Investment Watch

March 2018

morgans

Contents

Welcome

We're excited to launch the new-look Investment Watch. It's been designed to keep you informed with what is relevant in an easy to read format. We'd love your feedback on anything we can do to make it easier and faster for you to get the information you need. This month's edition comes off a solid reporting season for Australian companies. In this month's feature article, we pick-apart important themes and highlight the key investment ideas. Happy reading.

Recently published research

- Reporting Season Review (2/3)
- Link Administration – Enough to support the current share price (28/2), ADD
- Macquarie Atlas Roads – Hang on for the ride (28/2), ADD
- Ramsay Health Care – 1H soft watchful waiting (28/2), HOLD
- Megaport – Mega op(port)unity in North America (21/2), ADD

Corporate offers – MCP Income Trust

MCP
METRICS CREDIT PARTNERS

The MCP Income Trust seeks to provide investors with direct exposure to the Australian corporate loan market and is listed on ASX. Through investments in and alongside wholesale funds managed by MPC, investors will gain access to monthly income, low capital volatility and portfolio diversification. Metrics Credit Partners (MCP or Manager) is making a 1 for 1.7 pro-rata non-renounceable entitlement offer of new fully paid ordinary units in the MCP Master Income Trust (MCP Income Trust or Trust). Eligible Unitholders who take up their Entitlement in full may also apply for Additional New Units in excess of their Entitlements at the Offer Price. Any units not taken up under the Entitlement Offer or the Oversubscription Facility will be offered to new investors under the Shortfall Offer. Gross proceeds raised under the Offer will be invested in opportunities identified by MCP.

Key terms
Issuer: Metrics Credit Partners
ASX code: MXT
Offer Size: $303.6 million (with potential over subscriptions)
Unit Price: $2.00
Minimum application amount: $1,000 under the Broker Firm Offer
Targeted Distribution Rate: 3.25% above the RBA Cash Rate
Indicative initial Distribution Rate: 4.75% (assuming a 1.50% Cash Rate)

Key dates
Record Date for Entitlement Offer 1 March 2018
Offer opens: 5 March 2018
Morgans closing date: 27 March 2018
Settlement date: 3 April 2018
Commencement of trading: 10 April 2018

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Economics – The role of the US dollar in global trade

In January we attended a presentation by Valentina Bruno of the American University in Washington DC and Hyun Song Shin of The Bank of International Settlements. This presentation was given in Philadelphia.

The presenters argued that global value chains (GVCs) figure prominently in global trade. GVCs lie at the intersection of two important themes. The first is the financing requirement for working capital. The second is the prevalence of dollar invoicing in global trade. The result of the interaction of these two themes is that the dollar exchange rate emerges as a determinant of GVC activity. Specifically, this means that "a stronger dollar is associated with tighter credit conditions and subdued GVC activity." Surprisingly, this means that exports from emerging economies may fall when their currencies fall against the US dollar.

The theme of the presentation was the close relationship between variations in the US Dollar and the exports of emerging economies. It appears that 82% of trade of emerging economies is financed in US dollars. It was argued that there was "mismatching" of US dollar exposure by emerging economies. This means that US dollar exposure held by emerging economies was essentially unhedged.

In theory this would suggest that if emerging economy currencies rose against the US dollar then there would be a greater volume of funds available to finance exports and imports of US dollar denominated products in developing economies. Turns out this is also true in practice.

The presenters showed charts demonstrating that the finance available to finance the trade in manufactured products made by emerging economies rose as the US dollar fell and fell as the US dollar rose. This increase in finance had a direct result.

The real volume of trade by emerging economies rose when the US dollar fell and fell when the US dollar rose. They noted that it was particularly apparent when one used the Bank of International Settlements measure of the broad index of the US dollar using the currencies of many developing economies.

Although this was still apparent when one used the Bank of International Settlements narrow measure of the US Dollar Index including only major economies; statistically the relationship was much stronger when one used the BIS Broad US Dollar Index. We have found a similar relationship between the broad US dollar index and the manufactured product trade of emerging economies.

