Week

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Stories To Read From FNArena

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FNArena
Financial News, Data & Analysis

GPO Box 3145
Sydney NSW 2001

info@fnarena.com

Your editor
Rudi Filapek-Vandyck

Your dedicated team of journo's
Greg Peel
Eva Brocklehurst

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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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Caltex Softens Outlook, All Eyes On BP

Caltex has guided to softer than expected profit for 2017 but brokers agree the key issue for 2018 will be the reaction from BP/Woolworths to the ACCC decision.

-Headwinds likely to persist into 2018, including increased retail competition and rising commodity prices -Lower mix of premium petrol affecting retail margins -Blocking of the BP/Woolworths transaction could be a major positive for Caltex in 2018

By Eva Brocklehurst

Brokers were slightly disappointed with 2017 profit guidance from Caltex ((CTX)), as it appeared soft in the context of a half-year contribution from the Milemaker acquisition and four months from the Gull acquisition.

The company expects net profit (RCOP basis) of $600-620m. The mid point of this guidance is -8% below Deutsche Bank's prior estimates. However, the broker points out supply & marketing, which drove the miss to most estimates, includes an impact from FX and timing lags.

Headwinds are likely to persist into 2018, emanating from lower retail margins experienced in the second half, which were driven by increased retail competition. Deutsche Bank expects this level of competition to be maintained, if not intensify, in 2018 and weigh on margins.

There is also a lower mix of premium petrol. While total premium fuel volumes have increased, this was lower-margin premium diesel rather than petrol. Non-fuel income is also expected to be lower because of the impact on operations from franchise conversions.

The company has highlighted that diesel product is trending stronger against petrol amid softening non-fuel income, but provided no guidance into the new year. Citi ascribes the soft guidance to ongoing costs from the franchise review and Foodary, plus modest margin pressure compared with a strong first half. Morgan Stanley expects a softening of margins over time as the consumption of fuels changes in Australia. This is likely to lead to greater competition.

Marketing may have been a bit weak but Credit Suisse finds the fact margins were a little softer and premium volumes slightly lower not much for the bears to get excited about. On a global basis, the broker adds, this is even less exciting, given gasoline demand peaked in most OECD countries more than a decade ago.

Credit Suisse believes discounting from Coles ((WES)) led to some of the margin weakness in the September quarter, a trend that is likely to have reversed in the December quarter. While this isn't a business with a lot of organic growth, the broker asserts it is solid, generating cash, under-geared as well as highly defensive.

Caltex is in transition, in Ord Minnett's view, with several strands to its efforts to drive shareholder returns. The core business is attractive and the broker expects refiner margins can support earnings growth and generate cash, with potential to deploy this into higher-multiple opportunities.

Transport fuel margins, while likely to be down in the second half of 2017 versus the first half, should be supported by the product mix and competitive dynamics. Meanwhile, acquisitions and cost savings should drive supply & marketing earnings growth.

UBS agrees Caltex has a number of levers to drive growth in marketing & supply including supply-chain optimisation, fuel premiumisation and convenience store roll-out. The broker believes acquisitive growth remains a priority, although the balance sheet suggests there is limited capacity to undertake material acquisitions or buybacks in the near term.

ACCC Decision

Despite the ACCC decision to oppose the sale of Woolworths ((WOW)) petrol outlets to BP, Deutsche Bank continues to factor in a six-month delay to the transaction, pending a probable response from BP and Woolworths.

Citi is already modelling cost improvements and acquisitions offsetting the lost business from Woolworths but awaits developments, suspecting there could be more upside for Caltex from the BP/Woolworths transaction. Further updates are expected at the February results.

UBS retains its Buy thesis based on Caltex retaining the fuel supply deal with Woolworths, and awaits a response from BP as to whether it will challenge the decision. The broker believes the muted reaction in the Caltex share price to the news is an indication the market envisages considerable risk that BP will not only challenge decision, but also win.

If BP does challenge, Caltex shareholders would need to await the outcome of the case before knowing the final impact. If BP does not challenge then it would be up to Woolworths to determine the next course of action.

Ord Minnett cuts forecasts for earnings per share by -4.9% for 2017 and -6.6% for 2018, although raises forecasts for 2019 by 6.2% to incorporate the retention of the Woolworths petrol volumes.

Credit Suisse considers the blocking of BP's acquisition of Woolworths a major positive for Caltex and considers it highly unlikely that Caltex will lose the Woolworths volumes in 2018, so these are added back into the numbers.

Credit Suisse excludes the Woolworths earnings from 2019 onwards until there is more clarity on BP's plans. All up, Credit Suisse tentatively raises 2018 estimates by 11% and reduces 2019 by -5%. The broker suggests, if Woolworths volumes are sustainably retained, the economics of infrastructure divestments are even stronger.

RCOP

Caltex reports results on a replacement cost of sales operating profit (RCOP) basis which removes the impact of fluctuations in the US dollar price of crude oil and foreign exchange on cost of sales to give a more accurate picture of underlying performance.

FNArena's database shows four Buy ratings, two Hold and one Sell (Morgan Stanley). The consensus target is $35.99, signalling 4.6% upside to the last share price. Targets range from $27.00 (Morgan Stanley) to $40.80 (Credit Suisse).

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

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Pilbara Minerals' Rally Considered Excessive

Pilbara Minerals has negotiated the sale of run-of-mine ore from Pilgangoora and brokers welcome the deal as an opportunity to generate some cash while the project is developed.

-Sale could generate cash to largely cover increased capital expenditure for Pilgangoora -Brokers still suspect timeframe for development of Pilgangoora is stretched -Rally in the share price considered excessive

By Eva Brocklehurst

Pilbara Minerals ((PLS)) plans to supply direct shipping ore (DSO) from its Pilgangoora lithium-tantalum project to Atlas Iron ((AGO)) over a period of 15 months. Brokers expect this sale will provide some early cash flow as commissioning of stage I gets underway.

Capital for stage I of the Pilgangoora project has been increased by around $50m to $274m. The additional capital is to be spent on the process plant with costs being incurred in order to accelerate construction and maintain the original schedule. Additional investment in the plant is in line with the company's strategy to target long-term supply of high-quality material.

The agreement encompasses 1.0-1.5 mtpa of run-of-mine ore, and pricing is underpinned by a US-dollar fixed base price, with adjustments according to material specifications and the cost of final shipping. Atlas Iron will use the existing Mt Dove infrastructure to crush and ship the product to final customers in China. As part of the deal Atlas will make a pre-payment of US$3m to fund the establishment costs and claw this back with US$500,000 in offsets over the first six invoices.

Canaccord Genuity expected Atlas Iron would be engaged for mining services but welcomes the extension to a purchase of ore. The broker also suspected an additional $40m in cash flow could be generated over 2018/19 if the company undertook 1mt of DSO sales.

The broker calculates that assuming Atlas Iron can achieve a price of US$110/t, Pilbara Minerals can receive a mine gate price of around $50/t for its product. This should cover the additional capital of $40m associated with increasing work activities at Pilgangoora, and retain the goal of first production by June 2018. Canaccord Genuity has a Hold rating and $1.19 target.

Pilgangoora will come into focus as the market for battery materials evolves, in Macquarie's opinion. Despite the up-front payment from Atlas, the broker believes the project schedule is still looking stretched. The lithium market remain short and demand for DSO high, so a supply shortage is expected to persist in 2018, and there is potential for sales to continue beyond the scheduled 15 months.

The stock has rallied strongly amid positive news on the lithium sector and Macquarie downgrades to Neutral from Outperform on valuation grounds, raising the target to $1.15 from $1.10.

