ANALYST OUTLOOK FOR 2020.

Our analysts share their outlook and top stock picks for 2020.

BELL POTTER

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BANKS & GENERAL INSURERS.

TS Lim

Our 2020 top three picks possess strong risk management capabilities and defensive qualities including healthy balance sheets and surplus capital that could be returned to shareholders.

These specialist companies have undergone massive transformation over the years to improve the quality and consistency of their earnings. Our selection comprises two diversified financials (MQG and SUN) and one general insurer (IAG). The operating environment remains positive for MQG (e.g. capitalising on rising global demand for asset management services and infrastructure/green investments) and SUN and IAG (e.g. continuation of volume and rate tailwinds and cost efficiencies backed by adequate reinsurance arrangements). Our 2020 choice of companies also reflect fewer sector headwinds and distractions ahead when compared with the major banks.

Macquarie Group (MQG)

MQG's value lies in its ability to manage risk and adapt to changing market conditions. This has allowed itself to transform and push for higher sustainable revenues. MQG is largely a global asset/risk manager with world-class expertise in infrastructure/green investments and broad banking capabilities. These attributes in addition to predominantly lower-risk and higher return annuity-style earnings activities (60% of 1H20 Group net profit contribution, ~24% return on ordinary equity) and capital management flexibility (~$4.9bn surplus capital based on 10.5% RWA) continue to underpin our bullish view. As a lower risk, higher return investment proposition, MQG remains our top sector pick.

Buy, Price Target $149.00

Suncorp Group (SUN)

SUN's top line and cost trends in 1Q20 remain in line with expectations and a higher natural hazard allowance would improve its capacity to deal with catastrophes. SUN is also committed to repricing for higher hazard costs and this adds to its defensiveness. The Capital S.M.A.R.T sale will generate ~$300m excess CET1 capital. Given strong organic capital generation and assuming natural hazards are in line with allowance, another 8¢ special dividend and further return of surplus capital are highly likely in FY20. Longer term, we still expect SUN to divest its sub-scale bank that currently sits on ~$3bn CET1 capital.

Buy, Price Target $14.80

Insurance Australia Group (IAG)

IAG is in our view the best pure play general insurer given its better risk-adjusted return profile, cost discipline and very strong reinsurance arrangements. FY20 guidance is for further improvement in underlying performance (based on further premium increases in short tail personal and commercial lines, modest volume growth, ongoing cost discipline and 16-18% reported insurance margin) and was reaffirmed at its recent AGM. Organic capital generation remains strong and the recent sale of its 26% interest in SBI General will boost surplus CET1 capital by $400m and increase the likelihood of a special dividend and/or return of capital in FY20.

Buy, Price Target $8.40

LICs & LITs.

Will Gormly

2019 was a testing time for the closed-end listed managed investment structure. The ALP's controversial franking credit policy would've diminished the appeal of LICs for retirees, coupled with the tax-loss selling heading into June saw discounts widen across the board. As a result, attractive opportunities arose with many large and reputable LIC/LITs trading at historically large discounts.

Our top picks for 2020 are MFF Capital Investments Limited (MFF) which has delivered continued superior long-term performance, Plato Income Maximiser Limited (PL8) which specialises in maximising income for pension-phase and SMSF investors, and MCP Master Income Trust (MXT) which provides non-equity income diversification for investors seeking yield in a period of historically low rates.

MFF Capital Investments Limited (MFF)

MFF's primary focus is to invest in large listed international companies that have attractive business characteristics at a discount to their assessed intrinsic values. The Directors believe that this will generate superior risk adjusted returns over the medium to long term, while minimising the risk of permanent capital loss. As at the end of October 2019, we calculate MFF had a 10 year share price annualised return (incl. net dividends) of 21.2% p.a. and a pre-tax NTA return of 18.9% p.a. compared to the MSCI World Index (in AUD) return of 12.4% p.a. Performance is calculated after the payment of tax, which is MFF's greatest expense. Tax paid can result in franking credits eventually being transferred through to the benefit of shareholders and MFF had a franking reserve over $58m as at 30 June 2019. The FY19 Indirect Cost Ratio of 0.44% was the lowest we calculated amongst global mandated LIC/LITs, whilst the Manager and the Company have agreed to cease the entitlement to a Performance Fee for the period ending December 2019.

Plato Income Maximiser Limited (PL8)

PL8 provides a well-diversified portfolio of Australian listed equites that aims to deliver shareholders with annual income (incl. franking credits) in excess of the S&P/ASX 200 Franking Credit Adjusted Daily Total Return Index (Benchmark). The Company will also aim to outperform (after fees) the Benchmark in total return terms (incl. franking credits) over each full investment cycle. The Manager, Plato Investment Management Limited, achieves this by 3 means; dividend run-up effect, franking credits and running a dividend trap model. PL8 invests directly into a 'no fee' class of one of the Manager's unlisted funds. Due to this, PL8's investment portfolio is classified as long-term holding with the movements in the underlying portfolio reported in other comprehensive income. PL8's profits will therefore be derived from the distributions of the underlying fund. This creates greater confidence about available profits from which to source payment of a franked dividend on a monthly basis. Based on the 31 October share price, PL8 is trading on a 7.3% annualised gross yield. Management Fees are 0.82% p.a. (incl. GST & RITC) and there is no Performance Fee.

MCP Master Income Trust (MXT)

MXT is a fixed income LIT that aims to provide exposure to the Australian corporate loans market with diversification by borrower, industry and credit quality. Of the 125 investments in the portfolio at the end of October 2019, 55% were of investment grade. Metrics Credit Partners (The Manager) is an alternative asset manager with an experienced investment team that have the capability to cover all fundamentals of direct lending and private credit including originating, structuring and distributing private debt. As at the end of October 2019, we calculate MXT had a 1 year share price return (incl. net dividends) of 4.1% and a NAV return of 5.7% compared to the RBA Cash Rate +3.25% return of 4.5%. MXT has a target return of the RBA Cash Rate +3.25% (currently 4.0%) net of fees. As at the end of October 2019, the trailing 12 month yield was 5.5%. Management Fees are 0.64% p.a. and there is no Performance Fee.