Quite simply as the broad index of the US dollar falls, the volume traded and the price of commodities produced by emerging economies rises.

As the broad index of the US dollar rises, the volume and the price of commodities produced by emerging economies falls. This is not simply a direct currency pricing effect. As the US dollar falls, the amount of finance available to finance the international trade in commodities produced by the emerging economies rises.

Thus the volume of exports of commodities by developing economies rises. The price rises too. Why is this important?

We are entering a period where the US budget deficit is increasing. This budget deficit is increasing in order to finance the essential programs of the incumbent Republican Party. The Major tax reforms passed by the Republican Party in late 2017 are resulting in a larger US budget deficit.

Increased military spending passed by the US Congress in a bipartisan bill in early 2018 will further increase the US budget deficit.

An increase in the US budget deficit will generate an increase in US demand. An increase in US demand will generate a larger US current account deficit.

An increase in the US current account deficit will generate a lower US dollar. A lower US dollar will generate an increase in the volume of finance available to finance the commodity exports of emerging economies. The volume and price of internationally traded commodities will rise.

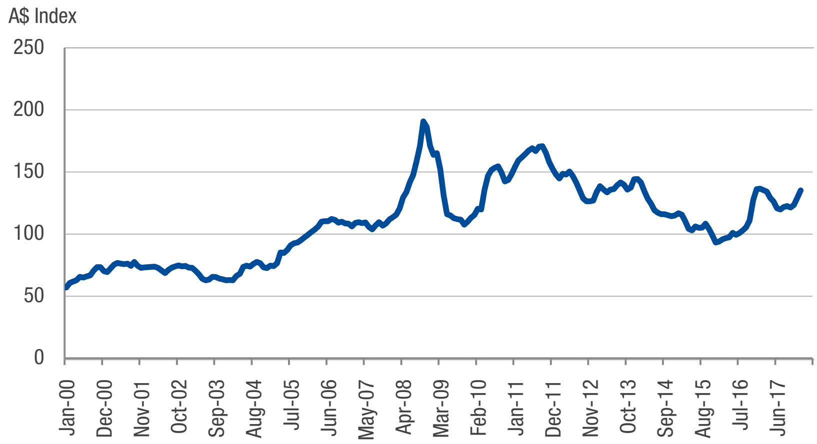
Conclusion

The increase in the US budget deficit required to finance the Republican legislative program will have far reaching effects. The US dollar will fall. The volume of international trade in manufactures and commodities will rise.

Commodity export volumes and commodity export prices will go up. The outlook for Australian commodity exporters may be greater than we think.

We have found a similar relationship between the broad US dollar index and the manufactured product trade of emerging economies.

RBA Commodity Price Index since 2000



Source: RBA

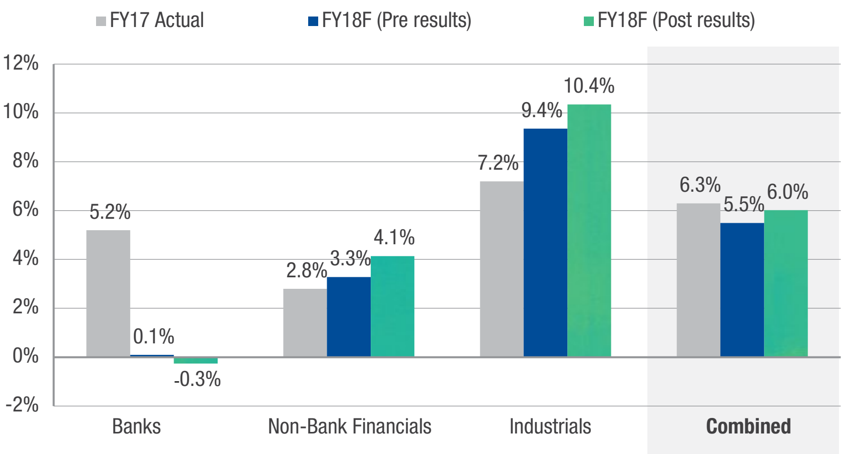
Equity strategy
– reporting season review

There was a lot to like about the February reporting season. By our estimates, over 30% of large caps beat the market's expectations, and unlike previous seasons, estimates held firm rather than falling away into results. Downgrades and significant misses were largely a non-event and overall management commentary reflected the most buoyant conditions we've seen for a while. We pick-apart key themes we identified around large cap outperformance, offshore earnings growth, industrials earnings momentum (up slightly), capital management (up), and the resource cycle (maturing).

