Research Highlights

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

Morningstar Equity Research
Feb. 19-23, 2018

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

Pessimism Grows for Land Drillers

We are lowering our fair value estimates for land drillers by 5% to 15%, with Helmerich & Payne moving to $41 from $43, Precision to $3 from $3.25, Patterson to $13.50 from $14, and Nabors to $6.50 from $7.50. Our no-moat rating for all of the names remains in place.

The lower fair values come partly from a more pessimistic near-term outlook for the companies' results, because we think their U.S. land rig counts are likely to peak in mid-2018 along with the overall U.S. horizontal rig count, but then decline thereafter in response to falling crude prices (which in turn will be a response to surging U.S. shale production). We expect a rebound in rig counts in 2020 to around our pre-existing midcycle view (a U.S. horizontal rig count of just over 800), to step up the pace of U.S. shale production. Yet, this more distant target date reduces the near-term cash flows, which weigh heavily on our valuation model.

Additionally, the lower fair values reflect the meager pace at which rig pricing has resumed so far into the U.S. shale activity recovery. As of the third quarter, the average U.S. land gross margin per rig day stood at about $6,500, well below peak 2014 levels of around $12,000 per day. This is a tepid recovery given that the combined U.S. land rig count for the companies is now over 80% of our forecast midcycle levels. We still expect that the average for the cohort will increase to about $10,000 per day by midcycle, but we have slightly lowered our expectations from our prior levels.

Among the group, Helmerich & Payne and Patterson take the smallest hit in fair value revision due to their relative outperformance so far in terms of U.S. drilling profitability. Additionally, we have slightly increased our expectations for Patterson's pressure pumping business. Nabors takes the largest fair value hit, as it severely las both Precision and Patterson in terms of gross margin per day performance, even though the three companies averaged similar levels during 2013 to 2016.

Helmerich & Payne

Helmerich & Payne has exhibited robust operating performance relative to peers in the past several years. It increased its share of U.S. land horizontal rig revenue days from 14% to about one fifth amid a general downturn for drillers. By building a fleet of rigs optimal for the multiwell pad drilling that offers the best economics for oil and gas producers, H&P has positioned itself on the leading edge of industry trends.

However, we believe that this relative operating outperformance will be overshadowed by the overall industry climate. H&P's aggressive capital spending to build a large rig fleet means that it needs high rig counts to realize high returns on invested capital. Given our assumptions about market share and margins, a midteens ROIC for H&P, as the company earned in 2010-14, would require a U.S. horizontal rig count average of well over 1,000. Such a high rig count would yield an unsustainably high level of production, which is incongruent with our current supply forecasts.

Despite the recovery in U.S. shale activity, the U.S. land rig market today is still marked by overcapacity and low day rates and margins. We expect utilization for even Tier 1 rigs (high-quality AC rigs with 1.5k-plus horsepower and multiwell pad drilling capabilities) to remain below 80% in the near future. While our view is that incremental global oil supply needs will largely be met by U.S. tight oil in 2018, fewer rigs will be needed to meet this requirement than in the past, owing to increased efficiencies. This limits the scope for improved pricing and utilization for all U.S. land drillers even as overall industry fundamentals recover.

Patterson-UTI Energy

The downturn in U.S. oil & gas drilling and completions activity has weighed heavily on profitability in Patterson's primary business lines: contract drilling and pressure pumping.

We expect Patterson to have average performance among land drillers. While utilization for its Tier 1 APEX 1500 series rigs has held up well during the downturn, utilization for several of its other classes of rigs (even some of its newer-built rigs) has been abysmally low. We believe that the underperformance of these classes of rigs will persist.

Meanwhile, we expect pressure pumping utilization to be nearly fully recovered by early 2018. Horizontal well completions have continued to trend toward increased need for pressure pumping services, and this will combine with sharply rising well completions in 2018 to lift demand to near its prior peak. Moreover, rapid equipment attrition means that the marginal horsepower of pressure pumping will be supplied by new-build capacity, meaning that pricing should recover to the point that adding capacity is an NPV-positive decision.

Precision Drilling

Precision is among the top-tier U.S. drillers and leads the Canadian drilling market with close to one third share of drilling in 2017. However, the company's profitability has been curbed in recent years by a downturn in drilling activity, resulting in lower utilization and day rates than in past years.

