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MORNINGSTAR®

Huntleys' Your Money Weekly

ASX abandons the retail investor, U.S. recovery enduring

The Australian Securities Exchange (ASX) is Australia's primary securities exchange. It was created in July 2006 with the merger of the Australian Stock Exchange and the Sydney Futures Exchange. ASX is a market operator, clearing house and payments facilitator. It oversees compliance, promotes standards of corporate governance and helps educate retail investors.

Prior to the merger, the Australian Stock Exchange was an 'incorporated club' with individual and corporate members. The well-being of stock broking firms was of uppermost importance. The principle that all investors should be treated equally and fairly was critical to attracting and growing retail client lists. Most broking firms were private client oriented while some focused on the institutional end of town. Almost all firms had a private client operation which also provided the distribution and spread channel for new listings.

The Australian Stock Exchange was responsible for the governance of both the primary and secondary equities markets – the primary market being new listings and capital raisings and the secondary market, the more mature listed securities market. A listing sub-committee consisting of experienced market participants drawn from the membership ranks was responsible for vetting and approving all new listings and capital raisings. Prospectuses were thoroughly scrutinised for pricing, earnings and dividend projections, vendor consideration, escrow conditions etc. New capital issues were usually all renounceable with rights or entitlements trading for at least two weeks, meaning all shareholders benefited equally.

Things have changed, and in my opinion, to the detriment of the retail investor. The Australian Securities and Investments Commission (ASIC) is now the gatekeeper of the primary market. I question the quality and experience of its staff in aspects of financial markets. Important aspects like pricing are now in the hands of the underwriter – usually the conflicted corporate departments of investment banks – via a book-building process. Now institutions effectively price new issues and the retail investors can take or leave the crumbs. In hot issues the retail investor gets zilch. In those less attractive – how many would you like? Nine Entertainment and Dick Smith are recent examples. If the vendors don't wish to accept the book-build price the issue can be pulled as was the recent case with Mantra.

It is about time the management of the ASX stood up for the retail investor. Collectively retail investors, including self-managed super funds (SMSF), own almost 50% of the four major banks and 45% of Telstra. The four major banks are in the top five of Australia's largest companies by market capitalisation. They are not a force to be alienated but encouraged. Should these investors believe they are getting a raw deal then offshore investment will look more attractive. The management of the ASX should be looking hard at ways to ensure retail investors play on a level field and are treated equally in every respect.

ASX CEO Elmer Funke Kupper was previously CEO of Tabcorp. Investing is much more serious than gambling. At Tabcorp, the small punter is ripped off. Collectively they establish significant pools that allow the corporate bookmakers to lay off which affects the returns to the small punter. It seems the big players, whether in the fields of investment or gambling, are more important to him than the smaller market participant.

In late 2013 well-known companies Ansell and Insurance Australia Group raised new capital to fund respective acquisitions. In both cases retail investors were hung out to dry. Their interests were diluted while institutions were favoured. The current issue by Transurban is yet another example where the playing field is tilted in favour of the institutional investor. Why are accelerated issues allowed? What is the hurry? What is the rationale? In most cases shares taken up in the institutional placement or the institutional component of an entitlement issue are

Continued on page 2

Australia's Leading Independent Investment Newsletter Since 1973

Peter Warnes
Head of Equities Research

Overview continued from Page 1

Key Terms
Buy: Substantially undervalued.
Accumulate: Modestly undervalued.
Hold: Appropriately priced, neither buy nor sell.
Reduce: Sell part holding.
Sell: Sell all holdings now.
Avoid: Not investment grade.

Uncertainty Rating: The Morningstar Uncertainty Rating demonstrates our assessment of a firm's cash flow predictability, or valuation risk. From this rating, we determine appropriate margins of safety: The higher the uncertainty, the wider the margin of safety around our fair value estimate before our recommendations are triggered. Risk-and volatility-averse investors should generally avoid very high and extreme uncertainty companies.

trading before the retail component of the entitlement issue or of a token retail Share Purchase Plan, with dilutive limits, are closed.

It is time the playing field was levelled – no more institutional placements as part of a new capital raising. It is time to go back to the vanilla renounceable entitlement issues so all shareholders are treated equally. Companies and the ASX have allowed the investment banks to run roughshod over the fair and equal process of capital issues and new listings. In this space the ASX mission statement is not reflecting reality. It is time to draw the line!

And while on the subject of retail investors getting the rough end of the pineapple, can someone at the ASX tell me the benefits of high frequency trading? And please don't give me the liquidity argument. How does the ASX allow unnecessary middlemen living in dark holes to hijack legitimate retail orders? It can and does force retail investors to pay a higher price when buying and receive a lower price when selling. How are these fringe dwellers adding value to or assisting the well-being of the securities industry?

U.S. – an enduring recovery

The pace of the U.S. economic recovery is frustrating some. Five years after the nadir of the post GFC fall out, the recovery is hamstrung – stuck in the slow lane. That is despite the major market indices surging at least 1.5 times since early March 2009. But that may be a positive as the recovery from the 2009 recession may prove to be one of the most enduring. I believe it is far too early in this long recovery for markets to capitulate. Initially the withdrawal of stimulus measures was feared. Now as the Federal Reserve makes its fourth consecutive US$10bn cut to monthly asset purchases, equity and bond markets are taking it in their stride. U.S. 10

YMW Portfolio

What is the YMW portfolio? It is a theoretical portfolio set up as an example of the art of long term, diversified investing.

⊕ = Shares Added
⊖ = Shares Sold
✶ = New Holding
UR = Under Review

Portfolio Holdings	Morningstar Ratings & Fundamentals								
Stock Name	Morningstar Recommendation	Morningstar Style Box	Business Risk	Fair Value ($)	Price ($) 30 Apr 14	Moat Rating	Forecast Dividend Yield (%)	Franked (%) (est)	Mkt Cap ($Mil) 30 Apr 14
AGL Energy	Hold		Medium	16.00	15.77	Narrow	4.1	100	8,827
ANZ	Accumulate		Medium	39.00	34.47	Wide	5.4	100	94,590
APA Group	Reduce		Medium	6.00	6.66	Narrow	5.5	0	5,566
ASX	Hold		Medium	35.00	35.54	Wide	5.3	100	6,880
Alumina	Buy		High	2.60	1.35	None	8.6	100	3,788
BHP Billiton	Accumulate		Medium	44.00	37.75	Narrow	3.6	100	121,241
Commonwealth Bank	Hold		Medium	76.00	78.90	Wide	5.3	100	127,922
Coca-Cola Amatil	Hold		Medium	10.00	9.25	Narrow	5.5	66	7,063
CSL	Hold		Medium	64.00	68.43	Narrow	2.1	0	32,892
Dart Energy	--	--	--	--	0.12	--	--	--	--
Origin Energy	Hold		Medium	15.00	14.90	None	3.4	100	16,444
OZ Minerals	Hold		Very High	4.30	3.68	None	1.4	0	1,117
Primary Health Care	Hold		Medium	5.00	4.69	None	4.9	100	2,372
QBE	Accumulate		Medium	16.00	11.58	Narrow	6.0	50	14,520
Qube Holdings	Hold		Medium	2.20	2.22	Narrow	2.3	100	2,283
Ramsay Health Care	Hold		Medium	44.00	44.81	Narrow	2.1	100	9,055
Sonic Healthcare	Reduce		Medium	15.00	17.70	Narrow	4.2	45	7,094
Telstra	Hold		Medium	5.00	5.22	Narrow	5.6	100	64,953
Westpac	Hold		Medium	35.00	35.12	Wide	5.7	100	109,190
Wesfarmers	Hold		Medium	42.00	42.71	Wide	5.2	100	48,829
Woolworths	Hold		Low	36.00	37.32	Wide	3.8	100	46,825
Woodside Petroleum	Accumulate		High	50.00	40.80	Narrow	6.3	100	33,616
Cash Balance									
Grand Total									

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and 30 year bond yields are now, against most expectations, lower than when the Fed started the taper in December 2013. The Dow is at an all-time high, ahead 2.5% from a then all-time high and S&P 500 up 4.1%, just off its 2 April peak.

There is still meaningful spare capacity throughout the U.S. economy. The shale gas revolution has changed the energy equation dramatically with the pendulum swinging to a significantly positive position. With a reservation policy in place, cheaper energy will enhance the competitive position of U.S. manufacturing industries, create employment, increase disposable income and importantly boost government revenue. The Federal Reserve is likely to hold official rates at low levels until late 2015 which should allow corporate America to enjoy favourable conditions for some time. I remain positive on the outlook for the U.S. economy and financial markets through 2015. This U.S. economic leadership will ultimately spread to other developed and emerging economies although it will not be all plain sailing as the current geopolitical issues indicate.

Domestically the Federal Budget looms. Given the parlous state of the country's finances the government has a difficult road to negotiate. The market will be looking for responsible action on both revenue and expense issues. It will have to be a two-sided manoeuvre without having a lasting effect on overall consumption. Discretionary retail is likely to be affected while low cost value providing retailers including Woolworths, Coles and Kmart should be OK. Interest rates will remain on hold for a considerable time assisting residential building activity, both new and renovation. Bunnings is very well placed to continue its quite extraordinary performance in the home improvement space. MI

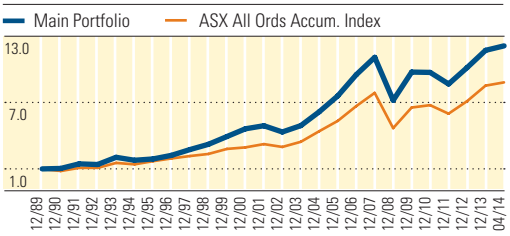
Portfolio Transactions / **Portfolio Value**

Code	Last Transaction Date	# of Shares +/- Change	Total Held	Cost Basis/ Share ($)	Total Cost ($)	Current Value ($)	% Gain/ Loss	% of Portfolio
AGK	2/91, 7/92, 4/99, 2/10, 6/12	0	11,900	8.28	98,537	187,663	90	3.1
ANZ	01/13	0	11,000	25.52	280,750	379,170	35	6.2
APA	09/13	0	25,000	5.98	149,480	166,500	11	2.7
ASX	7/06, 8/06,7/13	0	3,316	34.10	110,027	117,851	7	1.9
AWC	03/14	0	165,000	1.22	201,647	222,750	10	3.6
BHP	9/04, 5/05, 6,8/07, 5/10, 4/11	0	9,300	25.88	240,653	351,075	46	5.7
CBA	12/92, 10/97, 8/08, 9/08, 4/11	0	5,550	19.37	107,514	437,895	307	7.2
CCL	06/10,12/10,10/13	0	23,000	11.80	271,352	212,750	-22	3.5
CSL	2/02, 6/03	0	6,250	14.50	90,622	427,688	372	7.0
DTE	4/11, 5/11	0	148,991	0.76	113,842	17,879	-84	0.3
ORG	3/11, 4/11	0	14,400	15.97	229,960	214,560	-7	3.5
OZL	5/10 adjtd for cap retn & 1:10	0	7,000	9.41	65,847	25,760	-61	0.4
PRY	Oct-13	0	20,500	4.98	102,076	96,145	-6	1.6
QBE	94, 97, 00 ,01, 03, 3/08, 4/11	0	14,100	7.79	109,889	163,278	49	2.7
QUB	12/10, 4/11	0	245,000	1.40	342,253	543,900	59	8.9
RHC	10/13	0	2,800	35.69	99,920	125,468	26	2.0
SHL	10/13	0	6,400	15.88	101,614	113,280	11	1.9
TLS	06, 07, 08, 09, 3/10, 4/11	0	127,500	3.39	432,453	665,550	54	10.9
WBC	08/10,1/13	0	8,000	24.76	198,118	280,960	42	4.6
WES	97, 03, 05, 5/08, 2/09, 4/11, 12/13	0	10,321	16.37	168,956	440,810	161	7.2
WOW	7/93, 12/05, 1/08	0	9,000	8.94	80,500	335,880	317	5.5
WPL	7/03, 2/04, 6/07, 4/11	0	7,000	19.03	133,229	285,600	114	4.7
						310,590		5.1
						6,123,001		100.0

Portfolio Performance

Returns (%)	YMW Portfolio (CAGR)	ASX Accum Index
24 Years (to 31/12/13)	10.9	9.4
10 Years (to 31/12/13)	9.1	9.4
5 Years (to 31/12/13)	10.3	12.7
3 Years (to 31/12/13)	6.4	8.0
1 Year (to 30/4/14)	7.9	10.4

Total Return (x)



Top Five Sectors	%
Financial Services	23.7
Consumer Defensive	17.1
Healthcare	13.2
Communication Services	11.5
Basic Materials	10.3

Style Breakdown (%)

	Value	Core	Growth
Lg	20	21	41
Med	0	5	13
Sm	1	0	0

0-10 10-25 25-50 >50

The Morningstar Style Box is a nine-square grid that provides a graphical representation of the "investment style" of stocks. It classifies securities according to market capitalisation (the vertical axis) and growth and value factors (the horizontal axis).

YMW Portfolio: ANZ… nice dividend lift, up 14%. Beauty! And congratulations to Morningstar

Ian Huntley

In looking at the portfolio today, as I write ANZ (I own ANZ shares) announced an excellent profit if anything slightly ahead of expectations. The plum, to me, was the 14% increase in interim dividend to 83c a share, fully franked. Indicators of bad debts continued to fall to new lows – so a nice raspberry to all those who a few years ago were saying we were in for a housing crash and major banking problems. The incursion into Asia continues to go well, and is a major differentiator to other big three banks, but not necessarily an invitation for them to join in.

