MORNINGSTAR Market Outlook

Australian Equity Market Outlook: Q3 2024

There are plenty of cheap, high-quality stocks in a fairly valued market.

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Market Outlook

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Market Treads Water Amid Emerging Risks

After an unexpectedly strong March quarter, some emerging risks weighed on the local market. The S&P/ASX 200 Index declined about 2% to finish the June quarter at close to 7,770. On an unweighted average, our coverage trades at close to fairly valued, slightly better than the 10-year average price/fair value of 1.04.

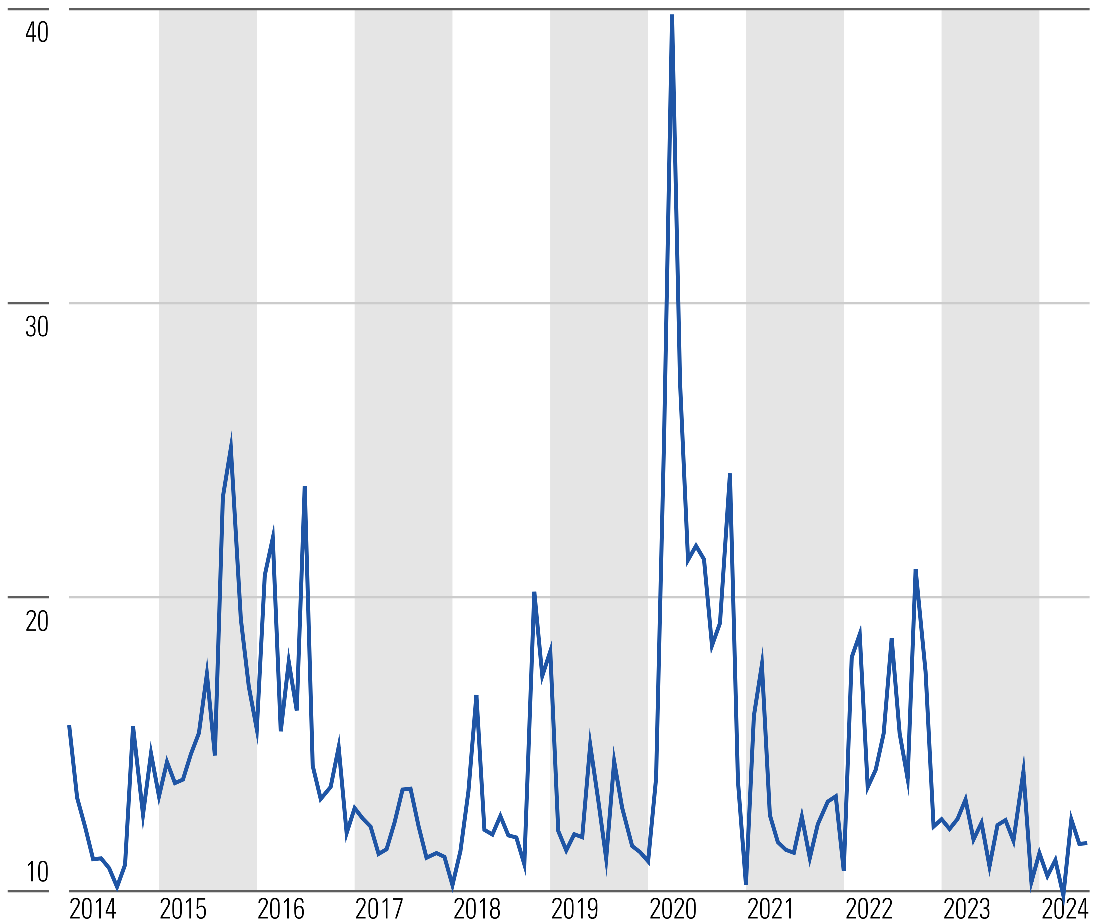
The materials sector, which accounts for about 21% of the index, underperformed, with the big iron ore miners dragging down the index. Fortescue was a big loser, down 17% in the June quarter after falling 13% in the March quarter. BHP and Rio Tinto also fell, but only modestly. We generally think the iron ore miners are still expensive, particularly Fortescue, which has the slimmest margins of the major Australia-listed players.

There is room for further disappointment. The health of China's steel consumption increasingly relies on government stimulus for infrastructure and manufacturing capital expenditure, and support for the ailing real estate sector. Iron ore futures of USD 92 per metric ton by the end of 2026 are still relatively healthy and don't factor in a wholesale reduction in steel production and consumption in China.

Capital expenditure to expand manufacturing capacity has so far made up for demand weakness from infrastructure and residential construction. However, the runway for significant further capacity growth appears limited, and it is questionable if the global economy will continue to absorb the wave of cheap exports. A second term for Donald Trump could mean significant tariffs against Chinese exports, slowing the wave of investment and stemming China's rapid expansion in solar, battery, and electric vehicle exports.

Subdued VIX Implies Market Remains Relatively Complacent

S&P/ASX200 Volatility Index (VIX)



Source: Haver Analytics. Data as of June 28, 2024.

Market Treads Water Amid Emerging Risks

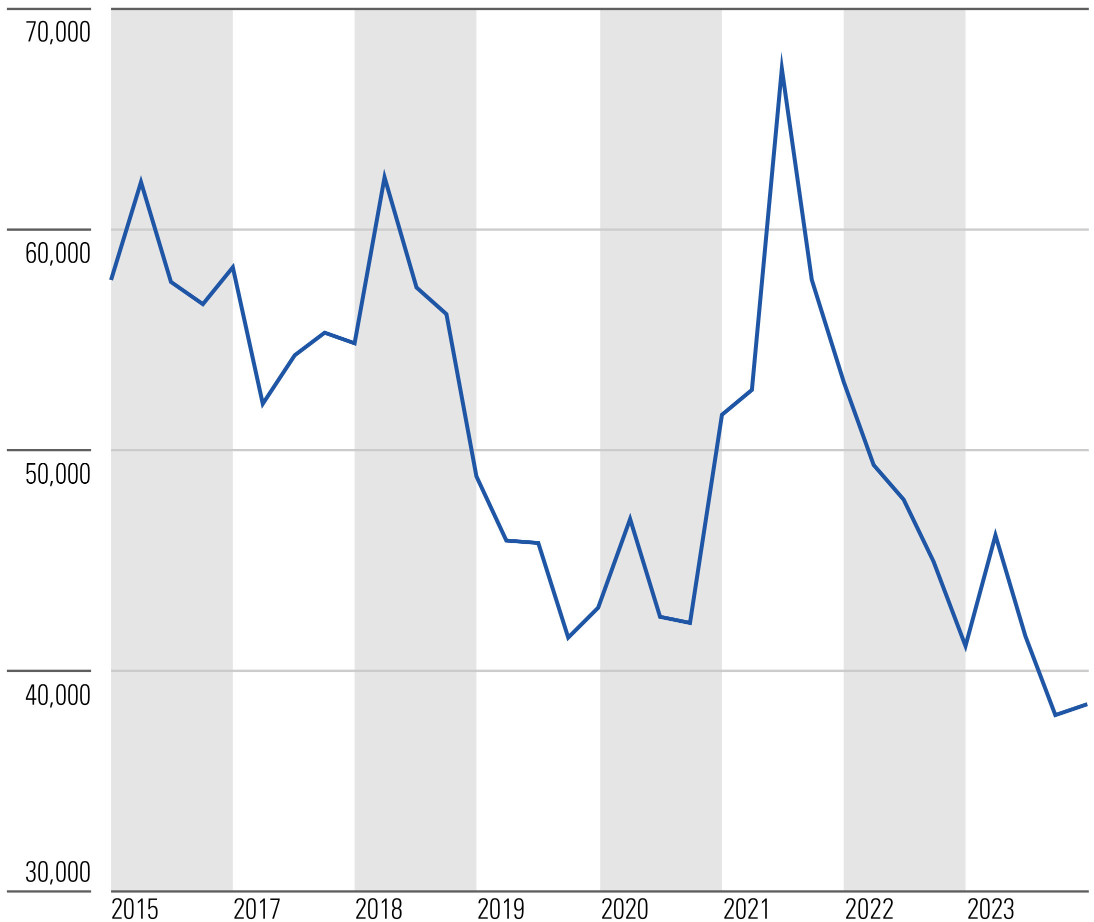
The other big driver of the Australia-listed equity market is financials, making up more than 30% of the ASX 200 Index. The Big Four banks alone account for more than 20% of the index. The majors continued to power ahead in the June quarter, buoyed by rising rates and the prospect of less margin pressure. The Commonwealth Bank's price rose 6%, NAB nearly 5%, and Westpac 4%, with ANZ the outlier, falling 4%.

Value is thin on the ground, with only ANZ and Westpac at modest discounts to our fair value estimates. NAB is trading in 2-star territory and CBA is significantly overvalued, trading at about a 40% premium and with a 1-star rating. All four banks trade at a premium to their five-year average price/book, but Commonwealth is an outlier. With a price/book approaching 3, Commonwealth looks expensive relative to its own history and relative to peers. We understand the quality argument, with Commonwealth enjoying a strong deposit base that becomes more profitable as interest rates rise, but fundamental value still matters.

Specific risks to the banks appear to have lessened. The downside risk would be a persistent reinvigoration of inflationary pressures, which could force central banks to raise rates materially, thus risking a hard landing. However, although inflation appears to be volatile, the overall trajectory appears to be downward. There's much to be said for incredibly strong immigration rates, with a dearth of housing and falling new starts placing upward pressure on house prices. While painful for renters and would-be first-time homebuyers, this bodes well for the quality of bank home loan books. Relatively low bad debts, coupled with stabilizing margins, are important tailwinds.

High Interest Rates Deterring New Supply

Number of dwellings commenced in Australia, seasonally adjusted.



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

Economic Outlook

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A Hot June Inflation Figure Could Force Reluctant RBA's Hand

The market's forecast for the Reserve Bank of Australia's cash rate shifted significantly in recent weeks. When we published our last Market Outlook in mid-April, the futures market expected a 40% chance of a cut at the RBA Board meeting in August 2024. Fast-forward to the end of June, and the market now prices a 50% chance of a rate hike.

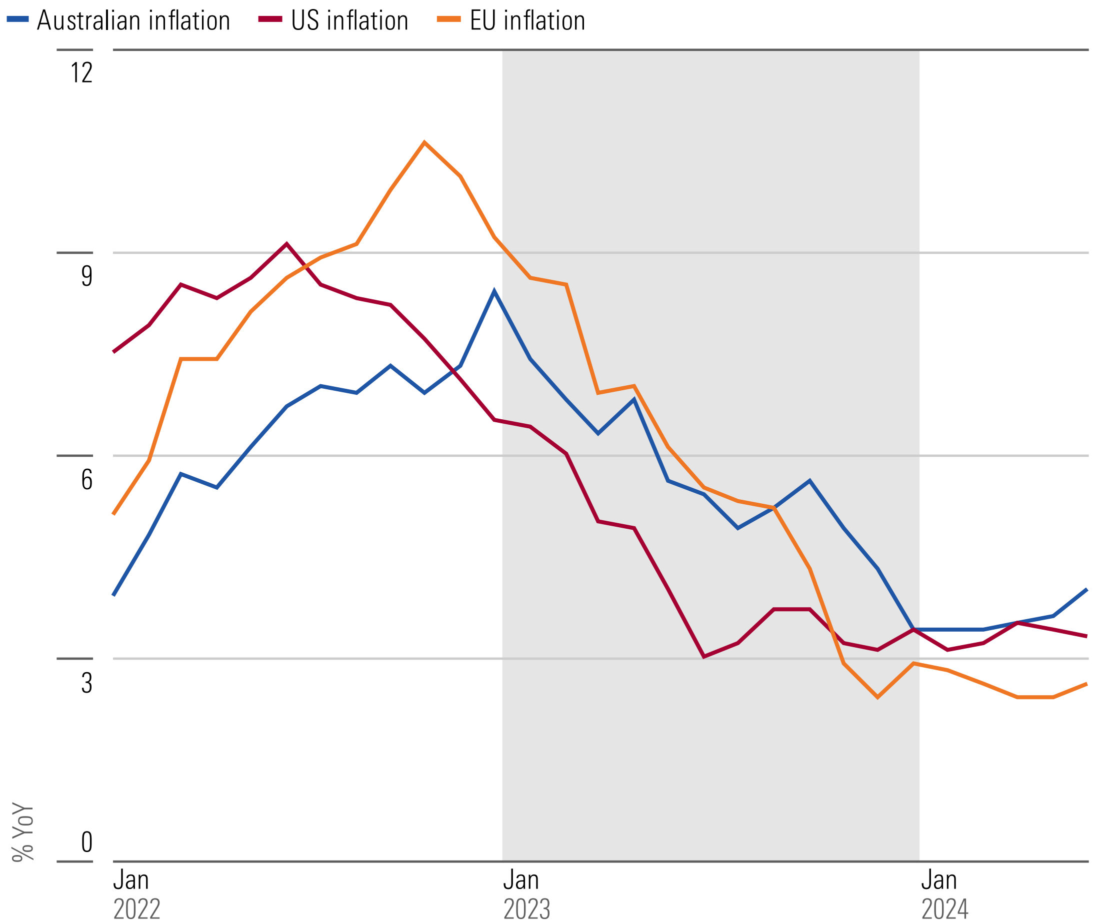
Hotter-than-expected monthly CPI data for May 2024 upended cash-rate expectations. Headline inflation was at 4%, above the previous corresponding period and missing economists' expectations of a 3.8% rise. Inflation remains firmly above the RBA's 2%-3% target band, and May is the fifth consecutive month when annual inflation either tracked sideways or drifted up.

Services inflation is a persistent thorn in the RBA's side. The fastest-growing categories in the consumption basket include insurance, education, health, and housing (namely rents). The RBA must prevent expectations of higher inflation becoming embedded, which could spark a wage-price spiral.

Inflation is now higher in Australia than many developed markets. Commentators argue this is because the RBA kept rates lower than global central bank peers. The cash rate of 4.35% is below policy rates in the US, the UK, Canada, and New Zealand. Whether the RBA can defend this will in part depend on the June-quarter CPI, due a week before the August board meeting. If we get another upside surprise, it becomes much harder for the RBA to sit on its hands.

Australian Inflation Above Global Peers

Monthly CPI inflation, year-on-year growth.



Source: Bureau of Labour Statistics, European Central Bank, Australian Bureau of Statistics, Morningstar. Data as of 26 June, 2024.

A Hot June Inflation Figure Could Force Reluctant RBA's Hand

In late June, the RBA estimated the "neutral" cash rate—the rate at which monetary policy is neither expansionary nor contractionary—was around 3.5%. If its estimate is accurate, then the current 4.35% cash rate is restrictive. And without any further hikes, demand will keep softening and inflation should fall.

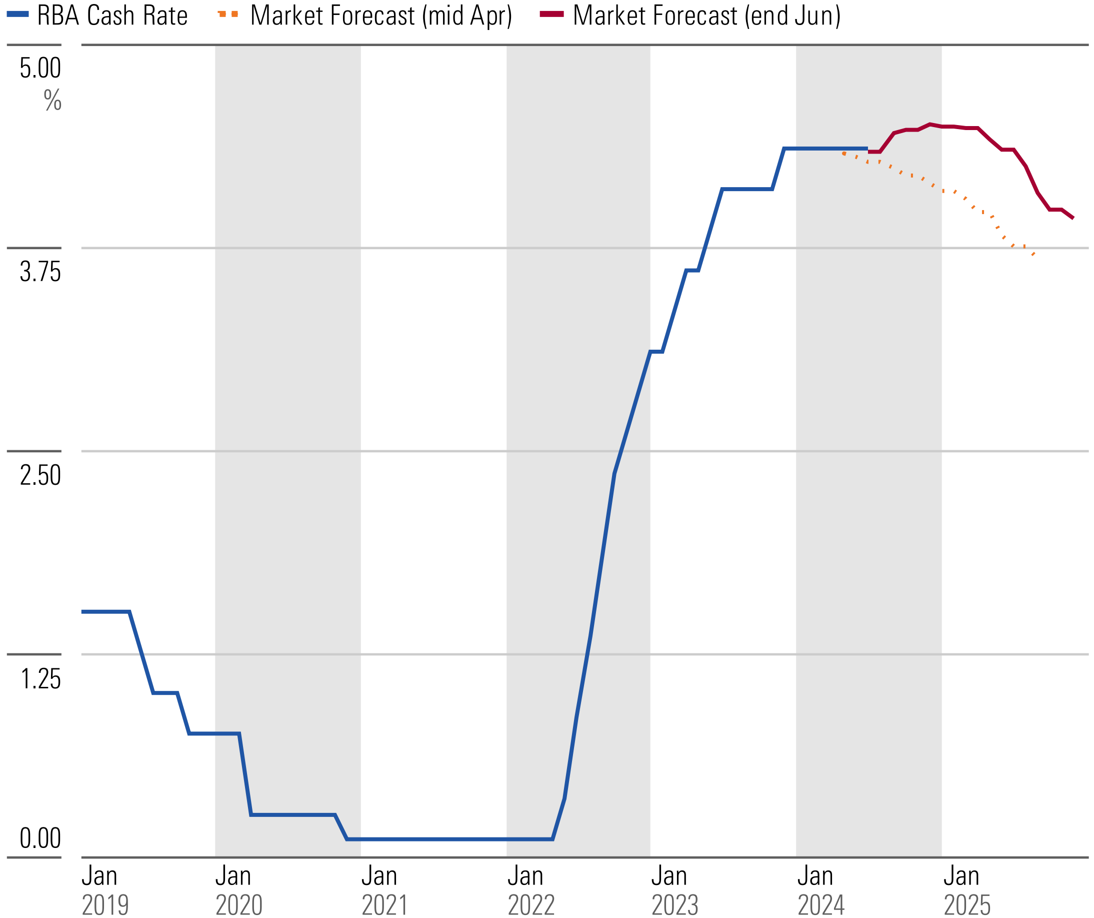
The slowdown in economic activity supports the RBA's view that monetary policy is indeed contractionary. Real GDP lifted a meager 0.1% in the June quarter, and this was on population growth of 0.7%. In per capita terms, June marked the fifth consecutive quarter of outright declines in real GDP. The labor market, while tight by prepandemic standards, is also gradually softening. The unemployment rate was 4.0% in April 2024, up from the recent trough of 3.5% in May 2023.

Further, the last of the low fixed-rate mortgages will roll onto variable rates this year. The RBA estimates this will add 20 basis points to the average outstanding mortgage rate. In essence, for mortgage holders in aggregate, there is almost a full rate hike to feed through before year-end.

The RBA is reluctant to raise interest rates further, as it could jeopardize the employment gains since the pandemic. Based on its latest forecasts, the bank is expecting annual CPI growth of 3.8% in June. If June inflation comes in at or below 3.8%, we think the RBA would interpret this as evidence that the economy remains on the narrow path to a soft landing and keep rates unchanged in August. However, a material upside surprise could force the RBA into another 25-basis-point hike.

Abrupt Pivot in Cash-Rate Expectations

Reserve bank of Australia cash rate and futures-implied forecast.



Source: Westpac, Reserve Bank of Australia, Morningstar. Data as of 28 June, 2024.

Valuation Overview and Top Picks

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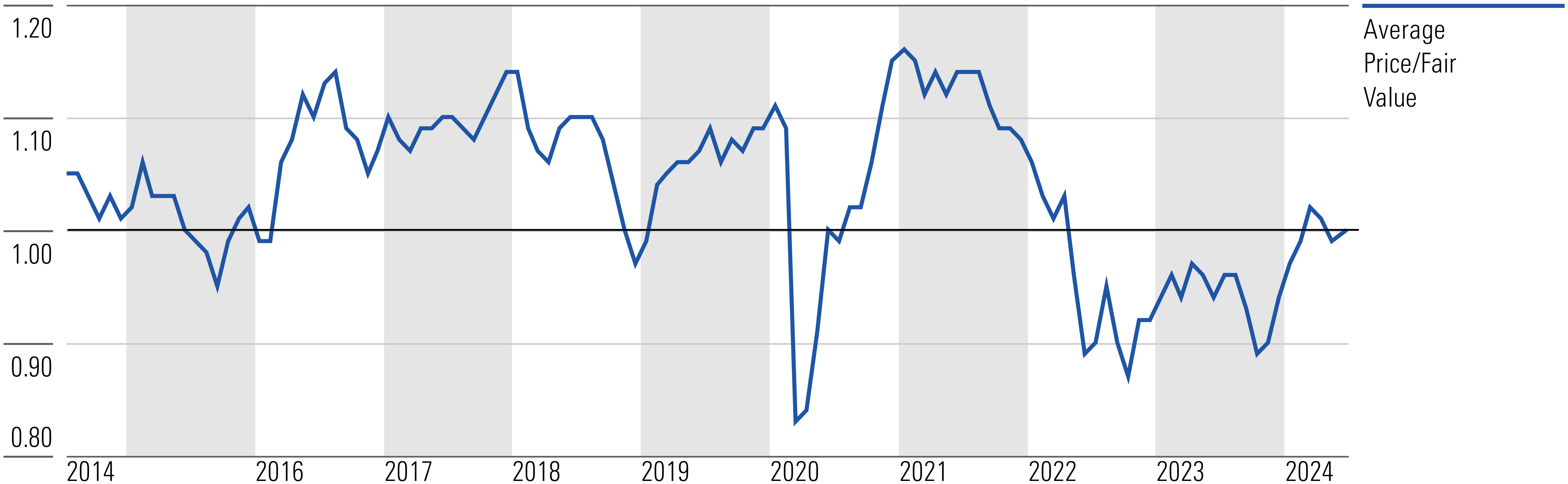
Market Is Fairly Valued

Australian and New Zealand stocks traded lower in the June quarter on weaker commodity prices and concerns about sticky inflation. As of June 28, 2024, our Australia and New Zealand coverage trades close to our fair values on average, compared with a 10% discount in the October 2023 dip.

