

Week  
**50**

# Stories To Read From FNArena

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FNArena  
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Analysis

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## Brokers Neutral On IAG Deal

Insurance Australia Group has done another quota share deal, this time with a group of reinsurers. Brokers suggest the advantages are already factored into the stock.

-Swaps volatility for a fee-based income stream, lowering risk -Upside considered largely factored into the stock - Return of capital expected end FY18, or FY19

By Eva Brocklehurst

Insurance Australia Group ((IAG)) now has a quota share covering 32.5% of its book. Should it be valued differently? Following on from the inaugural deal with Berkshire Hathaway, the company has signed agreements with Munich Re, Swiss Re and Hannover Re. These agreements cover consolidated business in Australasia and Thailand, unlike the Berkshire Hathaway deal which just covered Australia.

While suggesting this is a good deal for IAG, Ord Minnett cannot see how it makes sense for the reinsurers. The deal results in the three reinsurers receiving 12.5% of the gross earned premium and paying 12.5% of the claims and expenses. In addition, Insurance Australia will receive an exchange commission in the form of a fixed fee and additional profit share arrangement.

The company expects most of the expense savings, the turn in the cycle or reserve releases would return to its coffers, retaining 90-95% of the upside on a group basis. Citi assesses this statement includes both the original Berkshire Hathaway deal and the more recent deal and implies IAG may have given away around 25% of the upside on the business quota share.

The broker believes the stock is still expensive, although the news flow is likely to remain strong. The new quota share swaps volatility for a fee-based income stream and lowers risk. The company should now be able to generate a 15% return on equity on the 32.5% of its business. While this suggests a premium to historical trading multiples is justified, even so, Citi suggests the stock is fully valued.

Given the percentage of the book now running limited balance sheet risk, Deutsche Bank believes IAG should be valued closer to an insurance broker and uses Steadfast Group ((SDF)) as its base. As the terms of the deal are around five years the broker questions whether this should be thought of as a long-term funding... or does it more closely resemble a debt security?

Macquarie estimates the reinsurance counterparties involved in the deal will be wearing an underwriting loss but international capital diversification benefits and investment opportunities also need to be recognised as incentives to participate in these deals.

The primary benefit of such a deal is reduced volatility and, in turn, the stock should attract a higher PE multiple, in Macquarie's opinion. Nevertheless, this broker believes this is already captured in this share price and investors should now focus on the pricing cycle and cost reductions heading into the next result.

### Outlook

The company indicated it was satisfied with the current level of reinsurance and the deal is effective from the second half of FY18. Guidance for FY18 has been reaffirmed, and a 250 basis points uplift is expected in the second half from the new quota share arrangement. Ord Minnett makes additional earnings upgrades beyond the reinsurance deal to reflect increased confidence that the cost savings and cycle changes will benefit the company.

UBS notes, unlike the Berkshire Hathaway deal, the market already anticipated and re-rated the stock ahead of this agreement. UBS estimates the pro forma capital mix post capital management would shift to 52% tangible equity, 28% debt and 20% quota share reinsurance.

As a result debt plus reinsurance rises to 91% of tangible equity, from 67%. This introduces greater risk on the capital renewal front and a staggered maturity profile. On the other hand a broader number of providers for the quota share reduces the risks.

Morgan Stanley finds the deal broadly neutral prior to any capital management initiatives. The FY18 natural perils allowance falls to \$627m after the deal, from \$680m. Assuming the excess capital is return via a share buyback, and adjusting for the reduced earnings on shareholder funds, the broker considers the deal around 1% accretive.

## Capital Return

Citi envisages potential for a return of capital as early as the first half of FY19 and assumes a buyback of \$500m, while Macquarie expects a \$400m buyback will be announced at the first half result and includes this in forecasts for the first half of FY19. Still, the broker points out current share price makes the impact of such actions relatively inefficient. Despite favourable near-term earnings trends Macquarie continues to believe there are challenges for the industry longer term.

Morgans believes the deal will reduce risks and could preserve potential earnings upside. The capital release should allow a \$300m buyback, maybe by the end of FY18. Morgans agrees the impacts of the quota share are largely neutral at the earnings per share level, ex-capital management. A strong first half is expected, with a near-term tailwind from cost reductions.

Credit Suisse allows for a \$250m buyback in FY18 and a further \$350m in FY19, acknowledging clarity on a few of the moving parts is required before allocating upside and capital management opportunities to specific periods.

FNArena's database shows six Hold ratings and two Buy. The consensus target is \$6.77, signalling -7.1% downside to the last share price. Targets range from \$5.95 (Macquarie) to \$7.50 (Credit Suisse). The dividend yield on FY18 and FY19 forecasts is 4.0% and 4.3% respectively.

This stock is not covered in-house by Ord Minnett. Instead, the broker whitelabels research by JP Morgan.

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## Cost Pressures Mount For South32

Cost pressures are mounting for miner South32 but so far higher commodity prices have enabled margins to increase across the operations.

-Costs in the year-to-date already running higher than guidance -Worsley running close to full capacity -Special dividends may supplement buyback, brokers suggest

By Eva Brocklehurst

South32 ((S32)) has expanded on the outlook for its operations in FY18 and the market, fearful there may be some nasty surprises, was relieved. Cost pressures were revealed, related to uncontrollable inputs such as pitch, caustic soda and coke, yet higher commodity prices have led to increases in margins across the operations.

Total capital expenditure guidance for FY18 has been revised down to US\$520m from US\$550m, largely as a result of the deferral of underground development at Appin (Illawarra coal). UBS notes, except for the smelting business, where margins have contracted relative to FY17, the Worsley refinery has benefited from high alumina prices and, therefore, there's been a net margin increase for the aluminium group.

The company also provided a site tour of its Saddleback and Marradong bauxite mines, as well as the Worsley aluminium refinery south of Perth, Western Australia. There are two mining hubs producing 18wmt at a unit cost of US\$10/t of bauxite. The use of caustic soda, a key cost, should improve going forward with the inclusion of West Marradong which has a low reactive silica content.

In FY17 Worsley produced 45% of supply for the company smelters in Africa. Despite an expected improvement in caustic soda usage, raw materials and inflation are expected to drive around a 4% increase in costs in FY18, to US\$211/t, although Citi notes costs are already running ahead of this over the year-to-date. Deutsche Bank envisages costs increasing 5%, despite lower consumption of caustic soda because of higher grade ore from West Marradong.

### Worsley

Worsley is seen operating at full capacity at current production rates around 4.0mtpa. With over 1mt of bauxite resources the mineral base is secure for the foreseeable future, while the West Marradong agreement with Alcoa, Macquarie suggests, is beneficial to both parties and should provide incremental benefits to Worsley through additional ore sources.

The broker suggests productivity at Worsley is now likely to come through improving the cost base rather than through incremental tonnage. Water availability is considered an increasingly large risk because of the consistent decline in rainfall and the company is also working on diversifying the energy base to include gas and biomass, versus the predominant coal input.

Credit Suisse is impressed with the inroads already made into costs at Worsley but acknowledges the easy opportunities have been addressed. A doubling of caustic prices is expected to affect financial performance, although there are near-term opportunities around gas re-contracting, technology and plant efficiency.

### Outlook

Macquarie expects most of the company's core commodity prices will decline from current levels but there is material upside to the base case at spot prices, particularly from alumina. Ord Minnett continues to be attracted to the diversified earnings stream and strong balance sheet but considers the stock fairly valued.

UBS believes the company is in a strong position to capitalise on growth opportunities and deliver returns to shareholders, with special dividends to make up for the slow pace of the buyback. Deutsche Bank maintains a Sell rating on the stock on valuation, although acknowledging the buyback might be supplemented with a special dividend in February.

The broker is positive on the outlook for zinc silver and nickel over the medium term but cautious on manganese, thermal coal alumina and aluminium and values Worsley at \$0.65 per share. Worsley represents \$1.00 a share of Citi's valuation at a long-term alumina price of US\$350/t.



FNArena's database shows one Buy rating (Citi), six Hold and one Sell (Deutsche Bank). The consensus target is \$3.25, signalling -0.4% downside to the last share price. The dividend yield on FY18 and FY19 forecasts is 4.1% and 4.0% respectively.

See also, South32 Cutting South Africa Risk on November 28 2017.

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## Brokers Keen On Cleanaway-Tox

Cleanaway Waste Management intends to acquire Tox Free Solutions, consolidating Australia's waste management industry, and brokers are largely positive about the merger.

-Significant areas in common but broadens Cleanaway's geography and exposure -Synergies need to be realised to generate real value -Unlikely another competitive bid for Tox Free will emerge

By Eva Brocklehurst

A pre-Christmas clean-up of waste management is heralded with the offer from Cleanaway Waste Management ((CWY)) for Tox Free Solutions ((TOX)), a competitor in the Australian market. Issues with market share are not expected, given the combined entity would still be the number two player.

The two companies have significant areas in common but the acquisition broadens Cleanaway's geographical reach and provides exposure to Tox Free's high-growth health segment. It also increases Cleanaway's exposure to the improving, and higher returning, liquids & industrial business.

Cleanaway will undertake a \$590m underwritten entitlement offer to fund the acquisition, increasing its share count by 27%. The offer price for Tox Free of \$3.425 represents a 30% premium to 1-month VWAP and 21% to the last Tox Free closing price.

### Synergies

Deutsche Bank believes the acquisition is positive, estimating it to be 2% accretive to value based solely on projected cost synergies, and suggests the forecast for \$35m in annualised synergies by FY21 does not capture the improved industry structure, particularly for the liquids & industrial division. Nor does it capture Tox Free's more attractive organic returns.

Credit Suisse is more neutral. Excluding synergies, the broker finds the deal only marginally accretive, noting recent market downgrades to Tox Free. Nevertheless, Cleanaway management has runs on the board in executing turnarounds and acquiring a struggling business, a positive aspect. Synergies are required to generate real value and should become evident through cost reductions and improved industry structures, although the broker suggests this will take time to flow to earnings.

The positives are several and include a re-positioning of business, adding exposure to a recovering resources industry, improving the market structure in liquids & industrials and access to some higher quality business streams. Credit Suisse notes Cleanaway has achieved on most of its organic opportunities so the propensity for a positive surprise is reduced.

Meanwhile, Tox Free has more volatile end markets and its earnings profile has been a disappointment over recent years. Credit Suisse suggests the \$35m synergy target partly addresses this but there is also an opportunity around intangibles.

