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Morgans IN ALLIANCE WITH CIMB

Holiday Edition 2014

# Investment Watch

## Season's Greetings

What a year! With Christmas around the corner, we take this opportunity to look back on an eventful year.

It has been fantastic to see investor confidence strengthen on the back of continued low interest rates and ongoing thirst for yield; an improving housing market; and weakening Australian Dollar. While 2014 has been a volatile year in terms of market performance, the ASX 200 is likely to finish the year relatively flat. However, to put 2014 into context, the market has risen more than 30% over the last three years. Against the market backdrop, we are proud of our Morgans Model Portfolios across Growth, Balance and Income all outperforming their relative benchmarks.

Despite the volatility from falling commodity prices and the downturn of mining investment, the market has had a very healthy appetite for new companies coming to market and secondary market capital raisings to fund growth. The Healthcare sector benefited from a number of new companies joining the ranks with Healthscope, Japara, Regis Healthcare and fertility providers all joining the index. To end the year we had the Government sell-down of Medibank which we were proud to be a Co-Lead Manager of and enabled us to provide our clients with this opportunity. During 2014, Morgans has raised over $7 billion and provided clients with the opportunity to participate in 26 of the 58 Initial Public Offerings that listed in 2014. We will continue to deliver great investment opportunities to our clients and believe 2015 will provide just as many new opportunities to add to your portfolios.

In the year ahead, we expect the Australian market to rally as further evidence of a progressive recovery in earnings is seen. Michael Knox, our Chief Economist is forecasting the ASX 200 index to finish 2015 at around 6,100 points, which is 15% higher than current levels. Our expectation is that the market will move higher overall and, as always, some sectors will outperform others. That is why in this Investment Watch Holiday Edition we include our key themes for 2015 on page 3 and our high conviction stocks are outlined in the closing pages. As always, speak to your adviser in relation to which stocks suit your investment goals.

For the Morgans team it has been an exciting year, with our Branch network expanding with the addition of two new branches, being Tynan Partners (Brisbane) and Bowral. This increases our total branches around Australia to over 60. Our Chairman, Tim Crommelin was awarded the 2014 Northern Regional Champion of Entrepreneurship at the EY Entrepreneur of the Year awards. The award is given in recognition of sustained, outstanding entrepreneurial achievement and is a strong endorsement of Morgans and the dedication and energy Tim has devoted over many years in helping build our business from a small operation to the significant business it is today. In 2014, we also launched our new media campaign 'hellomorgans' to build our brand awareness around Australia. You will see more of this initiative in 2015.

We would like to thank you for your ongoing support of the Morgans Foundation. In 2014, we had the great pleasure of supporting a number of charities including RSPCA, Cancer Research and Spinal Injuries. Please keep in mind, our small holdings initiative when reviewing portfolios which allows clients to dispose of unwanted shares for no brokerage with all money raised donated to our foundation.

From all the staff and management at Morgans we appreciate your ongoing support as a valued client of our business. Wishing you and your family a safe and happy festive season, and we look forward to sharing with you what we believe will be a prosperous 2015.

Brian Sheahan
Managing Director

Important disclosures regarding companies that are the subject of this report and an explanation of recommendations can be found at the end of this document.
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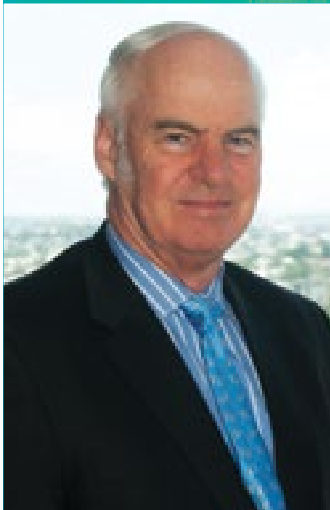
Visit our website to watch our Chief Economist Michael Knox discuss his views on the economy.



# Tackling the macro

## Economic factors spooking domestic equities

Investors can be forgiven for thinking that 2014 has been a confusing year. Australian shares look likely to record a year of negligible capital growth after quickly giving up 6% since the August highs. This is in stark contrast to US stocks which have recorded impressive capital growth of 12% so far in 2014. Falling iron ore and oil prices are grabbing headlines and raising concerns around economic growth both abroad and in Australia. So what's going on?

We conducted an interview with Chief Economist Michael Knox about the key issues confronting investors, and what he expects will unfold in 2015.

### How do you interpret the current volatility in Australian shares?

First it's important to distinguish from the standard type of volatility that markets need to function efficiently, versus current volatility in Australian stocks which we interpret more as a currency effect.

Equity markets need a reasonable amount of volatility to achieve sufficient market clearing between buyers and the sellers. Volatility during periods in early 2014 was well below average, so to achieve market clearing, we did see volatility spike above average for short periods to enable markets to re-balance. This causes short corrections like the ones we saw in the US during the year, and is entirely normal.

What we're seeing in the Australian market is far more a function of the falling Aussie dollar. When the dollar falls, foreign investors will stay away from our market for a few days, sometimes weeks, while the value of their foreign currency invested here stabilises in Aussie dollar terms.

For Australian market volatility to abate, what we really need to see is the Australian dollar to achieve fair value against the US dollar of 80 cents or below. When the Australian dollar stabilises, we're convinced that foreign investors will return and bid up Australian stocks again.

### Currency rebalancing on the back of a strengthening US dollar was your highest conviction call for 2014. Where do you now see fair value for the Australian dollar?

Aussie dollar rebalancing is clearly underway. I think the Aussie should achieve my 80 cent fair value target against the US dollar in the coming 3-4 months, and will test the 74 cent level by the end of 2015. Yes, this is likely to generate its fair share of scary moments for Australian equities, but again, as soon as the currency stabilises, markets are then free to trade upward based on fundamentals again.

### Should investors be worried about key commodities like oil leading the equities market lower?

We think that current oil prices are simply unsustainable at these levels. We've done a lot of work showing that rapid appreciation in the US dollar in the past has exaggerated the negative movement of key commodities like oil. This occurs as the owners, traders and intermediaries handling very large inventories of oil, financed with US dollars, seek to manage the currency impact on price by altering the movement and delivery of oil cargoes thus creating periods of currency driven oversupply.

Again, we think that stabilisation in the US dollar early in 2015 will stabilise oil pricing as international trade and the movement of oil inventories gets back to its normal pattern. This could in fact trigger the beginning of a multi-year upswing in oil pricing as we witnessed for similar reasons from late 2008.

