Switzer Super Report
Advice you can trust

Thursday 28 April 2016

Big news week

A bumper issue this week filled with big news. My mate Charlie Aitken gives us his take on what to expect from the US earnings season and a raft of announcements from our local companies over the coming weeks.

Also in today's *Switzer Super Report*, Tony Featherstone looks at NAB's UK spinoff CYBG and gives us a takeover portfolio update, while James Dunn shortlists five value stocks to consider. George Boubouras joins us this week to provide a bank outlook ahead of the half-year results next week.

Sincerely,

Peter

Peter Switzer

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Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
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2 big weeks of earnings news in the US and Australia

by Charlie Aitken

In the short-term the equity market is a voting machine, in the long-term it's a weighing machine.

What does that mean? In the short-term anything can drive a share price up and down: in the long-term the true driver of share prices are earnings and dividends.

You'll find that in between reporting seasons in the USA and Australia the vast bulk of share price movements are driven by macroeconomics and sentiment. During reporting seasons the SOLE driver of share prices are delivered earnings versus expectations and outlook statements.

The good news is over the next two weeks in the USA and Australia we will see some clear earnings and outlook facts. There will be share price volatility, but it will be based on fact rather than suspicion.

The Q1 reporting season is already well underway on Wall St. But this week it really gets going and we will get a very clear picture of the overall state of US corporate earnings.

S&P 500 Earnings

This week is the biggest week of 1Q16 earnings. **36.4% of the S&P market cap** (185 companies) will be reporting earnings. On a sector basis, for six of 10 sectors this week is the biggest one this earnings season: 31% of Consumer Discretionary, 31% of Consumer Staples, 61% of Energy, 40% of Health Care, 53% of Materials, and 51% of Telecom will be reporting earnings. Additionally, 28% of Financials, 42% of Industrials, 35% of Technology, and 42% of Utilities will be releasing numbers.

Thirty eight per cent of the S&P market cap has reported earnings as of last Friday after the close. On the EPS side, the surprise ratio remains positively skewed vs history, as 76% of the S&P 500 came in above expectations and only 16% below expectations, compared to the average since 1Q04 of 66%.

Revenue surprise ratio also remains positively skewed with 58% coming in above expectations and 41% below.

Although improved, the amount by which companies in the S&P 500 beat EPS remains below the historical average (4.1% vs 5.1% avg). Sales results have beaten expectations by 10bps. For historical context, during the last eight quarters, we had seen a 60bps beat in sales on average. The S&P 500 Ex-Fins has beaten EPS by 4.6% and beaten sales expectations by 10bps.

However, it must be pointed out that "high expectation" stocks are being hit if they don't deliver on the markets high expectations. Already we have seen Netflix, Microsoft, Alphabet (Google), Twitter and Apple all fall -7% to 20% after confirming revenues worse than expected. This is interesting because "tech" has led Wall St for many, many years and some parts of tech, particularly Apple, are looking tired because they are growthless. American investors seek growth over value, never forget that. That was why Facebook is up +7% after reporting; it delivered revenue surprise to the upside.

Below is a chart of **Apple's CY16 consensus earnings estimates (red line) vs. the share price in white**. On last night's close the share price has fallen almost exactly the same percentage as the consensus downgrade.

In Australia, over the next three months, next week will be the most important week for the ASX200.

Why will May 2nd to 9th be THE most important week for the ASX 200?

1. By market capitalisation almost 50% (47%) of the ASX 200 and 10 of the top 13 market weighted stocks will provide data points – sales / earnings / trading updates / shipments / AGMs / guidance over that six day period.
2. Notably, that 47% of market cap figure EXCLUDES all companies presenting at a Macquarie's "Australia Conference" from May 4 to 6.
3. If I include the conference and avoid double counting, that 47% of market cap figure becomes almost 65%.
4. Importantly the spectrum of industry covered in those five days, excluding the conference, is very broad – banking (WBC ANZ CBA NAB & MQG); financial services (AMP IRE & GMA); wealth management (BTT); supermarket retailing (WOW); mining (BHP FMG & AWC); real estate (DXS GPT GMG MGR & SCG); media (OML NWS & REA); infrastructure (TCL); contracting / mining services (DOW); and marketing (CTX).