Ord Minnett assesses the acquisition price is full, and the value accretion highly reliant on the expected synergies. The broker has always believed the waste management industry in Australia was a prime candidate for consolidation, but also an example of where earnings per share and value accretion are not always aligned.

The waste industry is very large and incorporates many segments with different barriers to entry and return profiles. The broker does not believe the accretion for Cleanaway will translate to the same level of value for shareholders, as a higher barrier to entry and return on assets in Tox Free represent a relatively small portion of earnings.

Acquiring Tox Free should diversify Cleanaway's earnings and provide material benefits, UBS believes. The broker does not include the acquisition in forecasts, pending approval of the deal. Preliminary estimates of the earnings accretion are around 12% in FY19, incorporating the full \$35m in synergies.

UBS expects Cleanaway to grow revenue at 5.3% compound over FY17-20, based on forward-looking economic data and the specific drivers that affect the waste management industry in a positive way. Over the next three years the broker forecasts a -\$45m reduction in operating costs and business efficiencies, representing 3.9% of the company's cost base.

UBS upgrades to Buy from Neutral, as the issues round restructuring and transition have largely been resolved and Cleanaway management is now able to focus on day-to-day operations. Reasonable top-line growth, aided by a marginally stronger macro economic backdrop, is expected to represent the start of a multi-year earnings upgrade cycle for the company.

#### Tox Free Dividend

Ord Minnett also suggests is unlikely another competitive bid for Tox Free will emerge, given the limited number of industry participants that could target a similar level of synergies. The extent of the company's ability to distribute available franking credits is too hard to assess, even though the consideration in the transaction could be influenced by the special dividend.

The scheme agreement allows Tox Free to declare and pay a fully franked first half FY18 dividend of 5c per share. It also allows for Tox Free to pay a special dividend ahead of the scheme's implementation, reducing the cash consideration payable by Cleanaway to Tox Free shareholders.

Cleanaway Waste has three Buy ratings and two Hold on FNArena's database. The consensus target is \$1.57, signalling 6.5% upside to the last share price. This compares with \$1.43 ahead of the announcement.

This stock is not covered in-house by Ord Minnett. Instead, the broker whitelabels research by JP Morgan.

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## AWE In Play

Oil and gas explorer AWE has landed a second bid in as many days, with Mineral Resources revealing its hand with an all-scrip offer.

-Mineral Resources plans to vertically integrate its energy supply -AWE's Waitsia is a much sought-after asset -Perth Basin may be on the verge of a renaissance as the oil market recovers

By Eva Brocklehurst

Corporate interest in oil & gas explorer AWE Ltd ((AWE)) has been heightened, with a further bid emerging following the offer from China Energy Reserve and Chemical (CERCG). Mineral Resources ((MIN)) has confirmed an all-scrip offer through a scheme of arrangement.

AWE shareholders are offered one Mineral Resources share for every 22.325 shares held. This values AWE at \$0.80 a share as of the close on December 8 and would result in AWE shareholders owning approximately 13.1% of the combined group.

Mineral Resources is interested in the company in order to vertically integrate its energy supply chain, having commented on this several times in presentations. Deutsche Bank notes the company does not currently intend to sell any gas from the AWE Waitsia project offshore, as it is committed to supplying domestic gas in Australia and remains a large consumer of domestic gas.

While there are no FIRB approval conditions, as opposed to the bid by CERCG, this bid still has to be weighed up against the cash offer from the latter.

Although AWE has undeveloped Western Australian gas assets, they are not close to Mineral Resources' Wodgina, so Morgan Stanley suggests there could be opportunities to swap assets with other northern gas producers. Given WA is currently long gas, the broker suspects the timing of the bid is a combination of opportunism and strategic analysis.

Still, the market's reaction to Mineral Resources' offer makes it clear to the broker there are doubts, as it has lost around -\$274m in market capitalisation, 57% of the offer for AWE equity. Morgan Stanley calculates a valuation gap has opened and, hence, retains an Outperform rating on MIN.

Citi suggests shareholders should evaluate any further interest emerging in the stock in coming weeks and, ultimately, they will need to review any final offer relative to what value current management can deliver. While the broker envisages potential for blue-sky valuation up to \$1.01 per share, management is expected to be able to unlock only \$0.77 of this value over the coming 18 months. Although the two competitive bids are enticing, Citi doubts an acquirer would pay away all the upside.

Moreover, there is significant downside if the bids are not completed and share prices revert to recent trading levels. If the deals fall over shareholders will need to trust management to deliver full value from Waitsia despite the risks around execution. The broker suspects Santa will not reward shareholders this close to Christmas for sitting around awaiting another offer that is higher than the current share price, and downgrades AWE to Sell/High Risk from Neutral/High Risk.

### Potential In AWE

AWE is an early-stage opportunity and Morgan Stanley assesses two projects, Waitsia and Ande Ande Lumut in Indonesia, underpin more than 80% of estimated valuation, and both are 50% owned. This adds to the complexity of the projects proceeding, although they are somewhat de-risked as both counterparties have oil & gas experience. Whether Mineral Resources could sell down its stake, especially the Indonesian asset, remains to be seen.

Nevertheless, Morgan Stanley acknowledges that Waitsia is regarded as the largest onshore conventional gas discovery in Australia, making it a sought-after asset. Although expecting Mineral Resources to be disciplined in its approach, the possibility of a bidding war exists, particularly as its stock has fallen -82% since December 11.

This implies the offer price for AWE is now around \$0.73 per share, adding the risk that Mineral Resources may have to increase its offer. Moreover the broker's oil & gas analysts expects the market in WA to get tighter from 2020, which could justify Mineral Resources taking on additional implementation risk.

### CERCG

DJ Carmichael notes CERCG is keen to acquire the company's share of Waitsia as well as obtain the operatorship. The balance of the field is owned by Beach Energy's ((BPT)) Lattice Energy. CERCG made its offer, upwardly revised after the AWE board knocked back its first approach, directly to shareholders, thereby making the bid hostile. The bid is \$0.73 a share.

CERCG stated that shareholders have encouraged it to bypass the AWE board, which the researcher suspects could mean there is support for the bid amongst the share register. Waitsia is material for WA because of its potential size and, until now, it appears AWE has not been able to maximise that potential.

DJ Carmichael believes the market has been frustrated by the inability of management to secure a meaningful gas sales agreement with a customer in WA. The researcher is also of the opinion that the Perth Basin is on the verge of a renaissance as the oil market recovers. While not reflecting on the play by Mineral Resources, DJ Carmichael also notes its recent seizure of regional assets from Empire Oil & Gas, which recently entered voluntary administration.

AWE has two Sell ratings, two Hold and one Buy (Credit Suisse, yet to comment on the bid) on the FNArena database. The consensus target is \$0.57, signalling -30.0% downside to the last share price. Targets range from \$0.45 to \$0.72.

Mineral Resources has two Buy and one Hold (Deutsche Bank, yet to comment on the bid) on the database. The consensus target is \$19.43, signalling 17.8% upside to the last share price. The dividend yield on consensus forecasts for FY18 and FY19 is 4.1% and 6.1% respectively.

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## What Will ANZ Do With Its Surplus Capital?

ANZ Bank has sold its life insurance operations to Zurich Financial. Most brokers consider the price reasonable and speculate about the use of the proceeds.

-Sale moves the bank from an area where it lacked competitive advantage -ANZ returning focus to Australasia at a time when the banking environment is becoming increasingly challenged -Buyback could be imminent with increased potential

By Eva Brocklehurst

ANZ Bank ((ANZ)) has completed the simplification of its wealth management division with the sale of its life insurance operations, following on from the divestment of the OnePath and aligned dealer group businesses to IOOF ((IFL)) in October.

The bank has announced the sale of life insurance operations in Australia to Zurich Financial for \$2.85bn. Citi observes a decision to pursue a single transaction divestment strategy ultimately proved unsuccessful, which may have affected the sale, describing the price as "light", while Deutsche Bank suggests it is close to the multiple that Commonwealth Bank ((CBA)) received for its life business.

ANZ will need to separate out the investments business, which is set to be offloaded to IOOF, before the sale of the life insurance business can be completed in 2018. Ord Minnett believes the sale process has been successful from a financial perspective, while it moves the bank out of an area where it lacked a competitive advantage.

Macquarie considers the price reasonable and estimates the transaction to be around 1% accretive to operating earnings per share and around 50 basis points to return on equity, while Morgan Stanley suggests the sale will be dilutive to earnings at around -2.5% ahead of a capital release. Following the sale, Macquarie estimates the bank's pro forma CET1 ratio to be around 12.2%, which is 1.7% above APRA's target of 10.5%.

Bell Potter's valuation is unchanged, with the bank's lower cash earnings stream offset by a higher surplus capital position. The retained businesses make sense to the broker as they are in line with the banking business, and have higher returns for a given level of risk.

Retained businesses include lenders mortgage insurance, general insurance distribution and share investing. Bell Potter, not one of the eight stockbrokers monitored daily on the FNArena database, has a Buy rating and \$32.50 target.

CLSA commends the bank's zeal in exiting non-strategic business but believes the sale price is weak and the profitability of the bank mid-cycle is well below its peers. The stock is overvalued, in the broker's opinion, and the FY19 earnings gap from normalised market earnings and the non-recurring sale of Queen Street cannot be bridged by cost reductions or buybacks.

Moreover, the fact ANZ does not have surplus franking credits suggests a buyback is imminent, although as the stock is relatively expensive handing the cash back as an unfranked dividend may appeal. CLSA, not one of the eight, retains a Underperform rating and target of \$27.70.

UBS considers the decision to re-balance the portfolio prudent but remains concerned that the bank is returning its focus to Australasia at a time the banking environment is becoming increasingly challenged, given the end of a multi-decade housing leveraging cycle and increasing regulatory and political burdens. In order to prosper in this environment the broker believes the strategy should be focused on speed, digital innovations and culture.

However, UBS questions whether a strategy of superior execution is sustainable given ANZ's weaker domestic franchise. The bank has now announced six businesses divestments over the last year and has shrunk its institutional business by around -25% since FY15.

Two substantial businesses remain to be sold, including AMMB Malaysia and Panin Indonesia. Macquarie envisages scope for further three large divestments which, if sold, would potentially generate an additional \$2.5bn in capital.

### Capital Management

Brokers generally expect the capital from the sale of these assets will be returned via on market buybacks, leaving the financial impact broadly neutral. Anticipated capital returns have become larger in size. Citi already has around

\$5.0bn of capital returns in forecasts and this transaction adds another \$2.5bn.

