Changes to the Lonsec SMA – Core

17 April | 2019

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Portfolio changes

Add/Increase

Code	Sector	Weight*
ALL	Consumer disc.	+5.0% (add)
JHX	Materials	+5.0% (add)

Remove/Reduce

Code	Sector	Weight*
CPU	IT	-5.0% (remove)
DLX	Materials	-5.0% (remove)

*The tables show the model portfolio weights. The weights implemented in the Lonsec SMA - Core may slightly vary.

Portfolio Rationale

In this review, Lonsec has elected to implement the following changes to the portfolio:

- Take profit on two holdings, Dulux Group (DLX) and Computershare (CPU).

On the inclusion side, we are implementing the following changes:

- Aristocrat Leisure (ALL) and James Hardie Industries (JHX) have been selected for addition to the portfolio.

Each of these businesses meet our 'Quality at a Reasonable Price' stock selection criteria and enhance the portfolios diversification, growth profile and yield.

Portfolio Removals

Dulux Ltd (DLX) - $9.75

DLX was added to the portfolio in September 2013 and has contributed positively to the overall performance of the portfolio since inclusion with a total return of 158% (IRR: 18.6% p.a.).

In April 2019, DLX received a takeover offer from Nippon Paint Holdings Co., Ltd to acquire the Group via Scheme of Arrangement for $9.80 per share in cash, inclusive of $0.15 per share interim dividend intended to be paid by DLX. The offer values DLX at PE ratio of 25.3x or 16.1x FY18 EV/EBITDA and represents a 35.4% premium to the 3-month VWAP of $7.24/share. The DLX board unanimously recommends the Scheme. In Lonsec's view, the offer represents an attractive valuation for shareholders (a 28% premium to our valuation), particularly given the growing headwinds for the Group over FY19-20. Accordingly, we have elected to remove the stock from the SMA Core portfolio, with a view of reallocating the proceeds in a company with a more attractive growth profile over the medium term (JHX).

Computershare Ltd (CPU) - $17.75

CPU was added to the portfolio in December 2016 and has contributed positively to the overall performance of the portfolio since inclusion with a total return of 50.1% (IRR: 19.1% p.a.).

CPU has performed strongly over the last two years, growing earnings by c.14%p.a. over FY17-19. This has been driven through a combination of efficiency gains, synergy benefits and contributions from recent acquisitions. Margin income has also been a large driver of CPU's earnings growth, particularly in 1H19, as interest rates trended higher over the period. This tailwind appears to have run its course, with the recent change in monetary stance by the Fed and subsequent flattening of the yield curve. Looking ahead, cost-out and interest rate fluctuations will be the key drivers of CPU's earnings growth over the medium term, as organic growth stagnates across a number of CPU's operating divisions. At this stage, given the lack of organic growth across a number of CPU's divisions, Lonsec regards the stock as fully valued, with risks skewed to the downside post FY20. Accordingly, we have elected to remove CPU from the portfolio.

Portfolio Additions

Aristocrat Leisure Ltd (ALL) - $25.86

	FY19E	FY20E
PER (X)	19.5	17.1
P/B (x)	7.6	6.2
YIELD (%)	2.1	2.3
EPS GROWTH (%)	14.8	14.0
ND/EBITDA (x)	1.3	0.9
ROE (%)	41.5	38.4

Source: Lonsec, Thomson Reuters

ALL is a leading global developer, manufacturer and distributor of gaming/slot machines and gaming software. ALL is also a major player in online gaming, via its Product Madness, Big Fish and Plarium brands.

Gaming Operations – ALL provides slot machines to casinos globally with strong exposure to the US, where over 50% of gaming operations revenue is generated. FY18 revenue of $1.6bn has grown by a CARG of 37% over the last four years as ALL benefited from strong growth in Nevada and the expansion of Native Indian casinos. ALL has also performed well in Australia and New Zealand with top line growth running at 5% and EBITDA margins above 45%.

Looking ahead, the growth of new casinos has tempered with the legalisation of gambling in Japan a potential tailwind in the coming years. ALL will look to increase floor space in casinos via the development of new consoles that drive foot traffic. The global casino and online gambling industry is expected to grow at an annualised rate of 3.6% over the next five years to 2023.

