Australian Equity Market Outlook: Q1 2024

Opportunities abound in undervalued market.

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Market Outlook

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Optimism Over the Interest Rate Outlook Mesmerizing Markets

A Santa Claus rally is possible before the quarter ends. However, the outlook for first quarter 2024 is challenging as deteriorating economic data balances optimism around hopes of rate cuts. This optimism is reflected in the low volatility index (VIX) and high complacency. The risk of disappointment is elevated. We expect the market to trade in a narrow band between 6,900 and 7,300.

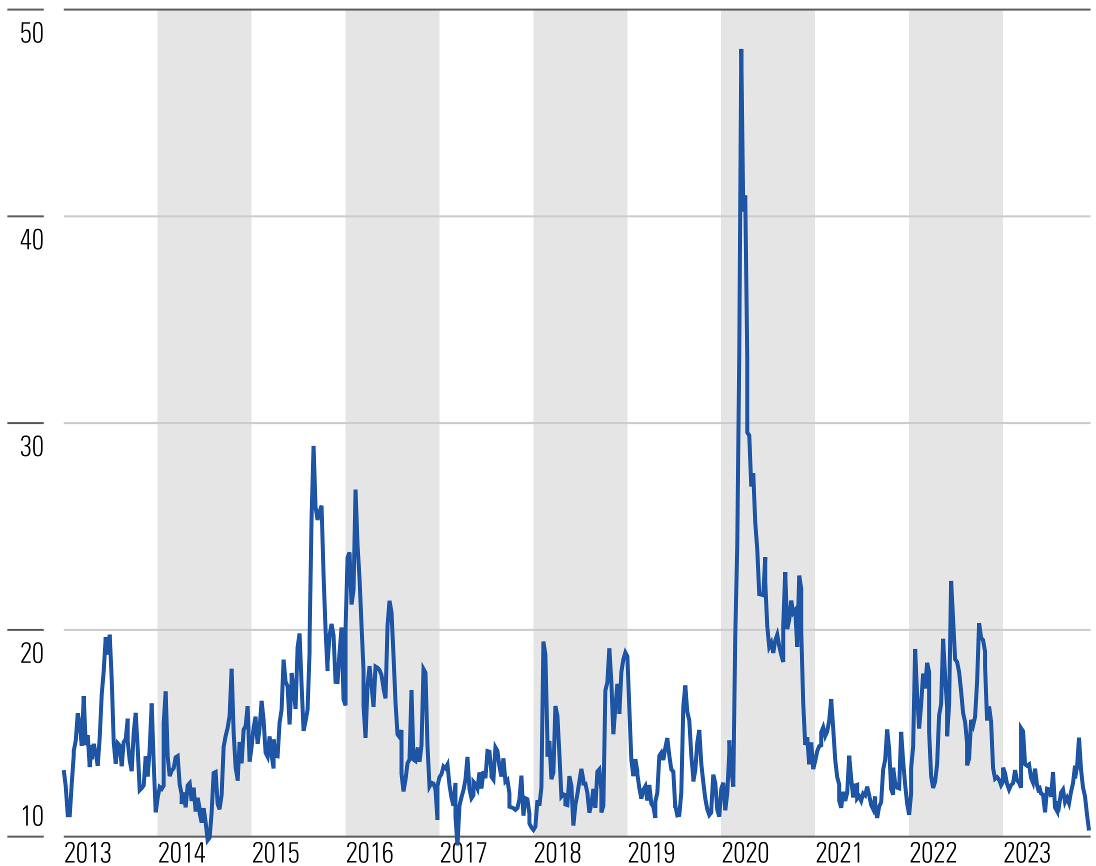
Our forecast for the Australian market to "remain under pressure and trade in a narrow band" over the past three months has been reasonably accurate to date. The outlook from here depends on the December quarter Consumer Price Index due Jan. 31 and the Reserve Bank of Australia's, or RBA's reaction on Feb. 6, but the dismal September quarter GDP report could be a game changer. The half-yearly reporting season in February and earnings guidance for the second half will also determine the overall direction.

Global markets are convinced the interest rate tightening cycle is over and central banks will begin cutting rates as early as the June quarter of 2024. The reasoning is twofold: first, inflation is trending down, although still above long-term targets; and second, a sharp deterioration in economic activity is expected and a recession, whether a soft or hard landing, is possible. There could be an arm wrestle between equities and bonds in the June half.

Currently, the eurozone teeters on the edge of a contraction; several stimulus programs have had a muted impact on the Chinese economy as the real estate sector continues to struggle and falling house prices erode the wealth effect and dampen domestic demand.

Rock Bottom VIX Signals Complacency

S&P/ASX200 Volatility Index.



Source: Haver Analytics. Data as of Dec. 1, 2023.

Optimism Over the Interest Rate Outlook Mesmerizing Markets

In the United States, the balance sheet of the Federal Reserve is above USD 7.7 trillion and still needs to be reined in. U.S. equity markets are close to record levels and further stimulus via easing monetary policy appears misplaced. Despite falling inflation, real interest rates are well below long-term averages.

Year-to-date, Australia's benchmark S&P/ASX 200 has meaningfully lagged U.S., Japanese, and German markets. Chinese markets have posted losses.

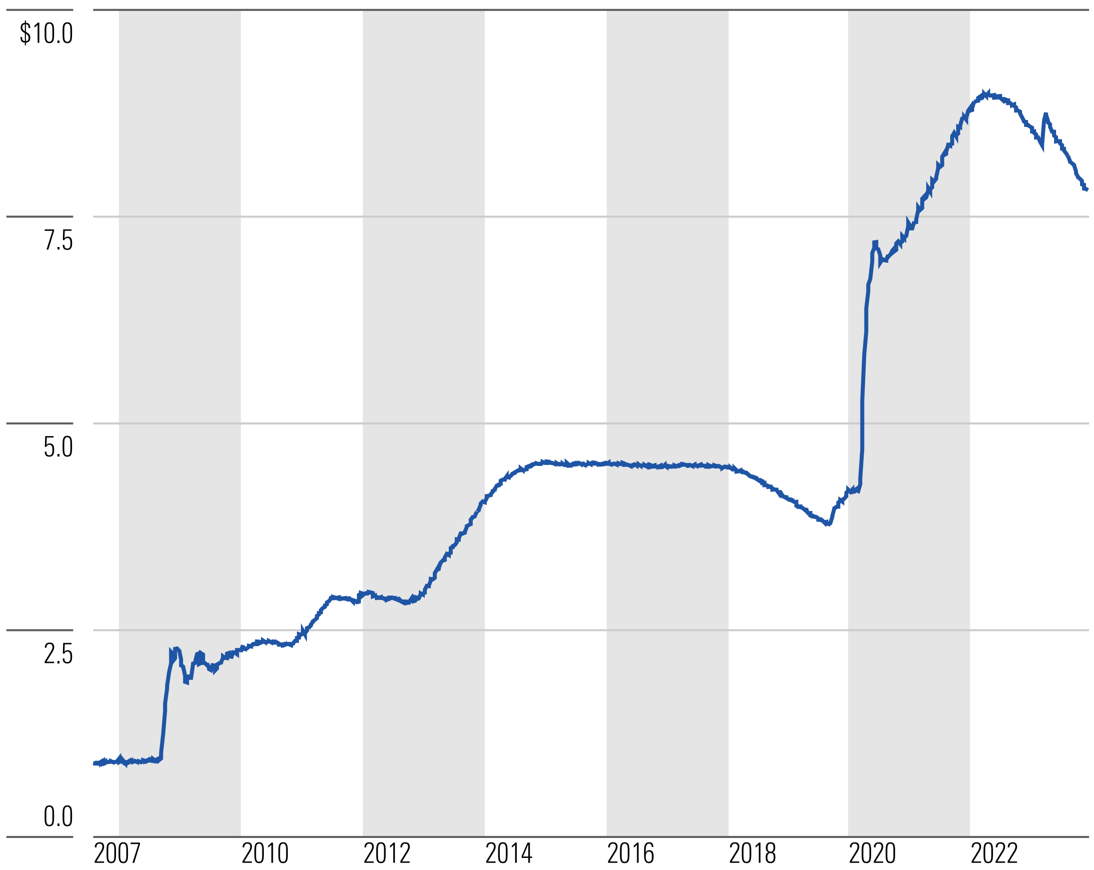
The strong iron ore price, currently above USD 130 per metric ton, is supportive for leading miners BHP, Rio Tinto, and Fortescue, the heavyweights in the basic materials sector. Offsetting this is weakness in the USD and rising AUD operating costs squeezing margins, although earnings and dividends should still be reasonable. However, all three companies scan as overvalued, in 1- or 2-star territory. Basic materials account for 24% of the S&P/ASX 200, the three iron ore miners 14%.

The four major banks account for almost 20% of the benchmark and the financial services sector represents 26%. The outlook is for subdued credit growth and ongoing pressure on net interest margins, although rising interest rates support interest income. The reverse will occur as rates decline.

The concentration of the S&P/ASX 200, where 11 companies account for just over 50% of the index, raises issues. If these stocks are at or near full value, it is difficult to see any sustained improvement in the index in the March quarter.

The Fed's Bloated Balance Sheet Needs to Shrink

Total assets of the Federal Reserve (USD trillions).



Source: Federal Reserve. Data as of Dec. 1, 2023.

Economic Outlook

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Contraction in Economic Growth Ahead

Elevated “home grown” inflation, primarily caused by high wages growth and falling labor productivity, is Australia’s most pressing near-term economic challenge. Normally, this would mean tight monetary policy remains and a further rate increase in February can’t be ruled out. The December-quarter CPI reading due on Jan. 31 is critical.

However, the economy hit a brick wall in the September quarter with gross domestic product, or GDP, growth of just 0.2% quarter on quarter. Slowing economic growth and nagging inflation are worrying but likely to persist for the foreseeable future. A perceived tighter bias in Australia’s monetary policy due to differing inflationary conditions and an easing one in the U.S. could see interest rate differentials push the AUD/USD exchange rate toward 0.70.

The latest macro forecasts from the RBA include GDP growth of 1.75% for the year ended both June and December 2024, improving modestly to 2.0% for the year ended June 2025, meaningfully below the long-term average of 3.37% between 1960 and 2023. The weak September-quarter GDP data puts even these subdued forecasts at risk.

The 2.1% year-on-year reading for the September quarter will likely fall in the December quarter. This pedestrian economic growth stands in the shadow of the RBA’s trimmed mean inflation forecast for the year ended June 2024 of a still-elevated 4%.

Accelerating Wages Adds to Inflation Outlook

Wage Price Index annual growth.

Source: Australian Bureau of Statistics. Data as of September 2023.

Contraction in Economic Growth Ahead

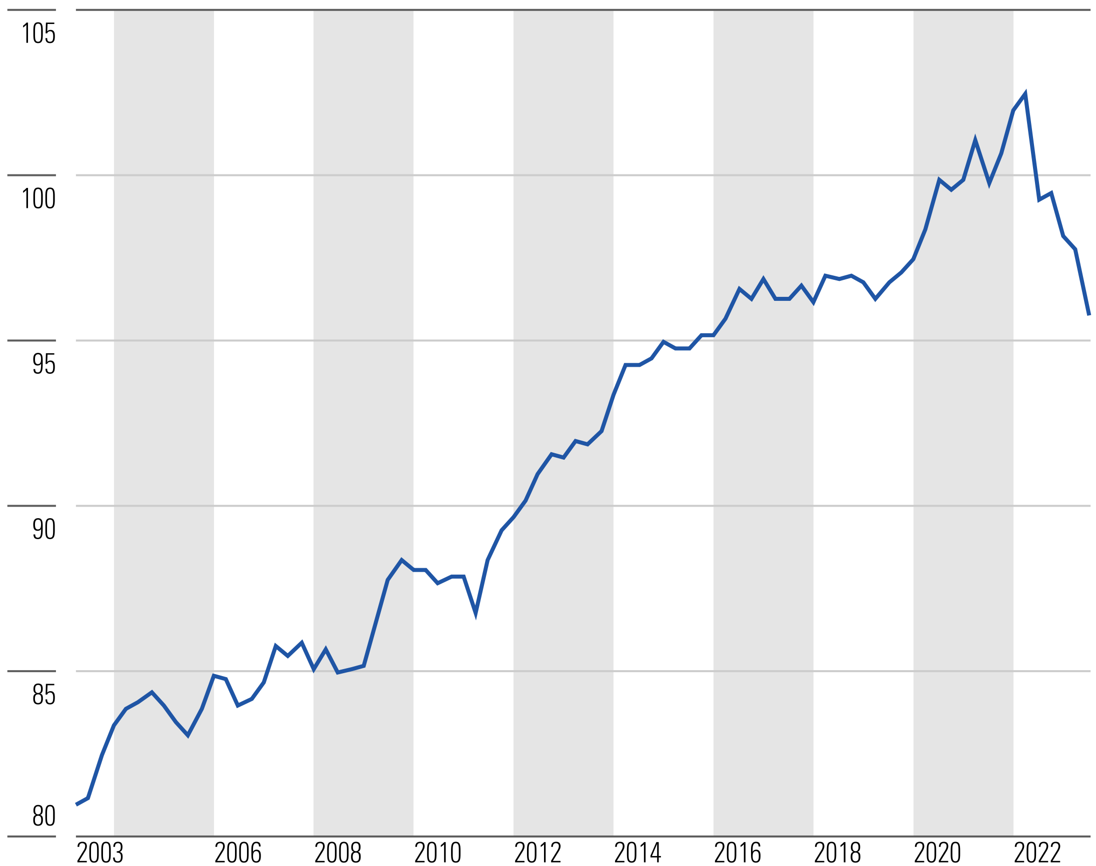
The surprising economic resilience through 2023 is fading fast and will roll into 2024 as the lagged effects of a cumulative tightening of 4.10% in official interest rates and high and rising nondiscretionary cost-of-living expenses drive a contraction in real household disposable income. The impact of a sharp rise in immigration has driven negative readings of per-capita GDP in the March, June, and September quarters.

Trimmed mean inflation eased slightly in the year-ended October to 5.2% and pleasingly the trend is down, but there is still work ahead in 2024. Disturbingly the nondiscretionary (necessities) segments are the cause of the ongoing inflation. Food and nonalcoholic beverages up 5.3%; housing up 6.1%; health up 6.3%; transport up 5.9%; and insurance and financial services up 8.6%, are all increasing at a pace above the trimmed mean. Nondiscretionary segments are growing at a much lower pace, including clothing and footwear down 1.5%; furnishings, household equipment, and services up 0.4%; and recreation and culture, including holiday travel and accommodation, up 2.7%.

Retail sales fell 0.2% in October and real per-capita sales declined by an estimated 4.5%-5.0%. Record Black Friday and Cyber Monday sales will reverse October's result. However, the festive season and the March-quarter sales are likely to be subdued, which will affect GDP growth given the dominating influence of household consumption. Government infrastructure spending, including energy transition, is adding to cost pressures while business investment is relatively subdued given the uncertain economic environment.

Fall in Labor Productivity Leads to Lower Economic Growth and Higher Inflation

GDP per hour worked index (rebased to 100 in 2021).



Source: Australian Bureau of Statistics. Data as of September 2023.

Valuation Overview and Top Picks

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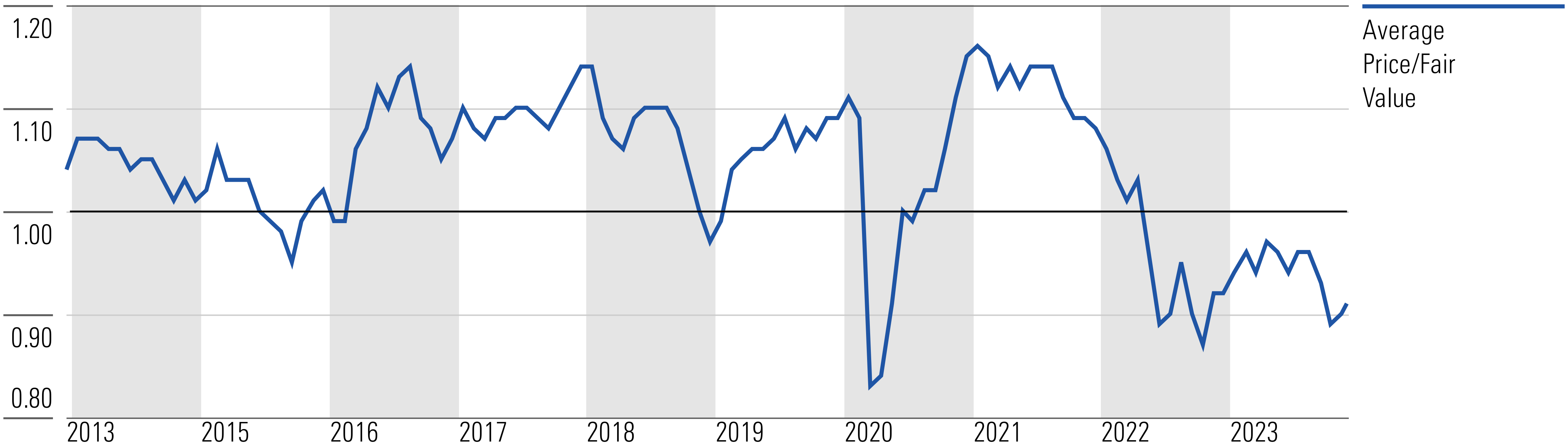
V A L U A T I O N   O V E R V I E W

Market Trades at a Small Discount

Stock markets traded sideways in the December quarter, with Australia and New Zealand stocks still undervalued. As of Dec. 1, 2023, our Australia and New Zealand coverage trades at a 9% 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 Undervalued on Average

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



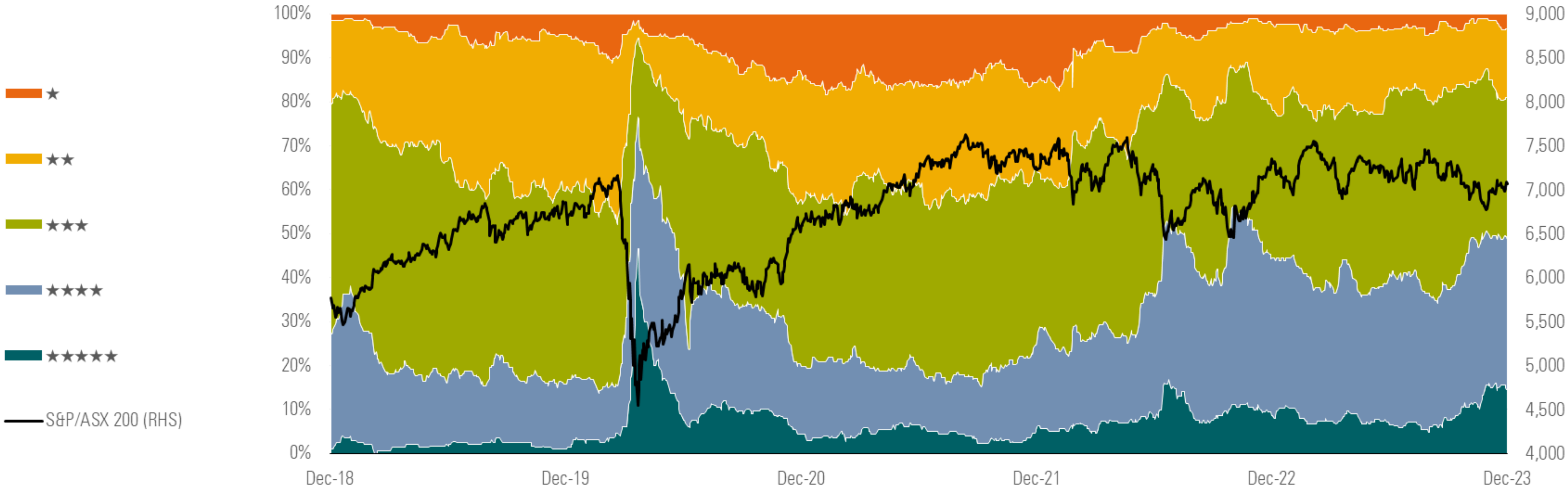
Source: Morningstar. Data as of Dec. 1, 2023.

