

Week  
**5**

# Stories To Read From FNArena

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FNArena  
Financial News, Data &  
Analysis

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## Contents

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### Australia

- 1** [Zodiac Discovery The Focus For Northern Star](#)
- 2** [2018 Looks Bright For Iluka Resources](#)
- 3** [Afterpay's US Foray Carries High Expectations](#)
- 4** [Price Discounts The Key Risk For Fortescue](#)
- 5** [US Opportunity To Drive Growth At Credit Corp](#)
- 6** [Acquisitions Key To GUD Holdings Outlook](#)
- 7** [Distribution Yield Lights Up Viva Energy](#)

### Commodities

- 8** [Iron Ore Price To Remain Elevated](#)

### FYI

- 9** [Weekly Ratings, Targets, Forecast Changes](#)
- 10** [Uranium Week: Ground To A Halt](#)
- 11** [The Short Report](#)
- 12** [The Wrap: Builders, Financials & Child Care](#)

### Small Caps

- 13** [Rapid Expansion Potential With LiveTiles](#)
- 14** [Uncertainty Stymies Integral Diagnostics](#)

### Weekly Analysis

- 15** [Tale Of Two Consumer Stocks](#)

## Zodiac Discovery The Focus For Northern Star

Brokers are focused on the Zodiac discovery as Northern Star Resources accelerates its growth plans and exploration.

-Zodiac promoted as a large scale, high-grade new discovery -Stake in Echo Resources now 19.2%, regional consolidation possibility -Any re-opening of Paulsens contingent on near-mine exploration

By Eva Brocklehurst

Western Australian/Northern Territory gold miner Northern Star Resources ((NST)) has accelerated its growth plans and exploration in the December quarter. Brokers find the environment supportive of gold producers generally, but consider the stock is fully valued at the current share price.

December quarter production totalled 129,000 ounces at an all-in sustainable cost of \$1067/oz. Grades moved back towards a long-run average at Jundee following the stronger preceding two quarters.

Underground exploration continued as did decline development across various areas of all assets. Kalgoorlie produced 61,289 ounces with costs at \$1195/oz. The result included 7072 ozs from Millennium.

Paulsens has also been shut down sooner than many expected, providing some variance to broker numbers. The company has reiterated FY18 guidance of 525-570,000 ounces at AISC of \$1000-1050/oz.

Ord Minnett is comfortable that production rates from the main assets, Jundee and Kalgoorlie, will increase in the second half and guidance will be met. Mill throughput increased 8% in the quarter at Jundee and 12% at Kalgoorlie.

The recent investment in Echo Resources ((EAR)) and the acquisition of Western Tanami assets have also provided access to two more processing plants.

### Jundee

The main difference with Citi's expectations in the quarter was the head grade at Jundee, at 5g/t compared with 6.1g/t in the September quarter amid a -13% drop in ounces produced.

Construction of the secondary crushing circuit at Jundee was completed during the quarter, lifting throughput to an annualised rate of 1.9 mt and well ahead of the targeted 1.7mt run rate.

Canaccord Genuity continues to watch the development of the Zodiac discovery at Jundee, as four surface rigs are now tracing the mineralised trend for over 2km. Citi agrees this could also generate a resource upgrade. An exploration update for all projects is expected in February.

Much has been promised from the rigs operating out of Zodiac, which is promoted as a large-scale high-grade new discovery. Noting this, Credit Suisse asserts that if the scale and potential are confirmed, Jundee will become constrained in terms of capacity.

Options will need to be sought to increase capacity while balancing against a strategic move to lock up more ground to support medium-term mill feed. The broker suggests this could lead to a regional consolidation play, as the company seeks to increase its exposure, as well as the latent capacity of the high-quality Bronzewing mill and mine camp.

Construction of the secondary crushing circuit at Jundee was completed during the quarter, lifting throughput to an annualised rate of 1.9 mt and well ahead of the targeted 1.7mt run rate.

During the quarter the company took a further stake in Echo Resources now owning 19.2%. Canaccord Genuity considers this move a logical one, as the landholding of the former is strategically located 100km south of Jundee.

The current open pit reserve base supports an eight-year life and first gold is expected late this year. The Bronzewing processing plant will provide a rapid transition to production.

### Paulsens

Paulsens produced 10,808 ozs, marginally better than Macquarie had expected. Costs were also substantially better than forecast, although of minimal impact on the overall result.

No further production is forecast from the mine, at least for the remainder of FY18. Management had forecast a rebound in grade in order to achieve guidance for the half of the mine in operation. This did not occur.

The company will seek to build inventory to return operations to former throughput rates and appropriate levels of profitability. Citi suspects any re-opening is contingent on successful near-mine exploration, or a higher gold price. Technically, Paulsens is still in operation as drilling is in progress so there is no bright down expected in the first half.

The stock is currently trading near its all-time highs and considered fair value by several brokers. Canaccord Genuity, not one of the eight stockbrokers monitored daily on the FNArena database, maintains a Hold rating and \$6.05 target.

Macquarie highlights the progress being made on growth projects, with positive results being delivered from exploration, yet agrees the stock appears fairly valued on current forecasts for both production and US dollar gold prices.

Credit Suisse downgrades to Underperform from Neutral, given share price strength has meant the stock exceeds its valuation. The broker notes ample capacity to fund internal growth projects as well the execution capability for developing the corporate opportunities surrounding Bronzewing.

FNArena's database has four Hold ratings (including UBS, yet to update on the report) and three Sell (including Deutsche Bank and Morgan Stanley yet to update on the report). The consensus target is \$5.21, signalling -11.8% downside to the last share price. Targets range from \$4.55 (Credit Suisse, Morgan Stanley) to \$6.10 (Macquarie).

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## 2018 Looks Bright For Iluka Resources

Iluka Resources maintained strong output of mineral sands in the December quarter while brokers flag substantial price increases for both zircon and rutile over 2018.

-Iluka calls out structural deficit in the zircon and rutile markets -Temporary reduction in demand for zircon in China -Does the mineral sands price upgrade cycle have further to run?

By Eva Brocklehurst

Strength in both the zircon and rutile markets have allowed Iluka Resources ((ILU)) to lift its prices in 2017, and further price increases are expected in 2018. Credit Suisse considers 2017 a transformational year and fitting that company exceeded production expectations while hitting guidance for sales volume.

The company should be a significant beneficiary of the price momentum expected in both the zircon and high-grade titanium dioxide markets throughout 2018. The broker notes demand is robust but the supply chain lean, and Iluka has called out a structural deficit in the market.

Morgan Stanley believes Iluka is in a strong position, as both its downstream markets are improving. Competitors have increased zircon prices by US\$125/t in the current quarter and the company's next pricing review will be effective from April 1, 2018.

Meanwhile, rutile pricing in the second half of 2017 was 9% higher than the first half. The company has advised customers of an 8% increase in the rutile price effective for the first half of 2018, with contracts now in place for 60% of first half production. Iluka will allow remaining production to be exposed to spot prices over the course of the year.

Supply/demand imbalances have grown in the zircon market, Morgan Stanley observes. Demand growth is being experienced in most geographies. China remains the exception, where environmental controls have forced many plants to shut down, resulting in what Iluka believes will be a temporary reduction in demand as consumers of zircon upgrade and/or relocate facilities.

Pigment inventory remains below seasonal norms, as the combined impact of European plant outages and environmental actions in China dampen supply. Capacity utilisation rates across other plants, many of which are Iluka customers, have increased in the current circumstances and this provides support for rutile and synthetic rutile demand.

Macquarie's analysis is more reserved. Realised prices for zircon and rutile in the quarter were broadly in line with the broker's expectations as was mineral sands revenue. Rutile production stood out, 35% above what the broker had forecast. Ilmenite output was also a positive surprise, 67% above forecasts.

Meanwhile, shipments were lower than Macquarie anticipated, a surprise given the strong production result. Rutile shipments were the weak spot and Macquarie had expected Iluka would reduce rutile inventory during the quarter.

While anticipating price increases in the company's key commodities, the broker believes there is limited upside beyond the near-term spate of upgrades and the stock's valuation premium should start to contract once zircon and rutile price momentum slows.

Sales were lower than Citi expected in the quarter but this is not a great concern, as lower production and depleting inventory mean the shortfall in 2017 can be sold at higher prices in 2018.

Citi make significant changes to its production profile, factoring in an increase in rutile and a decline in zircon production in 2020. Sales are expected to be constrained by production beyond 2019.

While this is not a major issue for rutile, because of the expected increase in synthetic rutile production, it is for zircon, where the broker expects sales will fall to 250,000t in 2020 from 380,000t in 2017. This assumes no changes to the Jacinth-Ambrosia mine plan.

Citi expects a further US\$100/t increase in the December quarter 2018 for zircon, and similar increases in 2019 and 2020. With Iluka providing one third of the zircon market and facing declining sales, the risk to zircon prices remains to the upside in the broker's opinion.

Favourable market conditions should continue in 2018, UBS believes, noting the company's observations that demand for product exceeds what it is prepared to supply. The broker believes the mineral sands cycle still has further to run in terms of price and volume.

### Cataby

Site works at Cataby have proceeded on schedule and budget, with the company securing offtake for 85% of synthetic rutile production for a minimum of four years. First production is expected in the second quarter of 2019, with an 8.5 year mine life and annual production of 200,000t synthetic rutile, 50,000t zircon and 30,000t rutile.

FNArena's database shows three Buy ratings, two Hold and two Sell. The consensus target is \$9.84, signalling -4.4% downside to the last share price. Targets range from \$7.50 (Deutsche Bank) to \$11.50 (UBS).

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## Afterpay's US Foray Carries High Expectations

Australia's dominant 'buy now, pay later' success story is leveraging its first-mover advantage to target the US, an ecommerce opportunity worth 20 times the local market.

-Rapid penetration into online sales exerts magnetic 'network effect' on merchants and customers -Partnership with seasoned tech-focused venture capital firm underpins US strategy -Analysts tip rise of 20% to 40% in Afterpay shares over the coming year

By Nicki Bourlioufas

Afterpay Touch Group ((APT)) continues to attract investors' attention as a rapidly growing fintech that has established itself as the market leader in 'buy now, receive now, pay later' finance for both online and instore shoppers.

