Week

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Stories To Read From FNArena

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Contents

Pendal Facing Weak Flows, Increased Costs

Strong first half result aside, brokers suggest Pendal Group is facing weak flows and increasing costs which could depress the outlook.

-Higher fixed cost base reduces earnings leverage if weak market conditions persist -Continuing to build global asset management business, 20% of FUM now US domiciled -Some strongly performing strategies considered niche and small

By Eva Brocklehurst

Revenue for Pendal Group ((PDL)), formerly BT Investment Management, rose 22% in the first half because of strong growth in management fees. Higher funds under management drove the increase, while fee margins also expanded because of an improved product mix.

The company's first half profit was up 30% on the prior corresponding half and well above forecasts. However, costs were up 20%, driven by a 28% increase in non-compensation expenses and an 18% increase in compensation costs. An increased fixed cost base is creating downside risk to earnings leverage, brokers suggest, particularly if weaker market conditions persist.

The company increased its FY18 fixed costs growth guidance to 18-20%, from 13-15%, largely because of the impact of the AUD/GBP. Net outflows of -$2.1bn were previously announced, affected by a mandate loss from JO Hambro and transition to MySuper.

On a full year basis, Morgans suspects operating margins will deteriorate by around 70 basis points but believes Pendal is continuing to execute on its strategy to build out a global asset management business. Around 20% of funds under management (FUM) are now US domiciled.

The broker is not concerned about the outflows in JO Hambro, previously flagged, and suggests an improvement in the coming quarter should provide more confidence. In the short term, Morgans acknowledges the prospect of Westpac selling its remaining 10% stake as well as the market volatility that could weigh on performance.

Taking a longer term view, the broker considers the current valuation a solid entry point for the stock and maintains an Add rating.

Macquarie envisages scope for the current discount to unwind as the business continues to perform well. As of March 31 72% of FUM have outperformed the respective benchmarks over the last three years. This compares with 82% at the FY17 result.

The reduction in performance is being driven by fixed income as well as the Asian and global equity strategies. The broker notes Asian equities have been poor performers recently and driving outflows from JO Hambro, and this appears set to continue.

Headwinds

Morgan Stanley acknowledges first half results were better than expected but notes some headwinds emerging in the second half. Westpac's BTFG is redeeming an additional $2.0bn in the second half and this, all else being equal, creates around a -1% earnings headwind.

FY18 fixed cost growth is also up sharply. Morgan Stanley notes around two percentage points of the first half increase involved a one-off re-branding cost. Overall, fixed cost growth is envisaged to be a -4.5% headwind to FY18 earnings.

Noting the upgrade to fixed cost estimates, UBS envisages operating margins will moderate from a first half record level of 45.4%. This view is based on a softer outlook for assets and revenue growth from weaker fund flows and lower performance fees.

The broker's Neutral rating reflects the downside risks to earnings estimates from lower JO Hambro performance fees and flows. UBS suspects that a more mixed performance from the UK and prospect of further outflows may offset the positive flows into US funds.

While Pendal experienced -$1.0bn in net flows because of the outflows largely relating to MySuper changes, traction elsewhere appears to be improving, with $1.2bn added in the first half. Momentum, nonetheless, will need to continue into the second half, UBS suggests, if Pendal is to offset the further $2bn of MySuper outflows recently flagged by Westpac.

Outflows of note in European equity strategies emerged in April, Credit Suisse points out, and the first half was flattered by high seed capital gains. The broker calculates that the increased fixed cost growth guidance is equivalent to 6% of the FY18 operating profit estimate and this could continue into FY19.

Credit Suisse considers the stock inexpensive, as its PE is near five-year lows, but with risks around flows being elevated the case can be easily made for deterioration at this point.

Under a more bullish scenario, the broker can envisage opportunities for new strategies which have hit the three-year track record and a strong performance should attract inflows. There is also potential for greater penetration of the Australian market without the association with BT/Westpac.

Alternatively, the argument could also be made that some of the strongly performing strategies are niche in nature and small in capacity, and could easily be influenced by asset class and risk allocation.

FNArena's database shows three Buy ratings and two Hold. The consensus target is $10.97, suggesting 5.9% upside to the last share price. Targets range from $9.75 (Credit Suisse) to $12.00 (Morgan Stanley). The dividend yield on FY18 and FY19 forecasts is 5.0% and 5.3% respectively.

Stockland Increases Focus On Business Parks

Stockland is deploying the proceeds of asset sales towards industrial developments as it shifts its portfolio mix.

-Residential communities expected to be main driver of performance in FY18 -Continued disruption being experienced in apparel, discount and department stores -Sydney residential market moderating, new releases taking longer to sell

By Eva Brocklehurst

Stockland ((SGP)) has outlined a plan to reduce its exposure to retail centres and favour the development of logistics and business parks. The company will divest around $300m in non-core assets and take the logistics & business parks division to 20% of the portfolio, from a current 14%.

Stockland has divested $124m of retail assets in the second half to date and proceeds are being deployed back into other segments such as industrial. Over the longer term the company also intends to reposition some office assets via redevelopments. Medium density housing will also represent more than 50% of residential settlements versus the current 5%.

Macquarie assesses the risks for the business will increase as the shift to industrial, retirement and medium-density housing development takes place, although a large diversified asset base should limit volatility.

Internal rates of return on development since 2013 have only been around 10% in the industrial development segment and, whilst higher than passive rent collection, the broker suggests this area is subject to a greater risk.

While retail asset sales are of concern in the current environment Credit Suisse envisages upside in other parts of the business, and residential communities are expected to be the main driver for outperformance in FY18.

Meanwhile, headwinds and reputation issues for the retirement living industry have affected recent returns and FY18 returns are expected to be below 6%, although the company cites an improvement in recent weeks.

Retail

Stockland has experienced an improvement in sales growth over the last two quarters but now expects rental reversion on new space to turn negative because of increased re-mixing. The company has reduced its targeted capital allocation to the sector to 40-50% from 45-50%.

The company is experiencing continued disruption in apparel, discount and department stores. Supermarkets and other anchor tenants are observed to be focused more on profitability per store rather than adding stores and development opportunities in retail will be curtailed.

Over the medium term, Stockland envisages around 3.5% sales growth can be achieved. The re-mix of retail is trending towards the growth areas of services, entertainment and food catering. Health services is the one category that is considered least affected by the growth in online retailing.

Ord Minnett suggests the retail portfolio would be better placed if seven assets, valued at around $820m or 11% of the retail portfolio, were offloaded. The broker speculates Stockland may look at JV capital for some of the larger assets, and could also package up some of the lower-quality assets with stakes in larger and better-performing assets.

Industrial

Offsetting the reduced exposure to retail will be the increased weighting for the logistics & business parks segment, to 15-25% from 15-20%. This will occur through development of land already controlled by the company.

Development will come via a $590m pipeline the company has flagged. Proceeds from recent asset sales, Wallsend and Highlands, will also be directed to this division.

As there is $176m in assets recently completed or currently in development, Macquarie calculates, to reach the new capital targets, a further $900m of capital is required. Given the $590m flagged over the next five years, this implies an extra $300m is required through a further pipeline of developments or greenfield acquisitions.

Residential

Fundamentals for residential communities remain robust and price growth in three of the company's four major markets has significantly exceeded Credit Suisse's assumptions. Margin expectations have been upgraded to 17%.

In the light of strong population growth and a competitive advantage, Stockland should be increasing capital allocation to residential development, in Macquarie's opinion. The sale of this higher value product would support earnings growth.

Ord Minnett notes medium density margins are lower than margins for straight land sales but contribute a higher profit per sale, as prices are at least double the price of land. This should potentially help to offset slower market conditions.

Management has reiterated a view that the Sydney residential market is moderating and new releases are taking longer to sell versus 12-18 months ago. Regardless, despite the longer marketing period, management is confident in achieving 6500 settlements in FY18.

FNArena's database shows four Buy ratings and three Hold. The consensus target is $4.50, suggesting 5.6% upside to the last share price the dividend yield on FY18 and FY19 forecasts is 6.3% and 6.6% respectively.

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Macquarie Group: Too Good To Fail?

As the Australian banking industry slowly implodes, investment banking conglomerate Macquarie Group offers an oasis of ongoing earnings growth.

-Six years of consecutive guidance beats -Diversification of earnings growth sources -A rare bright light in the banking sector

By Greg Peel

"Great companies under-promise and out-deliver," said CLSA bank analyst Brain Johnson in a note assessing Macquarie Group's ((MQG)) FY18 earnings result, delivered early this month. Indeed, Macquarie has turned upside surprises into an art form.

It was over a decade ago that Johnson, then at JP Morgan, famously valued Macquarie as an investment bank at in excess of $100 when consensus targets were much, much lower. Johnson's previous employer was a little shop called Macquarie Bank. The share price did indeed climb towards the $100 mark in 2007 but along came a thing called the GFC.

Macquarie bottomed under $17 in 2009 and in January this year finally exceeded $100, but not before another difficult period for investment banks in 2011-12 around the time the EU was threatening to implode. Those two years were the only two in the past twelve that Macquarie has not exceeded initial earnings guidance set at each AGM. Guidance has been exceeded every year in the past six.

Prior to Keating's recession, Macquarie made its mark as a proprietary trading house. When market volatility evaporated in the early nineties the bank switched focus to infrastructure and other bond proxy-style funds – a move which worked extremely well until the credit crunch which preceded the GFC. A further remodelling was required under the new CEO.

While today's Macquarie Group remains active in capital markets, annuity-style businesses now account for some 60% of income and 70% of profit, Bell Potter notes. While the group has also moved into commercial banking activities – deposits and mortgages – the distinction between Macquarie and Australia's Big Four could not be more stark.

For one, Macquarie is a global operation, cross-divisionally leveraged, Johnson notes, to everything from non-conventional monetary policy (QE, low rates) to public-private infrastructure stimulus. The Macquarie Infrastructure & Real Assets division currently has $14.8bn in cash ready to be deployed while boasting a long tail of future performance fees as funds initiated up to ten years ago mature.

The Banking & Financial Services Division holds $5.1bn in deposits in excess of loans which, when deployed, increases the bank's net interest margin.

The traditional capital markets divisions are currently benefitting from increased market volatility.

The group carries a sufficient tier one capital surplus that the regulator, having last year set increased "too big to fail" capital requirements on all the major banks, has approved a $1bn share buyback that Macquarie has yet to activate.

To top it off, Trump's tax cuts will add around 5% to earnings growth and the group is positively leveraged to a weaker Aussie dollar.

Bell Potter claims Macquarie's unbroken six-year run of guidance beats to be "remarkable" and believe this is largely due to the company's transformation and exceptional risk management. With the stock now having gone ex-dividend, analyst TS Lim has upgraded Bell Potter's recommendation to Buy from Hold.

Grudging Acknowledgement

CLSA and Bell Potter are not included in FNArena's stockbroker database. At the time of Macquarie's FY18 result release, brokers within that database were in agreement that FY19 offered more in earnings upside risk than downside. In a reversal of the "cry wolf" fable, analysts struggle to accept management's guidance that FY19 earnings will be "broadly in line" with FY18.

It took the analysts at Citi till the FY18 result to finally capitulate and upgrade Macquarie to Neutral from a prior Sell based on valuation. The broker quietly lifted its target price to $110.15 from $79.50.

Citi joined three other brokers within the database to set Hold (or equivalent) ratings, alongside three Buy. All broker targets now exceed $100 and database consensus has been upgraded to a net $109.85 post-result from $101.19 previously.

Forecasting a total shareholder return (share price plus dividends) in excess of 15% over twelve months, Bell Potter has lifted its target to $125.00 from $116.50.

But the last word goes to Brian Johnson, who no doubt feels some level of déjà vu in setting a $130.00 target and, subsequently, a Buy (High Conviction) rating.

Is Another Dividend Cut Looming For Telstra?

Intense competition is persisting for Telstra and brokers suggest it may be only a matter of time before the company has to cut its dividend, again.

-Competitive conditions could be more strained as the mobile industry moves to unlimited plans -Increased pressures signal a more conservative view on the long-term dividend -Is the market factoring in the 5G options?

By Eva Brocklehurst

Telstra ((TLS)) has lowered guidance for key metrics in FY18, with the exception of free cash flow. Difficult trading conditions persist in both the mobile and fixed areas of the business and the company has signalled that the FY18 result will be at the bottom end of the $10.1-10.6bn profit guidance range.

Mobile subscriber growth has stayed strong but postpaid average revenue per unit (ARPU) fell by -3.6% in the March quarter. Pre-paid mobile broadband revenues also fell. The company reported solid retail fixed data net additions and growth in mobile postpaid subscribers, but competitive pressure has led to lower minimum monthly commitments.

Competitive conditions could be more strained as the industry moves towards unlimited plans, while the continued roll-out of the NBN is also expected to put pressure on fixed-line revenue. CLSA suggests that as Telstra now expects one-off NBN income to be higher, this must imply the underlying business is weaker in the second half.

While management guided to free cash flow at the top end of the $4.2-4.8bn range, brokers note this is primarily because of favourable timing of working capital movements in the current half-year.

Macquarie agrees with CLSA that the underlying business performance is weaker again, if allowing for the fact this includes NBN one-off payments in the top half of Telstra's range. The broker suggests new guidance parameters indicate Telstra's EBITDA (operating earnings) ex-NBN one-offs is falling by more than -10%.

Dividend

Excluding one-off NBN income, CLSA calculates Telstra is trading on a 16.0x PE on FY19 estimates and the $0.22 dividend may not be sustainable given deteriorating core earnings. The broker, not one of the eight monitored daily on the FNArena database, has an Underperform rating and $3.07 target.

Ord Minnett is also of the belief that a dividend reduction by FY21 is inevitable, suggesting the competitive environment in mobile has not yet reached its peak and this is likely to happen when TPG Telecom ((TPM)) launches its mobile service later this year or early next year.

