# ANALYST STOCK PICKS FOR FY19.

Our analysts share their outlook and top stock picks.

July 2018

BELL POTTER

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# BANKS & GENERAL INSURERS.

TS Lim

The banking sector has never been stronger in terms of capital and liquidity including funding and asset quality. However, emerging revenue headwinds will now have a greater impact on the bottom line.

These include NIM pressure on the asset side (repricing tailwinds easing, differential between the front and back books narrowing and price competition effects as big and small banks alike fight for volume growth) and the liability side (higher funding costs from elevated 90 day BBSW rates impacting the wholesale funding space including securitisation and from price competition to secure stickier term deposits) as well as decreasing sources of non-interest income (driven by removal of ATM fees and wealth contributions, competition and fewer trading opportunities).

While the major banks have the capacity to further reduce operating expenses to cushion the blows, the smaller players appear to be caught in the perfect storm where top line constraints are combined with the relative inability to quickly reduce costs given their lack of scale. Given these constraints and ongoing concerns over how the Royal Commission will ultimately impact the sector, we believe the prospects are better in the next 12-18 months for players with diverse earnings and offshore exposure such as MQG and CYB. Of the majors, WBC is now our top pick.

**Macquarie Group (MQG)**

MQG's long term value lies in its ability to understand risk and adapt its strategy and business mix to changing market conditions. This has enabled the company to transform itself and push for higher and more sustainable revenues. The more obvious benefits of the transformation are the higher margin and capital efficiency achieved that have resulted in higher profit contributions and Group ROE in return for lower volatility. Our estimates suggest this transformation occurs on average once every 4-5 years for annuity-style revenue components such as net interest income and base fees.

We also believe MQG's performance fees now have some annuity-style characteristics, given the timeline of AUM growth and pipeline of realisation, and this should be stable at around 50bp of EUM. Other fees and commissions were first rebased after four years but appear to have stabilised at ~$1.5bn while capital markets facing M&A fees and trading income also show a level of sustainability.

We continue to regard MQG as a global asset and risk manager with world-class expertise in infrastructure investment (leading player with $495bn AUM and $86bn EUM) and also in the finance, banking, advisory and risk and capital solutions space. These attributes in addition to predominantly lower-risk annuity-style earnings streams (~70% of Group net profit contribution) and strong capital management flexibility (~$2.4bn surplus capital based on 10.5% RWA) continue to underpin our bullish view of MQG. As a lower risk, higher return investment proposition, MQG remains our top sector pick.

Buy, Price Target $125.00

# BANKS & GENERAL INSURERS.

TS Lim

**Clydesdale Bank (CYB)**

The Boards of Virgin Money Holdings (UK) plc (Virgin Money) and CYB have agreed the terms of a recommended all-share offer to be made by CYB for Virgin Money. The merger would create the largest mid-sized bank and the sixth largest bank in the UK that would be active in the retail and SME space with scale and national presence, leading digital and mobile banking capabilities and ~6m customer base. CET1 ratio for the merged entity is expected to be >12% and this should further increase following near-term capital optimisation initiatives and mortgage risk weight accreditation.

CYB would acquire all the ordinary share capital of Virgin Money using an exchange ratio of 1.2125 new CYB shares for each Virgin Money share (i.e. ~547m new CYB shares will be issued for Virgin Money's ~451m shares). The offer implies a 19% premium to Virgin Money shareholders based on Virgin Money's closing price of £3.12 per share and a 35% premium based on its three-month VWAP of £2.76 per share.

Upon completion, Virgin Money shareholders will own ~38% of the merged entity. Virgin Money shareholders would also be entitled to any dividend declared and paid in the interim period ended 30 June 2018. The transaction is expected to be materially earnings accretive based on estimated annual pre-tax cost synergies of £120m (BP estimate £118m based on £85m after tax and effective tax rate of 28%) with a full run rate to be achieved after 30 September 2021. The proposed cost synergies equate to ~19% of CYB's underlying cost base and ~12% of the merged entity's underlying cost base.

All else being equal, the proposed deal should be highly value accretive in terms of underlying EPS (up to 16% upside given the full run rate for cost synergies) and ROE (this should improve by up to 2.4% in absolute terms). The merged entity would be valued at $6.23, in line with our $6.30 price target.

Buy, Price Target $6.30

**Westpac Group (WBC)**

WBC has a reputation for producing clean results and its 1H18 was no exception. Cash earnings were mainly driven by strong NIE including stellar NIM growth, stable other income, cost discipline and strong and conservative credit risk management on top of a benign credit environment.

As in the past few years, WBC's consumer and business banks remain the key drivers of earnings and ROE. Group ROE was at the top end of the 13-14% target range while CET1 ratio was 10.5%, equal to APRA's 2020 minimum requirement. The interim dividend was unchanged at 94cps and WBC intends to maintain dividends until the payout ratio normalises to the 70-75% target range.