Afterpay recently announced a strategic partnership with experienced tech-focused US venture capital firm Matrix Capital Partners, which will invest in and advise on the Australian company's US expansion plans.

Afterpay IPO-ed in 2016 and in June 2017 merged with another listed fintech, Touchcorp, to form Afterpay Touch Group.

The company's deferred payment product allows shoppers to make purchases without interest charges, up-front fees or loan application forms. Consumers typically pay off these 'reverse laybuys' in four equal fortnightly instalments.

Afterpay's revenue comes from merchant fees, which averaged 4.1% in 2016-17, plus late fees levied on users who miss deadlines.

The Touchcorp side of the business provides the Touch System Platform, which the company says offers advantages including fraud protection, regulatory compliance, and data collection and analysis.

Afterpay's algorithms assess the shopper's repayment capabilities and risk of fraud automatically and in real time.

The company holds an Australian Credit Licence, even though it is not required to given it does not charge interest or fees and its credit duration is a relatively short 56 days.

The rapid repayment cycle means that every \$100 in capital deployed generates about \$57 of revenue over the course of 365 days, assuming returns are reinvested.

Underlying total transaction volumes hit \$2.2bn in the December quarter of 2017, five times the level of a year before.

End-customers more than tripled over the same period to about 1.5m and merchant numbers grew by 450% to 11,500.

Brokers optimistic on underlying growth trajectory

Afterpay closed at \$7.71 on January 30, a nudge up from its January 16 close after the Matrix announcement.

Stockbroking analysts covering the stock remain highly optimistic about prospects, to say the least, tipping a rise of 20% to 40% for the shares over the coming year.

Wilson's forecast might serve as a broad gauge for the optimism expressed across the board: "2017 was a stellar year for APT. We believe momentum will continue in 2018."

The broker recently reiterated its Buy recommendation and raised its 2018 target price to \$10.41, suggesting 39% in total shareholder return.

Bell Potter also maintained its Buy call, raising its target price to \$9.20 from \$7.30. Bell factored in some costs from the US expansion, while holding off from including any revenue until the company provides more detail.

Ord Minnett initiated coverage with a Buy recommendation and a target price of \$9.50, citing Afterpay's "high uptake velocity, as the network effect continues to drive more retailers to offer the product, therefore allowing

more consumers to use it more frequently.”

Afterpay facilitated 8% to 9% of online sales in Australia in the December quarter. Its service is now offered in 5,000 shopfronts, which contributed 8.5% of the sales mix in December.

Bell Potter notes that although Afterpay does not use a traditional lending model, it “is still exposed to the risk of default or a loss of principle” and the ability of its technology to prevent fraud and recover bad debt is crucial to the company’s viability.

US ecommerce market promises big wins

Having already had a stellar run on the ASX, on January 16 Afterpay announced a partnership with US tech-focused venture capital firm Matrix Capital Partners, which will take a strategic stake in the company and advise on its US expansion.

Matrix General Partner Dana Stalder, who has held senior roles at eBay and Paypal, will join the Afterpay board as an independent non-executive director.

Matrix will invest US\$15m in equity, in the form of 2.88m shares at \$6.51 per share, with escrow periods of three and seven years. As well, new subsidiary Afterpay US Inc will issue US\$100,000 in convertible notes to two funds managed by Matrix. The notes will convert to up to 10% of the future value of the company in excess of US\$50m when the conversion period rolls around in 5 to 7 years’ time.

Wilsons quotes FTI Consulting’s estimate that online e-commerce activity in the US was worth US\$445bn in 2017, up 12.7% on 2016, adding: “This opportunity appears to be at least 20 times the size of the Australian online retail market.”

Afterpay listed in May 2016 with Touchcorp as a 35% shareholder. The shares rallied 30% within the first week of listing, immediately capturing the attention of investors. The stock has not fallen off the market’s radar since.

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## Price Discounts The Key Risk For Fortescue

Despite increased discounts for its iron ore product in the December quarter, Fortescue Metals maintains FY18 guidance.

-Price realisation expected to settle in guidance range of 70-75% -Overburden removal costs offset despite rise in strip ratios -Eliwana the key to a lift in iron ore grade

By Eva Brocklehurst

Brokers continue to be preoccupied with price realisation for Fortescue Metals' ((FMG)) low-grade iron ore. In the December quarter, realised prices were lower than the market expected, related to the achieved price discount and shipment volumes.

The discount to the benchmark on iron ore sales grew to -34% from -29% in the preceding quarter. Shipments were -8% lower quarter on quarter. Yet FY18 guidance is unchanged, and includes costs at \$11-12/t and a full year discount of -25-30%. No information was provided on the new product strategy and the underperformance of shipments was attributed to maintenance.

Ord Minnett had expected a larger impact from a reduction in low-grade ore demand but notes costs provided another record quarterly outcome despite a rise in the strip ratio. The broker, maintaining a Hold rating, would look to become more positive on the stock at a lower entry point, or when more information about the revised product strategy is released.

### Cost Controls

Deutsche Bank was impressed with what the company achieved on costs, considering an increase in strip ratio and the fall in shipments. A further reduction in costs is expected in FY19 with the new autonomous fleet at Chichesters and overland conveyor systems at Cloud Break.

Shaw and Partners notes, importantly, overburden removal, one of the largest cost components, has been offset despite the rising trend in strip ratios.

Cost reductions impressed UBS as well, given the low volumes in the quarter, and productivity initiatives appear to have more than offset higher strip ratios, exchange rates and fuel prices.

The broker retains a Buy rating with a view that the market is already pricing in high discounts for the longer term and there is potential upside as the company embarks on a change in its mine plan that could mean over 50% of its volumes achieve an iron grade of over 60%.

Key to lifting grade will be the development of Eliwana and a decision on this is expected before the end of FY18.

### Price Realisation

Credit Suisse considers price realisation to have a far bigger impact on margins and value in the near term. The broker sides with the view that discounting is a cyclical dynamic. As steel margins have recently eased, anecdotally at least, the broker notes a greater interest in lower quality iron ore.

This has not played out materially in the iron ore indices to date, although it is starting to have an impact on the market, as Credit Suisse points to reports that Cliff Resources is looking to close Australian operations.

Credit Suisse assumes price realisation slowly returns to 85% in FY21 from 75% in FY19. If discounting is indeed cyclical, the broker believes there is a strong valuation case, as well as the opportunity to take a decent dividend on the way through.

The new product strategy is still to be explained and there are headwinds for price and discounting so the road ahead could well be bumpy, but the broker considers this may present good entry opportunities.

Macquarie assumes discounts remain around current levels before price realisation rises towards the 70-75% guidance in the June quarter. Shaw and Partners agrees that discounts should ease in the second half and land prices within the guidance range.

To meet the company's target would require a second half price realisation of at least 72%. The broker, not one of the eight monitored daily on the FNArena database, has a Buy rating and \$5.16 target.

CLSA continues to envisage risks around guidance for the full year yet retains a price realisation estimate just shy of guidance, at 69%. This could be reduced in the next quarter if discounts persist, which underscores the broker's base case.

Sales in the quarter were also lower than CLSA anticipated and the increase in low-grade stockpiles at Chinese ports are considered an early sign that volumes may not be placed so readily in steel mills. CLSA prefers to await the third quarter volume data.

The broker suspects steel mills may have more bargaining power at present and can push back on prices when margins narrow. Lower grade iron ore demand is expected to remain elevated over the current quarter, albeit a temporary situation.

As pricing risk remains in focus, and the quarterly missed CLSA's forecasts on all aspects except costs, an Underperform rating is maintained. The broker, also not one of the eight, has a \$5.10 target.

FNArena's database shows four Buy ratings, three Hold and one Sell (Morgan Stanley, yet to update on the quarterly). The consensus target is \$5.45, suggesting 7.5% upside to the last share price. The dividend yield on current FX values for FY18 is 6.2% and 5.1% for FY19.

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## US Opportunity To Drive Growth At Credit Corp

All business divisions at Credit Corp performed strongly in the first half. Brokers diverge as to whether the positive outlook is fully priced into the stock.

- US and consumer lending expected to drive growth in FY18 -Can the business sustain a premium to its historical PE?
- Competitive pressures may impact on the domestic business in FY19

By Eva Brocklehurst

Credit Corp ((CCP)) has impressed brokers with the growth rates in its debt purchasing business over recent years, having grown earnings per share at a compound rate of around 10% as well as diversified its business.

The company's Australian purchased debt ledger (PDL) business has been the main profit driver since listing and operations have now expanded into the US, while a consumer lending business has also been established.

Ord Minnett expects these two businesses to drive all the growth in FY18 as the Australian PDL market is affected by increased capital and price inflation. The broker considers the consumer lending business one of the best examples in the Australian market of the company transferring its core competency into a complementary line.

While assessing the earnings outlook as robust, pre-result strength in the share price suggests the stock is now much closer to a market multiple and this prices in the positives, in Ord Minnett's opinion. As a result the broker's rating is downgraded to Hold from Accumulate with a target of \$22.

First half net profit growth was 18.2% while full year guidance of \$62-64m has been confirmed, up 12-16%. PDL purchasing guidance is upgraded to \$190-200m, with \$190m already contracted. Two PDL tenders will take place in the second half and therefore, Morgans notes, some potential upside exists to expectations if the company is successful.

The broker suspects competitive pressure may start to affect domestic earnings in FY19 yet still expects Credit Corp to deliver over FY19/20, just at marginally lower rate. Moreover, the company has potential to scale up its contingent collections division via acquisitions. Growth is expected in consumer lending and US debt, delivering a 10% growth rate in the medium term.

Morgans believes that company can sustain a premium to its historical PE, given its growth profile and a substantial opportunity in the US. Hence, an upgrade in recommendation to Add from Hold.

Canaccord Genuity agrees the domestic business faces a challenge in FY19 and notes management does not expect domestic collections to maintain a growth rate of over 4% in the second half. Domestic purchasing levels are falling as the company elects not to overpay for debt in the current market.

The broker notes evidence in the results that staff were working the back book of aged debt harder following the big purchasing years of FY16 and FY17.

Canaccord Genuity does not discount all potential upside in FY19, as there are significant forward flows that may be up for grabs, and any fall-out from competitors overpaying for acquisitions could mean domestic prices ease.

