

Australia & New Zealand Equity and Credit Markets Outlook 2016

Expect similar thematics to 2015. U.S. dollar and dividend yield stocks are preferred. Not time yet to get back into resources.

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Executive Summary

- ▶ The global economic backdrop, in our view, is likely to be similar to 2015. While we expect the U.S. economy to continue to strengthen, we expect the Federal Reserve will increase interest rates in 2016 by less than the 1% they forecast. In our view, China will begin to transform from an infrastructure asset spend phase to a more consumer spending phase, and the eurozone will continue to struggle with pockets of deflation persisting and with no clear end in sight to the ECB's negative interest rate cycle. We don't expect any change in the country composition of the euro.
- ▶ We forecast Australia's real GDP growth of 2.5% in 2016 and 3% in 2017, and 2.3% in 2016 for New Zealand and 2.5% for 2017. Recent Australian economic data points have been better than expected, indicating that a low-single-digit economic growth outlook is intact and the risk of economic growth turning negative is reduced, unless there is another unexpected external shock. We are not expecting any further cut to the current cash rate of 2.0% during 2016.
- ▶ We expect a 2016 trading range for the S&P/ASX 200 Index of 5,000 to 5,800, similar to that seen in 2015. In our view, the commodities drag on the equity markets will not be as dominant in 2016 and the market direction may be more influenced by the Fed commentaries around further U.S. interest rate rises and the release of indicators on the underlying strength of the Australian economy. We believe equity market volatility will again feature in 2016, noticeably around unexpected bond yield movements. We estimate the Australian equity market is currently marginally undervalued trading at 0.98 times the aggregate market fair value based on our bottom-up earnings forecasts. Dividend yields relative to bonds remain attractive. We estimate the S&P/ASX 200 is currently trading on a prospective 2016 dividend yield of 4.6% and 2017 of 4.9%, relative to the 15-year long run average of 4.3%. We estimate the S&P/ASX 200 is trading on a historical dividend yield to 10-year bond yield gap of 2.3 times relative to the 15-year long run average of negative-0.8 times. Realistically, until we see a sustained rising interest rate environment, the dividend yield to bond yield gap should remain positive. We estimate the Australian equity market is trading on a prospective 2016 P/E ratio of 15.7 times and 2017 of 14.6 times relative to the 10-year long run average of 13.4 times.
- ▶ Based on our company earnings forecasts, those sectors with a positive 2016 earnings outlook include Banks, Diversified Financials, Gaming, Healthcare, Other Industrials and Infrastructure. Some of these sectors though are not cheap such as Infrastructure. We continue to view companies with U.S. dollar earnings positively such as Brambles, CSL, Resmed and Fisher and Paykel Healthcare.
- ▶ Those sectors with a negative 2016 earnings outlook include Metals and Mining, Oil and Gas, and Mining Services, and while some companies may look attractive on a share price/estimated fair value basis, we would still remain cautious and underweight these sectors. The Retail sector, while it too is forecast to have a negative 2016 earnings outlook, has pockets of value such as Woolworths which is trading well below our fair value on a medium-term view.

Key Thematics

Global Economic Back-drop

Global GDP growth will remain below the long-term trend in 2016. In major economic blocs, central banks will be guiding monetary policy in different directions. In answer to the question, "Will central banks tighten monetary policy in 2016?" the most likely answer is, for the Fed: Yes; the European Central Bank: No; the Bank of Japan: No; the Bank of England: possibly; the People's Bank of China: unlikely; and the Reserve Bank of Australia: unlikely. Global monetary policy will remain very accommodative in 2016.

We expect global interest rates will remain low for a number of years, despite the first tightening by the Fed in nearly a decade. We share the market view that the Fed is unlikely to embark on a further four 25 basis point interest rate increases during 2016 as suggested by their own forecasts. Cash and bank term deposits will provide poor returns and this should continue to support the appetite for risk assets. With economic growth still comfortably below trend, sustainable income-producing assets will remain a focus for investors.

Global equity markets are likely to move moderately higher in 2016. Generally accommodative monetary policy, improving global economic growth, and subdued inflation should support equity markets. The gap between earnings yields and 10-year bond rates should support risk assets. A stronger U.S. dollar will support eurozone and Chinese exports. Commodity prices are a wild card as a general lack of discipline in supply, which has spread to the oil sector, swamps tepid demand. Holders of junk rated U.S. shale oil debt — either banks directly or institutions holding bonds — could see defaults spike. High yield fund managers and exchange-traded funds focused on this asset class will experience redemption runs. The lack of liquidity in these markets will be their enemy.

In 2016, China will be the fastest growing economy of the major OECD countries. Its gross domestic product is likely to expand at a rate of more than twice the rate of the U.S., three to four times that of the eurozone and more than twice global growth. China, the whipping horse for most of 2015, will continue to contribute more to global growth than any other top 10 nation in 2016. The eurozone is the world's largest economy, the U.S. second, and China third. China is still punching well above its weight, which doesn't say much for the rest. While the U.S. economy is in recovery and gaining traction, the eurozone is where we need to see some tangible response to the massive stimulus program of the past seven years.

Australian Economic Back-drop: Rebalancing Despite Headwinds

We forecast Australia's real GDP growth of 2.5% in 2016 and 3% in 2017. While these forecast growth rates are below the 20-year historical long-term trend of 3.2 %, recent economic data releases indicate that the economy should achieve low-single-digit growth with the transition from the resources industry driving economic growth to more of a services/ infrastructure/building-led economic growth base. Our base case forecasts do not factor in any hard landing for the Australian economy, albeit some sectors will clearly struggle reflecting specific industry dynamics and challenges. The east coast states, led by New South Wales, are enjoying meaningful growth as

activity in the mining regions in Western Australia and Queensland contracts sharply. Construction activity — residential, commercial, and infrastructure — is driving solid employment growth, while inbound tourism is providing impetus in the hospitality and retail sectors.

We continue to be reassured by the positive trends in domestic employment growth. Australia's unemployment rate now stands at 5.8% with a strong 65.3% participation rate. New South Wales boasts the lowest unemployment rate at 5.2%. Few, if any economists forecast falling unemployment in 2015 and while the strong recent growth numbers are unlikely to continue, it is difficult to see an unemployment rate above 6.5% in 2016, as was previously widely predicted.

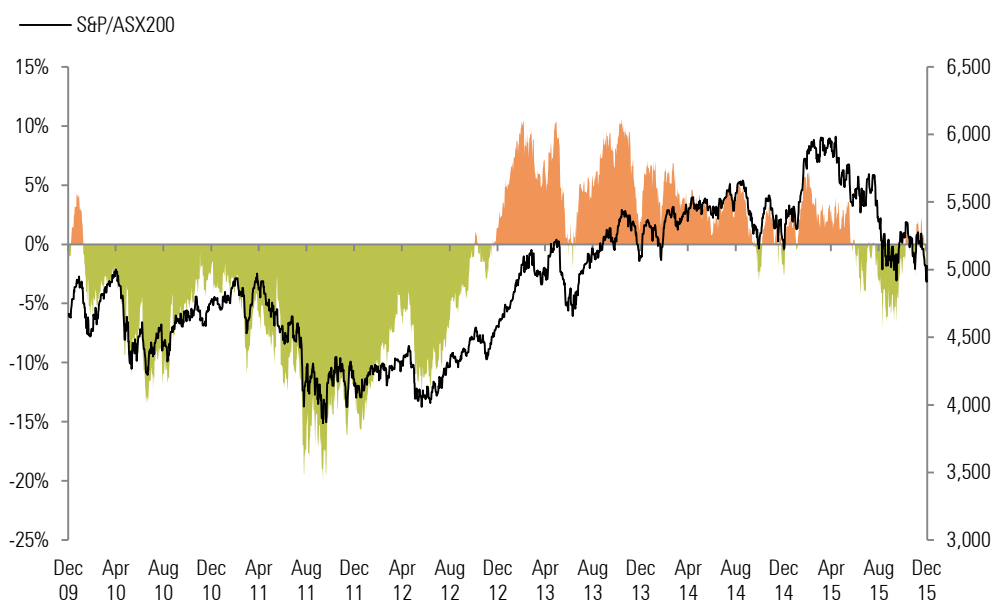
Residential construction activity should peak in 2016. Macro-prudential measures, interest rate increases outside official changes as a result of increased capital costs, and a moderating intensity of Chinese buying will see housing prices consolidate, not crash. The infrastructure pipeline, with a strong emphasis on transport, has a much longer pipeline. Again, New South Wales leads the pack, recycling utility and port assets into productive transport-related infrastructure to cope with strong increases in population.

The path of the Australian dollar through 2016 is difficult to predict. The weakening terms of trade would normally make the task easy. But there are many conflicting forces at play. It is not a one way street down to below AUD 0.65 against the U.S. dollar. After the U.S. tightening, the Fed will take a gradual approach to further tightening. The initial 25 basis points move will not move the interest rate differential needle. Growth in in-bound tourism, total foreign investment in residential, commercial and agricultural property, and mergers and acquisitions, or M&A, activity will be offsetting factors to interest rate differentials or a further weakening in the terms of trade driven by lower commodity prices. Further rate cuts would clearly assist further weakening in the currency, but not necessarily against the euro or yen.

Australian Equities Market Outlook for 2016

- ▶ We estimate the Australian equity market is currently marginally undervalued trading at 0.98 times the aggregate market fair value based on our bottom-up earnings forecasts.
- ▶ We estimate the Australian equity market is trading on a prospective 2016 P/E ratio of 15.7 times and in 2017 of 14.6 times relative to the 10-year long run average of 13.4 times.

