



**iInvest Securities**

Stockbroking & Wealth Management

## *iInvest - Top Stock Picks*

**June 2017**

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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 encourage investors to read our most recent stock reports for a more detailed appraisal.

This month we have seven companies in our Top Stock Picks list. Since last month, we have added Westfield Corporation and removed Sonic Healthcare from our list.

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

This month we have added Westfield Corporation to our Top Stock Picks list. We think the escalation in the number of struggling U.S. apparel brands along with the prospect of rising interest rates are the two factors weighing on the share price of narrow moat-rated Westfield Corporation. Both risks are real, but we believe there has been a share price over-reaction and Westfield now screens as attractively priced. We believe brick-and-mortar will face further challenges from a higher proportion of sales occurring through online channels, but Westfield has the option to reallocate space that is currently occupied by struggling fashion brands to alternative uses such as dining and services. We expect the incoming tenants to have marginally lower rent-paying capacity and account for this in our forecasts for the annual growth trajectory to systematically trend down to 3%. As has already occurred in major Asian cities, we see Westfield's retail malls evolving to become de facto town centres, rich with entertainment, dining, and essential services, but also extended trading hours.

We are removing Sonic Healthcare from our Top Stock Picks List. Our narrow-moat rating is unchanged and we remain positive on the company's commercial prospects given increasing geographic diversification of its offshore pathology business, and the reinstated indexation of Medicare rebates for general practitioners in Australia announced in the May Budget. However, we regard the current discount to our fair value estimate as insufficient to warrant remaining on the Top Stock Picks List.

### **Brambles Limited (ASX: BXB)**

**Current Market Price: \$10.52**

**Estimated Fair Value: \$11.60**

# **Brambles**

Wide moat-rated Brambles is trading at an 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 flow 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: \$3.04**

**Estimated Fair Value: \$3.40**



Narrow moat-rated Hotel Property Investments is one of our preferred picks in the Australian REIT sector, currently trading at an 11% discount to our fair value estimate of AUD 3.40. The current price implies an estimated fiscal 2018 distribution yield of about 7%. Hotel Property Investments owns a portfolio of pub properties primarily in Queensland state. 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.

## Platinum Asset Management (ASX: PTM)

**Current Market Price: \$4.48**

**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 benefiting 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: \$69.87**

**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 services, 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: \$3.27**

**Estimated Fair Value: \$5.30**



Santos returned to the Top Stock Picks list after a material reduction in balance sheet risk. With shares trading near AUD 3.30, we believe investors are offered 60% 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.

## **Vocus Communications Limited (ASX: VOC)**

**Current Market Price: \$2.89**

**Estimated Fair Value: \$4.80**



Despite the recent reduction in our fair value estimate for Vocus to AUD 4.80 per share, the stock is still trading at a material discount to our intrinsic assessment. Management's 16% downgrade to its previous fiscal 2017 EBITDA guidance raises serious doubts about the group's financial controls and systems, and makes it clear Vocus has bitten off more than it can chew with its recent spate of mergers and acquisitions. The good news amid the current mess is that most of the factors behind the downgrade appear self-inflicted and fixable. It underscores the importance of the transformation program currently underway, involving restructuring of the finance function, consolidating all reporting/finance tools and unifying the enterprise resource planning system. It is a process we expect management (either under the current CEO or a replacement) to execute successfully, albeit it is likely to be a long, arduous one. Our investment thesis for Vocus remains anchored to the long-term upside from lifting market share in corporate (from current 5% level) and mass market broadband (from the current 7% level). There are market concerns regarding the impact of National Broadband Network, or NBN, 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. 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 fair value estimate closing over time.

## **Westfield Corporation (ASX: WFD)**

**Current Market Price: \$8.57**

**Estimated Fair Value: \$10.00**



We think the escalation in the number of struggling U.S. apparel brands along with the prospect of rising interest rates are the two factors weighing on the share price of narrow moat-rated Westfield Corporation. Both risks are real, but we believe there has been a share price over-reaction and Westfield now screens as attractively priced. We believe brick-and-mortar will face further challenges from a higher proportion of sales occurring through online channels, but Westfield has the option to reallocate space that is currently occupied by struggling fashion brands to alternative uses such as dining and services. We expect the incoming tenants to have marginally lower rent-paying capacity and account for this in our forecasts for the annual growth trajectory to systematically trend down to 3%. As has already occurred in major Asian cities, we see Westfield's retail malls evolving to become de facto town centres, rich with entertainment, dining and essential services, but also extended trading hours. The combination of an attractive tenant mix and the higher household income of inner city locations is forecast to result in the sales and rental performance of Westfield's larger centrally located malls outperforming the broader market. The demographic trends towards apartment living is driving up the population density in major global cities. Westfield's strategy is to leverage these trends by deploying capital to develop new malls or expand existing ones in London, Milan, San Diego, Los Angeles, and San Francisco. In approximately five years, these inner-city super-regional malls will represent 90% of Westfield's portfolio.

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