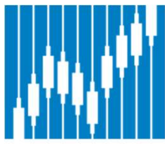

iInvest Securities
Stockbroking & Wealth Management

iInvest - Top Stock Picks

October 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.

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This month we have 10 companies in our Top Stock Picks list. Since last month, we have added Coca-Cola Amatil, Commonwealth Bank of Australia, Domino’s Pizza Enterprises, and Healthscope. We removed Hotel Property Investments from the list.

We are removing narrow-moat-rated Hotel Property Investments from our Top Stocks 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 6.3%. Our investment thesis is unchanged. Medium-term earnings are highly secure, due to its strong tenant, Coles, and no material lease expirations until fiscal 2021. 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 expire. Hotel Property Investments was added to Top Picks on May 1, 2016, returning a total of 10%, including dividends.

In alphabetical order, our Top Stock Picks list comprises: Brambles; Coca-Cola Amatil; Commonwealth Bank of Australia; Contact Energy; Domino’s Pizza Enterprises; Healthscope; QBE Insurance Group; Ramsay Health Care; Santos; and Westfield Corporation. We discuss each stock within the report.

Brambles Limited (ASX: BXB)

Brambles

Current Market Price: $8.96 Estimated Fair Value: $11.20

Wide-moat-rated Brambles remains undervalued, in our view, with the shares trading at a 20% discount to our 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 compound annual growth rate of 10.2% and average returns on invested capital of 14% for the next five years.

Coca-Cola Amatil (ASX: CCL)

Current Market Price: $7.81 Estimated Fair Value: $9.40

Coca-Cola Amatil shares trade at a sizable discount to our fair value estimate. The market appears overly concerned about a continued secular decline in carbonated soft drinks, continued pricing pressure from competitors and retail customers, and diminishing brand strength. While these are valid concerns, Coca-Cola Amatil has defences. We expect smaller package sizes to drive higher revenue per case, successful new product launches in noncarbonated beverages to mitigate sparkling declines, and better overall alignment with parent Coca-Cola to preserve sales and profitability in the core Australian segment. Moreover, we're encouraged that profitability in New Zealand and Fiji, as well as the Indonesia and Papua New Guinea segments, continues to improve nicely. Overall, we believe Amatil's narrow economic moat, driven by strong brand intangible assets and cost advantage, is intact. We forecast consolidated EPS growing at about 4%-5% per year from fiscal 2017, leading to our AUD 9.40 fair value estimate. The market appears to be pricing in a margin of safety that accounts for minimal annual earnings growth. In a realistic bear case for the Australian business, in which revenue declines at 3% annually and operating margins fall below 15% from 17% in fiscal 2016, we estimate shares would still be worth roughly AUD 8.40, or approximately 9% above the current quote. We also note that the stock offers a nearly 6% dividend yield, which we view as sustainable given Amatil's strong free cash flow conversion and conservative balance sheet. The market is not pricing for a turnaround in Coca-Cola Amatil's fortunes, but we think some improvement is likely longer term and investors are being paid to wait.

Commonwealth Bank of Australia (ASX: CBA)

Current Market Price: $76.35 Estimated Fair Value: $85.00

Wide-moat Commonwealth Bank of Australia remains in a strong position despite increasing regulatory and compliance risk. We reduced the bank's stewardship rating to Standard from Exemplary in early August, and several subsequent events have driven an 11% fall in the share price to current levels around AUD 75. In our opinion, Commonwealth Bank is attractively priced, trading 10% below our AUD 85 fair value estimate with a 5.8% forecast fiscal 2018 dividend yield grossing to 8.3% for Australian resident taxpayers. In late August, the Australian Prudential Regulation Authority announced an inquiry into governance, cultural, and accountability issues at Commonwealth Bank. The bank has experienced a horror two month period with the AUSTRAC anti-money-laundering allegations, a potential shareholder class action, the announcement the CEO is to retire no later than June 30, 2018, and the APRA inquiry. But we believe the share price fall is overdone and the stock price offers an attractive entry point. In our view, the regulatory and compliance issues do not detract from the bank's strong competitive advantages that underpin our wide economic moat rating. Commonwealth Bank's robust balance sheet, dominant market positions, strong profitability, solid organic capital generation, and sound loan book are attractive. The bank continues to benefit from modest economic growth in Australia supported by substantial infrastructure spending, high levels of residential construction in major East Coast cities, attractive commodity export prices, increasing export volume, record-low interest rates, good credit growth, and low unemployment, and GDP growth, while subtrend, is expected to pick up, in the Reserve Bank of Australia's view. Although wage growth and savings levels remain low, on balance we believe the current macroeconomic backdrop remains favourable for Commonwealth Bank.

Contact Energy Limited (ASX: CEN)

Current Market Price: $4.96 Estimated Fair Value: $6.20

Narrow-moat Contact Energy is one of New Zealand's major energy utilities. Shares trade at a 12% 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. *The data points are in New Zealand dollars.

Domino's Pizza Enterprises (ASX: DMP)

Current Market Price: $45.38 **Estimated Fair Value: $53.00**

Shares in narrow-moat Domino's trade at a discount of 12% to our AUD 53 fair value estimate. This provides an opportunity for long-term investors to gain exposure to a high-quality growth stock with good geographic diversification. We estimate long-term store counts in Australia, Europe, and Japan to equate to an average capita per store of 28,000, 70,000, and 146,000, respectively. Our Australian forecast is clearly the most aggressive, albeit achievable in our view. The average Australian household has 2.6 persons, equating to a long-term penetration of one Domino's pizza outlet per 11,000 Australian households. This is comfortably above the minimum 3,000 households that we understand are required to underpin a store's profitability. Although not immune to aggregators such as UberEats and Menulog, Domino's has a strong online presence and competes effectively with other takeaway operators, especially on delivery times. In Australia, the firm's e-commerce channel accounts for over 70% of sales, representing an impressive 3% of total Australian online sales across all retail categories. Domino's continues to develop its digital platform, which is driving online sales in all countries. Further, the company is undertaking a share buyback worth as much as AUD 300 million, which we believe is solid capital allocation, given that shares are below our fair value estimate.

Healthscope Limited (ASX: HSO)

Current Market Price: $1.775 **Estimated Fair Value: $2.60**

Unlike larger listed private hospital peer Ramsay Health Care, Healthscope's less diversified business has earnings largely driven by the domestic hospital portfolio and, as a result, more reliant on timely completion and ramp of its ongoing brownfield projects. As such, the slower-than-expected ramp-up in volume at several sites in the state of Victoria disappointed at the full-year result. The shares were sold off following management comments of problems persisting and remaining a drag in the first half of 2018. Nonetheless, at current levels, we consider the shares significantly undervalued and add them to our Top Picks list.

QBE Insurance Group (ASX: QBE)

Current Market Price: $10.30 **Estimated Fair Value: $13.00**

Despite requiring further remedial action to resolve operational problems in the Asia-Pacific and Latin America businesses, we maintain our positive view on narrow-moat-rated global general insurer QBE. Short term, we expect more earnings volatility but from 2018 we forecast steady and consistent earnings growth. We believe in the QBE turnaround story based on improving macro momentum with a long-awaited upturn in global insurance rates, stronger economic conditions in 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.

Ramsay Health Care (ASX: RHC)

Current Market Price: $62.93 **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: $4.04 **Estimated Fair Value: $5.75**

With Santos' shares trading around AUD 4.00, 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 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 USD 33 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: $7.61 **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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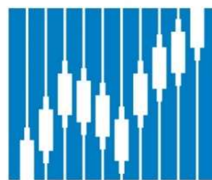

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