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Stories To Read From FNArena

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Capex Plans To Feature For Fortescue Metals

Fortescue Metals delivered record June quarter shipments but brokers remain concerned about the lack of detail on capex in FY19, hoping some uncertainties will be allayed in the August results.

-Current share price factoring in a realised iron ore price around US$44/t -Short pay-back period signalled for Eliwana -Difficult to ascertain opportunity without targets

By Eva Brocklehurst

Fortescue Metals ((FMG)) offers upside if it can enhance its product mix and improve realised pricing, brokers suggest, yet the comapny's positive quarterly performance was eclipsed by concerns about forthcoming capital expenditure.

The company delivered record quarterly shipments, helped by less time spent on unplanned maintenance and weather delays as well as the usual push on productivity at the end of the financial year. These features, as well as a focus on diversifying the customer base, underpin estimates for FY18. FY18 shipments totalled 170mt and FY19 guidance is 165-173mt. The latter, UBS suggests, is a reflection of the flexibility required as the company changes its product mix.

Macquarie reduces FY18 and FY19 and estimates for earnings by -9% to reflect lower assumptions on price realisation. The broker estimates the current share price is factoring in a realised price around US$44/t. June quarter realised prices were 58% against the index and brought FY18 realisations to 64%. No guidance was provided for FY19.

Citi forecasts an average realisation of 67% in FY19 against an index price of US$63/t, increasing to 72% in FY20 against an index price of US$58/t. The broker downgrades to Neutral after adjusting for costs, price realisation and capital expenditure. Ord Minnett was disappointed with the lack of detail surrounding capital expenditure although, importantly, notes the Eliwana budget of US$1.28bn is unchanged.

Increased Capex

Ord Minnett was disappointed with the lack of detail surrounding capital expenditure although, importantly, notes the Eliwana budget of US$1.28bn is unchanged. Capital expenditure will increase in FY19 because of accelerated spending on Eliwana that could start earlier than previously assumed. First ore is due in December 2020. At this stage it is unclear as to the split on project expenditure and further detail is expected with the financial results in August.

Costs are higher than Bell Potter estimated and the capital expenditure for Eliwana is expected to lower free cash flow forecasts. Nevertheless, the broker is of the view that Fortescue Metals is in a strong position to pursue Eliwana and the capital intensity points to a short pay-back period on a mine life that is more than 20 years.

The broker, not one of the eight monitored daily on the FNArena database, considers the stock high quality and retains a Buy rating with a $5.45 target. Shaw and Partners, also not one of the eight, views lower provisional pricing as the only blemish in the June quarter.

The recovery in the share price will be a slow burn, the broker suspects, supported by valuation metrics and correlations. Some catch up is due, given the iron ore price has significantly outperformed the company's share price since late May and typically these are well correlated. Shaw and Partners has a $5.60 target and Buy rating.

Cloudy Outlook

Credit Suisse finds more questions than answers. The broker acknowledges Fortescue is focusing on optimising margins to meet market demand as a new product strategy is implemented, but finds a lack of context for what is occurring in the market presently, and no clarity on what 60% product volumes are being targeted in FY19 or the longer term. It is also unclear if volumes ex China will be higher or lower in FY19.

Credit Suisse accepts the cost profile is evolving, amid sector-wide pressures, and has no issue with the fact Fortescue is not targeting a majority of production over 60% any more. It is just difficult to ascertain the opportunity without any targets.

A decision regarding the Iron Bridge magnetite project is expected by the end of the year, described by Credit Suisse as a "black box" as there is no detail on expenditure. Ord Minnett recognises the re-rating catalysts are long-dated but retains its Accumulate rating based on the undemanding valuation.

FNArena's database shows five Buy ratings and one Neutral (Citi). Consensus target is $5.29, suggesting 21.6% upside to the last share price. The dividend yield on FY18 and FY19 forecasts is 4.5% and 4.9% respectively.

See also, Could Eliwana Reduce Fortescue's Discount? on June 4, 2018.

Not Over Yet For AMP

AMP has “reset” its expectations, implying a profit warning, but brokers fear there is likely still more to come as uncertainties remain.

-Profit downgrade, costs taken, fees reduced -Core businesses performing okay -Capital comfortable -Too many uncertainties

By Greg Peel

“First press of the reset button,” says Macquarie. “Reset seems only partial, plenty of uncertainty still,” says Citi. “Addressing customers first,” notes Credit Suisse.

“It’s not broken,” says Morgan Stanley.

Brokers have responded to last week’s guidance update from embattled AMP ((AMP)), which management described as an “action to reset the business”. Profit guidance for the first half FY18 has been lowered to $490-500m, below consensus forecasts, and is thus a profit downgrade by any other name.

The downgrade is nevertheless attributed by management to “negligible operating earnings” from the Wealth Protection business. This provides a new issue for investors to focus on, suggests UBS, given AMP’s intention to sell the business.

The reset actions include $565m of upfront costs over the next three years, and fee-repricing for MySuper, following BT Financial’s ((WBC)) first-cab-off-the-rank move last week. Additional margin squeeze is also expected in other products.

In order to buffer its capital position, AMP will reduce its dividend to the lower end of 70-90% payout ratio guidance.

The profit downgrade was greater than brokers had assumed and below the line costs taken seem quite excessive. However, not all the news is bad.

The Good News

There was not much of an update on AMP’s other businesses, but if the profit downgrade is all about Wealth Protection, this implies the core businesses are still doing okay. Thanks to strength in markets, assets under management (AUM) have actually increased.

There was fear AMP would have to go as far as raise new capital to cover the ultimate fallout costs from the Royal Commission (RC) but for now at least, the board feels comfortable enough with $1.8bn in excess capital despite little hope of organic capital growth in the near term. The dividend has been reduced but the DRP will not be neutralised.

Morgan Stanley notes the rest of AMP’s portfolio, outside of Wealth Protection, appears to be performing slightly better than the market feared. A consensus view that some $4bn per year in funds outflows over coming years as the likely fallout will likely prove too bearish, the broker suggests.

Notably, no large accounts have gone to tender and there has been no significant “buyer of the last resort” requests from advisors. (Contracts have AMP obliged to buy out advisors who choose to retire. It was assumed many would take this opportunity to bail.) The implication is apparent “franchise resilience”, Morgan Stanley suggests.

Citi agrees it was “perhaps encouraging” that the core growth businesses are still growing and AMP has confirmed no significant BoLR liability so far, and nor does it appear advisor departures have led to a significant drop in assets under management.

But there has to be a “but”.

The Bad News

“Today’s update appears more like an entrée to us,” UBS warns. And UBS is not alone.

The broker believes the “main course” will need to address a wide range of other significant issues, including the new CEO’s strategy, RC responses, grandfathering and budget proposals.

Macquarie sees the “reset” as a step in the right direction, but the broker continues to see risks of further rebasing, additional one-off costs and a reduced excess capital position.

Citi notes the reset deals with some risks, but there seem to be several others that were not addressed. It is still too early to quantify the impact of the salient factors, the broker warns, including RC-related brand damage.

Credit Suisse concurs that there remains uncertainty around how much brand damage has been done, and how this translates into Assets under Management (AUM) loss. Further, it is unclear what additional fee reductions may be required. The broker forecasts $15bn of AUM outflows over the next 18 months but suggests “market-leading” fees may not need to as dramatic an adjustment.

“However, only time will prove this right or wrong.”

Credit Suisse is nevertheless prepared to give AMP some benefit of the doubt. Over time the broker expects overly pessimistic concerns to be addressed and the share price to recover. The business can stabilise and return to growth, so CS retains an Outperform rating, but warns this may take 12-18 months.

Morgan Stanley maintains its role as flag-waver for the stock. With an implied PE of 2.5x for the wealth division, the market is pricing in material downgrades and material loss, the broker suggests. AMP’s update likely indicates franchise resilience as the clean-up continues. Morgan Stanley retains Buy.

