MORNINGSTAR®

Australia and New Zealand Share Market and Credit Outlook

Investor confidence returns but value becoming scarce

- The market is fairly valued, in our view. Fair value should lead to a fair return over a multi-year period: High-single-digit annualised total returns roughly split between capital appreciation and dividend yield.
- The easy money has been harvested, and we now have slightly more negative recommendations than positive. Having said that, a diversified portfolio of our buy, accumulate, and hold stocks should generate total returns greater than interest on cash. Stock selection is more important than ever.
- Energy and materials offer the best value, but investors will require patience while commodity prices slide toward historical average levels. We prefer companies with economic moats, as always. Banks have provided strong investor returns in the last year and we see further upside, but this sector is now closer to fair value.
- Health care has been a sought-after area for investors for its prized defensive earnings growth streams, and is now one of the most expensive sectors. Share prices for retailers and media companies, which are facing structural and cyclical headwinds, have also risen beyond levels justified by fundamentals.
- New Zealand's share market is also fairly valued, but we do see investment opportunities in telecommunications, while health care and building materials are the least preferred areas on valuation grounds.
- Australian listed credit securities have rallied due to declining interest rates and the search for high yield. We still see value in some bank-issued securities issued prior to recent regulatory changes as these are trading in line with the newer securities, which have longer terms to maturity and less favourable structural characteristics.

Equities investors are certainly a lot happier than they were this time last year, having enjoyed strong returns, particularly since mid-2012. What of the coming year? On our numbers, any additional rise will be muted and we don't expect anything like the gains seen in the last 12 months. Selected opportunities remain but are harder to find in what we see as a fully-valued market. The market-cap weighted average price/fair value across our Australia and New Zealand coverage universe of around 230 stocks is 0.99, which would put the market as a whole firmly in the middle of our hold range.

Australian stocks appear cheaper than New Zealand stocks overall, with price/fair value now 0.96 compared with 1.08 for New Zealand. Australian price/fair value has risen from 0.80 in June 2012 and 0.90 in December as the market strengthened and a number of our positive calls played out. Much of the value continues to dwell in the large caps, particularly resources heavyweights like BHP Billiton (BHP), Rio Tinto (RIO) and Woodside Petroleum (WPL) that have lagged the market on concerns of weak global growth and rising costs, and QBE Insurance (QBE) which the market hasn't yet fully forgiven for its earnings downgrades last year. The median price/fair value of our coverage universe (1.06) is higher than the market-cap weighted average (0.99), indicating that there are more overvalued stocks than undervalued, although only mildly. Still, bottom-up stock selection when constructing direct equity portfolios is crucial to out-performance.

The rally started in June 2012 as the market realised the world was not falling into a black hole and unprecedented global stimulus reduced the attractiveness of cash and bonds. Much of the rally has related less to company fundamentals than the global asset allocation shift away from cash and fixed interest, which offer abysmal returns. Initially there was a flight to quality, but the rally has recently been more broadly based across defensive, growth and small cap stocks as investor confidence improved.

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On fundamental grounds it is hard to pick the share market's direction. The higher the market trades, the greater the adverse impact of unforseen negative shocks. However, we can envision a continued asset allocation shift to equities, pushing the market into more clearly overvalued territory. The average gross dividend yield of our Australian coverage universe is 5.0%, which compares very favourably to global cash and bond yields, as well as Australian term deposit rates that will likely decline further if there are more official interest rate cuts this cycle.

Australian economic growth should moderate as mining investment peaks, non-mining activity remains subdued and unemployment creeps higher. Company margins have improved through cost cuts, but these efforts can only go so far. With only modest revenue growth expected overall, it will be difficult for margins to improve meaningfully for a while yet. The global economy is a net positive, offset partially by the high Australian dollar. The continuing recovery in the U.S. is evidenced by recent positive housing, employment and retail spending data. China is shaken but long-term fundamentals are still compelling. Europe could continue to be the cause of intermittent shocks to confidence as it muddles through its debt crisis, exampled by the recent debate over Cyprus's bank bailout measures. We never know for sure where the shock will come from…but we sleep well at night by focusing our best ideas and portfolios on fundamental measures of intrinsic value and margins of safety.

Our recommendations are taking on a negative bias as the market rises

Given the rise in the market, and industry factors playing out broadly in line with our long-term expectations, there has been a substantial shift from a positive to negative bias to our recommendations since last June. Buy and accumulate recommendations are now outweighed by reduces and sells – 15% of our recommendations are positive while 32% are negative. In December there was a more even balance – 20% positive versus 22% negative. In June we had 39% positive versus just 8% negative. Outright buys are now much harder to find, representing just 3% of our current calls, compared with 10% in June.

Many stocks are trading around fair value; in fact 52% of our recommendations are holds. With so many of our calls in this category, it's important to be clear on what this recommendation actually means. 'Hold' indicates that investment returns should be modestly positive over the next few years and investors should receive a fair risk-adjusted return. A fair risk-adjusted return is essentially cost of equity, which we would summarise loosely as a high-single-digit return roughly split between capital appreciation and dividend yield, in the Australian share market. Stocks bought in our accumulate or buy zones as part of a diversified portfolio should generate a greater than 'fair' return.

We always encourage a focus on attractively-priced competitively-advantaged (economic moat) companies held over the long term, so the benefits of compounding can accrue. History, along with our own equity portfolios, shows that this is the best way to achieve market-beating returns with less risk. We always prefer to purchase stocks in the buy zone as these provide a margin of safety that limits the downside and extends the potential upside, but investors committed to the market for the long term should focus on the best opportunities at all times. The best relative value when the market is fully valued may be stocks in the hold zone in some cases.

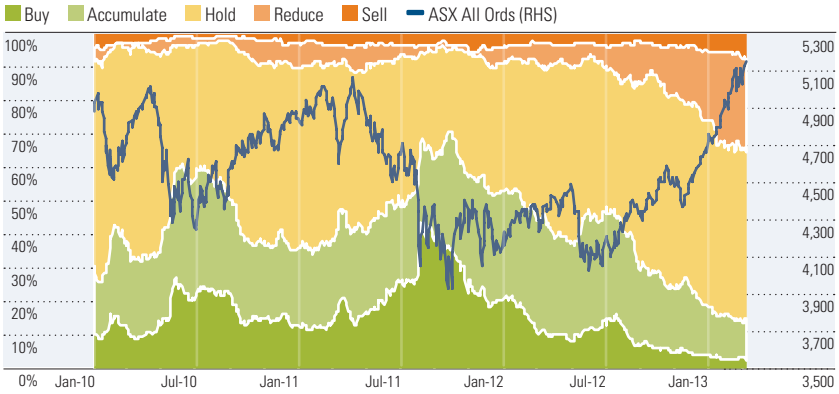
Stock selection is more important than ever

With little value in the market generally, stock selection has taken on a new level of importance. A number of stocks we recommended in 2011 and early 2012 are now significantly overvalued. General insurer Insurance Australia Group (IAG) has returned 73% in the last year; online car classifieds provider Carsales.com (CRZ), 66%; online job ads provider Seek (SEK), 44% and telecommunications services provider Amcom (AMM), 74%. Each of these stocks are now in the reduce zone. We have had a positive bias to health care for some time, but many stocks in this area, like CSL (CSL) and Ramsay (RHC), are now looking stretched.

Our positive calls on each of the major banks for much of the last three years have played out well for our clients. Australia & New Zealand Bank (ANZ) has returned 29% in the past year, National Australia Bank (NAB), 33%, Commonwealth Bank (CBA) 45%, and Westpac (WBC) 48%. NAB and ANZ still offer attractive value while Westpac is just below fair value and Commonwealth is slightly above.

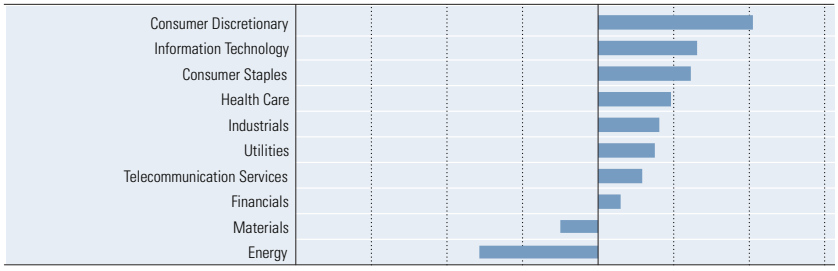
Our recommendations are based on a long-term fundamental view and rigorous, consistently-applied methodology, so the proportion of positive versus negative recommendations will ebb and flow in negative correlation with moves in the market. Figure 1 demonstrates how our recommendations have helped clients generate wealth in the last few years. We had many positive recommendations as the market sold off through 2011 and many of these transferred to holds and then reduces as the market rallied since mid-last year.

Figure 1: Morningstar's Stock Recommendation History



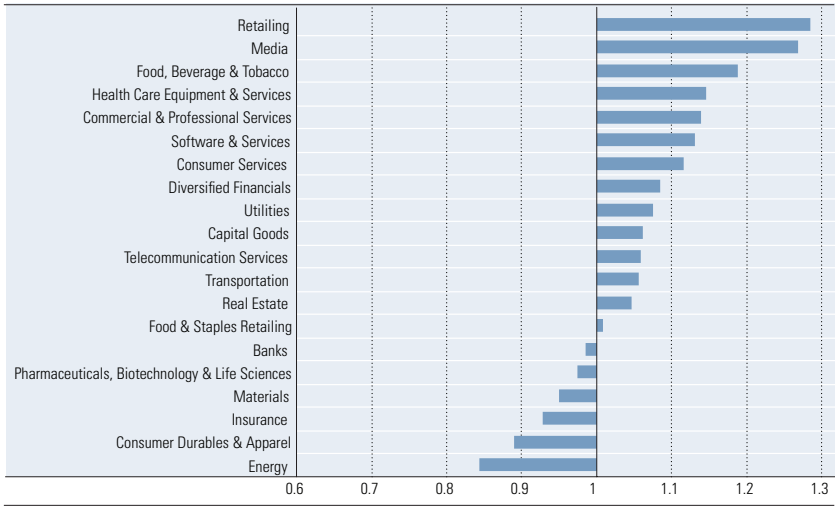
Source: Morningstar Analysts, ASX

Figure 2: Australia and New Zealand Sector Price/Fair Value



Source: Morningstar Analysts.

Figure 3: Australia and New Zealand Industry Group Price/Fair Value



Source: Morningstar Analysts.

Resources and financials remain the most attractively priced areas

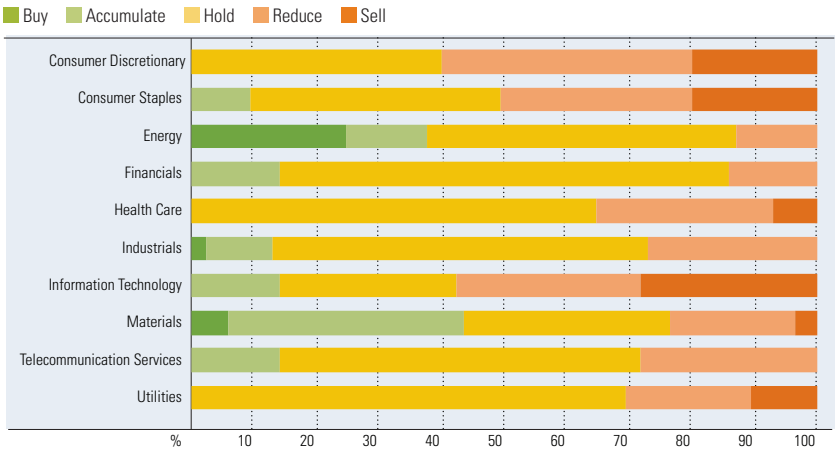
Energy is the cheapest industry across our coverage, and high quality mining is also among the most attractively valued. Given the earnings instability typical of companies in this area, due to large upfront capital costs and exposure to volatile commodity prices and production success rates, we encourage a focus on moat companies with a patient long-term view.
Our preferred resources picks are globally-scaled, low-cost producers BHP, Rio and Woodside. BHP and Rio are better placed than others to withstand the likely depreciation in commodity prices, while the probable further rise in Henry Hub gas prices and shortage of cheap new conventional oil supply are positives for Woodside. Alumina (AWC) is also a favourite right now.

Banks continue to be one of our preferred investments though they are closer to fair value following their strong share price gains in line with our positive recommendations. Strong industry positions, modest but positive credit growth, lower wholesale funding and operating costs, and strong capital positions, support solid growth in earnings and dividends. NAB is our preferred bank on the grounds of relative value, and stronger earnings and dividend growth.

Insurance is one of the cheaper industries, mainly for the value still available in QBE Insurance. We expect a strong recovery in earnings through a return to normalised rates of catastrophe and natural disaster claims, improved operational performance and better investment returns from the eventual rise in global interest rates.

