

September 2017

Investment Watch

Recalibrating expectations

The very modest gains in share prices at a time when other developed markets have generally been rising faster, reflect the difficulty the local economy has faced in breaking out of its post-mining slump. Although there are some promising signs that business conditions are finally taking a turn for the better, consumer sentiment remains weak, and the equity market may continue to be side-lined by ongoing subpar growth until a clear signal emerges. This month we look at Australia's terms-of-trade and what an improving ratio means for corporate investment decisions and whether this is the circuit breaker needed to spur a rebound in earnings (Page 2).

FY17 results dominated market headlines over the past month, and despite all the noise about high-profile companies missing the mark (Telstra, Dominos Pizza, CSL), the ASX200 finally

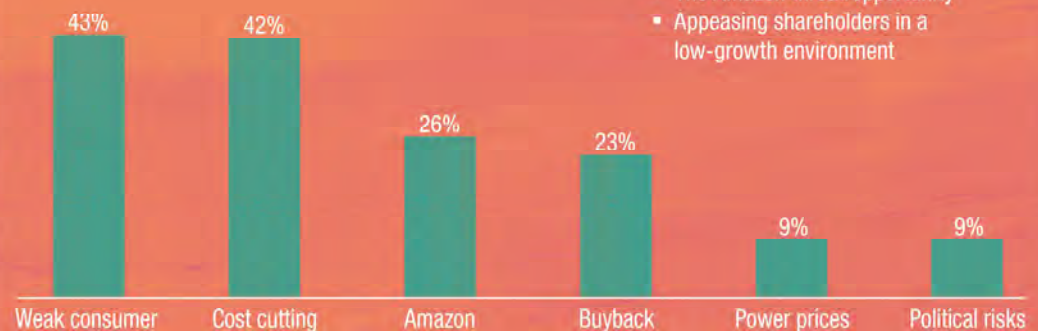
shrugged off the three-year profit recession closing the financial year with 13% earnings growth. The substantial turn-around in the nation's terms-of-trade was the main contributor to the improvement in profit. Investors however, are not yet extrapolating the growth beyond FY17 as such the market

continues to lack direction and with corporate outlook statements erring on the side of caution we think it will remain in a wait-and-see mode. We summarise our view on reporting season and best ideas on page 3.

For better or worse the banks have again returned to the spotlight. A set of solid results

by CBA have tamed the bears however multiple inquiries into major breaches of reporting and compliance threatens to undo the good work done to steer the company out from a difficult period for earnings. Following the recent market updates we provide our latest views on the sector on Page 5.

Results Conference Calls: keyword bingo
– some common themes emerge
(% of reporting companies mentioning the theme/topic)



Source: Bloomberg, Morgans

What keeps management up at night?

- Weak consumer sentiment
- Stripping costs out
- The Amazon threat/opportunity
- Appeasing shareholders in a low-growth environment

Contents

This edition we look at ...

Recalibrating expectations ▶ 1

Economics – a rise in investment spend ▶ 2

Equity strategy – reporting season review ▶ 3

Recent research Initiations ▶ 4

Major banks – the future looks promising ▶ 5

Healthcare – new skin in the game... who's strategy is best? ▶ 5

Technical corner – has the ASX 200 lost its way? ▶ 6

High Conviction Stocks ▶ 7

Economics – a rise in investment spend

It is a remarkable thing when an economist actually gets a forecast right. Back in September 2014, esteemed Australian Economist Peter Dixon from the Centre of Policy Studies of Victoria University forecasted an outlook for the Australian Economy from 2014 to 2020.

The piece was called 'Quantifying Dog Days'. In his piece Dixon discussed the implications of an earlier book published by Ross Garnaut published in 2013. In his book, Garnaut described the three phases of a mining boom. The third phase featured the expansion of export volumes and declines in the Terms-of-Trade (TOT).

Declining TOT

Between 2001 and 2012 Australia's TOT increased by 90%. The TOT then fell 18% from a peak in September 2011 until mid-2014. Dixon estimated that it would return to a 2006 level by the end of 2020.

Dixon notes that mining accounted for 28% of domestic investment in 2013. He expected it to decline to half that level by 2017.

Simulation results

Dixon and the group working, forecasted that growth in GDP would fall from 2.92% in the 10 years to 2014 to only 2.12% from 2014 to 2020. The main reason is slower capital investment.