> "What we really need to see to stabilise many asset classes is a levelling off in the US dollar, which we expect early in 2015."

### Are you more optimistic on the Australian economy than the media and a flat market would have us believe?

Well it's certainly true that the Australian economy is recovering now and will recover at a faster pace into next year. We estimate that Australian economic growth of 2.9% this year will accelerate to 3.4% next year. The key reason for this is much faster growth in the US economy – remember that in 2015 the US economy looks set to grow at its fastest pace since 2006.

Now, stronger US growth improves Australian growth in two ways. Firstly, we expect to see capital inflow step up via new investment from American corporations operating in Australia. Secondly, US wholesale capital markets will generate more funds, improving the amount of liquidity for Australian banks to borrow. With Australian banks able to import more money, this in turn improves the supply of loans and liquidity for local investors and businesses to deploy into new investments.

So no, we aren't bearish on Australia. In fact we expect to see stronger than anticipated growth in headline GDP and in earnings per share in 2015.

# Tackling the macro (continued)

### If Australian growth is going to surprise to the upside, what implications does this have on Australian interest rates in 2015?

We're tempering our expectations on any rise in interest rates any time soon. What we're witnessing at a macro level is a flow of funds out of Europe and into the US and Australian economies which has been driving down long term interest rates to a lower level than we had expected. With long rates coming down, we now think there will be no Australian interest rate rises in 2015, and quite possibly longer.

### Are you a buyer of Australian equities heading into 2015?

In a word, definitely. We peg fair value for Australian stocks (ASX200) at 5,770 which implies that the market is currently 5-10% undervalued. Even with modest consensus earnings growth, by the end of 2015 our estimate of fair value rises to over 6,100 points which implies 15% of capital upside from here. So clearly the market is hundreds of points too cheap now, and looking significantly cheaper based on where we expect to be in 12 months time.

### Comment from Morgans Equity Strategist, Tom Sartor

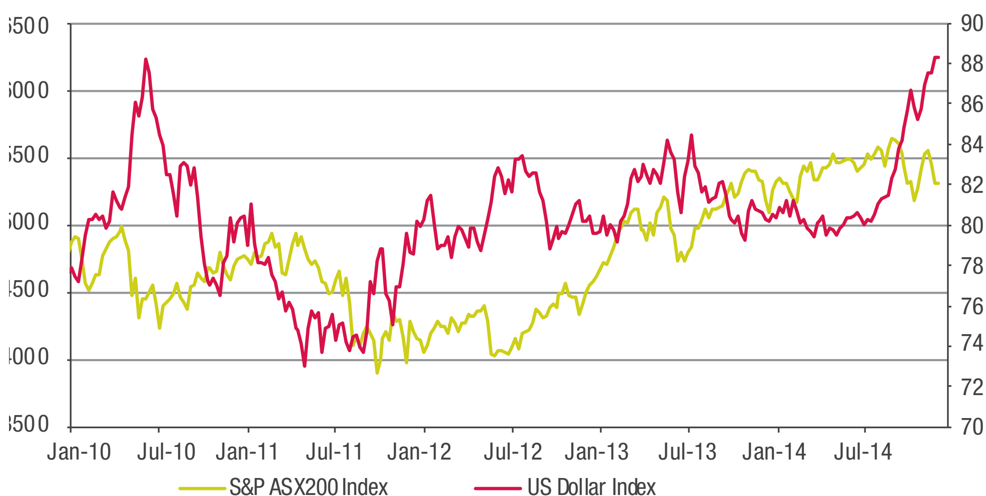
Michael's views are consistent with Morgans current equity strategy. We continue to structure our strategies around the core themes:

- Superior opportunities in stocks leveraged to better growth fundamentals in offshore markets relative to Australia
- Persistently low Australian interest rates, sustaining valuations for reliable dividend growers (blue chips) and long duration income investments (property, infrastructure)
- Strengthening of the US economy and the US dollar sustaining downward pressure on the AUD, and
- Tactical positioning toward stocks offering capital management potential and or M&A optionality.

Clearly the ongoing rebalancing of the Australian dollar, as a result of the strengthening US dollar, is a major driver of Australian equities and especially recent volatility. What we really need to see to stabilise many asset classes is a levelling off in the US dollar, which we expect early in 2015.

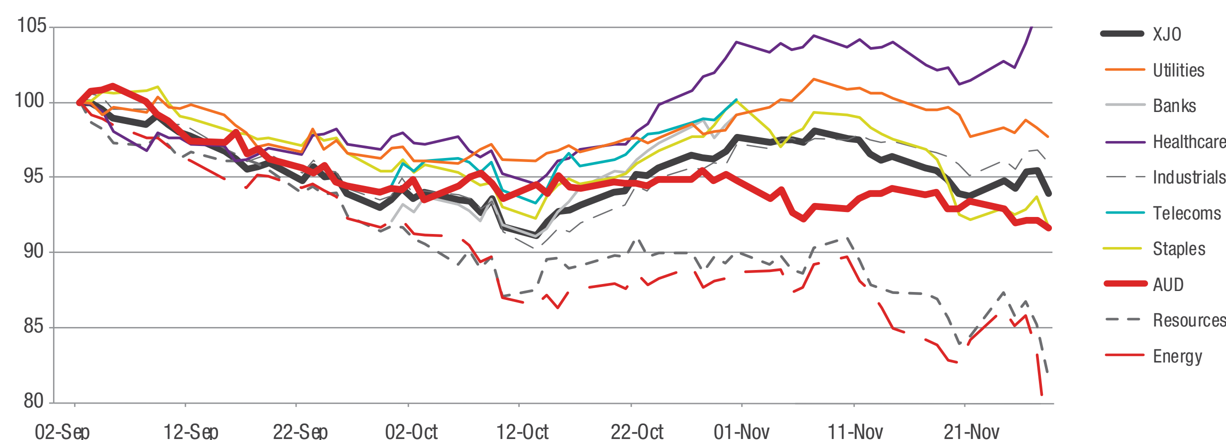
We still advocate relatively defensive positioning in large cap, fully franked dividend paying stocks. However, recent volatility is now offering up compelling opportunities in growth oriented sectors such as energy, diversified financials and consumer discretionary stocks for investors willing to see through the economic cycle and to take on positions while the broader market may feel that it's unfashionable to do so.

**A surge in the US dollar is crystallising volatility in risk assets including commodities, commodity currencies and therefore Aussie equities.**




Source: IRESS, Morgans

**It's conspicuous that movements in the AUD have dictated the recent direction of Australian stocks. Clearly the market is seeking security in income and certainty and away from growth.**




Source: IRESS, Morgans

# High Conviction

## 2014 in review

Below we explain why a flat market shouldn't equate to a flat performance for Morgans clients following our High Conviction stock ideas lists.

