

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

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

Platinum Asset Management is removed from our Top Picks list as it is now fairly valued. We continue to believe that this boutique active global equities manager is well-placed to benefit from favourable demographic trends and a mandated superannuation system. Our expectation that global equities will represent a growing part of retirement savings bodes well for Platinum given its long-term investment performance track record, strong brand, and good distribution relationships. Weaker shorter-term performance of funds had weighed on the stock but the latest update to June 30 saw a marked improvement. This saw Platinum shares rally strongly during July to be trading near our fair value estimate. Our forecasts already assume Platinum's highly rated funds (by Morningstar) maintain their long-term investment performance track record. We expect this along with the recent reduction in base management fees and wider availability of performance fee options to help improve fund flows.

Westpac Banking Corporation is removed from our Top Picks list as it is trading close to fair value. We continue to believe the Australian major bank is a high-quality, well-managed, competitively advantaged bank warranting a wide economic moat rating. We forecast steady, but modest EPS growth to average 3.4% per year to end fiscal 2021. Despite the positive long-term outlook, recent prudential and political changes are having an impact on the investment case for Australia's oldest bank. But in our opinion, Westpac remains well-placed to benefit from steady but slow economic growth, modest credit growth, benign loan quality conditions, favourable demographic trends, and a strong brand. Large-scale national distribution capability supports the best-in-peer-group low-cost/income ratio. Our group fiscal 2017 cash profit forecast of AUD 8.2 billion and total fully franked dividend of AUD 1.88 per share are unchanged. Westpac does not provide quarterly trading updates and fiscal 2017 results are due Nov. 6. Westpac's lending growth continues at a reasonable pace with Australian residential mortgage balances outstanding increasing 6.4% for the year to May 31.

Brambles Limited (ASX: BXB)

Current Market Price: \$9.37 Estimated Fair Value: \$11.60

Brambles

Wide-moat-rated Brambles is trading at a 20% 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 CAGR 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: \$5.08

Estimated Fair Value: \$6.00



Narrow-moat Contact Energy is one of New Zealand's major energy utilities. Shares trade at a 11% 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, normalization 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 it 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: \$3.03

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 a 13% 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.

Ramsay Health Care (ASX: RHC)

Current Market Price: \$71.00

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: \$3.41

Estimated Fair Value: \$5.75



With Santos' shares trading around AUD 3.35, 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 \$8.50 per barrel of oil equivalent, restructuring that included a 580-person reduction in workforce, leaving operations free cash flow positive at oil prices above \$36.50 per barrel. Latest news has that figure reduced to just \$33 per barrel, 30% below 2015's \$47 figure. 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: \$3.45

Estimated Fair Value: \$4.80



Kohlberg Kravis Roberts' indicative proposal in June 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 hood (assuming it is allowed due diligence). That was followed by a similar indicative proposal from another private equity party Affinity in July, also at AUD 3.50 per share. However, both indicative proposals are 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 to 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, Affinity, and potentially other interested parties, appear willing to bear 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: \$7.65

Estimated Fair Value: \$8.90



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 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 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 super-regional malls will represent 90% of Westfield's portfolio.

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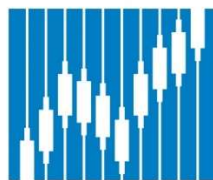
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