

**iInvest Securities**

Stockbroking & Wealth Management

## *iInvest - Top Stock Picks*

### July 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 nine companies in our Top Stock Picks list. Since last month, we have added Contact Energy and Westpac Banking Corporation to the list. In alphabetical order, our Top Stock Picks list comprises: Brambles; Contact Energy; Hotel Property Investments; Platinum Asset Management; Ramsay Health Care; Santos; Vocus Group; Westfield Corporation; and Westpac Banking Corporation. We discuss each stock within the report.

This month we have added Contact Energy to our Top Stock Ideas list. Narrow-moat Contact Energy is one of New Zealand's major energy utilities. Shares trade at a 13% discount to our fair value estimate, and we believe patient investors will see strong dividend growth over the medium term. Earnings face headwinds at present from weak wholesale electricity prices and the firm's low hydro storage levels, which force the firm to rely more on its costlier gas-fired power stations. But modest demand growth, normalisation of rainfall, lower transmission prices, and cost savings from new IT systems lay a clear path for earnings growth over the medium term. While Contact's dividend yield isn't as heroic as some peers, its free cash flows are very strong, positioning the firm well to either significantly increase dividends or undertake a share buyback once financial leverage falls to target levels in a year or two. To put in perspective, we believe it could afford, if it chooses, to increase dividends by up to 50% within a couple of years.

We add wide-moat-rated Westpac to our Top Stock Picks list following a recent share price pullback. Westpac is trading at a 13% discount to our AUD 35 fair value estimate and is currently the most attractively priced Australian major bank. Westpac is highly exposed to the strongest and most populous states of New South Wales and Victoria, and in our opinion, possesses the best earnings growth prospects of Australia's highly profitable major bank oligopoly. Our earnings per share growth forecasts are underpinned by steady credit growth, broadly stable net interest margins, and a best-in-peer-group record of loan underwriting standards. Westpac's low loan-loss rate continues to impress, despite modest increases expected over the next few years. The key attraction for Westpac is its globally impressive efficiency underpinned by its peer-group-low sub-42% cost/income ratio. Our fiscal 2017 forecast dividend yield of 6.2% grosses to a very attractive 8.9% when adjusted for franking credits for Australian taxpayers. Recent price weakness is overdone as Westpac suffered more than peers from a round of unimpressive interim financial reports in early May and increased political scrutiny, culminating in the federal government's bank levy followed by a similar levy announced by the South Australian state government. A key near-term share price catalyst is a more-benign-than-expected capital outcome when the banking regulator clarifies "unquestionably strong" in the next month

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

**Current Market Price: \$9.70 Estimated Fair Value: \$11.60**

# Brambles

Wide-moat-rated Brambles is trading at a 16% 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 entrench Brambles' dominant market share of 40%, which eclipses the 7% share of number-two player Peco. We forecast an earnings per share compound annual growth rate of 9.2% and average returns on invested capital of 16% for fiscal 2017-21, which underpin our fair value estimate

## Contact Energy Limited (ASX: CEN)

**Current Market Price: \$4.98**

**Estimated Fair Value: \$6.00**



Narrow-moat Contact Energy is one of New Zealand's major energy utilities. Shares trade at a 13% discount to our fair value estimate, and we believe patient investors will see strong dividend growth over the medium term. Earnings face headwinds at present from weak wholesale electricity prices and the firm's low hydro storage levels, which force the firm to rely more on its costlier gas-fired power stations. But modest demand growth, normalisation of rainfall, lower transmission prices, and cost savings from new IT systems lay a clear path for earnings growth over the medium term. While Contact's dividend yield isn't as heroic as some peers, its free cash flows are very strong, positioning the firm well to either significantly increase dividends or undertake a share buyback once financial leverage falls to target levels in a year or two. To put in perspective, we believe it could afford, if it chooses, to increase dividends by up to 50% within a couple of years.

## Hotel Property Investments (ASX: HPI)

**Current Market Price: \$3.00**

**Estimated Fair Value: \$3.40**



Narrow-moat-rated Hotel Property Investments is one of our preferred picks in the Australian real estate investment trust sector, currently trading at a 12% 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. The pubs are leased almost exclusively to subsidiaries of supermarket giant Coles. Medium-term earnings are highly secure due to its strong tenants and no material lease expiries until fiscal 2021. Unlike with 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: \$4.69**

**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. 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 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. Shorter-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 fund 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 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 affect funds net outflows.

## Ramsay Health Care (ASX: RHC)

**Current Market Price: \$73.39**

**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. The scale of Ramsay's operations in the Australian context underpins, in our opinion, a sustainable competitive advantage that 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, we 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.

## Santos Limited (ASX: STO)

**Current Market Price: \$3.07**

**Estimated Fair Value: \$5.30**



With Santos' shares trading around AUD 3, we believe investors are offered 75% 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 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 that PNG and Gladstone's LNG trains were built at the peak of resources investment boom

## Vocus Communications Limited (ASX: VOC)

**Current Market Price: \$3.38**

**Estimated Fair Value: \$4.80**



Kohlberg Kravis Roberts' indicative proposal to acquire narrow-moat Vocus at AUD 3.50 per share is following a typical private equity playbook: lob a lowball indicative offer, litter it with an exhaustive list of conditions, and hope there are no competing bids while it takes a look under the bonnet (assuming it is allowed due diligence). However, the indicative proposal is pitched at a multiple of 7.6 times fiscal 2018 EBITDA estimate, hardly a knockout premium to the 6.6 times sector average. It is also substantially below our unchanged AUD 4.80 fair value estimate. We concede there is a long, arduous road ahead for existing management to fix the current inadequate systems, processes, and controls and properly integrate the recent string of acquisitions. However, we believe most of these issues are self-inflicted and fixable. Our investment thesis for Vocus remains anchored to the long-term upside from lifting market share in corporate (from the current 5% level) and mass-market broadband (from the current 7% level). KKR, and potentially other interested parties, appear willing to wear the near-term pain so as to benefit from the longer-term gain that we are incorporating in our intrinsic assessment.

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

**Current Market Price: \$8.01**

**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. Both risks are real, but we believe there has been a share price overreaction and Westfield now screens as attractively priced. We believe bricks 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. Demographic trends toward apartment living are 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 superregional malls will represent 90% of Westfield's portfolio.

## **Westpac Banking Corporation (ASX: WBC)**

**Current Market Price: \$31.12**

**Estimated Fair Value: \$35.00**



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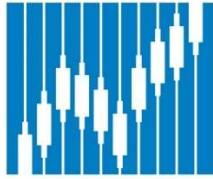
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