

## *iInvest - Top Stock Picks*

November 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 13 companies in our Best Stock Ideas list. Since last month, we have added Ramsay Health Care to the list. There are no removals from the list from last month.

### **Abacus Property Group (ASX: ABP)**

**Current Market Price: \$2.80**

**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: \$97.49**

**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: \$6.37**

**Estimated Fair Value: \$7.00**



**DuluxGroup**

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: \$2.48**

**Estimated Fair Value: \$3.10**



**Folkestone**  
EDUCATION TRUST

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: \$5.71**

**Estimated Fair Value: \$8.50**



**ILUKA**

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: \$27.50**

**Estimated Fair Value: \$31.00**



National Australia Bank reported a solid fiscal 2016 result with clear signs the benefits of existing legacy assets is 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 overtime 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: \$4.84      Estimated Fair Value: \$7.00**



Platinum Asset Management is a highly successful Australian fund manager specializing 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: \$71.52      Estimated Fair Value: \$87.00**



Narrow moat Ramsay Health Care is a global hospital group operating 223 hospitals and day surgery facilities across Australia, the United Kingdom, France, Indonesia and Malaysia. It is also the largest and most diversified operator of hospitals in the Australian private sector. 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 providers given the fiscal challenges facing the government. 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 cover as a core component of health insurance policies and given its large and geographically diversified catchment area, 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 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, we regard the stock as significantly undervalued at current levels and add Ramsay to our best ideas list.

## ResMed (ASX: RMD)

**Current Market Price: \$7.52      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: \$19.87**

**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: \$5.24**

**Estimated Fair Value: \$7.40**



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: \$27.71**

**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 mmbob 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: \$23.09 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 2017 expected to be 4.4% compared with 4.8% in fiscal 2016. 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. iInvest Securities Pty Ltd (ABN 44 246 838 283) ("iInvest") does not guarantee or take responsibility for the accuracy, completeness, estimates or appropriateness of any information or statement of opinion (any of which may change without notice) set out in this document.



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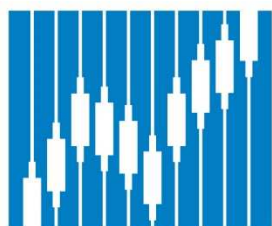
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