Research Highlights

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

Morningstar Equity Research
July 23-27, 2018

Contents

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

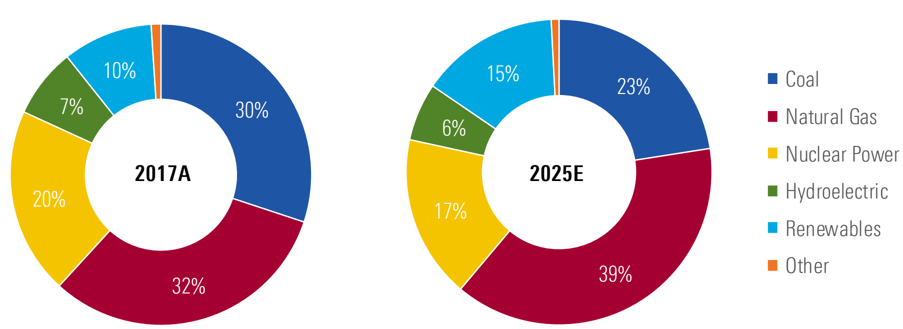
Disclosure
The conduct of Morningstar's analysts is governed by Code of Ethics/Code of Conduct Policy, Personal Security Trading Policy (or an equivalent of), and Investment Research Policy. For information regarding conflicts of interest, please visit: http://global.morningstar.com/equitydisclosures

Coal's Future Still Ugly

Cheap natural gas, sluggish power demand, growing renewable energy, and emissions regulations will all continue to crowd out coal as U.S. utilities use more natural gas and renewables for electricity generation through 2025. Since our last update in December 2017, we have seen more U.S. utilities incorporate renewables and natural gas-fired generation into their long-term resource planning as coal fleets dwindle. The economics of offshore wind energy continue to improve, and two major projects, one off the coast of Massachusetts and another off Rhode Island, were recently selected by state officials to move forward. Connecticut and New Jersey recently approved legislation providing financial support for nuclear plants. However, more than offsetting these positives are three money-losing merchant nuclear plants that recently announced retirement dates early next decade.

What hasn't changed since our last update: Our midcycle natural gas price remains $3 per thousand cubic feet. In February, the U.S. Energy Information Administration lowered its 2025 natural gas price forecast roughly 10%. This lowered EIA's view of coal-fired generation in the next decade, and our bearish view is now between its reference case and natural gas price bear case. What also has not changed is our investment thesis: Integrated utilities with supportive state regulatory frameworks should benefit as they retire coal plants and replace these generating assets with natural gas and renewables. Dominion Energy, Duke Energy, and Southern Co. are investing billions in narrow- and wide-moat projects that should result in strong earnings and dividend growth.

Exhibit 1 Morningstar's 2025 U.S. Power Generation Forecast: More Gas and Renewables, Less Coal



Source: U.S. Energy Information Administration, Morningstar

- We believe coal generation is in a secular decline and will continue its downward spiral through the next decade. Although President Donald Trump has been supportive of the coal industry, we don't believe coal-fired electric generation can overcome four demand killers: cheap natural gas, sluggish power demand, growing renewable energy sources, and emissions regulations.
- We forecast coal-fired generation will represent about 23% of total U.S. generation in 2025 versus 30% in 2017. Our forecast remains below EIA's 2018 Annual Energy Outlook reference case of 27.1%. However, EIA significantly reduced its forecast for coal generation in its natural gas price bear case to 20.7% versus the 2017 AEO of 27.8%, and our forecast is now within EIA's wide 2025 forecast range for coal generation of 20.7%-33.5% of total electric generation.
- Natural gas generation continues to be the primary beneficiary of coal's secular decline. We estimate that gas plants will produce about 39% of total 2025 generation, equal to our previous forecast.
- EIA's more bullish view of natural gas generation (increased 2025 reference case to 33.2% from 29.6%) is driven by its lower outlook for natural gas prices, falling about 10% to $4.07 per mcf in 2017 dollars for its 2025 reference case. Its natural gas price bear case declined about 14% to $2.97 per mcf and is now in line with our $3 per mcf midcycle price. EIA's more bearish view puts our 2025 gas generation forecast of 39% of total generation in the upper half of its wide range of 33.2%-42.2% versus its 2017 AEO, where we were above its forecast range.
- In March, FirstEnergy announced it would close three nuclear plants by 2021. Incorporating these closures pushes our nuclear generation forecast down to about 17% of total electricity generation in 2025 versus our previous estimate of 18%. Our estimate is higher than EIA's reference case estimate of 16.5%. We believe our modestly more bullish view of nuclear is due to our higher level of confidence that Trump will have some success supporting nuclear energy and planned uprates.
- Our renewables estimate (excluding hydroelectric) for 2025 increased to 15% from 13%. Renewable demand from utilities and corporations is stronger than we expected following the phasing out of tax benefits. However, what most surprised us since our last update is the strong interest in and recent approvals of offshore wind projects in the Northeast. We remain less bullish on renewables than EIA but note the 2018 AEO reference case for renewables was lowered to about 16%; our estimate is now only about 100 basis points lower than EIA's.
- Conservative income-oriented investors should not worry about the continued decline in coal-fired generation. Integrated utilities with supportive state regulatory frameworks should benefit as they retire coal plants and build natural gas infrastructure and renewables. Best Idea Dominion Energy, Duke Energy, and Southern are investing billions in narrow- and wide-moat projects that should result in strong earnings and dividend growth.