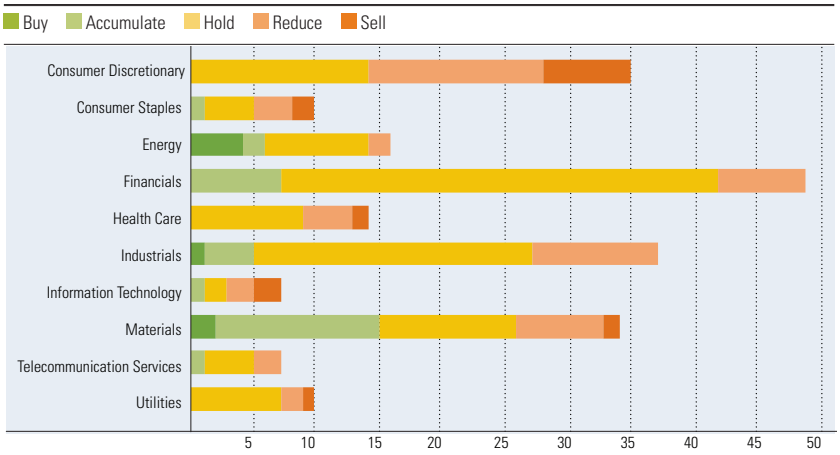
Telecommunications, real estate investment trusts (REITs) and utilities are generally fairly valued, but there are still opportunities within these areas for income-focused investors. We encourage a focus on lower-uncertainty moat companies with sustainable yields above market-average levels and well above term-deposit interest rates.
Within telecommunications, Telstra (TLS) remains a standout from a yield perspective, offering a 6% plus fully-franked yield, with solid cash flows supported by mobile growth and national broadband network (NBN) payments. With a possible change of government in September, any renegotiation of NBN arrangements is likely to be made on mutually-beneficial terms.
Our favoured REITs are ALE Property (LEP), BWP Trust (BWP) and Charter Hall Retail (CQR) each with above-average distribution yields supported by high-quality tenants, long leases with fixed or inflation-linked rental increases and low vacancy rates.
Within utilities, our picks are lightly-regulated APA Group (APA) and Sydney Airport (SYD).

Figure 4: Australia and New Zealand Recommendation Dispersion Across Sectors (%)



Source: Morningstar Analysts

Figure 5: Australia and New Zealand Recommendation Dispersion Across Sectors (no. of stocks)



Source: Morningstar Analysts

Discretionary retail and media, both facing cyclical and structural headwinds, are our least-preferred sectors, following rebounds in share prices beyond levels supported by fundamentals. We expect consumer conservatism and focus on debt repayment to subdue retail spending growth for some time, while retailers themselves face an increasingly competitive environment through the influx of foreign brands and a shift to online sales. Our long-term projection for traditional newspaper and television media firms is softened by the shift in advertising spend online.

Health care is a sector we love to own but prices are at or near unsustainable levels. We have held a long-term positive bias in this area because of the high presence of moats and defensive earnings growth streams, but these companies have been popular with investors and valuations are beginning to look stretched. We have reduce recommendations on most in this space and we have relatively low conviction on the two cheapest stocks, biotechnology developers Mesoblast (MSB) and Acrux (ACR), which are holds with very-high uncertainty.

Please enjoy our detailed outlook for each sector in the reports that follow.

Morningstar's Best Stock Ideas

The Morningstar Best Stock Ideas that follow feature our most vetted investment ideas trading at attractive prices today. These ideas are intended to have broad application in a variety of equity strategies, but individuals should consider their personal investment goals and positioning before investing.

Code	Name	Price $	Fair Value $	Price/ FV	Mkt Cap $bn	Moat Rating	Business Risk	FY13 PE	FY13 Yld %	Franked %	Morningstar Reccomendation	Notes
Banks												
ANZ	**ANZ Bank**	28.55	32.00	0.89	78.33	Narrow	Medium	12.2	5.3	100	Accumulate	Earnings growth is underpinned by ANZ's Asian expansion strategy, steady business and home lending, and cost savings. Management is strong, capital levels are high and the yield is attractive.
NAB	**National Aust. Bank**	30.63	35.00	0.88	71.75	Narrow	Medium	12.0	6.2	100	Accumulate	We expect funding costs to decline further and productivity to improve, while stronger equity markets will drive wealth earnings and the worst of peer bad debts will benefit from a stronger economy.
QBE	**QBE**	13.07	18.00	0.73	15.64	Narrow	Medium	13.1	3.8	32	Accumulate	Despite sharply lower recent profits due to higher individual and catastrophe claims and low bond yields, we expect a solid recovery in profits in the next few years. Long term value remains.
WBC	**Westpac**	30.50	33.00	0.92	97.43	Narrow	Medium	13.7	5.7	100	Hold	WBC benefits from its multi-brand distribution strategy, strong market share, relatively low bad debts, improving margins and the best cost-to-income ratio.
Resources												
AWC	**Alumina**	1.16	2.85	0.41	3.26	None	High	22.0	5.3	100	Buy	AWC's key assets are substantial global bauxite reserves and low cost alumina refining operations. Earnings could improve substantially in time as a de-linking of aluminium and alumina prices allow alumina producers to raise prices.
BHP	**BHP Billiton**	33.43	50.00	0.67	107.37	Narrow	Medium	13.6	3.4	100	Buy	A balanced suite of world class, long life assets in conjunction with a power-house balance sheet and strong management.
RIO	**Rio Tinto**	57.92	95.00	0.61	113.6	Narrow	Medium	8.6	3.2	100	Buy	A large discount to fair value and world class, long life assets. Now recovered from balance sheet over-gearing.
WPL	**Woodside Petroleum**	36.94	70.00	0.53	30.44	Narrow	High	17.0	3.5	100	Buy	As Australia's premier oil play, Woodside Petroleum's operations encompass liquid natural gas, natural gas, condensate, crude oil and liquefied petroleum gas.
Small Cap												
REX	**Regional Express**	1.15	1.40	0.82	0.14	None	High	7.6	5.7	100	Accumulate	This independent regional airline faces limited competition as the majority of airline routes would be unprofitable for the majors to service.
SMX	**SMS Management and Tech**	5.27	6.00	0.88	0.37	None	Medium	14.3	5.9	100	Accumulate	SMS provides a range of IT consulting services to a diversified portfolio of largely long term clients. We like the fact that switching costs are high, with SMS staff embedded into client work practices.

Outlook for Financials

We continue to see major banks as a preferred investment area, while there are opportunities in insurance, property and utilities as well

David Ellis
Sector Head: Financials, Infrastructure, Insurance, Property

Adrian Atkins
Senior Analyst: Infrastructure, Property

Tony Sherlock
Senior Analyst: Property

- Our positive major bank investment thesis remains intact and is supported by moderate GDP growth, stable unemployment, moderate earnings growth and dividends growing in line with earnings per share growth.
- National Australia Bank is our preferred bank based on a stronger earnings and dividend growth outlook and relative value compared with peers. It will continue rerating to peer valuation metrics, boosting the share price.
- Our upgraded earnings forecasts reflect a more positive outlook for the general insurance sector. We expect QBE Insurance to deliver significant improved earnings, underpinned by higher insurance margins, improved productivity, strong cash flow and higher investment returns.
- The wealth managers are well placed to leverage the recovery in investor confidence, an increasing appetite for risk and higher returns from equity markets. Higher revenues on relatively fixed-cost bases lift bottom-line profit growth.
- Rents continue to grow, but the pace of growth has moderated, particularly for the retail landlords where tenant sales growth remains subdued. Tenant quality is a key differentiator, with investors prepared to pay a premium for property assets with long leases, fixed or CPI-linked escalations and low vacancy risk.

Banks: Improved productivity and revenue focus supports profit growth

We are increasingly confident surplus capital will continue to accumulate, supporting growing dividends and other capital management initiatives. Ironically, return on equity (ROE) will be under pressure due to increasing capital, despite higher profits. ROEs could shrink without capital management initiatives.

An extended period of low interest rates is driving yield-conscious investors to banks. Major bank dividends are expected to increase while deposit rates could fall further. An economic slowdown in Australia will likely see higher bad debts, but this is not our base case. We are confident loan quality is solid, provisions are adequate and, importantly, earnings and capital buffers are sufficient to cope with any eventual economic downturn.

The major banks' narrow moats are underpinned by strong competitive advantages, including dominant pricing power, high barriers to entry, large-scale low-cost operations, access to lower-cost funding, a large, sticky customer base and a high-profile, well-regarded brand. The major banks operate in a highly profitable government-regulated oligopoly and we believe the four majors will 'over earn' for several years. We believe earnings growth will surprise on the upside, hence our positive view.

Table 1: Financials Best Ideas

Code	Name	Morningstar Recocmendation	Fair Value	Economic Moat	Uncertainty
AMP	**AMP Limited**	Accumulate	7.00	Narrow	Medium
APA	**APA Group**	Hold	6.00	Narrow	Medium
ANZ	**ANZ Bank**	Accumulate	32.00	Narrow	Medium
GMG	**Goodman Gp**	Hold	4.60	Narrow	Medium
NAB	**National Aust. Bank**	Accumulate	35.00	Narrow	Medium
QBE	**QBE**	Accumulate	18.00	Narrow	Medium

Table 2: Bank Key Valuation Comparison at 21 March 2013

Bank	Morningstar Recommendation	Share Price $	Fair Value $	Market Cap $m	P/E (x)			EPS Growth %			Dividend Yield % (Fully Franked)		
					2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
ANZ	Accumulate	28.55	32.00	77,209	9.8	11.9	11.5	3.1	4.7	4.1	6.6	5.4	5.7
CBA	Hold	68.63	63.00	110,470	10.9	14.6	13.8	2.4	4.9	5.5	6.8	5.2	5.5
NAB	Accumulate	30.63	35.00	71,093	10.2	11.8	11.1	-3.4	8.2	7.1	7.5	6.3	6.8
WBC	Accumulate	30.50	33.00	93,360	10.1	13.3	12.5	3.1	4.9	6.0	7.6	5.9	6.2
BEN	Hold	10.19	10.00	4,113	9.7	11.6	10.5	-8.8	5.0	10.1	7.3	5.9	6.5
BOQ	Hold	9.44	8.50	2,960	Large	14.2	12.0	-82.0	Large	19.0	7.2	5.6	6.0
Major Bank Average					10.3	12.9	12.2	1.3	5.7	5.7	7.1	5.7	6.1

Source: Morningstar Forecasts

Lower funding costs, tight cost control, moderate credit growth and benign bad debts should boost earnings growth as margin pressure eases. Put simply, the major banks have pricing power if margins are squeezed – this is a key differentiator and greatly enhances the investment case. Improved confidence would trigger a rebound in consumer spending and business activity, leading to increased demand for credit. Improved equity markets will boost wealth management earnings. Stable credit quality will keep the lid on bad debts and better technology leverage will improve productivity and increase the gap between revenue and expense growth. We are positive on the outlook for all four major banks, assuming economic growth remains close to trend with dividends growing at least in line with earnings per share growth. In this environment the biggest risk is a self inflicted 'stuff-up', but we do not rank this highly as all banks are mindful of this risk.

The banks are undergoing major IT modernisation projects to better service a growing and rapidly changing client base. They have the scale, financial resources and balance sheets to invest in systems upgrades, new products, systems and distribution, but most importantly they realise how crucially important it is to stay ahead of trends and changes. We expect the significant project work to deliver meaningful cost savings and improved operational efficiency, and to provide revenue growth opportunities. But implementation risk increases due to the complexity and size of the projects.

At present, valuations look stretched, with the major banks' average fiscal 2013 P/E ratios around 13 times, a level crossed only twice in the past seven years, being June 2006 and June 2009. Further out our fiscal 2014 forecast P/E ratios are more attractive, around 11 to 12 times. We expect moderate earnings growth will bring P/E ratios down to more attractive levels. The key to long-term earnings growth is the health of the economy as they leverage GDP growth, increasing consumer and business confidence, rising incomes, population growth and a recovery in demand for credit. Two-way regional capital flows between Australia and Asia provide attractive long-term growth opportunities.

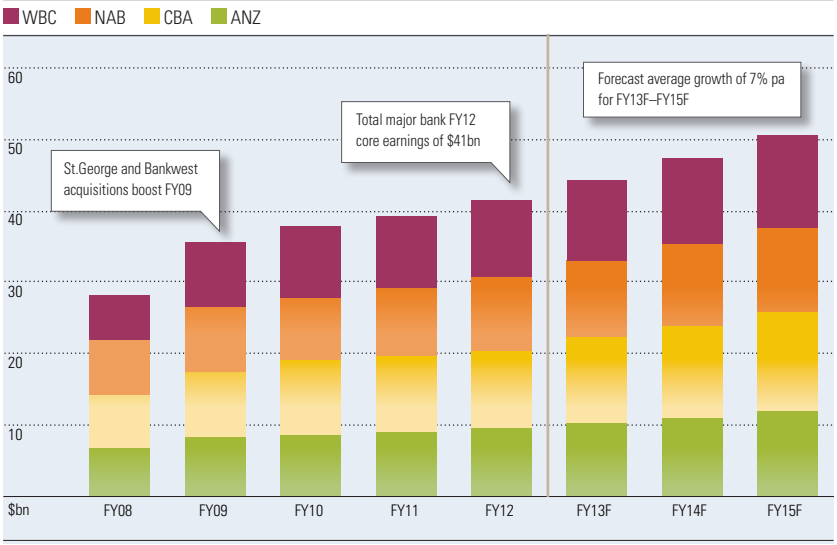
Banks represent good long-term value. Investors who wait for concrete proof of higher earnings and dividends will miss out on further capital upside. We strongly believe evidence of earnings growth will unfold over the next few years, based on trend GDP growth, improved margins, benign bad debts and, most importantly, conservative management decisions.

National Australia Bank (NAB) is set to surprise with strong, high-quality earnings growth, resurrecting its long-forgotten reputation as a sought-after major bank. NAB's Achilles' heel is U.K. banking, but we expect slow improvements in the U.K. and European financial services sector to provide exit strategies over the next year or so. Our reassessment of the merits and rankings of the big banks promotes NAB to our preferred bank, based on a stronger earnings and dividend growth outlook and relative value compared to peers. NAB will continue rerating to peer valuation metrics (that is, price/earnings, dividend yield and price/book), boosting the share price.

We have long argued NAB offered the best upside but carried higher risks than peers; however, we now consider the risks are decreasing and the potential upside is very attractive. NAB's leading market share of the business banking sector will bear fruit when the economy starts to recover. Home loan growth of 7.7% is sector-leading and customer deposit growth is strong. The earnings story for NAB is not just cost cutting. It produces solid revenue growth which is critical for rerating. NAB has attractive fundamentals: a healthy balance sheet, high ROE, technological advantage, high market share, and strong growth.