For others, too much uncertainty lingers. This keeps Macquarie and Citi on Neutral, while UBS is sticking to Sell, seeing further downside risk for the next 2-3 years.

The three remaining brokers in the FNArena database are yet to respond, leaving four Buy or equivalent ratings, for now, two Hold and a Sell. The consensus target price has fallen to $4.00 from $4.20 pre-update, on a range from $3.30 (UBS) to $4.56 (Morgans, yet to update).

The consensus FY18 dividend yield at current pricing is 7.0%.

Delay In High Grade Shades Sandfire Outlook

Delays to the high-grade feed at Monty and the looming end to DeGrussa's mine life are pressuring Sandfire Resources to find and develop more copper-gold resources.

-FY19 guidance below expectations because of delays in accessing higher grades -Growth now being pursued on several fronts -Stock at current price requires faith in the company's development strategy

By Eva Brocklehurst

Sandfire Resources ((SFR)) comfortably met FY18 guidance for gold and copper production and remains disciplined on operating costs, yet FY19 guidance is below expectations because of a delay in access to higher grade ore at Monty.

Mine sequencing has deferred higher grades until late FY19, despite first ore being due on schedule in the second quarter. The costs will also be higher because of the greater hauling distance and narrower stopes.

While this is simply a deferral, Morgans suspects the latest news has knocked the market's confidence in the stock. Citi agrees, pointing out that while the copper ramp-up is delayed into FY20, it is not lost. The broker expects FY20 copper output will increase to 87,000t with sustained high grades at Monty.

Beyond DeGrussa?

The need for a material discovery to extend mine life at DeGrussa is intensifying. The outlook is increasingly dependent on exploration and development at Black Butte, which moves into development from early 2019 if approved on schedule.

Credit Suisse finds reasons to be optimistic regarding the Black Butte, Montana, permit process, and the two-year underground development could commence within 12 months, meeting first production expectations in early 2021.

Yet the broker is extremely cautious about modelling 2018 preliminary economic assessments, particularly when the numbers were stated with an estimation risk of circa plus or minus 40%. In addition, this assessment excludes the Lowry zone, which offers near-term upside, and was based solely on the Johnny Lee zones.

Morgans suggest the stock may have materially different risk profile within 1-2 years and this may not suit the current market, which is primarily rewarding near-term cash accumulation.

The broker believes the market will become increasingly concerned as DeGrussa reserves are depleted over the remaining four years of its mine life, while the stock currently requires trust in the company's growth strategy. Morgans maintains a Reduce rating and a preference for Oz Minerals ((OZL)) in pure copper.

The stock is performing well from an operating standpoint, while Monty offers the potential for higher-grade feed, yet Ord Minnett would become more positive at a lower entry point.

The company is pursuing growth on several fronts, including aggressive exploration around Doolgunna,and has been increasingly active in the M&A and joint ventures, mopping up Talisman's ((TLM)) minority in Monty and farming into zinc projects in Alaska and Bosnia.

Nevertheless, its DeGrussa flagship copper-gold project in Western Australia has limited mine life at around five years, although the declining development profile and associated increase in cash flow is well timed for the increased expenditure expected at Monty, Credit Suisse asserts.

The broker suggests Sandfire paid a full price to take over Monty and, while understanding that may be necessary to remove complexity and save costs, hopes this is not used as a pricing approach for future transactions unless the deal terms use Sandfire paper.

Production

Guidance on costs drives a downgrade to UBS estimates. FY19 guidance is for 63-67,000t of copper and 37-40,000 ounces of gold at a cost of US$1-1.05/lb versus UBS estimates of 68,000t of copper at a cost of US$0.88/lb. Production is expected to benefit in the next couple of years from the step-change in grade from Monty.

Macquarie notes the strong outcome in the June quarter for both copper and gold production as well as lower costs enabled a cash balance of $243m in FY18, 9% above forecasts. Lower grades in the early months at Monty and lower grades at DeGrussa drive a reduction in the broker's forecasts by -10% and -6% for copper and gold respectively.

DeGrussa produced 17,900t of copper and 9,500 ounces of gold in the June quarter. Cash costs of US$0.80/lb were -19% lower than Macquarie forecast. This was a result of higher byproduct credits and lower transport charges.

There are three Hold ratings and four Sell on FNArena's database. The consensus target is $7.92, signalling 3.8% upside to the last share price. Targets range from $6.70 (Credit Suisse) to $9.10 (Macquarie).

See also Sandfire Needs Options Beyond DeGrussa on May 1, 2018.

Confidence Jolted In Independence Group

Reactions to Independence Group's downgrade to reserves at Nova have been mixed but brokers generally agree mine life has been shortened.

-Average nickel grade reduced to 1.86% and copper to 0.76% -Earnings impact could be offset by targeted throughput -Yet expansion at Nova throughput likely at the expense of mine life

By Eva Brocklehurst

Reduced grades will now be forthcoming from the Nova reserve, casting a shadow over the medium-term outlook for Independence Group ((IGO)). The latest reserve update at Nova has indicated a -23% decline in ore and -9% decline in grade, with a mine life of less than eight years.

Macquarie was one broker that was surprised by the magnitude of the reduced reserve grades, lowering its production expectations for nickel and copper by -17% and -20% respectively. Higher cash costs and lower production drive a -26% reduction to the broker's valuation of the Nova mine.

FY19 guidance for metal production at Nova is only marginally below Macquarie's forecasts, with the main impact in FY20-23. The 2018 reserve statement has reduced the average grade of nickel to 1.86% from 2.06% and copper to 0.76% from 0.83% over eight years at 1.5mtpa.

UBS, on the other hand, believes confidence in the reserve has lifted materially and raises nickel production estimates for FY20 by 2%, expecting a higher mining/milling rate will more than offset the grade decline. Canaccord Genuity models a higher cost profile at Nova but this is largely softened in its valuation by incorporating updated metal prices and FX.

The broker, not one of the eight monitored daily on the FNArena database, acknowledges the cash flow forecast for FY19 appeals to investors looking for low-risk exposure to diversified metal production, but retains a Sell rating on valuation grounds. Its target is $3.90.

Production Target Always A Stretch

The market considered the June quarter production target was unlikely to be achieved. It did pull up short of management's guidance, presumably from grade as throughput was above nameplate, Credit Suisse points out.

In hindsight, the broker now suspects this was a pre-emptive warning the downgrade to Nova's reserve was coming and remains apprehensive about the mine meeting guidance for average annual production.

Citi suspects that the miss to production guidance back in the March quarter may have resulted from a smaller-than-expected high-grade core at the deposit. Ord Minnett, while considering a downgrade was well flagged, found the outcome worse than expected.

Still, Independence Group expects to maintain 27-30,000tpa of nickel for the next three years and this is positive versus the broker's forecasts. Ord Minnett downwardly revises earnings estimates by -2% for FY19 and -4% for FY20.

The resource at Nova increases 32% in terms of total tonnage after accounting for depletion, because of changes in the cut-off grade to a net smelter return and after the inclusion of some lower grade zones.

Credit Suisse considers Nova an impaired asset compared with prior understanding, although the earnings impact can be offset by throughput as 1.8mtpa has been demonstrated and is now a target. Still, this expansion will come at the expense of mine life.

UBS observes, outside of the SAG mill outage that caused production to come in below guidance, the mill was actually operating at a 1.8mtpa run rate in the quarter. There is also 90,000t of ore at surface which de-risks production somewhat for FY19.

Life Of Mine

CLSA expects investors will now have to revise down lofty expectations for Nova's mine life, and lowers valuation by -11% after incorporating the updated Nova grade and life profile. The broker, not one of the eight monitored daily on the database, reiterates a Sell rating and $3.85 target.

The revised reserve now provides some certainty, Credit Suisse acknowledges, regarding the outlook for Nova following a 12-month wait for a revised reserve and completion of grade control drilling for the entire orebody.