Charles Fishman, CFA | charles.fishman@morningstar.com

Urbanization and Real Estate With China Characteristics

Urbanization in China has taken on unique Chinese characteristics, resulting in a very diffuse landscape in terms of geography, population, and economic activities, with small and midsize cities receiving a higher influx of population, resulting in faster growth. Consequently, the real estate sector is likely to evolve in a fragmented fashion. For real estate developers, the fragmentation means lower efficiency gains from scale and less industry concentration. The purely scale-based homebuilder model, while successful so far, will gradually lose its competitive advantage. Instead, we see specialist firms, focusing on certain geographic regions or market segments, gradually gaining prominence.

- Chinese urbanization is a very diffuse process in terms of geography, population, and economy. The diffuse landscape is driven by history, government policy, and physical scalability and is expected to persist.
- The impact on the real estate sector is pronounced market fragmentation, growing supply and demand in lower-tier cities, and low industry concentration. Scale will become a less important competitive advantage; successful developers will need to adapt by specializing through geography, product type, and business model.
- In our China real estate coverage, we believe no-moat China Resources Land and no-moat China Vanke are undervalued, based on their strong operational ability, focused land bank, and diversified businesses. We also believe no-moat Hong Kong developer Hang Lung Properties and narrow-moat Singapore developer CapitaLand are undervalued. Both are strong retail asset managers with significant exposure to the fast-growing Chinese retail sector.

Preferred Picks

Almost all large listed Chinese real estate developers operate with a scale-based pure homebuilding model. The trend of diffused urbanization presents a challenge to these developers. Hence, we look to those under our coverage that are moving away from the scale-based model by becoming more focused in geography or market segment. We also look to some nondevelopers with large retail exposure to China.

Overall, we favor developers with the following characteristics:

- Strong balance sheet with room to take asset intensive initiatives.
- Substantial recurrent incomes from investment properties.
- Favorable geographic exposure to city clusters with a good balance of population growth, land availability. and income growth.

Among our coverage of Chinese developers, no-moat Country Garden and no-moat China Evergrande have been the clear beneficiaries of scale-based expansion over the past two years. Both companies expanded to more than 200 cities and saw their contract sales grow at rapid pace, which powered strong double-digit revenue growth along with expanding margins. We believe the era of rapid expansion is coming to an end, however, as the overall market flattens out. The diffused urbanization trend will limit the scope of consolidation, making scale a less effective competitive strategy. On the other hand, we believe no-moat China Resources Land and no-moat China Vanke are undervalued.

These two companies are operationally strong developers with better margins than sector peers. They have prudently limited the geographic scope of their land banks with projects in 60-80 cities. While most of the exposure is in upper-tier cities where volume growth may be muted going forward, both companies have strong ties with state-owned enterprise holding large legacy land banks, which are available for future acquisition and development. More important, both companies have made consistent efforts to diversify away from pure residential development.

China Resources Land is the only large Chinese developer with a credible investment property business targeting the mid- to high-tier retail segment. The investment property business contributes 6% of revenue and 8% of earnings. The company has developed its MixC complex into a chain of successful mid- to high-end retail malls with 15 locations in China. This is significant as the retail landscape in China is still mostly dominated by Hong Kong and Singapore operators.

China Vanke assembled a portfolio of 172 commercial projects under an associate company, SCPG. This is the platform that China Vanke uses to hold its retail assets as well as make additional acquisitions, with the latest being 20 midtier malls from Singapore's CapitaLand. The company also made a major push into logistics to take advantage of the fast-growing e-commerce sector in China. The company currently holds 62 logistic projects with gross floor area of 5 million square meters. It was also part of the consortium that acquired GLP earlier this year. GLP is the largest logistics property manager in China, holding a land bank of 30 million square meters. China Vanke is the largest shareholder in GLP with a stake of 21.4%.

We also include two non-Chinese developers, no-moat Hang Lung Properties and narrow-moat CapitaLand, among our preferred stocks because of their exposure to the retail sector in China. The retail sector in China has grown rapidly, with retail sales up more than 10% annually. Currently, there is a dearth of quality retail asset managers. The most successful retail properties in China are usually managed by Hong Kong and Singapore operators. Against the backdrop of the rise of e-commerce, it is ever more important for retail asset managers to work closely with retail brands in creating and executing a sustainable marketing and distribution strategy.

