Research Highlights

A weekly summary of our best ideas and developments in the companies we cover.

Morningstar Equity Research
June 25-29, 2018

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Online
Interactive web-based models are available for our Best Ideas at Trefis.

Strong Moats in CAD, PLM, and IoT

We believe that strong economic moats characterize the computer-aided design, or CAD; product life cycle management, or PLM; simulation; and Internet of Things, or IoT, software markets. Combined, these four disciplines improve product design and product management for users that are under constant pressure to innovate, improve their time to market, and deliver high-quality products and experiences. Based on high customer switching costs and network effects, we assign wide economic moats to Autodesk and Dassault, and narrow economic moats to Ansys and PTC. Rosy fundamentals underlie a healthy outlook for all four software vendors noted in this report, and from an industry standpoint, we think the CAD and PLM markets will grow at a 6%-7% CAGR over the next five years, while simulation will grow 8%-10%, and IoT software around 30%-40%. In addition, we see company-specific factors such as software vendor consolidation, cloud technology, and subscription model changes that will aid good financial performance.

Still, we think the market is too bullish and see the space as overvalued. With current multiples reflecting times not seen since the dot-com bubble of the late nineties and early 2000s, we would need to see notable pullbacks before considering any vendor for investment. Even after adjusting for a better long-term outlook and recently revised fair value estimates for each company, these firms trade in either 1-star or 2-star territory. Upon an industry correction, however, we think investors should be most opportunistic in accumulating positions of relatively less expensive 2-star Autodesk and PTC, which trade at price/fair value ratios of 1.22 and 1.41, respectively.

- Throughout the CAD, PLM, and simulation industries, we find high customer switching costs and network effects. We believe that these moat sources result in either wide or narrow economic moats, which makes these industries attractive for technology investors looking for relatively stable competitive positions and reliable financial performance. We assign wide economic moats to Autodesk and Dassault, and narrow economic moats to Ansys and PTC.
- Although Autodesk and Dassault have been awarded wide economic moat ratings, we are hesitant to award such a distinction to Ansys or PTC. Our narrow economic moat outlook for both Ansys and PTC is based on the fact that they remain subscale relative to well-resourced peers such as Autodesk and Dassault, and they are highly concentrated in specific, niche markets.
- We see Autodesk and Dassault as having strong positions in the CAD market (29% and 22% market share, respectively), Dassault as strong in the PLM market (31% market share), Ansys as strong in the simulation market (24% market share), and PTC as strong in the IoT market (regarded as having a leadership position in IoT by numerous third-party research providers).

- From an industry standpoint, we think the CAD and PLM markets will grow at a 6%-7% CAGR over the next five years, simulation will grow 8%-10%, and IoT software around 30%-40%.
- We believe the CAD, PLM, and simulation markets will be characterized by ongoing vendor consolidation, given the fragmented nature of these markets. This will benefit the largest vendors that have the most capital to invest as the strong get stronger
- We think cloud computing and transitions toward subscription-based pricing models are a boon for software firms like Autodesk, Ansys, Dassault, and PTC, mitigating customer upgrade risk and piracy while providing better lifetime customer economics.
- With a notably different pricing opinion on these stocks, we don't believe we're miscalculating the overall story of this industry, nor do we claim to be overly bearish. Our financial expectations for these companies incorporate overall rosy growth conditions, while including the shift to subscription for both Autodesk and PTC. Notably, multiples implied in today's stock prices haven't been seen since the dot-com bubble of the late nineties and early 2000s.
- For Ansys to achieve a $182 fair value estimate in our model (assuming our margin outlook is unchanged, as per management's expectation), the company's five-year projected revenue CAGR would have to be about 23%, which is way beyond what we think is a reasonable estimate (our current forecast is 10.2%).
- For Dassault to achieve a EUR 123 fair value estimate in our model (assuming our margin outlook remains unchanged), the company's five-year projected revenue CAGR would have to be about 21% (our current forecast is 8.7%).
- In an industry notably devoid of discounted entry points, we think investors should look for rare instances of pullbacks to buy when prices get modestly below fair value, rather than steep discounts. Autodesk and PTC are the least expensive stocks with price/fair value ratios of 1.22 and 1.41, respectively, and we think investors should be most opportunistic in accumulating positions of these two firms.
- At price/fair value ratios of 1.58 and 1.52 for Ansys and Dassault, respectively, we'd need to see very considerable declines before even considering these two stocks for investment.