Life of mine grade-control drilling is highly unusual, the broker points out, but apparently had nothing to do with concerns regarding the integrity of the reserve. Rather, management insisted it was an opportunistic decision to lock in favourable diamond drilling rates and exploit access afforded by the nature of the orebody.

Either way, the implication the broker draws for mine life on the revised ore is 7.5 years, at a lower average production rate on lower grade, and exploration success will be needed to support the $350m investment in technology.

The technology being contemplated involves converting low payability nickel sulphide to sulphate, which the company hopes to sell at a premium to nickel metal. Independence will spend $47-54m on exploration in FY19, with the focus still on the prospective Nova district.

Regionally, Citi highlights reports that indicate major shareholder Mark Creasy has made a nickel-copper discovery around 25km from Nova. If this proves positive then the broker suspects Independence Group could be favoured in negotiating treatment through its mill.

FNArena's database runs the gamut and has two Buy, three Hold and two Sell ratings. The consensus target is $4.67, suggesting 4.7% upside to the last share price. Targets range from $3.95 (Credit Suisse) to $5.20 (Ord Minnett, UBS).

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GUD Primed For Further Auto Acquisitions

Cash conversion was strong at GUD Holdings in FY18 and brokers highlight the potential for the company to consolidate its position in the automotive segment.

-Potential downside risk to automotive margins -Is GUD positioning to divest Davey? -Substantial capacity for further acquisitions

By Eva Brocklehurst

Organic growth and bolt-on acquisitions in the automotive segment should underpin GUD Holdings ((GUD)) in FY19. Cash flow was the highlight of FY18, as second half cash conversion lifted to 89%.

Substantial balance-sheet capacity and further cash generation are expected to support potential acquisitions. Automotive revenue growth was 16% in FY18 and organic growth improved to 9% from 8% in the first half.

Ord Minnett believes the company is positioning to divest Davey Pumps, as the new CEO's prior role was with Ford Australia, and the company has previously been busy divesting businesses and focusing on automotive. Around $6m in write-offs have been taken in the Davey business which should assist future EBIT (operating earnings) margins.

A transaction would be considered positive by the market, in the broker's view, because of benign growth at Davey and the more attractive opportunities available in automotive. Nevertheless, Ord Minnett believes much of the re-rating the stock has already occurred.

A divestment of Davey, the last remaining business outside of the automotive segment, could generate around $80m or more, in Macquarie's calculations, and drive 19% compound growth to EPS in FY18-21. The broker finds the stock valuation undemanding given the quality of the business and growth outlook.

Margins

Citi expects the stock will also be supported by margin expansion from synergies and scale benefits and believes the 20.4x PE implied in its target is justified, given the company's consistency and the resilience of organic growth.

FY18 earnings missed estimates, largely because of margins, and UBS takes a cautious view regarding the long-term profile for the automotive division. That said, the broker does not expect electric vehicles to have a major impact on Australia's car industry over the next decade. Around 46% of the company's automotive sales relate to internal combustion engines and non-ICE sales typically generate lower margins, particularly against the highly regarded Ryco brand.

However, UBS believes increasing consolidation of the trade distribution channel and rising private label penetration will eventually pressure elevated automotive margins towards a long-term forecast of 24.9%, from the current 28.1%.

Credit Suisse incorporates the dilution from lower-margin acquisitions in FY19 but only assumes modest declines beyond that point although accepts, given GUD supplies large customers, downside to margins remains a potential risk.

Meanwhile, growth is considered elusive for Davey, albeit the pumps business is small in a group context. The flat result at Davey was the main reason EBIT were slightly lower overall versus the broker's expectations.

Acquisitions

Organic growth in automotive has been supported by growth in vehicle numbers over the past decade and GUD is increasing its share as major customers consolidate and the product range is expanded. Credit Suisse considers high single-digit organic growth in automotive sustainable and agrees there is substantial capacity, highlighting the company's inclination towards further acquisitions.

Citi envisages the primary drivers of the company's business are continued growth in car numbers and annual price rises, as well as a positive shift in mix to more expensive parts and new product development. The broker estimates GUD could fully fund via debt up to $90m in acquisitions before reaching the upper end of its net debt/EBITDA target range of 1.8-2.0x in FY19.

GUD is a logical consolidator of automotive brands, being an independent distributor, Macquarie suggests, and there are plenty of highly accretive acquisitions available from which significant synergies could be extracted.

FNArena's database shows two Buy and three Hold ratings. The consensus target is $14.70, suggesting 2.8% upside to the last share price. Targets range from $13.85 (UBS) to $15.50 (Citi, Macquarie). The dividend yield on FY19 and FY20 forecasts is 4.1% and 4.5% respectively.

Cost Concerns Dull Regis Resources

The potential for costs to creep back into production from sourcing satellite ore was a feature of Regis Resources' June quarter report, instigating a sell off in the shares.

-Higher strip ratios, diesel costs underscore increase in AISC in FY19 -Multiple gold sources now providing greater certainty of supply -Main risk is timing at McPhillamys and mining parameters at Rosemont

By Eva Brocklehurst

The market responded negatively to the June quarter result from Regis Resources ((RRL)) despite record gold production, which came in at the high end of guidance.

Ord Minnett believes the sell-off could be partly stock specific and partly a broader sector sell-off, as momentum stocks miss consensus expectations. New information included All-In Sustaining Costs (AISC), FY19 guidance and an update on McPhillamys, all which arguably missed expectations.

The sound result was overshadowed by the outlook, Deutsche Bank asserts, as management has highlighted accessing satellite pits is leading to higher costs and the scale of cost increases goes beyond expectations.

FY19 guidance is for 340-370,000 ounces and AISC of $985-1055/oz, which is up 13% on FY18 at the mid point. Higher strip ratios and diesel costs, the latter is 15% of operating expenditure, underscore the increase.

One reason for Citi's Sell rating has been the potential for Duketon operating expenditure to increase as the operation matures and more ore is sourced from satellite deposits. Yet Macquarie expects a rapid reversion to the norm in subsequent years.

Supply Assured

Credit Suisse believes the company's willingness to forecast, and achieve on, a tight range indicates a level of confidence in the now-robust reserves, as well as the reliability of the three plants and mining capacity. Multiple ore sources are now available and this provides greater certainty of supply. The majority of the expenditure budget is earmarked for the development of Duketon's satellite operations.

Ord Minnett is content with the top end of guidance. Of more concern is a lack of progress at McPhillamys and Rosemount underground, two projects that need to be valued in order to obtain anywhere near the share price. The broker does not include the Rosemont underground until results from the mining study are known.

Macquarie upgrades to Outperform from Neutral, envisaging long-term earnings growth beyond FY19. While FY18 could be considered a high point for earnings the broker believes this is unlikely to be the case.

Expansion Options

There is a strong exploration pipeline and further organic growth prospects at Duketon and McPhillamys which could add material production from FY21. An underground development at Rosemont and potentially Garden Well could also provide extensions to mine life.

The broker expects McPhillamys will experience upside from the feasibility study via additions of higher grade ore from Discovery Ridge. Regis Resources has completed 65km of drilling over the June quarter, including the Rosemont underground and at Discovery Ridge.

A maiden underground resource is expected at Garden Well in FY19. Exploration is set to continue to deliver extensions and compelling results across the Duketon belt, Credit Suisse suggests, providing additional feed for the low-cost milling infrastructure. The opportunity for underground mining a Garden Well is also emerging rapidly.

Ord Minnett concurs that Regis Resources is in a strong position and can comfortably fund its growth options. The main risk is timing, and the broker is concerned that first gold from McPhillamys in FY20 may be optimistic. Rosemont drilling is proving up the high-grade tenor of the deposit but understanding mining parameters and grade dilution will be important for putting a value on underground options.

Citi suggests the plan to mine underground at Rosemont and Garden Well is gaining momentum. While operating expenditure is uncertain pre-production expenditure is likely to be modest.

The risk is whether the $250m of pre-feasibility capex planned for McPhillamys will creep higher. Nevertheless, the broker considers the company is a highly-committed brownfields driller and positive news flow should ensue from new targets over the next year.