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

Almost half of Australian and New Zealand stocks under coverage are either 4- or 5-star-rated, about double the trailing 10-year average of 25%. High-quality stocks are generally richly priced, but we still see plenty of opportunities outside of those names. Perceived risk is being harshly discounted in the current market.

Market Weakness Means Many Companies Are Undervalued

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



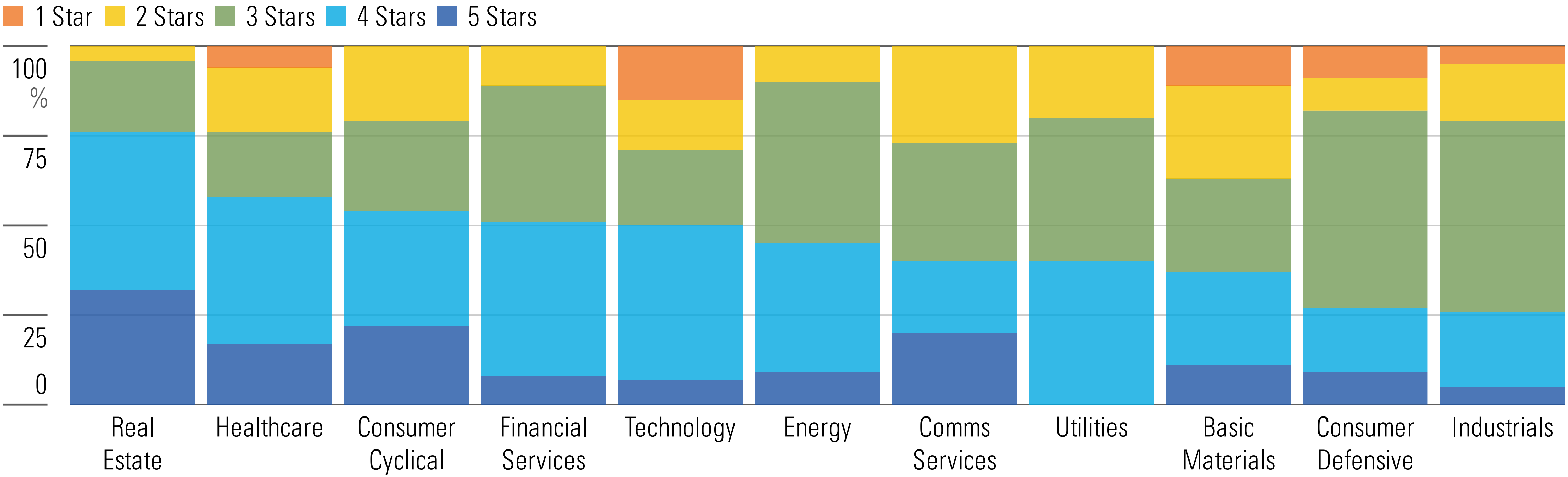
Source: Morningstar. Data as of Dec. 1, 2023.

Positive Ratings in Many Sectors

The real estate sector is most undervalued on fears of rising debt costs and the potential for discounted equity raisings. While a headwind to earnings, we think most REITs are in sound financial health and see good long-term value. We also see plenty of opportunities across healthcare, consumer cyclical, financials, technology, energy, and communications.

Plenty of Positive Ratings in Most Sectors

Star rating distribution by sector.



Source: Morningstar. Data as of Dec. 1, 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							
Newmont (NEM)	★★★★	AUD 82.00	AUD 60.78	Medium	None	0.73	AUD 71.76
Nufarm (NUF)	★★★★★	AUD 7.70	AUD 4.67	High	None	0.62	AUD 1.78
South32 (S32)	★★★★	AUD 3.90	AUD 3.09	High	None	0.79	AUD 14.00
Communication Services							
TPG Telecom (TPG)	★★★★★	AUD 7.40	AUD 4.71	Medium	Narrow	0.64	AUD 8.76
Nine Entertainment Company (NEC)	★★★★	AUD 2.80	AUD 1.90	High	None	0.69	AUD 3.09
Southern Cross Media Group (SXL)	★★★★★	AUD 1.70	AUD 1.04	High	None	0.62	AUD 0.25
Consumer Cyclical							
Kogan.com (KGN)	★★★★★	AUD 10.70	AUD 5.12	Very High	None	0.49	AUD 0.52
Bapcor (BAP)	★★★★★	AUD 8.00	AUD 5.34	Medium	Narrow	0.67	AUD 1.81
Domino's Pizza Enterprises (DMP)	★★★★	AUD 68.00	AUD 52.68	High	Narrow	0.79	AUD 4.73
Consumer Defensive							
Bega Cheese (BGA)	★★★★	AUD 4.00	AUD 3.07	Medium	None	0.80	AUD 0.93
Endeavour Group (EDV)	★★★★	AUD 6.10	AUD 5.00	Low	Wide	0.81	AUD 8.95
The a2 Milk Company (A2M)	★★★★★	AUD 7.20	AUD 3.88	High	Narrow	0.54	AUD 2.80

Source: Morningstar. Data as of Dec. 1, 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							
Santos (STO)	★★★★★	AUD 12.30	AUD 6.90	High	None	0.56	AUD 22.41
Beach Energy (BPT)	★★★★	AUD 2.50	AUD 1.49	High	None	0.59	AUD 3.39
Whitehaven Coal (WHC)	★★★★	AUD 10.00	AUD 7.26	Very High	None	0.71	AUD 6.07
Financials							
ASX (ASX)	★★★★★	AUD 72.50	AUD 57.95	Low	Wide	0.80	AUD 11.22
Perpetual (PPT)	★★★★	AUD 27.50	AUD 22.54	Medium	Narrow	0.82	AUD 2.55
Westpac Banking (WBC)	★★★★	AUD 28.00	AUD 21.27	Medium	Wide	0.76	AUD 74.53
Health Care							
Ansell (ANN)	★★★★	AUD 30.00	AUD 23.54	Medium	Narrow	0.79	AUD 2.95
Ramsay Health Care (RHC)	★★★★	AUD 68.00	AUD 48.59	Medium	Narrow	0.72	AUD 11.15
ResMed (RMD)	★★★★★	AUD 40.00	AUD 23.94	Medium	Narrow	0.61	AUD 35.49
Industrials							
Ventia (Australia) (VNT)	★★★★	AUD 4.00	AUD 3.01	Medium	None	0.75	AUD 2.58
Aurizon Holdings (AZJ)	★★★★	AUD 4.70	AUD 3.54	High	Narrow	0.75	AUD 6.52
Qube Holdings (QUB)	★★★★	AUD 3.30	AUD 2.92	Medium	Narrow	0.88	AUD 5.16

Source: Morningstar. Data as of Dec. 1, 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)
Real Estate							
Lendlease (LLC)	★★★★★	AUD 14.45	AUD 6.61	High	None	0.46	AUD 4.56
Dexus (DXS)	★★★★★	AUD 10.80	AUD 6.95	Medium	Narrow	0.65	AUD 7.48
Charter Hall Group (CHC)	★★★★★	AUD 15.90	AUD 10.22	Medium	Narrow	0.65	AUD 4.83
Technology							
WiseTech Global (WTC)	★★★★	AUD 95.00	AUD 66.16	High	Narrow	0.70	AUD 22.05
Fineos (FCL)	★★★★	AUD 3.10	AUD 1.68	Very High	Wide	0.55	AUD 0.56
Megaport (MP1)	★★★★	AUD 17.00	AUD 9.59	Very High	None	0.57	AUD 1.53
Utilities							
Manawa Energy (MNW-NZ)	★★★★	NZD 6.30	NZD 4.52	Medium	Narrow	0.72	NZD 1.41
APA Group (APA)	★★★★	AUD 9.30	AUD 8.54	Medium	Narrow	0.92	AUD 10.96
AGL Energy (AGL)	★★★★	AUD 12.80	AUD 9.43	High	Narrow	0.74	AUD 6.34

Source: Morningstar. Data as of Dec. 1, 2023.

Basic Materials

Jon Mills | jon.mills@morningstar.com

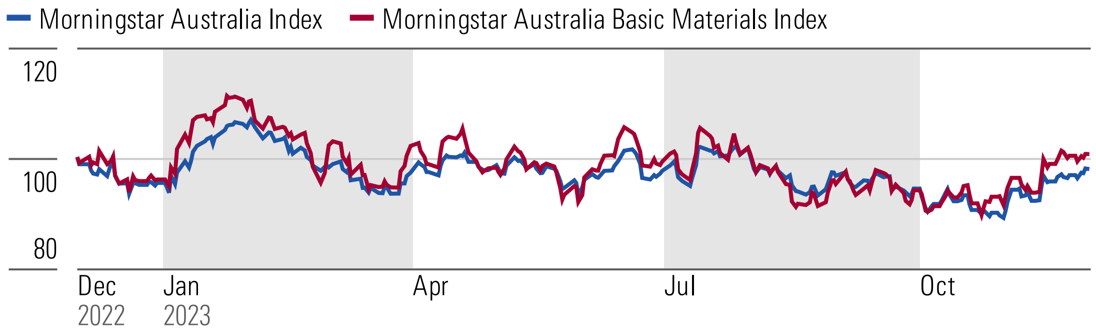
Strong China Steel Production but Miners Are Modestly Undervalued

Commodity prices have generally diverged in recent months. China steel production has remained strong despite a weak property market and negative steelmaker margins, supporting iron ore and metallurgical coal prices. Elsewhere, rising interest rates and concerns over slower western economic growth have seen base metals prices generally fall. Copper prices have risen recently on supply concerns and optimism of interest rate rises nearing an end.

Our basic materials coverage is now modestly undervalued on average and gold miners, including Newmont, stand out as most undervalued. A falling U.S. dollar and expectations of declining interest rates have pushed U.S. dollar gold prices to near-record highs. Though AUD gold prices have been affected by the stronger AUD/USD exchange rate. Increased stimulus and government assistance to China's tottering residential property sector have supported iron ore, and the share prices of the iron ore miners remain elevated.

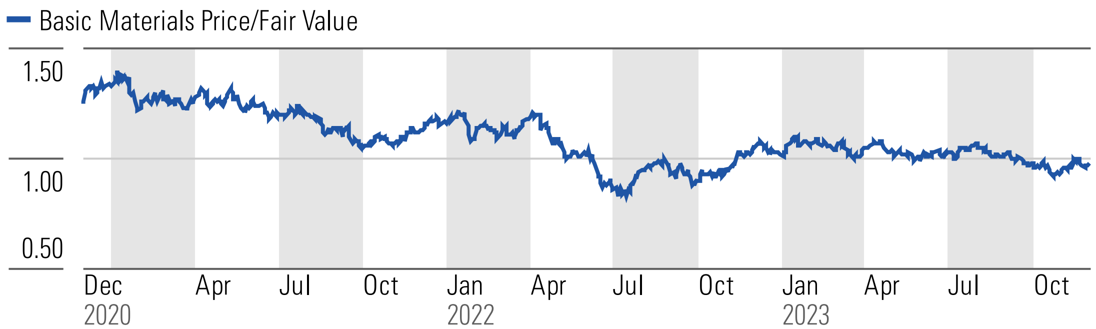
In chemicals, explosives company Incitec Pivot remains considerably cheaper than peer Orica given uncertainty around a demerger/sale of Incitec's fertilizer segment. We think this represents opportunity. We see explosives recontracting into a tighter market and easing labor and supply chain tightness as core drivers of earnings growth. And recent receipt of cash from the sale of the WALA ammonia plant in Louisiana confirms value realization. Crop protection specialist Nufarm has attractive fundamentals including a growing population and rising disposable income, supported by arable land constraints. Growth from its seeds segment is a key attraction.

Strong Iron Ore Prices Support the Sector



Source: Morningstar. Data as of Dec. 1, 2023.

Sector Close to Fairly Valued on Average



Source: Morningstar. Data as of Dec. 1, 2023.

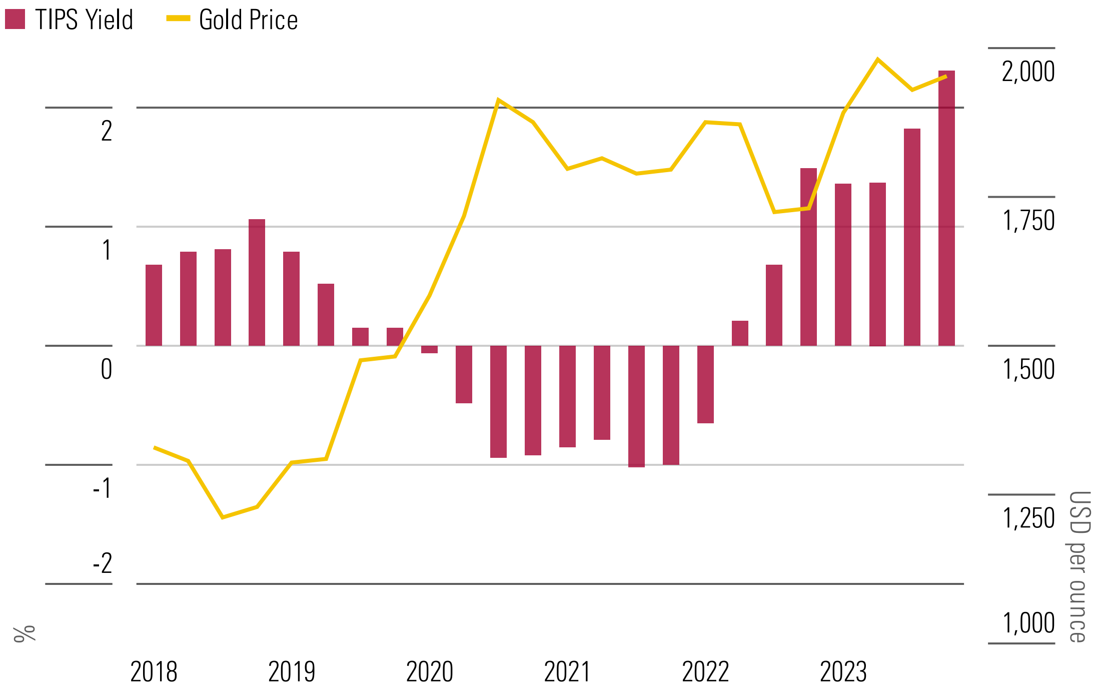
Strong China Steel Production but Miners Are Modestly Undervalued

Gold investment lacks cash flows and rising yields make bonds relatively more attractive, and vice versa. With increasing optimism that interest-rate increases are close to done, gold prices are rising on expectations that interest rates will fall.

China's steel production is high, but steelmakers are losing money, symptomatic of weak demand. A steel production cap is possible and would be negative for iron ore. Steel demand from property and infrastructure development in China is key.

Gold Prices Rising on Expectations of Falling Interest Rates

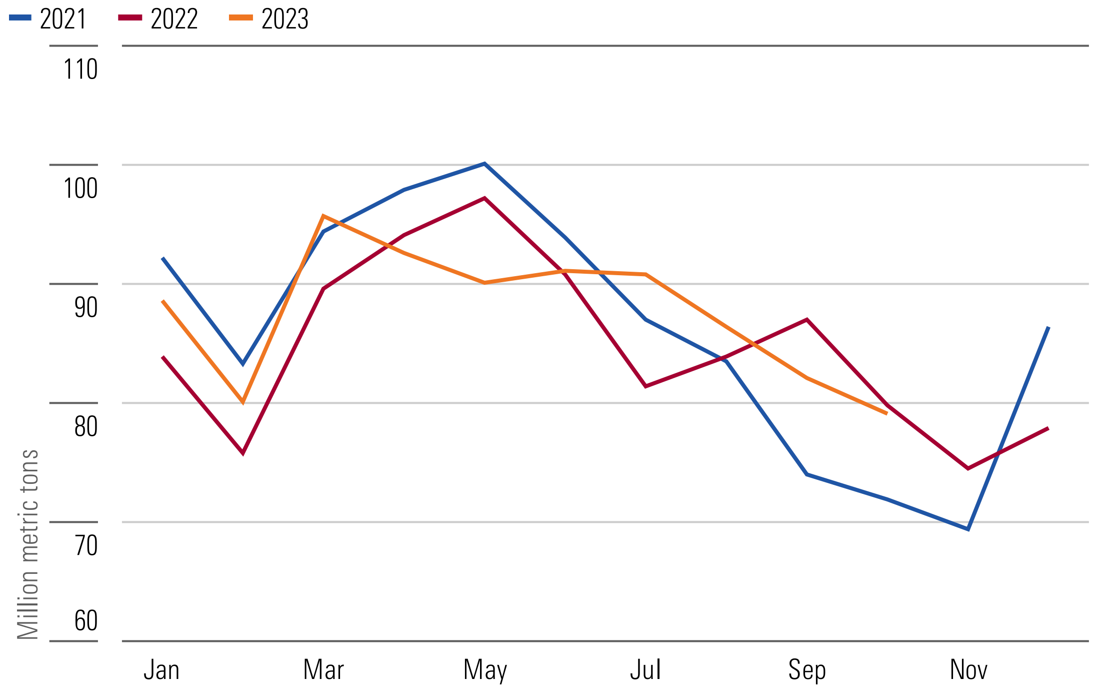
Gold price and yield on Treasury Inflation-Indexed Securities, or TIPS.