Hang Lung Properties is a Hong Kong property developer with most of its exposure in China retail. The company made a strategic transition beginning in late 2000s, when it deployed proceeds from several successful large residential projects in Hong Kong into developing several large retail projects in second-tier cities in China. The company currently derives 40% of its income from retail malls in China, and this is expected to grow to 60% as several most projects come to completion. The company recently made a large acquisition in Hangzhou, reaffirming its strategic vision of becoming the leading retail asset owner and manager in China. Our thesis on Hang Lung Properties is detailed in our company report published in January. The company's shares have retreated in recent weeks, as the performance of its malls has been overshadowed by the success of a few projects recently opened by other Hong Kong operators. As China's retail landscape has undergone some changes, notably the anticorruption campaign, the rise of e-commerce, and shifting consumer tastes, Hang Lung Properties is in the process of repositioning and revamping some of its assets, since it had entered the sector earlier than its Hong Kong peers. We believe its newer projects are well located and will surprise on the upside once they come on line.

CapitaLand is a property conglomerate with design and development expertise and active asset-management capabilities across all property types. Its narrow moat rating is based on its core office and retail portfolio in Singapore; however, the firm is also well-positioned to benefit from emerging-market growth. Singapore remains a core market, with assets in the city-state making up 36% of the company's total, but the business has been shifting toward China (47%) and elsewhere in Asia, where an increasing proportion of the population is moving into the middle-class cohort. This leads to rising disposable income and consumption growth well above that of developed countries. This wealth effect will drive demand for residential units and higher retail spending at shopping malls, while rising economic growth will underpin demand for well-located offices and serviced residences. The company has direct exposure to residential, commercial, retail, office, and service residence developments in China. In retail, its five shopping malls will open later in 2018 and add to a portfolio of 61 malls. CapitaLand's retail assets consist of mostly midrange malls in higher-tier cities as well as a few premium assets under the Raffles City mall brand. The malls are nearly fully occupied and have rising foot traffic, translating into tenant sales growth and rental increases. CapitaLand's Ascot serviced apartment brand is well regarded globally with 30% of total units in China. The company's shares declined 15% after the Singapore government announced a cooling measure targeting the property market. We believe this is an overreaction, given CapitaLand's limited exposure to the city's residential sector, and doesn't account for the company's investments in other sectors and regions.

Phillip Zhong | phillip.zhong@morningstar.com

What We Learned at the Farnborough Airshow

We came away from the Farnborough International Airshow in the United Kingdom thinking that signs of life exist in regional jets, the Boeing 797 aircraft might not be launched after all, and demand is still very weak for large wide bodies like the 777X and A350-1000.

According to the Flight Global order tracker, aircraft manufacturers landed 1,464 orders and options (excluding conversions), which represents a 238 aircraft increase over the 2017 Paris Air Show. Additionally, a tentative deal between the U.S. Department of Defense and Lockheed Martin on the F-35 lot 11 contract was announced at the show.

As usual, narrow bodies (the 737 MAX and A320neo) racked up the most sales, but regional jets were the real stars, capturing nearly a fourth of all sales. Although we anticipated interest in regional jets, the high level of demand was surprising. A few days before the show, the Airbus A220 (previously the C Series) was off to a strong start as it beat the Embraer E-195-E2 on a 60-aircraft order for JetBlue. In the end, however, the A220 only landed 60 additional orders from a startup airline.

The E1/E2 jets racked up 300 orders, commitments, and options versus a backlog of 360 going into the event. We'd note that 200 of the E1/E2 aircraft sold were linked to a Republic Airways deal (100 via a letter of intent plus 100 purchase options). We think Embraer might have gotten a modest boost from its recently announced joint venture with Boeing, which if approved would close by year-end 2019. We're looking ahead to Embraer's second-quarter earnings on July 31 and may rework our E1/E2 transition, while concomitantly increasing deliveries in the later years of our forecast.

Several months ago, we gave a next-generation midsize aircraft, dubbed the Boeing 797, a 70% chance of being launched, but coming out of Farnborough we think it's more like 50/50. The engine manufacturers (GE in particular) continued to voice concerns over the market size for the 797, and the design of the aircraft seems to still be in flux.

Rumors circulated earlier in the show that Boeing was moving away from a composite fuselage on the aircraft, and although Boeing's management team sought to tamp down this speculation, the fact that it surfaced indicates the uncertainty of the design configuration for the 797, owing to competing customer requirements. We think Boeing now has an even higher bar to meet to convince shareholders that the $16 billion-$18 billion it will most likely spend on developing this clean-sheet aircraft is a good use of funds. If Boeing doesn't launch the program, then we think the question on investors' minds will be what Boeing plans to do with all the cash it's throwing off. We outlined why the 797 business case is so difficult to nail down in our December 2017 Observer Over my Dead Wide-Body.

We thought that China might use the show to send a message to the Trump administration on trade by putting in a large wide-body order with Airbus, but this didn't materialize, and the only disclosed activity from a China carrier or lessor was for 10 A350-900s, which were previously announced earlier in 2018. Large wide-body orders were conspicuously absent from the show, but we weren't surprised. The A350-1000 landed 12 orders from Starlux Airlines, but in a repeat of the 2017 Paris Air Show, the 777X program once again walked away with zero orders. We continue to forecast fewer large wide-body deliveries than either Boeing or Airbus over the next two decades.