Stocks Fairly Valued on Average

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



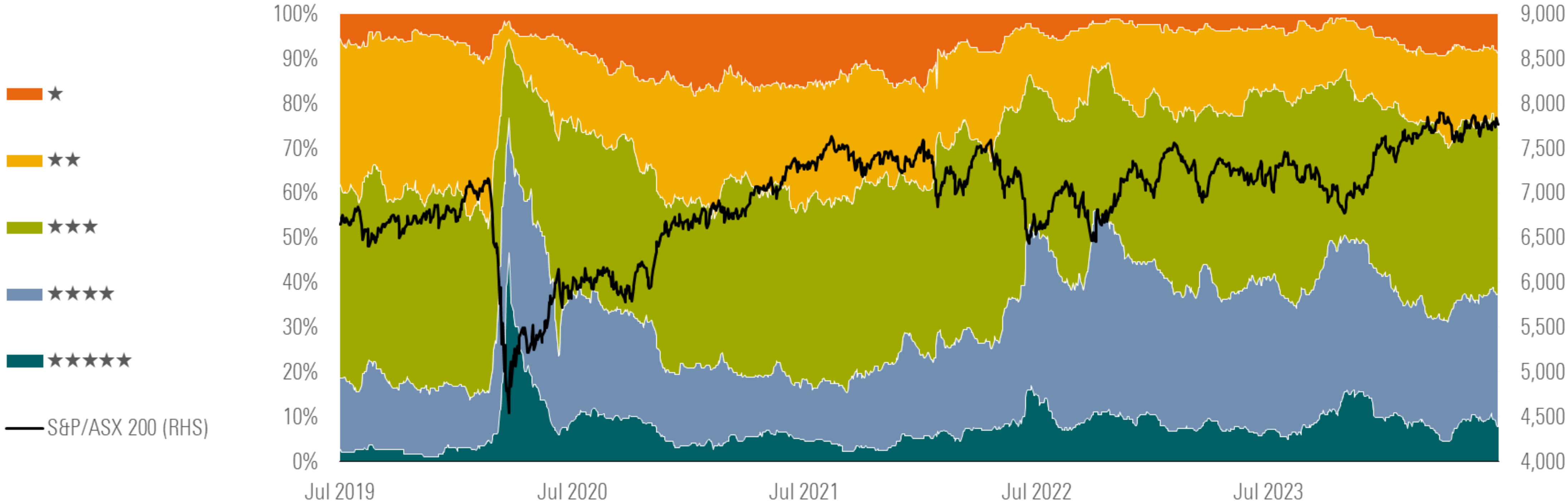
Source: Morningstar. Data as of June 28, 2024.

Plenty of 4- and 5-Star Ratings

Close to 40% of Australian and New Zealand stocks under coverage are either 4- or 5-star-rated, well above the trailing 10-year average of 25% despite the market rally from October 2023. There are plenty of moaty stocks trading at attractive prices, particularly in the healthcare and consumer cyclical sectors.

Positive Ratings Remain Plentiful

Star rating distribution over time.



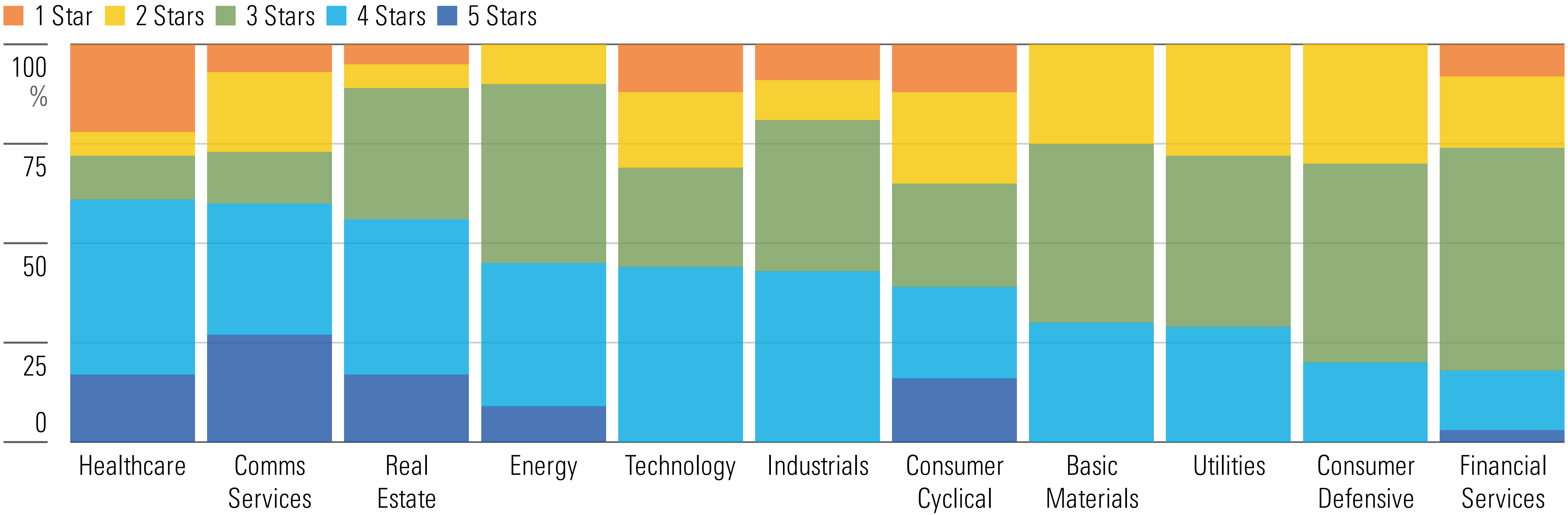
Source: Morningstar. Data as of June 28, 2024.

Positive Ratings in Many Sectors

There has been a large divergence between sectors since late last year, with those likely to benefit from lower interest rates such as consumer cyclical, financial, real estate, and technology outperforming, while basic materials, consumer defensive, and healthcare have struggled. We see most 4- and 5-star-rated opportunities in healthcare, real estate, communications services, and energy.

Plenty of Positive Ratings in Most Sectors

Star rating distribution by sector.



Source: Morningstar. Data as of June 28, 2024.

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							
Nufarm (NUF)	★★★★	AUD 7.70	AUD 4.60	High	None	0.61	AUD 1.76
Iluka Resources (ILU)	★★★★	AUD 9.50	AUD 6.55	High	None	0.70	AUD 2.80
Newmont (NEM)	★★★★	AUD 78.00	AUD 63.47	Medium	None	0.80	AUD 72.60
Communication Services							
Nine Entertainment (NEC)	★★★★★	AUD 2.70	AUD 1.40	High	None	0.51	AUD 2.23
TPG Telecom (TPG)	★★★★★	AUD 6.60	AUD 4.58	Medium	Narrow	0.68	AUD 8.52
Telstra (TLS)	★★★★	AUD 4.50	AUD 3.62	Medium	Narrow	0.80	AUD 41.83
Consumer Cyclical							
SkyCity Entertainment Group (SKC)	★★★★★	AUD 2.90	AUD 1.33	High	Narrow	0.46	AUD 1.02
Bapcor (BAP)	★★★★★	AUD 7.30	AUD 5.14	Medium	Narrow	0.70	AUD 1.74
Domino's Pizza Enterprises (DMP)	★★★★	AUD 61.00	AUD 35.89	High	Narrow	0.60	AUD 3.26
Consumer Defensive							
IDP Education (IEL)	★★★★	AUD 22.50	AUD 15.15	High	Narrow	0.67	AUD 4.22
Endeavour Group (EDV)	★★★★	AUD 6.10	AUD 5.05	Low	Wide	0.84	AUD 9.04
a2 Milk (A2M)	★★★	AUD 7.40	AUD 6.77	High	Narrow	0.90	AUD 4.89

Source: Morningstar. Data as of June 28, 2024.

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							
Woodside Energy (WDS)	★★★★★	AUD 45.00	AUD 28.21	Medium	None	0.63	AUD 53.56
Santos (STO)	★★★★	AUD 12.30	AUD 7.66	High	None	0.62	AUD 24.88
Whitehaven Coal (WHC)	★★★★	AUD 9.90	AUD 7.65	Very High	None	0.77	AUD 6.40
Financials							
ASX (ASX)	★★★★★	AUD 75.00	AUD 60.00	Low	Wide	0.79	AUD 11.63
Insignia Financial (IFL)	★★★★	AUD 3.60	AUD 2.29	High	None	0.64	AUD 1.54
AUB Group (AUB)	★★★★	AUD 35.00	AUD 31.69	Medium	Narrow	0.90	AUD 3.67
Health Care							
Ramsay Health Care (RHC)	★★★★	AUD 68.00	AUD 47.46	Medium	Narrow	0.69	AUD 10.90
ResMed (RMD)	★★★★	AUD 40.00	AUD 29.10	Medium	Narrow	0.72	AUD 42.29
Ansell (ANN)	★★★★	AUD 32.00	AUD 26.55	Medium	Narrow	0.82	AUD 3.87
Industrials							
Brambles (BXB)	★★★★	AUD 19.00	AUD 14.53	Medium	Wide	0.76	AUD 20.24
Aurizon Holdings (AZJ)	★★★★	AUD 4.70	AUD 3.65	Medium	Narrow	0.79	AUD 6.72
Amcor (AMC)	★★★★	AUD 17.80	AUD 14.89	Medium	Narrow	0.84	AUD 21.26

Source: Morningstar. Data as of June 28, 2024.

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							
Dexus (DXS)	★★★★★	AUD 10.80	AUD 6.48	Medium	Narrow	0.60	AUD 6.97
The GPT Group (GPT)	★★★★	AUD 5.55	AUD 4.00	Medium	None	0.72	AUD 7.66
Charter Hall Group (CHC)	★★★★	AUD 16.25	AUD 11.18	Medium	Narrow	0.72	AUD 5.29
Technology							
SiteMinder (SDR)	★★★★★	AUD 10.00	AUD 5.09	High	Narrow	0.52	AUD 1.42
Fineos (FCL)	★★★★	AUD 3.10	AUD 1.69	Very High	Wide	0.53	AUD 0.57
Pexa Group (PXA)	★★★★	AUD 17.25	AUD 13.79	Medium	Wide	0.81	AUD 2.45
Utilities							
Manawa Energy (MNW-NZ)	★★★★	NZD 6.10	NZD 4.12	Medium	Narrow	0.68	NZD 1.29
APA Group (APA)	★★★★	AUD 9.30	AUD 7.99	Medium	Narrow	0.85	AUD 10.25
AGL Energy (AGL)	★★★	AUD 11.50	AUD 10.83	High	None	0.93	AUD 7.29

Source: Morningstar. Data as of June 28, 2024.

Basic Materials

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Sector Fairly Valued on Average; Better Value in Mining

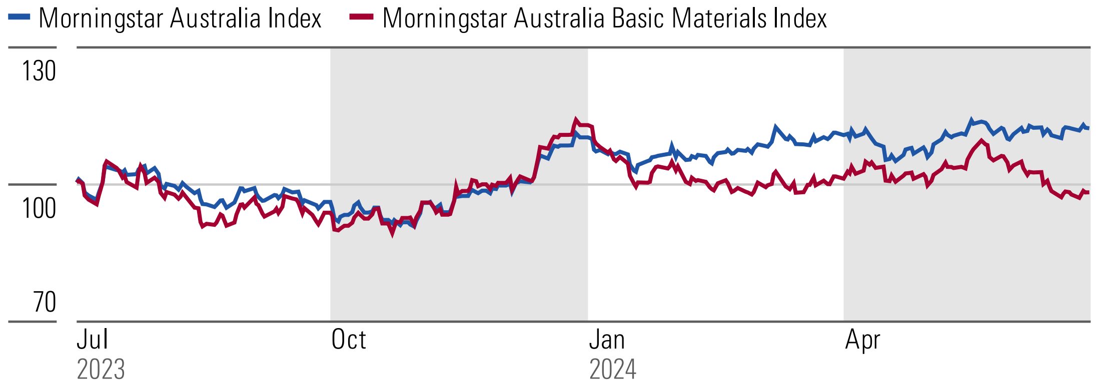
Our basic material coverage is overvalued on average, but there is some value on offer. Minerals sands miner Iluka Resources is materially undervalued, driven by the cyclical downturn in property markets in China and elsewhere. Gold miner Newmont is also cheap. Its shares should benefit from higher gold prices along with rising production and lower costs. Iron ore miners BHP and Rio Tinto are close to fairly valued, while Fortescue is materially overvalued.

Copper prices have risen in 2024 on persistent demand from China and expectations of increased demand for use in electric vehicles and the renewable transition. Supply issues have also contributed. Gold prices are also higher, with concerns over western governments' deteriorating fiscal balances adding to expectations of lower real interest rates acting as a tailwind. Iron ore and metallurgical coal prices are broadly stable, albeit volatile, with China's steel production remaining relatively strong.

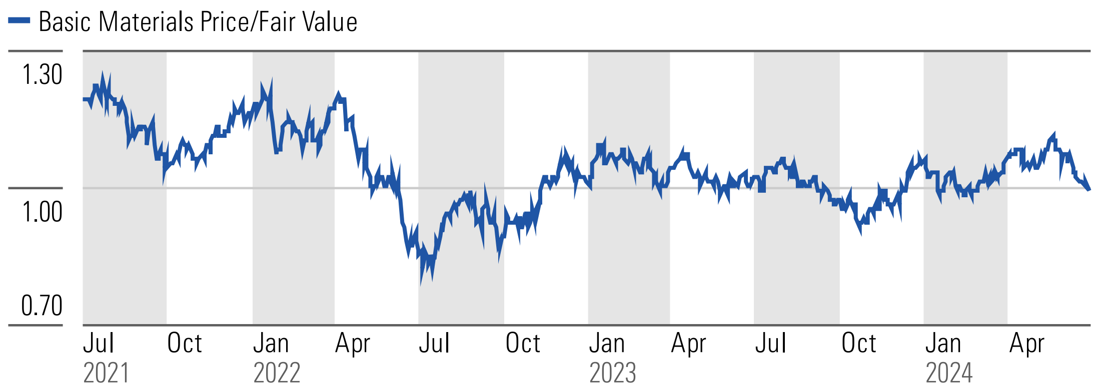
Explosives companies Orica and Incitec Pivot reported stronger first-half earnings from continuing businesses, and we expect continued improvement. Orica points to 12% fiscal 2024 EBIT growth, while Incitec Pivot guides to mid- to high-single-digit EBIT growth from North America in addition to growth from Asia-Pacific. Shares have softened, with Orica coming back to fair value and Incitec Pivot still materially undervalued.

Crop-protection company Nufarm is attractively priced with a favorable outlook for its seed technologies business. Alumina shareholders will vote on Alcoa's takeover proposal on July 18, 2024.

Slowing Economic Growth a Headwind for Basic Materials



Sector Fairly Valued on Average, but Some Miners Are Cheap



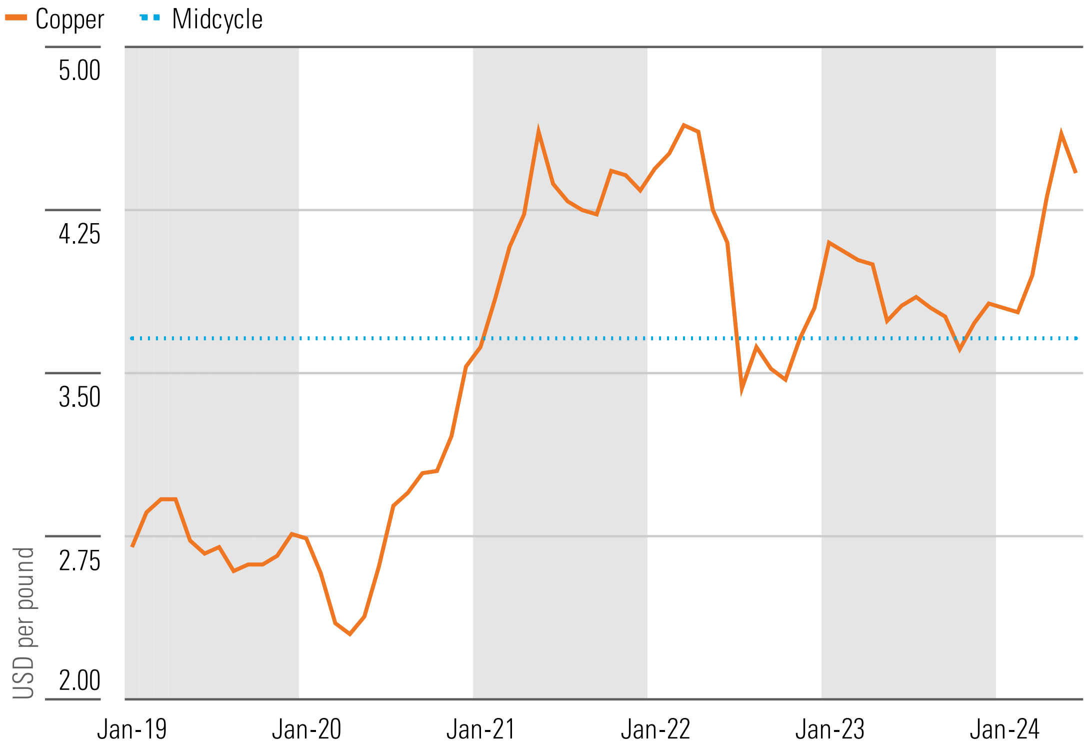
Source: Morningstar. Data as of June 28, 2024.

Sector Fairly Valued on Average; Better Value in Mining

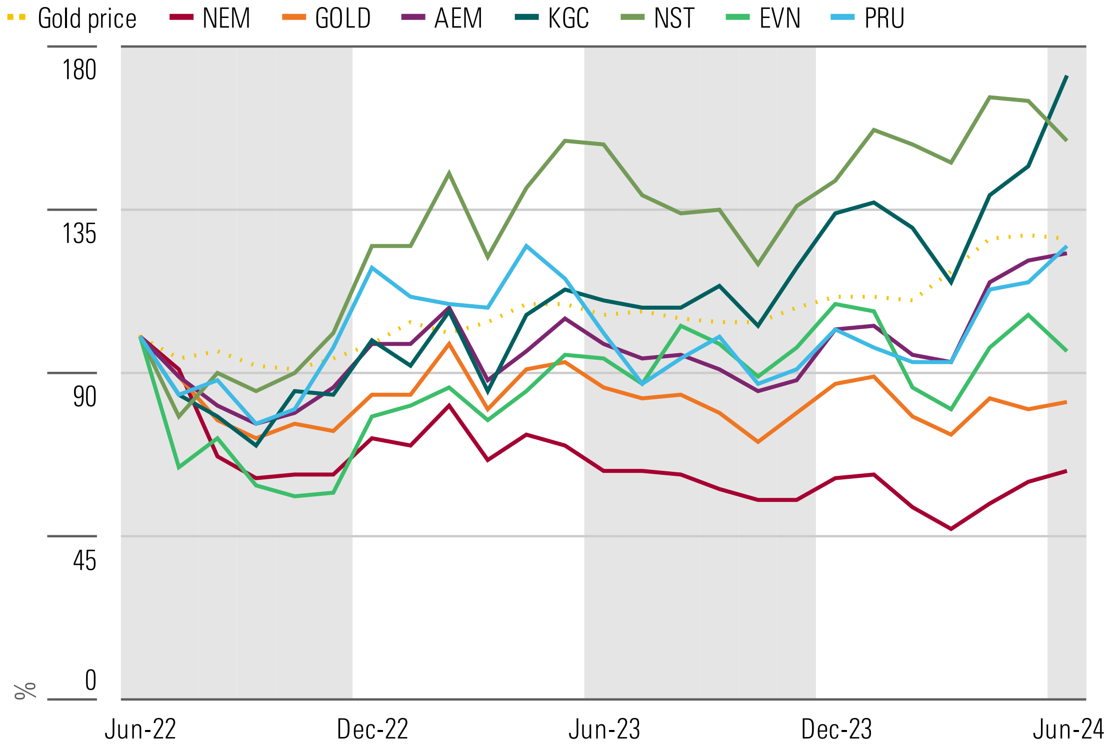
China accounts for about half of mined copper demand. However, optimism over rising demand from the rollout of electric vehicles, renewables and electricity grid investment, along with supply concerns, are pushing copper prices higher.

