Australia Equity Market Outlook: Q3 2023

Market undervalued, but headwinds to corporate profits could trigger weakness.

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Market Outlook

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Challenges Ahead as Weaker Spending Weighs on Corporate Profits

The fiscal 2023 results season is the focal point this quarter with 170 companies of the S&P/ASX 200 Index reporting. Reporting wraps up at the end of August. Outlook statements are critical and will be closely monitored.

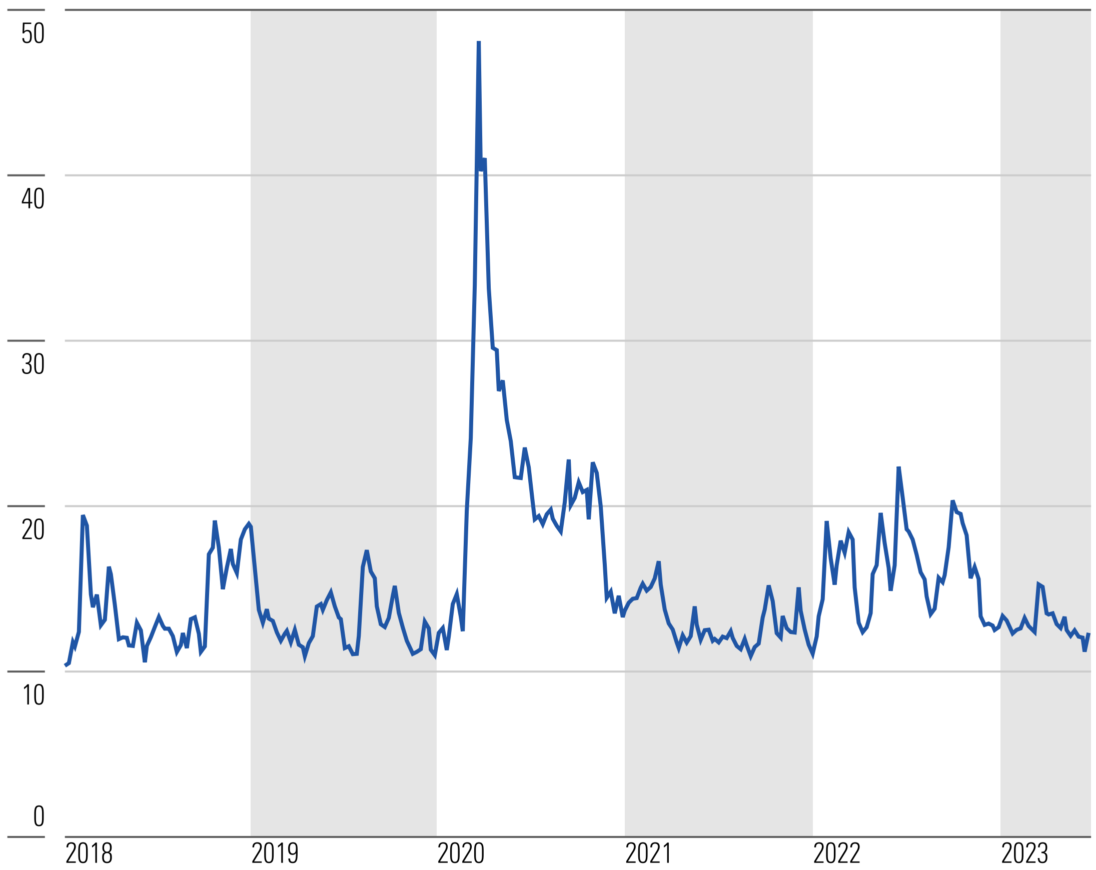
Attention will also focus on key domestic economic data including inflation, labour force, and retail sales, as well as monitoring the pulse of household spending. Inflation for the June quarter, monthly Consumer Price Index indicators for July and August, and Reserve Bank of Australia, or RBA, decisions on Aug. 8 and Sept. 5 are likely to influence the market.

Economic growth slowed from 0.6% in the December quarter 2022 to 0.2% in the March quarter 2023. We expect further weakness in the June quarter and a September-quarter contraction is possible. Against this backdrop, corporate profit growth is likely to slow in the June half, particularly in the sectors reliant on household spending. Price rises have typically lagged cost increases, putting margins under pressure, while volume growth has declined as households tighten their spending.

As rising interest rates increase debt servicing commitments, the disposable income of indebted households is under pressure. The savings buffer from massive fiscal stimulus programs in 2020 and 2021 has depleted and household consumption is being curtailed.

Low Volatility Unlikely To Persist

S&P/ASX 200 Volatility Index (VIX).



Source: Haver Analytics. Data as of June 28, 2023.

Challenges Ahead as Weaker Spending Weighs on Corporate Profits

Discretionary retailers are experiencing hardship and the online channel, which has a greater proportion of impulse spending, appears to be suffering most.

Despite the boost to interest income from rising interest rates, bank net interest margins are under pressure from the higher cost of funds in both the wholesale and retail markets, as bond yields remain elevated, and depositors demand higher rates. While well provisioned, the banks are likely to see rising credit impairments. Financial services, dominated by banks, represents almost 26% of the benchmark S&P/ASX 200 Index.

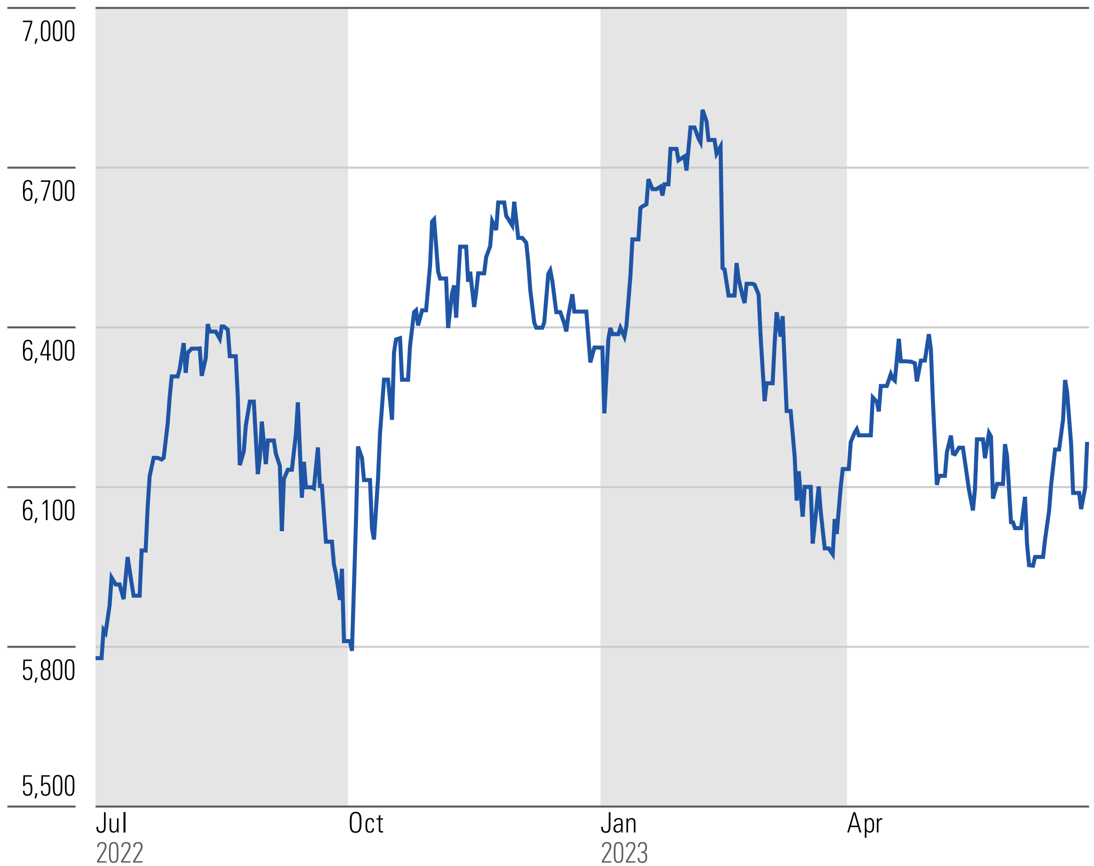
Basic materials is 24% of the index and includes Australia's largest company by market capitalisation, BHP. Sluggish commodity prices are having an impact on revenue, while inflation pushes costs higher. Focus will be on the extent and effect of Chinese stimulus.

The outlook for fiscal 2024 is for moderating corporate profit growth. Earnings may decline in many cases as household consumption growth stalls. It could well contract in the current half to December 2023.

We expect a subdued market in this quarter, although July is a traditionally stronger month as funds are allocated for the new financial year.

Financial Index Is Very Dependent on Banks

S&P/ASX 200 Financials PR index.



Source: Morningstar Direct. Data as of June 28, 2023.

Economic Outlook

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Rate Hikes Not Over as Services Inflation Persists

Australia's economy has softened since early 2023 and the contraction in economic activity is likely to continue for the next year. Gross domestic product growth slowed to 0.2% in the March quarter with the annual rate to March of 2.3%. At least one negative quarterly reading is likely in 2023, probably the September quarter, with a close call likely in the June quarter. A technical recession by mid-2024 is possible.

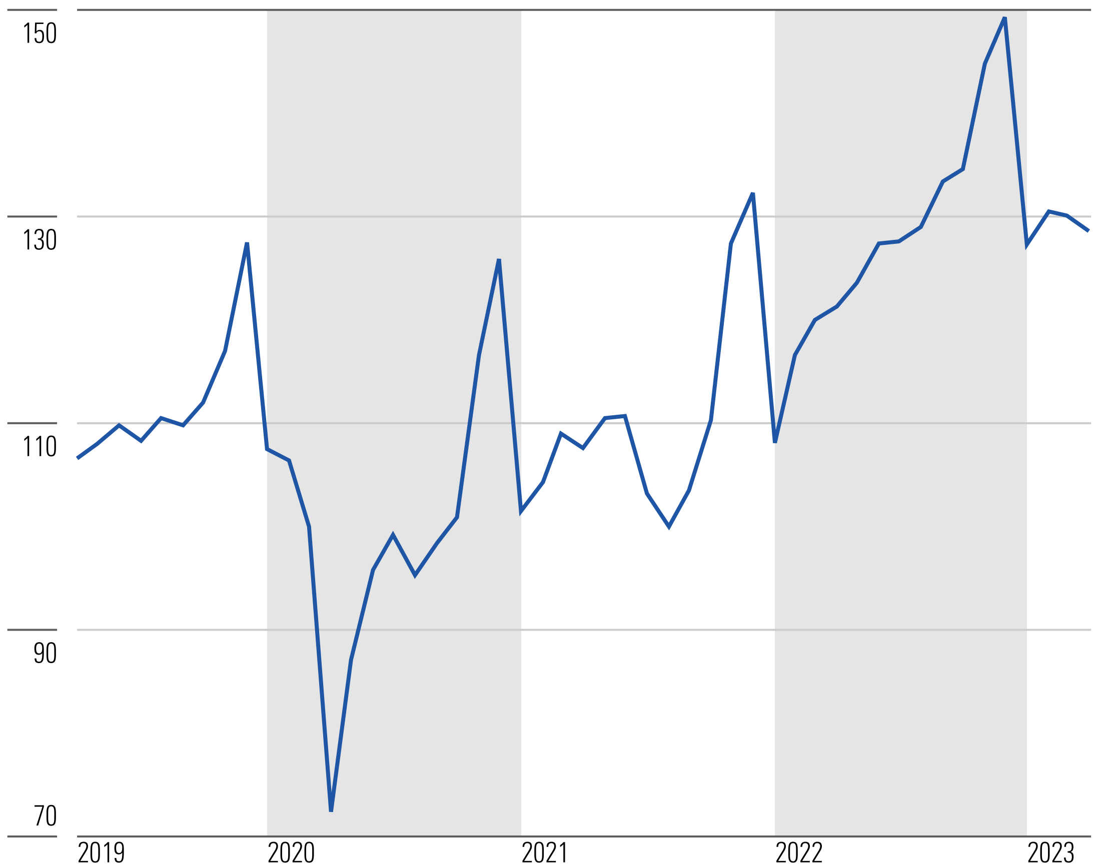
The outlook for household consumption, the largest contributor to GDP, is the major influencing factor. Interest rate hikes and the refinancing of ultra-low fixed rates will meaningfully reduce the disposable income of indebted households.

Growth in household consumption of less than 0.5% in both 2023 and below 1% in 2024 is forecast. A negative reading is probable in the June half of 2024, before a recovery in the December half. On a per capita basis, we anticipate recession in both household consumption and GDP in both 2023 and 2024.

Helping to offset a subdued household consumption contribution, both business investment and government spending should support GDP, underpinned by meaningful energy transition related infrastructure. Investment in affordable housing is likely to start contributing later in 2024, at the earliest. Skilled labour shortages remain an issue.

Household Consumption To Stall as Savings Buffers Deplete

Household spending index.



Source: Australian Bureau of Statistics, Monthly Household Spending Indicator. Data as of June 6, 2023.

Rate Hikes Not Over as Services Inflation Persists

The fall in house prices from higher interest rates appears to be done, limiting the downside impact of a falling "wealth effect." The housing shortage and sharply increased immigration are offsetting factors.

Inflation remains a concern. The monthly CPI indicator for year to May was exceptional, rising 5.6% for the year, well below expectations of 6.1% and down sharply from April's worrisome 6.8%. The market reaction was positive, with both equity and bond prices rising, yields falling, but this appears short-sighted. While it may influence the RBA to pause or skip on July 4, it does not mean rate hikes are over. Services inflation is not dead, far from it.

Unemployment is likely to rise through 2023 and into 2024 from the current 3.6%, possibly reaching 5% by end 2024. The lack of any improvement in labour productivity is a drag on near-term GDP growth. The RBA's assistant governor recently suggested unemployment needs to lift to 4.5% if the trimmed mean inflation target of 2%-3% by mid-2025 is to be achieved. This optimistically assumes the participation rate stays at a record 66.9%.

Unemployment Inching Up From Very Low Levels

Australian unemployment rate (seasonally adjusted).

Source: Australian Bureau of Statistics, Labour Force Australia. Data as of June 15, 2023.

Valuation Overview and Top Picks

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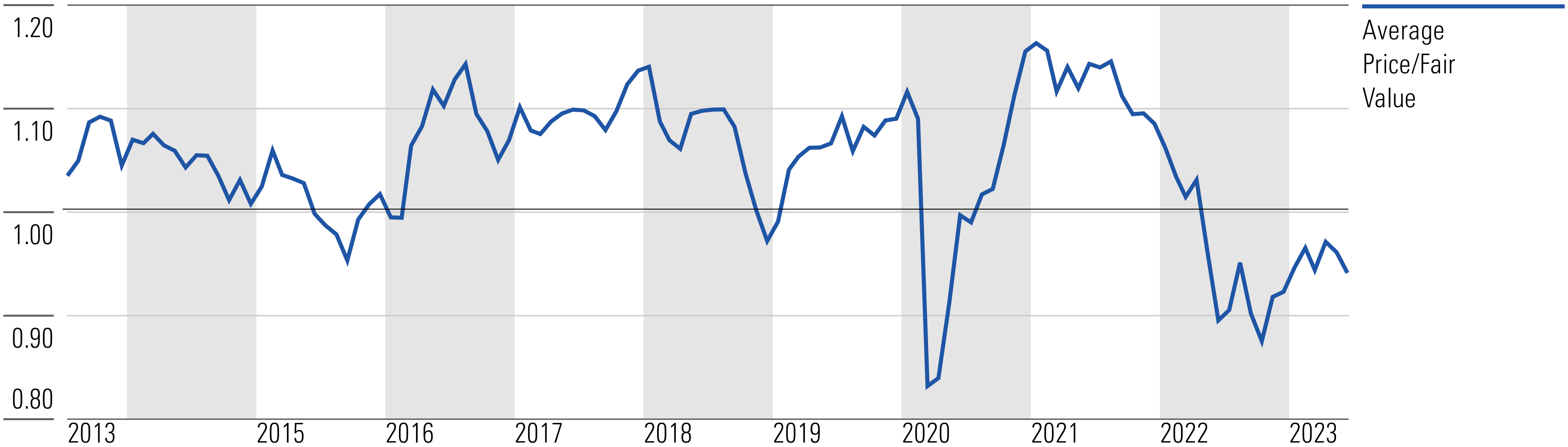
Market Trades at a Small Discount

Stock markets traded sideways in the June quarter, with Australia and New Zealand stocks slightly undervalued. As of June 26, 2023, our Australia and New Zealand coverage trades at a 7% discount to fair value on average, compared with a 15% discount at the September 2022 low and an average 5% premium over the past 10 years.

Stocks Slightly Undervalued on Average

Morningstar Australia and New Zealand coverage: monthly average price/fair value estimate.



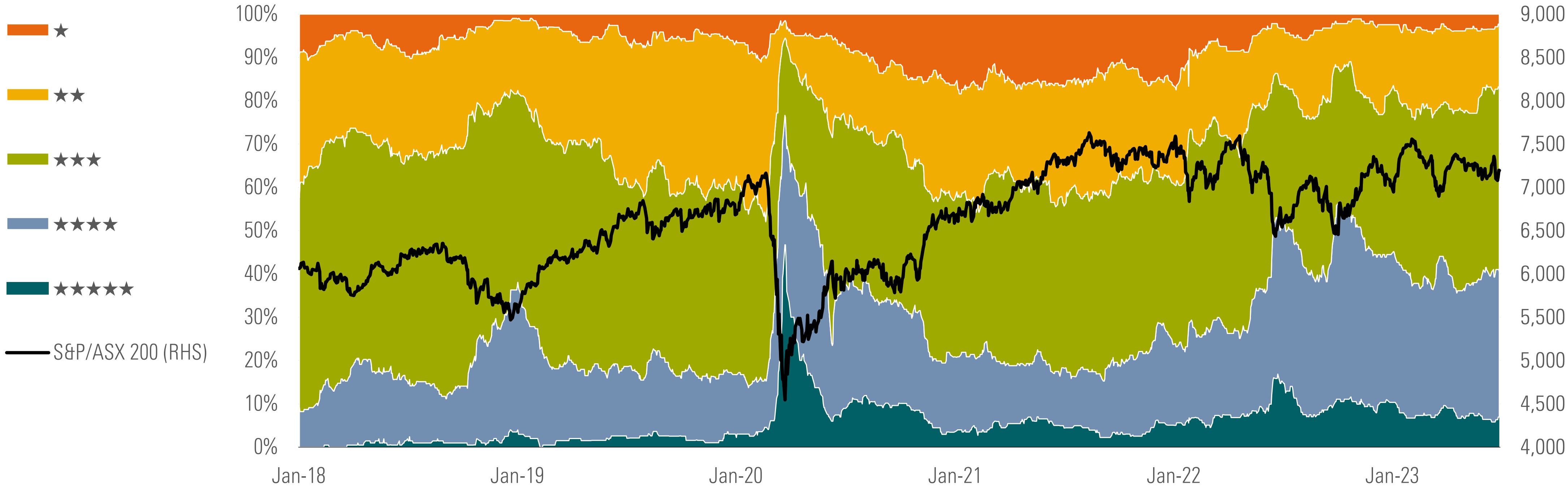
Source: Morningstar. Data as of June 26, 2023.