However, we maintain our more bullish stance on smaller wide bodies like the 787 and A330neo. That said, the A330neo has been under significant pressure in the market, and we think Boeing continues to attack the program with a highly competitive 787 offering to pave the way for a 797 aircraft. Thankfully for Airbus, AirAsia expanded its order from 66 A330neos to 100 of this aircraft type. Although this is indeed positive, the carrier now represents nearly 40% of Airbus' A330neo orders, creating a significant customer concentration risk.

We'd be remiss not to mention some defense activity at the show. Lockheed announced a "handshake" agreement on lot 11 of the F-35 program's low-rate initial production with the Department of Defense, covering 141 aircraft. Lockheed didn't mention the unit cost for the Air Force variant of the F-35 under the lot 11 contract, but reports surfaced that this figure could come in below $90 million per aircraft, which would be a 6% drop versus lot 10. The company also discussed the possibility of a future multilot buy with the Department of Defense, which sounds a lot like a multiyear procurement, but the company stopped short of calling it this. We think this agreement will cover lots 12 through 14 and could be for up to 450 aircraft.

Turning to international defense sales, the U.S. government's Defense Security Cooperation Agency, which assists in the transfer of defense weapons and systems to international militaries, reported at Farnborough that the U.S. State Department had approved deals worth $47 billion of international weapon sales through the first half of 2018, which is about $5 billion above all of 2017. We think strong demand from Asia and the Middle East are driving sales, but we still believe that lower oil prices (the Morningstar energy team forecasts a normalized Brent price of $60), combined with elevated levels of military spending as a percentage of GDP across the Middle East, means that over the medium term, Middle Eastern defense budgets will moderate. Raytheon remains the most exposed to the Middle East, with about half of its international business driven by customers from the region.

Chris Higgins | chris.higgins@morningstar.com

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	$11.29	High	Narrow	0.66	4.33	Inton
Compass Minerals International (CMP)	★★★★	$83	$68.6	High	Wide	0.83	2.32	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$206.85	High	Narrow	0.78	13.02	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 224.85	High	Narrow	0.62	22.31	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 69.9	Medium	Narrow	0.69	1431.24	Baker
Comcast (CMCSA)	★★★★	$42	$34.75	Medium	Wide	0.83	159.22	Macker
Telefonica (TEF)	★★★★★	$13	$7.66	High	Narrow	0.59	39.80	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.76	Medium	Narrow	0.63	32.83	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$157	$141.78	Medium	Narrow	0.90	10.50	Akbari
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 83.39	High	Narrow	0.71	54.18	Hilgert
Expedia Group (EXPE)	★★★★	$180	$125.8	High	Narrow	0.70	18.89	Wasiolek
General Motors (GM)	★★★★	$45	$36.75	High	None	0.82	51.85	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 5.65	High	None	0.42	81.02	Su
Hanesbrands (HBI)	★★★★	$29	$22.01	Medium	Narrow	0.76	7.93	Hottovy
InvoCare (IVC)	★★★★	AUD 17	AUD 14.17	Medium	Wide	0.83	1.56	Ragonese
Mattel (MAT)	★★★★	$21.5	$15.6	High	Narrow	0.73	5.37	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$50.05	High	Narrow	0.73	11.25	Katz
Walt Disney (DIS)	★★★★	$130	$113.51	Medium	Wide	0.87	168.76	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1177.5	Medium	Narrow	0.79	14.86	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★	AUD 4	AUD 2.63	High	None	0.66	1.19	James
General Mills (GIS)	★★★★★	$59	$44.17	Low	Wide	0.75	26.21	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2854.5	Low	Wide	0.73	27.22	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8403	Low	Wide	0.95	4095.79	Wei
Mondelez International (MDLZ)	★★★★	$51	$43.27	Medium	Wide	0.85	63.83	Lash
PepsiCo (PEP)	★★★★	$123	$115	Low	Wide	0.93	162.65	Vora
Procter & Gamble (PG)	★★★★★	$98	$80.09	Low	Wide	0.82	201.39	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6311	Low	Wide	0.86	44.59	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$13.39	Very High	None	0.64	16.45	Gemino
Enbridge (ENB)	★★★★	$64	$45.93	Medium	Wide	0.72	78.30	Gemino
Enterprise Products Partners (EPD)	★★★★	$32.5	$29.91	Low	Wide	0.92	64.98	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$70.17	Low	None	0.90	286.11	Good
Total (TOT)	★★★★	$74	$63.13	Medium	None	0.85	162.05	Good
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.59	High	Narrow	0.85	1247.13	Tan
American International Group (AIG)	★★★★	$76	$54.25	Medium	None	0.71	48.70	Horn
Capital One Financial (COF)	★★★★	$127	$96.48	Medium	Narrow	0.76	46.16	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 15.67	High	Narrow	0.71	39.80	Scholtz
Invesco (IVZ)	★★★★★	$38	$25.72	Medium	Narrow	0.68	10.56	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 692	Medium	None	0.79	9078.73	Wu
QBE Insurance Group (QBE)	★★★★	AUD 12	AUD 10.11	High	None	0.84	13.73	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 29.47	Medium	Wide	0.84	99.79	Ellis