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Buffett Should Take Another Look at Utilities

In 2017, we warned the Oracle of Omaha against buying utilities, as valuations were climbing. Berkshire Hathaway attempted a rich deal for Oncor in July 2017, but ceded as its offer was bested by Sempra Energy. Utilities peaked at 18% overvalued in November but now trade in line with our fair value estimates, as the jump in interest rates led to utilities selling off and improving fundamentals lifted our valuations. Unlike in 2017, we think now is a much more opportune time for Berkshire to add to its utilities portfolio.

At Berkshire's annual meeting this year, we questioned what BHE would do once it pulled back from its currently heavy capital investment in renewables—send the excess capital up to the parent company, or explore other investments? CEO Warren Buffett and vice-chairman Charlie Munger were adamant that BHE would not make cash distributions to Berkshire, believing there would be plenty of opportunities ahead for the subsidiary to "deploy capital intelligently in energy."

We think BHE's cash flows can easily support its $16 billion three-year capital plan and a $10 billion-plus acquisition during the next several years. If Berkshire adds some of its own cash, we could see an acquisition reach $20 billion.

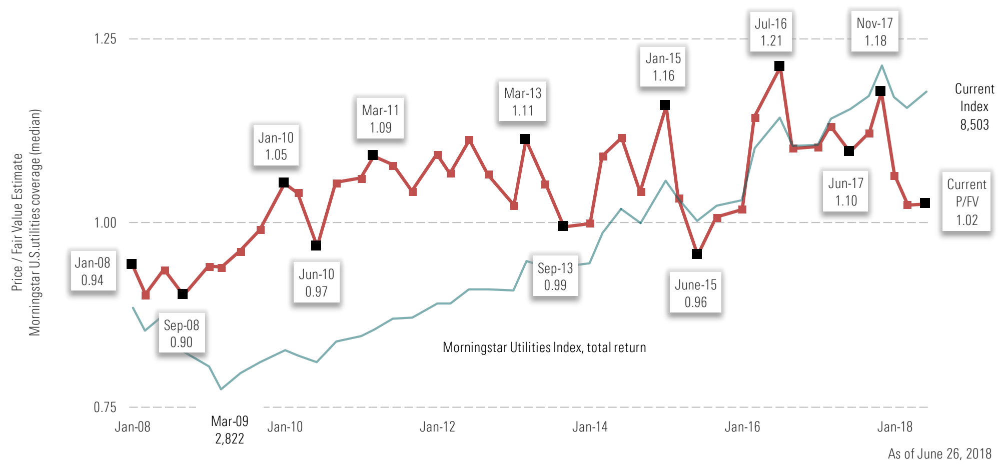
- **Valuation:** The recent utilities sector sell-off creates a rare opportunity for Berkshire to revisit opportunities to add to its utilities portfolio. Utilities peaked at 18% overvalued in November but now trade near fair value, equally attributed to the market sell-off and fair value increases.
- **Top targets:** We rank acquisition candidates on six attributes: 1) valuation, 2) growth, 3) renewable energy portfolio, 4) management, 5) operating efficiency potential, and 6) regulatory environment. We believe Alliant Energy is an ideal fit for Berkshire, with its long runway of renewable energy growth.
- **Other possible targets:** We think PPL could be tempting for Berkshire. Unlike Alliant, which is overvalued on a stand-alone basis, PPL trades at a steep discount to our fair value estimate and would expand BHE's U.K. presence. Well-run Xcel Energy and WEC Energy Group also check the acquisition target boxes.