Newmont shares continue to underperform rising gold prices and peers. Yet, we think sales volumes and margins will improve, driven by higher production at its generally larger, lower-cost mines and the likely sale of up to six smaller, higher-cost mines.

Supply Issues, Decarbonization and Electrification Driving Copper Prices
Copper price.



Newmont Shares Trail Gold Price and Peers for Two Years
Selected gold miner shares compared to gold price.



Source: LME, Morningstar (left). COMEX, PitchBook, Morningstar (right). Data as of June 24, 2024.

Basic Materials

Company (Ticker)		Rating
Nufarm (NUF)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 4.60	AUD 7.70	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 1.76	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 technology growth via Omega-3 canola and bioenergy developments. Nufarm's modest dividend doesn't particularly appeal, but the stock is a growth story. We project a five-year earnings per share compound annual growth rate of 24% for an attractive, prospective mid-single-digit P/E by fiscal 2028. 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 planting for biofuel offtake is agreed with BP.

Company (Ticker)		Rating
Iluka Resources (ILU)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 6.55	AUD 9.50	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 2.80	None	Exemplary

China's attempts to support its ailing property market aren't yet flowing through to increased zircon demand, though no-moat Iluka has had a solid start to 2024 zircon sales. While titanium dioxide demand is also muted, downstream inventory is low, and Iluka's customers believe the worst may have passed. We see significant supply challenges for zircon and high-grade titanium dioxide feedstocks longer-term given declining grades at existing mines and a general lack of investment in new mines. This bodes well for Iluka when demand recovers, as we think likely in the future. Its strong balance sheet—net cash was about AUD 230 million at the end of December 2023—gives us confidence it can ride out the cyclical downturn. And given the strategic nature of its Eneabba rare earths refinery to Australia and the developed world, we think additional government support is likely, thereby reducing the downside from inflation in capital expenditure to build the refinery.

Company (Ticker)		Rating
Newmont (NEM)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 63.47	AUD 78.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 72.60	None	Standard

No-moat-rated Newmont acquired Australian Newcrest in November 2023. The acquisition extends Newmont's lead over Barrick Gold as the world's largest gold miner. We forecast 2024 attributable sales of roughly 6.9 million ounces of gold. The combined company also has material copper production and numerous development projects we think valuable and likely overlooked. We think Newmont's shares are undervalued given its weak sales volumes and elevated unit costs in 2023, and disappointing 2024 guidance. However, sales volumes are likely to recover and unit cash costs to commensurately fall to drive some improvement in Newmont's aggregate position which is currently around the middle of the cost curve.

Source: Morningstar. Data as of June 28, 2024.

Communication Services

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Cost-Cutting Top Priority for Telecoms While Advertising Weakness Drives Down Media Shares to Extreme Levels

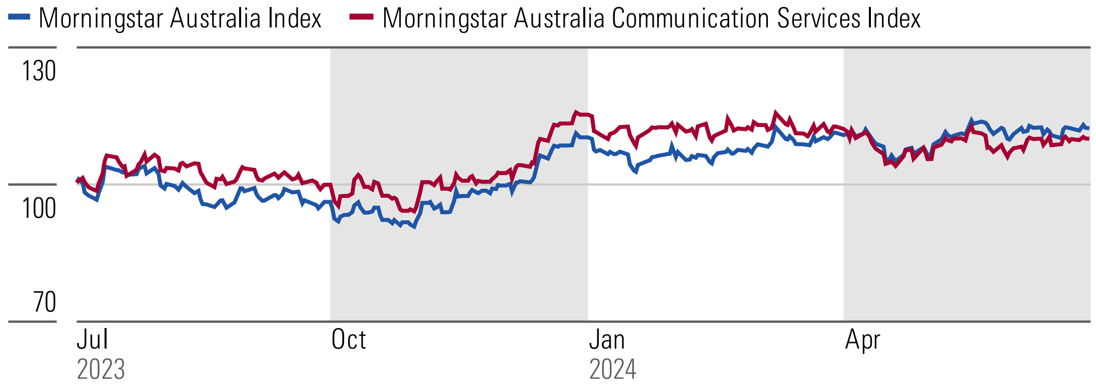
Telecom shares are losing some of their defensive shine against the current uncertain economic backdrop. This is not due to any slippage in the mobile earnings recovery thesis. Telstra's wireless EBITDA margins are approaching 50% (from 35% three years ago), TPG/Vodafone's mobile gross profits are on track to post 8% CAGR to 2024, and all three operators (including Optus) are still raising prices to improve return on capital. However, the drag on the sector is coming from fixed-line businesses, especially in the enterprise arena for Telstra and the consumer broadband space for TPG.

Consequently, cost-cutting and efficiency improvements are a top priority for all telecoms under our coverage. While most have already been engaged in such measures in recent years, persistent structural changes in demand and pricing pressures for many fixed-line products (connectivity, calling applications, professional services) are forcing a fundamental reconfiguration of telecom cost bases.

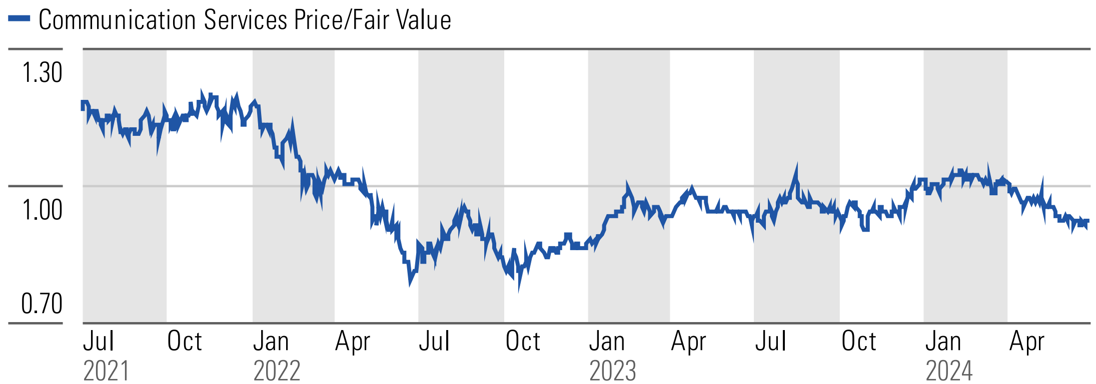
The advertising market is showing no signs of bottoming, especially in traditional media channels such as TV, newspapers and radio. However, stock price reaction to the downturn is reaching extreme levels, and the discounts to our fair value estimates are significant. Balance sheets are generally solid across our media sector coverage, sufficiently so to see through the current market malaise.

Understandably, questions arise about whether the weakness is structural, as they always do during the trough of the advertising cycle. But such concerns are more than priced in at current levels, and most companies under our coverage are still generating healthy free cash flow and investing to become more digital-centric.

Near-Term Earnings Concerns Hurt Performance



Value Emerging in Telecoms While Media Shares Remain Cheap



Source: Morningstar. Data as of June 28, 2024.

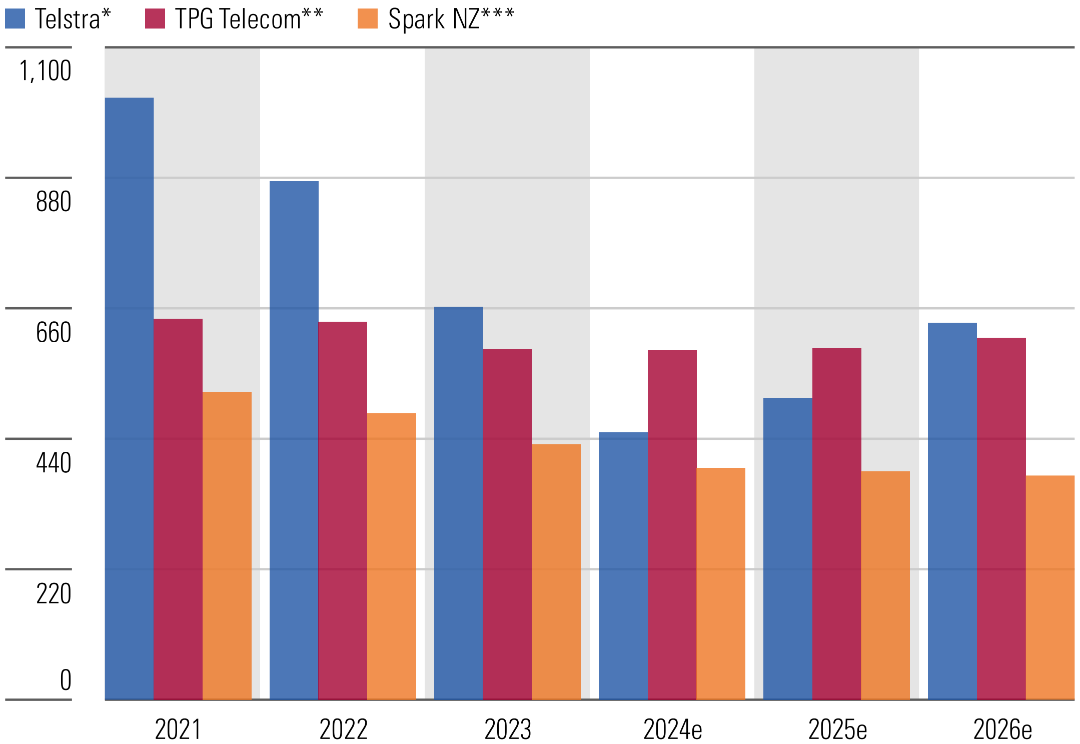
Cost-Cutting Top Priority for Telecoms While Advertising Weakness Drives Down Media Shares to Extreme Levels

Structural pressures are weighing on telecom' earnings from fixed-line businesses. This is necessitating a wholesale reconfiguration of their cost structures, with digitization and automation to play a key role.

Demand for traditional advertising remains weak. Consequently, media company shares are in the doldrums, with negative sentiment even spreading to those more exposed to resilient channels such as digital and outdoor like Nine and oOh!media, respectively.

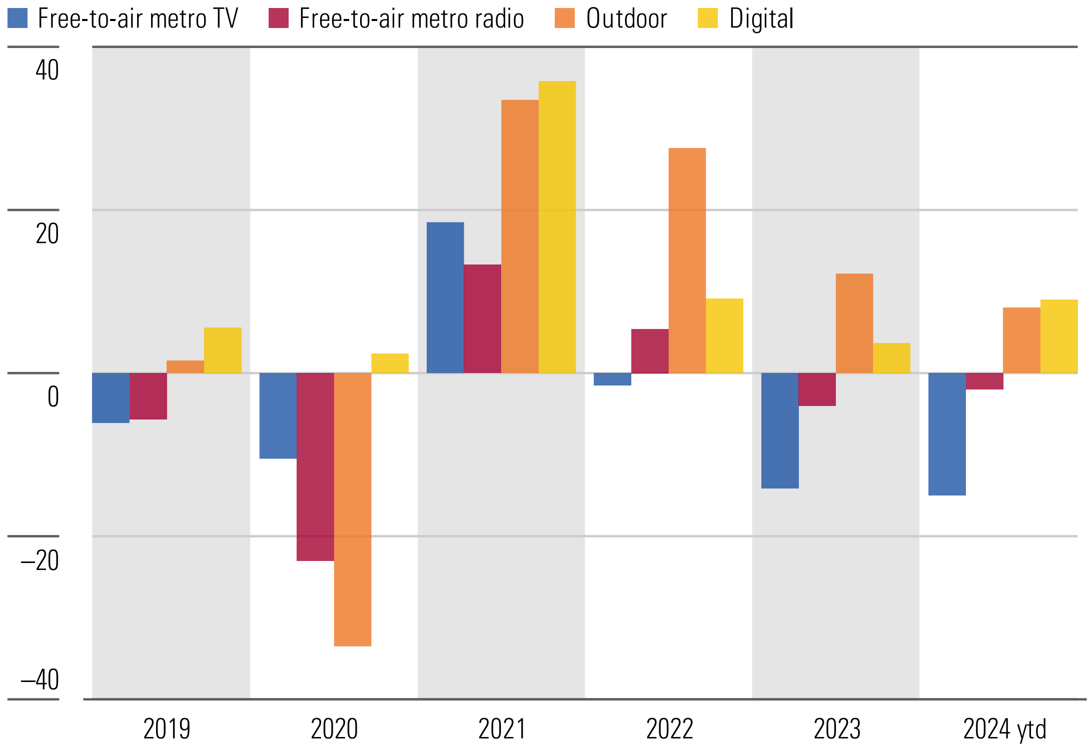
Cost Cuts Needed for Telecoms to Offset Fixed-Line Revenue Pressure

Earnings from fixed-line (in AUD million, except Spark in NZD million), June year-end.



Traditional Advertising Still in the Dumps, but Outdoor and Digital Proving Resilient

Year-on-year change in advertising expenditures by media platform (%).



* EBITDA from consumer broadband, fixed-enterprise, and fixed wholesale. ** Gross profit from consumer broadband. *** Gross profit from voice and consumer broadband.
Source: Company reports and Morningstar estimates. ThinkTV, Commercia Radio of Australia, Outdoor Media Association, Interactive Advertising Bureau, and Morningstar estimates. Data as of June 2024.

Communication Services

Company (Ticker) Nine Entertainment (NEC)		**Rating** ★★★★★
Price AUD 1.40	**Fair Value** AUD 2.70	**Uncertainty** High
Market Cap (bil) AUD 2.23	**Economic Moat** None	**Capital Allocation** Standard

No-moat Nine Entertainment spans advertising and entertainment in Australia. 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 the 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 advertising downturn. 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) TPG Telecom (TPG)		**Rating** ★★★★★
Price AUD 4.58	**Fair Value** AUD 6.60	**Uncertainty** Medium
Market Cap (bil) AUD 8.52	**Economic Moat** Narrow	**Capital Allocation** Standard

Shares in narrow-moat TPG Telecom screen as the most attractive under our Australia and New Zealand telecom coverage. We see medium-term earnings recovery on several fronts and forecast an adjusted EBITDA CAGR of 5% over the next five years. Benefits from a more rational mobile market are coming through, augmented by continuing growth from fixed wireless and the corporate unit. Cost-outs from the current transformation program are progressing slower than we had previously anticipated, curtailing near-term earnings growth amid the current 5G rollout-related capital expenditure hump. Overhang of major shareholders whose holdings are now out of escrow after the Vodafone merger is also causing some investor consternation. However, these concerns are more than reflected in the share price, especially given the longer-term tailwinds for the telecom industry as it makes the transition to 5G and as transformation benefits are gradually realized.

Company (Ticker) Telstra (TLS)		**Rating** ★★★★
Price AUD 3.62	**Fair Value** AUD 4.50	**Uncertainty** Medium
Market Cap (bil) AUD 41.83	**Economic Moat** Narrow	**Capital Allocation** Standard

There is a defensive appeal to narrow-moat Telstra's earnings. Over 60% of the group's underlying EBITDA is generated by the mobile telephony unit, benefiting from favorable industry tailwinds. Mobile prices and average revenue per user are rising as competition becomes more rational and operators refocus on extracting appropriate returns from their considerable 5G network investments. As the market leader in the concentrated three-player space in Australia, Telstra's mobile business is firing, with mobile margins now above 47%, up from 35% in fiscal 2021. Continuing structural and competitive pressures on Telstra's fixed-line and legacy voice-related businesses take some shine off the mobile renaissance. However, management is stepping up its cost-cutting and efficiency improvement initiatives.

Source: Morningstar. Data as of June 28, 2024.

Consumer Cyclical

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Lower Savings Rate Lessens Pain for Cyclical Retailers

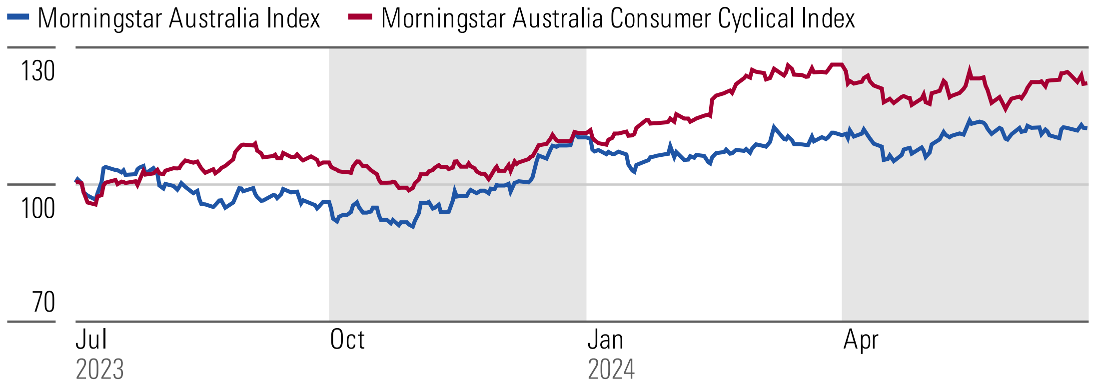
The upcoming August 2024 reporting season is set to close off a difficult year for Australian retailing, which navigated soft demand and soaring labor costs. The combination results in a profit margin crunch and declining earnings for many retailers. While total industry sales are up slightly, volumes are down. And cyclicals are faring worse than supermarkets. Amongst cyclical categories, demand for durable household goods like furniture and consumer electronics is particularly weak.

It could have been worse. Without a lower savings rate, we estimate total retailing sales would be in decline. We believe consumers are comfortable with saving less as long as the housing and equity markets remain strong and excess savings accumulated during the pandemic aren't completely depleted. In the lead up to the global financial crisis of 2007-2009, the savings rate averaged close to zero for over a decade.

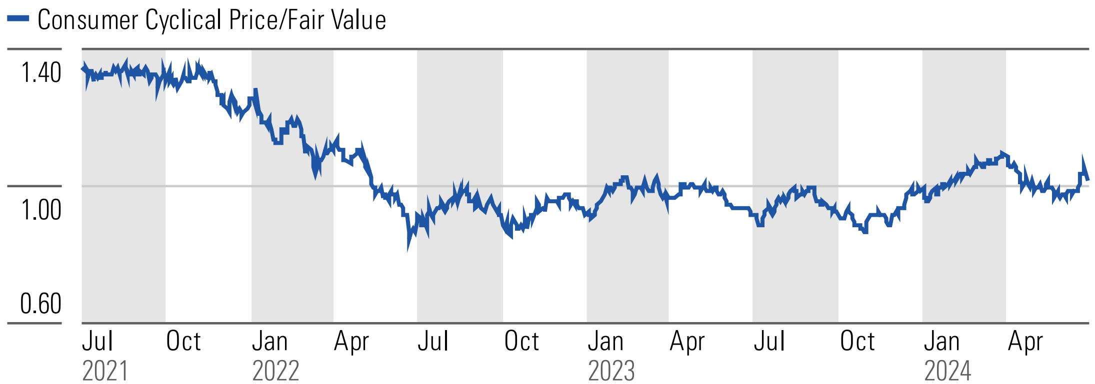
Ecommerce is outperforming. In fiscal 2024 to date, online sales are up 3% on the PCP, compared to 1% sales growth in the brick-and-mortar channel. Some categories are more sheltered from online competition, like those of narrow-moat auto parts retailers.

Super Retail Group's Supercheap Auto appears to be capturing retail share from Bapcor's Autobarn, capitalizing on the latter's management turmoil amid cyclically weak discretionary sales—which typically generate about half Autobarn's and Supercheap's earnings. By contrast, maintenance-related categories continue to perform strongly at Bapcor's Burson trade business.