And one great out of the box comment: huge congratulations to Morningstar Inc for inclusion of a senior Morningstar analyst in the Berkshire Hathaway AGM Question and Answer with Warren Buffet and Charlie Munger. It certainly reads as an acknowledgement of Morningstar's huge emphasis on delineating the moat aspects of a company… the moat or competitive advantage/barriers to entry concept that Buffett himself has profitably emphasised for so many years.

In looking at the global issues, Ukraine hits the headlines more and more, particularly in Europe. President Obama's rating on foreign policy in the U.S. has dropped to the 30s, the lowest in his term. Use of trade/financial bans against Russia raises the spectre of that country using its supply of natural gas to Europe as a very heavy-duty weapon.

For those calibrating perceptions of Obama weakness (hell, what is he supposed to do, bomb Moscow? shoot Putin?) with broad U.S. weakness, let's think again. A friend recently remarked the 21st century has a "born in America" label, or specifically "born in Silicon Valley". Just, look at the revolution stemming from Google, Apple, and Facebook, just to name a few. The dynamic supercharge of smartphones across the world is one of the great, extraordinary revolutions, with many a gigantic step ahead, difficult for us poor mortals to predict say more than five years in advance if that. It is a huge spur to growth in the undeveloped worlds of Africa, South America and India, bringing communication and computing power in the hand.

The U.S. Fed is maintaining its tapering policy and is correctly positive on the economic outlook. Unemployment is falling, household debt has been slashed by over $US1trillion. (But think of the cost, all those write offs – a sharp contrast to Australian experience where debt remains because the consumer can pay the interest. Guess the nicer result!) Now U.S. household borrowing is creeping up again in line with sharply improving consumer confidence. Funny money debt balloons are also growing, seeds of issues down the track.

The Fed continues to stress low interest rates will remain for a significant time, with most expecting the first upward move second half 2015, but coupled with significant growth in the U.S. economy. That first rise in interest rates does not mean the end of the cycle; it takes more interest rate pressure to emerge. My wariness on the Fed's judgement remains. Forecasts are complex things, and changes can be abrupt.

In Australia the kerfuffle over the coming budget is front page day after day. I sincerely hope the Government does rein in ballooning costs, and does bring in a short term levy. First, progress to getting government finances in order is a plus for the markets and our future economic health. And second, it could mean a slower economy (but you never quite know) and thus lower interest rates for longer. My view is the No 1 promise of an incoming Government is to manage the economy soundly in the interests of the entire population. Everything else, second.

The portfolio is to my mind a conservative one, which is how I like it. We don't own any discretionary retailers; Wesfarmers and WOW are dominated by very stable food and liquor operations. The new housing cycle has begun nicely, with good housing stats on the way – Bunnings a clear winner. Sale of Rio reduced our iron ore exposure – though exports continue to drive higher but at lower prices as booming supply overtakes still growing demand. Alumina, a recent addition, is performing well.

I will delay my update on dungeons and dragons, but add one comment thanks to a subscriber. In the 10 years to June 30 2012, two bureaucrats were added to the work force for every new miner, according to an April 30 Bloomberg report!

Outlook for Resources

Iron ore sell-off sees better value in the iron ore miners while LNG remains attractive

Mathew Hodge
Sector Head: Basic Materials, Energy, Utilities

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- The decline in the iron ore price from US$135 to US$110 per tonne in the March quarter, and the associated China jitters, sees the major miners such as BHP Billiton and Rio Tinto trading at increased discounts to fair value and offering more attractive investment metrics.

- We remain attracted to the liquefied natural gas (LNG) players, particularly Woodside and Santos. Additional capacity can be built in the U.S. but only at a price. Gas is set to remain the fastest growing fossil fuel and demand in the Asia-Pacific will be a key component of that growth which Australia is well placed to service.

- Australian mining and energy companies, particularly the large ones, are positioned to continue to extract cost savings from contractors, suppliers and labour. The excesses of the previous boom are being unwound which should benefit margins and make future expansions, for example LNG capacity, more competitive.

Iron ore's hiccup shows the transition is underway

The transition of China's economy from largely fixed-asset investment-driven to consumption-driven is underway. Production of steel in China in 2013 grew at a heady 9.3% to virtually match output from the rest of the world combined. China consumes almost half of the world's steel. This is outsized relative to other commodities and additional strong growth from this high base will be challenging. Pushing the fixed-asset investment model further, risks future economic shocks. As Exhibit 1 shows, China's economy consumes more steel per unit of gross domestic product than anywhere else.

In 2014, the rate of growth in steel production has slowed to 4.3% in the year to date. We view this as healthy and a sign of the ongoing shift in economic focus towards consumption and services. The building of iron ore stocks at China's ports is an inevitable by-product of slowing demand growth. At the same time we expect supply to do a better job satisfying the slower rate of demand growth. In the near term, high and rising iron ore stockpiles scare the market, however, the most likely scenario is that the iron ore price will go through periods of volatility around a declining trend. For the high-quality, low-cost producers such as BHP Billiton and Rio Tinto, healthy margins will continue and periodic sell-offs, fuelled by sharp declines in the iron ore price, can be opportunities.

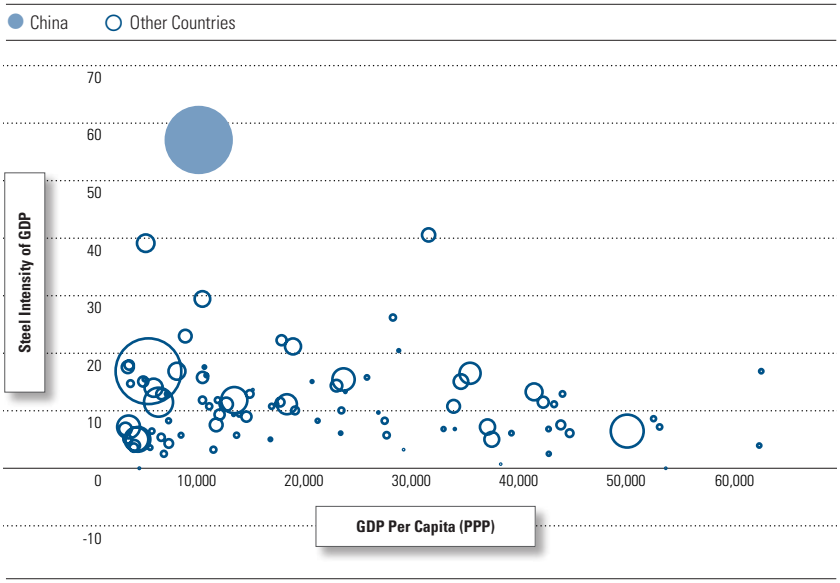
The low-cost producers are best placed to continue to grow and take market share in a lower price environment at the expense of higher-cost producers, particularly low-grade, high-cost miners in China. While margins are unlikely to be as favourable in future, they should still be attractive for the low-cost miners with several hundred million tonnes of high-cost Chinese iron ore still to be pushed off the cost curve. BHP Billiton and Rio Tinto remain Best Ideas and are both well placed to continue to extract cost savings through labour efficiencies and pressuring contractors and suppliers. By reducing capital expenditure, the major miners in particular have strengthened their hand and shareholders should be the beneficiaries.

Australian LNG players moving to payout phase

The peak of capital expenditure has passed for Santos. Just as Woodside increased its dividends significantly with the start of Pluto cash flows, Santos is well placed to repeat the dose in the next few years as production starts at the Papua New Guinea LNG and Gladstone LNG projects. Origin benefits to a lesser degree through its APLNG project but approximately two-thirds of the fair value estimate is attributed to utility-like electricity generation and retail divisions which won't enjoy a commensurate uplift. We recently upgraded our economic moat rating on Santos from no-moat to a narrow-moat based on low-cost gas supply to the Asian market. Reflecting our more favourable view of Santos, we have added it to our Best Ideas list, joining fellow LNG producer Woodside which remains a Best Idea.

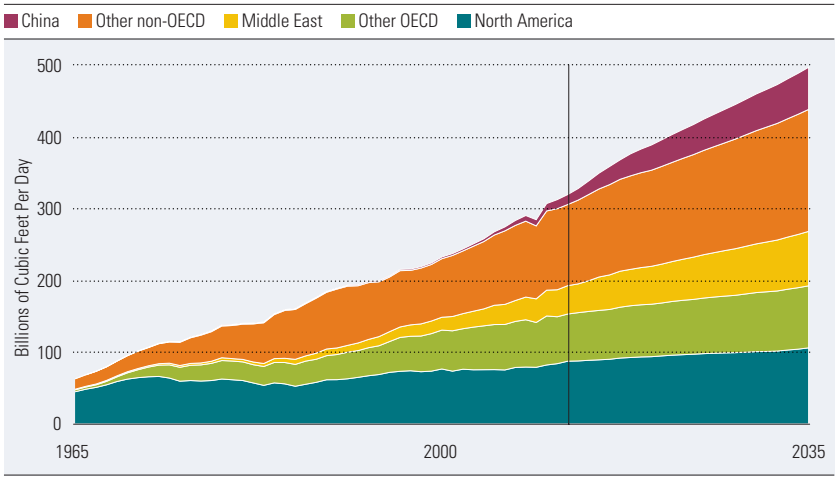
For Australia's two largest independent oil and gas names, we like the low-cost gas supply to Asia story and the expandable base. While the resources investment boom made Australia a high-cost place to build capacity, those companies already in production, or who are soon to be, have the ability to expand at a lower capital cost from the existing base. Companies such as Woodside, Santos and, to a lesser extent, Origin are positioned to benefit from a likely decline in the cost of labour,

Exhibit 1: China's Intensity of Steel Use Versus GDP per Capita



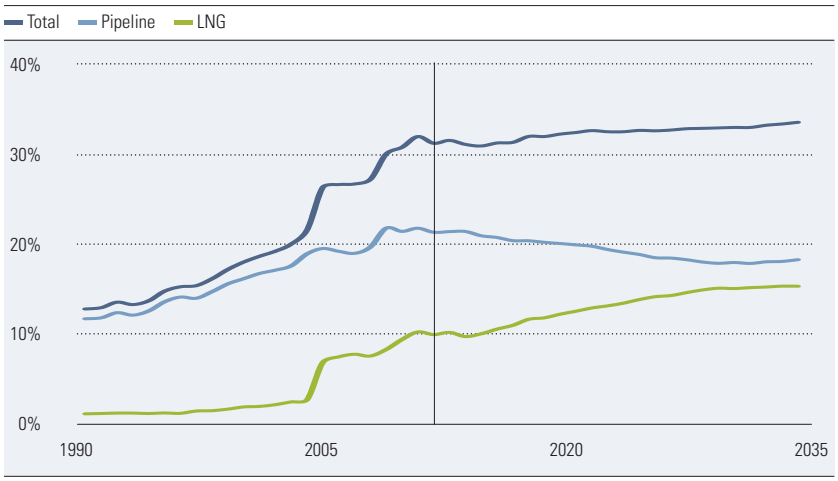
Source: World Bank, World Steel Association

Exhibit 2: Global Gas Demand by Region



Source: BP 2035 Outlook

Exhibit 3: Share of Total Gas Demand Met by Pipeline and LNG Imports



Source: BP 2035 Outlook

contracting services and inputs, and potentially also if the Australian dollar continues to head lower. It will be very surprising if expansion of LNG footprints is not an attractive option in the next three to five years as the heat comes out of Australia's capital boom.

Japan, South Korea and Taiwan are the dominant sources of demand for Australian LNG, accounting for more than 80% of sales volumes in 2012. Japan still takes more than half of total LNG volumes in the Asia-Pacific region and one-third of the world's output. Energy-poor countries are almost certain to remain significant net importers.

Natural gas is the fastest growing of the fossil fuels and, within that segment, demand for LNG is growing faster still. BP, in it's 2035 outlook, expects growth in gas demand of 1.9% per annum. LNG should take an increasing proportion of total gas consumption and grow at a faster 3.9% per annum to 2035. Gas is a very small share of total energy consumption in China and is set to lift as the country moves away from coal. LNG should at least capture a portion of that demand. The key risk to our thesis is if China was to discover a large, low-cost source of shale gas. That would see China supply its own needs, removing a large chunk of demand for LNG in Asia. However, the existing businesses in Japan, Korea and Taiwan should remain attractive with long-term oil-price-linked contracts underpinned by buyers who tend to be partners in the LNG projects. China is a relatively small LNG importer but is important to future growth.

China's shale gas industry is still in its infancy, though a repeat of the U.S. experience is unlikely. The gas is generally deeper and the geology challenging which does not lend to underpinning a low-cost supply. China's infrastructure is poor relative to the U.S. which is criss-crossed by pipelines largely built on conventional gas reserves. There is a chicken-and-egg dynamic which is likely to take years to play out. Without the pipelines to deliver gas, commercialising discoveries is harder and exploration expenditure will be dampened. Without large gas discoveries, the pipelines will be slow to come. We expect China's infrastructure will improve, but will take time - a story for the next decade rather than this one.

Looking for base metals demand to slow

Growth in demand for copper from China is likely to continue through electrification and the rise of the

consumer, but we expect it to moderate. China consumes about 40% of the world's copper versus nearly 50% for steel. We see room for the industry to improve capital discipline and to drive the efficiency of labour now the mining construction boom has peaked.