A Rare Opportunity for Acquisitions

We believe now is an opportune time for Berkshire Hathaway to add to its utilities portfolio. On a median basis, U.S. utilities now trade in line with our fair value estimates, the cheapest they've been since 2015 and a sharp reversal from mid-November 2017, when utilities reached a peak 1.18 price/fair value ratio. Since then, Morningstar's US Utilities index is down 6% and has underperformed the S&P 500 by 13 percentage points. The difference is attributed to an increase in our fair value estimates, which we increased due to improving fundamentals in competitive power markets, utilities extending and increasing already healthy capital budgets, and time value appreciation.

No other sector has performed as poorly. Since July 2016, when our coverage touched a 1.21 price/fair value ratio, utilities have returned 8% and underperformed the S&P 500 by 23 percentage points, both including dividends. Buffett has been wise to show discipline as utilities' valuations soared (Exhibit 1).

Exhibit 1 Utilities Haven't Been This Cheap Since June 2015



Source: Morningstar.

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IPO Report for Viva Energy Group

We think investors can comfortably invest in the initial public offering of Viva Energy Group Limited, as it is priced below our AUD 3 fair value estimate. Based on the indicative pricing range of AUD 2.50 to AUD 2.65 per share, we see reason to invest in the IPO, though our buy recommendation is more moderate, because the offer range equates to a 4-star rating, not 5. Viva shares are expected to begin trading on a normal settlement basis on the Australian Securities Exchange under the ticker VEA on July 20, 2018.

There is a lot to like about the Viva business. It is the second-largest refined fuel supplier in Australia at 14.2 billion litres, or 24% share of the 60 billion-litre market overall, behind Caltex Australia Limited, with approximately 27% share. It is also one of the most vertically integrated firms in the country, with the second-highest refining capacity, second-most-comprehensive pipeline infrastructure, the highest number of fuel terminals, and third-largest number of retail sites. The pipeline and terminal infrastructure furnish competitive advantage, though we don't think sufficiently to justify an economic moat.

- Viva enjoys a strategically advantaged infrastructure base from which to refine, store, and distribute fuel across Australia. It has a market-leading position in Victoria, and near-market-leading positions in most other Australian states. Since Shell's Australian downstream operations were acquired in 2014, Viva management has delivered noteworthy two-year underlying pro forma EBITDA CAGR of 11.1% to AUD 700 million.
- Our base-case DCF fair value estimate of AUD 3 per share assumes revenue and EBITDA CAGR of 5.9% and 5.2%, respectively, over the next five years. We have adopted prospectus forecasts for 2018 and first-half 2019. However, unlike Viva, we include Viva Energy REIT and Liberty Oil contributions in underlying earnings. Consequently, our underlying 2018 and first-half 2019 NPAT forecasts are AUD 345 million and AUD 191 million, respectively, slightly higher than Viva's AUD 306 million and AUD 171 million.
- Our Viva fair value estimate equates to a 2022 EV/EBITDA multiple of 8.6 to Caltex at 8.4, high enough, we think, given the risks. Investing in older and far smaller refineries than Asian megacousins is a potential trap that must be carefully navigated, and the distant but real threat from electrification of transport is an inevitable market detractor.

Investment Summary

We initiate on Viva with an AUD 3 per share DCF fair value estimate, which is above the top of the offer price range of between AUD 2.50 per share and AUD 2.65. Based on our fair value estimate and valuation multiples for peers, we believe Viva shares are 12% undervalued at the top end of the indicative pricing range and approximately 17% undervalued at the lower bound.

It can be an uncomfortable feeling being asked to invest in an IPO where none of the cash proceeds are retained by the company. Rather it is a 100% cash extraction by the vendor, and the second if you count the value withdrawn via the initial Viva Energy REIT IPO sell-down. However, while it requires investors to take just that little extra leap of faith, Viva has some quality assets to allay fears, and the price does offer value.