The fall in the capital investment growth rate reflects three factors.

1. A fall in the terms-of-trade;
2. A rise in required return on investment; and
3. A slight rise in multi-factor productivity.

He forecasted that from 2014-2020 Australia would face challenges. He thought the TOT would fall to the 2006 level by 2020, mining investment would fall by a half from 2013-2020, there would be a decline in the ratio of employed hours relative to the population, and there would be subdued growth in productivity.

With all of these assumptions in place he forecasted an average

real growth rate of 2.1%. He noted that this was only slightly higher than annual average population growth. This meant that real GDP per capita would rise by only 0.4% per annum. This led to a forecast for a decline in the growth rate of real gross national product per capita at a rate of 0.3%. This is an outlook for slow growth and slow wages growth. The main reason is slower private capital investment.

The one significant change that we can say about Peter Dixon's outlook is that the decline in the TOT in which he forecast, ceased at the beginning of 2016. The TOT is made up of two components. The first is export prices. The other is import prices. Import prices move in a relatively stable way. Export prices move in big swings brought about by big swings in commodity prices.

Every month the Reserve Bank of Australia publishes its index of commodity prices. In US\$ terms, the RBA index of US\$ commodities peaked at an index level of 246.5 in July 2011. From that time, commodity prices fell (and the TOT fell) in the same way that Peter Dixon had suggested.

Now all of the things that Peter Dixon forecast were then experienced by the Australian economy. The TOT had fallen. This had led to a fall in investment and a slowdown in jobs growth.

The commodity index in US\$ terms had fallen to 90.8. This means that the TOT stopped declining.

The turnaround

Then what happened was commodity prices started to rise. This meant that the TOT started to rise. By July 2017, the RBA index of commodity prices in US\$ terms had risen to 122.4.

A rise in the TOT should lead to a rise in investment. A rise in investment should lead to a rise in employment growth. This should also lead to a rise in GDP growth. This is what is about to happen in the Australian economy.

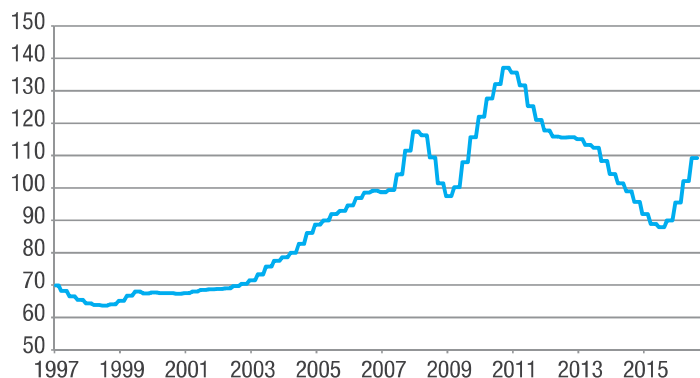
The period forecast by Peter Dixon has ended earlier than he forecast. Instead of continuing until 2020, the decline in the TOT came to an end in January 2016. Since that time, the TOT have begun to improve. This will generate stronger growth in investment, GDP and jobs. This is the turnaround we are about to experience.

Equities Market

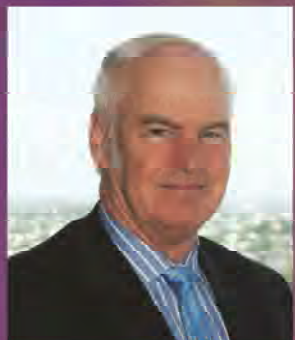
The improvement in the TOT is leading to an improvement of earnings in companies in the ASX200. As of 29 August, our model tells us that a fair value for the ASX200 should be 5700 points. We are currently in the reporting period and as we come out of this, we believe that fair value for the ASX200 will rise to 5870 points.

A turnaround in the TOT is generating a turnaround in investment and a turnaround in earnings.

Australia's terms-of-trade



Source: ABS



Listen to the latest podcast from Chief Economist Michael Knox as he explains **Why the Australian Economy will turn around.**

<https://www.morgans.com.au/michael-knox>

Equity strategy – reporting season review

Reporting season in a nutshell

Fewer-than-usual corporates exceeded market expectations this reporting season, with notable large cap misses from the likes of Telstra, Suncorp, Ramsay and Woolworths a concern. Corporate outlook statements were again broadly cautious reflecting several uncertainties in the economy. We pull apart key themes we identified around earnings tailwinds (lagging), capital investment (higher), buybacks (up), EPS certainty versus growth and small-caps (rebounding).

