

Franking(ly), it's complicated!

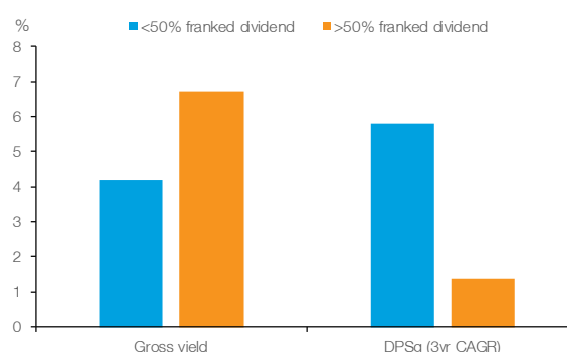
- We expect the ALP's proposed policy change to franking credit refunds to have the following major implications for investors:

1. At the margin, drive a minor de-rating of high yield/highly franked stocks vis-à-vis high yield/low or no franked stocks as the loss of the tax kicker is priced in. However, because retail investors are not the only price setter, we don't expect this to be meaningful;
2. Raise the attraction of high yield/highly franked stocks which have stronger earnings and dividend growth prospects as investors increasingly look at total return (growth plus yield) over just income – see table 1 for a full stock list. In addition, stocks where dividend payout ratios might already be high and/or unsustainable could also suffer from selling pressure;
3. A de-rating of Tier 1 hybrids and Listed Investment Companies (LICs). Part of this discounting appears to have already taken place, but more can be expected should the market perceive an increasing chance of proposed policy becoming legislation;
4. Hybrid issuers to raise the yield (reducing their own margins) to offset any weaker demand as they attempt to provide greater compensation for a loss of tax benefits. Expect to see a continuation of the trend to issue Listed Investment Trusts versus LICs.

- We expect a continuation of capital management activity from corporates as they rush to empty excess franking credit balances. In the short-term, this means that not all fully franked dividend yield paying stocks carry the same near-term downside risk. This is clearly positive for short term income seekers but distributing excess franking credits also comes at a cost of lowering capital investment, potentially impacting future growth options.

- We don't expect proposed policy changes to drive immediate asset allocation shifts. However, short term policy changes add to structural drivers that are already affecting domestic asset allocation trends. Retail investors are too overweight Australian equities and dividend yield stocks at the expense of fixed income and international equities and over the medium to longer term we expect these structural portfolio imbalances to be increasingly addressed.

Fully franked dividend payers provide little dividend growth (S&P/ASX 50)



Source: Macquarie Research, MWM Research, March 2019

- Our key recommendations should this policy proposal become law are as follows:
 1. Those investing for total return should consider selling high yield / low growth stocks and be prepared to add stocks with lower yield but higher earnings / dividend growth opportunities. Similarly, stocks where the payout ratio has the capacity to increase could also provide incremental income. International equities or high-growth ASX stocks (see table 2 and 3) should also be considered.
 2. Investors overly exposed to franking credits could consider reweighting to stable dividend payers with lower franking such as REITs, infrastructure and offshore earners (see table 1 S&P/ASX 50 stocks). This should also reduce portfolio volatility by providing

diversification away from financials towards more defensive (longer duration) sectors.

- For those considering adding managed income funds to supplement income from direct equities, we recommend the Nikko AM Australian Share Income Fund and the PIMCO Income Fund within Australian equities and fixed interest respectively.

What's the proposal?

The Australian Labor Party (ALP) recently announced a proposal to remove franking credit refunds. Exempt from this proposed policy change would be:

- Charities;
- Not-for-profit institutions; and
- Age pensioners and allowance recipients, including SMSFs with at least one pensioner / allowance recipient prior to March 2018.

At this point, the ALP has stated that the intention is to implement the proposal by 1 July 2019 with no grandfathering.

To date, the focus of much of the discussion has been on the negative consequences for some investors depending on their taxable income due to the removal of the franking credit refund. However, there are broader implications including for corporates, the overall listed market as well as individuals and superannuation funds.

What are the key impacts should the proposal become legislation?

Stock price and asset allocation impacts for individual investors with taxable income brackets lower than the corporate rate and superannuation funds are impacted negatively from an income perspective. We expect that we would see some short-term volatility as these investors reassess the value of highly franked/high dividend stocks. However, historically, policy driven spikes in volatility tend to be short lived, with the market typically finding an equilibrium.

We expect it to be negative for high yield/high franking stocks relative to stocks with little or no franking as investors reprice stocks for the loss of the tax benefit, but because retail investors are not the only price setter for high yield stocks, we don't expect the impact to be particularly large.