Exhibit 1 Average Premium/Discount to Fair Value of Morningstar Coverage Universe and S&P/ASX 200 Index (to 16 December 2015)



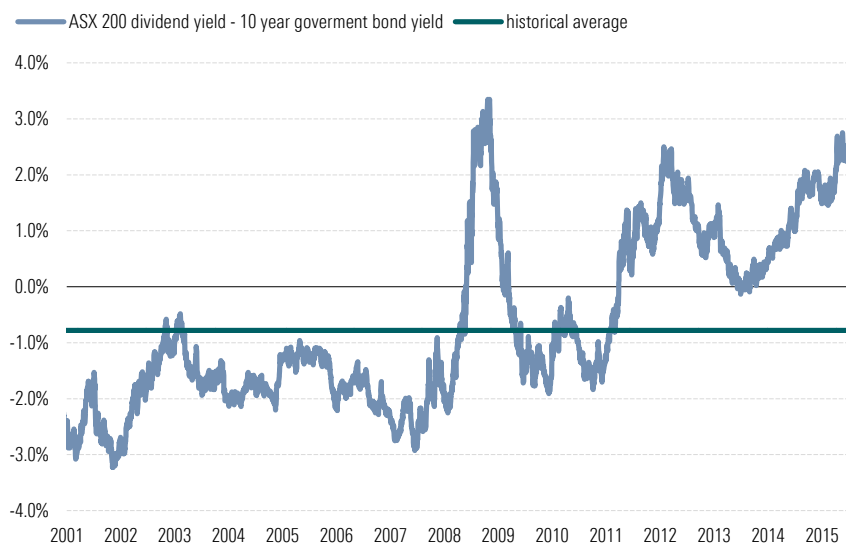
Source: Morningstar

- ▶ Based on our company earnings forecasts, those sectors with a positive 2016 earnings outlook include Banks, Diversified Financials, Gaming, Healthcare, Other Industrials and Infrastructure. Some of these sectors though are not cheap such as Infrastructure and hence we would look for pullbacks in the respective share prices before adding or increasing exposure.
- ▶ Those sectors with a negative 2016 earnings outlook include Metals and Mining, Oil and Gas, and Mining Services, and while some companies may look attractive on a share price/estimated fair value basis, we still would still remain cautious and underweight these sectors. The Retail sector while it too is forecast to have a negative 2016 earnings outlook, has pockets of value such as Woolworths which is trading well below our fair value on a medium-term view.
- ▶ We continue to view companies with U.S. dollar earnings positively such as Brambles, CSL, Resmed and Fisher and Paykel Healthcare.
- ▶ We see the risk to our 2016 equity market outlook is the end of the global interest rate easing cycle and a return to a tightening bias, albeit gradually over a number of years. This would potentially result in a reassessment of the risk-free rate used in our weighted average cost of capital assumptions for our fair value estimates as well as investors cycling out of defensive stocks and those with high debt levels to consumer cyclicals. We highlight that we have

experienced similar thematic sector reweightings a few times in the last two years as during the March 2015 period displayed in Exhibit 3, but the realisation that increases in interest rates will take years, and with the defensives delivering on strong dividend growth, meant that the previous reweightings were premature.

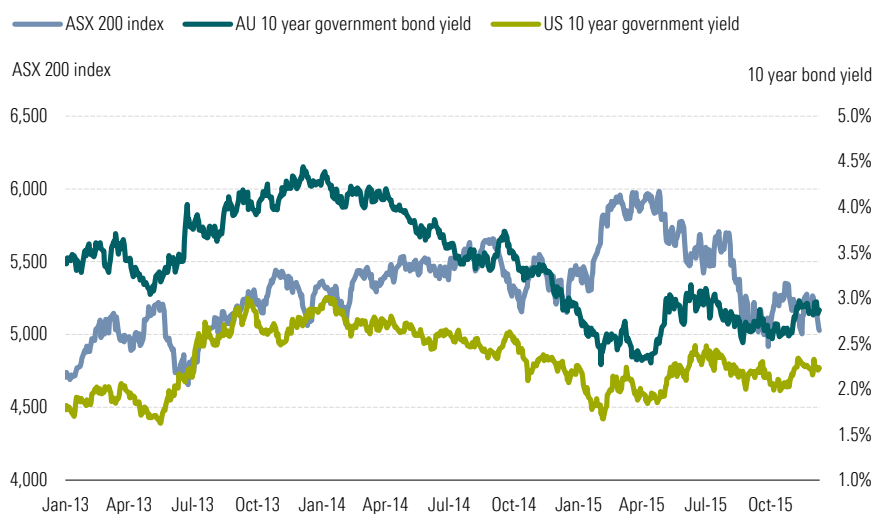
- Dividend yields relative to bonds remain attractive. We estimate the S&P/ASX 200 is currently trading on a prospective 2016 dividend yield of 4.6% and 2017 dividend yield of 4.9%, relative to the 15-year long run average of 4.3%. We estimate the S&P/ASX 200 is trading on a historical nominal dividend yield to 10-year bond yield gap of 2.3 times relative to the 15-year long run average of negative-0.8 times as shown in Exhibit 2. Realistically, until we see a sustained rising interest rate environment, the dividend yield to bond yield gap should remain positive.

Exhibit 2 ASX 200 Nominal Dividend Yield and 10-year Government Bond Yield



Source: Morningstar estimates, Reuters

Exhibit 3 Correlation of ASX 200 Index and 10-year Government Bonds



Source: Morningstar estimates, Reuters

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Economic/Interest Rate Outlook

Key Themes for 2016

- ▶ We anticipate a continuation of below trend economic growth of about 2.5% during 2016, supported by a steady unemployment rate of about 6.0%, and benign inflation of approximately 2.0%.
- ▶ Investors will continue their "search for yield", amid a backdrop of a continued low cash rate which we expect to remain at 2.0% during 2016.
- ▶ Key downside risks to our outlook include a hard landing in China and a housing market crash domestically. Key upside risks include a rebound in China and a faster-than-anticipated domestic transition away from the mining economy.

Challenging Domestic Economic Environment Ahead, but Economy Should Prove Resilient

- ▶ The transition away from the mining to the nonmining economy should continue to play out, albeit slowly. A lower Australian dollar should provide some support to trade-exposed industries such as tourism, agriculture, education, and manufacturing.
- ▶ We anticipate a continued shift from a capital-intensive, goods-based economy to a labour-intensive, services-based economy. This should continue to support employment at the expense of capital expenditure.
- ▶ A low interest rate environment with capacity for further cuts, a lower Australian dollar compared to previous years, a stable inflation environment, and improving employment, should provide some support to the domestic economy in the event of any negative surprises.

Government Bond Yields and Corporate Spreads to Grind Higher

- ▶ We expect the 10-year Australian Government yield to maintain its long-time correlation with the U.S. 10-year yield and trade near 3.0% during 2016.
- ▶ We believe domestic issuer credit profiles will weaken, but remain resilient. They should continue to be able to efficiently access required funding, albeit at a higher cost than previous years.
- ▶ We expect corporate spreads to widen as credit conditions become less favourable than recent years. The Australian iTraxx Index, currently trading at about 130 basis points, should continue to display volatility around current levels and end the year higher.

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Banks

Well-Placed to Leverage Subdued Economic Conditions and Dividend Yields Remain Attractive

Earnings Outlook: Positive

Key Themes for 2016

- ▶ Operating conditions remain challenging but the outlook for earnings and dividend growth is more positive following better-than-expected recent economic news (unemployment, gross domestic product, building approvals, and credit growth), and the recent initiatives to strengthen balance sheets.
- ▶ The risks of a major recession in Australia are receding as key nonresource industries (tourism, construction, education, health, and professional services) benefit from low interest rates and a lower Australian dollar, particularly in the more populated and prosperous areas of New South Wales, Victoria, and south-eastern Queensland.
- ▶ If the economy enters a sustained recession, bad debts will increase, profits will fall, and dividends will be cut. However, this is not our base case.

Despite Widespread Doom and Gloom, the Outlook for the Major Banks is Positive

- ▶ Bank balance sheets are growing. The economy is 2.5% larger than a year ago, credit growth is a healthy 6.7%, deposits are up 10%, and repricing will support net interest margin expansion.
- ▶ Bad debts are likely to remain benign as a result of historically low interest rates, stable unemployment, and robust demand for both residential and commercial property. That said, the four major banks are exposed to a collapse in residential property prices, particularly Commonwealth Bank and Westpac. ANZ Bank is most exposed to weakness in the commodity and agricultural sectors.
- ▶ We forecast flat average EPS growth in fiscal 2016 as a result of recent capital raisings before increasing to between 4% and 5% from fiscal 2017 based on solid credit growth (5%–6% per annum), improving net interest margins, and improved cost-to-income ratios.

Most/Least Preferred Stocks in the Sector

- ▶ CBA is our preferred major bank despite ANZ having the largest discount to fair value of the four major banks. We believe ANZ's higher risk profile, Asian growth strategy, lower shareholder returns and CEO transition preclude it as our preferred major bank.
- ▶ Commonwealth Bank is trading at a 13% discount to our AUD 91.00 fair value estimate. It is the least risky major bank, has the highest return on equity, is conservatively managed, Australia and New Zealand-focused, benefits from large market shares, and boasts a lower risk loan book and a sustainable and attractive fully franked dividend.