WBC's corporate memory over credit losses remains intact in our view (after having had a near-death experience in the early 1990s) and the bank continues to recognise the need for quality credit and operational risk management (in addition to managing for profitable growth) and a very strong balance sheet (capital, liquidity and funding). This is the conservative side of Australia's oldest bank which we think will continue to underpin lower risk and steady earnings growth (in line with GDP) in the years ahead.

Buy, Price Target $31.90

# DIVERSIFIED FINANCIALS.

Lafitani Sotiriou

**Pendal Group (PDL)**

PDL (formerly BTT) returns as one of our Key Picks for FY2019, with the company continuing to focus on future growth through the selective expansion of its investment capabilities, and significant investment in seeding new offerings.

PDL is expected to exceed A$100bn in FUM during FY19, and we believe PDL's strategy remains supportive of our double digit EPS growth forecast over the medium term. We continue to rate the stock as one of our top picks in the sector.

Buy, Price Target $15.50

**Challenger (CGF)**

CGF is set to benefit from some of the biggest changes to the Australian Superannuation system in a number of years. We see the forthcoming introduction of Deferred lifetime Annuities (DLAs), and the Federal Government's Comprehensive Income Products for Retirement or CIPRs framework as being significant catalysts for CGF over the medium-term.

We estimate these changes have the potential to create over $10 billion in additional market demand for annuities products, which represents a significant opportunity for CGF to capitalize on given its strong brand recognition, expertise, and broad distribution reach within the Australian Market.

Buy, Price Target $17.49

**Janus Henderson Group (JHG)**

JHG is set to continue its post-merger success into FY2019, with the company expected to realize further cost synergies, and revenue opportunities arising from its broad cross-border distribution base.

We foresee JHG delivering double digit EPS growth over CY18e & CY19e, supported by a recently announced buyback. We believe JHG is a compelling growth and yield opportunity over the medium term.

Buy, Price Target A$70.00

# FIXED INCOME.

Damien Williamson

After a strong start to 2018, the ASX listed debt and hybrid market saw weakness over February and March. This was associated with the digestion of over $3bn of new issuance and the negative reaction to Bill Shorten's policy proposal on scrapping cash rebates on excess franking credits announced on 13 March. These factors contributed to both WBCPH and CBAPG listing at a discount, breaking the winning sequence of 14 bank / financial hybrid lists spanning back to December 2015.

We have seen some stabilisation since early April, when investor sentiment received a boost with the resumption of positive new listings, after the MQGPC new issue was priced attractively enough to list at a premium on 8 June. One catalyst for a recovery is the $4.5bn pipeline of redemptions over the next 6 months, spanning 6 ASX listed debt and hybrid securities. We expect a refinancing issue for the $2.0bn CBAPC, where the refinancing requirement has been reduced via the $1.365bn CBAPG issue completed in April. The $2.4bn pipeline of pending ASX listed debt issue redemptions will most likely be refinanced through the wholesale debt market.

**Bendigo and Adelaide Bank Convertible Preference Shares 3 (BENPF)**

BENPF remains attractively priced relative to other hybrids from financial issuers. Paying half yearly income at a margin of 4.00% above 180 day bank bill, BENPF has benefitted from the recent spike in bank bill rates. Its December 2018 dividend of $2.1871 fully franked will be the highest dividend payment since June 2016, having been reset at the 180 day bank bill rate on 15 June 2018 of 2.1644%.

Call Date 15 June 2021

Fair Value $102.72

**Crown Subordinated Notes II (CWNHB)**

Since being priced at a margin of 4.00% in March 2015, Crown has significantly de-risked, focusing operations on its casino monopoly in Melbourne and Perth, and its Barangaroo development in Sydney. Net debt has reduced from $2.4bn (Dec 2014) to $250m (Dec 2017), following the A$4.3bn divestment of its 34.3% stake in Melco. In early 2018, Crown realised US$264m from the sale of the Alon Las Vegas site and A$150m (including advanced loans) for the sale of its 62% stake in CrownBet. CWNHB is likely to see support from the $2.4bn pipeline of pending ASX listed debt redemptions over the next 6 months.

Call Date 23 July 2021

Fair Value $102.69

**Westpac Capital Notes 5 (WBCPH)**

The launch of the WBCPH issue on 5 February 2018 coincided with the 2018 peak in the hybrid market. The subsequent weakness has seen this security trade below $100. The likelihood of redemptions exceeding hybrid issuance over the next 6 months provides a catalyst for WBCPH to narrow its discount to face value.

Call Date 22 September 2025

Fair Value $98.06

# AGRICULTURAL FMCG.

Jonathan Snape

Investments in the Agricultural & FMCG sector should be considered high risk and come with volatility. For this reason we tend to focus on stocks where we see either: a structural uplift in ROIC through the cycle (A2M, SM1) or cyclical growth stories (SHV).

**The a2Milk Company (A2M)**

Despite a recent profit downgrade for FY18e, A2M continues to achieve strong levels of earnings growth while generating high levels of operating cash realisation. Near term we see China as a key driver of earnings growth as both the distribution footprint expands and sales velocities improve, however, we are also optimistic about other growth levers open to A2M including the US, UK and adult nutrition. Longer-term we see both the geographic and product expansion strategy for A2M as providing the next legs of growth, with the company's success in the IMF category allowing A2M to internally fund both its geographical expansion and product diversification strategy.

