

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

December 2016

iInvest Securities monthly Top Stock Picks 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 11 companies in our Best Stock Ideas list. Since last month, removed Abacus Property Group and Woolworths from the list. There are no additions from last month.

Since we placed Abacus on the Best Stock Ideas list at the start of October, the share price has increased 2%, but bond yields have increased materially, affecting the cost of capital for wholesale property investors and mortgage rates for residential buyers. Higher bond yields will affect medium-term earnings from development, and in mid-November, we cut our earnings outlook and fair value estimate for Abacus to AUD 3.00 per share from AUD 3.50 per share. With the stock currently trading around AUD 2.98, we see more attractive investment opportunities elsewhere and are removing the firm from the Best Stock Ideas list.

We have removed Woolworths from our Best Stock Ideas list because of a cut to our fair value estimate to AUD 22.00 per share, following a comprehensive review of our long-term forecasts on market share and margins in the Australian food industry. We continue to rate an investment in Woolworths as defensive in nature, given its status as a leading Australian large-cap stock in the consumer staples sector, trading at about our fair value estimate, with an attractive dividend yield of some 4%. However, we no longer expect Woolworths to widen its margins toward the levels it had enjoyed until recently, as the Australian supermarket sector has structurally changed with the reintroduction of the discounting channel by Aldi. Instead, we expect Woolworths to successfully defend its market share in food and liquor in the long term by lowering its EBIT margins to 4.2%.

CSL (ASX: CSL)

Current Market Price: \$98.08

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: \$5.89

Estimated Fair Value: \$7.00



DuluxGroup

DuluxGroup's high-quality, narrow-moat decorative paint business is an exceptional consumer franchise. With an iconic brand, a strong culture of research and development, and a 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. Both population-growth-fueled new housing stock and the aging housing stock profile support the positive long-term demand outlook. 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: \$2.33

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 an 8% 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 compound annual growth rate 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: \$6.57

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: \$29.07

Estimated Fair Value: \$31.00



National Australia Bank reported a solid fiscal 2016 result with clear signs that the benefits of existing legacy assets are bearing fruit. The bank is now much leaner and focused on core businesses in Australia and New Zealand. In our opinion, National Australia Bank is now in the best strategic position for at least a decade to leverage its business banking and retail franchises, and over time, we expect further value to be

created as the bank releases capital from better internal capital allocation, lowers loan loss provisioning, and further operating costs reductions. 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. Growing economies of scale, steady market positions, pricing power, a strong balance sheet, and high credit ratings provide a robust platform to drive growth. CEO Andrew Thorburn is starting to produce consistent, higher-quality earnings with further benefits to flow through to shareholders over the next three to five years

Platinum Asset Management (ASX: PTM)

Current Market Price: \$5.44 Estimated Fair Value: \$6.30



Platinum Asset Management is a highly successful Australian fund manager specialising in international equities, with a narrow economic moat thanks to its strong brand and customer switching costs. It derives its income predominantly from base management fees on funds with specific mandates, 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 expenditures and an impeccable balance sheet, the firm can pay out practically all profit as fully franked dividends. Short-term investment underperformance and fear of weakening equity markets are currently weighing on the share price. We remain confident that initiatives to drive inflow, combined with Platinum's investment talent, will deliver strong growth in funds under management and earnings over the medium to long term.

Ramsay Health Care (ASX: RHC)

Current Market Price: \$69.00 Estimated Fair Value: \$87.00



Narrow moat-rated Ramsay Health Care is a global hospital group operating 223 hospitals and day surgery facilities across Australia, United Kingdom, France, Indonesia, and Malaysia. It is also the largest and most diversified operator of hospitals in the Australian private sector. The scale of Ramsay's operations in the Australian context underpins, in our opinion, a sustainable competitive advantage which drives both cost advantage and a reasonable level of pricing power in negotiations with private health insurers. Unlike the United States, the Australian healthcare system relies on a unique blend of public and private service, most evident in the symbiotic relationship between private hospital operators and the private health insurance industry. Beyond the relatively benign reforms of prosthesis pricing recently, we believe government policies designed to support private health insurance membership, combined with current inefficiencies of the public hospital system, protect private hospitals from major funding related disruptions. Furthermore, we regard hospital coverage as a core component of health insurance policies, and given its large and geographically diversified catchment area, we regard Ramsay as well positioned to negotiate attractive commercial terms. We believe its deep pipeline of brownfield projects and recent move into community pharmacy bodes well for earnings growth over the medium to long term. A cautious trading update from peer Healthscope has led to a sell-off in Ramsay's shares, which we think is unjustified, with low levels persisting despite reiteration of full-year guidance by management. At an 18% discount to our fair value estimate, the stock appears significantly undervalued at current levels.

ResMed (ASX: RMD)

Current Market Price: \$8.01 Estimated Fair Value: \$10.50



Narrow moat-rated 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: \$21.65

Estimated Fair Value: \$24.00



**SONIC
HEALTHCARE**

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: \$4.21

Estimated Fair Value: \$7.00



A series of adverse developments since September has opened up an attractive discount between Vocus Communications' stock price and our recently revised AUD 7 fair value estimate. The ructions at the board level (leading to the October resignation of two directors due to difference in opinions regarding the CEO) and the near-term operating slippages unveiled in the November trading update showed we underestimated the cultural and integration risks with the February merger with M2 and Nextgen. However, Vocus now has a unified board and a fully backed management team to drive the company longer term. Despite its teething problems with integrating

three recent large acquisitions, 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 still coming through, although the Nextgen acquisition is underdelivering on initial expectations. A subdued earnings outlook in September from a major competitor in the Australian telecom space raised concerns regarding the impact of National Broadband Network 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 affected 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 as a catalyst. Consequently, we see the current stock price discount to our intrinsic assessment closing over time

Woodside Petroleum (ASX: WPL)

Current Market Price: \$30.94

Estimated Fair Value: \$34.00



woodside

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 the second half of 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.

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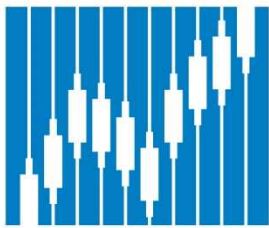
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