Based on our valuation, we think investors stand to benefit over the long term by investing in the IPO. We recommend investors apply for shares in the IPO, but with a tempered enthusiasm appropriate for a 4-star stock. This is not quite a high-octane buy. The stake available to IPO investors is being sold down by Vitol Investment Partnership, a consortium of the Dutch group Vitol, one of the world's largest independent energy commodity trading companies, and the Abu Dhabi Investment Council. Vitol expects to hold between 40% and 50% of the shares at completion of the offer. No surprises Viva will source the majority of its crude and refined products from Vitol, a positive given Vitol is an energy trading giant. However, it is conceivable if more competitive terms were available from suppliers other than Vitol, Viva may be placed at a competitive disadvantage.

The indicative IPO pricing range reflects an enterprise value/EBITDA multiple of 6.5 to 6.9 for the nonfiscal year to June 2019 based on prospectus forecasts. We think this flatters the truth by removing the Viva Energy REIT and Liberty Oil equity values from the denominator. But by our measure of 7.0 to 7.5, which adds back Viva Energy REIT and Liberty Oil to the denominator, the Viva offer remains attractive.

But we don't believe the company benefits from an economic moat. In the fuel supply and retailing industry, we think the two potential sources for a moat would be cost advantage or efficient scale, and in our view, neither Viva or any other player in Australia is likely to achieve a sufficiently sustainable competitive advantage from either aspect to warrant a moat.

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Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Basic Materials								
Cameco (CCJ)	★★★★	$17	$11.07	High	Narrow	0.65	4.39	Inton
Compass Minerals International (CMP)	★★★★	$83	$65.45	High	Wide	0.79	2.22	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$221.08	High	Narrow	0.83	13.92	Inton
Communication Services								
BT Group (BT.A)	★★★★★	GBX 360	GBX 217.25	High	Narrow	0.60	21.56	C. Nichols
China Mobile (941)	★★★★	HKD 102	HKD 69.7	Medium	Narrow	0.68	1427.14	Baker
Telefonica (TEF)	★★★★★	$13	$7.27	High	Narrow	0.56	37.79	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.62	Medium	Narrow	0.60	31.16	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$157	$135.11	Medium	Narrow	0.86	10.00	Akbari
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 77.56	High	Narrow	0.66	50.44	Hilgert
Domino's Pizza Enterprises (DMP)	★★★	AUD 53	AUD 52.22	Medium	Narrow	0.99	4.46	Faul
Expedia Group (EXPE)	★★★★	$180	$120.5	High	Narrow	0.67	18.09	Wasiolek
General Motors (GM)	★★★★	$56	$40.52	High	None	0.72	57.11	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 6	High	None	0.44	88.38	Hu
Hanesbrands (HBI)	★★★★	$29	$22.06	Medium	Narrow	0.76	7.95	Hottovy
InvoCare (IVC)	★★★★	AUD 15.5	AUD 13.74	Medium	Wide	0.89	1.51	Ragonese
Mattel (MAT)	★★★★	$21.5	$16.34	High	Narrow	0.76	5.62	Katz
Walt Disney (DIS)	★★★★	$130	$104.77	Medium	Wide	0.81	155.77	Macker
Williams-Sonoma (WSM)	★★★	$68	$61.31	Medium	Narrow	0.90	5.10	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1195.5	Medium	Narrow	0.80	15.08	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★	AUD 4	AUD 2.33	High	None	0.58	1.06	James
General Mills (GIS)	★★★★★	$59	$44.68	Low	Wide	0.76	26.50	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2811.5	Low	Wide	0.72	26.81	Gorham
Kao (4452)	★★★	JPY 8800	JPY 8450	Low	Wide	0.96	4130.51	Wei
Mondelez International (MDLZ)	★★★★	$51	$40.9	Medium	Wide	0.80	60.33	Lash
PepsiCo (PEP)	★★★★	$123	$108.68	Low	Wide	0.88	154.09	Vora
Procter & Gamble (PG)	★★★★★	$98	$78.05	Low	Wide	0.80	196.26	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6187	Low	Wide	0.85	43.69	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$13.33	Very High	None	0.63	16.38	Gemino
Enbridge (ENB)	★★★★★	$64	$43.9	Medium	Wide	0.69	74.84	Gemino
Enterprise Products Partners (EPD)	★★★★	$31	$27.56	Low	Wide	0.89	59.88	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$72.61	Low	None	0.93	293.35	Good
Total (TOT)	★★★★	$74	$60.23	Medium	None	0.81	158.79	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$53.23	Medium	None	0.70	47.78	Horn
Capital One Financial (COF)	★★★★	$123	$92.45	Medium	Narrow	0.75	44.97	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 14.95	High	Narrow	0.68	37.97	Scholtz
Invesco (IVZ)	★★★★★	$40	$26.59	Medium	Narrow	0.66	10.92	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 631.1	Medium	None	0.72	8289.38	Wu
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.74	High	Narrow	0.75	13.23	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 29.3	Medium	Wide	0.84	99.21	Ellis