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 (cyclical growth stories) or counter-seasonal crop exposures.

Our key commodity call for 2020 is the unwinding of the drought induced dislocation between domestic cattle prices and export meat prices on a normalisation in weather patterns. Our three stocks carry varying degrees of exposure to this dynamic.

Australian Agricultural Company (AAC)

AAC is a vertically integrated cattle and beef producer with operations that span the entire supply chain across genetics, nutrition, pastoral operations, feedlots and processing.

The issues that have faced AAC in FY19-20 (attrition, high feed costs and weaker cattle prices) are cyclical rather than structural in nature. Over the past 18 months, direct drought related costs have resulted in a cost structure ~30% higher than what would be achieved in normal conditions. In our view, this additional cost is masking a 12% YOY uplift in meat supply chain returns (ex-Livingstone). When more normal weather patterns return we expect a to see a material improvement in the underlying returns per kilogram that AAC is delivering. In addition we would expect any material pick-up in the cattle price would be beneficial for AAC's NAV.

Elders (ELD)

ELD is a leading supplier of fertiliser, agricultural chemicals and animal health products to rural and regional Australia, with strong agency positions in livestock, wool and real estate.

The share price of ELD has been impacted by ongoing dry conditions across Eastern Australia and subdued cattle prices. Our FY20 forecasts assume a normal winter cropping season, a 10 month contribution of AIRR and continued transition of the ag-chem business to Titan. Rain is the ultimate catalyst for ELD, with the benefits that naturally flow through to the rural merchandise, livestock agency and StockCo businesses. We estimate EBITDA in a range of $130-140m under more normalised seasonal conditions and a stronger livestock pricing environment, once Titan and AIRR are fully integrated. It is this view of operational leverage in ELD which forms the basis of our Buy rating.

Rural Funds Group (RFF)

Rural Funds Group (RFF) is a listed agricultural REIT with a portfolio covering 50 properties, focused on almond orchards, vineyards, cattle, cotton and macadamias. Assets in the portfolio are some of the most productive in the industry and leased to high quality tenants including Treasury Wine Estates, Olam, Select Harvests, AACo and Stone Axe Pastoral, with a WALE of 11.3 years. RFF is externally managed by Rural Funds Management (RFM), who have been managing agricultural investments since 1997.

The RFF portfolio continues to transition to natural resources (from 46% to 59% of FY20e revenues), which are appreciating rather than depreciating assets, and towards assets with market linked rental reviews (from 37% to 43% of FY20e revenues). Over time as capex is deployed we expect favourable asset revaluations and growth in rental incomes from newly acquired assets. In addition as the investment in the cattle sector has lifted so too has the exposure the business has to cattle prices, through EYCI rent linkages on some leases.

TECHNOLOGY.

Chris Savage

We continue to be positive on the technology sector in Australia. 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 many stocks in the sector have had a strong re-rating over the past couple of years but 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).

Citadel Group (CGL)

Citadel is a software and services company that provides integration and managed service solutions to state and federal government departments and the private sector in Australia. The company has had a tumultuous 2019 with a disappointing FY19 result and the resignation of the CEO which have resulted in a significant fall in the share price. This, however, provides an opportunity as the company is not broken and in fact is getting better with investment in technical, delivery and sales capabilities that ultimately will deliver a much higher percentage of repeatable revenue across a much broader customer base. In our view the stock looks good value on an FY20 PE ratio <20x.

BUY, Price Target $5.50

Uniti Group (UWL)

Uniti is a diversified provider of telecommunications services, specialising in fixed-wireless, fibre and specialty telecommunication services. The company has grown rapidly through a number of acquisitions over the past 12 months and is now a strongly profitable and highly cash generative business. Uniti looks set for further strong growth over the next 12 months through both organic growth and likely further acquisitions and is well positioned to fund this growth with a strong Balance Sheet as well as the cash generated from the existing businesses. The stock looks reasonable value on an FY21 PE ratio of <30x.

BUY, Price Target $2.10

Adacel Technologies (ADA)

Adacel is a leading global provider of simulation and control systems for the civil aviation and defence sectors. The company had a difficult FY18 and FY19 which was driven by the loss of a key contract with the FAA in the US and a cost blowout on a contract with DSNA of France. FY20, however, has started much better with the company reiterating its guidance at the FY19 result in August and then slightly upgrading the guidance at the recent AGM in November. Importantly the problems on the DSNA contract now appear behind the company and there appears good potential for further contracts. The stock looks very good value on an FY20 PE ratio <15x.

BUY, Price Target $0.75

DISCRETIONARY RETAIL.

Sam Haddad

Macro stimulus from tax rebates and interest rate cuts has to date had limited flow-through benefit to discretionary retailers. Consumers are focusing more on the reasons behind the interest rate cuts and becoming increasingly cautious on their discretionary spending decisions.

With this challenging domestic backdrop, we continue to prefer retailers that offer growth through-the-cycle prospects by being leveraged to global expansion opportunities or to structural tailwinds (such as the shift to online).

Three stocks that fit this profile very well are CCX, LOV and TPW.

City Chic Collective (CCX)

CCX is a global multichannel retailer specialising in plus-size (size 14+) women's apparel, accessories and footwear. It is a collective of customer-led brands including City Chic, Avenue and Hips & Curves. City Chic appeals to fashion-forward women and its multichannel model comprises: a network of >100 stores across Australia/New Zealand; multiple websites operating in Australasia and USA; marketplace and wholesale partnerships with major US retailers such as Macy's and Nordstrom; and a wholesale business with European partners such as ASOS and Zalando. Avenue targets value-conscious women and Hips & Curves is an intimates brand; both are online only with a significant customer following throughout the USA. Led by a strong management team with a proven track record and backed by a strong balance sheet, we believe CCX is well positioned to grow globally. The key growth opportunity is the significant USA market where we believe the City Chic brand is building strong traction. Also, we believe the recent acquisition of Avenue's e-commerce assets is attractive on a number of fronts including: being highly EPS accretive; provides immediate leading exposure to the US value segment; materially accelerates US customer acquisition, with cross-selling potential; and includes opportunity to realise synergies in buying disciplines and the supply chain.

