iInvest Securities
Stockbroking & Wealth Management

iInvest - Top Stock Picks

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iInvest Securities monthly Best Stock Ideas highlights high-quality large capitalisation Australian and New Zealand companies, which are currently trading at discounts to our assessed fair values. The ideas, chosen from our coverage universe of about 220 companies, are intended to have broad application in a variety of equity strategies, but individuals should consider their personal investment goals and positioning before investing. We provide brief descriptions of each best idea in this report and also encourage investors to read our most recent stock reports for a more detailed appraisal.

This month we have 12 companies in our Best Stock Ideas list. Since last month, we have added Vocus Communications and Abacus Property Group, and removed Ainsworth Game Technology, Commonwealth Bank of Australia and Westpac Banking Corporation from our list.

We have removed Ainsworth Game Technology from our Best Ideas list. The firm's removal is due to persistent weakness in its domestic operations and the absence of a near-term share price catalyst. While Ainsworth's international businesses, in particular North America, are performing well, the Australian operation's performance is suffering from a slower-than-anticipated recovery. We have removed Commonwealth Bank of Australia and Westpac Banking Corporation from our Best Ideas list because of weakness in the outlook for near-term earnings growth and increasing political scrutiny of Australia’s highly profitable major bank oligopoly. We are maintaining our positive long-term view but the absence of a near-term share price catalyst prompts the removal from our Best Ideas. On the positive side we expect operating cost growth to lag revenue growth, resulting in improved cost/income ratios.

Abacus Property Group (ASX: ABP)

Current Market Price: $2.87 **Estimated Fair Value: $3.50**

Abacus Property Group is a diversified property firm with assets spread among retail, office, warehouse, self-storage, and residential development. It derives the bulk of its rental income from mid-tier assets and these receipts form the basis of the firm's annual dividend. The fact that the majority of Abacus’ capital is allocated to asset classes with moderate to low entry barriers is the reason we give the firm a no-moat rating. The firm is also an optimistic investor, with a long history of buying difficult assets at deep discounts to their improved value. There are signs the Sydney residential development cycle is slowing, but we think the firm has been overly sold down in response and is attractively priced at current levels. Likely catalysts to close the gap between share price and fair value are evidence of resilience in Sydney home prices and further progress on rezoning of the firm’s large residential development site in the Sydney suburb of Camellia.

CSL (ASX: CSL)

Current Market Price: $106.94 **Estimated Fair Value: $125.00**

Narrow moat-rated CSL is the largest healthcare stock on the ASX and the world's largest blood plasma fractionator by market capitalisation. We believe integration of the Novartis cell-based influenza vaccine manufacturing operations with CSL's existing vaccine business under the rebranded Seqirus division is positive for shortening the path to market and increasing the company's global market share in seasonal influenza vaccines. This in conjunction with the launch of several new recombinant coagulation products and the steady progress in the broad R&D pipeline augurs well for earnings growth over the next five years.

Dulux Group (ASX: DLX)

Current Market Price: $6.71 **Estimated Fair Value: $7.00**

DuluxGroup's high-quality narrow moat decorative paints business is an exceptional consumer franchise. With an iconic brand, a strong culture of R&D, and successful partnership with Bunnings, Dulux has scope to lift its market share from 45% to 50% over the next five years, in our view. Moreover, decorative paint is an oligopoly industry in Australia and New Zealand with high barriers to entry, and the long-term demand outlook remains positive, supported by both population-growth-fuelled new housing stock and the ageing housing stock profile. Dulux is much less cyclical than its building materials peers, reflecting its higher exposure to alterations and additions spending. While new housing approvals are at a cyclical peak and activity in the housing market has recently slowed, we believe the equity market does not fully appreciate the resilience of Dulux and strength of its brand.