Australian shares look likely to finish 2014 close to where they started. As at the start of December, the ASX200 benchmark is near enough to flat for the year, down by 0.7% since 1 January. This means that the total shareholder return has been driven by dividend yield alone, rather than capital growth. Total returns for the benchmark equate to a miserly 4%, or about 5% including franking.

We can argue that Australian shares are discounting several key valuation inputs, be it domestic consumer demand or commodity price forecasts for example. These in turn may be a function of broader inputs like the unemployment rate or the trajectory of Asian growth. Many of these inputs also carry significant inherent uncertainty.

So it's easy to form 'Buy' arguments for many discounted stocks under optimistic scenarios. The far harder task for analysts is to gain a high level of confidence (high conviction) in those optimistic scenarios. This is where we focus our attention at Morgans, which we believe in turn adds value and confidence to our High Conviction stock 'Buy' ideas.

The Research team publishes updated High Conviction stock ideas lists in conjunction with Investment Watch every month. High Conviction stocks are simply those stocks we think offer the highest risk adjusted returns over a 12 month timeframe, supported by a higher level of confidence and often tangible catalysts.

We're pleased to report that the performance of Morgans High Conviction stocks have significantly outperformed the broader market (ASX200) over 2014.

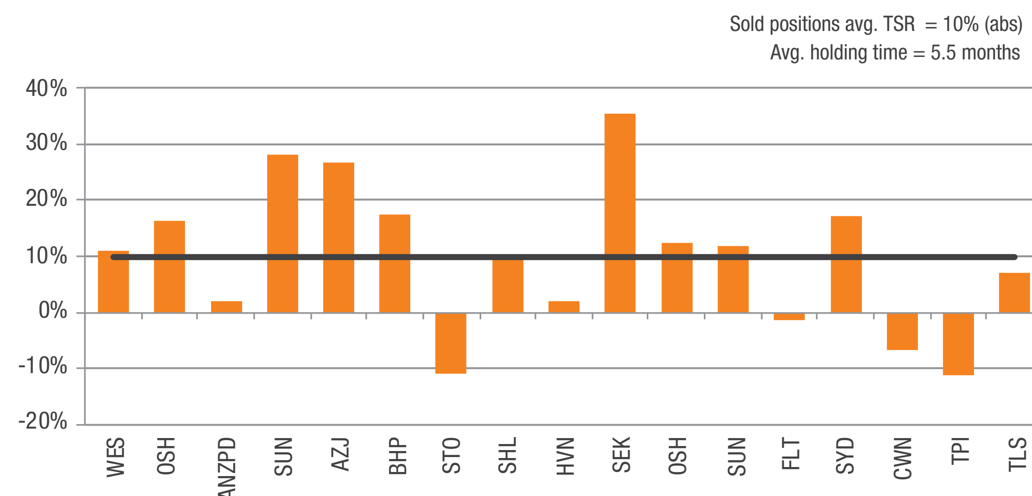
The large cap (ASX100) list has generated an average total shareholder return of 10% from positions 'sold' from the list over an average period of less than six months. This comfortably exceeds the market return of 5% over a 12 month timeframe which makes the annualised returns far more impressive.

The mid-caps (Ex-ASX100) list has generated an average total shareholder return of 8% over an average period of less than 4 months on the list. This comfortably exceeds the return of the Small Ordinaries Index (XSO) which actually fell in value by 7% during 2014 and is currently close to 12-month lows.

This demonstrates that strong performance is still achievable in flat or choppy markets. It also shows that in a market offering plenty of apparent value – provided you have confidence in a particular scenario – a higher level of confidence (conviction) in that scenario is far more valuable than the 'Buy' idea itself.

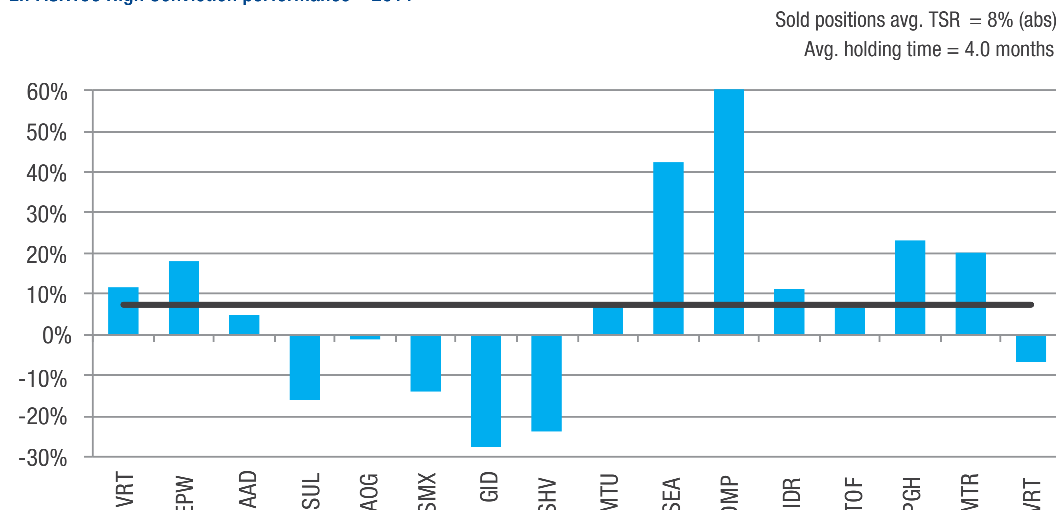
During this and every month, turn to the final pages of Investment Watch to see the monthly changes to our High Conviction lists, including a synopsis on each stock. Flat markets need not result in flat performance for Morgans clients.

**ASX100 High Conviction performance – 2014**




Source: Morgans, as at 1 December 2014

**Ex-ASX100 High Conviction performance – 2014**




Source: Morgans, as at 1 December 2014

# Australian Supermarkets

## The threat of PE contraction is rising, and quickly

In this article we highlight the mounting pressures on the domestic supermarket operators, Wesfarmers (via Coles), Woolworths and Metcash (via IGA).