Source: Federal Reserve, Morningstar. Data as of Nov. 30, 2023.

China's Steel Production Growing in 2023 Despite Headwinds

Monthly China steel production (million metric tons).



Source: World Steel Association. Data as of Nov. 22, 2023.

Basic Materials

Company (Ticker)		Rating
Newmont (NEM)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 60.78	AUD 82.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 71.76	None	Standard

Newmont acquired Australian Newcrest in November 2023. The acquisition extends Newmont's lead over Barrick Gold as the world's largest gold miner, with pro forma 2023 sales of roughly 7.3 million ounces of gold from its mines in the Americas, Australia, Papua New Guinea, and Ghana. The combined company also has material copper production of roughly 160,000 metric tons and numerous development projects we think valuable and perhaps overlooked. We think Newmont's shares are undervalued given its weak sales volumes and elevated unit costs in the first nine months of 2023. However, we think sales volumes will recover and unit cash costs fall to drive some improvement in Newmont's aggregate position near the middle of the cost curve. Gold miners have generally been out of favor due to concerns over rising interest rates, which increases the opportunity cost to hold gold.

Company (Ticker)		Rating
Nufarm (NUF)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 4.67	AUD 7.70	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 1.78	None	Standard

Australian agricultural innovator Nufarm is on track to meet fiscal 2026 revenue aspirations of more than AUD 4.6 billion, up 30% on fiscal 2023's AUD 3.5 billion. This captures new crop protection product introductions and accelerated seed technologies growth via Omega-3 canola and bioenergy developments. Nufarm's modest dividend doesn't particularly appeal, but it is a growth story. We project a five-year EPS CAGR of 24% for an attractive prospective P/E of less than 6 by fiscal 2028 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
South32 (S32)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 3.09	AUD 3.90	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 14.00	None	Standard

No-moat-rated South32's undemanding valuation metrics, diversified portfolio of future-facing commodities and strong balance sheet are attractive. Its strategy is to transition its portfolio to metals such as aluminum, alumina, copper, and zinc, commodities more likely to benefit from decarbonization and electrification. As such, while elevated metallurgical coal prices saw the division comprise around one-third of fiscal 2023 EBITDA, we forecast metallurgical coal to be less than 10% of EBITDA at the end of our forecast period in fiscal 2028. A weak 2023 result and concerns over lower near-term commodity prices drive the valuation discount.

Source: Morningstar. Data as of Dec. 1, 2023.

Communication Services

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Telecom Tailwinds Fueling "Growth" Aspirations While Media Headwinds Fuelling M&A Temptations

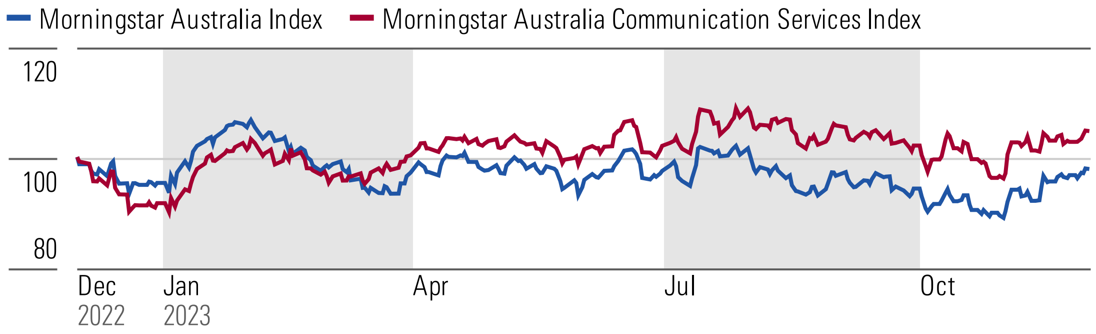
In telecom, industry thematics are positive against an uncertain macroeconomic backdrop. Earnings and returns are on an upward trajectory, as competitive rationality returns in mobile, the legacy fixed-line drag dissipates, and operating and capital efficiencies improve, aided by digitization and pricing discipline.

However, be wary if these positive thematics give management false confidence to invest, in the name of "growth." Telstra is spending more on building intercity fiber and digital businesses. Spark is expanding into data centers and high-tech areas. There is a risk of these investments diluting returns and management focus, at a time when telecom operators may need to expend more on network resilience, following recent high-profile network outages. There are enough internal levers to liberate value within the sector, without resorting to peripheral "growth" projects.

In media, advertising market recovery is tepid given fragile marketer confidence and consumer sentiment. Companies are responding by focusing on things within their control—leveraging their solid balance sheets to buy back shares, cut costs, and make judicious content acquisitions.

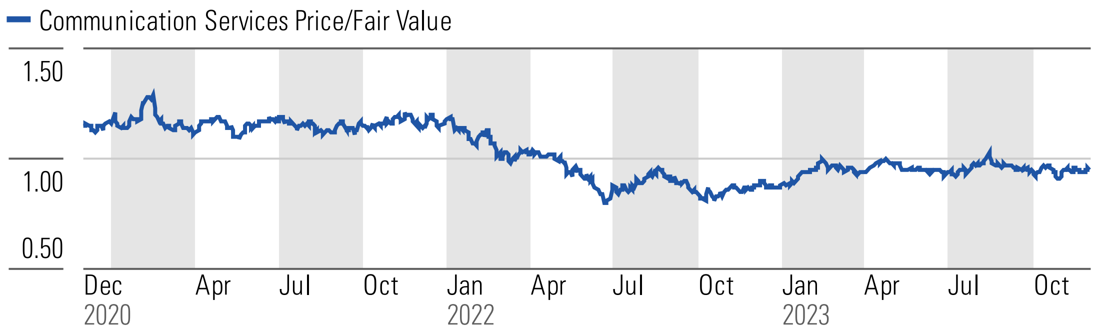
All media operators are frantically digitizing to reduce dependence on traditional advertising. However, if the current cyclical downturn extends, history suggests mergers and acquisitions, to quickly boost scale and extract synergies, are likely. Indeed, consolidation moves are already afoot with Southern Cross Media attracting interest from ARN Media which, in turn, is attracting interest from Seven West Media.

Communication Outperforming Over the Past Year



Source: Morningstar. Data as of Dec. 1, 2023.

Discount Mainly in Media



Source: Morningstar. Data as of Dec. 1, 2023.

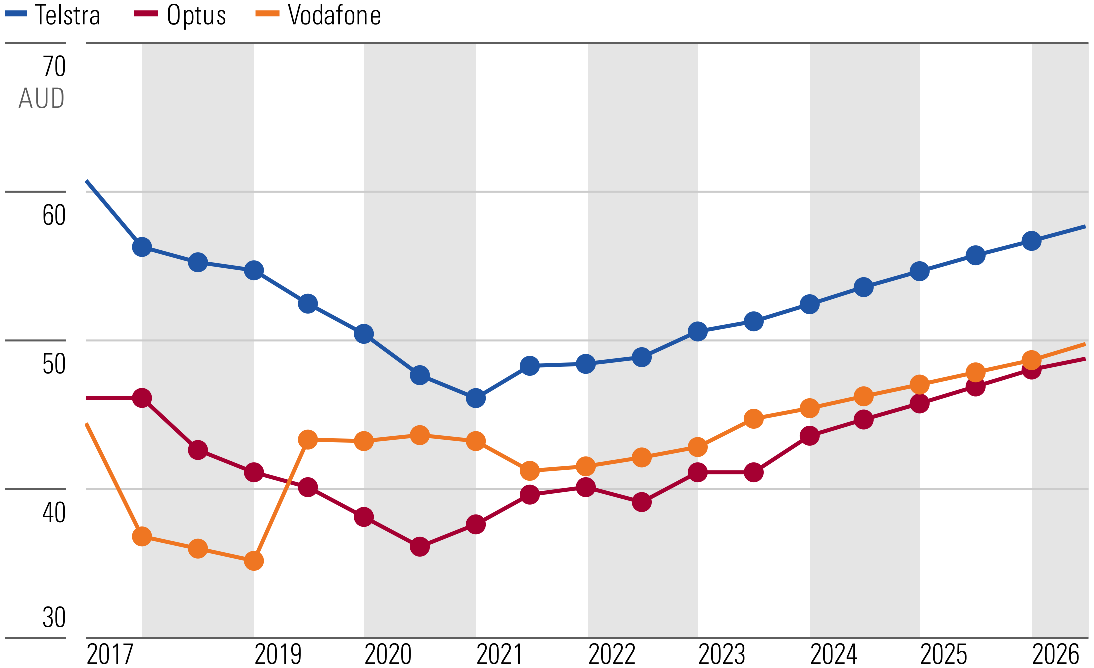
Telecom Tailwinds Fueling "Growth" Aspirations While Media Headwinds Fuelling M&A Temptations

Around 60% of group earnings for Telstra, TPG Telecom, and Optus (not listed) are from mobile. The key profit driver, postpaid revenue per user, is recovering strongly for all. Monetization of this is more important than peripheral projects in the name of "growth."

Faced with an uncertain economic outlook and rising costs, marketing budgets are under pressure. Consequently, advertising expenditures are weak, except for outdoor. Expect further cost control and digital transformation, and potentially consolidation.

Value in Telecom Without Resorting to Peripheral Growth

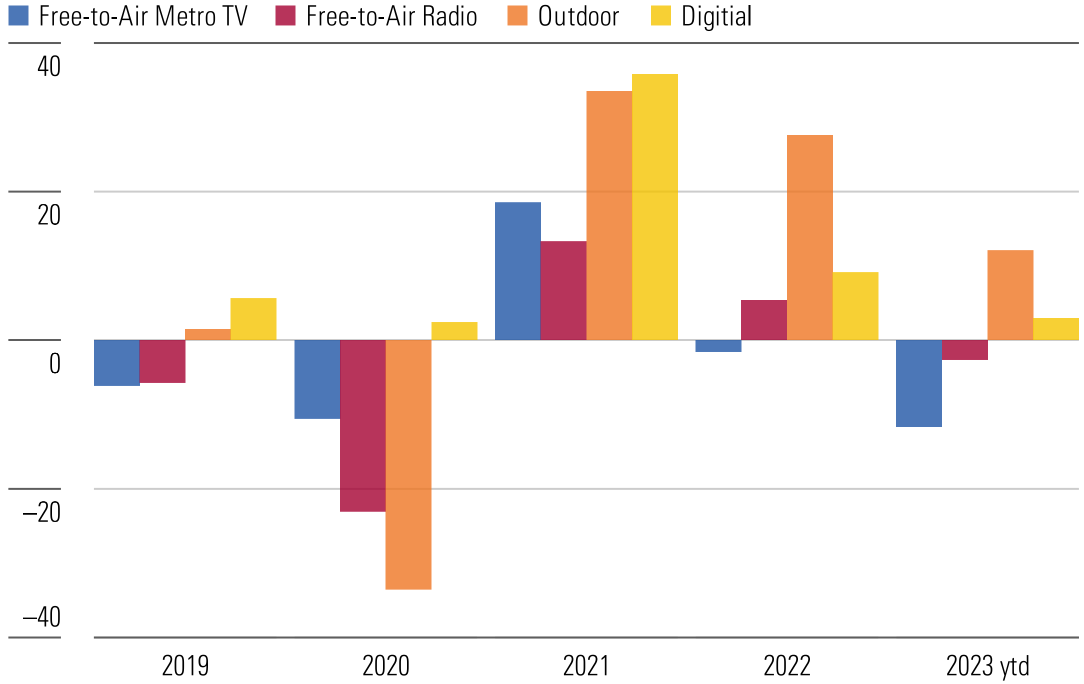
Postpaid mobile average revenue per user per month (AUD)



Source: Company report and Morningstar.

Advertising Recovery Tepid Due to Economic Uncertainties

Advertising expenditure by media – year-on-year % change



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

Communication Services

Company (Ticker)		Rating
TPG Telecom (TPG)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 4.71	AUD 7.40	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 8.76	Narrow	Standard

Shares in narrow-moat TPG Telecom screen as the most attractive under our Australia and New Zealand telecom coverage. We see clear catalysts for 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 cost-outs from the current transformation program are the key drivers, augmented by growth from fixed wireless and the corporate division. Market concerns linger over execution of the current cost-cutting plans and the overhang of major shareholders whose holdings are now out of escrow after the Vodafone merger. However, 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. Termination of discussions with Vocus to sell the enterprise fixed-line assets for AUD 6.3 billion in November 2023 removes a near-term catalyst to liberate value but it has no impact on our fair value estimate.

Company (Ticker)		Rating
Nine Entertainment Company (NEC)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 1.90	AUD 2.80	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 3.09	None	Standard

No-moat Nine Entertainment spans Australia’s advertising and entertainment space. 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. The publishing unit has transformed to become a digital-first news provider, decreasing exposure to traditional print media. Business diversification and a solid balance sheet position Nine to weather the current downturn in advertising markets. The ability to flex costs and utilize efficiencies is not at the expense of the competitive position, with Nine's audience, revenue share, and subscriptions growing across all businesses.

Company (Ticker)		Rating
Southern Cross Media Group (SXL)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 1.04	AUD 1.70	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 0.25	None	Standard

No-moat-rated Southern Cross Media’s near-term earnings trajectory is pedestrian, hampered by the weak advertising market and digital radio investments. However, as the Australian radio market leader, the earnings outlook from fiscal 2024 is positive, as radio advertising normalizes and digital radio losses reduce. Radio accounts for close to 80% of group earnings. Importantly, fundamentals remain solid, with radio’s advertising share increasing slightly in metropolitan markets to 27.2% in fiscal 2023 and regional share steady. The balance sheet is solid, the company is free cash-generative, trading multiples are depressed, and the yield is attractive. The value is beginning to be recognized, at least by the corporates, with ARN Media tabling a takeover offer in October 2023 which we see as opportunistic and unnecessarily complicated.

Source: Morningstar. Data as of Dec. 1, 2023.

Consumer Cyclical

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Recession-Like Consumer Sentiment and Rising Wage Bills Paint Bleak Outlook

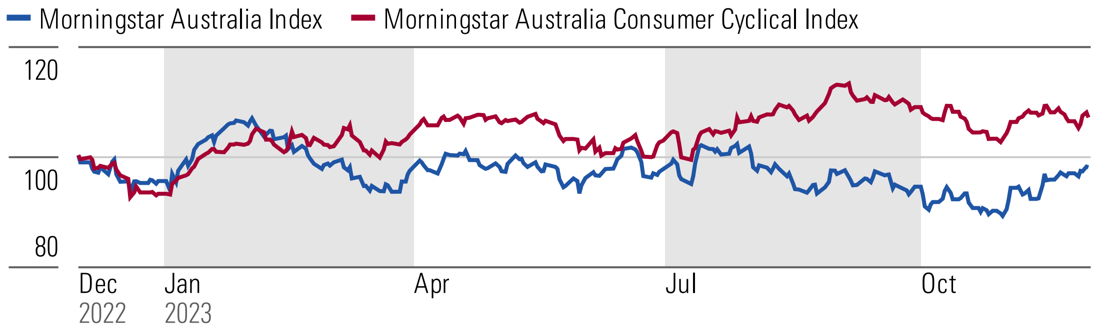
Discretionary retailers have had a tough start to fiscal 2024. And we expect most to grapple with declining sales into calendar 2024. Soft consumer demand for nonessential goods and ample supply of products are bound to intensify competition and fuel promotions, pressuring gross profit margins.

We expect wage hikes to outstrip same-store sales growth, further weighing on profits. In the near term, the most vulnerable categories to material declines in earnings are apparel retailers like Myer, Premier Investments, and Accent, as well as consumer electronics retailers like JB Hi-Fi and Harvey Norman. After being confined at home, Australians are still refreshing wardrobes, but we expect the fashion binge to unwind. Brought forward demand for televisions and fridges weighs on household goods sales.

Automotive spare parts retailers exposed to DIY, like Bapcor's Autobarn or Super Retail Group's Supercheap Auto, are seeing weak discretionary sales—typically about half Autobarn's and Supercheap's earnings. However, maintenance-related categories continue to perform strongly.

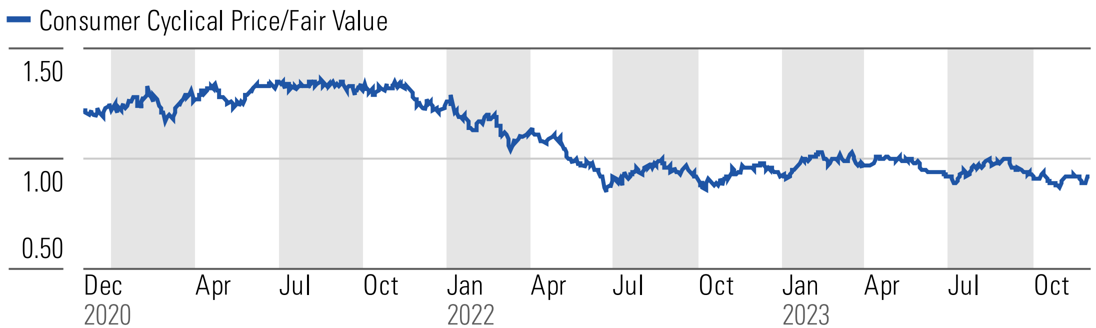
The storm will eventually pass. From fiscal 2025, we expect the consumer to recover, and most consumer cyclical companies have emerged from the pandemic with balance sheets solid enough to weather temporary pain.