The ban on raw materials exports from Indonesia in 2014 has yet to bite with China building ore stocks in advance of the edict. If it persists, the ban could impinge on China's ability to continue to flood the world with aluminium and provide a much needed boost for the beleaguered metal. It will be interesting to see how the vested interests in Indonesia balance out with China's desire to keep importing ore and Russia's plans to only invest in Indonesian metals processing if the ore ban is sustained. Continuing the ore ban would be a plus for Russia's investments in aluminium and nickel, and having the leverage of potential investment may strengthen Indonesia's resolve. This would be upside to our thesis.

We still think profits and value in the aluminium industry will continue to move upstream to the alumina refiners and bauxite miners. This is the area of the industry where China's position as a supplier is weakest. Alumina and bauxite prices trade below rational fundamentals. The move to spot alumina pricing will return upstream phases of the aluminium production chain to more realistic pricing and restore industry profitability. This thesis underpins our positive call on Alumina Limited which is a Best Idea.

The vast majority of nickel is used in stainless steel. At more than seven kilograms per person, stainless steel consumption in China is rapidly approaching Western world levels of approximately ten kilograms per person. We expect the growth in consumption of stainless steel to slow considerably. However, in a market dominated by supply growth in nickel pig iron, we think the rebalancing of Chinese demand is unlikely to be a major driver for nickel. What China does on the supply side of the equation is key. As for aluminium, the Indonesian ore ban could provide a lift. A permanent restriction on the supply of low-grade ore from Indonesia is likely required for sustained improvement in nickel prices. Industry conditions remain tough with the vast majority of nickel supply unprofitable.

We expect a rebalancing of Chinese GDP from extreme investment intensity to a more balanced economic composition to be the defining macro theme for the next decade. For investment-oriented commodities, such as steel and steelmaking materials, we expect a deceleration in demand. Commodities less dependent on infrastructure and construction activity will suffer less. Those most closely tied to household consumption, such as precious metals, are the relative standouts as China rebalances.

Resources Best Ideas

Our resources Best Ideas include the best opportunities available with a bias to quality. Commodity prices can be extremely volatile so investors should focus portfolios on miners with sustainable competitive advantages (low-cost and long-life) and the ability to generate good returns in almost any metal price environment. This is particularly relevant for miners most leveraged to the Chinese fixed-asset investment boom, such as those which produce iron ore and metallurgical coal.

As part of the evolution of our research, we are rolling out stewardship ratings on individual stocks. As a result of incorporating those ratings into our process and thinking, we have decided to remove Newcrest from our Best Ideas list. Our poor stewardship rating for Newcrest reflects the deterioration in the cash cost position and balance sheet as the overpriced Lihir acquisition and troubled expansion distracted attention from operations. While we are encouraged by the recent two quarters of improvement, more needs to be done to re-establish the low cost position and to right the balance sheet. While we still consider the company to be significantly undervalued, poor stewardship coupled with high fair value uncertainty and no moat ratings mean we do not have sufficient confidence in Newcrest to rate it a Best Idea and add Santos in its place. We recently upgraded Santos from no moat to narrow moat. It is undervalued, has strong growth in train with the start of LNG production from plants at Port Moresby and Gladstone and the domestic business is set to benefit from rising domestic gas prices which are moving towards export parity pricing.

Alumina (AWC)

Alumina is predominantly exposed to bauxite and alumina production. The company is a low-cost global producer of alumina, with cash costs in the bottom quartile of the cost curve. Large, high-quality bauxite resources and access to long-term gas from the North West Shelf are key advantages, though not sufficient to justify a moat. Alumina is a

higher-risk counter (no-moat and high fair value uncertainty), however, we feel the discount to fair value is compelling and sufficient to justify its inclusion as a resources Best Idea. With the alumina industry as a whole loss-making, and Alumina's enterprise value one-third of the replacement cost of alumina capacity, there is compelling value. The move from long-term contract pricing of alumina to spot pricing will assist, but there is meaningful uncertainty about the ultimate strength of improvement in prices and industry returns.

BHP Billiton (BHP)

A narrow-moat, diversified global miner thanks to low-cost positions in a number of key commodity segments, particularly iron ore. Better-than-industry-average margins provide BHP Billiton the option to either return capital to shareholders and/or continue to invest through the cycle. Mothballing of mega expansion projects such as Olympic Dam and the Port Hedland Outer Harbour are a positive and show capital discipline. Many of the company's assets were built at a time when capital costs were a fraction of what they are today, which enhances returns and makes it difficult for new competitors. Diversification brings some benefit to cash flows. We think the market underestimates BHP's inherent strengths that come from long-life, low-cost, expandable assets, and the company is well placed to withstand, and deliver returns in, a less-favourable commodity market. We are hopeful new management will increase the emphasis on returning cash to shareholders and tighten the reins on capital expenditure. There is plenty of scope for cost cuts and this is a core management focus.

Rio Tinto (RIO)

With the demise of aluminium and coal and significant expansions in iron ore, Rio Tinto's earnings are now dominated by iron ore. The company enjoys the lowest global production cost for iron ore delivered to China. Long-life assets and low cash costs in iron ore, and to a lesser extent copper, underpin the narrow moat. Rio Tinto's famous record for capital discipline went out the window on Tom Albanese's watch, with the disastrous Alcan acquisition and forays into exotic locales like Mozambique, Guinea and Mongolia which bring significant sovereign risk. However, we feel new managing director Sam Walsh will help right the ship and return Rio Tinto to its more staid and reliable self. Like BHP Billiton, Rio Tinto's low costs and long-life assets mean the company will be able to expand at the expense of competitors even in a less favourable commodity environment.

Santos (STO)

Santos is undervalued and was recently upgraded from no moat to narrow moat. Production is expected to near double over the next two years and earnings rise three-fold as new LNG plants at Port Moresby in PNG and Gladstone in Eastern Australia commission. Santos also faces the enjoyable prospect of higher domestic gas prices on its existing domestic infrastructure, a powerful valuation enhancer given limited additional capital spend required. Two birds with one stone as export parity pricing drives eastern Australian gas prices higher. We don't think the market fully prices for the very substantial rise in earnings on foundation projects, let alone accounts for potential to further expand LNG capacity by adding more trains at lower capital intensity. Additionally it is unlikely the market fully appreciates just how strategic Santos' Moomba gas processing facilities in central Australia in fact are. Moomba is likely to feature large in any shale gas developments from the middle of the country.

Woodside Petroleum (WPL)

Woodside is Australia's premier oil and gas play with a strong tilt to Asian gas consumption via LNG. Recently expanded capacity with Pluto is now meaningfully contributing to earnings. We feel the perceived shale gas to LNG threat is overblown and China will not start producing its own shale gas in any meaningful quantity until next decade. The lack of pipelines in China, the early stage of development of the industry and much less favourable geology compared with the U.S are significant headwinds. Early drilling has not been positive. Woodside Petroleum is a low-cost, long-life LNG producer which underpins the narrow moat. Fair value uncertainty is high because earnings rely on the Asian gas price. The expandable LNG footprints at the North West Shelf, and Pluto in particular, bring tangible growth potential, capital cost advantages over greenfields projects, and significant blue-sky upside if meaningful exploration discoveries are made.

Table 1: Resources Best Ideas

ASX Code	Company Name	Recommendation	Economic Moat	Fair Value Uncertainty	Fair Value AUD	Price AUD	Price/Fair Value
AWC	**Alumina**	Buy	None	High	2.60	1.34	0.51
BHP	**BHP Billiton**	Accumulate	Narrow	Medium	44.00	37.75	0.86
RIO	**Rio Tinto**	Accumulate	Narrow	Medium	77.00	61.20	0.79
STO	**Santos**	Accumulate	Narrow	High	18.00	13.72	0.76
WPL	**Woodside Petroleum**	Accumulate	Narrow	High	50.00	41.06	0.82

Outlook for Consumer

A recovery in consumer confidence and retail spending should boost earnings for retailers and media companies in fiscal 2014 but headwinds loom for 2015


Peter Rae
Sector Head: Consumer


Tim Montague-Jones
Senior Analyst: Consumer


Daniel Mueller
Analyst: Consumer


Chris Kallos
Analyst: Healthcare, Consumer


Nachi Moghe
Senior Analyst: Consumer, Healthcare, Industrials

- Despite a strong Christmas, we expect the lower A$ to restrict retailers' earnings growth as import costs rise. We expect this to more than offset the potential benefit of overseas online retailers becoming more expensive. We favour stocks with economic moats that can withstand or even benefit from a lower A$. These include the large, high-quality, wide-moat retailers (Woolworths and Wesfarmers) but their shares are trading close to fair value. Narrow-moat Wotif.com Holdings offers exposure to travel and leisure activities which continue to outgrow bricks-and-mortar retail.

- We expect the shift in advertising dollars to online media to continue in the medium term favouring stocks such as REA Group, Carsales.com, Seek and New Zealand based Trade Me Group. Valuations in this sector are stretched, but Trade Me offers good value, trading below our fair value estimate and it is our preferred pick in this sector. Seven West Media is our preferred traditional media exposure, trading at a 28% discount to fair value.

- In the gaming sector, New Zealand casino operator SkyCity Entertainment Group is our preferred pick. We think the market underestimates the long-term benefits of its Auckland and Adelaide casino expansions.

- The healthcare sector in general is overvalued and the upcoming federal budget is a potential headwind for a number of domestic focused healthcare stocks. Conversely, the larger globally focused healthcare businesses with cash flow less reliant on the Australian government are less exposed to any budget changes. ResMed offers some value trading at a discount to fair value.

Retail delivers a strong start to the year but a pull-back seems inevitable

While consumer confidence has declined in recent months, this has not translated into a decline in retail sales, which are at a four-year high.

The divergence surprises but is probably influenced by headlines of widespread job losses in manufacturing and a pull-back in mining and resource activity. Retail sales figures clearly show the consumer is spending after an extended period of frugality. Interest rates are likely to remain at low levels for the remainder of 2014 although a move upward is likely towards the end of 2014/early 2015.

The weaker A$ could be a threat to retailer gross margins and we do not believe the market is incorporating this in share prices, preferring to extrapolate the buoyant Christmas trading period which is now history. But the resilient currency currently defies economists and forecasters.

The wide-moat supermarket retailers Woolworths and Wesfarmers (owner of Coles) are well positioned in this environment through a combination of their cost advantages and being relatively shielded from currency and online threats. The emergence of currency pressure will be much more difficult to manage for the no-moat discretionary retailers. Department stores and electrical retailers are in the weakest position to withstand these threats.

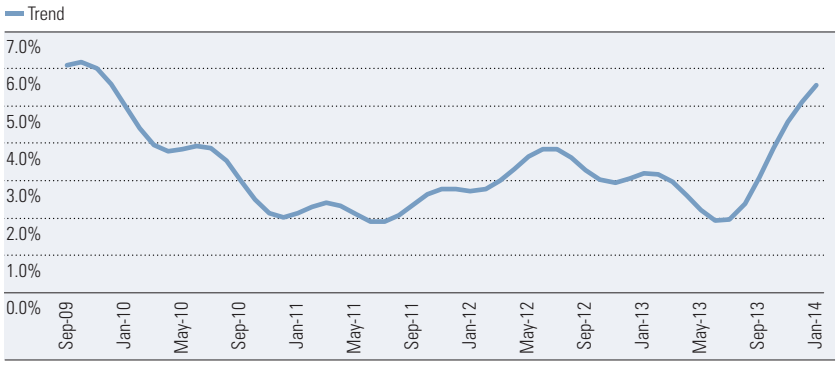
We expect lifestyle activities to continue attracting consumer dollars that used to be spent at traditional bricks-and-mortar retailers. Our preferred exposure to this thematic is narrow-moat Wotif.com, which is trading at a 17% discount to our fair value estimate.

Digital benefits from a modest bounce-back in advertising spend

Advertising dollars placed by media agencies in Australia topped $7.5bn in 2013, up 2.4% from the year earlier. Industry surveys carried out by Starcom MediaVest anticipate growth will continue by a further 2.6% in 2014. We expect this growth will be largely directed toward the digital channel at the expense of print, with television showing some moderate mid-single-digit growth. We view the expenditure trends from the standard media index for 2013 (Exhibit 3) as revealing the structural change in play. We believe these trends are likely to continue in the medium to long term. Digital media is the key area of growth as advertisers follow audiences online.

