

Aluminium production was slightly higher and pricing premiums remain elevated in the first half. Rio Tinto pointed to a strong performance of the ISAL and Betancourt smelters.

Copper

Mined copper production was down -12% in the quarter because of a slope failure at Kennecott (US) and covid-19 disruptions at Escondida (Chile) and Oyu Tolgoi (Mongolia). Escondida sustained lower recoveries and throughput and the planned relocation of the inter-pit crusher at Kennecott affected production.

There were no injuries from the slope failure at Kennecott, as it had been anticipated and mining restarted progressively in June. Rio Tinto expects to recover material from the slide, which is largely copper-bearing ore. Yet mining rates will be slower and high-grade production scheduled for later this year will be deferred to 2022.

At Oyu Tolgoi delays related to the pandemic and discussions with the government in respect of approvals will have a negative impact on timing and costs. Rio Tinto, so far, estimates incremental development costs of US\$100m as a result of the delays.

Various approvals from the Mongolian government are still required for caving and UBS envisages material risk that the October 2022 start-up will be delayed. To comply with pandemic-related restrictions site manning levels were less than 25% of planned requirements.

Targeted production for the Winu (WA) copper project is now 2025, a one-year delay. **Titanium dioxide slag production guidance has been removed amid risks associated with the security disruptions in South Africa** and the company has declared force majeure at its Richards Bay operations.

Dividends

The focus for the August result will undoubtedly be on cash dividends, Morgans asserts, given the limit on major shareholder ownership levels by the Foreign Investment Review Board.

Citi forecasts a balance sheet that is net cash to the tune of \$7bn at the end of the first half, implying at an aggregate pay-out of 95% an interim dividend of US\$7.30/share. Macquarie expects record earnings and dividend performance in the first half and anticipates a first half dividend of US\$4.65.

Despite a disappointing first half production performance Credit Suisse expects strong free cash flow and assesses the dividend yield alone should be enough to justify its Outperform rating. Yet the broker sounds a note of caution as any prolonged risk to operations, which can be ignored in a high pricing environment, could be more significant if and when markets subside.

FNArena's database has four Buy ratings, two Hold and one Sell (UBS). The consensus target is \$135.43, suggesting 6.2% upside to the last share price. The dividend yield on 2021 and 2020 forecasts is 12.3% and 9.0%, respectively.

See also, [Rio Tinto Secures Oyu Tolgoi Financing Deal](#) on April 14, 2021.

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AUSTRALIA

Orbost Renewal Key To Cooper Energy Outlook

Cooper Energy is ironing out problems associated with the Orbost gas plant and the subsequent performance of Sole gas production will be critical to the outlook

- Gas sales supported by third-party purchases, compensation from APA Group
- Athena plant to take over Cooper Energy's gas processing in Otway
- Upcoming risk in the abandonment of Basker Manta

By Eva Brocklehurst

Impetus for Cooper Energy ((COE)) needs to come from better performance from the Sole gas field, as production has been beset by problems stemming from the performance of the Orbost gas processing plant.

June quarter production was 0.66mmboe along with sales of 0.97mmboe, in line with the most recent guidance, and taking FY21 production to 2.6mmboe. Problems at the Orbost plant were exacerbated by reduced availability from the Iona gas plant (owned by Lochard).



Gas sales in the period were supported by third-party purchases and compensation from APA Group ((APA)), the owner/operator of the Orbost plant, helping to preserve cash margins. Cooper Energy is supplying some gas from its Otway operations (Casino Henry) into Sole to reduce reliance on third-party purchases.

Morgans asserts this was an important feature of the update, as it shows customer alignment/relationships are being maintained. Ord Minnett also notes a "reasonable" margin was generated on third-party sales as the cost was materially less than the company's average realised gas price.

Capital works will be carried out at Orbost to improve production rates and stability while the upgraded Athena plant will take over gas processing in the Otway from Iona later in 2021, with the expectation that reliability

will be substantially improved.

Macquarie points out, in moving to Athena from Iona, there are tangible benefits from self-owned "uninterruptible" processing capacity, noting the experience when Lochard turned of capacity for Cooper Energy's gas processing at Iona periodically.

FY21 has been difficult, Canaccord Genuity agrees. Still, gas prices are rising and there is some optimism regarding the future performance of Orbost, so a Buy rating is maintained. More conservative assumptions mean the broker, not one of the seven monitored daily on the FNArena database, has lowered the target to \$0.45 from \$0.49.

Spot gas prices in Victoria averaged \$9.60/gigajoule in June, and in July to date have averaged \$17/gigajoule amid a tight market. Canaccord assesses that with production from Esso/BHP Group ((BHP)) on the decline in Bass Strait, and few new projects around, **Victoria is the most vulnerable gas market on the east coast.**

In turn, this provides a positive growth signal for the Athena gas plant, which Cooper Energy expects will be commissioned in the December quarter. The works should deliver lower operating costs, increased production and, potentially, reserves, opening up the development of Annie, Henry-3 and future discoveries, the broker suggests.

Orbost

Fouling issues at the Orbost gas plant have continued with the sulphur absorbers now being cleaned every two weeks to maintain stable production. Cooper Energy and APA Group have approved the next phase of works, 2B, which will involve revisions to the distribution system and the inclusion of the filtration circuit.

Morgans acknowledges further information is required regarding the new filtering technology yet highlights, over the last month, the daily performance at Orbost has been better. With frequent cleaning the broker is more confident Sole can continue to produce an average 40-45TJ/day of gas.

Canaccord expects the works will cost around \$20m, based on previous indications, and could increase capacity towards 50TJ/day. Jarden factors in \$30-40m in expenditure in FY22, with peak production of 55TJ/day after the activities have been completed. Work to identify the actual cause of the fouling is ongoing and more detail is expected at the August results.

Macquarie points out that **expenditure and sharing between Cooper Energy and APA Group has not yet been confirmed** and the performance of Sole gas following the phase 2B works will be critically important.

Debt

Cooper Energy and its lenders have a facility adjustment which includes a realignment of principal repayments. The alignment with a re-based production level of 40-45 TJ/day for Orbost's gas processing plant will also preserve liquidity for advancing current growth projects.

The company intends to refinance and expand the Sole debt facility, which is still maturing in 2024. The timing of the final investment decision on Annie and Henry will depend on drilling rig availability, funding and marketing optimisation. Yet Morgan Stanley assesses the medium-term risk is the upcoming Basker Manta abandonment.

The broker forecasts net debt of \$127m will remain flat over the next 12 months and then increase significantly to \$200m in 2022, given the capital outlay required for abandonment. As a result, Morgan Stanley suspects Cooper Energy will need to expand its debt facilities.

Jarden, in valuing Cooper Energy, includes a risk value for the undeveloped Manta gas field as well as liabilities for abandonment of Basker Manta. The broker also assumes the cost of capital will rise over time to reflect reduced investor appetite to own the sector, although the company's lower emissions places it at an advantage relative to peers.

Jarden, not one of the seven monitored daily on the database, has an Overweight rating and \$0.32 target. The database has two Buy ratings and three Hold. The consensus target is \$0.35, suggesting 46.7% upside to the last share price. Targets range from \$0.29 (Macquarie) to \$0.45 (Ord Minnett).

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AUSTRALIA

Stockland Ups Exposure To Land Lease Sector

On acquiring Halcyon, Stockland is expanding its presence in the land lease sector, which is considered a positive strategic move

- Halcyon should provide Stockland with a strong brand to scale up in this segment
- As a result there should be an improvement in rental and development margins
- A positive strategic move yet does not inspire brokers to change their views

By Eva Brocklehurst

Stockland ((SGP)) is expanding its presence in the retirement living sector, acquiring land lease operator and developer Halcyon for \$620m. The acquisition comprises 1500 established sites and 2300 development sites, the majority being in Queensland.

Halcyon should significantly accelerate Stockland's scaling up in an attractive segment, Citi believes, given it provides an affordable housing solution to a growing group of ageing Australians.



Following the acquisition, Stockland will have a portfolio of 1500 rental units, all from Halcyon, and 6300 development units, comprising of 37% from Halcyon. In a land lease model the home is owned but the land on which it is situated is leased from the community operator.

Rent is paid for the right to occupy the site with a manufactured home or transportable dwelling. Stockland intends to fully integrate Halcyon while the founders will remain involved and provides consulting services for at least 12 months.

UBS notes Halcyon villages are unique and therefore arguably deserve some premium for the quality and location, although **around 67% of the acquisition relates to development where the value is less clear.**

As Stockland achieves scale in this area there should be an improvement in both rental and development

margins, currently 55% and 10% respectively, on the initial Halcyon portfolio, Macquarie suggests.

The cost of the acquisition is elevated compared to previous transactions in this segment, the broker adds, yet it should provide Stockland with expertise and a strong brand that can be used across its roll-out.

The first tranche of the price will be paid upon completion of the transaction, expected in August 2021, with the balance of \$310m deferred until July 2022. Around \$200m of the transaction price is attributable to rent-collecting assets and the remainder to the development portfolio.

This reflects \$138,000 per occupied site. These sites generate a margin of 55-60%, equating to a passing yield of 4.3%. Management expects to lift the margin to 65%. The passing yield is significantly firmer than the capitalisation rate of 6.25% for book values of listed peers, Ord Minnett notes, such as Lifestyle Communities ((LIC)) and Ingenia Communities ((INA))

The broker is a little surprised Stockland is investing so much in increasing its exposure to retirement accommodation, given the challenges that have existed with its own retirement business.

Still, the land lease model has a stronger track record, Ord Minnett acknowledges, and is a better fit for listed investment while being aligned with Stockland's skill set. Morgan Stanley estimates Halcyon will generate operating earnings in FY22 of \$21-22m, equating to a 20x enterprise value/EBITDA multiple.

The transaction will be funded by debt at a 3% interest rate. As a result, Morgan Stanley considers the acquisition 1% accretive to current estimates for FY22 earnings per security of 36.2c.

Macquarie estimates in isolation the company's gearing moves up to 24.5% from 2.5% and towards the mid-point of the company's target range of 20-30%, still leaving some deployment capacity. **Stockland has signalled it will introduce third-party capital to the business over time.**

A Positive Strategically

The acquisition is considered a positive strategic move by Morgan Stanley, providing capacity to double the company's current land lease settlement target to more than 600 per year by FY24.

Residential remains one of Citi's preferred exposures within the property sector and therefore the Halcyon acquisition is considered strategically attractive. Macquarie agrees the land lease sector is attractive but, given growth in residential sales is likely to prove difficult going forward, this is insufficient to change its thesis.

FNARENA's database has one Buy rating (Morgan Stanley), four Hold and one Sell (Ord Minnett). The consensus target is \$4.59, which suggests 6.5% upside to the last share price. The dividend yield on FY21 and FY22 forecasts is 5.8% and 6.2%, respectively.

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AUSTRALIA

What's Next For BHP Group After Iron Ore Falls?

BHP Group's production performance impressed in the June quarter as the iron ore division continued its stellar run. Yet, what will garner attention when the iron ore price inevitably falls?

- Focus on capital management and divestments likely at the August results
- Fundamental support continues for the share price, yet is the upside limited?
- Is BHP Group planning to accelerate the exit from fossil fuels?

By Eva Brocklehurst

Upside for BHP Group ((BHP)) earnings in FY22 is predicated on the trajectory of iron ore prices, which continue to defy expectations and remain at record highs. Outside of iron ore, there is a noted softening in guidance for copper and coal.

Yet Shaw and Partners believes it is worth highlighting the achievement in BHP's operations under the CEO Mike Henry, as the company is now the lowest cost iron ore miner globally.

June quarter numbers may have been sound but the guidance for FY22 is a little soft for Credit Suisse's liking. The iron ore division continued its stellar run in FY21 yet production guidance implies a flat or only marginal increase for FY22.

Still spot iron ore prices should provide a buffer for any volume downside, the broker acknowledges, and the focus will be on capital management and consolidation of the portfolio at the August results.



Assuming 100% pay-out of earnings per share the broker forecasts a total dividend of US\$2.17 per share equating to an annualised dividend yield of 11%. Citi forecasts FY21 dividends of US\$3.28/share at a pay-out ratio of 95% and notes FY21 net debt is forecast at \$8.7bn, implying additional capital management potential

of around \$3-8bn.

Western Australian iron ore production is guided at 278-288mt while petroleum is guided at 99-106mmboe, which suggests an improvement year-on-year. Copper guidance is 1.59-1.76mt metallurgical coal 39-44mt and NSW thermal coal 13-15mt.

Guidance for Cerrejon has been withdrawn as divestment is expected to be finalised in the first half of 2022. BHP will recognise an impairment charge of -US\$85m in the FY21 results.

While costs are within guidance there will be a hit to the profit & loss at the August results from higher rehabilitation and closure costs as well as depreciation. Credit Suisse notes rehabilitation costs may be a one-off but the depreciation impact will linger.

South Flank achieved first production in May and the ramp-up of this project is expected to lift the quality of iron ore production. The Western Australia iron ore division's port licence is expected in the next six months.

Both major projects, Mad Dog (oil & gas) and Jansen (potash) are on track, with a final investment decision on the latter due in the next two months. Ord Minnett would not be surprised if there was a write-down of the carrying value of Jansen, which is being assessed.

Outlook

Incorporating a softer outlook for copper and coal and higher unit costs drives -5% reductions to Macquarie's estimates for FY22-24. Macquarie reduces copper production forecasts by -5-8% over the next three years and flattens the volume outlook for thermal coal.

Yet the upside from iron ore revenue more than offsets this, in the broker's view, and this presents the most material risk to forecasts. Shipment volumes from BHP have been consistent, Macquarie notes, and the strong performance in the June quarter is undoubtedly attributable to South Flank which delivered its first ore in May.

Goldman Sachs expects 7% copper equivalent growth in FY23 amid the full ramp-up of Spence (copper) in Chile and several new conventional oil projects in the Gulf of Mexico. Sulphides are expected to double production at Spence by the end of FY22.