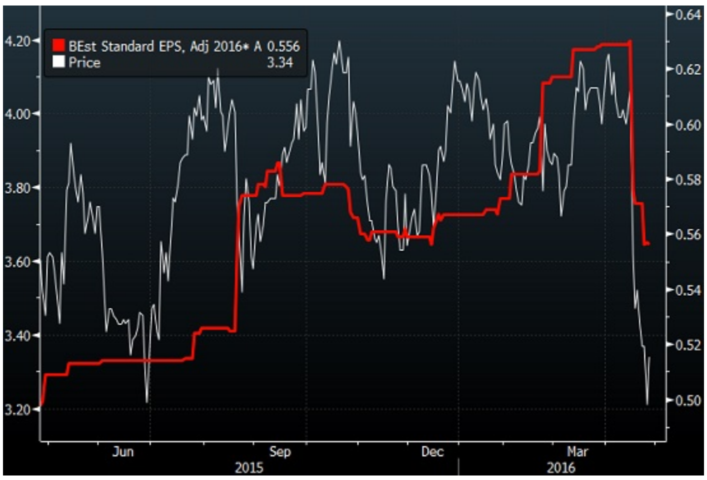
It needs to be remembered that the Macquarie conference has often been used by domestic companies to downgrade expectations. With a Federal election campaign now underway I wouldn't be surprised to see some Australian companies blame the combination of political uncertainty, the higher AUD, weak consumer confidence and unseasonably warm weather as an excuse to hose down earnings. I'd suspect discretionary retailers are a sector to be cautious on into next week, particularly clothing retailers.

Remember, we've already seen Qantas (QAN) blame the election/consumer/business confidence for a reduction in domestic capacity that has seen -20% wiped off their share price. McGrath (MEA) stated that NW Sydney sales volumes were down -30%, while Murray Goulburn (MGC) pointed to the AUD as a reason for a -34% earnings downgrade. The Australian earnings downgrade season has started and I expect it to continue next week.

That is why I am attempting to keep my Australian exposure to rock-solid non-cyclical exposure. I am very much parked in what I consider "earnings and dividend certainty" stocks even though they have underperformed a little recently as resources experience a major short-squeeze positioning rally.

Clearly, in markets like these the share price punishment for the "crime" of downgrading expectations is outsized. We are seeing way more than just the effect of the earnings downgrade wiped off share prices. In the Qantas example the consensus analyst downgrade was -7% and the share price fell 20%, meaning the P/E effectively fell 13%. The chart below demonstrates this and suggests QAN is currently oversold.

QAN FY16 consensus earnings estimates (red line) vs. share price.



While all this earnings news and trading updates are coming out globally and locally we also have news from central banks. The Fed said nothing new last night and bond yields fell to reflect the view the Fed is on hold until later this year. The Bank of Japan comments this afternoon but expectations of news are low there.

What has been most interesting is the Australian economists response to the much weaker than expected Q1 CPI print here yesterday that saw the AUD/USD fall -2% to 76.00usc.

That clearly was a surprise to everyone. You don't see the AUD move like that unless there is a genuine surprise, and that weak CPI number was a genuine negative surprise. When followed in the afternoon by Westpac confirming they won't lend to foreign-based property investors, it is understandable why interest rate cut expectations increased sharply in the interest rate futures market.

They are now many forecasters calling for Australian cash rates to drop to 1.50%. I'm not so certain about that but put it this way, the risk of them rising in the short to medium-term is 0% and the risk of them being cut is now around 50%.

What does all this mean for an Australian SMSFs? It firstly means the search for yield will continue. The so called "yield trade" is far from dead: in fact it's more alive than ever. That is why I've been banging away in these notes about assured dividend/distribution growth stocks such as Telstra (TLS), Transurban (TCL) & Sydney Airport (SYD).

What it also means is that the AUD has most likely peaked for the short to medium term and foreign earning industrials and unhedged offshore funds will outperform. I think it's the perfect scenario to seek income in Australia and growth internationally. Those who attended the recent Switzer Investor Strategy Day seminars would be well versed in my view and portfolio positioning of *"Australia for income, international for growth".*

And finally, I hope you're all sitting down, I believe that **there's a growing chance of a relief rally in battered Australian banks.** Clearly short positions are enormous and expectations are pessimistic ahead of results and dividends starting next week. But remember this is what the resource sector looked like in January when my olde mate Peter Switzer was telling you to buy BHP at $15.00.

Personally I think the Australian bank sector is lining up for a ***"short cover the fact"*** reporting season and hopes of lower cash rates will help that scenario. Don't get me wrong, I don't think you all need to run out and buy more banks, you all own plenty, but there's a clear chance of a relief rally in Australian banks over the next few weeks.