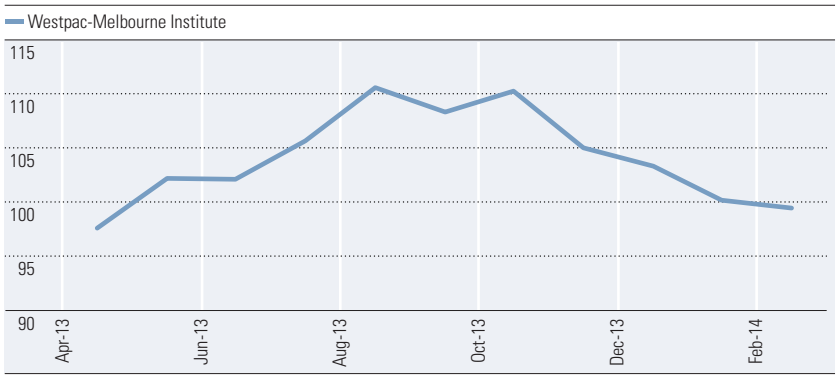
We expect digital advertising to remain a growth market, reflecting the increasing usage of digital devices by consumers. Australia has one of the highest penetration rates of smartphones at 73% of

Exhibit 1: ABS Retail Sales 2009–2013 (12-Month Rolling Growth)



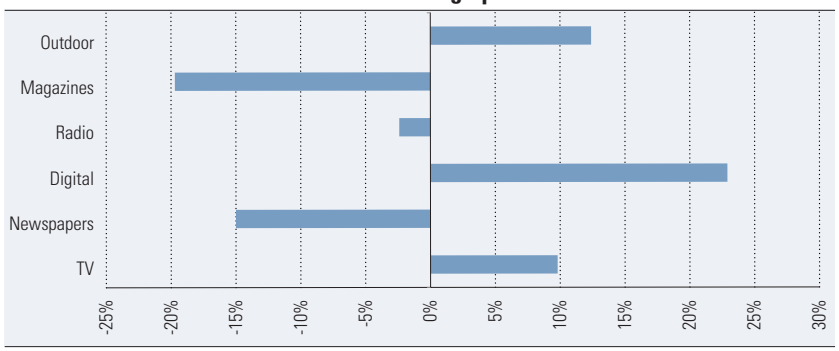
Source: Australian Bureau of Statistics

Exhibit 2: Consumer Confidence Index



Source: Westpac-Melbourne Institute

Exhibit 3: Standard Media Index – Advertising Spend 2013 Growth Versus 2012



Source: Standard Media Index

the population. This growth is already reflected in the earnings multiples for the Australian online classified companies, REA Group, Carsales.com and Seek and why we consider these companies as overvalued. Wide-moat New Zealand-based Trade Me is New Zealand's most popular auction and classifieds website. Similar to its Australian peers, it is benefiting from the growth in online advertising and commerce. Trade Me is our preferred stock in this space, trading at a discount to fair value.

Print advertising is likely to remain on a downward trajectory in 2014 and beyond, reflecting the migration of revenue online. We view general news content as a freely available commoditised product accessed from a range of online sources. We expect publishers of news in isolation will find it increasingly difficult to achieve an acceptable return and will need to broaden their range of content.

Some components of media legislation are expected to be repealed in the last quarter of 2014 which will lead to industry consolidation. The metropolitan television broadcasters have balance sheet capacity to quickly make a move on their smaller regional affiliates to extract combined cost savings. Seven West Media is our preferred media exposure, trading at a 25% discount to our fair value.

May federal budget a potential headwind for some healthcare stocks but the large global operators are relatively immune

The first budget of the Abbott government will be handed down on 13 May. Recent comments by the health minister suggest health care, following the Commission of Audit report, will be a prime target for reforms which collectively aim to curb the growing deficit estimated at $47bn by end 2014. Potential changes to subsidies through the Medicare Benefits Scheme (MBS), Pharmaceutical Benefits Scheme (PBS) and the Private Health-Insurance Rebate are obvious soft targets for any reform and would impact listed healthcare service providers differently. One proposal flagged is the introduction of a co-payment scheme for medical services. Under a plan to means test bulk-billed general practitioner visits and charge an extra $5 for prescription medicines, the government estimates it could save about $2bn. Stocks affected by changes in MBS and PBS include Sigma Pharmaceuticals, New Zealand-based EBOS and Primary Health Care.

In contrast, companies with global footprints and cash flow unrelated to Medicare should remain relatively immune. These include some of the largest companies under our coverage, namely CSL, Cochlear, Resmed, Ramsay Health Care and biotechnology company Mesoblast. Importantly, Mesoblast, while not exposed to government reform, is subject to the typical myriad of risks common to all drug development companies. At current prices, these stocks are largely at, or above, our fair value estimates, although ResMed offers good value trading below fair value.

Pathology service providers, such as Sonic Healthcare and the pathology division of Primary Health Care, have for the moment not been touted as cost-cutting targets and therefore may not be at risk. That said, given its size, geographic diversification and associated economies of scale, minor adjustments to funding for pathology

services would most likely have a minimal impact to the profitability of Sonic Healthcare. At its current price we view Sonic as overvalued.

Consumer Best Ideas

Our sector best ideas are based on the best opportunities available with a bias to quality. Most of our best ideas will have buy or accumulate recommendations though some are holds. A hold recommendation indicates investors should receive a fair risk-adjusted return during the next few years.

Wotif.com (WTF)

Narrow-moat Wotif.com has been under immense pressure in recent years as global behemoths, Expedia and Priceline.com, have aggressively entered the Australian market, attracted to Wotif's high operating margins and returns on capital, and taken significant market share. Responding to this threat, Wotif.com is resetting its cost base in fiscal 2014 to position the company for growth and we forecast an earnings rebound in fiscal 2015. The share price is reflecting a more bearish scenario of cost growth outpacing revenue growth for the foreseeable future and this is reflected in the stock trading on a price/earnings multiple of 12.1 times fiscal 2015 earnings, a 17% discount to our fair value estimate, and an attractive 7.6% fully franked dividend yield.

Seven West Media (SWM)

Seven West Media generates 68% of earnings from Australia's most popular television network, with newspapers and magazines contributing 30%. A television broadcast license combined with desirable content represents a compelling piece of media real estate to capture a sizable and consolidated audience to sell to advertisers. Media expenditure is highly cyclical and explains why we attach high uncertainty investment risk to the company. In our view, most of this cyclical earnings risk is now fully reflected in the stock price which is at a 28% discount to our fair value estimate. After a period of cutting operating costs, the company is well positioned to profit from the bounce-back in television advertising expenditure in 2014.

Table 1: Consumer Best Ideas

ASX Code	Company Name	Recommendation	Economic Moat	Fair Value Uncertainty	Fair Value AUD	Price AUD	Price/Fair Value
WTF	**Wotif.com**	Accumulate	Narrow	Medium	3.20	2.63	0.82
SWM	**Seven West**	Accumulate	None	High	2.60	1.87	0.72
SKC	**Skycity**	Accumulate	Narrow	Medium	4.10	3.82	0.93
TME	**Trade Me**	Accumulate	Wide	Medium	4.05	3.69	0.91
OFX	**Ozforex**	Accumulate	None	High	4.10	3.04	0.74

SkyCity Entertainment Group (SKC)

The shares of New Zealand casino group SkyCity are trading at a healthy discount to our intrinsic value and appear compelling in our view. Furthermore, the stock offers a very good dividend yield of 5.5%, which is fully imputed for New Zealand shareholders. SkyCity has dug a narrow economic moat around its business, with its monopoly casino licenses in Auckland, Adelaide and Darwin. The company has high returns on capital and generates copious free cash flows. We believe the expansion of Adelaide and Auckland will provide a platform for growth during the next several years and augment shareholder value.

Trade Me Group (TME)

Trade Me is one of New Zealand's most popular websites, offering auction and classified services to members. The company's online marketplace consists of three million members, or about 70% of New Zealand's population, with nearly more than one million members logging on to the website per month. Such strong brand equity, coupled with limited competition and the continued migration of trade online, provides Trade Me with a sustainable competitive advantage. Furthermore, the firm has a powerful business model driven by the network effect--more buyers attract more sellers which attract more buyers and so on. Sound financial position and solid cash flows provide Trade Me with the ability to pursue organic as well as inorganic growth opportunities. We see good growth opportunities, especially in classifieds and new goods business. The stock offers a dividend yield of 4%, which is fully imputed for New Zealand shareholders.

OzForex Group (OFX)

OzForex lives up to its brief of being a low-cost, easy-to-use, and secure provider of foreign exchange services. A relatively new online model incorporates an efficient platform to handle everything from client acquisition and trade execution, to compliance and risk management. Combined with bank accounts and regulatory licenses around the world, OzForex continues to branch out from its Australian roots. We estimate the firm accounts for roughly 5% of its addressable market in Australia, leaving it with strong growth opportunities. The banks are unlikely to aggressively compete with OzForex as it would mean forfeiting massive profits. Setting up in the United States in 2012, OzForex is in a strong position to grow in this currently uncompetitive, high-fee market. While we don't believe OzForex currently has an economic moat, it is well on the way to developing one by building goodwill and cost advantages.

Outlook for Industrials

Early signs point to cost-out strategies dominating as revenue growth languishes

Ross MacMillan
Sector Head: Industrials

Scott Carroll
Analyst: Telecoms, Aviation

Tim Mann
Analyst: Industrials

- Industrial companies provide few buying opportunities with most stocks under coverage having a hold or reduce recommendation. We believe the market is overly optimistic on economic growth in this space and the earnings potential of industrial stocks over the next 12 months.

- In the current low-growth environment, industrial companies are focusing on "cost-out" strategies, which involve the substantial reduction in operating costs and capital expenditure but limited attention on growth initiatives. The low interest rate environment will prove irresistible to many industrial companies and further major debt refinancing is expected to lock in interest costs for longer terms.

- Management's dialogue with investors is likely to centre on how cost containment strategies are ensuring their companies are leaner and more focused for the inevitable return of stronger economic growth. The exact timing of improved growth is of course difficult to predict, but biasing an equity portfolio to fairly or undervalued high quality stocks is the best way to weather uncertainty.

Transport & Airlines

Recent results and announcements from most listed industrial companies suggest domestic economic conditions remain subdued, with limited growth expected over the next year. This has direct implications for transport volumes which are highly leveraged to cyclical conditions, in particular domestic consumption. Rail and road transport operators Toll Holdings, Qube Holdings and Asciano all indicated organic volumes were flat to marginally higher in the six months to 31 December 2013.Container volume growth at Australian ports in 2013 was below 1%. Historically container volume growth has exceeded gross domestic product, as illustrated in exhibit 1. Weak conditions in 2013 followed three consecutive years of mid-single digit growth.

We expect low volume growth for stevedores, logistics providers, freight forwarders, haulage and transport operators ahead of a pick-up in non-resources demand in 2015. Qube will be the exception, with ongoing investment in its business and prior-period contract wins supporting robust earnings growth. Narrow-moat Asciano and Aurizon will deliver earnings growth in fiscal 2014 and 2015 supported by their coal haulage operations and continuing focus on cost-out strategies.

Operating conditions in the domestic aviation industry are extremely challenging with limited scope for relief in the short term. Excess capacity, aggressive competition, cost pressures and subdued demand have combined to see the airlines incur losses – substantial in some cases. Long-term industry returns have historically been poor with airlines typically not earning their cost of capital through the cycle.

Paper & Packaging

The main theme driving the Paper & Packaging sector has been industry-wide restructuring, which delivered a series of recent spin-offs. Orora and Pact listed on the ASX in December 2013 and January 2014, respectively, and now offer investors pure-play exposure to relatively defensive, Australasian packaging end markets. The anticipated recovery in global growth, currency movement benefits and continued cost-cutting are major issues which will impact the industry next year.

Narrow-moat Amcor offers investors a long track record of earnings growth and provides exposure to a solid global asset base.

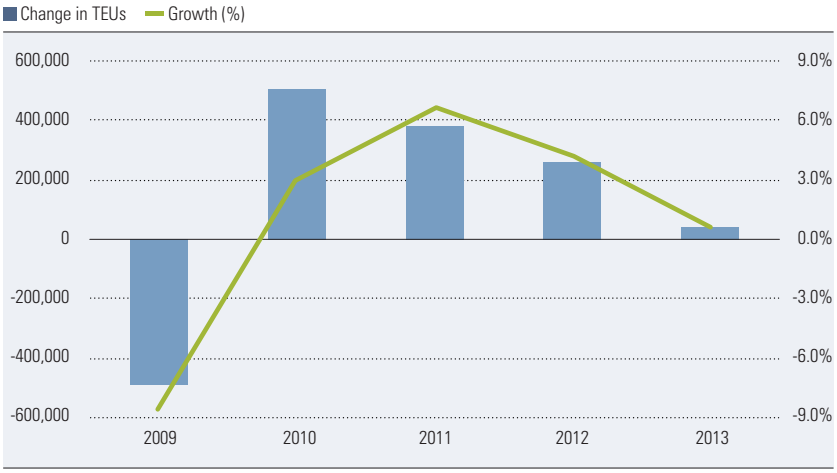
Newly listed, Orora and Pact's earnings are largely driven by domestic growth and cost-cutting.

Building Materials

The key thematic currently driving the building materials sector, notably Boral, CSR, and James Hardie, is the upswing in building approvals and associated earnings leverage. Nevertheless, the housing upswings in Australia and the U.S. are at different stages with residential dwelling starts in Australia now above mid-cycle levels, while U.S. starts remain 40% below long-term averages.

Improving volumes and cost-cutting are driving margin recovery, but returns on equity remain sub-par for many companies. Boral is struggling to match its cost of capital despite mid-cycle trading

Exhibit 1: Container Volumes at Australia's Four Major Ports



Source: BITRE, Port Corporations and Morningstar Research

Exhibit 2: Domestic Housing Approvals

Source: ABS and Morningstar Research

conditions. It appears the company has now stepped away from its target of 15% return on funds employed, which reflects the increasingly competitive environment. Cost-cutting remains a strong theme and we believe the industry requires further restructuring, particularly in brick manufacturing, to support higher returns. The merger of the brick operations of CSR and Boral is a positive development. Domestic housing starts need to approach 180,000 for earnings to exceed the industry's cost of capital. However, we do not believe this level is sustainable, with housing investors currently disproportionately influencing the housing market and mortgage rates are likely to trend higher during the next two to three years. In addition, it appears the "chase for yield" has spilled into the domestic property market, artificially inflating the multiples on building materials companies.