Precision's Tier 1 rigs have performed well in U.S. markets, and these rigs have recovered substantially in utilization from low trough levels. Unfortunately, Precision also has a very large fleet of non-Tier 1 rigs. These will struggle to reach reasonable levels of utilization even through 2022. This trend predates the late 2014 downturn, as Precision began losing market share in 2012 as operators' preferences shifted toward deeper wells and longer laterals, which disqualified many of Precision's non-Tier 1 rigs, their high efficiency and mobility notwithstanding.

Thus, even a full recovery in oil drilling activity would not be enough to restore Precision to prior levels of profitability, in our view.

Nabors Industries

Nabors is among the top-tier U.S. and international onshore drillers, but its profitability has also been curbed since 2014 by a downturn in drilling activity.

Not only is Nabors beset by a collapsed U.S. horizontal rig market, it's also lost market share over the years. This is a result of factors that appear likely to persist into the near future. Effectively, Nabors has invested to build a rig fleet that while expensive and high-spec, is only partly composed of rigs tailored to the drilling trends of the past several years. The company's investment in lower-horsepower, lighter-footprint AC rigs is emblematic of this; while these rigs played well early in the shale boom, they are less well equipped to handle the longer laterals and deeper wells prevalent more recently.

These bleak prospects on the U.S. side are counterbalanced somewhat by improving international prospects. In particular, we expect Nabors to maintain its nearly one third of Saudi drilling market share even while Saudi drilling activity grows by about 40% from 2016 to 2022. Additionally, we project a modest recovery in Latin American drilling activity, where Nabors is prominent.

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Look Beyond Accounting to See Scana's Performance

We are reaffirming our $60 fair value estimate and narrow, stable moat ratings after Scana reported 2017 earnings that included a $1.1 billion pretax write-off for its terminated nuclear project yet showed a mostly healthy core business, as we expected. Although accounting earnings show an $0.83 per share loss for the year, earnings excluding nuclear project and tax reform charges were $4.20 per share, in line with our outlook.

Our fair value estimate continues to include a 75% likelihood that regulators will approve Dominion Energy's $14.6 billion all-stock acquisition offer. We believe the 0.669 share exchange ratio is value-neutral for both companies' shareholders. Both are top picks among our U.S. utilities coverage. We also think Scana's 25% discount to Dominion's implied purchase price as of late February offers an attractive risk-reward proposition if an investor were to buy Scana and short Dominion stock.

Political and regulatory developments this month suggest it will be difficult for Dominion to close its deal by this fall but possibly by year-end. We don't think timing alone will kill the deal. The South Carolina House has taken what we consider an extreme populist stance, recently voting to cut Scana's customer rates and fire all seven state utility regulators. We think the Senate's more measured approach is better for all stakeholders. It appears state senators won't take any legislative action until they review a report that regulators have commissioned assessing Scana's bankruptcy risk related to nuclear project cost recovery.

The outcome of the bankruptcy review presents an unusual scenario for Scana shareholders. If bankruptcy is a legitimate concern—as management has suggested—it could be a positive catalyst since it could make the Dominion deal more attractive and regulators less likely to make large rate cuts. Alternatively, we think the market already is pricing in a drastic rate cut.

Scana

Scana's decision to abandon its new nuclear plant construction in mid-2017 created a political and regulatory headache that could have persisted for several years if not for Dominion's acquisition proposal in January 2018. Now Dominion will have to resolve the aftermath of a project whose costs ballooned from $6.3 billion in 2008 to nearly $10 billion in 2017 for Scana's 55% stake. Dominion and Scana shareholders will both feel near-term pain.

Part of Dominion's offer is effectively punting on much of Scana's $5 billion investment. We estimate $2.2 billion of capital is at risk after taxes and monetization of Toshiba's guaranty payments. Also at risk is some $1.9 billion of cash Scana has collected from customers. If regulators approve a full write-off and refund, Scana could be in a challenging financial condition and Dominion would probably exit.

Scana management has done a good job protecting shareholder value during the project, but Dominion's reception will be critical. The 2007 South Carolina Base Load Review Act allows Scana to collect financing costs and capital investment from rate payers even if it abandons the project, but we expect legal challenges could negate those protections. Scana also is returning to customers $1.2 billion of guaranty payments from Westinghouse and Toshiba.