Source: Morningstar. As of July 27, 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	$177.59	Medium	Wide	0.68	60.21	Waterhouse
McKesson (MCK)	★★★★★	$210	$127.06	Medium	Wide	0.61	25.64	Lekraj
Medtronic (MDT)	★★★★	$105	$89.26	Medium	Wide	0.85	120.65	Wang
Ramsay Health Care (RHC)	★★★★★	AUD 82	AUD 56.89	Medium	Narrow	0.69	11.50	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 243.5	Low	Wide	0.72	208.15	Andersen
Shire (SHP)	★★★★	GBX 4890	GBX 4363.5	Medium	Narrow	0.89	39.90	Andersen
Industrials								
Allegion (ALLE)	★★★★	$91	$81.48	Medium	Wide	0.90	7.74	Bernard
Anixter International (AXE)	★★★★★	$107	$69.95	Medium	Narrow	0.65	2.34	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 38.6	Medium	Narrow	0.67	48.72	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.84	Medium	Wide	0.88	15.66	Fleck
CK Hutchison Holdings (1)	★★★★★	HKD 125	HKD 84.6	Medium	None	0.68	326.36	Tan
G4S (GFS)	★★★★	GBX 337	GBX 268	Medium	None	0.80	4.16	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 32	Medium	Wide	0.68	5.78	Molina
Grupo Aeroportuario del Pacifico (GAP B)	★★★	MXN 217	MXN 193.22	High	Wide	0.89	108.40	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.08	High	None	0.60	34.53	Song
Johnson Controls International (JCI)	★★★★	$53	$35.72	High	Narrow	0.67	33.08	Bernard
KION GROUP (KGX)	★★★★	EUR 90	EUR 60.52	Medium	Narrow	0.67	7.15	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 38.23	Medium	Narrow	0.91	35.62	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 92.2	Medium	Narrow	0.84	13.67	Field
Stericycle (SRCL)	★★★★	$86	$70.44	High	Narrow	0.82	6.03	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.8	AUD 2.34	Medium	None	0.84	1.36	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 122.9	Medium	Narrow	NA	356.04	Zhong
Welltower (WELL)	★★★★	$74	$64.31	High	None	0.87	23.92	Brown
Technology								
Intel (INTC)	★★★★	$65	$52.16	Medium	Wide	0.80	243.07	Davuluri
KLA-Tencor (KLAC)	★★★	$125	$105.23	High	Wide	0.84	16.37	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$94.67	Medium	Wide	0.85	22.29	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 3.14	Medium	Narrow	0.82	1.88	James
Qualcomm (QCOM)	★★★	$72	$63.58	High	Narrow	0.88	93.41	Davuluri
Synaptics (SYNA)	★★★★	$64	$50.26	Very High	None	0.79	1.74	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 11510	High	None	0.92	1453.08	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 373	High	Wide	0.58	3544.69	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$71.5	Low	Wide	0.85	46.68	Fishman
FirstEnergy (FE)	★★★★	$40	$35.21	Low	Narrow	0.88	16.79	Fishman
Gas Natural SDG (NTGY)	★★★	EUR 23.5	EUR 23.12	Medium	Narrow	0.98	23.12	Fulop
SCANA (SCG)	★★★★★	$56	$40.18	Medium	Narrow	0.72	5.73	Miller

Source: Morningstar. As of July 27, 2018

Highlighted Stocks

Martin Marietta Materials MLM

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Basic Materials	Stable	USD	265	205.72	High	Narrow	0.78	13.02

Source: Morningstar. As of July 27, 2018

Based on the market reaction, one would assume a disappointing earnings release and gloomy revised outlook. In our view, however, results were solid, and the outlook for growth remains strong.

Analyst Note, July 26, 2018
After reporting second-quarter earnings on July 26, Martin Marietta shares have fallen roughly 7% as we write. Based on the market reaction, one would assume a disappointing earnings release and gloomy revised outlook. In our view, however, results were solid, and the outlook for growth remains strong.

During the second quarter, revenue grew 13% to $1.2 billion and gross profit rose 15% to $316 million. Performance could have been even stronger had tightness in rail and truck availability as well as contractor labor shortages not weighed on shipment volumes. We view these headwinds as temporary, as costly construction delays often fall on the contractor, increasing their incentive to pay more to better secure transportation and increase salaries to grow the labor force.

Meanwhile, our outlook is unchanged. Construction pipelines continue to look strong, augmented further by state governments continuing to expand investment to address deteriorating infrastructure. Infrastructure projects tend to be particularly aggregates-intensive, which buoys our positive outlook for continued volume and pricing growth.

Martin Marietta made minor changes to its full-year guidance, slightly raising its midpoint EBITDA target. With the second half of the year typically the bigger contributor, we think the company is within reaching its guidance. As such, we’re maintaining our fair value estimate of $265 per share, as well as Martin Marietta’s narrow-moat rating.