Ord Minnett expects a steeper decline in mobile ARPU and now estimates the dividend will be reduced to $0.18 a share from FY21. This is based on the current dividend policy of paying 70-90% of normalised earnings.

Macquarie downgrades estimates for EPS in the near term by -7-10% and cuts dividend estimates for FY19 and beyond to $0.20 a share. While Telstra could use NBN one-off payments to sustain the dividend for the next few years under its current policy, the broker contends increased pressures provide the scope for a more conservative view on the long-term dividend outlook.

Telstra has stated it will update the market in June on additional strategic initiatives being put in place to address the trends. Macquarie expects there may be further cost initiatives. Telstra could review some of the loss-making businesses in its new business segment and this could provide a near-term benefit to operating earnings.

It remains less clear as to what initiatives could be announced to improve market share and ARPU in the core operations. In fixed line, Macquarie expects the competitive dynamic will be challenging and Vodafone is likely to win some share over the next 12 months.

Citi agrees it no longer makes sense to pay $0.22 a share beyond FY18 when the ordinary dividend is likely to fall to $0.11 once the one-off payments end.

Catalysts

UBS estimates Telstra could be worth up to $4 in the long-term by factoring either upside from the 5G bypass of the NBN or Telstra taking a material share of the growth that is forecast for new 5G enterprise revenue.

Despite the long-term value, the broker envisages share price downside once TPG enters the mobile segment in the second half of this year. Hence, UBS remains Neutral on negative near-term catalysts.

Once these crystallise, nonetheless, Telstra could be attractive on a long-term risk versus reward basis. The broker's scenario analysis implies the market may be factoring most of the NBN headwinds but little of the associated 5G option.

Citi asserts drastic action is required to slow the earnings decline. There is limited scope for revenue growth in core businesses but Telstra could consider more aggressive cost reductions and asset sales.

The broker believes Telstra's current strategy is not working and the 5G is no panacea either. 5G provides cost savings because of efficiency gains over 4G and in the current competitive environment this simply allows for continued data limit growth, rather than improved profitability.

Similarly, with 180 NBN retail service providers (RSPs) the competition is so intense that any wholesale price cuts are likely to be competed away, rather than delivering margin expansion for RSPs.

Morgans has a positive investment thesis based on a pessimistic valuation, undemanding fundamentals and the probability that the NBN is forced to lower last-mile access prices.

The broker suggests "maximum pessimism" is nigh, as in the next 12 months NBN peak migrations will occur along with TPG launching its mobile network. At this juncture some positive catalysts are required to provoke investor interest, yet, Morgans points out, investors are getting paid to wait for this event to occur.

FNArena's database shows three Buy ratings, three Hold and two Sell. The consensus target is $3.39, suggesting 14.2% upside to the last share price. Targets range from $2.70 (Citi) to $3.99 (Morgans). The dividend yield on FY18 and FY19 forecasts is 7.4% and 7.3% respectively.

BlueScope Guidance Still Conservative?

Steel spreads have increased strongly and BlueScope's North Star mill in Ohio is enjoying the benefit, resulting in an upgrade to the company's second half guidance.

-Upgraded guidance could still be conservative -Challenge for brokers is what lies ahead for steel spreads beyond FY19 -Further capital management and growth initiatives expected

By Eva Brocklehurst

Strong US steel margins have caused BlueScope ((BSL)) to upgrade second half guidance by 12%, now expecting FY18 second half operating earnings (EBIT) of $680m. The increase is mainly because of realised steel spreads, which have increased strongly for the North Star mill in Ohio. Upgraded guidance implies FY18 operating earnings of around $1.2bn.

Several brokers believe the announcement remains conservative for the current year and envisage further earnings and valuation upside if US prices hold up. Ord Minnett calculates that guidance implies North Star spreads are US$95/t higher than the first half.

The broker upgrades FY19 forecasts to reflect the assumed strength in US steel prices but reduces FY18 estimates because of a delay in anti-dumping measures into FY19 and also to reflect higher zinc and aluminium prices. As a result, the broker forecasts operating earnings of $719.3m in the second half, imply a $1.24bn outcome in FY18.

US hot rolled coil (HRC) prices have climbed steadily since the announcement of US steel tariffs in March. Prices have now settled at elevated levels, having spent 65 days within 5% of the current spot price of US$972/t, Ord Minnett observes.The broker calculates that, for every three months the current pricing remains firm, BlueScope grows full year earnings by around $130m.

The upgrade implies a strong start to FY19 and US import tariffs are supportive as is China's capacity management and global growth expectations so Citi assesses, as does Ord Minnett, that the latest upgrade underpins capital management initiatives.

Citi's US steel analysts consider the fundamental backdrop is the strongest for several years and there is potential for an extended period of elevated prices if exemptions are not extended, or other countries agree to import quotas similar to Korea. The sharp drawdown in Chinese steel inventory confirms a seasonal pick-up in demand is underway and this appears sustainable to the broker.

Morgan Stanley agrees strong cash flow and a more aggressive stance on capital management represent the next leg of upside for the business. The broker retains estimates that run ahead of guidance, noting that BlueScope provided first half guidance in December last year and went on to report a substantially better outcome two months later.

Amid good visibility over the remaining six weeks of the second half, Credit Suisse had suspected a higher upgrade was possible, and agrees higher reported FY18 earnings could still be possible.

The broker notes the upgrade is largely attributed to stronger US steel spreads as well as modestly stronger Australian steel products, partly offset by lower contribution from the ASEAN operations within the building products JV.

UBS suspects the market is now finding it difficult to firm up expectations for FY19. Spreads have historically averaged around US$300/t but strong US demand, concerns over tariffs and the possible rollover of medium term contracts all combine to suggest spreads will be higher in FY19. UBS increases FY19 estimates by 25% to US$375/t which drives a 20% upgrade to earnings estimates.

ASEAN

Meanwhile, the broker suggests the ASEAN division is struggling. Volumes and margins are now expected to be lower as general business activity and foreign investment slows down with elections in several jurisdictions. This should be somewhat temporary but the strength of the US is considered to be only partly offsetting the ASEAN weakness.

Credit Suisse suggests the underperformance in the ASEAN operations will be the focus of the new chief of this division, now based in Singapore, and resolution of Malaysia's political transition should also mean a recovery in that country, with perhaps a slower turnaround in the Thai business.

Beyond FY19

Morgan Stanley calculates the company will be in a net cash position in the second half with more than $2.5bn in free cash flow forecast to FY20. The broker expects a doubling of the buyback to $600m per annum in FY19, which still provides surplus cash flows to pursue growth initiatives.

The challenge for brokers is what lies ahead for steel spreads in FY19 and what, as Credit Suisse points out, to assume when the current US tariff protection benefits to US earnings might abate in FY20.

Although spot spreads are well above its FY19 forecasts Morgan Stanley is reluctant to factor in continued outcomes of this magnitude. Nevertheless, should the current dynamics continue the broker acknowledges meaningful upside exists.

Credit Suisse acknowledges its FY20 earnings now look conservative in the context of current spot spreads, albeit realistic relative to historical averages. While the implied collapse in FY20 forecasts looks precipitous and unlikely, projecting current spot spreads from those prevailing in the first half of FY18 would have appeared equally preposterous, the broker suggests.

Credit Suisse has no doubt that a shortage of HRC in the US is supporting elevated prices and there is capacity to import HRC and pay both freight and a 25% tariff and still make margin on higher US domestic prices.

Nevertheless, the broker does not believe there are material re-start opportunities in the US that would mean a sufficient near-term increase in US domestic production to improve the current supply/demand balance.

Elevated US imports of scrap also signal it is now economic to bring scrap into the US, while also improving the domestic supply situation and constraining the local price.

In the final analysis, Credit Suisse envisages no justification for adjusting its spread assumptions in FY20 to reduce the current gap to spot spreads, or to achieve an FY20 earnings outcome that would support the maintenance of the current share price.

FNArena's database shows six Buy ratings. Targets range from $16.90 (Credit Suisse) to $20.50 (UBS). The consensus target is $19.10, suggesting 6.2% upside to the last share price.

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Orora Bottling Innovation

Innovation remains a central theme at packaging business Orora. Brokers are confident in the expectations for Australasia while North America remains challenged and there is potential for further investment in that division.

-Investing in innovation to deflect rising costs -Strong growth in Australasian glass business -Potential for further US acquisitions

By Eva Brocklehurst

Packaging business Orora ((ORA)) has provided insight into its plans for growth in the Australasian business, showcasing its solutions as well as a new state-of-the-art digital printer and laser cutter, one of the first of its kind in the world.

CLSA believes the company is well-placed for further steady earnings growth and warrants a premium valuation. Innovation remains the central theme, ensuring the long-term strategy is not overly dependent on acquisitions.

While CLSA, not one of the stockbrokers monitored daily on the FNArena database, is comfortable on the outlook, as the stock has materially outperformed the broader market since FY17, an Underperform rating is maintained. Target is $3.30.

Credit Suisse believes management is taking a proactive approach by investing in innovation to deflect rising costs. As the company is making such investments the broker suggests Orora is unlikely to win in the "price" segment of the market, preferring a strategy of differentiation, particularly in Australasian fibre.

The commentary has not induced the broker to make material changes to earnings and valuation. The trading multiple is now closer to that of Amcor ((AMC)), which is a globally diverse packaging company that arguably supports a higher multiple. Credit Suisse believes Amcor's trading multiple would represent somewhat of a ceiling for Orora.

Australasia

The glass business has grown strongly and management has announced an investment of $35m towards a new warehouse in South Australia, to be completed by the first half of 2020 with a targeted return on investment of 15%.

Such investments suggest that the company is willing to maintain a competitive advantage and Morgans remains confident in the long-term growth prospects. Ord Minnett, too, is more confident in the growth expectations for the Australasian division and believes there is upside to earnings estimates.

The company's investment in the new glass warehousing capacity can be justified, in the broker's opinion, because of growth in the export market for Australian bottled wine. Orora has renewed its contract with the largest glass customer for another four years and will supply high-end bottles with anti-counterfeit features.

Orora has also signed a long-term renewable energy agreement with a new wind farm in Victoria, complementing the one signed in the first half with Pacific Hydro in South Australia. This is expected to reduce annual energy costs to around $7m from $12-16m. The energy deals mean 80% of the company's electricity requirements in Australia will be generated from renewable sources.

Meanwhile, the company is expecting its B9 plant will achieve 400,000 tonnes of production this year and, in successive years, can be engineered for 1-2% of incremental capacity per annum. This makes Credit Suisse confident in its forecasts for 5.6% growth in operating earnings for Australasian fibre in FY19.

There is also diminished sensitivity in the second half from changes in commodity costs, secured by locking in longer-term arrangements in a more advantageous local market. Credit Suisse calculates this achieves savings of $2.5m in the second half but has a minimal impact in the first half of FY19.

North America

In contrast, growth prospects in North America are softer. Some enterprise software systems problems at the Orora Packaging Solutions business has resulted in slower growth versus historical rates. The roll out of the system (SAP) is now almost complete and M&A opportunities are back in focus, although management has reiterated its intention to retain a disciplined approach.

Morgans believes the issues in North America are of a short-term nature and once the roll out is complete by August performance should improve.

Events such as Toys 'R' Us going into administration has also had a negative impact on earnings. The bad debt (Toys 'R' Us) at Orora Visual has exacerbated the risks and the provision has grown to US$2.5m from US$1.0m.

Credit Suisse conservatively models 2.0% sales growth in North America in FY19, less than the company is targeting because of this lost customer sales account. Credit Suisse models earnings expansion in the second half of 7.2% and projects a further increase to 7.7% in FY19 as Orora extracts synergy from its Orora Visual acquisitions.

Macquarie expects organic earnings and initiatives should mean growth continues, while there is potential for acquisitions, suspecting more activity over the next six months. There is steady progress on integration at Orora Visual although more work is required to get the business into shape, in the broker's view.

End markets remain challenged for growth in North America, yet Ord Minnett agrees there is potential for investment in the division.

Management has acknowledged it could take some time to pass through the recent paper price increase to customers and, similar to other industrial and distribution businesses in the US, rising freight rates may also challenge margins for the operations in the near term.

There are four Buy ratings and three Hold on FNArena's database. The consensus target is $3.50, suggesting 0.7% upside to the last share price.

Disclaimer: The writer has shares in the company.

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A2 Milk Growing Strongly Despite Slowdown

A transition to new infant formula packaging appears to have slowed revenue growth for a2 Milk but brokers believe the share price has over-reacted.

-Revenue growth still expected to be up 64-68% in FY18 -Yet, trading on a large PE multiple leaves no room for disappointment -a2 Milk intentionally running down old-labelled stock to limit discounting

By Eva Brocklehurst

A2 Milk ((A2M)) has guided to FY18 sales below consensus expectations, catching the market unawares and creating a downdraught for the share price.

A transition to new infant formula packaging appears to have slowed revenue growth and, while the outlook commentary is broadly consistent with the first half result, UBS suggests it implies -10% downgrades to market estimates that had assumed stronger gross margins and lower marketing costs.

The company expects FY18 revenue to be in the range of NZ$900-920m, up 64-68% year-on-year. Gross margins are expected to be in line with the first half and marketing costs to be NZ$82-87m versus prior expectations of $82-92m.

UBS reduces FY18 estimates by -5-10% to reflect the changes in guidance. Beyond FY18 downgrades are more modest, at -5-8%, and reflect a view that a2 Milk will benefit from recent increases in stage III pricing and increased penetration in China as well as the shift to higher margin products. The broker believes, at current levels, its valuation incorporates the outlook.

The update did not address all the market concerns, although Macquarie assesses the impact on channel inventory of new packaging explains a large amount of the difference to consensus expectations.