Active Recommendations (as at 16 December 2015)

Table Recommendations (as of 30 December 2017)																
Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
ANZ Banking Group ANZ	AUD	Buy	Wide	Medium	260.3	264.4	274.3	2.7	186.0	194.0	100%	9.8	7.2%	26.01	38.00	0.68
Commonwealth Bank CBA	AUD	Accumulate	Wide	Medium	560.9	563.4	596.5	3.2	425.0	447.0	100%	14.0	5.4%	79.09	91.00	0.87
National Australia Bank NAB	AUD	Accumulate	Wide	Medium	227.6	254.2	260.1	7.0	200.0	203.0	100%	11.2	7.0%	28.38	36.00	0.79
Westpac Banking Corporation WBC	AUD	Accumulate	Wide	Medium	249.5	252.3	266.5	3.4	189.0	195.0	100%	12.5	6.0%	31.46	38.00	0.83

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Insurance

General Insurers should achieve Solid Earnings Growth Despite Tough Competition

Earnings Outlook: Neutral

Key Themes for 2016

- ▶ The short term outlook for general insurers is challenging, with stiff competition from both traditional and online rivals exerting pressure on pricing, slowing gross written premium growth, and trimming insurance margins for general insurers. The focus on claims management, productivity improvement and integration benefits partially offset weaker headline revenue growth.
- ▶ Natural disasters continue to impact claims costs but lower reinsurance rates partially offset.
- ▶ Solid revenue and earnings growth for health insurers as a result of favourable regulatory structure.
- ▶ Higher U.S. interest rates in 2016 will support investment returns, particularly for QBE Insurance.

Health Insurers Provide Lower Earnings Risk than More Volatile General Insurers

- ▶ The outlook for top-line premium growth for general insurers is soft in the short term, but we remain positive the general insurance pricing cycle will turn up (harden) later in 2016, providing support for 2017 and 2018 earnings.
- ▶ The health insurers are well placed, benefiting from demographic tailwinds and a highly regulated, highly profitable industry structure and will continue to vigorously improve operational efficiency to support earnings growth.
- ▶ Insurers under our coverage continue to strengthen their businesses, with cost ratios declining, surplus capital building, and claims provisions increasing.

Most/Least Preferred Stocks in the Sector

- ▶ QBE Insurance is the most preferred, trading at a 34% discount to our fair value estimate. We forecast QBE will deliver above sector average EPS growth at 21% in 2016 and 15% in 2017, driven by productivity improvements, cost outs and tighter claims management. We are confident the focus on restructuring, tightening underwriting standards, cost-outs and improving operational efficiency will deliver sustainable earnings and dividend growth. QBE Insurance's new management team is turning the business around, and we expect the ongoing transformation and de-risking to deliver more benefits to the balance sheet and earnings quality.
- ▶ Insurance Australia Group is our least preferred general insurer as it is most exposed to the industry headwinds of increasing competition, a slowdown in gross written premium growth, and higher claims costs. Exposure to natural peril events, a new CEO, a recent organisational restructure, and increasing exposure to Asia, all create uncertainty which could impact future earnings.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
QBE Insurance QBE (FY15 forecast)	AUD	Accumulate	Narrow	High	91.0	110.4	127.0	18.1	71.0	83.0	100%	13.1	6.0%	11.9	18.00	0.66
Steadfast Group SDF	AUD	Accumulate	None	Medium	9.8	11.1	11.8	9.7	6.0	6.5	100%	13.0	4.2%	1.44	1.80	0.80
Insurance Australia IAG	AUD	Hold	None	Medium	42.3	41.3	44.8	2.9	29.0	31.0	100%	12.8	5.5%	5.28	6.00	0.88

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Diversified Financials

Asset Managers Should Deliver Impressive EPS Growth and Offer Attractive Dividend Yields

Earnings Outlook: Positive

Key Themes for 2016

- Compulsory superannuation contributions, scheduled to increase from 9.5% currently to 12% by fiscal 2025, will continue to underpin inflows into the asset management industry. At 30 September 2015, superannuation assets in Australia totalled AUD 2 trillion, growing by 11% compound in the last five years. We expect growth to slow in 2016.
- We expect total equity market returns of 8% per annum for international equities and 7.5% per annum for Australian equities in the next few years. In comparison, in the year to 30 November 2015, the S&P/ASX 200 Accumulation Index returned 1.9% while the MSCI AC World Net Index in Australian dollars increased 14.9%. In our view, asset managers will continue to diversify offshore and Australian dollar distributions from unhedged funds will benefit from a weak Australian dollar. Platinum Asset Management and Magellan Financial Group are well-placed.
- We do not expect significant pressure on fees for the large competitively advantaged active investment managers. Investment managers with impressive investment performance track records and strong brands should be able to largely maintain fee structures. We also view "robo" advice as more an opportunity than a threat, initiating relationships with investors.
- Mergers and acquisitions activity will likely slow after overseas buyers take out Veda and OzForex. The ASX would fit nicely with foreign stock exchanges, but foreign ownership restrictions preclude a deal. IOOF Holdings is more likely to continue consolidating smaller players in advice and administration rather than become a target.
- Outsourcing of fund administration will continue to drive margin expansion at some asset managers and prove a continued opportunity for administration companies like Link.
- While our base case assumes continued growth in the Australian economy with real GDP of 2.5% in 2016, we highlight that of the investment managers, Perpetual is most highly leveraged to weaker-than-expected conditions with 75% of assets in Australian equities. Global managers such as Platinum, Magellan, and BT Investment Management are the least exposed.

Most/Least Preferred Stocks in the Sector

- AMP is trading at a 21% discount to our estimated DCF-based fair value and Platinum at a 10% discount. The sector offers attractive dividend yields with AMP trading on a 2016 yield of 5.8% with 80% franking, and Platinum at 5% with 100% franking and potential for special dividends.
- Outside of asset managers, Computershare is attractive trading at a 20% discount to our fair value with forecast EPS growth of 9.4% compound in the next two years and the potential for capital management initiatives. Link, at a 35% premium to fair value is our least preferred.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
AMP (AMP) (FY15 forecast)	AUD	Accumulate	Narrow	Medium	38.6	41.5	44.2	7.0	32.0	34.0	80%	13.3	5.8%	5.51	7.00	0.79
Computershare CPU	AUD	Accumulate	Narrow	Medium	71.0	77.5	84.9	9.4	32.0	34.0	20%	14.5	2.8%	11.23	14.00	0.80
Platinum Asset Management PTM	AUD	Accumulate	Narrow	Medium	36.7	41.3	46.9	13.0	38.0	42.0	100%	18.6	5.0%	7.67	8.50	0.90
Link Admin Holdings LNK	AUD	Reduce	Narrow	Medium	n/c	26.6	30.8	n/c	7.4	17.0	0%	27.8	1.0%	7.4	5.50	1.35

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Telecommunications

Mobile Competition to Heat Up, but Dividend Yield Remains Attractive

Earnings Outlook: Neutral

Key Themes for 2016

- Transformation from a legacy model to a multiline, service-focused one will continue for the incumbents. During the past five years, fixed voice revenue has fallen 30% for Telstra Corporation and 33% for Spark New Zealand. Consequently, mobile growth, product-bundling and differentiation are likely to be key, and will lead to further activities in content, connectivity and infrastructure.
- Mobile competition in Australia is likely to step up amid full saturation (even smartphone penetration has reached 85%). Having gained 1.9 million subscribers in the past five years and with a market share of 54% (up from 41% five years ago), Telstra will find growth harder to achieve in 2016, as Optus and Vodafone improve network quality/coverage and offerings. As such, performances of Telstra's emerging businesses will attract even greater scrutiny.
- After a whirlwind of M&A activity recently, we anticipate a year of "knuckling down" at the junior end. TPG Telecom needs to integrate iiNet and M2 Telecommunications will be absorbed into Vocus Communications, with both needing to deliver on bullish synergy expectations (up to AUD 100 million for TPG/iiNet and AUD 40 million for Vocus/M2).
- Our base-case scenario assumes real GDP in Australia in 2016 of 2.5% and 2.3% in New Zealand, but we highlight our sensitivity analysis shows telecommunications companies would be one of the most resilient in an economic downturn relative to other sectors, with EPS declining by only about 10% from current estimates. We also note most companies in the sector have solid balance sheets, providing dividend security in a downturn. Furthermore, telecommunications services are increasingly exhibiting a staple characteristic.

Most/Least Preferred Stocks in the Sector

- Telstra is our most preferred stock. It is not only trading at an 11% discount to our fair value estimate, but the dividend is secure on the back of Telstra's prodigious free cash generation. This is important as we believe the 5.9% yield will continue to be an important feature in what is likely to remain a low earnings growth environment for corporate Australia.
- For similar reasons, we rank Spark New Zealand as our second most preferred stock in the sector as a result of its attractive 7.0% yield, backed by solid cash flow, despite subdued earnings outlook.
- Our least preferred stock is TPG Telecom, purely on valuation grounds. While management has a stellar track record of growth, shares in TPG Telecom are trading at a ritzy 19% premium to global telecommunications company and 24% above our fair value estimate of AUD 8.00.

