The "Beam us up, Scotty, Budget"

Scott Morrison presented the Budget this week, and I called it a "Beam me up, Scotty, Budget". You can read my thoughts here. Charlie Aitken also shares his views on the Budget today, including the new bank tax, and why he’s going long on Henderson Group.

Also in the Switzer Super Report, Tony Featherstone details five ways investors can regain market confidence if their portfolio has taken a hit.

Sincerely,

Peter Switzer

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I didn’t think I’d actually see the day a Federal Liberal Government introduced an extra tax on the banks, but here we are. At the top of the commodity cycle, Canberra introduced a mining tax, and at the top of the housing cycle Canberra introduced a new bank tax, which really is a banks super profit tax. It also appears there was absolutely no consultation with the major banks.

And just look how offshore investors reacted to unexpected regulatory change: exactly as they did with the mining tax. They dumped the sector.

On Tuesday, the big four Australian banks lost a combined market cap of $14.1b. This was solely driven by a leaked news story that the new bank levy would generate $6b of revenue over four years.

Scott Morrison needs to understand that with this single pen stroke he has driven bank profits down (-5% according to analysts), bank dividends down, and share prices down. He has INCREASED the cost of bank capital and will INCREASE the cost of mortgages, as banks will end up passing on this new tax. This decision will lead to LOWER Australian GDP growth and a LOWER ASX200 than would otherwise have occurred. The ripple effects will be widespread.

The clear problem is not bank profits. They are a good thing. The clear problem is Australia and Australians living beyond their means. The government and households are simply spending more than they are earning, and financing the difference from an ever-increasing pile of government and mortgage debt.

The Australian government is now “reclassifying” debt between good and bad debt. That only happens when you have TOO MUCH DEBT. The Australian government raised the “debt ceiling”. That only happens when you have TOO MUCH DEBT.

Similarly, a record number of Australians are paying interest only loans. This generally happens when you have TOO MUCH DEBT.

We are all borrowing from the future and that means growth will be lower for longer than anyone believes and the Federal Budget will remain in deficit for decades. Is it then any surprise that Australian retail sales have been NEGATIVE for three straight months? People aren’t spending because they have so much mortgage debt, rising living costs and flat wages. You can see hedge funds are already shorting Australian retailers because they can see what is happening. This isn’t all about Amazon arriving in Australia.
I basically think we reached the point of maximum gearing in Australia, at the government and household level. If I am right, you will start seeing a savings culture emerge, which appears to be starting in the household sector. Australians will service their mortgage debt pile and have not much else to discretionaryly spend. This probably means you should buy the dip in Australian banks, but be very careful in discretionary retailers, supermarkets, property developers, retail landlords and anything consumer facing.

This will mean it will become harder and harder to find earnings growth from domestic exposed Australian companies. In fact, if the Australian dollar continues to fall, the best earnings growth in the ASX will come from industrial companies with a very high percentage of offshore earnings.

I should thank Scott Morrison for driving my fund’s performance in stocks like Treasury Wine Estates (TWE), Aristocrat (ALL), IPH, Henderson Group (HGG), EML Payments and CYBG (CYB) to name a few. I should also thank him for making investors aware of the risk of owning too much Australian exposure in a period where Australia simply has too much government and household debt, as it drives the outperformance of Australian-based Global funds.

But as an Australian and a capitalist, I genuinely hate decisions that do damage to Australia’s international reputation. Australia and Australians are genuinely WORSE OFF from what is the most short-sighted revenue grab since the mining tax at the top of the mining cycle. It’s simply poor populist policy.

However, it is what it is and we, as investors, need to deal with consequences. They are material consequences as you’ve seen this week in bank share prices, retailer share prices etc.

What I think this ensures is a period of underperformance from Australian banks and the ASX200. The bank tax has also come during the seasonally weak period for commodity prices and commodity equities. In previous weeks, there had been rotation from resources to banks, but that all ended with the bank tax and now both sectors are underperforming.

I encourage investors to look for large cap offshore earners, which will continue to outperform as global GDP and global earnings growth accelerates.

One I like is Henderson (HGG), which is in the process of merging with another large fund manager in US based Janus (JNS).