The market had assumed an acceleration of growth in the second half to 75-80%, suggested by the gains in the shares, while guidance implies growth around 50-60%. The company is continuing to actively support the daigou channel and Macquarie observes this is being carefully managed, given consumer sensitivity to the perceptions of older stock.

The company has been intentionally running down stock so that distributors are not left with old packaging, and to limit the chance of discounting.

The impact of the transition to new label formats in the June quarter appears to be larger than previously expected, Bell Potter agrees, and has taken some momentum out of revenue growth.

The broker still believes the business is high growth and, as the number of stockists in China and the US continue to increase, this is an indication of future earnings growth potential. Bell Potter, not one of the eight monitored daily on the FNArena database, has a Buy rating and $12.80 target.

Outlook

Multinationals that operate in the company's market are noting double-digit growth in consumption and management has stated that Nestle's new infant formula, Atwo, has had no noticeable impact on its sales, albeit it is early days for that product in the market.

The company's share of distribution in Australia has risen slightly to 9.6% and progress is being made in the US on its footprint. Macquarie estimates a2 Milk had an average share of 3.1% in the second half of FY17 and this has increased to 5.8% as of March 2018. Assuming this holds, it would imply around 90% growth in volume before market and pricing changes.

Citi downgrades to Neutral from Buy because of the increased uncertainty around the short-term outlook. The transition to new infant formula packaging should be a one-off but the broker remains concerned about re-seller price reductions.

Citi remains happy with the potential for infant formula growth in the long-term in China. Still, over the last few months, modest re-seller price reductions across Australian daigou stores and Chinese e-commerce platforms have been observed.

Reductions have the potential to lead to lower margins and make daigous hesitant to purchase new stock, Citi asserts. The company is guiding to -$5m less in second half marketing than originally planned, which the broker acknowledges partly offsets the earnings impact of the weaker sales.

Morgans downgrades FY18 net profit estimates by -8.7%, although forecasts NZ$192.1m, which is 112% above the prior year. This also includes a forecast for marketing expenditure to more than double.

While reducing forecasts for FY19 and FY20 net profit by -12.2% and -12.1% respectively, Morgans still expects the company to report earnings growth, reflecting wins in market share and increased distribution across geographies, as well as incremental growth from new products and the Fonterra strategic relationship.

While the miss to FY18 revenue is disappointing, Morgans accepts the reasons but points out that, trading on a large peer multiple, there is no room for disappointment in the stock.

Macquarie agrees this slightly disappointing trading update may mean the stock trades at a lower PE ratio in the near term, until the market regains confidence, but the backdrop to FY19 earnings is strong and the growth trajectory should continue.

FNArena's database has four Buy and two Hold ratings. The consensus target is $11.96, suggesting 9.2% upside to the last share price. This compares with $13.80 ahead of the update.

See also, A2 Milk Creaming Market Share In China on March 14 2018.

Treasury Wine Crushes China Worries

Brokers are relieved at how Treasury Wine Estates dealt with speculation that inventory was building up in China. Nevertheless, they disagree on valuation.

-Customer depletions in China have more than doubled and all brands show growth -Main issue in China is sustaining volume growth and extending reach beyond Penfolds -Outlook less clear for FY20 as 2017 was an inferior vintage

By Eva Brocklehurst

Treasury Wine Estates ((TWE)) has hit back at speculation regarding excess inventory in China, outlining the rigorous audit process that allows it to take action should distributors not play by the rules.

Most brokers were relieved with how the company dealt with the speculation that inventory was building up in China. The company has recently cut off supply to a number of customers after they failed to appropriately sell through the full portfolio of wine.

CLSA suggests these customers were not impressed with the move and are trying to manoeuvre their way back into accessing the company's wine. Treasury Wine has emphasised that picking and choosing wine by distributors/customers will not be tolerated and they need to sell the full portfolio.

Meanwhile, customer depletions in China have more than doubled in the last quarter and all brands are showing growth, so the company suggests there is no inventory problem. The response makes CLSA much more comfortable. The broker, not one of the eight stockbrokers monitored daily on the FNArena database, upgrades to Buy. Target is $21.

Morgan Stanley agrees that, even if the company is playing hard ball in China, in the long-term it will strengthen the stable of brands and, if Treasury Wine gives in to distributor demands, it would not be in full control of its marketing.

The broker believes the company's US wine is important to the expansion in China, estimating Treasury Wine generates $20m in annual sales of US product to China, or 8% of its sales to China.

Citi takes a different view. The broker is encouraged by the company's assertion that depletions grew 100% in the year to date in China, as this suggests any build up in inventory is not widespread, but questions why the company's lower-end wines are increasingly being discounted in e-commerce channels in China.

The price premium paid in China versus Australia for Rawson's Retreat was 30% last year and has been observed at 5% recently. The broker forecasts price per case for Treasury Wines Asia to fall -7% in FY18, the cause being a shift towards lower-priced wines.

Citi has a Sell rating and does not believe the pace of growth justifies the stock's P/E ratio, and there is downside risk to volumes as demand for brands other than Penfolds grows more slowly.

Distribution Centre

The company has acknowledged slower volumes in China since April because new labelling laws have specifically affected those with warehouses. Citi suspects this action is quite targeted and a reminder of the regulatory risks of dealing in China.

The Chinese government has cracked down on exports to Treasury Wines' Chinese distribution centre but the company is able to export directly to wholesalers and retailers, as Morgan Stanley understands it.

The distribution centre was established in 2017 to serve small customers and the financial impact of shipments being curtailed appears limited to the broker. Credit Suisse suggests the company can, for example, increase shipments to customer warehouses rather than its proprietary warehouse but ascertains that, for most investors, such situations are rather opaque.

Regardless, the main issue for the company in China is sustaining the pace of volume growth and extending reach beyond Penfolds, in Citi's view, and sustaining a healthy price per case would be the best evidence.

Moreover, because sales of premium Penfolds product is formally tied to sales of Rawson's Retreat and other brands like Wolf Blass, the broker considers this situation unsustainable and suggests consumer demand must ultimately determine sales.

Morgan Stanley calculates that excess quantities of brands outside of Penfolds, which is estimated to be 70% of the company sales in China, are unlikely to affect earnings significantly and is now more comfortable with the outlook.

The company reiterated guidance for operating earnings (EBITS) of $524m in FY18 and $655m for FY19, which Morgan Stanley believes underscores an unchanged outlook and signals the sell-off in the stock is overdone.

Credit Suisse asserts that the media reports were old news and exaggerated, noting that as far back as July last year there were issues in China around the Rawson's Retreat brand and the company had begun to rectify the situation.

Outlook

FY19 guidance for 25% growth in operating earnings is considered achievable and the issues are small enough to be contained. Nevertheless, FY20 consensus estimates are too high and the broker expects the stock to be range bound.

There is potential for an accretive acquisition but, unlike when the uncontested Diageo deal was done, interest rates have risen and the multiple the company is likely to pay for quality will be higher. Credit Suisse upgrades to Neutral from Underperform until there is more confidence surrounding FY20 estimates.

Also, the 2017 vintage was inferior to 2016 so the company may not have the uplift in luxury volume that will benefit FY19. 2018 is envisaged as a high-cost vintage which the company is now likely to defray with a new cost reduction program.

Ord Minnett is confident that the company is executing well, and having optimised the route to market for the wine in China is now doing the same in the US. The broker believes Treasury Wine is well-placed to access the structural growth drivers of the Asian wine market, despite recent customs issues in China.

The company has a disciplined approach to capital, which in the broker's view provides potential for strong earnings growth on a multi-year basis. While acknowledging the multiple is high, Ord Minnett suggests growth in earnings per share is also very high and maintains an Accumulate rating.

There are three Buy ratings, three Hold and one Sell (Citi) on the database. The consensus target is $17.13, signalling 0.6% upside to the last share price. Targets range from $13.30 (Citi) to $20.00 (Morgan Stanley, Ord Minnett).

Material Matters: Crude, Cobalt & Lithium

A glance through the latest expert views and predictions about commodities. Crude oil; iron ore; cobalt; and lithium.

-Upside for energy equities should oil prices stay at current levels -Changes in marine fuel standards will concentrate demand for oil -Cost pressures increasing for iron ore producers -Retracement in cobalt prices considered a buying opportunity -Morgan Stanley remains bearish on lithium as SQM asserts its dominance

By Eva Brocklehurst

Crude Oil

Morgan Stanley raises its oil price forecasts to US$90/bbl by 2020. The broker believes there is significant upside for energy equities should oil prices remain at current levels. The broker retains a Overweight ratings for Woodside Petroleum ((WPL)), Beach Energy ((BPT)), WorleyParsons ((WOR)) and FAR ((FAR)).

Morgan Stanley now expects Brent to average US$76/bbl in 2018 and US$80/bbl in 2019 and believes Beach Energy is the way to play the theme, as those companies that focus on free cash have been outperforming in North America and Australia is experiencing the same trend.

Upside risk to the sector remains, given the significant underinvestment since 2014 at the same time oil demand has stayed resilient. Expansion opportunities, nonetheless, depend largely on LNG markets, which appear to be strengthening.

Morgan Stanley also points to upcoming changes in marine fuel standards that will concentrate the demand for oil into a narrower part of the complex. This should drive both middle distillate and crude demand, requiring refining margins to rise.

The broker notes the shipping industry accounts for around 5% of global oil demand but remains responsible for 40% of oil-based sulphur emissions. The broker cites, for context, sulphur emissions for one cruise liner are the same as around 380m cars.

New regulations by the International Maritime Organisation that kick in at the start of 2020 are targeting this factor. Installing a scrubber to clean exhaust gases is one option that may allow shippers to use high-sulphur fuel oil but this is capital intensive.

Alternatively, they can convert to LNG but this option suffers from a limited distribution network. So far, shippers plan to use lower-sulphur fuels such as marine gasoil or very-low-sulphur fuel oil (VLSFO) blends.

Morgan Stanley suggests the new regulations could displace 2.5-3mbpd of high-sulphur (HSFO) demand and shift some of this into the middle distillate pool, creating a severe oversupply of HSFO and an equally tight market for middle distillates.

Middle distillate demand is growing strongly and inventory is approaching five-year lows, the broker observes. The new IMO regulation should add another 1.5mbpd to demand by 2020. Morgan Stanley expects the scramble for middle distillates will drive crack spreads higher and drag oil prices along.

Oil supply growth is dominated by condensate and LNG, from which refiners cannot make middle distillates. Middle distillates require crude oil in a ratio of 1.8 barrels for every one barrel of middle distillate. On current trends, therefore, crude oil supply would need to increase 5.7mbpd by 2020 and Morgan Stanley suggests this is unlikely.

Hence, the broker argues that middle distillate prices will need to rise to a level where demand slows, suspected to be the case when gasoil reaches US$850/t, ie around 25-30% above the current level.

Iron Ore

UBS observes cost pressures for iron ore producers are on the increase from rising oil prices, although transportation is a big differentiator between regional iron ore producers. The March quarter produced some hits to price realisation.

Fortescue Metals ((FMG)) reported price realisation of 62% in the quarter, down from 66% in the December quarter and from 71% in the September quarter. The broker notes, while discounts remain high for Fortescue, steel mills are prepared to pay a premium for high-quality iron ore, pellets and lump. Compared with September 2017, UBS assesses iron ore producers have had their break-even costs increase to US$30-$70/dmt from US$27-67/dmt.

Meanwhile, Vale's costs have reduced because of a weakening of the Brazilian real and ramp up of the lower-cost S11D asset. Conversely, costs for both BHP Billiton ((BHP)) and Rio Tinto ((RIO)) have increased because of a fall in the lump premium since September.

Numerous factors are affecting the market in the spreads between low and high quality iron ore. These include the restructure of the Chinese steel industry as the government cracks down on pollution. New supply from Australia and Brazil in the higher quality range of iron ore means less high-grade iron ore to blend and less low-grade iron ore being sought.

There has also been an increase in port stocks, specifically of low-grade iron ore and, in order to shift these stocks, large discounts are being offered.

Macquarie notes iron ore shipments from Western Australia have increased significantly over the past six weeks, although the increase may not be enough for either BHP or Fortescue to hit their FY18 shipment guidance.

In the June quarter a combined shipping rate of over 800mtpa is expected for the first time from the three big WA exporters. Any miss to guidance by the major producers is expected to present a positive catalyst for the broader iron ore market.

Macquarie suggests the recent rally in share prices has captured a significant proportion of the upside to price targets. Macquarie retains a preference for BHP over Rio Tinto and Outperform ratings for both Fortescue and Mt Gibson Iron ((MGX)).

Cobalt

The recent retracement of cobalt prices to US$89,000/t is a buying opportunity, Citi believes. The broker expects cobalt prices to rise by 20% over the next two years on the back of a sustained deficit, amid a build up in stocks, given high levels of supply risk. The broker expects prices will average US$100,000/t by the December quarter and US$110,000/t by 2020.

Even without the supply risks from the Democratic Republic of Congo materialising, the broker suggests cobalt will remain scarce and stockpiling continue. The DRC accounts for more than 60% of global supply and the majority of incremental supply in the next two years.

Battery producers and car manufacturers are observed to be signing deals or in talks with various producers to secure their future supply. Substitution is an issue but unlikely to be a game changer, in the broker's opinion, until 2020. Key applications susceptible to substitution are metallurgical, chemicals and super alloys, accounting for around 46% of global demand.

Lithium

Sociedad Quimica y Minera de Chile (SQM) has unique assets and leads the lithium market. Morgan Stanley estimates the company will double its lithium production in 2019 and double again by 2023. This will be positive for the company but negative for lithium prices.

The broker suggests the company is attempting to catch the jump in demand and expansions will come faster and larger than many suspect. The main bottlenecks to the company's intentions are the industrial plant licenses, which take around six months to be issued, while capacity then needs to be added to the industrial plant.