4- and 5-Star Ratings Remain at Historically High Levels

Forty-one percent of Australian and New Zealand stocks under coverage are either 4- or 5-star-rated, comparing favourably with the trailing 10-year average of 22%. High-quality stocks are in strong demand, but we still see plenty of opportunities. A third of moat stocks and close to half of no-moat stocks are 4- or 5-star-rated.

Market Uncertainty Caused a Significant Increase in the Number of Undervalued Companies in 2022

Star rating distribution over time (Australian-listed firms only).



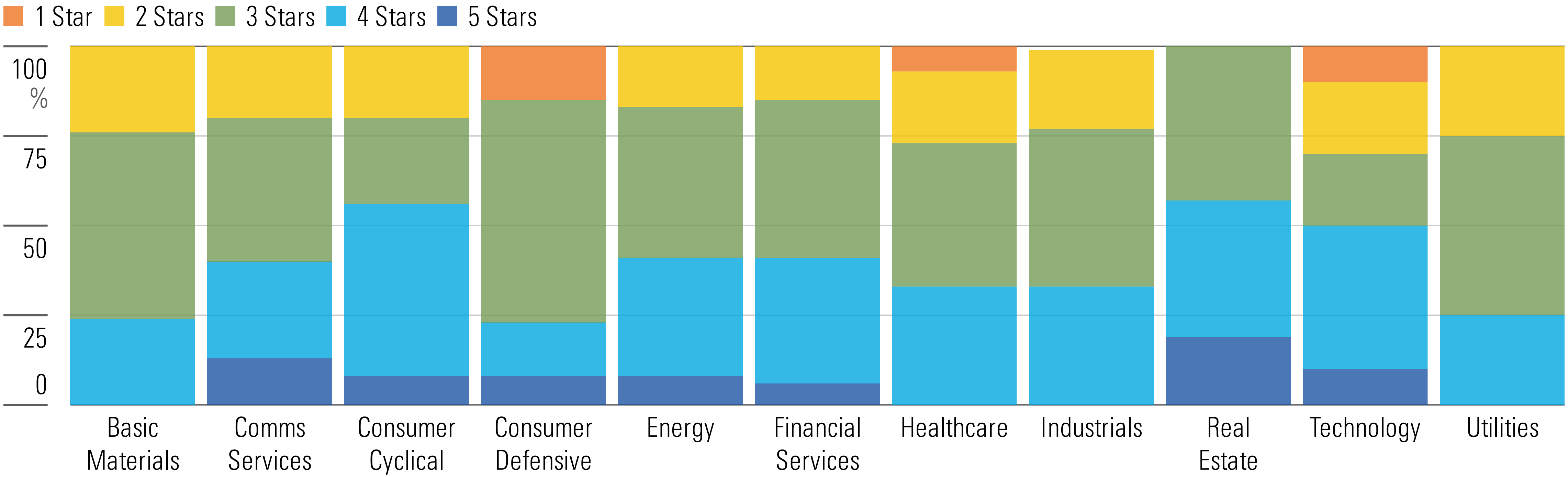
Source: Morningstar. Data as of June 26, 2023.

Positive Ratings in Many Sectors

The consumer cyclical sector is now one of the most undervalued given growing headwinds to consumer spending. Value has also improved in the healthcare sector, while many other sectors have become more expensive. Nonetheless, we see plenty of opportunities across real estate, technology, financials, energy, and communications.

Plenty of Positive Ratings in Most Sectors

Star rating distribution by sector.



Source: Morningstar. Data as of June 26, 2023.

Top Picks in Each Sector

Company and Sector	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)
Basic Materials							
Newcrest Mining (NCM)	★★★★	AUD 33.00	AUD 26.20	Medium	None	0.78	AUD 23.43
Nufarm (NUF)	★★★★	AUD 7.70	AUD 4.96	High	None	0.65	AUD 1.89
Incitec Pivot (IPL)	★★★★	AUD 3.50	AUD 2.68	Medium	None	0.77	AUD 5.21
Communication Services							
TPG Telecom (TPG)	★★★★	AUD 7.40	AUD 5.04	Medium	Narrow	0.69	AUD 9.37
Nine Entertainment Company (NEC)	★★★★	AUD 2.80	AUD 1.91	High	None	0.69	AUD 3.26
Southern Cross Media Group (SXL)	★★★★★	AUD 1.80	AUD 0.82	High	None	0.45	AUD 0.20
Consumer Cyclical							
Kogan.com (KGN)	★★★★★	AUD 10.70	AUD 4.88	Very High	None	0.46	AUD 0.51
Bapcor (BAP)	★★★★	AUD 8.00	AUD 5.86	Medium	Narrow	0.74	AUD 1.99
Domino's Pizza Enterprises (DMP)	★★★★	AUD 68.00	AUD 43.52	High	Narrow	0.64	AUD 3.88
Consumer Defensive							
Bega Cheese (BGA)	★★★★★	AUD 5.20	AUD 3.43	Medium	None	0.68	AUD 1.04
Inghams Enterprises (ING)	★★★★	AUD 3.50	AUD 2.64	Medium	None	0.76	AUD 0.98
The a2 Milk Company (A2M)	★★★★	AUD 7.20	AUD 4.90	High	Narrow	0.68	AUD 3.54

Source: Morningstar. Data as of June 26, 2023.

Top Picks in Each Sector

Company and Sector	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)
Energy							
Beach Energy (BPT)	★★★★★	AUD 3.00	AUD 1.33	High	None	0.44	AUD 3.03
Santos (STO)	★★★★	AUD 12.00	AUD 7.32	High	None	0.61	AUD 23.83
Whitehaven Coal (WHC)	★★★★	AUD 9.80	AUD 6.56	Very High	None	0.68	AUD 5.73
Financials							
ANZ Group Holdings (ANZ)	★★★★	AUD 31.00	AUD 22.77	Medium	Wide	0.74	AUD 68.29
Perpetual (PPT)	★★★★	AUD 33.00	AUD 25.15	Medium	Narrow	0.76	AUD 2.83
Westpac Banking (WBC)	★★★★	AUD 28.00	AUD 20.68	Medium	Wide	0.74	AUD 72.46
Health Care							
Ansell (ANN)	★★★★	AUD 30.00	AUD 25.74	Medium	Narrow	0.86	AUD 3.28
Ramsay Health Care (RHC)	★★★★	AUD 68.00	AUD 54.45	Medium	Narrow	0.81	AUD 12.48
ResMed (RMD)	★★★★	AUD 39.00	AUD 32.14	Medium	Narrow	0.83	AUD 47.18
Industrials							
Ventia (Australia) (VNT)	★★★★	AUD 3.60	AUD 2.92	Medium	None	0.80	AUD 2.50
Aurizon Holdings (AZJ)	★★★★	AUD 4.70	AUD 3.84	High	Narrow	0.82	AUD 7.07
Amcor (AMC)	★★★★	AUD 16.00	AUD 14.80	Low	Narrow	0.93	AUD 21.94

Source: Morningstar. Data as of June 26, 2023.

TOP PICKS

Top Picks in Each Sector

Company and Sector	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)
Real Estate							
Lendlease (LLC)	★★★★★	AUD 14.45	AUD 7.00	High	None	0.48	AUD 4.83
Dexus (DXS)	★★★★	AUD 10.80	AUD 7.71	Medium	Narrow	0.71	AUD 8.23
Charter Hall Group (CHC)	★★★★★	AUD 16.20	AUD 10.52	Medium	Narrow	0.66	AUD 4.98
Technology							
WiseTech Global (WTC)	★★★	AUD 90.00	AUD 77.28	High	Narrow	0.85	AUD 25.65
Fineos (FCL)	★★★★	AUD 3.40	AUD 2.20	Very High	Wide	0.65	AUD 0.70
Megaport (MP1)	★★★★	AUD 13.00	AUD 6.90	Very High	None	0.54	AUD 1.10
Utilities							
AGL Energy (AGL)	★★★★	AUD 12.80	AUD 10.98	High	Narrow	0.86	AUD 7.39
Manawa Energy (MNW)	★★★★	NZD 6.80	NZD 4.89	Medium	Narrow	0.72	NZD 1.54
APA Group	★★★	AUD 10.20	AUD 10.31	Medium	Narrow	1.01	AUD 12.20

Source: Morningstar. Data as of June 26, 2023.

Basic Materials

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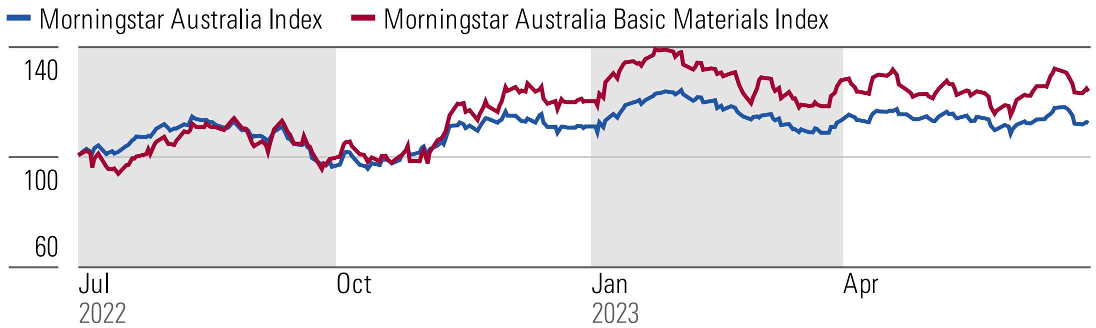
Subdued China Reopening and Potential Recession Dampens Optimism; Miners Close to Fairly Valued

Disappointing economic data from China suggests its reopening is softer than the market anticipated. Miners' share prices have fallen in response. Western central bank efforts to control inflation through higher interest rates are likely to slow economic growth and near-term demand for commodities. Longer-term, we think demand from China is likely to moderate as consumption drives economic growth at the expense of investment, allowing iron ore and copper prices to trade closer to the cost of production.

Our basic materials coverage is now near fair value on average. In our mining coverage, gold miners including Newcrest Mining are the standout. While the gold price has fallen modestly to approach USD 1,900 per ounce, gold miner shares have fallen further, despite Australian dollar gold prices remaining near record highs. Iron ore miners rallied late in the quarter as the iron ore price improved on hopes of additional government stimulus in China. But the iron ore price remain elevated and so too the shares.

Explosives companies Orica and Incitec Pivot should benefit from robust coal and iron ore volumes, supplemented by growth in future-facing metals. While volumetric demand for future metals like lithium is much less than for iron ore or coal, for example, waste mining requirements are higher, meaning significant explosives demand regardless. Incitec Pivot is currently cheaper than Orica given gas issues at Phosphate Hill, uncertainty over demerger timing for fertilisers and Jeanne Johns having stepped down as CEO. However, we think this is an opportunity as issues will resolve and given strong macro tailwinds.

Miners Fall on Concerns Over Subdued China Reopening, Potential Recession



Source: Morningstar. Data as of June 26, 2023.

Basic Materials Coverage Close to Fairly Valued on Average

Source: Morningstar. Data as of June 26, 2023.

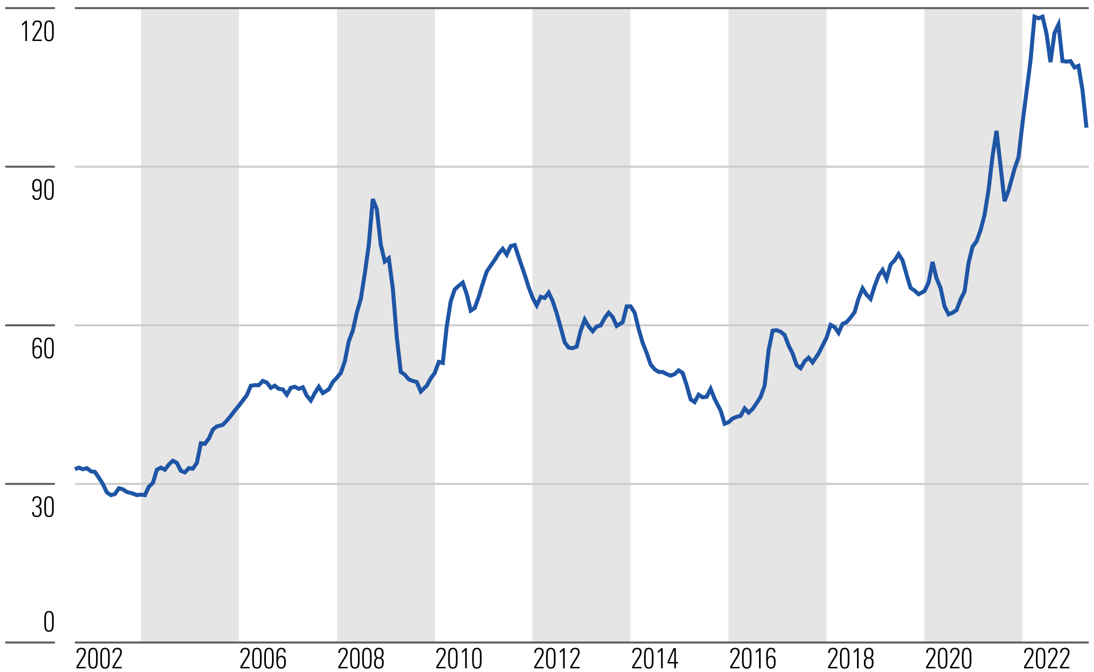
Subdued China Reopening and Potential Recession Dampens Optimism; Miners Close to Fairly Valued

Commodity prices are generally lower in 2023, but still high relative to history and cost support. We generally expect prices to fall toward the marginal cost of production longer-term, which seems broadly in line with market expectations on average, though the assumptions for individual commodities will vary.

Global demand for iron ore appears solid in the near term. Gradual falls in demand from China as its economy transitions from fixed asset investment-driven economic growth to consumption are offset by rising demand elsewhere, including India and Southeast Asia.

Commodity Prices Remain Elevated Relative to Historical Values

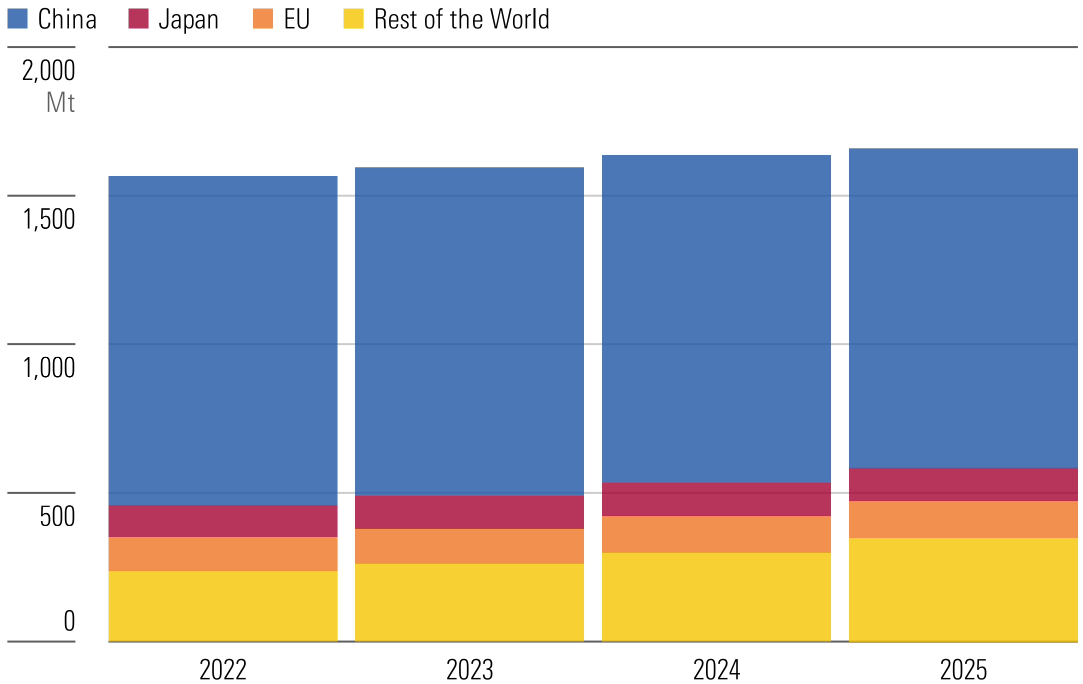
RBA Index of Commodity Prices (AUD).



Source: Reserve Bank of Australia.

China Accounted For About 70% of Iron Ore Imports in 2022

Iron ore imports (million metric tons).



Source: World Steel Association, International Trade Centre, Australian Government Department of Industry, Science and Resources

Basic Materials

Company (Ticker)		Rating
Newcrest Mining (NCM)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 26.20	AUD 33.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 23.43	None	Exemplary

After rejecting Newmont's two earlier nonbinding indicative offers, Newmont's higher offer is reasonable and likely enough to seal a deal, subject to approvals. The combined entity will be the world's largest gold miner with pro forma 2023 production of roughly 8 million ounces of gold from its mines in the Americas, Australia, Papua New Guinea, and Ghana, around double that of Barrick Gold, the world's second-largest gold miner by production. It will also produce roughly 190,000 metric tons of copper and have numerous development projects that we think are valuable and perhaps overlooked. With Newcrest shareholders set to inherit shares in the combined group, and Newmont's shares having sold off recently with the lower gold price, we think there is still value in Newcrest. Newmont's sales were weak in early 2023, but think Newmont's sales will recover this year, helping lower unit cash costs and improve margins.

Company (Ticker)		Rating
Nufarm (NUF)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 4.96	AUD 7.70	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 1.89	None	Standard

Australian agricultural innovator Nufarm maintains fiscal 2023 guidance for modest underlying earnings growth assuming normal seasonal conditions. Nufarm's earnings are sharply seasonally skewed to the fiscal first half, though cash flows don't normally present until the second half. Nufarm's modest dividend doesn't particularly appeal, but it is a growth story. We project a five-year EPS CAGR of just over 16% to AUD 0.71, for an attractive prospective P/E of less than 10 by fiscal 2027 based on the current share price. Nufarm's top 22 pipeline crop protection projects have all passed proof of concept and target an addressable market of around USD 6.6 billion. As for seed technologies, Omega-3 canola revenue is growing fast and bioenergy carinata offtake is agreed with BP.

Company (Ticker)		Rating
Incitec Pivot (IPL)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 2.68	AUD 3.50	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 5.21	None	Standard

Incitec Pivot aims to expand its business around its strong global market share in explosives. Competitive advantages include a duopoly Australian explosives business and global explosives operations. Incitec Pivot is a key player in the Australian domestic fertiliser market and enjoys a degree of domestic fertiliser pricing power from its large share in the eastern states. Explosives earnings are leveraged to mining volumes as price. It should benefit from long-term growth in demand for minerals and metals, including anticipated strong growth in new-facing metals. Additionally, mining strip ratios are likely to rise over time, creating demand, with more explosives required to mine the same amount of ore.

Source: Morningstar. Data as of June 26, 2023.