This looks to me a stock that should be $5.00 in 12 months’ time, as investors warm to the mathematics of the merger. I think it’s a cheap stock versus its growth prospects and will be a great way for domestic investors to effectively buy exposure to the Eurozone and US equity markets.

HGG is cheap, has solid growth ahead, an excellent balance sheet, excellent management, rising ROE, consensus earnings upgrades and growing dividend yield. It has every attribute I seek in a medium-term investment.

UBS this week upgraded HGG to “buy” with a $5.00 price objective. Below I quote directly from the UBS report because I think it’s a very good summary of the HGG investment case.

Four reasons UBS like HGG

1. Stock is too cheap
   - 13x 1-year f P/E (pro-forma) and forecast to deliver 9% three-year EPS CAGR with upside via better cost/revenue synergies.
   - That’s an 11% discount to US peers…7% discount to UK peers…and a whopping 23% discount to Australian peers.
   - JNS has traded at an average P/E of 14.8x over the past three years…that’s despite its terrible FUM flow and fee performance.
   - I don’t think anyone will disagree that HGG has been a better run biz + deserves a higher multiple than JNS…similarly I don’t think anyone will disagree that a combined JNS/HGG (JHG) has greater prospects than a standalone JNS…on that basis, it seems logical to assume that JHG should trade at >14.8x P/E over time with upside to the 16-21x P/E multiples afforded to the Australian fund managers.
2. **FUM flows should normalize (market is pricing in negative flows forever)**

- JNS has had a particularly difficult time with FUM flows in recent years (-1.9% p.a. over past three years)...HGG has performed much better but struggled over the past few quarters due to a bout of softer performance + Brexit impacts.
- The merger will significantly enhance both HGG and JNS' distribution capabilities...HGG has historically struggled in the US/Japan, while JNS has never had much traction in EMEA, LatAm or Australia...We also think the market is underestimating the Dai-Ichi relationship...Dai-Ichi was a significant help in growing JNS' Japanese biz (HGG hardly has one) + have committed to taking their post-merger stake in JHG to 15% (from 9%)...that could also absorb a chunk of the UK passive selling.
- On top of that, while recent performance for HGG/JNS funds has been softer, three-year metrics remain solid...73% of HGG's AUM has outperformed benchmarks over the past three years...while 83% of JNS' complex-wide mutual fund AUM sits in the first or second quartile.
- HGG's monthly retail flow momentum is already improving with £800m insto mandates already funded in 2Q + improved investment performance across both HGG and JNS.
- The market is pricing too pessimistic an outcome for group FUM flows...current share prices imply -0.5% FUM flows p.a. going forward...we think JHG should see flows lift to +1.5% p.a. by FY20.

3. **Performance fees should normalize**

- Risk skewed to the upside, with HGG performance fees near historic lows...while JNS' fulcrum performance fees are approaching negative limits (JNS earn negative performance fees during periods of underperformance though these are capped at -$61m p.a. vs. annualising at -$53m p.a. currently).
- FY16 saw HGG performance fees fall to 13.5bps (vs. historic avg 25bps).
- We assume a recovery in performance fees for both JNS and HGG...but still assume negative fees for JNS going forward.

4. **US$110m cost out targets are realistic...and potentially conservative**

- Targeting US$110m cost synergies = 9.3% of combined cost base...that's in-line with cost-out achieved from other large global asset management deals (we've looked at the 10 largest).
- Post-synergies, JHG cost:income will sit at ~64%...that's still 310bps above similar sized peers = realistic + offers upside if they can do more.

**Story in pictures**

1. HGG and JNS FUM flows have been impacted by softer performance + Brexit related sentiment issues + structural headwinds.

2. But we see this improving, thanks to enhanced distribution capabilities post-merger + still strong three-year performance metrics.

3. Performance fees are tracking at historic lows...we see this improving going forward.
4. US$110m synergy target appears realistic in the context of other mega-mergers.

5. Most importantly, the stock is cheap! Chance to buy a world-class fund manager at a significant discount to peers.

And finally after a big period of underperformance, HGG is breaking long-term downtrends technically. HGG has broken up through its 50,100 and 200 day moving averages.