Nevertheless, arriving at an estimate of 200,000t capacity by mid 2023 does not require additional brine extraction or pond capacity. The broker suggests the company's expertise in lithium production is crucial for Chile to recover its global leadership in the product.

As a result, Morgan Stanley reiterates a bearish call on lithium, expecting an inflection point to come in the medium term. In 2019 the broker expects significant new capacity to begin placing prices under pressure, amid a continued de-rating of lithium-related equities.

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The Great Tech Tax Dodge

Richard (Rick) Mills Ahead of the Herd

Trump's next target, the great tech tax dodge

As a general rule, the most successful man in life is the man who has the best information.

Donald Trump's enmity towards Amazon and its founder Jeff Bezos, the richest man on Earth, has indeed been going on for a long time, and it's easy to frame the tiff as two billionaires marking their territory like two pit bulls in a fight ring. After all, Trump is a billionaire capitalist too, and it's not as though he hasn't done his fair share of tax dodging.

But the success of Amazon and other giant tech companies - Facebook, Twitter, Google, Apple and Microsoft come to mind - does run up against Trump's vision of America, where jobs are created or brought back to the United States, corporate taxes are kept low and companies pay them, and trade deals are fairly negotiated that do not put US firms at a disadvantage. It's all part of "Making America Great Again". Amazon represents the new economy where commerce is done online, the business is global, and tens of thousands of employees work for Amazon outside of the US.

While Trump has aimed his economic bullets at China, mostly, threatening $150 billion worth of tariffs, and his closest trading partners Canada and Mexico through the renegotiation of NAFTA, he has also brought Facebook and Amazon into the spotlight, the latter through his very public feud with Bezos, and the former due to Facebook's Cambridge Analytica scandal.

With every negative tweet Amazon loses billions. Since Axios first reported Trump is "obsessed" with the company on March 28, Amazon has lost $60 billion in market value. The tech-heavy Nasdaq has also been hammered, dragged down by heavyweights Amazon and Facebook, (although it's rebounded since the beginning of April) but also over the perception that Trump is envisioning more regulation on the sector.

"He's wondered aloud if there may be any way to go after Amazon with antitrust or competition law," according to a source who's spoken to the President. Whether or not that happens, there is absolutely no doubt that Trump has a point in his criticism of large tech companies for paying little to no taxes. This article is about the "great tech tax dodge" that Amazon, Facebook, Google, Apple and others have been practising for years. The colossal amount of money that has stayed out of the government's hands is a libertarian's dream, but it's also money that could have been put against the $20 trillion US debt, and that had to be covered by other companies and individuals who are paying their fair share, so that the US government could pay its expenses. If this article makes you hopping mad, it should.

Trump vs Bezos

Briefly, let's recap what Trump says about Amazon, and separate some of the truth from fiction. The fight began in 2015 when Trump accused Bezos of using the Washington Post, the newspaper he owns, as a tax shelter for Amazon - even though the Post is owned by Bezos, not Amazon. But that hasn't stopped Trump from calling the Washington Post a "lobbying tool for Amazon" through anti-Trump Administration coverage that fits with politicians who are sympathetic to Amazon and are unlikely to go after its tax policy.

Amazon is a tech behemoth that is also a retail industry disruptor. It employs some 566,000 people worldwide, 341,400 more than it did at the end of 2016. Nearly two-thirds of US households have an Amazon Prime account. Online sales now account for 11.7% of total retail sales, according to Forbes, while major retailers like Sears and Macy's have closed hundreds of stores. Axios points out that Trump is a man of the 1950s, whose wealthy friends tell him Amazon is destroying their businesses - such as shopping malls and bricks and mortar stores:

"Trump told Axios last year he doesn't mind Facebook because it helps him reach his audience. He's an old-school businessman who sees the world in terms of tangible assets: real estate, physical mail delivery, Main Street, grocery stores. It reminds me of the story Jim [VandeHei] wrote a while back about Trump's fixation with 1950s life. Amazon takes direct aim at some of the core components of mid-century business."

More practically, Trump takes issue with Amazon using the US Postal Service to deliver its packages, claiming Amazon pays less than it should, as well as skirts paying state taxes. It's been shown that in fact Amazon pays the same low rates as other bulk shippers and collects sales tax in every state that charges it. But that's not the real issue here. The real issue is how much tax Amazon and other tech companies have avoided paying. It is truly mind-boggling.

Trump carried his apparent hatred of Bezos and Amazon into the election campaign, using the company as a whipping boy to drum up support for tax reform. This also included lowering the corporate tax rate - before the tax bill was passed in December US corporate taxes were among the highest in the world - which fit into Trump's vision of repatriating profits long held overseas by companies like Amazon and finally making them pay what they owe. Lower-taxed companies would be more profitable and therefore create more jobs in America, his thinking went, although that hasn't actually happened.

Repatriation 2.0

The Republican tax overhaul lowered corporate taxes from 35 to 21%, and also changed the rules around the repatriation of corporate profits from the estimated $2.6 trillion in profits multinationals hold overseas. Bringing them back to America ("repatriation") would mean getting taxed at 35% so most large companies deferred them, meaning they were kept offshore tax-free. Under the new law, these profits get mandatorily taxed, one time, at either 15.5% for cash holdings or 8% for illiquid investments. For example Apple under the new legislation is allowed to repatriate $252 billion in foreign cash, and will pay just $39.1 billion, or 15.5% in taxes, not 35%.

While Reuters points out that companies can manipulate their cash positions so they pay the lower rate, thus saving billions in taxes, the main point is that unless new laws are passed to avoid the tax dodges practised by the big tech companies and other large American firms, the IRS will continue to lose out "bigly", to use a Trumpism.

And the IRS isn't the only loser from this repatriation game. When repatriation was done by President George W. Bush back in 2004, the idea was the same (Ie. to spark an investment boom with all that cash plowed back into US companies) but it was regarded as an abject failure because up to 92% of the profits went into share buybacks - which as we have written about recently, benefit company executives, not individual shareholders. Why? Because repurchasing shares means money is not being spent on the company itself, such as buying new equipment or expanding, while also inflating earnings per share by reducing the share count. Buybacks also make it easier for executives to hit targets, and receive bonuses, by reducing the number of shares.

Tax evasion: by the numbers

You probably figured that most big companies hire large accounting firms to help them minimize their tax burden, and you'd be right. But the problem goes much deeper than this. Did you know that almost a quarter of large profitable US corporations in 2012 paid no tax at all? That's right. Zilch.

Those that did, paid well below the 35% corporate tax rate - on average, 14% between 2008 and 2012 according to the Government Accountability Office (GAO).

"There is something profoundly wrong in America when one out of five profitable corporations pay nothing in federal income taxes," Democratic presidential candidate Bernie Sanders, who asked for the numbers, said. "We need real tax reform to ensure that the most profitable corporations in America pay their fair share in taxes. That means closing corporate tax loopholes to raise the revenue necessary to rebuild America and create millions of jobs." Tax reform. Probably the only thing that Trump and Sanders agree on.

The GAO explains the discrepancy as due to tax deductions for losses companies had in previous years that they carried forward. Or making profits offshore that they haven't yet brought back to the US. But there's something much more nefarious going on, as we shall soon see. But first, another few numbers.

The IRS estimates that tax evasion cost the federal government $458 billion a year between 2008 and 2010; the tax collectors think only $52 billion of that will ever be recovered.

Another report from Oxfam found that the country's 50 largest corporations have stashed over a trillion dollars offshore (the total is actually $2.6 trillion, as mentioned above), in over 1,500 subsidiaries in tax havens like the British Virgin Islands and the Caymans, costing the US government about $111 billion annually. In case you were wondering, this practice isn't illegal.

Just take Apple as an example. The Panama Papers investigation found the iPhone maker had accumulated $252 billion in offshore profits. Out of $41 billion Apple made in non-US profits, it paid taxes of just $2 billion, or 4.8%. Worldwide, multinationals withhold an estimated $500 billion from public coffers, The Guardian reported.

Sixty years ago corporations paid a third of federal government revenue; today, they pay about one-tenth. According to Americans for Tax Fairness, the average American family paid more taxes in one year than General Electric and dozens of companies paid in five.

How they do it

One of the most common is known as "tax inversion". Here the large company buys a smaller company in another country. The larger company then takes the smaller company's citizenship. This allows the larger company to take advantage of the foreign country's lower tax rate without actually moving operations. The larger company also doesn't pay the US tax rate on profits it earns overseas, until it repatriates them.

Three other tactics for avoiding taxes are:

The US firm channels its profits through a subsidiary and then makes the subsidiary "disappear" by checking a box on an IRS form. The company sells the right to patents and licenses to an offshore subsidiary, in a tax haven, at a low price. The subsidiary then licenses back to the US parent at a steep price, allowing it to sell its products in the US. This makes it appear the company is making profits in the tax haven rather than the US. This is Amazon and Google's preferred means of tax evasion (see below). Banks and firms with large financial units move US profits offshore using the "active financing exception" which makes it easier for multinationals to expand overseas. They avoid tax by creating "captive" foreign financing and insurance subsidiaries. Big US tech companies have become experts in using some or all of these methods in different and complex variations.

Amazon

Jeff Bezos' distaste for paying taxes goes as far back as 1995 when he was deciding where to set up his new e-commerce business. The story goes that his first choice was an Indian reservation near San Francisco where the taxes would have been considerably lower than anywhere else, but California vetoed the plan.

Bezos didn't give up, and found the best way to be a tax evader was to get out of the US. Not literally, but by setting up his global headquarters in Luxembourg, of all places. There are reportedly 1,400 Amazon employees in the tiny landlocked European nation, compared to over 40,000 in Seattle.

The relationship with Luxembourg gets even juicier when one discovers that Jean-Claude Juncker, the former Luxembourg Prime Minister, and the current head of the European Commission (the executive branch of the EU) helped Amazon to locate there and met with several Amazon tax officials to set up the company's European tax structure - allegations which Juncker of course denies.

Newsweek reports the tax structure was organized through "a labyrinth of subsidiaries designed to shift profits into Luxembourg" called Project Goldcrest:

"Project Goldcrest, which is still in place, uses a series of complex intercompany contracts to transfer intangible assets—vital software, trademarks and other intellectual property (IP)—to one of Amazon's Luxembourg companies, Amazon Europe Holding Technologies. A separate subsidiary, Amazon EU Sarl, then pays AEHT huge sums every year in royalty fees, reducing the amount of taxable income within the company.

In return for controlling the European licensing rights, AEHT makes payments to one of Amazon's U.S. companies. U.S. authorities believe these payments are too low, which is why the case has gone to court. Amazon has largely avoided federal taxation by managing its books to avoid reporting any meaningful profits over the past 20 years. In the last quarter of 2015, for example, Amazon paid just $73 million in taxes on $35.7 billion in revenues." (Newsweek)

The European Union accused Luxembourg of giving illegal tax breaks to Amazon and ordered the country to recover $295 million in back taxes. The IRS then took Amazon to court, but lost in a landmark case in 2017 - meaning that Amazon avoided having to pay $1.5 billion in taxes.

The IRS said "Amazon overestimated the value of 'intangible' assets, such as software and trademarks, it had transferred to a Luxembourg unit, Amazon Europe Holding Technologies SCS" according to Fortune.

Amazon reportedly made $5.6 billion last year and paid nothing in federal taxes. The e-commerce giant, whose CEO's net worth is $105 billion, is projecting a $789 million windfall from the Republicans' tax bill. Meanwhile a January report found more than 10% of Amazon employees in Ohio rely on food stamps to buy groceries.

Amazon also pads its profits by allowing customers to avoid state sales taxes and share the savings according to Business Insider.

Other countries in which Amazon does business have also lost out on billions in tax revenue. The Mirror reported in 2016 that five of the world's biggest tech companies avoided paying over a billion British pounds in taxes. Amazon, Apple, eBay, Facebook and Google reported revenues of just £2.6 million but the UK sales of the five firms were closer to £18 billlion - a discrepancy that meant the five paid just £45 million in corporation tax - a rate of 0.25%.

A February Esquire article on Silicon Valley's "tax-avoiding, job-killing, soul-sucking machine" notes "The Big Four" tech giants - Amazon, Apple, Facebook and Google - have a combined market cap of $2.8 trillion (the same GDP as France) and represent a quarter of the S&P 500 Top 50. With a market value of $591 billion Amazon is worth more than Walmart, Costco, T. J. Maxx, Target, Ross, Best Buy, Ulta, Kohl's, Nordstrom, Macy's, Bed Bath & Beyond, Saks/Lord & Taylor, Dillard's, JCPenney, and Sears combined, writes author Scott Galloway. Facebook and Google (now Alphabet) are together worth $1.3 trillion.

Between 2007 and 2015, Galloway calculates Amazon paid 13% of its profits in taxes, Apple 17%, Google 16%, and Facebook 4%. Recall the corporate tax rate until 2018 was 35% and the average tax rate for the S&P 500 was 27%.

Google/ Alphabet

What do Ireland, Holland and Bermuda have in common? Nothing, apart from the fact that the three countries are linked into a complicated scheme for California-based Google to take advantage of loopholes that help it avoid paying US taxes. In 2003, the year before it went public, the world's most well-known search engine started moving the parts in place. It first transferred all its intellectual property to an entity it set up called Google Ireland Holdings. Why Ireland? Because the home of leprechauns, shamrocks, some pretty good whiskey and U2 has a lower tax rate than the US and allows Google Ireland Holdings to be incorporated there but "managed" in Bermuda, which has no corporate tax. Another Irish subsidiary, Google Ireland Limited, was created and granted a license to use the technology owned by Google Ireland Holdings. Google Ireland Limited is the company that licenses Google's technology to other countries, for which it is paid royalties. And in the final step, Google Ireland Limited moves its profits to Bermuda.

A report in The New York Times states that in 2015, $15.5 billion in profits went to Google Ireland Holdings in Bermuda, despite having no employees there. That equates to each inhabitant of the island making the company $240,000. The tax shell game saved Alphabet, Google's parent company, $3.6 billion in taxes.