Communication Services

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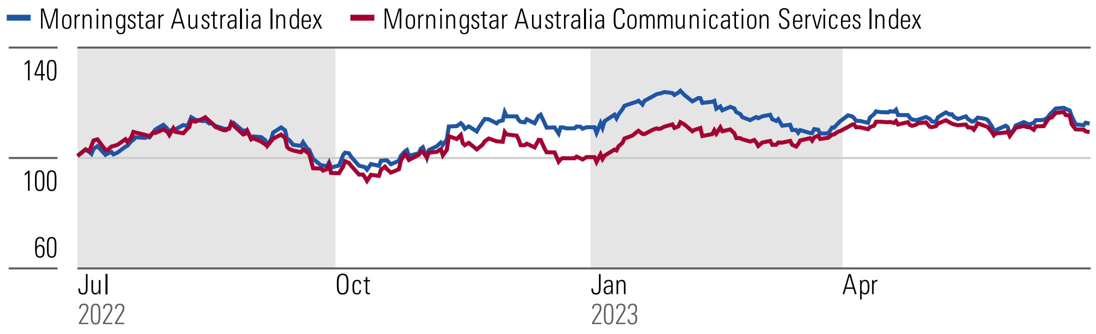
Telecom Tailwinds Gather Momentum, but Media Mired in Cyclical Downturn

In telecom, rising plan prices, continuing cost reductions, and a reinvigorated focus on return on capital make a favourable backdrop for medium-term sector earnings. Mobile average revenue per user, or ARPU, is growing as Telstra, Optus, and Vodafone increase prices. Rising living costs may lead some users to trade-down to lower-price mobile plans. But we think the services are affordable and consumers are getting value, especially relative to utility prices and given the heavy discounts enjoyed until mid-2020.

In media, the cyclical downturn in advertising and subscription spending is likely to persist in the near term. Escalating interest rates, waning consumer sentiment, and declining corporate profits are three significant headwinds for the sector. Earnings for media companies are likely to be depressed for the remainder of the year.

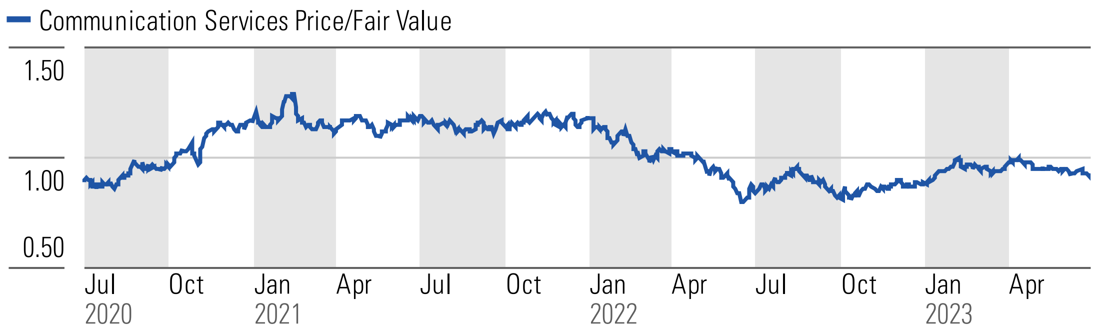
To combat the challenging revenue conditions, cost cuts and efficiency efforts are likely priorities for media companies. Importantly, balance sheets are sound across all media companies under our coverage. This provides resilience to the current cyclical downturn and positions the sector for consolidation and scope for companies to diversify across content delivery channels and advertising platforms.

Communication Sector Performance Held Up by Resilient Telco Sector



Source: Morningstar. Data as of June 26, 2023.

Communication Sector Discount Driven by Undervalued Media Stocks



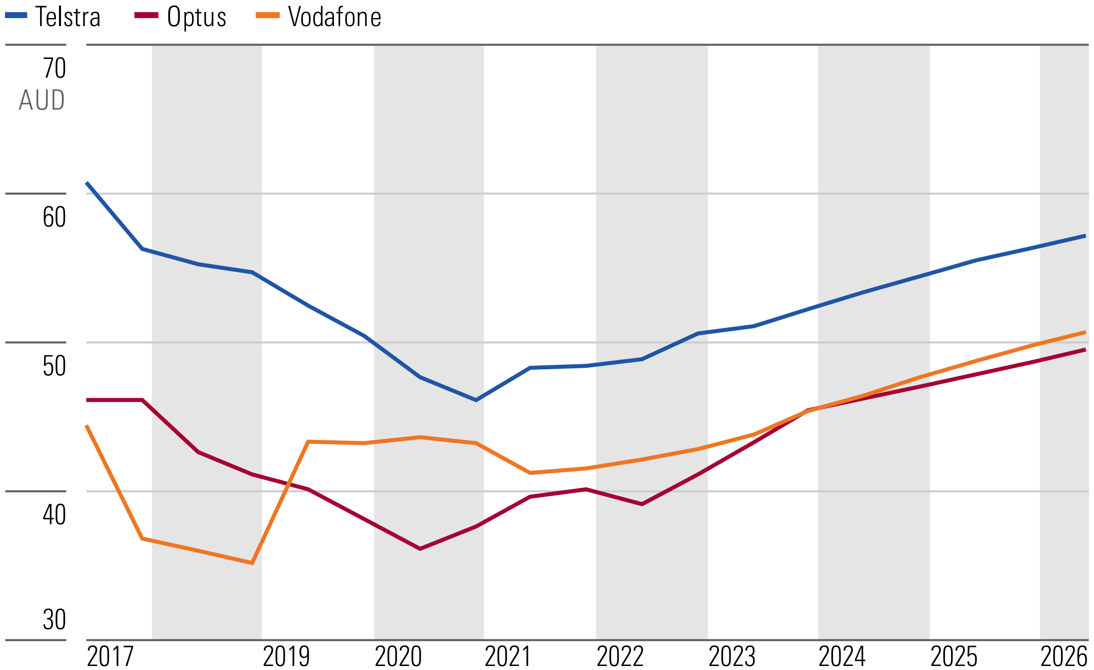
Source: Morningstar. Data as of June 26, 2023.

Telecom Tailwinds Gather Momentum, but Media Mired in Cyclical Downturn

Since their lows in mid-2020, mobile ARPU has recovered solidly for both postpaid and prepaid plans. Improving competitive rationality and a reinvigorated focus on return on capital is set to drive further ARPU growth, especially as 5G penetration increases.

Mobile ARPU on the Mend With Further Recovery on Horizon

Postpaid mobile ARPU (AUD per month).

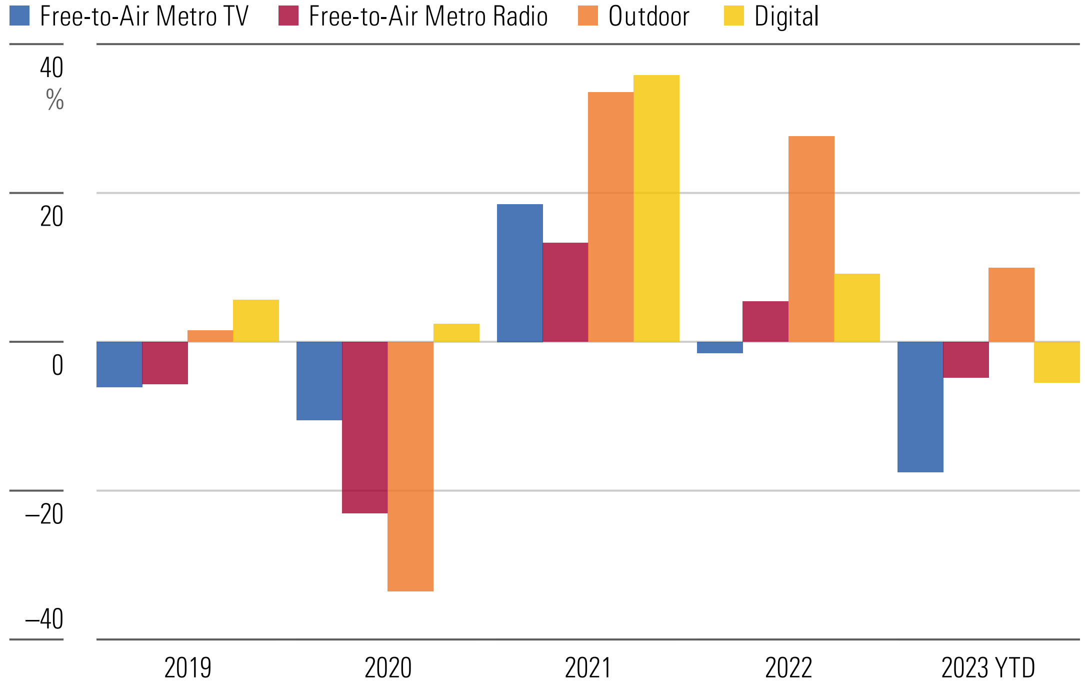


Source: Company reports, Morningstar Equity Research

Escalating interest rates, waning consumer sentiment, and declining corporate profits are buffeting advertising spending. Fortunately, balance sheets are solid, and concerted efforts to reduce costs are already underway.

Slumping Advertising Due to COVID-19 Hangover and Economic Uncertainties

Year-on-year advertising expenditure growth.



Source: ThinkTV, Commercial Radio of Australia, Outdoor Media Association, Interactive Advertising Bureau, and Morningstar estimates.

SECTOR TOP PICKS

Communication Services

Company (Ticker) TPG Telecom (TPG)		**Rating** ★★★★	We see clear catalysts for narrow-moat TPG Telecom's earnings recovery on several fronts and forecast an adjusted EBITDA CAGR of 8% over the next three years. Recovery from COVID-19 effects, benefits from a more rational mobile market, and synergies from the Vodafone merger are the key drivers, augmented by growth from fixed wireless and the corporate division. Market concerns linger over execution of the current simplification and cost-cutting program as well as the overhang of major shareholders whose holdings are now out of escrow after the Vodafone merger. However, we believe these concerns are more than reflected in the share price, especially given the longer-term tailwinds for the telecom industry as it transitions to 5G.
Price AUD 5.04	**Fair Value** AUD 7.40	**Uncertainty** Medium	
Market Cap (bil) AUD 9.37	**Economic Moat** Narrow	**Capital Allocation** Standard	
Company (Ticker) Nine Entertainment Company (NEC)		**Rating** ★★★★	No-moat Nine Entertainment is well-diversified across the entire spectrum of the Australian advertising and entertainment space. Its exposure to the structurally challenged free-to-air television advertising market is complemented by a broadcast streaming offering, a subscription video-on-demand service, and 60% ownership of digital real estate business Domain. Moreover, the publishing unit has undergone significant transformation to become a digital-first news provider, further decreasing exposure to traditional print media. The business diversification and a solid balance sheet position Nine well to weather the current downturn in advertising markets, coming off a pandemic-driven highs of recent years.
Price AUD 1.91	**Fair Value** AUD 2.80	**Uncertainty** High	
Market Cap (bil) AUD 3.26	**Economic Moat** None	**Capital Allocation** Standard	
Company (Ticker) Southern Cross Media Group (SXL)		**Rating** ★★★★★	No-moat-rated Southern Cross Media's near-term earnings trajectory is pedestrian, hampered by the current advertising market slowdown from COVID-19 highs and investment spending on digital radio. However, as the market leader in Australian radio (accounting for close to 80% of group earnings), earnings outlook from fiscal 2024 is positive, as radio advertising market normalises and the digital radio losses reduce. Critically, balance sheet remains solid (net debt/EBITDA of 1.3), the company is free cash-generative, and the stock is trading at sub-10 times forward EPS, with an attractive fully franked yield.
Price AUD 0.82	**Fair Value** AUD 1.80	**Uncertainty** High	
Market Cap (bil) AUD 0.20	**Economic Moat** None	**Capital Allocation** Standard	

Source: Morningstar. Data as of June 26, 2023.

Consumer Cyclical

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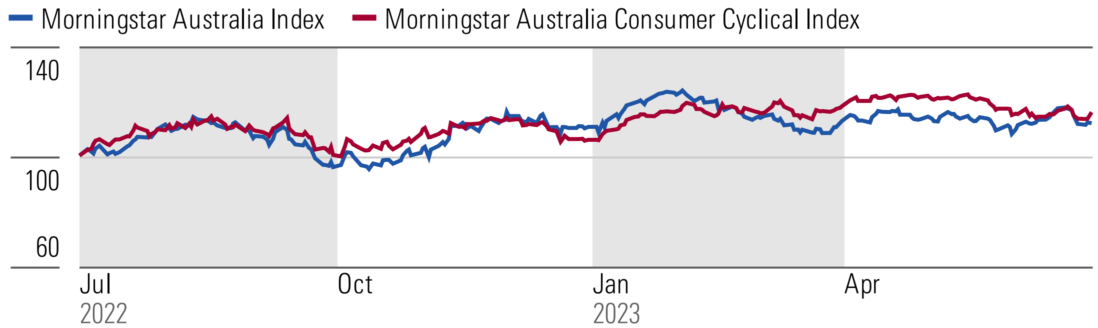
Discretionary Retailer Sales Under Pressure

Discretionary retailing sales growth is slowing as spending patterns revert to prepandemic trends. Australians are spending more on services and at the expense of goods, with demand for goods also suffering from recession-like consumer sentiment. Consumers aren't cutting expenditure equally across all categories with spending on essentials picking up.

Real household income is under pressure with inflation growing faster than wages. Nevertheless, the tough outlook means we see some discretionary retailers as oversold, such as Kogan and Harvey Norman. The shift to services benefits gaming businesses, with casino operator SkyCity and gaming machine manufacturer Aristocrat screening as most attractive.

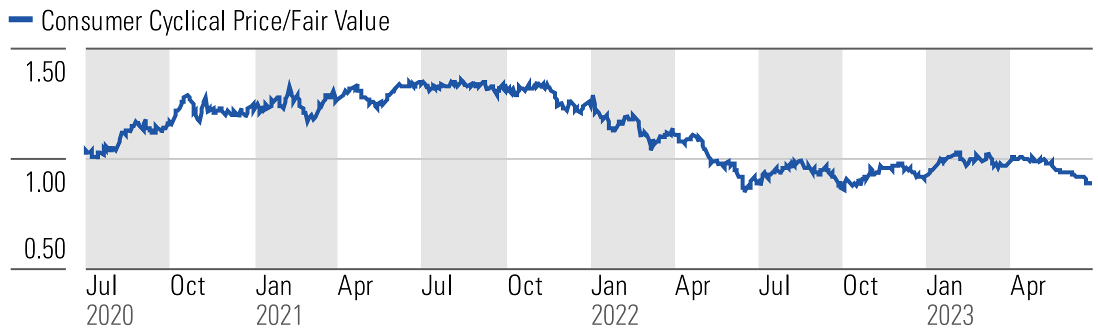
Automotive spare parts retailers exposed to do-it-yourself, like Bapcor's Autobarn or Super Retail Group's Supercheap Auto, are seeing a deceleration in discretionary sales. However, maintenance-related categories continue to perform strongly. We estimate discretionary spending typically comprises about half of Supercheap's and Autobarn's earnings. Bapcor is better placed in this environment. About 80% of Bapcor's earnings come from its trade and specialist wholesale businesses, principally selling nondiscretionary, maintenance-related automotive parts.

Despite Difficult Conditions, Cyclicals Have Outperformed the Market



Source: Morningstar. Data as of June 26, 2023.

Value Is Beginning To Emerge for Cyclicals on Average



Source: Morningstar. Data as of June 26, 2023.

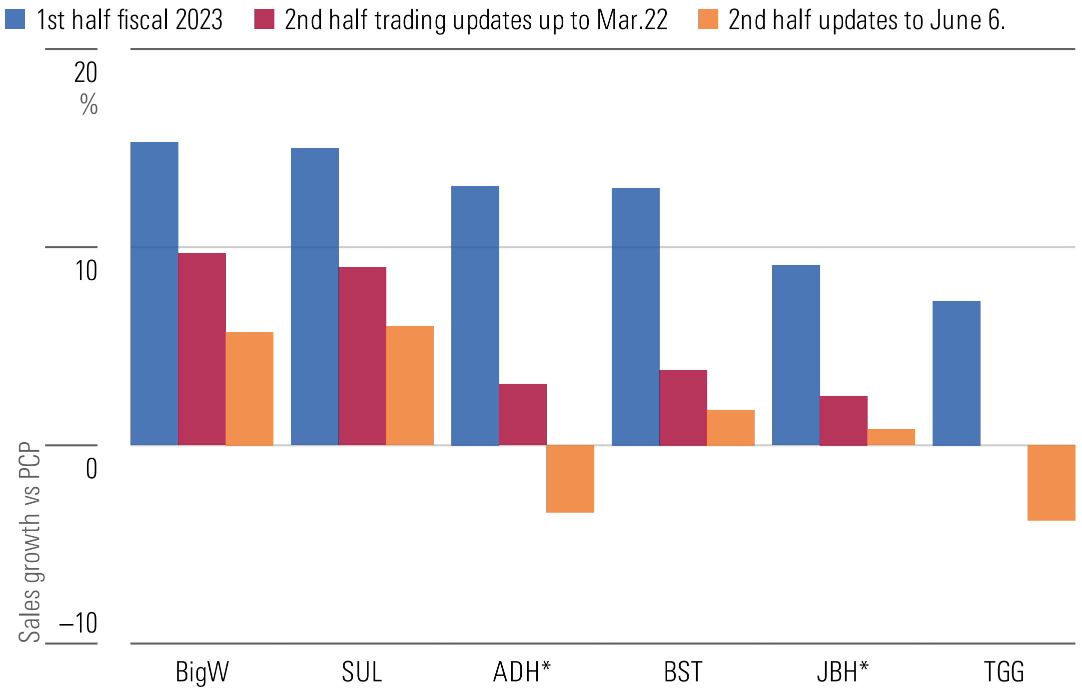
Consumers Are Cutting Back and Trading Down

Some market observers expected young consumers to be less exposed to rising rates, but millennials are reining in spending, including on clothes, groceries, and toiletries. Note Best and Less sales have since deteriorated more than the chart below, with sales for the five weeks to June 18 at 12% below the previous corresponding period.

Amazon gained market share in Australian e-commerce and total Australian retailing in 2022. We expect Amazon to continue to grow in what is likely to remain a highly fragmented market.

Omnichannel Retailers' Sales Momentum Has Cratered in Calendar 2023

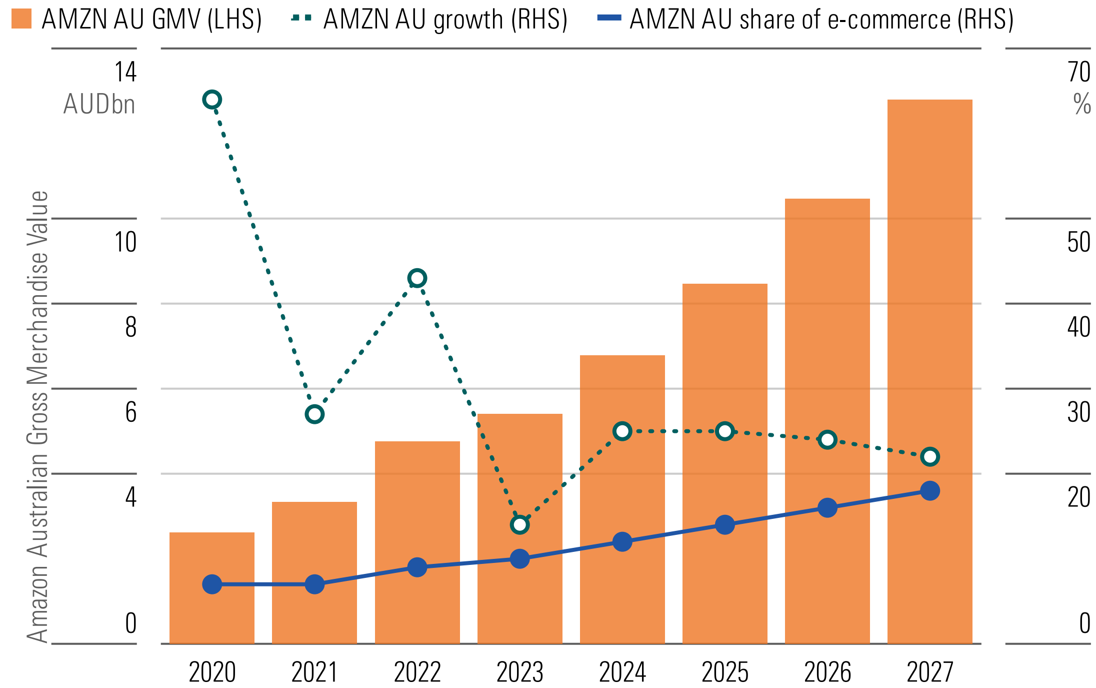
Year-to-date sales growth update period varies between companies.