Citi also downgrades, to Sell/High Risk on the back of the share price performance. The broker believes most of the positive catalysts, such as offtake and expansion, are factored into the current share price. There is now the potential for downside risk associated with delays that are prevalent for construction and commissioning in the mining industry.

To allow for the agreement Citi increases the costs of DSO sales and assumes revenue of US$120/t and effective costs of US$78/t for Pilbara Minerals. Increasing the probability of the 5mtpa expansion to 100%, given the outlook for the lithium market, and the signing of offtake contracts, increases the broker's target to $1.05 from $0.95.

Citi agrees a 200% increase in the share price since September is excessive and this does not allow for any execution risk associated with the Pilgangoora project, which is yet to generate any cash flow.

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Outlook For 2018: Australia

Australia's growth in 2017 has lagged that of a synchronised global economy, reflected in a positive but underperforming stock market. Is 2018 the year of catch-up? Or are further domestic pressures building?

- Brokers mostly upbeat, but not all - Banks, miners and consumers in the spotlight - Growth preferred over value - Wide range of index forecasts

By Greg Peel

This Outlook feature follows on from Outlook For 2018: Global, published last week. If there is one stand-out element of pundit views of the global economy in 2018, it is a general consistency. The synchronised growth story will continue into 2018, central banks will remain relatively supportive and US tax reform will provide an added boost. But…

But risks will begin to emerge in 2018 that will not deliver, but may portend the coming end to the Goldilocks period that dominated 2017. Investors are not yet complacent, let alone euphoric, hence caution and cash on the sidelines suggest stock market gains have not yet run their course. Volatility will, however, begin to make a comeback.

If there is a stand-out element of the views of stock brokers, research houses and economists with regard Australia in 2018, it is a lack of consistency. Most pundits are upbeat about 2018, but certainly not all. With regard the Australian stock market, divergence of views can be immediately noted in a range of end-2018 targets for the ASX200, from those sourced for this feature, of 5800 to 6500.

While views on the global market may be relatively consistent, there are still peculiarities within individual regions. The US is all about Trump and tax reform, alongside Fed policy tightening. The UK has to deal with Brexit. The EU has to hang together to consolidate its recovery while the ECB looks to ease as well. China has a growing debt problem and seemingly perpetual risk of slowdown.

Australia offers a long list of peculiarities. We have a resources sector riding high on Chinese government crackdowns. We have a banking sector under siege from regulators and politicians. We are now seeing both the end of the mining investment slump and the end of the housing boom. We have consumers overstretched by mortgages set at historically low variable interest rates who are seeing no wage growth as they run out of savings. We have governments pouring funds into infrastructure, and businesses feeling the most confident they have since pre-GFC days.

We have a whole series of factors to consider as we head into 2018. How the year plays out will depend on just how much influence each of these factors has. Where the pundits see the situation by end-2018 depends entirely on how these various risk/reward scenarios play out, in their own views.

Opinions are divided.

The Banks

Year to date, the Australian stock market has risen 5% compared to the US rally of 25%. Deutsche Bank suggests Australian equites have lagged global peers by around -10%. Yet take out the banks, and ASX200 has tracked broadly in line.

The Big Four Australian banks represent 25% of the market cap of the ASX200. The Big Five gets us to 27%. The ASX20 – twenty highest market cap stocks – boasts nine members of the financials sector, not counting property stocks, when we add in wealth managers/insurers. Add in regionals and other non-bank financials and the financials sector, ex-REITs, is 35% of the ASX200.

2018 started well for Australian stocks, riding along on the Trump wave, but then we fell into a hole after April. We were stuck in that hole for five months before finally managing to climb out in October. Meanwhile, Wall Street surged on to post ever higher highs.

It was all about the banks.

The banks brought it upon themselves. On the one hand they became more and more lax about lending money into the housing boom which they themselves were fuelling by doing so. On the other hand, a string of scandals meant the government could simply no longer ignore the ever growing, increasingly angry, pitchfork wielding mob. The tipping point was yet another string of bank profits in the billions.

The regulators acted, and tightened the screws. The government acted, first with a bank levy and now with a Royal Commission. In isolation the banks are facing a slowdown in mortgage lending in 2018 but a potential pick-up in business lending. Capital positions are sound and the ongoing process of divesting non-banking businesses (insurance/wealth management) is bringing a new round of capital management for shareholders. Rising global rates should be a positive.

The negative is sentiment. While the banks will always find a share price floor based on dividend yield, upside is limited when the market continues to worry about what might come out of the Royal Commission (running all next year), what further politically-motivated screws the government might turn, and what further housing boom screws the regulators might turn.

If the banks are not going to find investor support in 2018, can the ASX200 push onto new horizons without that huge chunk of market cap?

Macquarie's stance on the banks is Neutral. Bank balance sheets are in good shape, the broker notes, and will benefit from improving growth and yield curve steepening early in 2018, but the government "has the sector in its crosshairs", leaving the regulatory risk premium elevated and limiting performance upside.

UBS cites a marginally disappointing full-year result season for the majors as reason to downgrade its recommendation on the banks to Neutral from Overweight. UBS prefers non-bank financials, which offer leverage to higher interest rates and buoyant capital market conditions.

Morgan Stanley, too, has a preference for non-banks in the sector.

Citi sees "household-facing" sectors offering less to investors in 2018, and this includes the banks.

The consensus on Australian banks is relatively consistent among brokers. As Citi puts it, "sentiment towards the banks and the political uncertainty seem to have been factors holding the market back" in 2017, and such sentiment is unlikely to improve in the near term.

Resources

The opposite is true when it comes to the resource sectors, or more specifically, commodity prices in 2018. Broker views are polarised.

Materials represent around 17% of ASX200 market cap and energy 5%. BHP ((BHP)) alone is 5% and its spin-off South32 ((S32)) another 1%, with Rio Tinto ((RIO)) on 1.7%. Woodside Petroleum ((WPL)) dwarfs other energy sector components at 1.5%.

ANZ Bank's economists suggest 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.

As 2017 draws to a close, resources continue to offer the best combinations of value and growth, says Deutsche Bank.

The resources sector does present a source of some potential upside to 2018 earnings estimates, says UBS, as was the case in 2016 and 2017. Were the broker to mark its 2018 commodity price forecasts to current spot, earnings upgrades in the order of 20-30% would follow.

Macquarie, too, oft points out that its own forecasts are well below spot pricing.

UBS retains an Overweight in in resources, in part due to expectation of solid global growth in 2018 supporting commodity prices, but also because of relatively undemanding valuations and the ability of the resource sector to act as a hedge against rising inflation and interest rate risks.

UBS does see downside risk for certain individual commodity prices, namely alumina, manganese and coal, as supply returns beyond the Chinese winter. But China's focus on reform and pollution will continue through to 2018 and together with producer discipline outside of China, the analysts expect elevated commodity prices, and hence healthy profits and increased returns for the sector.

Citi sees upside risk to the ASX200 in 2018 as concentrated in the resource sector, which could trade above 2x book value (1.7x now).

Morgan Stanley sees "merit" in holding resource and energy exposures given sustained momentum forecast for global growth as well as improved quantum and quality of earnings for key names.

So far, so good. But…

Macquarie has downgraded its recommendation on resources to Neutral. The miners are momentum stocks and are losing earnings support despite free cash flow generation, the broker notes. Slowing Chinese growth is a downside risk for spot commodity prices with any upside surprises being relatively short-lived. There are nevertheless sub-themes within the commodities space that "still have legs", the broker suggests, such as anything to do with electric vehicles.