The strength of the company's fundamental support the share price although Morgans asserts limited upside potential affects its conviction beyond the attractive yield on offer, while UBS considers the risk/reward is balanced as high cash returns are supportive of the share price in the near term, although the iron ore price is vulnerable to a retracement from its lofty heights.

Ord Minnett, on the other hand, makes the comparison with Rio Tinto ((RIO)) which had a fraught June quarter. Rio Tinto's shipments were down on the March quarter and the achieved price was -US\$3/t below BHP's, which had strong performances at Yandi and Mining Area C despite significant impacts from weather and temporary rail labour shortages.

Citi was also pleased with the copper production at Olympic Dam of 205,000t but with a large scale smelter maintenance program scheduled for the first half of FY22 guidance is 140-170,000t.

Olympic Dam stood out for Shaw too, providing the highest copper production under BHP stewardship as well as record gold production. The broker highlights **four major projects were delivered on time and budget during the financial year.**

Divestments

BHP has previously stated it was looking to divest its metallurgical coal assets although an update on the sale process was not provided, nor was there any update on the divestment of the NSW thermal coal assets. The company expects Chinese restrictions on Australian coal will continue for a number of years.

Morgan Stanley notes media speculation that BHP may be considering exiting the petroleum business in order to accelerate a complete exit from fossil fuel commodities.

The speculation implies the business could be worth around US\$15bn. While the company has not commented, the broker believes an exit of fossil fuels could enhance the investment case and ESG credentials significantly.

That said, management has consistently remarked on the attractive nature of the oil & gas business and revealed a willingness to continue investing in these opportunities to improve returns. Morgan Stanley values this segment at US\$11.3bn, estimating operating earnings (EBITDA) in FY21 were around 6% of the group total.

Among those stockbrokers not monitored daily on the FNArena database, Shaw and Partners has a Buy rating

and \$56.00 target for BHP Group while Goldman Sachs has a Buy rating and \$57.70 target.

FNArena's database has three Buy ratings and four Hold. The consensus target is \$50.53, signalling 0.9% upside to the last share price. Targets range from \$42 (UBS) to \$60 (Macquarie, Ord Minnett). The forecast dividend yield, on present FX values, is 7.7% and 7.6% for FY21 and FY22, respectively.

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AUSTRALIA

Santos-Oil Search: Who Wins?

Now the Santos bid for Oil Search is out in the open what does it mean for the future of both companies?

- Highly opportunistic bid, given Oil Search is without a permanent CEO
- Merged company would improve access to debt capital markets for Santos
- Reducing the Oil Search stake in Alaska may be key to any deal

By Eva Brocklehurst

Santos ((STO)), it seems, is seriously eyeing off Oil Search ((OSH)). From all reports there was a bid in the wind on June 25 and the latter has finally indicated this was rejected, although remained willing to engage.

Following the controversial resignation of CEO Kieran Wulff, Oil Search confirmed speculation it had received and rejected an indicative non-binding bid, and Santos subsequently disclosed it was the suitor. Santos had approached with an all-scrip offer of 0.589 shares for every Oil Search share.

The merger of the two would significantly improve scale and quality, taking advantage of the weakness in the Oil Search share price. Hence, it is considered opportunistic. Yet this does not mean it is without strategic merit, Jarden asserts.

The broker notes the takeover approach from Woodside Petroleum in 2015 was considered to grossly undervalue the company, yet at that time the bid/ask spread was too wide and a deal did not progress.

This time the circumstances are different, as the Santos CEO, Kevin Gallagher, is well regarded while Oil Search is currently without a permanent CEO. Morgans agrees that this time the timing is fortunate for Santos with the sudden departure of the Oil Search CEO because of "unacceptable behaviour".



UBS also suspects that in the wake of Dr Wulff's resignation, Santos may now believe it has more leverage in discussions. The broker considers **the rationale remains sound as the merged company would be the largest Australian listed oil & gas company by market capitalisation.**

The bulk of Oil Search's value is tied up in relatively long-life, low-cost assets in PNG. This would mean Santos, with its PNG interests, can reduce exploration expenditure and develop the resource base at an appropriate time.

Santos would obtain a further 29% stake in PNG LNG, a top tier project to add to its existing stake. Yet, in the case of Gladstone LNG, the company's interest would be diluted in a merged entity to just 14% of net asset value, from 24% currently.

The market capitalisation of Santos has been nearing an all-time high, Jarden observes, while Oil Search has failed to rally in 2021 despite the 50% increase in the Brent crude price.

What Now For Santos?

The challenge for Santos is how to proceed, and there is a question for shareholders as to whether to support the company if it chose to pursue Oil Search and/or raise the offer. Santos shareholder stakes would be diluted but the quality of the company's asset base would also improve and the growth trajectory become more diversified, Jarden asserts.

UBS believes, for an all-scrip deal to be pursued, the Santos share price would need to lift from the July 20 close of \$6.49, and/or the company may need to offer a higher scrip ratio. The broker estimates the scrip ratio could rise to 0.60 Santos shares. beyond which the economics would become dilutive.

From the Santos point of view an all-scrip offer would avoid the need to raise equity or draw down debt at a time when gearing is above 33%. Moreover, UBS assesses the merged company could improve access to debt capital markets for Santos and support growth while the company can still pay sustainable dividends.

Ord Minnett points out energy company valuations have disassociated from benchmark oil prices recently, amid a growing focus on environmental, social and governance (ESG) considerations. While this is unlikely to change in the short term, the broker believes exploration & petroleum companies could take advantage of low debt and attractive equity valuations to make acquisitions.

In this vein, UBS wonders how ESG-sensitive investors would view Pikka, the greenfield oil development in Alaska, and its fit with the Santos 2040 net zero emissions target and plans to be a "green gas company" in ten years.

The proposal assumes almost nil value for the Oil Search Alaskan asset, in Morgan Stanley's view and, yes, **there are risks for Santos in terms of its ESG credentials**, meaning it would be better if Alaska was offloaded, as not only is there financial risk but Santos has negligible experience in that part of the world.

What's In It For Oil Search?

Concerns regarding Oil Search centre on Alaska, and the departure of the CEO has raised corporate governance risks. Morgans asserts. Yet, with investor sentiment having taken a hit, shareholders may be willing to accept a lower premium in return for Santos taking over management of their investment.

Furthermore, an all-scrip bid at a small premium would mean any potential upside to value would come from the share price performance of the merged entity and most of this would be from unlocking the growth assets of Oil Search rather than from within the Santos portfolio.

The main question Jarden poses for shareholders is whether it would be better to own a smaller share of growth and an improved chance of this being unlocked, or a larger potential exposure with the associated risk of Oil Search delivering production on its own.

The broker believes the Oil Search board needs to offer a "Plan B" and address the perceived corporate governance risks while outlining a path to value creation for the next 1-2 years. This would enable shareholders to judge the relative merits of any proposals.

Morgan Stanley notes, on the present offer, it appears more favourable to Santos than Oil Search shareholders. Still there will be pressure on the board of Oil Search to engage amid concerns about the Alaskan sell-down and high executive turnover recently.

Alaska

Oil Search has commenced a sale process for a stake in the Alaskan project, ahead of a final investment decision later this year. Morgan Stanley believes the issue is now about whether the sale process will be halted until a new CEO is on board.

Without a sell-down of the Alaskan asset, Oil Search is too leveraged in the broker's view, and has underperformed global peers and Santos while outperforming Woodside Petroleum ((WPL)) and Beach Energy ((BPT)) in the year to date.

Before the Alaskan acquisition in late 2017, Macquarie assesses Oil Search was the most attractive oil &

gas takeover target in the Asia Pacific region. The broker asserts natural owners of PNG gas/LNG assets are unlikely to be natural owners of Alaskan oil and therefore reducing the stake in Alaska is key to any deal.

Jarden, not one of the seven stockbrokers monitored daily on the FNArena database, has a Neutral rating on Oil Search with a \$4.00 target and a Sell rating on Santos with a \$5.90 target.

The database has four Buy ratings for Santos and three Hold. Is \$7.96, suggesting 19.5% upside to the last share price. For Oil Search there are three Buy ratings, three Hold and one Sell (Credit Suisse, yet to comment on the bid or the Oil Search CEO exit).

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AUSTRALIA

The Wrap: Oz Equities, Investors, Covid-Strategy, Housing

Weekly Broker Wrap: Oz equities momentum, investor confidence, strategies for living with covid, global housing ripe for price reversal

- Wilsons suspects peak earnings momentum may be reached this quarter
- Investor expectation of economy recovering well post-covid, drives 'mum & dad' confidence in ASX-listed companies above pre-pandemic levels
- Major Asian economies are expected to shift from 'zero covid' to 'low covid' strategies

By Mark Story

Oz equities: Is earnings momentum about to peak?

With both the ASX200 index and forward earnings estimates now sitting higher than pre-covid level highs, the question Wilsons suggests investors are now pondering is whether growth is peaking.

Wilsons looked to the 2010 post-GFC period for insights into how markets typically behave after earnings momentum peaks. The broker discovered that during 2010, the market generated gains in both the three- and six-month periods before earnings momentum peaked.

The market then contracted by around -11% in the first three months after the peak.

The broker's research also suggests that while cyclicals are historically the most sensitive to this shift - as earnings momentum peaks and rolls over - the growth or defensive sectors should start to outperform once the market turns a corner on momentum.

While the reflation trade - reflected in an economic cycle upswing - has carried value stocks to above pre-covid levels, Wilsons suspects a rotation back towards growth stocks if earning growth rates start to peak.

Given earnings momentum is currently at exceedingly high levels, **Wilsons believes there is now a growing risk that growth has peaked, and the market will struggle to sustain this momentum over the next 6-12 months.**

While some of this rotation has been evident since March, Wilsons notes it has become more pronounced over the last month as growth concerns have returned to the market's thinking.

Wilsons believes we may reach peak earnings momentum this quarter. However, due to stronger global stimulus than post-GFC, and a commodities cycle that's still in the first half of expansion, the **broker suspects this expansion phase could be longer than in other periods.**

Also fueling this outcome is an economic recovery that's likely to take another 6-12 months as the world reopens.

Assuming earnings keep growing at a slower rate than over the last six months, the broker believes the market will not get sufficiently spooked to reverse the reflation trade.

Having concluded that the risk-return trade-off is not as favourable for cyclicals as it was at the beginning of the cycle, Wilsons believes the stronger overriding theme of the next 12 months will be the reopening of the global and domestic economies.

Despite current lockdown hiccups, Wilsons suspects this theme should provide significant impetus to the earnings growth cycle. The broker suspects both the financials sector - due to further earnings upgrades - plus the materials sector - due to elevated levels of copper and iron ore prices - could push the index earnings per share (EPS) higher and support the reflation trade.

Wilsons expects to see further consensus upgrades going into the FY21 earnings season, and believes FY23 earnings could be upgraded, offering another tailwind for cyclicals. While Wilsons still believes this cycle will stay the course, the broker has trimmed weighting to cyclicals to 60% from 70% in light of the risk and probability of history repeating itself.

Over the last quarter, the broker has increased its holding in quality growth stock CSL ((CSL)), added Telstra ((TLS)) as a low beta, defensive stock; and removed Super Retail ((SUL)) and Reliance Worldwide ((RWC)), two cyclical, covid winners.

Investor confidence: Exceeds pre-pandemic levels

According to the Chartered Accountants Australia and New Zealand's (CA ANZ) latest annual survey, the confidence mum and dad Australians have in Australian capital markets (87%) and ASX-listed companies (90%) is now greater than pre-pandemic levels.

Despite the uncertainty of covid, investors with particularly rosy levels of confidence in the Australian markets (49%) have rebounded even more with a 13% rise over 2020.

Survey data attributes heightened confidence in investor expectation that the Australian economy will recover well post-covid, noting the ASX historically bounces back, and overall confidence in Australia's productivity.

Three-quarters of the 1000 investors surveyed by CA ANZ also registered confidence in capital markets outside of Australia. This marked an 11% rise from the same time last year compared to confidence in Australian capital markets making an 8% jump.

CA ANZ's Amir Ghandar suspects this domestic confidence could be spilling over into foreign investment opportunities, especially with Australian investors preferred international markets that are gaining control over the covid crisis and vaccine rollout.

"Whether this rebound is short-lived or here for the long haul will be proven by how well we manage this crucial next year of the crisis, particularly as other global economies start to re-open," explained Ghandar.

'Zero-covid' strategies waning

While the "zero covid" strategy practised in parts of Asia has delivered health and economic benefits, The Economist Intelligence Unit (EIU) suspects it will become unsustainable as the global economy reopens.

To preserve their status as business hubs, the economic think tank suspects a cluster of major Asian economies will shift from policies aimed at eliminating covid - including successful stringent lockdown measures - to one based on living with it.

Conditional on achieving widespread vaccination, the EIU expects transitioning away from zero-covid strategies - to low-covid models like those adopted by Japan and South Korea - to occur gradually in each of the zero-covid economies (excluding Vietnam) by mid-2022.

However, there is also the risk, adds the EIU that the emergence of covid variants resistant to current vaccines could quickly persuade zero-covid countries to retain their current approach. The EIU suspects any liberalisation of border controls would also see Australia and New Zealand directly benefit from a revival in international tourism and student flows.

While China will be the most cautious about reopening, the EIU expects zero-covid regions to retain tight border controls throughout 2021, only relaxing them from early 2022 when mass vaccination has been achieved.

Based on the EIU analysis, the pressure to rethink covid strategies will be most acutely felt in Asia's city-states of Hong Kong, Macau, and Singapore, where there's a heavy reliance on international business and tourism.

For example, Hong Kong and Singapore have sizable foreign worker numbers, with 30% of the latter's population having neither citizenship nor permanent residency status. If neither Hong Kong nor Singapore can operate effectively as a hub, EIU suspects businesses may prefer to move more of their operations elsewhere.

Global housing: 10% overvalued

Based on data from the Jorda-Schularick-Taylor macroeconomic history database, Oxford Economics concludes that real house prices within advanced economies maybe around 10% overvalued versus long-term trends.