Source: Morningstar. As of June 29, 2018

Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Healthcare								
Allergan (AGN)	★★★★★	$263	$168.58	Medium	Wide	0.64	57.16	Waterhouse
McKesson (MCK)	★★★★★	$210	$135.8	Medium	Wide	0.65	27.40	Lekraj
Medtronic (MDT)	★★★★	$105	$86.33	Medium	Wide	0.82	116.69	Wang
Ramsay Health Care (RHC)	★★★★★	AUD 82	AUD 53.98	Medium	Narrow	0.66	10.91	Kallos
Roche Holding (ROG)	★★★★★	CHF 325	CHF 220.55	Low	Wide	0.68	188.87	Andersen
Shire (SHP)	★★★★	GBX 4890	GBX 4221.5	Medium	Narrow	0.86	38.59	Andersen
Industrials								
Allegion (ALLE)	★★★★	$91	$77.18	Medium	Wide	0.85	7.33	Bernard
Anixter International (AXE)	★★★★★	$107	$63.3	Medium	Narrow	0.59	2.12	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 38.2	Medium	Narrow	0.66	48.21	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 8.88	Medium	Wide	0.79	14.13	Fleck
CK Hutchison Holdings (1)	★★★★★	HKD 124	HKD 83.2	Medium	None	0.67	320.96	Tan
G4S (GFS)	★★★★	GBX 337	GBX 264.9	Medium	None	0.79	4.11	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 28.91	Medium	Wide	0.62	5.22	Molina
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 216	MXN 187.7	High	Wide	0.87	105.30	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.42	High	None	0.65	34.21	Song
Johnson Controls International (JCI)	★★★★	$53	$33.29	High	Narrow	0.63	30.83	Bernard
KION GROUP (KGX)	★★★★	EUR 90	EUR 60.6	Medium	Narrow	0.67	7.16	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 35.72	Medium	Narrow	0.85	33.95	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 84.9	Medium	Narrow	0.77	12.59	Field
Stericycle (SRCL)	★★★★	$86	$64.62	High	Narrow	0.75	5.53	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.8	AUD 2.43	Medium	None	0.87	1.41	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 118.4	Medium	Narrow	0.77	343.00	Zhong
Welltower (WELL)	★★★★	$74	$62.36	High	None	NA	23.20	Brown
Technology								
Intel (INTC)	★★★★	$62	$49.25	Medium	Wide	0.79	229.51	Davuluri
KLA-Tencor (KLAC)	★★★★	$125	$101.81	High	Wide	0.81	15.84	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$90.44	Medium	Wide	0.81	21.26	Colello
Microsoft (MSFT)	★★★★	$122	$98.63	Medium	Wide	0.81	757.79	Lange
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 2.89	Medium	Narrow	0.76	1.73	James
Qualcomm (QCOM)	★★★★	$75	$55.9	High	Narrow	0.75	82.89	Davuluri
Salesforce.com (CRM)	★★★★	$158	$135.12	Medium	Wide	0.86	100.38	Lange
Synaptics (SYNA)	★★★	$64	$49.78	Very High	None	0.78	1.72	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 11320	High	None	0.91	1429.09	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 393.8	High	Wide	0.61	3742.36	Tam
Utilities								
Dominion Energy (D)	★★★★★	$84	$68.47	Low	Wide	0.82	44.70	Fishman
FirstEnergy (FE)	★★★★	$40	$36.19	Low	Narrow	0.90	17.26	Fishman
Gas Natural SDG (GAS)	★★★	EUR 23.5	EUR 22.68	Medium	Narrow	0.97	22.68	Fulop
SCANA (SCG)	★★★★★	$56	$38.5	Medium	Narrow	0.69	5.49	Miller