**Synlait Milk (SM1)**

The key driver of earnings and value at SM1 has been the transition from a producer of bulk dairy ingredients to a producer of higher value consumer packaged and IMF products. To date this process has been driven by A2M branded products but increasingly we expect SM1 to benefit from supply agreements with New Hope Nutritionals, Bright Dairy, Munchkin and Foodstuffs. Over the coming twelve months we see potential share price catalysts for SM1 including: (1) receival of CFDA registration for New Hope and Bright IMF products; (2) USFDA approval for the Munchkin grassfed product; (3) completion of the liquid beverage plant and clarification on the RTD nutritional strategy; and (4) completion of the Pokeno facility and transition from base ingredients to nutritional's products supporting an improving ROIC profile in FY21-22e.

**Select Harvests (SHV)**

In the near term we see SHV as the beneficiary of tighter global supply-demand dynamics in almond markets following weaker than expected projection for the Californian crop (~80% of global supply). In the long-term we see SHV as the beneficiary of rising production (on an expanded acreage) at a time when global almond prices look to have moved through the low of the current long-run pricing cycle. We see SHV as having greater operating leverage to elevated almond prices in this cycle than the last, with production at its peak (FY24-26e) forecast to exceed FY15 levels (the previous peak in almond prices when SHV generated EBITDA of $100m) by ~50%. With modest net debt (excluding lease liabilities) and tailwinds emerging in almond prices and volume growth, we see SHV entering an extended period of improving ROIC.

# TECHNOLOGY.

Chris Savage

We continue to be positive on the technology sector in Australia as, in an environment of low interest rates and low growth, we believe there are a number of good quality stocks in the sector with reasonable to strong growth outlooks. We acknowledge that many stocks in the sector have had a strong re-rating over the past year or so but we believe there is still some value in the sector with a number of good quality stocks on reasonable forward PE ratios. Our goal is to find good quality tech stocks with strong growth outlooks that are currently trading on forward PE ratios of around 25x or less and that, over time, can re-rate up to over 30x as has happened with stocks like WiseTech Global (WTC) and Altium (ALU).

**The Citadel Group (CGL)**

Citadel is a software and services company that provides integration and managed services solutions to state and federal governments and the private sector in Australia. The stock is currently trading on an FY19 PE ratio of c.22x and so, in our view, is being priced by the market as a mix of both software and services which is probably reasonable. Over time, however, we believe the company will become more like a pure software company and so will get re-rated by the market and trade on a forward PE ratio of c.30x or more. We believe this transition will become increasingly evident during FY19 and so the re-rating will gradually occur over the next 12 months or so.

BUY, PT $7.50

**Integrated Research (IRI)**

Integrated Research is a software company that has one key product – called Prognosis – which monitors the performance of a customer's network. The company has many of the attributes we look for in a tech company: global presence, leading market position, high quality customers, large recurring revenue, long history, barriers to entry, strong balance sheet and good management. The share price has recently fallen on no new news but some apparent concern on the growth outlook. We, however, believe the stock can continue to deliver strong double digit EPS growth over the medium term and so see good value in the stock at present on an FY19 PE ratio of c.21x.

BUY, PT $4.15

**Technology One (TNE)**

Technology One is an end-to-end provider of enterprise software in Australia, New Zealand, Malaysia and the UK. We regard Technology One as one of the highest quality listed tech stocks in Australia and accordingly the stock tends to trade on a forward PE ratio of >30x. The share price – and PE ratio – has recently fallen, however, due to a contract dispute with a customer (that has now been resolved) and a modest reduction in growth in both FY17 and FY18. The outlook, however, is for a return for strong growth in FY19 and so over the next 12 months we expect the stock to re-rate and return to a forward PE ratio of c.30x or more.

BUY, PT $5.50

# DISCRETIONARY RETAIL & PROFESSIONAL SERVICES.

Sam Haddad

**Premier Investments (PMV)**

We continue to prefer retailers with the following key attributes:

- Leveraged to global growth opportunities;
- Elements of scalability on a global platform;
- Preferably own their own brands;
- Preferably own differentiated brands or have a unique market position;
- Are market leaders in their category;
- Strong omni-channel capability; and
- Have defensive attributes.

Amongst the retail stocks we cover, we believe LOV and PMV meet these key attributes very well, although we recently downgraded our rating on LOV from Buy to Hold based on valuation. This leaves PMV as our key retail pick.

PMV is an investment company whose major investment is in discretionary retailer Just Group. Just Group operates specialty retail brands Just Jeans, Jay Jays, Portman's, Jacqui E, Dotti, Peter Alexander and Smiggle.

Our positive view on PMV is supported by the company's strong long-term earnings growth outlook underpinned by three key growth pillars: Smiggle's global expansion (the primary growth pillar), Peter Alexander and online.

