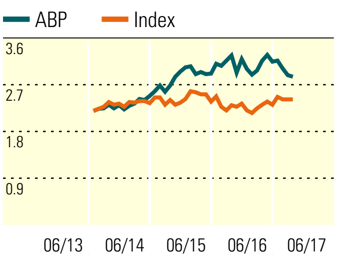
Abacus Property Group ABP

Pullback in Abacus' Security Price Presents a Buying Opportunity

Snapshot

Fair Value Uncertainty	Medium
Moat Rating	None
Fair Value $	3.50
Stewardship Rating	Standard
Market Cap $Mil	1,637
Morningstar Style Box	
Price $ (4:00PM 05-Oct-2016)	2.86
52 Week High/Low $	3.41/2.77
Shares Issued Mil	572
Morningstar Sector	Real Estate
Morningstar Industry	REIT - Diversified
GICS Sector	Real Estate

Price vs. Market



	06/15	06/16	06/17e	06/18e
NPAT ($Mil)	128.3	124.0	119.2	193.6
EPS ¢	24.5	22.4	21.4	34.8
EPS Chg %	17.4	-8.7	-4.2	62.4
DPS ¢	17.0	17.0	17.0	17.0
Franked %	0.0	0.0	0.0	0.0
Div Yld %	6.0	5.5	5.9	5.9
P/E x	11.6	13.8	13.4	8.2

Source: Morningstar estimates 27-Sep-2016.

Profile

Abacus Property Group (ABP) is a diversified property group that specialises in investing in core plus property opportunities across Australia's commercial property markets. It invests in office, retail and industrial properties, self-storage facilities, participation in property ventures and developments and property funds management.

Morningstar Recommendation

Accumulate (10:10AM 06-Oct-2016)

$	Buy	Accumulate	Hold	Reduce	Sell
	2.45	3.15	3.85	4.73	

▼2.86 Price

Investment Perspective By Tony Sherlock (19-Aug-2016)

Abacus Property Group is a property investment and funds-management group, with interests in property lending, joint ventures, and development. It is a stapled security comprising a share in each of Abacus Group Holdings and Abacus Group Projects and a unit in each of Abacus Trust and Abacus Income Trust, which can only be traded together. Abacus has a strong track record of acquiring mispriced assets, actively managing them to increase value, and then either selling or recycling them into funds management products. Annuity-style earnings from asset ownership are expected to comprise 60%-70% of ongoing EBITDA, with the balance from volatile private-equity-style activities.

Analyst Note (10:10AM 06-Oct-2016)

We think the recent pull back in Abacus' security price over September is mostly due to debt markets pricing in higher future interest rate expectations, with the accompanying rise in the yield curve weighing on the security price of all REITs. Abacus' security price has fallen more than its peers and this probably reflects a delay in the disposal of the huge Camellia apartment site in Sydney's west and a spate of negative press around Australian house prices. This is material, as property ventures represented 24% of Abacus' investments (development equity at 18% and development loans at 6%) as at June 2016.

Even though growth in dwelling prices has significantly outstripped income growth over the past five years, we don't see a clear near-term catalyst that will trigger a retracement in prices. The most likely trigger for a price correction is higher interest rates, and commentary from the RBA on Oct. 4 shows no hints the bank is planning to raise rates soon. A spike in the unemployment rate would also weigh heavily on dwelling prices, but we also don't see a catalyst for a material rise in unemployment in the coming two years. We think Abacus' residential property exposure is not high risk as most of the assets are in Sydney, a city suffering from a prolonged period of undersupply. Further, we see significant price support from Chinese investors, as Sydney property offers significantly higher yields and far stronger property rights. While early days, restrictions on investing in mainland China property were recently raised, which is likely to result in greater capital flows to Australian capital city apartments, providing further price support.

At current levels, no moat-rated Abacus is considered one the most undervalued Australian REITs under coverage, with the current price of AUD 2.86 representing a 22% discount to our unchanged fair value of AUD 3.50. Forecast fiscal 2017 distributions of AUD 17 cents currently imply a dividend yield of 5.9%.