Stocks most likely to be impacted negatively

Code	Company	Yield (% , FY1)	Franking (%)	Biggest overweights in SMSF (%)
NAB	National Australia Bank	6.5	100	2.40
TLS	Telstra Corporation	4.9	100	2.20
WBC	Westpac Banking Corp	7.0	100	1.60
ANZ	ANZ Bank	5.7	100	1.40
WES	Wesfarmers	7.7	100	0.70
CBA	Commonwealth Bank	5.8	100	0.50

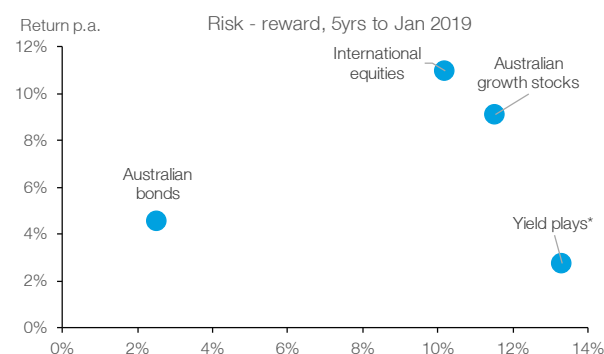
High yield stocks that don't pay franking

Code	Company name	Franking (% , FY1)	Yield (% , FY1)	S&P/ASX 100
SGP	Stockland	-	7.85	Y
URW	WFD Unibail-Rodamco NV	-	7.57	Y
SKI	Spark Infrastructure Group	-	6.33	Y
JHG	Janus Henderson Group	-	5.92	Y
SCG	Scentre Group	-	5.85	Y
SYD	Sydney Airport	-	5.46	Y

Source: Macquarie Research, MWM Research, March 2019

Over the medium to longer term, we expect to see proposed policy changes will add to structural forces driving asset allocation changes for domestic investors. In all likelihood, investors will look to increase allocations to fixed income in order to maintain yields and towards international equities for exposure to growth assets. This should be viewed as a positive given total risk-adjusted returns are likely to improve as investors move to a more balanced versus yield focused portfolio.

Adding growth stocks and fixed income leads to portfolios with superior risk-reward



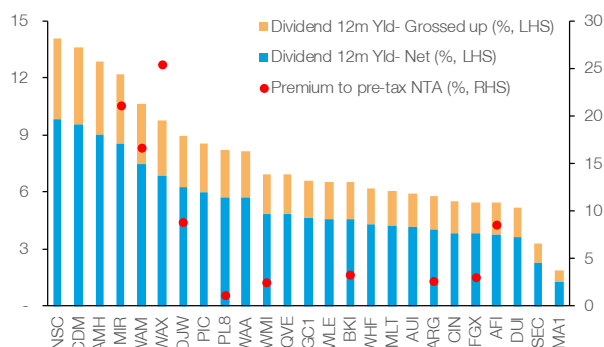
* equal weight portfolio of ANZ, CBA, NAB, WBC, WES, WOW.
Source: Morningstar, Macquarie Research, March 2019

Listed Investment Companies (LICs) have been a popular investment vehicle (particularly for SMSFs) partly due to 100% franking. We believe Australian equity LICs trading at a premium and valued on their dividend yield would be most at risk of a sell-off. Based on our analysis, Mirrabooka (MIR), WAM Capital (WAM), WAM Research (WAX) and Djerriwarrh Investments (DJW) look most vulnerable due to each

trading on substantial premiums and offering fully franked yields of up to 10%.

It already appears that a transition is underway from LICs towards Listed Investment Trusts (LITs) judging by recent issuance. This trend will likely gather steam if it appears that the proposed policy is likely to be implemented.

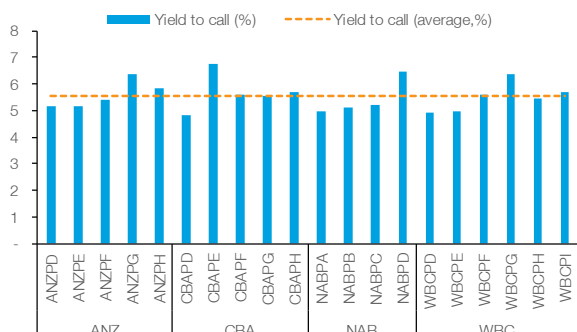
LICs trading at a premium with fully franked yields are likely to reprice most



Source: Iress, MWM Research, March 2019

Hybrid valuations and demand will also likely come under downward pressure, particularly Tier 1 hybrids given the high participation of SMSFs. We believe this could be further exacerbated by low liquidity in these markets. Key to our expectation that Tier 1 hybrids will reprice lower is that this change, were it to become legislation, will not be a tax event which means issuers are not obligated to redeem the security. Issuers are also unlikely to provide any offset in our view. We would expect that the traded margin will widen on existing issues and for any new issues that come to market, to be offered at higher yields as investors demand compensation for the loss in the tax pickup.