Morgan Stanley envisages the prospect of a \$3bn buyback late in 2018 while Ord Minnett increases its share buyback forecasts to \$8bn over the next three years versus the prior forecasts of \$4bn.

Shaw and Partners, also not one of the eight, has a \$30.56 target and upgrades to Buy on the likelihood of a expansion in returns on equity and capital management. The broker suggests a \$7-8bn buyback could be on the way. While profits should be flat over the next two years as the bank exits low-returning business, Shaw and Partners estimates earnings per share should lift 6-7% as the share count falls.

There are two Buy ratings and five Hold on FNArena's database. The consensus target is \$30.10, suggesting 4.3% upside to the last share price. The dividend yield on FY18 and FY19 forecasts is 5.6%.

This stock is not covered in-house by Ord Minnett. Instead, the broker whitelabels research by JP Morgan.

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## What Next For the BP/Woolworths Fuel Deal?

The ACCC has opposed BP's proposed acquisition of the Woolworths petrol business. Brokers suggest a capital return for Woolworths is now less likely and Caltex is less likely to lose -\$150m in earnings.

-Decision reflects the greater influence of the Woolworths sites nationally than occurred with the Milemaker acquisition  
 -Setback raises questions regarding the funding of the Woolworths store refurbishment  
 -Woolworths supermarkets return to growth, irrespective of the ownership of the fuel outlets

By Eva Brocklehurst

Australia's competition regulator, the ACCC, has thrown a spanner in the works for BP's acquisition of the Woolworths ((WOW)) service stations business. The ACCC has stated it will oppose the acquisition on the basis it would substantially lessen competition in the retail supply of fuel. Notably, the ACCC said the underlying concerns would not be addressed by the divestments proposed by BP.

Ord Minnett had assumed the transaction would occur, but with a significant number of divestments. This was based on the fact that the ACCC allowed Caltex ((CTX)), which is generally a higher-price competitor that leads pricing cycles upwards, to acquire Milemaker, which typically contributes downward pressure to prices.

It appears the greater influence nationally from the Woolworths petrol business versus Milemaker's concentration in Melbourne, along with a large overlap between the BP and Woolworths sites, are factors that weighed more significantly on this decision than many had envisaged.

Brokers now canvass the options available for the fuel business going forward. BP and Woolworths are expected to challenge the decision and Woolworths may seek an alternative buyer, or it might also decide to retain the business.

Ord Minnett suggests, given Foreign Investment Review Board (FIRB) approval is required, and that often requires ACCC approval, forcing the the issue to the Federal Court is unlikely. BP and Woolworths would need to consider whether they were willing to invest further time and money in the process.

Morgans always believed there would be issues with the deal, given the amount of overlapping sites, as well as the fact BP is a premium-price fuel retailer compared to Woolworths being a more discount-oriented operator. Moreover, the broker believes any future deal with an existing major fuel retailer is likely to face similar ACCC concerns.

Caltex

In the absence of a sale of the Woolworths fuel business the exclusive contract for wholesale supply from Caltex to these outlets will probably continue. Citi suggests Caltex may now supply Woolworths for at least a further 12 months. In addition, the cessation of the BP-Woolworths alliance may also lower competition for the Caltex Foodary roll out.

While Caltex has already offset the potential contract loss through acquisitions and cost reductions, Citi continues to believe the market under-appreciates the opportunity to further offset lost sales via the acquisition of BP re-sellers, if the deal is ultimately successful, or by maintaining wholesale supply if it fails.

Morgan Stanley suggests failure of the deal would be a good outcome for Caltex, although understands that some of the targeted cost reductions were dependent on the loss of the Woolworths supply contract so there might be fewer savings to be had if Caltex retains the business.

The broker considers the ACCC decision puts in focus the retail margins of petrol and diesel, which have trended higher over the past decade and remain high in Australia. The broker expects some standardisation to the margin over time and believes this is also the start of changes to fuel consumption patterns.

Caltex has guided to a -\$150m annualised earnings headwind from the resulting sale of the fuel network. If the transaction is not to be completed, Deutsche Bank estimates this would represent a 9% and 8% increase to 2018 and 2019 net profit estimates respectively.

The broker makes no changes to earnings estimates at this stage and, having already factored in delays regarding the sale to its price target, downgrades to Hold from Buy.

## Woolworths

For Woolworths, Deutsche Bank believes there were always going to be underlying earnings upgrades irrespective of the ACCC decision. The company does not need this deal as badly as it did a year ago because the balance sheet is in much better shape and the business operations have improved materially. However, keeping the petrol business means there will be no excess capital to return.

Deutsche Bank also highlights the lessening emphasis that consumers are placing on petrol. The broker points out the ACCC's intention to oppose the transaction does not mean the deal is impossible, just much less likely. Meanwhile, Woolworths is turning around its supermarket division, which is more critical to the broker's investment thesis.

Given the strategic nature of the 531 sites, the -4-5% dilution to earnings per share from the sale and the limited benefit from a balance sheet perspective, UBS does not believe retaining the business is a negative and suspects the news will drive modest upgrades to consensus estimates for Woolworths. While the Woolworths business remains challenged the broker believes a return to growth is positive and encouraging, regardless of how the fuel situation is resolved.

Macquarie suggests the setback still raises questions regarding the sustainability of funding the Woolworths store refurbishment program. Despite a strong start to FY18 the broker has not observed funding for refurbishments from the sales performance and expects comparables to get harder to cycle.

Citi re-incorporates the petrol business back into its forecasts, noting the sale would have accelerated repairs to the balance sheet and shifted the business to a net cash position by June 2019. The broker acknowledges prospects for a capital return in the next 2-3 years have diminished but suggests Woolworths is still well placed to use the 531 sites for its convenience food and the online click & collect strategy.

Morgan Stanley agrees the potential for special dividends or buybacks is now limited. The broker considers Woolworths stock expensive, despite the recent improvements in operations and, as more challenging comparable periods are lapped, expects food sales growth to slow and the shares to de-rate.

Woolworths has three Buy, two Hold and three Sell ratings on FNArena's database. The consensus target is \$26.32, suggesting -2.7% downside to the last share price. Caltex has four Buy ratings, two Hold and one Sell (Morgan Stanley). The consensus target is \$35.49, signalling -0.2% downside to the last share price.

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## Material Matters: Silver, 2018 View & Miners

A glance through the latest expert views and predictions about commodities. Silver; gold; copper & nickel; 2018 outlook; and miners.

-Potential for silver to rally after lacklustre 2017 -Gold outlook deteriorates, negative backdrop for gold equities - May be hard for nickel names to recapture 2017 highs -Moves by China to manage growth may produce headwinds later in 2018 -Morgan Stanley singles out miners with additional options as costs and expenditure likely to rise

By Eva Brocklehurst

### Silver

Macquarie has been bored by silver this year. It did not rise along with the base metals and is now easing. Investors appear to have headed elsewhere. However, the broker believes a turnaround in 2018 may be on the cards. This is firstly with a re-rating against gold as industrial demand rises, and then joining gold in a rally as the US dollar weakens.

Macquarie notes the average price for silver in the year-to-date has been US\$17.12/oz, almost identical to 2016. If anything dramatic occurs it is likely to be on the downside, in the broker's opinion. Recently, the metal appears to have traded more like platinum than gold, with which it is most associated.

The broker asks why investors may have soured on silver which, as an industrial metal, should have been swept up in the industrial improvement over the current year. Silver may have suffered in comparison to buoyant equity markets but the broker finds it hard to obtain evidence this is the case. Perhaps Bitcoin and other crypto-currencies have attracted some money which would otherwise have been put into silver?

Nevertheless, industrial demand is expected to remain strong and the events that were negative for silver in 2017 are considered unlikely in 2018. Macquarie expects the first leg of a rally will be a re-rating against gold. This assumes base metal and gold prices remain where they are. The broker reiterates a forecast for an average silver price of US\$20/oz in 2018.

### Gold

UBS believes the 2018 outlook for gold has deteriorated, with rising US rates and an improving global growth trajectory. This provides a negative backdrop for gold equities, although those with strong free cash flow are expected to experience firm pricing. A focus on internal growth at Newcrest Mining ((NCM)) should keep the stock at a premium. At the smaller end, the broker expects Alacer Gold ((AQG)) to commission its sulphide project, while Perseus Mining ((PRU)) is likely to commission Sissingue by the June quarter.

### Copper & Nickel

Copper equities have been struggling and UBS envisages growing risks to the downside for both OZ Minerals ((OZL)) and Sandfire Resources ((SFR)) in 2018.

The broker notes client engagement for nickel has been very high and driven by enthusiasm for electric vehicles and batteries but with nickel back near US\$5/lb the equities have de-rated. The broker remains positive on the demand outlook but suspects it could be hard for nickel names to recapture their 2017 highs without internal catalysts.

### 2018 Outlook

With a number of commodities trading above long-term forecasts, UBS envisages a risk to the downside as the Chinese winter passes and supply returns to the market. These commodities include alumina, manganese and coal. However, the broker expects China's focus on reforms and pollution to continue through 2018.

UBS retains a preference for BHP Billiton ((BHP)) over Rio Tinto ((RIO)) as BHP is expected to announce capital management. UBS upgrades Whitehaven Coal ((WHC)) and Fortescue Metals ((FMG)) to Buy, as value is envisaged in these stocks.

Metallurgical coal prices are revised up 16-23% for 2018-19 amid a view that Chinese authorities will manage domestic coal output to target higher-than-market prices in order to help pay for capacity reforms. Demand drivers

for thermal coal are expected to ease throughout 2018 but UBS expects ongoing safety issues will keep the Chinese coal market tighter, and prices higher, for another year or two.

The biggest changes to the broker's forecasts are a 16% lift to hard coking coal forecasts, an 11% lift to alumina, 9% lift to oil and 7% lift to iron ore, while platinum and silver are downgraded. Platinum is downgraded by -8-15% across the forecast horizon to reflect a view that it will be weighed down by themes in the automotive sector. This also takes into account a more benign outlook for gold.

Morgan Stanley expects demand to return to the fore in 2018 on a broadening of the global macro economic recovery. However, moves by China to manage growth in key commodity consuming sectors may produce headwinds through the second half of the year.

The broker reflects this in declining price profiles for steel-exposed commodity such as iron ore and metallurgical coal. Government policy is also expected to continue playing a role in commodity markets in 2018.

The broker remains bullish on palladium which tops its list of robust demand growth. The gold outlook is lifted slightly on a weaker US dollar but remains suppressed by the US Federal Reserve's rate hike cycle through 2018.