But is the problem with corporates, or with market expectations?

We suspect the latter. Australian companies (ex-Resources) grew their profits at a modest 6.3% in FY17, which eroded from expectations of 7.4% growth 12 months ago. Expectations

for FY18 corporate profit growth currently sit at 6.3%, or 9.4% excluding banks and financials. With elevated valuations heading into results (>16x forward PE) and this level of profit growth, it's not surprising the market was tough to please in August.

Investment strategy remains cautious

The valuations that investors are paying for earnings remain elevated by historical standards, and as such, we caution investors from expecting higher-than-average returns. We think the market's frustratingly sluggish/sideways trade reflects the reality check that higher earnings, which the market was pricing in earlier in 2017, will take longer to deliver than was hoped. Given that prices tend to over and under shoot around the earnings trajectory (see Figure 5), it's important to stand ready to accumulate preferred exposures when the inevitable bouts of market volatility hit.

We remain optimistic on the corporate outlook over the medium term but think that market pricing and EPS expectations had gotten ahead of themselves as they have done several times before as the economy continues its slow recovery. Pullbacks provide buying opportunities.

Sentiment not yet translating into investment

Despite business surveys showing signs of improvement leading into August, meaningful cyclical tailwinds failed to materialise either through the results or outlook statements. Retiring CBA CEO Ian Narev summarised the economy as:

'... in many cases better than they were six months ago or certainly 12 months ago when we were talking about the result, but the experience of people within the economy geographically in different paths of economy is still varied. And we do see ongoing concerns

at the household level about job security, about wage growth and about the cost of living.' Ian Narev 9 August 2017

At least for now, in the absence of meaningful earnings catalysts, the overall market appears to be range-bound. As mentioned above, the multiple investors pay for earnings remains elevated by historical standards. As such, we caution investors against expecting higher-than-average returns.

Unearthing companies that can thrive regardless

Despite challenging conditions overall, we continue to identify individual companies capable of thriving in this environment, that offer good value for investors. Indiscriminate selling and under-recognition of strong results have created some notable opportunities amid the volatility. We profile our best ideas arising from the August results below.

Stock	Comment
CSL Limited (CSL)	CSL didn't renew its buyback, instead flagging FY18 as a re-investment year, which drove post-result weakness. CSL isn't overly cheap, but has an enviable track record of EPS growth over a very long time frame.
Ansell (ANN)	Divestments and business transformation have re-based and re-focused ANN. FY18 guidance looks conservative and the earnings trajectory looks solid.
Healthscope (HSO)	Despite the core hospital division disappointing, brownfields operations and core portfolio growth are improving. Looks cheap on a multi-year view.
ResMed (RMD)^	Although volumes fell in 4Q, supply constraints are a thing of the past and operating leverage should improve supporting a strong earnings trajectory.
BHP Billiton (BHP)	We think moves to jettison the problematic shale business combined with cashflows supporting higher shareholder returns make BHP one of the most compelling buys in our coverage.
Oil Search (OSH)^	OSH will bounce around with short-term oil sentiment, but we think the market is undervaluing its growth potential, which should unfold over time.
Link Administration (LNK)	We like the LNK story and see value emerging into FY19 on benefits from the CAS acquisition and further Superpartners synergies.
Westpac (WBC)^	Our preferred major bank with low risk of a dividend cut, good organic capital generation capacity and a compelling +6% yield pre franking.
Suncorp (SUN)	SUN's result disappointed vs high market expectations but we think it represents an income opportunity offering a ~5.5% FY18F dividend yield fully franked, and with confidence in its sustainability given \$350m of excess capital above regulatory requirements.
AFG Group (AFG)^	Reported a strong FY17 result supporting our view that AFG looks cheap versus its growth outlook and +7% yield.
Cromwell (CMW)	CMW's active management style should deliver long-term returns via an 80/20 split between property and funds management earnings. We upgraded to Add due to several near-term catalysts approaching.
Viva Energy (VVR)	VVR offers an attractive +6% distribution yield with support from further accretive acquisitions in the pipeline, asset re-ratings and DPS outperformance.