HGG is a cheap stock with plenty of medium-term upside to be released. There will be index change later this month, as HHG leaves the UK and re-lists on the NYSE, but I think any short-term pullback driven by one-off index changes is a buying opportunity. It may well be your last buying opportunity at discounted prices.

All in all, I am hugely disappointed by the Federal Budget. I think it ensures the ASX200 underperforms the world due to the attack on our major banks, but on the other hand, I think it ensures the further outperformance of global earning stocks and global investment strategies.

I encourage you to consider an investment in HGG, which should continue to be re-rated in the months ahead.

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A young family member asked me about investing. He wanted to buy junior mining stocks after his friend made $10,000 in quick profits.

"My friend has a fool-proof investment system," he said. I replied: "Don’t do it. You’ll blow your savings and set yourself back financially for years. Put your money in a low-cost managed fund, educate yourself on shares and follow the market.”

Of course, he did not heed my advice. Does any 20-year-old take conservative, sensible advice on money matters from someone more than twice his age? He invested $8,000 in a mining stock and within a year lost most of his capital.

That $8,000 was saved through a series of part-time jobs and weekend sacrifices. The funds could have bought a cheap used car and his first overseas holiday. Or better still, been the start of a sharemarket portfolio.

My young relative has sworn off the sharemarket. His confidence is busted. It will take years before he regains enough confidence to buy shares, if ever.

A twenty-year-old punting on junior mining stocks seems an extreme example of sharemarket confidence gained and lost. But even seasoned investors lose their confidence when well-researched stock purchases turn sour and destroy capital.

Resilience is an under-appreciated skill. Great investors have it in spades. They recover from setbacks and live to fight another day. They know the two most important words in investing are Capital Preservation.

Regaining confidence, after the market mauls your portfolio and comes back for a second helping, is never easy. But the ability to buy stocks when others lose their confidence and panic can supercharge portfolio returns.

Here are five ways for small investors to regain their sharemarket confidence:

1. **Have realistic expectations**

   Confidence is all relative. Some investors give up the market after their first loss, not realising that even professional investors struggle to beat the index.

   Almost 70% of Australian general equity funds underperformed the S&P/ASX 200 index over five years to the end of 2016, Standard & Poor’s found.

   Put another way, seven in 10 funds, each run by professionals who invest in the sharemarket as their day job, could not do better than ASX 200 over long periods.

   A friend, a successful Melbourne stockbroker, says his goal each year is to pick one unknown small-cap star. Yes, just one. He manages it about two in every five years, but the gains from a stock that increases five or tenfold more than outweigh average returns and small losses in others part of his portfolio.

   Have realistic return expectations. Australian shares returned 5.5% annually (before fees) over 10 years to the end of 2015, found the 2016 ASX/Russell Investments Long-Term Investing Report. That’s lower than normal because of a weak 2015, but single-digit returns have been, on average, the norm since the 2009-08 Global Financial Crisis.

   These stats are not meant to deter you from share investing. Rather, they provide some context for expected returns. You’re doing well if your portfolio
consistently returns more than 10% each year, after fees — and if your stock winners outnumber loses each year by a decent margin.

Think about that next time your confidence is shattered and you give up. Every investor has losing stocks. It’s how you limit losses and recover that matters.

2. Invest in education

It sounds cliched or trite to suggest that “education is the best investment” and a cure-all for struggling investors who lose their confidence. There’s no magic formula in the sharemarket or “how-to” guide that delivers dazzling returns.

I’m always surprised when investors put thousands of dollars into a stock with barely any research into the company or sharemarket generally. Like my young family member, they are easy prey for savvy investors who take their money.

If your sharemarket confidence has evaporated, use the next six months to learn about investing. Buy a good, readable local investment book, such as Roger Montgomery’s Value.Able or Michael Kemp’s UnCommon Sense. Or classics by US investing gurus Peter Lynch, Jeremy Siegel and others.

Enrol in the ASX Public Sharemarket Game. This free, online simulated trading game allows you to buy and sell shares, without money. It’s a great way to test your investment or trading strategy and get some confidence back.