Of the base metals, Morgan Stanley has nickel and aluminium at the top of its list. Aluminium is supported by China's supply reform policies and nickel is close to its marginal cost of production, so there is room for upside as the market tightens. A balanced market is expected in copper, likely to bring some downside versus the spot price.

Zinc is expected to come under pressure through expanding supply. Morgan Stanley is most bearish on bulk commodities, expecting expanding domestic coal supply in China will also weigh on thermal coal after the winter. Expanding supply of lithium and cobalt is expected with the price of lithium looking set to fall as China's domestic output improves and Australia's hard rock supply rapidly increases.

#### Miners

Morgan Stanley observes miners are profitable and well capitalised with the luxury of excess cash flow to redistribute after a strong 2017. However, this position is likely to erode as costs and capital expenditure rise. The broker prefers those stocks with additional options to provide relative protection such as BHP Billiton in terms of divestments, Mineral Resources ((MIN)) with growth options and South32 ((S32)) with capital returns.

The broker has made several rating changes, raising South32 and Oz Minerals to Overweight. The former is underpinned by the benefit of higher forecasts for metallurgical coal, aluminium and manganese while copper supports the latter. Alumina Ltd ((AWC)) is raised to Equal-weight given Chinese capacity reductions should drive firmer alumina prices, while Independence Group ((IGO)) is downgraded to Equal-weight as it now looks fairly valued.

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.

## Outlook For 2018: Global

2017 has been a remarkable year in global markets. Will it all come to an end in 2018? Or 2019? Brokers, economists and research houses offer their views.

- 2017 a remarkable year - No reason for it to all end in 2018 - There are nevertheless risks, including monetary policy - Yet investors are cautious, not complacent

By Greg Peel

It is inevitable that economies undergo cycles. Economies will strengthen and asset valuations rise until confidence becomes complacency and both begin to overheat. Rising inflation forces central banks to tighten and a recession is triggered.

Fear ultimately subsides to begrudging acceptance and asset valuations fall too low as a slowing economy begins to bottom out after central bank easing.

Rinse and repeat.

It is this inevitability that leads analysts into assessing at just which point in the cycle an economy may currently be: early, mid or late. Early suggests the beginning of a bull market, mid suggests stay on board and late suggests a recession is coming, time to exit.

With hindsight we can note that the US bull market began in 2009 after the Fed introduced its first round of QE - the equivalent of easing to a negative cash rate - in the wake of the GFC. That bull market is now one of the longest in history.

Europe was even more hard hit by the GFC and thus did not enjoy a simultaneous recovery with the US. Lingering PIIGS issues, the long-running Grexit scare and the constraints of a single currency meant Europe's GFC extended for a few more years before an economic recovery was evident.

Beijing avoided a GFC in China by throwing historic amounts of fiscal stimulus at the Chinese economy but after reaching a peak, China's growth rate has been slowing ever since.

Japan was already in a recession thus didn't notice much difference.

Emerging markets (and by now we can leave China out of this group) were hard hit by the GFC but have since been beneficiaries as China's economy matures, particularly among China's near neighbours.

2018 will mark the tenth anniversary of the Fall of Lehman. 2017, all analysts agree, has been a remarkable year. As hackneyed as her name has become, Goldilocks remains the best analogy. Can 2018 bring more of the same? Or is it time to start worrying?

2017 - The year of synchronicity

Of the 198 countries party to the International Monetary Fund, only six are currently suffering economic contraction, Legg Mason notes. Half of those are in the Caribbean, recently ravaged by hurricanes. The rest are in Africa.

Morgan Stanley notes that while US tech stocks received most of the attention in 2017 (and fair enough too, the FANGs and friends are alone responsible for some 25% of Wall Street's gain), it was actually one of the broadest equity markets on record, globally. There were no meaningful pullbacks, making risk adjusted returns "almost absurdly good".

ANZ Bank economists note the global recovery so far has been helped by some "serendipity". Political risks in Europe (at least in terms of EU break-up fears, while there are other risks, more on that later) and Trump have not done much damage to global trade, yet. China has again managed to deal with its issues, to the surprise of many. And consumers have continued to spend despite low income growth.

A combination of solid global growth and low inflation has seen risk assets move substantially higher. But despite the strong gains, the rally has been amongst the most "unloved" in history, as Macquarie notes. A common analogy is "climbing a wall of worry". Concerns over stretched valuations and the risk of further shocks have kept many investors on the sidelines.

In essence, 2017 was so good it was almost too good, and that's why the concern. Nothing that good can last forever.

Where are we?

Analysts all agree that after eight years of growth, the US economy is now late in the cycle. However that does not mean "get out now!" Economies cycle in years, not months or weeks.

To that end, we can drop down another level and assess whether we are currently early in the late cycle, in the middle, or late in the late cycle. It is only late in the late cycle that investors need to batten down the hatches.

While consensus also has the global economy under a banner of "late cycle", realistically the synchronicity story breaks down here. Some developed market central banks have begun to tighten monetary policy (most notably the US) but others remain in easing mode as yet (Europe, Japan).

Morgan Stanley suggests the US and China are late-cycle, the EU and Japan are mid-cycle and emerging market commodity exporters are only early-cycle.

While there is disparity among central banks with regard monetary policy, it is not stark. The Fed's pace of tightening has been gradual. The ECB is still implementing QE but next year will begin to back off. Japan will enter 2018 without any change to its negative cash rate policy. The reason no one has proceeded to barrel into monetary tightening even eight years after a recession is because inflation remains stubbornly low. "Mystifyingly" low as far as the Fed is concerned.

The clearest sign an economy is about to blow off and tip into recession is too-high inflation, leading to central banks slamming on the economic breaks. The primary driver of too-high inflation is rampant wages growth. Globally, wage growth remains benign.

Canaccord Genuity suggests given some central banks are now tightening, the early stage of the late cycle has passed. But because some aren't, the late stage of the late cycle is yet to be reached.

Goldman Sachs notes economic cycles and bull markets do not generally "die of old age". Major pullbacks require triggers. The most severe type of bear market is structural - the consequence of the unwinding of major economic imbalances and, typically, a financial bubble (See: GFC). Cyclical bear markets are the function of the economic cycle and are almost always triggered by the tightening in response to inflation pressure.

Goldman believes the risk of a structural bear market is low given those imbalances existing pre-GFC have been reduced or shifted to central banks. Cyclically, without higher inflation it is unlikely we have the conditions for a recession and, therefore, a bear market.

There is nevertheless one point of concern among market-watchers: the US yield curve is flattening.

### The Yield Curve Mistake

A yield curve represents a line drawn between the overnight cash rate, through short term bond yields and on to long term bond yields. A healthy economy would be represented by a positive yield curve - interest rates rising from short to long. Higher long term yields suggest faith in a growing economy.

But when an economy begins to overheat, inflation rises. This forces a central bank into raising the cash rate, while higher inflation priced into the longer term reduces longer term rates. The yield curve flattens, and then turns negative. The rule of thumb is a negative yield curve portends a recession in 6-12 months' time.

Over the course of 2017, US stock prices have soared while the US yield curve has begun to flatten. Ergo, say some, a recession is coming in the not too distant future.

But to heed to this supposed yield curve truism, and, equally, to find low inflation in a period of synchronised global economic growth "mystifying", is to linger in the past. Globalisation was not a word when the economics text books were written that still inform today's assumptions.

The US economy is no longer an economy in isolation from the rest of the world. The yield curve argument would hold true were inflation rising, but it's not. The US yield curve is flattening because US short term rates have begun to rise on Fed tightening but US long term rates are being dragged down by the differential to long term rates in Europe and Japan in particular.

If US long rates were much higher, one can borrow in yen and invest in US bonds for what is a "carry trade" that is profitable as long as exchange rates remain stable. The more investors jump on the carry trade, the faster the differential will close. European and Japanese long bond yields remain very low, hence US yields are low. The Fed is tightening but the Bank of Japan is not, and as yet the ECB is not.

To this end, suggesting a flattening US yield curve is pointing to recession is “erroneous”, as Canaccord puts it. An alternative gauge of US growth – the ratio of the US leading economic indicator to the coincident (now) economic indicator – is “powering” higher, notes Canaccord. This suggests the US economy is not losing but gaining momentum.

Incidentally, a stock market is considered a leading indicator (as it discounts future earnings).

Can it keep on keeping on?

Another warning signal market-watchers constantly point to is the US VIX volatility index. When that index falls to low double-digits, the suggestion is the market has become too complacent and disaster is just around the corner. Recently the VIX has been hitting 9.

But the VIX is not a confidence survey, it simply reflects the demand for options on the S&P500 index. If fear rises, investors hedge their portfolios by buying put options over the index, and this pushes up the VIX. But in today’s market, index put options have become a bit old hat.

There are other ways to hedge positions, and the fastest growing market in recent times has been exchange-traded funds. ETFs have allowed investors to both concentrate their portfolios into sectors they like, and also to hedge via short-side ETFs. To concentrate solely on the VIX is to ignore, once again, market evolution.

(ETFs are a risk unto themselves, but that’s a story for another day).

Morgan Stanley believes the breadth and stability of equity markets in 2017 reflect the synchronous economic recovery and very low dispersion in earnings estimates, not investor complacency. Morgan Stanley is also one of several analysts pointing to a distinct lack of retail investor participation in the bull market to date.

Market-watchers often quote John Templeton – “bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria”. The rule of thumb measure of euphoria is when your cab driver starts giving you stock tips. But retail investors remain absent from this market.

Therefore, we have not reached the euphoria stage. Therefore, we are not yet late in the late cycle.

Macquarie believes the global economy has finally moved onto a stronger footing, with above average growth likely to persist over 2018, notwithstanding a slowdown in China. Equity markets will rally further, as the US benefits from tax cuts and continued growth, while Europe, Japan and Australia play catch-up.

But “make hay while the sun shines,” warns Macquarie. 2019 is the year to be worried about.

Research house Lazard expects the ongoing US recovery to last an additional three to five years, assuming there are no exogenous shocks (something no one saw coming, like a missile) or abrupt policy shifts.

Goldman Sachs believes 2018 will be a year of “rational exuberance”, driven by above-trend US and global growth, low, albeit rising, interest rates and earnings aided by US corporate tax reform. But Goldman is on the same page as Macquarie: “One final year of valuation expansion before multiples (PEs) plateau”.

But “plateau” does not mean crash, it just means “not rise any further”. Goldman’s 2018 year-end forecast for the S&P500 is 2850 (assuming tax reform, 2450 if that fails), 3000 for 2019 and 3100 for 2020.