Source: Source: Company filings. Note: *ADH: Adairs only; *JBH: JB Hi-Fi Australia only; SUL=Super Retail Group; BST=Best & Less; TGG=The Good Guys.

Amazon's Australian Business Outperformed the Domestic Online Market in 2022

Amazon's Australian gross merchandise value.



Source: Company filings, NAB Online Retail Sales Index, Morningstar estimates. Data as of June 16, 2023.

Consumer Cyclical

Company (Ticker) Kogan.com (KGN)		**Rating** ★★★★★	Kogan's shares have slumped with the material decline in sales and earnings as the COVID-19-fueled online retail boom unwound. We expect revenue growth to reignite as consumer spending growth moves back online. We also anticipate near-term margin expansion as marketing and warehouse expenses are scaled back and discounting to clear excess inventory stops. There are early signs of improvement with a return to an adjusted EBITDA profit in March quarter 2023. We also expect Kogan First to underpin customer loyalty and generate a valuable recurring revenue stream. More rational online competition is also likely to reduce some operating cost pressures.
Price AUD 4.88	**Fair Value** AUD 10.70	**Uncertainty** Very High	
Market Cap (bil) AUD 0.51	**Economic Moat** None	**Capital Allocation** Exemplary	
Company (Ticker) Bapcor (BAP)		**Rating** ★★★★	Pessimism sees the fundamental strength and resilience of Bapcor's automotive parts business underappreciated. We forecast Bapcor to capture more market share from a long tail of small, fragmented competitors by distributing a wider range of spare parts more quickly and reliably, and at a lower cost. These competitive strengths underpin the firm's narrow economic moat. We think concerns about discretionary consumer spending are overblown. We estimate most earnings are tied to vehicle maintenance. Bapcor enjoys an element of countercyclicality and benefits when consumers choose to maintain their existing car rather than buy a new car.
Price AUD 5.86	**Fair Value** AUD 8.00	**Uncertainty** Medium	
Market Cap (bil) AUD 1.99	**Economic Moat** Narrow	**Capital Allocation** Exemplary	
Company (Ticker) Domino's Pizza Enterprises (DMP)		**Rating** ★★★★	We view Domino's as a high-quality company with a long growth runway. We forecast a 16% earnings CAGR for the next five years, underpinned by a global store rollout. Domino's sales growth is variable, particularly given elevated inflation, and the share price tends to reflect near-term trading conditions rather than longer-term potential. However, we believe the long-term growth potential is significant and intact. We forecast the network to grow to 6,200 stores by fiscal 2032, from about 3,700 as of December 2022, which is below management's long-term target of 7,100.
Price AUD 43.52	**Fair Value** AUD 68.00	**Uncertainty** High	
Market Cap (bil) AUD 3.88	**Economic Moat** Narrow	**Capital Allocation** Exemplary	

Source: Morningstar. Data as of June 26, 2023.

Consumer Defensive

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Staples Resilient but Consumers Trading Down

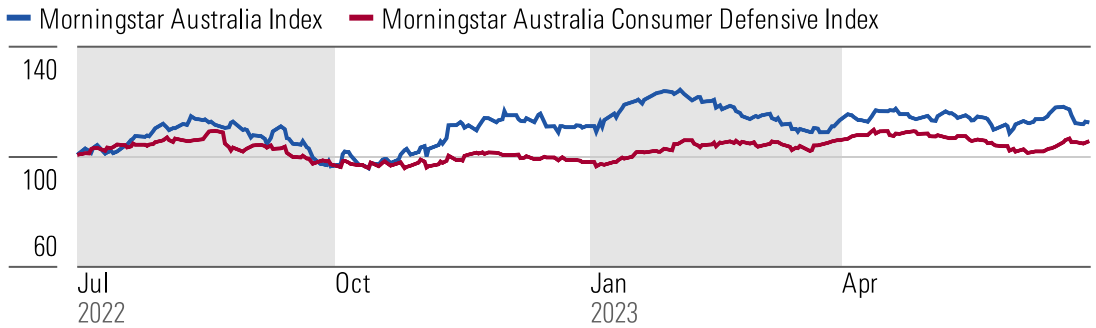
In contrast to discretionary retailing, sales momentum is picking up for supermarkets and liquor stores. Nondiscretionary retailers are popular with investors, meaning Coles and Woolworths look expensive. We see value emerging in Endeavour and Metcash.

Sales growth is being driven by extraordinarily high price inflation while volume growth lags population growth. Consumers are trading down within and across categories when grocery shopping. We think shoppers are substituting more expensive products with cheaper alternatives (chicken for red meat) and private label brands (like Coles-brand milk) for national brands (like Dairy Farmers). As private labels become more prominent, majors are in more direct competition with Aldi, which may reduce friction to switch to the discounter.

The trading-down trend should underpin cyclically stronger demand for Inghams' poultry products as chicken is a cheaper alternative to competing meats. But this trend is weighing on Bega where national brands compete directly with cheaper, private labels. Suppliers such as Bega generally struggle to pass on cost inflation given the buying power of the large supermarkets. Inputs like feed, milk, fertiliser, and labour remain elevated.

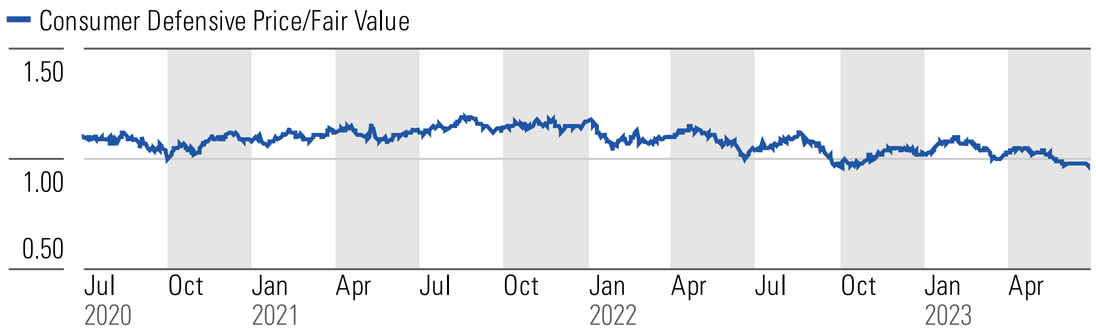
Nevertheless, we expect supplier margins to gradually recover as cost pressures abate, cost efficiencies are won, and lagged price increases begin to take effect. Both Inghams and Bega screen as undervalued.

Defensives Have Underperformed the Market Despite Economic Headwinds



Source: Morningstar. Data as of June 26, 2023.

Defensives Close to Fairly Valued on Average, but We See Some Opportunities



Source: Morningstar. Data as of June 26, 2023.

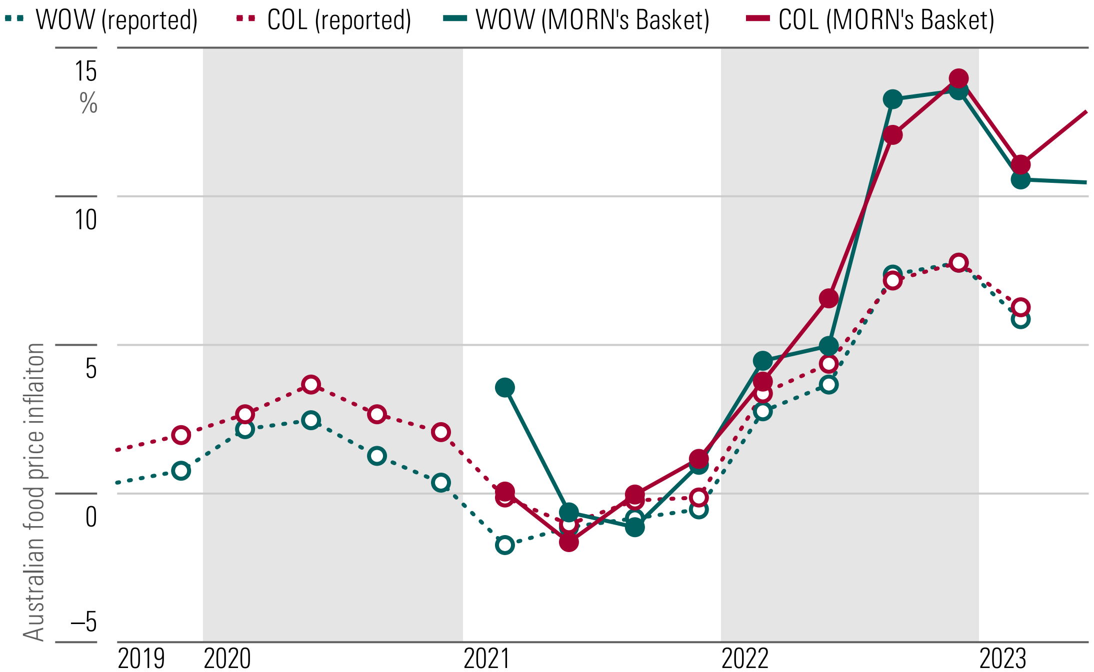
Staples Resilient but Consumers Trading Down

Rapid sales growth at the major supermarkets is being driven by high food price inflation. However, volumes are weak. Our Little Shopping Basket suggests June-quarter 2023 food price inflation remains high.

Growth in generic brands is outstripping overall growth as consumers trade down. We think this reflects pressure on household finances given below-inflation income growth and much higher interest rates.

Food Price Inflation Appears To Have Peaked, but Remains at Very High Levels

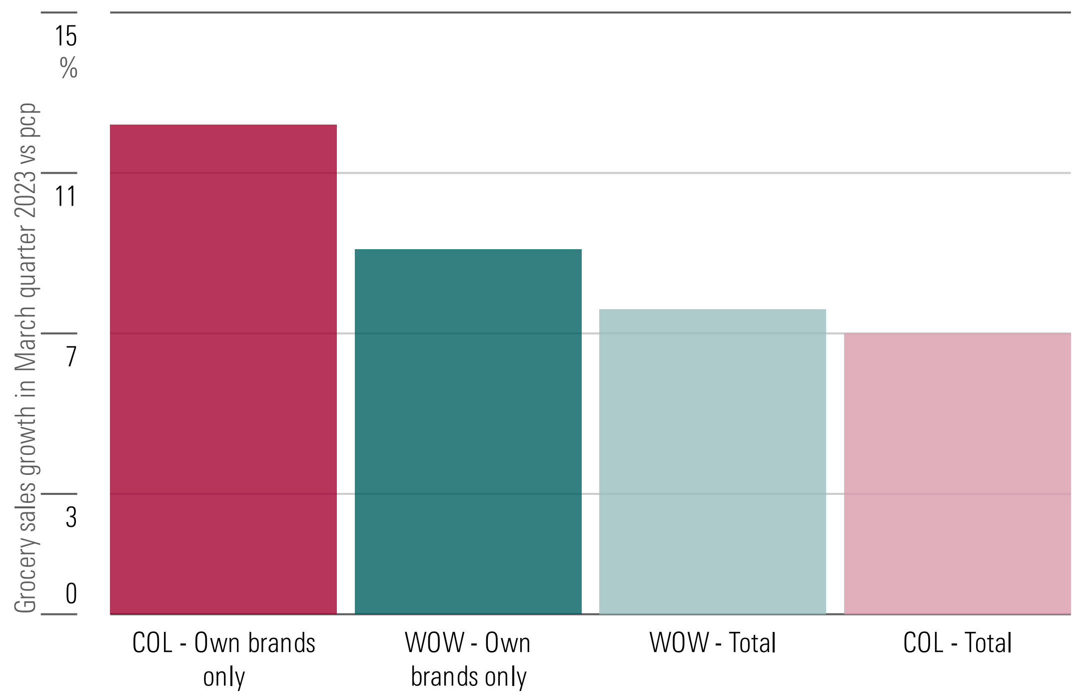
Quarterly food price inflation versus previous corresponding period.



Source: Company filings, Morningstar estimates. Data as of June 16, 2023

Price-Sensitive Consumers Are Switching to Private Labels

Quarterly growth rate of total supermarket sales and own food brands sales only vs PCP.



Source: Company filings, Morningstar estimates

Consumer Defensive

Company (Ticker)		Rating
Bega Cheese (BGA)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 3.43	AUD 5.20	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 1.04	None	Standard

Despite input cost pressure, we think shares in Bega are good value. The spiking cost of milk, a key input for Bega's cheese, weighs on near-term earnings. With an oversupply of milk processing capacity, competition is high for a limited supply of milk, exacerbating the impact of elevated global commodity milk prices. We expect profitability relief beyond fiscal 2024 to be twofold: moderating input costs as stronger prices encourage greater milk supply, and price increases for Bega's products. Price hikes typically happen on a lag, and due to Bega's reliance on powerful supermarket customers, we expect only a proportion of input cost spikes can be passed through in the near term. We forecast underlying margin improvement from fiscal 2024, given mix shift to higher-margin products and cost-outs from the Lion Dairy & Drinks merger to drive low-double-digit earnings growth in the five years post-Lion.

Company (Ticker)		Rating
Inghams Enterprises (ING)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 2.64	AUD 3.50	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 0.98	None	Standard

We think the market's concerns about Inghams are overdone. Granted, input costs—principally labour and feed—are elevated, and commensurate price increases slow to respond. Margin pressure is exacerbated by an unfavourable product mix, which has been disrupted since the onset of the pandemic. But we expect headwinds to be transitory and forecast profitability improving further from fiscal 2024 as prices increase and mix shift normalises. We expect the trend of consumers trading down to benefit near-term poultry demand as chicken meat is a cheaper alternative to competing proteins. Longer-term, we expect robust poultry demand. We forecast low-single-digit growth in per-capita chicken consumption over the next five years, before moderating as consumption approaches saturation.

Company (Ticker)		Rating
The a2 Milk Company (A2M)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 4.90	AUD 7.20	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 3.54	Narrow	Standard

Fundamentally, there is much to like about a2 Milk, notably in China, the key battleground. A2's share of Chinese-language-labelled infant formula is growing, supported by a2 Platinum's solid brand health underpinning its narrow moat. Granted, there are hurdles. Births in China are declining and the tailwind of consumers preferring foreign brands no longer blows. Offsetting this, we anticipate further premiumisation and for a2 Milk to capture market share. We forecast 12% annual revenue gains to fiscal 2027 as channel inventory levels normalise and market share increases; alongside improved sales of higher-margin English-label product and operating leverage from higher revenue.

Source: Morningstar. Data as of June 26, 2023.

Energy

Mark Taylor | mark.taylor@morningstar.com

Energy Index Outperformance Persists, but Buying Opportunities Remain

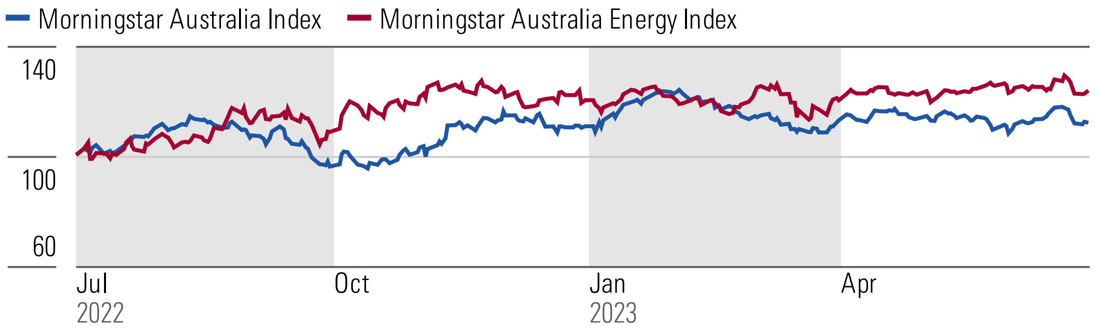
At around USD 75 per barrel, the Brent crude price is a far cry from the USD 115 peaks of mid-2022. We expect upstream oil and gas company earnings in 2023 to approximately halve on 2022 levels—but this shouldn't translate to weaker share prices. Energy commodity prices are still very healthy for the likes of Woodside and Santos. They can earn favourable margins even at lower prices.

Longer-term we still see secular demand decline for oil, but we think the market is probably too bearish about its timing and severity. We think global demand will creep higher in the next few years. And when it does start to decline—in the early 2030s in our base case—the rate will be modest due to growing demand for jet fuels and petrochemicals.

We expect strong and growing demand for natural gas to balance renewable energy generation and for peaking power. This is important for gas-heavy Australian E&Ps given natural gas is an energy transition commodity. We think the Australian E&Ps should enjoy multidecade runway to maintain and grow operations and generate robust free cash flows, with much of this to go to shareholders via buybacks and dividends. Longer-term our USD 60 per barrel midcycle Brent crude price forecast is still where we see sufficient supply being incentivized, but U.S. shale production isn't overstimulated.

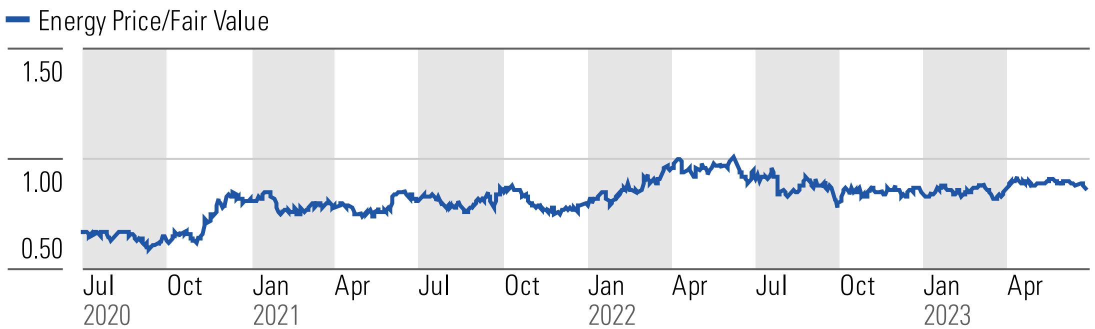
The thermal coal price has fallen from historical highs reached in 2022. Slower economic growth in the West and significant increases in Chinese domestic production are headwinds. But above USD 100 per metric ton, the price exceeds the long-run average.