Beware buying expensive courses or software when your investing confidence is low. Some financial products prey on disheartened investors who seek a quick fix to recoup their losses.

3. Learn money-management techniques

In the earlier example, my family member punted his entire portfolio on a single stock. He should have invested in a low-cost active fund or exchange-traded fund that provided diversification.

He had no idea of the stock’s valuation and no stop-loss rule (a pre-determined price point to sell the stock, to limit losses). As so often happens, he rode the stock all the way to the bottom, hoping it would recover.

Limiting your losses is central to successful sharemarket investing. Ever noticed how many fund managers dump a stock as soon as it downgrades its earning guidance? They take a small loss early, to limit larger losses later.

My relative could have invested $2,000 across four stocks (forget about transaction costs, for now). He could have had a 20% stop-loss on each trade. For example, a 10-cent stock is sold if it hits 8 cents, and the stop-loss is lifted as the stock rallies, to protect profits.

Using this basic technique, he would have limited the loss on the bad mining investment to $400 (plus transaction costs), instead of the $8,000.

Some simple rules on portfolio diversification, position sizing (how much you allocate to each stock) and knowing when to sell go a long way to preserving capital. Your investing confidence will stay intact if you limit losses when things go wrong and preserve capital.

4. Consider a funds approach

Too many first-time investors dive straight into stocks and forget about managed funds. In doing so, they risk poor portfolio diversification and take on too much risk.

Choosing an actively managed fund with a sound, long-term record and investment style is a good idea at any time, and especially when your confidence is down. You focus on picking the right manager, not the stocks its portfolio holds.

Listed investment companies, a form of listed funds on ASX, are a good option for new investors with limited funds to invest.

Plenty can go wrong with manager selection: yesterday’s star can be tomorrow’s underperformer. But it’s easier to pick a high-quality manager than to spot an exceptional company trading below its
intrinsic or fair value.

It’s also rewarding earning 10% or more from a fund that holds dozens of stocks (thus reducing risk) and where the manager does the hard work.

Focus on choosing the right active and/or passive funds for the core of your portfolio and you’ll soon develop the confidence to buy stocks directly as portfolio satellites.

Having most of your portfolio held through funds allows you to focus on fewer direct stocks where you have a strong view on their prospects.

5. Stick to the best companies

Focus on high-quality companies when your investing confidence is down. Do not chase mid-, small- or microcap stocks, unless there are compelling reasons.

As I outlined previously for The Switzer Super Report, exceptional companies tend to have a high and rising return on equity (ROE), low or no debt, strong surplus cash flow to fund growth internally, and a clear, sustainable competitive advantage.

Better still, look for exceptional companies with reliable, fully franked dividends. Their yield will eventually attract investors if the share price falls too far and investors are confident the dividend will be maintained.

Most of all, think like a company owner, not an asset trader or speculator. Focus on buying strong companies when they trade below their true value, often during market corrections or pullbacks that affect most stocks.

A few good wins from exceptional companies will soon boost your confidence. Your portfolio will benefit from higher returns at lower risk, your wealth will grow and you’ll develop greater clarity on investment decisions.

Remember, confidence works both ways. It’s a killer when you blow your hard-earned savings on a stock. And an investment weapon when you have the confidence to buy great funds or stocks when everyone else is nervous.

Tony Featherstone is a former managing editor of BRW and Shares magazines. The information in this article should not be considered personal advice. All prices and analysis at May 10, 2017.

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Professional’s Pick – Helloworld
by Ben Griffiths

What is the stock?
Helloworld Limited (HLO)

How long have you held the stock?
A very recent addition to our new Emerging Companies Portfolio, so the position is about two months old.

What do you like about it?
Helloworld is an integrated travel services company that participates in several key components of the travel industry. They are a travel retailer (Helloworld – formerly known as Harvey World Travel), wholesaler of domestic/international/inbound tour travel products and provider of corporate travel services.

The company had been in serious tumult for several years. Its management and its ownership have undergone significant change as a result and this had the potential to damage the business model and culture irreparably. Install seasoned management, an ethos of operational excellence/fiscal discipline and a favourable travel environment and you have the formula for a great turnaround story.

