Morgans IN ALLIANCE WITH CIMB

Special Bulletin

Stocking fillers

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- Harvey Norman
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Small Cap Picks

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What to buy for Christmas

As we move into 2014, we expect Australian equities to re-rate as the markets begin to see evidence of a progressive recovery in earnings. Indeed, we forecast the ASX200 to finish at around 5810 points at the end of 2014. While we have seen some evidence of a market recovery, recent volatility provides an opportunity to introduce exposure to cyclical stocks in order to ensure that portfolios are well positioned for the year ahead. With the New Year around the corner we highlight our key portfolio picks for the year ahead.

Chart 1: What to buy in the year of the Horse

Name	Code	Rating	Share Price	Price Target	PE	% Upside	Yield	TSR
Amcor	AMC	NEUTRAL	11.02	11.07	16.2	0%	3.8%	4.3%
BHP Billiton	BHP	OUTPERFORM	37.25	43.10	13.1	16%	3.5%	19.2%
Crown	CWN	OUTPERFORM	16.85	18.46	19.6	10%	2.2%	11.8%
Fletcher Building	FBU	OUTPERFORM	8.26	10.01	16.1	21%	3.8%	24.9%
Harvey Norman	HVN	OUTPERFORM	3.21	3.60	16.4	12%	3.1%	15.3%
Sonic Healthcare	SHL	OUTPERFORM	16.48	16.91	16.5	3%	4.4%	7.0%
NAB CPS II	NABPB	Listing on 19 December - Forecast gross dividend yield of 5.84%						
FKP Property	FKP	OUTPERFORM	2.13	2.38	22.8	12%	0.0%	11.6%
GWA Group	GWA	NEUTRAL	3.03	3.03	18.0	0%	4.6%	4.5%
Select Harvests	SHV	OUTPERFORM	4.82	5.42	8.2	12%	4.3%	16.7%
Silver Chef	SIV	OUTPERFORM	7.15	8.57	15.9	20%	4.1%	23.9%
Super Retail Group	SUL	OUTPERFORM	13.53	14.73	19.7	9%	3.2%	12.1%
SMS Management	SMX	OUTPERFORM	4.06	5.25	14.5	29%	5.5%	34.7%

SOURCE: Morgans; Company Data, Prices as at 28 November 2013

The Aussie market is undervalued

It is encouraging to see investor confidence start to re-appear, driven by ongoing low interest rates, an improved housing market and greater certainty on Government policy post the Federal Election. In September, we valued the ASX 200 index at 4866 points and expect it to move towards 5540 by June 2014 and 5810 points by end 2014. For this to occur, earnings need to be upgraded in the February reporting season, as current volatility suggests the market needs evidence of improved earnings to move ahead strongly from here.

We expect the market to re-rate ahead of the recovery

We expect to see a progressive recovery in Australian company earnings in the year ahead. Traditionally, the market moves ahead of earnings expectations and despite recent volatility, we have already seen this to some extent. We believe that in addition to maintaining exposure to quality blue chip companies, particularly those with a fully franked dividend yield, investors should start to add growth to their portfolios through cyclical stocks.

Investors should position portfolios ahead of this recovery

Stock selection remains critical. With this in mind, we have selected six large cap and six small cap companies we expect to outperform during 2014. Look for those leveraged to the improving domestic economy and therefore improving consumer confidence and discretionary spending (CWN, HVN, SIV, SUL, SMX), the housing recovery (FKP, FBU, GWA), a commodity price rebound (BHP, SHV), healthcare (SHL) and with a falling AUD, global growth stories (AMC). For income investors, we view NABPB as attractive relative to peers.