Either way, there is a plethora of stock specific information over the next two weeks and it will give us all far greater clarity on the state of US and Australian corporate earnings.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

CYBG revitalised

by Tony Featherstone

Investors could be forgiven for avoiding Australian bank stocks even though they are reasonable value at current prices.

Politicians on both sides seem intent on having another kick at financial services – the political football that keeps on giving.

Labor's call for a Royal Commission into the banks, rife with political opportunism, has struck a chord in the electorate. And the Australian Securities and Investments Commission's war on bank culture shows a more aggressive regulatory approach.

Requirements for banks to hold greater capital and be better placed to withstand the next financial shock will further weigh on their return on equity and challenge their capacity to increase, or in the case of ANZ Banking Group (ANZ), maintain the dividend.

Oh, and let's not forget never-ending hysteria about an imminent property collapse, the coming spike in bad debts, and deterioration in bank balance sheets.

For the angst, credit growth in Australian continues to increase and business sentiment, as measured by NAB's monthly business survey, in March hit its highest level since 2008.

Two conclusions can be drawn. First, irrational pessimism has created a buying opportunity in Commonwealth Bank (CBA) and National Australia Bank (NAB). The CBA is trading slightly below fair value and NAB is a little better again.

Second, returns from Australian banks in the next three years could slow, amid a more challenging regulatory environment.

Consequently, the case to invest in overseas banks is strengthening, principally because some offshore banking markets have more favourable regulatory and growth settings.

Which brings me to CYBG Plc, the latest inclusion in the *Switzer Super Report* takeover portfolio. To recap, NAB Bank spun out CYBG through a demerger in February 2016.

NAB had been itching to offload its troubled United Kingdom banking operations, built through the acquisitions of Clydesdale Bank in 1987 and Yorkshire Bank in 1990. The UK business, a serial underperformer, weighed on NAB's return on equity.

CYBG Plc is one of the more interesting demergers on ASX in recent years. It was a classic example of a potentially strong business struggling within a larger conglomerate, and having better prospects as a standalone listed company.

CYBG has performed well since listing. Its CHESS Depositary Interests on ASX (CYBG's primary listing is in London) have rallied from $3.69 to $4.28.

I nominated CYBG as a one of six "turnaround" ideas for the *Switzer Super Report* in March when it was $3.94. As an aside, another demerger in this report's takeover portfolio, South32, has almost doubled since mid-January after a difficult first six months as a listed entity.

CYBG could appeal to a European bank that wants a foothold in the attractive UK banking sector. It has almost 3 million customers, 175 years of history, and a well-known and respected brand. It ranks in the bottom half of the top 10 banks for most of its products and is strongest in Northern Europe and Scotland.

The UK banking sector has good prospects. UK authorities are intent on fostering greater competition in the UK banking sector, which is not unlike Australia's with four banking giants dominating the market. More banks are entering the UK market, but CYBG is arguably one of few with the credibility to help lift competition.

Its exposure to about a third of the UK population, through its extensive retail branches and business centres, could be more valuable in the hands of a larger European bank with deeper pockets and the desire to win market share in the UK.

The UK economy is one of Europe's best performing and it has better medium-term prospects than many advanced economies. A strengthening UK economy, increased banking competition, and more favourable regulatory settings could see UK banks collectively produce stronger returns than Australian banks over the coming decade.

At a micro-level, CYBG has scope for improvement. Good demergers have a knack of motivating staff, as they no longer run the business in the shadow of a conglomerate. A new CEO and expanded management team at CYBG are excellent signs.

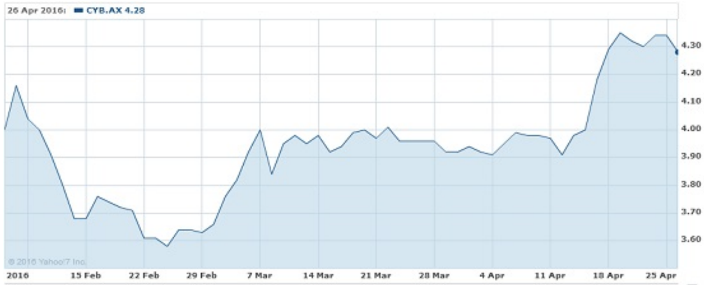
Unlike many demergers, CYBG's investment program is well underway. Parent companies have a habit of badly underinvesting in businesses that are spun out as standalone entities and, as a result, take years to fix. CYBG's large investment program began last year. It will reduce the cost gap between CYBG and its UK peers and lift its poor return on equity.

CYBG looks a solid investment with or without a takeover. It came to market cheaply, can lift performance through restructuring and investment initiatives, and has consolidation potential as competition in UK banking rises.

