



iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

February 2017

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 eight companies in our Best Stock Ideas list. Since last month, we have added iSentia Group. We have removed CSL, Iluka Resources, National Australia Bank and Woodside Petroleum from our list, due to price appreciation in the names.

In alphabetical order, our Best Stock Ideas list comprises: DuluxGroup; Folkestone Education Trust; iSentia Group; Platinum Asset Management; Ramsay Health Care; ResMed; Sonic Healthcare; and Vocus Group. We discuss each stock within the report.

We are removing CSL from our Best Ideas list given the 21% increase in the share price since Dec. 8, 2016, compared with an increase of approximately 2% in the S&P/ASX 200 over the same period. Although we continue to see upside earnings potential from integration of the Novartis influenza vaccine business, we regard the current discount to our fair value estimate as insufficient to warrant remaining a Best Idea.

We remove Iluka Resources from our global Best Ideas list as the shares have converged most of the way towards our AUD 8.50 per share fair value estimate. Rapid share price appreciation to above AUD 7.50 in January 2017 from October 2016 lows around AUD 5.60 means the shares trade near our fair value estimate and we no longer see sufficient value on offer for Iluka to remain a Best Idea. The market has responded positively to the acquisition of Sierra Rutile and has started to factor in better prices for zircon and high grade titanium dioxide feedstocks; rutile and synthetic rutile. Markets for zircon and titanium dioxide feedstocks have been tightening through 2016 and price increases slated for 2017 have boosted sentiment.

Following a strong share price performance during the past seven months, National Australia Bank is trading close to our AUD 31 per share fair value estimate and we now remove the stock from Best Ideas. Still, we remain comfortable with our long-term view; the removal from the Best Ideas is purely price-driven. Excluding dividends, the stock has returned around 11% since inclusion in Best Ideas in early July 2016. Our positive view has played out as it ramps up investment in its profitable Australian and New Zealand banking franchises following years of painful restructuring of its underperforming international assets. Disposing of legacy assets, focusing on higher return business, improving operational efficiency, tightening loan underwriting standards and boosting retail customer satisfaction levels underpin the earnings outlook.

Woodside Petroleum has risen more than 30% since AUD 24 per share April 2016 lows, and we have removed it from the Best Ideas list. At AUD 32, the discount to our AUD 35.50 fair value estimate has narrowed to just 10% and the margin of safety is no longer sufficient. Fair value uncertainty for this no-moat-rated stock remains high. Still, we remain comfortable with our long-term view, removal from Best Ideas is purely price-driven. The outlook for Woodside remains positive, as the company is the least leveraged of the three larger Australian hydrocarbon producers, with a rising production profile due to commissioning of Wheatstone LNG. The company is also well placed to participate in further LNG capacity growth via expansion of its existing facilities including Pluto LNG, or participation in third-party deals.

Dulux Group (ASX: DLX)

Current Market Price: \$6.10

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-fuelled new housing stock and the ageing 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: \$2.47

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 discount to our fair value estimate and offers a 5% 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, 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.

iSentia Group (ASX: ISD)

Current Market Price: \$2.61

Estimated Fair Value: \$3.50



A profit downgrade in the second half of 2016 had an impact on iSentia's share price, relating to its recently acquired content marketing division. However, only around 5% of group EBITDA comprises content marketing and we consider these issues to be fixable. We expect confidence to gradually return to the stock as earnings are announced and investors recognise attractive attributes such as a high proportion of recurring earnings and Asian growth potential. The company already has a dominant position in Asia with a leading revenue market share of around 30%, or five times its nearest competitor Meltwater, and a revenue market share of around 90% in Australia and New Zealand. Earnings are reasonably sticky and the average tenure of iSentia's top 50 clients is around 11 years. The business model is also capital-light, meaning financial leverage is likely to remain relatively low and cash flows should be available for dividends and acquisitions.

Platinum Asset Management (ASX: PTM)

Current Market Price: \$4.96 Estimated Fair Value: \$6.30



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 net inflows. Key positives include strong brand recognition stemming from excellent long-term fund performances and a tailwind from Australia's growing pool of superannuation savings. We believe international equities will be an increasing part of individual retirement savings strategies in Australia as we expect Australia's investable asset pool over time not being large enough to meet the increasing flow of superannuation fund contribution as well the opportunity to invest in a more diverse range of industries offshore than available on the Australian market. Platinum is well positioned in this regard having a long presence and investment track record in this space. With minimal capital expenditures and a very strong 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. Platinum is attractively priced and while there are short-term pressures, we expect earnings to recover given its strong brand and long-term investment performance track record. The ability of Platinum funds to take short positions provides it with opportunities to outperform in most market conditions. Downside risks come from protracted investment underperformance of key funds and funds net outflows.

Ramsay Health Care (ASX: RHC)

Current Market Price: \$67.23 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, 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 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. We also think Ramsay's centralized procurement strategy leveraging global purchasing power of the group bodes well for margin expansion. 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 the current discount to our fair value estimate, we regard the stock as significantly undervalued.

ResMed (ASX: RMD)

Current Market Price: \$8.78

Estimated Fair Value: \$10.00



We are retaining narrow -moat ResMed, the only listed pure-play company focused on sleep-disordered breathing, on our Best Ideas list given the still attractive discount to our fair value estimate. We remain comfortable with our forecasts given the strong second quarter financial result which was underpinned by ongoing strong demand for the Airsense10 flow generator coupled with the healthy uptake of the recently launched Airfit F20 full-face mask and the Airfit N20 nasal mask in the United States. We think the negative sentiment generated by the disappointing results of the Serve-HF trial is finally dissipating and remain positive with the company's efforts to diversify into adjacent medical areas such as chronic obstructive pulmonary disease. Although SERVE-HF was disappointing, we believe clinical evidence to date linking sleep-disordered breathing to a host of medical disorders beyond cardiology represents commercial opportunities for ResMed. ResMed's integrated product suite creates an application ecosystem in sleep apnea, thereby strengthening switching costs for clinicians and patients. Notably, given the primary listing on NYSE, ASX-traded CDI's (CHESS Depository Instruments) also benefit from weakness in the Australian dollar versus the U.S. dollar.

Sonic Healthcare (ASX: SHL)

Current Market Price: \$21.14

Estimated Fair Value: \$24.00



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Vocus Communications Limited (ASX: VOC)

Current Market Price: \$4.18

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 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 chief executive officer) and the near-term operating slippages unveiled in the November trading update showed that 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 fiber and Ethernet unit--one that enjoys juicy margins (40%-plus) and return on invested capital (20%-40% -plus, depending on the number of customers to a fiber -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 facilitating as a catalyst. Consequently, we see the current stock price discount to our intrinsic assessment closing over time.

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