While the prices or price-to-rent ratios look 10% or more above trend in several economies, within certain countries that is not the case.

Looking across four indicators, Oxford identified the Netherlands, Canada, Sweden, Germany, and France as

the riskiest markets, and notes the German price-to-rent ratio has not increased much from 1990 relative to other markets.

Interestingly, Oxford also notes some previous hot spots such as Australia - which registered the highest price-to-rent ratio across 14 advanced economies - does not feature here, thanks in part to price corrections in 2018-2019.

Oxford assesses the macroeconomic risks from the current house price boom as twofold: Firstly, it might exacerbate overheating risks, and secondly, it might push prices far from fundamentals, risking a later price crash that threatens activity and financial stability.

The economic forecaster's long-run assessment of the current boom suggests the risks are skewed to the second kind, which would result in a big price reversal. With valuations already looking high in many economies, Oxford suspects the length of the boom also adds to the risk.

What's clear from the evidence, adds Oxford **is that the longer a housing boom continues, the more likely it is to end, especially as prices become more detached from fundamentals.** But that said, Oxford believes the risks look lower this time compared to the lead-up to the global fiscal crisis, with the slower rise in mortgage credit making a notable difference.

Overall, in light of opposing influences such as demographics, the savings glut, and the possibility of higher inflation, the economic forecaster sees the behaviour of real rates as the key issues for coming years.

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COMMODITIES

Material Matters: Coal, Iron Ore And Copper

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

- More volatile second half expected for Australian resource stocks
- Thermal coal prices remain elevated and production is expected to surge
- Iron ore market likely to remain tight into 2022 so price downside limited
- Short-term bearish signals prevailing for copper

By Eva Brocklehurst

Commodities Outlook

Commonwealth Bank strategists suggest the outlook for Australian listed resource stocks is favourable, as they experience strong cash flow and high dividends. Yet a more volatile second half of 2021 is likely.

The strategists expect China's demand for commodities may ease in the second half of 2021 but this will be partially offset by strengthening demand outside of China and the continuing transition to a low carbon global economy.

Commodities have come under pressure in recent weeks as the spread of the more virulent Delta variant of coronavirus affected mobility and growth expectations. Meanwhile, central banks have implied more hawkish policy stances and some have announced a slowdown in bond buying.

A third issue has been the assertive campaign in China to put downward pressure on **industrial metals** prices, such as **steel**. This means the environment in the second half will be more volatile after the run-up that sent **copper** and **iron ore** prices to all-time highs.



ANZ Bank analysts have noted Chinese steel demand started 2021 strongly although momentum has begun to

wane. Infrastructure investment has been contracting and property sector growth has also softened.

Chinese steel margins eased back sharply and June recorded the first monthly decline in steel production since November 2020. High-frequency data shows steel production is slowing and in early July profitability turned negative.

China's steel exports have continued to rise and growing demand outside China could offset some of the weakness in domestic demand in the second half, the analysts suggest.

Demand has been coming from developing markets such as Vietnam, with foreign direct investment growing 6.5% in the first quarter as the country becomes a manufacturing alternative to China. The outlook for the Europeans is also improving.

Coal

Spot prices have surged for **coking (metallurgical) coal** since the beginning of May yet a peak may be forming, the CBA strategists point out, as some steel product margins are already in negative.

Meanwhile, supply concerns amid seasonal demand from the warmer-than-usual summer in North Asia has kept **thermal coal** elevated. Longview Economics also notes thermal coal prices have increased threefold since the start of the pandemic.

There was a net increase in Chinese coal power capacity of 3% over 2020 while, globally, additions excluding China were just 9GW and retirements 25GW. Hence, China continues to grow its coal capacity while the rest of the world is cutting back.

Longview Economics also notes the correlation between coal prices and supply growth suggests production will increase by over 400mt in 2021. In the US mined coal supply is growing at over 35%.

Iron Ore

Economic data from China in June is unlikely to stem concerns regarding fading growth. Hence, ANZ Bank analysts believe this could increase the downward pressure on iron ore prices.

A sharp correction is not envisaged, nevertheless, as the market remains tight. While demand outside of China can offset some of the weakness, iron ore prices are expected to trend lower in the second half, although the downside will be limited.

ANZ analysts expect momentum in the second half in China will largely rely on domestic demand as the global recovery is soft while the pandemic still rages. The analysts retain a three-month target of US\$185/t.

They expect iron ore prices will decline to US\$170/t by the December quarter and continue to decline in 2022 as Vale's iron ore production increases more noticeably.

On the supply side, Vale had a number of pandemic-related disruptions over 2020 that affected rectification work on its dams while Australia struggled to meet the shortfall. The analysts expect total exports from the four largest producers - Australia, Brazil, South Africa and India - will rise by only 16mt in 2021.

Most of this will come from Brazil as Australian production is expected to be relatively flat. While small operators are taking advantage of a rise in prices, the analysts suggest output is small and costly and they are unlikely to stay in the market for longer.

Meanwhile, Western Australia is reviewing its Aboriginal Heritage Act and the proposed new legislation will put greater onus on operators such as the iron ore giants to come to agreement with traditional landowners.

Copper

While the long-term outlook is bullish, there are several developments which have signalled to Longview Economics that copper should break to the downside. Growth and inflation expectations have peaked at high levels. Fund managers believe the global economy has reached "peak boom" and are less convinced about high inflation.

This view, Longview suggests, should result in lower break-even inflation and, in turn, copper prices. The US Federal Reserve's potential tapering of bond purchases adds to the case for weaker copper prices as this will lead to reduced liquidity.

There is also some sign that copper production is picking up as Glencore will re-open the Mutanda copper and **cobalt** mine in Congo this year. At its peak the mine produced around 200,000t of copper annually before closing in late 2019 as a result of low prices.

The CBA strategists have upgraded long-term copper price forecasts by 27% to US\$3.20/lb and expect demand will lift strongly as decarbonisation goals encourage electrification and electric vehicles.

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ESG FOCUS

ESG Focus: Green Finance Offers Reprieve For Banks

FN Arena'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:

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ESG Focus Green mortgages a reprieve for banks

As big capital extends green financial nets into the retail, SME and corporate markets, banks are likely to be sheltered from the worst ravages of competition behind anti-trust legislation.

- EU launches sustainable finance strategy
- Global anti-trust and anti-big-tech sentiment given a voice
- Green mortgages on the way
- Capital questions: who gets what when stress strikes
- The Australian scene - property is the easy target

By Sarah Mills

Sustainability-linked finance is about to sweep the world, and property investors will be among the first in its path.

Banks globally have been preparing for the new lending paradigm, which is forecast to incorporate green priorities into all property-secured lending and issuance within a decade.

As with most things green, the European Union (EU) is leading the charge and this week ushered in the new financial year with its Sustainable Finance Strategy.

The big takeout was that the EU and the European Banking Authority are exploring supporting a taxonomy-aligned uptake of green mortgages and green loans - ready by 2022.

This will be part of an inclusive finance framework that is likely to provide a blueprint for other nations.

A strategy highlight was the suggestion that mortgages will become the first asset class in the world to receive preferential capital requirements, to encourage the finance sector to take carriage of the green transition.

As part of its roadmap, the European Central Bank says that over the next 18 months, it will develop indicators for banks' carbon footprints and exposure to physical climate risk.

Banks globally are preparing for the new ratings and assessment regimes and are already creating their own green lending frameworks.

While the EU's sustainable finance strategy addresses both GSS use-of-proceeds and sustainability-linked bonds and loan markets; this story focuses primarily on the sustainability linked market and the banks.

Not so brave new banking world

Big capital is placing carriage of the green transition into the hands of banks, which will mobilise capital towards a sustainable future.

In return for accepting this baton, it is highly likely that the banking industry will be protected from online retail behemoths like Amazon for at least the next decade.

The capacity of the banks to take carriage of a task the scale of the green transition, while fighting tooth and nail against disruption, would be compromised.

The retail/investment banking nexus has proved a powerful tool for big capital to exert global control through the process of financialisation.

Banks have essentially turned to investment banking market for greater profits, while offsetting losses through its retail oligopolies.

Retail banking is to the banks what classifieds were to the press. Without it, they would face a precarious future, and one of big capital's command and control mechanisms would be compromised, as would an escalation of financialisation through ESG finance.

So it is fair to say that banks are safe from serious competition for now.

So while smaller financial industry competitors will continue to nip at banks ankles, the banks will enjoy a double advantage:

Protection from major competition on one front; while the greater complexity of sustainability-linked retail products will help shore up their competitive moats in the sector on another front.

Banks will also gain extra fee income from deal-making in fixed-income markets; carbon-trading activities; potential funding advantages; and preferential capital treatment.

But let's take a step back

The future of retailing is very different to the past.

Without regulation, the logical evolution of the online retail industry is for supermarkets, department stores, banks and media to merge into single-branded online portals, such as Amazon - or at the very least to sell their products through such portals.

It then becomes a battle of the portals for supremacy.

Categories would still exist but market dominance would hold with the portals.

Already Amazon has been purchasing, building and experimenting with tools, systems, fin-tech buyouts and financial products that expand its merchant participation.

It has also contemplated partnerships with major US banks offering accounts in the online market place, and also has the option of plumping for a cut of financial products sold on its platform.

Amazon alone represents a serious threat to the global banking industry, let alone other competitors when the broader retail disruption gets under way.

For now, Amazon has played it very cool on the banking front, largely confining its activities to those surrounding core merchandising activities.

Amazon founder Jeff Bezos was bred on Wall Street and has no illusions of the scale of defence the global financial system would mount to a serious affront.

Only fools go where angels fear to tread; and Bezos is no fool.

But just to be safe, the establishment sabres are rattling and big-tech is on the back foot: a signal that retail disruption is being sidelined in favour of green and Fourth Industrial Revolution disruption.

Anti-trust bills on the rise

Regulators are backing the banks - and other vulnerable industries.

Last month, the United States House Judiciary Committee approved half a dozen bills with bipartisan support targeting the break-up of the nation's tech giants.

The bills would create a framework to break up the big tech companies into smaller ones; break up businesses that use their dominance in one area to get a stronghold in another; and make mergers more expensive and difficult.

The big beneficiaries of such legislation would be the banks, supermarkets and department stores -generally some of the world's largest employers.

Given green sustainability goes hand in hand with social sustainability and stability, this is telling.

The trade-off for old-model retail industries is likely to be the provision of greater job security and stability during the transition; keeping in mind stable income is required to fund green mortgages, bonds and loans.

Expensive labour also creates barriers to entry.

Banks jostling for carbon-trading positions

Globally investment banks are chasing opportunities in the US\$227bn carbon-credit market.

Greenbiz expects the market will need to rise ten-fold to meet the Paris Climate targets by 2030 and that the carbon price could rise to US\$50 a tonne. Reuters estimates the increase at 15-fold.

Banks have three main sources of income from carbon credit markets: buying and selling emissions rights on behalf of corporations to profit from bid-offer spreads; investment in carbon offset development under the Kyoto Protocol's clean development mechanism; and proprietary trading.

This month, National Australia Bank, NatWest Group, the Canadian Imperial Bank of Commerce and Itau Unibanco launched a pilot platform for buying and selling voluntary carbon credits.

The platform is expected to record its first trade this August.

This will add to green income from bank retail arms, via green mortgages (see below) and other sustainability-linked lending.

Also this week, Washington State has just passed its cap-and-trade bill, joining California. More states are expected to follow.

Green mortgages first off the rank

The EU's review of upcoming Mortgage Credit Directive will include means to support the uptake of green mortgages, and provide a blueprint for other nations.

The European Commission said in its Sustainable Finance Strategy this week that it plans: "to recognise that measures to enhance energy efficiency of a mortgage collateral can be considered as unequivocally increasing property values," in the section on amending capital requirements.

This suggests the EU plans to lower capital charges on assets that support its 2050 climate goals.

The EU has been working on an Energy Efficient Mortgages Action Plan for about three years, in which the banks have been setting parameters for energy-efficient mortgages, developing a pool of complying assets upon which they can perform risk analysis.

The upshot was that it identified a link between sustainability and default: higher energy costs for non-sustainable buildings increased the likelihood of default.

This was a bit of a no-brainer given it would obviously affect disposable income.

Another EU finding from various studies was that people who are more environmentally and socially conscious tended to be more conscientious in other life habits such as debt repayment.

Turns out they're better credits.

These findings lay the foundation for preferential capital treatment.

The capital question

The EU's next step is to explore whether ESG factors improve the risk profile of other asset classes.

If so, it will "propose amendments to the prudential framework for banks to ensure ESG factors are consistently included in the risk-management systems and supervision."

The European Commission (EC) is bringing forward the date to make these assessments from 2025 to 2023; and also has the insurance sector in its sights.

The EC is also planning on building climate stress tests into the Capital Requirements Directive that governs European banks.

Also on the agenda are plans to improve the "reliability, comparability and transparency of ratings agencies".

Credit hierarchy - who gets what when stress strikes

As banks enter new waters, investors will have to navigate new risks.

Other stories in this ESG Focus series cover the current lack of protection for bond investors associated with green "default"; and other risks associated for both equity investors and fixed-income investors with green

finance.

This section focuses on risks surrounding debt seniority.

Policymakers are considering whether a preferential capital regime can be justified for green financing to reflect transition risks to a low-carbon economy, keeping in mind that it will be an interim measure.

Over time, most assets will be underpinned by sustainable behavior; and become the new norm.

Until then, a new class of green regulatory capital to support the financing of sustainable assets is likely.

But Fitch says this would only make sense if the taxonomy and classification were clear and consistent globally.

The capital issue is just as important for equity investors as fixed-income investors; given regulators could force green bonds to absorb losses and write-downs on all assets, including non-green assets.

This has triggered a discussion on ring-fencing sustainable assets and liabilities.

But to do so, may set up a fight with the global bank prudential regulators.

The EU taxonomy is one thing but doesn't answer many technical considerations for complex green instruments beyond senior and unsecured bonds, says Fitch Ratings.

There are no mechanisms in bank liquidation or resolution procedures allowing the ring fencing of assets other than those specifically pledged as collateral.