We note these growth pillars are higher margin and therefore a tailwind to group margins. We believe the Smiggle brand can become a global brand given its leverage to youth education and hence universal appeal across cultures, and differentiated market position.

The growth opportunity for Smiggle is significant, with the brand only now entering Continental Europe and yet to enter North America. Management has guided for Smiggle annual sales to exceed $450m by FY20, which represents a significant doubling vs Smiggle's FY17 sales.

**Propel Funeral Partners (PFP)**

PFP is the second largest provider of death care services in Australia and New Zealand. PFP's portfolio footprint comprises 105 locations including 24 crematoria and 7 cemeteries. We believe PFP's location footprint is difficult to replicate as many of its funeral homes have been operating since the late 1800s and early 1900s. Management have significant experience investing in the death care industry spanning over 10 years and is strongly aligned through significant equity ownership, the majority of which is escrowed for 10 years. Based on a proven growth strategy, the leadership of an experienced management team and the backing of a strong balance sheet, we believe PFP is well positioned to drive further industry consolidation. Both markets in Australia and New Zealand are ripe for consolidation with a long tail of independently owned operators.

PFP also stands to benefit from the compelling fundamentals of the death care industry, including the positive long term trend in the number of deaths underpinned by an increasing and ageing population, the industry's highly defensive attributes and the relatively high barriers to entry.

**IPH (IPH)**

IPH wholly owns Spruson & Ferguson (which now includes former FAKC and Cullens), Pizzeys and AJ Park. IPH is the leading Intellectual Property (IP) services group in the Asia-Pacific region employing ~635 staff. Over recent reporting periods, IPH has been impacted by external issues primarily relating to the America Invests Act (AIA). This resulted in a series of negative earnings surprises and a de-rating in PE. However we believe AIA impacts are now behind and expect underlying IP market trends to normalise moving forward. The key positive factors we see for IPH include: 1) the resumption of solid growth, especially in IPH Asia; 2) the recent expansion into China, opening significant long-term growth prospects; 3) the realisation of FAKC - Cullens merger efficiency benefits; 4) material efficiency opportunities in AJ Park; 5) neutralising losses in the Data Services business; and 6) potential FX tailwinds on the back of recent weakness in the $A/$US FX rate.

# INDUSTRIALS.

Tim Piper

**Corporate Travel Management (CTD)**

Our longer term investment thesis on CTD is based on the opportunity to continue growing market share in large, highly fragmented global corporate travel markets driven by CTD's customer value proposition. While the share price has rallied recently resulting in a slightly full forward P/E multiple, we believe this multiple will be justified by a strong FY18e result in August and the likelihood of further accretive acquisitions in the near term. Macro drivers also remain in CTD's favour with strong business confidence levels across key markets such as Australia and North America driving higher business travel activity levels.

BUY

**Johns Lyng Group (JLG)**

We like JLG's exposure to growing general insurance claims and extreme weather related events which we expect to deliver ~20% EBITDA growth in FY18e. The FY18e result will benefit from strong CAT earnings from Cyclone Debbie, however we note that underlying business as usual (BAU) Insurance Building revenue also continues to track well. The current Suncorp trial contract presents another growth opportunity running into FY19e if secured, but we do note that JLG is carrying some extra overheads through FY18e to support this Suncorp trial. The company recently reaffirmed FY18e guidance.

BUY

# RESOURCES.

David Coates, Peter Arden & Stuart Howe

Resource equities overall have had a solid start to 2018, with the broader Metals and Mining Index up approximately 7.1% for the year to date. Having said that there is a sense in some corners of the market that valuations are full. Over the last month or so concerns around free trade restrictions and a stronger US$ are dampening sentiment, with the Index 4.2% down from the high reached in mid-May.

The underlying commodities are generally off the elevated levels at which they started the year, with the latest round of free trade rhetoric and US dollar strength driving further price drops. For 2018 year to date zinc is off 13.5%, iron ore 10.0%, copper 6.8%, aluminium 4.0%, lead 3.4% and tin 0.4%. The exceptions are nickel up 15.7%, thermal coal up 9% and the Australian dollar gold price up 9%.

In the base metals, however, fundamental indicators remain encouraging with all markets facing supply deficits and stockpile drawdowns over 2018. Copper in particular looks tight over the balance of the year. The global composite PMI has remained in growth territory as it has for key economies such as China and the US.

Together with a weaker Australian dollar we believe this helps explain the relative stability of the equities. Notwithstanding that, it is our view that it is difficult to find compelling value in the sector.

In the energy sector, the lift in the oil price from the combination of supply constraint and increased demand has reduced oil stockpiles with the result that OPEC is talking about lifting output slightly, so prices may flat-line for a while. Gas prices in Eastern Australia have retraced from recent peaks after improved supply but are set to remain at elevated levels as the global LNG market faces strong demand growth. The continued expansion of electric vehicle models by the major car makers and forecasts of strong growth in storage batteries points to very strong supply growth requirements for lithium and associated battery components (nickel, cobalt and copper). Significant potential expansions of lithium supply have caused some forecasters to predict lithium prices will begin to decline in 2018. However there is considerable doubt about the ability of many forecast new lithium projects to achieve their slated output, pointing to firmer lithium prices.