Stock	Comment
Aventus (AVN) [^]	AVN offers an attractive +7% distribution yield and looks oversold on Retail fears. The organic growth pipeline and potential acquisitions are potential catalysts.
Inghams (ING)	ING strongly surprised the market's conservative expectations in August in both earnings and debt reduction. Our confidence in the stability of earnings has improved.
IPH Limited (IPH)	IPH continues to deliver strong and reliable base earnings with good cashflow conversion into a solid yield. Looks cheap given IPH also has growth options.
Corporate Travel (CTD)	Another stellar result in-line with high expectations in August. We expect ongoing delivery of strong double-digit growth in coming years. Buy near \$20.00 per share.
NextDC (NXT) [^]	We remain attracted to NXT's long-term growth potential driven by strong structural tailwinds supported by the exponential growth in data usage and storage.
PWR Holdings (PWH) [^]	Ongoing constant currency revenue growth of 15% for the core Motorsports division was the highlight of the result, supporting strong growth in future years.
Jumbo (JIN)	JIN offers exposure to traditional lottery markets and the shift to digital sales channels, which we think supports strong EPS growth over coming years.
Apollo Tourism (ATL)	ATL looks cheap with more growth optionality offshore. We forecast another strong year in FY18 assisted by recent acquisitions.
Aveo Group (AOG)	The '4-Corners discount' built into the stock looks increasingly unsustainable versus our view that brand damage appears to be moderating and that NTA will likely move toward \$4 in coming years.
Lovisa (LOV)	We highly rate LOV's offshore expansion potential, enviable gross margins, rapid store payback and net cash position. Buy the pullbacks.

[^] Morgans High Conviction Stock

Recent research initiations

The Morgans Research team recently initiated coverage on a broad range of companies which we believe offers investors attractive growth prospects.

Spark Infrastructure (SKI)

SKI is an internally managed, direct infrastructure fund with an objective to invest in regulated electricity distribution businesses. It currently holds equity stakes in three high quality energy infrastructure assets – Victoria Power Networks, South Australia Power Networks and Transgrid. The majority of revenues generated by SKI's asset companies is sourced from their regulated electricity networks. The AER sets revenue allowances for a five-year regulatory cycle. We estimate across SKI's three asset companies the return on and return of capital contributes about 60% of revenues. This approach means that the Regulated Asset Base anchors

long-term revenues and value. SKI provides investors with defensive earnings and a reliable and growing distribution (at least until 2021 on our forecasts). Estimated cash yield is 6.1% with a price target of A\$2.72.

Kelly and Partners (KPG)

KPG is a network of owner-driver accounting businesses, primarily focused on providing accounting and tax-related services to private small-medium enterprises, their owners and high net worth individuals. The network comprises 16 operating businesses across 13 locations (across Greater Sydney and one office in Hong Kong). KPG was founded by Brett Kelly (Executive Chairman and CEO) in 2006. KPG's growth to-date has been driven by a combination of greenfield partnerships and transforming existing accounting firms into KPG partnerships, supported by steady organic revenue growth.

We expect network expansion to continue to be a meaningful driver of growth, with several regions in greater Sydney being targeted. We value KPG at A\$1.48ps using a blended PE and DCF valuation. We believe KPG has a visible and relatively defensive growth profile, but we initiate coverage on a Hold recommendation based on short-term valuation metrics (15.5x FY18F PE). The upside to our neutral rating is potential acquisitions occurring earlier and/or being more material versus expectations.

Emeco (EHL)

Formed in 1972, EHL is an equipment rental business that provides heavy equipment solutions to the Australian natural resources industry. EHL operates a global fleet of original equipment manufacturer (OEM) machines to deliver suitable equipment rental solutions for customers, with a focus on Australia's mining industry. EHL announced

a recapitalisation and merger with two similar businesses – Andy's Earthmoving and Orionstone. The merged entity significantly improves EHL's credit metrics, increases EHL's exposure and capabilities in SA, VIC and QLD, increases the size of the fleet (while reducing the average age of assets) and provides significant cost saving synergies. At the current level of mining activity, the restructured EHL business appears well positioned to de-lever the balance sheet and increase shareholder equity. We currently have EHL as an ADD recommendation with a \$0.17c price target.

