MORNINGSTAR®

Australia and New Zealand Best Stock Ideas

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Morningstar's monthly Best Stock Ideas highlights high-quality Australian and New Zealand companies, which are currently trading at discounts to our assessed fair values. The ideas, chosen from our coverage universe of more than 200 companies, are intended to have broad application in a variety of equity strategies, but individuals should consider their personal investment goals and positioning before investing. We provide brief descriptions of each best idea in this report and encourage investors to read our most recent stock reports for a more detailed appraisal.

This month we have 10 companies in our Best Stock Ideas list. Since last month, we have added InvoCare, and removed Bapcor and Contact Energy from the list.

We are adding wide-moat-rated Invocare to our Best Ideas List, with its shares trading approximately 15% below our fair value estimate. The company is in the midst of a major reinvestment cycle that has resulted in temporary closure of a significant portion of its stores, resulting in a temporary dip in sales. However, this disruption is short term, and the medium- to long-term outlook remains positive. Upon completion of the current reinvestment program, the firm should be in a much stronger position to continue increasing its share of the steadily growing funeral services market. We view the recent sell-off as an opportunity to invest in a high-quality stock at a significant discount to our fair value estimate.

Upon reopening of the refurbished facilities, we expect high-single-digit earnings per share growth to resume and this pace to continue over the medium term. The key earnings drivers are 1%-2% growth in the annual death rate, incremental market share gains, and around 3% per year in price growth, slightly ahead of inflation. We forecast EBITDA margins averaging 28% during the next five years, compared with 25% during the past three years, which is mainly an outcome of operating leverage, favourable mix shift, and most notably the ongoing cost-cutting initiatives as part of the Protect and Grow project. The firm's competitive advantages stem from its intangible brand assets as well as cost advantage. We believe the strong branding, reputation, and in many cases regional monopolies will allow InvoCare to continue raising prices ahead of inflation while building on its leading one third share of the Australian market.

We are removing narrow-moat–rated Bapcor from the Best Ideas List. Following recent share price appreciation, the stock is now trading at close to our fair value estimate. Our investment thesis is unchanged, and we continue to believe the company has a strong earnings growth outlook, resilience to economic cyclicality, and a dominant competitive position in its core markets. An increasing pool of vehicles, which we expect to continue growing at around 2% per year, underpins underlying demand growth for Bapcor's products. In addition, consumers are inclined to prolong the life of an existing vehicle when times are tough rather than replace it with a new one, bolstering Bapcor's resilience to economic downturns.

The company's intangible assets and cost advantage, which are sourced from its extensive distribution reach and scale, underpin Bapcor's narrow economic moat. Bapcor's trade customers' main priorities are product range, part availability, fast delivery, and expertise of staff. With over 160 trade outlets conveniently located within 5 kilometres of each of Bapcor's 30,000-plus auto workshop customers, a product range exceeding 500,000 items, and a leading 30% market share, it is extremely difficult for smaller players to offer the same level of service.

We are removing narrow-moat-rated Contact Energy from our Best Ideas List as recent share price strength has narrowed the discount to our unchanged fair value estimate. Since we added it to the Best Ideas List, Contact has generated a total shareholder return of 12%, while the NZX50 index has appreciated just 3%. We continue to believe Contact is a good-quality company, with solid earnings growth potential from, among other things, normalisation of rainfall and cost-out initiatives.

Company Name	*Morningstar Analyst Rating*	*Fair Value (AUD)*	*Discount/ (Premium) to FV*	*Economic Moat*	*Uncertainty Rating*
Recent Additions					
InvoCare (IVC)	★★★★	15.50	15%	Wide	Medium
Recent Removals					
Bapcor (BAP)	★★★	7.00	4%	Narrow	Medium
Contact Energy (CEN-NZ)*	★★★★	6.20	7%	Narrow	Medium

*The data points are in New Zealand dollars.