FNArena's database shows one Buy (Macquarie), one Hold (Credit Suisse) and four Sell ratings. The consensus target is $4.28, suggesting -6.5% downside to the last share price. The dividend yield on FY18 and FY19 forecasts is 4.5% and 4.1% respectively.

Rio Tinto Ramps Up Shareholder Returns

Brokers are adding up the substantial returns expected from Rio Tinto over the next 12 months, as the company signals an intention to pay out proceeds from asset sales.

-First half results short of expectations because of higher costs -Strong returns generated from cash flow and sale of non-strategic assets -Rio Tinto maintains conservative stance on growth options

By Eva Brocklehurst

First half results from Rio Tinto ((RIO)) were weaker than generally expected but this is being overlooked by heightened anticipation of capital management. Rio Tinto is set to pay out 72% of earnings including a further US$1bn buyback. The ability to deliver such strong industry returns has been a function of both healthy cash flow from operations and the disposal of non-strategic assets.

The company has completed the sale of its remaining coal assets for US$2.95bn, all of which is expected to be returned to shareholders. Smelter and Grasberg proceeds are also expected over the next 12 months.

The results fell short of UBS estimates, largely from higher costs and expenditure on items such as restructuring and information systems. Net debt increased to US$5.2bn, resulting from a catch-up payment on 2017 tax, increased capex and shareholder returns.

Rio Tinto has declared an additional US$7.2bn will be returned to shareholders, topping up its market buyback by US$1.0bn and declaring an interim dividend totalling US$2.2bn. Details on the remaining $4bn in returns will be dealt with in the second half.

Higher Costs

UBS lowers 2018-20 earnings estimates by -6-7% to reflect higher central office costs and inflation across the product group. While "other items" were significant in this half-year, these are expected to ease in the second half as many were one-off set-up items, such as restructure of the operating model and establishment of a Singapore hub.

However, offsetting rising raw materials costs, particularly in aluminium and energy, were higher volumes and prices, UBS points out. Sales volumes increased the underlying operating earnings by US$887m year-on-year, a function of more iron ore from the Pilbara, more copper from Escondida, Kennecott & Oyu Tolgoi and higher bauxite sales.

Higher aluminium cash costs contribute to a -4% reduction in Ord Minnett's estimates over the next few years. While disappointed, the broker maintains an Accumulate rating given the attractive valuation and strong returns.

An increase in valuation offsets the impact of earnings downgrades for Citi as well. Although costs are increasing, and an escalation of the trade wars amid a slowing Chinese economy is a threat, upside risk exists to estimates from spot iron ore prices and cash generation.

Morgans was disappointed legacy contracts held down realised alumina prices and bauxite supply from Guinea continues to keep a lid on pricing. Morgans also notes margins appear to have already peaked.

Production guidance for all major divisions remains unchanged from the June quarter results with the exception of coal, which is reflecting the earlier-than-expected disposal of assets. Iron ore stood out as a division while aluminium and copper were weaker than Macquarie expected. High costs in aluminium and lower revenue in copper were the main causes.

Returns Or Growth?

Channelling excess cash flow back to shareholders is a more attractive investment proposition than a large miner offering hefty premiums to acquire development assets, and so Morgans is comfortable with the company's current stance on capital deployment.

Nevertheless, investor demand for growth is expected to increase as the cycle progresses and this may mean a shift in the company's current conservative approach.

The broker's impression from the first half result is that Rio is more conservative and measured when it comes to considering growth options than previously supposed. Morgans had expected that spare capital from the divestments might be spared for growth but instead the company has flagged an intention to return net proceeds from asset sales entirely to shareholders.

CLSA believes the balance sheet is too conservative and calls for higher capital management and an increased focus on growth, citing an opportunity cost of not utilising debt capacity or holding excess cash on the balance sheet. CLSA, not one of the eight stockbrokers monitored daily on the FNArena database, has an Outperform rating and $85.10 target for the stock.

Rio Tinto is ready to pounce on the right growth opportunity but UBS suggests, currently, there are none. The broker retains a Buy rating with a view that the company will focus on value over volume and return surplus cash to shareholders.

The database shows six Buy ratings and two Hold. The consensus target is $88.02, suggesting 11.7% upside to the last share price. Targets range from $80.67 (Morgans) to $94.00 (Ord Minnett). The dividend yield on current FX values for 2018 is 5.0% and 2019 4.8%.

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Material Matters: China Policies, Coal And Iron Ore

China's greener policies are leading to increased burning of coal, for now, while the US shale revolution is hampered by infrastructure constraints with RBC Capital worried about short term outlook for iron ore prices.

- China's environmental plan good news for high-grade exports - Most vulnerable to new policy are thermal coal and low-grade iron ore and coking coal - Risk of US oil output contributing to world over-supply is mitigated by pipeline constraints - Drop in iron ore prices forecast to drag down Rio Tinto stock

By Nicki Bourlioufas

China's anti-pollution plan drives preference for higher-grade raw materials

China has announced its new anti-pollution plan, "2018-2010 3-Year Action Plan for Winning the Blue Sky War", building on the Air Pollution Prevention and Control Action Plan (APPCAP) that expired at the end of 2017. The new plan expands the geographical scope of environmental protection measures that are already in place, but doesn't make them any tougher. Commonwealth Bank analysts believe the sectors that appear to be most vulnerable to the new environmental protection policy are steel, iron ore and coking coal.

CBA identifies four trends from the 3-year action plan: i) coal to gas switching will likely be gradual, ii) metal production costs are set to rise in the areas under focus iii) the preference towards higher quality raw materials is expected to continue and iv) profitability in China's industrial sectors will likely remain resilient.

While it is too early to tell how Australian mining exports will respond, the winners will likely be high-grade iron ore, coking coal and LNG exporters. Australian LNG exports may be constrained by the Domestic Gas Security Mechanism, which broadly looks to address shortages in east-coast Australia before exports. Low-grade iron ore, coking coal and thermal coal exporters are likely to be the losers from the plan.

Iron ore and coking coal exporters also face increasing risks from China's environmental push towards using more scrap steel in steel production. While that substitution risk is unlikely to be meaningful until next decade, it is a risk that is emerging more quickly than expected, according to the analysts.

China's increasing call for electricity takes coal full circle

Analysts at Macquarie note that in trying to clean up air quality, China has boosted demand for electricity and this, ironically, has had a knock-on effect on demand for coal.

Demand for electricity is being driven by many of Beijing's key policies on the environment, including emission controls in steel, the shift from trucks to rail transport, and support for electric vehicles. China's power consumption rate in the first half of 2018 jumped 9.2% year on year, much faster than the corresponding rise in GDP.

Curiously, despite the country's spectacular growth in alternative power options such as nuclear and renewables, China is burning more coal to meet this demand kick. Macquarie says this is a tricky outcome for Beijing, since China's government is trying to be a champion of global pollution reform.

Pipeline infrastructure likely to constrain rise in US oil output

Commonwealth Bank analysts suggest constraints on pipeline infrastructure mitigate the rise of oversupply in the oil market posed by rising US output.

The major question mark hangs over the pipeline infrastructure in the Permian basin, which is the largest shale oil basin in the US. Infrastructure constraints could start weighing on Permian supply growth from August and continue until the end of 2019, predict the analysts.

The US Energy Information Administration (EIA) expects output to rise in all the major US shale oil basins by August. The EIA is forecasting US oil production will rise 15.4% to 10.79 md/d this year and another 9.3% to 11.8mb/d in next year.

As well as the Permian, rises are expected in the Bakken, Eagle Ford, Niobrara, Anadarko and Appalachia basins. In the Haynesville basin, which is predominantly a gas producer, oil output is expected to remain stable. These seven basins have accounted for nearly all of the growth in US oil output in recent years.

The increase in output has been helped by the rapid expansion in US oil rigs, which are now close to levels last seen in March 2015. However, CBA says the backlog of oil wells to be completed also continues to rise.

