

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

May 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 seven companies in our Top Stock Ideas list. Since last month, we have added Hotel Property Investments, and removed Folkestone Education Trust and ResMed from our list.

In alphabetical order, our Top Stock Ideas list comprises: Brambles; Hotel Property Investments; Platinum Asset Management; Ramsay Health Care; Santos; Sonic Healthcare; and Vocus Group. We discuss each stock within the report.

Narrow moat-rated Hotel Property Investments is one of our preferred picks in the Australian REIT sector, currently trading at a 13% discount to our fair value estimate of AUD 3.40. The current price implies an estimated fiscal 2017 distribution yield of about 7%. Hotel Property Investments owns a portfolio of pub properties primarily in Queensland. The pubs are leased almost exclusively to subsidiaries of supermarket giant Coles. Medium term earnings are highly secure, due to its strong tenant and no material lease expiries until fiscal 2021. Unlike many Australian REITs, we expect the portfolio to realise robust rental income growth of about 4% per year. It is assured by typical contract terms of rental increases of twice the consumer price index, or at a fixed rate. Population growth in Queensland provides a positive macroeconomic backdrop. Key risks include potential changes to Queensland gambling and liquor regulation, which could negatively affect pub profitability and therefore rents as leases roll over. Considering the distribution yield, relatively secure medium-term earnings, and solid growth, we consider Hotel Property Investments an attractive income stock.

We are removing narrow-moat-rated Folkestone Education Trust from our Top Ideas list on valuation grounds, as we see more attractive opportunities elsewhere. Units are now roughly fairly priced, trading at only a 6% discount to our intrinsic assessment and offering an estimated distribution yield of 5.0%. Our investment thesis is unchanged. We expect child care operators and by extension child care centre owners such as Folkestone Education Trust to benefit from the positive macroeconomic trends affecting the child care industry. As we had anticipated, the federal government remains supportive of long-day child care, with legislation for the overhaul of the child care system passing the senate in March 2017. We expect government funding to continue growing in real terms above the population growth rate for the foreseeable future. Folkestone Education Trust was added to Top Ideas on Aug. 31, 2016.

We are removing ResMed from our Top Ideas. Our narrow moat rating is unchanged and we remain positive on the company's commercial prospects in both sleep apnea and adjacent medical indications. However, we regard the current discount to our fair value estimate as insufficient to warrant remaining on the Top Stocks list.

Brambles Limited (ASX: BXB)

Current Market Price: \$10.20

Estimated Fair Value: \$11.60

Brambles

Wide-moat rated Brambles is trading at a 11% discount to our AUD 11.60 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 9.2% and average ROICs of 16% for fiscal year 2017-21, which underpin our fair value estimate.

Hotel Property Investments (ASX: HPI)

Current Market Price: \$2.98

Estimated Fair Value: \$3.40



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typical contract terms of rental increases of twice the consumer price index, or at a fixed rate. Population growth in Queensland provides a positive macroeconomic backdrop. Key risks include potential changes to Queensland gambling and liquor regulation, which could negatively affect pub profitability and therefore rents as leases roll over. Considering the distribution yield, relatively secure medium-term earnings, and solid growth, we consider Hotel Property Investments an attractive income stock.

Platinum Asset Management (ASX: PTM)

Current Market Price: \$4.35

Estimated Fair Value: \$5.50



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. We recently lowered our fair value estimate to account for lower base management fees but our long term positive view remains. 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, fear of weaker equity markets and the impact of lower fees are currently weighing on the share price. We look to the full year result release in late August for an update on whether lower fees and more performance fees fund options are benefitting funds flows. 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 which would impact funds net outflows.

Ramsay Health Care (ASX: RHC)

Current Market Price: \$70.70

Estimated Fair Value: \$87.00



Narrow-moat 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. 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. At the current discount to our fair value estimate, we regard the stock as significantly undervalued.

Santos Limited (ASX: STO)

Current Market Price: \$3.45

Estimated Fair Value: \$5.30



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 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: \$22.15

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 think the upcoming federal budget in Australia may contain a few surprises with potentially positive implications for Sonic. Sonic is currently trading at an 8% discount to our intrinsic valuation.

Vocus Communications Limited (ASX: VOC)

Current Market Price: \$3.43

Estimated Fair Value: \$6.40



A series of adverse recent developments has opened up an attractive discount between Vocus' stock price and our AUD 6.40 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 near-term operating slippages showed that we underestimated the cultural and integration risks with the M2 merger and the Nextgen purchase. However, Vocus now has a unified board and a fully backed management team to drive the company forward. Despite its teething problems with integrating recent 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%). In addition, synergies are still coming through from all the recent acquisitions. There are market concerns regarding the impact of National Broadband Network on Vocus. However, we believe the NBN impact on Vocus is relatively limited 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. TPG Telecom's intention to become the fourth mobile network operator in Australia is likely to have a negative impact on the group's Australian mass market unit. It will heighten competitive tension for Vocus' dodo and iPrimus broadband offerings, with the former's value-conscious customers particularly vulnerable to what is likely to be keenly-priced mobile/broadband packages from TPG. However, this threat has several years to play out and is already factored into our intrinsic assessment. Consequently, we see the current stock price discount to our intrinsic assessment closing over time.

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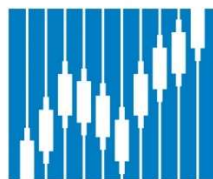
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