Data as at 31 May 2018

Best Stock Ideas (as at 31 May 2018)

★ Denotes new entry to Best Stock Ideas

Code	Company Name	Market Price (AUD)	Fair Value Estimate (AUD)	Price/ Fair Value	Mkt Cap (AUD Billion)	Moat Rating	Fair Value Uncertainty	Forecast P/E	Forecast Yield (%)	Franked (%)	Morningstar Analyst Rating
AOG	Aveo Group	2.58	3.10	0.83	1.50	None	Medium	12.5	4.3	0	★★★★

Aveo's share price fell after negative media attention in June 2017, and we view the stock as undervalued, trading at a meaningful discount to our fair value estimate. Accusations raised by the media focused on legacy resident freehold contracts in villages that Aveo acquired in August 2016 and have no bearing on the remaining villages where residents stay under leasehold contracts. The long-term fundamentals of Aveo's business are ostensibly unchanged, with the firm well positioned to benefit from the ageing Australian population, driving demand for retirement living units and serviced apartments. Compared with 2017, the number of people turning 75 will be up 14% in 2019 and up 49% in 2022. Aveo continues its high-growth strategy of upgrading legacy units and adding to resident amenities. The firm estimates it can deliver AUD 0.90 in book value accretion to the portfolio from these initiatives over the next three years.

Aveo's reputation has been tarnished, but by no means as much as the share price would imply, in our view. Around 60% of Aveo's annual earnings is unaffected, representing accrued earnings on resident deferred fee contracts entered into roughly 10 years prior. As such, near-term earnings risk centres on a slower sales rate for units being turned over or newly developed units. Aveo is tackling this risk head-on by significantly increasing buying protection on its standard leasehold contracts. Standard contracts now incorporate a try-before-you-buy option, enabling residents to stay for six months before committing to purchase. We believe this increased buyer protection plus guaranteed buyback when a resident departs, simplified contract terms, and enhanced disclosure will significantly allay residual concerns of prospective buyers without significant long-term cost to Aveo. (Tony Sherlock)

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BXB	Brambles Limited	9.03	11.20	0.81	14.38	Wide	Medium	17.1	3.2	27.5	★★★★

Wide-moat-rated Brambles remains undervalued, in our opinion, trading at a nearly 20% discount to our fair value estimate. We believe the market is concerned about the sustainability of pallet growth and the Brambles business model, given the growth of e-commerce, and particularly Amazon. We do not expect e-commerce to halt pallet growth and see these concerns as misplaced. Providing support to this view, the firm noted at its recent analyst day that all new major online fresh produce retailers are beginning to work with IFCO's reusable plastic crates, which should help the segment capture market share.

In our view, investors are underestimating Brambles' earnings leverage to U.S. growth, the associated benefits of higher pallet flows from emerging markets, and further consolidation. In the short term, we expect new management to address recent underperformance in the U.S. pallet segment, which accounts for more than 40% of earnings, by strengthening key retail relationships, reducing damage rates, and lifting service levels. We expect these moves to entrench Brambles' dominant market share of 40%, which eclipses the 7% share of number-two player Peco, while investment in more automation should also help to improve margins in this geography over the next several years.

In all, we forecast an EPS compound annual growth rate of 9.5% and average returns on invested capital of 14% for the next five years. (Adam Fleck)

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DMP	Domino's Pizza Enterprises Limited	49.23	53.00	0.93	4.20	Narrow	Medium	32.6	2.1	50	★★★★

The discount at which narrow-moat Domino's shares trade to our fair value estimate provides an opportunity for long-term investors to gain exposure to a high-quality growth stock with good geographic diversification. We estimate long-term store counts in Australia, Europe, and Japan to equate to an average capita per store of 28,000, 70,000, and 146,000, respectively. Our Australian forecast is the most aggressive, albeit achievable, in our view. The average Australian household has 2.6 persons, equating to a long-term penetration of one Domino's pizza outlet per 11,000 Australian households. This is comfortably above the minimum 3,000 households that we understand are required to underpin a store's profitability. Although not immune to aggregators such as Uber Eats and Menulog, Domino's has a strong online presence and competes effectively with other takeaway operators, especially on delivery times. In Australia, the firm's e-commerce channel accounts for over 70% of sales, representing an impressive 3% of total Australian online sales across all retail categories. Domino's continues to develop its digital platform, which is driving online sales in all countries. Further, the company is undertaking a share buyback worth as much as AUD 300 million, which we believe is solid capital allocation, given that the shares trade below our fair value estimate. (Johannes Faul)

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GEM	G8 Education Limited	2.49	4.00	0.62	1.13	None	High	13.2	7.8	100	★★★★

G8 Education shares are trading significantly below our AUD 4 fair value estimate. A short-term oversupply of childcare centres in Australia has driven a share price slump; however, we believe the current share price reflects a market overreaction and that supply challenges are a cyclical rather than a structural problem. Population growth and growing female workforce participation underpin demand for childcare, an essential service, and we expect the July introduction of the childcare subsidy to boost demand further. Although G8 is experiencing weakening occupancy rates currently, and its lack of an economic moat means the company is vulnerable to competitive pressures, we expect the demand tailwind to boost occupancy rates over the next two years. G8's balance sheet is in good shape following the debt refinancing and reduction in 2017, with the net debt/EBITDA ratio at a comfortable 1.5 as of Dec. 31, 2017. A further AUD 200 million in undrawn debt facilities that mature in August 2020 also provides refinancing support for the current net debt of around AUD 200 million, which mainly matures in May.