Demergers often underperform in the first year as a standalone company, before stronger performance. CYBG's good start in a difficult market shows the potential for another financial services company to make more of its assets than NAB did during its ownership.

Five of seven broking firms that cover CYBG have a buy recommendation, one has a hold and one has a sell. A consensus target share price of $4.59 suggests CYBG is slightly undervalued at the current price.

Chart 1: CYBG



Source: Yahoo!7 Finance. Refers to ASX listing.

Ardent Leisure's potential

Regular readers the *Switzer Super Report* know I avidly follow the boom in middle-class consumption in Asia and its effect on demand for Australian tourism and education.

Growth in Chinese inbound tourism partly explains why I have favoured stocks such as Sydney Airport and casino operator The Star Entertainment Group over the past three years. Both have excellent medium-term prospects as Chinese tourism in Australia grows, are well run, but look fully valued at the current price.

Ardent Leisure Group should be another beneficiary of inbound Asian tourism through its Gold Coast theme parks, which make up just under a fifth of its revenue. Bowling alleys, family entertainment centres and health clubs make up the rest.

Ardent has delivered an 11.8% total return (including dividends) over the past year – better than the market, but arguably too low given its exposure to Chinese tourism and rising demand for health and fitness products.

I like Ardent's restructuring decision to sell the marinas and redeploy cash to the higher-performing Main Event family entertainment centres in the United States – the largest earnings contributor. Improving performance in the fitness clubs is another good sign and there is plenty of potential to transform some bowling centres into family entertainment centres.

But investors should expect stronger performance from Ardent given the outlook for the tourism, entertainment and fitness industries. Asset sales are probably likelier than a takeover, and market pressure on the company is building.

Nevertheless, six brokers have a buy recommendation and five have a hold. A consensus price target of $2.35 suggests Ardent is a touch undervalued.

It will be worth a lot more if it lifts performance at its theme parks and fitness centres and quickens the rollout of its promising Main Event business.

If it takes too long, watch for a predator, such as a US private equity firm, to find value by carving up its assets and selling them to the highest bidders. The market has speculated on such an event, but it may take further share-price weakness for it to happen.

Chart 2: Ardent Leisure Group

Source: Yahoo!7 Finance

Portfolio update

A better performance from the takeover portfolio this month as several laggards, particularly in the resource sector, enjoyed price boosts. Standouts include Gold Road Resources, NIB Holdings and OrotonGroup. Monash IVF Group is another with improving prospects and Challenger's gain was pleasing given its potential as demand for annuity investments rises. The portfolio's 6% loss over 12 months (on a total-return basis) was in line with the S&P/ASX 200.

Takeover Targets	One-year total shareholder return (%)*
Treasury Wine Estates	74
Gold Road Resources	37
Challenger	31
Monash IVF Group	20
NIB Holdings	17
CYBG Plc	16
Ardent Leisure	12
OrotonGroup	9
Nufarm	0
OzForexGroup	-2
Automotive Holdings Group	-3
Aurizon Holdings	-7
Qube Holdings	-11
Australian Agricultural Company	-13
South32	-18
Myer Holdings	-20
Ansell	-22
iSelect	-25
Reckon	-27
Santos	-33
WorleyParsons	-40
3P Learning	-50
Ten Network Holdings	-50
AWE	-50
Average portfolio total return over 12 months %	**-6**
1-year total return S&P/ASX 200 index %	**-6**

*Source: Morningstar (one-year return), Standard and Poor's (S&P/ASX 200 total return). * assumes dividend reinvestment. Prices at April 26, 2016*

– Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at April 26, 2016.

5 value stocks to consider

by James Dunn

Just when the Australian market seemed to have put behind it the awful start to the year – which opened with a double-digit loss before investors had even settled into the new year – and seemed poised to push into clear water, along came the announcement of a federal election.

All-but-confirmed for July 2, the national election is likely – being a longer-than-usual campaign – to see spending decisions by businesses and households shelved through the election campaign. Should this happen, it would delay the long-mooted transition of the Australian economy from being mining-driven to being powered by the non-mining sectors of the economy. Low interest rates and low petrol prices were supposed to help with this transition, by encouraging consumers to spend, but the election may act as lead in the economy's saddlebags for a couple of months at least.