Despite a Difficult Year, Cyclicals Have Beat the Market



Better Value Emerging in Recent Months



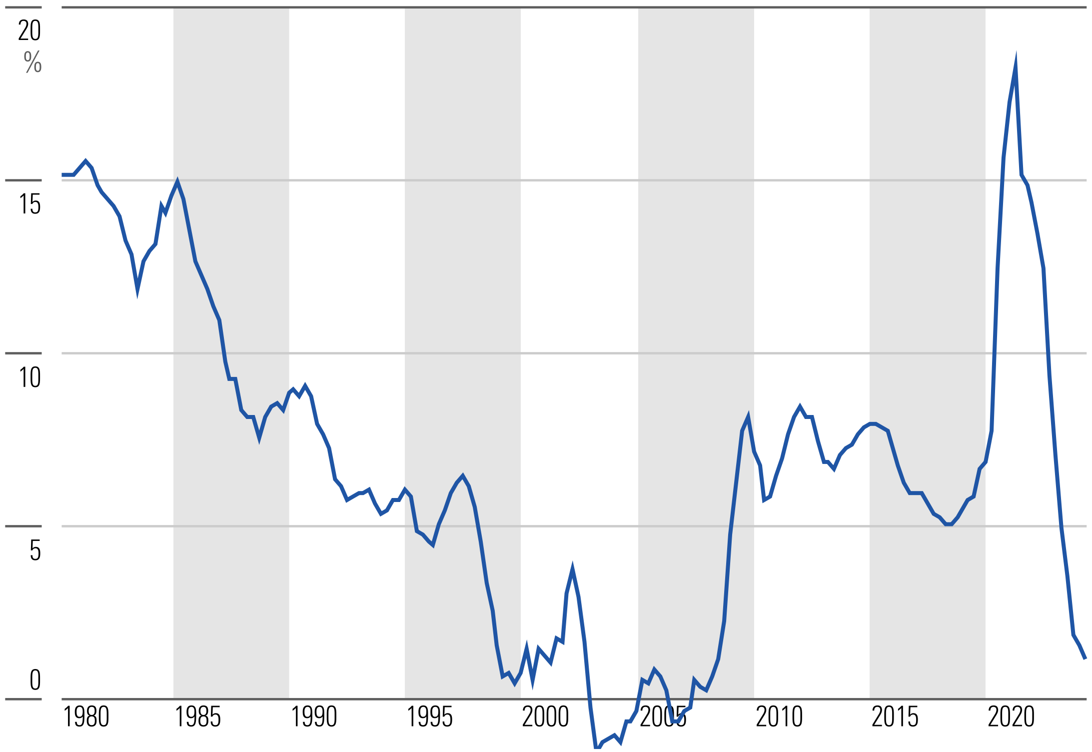
Source: Morningstar. Data as of June 28, 2024.

Lower Savings Rate Lessens Pain for Cyclical Retailers

Households are adjusting to the cost-of-living crisis by dialing back their savings to next to nothing—the savings rate sits at 1%, down from 4% in fiscal 2023. But the 2000s illustrate savings rates can remain low for years, even as incomes improve.

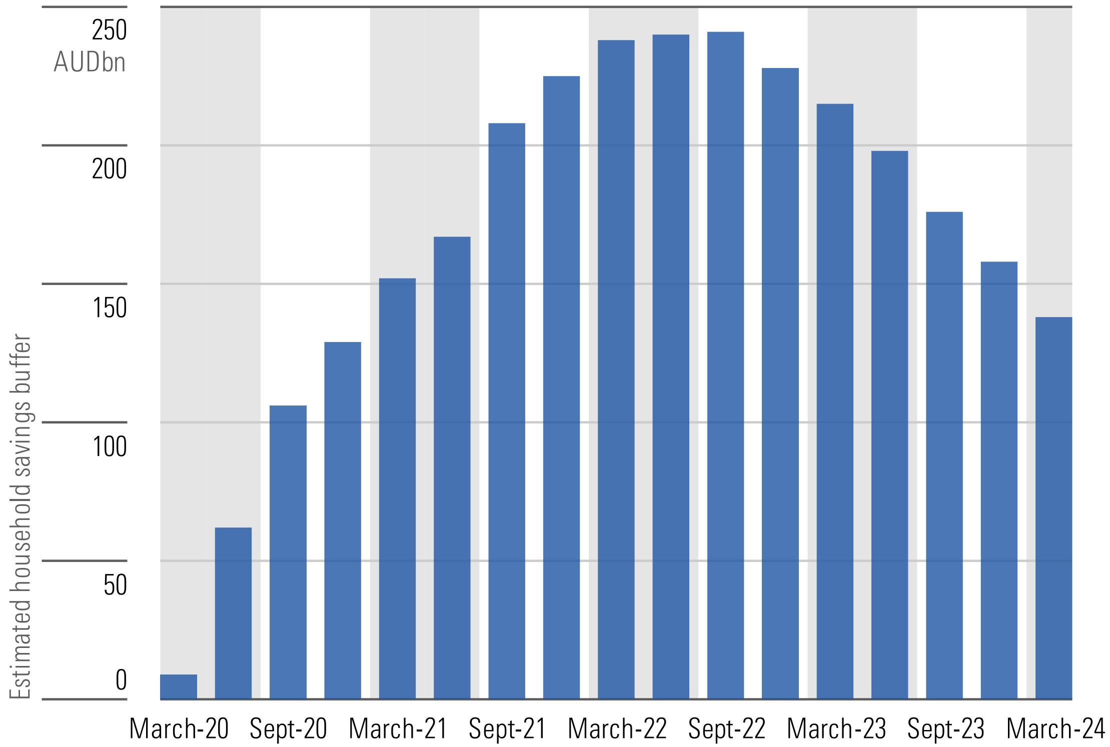
We estimate households accumulated AUD 250 billion of excess savings during the pandemic and are drawing on these to prop up spending while maintaining a lower savings rate. We think nearly half of this savings buffer has been exhausted.

Consumers Adjusting Savings Rate to Maintain Spending



Accumulated Savings Withering Away; Almost Half of Nest Egg Spent

Net household savings above 10-year average prepandemic levels.



Source: Australian Bureau of Statistics. Data as of March 31, 2024.

Consumer Cyclical

Company (Ticker) SkyCity Entertainment Group (SKC)		**Rating** ★★★★★
Price AUD 1.33	**Fair Value** AUD 2.90	**Uncertainty** High
Market Cap (bil) AUD 1.02	**Economic Moat** Narrow	**Capital Allocation** Standard

Regulatory headwinds and weaker earnings weigh on SkyCity shares. A short-term suspension of the New Zealand casino license is likely, the Adelaide casino license is under review, and regulatory and compliance costs are up sharply—much of which we expect to be permanent. The weaker discretionary environment also weighs on the mass market consumer—notably in gaming machine play. But we think pessimism is overblown. We expect a recovery from the current cyclical downturn and for the core Auckland property to capitalize on the continued recovery in New Zealand tourism. Capital spending is also set to ease materially as about NZD 1 billion in major projects across Auckland and Adelaide near completion.

Company (Ticker) Bapcor (BAP)		**Rating** ★★★★★
Price AUD 5.14	**Fair Value** AUD 7.30	**Uncertainty** Medium
Market Cap (bil) AUD 1.74	**Economic Moat** Narrow	**Capital Allocation** Exemplary

Negative sentiment amid short-term headwinds, management turmoil, and structural changes facing the automotive industry have left the fundamental strength and resilience of Bapcor's automotive parts business underappreciated. A slowdown in discretionary spending weighs on retail in the near term, a new management team will need to prove itself, and the proliferation of electric vehicles is a long-term obstacle for the trade business. However, we think near-term pessimism overlooks fundamental resilience in automotive spare parts, and Bapcor is likely to successfully adapt to the gradual technological transition.

Company (Ticker) Domino's Pizza Enterprises (DMP)		**Rating** ★★★★
Price AUD 35.89	**Fair Value** AUD 61.00	**Uncertainty** High
Market Cap (bil) AUD 3.26	**Economic Moat** Narrow	**Capital Allocation** Exemplary

Domino's Pizza is 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. Domino's 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 a moderation in elevated inflation. However, we believe the market is overlooking Domino's intact and 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%.

Source: Morningstar. Data as of June 28, 2024.

Consumer Defensive

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Angus Hewitt, CFA | angus.hewitt@morningstar.com

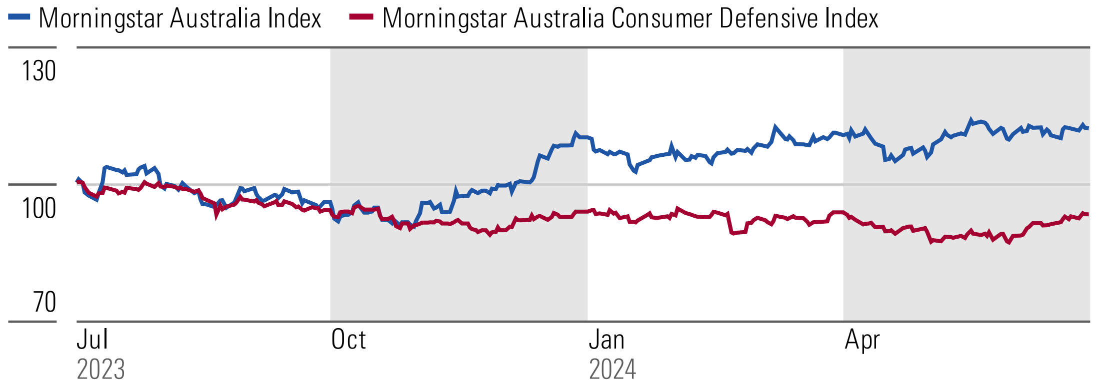
Consumers are Still Dining Out, but for How Long?

While supermarkets are outperforming most other retailing categories, we think they can do better as spending between eating out and eating at home normalizes. Sales growth rates at supermarket and restaurants were on par in March-quarter 2024, at 2%. Overall retail sales barely increased in the quarter, up 1%. Consumers are spending less overall at supermarkets than prior to the pandemic, providing an opportunity for a reallocation of spending back toward supermarkets over the medium term.

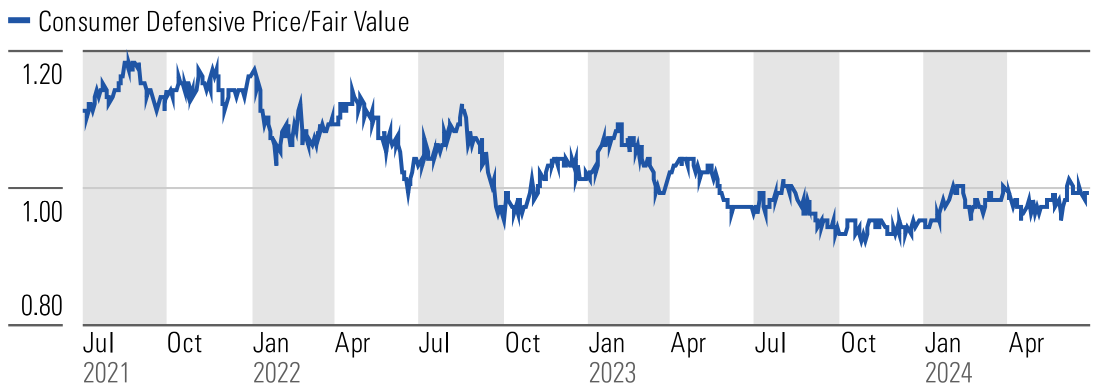
We expect this reallocation to have a negative downstream effect on suppliers like Inghams and Bega. We think the balance of power between suppliers and the major supermarkets lies firmly with the supermarkets, making it a relatively less lucrative channel.

While not impacting Inghams' broiler farms directly, avian influenza has been detected in Australia at two egg farms. Bird flu has breached Australia's shores before and been successfully eradicated with minimal spread between farms. Should bird flu occur in the Inghams flock or in areas where Inghams operates, the firm may be required to destroy poultry or be restricted from transporting the product to customers to control the outbreak. But at this stage, there appears to be limited impact from the bird flu outbreak on consumer demand for poultry products. The rising cost of living is weighing on consumers, which is leading to an overall increase in poultry demand. Consumers are substituting more expensive meats, like beef, with cheaper alternatives, like chicken.

Defensives Have Underperformed the Market



On Average, Defensives are Trading at About Fair Value



Source: Morningstar. Data as of June 28, 2024.

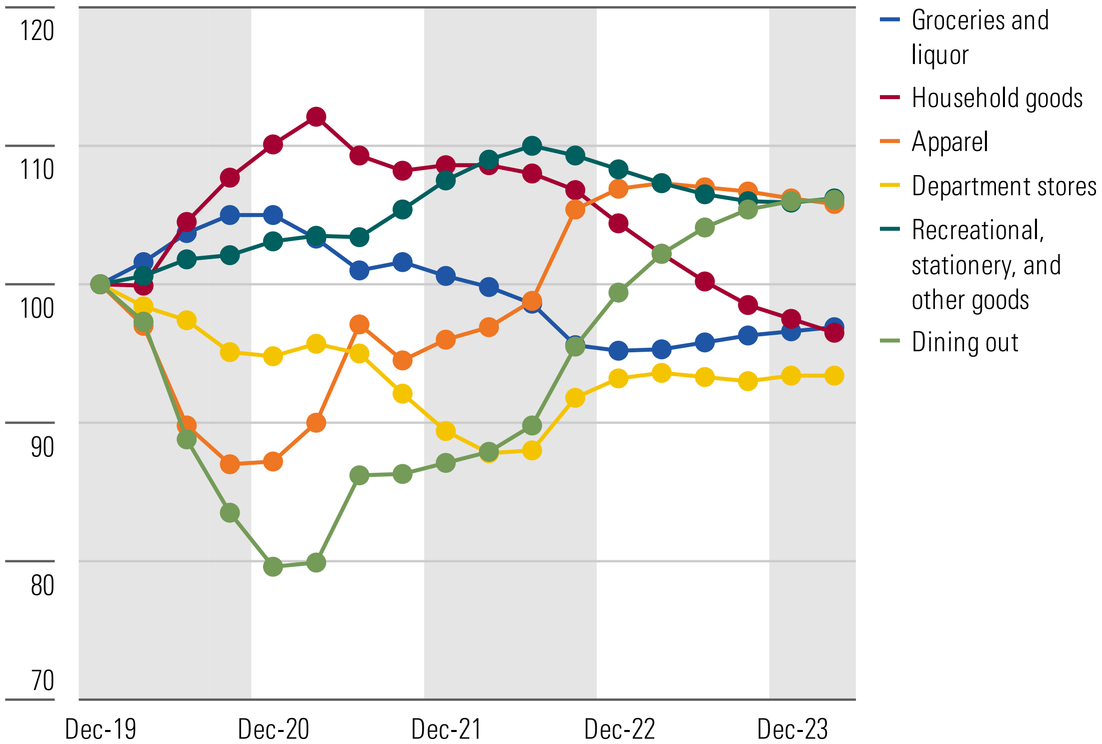
Consumers Are Still Dining Out, but for How Long?

Consumers are spending less overall at supermarkets than before. We estimate the supermarket industry could benefit from a reallocation of elevated dining-out spending over the medium term, potentially lifting cumulative sales levels by 3%.

Despite falling births in China and a shift in consumer preference towards domestic brands, a2 Milk continues to capture share. A2's brand equity is resonating with consumers as premiumization in infant formula continues.

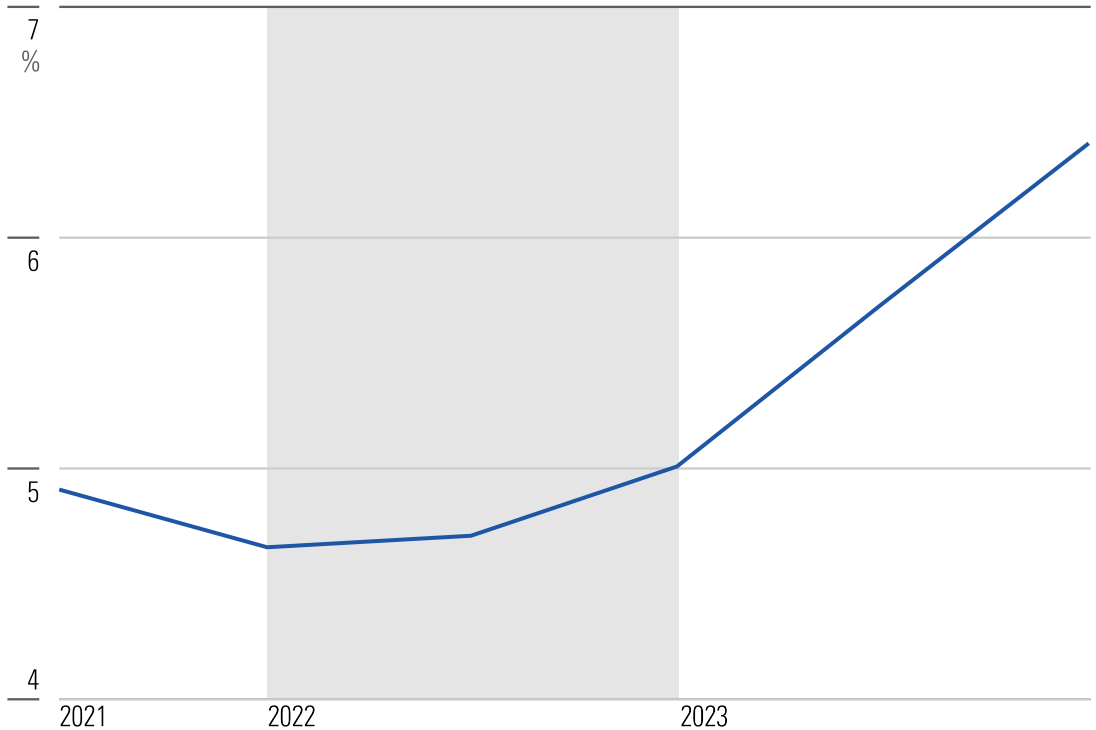
Spending Behavior Taking Time to Normalize; Dining and Grocery Correlated

Indexed category share of retail spending on a rolling 12-month basis (Dec. 2019 = 100).



A2 Milk's Share in China Continues to Grow

A2 Milk value share of the Chinese infant-formula market.



Source: Australian Bureau of Statistics, Kantar. Data as of March 31, 2024.

Consumer Defensive

Company (Ticker)		Rating
IDP Education (IEL)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 15.15	AUD 22.50	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 4.22	Narrow	Exemplary

We expect IDP Education to benefit from the long-term demand for higher education. First-half fiscal 2024 adjusted NPAT increased 23% driven by impressive pricing power and significant market share gains in student placement. However, tighter immigration and visa settings will likely see industry volumes decline near-term. Nonetheless, IDP continues to take market share from less-reputable players and is becoming a structurally leaner business, better placed for the longer term. It remains a high-quality operator, boasting superior average student visa approval rates, and is a part owner of one of the world's most recognized and trusted certifiers of English proficiency.

Company (Ticker)		Rating
Endeavour Group (EDV)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 5.05	AUD 6.10	Low
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 9.04	Wide	Exemplary

Shares in wide-moat Endeavour offer an attractive fully franked yield. We think the market is underappreciating the defensive long-term earnings outlook, with consumers currently pulling back on nonessential spending. However, fiscal stimulus is about to boost household budgets from July 2024. We forecast Australian liquor retailing sales increasing midsingle digits after barely growing at all in fiscal 2024. We believe concerns regarding regulatory risk are overdone. Our relatively cautious forecast accounts for more-stringent gaming restrictions curbing earnings growth in fiscal 2025, but thereafter we see group profit increasing at an average rate of 6%.

Company (Ticker)		Rating
a2 Milk		★★★
Price	**Fair Value**	**Uncertainty**
AUD 6.77	AUD 7.40	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 4.89	Narrow	Standard

There is much to like about a2 Milk, particularly in China, the key battleground. A2's share of Chinese-language-labeled 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 dies down. Offsetting the falling number of births in China, we anticipate further premiumization and for a2 Milk to capture market share. We forecast 8% annual revenue gains to fiscal 2028 as channel inventory levels normalize and market share increases. We also see improved sales of higher-margin English-label products and operating leverage from higher revenue.

Source: Morningstar. Data as of June 28, 2024.