Active Recommendations (as at 16 December 2015)

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					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Telstra TLS	AUD	Accumulate	Narrow	Medium	34.3	35.1	35.4	1.6	31.5	32.5	100%	15.2	5.9%	5.33	6.00	0.89
Spark New Zealand SPK.NZ	NZD	Hold	Narrow	Medium	20.0	18.8	18.6	-3.6	22.0	22.0	100%	16.8	7.0%	3.15	3.10	1.02
TPG Telecom TPM	AUD	Reduce	Narrow	Medium	28.2	38.1	40.4	19.7	15.0	18.0	100%	26.0	1.5%	9.92	8.00	1.24

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Media

Urge to Merge to Boil Over Amid Challenging Fundamentals

Earnings Outlook: Neutral

Key Themes for 2016

- Potential liberalisation of archaic rules governing the sector is likely to dominate headlines, with cross-media, audience reach, and antisiphoning restrictions all set to be scrutinised. This has the potential for share prices of domestic media companies to diverge from our fair value estimates. The "urge to merge" will be driven by structural headwinds buffeting traditional media, with consumer preference and advertising expenditure set to continue migration to digital platforms.
- In the past five years, advertising spend on traditional media has declined by an average of 19% per annum, with newspapers particularly hit hard. We expect the market decline to be down another 3% in 2016, although the Rio Olympics may add 2% to 3% in incremental growth. In contrast, digital advertising has enjoyed a compound annual growth of 21% in the past five years. Exposure to this space can be meaningfully gained via Seek, Carsales.com and REA Group.
- Aside from positioning for corporate action, management focus is likely to be on cost base recalibration in response to the challenging revenue outlook. However, the strategy of cost-cutting to prosperity is unsustainable, and we believe astute investment in content and technology is critical to maintaining and monetising audience longer term.
- Although our base case assumes real GDP in Australia of 2.5% in 2016, our sensitivity analysis highlights Fairfax Media and Seven West Media would experience the most profit deleverage if economic conditions were worse than expected, reflecting their high fixed costs and greater weightings towards the cyclically-sensitive print media. We estimate EPS could reduce by approximately 40% from current estimates if GDP growth turned negative.

Most/Least Preferred Stocks in the Sector

- News Corporation is our most preferred stock in the sector given its 19% discount to our fair value estimate, with the quality of its print assets and financial strength underappreciated by the market. The stock will also benefit if the Australian dollar continues to weaken against the U.S. dollar.
- Nine Entertainment is our second most preferred stock. While the recent rally has catapulted the shares past our fair value estimate, the 7.5% yield remains attractive and Nine's strong net cash balance sheet position makes it a prime target if media ownership reform eventuates.
- Fairfax Media is our least preferred stock trading at a 21% premium to our fair value estimate. The market's obsession with Domain's value (we estimate it accounts for 59% of the group's enterprise value, despite representing just 32% of EBITDA) is not adequately balanced against Fairfax's still-substantial exposure to the traditional newspaper sector.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
News Corporation NWS	AUD	Accumulate	None	High	55.6	66.5	82.3	21.7	27.4	27.7	0%	29.1	1.4%	19.32	24.00	0.81
Nine Entertainment NEC	AUD	Hold	None	High	14.9	14.6	15.8	3.0	13.0	14.0	100%	11.8	7.5%	1.725	1.70	1.01
Fairfax Media FXJ	AUD	Reduce	None	High	6.0	6.6	6.6	5.1	5.0	5.2	50%	13.0	5.8%	0.86	0.71	1.21

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Technology/Professional Services

Technology Stock Performance Should Moderate Following Relatively Strong 2015

Earnings Outlook: Neutral (Technology)/Positive (Professional Services)

Key Themes for 2016

- The structural migration of Australian advertising, from print to online, will continue to slow in 2016 with online already comprising 80% of employment and 65% of real estate spending. Platform owners, REA Group, Seek, and Carsales.com, will bolster growth via product and geographic diversification, but we expect core revenue growth to slow from the average 16% compound growth in the past five years across online platforms to 8% in fiscal 2016, underpinned by real GDP growth of 2.5%.
- The slowing real estate market may negatively impact REA Group in calendar 2016. We forecast EPS growth to slow from 40% in fiscal 2015, which was boosted by fee increases to 9.5% in fiscal 2016, before overseas growth drives EPS up 17% in fiscal 2017.
- We expect software companies, including MYOB and Technology One, will continue to focus on migrating customers from locally hosted software to cloud-based software, and forecast underlying profit growth of approximately 20%, although we believe this is factored into share prices. The size of the market opportunity will result in increased competition, particularly from startups.
- Although our base case assumes the continuation of low-single-digit real GDP growth, we highlight most software platforms operate on high operating margins and low fixed costs and hence would be least affected should the economic environment deteriorate. Further, we note most companies in the space are not overgeared, which provides some comfort around capital raising risks. The outlier is SMS Management & Technology which operates on low-single-digit EBITDA margins and hence would be most negatively impacted.

Most/Least Preferred Stocks in the Sector

Slater & Gordon and G8 Education offer value, albeit with relatively high risks, following overreactions to negative announcements in 2015. Technology One and REA Group now appear overvalued, despite strong EPS growth potential. SMS and Reckon face structural headwinds which we expect to limit earnings growth.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)	Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2years	FY16	FY16F	FY16F	FY16F	FY16F	FY16F	FY16F
Slater and Gordon SGH	AUD	Buy	None	Very High	48.5	23.0	23.2	-30.8%	0.0	0%	4.7	0.0%	1.08	2.30	0.47
G8 Education GEM	AUD	Accumulate	None	High	18.6	23.3	26.2	18.7%	21.7	100%	14.2	6.5%	3.32	4.50	0.74
Seek SEK	AUD	Hold	Narrow	Medium	55.1	52.5	59.2	3.7%	34.0	100%	27.2	2.4%	14.30	13.00	1.10
Carsales.com CAR	AUD	Hold	Narrow	Medium	41.5	43.9	48.4	8.0%	37.0	100%	25.6	3.3%	11.23	11.00	1.02
REA Group REA	AUD	Reduce	Narrow	High	159.6	174.7	205.2	13.4%	96.2	100%	29.3	1.9%	51.10	43.00	1.19
Technology One TNE	AUD	Sell	Narrow	Medium	11.6	13.4	15.3	14.8%	9.0	100%	35.7	1.9%	4.79	2.90	1.65
SMS Management SMX	AUD	Hold	None	High	27.4	24.7	28.5	2.0%	18.0	100%	12.1	6.0%	2.99	2.70	1.11
Reckon RKN	AUD	Sell	None	Medium	14.1	14.6	15.1	3.5%	10.0	74%	16.4	4.2%	2.40	1.75	1.37

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Gaming

Bargain Hunting in Casino Space, While Consolidation Likely in Wagering

Earnings Outlook: Positive

Key Themes for 2016

- We expect a reversal of fortune for companies in specific subsectors. In casinos, Crown Resorts is likely to recover as negative sentiment on its Macau exposure subsides, while resilience is a feature of its domestic casinos. We forecast compound annual growth in EPS of 16% in the next two fiscal years, and expect the 35% discount to our fair value estimate to narrow. The Star Entertainment shares are due for a breather after a stellar year of earnings growth.
- Similarly, in pokies, we expect Ainsworth Game Technology to finally show signs of earnings bottoming in fiscal 2016 and enter a growth phase from fiscal 2017, as its new products gain traction with customers (especially in Australia). On the other hand, Aristocrat Leisure is likely to struggle to maintain the hyper earnings growth enjoyed in fiscal 2015 which was driven by organic share gains and a transformative acquisition of Video Gaming Technologies.
- In wagering, we believe Tabcorp and Tatts will reignite merger talks which is likely to be taken positively by the market. In our view, while there are clear strategic merits to combining, the desire to merge is also a tacit recognition of the ongoing structural uncertainties and unrelenting incursion of pure digital competitors into the space.
- Based on our sensitivity analysis, the gaming companies most affected should our base case economic GDP forecast of 2.5% in 2016 prove optimistic are Tabcorp and Tatts, reflecting their high fixed costs, compounded by continuing pressures from digital-only competitors.

Most/Least Preferred Stocks in the Sector

- Crown Resorts is our most preferred stock in the sector given its 35% discount to our fair value estimate. The quality of its domestic casinos is currently overshadowed by concerns over its exposure to Macau which we expect will stabilise in 2016.
- Ainsworth Game Technology is our second most preferred stock. While currently held back by weakness in Australia, we see earnings recovering strongly from fiscal 2017 onwards as recently unveiled new products gain traction, aided by continuing robust growth in the Americas.
- Our least preferred stocks are Tabcorp and Tatts, purely on valuation grounds. Despite the muted earnings growth outlook, shares in both companies are trading at approximately 25% premium to our fair value estimates as a result of anticipation of corporate action.

Active Recommendations (as at 16 December 2015)

Share Recommendations (as at 15 December 2019)																
Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Crown Resorts CWN	AUD	Accumulate	Narrow	High	72.1	83.2	96.1	15.5	40.0	42.0	50%	14.1	3.4%	11.77	18.00	0.65
Ainsworth Game Technology	AUD	Buy	Narrow	High	16.2	15.8	19.4	9.4	10.0	11.5	100%	13.8	4.5%	2.20	3.70	0.59
Tabcorp TAH	AUD	Reduce	Narrow	Medium	21.6	23.1	23.8	5.0	24.5	25.0	100%	19.5	5.4%	4.51	3.60	1.25
Tatts TTS	AUD	Reduce	Narrow	Medium	17.7	18.2	19.3	4.4	17.0	17.5	100%	23.2	4.0%	4.22	3.40	1.24

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Retail/Food and Beverage

Structural Headwinds to Continue into 2016 with Currency Pressuring Earnings

Earnings Outlook: Negative

Key Themes for 2016

- ▶ While consumer confidence has received a short-term boost from the "Turnbull effect", structural headwinds will continue into 2016. Traditional retailers are increasingly susceptible to the shift to online, fragmenting the market. Online in Australia and New Zealand represent 7% of total sales, however, listed retailers have been slow to embrace online at just 2%–3% of their sales.
- ▶ Imported cost pressures from the stronger U.S. dollar will create earnings headwinds for retailers in 2016, if the underlying retail conditions are not conducive to lifting selling prices. Both the Australian dollar and New Zealand dollar depreciated 13% against the U.S. dollar in 2015.
- ▶ Softer economic conditions in Australia will negatively impact consumer spending. While ABS retail sales figures grew 3.9% for the year to October, this is below the 12-month trend of 4.3%. The New Zealand economy remains reasonable but is slowing, leading to a decelerating trend in retail sales growth over two quarters to 4.4% for the year to September 2015.
- ▶ Within the Australian supermarket industry, the increasing trend towards lower prices will continue into 2016. The expansion of Aldi's store network is effectively driving structural changes in the industry. Aldi's store count is expected to jump by approximately 15%–20% in 2016 from 376 currently as they expand into South Australia and Western Australia.
- ▶ Based on our sensitivity analysis, those Australian retailers worst affected by a deterioration in economic conditions are Myer and JB Hi-Fi reflecting the high fixed cost nature of their businesses and inability to cut supplies quickly.