Commonwealth Bank (CBA) was our preferred bank during 2011 and early 2012, and in early August 2011 we published a buy recommendation at AUD 45, now AUD 69, up 53% excluding dividends. We recommended buy or accumulate on all four major banks through 2011 and 2012, with our CBA recomendation moving to hold in July 2012. Following CBA's strong share price rise we moved from CBA to Australia & New Zealand Banking Group (ANZ) as

Figure 1: Major Bank Core Profits-Revenue less Operational Expense



Source: Company Accounts/Morningstar Forecasts. Note: Core earnings are net profits before tax and bad debts.

preferred major bank exposure in early 2012. Very strong share price growth has seen our recommendation on ANZ move from buy to accumulate and is close to our hold trigger point. Excluding dividends, ANZ has risen over 65% during the past 18 months.

Strong growth attracts investors. The core businesses are running well, with margins holding up due to strong competitive positions. The ability to reprice loans surprised some throughout 2012, but we have long argued this ability is key to the bank's competitive strength and narrow moat. The solid 5.4% increase in total major bank fiscal 2012 core earnings (profits before bad debts and tax) was a real standout. We forecast an average 7% per annum increase in core earnings between 2013 and 2015 providing a strong buffer in case bad debts spike. We expect the total of major bank core earnings to reach AUD 50 billion in fiscal 2015, refer to Figure 1).

Insurers: Restructuring and business simplification support earnings

Results for the six months to December 2012 were clear of major natural peril events in Australia and New Zealand, with significantly higher insurance margins testament to earnings leverage in the domestic oligopoly. QBE Insurance (QBE) suffered from major catastrophes, particularly in North America. We expect strong cost control despite further investment in technology and systems. Balance sheets and capital levels continue to benefit from higher profits and lower operational risk. We recently increased our fair value estimates based on an upgraded investment thesis, as operating improvements are likely to be realised sooner than previously expected. We are increasingly confident QBE's new management will deliver earnings of improving quality despite future natural peril events.

Widespread industry restructuring and business simplification is bearing fruit. We argue uncertainty in the outlook for future earnings is reducing, particularly in the core consumer and business insurance markets. Material increases in premium rates, tightly-managed claims costs and increased investment returns will boost earnings. At current prices we consider QBE undervalued, Suncorp (SUN) fairly valued and Insurance Australia Group (IAG) overvalued. We now have a much more positive view on the earnings outlook for the insurers due to significant progress in improving insurance profitability and lowering risk profiles. QBE is undergoing a long-needed consolidation, restructuring and adjustment phase following an extended period of growth via acquisition. Longer term, we expect stronger economic conditions in the U.S. (less so in Europe) and higher northern hemisphere interest rates to boost returns. The cost reduction program is guided to reduce operating expenses USD 250 million per year by 2015, but we believe this is a conservative estimate.

Wealth Managers: Market recovery and improved confidence boosts outlook

A continued low interest rate environment and improved sentiment has boosted confidence in the sector. However, operating conditions are still tentative, and many companies are focused on costs as regulatory conditions remain tough. Flows for the second half of 2012 were generally disappointing, but the outlook has improved substantially. Wealth managers with good access to investment platforms, or better yet still manage their own platforms, have a distinct advantage over those that do not. A sticky base of retail funds under management, a significant financial planning network, leading investment platforms, and extensive exposure to compulsory superannuation flows are clear competitive advantages. Combined with better market conditions and changing demographics, we expect comprehensive business models and strong brands to deliver stronger earnings performance. High returns on capital employed, strong free cash flows and robust balance sheets make wealth managers particularly attractive in bull markets. We expect further M&A activity as the major players (the major banks, AMP and to a lesser extent IOOF Holdings (IFL)) look to bulk up.

Our preference for vertically-integrated business models remains unchanged; AMP and IFL remain our preferred pure wealth managers for lower-risk investors, with both being vertically-integrated, providing financial advice and distribution, platform management and administration, investment management and trustee services. We consider Challenger (CGF) and Henderson (HGG) undervalued but are more risky plays considering CGF's higher capital requirement and business model built around annuities and HGG's U.K.-based European fund management focus. The major banks are significant participants in the space. Importantly, the banks (as well as AMP and IOOF) are the gatekeepers through their ownership of dealer groups, control of approved product lists (APL) and the management of industry-leading investment platforms. Despite potentially generating strong investment returns, asset managers can struggle to attract new flows without access to the dominant platforms.

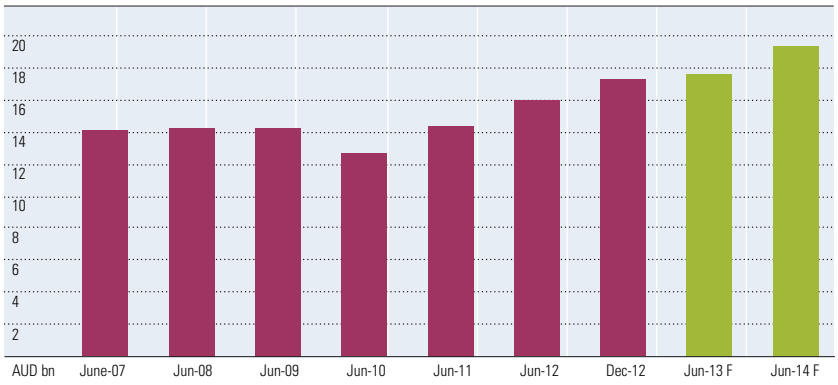
Property: Despite strong price growth, yields still attract

The Australian real-estate investment trust (AREIT) sector still offers an attractive yield premium to bonds, despite the recent rally in AREIT security prices. The rally could continue further, but we caution investors coming late to the property party are unlikely to see the same outperformance as in 2012. Overall, we believe the property sector is fairly valued and have hold recommendations on nearly all of the property stocks in our coverage universe. On this basis, we believe investors are getting a fair risk-adjusted return based on current security prices. The main risk is the potential for the economy and global credit markets to substantially deteriorate, leading to lower rents, higher vacancies and more costly and difficult-to-access debt. Balance sheets are much stronger than they were before the global financial crisis so most AREITs provide solid, defensive characteristics.

Near-term earnings forecasts for the property sector were raised slightly during the February reporting season, driven mostly by lower average borrowing costs. Rents continue to grow, but the pace of growth has moderated, particularly for retail landlords where tenant sales growth remains subdued. Tenant quality is a key differentiator, with investors prepared to pay a premium for property assets with long leases, fixed or CPI-linked escalations and low vacancy risk. Stocks with these traits include Shopping Centres Australasia (SCP), BWP Trust (BWP), Charter Hall Retail (CQR) and ALE Property (LEP), where the main tenants are divisions of the major supermarket chains.

We are forecasting the moderating Australian growth outlook to weigh on rental growth over the medium term, but expect occupancy to remain high as speculative construction activity is low in most markets. The exception is the Melbourne and Sydney office markets, where rent growth is expected to be weak over the next three to five years due to overbuilding and head count reductions in the public and private sectors. Against this backdrop, our preferred property exposures are to those with conservative gearing and less risk to rents and occupancy.

Figure 2: Goodman Group – Actual and Forecast change in Funds Under Management (AUD billion)



Source: Company/Morningstar

Infrastructure: Unregulated stocks to outperform

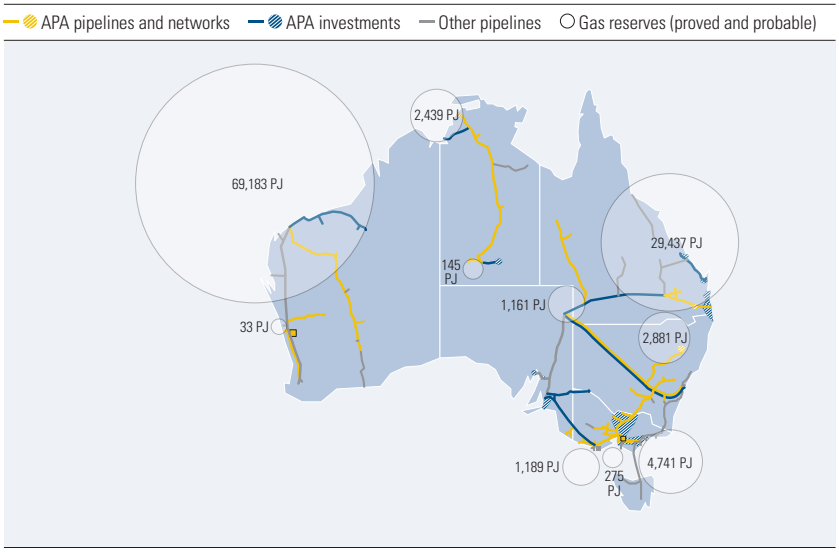
There is no change to our preference for unregulated and lightly-regulated infrastructure companies over fully-regulated utilities. Unregulated and lightly-regulated stocks include APA Group (APA), Sydney Airport (SYD) and Transurban (TCL). Regulated utilities include DUET (DUE), Envestra (ENV), Spark Infrastructure (SKI) and SP AusNet (SPN).

We are cautious on regulated utilities as high household utility bills and the low risk-free rate have engendered a more hostile regulatory environment. As regulatory resets only occur every five years, some networks will continue to generate good returns in the near term, but the longer-term outlook is poor. Most infrastructure stocks have rallied strongly in recent years. We believe Envestra and DUET are now substantially overvalued, while Spark and SP AusNet are more reasonably valued and may still appeal to income investors. On a longer term view, our preference is for APA and Sydney Airport. These lightly-regulated stocks are in strong positions to withstand downward pressure on returns. Both are roughly fairly valued on an absolute sense and are in our hold zone. However, compared to other income stocks, we believe they are relatively attractive.

APA owns an excellent gas transmission network stretching across most of the country. The long-term outlook for gas is good and APA can generate healthy returns from increasing use of its existing assets. Current growth is suppressed by high investment in projects which are yet to start operating, but strong growth is expected from fiscal 2016 upon commencement of new contracts on the recently-acquired South West Queensland Pipeline.

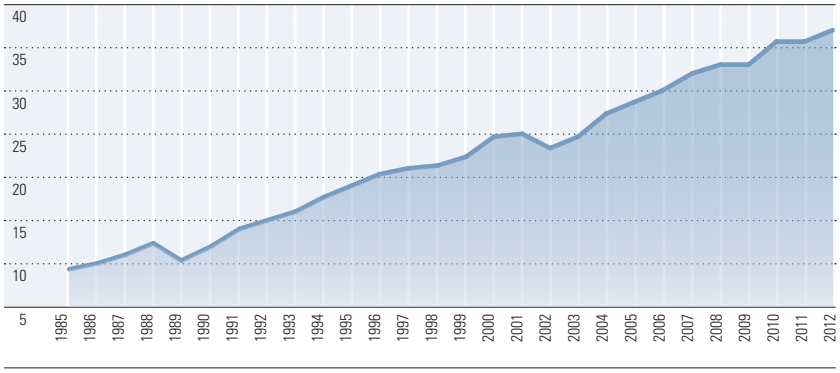
Sydney Airport also owns an excellent asset, Australia's largest airport and key international hub. Half of revenues come from aeronautical charges, which the regulator keeps an eye on, but doesn't get actively involved in setting. The balance comes mostly from retail store rents, car park operations, and rent from the airlines, car hire companies, the Australian Federal Police and customs. While we think highly of

Figure 3: Australian Gas Infrastructure Assets



Source: APA presentation

Figure 4: Sydney Airport Passenger Numbers (millions)



Source: Morningstar Analysts

the asset, the capital structure is aggressive, with high gearing and a high distribution payout ratio. This could deter very conservative investors but shouldn't be a deal breaker for most. In the worst case scenario, the capital structure can be fixed by an equity raising, which shouldn't be too dilutive for a high-quality asset like this.

Share prices for most infrastructure stocks have risen strongly in recent years. Combined with cheap debt, infrastructure companies could easily justify raising capital in 2013 to fund accretive acquisitions. Another issue to watch this year is the Australian Taxation Office's review into infrastructure companies. This may lead to tax increases, but domestic investors' returns wouldn't be materially impacted due to the benefit of franking credits. Returns for international investors could be hurt modestly, resulting in temporary selling pressure in affected stocks. Overall, we don't consider this a major concern.

Financials Best Ideas

Our sector best ideas are based on the best relative value opportunities with a bias to quality. Most of our best ideas will have buy or accumulate recommendations though some are holds. A 'hold' recommendation indicates that investment returns should be modestly positive over the next few years and investors should receive a fair risk-adjusted return.

AMP Limited (AMP)

AMP is our preferred wealth manager due to high market share, a strong brand, large sticky customer base, a low cost base and the largest aligned financial planner network in Australia and New Zealand. We believe these strong competitive advantages underpin AMP's narrow moat. We argue AMP is well run and we are confident management can deliver on guidance to reduce costs even further, setting the platform for revenue growth to exceed expense growth.

APA Group (APA)

APA owns an excellent gas transmission network stretching across most of the country. The long-term outlook for gas is good and APA generates healthy returns from increasing use of existing assets. Lightly-regulated, APA is in a strong position to withstand downward pressure on returns and at current prices offers attractive value.

Australia & New Zealand Banking Group (ANZ)

The Asian growth strategy is gaining momentum with good volume growth, and the Australian franchise continues to efficiently manage costs and margins. Our positive view is intact despite constrained revenue growth and flat margins in Australia and New Zealand in 2012. The differentiated super-regional growth strategy is on track and we are confident management will deliver. We are upbeat on the bank's medium-to long-term prospects, with income growth to exceed cost growth.

Goodman Group (GMG)

Goodman is a specialist in the development and management of higher-quality industrial property and business parks. The high rental yield on offer on quality industrial property, compared with bonds, supports strong investor inflows to its funds management platform over the foreseeable future. Well-established relationships with large sovereign wealth funds are a definite plus, as is an expanded geographic reach in Brazil, China and the USA.

