JM Financial Group

Issue 27: July 2017

Investment Newsletter

Market Performance (As at 31st July 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	0.18	3.08	7.04

***Month in Review** – A review of events that influenced the share market in July*

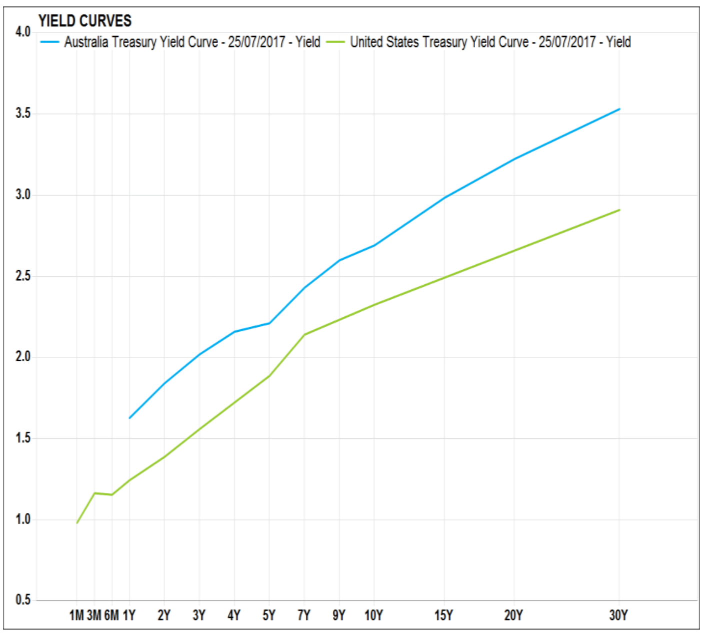
The All Ordinaries Accumulation Index increased 0.18% in July. Strongest sectors included Materials +3.6% and Financials +1.2%. Healthcare was the weakest sector, falling 7.5%. This was largely a function of A$ strength with the two largest stocks in the sector, CSL and Cochlear, each generating the bulk of their earnings in foreign currency. The yield unwind continued in July with Utilities falling a further 5.3%, Telecommunications down 4.3% and Industrials, which includes Transurban and Sydney Airport, down 3.1%.

Commodity prices continued to enjoy a recovery in July with the majority finishing well up for the month. Iron Ore rallied 18% to over US$66/t and West Texas Intermediate oil rallied 9% to over US$50/barrel. In US$ terms copper rose 7%, Nickel 10%, Gold and Zinc 2% while Aluminium was flat. The story was not as positive for soft commodities with Wheat down 8% and Cotton flat over the month. Unfortunately the A$ strength mitigated some of the hard commodity gains, rising around 4% against the US$ over the month, to break the 80c barrier. It also rose 2-3% against the Euro, Pound and Yen.

For companies like BHP Billiton and Rio Tinto, the higher ore price for both, and higher oil price for BHP, provided ongoing support to the strong earnings yields each of these companies have been able to produce over recent years. Expectations for increased distributions or capital management in the upcoming results may well have provided further support. In July BHP and RIO rallied 11% and 5% respectively. BHP has a forecast free cash flow yield of 14% for FY17 with RIO at 9%. Iron ore prices are generally forecast to decline as world supply increases over coming years. The extent to which this occurs depends on the level of global growth, which is currently improving.

While difficult to see iron ore prices moving higher for any sustained period, they may remain well above broker forecasts for some time. Many brokers are calling for ore prices to fall to sub US$45/t over coming years, including FY18. Earnings upgrades for each of BHP and RIO are likely at least for FY18. For now we are comfortable holding both BHP and RIO in portfolios.

Chart of the Month – Yield Curves



Global equity markets have continued to rally. Despite this, the Australian market has remained stubbornly bound in a trading range. Major international equity markets are at, or near, all-time highs. Over the last 12 months the S&P 500 has risen over 16% on a total return basis, the FTSE (UK) over 15%, the CAC (Fr) and DAX (Germ) are both up c20%. Asian markets have also been strong: Hang Seng (HK) and Nikkei (Japan) over 20% and 25% respectively.

By comparison, the total return for ASX All Ordinaries is around 7% over the past 12 months. The Australian market has been in a tight trading range through CY17, ranging between 5700-6000 (All Ordinaries price index).

Earnings growth has generally been solid in foreign markets with high single/low double digit growth expectations for 2017. To this point the fundamentals for equity markets still look comfortable. Yield curves as shown in the chart opposite are normal {not inverted as is often the case when economies are at risk} and equity risk premiums are still comfortably above longer term averages, allowing for some earnings growth slippage from attractive EPS growth forecasts without necessarily damaging index levels. Overall we feel global and local factors are supportive of equity markets, excluding any left-field events.

