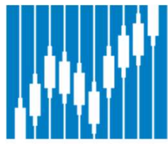

iInvest Securities

Stockbroking & Wealth Management

iInvest - Top Stock Picks

December 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 nine companies in our Top Picks list. Since last month, we have added Auckland International Airport. We removed Commonwealth Bank of Australia, Crown Resorts, Santos, and Westfield Corporation from the list.

Wide moat-rated Commonwealth Bank of Australia's strong start to fiscal 2018 highlights the bank's commanding market position despite the significant brand and reputational damage caused by the AUSTRAC anti-money laundering charges announced in early August. The stock has recovered 10% since hitting August lows and is up 7% since addition to Top Picks in early October. Following the share price recovery, the stock is trading about 7% below our unchanged AUD 85 fair value estimate and consequently we remove the bank from Top Picks. Strong competitive advantages and wide economic moat are undiminished, with Australia's most profitable bank on track to achieve our AUD 10.3 billion fiscal 2018 cash profit forecast with EPS forecast to increase a modest 3.5% on fiscal 2017. A key highlight of first-quarter fiscal 2018 trading update was the decade-low bad debt expense of just AUD 198 million, representing a very low annualised loss rate of 0.11%. The balance sheet continues to strengthen, with good volume growth and improved net interest margins boosting operating income. Commonwealth Bank's robust balance sheet, dominant market positions, strong profitability, solid organic capital generation, and sound loan book underpin attractive long-term earnings upside.

We are removing Crown Resorts from the Top Picks list. The discount to our fair value estimate has narrowed following strong share price performance. As such, the shares are only modestly undervalued at current levels. We have removed Santos from the Top Picks list. Share price appreciation, most recently on the back of takeover rumours, means Santos' fair value discount has narrowed to just 12%. While we are still positive on the outlook for Santos, the price discount is not sufficiently compelling in a high fair value uncertainty company.

We put Westfield on the Top Picks list as the market had overreacted to the escalation in the number of struggling retailers, and now remove it after the share price has recovered towards our fair value estimate. Retail landlords face challenging conditions going forward, most particularly due to more sales occurring via digital channels. However, Westfield is one of the best placed to withstand these challenges as the central locations and attractive tenant mix will provide an enduring drawcard for people to congregate and spend. Further, the high customer amenity at Westfield's premium malls provides significantly greater optionality than lower-grade malls.

In alphabetical order, our Top Stock Picks list comprises: Auckland International Airport; Aveo Group; Brambles; Coca-Cola Amatil; Domino's Pizza Enterprises; Healthscope; QBE Insurance Group; Ramsay Health Care; and Telstra Corporation. We discuss each stock within the report.

Auckland International Airport (ASX: AIA)

Current Market Price: $5.95 **Estimated Fair Value: $6.40**

We think shares of wide-moat Auckland Airport look attractive, owing to investors' focus on near-term pressures instead of the airport's potential for long-term value creation. While the airport's latest pricing and capital spending forecast will lead to sharply lower cash generation over the next five years, we expect the resulting substantial expansion and facility upgrades will support further passenger growth and accelerated pricing, driving healthy EBITDA growth of 9% per year, on average, over the next decade. Moreover, the firm's wide moat remains intact. Auckland Airport is unlikely to face any competition in the foreseeable future, allowing it to continue operating as the predominant airport in New Zealand, and we continue to expect solid passenger traffic growth as the country builds upon its status as a tourist destination. The firm's retail business also offers a high-margin growth opportunity as the airport expands its international terminal to substantially increase retail floor space to take advantage of big-spending international visitors; we forecast this segment climbs to 32% of group revenue from 26% in fiscal 2017. Beyond a decent discount to our fair value estimate, shares also offer a 3.5% distribution yield, and a payout that we expect to grow about 5% per year. The company's balance sheet supports these distributions. We anticipate Auckland will maintain its A- credit rating, supported by its long-term growth outlook, and even a potential equity raising a few years out would reduce our valuation by only 1% to 2%.

Aveo Group (ASX: AOG)

Current Market Price: $2.60 **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 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 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)

Current Market Price: $10.20 **Estimated Fair Value: $11.20**

Wide-moat Brambles remains undervalued, in our view, with the shares trading at a nearly 10% 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: $8.45 **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 long-term 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. While recently accelerated marketing and technology investments will limit near-term earnings growth, we still forecast consolidated EPS growing at about 4%-5% per year over the longer term, 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 4% annually and operating margins fall below 13% from 17% in fiscal 2016, we estimate shares would still be worth roughly AUD 8.00, about even with the current quote. We also note 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.

Domino's Pizza Enterprises (ASX: DMP)

Current Market Price: $46.85 **Estimated Fair Value: $53.00**

Shares in narrow-moat Domino's trade at a discount of 11% 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: $2.05 **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, we are encouraged by progress being made at the Northern Beaches Hospital project, which remains on track and on budget, and view the shares as significantly undervalued at current levels.

QBE Insurance Group (ASX: QBE)

Current Market Price: $10.70 **Estimated Fair Value: $13.00**

Despite requiring further remedial action to resolve operational problems in the Asia-Pacific and Latin America businesses, we are positive on narrow-moat-rated global general insurer QBE Insurance Group. Short term, we expect more earnings volatility but from 2019 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 growing surplus capital 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 $60 million in emerging-markets losses, we estimate QBE is capable of reporting midcycle cash profits of around $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: $70.41 **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 U.S., 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.

Telstra Corporation (ASX: TLS)

Current Market Price: $3.69 **Estimated Fair Value: $4.60**

Shares in narrow-moat Telstra are trading at an attractive 25% 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 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 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 TPG's network in terms of quality and coverage. Finally, we think the recently lowered dividend payout is sustainable, providing investors with an attractive 6.5% 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.

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