Lovisa Holdings (LOV)

LOV is a leading specialist fast fashion jewellery retailer that is strategically focused on the affordable jewellery segment. Australia is LOV's largest market exposure, however the company is embarking on an international store rollout strategy. Our positive view on LOV is supported by the company's strong long-term earnings growth outlook underpinned by significant global store rollout opportunities. LOV has entered a number of major new territories in the northern hemisphere including the USA, the UK and France (plus Spain in pilot). Among these, the USA is the 'big prize' where we believe store rollout is progressing strongly. We believe LOV is well placed to execute on its international growth plans given a number of attractive business attributes. These include LOV's vertical business model that supports high gross margins and brand control, compelling store metrics with high sales intensity and short average payback period, fast supply chain (only 8-10 weeks from product development to being in-store), and a regionally adaptable product range. We also believe LOV has defensive attributes as customers are able to treat themselves without putting pressure on their budgets (given LOV's low dollar value transactions).

Temple & Webster (TPW)

TPW is Australia's largest online only furniture and homewares retailer with circa 150,000 products on sale from roughly 700 suppliers. The business runs an innovative drop-shipping model, where products are sent directly to customers by suppliers, enabling a larger product range, faster delivery times and reducing the need to hold inventory. The drop ship range is complemented by a private label range which is sourced directly by TPW from overseas suppliers. We believe TPW is well positioned to benefit from a number of structural trends, including: the migration to online (only 4-5% of Australia's furniture and homewares sales is online, vs 14% in the US and UK); online savvy millennials now entering TPW's core demographic; and faster internet/mobile speeds. With a stabilised platform and strong balance sheet in place (net cash of $13.5m at 30 June 2019), management is able to focus more on driving top-line growth. There are several initiatives underway to drive sales growth including: adding depth and breadth to the company's core offer; continuing to invest in the trade and commercial segment; adding new adjacent categories; and the launch of a mobile app.

TRAVEL & TOURISM.

Alex McLean

Investments in the Travel & Tourism sector are generally considered cyclical. For this reason we try to focus on stocks with a diversified business model across multiple travel businesses with exposure to global growth opportunities.

Corporate Travel (CTD)

CTD is a corporate travel service provider with operations in Australia & New Zealand, North America, the UK and Asia. CTD's business model revolves around its customer value proposition which combines superior client service and technology solutions to deliver return on investment and cost savings to corporate clients. In our view, we see CTD continuing to leverage this value proposition, further increasing its market share both domestically and internationally. We continue to back CTD's experienced management team and refer to the strong return on capital metrics when assessing the quality of the business. Management have already guided to a stronger second half in FY20 - suggesting a weaker first half. We do however expect a number of key tailwinds to positively contribute to FY20 (FX/M&A/cost-synergies) and offset low expectations for organic growth to reach market expectations, which are now set at the lower end of guidance.

BUY, PT $23.50

Helloworld Travel (HLO)

HLO is an Australian based travel distribution company comprising retail travel businesses, destination management services (inbound), air ticket consolidation, wholesale, corporate and online operations. HLO is well placed to generate earnings growth on the back of merger synergies, cost savings and further acquisitions. Despite challenging macro conditions, momentum across HLO's portfolio has been relatively resilient as highlighted by a strong Q1 trading update which included Total Transaction Value (TTV) growth of 10.4% (9.2% organic growth) and EBITDA growth of 7.7%. We remain confident in management's ability to execute on its growth strategy and with forecast EPS CAGR of c.16% over the forecast period and a forward P/E ratio of c.12x earnings, HLO presents a compelling buying opportunity with limited downside risk.

BUY, PT $5.85

ENGINEERING & CONSTRUCTION.

Steven Anastasiou

Monadelphous (MND)

MND is a premier Australian provider of Engineering Construction (EC) and Maintenance & Industrial Services (M&IS) to blue-chip clients in the resources, energy and infrastructure sectors. Through a conservative management style, MND has retained a net cash position above $100m since FY08 and paid a fully franked dividend every year since 1994.

With Australian resources production reaching record levels, MND has seen strong revenue growth in its M&IS division of ~52.9% since FY17, with it comprising ~62% of FY19 group revenue. M&IS provides recurring style revenue with most contracts awarded under multi-year agreements.

Additionally, MND's construction division is set to benefit from Australia's iron ore majors committing to ~US$11.4bn of new projects, with MND currently having won ~$312m of work on BHP's South Flank and Rio Tinto's West Angelas projects.

Lycopodium (LYL)

Having completed over 5000 studies and 300 projects in over 55 countries, LYL has proven itself to be a premier provider of full life cycle minerals processing services across a wide array of commodities, including Gold, Copper, Graphite, Lithium, Iron Ore, Nickel, Mineral Sands and Diamonds.

By establishing repeat relationships with numerous clients, including Rio Tinto, BHP and Newcrest, LYL has amassed a ~$60m net cash balance, representing ~28% of its market cap at a share price of $5.40.

Being particularly leveraged to gold, LYL is set to benefit from any continued strength in the gold price, which is likely to drive demand for new studies and projects. In addition, LYL's Mondium JV with MND, which is targeting large-scale Australian EPC projects, is continuing to gain market traction, as evidenced by winning a ~$100m contract from Talison Lithium in May 2019.

On a trailing dividend yield of ~5.6% and BP forecast FY20 yield of ~5.9% (based on a $5.40 share price), LYL provides a rare opportunity for investors to both gain exposure to a rising gold price, and earn a strong income.