National Australia Bank (NAB)

We recently upgraded our forecasts and increased our fair value estimate as underlying profit growth is gaining traction faster than previously anticipated. We expect funding costs to decline sooner and by a greater degree, productivity will likely improve faster, stronger equity markets will drive wealth earnings and the worst of peer bad debts will benefit from a stronger economy.

QBE Insurance (QBE)

QBE is undergoing a long-needed consolidation, restructuring and adjustment phase following an extended period of growth via acquisition. We are confident the new CEO will turn the business around, strengthen the balance sheet and improve operational efficiency. We are increasingly confident earnings will recover and support management actions to deliver improved operational performance. Disciplined underwriting and major productivity improvements are key. IM

Note: David Ellis holds shares in all four of the major banks and QBE Insurance.

Outlook for Resources

Unloved sector provides value at the high-quality end

Mathew Hodge
Sector Head:
Basic Materials,
Energy

Mark Taylor
Senior Analyst:
Basic Materials,
Energy

Gareth James
Senior Analyst:
Basic Materials,
Energy, Utilities

- The market still offers value at the high-quality end of the resources sector. We expect commodity prices to continue to trend down towards long-term averages from previously elevated levels. The iron ore market already shows signs of improved balance. We consider miners with sustainable competitive advantages (low costs and long life) as best placed to defend margins, take market share and/or return cash to shareholders. Some commodities like thermal and coking coal, and aluminium, are trading closer to cyclical lows and have potential for longer-term upside.
- Senior management changes at global resources majors could herald a welcome change in focus from volume growth to cost reduction, minimising capital expenditure and returning cash to shareholders. We consider volume growth to be a poor strategy at this point in the cycle, particularly for commodities like iron ore. Capital costs are very high and demand growth is softening, probably permanently, from very high levels. Capital discipline is critical to defending margins and maximising free cash flow by not overwhelming weaker demand with too much supply.
- We still expect Henry Hub gas prices to rise meaningfully from current levels, despite a significant recovery from April 2012 lows of sub USD 2.00 per thousand cubic feet (mcf) to near USD 4.00 per mcf in March 2013. This reflects a rational reduction in gas-well drilling rates in response to low prices. Longer term, our U.S. energy team expects the Henry Hub gas price to rise to USD 5.40 per mcf, which is likely to reduce North American exports to only a minor proportion of the seaborne liquefied natural gas (LNG) market. This is particularly positive for Woodside and growing LNG producers like Santos, Origin Energy and Oil Search.

Table 1: Resources Best Ideas

Code	Name	Morningstar Reccomendation	Fair Value	Economic Moat	Uncertainty
AWC	**Alumina**	Buy	2.85	None	High
BHP	**BHP Billiton**	Accumulate	50.00	Narrow	Medium
NCM	**Newcrest Mining**	Accumulate	31.00	None	High
RIO	**Rio Tinto**	Buy	95.00	Narrow	Medium
WPL	**Woodside Petroleum**	Buy	70.00	Narrow	High

Our least-preferred resource companies

Our outlook for falling iron ore prices dictates negative recommendations for iron ore miners with below average profit margins and weak balance sheets. Arrium (ARI) and Fortescue (FMG) are leveraged both financially and operationally, in part due to relatively inferior quality iron ore which attracts discounts to the benchmark iron ore fines price. They are also highly geared. We consider steel to be structurally challenged and Arrium has exposure there too. BlueScope (BSL) repaired its balance sheet at considerable expense – the number of shares on issue more than quadrupled from 2008 – and stability of the business is greatly increased, but the share price has run ahead of any meaningful fundamental improvement.

Mining: Outlook for lower demand growth and prices places a premium on quality

Large, low-cost and expandable assets are the litmus test for building an economic moat in the mining industry. Large producers, such as BHP Billiton (BHP) and Rio Tinto (RIO), with favourable positions on their respective cost curves, are best placed to cope with likely softer demand growth. A decade of surging Chinese commodity demand and high commodity prices justified higher volumes, but weaker demand growth and prices caused investor focus to switch to profit margins. Mining companies now seek efficiencies via lower operating and capital costs. Maximising returns on existing capital is the name of the game, rather than continuing to invest while costs are high.

Worldwide industrial production and fixed-asset investment are crucial to commodity demand, with emerging markets particularly important. For some commodities, like copper, new globally-significant discoveries are few and far between. Average head grades are falling and production disruptions imply a positive near-term price outlook. Gold follows a similar script, as miners battle the headwinds of declining grades and increasing depth.

The supply outlook for aluminium is less constrained. A decline in consumption in 2009 forced warehouse inventories to record levels. Comparatively low barriers to entry and a desire to stimulate growth saw China invest heavily in new smelting capacity. We are much more positive on the outlook for bauxite and alumina; however, as the alumina price delinks from the aluminium price. We see robust demand for alumina and very little new supply over the next few years which should be positive for the alumina price. Nickel supply, like aluminium, is also less constrained for several reasons, including the emergence of massive laterite nickel projects and nickel pig iron as a large, but higher-cost, source of supply. Where China can boost supply of a commodity, by building processing capacity, it has done so to the detriment of prices and margins.

The fate of bulk commodities rests on steel demand where the real question centres around what will happen outside the U.S., namely in Europe and China. The short-term outlook remains uncertain and is likely to be volatile. Longer-term global commodity consumption should be robust but we don't expect anything like the China-fuelled consumption growth rates of the past decade. All commodities will benefit from China's consumption, but the rate of growth will slow, particularly for iron ore and coking coal, these being early-cycle beneficiaries in developing economies. Per-capita consumption of steel in China is already at Western world levels.

The steel making materials, iron ore and coking coal in particular, are likely to be the worst performing commodities from a volume demand growth perspective. China's per-capita steel consumption is at Western world rates and there is considerable risk in projecting further strong consumption growth. Demand increases for copper, thermal coal, aluminium and titanium dioxide should be far greater. These are not early-cycle commodities and developing world consumption is generally still well below Western world levels.

We expect a gradual pull-back in commodity prices to levels, nonetheless above long-term historical averages, before China's economic emergence. Capital and operating costs are significantly above historical levels which will see the cost curve support prices. With iron ore, our long-term forecast delivered-China price remains USD 90 per tonne (2013 dollars, inflated at 2.5% per annum), 50% below first-quarter 2011 highs of USD 180 per tonne, but well ahead of the price just 10 years ago of USD 20 per tonne. Weaker prices will encourage mining companies to switch focus from volume growth to profit margins.

The position on the cost curve is of vital importance and the industry has finally caught on. Industry leaders BHP Billiton and Rio Tinto both target significant operating cost savings.

Energy: U.S. gas prices up, a positive for Australian LNG Players

In recent weeks the Henry Hub natural gas price has risen strongly toward USD 4.00 per thousand cubic feet (mcf). Not driven by demand but by curtailment in supply. Our view is unchanged. We still expect Henry Hub gas prices to rise meaningfully from current levels, despite a significant recovery from April 2012 lows of sub USD 2.00 per mcf toward USD 4.00 per mcf in March 2013. This reflects a rational reduction in the rate of drilling new gas wells in response to the unsustainably low price. Longer term, we expect the Henry Hub gas price to rise to USD 5.40 per mcf. When adding an approximate USD 6.00 per mcf for compressing and shipping LNG into the high-priced Asian market, North America is likely to only ever be a minor player in the seaborne market. This is positive for Woodside (WPL) as well as emerging LNG players like Santos (STO) and Origin Energy (ORG).

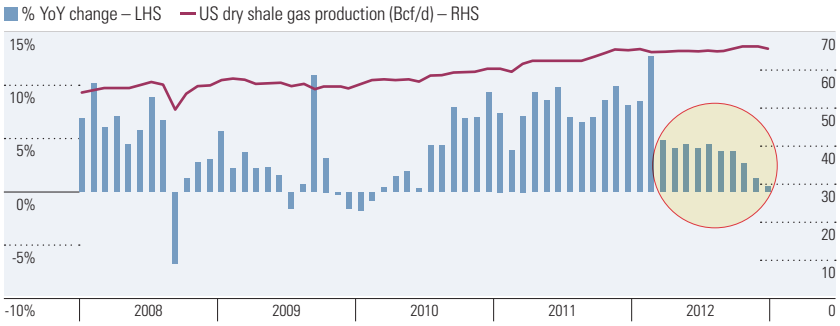
The rising Henry Hub gas price is in line with our thesis for onshore U.S. gas and suggests North America will not flood the Asian energy market with LNG. Woodside remains the best way to play the Asian LNG market. It is the most undervalued of the large energy stocks that we cover. The vast majority of earnings come from LNG.

Over a third of Santos's fair value is derived from LNG, including the PNG LNG project in Papua New Guinea and Gladstone LNG in Queensland. Origin has the least exposure to LNG with approximately one quarter of our fair value derived from APLNG. Both Santos and Origin are moderately undervalued. Oil Search's (OSH) valuation is dominated by the PNG LNG project in partnership with ExxonMobil and Santos. However, Oil Search is our least-preferred LNG exposure. The stock is somewhat overvalued as the market underestimates the sovereign risk that comes with the wilds of Papua New Guinea. This is particularly important for a highly capital-intensive, long-life LNG project.

Slowing U.S. production growth is supportive for gas prices

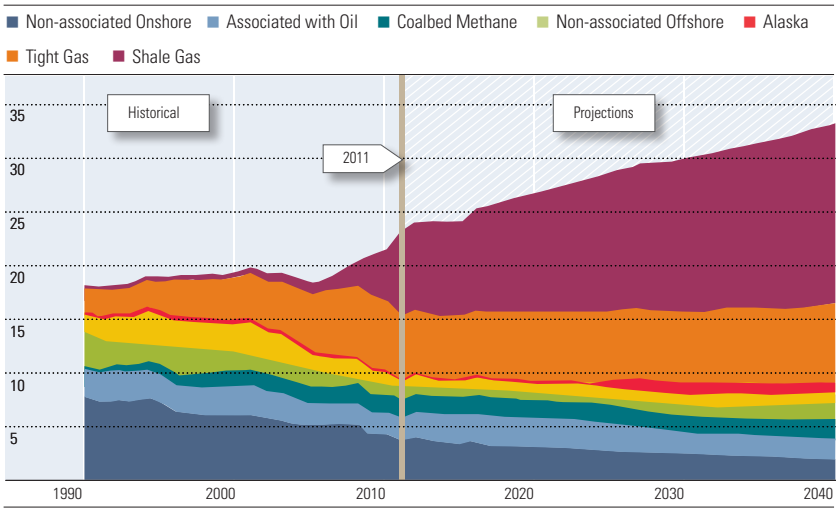
U.S. gas production is slowing and looks set to fall modestly in 2013. Year-over-year growth in dry gas production dramatically decelerated in recent months. Note the area in the red circle in Figure 1 below. By our estimates most producers are still losing money on dry gas; only liquids content and hedging have provided cash flow support.

Figure 1: US Dry Gas Production



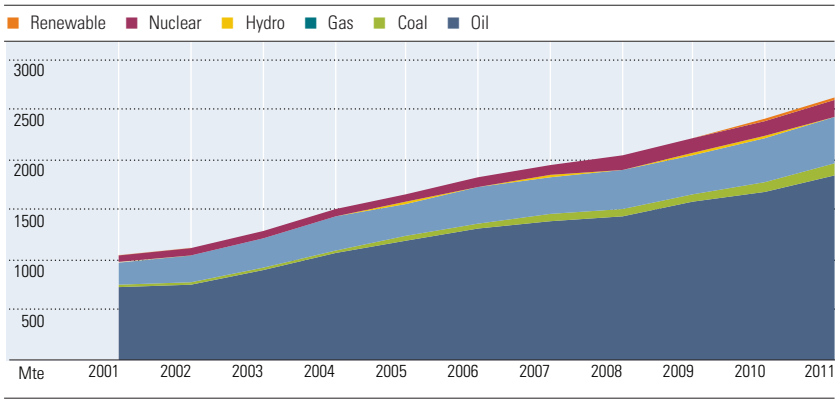
Source: EIA, Morningstar

Figure 2: US Natural Gas Production (trillion cubic feet)



Source: EIA Annual Energy Outlook 2013

Figure 3: China Energy Consumption (mte)



Source: BP Statistical Review

Examining U.S. natural gas production highlights three trends: 1) the underlying decline that's taking place in the conventional supply base; 2) the role of the Marcellus in driving incremental domestic volumes; and 3) the impact of associated gas from the Eagle Ford and Bakken shales. The Barnett and Haynesville are now in decline, with fourth-quarter year-over-year production decreases of 5% and 11%, respectively. The Marcellus offsets these declines, however, adding 2.9 billion cubic feet per day (Bcf/d) of production in the fourth quarter of 2012, a 66% increase. Gas from the Eagle Ford and Bakken, primarily produced as a by-product of liquids-directed drilling, increased by 1.1 Bcf/d, or 60%. Outside of the Marcellus and certain liquids-rich plays, dry gas has capitulated. We see this as a positive sign for gas prices, as there is no longer broad support for supply growth.

Rise in US shale gas little threat to Asian export markets

The shale gas revolution, and in particular gas from the U.S., is regularly touted as a threat to Australia's fledgling LNG industry. Figure 2 shows the dramatic increase in shale gas production forecast by the U.S. Energy Information Administration (EIA). The USD 16 mcf gas price, delivered Asia, versus the USD 4.00 per mcf Henry Hub price could be a powerful motivator for U.S. exports. However, if the U.S. is serious about energy self sufficiency, its gas is of little threat to Asian export markets. Also, the gas price differential between the U.S. and Asia could quickly resolve even with only modest U.S. exports. U.S. gas to LNG becomes marginal at a Henry Hub price of USD 6 per mcf. Coincidentally, we estimate the long-term marginal cost of North American gas production is USD 5.40 per mcf.