NYT also drops this gem: nearly two-third of all profits made by US multinationals are reported in six countries where the tax is either zero or very low: the Netherlands, Bermuda, Luxembourg, Ireland, Singapore and Switzerland.

With me so far? Now it gets complicated. Adding another layer of tax avoidance known as the "Double Irish", which sounds a lot like a hardball, a pair of Irish companies are formed to turn intellectual property payments into tax-deductible royalty payments. Google then forms a subsidiary in Ireland and signs the European intellectual property rights to the new company. The subsidiary in return gets to market the products in Europe - meaning all the European income is taxable in Ireland rather than the US. However no tax is paid in Ireland at this point, because the Irish subsidiary moves its headquarters to Bermuda. A second Irish subsidiary is disregarded for US tax purposes by ticking a box on the IRS form (see bullet point one above). The first Irish company then licenses products to the second Irish company, which receives royalties. The result is a 12.5% tax rate in Ireland versus 35% in the US (now 21%). The tax can be reduced further because the royalties going to the Bermuda company are tax-deductible. According to SEC filings, Alphabet's tax rate outside the US was 6.4% in 2015.

With a "Dutch Sandwich", the arrangement starts with a Double Irish, and adds a third subsidiary in the Netherlands, which according to Forbes, is Google's model. Facebook and Google are thought to use similar tax structures, with Facebook reportedly flipping over $700 million to the Cayman Islands as part of a "Double Irish".

Facebook

Facebook has been in the news a lot lately over privacy concerns relating to the hijacking of personal data by a political firm, but it is less known that the world's largest social media platform is also one of the most successful tax dodgers. Think about that next time you "like" something. Along with offshore tax shelters, Facebook avoids paying US tax through a loophole whereby highly paid employees receive stock options rather than a salary. When companies do this, they get big tax deductions. For example, an executive is given the option to buy a million shares at 5 cents apiece, and later cashes them when they're at $20 a share. The difference can be deducted by the company as a tax break, as explained by Mother Jones. The companies can "store" these tax breaks, allowing them to avoid paying taxes for years. The chart below shows how much tax 12 companies saved through this loophole:

Mother Jones bashes a counter-argument that the executive who cashes in his options has to pay income tax at a higher (individual) rate versus the corporate rate, because under the loophole the company is allowed to effectively write off the employee's salary:

"If Facebook buys Zuckerberg a lottery ticket for a buck, and then he wins a million dollars, should the company be able the write off that million? That's absurd, but that gives you a sense of what's going on here," the publication quotes Matt Gardner, executive director of the Institute on Taxation and Economic Policy.

Facebook is also playing tax games in the UK with its British arm. The Guardian notes in 2014 the company's UK employees received over £210,000 in pay and bonuses, while Facebook UK paid just £4,327 in corporation tax. Facebook also inexplicably reported a loss that same year of £28.5m, enabling it to pay under £5,000 in taxes, despite shelling out over £35m to its 362 staff in a share bonus scheme.

Apple

Who doesn't love Apple, with its user-friendly operating system, easy compatibility between devices, and shiny lightweight phones? You, once you learn about how America's favorite handheld company manages to dodge billions in corporate taxes.

Earlier I mentioned that Apple under the new tax code will pay $39.1 billion in taxes at the new 15.5% rate for repatriated foreign cash totalling $252 billion. At the previous 35% rate it would've paid $78.6 billion in taxes - enabling Apple to avoid nearly $40 billion in taxes. Hardly something worth cheering about. Fortune also notes that between them, Microsoft, Facebook, Apple and Alphabet spent $16.3 million in the third quarter lobbying the federal government for a one-time, 15.5% "tax holiday" for their repatriated overseas profits. Even more galling is that Apple announced that it's planning to create 20,000 new jobs as a result of the tax changes. But as Fortune columnist Josh Hoxie, director of the Project on Opportunity and Taxation, opines, the last time firms were allowed to repatriate cash held overseas, in 2004, the top 15 repatriating firms actually cut their US workforce by 21,000 jobs.

Apple is also no dummy when it comes to offshore tax loopholes. According to the Paradise Papers, in 2014 Apple learned that Irish tax authorities were going to close loopholes it had used to funnel overseas profits sheltered from US tax. The tech giant therefore simply moved its tax shelter to Jersey, the English Channel island, which does not tax corporate income. US Senators were apparently incensed by the move, including Republican Senator John McCain, who said:

"Apple claims to be the largest US corporate taxpayer, but by sheer size and scale it is also among America's largest tax avoiders ... [It] should not be shifting its profits overseas to avoid the payment of US tax, purposefully depriving the American people of revenue."

Well said, John.

Conclusion

US technology companies have rewarded shareholders and been a major force behind the stock market bull over the past few years, so it's easy to look the other way if you're one of the ones sharing their profits. But the success of tech comes at a price, and it's a price being paid by US taxpayers who are owed a hell of a lot more than they're getting from these corporate tax avoiders - some who it should also be noted, are making huge profits off of the backs of their users, who either willingly or without their knowledge, are surrendering their private information to advertisers who are free to pester them with pop-up ads and videos that follow people around like a bad smell.

It's time to get serious about corporate tax evasion. The simplest solution would be to tax multinationals on where they actually do businesses, not where they artificially, and opaquely, shift their profits. Like to Bermuda, the Cayman Islands or Jersey. But nothing will happen unless officials at the highest level of the US government force them to change their tax, or more appropriately, anti-tax policies. Enter President Trump. Love him or hate him, Trump may be the guy to take the tech giants to the wall. And make them finally pay what they owe. Are you pissed off, have you got the great tech tax dodge on your radar screen?

If not, perhaps you should.

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Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

Guide:

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

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

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

Summary

Period: Monday May 7 to Friday May 11, 2018 Total Upgrades: 12 Total Downgrades: 19 Net Ratings Breakdown: Buy 44.93%; Hold 40.29%; Sell 14.78%

The sharp recovery in (in particular) cyclicals and other laggards in the Australian share market has triggered a flurry in rating changes among stockbroking analysts. For the week ending Friday, 11th May 2018, FNArena counted twelve upgrades for individual ASX-listed stocks versus 19 downgrades.

Also obvious: most companies releasing financial results and quarterly market updates this month are triggering negative responses. If it weren't for exceptions such as Macquarie Group, Xeroa and REA Group, and for positive momentum behind miners and energy producers, underlying momentum would be a lot weaker.

Only six out of the twelve upgrades leapt to a Buy, with Platinum Asset Management receiving three upgrades during the week, but only one to Buy. Challenger received two upgrades to Buy following the Federal Budget's attempt to stimulate retirees into buying more annuities.

On the flipside, seven out of the 19 downgrades moved to Sell. AMP received two downgrades, with only one moving to Sell. Other stocks receiving a Sell downgrade include Greencross (profit warning), Independence Group (profit warning), Incitec Pivot (disappointing FY18 result) and Woodside Petroleum (Citi taking a negative view on LNG outlook).

Premium priced outperformer Macquarie Group commanded pole position for the highest gain in consensus price target for the week, on the back of yet another strong result, followed by CSR (FY18 report), Super Retail, and Challenger. Negative adjustments on average were larger with the biggest hit for AMP, followed by Incitec Pivot, Link Administration, and IOOF Holdings.

Macquarie Group equally took top position for positive revisions to earnings estimates, followed by Downer EDI, Pendal Group, and Oil Search. Again, negative adjustments are larger, with Incitec Pivot suffering the largest blow to forecasts, followed by Baby Bunting, CSR, Independence Group, then National Australia Bank.

Local reporting season continues this week, alongside investor days, AGMs, quarterly updates and major banks going ex-dividend.

Upgrade

BABY BUNTING GROUP LIMITED ((BBN)) Upgrade to Neutral from Sell by Citi .B/H/S: 2/2/0

Citi believes its sell thesis surrounding disruption from competitor closures has played out quicker than expected. The broker upgrades to Neutral/High Risk from Sell, envisaging the risks over the next 12 months as evenly balanced. Operating momentum is expected to improve following the latest round of competitor closures.

The broker trims FY18 forecasts to reflect downgraded guidance but upgrades FY19 forecasts to reflect market share gains, and believes the company is well-placed to be the winner in the fall-out from competitors. Target is raised $1.50 from $1.20.

CHALLENGER LIMITED ((CGF)) Upgrade to Buy from Neutral by Citi and Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 3/3/1

The changes mooted in the 2018 federal budget to the age pension suggest test requirements for retirement products are more favourable for the product providers than previously proposed.

The rules change the way in which lifetime annuities interact with the age pension by altering the amount to be included in means test calculations.

Aged care changes may also be favourable for the company's CarePlus product. Partly offsetting this positive news for the company, Citi suggests Japan may not be as strong a growth option as previously thought.

Rating is upgraded to Buy from Neutral. Target is raised to $13.60 from $11.20.

Credit Suisse has become more optimistic around the growth drivers for Challenger. The stock has underperformed the market by around -15% in the past 12 months and the broker considers the share price is now attractive again.

There had been some concern that means testing of lifetime products would be negative for annuities and lead to a slowdown in the company's annuity sales. However, Credit Suisse observes there remains a strong case for the purchase of a lifetime annuity by those with higher assets, although account-based pension still offer better value for those with less assets.

The broker upgrades to Outperform from Neutral. Target is steady at $13.20.

DOMINO'S PIZZA ENTERPRISES LIMITED ((DMP)) Upgrade to Neutral from Sell by Citi .B/H/S: 2/5/1

Citi analysts now believe the specific risks surrounding Domino's Pizza have been priced in, suggesting limited downside, apart from day-to-day volatility. Hence the rating is upgraded to Neutral from Sell.

Interestingly, the analysts do not think the company will achieve its 20% growth target for the running year, but forecast 16% instead, with the added comment this is in line with market consensus.

The analysts are anticipating a tighter trading range. Price target $44.60.

MACQUARIE GROUP LIMITED ((MQG)) Upgrade to Neutral from Sell by Citi .B/H/S: 3/4/0

Macquarie is "firing on all cylinders", in Citi's words, with Friday's FY18 result boosted by lower taxes. Plenty of growth opportunities are on the horizon. So what's not to like?

Citi had, until now, stoically stuck with a below the market price target accompanied by a Sell rating, but today is the day. Sell rating upgraded to Neutral while the price target makes a leap all the way to $110.15 from a miserly $79.50. It's called vindication, or from a different angle: egg on the face.

The analysts have now joined the chorus of peers predicting guidance for the year ahead will prove conservative.

PLATINUM ASSET MANAGEMENT LIMITED ((PTM)) Upgrade to Neutral from Underperform by Credit Suisse and Upgrade to Buy from Sell by Ord Minnett and Upgrade to Neutral from Underperform by Macquarie .B/H/S: 1/3/0

The fund manager has underperformed the market by some -30% since its first half result, Credit Suisse notes, as sentiment drove the PE down to 16x from 21x. It is still the most expensive under the broker's coverage, but net flows are positive and fund performance remains strong.

On that basis the broker has left its target unchanged at $5.50 but upgraded to Neutral from Underperform.

Ord Minnett observes the business performed well in April, with weighted average investment returns of over 2.5% and over $50m of net inflows. Following a marking to market, the broker's forecasts are little changed.

The target is reduced to $6.50 from $6.64, which now offers 16% upside in addition to a fully franked FY19 yield of 5.5%. With over 20% total shareholder return on offer, sustained net inflows and the stock trading at the low end of its PE range the broker upgrades to Buy from Sell.

Macquarie estimates $500m in net inflows in April and suggests the announcement that Kerr Neilson was stepping down as CEO of the flagship fund is having less impact than initially anticipated.

Rating is upgraded to Neutral from Underperform. Target is raised to $6.25 from $6.11.

RESAPP HEALTH LIMITED ((RAP)) Upgrade to Add from Hold by Morgans .B/H/S: 1/0/0

The company expects to report the headline results from two clinical studies by mid this year. The company has now enrolled 640 patients in its SMARTCOUGH-C-2 study to evaluate the efficacy of the ResAppDx smartphone application in the diagnosis of childhood respiratory diseases.

Morgans makes no changes to forecasts but reduces the discount to valuation ahead of the expected release of the key clinical results. Rating is upgraded to Add from Hold and the target to $0.28 from $0.12.

SUPER RETAIL GROUP LIMITED ((SUL)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 4/4/0

Ord Minnett considers the Australian consumer outlook robust because of employment growth, while the launch of Amazon has been underwhelming.

Despite the company's recent share price performance, the broker considers the risk/reward ratio for investors is attractive, even if only the automotive and capital targets are met. The broker upgrades to Buy from Hold and raises the target to $9 from $8.

WISETECH GLOBAL LIMITED ((WTC)) Upgrade to Buy from Neutral by Citi .B/H/S: 2/1/1

Following the company's inaugural investor briefing Citi upgrades to Buy from Neutral and increases revenue forecasts for FY19-20 by 3-10%.

The target jumps to $14.12 from $9.51 because of the expansion in FY19 peer multiples and an increase to the stock's premium, reflecting greater confidence in the company's organic growth trajectory.

Growth is expected to be led by new product developments and the ability to integrate acquisitions over the medium term.

XERO LIMITED ((XRO)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 1/3/1

The company reported a net loss of NZ$27.8m, better than expected. Macquarie observes FY18 was a transition year as the company reported its first positive EBITDA and operating cash flow. The improvement reflects ongoing growth in the subscriber base.

Earnings are beginning to highlight the significant operating leverage within the business and Macquarie upgrades assumptions. Rating is raised to Neutral from Underperform. Target is increase to $37.00 from $27.19.