Energy

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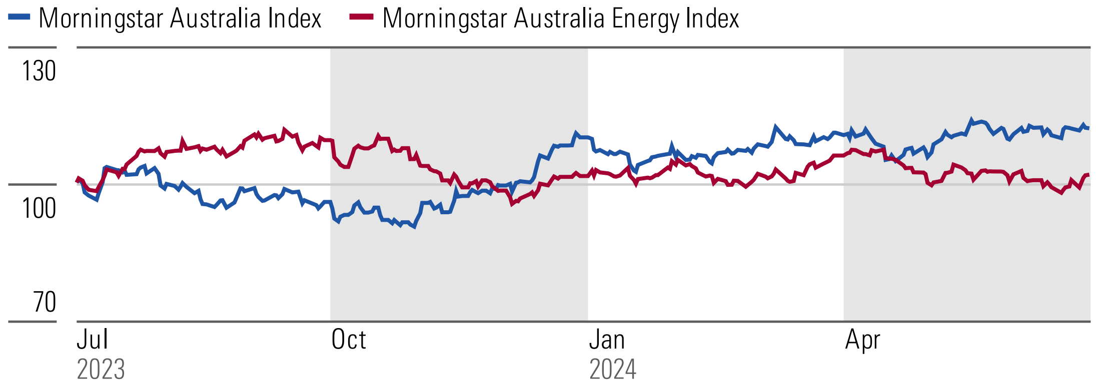
Brent Crude Price Drifts, but Spot LNG Improves on Chinese Demand

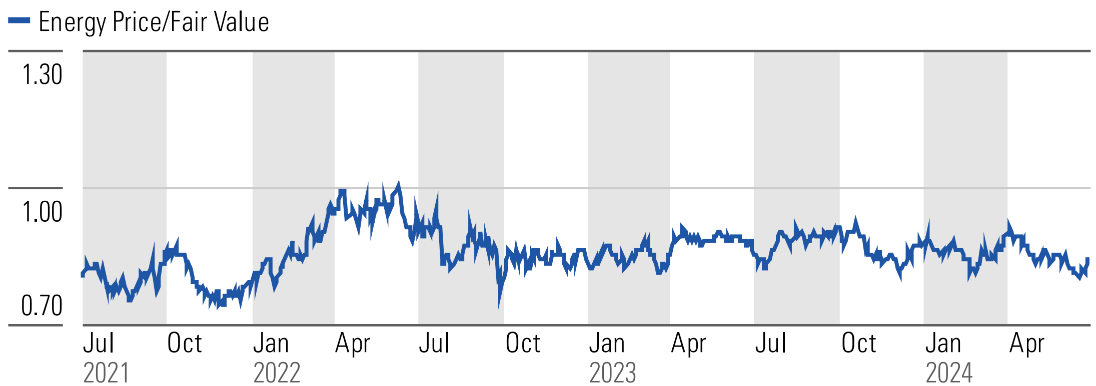
The US Energy sector outperformed last quarter, though largely reflective of a well-received jump in M&A activity, including Diamondback/Endeavor and ConocoPhillips/Marathon. Locally, the index drifted, in keeping with the oil price albeit at odds with improving spot liquefied natural gas. The latter is most important for Australian LNG exporters such as Woodside and Santos. At USD 84 per barrel, Brent crude is above our USD 80 forecast for 2025 and our unchanged USD 60 midcycle estimate. In support of pricing, OPEC+ has extended deadlines to production cuts by a year, largely to the end of 2025. The cartel has three separate cuts in progress, totaling 5.9 million barrels per day, equivalent to 6% of 2023 global demand. This is reflective of a well-supplied market, and the Saudis' desire to sell USD 11 billion in state-run Aramco stock to fund Vision 2030.

The news is brighter for natural gas with spot LNG up more than 50% to USD 12.50 per million Btu from February 2024 lows. Chinese gas consumption rose 11% year on year for the first four months of 2024, including robust LNG imports, up 23%. A high import dependency ratio of 40% is likely to continue to support LNG volumes in 2024, as will environmental considerations, particularly switching from coal. Our midcycle LNG price remains USD 8.40 per mmBtu from 2026, reflecting the marginal cost of supply and equivalent to a standard 14% of our unchanged USD 60 per barrel midcycle Brent crude forecast. Our midcycle prices are healthy for Australian exploration and production companies, which we expect to continue to enjoy robust free cash flows, with much likely to go to shareholders via buybacks and dividends with limited large projects in the pipeline. Potential for M&A in Australia is limited.

Energy Sector Has Underperformed in Recent Months



Energy Stocks Remain Materially Undervalued



Source: Morningstar. Data as of June 28, 2024.

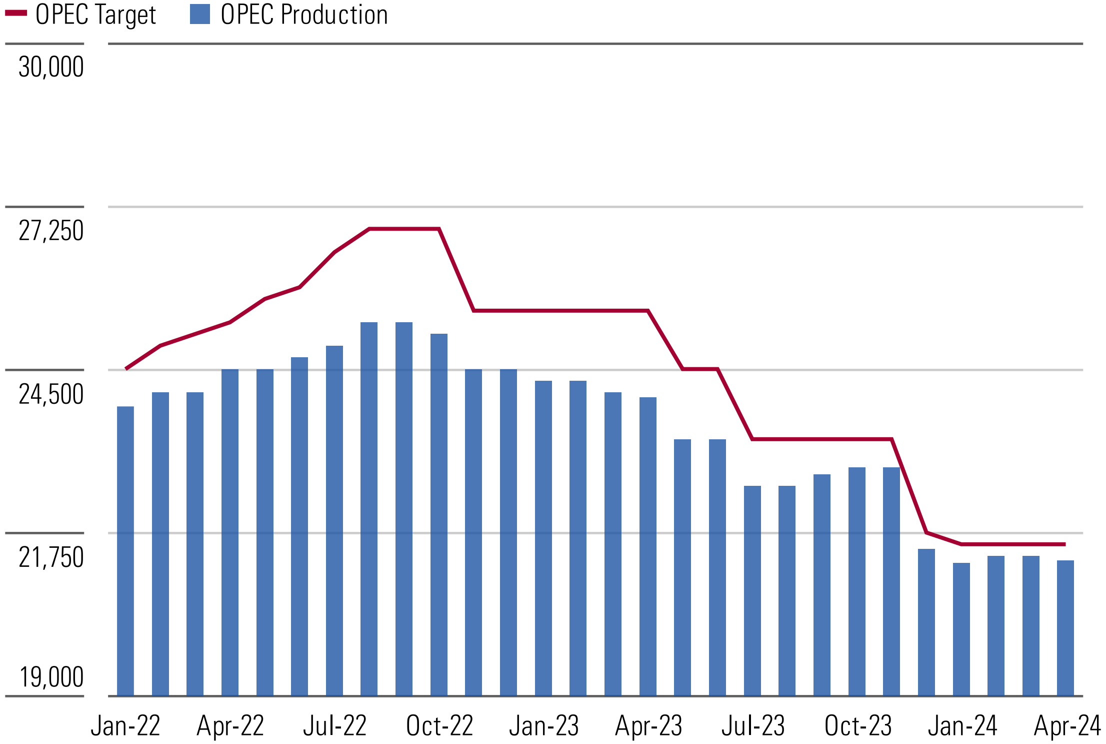
Brent Crude Price Drifts, but Spot LNG Improves on Chinese Demand

OPEC has had to repeatedly reduce quotas in support of oil prices, even with improving member production compliance. The cartel's cuts total almost 6 million barrels a day. EVs will be detrimental to demand over the medium to longer term.

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 this persists, LNG producer earnings could beat our medium-term earnings estimates.

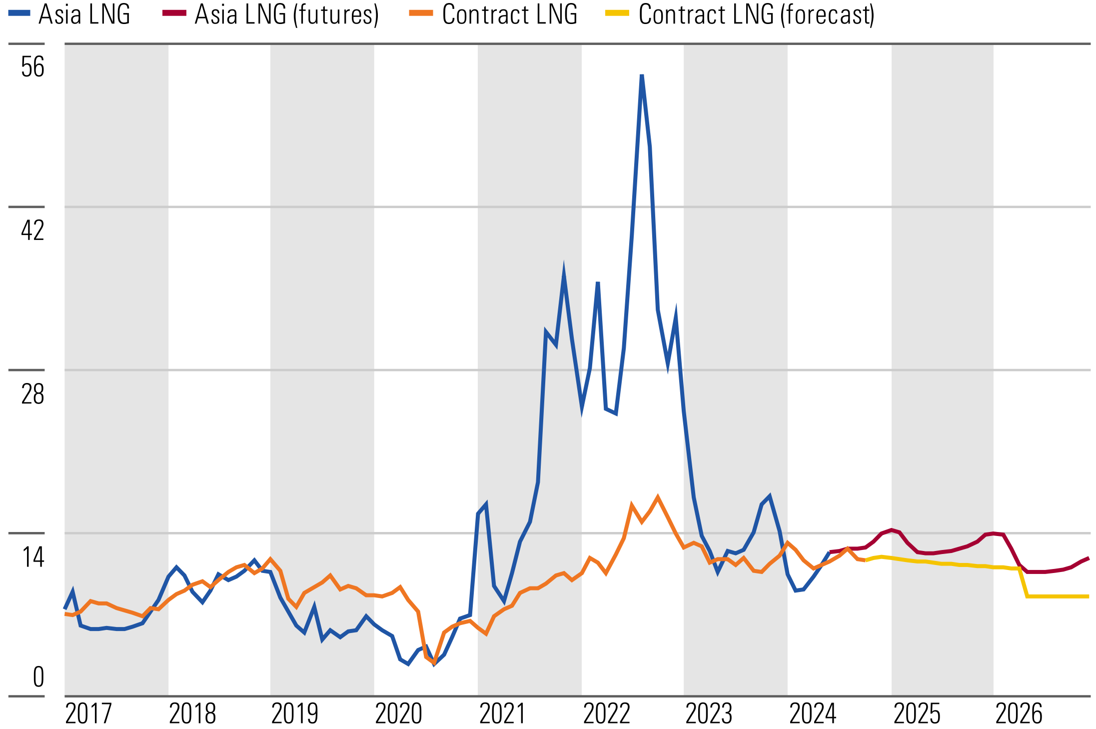
OPEC Production Compliance Has Improved

Oil Production '000 barrels per day



LNG Futures Now Exceed the Brent-Referenced Contract

LNG Price – USD per mmBtu



Source: Organization of the Petroleum Exporting Countries, or OPEC. Data as of May 29, 2024.

Energy

Company (Ticker)
Woodside Energy (WDS)

Rating
★★★★★

Price
AUD 28.21

Fair Value
AUD 45.00

Uncertainty
Medium

Market Cap (bil)
AUD 53.56

Economic Moat
None

Capital Allocation
Standard

Woodside has meaningful developments underway, including Scarborough/Pluto T2 LNG, and Sangomar oil has just been commissioned. While net production growth is smaller than Santos', the increase is regardless material for returns given capital efficiency. We expect returns on invested capital to improve after 2026 with the start of Pluto T2 and to exceed WACC before the end of the decade. We credit group production growing 15% by 2028 versus 2023. Woodside's balance sheet is conservatively geared in support of a strong 80% dividend payout ratio and a healthy, fully franked yield, despite capital expenditures. Woodside can to some extent be viewed as an infrastructure play, given LNG processing trains can treat third-party gas if the circumstance dictates.

Company (Ticker)
Santos (STO)

Rating
★★★★

Price
AUD 7.66

Fair Value
AUD 12.30

Uncertainty
High

Market Cap (bil)
AUD 24.88

Economic Moat
None

Capital Allocation
Standard

We don't think Santos is being sufficiently credited for new oil and gas developments underway. A solid balance sheet and competitive cash operating costs, including a modest freight advantage to Asia, mean the company is well placed in cyclical price downturns. That said, less favorable capital costs preclude a moat. However, crude and LNG prices are healthy now, and gas has a growing role in fueling the world, including complementing increasing renewable energy production. We forecast group hydrocarbon volume growth of 85% by 2028 from 2023, chiefly from the Pikka oilfield development in Alaska and the reinvigoration of Darwin LNG's output with the Barossa gas field development. We forecast a strong five-year EBITDA CAGR of 11% to USD 6.3 billion by 2028 versus 2023.

Company (Ticker)
Whitehaven Coal (WHC)

Rating
★★★★

Price
AUD 7.65

Fair Value
AUD 9.90

Uncertainty
Very High

Market Cap (bil)
AUD 6.40

Economic Moat
None

Capital Allocation
Standard

Whitehaven continues to be penalized for ESG concerns. We think its purchase of two metallurgical coal mines from BHP is a good one, diversifying its production to roughly half thermal coal and 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 price upside. 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 such as Japan and South Korea while meeting emissions targets under various international agreements.

Source: Morningstar. Data as of June 28, 2024.

Financial Services

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Shaun Ler | shaun.ler@morningstar.com

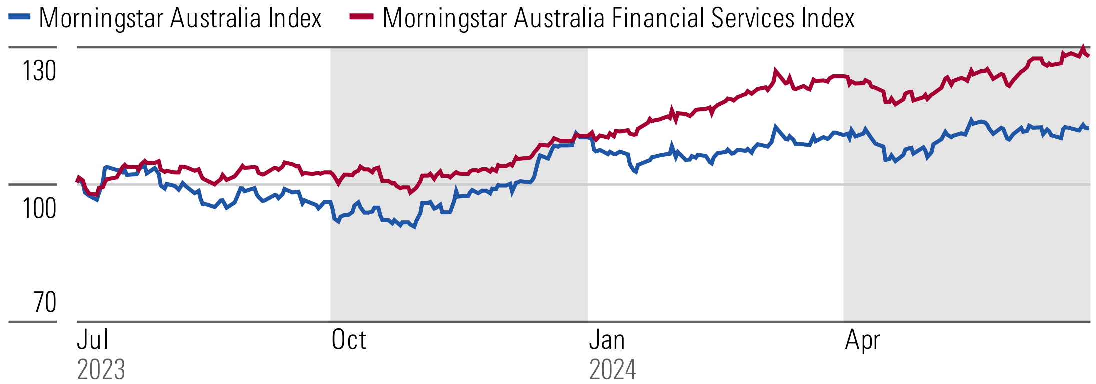
Big Banks Have Rallied; Value Remains Elsewhere

The Big Four banks outperformed the market in the quarter, with Commonwealth Bank rallying strongly, and now materially overvalued. ANZ Group and Westpac are the cheapest of the majors. Across the sector, we expect credit growth, modest margin improvement, and cost savings to underpin mid-single-digit EPS growth over the next five-years. Margins are beginning to stabilize, and bad debts are below long-term averages. More borrowers are falling behind on payments, but equity buffers, rising house prices, and low unemployment, means it is not translating into a rise in loan losses. Dividends are well supported by surplus capital, with further buybacks likely.

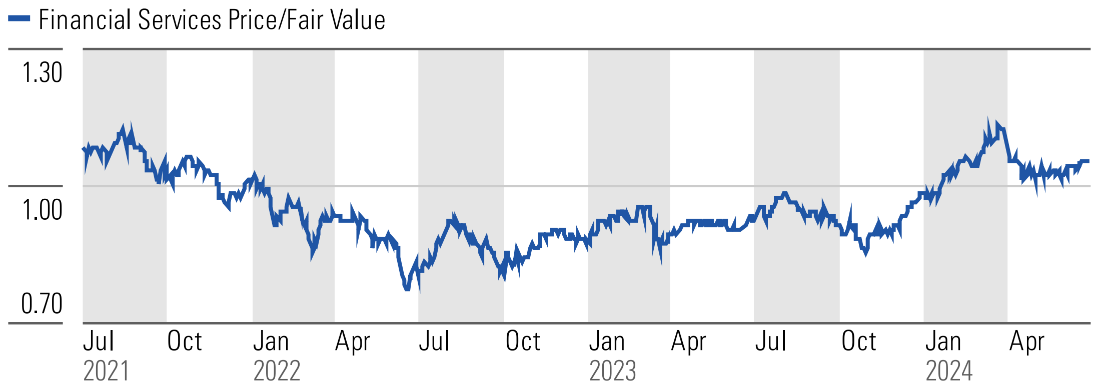
The earnings outlook for general insurers IAG and Suncorp is positive. Higher claims are being matched with higher premium rates, while higher cash rates lift investment income on policyholder and shareholder funds. We prefer narrow-moat-rated insurance brokers Steadfast and AUB Group over the insurers on valuation grounds, given that they can ride industry tailwinds without taking on the underwriting risk.

We expect FUM and earnings for most our covered asset managers to recover from fiscal 2023 lows through to fiscal 2025. In fiscal 2025, potentially falling US federal-funds rates, which influence interest rates globally, are likely to revive interest in growth assets, helping flows recover and supporting higher asset prices. This expectation has already led to some preemptive recovery in flows and investment returns in fiscal 2024. However, we anticipate sectorwide earnings growth to subside in the medium term because of fee compression, cost inflation, and as the rate of net flows normalize.

Optimism in Financials Despite Rates Staying Higher for Longer



Some Value in Banks Within Modestly Overvalued Financial Services Sector



Source: Morningstar. Data as of June 28, 2024.

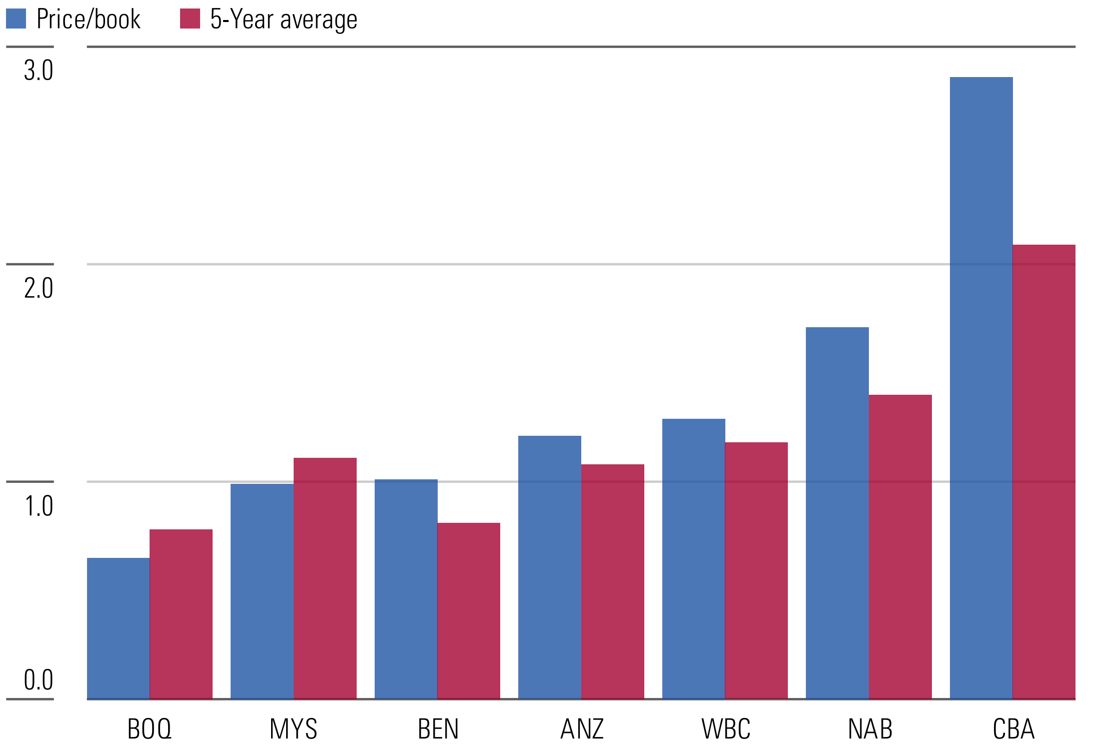
Big Banks Have Rallied; Value Remains Elsewhere

Bank valuations are reasonable, excluding Commonwealth Bank, which trades on a forward P/E above 20 and a dividend yield of 4%. We expect market share and efficiency gains, but our fair value estimate is 30% under the share price.

Lower rates should boost risk appetite, enhancing asset manager fund flows. The US federal-funds rate is expected to decline from present highs in fiscal 2025, but this prospective tailwind is cyclical and does not lessen structural issues for asset managers.

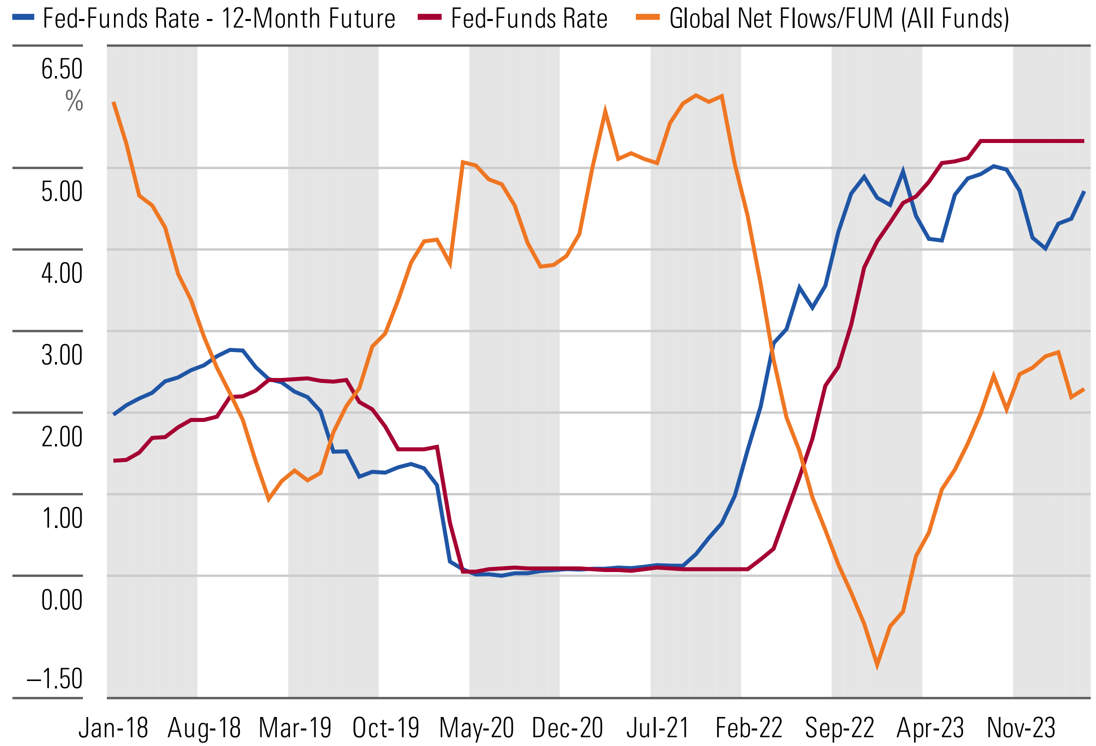
Commonwealth Bank Valuation Is Stretched

Share price/book value



Global Flows Recovering With Prospects of Lower Interest Rates

The relationship between interest rates and fund flows.