Service Stream (SSM)

Across its Telecommunications and Utilities segments, SSM provides outsourced services to Australia's telecommunications, gas, electricity and water utilities with an impressive list of blue-chip customers which include NBN Co, Telstra, Sydney Water and APA Group.

The Telecommunications segment comprises Fixed Communications (completing nbn activations & maintenance) and Network Construction (now primarily focused on wireless mobile towers).

The Utilities segment comprises Energy & Water (meter reading and replacement, commercial solar installations, and electrical inspections) and Comdain Infrastructure (end-to-end engineering construction and asset management services to the water and gas sectors on Australia's east coast).

SSM has a strong track record, having delivered 12 consecutive halves of profit growth and tight working capital control that routinely sees it deliver strong operating cash flow conversion. Despite a wind-down in nbn construction work, SSM's long-term relationships with key clients in defensive industries should help it to continue delivering solid operational performance in the years ahead.

INDUSTRIALS.

Hamish Murray &
James Filius

Hamish Murray

Imdex (IMD)

IMDEX (IMD) is the market leader in downhole instrumentation solutions for mining exploration and development, with sales in 102 countries and the presence of an IMD product on ~70% of mineral drill sites globally. The company has been able to successfully leverage its end-to-end product suite, portfolio of intellectual property and market leading cloud-based platform to grow revenues faster than global exploration expenditure trends.

We believe 2020 is positioned to be a transformational year for IMD given: (1) the company had a record first quarter, driven by improving trading conditions globally and growing interest in its technologies; (2) momentum in capital raising, drilling data and structural factors such as the gold price, continue to point to a positive outlook for global exploration spend which should provide a tailwind; and, (3) material growth opportunities from four new technologies that in our view are not reflected in the current market valuation.

IMD has a net cash position, which provides the ability to increase the payout ratio over time and return capital to shareholders. We believe shareholders are exposed to robust FY20e growth in the core business, while certainty surrounding the pricing models and adoption rates of the four emerging technologies presents potential for material upside.

Buy, Target Price $1.62ps

Carbon Revolution (CBR)

Carbon Revolution (CBR) is a state of the art manufacturing company that has developed the only single piece carbon fibre automotive wheels to Original Equipment Manufacturer (OEM) quality standards with commercial adoption across several major OEM models.

CBR is currently contracted to supply wheels to nine different vehicle programs for Ferrari, Ford, Renault and two additional undisclosed OEMs. We believe there are push and pull factors compelling other OEMs to offer a carbon wheel option, including: (1) the increased average ticket size and margin; (2) carbon wheels act as a key differentiator for competitor vehicles; and (3) there is limited downside risk to OEMs offering carbon wheels as an option beyond the initial costs of design, testing and validation.

The ongoing industrialisation program positions CBR at a significant inflection point. Successful execution of the program can materially increase manufacturing capacity, lower production unit costs and increase the scalability of production; thereby providing the potential for much broader adoption of carbon wheels in the automotive wheel market. While the execution of the industrialisation program presents execution risk, we believe the prospects for hypergrowth and the current trajectory to be EBITDA positive in 4Q20e justifies CBR trading on ~5-6x EV/Sales in the near-term.

Buy (Speculative), Valuation $5.80ps

James Filius

Frontier Digital Ventures (FDV)

FDV offers unique exposure towards fast growing frontier and emerging markets where a structural shift towards the use of online classified platforms is rapidly developing. The company owns an assortment of stakes in 12 online classifieds businesses located in Developing Asia, South/Central America, and Africa/MENA. Whilst the prospect of investing in emerging markets is inherently risky, we believe FDV exhibits a number of factors that have begun to "de-risk" the company's portfolio, including: 1) 9 companies within FDV's portfolio are now annualising revenues of >A$1m, an important milestone for an early stage business; (2) 4 portfolio companies have now begun to trade profitably at the EBITDA level, and have become self-funding; 3) FDV continually evaluates opportunities to optimise its portfolio (recently increasing its stake in fast growing South/Central American Property Portal, Infocasas); and 4) FDV has ~A$10m in cash which ensures the company has the ability to consider further investment opportunities.

We believe FDV is well placed entering FY20, as we forecast that FDV's Portfolio companies will deliver strong double digit revenue growth in FY20, and believe that the company will continue to benefit from increasing revenue diversification, as up and coming businesses such as E24, Propzy and Infocasas begin to contribute a larger proportion of Group revenues and earnings as these business edge closer to profitability.

Buy (Speculative), Valuation $1.10ps

HEALTHCARE.

John Hester

The small to mid market cap biotech/healthcare section of the market has had a banner year in 2019 with numerous stocks enjoying the benefit of success in the clinic (Paradigm Biopharmaceuticals) as well as regulatory and commercialisation success (Avita Medical). Among the medical device stocks and those with an exposure to healthcare IT, Nanosonics, Promedicus and Volpara Health Technology have each enjoyed significant gains in market share and revenue growth.

Turning to the outlook for 2020 and a predominantly new group of stocks are included in our key picks including Oncosil Medical and Botanix Pharmaceuticals. Both are undervalued in our view with significant news flow likely in 2020.

Longer term we believe stocks developing gene therapies will be at the cutting edge of new drug development over the next decade. These drugs have the potential to cure previously untreatable disease including many debilitating inherited genetic conditions of which there are thousands. In our stock coverage the company with the nearest term drug candidates (albeit still pre-clinical) is Avita Medical (AVH).

Oncosil Medical (OSL) (Speculative)

Following a long period of sustained effort, Oncosil Medical is finally on the verge of obtaining a CE Mark in Europe. This should lead to first commercial revenues in 2020. Oncosil has a brachytherapy device for the treatment of inoperable pancreatic cancer as well as for use in down staging of borderline cases such that patients become eligible for surgical cure.

Data from the 42 patient trial conducted in Europe and Australia demonstrated an impressive survival benefit compared to patients treated with the standard of care. The overall survival benefit is at least 3 months with 50% of patients still alive and in long term follow up.

We expect the company will receive a humanitarian device exemption in the United States in 2020 and this is likely to be followed by a larger clinical program at some point.