For more refer to the initiation notes. **SKI: Yield and scarcity value** published 18 July. **KPG Partnering for success** published 9 August and **EHL: Time to back the truck up?** published 3 July.

Major banks – the future looks promising

The major banks did not disappoint with the August round of results and trading updates, and while there is not much growth on offer, the dividend outlook is looking increasingly robust. One of the standout themes in the latest round of reporting was stable/improving asset quality. Credit impairment charges, as a percentage of loan books, have been hovering at cyclically low levels for some time now and are still not showing signs of trending up. While there are pockets of stress that we are keeping a close eye on, such as retail trade and mining regions, overall asset quality has not deteriorated.

The key reason why the sector is not offering much growth is that income growth is subdued. Having said this, we expect net interest margins (NIMs) to expand in the current half-year period from the prior period

despite the major bank levy coming into effect on 1 July 2017. We expect NIM expansion to largely be the result of home loan repricing and reduced term deposit competition.

While some have feared that macroprudential rules will result in significantly reduced system home loan growth, this has not yet happened. Our base case has been and continues to be that reduction in the rate of investor home loan growth will largely be offset at the system growth level by increased owner-occupier home loan

growth. System home loan growth was 6.6% over the 12 months ended 30 June 2017 and we expect system home loan growth to be 6% pa over the next two years.

The major banks have generally continued to focus on optimising risk weighted assets and this has supported their common equity tier 1 (CET1) capital ratios. Our base case continues to be that the major banks will meet APRA's 'unquestionably strong' CET1 benchmark of 10.5% by 1 January 2020 without the need

to resort to outright capital raisings or dividend cuts.

With asset quality not deteriorating, NIMs improving, credit growth subdued and a stronger ROE focus from the major banks generally, the dividend outlook for the sector is looking increasingly robust. WBC remains our preferred major bank followed by NAB. We recently downgraded CBA to a Hold. The ongoing civil proceedings and APRA's prudential inquiry is likely to put pressure on the share price for some time and we can't rule out a credit rating downgrade.

Ranking	Recommendation	Current Share Price (\$)	Target Price (\$)	Forecast TSR
1. WBC	ADD	\$31.22	\$38.00	31%
2. NAB	ADD	\$30.34	\$35.00	26%
3. CBA	HOLD	\$73.94	\$83.00	18%
4. ANZ	HOLD	\$29.10	\$30.00	11%

Source: IRESS. Data as at 11 September 2017

Healthcare – new skin in the game... who's strategy is best?

Outlook for private hospital operators – Healthscope (HSO) and Ramsay (RHC)

While we believe fundamentals remain unwavering for the domestic private-hospital operators (eg ageing population, increased chronic disease, new technologies and population growth), both HSO and RHC are faced with ongoing concerns around domestic affordability, volatile (albeit improving) utilisation rates, ongoing Government review and adjusting to new CEOs.

We view HSO as carrying much more near term earnings risk than RHC. However, trading levels appear reflective and an 8.5% short register may feel the pain if the 'sky doesn't fall' with reporting. A deeper focus on the core hospital business on the back of the recent Australia medical



centres divestiture and brownfields expansions should see medium/longer term earnings improve.

While we believe RHC's FY17 guidance (12-14% NPAT growth) is achievable, mainly on the strength of the domestic business, we do not believe the market has fully appreciated the challenges moving forward with offshore operations (eg tariff cuts, higher labour costs, political uncertainty – Brexit/Macron). Given we believe these are unlikely to be off-set by

procurement savings and building its network of retail pharmacies, RHC's outlook may be below expectations.

SRX cost-outs amplify leverage despite a depressed top line

Beyond the vagaries of trying to predict the outcomes of clinical trials, it is refreshing to see new CEO Andrew McLean target improved underlying profitability. However, it remains unknown exactly how he intends to do that i.e. to increase use, to expand

utilisation and to open up new geographies for its sole SIR-Sphere product. We don't envisage any insight with reporting until Andrew reveals his strategy (slated for some time in November). Regardless, despite near term sales most likely being anaemic, recent structural changes (i.e. 15% staff cut, A\$90m R&D impairment) improve margins and earnings leverage.

Technical corner – has the ASX 200 lost its way?