### US Expansion

The company purchased \$30m of US PDL in the first half and expects to achieve \$55m in FY18. At full capacity the company's new collection facility in Salt Lake City should enable around \$80m of US debt purchases, Canaccord Genuity calculates. A second site is also being considered over the next 12 months.

The broker suspects this could mean FY19 ends up being a "high single digit" growth year rather than the "double digits" the market has become accustomed to. This may also explain why the stock slipped around -8% following the first half results.

Regardless, the broker considers the market opportunity is unchanged and the plans to build a US operation of similar size to the Australian business should mean profits lift significantly over the next four years.

Australian operations generate around \$45m in net profit annually while the US business has just moved to break even. Moreover, the company has over \$100m in balance-sheet capacity to exploit opportunities.

The broker acknowledges the expansion will require additional upfront costs and is unlikely to be fully utilised for some time. Management is also trialling new loan products, specifically an automotive offering and small business lending. Canaccord Genuity maintains a Buy rating and price target of \$22.25.

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## Acquisitions Key To GUD Holdings Outlook

GUD Holdings posted a robust first half and brokers are largely positive on the outlook, which remains heavily premised on further automotive acquisitions.

-Ability to adapt to electric vehicle market expected to dominate attention going forward -Well positioned to consolidate automotive brands -Margin pressure possible in the medium term

By Eva Brocklehurst

Brokers suggest the growth outlook for GUD Holdings ((GUD)) is attractive, as the company consolidates the automotive aftermarket. Yet, several have lingering concerns regarding margins.

Credit Suisse agrees the growth outlook is attractive and operating condition supportive, suspecting full year results may exceed estimates, if for no other reason than no acquisitions are incorporated in its forecasts, and the company will almost certainly make some more.

Nevertheless, while valuation does not appear expensive, for Credit Suisse to engage in a re-rating requires the market to appear comfortable about the exposure to a sunset industry (internal combustion engine at 48% of revenue exposure) and the company's ability to adapt to electric vehicles. The broker expects this topic will dominate investor attention going forward.

UBS points out that management emphasised the minor impact that electric vehicles would likely have on Australia's car pool over the next decade. Moreover, automotive division sales now comprise 52% of components that are unrelated to the internal combustion engine.

### Acquisitions

The company appears well-placed to acquire high-quality automotive aftermarket brands that are not too reliant on sales to either Bapcor ((BAP)) or Repco, UBS asserts. Given the company has stated it has a strong potential pipeline of acquisition opportunities, the broker acknowledges an accretive acquisition remains the main risk to its Sell rating.

Ord Minnett agrees that outside of a material acquisition, further multiple expansion or meaningful earnings upgrades are unlikely. Yet, given the industry is relatively fragmented, the broker expects more bolt-on acquisitions to be made over the year.

Macquarie upgrades to Outperform, expecting strong growth in the automotive division. GUD beat the broker's first half forecasts with strong performances across key product lines amid new products driving growth. Macquarie believes the company is uniquely positioned to further consolidate automotive brands.

This advantage versus sector peers lies in the fact that GUD does not suffer from sales leakage to competitors on acquisition. Macquarie expects GUD to further leverage its scale and distribution network for newly acquired products and deliver a mutually beneficial uplift in sales for its customers as well.

The broker's tracking of the SuperCheap Auto ((SUL)) website shows the number of Narva & Projecta units stocked increase significantly under GUD ownership. Macquarie likes the leading market position, which consistently delivers high single digit organic growth, and suggests the discount at which the stock is trading is unjustified.

### Margins

Citi expects further automotive acquisitions and margin expansion from the synergies being extracted from recent acquisitions. The broker estimates the automotive business delivered margins of 28.8%, a 10% improvement on the first half of FY17.

Credit Suisse found the cash flow conversion disappointing, while noting lower automotive operating earnings margins were ascribed to a mix of newly-acquired businesses, some of which should do better within the broader GUD group. The broker was encouraged by the improvement in costs at Davey but remains mindful of the volatile earnings in that division.

Since the AGM in late October, when management guided to \$90-94m in operating earnings (EBIT) for FY18, the company has divested Oates and acquired AA Gaskets. GUD now expects earnings to be about \$90m, which

incorporates seven months contribution from AA Gaskets and six months from Oates.

Accounting for these adjustments, Ord Minnett estimates the new guidance is effectively based on the mid point of the original \$90-\$94m forecast and implies no change to the outlook.

Earnings are skewed around 90% to automotive products, a relatively defensive category UBS concedes, but with some medium-term margin pressure. UBS agrees the cash performance was poor but found it difficult to judge this, given the number of divestments and acquisitions that have been made in recent times.

UBS believes the current share price does not factor in these margin risks. The broker still suspects that increasing consolidation of the trade distribution channel and private labels will eventually pressure the elevated margins the company enjoys in automotive, although in the shorter term margins may rise as recent acquisitions are integrated and revenue synergies realised.

FNArena's database has two Buy ratings, two Hold and one Sell (UBS). The consensus target is \$12.80, signalling -0.5% downside to the last share price. This compares with \$12.23 ahead of the report. Targets range from \$12.25 (Ord Minnett) to \$13.90 (Citi). The dividend yield on FY18 and FY19 forecasts is 4.0% and 4.5% respectively.

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## Distribution Yield Lights Up Viva Energy

Viva Energy REIT has a property portfolio of service stations in Australia offering fixed income growth. Ord Minnett initiates coverage of the stock.

-Long average lease expiries and fixed annual rent reviews -Pays a sector-average 6.7% dividend yield -Potential for growth in acquisitions

By Eva Brocklehurst

Viva Energy REIT ((VVR)) is considered to be a low-risk, defensive stock which is trading on multiples that are in line with its long-leased A-REIT peers. The company has a property portfolio of service stations across metropolitan and regional Australia, valued at \$2.2bn, which offer fixed income growth at low management costs.

Brokers note tenant stability is supported by demand for motor vehicle fuel and convenience food. The service stations are operated by Coles Express ((WES)).

The portfolio has a 14.2-year weighted average lease expiry (WALE), with only 1.5% expiring prior to 2026, and fixed annual rent reviews at 3%. These rents are triple net, in that the tenant is responsible for all property repairs and maintenance.

East coast capitals account for 63% of the portfolio by value and 58% by income. More than 95% of the earnings are from properties with fixed annual rent reviews.

Ord Minnett initiates coverage on the stock with an Accumulate rating and \$2.30 target, classing Viva Energy as a low-risk A-REIT which pays a sector-average 6.7% distribution yield. The company has guided to 2017 earnings and distributions per security of 13.2c.

The broker envisages potential for growth in convenience stores sales, further acquisitions and capitalisation rate compression.

Both Morgans (Add, \$2.53 target) and Deutsche Bank (Buy, \$2.72 target) have noted the successful acquisition of properties over 2017 and expect more of the same in 2018.

Deutsche Bank calculates that assuming the trust's interest cost is 3.7%, further acquisitions at the average cap rate of 6.25% should be accretive to earnings. The broker considers the stock cheap versus its peers, based on the distribution yield. Importantly, the revenue stream is locked in for the medium term.

Morgans assumes \$50m in acquisitions in 2018 as well as the settlement of the \$19.3m Coomera acquisition. The broker points out that the security can gyrate depending on the direction of bond rates yet the distribution yield is attractive compared with term deposit rates.

Potential catalysts include accretive acquisitions, debt refinancing and asset re-rating. The risks centre on higher interest rates, tenant default, and disruptions to petrol-based retailing.

FNArena's database has three Buy ratings for Viva Energy. The consensus target is \$2.52, signalling 21.6% upside to the last share price. The distribution yield on 2017 and 2018 estimates is 6.3% and 6.8% respectively.

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## Iron Ore Price To Remain Elevated

Rapidly rising Chinese inventories do not portend weaker iron ore prices, given growing demand disparity between low and high grade ore.

-Rising Chinese iron ore inventories misleading -Demand for high grade ore expected to rise -Low grade discount could widen further

By Greg Peel

Since October 2016, iron ore inventories at Chinese ports have increased by 43% to a record high, ANZ's analysts note. Typically, with regard any commodity, rising stockpiles imply falling prices as new demand diminishes.

For the bulk of this century, commodity prices, particularly that of iron ore, have ebbed and flowed in line with China's typical seasonal restock/destock cycle. Record inventories would normally imply the beginning of a destocking phase, meaning lower new demand and lower prices. But that was before Beijing started clamping down on the Chinese steel industry.

The government has moved to close down older, heavy polluting mills and further to force mill closures during winter, when heating-related pollution is at its peak. The end result is that while inventories may have risen 43%, over the same period the iron ore price has risen 16%.

All is Fine

The "iron ore price" specifically implies the price of high-grade, 62% minimum iron content "fines", which China sources predominantly from Australia and Brazil. Lower grade ore is priced at a discount to the benchmark fines price.

Credit Suisse notes that the steel industry trade press has suggested Chinese mills are switching to lower grade (cheaper) ore as steel prices and margins weaken. However, were this the case, the discount to the fines price for lower grade ore would diminish on stronger low grade demand. But this has not happened. Indeed, the discount has blown out to a record -40%.

Aside from low grade ore not often being sold in the spot market, making true price discovery difficult (Fortescue Metals ((FMG)) does not sell into the spot market, for example), Credit Suisse notes Chinese steel mills already have abundant stockpiles of low grade ore and thus have no need to seek more. As China emerges from the winter and construction ramps up once more, steel prices should rise and margins widen, the analysts suggest.

Mills will thus seek to maximise profit, and to do this they will want to use high grade ore.

But it's not just about profit. The higher the iron content in the ore, the less processing is required to produce steel, thus less pollution is generated. Beijing's clampdown on high-polluting steel capacity will continue into 2018 and this will force steelmakers towards high grade ore.

The government's capacity focus is nevertheless set to shift away from simply closing down heavy-polluting mills to updating and upgrading mill capacity. Smaller inland mills will be replaced by investment in newer, bigger and cleaner mills located on the coast, ANZ notes.

High grade ore arrives by sea.

The bottom line is that forecasting iron ore prices ahead is no longer an exercise of tracking Chinese inventories. The big inventory build-up since 2016 has been mostly in low grade ore. This alone implies ongoing hefty discounts for low grade ore, but add in above reasons why Chinese mills will prefer high grade ore anyway and the conclusion is one of high-grade ore prices continuing to be supported through 2018.