To ring-fence assets would firm up the green credentials of subordinated instruments and increase green asset expansion given the inherent leverage of green regulatory capital instruments.

But it would also weaken banks' capital resilience as it weakens the ability of stronger parts of a bank to support weaker parts.

When it comes to tier one debt, there is no regulation or market precedent beyond the usual creditor hierarchy for how the use-of-proceeds would be tracked if the instrument were required to absorb losses.

Meanwhile, Fitch Ratings notes green bond ratings will of course revolve around debt seniority; and like the early days of convertible bonds, the markets are waiting on more stress scenarios to clarify risk performance.

So far banks have largely issued green hybrid bonds, which qualify as additional Tier 1 capital; and subordinated Tier 2 bonds.

Both instruments can be used to absorb losses through write-downs or conversion in the event of deep stress.

Banks have also toyed with green residential-mortgage-backed securitisation.

Not everyone agrees

Many critics argue that the EU's measures focus too strongly on capital requirement reward for good green behavior rather than simply penalising polluters.

In other words, it means broader classes investors will be paying for the transition of brown companies rather than those who threw their lot in with fossil fuel companies in the first place.

Many prudential regulators and other industry bodies have qualms for other reasons.

The European Leveraged Finance Association (ELFA) is the latest of many, including the European Banking Authority, to voice concerns over coupon step-ups related to missed ESG KPIs and targets on sustainability-linked bonds (SLBs).

An ELFA survey cites issuers' ability to game "greeniums", through high-yielding SLBs that are callable prior to penalties kicking in for ESG misses, taking advantage of the greenium while reducing the risk of step-ups.

Half of respondents suggested the cost of calling the bond should 50% plus the step-up if the non-call period ends prior to KPI testing.

Use-of-proceeds market has its own problems

When it comes to the use-of proceeds market, banks ask how can a green bond be perpetual if there are no perpetual green assets (keeping in mind the proceeds are earmarked for projects).

Spanish bank BBVA suggests providing a portfolio of eligible assets that proves the bond's reinvestment capacity; i.e. that the corporation has a reliable and robust capacity to generate more said assets.

That way bond maturity doesn't have to match the maturity of the underlying assets.

Others suggest simply securitising assets, or using the assets as collateral.

BBVA suggests separating the capital buffer requirement from the commitment to devote the proceeds to fund new eligible sustainable products - as independent elements.

It says it is also important to differentiate between the green target of the bond and the financial rationale of the operation.

Banks doing their own legwork

Banks are already setting up systems that certify that assets meet their frameworks; and that asset selection is carried out against these framework.

A big issue for banks is to ensure issuance outpaces amortization.

Like the Climate Bond Initiative and other standards platforms, banks favour traceable assets; independent opinions; solid governance and certified environmental impact (we refer to the fallibilities of certification in earlier stories).



Australian banks ready to rock

The banks aren't waiting until 2023. They already have their sustainability skates on, and this is already affecting capital markets.

At a Bloomberg panel earlier this year, the sustainability heads of all four Australian major banks predicted that sustainability finance would break from the gates in the second half of 2021.

In July 2017, the Climate Bond Initiative (CBI) released its first qualifying criteria under the Climate Bond Standard tailored to Australian residential mortgages called the low-carbon residential buildings proxy criteria.

The criteria specifies location-specific requirements that Aussie residential buildings have to satisfy to receive a Certified Climate Bond.

Again, like everything, the criteria are fairly loose and are expected to tighten over time. The CBI will review prerequisites twice a year.

The proxy criteria are based on the minimum design standards for thermal efficiency and energy efficiency of Australian residential buildings within states.

The criteria require buildings to be in the top 15% of residential buildings in a local market for emissions.

National Australia Bank ((NAB)) issued Australia's first green residential mortgage-backed securities (RMBS) in February 2018 - a \$300m tranche of the bank's 2018-1 \$2bn securitisation.

NAB was the first bank to issue a sustainability-linked mortgage in January 2020 at a 2.44% interest rate.

Property market an easy target

As the largest holders of real-estate in Australia, the property market is an obvious target for banks' sustainable finance arrows.

The Clean Energy Finance Corporation estimates that property accounts for about 23% of Australia's emissions and residential property accounts for about a half of that.

The main source of residential emissions is heating and cooling (40%) followed by appliances at 25% and water heating at 23%.

The average house emits about 7 tonnes of greenhouse gases per year.

From a carbon brownie-point of view, thermal performance of buildings is tipped to be favoured over renewable energy generation such as residential solar panels.

To increase the energy efficiency rating of a new-build home by one star translates to about 1% to 4% of construction costs (just to give an estimate of the likely flow-on affects into the construction industry and construction-industry suppliers).

Banks will issue rate discounts to borrowers linked to targets.

At the moment, these range from as little as 10 basis points to 40 basis points for five years on a maximum LVR of 80%.

In some respects, it can be zero basis points given most building code requirements demand certain levels of efficiency and banks are already securitising assets based on the percentage of those assets that would likely conform to these standards (i.e. those built in the past 10 years).

Residential mortgages represent half of NAB's balance sheet, for example, so the existing mortgage pool definitely represents low-hanging fruit.

Nonetheless, it is expected that banks will try to incentivise borrowers to perform above code.

As rates fall, the above basis-point discounts become more attractive. As rates rise, benefits to borrowers fall. It is likely financiers will adjust these rates accordingly.

The interesting thing for borrowers and investors, is going to be the extent of step-up margins and penalties in the event of missed KPIs and targets.

If it is anything like credit cards, it could prove a lucrative business for the banks, although as with most things green, markets will be eased in gently.

Borrowers may increasingly be requested to fill out scorecards, thereby improving bank efficiency in the screening process.

All of this also requires a lot more work on behalf of the borrower to prove eligibility.

Policing appears loose at this stage of the game.

The EU's Energy Efficient Mortgages Initiative has put an energy efficiency data protocol in place where it is collecting data among banks and sharing reporting on it to gauge performance.

The initiative's 2020 study of 72,000 Italian mortgages between 2012 and 2020 demonstrate a -30% lower default rate of higher rated homes - obviously they have deeper pockets.

This puts pricing into perspective and makes a 10 basis rate differential seem a bit stingy; although the profile of borrowers is likely to change over time as the transition gains pace.

Given the general lack of comparability of bank products, 10 basis points could easily get lost in translation.

Apart from thermal efficiency, banks are likely to fund the following inclusions in new builds and for retrofits:

- Solar and photovoltaic panels;
- Solar battery storage systems;
- Solar hot water systems;
- Gas hot water systems;
- Solar pool heaters;
- Solar hydroponic heat pump systems;
- Rainwater tanks;
- Water pumps;
- Grey-water treatment systems;
- Home insulation that meets government standards for geographic areas;
- Certified double glazing and triple glazing for windows;
- Split air-conditioning systems (that will muscle out gas over time);
- Evaporative coolers or zoned air-conditioning units with complying energy ratings;
- LED lights in more than 75% of the property.

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ESG FOCUS

ESG Focus: Transition Bonds - The Great Controversy

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Transition bonds - the controversial new asset class

The anaemic transition-bond market has suddenly become one of the hottest topics in the bond market today - and the stakes are high.

- Transition bonds a US\$1trn a year market
- The great debate that could threaten the transition
- The stakes are high
- Risks to investor

By Sarah Mills

"Climate Transition Finance is arguable the most important topic for the sustainable finance market to deal with in the coming 12-36 months."

- Jacob Michaelson, Nordea, November 2020

One of the hottest topics in the sustainable debt markets is that of a relatively new bond type designed to allow brown and not-so-green companies to finance their gradual shift to a cleaner way of doing business - the transition bond.

These bonds are designed to fund the imminent transition of nearly all of the world's economies and corporations - a massive funding call.

In March, Standard & Poor's Global forecast transition finance could account for US\$1trn of the expected US\$3trn annual funding required to meet climate goals.

Others estimate the figure will be closer to US\$1.6trn a year.

Yet uptake has been anaemic.

Bloomberg NEF notes that only six transition bonds had been issued this year to May, which compares with the Climate Bond Initiatives estimate of a total of 11 during 2020.

Dealogic notes that only US\$7.3bn of transition bonds have been sold since 2017.

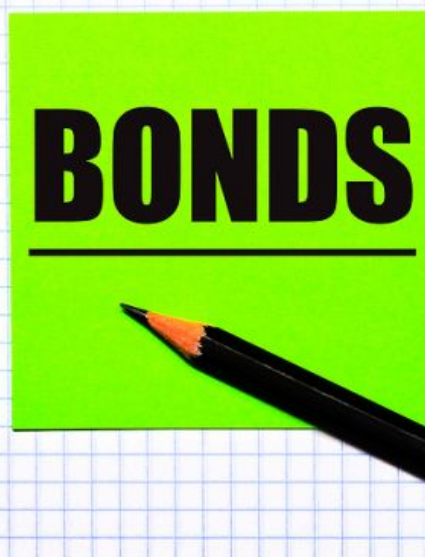
Most corporations and supra-nationals have favoured the loosely policed but more liquid green-bond market.

But big capital is expected to head "transitioners" off at the pass and corral them into transition finance - which is being treated as a new asset class.

Regulatory and government organisations are expected to lead the way. The London Stock Exchange launched a transition bond category in February on its sustainable bond market.

Japan's Ministry of Economy, Trade and Industry is being pressured to sell 30 transition bonds by 2023.

The Asian Development Bank has announced it will no longer fund fossil-fuel exploration and will fund transition and environmentally supportive projects instead, including emission-control technologies.



The transition challenge

The problem for the powers that be is that many pure-play green funds, not to mention cautious investors, will not buy transition bonds - the prospect of stranded assets sending private capital running for the hills.

Fund managers, in particular, are baulking at the lack of clarity and risk.

Some countries like Germany avoided much of this argument, with the German government paying for much of the transition through taxpayer dollars; the quid pro-quo being labour deals.

But calculations suggest that outside wealthy Germany and a handful of others, governments have insufficient funds to support a transition of this scale and private investors are being called upon to foot the bill.

The nature of transition bonds

There is no clear definition of transition bonds.

At present, transition bonds are use-of-proceeds or sustainability-linked bonds, directed specifically to transition but the difference between transition bonds and green bonds lacks clarity.

The general idea is that green bonds fund innovation, then transition bonds provide funding to corporations to transition to the new technologies borne of the green bond market.

Fossil-fuel dependent companies can still tap the green bond market for in-house green R&D, for example, but retrofits would fall under transition finance - particularly as the market progresses.

Transition bonds differ from green bonds in that green bonds are ideally dedicated to green impact - think innovation in green technology or water sustainability - although the reality is they are being used for retrofits.

In essence, the concept of additionality holds greater sway in the green market, and some argue that transitioning has a very low additionality quotient.

Green bonds tend to be earmarked for specific projects but transition bonds, while linkable to projects, ideally take into account the impact on the company-wide transition, and steps towards emissions reduction.

A matter of standards

As with all “green” financing, issuers are expected to comply with standards.

The five transition principles are:

- Aligning with zero carbon by 2050 and nearly halving emissions by 2030;
- Be led by scientific experts and not be entity or country-specific experts;
- Be sure edible transition goals and pathways don't count offsets;
- Include an assessment of current and expected technologies, which can be used to determine a decarbonisation pathway;

- Be backed by operating metrics rather than a commitment or pledge.

There is also a brown taxonomy and criteria being developed.

The Climate Bonds Initiative is expected to kick-start the market with a transition bond framework covering four priority sectors: chemicals, metals and mining, plastics, and oil and gas.

It will also determine which targets companies should meet (such as company-wide emissions) in order to qualify for transition issuance,

Meanwhile, the European Technical Expert Group suggests that such a taxonomy should (echoing the green bond principles of do no harm) incorporate technical screening criteria for significant levels of harm to environmental objectives.

The CBI is understood to be developing certification for the market, which might also help with the growing problem of transition-washing.

One of the main issues for investors was the lack of clarity in ICMA's Climate Transition Handbook, published in December 2020, as to when a transition label can be applied.

The handbook is a set of definition is under what qualifies as an investment under that framework, and this was perceived as a grating oversight.

The great debate

It is this risk-reward dilemma that has the capital heavyweights at odds, and threatens the future of the transition market.

The classification of transition bonds is arguably one of the most hotly contested topics in the ESG bond market.

At the moment, transition bonds are classified as both use-of-proceeds and sustainability-linked bonds (SLBs).

In the past, the International Capital Market Association had no separate rules for transitioners and encouraged them to use the existing GSS bond market.

Then, when the sustainability-linked bond market was established, they left it to the issuer to decide whether they opt for use of proceeds or sustainability-linked bonds.

But a heated debate is raging as to whether a transition-bond label is still needed now sustainability-linked bond principles have been published.

Environmental Finance also notes a growing push to expand the transition label from debt to equity issuances, and asset-backed structured solutions.

Of particular concern is that the format of transition bonds don't guarantee company wide improvements: just that "underlying projects are not as dirty as they could be".

From a technical perspective, some believe that SLBs and loans represent a subset of transition finance (particularly given as transition finance is being treated as an asset class); not that transition finance should be a subset of sustainability-linked finance.

The stakes are high

Investors stand to benefit from step-up margin and penalties. Companies that miss targets will have to foot the bill. For now these penalties are low but are forecast to rise.

Also at stake is debt seniority.

Regulators are signaling that use-of-proceeds issuance will be treated as senior debt but not SLBs.

Use-of-proceeds bonds, which are typically earmarked for projects, also have far less onerous penalties for failure to meet ESG targets; and they do not demand company-wide innovation (despite the transition principles) - for now at least.

Like the green bond market, a total miss will not result in loan default (nor will SLBs for now).

The SLB argument

The SLB camp also argues that transition bonds may mislead investors as to the green credentials of a transitioning company.

Transition-washing, a subset of green-washing, is rampant and is expected to escalate over the next few years as the stakes rise.

For example, *Responsible Investor* refers to a recent issuance from Indonesia's state-owned electricity company PLN that was basically used to plug a working capital hole. The debt was also issued to PLN to improve its "credentialing".