Expectations for FY18 corporate profit growth (ex-Resources) were revised 0.5% higher over the course of reporting season to 6.0%, or 10.3% if we exclude banks and financials. Unlike recent seasons, estimates also held firm rather than falling away into results.

The correction in early February saw the market multiple trade as low as 15.2x and doubtless made it easier for companies to meet investor expectations. On the whole, the large caps (ASX50) were the star performers with 30% beating consensus expectations while only 9% missing. Small and Mid-caps saw more varied results with 25% beating and 19% missing consensus expectations. The higher valuations for the Small/Mid-caps set a higher hurdle for companies to beat expectations.

Consensus FY18 profit growth forecasts (ex-Resources)



Source: Morgans, Factset

The market has been prone to over-shoot the actual earnings trajectory in recent years and we think investors should stand ready to buy the dips when the inevitable bouts of market volatility hit, rather than chase expensive stocks higher.

Investment strategy remains cautious

The valuations investors are paying for earnings remain elevated by historical standards, and we caution investors from expecting higher-than-average returns. Current earnings growth sits well below the long-term average (~9-10%), reflecting below-trend economic growth, while valuations (XJI on ~16x forward) appear to be pricing in earnings acceleration that is yet to be delivered. The market has been prone to over-shoot the actual earnings trajectory in recent years and we think investors should stand ready to buy the dips when the inevitable bouts of market volatility hit, rather than chase expensive stocks higher.

Unearthing compelling value

Market aggregate analysis can mask the fact that plenty of compelling opportunities still exist in companies capable of thriving despite the challenging economy. We profile our updated Best Buys (and Sells) on pages 2-3, with the standouts including Telstra, Macquarie Atlas Roads and AFG Group which all look 20-25% too cheap today.

We highlight some themes that we believe will set the tone for 2018.

- Management gives the green light on the economy – The robust business surveys were reflected in the mostly upbeat tone across the results. While results were good, it wasn't hitch free. The Retail and Telco sectors continue to struggle against structural change and higher payouts continue to be the M.O.; nonetheless, the economy remains on much firmer footing than it has for some time.
- Large caps catch a bid – The investment playbook for the goldilocks environment of growth without inflation was to buy growth. Since October the MSCI Growth index has outperformed the Value index by 3% and even more pronounced was the outperformance

of small caps over large caps (+8%). With the re-emergence of inflation and better-than-expected large cap results (particularly among Financials and Healthcare) a rotation back towards large caps was inevitable and unlikely to be confined to just a temporary move.

- Offshore growth surprises on the upside – Global growth and favourable changes to the US tax code continue to be a strong source of upside for stocks with exposure to the recovery in US and Europe. The median EPS revision for the Morgans basket of offshore earners was 2.4% and a 1.8% price reaction since the result. The strong results reaffirmed our view that offshore cyclicals will continue to perform over the next 12 months.
- Investors still hung up on high PE growth – The large valuation divergence between high PE and low PE stocks closed marginally, we think this is unlikely to be sustained in the context of stronger growth and rising inflation. We think expensive growth will underperform GARP and value over the short term.
- No surprise, capital management still in vogue – Capital management is still preferred over reinvestment. Companies are still unwilling to dial back payout ratios or scale down buyback programs. Dividends were up for 69% of February reporting companies and some major buybacks were accounted including QAN, LLC and RIO.