Most/Least Preferred Stocks in the Sector

- ▶ Our preferred stock is Woolworths trading at a 30% discount to our fair value estimate, whereas the least preferred are Domino's, ARB Corp and Treasury Wines all trading well in excess.
- ▶ In addition to the significant discount to fair value, Woolworths offers an attractive dividend yield at 6.0% in 2016 with 100% franking. We do not believe the current situation is terminal, but it does require changes in strategy and any transformation will take time. We have factored into our fair value the closure of Masters and continued supermarket market share loss for the next few years. Reducing grocery prices to close the margin between it and its competitors is positive but will clearly hurt short-term profitability. Announcements around the appointment of new management and the potential sale of Big W could be viewed positively by the market and may lead to a partial closing in the discount to fair value.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Woolworths WOW	AUD	Accumulate	Narrow	Medium	195.9	150.6	163.2	-8.7	140.0	140.0	100%	15.4	6.0%	23.26	33.00	0.70
The Reject Shop TRS	AUD	Sell	None	High	66.4	65.1	62.5	-5.9	39.0	37.0	100%	15.3	3.9%	9.98	6.00	1.66
ARB Corporation ARB	AUD	Sell	Narrow	Medium	57.8	64.5	71.3	23.4	32.3	35.6	100%	24.1	2.1%	15.53	11.00	1.41
Domino's Pizza Enterprises DMP	AUD	Sell	None	High	74.2	96.4	123.7	29.1	67.0	86.0	100%	55.4	1.3%	53.44	34.00	1.57
Treasury Wine Estates TWE	AUD	Sell	None	High	19.5	25.1	32.7	29.5	15.0	19.7	0%	32.2	1.9%	8.07	3.80	2.12

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Healthcare

Funding Risk, Geographic Diversification and Emerging Markets – Theme and Variations

Earnings Outlook: Positive

Key Themes for 2016

- We expect government funding risk to be a key issue in 2016 for domestic medical service providers given the systematic review of the Medicare Benefits Schedule, or MBS, which is expected to lead to cuts in the list of 5,700 items currently covered. Similarly, the recently commenced review of private health insurance raises some concerns about price setting in negotiations between private hospitals and private health insurers.
- We see the thematic of global diversification of healthcare continuing and becoming an advantage in 2016 for companies exposed to domestic funding risk, from both revenue and cost perspectives. Currency translation gains aside, we expect offshore earnings for Sonic Healthcare, for example, to provide an important buffer to changes in the MBS domestically. Similarly, we see global consolidation of procurement activity by Ramsay Health Care, and the leveraging of buying power at the local level, to drive savings in consumables as an important new dynamic which could lower costs by AUD 400 million over a two- to three-year period.
- We anticipate China and Asia to come into focus as healthcare players look to emerging markets for growth opportunities. The China-Australia Free Trade Agreement should support efforts by product manufacturers seeking to capitalise on demand from the rising middle class in China.
- Although the sector is trading at fair value overall, our positive outlook on healthcare remains intact. Ageing of the Australian population and the importance of the private sector in defraying the cost burden to government underpin defensive earnings in the event of economic downturn.

Most/Least Preferred Stocks in the Sector

- ResMed is our most preferred stock in the sector given its 19% discount to fair value. ResMed is a global innovative leader in terms of its product offering in the sleep apnea space, and well positioned given its Australian dollar-denominated cost base and U.S. dollar revenue.
- CSL is our second most preferred stock. At a 5% discount to our AUD 106.00 fair value estimate, we believe the market is underestimating the impact of its new Seqirus vaccine division and the upcoming launch of several new recombinant coagulation products.
- Primary Health Care is attractive given its 48% discount to our fair value. Our base-case factors in modest cuts in government funding, given its bulk billing model, and does not attribute any potential divestment of assets under new management's strategic review. Primary is addressing the issue of GP attrition with a new flexible acquisition strategy. We believe the discount to fair value will narrow should uncertainties related to GP numbers, pending positive news at the interim result, and the extent of funding cuts to MBS are removed in the next six months.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair ValueEst (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16	FY17F		FY16F	FY16F	FY16F		
ResMed RMD	AUD	Accumulate	Narrow	Medium	32.3	34.0	37.1	7.2%	13.9	15.2	0%	22.8	1.8%	7.74	9.50	0.81
CSL (CSL)	AUD	Hold	Narrow	Medium	316.8	430.9	505.7	26.3%	180.5	211.8	0%	23.4	1.8%	100.89	106.0	0.95
Primary Health Care PRY	AUD	Buy	None	Medium	23.3	22.8	23.3	0.0%	15.0	16.0	100%	10.2	6.4%	2.33	4.50	0.52

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Building Materials

Growth in Infrastructure Spend to Offset Slowdown in Housing

Earnings Outlook: Positive (though Australian housing starts appear to have peaked)

Key Themes for 2016

- Supported by strong housing activity, we are forecasting average earnings growth above 10% for the Building Materials sector (CSR 4.9%, James Hardie 29.8%).
- Australian housing starts year-to-date are currently running at approximately 225,000 and are forecast to fall to 215,000 in calendar 2016. Further out, we expect new housing starts to normalise at 170,000 by 2020, well above the average for the 30 years to 2015 of 150,000 per annum as household formation starts from current lows of 1.4 persons per new dwelling towards the long-term average of more than two persons per household.
- Infrastructure spending in Australia is forecast to remain flat in 2016 at AUD 16 billion before picking up in 2017, led by AUD 8 billion in roads spending. The majority of growth is on the east coast, with Western Australian volumes still under pressure (negative 2%). Boral is best positioned for the infrastructure upswing (65% of earnings).
- New Zealand housing and infrastructure is forecast to remain strong, although the Christchurch re-build is winding down. Fletcher Building has guided to 10%–15% earnings growth in 2016.
- We are very bullish on U.S. housing and expect 19% CAGR growth between 2015 and 2019. Morningstar's U.S. building materials team expects single family starts in the U.S. to increase from 715,000 in 2015 to 1.425 million in 2019, before reverting to 975,000 in 2024. As well, alterations and additions spend is expected to grow by 5.6% per annum between 2015 and 2019.
- While our base case assumes real GDP growth in the range of 2%–3% in the next two years in both Australia and New Zealand, Boral would be worst affected should economic conditions deteriorate while CSR in our view given its diversification and sensitivity analysis and James Hardie, given its U.S. housing exposure would be least exposed.

Most/Least Preferred Stocks in the Sector

- We prefer CSR and Fletcher Building, given their valuation discounts, 6% plus dividend yields, and reasonable price/earnings to growth, or PEG ratios. We consider Boral and James Hardie to be overvalued, although James Hardie has a low PEG ratio and strong operating leverage to a resurgent U.S. housing market.
- Potential catalysts for a positive rerating and a narrowing of the valuation gap of CSR include higher aluminium prices and/or housing construction surprising on the upside. Boral and James Hardie could be negatively impacted by greater competition and a slowdown in U.S. housing, which could remove premiums to fair value.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Boral BLD	AUD	Hold	None	Very High	31.6	33.4	37.9	9.6	22.0	25.0	100%	16.1	4.1%	5.39	4.90	1.10
CSR CSR	AUD	Accumulate	None	High	29.0	29.9	31.8	4.9	22.0	23.0	0%	9.0	8.2%	2.68	3.20	0.84
James Hardie JHX	AUD	Hold	Narrow	High	51.7	61.0	65.8	12.8	35.6	38.9	0%	19.6	3.0%	15.36	14.50	1.06
Fletcher Building FBU.NZ	NZD	Hold	None	High	46.5	53.3	54.9	8.8	40.7	41.7	0%	11.2	6.2%	6.90	7.60	0.91

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Paper & Packaging and Other Industrials

Sector Well Placed to Benefit from a Strengthening U.S. Economy

Earnings Outlook: Positive

Key Themes for 2016

- We forecast low-single-digit real GDP growth in key regions with Australia at 2.5%–3% in the next two years and U.S. economic growth accelerating. Combined with efficiency gains, cost cutting and incremental market share gains in select high-margin product lines, we expect above sector average EPS growth in the next two years for Orora at 15% and Pact at 10.6% while Brambles is forecast at 6.4%. We view risk to earnings is weighted to the upside given the U.S. market accounts for close to 50% of the sector's earnings and U.S. economic growth may be better than expected.
- Brambles' predicts 1.9% earnings growth in 2016 and is held back by currency headwinds, although a solid U.S. recovery would similarly deliver upside risk. In 2017, we forecast EPS growth of 10.3%. We have factored into our earnings the benefit from its USD 1.5 billion capital expenditure spend while organic growth accounts and expected incremental new contract wins also drive EPS growth in 2017.
- Amcor, Orora, Pact and Brambles all have strong balance sheets with the average net debt/EBITDA ratio of less than 2 times, thereby creating scope for value-accretive acquisitions and/or capital management initiatives.
- Our base case assumes real GDP in Australia to remain within the 2.5%–3% band over the next two calendar years. That said, based on our sensitivity analysis Orora would be most negatively impacted should economic conditions deteriorate given 70% of its earnings are leveraged to the domestic economy and its 60% fixed cost base. The geographical diverse earnings bases of both Amcor and Brambles should protect earnings to some degree from economic conditions in Australia.