We view the recent share price pullback as an opportunity to acquire Martin Marietta shares at an attractive risk-adjusted discount. Shares traded at nearly $230 as recently as June, and we see no developments that have changed the company’s promising growth from then to now. We continue to forecast rising volumes, supporting continual price increases. Combined with the fixed-cost leverage of aggregates and cement production, we forecast that EBITDA will more than double by 2022 from 2017.

Kristoffer Inton | kristoffer.inton@morningstar.com

LKQ LKQ

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	43	33.94	Medium	Narrow	0.79	10.79

Source: Morningstar. As of July 27, 2018

Europe organic growth was exceptionally strong at 8.3% on new branches opened in Eastern Europe.

Analyst Note, July 26, 2018

Narrow-moat-rated LKQ, which provides alternative and specialty parts to repair and accessorize vehicles, reported second-quarter earnings per share before special items of $0.61, $0.03 better than the consensus EPS of $0.58 but $0.08 higher than the $0.53 reported in the same period a year ago. Organic parts and service revenue growth was strong at 7.2%, while acquisitions added 12.7% and favorable currency translation added 2.9%. Total consolidated revenue, including LKQ's scrap metal business, was up 23.3% to $3.0 billion versus $2.5 billion reported in the second quarter of 2017. The 4-star-rated LKQ shares currently trade at an attractive 22% discount to our $43 fair value estimate.

Europe organic growth was exceptionally strong at 8.3% on new branches opened in Eastern Europe. North America second-quarter organic growth was impressive and above management's long-term target of 4%-6%, increasing 7.4%. Growth was attributable to healthier volume after mild winter weather affected first-quarter 2018 results, but also favorable wholesale pricing during the second quarter. However, the outperformance in North America was partially offset by softer specialty segment organic growth of 4.1%. Higher steel prices drove scrap organic growth to 30.2%.

Consequently, management tweaked guidance slightly higher on combined organic growth and better margin guidance on the ramp-up of a large automated distribution facility in the U.K. The new guidance increased management's adjusted income from continuing operations guidance by $25 million, to a range of $710 million to $735 million. This resulted in a $0.04 increase in the midpoint of EPS guidance to $2.25 to $2.33. We maintained our 2018 EPS estimate of $2.30, including the Stahlgruber acquisition that closed on June 30.

Richard Hilgert | richard.hilgert@morningstar.com

Total TOT

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	USD	74	63.98	Medium	None	0.86	162.05

Source: Morningstar. As of July 27, 2018

At current levels, we do not think shares accurately reflect this multiyear improvement, leaving shares undervalued.

Analyst Note, July 26, 2018
Best Idea Total reported a solid second quarter, capitalizing on higher oil and gas prices to deliver strong earnings and cash flow growth. With results largely tracking to our full-year estimates, our fair value and no-moat rating are unchanged, leaving Total as one of the most undervalued global integrateds, in our view.

Upstream earnings nearly doubled during the quarter thanks to a 50% increase in oil prices and a 9% increase in production. A 22% increase in liquids production offset a 5% decline in gas volumes thanks to new projects starting and the addition of acquired volumes. With the strong performance, Total increased its full-year growth guidance to 7% from 6% while also increasing its 2014-18 targeted cost savings to $4.2 billion from $4 billion. We expect Total to continue delivering impressive growth relative to peers for years to come, as it is targeting a 5% production CAGR though 2022.

Total's other segment performed well also, with gas and power earnings doubling, marketing and services increasing 10%, and refining and chemicals slipping only 5% despite a 15% decrease in refining margins. Meanwhile, operating cash flow increased to $6.2 billion from $4.6 billion a year ago.

We expect Total to continue increasing its cash flow generation capability in the coming years, which should lead to increased shareholder returns. It has already committed to dividend growth of 10% and to repurchasing $5 billion of shares through 2020. As part of this program, management repurchased $600 million in shares during the quarter in addition to what was done to offset dilution from the scrip dividend. At current levels, we do not think shares accurately reflect this multiyear improvement, leaving shares undervalued.

Allen Good, CFA | allen.good@morningstar.com

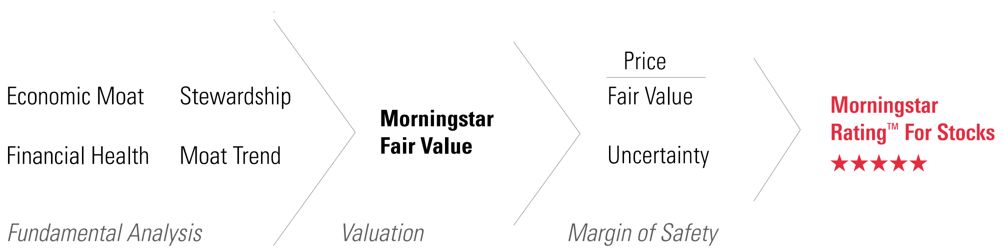
Research Methodology for Valuing Companies

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.