Despite the price drop, iron ore has held up well, having maintained an average price for 2018ytd above US$70/t and consensus has come up to meet our US$64/t price forecast for 2018. However, the increased spread between benchmark 62% prices and lower grade 58% grade product has remained a feature of the market.

Gold has been mixed with a weaker US$ price offset by gains in the A$ gold price. What has emerged as a strong feature of the market is the strong outperformance of gold equities, particularly over the last quarter. The ASX Gold Index has risen 10% in this time and share prices of the larger producers are at or near all-time highs.

# RESOURCES.

David Coates

**Aeon Metals (AML)**

AML is focused on the exploration and development of its 100%-owned Walford Creek Copper-Cobalt-Zinc project in NW Queensland. Following the delineation of a small, high grade Resource in 2017, AML has developed a robust geological model for the Walford Creek deposit. This model has since successfully intersected high grade extensions of the Resource and points to the potential for significant Resource growth over +20km of prospective strike length. A $30m capital raise in late 2017 is funding a major drilling campaign through 2018 which has commenced and yielded exciting results. It is likely to drive a material Resource upgrade in early 2019 with strong newsflow in the interim. In our view AML has entered an exciting period of cost effective discovery and growth which we expect more recognition of in 2018.

Speculative Buy, Valuation $0.54/sh

**Pantoro Limited (PNR)**

PNR is a growing gold production company, operating its flagship, 100% owned, Halls Creek Project (including the Nicolsons Gold Mine) in the Kimberley Region of Western Australia. Over the course of 2017 it grew production, lowered costs and strengthened its balance sheet. PNR is now debt free and has just completed a major capital investment program which is planned to lift production from ~50kozpa to 80-100kozpa by the end of CY18 and result in All-In-Sustaining Costs (AISC) dropping to A$1,000/oz. Exploration upside and Resource and Reserve growth remains compelling and we expect this to underpin mine life extensions, adding further value.

Buy, TP $0.36/sh

We have switched our third top pick from FMG to BRB. Ongoing wide discounts to the benchmark iron ore price are dampening the upside for FMG. In contrast, BRB has suffered a strong selloff while at the same time achieving a significant de-risking milestone in the release of a maiden Resource for its Lake Roe Gold project in WA, making the upside compelling from this point.

**Breaker Resources (BRB)**

BRB recently released a maiden Resource for its Bombora gold discovery at the Lake Roe gold project of 11.8Mt @ 1.6g/t Au for 624,000oz, of which 42% was in the higher confidence Indicated category and of which ~240koz is within 50m of surface. BRB has also put forward an Exploration Target of 1.1-1.3Moz which, for a greenfield Resource limited largely by the extents of drilling, we view as highly likely to be achieved. We estimate the Resource has been delineated at a discovery cost of A$23/oz – which we view as both competitive and value adding. Clearly market expectations were not met. The share price has been hit by ~35% since the Resource has been released and this is disappointing. However, looking at the Resource as it stands, we see a good foundation that is likely to grow and an opportune entry point created by emotional rather than rational selling.

Speculative Buy, Valuation $0.96/sh

# RESOURCES.

Peter Arden

### FAR (FAR)

FAR currently has a 15% interest in several major oil discoveries it has made in offshore Senegal that are economically attractive and now about to enter the development phase. With 2C Resources of 641 million barrels (Mbbls) (recoverable), the SNE field is still one of the largest oil discoveries in the last four years and along with the nearby FAN discovery (with 2C Resources of 198Mbbls) is nearing a development decision in early 2019. FAR has also been very active in the adjoining areas, where it is Operator and is farming down to a 40% interest in Blocks A2 and A5 in The Gambia, close to and in the same geological play as the SNE field. FAR has identified the Samo Prospect in these blocks containing P50 Prospective Resources (best estimate) of 825Mbbls that will be drilled by a well in late 2018 under a favourable farm-out arrangement with global oil major, PETRONAS.

Speculative Buy, Valuation $0.26/sh.

### Metals X (MLX)

MLX is a copper and tin producer. Its 100% owned Nifty mine in WA is transitioning to producing 35ktpa of copper in concentrate after overcoming several production issues related to the rundown nature of the operation, which it acquired in August 2016. Nifty's future operation is based on a new Resource containing a significant component of recently discovered ore outside the historic mining area. MLX also owns a 50% interest in and is Operator of the world scale Renison tin mine joint venture (JV) in Tasmania where tin output is currently being lifted by about 15% using ore sorting technology and the JV partners are considering a further 55% increase in tin output to about 13ktpa (100% basis) from the Rentails fuming project. MLX also has 100% of the large Wingellina nickel-cobalt limonite deposit in Central Australia which is now focused on advancing the high grade cobalt deposits.

Buy, Target Price $0.98/sh.