It is possible the investment community has punitively valued Abacus' self-storage business, which at AUD 575 million, represents 28% of the firm's investment assets as at June 2016. We think self-storage has quite stable income streams as supply side pressures are benign compared with other asset classes. Even though it is easy to set up a self-storage asset, it generally takes three years for an asset to reach occupancy levels needed to break even. We view the protracted period to profitability as a natural entry barrier. A negative, is a large proportion of retail occupants in self-storage are households temporarily storing possessions when they sell or move between dwellings. The rise in the Australian house prices has coincided with a step up in the dwelling turnover rate. Should dwelling prices decline, we anticipate dwelling turnover to fall and by extension softening demand for self-storage and hence rents. Self-storage being a new investment class means there is no data on how the sector performs during a down property cycle. We account for this risk by assuming growth in rent per available metre (RevPAM) remains at 2.5% going forward, down on the 3.2% and 2.9% growth in fiscal 2016 and fiscal 2015, respectively.

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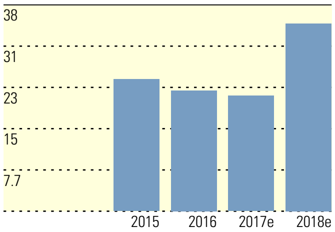
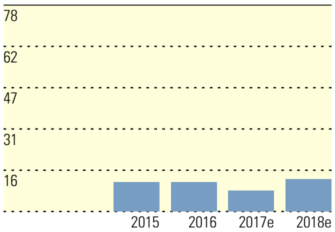
Key Valuation Assumptions

Cost of Equity %	9.0
Weighted Avg Cost of Capital %	8.7
Long Run Tax Rate %	0.0
Stage II EBI Growth Rate %	4.0
Stage II Investment Rate %	8.0
Perpetuity Year	50.0

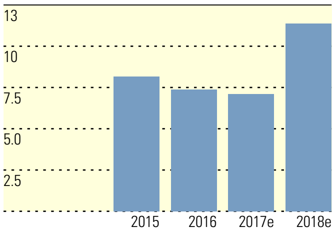
EPS ¢



Return on Equity (ROE) %



Return on Invested Capital (ROIC) %



The bulk of earnings come from rental income, with upside from opportunistic property development.

Thesis (18-Aug-2016)

Abacus is a property investment and funds management business, with interests in property lending, joint ventures, and development, operating in Australia and New Zealand. Abacus owns one of Australia's top three portfolios of self-storage facilities. Earnings volatility is above that of conventional REITs, reflecting Abacus' opportunistic investment approach.

Abacus has no specific targeted weighting to any asset class, but the most recent portfolio weighting was 22% office, 17% retail, 5% industrial, 25% self-storage, 21% in property ventures, and the balance invested in asset-specific funds and cash.

The majority of Abacus' revenue is sourced from annuity-style net rentals and management fees from retail property funds. This is medium-risk revenue, with the secondary quality characteristics of the property portfolio increasing the risk of vacancy and subdued rental growth as occupier demand remains subdued. Rental revenue is supplemented by variable transactional earnings from the creation and termination of property funds, property lending, joint ventures, and property development. Effectively the bulk of earnings comes from rental income, with upside from opportunistic property development. Allocation of 15%-20% of capital to more speculative property ventures means there is a modest amount of capital at risk.

We expect little variable transaction revenue in the short term, but there is potential for significant growth as markets improve Abacus' strengths are in the identification and active management of assets it believes have been mispriced by the market. In this regard, Abacus has a solid track record of generating capital returns across a range of property sectors for its actively managed core-plus assets. We consider Abacus' earnings to be of lower quality than those of many listed Australian REITs because of the more speculative nature of the portfolio.

Over time, Abacus has advanced loans and working-capital facilities and provided other financial support to its managed funds. While most of the loans advanced by Abacus are senior debt or first mortgages for property, these financing activities still carry elevated risk of capital loss if a property venture doesn't meet expectations. Abacus is making progress to systematically exit these property venture activities.