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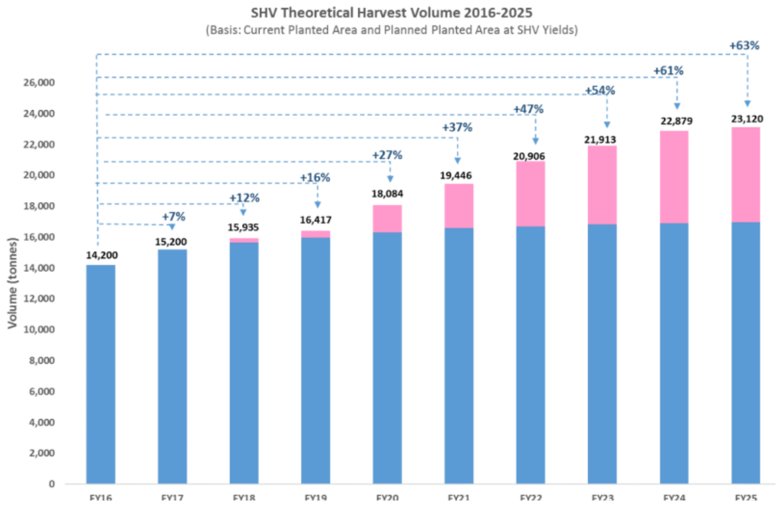
Due Diligence – *Select Harvests (SHV)*

Select Harvests is a vertically integrated nut and health food company operating across Horticulture, Orchard Management, Processing, Sales, and Marketing. It is one of Australia's largest almond growers and the leading manufacturer, processor, and marketer of nut products. Since mid-2015 SHV has seen its share price decline from over $13/share to as low as $4/share. A number of events have eroded the share price. After a record harvest of 14,500t, record average pooled almond price of A$11.45/kg in FY15 and underlying NPAT over $59m, harvest volume fell slightly in FY16 but the average pooled almond price fell in the order of 30% to A$8.08/kg. NPAT for FY16 fell to $28m. Against an initial expected harvest of 15,200t in FY17, SHV subsequently downgraded to 14,100t due to a poor pollination period, and the A$ price declined almond pricing to around A$7.45/kg in FY17.



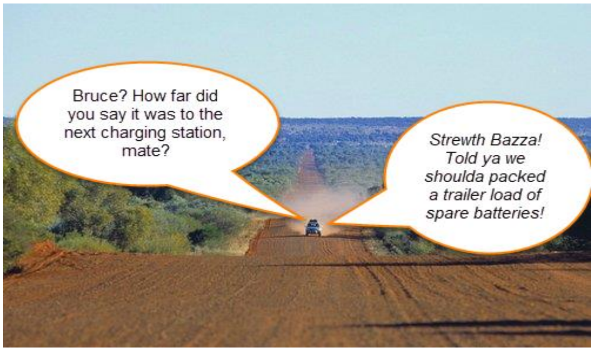
Guidance for NPAT in FY17 is $7-8m. Earnings volatility should be expected of a commodity producer where both price and volume vary substantially on seasonal conditions. SHV however will grow volume at its owned and managed plantations as they mature. This alone should provide earnings growth over time, albeit with volatility from year to year. In a 'normal season' year we expect earnings for SHV to be in the order of $25m, which would equate to a PER of 15x. At its current share price, SHV is trading at a Price/Book Value of 1.2x, Price/Tangible Book Value of 1.6x and should generate Return On Equity nearing 10% on 'normal season' earnings. 'Normal season' earnings will expand as expected almond production climbs from 14,000t in FY17 toward 23,000t by FY25.

Waiting for the Electric Vehicle – Has Tesla Delivered?

Much has been discussed about the electric vehicle. It is already here, but broad acceptance is still likely to be some way off. The obvious benefits are reduced metropolitan pollution, potentially cheaper running costs, and convenient recharging locations. The ultimate solution however requires affordable clean energy, otherwise pollution is simply being shifted from metro areas to regional power generation locations. To be truly successful, an electric vehicle needs to be competitive on price, whilst incorporating at least all the expected features of similarly priced vehicles. It must also provide a range that allows the vehicle to be more than just an urban runabout.

Tesla has just launched its Model 3. It is supposed to be the first scalable mass market competitive electric vehicle. The initial feedback has been disappointing, quite apart from the fact that the business is running losses around US$400m per quarter. The car does look good from the outside but there has been some criticism of the dashboard. The company had previously spoken of receiving 500,000 deposits of US$1,000 each. No update has been provided as to how many order cancellations have occurred. Let's accept the vehicle looks good and that it probably handles well; it even accelerates to 100km/h in 5.6 seconds.

The real test is price and range. The Model 3 is a mid-sized vehicle and so price needs to be considered on this basis. The advertised range is 346km. The real range – when loaded with passengers and luggage and running the air conditioning – is presumably less than this. How much less? We don't know, but 250km or less may be realistic; with Lithium battery degradation over time, perhaps even less again. Range will improve eventually as battery technology develops, but it's hard to imagine people parting with significant sums when range is potentially such a limiting factor. The other significant uncertainty is resale value, which could be far worse than it is for traditional combustion engines. Why? Because as the underlying power-plant technology, particularly in terms of range, improves substantially with future models, that in itself will drive depreciation of existing models: the faster the pace of technology improvement, the more rapid the depreciation – the concern being advancements may come at a faster pace than the innovation track record of combustion engines. And the price? We hear it is around A$65,000 in Australia and US$50,000 in the U.S. Our view: wait for the next model and then reconsider.



Tesla's Model 3 (below) delivered and perhaps competitive. Next up: Model Y, Tesla's SUV Crossover.