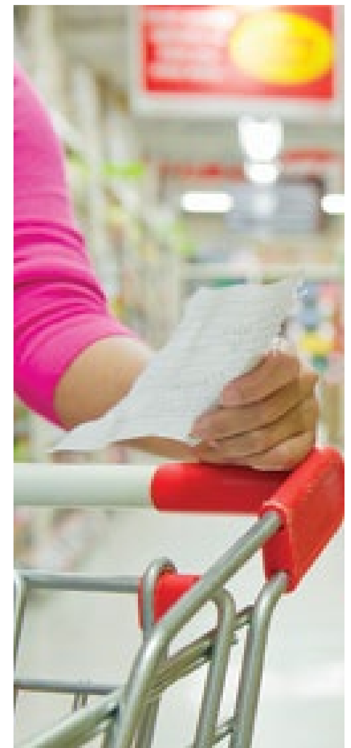
Wesfarmers (WES) and Woolworths (WOW) have long been considered core, defensive stocks which you could "buy, put away and forget" due to healthy dividends and good capital gains backed by clear earnings growth prospects. With cut-price competition from new market entrants Aldi and more recently Costco, should investors be worried that the duopolistic advantage enjoyed by Coles and Woolworths is under threat? Are we seeing the beginning of a Tesco scenario where the discounters (Aldi and Lidl) have doubled market share in the UK within a few years?

In our view, there is no doubt the headwinds are rising and stock trading multiples are at risk.

The Australian grocery market is becoming more and more price competitive with the discounters looking to price comparable items about 20% lower, and consumers became more discerning about the pricing of their trolley contents each week. We saw this recently with Woolies, where quarterly sales missed the mark due to a lack of promotional activity – so we know constant promotions are necessary. Coles is well ahead in this regard.

Additionally, the ACCC has launched its second big legal action against Coles in six months, accusing the retailer of unconscionable conduct against five grocery suppliers by paying fines for late deliveries and wastage of its products. The ACCC is on a mission to even the playing field between the majors and their suppliers. However this plays out, it will undoubtedly make it harder for the majors to expand margins to fund store growth and maintain or increase market share.

All of these factors will undoubtedly play out against WES, WOW and Metcash. Those that fair the best will be the ones that are prepared to invest in pricing/promotions. Coles is already well in front in this regard while WOW and MTS are most at risk in our view. Either way, price investment and therefore margin contraction will likely play out over the next few years… just as it has done in the US, UK and Europe.



# Retail Sector

## Expecting a couple more presents under the Christmas tree this year

The crucial Christmas trading period is here and it will again be a critical litmus test for how the average consumer is faring. The Christmas period is pivotal for the majority of the discretionary retailers who typically earn a large portion of their earnings during this period.

With the AGM season behind us, it is clear that retailers in general are highly cautious with comparative sales growth generally remaining quite modest and consumers remaining very focused on value and promotional activity.

The positives for retail trade currently include: positive wealth effects (housing and equity markets), credit growth and steady consumer sentiment. The negatives for retail trade include: continued price deflation, weak employment growth and slowing wages growth. If we were to see above average increases in credit and/or wages growth, this would be a very positive sign for consumer spending and therefore retail trade. Conversely, any deterioration in these trends would have a negative impact.

The stronger housing market has seen solid demand for the homewares, lighting, hardware and furniture categories and we expect this will continue.

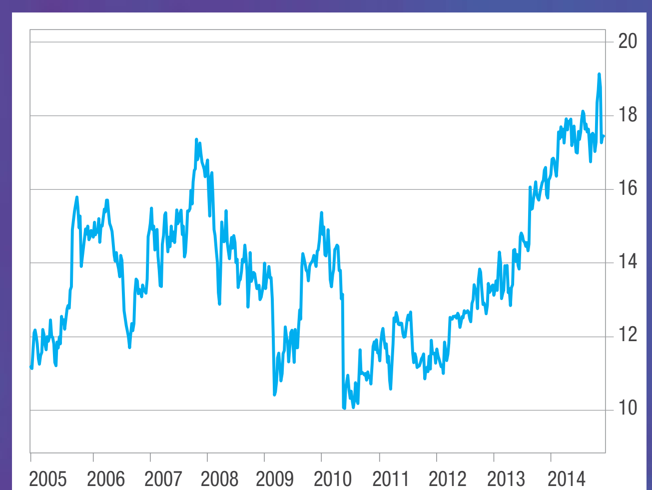
Looking to Christmas, we are cautiously optimistic and expect modestly higher levels of spending. Our preferred retail exposures currently include: **Harvey Norman (HVN), Beacon Lighting (BLX)** and **Domino's Pizza (DMP).**

We believe the consumer backdrop is generally conducive on a long term view. However, investors need to be highly selective in terms of stock picking.

# Technical Corner

## Sonic Healthcare (SHL)

SHL's share price has been trading in an up-trend over the long term, which remains technically intact. The current pull back retraced close to its previous support of $16.80, where buying interest is likely to arise. Momentum indicators have reached oversold territory, suggesting that the price is likely to bounce soon. Given the proximity to support and the oversold momentum we are comfortable to start accumulating SHL around the current price. The potential long term upside target is $19.50.




Source: IRESS, Morgans

# Medibank

## A successful listing

**Medibank Private (MPL)** successfully listed on 25 November 2014 and will be one of Australia's top 50 listed companies with a market capitalisation of A$6bn (at a share price of $2.18 as at 30 November 2014). MPL's solid long-term outlook is supported by consistent growth in Australian healthcare expenditure (7.9% compound annual growth over the past 10 years), combined with supportive government policy towards the private healthcare sector. The strong thematics of an aging population, medical innovation and outsourcing opportunities to the private sector as governments look to shift the cost burden, are all set to ensure that well run health and health-related companies are attractive investments. MPL's growth will come from driving cost efficiencies and identifying opportunities in its 'complementary services' division. We have added MPL to the Morgans Balanced Portfolio with a fully franked annualised yield of 3.5% p.a. (at the $2.00 retail issue price).

# Fixed Interest

## Looking for some shorter-dated exposure

We believe there are a number of attractive, shorter-dated securities which clients should be buying at current prices following the recent sector correction. While prices on these names have rallied from their lows, we still view the returns on offer as attractive relative to other securities. ANZPA (Add, 5.29%), PCAPA (Add, 5.87%) and WCTPA (Add, 6.02%) are all preference shares with call dates in 2016 when we would expect to see them redeemed by their respective issuer. None of the securities contain non-viability or common equity triggers which makes them attractive for more conservative investors as they cannot be converted into ordinary shares at a discount to their par value.

For those clients seeking longer-dated major bank issued preference shares we recommend **ANZPE** (Add, 6.91%), **CBAPD** (Add, 6.77%), **NABPB** (Add, 6.78%) and **WBCPD** (Add, 6.55%).