Cyclicals Outperforming Despite Weakening Consumer



Source: Morningstar. Data as of Dec. 1, 2023.

Sector on Average More Reasonably Priced Than Pandemic Years



Source: Morningstar. Data as of Dec. 1, 2023.

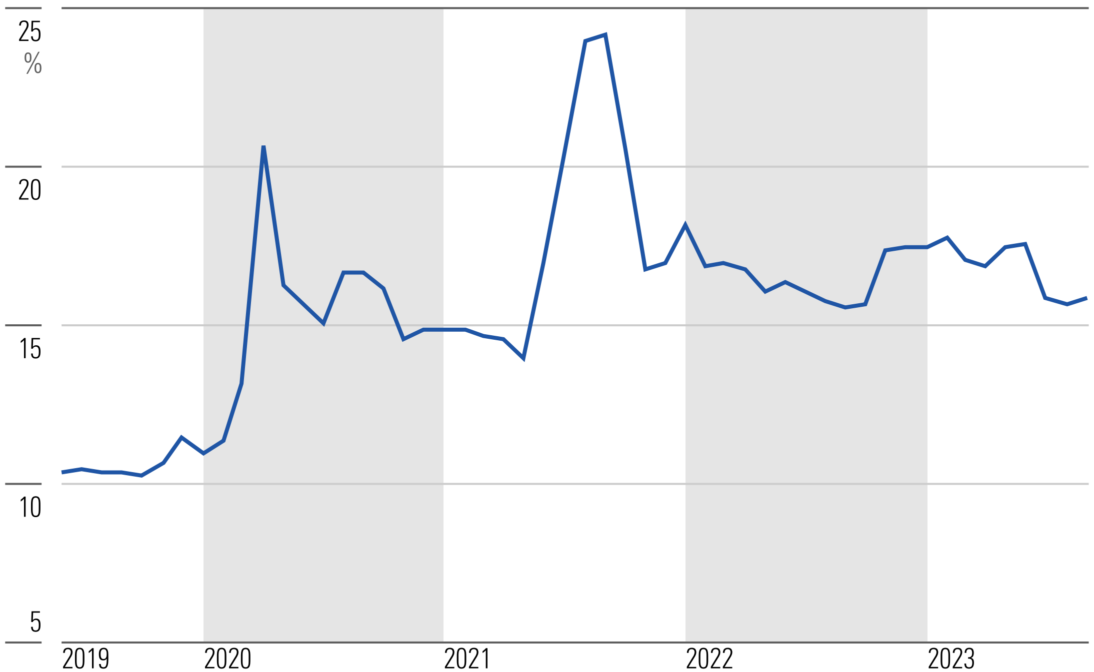
Recession-Like Consumer Sentiment and Rising Wage Bills Paint Bleak Outlook

Omnichannel retailers are increasingly seeing e-commerce platforms outperform store-originated sales. Retailers with greater online sales are likely to take market share.

Amazon investing heavily in its Australian fulfilment infrastructure raises competition, especially in consumer electronics retailing. We estimate its new mega-warehouse in Melbourne will add AUD 3 billion in sales capacity, or 9% of nongrocery e-commerce.

Australians Buying Much More Online Than Before the Pandemic

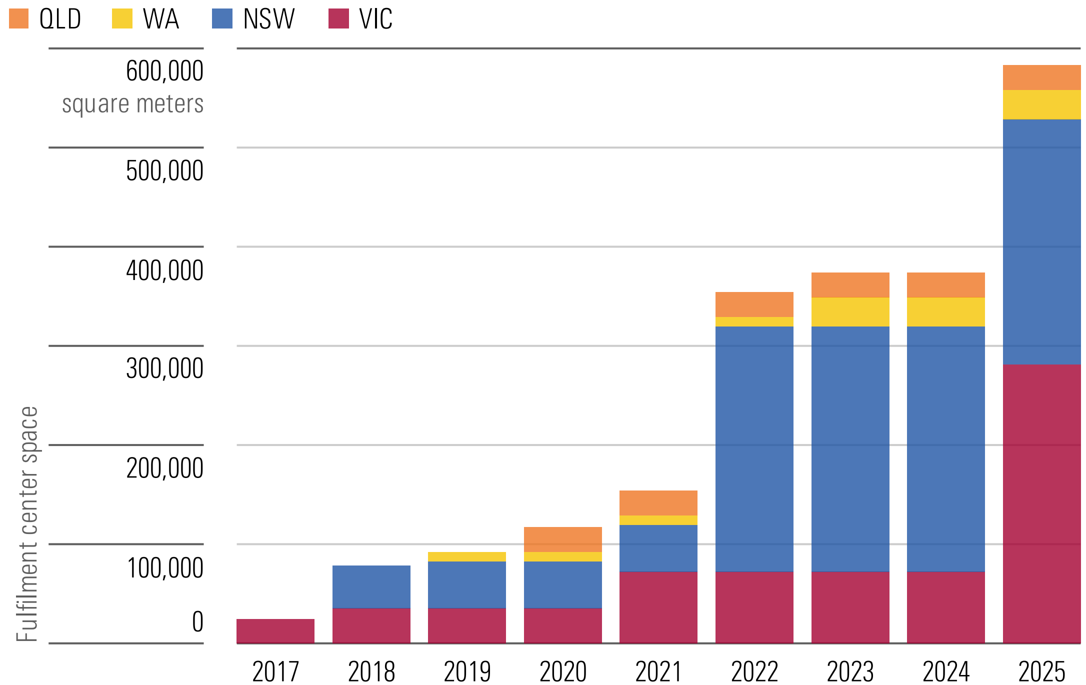
Online penetration of discretionary retailing sales.



Source: Australian Bureau of Statistics. Data as of Sept. 30, 2023.

Amazon Relentlessly Expanding Australian Fulfilment Capabilities

Amazon's Australian footprint in square meters – customer fulfilment centers only.



Source: Amazon Australia, MWPVL.

Consumer Cyclical

Company (Ticker) Kogan.com (KGN)		**Rating** ★★★★★	We ascribe share price weakness to a material decline in sales and earnings from boom-time levels. We expect revenue growth to reignite as consumer spending moves online and for margins to expand as operating expenses normalize. Signs are emerging that sales are stabilizing. A raft of Australian retailers are seeing a renaissance of e-commerce—and Kogan is benefiting as consumers again shift to online. Despite encouraging improvements, the market appears cautious over Kogan's ability to expand profit margins and its long-term sales growth potential, but we expect tailwinds from a structural shift to e-commerce.
Price AUD 5.12	**Fair Value** AUD 10.70	**Uncertainty** Very High	
Market Cap (bil) AUD 0.52	**Economic Moat** None	**Capital Allocation** Exemplary	
Company (Ticker) Bapcor (BAP)		**Rating** ★★★★★	Creeping negative sentiment means the fundamental strength and resilience of Bapcor's automotive parts business is underappreciated. We forecast Bapcor will capture market share from the long tail of smaller competitors by distributing a wider range of spare parts quicker, more reliably, and at a lower cost—competitive strengths which underpin the firm's narrow moat. We think concerns about the looming unwinding of elevated discretionary expenditure and potential lost market share are overblown. The vast majority of Bapcor's earnings are tied to largely nondiscretionary vehicle maintenance. It enjoys an element of countercyclicality as consumers choose to maintain their existing car rather than upgrading to a newer vehicle.
Price AUD 5.34	**Fair Value** AUD 8.00	**Uncertainty** Medium	
Market Cap (bil) AUD 1.81	**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 24% earnings CAGR for the next five years, underpinned by its global store rollout. Sales growth has been volatile, and the share price tends to reflect near-term trading conditions rather than longer-term potential. The near-term outlook is uncertain and hinges on moderating inflation. However, we believe the market is overly discounting Domino's significant long-term growth potential. We forecast the network to grow to 6,200 stores by fiscal 2033, from some 3,800 as of June 2023, below management's long-term target of 7,100. Hitting management's target would lift our valuation by 11%.
Price AUD 52.68	**Fair Value** AUD 68.00	**Uncertainty** High	
Market Cap (bil) AUD 4.73	**Economic Moat** Narrow	**Capital Allocation** Exemplary	

Source: Morningstar. Data as of Dec. 1, 2023.

Consumer Defensive

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Labor Costs Are Outpacing Normalizing Revenue Growth

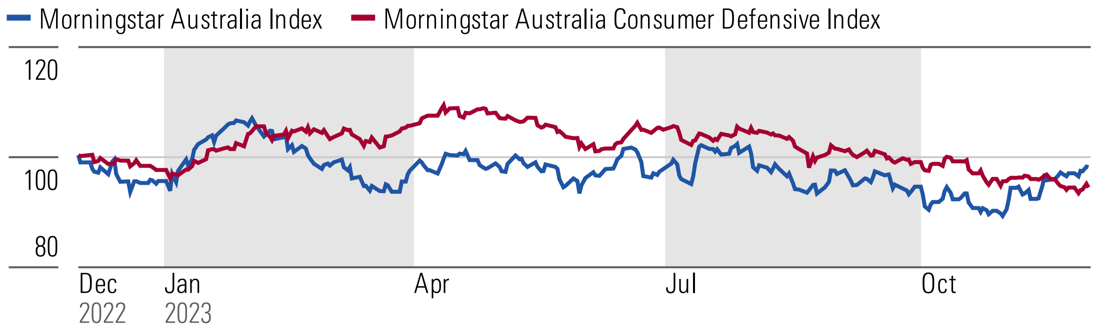
Wages growth is proving a massive headwind for the consumer defensive sector—particularly as grocery price inflation decelerates. At Woolworths, weekly grocery price inflation as experienced by customers at the checkout was 3.4% in mid-November 2023, down from a peak of over 10% in November 2022, per Woolworths. Comparable item growth was 1.6% in the September quarter. Assuming similar volume growth to the first quarter, which was negative on a per-capita basis, sales are up about 5%, versus wages growth of closer to 6%—weighing on margins.

Labor is also a major input cost for suppliers like Bega and Inghams. There is an offset in Inghams' case as feed prices moderate—Chicago SRW Wheat Futures are down about 30% since November 2022. The same cannot be said for Bega, grappling with an oversupply of milk-processing capacity in Australia, and high farmgate milk prices.

Consumers are adjusting shopping habits by trading down—substituting more expensive products and brands with cheaper alternatives. While this underpins cyclically stronger demand for Inghams' poultry products, as chicken is cheaper than competing meats, the trend weighs on Bega. Bega's national brands like Dairy Farmers compete directly with cheaper, private labels.

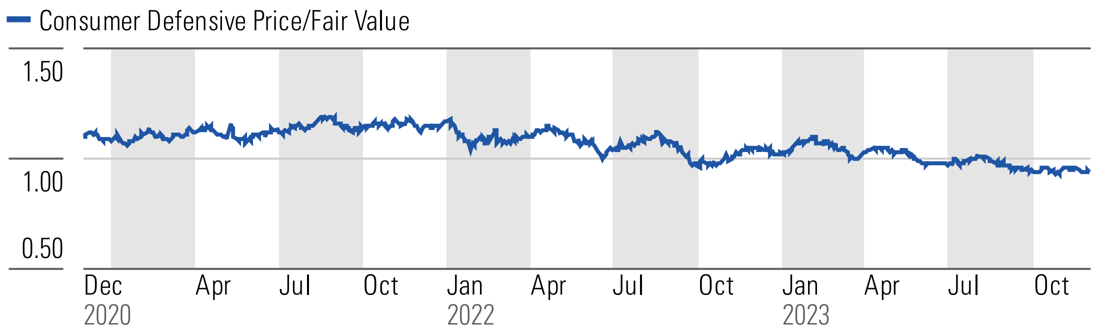
Shoppers are also trading down within liquor, buying mainstream beer brands instead of craft beers. We think Endeavour's Dan Murphy's chain—with its lowest liquor price guarantee—is well-placed to capture market share in this environment.

Defensive Stocks Broadly Tracking Overall Market



Source: Morningstar. Data as of Dec. 1, 2023.

Defensives Slightly Undervalued on Average



Source: Morningstar. Data as of Dec. 1, 2023.

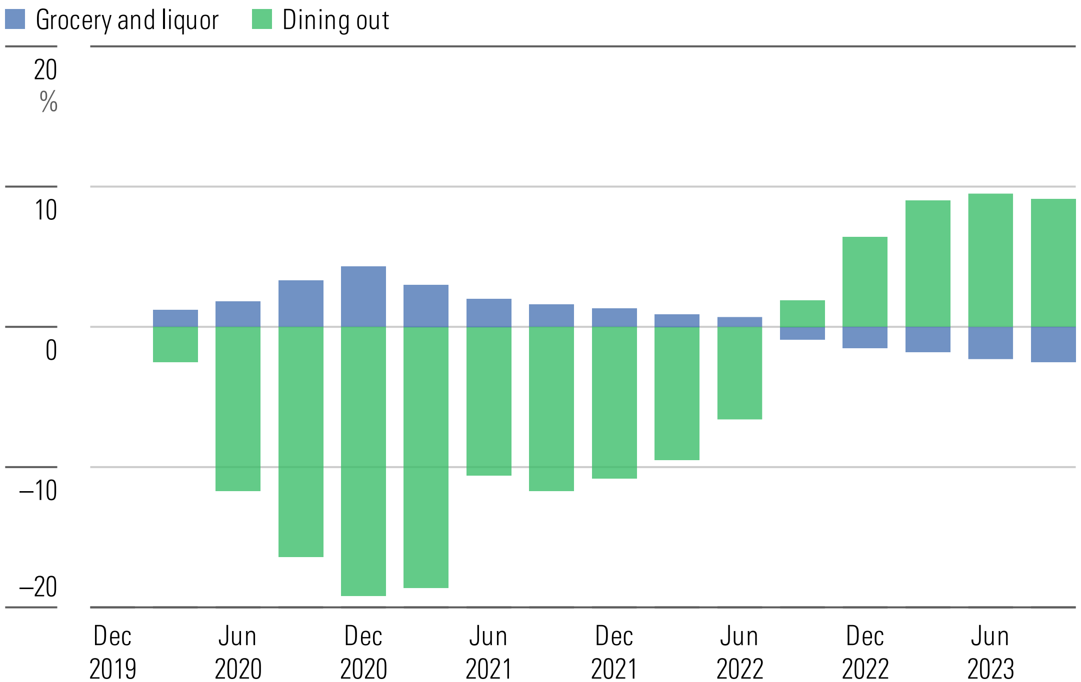
Labor Costs Are Outpacing Normalizing Revenue Growth

Consumers are increasingly eating at-home, reversing a recent dining out boom. The Commonwealth Bank of Australia estimates hospitality sales declined 1% in October 2023 versus the previous corresponding period, while spending on food and beverages increased by 2%.

Labor costs are a headwind. For the September 2023 quarter, the seasonally adjusted wage price index is up 4.2% over the past year—the highest annual rise since 2008. The average hourly wage increase was 5.8%.

Grocery and Dining Out Sales Volumes Likely to Normalize

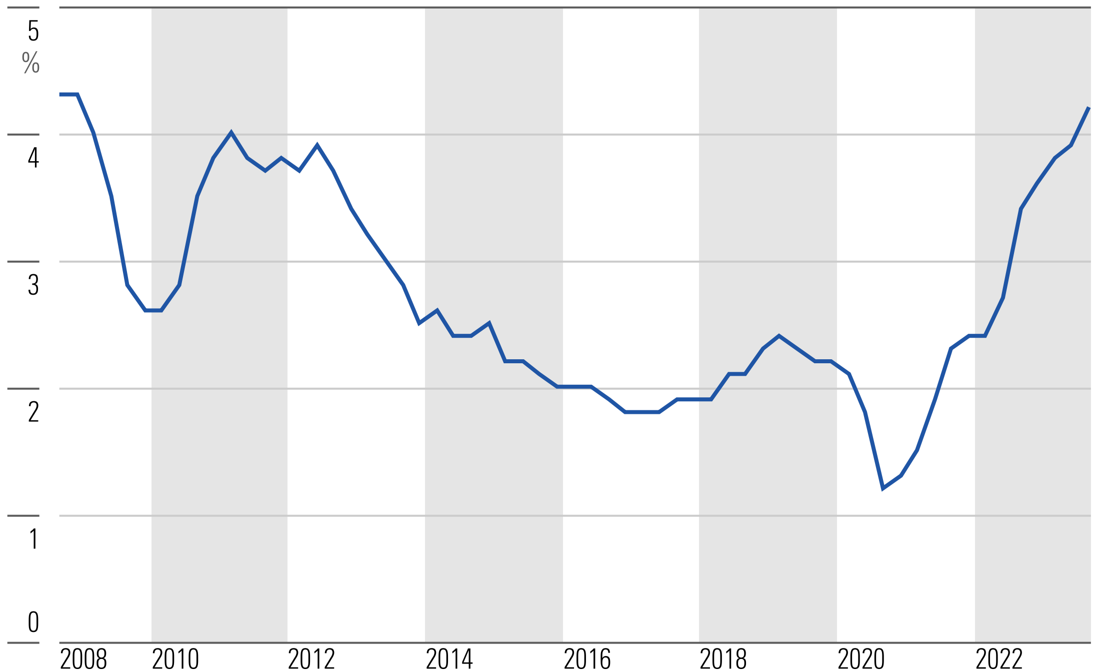
Retail volumes vs prepandemic trend levels (Dec-19=0%).



Source: Australian Bureau of Statistics. Data as of Sept. 30, 2023.

Rising Wages Mean Significant Near-Term Margin Pressure

Annual private sector wage growth, seasonally adjusted.



Source: Australian Bureau of Statistics.