Source: Morningstar. As of June 29, 2018

Highlighted Stocks

Adient ADNT

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Negative	USD	72	49.37	Very High	Narrow	0.69	4.57

Source: Morningstar. As of June 29, 2018

We consider Adient's problems to be primarily from poor execution and therefore fixable.

Select Report, June 28, 2018
Adient's stock has taken a wild ride since its spin-off from Johnson Controls on Oct. 31, 2016. Shares of the world's largest automotive seating company, with about a third of the global market share, briefly dipped under $40 in November 2016, then reached an all-time high of $86.42 in September 2017. In 2018, the stock has fallen by as much as 40% as operational problems disclosed in January in the seat structures and mechanisms group turned out to not be confined to that segment. On June 11, management lowered fiscal 2018 guidance due to unspecified manufacturing issues in the seating segment and announced the immediate resignation of Chairman and CEO Bruce McDonald, causing the stock to fall as much as 17% that day.

We think this sell-off is an excellent buying opportunity for the long-term investor. Here's where we think we differ from the market: We consider Adient's problems to be primarily from poor execution and therefore fixable. Also, we do not consider the company to be heading toward financial distress, and we think it can even maintain its dividend as it restructures. Adient still has expenses to cut from its Johnson Controls days and manufacturing to move from high-cost countries to low-cost countries. Adient's seating EBIT margins trail those of its top competitor, Lear, and we don't see why that difference must be permanent. Adient also dominates seating in China, with nearly half the market share in the world's single largest auto market. The firm's 20 seating joint ventures are accounted for under the equity method, but their unconsolidated revenue is about $9 billion. We see Adient remaining the top seating firm in China because U.S. and European customers operating there want a company that can supply seats globally and very few firms can do that.

Option value comes from Adient seeking $1 billion of nonautomotive revenue by fiscal 2022, which for now may come mostly from business-class airplane seats thanks to a newly formed joint venture with Boeing. Autonomous vehicles also bring upside potential because Adient owns 30% of the world's largest automotive interiors company.Interiors have long been thought of as a commodified area of automotive design, but we think it could become much more critical to vehicle appeal in a fully autonomous world. We see Adient having a bright future in seating and autonomous vehicles, but we do think a turnaround will take well into calendar 2019, so investors will need patience.

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Enbridge ENB

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Energy	Stable	USD	50	35.63	Medium	Wide	0.71	54.14

Source: Morningstar. As of June 29, 2018

The positive outcome is consistent with our expectations that the project would be approved and has been at the heart of our thesis that the stock is deeply undervalued for almost a year.

Analyst Note, June 29, 2018

On June 28, the Minnesota Public Utilities Commission unanimously approved Enbridge's Line 3 replacement project by awarding the company a certificate of need after the market close. Later in the evening, the commission approved Enbridge's preferred route by a slim 3-2 vote, with minor modifications and conditions. The conditions include a decommissioning fund for the future retirement of the pipeline when the useful life has expired, along with removing portions of the old Line 3 pipeline from individual landowners upon request. Enbridge doesn't expect any material impact to the $7.5 billion in costs and reaffirmed the second half of 2019 for the pipeline to be placed into service.

We expect Enbridge to use the remainder of the year to finalize work on the conditions highlighted in the approval, and construction is set to start in early 2019. We think the timeline remains a bit optimistic, but we don't expect any impact on our early 2020 timeline of the route. The positive outcome is consistent with our expectations that the project would be approved and has been at the heart of our thesis that the stock is deeply undervalued for almost a year.