The portfolio has a relatively high proportion of leases (16%) expiring in fiscal 2016. With the portfolio skewed to lower-quality assets, reletting risk is elevated, particularly for the office portfolio, reflecting oversupply issues in the major Australian markets.

While initially small, the new joint venture partnering with Heitman, a U.S. institutional real estate investment house, provides a platform for capital raisings for future acquisitions of better-quality core assets. The trust does not have a moat, with the business model and platform offering no clear competitive advantage over similar Australian REITs.

Economic Moat

We consider the Abacus business model to have no economic moat, as there are no notable sustainable competitive advantages in the major business divisions. Abacus generates income from a diverse range of activities, with capital allocated across a broad range of asset types. The firm allocates 17% of capital to retail; 23% to office; 5% to industrial; 24% to self-storage; 21% to property ventures; and the balance in fund management activities. While Abacus has a strong delivery record, the key assets tend to be of lower quality, and the other business divisions operate in areas with negligible moat traits. Abacus is typically not a long-term holder of individual assets, generally targeting "difficult" or "unloved" assets where there is upside from rezoning, development, repositioning, and letting up. As such, most acquired assets are of lower quality, but often in good locations. Their moat would strengthen materially once redeveloped, but Abacus would usually sell for a profit at this point. The self-storage and property venture businesses are both no-moat activities, as entry barriers, switching costs, and network effects are generally nonexistent. The fund-management activities have moat traits from high switching costs.

Valuation, Growth and Profitability (19-Aug-2016)

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Reflecting raised margin and volume expectations for residential lot sales, our fair value estimate for Abacus Property Group is unchanged at AUD 3.50. Our fair value estimate implies a fiscal 2017 price/earnings of 15 times and an enterprise value/EBITDA of 15 times.

Fiscal 2018 earnings will spike, reflecting the anticipated sale of a major asset in Camellia (inner city). Our fair value estimate represents a 30% premium to Abacus' net tangible assets of AUD 2.66 per share as at June 2016.

We have valued Abacus on a DCF basis using a 9% cost of equity assumption and an 8.7% weighted average cost of capital assumption.

We forecast annuity-style earnings growth from property ownership and managed funds to track slightly ahead of inflation in the short term, with property ventures to generate strong growth as the firm brings its residential development projects to market.

Risk

The principal risk to business viability stems from governance, with management's implementation of a relatively loose strategy lacking the control of an independent board. Capital risk arises from investment in a secondary quality property portfolio, with increased revaluation risk and limited liquidity during a property market downturn. Revenue risk arises from declining occupier demand reducing effective rentals and a subdued investment environment preventing the transfer of assets off the balance sheet into newly established funds-management vehicles.

Financial Health

The Abacus balance sheet is reasonably sound, with gearing (net bank debt divided by total assets minus cash) of 26% at June 2016. Covenant gearing (total liabilities net of cash, divided by total tangible assets net of cash) is higher at 29%, but well under the 50% covenant limit.

The interest coverage ratio comfortably exceeds 4 times, well above the 2.0 times covenant. Abacus has no significant debt expiry until fiscal 2019, when AUD 200 million expires.

Annuity-style property and funds management net income underwrites stable profitability, with distributions reduced to a level payable from recurrent earnings only, but likely to increase with the return of transactional income as financial, property, and credit markets improve.

Stewardship (19-Aug-2016)

We assign Abacus a Standard stewardship rating. Despite its concentrated ownership structure, we believe the Abacus executive and board strive to preserve capital and generate shareholder wealth. Significant shareholder Kirsh Group (41% ownership) has one of the six board positions, indicating that it is not in a position to unduly influence board decisions. We consider CEO and managing director Frank Wolf to be an experienced operator with good property acumen. He has more than 20 years' experience in the property and financial services industries, including involvement in retail, commercial, industrial, and hospitality-related assets in Australia, New Zealand, and the United States. CFO, Robert Baulderstone was appointed in October 2012, having previously served Abacus as general manager in finance. Prior to Abacus, Baulderstone was the CFO of a national wealth-management group.

Bulls Say

► Entrepreneurial management focused on sourcing wide-ranging opportunities in distressed markets.

