iInvest Securities
Stockbroking & Wealth Management

# iInvest - Top Stock Picks

## September 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 added QBE Insurance Group, and removed Vocus Group from the list.

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

Despite requiring further near-term remedial action to resolve operational problems in the Asia-Pacific and Latin America businesses, we maintain our long-term positive view on narrow-moat global general insurer QBE. Short term, we expect more earnings volatility, but from 2018 we forecast steady and consistent earnings growth. We continue to believe in the QBE turnaround story based on improving macro momentum with a long-awaited upturn in global insurance rates, stronger economic conditions in the U.S. and Europe, operational cost savings, and increasing global interest rates. Key businesses continue to improve underlying performance. A strong balance sheet with a growing surplus capital position underpin our dividend growth forecasts and the three-year cumulative AUD 1.0 billion share buyback, which should help support the share price. We like the decision to split the troubled emerging-markets division into its previous structure of separate divisions for Asia-Pacific and Latin America. This should enable a quicker resolution of identified problems. Looking ahead, we expect group profit growth and cash flow generation to impress. Excluding the negative impact of the one-off U.K. Ogden decision and adjusting for USD 60 million in emerging markets losses, we estimate QBE is capable of reporting midcycle cash profits of around USD 1.1 billion per year based on an insurance margin of 10% and modest insurance premium growth. Strong cash conversion, higher dividends, and completion of the buyback should underpin investor interest.

We have removed Vocus from our Top Stock Picks list following the 38% cut to our fair value estimate to AUD 3 on Aug. 23. The recent AUD 1.5 billion goodwill impairment testifies to the excessive optimism on which Vocus pursued acquisitions in recent years and is a belated recognition of its reduced earnings potential in light of rising competition. The current transformation program, partly designed to rectify the consequences of these acquisitions and their failed integration, also appears to be more complicated and likely to take longer than we had previously thought. We see the two private equity firms' recent decisions to walk away from acquiring Vocus as validating these concerns. While we may never know the real reasons, the snub after more than a month of due diligence points to the likelihood that both Kohlberg Kravis Roberts and Affinity Equity also overestimated Vocus' sustainable earnings power. Furthermore, they were perhaps not sufficiently confident that the current efforts to fix Vocus' systems and controls could be done within the typical time frame for private equity before existing at an acceptable internal rate of return. Given these uncertainties, we no longer see Vocus’ place on the Top Stock Picks list as warranted.

## Brambles Limited (ASX: BXB)

**Current Market Price: $9.34  Estimated Fair Value: $11.20**

Wide-moat-rated Brambles remains undervalued, in our view, with the shares trading at a 17% discount to our revised AUD 11.20 fair value estimate. We believe the market is concerned about the sustainability of pallet growth and the Brambles business model, given the growth of e-commerce, and particularly Amazon. We do not expect e-commerce to halt pallet growth and see these concerns as misplaced. 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 more than 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 EPS CAGR of 10.2% and average returns on invested capital of 14% for the next five years.

## Contact Energy Limited (ASX: CEN)

**Current Market Price: $5.01  Estimated Fair Value: $6.00**

Narrow-moat Contact Energy is one of New Zealand's major energy utilities. Shares trade at a 10% 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 the firm's low hydro storage levels, which force it 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. Contact's free cash flows are very strong, positioning the firm well to significantly increase dividends as financial leverage falls to target levels shortly. Guidance is for dividends to jump 23% to NZD 0.32 in fiscal 2018, and we expect a similar increase in fiscal 2019.

## Hotel Property Investments (ASX: HPI)

**Current Market Price: $3.05  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 8% discount to our fair value estimate of AUD 3.40. The current price implies an estimated fiscal 2018 distribution yield of about 6%. 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.

## QBE Insurance Group (ASX: QBE)

**Current Market Price: $10.37** **Estimated Fair Value: $13.00**

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## Ramsay Health Care (ASX: RHC)

**Current Market Price: $66.21** **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. We think Ramsay’s move into community pharmacy is complementary to acute treatment settings and extends the company’s reach into chronic disease management; this is a growing area, given the ageing demographic. 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: $3.75** **Estimated Fair Value: $5.75**

With Santos' shares trading around AUD 3.70, we believe investors are offered 55% 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 USD 36.50 per barrel. Latest news has that figure reduced to just USD33 per barrel, 30% below 2015’s USD 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.

## Westfield Corporation (ASX: WFD)

**Current Market Price: $7.65** **Estimated Fair Value: $8.70**

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 approximately 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.



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