



iInvest Securities

Stockbroking & Wealth Management

ilInvest – The Best of the Rest

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With the big 4 banks coming under further pressure due to the Hayne Royal Commission, and the potential of trade wars weighing heavily on the larger mining stocks, we are looking to identify great areas for growth going forward outside of these areas. We see the below stocks as great potential for growth in the upcoming reporting season. The stocks in this report all sit outside of the top 20 stocks on the ASX.

iInvest Securities Monthly 'Best of the Rest' report 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 9 companies in our 'Best of the Rest' report. Since last month, we have added Vanguard High Yield Fund, Challenger Limited, Netwealth Group and Sonic Healthcare to the list. We have removed Domino's Pizza, Invocare, MYOB, Ramsay Health Care and Telstra from the list.

In alphabetical order, our 'Best of the Rest' report comprises: Aveo Group; Banks of Queensland; Brambles; Challenger Limited; G8 Education; Netwealth Group; QBE Insurance Group; Sonic Healthcare and Vanguard High Yield Fund. We discuss each stock within the report.

Aveo Group (ASX: AOG)

Current Market Price: \$2.36

Estimated Fair Value: \$3.10



Aveo's share price fell 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 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 amenities. 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

Bank of Queensland (ASX: BOQ)

Current Market Price: \$11.04 Estimated Fair Value: \$10.80

As one of Australia's three remaining regional banks, Bank of Queensland's strengths are brand, customer loyalty, and its unique owner-managed branch model. It has a strong presence in Queensland and pursues interstate expansion through business specialists and mortgage brokers. The balance sheet is skewed towards residential mortgages, backed by solid retail deposit funding. Bad debts are expected to trend higher and margins to come under pressure. Improved risk management and more diversification should reduce the chances of

a repeat of 2012's spike in bad debts. We expect the bank to continue to deliver solid operating results, but over the long term, we do not expect consistent returns in excess of our estimated cost of equity. Bank of Queensland are one of the highest dividend stocks outside of the big 4 banks, offering a fully franked dividend of \$0.76 per annum, representing a 7% yield.



Brambles Limited (ASX: BXB)

Current Market Price: \$9.88 Estimated Fair Value: \$11.20

Wide-moat-rated Brambles remains undervalued, in our opinion, trading at a nearly 20% 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 reusable 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.



Challenger Limited (ASX: CGF)

Current Market Price: \$12.50 Estimated Fair Value: \$13.50

Challenger is a wealth manager providing retirement-income products via its regulated wholly owned subsidiary Challenger Life. It is the clear leader in the Australian retail annuity market with strong brand recognition and broad distribution. The business is well positioned to leverage long-term tailwinds for the wealth sector, supported by an ageing demographic seeking retirement income solutions and Australia's mandated superannuation. However, it has a higher-risk business model than most wealth managers, as the core operation is effectively an insurance business. Challenger has to generate returns on investments above guaranteed annuity payment commitments and other costs and satisfy regulatory capital requirements. The funds management business manages investments backing annuity liabilities and has minority stakes in boutiques; it is growing strongly, but is a relatively small contributor to group profits.



G8 Education (ASX: GEM)

Current Market Price: \$2.54

Estimated Fair Value: \$4.00

G8 Education shares are trading significantly below our AUD 4 fair value estimate. A short-term oversupply of childcare centres in Australia has driven a share price slump; however, we believe the current share price reflects a market overreaction and that supply challenges are a cyclical rather than a structural problem. Population growth and growing female workforce participation underpin demand for childcare, an essential service, and we expect the July introduction of the childcare subsidy to boost demand further. Although G8 is experiencing weakening occupancy rates currently, and its lack of an economic moat means the company is vulnerable to competitive pressures, we expect the demand tailwind to boost occupancy rates over the next two years. G8's balance sheet is in good shape following the debt refinancing and reduction in 2017, with the net debt/EBITDA ratio at a comfortable 1.5 as of Dec. 31, 2017. A further AUD 200 million in undrawn debt facilities that mature in August 2020 also provides refinancing support for the current net debt of around AUD 200 million, which mainly matures in May. G8 is a relatively capital-light business that enables regular fully franked dividend payments at a high payout ratio. However, a temporary suspension of the dividend could be used to strengthen the balance sheet if required. At the current market price of AUD 2.20 per share, G8 trades on a price/earnings ratio of just 11, which we think is cheap, especially as we expect EPS to grow with occupancy improvement and growth in the size of the childcare centre portfolio. In early 2017 listed Chinese investor China First Capital Group invested AUD 96 million in G8 Equity at AUD 3.88 per share, and the recent weakness in the G8 share price and CFCG share price strength may encourage the Chinese childcare group to invest more in the company and provide a catalyst to narrowing the price/fair value discount.