The Bank of China also tested patience with its false and misleading marketing of an US\$781m transition bond, claiming it met the EU sustainable finance taxonomy (which it did not), and that it aligned with ICMA's handbook (which it didn't).

The SLB camp says transition bonds should be classified solely as sustainability-linked bonds, which are subject to step-up margins and penalties in the event targets are not met, to create a merit-based funding system.

They believe SLBs are better suited for transitioning because they are forward-looking in nature, whereas use-of-proceeds (with their project focus) are not.

SLBs demand improvement from a baseline, ensuring company-wide progress.

The more extreme SLB purists argue that even supporting efficiency upgrades in companies is a waste of money given the market is more than capable of driving the transition as companies seek ever more efficient sources of energy and water.

They argue that transition bonds represent more of a fossil-fuel subsidy (often to laggard giants) than a destination worthy of green funds - money for nothing given pricing economies alone should drive the transition.

They claim providing funding subsidies to "recalcitrants" may delay rather than hasten the transition; and exacerbate losses in the long-term investment market from stranded assets. Laggards could well be defunct within a decade.

Many fund managers also support the SLB argument for technical reasons:

"We are better off, as a market, to give sustainability-linked bonds our full attention instead of diverting it into a label that is not fully understood and which may call into question the validity of the overall labelled bond market," says Nordea's global head of sustainable finance, Jacob Michaelson.

Many also note that in the absence of what constitutes a relevant transition, such that an updated taxonomy would provide, the risk of greenwashing goes up and that this suggests transition bonds carry more downside risk than is to be gained.

If fund managers are to take a risk on transition, they expect to be rewarded, and SLB step-up payments and penalties for missed targets addresses this issue.

The use-of-proceeds/combo arguments

The use-of-proceeds (UOP) camp generally favours a double classification - one that allows brown companies to tap both use-of-proceeds and SLB markets.

The UOPs argue that the transition cannot be efficiently and politically achieved without such subsidies to some of the world's largest economic powerhouses.

They note that hard-to-abate sectors account for a large proportion of emissions and have the greatest impact. They also have greater transitioning challenges.

Then there is the democratic argument. The use-of-proceeds camp says transition is already baked into the green bond market and green bonds should be for everyone.

For example, if banks, with their broad exposure to the energy sector, can issue green bonds, why not oil companies?

They also argue that a transition market is being developed and that more options is likely to equate to a swifter transition.

Credit Suisse's Marisa Drew, global head of strategy, finance and advisory, arguing for the defence in an *Environmental Finance* debate on the subject says the market should:

"...encourage the broadest, most inclusive lense when thinking about the provision of capital to fund transitions while still protecting the integrity of the markets to allow them to scale with confidence."

Odds are on sustainability-linked bonds

The odds are rising that transition bonds will be treated as a sustainability-linked bonds.

But not all issuers or investors want to see their coupons linked to sustainability KPIs and doing so doesn't work for all asset classes.

Regulators may offer a solution to the innovation problem by implementing company-wide carbon-intensity commitments as a pre-requisite for use-of-proceeds issuance.

Certainly pressure on government organisations to issue transition bonds suggests a desire on behalf of the powers that be to test market appetite.

Risks to investors

When examining ESG risks, FNArena is usually talking to long-term investors - the sit-and-holds.

Risks do exist for short-term and medium-term traders, but volatility in energy prices is likely to remain a feature of global markets for some time, allowing trade-outs.

But these investors are keeping a keen eye to key ESG timelines.

For example, the MSCI's Net-Zero Tracker, listed companies have less than six years to align with the 1.5 degree Celsius warming target.

Net-Zero aligned funds currently constitute nearly one half of the world's assets under management and are growing rapidly - a few billion dollars in assets under management being added in the first weeks of July alone.

So when it comes to transition, what investors really care about is issuers strategies that lead to net zero.

Meanwhile, MSCI modelling suggests that there is potential for investors to make money from transitioning companies.

Institutional investors face an array of risks when investing in products with weak ESG performance, ranging from forced sales of bonds that don't meet their standards to dissolution of the fund.

A lot will also depend on regulation. MSCI argues that new policies and investor-driven transition risk may be rising and suggests institutional investors may want to re-evaluate their bond portfolios - particularly the vanilla bond portfolios.

It suggests that a properly constructed transition bond from the right company could provide risk advantages over a standard bond. But as noted above, construction remains at the core of debate.

Equity market investors face the greater risk given green debt has seniority.

That could change depending on the complexity of instruments and lack of transparency as the market matures (think GFC).

Coming up

Our next article will be an introduction to the emerging sovereign GSS bond market.

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

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

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WEEKLY REPORTS

Weekly Ratings, Targets, Forecast Changes - 16-07-21

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

By Mark Woodruff

Guide:

The FN Arena database tabulates the views of seven major Australian and international stock brokers: Citi, Credit Suisse, Macquarie, Morgan Stanley, Morgans, Ord Minnett and UBS.

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

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

Summary

Period: Monday July 12 to Friday July 16, 2021

Total Upgrades: 9

Total Downgrades: 6

Net Ratings Breakdown: Buy 53.80%; Hold 39.22%; Sell 6.98%

For the week ending Friday 16 July, there were nine upgrades and six downgrades to ASX-listed companies by brokers in the FN Arena database.

There were no material changes to target prices by brokers during the week.

Coronado Global Resources had the largest percentage increase in forecast earnings. Morgans upgraded its rating to Add from Hold, and estimates leverage to sharply higher coking coal prices will offset any dilution after the company recently raised capital.

Credit Suisse notes the Curragh operations are generally subject to a three-month pricing lag, and expects the met coal pricing rally from May to take effect in the June half, with significant free cash flow growth likely to be reflected beyond the December half.

Next was Viva Energy Group. A first half trading update and a lift in FY21 guidance was lauded by all five brokers who cover the stock on the FN Arena database. Macquarie was impressed by an ability to capture market share in both retail and commercial. The dividend is expected to be reinstated and a return of up to \$100m in capital from the sale of the property portfolio could follow at the August result.

Meanwhile, UBS pointed out total fuel volumes (ex-jet) are now above pre-covid levels and diesel demand in regional Australia, particularly from agriculture and resource industries, has offset weakness in lockdown-affected metro fuel sales.

Both Pilbara Minerals and Galaxy Resources featured in the top percentage gainers to forecast earnings by brokers, after Ord Minnett lifted lithium forecasts. An estimated 10% market deficit out to 2024 supports higher near-term prices and the broker sees risk attached to an aggressive demand increase.

The broker's rating for Pilbara Minerals was upgraded to Hold from Lighten and its target price increased to \$1.50 from \$1.05. Based on the assumption that the proposed merger with Orocobre will go ahead, the broker's rating for Galaxy Resources was also upgraded to Buy from Accumulate, and its target price increased to \$4.80 from \$4.20.

A trading update and increased FY21 guidance from ARB Corp resulted in forecast earnings upgrades by brokers

in the FNArena database last week. The main drivers included a marked uplift in new vehicle sales in Australia, strong export sales growth and higher operating margins.

While Ord Minnett expects demand will stay strong in the short term and future sales are likely to be driven by continued growth in demand in 4WD and SUV markets, Credit Suisse feels visibility beyond the first half FY22 remains low, and sees some risk to end-demand as international travel resumes.

Sydney Airport had the largest negative percentage change in forecast earnings. Commentary centred on management's rejection of a \$8.25 takeover offer from an infrastructure consortium. Morgans believes it is a signal of optimism for the future by the board and suspects this is not the last takeover approach, while the share price languishes due to covid. Citi expects the consortium, or another potential bidder, will eventually acquire the company, albeit at a slightly higher price.

Another consortium made a takeover approach for Spark Infrastructure Group. Ord Minnett feels management may come under pressure to engage though it doesn't recommend investors buy the stock in anticipation of a higher bid price. The broker estimates there's circa -14% potential downside to consensus valuation and the offer price appears fair.

Next was Audinate Group, and while FY21 guidance was a 2.5% beat on Morgan Stanley's revenue estimates, there remains some impact from chip headwinds. With a record order backlog, the analyst highlights a head start in FY22. However, the Live segment is still likely depressed.

Finally, Western Areas appeared in the list of material forecast earnings downgrades. Macquarie lowered its rating to Neutral from Outperform last week after a mixed June quarter production report, with nickel production 7% higher than forecast, but shipments -5% lower. Given Flying Fox continues to underperform expectations, the ability to deliver a replacement source is now a key catalyst. The broker now expects the miner to report a small loss at its FY21 result release.

Total Buy recommendations take up 53.8% of the total, versus 39.22% on Neutral/Hold, while Sell ratings account for the remaining 6.98%.

Upgrade

ADBRI LIMITED ((ABC)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 0/6/1

Morgan Stanley makes revisions to the ratings and preferences for building materials companies. While challenges remain in the short term, it's felt Adbri will be well positioned to benefit, once encouraging infrastructure lead indicators translate to materials demand.

The broker upgrades the rating to Equal-weight from Underweight and retains the \$3.30 target. Industry view: Cautious.

The analyst's prior Underweight stance was more predicated on being the least preferred sector exposure rather than any meaningful issue with the valuation or demand drivers.

CSR LIMITED ((CSR)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 3/3/0

Morgan Stanley makes revisions to the ratings and preferences for building materials companies. The rating for CSR is lifted to Overweight from Equal Weight, due to underperformance versus the ASX200 by -18% since the FY21 results in May.

This runs counter to the company's position of having the greatest exposure of peers to the detached housing market, the strongest domestic end market, explains the broker. The target price of \$6.30 is unchanged. The industry view is cautious.

With a net cash position and strong cash generation, the analyst expects special dividends will be a regular feature and sees CSR trading on an attractive 6% fully franked yield for FY22.

GALAXY RESOURCES LIMITED ((GXY)) Upgrade to Buy from Accumulate by Ord Minnett .B/H/S: 3/2/1

Ord Minnett has provided an update to its lithium supply-and-demand model and near-term pricing, resulting in boosted earnings estimates to lithium stocks.

The broker has increased demand for lithium carbonate equivalent by 7% by 2030. Although supply constraints will ease in the later part of the decade, near-term supply is lower and risk is attached to an aggressive demand increase. Ord Minnett notes a forecasted 10% market deficit to 2024 supports higher near-term prices.

Based on the assumption that Galaxy's proposed merger with Orocobre will go ahead, the rating is upgraded to

Buy and the target price increases to \$4.80 from \$4.20.

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

Morgans raises the rating to Add from Hold and maintains its \$5.85 target price. It's considered the \$79m capital raising will further strengthen the balance sheet position, and the broker now forecasts FY22 net debt of just \$54.7m.

Along with total debt facilities, recently increased to \$300m, the company is now free to pursue further M&A opportunities, believes the analyst. The broker makes modest EPS forecast downgrades, as the placement dilution is partially offset by lower net interest costs.

NATIONAL AUSTRALIA BANK LIMITED ((NAB)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 2/4/0

Macquarie suspects the perceived benefit for banks from rising interest rates is inflated. Various offsets, including competition, have constrained margin upside.

The broker expects banks will remain leveraged to bond yields and, if the sector continues to outperform from rising rate expectations, then investors are advised to take profits ahead of the turn around.

National Australia Bank's rating is upgraded to Outperform from Neutral, following the recent underperformance in the share price.

The strong capital position and provisioning leaves the balance sheet well-placed to absorb potential issues for both AUSTRAC and an economic slowdown, Macquarie suggests. Target is steady at \$28.

OCEANAGOLD CORP ((OGC)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 1/2/0

OceanaGold has received renewed approval from the Philippines government for its Didipio mine, allowing it to restart. This removes a key obstacle to the resumption of operations and the company is now prioritising the retraining and hiring of its workforce.

Meanwhile, news on Haile was less positive as re-handling and processing problems are weighing on costs and approval delays could affect the mine over the longer term.

Didipio, in Macquarie's view, remains the best asset and the rating is upgraded to Neutral from Underperform. Target is steady at \$2.70.

OROCOBRE LIMITED ((ORE)) Upgrade to Buy from Accumulate by Ord Minnett .B/H/S: 4/3/0

Ord Minnett has provided an update to its lithium supply-and-demand model and near-term pricing, resulting in boosted earnings estimates to lithium stocks.

The broker has increased demand for lithium carbonate equivalent by 7% by 2030. Although supply constraints will ease in the later part of the decade, near-term supply is lower and risk is attached to an aggressive demand increase. Ord Minnett notes a forecasted 10% market deficit to 2024 supports higher near-term prices.

Based on the assumption that Orocobre's proposed merger with Galaxy Resources will go ahead, the rating is upgraded to Buy and the target price increases to \$8.45 from \$7.40.

PILBARA MINERALS LIMITED ((PLS)) Upgrade to Hold from Lighten by Ord Minnett .B/H/S: 1/3/0

Ord Minnett has provided an update to its lithium supply-and-demand model and near-term pricing, resulting in boosted earnings estimates to lithium stocks.

The broker has increased demand for lithium carbonate equivalent by 7% by 2030. Although supply constraints will ease in the later part of the decade, near-term supply is lower and risk is attached to an aggressive demand increase. Ord Minnett notes a forecasted 10% market deficit to 2024 supports higher near-term prices.

The rating on Pilbara Minerals is upgraded to Hold and the target price increases to \$1.50 from \$1.05.

VIVA ENERGY GROUP LIMITED ((VEA)) Upgrade to Add from Hold by Morgans .B/H/S: 5/1/0

After a first half trading update from Viva Energy Group, Morgans upgrades the rating to Add from Hold, and increases the target price to \$2.50 from \$2.30. It's felt an acceleration in earnings growth will lift earnings above pre-covid levels as the economic recovery continues.

Management raised first half earnings (EBITDA) guidance to \$390-\$410m compared to the \$324m forecast by the broker. A material recovery in refining margin has increased the analyst's confidence in the most volatile

part of the business.