Still Opportunities in Energy Despite Sector Outperformance



Source: Morningstar. Data as of June 26, 2023.

Oil and Gas Producers Remain Undervalued



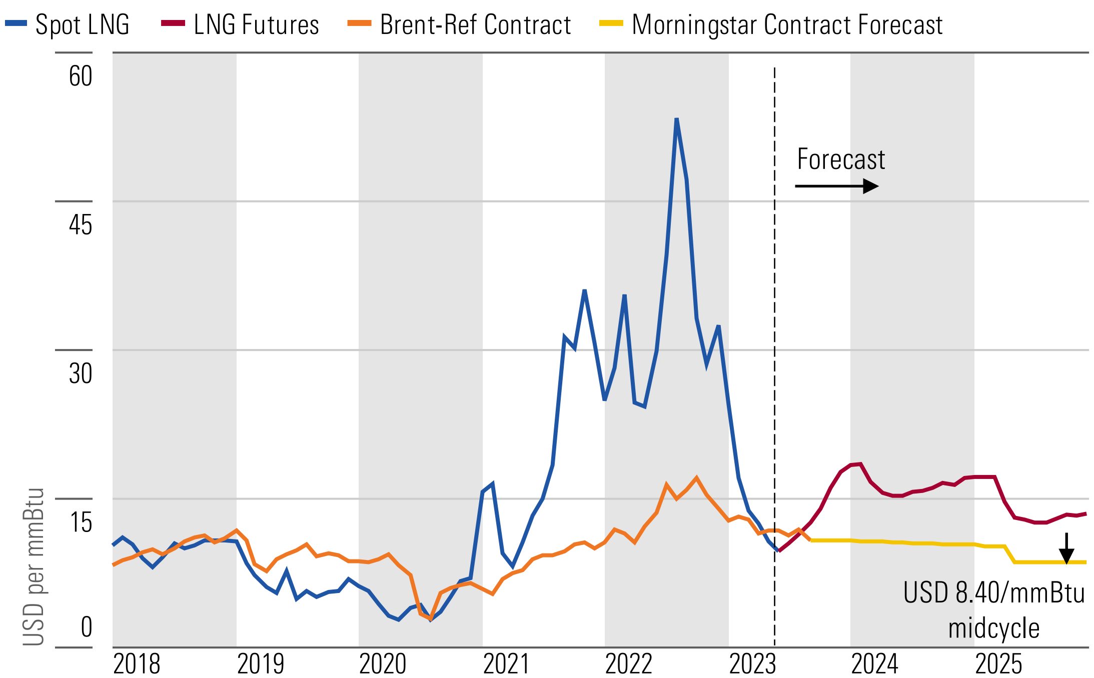
Source: Morningstar. Data as of June 26, 2023.

Energy Index Outperformance Persists, but Buying Opportunities Remain

Spot prices have fallen toward our midcycle levels of USD 60 per barrel for Brent crude and USD 8.40 per million Btu for Asia liquefied natural gas. This is a sharp pullback particularly for spot LNG. However, spot LNG futures are still more bullish than for Brent crude.

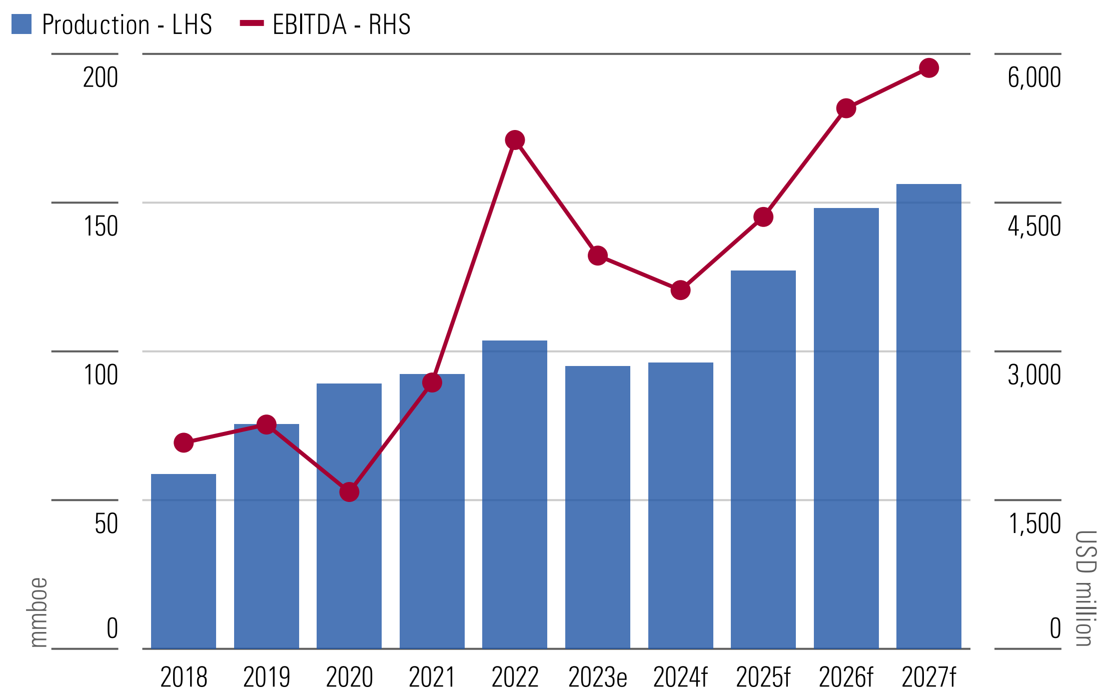
Despite strong forecast production growth including from Barossa, Pikka, and Papua LNG, we anticipate Santos' earnings to fall from record 2022 levels given lower prices. Regardless, we expect profitability to remain strong.

Spot LNG Price Below Contract Levels, but Futures More Bullish



Source: Meti/investing.com/CME as of June 19, 2023, Morningstar.

Santos' Record 2022 Earnings Unlikely To Be Repeated Before 2026



Source: Company Filings as of June 19, 2023, Morningstar.

Energy

Company (Ticker)		Rating
Beach Energy (BPT)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 1.33	AUD 3.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 3.03	None	Standard

We forecast strong EPS growth for Beach, but the market may be penalising it for lesser field life and cost blow-outs at its Waitsia gas project in the Perth Basin. While some discount is warranted, we think it's too harsh. Beach recently removed targeted cost and schedule estimates for Waitsia after new contractor, Webuild, took over from Clough, now in administration. First gas from Waitsia was expected at end 2023. While disappointing, we still expect Waitsia to be a value-accretive cornerstone asset for Beach. We still forecast a healthy EBITDA CAGR of just over 10% to USD 1.4 billion in fiscal 2027 versus fiscal 2022.

Company (Ticker)		Rating
Santos (STO)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 7.32	AUD 12.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 23.83	None	Standard

We think Santos is not being sufficiently credited for new oil and gas developments underway and the shares are cheap. A solid balance sheet and low costs, including a freight advantage to Asia, mean the company is well placed to weather any cyclical low prices. But crude and LNG prices are strong now and gas has a growing role to fuel the world, including to complement increasing renewable energy production. We forecast group hydrocarbon growth of around 60% by 2027 from 2023, chiefly from the Pikka oilfield development in Alaska and reinvigoration of Darwin LNG's output with the Barossa gas field development. We forecast strong four-year EBITDA CAGR of 10% to USD 5.9 billion by fiscal 2027.

Company (Ticker)		Rating
Whitehaven Coal (WHC)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 6.56	AUD 9.80	Very High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 5.73	None	Standard

While thermal coal prices have fallen from historical highs, they remain elevated as Russia's invasion of Ukraine reinforced the importance of energy security. Whitehaven Coal is generating substantial cash flows and with a very strong balance sheet, much of its excess cash is likely to go to shareholders via share buybacks and dividends. We think demand for Whitehaven's high-quality (high-energy, low-ash) thermal coal will remain strong for at least the next decade, especially from countries in Southeast Asia such as Japan, South Korea, and Taiwan. High-quality thermal coal allows these countries to meet the energy needs of their populations while also helping reduce emissions in line with their obligations under various international agreements. Opposition from regulators to bringing on new supply could also support prices longer-term.

Source: Morningstar. Data as of June 26, 2023.

Financial Services

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Shaun Ler | shaun.ler@morningstar.com

Interest Rate Tightening Creates Temporary Cyclical Earnings Headwinds for Financials

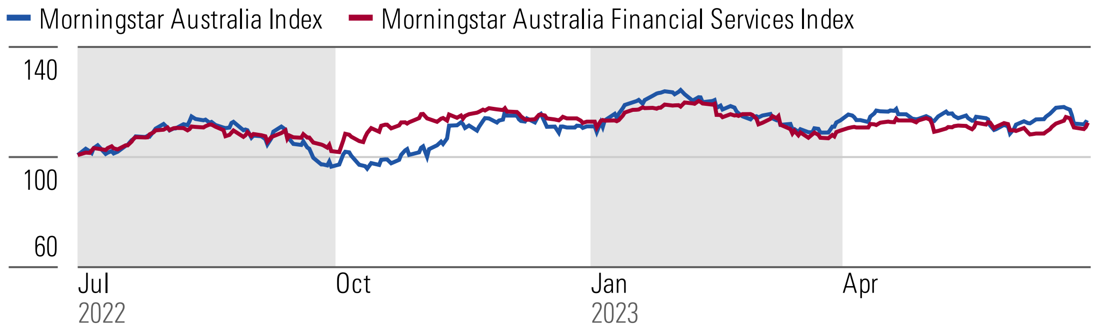
We see value in Australian banks, with most trading at material discounts to our fair value estimates. Australian banks delivered strong results, but a peak in net interest margins, and likely rising loan losses as more households and businesses face financial stress, makes for a more challenging near-term outlook.

We still expect margins to improve from fiscal 2022 levels, but a lot of the upside from a higher rate environment is being competed away as banks fight to hold market share amid slow credit growth, high refinance activity, and fixed rate loans maturing. Still, we think banks will be rational when pricing deposits and loans to make an appropriate return for shareholders over time. Higher rates raise the risk loan losses exceed our expectations, but the strong economic starting point and household and business equity buffers provide comfort.

The earnings outlook for general insurers, IAG Group and Suncorp, is positive, benefiting from more favourable weather after three years of La Nina, and higher premiums in the face of rising claims inflation, natural hazards, and reinsurance costs.

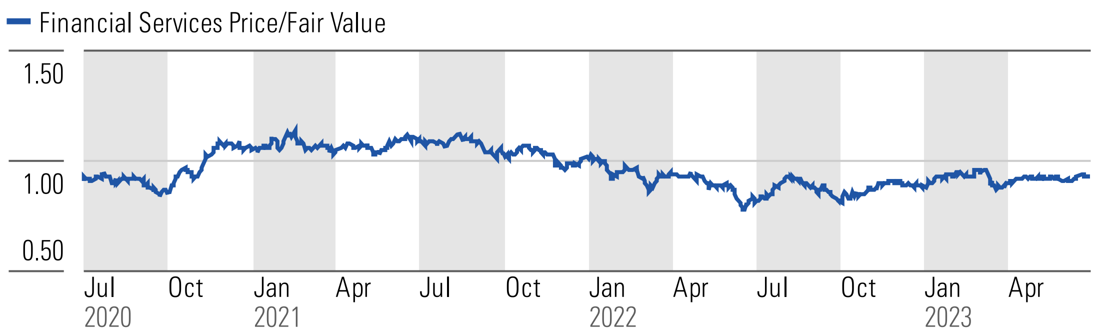
We expect wealth and asset managers to see earnings improvement in fiscal 2024, driven by a likely recovery in stock markets. We expect flows and returns to improve as interest rates stabilise (or potentially decrease) over fiscal 2024. Diversified and strong-performing players like Pinnacle and GQG Partners should recover faster than peers. Competition for platform flows will likely be less skewed in favour of market favourites Hub24 and Netwealth, relative to history.

Banks and Asset Managers Remain Unloved as Tightening Cycle Continues



Source: Morningstar. Data as of June 26, 2023.

We Prefer Wide- and Narrow-Moat Names Among Cheap Financials



Source: Morningstar. Data as of June 26, 2023.

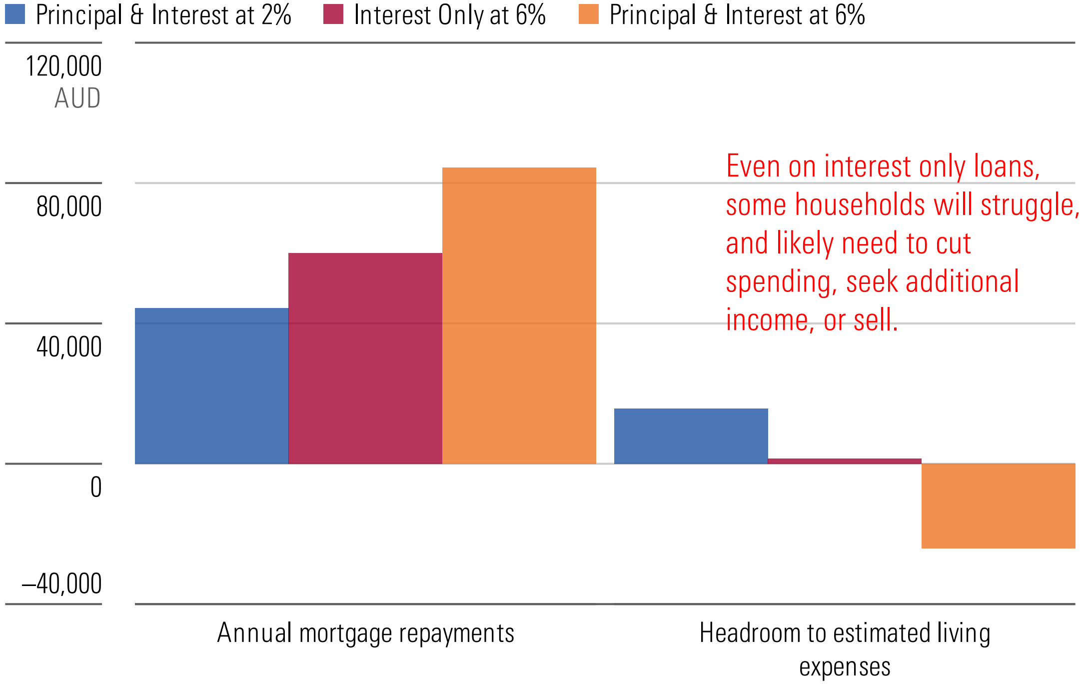
Interest Rate Tightening Creates Temporary Cyclical Earnings Headwinds for Financials

Higher interest rates hurt discretionary spending, but we expect mortgage defaults to only marginally exceed long-term averages. In addition to cutting spending, households can extend principal repayments to avoid defaulting.

Anecdotal evidence suggests many investors and asset managers are defensive and believe the full impact of interest rate rises have yet to hit earnings. Interest rates likely need to stabilise and start to retreat for the foundations of the next recovery to be laid.

Some Switching to Interest-Only Repayment Likely To Help Manage Arrears

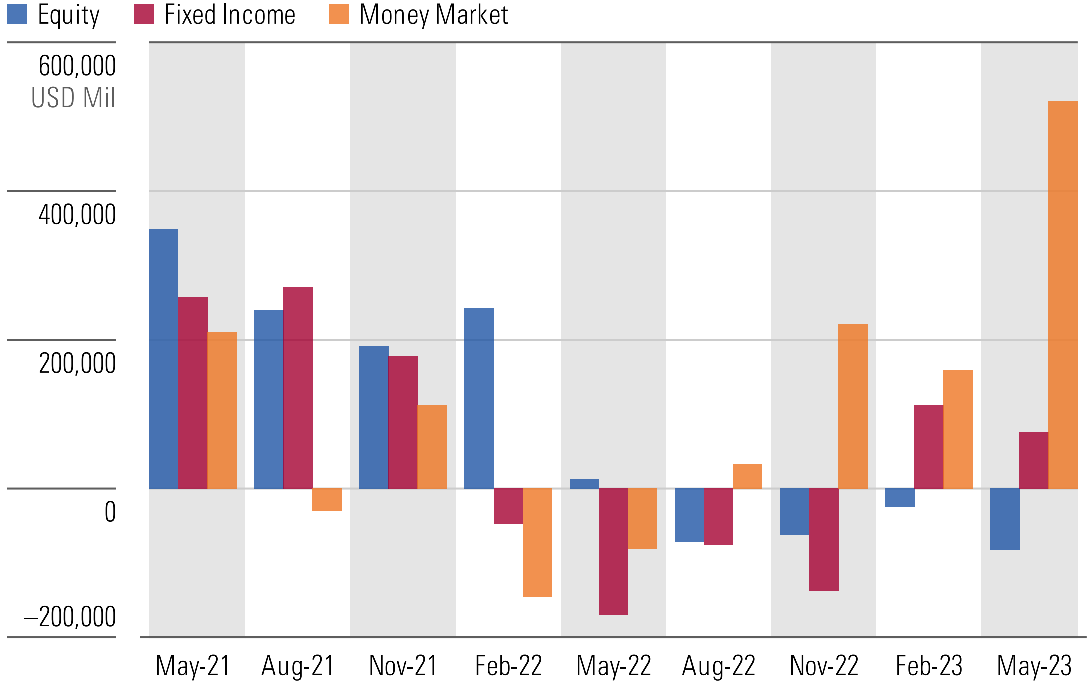
Principal & interest repayments can also be lowered by paying down principal slower.



Source: Morningstar estimates for a family of four, with a AUD 1 million loan and income of AUD 167,000.

Global Investors Remain Cautious Toward Equities, Rebound To Take Time

Estimated net flows into asset classes, global markets.



Source: Morningstar Direct. Data as of May 31, 2023.

Financial Services

Company (Ticker) ANZ Group Holdings (ANZ)		**Rating** ★★★★
Price AUD 22.77	**Fair Value** AUD 31.00	**Uncertainty** Medium
Market Cap (bil) AUD 68.29	**Economic Moat** Wide	**Capital Allocation** Standard

ANZ Group has lost material home loan market share, and having less funding sourced from low-cost household customer deposits, has incurred material margin pressure. We suspect shares do not fully factor in the margin benefit of rising cash rates and process investments which should improve the competitiveness of this wide-moat bank. In recent months, ANZ has grown home loans ahead of market, and with no worse margin pressure than peers. Exposure to corporate lending, which has not seen the same level of price competition as mortgages, helps. While improving the loan approval process and customer offering comes with added expenses, they should help drive earnings growth and returns on equity. Suncorp Bank should improve bank efficiency, but the acquisition and integration costs make it unlikely to be materially value-accretive.

Company (Ticker) Perpetual (PPT)		**Rating** ★★★★
Price AUD 25.15	**Fair Value** AUD 33.00	**Uncertainty** Medium
Market Cap (bil) AUD 2.83	**Economic Moat** Narrow	**Capital Allocation** Standard

While narrow-moat Perpetual's acquisition of Pendal brings risks, we believe the downside from fund outflows or cost blowouts is more than priced in. We expect staff retention and product distribution efforts to effectively manage outflow risk, and see room to cut costs though centralising operations. While Perpetual's investments business remains in net outflows, we believe the division's gradually improving investment performance supports new mandate wins and aids in reducing overall redemptions. Its private wealth and corporate trust businesses, Perpetual Private and Perpetual Corporate Trust, also face less competitive intensity relative to the investments business. Perpetual Private continues to gain share in the high-net-worth advice market, while Perpetual Corporate Trust is extracting more revenue from existing customers. We believe Perpetual is trading below its sum-of-the-parts, which could raise the potential for a future asset sale.