ANZ sees the 62% iron ore price holding around \$US70/t in the first half. Risks to this forecast include a ramp-up in high grade supply in response, a deceleration in Chinese construction, or further tightening in Chinese credit markets.

Late Mail

Beijing had instructed China's provincial governments to direct the shutting down of mills during winter in order to reduce pollution. By rights, those mills should begin reopening after the Chinese New Year break in mid-February. However, unconfirmed reports suggest Hebei Province is considering an extension of mill curtailments for another two months, to mid-May.

If there is any truth to the rumour, Credit Suisse expects a spike in steel prices beginning in March. Ongoing shutdowns mean steel inventories will need to be drawn upon in order to meet demand, and "the price can be expected to soar".

Those mills able to reopen will look to cash in by maximising production while steel prices are high, and that means using high grade rather than low grade ore.

To that end, discounting of low grade ore could be expected to reach a new level of intensity under a protracted steel price spike, Credit Suisse warns.

For further reading, see also Price Discounts The Key Risk For Fortescue, published January 31, 2018.

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

## Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

### Guide:

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

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

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

### Summary

Period: Monday January 22 to Friday January 26, 2018 Total Upgrades: 16 Total Downgrades: 11 Net Ratings Breakdown: Buy 41.20%; Hold 42.06%; Sell 16.74%

The Australian share market is experiencing a corporate earnings upgrade cycle. Not that anyone can tell from the share market's performance year-to-date thus far, but since the closing quarter of calendar 2017 analysts have been forced to succumb to higher for longer commodity prices, and it shows up in steadily rising profit estimates for the year(s) ahead.

The positive undercurrent is not just a commodities affair. Growth over-achievers such as a2 Milk, CSL and Aristocrat Leisure are putting in their positive contributions as well.

This upgrade cycle is robust and still ongoing, as clearly visible in this week's tables for positive revisions to earnings estimates and valuations/price targets. The week's overview for negative adjustments to broker price targets is not even worth mentioning.

Things are a little more complicated when we zoom in on stock specific ratings published by stockbroking analysts. For the week ending Friday, 26 January 2018, FNArena registered 16 upgrades in recommendations for individual stocks versus 11 downgrades.

Resources stocks remain prominently involved on both sides of the ledger, with the likes of Alumina Ltd, Graincorp, Orica and Pilbara Minerals receiving upgrades during the week, while Galaxy Resources and St Barbara (2x) are amongst the receivers of downgrades. Outside of the resources space, Fairfax offshoot Domain received two upgrades following its hefty price fall after the CEO's sudden departure, with QBE Insurance also receiving two upgrades following an initial bad reception of its market update accompanied by yet more write-downs.

All in all, total Hold/Neutral ratings for the eight stockbrokers monitored daily by FNArena remain the largest group, at 42% of total recommendations, with Buys totalling 41.20% and the remaining 16.74% filled with Sell ratings. Morgans, Morgan Stanley and Macquarie are the only three (out of eight) with more Buy ratings than Neutral/Holds under coverage.

This week the local reporting season starts warming up. Time to assess whether the underlying optimism is justified, if not already in the share price.

### Upgrade

ALUMINA LIMITED ((AWC)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/3/1

Higher alumina prices are expected to underpin a strong year for earnings and dividends and Macquarie expects Alumina Ltd to deliver a 10% yield in 2018.

Rating is upgraded to Outperform from Neutral. Target is raised to \$2.70 from \$2.50.

BORAL LIMITED ((BLD)) Upgrade to Accumulate from Hold by Ord Minnett .B/H/S: 5/0/1

Ord Minnett believes Boral has entered a prolonged period of strong earnings growth that is not fully reflected in the share price.

The broker believes investment in infrastructure will be the main driver of growth domestically. In the US, the single family sector appears to be trending higher and repair activity should expand.

The broker upgrades to Accumulate from Hold and raises the target to \$8.50 from \$6.70.

DOMAIN HOLDINGS AUSTRALIA LIMITED ((DHG)) Upgrade to Buy from Sell by UBS and Upgrade to Hold from Sell by Deutsche Bank .B/H/S: 2/3/2

CEO Antony Catalano has unexpectedly resigned, citing family commitments and difficulties with relocating to Sydney.

Regardless of the reasons for his departure, UBS believes investors were partly pricing the stock at a premium to the REA Group ((REA)) because of a belief that he could help drive significant growth in the business.

Even if the risk to forward growth has increased UBS believes the uncertainty is more than priced in and upgrades to Buy from Sell. Target is \$3.20.

Deutsche Bank had initiated with a Sell in November last year, but after share price weakness following the sudden departure of the CEO, the broker thinks it is time for an upgrade to Hold. Price target has remained \$3.35.

The analysts acknowledge the immediate outlook is now clouded with uncertainty, but they also believe this is now well and truly reflected in the share price.

GRAINCORP LIMITED ((GNC)) Upgrade to Add from Hold by Morgans .B/H/S: 3/2/0

Graincorp's winter grain receivals were down some -50% on the previous winter. Given high fixed costs, Morgans notes a below average year means crunched margins, increased competition and potential loss of market share.

The summer crop is not looking too good either, given ongoing dry conditions. The broker has slashed earnings forecasts and lowered its target to \$8.51 from \$8.73. The broker nevertheless notes that the time the buy Graincorp is in a bad year, rewarding the patient investor when crops normalise.

Upgrade to Add.

LEND LEASE CORPORATION LIMITED ((LLC)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 3/3/0

Macquarie upgrades to Outperform from Neutral, considering the pending construction issues are now, at least partly, factored into the share price. The broker also retains more confidence in the sources of other profits.

The broker believes, in a changing macro environment, the outright chase for yield has returned the focus to growth and, hence, Lend Lease is well-placed. Target is \$17.63.

NINE ENTERTAINMENT CO. HOLDINGS LIMITED ((NEC)) Upgrade to Buy from Hold by Deutsche Bank .B/H/S: 3/1/2

Deutsche Bank now forecasts marginal growth in the metro TV market in FY18. Some of the momentum seen in the first half should continue into the second half, driven by advertising revenue linked to the Commonwealth Games and greater monetisation by Nine Entertainment of some of its better-performing 2017 programs.

Heading into FY19 the broker believes growth will be difficult to maintain, particularly in the light of audience declines. Rating is upgraded to Buy from Hold, as a broker envisages upside from current levels. Target is raised \$1.80 from \$1.50.

ORICA LIMITED ((ORI)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 1/5/1

Morgan Stanley reviews its position on chemicals coverage amid increased confidence in the commodity cycle.

The broker believes recent commodity price strength will prove a precursor to expansion activity and an increase in supply. This has prompted an increase in explosives demand forecasts.

The broker calculates Orica has earnings leverage to increased volumes that is underappreciated.

Rating is upgraded to Overweight from Equal-weight. Target is raised to \$21.20 from \$16.50. Industry view is Cautious.

PILBARA MINERALS LIMITED ((PLS)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 1/0/1

Macquarie makes material upgrades to 2018 carbonate and spodumene prices, upgrading these by 14% and 19% respectively. The broker still envisages supply will overshoot near-term demand and maintains a bearish view for 2019/20.

The company's exposure to upgraded long-term lithium pricing leads the broker to upgrade the stock to Outperform from Neutral on a stronger long-term outlook. Target is raised \$1.20 from \$1.15.

QBE INSURANCE GROUP LIMITED ((QBE)) Upgrade to Accumulate from Hold by Ord Minnett and Upgrade to Outperform from Neutral by Macquarie .B/H/S: 4/2/2

Ord Minnett has decided to upgrade to Accumulate from Hold, while lifting its price target to \$11.20 from \$10.95. The moves are being justified via a reference to management now having rebased FY18 guidance, in combination with expected upside from the cycle and interest rates, plus possible benefits to margins from a restructure.

The broker does acknowledge there remain risks, with reserve releases potentially drying up in some markets, eventually a rise in reinsurance costs and the need for QBE to increase its underlying margins by some 2% to validate the upside valuation thesis.

New management has re-based margin guidance for 2018. Heading into the February results, Macquarie believes the buyback, premium growth and portfolio sales will remain the focus for investors.

Now the negative catalyst of a profit downgrade is behind the market, the broker believes there is enough clear air to invest in a stock that is trading at a -15% discount to weighted international peers.

Rating is upgraded to Outperform from Neutral and the target reduced to \$11.10 from \$11.70.

SUNCORP GROUP LIMITED ((SUN)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 4/3/1

FY18 underlying margins are falling and, given earnings risks in the medium term and the need for personal lines to improve, Morgan Stanley believes the stakes on the company's "marketplace" strategy are high. The broker targets a first half underlying margin of 10.4%.

Rating is upgraded to Equal-weight from Underweight. Target is raised to \$13.20 from \$12.90. In-Line sector view.

SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Upgrade to Add from Hold by Morgans .B/H/S: 3/2/1

December passenger numbers showed strong international growth and Morgans expects 11% growth in net operating receipts in 2017. Over the next three years the broker expects 6% per annum compound growth in cash flows.

Rising government bond rates remain the key risk to the investment view and the broker suggests investors retain the capacity to take advantage of share price weakness that may occur if bond rates lift materially.

Morgans upgrades to Add from Hold. Target is raised to \$7.14 from \$7.11.

SYRAH RESOURCES LIMITED ((SYR)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 4/1/0

Macquarie makes material upgrades to 2018 carbonate and spodumene prices, upgrading these by 14% and 19% respectively. The broker still envisages supply will overshoot near-term demand and maintains a bearish view for 2019/20.

The broker observes commissioning of Balama appears to have gone well for Syrah Resources. The broker's upgraded outlook leads to a lift in long-term prices for battery anode materials. Rating is upgraded to Outperform from Neutral. Target is raised to \$5.20 from \$4.70.

TREASURY WINE ESTATES LIMITED ((TWE)) Upgrade to Buy from Neutral by UBS .B/H/S: 3/1/2

UBS believes the company has the opportunity to accelerate both value and volume share in China over the next 3-5 years. Asia is expected to become the largest contributor to operating earnings by FY19.