Folkestone Education Trust (ASX: FET)

Current Market Price: $2.70 **Estimated Fair Value: $3.10**

Narrow moat-rated Folkestone Education Trust is an owner of child-care centres, and we expect it to benefit from positive macroeconomic trends. We anticipate government funding for long-day child care to continue growing in real terms above the population growth rate. Also, a continuously growing child-care consumer base, children up to 5 years old, is expected to drive demand for child-care places. At the current share price, we believe Folkestone presents a relatively low-risk opportunity to invest in these macro themes. It is trading at a 14% discount to our fair value estimate and offers a 5.0% distribution yield based on fiscal 2017 distribution guidance of AUD 14.2 cents per unit. The restructuring of the Australian government's child-care subsidies is yet to pass the Senate after the federal election, but we anticipate the trend of steadily rising subsidies for child care to continue in the foreseeable future. Government subsidies, which represent approximately 54% of a child-care centre's revenue, have increased at a CAGR of 16% during the past 10 years, and we forecast this to increase by a CAGR of 14% during the next five years. In its midcase scenario, the Australian Bureau of Statistics expects the population of 0- to 5-year-olds to grow by a CAGR of 1.4% during the next five years. This growth could be compounded by an increasing female participation rate, a key policy goal of the child-care subsidies. We forecast an annual rental growth rate of 2.5% during the next five years, supported by underlying industry fundamentals.

Iluka Resources (ASX: ILU)

Current Market Price: $6.34 **Estimated Fair Value: $8.50**

Narrow moat-rated Iluka Resources is the world's leading, low-cost mineral sands miner. A tough external environment sees prices and volumes near cyclical lows and the shares trading at a meaningful discount to fair value. The company has set itself apart from mining peers by focusing on return on capital, withholding supply from the market when conditions were weak and paying out the majority of free cash flow as dividends. There are some encouraging signs of a change in the cycle with titanium dioxide feedstock shipments accelerating in 2016 and the zircon price rising by 6% or USD 60 per tonne in July. Free cash flow from the liquidation of excess inventory, and the likelihood it will be paid as dividends, means shareholders are paid to wait for the recovery, which may be underway.

National Australia Bank (ASX: NAB)

Current Market Price: $28.13 **Estimated Fair Value: $30.00**

Following the Clydesdale demerger in February, we expect National Australia Bank to deliver good revenue and volume growth, reduce the cost base, and improve return on equity from the core Australian and New Zealand franchise. We consider National Australia Bank offers the best short- to medium-term upside of the major banks on our Best Ideas. With considerable relief, the bank's first-half fiscal 2016 cash profit increased 6.5% to an impressively "clean" AUD 3.31 billion. The interim dividend was flat at a fully franked AUD 0.99 per share, based on a high 79% payout and unchanged on the past four semiannual dividend payments. Our full-year fiscal 2016 dividend is based on an unsustainably high 80% payout, exceeding the medium-term target range of 70%-75% of cash profits. We forecast the payout ratio falls progressively to 71% by fiscal 2020. CEO Andrew Thorburn and senior management need to produce consistent, high-quality earnings to erase previous disappointments and rebuild investor confidence, in order to increase the likelihood that the share price will recover from its long period of underperformance. National Australia Bank has substantial exposure to the business sector, with 45% of revenue from business banking, and is well placed to take advantage of the recovery in demand for business credit.

Platinum Asset Management (ASX: PTM)

Current Market Price: $5.04 **Estimated Fair Value: $7.00**

Platinum Asset Management is a highly successful Australian fund manager specialising in international equities, with a narrow economic moat thanks to its strong brand. It derives its income predominantly from base management fees on funds with specific mandates, typically by geography, though performance fees can add meaningfully in good years. Earnings growth is primarily driven by growth in funds under management, which is a function of performance and inflow. Key positives include strong brand recognition stemming from excellent long-term fund performances and a tailwind from Australia's growing pool of superannuation savings. With minimal capital expenditure and an impeccable balance sheet, the firm can pay out practically all profit as fully franked dividends. Investment returns trailing peers and its relative benchmark and fear of weakening equity markets are currently weighing on the share price. We remain confident initiatives to drive inflow, combined with Platinum's investment talent, will deliver strong growth in funds under management and earnings over the medium term.

ResMed (ASX: RMD)

Current Market Price: $8.50 **Estimated Fair Value: $10.50**

Narrow moat ResMed has been affected by negative sentiment in recent months, generated by the disappointing results of the Serve-HF trial, which in turn has led to its shares trading at an attractive discount to our fair value estimate. While the unfavourable result was a setback, we believe clinical evidence to date linking sleep-disordered breathing to a host of medical disorders beyond cardiology represents commercial opportunities for ResMed. The obstructive sleep apnea business remains robust and progress in the adjacent medical areas of chronic obstructive pulmonary disease is positive for growth. ResMed's integrated product suite creates an application ecosystem in sleep apnea, thereby strengthening switching costs for clinicians and patients, and it stands to benefit from further weakening of the Australian dollar.