Botanix Pharmaceuticals (BOT) (Speculative)

Botanix Pharmaceuticals is an Australian biotech company engaged in the development of novel compounds for the treatment of a range of dermatological conditions. All products utilise synthetic cannabidiol (CBD) in conjunction with Permetrex skin delivery technology. The company has exclusive rights to this technology for all drugs that treat dermatology conditions. The first two indications are for chronic acne and atopic dermatitis (AD). Botanix recently reported results from a phase II trial in the treatment of moderate to severe acne. The trial did not meet the primary clinical endpoints, nevertheless we believe extenuating circumstances contributed materially to this outcome, namely the US DEA restrictions regarding the transport and storage of drugs involved in the trial. These restrictions have now been relaxed and will allow for a much tighter level of control in subsequent clinical programs. The results from the Australian sites were in line with earlier testing and are supportive of further analysis.The company's approach to testing and registration of this controversial new class of drug is no different to any new chemical entity. Feedback from clinicians and patients involved in the clinical program has been highly encouraging with the safety aspect of the drug representing a significant advantage over competitors.

HEALTHCARE & BIOTECH.

Tanushree Jain

The fundamentals and demographic trends for the healthcare and biotech sector remained strong in 2019 and we expect some of the key themes from this year to continue to play out in 2020:

1. Supportive regulatory environment – We believe the US FDA will continue to balance its historical standards of safety and efficacy with its desire to speed drugs to patients in need, through accelerated pathways. New FDA commissioner Hahn may take a few months to get his bearings, but we believe the culture at FDA is unlikely to change.
2. Licensing and M&A activity to remain high with fewer but bigger deals – 2019 was a year of mega-merger deals in the US (BMS/Celgene and Abbvie/Allergan) making it a record M&A year. However, another trend which emerged was fewer but bigger licensing deals, driven in part by smaller companies having stronger negotiating power due to their ability to access alternative sources of financing to move their projects forward. While the mega merger deals may not repeat in 2020, we expect the trend of fewer but bigger deals will be evident in 2020, supported by companies having other fundraising options for promising assets.
3. Further maturing of ASX listed biotechs/ medical devices - We also expect further maturing of companies we cover, with more trial readouts, potential partnerships and commercial launches throughout the year. For medical device/ diagnostic companies in initial stages of commercial roll out, we expect commercial momentum for their marketed products to pick up, driven in part by expansion into new geographic markets.

We continue to believe that companies that deliver solid, unequivocal data and commercial outcomes in 2020 are likely to be rewarded for their efforts in terms of stock price appreciation and will attract investors and partners/suitors, with OPT, MSB and PXS our Top 3 picks for having the potential to do so.

Opthea (OPT) (Speculative)

Opthea is a Melbourne-based biopharmaceutical company focused on the development of therapies for the treatment of eye diseases. Its drug OPT-302 is targeting wet age-related macular degeneration(wet AMD) and Diabetic Macular Edema (DME), an attractive market with 2 standard of care (SOC) anti-VEGF-A drugs generating US$10bn revenue in 2018. Recent results from OPT-302's Phase 2b wet AMD trial demonstrated strong vision gain with OPT-302 combination over SOC alone and led to a strong re-rating of the stock. In the current landscape, there is scarcity of novel combination approaches, existing blockbuster drugs are facing patent expiry and biosimilar competition and focus has moved to increasing durability with longer acting anti-VEGF-A agents. The meaningful additional efficacy offered by OPT-302 and its potential to be combined with any anti-VEGF-A agent, in our view makes the company a strong candidate for takeover or partnering. A recent placement has strengthened its negotiating position (proforma cash of $80m provides cash runway through 1HCY21), providing flexibility to evaluate all strategic options while preparing for Phase 3 registrational trials for wet AMD. Strong re-rating catalysts in 2020 include results from Phase 2A DME trial in 2QCY20 and a potential global licensing deal in 2HCY20 (BPe worth over US$1bn).

Buy, speculative, Valuation $4.80/sh

Mesoblast (MSB) (Speculative)

Mesoblast is the leading allogeneic regenerative medicine player with one of the most diversified pipelines and several products in late stage. It has strategic licensing agreements in place with Tasly for China (heart) and Grunenthal for EU and LATAM (back pain). The company is heading towards a transformational 2020 with its first US product approval in sight, two Phase 3 clinical trial results and potential for further partnering deals. The company's focus remains on completing its BLA filing for remestemcel-L product for SR-aGvHD in children in US, with approval and launch expected in 3QCY20. In preparation for commercial launch MSB is building inventory with Lonza and a 15 person sales force. Other late stage assets are also approaching inflexion points. Revascor for advanced heart failure is on track for full accrual of events in Phase 3 trial by end of CY19, with Top-line results expected in 1HCY20. For Revascor for end stage HF, the Phase 3 trial protocol has been agreed on with InCHOIR and the trial is expected to start in 1QCY20. The low back pain Phase 3 trial in US is on track to report in mid-CY20. Royalties from Temcell GvHD product in Japan are continuing to grow which bodes well for remestemcel-L's US launch. MSB has cash runway into 2HCY21 (proforma cash of ~US$99m, US$30m milestone from Grunenthal in CY20, US$35m drawdown from existing debt facilities).

Buy, speculative, Valuation $5.10/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 is approaching key inflexion points – a) Commercial assessment and results from Phase 2A NASH trial run by partner BI is expected in Dec'19. Decision by BI to move to Phase 2b trials could add over 10 cents to our valuation; b) completion of commercial process for LOXL-2 asset is targeted by end CY19 (BPe US$700m deal); c) FDA approval decision on Bronchitol for cystic fibrosis in 2QCY20, with US$10m milestone from partner Chiesi and launch in US in 3QCY20 and d) Commercial assessment and results from Phase 2A diabetic retinopathy trial run by partner BI in 3QCY20. Proforma cash of ~$29m provides runway through CY20, with a further boost expected through Bronchitol US milestone and upfront from LOXL-2 deal in 2020.