► Rezoning and redevelopment of the Camellia site in Sydney's west should be a very strong near-term earnings catalyst.

► Strong appreciation in Sydney land sites bode well for recycling of the development land bank in the near term.

Bears Say

► A second-tier property portfolio, coupled with the speculative nature of property ventures, means asset values are likely to be highly sensitive to economic cycles.

► The portfolio of residential development loans represents roughly 10% of capital, which means the group faces the risk of capital loss if residential

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markets weaken materially.

► Sustained lower levels of financial-markets activity will delay the ability to secure higher-margin transactional earnings.

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General Financials

					Historical			Forecast
Per Share	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Sales ¢	41.3	52.3	63.1	45.1	41.2	53.1	75.3	55.2
Adjusted Earnings ¢	19.2	18.8	20.8	24.5	22.4	21.4	34.8	23.1
Free Cash Flow ¢	36.3	16.9	28.1	15.9	-13.8	40.7	51.9	16.3
Net Tangible Assets ¢	268.0	245.2	258.6	268.0	275.2	280.5	298.3	303.2
Book Value ¢	263.6	242.8	257.8	268.3	273.3	278.6	296.4	301.3
Dividends ¢	16.5	16.5	16.8	17.0	17.0	17.0	17.0	19.5
Franking %	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Growth %	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Sales Revenue	-17.1	41.1	31.3	-22.9	-3.4	29.3	42.0	-26.7
EBITDA	12.0	4.2	17.3	10.3	-2.5	0.2	54.3	-37.2
Pre-Tax Profit	7.4	16.8	27.1	15.9	-2.6	-2.0	75.5	-40.7
Adjusted EPS	-1.7	-2.0	11.0	17.4	-8.7	-4.2	62.4	-33.5
DPS	0.0	0.0	1.5	1.5	0.0	0.0	0.0	14.7
Free Cash Flow per share	2,917.7	-48.1	80.7	-38.9	-191.8	–	27.5	-68.5

Profit & Loss ($Mil)	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Sales Revenue	165.6	233.7	306.9	236.5	228.4	295.3	419.3	307.3
EBITDA	124.3	129.5	151.9	167.6	163.4	163.7	252.7	158.7
Depreciation	2.3	2.4	3.0	3.0	1.8	1.9	1.8	1.7
Amortisation	–	–	–	–	–	0.0	0.0	0.0
EBIT	122.0	127.1	148.9	164.6	161.6	161.8	250.9	157.0
Interest Expense	42.6	38.3	34.8	30.9	31.3	34.5	25.9	23.5
Interest Income	-1.3	2.4	1.8	0.6	0.5	0.9	0.0	0.0
Profit Before Tax	78.1	91.2	115.9	134.3	130.8	128.2	225.0	133.5
Tax	1.3	5.8	14.2	5.2	6.8	9.0	31.4	4.7
Reported NPAT	24.5	68.3	111.6	147.6	160.7	119.2	193.6	128.7
Non-Recurring Items After Tax	-52.3	-15.5	10.3	19.3	36.7	0.0	0.0	0.0
Adjusted NPAT	**76.8**	**83.8**	**101.3**	**128.3**	**124.0**	**119.2**	**193.6**	**128.7**
Free Cash Flow	145.6	75.6	136.6	83.4	-76.5	226.6	289.0	90.9
Effective Tax Rate %	1.7	6.4	12.2	3.9	5.2	7.0	13.9	3.6