### Xanadu Mines (XAM)

XAM is an advanced copper-gold exploration company based in Mongolia. Recent drilling at XAM's effectively 76.5% owned Kharmagtai Copper – Gold Project in the South Gobi porphyry district has discovered significant higher grade extensions outside the existing Resources at the White Hill and Stockwork Hill Prospects and a major new porphyry centre nearby at the Zarra Prospect. The latest drilling has benefited from several recent studies that have given XAM new insights into the nature and extent of the porphyry mineralisation, and has indicated potential for high grade bornite-rich mineralisation at depth, confirming Kharmagtai is one of the most attractive undeveloped copper-gold prospects in one of the most pro-mining jurisdictions in the world at a time when there are few quality new copper projects. Recent drilling at XAM's other Mongolian project, Red Mountain, continues to discover significant new zones of high grade copper-gold porphyry and epithermal gold mineralisation.

Speculative Buy, Valuation $0.58/sh.

# HEALTHCARE & BIOTECH.

Tanushree Jain

The fundamentals and demographic trends for the healthcare and biotech sector remained strong in FY18 and we expect this momentum to continue into FY19, based on the following 3 key themes:

1. Friendly regulatory environment – the US FDA not only approving more drugs, but also making efforts to expedite the approval of much needed innovative drugs.
2. Increased activity in licensing and M&A – driven by large pharma and biotech's need to replenish pipelines following the expiry of patents on their legacy blockbuster products and US tax reforms. We have already seen an uptick in licensing and M&A activity in 1H18 in both US and Australia.
3. Companies approaching maturity phase - several of the ASX listed biotech and healthcare stocks we cover will reach maturity, with sentiment overall likely to be driven by late stage trial read-outs, regulatory approvals and launches, increased commercial momentum and partnering activity.

In view of these factors we believe the following stocks stand out as potential winners:

**Mesoblast (MSB)**

Mesoblast is a biotechnology company commercialising the therapeutic use of mesenchymal lineage cells (MPCs and MSCs) – a kind of adult stem cell.

It is the leading allogeneic regenerative medicine player with one of the most diversified pipelines and several products in late stage. We view the positive results to date from the company's paediatric GvHD (Graft vs. Host Disease) Phase 3 trial as an important de-risking milestone for it which not only validates its technology platform and clinical design strategy, but also takes it closer to having its first product approved in the US market.

MSB is currently focusing its partnering efforts on its Tier 1 assets and we expect late stage data read-outs, followed by potential partnering deals to act as re-rating catalysts for the stock over the next 6-12 months. Next Key catalysts: Day 180 safety and survival data from Phase 3 GvHD trial in 3QCY18 and Top-line results from Phase 2B end stage heart failure trial in 3QCY18.

Buy, speculative, Valuation $3.75/sh.

**Pharmaxis (PXS)**

Pharmaxis is a biopharmaceutical company focused on the development of drugs for inflammatory and fibrotic diseases. Its lead assets Phase 2 SSAO/VAP-1 inhibitor BI_1467335 partnered in a multi-million dollar deal with Boehringer Ingelheim (BI) and currently unpartnered Phase 1 LOXL-2 inhibitors are targeting Non-alcoholic Steatohepatitis (NASH), a multibillion dollar market with currently no approved treatments. PXS' LOXL-2 assets have successfully completed the first stage of its Phase 1 program indicating no safety or tolerability issues and have demonstrated significant and long lasting inhibition of LOXL-2 highlighting its best-in-class profile. PXS is already engaged with multiple companies in discussions around partnering this asset.

The company has a strong cash position and several upcoming value inflexion points which include: results from Phase 2A trials in NASH and Diabetic Retinopathy for partnered asset with BI in 1HCY19 and results from Phase 1 trial with LOXL-2 assets are expected in 3QCY18, with a partnership deal expected to follow later in the year.

Buy, speculative, Valuation $0.52/sh.

# HEALTHCARE & BIOTECH.

Tanushree Jain

**Bionomics (BNO)**

Bionomics is an Adelaide-based drug discovery company focused on development of drugs to treat CNS disorders such as anxiety, Alzheimers disease and post-traumatic stress disorder (PTSD).

The company has recently sharpened its focus on its core strength in ion channel biology and drug discovery. The platforms supporting this have been validated by partner Merck who has inked two multi-million dollar deals with the company and is also a shareholder in BNO. Clinical stage non-core oncology assets are in the process of being monetised. Recruitment has been completed for BNO's Phase 2 PTSD trial with lead asset BNC210, with results expected in 3QCY18 which would be a key inflexion point for the stock. Positive results from this trial when combined with previous strong results from Phase 2 General Anxiety Disorder (GAD) is bound to attract strong partnering interest.

The company has also recently started a third Phase 2 trial with the drug for agitation in elderly patients with results due in 1QCY19. With currently no approved treatments for agitation positive results from this trial would further enhance the assets licensing prospects.

The stock represents compelling value ahead of the upcoming results from the BNC210 trials and a partnership deal later in FY19.

Buy, speculative, Valuation $0.92/sh.