Downgrade

AMP LIMITED ((AMP)) Downgrade to Neutral from Outperform by Macquarie and Downgrade to Sell from Neutral by UBS .B/H/S: 3/4/1

AMP sustained net outflows of -$200m in the March quarter. As this reflects the performance prior to the Royal Commission, Macquarie expects a further negative impact on flows to be evident from the June quarter onwards.

The broker envisages limited upside to the share price amid the continued distraction from the fall-out of the Royal Commission and downgrades to Neutral from Outperform. The broker also transfers coverage to another analyst. Target is reduced to $4.30 from $5.65.

UBS believes there are numerous risks and operating challenges that cannot be readily quantified and the business faces a 2-3-year rebuild before management, structure, governance and operating stability return. Moreover, turnarounds in insurance always take longer.

Accordingly, the broker is unable to recommend the shares on a 12-month view and downgrades to Sell from Neutral. Target is reduced to $3.80 from $5.40.

AURIZON HOLDINGS LIMITED ((AZJ)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 2/2/3

Morgan Stanley believes the company's activist regulatory campaign adds uncertainty and reduces the opportunity for cost reductions and top-line growth.

The broker suspects the market may not be fully pricing in the low margin for safety as the campaign will be long, public and drawn out and the Queensland intermodal sale may not proceed.

Morgan Stanley downgrades to Underweight from Equal-weight. Target is reduced to $4.00 from $4.88. Industry view: Cautious.

CSR LIMITED ((CSR)) Downgrade to Underweight from Equal-weight by Morgan Stanley .B/H/S: 1/3/2

FY18 results were broadly in line with Morgan Stanley. The main negative came from energy cost pressures in aluminium. The broker suggests earnings have likely peaked and downgrades to Underweight from Equal-weight. Target is reduced to $4.75 from $5.00.

The inevitable decline in overall Australian housing construction suggests that FY18 is almost certainly to be the peak and the broker suggests a one-off spike in property sales may be the only thing that can change this scenario. Industry view: Cautious.

GOODMAN GROUP ((GMG)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 3/4/0

Guidance for FY18 has been reaffirmed at 46.5c in earnings per share, up 8%.

Although Deutsche Bank expects ongoing strength in the e-commerce sector will drive demand for industrial assets, the share price has increased 14% since it previously upgraded to Buy.

Hence, now the stock is trading ahead of the target of $8.80 the rating is downgraded to Hold.

GRAINCORP LIMITED ((GNC)) Downgrade to Hold from Add by Morgans .B/H/S: 1/4/0

While it is early in the new season, Morgans believes it prudent to revise FY19 forecasts given the poor start to cropping conditions on the east coast.

Over February to April rainfall across most cropping regions, particularly in NSW and Victoria, was very much below average. These regions also experienced some of the warmest temperatures on record.

The broker downgrades to Hold from Add. Target is reduced to $8.00 from $8.47.

GREENCROSS LIMITED ((GXL)) Downgrade to Sell from Hold by Deutsche Bank .B/H/S: 0/3/1

The company's update highlighted a sudden deterioration in the veterinary business, a segment which Deutsche Bank had expected to be more stable. Revenue has been affected by a reduction in visits to stand-alone clinics.

The broker believes the earnings trajectory bodes poorly for FY19, especially given the competitive intensity in the industry and the large debt the group is carrying. Rating is downgraded to Sell from Hold. Target is $3.70.

IOOF HOLDINGS LIMITED ((IFL)) Downgrade to Neutral from Buy by UBS .B/H/S: 4/1/0

The business has not yet appeared in front of the Royal Commission and, therefore, UBS observes, sidestepped the direct fall-out affecting other vertically integrated operators.

Still, as an almost pure play in the sector, the broker believes cost and flow implications are more pronounced. The business would be most impacted under a scenario where advice and platforms are structurally separated, and UBS ascribes a notional 20% probability to this.

The broker downgrades to Neutral from Buy, given the value constraints until the risk dissipates. Target is reduced to $10.00 from $11.50.

INDEPENDENCE GROUP NL ((IGO)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 0/4/2

March quarter production was weak, Macquarie observes. Given the increased risk of misses to production and cost guidance the broker downgrades to Underperform from Neutral.

Incorporating the weaker result drives a -10% reduction to earnings estimates for FY19 and FY20. Target is reduced to $4.60 from $4.90.

INCITEC PIVOT LIMITED ((IPL)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 3/3/1

Headwinds in Australian explosives are increasingly apparent, and there is some uncertainty around capital expenditure and costs from an extended maintenance cycle, Credit Suisse observes.

In the absence of a significantly improved outlook for fertiliser prices the broker suggests earnings are likely to be relatively flat for the next two years. Rating is downgraded to Underperform from Neutral. Target is reduced to $3.39 from $3.85.

ISELECT LIMITED ((ISU)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 0/1/0

Credit Suisse considers the company could be a contender for the downgrade of the year. While shifting too far away from search engine marketing in the second half was a key misstep that could be rectified, rising customer acquisition costs may be an ongoing issue.

Missteps have played a large role, although the size and speed of the reduction in earnings in the second half has raised questions about the profitability of the business model. Credit Suisse believes extremely low earnings visibility is matched only by a low conviction in forecasts.

Rating is downgraded to Neutral from Outperform. Target is reduced to $0.58 from $1.95.

JB HI-FI LIMITED ((JBH)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 3/3/2

Deutsche Bank's investigations indicate that, while competition has been an issue for The Good Guys in terms of margins, the sales mix has been a larger problem.

The business is without enough skilled sales staff and incentive structures, as a result of the takeover, to up-sell consumers to high margin premium appliances.

The broker suggests margins are likely to remain weak for some time. While JB Hi-Fi's valuation is not demanding, Deutsche Bank downgrades to Hold from Buy. Target is $24.

LINK ADMINISTRATION HOLDINGS LIMITED ((LNK)) Downgrade to Neutral from Buy by Citi .B/H/S: 2/4/0

It's the "material uncertainty" that has triggered the downgrade to Neutral from Buy, with Citi analysts adding the loss of the CareSuper contract, while small in impact, is not helping sentiment either.

The proposed measures in the Federal Budget are now overshadowing the positive narrative, and Citi analysts have decided to slightly reduce their forecasts, and cut their target to $8.10 from $9.85, on the uncertainty that will linger for longer.

MINERAL RESOURCES LIMITED ((MIN)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 2/2/0

The company intends to sell 49% of Wodgina as part of an offtake and partnering process. Ord Minnett values Wodgina at $2.4bn on a 100% basis. Wodgina accounts for $12.60 a share or 65% of valuation.

The broker believes Wodgina can largely self-fund its vertical integration, so Mineral Resources will need to consider how much of the sale proceeds should stay with the joint venture, how much should be spent on other businesses and how much returned to shareholders.

Ord Minnett downgrades to Hold from Accumulate. Target is $19.50.

ORIGIN ENERGY LIMITED ((ORG)) Downgrade to Neutral from Buy by Citi .B/H/S: 5/3/0

Citi transfers coverage of Australian energy to another analyst. In the large cap stocks the broker's top pick is Caltex ((CTX)) followed by Origin Energy, which is downgraded to Neutral from Buy. The broker raises the target to $10.13 from $10.06.

SUNCORP GROUP LIMITED ((SUN)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 5/2/1

The share price has risen 10% since mid February and Credit Suisse downgrades the rating back to Neutral from Outperform. Target is unchanged at $14.50.

The broker remains confident the business will deliver a significant turnaround in underlying insurance margin in the second half and supports the business improvement program.

However, Suncorp has suffered from volume loss recently and ongoing premium rate increases may mean this continues and reduces some of the potential earnings upside.

SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Downgrade to Hold from Add by Morgans .B/H/S: 5/2/0

The company has outlined its growth opportunities at the investor briefing. After the NSW and federal elections the business intends to lobby for an easing of regulatory restrictions related to aircraft movement caps and regional flights.

Morgans makes reductions to long-term forecasts and assumes a slowing of distribution growth beyond FY18. The broker downgrades to Hold from Add because of the recent strength in the share price. Target is reduced to $7.12 from $7.45.

TPI ENTERPRISES LIMITED ((TPE)) Downgrade to Hold from Add by Morgans .B/H/S: 0/1/0

Morgans downgrades to Hold from Add, given the ongoing uncertainty and a lack of visibility as the business transitions. The broker continues to expect a strong operating performance will be needed to restore investor faith in management.

Post the acquisition of the API and contract manufacturing divisions of Norwegian based Vistin the company has made a strategic decision to focus on narcotic raw material production and higher opiates ingredients downstream processing, reducing the emphasis on external sales and toll processing. Target is reduced to $1.77 from $2.79.

WOODSIDE PETROLEUM LIMITED ((WPL)) Downgrade to Sell from Neutral by Citi .B/H/S: 2/4/2

Citi transfers coverage of its Australian energy sector to another analyst. The broker's pecking order now places LNG-exposed names such as Woodside and Oil Search ((OSH)) as its least preferred.

There is speculation that changes to the Petroleum Resource Rent Tax may be introduced in the federal budget, although Citi points out that last year's budget was also flagged as one where changes would be made that never transpired. This year may be different as the government is not preoccupied with gas market reform.

The broker envisages potential for the market to over-react if the media articles prove accurate regarding proposed changes. A bear scenario is one where the government introduces more drastic measures, such as an offshore royalty.

Citi downgrades to Sell from Neutral. Target is raised to $28.68 from $28.34.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 BABY BUNTING GROUP LIMITED Neutral Sell Citi 2 CHALLENGER LIMITED Buy Neutral Citi 3 CHALLENGER LIMITED Buy Neutral Credit Suisse 4 DOMINO'S PIZZA ENTERPRISES LIMITED Neutral Sell Citi 5 MACQUARIE GROUP LIMITED Neutral Sell Citi 6 PLATINUM ASSET MANAGEMENT LIMITED Neutral Sell Macquarie 7 PLATINUM ASSET MANAGEMENT LIMITED Neutral Sell Credit Suisse 8 PLATINUM ASSET MANAGEMENT LIMITED Buy Sell Ord Minnett 9 RESAPP HEALTH LIMITED Buy Neutral Morgans 10 SUPER RETAIL GROUP LIMITED Buy Neutral Ord Minnett 11 WISETECH GLOBAL LIMITED Buy Neutral Citi 12 XERO LIMITED Neutral Sell Macquarie Downgrade 13 AMP LIMITED Neutral Buy Macquarie 14 AMP LIMITED Sell Neutral UBS 15 AURIZON HOLDINGS LIMITED Sell Neutral Morgan Stanley 16 CSR LIMITED Sell Neutral Morgan Stanley 17 GOODMAN GROUP Neutral Buy Deutsche Bank 18 GRAINCORP LIMITED Neutral Buy Morgans 19 GREENCROSS LIMITED Sell Neutral Deutsche Bank 20 INCITEC PIVOT LIMITED Sell Neutral Credit Suisse 21 INDEPENDENCE GROUP NL Sell Neutral Macquarie 22 IOOF HOLDINGS LIMITED Neutral Buy UBS 23 ISELECT LIMITED Neutral Buy Credit Suisse 24 JB HI-FI LIMITED Neutral Buy Deutsche Bank 25 LINK ADMINISTRATION HOLDINGS LIMITED Neutral Buy Citi 26 MINERAL RESOURCES LIMITED Neutral Buy Ord Minnett 27 ORIGIN ENERGY LIMITED Neutral Buy Citi 28 SUNCORP GROUP LIMITED Neutral Buy Credit Suisse 29 SYDNEY AIRPORT HOLDINGS LIMITED Neutral Buy Morgans 30 TPI ENTERPRISES LIMITED Neutral Buy Morgans 31 WOODSIDE PETROLEUM LIMITED Sell Neutral Citi Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 PTM PLATINUM ASSET MANAGEMENT LIMITED 25.0% -75.0% 100.0% 4 2 BBN BABY BUNTING GROUP LIMITED 50.0% 25.0% 25.0% 4 3 CGF CHALLENGER LIMITED 19.0% -6.0% 25.0% 8 4 MQG MACQUARIE GROUP LIMITED 43.0% 29.0% 14.0% 7 5 SUL SUPER RETAIL GROUP LIMITED 50.0% 38.0% 12.0% 8 6 DOW DOWNER EDI LIMITED 58.0% 50.0% 8.0% 6 7 COH COCHLEAR LIMITED -31.0% -36.0% 5.0% 8 8 BEN BENDIGO AND ADELAIDE BANK LIMITED -21.0% -25.0% 4.0% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 CSR CSR LIMITED -17.0% 20.0% -37.0% 6 2 APO APN OUTDOOR GROUP LIMITED 20.0% 50.0% -30.0% 5 3 AMP AMP LIMITED 19.0% 44.0% -25.0% 8 4 GNC GRAINCORP LIMITED 20.0% 40.0% -20.0% 5 5 CGC COSTA GROUP HOLDINGS LIMITED 63.0% 83.0% -20.0% 4 6 IFL IOOF HOLDINGS LIMITED 80.0% 100.0% -20.0% 5 7 LNK LINK ADMINISTRATION HOLDINGS LIMITED 33.0% 50.0% -17.0% 6 8 IGO INDEPENDENCE GROUP NL -33.0% -17.0% -16.0% 6 9 SYD SYDNEY AIRPORT HOLDINGS LIMITED 71.0% 86.0% -15.0% 7 10 GMG GOODMAN GROUP 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 MQG MACQUARIE GROUP LIMITED 109.850 101.190 8.56% 7 2 CSR CSR LIMITED 5.162 4.808 7.36% 6 3 SUL SUPER RETAIL GROUP LIMITED 8.523 8.176 4.24% 8 4 CGF CHALLENGER LIMITED 12.196 11.738 3.90% 8 5 BBN BABY BUNTING GROUP LIMITED 1.588 1.545 2.78% 4 6 RRL REGIS RESOURCES LIMITED 4.130 4.030 2.48% 7 7 COH COCHLEAR LIMITED 165.200 161.514 2.28% 8 8 DOW DOWNER EDI LIMITED 7.472 7.390 1.11% 6 9 GMG GOODMAN GROUP 8.634 8.580 0.63% 7 10 ASX ASX LIMITED 55.540 55.415 0.23% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 AMP AMP LIMITED 4.525 5.255 -13.89% 8 2 IPL INCITEC PIVOT LIMITED 3.836 4.070 -5.75% 7 3 LNK LINK ADMINISTRATION HOLDINGS LIMITED 8.582 9.087 -5.56% 6 4 IFL IOOF HOLDINGS LIMITED 11.620 11.920 -2.52% 5 5 APO APN OUTDOOR GROUP LIMITED 4.762 4.828 -1.37% 5 6 GNC GRAINCORP LIMITED 8.660 8.754 -1.07% 5 7 IGO INDEPENDENCE GROUP NL 4.683 4.733 -1.06% 6 8 JBH JB HI-FI LIMITED 25.591 25.819 -0.88% 8 9 SYD SYDNEY AIRPORT HOLDINGS LIMITED 7.270 7.317 -0.64% 7 10 MYO MYOB GROUP LIMITED 3.948 3.950 -0.05% 6 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 MQG MACQUARIE GROUP LIMITED 776.220 706.429 9.88% 7 2 DOW DOWNER EDI LIMITED 41.242 40.090 2.87% 6 3 PDL PENDAL GROUP LIMITED 62.783 61.267 2.47% 6 4 OSH OIL SEARCH LIMITED 30.419 29.796 2.09% 8 5 JHG JANUS HENDERSON GROUP PLC. 370.500 363.312 1.98% 6 6 SXY SENEX ENERGY LIMITED -0.771 -0.786 1.91% 7 7 SWM SEVEN WEST MEDIA LIMITED 7.875 7.797 1.00% 6 8 BPT BEACH ENERGY LIMITED 14.083 13.950 0.95% 6 9 RRL REGIS RESOURCES LIMITED 32.460 32.180 0.87% 7 10 WOR WORLEYPARSONS LIMITED 61.085 60.603 0.80% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 IPL INCITEC PIVOT LIMITED 19.310 22.084 -12.56% 7 2 BBN BABY BUNTING GROUP LIMITED 7.925 9.025 -12.19% 4 3 CSR CSR LIMITED 37.678 42.000 -10.29% 6 4 IGO INDEPENDENCE GROUP NL 13.044 13.804 -5.51% 6 5 NAB NATIONAL AUSTRALIA BANK LIMITED 214.643 223.163 -3.82% 8 6 NUF NUFARM LIMITED 42.893 44.551 -3.72% 7 7 AMP AMP LIMITED 32.514 33.743 -3.64% 8 8 NWS NEWS CORPORATION 58.999 61.215 -3.62% 6 9 MIN

