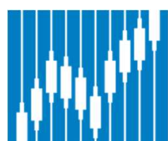


iInvest Securities
Stockbroking & Wealth Management

iInvest - Top Stock Picks

April 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 top pick 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 Brambles and removed Dulux Group from our list.

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

Brambles returns to Top Picks, following the recent change in management in its U.S. pallet division. The stock was originally added in November 2015 and removed in February 2016, during which period the share price went up about 7%, Since Brambles was taken off from the list, the share price fell about 16% in comparison with last close price. Wide moat-rated Brambles is trading at a 15% discount to our AUD 11.00 fair value estimate. In our view, investors are underestimating Brambles' earnings leverage to U.S growth, the associated benefits of higher pallet flows from emerging markets, and further consolidation. In the short term, we expect new management to address recent underperformance in the U.S. pallet segment, which accounts for 40% of earnings, by strengthening key retail relationships, reducing damage rates, and lifting service levels. We expect these moves to further entrench Brambles' dominant market share of 40%, which eclipses the 7% share of number-two player Peco. We forecast EPS CAGR of 8% and average ROICs of 15% for fiscal years 2017-21, which underpin our fair value estimate.

We are removing Dulux Group from our Top Picks list following recent share price outperformance and its movement into the Hold recommendation zone. The stock is now trading at only a 7% discount to our AUD 7.00 fair value estimate. Dulux has benefited from investor optimism surrounding an expected pickup in housing renovation spend (4.8% CAGR for fiscal years 2017-21) and recent success in introducing its high-margin Wash & Wear paint range. Recent global M&A activity (PPG/Akzo Nobel and Sherwin Williams/Valspar) has also provided valuation support. With 80% of earnings tied to renovations activity, Dulux has a high level of earnings visibility with EPS CAGR of 5.5% for fiscal year 2017-21. Dulux Group was added to the Top Picks on June 30, 2016. The stock delivered an approximately 9% total return during this period.

Brambles Limited (ASX: BXB)

Brambles

Current Market Price: $9.43 **Estimated Fair Value: $11.00**

Wide moat-rated Brambles is trading at a 15% discount to our AUD 11.00 fair value estimate. In our view, investors are underestimating Brambles' earnings leverage to U.S growth, the associated benefits of higher pallet flows from emerging markets, and further consolidation. In the short term, we expect new management to address recent underperformance in the U.S. pallet segment, which accounts for 40% of earnings, by strengthening key retail relationships, reducing damage rates, and lifting service levels. We expect these moves to further entrench Brambles' dominant market share of 40%, which eclipses the 7% share of number-two player Peco. We forecast EPS CAGR of 8% and average ROICs of 15% for fiscal years 2017-21, which underpin our fair value estimate.

Folkestone Education Trust (ASX: FET)

Current Market Price: $2.80 **Estimated Fair Value: $3.10**

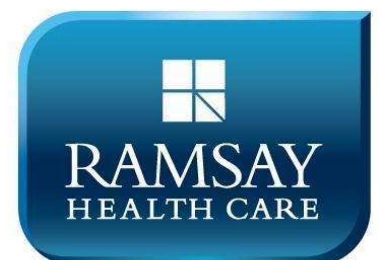
Narrow -moat-rated Folkestone Education Trust is an owner of child-care centres, and we expect it to benefit from positive macroeconomic trends. We anticipate government funding for long-day child care to continue growing in real terms above the population growth rate. Also, a continuously growing child 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. We anticipate the trend of steadily rising subsidies for child care to continue in the foreseeable future, underpinned by the progression of the Federal Government's Jobs for Families Child Care Package bill through the Senate. 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.

Platinum Asset Management (ASX: PTM)

Current Market Price: $5.08 **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. Given its ability to take short positions in its funds, historically, Platinum funds have typically outperformed in bear markets and produced market returns in bull markets. Downside risks come from protracted investment underperformance of key funds and funds net outflows

Ramsay Health Care (ASX: RHC)



Current Market Price: $68.80 **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: $9.37 **Estimated Fair Value: $10.00**

We are retaining narrow-moat ResMed, the only listed pure-play company focused on sleep-disordered breathing, on our Top Picks 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 CDIs (CHESS Depositary Instruments) also benefit from weakness in the Australian dollar versus the U.S. dollar.

Santos Limited (ASX: STO)

Current Market Price: $3.70 **Estimated Fair Value: $5.30**

Santos returns to the Top Picks 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 largely a 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 boe, 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 don't assign a moat to the company given PNG and Gladstone's LNG trains were built at the peak of resources investment boom.

Sonic Healthcare (ASX: SHL)

Current Market Price: $21.82 **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 Top Picks list given the current 8% discount to our intrinsic valuation.

Vocus Communications Limited (ASX: VOC)

Current Market Price: $4.16 **Estimated Fair Value: $7.00**

A series of adverse developments since September have opened up an attractive discount between Vocus Communications' stock price and our AUD 7.00 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 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 facilitating as a catalyst. Consequently, we see the current stock price discount to our intrinsic assessment closing over time.

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