LARGE CAP STOCKS

Amcor (AMC)

Historically, demergers have been a popular way of extracting value for shareholders. The spin-off of Orora from AMC is no different and we expect it to unlock value for Amcor shareholders, providing an obvious catalyst for the stock going forward. We expect that the new Amcor will trade on a higher multiple than it currently does as its overall return profile will improve following the demerger of a lower margin and lower returning business. The new Amcor, has market leadership globally, a high degree of earnings certainty, a stronger underlying growth profile and larger presence in emerging markets (around 30%). Remember that Amcor offers investors a Total Shareholder Return (TSR) of 10-15% pa (includes a 4% dividend yield). In the future, Amcor's strong cashflow will be invested in: 1) organic growth; 2) acquisitions; and 3) capital management. We see Orora as essentially a cash-cow which should be capable of paying an attractive dividend yield. While Orora is a lower growth, margin and return business, the new Botany Paper Mill and self-help measures (largely cost savings), should underpin solid earnings growth over the next two-three years. A total of A$81m of benefits will be delivered over this period (A$30-40m in FY14). Orora will also benefit from increased management focus and less competition for capital post the demerger. In addition, we expect management will make further acquisitions. Given its open register, smaller size and the fact that the sector is consolidating, we believe that Orora warrants corporate appeal. Both businesses are also a key beneficiary of a falling AUD.

BHP Billiton (BHP)

BHP is the world’s largest mining company. Its major assets include iron ore, copper, petroleum and coal. Exploration and Development is multicommodity, with emphasis on potash. As owner of numerous Tier 1 assets, BHP enjoys the security of a low cost production position for its key products, ensuring profitable operations through the commodity cycle. BHP offers solid valuation upside with a lower risk profile relative to peers. As the sector leader, BHP is likely to be a major beneficiary of any improvement in the outlook for global growth, commodities demand (including China) and risk appetite.

Crown (CWN)

We recently resumed coverage of Crown with an Outperform recommendation and A$18.46 target price. With its growing Australian footprint and exposure to Chinese gambling in Macau, we are positive on CWN's ability to generate strong returns on investments both domestically and internationally. While we are cognisant of the potential risks to earnings in Crown Perth due to the end of the iron ore capex cycle, we are comforted that: (a) our forecasts are conservative; (b) the refurbished Crown Perth has yet to see material softness; and (c) the property has a monopoly position (and continues to invest to drive footfall). However, with the potential for a Melco dividend in the short term and Crown Sydney in the long term, on balance we see the risk to CWN’s current share price lying to the upside.

Fletcher Building (FBU)

Fletcher Building Limited (FBU) delivers building products, construction materials and services across Australasia, Asia, the Americas, Europe, the Middle East and the South Pacific. Its main divisions are Building products, Construction, Crane, Distribution, Infrastructure products and Laminates & Panels. FBU remains our preferred sector exposure. We believe that the “3 C's” of cyclical leverage, Christchurch rebuild and cost-outs, will combine to provide multiple years of earnings growth for FBU. While we view valuations across the sector as relatively full, FBU's FY14 PE multiple of 14.7x provides the most attractive value across the sector, in our view.

Harvey Norman (HVN)

HVN is an integrated retailer, specializing in electrical goods, furniture, bedding, white goods and small appliances. It is leveraged to an improving retail and housing market (which is underway) and a more rational pricing environment (inflation is back = positive leverage). HVN also has A$2.3bn of net asset backing providing asset support. In tougher sales periods, HVN typically provides franchisee support. Last year they spent 2.7% of sales on tactical support to franchisees. This will fall in the better sales environment, providing extra leverage.

Sonic Healthcare (SHL)

One of the challenges the world faces is the rising cost of healthcare driven by the aging population and as diseases such as diabetes and obesity reach epidemic proportions. Increasingly companies like Sonic Healthcare are well placed to provide pathology and diagnostic services to an increasing number of people. Recent US health reforms are set to alter the US healthcare system dramatically. Obamacare potentially will expand health services to approximately 50m Americans (15% of population) who are uninsured and Sonic will benefit from higher pathology volumes. Sonic Healthcare currently derives 75% of its revenue from pathology (20% - US, 30% - Australia, 25% - Europe) and balance from diagnostic imaging and GP services.

