

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

November 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 12 companies in our Top Stock Picks list. Since last month, we have added Aveo Group, Crown Resorts, and Telstra Corporation. We removed Contact Energy from the list.

We remove narrow-moat Contact Energy from our Top Picks list on valuation grounds following recent share price strength, which sees the discount to fair value fall to just 7%. Contact is one of New Zealand's major energy utilities. Earnings face headwinds at present, 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 earnings growth should be moderate, dividends will grow strongly as the firm increases its payout ratio once financial leverage returns to target levels. Guidance is for dividends to jump 23% to NZD 0.32 in fiscal 2018, and we expect a similar increase in fiscal 2019.

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

Aveo Group (ASX: AOG)

Current Market Price: \$2.66 Estimated Fair Value: \$3.10



Aveo's share price has fallen after negative media attention in June 2017, and we view the stock as undervalued, trading at meaningful discount to our AUD 3.10 fair value estimate. Accusations raised by the media focused on legacy resident "freehold" contracts in villages that Aveo acquired in August 2016 and have no bearing on the remaining villages where residents stay under "leasehold" contracts. The long-term fundamentals of Aveo's business are ostensibly unchanged, with the firm well-positioned to benefit from the ageing Australian population, driving demand for retirement living units and serviced apartments. Compared with 2017, the number of people turning 75 will be up 14% in 2019 and up 49% in 2022. Aveo continues its high-growth strategy of upgrading legacy units and adding to resident amenity. The firm estimates it can deliver AUD 0.90 per share in book value accretion to the portfolio from these initiatives over the next three years. We have no doubt that Aveo's reputation has been tarnished, but by no means as much as the share price would imply. Around 60% of Aveo's annual earnings is unaffected, representing accrued earnings on resident "deferred fee" contracts entered into roughly 10 years prior. As such, near-term earnings risk centres on a slower sales rate for new and existing units. Aveo is tackling this risk head-on by significantly increasing buying protection on its standard leasehold contracts. Standard contracts now incorporate a try-before-you-buy option, enabling residents stay for six months before committing to purchase. We believe this increased buyer protection, plus guaranteed buyback when a resident departs, simplified contract terms, and enhanced disclosure will significantly allay residual concerns of prospective buyers, without significant long-term cost to Aveo.

Brambles Limited (ASX: BXB)**Brambles****Current Market Price: \$9.67 Estimated Fair Value: \$11.20**

Wide-moat-rated Brambles remains undervalued, in our view, with the shares trading at a 16% 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: \$8.14 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 3% 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: \$80.94 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 drove the share price down 11% to around AUD 75 in late September. The stock price has staged a 5% recovery and in our opinion, Commonwealth Bank remains attractively priced, trading 8% below our AUD 85 fair value estimate with a 5.8% forecast fiscal 2018 dividend yield grossing to 7.9% 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 months 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.

Crown Resorts Limited (ASX: CWN)

Current Market Price: \$12.15

Estimated Fair Value: \$13.50



Narrow-moat Crown Resorts is trading at an attractive 14% discount to our AUD 13.50 fair value estimate. The share price has been punished after the arrest of several Crown employees in China, the consequential blowback for VIP volumes, and, more recently, the allegations of poker machine tampering. The company has denied these serious allegations, and we are giving it the benefit of the doubt for now and treating this as short-term noise. With regards to the VIP volumes, we believe the worst has passed, and we expect a gradual recovery over the coming five years. Looking beyond these near-term challenges, we believe there is a lot to like about the stock. It boasts high-quality, monopoly assets in both Melbourne and Perth, and come 2021, it will open a high-end premium-focused casino in Sydney. Given Crown's strong track record of casino development and exceptional operational performance, we expect returns on the casino to exceed the cost of capital, largely at the expense of local rival The Star Entertainment Group. We are also positive on the company's digital wagering offering CrownBet, which is still in its infant stages, but growing strongly, underpinned by a structural shift toward digital wagering. We are projecting low-double-digit operating income growth over the next five years. Further, the business has undergone a transformation during the past 12 months, withdrawing from Macau and Las Vegas, while scrapping the planned floats of property assets among other sources of distraction. After paying down most of its debt, the balance sheet is in great shape, the business is somewhat derisked, and management is focused on the core domestic portfolio.

Domino's Pizza Enterprises (ASX: DMP)

Current Market Price: \$46.43

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: \$1.95

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 continue to view the shares as undervalued and maintain them on our Top Picks list.

QBE Insurance Group (ASX: QBE)

Current Market Price: \$11.09

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: \$68.29

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: \$4.65

Estimated Fair Value: \$5.75



With Santos' shares trading around AUD 4.50, we believe investors are offered 20% 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 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 the resources investment boom.

Telstra Corporation (ASX: TLS)

Current Market Price: \$3.47

Estimated Fair Value: \$4.60

Shares in narrow-moat Telstra are trading at an attractive 23% discount to our AUD 4.60 fair value estimate, with investors preoccupied with a number of risks facing the group. First, competition is intensifying in the Australian telecom space across all segments. However, we believe Telstra boasts the strength to compete, given sustainable cost advantage from unrivalled scale, infrastructure footprint, and consistent capital spending to maintain this competitive edge. Second, at the current price, the market is assuming that Telstra fails to plug the AUD 3 billion EBITDA hole from the National Broadband Network--an excessively bearish view given the group's competitive position and its solid track record of replacing lost earnings over the past decade. Our intrinsic assessment assumes that Telstra replaces more than AUD 2 billion of the NBN-inflicted earnings hole. Third, while the impending entry of TPG Telecom as a fourth player in the Australian mobile market will reduce Telstra's dominance, we see the overall impact on group earnings as less than 10% given the likely inferiority of TPGs network in terms of quality and coverage. Finally, we think the recently lowered dividend payout is sustainable, providing investors with an attractive 6.2% fully franked yield at current prices, especially with a conservative leverage ratio of 1.4 times. As such, we view the risks facing Telstra as more than reflected in the current stock price, trading at 11 times forward EPS and 5 times EBITDA



Westfield Corporation (ASX: WFD)

Current Market Price: \$8.10

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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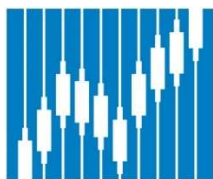
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