Given ANZ’s economists consider 2017 to have been “serendipitous”, they suggest rates of growth may moderate as 2018 progresses.

Given valuations are becoming stretched on an historical basis, Canaccord suggests “2018 could well be the year when the global equity bull market comes to an end”.

Morgan Stanley suggests the signing of the US tax bill may prompt the final missing ingredient of retail investor participation, thus signalling the end of the bull market is nigh.

It’s way too early to call a recession, says Morgan Stanley, and it won’t happen in 2018, but 2018 may be the year the equity market begins to discount the arrival of a recession in 2019. The broker suggests surprisingly strong economic data and earnings growth will both likely begin to wane in 2018, and global growth become less synchronous.

Putting it all together, the general feeling is 2017 was indeed too “good” to expect a repeat performance in 2018. But overall, the game is not over yet. There is no need to panic.

That does not mean there are no risks.



What could possibly go wrong?

There is much speculation that having so enthusiastically priced in expected US tax reform, Wall Street might just experience a “sell the fact” response when it becomes law. For what else is left to deliver 2017-style upside in 2018?

That would preclude the missing link of retail investor participation, but assuming there is a sell-the-fact response, it may not be too stark given at some point PEs will fall to levels not reflecting earnings upside from said tax cuts and thus the buyers would be back in business.

A greater risk is that despite low inflation, the Fed tightens too quickly. This, too, may be prompted by tax reform, which provides the fiscal stimulus that has been absent in the US since the GFC, thus forcing the Fed to do all the heavy lifting. If the Fed fears inflation will finally jump on lower taxes, it may become too aggressive.

Since 2009, the global economic recovery has been underpinned by central bank policy. It stands to reason that if central banks now reverse that policy, so too must markets reverse.

And it's not just a Fed story. The ECB is getting close to monetary tightening via QE tapering, if not actual rate rises in the foreseeable future. The ECB, too, could get the timing wrong.

Talk of tax reform takes us to politics. Brexit is still a big unknown. There is still no government in Germany. Catalan unrest has not yet been extinguished. Italy goes to the polls next year. Congressional mid-term elections are due in the US late in 2018.

Trump the hero may well become Trump the villain in 2018. Riding high on tax reform success, he will feel sufficiently confident to push harder on his protectionist agenda. The US is already out of the TPP. Trump wants out of NAFTA. Many observers suggest a collapse of NAFTA alone would be enough to end the bull market in a hurry.

Then there's that old chestnut, a slowdown in China. I'm not sure exactly how many years now there have been warnings of a slowdown in China, but it's definitely several and yet China has sailed on through.

But China's 2016 growth rate was the lowest in 25 years, the fear-mongers point out, and 2017 could well be lower. Yes it was, down from double digits back in the prior decade when China's economy was not so much “emerging” as “embryonic”. Imagine if an economy grew at 14% every year ad infinitum. Would we call that “overheated”?

At the same time, 3% global growth is considered healthy. Trump reckons he can get the US to 4%. I suggested earlier in this piece that it's a bit late now to be calling China an “emerging market”. China's economy is maturing, and with maturity comes slower year on year growth. What is often overlooked is that 6.6% growth in 2017 is, in actual dollar terms, a significantly larger amount than 14% was back in the early noughties.

There is, of course, the issue of China's rising debt. Yes, it poses a risk. As was highlighted in 2016, 2015, 2014...

A potentially more worrying risk than China is the global consumer.

As noted earlier, global consumer spending has proven resilient despite low wages growth. How have consumers paid for their consumption? By dipping into savings. Savings rates shot up following the GFC as consumers rushed to pay down debt and lived in fear of another Great Depression. Those rates are now back to where they were pre-GFC.

This leaves consumers in a vulnerable position going into 2018. They have nothing left to draw upon and for the time being, their wages are not growing. In Australia, many consumers are already stretched with regard their mortgage obligations. Rates are set to rise.

If asset prices do tip over, consumers may be forced to back right off yet again.

Is there any good news?

One source of good news would of course be “none of the above”. For they are risks, not realities. In the wider scheme of things, there are some potential positives to consider.

ANZ suggests that for the first time since 2011, there is some prospect of commodity prices enjoying sustained gains. Commodity demand is becoming broader, shareholders are focused on returns (capital management) which limits new investment in supply, China continues to clamp down on excess and polluting supply, and new sources of commodity demand are emerging (batteries, EVs).

And from a technical perspective, commodity price action looks strong.

Credit Suisse notes Millennials are opening up new opportunities for investors. In 2018 the analysts see renewable energy, including solar, wind and energy storage systems, as offering strong prospects. On the other hand, Millennial

preference for online shopping will mean continued pressure on the traditional retail sector.

The GFC caused a global slump in corporate capital expenditure, Credit Suisse notes, but capex has been building since that time, albeit very slowly. The broker expects 2018 to see an acceleration in capex, thanks to a combination of strong business confidence and solid profits meeting capacity constraints.

Higher investment boosts economic growth while limiting inflation pressure due to productivity gains, Credit Suisse notes.

US tax reform is also a clear driver of increased investment. Tax reform will provide a boost at a time finance costs are still low and corporate cash levels are high. This suggests corporate M&A, which has already picked up pace in 2017, may well accelerate in 2018.

Assuming all the extra money does not simply end up funding share buybacks, which have underpinned (indeed inflated) earnings per share numbers for the past few years.

And finally, Credit Suisse joins others in pointing to the fact investors are not complacent, as we touched upon earlier. Recent sentiment surveys suggest consensus remains quite cautious, with a large majority of views being “neutral”.

While there are many who can lay claim to “calling” a market crash, most celebrated bears called a crash every year for years as the market rose, only to be finally right one day. No doubt there are those who have indeed got it right (See: The Big Short), but history suggests crashes only occur when no one is expecting them to.

At this stage, analysts see caution, not euphoria.

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

## Weekly Ratings, Targets, Forecast Changes

By Rudi Filapek-Vandyck, Editor FNArena

### Guide:

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

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

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

### Summary

Period: Monday December 4 to Friday December 8, 2017 Total Upgrades: 13 Total Downgrades: 8 Net Ratings Breakdown: Buy 41.61%; Hold 42.01%; Sell 16.39%

The week ending Friday, 8th December 2017 marked an event not often seen in Australia in 2017: stockbroking analysts issued more upgrades than downgrades for individual ASX-listed stocks.

Investors can thank Citi's shift towards a more constructive view on mining stocks for that. With the noticeable help from Citi (contributing seven out of 15 upgrades) which saw the likes of BHP, Rio Tinto, Alumina Ltd and Fortescue Metals all upgraded to a Buy, total upgrades for the week rallied to 15 against only eight downgrades.

The stand-out observation to make about the latter group is that five out of eight downgrades moved to Sell.

Amendments to valuations and price targets remain skewed to the positive, though the week saw some hefty adjustments to the downside too. On the positive side, Metcash tops the table with a 17% increase, followed at arm's length by Alumina Ltd, TPG Telecom and Oil Search.

On the negative side, both G8 Education and Tassal Group stand out with reductions in excess of -9% and -8% respectively. In line with the trend post August reporting season, positive adjustments continue to outnumber negative revisions.

The tables for revisions to earnings forecasts exhibit that same trend too. Western Areas and Aristocrat Leisure stand out with gains in excess of 45% and 30% respectively, at considerable distance followed by Independence Group, Spotless (yes, still listed) and Metcash.

Amongst those suffering downgrades to growth forecasts, G8 Education is leading the pack, followed by Telstra, Fletcher Building and AWE Ltd.

### Upgrade

**ALUMINA LIMITED ((AWC)) Upgrade to Buy from Neutral by Citi .B/H/S: 2/3/2**

Citi makes commodity price revisions, with significant upgrades for bulk commodities. Better-than-expected Chinese growth and supply-side reforms have provided support for the market.

Key 2018 forecasts are US\$64/t for iron ore, US\$155/t for metallurgical coal and US\$78/t for thermal coal. Upgrades are also made to manganese, copper, alumina, and aluminium.

Rating is upgraded to Buy from Neutral. Target is raised to \$2.50 from \$1.90.

**BHP BILLITON LIMITED ((BHP)) Upgrade to Buy from Neutral by Citi .B/H/S: 6/2/0**

Citi makes commodity price revisions, with significant upgrades for bulk commodities. Better-than-expected Chinese growth and supply-side reforms have provided support for the market.

Key 2018 forecasts are US\$64/t for iron ore, US\$155/t for metallurgical coal and US\$78/t for thermal coal. Upgrades are also made to manganese, copper, alumina, and aluminium.

The broker upgrades to Buy from Neutral. Target is raised to \$32 from \$29.

**CORPORATE TRAVEL MANAGEMENT LIMITED ((CTD)) Upgrade to Add from Hold by Morgans .B/H/S: 3/2/0**

Following share price weakness Morgans upgrades to Add from Hold. The broker expects the company to deliver strong double digit growth in earnings per share over coming years.

The highly fragmented nature of the global corporate travel market means there is significant share opportunities to realise over time.

The broker also believes the company can increase its market share in Australasia from around 15%. The company also stands to benefit from lower tax rates in the UK and the US should they materialise. Target is \$23.

**DOMAIN HOLDINGS AUSTRALIA LIMITED ((DHG)) Upgrade to Neutral from Underperform by Macquarie .B/H/S: 1/1/3**

Domain is positioned for growth given strong fundamentals in the sector. While the current valuation appears to reflect much of the opportunity, Macquarie considers it more attractive in a relative sense versus REA Group ((REA)).

The business has made significant investment in its platform over the last three years to allow participation in future segment revenue growth.

The broker upgrades to Neutral from Underperform, primarily because of the correction in the share price since listing. Target is raised to \$3.50 from \$3.40.

**FLETCHER BUILDING LIMITED ((FBU)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 4/1/1**

The share price has underperformed since the update at the AGM. Morgan Stanley suspects the current uncertainty will prove to be an opportunity for those with a longer investment horizon.

The broker is unable to say definitely whether construction losses are at an end, but believes value is too significant at this point to ignore.

Rating is upgraded to Overweight from Equal-weight. Target is NZ\$8.50. Industry view is: Cautious.

**FORTESCUE METALS GROUP LTD ((FMG)) Upgrade to Buy from Neutral by Citi .B/H/S: 4/3/1**

Citi makes commodity price revisions, with significant upgrades for bulk commodities. Better-than-expected Chinese growth and supply-side reforms have provided support for the market.