For investors seeking exposure to the building cycle we caution that most stocks are trading above fair value. In addition, the asset mix of the companies under our coverage varies significantly, as does the return profile of individual business units. CSR is a conglomerate with its domestic east-coast earnings exposure offset by volatile aluminium earnings. Boral has assets in Australia and the U.S., with the majority of its earnings skewed to the non-residential and engineering construction sectors. Narrow-moat James Hardie is the purest play on the U.S. housing cycle, with a market-leading fibre cement franchise. Dulux offers late-cycle exposure to the housing remodelling and renovation market with a strong paint franchise which provides a narrow moat but is partially offset by Alesco's no-moat businesses. Encouragingly, balance sheets at this stage of the cycle are strong. CSR and James Hardie have net cash positions, which support future consolidation activity. While we acknowledge the strength of the recovery, we believe investors are paying very high prices for building material companies based on their earnings leverage to improving but uneven growth in housing starts.

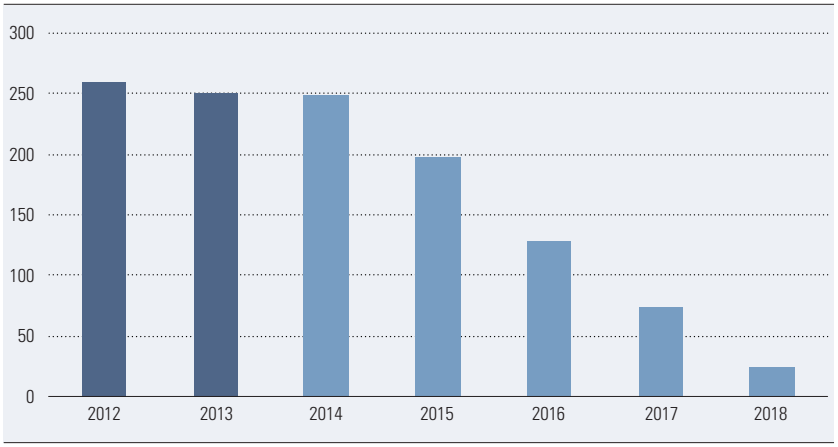
Engineering, Construction and Mining Services

Unfortunately, the recent reporting season did little to improve the doom and gloom surrounding the engineering, construction and mining services sector, with most companies reporting significantly lower earnings than the year earlier. Engineering and construction companies face a shortage of new projects from the mining sector. Key problems facing the mining service companies are lower exploration activity, only limited mining production growth, significant surplus of unutilised mining equipment, stronger competition and mining companies adopting cost reduction strategies. The worst results and gloomiest outlook continues to be reported by the mineral drillers, including Ausdrill and Boart Longyear

Fortunately, engineering and construction contractors to the energy and infrastructure sectors faired marginally better, particularly the two narrow-moat companies in the sector, Monadelphous and Leighton. In March Leighton's majority shareholder, Hochtief AG, launched a proportional off-market cash offer to increase its shareholding to 74%. We were very surprised by Hochtief's haste, particularly when it could have negative longer-term implications for debt collectability and ultimately earnings.

The outlook for the engineering, construction and mining services sector remains largely unchanged. Limited mineral exploration work will be

Exhibit 3: Outlook for Domestic Mining and Energy Project Investment (AUD billions)



Source: BREE and Morningstar Research

undertaken in the next 18 months but production contracts for quality low-cost mine operations will continue to be renewed. Production volumes have stabilised and customers are focused on increased productivity and substantially lowering costs. Large customers are exerting bargaining power by threatening or taking mining operations in-house. Engineering and construction contract work will steadily decline as committed and under-construction mining and energy projects complete. We believe rationalisation and consolidation in the sector is still at least 18 months away.

Telecommunications

While we are supportive of the fundamentals driving the major listed Australian telecommunication companies, particularly Telstra, TPG Telecom and iiNet, we believe each of these is fairly valued at current trading levels. Strong recent share price performance for TPG Telecom and iiNet reflects excellent free cash flow generation, potential consolidation opportunities and growth opportunities in regional areas presented by government investment in the National Broadband Network.

In the fixed-broadband market we remain focused on long-term implications from government investment in the national broadband network, or NBN. While the exact structure of the NBN may change as part of a review, we expect implications for domestic internet service providers, or ISPs, to remain broadly positive. Government investment will reduce the future capital expenditure burden facing the ISPs and improve free cash flow. iiNet and TPG Telecom are already very strong cash-flow generators, with the potential for further upside in the medium term and we remain positive on the fundamentals for both businesses. Nonetheless, we note the risk of open access to broadband infrastructure under the NBN model could encourage new entrants and increase competition. Long-term uncertainty still remains around the market structure after the federal government's NBN investment is complete.

We remain cautious about a resurgent Vodafone which is offering aggressive pricing on post-paid plans and high data allowances. This is a competitive response to sustained market share losses throughout calendar 2012 and 2013. Telstra has been the main beneficiary although perceived network issues at Vodafone have also helped fixed-broadband players such as iiNet and TPG Telecom gain traction in mobile. We believe higher-spend subscribers will continue to pay a premium for network quality and remain relatively sticky. This customer preference for network quality and coverage is the basis for our view that narrow-moat Telstra will remain the market leader in mobile going forward.

Monetisation of data is a key growth opportunity for Australian mobile operators. While more rational pricing has emerged in the domestic mobile market during the past year, most operators have increased data allowances on post-paid plans, particularly at the upper end of the market. Although this has the potential to hurt average revenue per user (ARPU) the strategy aims to encourage users to trade up to higher-value contracts thereby increasing ARPU. Given the marginal cost of additional data usage is relatively small for the operator, higher spend is likely to be positive for margins.

Industrials Best Ideas

Our sector best ideas are based on the best opportunities available with a bias to quality. Most of our best ideas will have buy or accumulate recommendations though some are holds. A hold recommendation indicates investors should receive a fair risk-adjusted return during the next few years.

Orica (ORI)

Narrow-moat Orica's AGM provided little in the way of new information but we expect near term conditions will remain challenging. Despite this, we still expect earnings improvement in FY14, weighted to the second half. There is no change to our medium- to long-term outlook for the explosives industry and we still we expect demand to continue

to rise over the next decade. The industry benefits from an oligopoly structure and it is very hard for new players to enter given the high cost of building facilities and regulatory requirements. We see the shares as good value, trading at 0.87 times our fair value estimate.

Table 1: Industrials Best Ideas

ASX Code	Company Name	Recommendation	Economic Moat	Fair Value Uncertainty	Fair Value AUD	Price AUD	Price/Fair Value
IPL	**Incitec Pivot**	Accumulate	None	Medium	3.30	2.91	0.88
ORI	**Orica**	Accumulate	Narrow	Medium	25.00	21.99	0.88

Incitec Pivot (IPL)

We expect a modest increase in earnings in FY14, with continued growth in production at the Moranbah ammonium nitrate plant offsetting lower fertiliser prices. In the medium to longer term, we expect steady growth in demand for explosives from the resources sector. IncitecPivot benefits from the oligopolistic structure of the global explosives market. However, unlike Orica, it has a large fertiliser business which is subject to cyclical demand and a lack of pricing power. Earnings are volatile because of large swings in fertiliser prices. Trading at 0.89 times our fair value estimate, we view the shares as offering reasonable value at current levels. IM

New Zealand Share Market Outlook

The market remains at fair value but opportunities exist in telecommunications, gaming and consumer

Nachi Moghe
Senior Analyst: Consumer, Healthcare, Industrials

- The New Zealand market appears fairly valued and we advise investors to be cautious and stock selective. Hold remains our predominant recommendation at about 60% of our coverage universe.
- Electricity companies continue to be out of favour because of regulatory risks and appear the most compelling value. Political risk cannot be ignored, but we think the likelihood of regulation is not imminent. We see value in the sector with narrow-moat Mighty River our preferred pick.
- The telecommunications sector is now trading at fair value. After being pummelled following an adverse regulatory outcome, the Chorus share price has recovered some lost ground. Narrow-moat Telecom Corporation of New Zealand is a preferred pick with a lower risk profile than Chorus but is now in the Hold zone.
- Narrow-moat casino operator, Sky City Entertainment Group, is compelling in our view and offers an attractive dividend yield. We still believe the market is underestimating the benefits of the Adelaide and Auckland casino expansions.
- The outlook for the New Zealand property stocks is positive and the sector is trading at close to a 10% discount to fair value. We have no positive recommendations in the sector, but Kiwi Income Property Trust looks reasonable value, trading at a slight discount to our NZ$1.20 fair value.
- Healthcare stocks remain expensive trading at 1.2 times fair value with the market, in our view, overpaying for a relatively positive earnings outlook. Transport (1.1 times fair value) and building materials stocks (1.2 times fair value) also look expensive.

The market's love affair with healthcare stocks could turn sour should valuations correct

Healthcare embraces Ryman Healthcare, Fisher & Paykel Healthcare and EBOS Group. We believe healthcare stocks in general will benefit from a growing ageing population. We believe the share prices are more than pricing in the growth prospects and valuations appear stretched at the moment. While we see no imminent catalysts for repricing, other than rich valuations, we believe investors should be cautious and wait for a decent pull-back before initiating positions.

The electricity sector appears cheap as regulatory concerns and weak demand weigh on valuations

The utilities sector includes firms that generate, retail and distribute electricity. The electricity market is dominated by four major vertically integrated power companies, including the recently listed Genesis Energy. These four players enjoy efficient scale, which acts as a significant

barrier to entry. Overall, we believe stock prices of electricity companies are accounting for some of the risks and appear attractive, especially from a dividend yield perspective.

Transport sector slightly overvalued
The transport sector which consists of businesses such as freight and logistics, port operations, airports and airlines has slightly outperformed the market over the past year with Air New Zealand and Auckland International Airport being the stand-outs. A pick-up in the economy should translate to higher volumes for logistic companies such as Freightways and Mainfreight. Port of Tauranga is reaping the benefits of strong log exports through the port which we expect to continue in the medium term on the back of strong Chinese demand.

The telecom sector is trading close to fair value
Network investment and aggressive pricing saw Telecom New Zealand gain further traction in mobile in the December half, adding 6% to its subscriber base during the period. While we recognise the near-term margin impact of focusing on market share, in the medium term we believe Telecom New Zealand can establish a leading market position and leverage its broad product suite through bundling.

Strong economy buoys New Zealand property
The strengthening conditions for property stocks in 2013 carried over into 2014 and we see no pressing threats. Economic commentary accompanying the decision by the Reserve Bank of New Zealand to raise the overnight cash rate points to a positive outlook for owners of commercial property. These include rising business hiring intentions, growing demand from within Asia for agricultural products and 3.5% growth in real consumer spending. However, upside in rents over the coming years is likely to be partly offset by a gradual increase in borrowing costs.

Table 1: New Zealand Best Ideas

ASX Code	Company Name	Recommendation	Economic Moat	Fair Value Uncertainty	Fair Value AUD	Price AUD	Price/Fair Value
SKC	**Skycity**	Accumulate	Narrow	Medium	4.10	3.82	0.93
TME	**Trade Me**	Accumulate	Wide	Medium	4.05	3.69	0.91
TEL	**Telecom Corp. of NZ**	Hold	Narrow	Medium	2.40	2.56	1.07

We consider the three major New Zealand property trusts (Precinct Properties New Zealand, Goodman Property Trust and Kiwi Income Property Trust) to present respectable risk-adjusted yields of about 6% and solid growth prospects. Of these, we see best value in Kiwi Income Property Trust.

Building materials are benefiting from Canterbury rebuild, nonetheless bellwether Fletcher Building seems overpriced
The key New Zealand residential market is benefiting from strong activity levels. The Canterbury region home rebuilding is expected to continue into fiscal 2015, while demand for civil infrastructure is expected to benefit from government spending around major projects in Auckland, Wellington and Canterbury. Funding arrangements for a number of landmark projects appear in place, and we expect Fletcher to win its fair share of work during the tendering process. Operational efficiency gains will drive earnings growth ahead of a volume recovery but the stock looks expensive. Nuplex is trading closer to fair value.

New Zealand Best Ideas

SkyCity Entertainment Group (SKC)
See comments in Comsumer section.