Global gas markets have been growing very strongly. World gas consumption increased at an average of 70 million tonnes of oil equivalent (Mtoe) per annum over the last 10 years, the equivalent of 15 new LNG trains annually Gas is also a depleting asset – additional projects are needed for global production just to stand still. Energy consumption globally seems set to increasingly rely on natural gas, with coal likely to be curbed due to carbon concerns, while conventional oil supply is challenged. Gas is likely to be required to pick up the slack from oil.

China's shale gas also warrants mention. Over the last decade China's energy supply has fallen from one of excess capacity to a deficiency of around 6% of consumption. In the mix, gas consumption is comparatively small at less than 5% of primary energy used. In 2011, 20% of Chinese gas was imported. It's highly likely China will want to diversify away from

coal at a massive 70% of energy consumption. This alone may limit potential Chinese shale gas exports. The Chinese shale gas opportunity though is large. Energy Information Administration (EIA) estimates a technically-recoverable resource of 33 billion tonnes of oil equivalent, almost half its equivalent in coal reserves. Yet, even here, this represents just 13 years of China's 2011 hydrocarbon consumption, and only nine years if the prolific 10-year annual hydrocarbon consumption growth rates of 10% persist. China's energy intensity per capita is still only a quarter that of the United States. There is also significant uncertainty around how much gas can be produced with the geology much less favourable than in the U.S.

As Figure 3 shows, China's energy consumption is dominated by coal, and gas consumption is relatively low. We expect Chinese gas consumption to rise at least in line with per-capita GDP, in part to aid lower airborne pollution, and faster than overall energy consumption growth. Also, a country that is short natural resources is likely to covet promised gas reserves rather than export them. That's even before considering commercial aspects. Shale gas is a nice supply kicker, but does not appear to be a solution to the world's energy problems. China's nuclear ambitions continue with 15 reactors in operation and 26 under construction. Nuclear accounted for less than 1% of the country's primary energy consumption in 2011, though a five- to six-fold increase is anticipated by 2020. In addition to the 41 reactors now operating or under construction, the country has a further 51 at planning stage, and 120 proposed. China is likely to require a myriad of energy sources to supply its growing demand.

The evolution of shale gas as a force in primary energy is undoubted but is needed to offset declining conventional gas production, stagnant-to-declining oil production and ongoing growth in primary energy demand in general. Shale gas is not a solution to the world's energy problems, but a larger part of the picture for a period. Short-term imbalances aside, we don't see U.S. or Chinese shale gas as a threat to Australian LNG. There is sufficient demand and meaningful energy supply challenges for shale gas which means a dramatic oversupply is unlikely long term. Shale gas is more technical, costly and time consuming to produce than conventional sources. As an embryonic industry with large doubts surrounding geology, depth, cost of production and the speed at which the pipeline network can be built, the supply story in China is uncertain. At the very least, these supply challenges will slow the progress of shale gas to market.

Oil remains a premium product

In the longer term, new sources of oil production like deepwater, tar sands and shale oil will be more expensive to develop, underpinning the USD 100 per barrel long-term price. Constrained supply against the backdrop of 2.5% compound annual growth in global primary energy consumption is compelling. Interesting to note is that key Middle Eastern oil production remained steady at 25 million barrels of oil per day (mmbopd) over the eight years to 2010 but consumption rose by one-third to 8 mmbopd, meaning a net decline in exportable oil of 12% to 17 mmbopd. This is important as the Middle East accounts for one-third of global oil and gas liquids supply.

Thermal coal suffering from shale gas

A weak natural gas price encourages utilities to switch from coal to gas where possible. In 2012, U.S. gas-fired electricity generation increased by 30% on 2011. This has an impact on the Pacific thermal coal export market with some U.S. coal desperately finding its way to export. It also exacerbates demand weakness at a time when Australian supply is improving following extreme weather in 2010 and 2011.

The Australian dollar remains stubbornly high and weighs on the entire commodity complex, with the exception of iron ore, oil and gas where prices are still relatively attractive. High capital costs, combined with unfavourable prices, have conspired to seriously curb thermal coal expansion plans. This is a positive longer term. We believe the current thermal coal price in Asia reflects abnormal circumstances, due to unsustainably low U.S. natural gas prices driving U.S. coal exports into the Asian market. While a turn in the cycle is unlikely in the short term, we feel the cycle is closer to the bottom than the top.

Resources Best Ideas

The Morningstar Resources Best Ideas list aims to bring clients the best investment opportunities from our Australian resources coverage universe. We prefer quality companies, which in the resources sector, means long-life and sustainably high margins, underpinned by low unit operating costs relative to peers. We particularly like companies with economic moats and prefer to minimise exposure to companies with very-high and speculative/extreme fair value uncertainty as these companies bring a heightened risk of permanent capital loss.

Our current best ideas are: Alumina, Woodside, Rio Tinto, BHP Billiton and Newcrest. The previous list in the December quarterly outlook included Origin (ORG), which has since returned 15%, including capital growth and dividends. Santos represented good value

and was close to being a Resources Best Idea but has risen 17% over the past three months and other companies now represent more compelling value. Newcrest (NCM) and Alumina Limited are new additions to the list. Our extensive research on Alumina Limited confirms deep value with significant upside as China increases reliance on imported alumina and bauxite. Newcrest's performance has been sedate since December, resulting in an attractive price/fair value. The stagnant gold price sees gold equities somewhat out of favour which helps the value proposition.

Of our five best resources ideas, three have narrow moats being Woodside, Rio Tinto and BHP Billiton. This in a sector that globally tends to have few moats. Resource companies have depleting reserves which means ongoing exploration expenditure is required to maintain life. All of our best resource ideas have long reserve life and, in aggregate, are vastly superior to the majority of other resource companies under our coverage, and in the broader market. Newcrest has no moat, largely due to the disastrous Lihir acquisition, which will dilute returns for the foreseeable future. The underlying assets though are significantly better than average in the gold space and Newcrest enjoys longer reserve and resource life than most of its peers. It is also set to recapture its position as a lower-than-average-cost producer with the Lihir and Cadia expansions just starting to produce. Alumina is a no moat company but has a relatively low cost-curve position, just above the lowest quartile. Industry dynamics have been unfavourable but we see this situation improving over the next few years.

BHP Billiton and Rio Tinto both have medium fair value uncertainty ratings, thanks to low-cost production. Profit margins should be relatively stable compared to peers. Strong operating cash flows provide management the options to return significant cash to shareholders and/or invest throughout the cycle. We have been disappointed with the growth fetish within the resource industry, particularly at a time of weakening demand and near top-of-the-cycle capital costs. Investing when capital costs are high, risks locking in poor returns permanently. However, there is cause for optimism with new management at both BHP Billiton and Rio Tinto planning to cut costs. Hopefully this translates to stronger returns to shareholders.

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 allow BHP Billiton to return capital to shareholders and/or continue to invest through the cycle. Recent mothballing of mega expansion projects like Olympic Dam and the Port Hedland Outer Harbour are a positive and shows 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 to compete. 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.

Rio Tinto (RIO)

With the demise of aluminium, 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 and low cash costs in iron ore, and to a lesser extent copper, underpin the narrow moat. The company'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, Rio Tinto's low costs and long life mean the company will be able to win market share and expand even in a less favourable commodity environment.

Woodside Petroleum (WPL)

Australia's premier oil and gas play with a strong tilt to Asian gas consumption via LNG. Recently expanded capacity with Pluto is just starting to contribute to earnings. We feel the perceived US 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 to the US are headwinds. Woodside is a low cost, long life LNG producer which underpins the narrow moat. Fair value uncertainty is high due to earnings relying on the Asian gas price.

Newcrest (NCM)

Traditionally a low cost producer of gold, but severe mining industry inflation in Australia and a number of operational setbacks see cash costs near the industry average. The company is set to regain its low cost

position with expansion at the low cost Lihir and Cadia Valley mines. Mine life is generally much longer than peers and historical returns have been attractive but the Lihir acquisition decimated economic returns and sees Newcrest without a moat. Such was the dilution from overpaying on Lihir that returns are unlikely to improve to acceptable levels in the foreseeable future. However, the underlying assets remain of reasonable quality and we believe it is unlikely management will repeat the Lihir mistake. The company's exploration track record is excellent and with large deposits further success is likely. We agree with the return to an exploration and development focus rather than acquisitions, but the arduous delay between initial discovery and first production means it will take years if not decades for value to be added.

Alumina (AWC)

Alumina Limited is predominantly exposed to bauxite and alumina production. The company is a low cost global producer of alumina with cash costs approaching 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 sufficient to justify addition to the best ideas. With the alumina industry as a whole not making money and Alumina's enterprise value a 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. MI

Outlook for Consumer

Weak consumer sentiment, structural headwinds and overvalued defensives limit investment opportunities


Peter Rae
Sector Head: Consumer, Healthcare, Industrials, Tech & Telecom


James Cooper
Senior Analyst: Consumer and Healthcare


Tim Montague-Jones
Senior Analyst: Consumer, Tech & Telecom


Michael Wu
Senior Analyst: Tech & Telecom


Nachi Moghe
Senior Equities Analyst

- With the retail outlook remaining weak, our preference in the sector is for Woolworths, given its wide economic moat, recurring and modest growth earnings stream, and attractive value relative to the sector despite trading in the hold zone.
- We also retain a positive view on Telstra, given its strong cash flows and high, sustainable dividend yield despite the shares trading modestly above fair value.
- The media sector offers little value at present, and we would use market strength to reduce exposure.
- The gaming sector offers a defensive earnings profile, but most stocks are close to, or above, fair value. New Zealand based Sky City stands out as reasonable value with good growth prospects.

Retail: Consumer frugality continues to cloud retail outlook

Retail sales month-on-month increased 0.9% for January 2013. This represents a strong reversal after preceding negative months. Favourable weather over the key Christmas trading period, combined with rising equity values and falling interest rates, led consumers to return to spending over the holiday period. We take a view that the underlying trend in consumer expenditure will remain weak as the deleveraging of the household balance sheet continues. Retailers reporting the strongest increase in sales volumes are discount department stores such as Kmart and BigW. Consumers continue to seek value as rising utility bills, stagnant house values and high levels of household debt constrain the family appetite to spend.
We believe Woolworths (WOW) and Wesfarmers (WES) are taking market share from smaller independent retailers, which are unable to compete on scale. These two moat companies remain fully valued, but with Woolworths trading in our Hold range it is our preferred investment in the sector. Its wide economic moat and low uncertainty rating make it particularly appealing.

Table 1: Consumer Best Ideas

Code	Name	Morningstar Recommendation	Fair Value	Economic Moat	Uncertainty
WOW	**Woolworths**	Hold	34.00	Wide	Low
TLS	**Telstra**	Hold	4.30	Narrow	Medium
CNU	**Chorus**	Accumulate	2.80	Narrow	High
SMX	**SMS Management & Technology**	Accumulate	6.00	None	Medium
SKC	**Sky City**	Hold	3.70	Narrow	Medium

Media: Corporate activity could provide some interest, but structural and cyclical issues remain a drag on earnings

Our December quarter outlook highlighted that 2013 would be a year in which the media landscape would be redefined through media reform legislation. The government tried, but failed, to achieve a general consensus on pivotal pieces of legislation, with the reach rule remaining in place. The removal of the reach rule that prevents a TV license holder from covering more than 75% of the population is a key piece of legislation which, if ultimately passed, will enable regional TV stations to merge with the larger metropolitan channels. Combined organisations will be positioned to extract cost savings and improve returns. Channel Nine, which is predominantly owned by U.S. hedge funds, is eager to capture capital through a public offering and a merger with Southern Cross Media (SXL) is viewed as a potential exit plan. Negotiations remain in play, but we expect some form of combination of assets will emerge even if the reach rule remains. The combined group will have a wider audience to negotiate favourably for marketing dollars and sports content, and this may instigate further partnerships between Seven West Media and Prime, and Channel Ten with WIN.

Advertising expenditure remains weak despite an up-tick in consumer confidence over the last three months. Businesses we speak to remain sceptical that consumers will reverse saving habits and return to spending and we expect corporates to continue cutting costs in anticipation of enduring weakness in trading conditions. We expect total advertising spend to rise by 3% for 2013. Within this we expect double digit rates for online sites which attract sizable audiences, while traditional print and publishing titles will continue to report high single-digit negative comparables.

We have no positive recommendations within the sector. In our view, any short term investor optimism represents an opportunity to reduce holdings and allocate to more promising market sectors.

Telecommunications and Technology: Earnings and dividend stability remain the key attractions

The telecommunications sector has performed broadly in line with the wider market year to date. We did not expect the sector to repeat its strong performance of 2012. In line with our expectations, Telstra's (TLS) share price carried the first-half dividend and the share price is well supported in a low interest-rate environment. Telstra is our preferred pick in the sector, given its narrow moat rating and a sustainable high yield. New Zealand telco Chorus (CNU) is trading on an attractive valuation and offers investors a high dividend yield. Its fixed-line infrastructure assets are a near-monopoly and its network is costly to replicate, underpinning its narrow moat rating. However, we continue to believe regulatory pressure will prevent Chorus's share price from converging to our fair value in the short term.

A spectrum auction in April and rollout of the national broadband network (NBN) remain key issues for the sector. The rollout of the NBN is proceeding at a slower pace than expected. While the only certainty is a federal election in September, we continue to believe Telstra's and Optus's deal with the NBN Co. will remain in place. Any attempt by the government to renegotiate arrangements will only occur if it benefits their respective shareholders. Voiding existing arrangements will result in financial penalties for the government. The federal opposition is opting for a scaled-back, or fibre-to-the-node network. Telstra, along with NBN Co, is open to reconfiguration of current network design. Again, shareholder interest is a priority in any negotiation. On the mobile front, payment of the new digital licence is not due until the second half of calendar 2014, or the second half of fiscal 2015 for Telstra and third-quarter fiscal 2014 for SingTel (SGT). An immediate payment was previously scheduled post the auction. All three mobile operators will participate in the auction. There is no change in our view Telstra will maintain its competitive advantage in mobile going forward.