## Corporate investment opportunities offered to clients in 2014 by Morgans

Over 2014, Morgans has underwritten, placed and raised over $3.5 billion for 85 growing companies.

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# Cashing in on yield

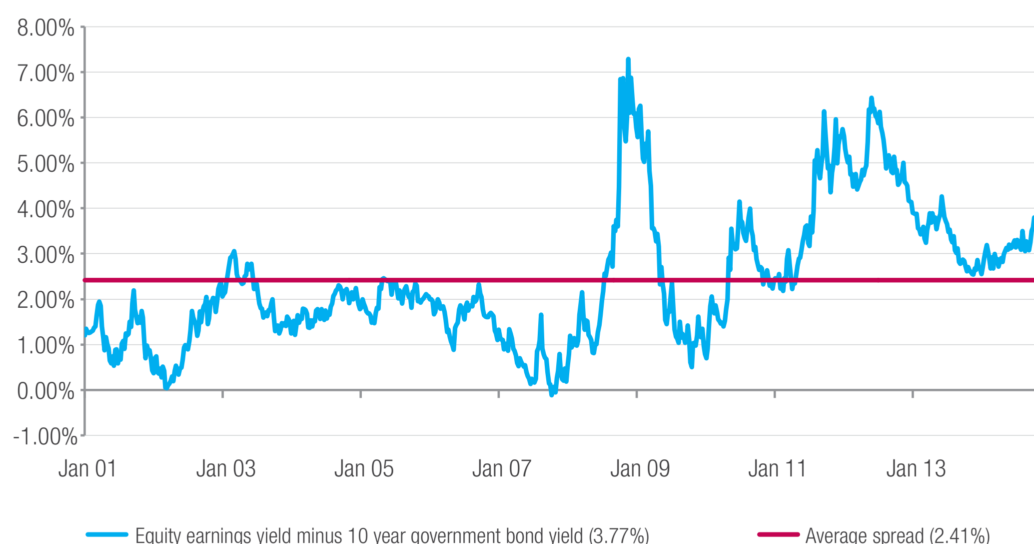
One theme we have been discussing for quite some time has been the recent reductions in term deposit rates by financial institutions in the face of a flat outlook for the official RBA cash rate. In our view this, coupled with changing regulation from APRA regarding breaking term deposits, has reduced the attractiveness of term deposits. With government bond yields remaining low and the official cash rate expected to stay at or below current levels for an extended period, equities continue to look attractive for investors.

Since 2001, the earnings yield on equities has on average been 241bp above the 10 year bond yield. The current spread between these two yields is 343bp suggesting that equities are cheap on a relative basis to government bonds. Our Chief Economist Michael Knox currently has a fair value yield on the 10 year bond of 4.09% which compares to the current yield of approximately 3.34%. Even with a government bond yield of 4.09% equities would still be attractive relative to bonds.

We still believe clients should hold term deposits as part of a diversified portfolio but acknowledge the lowering of deposit rates coupled with changes to break rules make them less appealing to investors. While interest rates will increase at some point in the future, we don't see this as a near-term risk. Consequently we believe it is important for investors to focus on equities that have increasing dividends. These companies will be better positioned to withstand a rising interest rate environment when lower risk alternative investments become more attractive. We are buyers of **ANZ Bank, Pact Group, Stockland, Sydney Airport, Transurban** and **Telstra** given the attractive yields on offer and the fact that these companies offer investors a growing dividend profile over the coming years.

Visit our website to read **Income Strategy – cashing in on yield,** published 24 November 2014.

**Spread between equity earnings yield and government bond yield**




Source: Morgans, IRESS, RBA

# Banks

## Regulation may create a buying opportunity

With an increased focus on regulation for the major banks we thought it timely to remind investors why we think our four major Australian banks are quality investments. There are increasing concerns that regulators will force the major banks to hold more capital (because they are too big to fail). Mathematically this would reduce their Return on Equity (ROE) and limit their capacity to keep growing dividends (payout ratios might contract as the banks increase their retained earnings to grow their equity base).

Many investors and several of the major bank CEO's expect these higher regulatory costs to be passed on to consumers. However, there is a risk that if the banks are unsuccessful in passing on these higher costs, this could result in a lower ROE and a contraction of trading multiples. In our view, the final scenario will take years to play out. As such, any volatility may create a good buying opportunity for investors with a medium-term investment horizon. Banks offer reasonably defensive earnings, pricing power, lower relative share volatility (due to ROE stability) and an ability to gradually increase dividends is why we think the banks remain attractive investments and an important part of every portfolio.

Our preferred picks are **ANZ Bank (ANZ)** and **Commonwealth Bank (CBA)**. We like ANZ for its Asian exposure and note that its ROE will improve as Asian earnings have just hit critical mass. We favour CBA for its overweight exposure to mortgages and wealth management which are the two best performing areas of financial services. We also believe CBA has a significant technological advantage over peers and note that it is the best performing bank in terms of ROE and total shareholder returns.

Visit our website for our latest special bulletin on the Banks **Short term pain = long term gain,** published 24 November 2014.

# Healthcare – continues to deliver

November has been another strong month for the healthcare sector with the index outperforming the ASX 200 by 4%. The main contributor has been **CSL Limited (CSL)**, which remains in our High Conviction list and is expected to deliver average earnings growth of 12% p.a. for the next three years.

During October, Morgans was a Co-Lead Manager and Underwriter to the **Regis Healthcare (REG)** float which successfully listed and is now trading up over 15% from its issue price. We have seen some weakness in the IVF sector with both **Virtus (VRT)** and **Monash IVF (MVF)** coming under some selling pressure as IVF cycle numbers for the first quarter were lower than forecast, however we continue to see long term value in these names. Also **Sonic Healthcare (SHL)** announced a small downgrade to its FY15 profit guidance and was harshly marked down by the market. Coupled with the recent news that GP co-payments won't proceed, we believe **SHL**'s share price weakness has been overdone with the stock now in buying territory.

**Medibank's (MPL)** listing was well supported by both retail and institutional investors and we expect investor interest in the Healthcare sector to remain solid. In our view, hospital operators such as **Healthscope (HSO)** and **Ramsay Healthcare (RHC)** are likely to benefit from the redeployment of **MPL** refunds. At the smaller end of the market, Impedimed has achieved a major milestone with a higher than expected reimbursement rate to be paid by Medicare in the US. Their rights issue closed 5th December and clients were encouraged to take up their rights.