Key 2018 forecasts are US\$64/t for iron ore, US\$155/t for metallurgical coal and US\$78/t for thermal coal. Upgrades are also made to manganese, copper, alumina, and aluminium.

The broker upgrades to Buy from Neutral. Target is raised to \$5.40 from \$5.10.

**LEND LEASE CORPORATION LIMITED ((LLC)) Upgrade to Buy from Neutral by Citi .B/H/S: 2/4/0**

A new analyst in charge has adopted a fresh approach on Lend Lease, arguing the company should consider spinning off its Engineering division via an in specie distribution to shareholders.

On Citi's projections, the Engineering spin-off could unlock no less than 37% upside. Otherwise, Engineering is seen as the key downside risk, with EPS estimates rising because, as Citi puts it, the company's urban regeneration pipeline continues to be activated.

Price target lifts to \$18 (from \$16.56 in August). Citi continues to see further upside potential.

**MAGELLAN FINANCIAL GROUP LIMITED ((MFG)) Upgrade to Buy from Neutral by UBS .B/H/S: 3/3/0**

UBS notes that while rising equity markets and strong net flows suggest the business is on track for 15% growth in assets under management in the first half, the shares have declined -13%.

Large one-off costs from the Global Trust raising will affect the first half result but the broker suggests growth in assets under management provides support heading into 2018.

Hence, UBS upgrades to Buy from Neutral and raises the target to \$30.00 from \$27.30.

**OIL SEARCH LIMITED ((OSH)) Upgrade to Buy from Sell by Citi .B/H/S: 4/4/0**

Analysts at Macquarie have lifted medium term and spot LNG prices forecasts and upgraded Oil Search to Outperform as a direct result. Price target increases to \$7.80.

Macquarie remains concerned about global oversupply of LNG, but the analysts are also of the view PNG LNG remains one of the leading projects under development, while Asian buyers are looking for diversification in supply.

**RIO TINTO LIMITED ((RIO)) Upgrade to Buy from Neutral by Citi .B/H/S: 6/2/0**

Citi makes commodity price revisions, with significant upgrades for bulk commodities. Better-than-expected Chinese growth and supply-side reforms have provided support for the market.

Key 2018 forecasts are US\$64/t for iron ore, US\$155/t for metallurgical coal and US\$78/t for thermal coal. Upgrades are also made to manganese, copper, alumina, and aluminium.

Rating is upgraded to Buy from Neutral. Target is raised to \$82 from \$71.

**SOUTH32 LIMITED ((S32)) Upgrade to Buy from Neutral by Citi .B/H/S: 1/6/1**

Citi makes commodity price revisions, with significant upgrades for bulk commodities. Better-than-expected Chinese growth and supply-side reforms have provided support for the market.

Key 2018 forecasts are US\$64/t for iron ore, US\$155/t for metallurgical coal and US\$78/t for thermal coal. Upgrades are also made to manganese, copper, alumina, and aluminium.

Rating is upgraded to Buy from Neutral. Target is raised to \$3.75 from \$3.50.

**TELSTRA CORPORATION LIMITED ((TLS)) Upgrade to Outperform from Neutral by Macquarie .B/H/S: 4/2/2**

The company updates guidance to incorporate NBN ceasing HFC sales for 6-9 months. Telstra expects the anticipated delay to be modestly financially positive over the full roll-out because of the effects of a natural hedge.

The broker acknowledges there are challenges to the operations but believes the dividend is underpinned by NBN payments over the medium term and the yield should provide support.

Rating is upgraded to Outperform from Neutral. Target is steady at \$3.70.

**TPG TELECOM LIMITED ((TPM)) Upgrade to Hold from Reduce by Morgans .B/H/S: 1/5/1**

Morgans upgrades to Hold from Reduce, suspecting that the NBN will fail financially sooner than originally anticipated, and this will be positive for TPG Telecom.

The broker re-builds its model to better include the earnings shift in mobile and also increases the peer multiple applied to valuation. Morgans believes delays to the roll out of NBN should be positive for the company, so envisages this creates upside risks to guidance.

The company hosted its AGM and provided little news, but reiterated that FY18 guidance is tracking well. Directors are disappointed about margin headwinds from the NBN but are confident their strategies will create value for shareholders in the longer term.

Target is raised to \$5.95 from \$4.30.

**Downgrade**

**ASX LIMITED ((ASX)) Downgrade to Sell from Neutral by UBS .B/H/S: 0/3/5**

ASX has decided to replace CHESS with a distributed ledger technology (DLT). UBS is not surprised but notes timing and financial implications are still unclear. The broker believes the boost to the share price in the lead up to the decision is likely to fade.

Also, buoyant equity markets over the first half have not translated into stronger revenue and valuation metrics appear increasingly stretched. UBS downgrades to Sell from Neutral. Target is raised to \$52.90 from \$51.60.

**CENTURIA INDUSTRIAL REIT ((CIP)) Downgrade to Hold from Add by Morgans .B/H/S: 0/1/0**

The A-REIT has revalued its portfolio, resulting in pro forma net tangible assets increasing \$0.12 to \$2.47. The portfolio is valued at around \$1bn across 39 assets.

Centuria Industrial also recently acquired a 7.7% stake in Propertylink ((PLG)) for \$0.95 per share.

Morgans downgrades to Hold from Add as the stock is now trading around the revised price target. The stock offers an attractive 7.4% distribution yield paid quarterly, the broker notes. Target rises to \$2.59 from \$2.54.

COCHLEAR LIMITED ((COH)) Downgrade to Lighten from Hold by Ord Minnett .B/H/S: 0/2/4

Ord Minnett revises medium-term earnings estimates to better reflect the large opportunity the company has begun to tap in the seniors category. While the potential is substantial, the broker is also wary that expectations have become elevated.

Management's stated intention to invest in market development as aggressively as its financial situation allows also limits potential for a near-term earnings surprise, in the broker's opinion.

Rating is downgraded to Lighten from Hold. Target is raised to \$162 from \$145.

ESTIA HEALTH LIMITED ((EHE)) Downgrade to Neutral from Buy by UBS .B/H/S: 0/3/0

Over 2017 the company has significantly outperformed its peers in the residential aged care sector. UBS observes this is coupled with guidance for modestly higher growth and upside risks to margins through cost rationalisation and refurbishment investments.

This meant the stock has re-rated to be the most expensive in the sector. UBS downgrades to Neutral from Buy. Target is raised to \$3.75 from \$3.50.

METCASH LIMITED ((MTS)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 2/2/2

First half results were in line with Credit Suisse. In the near-term further cost reductions in supermarkets and growth in hardware provides potential for moderate growth.

In terms of capital management, the broker suspects the company will probably move to a higher dividend pay-out or a buyback in the absence of significant initiatives.

The broker is not confident that free cash flow yield of 8% adequately compensates for the downside in medium-term earnings and downgrades to Underperform from Neutral. Target is raised to \$2.70 from \$2.26.

REA GROUP LIMITED ((REA)) Downgrade to Underperform from Neutral by Macquarie .B/H/S: 1/5/2

While the operating outlook is positive, Macquarie believes the implied multiple is too high at current levels. The broker believes there is heightened risk that future growth in earnings is absorbed by a relative de-rating.

There is justification, on a DCF analysis, for \$80 a share. This implies core earnings growth rates will be sustained at current levels and operating earnings will double over the next six years. While doable, the broker believes this is a lot to pay for today.

Rating is downgraded to Underperform from Neutral. Target is raised to \$74 from \$66.

SANTOS LIMITED ((STO)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 3/4/0

Macquarie was an "early believer" in the sustainability of Santos' cost cutting and the change of culture in the company. Forecast LNG prices have now been increased due to strong Asian winter demand, while a site tour has made the broker more comfortable about GLNG.

Santos will continue to deliver strong earnings in 2018, the broker believes, but since the Harbour Energy bid the stock has re-rated, and the broker does not believe an offer can be made high enough to satisfy the board. Downgrade to Neutral from Outperform.

Target rises to \$5.50 from \$5.00.

TASSAL GROUP LIMITED ((TGR)) Downgrade to Lighten from Buy by Ord Minnett .B/H/S: 2/1/0

Ord Minnett downgrades its recommendation to Lighten from Buy and lowers a target of \$3.43 from \$5.00.

The broker incorporates reduced export prices, following a -32% decline in the international salmon price since May, although limited impact on the Australian wholesale market is expected in the short term.