Enter Ord Minnett…

"Our positioning on commodities is unambiguously negative, with precious metals the only segment of the market for which we see potential upside from current levels."

Ords is particularly negative across the bulks complex, forecasting an iron ore price -9.0% below current spot and -6.6% below forward prices. For thermal coal, the broker's forecast is -12.4% below forward pricing and for coking coal, -19.0% below.

Ords has downgraded its recommendation on the resource sector to Neutral. As an asset class, commodities are projected to deliver poor returns in 2018, with agriculture and precious metals the only bright spot. So says the broker.

The Consumer

The issues facing the average Australian household heading into 2018 are well documented. The housing boom has been fuelled by historically low interest rates that have led households into mortgages that represent more than the traditional third, and in some cases up to a half, of household monthly budgets, in terms of repayments. Interest rates are most likely to rise from here, albeit perhaps not at all in 2018.

Inflation may be low but wage growth is negligible, meaning wages are going backwards in real terms. Utility bills have risen by ridiculous amounts, adding further burdens on top of mortgages. The return to a mindset of savings as a result of the GFC has now evaporated – savings have now fallen back to the low levels they were before the crisis.

The housing market is cooling. While household wealth is predominately tied up in the family home, history shows consumer spending is closely correlated with house prices given a consumer who "feels" wealthy will be more inclined to spend.

On the flipside, supermarket wars ensure the household grocery-spend has come down, down in real terms these past few years. Globalisation and the internet mean Australians no longer pay unsubstantiated premiums for the likes of electronic goods, and many other products. Amazon fear has retailers rushing to discount prices even in the lead-up to Christmas. But this benefit to households is no comfort for Australian listed retailers.

"Australia has lagged the global recovery," notes Morgan Stanley, "and we see this continuing in 2018 as a tightening credit cycle for housing and negative real income growth see consumer weakness overwhelm a pick-up in capex, and we revise down our 2018 GDP growth forecast to 1.5%, well below consensus of 2.8%".

That's it then.

Morgan Stanley believes the heavy-lifting, with regard Australia's GDP growth, will be done by state-based fiscal spending and sequential strength in infrastructure, but the domestic earnings cycle is "hamstrung by both slowing housing signals and fatigued consumers".

Morgan Stanley's right – consensus is for around a 2.8% GDP growth rate in 2018. Morgan Stanley, therefore, is on the outer with its consumer weakness warning.

Janus Henderson expects consumption to grow "at a modest pace". Macquarie suggests consumer spending will "muddle along" amid ongoing weak wages growth.

Macquarie believes economic growth should become marginally stronger through 2018 with credit restrictions "working to reduce housing risk", which is a positive twist on Morgan Stanley's assumed negative impact from a "tightening credit cycle for housing". But Macquarie also believes the attack on traditional bricks & mortar retail will continue.

This attack will potentially even drag down areas deemed almost “untouchable” to date, such as hardware. “It is too early to go back into this space,” says Macquarie. The broker recommends no retail or food staples.

The counter-argument to Macquarie’s supermarket/hardware warning comes from those who believe that by repositioning, the supermarkets can offer some hope of recovery from knocked-down levels. Citi, for example, likes Woolworths ((WOW)).

However the consumer sector performs in 2018 – whether indeed it does manage to at least “muddle along – there’s little disagreement the Australian consumer remains vulnerable. High levels of household debt and low levels of savings mean the consumer is in no position to weather any shocks.

While there is an almost unanimous expectation that the next rise in the RBA cash rate will be up – variation in views come down to the timing, be it late 2018 or not until 2019 – there is still a cohort who suggest the next move will be down. This is not to suggest therefore there will be relief in sight for indebted households, rather it will be household indebtedness and an end to the positive housing cycle that forces the central bank’s hand.

The Positives

There is general agreement the banks will not lend much support to the Australian stock market in 2018. There are differing views on the direction of commodity prices, although most analysts are pro-resources for another year. Consumer spending is a bone of contention, and at best a fragile sector. So what’s the good news?

There is little doubt the housing sector boom is at best cooling, at worst turning, as we head into 2018. For the past several years, strength in the housing sector has offset slow-burn weakness driven by the steady winding down of mining and energy investment. The housing sector will not be as predominant an economic driver in 2018, but the good news is the mining slowdown has pretty much come to an end.

That brings us back to neutral. Driving the economy forward in 2018 will be aforementioned government infrastructure spending. From a stock market perspective, this will benefit the building materials and engineering & contractors sector. Public spending will provide a significant chunk of GDP growth.

In the private arena, the signs for a pick-up in business capital expenditure are positive. It’s been a long time coming.

In the period since the GFC, businesses have been focused on cutting costs and repairing balance sheets. Historically low interest rates have allowed for refinancing and for those that can afford it, share buybacks. Indeed, shareholders have been the winners in the period since the GFC, having been wiped out during, as companies have sought to win back favour with capital management – buybacks, capital returns and increased dividends.

The concept of mining and energy companies being among the highest yield stocks in the market would have been met with hearty laughter in times gone by.

But companies are now lean and balance sheets healthy. Cash flow, particularly in the resources sector, is strong. As the GFC approaches its tenth anniversary, companies must look towards the next decade, and that means growth. And growth means investment.

The latest private capex data, from the September quarter, suggest it’s early days but it appears the capex tide is turning. Spending expectations over FY18 have surprised economists to the upside. Global interest rates may be set to rise but there is no expectation of such for Australia for a while yet. Financing remains affordable.

“The domestic infra/capex thematic has longevity,” Macquarie declares.

The good news is we don’t have to fear offshore influences, as most analysts expect synchronised global economic growth to continue into 2018, as was outlined in the Global version of this feature. Against a backdrop of solid major trading partner growth, and with public infrastructure work yet to be done, Janus Henderson believes Australia is well placed to manage the end of the housing boom. Alongside modest consumption growth we’ll see net exports benefitting from further LNG capacity expansion. Business investment is poised to become a source of growth as the drag from falls in mining investment finally ends.

Janus Henderson forecasts economic growth rising to 3%, in stark contrast to Morgan Stanley’s prediction of 1.5%.

One point to make on the “end of the mining investment boom”, as it is usually referred to, is that it is often mistaken as the “end of the mining boom”, suggesting doom and gloom. The reality is that investment was made over a number of years into production, and we have now moved into the production phase from the construction phase at a time most commodity prices are favourable.

LNG exporters are not exactly flavour of the month with households and businesses having heart attacks with each new gas bill, but the fact remains LNG exports are set to eventually exceed iron ore exports as Australia’s biggest single contributor to economic growth.

Most analysts also expect 2018 will be the year the Aussie dollar finally drops down to more sensible levels, as US tax reform and Fed rate hikes finally drive the US dollar higher. A weaker Aussie is net positive for the Australian economy, being one of export dominant over domestic consumption.

It is often overlooked that travel is one of Australia's biggest exports. There weren't many extra shrimps being thrown on the barbie when the Aussie was above parity, but the tourism industry is beginning to bounce back, with China the new primary driver.

The bottom line is that we will head into 2018 with a changing in the guard of economic drivers. There will be rotation among sectors.

And if that is the case, there should be rotation among stock market sectors as well.

Valuing Value

Stocks are typically divided into two camps for investment purposes – value and growth. Value stocks are typically identified by a low price/earnings ratio, where the share price is not reflecting earnings capacity. Growth stocks tend to have a high PE ratio but only because of rising earnings trajectories, which suggest PEs will normalise into time.