Trade Me Group (TME)
See comments in Consumer section

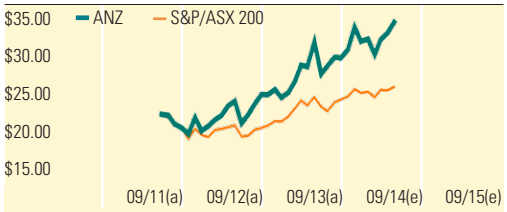
Telecom Corporation of New Zealand (TEL)
We believe the management's turnaround strategy is not fully factored in at current prices. Initial signs are promising with market share stabilising in fixed-broadband and evidence of subscriber growth in mobile. We expect management to continue an aggressive pricing strategy to maintain momentum in the mobile market. Mobile is a key asset for future growth with increased smartphone penetration and demand for data is likely to boost average spend per customer. The recent sale of Australian business AAPT has cleaned up the group structure and reduced operating risk in our opinion. In terms of competitive position, a new entrant into the New Zealand telecommunications would have to contend with three existing mobile players in a very small market. MI

ANZ Bank ANZ | $34.05

Large Cap | Banks - Global | 01 May 2014

Recommendation **Accumulate**

Uncertainty Rating	**Medium**
Stewardship Rating	Standard
Moat Rating	Wide
Fair Value ($)	39.00
Morningstar Style Box	
Mkt Cap ($ Mil)	94,590
Last Review	13/02/14 (YMW05)
Ann. Share Turnover (%)	44.3
ROE-FY13 (%)	15.0
Net Interest Cover (x)	--
52 Week Hi/Low ($)	35.07/26.30
Ex-Dividend	09 May 2014
Payable	01 July 2014



	09/11(a)	09/12(a)	09/13(a)	09/14(e)	09/15(e)
NPAT ($m)	5652.0	5830.0	6498.0	7006.4	7643.0
EPS (c)	218.4	218.5	238.1	253.5	271.0
EPS % Chg	17.2	0.0	9.0	6.5	6.9
DPS (c)	140.0	145.0	164.0	177.0	190.0
Franking%	100.0	100.0	100.0	100.0	100.0
Div Yield%	6.2	6.6	5.9	5.1	5.5
Grsd up%	8.9	9.4	8.5	7.3	7.9
P/E	10.3	10.1	11.6	13.6	12.7

Investment Perspective

The current ANZ Banking Group was established in 1951, but the brand and origins stretch back to 1835. The high-profile "super-regional" Asian growth strategy and well-regarded Australia and New Zealand franchise is slanted toward corporate and business banking, with increasing exposure to retail banking and wealth. ANZ Bank could deliver higher returns than major bank peers if it delivers on its super-regional strategy. Designed to leverage the bank to fast-growing trade and investment flows both within Asia, and among Asia, Australia, and New Zealand, the strategy offers higher growth than the banking system in Australia, where household and business deleveraging is reducing credit growth and business activity. The market is mispricing earnings upside potential and focuses too much attention on negative short-term issues.

The author's superannuation fund owns shares in all four Australian major banks.

Strong first half bodes well for future earnings growth

Another impressive earnings performance from ANZ Bank (ANZ) confirms our positive view on the wide-moat rated bank. 1H14 net cash profit of $3.5bn was up 11% on 1H13 and dividends increased 14% to $0.83 per share fully franked. The result was hard to fault with earnings and dividend modestly above market and our expectations. Weaker-than-expected net interest margins were a detractor. ANZ is our preferred major bank, reflecting a stronger-than-peer earnings outlook, more diversified revenue base, more reliable funding sources and a greater discount to our unchanged $39.00 per share fair value estimate. Revenue growth of 6% and a 12% reduction in bad debts underpinned the strong result. Return on equity edged up to a healthy 15.5%, though still lagging best of peer group Commonwealth Bank at 18.7%.

Michael Smith is an impressive CEO, leading a strong senior management team. We are increasingly confident the bank will successfully execute on its long-term growth strategy, with particular focus on the faster growing Asian region. What impressed most was the upbeat outlook on a wide range of potential growth options - ANZ is clearly no longer a narrowly focused domestic commercial lender. The increasingly important Asia Pacific provides opportunities to grow higher-return, less capital-intensive transactional-type products including foreign exchange, cash management, and trade and supply chain services.

Our FY14 earnings forecast of $7.0bn remains. Despite the 20% share price increase since early February the stock remains undervalued trading at a 13% discount to our valuation. The growth strategy is delivering impressive results with all businesses contributing to the high-quality performance, particularly Australia and New Zealand. International and institutional banking grew profits 9% and wealth reported earnings 11% higher than 1H13.

Fundamentals are good with loan quality, capital and funding at comfortable levels. Bad debts for FY14 are expected to be about 10% lower than the $1.2bn of FY13. The distinctive Asian strategy provides attractive long-term earnings growth options in addition to the bank's privileged position in Australia's highly profitable major bank oligopoly. Dominant market positions, cost advantages and improved productivity are expected to drive higher returns for the thriving wide-moat rated major banks.

The focus on Asia is paying off with profits sourced from the region increasing to 25% of group earnings, within touch of the 2017 target of 25%-30%. The growth strategy is proceeding to plan in Australia, New Zealand and across Asia with the bank well positioned to leverage increasing numbers of customers integrated in regional capital, trade and wealth flows. The focus on improving returns on equity to 16.0% by 2016 is welcome.

Income-seeking investors will cheer the 14% boost to the fully franked interim dividend, equating to a 65% payout. Our FY14 payout of 70% is maintained. Strong loan growth of 12% requires higher capital and unsurprisingly the interim dividend reinvestment plan is not neutralised. Despite strong organic capital generation in the half, the common equity tier-1 ratio declined marginally from 8.5% at September 2013 to 8.3% at March due primarily to robust loan growth.

Reconfirmed guidance calls for a reduction in the cost-to-income ratio to 43% or lower by the end of FY16. As expected, Australian home-loan and business lending growth continues to run above system growth rates, and strong household deposit growth reflects the bank's successful focus on customer service and product innovation. MI

Analyst: David Ellis

Newcrest Mining NCM | $10.02

Large Cap | Gold | 23 Apr 2014

Recommendation **Buy**

Uncertainty Rating	**High**
Stewardship Rating	Poor
Moat Rating	None
Fair Value ($)	22.00
Morningstar Style Box	
Mkt Cap ($ Mil)	8,232
Last Review	23/01/14 (YMW02)
Ann. Share Turnover (%)	177.1

	06/13(a)	06/14(e)	06/15(e)
NPAT	451.0	416.7	521.5
EPS	58.7	54.2	67.9
% Chg	-58.5	-7.6	25.1
DPS	12.0	0.0	0.0
Fr%	0.0	0.0	0.0
Div %	0.5	0.0	0.0
Grsd%	0.5	0.0	0.0
P/E	37.7	18.5	14.8

Costs continue to come out but more needed to realise the upside

3Q14 production was largely as expected, declining 11% to 552,000 ounces. Newcrest Mining (NCM) should deliver at the top end FY14 guidance of 2.0 to 2.3 million ounces. Cash costs increased from $695 to $723 per ounce, with lower output due to maintenance and reduced plant throughput. Operating costs remain on a downward trend. FY14 all-in sustaining costs should be at or below the bottom end of guidance of $2.73bn to $2.45bn. Management commentary around ongoing productivity efforts and cost controls is pleasing. Further improvement and optimisation is predicted, particularly at Lihir, and is consistent with our thesis.

No change to our $22.00 per share fair value estimate. Long-term assumptions remain US$1,100 per ounce gold and US$2.50 per pound copper (2013 dollars, inflated at 2.5% per annum) and an A$/US$ exchange rate of 0.90. NCM is undervalued. The long reserve and resource life is a key differentiator and supports future growth. The market is not interested in the large reserve base, but it provides valuable options long term. The price of purchasing gold resources and reserves via NCM is near decade lows reflecting the recent poor operating track record and the leveraged balance sheet, key drivers of our Poor stewardship rating. The renewed focus on productivity and costs is welcome but further steps are required. If improvement continues, the stewardship rating may move to Standard.

NCM has no economic moat with no significant cost advantage and a bloated asset base post the Lihir acquisition and recent major capital expenditure. High fair value uncertainty reflects the cost structure, single commodity exposure, capital intensity, financial leverage and the importance of exploration and future development projects like Wafi-Golpu. M

Analyst: Mathew Hodge

Santos STO | $13.44

Large Cap | Oil & Gas E&P | 17 Apr 2014

Recommendation **Accumulate**

Uncertainty Rating	**High**
Stewardship Rating	NA
Moat Rating	Narrow
Fair Value ($)	18.00
Morningstar Style Box	
Mkt Cap ($ Mil)	13,186
Last Review	20/03/14 (YMW10)
Ann. Share Turnover (%)	74.2

	12/13(a)	12/14(e)	12/15(e)
NPAT	504.0	662.7	997.4
EPS	51.5	67.0	101.6
% Chg	-18.0	30.0	51.7
DPS	30.0	30.0	40.0
Fr%	100.0	100.0	100.0
Div %	2.2	2.2	3.0
Grsd%	3.2	3.2	4.2
P/E	26.1	20.1	13.2

First-quarter volumes undershoot, but oil volumes and pricing partially offset impact

Santos (STO) reported a 14% decline on 4Q13 revenue to $913m, though only marginally below expectations. Revenue was 28% higher than 1Q13. Marginally softer production of 12.2 million barrels of oil equivalent (mmboe) overall was offset by higher than anticipated crude production, down only 15% to 2.5 million barrels. Crude is a higher value product and quarterly pricing of $128.50 per barrel improved slightly on 4Q13.

Our fair value estimate stands at $18.00 per share. We reduce our FY14 earnings forecast from $0.73 per share to $0.67 per share on lower than anticipated 1Q14 gas volumes and pricing, not meaningful longer term. Our FY14 production forecast is 55 mmboe versus unchanged guidance of 52–57mmboe. Pleasingly the PNG LNG project is progressing better than expected with first LNG cargoes slated for mid-2014. Condensate production began in March. PNG LNG will contribute around one-eighth of expanded STO revenues from 2015, a major driver of the anticipated 50% jump in forecast 2015 earnings to $1.02 per share. The other component is Gladstone LNG which remains on track and budget for first LNG in 2015 and is now 80% finished. Gladstone will comprise one-quarter of expanded revenues from 2016.

The narrow economic moat rating and high fair value uncertainty are unchanged. We continue to expect the new LNG projects in PNG and Gladstone to generate modest excess returns based on our long term price forecasts. LNG project progress means development risk is greatly reducing and cost pressures from a strong A$ and tight labour and contracting capacity have significantly abated. Commissioning of East Coast export plants is driving domestic gas prices higher. STO is Australia's largest domestic gas supplier and will benefit from the higher domestic gas prices. M

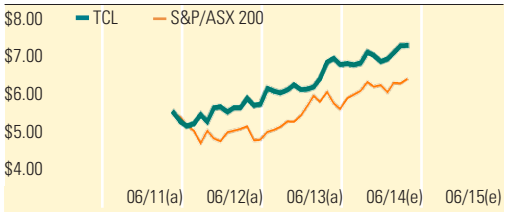
Analyst: Mark Taylor

Transurban Group TCL | $7.27

Large Cap | Infrastructure Operations | 29 Apr 2014

Recommendation **Reduce**

Uncertainty Rating	**Medium**
Stewardship Rating	Standard
Moat Rating	Narrow
Fair Value ($)	6.50
Morningstar Style Box	
Mkt Cap ($ Mil)	10,846
Last Review	17/04/14 (YMW14)
Ann. Share Turnover (%)	55.7
ROE-FY13 (%)	0.2
Net Interest Cover (x)	1.1
52 Week Hi/Low ($)	7.47/6.50
Ex-Dividend	23 Dec 2013
Payable	14 Feb 2014



	06/11(a)	06/12(a)	06/13(a)	06/14(e)	06/15(e)
NPAT ($m)	-34.7	-25.5	8.2	65.9	118.4
EPS (c)	-2.4	-1.8	0.6	4.3	6.2
EPS % Chg	--	--	--	--	--
DPS (c)	27.0	29.5	31.0	35.0	39.0
Franking%	0.0	25.0	25.0	25.0	25.0
Div Yield%	5.3	5.4	5.0	4.8	5.4
Grsd up%	5.3	5.9	5.5	5.3	5.9
P/E	--	--	--	--	--

Investment Perspective

Transurban Group is an internally managed toll-road operator with proven management skills and a good-quality portfolio of Australian toll-road concessions. Toll roads have high barriers to entry and benefit from rising traffic volumes and tolls, which grow at CPI (consumer price index) or higher. The firm offers a defensive and growing cash flow stream, but returns are lower than they appear at first blush given the roads are handed over to the government for no consideration when long-term concessions end, after repaying all related debt. Careful acquisitions and upgrades, including lane additions, can generate excess returns. Greenfield developments are less appealing as they carry high traffic-forecasting risk.

Large equity raising to fund Brisbane Beachhead

Transurban Group (TCL) is buying Queensland Motorways (QM) in a consortium with AustralianSuper and the Abu Dhabi Investment Authority for $7.1bn including costs. TCL's stake is 62.5%. The purchase price is relatively high, but the roads are good quality, have long concessions and cost savings are likely. The beachhead in Brisbane also puts TCL in a good position to leverage the asset base to grow organically and make further acquisitions. Additionally, above-average long-term population growth is likely in South-East Queensland, a good tailwind supporting traffic volumes.

Our forecasts adjust to incorporate the QM acquisition and the CityLink upgrade. With a large equity raising at a price above our valuation, a mildly positive acquisition and the CityLink upgrade, we increase our fair value estimate 8% to $6.50 per security. TCL remains slightly overvalued, in our opinion.

TCL will raise $2.7bn in equity to fund the QM acquisition with a placement to consortium partners and a 10 for 43 renounceable rights issue at $6.75 per security, representing a 6% discount to the theoretical ex-rights price. The retail offer closes 23 May 2014. We recommend not taking up rights as the offer price is slightly above our fair value estimate, though there is not much in it. Renounced rights will be sold in a bookbuild and proceeds above the issue price will be paid to renouncing investors. We continue to believe TCL has a narrow moat due to its large portfolio of high-quality roads. Its core roads generate strong returns compared with the cost to build or acquire them.