- The infrastructure opportunity – The trend remains positive for infrastructure activity in key urban markets. Macromonitor estimates that nearly $16bn p.a. will be spent on transport projects alone over the next three years and peak in 2020. Results from DOW, ABC, CIM and SVW highlight the magnitude of the upcoming pipeline.
- The Resource cycle is maturing – Resources and energy companies largely delivered as expected in February, with higher earnings flowing through into higher dividends and capital management initiatives. Two emerging themes stood out to us though around the return of cost inflation and notable growth via M&A rhetoric and or activity.

For more refer to our comprehensive Reporting Season Review published 2 March 2018.

Reporting Season – key picks and funding sources

Undemanding / Oversold	Best Cyclical Exposures	Backing Quality Results	Flying Under The Radar
Telstra	BHP	Wagners	AFG
Kina Securities	Webjet	Orora	PWR
Motocycle Holdings	Lindsay Australia	Macquarie Atlas	CML Group
Aventus	Emeco	Sydney Airport	Noni B

Sells / Funding Sources

Woolworths, QBE, Brambles, Santos, Blackmores, Accent Group, Monash IVF, Virtus Health, National Storage REIT, Bega Cheese, Infigen Energy, Range International

Industrials – a generally good reporting season

The Industrials sector experienced a generally solid reporting season with most companies delivering results either broadly in line or above our expectations.

There was of course the odd disappointment but overall it showed that economic conditions in Australia and the US were tracking along nicely. The environment in Europe looks to also be improving with global companies such as Amcor and Brambles both reporting modest underlying growth in that region. Emerging markets on the other hand remain mixed, especially in Latin America while Asia growth is also below trend.

Against this backdrop we favour companies with exposure to Australia and the US. We tend to like high quality businesses with strong management teams and two standouts from the recent reporting season are Orora and Reliance Worldwide Corp. While both have relatively defensive earnings, we also see good growth prospects over the next few years, especially in the US where both companies have meaningful exposures. Orora remains our top pick in the Industrials sector and we believe investors can buy the stock now. We like Reliance as a long-term investment but the valuation remains a stretch for us at the moment so it's one to keep on the watchlist for any future share price weakness. Another company we favour is PWR Holdings which easily passes the quality test and will also benefit from a lower AUD.

Growth in infrastructure remains a key theme that will benefit a number of construction and engineering companies. To support a growing population and ease congestion, both Australia and the US have grand plans to upgrade or build new roads, railways, bridges, tunnels, etc. The desire to improve the infrastructure network will likely persist for some time. Stocks with exposure to this thematic include construction materials companies such as Wagners, Boral and Adelaide Brighton as well as engineers and contractors such as Cimic Group and Downer.

	Stock	Price	Price Target	PE (FY19)	Gross Dividend Yield	12m TSR
Orora	ORA	$3.32	$3.54	18.0	4.2%	11%
Reliance Worldwide	RWC	$4.14	$4.33	21.8	2.4%	7%
PWR Holdings	PWH	$2.36	$3.10	17.7	4.1%	35%
Wagners	WGN	$4.25	$4.22	22.1	0.4%	0%

Source: FactSet, IRESS. Data as at 6 March 2018

Healthcare – strap yourself in it's merger and acquisition time

The reporting season saw plenty of volatility. Stand-out performances came from the heavy weights of CSL (+18.7% over month) which benefitted from a more severe flu season in the US, Cochlear (+11.9% over month) with new products driving future growth, ResMed (+12.1% over month) with mask revenue posting solid growth across all geographies, and Ansell (+14.1% over month) with upgraded guidance as its cost-out program delivers.

Not all stocks across our coverage performed well in February, Nanosonics fell 12% after reporting lower-than-expected profit reflecting a transition to a rental base model from capital and higher R&D costs, all positive for the longer term but causing short-term pain, and hospital operator Healthscope initially fell 6% on the release of its result despite reconfirming guidance, although the share price recovered that loss as the market looked towards the end of CY18 anticipating the opening of the Northern Beaches hospital.