There is no rule to say you can only invest in one or the other, but typically equity strategists will cycle between the two. Value investing made Warren Buffett what he is today, but "cheap" does not by default mean "value".

The "cheap" end of the Australian equity market is under pressure from cyclical and structural growth risks, warns Macquarie. This is a classic "value trap", where no sustainable growth rebound is evident. Stick to growth and quality, says the broker.

It is this belief that informs Macquarie's aversion to bricks & mortar retailing in 2018. Amazon is not the disruptor in the space, the broker screams from the rooftop, technology is. The pace of technology is accelerating at an exponential rate, Macquarie notes, and Australia is in the early stages of a long, technology-driven disruption cycle that compresses pricing power and margins.

We often tend to look at the stock market as a whole, and the ASX200 as its benchmark. There is much discussion about how the banks and miners will fare, given the extent of their market cap influence. But investors in "the index" would have been crying in their morning cereal during the long, dark months of a range-bound index from May to October, watching the share price of a2 Milk ((A2M)), for example, surging ever higher.

Morgan Stanley is the most downbeat with regard to the ASX200 in 2018 among the sources drawn upon for this feature, but on the flipside, the broker sees "good alpha opportunity".

Alpha is the up/downside risk offered by an individual stock in its individual space as opposed to the "beta" risk of the market as one whole. If you buy "the index", through perhaps an ETF or holding a portfolio of only big caps, you are playing beta risk. Holding a portfolio of "stories" – Chinese consumer growth, disruptor technology, batteries and EVs, 'big data", "the cloud", and others beside – means you're playing alpha risk.

It is of course a risky business. Many a high-flying, "new world" growth stock has had the rug pulled out from under them in 2017, and perhaps others will suffer the same fate in 2018.

Morgan Stanley likes stocks that will benefit from a lower Aussie as an alpha play. These include the true "global growers" and key name resource stocks. Exposure to infrastructure is recommended as are non-bank financials.

Macquarie likes domestic infra, the US housing market and soft commodities (eg fertiliser). UBS has pulled back to Underweight on some of the 2017 high-flyers, such as healthcare, online media and Chinese consumer plays, but is Overweight "GARP" stocks – growth at a reasonable price.

Solid returns are still achievable in this market, Morgans believes, but they should not come at the expense of investors taking on excessive levels of risk.

If there is one theme we can be relatively confident of in 2018, it's that of M&A. If this past month is anything to go by, mergers & acquisitions will step up in pace next year. As to which companies are potential targets, well, there are no particular themes. This is evidenced only this past week when a takeover bid was made for "new world", cloud-based software company Aconex, hot on the heels of a bid for very "old world" shopping mall icon Westfield.

Corporate balance sheets are in good shape and there are opportunities to be had. Industry consolidation will no doubt continue into 2018.

Credit Suisse notes Chinese authorities have recently introduced new policy to encourage more outbound acquisitions.

From another angle altogether, Credit Suisse points out that the average allocation to cash of superannuation funds is currently 14% -- “unusually high” given the low level of the cash rate. If we all had a dollar for every time someone has mentioned “cash on the sidelines” since 2009 then we’d have no need to trade the stock market. But it’s there.

And despite the synchronised global rally of 2017, with Australia lagging, retail investors remain conspicuous in their absence. Is 2018 the year the cab drivers finally jump in?

The Numbers

At the time of writing, the ASX200 had closed at 6071.

I opened this feature noting that among those sourced, forecasts for the index at year-end range from 5800 to 6500.

No prizes for guessing that Morgan Stanley is the low marker, providing a 5800 forecast underpinned by a belief the Australian consumer will drag down the economy in 2018.

Morgan Stanley further notes that if the Fed does hike three more times in 2018, and the RBA remains on hold, the “carry trade” for foreigners investing in Australia diminishes in appeal as the interest rate differential gap closes. The broker also notes a forecast dividend yield in 2018 for the ASX200 of 4.4% represents a trend to below the long-run average.

“But Australia still offers a world-leading dividend yield,” Deutsche Bank points out.

UBS has set its 2018 target at 6275.

Assuming strength in the resources sector over the course of the year, Citi is targeting 6400.

Support from rising earnings and still-low rates underpins Credit Suisse’s 6500 target.

A modest forecast of a 4% increase in earnings coupled with a rise in market PE to 17x from 16x gets Macquarie to its 6500 forecast.

Each of the brokers sourced for this feature offer lists of likes and dislikes among individual stocks for 2018. We could go on forever, and often specific choices among brokers clash, only serving to confuse readers.

FNArena updates broker stock picks regularly in the editor’s Weekly Analysis columns, thus readers are directed to those as 2018 unfolds.

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 Greg Peel, Acting 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 11 to Friday December 15, 2017 Total Upgrades: 11 Total Downgrades: 9 Net Ratings Breakdown: Buy 41.69%; Hold 41.82%; Sell 16.49%

Here we are trying to break out to new highs for the ASX200, with 6000 proving a tough nut to crack, yet broker upgrades still exceeded downgrades last week. It appears there's not too much overvaluation apparent at these levels, as far as brokers are concerned. Indeed, of last week's 9 downgrades, four related to takeover bids/mergers. All of AWE, Tabcorp, Tox Free Solutions and Westfield Corp saw downgrades to either Hold or Sell because their share prices have jumped up to bid levels.

Of the 11 upgrades, seven were for miners. It's that time of the quarter when resource sector analysts reset their commodity price expectations and this December consensus is for improving prices in 2018, flowing through to miner earnings. However it's not a unanimous view, with nickel miner Independence Group receiving both an upgrade and a downgrade. Caltax saw a similar response following the ACCC's decision on the BP-Woolies deal, while conflicting responses followed profit warnings last week, with Retail Food Group enjoying an upgrade but Asaleo Care a downgrade.

In last week's target price moves, Cleanaway Waste Management won the week with 9% as brokers applauded the company's takeover bid for Tox Free. Whitehaven enjoyed a 6% gain after UBS upgraded its target by 25% on higher coal price assumptions. Metcash also saw a 6% gain following its earnings release and expectations of capital management.

On the downside, Seven West Media's consensus target fell -5% when Citi initiated coverage with a Sell rating, while HT&E also lost -5% following an update.

The table of biggest earnings forecast changes last week is dominated by miners, up and down, given small moves in commodity price forecasts can translate through to large moves in earnings expectations.

Upgrade

ALUMINA LIMITED ((AWC)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 2/4/1

Morgan Stanley upgrades to Equal-weight from Underweight as the company benefits from Chinese capacity reductions that drive firmer alumina prices. Alumina price forecasts are increased by 12% for both 2018 and 2019.

Target is raised to $2.20 from $2.10. Attractive industry view retained.

CLEAN TEQ HOLDINGS LIMITED ((CLQ)) Upgrade to Buy from Hold by Deutsche Bank .B/H/S: 2/0/0

Deutsche Bank updates its mining and grade profile to aline with the latest technical document for the Sunrise project. The company has released the document in anticipation of listing on the Toronto Stock Exchange.

The stock is now trading at a discount to the broker's risk-weighted target of $1.60 and the rating is upgraded to Buy from Hold.

The company plans to mine at higher rates during the early stages of Sunrise to capture higher cobalt credits. Deutsche Bank updates assumptions to allow for a higher strip ratio during the first seven years.

CALTEX AUSTRALIA LIMITED ((CTX)) Upgrade to Buy from Neutral by UBS .B/H/S: 4/2/1

The ACCC intends to oppose the proposed acquisition by BP Australia of the Woolworths ((WOW)) retail service station network. The ACCC argues the acquisition would lessen competition in retail fuel. UBS believes the decision is largely positive for Caltex.