Recent earnings results highlighted the strategies the smaller telecoms are exploring in growing revenue in a mature fixed-line market. In the retail market, iiNet (IIN) and TPG Telecom (TPM) are focused on penetrating their customer bases with increased product take-ups. Both telecoms have successfully broadened their product offerings into mobile and pay television. Take-up of additional services are tracking well, with iiNet and TPG increasing their mobile subscriber bases by 16% and 19% respectively in first half fiscal 2013. We believe the strong mobile subscriber additions are attributable to Vodafone's struggle and consumer preference in consolidating multiple services to one operator. The focus on cross-selling weighed on iiNet's fixed broadband subscriber additions but we expect sales efforts to be redirected to subscriber growth in second half fiscal 2013. For TPG, we expect mobile growth in the second half to be complimented with higher take-up of fixed broadband and voice bundles. In the corporate market, Amcom (AMM) is also seeking to penetrate its fibre customer base with additional telephone, cloud and IT services.

Project deferrals and lower spending on technology continue to hamper the information technology sector. This saw SMS Management and Technology (SMX) report a soft first-half result. We believe lower demand is cyclical and expect current weakness in activities to pick up. SMS expects a number of new projects to start over the next few months. The stock remains our preferred small cap technology exposure.

Gaming: Resilient earnings outlook in an otherwise weak consumer environment

Most of the companies in the gaming sector are trading close to, or above, our fair value estimates and don't currently offer particularly appealing entry points. To us, Crown (CWN) is the most attractive business in the casino segment for its emerging market exposure. Its joint venture Melco-Crown in Macau is performing well with further growth potential. This is underpinned by a second property development on the Cotai strip and a joint venture project in the Philippines. However, the shares are currently trading above fair value. We also like New Zealand based Sky City (SKC). We think the AUD 350 million expansion of its Adelaide casino will enhance the firm's competitive position and drive growth overtime. The shares are currently trading at a modest discount to our fair value with potential for upside to our valuation if the company wins the impending National Convention Centre project in Auckland.

Domestically, we see Tatts' (TTS) and Tabcorp's (TAH) operations as more resilient relative to other stocks in the consumer cyclical sector. In our view, lottery and wagering revenue is defensive despite an environment of lower discretionary spending. Tatts benefited from a strong run of jackpots in its lotteries division over the first half. We expect slower revenue growth in the second half as the number of jackpots should normalise.

The stock is trading above our fair value estimate but its long-term licence and defensive revenue and cash flow streams support a higher earnings multiple relative to peers. While Tabcorp is investing heavily in digital technology to stay competitive in the wagering market, online operators are pressuring top-line growth. Group earnings are highly dependent on wagering, which makes up 60% of operating profit. However, we believe this is factored into the current share price and our recommendation on the stock is Hold.

Health Care: Positive earnings outlook, but already priced in

After the last year's strong outperformance, returns from the health-care sector will be less spectacular in the year ahead. These outsized returns in most instances reflect strong earnings growth amid significant economic weakness, highlighting the defensive nature of the sector. Due to their quality, many of these companies have attracted significant buying interest from offshore investors, the resilience of the Australian dollar adding to the attraction.

The popularity of these stocks means that, in many cases, price/earnings (P/E) ratios are now stretched and dividend yields meagre. Over the next year we don't expect sector returns to be any greater than the sum of earnings growth and current dividend yields. In other words, additional gains from P/E expansion are unlikely; if anything, P/Es will compress from current high levels. Currently no health-care stocks have positive recommendations, with several in the reduce or sell zones.

The earnings outlook for the majority of companies in the sector remains favourable, a function of the inherent resilience of health-care demand, underpinned by ageing populations and impressive innovation delivering novel and enhanced products. A risk is that strained public and private finances in North America and Europe lead to falling reimbursement by both government and private insurance companies, with the latter experiencing declining membership due to lower employment. This could impact companies that sell product in those markets, including ResMed (RMD), CSL (CSL), Cochlear (COH), and Sonic (SHL). The weak economy has impacted the U.S. pathology industry, a result of doctor visits falling due to heightened consumer concern about personal finances. There are signs this trend is now turning, but the duration of any improvement depends on a sustained improvement in the U.S. economy.

Consumer Best Ideas

Our sector best ideas are based on the best relative value opportunities with a bias to quality. They will typically have buy or accumulate recommendations though given the scarcity of undervalued stocks, three are holds. A 'hold' recommendation indicates that investment returns should be modestly positive over the next few years and investors should receive a fair risk-adjusted return.

Woolworths (WOW)

We view Woolworths as Australia's premier supermarket operator with the highest operating margins at 7.7% compared with rival Coles at 4.7%. Operating scale enables Woolworths to deliver products to the consumer at the lowest cost, enabling it to generate superior returns on capital. We expect this scale advantage will allow the company to redirect cost savings into lower prices and so capture a larger share of the consumer dollar. An ongoing store rollout program will help lift supermarket revenues over the next three years, while the home improvement division, Masters, will begin to contribute to earnings from 2016.

Telstra (TLS)

Despite trading at a modest premium to our fair value estimate, we like Telstra for its narrow moat rating and sustainable high yield. We expect dividends to be supported by strong cash flows and forecast an increase in dividends in fiscal 2014. While a change of government in September presents some threats to the NBN deal, we think Telstra is well-placed regardless. We think Telstra is in a strong position to maintain its competitive advantage in mobile going forward.

Chorus (CNU)

Chorus's fixed-line infrastructure assets are near-monopoly and its network is costly to replicate, underpinning its narrow moat rating. We expect the rollout of a fibre network, which covers 75% of New Zealand, to be on time and on budget. With rising data demand for rich multimedia content, we expect this to be the main driver for consumers to upgrade from copper to fibre technology. We believe the risk of mobile and wireless substitution to be overplayed given the technological difference and, more importantly, premium pricing for wireless on a per-unit basis.

SMS Management & Technology (SMX)

SMX's first-half fiscal 2013 profit fell 15% and the outlook is for a similar decline for the full year. However, we expect a recovery in fiscal 2014 as new projects commence and industry conditions start to improve. We continue to view SMX as an attractive business and it remains our preferred exposure in the

small IT services sector. In our opinion, current weakness in demand is cyclical and earnings will return to a growth trajectory when the economy improves.

Sky City (SKC)

Sky City enjoys licence exclusivity across all its casinos. This enables the firm to generate solid returns and cash flows. We think the AUD 350 million expansion of the Adelaide casino will enhance the firm's competitive position and drive growth overtime. Sky City shares are currently trading at a modest discount to our fair value of NZD 4.60 per share. We expect a further uplift in valuation to the tune of NZD 35 to NZD 70 cents per share should the company bag the impending National Convention Centre (NCC) project in Auckland.

Our least-preferred consumer stocks

Harvey Norman (HVN)

Over time, we expect Harvey Norman's scale advantage will be undermined as sales volumes become increasingly fragmented across numerous online competitors. The lower cost of operating an online store, which avoids running costs associated with a bricks and mortar store portfolio, ensures online stores will be able to offer better prices and take market share. Harvey Norman, and many other listed retail companies, continue to promote their online strategies, enabling consumers to purchase online and pick up in-store and we view this as a competitive advantage. We see no compelling reason why consumers will transact at a Harvey Norman store unless it can offer the lowest prices.

Network Ten (TEN)

We expect Network Ten will continue to struggle as the free-to-air industry adapts to structural challenges as audiences increasingly opt to watch content online. Audience fragmentation means there are less viewers watching mainstream free-to-air content. Advertisers are following audiences and we expect them to allocate less expenditure in total, rationalising it to a targeted approach and rewarding those channels which can prove consistency in capturing a sizable audience. This fragmentation of audiences leads to the marginalisation of TEN as a credible option for advertisers to allocate their budgets. M

Outlook for Industrials

Impending mining investment peak and mild housing rebound make stock selection critical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Senior Analyst: Industrials


Michael Higgins
Analyst

- We struggle to find value in the building materials sector despite expectations of an improvement in housing approvals and a better earnings outlook.
- A weak retail and consumer environment clouds the outlook for transport, but Regional Express still stands out as good value.
- In a challenging mining services environment, our preference remains for moat companies and those with exposure to the energy sector, and long-term operational and maintenance work.

Building Materials: Improvement in housing approvals to drive growth in fiscal 2014

We struggle to find value in the building materials sector. While approvals are starting to improve, we think share prices already reflect a strong recovery and leave little room for disappointment. On an annualised seasonally-adjusted basis, approvals for the six months to January 2013 rose 7.7% to 158,000, with actual approvals up 5.5% over the same period. The long-awaited improvement is not surprising, and is viewed as sustainable, supported by relatively low unemployment, a low interest-rate environment (with additional cuts possible) tight rental markets, and consumer deleveraging improving affordability. However, for building material suppliers, the key is detached housing, not apartments. According to RP Data, current auction clearance rates in Sydney and Melbourne are around 68% and 62% respectively, compared to 45% and 56% in December 2012. This growing confidence, and hence demand for existing houses, should eventually flow into new housing. With house prices rising and selling so quickly, government approval for new developments might be the bottleneck.

Table 1: Industrials Best Ideas

Code	Name	Morningstar Recommendation	Fair Value	Economic Moat	Uncertainty
QUB	**Qube Holdings**	Hold	1.80	None	Medium
REX	**Regional Express**	Accumulate	1.40	None	High
ORI	**Orica**	Hold	26.00	Narrow	Medium
WOR	**WorleyParsons**	Hold	26.00	Narrow	High

The degree and pace of a recovery is always difficult to assess, but the recent improvement in approvals supports our expectations for a return to top-line growth in fiscal 2014, as well as improved profitability from leaner manufacturing operations. In response to lower demand, all companies have done the right thing, with extensive rationalisation of high fixed-cost manufacturing facilities which will help utilisation rates across the industry and assist margin recovery.

While housing-sensitive building products earnings have been pummelled by lower demand, construction materials have been helped by large resource and infrastructure project activity. The fall in construction activity related to large LNG projects will create earnings headwinds in fiscal 2015, but we expect non-resource sector engineering construction to offset the majority of the decline. We expect key areas of demand to include roads and highways, railways, harbours, telecommunications and pipelines. A recovery in residential construction, and cement and aggregate price increases will also help.

The businesses in our coverage universe have varying levels of barriers to entry, product differentiation and capital intensity. Our preference is for narrow moat companies Adelaide Brighton (ABC) and James Hardie (JHX). Adelaide Brighton, through cost advantages in cement and aggregates, and James Hardie, via cost and technology advantages and superior products in fibre cement, through the cycle, have achieved attractive returns, warranting narrow moat ratings. Adelaide Brighton is currently slightly overvalued and James Hardie more substantially overpriced, despite the earnings boost from leverage to the recovering U.S. housing market (75% of revenue). U.S. housing starts in February rose to an annualised 917,000. We assume low interest rates, large declines in inventory for both new and existing homes, and improved consumer confidence supports a return to annualised starts of 1.5 million over the next five years.

Share prices of companies covered improved over the last three months and, without exception, are trading above fair value. Weaker-than-expected trading updates or declines in lumpy housing approvals data

could easily see share prices retreat, potentially providing buying opportunities. Our mostly high to very-high uncertainty ratings across the sector reflect a margin of safety to account for generally volatile earnings and high fixed costs.

Transportation: Individual strategies to drive earnings in a weak business environment

Transportation stocks continue to face subdued economic conditions given the weak underlying business and consumer environment. Despite this, the earnings outlook for the major transport and logistics firms Toll Holdings (TOL), Asciano (AIO) and Aurizon (AZJ) is positive, with these firms benefiting from their own growth and efficiency initiatives. Asciano and Aurizon in particular are benefiting from significant growth in coal rail haulage volumes. However, growth expectations are already factored in, with share prices of these firms above our fair value estimates. Qube Holdings (QUB) remains a best sector idea with its good first-half fiscal 2013 result confirming a strong growth outlook. The shares are trading at a modest discount to our fair value estimate.

The airline industry is facing intense competition, volatile economic conditions and high fuel prices, making it difficult to forecast earnings. Despite this, Qantas (QAN) is expected to achieve earnings growth on the back of improvements in the international division. However, the domestic market is expected to remain difficult in the short term, with extra capacity keeping pressure on prices. This in particular will hurt Virgin Australia Holdings (VAH). Given difficult industry conditions and very low returns on capital we do not view firms within the airline industry as having economic moats. Regional Express Holdings (REX) remains our best airline sector idea despite a softer-than-expected first-half fiscal 2013 result. REX remains a highly-profitable and well-run airline, with a strong balance sheet and monopoly positions on most of its routes. The stock is trading well under our fair value estimate.

Mining Services: Volatile resources outlook and peaking investment a strong headwind

Despite the mining service sector's renewed confidence in the outlook for 2013, we maintain our thesis of falling commodity prices, reduced demand and project deferments, ultimately causing lower growth and falling profitability for the contractors. Even if the AUD 10 billion Roy Hill Iron Ore Project goes ahead, the majority of construction projects will be completed by the end of fiscal 2014 and the mining services industry will be faced with a major slowdown, searching for the next sign of large-scale mining investment. Energy projects, particularly large-scale LNG projects, will continue to provide some contract work, but the major share of the energy project work will be managed and completed by foreign engineering, construction and project management companies. The mining service sector's main problem is its heavy dependence on increasing levels of mining and energy sector capital investment for growth, which is not likely to occur at the levels witnessed during the past decade.

The abrupt slowdown in mining activity during mid 2012 significantly impacted demand for drilling services and mining equipment. We believe mining services companies with a strong exposure to mineral drilling, including Boart Longyear (BLY) and Ausdrill (ASL), will continue to see significant volatility in demand, reduced margins and lower growth during 2013. Demand and supply factors in the global drilling services and mining equipment markets are extremely unstable and rapid changes in conditions are highly probable. Demand for drilling rigs and mining equipment will remain limited while volatile commodity prices, reduced exploration activity and uncertain global economic conditions persist.