Company (Ticker) Westpac Banking (WBC)		**Rating** ★★★★
Price AUD 20.68	**Fair Value** AUD 28.00	**Uncertainty** Medium
Market Cap (bil) AUD 72.46	**Economic Moat** Wide	**Capital Allocation** Standard

Source: Morningstar. Data as of June 26, 2023.

Wide-moat Westpac has lost market share in home loans and pulled its cost-saving targets, but we think it will improve on both fronts. Despite intense competition, we expect margins to benefit from a large customer deposit funding base. Westpac is Australia's second-largest lender, number two in mortgages and number three in business loans. Funding cost advantages should allow the bank to reprice loans to generate better margins as smaller banks struggle to make a decent return on equity given higher wholesale funding costs. Bank cost inflation is meaningfully tied to customer remediation and improving risk management, and much of this should dwindle. Market share has stabilised in recent months, supporting our confidence there are no serious loan approval issues. Westpac has surplus capital, is well provisioned, and pays generous fully franked dividends.

Healthcare

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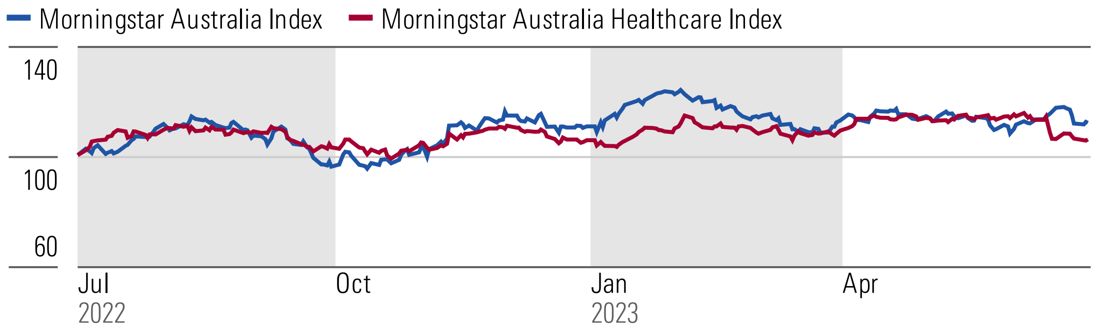
Attractive Healthcare Opportunities Amid Rising Inflation

The healthcare sector underperformed the Morningstar Australia Index in the June quarter of 2023. We view the sector as fairly valued on average, but we see buying opportunities with over a third of our coverage trading in 4- or 5-star territory. The most attractive names are Ramsay and Ansell where we see margins expanding, and ResMed where we expect supply constraints to alleviate. Meanwhile, Pro Medicus, Ebos, and Cochlear are our most overvalued stocks.

Healthcare is somewhat defensive and generally able to pass on cost inflation without a material impact on demand. Although CSL recently provided disappointing guidance for fiscal 2024, we remain optimistic on long-term product demand given it's underpinned by chronic indications. As plasma supply improves, we expect blood donor fees to fall and margins to expand with operating leverage, as labour and overhead costs scale with collection volumes.

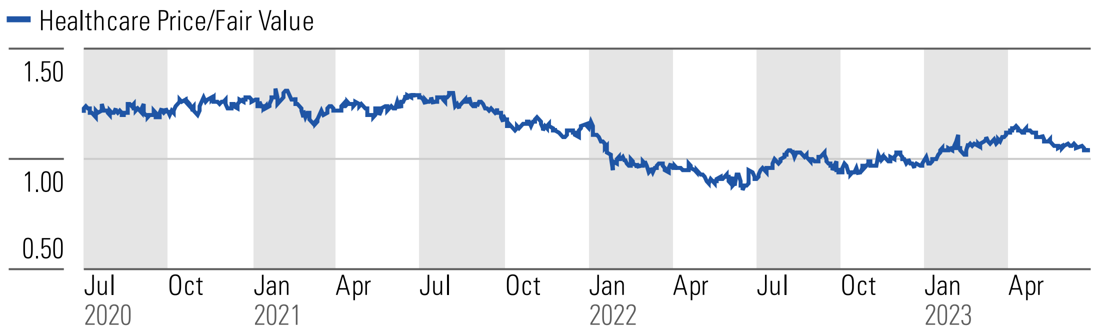
The Australian government's new bulk billing plan to make doctor appointments more affordable is likely to support diagnostic testing volumes. Imaging services are also set to benefit from a 4% price increase in fiscal 2024. Sigma has strengthened its business by winning back the Chemist Warehouse contract for prescription medicine from Ebos. We think Sigma is likely to retain the business longer-term given its warehouse capacity and Ebos' focus on higher-margin pet and medical devices distribution.

Healthcare Has Underperformed the Broader Market



Source: Morningstar. Data as of June 26, 2023.

Several Names Appear Attractive in Fairly Valued Sector

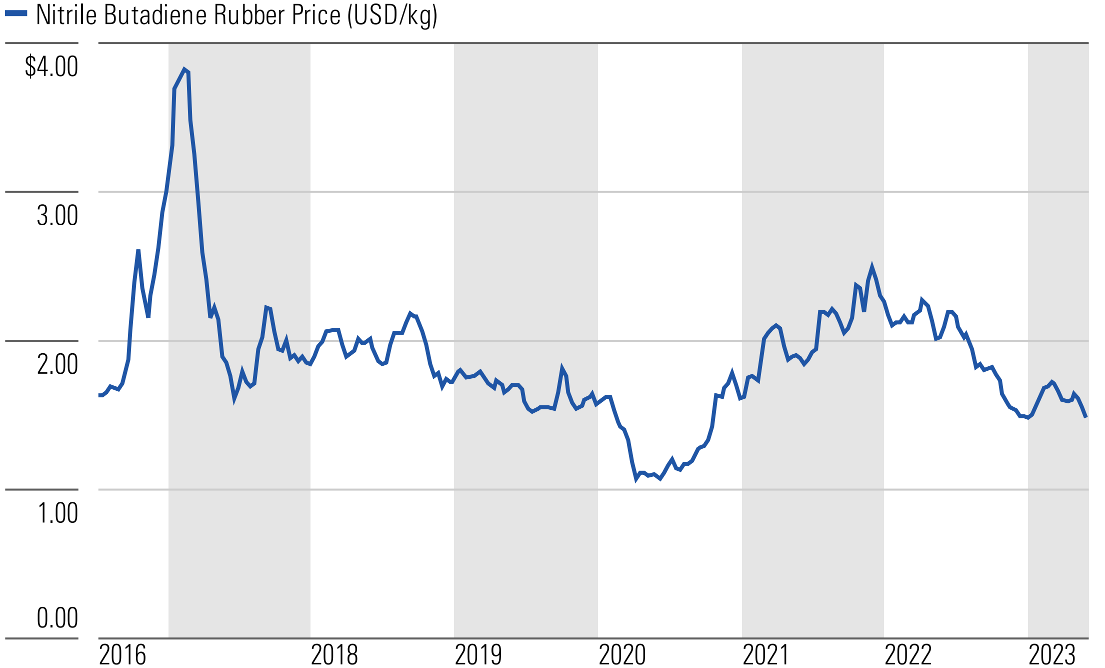


Source: Morningstar. Data as of June 26, 2023.

Attractive Healthcare Opportunities Amid Rising Inflation

We expect Ansell to benefit from easing input costs. The cost of nitrile butadiene rubber which is a byproduct of petroleum used to make synthetic latex, is roughly 40% below the December 2021 peak. NBR is about 15% of Ansell's total operating costs.

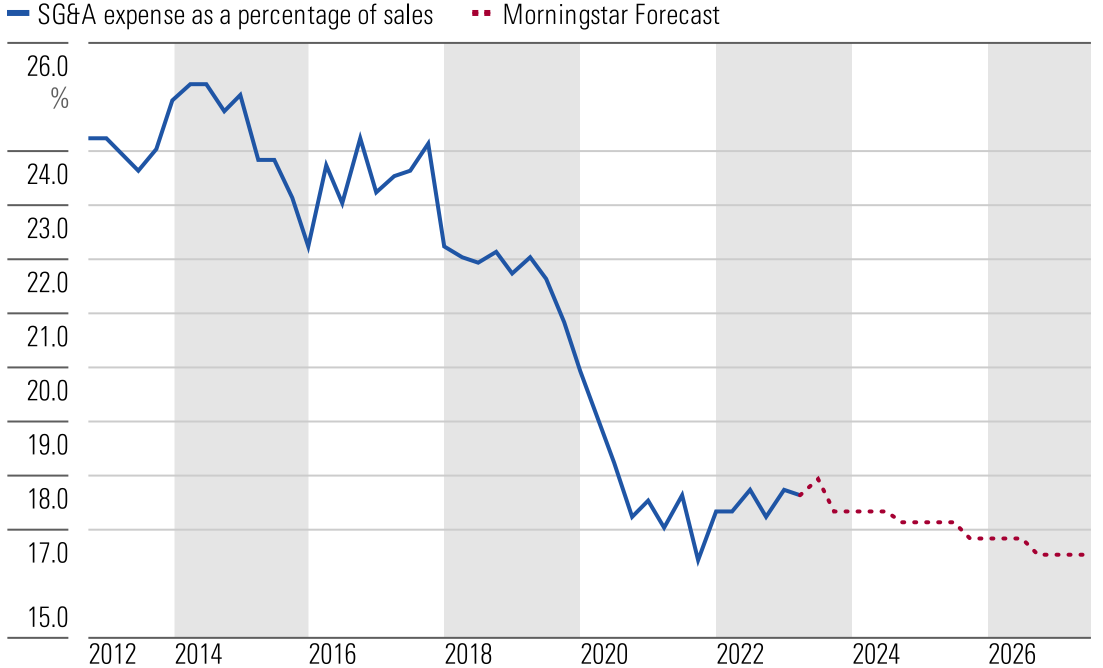
Synthetic Rubber Costs Continue To Trend Lower



Source: China National Bureau of Statistics, Haver Analytics.

ResMed's selling, general, and administrative expenses have trended down as a percentage of sales over the past decade. We think this partly reflects increasing mainstream understanding of the clinical evidence for sleep apnea and its treatment.

We Expect Cost Control To Support ResMed's Margin Expansion



Source: Morningstar estimates, Company filings.

Healthcare

Company (Ticker)		Rating
Ansell (ANN)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 25.74	AUD 30.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 3.28	Narrow	Exemplary

We anticipate Ansell's recent margin pressures to abate as supply chain constraints normalise and pricing for undifferentiated single-use exam gloves stabilise to around prepandemic levels by fiscal 2024. Volumes for Ansell's differentiated single-use exam gloves grew 15% in fiscal 2022 with cost inflation offset by price increases. We see limited competitive pressure on Ansell's differentiated products and reiterate its narrow-moat rating based on intangible assets. We forecast gross margin to recover to 39% by fiscal 2024 from 37% in first-half fiscal 2023 as Ansell insources more manufacturing, better utilises its facilities, and improves the sales mix. See our special report "Undervalued Ansell Provides Investors Adequate Margin of Safety" published on Nov. 10, 2022, for more details.

Company (Ticker)		Rating
Ramsay Health Care (RHC)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 54.45	AUD 68.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 12.48	Narrow	Exemplary

Narrow-moat Ramsay's third-quarter fiscal 2023 trading update was disappointing, with margins still depressed. However, we think the market has overreacted with Australian doctors taking abnormally more leave in the third quarter after a grueling period. Importantly, labour shortages are easing with immigration recovering, and Ramsay continues to invest in recruiting and training programs. We expect margins to improve as Ramsay uses fewer agency staff members, as case mix and volumes normalise for nonsurgical services, and with efficiencies from digital investments. The firm is also well placed longer-term as it adds capacity in its development pipeline. Management still expects conditions to normalise by fiscal 2024 and we agree with that view.

Company (Ticker)		Rating
ResMed (RMD)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 32.14	AUD 39.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 47.18	Narrow	Exemplary

ResMed is performing strongly, recording its highest quarter of new patient setups and strong device sales in the third quarter of fiscal 2023. Given supply shortages, with Philips hampered by its remediation work, there is excess demand for ResMed's products. The company expects to meet demand by the end of 2023 as the semiconductor chip supply improves. In fiscal 2022, ResMed successfully launched a redesigned AirSense 10 card-to-cloud device to reduce reliance on components in short supply. The firm has a long growth trajectory given both developed and emerging markets are underpenetrated. It is also exposed to strong industry trends such as aging populations, obesity, underdiagnosis, and a focus on digital and home healthcare.

Source: Morningstar. Data as of June 26, 2023.

Industrials

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Select Opportunities in Industrials Despite Economic Headwinds

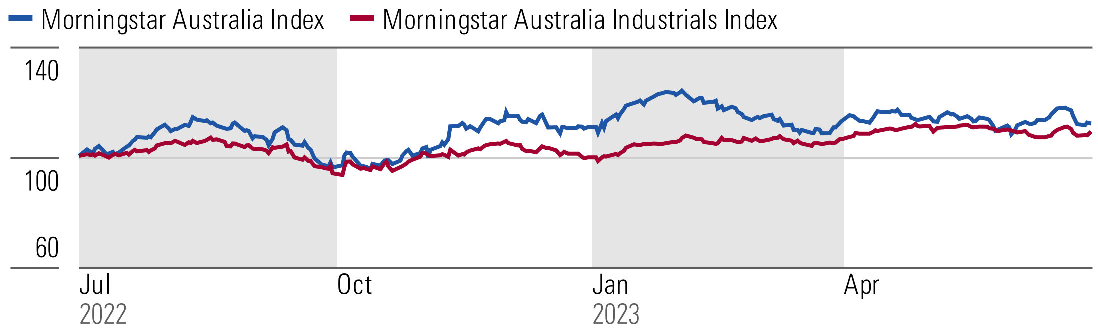
The industrials sector has lagged the Morningstar Australia Index in the past year due to fears of an economic slowdown. The sector appears fairly valued on average and we see select buying opportunities. Our top picks are Ventia, Aurizon, and Brambles.

Toll road owners Transurban and Atlas Arteria have favourable outlooks, but these are priced in with shares ahead of our fair value estimates. These toll road operators are benefitting from fixed cost leverage as a recovery in traffic volumes and CPI-linked tolls boost cash flows. Rising interest rates and credit spreads are a headwind, but interest rate hedging should soften short-term impacts. Air travel demand has roared back, outpacing constrained supply and driving tremendous profitability for Qantas and Air New Zealand. But we expect conditions to normalise as capacity bottlenecks, particularly labour shortages, ease.

Container imports slowed in early 2023, suggesting moderating earnings growth for logistics company Qube. Coal-exposed Aurizon suffered from wet weather hampering mine output and thus haulage volumes, but the medium-term outlook is good.

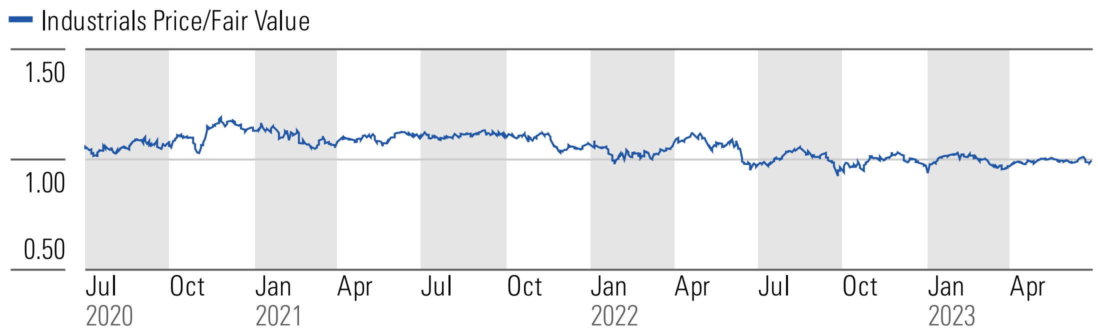
Urban services businesses Downer EDI and Ventia Services Group trade at material discounts to their fair values despite strong revenue trajectories supported by a positive outlook for government demand. Both are multidisciplinary defence services providers, and the federal government plans transformative expenditure across all areas of defence estate management and advisory. They also specialise in renewable energy solutions and should benefit from significant investment toward Australia's Net Zero target.

Industrials Lag the Broader Market on Economic Fears



Source: Morningstar. Data as of June 26, 2023.

Industrials Screen as Fairly Valued



Source: Morningstar. Data as of June 26, 2023.

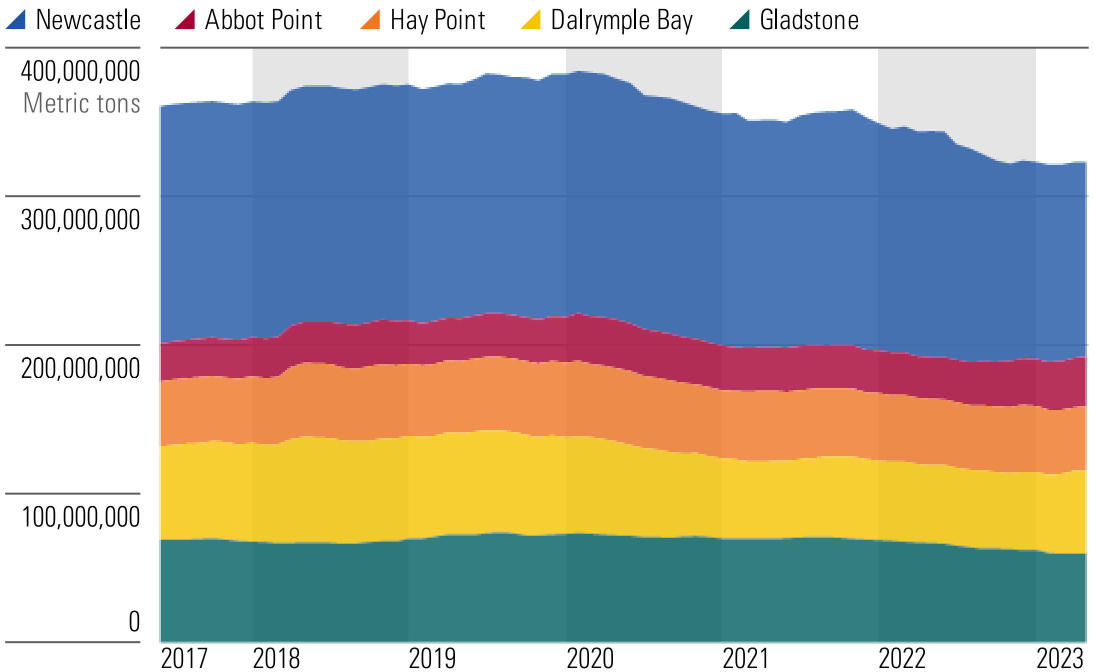
Select Opportunities in Industrials Despite Economic Headwinds

Australian coal exports in the past year are down about 15% from the peak as heavy east coast rainfall took a toll on mine productivity. We expect a solid recovery as the Bureau of Meteorology forecasts much drier conditions ahead.