Most/Least Preferred Stocks in the Sector

- We prefer Brambles in the sector given its 10% discount to our estimated fair value and its leverage to a strengthening US economy. We also highlight Brambles is valued as a U.S. dollar company and hence our estimated fair value when translated to Australian dollars, benefits from a weak Australian/U.S. dollar exchange rate.
- Amcor is our least preferred in the sector, trading at a 8% premium to our estimated fair value and we forecast less than sector average EPS growth in the next two years at 3.2%.
- Orora is also rated a Reduce and is trading at a 21% premium to our estimated fair value, albeit we highlight it is forecast to achieve 12.8% compound EPS in the next two years.

Active Recommendations (as at 16 December 2015)

Share Recommendations (as of 30 December 2017)																
Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Amcor AMC	AUD	Hold	Narrow	Medium	55.5	54.4	59.1	3.2%	54.4	59.1	0%	23.7	4.2%	12.90	12.00	1.08
Orora ORA	AUD	Reduce	None	Medium	11.0	12.8	14.0	12.8%	9.0	9.0	0%	17.3	4.0%	2.18	1.80	1.21
Pact PGH	AUD	Hold	None	Medium	16.8	35.0	39.1	52.6%	20.0	20.0	0%	13.3	4.3%	4.65	4.60	1.01
Brambles BXB	AUD	Accumulate	Wide	Medium	47.8	55.4	61.4	13.3%	34.0	42.0	20%	17.1	3.3%	10.85	12.00	0.90

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Transport

Mining Downturn will Continue to Drag on Rail/Road Transport Stocks

Earnings Outlook: Neutral/negative for mining exposed transports. Positive for airlines

Key Themes for 2016

- Our base case is for real GDP growth in Australia of 2.5% in 2016 and 3% in 2017, which should support low-single digit growth in containerised trade volumes and general freight movements.
- Listed companies in the transport sector (excluding airlines), are more exposed to the resources sector and infrastructure capital projects. With resource related infrastructure projects essentially complete and new projects deferred, the ability to replace earnings with civil infrastructure projects may prove difficult in the short to medium term.
- The impact of the significant declines in resource commodity prices on export volumes especially for coal and iron ore in our view is yet to play out as a result of take-or-pay contracts. Unless there is a material and sustainable increase in commodity prices, there is a real risk contracts will need to be renegotiated. The transport company most negatively affected is Aurizon with 90% of its earnings exposed to the coal industry. It will aim to ensure any renegotiation is net present value neutral, but short- to medium-term earnings would presumably reduce, and any cost and efficiency initiatives may not be sufficient to offset the impact.
- Given Asciano and Qube's more diversified earnings base they should be less affected by commodity-based take-or-pay contract renegotiations than Aurizon. Further, the machinations surrounding the bid for Asciano may mean underlying earnings are a side-show to corporate activity announcements.
- Australasian airline company earnings in the next two years will continue to benefit from low jet fuel prices which generally comprise between 25% and 30% of operating costs; rational seat capacity decisions in the domestic Australian market by Qantas and Virgin, and the continued focus on driving operational efficiencies. Our forecasts assume oil prices revert to USD 66/bbl by 2018 but with current prices below USD 40/bbl, the risk to earnings is weighted to the upside.

Most/Least Preferred Stocks in the Sector

- Our preferred stock is Qube, trading at a 19% discount to our estimated fair value. Despite near-term headwinds, the medium-term outlook for the integrated logistic provider is sound, underpinned by the Moorebank Intermodal terminal.
- Asciano's price is well above our assessed valuation reflecting a takeover premium. The Board recommendation and Australian Competition & Consumer Commission decision will dictate how the stock will perform.
- While the airlines are trading close to fair value, the risk is to the upside if low oil prices persist.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Qube Holdings QUB	AUD	Accumulate	Narrow	Medium	10.0	10.1	10.6	3.0	6.0	6.0	100%	22.5	2.6%	2.27	2.80	0.81
Aurizon AZJ	AUD	Hold	Narrow	Medium	28.2	28.6	30.8	4.5	26.0	29.0	35%	17.6	5.2%	5.03	5.50	0.91
Asciano AIO	AUD	Sell	Narrow	Medium	42.5	43.8	46.2	4.3	24.0	25.0	100%	20.1	2.7%	8.81	6.50	1.36
Air New Zealand AIR.NZ	NZD	Hold	None	Very High	30.9	46.7	36.7	9.0	20.0	17.0	100%	6.1	7.0%	2.87	2.80	1.03
Qantas QAN	AUD	Hold	None	Very High	31.3	58.0	55.0	33.5	12.0	13.5	0%	6.6	3.2%	3.80	3.60	1.06

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Property/REITs

Volatile Sales Trajectory Expected to Slow Along with Rents in the Medium Term

Earnings Outlook: Neutral

Key Themes for 2016

- ▶ The combination of low-single-digit GDP growth, nearly full occupancy for most property classes (except office) and prudent use of hedging support our forecasts the property sector will grow earnings and distributions moderately in the coming two years.
- ▶ Most property firms have hedged 60%–70% of near-term debt and extended average debt terms to four to five years, guaranteeing low borrowing costs for at least the next two years. Companies with better credit ratings, such as Westfield and GPT Group have been able to push average debt maturities out further (6.2 years and 5.8 years, respectively).
- ▶ The relatively stable income stream generated by REITs and their high distribution yields has attracted significant inflows driving capitalisation rates (yields) to record lows. Consequently, REIT prices are now far more sensitive than usual to small changes in bond yields.

Retail Landlords

- ▶ Retail landlords are largely insulated, with all leases containing annual fixed or CPI-linked escalations. Relatively stable occupancy rates and modest annual sales growth of 2%–3% underpins our forecasts for annual rents to grow 2.5%–4.0% in the next two years.
- ▶ Landlords achieving higher rent growth have invested heavily to elevate the amenity and customer value proposition of their shopping assets (Stockland, Scentre Group, Mirvac) compared to smaller less resourced competitors.
- ▶ Occupancy is expected stay above 99% for larger, higher quality shopping centres, but slip slightly from 97% for neighbourhood assets as supermarkets cannibalise smaller, specialty retailers.

Office Landlords

- ▶ The Australian office market continues to face the challenge of oversupply in Sydney and Melbourne, with conditions far worse in Brisbane and Perth. Demand from the traditional white collar sector is waning and is a key reason why we are negative on the office sector.
- ▶ Vacancy rates in Brisbane and Perth are expected to rise modestly from already elevated levels putting further pressure on rents. Sydney's 6.3% vacancy rate is expected to increase to about 8% in the next two years as the significant supply under construction completes. Sydney rents are forecast to grow by approximately 4% per annum. Melbourne has only modest new supply hitting the market, but as most is precommitted, vacancy rates are expected to remain stable and we forecast rent growth in 2016 to average 3.0%.
- ▶ The key positive for office is rental yields are 1.0%–1.5% above comparable assets in the U.S., EU and Asia, which has led to significant inflows of offshore capital, pushing up asset values and depressing yields. Offshore demand should remain robust while bond yields are low, but "hot" capital will exit as bond yields rise, weighing heavily on office values.

Most/Least Preferred Stocks in the Sector

- ▶ All property classes will be impacted by the eventual rise in bond yields, so investors should focus on firms with sustainable rental growth and a long debt maturity profile. Our preferred exposures are Goodman Group, Westfield Corporation and Folkestone Education Trust.
- ▶ Goodman Group is attractive as roughly 70% of earnings are annuity style, derived from rent (55%) and fund management income (15%). Goodman is trading at an 16% discount to our estimated fair value.
- ▶ Westfield Corporation isn't immune to the threat of online competition, but its focus on being a premium retail destination supports high tenant demand, low vacancy and superior rent growth. We forecast a three-year distribution CAGR of 5.7%, with the stock attractively priced at a 11% discount to our AUD 11.00 fair value.
- ▶ Folkestone Education Trust's forecast fiscal 2016 distribution yield at 6.1% is one of the highest in the property sector with all leases incorporating annual CPI escalators, low vacancy risk, 100% occupancy, and an eight-year average lease term. The risk is a wind-back of government childcare incentives, but this is considered unlikely.

Active Recommendations (as at 16 December 2015)

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					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
Goodman Group GMG	AUD	Accumulate	Wide	Medium	36.9	39.0	41.4	5.8	23.8	25.0	0%	16.1	3.8%	6.28	7.50	0.84
Westfield Corporation WFD	AUD	Accumulate	Narrow	High	50.3	52.3	57.6	7.0	32.9	35.7	0%	19.4	3.4%	9.74	11.00	0.89
Folkestone Education FET	AUD	Hold	Narrow	High	13.3	13.9	14.3	4.0	13.4	13.8	0%	15.8	6.1%	2.20	2.30	0.96

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Utilities

Headwinds to Earnings but Dividend Growth Is Sustainable for Most

Earnings Outlook: Neutral

Key Themes for 2016

- Regulatory risk remains key in both Australia and New Zealand. AusNet Services, Spark Infrastructure and DUET Group all face regulatory resets in January 2016, with allowed returns on equity estimated to reduce from 10.3% to around 7.3% for the next five years. Lower interest rates will help offset some of the expected fall in revenue but the regulator will also cut interest expense allowances.
- APA Group is partly exposed to falling regulatory returns and is seeing softening demand on the Moomba Sydney Pipeline, but revenue will jump nearly 50% in fiscal 2016 on the recent BG pipeline acquisition, new contracts to accommodate LNG exporters, and other organic growth. Dilution from raising equity will keep EPS growth to near 10%.
- In the past five years, electricity demand declined on average by 1.5% per annum on east coast Australia. We expect demand will continue to ease in coming years, and this should limit wholesale electricity price growth. Nonetheless, AGL Energy should be able to drive earnings growth on cost-cutting and new products. With its LNG export business and oil and gas resources making up close to 50% of Origin Energy's business, it is highly exposed to the oil price. Following a 40% plunge in the oil price in the past year, Origin's earnings could roughly halve in fiscal 2016 despite commencing LNG exports. With gearing still high, Origin is the riskiest of the utilities.
- Prospects for the New Zealand utilities are improving with mothballing of thermal power stations supporting electricity prices. Futures markets suggest wholesale electricity prices will increase by about 10% by the 2019 winter. Nonetheless, headwinds from intense retail competition and oversupply of electricity following construction of geothermal and wind projects in recent years, will make earnings growth more challenging. Dividend yields are attractive and can grow, as capital expenditure requirements are minimal.