INCOME

NAB CPS II (NABPB)

Investor appetite remains high for listed hybrid securities and this was clearly illustrated by the strong demand for the NAB CPS2 offering. NABPB will pay investors floating rate gross distributions based on a rate of 3.25% above the 90d BBSW. Based on current rates, this equates to an initial income yield of 5.85%. The security has a call date of 17 December 2020 when the issuer can redeem the security. We view the pricing of the security as attractive relative to other major bank issued convertible preference shares and capital notes and recommend clients add NABPB to their income portfolios.

SMALL CAP STOCKS

FKP Property (FKP)

FKP is involved in development and investment in retirement living, residential communities, commercial and industrial and funds management and investments. FKP recently recapitalised its balance sheet with a A$232m entitlement issue. It is now trading at an attractive 27% discount to NTA. FKP is also refocusing its business to become a pure retirement owner/ operator in the future which will occur via the sale of its nonretirement assets (approximately A$800m). With FKP's 1Q trading update reflecting improving residential and retirement conditions, we believe now is the time to buy the stock.

GWA Group (GWA)

We believe GWA continues to offer an appealing investment case in current markets given: 1) cyclical leverage via exposure to an improving macro dynamic (housing), and 2) additional further internal improvements. GWA's guidance is for FY14 EBIT of approximately A$80m, however we believe earnings risk lies to the upside. FY15 will be a particularly strong year as the company benefits from the combination of price increases and a likely volume recovery (expect 2H14), something we haven't seen in a long time. With a more lean and efficient cost structure, GWA's leverage will be even more pronounced.

Select Harvests (SHV)

SHV is a fully integrated almond business. Following a change in strategy, SHV is a much simpler investment proposition. New management have done a solid job in turning around the business. Attractive industry fundamentals and a strategy focused on improving returns, saw us initiate coverage with an Outperform recommendation and A$5.20 price target. The day after we initiated, the company announced an accretive acquisition, raising our price target to A$5.42. We see more acquisitions to complement the company's maturing almond orchard profile as a possibility. Globally, demand for almonds is growing at 8% pa, while supply is growing at only 4% due to production constraints. The caveat is that SHV is an agricultural business exposed to the usual vagaries of the sector, however it offers value trading on 8x FY14 with a dividend yield of 4.5%.

Silver Chef (SIV)

SIV provides equipment funding solutions to SME's across numerous sectors. SIV's dominant position is in Hospitality equipment funding, in which it has carved out a niche and driven growth through various economic cycles. Growth is not just reliant on improving economic conditions (SIV's track record has demonstrated this), and improving business confidence could become another tailwind for the business into FY15. SIV is also investing in its long-term growth, with the recent entry into Canada. We believe SIV is on track to deliver its long-term goal of 10-20% EPS growth pa, making the stock an attractive growth story.

Super Retail Group (SUL)

SUL is a specialty retailer: Auto (Super Cheap Auto); Leisure (BCF, Ray's Outdoors and FCO); and Sports (Rebel and Amart Sports). In addition to a strong earnings growth profile (3-year EPS CAGR of 14%), it has $75-100m of working capital to be released over FY15/FY16 and capex will peak in FY14 (SUL will spin off significant cash flow thereafter). SUL also has an exceptional management team with a strong track record of delivering topline and margin growth.

SMS Management (SMX)

SMX is one of the largest most liquid ASX listed IT companies and is typically considered by the investment community to be led by an experienced and credible management team. It has experienced significant earning pressure over the last few years as discretionary IT spend has been deferred. We like the company as we think 1H14 will mark the bottom of the downgrade cycle and see strong operating leverage as things improve. If SMX is able to increase its utilisation from 80% (now) to 90% (its target) then profitability of the business should double. We also like the fact that the CEO just bought around A$0.5m of SMX stock in market.

QUEENSLAND

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EMERALD	(07) 4988 2777
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GOLD COAST	(07) 5581 5777
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