Ord Minnett finds the cost reduction outlook less compelling for Tassal and forecasts margin declines year-on-year.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ALUMINA LIMITED Buy Neutral Citi 2 BHP BILLITON LIMITED Buy Neutral Citi 3 CORPORATE TRAVEL MANAGEMENT LIMITED Buy Neutral Morgans 4 DOMAIN HOLDINGS AUSTRALIA LIMITED Neutral Sell Macquarie 5 FLETCHER BUILDING LIMITED Buy Neutral Morgan Stanley 6 FORTESCUE METALS GROUP LTD Buy Neutral Citi 7 LEND LEASE CORPORATION LIMITED Buy Neutral Citi 8 MAGELLAN FINANCIAL GROUP LIMITED Buy Neutral UBS 9 OIL SEARCH LIMITED Buy Sell Citi 10 RIO TINTO LIMITED Buy Neutral Citi 11 SOUTH32 LIMITED Buy Neutral Citi 12 TELSTRA CORPORATION LIMITED Buy Neutral Macquarie 13 TPG TELECOM LIMITED Neutral Sell Morgans Downgrade 14 ASX LIMITED Sell Neutral UBS 15 CENTURIA INDUSTRIAL REIT Neutral Buy Morgans 16 COCHLEAR LIMITED Sell Neutral Ord Minnett 17 ESTIA HEALTH LIMITED Neutral Buy UBS 18 METCASH LIMITED Sell Neutral Credit Suisse 19 REA GROUP LIMITED Sell Neutral Macquarie 20 SANTOS LIMITED Neutral Buy Macquarie 21 TASSAL GROUP LIMITED Sell Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 OSH OIL SEARCH LIMITED 44.0% 19.0% 25.0% 8 2 CTD CORPORATE TRAVEL MANAGEMENT LIMITED 50.0% 30.0% 20.0% 5 3 FBU FLETCHER BUILDING LIMITED 50.0% 33.0% 17.0% 6 4 MFG MAGELLAN FINANCIAL GROUP LIMITED 50.0% 33.0% 17.0% 6 5 LLC LEND LEASE CORPORATION LIMITED 33.0% 17.0% 16.0% 6 6 SGP STOCKLAND 36.0% 21.0% 15.0% 7 7 AWC ALUMINA LIMITED -7.0% -21.0% 14.0% 7 8 TPM TPG TELECOM LIMITED -6.0% -19.0% 13.0% 8 9 TLS TELSTRA CORPORATION LIMITED 25.0% 13.0% 12.0% 8 10 RIO RIO TINTO LIMITED 75.0% 63.0% 12.0% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 TGR TASSAL GROUP LIMITED 38.0% 75.0% -37.0% 4 2 GEM G8 EDUCATION LIMITED 50.0% 75.0% -25.0% 4 3 SIQ SMARTGROUP CORPORATION LTD 58.0% 75.0% -17.0% 6 4 STO SANTOS LIMITED 43.0% 57.0% -14.0% 7 5 MTS METCASH LIMITED -7.0% 7.0% -14.0% 7 6 ASX ASX LIMITED -63.0% -50.0% -13.0% 8 7 COH COCHLEAR LIMITED -64.0% -57.0% -7.0% 7 8 ALL ARISTOCRAT LEISURE LIMITED 64.0% 71.0% -7.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 MTS METCASH LIMITED 2.820 2.409 17.06% 7 2 AWC ALUMINA LIMITED 2.221 2.136 3.98% 7 3 TPM TPG TELECOM LIMITED 5.738 5.531 3.74% 8 4 OSH OIL SEARCH LIMITED 8.059 7.789 3.47% 8 5 MFG MAGELLAN FINANCIAL GROUP LIMITED 28.580 27.893 2.46% 6 6 ALL ARISTOCRAT LEISURE LIMITED 25.400 24.850 2.21% 7 7 COH COCHLEAR LIMITED 148.686 146.257 1.66% 7 8 ASX ASX LIMITED 52.239 51.444 1.55% 8 9 STO SANTOS LIMITED 5.073 5.001 1.44% 7 10 LLC LEND LEASE CORPORATION LIMITED 17.972 17.732 1.35% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 GEM G8 EDUCATION LIMITED 4.125 4.575 -9.84% 4 2 TGR TASSAL GROUP LIMITED 4.308 4.700 -8.34% 4 3 DHG DOMAIN HOLDINGS AUSTRALIA LIMITED 3.498 3.663 -4.50% 5 4 TLS TELSTRA CORPORATION LIMITED 3.781 3.788 -0.18% 8 5 SIQ SMARTGROUP CORPORATION LTD 9.268 9.275 -0.08% 6 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 WSA WESTERN AREAS NL 5.758 3.958 45.48% 7 2 ALL ARISTOCRAT LEISURE LIMITED 101.160 77.624 30.32% 7 3 IGO INDEPENDENCE GROUP NL 20.222 18.555 8.98% 6 4 SPO SPOTLESS GROUP HOLDINGS LIMITED 8.550 8.033 6.44% 3 5 MTS METCASH LIMITED 22.047 20.820 5.89% 7 6 AWC ALUMINA LIMITED 16.276 15.476 5.17% 7 7 BPT BEACH ENERGY LIMITED 8.130 7.797 4.27% 5 8 BHP BHP BILLITON LIMITED 195.687 187.786 4.21% 8 9 SFR SANDFIRE RESOURCES NL 60.546 58.421 3.64% 8 10 CTD CORPORATE TRAVEL MANAGEMENT LIMITED 77.780 75.980 2.37% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 GEM G8 EDUCATION LIMITED 22.650 25.225 -10.21% 4 2 TLS TELSTRA CORPORATION LIMITED 28.493 30.393 -6.25% 8 3 FBU FLETCHER BUILDING LIMITED 39.640 42.157 -5.97% 6 4 AWE AWE LIMITED -12.350 -11.922 -3.59% 6 5 MHJ MICHAEL HILL INTERNATIONAL LIMITED 8.733 9.000 -2.97% 4 6 NUF NUFARM LIMITED 51.811 53.274 -2.75% 7 7 LLC LEND LEASE CORPORATION LIMITED 140.467 141.433 -0.68% 6 8 QAN QANTAS AIRWAYS LIMITED 58.594 58.994 -0.68% 5 9 CSL CSL LIMITED 452.005 452.530 -0.12% 7 10 A2M THE A2 MILK COMPANY LIMITED 21.841 21.853 -0.05% 5 Technical limitations

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

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## Uranium Week: More Production Cuts

Last week's production cut announcement from Kazakhstan sparked further volatility in the uranium market for a further price gain.

-Kazakhstan cuts production -Spot price hits year's high -Volatility reigns once more

By Greg Peel

Last month leading global uranium producer Cameco announced it would shut down production at one of its major operations in Canada until such time as uranium prices improved. It was the catalyst the spot uranium market needed after months in the doldrums.

The spot price finally broke out of its tight range around US\$20/lb and headed towards US\$25 before utility buying receded and the sellers moved in once more. Price action has been volatile in recent weeks as the market attempts to quantify the impact of Cameco's production cuts.

Kazakhstan boasts the world's largest reserves of uranium and has become a swing player in the market, able to influence prices OPEC-style on production quotas. Early last week state-owned producer Kazatomprom announced it would cut production by -20% for the next three years. The spot uranium market went into a frenzy.

The spot price shot up from US\$23.25/lb to US\$26.50/lb, which is the previous high price for 2017 posted in April. That was a sufficient level to satisfy the sellers, and by week's end industry consultant TradeTech's weekly spot price indicator had fallen back to US\$25.00/lb, up US\$1.75 for the week.

TradeTech reports seven transactions totalling 800,000/lbs U3O8 equivalent, down from 1.6mlbs the week before. Despite that week's strong volume, utility buying was absent, ensuring volatility as intermediaries and speculators battled it out and producers sought to buy in to satisfy delivery contracts. Last week saw utilities return to the market.

### The Impact?

Uranium producers have been cutting production, idling operations or shutting them down altogether for a couple of years now. To date, it's had no impact on price. Indeed the spot price has languished in that time. But production cuts from Cameco and Kazatomprom do imply a significant loss of global supply. Again we might draw upon the OPEC analogy, with production cuts from OPEC and non-OPEC members ensuring a rally in the crude oil price.

Consensus suggests uranium production cuts will indeed lead to higher prices. The question is then one of when, and for how long? Cameco has set an initial ten month shut down timetable, subject to review. At some price point Cameco will decide to fire back up again.

And it should be noted that Kazatomprom cut its production by -10% in 2017, clearly to no avail. Will -20% over three years do the trick?

It will come down to the demand side. Here the swing player is China. On the back of China's reactor building program, research house Morningstar is forecasting a spot uranium price of US\$65/lb. But not until 2021.

There was one transaction reported in term uranium markets last week. TradeTech's term price indicators remain at US\$28.00/lb (mid) and US\$31.00/lb (long).

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## The Short Report

### Guide:

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

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

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

### Summary:

Week ending December 7, 2017

Last week saw the ASX200 bang its head up against 6000 before falling back to around 5940 as Wall Street took a brief breather. This week has seen the reverse, and a tentative sneak past 6000.

It is becoming apparent short-players in the market are now in the process of winding down ahead of a summer break. You wouldn't want to be lying on a beach oblivious if, say, someone made a takeover bid for Westfield ((WFD)).

Sorry, what?

On that note, last week had Westfield 4.5% shorted (see table below) ahead of this week's takeover announcement and 13% share price pop out of suspension. With brokers not ruling out a counter-bid, it will be interesting to see who Westfield shorts look in next week's Report.

It is also quite likely shorters are a little nervous about the Republicans actually managing to get a tax bill through before Christmas, as they suggest they can. This might spark a Wall Street surge and a sympathetic break-out locally. Or it might be a case of "sell the fact", but it's a risky bet to make.

Whatever the case, all we see below is a sea of green and yet another reduction in the total number of ASX-listed stocks shorted by 5% or more. Not only is the table one of the shortest I've experienced, I believe the actual 5-6% bracket currently holds fewer stocks than I can ever recall.

Despite a lot of movement, no move either way exceeded one percentage point. Coming close was Flight Centre ((FLT)), which has reappeared in the 10% plus club after a brief absence. Flight Centre began a bit of a rally last week but clearly the shorters aren't buying it, pardon the pun, and shorts have risen to 10.0% from 9.1%.

Last week I said this:

"I could make a big deal out of the fact that for the first time in a very long time, Myer ((MYR)) has slipped out of the 10% plus shorted club. But as it's only to 9.7%, there's no point in looking for a trend at this stage."

Last week Myer shorts fell to 8.8%. Maybe there is a trend.

And I also said this:

"I could also note that Woolworths ((WOW)) is back into the 5% plus table after a period of absence, to be the only other ASX Top 20 company alongside Rio Tinto to be shorted to such an extent, but as it's a move to 5.0% from 4.8% shorted, I won't."

Just as well I didn't. Woolworths has fallen back to 4.9% shorted.

So once again, no Movers & Shakers this week as the year winds down.

Next week's Short Report will be the last for 2017 before returning in January.

Weekly short positions as a percentage of market cap:

10%+

SYR 21.0 IGO 18.8 DMP 16.7 JBH 15.5 HSO 14.7 RFG 11.9 AAD 11.1 WSA 10.2 FLT 10.0

In: FLT Out: ACX, MTS, APO

9.0-9.9

ACX, APO, HVN, VOC, MTS In: ACX, APO, MTS Out: FLT, MYR, HT1, JHC

8.0-8.9%

HT1, NWS, ORE, MYR, JHC, QJN

In: HT1, MYR, JHC

7.0-7.9%

GXY, MYX, GXL, TPM, AAC, NXT

Out: NSR, RIO, SHV, GTY

6.0-6.9%

MYO, SHV, RIO, NSR, GTY, BAP, AHG, BEN, TAH, ISD, SEK

In: SHV, RIO, NSR, GTY, TAH, SEK Out: KAR

5.0-5.9%

KAR, GMA, CSR, PRU, QUB, ABC

In: KAR Out: TAH, SEK, IPD, MND, SUL, WOW

Movers and Shakers

See above.

ASX20 Short Positions (%)

To see the full Short Report, please go to this link

#### IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

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

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

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

Aside from all the above reasons as to why it would be a potential misconception to draw simply conclusions on short percentages, there are even wider issues to consider. ASIC itself will admit that short position data is not an exact science given the onus on market participants to declare to their broker when positions truly are "short". Without any suggestion of deceit, there are always participants who are ignorant of the regulations. Discrepancies can also arise when short positions are held by a large investment banking operation offering multiple stock market services as well as proprietary trading activities. Such activity can introduce the possibility of either non-counting or double-counting when custodians are involved and beneficial ownership issues become unclear.