Production contracts for quality low-cost mine operations will continue to be renewed, but customer bargaining power will increasingly be exerted during future negotiations. Our major concern surrounds the possibility of another round of delays, deferments and cost-cutting from major iron ore mining companies, due to a sudden and unexpected fall in the iron ore price from current high levels. BHP Billiton (BHP), Rio Tinto (RIO) and Fortescue Metals Group (FMG) will undoubtedly attempt to lower operating costs in the next year through tighter contract pricing, eventually impacting the contractor's growth and margins as new contracts commence.

New opportunities for operational and maintenance services work will begin to appear in the next three years as the major energy construction projects reach completion and move to the production phase. The completed LNG projects will provide a source of prospective long-term operational and maintenance contract work for companies with a strong record of understanding and managing contract execution risk. Monadelphous (MND) and WorleyParsons (WOR) will benefit from the increase in new work but contracts will be strongly contested with increasing competition from global corporations. Long-term maintenance contracts are highly desired by mining service

contractors as they generally develop into mutually-beneficial relationships, with high switching costs.

We retain a strong preference for mining service companies with low debt levels, limited capital expenditure requirements, exposure to the more stable energy sector and undertaking long-term operational and maintenance contract work. However, investors should remember all mining services companies operate in highly-fragmented and cyclical markets with limited barriers to entry, leading to our high to very-high uncertainty rating on earnings. Most mining contractors lack the sustainable competitive advantages to establish a moat with only Monadelphous, Leighton Holdings (LEI), WorleyParsons, Orica (ORI) and ALS (ALQ) having secure narrow moat ratings. WorleyParsons and Orica remain our preferred sector exposures.

Industrials Best Ideas

Our sector best ideas are based on the best relative value opportunities with a bias to quality. Best ideas will typically have buy or accumulate recommendations though given the scarcity of undervalued stocks presently, three are holds. A 'hold' recommendation indicates that investment returns should be modestly positive over the next few years and investors should receive a fair risk-adjusted return.

Qube Holdings (QUB)

Qube does not have an economic moat and it operates in a competitive industry. However, the company is growing strongly, both organically and via acquisitions. Current initiatives will provide strong earnings growth in fiscal 2013 and 2014, and long-term we believe the company's growth strategies will see it become a major Australian ports and logistics operator. Plans to build an intermodal terminal at Moorebank offer upside despite current uncertainty.

Regional Express Holdings (REX)

Despite a weaker earnings outlook in fiscal 2013, we still view Regional Express as having a resilient core airline business, holding a monopoly position on most routes. Trading on a low P/E and offering a high dividend yield, we see the shares as good value.

Orica (ORI)

Despite a weaker resources sector and potential short-term pressure on mining volumes, Orica is well positioned to benefit from growth in mine production over the next decade. Strong volume growth by the major miners, and declining ore grades, mean the demand for explosives will continue to rise and so too will Orica's earnings.

WorleyParsons (WOR)

Despite some pressure from slower mining activity, WorleyParsons is well positioned to leverage the strong growth in the global oil and gas sector. In particular, its technical expertise and global network mean it is well positioned to capitalise on significant opportunities in unconventional oil and gas, and growth in emerging regions. MI

New Zealand Share Market Outlook

Value hard to find, but telecommunications sector offers interesting opportunities


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- New Zealand's share market is fully valued, but we do see investment opportunities in telecommunications, while health care and building materials are the least-preferred areas on valuation grounds.
- Consumer activity should maintain modestly positive growth, particularly while housing prices keep improving and rebuilding in Canterbury continues, but share prices aren't attractive following their strong recent run.
- We encourage investment in attractively-valued economic moat companies, and while opportunities to buy with a reasonable margin of safety are limited, a number are trading around fair value, so not excessively valued.

The continued market rally has made buying opportunities even harder to find than in December when we published our last quarterly outlook. We felt the market was fully valued then; the market-cap weighted average price/fair value was 1.04 based on our coverage of 27 New Zealand companies. Now the figure is 1.08, still in what we would regard as the market's hold range, but clearly closing in on the reduce trigger.

Hold is our dominant recommendation, 67% of the total, indicating how difficult value is to find. Reduce recommendations represent 22% of our recommendations and we have two sells representing 7% – discretionary retailers Michael Hill International (MHI) and The Warehouse Group (WHS). We continue to find opportunities to purchase stocks below a reasonable margin of safety few and far between. In fact only one of our New Zealand stocks has a positive recommendation, Chorus (CNU), and that comes with high uncertainty.

Table 1: New Zealand Best Ideas

Code	Name	Morningstar Recommendation	Fair Value	Economic Moat	Uncertainty
SKC	**SkyCity**	Hold	4.55	Narrow	Medium
CNU	**Chorus**	Accumulate	3.60	Narrow	High

We do think the balance of risk with Chorus is to the upside and investors can enjoy the 9% fully-imputed dividend yield along the way. We purchased the stock for the Morningstar Equities Small Cap Portfolio in February and added to the position in the past week. As most of its assets are near-monopolies, wholesale pricing is regulated with a number of decisions yet to be finalised. We expect a better outcome post industry consultation than the much lower-than-expected draft wholesale broadband price decision in early December.

Investment in undervalued moat companies is always our preferred strategy as these companies are likely to generate excess returns on capital for many more years than no-moat firms. Over half of the companies under our New Zealand coverage have moats, a much higher proportion than our Australian coverage which has just 30%. Beyond Chorus, the cheapest moat companies are monopoly pay TV provider Sky Network Television (SKT), telecommunications service supplier Telecom New Zealand (TEL) and casino operator SkyCity (SKC), each of which are trading slightly below fair value, but in the hold zone, and are relatively more attractive than alternative market offerings.

Telecommunications is the cheapest sector but regulatory overhang is affecting valuations

Telecommunications remains the cheapest sector across our coverage. Telecom New Zealand is in transition phase, including scaling back of the Australian IT services division. We believe this is a positive move given the low returns on offer in this highly-competitive sector and it will allow greater focus on the New Zealand operation. The key focus is on mobile and limiting fixed-line churn rates. Telecom remains firm on its 4G network rollout timetable for the end of this year, despite competitor Vodafone switching on its 4G service in Auckland last month. We do not see a significant first-mover advantage for Vodafone given the rollout is progressive and coverage footprint is limited. We believe the move will allow Vodafone to better utilise its spectrum and alleviate network traffic on its 3G network.

It has been a tough half for Chorus as the regulator lowered wholesale copper-based broadband prices in

an adverse draft decision in December last year. With a vested interest in Chorus, the New Zealand government has stepped in to initiate a review of the regulatory regime of the telecom sector. We continue to believe regulatory pressure will prevent Chorus's share price from converging to our fair value in the short term. However, the stock is trading an attractive fully-imputed dividend yield of 9%. The take-up of fibre connection underpins Chorus's longer-term value and we believe fixed broadband will complement wireless given technological and pricing difference between the two products.

Health care offers good growth opportunities, but stocks modestly expensive

The health-care sector has outperformed the broader market over the last year and Ryman Healthcare (RYM) has been the standout with its share price appreciating by 59%. Health-care stocks in aggregate appear modestly overvalued from a valuation perspective.

We have a positive view on the outlook for health care. Health-care expenditure is likely to far outpace GDP growth over the longer term as medical service requirements increase with an ageing population. A recent study conducted by the New Zealand government concluded that the number of people aged 75 and over is expected to double from 261,000 to 516,000 by 2031. This provides an attractive landscape, supportive of revenue and profit growth for companies catering to the elderly population. Ryman Healthcare and EBOS Group (EBO) will be the biggest beneficiaries of this trend, given their domestic-orientated business model. Ryman Healthcare in particular seems well positioned to capitalise on the ageing population as a higher proportion of the elderly are choosing to spend their latter years in a retirement village.

Fisher & Paykel Healthcare (FPH) is our preferred stock in the sector as the firm is trading close to our fair value of NZD 2.60 per share. We expect the company's revenue growth in constant-currency terms to increase by double digits, driven by the transition to home sleep testing (HST) in obstructive sleep apnea (OSA) and increased sale of new products and applications in the respiratory and acute care (RAC) business. Underlying profit is likely to exceed revenue growth as margins would be buoyed by the introduction of premium new products, cost savings from transferring consumables manufacturing to Mexico and supply-chain efficiencies.

Utilities face excess supply and depressed demand

The utilities sector encompasses firms that generate, retail and distribute electricity. Each of the stocks we cover in the sector are trading close to fair value. The industry is highly weather-dependent as hydro generation accounts for over 50% of the total electricity output. Excess rainfall could cause increased hydro output, which in turn could put pressure on wholesale electricity prices and vice versa. Wholesale and retail electricity prices in New Zealand are unregulated, but distribution and transmission prices are regulated by the commerce commission. Electricity demand in New Zealand has historically tracked 0.6 times GDP whilst prices have risen by around 1.5 times inflation.

We think the near- to medium-term outlook for the electricity industry is not very promising. The sector is characterised by excess supply as a spate of new capacity came on stream in the last few years and more supply is expected over the next 6 to 12 months. At the same time, demand has barely budged since 2008 due to a combination of economic weakness and reduced energy usage by households and businesses. We think the decreased energy consumption per household is due to the installation of smart meters and increased efficiency is a structural issue, which will continue to constrain demand over the longer term. Consequently, we anticipate consumption growth to decline from 2% per annum historically to around 1.5% per annum over the next decade.

In addition to structural issues impinging on electricity demand, there is a great deal of uncertainty stemming from the possible closure of the Tiwai Point smelter in the South Island. The plant, which belongs to Rio Tinto, consumes around 15% of New Zealand's electricity output. However, the smelter is struggling to generate adequate returns due soft aluminium prices and the high New Zealand dollar. Meridian Energy supplies electricity on a long-term contract basis, part of which is linked to aluminium prices. There are rumours that Rio Tinto (RIO) might sell the unit or shut it down if it cannot find a buyer. We understand the earliest the company can close the plant is in 2018. Closure of the plant would further upset the demand/supply balance. In response to this uncertainty we envisage no major capacity additions (except the ones that are committed) and possible closures of a few thermal plants.

Our preferred stocks in the sector are Contact Energy (CEN) and Trustpower (TPW). They are integrated power companies producing and supplying electricity to retail and industrial customers. Contact Energy is likely to benefit from the commissioning of the Ti Mihi geothermal facility in the not-too-distant future. This plant is likely to dramatically reduce the company's cost of production and further improve its competitive position. We currently have a narrow economic moat

rating on the stock due to the firm's reasonable returns on invested capital (excluding revaluations) and its dominant market share position. Trustpower is focussing on expanding in Australia by building a 270 MW wind power plant in South Australia (called Snowtown 2) for an investment outlay of AUD 439 million. We believe Snowtown 2 will be a reasonably profitable venture for the company. Electricity output of 985 GWh will be sold to Origin Energy (ORG) under the power purchase agreement at a fixed price with CPI escalations. The plant is estimated to generate AUD 78 million in EBITDA, AUD 20 million in NPAT and AUD 42 million in operating cash when fully operational.

We are not a big fan of Vector (VCT) because its electricity and gas distribution businesses are highly regulated, preventing it from earning an appropriate rate of return. The stock is also well above are fair value of NZD 2.60 per share and appears modestly expensive.

Revival in housing likely to spur consumer discretionary

The consumer services sector encompasses retailing and other discretionary industries such as gambling and media. Consumer confidence appears to be improving on the back of low interest rates and an ebullient housing market, especially in the all-important Auckland region. In the December 2012 quarter, the total volume of retail sales rose 2.1%, which was the strongest increase since the December 2006 quarter. Not surprisingly, hardware, building and garden supplies were among the biggest drivers of this growth, underpinned by a strong housing market.

We think the housing market will continue to underpin consumer confidence. Furthermore, the rebuilding of the earthquake-ravaged Canterbury region is also likely to provide a fillip to the economy and aid consumer spending. Given this backdrop, we expect discretionary retailers to do well. However, the structural shift to online retail will continue to hurt discretionary retailers that have been slow to adapt to this trend. Online revenue growth is accelerating as the proliferation of smart phones and tablets are making it easier for consumers to shop online. We estimate that Kiwis spend approximately NZD 2.7 billion on new goods online, of which an estimated NZD 940 million is spent on international websites. The market is growing at a double-digit rate, prompting players like Trade Me (TME), which has predominantly been an auction and classifieds website, to branch out into online retail.

While we expect reasonably good growth from retailers in the near to medium term, we believe valuations look stretched. We currently have a negative recommendation on The Warehouse Group, Trade Me, Briscoes (BGR) and Michael Hill as they are trading well about our intrinsic value. On the other hand, Sky City and Sky Network Television appear fairly valued and remain our top picks in the sector.

Transport: good fundamentals and reasonable valuations

Transport comprises companies in businesses such as freight and logistics, port operations, airports and airlines. The transport, freight-forwarding and logistics industry has a high level of cyclical exposure to global economic conditions. Stronger household and business expenditure on goods predictably converts into increased demand for freight and logistics services. We believe that a pick-up in the New Zealand economy augurs well for Freightways (FRE) and Mainfreight (MFT). We like Freightways in particular due to its strong market position in a duopolistic express package landscape in New Zealand. This, along with solid returns on capital, gives it an economic moat. The stock is trading at fair value and offers a good dividend yield of 4.2%, fully-imputed for New Zealand shareholders.

Ports in New Zealand are leveraged to export commodities such as agriculture and forestry products and imports of oil, fertilisers, cars and general merchandise. Exports of dairy and forestry products in particular have been showing strong growth, reflecting Asia's insatiable appetite for these goods. However, imports have been weak due to a depressed domestic economy. Going forward, we anticipate stronger contribution from imports as the economy strengthens. Port of Tauranga (POT), the biggest port in New Zealand, is enjoying a period of strong growth driven by uplift in forestry and container volumes. We believe the firm will continue to gain market share from rival Ports of Auckland due to its low cost structure and non-unionised workforce. However shares are trading well above our fair value of NZD 12.00 per share.