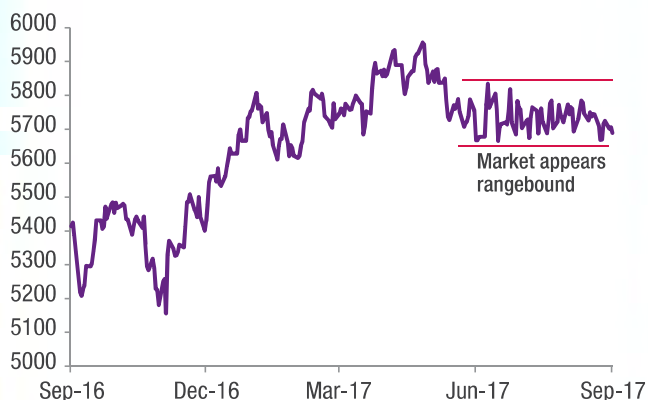


Over the past three months the XJO has been struggling to find direction and has been trading sideways, fluctuating between 5629 and 5836.

Although the shape of the current consolidation shows that market sentiment is neutral, the lower highs within the current trading range is a concern and show that the sellers are gaining momentum. Therefore, near-term we see the probability of a downward breakout being higher than an upward breakout.

The key level to watch is 5629. A break below this level will signal an extension of the current correction with a downside target of 5422. However, over the medium term, our view on the index remains positive and such potential weakness would provide a good entry into the market. Our economist Michael Knox currently has a fundamental fair value for the ASX200 of 5800 by year-end lifting to 6200 at the end of 2018.

ASX 200 Index – lacking direction



Source: IRESS

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Reporting season review

Fewer-than-usual corporates exceeded market expectations this reporting season, with notable large-cap misses from the likes of Telstra, Suncorp, Ramsay and Woolworths a concern. Corporate outlook statements were again broadly cautious reflecting several uncertainties in the economy. Refer to our recent reporting season review which pulls apart key themes we identified around earnings tailwinds (lagging), capital

investment (higher), buybacks (up), EPS certainty versus growth and small-caps (rebounding).

We have added PWR (PWH), Aventus (AVN) and NextDC (NXT) to the list this month.

PWH is an alumni of the list and we reintroduce it this month following its standout FY17 result. Management expects the 2H bias to revenue to continue in FY18 with further inroads into the motorsports market expected to generate additional organic growth. Some niche

OEM programs will come on line progressively in FY18/19 and opportunities remain in emerging technologies, particularly in electric vehicle cooling.

AVN's income is underpinned by leases to a diverse range of tenants with structured rental growth. While headwinds are impacting the broader retail sector, we believe AVN is well placed to navigate any challenges given:

1. Low vacancy rates and incentives
2. Ability to re-mix tenants

3. Low maintenance capex requirements
4. Limited new supply
5. Opportunities for consolidation in a fragmented market

NXT has also previously been on the list, we like its solid growth outlook and we think there are a number of upcoming catalysts including the resolution of the ADJ REIT deal and securing cornerstone customers in its Gen 2.0 facilities.

For more detail refer to our latest [High Conviction Stock list](#) published 7 September 2017.

Morgans' High Conviction Stocks

ASX 100								
	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR	
🔒	ResMed	RMD	\$9.96	\$10.52	1.8%	1.8%	25.9	11%
🔒	Westpac	WBC	\$31.22	\$38.00	6.1%	8.8%	11.9	32%
🔒	Oil Search	OSH	\$6.75	\$10.16	2.0%	2.0%	21.2	59%

Ex-100								
	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	PE 12mf (x)	12m TSR	
🔒	Motorcycle Holdings	MTO	\$4.28	\$4.37	3.7%	5.3%	16.1	8%
🔒	Aventus	AVN	\$2.30	\$2.46	7.1%	7.1%	12.7	14%
🔒	Bapcor	BAP	\$5.47	\$6.19	3.1%	4.4%	17.4	15%
🔒	NextDC	NXT	\$4.73	\$5.38	0.0%	0.0%	113.0	18%
🔒	Australian Finance Group	AFG	\$1.52	\$1.70	7.2%	10.3%	10.0	22%
🔒	PWR	PWH	\$2.40	\$3.10	2.8%	4.0%	21.5	33%

Source: Factset Data as at 11 September 2017.

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