Cash Flow ($Mil)	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Receipts from Customers	170.9	226.1	305.3	246.0	231.2	286.5	411.9	314.0
Payments to Suppliers	-41.4	-71.3	-196.8	-60.6	-68.6	-128.2	-154.2	-159.7
Other Operating Cashflow	-43.2	-68.5	-22.3	-99.1	-76.3	-44.6	-62.2	-23.8
Net Operating Cashflow	**86.2**	**86.2**	**86.2**	**86.2**	**86.2**	**113.7**	**195.5**	**130.5**
Capex	-1.2	-7.8	-6.8	-3.6	-3.6	-13.3	-12.7	-12.2
Acquisitions & Investments	17.4	-36.9	28.5	-27.5	-186.7	95.0	84.0	-50.0
Sales of Investments & Subsidiaries	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Investing Cashflow	0.0	2.0	0.0	0.0	-1.8	0.0	0.0	0.0
Net Investing Cashflow	**16.1**	**-42.7**	**21.7**	**-31.2**	**-192.0**	**81.7**	**71.3**	**-62.2**
Proceeds from Issues	62.9	0.0	91.6	107.6	10.0	10.0	0.0	0.0
Proceeds from Borrowings	-67.4	-40.4	-167.6	-125.2	55.0	-110.0	-170.0	30.0
Dividends Paid	-40.3	-49.1	-45.9	-93.0	-94.5	-94.6	-94.6	-101.6
Other Financing Cashflow	-68.1	-0.7	-4.1	-0.6	0.0	0.0	0.0	0.0
Net Financing Cashflow	**-112.9**	**-90.2**	**-125.9**	**-111.3**	**-29.5**	**-194.6**	**-264.6**	**-71.6**
Net Increase Cash	-10.5	-46.7	-18.0	-56.2	-135.2	0.7	2.1	-3.3
Cash at Beginning	64.7	91.5	79.6	94.6	179.0	43.8	44.5	46.6
Exchange Rate Adjustment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash at End	54.1	44.8	61.7	38.4	43.8	44.5	46.6	43.2

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General Financials

	Historical					Forecast		
Balance Sheet ($Mil)	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Cash & Equivalents	54.1	44.8	61.7	38.4	43.8	44.5	46.6	43.2
Accounts Receivable	11.9	19.6	21.2	11.7	8.9	17.7	25.2	18.4
Inventory	26.5	73.0	14.2	7.5	9.8	11.8	16.8	12.3
Other Short-Term Operating Assets	221.0	181.8	197.8	57.2	98.8	98.8	98.8	98.8
Total Current Assets	313.5	319.2	294.8	114.7	161.3	172.9	187.3	172.8
Property Plant & Equipment, Net	1,558.1	1,589.9	1,523.8	1,685.0	1,904.9	1,821.3	1,748.2	1,808.7
Goodwill, Net	–	–	–	–	–	0.0	0.0	0.0
Other Intangibles	33.5	33.3	33.3	33.3	32.5	32.5	32.5	32.5
Other Long-Term Operating Assets	185.5	173.5	222.0	297.6	340.8	340.8	340.8	340.8
Deferred Tax Assets	16.3	11.9	5.5	6.7	10.8	10.8	10.8	10.8
Long-Term Non-Operating Assets	–	–	–	–	–	0.0	0.0	0.0
Total Assets	**2,106.8**	**2,127.8**	**2,079.3**	**2,137.2**	**2,450.3**	**2,378.3**	**2,319.7**	**2,365.6**
Accounts Payable	30.4	63.3	21.5	29.8	26.2	29.5	41.9	30.7
Short-Term Debt	30.0	164.3	16.7	0.0	124.7	124.7	124.7	124.7
Other Short-Term Operating Liabilities	5.2	19.3	14.8	12.4	57.6	57.6	57.6	57.6
Total Current Liabilities	65.5	246.9	53.0	42.2	208.5	211.8	224.2	213.0
Total Long-Term Debt	772.3	639.3	620.3	544.0	631.3	521.3	351.3	381.3
Long-Term Operating Liabilities	12.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deferred Tax Liabilities	10.2	10.3	10.3	10.5	9.5	9.5	9.5	9.5
Long-Term Non-Operating Liabilities	138.2	103.5	105.6	101.9	41.7	41.7	41.7	41.7
Total Liabilities	**998.9**	**1,000.0**	**789.2**	**698.7**	**891.0**	**784.4**	**626.8**	**645.6**
Preferred Stock	–	–	–	–	–	0.0	0.0	0.0
Minority Interest	51.0	43.8	36.8	31.0	43.3	43.3	43.3	43.3
Total Equity	**1,107.9**	**1,127.8**	**1,290.2**	**1,438.1**	**1,559.3**	**1,593.9**	**1,692.9**	**1,720.0**