Netwealth Group (ASX: NWL)

Current Market Price: \$7.46

Estimated Fair Value: \$11.00

A specialist investment platform technology provider in Australia that offers investment management solutions to financial intermediaries, who provide financial advice on superannuation and other investments, and self-directed individuals who have chosen not to seek advice. In recent years, the group has been taking market share from the institutional platform providers such as the major banks and other large diversified financial companies. Looking forward, a structural shift within the wealth management sector from large vertically integrated players towards the more independent players should further boost the group's growth outlook.



QBE Insurance Group (ASX: QBE)

Current Market Price: \$10.23

Estimated Fair Value: \$13.00



Narrow-moat QBE Insurance's restructuring and rebuilding continues with the announcement of another round of senior management changes. Our regular post-result catch-up with management reinforced the changes afoot at the troubled insurer. Despite challenges, our AUD 13 fair value estimate is unchanged. New CEO Pat Regan has only one shot at invigorating the diverse global general

insurer after many years of disappointments, and early changes across the organization make his intentions clear. He is stamping his authority, reinforcing that the old way of running the business is unacceptable. The new way is based on achieving rigorous financial hurdles, high levels of management accountability, and aggressively improving underwriting discipline at the expense of top-line growth. We have been overconfident on the recovery of QBE, and the next one to two years will determine the long-term fate of the group. Turning the business around requires insurance portfolio reshaping, cost-cutting, tightened underwriting standards, and greater accountability across the group. Shareholders should be rewarded with the share price expected to increase, closing the current 27% gap to fair value. If the restructuring and reshaping does not deliver the

goods, QBE will be an easy takeover target for a global insurer looking to expand in key areas of Europe, Australia/New Zealand, and Asia-Pacific. It will be at least 12 months before improvements flow through to published financial accounts. We expect to see some type of nonquantifiable scorecard at half-year results in August, with quantifiable measures likely to be released at the 2018 results in February 2019.

Sonic Healthcare (ASX: SHL)

Current Market Price: \$26.17

Estimated Fair Value: \$27.25



During the past two decades, Sonic has built a dominant position in the Australian medical diagnostics market; it is now the largest Australian pathology laboratory operator. This scale gives it a significant cost advantage, the primary source of its narrow economic moat. Sonic invested heavily throughout the six years to 2011 to establish critical mass in the U.S. and European pathology markets. The firm is now generating synergies from acquired businesses, the same strategy it implemented so successfully in Australia. We expect steady realisation of synergies in the U.S. and European markets to gradually boost margins for many years and help drive Earnings Per Share (EPS) growth of about 10% during the next five years. Several dynamics underpin pathology test volume globally, including ageing populations, the economic benefits of preventative medicine, and ongoing innovation in pathology testing technology.

Vanguard High Yield Fund (ASX:VHY)

Current Market Price: \$58.14

Estimated Fair Value: \$60

Vanguard Australian Shares High Yield ETF (VHY) is an exchange-traded fund that seeks to match the return (income and capital appreciation) of the FTSE ASFA Australia High dividend Yield Index before taking into account fund fees and expenses and provides a tax-effective income stream with the potential for capital growth in the one investment. The Fund seeks to achieve its objective by investing mainly in securities that comprise its relevant Underlying Index and through transactions that provide similar exposure to securities in the Underlying Index by using representative sampling method. For the FTSE ASFA Australia High Dividend Yield Index, it is a real-time, market capitalization-weighted index comprised of companies listed on the Australian Stock Exchange with higher forecast dividend yields, the Index is calculated on a before tax basis only and is not part of the after-tax FTSE ASFA Australia Index Series. The securities with the highest forecast dividend yields which make up 50% of the float-adjusted market capitalization of the Index are selected, capping exposure to any one industry at 40% and to any one company at 10%. The Fund may invest in securities that have been removed from or are expected to be included in the index. Although this fund won't achieve large levels of capital growth, this fund is currently offering a healthy dividend yield of 8.15%.



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