Downgrade

ARENA REIT ((ARF)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 1/2/0

Morgan Stanley downgrades to Equal-weight from Overweight on valuation. At the current share price the stock is implying lofty multiples. The broker assesses Arena REIT is among the most expensive amongst the asset-heavy rent-collecting A-REITs under coverage.

Still, Morgan Stanley finds strong reasons for investors to continue holding the stock including a 15-year weighted average lease expiry and the fact child care operators are one of the more secure tenant classes.

Target is raised to \$3.66 from \$3.14. Industry view is In-Line.

BORAL LIMITED ((BLD)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 1/3/1

Morgan Stanley makes revisions to the ratings and preferences for building materials companies. It's felt downside risks prevail for the Boral share price in the short term, with a cessation of the takeover offer coinciding with the completion of the buyback.

The broker expects the company's index weighting to reduce, given Seven Group Holding's increased stake and a reluctance from domestic investors, due to a lower free float and liquidity.

Morgan Stanley downgrades the rating to Underweight from Equal-weight and reduces the target price to \$6.80 from \$7.60. Industry view is in-line.

COMMONWEALTH BANK OF AUSTRALIA ((CBA)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/3/3

Macquarie suspects the perceived benefit for banks from rising interest rates is inflated. Various offsets, including competition, have constrained margin upside.

The broker expects banks will remain leveraged to bond yields and, if the sector continues to outperform from rising rate expectations, then investors are advised to take profits ahead of the turn around.

Commonwealth Bank's rating is downgraded to Underperform from Neutral, following a strong rally in the share price. The main upside, Macquarie assesses, is ongoing material share gains and the ability to preserve margins despite the impact of lower rates. Target is raised to \$88.50 from \$86.00.

DACIAN GOLD LIMITED ((DCN)) Downgrade to Underperform from Outperform by Macquarie .B/H/S: 0/0/1

Macquarie assesses Dacian Gold had a softer end to FY21, with a modest guidance miss. A materially higher capex forecast at Mt Morgans in FY22 leads the broker to lower the rating to Underperform from Outperform. The target price also falls to \$0.28 from \$0.32.

FY22 production estimates, however, were in-line with the analyst's forecast. The company will release a new life-of-mine plan for Mt Morgans in the first quarter FY22.

POLYNOVO LIMITED ((PNV)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 1/1/0

Polynovo has announced FY21 revenue of around \$25.5m, signalling 34% growth over FY20. All geographies grew, although from a low base.

Yet there is uncertainty regarding US hospitals re-engaging and a lack of formal guidance was a surprise to Ord Minnett, given robust commentary from US peers.

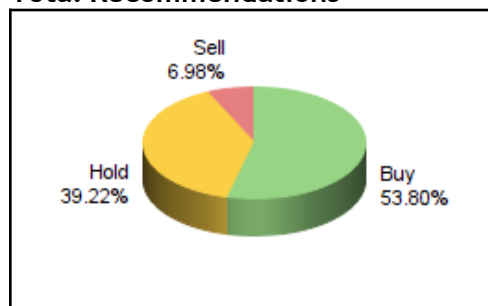
Ord Minnett suspects FY22 will be lumpy and there is a wide range of potential outcomes. The broker resets base projections and awaits evidence of a more stable and predictable environment, downgrading to Hold from Accumulate. Target is reduced to \$2.54 from \$3.10.

SPARK INFRASTRUCTURE GROUP ((SKI)) Downgrade to Hold from Add by Morgans .B/H/S: 2/5/0

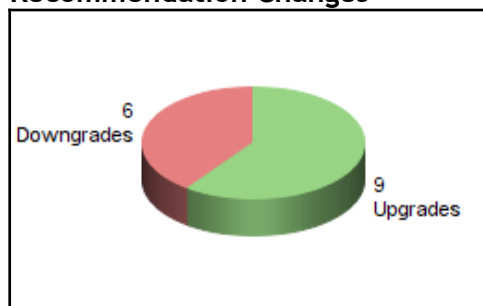
Morgans downgrades its rating to Hold from Add, given the M&A-driven price spike, after Spark Infrastructure Group announced it had received a takeover approach. The broker's target price of \$2.80 is set in-line with the bid price.

Given the group is a minority owner in the bidder's companies, the analyst doesn't foresee the FIRB having issues with the bid consortium. Also, as the group's key electricity network assets are regulated, it's felt there shouldn't be issues with the ACCC's review of the bid.

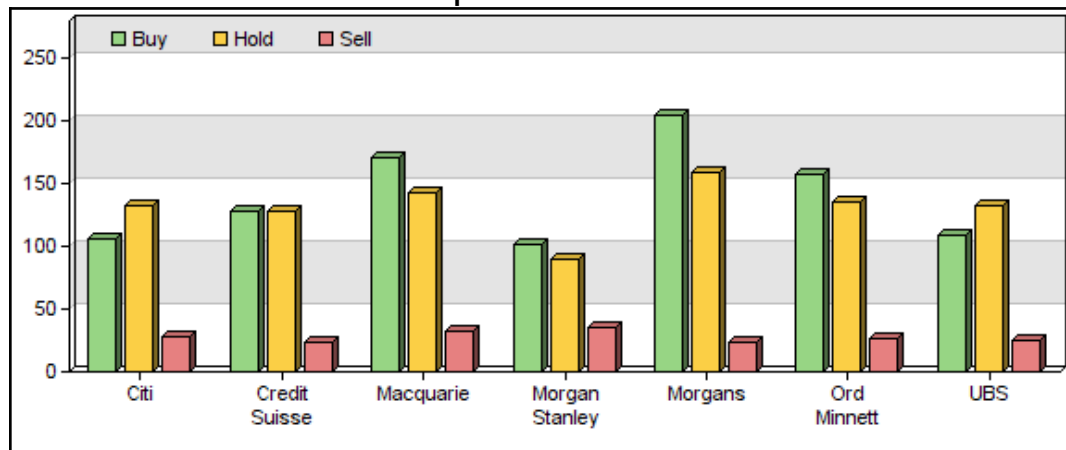
Total Recommendations



Recommendation Changes



Broker Recommendation Breakup



Broker Rating

Order	Company	New Rating	Old Rating	Broker
Upgrade				
1	ADBRI LIMITED	Neutral	Sell	Morgan Stanley
2	CSR LIMITED	Buy	Neutral	Morgan Stanley
3	GALAXY RESOURCES LIMITED	Buy	Buy	Ord Minnett
4	MAAS GROUP HOLDINGS LIMITED	Buy	Neutral	Morgans
5	NATIONAL AUSTRALIA BANK LIMITED	Buy	Neutral	Macquarie
6	OCEANAGOLD CORP	Neutral	Sell	Macquarie
7	OROCOBRE LIMITED	Buy	Buy	Ord Minnett
8	PILBARA MINERALS LIMITED	Neutral	Sell	Ord Minnett
9	VIVA ENERGY GROUP LIMITED	Buy	Neutral	Morgans
Downgrade				
10	ARENA REIT	Neutral	Buy	Morgan Stanley
11	BORAL LIMITED	Sell	Neutral	Morgan Stanley
12	COMMONWEALTH BANK OF AUSTRALIA	Sell	Neutral	Macquarie
13	DACIAN GOLD LIMITED	Sell	Buy	Macquarie
14	POLYNOVO LIMITED	Neutral	Buy	Ord Minnett
15	SPARK INFRASTRUCTURE GROUP	Neutral	Buy	Morgans

Recommendation

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	VRT	VIRTUS HEALTH LIMITED	50.0%	33.0%	17.0%	4
2	CSR	CSR LIMITED	50.0%	33.0%	17.0%	6
3	VEA	VIVA ENERGY GROUP LIMITED	75.0%	58.0%	17.0%	6
4	NAB	NATIONAL AUSTRALIA BANK LIMITED	33.0%	17.0%	16.0%	6
5	ABC	ADBRI LIMITED	-14.0%	-29.0%	15.0%	7
6	IPL	INCITEC PIVOT LIMITED	100.0%	86.0%	14.0%	7
7	PLS	PILBARA MINERALS LIMITED	25.0%	13.0%	12.0%	4
8	GXY	GALAXY RESOURCES LIMITED	33.0%	25.0%	8.0%	6
9	ORE	OROCOBRE LIMITED	57.0%	50.0%	7.0%	7

10 [WOW](#) WOOLWORTHS GROUP LIMITED
Negative Change Covered by > 2 Brokers

-20.0% -25.0% 5.0% 5

Order	Symbol	Company	New Rating	Previous Rating	Change	Recs
1	ARF	ARENA REIT	33.0%	67.0%	-34.0%	3
2	CBA	COMMONWEALTH BANK OF AUSTRALIA	-50.0%	-33.0%	-17.0%	6
3	SXY	SENEX ENERGY LIMITED	67.0%	83.0%	-16.0%	6
4	WSA	WESTERN AREAS LIMITED	29.0%	43.0%	-14.0%	7
5	SKI	SPARK INFRASTRUCTURE GROUP	29.0%	43.0%	-14.0%	7

Target Price

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	SKI	SPARK INFRASTRUCTURE GROUP	2.504	2.299	8.92%	7
2	PLS	PILBARA MINERALS LIMITED	1.445	1.333	8.40%	4
3	VEA	VIVA ENERGY GROUP LIMITED	2.382	2.225	7.06%	6
4	ARF	ARENA REIT	3.380	3.207	5.39%	3
5	ORE	OROCOBRE LIMITED	6.824	6.517	4.71%	7
6	VRT	VIRTUS HEALTH LIMITED	6.510	6.297	3.38%	4
7	GXY	GALAXY RESOURCES LIMITED	3.897	3.797	2.63%	6
8	IPL	INCITEC PIVOT LIMITED	3.040	2.976	2.15%	7
9	SXY	SENEX ENERGY LIMITED	3.880	3.845	0.91%	6
10	WOW	WOOLWORTHS GROUP LIMITED	36.404	36.105	0.83%	5

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New Target	Previous Target	Change	Recs
1	WSA	WESTERN AREAS LIMITED	2.587	2.601	-0.54%	7
2	CSR	CSR LIMITED	6.362	6.395	-0.52%	6

Earning Forecast

Positive Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	CRN	CORONADO GLOBAL RESOURCES INC	2.399	-1.146	309.34%	4
2	VEA	VIVA ENERGY GROUP LIMITED	8.288	5.573	48.72%	6
3	PLS	PILBARA MINERALS LIMITED	-0.168	-0.223	24.66%	4
4	ARB	ARB CORPORATION LIMITED	136.500	116.850	16.82%	4
5	GXY	GALAXY RESOURCES LIMITED	3.076	2.635	16.74%	6
6	IPL	INCITEC PIVOT LIMITED	16.050	14.036	14.35%	7
7	OSH	OIL SEARCH LIMITED	21.290	19.908	6.94%	7
8	ALD	AMPOL LIMITED	140.550	135.733	3.55%	6
9	RIO	RIO TINTO LIMITED	1969.099	1915.866	2.78%	7
10	VRT	VIRTUS HEALTH LIMITED	46.425	45.300	2.48%	4

Negative Change Covered by > 2 Brokers

Order	Symbol	Company	New EF	Previous EF	Change	Recs
1	SYD	SYDNEY AIRPORT	-6.456	-4.184	-54.30%	6
2	SKI	SPARK INFRASTRUCTURE GROUP	2.534	4.548	-44.28%	7
3	AD8	AUDINATE GROUP LIMITED	-4.950	-3.600	-37.50%	3
4	WSA	WESTERN AREAS LIMITED	-1.376	-1.090	-26.24%	7
5	CWN	CROWN RESORTS LIMITED	-6.114	-4.914	-24.42%	5
6	ORE	OROCOBRE LIMITED	-5.482	-4.665	-17.51%	7
7	TCL	TRANSURBAN GROUP LIMITED	-1.907	-1.623	-17.50%	6
8	NIC	NICKEL MINES LIMITED	7.379	8.192	-9.92%	3
9	WHC	WHITEHAVEN COAL LIMITED	-6.794	-6.267	-8.41%	7
10	SXY	SENEX ENERGY LIMITED	10.433	10.825	-3.62%	6

Technical limitations

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WEEKLY REPORTS

Uranium Week: Uranium's Relative Underperformance

As the uranium spot price fell marginally last week, Morgan Stanley sees uranium as the most preferred commodity and seeks to explain its relative underperformance.

- Uranium is Morgan Stanley's most preferred commodity
- The Sprott Physical Uranium Trust commences trading
- Uranium spot price falls by less than -1% for the week

By Mark Woodruff

Uranium is the most preferred commodity by Morgan Stanley, and its commodity strategists see a tighter market going forward.

Uranium's recent underperformance, relative to base metals and iron ore, is considered partly due to its **limited exposure to financial inflows and speculative activity**. In addition, relative underperformance has been caused by **utilities drawing down their inventories**, which means that actual market purchases are falling short of the investment manager's forecast reactor demand.

Base metals are up more than 80% since the lows of March 2020, and iron ore has rallied 140%, while uranium has gained only 19% over the same period.

With uranium mine supply is still below pre-covid levels, and well short of the average utility consumption rate, Morgan Stanley's supply-demand model projects a -25mlbs or -14% deficit this year.

The strategists forecast 2021 mine supply of 128mlbs and expect utilities to consume 182mlbs, therefore 54mlbs has to come from inventories and secondary supply sources.

Morgan Stanley adopts an average **spot uranium price forecast for 2021-23 of US\$36/lb, US\$41/lb and US\$49/lb**, respectively.

Company News

The much-anticipated first trading in units of the newly established **Sprott Physical Uranium Trust** commenced July 19 on the Toronto Stock Exchange. The Trust is the world's largest publicly-listed physical uranium fund and will look to provide liquidity for investors through exposure to the physical commodity.

Spain's Nuclear Safety Council has blocked ASX-listed **Berkeley Energia's** ((BKY)) planned uranium mine in the province of Salamanca because of safety concerns. It says it took the decision due to a lack of reliability and a high level of uncertainty over how radioactive waste would be stored at the facility.

Berkeley, which has a triple listing in Britain, Spain and Australia, and operates no other projects, had insisted the planned mine could be profitable since conducting initial studies in 2007.