Caltex has previously estimated the impact of losing the Woolworths supply agreement to be around -$150m. However, cost savings previously assumed from the loss of the supply contract may not be realised if Caltex retains the network.

UBS increases valuation to reflect the increasing possibility that Caltex retains a supply agreement and upgrades to Buy from Neutral. Target is raised to $39.10 from $35.00.

See also CTX downgrade.

CLEANAWAY WASTE MANAGEMENT LIMITED ((CWY)) Upgrade to Buy from Neutral by UBS .B/H/S: 3/2/0

Cleanaway has made a cash bid for Tox Free Solutions ((TOX)) at $3.425, which amounts to a 28% premium. UBS had considered Tox' assets to be undervalued and an acquisition would diversify Cleanaway's earnings base and provide significant synergies.

UBS also considers consensus earnings forecasts for Cleanaway to be too low. The broker has not yet factored a successful takeover into forecasts, but has added a 50% chance to its valuation, increasing its target to $1.64 from $1.38, sufficient for an upgrade to Buy.

FORTESCUE METALS GROUP LTD ((FMG)) Upgrade to Buy from Neutral by UBS .B/H/S: 5/2/1

As part of a broader update on commodities' outlook for 2018, UBS has upgraded Fortescue to Buy from Neutral. The price target gains 1% to $5.30 but the broker's Net Present Value (NPV) dives by -17% to $5.30.

The upgrade has been inspired by "value", explain the analysts. UBS is very much Overweight the sector, attracted by higher-for-longer elevated price levels and prospects of plenty of excess cash, much of which should find its way into shareholders' pockets.

INDEPENDENCE GROUP NL ((IGO)) Upgrade to Buy from Sell by Citi .B/H/S: 1/4/1

Citi analysts have implemented a double step upgrade, to Buy from Sell, on a combination of supportive in-house view on base metals in 2018 and the company update which has Nova ramping up to full production and a mill expansion adding further value.

The analysts also mention the recent share price weakness. Price target lifts to $4.50 from $4.20. Citi sees further value accretion from ongoing mining efficiencies.

DPS estimates have been significantly upgraded to 11c per annum for the three years ahead.

See also IGO downgrade.

METCASH LIMITED ((MTS)) Upgrade to Neutral from Sell by UBS .B/H/S: 2/3/1

UBS is now increasingly confident in the company's ability to maintain its operating earnings in food & grocery despite the structural headwinds.

Moreover, the broker has been surprised by the ability to bank cost reductions to date without the need to reinvest in price any further.

With a strong balance sheet and cash generation the broker envisages scope for capital management of up to $150m.

Rating is upgraded to Neutral from Sell. Target is raised to $3.10 from $1.90.

OZ MINERALS LIMITED ((OZL)) Upgrade to Overweight from Underweight by Morgan Stanley .B/H/S: 5/3/0

Morgan Stanley upgrades to Overweight from Underweight. The broker increases copper price assumptions for the near and longer term and includes more near-term depreciation at Prominent Hill to reflect the drawdown of ore inventory.

Target is raised to $9.00 from $7.80. Industry view: Attractive.

RETAIL FOOD GROUP LIMITED ((RFG)) Upgrade to Neutral from Sell by UBS .B/H/S: 0/1/0

The company is conducting a business-wide review to better ensure a sustainable future. UBS reduces long-term growth forecasts to account for the risk of increased franchisee support.

UBS reduces its nominal terminal growth rate estimate for RFG to 1% from 3%.

However, given weakness in the share price the broker upgrades to Neutral from Sell. Target is reduced to $3.15 from $4.55.

SOUTH32 LIMITED ((S32)) Upgrade to Overweight from Equal-weight by Morgan Stanley .B/H/S: 2/5/1

Morgan Stanley upgrades to Overweight from Equal-weight. Commodity price revisions, particularly metallurgical coal, aluminium and manganese, have affected FY18 and FY19 earnings estimates by -6% and 24% respectively.

The broker reduces the buyback value for the first half and carries the value into FY19, in line with the slower rate of take-up evident through the first half.

Target is raised to $3.75 from $3.40. Industry view is Attractive.

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

As part of a broader update on commodities' outlook for 2018, UBS has upgraded Whitehaven Coal to Buy from Neutral. The price target gains 25% to $4.50.

The upgrade has been inspired by "value", explain the analysts. UBS is very much Overweight the sector, attracted by higher-for-longer elevated price levels and prospects of plenty of excess cash, much of which should find its way into shareholders' pockets.

Whitehaven will be swimming in cash next year predict the analysts.

Downgrade

AGL ENERGY LIMITED ((AGL)) Downgrade to Neutral from Buy by Citi .B/H/S: 5/2/0

It appears Citi analysts were not that impressed with AGL's Strategy Day presentation. They note higher growth plans come with higher capex attached and there is not much clarity about how exactly earnings are going to benefit.

Citi has thus decided to adopt a more cautious view, hence the downgrade to Neutral from Buy. The analysts would like to see a more attractive entry point, given uncertainty about the next growth phase, unless there is another spike in wholesale electricity prices.

Target price declines to $26.31 from $26.88. Earnings estimates have been slightly reduced.

ASALEO CARE LIMITED ((AHY)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/2/1

The company has downgraded FY17 underlying operating earnings guidance, expecting a -4.7% decline at the mid point of the range.

Citi notes the company is losing share in feminine hygiene even though other categories are performing strongly. The broker downgrades to Sell from Neutral. Target is reduced to $1.35 from $1.60.

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

Mineral Resources ((MIN)) has confirmed an all-scrip offer for AWE, with AWE shareholders receiving one MIN share for every 22.325 shares held.

This values AWE at $0.80 a share as of Friday's close and compares with the bid from China Energy Reserve and Chemical at $0.73 per share, cash.

So close to Christmas, Citi is not sure that investors awaiting a higher offer will be rewarded by Santa and downgrades to Sell/High Risk from Neutral/High Risk rating. Target is $0.72.

CALTEX AUSTRALIA LIMITED ((CTX)) Downgrade to Hold from Buy by Deutsche Bank .B/H/S: 4/2/1

The ACCC intends to oppose the proposed acquisition of the Woolworths ((WOW)) service station network by BP. BP and Woolworths are currently considering options in the light of the decision.

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

Deutsche Bank makes no changes to earnings estimates at this stage and, having already factored in delays to its price target, downgrades to Hold from Buy. Target is $36.15.

See also CTX upgrade.

INDEPENDENCE GROUP NL ((IGO)) Downgrade to Equal-weight from Overweight by Morgan Stanley .B/H/S: 1/4/1

Morgan Stanley downgrades to Equal-weight from Overweight. The target is increased to $4.15 from $3.75 to reflect higher nickel price forecasts.

As the equity is trading in line with the new target and offers only limited upside the broker has downgraded its rating. Attractive sector view retained.

See also IGO upgrade.

INVOCARE LIMITED ((IVC)) Downgrade to Sell from Neutral by UBS .B/H/S: 2/1/3

UBS finds it hard to ignore the stock's 1-year forward PE of 30.9x, which represents a 70% premium against the Small Industrials index. This is well above the 7-year historical premium of 59%.

While the trend of high PE stocks as a key contributor to index strength has eased over the year, the broker notes that Invocare's share price has only fallen -3% since its all-time highs.

Rating is downgraded to Sell from Neutral. Target is raised to $16.10 from $14.70.