The EIA reported that drilled but uncompleted (DUC) wells have increased to a multi-year high of 7,943 at the end of June. These DUC wells just require fracking to bring oil to the market. And since these wells require less labour to bring online, they are a source of low cost production, CBA points out.

Falling iron ore prices weigh on Rio Tinto

The local research team of RBC Capital cut its price target for Rio Tinto ((RIO)) to $65 from $76 while downgrading its rating to Underperform from Sector Perform, in the light of forecasts of falling iron ore prices.

Rio Tinto remains significantly more exposed to iron ore than BHP ((BHP)), given the reduction in volume contribution from coal and a lack of exposure to oil. As a result, Rio's fortunes remain linked to both the rise and fall of the iron ore benchmark and market sentiment, highlight the analysts.

RBC's analysis suggests that a drop in Chinese steel demand will cause steel margins to fall from their current highs and this is likely to see both de-stocking and an unwind of iron ore premiums and discounts as China margins fall.

“We reduce our iron ore price forecasts from US$65/t to US$49/t for the second half of 2018, and from US$70/t to US$63/t for 2019. Regression analysis suggests that a price below US$50/t is a real concern before stabilising,” so the RBC forecast goes.

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 July 23 to Friday July 27, 2018 Total Upgrades: 6 Total Downgrades: 11 Net Ratings Breakdown: Buy 44.99%; Hold 39.46%; Sell 15.55%

For the week ending Friday, 27th July 2018 FNArena registered six upgrades for ASX-listed stocks from the eight stockbrokers we monitor daily, but also eleven downgrades.

Four of the six upgrades moved to Buy with long time suffering shareholders in iSentia finally receiving a boost of hope, while the same can be said about those still holding on to shares in Mayne Pharma.

Newcrest Mining and Pinnacle Investment Management are the two remaining "lucky" ones for the week.

When it comes to downgrades, Scentre Group was the sole receiver of two downgrades during the week. Of the eleven downgrades issued, five moved to Sell. A-REITs and other "defensives", including Charter Hall and Woolworths, are prominently represented among the week's eleven downgrades.

Positive revisions to target prices remain the territory of resources stocks with Iluka Resources commanding top spot for the week, followed by Northern Star, Cimic and OZ Minerals.

Negative revisions to price target for the week are hardly worth mentioning considering Fortescue Metals sits on top of the negative ladder with an adjustment of -1.30% only.

There are a lot more fireworks to admire in the table for positive revisions to earnings estimates, which should not surprise with resources stocks enjoying positive momentum. Alacer Gold, Galaxy Resources and Iluka Resources all enjoyed increases of 14.90% and beyond.

As is typical for the sector, there are equally large adjustments to the downside with Western Areas suffering the biggest blow for the week, -34.9%, followed by Nufarm, Pilbara Metals, Fortescue Metals and James Hardie.

Earnings reporting season is slowly ramping up this week. See FNArena's calendar on the website. For specific company reporting dates, investors can visit the dedicated Corporate Earnings Monitor.

Upgrade

ISENTIA GROUP LIMITED ((ISD)) Upgrade to Buy from Neutral by UBS .B/H/S: 1/1/1

UBS argues that a significant level of earnings downside is now factored into the share price. The broker envisages FY19 as a potential year of transformation.

Analysis suggests upside for valuation and earnings growth and, if not, the stock then becomes a cash-flow yield play on declining earnings. Rating is upgraded to Buy from Neutral. Target is reduced to $1.00 from $1.05.

MAYNE PHARMA GROUP LIMITED ((MYX)) Upgrade to Outperform from Neutral by Credit Suisse .B/H/S: 2/0/0

Credit Suisse assesses the market for two new drugs the company intends to launch in FY19 and does not believe the current share price adequately reflects the intrinsic value of these drugs.

The broker considers the stock undervalued and upgrades to Outperform from Neutral. Target is increased to $1.00 from $0.74 and further weakness in the upcoming results is considered a buying opportunity.

NEWCREST MINING LIMITED ((NCM)) Upgrade to Buy from Hold by Deutsche Bank .B/H/S: 3/3/2

Deutsche Bank notes June quarter production was supported by a strong performance of the core assets. Lihir lifted mill throughput to a record 4mt while Cadia and Telfer lifted production by around 6% quarter on quarter.

Deutsche Bank expects the company can lift production in FY19 by 4% and at the same time reduce AISC by -22%. Rating is upgraded to Buy from Hold on valuation. Target is steady at $23.50.

NIB HOLDINGS LIMITED ((NHF)) Upgrade to Equal-weight from Underweight by Morgan Stanley .B/H/S: 1/6/1

Morgan Stanley has used a sector preview to upgrade to Equal-weight from Underweight, with reference to the fact the shares have fallen -17% year-to-date. Estimates have risen. Price target gains 20c to $5.30.

PINNACLE INVESTMENT MANAGEMENT GROUP LIMITED ((PNI)) Upgrade to Buy from Hold by Ord Minnett .B/H/S: 1/0/0

The company has invested in Metrics Credit Partners and Omega Global Investors for a combined $48m. Pinnacle has provided third-party distribution assistance to Metrics Credit since 2013. Ord Minnett suggests this relationship mitigates some of the usual investment risks.

Affiliate funds under management finished FY18 better than expected and this provides some momentum in FY19 to supplement the accretion from these investments. Ord Minnett upgrades to Buy from Hold. Target is raised to $6.43 from $5.19.

WESTERN AREAS NL ((WSA)) Upgrade to Neutral from Sell by Citi .B/H/S: 3/3/1

Previously Citi's house forecast was for weaker nickel prices ahead, which underpinned its Sell rating for Western Areas. As the house view has now shifted towards "a more constructive view" on nickel (their words) the rating has moved to Neutral. Target price lifts to $3.20 from $2.60.

Downgrade

COCA-COLA AMATIL LIMITED ((CCL)) Downgrade to Underperform from Outperform by Macquarie .B/H/S: 1/4/2

Macquarie downgrades to Underperform from Outperform, following recent strength in the share price. The broker believes Australian beverages remain susceptible to a number of headwinds and more money is expected to be spent in order for volumes to remain static.

Ongoing weakness in Indonesia is also likely to affect near-term earnings. Target is reduced to $8.87 from $9.26. The company will report its result on August 22.

CHARTER HALL RETAIL REIT ((CQR)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/3/2

Citi analysts don't think recent share price rallies for some of the retail AREITs can be justified, hence the downgrade to Sell from Neutral. The analysts remain more bullish on AREITs with office, industrial and funds management exposure. Target falls to $3.76 from $3.87.

The analysts acknowledge theirs are not consensus calls and therefore likely to trigger debate among investors and among peers. Among factors noted to worry about are ongoing structural headwinds, above average multiples and the potential for falling house prices to weigh on tenant sales.

FORTESCUE METALS GROUP LTD ((FMG)) Downgrade to Neutral from Buy by Citi .B/H/S: 6/1/0

June quarter shipments were in line with expectations. Realised prices of US$38/t were 58% against the index and brought FY18 realisation to 64%. Cit expects free cash generation of US$500m in FY19, falling to roughly break even in FY20 because of increased expenditure on Eliwana.

Rating is downgraded to Neutral from Buy. Target is reduced to $4.70 from $4.90.

SCENTRE GROUP ((SCG)) Downgrade to Neutral from Outperform by Macquarie and Downgrade to Sell from Neutral by Citi .B/H/S: 3/2/2

Macquarie expects 2018 guidance to be reaffirmed at the first half results, factoring in organic growth, a lower cost of debt and development completions.

The stock remains the highest quality retail offering in Australia which should mean it is better shielded from structural headwinds, the broker suggests.

Macquarie downgrades to Neutral from Outperform, given the recent rally. Target is $4.46.

Citi analysts don't think recent share price rallies for some of the retail AREITs can be justified, hence the downgrade to Sell from Neutral. The analysts remain more bullish on AREITs with office, industrial and funds management exposure. Target drops to $4.11 from $4.19.