G8 is a relatively capital-light business that enables regular fully franked dividend payments at a high payout ratio. However, a temporary suspension of the dividend could be used to strengthen the balance sheet if required. At the current market price of AUD 2.20 per share, G8 trades on a price/earnings ratio of just 11, which we think is cheap, especially as we expect EPS to grow with occupancy improvement and growth in the size of the childcare centre portfolio. In early 2017 listed Chinese investor China First Capital Group invested AUD 96 million in G8 Equity at AUD 3.88 per share, and the recent weakness in the G8 share price and CFCG share price strength may encourage the Chinese childcare group to invest more in the company and provide a catalyst to narrowing the price/fair value discount. (Gareth James)

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★	IVC	InvoCare Limited	13.20	15.50	0.85	1.45	Wide	Medium	23.5	3.4	100	★★★★

We are adding wide-moat-rated Invocare to our Best Ideas List, with its shares trading approximately 15% below our fair value estimate. The company is in the midst of a major reinvestment cycle that has resulted in temporary closure of a significant portion of its stores, resulting in a temporary dip in sales. However, this disruption is short term, and the medium- to long-term outlook remains positive. Upon completion of the current reinvestment program, the firm should be in a much stronger position to continue increasing its share of the steadily growing funeral services market. We view the recent sell-off as an opportunity to invest in a high-quality stock at a significant discount to our fair value estimate.

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MYO	MYOB Group Limited	2.81	4.05	0.69	1.68	Narrow	Medium	16.4	4.0	0	★★★★

Narrow-moat-rated accounting software firm MYOB trades at a material discount to our fair value estimate, providing investors with an attractive entry point to a high-quality and well-established Australian software company. We believe the market is preoccupied with Bain Capital's planned sell-down of its relatively large shareholding and ignoring the progress being made with the underlying business. Although the company was slow to respond to the emergence of cloud-based software as a service, it is now quickly transitioning its customers to lucrative cloud-based subscription contracts and defending its strong position in the Australian and New Zealand marketplace. MYOB unfairly remains in Xero's shadow in the eyes of investors as its New Zealand-based competitor has grown more quickly, albeit off a low base, and is building a global business in contrast to MYOB's regional business. However, we are reassured by MYOB's existing profits at a time when profit is almost a dirty word in the software sector. We also applaud management's connected practice strategy, which essentially means creating a platform across which businesses, customers, advisors, and regulators can interact. Features such as Pay Super, PayDirect, and smart bills are also increasing customer switching costs--the source of the company's economic moat--and retention rates. The Paycorp acquisition in particular significantly increases MYOB's total addressable market and provides a relatively straightforward and logical cross-sell to existing clients. We expect the recently announced acquisition of Reckon's accounting practice business to strengthen MYOB's competitive position. (Gareth James)

QBE	QBE Insurance Group Limited	9.48	13.00	0.73	12.86	Narrow	High	13.4	4.7	30	★★★★

Narrow-moat QBE Insurance's restructuring and rebuilding continues with the announcement of another round of senior management changes. Our regular post-result catch-up with management reinforced the changes afoot at the troubled insurer. Despite challenges, our AUD 13 fair value estimate is unchanged. New CEO Pat Regan has only one shot at invigorating the diverse global general insurer after many years of disappointments, and early changes across the organization make his intentions clear. He is stamping his authority, reinforcing that the old way of running the business is unacceptable. The new way is based on achieving rigorous financial hurdles, high levels of management accountability, and aggressively improving underwriting discipline at the expense of top-line growth.