Consumer Defensive

Company (Ticker) Bega Cheese (BGA)		**Rating** ★★★★	Despite a collapse of profitability in Bega's bulk segment, we estimate the branded segment alone can justify Bega's stock price. Bega's consumer brands are proving more resilient than others. Even with cost-of-living pressures and consumers trading down, Bega's brands managed double-digit price increases and grew volumes 5% in fiscal 2023. Bega is focusing on its branded portfolio, and we expect the bulk business to shrink materially. With an oversupply of milk-processing capacity, competition is high for raw milk in Australia, despite falling global prices. The disconnect between the global milk price and Australian farmgate prices has decimated Bega's bulk margins. But there is upside should the business turn around faster than we expect—either through capacity rationalization, or from an increase in local milk supply or global commodity pricing.
Price AUD 3.07	**Fair Value** AUD 4.00	**Uncertainty** Medium	
Market Cap (bil) AUD 0.93	**Economic Moat** None	**Capital Allocation** Standard	
Company (Ticker) Endeavour Group (EDV)		**Rating** ★★★★	We think the market's concerns regarding regulatory risk are overdone. Liquor demand is defensive and likely underpinned by inflation and population growth. The premiumization trend also likely counterbalances the structural decline in per-capita liquor consumption. We forecast gaming restrictions proposed by the Victorian government to weigh on Endeavour's earnings, and we expect New South Wales to follow suit. But we estimate the combined impact to be moderate with EPS declining by 1% in fiscal 2025. From fiscal 2026, we expect group profit to grow at an average rate of 6% to fiscal 2033.
Price AUD 5.00	**Fair Value** AUD 6.10	**Uncertainty** Low	
Market Cap (bil) AUD 8.95	**Economic Moat** Wide	**Capital Allocation** Exemplary	
Company (Ticker) The a2 Milk Company (A2M)		**Rating** ★★★★★	There is much to like about a2 Milk, notably in China, the key battleground. A2's share of Chinese-language-labeled infant formula continues to grow, 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 the falling number of births in China, we anticipate premiumization to continue and a2 Milk to capture market share. We forecast 9% annual revenue gains to fiscal 2028 as channel inventory levels normalize and market share increases; alongside improved sales of higher-margin English-label product and operating leverage from higher revenue.
Price AUD 3.88	**Fair Value** AUD 7.20	**Uncertainty** High	
Market Cap (bil) AUD 2.80	**Economic Moat** Narrow	**Capital Allocation** Standard	

Source: Morningstar. Data as of Dec. 1, 2023.

Energy

Mark Taylor | mark.taylor@morningstar.com

Producers Unloved Despite Favorable Outlook for Natural Gas

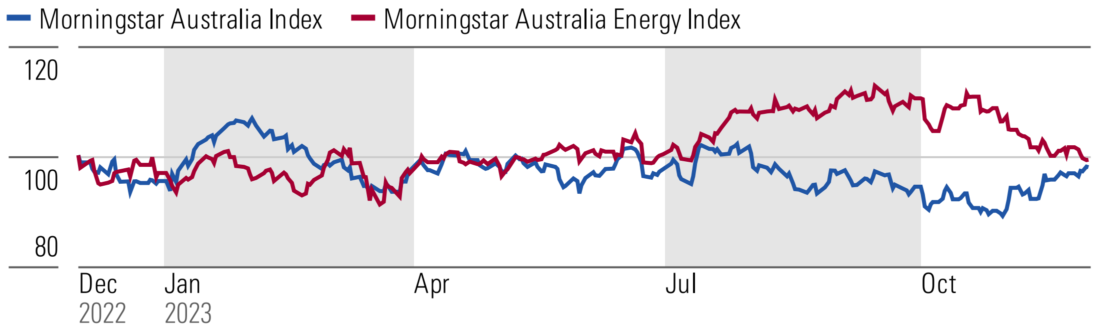
In November 2023, OPEC+ announced 2.2 million barrels per day, or bbl/d, of production cuts from January to March 2024, with about 896,000bbl/d being incremental to existing voluntary cuts. This is likely to keep the market in supply deficit, or close to one, and prices in what seems to be OPEC+'s preferred band of between USD 80 and USD 100 a barrel. These are real barrels being removed from the market.

The Saudis have no doubt been disappointed with recent oil prices near USD 80 a barrel and will likely need prices averaging USD 100 a barrel over the next five years to support the more-than USD 1 trillion investment into Saudi Vision 2030.

Oil prices consequently remain high, with Brent around 33% above our USD 60 midcycle estimate, which kicks in from 2025. It is a very healthy price for Australian exploration and production companies, including for gas producers via Brent-referenced liquefied natural gas contracts. Contract LNG prices are high at around USD 11 per million Btu and Asia LNG spot prices are even better at about USD 16 per mmBtu. Woodside and Santos sell up to a third of LNG into spot markets.

In the longer term, we see secular oil demand falling, but not before the early 2030s. The rate of decline is likely to be modest given growing jet fuel and petrochemicals demand. We are bullish on natural gas demand to balance renewable generation and for peaking power. We expect Australian E&Ps to enjoy a multidecade growth runway and robust free cash flows, and much of this likely to go to shareholders via buybacks and dividends.

Energy Names Pulled Back Again



Source: Morningstar. Data as of Dec. 1, 2023.

Concentrate on High-Quality Names in Undervalued Sector

Source: Morningstar. Data as of Dec. 1, 2023.

Producers Unloved Despite Favorable Outlook for Natural Gas

Spot and futures prices are above our midcycle levels of USD 60 per barrel for Brent crude and USD 8.40 per million Btu for Asia LNG. If borne out, the implication for LNG producer earnings is positive.

Coal prices continued to moderate over the quarter compared with record 2022 highs. However, we think demand for high-quality coal, such as from Whitehaven and New Hope, is likely to remain robust in Southeast Asia in particular.

Bullish LNG Futures Above the Brent-Referenced LNG Contract

Source: Meti/investing.com/CME as of Dec. 4, 2023, Morningstar.

Thermal Coal Prices Down From 2022 Highs but Still Elevated

globalCOAL NEWC Index.

Source: globalCOAL, Morningstar forecasts. Data as of Dec. 7, 2023.

Energy

Company (Ticker)		Rating
Santos (STO)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 6.90	AUD 12.30	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 22.41	None	Standard

We don't think Santos is being sufficiently credited for new oil and gas developments underway. A solid balance sheet and low costs, including a freight advantage to Asia, mean the company is well placed to weather any cyclically 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 80% 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 11.9% to USD 6.3 billion by 2027 versus 2023.

Company (Ticker)		Rating
Beach Energy (BPT)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 1.49	AUD 2.50	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 3.39	None	Standard

We forecast strong earnings growth for Beach, but the market may still be penalizing shorter 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. Importantly, the Waitsia Stage 2 gas project in the Perth Basin has achieved significant milestones, and construction continues to target first gas in mid calendar 2024. Waitsia Stage 2 is expected to add a 20% increment on normalized current group production levels and the project comprises around AUD 0.60 or nearly 25% of our group fair value estimate. We forecast a healthy group EBITDA CAGR of 8.6% to USD 980 million in fiscal 2028 versus fiscal 2023.

Company (Ticker)		Rating
Whitehaven Coal (WHC)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 7.26	AUD 10.00	Very High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 6.07	None	Standard

Whitehaven continues to be penalized due to ESG concerns. We think its deal to buy two metallurgical coal mines from BHP, likely effective late fiscal 2024, is a good one, diversifying its production to roughly half thermal coal, half metallurgical coal. Debt to help finance the purchase is manageable, though returns to shareholders are likely to be constrained until it is repaid. New coal supply is restrained, affected by ESG concerns and opposition from regulators, which could bring longer-term upside to prices. In our view, demand for metallurgical coal for use in steelmaking is likely to persist, with alternative green steel technologies unlikely to be economic at scale for decades. We also think demand for Whitehaven's high-quality thermal coal is likely to be strong for at least the next decade, especially from Southeast Asia. High-quality thermal coal meets the energy needs of countries like Japan and South Korea while meeting emissions targets under various international agreements.

Source: Morningstar. Data as of Dec. 1, 2023.

Financial Services

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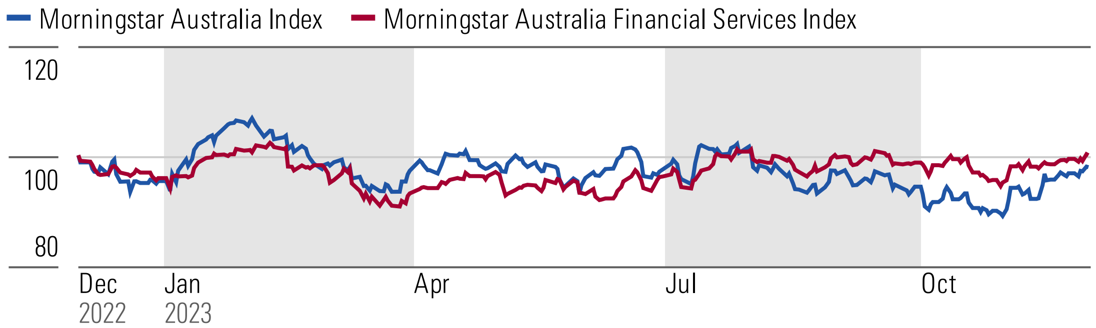
Moat-Rated Firms Should Shine Given Cyclical Challenges

We see value in Australian banks, with most trading at material discounts to our fair value estimates. After an initial tailwind from higher cash rates, the earnings trajectory turned negative as more expensive customer deposits and aggressive mortgage discounting hurt margins. Profitability is still solid, and we expect margins to stabilize in 2024 and improve in 2025. There are signs of more rational pricing, which we expect to be more pronounced as refinancing activity slows. The number of borrowers in arrears is low but rising as households suffer cost of living pressures. The major banks hold surplus capital, which provides comfort dividends can be maintained as earnings soften.

The earnings outlook for general insurers, IAG Group and Suncorp, is positive. Higher claims and reinsurance costs are being matched with higher premium rates. Additionally, higher cash rates are driving a material increase in investment income on policyholder and shareholder funds. We prefer the insurance brokers Steadfast, AUB Group, and PSC Insurance Group which ride these tailwinds without the underwriting risk.

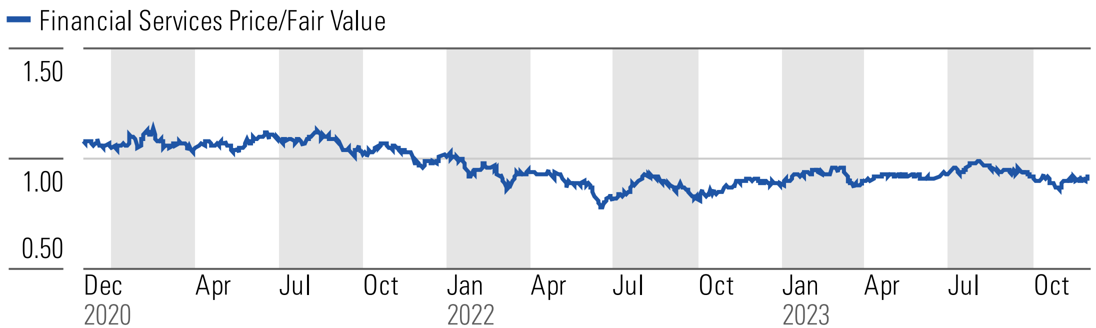
We expect a gradual recovery for the asset and wealth managers, supported by a stabilization of interest rates. About 70% of them are expected to generate higher EPS in fiscal 2024, up from cyclical lows in fiscal 2023. Slightly more than half are likely to see their funds under management/administration revert to pre-fiscal 2022 levels by the end of fiscal 2024. These include those capturing share from underperforming peers, like Pinnacle and GQG; and firms benefiting from structural tailwinds, notably Challenger. Cost-outs and product rationalization are also likely to help defend profit margins.

Banks and Asset Managers Are Unloved



Source: Morningstar. Data as of Dec. 1, 2023.

Focus on Moat-Rated Stocks in Undervalued Sector



Source: Morningstar. Data as of Dec. 1, 2023.

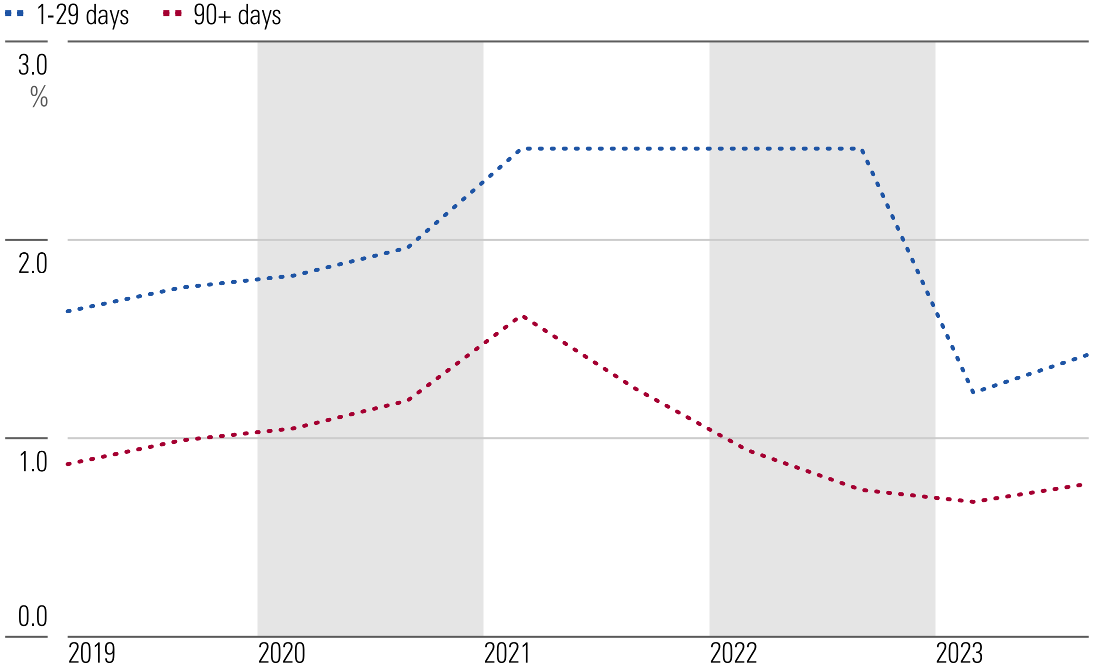
Moat-Rated Firms Should Shine Given Cyclical Challenges

The material jump in loan repayments is putting more homeowners under financial pressure, but low unemployment, savings buffers, and strong house prices are contributing to low levels of bad debts for banks.

We expect the average profit margin for wealth and asset managers to stabilise in fiscal 2024 after falling in fiscal 2023. If interest rates stabilise as we expect, investor risk appetite is likely to rise, benefiting fund flows. Cost efficiencies should help margins.

Home Loan Arrears Rising but Not Alarmingly

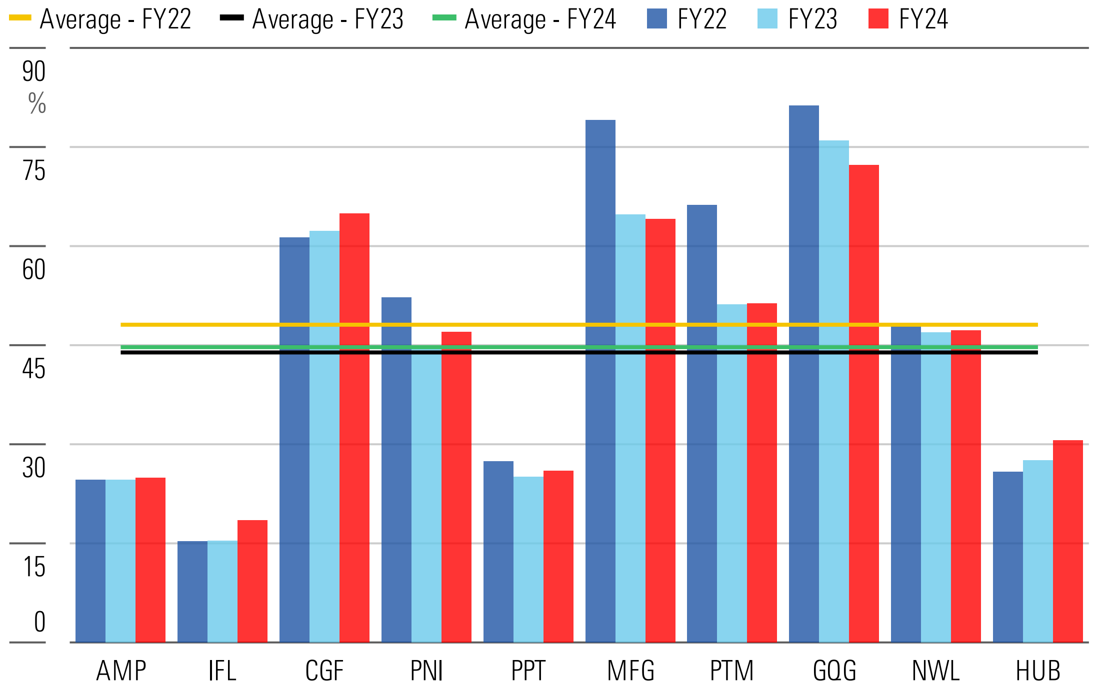
National Australia Bank home loan balances behind in repayments.



Source: National Australia Bank. Data as of Sept. 30, 2023.

Expected Margin Stabilization Could Support a Rerating

Company operating margins



Source: Company Filings. Data as of Sept. 30, 2023.