Source: Morningstar. Data as of June 28, 2024 (left). Chicago Mercantile Exchange, Federal Reserve Board, Morningstar (right). Data as of May 1, 2024.

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 60.00	**Fair Value** AUD 75.00	**Uncertainty** Low	
Market Cap (bil) AUD 11.63	**Economic Moat** Wide	**Capital Allocation** Poor	
Company (Ticker) Insignia Financial (IFL)		**Rating** ★★★★	We believe the market underestimates Insignia's ability to stabilize earnings, with cost-outs counterbalancing tepid revenue declines. There is still ample room to remove duplicate or nonessential costs to extract scale efficiencies. Moreover, we think revenue will decline in the long term but at a manageable rate. This reflects our expectation for a slower compression in fees, and likely improved fund flows over the medium term. As administered funds increase, cost synergies are extracted, and operating margins stabilize, debt serviceability should improve. We think the odds of multiple expansion are good at current prices, particularly if outflows lessen and margins stabilize.
Price AUD 2.29	**Fair Value** AUD 3.60	**Uncertainty** High	
Market Cap (bil) AUD 1.54	**Economic Moat** None	**Capital Allocation** Standard	
Company (Ticker) AUB Group (AUB)		**Rating** ★★★★	AUB is the second-largest general insurance broker network in Australia and New Zealand. Higher insurance premiums are an industrywide tailwind, with bolt-on acquisitions and operating leverage boosting earnings growth. We believe AUB has earnings upside from its market position, customer and insurer relationships, acquisition strategy, and organic growth opportunities. We expect the general insurance pie to expand with single-digit premium increases and for AUB to take share of the intermediated general insurance market. Ongoing marketing and operating efficiencies allow brokers to increase policies per client and service lower premium clients profitably. The investment in BizCover should attract smaller business clients.
Price AUD 31.69	**Fair Value** AUD 35.00	**Uncertainty** Medium	
Market Cap (bil) AUD 3.67	**Economic Moat** Narrow	**Capital Allocation** Standard	

Source: Morningstar. Data as of June 28, 2024.

Healthcare

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Buying Opportunities in High-Quality Healthcare Names

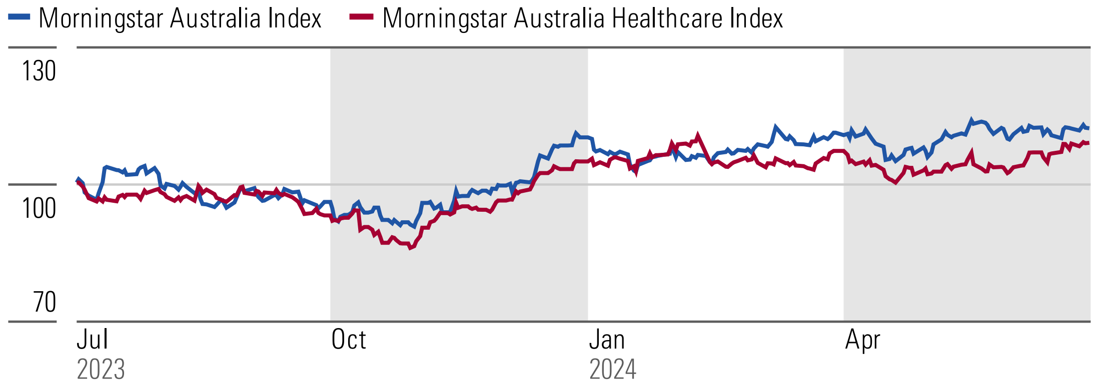
We view the healthcare sector as overvalued on average, but roughly half of our coverage still trades in 4- or 5-star territory. The most attractive names are ResMed, where we expect continued strong revenue growth, and Ramsay and Ansell where we see margins expanding. Meanwhile, Pro Medicus, Polynovo, Sigma, and Cochlear are our most overvalued stocks.

It has been a tough period recently for pathology providers due to cost inflation. However, as we expected, supportive pathology policy changes were announced with the federal budget in May. About 50% of the pathology schedule by revenue is resuming indexation from July 1, 2025. The increased government funding will help to offset inflationary pressures and is generally allocated for lower-margin labor-intensive diagnostics. Sonic, Healius, and ACL remain undervalued.

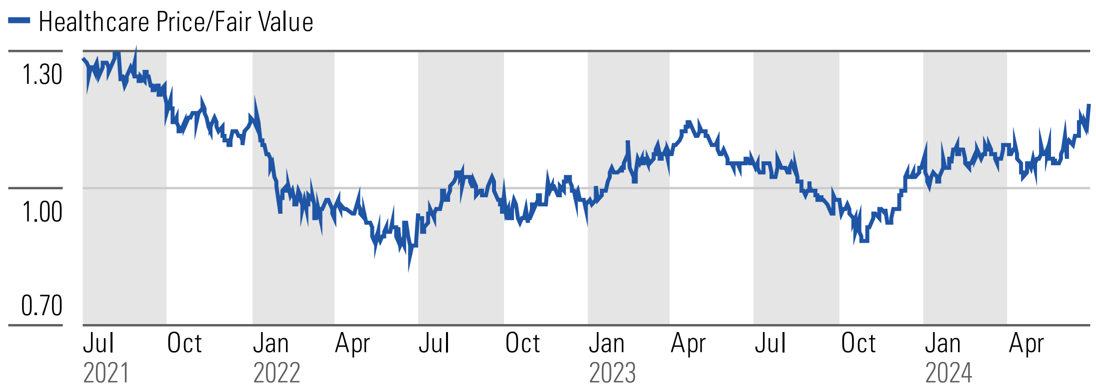
Integral Diagnostics announced a merger with Capitol Health in June, which will create Australia's third-largest imaging provider behind market leader I-MED Radiology and Sonic Healthcare. We think the deal is attractive for Capitol, but not for Integral shareholders. However, this bodes well for Healius, which is currently exploring options to sell its imaging division.

In June, the Australian Competition and Consumer Commission outlined competition concerns at both the retail and wholesale level for Sigma's potential acquisition of Chemist Warehouse. Due to the risk of regulatory resistance, we still do not factor in a deal in our base case. A final decision is expected in September 2024.

Healthcare Has Underperformed the Broader Market



Several Names Still Attract Despite Overvaluation of Sector



Source: Morningstar. Data as of June 28, 2024.

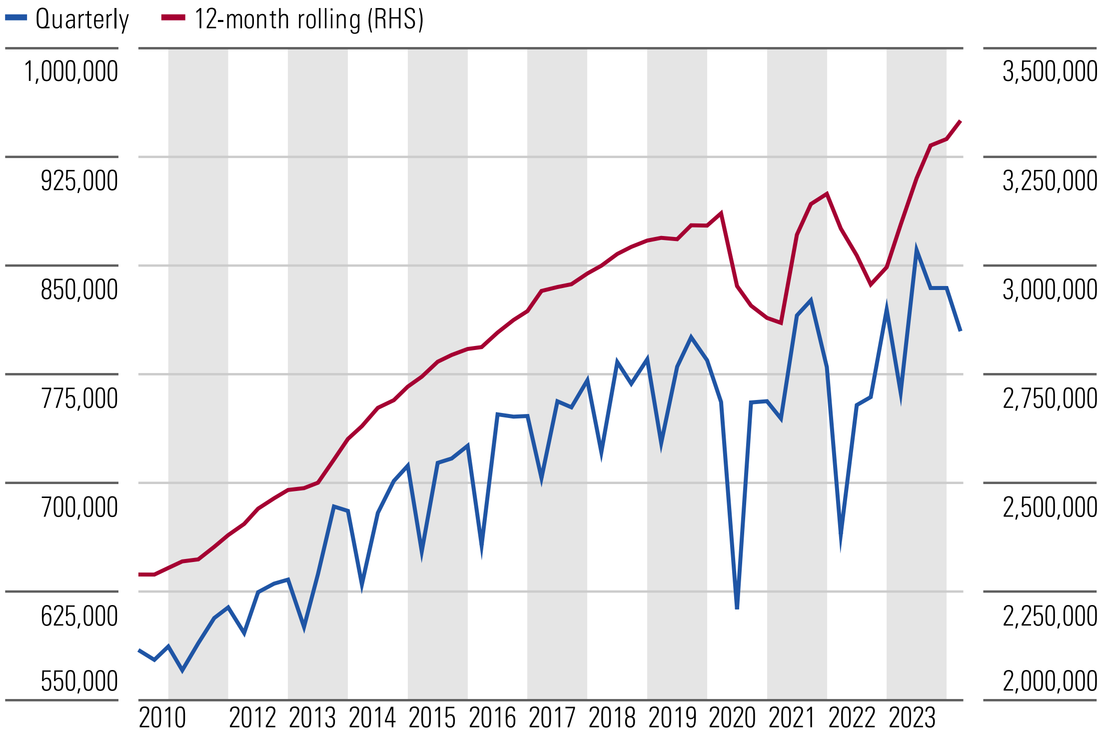
Buying Opportunities in High-Quality Healthcare Names

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.

Despite the pandemic causing disruption to routine pathology testing, underlying demand is defensive and underpinned by population growth, aging demographics, higher incidence of diseases, wider adoption, and a higher number of tests available.

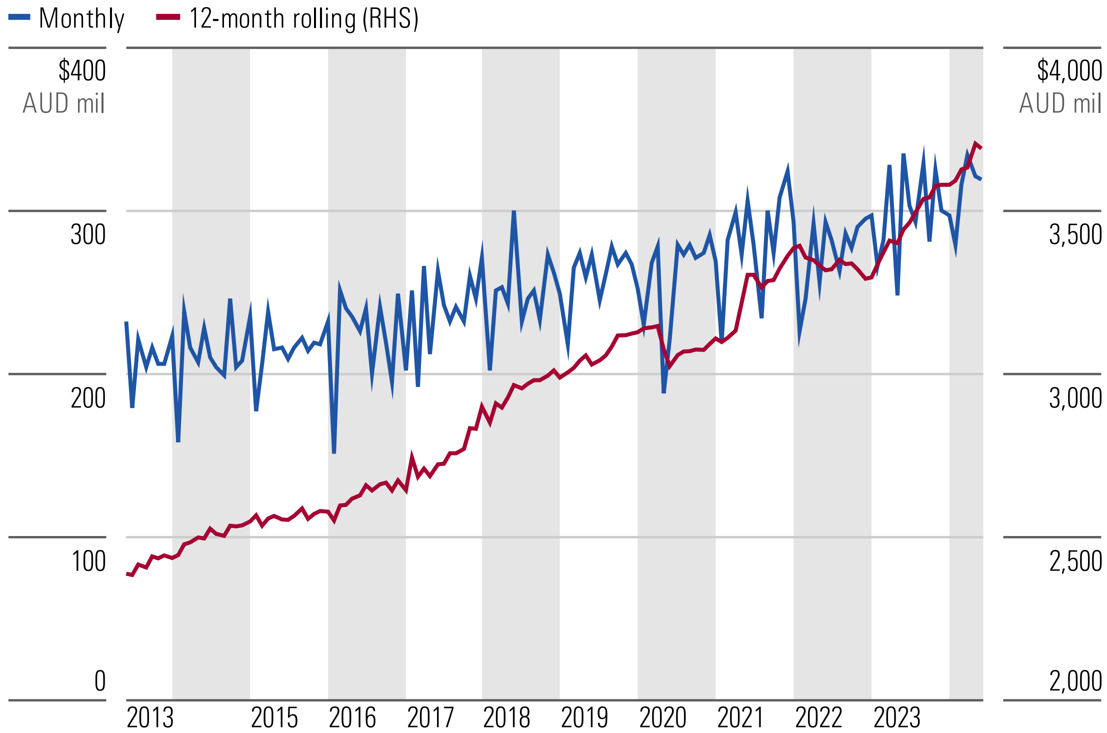
Recovery in Hospital Visits to Support Ramsay's Top Line

Australian private hospital episodes.



Core Pathology Revenue Growth Recovering

Total pathology industry benefits paid, excluding coronavirus Medicare items.



Source: Australian Prudential Regulation Authority. Data as of March 31, 2024 (left). Medicare. Data as of May 31, 2024 (right).

Healthcare

Company (Ticker)		Rating	
Ramsay Health Care (RHC)		★★★★	Inflationary pressures and accelerated investment in digital are weighing on Ramsay's profitability. However, 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. Notably, labor shortages are easing with immigration recovering, and Ramsay continues to invest in recruiting and training. The firm negotiated higher reimbursement rates to meet cost inflation and has deleveraged its balance sheet by selling its share of Ramsay Sime Darby. Please see our stock pitch Ramsay Health Care: Margin improvement ahead; shares are cheap published on Dec. 12, 2023, for more details.
Price	**Fair Value**	**Uncertainty**	
AUD 47.46	AUD 68.00	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 10.90	Narrow	Exemplary	

Company (Ticker)		Rating	
ResMed (RMD)		★★★★	ResMed is seeing strong new patient flow with sleep apnea diagnosis rates recovering and device availability improving. Group EBIT increased 8% sequentially in the March quarter of 2024, reflecting strong device sales and a sharp rebound in gross margin. We think widespread adoption of weight loss 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 experience weight loss stay obese. In most cases, they will likely still benefit from a CPAP device.
Price	**Fair Value**	**Uncertainty**	
AUD 29.10	AUD 40.00	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 42.29	Narrow	Exemplary	

Company (Ticker)		Rating	
Ansell (ANN)		★★★★	We expect Ansell's margin pressures to abate. A productivity program is set to deliver over USD 50 million of cost savings by fiscal 2026, roughly one third of annualized first-half fiscal 2024 EBIT. Employee expenses are falling through automation in packaging and streamlining management. Despite customer destocking, we see limited competitive pressure due to 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. Ansell also acquired Kimberly-Clark's Personal Protective Equipment business, which strengthens the group's product differentiation and provides greater exposure to higher-margin product categories.
Price	**Fair Value**	**Uncertainty**	
AUD 26.55	AUD 32.00	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 3.87	Narrow	Exemplary	

Source: Morningstar. Data as of June 28, 2024.

Industrials

Esther Holloway | esther.holloway@morningstar.com

Industrial Stocks Bear the Brunt of Cyclical Demand

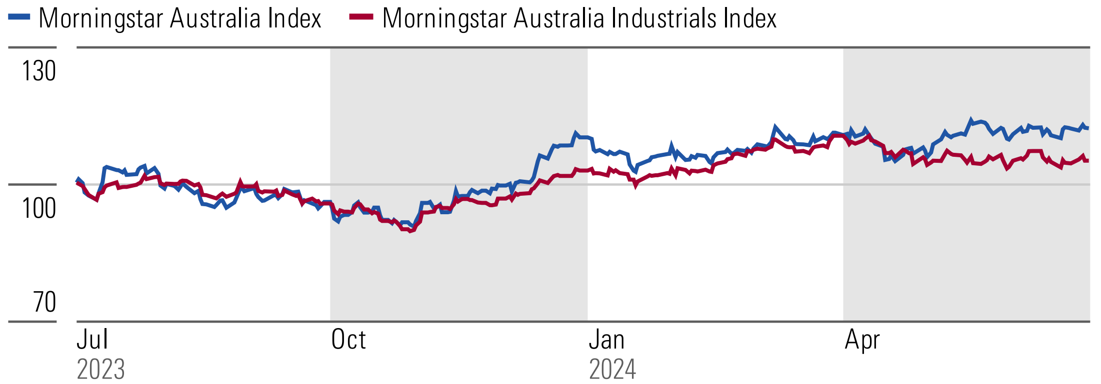
On average, industrials stocks are fairly valued, but some pockets of value remain, with about one third of our industrial coverage in 4-star territory.

This quarter, three industrial companies changed hands. Adbri and CSR sold to overseas building companies, and Boral was taken over by Seven Group. For investors looking for similar firms, wide-moat James Hardie is a good fit, although its earnings are mostly from the US, while Adbri, CSR, and Boral are mainly Australian.

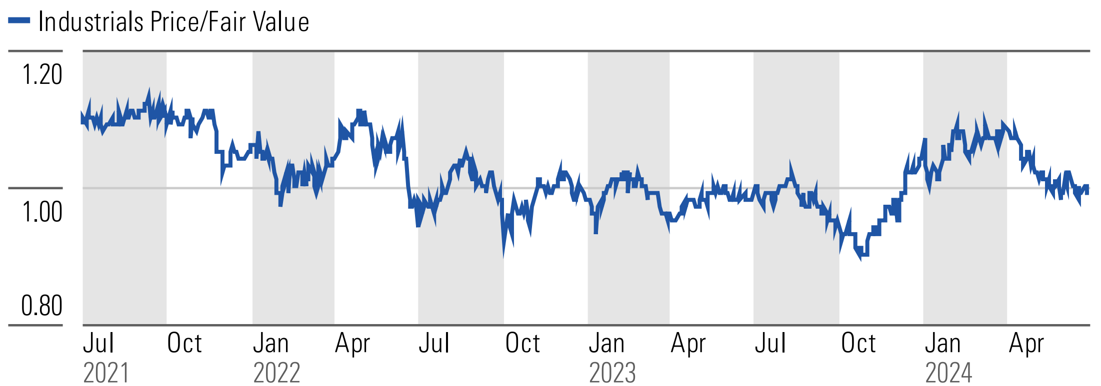
James Hardie is posting record sales, but we expect a subdued fiscal 2025 with high interest expenses and inflation causing US homeowners to delay discretionary house repairs and renovations. Longer term, we are optimistic about Hardie's outlook. Fiber cement has been gaining market share over lower-cost vinyl siding and is supported by aging North American houses, half of which are 40 years or older.

Qube is seeing healthy demand across most of its businesses. Solid population and economic growth bode well for its diversified logistics operations, but it is now fairly valued after a strong run. Aurizon is a better value, and also has a good outlook as coal exports recover and tariffs increase. Atlas Arteria's share price weakened after an election swing toward Marie Le Pen, who advocated for nationalizing toll roads in 2022. We're not too concerned as the roads are contractually protected, and we think that Atlas is now undervalued. Traffic volumes for Atlas and Transurban have been soft in recent quarters, hurt by economic headwinds and one-offs. However, tailwinds from population growth and mostly CPI-linked tolls support a solid longer-term outlook.

Industrial Sector Weakens Against the Index



Industrial Stocks Return to Fairly Valued After a Tumultuous Fiscal Year



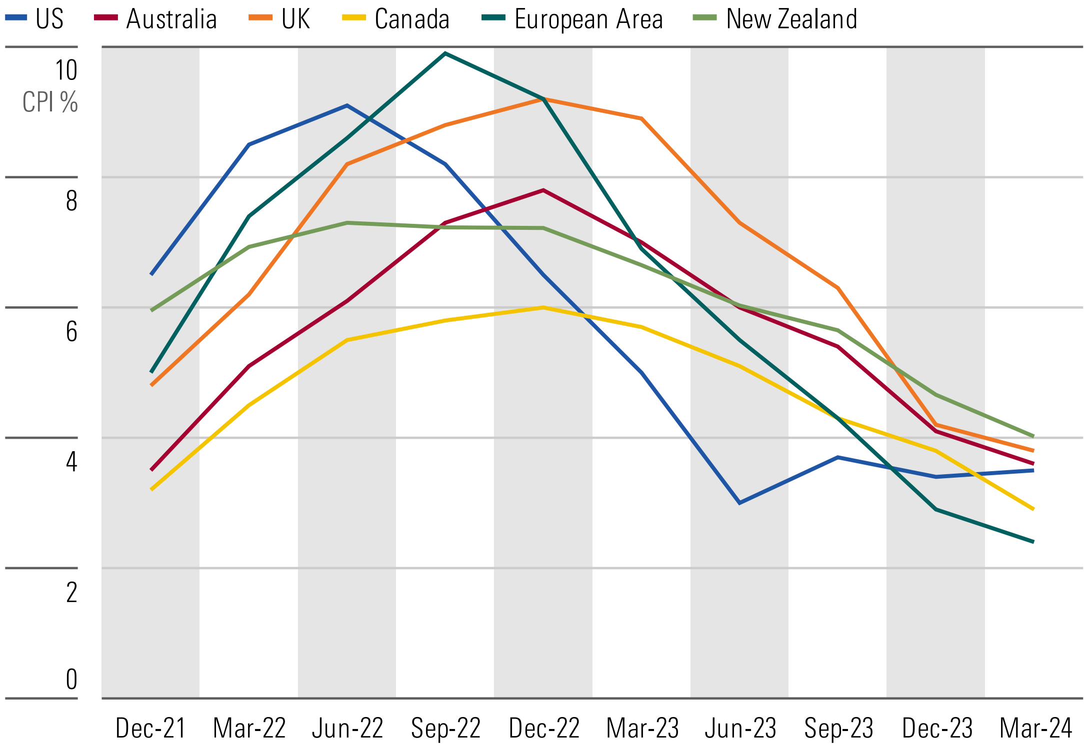
Source: Morningstar. Data as of June 28, 2024.