MINERAL RESOURCES LIMITED 173.500 179.000 -3.07% 4 10 APO APN OUTDOOR GROUP LIMITED 29.684 30.330 -2.13% 5 Technical limitations

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Uranium Week: US Production Plummets

US production of uranium has halved in the space of a year, but has not affected the spot price.

-US uranium production falls -50% -Producers request government action -Uranium price unmoved

By Greg Peel

Last week the US Energy Information Agency reported US uranium production dropped by -64% in the March quarter from the December quarter and -50% from the March quarter last year.

Production in 2017 totalled 2.4mlbs U3O8, which was -16% less than 2016 and the lowest level of production since 2004.

Two US producers, Energy Fuels and Ur-Energy, are currently petitioning the government to apply a section 232 national security ruling to oblige US utilities to purchase at least 25% of their uranium from domestic producers. This latest data gives weight to the request, the two companies have argued. In a joint statement the two CEOs commented:

“The EIA’s report reflects the harsh reality facing the domestic uranium mining industry. Our companies...have been sounding the alarm about the threats that brought us here. Chief among those threats are state-owned enterprises from Russia, Kazakhstan, Uzbekistan, and increasingly China, that flood the US with cheap uranium and nuclear fuel. We rely on uranium to fuel the nuclear power plants that provide 20 percent of our electricity and nearly 60 percent of our zero-carbon electricity.

"That’s why we jointly submitted a petition to the US Department of Commerce seeking an investigation into the impact of uranium imports on our national security. With US uranium production falling to all-time lows and geopolitical tensions with Russia, the government must act now to protect our energy and national security."

Stalemate

It is just the sort of request one would expect the current US president to cede to. Or perhaps he might go the other way and slap a 25% tariff on uranium imports, as is the case with steel, although the extent to which this tariff will be applied and on whom remains unclear.

The simple problem is US power companies are shutting down, planning to shut down or threatening to shut down their legacy reactors given nuclear power cannot compete with gas-fired generation or subsidised renewable energy sources. And yet the uranium price has not been this low since 2004. Forcing US power companies to purchase 25% of their uranium domestically, and more expensively, will only accelerate reactor shutdowns.

The US government needs to make a definitive decision as to where it sees nuclear power as part of the future energy mix.

Prior to 2004, the uranium price had traded below US$20/lb for decades. The price took off in 2005, the year of the signing of the Kyoto Protocol. Climate change was the buzzword that swung the world’s focus on nuclear energy at a time when fracking was little known about and renewable energy was a long way from offering a commercial solution. Speculative hype took the uranium price to almost US$140/lb in 2007 before crashing spectacularly back down again.

2010 saw a rally back from a trough of US$40/lb to US$70/lb, before Fukushima refocused the world’s attention on the inherent dangers of nuclear energy. The uranium price bottomed out at around US$20/lb once more and has gone nowhere ever since.

In 2018, uranium producers cannot make a profit on US$20/lb uranium and power companies cannot make a profit on US$20/lb uranium.

Last week saw subdued activity in the spot uranium market. Industry consultant TradeTech reports six transactions concluded totalling 850,000lbs U3O8 equivalent. Prices remain divergent between delivery points in Europe and the US.

The bulk of “spot” demand is for deliveries in late 2018 and into 2019, TradeTech notes. While this may bode well for medium term pricing, a lack of near term demand is ensuring little movement in the spot price. TradeTech’s weekly spot price indicator has fallen -US10c to US$21.40/lb.

TradeTech's term price indicators remain at US$25.50/lb (mid) and US$28.00/lb (long).

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.

The Short Report

Guide:

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

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

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

Summary:

Week ending May 10, 2018

Last week saw the ASX200 reach, but fail to close above, the post-GFC high of 6135, despite a couple of forays intraday. The index is currently consolidating at this lofty level rather than turning tail, and it is now becoming evident the shorters are starting to hurt.

To that end, we note that only yesterday, Domino's Pizza ((DMP)) and JB Hi-Fi ((JBH)) posted the second and third gains among ASX200 stocks while Myer ((MYR)) jumped 16%. Those stocks were, as at last week, respectively the second, third and fifth most shorted stocks on the market. We'll keep an eye out in next week's numbers.

Last week, as the table below indicates, there were a lot more short position reductions than increases.

Last week shorters continued to bail from Nanosonics ((NAN)) in the wake of FDA approval for the company's disinfectant product. Having fallen to 13.1% from 14.1% the week before, last week Nanosonics shorts fell to 11.6%.

Healthscope ((HSO)) has now received a counter takeover offer. Last week Healthscope dropped off the 5% plus shorted table from 6.2%.

Shorts in Afterpay Touch ((APT)) plunged to 7.3% from 9.7%.

Shorts in Metals X ((MLX)) fell to 6.8% from 8.3%.

On the flipside, a profit warnings and subsequent -22% share price plunge for Greencross ((GXL)) only served to invigorate the shorters. Rather than falling on profit-taking, Greencross shorts jumped to 8.5% from 6.7%.

Shorts in G8 Education ((GEM)) rose to 8.5% from 7.4%.

See below.

Weekly short positions as a percentage of market cap:

10%+

SYR 20.9 DMP 16.3 JBH 16.2 GXY 14.5 MYR 11.9 VOC 11.7 NAN 11.6 ORE 11.4 AAC 11.1 NWS 11.1 BWX 10.8 IVC 10.6 RFG 10.6 HT1 10.3 IGO 10.2 APO 10.1

No changes

9.0-9.9

MYX

Out: APT, FLT, AAD

8.0-8.9%

HVN, GEM, GXL, AAD, FLT, BIN

In: AAD, FLT, GEM, GXL, BIN Out: PLS, MLX, WEB, IPH

7.0-7.9%

IPH, BGA, MTS, GMA, PLS, WEB, TGR, IFL, APT, CSR, TPM

In: APT, IPH, PLS, WEB, IFL Out: GEM, BIN

6.0-6.9%

ING, MLX, PRY, BKL, QUB, BAP, SEK

In: MLX Out: GXL, IFL, HSO, NSR, KAR

5.0-5.9%

BOQ, NSR, BEN, KAR, RSG, SFR, SUL, CCP, IMF, MYO, NXT, MOC, AHG

In: NSR, KAR Out: JHC, NUF, MQA, IRE

Movers & Shakers

The share price of payment system disruptor Afterpay Touch enjoyed a brief spike last week before falling back. This week saw another spike up.

Afterpay had moved steadily up the 5% plus shorted table for many weeks as questions were raised over the sustainability of the company's business model. Stockbroker Morgans has nevertheless been talking up Afterpay's prospects and last week the shorters began to bail, reducing positions to 7.3% from 9.7%.

This week the company announced its US launch, with first customer off the blocks large retailer Urban Outfitters. We'll see how the shorters reacted to this news next week.

The price of tin fell last week but the share price of tin miner Metals X actually rose, which may be why shorts fell to 6.8% from 8.3%.

Combining a pet barn with a veterinary clinic at a number of locations seemed to the market like a good idea a few years ago but Greencross has struggled ever since. The share price has halved since 2014 and last week fell -22% in a day following a profit warning. It appears pet owners are not choosing to visit the vet clinics.

The opportunity for profit-taking was not taken. Short positions in Greencross last week rose to 8.5% from 6.7%.

Last month the share price of child care centre operator G8 Education tumbled after the company conceded occupancy rates were continuing to disappoint in an increasingly competitive market. The stock has recovered in the recent market rally, which is providing fodder for the shorters.

G8 shorts rose to 8.5% from 7.4%.

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.

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.

The Wrap: Wealth, NZ Insurance, Oil, US Coal

Weekly Broker Wrap: wealth management; NZ general insurance; oil; US coal; and salaries.

-ASIC views on reforms could weigh on wealth management sector -NZ general insurer GWP and margins set to improve -Shale growth not enough to offset looming oil supply gap -Renewed pressure on US coal power envisaged in 2018

By Eva Brocklehurst

Wealth Management

Although ASIC conditionally endorses vertical integration in the financial industry it has expressed clear views on some of the core components. The views of the regulator indicate that more extensive reform is required. This could weigh on sector ratings, UBS believes, until the findings of the Royal Commission become clearer.

The 2013 government's FOFA reforms banned advice trail commissions on new business but grandfathered pre-existing arrangements. ASIC has noted grandfathered commissions remain a significant part of adviser remuneration and provide incentives to maintain clients in legacy products even when there are better products.

ASIC believes grandfathering should cease to the maximum possible extent and UBS expects this could materially affect advice economics, increasing legacy product churn and pressure on platform fees.

Furthermore, the ability of ongoing service fees to be deducted automatically from platform investments may obscure the significance of the fees, ASIC attests.

While a requirement that service fees be invoiced to the customer and payment specifically authorised would not remove the ability to pay for advice from the platform, UBS suggests greater visibility of the fees may also affect adviser revenues.

The Royal Commission has also highlighted some deficiencies regarding the lawful entitlement of the recipients to fees the platforms deduct. While it remains unclear how pervasive the shortfall on controls is across the industry, UBS suspects this could be a key component of higher costs.

NZ General Insurance

Macquarie has analysed current trends in New Zealand's general insurance market. The broker concludes that the portfolios of Insurance Australia Group ((IAG)) and Suncorp ((SUN)) could be experiencing price rises of 13% and 12% respectively.

The broker also calculates the potential upside to the market from changes to regulations from July 2019. The Earthquake Commission will increase cover for losses to NZ$150,000 from NZ$100,000 from July and remove the NZ$20,000 cover for contents.

Macquarie suggests this could improve gross written premiums (GWP) and margins across the market for private insurers and estimates NZ$100m of additional GWP could be added to the market in five years. The broker estimates margins could improve by 120 basis points for Insurance Australia Group's NZ division and by around 110 basis points for Suncorp from FY20.

Macquarie has downgraded Insurance Australia Group to Underperform from Neutral, envisaging heightened risk, given the stock is currently trading at a two-year forward PE of 19.2x. The broker remains cautious about the potential for downside surprise in the second half result for Suncorp and retains an Underperform rating.

Oil

Oil supply concerns now represent a sudden shift from the abundant production and low prices experienced between 2014-2016, when OPEC attempted to take market share from rapidly growing shale producers. Aberdeen Standard asks, with prices rising again, will shale oil be able to fill the supply gap?

Research suggests producers with existing wells can provide up to 6mbpd and, at prevailing prices, this could rise to almost 10mbpd as new projects become profitable. The downside, Aberdeen Standard notes, is that it will take until 2024 these wells to come on line. Therefore, shale supply is not elastic enough to prevent short-term tightness.

Analysis shows the oil futures forward curve is indicating markets expect the recent spike in oil prices to prove temporary and for Brent to slowly decline from current levels. Nevertheless, the analysts expect that, if prices continue to spike, oil supply shocks risk denting a synchronised global upswing.

Brent prices have been rising steadily and are currently trading at US$78 a barrel, a 50% increase over the past 12 months and the highest price since oil started to fall precipitously in late 2014. Explanations include the US withdrawal from the Iran nuclear deal and fears over Venezuelan production, as well as geopolitical tensions in the Middle East.