We like the continuing exposure to inbound tourism strength (especially growth in Chinese and Indian markets), the prospect of material growth in revenue margins, opportunities to increase the cross-sell of wholesale services into the company’s retail channel and the chance to meaningfully grow their share of local corporate travel spend. All areas seemingly passed over by previous management.

How is it better than its competitors?
It is not necessarily better, rather it is a different service offering, starting from a long way back versus incumbent competitors. Its retail channel endured a name change and online competitive challenges from within the group, somewhat disenfranchising its customer base whilst Flight Centre thrived with a well run, disciplined and identifiable offering. Helloworld is now better placed as a retail offering and able to access internal wholesale product more effectively and profitably than ever before. In corporate travel, the company is now demonstrating its bona fides from clients like PWC and the federal government and we expect they will slowly take share from AMEX, Carlson Wagonlit and ASX listed Corporate Travel Mgt.

What do you like about its management?
Chief Executive, Andrew Burns and his wife Cinzia (also active in the business) collectively own around 37% of the company, so they are seriously aligned with a successful turnaround of the business. To date, Burns has demonstrated an ability to effect change with a sense of urgency. Restoration of morale amongst retail franchisees was a high on the turnaround triage and we believe he has done this. His travel experience has made for a redoubtable leader and his careful selection of replacement senior managers shows good judgement. His quick grasp of what needed to be done has parlayed nicely into results to date and likely in the medium-long term. He and his management team have adapted well to public company life.

What is your target price?
We don’t set target prices but it is not unrealistic to think that the company could easily be trading on 18x FY18 estimates. Assuming eps of ~ $0.29, that would equate to a $5.22 share price ($3.92 currently).
At what point would you sell it?

When we deem the stock expensive (in terms of PE ratio) versus its forecast three years eps growth profile. Emerging companies are best held for 3-5 years for optimal returns.

How much has it added (subtracted) to your overall portfolio over the last 12 months?

The stock was one of the first purchases our new fund, the Eley Griffiths Group Emerging Companies Fund, made and we are marginally in front to date.

Where do you see the value?

At 13x FY18 earnings and forecast 25% growth rate for the next three years, we see a well-priced growth counter and that excludes sizable cost and revenue synergies the company is pursuing. Investors need to remember that Helloworld is a turnaround story and the travel industry is inherently cyclical but on our risk/reward assessment Helloworld screens favourably.

Source: ASX. Data as at 10 May, 2017.

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Buy, Sell, Hold – 3 bank downgrades and 1 upgrade
by Staff Reporter

In the good books

Commonwealth Bank (CBA) Upgraded to Add from Hold by Morgans B/H/S: 1/4/3

Cash earnings for the March quarter tracked in line with Morgans second half expectations. Income was a little softer than expected and credit impairment charges a little better than expected.

The broker upgrades to Add from Hold as a result of recent share price weakness. Cash earnings forecasts are reduced by -0.7% and -0.5% for FY17 and FY18 respectively. Target is lowered to $87.50 from $88.00.

See downgrade below.

Henderson Group (HGG) Upgraded to Buy from Neutral by UBS B/H/S: 1/4/0

Post shareholder approval of Henderson’s merger with Janus, UBS has swapped analysts and the rating has been upgraded to Buy on the basis it is a transformational deal, offering cost synergies and a performance fee rebound.

Funds flow targets appear ambitious but UBS does not think the market is pricing in any growth. Target rises to 275p from 240p.

Investa Office Fund (IOF) Upgraded to Hold from Lighten by Ord Minnett B/H/S: 0/2/2

The company has revalued its portfolio, booking a $0.30 uplift to net tangible assets to $4.80 a share. The board has also endorsed the potential joint-venture acquisition of the property group platform in the absence of a formal cash offer from Cromwell (CMW).

Ord Minnett observes the revised NTA cuts through the proposed indicative cash offer price of $4.75 a share. The broker suspects the board is holding out for $5 a share, reflecting more bullish investor sentiment in recent weeks.

Ord Minnett raises its recommendation to Hold from Lighten and the target to $5.00 from $4.75.