The broker's analysis shows that the company's brands are materially under penetrated but rate highly among wine consumers. UBS upgrades to Buy from Neutral. Target is raised to \$17.30 from \$13.00.

WHITEHAVEN COAL LIMITED ((WHC)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 3/3/2

Incorporating significant changes to bulk commodity price forecasts, Macquarie upgrades Whitehaven Coal to Neutral from Underperform. Target is raised to \$4.40 from \$3.90.

The broker lifts 2018 forecasts for coking coal by 40% and thermal coal by 30%.

Downgrade

COMMONWEALTH BANK OF AUSTRALIA ((CBA)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/6/2

Citi analysts have moved to a Sell, from Neutral, while lowering their price target to \$72 (was \$76.75).

The analysts justify their decision with the assessment that CBA is facing a decline in balance sheet momentum combined with rising compliance and remediation costs.

Examining previous crises suggests the CBA share price remains poised for a period of underperformance, according to Citi.

**CIMIC GROUP LIMITED ((CIM))** Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 1/1/2

Deutsche Bank retains a positive outlook for the Australian infrastructure construction sector in 2018, given a high backlog in work in hand.

Nevertheless, share prices appear already to be pricing in most of the positives as the broker observes valuations are towards the top end of historical ranges.

Cimic is downgraded to Sell from Hold and the target raised to \$38.39 from \$38.03.

**GALAXY RESOURCES LIMITED ((GXY))** Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/3/1

Macquarie makes material upgrades to 2018 carbonate and spodumene prices, upgrading these by 14% and 19% respectively. The broker still envisages supply will overshoot near-term demand and maintains a bearish view for 2019/20.

Macquarie believes Sal de Vida is unlikely to be brought into production. Removing the development means upgrades to medium-term earnings for Galaxy Resources because of reduced operating costs, while long-term earnings estimates are down -15-45%.

The broker downgrades to Underperform from Neutral and reduces the target to \$3 from \$4.

**HOTEL PROPERTY INVESTMENTS ((HPI))** Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 0/2/0

Ord Minnett observes improving underlying fundamentals for A-REITs and considerable strength in transaction markets. Nevertheless, the sector is trading at a significant -9% discount to valuation. The broker expects an improvement in 2018 in retail operating conditions, driven by a pick up in consumer sentiment.

Hotel Property is downgraded to Hold from Accumulate. Target is raised to \$3.30 from \$3.20.

**HUB24 LIMITED ((HUB))** Downgrade to Hold from Buy by Ord Minnett .B/H/S: 0/1/0

Ord Minnett expects flows to remain strong for the company. Adviser numbers are also up 41% in the December quarter.

The broker likes the business fundamentally but prefers a cheaper entry point and believes the stock has run too hard, too quickly.

Rating is downgraded to Hold from Buy. Target rises to \$11.00 from \$9.57.

**JANUS HENDERSON GROUP PLC. ((JHG))** Downgrade to Neutral from Buy by Citi .B/H/S: 3/3/0

Citi upgrades 2018 and 2019 estimates by 7%, updating flow estimates and performance fee calculations while allowing for US tax cuts.

Given the stock's recent rally, the broker notes it is now trading at a 5% premium to its peer group. Rating is downgraded to Neutral from Buy. Target is raised to \$51.30 from \$50.75.

**MICHAEL HILL INTERNATIONAL LIMITED ((MHJ))** Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 2/2/0

The company has announced it will exit the US market and re-position the Emma & Roe brand. Credit Suisse welcomes this announcement but, given the recent share price performance, believes the impact is largely priced in.

The broker updates forecasts to reflect a reduced loss profile for Emma & Roe and the exit of the US market, but expects to further refine assumptions once more detail emerges regarding the new proposition for the company.

Rating is downgraded to Neutral from Outperform and the target raised to NZ\$1.55 from NZ\$1.50.

**RESMED INC ((RMD))** Downgrade to Underperform from Neutral by Macquarie .B/H/S: 4/2/1

Revenue of US\$601m was 4% ahead of Macquarie's forecasts in the second quarter. This was driven by stronger device sales in the Americas. Globally, masks and accessories were robust.

Macquarie finds limited appeal relative to domestic healthcare peers and downgrades to Underperform from Neutral. Target is raised to \$11.80 from \$11.65.

ST BARBARA LIMITED ((SBM)) Downgrade to Underperform from Outperform by Credit Suisse and Downgrade to Hold from Buy by Ord Minnett .B/H/S: 0/3/2

Credit Suisse observes December quarter production was strong and FY18 guidance is upgraded. The broker notes cash is building and the Gwalia extension project remains on budget and on schedule.

Rating is downgraded to Underperform from Outperform on the basis of the share price performance exceeding the valuation. Target is raised to \$3.00 from \$2.95.

Ord Minnett has downgraded to Hold from Buy, with the decision seemingly related to the fact that updated guidance of all-in sustaining costs (AISC) of US\$910/oz is some 8% higher than what the broker had penciled in.

Having said so, the broker does believe management will likely beat its own cost guidance for the full year. Target price gains 10c to \$3.50. St Barbara remains one of Ord Minnett's favourites in the sector as the company is considered to be in an enviable position led by strong cash flow, no debt and organic growth options.

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

Somnomed has reported record second quarter revenues thanks to strength in Europe, and early, but significant, contributions from the Renew Sleep Solutions business, Morgans notes. However FY18 guidance has been downgraded due to slower than forecast initial RSS sales.

The result is a pushing out in time of earnings growth expectations. The broker has cut its target to \$3.58 from \$4.04 and downgraded to Hold.

#### Total Recommendations Recommendation Changes

#### Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ALUMINA LIMITED Buy Neutral Macquarie 2 BORAL LIMITED Buy Neutral Ord Minnett 3 DOMAIN HOLDINGS AUSTRALIA LIMITED Buy Sell UBS 4 DOMAIN HOLDINGS AUSTRALIA LIMITED Neutral Sell Deutsche Bank 5 GRAINCORP LIMITED Buy Neutral Morgans 6 LEND LEASE CORPORATION LIMITED Buy Neutral Macquarie 7 NINE ENTERTAINMENT CO. HOLDINGS LIMITED Buy Neutral Deutsche Bank 8 ORICA LIMITED Buy Neutral Morgan Stanley 9 PILBARA MINERALS LIMITED Buy Neutral Macquarie 10 QBE INSURANCE GROUP LIMITED Buy Neutral Macquarie 11 QBE INSURANCE GROUP LIMITED Buy Neutral Ord Minnett 12 SUNCORP GROUP LIMITED Neutral Sell Morgan Stanley 13 SYDNEY AIRPORT HOLDINGS LIMITED Buy Neutral Morgans 14 SYRAH RESOURCES LIMITED Buy Neutral Macquarie 15 TREASURY WINE ESTATES LIMITED Buy Neutral UBS 16 WHITEHAVEN COAL LIMITED Neutral Sell Macquarie Downgrade 17 CIMIC GROUP LIMITED Sell Neutral Deutsche Bank 18 COMMONWEALTH BANK OF AUSTRALIA Sell Neutral Citi 19 GALAXY RESOURCES LIMITED Sell Neutral Macquarie 20 HOTEL PROPERTY INVESTMENTS Neutral Buy Ord Minnett 21 HUB24 LIMITED Neutral Buy Ord Minnett 22 JANUS HENDERSON GROUP PLC. Neutral Buy Citi 23 MICHAEL HILL INTERNATIONAL LIMITED Neutral Buy Credit Suisse 24 RESMED INC Sell Neutral Macquarie 25 SOMNOMED LIMITED Neutral Buy Morgans 26 ST BARBARA LIMITED Sell Buy Credit Suisse 27 ST BARBARA LIMITED Neutral Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 SYR SYRAH RESOURCES LIMITED 80.0% 60.0% 20.0% 5 2 GNC GRAINCORP LIMITED 60.0% 40.0% 20.0% 5 3 LLC LEND LEASE CORPORATION LIMITED 50.0% 33.0% 17.0% 6 4 SYD SYDNEY AIRPORT HOLDINGS LIMITED 33.0% 17.0% 16.0% 6 5 TWE TREASURY WINE ESTATES LIMITED 8.0% -8.0% 16.0% 6 6 AWC ALUMINA LIMITED 21.0% 7.0% 14.0% 7 7 FLT FLIGHT CENTRE LIMITED -25.0% -38.0% 13.0% 8 8 SUN SUNCORP GROUP LIMITED 31.0% 19.0% 12.0% 8 9 WBC WESTPAC BANKING CORPORATION 50.0% 38.0% 12.0% 8 10 BLD BORAL LIMITED 58.0% 50.0% 8.0% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 SBM ST BARBARA LIMITED -40.0% 20.0% -60.0% 5 2 SRX SIRTEX MEDICAL LIMITED 33.0% 67.0% -34.0% 3 3 S32 SOUTH32 LIMITED -13.0% 13.0% -26.0% 8 4 MHJ MICHAEL HILL INTERNATIONAL LIMITED 50.0% 75.0% -25.0% 4 5 OZL OZ MINERALS LIMITED 38.0% 63.0% -25.0% 8 6 BPT BEACH ENERGY LIMITED -10.0% 10.0% -20.0% 5 7 APO APN OUTDOOR GROUP LIMITED 50.0% 67.0% -17.0% 6 8 JHG JANUS HENDERSON GROUP PLC. 50.0% 67.0% -17.0% 6 9 NXT NEXTDC LIMITED 71.0% 86.0% -15.0% 7 10 RMD RESMED INC 43.0% 57.0% -14.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 RMD RESMED INC 12.012 10.782 11.41% 7 2 BPT BEACH ENERGY LIMITED 1.034 0.942 9.77% 5 3 TWE TREASURY WINE ESTATES LIMITED 14.808 13.758 7.63% 6 4 SYR SYRAH RESOURCES LIMITED 5.012 4.712 6.37% 5 5 S32 SOUTH32 LIMITED 3.560 3.354 6.14% 8 6 BLD BORAL LIMITED 7.738 7.438 4.03% 6 7 OZL OZ MINERALS LIMITED 9.598 9.240 3.87% 8 8 AWC ALUMINA LIMITED 2.350 2.293 2.49% 7 9 FLT FLIGHT CENTRE LIMITED 45.738 44.975 1.70% 8 10 NXT NEXTDC LIMITED 5.869 5.789 1.38% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 GNC GRAINCORP LIMITED 8.792 8.932 -1.57% 5 2 SRX SIRTEX MEDICAL LIMITED 18.993 19.227 -1.22% 3 3 CBA

