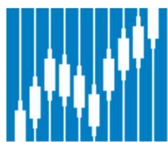


# iInvest - Top Stock Picks

## April 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 11 companies in our Top Stock Picks list. We make no changes to the list from last month.

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

### 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 a meaningful discount to our 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: $5.60** **Estimated Fair Value: $7.00**

Narrow-moat Bapcor is 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: $9.94** **Estimated Fair Value: $11.20**

Wide-moat-rated Brambles remains undervalued, in our view, trading at a discount to our 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. Providing support to this view, the firm noted at its recent analyst day that all new major online fresh produce retailers are beginning to work with IFCO's reus able plastic crates, which should help the segment capture market share. 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, while investment in more automation should also help to improve margins in this geography over the next several years. In all, we forecast an EPS compound annual growth rate of 9.5% and average returns on invested capital of 14% for the next five years.

## Contact Energy (ASX: CEN-NZ*)

**Current Market Price: $4.95** **Estimated Fair Value: $6.20***

The recent share price dip provides another opportunity to pick up shares in narrow-moat-rated Contact Energy, one of New Zealand's major energy utilities. Earnings for the high-quality firm have been under pressure from a combination of weak wholesale electricity prices and low South Island rainfall affecting its hydro generation. While dry conditions remain a risk, wholesale prices are trending up, which provides opportunities for Contact to ramp up output from its gas-fired power stations and push through retail price increases over time. Other medium-term positives include normalisation of weather, cost -out initiatives, modest demand growth, and lower transmission costs. All up, we believe the market is too focused on near-term headwinds and missing the improving medium-term outlook. Plus, debt has fallen to comfortable levels, allowing Contact to divert more free cash flows to dividends. Based on current prices around NZD 5.25, the fiscal 2019 dividend yield of 7% is attractive, and we expect dividends to grow ahead of CPI over the medium term as earnings recover. *The data points are in New Zealand dollars.

## Domino's Pizza Enterprises (ASX: DMP)

**Current Market Price: $40.12** **Estimated Fair Value: $53.00**

The discount at which narrow-moat Domino's shares trade to our 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 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: $1.895** **Estimated Fair Value: $2.40**

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: $3.01** **Estimated Fair Value: $4.05**

Narrow-moat-rated accounting software firm MYOB trades at a material discount to our 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, a nd 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: $9.60** **Estimated Fair Value: $13.00**

Narrow-moat rated QBE Insurance Group's 2017 result was consistent with late January guidance with a reported loss of USD 1.26 billion. 2017 was a horror year for QBE with natural peril events across the globe resulting in the costliest year in the history of the global insurance industry. The sale of the Latin American operations is a good but belated move. The sale to Zurich Insurance Group is expected to complete by the end of 2018 and will reduce risk and enable more focus on the core regions of the United States, Europe, and Australia and New Zealand. QBE's Europe and Australia and New Zealand businesses account for 29% and 28% of respective group gross written premium and USD 335 million and USD 438 million in respective insurance underwriting profit, including policyholder investment returns. Despite the significant loss, our fair value estimate is unchanged. The insurance events and one-off items in 2017 do not affect our long-term view. The stock is currently undervalued, trading 26% below our valuation. The three-year AUD 1.0 billion on-market share buyback remains on hold, with just AUD 139 million purchased in first-half 2017. Guidance is for approximately USD 333 million in buybacks during 2018. We continue to believe QBE is capable of reporting midcycle cash profits of approximately USD 1.0 billion per year based on an insurance margin around 10%. The insurance margin has averaged 9% for the past seven years. We expect QBE Insurance to deliver midcycle returns on equity around low-double-digit levels, modestly above our 9% cost of capital estimate. Despite our confidence, the next two years will require further restructuring, particularly in the North American and Asia-Pacific businesses. We forecast cash profits of USD 847 million in 2018 and USD 1.05 billion in 2019. If achieved, this will be a strong recovery from the disappointments of 2017. Going forward, we expect more sustained and consistent earnings 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.

## Ramsay Health Care (ASX: RHC)

**Current Market Price: $61.47** **Estimated Fair Value: $82.00**

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: $3.13** **Estimated Fair Value: $4.60**

Shares in narrow-moat Telstra are trading at an attractive discount to our 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 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 6.3% fully franked yield at current prices, especially with a conservative leverage ratio of 1.6 times. As such, we view the risks facing Telstra as more than reflected in the current stock price, trading at around 12 times forward EPS and less than 6 times EBITDA.

## Westpac Banking Corporation (ASX: WBC)

**Current Market Price: $28.74** **Estimated Fair Value: $35.00**

Wide-moat-rated Westpac Banking Corporation is our preferred Australian major bank due to stronger-than-peer-group earnings growth forecasts, best-in-peer-group operational efficiency, impressive returns on equity, stable senior management, a strong risk management record, and an Exemplary stewardship rating. We like its record of discipline around cost control, risk management, net interest margins, and shareholder returns. Continued focus on productivity improvement and sustainable growth without the distractions of exiting underperforming legacy assets supports steady but sustainable EPS growth. We expect underlying growth in risk-weighted assets to be modest and, combined with strong profitability and benign credit quality, we expect sustainable but modest growth in the fully franked dividend to be maintained. We forecast average dividend growth of 2% during the next five years with the payout forecast to decline to 74% in fiscal 2022 from 78% in fiscal 2017. Capital levels continue to build, and we anticipate no problems achieving the regulator's definition of "unquestionably strong" by the January 2020 deadline. We expect fully franked special dividends to start by fiscal 2019. Medium term, we expect modest economic growth in Australia with real GDP growth of 2.5%-3.0% per year continuing to support modestly positive operating conditions for the major banks. Forecast nominal GDP growth of 4.0%-4.5% per year underpins our credit growth assumptions. Solid employment growth and a slow and steady increase in interest rates should keep loan losses close to historical lows.

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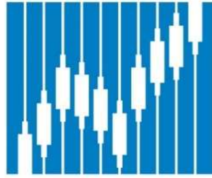

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