In the not-so-good books

AGL (AGL) Downgraded to Neutral from Outperform by Macquarie B/H/S: 3/3/1

Macquarie believes the rapidly falling price of renewables is creating a new threat in the market, namely that the Renewable Energy Certificates market is likely to be structurally oversupplied from FY22.

Macquarie downgrades to Neutral from Outperform. Whilst the company is becoming light on capital needs, there are challenges such as retail pricing reviews, five-minute pricing and the potential REC price collapse, as well as some softening of spot electricity prices.

While none of these affect the near term they undermine the scope of earnings growth and the terminal value of the business, in the broker’s opinion. Target is reduced to $25.00 from $25.81.

Asaleo Care (AHY) Downgraded to Sell from Neutral by Citi B/H/S: 1/1/1

Citi has downgraded to Sell from Neutral with an unchanged price target of $1.50. The analysts do not believe investors are sufficiently appreciating the risks and challenges that lay ahead for the company.
The analysts are anticipating weak results ahead and this can potentially lead to a derating for the shares. Following a strong rally, the shares are now deemed expensive. The dividend outlook remains stable.

**Commonwealth Bank (CBA) Downgraded to Underperform from Neutral by Macquarie B/H/S: 1/4/3**

The March quarter trading result was short of Macquarie’s expectations and, similar to peers, the improving capital position and organic capital generation were the key positives. Should underlying results remain under pressure, the broker envisages risk to the bank’s ability to maintain its premium over the medium term.

Separately, Macquarie notes the Commonwealth budget has put further pressure on the bank earnings outlook and the proposed bank levy will take -4-5% off earnings. The broker has become increasingly cautious about the sector in recent months.

The main near-term upside risk is that the changes announced in the budget are watered down, while the longer-term theme underpinning the broker’s outlook remains in place.

Rating is downgraded to Underperform from Neutral. Target is reduced to $81 from $85.

See upgrade above.

**CSR (CSR) Downgraded to Sell from Neutral by Citi B/H/S: 0/4/2**

Citi downgrades to Sell from Neutral as concerns on housing combine with FY17 margin weakness, the analysts explain. Price target drops to $4.10 from $4.32.

The analysts do think there will be one more hurrah, with FY18 projected to be peak earnings year for CSR. As housing approvals fall, compression of peak FY18 earnings should follow, predict the analysts.

**Crown Resorts (CWN) Downgraded to Neutral from Buy by UBS B/H/S: 2/4/0**

Crown has outperformed the index by 21% since posting its result in Feb, which revealed cost reductions and a more simplified business structure focused on domestic assets. The Melbourne and Brisbane casinos are now passed their capex peaks, UBS notes.

Sydney capex is next, and there is debt to repay, so little likelihood of capital management. UBS warns of the prospect of weaker gaming floor trends and uncertainty with regard VIPs. With the stock now trading on a five-year high relative PE, the broker downgrades to Neutral.

Target falls to $13.19 from $13.39.

**G.U.D (GUD) Downgraded to Sell from Neutral by Citi B/H/S: 0/4/1**

Citi downgrades to Sell from Neutral as the share price has run well ahead of underlying fundamentals, say the analysts. They reiterate being positive on the prospects for the Automotive division, but clearly the market is so too.

Earnings estimates have been increased by 1-6% for the years ahead. Target price rises to $11.44 from $10.45. Citi continues to see Oates and Davey as noncore businesses and believes GUD should focus on divesting these businesses, in addition to Dexion, which remains up for sale.

**Incitec Pivot (IPL) Downgraded to Neutral from Buy by Citi and to Underperform from Neutral by Credit Suisse B/H/S: 3/3/2**

Citi analysts applaud management for delivering on its growth strategy thus far. They note the last of three key assets (WALA) is forecast to ramp up to its targeted 800ktpa operating capacity by the end of FY17.

But now what? The analysts seem to suggest a new strategy is lacking. Luckily, the fertiliser price seems to have bottomed. Increased forecasts are premised on the latter. Target price gains 9c to $4.09.

Credit Suisse is not enthusiastic about the first half result, despite the company’s upbeat outlook. The broker believes balancing growth desires with the market reality is likely to be the key to shareholder

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Thursday 11 May 2017
returns.