Dominion Energy

Dominion Energy recently changed its name from Dominion Resources. More importantly for investors, however, the company has also made a strategic pivot. Since 2010, it has focused on the development of new wide-moat projects with conservative strategies, exited the exploration and production business, sold or retired no-moat merchant energy plants, and made significant investments in moaty utility infrastructure.

We expect wide-moat businesses to generate roughly half of Dominion's operating earnings by 2021, up from 30% in 2016. The remaining earnings primarily come from narrow-moat regulated gas and electric utilities in states with long histories of constructive regulatory frameworks, solid sales growth, and high-return investment opportunities. We believe Dominion's businesses will earn a material spread over our estimate of the company's cost of capital through the next decade.

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New Coverage of Japanese Retailer

We are initiating coverage of Japan's largest discount retailer, Don Quijote, or Donki, with a fair value estimate of JPY 5,600 and narrow, stable moat ratings. We think the company's off-price retail business benefits from cost advantages derived from its scale and sourcing capabilities—4,000 vendors and a buying fleet with more than 10,000 buyers—which allows it to buy merchandise in both large and small quantities, depending on availability. This buying power, combined with a distinct procurement system, contributes to Donki's broad array of products and its ability to offer significant discounts at its more than 360 stores. Though rivals might be able to develop a comparable network and team, they are unlikely to have the capacity to achieve Donki's scale. As for online competition, Donki's constantly changing merchandise and attractive prices create a treasure-hunt aspect that e-commerce is less likely to match.

The stock is trading at a 6% premium to our fair value estimate, although our earnings estimates are 12% above the 2017 guidance and 7% above consensus. The difference appears to lie in the profit contribution from a 40% stake in Uny, as Donki tends to guide toward a conservative outlook. We expect that share gains will continue, backed by the company's price leadership, and drive top-line and profit growth through store expansion, increased customer traffic, and operational leverage. We expect Donki's lean operation to support investment returns well above its costs of capital.

Our fair value estimate implies fiscal 2019 price/earnings of 24 times and enterprise value/EBITDA of 13.6 times, both trading toward the upper end of its historical range and at a 10% premium to the sector average, given a 50% rally over the past 12 months compared with a 20% rise in the Topix Retail Index.

We attribute its outperformance to robust same-store sales, in part boosted by increasing tourist spending, and a steady profit growth in a lackluster consumer environment. Despite our confidence in Donki's ability to gain shares and deliver earnings growth, we would prefer a wider margin of safety. Intensified pricing competition initiated by rivals poses potential downside to our estimates.

Bulls Say

- Don Quijote's Mega Donki format, which carries a wide variety of food products targeting families, is poised to take share from the JPY 13 trillion market of general merchandise stores whose sales are on a secular decline as consumers turn to specialty retailers and online channels.
- Donki's track record of turning around unprofitable stores, backed by its low-cost procurement and lean operations, indicate a strong likelihood that its partnership with Uny will be a success.
- Donki also operates a small chain of 37 supermarkets in Hawaii and California and opened its first non-Japan Asian outlet in Singapore in late 2017. Donki's popularity among foreign tourists bodes well for its overseas expansion. Its unique product assortment and entertaining store concept should set it apart from rivals.

Bears Say

- Growth may be dampened by consumers' shift to e-commerce, as decreased demand for discretionary items will deteriorate its product mix and hurt margins.

- A strategy focused on niche items constrains growth in private-label sales, which is critical to its long-term gross margins and price leadership, as higher margins generated by private-label sales can subsidize savings passed on to consumers.
- Donki's same-store sales might be dragged down by increased resources channeled to the joint-name stores with Uny.