TABCORP HOLDINGS LIMITED ((TAH)) Downgrade to Neutral from Outperform by Credit Suisse .B/H/S: 2/1/0

Shareholders have approved the scheme merger with Tatts ((TTS)). Credit Suisse has downgraded to Neutral from Outperform until there is more clarity regarding the company's ability to surpass $0.26 per share in dividends by FY20.

Credit Suisse expects the wagering industry structure is likely to improve further, with the advent of a possible point of consumption tax in Victoria from FY19. Target is raised to $5.20 from $4.80.

TOX FREE SOLUTIONS LIMITED ((TOX)) Downgrade to Neutral from Buy by UBS .B/H/S: 0/4/0

UBS downgrades to Neutral from Buy as the stock is trading largely in line with valuation. Target is raised to $3.50 from $2.85.

The broker believes Cleanaway's bid goes a long way to closing the valuation gap and peers may not be able to extract the same synergies, or be too heavily geared, to make a counter bid.

WESTFIELD CORPORATION ((WFD)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 3/1/1

Ord Minnett downgrades to Hold from Accumulate following further analysis of the takeover bid by Unibail-Rodamco. Valuation and target stands at $10.60, but the broker acknowledges there is limited upside from current levels in the absence of a higher bid.

Westfield shareholders will receive a 90% stake in OneMarket, formerly known as Westfield Retail Solutions and Westfield Labs, which will be spun out to security holders post the deal being implemented.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ALUMINA LIMITED Neutral Sell Morgan Stanley 2 CALTEX AUSTRALIA LIMITED Buy Neutral UBS 3 CLEAN TEQ HOLDINGS LIMITED Buy Neutral Deutsche Bank 4 CLEANAWAY WASTE MANAGEMENT LIMITED Buy Neutral UBS 5 FORTESCUE METALS GROUP LTD Buy Neutral UBS 6 INDEPENDENCE GROUP NL Buy Sell Citi 7 METCASH LIMITED Neutral Sell UBS 8 OZ MINERALS LIMITED Buy Sell Morgan Stanley 9 RETAIL FOOD GROUP LIMITED Neutral Sell UBS 10 SOUTH32 LIMITED Buy Neutral Morgan Stanley 11 WHITEHAVEN COAL LIMITED Buy Neutral UBS Downgrade 12 AGL ENERGY LIMITED Neutral Buy Citi 13 ASALEO CARE LIMITED Sell Neutral Citi 14 AWE LIMITED Sell Neutral Citi 15 CALTEX AUSTRALIA LIMITED Neutral Buy Deutsche Bank 16 INDEPENDENCE GROUP NL Neutral Buy Morgan Stanley 17 INVOCARE LIMITED Sell Neutral UBS 18 TABCORP HOLDINGS LIMITED Neutral Buy Credit Suisse 19 TOX FREE SOLUTIONS LIMITED Neutral Buy UBS 20 WESTFIELD CORPORATION Neutral Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 CWY CLEANAWAY WASTE MANAGEMENT LIMITED 60.0% 33.0% 27.0% 5 2 OZL OZ MINERALS LIMITED 63.0% 38.0% 25.0% 8 3 AWC ALUMINA LIMITED 7.0% -7.0% 14.0% 7 4 CTX CALTEX

AUSTRALIA LIMITED 50.0% 36.0% 14.0% 7 5 MTS METCASH LIMITED 7.0% -7.0% 14.0% 7 6 FMG FORTESCUE METALS GROUP LTD 44.0% 31.0% 13.0% 8 7 TWE TREASURY WINE ESTATES LIMITED -8.0% -21.0% 13.0% 6 8 WHC WHITEHAVEN COAL LIMITED 6.0% -6.0% 12.0% 8 9 OSH OIL SEARCH LIMITED 56.0% 44.0% 12.0% 8 10 ANZ AUSTRALIA & NEW ZEALAND BANKING GROUP 21.0% 19.0% 2.0% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 TAH TABCORP HOLDINGS LIMITED 38.0% 63.0% -25.0% 4 2 HT1 HT&E LIMITED 83.0% 100.0% -17.0% 6 3 AGL AGL ENERGY LIMITED 64.0% 79.0% -15.0% 7 4 IVC INVOCARE LIMITED -21.0% -7.0% -14.0% 7 5 APO APN OUTDOOR GROUP LIMITED 67.0% 80.0% -13.0% 6 6 ASX ASX LIMITED -63.0% -50.0% -13.0% 8 7 SWM SEVEN WEST MEDIA LIMITED -50.0% -40.0% -10.0% 6 8 DHG DOMAIN HOLDINGS AUSTRALIA LIMITED -50.0% -40.0% -10.0% 6 9 TCL TRANSURBAN GROUP 50.0% 57.0% -7.0% 6 10 AWE AWE LIMITED -20.0% -17.0% -3.0% 5 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 CWY CLEANAWAY WASTE MANAGEMENT LIMITED 1.566 1.433 9.28% 5 2 MTS METCASH LIMITED 2.991 2.820 6.06% 7 3 WHC WHITEHAVEN COAL LIMITED 3.688 3.481 5.95% 8 4 TWE TREASURY WINE ESTATES LIMITED 13.758 13.361 2.97% 6 5 TAH TABCORP HOLDINGS LIMITED 4.938 4.838 2.07% 4 6 CTX CALTEX AUSTRALIA LIMITED 35.494 34.909 1.68% 7 7 OZL OZ MINERALS LIMITED 9.128 8.978 1.67% 8 8 ASX ASX LIMITED 52.239 51.444 1.55% 8 9 IVC INVOCARE LIMITED 14.243 14.043 1.42% 7 10 TCL TRANSURBAN GROUP 12.917 12.747 1.33% 6 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 SWM SEVEN WEST MEDIA LIMITED 0.695 0.734 -5.31% 6 2 HT1 HT&E LIMITED 2.567 2.700 -4.93% 6 3 OSH OIL SEARCH LIMITED 7.880 8.059 -2.22% 8 4 DHG DOMAIN HOLDINGS AUSTRALIA LIMITED 3.448 3.498 -1.43% 6 5 APO APN OUTDOOR GROUP LIMITED 5.230 5.286 -1.06% 6 6 AGL AGL ENERGY LIMITED 27.309 27.476 -0.61% 7 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 ILU ILUKA RESOURCES LIMITED 22.729 19.071 19.18% 7 2 SYR SYRAH RESOURCES LIMITED -9.528 -10.344 7.89% 5 3 SPO SPOTLESS GROUP HOLDINGS LIMITED 8.550 8.033 6.44% 3 4 WHC WHITEHAVEN COAL LIMITED 44.318 41.943 5.66% 8 5 BHP BHP BILLITON LIMITED 203.197 195.687 3.84% 8 6 FMG FORTESCUE METALS GROUP LTD 55.646 53.729 3.57% 8 7 WSA WESTERN AREAS NL 5.958 5.758 3.47% 7 8 ORE OROCOBRE LIMITED 16.963 16.629 2.01% 6 9 AWC ALUMINA LIMITED 16.564 16.276 1.77% 7 10 IAG INSURANCE AUSTRALIA GROUP LIMITED 37.475 36.850 1.70% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 NST NORTHERN STAR RESOURCES LTD 33.623 36.480 -7.83% 7 2 AQG ALACER GOLD CORP 40.741 43.369 -6.06% 5 3 MYR MYER HOLDINGS LIMITED 6.850 7.250 -5.52% 7 4 OML OOH!MEDIA LIMITED 24.040 25.400 -5.35% 5 5 OGC OCEANAGOLD CORPORATION 30.246 31.780 -4.83% 6 6 CWY CLEANAWAY WASTE MANAGEMENT LIMITED 5.033 5.217 -3.53% 5 7 RRL REGIS RESOURCES LIMITED 29.903 30.903 -3.24% 8 8 NUF NUFARM LIMITED 51.811 53.274 -2.75% 7 9 TCL TRANSURBAN GROUP 23.828 24.385 -2.28% 6 10 EVN EVOLUTION MINING LIMITED 17.035 17.285 -1.45% 8 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.