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

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

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## The Wrap: Banks, Advisors, Retailers & Media

Weekly Broker Wrap: Australian banks; advisor platforms; high conviction stocks; Australian retailers; media; Pro-Pac Packaging; and Think Childcare.

-Australian banks likely to lag peers in 2018 -Bank-owned dealer groups likely to sustain greatest flight risk in advice platforms -Limits looming to investing-for-yield strategies -Fall-out could be forthcoming for retailing over January - Online and Outdoor the only segments likely to gain share of advertising market

By Eva Brocklehurst

### Australian Banks

UBS now has a flat earnings outlook for the major banks. Several inputs to a challenging outlook have conspired to put pressure on the sector. The Australian housing market faces a number of headwinds, amid the full impact of macro prudential measures on interest-only and investment property lending. APRA is also focused on lax mortgage underwriting standards.

Meanwhile, wages are weak and there is a slump in retail sales amid benign inflation and soft consumption. UBS downgrades forecasts for consumption growth to 2.0% in FY18 because of a fading household wealth affect and falling savings rate. The Reserve Bank is expected to keep official rates on hold until 2019.

Given this backdrop the broker downgrades housing credit growth forecasts to 4.4% in FY18 and 3.0% in FY19. Hence, the broker expects Australian banks will lag peers in 2018 as net interest margins come under pressure from competition and switching. The Banking Royal Commission is another area of uncertainty while mis-selling of mortgages and responsible lending risks are also a growing concern.

### Advisor Platforms

Morgan Stanley notes some opportunities for specialist advice-led wealth managers. More supportive markets and regulatory certainty has underpinned growth in independent financial advisers. Banks are reducing their commitment and investment in advice, given heightened regulatory scrutiny, and this has meant planners have re-evaluated their dealer groups.

Moreover, the unbundling of IP, technology advancements and fee-for-service requirements have created the opportunity to capture more value. The broker notes Hub24 ((HUB)) and NetWealth are prepared to package their platform as a service with execution-only capability.

In this area the major wrap platforms with a large independent advisor footprint that are hosted by BT Investment Management ((BTT)), Colonial ((CBA)) and Macquarie Group ((MQG)) are most at risk. Bank-owned dealer groups are likely to face the biggest flight risk, Morgan Stanley suggests.

Meanwhile, wealth manager networks of AMP ((AMP)) and IOOF ((IFL)) are supported by investment and a commitment to advice-led models. These, in turn, are supported by managed account capabilities. The broker also notes rising compliance scrutiny is driving inactive and unproductive planners out of the system.

### High Conviction Stocks

Morgans observes markets are in a sweet spot, as global growth is becoming entrenched and inflation conspicuously absent, but suspects this environment is unlikely to continue for much longer. While solid returns are still achievable the broker suggests these should not come at the expense of investors taking on excessive levels of risk.

Low growth and low rate settings have made investing for yield a profitable strategy post the GFC, but Morgans is starting to envisage limits to this strategy. The broker suggests the local market may lag peers until investors can get a clearer reading on a genuine acceleration in the business cycle, and active stock selection will be key to returns in 2018.

The broker adds Senex Energy ((SXY)) to its ex-100 list and considers the stock well-positioned to make a material impact on the east coast gas market. Bapcor ((BAP)) is removed, locking in a 12% total shareholder return over the last nine months. The broker remains attracted to the stock's defensive characteristics.

### Australian Retailers

Citi finds the signs not great for Christmas retailing. Discounting has been pulled forward and there are few "must have" items this year. The broker envisages the greatest downside threats are for Myer ((MYR)), Harvey Norman ((HVN)), JB Hi-Fi ((JBH)) and Premier Investments ((PMV)). The broker envisages a subdued Christmas and perhaps some fallout, with downgrades, over January.

Significant negative sentiment on retail in January is suspected to be an enhanced buying opportunity for Premier Investments and Super Retail ((SUL)) because of fundamental valuation support. Citi has a Neutral rating for Woolworths ((WOW)) and remains positive about the prospects for higher food inflation.

#### Media

Citi believes outdoor and online are the only sectors of the media likely to gain share in the advertising market in the medium term. The most immediate issue is a risk of earnings downgrades, as weak retail sales are a negative leading indicator for advertising expenditure. Retail turnover is currently near all-time lows and this points to the risk of downgrades across the sector. December-January sales will be the key catalysts for the sector.

Citi initiates coverage on the sector with a Buy rating for oOh!Media ((OML)) and Neutral ratings on APN Outdoor ((APO)) and HT&E ((HT1)). The broker has Sell ratings on Nine Entertainment ((NEC)), Seven West Media ((SWM)) and Southern Cross Media ((SXL)).

The broker notes TV broadcasters are now reliant on live sport and reality TV shows to drive audiences with streaming services dominating scripted content. Broadcast TV viewing has declined rapidly with the average hours watched down -16% in the past three years and revenue down -8%.

Meanwhile, online advertising has grown to become almost 50% of the advertising market in the past 17 years, although this is dominated by search and social segments, to which Australian media has negligible exposure. Citi expects online to reach around 60% of the advertising market by 2021.

#### Pro-Pac Packaging

Pro-Pac Packaging ((PPG)) manufactures a range of rigid packaging products and distributes a full array of packaging materials. Following a merger with Integrated Packaging in November, the group now manufactures flexible packaging products, predominantly stretch film, shrink film and other plain and printed flexible packaging. Bell Potter find significant benefits from the recent merger and an opportunity to release synergies.

The increased scale is expected to result in procurement savings. The broker initiates coverage with a Buy rating and target of \$0.50. When compared with listed packaging peers the company has a substantially lower forecast expenditure profile as a percentage of revenue. Bell Potter expects this will result in improved free cash flow and growing returns on capital.

#### Think Childcare

Think Childcare ((TNK)) is an owner/operator of 42 child care centres across Australia with an 85% weighting to Victoria. Moelis notes the company has a valuable pipeline of third-party owned centres which are providing a de-risked pathway to acquisitive growth, in addition to sourcing its own greenfield acquisitions.

As a result the portfolio will contain a mix of well-established centres (high occupancy), greenfield centres (low occupancy) and acquired centres (around 75% occupancy). Moelis initiates coverage with a Buy rating and \$2.70 target. Estimates assume the company will acquire 60 centres over the next six years at a total cost of around \$120m.

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## Genex Powers Up Pumped Hydro

Genex Power is positioned to benefit from changes occurring in the National Electricity Market. Canaccord Genuity initiates coverage with a speculative Buy rating.

-Material opportunity for electricity storage sourced from low-cost technologies -Catalysts include finalisation of K2-solar development and potential announcements on energy offtake -K2-solar development financial close targeted for mid 2018

By Eva Brocklehurst

Genex Power ((GNX)) has an investment proposition in the Australian utility sector that is unique and simple, with its pumped hydro development at Kidston in Queensland. Canaccord Genuity believes the proposition positions the company to benefit from changes occurring in the National Electricity Market and initiates coverage with a speculative Buy rating and \$0.40 target.

Globally, solar and wind are the two leading generation technologies, in terms of new additional capacity, and the broker suggests the penetration of intermittent electricity sources will rise substantially, given bipartisan federal support for Australia's international emissions commitments amid state schemes designed to facilitate new developments.

Embracing intermittent sources, in conjunction with a gas shortage, provides a material opportunity for electricity storage, particularly when sourced from low-cost technologies such as pumped hydro.

The last pumped hydro project in Australia was built over 30 years ago and a recent screening study from the Australian National University identified some 22,000 potential sites and only one of them has been the subject of a detailed feasibility study so far. The 50 MW Kidston stage 1 solar project (K1-solar) is in production and momentum is building for the stage 2, 250 MW development and co-located 270 MW solar (K2-solar).

Genex Power was floated in mid-2015 on the potential of pumped hydro, utilising the abandoned Kidston gold mine. At that point the investment basis was centred on the exploitation of an oversupply of base load coal-fired generation capacity and escalating peak power prices. The proposition has now moved slightly to take advantage of the solar opportunity although the broker suggests the basic premise of the original thesis still holds.

Industry needs energy policy certainty and the broker is encouraged by the sort of support provided by Infigen ((IFN)), AGL Energy ((AGL)) and Origin Energy ((ORG)). Canaccord Genuity concludes 2018 will be an exciting year for Genex Power amid support by the generation industry for the federal National Energy Guarantee.

Over coming months the broker will be on the look out for the finalisation of capital expenditure for the K2-solar development and a potential announcement on energy offtake and partnering for both the solar and hydro aspects.

### Valuation

Canaccord Genuity values the company's three key projects using a free cash flow-to-equity model and assumes a 50% sell-down of K2-solar for a developer margin. Generation from K1-solar commenced this month and a \$110m budget was funded through a \$100m debt package plus a \$8.9m grant. The efficient funding model, significant tax loss credits and a relatively high contract price has driven the broker's valuation to \$40m for the asset.

The company is targeting financial close for the K2-solar development by mid 2018. Assumptions are largely in line with K1-solar but the broker allows for some economies of scale and further reductions in solar capital expenditure. Nevertheless, these will be more than offset by lower electricity price assumptions and a lower proportion of debt funding.

### Pumped Hydro

Pumped hydro offers scale for intermittent supply from wind and solar at a lower cost than batteries. Enhancements and cost reductions from batteries assist but do not currently have the scale required to maintain grid stability and reliability.

Pumped hydro is responsible for around 97% of worldwide energy storage and while grid-scale batteries are expected to make inroads in the longer term, significant cost improvements and even larger storage capacity is required for this to happen.



Hence, the company's Kidston development has first-mover advantage. Over 7000 MW of solar developments have been proposed in Queensland but to Canaccord Genuity's knowledge only Kidston has an associated pumped hydro project. The broker envisages a high level of interest in Kidston by energy offtake and potential equity partners.

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## Limited Downside For Aristocrat

By Michael Gable

In this week's report we take a look at Aristocrat Leisure ((ALL)), on the back of some share price weakness following a recent acquisition.

The uptrend in ALL has stalled for the time being but there is nothing negative about that. At the moment the shares are consolidating here. It appears to be in the form of an ascending triangle, or we could see the shares come back a bit further towards \$20 to form a flat rectangle. Either way, we can only be negative on the chart if it falls through support near \$20. A pullback towards \$20 followed by a bounce would be ideal for an entry point. Otherwise a break to the upside (closing above \$24 for the week) could also be followed.

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