COMMONWEALTH BANK OF AUSTRALIA 78.000 78.594 -0.76% 8 4 APO APN OUTDOOR GROUP LIMITED 5.197 5.230 -0.63% 6 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 WTC WISETECH GLOBAL LIMITED 24.408 15.433 58.15% 4 2 OZL OZ MINERALS LIMITED 74.523 61.321 21.53% 8 3 WHC WHITEHAVEN COAL LIMITED 53.993 47.480 13.72% 8 4 RMD RESMED INC 43.185 39.241 10.05% 7 5 MIN MINERAL RESOURCES LIMITED 157.067 145.500 7.95% 3 6 OGC OCEANAGOLD CORPORATION 32.292 30.290 6.61% 6 7 BHP BHP BILLITON LIMITED 222.336 208.823 6.47% 8 8 S32 SOUTH32 LIMITED 30.131 28.373 6.20% 8 9 SRX SIRTEX MEDICAL LIMITED 95.333 90.000 5.93% 3 10 WSA WESTERN AREAS NL 7.612 7.238 5.17% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 MHJ MICHAEL HILL INTERNATIONAL LIMITED 6.456 8.300 -22.22% 4 2 GNC GRAINCORP LIMITED 33.084 40.544 -18.40% 5 3 BPT BEACH ENERGY LIMITED 7.382 7.880 -6.32% 5 4 ORE OROCOBRE LIMITED 17.598 18.336 -4.02% 6 5 SWM SEVEN WEST MEDIA LIMITED 8.835 9.152 -3.46% 6 6 AWC ALUMINA LIMITED 16.847 17.298 -2.61% 7 7 SEK SEEK LIMITED 59.718 61.293 -2.57% 8 8 IFL IOOF HOLDINGS LIMITED 56.660 57.940 -2.21% 5 9 TAH TABCORP HOLDINGS LIMITED 16.537 16.903 -2.17% 6 10 AVN AVENTUS RETAIL PROPERTY FUND 18.100 18.500 -2.16% 3 Technical limitations

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

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## Uranium Week: Ground To A Halt

A petition to the US government threatens to ensure uncertainty in the uranium market for some time.

-US producers appeal to president's protectionist ilk -Uncertainty rules -Spot and term prices remain under pressure

By Greg Peel

Last week's Uranium Week highlighted a petition filed with the US Department of Commerce by US uranium producers Ur-Energy and Energy Fuels. This petition has brought the uranium market to a screaming halt.

The petition requests that the DOC initiate a section 232 review of the Trade Expansion Act of 1962. The purpose of the Act is to protect national security industries that are under threat from imports. US uranium producers are under threat from "state-sponsored" producers which, although not specifically stated, would imply producers in Russia and Kazakhstan.

US producers would like to see a mandated requirement that US utilities purchase a minimum 25% of their requirements from US producers. US utilities have nevertheless warned that such a quota would force the early shutdown of some nuclear plants. For a protectionist president, such a quota would be consistent with current and evolving trade policy. But would Trump impose such a quota under the circumstances?

It may take a while to find out.

Sidelined

The DOC has ten days to decide whether or not to conduct an investigation. It then has 270 days to complete the investigation and report to the president. The president then has 90 days to take action. That's a total of 370 days, or February next year.

For the next ten days at least, uranium market participants are sitting on the sidelines.

Industry consultant TradeTech reports four transactions in the spot market last week totalling 420,000lbs U3O8 equivalent. TradeTech's weekly spot price indicator has fallen -US30c to US\$23.00/lb.

The weekly indicator has either remained unchanged or fallen for seven consecutive weeks.

Two transactions were reported in term markets last week, totalling 400,000lbs for mid-term delivery. TradeTech's term price indicators remain at US\$28.00/lb (mid) and US\$31.00/lb (long).

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## The Short Report

### Guide:

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

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

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

### Summary:

Week ending January 25, 2018

The Short Report will now revert to its usual week-on-week analysis.

Last week saw the ASX200 fall back to support at 6000 before rebounding.

There was not a lot of movement in short positions last week, as the table below suggests. One point of note is that lithium miners are seeing increasing shorts once more, with all of Galaxy Resources ((GXY)), Orocobre ((ORE)) and Pilbara Minerals ((PLS)) shifting up one bracket.

We note also that Vocus Communications ((VOC)) has shifted up a notch while telco peer TPG Telecom ((TPM)) has seen its shorts fall to 5.5% from 7.2%.

The other mover & shaker last week was Domino's Pizza ((DMP)), which saw a reduction in shorts to 13.6% from 16.6%.

See below.

Weekly short positions as a percentage of market cap:

10%+

SYR 20.7 IGO 16.7 JBH 14.4 HSO 13.8 DMP 13.6 RFG 13.1 HT1 10.5

No changes

9.0-9.9

FLT, APO, MYX, GXL, AAD, MYR, GXY, VOC In: GXY, VOC

8.0-8.9%

AAC, NWS, HVN, MTS, NXT

In: NXT Out: GXY, VOC

7.0-7.9%

WSA, BAP, ORE, PLS, SHV

In: ORE, PLS Out: NXT, TPM, ISD

6.0-6.9%

GTY, ISD, BEN, JHC, AHG, WEB, GMA

In: ISD Out: ORE, PLS

5.0-5.9%

TGR, NAN, KAR, RIO, IMF, CSR, QUB, TPM

In: TPM Out: SEK, IPD

### Movers and Shakers

TPG Telecom had an up and down year last year as investors tried to figure out whether the company's move to become the fourth Australian mobile provider was a good thing or not. A great opportunity or over-ambition?

More recently, the stock has been boosted, as has mobile dominator Telstra, by rollout problems for the NBN, albeit 2018 has seen TPG's share price sink back somewhat. With short positions rising in Vocus and falling in TPG, we may be seeing a pairs trade, or perhaps the shorters are concerned the NBN fiasco will continue to play into TPG's hands.

Domino's Pizza was trading at \$10 in early 2013 and \$75 mid-2016 as it became a market darling thanks to the standout success of its digital platform development. Then the wheels fell off when it was revealed the company was underpaying staff.

That issue is still before the Fair Work Tribunal but in the meantime, a slowing in the UK has also weighed on sentiment. Analysts have nevertheless decided that UK problems are execution-based and not structural, and thus can be sorted. Last week saw Domino's enjoy the beginning of a 10% rally, and shorters trimmed their positions by three percentage points.

### ASX20 Short Positions (%)

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

### IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

Often large short positions can be attributable to a listed hybrid security on the same stock where traders look to "strip out" the option value of the hybrid with offsetting listed option and stock positions. Short positions may form part of a short stock portfolio offsetting a long share price index (SPI) futures portfolio - a popular trade which seeks to exploit windows of opportunity when the SPI price trades at an overextended discount to fair value. Short positions may be held as a hedge by a broking house providing dividend reinvestment plan (DRP) underwriting services or other similar services. Short positions will occasionally need to be adopted by market makers in listed equity exchange traded fund products (EFT). All of the above are just some of the reasons why a short position may be held in a stock but can be considered benign in share price direction terms due to offsets.

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

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

Aside from all the above reasons as to why it would be a potential misconception to draw simply conclusions on short percentages, there are even wider issues to consider. ASIC itself will admit that short position data is not an exact science given the onus on market participants to declare to their broker when positions truly are "short". Without any suggestion of deceit, there are always participants who are ignorant of the regulations. Discrepancies

can also arise when short positions are held by a large investment banking operation offering multiple stock market services as well as proprietary trading activities. Such activity can introduce the possibility of either non-counting or double-counting when custodians are involved and beneficial ownership issues become unclear.

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

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

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## The Wrap: Builders, Financials & Child Care

Weekly Broker Wrap: Health insurers; salmon; building materials; diversified financials; office rents; child care; LiveTiles; and consumer sentiment.

-Morgan Stanley finds health insurance sector stretched and participation still challenged -International prices having limited effect on domestic wholesale salmon market -Macquarie prefers exposure to US building materials market -Buoyant investment markets hiding headwinds for Australian wealth managers -Strengthening demand expected to support growth in office rents -Occupancy in child care to remain challenging until funding increases in July

By Eva Brocklehurst

### Health Insurers

Morgan Stanley is cautious on the health insurance sector, reflecting stretched valuations and peak margins as well as challenges to participation. The broker believes the near-term benefits from subdued claims inflation is priced in.

Margins expanded in the September quarter, benefiting from modest growth in the average cost per treatment. Feedback suggests utilisation has been normalising recently.

The latest perception studies also show for the first time that consumers believe public hospital care is better than private. The broker suggests a growing perception that public hospitals provide adequate catastrophe cover risks is driving further downgrades to policies by healthier cohorts.

Morgan Stanley considers the nib Holdings' ((NHF)) brand is stalling while retention is poor. The broker has an Underweight rating. However, due to distribution via companies such as Qantas ((QAN)) and Suncorp ((SUN)) the business could sustain volume growth for now.

Morgan Stanley believes Medibank Private ((MPL)) is priced for success and retains an Underweight rating. The market appears to be backing Medibank to maintain its 8% margins and stem the downgrading.

The broker suggests attrition of the core brand is likely to continue and notes a lack of aggregator presence and shrinking pool of new-to-market customers.

### Salmon

Ord Minnett observes international prices are having a limited effect on domestics wholesale salmon markets. Barriers include distance from other growing regions as well as import restrictions.

Wholesale salmon prices remain around \$13.50-14.50/kg and the broker assumes wholesale prices of \$14.60/kg for Tassal Group ((TGR)) and \$14.25/kg for Huon Aquaculture ((HUO)) in FY18, although this includes varying proportions of smoked product which sells at a higher price.

The broker's checks suggests growing conditions are not being affected by warmer waters and there is nothing particular abnormal about temperatures at the moment. The broker maintains a Buy rating for Huon Aquaculture and a Lighten rating for Tassal.