On the stock market, the focus on high-yield stocks that has ensued as the Reserve Bank of Australia has taken interest rates down to 2% has become a crowded trade, with many of the yield favourites pushed close to expensive, if not to record highs. Many investors are starting to look for capital-growth situations, even if they may not be fully prepared to trust the resources mini-rally. Analysts and fund managers say that the current market does not show any clear pointers to sectors that are more battered than others – meaning that the search for value is down to good old-fashioned stock-picking.

Switzer Super Report picked the brains of two of Australia's best value-sniffers, Simon Mawhinney, managing director and chief investment officer at renowned "deep-value, contrarian" house Allan Gray, and Geoff Wilson, chairman and portfolio manager at listed investment company (LIC) stable Wilson Asset Management, to find out where they perceive value in the current market.

Austal (ASB, $1.57)

Market capitalisation: $548 million
Forecast FY16 EPS growth –17.5%, PE 12.9, Yield 3.2% fully franked
Forecast FY17 EPS growth 9.8%, PE 11.8, Yield 3.5% fully franked
Consensus target price $1.99, +26%
(Estimates collated by FN Arena)

Perth-based shipbuilder is one of Australia's manufacturing success stories, holding more than $US5 billion worth of contracts to build advanced aluminium warships for the US Navy. Austal operates shipyards at Henderson in Perth, in the USA (at Mobile, Alabama) and in the Philippines (Cebu). The major contracts for the US Navy are the $US3.5 billion Littoral Combat Ship (LCS) program, and the US$1.6 billion Expeditionary Fast Transport (EPF) program.

Austal has already delivered three Independence-variant LCS to the USN, two as subcontractor (LCS 2 and LCS 4) and one as prime contractor (LCS 6) under its separate ten-vessel contract. The company has seven LCS under construction at Mobile, with USS Montgomery (LCS 8) scheduled for delivery later in the year, and earlier this month won additional procurement and engineering work on the program. Six of the EPF vessels have already been delivered, with a further two being built at Mobile and the seventh ship, USNS Carson City, preparing for trials and scheduled to be delivered later this year.

Earlier this month Austal was awarded preferred tenderer status by the Australian government for the Pacific Patrol Boats Replacement (PPBR) Project, a potential $900 million contract under which Austal will build up to 21 steel-hulled patrol vessels for Australia and several Pacific Island countries, and maintain the ships at its service centre in Cairns.

The Henderson yard is also building eight Cape Class Patrol Boats for the Australian Customs and Border Protection Service, as well as two 72-metre High Speed Support Vessels (HSSVs) for the Royal Navy of Oman. Both the Omani vessels are expected to be delivered in 2016.

Simon Mawhinney describes Austal as “very cheap,” with the recent contract developments giving investors “even more confidence that the company’s earnings are sustainable.”

Source: Yahoo!7 Finance

Alumina (AWC, $1.44)

Market capitalisation: $4.2 billion
Forecast FY16 EPS growth 58%, PE 22.9, Yield 4.7% fully franked (at current A$/US$ exchange rate)
Forecast FY17 EPS growth 26.5%, PE 18.0, Yield 5.2% fully franked (at current A$/US$ exchange rate)
Consensus target price $1.38, –4.4%

Alumina is a 40% partner with Alcoa in Alcoa World Alumina and Chemicals (AWAC), the world’s largest alumina producer. The business mines bauxite, extracts alumina (aluminium oxide) and smelts aluminium metal. It has about 25% of the global alumina market. While aluminium, like all commodities, is a cyclical business, Alumina Limited is set to benefit from a series of contract wins that AWAC has signed over the last year, on the back of strong aerospace and automotive demand – the major new contracts were with Boeing, Airbus and Ford.

These contracts help to boost the outlook for Alumina, after the 2015 result (the company uses the calendar year as the financial year) was its best since 2008: net profit came in at $US88 million ($122 million), compared with a net loss of $US98 million in 2014. Despite a fall in the alumina price in the first quarter of 2016, Alumina is expected to show strong earnings growth this year and next.

Analyst consensus does not think much of Alumina’s capital growth prospects, but Mawhinney does not share that view: he says Allan Gray has “invested heavily” in the stock. He says Alumina’s operations are “at the very low end of the cost curve,” and the company has no debt. “We think Alumina is outstanding value,” he says.