Profitability %	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
EBITDA Margin	75.1	55.4	49.5	70.9	71.5	55.4	60.3	51.7
EBIT Margin	73.7	54.4	48.5	69.6	70.8	54.8	59.8	51.1
Net Profit Margin	14.8	29.2	36.4	62.4	70.4	40.4	46.2	41.9
Free Cash Flow Margin	87.9	32.3	44.5	35.3	-33.5	76.7	68.9	29.6
Return on Equity	2.4	6.4	9.6	11.1	11.0	7.8	12.1	7.7
Return on Assets	1.2	3.2	5.3	7.0	7.0	4.9	8.2	5.5
Return on Invested Capital(w/Goodwill)	6.1	6.4	7.5	8.2	7.4	7.1	11.4	7.1
ROIC (w/Goodwill) Less WACC	-2.6	-2.3	-1.2	-0.5	-1.3	-1.6	2.7	-1.6

Leverage & Liquidity	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Net Debt to Capital %	41.4	41.2	31.5	26.4	32.0	28.0	20.7	21.6
Net Debt/(Net Debt + Equity) %	41.4	41.2	31.5	26.4	32.0	28.0	20.7	21.6
Net Debt/Equity %	70.8	70.0	45.9	35.9	47.0	38.8	26.0	27.6
Net Debt/EBITDA x	6.0	5.9	3.8	3.0	4.4	3.7	1.7	2.9
EBIT/Net Interest Expense x	2.8	3.5	4.5	5.4	5.2	4.8	9.7	6.7
Current Ratio (Current Assets/Current Liabilities) x	4.8	1.3	5.6	2.7	0.8	0.8	0.8	0.8
Dividend Payout Ratio %	86.1	87.9	80.4	69.5	76.1	79.4	48.9	84.3
Net Cash Per Share ¢	-186.6	-170.0	-118.4	-96.4	-128.4	-108.1	-77.2	-83.2

Valuation	06/12	06/13	06/14	06/15	06/16	06/17	06/18	06/19
Price/Earnings x	10.2	11.3	11.1	11.6	13.8	13.4	8.2	12.4
PEG Ratio x	-0.2	-0.2	1.2	2.0	-1.2	-0.6	5.1	-4.1
EV/EBITDA x	12.3	13.2	11.2	11.9	14.8	14.0	9.1	14.5
EV/EBIT x	12.6	13.4	11.4	12.1	15.0	14.2	9.2	14.6
Free Cash Flow Yield %	18.5	8.0	12.2	5.6	-4.5	14.2	18.2	5.7
Dividend Yield %	8.4	7.8	7.3	6.0	5.5	5.9	5.9	6.8
Price/(OCF per share) x	9.1	11.0	13.0	17.2	19.8	14.0	8.1	12.2
Price/(FCF per share) x	5.4	12.6	8.2	17.8	-22.3	7.0	5.5	17.5
Price/Sales x	4.7	4.1	3.6	6.3	7.5	5.4	3.8	5.2
Price/NTA x	0.7	0.9	0.9	1.1	1.1	1.0	1.0	0.9
Price/Book x	0.7	0.9	0.9	1.1	1.1	1.0	1.0	0.9

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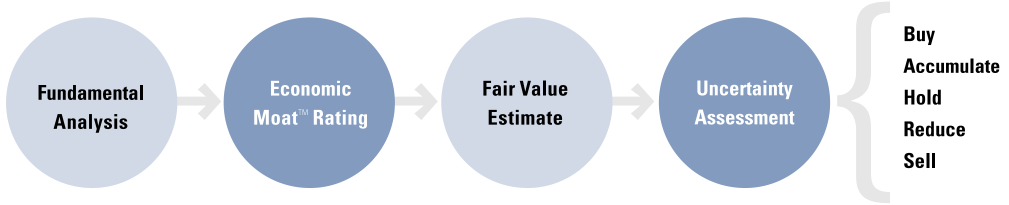
Equities Research Methodology