US Coal

Commonwealth Bank analysts observe US coal power faces renewed pressure in 2018. Coal decreased as a source of power generation to 26.8% in February from 29.9% a year earlier. The share of natural gas in the US electricity generation, meanwhile, averaged 31.4%, up from 27.9%. Other power sources, mostly wind and solar, lifted share slightly.

The analysts believe US coal power output is expected to fare worse than natural gas this year because of the decommissioning of 13GW of coal-fired power plants. In 2016 coal power generation slumped nearly -9%, driven by low prices for natural gas and a US energy policy that encouraged lower emissions.

These drivers have eased as gas prices move higher and President Trump supports the US coal sector but they still remain a threat. US coal output is estimated to have lifted 6% last year after a contraction of nearly -19% in 2016. The US Energy Information Administration still expects a growing deficit in the US coal market and supply to contract faster than demand.

The EIA remains more positive about natural gas power output, anticipating growth of 8.3% in 2018 along with the commissioning of around 20GW of new capacity. Natural gas is expected to average 4.9 percentage points higher share than coal in US power generation in 2018, and the gap is expected to expand in 2019.

Salaries

Salaries in Australia have risen for the first time in six years, a new report has found. The 2018 national salary survey has found an increase in the growth of wages to 2.9% from 2.8%. The survey, conducted by the Institute of Managers and Leaders, suggests the largest increase in wages growth is being experienced in the business and professional services industry.

The greatest decrease in salary movements is in fast-moving consumer goods manufacturing. The survey also notes a shift in the origins of Australia's migrant workforce. More businesses are employing talent from Europe and from China, with the proportion of organisations employing UK and North American staff dropping dramatically.

The migrant workforce is also experiencing a trend towards long-term employment, with a -3.1% drop in businesses hiring overseas workers for less than two years. This is against the steady movement towards casualisation of the Australian workforce in recent years, the report notes.

Nevertheless organisations are recruiting more permanent staff, with 51% of businesses reporting increases in the past 12 months. The workforce is also experiencing a hike in those workers demanding more flexible start and finish times.

Aussie Banks & Unintended Consequences

In this week's Weekly Insights:

-Aussie Banks & Unintended Consequences -Conviction Calls -Rudi Talks -Rudi On TV -Rudi On Tour -At The AIA Conference

Aussie Banks & Unintended Consequences

By Rudi Filapek-Vandyck, Editor FNArena

The easiest way to judge how companies are performing in Australia is by comparing stockbroker price targets before and after the release of financial results. It's a pretty straightforward measure and cuts out all the noise about one-offs and taxes, currencies and good/bad management and execution.

Cloud accountancy software provider Xero released its FY18 financial report on Friday. Price targets went up. Property listings platform REA Group updated on the March quarter. Price targets went up. The same happened for News Corp, though that was largely REA-inspired. After Macquarie Group released their financial report on the Friday prior, price targets jumped.

In most cases, however, price targets declined in the first two weeks of May indicating all is not going smoothly beneath the surface of rallying share prices and ongoing expectations for robust economic growth domestically. Incitec Pivot. Down. Orica. Down. Pendal Group. Down. Perpetual. Down. Village Roadshow. Significantly Down.

And the banks? Every single one has seen price targets decline this month on the back of either financial results or, in the case of CommBank ((CBA)), a quarterly trading update. Many a commentator continues to point at "cheap" valuations for the banks in Australia -all the banks, except Bendigo and Adelaide ((BEN))- and certainly that would seem to be the case given most share prices are trading below consensus price targets but maybe not as far off as one would be inclined to assume; between 6-8.5% for the Four Majors.

Yet, the observation remains banks are finding it difficult to participate in the broad based market recovery, regardless of all the value calls, the fact that cheap looking laggards have been regaining investor interest, and the fact most banks are paying out above market half-yearly dividends this month.

Clearly, something else is going on and it's not just about ongoing despicable embarrassments at the Royal Commission.

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Sector analysts at IBISWorld, widely known for their specialised sector research reports such as on retail spending and new trends in consumer electronics, published their initial findings on Monday about what most likely lays ahead for the sector once thought of as the closest thing to God by Australian investors (but no longer).

On their assessment, Australian banks will be hamstrung with higher capital requirements, tighter regulation, and higher costs as a result of the public outrage about their misconduct in years past, and the regulatory and political scrutiny that follows as a result. While IBISWorld suggests higher costs will at the very least be partially passed on to clients, the sector analysts now forecast declining revenues for the sector over the next five years.

Another consequence of the Royal Commission should be tightened standards for lending to investors, consumers and businesses, suggest the analysts. While this opens up a drive for increased market share by smaller competitors, including non-bank lenders, this will also have consequences for credit growth in general, which closely intertwines with economic momentum and house prices in Australia.

If anyone wonders why the team of banking analysts at UBS retains a negative outlook for the banks overall, there's no need to search any further.

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UBS's negative view on banks has consequences for the broader domestic economy with the house view fearful that tighter credit is likely to lead to weaker house prices with a flow on impact on household sentiment through a fading of the so-called wealth effect that stems from positive momentum for property prices.

No surprise thus, UBS thinks most GDP growth forecasts by economists elsewhere are likely to prove too optimistic, including the 3% maintained by the Reserve Bank for 2018. UBS suggests 2.75% is more likely, and this will keep the RBA on hold until the second half of 2019.

In a separate analysis, UBS' economists suggest tighter public scrutiny in Australia has the potential to spread out to New Zealand, where authorities already are taking notice. This could translate into yet more pressure for Australian banks who also dominate across the Tasman.

While further tightening of credit in New Zealand would add more downside risks for house prices and consumer spending in the country, and potential for bad debts to rise, an equally intriguing observation can be made from the graph below, taken from that same UBS report on Australian banks in New Zealand.

What the graph clearly shows is that tightening by banks has an almost immediate impact on house prices where there is elevated momentum (Auckland), and that a softening in lending standards once house prices are falling, takes a lot longer to then stabilise the market.

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An equally insightful analysis was published by the team of economists at JP Morgan last week. Banks have let their standards slip, as was revealed at the Royal Commission, and sector regulator APRA has already instructed banks to set limits on new loans in high debt- and high loans-to-income categories, in industry parlance known as DTI and LTI loans.

With aggregate household debt in Australia rising to 189% of disposable income, many including the RBA and APRA have kept a close watch on this particular segment of banking loans. JP Morgan believes now that banks are being forced into more conservative lending practices, the potential fall-out is nothing less than "significant", and likely underestimated by all and sundry.

The reason is that, on JP Morgan analysis, a big chunk of the positive momentum in house prices in recent years stems from investor-borrowers, and there appears to be a direct link to higher LTI loans with both sellers and buyers in this particular bracket enjoying high LTI mortgages.

JP Morgan is predicting credit growth slowing from 6% annualised to 4% over three years. This seems like a gradual, relatively small contraction, but the economists are explicitly concerned it might represent a much more significant impact. Consider the following maths: High LTI loans represent around 10% of total volume in new loans, but because of their above average size, JP Morgan believes these loans represent maybe 31% of all new lending in dollar terms.

Restrict new high LTI borrowing and current sellers will be forced to negotiate with lower LTI buyers, suggesting downward pressure on prices. For good measure: JP Morgan is by no means predicting a crash in house prices in Australia, but merely a noticeable slowdown in overall activity, which translates into lesser demand for credit. A crash requires forced sellers, remind the economists.

What all this boils down to is that the outlook for banks has not looked as clouded since the global financial system froze in 2008, and this is understandably turning the sector into one of the major laggards in the local share market. See also "Middle Class Poverty? Blame The Banks" in last week's Weekly Insights.

Investors holding shares in discretionary retailers better prepare for tougher times ahead. This is a slow going, long drawn out process and with little in the way of a sizeable increase in average wages, I'd be inclined to think the overall landscape for consumer spending can remain subdued for a lot longer than the optimists might be willing to consider.

Conviction Calls

Anyone feeling an urge to get overly excited about future potential for the Australian share market should have a read through Morgan Stanley's assessments on the Australian economy. It's akin to standing underneath an icy cold shower with no clean towel in sight.

Post a Federal Budget that, we noticed, got a few market bulls excited about a potential pick up in consumer sentiment, the four equity strategists at Morgan Stanley have responded by pointing out any tangible improvement from the Budget on household incomes won't be forthcoming until 2020 and even then it'll be closer to "negligible" than to "material", while in the meantime an emerging $4bn headwind is building from higher petrol costs in 2018.

That'll easily eat away that fleeting Budget improvement the bulls are referring to.

Read between the lines and what the four at Morgan Stanley are suggesting is that by the time Australian households end up receiving a small income bonus from new tax cuts, the extra money will merely function as a band aid for ongoing pressures building for Australian households' spending power. This still is not a wonderful time to run a retail franchise.

Interestingly, the investment bank's US economics team has calculated about one-third of US income tax cuts shall be withered away by today's gasoline prices. That still leaves two-thirds to prop up US GDP growth. Not so in Australia, thus, where Morgan Stanley sticks with GDP growth of no more than 2% for 2018; well below both market consensus (2.7%) and the RBA (3%).

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The Mid-Year Global Strategy update from US strategists at Morgan Stanley can probably be best described as "sobering". The 60 page report tries to convey the message that valuations for equities are far from cheap, while natural (and obvious) tailwinds for the asset class are now receding. The underlying message: things will only get harder from here onwards.

The strategy report's key sentence is probably the following one: "We think global equities are in a range-trading regime with limited 12-month upside". US ten year bond yields have no support above 3%, say the strategists, implying a flattening curve as the Federal Reserve remains intent on further normalising interest rates.

Key calls: Overweight European stocks and global energy equities, JPY to hit 95 by 3Q19, US Treasuries 10yr yields to end the year lower, with a flatter curve. Strong 12 month gains for the South African Rand and the Brazilian Real.

Base case forecast for the S&P500 in the US remains 2750 and that's not that far off from where the index is heading in the current rally.

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Market strategists at UBS are equally as unenthusiastic about the outlook for Australian equities. While the local share market has bounced strongly from its lows in March, UBS cannot see it stretching out much further, while noting Australian equities have proved very adept in underperforming their foreign peers in years past and UBS doesn't see any reason why this should all of a sudden change.

Weaker earnings growth is the answer, in case you struggled to justify UBS's scepticism.

Portfolio-wise, UBS strategists remain Overweight mining and energy stocks, while having downgraded banks to Underweight from Neutral.

New Model Portfolio additions are Domino's Pizza ((DMP)), Downer EDI ((DOW)), Seven Group Holdings ((SVW)), and Vicinity Centres ((VCX)). Only one constituent has been removed: Westpac ((WBC)).

UBS's Model Portfolio's key Overweight positions are: AGL Energy ((AGL)), Aristocrat Leisure ((ALL)), BHP ((BHP)), Iluka Resources ((ILU)), Janus Henderson Group ((JHG)), Macquarie Group ((MQG)), Origin Energy ((ORG)), Seven Group Holdings, Star Entertainment ((SGR)), and Woodside Petroleum ((WPL)).

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Macquarie strategists too have remained rather sceptical about any boost for consumer spending exposed sectors in Australia. Tax relief for low and middle income earners will arrive in the form of a non-refundable tax offset, points out Macquarie. If there were to be lumpy spending after Australians complete their tax return, it simply won't be enough to make a serious difference in an $1.7trn economy.

Consumer spending, predicts Macquarie, will continue to muddle along due to high household debt and low growth in wages, and that's not taking into account ongoing risks.

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Strategists at Citi have now added Orora ((ORA)) and Suncorp Group ((SUN)) to the Citi Focus List Australia/NZ. Both stocks replace ALS ltd ((ALQ)) and Goodman Group ((GMG)) which have been removed.

Remaining constituents of Citi's Focus List are Aristocrat Leisure, Lend Lease Group ((LLC)), Newcrest Mining ((NCM)), NextDC ((NXT)), Qantas Airways ((QAN)), Rio Tinto ((RIO)), Star Entertainment, and Trade Me Group ((TME)).

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Market strategists at stockbroker Morgans seem to be drinking from the same well as their peers at Morgan Stanley. The following sentence from their recent strategy update sums it up nicely: "There's no doubt after a strong 2017, conditions going forward may be more challenging at the macroeconomic level and we remind investors to remain vigilant".

Rudi Talks

We have added 2x more instalments of The Unfair Advantage.

One on yield investing in the Australian share market and one on Premium Quality, High PE stocks, and whether they are due for a fall:

https://www.fnarena.com/index.php/fnarena-talks/2018/04/06/the-unfair-advantage/

Both videos can also be accessed directly through the website. See FNArena Talks, The Unfair Advantage.

Rudi On TV

This week my appearances on the Sky Business channel are scheduled as follows:

-Tuesday, 11.15am Skype-link to discuss broker calls -Friday, 11am, Skype-link to discuss broker calls

Rudi On Tour

-Presentations to ASA members and guests Gold Coast and Brisbane (2x), on 12 & 13 June -ATAA members presentation Newcastle, 14 July -AIA National Conference, Gold Coast QLD, June 29-August 1 -Presentation to ASA members and guests Wollongong, on September 11 -Presentation to AIA members and guests Chatswood, on October 10

At the AIA Conference

As stated in the overview above, I will be presenting at the AIA National Annual Conference at the Marriott Resort and Spa Surfers Paradise, from 29th July til 1st August 2018.

This year's theme is SYNCHRONICITY, Identifying opportunities in a world growing in sync...

For the first time in over a decade, the world’s major economies are growing in sync.

What does a world that is structurally awash in capital look like?

What will it mean for investors?

http://www.investors.asn.au/events/aia-national-investors-conference/

(This story was written on Monday 14h May. It was published on the day in the form of an email to paying subscribers at FNArena, and again on Wednesday as a story on the website).

(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 or via the direct messaging system on the website).

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(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.)

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

P.S. **II** - 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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