Buy, speculative, Valuation $0.59/sh).

EMERGING COMPANIES.

Damien Williamson

PointsBet (PBH) (Speculative)

Founded in Melbourne in 2015, PBH commenced operations as an Australian corporate bookmaker in February 2017. The May 2018 decision by the US Supreme Court to overturn the Professional and Amateur Sports Protection Act (PASPA) has provided the opportunity for PBH to expand its corporate bookmaking business into the US market, as individual states introduce legislation to permit both online wagering and sports betting.

To apply for a US online sports betting licence, PBH is required to partner with a licensed operator in the form of a casino or racetrack. PBH currently partnerships in 10 US states with a combined population of 81m. PBH accepted its first customer bet in New Jersey in January 2019 and Iowa in August 2019. With online sports betting legislated in Indiana, West Virginia, Illinois and Colorado (combined population 27m), we see the potential for PBH to be live in these states by June 2020.

PBH is in the battle for the 3rd largest online bookmaker in New Jersey after reporting 6.7% share of online sports wagering turnover in the September 2019 quarter. At 30 September 2019, the US registered client base of 37,231 represented 25% of PBH's 148,902 total clients. After raising $75m in its June 2019 IPO, PBH's war chest has been further topped up to continue its customer acquisition efforts and entry into new US states following the completion of its $122m capital raising launched in October 2019.

US online sports wagering is an emerging market, where we see increasing strategic value for leading online bookmakers such as PBH when considering:

- US sport media annual broadcast rights of US$22.4bn (US$69 per capita): Sports represented 43 of the top 50 highest rating broadcasts in the US in 2018.
- 5,400 annual matches spanning NFL, NBA, NHL, MLB: Significant spectator interest from average attendance of >67,000 for NFL, >28,000 for MLB, >17,000 for both NBA and NHL.
- New Jersey online betting accounted for 85.5% of total turnover in Oct 2019: Up from 84.0% in Sep 2019, with the potential to approach 90% over US winter.
- Impetus for legislation in new states following successful New Jersey model
- Consolidation expected with 17 online bookmakers operating in New Jersey: Australia has 6 major bookies: TAB, Sportsbet, BetEasy, Ladbrokes, Bet365, PBH.
- Potential to negotiate partnerships in new states on more favourable terms following New Jersey success

Resimac (RMC)

RMC is one of Australia's leading non-bank mortgage providers, servicing over 50,000 customers with principally funded assets under management of $10.9bn. Resimac is the pioneer of securitisation of Australian residential mortgages with its first Australian Residential Mortgage-Backed Security (RMBS) issuance dating back to 1988 under the name Fanmac. To date, RMC has issued more than $29bn across 49 domestic and international RMBS issues. RMC does not have the overhead of maintaining an extensive nationwide branch network, rather it has relationships with over 85% of Australia's mortgage brokers, where customer service and a quick approvals process have been key factors for RMC increasing originations.

In a post Royal Commission environment where most mortgage providers are facing an earnings squeeze, RMC's 1H20 Net Profit Guidance of $24-27m implies growth of ~75% on the 1H19 result of $14.5m. Included in this guidance is growth in principally funded Assets Under Management of 7% from $10.2bn at 30 June 2019 to $10.9bn at 31 October 2019. By contrast APRA data indicates major bank mortgage lending declined 0.9% from June 2019 to September 2019, while non major bank lending increased 3.7%.

With a majority of its funding consisting of domestic floating rate Residential Mortgage Backed Securities (RMBS) priced at a margin to the 1 month bank bill, RMC has also benefitted from the 25bp RBA rate cuts in June, July and October. By comparison, CBA had 69% of its FY19 group funding comprising customer deposits, of which 64% of deposit funding was at call and / or non-interest bearing, limiting the ability to pass through rate cuts on deposit funding.

RMC's net interest margin is also a beneficiary from the fall in the spread between one month bank bills and the RBA cash rate. This spread is currently running at an average of 0.09% for 1H20, well below the average 0.39% for 1H19. RMC profitability remains highly sensitive to movements in the net interest margin, where we estimate a 1bp improvement in the net interest margin increases RMC's FY20 net profit by $777,000.

RESOURCES: BASE & PRECIOUS METALS.

David Coates

2019 has been a year when the macro issue of trade tensions between the US and China have dominated ("trumped", if you will), underlying market fundamentals. This has not been without justification: we have seen key demand metrics weaken over the course of 2019 as a result of poorer sentiment and the actual impact of trade restrictions.

We expect this to remain a factor into 2020. While market balances are anticipated to remain tight across our key commodity exposures (copper and nickel), there has been a reduction in the magnitude of forecast supply deficits. Supply constraints remain, with drivers including lower mined grades, industrial action across Latin American copper producers and the Indonesian nickel ore export ban coming into effect in January 2020. Partially offsetting these factors are lower expectations for demand growth, resulting from restrictions on global trade. The difficulty with this is it is a politically driven factor and hard to predict, particularly given the players involved. On balance, we have positive, albeit tempered, price expectations for 2020. We recommend retaining base metals exposure on supportive fundamentals and the upside risk of positive resolutions to ongoing trade disputes.

Throughout 2019 gold has re-established itself as a portfolio diversifier and benefitted from declining real interest rates. This has reignited investor interest and lifted the gold price. Despite the recent correction, the US$ gold price is up ~14% ytd (as at early December 2019). Although we view sentiment as relatively neutral into year-end and there being potential for the current pullback to have a little more to run, we believe gold remains an attractive exposure into 2020. Real interest rates remain in decline, gold remains cheap relative to equities and the USD is rangebound, all framing a favourable gold price environment.