We are maintaining our $50 (CAD 64) fair value estimate and wide moat rating. The stock climbed almost 5% on June 28 on the anticipation of the positive outcome (the final approval didn't occur until after market close), and despite the uptick in the share price, it still looks deeply undervalued. Investors can rest assured: We expect Enbridge to easily meet its 10% average annual dividend growth throughout 2020 and maintain a healthy distributable cash flow ratio of 1.45 times the forward dividend.

We consider Enbridge a rare triple threat, boasting a wide moat, an attractive 6.1% dividend yield, and a cheap valuation. We think the time is right for long-term investors to capitalize on the stock's considerable upside while collecting a steady stream of growing income.

As a reminder, Enbridge's Line 3 replacement project would restore Line 3 to its initial capacity of 760 thousand barrels per day, adding 370 mbbl/d of new pipeline capacity. Similar to other mainline routes, the Line 3 replacement will be a common-carrier pipeline. The pipeline is expected to originate in Hardisty, Alberta, and connect to the U.S. in Minnesota, where it will connect to other U.S. pipelines. It will provide additional access to refineries in eastern Canada; Cushing, Oklahoma; the U.S. Midwest; and the U.S. Gulf Coast at an expected cost of $7.5 billion.

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Allergan AGN

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Healthcare	Stable	USD	263	167.04	Medium	Wide	0.64	57.16

Source: Morningstar. As of June 29, 2018

The recent positive clinical data for atogepant and bimatoprost continue to make us think the market underappreciates Allergan's pipeline.

Analyst Note, June 26, 2018
We're maintaining our fair value estimate for wide-moat Allergan after making a few minor adjustments to our model. Near term, we've bumped up our revenue and earnings estimates for 2018 as a Restasis generic launch now looks likely for July, which is beyond our previous estimate for a launch earlier this quarter. Longer term, we're leaving most of our growth projections intact as recent phase 2 data for Allergan's episodic migraine drug atogepant and phase 3 data for sustained release bimatoprost for glaucoma have mostly fallen in line with our expectations. While, we're leaving our probability-weighted revenue estimates for these products unchanged for now awaiting further clinical trial data, initial results look encouraging. These developments also offset recent headwinds in Allergan's pipeline, including potential restrictions on Esmya for uterine fibroids following recent liver issues in Europe.

The recent positive clinical data for atogepant and bimatoprost continue to make us think the market underappreciates Allergan's pipeline. Atogepant—the first potential oral CGRP for episodic migraine—reported encouraging phase 2 results with a migraine reduction relatively on par with injectable CGRP monoclonal antibodies. More importantly, atogepant showed a clean safety profile, in our view, with few instances of elevated liver enzymes that matched the placebo arm. These results should also help allay liver concerns over ubrogepant, Allergan's other oral CGRP in development for acute migraine.

Bimatoprost's first phase 3 trial showed efficacy on par with daily drop prostaglandin analogues over a 12-week period, but management's claim that a majority of patients may only need one injection per year could make this drug a differentiated offering in a therapeutic area plagued with poor patient adherence. Pending additional phase 3 and safety clinical trials, management expects to file an application for bimatoprost with the U.S. Food and Drug Administration in 2019.

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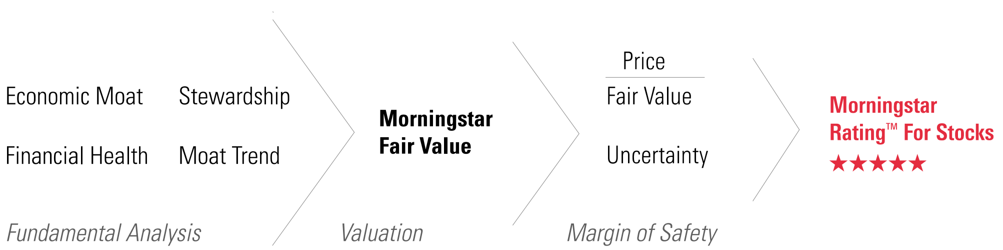
Research Methodology for Valuing Companies

Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Morningstar Research Methodology



Source: Morningstar.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate, and (4) the current market price. This process ultimately culminates in our single-point star rating.

Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward their cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger, stable where we don't anticipate changes to competitive advantages over the next several years, or negative where we see signs of deterioration.

Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last 5 to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested (RONIC)—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market value weights.

Uncertainty Around That Fair Value Estimate

Morningstar's uncertainty rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The uncertainty rating represents the analysts' ability to bound the estimated value of the shares in a company around the fair value estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

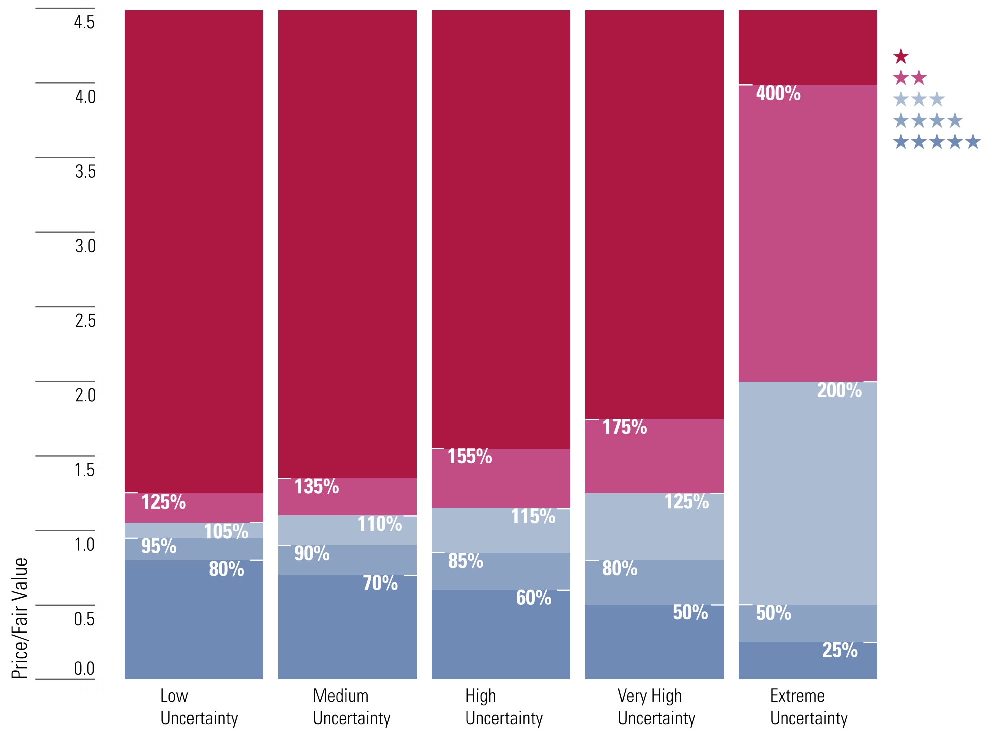
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty regarding the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

- Low: Margin of safety for 5-star rating is a 20% discount and for 1-star rating is a 25% premium.
- Medium: Margin of safety for 5-star rating is a 30% discount and for 1-star rating is a 35% premium.
- High: Margin of safety for 5-star rating is a 40% discount and for 1-star rating is a 55% premium.
- Very high: Margin of safety for 5-star rating is a 50% discount and for 1-star rating is a 75% premium.
- Extreme: Margin of safety for 5-star rating is a 75% discount and for 1-star rating is a 300% premium.

Morningstar Equity Research Star Rating Methodology



Market Price

The market prices used in this analysis and noted in the report come from the exchange on which the stock is listed, which we believe is a reliable source.

For more details about our methodology, please go to http://global.morningstar.com/equitydisclosures.

Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically recalculated at the market close on
every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow and, based on thorough and ongoing analysis, raise or lower their fair value estimates
as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn
5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true, the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience, and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to capital loss.

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