iInvest Securities
Stockbroking & Wealth Management

iInvest - Top Stock Picks

February 2018

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 ten companies in our Top Stock Picks list. Since last month, we have added Bapcor and MYOB Group to the list.

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

Aveo Group (ASX: AOG)

Current Market Price: $2.62 **Estimated Fair Value: $3.25**

Aveo's share price has fallen after negative media attention in June 2017, and we view the stock as undervalued, trading at a meaningful discount to our AUD 3.25 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 aging 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 in book value accretion to the portfolio from these initiatives over the next three years. Aveo's reputation has been tarnished, but by no means as much as the share price would imply, in our view. 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 units being turned over or newly developed 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 to 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

Bapcor Limited (ASX: BAP)

Current Market Price: $5.88 **Estimated Fair Value: $7.00**

We are adding narrow-moat-rated Bapcor to the Top Picks list. The shares are currently trading at almost 20% below our fair value estimate, which we believe is an opportunity to invest in a company with a strong growth trajectory, resilience to economic cyclicality, and a dominant competitive position in its core markets. Underlying demand growth for Bapcor's products is underpinned by an increasing pool of vehicles, which we expect to continue growing at around 2% per year. In addition, consumers are inclined to prolong the life of an existing vehicle when times are tough rather than replacing it with a new one, bolstering Bapcor’s resilience to economic downturns. The company’s narrow economic moat rating is underpinned by its intangible assets and cost advantage, which are sourced from its extensive distribution reach and scale. Bapcor's trade customers' main priorities are product range, part availability, fast delivery, and expertise of staff. With over 160 trade outlets conveniently located within 5 kilometres of each of Bapcor’s 30,000-plus auto workshop customers, a product range exceeding 500,000 items, and a leading 30% market share, it is extremely difficult for smaller players to offer the same level of service. Besides Repco, the competition is extremely fragmented. Bapcor is well positioned to continue executing its organic network expansion, stealing share from the smaller players and fortifying its competitive position. We expect scale benefits, operating leverage, and increasing private-label penetration, to drive EBITDA margins up 150 basis points to just over 13% by fiscal 2022.

Brambles Limited (ASX: BXB)

Current Market Price: $9.98 **Estimated Fair Value: $11.20**

Wide-moat-rated Brambles remains undervalued, in our view, trading at a 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: $8.43 **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, only slightly trailing 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.

Domino's Pizza Enterprises (ASX: DMP)

Current Market Price: $47.60 **Estimated Fair Value: $53.00**

The discount at which narrow-moat Domino's shares trade to our AUD 53 fair value estimate 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 Uber Eats 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 the shares trade below our fair value estimate.

Healthscope Limited (ASX: HSO)

Current Market Price: $1.925 **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 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 we view the shares as significantly undervalued at current levels.

MYOB Group (ASX: MYO)

Current Market Price: $3.35 **Estimated Fair Value: $4.05**

Narrow-moat-rated accounting software firm MYOB trades at a material discount to our AUD 4.05 fair value estimate, providing investors with an attractive entry point to a high-quality and well-established Australian software company. We believe the market is preoccupied with Bain Capital's planned sell-down of its relatively large shareholding and ignoring the progress being made with the underlying business. Although the company was slow to respond to the emergence of cloud-based software as a service, it is now quickly transitioning its customers to lucrative cloud-based subscription contracts and defending its strong position in the Australian and New Zealand marketplace. MYOB unfairly remains in Xero's shadow in the eyes of investors as its New Zealand-based competitor has grown more quickly, albeit off a low base, and is building a global business in contrast to MYOB's regional business. However, we are reassured by MYOB's existing profits at a time when profit is almost a dirty word in the software sector. We also applaud management's connected practice strategy which essentially means creating a platform across which businesses, customers, advisors, and regulators can interact. Features such as Pay Super, PayDirect, and smart bills are also increasing customer switching costs--the source of the company's economic moat--and retention rates. The Paycorp acquisition in particular significantly increases MYOB's total addressable market and provides a relatively straightforward and logical cross-sell to existing clients. We expect the recently announced acquisition of Reckon's accounting practice business to strengthen MYOB's competitive position.

QBE Insurance Group (ASX: QBE)

Current Market Price: $10.81 **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. In the 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 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 growing surplus capital underpins 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: $68.81 **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: $3.67 **Estimated Fair Value: $4.60**

Shares in narrow-moat Telstra are trading at an attractive 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 a 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 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 TPG's network in terms of quality and coverage. Finally, we think the recently lowered dividend payout is sustainable, providing investors with an attractive 6.1% 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 12.2 times forward EPS and 5.6 times EBITDA.

iInvest Securities

Stockbroking & Wealth Management