The analysts acknowledge theirs are not consensus calls and therefore likely to trigger debate among investors and among peers. Among factors noted to worry about are ongoing structural headwinds, above average multiples and the potential for falling house prices to weigh on tenant sales.

SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP ((SCP)) Downgrade to Sell from Neutral by Citi .B/H/S: 0/3/2

Citi analysts don't think recent share price rallies for some of the retail AREITs can be justified, hence the downgrade to Sell from Neutral. The analysts remain more bullish on AREITs with office, industrial and funds management exposure. Target rises by 4c to $2.18.

The analysts acknowledge theirs are not consensus calls and therefore likely to trigger debate among investors and among peers. Among factors noted to worry about are ongoing structural headwinds, above average multiples and the potential for falling house prices to weigh on tenant sales.

SPEEDCAST INTERNATIONAL LIMITED ((SDA)) Downgrade to Neutral from Buy by UBS .B/H/S: 1/3/0

UBS believe the stock is benefiting from potential earnings upgrades in FY19 from a rebound in energy verticals, as well as a multiple re-rating if investors obtain confidence that strong organic growth has returned.

Still, the broker concedes that, as the company has flagged, any recovery could be largely weighted to 2019. Rating is downgraded to Neutral from Buy. Target is raised to $6.00 from $5.80.

SOUTHERN CROSS MEDIA GROUP ((SXL)) Downgrade to Neutral from Buy by UBS .B/H/S: 2/2/2

UBS lifts FY19 operating earnings forecasts by 2% because of the lagged effect of the company's stronger-than-expected ratings momentum from the second half. No changes are made to FY18 forecasts.

The share price is up 17% since the February result and the broker downgrades to Neutral from Buy. From a cost perspective UBS envisages FY19 to be a relatively benign year across all businesses and, therefore, margin expansion is possible. The broker raises the target to $1.25 from $1.20.

SYDNEY AIRPORT HOLDINGS LIMITED ((SYD)) Downgrade to Neutral from Outperform by Macquarie .B/H/S: 3/4/1

Traffic growth in the first half is consistent with Macquarie's expectations. The broker expects some interest could emerge around Sydney Airport's masterplan but that will be offset by the Productivity Commission review and associated aeronautical negotiations.

Macquarie downgrades to Neutral from Outperform as the valuation is considered stretched based on a bond rate assumption of 4.25%. Target is raised to $7.10 from $6.85.

TREASURY WINE ESTATES LIMITED ((TWE)) Downgrade to Underperform from Neutral by Credit Suisse .B/H/S: 3/2/2

The recent rally in the share price has caused Credit Suisse to downgrade to Underperform from Neutral. The broker still believes FY19 guidance of 25% growth in EBITS is achievable.

Yet the new US distribution model is unproven and the latest retail sales data shows volume down -17% in the supermarket channel that accounts for 40% of the company's US volume. The broker suggests the share price is factoring in success. A $15.65 target is maintained.

WOOLWORTHS LIMITED ((WOW)) Downgrade to Hold from Accumulate by Ord Minnett .B/H/S: 2/4/2

Ord Minnett expects a moderation in Woolworths' like-for-like sales growth and margins due to the removal of single-use plastic bags. This leads to a downgrade to Hold from Accumulate and a reduction in the target price to $30 from $32.50.

The broker notes the recent share price performance and elevated P/E multiples have made the stock more vulnerable to any earnings downgrades. Hence, Ord Minnett has reduced FY19 earnings estimates by -3.7% and FY20 by -2.7%.

Total Recommendations Recommendation Changes

Broker Recommendation Breakup

Broker Rating Order Company New Rating Old Rating Broker Upgrade 1 ISENTIA GROUP LIMITED Buy Neutral UBS 2 MAYNE PHARMA GROUP LIMITED Buy Neutral Credit Suisse 3 NEWCREST MINING LIMITED Buy Neutral Deutsche Bank 4 NIB HOLDINGS LIMITED Neutral Sell Morgan Stanley 5 PINNACLE INVESTMENT MANAGEMENT GROUP LIMITED Buy Neutral Ord Minnett 6 WESTERN AREAS NL Neutral Sell Citi Downgrade 7 CHARTER HALL RETAIL REIT Sell Neutral Citi 8 COCA-COLA AMATIL LIMITED Sell Buy Macquarie 9 FORTESCUE METALS GROUP LTD Neutral Buy Citi 10 SCENTRE GROUP Neutral Buy Macquarie 11 SCENTRE GROUP Sell Neutral Citi 12 SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP Sell Neutral Citi 13 SOUTHERN CROSS MEDIA GROUP Neutral Buy UBS 14 SPEEDCAST INTERNATIONAL LIMITED Neutral Buy UBS 15 SYDNEY AIRPORT HOLDINGS LIMITED Neutral Buy Macquarie 16 TREASURY WINE ESTATES LIMITED Sell Neutral Credit Suisse 17 WOOLWORTHS LIMITED Neutral Buy Ord Minnett Recommendation Positive Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 PLS PILBARA MINERALS LIMITED 67.0% 25.0% 42.0% 3 2 CIM CIMIC GROUP LIMITED 50.0% 8.0% 42.0% 5 3 ILU ILUKA RESOURCES LIMITED 80.0% 50.0% 30.0% 5 4 NST NORTHERN STAR RESOURCES LTD -10.0% -36.0% 26.0% 5 5 OZL OZ MINERALS LIMITED 67.0% 50.0% 17.0% 6 6 STO SANTOS LIMITED -17.0% -33.0% 16.0% 6 7 S32 SOUTH32 LIMITED 29.0% 14.0% 15.0% 7 8 WSA WESTERN AREAS NL 29.0% 14.0% 15.0% 7 9 EVN EVOLUTION MINING LIMITED -13.0% -25.0% 12.0% 8 10 NCM NEWCREST MINING LIMITED 6.0% -6.0% 12.0% 8 Negative Change Covered by > 2 Brokers Order Symbol Company New Rating Previous Rating Change Recs 1 CCL COCA-COLA AMATIL LIMITED -19.0% 19.0% -38.0% 8 2 SCG SCENTRE GROUP 7.0% 36.0% -29.0% 7 3 SDA SPEEDCAST INTERNATIONAL LIMITED 25.0% 50.0% -25.0% 4 4 SCP SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP -40.0% -20.0% -20.0% 5 5 CQR CHARTER HALL RETAIL REIT -40.0% -20.0% -20.0% 5 6 TWE TREASURY WINE ESTATES LIMITED 7.0% 21.0% -14.0% 7 7 FMG FORTESCUE METALS GROUP LTD 79.0% 93.0% -14.0% 7 8 SYD SYDNEY AIRPORT HOLDINGS LIMITED 25.0% 38.0% -13.0% 8 9 FXJ FAIRFAX MEDIA LIMITED 40.0% 50.0% -10.0% 5 10 BLD BORAL LIMITED 36.0% 42.0% -6.0% 7 Target Price Positive Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 ILU ILUKA RESOURCES LIMITED 12.740 11.667 9.20% 5 2 NST NORTHERN STAR RESOURCES LTD 6.740 6.236 8.08% 5 3 CIM CIMIC GROUP LIMITED 47.378 44.683 6.03% 5 4 OZL OZ MINERALS LIMITED 10.567 10.117 4.45% 6 5 NCM NEWCREST MINING LIMITED 21.418 21.043 1.78% 8 6 FXJ FAIRFAX MEDIA LIMITED 0.846 0.832 1.68% 5 7 S32 SOUTH32 LIMITED 3.903 3.839 1.67% 7 8 PLS PILBARA MINERALS LIMITED 1.117 1.100 1.55% 3 9 SCP SHOPPING CENTRES AUSTRALASIA PROPERTY GROUP 2.262 2.232 1.34% 5 10 JHX JAMES HARDIE INDUSTRIES N.V. 25.107 24.792 1.27% 7 Negative Change Covered by > 2 Brokers Order Symbol Company New Target Previous Target Change Recs 1 FMG FORTESCUE METALS GROUP LTD 5.471 5.543 -1.30% 7 2 CCL COCA-COLA AMATIL LIMITED 8.785 8.859 -0.84% 8 3 BLD BORAL LIMITED 7.517 7.572 -0.73% 7 4 SCG SCENTRE GROUP 4.496 4.503 -0.16% 7 5 CQR CHARTER HALL RETAIL REIT 4.014 4.018 -0.10% 5 Earning Forecast Positive Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 AQG ALACER GOLD CORP 7.669 6.383 20.15% 4 2 GXY GALAXY RESOURCES LIMITED 11.667 10.120 15.29% 5 3 ILU ILUKA RESOURCES LIMITED 81.132 70.608 14.90% 5 4 NCM NEWCREST MINING LIMITED 74.024 70.203 5.44% 8 5 STO SANTOS LIMITED 34.654 33.303 4.06% 6 6 OZL OZ MINERALS LIMITED 76.068 73.286 3.80% 6 7 AHY ASALEO CARE LIMITED 4.967 4.800 3.48% 3 8 SBM ST BARBARA LIMITED 39.425 38.295 2.95% 5 9 CIM CIMIC GROUP LIMITED 241.000 236.840 1.76% 5 10 NST NORTHERN STAR RESOURCES LTD 35.414 34.928 1.39% 5 Negative Change Covered by > 2 Brokers Order Symbol Company New EF Previous EF Change Recs 1 WSA WESTERN AREAS NL 6.008 9.238 -34.96% 7 2 NUF NUFARM LIMITED 30.458 42.021 -27.52% 7 3 PLS PILBARA MINERALS LIMITED -0.877 -0.750 -16.93% 3 4 FMG FORTESCUE METALS GROUP LTD 43.322 47.239 -8.29% 7 5 JHX JAMES HARDIE INDUSTRIES N.V. 89.898 97.748 -8.03% 7 6 RWC RELIANCE WORLDWIDE CORPORATION LIMITED 14.525 15.775 -7.92% 4 7 AWC ALUMINA LIMITED 26.037 27.881 -6.61% 5 8 RCR RCR TOMLINSON LIMITED 23.067 24.000 -3.89% 3 9 FXJ FAIRFAX MEDIA LIMITED 5.620 5.820 -3.44% 5 10 EVN EVOLUTION MINING LIMITED 15.939 16.381 -2.70% 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.