Sonic Healthcare (ASX: SHL)

Current Market Price: $22.00 **Estimated Fair Value: $24.00**

Sonic Healthcare is the largest private pathology player in the Australian private pathology testing market with 40% share. Scale built via multiple acquisitions, integrated using a well-established hub-and-spoke operating model, has driven synergy benefits domestically and we believe will support the offshore growth strategy in the U.S. and European markets. Regulatory risk concerns have increased recently because of an ongoing government review of funding arrangements under Medicare. However, in our opinion, Sonic's foreign exposure diversifies revenue streams and lowers the company's vulnerability to Australian funding risk. International revenue as at the interim result stood at 59% of group revenue on a statutory basis.

Vocus Communications Limited (ASX: VOC)

Current Market Price: $6.06 **Estimated Fair Value: $8.50**

Shares in Vocus Communications are trading at an attractive discount to our AUD 8.50 fair value estimate. Despite the recent change in segmental disclosure, we believe Vocus is still generating solid organic growth, especially in the corporate fibre and ethernet unit--one that enjoys juicy margins (40%-plus) and return on invested capital (20% to 40%-plus depending on the number of customers to a fibre-connected building). In addition, synergies are coming through as expected from the most recent acquisitions (Amcom, M2). A subdued earnings outlook in September from a major competitor in the Australian telecom space has raised concerns regarding the impact of National Broadband Network, or NBN, on Vocus. However, we believe the NBN impact on Vocus is relatively limited (a potential EBITDA hit of around 7%) because only around 20% of its broadband subscribers are higher margin “on-net” and therefore directly impacted by the higher cost of accessing customers as they migrate to the NBN. Furthermore, with just around 7% of the fixed-line broadband subscribers in Australia, Vocus' strategy remains one of increasing market share, with the NBN rollout facilitating as a catalyst. Some multiple derating is understandable from previously unsustainable levels. However, we see the current stock price discount to our intrinsic assessment closing over time, as positive synergy realisation updates and better market appreciation of the NBN impact on Vocus come through.

Woodside Petroleum (ASX: WPL)

Current Market Price: $29.06 **Estimated Fair Value: $34.00**

We think Woodside is the best ASX-listed energy exposure for risk-averse investors. It is the least leveraged of the three larger hydrocarbon producers, due to earlier commissioning of Pluto T1, and should be free cash flow positive from 2016 given a wind-down in capital expenditures. It trades on the lowest 2016 enterprise value/EBITDA multiple of all three. At the end of December, net debt of $4.3 billion or $5.35 per share saw manageable net debt/net capital of just 23.7% and healthy net debt/adjusted EBITDA of 1.9 times. Our base case assumes group equity production will rise 8.7% on 2015's 93 million barrels of oil equivalent to 100 mmboe by 2018 largely because of commissioning of the massive Wheatstone LNG project from second-half 2016. Our projections allow for maintenance of an 80% dividend payout ratio to 2018 (3.3% fully franked 2017 yield) after which we assume a reduction to 60% to assist Pluto T2 construction.

Woolworths (ASX: WOW)

Current Market Price: $23.27 **Estimated Fair Value: $28.00**

Woolworths' dominant market position in the Australian supermarket sector in recent years allowed its retail prices and profit margins to rise above its competitors. The recent negative trend in comparative-store sales growth in its core Australian supermarket division, combined with the drag on earnings from the Masters chain expansion and various senior management departures, has been the main reason behind the share price declining 40% since April 2014. We do not believe the current situation is terminal, given the firm's superior store network, but it does require changes in strategy, and any transformation will take time. The closure of the Masters chain is a positive but was already factored into our fair value estimate as is a continued loss in supermarket market share to Aldi and Coles for the next few years. The new strategy of reducing grocery prices to close the margin between Woolworths and its competitors is positive but will clearly be negative for short-term profitability with the Australian food, liquor, and petrol EBIT margin for fiscal 2016 expected to be 5.0% compared with 7.2% in fiscal 2015. In our view, investing in price, in-store experience, and store refurbishments and launching a more attractive loyalty program may help stabilise market share in the short term, but ultimately we believe the market structure is changing and Woolworth's strategy that one shoe fits all may need rethinking. Divesting Big W and the petrol station network, which could collectively raise an estimated AUD 2.5 billion, may also help in narrowing the gap to our fair value estimate.

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