ASX-listed **Okapi Resources** ((OKR)) has signed a binding agreement to acquire Tallahassee Resources, which owns a 100% interest in the Tallahassee Uranium Project in the US State of Colorado. The company also has an option to acquire 100% of the Rattler Uranium Project, including the historical and high-grade Rattlesnake open-pit mine in the US State of Utah.

In addition, the company has launched a placement to raise \$2.84m, via the issue of 14.2m shares at \$0.20 per share. Proceeds will be used to fund acquisition costs, exploration and general working capital.

Uranium Pricing

Industry consultant Trade Tech's Weekly **Spot Price** Indicator fell -US30c to US\$30.30/lb last week. The Indicator currently sits nearly 18% above the 2021 low of US\$27.40/lb seen in mid-March.

The average Weekly Spot Price Indicator in 2021 is US\$30.30/lb, US\$0.59 above the 2020 average.

Activity in the spot uranium market was quiet on the surface this week, reports TradeTech, with prices trending down slightly. However, the lack of formal activity was offset by an increase in off-market activity, and buying by utilities across the spot, mid and long-term delivery periods.

Traders, financial entities, and producers were largely absent as buyers last week, marking the first time in many months that utility demand has outpaced purchasing by non-end users. Sellers continue to exhibit a greater willingness to show utilities lower offer prices than other buying entities.

TradeTech's term price indicators are US\$32.40/lb (mid) and US\$35/lb (long).

Uranium - U308



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WEEKLY REPORTS

The Short Report - 22 Jul 2021

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

Summary:

By Greg Peel

Week Ending July 15, 2021.

Last week the ASX200 plunged and rebounded, before being a little more steady for the rest of the week. The plunge was all about the collapse of US bond yields meeting increased cases in Sydney.

The recovery was all about not caring about collapsing US bond yields and lockdown extension threats.

As the table below shows, again not much happened in Short Land last week, except at the top of the table.

No surprise that Webjet ((WEB)) has regained its mantle as most shorted stock on the ASX, jumping to 11.9% from 10.9%, with peer Flight Centre ((FLT)) jumping to 10.5% from 9.0%. Lockdowns are not pleasant for travel agents.

But they are for online-only marketplaces, such as Kogan ((KGN)). Lockdowns are manna for Kogan, which had a cracking 2020 but this year has suffered as Australia reopened. Shorts fell last week to 9.7% from a top-of-the-table 10.9%.

The big move last week was for Zip Co ((Z1P)), soaring to 10.5% and number two position from a mere 7.9% the week before. See below.

Weekly short positions as a percentage of market cap:

10%+

WEB 11.9
ZIP 10.5
FLT 10.5

In: **ZIP, FLT** Out: **KGN**

9.0-9.9

KGN

In: **KGN** Out: **FLT**

8.0-8.9%

ING

No changes

7.0-7.9%

TGR, EOS, TPW, A2M

No changes

6.0-6.9%

MSB, MTS

Out: **RSG**

5.0-5.9%

RSG, PNV, IVC, JBH, BGL

In: **RSG, PNV**

Movers & Shakers

There's Zip Co and there's Afterpay ((APT)), and then there's Sezzle ((SZL)), Splitit ((SPT)), Latitude ((LFS)), Smartpay ((SMP)), Zebit ((ZBT)) and Humm ((HUM)).

And that's just some of the Australasian BNPLs.

While models vary within this group, each offers competition to the other. It seems BNPL exploded on the scene from nowhere, as if it were as innovative as the iPod. But the reality is payday finance, hire purchase and lay-buy were all available to Moses when he bought his first television.

The only difference today is that it's all digital.

If competition locally is not enough, last week saw an announcement from PayPal that it was bringing its "Pay in 4" service to Australia, and from Commonwealth Bank that it would soon be launching its StepPay product, and from Apple that it would be partnering with Goldman Sachs to provide its own BNPL service.

The only surprise in Zip Co's short position leap to 10.5% last week from 7.9% the week before (assuming this is not an ASIC data blip), is that Afterpay did not see the same response.

Indeed, Afterpay is not even on the 5%-plus table, and hasn't been for some time. Afterpay severely burned short-side hopefuls earlier in its meteoric rise to a triple-digit share price, and presumably most of those shorters are still in rehab.

ASX20 Short Positions (%)

Code	Last Week	Week Before	Code	Last Week	Week Before
ALL	0.1	0.2	MQG	0.2	0.2
ANZ	0.8	1.0	NAB	0.9	0.9
APT	1.8	1.9	NCM	0.1	0.1
BHP	4.1	4.2	RIO	0.2	0.3
BXB	0.4	0.5	TCL	0.6	0.6
CBA	0.5	0.6	TLS	0.2	0.2
COL	0.6	0.6	WBC	0.8	0.9
CSL	0.2	0.2	WES	0.2	0.3
FMG	0.5	0.6	WOW	0.3	0.3
GMG	0.2	0.2	WPL	1.0	1.0

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

Guide:

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

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

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

IMPORTANT INFORMATION ABOUT THIS REPORT

The above information is sourced from daily reports published by the Australian Investment & Securities Commission (ASIC) and is provided by 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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SMSFUNDAMENTALS

SMSFundamentals: Are Traditional Retiree Income Strategies Flawed?

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

For an introduction and story archive please visit FN Arena's [SMSFundamentals](#) section on the website.

Why Focus On Equities For Retirement Income

Martin Currie Australia argues that a focus on equity-based investment solutions that solve a client's income needs is more important than ever in a post covid world.

- Retirees requiring a reliable income stream to focus on the actual dollar income generated over time
- Retirement products need to be built with the characteristics of "sufficient income for life"
- Martin Currie expects income growth for high-quality Australian equities to return to strength as business recovers post-covid

By Mark Story

Equity specialist, Martin Currie Australia, rejects the notion commonly held by multi-asset retirement products that when retirees get to age 65 they should automatically move away from risky growth-style assets, and looks to covid to explain why.

For example, for retirees who relied on predictable dividends to live on the fallout from covid was disastrous. Based on Martin Currie's numbers, in 2020 Australian equity investors experienced a -\$27bn loss of income, while term deposit investors saw their yields fall by more than -75%.

What equity-based strategies should seek to address, concludes Martin Currie, is an over-reliance many self-funded retirees have to income as a percentage of their total returns.

Martin Currie Research Highlights The Need For A "Sufficient Income" Focus

Within a white paper titled: *Investing in a sufficient retirement income in a post-covid world*, Martin Currie highlights what was a clear disconnect between its understanding of sufficient income for retirees' needs, and typical defensive retirement portfolios based on the total risk/total return theory.

Martin Currie's analysis suggests that percentages are the wrong way to think about income in retirement. What is more important, the equity specialist argues, is for retirees who require a reliable income stream to focus on the actual dollar income generated over time, rather than a headline yield percentage, which is often their primary focus.

Given that it leads to a greater focus on growth assets in the retirement mix, Martin Currie also argues that the idea of income stability is a better substitute for the risk of impaired living standards for retirees than capital or total volatility as a standard risk measure.

Unsurprisingly, Martin Currie believes income stream volatility and growth are much more important as a measure of risk than capital volatility.

In summary, the equity specialist claims its research highlights why retirement products need to be built specifically to provide retirees with the characteristics of what it calls "sufficient income for life" and cites its recent history to prove the point.

For example, despite the short-term impacts of covid on the dividend-paying ability for Australian companies in 2020, Martin Currie claims its specifically designed retirement income strategies have performed in line with its income objectives. Equally important, Martin Currie maintains that its income focus has not been compromised by the effects of 2020.

Based on the feedback from investors, institutional clients, and financial advisers, Martin Currie realised that a source of retirement income needed to adhere to four key characteristics, which when combined deliver “sufficient income for life.”

These characteristics include a high and stable franked dollar income stream to support annual expenses and income growth for inflation protection. Then there’s capital growth to manage longevity risk - aka the risk of outliving your money - and diversified growth exposures to reduce income sequencing risk - aka the risk of occurring large losses when it is difficult to recoup them.



The Problem With Defensive Assets

Martin Currie notes the sufficient income focus differs significantly from the traditional accumulation phase investment objective of maximising capital growth based on the constraints of total risk and total return.

It became evident to the equity specialist as far back as 2010 that when defensive asset yields fell, the resulting income from a traditional defensive portfolio risked sending a retiree’s hard-earned capital into a downward spiral without any capital growth to top it up.

The equity specialist also recognised that the age pension was an insufficient safety net for a comfortable retirement.

For example, to earn \$51,300 income, which the Association of Superannuation Funds of Australia (ASFA) suggests a couple aged 65 needs, at a 0.3% term deposit rate today, a portfolio of over \$17 million is required. By comparison, a \$500,000 portfolio in 2008, based on an 8% yield, would have met all a retiree’s income needs.

By investing in high-quality companies with strong balance sheets and earnings, Martin Currie attempted to minimise the income draw down as much as possible, ensuring the long-term income potential of the portfolio remained robust, during covid.

The equity specialist expects income growth for high-quality Australian equities to return to strength as business recovers in the post-covid period.

Strategies Deployed

By deploying four key factors, Martin Currie created a portfolio that varies significantly from both traditional equities and other income-focused approaches. Firstly, to avoid income shock, the equity specialist built its income portfolios from stocks based on their ability to pay what it calls a forward-looking sustainable dividend.

Martin Currie’s analysts also screen for quality companies with less volatile income than the market. By using a non-benchmark portfolio construction approach, security and sector concentration risk is also limited to ensure a more stable income stream, while avoiding income shocks.

Fourthly, Martin Currie recognises the value of franking credits within its investment process and seeks to maximise the after-tax income for 0% taxpayers. This is done by actively selecting companies that both have a high rate of franking and pay sustainable dividends.

By deploying the above strategies, Martin Currie expects the next twelve-month income stream of its sufficient income for life-focused strategies to consistently remain higher and more stable than the peer strategies analysed. By comparison, Martin Currie notes defensive strategies are well below the required level of income.

In summary, the equity strategist concludes that by deploying a greater focus on stocks through the four abovementioned drivers, lower volatility capital growth can be achieved.

Australian Focus

Having aligned its portfolio construction methodology with inflation drivers specifically for Australian retirees, Martin Currie does not believe retirees should look to global equities or global fixed income for most of their income requirements.

While offshore investments are often seen in traditional 70/30 and 30/70 balanced funds, the equity specialist believes foreign exchange risk, rather than adding diversification, introduces an additional unintended risk in the volatility of the income stream.

Given that broader Australian equities are not a particularly good mirror of the effect Australian inflation has on long-term retirement income requirements, Martin Currie has structured its portfolios to have better diversification across the domestic economy, in sectors such as consumer, financials, and real assets. As a result, income growth is more linked to retiree income needs.

Focus On High Dollar Income

Overall, Martin Currie believes that by focussing on providing high dollar income, rather than on capital returns, it has been able to provide better income outcomes. Also contributing to high levels of capital, both when paying out actual dividends and the ASFA standard, there is less need to draw down capital to provide a sufficient income.

From Martin Currie's view, the same cannot be said about defensive assets or even a high yield approach that has impaired its capital despite a high headline income. While term deposits may have a stable capital base when only actual income is paid, Martin Currie reminds investors this income alone is woefully insufficient versus the AFSA standard.

The bottom line is if you are not invested in growth assets, you will quickly run down the value of capital, and this creates longevity risk. Similarly, by focusing on strategies that improve both growth and income, you can better meet the needs of income and capital protection.

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TREASURE CHEST

Treasure Chest: Move Early On Computershare?

FN Arena's Treasure Chest reports on money making ideas from stockbrokers and other experts. Computershare is highly leveraged to the interest rate cycle so is it time to start factoring in higher rates?

- Credit Suisse opts to be an “early mover” on the cash rate cycle
- Computershare offers growth from other areas such as corporate actions
- Yet, is it right to price the stock based on a longer-dated view?

By Eva Brocklehurst

How can investors price Computershare ((CPU)) based on current multiples and in view of the eventual rise in cash rates from very low levels? The share price has rallied recently, attributed to views that inflation could be about to materialise.

Computershare has strong leverage to higher interest rates and the recent acquisition of the Wells Fargo Corporate Trust Services (CTS) has doubled exposure to margin balances to more than US\$35bn.

Credit Suisse believes there is scope for earnings, hence the share price, to double in the next 3-5 years and makes its case by pointing out the potential for higher margin income stemming from increases to cash rates of around 100 basis points, implied by the current forward interest curve.

The broker acknowledges picking the timing of the interest-rate cycle is difficult so incorporates a large margin of safety, while still preferring to be an early mover rather than risk missing the opportunity.



Growth is expected to return in FY22, despite headwinds to margin income, given the benefits of cost reductions, and Credit Suisse also notes there are other areas of growth such as corporate actions and share plans.

Macquarie forecasts FY22 earnings (EBIT) growth, ex margin income, of 13% supported by cost reductions, a recovery in share plan revenue and elevated bankruptcy in class action volumes. This should be partially offset by normalising corporate actions.

The broker highlights **foreclosure restrictions in the US have been extended**. These restrictions impact mortgage servicing through the loss of foreclosure-related ancillary revenue and pushing the mix towards performing loans which are lower margin. Still, Macquarie retains the view that long-term growth prospects exist and remains encouraged by the steepening of forward curves.

Credit Suisse expects cost reductions and synergies should provide substantial benefits including the rest of the Equatex synergies. The CTS acquisition, due to close during the first half of FY22, should provide around 24% benefit to earnings per share.

Citi is more negative - the short-term outlook is tough. The broker accepts the leverage to short-dated interest rates is significant yet, outside the CTS acquisition, expects margin income will drop in FY22 and any recovery in US mortgage servicing will be modest.

Hence, the question is whether the focus should be on earnings pressure over the short term or the inflation hedge provided by the medium-term leverage to rising short rates. Citi acknowledges the issue is likely to play out for some time but, in conclusion, asserts FY22 guidance could disappoint.