However the success of early private toll roads now sees greater competition and has helped educate government negotiators. This weighs on the returns TCL is likely to achieve from acquisitions and developments in future. This fully priced QM transaction supports our view. This is an important point for investors. As the roads have finite concession lives, after which they are handed back to the government for no consideration and with no debt, new roads must be added to extend the firm's existence. With new additions likely to be fairly priced, replacing large existing assets will cost a commensurately larger amount of money, ensuring ongoing significant equity raisings.

The acquisition price of $6.7bn excluding transaction costs represents an enterprise value/EBITDA multiple of 27.5 times and broadly consistent with recent toll road acquisitions. We see the acquisition as detracting from near-term free cash flow per security, improving somewhat over the longer term. But overall we view the acquisition as mildly positive due to the material lengthening of TCL's average concession life and strategic benefits from establishing a beachhead in Brisbane.

QM's weighted average concession length is 38 years, compared with 22 years for TCL prior to the acquisition. Post acquisition, TCL's average concession length increases to 26 years.

Following the acquisition and equity raising, financial leverage measured as proportional debt to enterprise value remains roughly flat at 44% post acquisition, though forecast debt to EBITDA increases modestly. We still consider TCL's financial position sound. Distribution guidance remains $0.35 per security in FY14, but this will no longer be fully covered by free cash flow. Guidance for FY15 distributions of $0.39 is in line with our prior forecast.

Separately, TCL announced in-principle agreement with the Victorian government for a co-ordinated upgrade to CityLink and adjacent state-owned roads. The project will cost $850m, and construction will be carried out from 2015 to mid-2017.

Analyst: Adrian Atkins

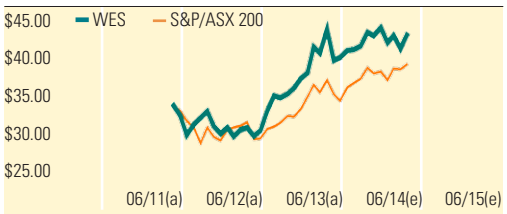
Wesfarmers WES | $43.89

Large Cap | Grocery Stores | 29 Apr 2014

Recommendation **Hold**

Uncertainty Rating	**Medium**
Stewardship Rating	Standard
Moat Rating	Wide
Fair Value ($)	42.00

Morningstar Style Box	
Mkt Cap ($ Mil)	49,172
Last Review	10/04/14 (YMW13)
Ann. Share Turnover (%)	49.6
ROE-FY13 (%)	8.8
Net Interest Cover (x)	7.8
52 Week Hi/Low ($)	44.69/37.10
Ex-Dividend	24 Feb 2014
Payable	02 Apr 2014



	06/11(a)	06/12(a)	06/13(a)	06/14(e)	06/15(e)
NPAT ($m)	1949.0	2173.0	2310.0	2343.3	2775.1
EPS (c)	168.6	188.0	199.8	204.8	242.6
EPS % Chg	24.4	11.5	6.3	2.5	18.4
DPS (c)	150.0	165.0	180.0	190.0	220.0
Franking%	100.0	100.0	100.0	100.0	100.0
Div Yield%	4.6	5.4	4.8	4.3	5.0
Grsd up%	6.6	7.7	6.9	6.2	7.2
P/E	19.3	16.3	18.7	21.4	18.1

Investment Perspective

Wesfarmers' diversified operational portfolio provides exposure to many segments of the Australian economy. In fiscal 2013, more than 80% of group revenue was consumer related. Contribution to group earnings before interest and tax from these operations is near 75%. Other operations provide exposure to resources, coal mining, agricultural, industrial, medical and industrial gases, and insurance. Wesfarmers is Australia's largest private-sector employer with more than 200,000 people on the payroll. We believe Wesfarmers has a wide moat sourced from cost advantages derived from its significant retail scale. Return on equity is affected by dilutive equity issues associated with the acquisition of Coles in 2008 and significant goodwill, but return on invested capital (excluding goodwill) comfortably exceeds the cost of capital.

Another solid quarterly sales performance with hardware a standout

Wesfarmers (WES) 3Q14 quarterly sales performance was solid with total sales up 4.4% on 3Q13 to $12.7bn. Investor attention was drawn to the Coles supermarket division which recorded a 3.9% increase in headline revenue which compares with growth of 4.9% in the December quarter. The earlier timing of Easter in 2013 reduces the clarity of comparing data with the company reporting an adjusted 3.5% increase in comparable sales. We view this as a reasonable result in light of ongoing price deflation, which was 0.8% for the quarter. Both Coles and Woolworths are reinvesting in price to take market share from independents. The Bunnings hardware division achieved robust like-for-like sales growth of 9% for the quarter as rising house values spilled over into an increase in home renovating and DIY activity. After accounting for the new sales data, we make no change to our fair value estimate of $42.00. We view the stock as fairly valued, reflecting its ongoing strategy to increase its retail presence while the company remains tight-lipped on any potential acquisition after the recent divestment of its insurance division.

We view WES as having a wide moat derived from cost advantages. With annual supermarket sales of $36bn from Coles and $9bn in hardware sales from Bunnings, the group generates cost advantages by negotiating favourable terms with suppliers and spreading operating costs across a large revenue base.

Coles remains on track to materially increase its store base over the next three years, with $1.1bn to be spent on an additional 70 supermarkets. The store closure program, focused on smaller non-performing stores, is nearing an end while the store refurbishment program is only 52% complete. We remain of the view that despite competitor Woolworths having similar capital expenditure to grow its supermarket store portfolio, both retailers will continue to take market share at the expense of smaller independent retailers.

Coles Express, the convenience brand, delivered a surprisingly strong performance with comparable sales (excluding petrol) up 8%. This is reflective of the positive customer response to the decision by management to bring many of its value offers across from the larger supermarkets to convenience outlets.

The Bunnings brand continues to press home its market dominance as the largest big-box hardware retailer to offer compelling value and range to attract customers. Comparable store sales increased 9% for the quarter. Bunnings continues to expand aggressively, with four warehouses opened during the period and a further 16 under construction. Bunnings is in the first year of a three-year plan to open 85 new stores at a cost of $1.5bn.

The Target brand remains in a process of transformation and the reason for a 3.6% decline in headline sales and a 5.9% fall in comparable store sales. This reflects a moving away from over-ordering and over-promoting to a "first price is the right price" strategy. We expect any turnaround in performance will take until 1H15 to materialise as the division starts to cycle weak comparable data.

Kmart reported a 1.9% increase in comparable sales after adjusting for Easter. We view this as a strong underlying performance in light of the financial constraint many households are under as value-conscious consumers are attracted to the offer of the lowest prices for everyday items. The potential for higher taxes in the forthcoming Federal Budget is likely to become a further hindrance to the financially constrained and we expect Kmart will continue to capture a growing share of value seeking consumer expenditure. IM

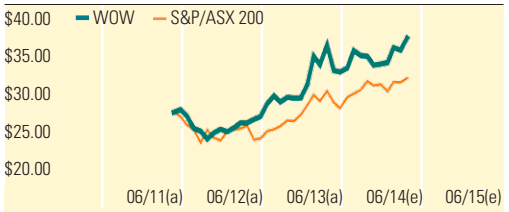
Analyst: Tim Montague-Jones

Woolworths WOW | $38.04

Large Cap | Grocery Stores | 30 Apr 2014

Recommendation **Reduce**

Uncertainty Rating	**Low**
Stewardship Rating	Standard
Moat Rating	Wide
Fair Value ($)	36.00
Morningstar Style Box	
Mkt Cap ($ Mil)	46,825
Last Review	06/03/14 (YMW08)
Ann. Share Turnover (%)	46.7
ROE-FY13 (%)	26.2
Net Interest Cover (x)	9.5
52 Week Hi/Low ($)	38.92/31.53
Ex-Dividend	17 Mar 2014
Payable	24 Apr 2014



	06/11(a)	06/12(a)	06/13(a)	06/14(e)	06/15(e)
NPAT ($m)	2107.6	2182.7	2355.3	2452.9	2574.8
EPS (c)	172.3	177.7	189.5	197.3	207.1
EPS % Chg	5.0	3.2	6.6	4.1	5.0
DPS (c)	122.0	126.0	133.0	140.0	140.0
Franking%	100.0	100.0	100.0	100.0	100.0
Div Yield%	4.5	4.9	4.3	3.7	3.7
Grsd up%	6.4	7.0	6.1	5.3	5.3
P/E	15.8	14.4	16.4	19.3	18.4

Investment Perspective

Woolworths is a dominant player in an oligopolistic supermarket landscape with 22% greater trading area than its nearest rival. By 2020, we expect Australian supermarket trading area to expand from 2.2 to 2.8 million square metres. Australian supermarkets contributed 68% of group sales and 84% of group earnings before interest and taxes, or EBIT, and margin is an impressive 7.9%. Diversification into home improvement in a joint venture with Lowe's offers exciting potential in a fragmented market where the leading market share is 16%. Woolworths' wide moat reflects its cost advantage relative to peers. Consistent elevated returns on equity and invested capital, and free cash flow generation over almost 20 years have driven enviable total shareholder returns. Defensive qualities with our growth expectations underpin this sleep at night investment counter.

Market share gains as both Woolworths and Coles flex scale to improve value for customers

Woolworths (WOW) reported another healthy increase in quarterly sales, which were up 5.3% for third-quarter FY14 to $15.1bn. Australian Food and Liquor, which represents 84% of group earnings, increased comparable sales, after adjusting for the timing of Easter, by 3.5%. This is the same rate reported by Coles but was below market expectations. Consensus forecasts expected WOW to end Coles four year plus period of outperformance in comparable sales growth in the critical Food and Liquor segment. Both companies reported strong customer numbers and market share gains. Both companies are reinvesting capital back into lower prices to further differentiate their value at a time when consumers remain increasingly cost conscious. Both supermarket groups are aggressively expanding their store footprints, with Woolworths adding 32 stores this year, on an increase of 21 last year and plans to add an additional 36 next year. Retail scale enables both groups to spread operating costs across a large revenue base and negotiate favourable terms with suppliers. We view these competitive advantages underpin both WOW and Wesfarmers (WES) wide economic moat-like qualities, derived from cost advantages. We make no change to our fair value estimate of $36.00 and view the company as fairly valued.

Customer data is becoming increasingly important to retain a competitive edge in the retail sector. Retail is becoming more of a science and less of an art as financial resources are allocated to collecting large amounts of data to analyse consumer buying habits and trends. Data is being used to direct promotional campaigns, increase customer loyalty and ensure stores cater for local demands. Woolworths is in the process of sharing the results from its analyses to its key suppliers so they can take advantage of purchasing habits to improve their ability to meet emerging customer demand. In our view, better understanding and predicting customer demand will further reinforce the competitive advantage both Woolworths and Coles have in taking share from smaller independent retailers.

BigW reported a 5.9% fall in comparable sales, after adjusting for the timing of Easter. The poor performance reflects the decision by management to reorganise the division to build a more compelling retail channel to sell general merchandise either in-store or online. Plans remain guarded but we expect store fronts will be focused on fast-moving products with larger slow-moving products housed centrally and offered through its online direct shipping channel. A new managing director, Alistair McGeorge, who has more than 20 years of general merchandise experience, starts in June and will be responsible for leading the transformation strategy. We expect any turnaround in performance will take time to flow through and we expect earnings to remain constrained until the latter half of FY15.

The Masters hardware brand continues to expand, with seven stores added during the quarter, taking the total to 45, with sales up 40% on the same period last year to $179m. The business remains in the development phase while management remains confident in retaining guidance of reaching break-even by FY16. We view the rationale of becoming a second sizable player in the $42bn big-box home improvement market as sensible considering its rival Bunnings is achieving attractive operating margins of over 12%. We expect sales growth will be erratic but, over time, WOW will tweak the Masters concept to resonate with consumers and offer the group another avenue to grow earnings.

Despite good economic conditions New Zealand supermarkets struggled with headline sales flat and comparable sales down 1%. A competitive marketplace and deflation inhibited progress. M

Analyst: Tim Montague-Jones

Woodside Petroleum WPL | $39.59

Large Cap | Oil & Gas E&P | 17 Apr 2014

Recommendation **Accumulate**

Uncertainty Rating	**High**
Stewardship Rating	Standard
Moat Rating	Narrow
Fair Value ($)	50.00
Morningstar Style Box	
Mkt Cap ($ Mil)	33,846
Last Review	20/02/14 (YMW06)
Ann. Share Turnover (%)	59.9

	12/13(a)	12/14(e)	12/15(e)
NPAT	1984.2	2687.5	2595.6
EPS	246.3	333.6	322.2
% Chg	-0.4	35.4	-3.4
DPS	192.7	266.9	257.7
Fr%	100.0	100.0	100.0
Div %	5.2	6.7	6.5
Grsd%	7.4	9.6	9.3
P/E	15.1	11.9	12.3

LNG prices continue to rise for narrow moat-rated Woodside

Woodside Petroleum (WPL) reported marginally higher 1Q14 revenue of US$1.7bn, up 1.5% sequentially, an upside surprise. The rise came courtesy of strong LNG prices despite steady sales volumes of 23 million barrels of oil equivalent and a slightly weaker Brent crude price of US$107.87 per barrel. LNG price achievement for NWS/JV was a marginally better than anticipated US$13 per million British thermal units (/mmBtu), steady on 4Q13. But the Pluto LNG price of US$10.65/mmBtu was again well ahead of expectations, reflective of 28% of sales at a higher price following a review. Pluto customers were given a sweetened start-up price that is unwinding faster than anticipated. WPL's 90% equity Pluto LNG start-up volumes are 50% greater than its 16.7% equity NWS/JV volumes.