Digital – ALL has invested heavily in online gaming with the acquisitions of Big Fish and Plarium, as they look to expand from legacy online casino-based gaming. The acquisition of Plarium for US$500m mid FY17, put ALL firmly in the Digital market. Plarium was a privately owned free-to-play mobile, social and web-based developer running 9 key titles including Vikings: War of the Clans. Plarium games can be played across iOS and Andriod as well as Facebook and browser-based games.

The acquisitions expand ALL's online addressable market into adjacent segments, increasing its total market from US$4.5bn to US$50bn, with the market expected to grow by 13% CAGR from 2017 to 2020. Whilst ALL has grown Digital revenue from US$148m to US$1.3bn over FY15-18, the recent acquisitions have lowered the EBITDA margin by 8.7% to 32.8%. Management expect this to improve over time as lower margin games are removed and investment in Design and Development (D&D) provides new revenues streams.

ALL has historically had a very strong balance sheet, but recent acquisitions have elevated Net Debt to just under 2 times. Historically ALL has utilised their operational leverage and provided strong free cash flow, which should enable ALL to pay down the debt over the coming years. ALL recently repriced US$2.2bn worth of debt and extended maturity to 7 years.

We expect ALL to maintain its global ship share in gaming operations with the success of its 'Dragon' and 'Lighting' series to continue attracting foot traffic over the medium term. Potential opportunities in Asia, particularly Japan where casinos recently became legalised, should sustain growth. We would also expect ALL to successfully integrate their Digital acquisitions and streamline the product offerings to improve margins and gameplay. With the investment in 'talent and technology' where D&D represents almost half their global employees, we think this should provide ALL with an advantage over competitors.

Overall, Lonsec regards ALL to be a quality consumer discretionary business with a strong market position and identifiable growth drivers. We have assessed ALL's intrinsic valuation to be $29.37, which assumes achievement of EPS CAGR of 10.3% over the medium term.

Bull points

- New casinos in the US, Europe and Asia potentially increases the customer base.
- Digital Gaming a large growth market.
- The industry has relatively high barriers to entry.
- Strong market position and track record.

Bear points

- An inability to develop games that attract users.
- Weakening economic conditions may lead to declining revenues in the gaming industry.
- FX risk, primarily with respect to the US dollar and Euro.
- Regulatory risks.

James Hardie Industries PLC (JHX) - $19.05

	FY19E	FY20E
PER (X)	19.6	17.1
P/B (x)	12.6	11.3
YIELD (%)	3.1	3.6
EPS GROWTH (%)	3.6	14.3
ND/EBITDA (x)	2.5	2.2
ROA (%)	13.2	13.1

Source: Lonsec, Thomson Reuters

JHX specialises in the manufacturing and sale of fiber cement, fiber gypsum and cement-bonded building products for interior and exterior building construction applications, primarily in the US, Australia, Canada, New Zealand, the Philippines and Europe.

Fiber cement products are used in a number of markets, including new residential construction, manufactured housing, repair and remodelling and a variety of commercial and industrial applications. JHX manufacture numerous types of fibre cement products with a variety of patterned profiles and surface finishes for a range of applications, including external siding and soffit lining, internal linings, facades and floor and tile underlay. JHX employs ~3,960 people and generated net sales of US$2.06 billion in FY18.

By volume, JHX sold 2,768 mmsf of fibre cement in FY18, with 80% of volumes sold in North America and 13% in Australia. Group EBIT margins in North America have been relatively stable between 20-25% over the last ~18 years, and this is despite large swings in US housing starts. The stability of margins has been a key differentiator for JHX. In FY19, the company is guiding to high single digit North American volume growth, driven by a lift in US housing starts and market share gains. Longer term growth will be generated from new fibre cement products in Europe as the company leverages the distribution channels of the recently acquired Fermacell business, as well as ongoing market share gains of fibre cement in the cladding market and JHX maintaining a 90% share of that segment.

JHX has building industry leadership as a key strategic focus. Investment in fiber cement products via Research & Development activities is a key facet of this focus. This focus on R&D has been consistently funded from JHX's free cash and the current run-rate is US$30m p.a. Overall, JHX has spent +US$490m on R&D since 2000.

JHX has accumulated substantial IP within the building materials market, having developed a proprietary technology platform that enables the production of thicker yet lighter- weight fiber cement products that are generally easier to handle than most traditional building products. JHX claims its products provide certain durability and performance advantages leading to improved maintenance, while offering comparable aesthetics to competing products such as wood and superior aesthetics when compared to vinyl siding.