Toll road traffic volumes have mostly recovered from COVID-19. Laggards are motorways in North America, where working from home has been more persistent, and those primarily serving airports, given international travel has been slow to recover.

Coal Exports Likely to Improve as La Nina Fades

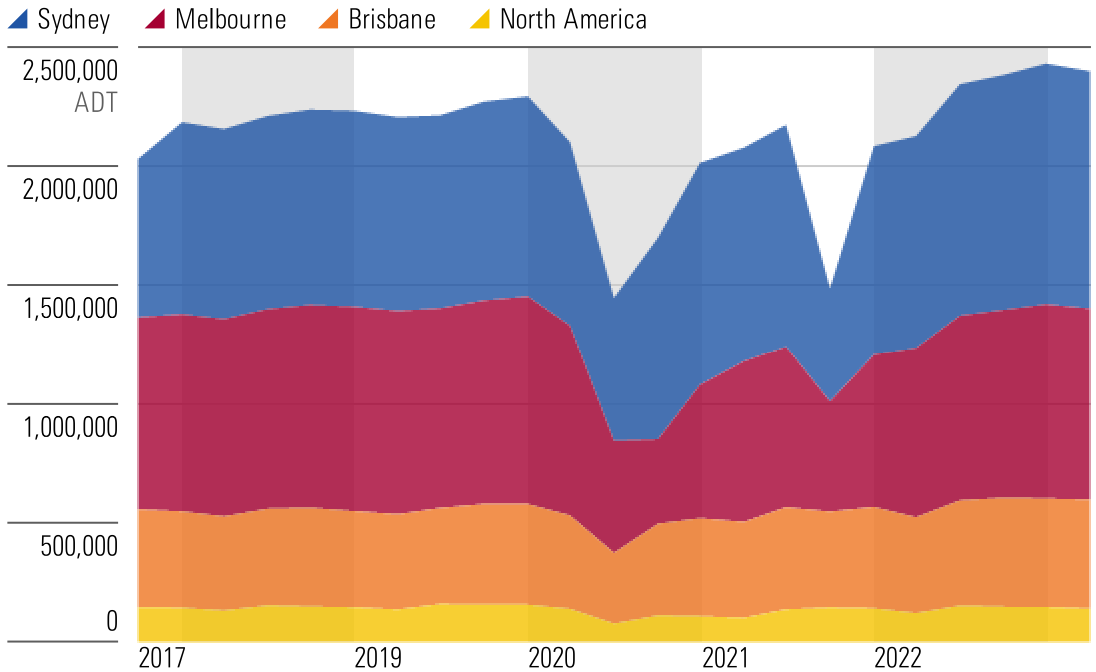
Coal exports from Australia's main ports (trailing 12 months).



Source: North Queensland Bulk Ports, Gladstone Ports, Port of Newcastle. Data as of May 31, 2023.

Most Toll Roads Have Recovered From the Pandemic

Average daily trips per quarter on Transurban's toll roads.



Source: Transurban. Data as of March 31, 2023.

Industrials

Company (Ticker)		Rating
Ventia (Australia) (VNT)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 2.92	AUD 3.60	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 2.50	None	Standard

The market is seemingly unimpressed by Ventia, perhaps reflecting a large but declining vendor shareholdings overhanging since the IPO. We project EPS growing at a near-4% CAGR to 2026 and a fully franked yield nearing 7% also by 2026. We like the relatively defensive revenue streams with maintenance cash flows comparatively resilient to external shocks. Business capital requirements are low, expected at less than 1% of revenue. Over the next four years, macro tailwinds including population growth, outsourcing volume rates, and environmental regulations underpin Ventia's expectation for the market to grow at robust 6.6% CAGR for Australia and New Zealand.

Company (Ticker)		Rating
Aurizon Holdings (AZJ)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 3.84	AUD 4.70	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 7.07	Narrow	Standard

Shares of narrow-moat Aurizon offer an attractive yield, underpinned by high-quality rail infrastructure and haulage operations. Considerable downside is priced into the shares and our analysis suggests risks for investors are skewed to the upside. Haulage volumes were weak in fiscal 2023 given wet weather, but the outlook is for volumes to recover, haulage tariffs to rise with the CPI, and as the regulator allows the rail track to earn higher returns. We think environmental concerns are overblown, providing an opportunity for investors to buy a better-than-average-quality company at a discount. Aurizon largely hauls coking coal from globally competitive mines. A commercially viable alternative to coking coal to make new steel is a long way off.

Company (Ticker)		Rating
Amcor (AMC)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 14.80	AUD 16.00	Low
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 21.94	Narrow	Standard

While recent volume trends are weak, we are more constructive over Amcor's medium- and long-term volumes, given exposure to the defensive areas of consumer stables, personal care, and healthcare. We forecast improvement once customer destocking and consumer trading down completes. From there, we expect incremental improvement in returns on invested capital over time. This reflects forecast strong single-digit organic sales growth through the reinvestment of free cash flows into emerging markets and higher-margin differentiated products.

Source: Morningstar. Data as of June 26, 2023.

Real Estate

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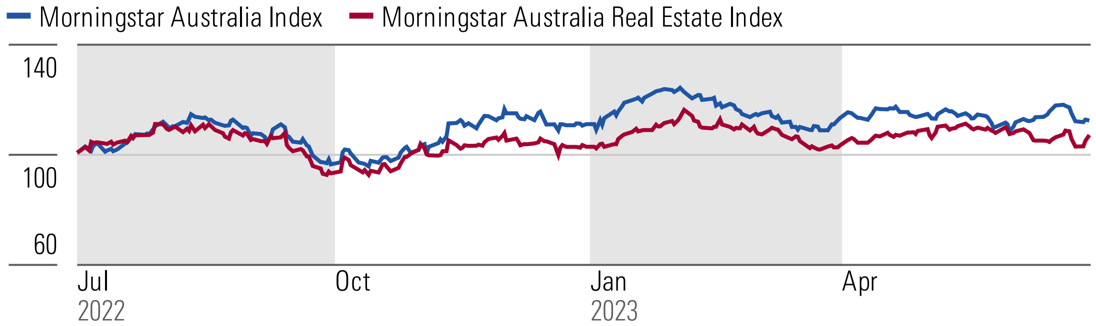
Tough Conditions Now, but Long-Term To Improve With Population Growth

Real estate conditions are tough, but major listed REITs have some recession defences in long leases, strong tenants, and fixed rate debt. The main risk we see is persistent high interest rates.

Office leasing is tough, but train passenger data shows Sydney's CBD is getting busier and should get busier still with generally growing minimum attendance levels. Development starts are slowing with high interest rates, which should help balance supply and demand. Dexus recently sold an A-grade office tower in Sydney at a 17% discount to book value, but it was one of Dexus' lower-quality towers. June 2023 office valuations from Charter Hall, Dexus, and Growthpoint saw 3.7% to 7.7% aggregate declines. Physical office values have declined, but not as far as security prices imply for undervalued office heavyweights Charter Hall, Dexus, GPT, and Mirvac.

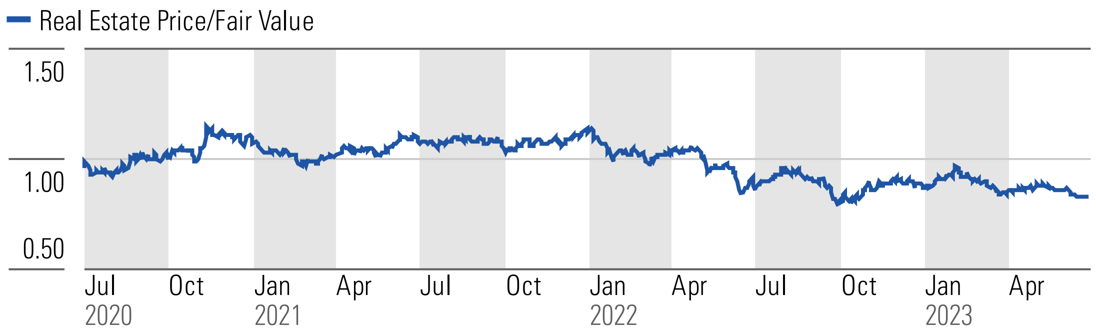
High interest rates and supply chain issues hamper residential developers. Underlying demand is good thanks to population growth, but affordability is constrained. We think undervalued Mirvac's housing solutions, including master-planned communities, apartments-for-sale, build-to-rent, and residential land-lease, are well placed to meet demand in an environment of constrained affordability. Recent government initiatives to promote supply should be supportive for large developers. We remain cautious on self-storage property given the absence of leases, recession risk, and expensive valuations.

Real Estate Likely Weak Until Interest Rates Peak



Source: Morningstar. Data as of June 26, 2023.

Property Was Expensive in 2021, but Now Looks Cheap



Source: Morningstar. Data as of June 26, 2023.

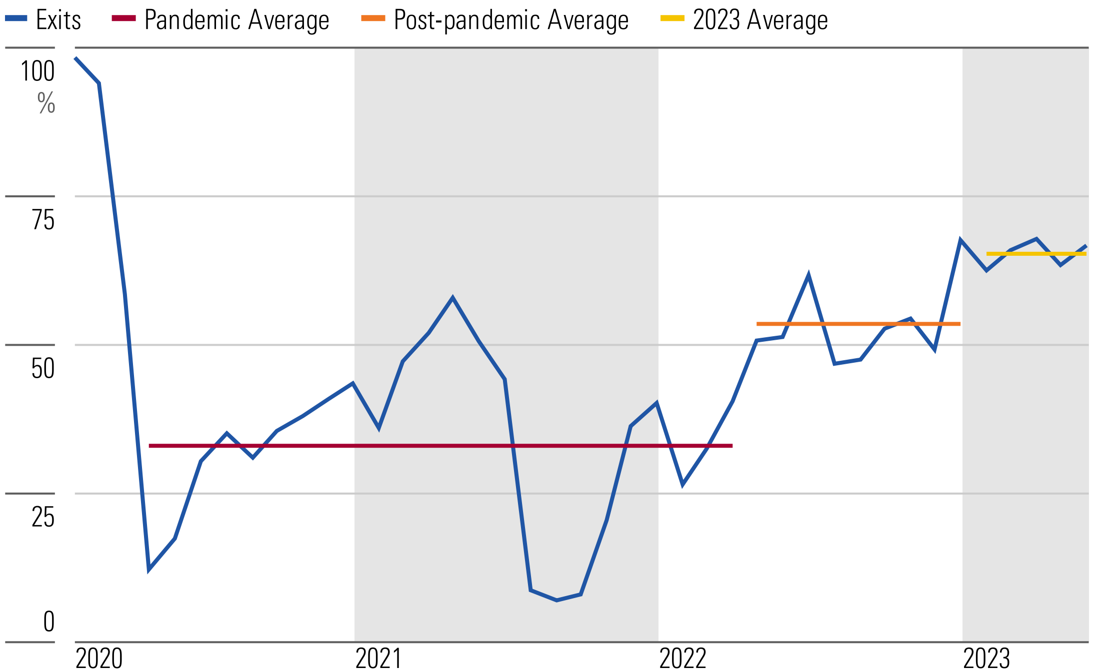
Tough Conditions Now, but Long-Term To Improve With Population Growth

Train passenger data supports our view that the recovery in CBD activity is not over, and office rents have likely bottomed. Rail passengers in Sydney's CBD are well above 2022 levels and we see employees increasingly required back in the office.

Residential vacancies are at record lows just as approvals for new dwellings collapse. Construction takes 1-2 years, so low supply looks baked in until at least 2025. Mirvac and Stockland have the financial strength to keep building and to take market share.

Train Passenger Data Shows Continuing CBD Recovery

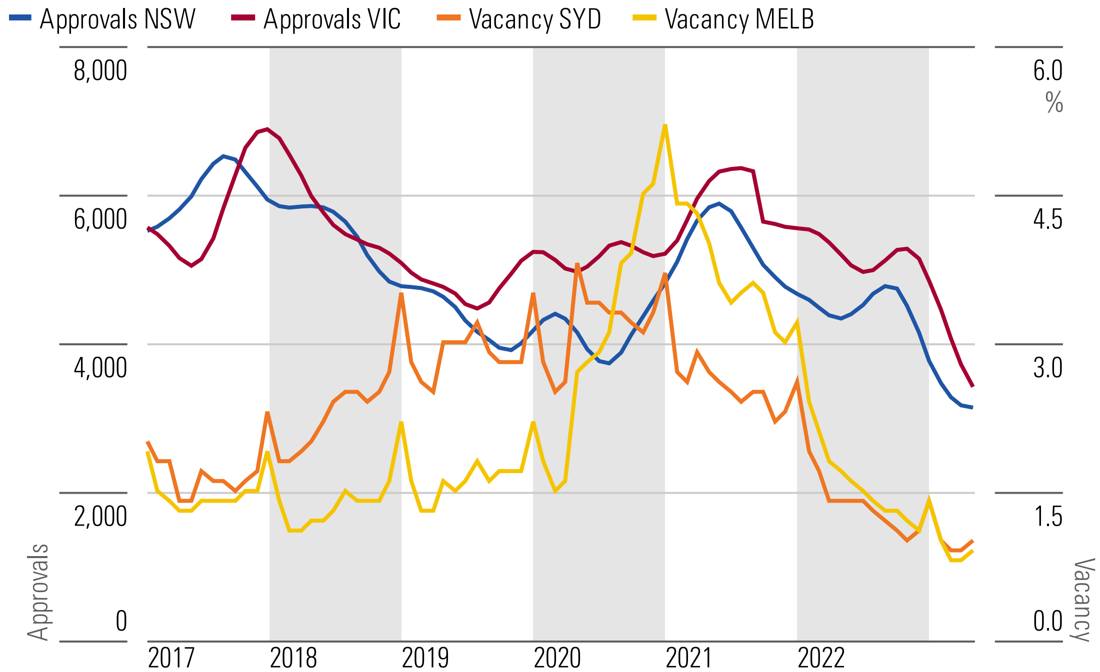
Sydney CBD train passenger exits as % of 2019.



Source: TransportNSW, Circular Quay, Martin Place, Museum, St James, Town Hall, Wynyard. Morningstar.

Residential Construction Unlikely To Solve Housing Shortage Soon

Rental vacancy versus monthly dwelling approvals.



Source: Domain Vacancy Report, ABS Trend Residential Dwelling Approvals, Morningstar.

Real Estate

Company (Ticker)		Rating
Lendlease (LLC)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 7.00	AUD 14.45	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 4.83	None	Standard

Lendlease securities trade near net tangible assets. This is overly pessimistic given about half of the group's EBITDA comes from development and construction, largely excluded from the NTA. The market seemingly fears a dilutive equity raising, but we think that's unlikely. Management denied plans to raise capital as recently as April 2023. Gearing remains modest and Lendlease can sell assets across retirement and residential communities to fund its development pipeline. Management reaffirmed in May 2023 it's on track for more than AUD 8 billion of development completions in fiscal 2024. The target looks reasonable, given development work in progress of AUD 18 billion plus new projects. Downside risks look more than priced in, and we see substantial upside if Lendlease reaches its targets in 2024 or 2025.

Company (Ticker)		Rating
Dexus (DXS)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 7.62	AUD 10.80	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 8.20	Narrow	Standard

Dexus trades at a material discount to NTA, which doesn't include the intangible value of the group's funds management business. Funds management contributed roughly 10% of funds from operations in fiscal 2022. Dexus missed out on acquiring some AMP mandates, but we see this as a short-term setback and expect funds management contributions to grow over time. Meanwhile Dexus' office portfolio looks to be close to stabilising, with lockdowns in the rear-view mirror, and tighter financial conditions likely to curtail future office supply. We expect higher interest rates to weigh on office valuations, but not as much as implied by Dexus' security price. The group's industrial properties (about 25% of its portfolio) are performing well.

Company (Ticker)		Rating
Charter Hall Group (CHC)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 10.52	AUD 16.20	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 4.98	Narrow	Exemplary

We think the securities overly discount expected weaker operating conditions, and its development pipeline is likely to continue to add to funds under management. Higher interest rates will likely hurt performance and transaction fees, but base management fees, 40% of 2022 fund management revenue, are stable. We believe there is a long-term trend toward institutions investing in property via specialised property fund managers, instead of directly. We expect Charter Hall to reap more inflows due to its strong track record, rising tax and management complexity, and as international investors seek local expertise. Charter Hall has no debt. Look-though gearing—net debt/assets including debt in its funds—is higher at 32%. But Charter Hall can call on committed equity lines from fund investors, and the more indebted vehicles typically have very strong tenant covenants and a high proportion of fixed rate debt. We think Charter Hall is well-prepared for tougher conditions.

Source: Morningstar. Data as of June 26, 2023.

Technology

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Shaun Ler | shaun.ler@morningstar.com

Technology Sector Pulling All Levers To Deliver Profits

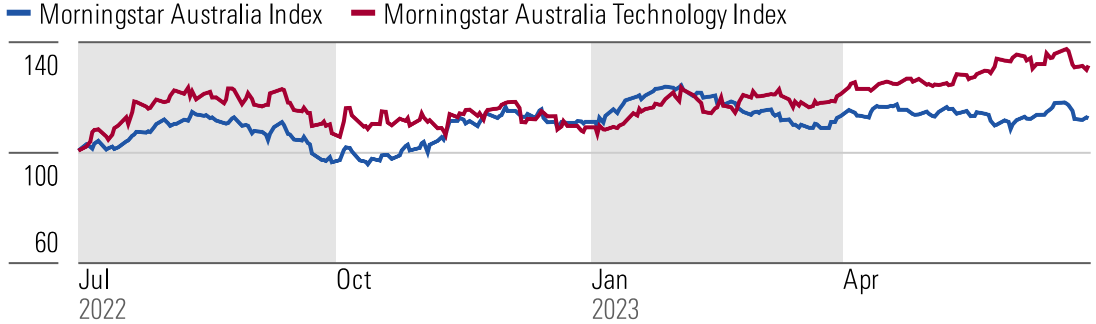
The technology sector has continued to outperform the broader market, which largely reflects the significant sector weighting and marked outperformance of WiseTech.

We expect the technology sector to continue focusing on improving profitability. For most of the past decade, technology companies spent lavishly to build new features, without commensurate price increases. With wide-spread layoffs, especially in product development, we see a cooling in the development arms race. Simultaneously, we see technology companies raising prices and testing their pricing power.

The differences between good-quality and subpar technology companies are becoming apparent, and we expect divergence to further widen. We have greater confidence in companies like WiseTech and Fineos, as they operate in a space with high barriers to entry, have sticky customers, and boast a suite of value-adding features to clients. Here, we see price increases and cost outs as maintainable levers for margin expansion without jeopardising growth.

On the flipside, companies like Zip, that provide a commodity and operate in a highly contested space, are likely to keep losing market share by pursuing similar revenue-maximising and cost-cutting measures. Only the strongest businesses can raise prices, improve margins, and grow market share. For the others, the options are a compromise at best.

Morningstar Australia Technology Index Outperforming



Source: Morningstar. Data as of June 26, 2023.