Fundamental Analysis

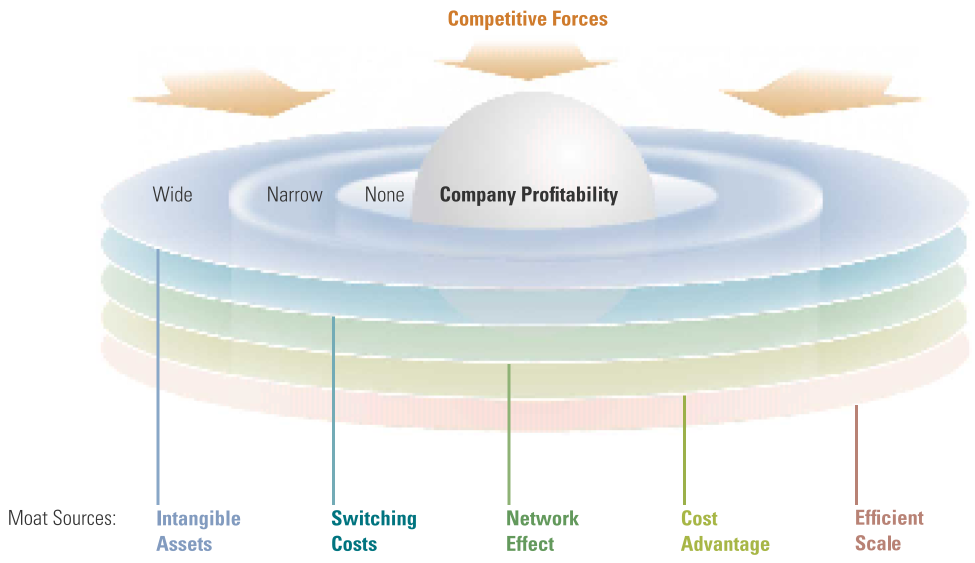
At Morningstar, we believe buying shares of superior businesses and allowing them to compound over time is the surest way to create wealth in the stock market. The long term fundamentals of businesses, such as cash flow, competition, economic cycles, and stewardship, are our primary focus because history has shown that market sentiment is fleeting, momentum can quickly reverse, and the herd is sometimes a dangerous crowd. Occasionally, this approach causes our recommendations to appear out of step, but willingness to be contrarian is an important source of outperformance and a benefit of Morningstar's independence. The brief definitions that follow help illustrate our methodology. Extensive methodology documents are available on our website.

Morningstar Research Process for Company Analysis



Economic Moat

The economic moat concept is a cornerstone of Morningstar's investment philosophy and is used to distinguish high quality companies. An economic moat is a structural feature that allows a firm to sustain excess returns over a long period of time. Without a moat, profits are more susceptible to competition. Companies with a narrow moat are likely to achieve normalised excess returns beyond ten years while wide moat companies are likely to sustain excess returns beyond 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low quality, no moat companies will see their returns gravitate toward the firm's cost of capital more quickly than companies with moats. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.



Fair Value Estimate

Our fair value estimate is primarily based on Morningstar's proprietary three-stage discounted cash flow model. We also use a variety of supplementary fundamental methods to triangulate a company's worth such as sum-of-the-parts, multiples, and yields, among others. We're looking well beyond next quarter to determine the cash-generating ability of a company's assets because history has shown that the market price of a security will migrate towards the firm's intrinsic value over time. Economic moats are not only an important sorting mechanism for quality in our framework, but the designation directly contributes to our estimate of a company's intrinsic value through sustained excess returns on invested capital.

Uncertainty Rating

The Morningstar Uncertainty Rating demonstrates our assessment of a firm's cash flow predictability, or valuation risk. From this rating, we determine appropriate margins of safety: The higher the uncertainty, the wider the margin of safety around our fair value estimate before our recommendations are triggered.