The earnings outlook is little changed while the explosives markets continue to be a volume story. Hence, Credit Suisse downgrades its rating to Underperform from Neutral and reduces the target to $3.37 from $3.58.

**JB Hi-Fi (JBH) Downgraded to Sell from Neutral by Citi B/H/S: 3/3/2**

Following analysis of US, UK and German retailer performance around Amazon Prime launches plus Citi’s survey of price differentials in key categories, the analysts have cut long term earnings forecasts for JB H-Fi by more than -40%.

According to Citi’s proprietary survey, Amazon is -15% cheaper than Australian retailers across three major categories. Target price falls by -35% in response, to $18.50. Downgrade to Sell from Neutral.

**Macquarie Group (MQG) Downgraded to Neutral from Buy by UBS B/H/S: 0/6/1**

The FY17 result was ahead of UBS estimates. The element that was most pleasing for the broker was the delivery on costs.

The cost-to-income ratio fell to 68.5% in the second half, continuing its downward trend from 85% in FY12. UBS envisages substantial operating leverage now, with every -5% reduction in the cost-to-income ratio providing 16% upside to earnings per share.

While the broker envisages material upside over time, the stock is up 53% over the last 12 months and ongoing evidence of cost reductions needs to be demonstrated to justify further appreciation. Rating is downgraded to Neutral from Buy. Target is raised to $91 from $89.

**Murray River Organics (MRG) Downgraded to Hold from Add by Morgans B/H/S: 0/1/0**

The company has made a material revision to FY17 earnings guidance because of adverse seasonal conditions. Underlying guidance for EBITDA is downgraded by -15-21%.

Morgans makes material downgrades to its forecasts and stresses that short-term earnings uncertainty exist, as 80% of the harvest is yet to be completed. The broker also observes gearing is now at uncomfortable levels for a highly cyclical business.

Rating is downgraded to Hold from Add. Target is reduced to $0.68 from $1.57.

**Myer (MYR) Downgraded to Underperform from Outperform by Credit Suisse B/H/S: 1/5/1**

Credit Suisse suspects the entry of TK Maxx and Amazon and, in the near term, a deteriorating discretionary spending environment are likely to be difficult for the company to overcome.

The two businesses are both selling premium branded products, with TK Maxx at significantly discounted prices. The broker notes TK Maxx is to have 35 stores in Australia after conversion of a former Trade Secret stores, providing a solid geographic footprint. Meanwhile, Amazon is likely to accelerate a shift to consumers spending online.

The broker downgrades forecasts on the expectation of slower sales growth. Rating is downgraded to Underperform from Outperform. Target is reduced to $0.82 from $1.44.

**National Australia Bank (NAB) Downgrade to Underperform from Outperform by Macquarie B/H/S: 3/1/4**

Macquarie notes the Commonwealth budget has put further pressure on the bank earnings outlook and the proposed bank levy will take -4-5% off earnings. The broker has become increasingly cautious about the sector in recent months.

The main near-term upside risk is that the changes announced in the budget are watered down, while the longer-term theme underpinning the broker’s outlook remains in place.

Earnings pressure from the announcement is expected to put the spotlight on NAB’s dividend and Macquarie envisages an increased likelihood the dividend will be cut. Rating is downgraded to Underperform from Outperform. Target is reduced to
$31.50 from $34.00.

REA Group (REA) Downgraded to Neutral from Outperform by Credit Suisse, to Neutral from Outperform by Macquarie and to Sell from Neutral by UBS B/H/S: 3/1/4

March quarter EBITDA growth of 20% was reported with Australian revenue growth accelerating to 16%. Credit Suisse observes this was a solid result, particularly given ongoing listing weakness in the period.

The broker reduces FY17 estimates for EBITDA by -2.4% because of higher forecast cost growth. Rating is downgraded to Neutral from Outperform. Target is raised to $65 from $60 to reflect higher longer-term forecasts.

March quarter EBITDA was up 20% and in line with Macquarie’s expectations. Volume headwinds still exist in Australia but have eased and the broker notes the company is starting to cycle weaker comparables.