### Building Materials

Macquarie believes most of the factors supporting the performance of the building materials sector remain in place. The broker prefers exposure to the US market, and housing in particular, and notes rising property prices and the spectre of gradually rising interest rates are the main factors to watch for a change to this view.

Australian infrastructure exposures are also expected to feature in 2018. The broker prefers James Hardie ((JHX)) as the strong brand is expected to win back lost market share.

Reliance Worldwide ((RWC)) is expected to consolidate its position and a foray into Europe is also considered possible in 2018. Meanwhile, any upgrades to synergy targets are considered a de-risking event for Boral ((BLD)), supporting a re-rating.

### Diversified Financials

UBS suggests buoyant investment markets over the last five years have hidden the multiple headwinds that are emerging for the revenue of incumbent Australian wealth managers. This comes as market share shifts away from market players and despite the supports from mandatory superannuation.

Weak wages growth is compressing gross flows as a percentage of assets under management, while an ageing population is supporting outflows and this is expected to limit future super flow prospects to just 0.5% of assets under management.

In comparison, net flows into investment products have been robust, assisted by an ongoing shift of direct assets to platforms. Fee pressure is expected to continue as legacy products assets churn to lower cost contemporary offers. UBS considers the current value discounts for AMP ((AMP)) and IOOF ((IFL)) warranted and retains a Neutral rating on both.

Meanwhile, platforms like Netwealth ((NWL)) are considered ideally positioned for growth, although flow and margin expectations implied by its PE of 41x appear unsustainable.

Elsewhere, UBS envisages credit spreads driving margin compression and eroding Challenger Group's ((CGF)) leverage while Perpetual ((PPT)) is still facing negative net flows. The broker retains a preference for global asset managers such as Janus Henderson ((JHG)) and Magellan Financial ((MFG)).

#### Australian Property

While many in the market believe the office rental growth cycle is finished, Citi believes strengthening demand will continue to support growth in rents, and forecasts supply to remain below the long-term average of 2% of stock. Market forecasts for city office rents are potentially starting to reflect this view, the broker suggests.

December quarter data indicates rents continued to grow at a rapid pace and Sydney's prime net effective rents were up 26% year-on-year and Melbourne up 13%. Citi suggests there is potentially more upside in Melbourne, as incentives remain higher versus historical levels.

#### Child Care

In the December quarter 72 new long day care centres were opened, taking the number of new centres opened in 2017 to 318. Canaccord Genuity notes the increase has been in excess of demand growth, particularly in certain areas of NSW, ACT and, more recently, Victoria.

From an occupancy perspective, the broker believes conditions will remain challenging until the government funding increases in July. Victoria continues to represent a large proportion of the new supply, as under-development combined with population growth has meant developers turned their attention to that state in the past couple of years.

Canaccord Genuity remains of the view that the level of new supply is greater than the increase in demand, currently, and this will cause problems in some areas in terms of improving occupancy.

Of the 72 centres opened, 18 are located within 2km of a G8 Education ((GEM)) centre while three are located within 2 km of a Think Childcare ((TNK)) centre. Canaccord Genuity retains a Buy rating on both.

#### LiveTiles

Subscription revenue at LiveTiles ((LVT)) was up 245% in December. Wilsons observes the product range is clearly resonating well. The stock has appreciated 117% since the broker initiated in October.

While remaining attracted to the multi-year growth opportunity around the company's Microsoft SharePoint overlay, the broker suspects a lot is priced in now and downgrades to Hold. Target is 66c.

EverBlu Capital takes up coverage with a Buy rating and 73c target, not expecting a significant profit until 2023 because the company is investing for growth. EverBlu proposes that LiveTiles should trade at a 10% premium to the market multiple in FY24.

#### Consumer Sentiment

The Westpac/Melbourne Institute Consumer Sentiment Index rose 1.8% in January to be up over 10% from its August low. Westpac observes this makes the most positive start to a calendar year since 2010, with the main positives being more confidence in the economy and jobs. Still, consumer assessments of their own finances are below long-run averages.

Risk aversion remains elevated. The modified indicator the analysts favour as a guide to actual expenditure rebounded 3.4% to be 5.7% above the average in the third quarter 2017. Despite the rise, Westpac suggests spending

over the first half of 2018 is weak and consumer views on major purchases remain downbeat.

Despite a gain in the “time to buy a dwelling” index this is also at levels well below the long-term average. The Westpac/Melbourne Institute Consumer House Price Expectations Index fell a further 8.2% over the quarter to January and is in line with the long-run average.

The Westpac/Melbourne Institute Unemployment Expectations Index fell a further 5% in the quarter and, while it looks to be sustaining a break into positive territory, the analysts note the views are still not particularly optimistic.

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## Rapid Expansion Potential With LiveTiles

LiveTiles has a large addressable market for its pre-configured software tiles and apps. Moelis initiates coverage on the stock.

-Products easily integrated on Microsoft's SharePoint and Azure -Organic growth requires limited additional costs

By Eva Brocklehurst

LiveTiles ((LVT)) has a suite of software products that provide "plug and play" tools for businesses, using Microsoft's SharePoint and Azure platforms. Moelis initiates coverage with a Buy rating and 79c target.

The software comes pre-configured with tiles and apps that can be placed via the drag and drop function, with no coding required. This improves the visual appeal of digital work spaces and helps with user engagement and the productivity of the organisation.

The broker notes the products integrate easily and can be rapidly deployed. The free offering "Mosaic" to the educational sector provides teachers and students with an ability to design and create digital classrooms and department portals.

LiveTiles has a large addressable market and a scalable business model, offering long-term recurring revenue. Organic growth requires limited additional costs as employee numbers grow or the platform is expanded. There is also minimal support required after the initial installation. Moelis anticipates a retention ratio above 90%.

The company sells to all major industry verticals, with its geographical focus on North America, Australia and parts of Europe.

As the broker sees it, the monetisation opportunity lies with the fact that less than 25% of customer employees are paying users. Moreover, there are around 6.8m non-paying student and teacher licences of LiveTiles Mosaic. At some point in the future the company is expected to look at monetising these users.

New products released in the first half, and expected to drive revenue growth in FY19 and beyond, include LiveTiles Bots, to be promoted to Microsoft customers in the United States as a quick artificial intelligence solution. The company is currently in discussions with several Fortune 500 companies to implement this.

There is also a retail AI solution "RAISE", launched in partnership with Microsoft this month. LiveTiles Intelligence is a new product which provides analytics for how a company's digital workplace is performing.

LiveTiles uses three sales channels: direct sales, with sales teams in Australasia, North America, UK and Europe (66% of sales); partner channels, sold through resellers such as PwC and Deloitte (33% of sales); and partnership with Microsoft to co-market products to commercial customers.

What will drive this market? Moelis estimates that around 60% of organisations will be using cloud-based office systems by 2020 and employees using their own devices, particularly tablets and smart phones, continue to proliferate. Around 43% of people in the US spend at least some time working remotely according to the latest data.

In this environment software tools allow organisations to collaborate in ways which have not been available previously. This includes real-time co-authoring, a single file repository to manage workflows and file versions, as well as social media tools. The growth and evolution of computing power has also supported the rise of AI and machine learning.

LiveTiles has strong sales momentum building in the first half, the broker notes, and FY18 is expected to be a significant year for investment and new products. Break even is expected in FY21.

Moelis assumes operating expenditure will almost double in the current financial year, given the significant level of investment. Very little capital expenditure is forecast in the near term. The broker assumes the customer base grows to 1250 by FY20, from 366 in FY17.

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## Uncertainty Stymies Integral Diagnostics

Integral Diagnostics performed strongly in the first half and FY18 guidance was recently upgraded but not all brokers are happy with the outlook.

-Capitol Health bid creates uncertainty absent a board recommendation -Cost reductions a major contributor to earnings upgrades, but will they hold?

By Eva Brocklehurst

Diagnostic imaging business Integral Diagnostics ((IDX)) is sustaining some early gains, with its first half performance accelerating on both a financial and market relative basis. Costs are down and favourable rates are being negotiated for premises against a robust radiology market.

Industry activity may well be improving but it is uncertainty over the completion of a takeover bid that leads Morgan Stanley to revert to a base case valuation and maintain an Underweight rating. The company reported its first half results not long after FY18 guidance was revised to 20% net profit growth, from "high single digits" previously.

Morgan Stanley considered this development surprising, in light of the two earnings downgrades that were made in under 12 months post the IPO, as well as the significant de-leveraging during the 2016 industry downturn.

Historically, earnings visibility has been poor and the broker considers the cost restructuring measures that the company has highlighted as the main contributor to the improvement are one-off in nature. Morgan Stanley also points to the relatively new turnover of management.

Capitol Health ((CAJ)) has offered 6.9 shares and \$0.36 cash for each share on issue in Integral Diagnostics, implying a value of \$2.46 per IDX share. Morgan Stanley suspects the stock will not trade on fundamentals while the board has not offered a recommendation to shareholders.

This keeps open the possibility the takeover bid will fail and implies downside risks. While the market may gravitate towards the offer price of \$2.46, Morgan Stanley's base case target of \$2.25 reflects its fair value estimate.

First half net profit of \$9.2m beat Ord Minnett's estimates and signals growth of 24.1% on the prior corresponding half. A strong result was expected, following the recent upgrade to FY18 guidance. Cost reductions were flagged as the major contributor but the speed and magnitude surprised the broker.

Ord Minnett suggest revenue growth has also picked up noticeably and new initiatives should contribute in the second half and beyond. In contrast to Morgan Stanley, the broker remains highly positive on the trajectory of industry growth rates, as well as management's ability to execute on its plans.

Still, with the share price trading in line with target, Ord Minnett maintains a Hold rating with a target of \$2.39. Management has previously outlined a plan to more effectively allocate resources according to volume, and the broker observes the first half result showed significant progress on this score.

Moreover, competition issues that previously affected the company have now washed through and referrals are accelerating. The broker now forecasts net profit growth of 25.6% in FY18.

The company is opening new clinics in Torquay, Victoria, and Miami Beach, Queensland, as well as making plans for a new prostate centre of excellence in FY19. This builds on previous experience with specialty centres in spinal and breast, and the clinics are expected to deliver a return on capital of around 25%.

Credit Suisse, while restricted on a rating and target at present, considers the results reflect internal and external tailwinds. The broker forecasts net profit growth in FY18 of around 20% and notes this forecast implies zero growth on the first half run rate.