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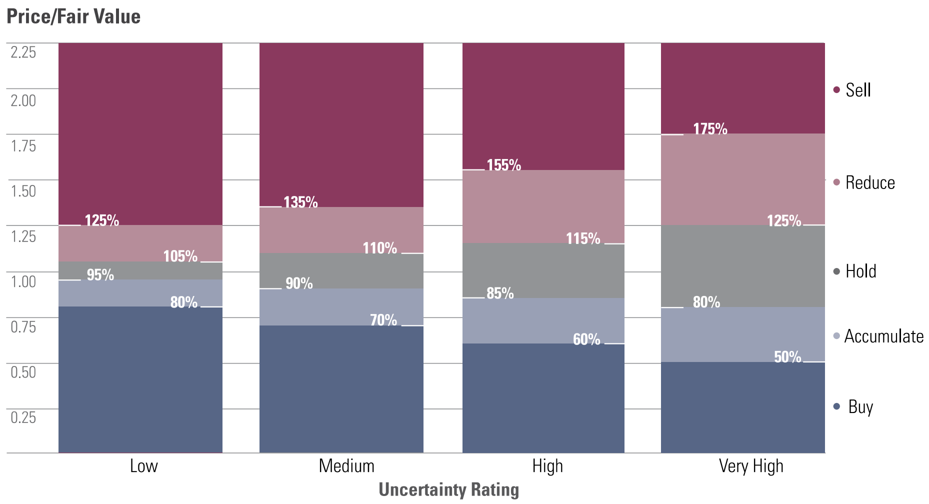
Our uncertainty ratings are low, medium, high, very high, and extreme. With each uncertainty rating is a corresponding set of price to fair value ratios that drive our recommendations: Lower price/fair values (<1.0) lead to positive recommendations while higher price/ fair values (>1.0) lead to negative recommendations. Our price/fair values have proven highly predictive of future stock returns. In very rare cases, the fair value estimate for a firm is so unpredictable that a margin of safety cannot be properly estimated. For these firms, we use a rating of extreme which indicates that nearly all investors should avoid speculating on that company's shares. Risk and volatility-averse investors should generally avoid very high and extreme uncertainty companies.



Recommendations

Our recommendations are based on the current share price relative to Morningstar's Fair Value Estimate after adjusting for an appropriate margin of safety. These recommendations are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

Depending on the portfolio strategy being employed, the ratings below can indicate different actions for different investors. For example, income investors might be best served holding a fairly valued investment with a reliable dividend stream instead of rotating into a buy recommendation with questionable income characteristics. Nonetheless, our recommendations serve as valuable starting points for equity portfolio strategies.

The Australia and New Zealand Buy, Accumulate, Hold, Reduce, and Sell recommendations are broadly aligned with the star ratings in Morningstar's global product. In order to reduce the volatility in Australia/New Zealand recommendations, a minor adjustment is made to the Australia/New Zealand recommendations for those stocks trading at a price very close to the point at which a change in the rating is triggered.

Buy (significantly undervalued, ★★★★★): Our buy recommendations indicate that we believe appreciation beyond a fair risk-adjusted return is highly likely over a multi-year timeframe. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximising upside potential. This rating encourages investors to consider an overweight position in the security relative to the appropriate benchmark.

Accumulate (modestly undervalued, ★★★★): Our accumulate recommendation indicates that we believe appreciation beyond a fair risk-adjusted return is likely. This rating encourages investors to own the firm's shares, possibly overweight relative to the appropriate benchmark after fully considering the security's fit with their targeted portfolio and more attractively-priced alternatives, such as our buy recommendations.

Hold (fairly valued, ★★★): Our hold recommendation indicates that we believe investors are likely to receive a fair risk-adjusted return (approximately cost of equity). Concentrated portfolios might consider reducing or exiting these positions if more attractively-priced alternatives are available.

Reduce (modestly overvalued, ★★): Our reduce recommendation indicates that we believe investors are likely to receive a less than fair risk-adjusted return and should consider directing their capital elsewhere. Securities with a reduce recommendation should generally be underweight and exited completely in most strategies, assuming less expensive alternatives are available.

Sell (significantly overvalued, ★): Our sell recommendation indicates that we believe there is a high probability of undesirable risk-adjusted returns from the current market price over a multi-year timeframe. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to substantial loss.

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Equities Research Methodology

This rating encourages investors to strongly consider exiting portfolio positions in the security in nearly all strategies.

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