Macquarie observes the company has had a material re-rating over the last six months on the back of stabilising volumes and strong operating performance.

As a result, while remaining very comfortable with the outlook, the broker believes this is now largely reflected in the share price. Downgrade to Neutral from Outperform. Target is raised to $65.00 from $63.50.

REA posted another strong quarterly result despite industry headwinds, with volumes, mix and new products likely the drivers, UBS suggests. The prospect is for continuing strong revenue growth ahead, but increased costs will weigh on earnings.

The broker warns of the signal provided by materially weaker building approvals numbers for March. REA is trading on an FY18 PE of 30x versus 27x for Seek (SEK) and 21x for Carsales (CAR). While UBS likes the long term growth story, near term a lower entry point would be desirable. Downgrade to Sell.

Treasury Wine Estates (TWE) Downgraded to Underperform from Neutral by Macquarie B/H/S: 2/3/2

The recent investor briefing provided a better explanation of the future growth strategy for Macquarie but risks to growth exist as a company relies increasingly on new regions and products to deliver upside.

The company has also announced changes in management, which flags a shift from restructuring to growth in the US but also indicates to the broker the company is planning for a CEO succession and clouds the future.

Macquarie downgrades to Underperform from Neutral. Target is $10.98.

Westpac (WBC) Downgraded to Neutral from Buy by UBS and to Neutral from Outperform by Macquarie B/H/S: 2/5/1

Westpac’s result was slightly ahead of UBS but subdued. As has been the case with the other banks, trading income provided a boost when revenue growth was flat. Capital was strong at 9.97% but the broker questions whether it’s wise to offer a discounted DRP when “unquestionably strong” is yet to be defined.

The main feature of the release was the revelation 50% of the bank’s mortgage book represents interest only loans. This implies a lot of work to get below APRA’s new 30% cap. UBS has thus cut its target to $32.50 from $33.50 and downgraded to Neutral.

Macquarie notes the Commonwealth budget has put further pressure on the bank earnings outlook and the proposed bank levy will take -4-5% off earnings. The broker has become increasingly cautious about the sector in recent months.

The main near-term upside risk is that the changes announced in the budget are watered down, while the longer-term theme underpinning the broker’s outlook remains in place.

Rating is downgraded to Neutral from Outperform. Target is reduced to $33.00 from $35.50.

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Questions of the Week – Woolworths (WOW) and Vocus (VOC)
by Questions of the Week

**Question:** In *Buy, Sell, Hold – what the brokers say* on 8 May 2017, Macquarie downgraded Woolworths from Neutral to Sell. What’s your view, please? I hold a large portion of my portfolio 2341 shares/21%, with a cost base price of $2.45.

Should I sell some or do the dividends make it a good hold?

**Answer (by Paul Rickard):** The market sees Woolworths as a recovery stock, but I think it has had a large part of the run up. I think it is rather expensive – trading on a forecast multiple of 25.1 times FY17 earnings, 21.8 times FY18 earnings. Forecast dividend yield of 2.7% and 3.2% for FY18.

So, I am in the “reduce” camp.

The question you may want to ask is: what are you going to replace it with?

**Question:** I would like your opinion on Vocus Communications (VOC). I was a long-time shareholder of M2 Communications, which recently merged with Vocus. I watched the share price get hammered and I’m not sure if it’s a structural issue with the company (massive debt and reduced margins), or whether it’s short-term indigestion from the mergers. I hate to sell companies that have had a massive fall, but I don’t want to hang on to it if it’s no longer the top quality company I originally bought. It currently makes up 7.5% of my portfolio, down from around 16%. Your thoughts are appreciated.

**Answer (by Paul Rickard):** Vocus has lost any shred of credibility it once had, so much so that every major analyst now has a Neutral or Sell rating (no Buys).

Analysts currently have a target price of $2.72.

I suppose I would be a reluctant holder, but don’t expect a massive or speedy recovery. There is an old adage in markets: “your first loss is your best loss”. Interestingly, that seems to work about eight out of 10 times.

If you need some clear air, sell some to get your weight down – otherwise, hang on and hope!

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