JHX has recently mostly debt-funded its Fermacell acquisition. However, the balance sheet remains in solid shape. Management have a broad target of 1-2x adjusted EBITDA. Currently (circa Feb'19) sitting just above this range at 2.2x. Broadly, JHX's current debt profile sees an average term to expiry of 6.6 years with average cost of debt of 4.4%.

JHX has a three-tiered strategy for driving long-term organic growth. These are highlighted below:

1. Its long-standing "35/90" strategy for the key US ('North American') market. The '35' represents JHX's plan to "grow fiber cement share to 35% of the exterior cladding market against other wood-looking siding alternatives". The '90' stands for JHX maintaining its category share North America Fiber Cement (NAFC) of at 90%.
2. Create a Euro €1billion business in Europe with "Hardie like returns" over the next decade.
3. Continued growth in Asia Pacific.

The key driver of JHX earnings is the exposure of the company to the US housing cycle. Hence current guidance is predicated on the US recording between 1.2m to 1.3m new housing starts in FY19. In this regard, the previous US housing cycle ended quite dramatically during the GFC. This led to Total Starts, which peaked at over 2.2m in 2006, falling to below 500k by 2009. While the market has recovered to some extent since the GFC lows, the current read of 1.1m to 1.2m as per US Census Bureau data is still well below the top of the previous cycle.

From an earnings perspective, JHX delivered a fiscal year 2019 earnings downgrade in November 2018. Previously, consensus has been for FY19 net operating profit of between US$313m and US$335m. Management downgraded this to US$295m to US$315m. This slowdown in earnings over the past year can be attributed to rising input costs, capacity constraints and demand variability in the US. In our view, this short term contraction in JHX's earnings over the past year appears to be cyclical and not to represent any emerging structural issues impacting JHX's long term growth profile.

Lonsec notes that JHX manufactured products containing asbestos up to 1987. To fund health related liabilities, it contributes up to 35% of its annual free cash flow to the Asbestos Injuries Compensation Fund (AICF). To date since 2007, JHX has contributed over A$1.2b. Note that under the agreement, cap is only in place for funding of AICF. There is no cap on individual claimants. This extends to at least 2045, with recurring automatic ten year extension periods, if required. Investors should note that our valuation for JHX has been adjusted to reflect JHX's asbestos liability.

Overall, Lonsec regards JHX to be a quality building products business, with a strong market position, high barriers to entry and positive demand drivers. We have assessed JHX's intrinsic FY19 valuation to be $21.32/share, assuming new construction starts of between 1.2 and 1.3 million in the US.

Bull points

- Dominant player in fiber cement market in US (circa 90% market share) and Asia Pac.
- Fermacell acquisition provides portfolio diversification into Europe with cross-selling opportunities.
- Fiber cement products has some strong advantages.
- US housing market below previous peaks a positive demand driver.
- Diversified earnings base.

Bear points

- Sales and margins have a very high correlation to the US and Australian housing cycles.
- CEO has recently resigned.
- Input cost inflation.
- FX volatility.
- Exposure to 'trade wars' via rising input & freight costs.
- M&A integration issues.
- Higher than expected Asbestos claims.

Sector Allocation

SMA Core Portfolio

GICS SECTOR	BENCHMARK (%)	PORTFOLIO (%)	ACTIVE WEIGHT (%)
Communication Services	4.4	2.5	-1.9
Consumer Disc.	6.8	5.0	-1.8
Consumer Staples	5.3	10.0	4.7
Energy	6.2	5.0	-1.2
Financials	29.9	27.5	-2.4
Health Care	8.5	22.5	14.0
Industrials	8.3	10.0	1.7
IT	3.0	0.0	-3.0
Materials	18.1	17.5	-0.6
Real Estate	7.5	0.0	-7.5
Utilities	2.1	0.0	-2.1
Cash	0.0	0.0	0.0
TOTAL	100.0	100.0	

- The latest changes reduce the portfolios underweight exposure to Consumer Discretionary to 1.8%, whilst the overall exposure to Materials remains unchanged with JHX replacing DLX.
- IT exposure reduces to an underweight position following the removal of CPU from the portfolio.
- The main overweight positions in the portfolio are: Consumer Staples, Healthcare and Industrials.
- The main underweight position in the portfolio are: Real Estate, IT, Utilities, Financials and Metal & Mining.
- Investors should note that JHX and ORA are ranked under Materials when widely viewed as Industrial exposures.

Analyst disclosure and certification

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Date released
17 April 2019

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