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Uranium Week: Price Jump

The spot uranium price saw its biggest weekly rise year to date last week but given the reasons behind it, can it be sustained?

By Greg Peel

There is something rather Heller-esque about a 5% jump in the share price of Canadian uranium producer Cameco last week.

In delivering its June quarter results release Cameco announced that the previously temporary suspension of operations at its McArthur River mine and Key Lake mill will now be indefinite. While the miner is maintaining strong cash flows from selling off stockpiles and focusing on operating efficiencies, the uranium market remains in the doldrums, hence the announcement.

In Heller's iconic novel, American alfalfa farmers are subsidised for not growing alfalfa. The more alfalfa they don't grow, the greater the subsidy.

Not only did Cameco's share price jump 5% on the announcement, the uranium spot price jumped US$1.50, or 6.2%, on the day. This is understandable – less supply implies higher prices – but given the supply constraint is all about low prices, it's a circular argument.

Over the week, the spot uranium price rose US$2.10 or 8.8% to US$25.85/lb, to mark the biggest weekly jump in 2018 to date. The increase was nevertheless not about notably increased demand from end-users.

National Security

Utilities are currently holding off on purchases pending the outcome of the section 232 investigation in the US, and US utilities are preparing their submissions to the Department of Commerce now that a 45-day period for public comment has been announced.

It's not hard to guess which side the utilities will be taking. They're not surviving now, at historically low uranium prices, so forcing them to buy 25% of their uranium supply domestically, at higher prices, is not exactly going to help.

But that's what US producers want, hence the investigation. The petitioning producers are citing "national security" as their incentive. Nothing to do with their own struggle to survive low uranium prices of course.

The Trump administration's infamous trade tariffs have been imposed under the guise of section 232 – implying a matter of national security. It is thus not a surprise the DoC's Bureau of Industry and Security last week stated it was "particularly interested" in comments and information related to national security.

The BIS specifically called for information on the quantity or circumstances related to uranium imports and US uranium production and production capacity needed to meet projected national defence requirements. National defence does not just mean bombs, but security of domestic electricity generation.

Which brings us back to nuclear power utilities. And that's where it will really become a Catch-22.

A total of 1.3mlbs U3O8 equivalent changed hands in the global spot market last week, industry consultant TradeTech reports. TradeTech's weekly spot price indicator has risen US$2.10 to US$25.85/lb.

TradeTech's term market price indicators remain at US$26.50/lb (mid) and US$28.00/lb (long), pending end of month reappraisal.

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 UIKeyInputLeftArrowamounts 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 July 26, 2018

Interday volatility for the ASX200 was evident again last week, but still the index is not ultimately going anywhere much. The observant among you will note I used exactly the same sentence to open last week's Report.

I also noted last week there was a lot more green in the table below than red, which is not unusual ahead of a reporting season. The theme continued last week as the first earnings reports trickled in. The 10% plus group shrunk further, as did the full 5% plus table. Indeed, only two stocks saw short position increases.

Harvey Norman's ((HVN)) increase was ever so slight, but enough to sneak it back into the 10% group, just.

More notable was increase to 7.2% shorted from 5.2% for Nufarm ((NUF)), which I had flagged last week post a big profit warning from the agri-chemicals company due to the drought, which by now I think everyone has come to appreciate. Particularly if you watch the ABC.

All of the short reductions last week represented bracket-creep bar one, being News Corp ((NWS)). See below.

Weekly short positions as a percentage of market cap:

10%+

SYR 19.0 JBH 19.0 GXY 15.2 DMP 14.8 ORE 13.6 ING 12.3 MTS 12.1 MYR 11.8 VOC 11.2 HVN 10.0

In: HVN Out: GXL, NWS

9.0-9.9

GXL, GEM, AAC, MLX

In: GXL Out: HVN, NAN, IVC, CSR 8.0-8.9%

NAN, NWS, CSR, IVC, BIN, IFL, SFR, IGO

In: NWS, NAN, CSR, IVC Out: HT1, MYX

7.0-7.9%

HT1, GMA, NUF, CCP, MYX

In: HT1, MYX, NUF Out: FLT, SIG, MOC

6.0-6.9%

MYO, NSR, RFG, BWX, KAR, TNE, MOC, FLT, SEK, BGA, SIG, NEC, BKL

In: MOC, FLT, SIG

5.0-5.9%

GNC, TPM, BEN, PLS, IPH, BAP, QUB, SUL, CLQ, AAD, RSG

Out: NUF, MSB, APT

Movers & Shakers

Brokers see the move by News Corp to merge Foxtel and Fox Sports as a sensible one, rather than running them separately, but it will still be tough going in the face of competition from streaming and ever more costly sports rights.

The positive news from last week nevertheless, albeit previously flagged, was an agreement between rival newspaper publishers News and Fairfax Media ((FXJ)) to share their printing operations. It’s win-win for both parties in cost savings and at least goes some way to countering the structural decline of hard copy newspapers and magazines.

But one can only assume the clock is ticking.

News shares popped on the announcement, with a bit of help from short-covering.

ASX20 Short Positions (%)

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

IMPORTANT INFORMATION ABOUT THIS REPORT

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

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

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

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

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

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

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

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

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

The Wrap: Banking, Housing And Wagering

Weekly Broker Wrap: banking; housing; and wagering.