Source: Yahoo!7 Finance

Peet & Co. Limited (PPC, 95 cents)

Market capitalisation: $465 million
Forecast FY16 EPS growth 10%, PE 11.2, Yield 4.7% fully franked
Forecast FY17 EPS growth 5.9%, PE 10.6, Yield 5.3% fully franked
Consensus target price $1.35, +41.6%
(Estimates collated by FN Arena)

Western Australia-based residential property developer Peet & Co. has projects in every mainland state and territory, but is “priced as if it is 100% exposed to WA,” says Mawhinney. Peet owns land and develops high-quality residential projects, often on behalf of syndicate, joint venture or co-investment partners. Peet expects to have more than 80% of its land bank in various stages of development by the end of FY17. The focus on land – as opposed to houses and apartments – is also poorly understood by the market, says Mawhinney. Nearly two-thirds of new projects are on the east coast, and the company has no exposure to the Sydney apartment market. Earnings growth expectations for Peet have come down, as has the target price, but on consensus, analysts expect Peet & Co. to reach $1.35, which would represent a significant gain from the current share price.

Source: Yahoo!7 Finance

Southern Cross Electrical Engineering Limited (SXE, 49 cents)

Market capitalisation: $77 million
Forecast FY16 EPS growth 224%, PE 20.2, Yield 5.6% fully franked
Consensus target price 38 cents, –22.4%
(Estimates collated by Thomson Reuters)

Perth-based Southern Cross Electrical Engineering is a specialist provider of electrical and instrumentation (E&I) services to the resources sector, in construction and over the life of a project. Southern Cross operates through three divisions: Construction, which installs and commissions power projects; Infrastructure, which provides the power infrastructure at a resources site; and Service, which offers maintenance services.

Analyst consensus sees Southern Cross Electrical Engineering shares falling from here, but Geoff Wilson argues that the analysts' view is wrong. Wilson says investors looking at the recent rally in commodities prices who are looking for a safer way of participating will be drawn to those service providers to the sector that have (a) a strong business and (b) little or no debt. Wilson says Southern Cross Electrical Engineering has $55 million in cash on the balance sheet (compared to a market capitalisation of $77 million) and has announced several new contracts so far this year. "We think SXE will earn $5 million in EBIT (earnings before interest and tax) this year, and on our analysis, it looks fundamentally cheap," he says.

Source: Yahoo!7 Finance

Macmahon Holdings (MAH, 10.5 cents)

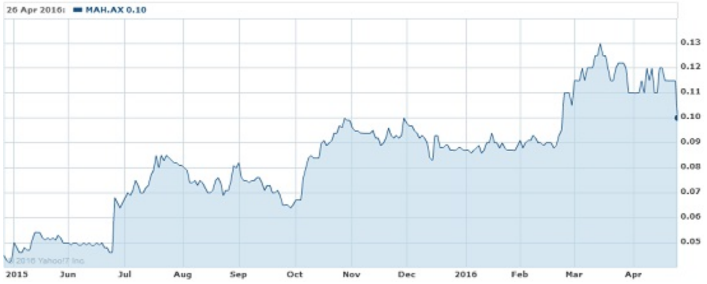
Market capitalisation: $131 million
Forecast FY16 EPS 0.9 cents, versus loss of 1.48 cents FY15
No dividend forecast
Consensus target price 11.3 cents, +7.6%
(Estimates collated by Thomson Reuters)

Mining contractor Macmahon has been hard-hit by the resources downturn, but Wilson believes the company has worked hard to re-establish itself as a good value proposition in a beaten-down sector.

Last financial year, several of Macmahon's major contracts concluded and others were terminated early, resulting in a significant hit to revenue and a net loss of $218 million. But Macmahon used cash from the $US65 million sale of its Mongolian coal operations to pay off its bank debt and it has net cash of $66.7 million on the balance sheet, and undrawn banking facilities available. The company also more than halved its workforce.

The company says the poor market conditions are making mine owners look for further cost reductions, resulting in opportunities for mining contractors. Given its strengthened financial position, Macmahon is able to look for these opportunities, and has won three new contracts so far this financial year, taking the order book to $1.5 billion. It is one of only a few contractors with complete surface and underground mining capabilities. In the first half of the financial year, Macmahon generated $11.7 million from operations despite the tough conditions. On the negative side, Macmahon concedes that its Nigerian operations are under-performing.

Wilson says Macmahon is in a similar position as Southern Cross Electrical Engineering: “it has no debt, it’s making money at a depressed point in the cycle, and it’s fundamentally cheap,” he says.



Source: Yahoo!7 Finance

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Evolution Mining (EVN) Upgrade to Buy from Hold by Deutsche Bank B/H/S: 3/2/0

Cowal has driven March quarter output and FY16 production guidance has been upgraded. Deutsche Bank also notes a significant reserve upgrade for Cowal and Mt Carlton.

The company now has an operating platform to produce over 800,000 ozs per annum to 2020, the broker maintains.