# SEEK

## Riding the global trend of improving hiring activity

Recent moves by the Chinese central bank to lower official interest rates has been a breath of fresh air in China and South East Asia and is likely to bolster employer confidence to increase hiring activity in 2015. Recently **SEEK's (SEK)** majority-owned employment website Zhaopin reported that revenues grew 23% in the September quarter, driven by a big increase in the volume of job ads.

Against that backdrop **SEK** is now riding a global trend of gradually improving hiring activity. In all markets in which **SEK** operates job ad volumes are rising, setting the scene for profit upgrades as FY15 unfolds.

Jobs are traditionally a lagging indicator of economic activity – employers tend to hire new recruits 3-6 months after the need for them becomes obvious. With global central banks keeping monetary policy easy with the express intention of driving stronger demand for labour, **SEK** offers investors a simple way to play rising global labour demand.

In addition to rising job volumes, **SEK** is also benefiting from a very strong performance from its online education business, **SEK** Learning. We expect this business to post high double-digit earnings growth in FY15.

**SEK** remains one of our High Conviction picks. We note that the stock is trading at a discount to our 12-month price target of $19.97.

Visit our website to read **SEEK – Still Humming along,** published 27 November 2014.

Tomorrow's
blossoms
rely on today's seeds

## Stay in touch with the market during your Christmas holiday

- **www.morgans.com.au** – breaking news, share prices and company research updates
- **www.morgans.com.au/blogs** – stay up to date with our analysts and key picks via their personal blog posts
- **@morgansAU** – follow us on twitter for daily market updates
- **LinkedIn**

# Agricultural industry

## Key beneficiary of the China FTA agreement

The Australian agricultural industry is a key beneficiary of the Free Trade Agreement (FTA) with China which will result in the elimination of tariffs over the medium to longer term. The deal follows FTA agreements earlier in the year with Japan and South Korea. The China FTA is the most important given China is our major trading partner with Australian farm exports doubling in the five years to 2013 and were valued at over $7 billion in 2013. The FTA will improve Australia's access to the Chinese market. The removal of import tariffs addresses a substantial barrier to trade faced by Australian exporters. It will make Australian products more competitive against countries without an FTA with China. The National Farmers Federation said the three FTA agreements pave the way for the 'golden age of Australian agriculture in the Asian century'. The FTA agreement is an endorsement of Australian agriculture's quality, traceability, freight advantage China and its 'safe' image. The agreement demonstrates that food security is a number one priority for government's around the world, particularly in developing economies.

As the graph below demonstrates, China needs Australia to feed its people. The products which are a key beneficiary of the FTA are dairy, beef, wine, horticulture and live exports. Unfortunately, wheat, rice, sugar and cotton were excluded from the agreement, however these industries will be reviewed in three years' time. The FTA should also ignite further investment from China in Australian agribusinesses.

**A summary of the tariff removals and time frame can be seen below:**

- **Dairy** – removal of all tariffs, of up to 20%, in 4-11 years
- **Beef** – removal of tariffs of 12-25% over 9 years
- **Wine** – removal of all tariffs, 14-20%, over 4 years
- **Horticulture** – removal of all tariffs, up to 30%, in 4 years
- **Live animal exports** – removal of tariffs of 10% in 4 years

**The listed companies which are a key beneficiary of the China FTA include:**

**Beef/live exports** – Australian Agricultural Company (AAC), Elders (ELD), RuralCo (RHL) and Ridley Corporation (RIC).

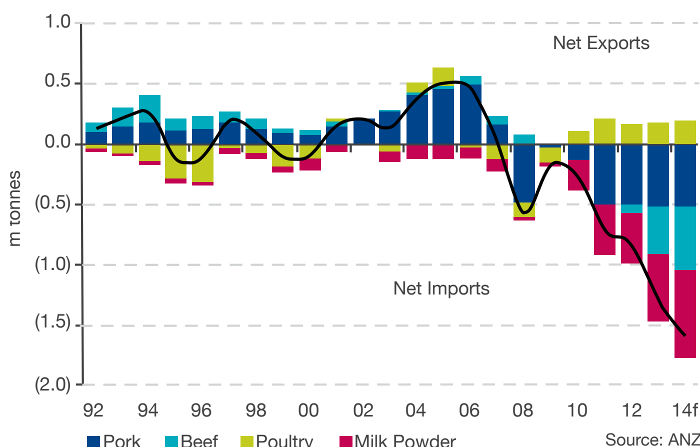
**Dairy** – Bega Cheese (BGA), Warrnambool Cheese & Butter (WCB), Fonterra Shareholders' Fund (FSF), Australian Dairy Farms (AHF), Bellamy's Australia (BAL), Freedom Foods (FNP) and Ridley Corporation (RIC).

**Wine** – Treasury Wine Estates (TWE) and Australian Vintage (AVG).

**Horticulture (nuts)** – Select Harvests (SHV) and Webster (WBA).

**Our key pick of the agricultural sector is Elders (Add and A$0.27 price target).**

China's animal protein net trade




Source: ANZ



# Lovisa Holdings Limited – Initial Public Offer

## About Lovisa

- Fast fashion jewellery retailer with a similar business model to international success stories Zara and Cotton On
- Rapid growth over the past 5 years with compound annual revenue growth of 60.7% from FY2011 to FY2014
- Operating profitably in 8 countries with a 220 store footprint (including 10 franchised stores)
- Vertically integrated business model provides strong competitive advantage and underpins high gross profit margins (averaging >75%)

**Morgans is Joint Lead Manager and Underwriter to the $102 million IPO of Lovisa which is expected to list on the ASX (deferred settlement) on Thursday, 18 December 2014.**

# High Conviction Stocks

In the digital edition, you may click on the stock tables for links to the latest company research reports from our website. You can also watch our analysts outline key reasons to buy these stocks in short videos available here **www.morgans.com.au/high-conviction-stocks-december-2014**

## Top 100

## This month's changes

This month we have made two changes to our Top 100 High Conviction list, adding Ramsay Healthcare (RHC) and removing Challenger Limited (CGF). CGF was removed after an unexpected backflip on a tax ruling by the Federal Government in respect of one of CGF's annuity products.

| Brambles BXB | | | |
|---|---|---|---|
| Price | $9.72 | PE (x) | 20.8 |
| Price Target | $10.62 | Yield | 3.5% |
| Upside | 9.2% | Gross Yield | 3.9% |

Brambles (BXB) is a supply-chain logistics company operating in more than 50 countries, primarily through the CHEP and IFCO brands.