Higher yields are expected for Tier-1 hybrid securities



Source: Iress, MWM Research, March 2019

In our view, Australian corporates will continue to empty franking credit balances, which has already

begun via off-market buybacks and special dividends. Most recently, we have seen Fortescue (FMG), Rio Tinto (RIO) and Wesfarmers (WES) surprise the market with special dividends, all fully franked, while Woolworths (WOW) promised an off-market buyback following the sale of its petrol division. This followed off-market buybacks from BHP/RIO and a large dividend increase from Harvey Norman (HVN) last year.

Capital management to pick-up

Code	Company	Recent capital management
BHP	BHP Group	Off-market buyback, special dividend
RIO	Rio Tinto	Off-market buyback, special dividend
WOW	Woolworths Group	Off-market buyback (pending FIRB)
WPL	Woodside Petroleum	Larger dividend (20% beat)
CBA	Commonwealth Bank	-
WBC	Westpac Banking Corp	-
FMG	Fortescue Metals Group	Larger dividend (30cps vs 10cps forecast)
CTX	Caltex Australia	Off-market buyback
TPM	TPG Telecom	-
RHC	Ramsay Health Care	-
HVN	Harvey Norman	Larger dividend (30cps vs 23cps forecast)
NHC	New Hope	-
WES	Wesfarmers	Larger dividend (\$1 special)

Source: MWM Research, March 2019

Further capital management appears likely if the policy comes into play. Macquarie analysts believe HT&E Ltd, Oz Minerals, Nick Scali, Premier Investments, Commonwealth Bank also have the potential to take action on their large franking balances.

What can investors do?

There are several options available for investors to offset the potential impacts from Labor's proposed targeting of franking credits, but we urge caution in rushing to make changes. These changes are dependent on Labor coming into government and the policy being fully implemented. Similarly, individuals should consider the reaction function of corporates via potential special dividends / buybacks which could serve to provide a near term income boost. In other words, the level of uncertainty around policy, its timing and the reaction function by both corporates and investors suggest that understanding the broad implications and not just those that stem from reduced dividend income will be important as the path to (potential) implementation becomes clearer. We summarize the four major options for offsetting franking credit policy below:

1. Restructuring existing portfolios to reduce reliance on securities paying franking dividends.

-
2. **Shifting funds away from SMSFs and into APRA-regulated funds** in a net tax-paying position appears one of the most likely behavioural responses. This could entail the entire SMSF balance or just the portion allocated to Australian equities. The parliamentary budget office (PBO) believes this response from SMSFs would be the most material, particularly in earlier years, with the revenue gain from SMSFs ~20% higher in the first year in the absence of this response.
 3. **Retirees with an SMSF structure may invite tax-paying members to their fund**, such as their children, to utilise franking credits to offset income from contributions and investments. However, the PBO expects this will have a low take-up given people tend to prefer managing their financial affairs privately.
 4. Similarly, **couples are expected to shift share ownership** away from the lower-income earner to the higher-income earner to fully utilise non-refundable credits.

Overall, we don't think the proposed policy changes are something that will have a large impact on the equity market. However, it will raise the attractiveness of high yield stocks that don't pay franking vis-à-vis those that do for a small group of investors. We think Hybrids and LIC's will be most negatively impacted given high SMSF participation and where they sit in the capital structure. We believe franking credit changes will not, in isolation, drive large scale asset allocation shifts but they will add to the structural drivers that are pushing driving greater weightings towards fixed income and international equities.

Jason & the Investment Strategy Team

Table 1: S&P/ASX 50 stocks, ranked by market cap. Dividend growth >5% highlighted.