With sector leading cash flow, the stock is one of Deutsche Bank's preferred gold exposures and the rating is therefore upgraded.

See also EVN downgrade.

Oil Search (OSH) Upgrade to Neutral from Sell by Citi B/H/S: 4/3/1

Citi is busy updating its commodity prices forecasts, revealing its global expert team remains on the bullish side for crude oil. Citi's forecasts are for crude to gradually recover to US$52/bbl by 4Q 2016, and further to US$60/bbl in 2017.

For Oil Search the update has led to an upgrade to Neutral from Sell.

Perseus Mining (PRU) Upgrade to Neutral from Sell by Citi and Upgrade to Outperform from Underperform by Macquarie B/H/S: 2/2/0

Citi analysts have updated by including the new life-of-mine plan (LOMP) for Edikan, plus assets acquired via the merger with Amara Mining. As a direct result, the recommendation moves to Neutral from Sell.

In the broker's view, Amara's assets are worth $0.30 and Perseus' original assets $0.40, with Net Asset Value (NAV) now amounting to $0.77/sh after net cash and corporate. Price target increases to 54c.

The company has released a revised life-of-mine plan for Edikan. This offers some improvements on the prior plan, Macquarie observes. Of most importance, it should allow sufficient cash flow for the company to consider going ahead with Yaoure.

The broker considers the merger with Amara and the new Edikan plan position the company to achieve its long-held ambition to develop a second mine.

Yaoure should double production in FY21, Macquarie suggests.

In the not-so-good books

Challenger (CGF) Downgrade to Neutral from Buy by Citi B/H/S: 4/3/0

Challenger's March quarter update contained several disappointments, including lacklustre retail annuity book growth, but Citi analysts are zooming in on the positives, and there were plenty to draw more confidence from (which they did).

A reduction in previous "volatility discount" sees the price target jump to $9.30 from $8.50 but this cannot prevent the broker being forced to downgrade this stock to Neutral from Buy. It's a valuation call.

CSR Limited (CSR) Downgrade to Hold from Accumulate by Ord Minnett B/H/S: 3/3/1

The share price has run higher in recent months and

Ord Minnett now considers the stock fully priced and downgrades to Hold from Accumulate.

The broker attributes the strong performance to east coast residential construction and a near-term bottom in aluminum prices. Although construction momentum is expected to stay positive the broker is less optimistic about aluminum.

Evolution Mining (EVN) Downgrade to Neutral from Outperform by Credit Suisse B/H/S: 3/2/0

Credit Suisse notes Cowal was the key contributor to the March quarter performance while Mt Carlton's grade-driven performance was also a highlight.

Other segments of the portfolio were mixed with the broker observing Edna May and Mt Rawdon were weak and high cost, affected by weather.

See also EVN upgrade.

GPT (GPT) Downgrade to Underperform from Neutral by Credit Suisse B/H/S 1/4/1

GPT is popular with investors as a high quality, defensive real estate investment trust (REIT), but Credit Suisse notes GPT's returns have meaningfully underperformed of late across all of retail, office and industrial. The broker believes super-regional malls are best placed to outperform at this stage in the cycle.

Credit Suisse thus sees Scentre Group (SCG) as a better placed REIT at present and has downgraded GPT to Underperform on valuation.

GWA Group (GWA) Downgrade to Hold from Buy by Deutsche Bank and Downgrade to Sell from Neutral by Citi B/H/S: 0/5/1

The company's guidance for second half earnings to be higher than the first half is unchanged. Management has announced an efficiency program, targeting $13-15m in cost savings between FY16-19.

Deutsche Bank downgrades to Hold from Buy on valuation. The broker expects housing to remain robust in FY17.

As the company presented its new strategic direction, aiming for a corporate transition that should see GWA turning from being a manufacturer to managing brands that deliver product solutions for its clients, Citi analysts remain supportive, but also sceptical about execution and time needed to deliver a positive outcome.

For these reasons the recommendation has been pulled back to Sell from Neutral.

OZ MINERALS LIMITED (OZL) Downgrade to Underperform from Neutral by Credit Suisse B/H/S: 1/4/3

March quarter production suggests the company is on track for full year guidance yet Credit Suisse notes record December quarter throughput was not maintained, constrained by a scheduled re-line and underground ore contamination.

Mining costs are expected to rise on the adverse fixed cost element of the Thiess contract, despite favourable oil and productivity gains.

A lack of action on M&A, despite a widespread search, has positioned the smaller scale Carrapateena as the main option, in the broker's observation.

