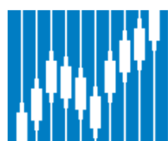

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

September 2016

iInvest Securities Monthly Top Stock Picks highlights high-quality large capitalisation Australian and New Zealand companies, which are currently trading at significant 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 13 companies in our Top Stock Picks list. Since last month, we have added Folkestone Education trust and removed Crown Resorts from our list. We are removing Crown Resorts from the Best Ideas list as the stock is trading near our fair value estimate due to a recent share price rally. Nonetheless, we continue to view Crown Resorts as a unique company offering defensive earnings quality (via its two dominant Australian casinos, in particular Melbourne) along with long-term attractive growth options via its 27.4% stake in Melco Crown Entertainment in Macau, as well as new casinos earmarked to be built in Sydney and Las Vegas.

Ainsworth Game Technology (ASX: AGI)

Current Market Price: $2.18 **Estimated Fair Value: $3.50**

Short-term concerns are weighing on Ainsworth Game Technology's share price. Weakness in Australia is holding back earnings because of a lull in new product releases and higher component costs as a result of a weak Australian dollar. However, the company boasts a narrow moat, one underpinned by over 200 unique jurisdictional licences (including online) to manufacture and sell electronic gaming machines in Australia, the United States, and seven other countries. While the company's recent result showed that operating conditions in Australia remain tough, the performance of the international business, which represents 71% of group revenue, exceeded expectations. The company's strategy of diversifying offshore is paying off. Our long-term view on Ainsworth is positive, underpinned by an expected recovery in Australia, albeit at a slower pace than previously expected, and further gains in overseas markets, particularly in North America. Also, now that the firm is under the control of Novomatic pending regulatory approvals, there is potential upside not explicitly factored into our forecasts from revenue synergy benefits, along with potential benefits from leveraging Novomatic's research and development clout, which puts Ainsworth in a better position to compete. Signs of stabilisation in Australia and benefits from the relationship with Novomatic would act as catalysts to close the gap between the current stock price and our fair value estimate.

Commonwealth Bank of Australia (ASX: CBA)

CommonwealthBank

Current Market Price: $71.91 **Estimated Fair Value: $85.00**

Wide moat -rated Commonwealth Bank of Australia offers good value and is our preferred Australian major bank for long -term investors. The bank has historically been the most expensive of the major banks, but the recent sell-off places it at an attractive discount to our fair value estimate. We believe convergence of the share price and our fair value estimate will occur as the market gains clarity on the bank's rising bad-debt profile. Some are concerned about an imminent crash in the Australian residential sector, but we do not expect a surge in loan defaults. Commonwealth Bank is the least risky of the four major banks. It is conservatively managed, Australia- and New Zealand-focused, and benefits from large market shares, a comparatively lower-risk loan book, and a sustainable and attractive fully franked dividend yield. The bank is well capitalised with a common equity Tier 1 ratio above 10%, following the AUD 5.1 billion capital raising in 2015. It has leading market shares in Australian home loans, credit cards, and household deposits and a strong position in wealth. It has a peer-leading return on equity of 16.5% and impressive cost/income ratio of 42.4%, relatively steady net interest margins of 2.07%, and strong asset quality with losses only 0.19% of gross loans in fiscal 2016. Mortgages are a high 66% of total loans

CSL (ASX: CSL)

Current Market Price: $104.09 **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: $6.18 **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: $2.85 **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 9% 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 mid-case 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: $6.23 **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: $27.53 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: $5.19 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: $8.84 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: $22.38 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.

Westpac Banking Corporation (ASX: WBC)

Current Market Price: $29.58 **Estimated Fair Value: $35.00**

Despite widespread concerns about deteriorating lending standards in Australia, Westpac continues to provide evidence to the contrary. Consumer credit quality remains sound. Negative investor sentiment on the Australian major banks is overdone and not based on hard facts. In our opinion, Westpac's valuation gap should start to close as investor confidence returns, global markets stabilize, Australia continues to generate relatively solid GDP growth, and unemployment remains around current levels. Westpac's first-half fiscal 2016 result was slightly softer than expected, with the interim dividend of AUD 0.94. Our fiscal 2016 earnings forecast of AUD 8.0 billion represents modest profit growth, but an increased share base sees earnings per share decline 4.7% from fiscal 2015. The full-year dividend forecast of AUD 1.87 per share is based on a 78% payout and implies an attractive fully franked yield of 6.2% grossed up to 8.9%. Lending and deposit growth are good, with return on equity modestly below 15.0%. Low exposures to the mining oil and gas sectors support Westpac's low loan impairments as a percentage of gross loans. Westpac's capital continues to impress with a robust common equity Tier 1 ratio above 10% at 30 June 2016. The internationally comparable common equity Tier 1 ratio of 14.1% is comfortably in the top quartile of global peers.

Woodside Petroleum (ASX: WPL)

Current Market Price: $28.61 **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: $24.05 **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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