Most/Least Preferred Stocks in the Sector

Given utilities are mostly fairly priced, our preference is for moaty companies trading around fair value, such as APA Group and the dual-listed New Zealand utilities which offer attractive, sustainable dividends and growth rates. Least preferred is DUET given higher business risk following the Energy Developments acquisition and question marks over earnings quality, and AGL which is expensive. Origin appears cheap but is only for the highly risk tolerant.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
APA Group APA	AUD	Hold	Narrow	Medium	18.5	20.2	22.3	9.8	41.0	44.0	5%	41.7	4.9%	8.43	8.00	1.05
Origin Energy ORG	AUD	Accumulate	None	High	61.2	29.5	52.3	-7.6	20.0	20.0	0%	15.4	4.4%	4.53	7.00	0.65
Mighty River Power MRP.NZ	NZD	Hold	Narrow	High	10.4	11.8	13.6	14.4	14.0	15.3	100%	23.1	5.1%	2.72	2.90	0.94
Genesis Energy GNE.NZ	NZD	Hold	Narrow	High	9.1	9.7	10.5	7.4	16.4	16.9	70%	19.7	8.6%	1.91	2.20	0.87
Meridian Energy MEL.NZ	NZD	Hold	Narrow	High	8.2	9.3	10.5	13.2	19.1	20.0	58%	25.5	8.0%	2.38	2.20	1.08

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Infrastructure

Low Interest Rate Environment and Focus on Dividend Yields Should Provide Support

Dividend Outlook: Positive

Key Themes for 2016

- Our base-case forecasts assume 2016 real GDP growth of 2.5% for Australia and 2.3% for New Zealand and inflation of 2.4% and 1.8%, respectively. The resilient underlying economic fundamentals are expected to drive continued average traffic growth of 2%–3% for Australian toll roads, and domestic passenger growth of 1.8% through Sydney Airport and 3% for Auckland.
- With the expectation the Australian and New Zealand dollar will remain in the low USD 0.70s and USD 0.60s, respectively, in the next few years, this should stimulate international passenger arrivals into both countries and lead to a pickup in domestic travel while dampening resident international departures. Both airports will continue to benefit from growth in Chinese visitors.
- Infrastructure companies have taken advantage of favourable debt markets, by extending debt maturities and locking in largely fully-hedged low interest rates. With the prospect of interest rates remaining relatively low for at least the next year, even though the Fed may move to raise rates slightly, our near-term dividend distribution forecasts in our view are achievable.
- Any material lift in interest rates may result in asset price devaluations and a sector derating as investors cycle out of "defensive" yield stocks and those high debt levels. Our cash flow base-case forecasts factor in increasing interest rates over the life of the respective concession assets.

Toll Roads are More Defensive in an Economic Downturn than Airports

Although our base case scenario assumes the continuation of low-single-digit real GDP growth, we do highlight should either economy experience a sharp recession or even a soft landing, Transurban's Australian toll roads' cash flow will be more resilient than those of Australasian airports. While toll road traffic growth may slow, toll rate increases are pegged to either inflation or in some cases a minimum of 4% per annum. In the case of airports, historical data shows economic downturns negatively impact resident passenger movements and given revenue is predominantly levied per passenger, earnings deleverage can be more pronounced.

The Sector Remains Expensive but Our Preferred Stocks Are Transurban and Auckland Airport

- Transurban offers a diversified toll road portfolio, many which are part of an integrated network. A large portion of consolidated debt is assigned to specific assets and nonrecourse. We view distribution growth of 9.5% per annum as sustainable and the 4.5% dividend yield as attractive.
- Auckland Airport is viewed as an airport mini city, owning the airport asset as well as the surrounding land of which 308 hectares is still to be developed. While aeronautical returns are effectively regulated, we forecast returns above cost of capital. Capital management is prudent.

Active Recommendations (as at 16 December 2015)

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					FY15	FY16F	FY17F		2 year	FY16F	FY17F	FY16F	FY16F			
Transurban TCL	AUD	Reduce	Narrow	Medium	n/c	12.0	16.4	n/c	44.5	49.0	20%	82.8	4.5%	9.94	9.00	1.10
Auckland Airport AIA.NZ	NZD	Reduce	Wide	Medium	13.7	14.6	15.8	7.4	16.1	17.4	100%	32.8	3.0%	5.28	4.20	1.26
Sydney Airport SYD FY15 forecast	AUD	Sell	Narrow	Medium	n/c	9.8	12.3	n/c	25.5	29.0	0%	62.3	4.2%	6.11	4.90	1.25
Macquarie Atlas MQA (FY15 for	AUD	Reduce	Narrow	High	18.6	18.8	22.6	10.2	16.0	18.0	0%	21.7	3.9%	4.08	3.40	1.20

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Metals and Mining

The End of the China Boom Sees Headwinds for the Foreseeable Future

Earnings Outlook: Negative

Key Themes for 2016

- Demand for commodities is likely to be weak as China's fixed asset investment boom ends. Expect the oversupply of mining commodities to persist through 2016.
- Continued operating and capital cost cuts will feature as miners attempt to soften the headwind of lower commodity prices. Cost cuts to date have been faster and deeper than expected by us and the market. These efforts have lowered industry cost curves and underpin lower long-term prices. Industry cost cuts of about 10% are factored into our long-term prices, but further material cuts beyond this level will be negative for prices and earnings.
- Miners are in a vicious cycle of expanding volumes through efficiency to lower unit costs. Production discipline, through closures and output constraint is required. We may see closure of supply among the smaller, higher-cost and less well capitalised miners, particularly in iron ore and coal. The first signs are emerging of broader supply discipline with the Anglo American layoffs and BC Iron suspending iron ore production at Nullagine.
- Sustained cost cuts in iron ore and coal increase the risk prevailing low prices could persist. If this bear case plays out, there is a further 67% downside in Fortescue Metals, 51% in Rio Tinto, 34% in Whitehaven and 24% in BHP Billiton. We're most positive on the outlook for gold which is tied to growing consumption in India in particular, and in China to a lesser extent. Expect further near-term downside in copper and aluminium prices as demand from China weakens.
- Resources are largely unaffected by the Australian economy, though there may be a correlation if the mining bust drives a local recession. Our sensitivity analysis shows Fortescue Metals and Arrium would be worst affected if our Australian real GDP 2016 of 2.5% and/or China infrastructure asset spend is weaker than expected. Both rely on iron ore and carry significant debt. The least affected are the gold miners Newcrest Mining and Regis Resources. Gold is tied to consumption, particularly in emerging markets, not fixed asset investment.

Most/Least Preferred Stocks in the Sector

Iluka Resources, BHP Billiton and Newcrest Mining are trading at the largest discounts to our fair value estimates, while Fortescue, Sandfire Resources and Mineral Resources all trade at substantial premiums. BHP Billiton, Rio Tinto and Iluka all have high forecast yields. However, we caution there is meaningful risk around those dividends should the outlook deteriorate.

Active Recommendations (as at 16 December 2015)

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					FY15	FY16F	FY17F	2 year	FY16F	FY17	FY16F	FY16F	FY16F		
Iluka Resources ILU (FY15)	AUD	Buy	Narrow	High	28.8	30.0	47.0	27.8	30.0	30.0	100%	17.8	5.35	9.00	0.59
Newcrest Mining NCM	AUD	Accumulate	None	High	66.8	19.6	39.8	-22.8	0.0	0.0	0%	64.2	0.0%	12.59	0.74
BHP Billiton BHP	AUD	Accumulate	None	High	139.3	44.9	89.9	-	140.4	143.0	100%	38.2	8.2%	17.18	0.75
Fortescue Metals Group FMG	AUD	Sell	None	Very High	12.1	13.1	15.8	14.3	1.7	2.0	100%	14.5	0.9%	1.90	1.90
Mineral Resources MIN	AUD	Hold	None	Very High	51.9	30.9	27.9	-	20.0	20.0	100%	13.1	4.9%	4.06	1.16
Sandfire Resources SFR	AUD	Reduce	None	Very High	54.3	38.1	28.1	-28.1-	22.9	16.8	0%	13.7	4.4%	5.23	1.31

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Oil & Gas

Focus Will Be on Cost-outs, Mergers and Acquisitions

Earning Outlook: Negative Near-Term

Key Themes for 2016

- ▶ All signs point to a harsh near term with producer cost-cutting delaying volumes exiting an oversupplied market.
- ▶ The focus on operational efficiency will continue with energy expansion plans firmly on the back-burner while oil prices wallow. Assets will be run for cash.
- ▶ Vulnerabilities like Santos' now bolstered balance sheet may attract still more opportunistic takeover bids, like Woodside's aborted tilt at Oil Search. Buying assets is cheaper than building them in the current malaise for companies with a longer-term outlook.
- ▶ If oil prices head lower still, more indebted companies like Oil Search, Santos and AWE Limited may require additional equity topups, or may succumb to opportunist bids from the financially stronger companies such as Woodside.
- ▶ There is light at the end of the tunnel with the current sub-USD 50 per barrel Brent oil price insufficient to incentivise replacement energy capacity that will ultimately be necessary. Our long-term oil price forecast remains at USD 70 per barrel from 2018.