Financial Services

Company (Ticker) ASX (ASX)		**Rating** ★★★★★	We view ASX as a natural monopoly providing essential infrastructure to Australia's capital markets. Despite the deteriorating regulatory environment, we believe the business is well supported by its wide economic moat based on network effects and intangibles. We also believe the energy transition is an underappreciated tailwind. We expect it to spark demand for resources in which Australia holds strong natural endowments, to deliver new listings and a long tail of revenue from trading and clearing activity.
Price AUD 57.95	**Fair Value** AUD 72.50	**Uncertainty** Low	
Market Cap (bil) AUD 11.22	**Economic Moat** Wide	**Capital Allocation** Poor	
Company (Ticker) Perpetual (PPT)		**Rating** ★★★★	We believe the market is overlooking narrow-moat Perpetual's likely earnings growth from better flows and cost reductions. While Perpetual's investments business is in net outflow, we believe improving investment performance supports new mandate wins and lower redemptions. Additionally, we anticipate improved flows for both wealth management and corporate trust from an eventual stabilization in interest rates and macroeconomic conditions, relative to present levels. Both businesses face less competitive intensity relative to the investments business. Elsewhere, there is room for cost cuts by centralizing operations and removing duplication following the acquisition of Pendal. Perpetual itself is cycling off a period of elevated investment.
Price AUD 22.54	**Fair Value** AUD 27.50	**Uncertainty** Medium	
Market Cap (bil) AUD 2.55	**Economic Moat** Narrow	**Capital Allocation** Standard	
Company (Ticker) Westpac Banking (WBC)		**Rating** ★★★★	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 this should wane. Market share has stabilized 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.
Price AUD 21.27	**Fair Value** AUD 28.00	**Uncertainty** Medium	
Market Cap (bil) AUD 74.53	**Economic Moat** Wide	**Capital Allocation** Standard	

Source: Morningstar. Data as of Dec. 1, 2023.

Healthcare

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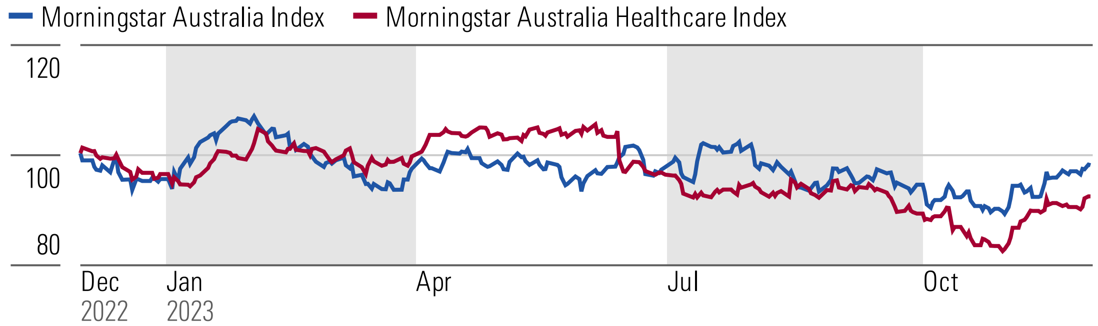
Buying Opportunities for High-Quality Healthcare Names

The healthcare sector underperformed the broader market in 2023. We view the sector as undervalued on average with just over half of our coverage trading in 4- or 5-star territory. The most attractive names are ResMed, where we expect continued strong revenue growth, and Ramsay and Ansell where we see margins expanding. Meanwhile, Pro Medicus, Cochlear, and Ebos are our most overvalued stocks.

A clear takeaway is the healthcare sector is not immune from inflation. Trading updates for Healius and Integral Diagnostics both significantly disappointed market expectations. The concern now is for other healthcare companies still at risk from higher employee and rental costs, and unable to pass on these costs. Companies with higher employee expenses as a percentage of sales could face margin pressures from wage inflation and a tight labor market in certain areas. This includes Ramsay, Fisher & Paykel, and pathology and diagnostic imaging providers, Sonic and Australian Clinical Labs.

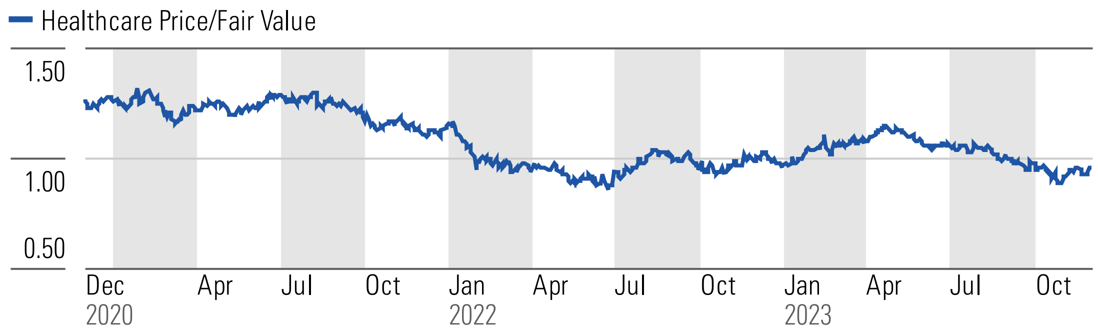
Among the healthcare companies with a relatively larger fixed cost base, we think Ramsay is better positioned for inflation given its narrow moat. As Australia's largest private hospital provider, we think Ramsay can negotiate better rates with key Australian private health insurers as they cannot afford to exclude Ramsay hospitals from their offering and risk members switching health funds. Ramsay's negotiating power is not a pure function of scale, but also factors its reputation for high-quality care and established network of medical specialists.

Healthcare Underperformed the Market in 2023



Source: Morningstar. Data as of Dec. 1, 2023.

Several Names Attractive in Undervalued Sector



Source: Morningstar. Data as of Dec. 1, 2023.

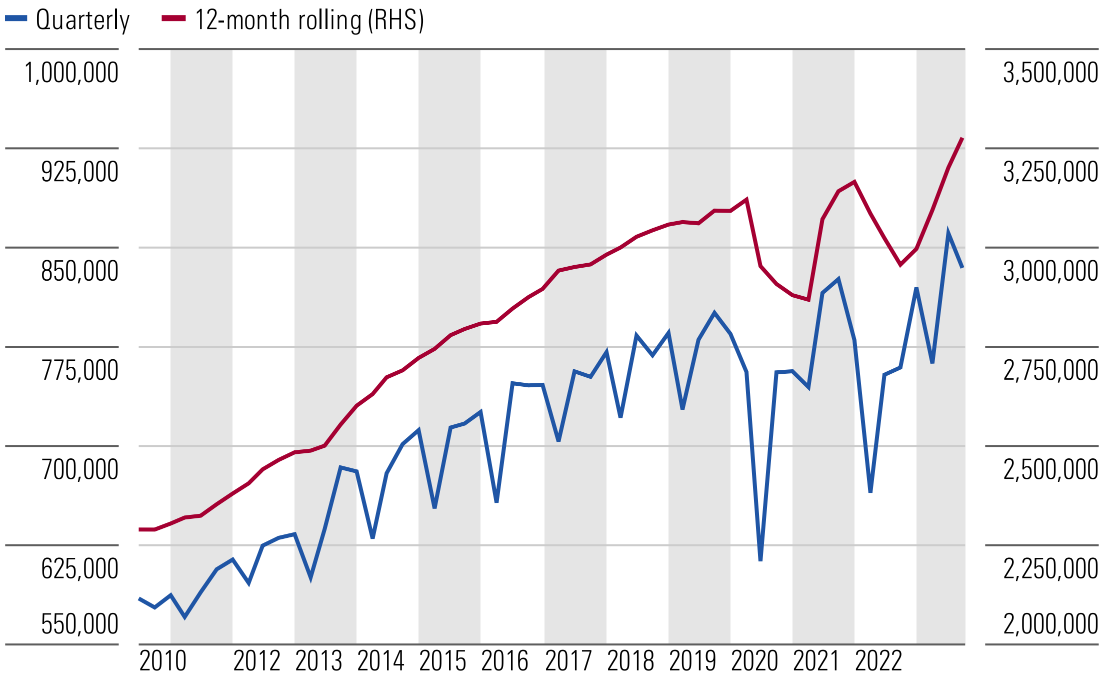
Buying Opportunities for High-Quality Healthcare Names

We expect Ramsay Australia to benefit from the recovery in volumes driven by improved staff availability. Growth drivers of increasing private health insurance membership, demographic factors, and increasing chronic disease and hospitalization rates are intact.

ResMed's selling, general, and administrative expenses have fallen as a proportion of sales due to operating leverage. We expect lower costs and stronger margins given a 5% reduction in its global workforce in October 2023, largely in noncore SG&A.

Recovery in Hospital Visits to Support Ramsay's Top Line

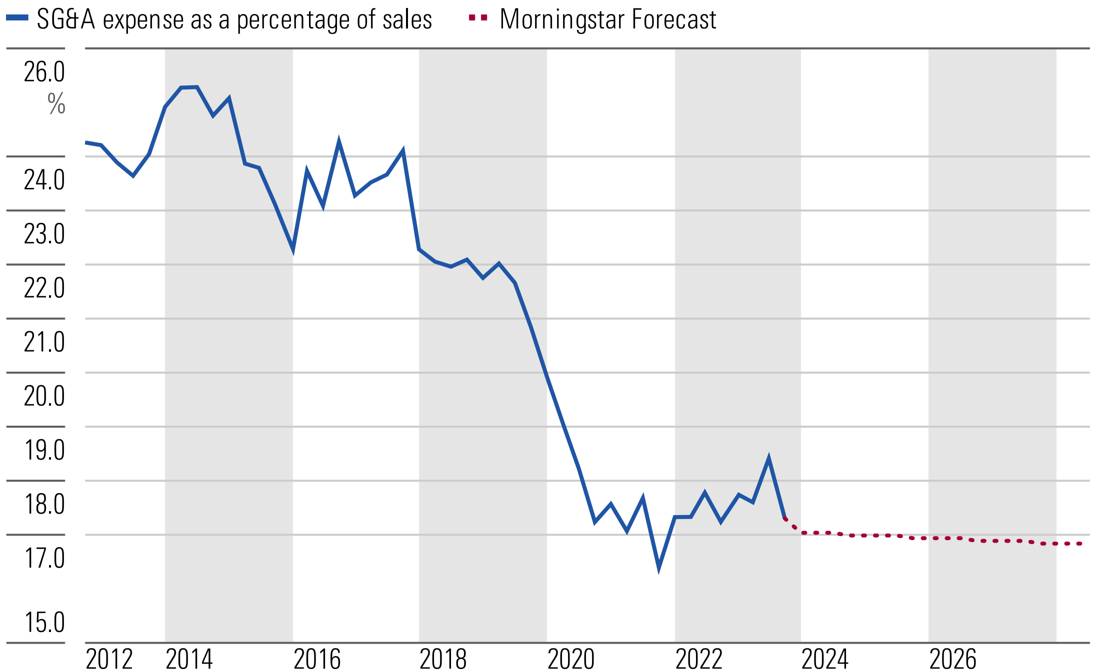
Australian private hospital episodes.



Source: Australian Prudential Regulation Authority. Data as of Nov. 22, 2023.

Operating Leverage to Support ResMed's Margins

Selling, general, and administrative expenses as percentage of sales revenue.



Source: Morningstar estimates, Company filings.

Healthcare

Company (Ticker)		Rating
Ansell (ANN)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 23.54	AUD 30.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 2.95	Narrow	Exemplary

We expect Ansell's margin pressures to abate. Pricing for undifferentiated single-use exam gloves has stabilized and a productivity program is set to deliver over USD 45 million of cost savings by fiscal 2026, over a fifth of current group EBIT. Employee expenses are falling through automation in packaging and reducing duplication of leadership responsibilities. Despite current customer destocking, we see limited competitive pressure and reiterate Ansell's narrow moat based on intangible assets. We forecast gross margin expansion as Ansell insources more manufacturing, better utilizes 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 48.59	AUD 68.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 11.15	Narrow	Exemplary

Narrow-moat Ramsay's June quarter 2023 showed solid margin improvement but profitability was constrained by inflationary pressures and accelerated investment in digital. However, we are optimistic for margin expansion. Importantly, labor shortages are easing with immigration recovering, and Ramsay continues to invest in recruiting and training programs. We expect margins to expand as Ramsay uses fewer agency employees, as case mix and volumes normalize for nonsurgical services, as capacity utilization improves, and as digital investment efficiencies are realized. The firm also recently negotiated higher reimbursement rates with health funds to meet cost inflation and deleveraged its balance sheet by selling its share of Ramsay Sime Darby.

Company (Ticker)		Rating
ResMed (RMD)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 23.94	AUD 40.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 35.49	Narrow	Exemplary

ResMed's experiencing record high patient flow with sleep apnea diagnosis rates recovering. U.S. mask sales also grew 7% sequentially in the September quarter 2023 reflective of ResMed's larger installed base due to Philips' recall. Recent share price weakness reflects concerns weight loss drugs will disrupt the sleep apnea industry. However, we think widespread adoption of these drugs will take time given the high cost, limited supply, and side effects. Obesity is also just one risk factor for sleep apnea, and many sleep apnea patients who lose weight are still obese. In most cases, they will likely still benefit from a CPAP device. See our special report "The Start of Unconstrained Sales for ResMed" published on July 25, 2023, for more details.

Source: Morningstar. Data as of Dec. 1, 2023.

Industrials

Esther Holloway | esther.holloway@morningstar.com

Higher Cash Rate to Weigh on Companies and Consumers Alike

The industrials sector has held up well despite fears of an economic slowdown. The sector appears fairly valued on average and we see select buying opportunities. Our top picks are Qube, Ventia Services, and Aurizon.

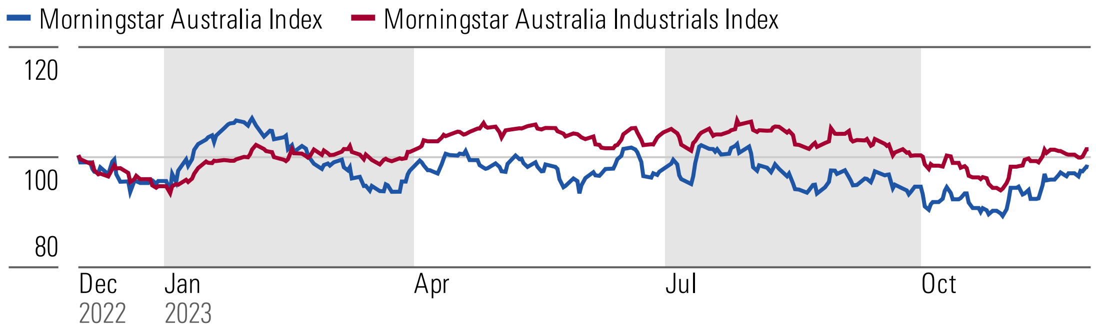
In the December-2023 quarter, the Reserve Bank of Australia lifted the cash rate by 25 basis points, for the first time since June 2023. Tighter credit conditions weigh on both customers and companies.

Container imports are trending lower as rate hikes flow through the economy, a key headwind for logistics company Qube. However, it is a diversified business and the long-term trend is intact. Coal export volumes are recovering as La Nina fades, a positive for Aurizon, which also benefits from CPI-linked tariffs and higher regulated returns.

Share prices for toll road owners Transurban and Atlas Arteria have fallen but are still not cheap. Overall, the outlook is positive with recovering traffic volumes and mostly CPI-linked tolls offsetting the impact of higher interest rates on these highly geared firms.

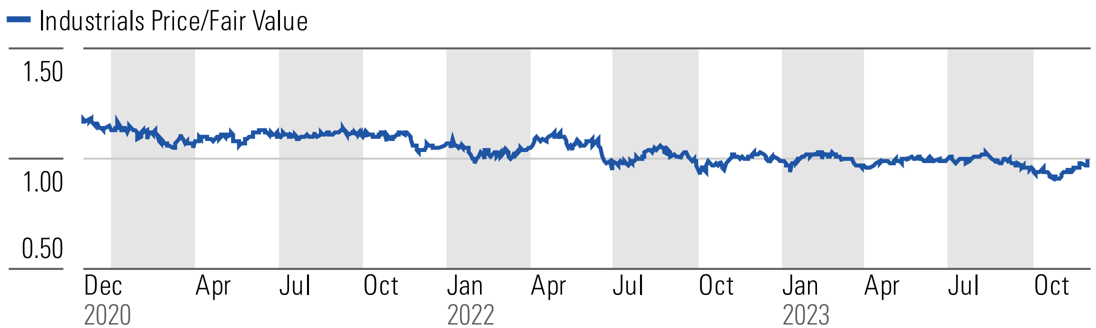
Subdued new housing approvals reflect a weak outlook for residential construction. Almost 20% fewer new homes were approved in October 2023 versus the same period a decade earlier, despite strong population growth. Reece and CSR are exposed to residential construction, but neither are cheap at today's prices. We expect residential construction to recover from 2026 due to an undersupply of Australian housing and, potentially, a lower cash rate.

Industrials Broadly Tracked the Market in 2023



Source: Morningstar. Data as Dec. 1, 2023.

Industrial Sector Again Fairly Valued



Source: Morningstar. Data as of Dec. 1, 2023.

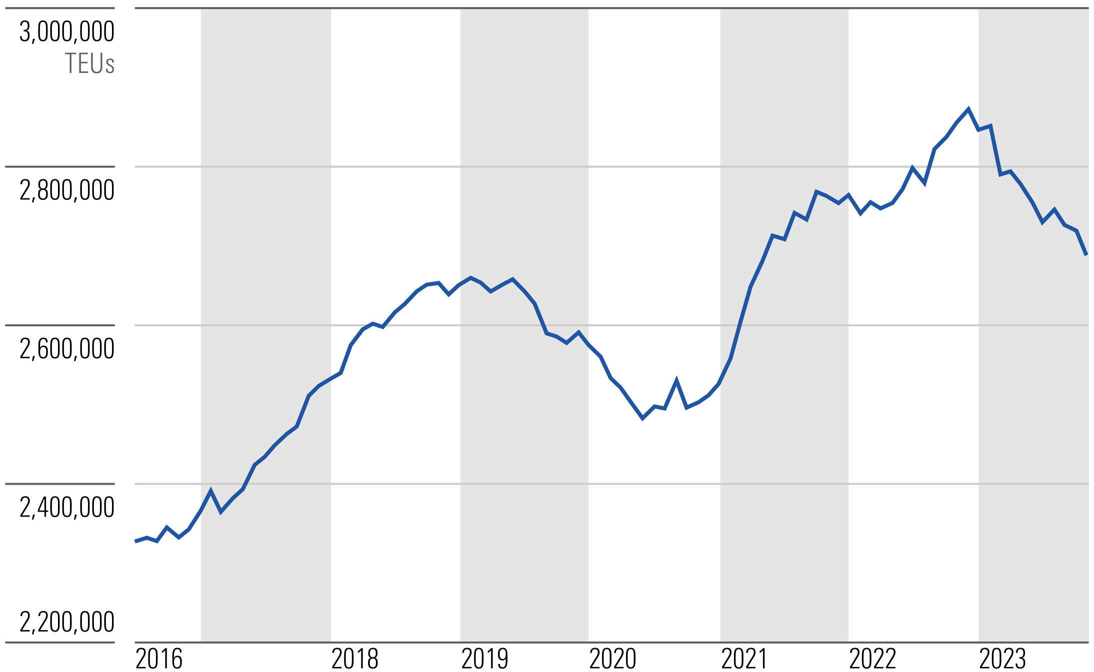
Higher Cash Rate to Weigh on Companies and Consumers Alike

Container imports are weakening as tighter monetary policy hurts domestic consumer spending. But the long-term outlook is supported by population growth and offshoring of manufacturing, and Qube also has significant exposure to commodity exports.