Code	Company	Sector	Market cap (\$b)	Net yield	Franking	Gross yield	Payout ratio	EPSg 3yr CAGR (%)	DPSg 3yr CAGR (%)
CBA	Commonwealth Bank	Financials	130.84	5.80	100	8.28	84.26	1.31	0.40
BHP	BHP Group	Materials	109.43	9.07	100	12.95	123.74	1.42	1.30
WBC	Westpac Banking Corp	Financials	92.77	6.96	100	9.94	83.74 -	1.39	0.35
CSL	CSL	Health Care	88.53	1.35	-	1.35	45.16	13.66	13.59
ANZ	ANZ Bank	Financials	81.13	5.71	100	8.15	70.92	2.66	1.29
NAB	National Australia Bank	Financials	68.61	6.42	100	9.17	72.43	3.92 -	5.14
WOW	Woolworths Group	Consumer Staples	37.86	3.03	100	4.33	69.81	4.60 -	1.30
WES	Wesfarmers	Consumer Discretionary	37.86	8.16	100	11.66	157.94 -	7.17 -	7.52
TLS	Telstra Corporation	Communication Services	37.23	5.11	100	4.56	62.93 -	12.78 -	10.07
RIO	Rio Tinto	Materials	35.24	5.99	100	8.56	59.42	1.56 -	16.60
WPL	Woodside Petroleum	Energy	33.38	4.33	100	6.18	79.72 -	3.47 -	8.93
TCL	Transurban Group	Industrials	32.55	4.73	6	4.85 nmf		2.70	5.65
GMG	Goodman Group	Real Estate	21.17	2.27	-	2.27	58.12	9.28	4.90
SCG	Scentre Group	Real Estate	20.98	5.74	-	5.74	91.95	3.50	3.26
S32	South32	Materials	20.09	5.07	100	5.77	45.52	3.89	8.06
BXB	Brambles	Industrials	18.98	2.25	48	2.72	50.18	6.41	4.20
NCM	Newcrest Mining	Materials	18.57	0.89	100	1.27	28.77	5.26	2.81
SUN	Suncorp	Financials	17.81	5.09	100	7.28	82.55	3.46 -	3.41
IAG	Insurance Australia Group	Financials	17.56	4.80	100	5.83	87.12	1.53 -	2.95
AMC	Amcor	Materials	17.31	4.30	-	4.30	73.53	9.96	7.51
QBE	QBE Insurance	Financials	17.14	4.87	30	5.50	66.43	25.73	18.50
ALL	Aristocrat Leisure	Consumer Discretionary	16.04	2.18	100	3.12	40.58	12.93	12.79
SYD	Sydney Airport	Industrials	15.94	5.51	-	5.51	216.81	14.40	5.07
AGL	AGL Energy	Utilities	14.07	5.47	91	7.60	76.28 -	5.12	1.96
ASX	ASX	Financials	13.59	3.27	100	4.67	89.99	3.98	3.99
COL	Coles Group	Consumer Staples	12.91	7.56	100	10.81	150.00 -	-	-
ORG	Origin Energy	Energy	12.80	2.75	100	3.92	31.05	8.30 -	-
DXS	Dexus	Real Estate	12.52	4.05	-	4.05	91.05	3.79	4.35
STO	Santos	Energy	12.21	1.30	100	1.86	16.42 -	5.94 -	18.54
APA	APA Group	Utilities	11.74	4.67	39	5.46	179.67	10.40	7.39
TWE	Treasury Wine Estates	Consumer Staples	11.00	2.66	100	3.81	64.66	18.62	20.24
SHL	Sonic Healthcare	Health Care	10.99	3.61	20	3.92	72.39	5.93	5.37
OSH	Oil Search	Energy	10.85	1.72	-	1.72	40.00 -	2.46 -	7.57
GPT	GPT Group	Real Estate	10.70	4.45	-	4.45	84.78	4.23	4.00
FMG	Fortescue Metals Group	Materials	10.24	13.30	100	16.39	68.61	7.54	24.98
COH	Cochlear	Health Care	9.91	1.84	100	2.63	68.73	10.59	10.45
MGR	Mirvac Group	Real Estate	9.67	4.44	-	4.44	74.36	5.10	5.15
QAN	Qantas Airways	Industrials	9.66	4.24	100	6.06	40.42	6.06	12.18
AZJ	Aurizon Holdings	Industrials	8.98	5.01	77	6.67	99.66	1.29	0.97
SGP	Stockland	Real Estate	8.76	7.65	-	7.65	89.71	2.87	3.97
CPU	Computershare	Information Technology	8.74	2.58	30	2.92	47.41	10.56	10.46
RHC	Ramsay Health Care	Health Care	8.26	2.33	100	3.33	52.77	6.76	6.31
VCX	Vicinity Centres	Real Estate	8.03	6.40	-	6.40	92.93 -	1.20 -	1.93
JHX	James Hardie Industries	Materials	7.91	3.20	-	3.20	55.64	15.07	14.79
MPL	Medibank Private	Financials	7.90	4.67	100	6.67	85.87 -	5.58 -	9.22
LLC	Lendlease Group	Real Estate	7.80	4.02	-	4.02	62.08 -	0.82 -	1.66
CTX	Caltex Australia	Energy	7.10	4.01	100	5.74	50.00	6.14	9.19
AMP	AMP	Financials	7.00	5.23	90	7.25	92.01 -	8.17	3.45
ORI	Orica	Materials	6.62	3.18	-	3.18	60.00	9.57	9.27