Our fair value estimate is unchanged at $50.00 per share. We increase 2014 and 2015 earnings forecasts by 15% and 25% to $3.34 per share and $3.22 per share, respectively, after increasing our oil production forecast on the back of a successful re-start to the prolific Vincent oil field, and after pushing out construction start-ups for Browse LNG and Pluto Train 2 by another year, to 2015.

We retain our narrow economic moat and high fair value uncertainty ratings. WPL is a high quality Australian oil and gas name with a leading growth profile. Appeal remains low-cost production, tenement prospectivity, and first-mover advantage in LNG infrastructure which can drive superior production and earnings growth and excess returns on invested capital. A shift in focus from the Western Australian heartland to international projects headlined by the Leviathan gas field in Israel continues to annoy. But underlying core assets are of a quality to ensure value will be realised eventually. MI

Analyst: Mark Taylor

Iluka Resources ILU | $9.11

Medium Cap | Copper | 17 Apr 2014

Recommendation **Accumulate**

Uncertainty Rating	**High**
Stewardship Rating	Exemplary
Moat Rating	Narrow
Fair Value ($)	11.00
Morningstar Style Box	
Mkt Cap ($ Mil)	3,697
Last Review	23/01/14 (YMW02)
Ann. Share Turnover (%)	126.7

	12/13(a)	12/14(e)	12/15(e)
NPAT	95.2	193.8	333.8
EPS	22.7	46.3	79.7
% Chg	-73.9	103.6	72.2
DPS	9.0	20.0	30.0
Fr%	100.0	100.0	100.0
Div %	0.9	2.2	3.3
Grsd%	1.3	3.1	4.7
P/E	44.6	19.7	11.4

Turnaround yet to materialise but enquiries suggest a demand pick-up

Conditions remain weak for Iluka Resources (ILU) with 1Q14 mineral sands sales down 7% on 1Q13 to $131m. This was weaker than expected and will likely see a decline in our FY14 earnings forecast of about 20%. We are yet to formally update our FY14 forecast. Earnings in FY14 are at a low ebb and the weak quarter is immaterial to our fair value estimate, unchanged at $11.00 per share. Management notes customer inventories have normalised and enquiries for products have increased but are yet to translate into sales volumes. ILU says 2Q will give a better guide to the trend.

ILU is moderately undervalued given the depth of the cyclical low and should enjoy pricing power once demand starts to meaningfully recover. If there is a global recovery in housing construction, ILU is well placed with tiles and paint big demand drivers for zircon and rutile respectively. Sales volumes are below GFC levels and a meaningful cyclical recovery is highly likely with customer inventories back to normal levels, producers cutting output and stocks and general economic conditions improving, particularly in the U.S. We maintain our high fair value uncertainty rating as mineral sands markets are relatively small and cyclical. Our narrow moat rating is intact, based on ILU's low-cost position thanks to high-grade reserves in the Eucla and Murray Basins.

ILU advances a range of development options, consistent with the view demand will recover. The counter-cyclical investment is consistent with our exemplary stewardship rating. Management's recent move to encourage demand for its products, and to potentially strengthen competitive advantage through an investment in titanium powder technology, is also in keeping with our rating. MI

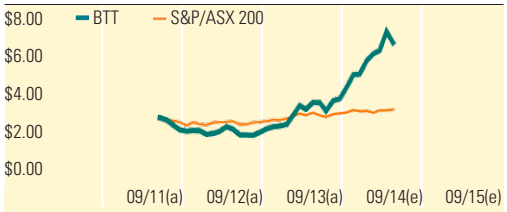
Analyst: Mathew Hodge

BT Investment Mgmt BTT | $6.70

Medium Cap | Asset Management | 30 Apr 2014

Recommendation **Hold**

Uncertainty Rating	**Medium**
Stewardship Rating	Standard
Moat Rating	Narrow
Fair Value ($)	6.50
Morningstar Style Box	
Mkt Cap ($ Mil)	1,894
Last Review	23/01/14 (YMW02)
Ann. Share Turnover (%)	26.7
ROE-FY13 (%)	9.7
Net Interest Cover (x)	40.6
52 Week Hi/Low ($)	7.45/2.82
Ex-Dividend	14 May 2014
Payable	02 July 2014



	09/11(a)	09/12(a)	09/13(a)	09/14(e)	09/15(e)
NPAT ($m)	30.5	41.5	61.9	118.7	120.6
EPS (c)	17.7	14.6	21.3	40.0	40.6
EPS % Chg	-3.2	-17.5	45.9	87.7	1.5
DPS (c)	16.0	12.5	18.0	28.0	33.0
Franking%	100.0	100.0	72.2	35.0	35.0
Div Yield%	6.1	6.4	5.8	4.2	4.9
Grsd up%	8.6	9.2	7.6	4.8	5.7
P/E	14.9	13.3	14.5	16.8	16.5

Investment Perspective

BT Investment Management is pure-play wealth manager with a decent performance record and sticky retail client base. The company benefits from secular growth in compulsory superannuation contributions, beneficial taxation treatment and favourable demographic trends. Stock market performance influences net inflows and funds under management, directly impacting revenue and making the share price volatile. Geographic diversification increased significantly following the U.K. J.O. Hambro Capital Management acquisition, removing the sole Australia focus. Our positive view is based on a recovery in global markets, increased investor confidence in Australia and a growing pool of savings, all of which grow funds under management and the potential for performance fees. Meaningful operating leverage will see margins strengthen as additional fee income mostly flows through to the bottom line.

Successful global expansion drives strong first-half result

BT Investment Management's (BTT) strong first-half performance confirmed our positive view on this narrow moat-rated wealth manager. Leveraging a sticky customer base, brand, and investment performance, BTT continues to grow funds under management (FUM) and increases the constant stream of profitable fee income it receives. Higher markets, increased FUM, performance fees, and net inflows all worked in unison to drive a 143% increase in cash NPAT to $83.1m in 1H14. As guided in the December quarter FUM update, strong investment performance saw a substantial increase in performance fees to $115m, from only $34m in 1H13. Performance fees sourced from the firm's UK subsidiary are paid annually and will not repeat in the second half. Base management fees beat our expectations, with a 40% increase, to $138m due to a favourable shift in the asset mix to higher margin retail funds and decline in lower-margin cash and fixed-income products.

Our fair value estimate increases from $6.00 to $6.50 on our more optimistic view of base management fee margins. At current prices, the stock is fairly valued. We previously assumed slight margin pressure over the explicit five-year forecast period, particularly in the crowded core equity space in Australia. We now believe a combination of lower asset allocation to cash and fixed income, and an increase in funds sourced from higher-margin retail investors, can largely offset these pressures. Base management fees for the group increased to 45 basis points in 1H14 from 40 basis points a year earlier, supporting an increase in our FY14 cash NPAT forecast from $107m to $119m.

While everything is seemingly going BTT's way, it is important to note how favourable underlying conditions have been. Australian and global equity markets rose 12% and 15%, respectively, during the period, and a 15% fall in the A$ against £Stg increases Australian reported earnings derived offshore. These conditions move in cycles, but we are pleased with strategic initiatives put in place to underpin long-term growth.

Management initiatives have not only helped propel earnings, but are building strong foundations for future growth, and help reduce business risk and earnings volatility. Management's focus to grow a global investment business has come to fruition, with UK based JO Hambro accounting for 85% of cash NPAT in the half. We believe the firm is taking advantage of its investment performance, brand, and scale as it grows into new markets and expands its investment capabilities.

JO Hambro's early success in expanding into the U.S. is encouraging. Four dedicated sales staff have made great inroads into the very large U.S. mutual fund market, with FUM increasing US$500m in the half alone, to US$1.1bn. Earnings volatility is reduced through geographic and product diversity, given markets do not move in tandem, and different products come in and out of favour.

Management continues to seek talented investment professionals from around the world, both teams and individuals, to expand BTT's suite of investment product and broaden regional exposures. While it doesn't appear to be high priority at the moment, we believe a successful global equity offering targeted at the Australian retail market is required. BTT does not actively pursue Australian capital to invest in global funds, as it sees better opportunities in filling its global portfolio capacity with higher margin FUM sourced outside Australia as more attractive. We argue this gap should be plugged as soon as possible, given our view an increasing portion Australia's growing superannuation asset pool will be invested in international asset classes.

Analyst: Nathan Zaia

JB Hi-Fi JBH | $20.80

Medium Cap | Specialty Retail | 23 Apr 2014

Recommendation **Sell**

Uncertainty Rating	**High**
Stewardship Rating	NA
Moat Rating	None
Fair Value ($)	11.00
Morningstar Style Box	
Mkt Cap ($ Mil)	2,038
Last Review	30/01/14 (YMW03)
Ann. Share Turnover (%)	237.7

	06/13(a)	06/14(e)	06/15(e)
NPAT	116.6	129.1	134.8
EPS	117.3	129.8	135.5
% Chg	10.8	10.6	4.4
DPS	72.0	79.2	82.7
Fr%	100.0	100.0	100.0
Div %	6.1	3.8	4.0
Grsd%	8.7	5.4	5.7
P/E	10.0	16.0	15.4

Appoints new CEO; reaffirms guidance

CEO Terry Smart's surprise retirement effective August 2014 after four years at the helm represents a loss of experience, given he has been with the company since the management-led buyout in 2000. His successor is current CFO Richard Murray and he is well-credentialed and experienced, having been CFO for more than 10 years. We don't expect major changes to the current strategy, given Murray is an internal appointment, and a board member since 2012.

JB Hi Fi (JBH) released a sound trading update for the March quarter and reaffirmed FY14 sales and NPAT guidance. Total sales are expected to be 6% to 8% higher, with NPAT between $126m to $129m. Comparable store sales for the March quarter were up 3.0% and total sales up 5.7%. The new store rollout is a key growth driver with two more added so far in 2H14. JBH still expects to have 22 HOME stores operating by 30 June with 19 stores converted to date. Gross margin was consistent with 1H14.

There are no changes to our forecasts or to our $11.00 fair value estimate. In our view, the shares are currently overvalued, trading at a significant premium to our fair value estimate.

Our view differs from the market. Over the long term, we expect JBH will find it increasingly difficult to extract earnings growth as the store portfolio reaches maturity. While diversification into other areas such as home appliances, commercial, and online will help boost sales, we expect this will only allow the company to extend its growth profile over the short term. This view is reflected in our earnings forecast, which decline from 2017. We also expect earnings to eventually reflect the impact of increasing competition from online sources. For this reason, we don't believe JBH has a sustainable competitive advantage or economic moat. M

Analyst: Tim Montague-Jones

ResMed RMD | $5.26

Medium Cap | Medical Instruments & Supplies | 25 Apr 2014

Recommendation **Accumulate**

Uncertainty Rating	**Medium**
Stewardship Rating	Standard
Moat Rating	Narrow
Fair Value ($)	6.00
Morningstar Style Box	
Mkt Cap ($ Mil)	7,377
Last Review	30/01/14 (YMW03)
Ann. Share Turnover (%)	98.2

	06/13(a)	06/14(e)	06/15(e)
NPAT	327.3	352.5	391.2
EPS	22.3	24.7	27.8
% Chg	30.6	10.7	12.6
DPS	7.6	10.4	11.4
Fr%	0.0	0.0	0.0
Div %	1.9	2.0	2.2
Grsd%	1.9	2.0	2.2
P/E	18.3	21.3	18.9

Weathering the CB2 storm with new products ready to launch; raising our fair value estimate

Despite the disruption to the pricing environment stemming from the ongoing roll-out of the Medicare competitive bidding (CB2) initiative in the United States, Resmed (RMD) reported 3Q14 earnings slightly above our expectations.

Top-line revenue increased 4% compared to 3Q13 (3% on a constant currency basis) to US$397.8m. This comprised revenue in the Americas of US$216.1m, essentially flat year on year, and revenue outside of the America's of US$181.6m, an increase of 6% in constant currency terms. A quarterly dividend of US$0.25 reflects a 40% payout ratio based on earnings per share of US$0.63. Net cash as at 31 March 2014 stood at US$543m.

Encouragingly, mask sales in the U.S. rose by 4% on a sequential quarter basis reflecting strong uptake of the new AirFit P10 nasal pillow interface, launched in January 2014. The AirFit P10 was recently launched in Europe and Asia-Pacific and bodes well for continued sales growth into 4Q14. Management also flagged the launch of two additional masks in 4Q in the U.S. - a new full face mask, the AirFit F10 and a new nasal mask, the AirFit N10. On the flow generator side, RMD expects to launch its new respiratory care platform into the U.S. pending FDA clearance commencing with the Astral life support ventilator later this year.

Our fair value estimate for RMD moves from US$49.00 to US$54.00 per share (A$5.50 per CDI to A$6.00), versus the current share price of US$46.75 (A$5.26 per CDI). Our perspective remains positive on the longer term prospects given the steady rate of well-differentiated and innovative product introductions coupled with growing evidence of the clinical relevance of sleep apnea to other medical conditions. M

Analyst: Chris Kallos