Nickel Mines (NIC)

During 2019 NIC achieved several key milestones, laying down an excellent track-record of delivery and driving a strong re-rating over the course of the year. This saw the completion of the ramp-up phase at the Hengjaya and Ranger Nickel Projects at the Indonesia Morowali Industrial Park (IMIP) in Sulawesi. All four NPI production lines reached full production within 21 months of construction commencing. Heading into 2020, we expect the reporting of strong financial results to follow on from the strong operational performance and the delivery of further production growth to to drive NIC's share price higher. We retain NIC as one of our top picks on the basis of it remaining cheap relative to peers and its pure nickel commodity exposure – one of our preferred base metals.

Buy, Target Price $1.23/sh

Pantoro (PNR)

PNR has been a disappointment in 2019. Plans to grow gold production to ~80kozpa following mill upgrades and new mine developments at Nicolsons failed to be realised, leading to a poor share price performance over the year.

However, we must take a forward looking view on our recommendations and we view the current share price as oversold. The recent completion of an operational review and outline of a detailed two year, 50kozpa production plan, we believe is a conservative, high-confidence base-case designed to under-promise and over-deliver. Furthermore, PNR has secured a 50% interest in, and management control of, the Norseman Gold Project. This offers the opportunity to establish a second production asset over the course of 2020. It's been our observation that the market is attributing a significant premium to multi-mine producers and PNR, if successful, could benefit materially from this over the course of 2020. PNR's balance sheet is debt free and will be unhedged from April 2019.

Buy, Target Price $0.20/sh

OZ Minerals (OZL)

OZL is an established, low-cost Australian copper producer with a strong track record of production and cost performance. We recently picked it as our preferred copper exposure. For 2020 we see the potential for a positive re-rating on the commencement of production from Carrapateena, which will ramp-up to ~65ktpa copper and 80kozpa gold. It will become OZL's second major copper mine, along with the Prominent Hill mine which currently produces ~100ktpa copper and 120kozpa gold. We forecast strong earnings growth and positive free cash flows in 2020 with OZL's CAPEX peak now having passed. It offers exposure to both copper and gold, both of which we favour in 2020 and has a debt free balance sheet.

Buy, Target Price $10.69/sh

RESOURCES: ENERGY.

Stuart Howe

Key drivers of energy markets into 2020 will be U.S.-China trade tensions and the potential for a resolution, European economic activity, and supply constraints as new projects are subjected to increasing environmental and social scrutiny. Metallurgical coal and Australia's domestic east coast gas markets are our preferred energy commodity exposures.

Domestic gas markets

The ACCC's ongoing inquiry of Australia's east coast gas market has seen regular publication of "netback" gas prices to assist market participants in negotiations. This netback price series takes into account the export parity price of gas entering the global market from key Gladstone LNG projects. The price series weakened in 2019 (averaging A$6.83/GJ, compared with A$10.88/GJ in 2018) on oversupplied global LNG markets. The major Gladstone LNG exporters (joint ventures with companies including Santos, Shell, Total, ConocoPhillips, Origin Energy, Sinopec, CNOOC, among others) also ensured sufficient gas production was directed to domestic markets, as they seek to appease this heightened political issue.

However, it is generally accepted that gas pricing for long term Gas Sales Agreements (GSAs) are significantly higher than the 2019 netback level. Strong pricing, together with the long-term tenor of these GSAs highlight an expectation of tight domestic gas markets over the medium to long term. With respect to global LNG markets, key energy research groups expect market deficits and stronger pricing from 2022-23. Stronger medium term global LNG prices will also support Australian domestic pricing, as suggested by the ACCC's ongoing netback analysis.

Metallurgical and thermal coal

Benchmark premium metallurgical coal prices held until mid-2019, highlighting the tight supply-demand fundamentals in this market. However, since July, adequate supply and weaker demand in Europe has seen prices retrace from averaging over US$200/t in 1H2019 into the US$130s/t recently. Prices appear to have found a floor at this level.

Seaborne thermal coal markets have been adequately supplied from key producing regions (Australia and Indonesia), and with no significant demand growth, prices continued to decline over the year. Swing thermal coal producers (U.S.) have largely exited the seaborne trade, providing some rebalance support. In early 2019, benchmark thermal coal prices were around US$100/t. Since August 2019, these prices have range-traded at US$65-70/t.

Despite the recent weakness in met coal prices, market participants generally expect improvement into 2020. In 2020, Consensus Economics' surveys have met coal prices lifting to average US$160/t (18% above current levels). Thermal coal prices are expected to remain subdued, with a US$68/t outlook for 2020 (similar to current levels).

Our top picks include:

Senex Energy (SXY)

SXY is ramping up two coal seam gas projects in Queensland's Surat Basin. The projects will deliver gas into Australia's east coast gas market and to the GLNG export facility in Gladstone. This production growth, together with established oil and gas operations in the Cooper Basin, will see SXY's production grow from around 1.2mmboe in FY19 to around 4.0mmboe by FY22. This gas production growth into Australia's supply short east coast market and improving global LNG market fundamentals should see substantial earnings growth for SXY over the short to medium term.

Buy, Target Price $0.48/sh

Comet Ridge (COI)

COI is progressing coal seam and conventional gas projects across three of Australia's prospective gas basins. The company has a 40% interest in the Mahalo JV located in Queensland's Bowen Basin; joint venture partners are Santos and APLNG. The Mahalo JV is expected to reach a final investment decision in June 2020 and is expected to produce 60TJ/day (3.8mmboe per year) gas initially, with expansion potential. The recently awarded Mahalo North project (100% COI) could leverage existing infrastructure for early stage gas production of 10TJ/day (0.6mmboe per year), again with expansion potential. COI also has prospective gas projects in the Galilee Basin and in the Gunnedah Basin.

Buy, Speculative, Valuation $0.28/sh

Coronado Global Resources (CRN)

CRN is the largest pure-play metallurgical coal producer. Its earnings and value are therefore leveraged to the recovery which we, and the market, expect in met coal prices. Private equity group EMG currently owns 80% of CRN listed equity, with 69% in escrow until February 2020. We expect that a tightly managed sell-down by EMG would increase free float and stock liquidity, and therefore increase index participation and broaden the company's investment appeal. CRN's operations are low cost, enabling the company to withstand the current weakness in met col prices. Its mines are mature, with limited growth capital required, enabling strong free cash flow generation and shareholder returns as met coal prices recover.