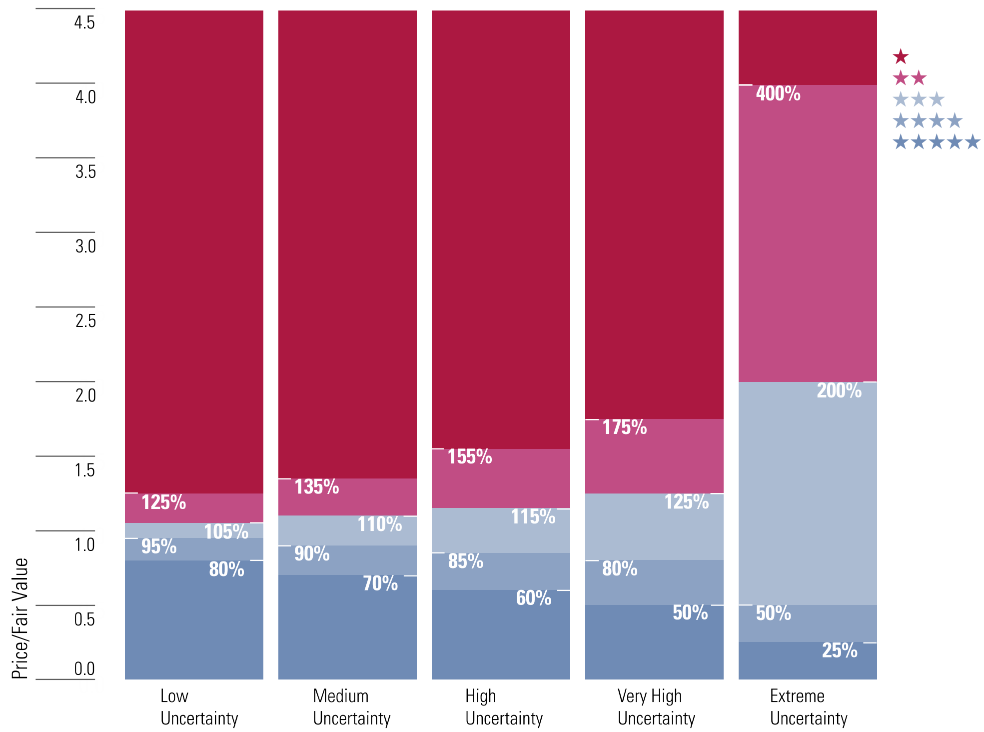
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than 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.

Risk Warning

Please note that investments in securities are subject to market and other risks, and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in the future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's uncertainty rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

General Disclosure

Unless otherwise provided in a separate agreement, recipients accessing this report may only use it in the country in which the Morningstar distributor is based. Unless stated otherwise, the original distributor of the report is Morningstar Research Services LLC, a U.S.-domiciled financial institution.

This report is for informational purposes only and has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. This publication is intended to provide information to assist institutional investors in making their own investment decisions, not to provide investment advice to any specific investor. Therefore, investments discussed and recommendations made herein may not be suitable for all investors: Recipients must exercise their own independent judgment as to the suitability of such investments and recommendations in the light of their own investment objectives, experience, taxation status, and financial position.

The information, data, analyses, and opinions presented herein are not warranted to be accurate, correct, complete, or timely. Unless otherwise provided in a separate agreement, neither Morningstar, Inc. nor the Equity Research Group represents that the report contents meet all of the presentation and/or disclosure standards applicable in the jurisdiction the recipient is located.

Except as otherwise required by law or provided for in a separate agreement, the analyst, Morningstar, Inc., and the Equity Research Group and their officers, directors, and employees shall not be responsible or liable for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions within the report. The Equity Research Group encourages recipients of this report to read all relevant issue documents (e.g., prospectus) pertaining to the security concerned, including without limitation, information relevant to its investment objectives, risks, and costs before making an investment decision and, when deemed necessary, to seek the advice of a legal, tax, and/or accounting professional.

The Report and its contents are not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country, or other jurisdiction where such distribution, publication, availability, or use would be contrary to law or regulation or which would subject Morningstar, Inc. or its affiliates to any registration or licensing requirements in such jurisdiction.

Where this report is made available in a language other than English and in the case of inconsistencies between the English and translated versions of the report, the English version will control and supersede any ambiguities associated with any part or section of a report that has been issued in a foreign language. Neither the analyst, Morningstar, Inc., nor the Equity Research Group guarantees the accuracy of the translations.

This report may be distributed in certain localities, countries and/or jurisdictions ("Territories") by independent third parties or independent intermediaries and/or distributors ("Distributors"). Such Distributors are not acting as agents or representatives of the analyst, Morningstar, Inc., or the Equity Research Group. In Territories where a Distributor distributes our report, the Distributor is solely responsible for complying with all applicable regulations, laws, rules, circulars, codes, and guidelines established by local and/or regional regulatory bodies, including laws in connection with the distribution third-party research reports.