Gearing is expected to remain comfortable although acquisitions are considered a possibility, despite a competitive market.

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## Tale Of Two Consumer Stocks

In this week's Weekly Insights (first edition of the new year):

-Welcome To 2018 -Tale Of Two Consumer Stocks -Conviction Calls: JPMorgan/Ord Minnett, CS and Morgans -AFIC Provides The Answer

By Rudi Filapek-Vandyck, Editor FNArena

Welcome To 2018

Welcome to 2018. Welcome to the first Weekly Insights of the new calendar year. We have not remained completely idle over the annual holiday season, instead making changes and improvements on the technical side which, all else remaining equal, should now result in faster access to the FNArena website and its numerous tools and applications.

In addition, we produced and published our first Special Report for the year: "Stories From 2017 To Re-Read In 2018" - for those who'd like to catch up on valuable stories they might have missed last year (it's ok, we're all busy).

Paid subscribers not yet familiar with the Special Reports section; head to the drop down menu on the website starting with Analysis & Data and check out the many goodies on offer.

Plus we've now added a Guide To The Website (see the black horizontal bar across the website) which hopefully will make it easier to navigate and to find more useful tips, tools and applications.

Lastly, FNArena has developed a brand new Australian Reporting Season Monitor, soon to become a permanent feature on our website. This will become everybody's one-stop destination for everything related to corporate results locally. Stay tuned as we are preparing for official take-off... not long now!

Tale Of Two Consumer Stocks

One section that has also been updated is the dedicated All-Weather Stocks page on the website (sorry, paying subscribers only). One regular complaint from last year was subscribers found it impractical to stay on top of my research through regular notes and observations provided by Weekly Insights updates.

This then led to questions such as why is this or that stock not in your table? The list of All-Weather Performers has been updated, and will continuously be reviewed and updated as time goes by. In line with my share market research, and with the strategy employed in the FNArena/Vested Equities All-Weather Model Portfolio, we have now added two extra sections: Emerging New Business Models and Prime Growth Stories.

A number of FNArena subscribers has grabbed the opportunity provided by the December-January festive season to congratulate myself and FNArena for providing this unique piece of research into Australian equities. If you are a paying subscriber, and you have as yet not paid any/much attention, then maybe today is as good a time as any?

The All-Weather Performers section at present showcases 40 different stocks, accompanied by plenty of writings and updates since 2013. Note there are Special Reports on the theme that can be accessed and downloaded as well. Feel free to ask more questions when necessary.

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One of the stocks included is Bapcor ((BAP)), a regularly recurring name in my All-Weather Performers research. I have stated many times in the past, and haven't changed my view to date, this company is blessed with one of the most resilient operations on the Australian Stock Exchange (hence its inclusion in my selection of All-Weather Performers).

One glance over the share price performance since listing in 2014 suffices to understand this company has the support of many happy shareholders. Yet, 2017 was pretty disappointing in terms of actual rewards for loyal shareholders. Nothing to do with management or the company itself, however.

How many AGMs did you visit last year where management and the board comfortably predicted 30% growth for the year ahead?

So what was holding back the performance last year? Amazon, of course, or more to the point: the fear of destruction from online competition through Amazon. There was also a protracted acquisition process in New

Zealand, which added several businesses that had to be put up for sale (as they don't fit in with the rest of the operations). Then there's all the talk about self-driving vehicles and electric cars.

For those who are as yet not familiar with Bapcor; this is the number one provider of automotive aftermarket parts and services on both sides of the Tasman. The mechanic who repairs your car at the garage probably orders his spare parts from Bapcor. The business is predominantly wholesale, with a smaller retail facing segment through chains including Autobarn, Autopro and Opposite Lock.

In case you are more familiar with Super Retail ((SUL)), this is the main competitor for their Supercheap Auto operations. I would not be surprised if, post a disappointing 2017, Bapcor is ready to re-establish itself as the reliable wealth creator it has been since IPO. Analysts have done their best to highlight the company's virtues and strong growth outlook over the months past.

The latest to update are analysts at Macquarie. Their report is littered with predictions of "further margin upside", alongside characteristics of "defensive growth profile" and "superior growth outlook". This is why Macquarie's price target sits at \$6.60, well above the current share price. Macquarie is not the high marker for Bapcor price targets. See Stock Analysis on the website.

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One consumer facing stock that is attracting a lot more attention these days is Retail Food Group ((RFG)), once upon a time highly successful with its various food related franchises, but things have changed for the worse, and rapidly too. Investigative journalism at Fairfax media has been followed up with quite severe profit warnings, and the share price has responded in accordance.

Of course, the share market has a habit of selling down out-of-favour stocks too far and thus Retail Food Group will be on many a value seeker's radar by now. Yet, I am giving it away straight up, I have no appetite for the stock. I see a company in serious trouble, and suspect there could be a lot more bad news lurking around the corner.

One of the few that still actively covers the stock, Wilsons, seems to agree. In its latest update on the company, Wilsons points out there is not much room for further downgrades as the company is already trading near its debt covenants; yet another hit to the bottom line will most likely trigger a heavily dilutive equity raising. I'd say: buyer beware.

Wilsons also points out weakness in franchise transactions is currently prevalent and there is no visibility about where profits are heading in the short to medium term; nor when profits might stop falling. Just to be safe, Wilsons forecasts now assume negative growth for the three years ahead. No surprise thus, the rating remains on Sell, with the share price target falling to \$1.64.

Conviction Calls: JPMorgan/Ord Minnett, CS and Morgans

One day during the holiday break I ran into a stockbroker who lives down my street. After the polite greetings, he was unable to stop bragging about the ten bagger he had managed to snatch up in the local share market last year. I won't bore you with the details, but this micro-cap stock multiplied by five in less than two months. No double guessing: here stood a stockbroker beaming from ear to ear.

Upon witnessing my rather lukewarm enthusiasm for his newfound gold mine, he asked which is your stock tip for the year? I gave it a few seconds and then said CSL ((CSL)).

CSL?

I cannot possibly describe the look on his face. Think something along the lines of: my mother is an alien from Mars, but psst, don't tell anyone my family secret.

The irony here is his micro-cap has since deflated by double digit percentage, while CSL's share price has steadily lifted from near \$140 to near \$150 on rising expectations from an early and severe flu season in the USA. No, CSL is not going to appreciate by a factor five anytime soon, but the risk profile involved is a lot closer to what I am looking for in the share market.

Behind the surprise also hides the widespread misconception that just because CSL is a large cap healthcare stock, whose performance in years past has been nothing short of excellent, investors now better look elsewhere for additional investment return.

I note numerous price targets set by analysts remain well above today's share price (see Stock Analysis); and yes, Morgan Stanley disagrees. But when share market strategists at JP Morgan earlier this month summarised their views and outlook for the year ahead through a small selection of most favoured stocks, they also included CSL, alongside Huon Aquaculture ((HUO)), WorleyParsons ((WOR)) AGL Energy ((AGL)), Amcor ((AMC)), and Scentre Group ((SCG)).

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Stockbroker Morgans' current selection of High Conviction Calls comprises of Westpac ((WBC)), ResMed ((RMD)), Oil Search ((OSH)), Link Administration ((LNK)), Aventus Retail Property Fund ((AVT)), PWR Holdings ((PWH)), Senex Energy ((SXY)) and Motorcycle Holdings ((MTO)).

Morgans' Model Portfolios have been adding Corporate Travel ((CTD)) in recent weeks, plus more of Aristocrat Leisure ((ALL)).

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Credit Suisse's local selection of Top Picks currently consists of 15 names, of which two carry a negative view ("short"). Those two are IDP Education ((IEL)) and TPG Telecom (TPM)).

The 13 most preferred ASX exposures are: AGL Energy, Coca-Cola Amatil ((CCL)), CSL, Caltex ((CTX)), Graincorp ((GNC)), Insurance Australia Group ((IAG)), IOOF ((IFL)), iSelect ((ISU)), National Australia Bank ((NAB)), Nine Entertainment ((NEC)), Qantas ((QAN)), Speedcast International ((SDA)) and Southern Cross Media ((SXL)).

### AFIC Provides The Answer

Australian Foundation Investment Company, shortcut AFIC, is the largest listed investment company on the ASX. It is also one of the oldest given a track record in excess of 80 years. AFIC specialises in achieving superior investment returns, including dividends, through investments in large cap Australian equities. Think the banks, and BHP and Rio Tinto, Woodside Petroleum, Wesfarmers, Woolworths, Telstra, CSL, plus AGL Energy and Origin Energy.

All the household names that are equally well-represented in most SMSF portfolios.

Which is why AFIC's latest market update should have every investor's attention. Total investment return has lagged the ASX200 accumulation index, not only for calendar 2017, but also over three and five years. Last year, total return didn't quite make it to double digit percentage, but at 9.9% it failed to keep up with the 11.8% total return for the ASX200 accumulation index (including dividends, but not accounted for franking benefits).

Over a five years horizon, the 8.8% in total return achieved by AFIC remains painfully below the 10.2% attached to the broader index. As many small and midcap stocks have shown significant outperformance in years past, one can adopt the argument that AFIC was always going to struggle to keep up.

The latter argument seems to be supported by the fact that AFIC's investment vehicle in small and midcap stocks, Mirrabooka Investments, is able to show better results up until the past five years. For 2017, Mirrabooka's gross return including dividends reinvested stands at 14.3%. Over the past five years, it has averaged 15.1% per annum.

Amidst widespread optimism about global synchronised growth and tax cuts in the USA, investment specialists at AFIC have indicated their focus will be on increasing exposure to emerging and disruptive technologies, without taking on excessive risk. I think the latter is the real message investors should take on board. But then again, I have been playing the same tune since 2015.

The FNArena/Vested Equities All-Weather Model Portfolio achieved 13.8% in calendar 2017. More about this in next week's edition.

(This story was written on Monday 29th January, 2018. It was published on the day in the form of an email to paying subscribers at FNArena.

(Do note that, in line with all my analyses, appearances and presentations, all of the above names and calculations are provided for educational purposes only. Investors should always consult with their licensed investment advisor first, before making any decisions. All views are mine and not by association FNArena's - see disclaimer on the website.

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

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