Credit Suisse downgrades to Underperform from Neutral.

Rio Tinto (RIO) Downgrade to Sell from Neutral by Citi and Downgrade to Hold from Add by Morgans B/H/S: 3/4/1

Citi analysts updated their prices forecasts for commodities and for the first time in a long while new forecasts went up, not down.

But it's not universal good news as the analysts remain bears on nickel, while retaining a sceptical view on bulk commodities once the strong steel restart/restocking in China has run its course.

In Citi's view, the iron ore crunch that was meant to happen in 2016 may just be pushed out to 2017.

The broker downgrades Rio Tinto to Sell from

Neutral.

The stock has risen on the surge in iron ore prices, beyond Morgans' target. The broker downgrades to Hold from Add. The broker maintains a positive view of the business, noting potential upside to earnings if the current strength lingers.

The broker's valuation has been revised following changes to production assumptions and the iron ore price rise.

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Banks face tougher outlook

by George Boubouras

Next week Westpac (WBC), National Australia Bank (NAB) and ANZ (ANZ) will announce their half-year results.

While Australian banks have benefited from a record breaking run of uninterrupted economic growth and a booming housing market, there is increasing evidence that this golden run is over. The sector certainly faces some serious challenges over the next 12 months.

For the past 35 years, banks – and other interest rate sensitive sectors of the economy – benefited from a structural decline in interest rates.

At its peak, the yield on the Aussie 10 year bond reached 16% in 1982, driven by the second OPEC oil crisis and rampant inflation.

But after central banks regained control of inflation, interest rates slowly began to decline. This trend decline, coupled with key financial market deregulation and low and stable inflation, spurred a structural leveraging-up of the Australian economy.

The banks benefited tremendously from this leveraging cycle. Despite a brief pause during the early 90s recession and GFC, credit growth has easily outpaced growth in GDP, leading to a significant increase in the economy's debt to GDP ratio.

This boom in credit helped the banks make record profits and dividends. Long term shareholders are pleased.

But there is reason to believe this structural decline in global interest rates is coming to an end. Linked to the interest rate cycle is the bad and doubtful debt cycle. When interest rates decline, debt servicing costs fall, asset prices rise and the economy generally expands which makes servicing debt easy.

We are currently in this phase of the cycle as evidenced by NAB reporting its lowest bad and doubtful debt charge since at least 1980.

Although this is great news for shareholders, the obvious question is where to from here?

My view is that the banks current bad and doubtful debt charge is unsustainably low. As the Aussie housing cycle matures, as the global interest rate cycle begins to normalise and as the fallout from the mining boom spreads through WA and Qld, bad debts will inevitably rise.

Also the Australian bank demerger cycle is well underway following decades of buying out their competitors. Non-core banking operations or capital intensive ones will continue to be sold in the years ahead, such as insurance, leasing, funds and wealth management operations.

Just to be clear, I am not foreshadowing a recession-like bad and doubtful debt cycle or a sharp correction in the banks. I believe the banks are high quality institutions by global standards that have been well regulated and have prudent mortgage books.

Rather, I expect a period of sub-par earnings growth where the majority of the sector's return will come from dividends rather than capital appreciation.

Given this outlook, we still have a slight overweight to the banking sector, particularly after the capital raisings in the second half of 2015.

Our preference in the following order is:

1. Westpac
2. Commonwealth Bank of Australia
3. National Australia Bank
4. ANZ Bank

We also like the regionals including Bendigo Bank and Bank of Queensland.

We will certainly be watching next week with interest.

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Qantas and infrastructure spending

by Questions of the Week

Question: Do you have any updates on Qantas in light of the recent market activity?

Answer (Peter Switzer): You have to remember that Qantas has had a terrific run, so when a piece of news hits, although not terribly material, profit taking occurs. I think the sell-off was way overdone, however, it comes after a very strong rise.

The analysts remain positive – according to FN Arena, a target price of $4.79 and a very positive sentiment rating of +0.9.

Question: With the recent speculation that the upcoming budget will provide funding for infrastructure, what companies should benefit?

Answer (Paul Rickard): I guess it depends a little on the quantum and type of infrastructure spending, the timeframe (how soon), and whether the news is already priced in.

I can think of three types of companies that could potentially benefit:

a) the listed infrastructure operators such as Transurban, Sydney Airports, APA Group etc;

b) the construction companies, such as CIMC, Lend Lease, possibly Downer EDI; and

c) the materials providers (cement, concrete etc)– such as Adelaide Brighton, Boral etc.

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