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.

Uranium Week: Looking To 2018

The uranium market went quiet last week following a period of volatility, as utilities look towards 2018.

- Kazatomprom cuts reverberate - Impact unknown - Market winds down for 2017

By Greg Peel

“Given the challenging market conditions, and in light of continued oversupply in the uranium market, we have taken the strategic decision to reduce production in order to better align our production levels with market demand. We believe that these measures strongly underline our commitment to ensuring the long-term sustainability of uranium mining; a critical component in the generation of clean, carbon free electricity around the globe.”

This was the comment from Kazakhstan’s state-owned uranium producer Kazatomprom two weeks ago, which led to another rally in the spot uranium price on top of the break-out rally sparked by Cameco’s earlier production shutdown announcement. In the wake of the two major announcements the spot uranium market had been volatile as utilities re-emerged as buyers and traders and speculators battled it out.

The question remains as to just what impact supply constraints will have on the uranium market in 2018. Kazatomprom had cut its production by -10% for 2017 and this had no impact on price. The market had expected another -10% cut for 2018 but instead got -20% over three years.

To put things into perspective, Kazatomprom, the world’s biggest uranium producer, produced 30.4mlbs U3O8 in 2016. In the same period, production at the world’s largest uranium resource, BHP’s ((BHP)) Olympic Dam in South Australia, was 8.4mlbs.

Publicly Minded

The large cut has been prompted, market commentators suggest, by the state-owned company’s plan to move to a public listing in the first half of 2018. Such a cut is consistent with a company moving into the public arena, stockbroker DJ Carmichael said in a note last week, rather than a state-owned entity.

“The statement from Kazatomprom indicating that the move was to ensure the long-term sustainability of uranium mining, indicates the pressure being exerted on uranium producers at the current low prices,” the broker suggested.

DJ Carmichael believes the impact of the Cameco and Kazatomprom cuts will eventually flow through to uranium term market pricing, and suggests 2018-19 could see a resurgence as utilities begin to scramble to secure supply into the 2020s.

Right now, utilities are waiting to assess just what the impact might be. Having mostly exhausted their 2017 budgets, utilities are now looking to next year. The spot market went very quiet last week following the volatility that followed the two production cut announcements.

Industry consultant TradeTech reports only four spot transactions last week, all off-market. TradeTech’s weekly spot price indicator has fallen -US40c to US$24.60/lb.

TradeTech’s term price indicators remain at US$28.00/lb (mid) and US$31.00/lb (long).

This is the last FNArena Uranium Weekly for 2017. The Weekly will make a return in January.

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

The Short Report

Guide:

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

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

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

Summary:

Week ending December 14, 2017

Last week the ASX200 pushed up towards the previous 6050 high before failing, and regathering to break the high this week.

The previous two weeks had been notable for the number of short position reductions and the reduction in the total number of stocks shorted by 5% or more. I suggested this may be a winding down of positions ahead of the summer break.

Last week we went completely the other way.

There's a lot of red on the table below, although it's only bracket creep, but there is one notable exception.

It was December 8 when the first of a series of damning Fairfax articles sent the share price of Retail Food Group ((RFG)) into a tail spin, and prior to today's 12% (at the time of writing) rebound, RFG had fallen -63%. One might has anticipated some welcome profit-taking from RFG shorters but no, they moved in for the kill.

RFG shorts rose to 13.4% from 11.9% last week. Perhaps today's rebound indicates some short-covering.

The other big mover last week was Japara Healthcare ((JHC)), which saw its shorts drop to 6.5% from 8.6% ahead of this week's profit warning. Bad timing perhaps.

It will be interesting next week to note any changes in short positions for Aconex ((ACX)), now under takeover, and Ardent Leisure ((AAD)), which is selling off its bowling business. Westfield ((WFD)) is also under takeover, and its shorts fell to 1.9% from 4.5% last week.

But alas, this is the last Short Report for the year. The Short Report will return in January.

Weekly short positions as a percentage of market cap:

10%+

SYR 21.5 IGO 18.7 DMP 16.6 JBH 16.1 HSO 13.6 RFG 13.4 AAD 11.0 ACX 10.3 APO 10.2 WSA 10.1

In: ACX, APO Out: FLT

9.0-9.9

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

8.0-8.9%

GXY, NWS, QIN, ORE, GXL

In: GXY, GXL Out: HT1, MYR, JHC

7.0-7.9%

MYX, AAC, NSR, TPM, ISD, SHV, NXT

In: NSR, ISD, SHV Out: GXY, GXL

6.0-6.9%

GTY, BAP, JHC, AHG, RIO, TAH, KAR, BEN, CSR, SEK

In: JHC, KAR, CSR Out: NSR, ISD, SHV, MYO

5.0-5.9%

GMA, PRU, BKL, QUB, IPD, WEB, NAN, MND

In: BKL, IPD, WEB, NAN, MND Out: ABC

Movers and Shakers

Merry Christmas and happy shorting.

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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McPherson's Looking Better In FY18

Moelis welcomes the divestment of the McPherson's home appliances division, expecting the company to now concentrate on growing its health & beauty business.

-Updated guidance offset some of the impact from the divestments -Another brand acquisition that strategically fits with health & beauty is likely

By Eva Brocklehurst

McPherson's Ltd ((MCP)) expects stronger trading conditions will prevail in FY18 as the non-core home appliances business is being divested to Glenn Dimplex for $28m. Updated guidance offsets some of the impact from the divestment, Moelis notes.

First half underlying pre-tax profit is expected to be at the "better end" of the guidance range provided at the AGM. This indicated FY18 pre-tax profit would be down -10-15%.

While the pre-tax contribution from the home appliances business is expected to be around $2m in FY18, in light of the expected in improvement to trading conditions in the first half, the broker's estimate for underlying pre-tax profit declines by just -$1.1m. Moelis forecasts core net profit of $12.3m for FY18 and $13.6m for FY19.

Based on forecasts for FY18 operating earnings (EBIT) of $4m for this division, the sale price suggests to Moelis a transaction multiple of 7x enterprise value/operating earnings. The sale will incur a non-recurring loss on divestment of between -$2-3m in the first half of 2018. Funds will be used to pay back an outstanding $25m after cash is received.

Moelis believes the stronger growth and profitability in the remaining health & beauty business warrants a higher valuation for the stock. Moreover, the divestment of a non-core business at a good price highlights management's ability to execute a sale and releases $28m that can be invested in the higher margin business.

The balance sheet is strong and the broker expects management to acquire another brand that fits strategically with the health & beauty business. However, this is not expected to be an opportunity that presents immediately.

Moelis downgrades forecasts for earnings per share by -1-6% in FY18-20 to reflect reduced earnings from the divestment of home appliances, partly offset by stronger trading conditions. However, with a significantly reduced debt load and a higher quality earnings stream from health & beauty, the broker believes the business deserves to trade at a higher multiple.

Moelis raises the target to $1.50 from $1.29 and retains a Buy rating. The broker forecasts a distribution of 7.3c in 2018 and 9.2c in 2019.

Among the McPherson's health & beauty brands are A'kin, Dr LeWinn's, Manicare, Swisspers, Eylure, Elegant Touch, maseur, Lady Jayne, Trilogy, Goodness and Moosehead.