Industrial Stocks Bear the Brunt of Cyclical Demand

The Canadian and European Central Banks lowered cash rates by 0.25% in June 2024. In the US, UK, Australia, and New Zealand we expect an eventual reduction in inflation and cash rates to support a recovery in cyclical industrial stocks.

Consumer Price Inflation Generally Nearing Target Inflation Range

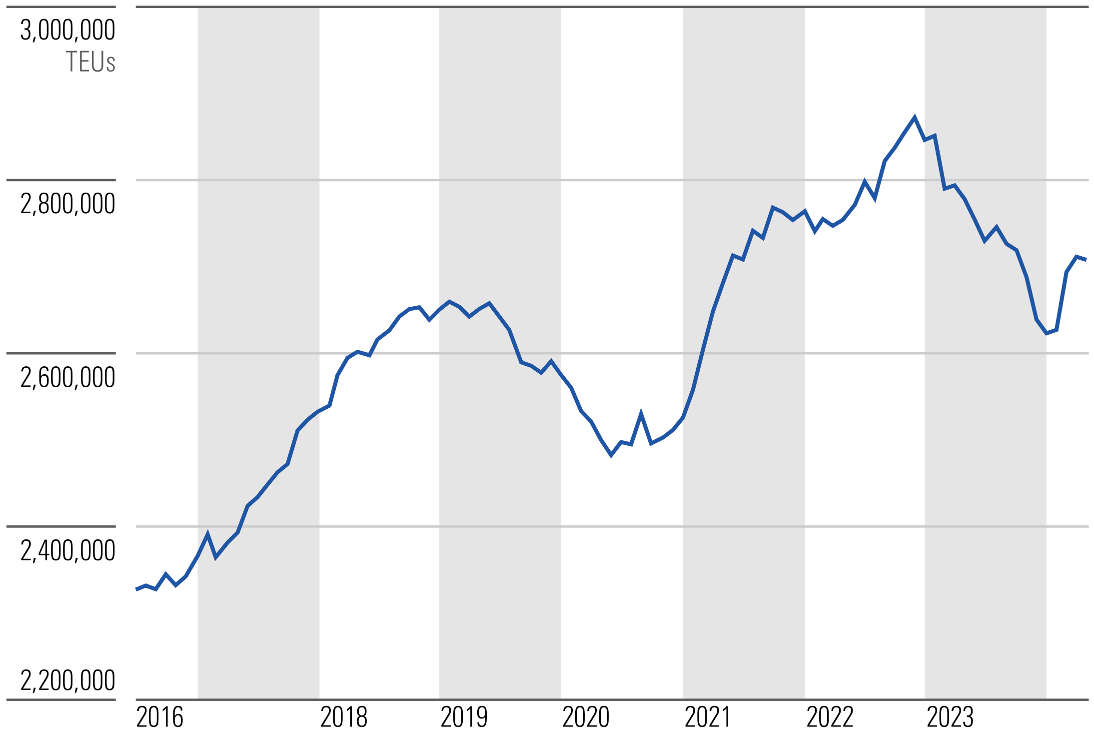
Consumer Price Inflation



Container imports remain fairly high despite tighter monetary policy and inflation hurting consumer sentiment. Population growth, economic growth, and offshoring of manufacturing support the long-term outlook.

Resilient Container Volumes Despite Cost-of-Living Pressures

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



Source: Government Statistics. Data as of Jun. 12, 2024 (left). NSW Ports. Data as of Apr.30, 2024 (right).

Industrials

Company (Ticker)		Rating	
Brambles (BXB)		★★★★	As the world's largest supplier of reusable wooden pallets, Brambles has close to a monopoly as a pooler in its main geographies. We believe this is due to its scale and first-mover advantage, limiting competition. This underpins a cost advantage, leading to our wide moat rating. Most of the firm's earnings are derived from large fast-moving consumer goods companies, which we consider mostly defensive, damping Brambles' correlation to the economic cycle. As such, we forecast steady revenue growth with a CAGR of 6% over the next decade. Earnings are further lifted by operating margin improvements, driven by the firm's efficiency projects in pallet repairs and transportation, and the integration of new digital technology.
Price	**Fair Value**	**Uncertainty**	
AUD 14.53	AUD 19.00	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 20.24	Wide	Exemplary	

Company (Ticker)		Rating	
Aurizon Holdings (AZJ)		★★★★	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 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 large-scale commercial alternative to coking coal for steelmaking is a long way off.
Price	**Fair Value**	**Uncertainty**	
AUD 3.65	AUD 4.70	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 6.72	Narrow	Standard	

Company (Ticker)		Rating	
Amcor (AMC)		★★★★	We think investors fail to appreciate the underlying defensiveness of Amcor's mainly food-and-beverage customer exposure. While our short-term outlook is for cyclically soft volumes, we are positive about the longer term. We expect the company to incrementally improve future returns on invested capital. This reflects strong single-digit organic sales growth through the reinvestment of free cash flows into emerging markets and higher-margin differentiated products. The Bemis deal in 2019 cemented the firm's position as the largest plastic packaging supplier in North America, with more than twice the market share than its nearest competitor.
Price	**Fair Value**	**Uncertainty**	
AUD 14.89	AUD 17.80	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 21.26	Narrow	Standard	

Source: Morningstar. Data as of June 28, 2024.

Real Estate

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A-REITs Look Undervalued, but We Prefer Names With Strong Balance Sheets

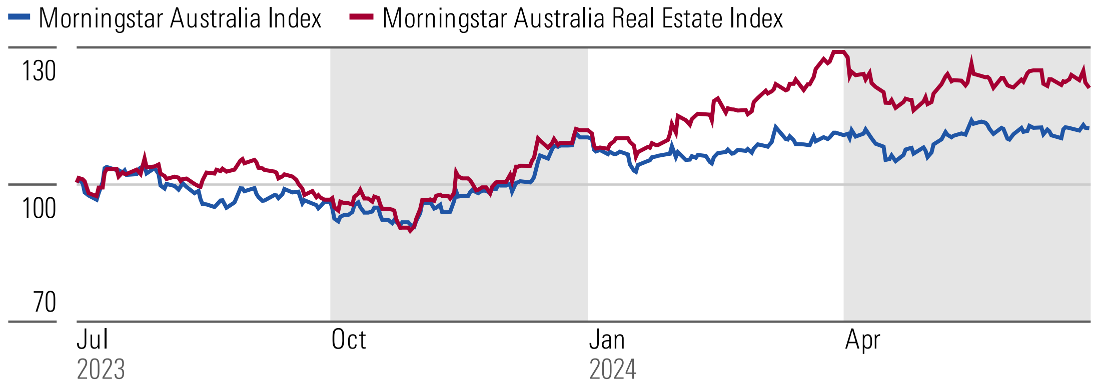
Despite recent interest-rate cuts in Canada and Europe, there is a growing view that rates may have to rise further in Australia to tame inflation. This contributed to a fall for A-REITs over the quarter, underperforming a flat stock market. Political pressure on recent rapid population growth may also have contributed. But even if politicians reduce inbound migration, population growth is likely to remain higher than pre-pandemic levels, supportive of real estate demand.

The real estate sector looks cheap, but rising finance costs means investors should focus on names with strong balance sheets and good quality portfolios. We don't see the need to play in overly-indebted REITs with lower quality assets.

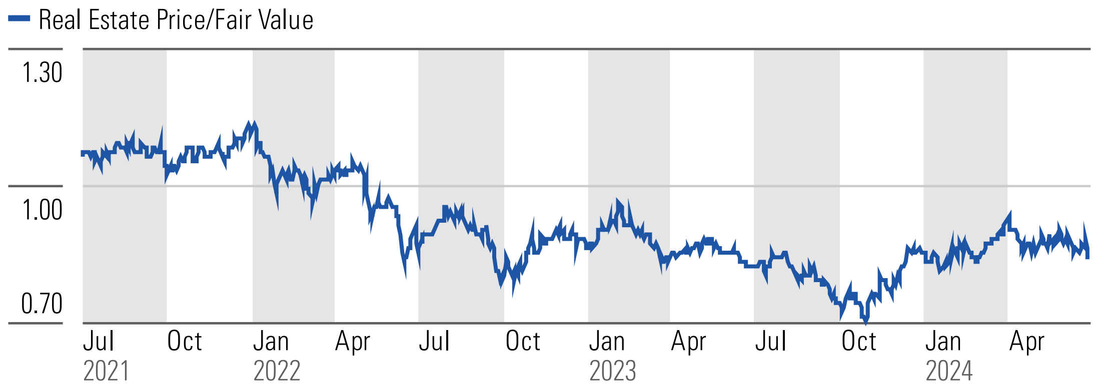
There appears to be substantial undervaluation even in large REITs with solid balance sheets. Dexus, GPT and Mirvac are undervalued. They are currently weighed down by weak conditions for office, but the situation should eventually improve for their mostly prime-grade office portfolios. New rival office supply looks constrained by construction and finance costs. Central business districts are likely to keep getting busier as major transport projects are completed, including Sydney Metro's opening in August 2024, Melbourne Metro Tunnel scheduled for 2025, and Brisbane Cross River Rail in 2026.

Retail conditions might worsen as consumers tighten their belts, but retail REITs have had more than two years of strong leasing conditions. We think that's helped REITs lock good tenants into attractive leases, mitigating downside risk of a retail slowdown. Vicinity Centres screens as undervalued and has a solid balance sheet.

Real Estate Declined Over the Quarter, Underperforming a Flat Market



Despite a Solid Rally Since October 2023, Real Estate Remains Undervalued



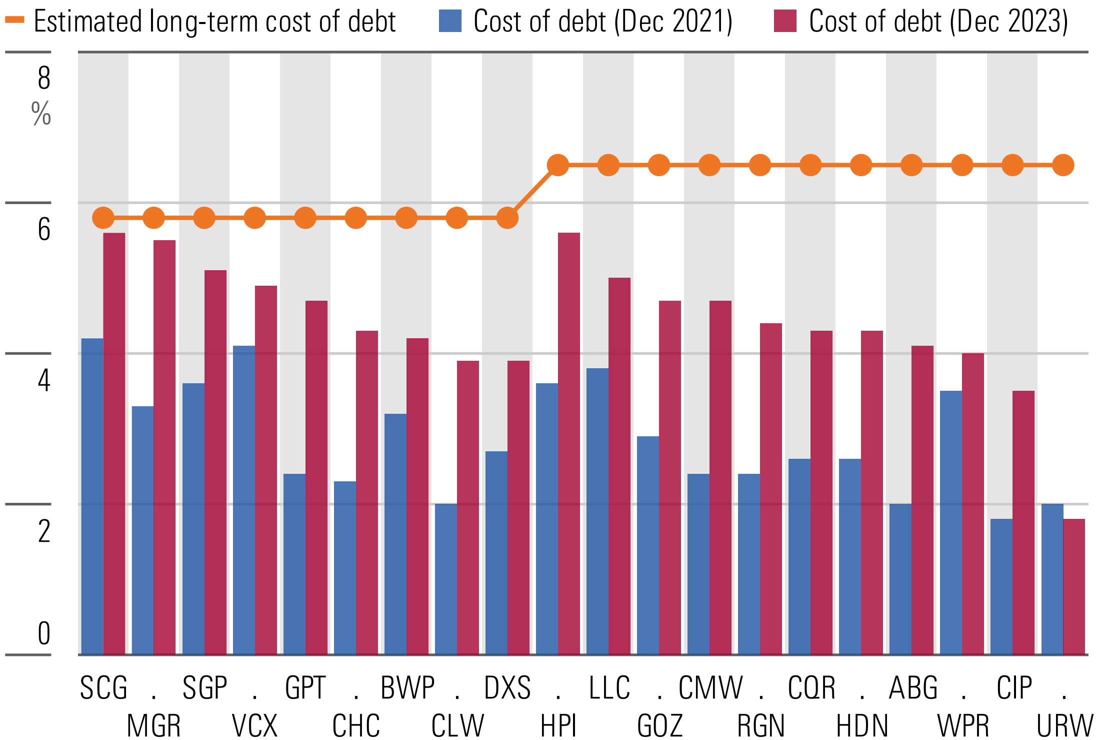
Source: Morningstar. Data as of June 28, 2024.

AREITs Look Undervalued, but We Prefer Names With Strong Balance Sheets

Some REITs have already seen finance costs rise to near our long-term estimates, while others still have a low cost of debt due to fixed-rate debt or hedges. As old debt or hedges expire and get refinanced, painful cost increases loom for Unibail, Centuria Industrial, Waypoint, Abacus, Charter Hall Long WALE REIT, and Dexus.

Debt Costs Still Rising; Looming Pain Will Vary Among REITs

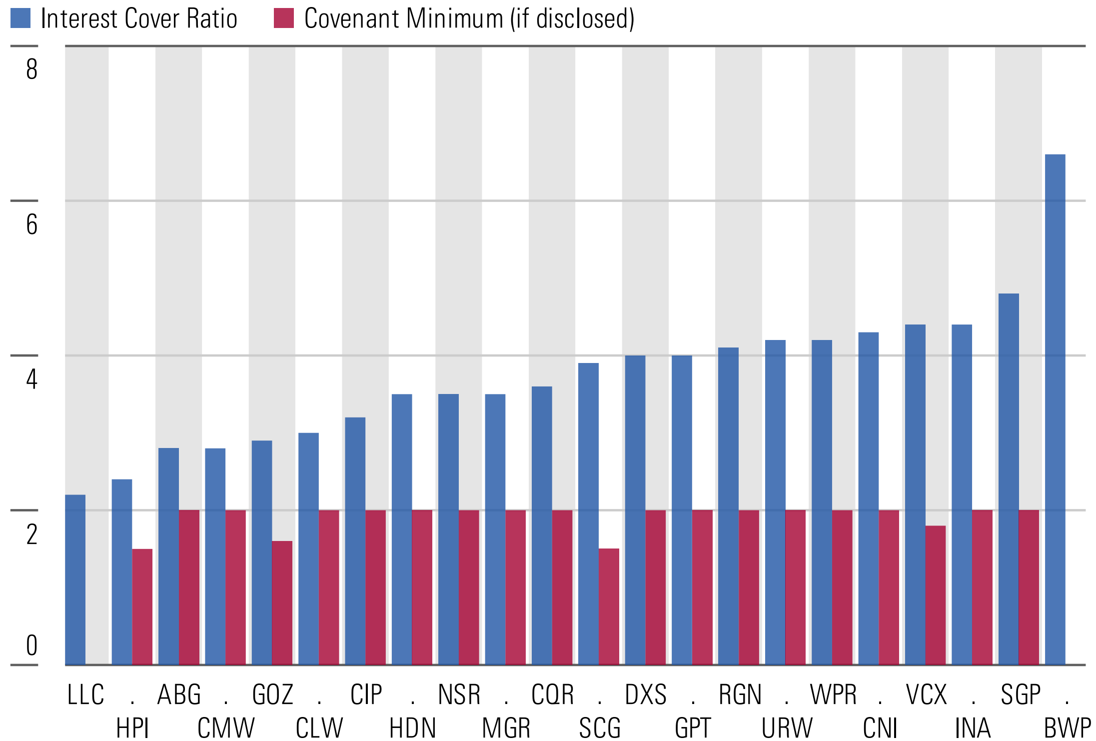
Recent debt costs, compared with 2021, and compared with our long-term estimates.



Most REITs have a decent buffer to banking covenants, but some are relatively close. Charter Hall Long WALE REIT, Cromwell, Lendlease, and Unibail are undertaking significant asset sales to reduce debt. Executing on debt reduction is critical for the most highly leveraged REITs.

Most REITs Have Buffers to Debt Covenants, but Some Are Too Close for Comfort

December 2023 interest cover-ratios compared with banking covenants.



Source: 2023 and 2021 finance costs, covenants and interest cover ratios sourced from company results presentations. Long-term estimated cost of debt sourced from Morningstar.

Real Estate

Company (Ticker) Dexus (DXS)		**Rating** ★★★★★
Price AUD 6.48	**Fair Value** AUD 10.80	**Uncertainty** Medium
Market Cap (bil) AUD 6.97	**Economic Moat** Narrow	**Capital Allocation** Standard

Dexus trades at a material discount to net tangible assets, which doesn't include the intangible value of the group's fund 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 fund management contributions to grow. Meanwhile, Dexus' office portfolio looks to be stabilizing with lockdowns in the 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 and are likely underappreciated by a market that views Dexus as purely an office play.

Company (Ticker) The GPT Group (GPT)		**Rating** ★★★★
Price AUD 4.00	**Fair Value** AUD 5.55	**Uncertainty** Medium
Market Cap (bil) AUD 7.66	**Economic Moat** None	**Capital Allocation** Standard

GPT Group offers a distribution yield comfortably above the current Australian 10-year bond yield. Tenant incentives such as fit-out payments are weighing on cash flow in the near term, but GPT's office occupancy stands at 92.3%, including nonbinding tenant agreements, up from 88.5% in June 2023. Its retail and industrial portfolios are nearly 100% occupied, with first-half rental growth strong. We believe GPT Group's industrial rents are below market, and in retail, GPT Group's centers achieved total sales growth of 11.8% in 2023, implying scope for more rent in both segments. Even GPT Group's city-retail assets appear to have recovered, with Melbourne Central 99.7% occupied and rents on new leases 5% above previous leases for the same space. GPT trades at about a 20% discount to net tangible assets of AUD 5.61 per security, which ignores the value of the fund management business. GPT increased funds under management to AUD 19.7 billion in December 2023, up from AUD 13.3 billion in 2019.

Company (Ticker) Charter Hall Group (CHC)		**Rating** ★★★★
Price AUD 11.18	**Fair Value** AUD 16.25	**Uncertainty** Medium
Market Cap (bil) AUD 5.29	**Economic Moat** Narrow	**Capital Allocation** Exemplary

We think Charter Hall securities extrapolate weak near-term operating conditions, but we think conditions will eventually improve. About 80% of Charter Hall's EBITDA comes from funds management, mainly in the form of base management fees, and performance and transaction fees. Higher interest rates hurt performance and transaction fees, which more than halved in fiscal 2023. However, recurring base management revenue increased by 20% and is about two thirds of Charter Hall's fund management revenue. Its development pipeline is likely to add to funds under management, and we expect Charter Hall to reap longer-term inflows given its strong track record, rising tax, and management complexity, and as international investors seek local expertise. Charter Hall has minimal debt on its own balance sheet. Look-though gearing—net debt/assets including debt in its funds—is higher at 34% and while tough conditions are likely to last a while yet, we think Charter Hall is well prepared.

Source: Morningstar. Data as of June 28, 2024.

Technology

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Shaun Ler | shaun.ler@morningstar.com

Artificial Intelligence Starting to Compete With Software—but Not in Australia

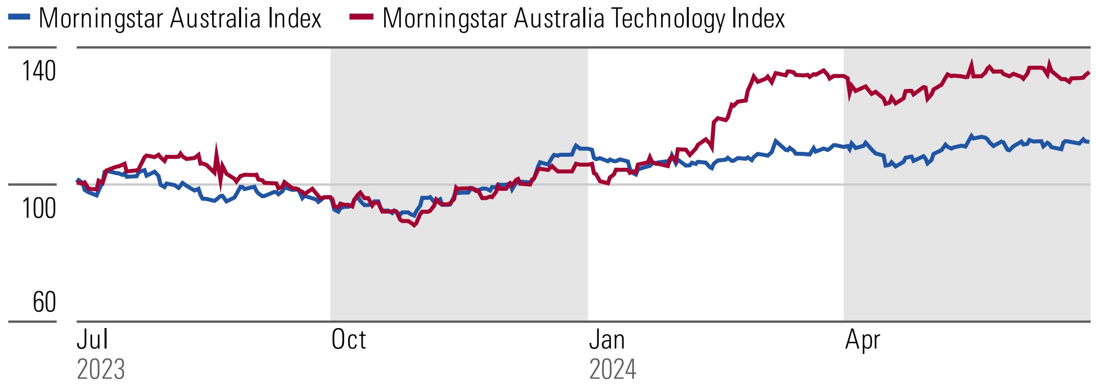
The Australian technology sector has performed well so far in 2024 and now screens as fairly valued, on average.

Software stocks in Australia have held up better than counterparts in the US, where some of the most well-known software companies sold off heavily after reporting earnings and a subdued outlook. This is on fears of investment into AI crowding out spending on software.