Lower for Longer Oil Would Hit Leveraged and Higher Cost E&Ps Hardest

Based on our sensitivity analysis, the Australian oil and gas names least affected by a sustained AUD 50.00 per barrel oil price are Caltex and Z Energy, reflecting their exposure to the retail fuel margin (cost pass-through to customer). Least impacted of the larger exploration and production names would be Woodside which would suffer a 38% decline in fair value to AUD 20.00 courtesy of no debt and low operating costs. Worst affected would be Santos, fair value down 46% to AUD 3.50, as a result of slightly higher operating costs and still comparatively high debt. Smaller names like Beach Energy and AWE would suffer the worst cash flow impact as a result of high operating costs. More of their fair value is in exploration potential.

Most/Least Preferred Stocks in the Sector

- ▶ We forecast Santos to double its EPS in the two years and with it trading a 47% discount to our fair value estimate, it is our preferred stock. Woodside is also undervalued and its dividend yield is attractive.
- ▶ The least preferred stocks are Caltex and Z Energy, trading in excess of our fair value estimates.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F			
AWE Limited AWE	AUD	Buy	None	High	-9.8	-5.9	-3.2	-ve	0.0	0.0	0	-ve	0.0%	0.53	2.10	0.25
Beach Energy BPT	AUD	Accumulate	None	Very High	6.9	-0.3	-0.5	-ve	1.5	1.5	100	-ve	3.3%	0.46	0.90	0.51
Caltex CTX (FY15 forecast)	AUD	Reduce	None	High	196.7	194.5	205.9	2.3	101.0	107.0	100	17.5	2.9%	34.45	25.00	1.38
Oil Search OSH (FY15 forecast)	AUD	Hold	None	Very High	41.5	36.1	43.3	2.1	18.0	21.6	0	15.0	3.0%	6.22	6.00	1.04
Santos STO (FY15 forecast)	AUD	Buy	None	High	11.0	30.0	41.0	93.0	12.0	16.0	100	30.8	5.8%	3.45	6.50	0.53
Woodside WPL (FY15 forecast)	AUD	Hold	None	High	190.0	159.0	195.0	1.3	127.0	117.0	100	16.0	4.9%	27.05	31.00	0.87
Z Energy ZEL.NZ	NZD	Hold	Narrow	Medium	30.5	29.3	42.4	11.6	19.0	27.5	100	22.6	2.9%	6.61	6.00	1.10

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Mining Services

Operational Streamlining and Reducing Exposures not Enough to Offset Margin Contraction

Earning Outlook: Negative for Some Time To Come

Key Themes for 2016

- The mining services sector has worn the sharpest brunt of the commodities downturn. We expect tough conditions to persist for a few years yet before markets rebalance via eventual supply cuts and demand stabilisation. Even then, we are looking at a permanently lower level of capital works.
- The focus of companies will be on streamlining, restructuring and pulling costs out of businesses. Australian engineering and construction expenditure grew to a peak of AUD 140 billion in 2012, a four-fold increase on levels a decade prior. We expect it to nearly halve to a low near AUD 80 billion in 2017/2018 before even a modest turnaround. Balance sheets will continue to be a focus for de-leveraging via noncore asset sales, operating lease lapses and capital raisings. Debt in this environment has the potential to be toxic and most companies are sensibly comparatively lowly geared or have no net debt including CIMIC, Downer, Monadelphous and UGL Limited. More highly leveraged companies include Broadspectrum and Bradken.
- Where practicable, overly mining-investment-exposed companies will attempt to diversify into servicing, civil engineering, and construction and other activities. The federal government has earmarked AUD 50 billion in infrastructure spend. Some companies have few diversification options and will feel the full force of the resource capital spending bust.
- Based on our analysis, the names least affected by a sustained mining/energy industry slowdown are Broadspectrum as an operations, maintenance and service provider, UGL Limited with its diversified portfolio and CIMIC with heavier focus on civil engineering and construction than mining. Most affected would be WorleyParsons, Monadelphous, Bradken and MMA Offshore as they almost entirely service the mining and/or energy sectors. Seven Group with its Westrac caterpillar business is also very exposed.

Most/Least Preferred Stocks in the Sector

We do not recommend investing in the sector given the negative earnings outlook. There could be industry consolidation which may result though in some individual stock performance. Based on where the stocks are trading relative to our estimated fair values we prefer ALS Limited, Downer and Seven West Group, while the stocks trading at the largest premiums to fair value include Orica, Incitec Pivot, CIMIC, UGL Limited and MMH Holdings.

Active Recommendations (as at 16 December 2015)

Name/Ticker	Currency	Morningstar Recommendation	Moat Rating	Uncertainty Rating	Adjusted EPS (cps)			EPS CAGR (%)	DPS (cps)		Franking (%)	Price/Earnings (x)	Dividend Yield (%)	Share Price (\$)	Fair Value Est (\$)	Price/Fair Value
					FY15	FY16F	FY17F	2 year	FY16F	FY17F	FY16F	FY16F	FY16F	FY16F		
ALS Limited ALQ	AUD	Accumulate	Narrow	High	33.4	30.0	30.9	-3.8	18.0	19.0	20.0	12.3	4.9%	3.68	5.00	0.74
Downer EDI Limited DOW	AUD	Accumulate	None	High	49.1	41.8	43.2	-6.2	0.0	0.0	100.0	7.8	6.5%	3.25	5.00	0.65
Seven West Holdings SVW	AUD	Accumulate	None	Very High	68.5	48.0	47.5	-16.7	40.0	40.0	100.0	10.1	8.2%	4.85	7.00	0.69
Incitec Pivot Limited IPL	AUD	Reduce	Narrow	High	24.3	21.6	26.0	3.4	10.8	13.0	50.0	17.1	2.9%	3.70	2.50	1.48
Orica Limited ORI	AUD	Reduce	Narrow	High	163.4	123.6	109.7	-18.1	74.0	66.0	45.0	11.8	5.1%	14.64	12.00	1.22
MMA Offshore MRM	AUD	Reduce	None	Very High	15.0	-7.1	-5.5	-ve	0.0	0.0	0.0	-ve	0.0%	0.23	0.15	1.53
UGL Group UGL	AUD	Hold	None	Very High	18.0	18.4	19.2	3.3	4.0	5.0	0.0	11.5	1.9%	2.12	1.90	1.12

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Hybrid Outlook

Key Themes for 2016

- ▶ The expectation of hybrid issuance to exceed redemptions will continue to weigh on hybrid prices, continuing the 2015 trend of margin widening.
- ▶ We continue to see value in select hybrids, maintaining our preference for moat-rated issuers with shorter term to calls given the flatness of the hybrid yield curve.
- ▶ Key risks for hybrids in 2016 are a hard landing scenario in China, large supply spikes and higher-than-expected increases in U.S. government yields.

We Expect the Major Banks to Continue to Drive Hybrid Issuance

- ▶ The financial sector will continue to drive hybrid issuance in 2016, placing further pricing pressure on secondary market supply and, ultimately, prices.
- ▶ We expect to see the recent trend of higher issue margins continuing, with the major bank issues having to move up towards the 4.5%–5.5% range.
- ▶ Among the nonfinancial sector, we expect hybrid issuance to be slow. We anticipate Woolworths will call their Woolworths Notes II at their November 2016 call date and replace it with a new issue.

Continued Hybrid Issuance to Weigh on Pricing

- ▶ Trading margins are likely to drift wider during 2016, driven by increasing supply and general economic conditions as the domestic economy continues its sub trend growth path.
- ▶ We expect to see the hybrid yield curve steepen during 2016 as issuers come to the market with higher issue margins.

Risk Environment Remains Elevated

- ▶ Although not our base-case scenario, a hard landing in China will have multiple negative effects on domestic hybrid issuers and their financial and business risk profiles. This will drive higher-than-anticipated margin widening. A rebound in China growth will have the opposite impact.
- ▶ A sharper-than-anticipated widening in U.S. yields will drive a widening in domestic yields, which will lead to repricing of all credit instruments, including hybrids, as their prices fall and trading margins increase. A sharper-than-expected tightening of U.S. government yields will have the opposite impact.

Debt and Hybrid Securities Best Ideas (as at 16 December 2015)

Name/Ticker	Recommendation	Issuer Moat	Security Investment Risk	Price	Next Call Date	Running Yield incl. franking	Yield to Reset incl. franking	Trading Margin
ANZ CPS3 ANZPC	BUY	Wide	Medium	99.58	1-Sep-17	5.77%	6.86%	4.14%
CBA PERLS VI CBAPC	ACCUMULATE	Wide	Medium	99.75	15-Dec-18	6.32%	6.40%	3.90%
NAB CPS NABPA	ACCUMULATE	Wide	Medium	94.72	20-Mar-19	6.00%	7.56%	5.02%
WBC CPS WBCPC	BUY	Wide	Medium	98.41	31-Mar-18	5.97%	7.12%	4.44%
GOODMAN PLUS II GMPPA	ACCUMULATE	Narrow	Medium	99.95	30-Sep-17	6.50%	7.23%	4.60%
WOOLWORTHS NOTES II WOWHC	ACCUMULATE	Narrow	Low	100.5	24-Nov-16	5.72%	5.66%	3.20%