We have been overconfident on the recovery of QBE, and the next one to two years will determine the long-term fate of the group. Turning the business around requires insurance portfolio reshaping, cost-cutting, tightened underwriting standards, and greater accountability across the group. Shareholders should be rewarded with the share price expected to increase, closing the current 27% gap to fair value. If the restructuring and reshaping does not deliver the goods, QBE will be an easy takeover target for a global insurer looking to expand in key areas of Europe, Australia/New Zealand, and Asia-Pacific. It will be at least 12 months before improvements flow through to published financial accounts. We expect to see some type of nonquantifiable scorecard at half-year results in August, with quantifiable measures likely to be released at the 2018 results in February 2019. (David Ellis)

RHC	Ramsay Health Care Limited	61.33	82.00	0.75	12.39	Narrow	Medium	21.5	2.4	100	★★★★

Narrow-moat Ramsay Health Care is a global hospital group operating 223 hospitals and day surgery facilities across Australia, the United Kingdom, France, Indonesia, and Malaysia. It is also the largest and most diversified operator of hospitals in the Australian private sector. The scale of Ramsay's operations in the Australian context underpins, in our opinion, a sustainable competitive advantage that drives both cost advantage and a reasonable level of pricing power in negotiations with private health insurers. Unlike the U.S., the Australian healthcare system relies on a unique blend of public and private service, most evident in the symbiotic relationship between private hospital operators and the private health insurance industry. Beyond the relatively benign reforms of prosthesis pricing recently, we believe government policies designed to support private health insurance membership, combined with current inefficiencies of the public hospital system, protect private hospitals from major funding related disruptions. We think Ramsay's move into community pharmacy is complementary to acute treatment settings and extends the company's reach into chronic disease management; this is a growing area, given the ageing demographic. We also think Ramsay's centralised procurement strategy leveraging global purchasing power of the group bodes well for margin expansion. (Chris Kallos)

TLS	Telstra Corporation Limited	2.80	4.40	0.64	33.30	Narrow	Medium	10.2	7.9	100	★★★★★

Shares in narrow-moat Telstra are trading at an attractive discount to our fair value estimate, with investors preoccupied with a number of risks facing the group. First, competition is intensifying in the Australian telecom space across all segments. However, we believe Telstra boasts the strength to compete, given a sustainable cost advantage from unrivalled scale, infrastructure footprint, and consistent capital spending to maintain this competitive edge. Second, at the current price, the market is assuming that Telstra fails to plug the AUD 3 billion EBITDA hole from the National Broadband Network. This is an excessively bearish view, given the group's competitive position, its solid record of replacing lost earnings over the past decade and the significant room for cost cuts/productivity gains. Our intrinsic assessment assumes that Telstra replaces more than AUD 2 billion of the NBN-inflicted earnings hole. Third, while the impending entry of TPG Telecom as a fourth player in the Australian mobile market will reduce Telstra's dominance, we see the overall impact on group earnings as less than 10%, given the likely inferiority of TPG's network in terms of quality and coverage. Finally, we think the recently lowered dividend payout is sustainable, providing investors with an attractive 7%-plus fully franked yield at current prices, especially with a conservative leverage ratio of 1.6 times. If Telstra decides to cut dividends further as a matter of prudence, the flexibility this will provide should further strengthen the group's ability to compete. As such, we view the risks facing Telstra as more than reflected in the current stock price, trading at 10 times forward EPS and 5 times EBITDA. (Brian Han)

WBC	Westpac Banking Corporation	27.85	35.00	0.80	95.34	Wide	Medium	11.3	6.8	100	★★★★

Wide-moat-rated Westpac Banking Corporation is our preferred Australian major bank due to stronger-than-peer-group earnings growth forecasts, best-in-peer-group operational efficiency, impressive returns on equity, stable senior management, a strong risk management record, and an Exemplary stewardship rating. We like its record of discipline around cost control, risk management, net interest margins, and shareholder returns. Continued focus on productivity improvement and sustainable growth without the distractions of exiting underperforming legacy assets supports steady but sustainable EPS growth.

We expect underlying growth in risk-weighted assets to be modest and, combined with strong profitability and benign credit quality, we expect sustainable but modest growth in the fully franked dividend to be maintained. We forecast average dividend growth of 2% during the next five years with the payout forecast to decline to 74% in fiscal 2022 from 78% in fiscal 2017. Capital levels continue to build, and we anticipate no problems achieving the regulator's definition of "unquestionably strong" by the January 2020 deadline. We expect fully franked special dividends to start by fiscal 2019. Medium term, we expect modest economic growth in Australia with real GDP growth of 2.5%-3.0% per year continuing to support modestly positive operating conditions for the major banks. Forecast nominal GDP growth of 4.0%-4.5% per year underpins our credit growth assumptions. Solid employment growth and a slow and steady increase in interest rates should keep loan losses close to historical lows. (David Ellis)