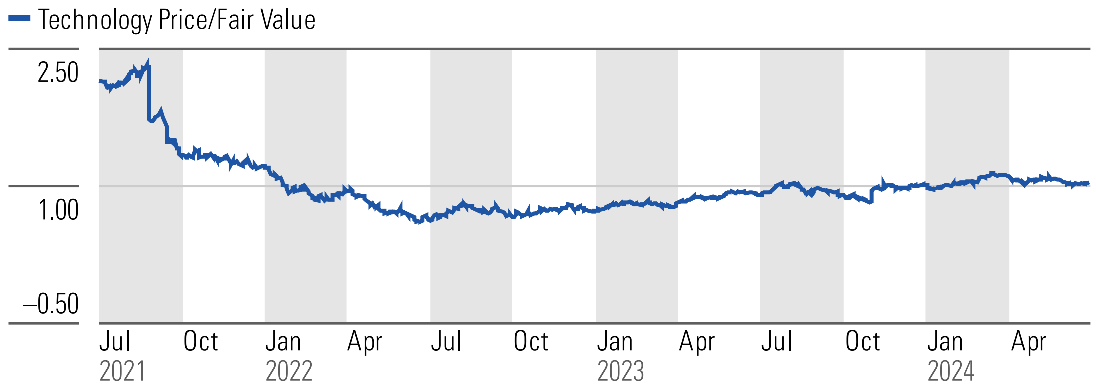
Potentially, the fact that few Australian software companies reported during the same period, due to our half-year reporting schedule, has shielded them from a similar selloff. But we don't expect the upcoming reporting season to mirror the US, either.

The primary reason is that, contrary to the US, most Australian software companies under our coverage are vertical software companies. This means they typically offer industry-specific software for which fewer competitors exist. For example, a generic ERP software provider faces far more competitors than a company like Technology One, which has carved out a niche in specific industries and geographies. Additionally, many of the companies under our coverage directly affect the core operations and performance of their customers, such as WiseTech's logistics software. We believe these attributes will shield the companies under our coverage from competition for budgets arising from AI investment, or experimentation.

Technology Sector Outperforming



Sector Screens as Fairly Valued



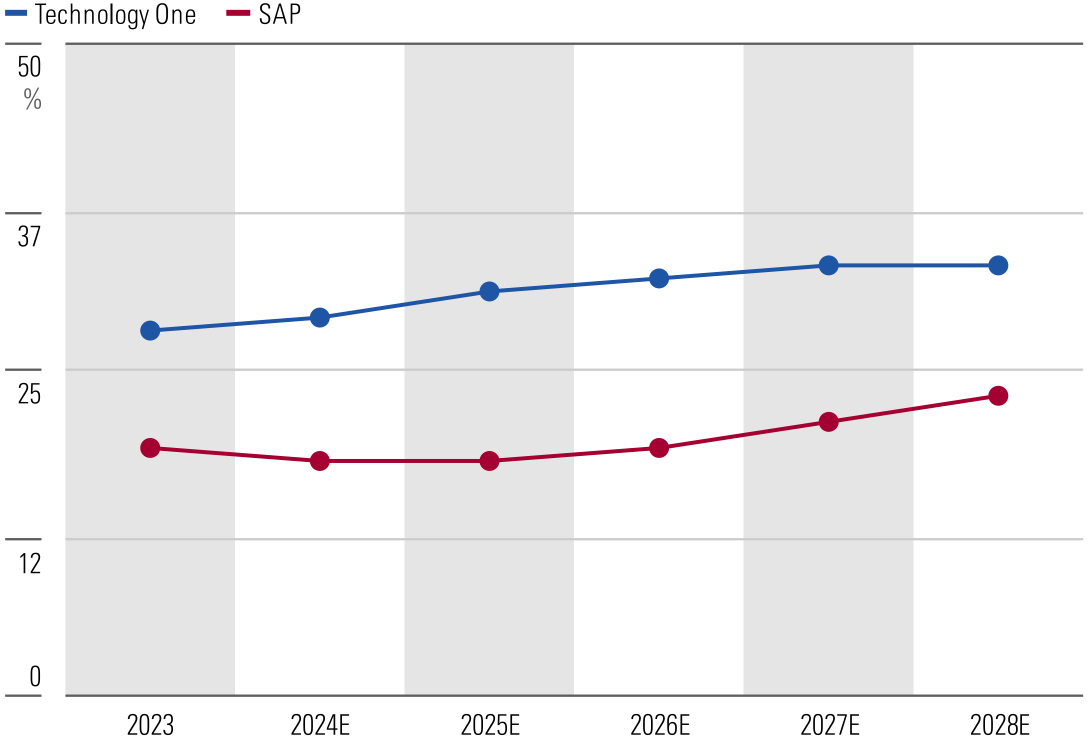
Artificial Intelligence Starting to Compete With Software—but Not in Australia

Technology One has carved out a niche and moat in ERP software in government and semigovernment institutions in Australia and New Zealand, while SAP operates globally and across industries, facing more competition.

Vertical software companies which drive the core performance of their customers, such as WiseTech and Altium, show higher margins than back-end vertical software, like Technology One, which hints at their less discretionary nature.

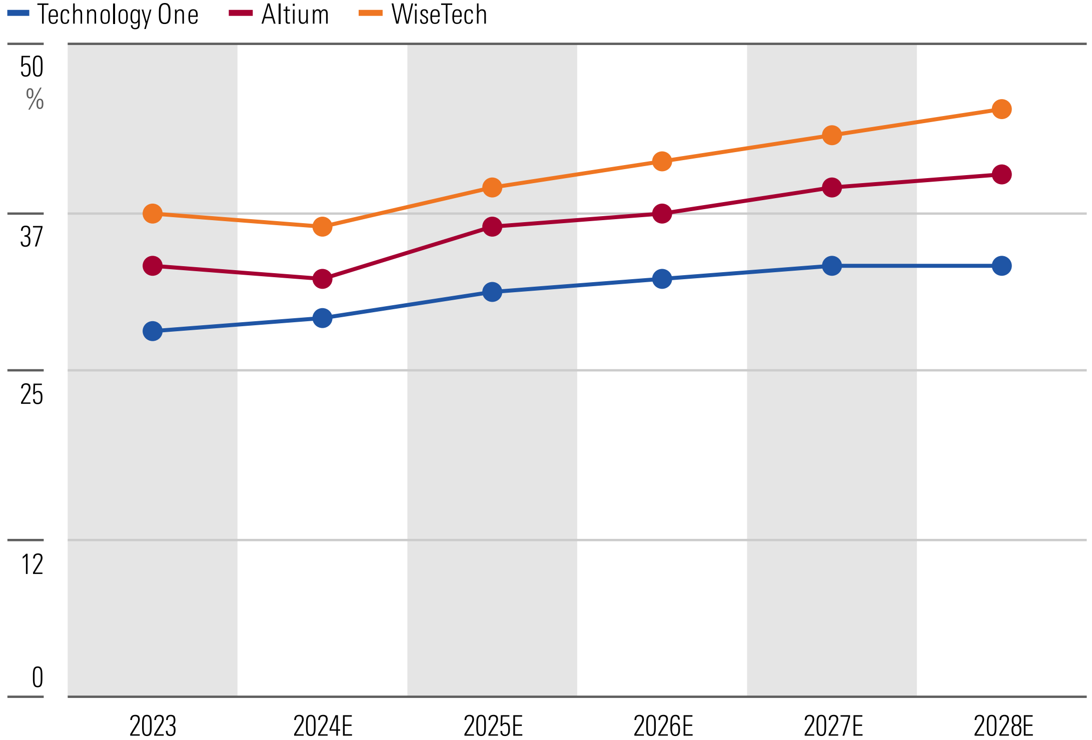
SAP Operating Margins to Decline, but Technology One Is Unaffected

Operating margins for ERP companies.



Better Margins for Software Companies That Drive Customer Performance

Operating margins for Australian usage-based vertical software companies.



Sources: Morningstar Equity Research. Note: Altium and WiseTech have June year ends, while Technology One has a September year end, and SAP has a December year end.

Technology

Company (Ticker)		Rating
SiteMinder (SDR)		★★★★★
Price	**Fair Value**	**Uncertainty**
AUD 5.09	AUD 10.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 1.42	Narrow	Exemplary

We believe Siteminder is an industry leader that is well positioned to win its large-market opportunity. We expect the channel manager industry to consolidate around scaled providers, like Siteminder, which can fractionalize large fixed technological and regulatory costs over a larger customer base. We also believe Siteminder's new Channels Plus product will help to evolve the company from a middleware software provider, where the company bears all the costs to create the value of its products, to a platform, where third parties also build some of the product value. We believe the market underestimates the adoption of Channels Plus and overestimates the strength of competitors.

Company (Ticker)		Rating
Fineos (FCL)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 1.69	AUD 3.10	Very High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 0.57	Wide	Standard

We believe wide-moat Fineos has investment merits not generally found within the broad band of profitless technology companies. Progression toward profitability is reaffirmed by its 2023 earnings results, which saw EBITDA turn positive from a previous loss. 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. Business reinvestments solidify switching costs with its sticky customer base, help win new business, and maintain its lead over would-be competitors. We anticipate share gains from more products per client, new clients, 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.

Company (Ticker)		Rating
Pexa Group (PXA)		★★★★
Price	**Fair Value**	**Uncertainty**
AUD 13.79	AUD 17.25	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
AUD 2.45	Wide	Exemplary

We believe the market is overly focused on wide-moat Pexa's costly expansion into the UK and overlooks the strength of Pexa's Australian exchange business. Pexa's Australian exchange business is demonstrating the potential for exceptional margins and profits, in line with other financial exchange businesses, such as the ASX. Moreover, this is becoming evident despite subdued property market turnover and elevated costs as the company develops and rolls out its exchange infrastructure across additional regions and use cases. We expect the UK business to either become profitable or be abandoned in the next few years.

Source: Morningstar. Data as of June 28, 2024.

Utilities

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Utilities Claw Back Some Underperformance With a Strong June Quarter

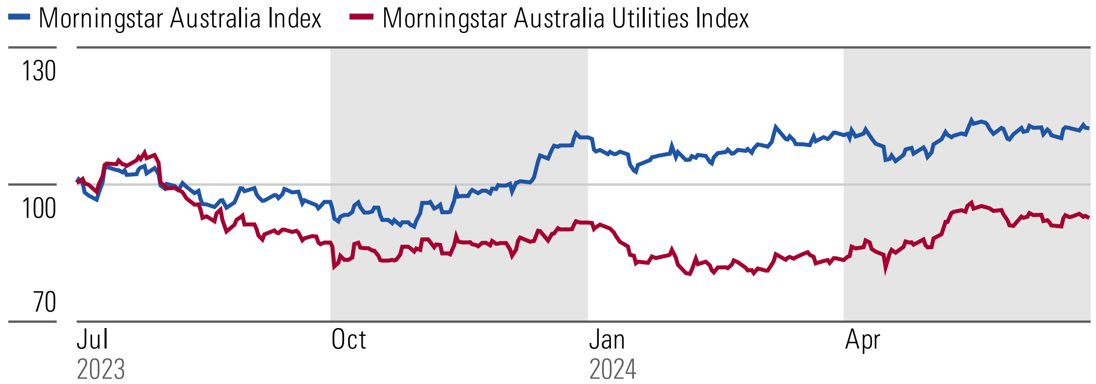
Australian utilities comfortably outperformed the broader market in the June quarter. Electricity futures prices for the next few years are up strongly across the East Coast, a boon for utilities that can continue to produce power cheaply. Wholesale electricity prices are even higher in New Zealand as gas supply issues curtail thermal generation. We think New Zealand-listed Manawa Energy is the cheapest, followed by APA Group and AGL Energy.

Australian wholesale electricity prices rose strongly in the past few months on subdued wind farm generation, unplanned outages at a couple of coal power stations, and fears of gas shortages in southern states. Baseload futures prices for 2025 are up 40% since the low in February 2024 in key markets of New South Wales and Victoria. If maintained for the medium term, which we think is likely, AGL Energy will be a big winner thanks to its large, low-cost coal power stations. High prices are needed to incentivize the massive investment needed for the transition to renewables.

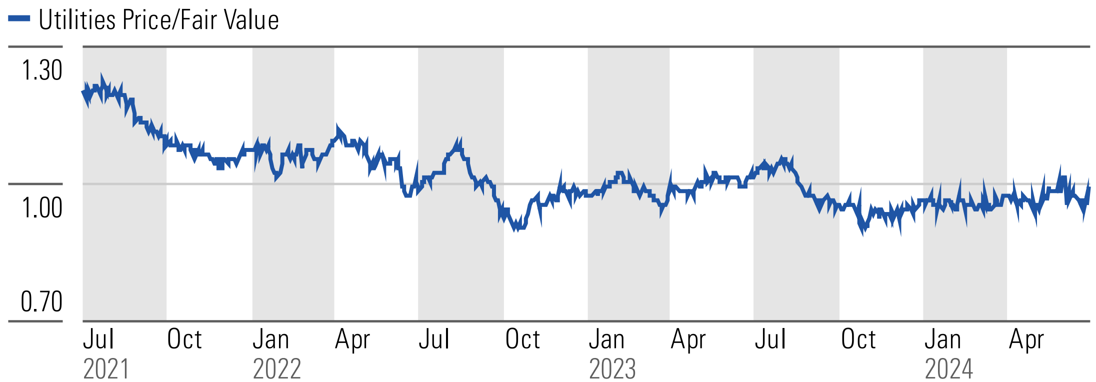
The outlook for New Zealand power producers further improved during the quarter. First, drilling at the Kupe oil and gas field failed to improve output, which is likely to limit output from gas-fired power stations. Second, the aluminum smelter agreed to stay for another 20 years, underpinning long-term electricity demand. Manawa is our top pick. It owns long-life hydroelectric power stations, and we expect strong earnings growth in the medium term as low-priced sales to Mercury NZ taper off.

Gas pipeline owner APA Group looks undervalued and should do well if bond yields fall as inflation moderates.

Australian Utilities Performance Improved in the Past Quarter



ANZ Utilities Are Fairly Valued on Average



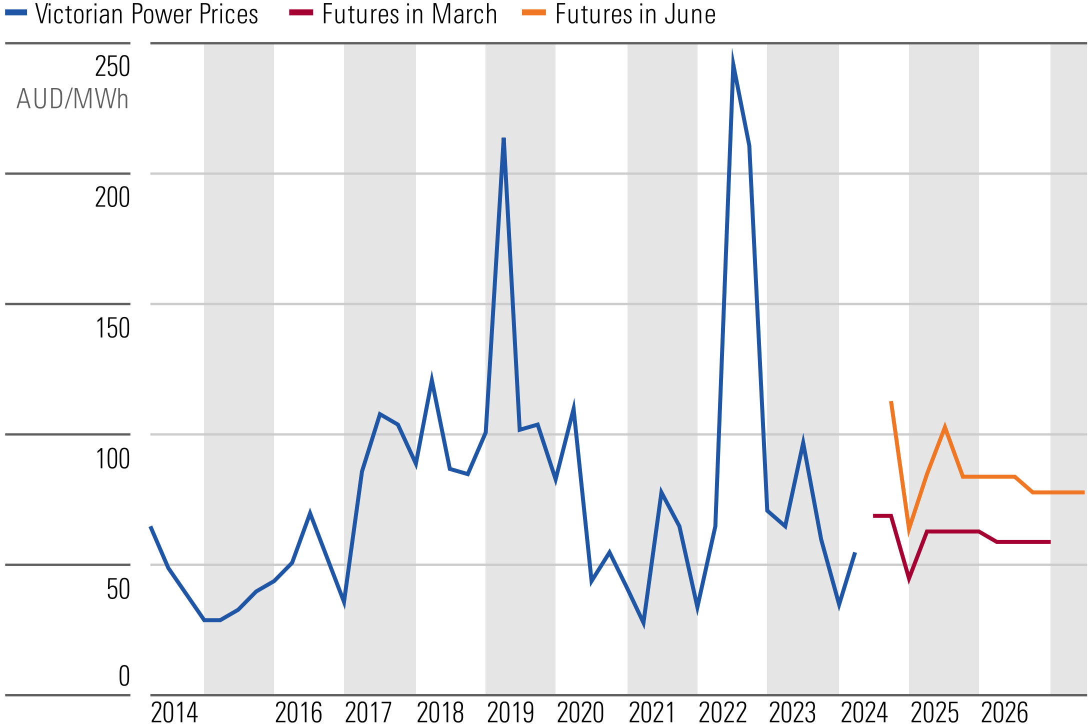
Utilities Claw Back Some Underperformance With a Strong June Quarter

Last quarter, we said electricity futures prices in Victoria were too low to incentivize the considerable investment needed for the renewable transition and were thus untenable. Prices have risen strongly since then, which bodes well for utilities, particularly AGL.

Australia's renewable energy rollout is behind schedule. High electricity prices are needed to justify investment in renewables to replace aging coal power stations. Remaining power stations should do well, particularly those with cheap fuel supply.

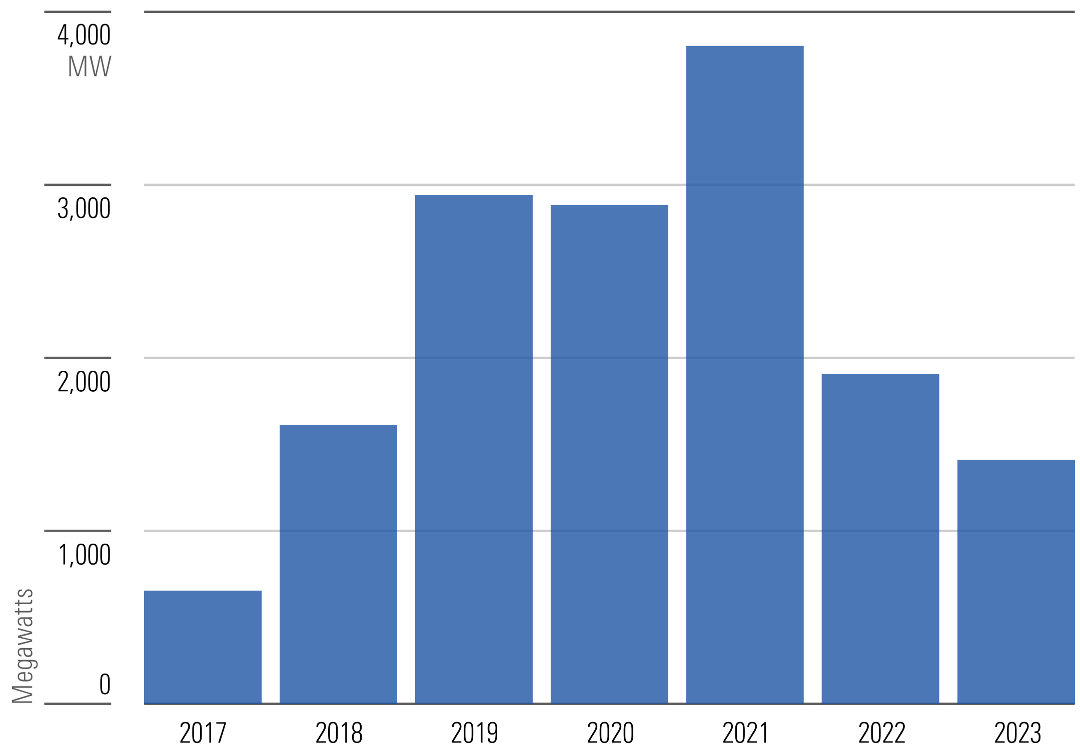
Higher Futures Prices Boost Outlook for AGL Energy

Victoria wholesale electricity prices (quarterly, AUD per megawatt hour).



Slowing Renewable Rollout Supports Electricity Prices

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



Source: Australian Energy Regulator, ASX Energy. Futures as of June 12, 2024 (left). Clean Energy Council (right).

Utilities

Company (Ticker)		Rating	
Manawa Energy (MNW-NZ)		★★★★	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 expand via wind and solar farm developments. It sells most of its power to Mercury NZ under long-term CPI-linked contracts, with earnings benefiting from elevated inflation. We also expect earnings to benefit from diverting more sales to tight wholesale markets as lower-priced contracted volumes progressively reduce in the medium term. The stock offers a decent yield, fully imputed for New Zealand residents.
Price	**Fair Value**	**Uncertainty**	
NZD 4.12	NZD 6.10	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
NZD 1.29	Narrow	Standard	
Company (Ticker)		**Rating**	
APA Group (APA)		★★★★	Narrow-moat APA Group is a good-quality company with an attractive yield. We expect near-term revenue growth to pick up 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 back up 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.
Price	**Fair Value**	**Uncertainty**	
AUD 7.99	AUD 9.30	Medium	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 10.25	Narrow	Poor	
Company (Ticker)		**Rating**	
AGL Energy (AGL)		★★★	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. Also, the planned early closure of coal power stations alleviates ESG concerns and allows 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 benefit earnings. Caps on domestic gas and coal prices have reduced electricity futures prices, but they're still conducive to a strong earnings rebound.
Price	**Fair Value**	**Uncertainty**	
AUD 10.83	AUD 11.50	High	
Market Cap (bil)	**Economic Moat**	**Capital Allocation**	
AUD 7.29	None	Poor	

Source: Morningstar. Data as of June 28, 2024.

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