Conflicts of Interest

- No interests are held by the analyst with respect to the security subject of this investment research report.
    - Morningstar, Inc. may hold a long position in the security subject of this investment research report that exceeds 0.5% of the total issued share capital of the security. To determine if such is the case, please click http://msi.morningstar.com and http://mdi.morningstar.com.
- Analysts' compensation is derived from Morningstar, Inc.'s overall earnings and consists of salary, bonus, and in some cases restricted stock.
- Neither Morningstar, Inc. nor the Equity Research Group receives commissions for providing research nor do they charge companies to be rated.
- Neither Morningstar, Inc. nor the Equity Research Group is a market maker or a liquidity provider of the security noted within this report.
- Neither Morningstar, Inc. nor the Equity Research Group has been a lead manager or co-lead manager over the previous 12 months of any publicly disclosed offer of financial instruments of the issuer.
- Morningstar, Inc.'s investment management group does have arrangements with financial institutions to provide portfolio management/investment advice, some of which an analyst may issue investment research reports on. However, analysts do not have authority over Morningstar's investment management group's business arrangements nor allow employees from the investment management group to participate or influence the analysis or opinion prepared by them.
- Morningstar, Inc. is a publicly traded company (ticker symbol: MORN) and thus a financial institution the security of which is the subject of this report may own more than 5% of Morningstar, Inc.'s total outstanding shares. Please access Morningstar, Inc.'s proxy statement, "Security Ownership of Certain Beneficial Owners and Management" section http://investorrelations.morningstar.com/sec.cfm?doctype=Proxy&year=&x=12
- Morningstar, Inc. may provide the product issuer or its related entities with services or products for a fee and on an arms' length basis including software products and licenses, research and consulting services, data services, licenses to republish our ratings and research in their promotional material, event sponsorship, and website advertising.

Further information on Morningstar, Inc.'s conflict of interest policies is available from http://global.morningstar.com/equitydisclosures. Also, please note analysts are subject to the CFA Institute's Code of Ethics and Standards of Professional Conduct.

For a list of securities that the Equity Research Group currently covers and provides written analysis on, please contact your local Morningstar office. In addition, for historical analysis of securities covered, including their fair value estimate, please contact your local office.

For Recipients in Australia: This Report has been issued and distributed in Australia by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544; ASFL: 240892). Morningstar Australasia Pty Ltd is the provider of the general advice ('the Service') and takes responsibility for the production of this report. The Service is provided through the research of investment products. To the extent the Report contains general advice, it has been prepared without reference to an investor's objectives, financial situation, or needs. Investors should consider the advice in light of these matters and, if applicable, the relevant Product Disclosure Statement before making any decision to invest. Refer to our Financial Services Guide (FSG) for more information at http://www.morningstar.com.au/fsg.pdf.

For Recipients in Canada: This research is not prepared subject to Canadian disclosure requirements.

For Recipients in Hong Kong: The Report is distributed by Morningstar Investment Management Asia Limited, which is regulated by the Hong Kong Securities and Futures Commission to provide services to professional investors only. Neither Morningstar Investment Management Asia Limited nor its representatives are acting or will be deemed to be acting as an investment advisor to any recipients of this information unless expressly agreed to by Morningstar Investment Management Asia Limited. For enquiries regarding this research, please contact a Morningstar Investment Management Asia Limited Licensed Representative at http://global.morningstar.com/equitydisclosures.

For Recipients in India: This Investment Research is issued by Morningstar Investment Adviser India Private Limited. Morningstar Investment Adviser India Private Limited is registered with the Securities and Exchange Board of India (Registration number INA000001357) and provides investment advice and research. Morningstar Investment Adviser India Private Limited has not been the subject of any disciplinary action by SEBI or any other legal/regulatory body. Morningstar Investment Adviser India Private Limited is a wholly owned subsidiary of Morningstar Investment Management LLC. In India, Morningstar Investment Adviser India Private Limited has one associate, Morningstar India Private Limited, which provides data-related services, financial data analysis, and software development. The Research Analyst has not served as an officer, director, or employee of the fund company within the last 12 months, nor has it or its associates engaged in market-making activity for the fund company.

* The Conflicts of Interest disclosure above also applies to relatives and associates of Manager Research Analysts in India
* The Conflicts of Interest disclosure above also applies to associates of Manager Research Analysts in India. The terms and conditions on which Morningstar Investment Adviser India Private Limited offers Investment Research to clients varies from client to client and are detailed in the respective client agreement.

For recipients in Japan: The Report is distributed by Ibbotson Associates Japan, Inc., which is regulated by Financial Services Agency. Neither Ibbotson Associates Japan, Inc. nor its representatives are acting or will be deemed to be acting as an investment advisor to any recipients of this information.

For recipients in Singapore: For Institutional Investor audiences only. Recipients of this report should contact their financial adviser in Singapore in relation to this report. Morningstar, Inc. and its affiliates rely on certain exemptions (Financial Advisers Regulations, Section 32B and 32C) to provide its investment research to recipients in Singapore.

About Morningstar® Institutional Equity Research™

Morningstar Institutional Equity Research provides independent, fundamental equity research differentiated by a consistent focus on sustainable competitive advantages, or Economic Moats.

For More Information

+1 312 696-6869
equitysupport@morningstar.com

MORNINGSTAR®

22 West Washington Street
Chicago, IL 60602 USA