Technology Sector Screens Fairly Valued

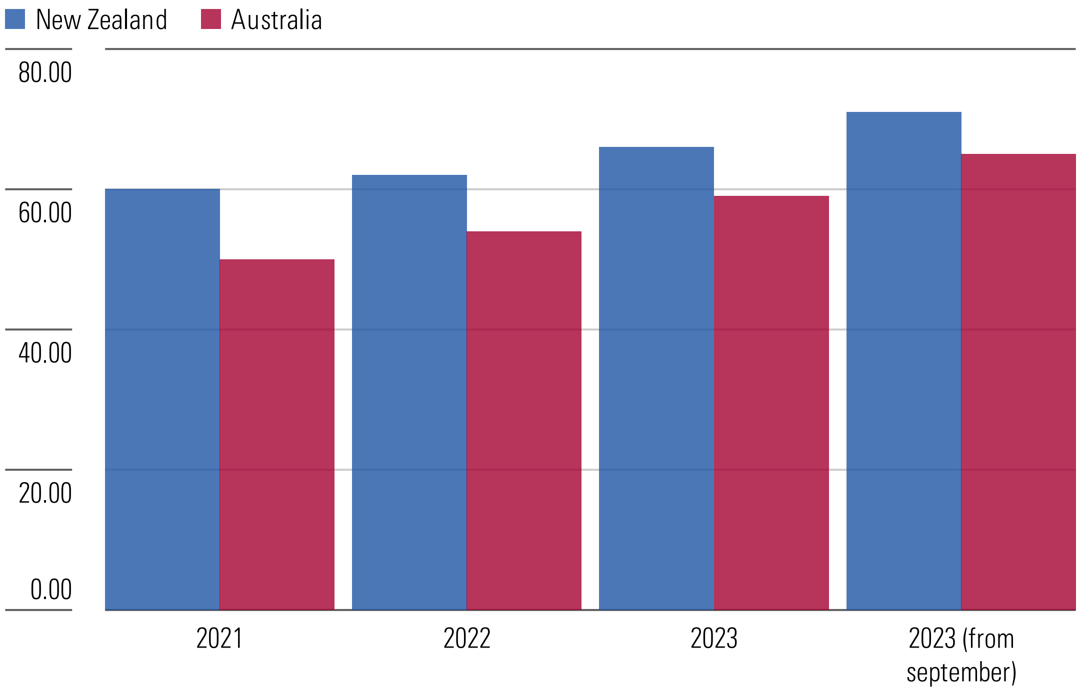
Source: Morningstar. Data as of June 26, 2023.

Technology Sector Pulling All Levers to Deliver Profits

Technology companies remain focused on improving profitability, including by raising prices and testing pricing power. For example, Xero has consistently raised prices in Australia and New Zealand, where it enjoys network effects. However, slowing price growth in NZ, its strongest market, suggests it is reaching a ceiling.

Xero Is Aggressively Raising Prices in Australia and New Zealand

Price of Xero standard plan (local currency).

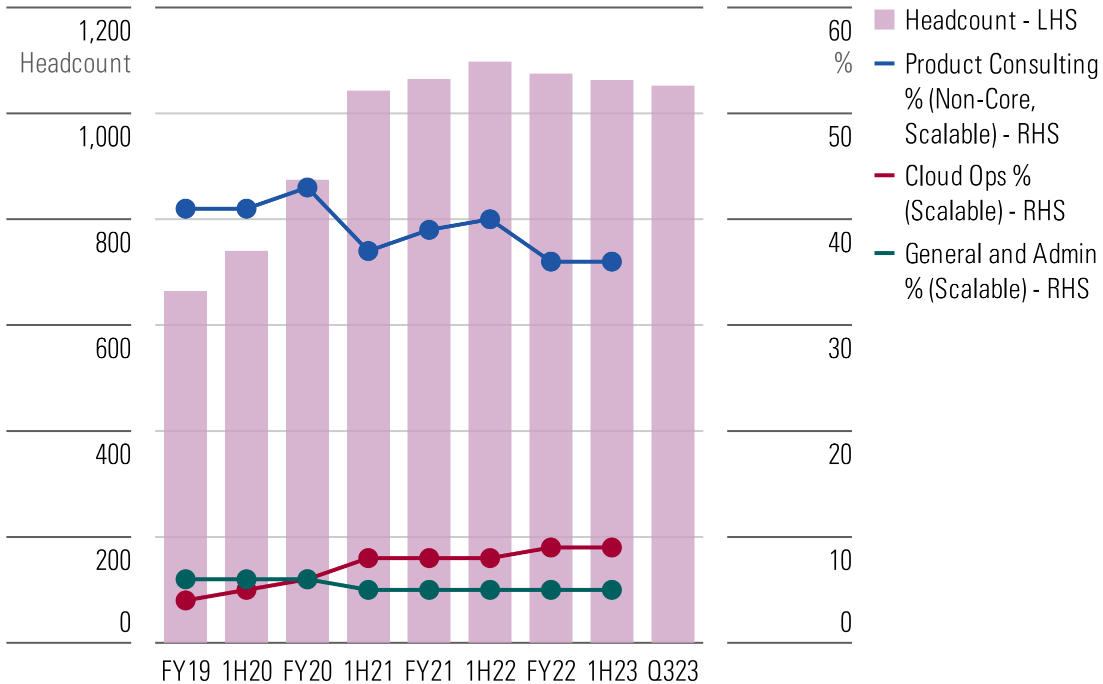


Source: Company website, archive.org, company correspondence. Data as of June 16, 2023.

We believe competitively-advantaged technology companies like Fineos can grow recuring revenue without commensurate cost growth as it benefits from economies of scale and automation.

Fineos Can Reduce Headcount, Improve Margins and Grow

Fineos' staff count and proportions of various scalable functions.



Source: Morningstar, company filings. Data as of May 31, 2023.

Technology

Company (Ticker)		Rating	
WiseTech Global (WTC)		★★★	We view narrow-moat WiseTech as a well-managed, high-quality company with a large and highly winnable market opportunity. We see WiseTech as providing technology to help logistics companies outperform their competition through increased productivity. The market for logistics services naturally selects for the lowest-cost providers and coupled with the cost advantages WiseTech provides, we think the large market opportunity is winnable. WiseTech's business quality is supported by a blue-chip client base, a highly recurring revenue model, and industry-leading annual customer retention rates.
Price	**Fair Value**	**Uncertainty**	
AUD 77.28	AUD 90.00	High	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 25.65	Narrow	Exemplary	

Company (Ticker)		Rating	
Fineos (FCL)		★★★★	We believe Fineos has investment merits not generally found within the broad band of profitless technology companies. We think the market underestimates revenue upside from the adoption of cloud software by insurers and the increasing stickiness of Fineos' insurer customers. Fineos is well placed to win new business supported by long-standing customer relationships and their referrals. Fineos is not yet profitable but reinvests to solidify switching costs with its sticky customer base, win new business, and maintain its lead over would-be competitors. We anticipate share gains from more products per client, new client adds, and expansions into new regions and adjacent businesses. There are also opportunities for cost efficiencies from client transitions to the cloud, automation of manual functions, and hiring in emerging economies. We expect Fineos to self-fund its future growth.
Price	**Fair Value**	**Uncertainty**	
AUD 2.20	AUD 3.40	Very High	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 0.70	Wide	Standard	

Company (Ticker)		Rating	
Megaport (MP1)		★★★★	The market downturn, dissatisfaction from the chairman with Megaport's execution, and management uncertainty led to Megaport's stock getting crushed earlier this year, despite sales growth remaining high and a continuing trend of significant margin expansion. Stabilisation on all fronts has led to a huge stock rebound and should only accelerate business performance, and we still think the stock is undervalued. Megaport should benefit from increasing global reliance on data traffic. With its software-defined network offering, it facilitates connections between data centres and/or premises for enterprises to integrate their architecture and connect to cloud providers. We expect sales growth to remain high and for EBITDA profitability from 2023. More importantly, we expect further profit growth and positive free cash flow by 2024.
Price	**Fair Value**	**Uncertainty**	
AUD 6.90	AUD 13.00	Very High	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 1.10	None	Exemplary	

Source: Morningstar. Data as of June 26, 2023.

Utilities

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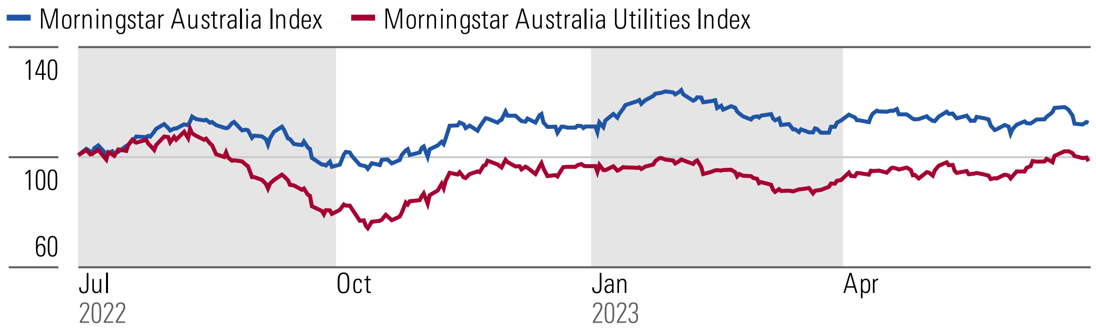
Rising Retail Electricity Prices To Boost Utility Earnings

Australian and New Zealand utilities have solid earnings outlooks given elevated electricity prices and, for some, CPI-linked revenue. The positive outlook is tempered somewhat by industrywide headwinds from higher interest rates and operating and development cost inflation. Australian utilities generally remain undervalued, while New Zealand utilities are slightly overvalued on average. We see best value in AGL Energy and Manawa Energy.

Wholesale electricity prices in Australia appear to be stabilising at relatively high levels, which supports our positive thesis. We expect a strong earnings recovery in fiscal 2024 as retail electricity prices increase 20% or more in most states to pass through high wholesale prices, with a lag. We expect high fuel costs, closure of ageing coal power stations and delays and cost blowouts for new generation supply to support wholesale electricity prices for at least the medium term. For AGL, disruption from activists and new directors has dissipated, and lenders have shown their support by refinancing AUD 1.6 billion of debt after it committed to exiting coal by the mid-2030s.

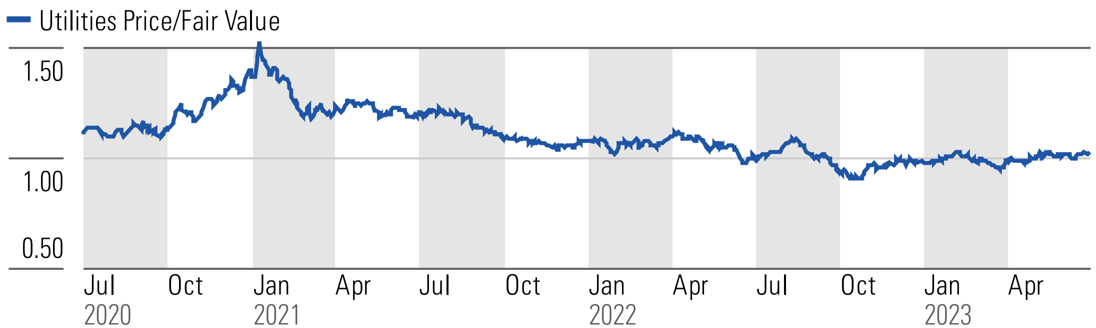
NZ utilities continue to benefit from high electricity prices and low generation costs. New generation supply is planned, but with demand growth, thermal power station closures, and likely construction delays, electricity prices are likely to be well supported for the next decade, allowing utilities to ratchet retail prices higher. Share prices have fallen, but most are still rated 2- or 3-star-rated.

Australian Utilities Underperformed in the Past Year



Source: Morningstar. Data as of June 26, 2023.

ANZ Utilities Fairly Valued on Average



Source: Morningstar. Data as of June 26, 2023.

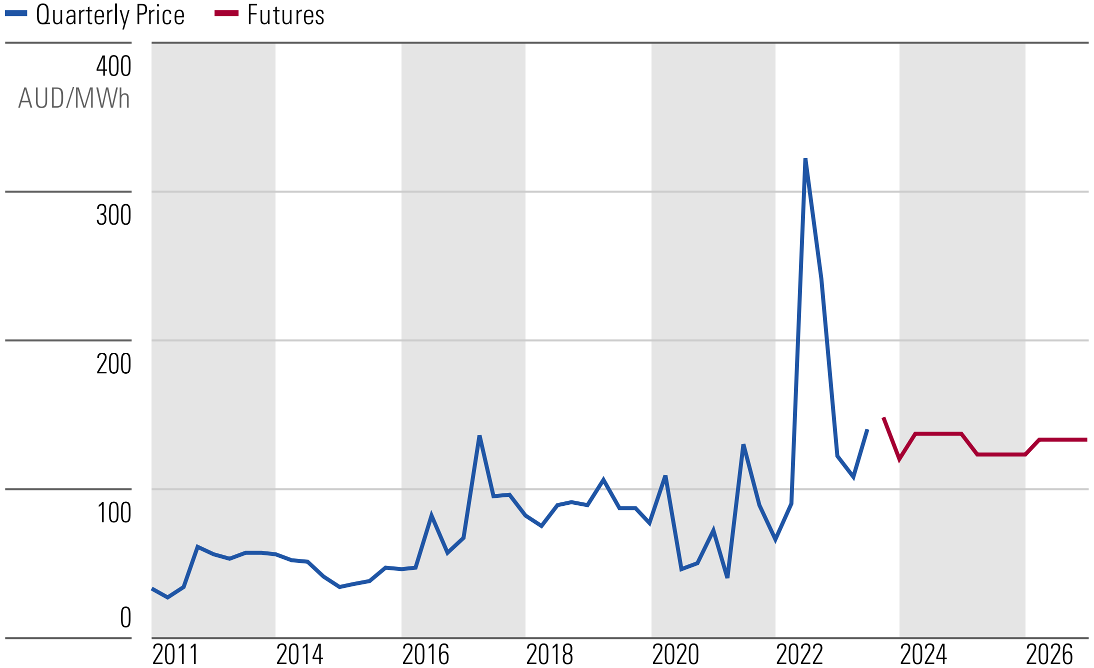
Rising Retail Electricity Prices To Boost Utility Earnings

After a volatile couple of years, Australian wholesale electricity prices appear to be stabilising at elevated levels. High wholesale prices flow through to mass market and business customers progressively, with the bulk of upside likely in fiscal 2024.

Higher interest rates are a key earnings headwind for highly geared firms like APA Group. Nonetheless, we expect APA's distributions to grow thanks to CPI-linked revenue, completion of developments, and extensive interest rate hedging.

Electricity Prices To Stay High Given High Fuel Costs

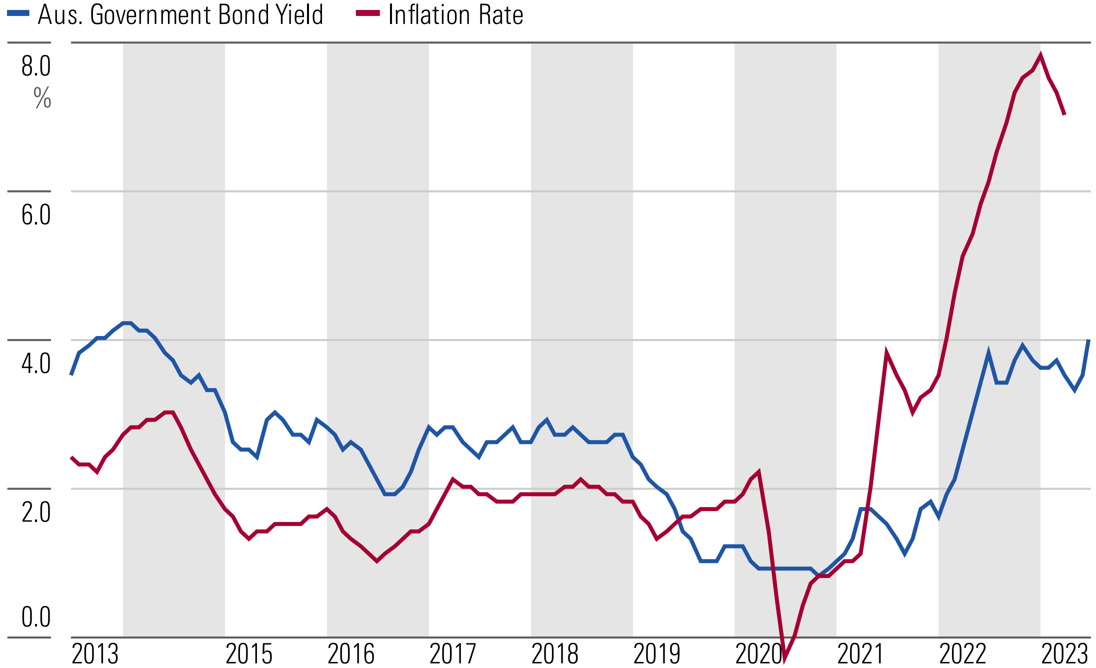
New South Wales wholesale electricity prices (AUD per megawatt hour).



Source: Morningstar, ASX Energy. Data as of June 22, 2023.

Inflation Still a Force for High Interest Rates

Australian Government 10-year bond yield and Australian inflation rate.



Source: Yieldbroker, Australian Bureau of Statistics. Data as of June 22, 2023.

Utilities

Company (Ticker)		Rating
AGL Energy (AGL)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 10.98	AUD 12.80	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 7.39	Narrow	Poor

Narrow-moat AGL Energy's recovery is gaining traction and the rebound in electricity prices in the past two years should underpin a strong earnings recovery in fiscal 2024. Risk is receding as the earnings outlook improves. Also, the planned early closure of coal power stations has alleviated ESG concerns and allowed continued bank support. As one of Australia's largest generators and retailers of electricity, we see substantial long-term value in the business. We expect slowing renewable energy supply additions, the closure of ageing coal power stations, and high gas costs to support electricity prices, which benefits earnings. Government caps on domestic gas and coal prices have reduced electricity futures prices, but they're still conducive to a strong earnings rebound.

Company (Ticker)		Rating
Manawa Energy (MNW)		★★★★
Price	**Fair Value**	**Uncertainty**
NZD 4.71	NZD 6.30	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
NZD 1.47	Narrow	Standard

Narrow-moat Manawa Energy, a New Zealand renewable energy producer, owns a fleet of small hydroelectric generators and, with a strong balance sheet, is well-positioned to grow via the development of wind and solar farms. It sells most power to Mercury NZ under long-term CPI-linked contracts, with earnings to benefit from elevated inflation. We also expect earnings to benefit from diverting more sales to tight wholesale markets as contracted volumes progressively reduce in the medium term. The stock offers a decent yield fully imputed for New Zealand residents.

Company (Ticker)		Rating
APA Group (APA)		★★★
Price	**Fair Value**	**Uncertainty**
AUD 9.93	AUD 10.20	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 11.72	Narrow	Standard

Narrow-moat APA Group trades near our fair value estimate but is a good-quality company with an attractive yield. We expect revenue growth to pick up in the near term as elevated inflation boosts CPI-linked tariffs, and on completion of developments. Acquisitions are also likely. APA Group should benefit from the transition to renewable energy. We expect ongoing investment in wind and solar farms while its core gas transmission networks benefit from growing gas use to backup intermittent renewable power supply. APA is also set to help remote mines in Western Australia replace diesel generators with a mix of solar panels, batteries, and gas turbines. This should reduce the mines' carbon emissions and operating costs.

Source: Morningstar. Data as of June 26, 2023.

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