Source: Macquarie Research, MWM Research, March 2019

Table 2 Listed Growth Portfolio

Code	Name	Weight	Franking	Gross yield	EPSg 3yr CAGR	DPSg 3yr CAGR
A2M	a2 Milk Company	8.07	-	-	35.75	-
BHP	BHP Group	8.00	100	12.95	1.42	1.30
CWY	Cleanaway Waste Management	6.79	100	2.36	15.71	24.45
BXB	Brambles	6.40	48	2.72	6.41	4.20
CSL	CSL	6.31	0	1.35	13.66	13.59
CTD	Corporate Travel Management	6.20	100	2.42	16.05	16.61
MFG	Magellan Financial Group	6.15	75	6.36	8.36	9.79
GUD	GUD Holdings	5.81	100	6.15	13.40	11.46
WTC	WiseTech Global	5.53	100	0.25	35.55	39.70
JHX	James Hardie Industries	5.50	0	3.20	15.07	14.79
ALL	Aristocrat Leisure	5.31	100	3.12	12.93	12.79
SEK	Seek	5.21	100	3.18	13.74	10.43
AMC	Amcor	5.14	0	4.30	9.96	7.51
ORA	Orora	4.51	39	5.05	7.98	8.51
RWC	Reliance Worldwide Corp	4.27	62	3.06	31.00	32.87
OML	oOh!media	3.85	100	5.21	16.35	16.35
SIQ	Smartgroup Corp.	3.60	100	7.51	6.54	7.22
BIN	Bingo Industries	3.38	100	2.87	7.42	18.98
Portfolio			66	4.0	15.1	13.1

Source: Macquarie Research, MWM Research, March 2019

Table 3 Listed Income Portfolio

Code	Name	Weight	Franking	Gross yield	EPSg 3yr CAGR	DPSg 3yr CAGR
AMC	Amcor	6.62	0	4.30	9.96	7.51
ALX	Atlas Arteria	6.27	0	4.35	19.40	29.28
ANZ	ANZ Bank	6.22	100	8.15	2.66	1.29
SCG	Scentre Group	6.16	0	5.74	3.50	3.26
TAH	Tabcorp Holdings	6.15	100	6.28	12.89	7.38
WBC	Westpac Banking Corp	6.12	100	9.94	-1.39	0.35
SHL	Sonic Healthcare	6.04	20	3.92	5.93	5.37
SYD	Sydney Airport	5.73	0	5.51	14.36	5.07
TCL	Transurban Group	5.00	6	4.85	2.71	5.65
DLX	DuluxGroup	4.97	100	5.59	4.65	4.55
WES	Wesfarmers	4.96	100	11.66	-7.17	-7.52
PMV	Premier Investments	4.78	100	6.11	13.13	12.95
GUD	GUD Holdings	4.66	100	6.15	13.40	11.46
NAB	National Australia Bank	4.55	100	9.17	3.92	-5.14
COL	Coles Group	4.53	100	10.81	n/a	n/a
CBA	Commonwealth Bank	4.30	100	8.28	1.31	0.40
CGF	Challenger	3.86	100	6.02	1.34	1.39
GPT	GPT Group	3.08	0	4.45	4.23	4.00
URW	WFD Unibail-Rodamco	3.07	0	7.54	0.35	3.15
DXS	Dexus	2.94	0	4.05	3.79	4.35
Portfolio			57	6.62	5.95	5.18

Source: Macquarie Research, MWM Research, March 2019

The report was finalised on 5 March 2019

Disclaimer

The analyst principally responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited ABN 94 122 169 279 AFSL 318062 ("MGL") and its related entities (the "Macquarie Group", "We" or "Us") and has taken reasonable care to achieve and maintain independence and objectivity in making any recommendations. No part of the compensation of the analyst is directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited ABN 41 002 574 923 AFSL 237504. The views expressed in this research reflect the personal views of the analyst. It does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. It has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. Past performance is not a reliable indicator of future performance. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but we do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research.

We have established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. Our officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. We may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. Our employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research. Important disclosure information regarding the subject companies covered in this report is available at www.macquarie.com/disclosures.

© 2019 Macquarie Group.