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Is Aconex In Play?

Oracle's bid for Aconex represents a substantial premium. Brokers suggest a counter bid, while highly unlikely, cannot be completely ruled out, but nor can the regulators be ignored.

-Implied multiples signal a material premium to listed comparables -FIRB, competition approvals an area of downside risk

By Eva Brocklehurst

Aconex ((ACX)), a leading provider of cloud collaboration software for the construction industry, has received an offer from Oracle at $7.80 cash per share. Brokers view this to be strong bid and, therefore, Oracle is highly unlikely to field a rival.

Aconex is considered a quality business, as its growth is based on the penetration of a superior solution and subscription model. It already has an international presence and a strong management team.

FNArena's database has six Hold ratings, with two brokers yet to comment on the bid. The consensus target prior to the takeover bid was $4.41, with four brokers subsequently lifting their targets to circa the bid price.

Macquarie considers the bid a good result for ACX shareholders, as it would remove any execution risk from the international expansion that is key to supporting the recent valuation above $5 a share.

Considering the premium being paid, there are few competitors in the space likely to have the scale or financial backing to complete a deal. The 47% premium to the last closing price is substantial, the broker notes, particularly considering the Aconex share price is up 30% over the last two months.

The proposed transaction values the company at $1.61bn, implying an enterprise value/sales multiple of 8.4x FY18 earnings. This multiple drops to 6.1x FY20 based on UBS forecasts for FY18-20 sales growth of 17%.

The broker estimates the company's global market share is more than 40%, post the acquisition of Conject. The number 2 competitor has 11% share. UBS estimates the penetration of cloud collaboration software for the construction industry will rise to 8% by 2020 from less than 5% in 2015.

Oracle has entered into a binding agreement to acquire Aconex by way of a scheme of arrangement. Aconex will be bound by exclusivity provisions as well as a 1% break fee and reimbursement fee of $16m. The likelihood of a competing bid is relatively low, UBS believes, based on the protracted nature of the negotiation and the matching rights from Oracle. As well, the offer has full support of the board, which owns 13.6% of the stock, and co-founders.

The deal makes strong strategic sense for Oracle, given it already has a presence in the sector with its Textura and Primavera software. In addition, UBS believes balance sheet strength and matching rights from Oracle would put off less-capitalised suitors operating in the construction management and design software segment.

The Regulators

The scheme is subject to court approval and Foreign Investment Review (FIRB) approval. Regulatory approval in the form of the FIRB is the key area of downside risk, Morgan Stanley points out, as well as competition concerns, given the potential combination of Aconex with Oracle's existing products in the construction vertical.

As the stock is trading in line with the bull case, and is unlikely to trade on fundamentals now, the broker concedes the race and downgrades to Equal-weight from Overweight. If the deal were to fall through, Morgan Stanley expects the stock to trade in line with its base case ($5.50), which reflects fundamental fair value.

The main upside risk is a counter bid, which Morgan Stanley does not completely dismiss given the user base of 5.5m and clear leadership on the global stage.

Based on Deutsche Bank's valuation the offer implies an 86% control premium. The broker notes the proposal follows a challenging 18 months for Aconex, as costs across R&D and sales & marketing have ramped up and it has limited long-term visibility on recurring revenue and earnings growth.

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Challenging FY18 For Japara Healthcare

Challenging conditions continue for Japara Healthcare, which has flagged a weak first half, and lower FY18 guidance, in the wake of a severe flu season that has affected occupancy.

-May be harder for Japara Healthcare to recover from a tough FY18 vs peers -Lower level of leverage vs peers an advantage -Two brownfield completions slip into first half of FY19

By Eva Brocklehurst

Aged care operator Japara Healthcare's ((JHC)) earnings have succumbed to the flu and FY18 operating earnings (EBITDA) guidance is now downgraded by -5-10%. This implies an updated earnings range of $54.2-57.2m. First half operating earnings are expected to be -15-17% below the prior corresponding half.

Management has blamed a severe flu season as a key driver of the downgrade, which UBS finds curious given the company reiterated guidance as recently as a month ago. The broker had always suspected that the swing required in the second half to hit the lower end of guidance was a stretch and this has now materialised.

Morgan Stanley also points out that there was no mention of an impact on expectations from a severe flu season at the AGMs of either of the company's key competitors. The broker believes cost reductions and additional services may be harder for Japara Healthcare to deliver compared with peers, and the recovery from a tough FY18 will be less pronounced than the share price implies. Hence, the broker retains a Underweight rating.

Morgan Stanley also suggests the poor occupancy and continued margin pressure raises questions about the quality of the portfolio. This exacerbates a first half where two wage increases are annualising from last year.

Occupancy

An extended outbreak of influenza across south-eastern Australia affected occupancy in the aged care sector. Japara's occupancy fell to 91.7% as of the end of September versus 94.2% of the end of June.

Following the trading update, Morgans revises profit forecasts down by -11.9% for FY18 and by -2.0% and 2.1% for FY19 and FY20 respectively. The broker assumes a decrease in occupancy to 93.0% from 94.4% in FY18.

Operating uncertainty is likely to continue to weigh on the stock, in the broker's opinion. Uncertainty surrounding funding cuts, however, is now factored into the share price. The downside risk involves an inability to pass additional costs onto residents while the upside risk centres on the attractive acquisition potential that is emerging.

Macquarie had already reduced its assumed occupancy to 93.3% from 94.5% at the time of the AGM, as the company had indicated the influenza outbreak was greater than usual in terms of duration and the number of people affected.

The broker also defends the sudden downgrade, noting AGM commentary had stated that flu incidents abated in October and occupancy levels had started to increase, although with the benefit of hindsight this optimism appears misplaced.

Macquarie finds the company has a significantly lower level of leverage, in terms of bank and refundable accommodation deposits (RADs), than its peers and this is attractive, given the current regulatory uncertainty. The stock is viewed trading at attractive multiples versus peers and the broker retains a Outperform rating.

UBS suggests the market should be factoring in the organic growth in the aged care sector - for the same site and optimised facility - in the low single digits. The sector is not consolidated and demographic-driven demand is healthy, so more substantial growth can be expected from acquisitions or developments, supported by RAD inflows.

Still, the broker notes the execution risk on the company's extensive development pipeline, with two brownfield projects slipping from the second half to completion in the first half of FY19.

FNArena's database shows one Buy (Macquarie), two Hold and one Sell (Morgan Stanley). The consensus target is $1.95, signalling -2.8% downside to the last share price. The dividend yield on FY18 and FY19 forecasts is 5.0% and 5.7% respectively.

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More Downside For Retail Food Group

By Michael Gable

The Australian market has had a good few days and looks set to finish the year on a high. Resources are kicking higher, and M&A activity such as Westfield Corporation (which we have been very positive on), and Aconex have added to the buoyant mood on the market.

Today we look at Retail Food Group ((RFG)).

RFG has broken under some long-term support here and at the moment there doesn't appear to be a reason for it to stop sliding just yet, with the shares seeing heavy selling on most days during the last week. We can see some support back near $2. It may not get that far, but the stock will need to spend a lot of time building a base at the very least.

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Michael is RG146 Accredited and holds the following formal qualifications:

• Bachelor of Engineering, Hons. (University of Sydney) • Bachelor of Commerce (University of Sydney) • Diploma of Mortgage Lending (Finsia) • Diploma of Financial Services [Financial Planning] (Finsia) • Completion of ASX Accredited Derivatives Adviser Levels 1 & 2

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