Buy, Target Price $3.50/sh

HYBRIDS.

Damien Williamson

The ASX listed hybrid market has had another year of positive performance driven by no ALP franking policy / Coalition election win, and the RBA cutting the official cash rate by 0.25% in June, July and October.

This has resulted in the average trading margin on major bank hybrids firming from 3.34% at 31 December 2018 to 2.74% on 11 December 2019. In the 6 weeks post the Federal Election which included the RBA rate cuts in June and July, the hybrid market margins slipped to the lowest level since January 2012, with the average trading margin on major bank hybrids firming 1.01% from 3.32% on 17 May to 2.31% on 2 July. The market has subsequently eased with $2.9bn of issuance since September, spanning ASX listed debt and hybrid issues from Australian Unity ($322m), CBA ($1,650m), Virgin Australia ($325m), Suncorp (>$300m) and AMP (>$250m).

Post the broker firm new issue settlement on SUNPH on 13 December and AMPPB on 20 December, we see the potential for buying strength to emerge for the ASX listed hybrid market, supported by over $1bn of redemptions from hybrids issued by IAG ($550m), NAOS ($26.5m) and Multiplex ($450m). In addition, December has 29 ASX listed debt / hybrid securities paying a total of $271m of cash coupons ($369m grossed up), where the flow of funds has the potential to once again result in a repeat of the Christmas rally in hybrids witnessed over this decade. Since 2011, the average trading margin on major bank hybrids has firmed 0.39% from the high in mid-December to the low in early January.

NAB Subordinated Notes 2 (NABPE)

As the only remaining ASX listed bank subordinated debt security, NABPE offers value on a 1.88% trading margin at $101.10. For moving one notch lower down the bank capital structure from senior debt to subordinated debt, NABPE currently offers an additional margin of 1.19% when compared with NAB September 2023 wholesale senior debt (0.69% trading margin), and a margin uplift of 0.25% when compared with WBC wholesale subordinated debt (June 2023 call) on a trading margin of 1.63%. The rally in the hybrid market over 2019 has seen the spread from moving one ranking notch lower from NABPE to 5 year major bank hybrids narrow from ~2.00% at the start of 2019 to currently ~1.00%. NABPE is worthy of consideration to cornerstone a low risk fixed income portfolio.

Optional Call Date 20 September 2023

Fair Value $102.08

ANZ Capital Notes 2 (ANZPE)

ANZ has moved to partial franking of dividends, reflecting the change to the geographical earnings mix. With ANZ declaring 70% franking on its final ordinary dividend, issue terms of ANZ listed hybrids provides for a cash top-up if the distribution is not fully franked. This has resulted in a 9.9% increase to the cash income on ANZ hybrids from the decline in franking from 100% to 70%. ANZPE currently offers value on a trading margin of 2.77% at $101.97, reflecting an attractive spread of 2.25% above ANZ March 2022 wholesale senior debt (0.52% trading margin). The higher cash component of income has the potential to result in a modest re-rating of partially franked ANZ hybrids versus other major bank fully franked hybrids.

Optional Call Date 24 March 2022

Fair Value $103.13

Macquarie Group Capital Notes 3 (MQGPC)

MQGPC is worthy of consideration for investors seeking to increase income levels. At $105.30, the capital price premium reduces the 4.00% issue margin to a trading margin of 2.83%. The cash top up required for MQGPC distributions being 40% partially franked results in our 12 month income forecast of $4.17 cash, plus $0.72 franking (issue margin 4.00% + 3 month bank bill of 0.89%). If MQGPC was 100% franked, cash income would decline 18% to $3.42, while franking would increase to $1.47.

First Optional Call Date 16 December 2024

Fair Value $106.30

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Bell Potter Securities acted as Co-Manager in MQG's Capital Notes 4 (MQGPD) offer (February 2019) and received fees for that service.

T S Lim holds long positions in IAG, MQG, MQGPC, MQGPD and SUN.

Bell Potter Securities acted as Sole Underwriter and Joint Lead Manager to the $43m Equity Placement of Pantoro Limited in May 2019 and received fees for that service.

Bell Potter Securities acted as Lead Manager to the $200m IPO of Nickel Mines in August 2018 and Lead Manager to the $55m Placement of Nickel Mines in June 2019 and received fees for that service.

Bell Potter Securities acted as a Co-Manager to the Entitlement Offer of Plato Income Maximiser Limited (PL8) in August 2019 and received fees for that service.

Bell Potter Securities acted as a Co-Manager to the IPO of MCP Master Income Trust (MXT) in September 2017, a Co-Manager to the Entitlement Offer in March 2018 and a Co-Manager to the Entitlement Offer in May 2019 and received fees for the services.

Bell Potter Securities acted as lead manager of UWL's IPO in February 2019 and capital raisings in May and August 2019 and received fees for that service.

Bell Potter Securities acted as Co Manager on both ANZPE launched in February 2014 and MQGPC launched in May 2018.

Bell Potter acted as lead manager of the BOT's August 2019 capital raise for $40m and received fees for that service.

Bell Potter Securities acted as joint lead manager for CRN's listings of CDIS on the Australian Securities Exchange in October 2018, raising approximately A$774m, and received fees for that service.

Bell Potter Securities Limited acted as Lead Manager to the PBH IPO in Jun 2019 and Institutional Placement and Entitlement Offer in Oct 2019 and received fees for these services.

Bell Potter Securities acted as lead manager for MSB's A$75m capital raise in Oct'19 and received fees for that service.

Bell Potter Securities acted as joint lead manager for PXS's A$24m placement in Aug'18 and received fees for that service.

Bell Potter Securities Limited acted as a Joint Lead Manager in CBR's Nov'19 IPO and received fees for that service.

Steven Anastasiou holds a long position in MND.

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.

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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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