-Housing credit growth moderates further in June, pressure on banks -Declines in house prices remain orderly, for the present -New wagering entrants enhance visibility but conversion rates low

By Eva Brocklehurst

Banking

Citi suggests the new CEOs at both Commonwealth Bank ((CBA)) and Bendigo and Adelaide Bank ((BEN)) may struggle to meet expectations in their first reporting season. In particular, if CBA misses consensus estimates this may put an end to the rally in Australian bank stocks.

A spike in the BBSW-OIS spread and ongoing competition in the front book are expected to weigh on second half revenue growth for both of these banks. Citi also expects a continuation of weak revenue trends for CBA that were evident at the disappointing third quarter update.

Macquarie notes housing credit growth has moderated further in June, to around 4.7% from 5.2%, and this is the lowest rate of growth since 2013. Major banks continue to shed market share and grew at less than 0.8x system.

Nevertheless, while accepting the current landscape is challenging the broker continues to envisage relative value in banks. Westpac ((WBC)) and National Australia Bank ((NAB)) grew ahead of system in the month in housing while ANZ Bank ((ANZ)) and CBA lost share. The broker suggests deposit pricing remains broadly stable throughout the second half of FY18 and regionals remain competitive in deposits.

Banking system credit growth is tracking in line with Credit Suisse projections, which reflect softer housing credit growth and consistent with a view that the peak has been reached in housing. The broker welcomes the return to business credit growth.

Based on APRA data, the broker believes Westpac has the strongest lending balance growth among the major banks while CBA has the softest. Both Bendelaide and Suncorp ((SUN)) lagged the banking system in lending growth in June. Suncorp's strongest lending was in corporate and core deposits.

Housing

Private credit growth in June rose just 0.3% month on month and after May's 0.2% was the equal weaker since 2012, UBS notes. This was dragged down by record low investor housing input. Meanwhile, dwelling price declines accelerated in July to a five-year low.

UBS notes new housing remains surprisingly resilient, supported by a booming population and migration. However, the tightening credit scenario is more negative for prices and the broker envisages prices will be down more than -5% over the next year and the Reserve Bank will maintain a steady hand on the official interest rate tiller until 2020.

House price declines accelerated in July falling -0.6% to be -2.4% below a year ago. Macquarie observes the declines have been greatest in Sydney and Melbourne and among more expensive properties. These also experienced the greatest increases in price previously.

While some may point to the acceleration in house price declines as evidence of credit restrictions, the broker suggests this is only part of the story and notes loan approvals are typically taking much longer now. Macquarie believes the current correction is orderly but warns that fears of a sharper descent may become fulfilling if housing demand falls more significantly.

Morgan Stanley's model suggests both prices and housing approvals are likely to fall further, given a subdued outlook for credit and supply. Moreover, prices are still elevated and households indebted.

The broker does not expect the market to form a trough in the immediate future, and remains alert for any sharp tightening in credit or weakening in the broader economy that may accelerate declines and spark negative feedback between the housing market and the consumer.

Industry analyst and economic forecaster BIS Oxford Economics believed changes to the age profile of the population in Australia over the next decade is likely to mean a shift in the type of demand for dwellings.

Over the past 15 years there has been rapid population growth amongst the 20-34 age bracket. Natural population movement into this age group has been supported by net overseas migration which has also been concentrated in this cohort.

This has supported a boom in apartment construction and, the report suggests, as this generation now moves into the family-forming stage, many will look to purchase a dwelling, most likely larger ones such as detached houses or townhouses.

This situation is likely to support a decade-long boom in demand for new houses and land in the housing estates on the outskirts of Australia's major cities and affordable regional centres. Hence, BIS Oxford Economics suggests pressure will also be maintained on house prices in established areas.

Wagering

UBS has survey 1005 Australian wagering customers, operating active accounts across 18 local and international wagering operators. Sportsbet remains a dominant brand in Australian digital. Results for Tabcorp ((TAH)) were ahead of expectations highlighted by the integrating of Tatts and its multi-channel distribution.

While promotions and attractive odds are two of the top three drivers of bet placement, only 15% of customers have any idea of what the odds should be. This provides an opportunity for bookmakers to absorb the POCT (point of consumption tax) through a collective increase in pricing, especially given more than 50% of punters have no predetermined betting amount.

Finally, the threat of turnover moving offshore remains low, with less than 2% of active accounts allocated to those bookmakers based offshore. Post the recent consolidation, the top three betting operators now have two thirds of all active accounts, the survey shows.

New entrants may have created high brand awareness but as conversion to active accounts is low this could show some signs of advertising fatigue and a lack of motivation to change, UBS adds.

New Financing Boosts Outlook For Senex Energy

Senex Energy's Surat Basin projects have received a boost from the securing of a senior debt facility.

-Infrastructure agreement key to increased pace of development -Corporate appeal likely enhanced by further growth in reserves -Risk of an equity raising now significantly reduced

By Eva Brocklehurst

Brokers are increasingly positive about the promise in Senex Energy's ((SXY)) Surat Basin projects as an attractive debt package has been secured to further de-risk development.

The company has an underwritten $150m debt facility to fund the development of Atlas and WSGP projects in the Surat Basin. Morgans is impressed with the terms of the facility, which is cheaper and longer duration versus expectations.

Flexibility is also a positive, as the debt can be increased or repaid early without any penalties. The 6% interest rate steps down towards 5.5% post development completion. Ord Minnett suggests the new facility is a key milestone as it provides sufficient funding for both development projects and alleviates concerns over any equity raising.

Canaccord Genuity, for modelling purposes, assumes $135m in capital expenditure in FY19 and that the WSGP processing is developed on balance sheet. The company remains in discussions with infrastructure providers for gas tolling services for WSGP.

The broker anticipates success in this regard would be accretive to project returns and potentially free capital to increase the pace of development. Canaccord Genuity, not one of the eight monitored daily on the FNArena database, includes 2c per share in valuation for reserve upside at Atlas.

While the quality of the WSGP asset remains subject to conjecture, the broker believes Senex is increasingly comfortable with its potential, particularly given the recent performance of GLNG's neighbouring Roma field. Canaccord Genuity has a Buy rating and $0.54 target.

In addition to attractive organic growth Morgans also envisages corporate appeal in the stock that will be enhanced by further growth in reserves.

Atlas

Citi is more comfortable, following a review of the geology around Atlas, regarding the ability to unlock target reserves, and does not believe the share price has fully incorporated the extent to which these reserves can increase. As a result, the broker upgrades to Buy/High Risk from Neutral/High Risk.

The 2P reserves in hand of 144PJ are well below the company's aspiration of 278PJ, which is predicated on drilling wells with commercial flow rates in the south-east of the block. Citi believes the quality of the coal seams in the south-east corner territory are not likely to deteriorate relative to those used in the current 2P reserves. Generally, the coals are a little deeper and lower quality but this appears to the broker to be a minor consideration.

Project De-Risking

The senior secured debt, along with the $67m cash on hand, a $43m gross carry by Beach Energy ((BPT)) in the Cooper and cash flow from production assets, provides the liquidity the company requires to push through its growth strategy. This should mean first gas from Atlas is ensured in late 2019 as well as sanctions for the next phase of WSGP and further drilling on the Western Flank.

Citi considers the infrastructure deal with Jemena and the new debt facility act to de-risk Queensland CSG in terms of the funding, scale and schedule. The broker improves its risk weighting for the Atlas to 90% from 75% and believes the risk of an equity raising, outside of M&A, has eased.

The company has highlighted that this is the first time senior debt has been secured for CSG acreage in Australia. Morgan Stanley agrees the risk of an equity raising is significantly reduced in the near term, although this cannot be ruled out completely, particularly should there be delays associated with development expenditure. The broker places the majority of its valuation in the undeveloped assets, so the key to stock performance remains delivery on these projects.

Production of 0.27mmboe in the June quarter was 33% above Citi's estimates and, in addition to the changes in modelling for Atlas, now forecasts Growler production will be higher for longer.

The database shows five Buy ratings and one Hold (Morgan Stanley). The consensus target is $0.50, signalling 7.1% upside to the last share price.

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