**Starpharma (SPL)**

Starpharma is a Melbourne-based platform company commercialising the science of nanoscale polymers called dendrimers. Its proprietary dendrimer technology is versatile with wide applicability across the pharmaceuticals sector. In drug delivery the company is focused on oncology (cancer) with platform validated by partner AstraZeneca.

In 2018, SPL licensed its VivaGel BV (Bacterial Vaginosis) product for most of Ex-US markets to Mundipharma with launch expected in 2019. Key upcoming catalysts include a) licensing deal for VivaGel BV for North America followed by approval and launch, b) initiation of Phase 1 trial with SPL/AZN's AZD0466 asset which triggers a US$3m milestone to SPL, c) launch of VivaGel BV by Aspen in Australia and Mundipharma in Europe and other licensed markets and d) initial data from ongoing Phase 2 DEP docetaxel trial and Phase 1 cabazitaxel trial.

Buy, speculative, Valuation $1.88/sh.

# HEALTHCARE & BIOTECH.

John Hester

**Avita Medical (AVH)**

Avita Medical is a medical device company specialising in the treatment of 2nd and 3rd degree burns requiring hospitalisation. The major catalyst over the course of the next 6 months is expected to be FDA approval allowing it to commence commercial sales in the US.

Following years of frustrating delay, Avita has completed clinical trials in the US and is now awaiting Pre-Market Approval (PMA) so that it may commence selling the ReCell device. We believe the risk of the PMA application being unsuccessful is low. The data from the US clinical trials demonstrates ReCell has an excellent safety profile with comparable healing rates in burns patients. The major benefits of the device are the ~30% reduction in the size of the donor site for grafting, improved aesthetic outcomes and shortened length of stay for hospitalisation. The shortened length of stay is equally as important as the clinical outcomes for commercial adoption.

The device is predominantly for hospital use and the hospital must be able to justify the use of new technology by either cost savings or additional revenue generation. ReCell can potentially achieve both criteria.

This clinical data is available for marketing in the US today and the product is available on a highly limited basis via Continuing Access and Compassionate Use programs. In addition the company expects the first large procurement order from the Biomedical Advanced Research and Development Authority (BARDA) in CY2018. This is part of a long term contract expected to generate tens of millions in revenues over the next three to five years.

Speculative, Buy

**Zenitas Healthcare (ZNT)**

The company has recently completed a series of acquisitions which we expect will drive the 45% EPS growth during FY19. At the time of writing the stock was trading at $1.00 representing a 1 year forward price earnings multiple of 8.7x.

ZNT remains a relatively young company whose earnings thus far have been acquisition driven. In our view the investor market will re-rate the company if it demonstrates adequate levels of organic growth. In our view there is ample scope for revenue synergies across the various allied health businesses now operated by the company. The challenge is now for those businesses to be integrated and to capture cross referrals.

The key aspects of the business model which differentiate Zenitas from healthcare role ups of the past are:

- the large components of self-pay – particularly in allied health which is generally not covered by Medicare;
- the absence of key man risk – the business does not employ medical specialists upon whom the entire practice revenue relies; and
- the company allows allied health care professionals to retain a meaningful equity stake in the business, effectively providing important cash incentives for founders.

In addition Zenitas does not pay upfront goodwill for single practitioner GP's and neither does it have a dependence on expensive capital items (such as radiology equipment). Consequently free cash flow is normally quite strong.

Our target price of $1.49 represents an upside of 49% to the current share price.

Buy

# HEALTHCARE & BIOTECH.

John Hester

**Elixinol (EXL)**

Elixinol is an established, leading brand in the nascent US market for hemp based nutraceutical products. The category is currently experiencing explosive revenue growth following recent regulatory changes to legalise the growing of hemp in the US and a growing acceptance of the clinical benefit from these products in controlling the symptoms of numerous chronic medical conditions.

The Australian operations of the group include Hemp Foods Australia (HFA) being a company focussed on the development of the market for Hemp Foods. This category is also expected to grow rapidly from a zero base. The catalyst for the sector was the inclusion of hemp foods on the Foods Standards Code.

The Group is led by Chief Executive Paul Benhaim who is the co-founder of both Elixinol US and Health Foods Australia. Following the IPO he retains 53% of the listed entity and is the largest shareholder by a considerable margin. Mr Benhaim is considered an expert in the field of industrial hemp and medicinal cannabis following more than two decades of experience in the sector both in Australia, the US and Europe.

The company has not provided earnings guidance for FY18, however, 1Q18 revenues grew by 24% over the prior sequential quarter. We expect further double digit growth for at least the remainder of the year and for some period thereafter.

We believe the imminent approval of the first medicinal cannabis product by the FDA in the US will provide further validation of the efficacy of CBD based medicines. Epidiolex is owned by GW Pharma and used for the treatment of Epilepsy in children. In our view this event is likely to have a flow on effect for other market participants including for the over the counter hemp CBD products markets by Elixinol US.

Our target price of $2.16 represents an upside of 56% to the current share price.