### Key reasons to buy

- Long-term international growth opportunities from new products and emerging markets
- BXB is leveraged to an economic recovery in the US and Europe (~80% of earnings). With organic growth forecast in those key markets we expect earnings growth to accelerate from mid-single digit to low double-digit.
- BXB's PE multiple is above the historical average of 18x, but well below previous peaks of over 25x and we think BXB is entering a PE re-rating cycle.

| CSL Limited CSL | | | |
|---|---|---|---|
| Price | $82.57 | PE (x) | 23.3 |
| Price Target | $72.58 | Yield | 1.7% |
| Upside | -12.1% | Gross Yield | 1.7% |

CSL is a leading global human blood plasma company which generates approximately US$5.0bn in sales (40% in US, 30% in Europe and 40% in the Rest of World).

### Key reasons to buy

- CSL has delivered average EPS growth of 21% for the last six years and our forecasts suggest mid teen growth for the next three years.
- To fund its continued growth CSL spends over 5% (or A$0.5bn) of revenue on R&D, with the most promising targets in the Haemophilia space.
- Although the current share price is higher than our fundamental price target, CSL offers investors with a medium term view attractive capital growth prospects.

| Oil Search OSH * | | | |
|---|---|---|---|
| Price | $7.97 | PE (x) | 12.2 |
| Price Target | $10.42 | Yield | 3.3% |
| Upside | 30.8% | Gross Yield | 3.3% |

Oil Search (OSH) is an E&P company with 18-20 mmboe production expected this year and further significant production growth expected in CY15.

### Key reasons to buy

- The share price has pulled back recently on macro commodity price concerns, resulting in an opportunity to buy a quality oil and gas stock with growth potential and a strong production base.
- The strategy review highlighted that OSH has a competitive advantage in PNG, and the remaining high returns expected for positions within PNG. The dividend policy has been set at a payout of 35%-50% of core NPAT which will start from the CY14 final dividend, highlighting increased cash flow from PNG LNG.
- Near term appraisal work in PNG may lead to additional LNG project growth potential, which may lead to de-risking and value upside.

| Origin Energy ORG | | | |
|---|---|---|---|
| Price | $12.25 | PE (x) | 17.2 |
| Price Target | $14.52 | Yield | 4.1% |
| Upside | 18.6% | Gross Yield | 4.1% |

Origin Energy (ORG) is the leading Australian integrated energy company with diverse operations across the energy supply chain, including an interest in the APLNG project being developed in Gladstone.

### Key reasons to buy

- APLNG is on track for completion mid-2015, driving significant growth in cash flows.
- A clear dividend policy of at least 60% payout post-APLNG startup, and a decision not to issue equity this year to fund its purchase of WA assets has reduced uncertainty.
- A diverse gas portfolio secured ahead of the startup of the LNG projects on the East Coast, which may benefit margins post- the LNG startups in Gladstone in 2015/2016.

| Ramsay Healthcare RHC | | | |
|---|---|---|---|
| Price | $54.15 | PE (x) | 28.9 |
| Price Target | $59.73 | Yield | 1.8% |
| Upside | 10.3% | Gross Yield | 2.6% |

Ramsay Healthcare (RHC) is Australia's largest private hospital operator and more recently has expanded its operations into the UK, France and parts of Asia, where now about 25% of its revenue is generated.

### Key reasons to buy

- RHC is benefiting from an aging population which uses more medical services.
- RHC consistently delivers above market earnings growth (last three years averaging 18% pa) and for the next three years is forecast to grow at 15% pa.
- RHC is expected to benefit from further public hospital outsourcing opportunities.

| Seek SEK | | | |
|---|---|---|---|
| Price | $17.09 | PE (x) | 25.1 |
| Price Target | $19.97 | Yield | 1.7% |
| Upside | 16.9% | Gross Yield | 2.5% |

Seek (SEK) is the leading provider of online employment services in Australia, China, Southeast Asia and Latin America. The company also owns a rapidly expanding online education business.

### Key reasons to buy

- The Australian recruitment cycle is at or near to all-time lows in churn rates and recently volumes have begun to rebound.
- Year-to-date job ad growth is higher than we have assumed in our forecasts.
- Seek's offshore operations will deliver high double-digit growth in FY15 as the benefits of the Jobstreet acquisition become available. The company is achieving strong growth while simultaneously de-leveraging its balance sheet.

| Stockland Group SGP* | | | |
|---|---|---|---|
| Price | $4.12 | PE (x) | 16.0 |
| Price Target | $4.28 | Yield | 5.8% |
| Upside | 3.9% | Gross Yield | 5.8% |

Stockland Group (SGP) is Australia's largest property developer with significant land banks.

### Key reasons to buy

- Around a third of earnings are derived from residential development. Given the improving macro environment, we believe SGP is well placed to benefit in the medium term.
- The balance of the investment portfolio is good quality (office, retail, logistics, retirement), and although medium term retail and office conditions are challenging, the earnings visibility is good given contracted rents. SGP's strategy is to reduce its office exposure over time.
- SGP offers investors an attractive distribution yield.

| Transurban Group TCL | | | |
|---|---|---|---|
| Price | $8.31 | PE (x) | 65 |
| Price Target | $8.22 | Yield | 4.7% |
| Upside | -1.1% | Gross Yield | 5.1% |

Transurban Group (TCL) develops, operates, and maintains toll roads in Australia and the US.

### Key reasons to buy

- We expect TCL to generate double-digit EBITDA growth over the next three years driven by traffic growth, CPI/CPI+ toll increases, ongoing cost control, and contribution from growth projects and acquisitions.
- We expect this traffic and earnings growth to translate into double-digit growth in distribution per share.
- Confidence in this growth outlook can be gained from the management incentive plan, which rewards management for growing free cashflow per share at 10-13% per annum CAGR across FY14-17.

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## Ex 100

## This month's changes

This month we have made four changes to our ex 100 High Conviction list, adding Impedimed and removing Mantra Group and Pact Group due to strong share price appreciation and Virtus due to below trend growth in IVF cycle numbers in Australia.

| Admedus AHZ | | | |
|---|---|---|---|
| Price | $0.12 | PE (x) | n/a |
| Price Target | $0.23 | Yield | 0.0% |
| Upside | 103.0% | Gross Yield | 0.0% |

Admedus (AHZ) has a diversified life science portfolio across medical products, regenerative medicine and DNA vaccines.