Airports and airlines are leveraged to passenger growth. We prefer airports as a business over airlines because they are generally monopolies, are able to price their services and earn a return above their cost of capital, and have stable and predictable cash flows over the long term. The airline industry is beset by overcapacity and yield pressures. Several airlines have gone bankrupt around the world and yet overcapacity seems to persist. This could be attributable to the fact that barriers to entry for the industry are low so invariably new players seem to crop up every now and then. Our preferred pick is Auckland Airport (AIA) as we believe the firm is well placed to capitalise on

expected strong growth in tourist arrivals from Asia in the long term. Our wide economic moat on Auckland Airport reflects its monopoly position, sizeable land bank of 1500 hectares (providing it with good long-term development opportunities) and a light-handed regulatory environment.

New Zealand Best Ideas

Sky City (SKC)

Sky City enjoys licence exclusivity across all its casinos. This enables the firm to generate solid returns and cash flows. We think the AUD 350 million expansion of the Adelaide casino will enhance the firm's competitive position and drive growth over time. Sky City shares are currently trading at a modest discount to our fair value of NZD 4.60 per share. We expect a further uplift in valuation to the tune of NZD 35 to NZD 70 cents per share should the company bag the impending National Convention Centre (NCC) project in Auckland. In return for building the NCC, Sky City would be granted regulatory relief, allowing it to significantly increase the number of machines and tables at the casino. This will propel earnings growth and returns since Auckland accounts for 65% of the firm's EBITDA. Consequently, we believe that the NCC will be a catalyst for Sky City's share price.

Chorus (CNU)

Chorus's fixed-line infrastructure assets are near-monopoly and its network is costly to replicate, underpinning its narrow moat rating. We expect the roll-out of a fibre network, which covers 75% of New Zealand, to be on time and on budget. With rising data demand for rich multimedia content, we expect this to be the main driver for consumers to upgrade from copper to fibre technology. The risk of a slower take-up rate is mitigated by the existing copper network, which will continue to generate returns. We believe the risk of mobile and wireless substitution to be overplayed given the technological difference and, more importantly, premium pricing for wireless on a per-unit basis.

The Warehouse Group (WHS) is our least preferred New Zealand stock. Consumer sentiment seems to be improving in New Zealand on the back of higher activity levels in the construction sector (due to rising house prices and the Christchurch rebuild) and strong agricultural commodity prices. We believe this augurs well for discretionary retailers like The Warehouse Group. However, an increasing number of shoppers are moving online, bypassing traditional bricks and mortar retailers. This arguably will be an impediment to revenues and earnings of traditional retailers. The Warehouse Group is cognisant of this threat and has responded by increasing its online presence and acquiring e-commerce retailers like Torpedeo 7 recently. The idea is to become a multi-channel retailer, offering goods through its network of stores and over the Internet. However we doubt The Warehouse Groupo will be competitive enough to ward off competition from reputed international websites such as Amazon, Ebay and in the home market from Trade Me (as it gears up to sell branded products through its website). We also remain concerned about The Warehouse's recent acquisition of retailer Noel Leeming Group as we expect margins to come under further pressure in the longer term from price deflation, technological changes and intense competition in whiteware. The current share price does not factor in our aforementioned concerns and is a trading at a 17% premium to our intrinsic value. M

Australian Credit Market Outlook

Some value remains, but most credit securities are fully valued at current spread levels

Nicholas Yaxley
Credit Analyst

- Credit spreads have maintained a tightening bias across the capital structure to a point where they are converging with long-term averages, and hence are arguably fully-valued.
- The first quarter of 2013 saw AUD 3.2 billion of new issuance against our full-year expectation of AUD 9.0 billion, suggesting we may have underestimated issuance, particularly from financial sector.
- The demand for yield-based product from retail investors continues to be strong, with all primary issuance deals substantially upsized. Yet, investors were still scaled back, suggesting the securities should be well supported in the secondary market.
- The market is not pricing any term risk premium into tier 1 issuance which suggests investors are buying these securities purely on running yield, rather than looking at the risks of the individual securities.
- The Reserve Bank of Australia (RBA) left the official cash rate at 3.0% at the last meeting, but interest rate futures imply a reasonable chance of rate cuts in late 2013, which would reduce yields on floating rate credit securities.
- Efforts to ignite a retail corporate bond market continue. In March 2013, the federal government introduced an amendment to the Corporations Act to facilitate retail debt fundraising through its simple corporate bond legislation.

The performance of credit securities was relatively flat in the first quarter of 2013, with benchmark rates stable and credit spreads flat to slightly tighter. Globally, the corporate bond market looks close to fully-valued at current spread levels.

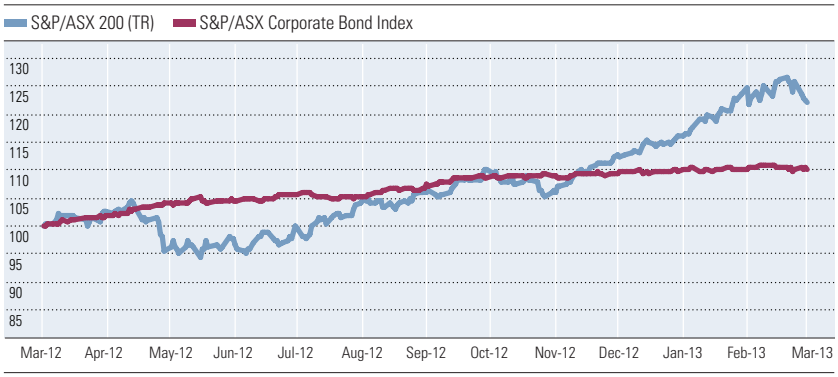
We expect returns in the single-digit range this year, much lower than the past year. To generate a higher return, interest rates would need to fall below already low levels, or credit spreads would need to tighten toward the historically tight levels experienced before the 2008–2009 credit crisis. We don't think either of these will happen. Current spread levels are now converging with the long-run average of credit spreads, excluding the 2006–2008 period. In the lead-up to the global financial crisis, an overabundance of structured credit vehicles, like collateralised debt obligations, were created which artificially pushed credit spreads too low. We don't expect a return to these levels.

The domestic listed credit securities market is a small subset of the broader corporate bond market. There is some value in the market, but the majority of securities are trading around fair value. In continuing the theme from last quarter, the technical perspective for listed credit securities couldn't look better. Demand remains strong as self managed super funds (SMSFs) and Asian private investors continue to seek Australian dollar yield and capital preservation. We are conscious that the demand for these products has pushed the pricing for some securities to a level which does not accurately reflect the embedded structural risks.

Table 1: Credit Securities Best Ideas

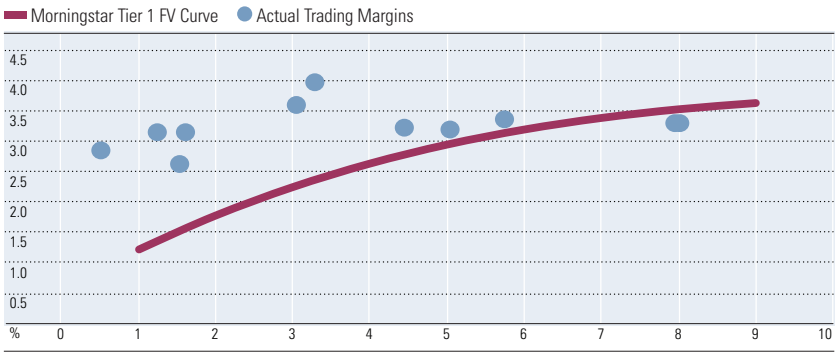
Code	Issuer	Morningstar Recommendation	Issue Size (AUD bn)	Time To Maturity (Yrs)	Trading Margin %	Running Yield inc Franking %	Yield to Reset inc Franking %
ANZPB	**ANZ**	Accumulate	1.0	1.24	2.89	5.65	5.96
CBAPA	**Commonwealth**	Accumulate	2.0	1.61	2.97	6.26	6.08
WBCPB	**Westpac**	Accumulate	0.9	1.53	2.63	4.59	5.73
GMPPA	**Goodman Gp**	Accumulate	0.3	4.78	5.32	6.45	9.16

Figure 1: Equity Returns vs. Corporate Bond Returns in the Last Year



Source: ASX

Figure 2: Trading Margin vs. Fair Value Curve



Source: Morningstar

For example, tier 1 bank capital was repriced over the past month, with bank syndicates successfully allocating AUD 2.9 billion in Basel III compliant securities at a spread of 3.20%. This pricing was broadly in line with the secondary market which repriced Commonwealth Bank's PERLS VI (which was issued at 3.80% over bank bill swap rate or BBSW) to around 3.30% within weeks of trading. The market is now in a situation where the majority of tier 1 securities are pricing at very similar trading margins, with no real distinction of term risk premium for recently issued securities. The term risk premium is the expectation that over time the probability of default (or conversion in the case of Basel III compliant securities) reduces as the term to expected maturity declines. Hence, the fair value credit spread will also reduce as the security approaches maturity. In our opinion, the fact that there is no clear difference says that either the newly issued securities are too expensive or the older tier 1 securities are too cheap. In reality it is a mixture of both.

Figure 2 shows the fair value credit spread of bank tier 1 securities relative to current trading levels. What is obvious from this chart is that retail investors are valuing these securities on running yield rather than their fair credit spread. We value credit partly on a distance to default basis which considers the likelihood of the issuer defaulting during the life of the security. Historical data tells us there is a smaller probability of default over a short time horizon and hence the fair credit spread for a security with a two-year term to expected maturity should be lower than one with an eight-year term to expected maturity. We recommend investors look at older-style hybrids for their portfolios even if they do provide less income than newly issued securities. Our best ideas are featured in section below.

New issuance will continue to be strong over the coming quarter as the current pricing is attractive for new issuers. We expect both Suncorp Bank and Macquarie Group to issue new securities to replace the maturing SBKPB and MQCPA securities. This is likely to have a knock-on effect to secondary pricing for comparable securities and therefore we remind investors to closely monitor the price of existing hybrid securities and look for opportunities in the secondary market.

We also expect the emergence of Basel III compliant tier 2 securities to test the retail market. These will be slightly different to the recent tier 2 subordinated notes (ANZHA, NABHB, WBCHA) as they did not fully comply with the new eligibility criteria.

Credit Securities Best Ideas

Morningstar's best ideas for credit securities are based on capital stability and providing an adequate risk-adjusted return for investors. As we have previously stated, the current market does not differentiate particularly well across bank tier 1 securities, hence we prefer securities with a shorter term to maturity.

ANZ CPS (ASX Code: ANZPB)

This security was issued in September 2008 at a spread of 2.50% over three-month BBSW. It has been a stable performer over the past few years and we are confident that it will be called at its June 2014 mandatory conversion date.

Commonwealth's PERLS V (ASX Code: CBAPA)

This security was issued in October 2009 at a spread of 3.40% over three-month BBSW. It has performed broadly in line with expectations, with some capital upside as credit spreads have tightened. We expect this security to be called on its October 2014 conversion date.

Westpac SPS II (ASX Code: WBCPB)

This security was issued at the height of the financial crisis in March 2009 at a spread of 3.80% over three-month BBSW. It has performed well over the past few years and we are confident that it will be called at its September 2014 mandatory conversion date.

Goodman PLUS II (ASX Code GMPPA)

This security is one of the few securities we currently see with capital upside as the spread trades tighter to reflect the restructured trust.

Official cash rate may fall further

The official cash rate remains a widely discussed topic in financial markets as the schools of thought between policy setters, economists and the market are diverse. Futures markets imply that if there are any further interest rate cuts, they will not be until late in the year.

This is a positive for investors in credit securities as they reset at a stable benchmark level.

The problem for the policy makers (RBA) is, even though it has cut rates by 1.75% in the last 18 months, the currency remains stubbornly high. This is due to a number of factors, including the high yield differential relative to OECD majors and new status as a reserve currency. This unusual position has caused the RBA to adjust its thinking and consider further easing to reduce the burden on domestic exporters. RBA assistant governor, Guy Debelle, recently stated: "We still obviously retain scope to lower interest rates further, should the need arise, including to counterbalance the pressures of an elevated exchange rate."

Retail corporate bond market – new legislation

In March 2013, the government introduced an amendment to the Corporations Act to further encourage the development of Australia's retail corporate bond market. This follows on from the Retail Trading Bill in 2012 which facilitated trading of government bonds on the stock exchange for retail investors.

The Bill is designed to simplify the task for businesses, issuing simple corporate bonds, making it easier to buy and sell these financial products.

The legislation had three key changes described below:

- introduce a two-part simple corporate bonds prospectus – the new prospectus reduces the current compliance costs associated with the offer of simple corporate bonds to retail investors, both in the first issuance and in subsequent tranches.
- modify the current directors' liability that is attached to the offer of simple corporate bonds, and to clarify the defences provided in respect to directors' liability that apply to all offers of securities.
- allow for simple corporate bonds to be transferred from the wholesale to the retail market, in line with the approach adopted for retail trading in government bonds, through the introduction of simple corporate bond depository interests.

This is part of the larger initiative to develop Australia into a financial services hub and relieve pressure on the banking sector. These changes will make it easier for issuers to directly attract funds from the self-managed super fund sector (among others). In turn it will also reduce Australia's reliance on offshore wholesale funding markets and reduce some of the risks international investors see as prevalent in Australia.

We consider this change a crucial element in the development of the retail corporate bond market. However, it is by no means the only requirement. The financial services industry needs to adopt these changes and invest in infrastructure to ensure the cost of distribution is reduced and the administration process is not cumbersome. This will ensure Australian retail investors have access to the same universe of investable securities as wholesale investors, and can manage a balanced portfolio which suits their investment objectives. IM