

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

March 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 Top Stock Picks list. Since last month, we have added Santos and removed iSentia Group from our list.

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

Santos returns to the Best Ideas list after a material reduction in balance sheet risk. With shares trading at nearly AUD 3.75, we believe investors are offered 40% potential upside. Capital expenditures now run at a largely maintenance level, and we forecast free cash flow to exceed AUD 1.0 billion by the end of 2021—sufficient to expunge net debt in that year all else being equal, including reinstatement of a 40% payout ratio from 2018. Santos is currently paying no dividends. Net debt/EBITDA stood at 2.9 in 2016, down from 4.1 a year earlier, with a reduced net debt load of AUD 4.3 billion because of the AUD 1.0 billion institutional placement in December. In conjunction with improved oil prices, we project net debt/EBITDA of just 1.5 in 2017, eminently manageable. We applaud Santos' focus on supporting five core, low-cost/long-life natural gas assets, all with significant upside potential. The refreshed management team is making good on promises for cash-generative restructuring. Upstream unit costs in 2016 fell 18% to USD 8.50 per barrel of oil equivalent, restructuring that includes a 580-person reduction in its workforce, leaving operations free cash flow-positive at oil prices above USD 36.50 per barrel. This is 22% below 2015's USD 47 figure and not far above Woodside's commendable USD 35 mark. This is the way to improve the company's competitive position, though we still don't assign a moat to the company given PNG and Gladstone's LNG trains were built at the peak of resources investment boom.

We have removed iSentia from the Best Ideas list after a material deterioration in the financial performance of the company over the past six months and a review of our investment thesis. The company appeared to be performing in line with our previous investment thesis as recently as last August when it announced a 17% increase in fiscal 2016 underlying net profit after tax. We believed the losses announced last November within the content marketing division were an isolated issue impacting a relatively small part of the business. However, the announcement of further weakness this month within the core ANZ SaaS division indicates a larger competitive threat, providing sufficient cause to materially reduce our earnings forecasts, cut our fair value estimate by 36%, and increase our fair value uncertainty rating from medium to high. We now believe the business is of insufficient quality for inclusion on the Best Ideas list.

Dulux Group (ASX: DLX)

Current Market Price: \$6.21

Estimated Fair Value: \$7.00



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: \$2.79

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 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.

Platinum Asset Management (ASX: PTM)

Current Market Price: \$5.09

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 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: \$69.46

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 U.K., 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 centralised 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: \$9.41

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 (CHES Depository Instruments) also benefit from weakness in the Australian dollar versus the U.S. dollar

Santos Limited (ASX: STO)

Current Market Price: \$3.72

Estimated Fair Value: \$5.30



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Sonic Healthcare (ASX: SHL)

Current Market Price: \$21.50

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. We retain Sonic on our Best Ideas list given the current 13% discount to our intrinsic valuation.

Vocus Communications Limited (ASX: VOC)

Current Market Price: \$4.42

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 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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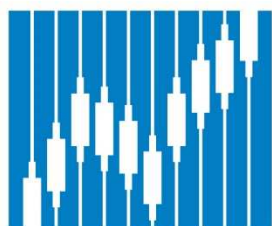
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