### Key reasons to buy

- AHZ is a well funded following an A$18m capital raising, which will accelerate sales in Europe and the US for its key regenerative medicine product called CardioCel.
- AHZ is developing DNA vaccines, using Prof. Ian Fraser's technology and an efficacy trial is expected to start later this year following a successful safety trial in HSV-2 (genital herpes).
- Plenty of newsflow is expected in the next six months – additional CardioCel approval in the Asian region, increasing sales for CardioCel, and further updates on the vaccine trial.

| GBST Holdings GBT | | | |
|---|---|---|---|
| Price | $3.83 | PE (x) | 20.3 |
| Price Target | $4.79 | Yield | 2.5% |
| Upside | 25.1% | Gross Yield | 2.5% |

GBST provides software and systems to banks and fund managers to enable them to manage order and settlement work flow in a highly automated and efficient fashion.

### Key reasons to buy

- The five-year drought in spending on new systems by financial institutions has come to an end, offering GBST a chance to pick up significant new contract wins over the next few years.
- The company implemented 16 new customer projects in FY14, some of whom were implemented at the end of the financial year. The full-year impact of these new installations will deliver double-digit growth in FY15.
- GBST will be debt free in FY15 and will be poised for acquisitions or capital management by FY16.

| Impedimed IPD | | | |
|---|---|---|---|
| Price | $0.69 | PE (x) | n/a |
| Price Target | $1.71 | Yield | 0.0% |
| Upside | 147.1% | Gross Yield | 0.0% |

Impedimed (IPD) has developed a medical device which aids in the clinical assessment of patients for the potential onset of secondary lymphoedema.

### Key reasons to buy

- IPD has an approved medical device which is being rolled out mainly across oncology centres in the US.
- Medicare in the US has determined it will reimburse each reading at US$112.67, which was well ahead of our forecasts.
- IPD's technology has wider applications in fluid monitoring, for example in nutrition and dialysis monitoring.

| National Storage REIT NSR | | | |
|---|---|---|---|
| Price | $1.43 | PE (x) | 15.6 |
| Price Target | $1.55 | Yield | 5.8% |
| Upside | 8.4% | Gross Yield | 5.8% |

National Storage REIT (NSR) is the first ASX-listed, internally managed and fully integrated owner and operator of self-storage centres.

### Key reasons to buy

- First mover advantage in the self-storage asset space
- Future growth potential via acquisitions given the fragmented storage market, and
- An attractive distribution yield.

| NextDC (NXT) | | | |
|---|---|---|---|
| Price | $1.94 | PE (x) | n/a |
| Price Target | $2.39 | Yield | 0.0% |
| Upside | 23.3% | Gross Yield | 0.0% |

NextDC (NXT) is Australia's only national, independent data centre operator, with five operational data centres.

### Key reasons to buy

- At their October AGM NXT upgraded guidance that it is now EBITDA positive. We expect this and the removal of an overhang will bring a new range of investors to the stock.
- We expect the rate of sales to accelerate as channel partners build up momentum, with more than 75c of every dollar of new sales benefiting EBITDA.
- NXT looks fundamentally undervalued, given trading close to replacement value. Positive news and the potential for short covering should help drive the share price higher.

| Shine Corporate SHJ | | | |
|---|---|---|---|
| Price | $2.76 | PE (x) | 16.0 |
| Price Target | $3.09 | Yield | 1.5% |
| Upside | 11.9% | Gross Yield | 1.5% |

Shine Corporate (SHJ) is a market leader in the area of damages-based plaintiff litigation.

### Key reasons to buy

- We believe SHJ's strong forecast EPS growth, balance sheet capacity for future accretive acquisitions, and internal initiatives to improve margins will see the stock re-rate further.
- SHJ will continue to benefit from a fragmented market and its ability to acquire value enhancing acquisitions.
- We expect further acquisitions and demonstration that disbursement funding is improving cashflow will drive share price performance.

| 360 Capital Industrial Fund TIX | | | |
|---|---|---|---|
| Price | $2.48 | PE (x) | 10.4 |
| Price Target | $2.47 | Yield | 8.2% |
| Upside | -0.2% | Gross Yield | 8.2% |

360 Capital Industrial Fund (TIX) owns a portfolio of 21 industrial assets across Australia valued at around $500m.

### Key reasons to buy

- Attractive yield.
- Cashflows supported by stable rents which average 3.5% rental growth p.a.
- Strong portfolio metrics (Woolworths is the largest tenant) including a WALE of 6 years.

Source: IRESS, Morgans, Factset FY15 Forecasts.

* Applies consensus forecasts. Priced at 1 December 2014.

## Queensland

| | |
|---|---|
| Brisbane – Head Office | +61 7 3334 4888 |
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| Brisbane – Tynan Partners | +61 7 3152 0600 |
| Bundaberg | +61 7 4153 1050 |
| Cairns | +61 7 4222 0555 |
| Caloundra | +61 7 5491 5422 |
| Emerald | +61 7 4988 2777 |
| Gladstone | +61 7 4972 8000 |
| Gold Coast | +61 7 5581 5777 |
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| Kedron | +61 7 3350 9000 |
| Mackay | +61 7 4957 3033 |
| Milton | +61 7 3114 8600 |
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| Noosa | +61 7 5449 9511 |
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| Bowral | +61 2 4851 5515 |
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| Gosford | +61 2 4325 0884 |
| Hurstville | +61 2 9570 5755 |
| Merimbula | +61 2 6495 2869 |
| Neutral Bay | +61 2 8969 7500 |
| Newcastle | +61 2 4926 4044 |
| Newport | +61 2 9998 4200 |
| Orange | +61 2 6361 9166 |
| Port Macquarie | +61 2 6583 1735 |
| Scone | +61 2 6544 3144 |
| Sydney – Level 9 | +61 2 8215 5000 |
| Sydney – Level 7 Currency House | +61 2 8216 5111 |
| Sydney Hunter St | +61 2 9125 1788<br>+61 2 9615 4500 |
| Sydney Reynolds Equities | +61 2 9373 4452 |
| Wollongong | +61 2 4227 3022 |

## Victoria

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|---|---|
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| Camberwell | +61 3 9813 2945 |
| Carlton | +61 3 9066 3200 |
| Farrer House | +61 3 8644 5488 |
| Geelong | +61 3 5222 5128 |
| Melbourne | +61 3 9947 4111 |
| Richmond | +61 3 9916 4000 |
| South Yarra | +61 3 9098 8511 |
| Traralgon | +61 3 5176 6055 |
| Warrnambool | +61 3 5559 1500 |

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| Darwin | +61 8 8981 9555 |

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## South Australia

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| Norwood | +61 8 8461 2800 |

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