New dwelling approvals are at the lowest in more than a decade as households respond to higher interest rates and cost of living. Industrial stocks CSR and Reece are exposed to residential construction, but we expect demand to recover from 2026.

Trade Volumes Starting to Show Household Strain

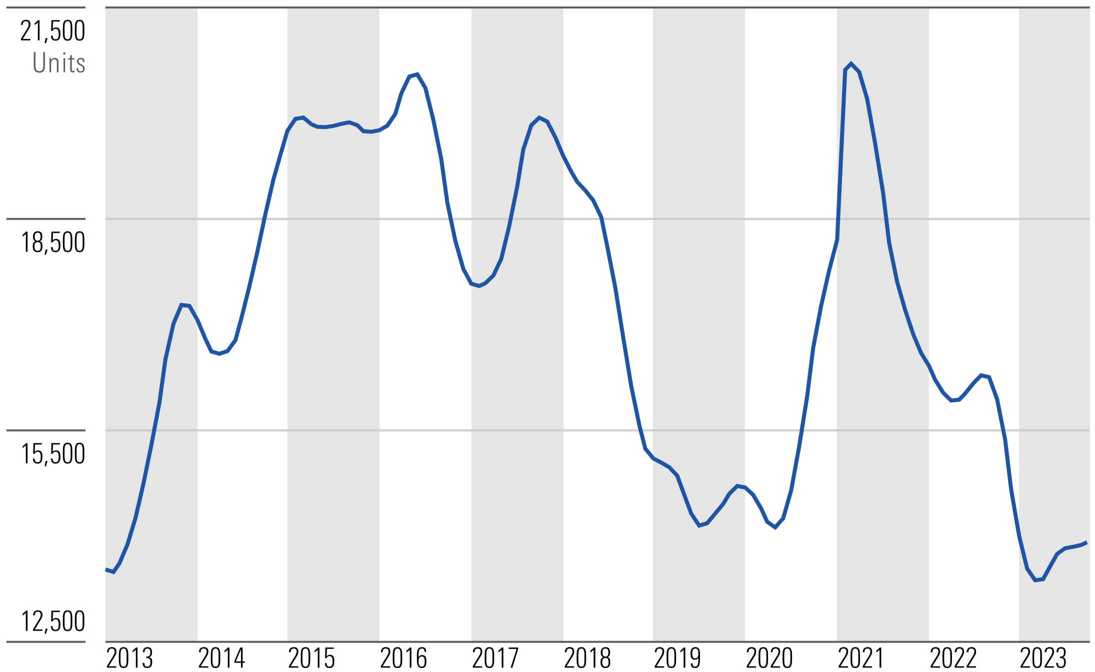
Port Botany container volumes (trailing 12 months, 20-foot equivalent units).



Source: NSW Ports. Data as of Oct. 31, 2023.

Demand for Residential Construction Inching Toward Recovery

Housing approvals at the lowest level in more than a decade (new dwellings, trend).



Source: Australian Bureau of Statistics. Data as of Oct. 31, 2023.

Industrials

Company (Ticker) Ventia (Australia) (VNT)		**Rating** ★★★★	The market remains puzzlingly unimpressed by Ventia, despite the removal of the large vendor shareholding overhang from the IPO. 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 five years, macro tailwinds including population growth, outsourcing volume rates, and environmental regulations underpin expectations for strong growth in Ventia's Australia and New Zealand markets. We project EPS growing at a near 7.0% CAGR to 2027 and a generous fully franked yield.
Price AUD 3.01	**Fair Value** AUD 4.00	**Uncertainty** Medium	
Market Cap (bil) AUD 2.58	**Economic Moat** None	**Capital Allocation** Standard	
Company (Ticker) Aurizon Holdings (AZJ)		**Rating** ★★★★	The 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 that risks skew to the upside for investors. Haulage volumes were weak in fiscal 2023 given wet weather, but the outlook is for volumes to recover, haulage tariffs to rise with the Consumer Price Index, and as the regulated rail track is allowed 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 and a commercial alternative to coking coal to make new steel is a long way off.
Price AUD 3.54	**Fair Value** AUD 4.70	**Uncertainty** High	
Market Cap (bil) AUD 6.52	**Economic Moat** Narrow	**Capital Allocation** Standard	
Company (Ticker) Qube Holdings (QUB)		**Rating** ★★★★	Narrow-moat-rated Qube Holdings is trading at a moderate discount to fair value. Solid earnings momentum carries into fiscal 2024, though headwinds are intensifying as high interest rates and other cost-of-living pressures start weighing on consumer spending and the broader economy. However, the business is diversified and has a long growth runway underpinned by population growth and market share gains as it leverages cost advantages to competitors, which stem from scale and vertical integration. It also boasts strong financial health, which allows the firm to augment organic growth with acquisitions and developments, and a savvy management team.
Price AUD 2.92	**Fair Value** AUD 3.30	**Uncertainty** Medium	
Market Cap (bil) AUD 5.16	**Economic Moat** Narrow	**Capital Allocation** Exemplary	

Source: Morningstar. Data as of Dec. 1, 2023.

Real Estate

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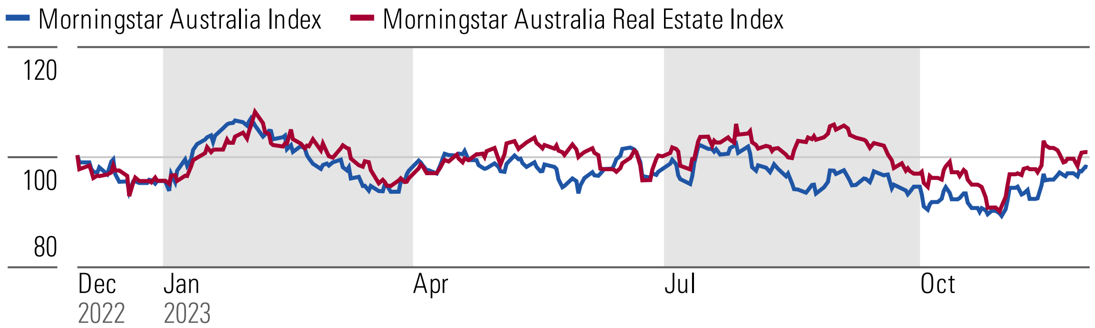
Lower Inflation and Bond Yields Offer Hope but Balance Sheet Strength Is Crucial

Falling bond yields buoyed property securities recently, as inflation eased in the U.S., Europe, and Australia. If central banks engineer a soft landing or mild recession, REITs could be in a sweet spot. Many locked in higher rents thanks to inflation and population growth, while debt costs are so far largely hedged. Interest rate hedges expire in the next few years, so the risk is if rates remain high. For those with weak balance sheets, typically rated high uncertainty or worse, outsize gains or losses are possible, depending on rates.

Value has emerged in retail names Charter Hall Retail REIT, Region Group, Scentre Group, and Vicinity Centres. Recession is a risk, but two years of strong leasing conditions since the pandemic helped to lock in good tenants, which mitigates some downside risk. Major office names Dexus, GPT, and Mirvac also look undervalued. We don’t expect a rapid office recovery, but the yields look attractive as is. We see office leasing conditions slowly improving as CBDs get busier from population growth, upcoming public transport projects, and formalization of hybrid work arrangements. Mirvac’s and Stockland’s residential businesses look well-placed. Construction costs and dwelling prices have stabilized, so we see robust development margins and volumes recovering, given population growth and a housing undersupply.

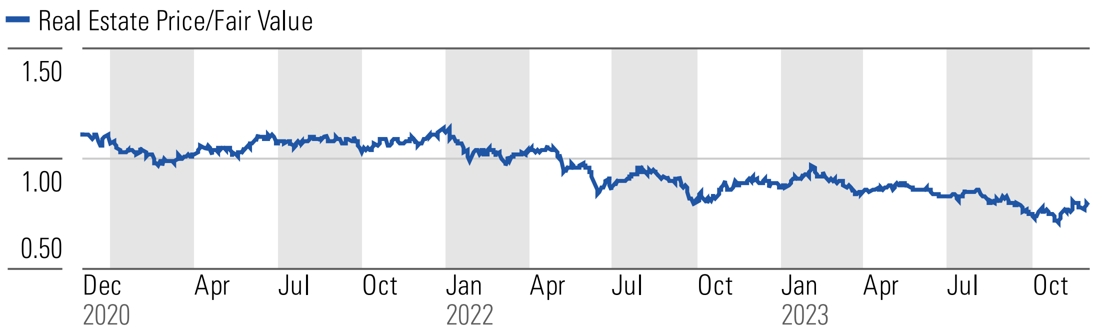
We remain cautious on self-storage REITs as strong rental growth for self-storage space since 2020 could unwind, particularly in a recession given the lack of leases. Given that risk, we don’t think debt levels or stock prices are low enough to make the sector attractive, compared with value we see elsewhere in real estate.

Real Estate Has Bounced



Source: Morningstar. Data as of Dec. 1, 2023.

But Real Estate Stocks Remain Undervalued



Source: Morningstar. Data as of Dec. 1, 2023.

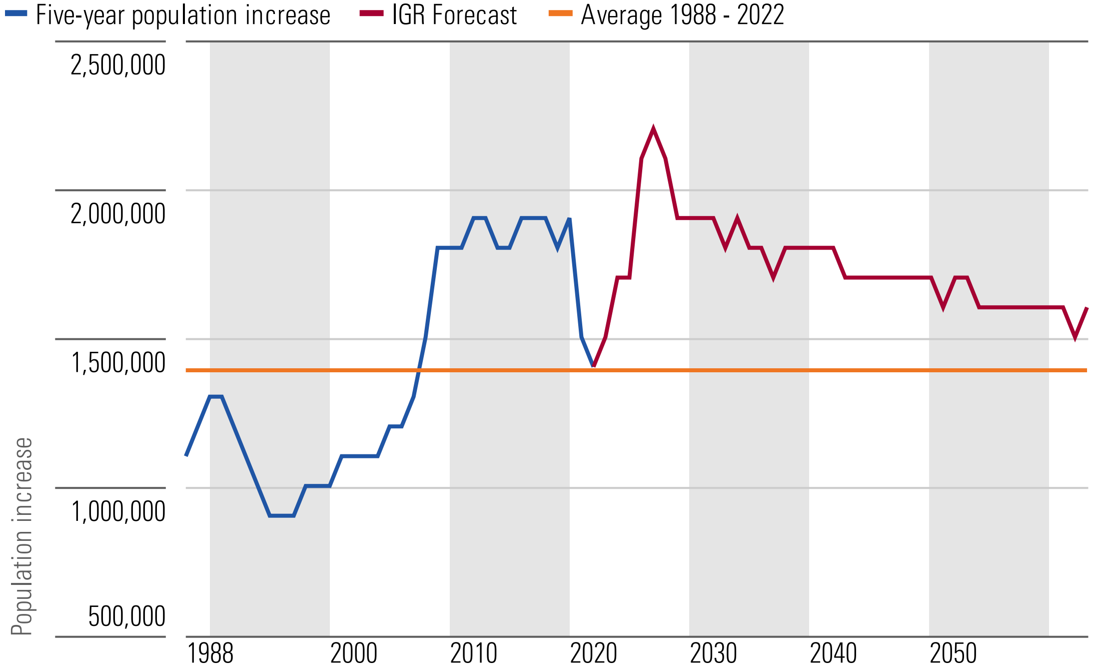
Lower Inflation and Bond Yields Offer Hope but Balance Sheet Strength Is Crucial

Rapid population growth should support rents for retail, residential, industrial, and to an extent, office property. Current population growth is likely exceeding the already high forecasts from the recent 2023 Intergenerational Report.

We expect residential robust development margins for Mirvac and Stockland given construction cost inflation has moderated, dwelling prices bounced to near record levels, and population growth has almost guaranteed a medium-term dwelling shortage.

Rapid Population Growth to Buoy Rents

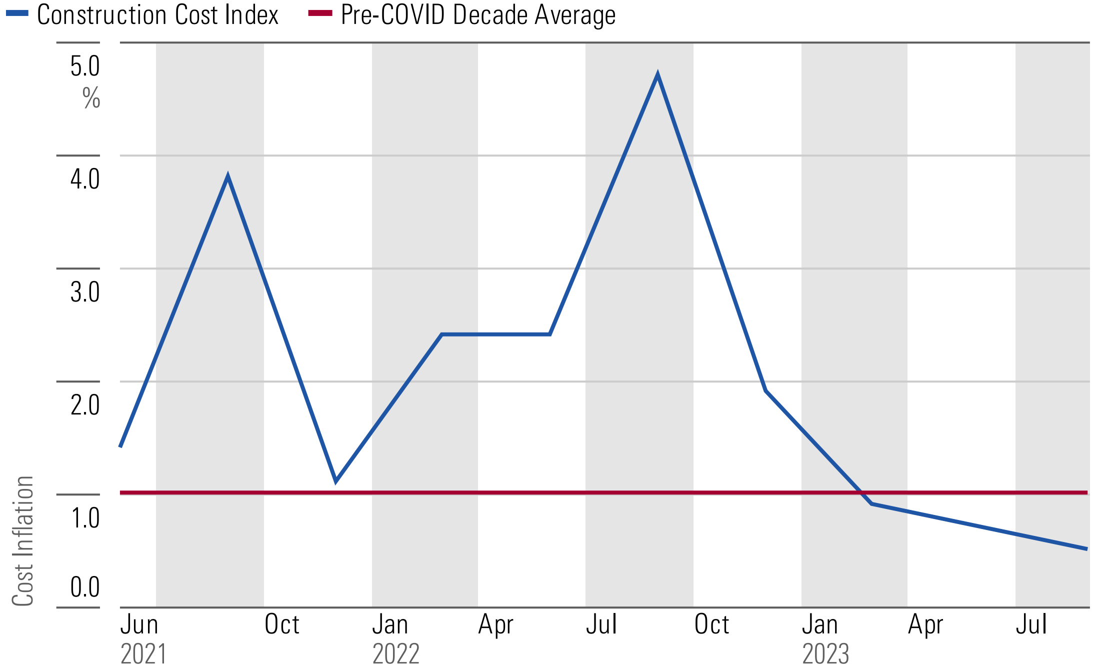
Estimated five-year population increase



Source: Intergenerational Report. Data as of August 2023.

Residential Margins to Benefit From Lower Cost Inflation

Quarterly residential construction cost inflation



Source: CoreLogic Cordell. Data as of September 2023

Real Estate

Company (Ticker)		Rating
Lendlease (LLC)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 6.61	AUD 14.45	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 4.56	None	Standard

Lendlease securities trade near net tangible assets, or NTA. This is overly pessimistic, given much of the group's EBITDA comes from intangible income sources in its development, construction, and investments businesses excluded from NTA. Despite headwinds, core operating profits rebounded in fiscal 2023. We expect further substantial uplift in development earnings in 2024, and management earnings longer-term. Management reaffirmed at its annual results in August 2023 that 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 increased to AUD 23 billion (up from AUD 18 billion at December 2022). 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 6.95	AUD 10.80	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 7.48	Narrow	Standard

Dexus trades at a material discount to NTA, which doesn't include the intangible value of the group's funds management business. Management operations contributed 20% of adjusted funds from operations in fiscal 2023, up from 14% 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. Meanwhile Dexus' office portfolio looks to be stabilizing with lockdowns past, and tighter financial conditions curtailing 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 10.22	AUD 15.90	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 4.83	Narrow	Exemplary

We think Charter Hall securities overly discount weaker operating conditions, and its development pipeline is likely to continue to add to funds under management. Higher interest rates hurt performance and transaction fees, which more than halved in fiscal 2023. But relatively repeatable base management revenue grew 20% and is about two thirds of Charter Hall's funds management revenue. We believe there is a long-term trend toward institutions investing in property via specialized property fund managers, instead of directly. We expect Charter Hall to reap inflows longer-term given its strong track record, rising tax and management complexity, and as international investors seek local expertise. Charter Hall has minimal debt on its balance sheet. Look-though gearing—net debt/assets including debt in its funds—is higher at 34% but we think Charter Hall is well-prepared for tougher conditions.

Source: Morningstar. Data as of Dec. 1, 2023.

Technology

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Balancing Growth and Profit Difficult for Some

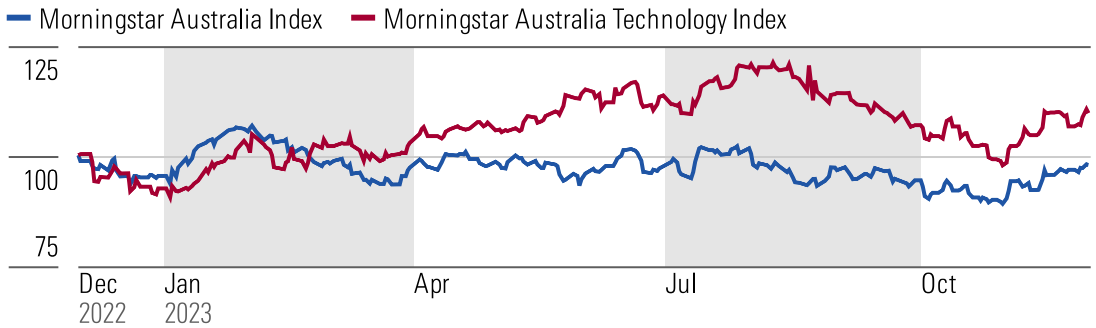
The technology sector continued its outperformance during the year, and the gap between share prices and our fair value estimates narrowed.