Company profits are important; however, the sector is seeing renewed interest in merger & acquisition activity. Already this year four take-over bids have been announced with Merck's bid for cancer company Viralytics (VLA) for cA$500m (A$1.75/share; a 160% premium to the one-month VWAP), Pacific Equity Partners' takeout of Lifehealthcare (LHC) for A$211m (A$3.75/share; a 46% premium to last close), Varian Medical's A$1.6bn (A$28/share) bid for Sirtex Medical (a 49% premium to last close), and PerkinElmer's A$25m (A$0.28/share) bid for RHS Limited.

We think this M&A activity will continue throughout 2018. So who will be next? We think those companies with approved products that have global applications. Potential companies that fit that criteria: Impedimed (IPD, muscle and tissue measurement company), Nanosonics (NAN, high level disinfection), Osprey Medical (OSP, contrast media removal company), Visioneering (VTI, disposable contact lens), and Airxpanders (AXP, breast reconstruction product).

CSL HOLD PT A$156.00	1H beats – guidance conservative or realistic?
Cochlear HOLD PT A$153.60	1H18 inline – N7 needs to ring loud and clear
ResMed ADD PT A$12.11	Strong all round
Ansell ADD PT A$26.30	1H18 mixed – looking through the noise

High Conviction Stocks

Stronger-than-expected results from the market's most important large caps, along with fewer misses, were key points of comfort from reporting season and we continue to identify compelling opportunities in companies capable of thriving despite the subdued economy.

We add BHP Billiton to the High Conviction list this month and remove Corporate Travel Management following a strong run post result.

Follow the link to our latest High Conviction Stock list published 6 March 2018.

Watch our analysts outline key reasons to buy our recently added stocks **youtube.com/c/morgans-financial-limited**

ASX 100	Ticker	Price	Price Target	FY18 Dividend Yield	FY18 Gross Yield	FY18 PE (x)	12m TSR
ResMed	RMD*	$12.27	–	–	–	–	–
Link Administration	LNK	$8.47	9.50	2.0%	2.9%	26.4	15%
BHP Billiton	BHP	$29.84	32.92	5.1%	7.3%	12.8	18%
Westpac	WBC	$30.35	36.00	6.3%	8.9%	11.9	28%
Oil Search	OSH	$7.24	10.27	2.0%	2.0%	21.3	44%
Ex-100	**Ticker**	**Price**	**Price Target**	**FY18 Dividend Yield**	**FY18 Gross Yield**	**FY18 PE (x)**	**12m TSR**
PWR	PWH	$2.37	$3.10	2.9%	4.1%	21.1	35%
Senex Energy	SXY	$0.38	$0.48	-	-	nm	26%

Source: FactSet, IRESS. Data as at 6 March 2018 * Under Review

Indicates published/linked Research Note

Recent initiations

It has been an busy few months for the Morgans research team with a number of new stocks added to our coverage – initiations listed below.

Lindsay Australia
ADD PT A$0.51
LAU is an integrated refrigerated transport, cold logistics and rural supply company, which has operated in Australia for +60 years.

People Infrastructure
ADD PT A$1.68
PPE operates in the contracted workforce and human resource outsourcing industry in Australia and New Zealand across a network of 17 locations.

Wagners
ADD PT A$4.22
WGN is a leading Australian construction materials and services provider. It is also an innovative developer and producer of new-generation building materials.

National Tyre & Wheel
ADD PT A$1.37
NTD's core business was founded 28 years ago and holds exclusive rights to import and distribute Cooper and Mickey Thompson branded passenger, SUV and light truck tyres (the higher growth vehicle segments).

Technical corner

- Apollo Tourism & Leisure (ATL) has been trading in an up trend since listing in November 2016 which remains technically intact.
- The current pull back is approaching its static and dynamic support of $1.50, where initial buying interest is likely to arise. The momentum indicators are approaching oversold territory, suggesting that the price is likely to bounce soon.
- The first potential upside price target is $1.75 followed by $1.90 in the months ahead.

Apollo Tourism & Leisure (1 year price chart)

Source: IRESS

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Caloundra	+61 7 5491 5422
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Gold Coast	+61 7 5581 5777
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Kedron	+61 7 3350 9000
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