Even if predicted rate increases are valid, the broker ponders the dilemma surrounding which year of earnings the market will use as a base to price the stock and concludes it would be unusual for the market to price the stock on long-dated earnings. As a result, Citi considers the current metrics make Computershare appear expensive.

Higher Rates Ahead

Yet Credit Suisse believes, while higher interest rates are a major part of its investment view, even without this scenario there is a case for around 10% growth in earnings per share per annum.

The business has provided valuable protection against inflation within portfolios, the broker notes, with around US\$20bn of balances exposed to interest rates, while every 25 basis points increase in interest rates adds 10% to earnings.

If inflation materialises, interest rates will rise and so will the company's earnings. Moreover, some of the business, particularly share registry, uses inflation-linked price clauses in contracts which should protect the stock from the impact of inflation on the cost base.

Credit Suisse flags the fact **interest-rate markets are pricing in significant increases to the cash rate by FY26, averaging around 100 basis points across the US, Canada and UK**.

The broker calculates, post the acquisition of CTS, Computershare has US\$80bn of which 25% is exposed to interest rates. Of the exposed balances a subset of 70-75% is exposed to US interest rates, 15-20% to UK rates and 5-10% to Canadian rates.

These balances are largely leveraged to the cash rate. Of note, partially offsetting this, will be the FY22 re-basing of margin income and higher interest costs on debt.

Long-Term Versus Short-Term View

In setting its target, raised to \$23.20 from \$13.90, Credit Suisse emphasises it applies a 20x multiple to what is an FY26 scenario as this multiple represents the current market price/earnings ratio. In addition, valuation is also revamped to reflect the US\$950m of capital that could be available to Computershare shareholders during that period, to either fund M&A or undertake buybacks.

As a result the broker upgrades to Outperform from Neutral. Morgans has taken a shorter-term view and, in an overview of all diversified financials, recently downgraded to Hold from Add as the stock has rallied 20-25% since March.

Morgans also makes more conservative operating earnings margin assumptions, while acknowledging there are both risks to the downside and upside. On the downside there is unforeseen deterioration in the core registry business amid a loss of market share and an inability to further grow in new verticals such as mortgage servicing.

On the other hand, the upside risk centres on an improving macro environment affecting global bond yields as well as corporate actions.

FNArena's database reflects this mix of views with three Buy ratings, three Hold and one Sell (Citi). The consensus target is \$17.90, suggesting 14.8% upside to the last share price. Targets range from \$14.60 (Ord Minnett) to \$23.20 (Credit Suisse).

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RUDI'S VIEWS

Rudi's View: Covid, Climate Change...Correction?

In this week's Weekly Insights:

- Covid, Climate Change... Correction?
- Conviction Calls
- Win A Book
- Research To Download

By Rudi Filapek-Vandyck, Editor FN Arena

Covid, Climate Change... Correction?

As per the old adage, experts in the share market are being paid to be optimistic, but those in bond markets are being paid to look out for the next worry.

Read any newspaper these days and there are valuable concerns everywhere. If it's not virus-related (now including Australia), then surely new concern relates to consequences of climate change turning Belgium, Germany, and other parts of Europe into submerged flood plains.

So maybe the divergence between the implicit messages coming from equities and bonds should not come as a huge surprise.

One looks at the prospects for ongoing strong recovery in corporate profits, and dividends, on top of capital management and corporate actions, while the other sees slowing growth, forecasts that may prove too optimistic, and potentially a delay in central bankers winding back extreme stimulus programs.

The problem with this divergence is that ultimately, financial markets are interconnected and sooner or later rallying bonds (lower yields) will have an impact on other markets, just like rising bond yields caused a quick flip-flopping in market positioning early in the year.

However, contrary to our grandfather's share market, assessing what the next action-reaction might look like has become a lot harder these days. Share markets have been posting gains for 11 out of the past 12 months prior to July, including seven out of seven post September, and there hasn't been even a mild pullback, let alone a temporary correction, since that speedy sell-off in February-March last year.

No surprise thus, the growing consensus among investors is that bonds are rallying because the economic recovery narrative is losing its shine, and dangers for disappointment are lurking. Equities, at face value, are trading on valuations that seem rich by historical standards, so might this provide that trigger so many have been waiting for, maybe, possibly?



One problem with that line of thinking is that it ignores the fact that share markets nowadays are much more polarised, and what is negative for one group of companies works usually to the benefit of the opposite basket of stocks.

We all have our own observations and theories about what happens in markets, and why, but mine has been that flip-flopping from one group into the other, and back again, and again, has to date replaced the old sell everything and buy back in again that used to pull markets down by -5%, -10%, or even more.

Having said so, the latest concern regarding US equities is that indices are seemingly being supported by a shrinking group of positive large cap performers. All the while the participation of retail investors in US markets might be at an all-time high.

So maybe bonds globally are spelling trouble ahead. 10-year yields in the US and Australia are below 1.30% while in Germany the comparable yield is back below zero. But there is an opposite view, in that maybe bond markets -for whatever reason- are simply over-stretching themselves, temporarily, into the chosen direction.

Bonds went too far in March, maybe they are now doing it again in the opposite direction?

Bond strategist Guneet Dhingra at Morgan Stanley is one of such proponents. He's reiterating his call -with conviction!- that ten-year yields will still be at 1.80% by year-end, meaning there will be another fierce reversal similar to what we experienced during the opening weeks of 2021.

Under this scenario, of course, the reflation trade will be back with a vengeance, just as it happened between October-mid-March.

Cautious conclusions from my desk:

- Don't bet 100% on either outcome; 2021 is when a balanced and diversified portfolio is a good portfolio
- It's never too late to secure profits and adopt a more cautious approach

All-Weather Portfolio

Look no further than to the **FN Arena/Vested Equities All-Weather Model Portfolio** to see how the reflation trade -inflation is coming!- has been gradually abandoned by equity markets since mid-March.

Portfolio performance ex-fees in March: 3.13%
ASX200 Accumulation Index: 2.44%

Portfolio performance ex-fees in April: 4.05%
ASX200 Accumulation Index: 3.52%

Portfolio performance ex-fees in May: 2.79%
ASX200 Accumulation Index: 2.33%

Portfolio performance ex-fees in June: 4.26%
ASX200 Accumulation Index: 2.30%

Portfolio performance ex-fees in July (up until Friday): 1.99%
ASX200 Accumulation Index: 0.32%

The All-Weather Portfolio is not so much a growth portfolio as it tries to combine my research into Quality performers on the ASX with a moderate inclusion of new business models and dividend providers, hence it certainly aligns more closely with growth than with reflation, with a less risky, diversified philosophy and while also not completely ignoring the re-opening trade.

But the fact the All-Weather Portfolio has now outperformed by some 5.31% over the past 4.5 months, and consistently, albeit with a lot of volatility in between, tells us all a lot about underlying market dynamics, and potentially also about the direct influence of falling bond yields after that big, sharp spike in January through to mid-March.

This is also one additional reason as to why the All-Weather Portfolio is taking on a little more caution this month.

Less Risk, But Not Defensive

Whether it has been the influence of falling bond yields on the general investor psyche or bond yields merely reflecting a change in mindset among investors, fact is the latest **global fund manager survey** conducted by **Bank of America** provides the perfect explanation of what has been happening beneath the surface of global equity markets in recent weeks.

In short: professionals and institutions have come to the view that growth momentum has peaked, with follow-through impact on portfolios and strategies. Lesser quality stocks have been sold in favour of Quality; smaller cap exposures have been abandoned in favour of large cap stocks and the balance between Value and Growth stocks has reverted back to where it was in October last year, pre-vaccine roll-outs and that US election.

Favoured long positions are back in large cap technology, while commodities remain very much on the menu too. Expectations for inflation have been pared back, which translates into less aggressive rate hike expectations; the Federal Reserve is now projected to announce its first rate hike in early 2023 instead of in November 2022.

Inflation is by an overwhelming majority seen as transitory, exposure to Emerging Markets has been wound back, but defensives are equally not in favour. The somewhat odd conclusion from the survey is that fund managers have pared back on risk, but they haven't gone defensive, and neither have they abandoned the reflation trade.

Hence, conclude the analysts at BofA, if you want to know whether/when the reflation trade is back 'on', watch the correlation between junk versus quality, small cap versus large cap, and Value against Growth. Average cash levels have risen to 4.1% from 3.9%, but that's nothing spectacular or anything to be worried about.

One problem that will present itself is when inflation might prove higher and stickier than is currently assumed, with the survey revealing only a net 22% of institutions seeing inflation higher in twelve months from now and with no fewer than 70% of respondents declaring inflation is transitory, with only 26% saying it is permanent.

73% of survey participants describes the economy as mid- or late-cycle. The net percentage that believes Value

will outperform Growth has more than halved over the past month, to 22% (down from 52% in the prior month's survey).

When asked about major risks, inflation sits on number one, followed by taper tantrum, asset bubbles, then a China slowdown.

Conviction Calls

T Rowe Price head of Australian Equities, Randal Jenneke, remains true to his conviction call that investors should look to face the second half year's uncertainties and challenges through allocating more weight in diversified portfolios towards Quality stocks.

In Jenneke's universe, Quality aligns with a strong return on capital and resilient earnings growth, among other filters used such as earnings quality and cash flow generation.

T Rowe Price's Australian portfolio recently added ResMed ((RMD)), Goodman Group ((GMG)), and Carsales ((CAR)).

Those who pay attention to my research into All-Weather Performers would be quite familiar with these choices.

Morgan Stanley's Australian Model Portfolio has incorporated six changes (three fresh buys and three sells) ahead of the August reporting season.

Have been added: BlueScope Steel ((BSL)), APA Group ((APA)), and IDP Education ((IEL)) in a bid to, respectively, capture the upside from an anticipated increase in market forecasts post-result, add some insurance in case the bond market goes off-script, plus insert extra exposure to structural quality growth.

Have been removed: Boral ((BLD)), Super Retail Group ((SUL)), and Endeavour Group ((EDV)). The latter was never actively added, rather inherited from Woolworths ((WOW)), which remains the sole consumer staples exposure in the portfolio.

Morgan Stanley too believes an increased bias towards Quality stocks in the portfolio seems but the correct strategy amendment at this stage. Both APA Group and IDP Education are considered worthy of that label.

Let there be little doubt about the upcoming results season in Australia: it will be a paradise for income seeking shareholders with Australia's number one bank CommBank ((CBA)) returning to old form and large cap iron ore producers swimming in cash, among many more positive surprises following asset sales (Telstra ((TLS)) comes to mind) and dividend reinstatements.

Investors should expect a lot more news about dividends and capital management over the coming seven weeks. What they probably are not expecting is a lot of the same happening in the US this year.

Analysts at **UBS** believe the average dividend payout increase in the US this year will run at 30%, on what they believe are rather conservative assumptions for corporate payouts given so many questions remain unanswered. But if US companies prove less hesitant, the average dividend increase in the US could well amount to 40%, on UBS's number crunching.

Companies identified as most likely to surprise to the upside include the likes of Microsoft, Mastercard, Nike and Activision Blizzard. Given the average forward-looking yield on such stocks is less than 1%, it remains doubtful many investors will be looking to jump on board ahead of increased payouts and sizeable increases to analysts' forecasts.

But UBS has equally selected a group of companies whose shares are currently yielding at least 2%, which might be more of interest to Australian investors. Here we find the likes of Morgan Stanley, UPS, American Tower Corp, Prologis, HP, and Eastman Chemical Co.

While most investors' research into equities usually revolves around profits and growth, past research by Citi

and others suggests a more reliable correlation can be established between rising dividends and share prices. The principle also applies to share markets in general.

Morningstar's Best Stock Ideas have seen a few changes too over the past month or so. Lendlease ((LLC)) and TPG Telecom ((TPG)) are now included, while Computershare ((CPU)) and Magellan Financial Group ((MFG)) are no longer on the list.

Morningstar's selection process is purely valuation-driven, often in complete disregard of whatever is happening in terms of bad news or negative developments, that may force patience upon investors prepared to take the hint and act accordingly.

Fifteen companies make up the selection of Best Stock Ideas, and apart from the two already mentioned, selected ideas are a2 Milk ((A2M)), AGL Energy ((AGL)), Brambles ((BXB)), Challenger ((CGF)), Cimic Group ((CIM)), G8 Education ((GEM)), InvoCare ((IVC)), Link Administration ((LNK)), Spark Infrastructure ((SKI)), Southern Cross Media ((SXL)), Viva Energy Group ((VEA)), Whitehaven Coal ((WHC)), and Woodside Petroleum ((WPL)).

Wilsons' recent update on its **conviction insights** revealed the removal of Telix Pharmaceuticals ((TLX)), following a strong rally in June, and the selection of Aroa Biosurgery ((ARX)). The latter is seen as full of potential, of course, while trading at a significant discount to peers.

Other than Aroa Biosurgery, Wilsons' list of conviction buys has thinned down to six candidates: ARB Corp ((ARB)), Collins Foods ((CKF)), Pacific Smiles ((PSQ)), Whispir ((WSP)), ReadyTech Holdings ((RDY)), and Plenti ((PLT)).

Win A Book

UK book publisher Kogan Page sent us two copies of the freshly released *Crypto Wars. Faked Deaths, Missing Billions and Industry Disruption* by 'crypto entrepreneur' Erica Stanford and while I am reading the first few pages already, for a book review later on, the second copy is hereby available to one lucky reader who announces his/her interest.

What you need to do: send us an anecdote about yourself and FNArena. How we met, or what we've done (or not). It can be funny, insightful, a memory, or simply a fact. Send it to info@fnarena.com with Crypto Book in the subject line and one of our staff members will organise an indiscriminate selection process to decide one lucky winner.

Cut off is midnight this Friday, July 23. Good luck!

Research To Download

Monthly Pharma & Biotech newsletter, by Independent Investment Research (IIR):

<https://www.fnarena.com/downloadfile.php?p=w&n=5D7D3DDF-B61F-35A5-2D58C43ACA708F99>

(This story was written on Monday 19th July, 2021. It was published on the day in the form of an email to paying subscribers, and again on Thursday as a story on the website).

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