Technology companies are still trying to balance revenue growth with profitability. For most of the past decade, as interest rates declined, markets valued technology companies for their ability to grow at any cost with profitability a secondary concern, at best. As interest rates have risen in recent years, markets have demanded technology companies prove profitability, while still expecting high revenue growth.

However, this is easier said than done. Some of the main levers to increase profitability, such as reducing spending on sales and marketing or research and development, should also reduce revenue, unless spending was particularly undisciplined.

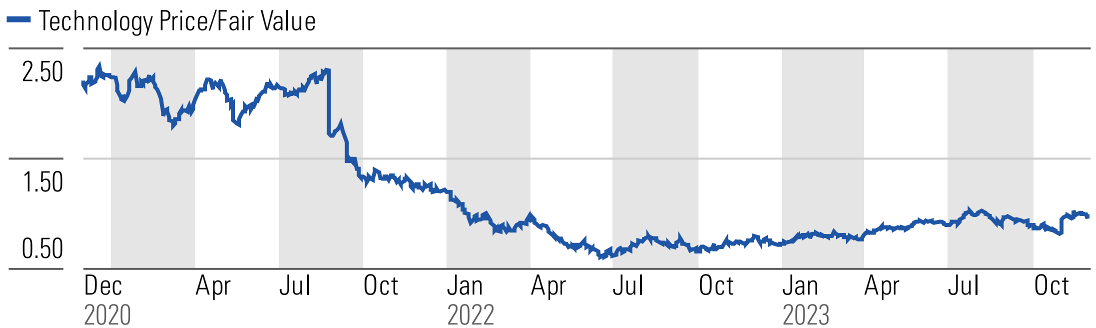
We expect companies with profitable growth to be better positioned to win market share over the next year or two. They include WiseTech, Altium, Technology One, and Iress. These firms benefit from customer switching costs, bolstered by strong product utility for customers and significant product development costs that can be prohibitive for competitors. Conversely, companies that are reliant on external funding for growth, such as Zip and Humm, are likely to see their competitive standing further weaken due to significantly higher cost of funds; and as their larger, better-resourced competitors increasingly outspend them in terms of product development.

Technology Sector Outperforming



Source: Morningstar. Data as of Dec. 1, 2023.

Sector Screens as Fairly Valued



Source: Morningstar. Data as of Dec. 1, 2023.

Balancing Growth and Profit Difficult for Some

Xero shares rallied in March on staff cuts and the intention to target the Rule of 40, which adds up revenue growth and free cash flow margins. Following initial signs of success, shares sank again in November as revenue growth disappointed.

Firms with stronger value propositions and stickier customers, such as Fineos and Iress, are focused on near-term growth and boosting their competitive edge over rivals. Commoditized firms like Zip and Humm are likely to primarily focus on cost reductions.

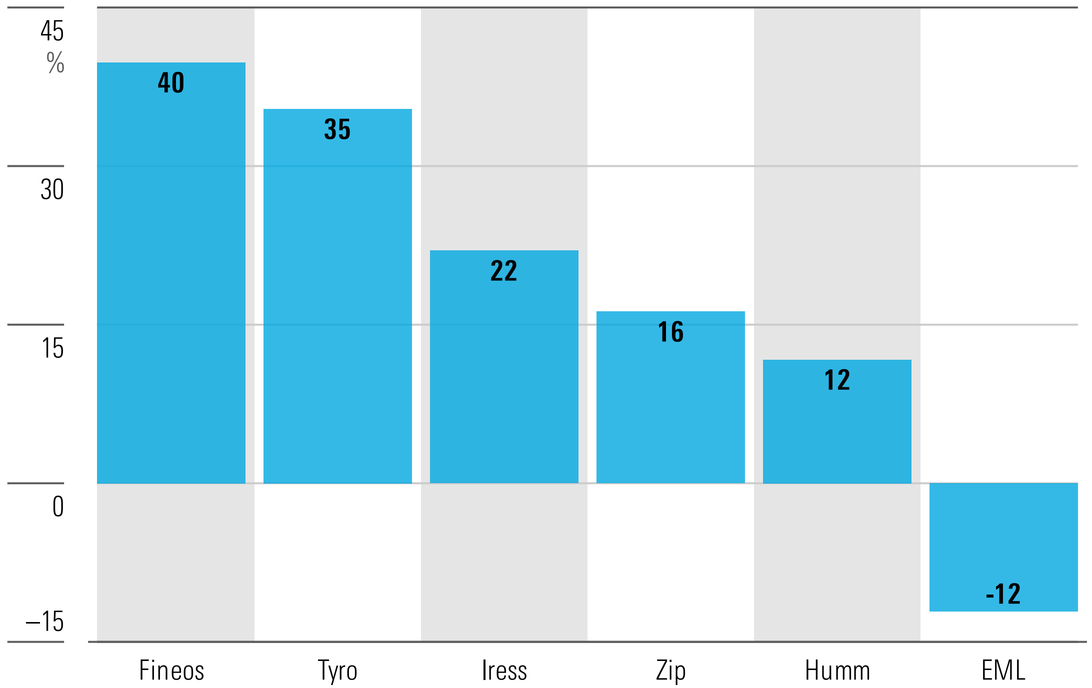
Xero's Share Price Volatile on Market Perceptions Around Its Profitability

Year-to-date share price performance for Xero.

Source: Pitchbook. Data as of Dec. 1, 2023.

Firms With Stronger Product Utility Are Better Placed to Grow

Compounded annual growth rate for earnings per share from fiscal 2024-2027.



Source: Company Filings. Data as of Nov. 30, 2023.

Technology

Company (Ticker) WiseTech Global (WTC)		**Rating** ★★★★	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 highly 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 AUD 66.16	**Fair Value** AUD 95.00	**Uncertainty** High	
Market Cap (bil) AUD 22.05	**Economic Moat** Narrow	**Capital Allocation** Exemplary	
Company (Ticker) Fineos (FCL)		**Rating** ★★★★	We believe wide-moat 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, noncore staff reductions, and hiring in emerging economies. We expect Fineos to self-fund its future growth.
Price AUD 1.68	**Fair Value** AUD 3.10	**Uncertainty** Very High	
Market Cap (bil) AUD 0.56	**Economic Moat** Wide	**Capital Allocation** Standard	
Company (Ticker) Megaport (MP1)		**Rating** ★★★★	The market downturn, dissatisfaction from the chairman with Megaport's execution, and management uncertainty saw Megaport's stock crushed earlier this year, despite strong sales growth and ongoing significant margin expansion. Stabilization on all fronts led to a huge stock rebound and should only accelerate business performance. Megaport should benefit from increasing global reliance on data traffic. With its software-defined network offering, it facilitates connections between data centers and/or premises for enterprises to integrate their architecture and connect to cloud providers. We expect strong sales growth and for EBITDA profitability from 2023. More importantly, we expect profit growth and positive free cash flow by 2024.
Price AUD 9.59	**Fair Value** AUD 17.00	**Uncertainty** Very High	
Market Cap (bil) AUD 1.53	**Economic Moat** None	**Capital Allocation** Exemplary	

Source: Morningstar. Data as of Dec. 1, 2023.

Utilities

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Decent Value Among the Utilities

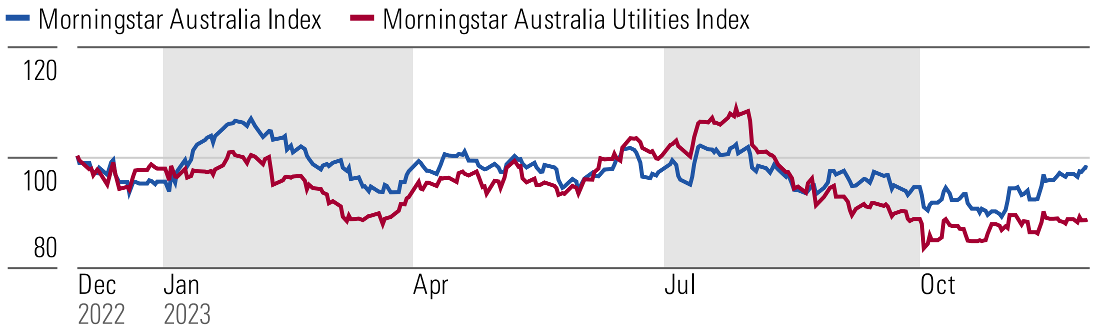
Australian and New Zealand utilities have solid outlooks. Power producers are increasing retail electricity prices to recoup stubbornly high wholesale prices, while gas pipeline owner APA Group benefits from CPI-linked revenue and a large development pipeline. These positives should outweigh headwinds from higher interest rates and cost inflation. We see best value in Manawa Energy, APA Group, and AGL Energy.

The Reserve Bank of Australia's efforts to slow the economy could hurt electricity demand and cause a temporary dip in prices and utility profits. But we think the longer-term outlook is healthy. A high electricity price is needed to justify building new supply given construction costs and interest rates are elevated. Utilities with cheap coal and gas supply are well placed to profit in that environment but cost advantages will erode over time as legacy fuel supply contracts end and aging low-cost power stations close.

The outlook for NZ power producers is better. They too benefit from high wholesale electricity prices but instead of aging coal and gas-fired power stations, they primarily own irreplaceable hydroelectric schemes. These long-life assets produce cheap electricity, have flexible output, and are environmentally friendly. But the positive outlook is priced in, and NZ utilities are fairly valued on average.

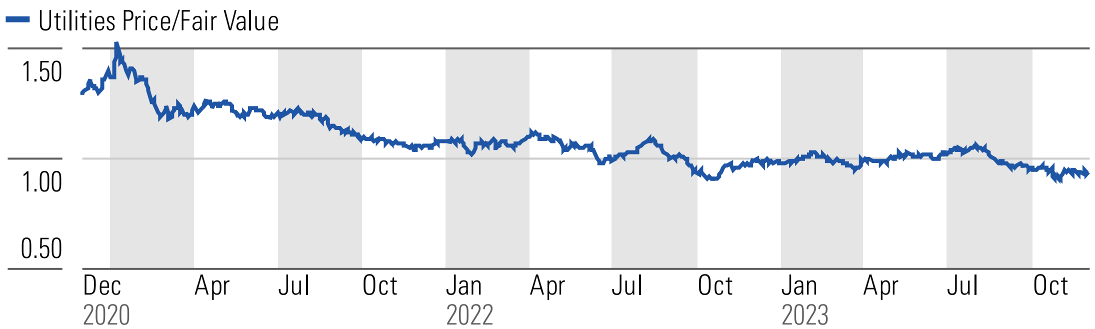
The outlook for gas pipeline operator APA Group is positive as revenue grows with CPI-linked contracts and accretive developments. High interest rates are a headwind for the highly geared firm, but hedging slows the impact. The stock screens as undervalued.

Australian Utilities have Underperformed the Broader Market



Source: Morningstar. Data as of Dec. 1, 2023.

ANZ Utilities are Now Slightly Undervalued on Average



Source: Morningstar. Data as of Dec. 1, 2023.

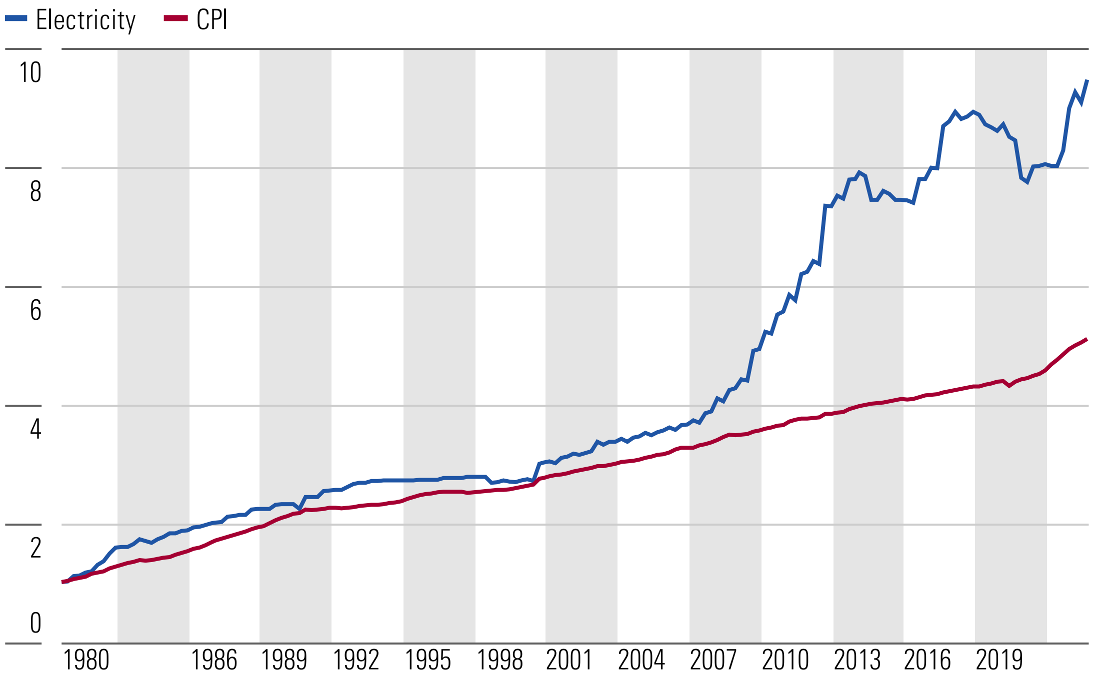
Decent Value Among the Utilities

Retail electricity prices have been driven higher by investment in distribution and transmission networks and higher wholesale prices. Upgrading networks for renewables and passing through higher costs of capital will add further upward pressure.

Australia's renewable energy rollout is behind schedule because of difficulty gaining environmental approvals and access to land, transmission network constraints, high construction costs, and high interest rates. Even with government subsidies, the tardy rollout likely supports electricity prices.

Electricity Costs Are Outstripping CPI by a Wide Margin

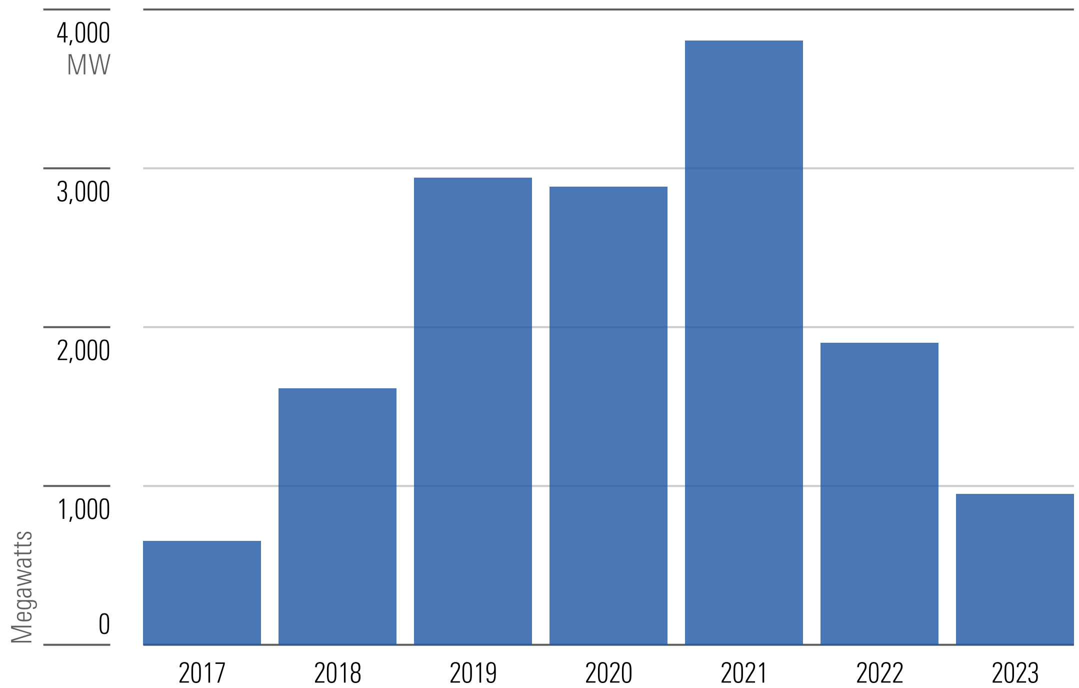
CPI index and electricity component of CPI (rebased to 1.0 in September 1980).



Source: Australian Bureau of Statistics. Data as of Sept. 30, 2023.

The Renewable Rollout has Stalled for Now

Total capacity of new wind and solar farms completed in Australia each year.



Source: Clean Energy Council. Data as of October 2023.

Utilities

Company (Ticker)		Rating
Manawa Energy (MNW-NZ)		★★★★
Price	**Fair Value**	**Uncertainty**
NZD 4.52	NZD 6.30	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
NZD 1.41	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 wind and solar farm developments. 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 8.54	AUD 9.30	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 10.96	Narrow	Poor

Narrow-moat APA Group 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. 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.

Company (Ticker)		Rating
AGL Energy (AGL)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 9.43	AUD 12.80	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 6.34	Narrow	Poor

Narrow-moat AGL Energy's recovery is gaining traction and the rebound in electricity prices of the past two years should underpin a strong fiscal 2024 earnings recovery. Risk is receding as the earnings outlook improves. Also, the planned early closure of coal power stations 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. We expect slowing renewable energy supply additions, the closure of coal power stations, and high gas costs to support electricity prices, which benefits earnings. Caps on domestic gas and coal prices have reduced electricity futures prices, but they’re still conducive to a strong earnings rebound.

Source: Morningstar. Data as of Dec. 1, 2023.

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