Speculative, Buy

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**Disclosures**

TS Lim holds 125 shares in Macquarie Group (MQG).

Lafitani Sotiriou holds 7,000 shares in Pendal Group (PDL); and 10,000 shares in Challenger (CGF).

James Filius holds 1,585 shares in Pendal Group (PDL).

Jonathan Snape holds 22,500 shares in The A2Milk Company (A2M); 7,000 shares in Synlait Milk (SM1); and 5,000 shares in Select Harvests (SHV).

Peter Arden holds 850,000 shares in FAR Ltd (FAR); 150,000 shares in Metals X Ltd (MLX); and 300,000 shares in Xanadu Mines Ltd (XAM).

Bell Potter Securities acted as Co-Manager in Macquarie Group's (MQG) May 2018 Capital Notes 3 (MQGPC) offer and received fees for that service.

Bell Potter Securities acted as a Broker to the Westpac Banking Corp's share sell down of BT Investment Management/Pendal Group (PDL) in May 2017 and received fees for that service.

Bell Potter Securities Limited has acted as Co-manager to the following issues: AMPHA, ANZPD, ANZPE, BOQPD, CBAPC, CBAPD, CBAPE, CBAPF, CWNHA, IANG, MXUPA, MQGPB, NABPA, NABPB, NABPD, NFNG, SUNPD, TTSHA, WBCHB, WBCPF, WBCPG, and WBCPH. Bell Potter Securities Limited received fees for these services.

Bell Potter Securities acted as Lead Manager for the $90m Institutional Placement and SPP of Select Harvests (SVH) in October 2017 and received fees for that service.

Bell Potter Securities acted as Lead Manager and Underwriter to Propel Funeral Partners' (PFP) IPO in November 2017 and received fees for that service.

Bell Potter Securities acted as Joint Lead Manager, Joint Book Runner and Sole Underwriter for Johns Lyng Group's (JLG) IPO in October 2017 and received fees for that service.

Bell Potter Securities acted as Lead Manager for the $30.0m Placement of Aeon Metals (AML) in December 2017 and Manager to the $5.0m Placement in August 2017 and received fees for that service.

Bell Potter Securities acted as a Participant in the $10.0m Equity Raise of Breaker Resources (BRB) and received fees for that service.

Bell Potter Securities acted as Lead Manager for the $15.4m placement of Xanadu Mines (XAM) in October 2017 and received fees for that service.

Bell Potter Securities acted as Lead Manager and Underwriter for the Placement of Mesoblast (MSB) in March and September 2017 and received fees for that service.

Bell Potter Securities acted as Lead Manager of Avita Medical's (AVH) Placements in March 2015, November 2017 and June 2018 and received fees for that service.

Bell Potter Securities acted as Lead manager of Zenitas Healthcare 's (ZNT) IPO in 2016 and Capital Raise in 2017 and received fees for that service.

Bell Potter Securities acted as Lead Manager of Elixinol Global's (EXL) IPO in 2018 and received fees for that service.

**Exploration Risk Warning:**

The stocks of resource companies without revenue streams from product sales should always be regarded as speculative in character. Since most exploration companies fit this description, the speculative designation applies to all exploration stocks. The fact that the intellectual property base of an exploration company lies in science and is generally only accessible to the layman in a limited summary form adds further to the riskiness with which investments in exploration companies ought to be regarded. Stocks with 'Speculative' designation are prone to high volatility in share price movements. Exploration and regulatory risks are inherent in exploration stocks. Exploration companies engage in exploration programs that usually have multiple phases to them where positive results at some stages are not indicative of ultimate exploration success and even after exploration success, there is often insufficient economic justification to warrant development of an extractive operation and there is still significant risk that even a development project with favourable economic parameters and forecast outcomes may fail to achieve those outcomes. Investors are advised to be cognisant of these risks before buying such a stock.

**Biotechnology Risk Warning:**

The stocks of biotechnology companies without strong revenue streams from product sales or ongoing service revenue should always be regarded as speculative in character. Since most biotechnology companies fit this description, the speculative designation also applies to the entire sector. The fact that the intellectual property base of a typical biotechnology company lies in science not generally regarded as accessible to the layman adds further to the riskiness with which biotechnology investments ought to be regarded.

Stocks with 'Speculative' designation are prone to high volatility in share price movements. Clinical and regulatory risks are inherent in biotechnology stocks. Biotechnology developers usually seek US FDA approval for their technology which is a long and arduous three phase process to prove the safety, effectiveness and appropriate application or use of the developed drug and even after approval a drug can be the subject of an FDA investigation of subsequently discovered possible links between the drug and other diseases not previously diagnosed. Furthermore, the Australian exchange listed biotechnology sector is subject to influence by the global biotechnology sector, particularly that in the USA. Consequently, Australian exchange listed biotechnology stocks can experience sharp movements, both upwards and downwards, in both valuations and share prices, as a result of a re-rating of the sector both globally and in the USA, in particular. Investors are advised to be cognisant of these risks before buying such a stock.

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