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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	$9.03	High	Narrow	0.53	3.58	Inton
Compass Minerals International (CMP)	★★★★	$82	$61.95	High	Wide	0.76	2.10	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 232.35	High	Narrow	0.63	23.05	C. Nichols
China Mobile (941)	★★★★★	HKD 110	HKD 74.75	Medium	Narrow	0.68	1530.54	Baker
Quebecor (QBR.B)	★★★★	CAD 27	CAD 24.07	Medium	Narrow	0.89	5.79	Zhao
Telefonica (TEF)	★★★★	$13	$8.02	High	Narrow	0.62	41.65	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.48	Medium	Narrow	0.76	41.39	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$155	$110.49	Medium	Narrow	0.71	8.17	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.86	Medium	Narrow	0.84	1.64	Ragonese
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 41.01	Medium	Narrow	0.77	3.59	Faul
General Motors (GM)	★★★★	$56	$40.91	High	None	0.73	57.38	Whiston
Great Wall Motor (2333)	★★★★	HKD 14.9	HKD 8.89	High	None	0.60	116.51	Hu
Hanesbrands (HBI)	★★★★★	$32	$20.13	Medium	Narrow	0.63	7.25	Weishaar
Mattel (MAT)	★★★★	$22.5	$16.64	High	Narrow	0.74	5.72	Katz
Starbucks (SBUX)	★★★★	$68	$55.4	Medium	Wide	0.81	77.87	Hottovy
The Interpublic Group of Companies (IPG)	★★★	$25	$23.94	Medium	Narrow	0.96	9.30	Mogharabi
TripAdvisor (TRIP)	★★★★	$55	$41.65	High	Narrow	0.76	5.79	Wasiolek
Walt Disney (DIS)	★★★★	$130	$105.24	Medium	Wide	0.81	158.25	Macker
Williams-Sonoma (WSM)	★★★★	$65	$53.25	Medium	Narrow	0.82	4.48	Katz
WPP (WPP)	★★★★	GBX 1640	GBX 1361	Medium	Narrow	0.83	17.28	Mogharabi
Consumer Defensive								
Coca-Cola Amatil (CCL)	★★★	AUD 9.4	AUD 9.05	Medium	Narrow	0.96	6.70	Fleck
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2609.5	Low	Wide	0.67	24.89	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7730	Low	Wide	0.88	3740.26	Wei
Mondelez International (MDLZ)	★★★★	$51	$43.51	Medium	Wide	0.85	64.71	Lash
Procter & Gamble (PG)	★★★★	$98	$80.84	Low	Wide	0.82	203.80	Lash
Energy								
Cenovus Energy (CVE)	★★★★★	$21	$9.31	Very High	None	0.44	11.44	Gemino
Enbridge (ENB)	★★★★★	$64	$42.57	Medium	Wide	0.67	72.16	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$76	$64.47	Low	None	0.85	263.34	Good
RSP Permian (RSPP)	★★★★	$57	$35.7	High	None	0.63	5.66	Meats
Total (TOT)	★★★★	$70	$57.53	Medium	None	0.82	145.32	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$59.96	Medium	None	0.79	54.11	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.32	Very High	None	0.87	23.92	Heathfield
Capital One Financial (COF)	★★★★	$120	$96.67	Medium	Narrow	0.81	47.01	Plunkett
Invesco (IVZ)	★★★★	$42	$32.94	Medium	Narrow	0.78	13.41	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 765.4	Medium	None	0.87	10074.83	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 10.73	High	Narrow	0.83	14.59	Ellis

Source: Morningstar. As of Feb. 23, 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	$159.4	Medium	Wide	0.61	52.65	Waterhouse
Express Scripts Holding (ESRX)	★★★★	$89	$74.72	Medium	Wide	0.84	42.32	Lekraj
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.92	Medium	Narrow	0.80	3.34	Kallos
McKesson (MCK)	★★★★	$210	$150.09	Medium	Wide	0.71	30.97	Lekraj
Ramsay Health Care (RHC)	★★★★	AUD 87	AUD 68.07	Medium	Narrow	0.78	13.76	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 222.05	Low	Wide	0.69	190.20	Andersen
Shire (SHP)	★★★★★	GBX 4890	GBX 3037	Medium	Narrow	0.62	27.64	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$77.5	Medium	Narrow	0.72	2.58	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 43.8	Medium	Narrow	0.76	55.28	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.64	Medium	Wide	0.86	15.34	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 120	HKD 99.3	Medium	None	0.83	383.07	Tan
Fluor (FLR)	★★★★	$69	$58.11	High	Narrow	0.84	8.13	Silver
G4S (GFS)	★★★★	GBX 312	GBX 260.3	Medium	None	0.83	4.04	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 38.86	Medium	Wide	0.83	7.07	Molina
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 5.2	High	None	0.76	39.22	Song
Johnson Controls International (JCI)	★★★★	$53	$37.98	High	Narrow	0.72	35.17	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 71.14	Medium	Narrow	0.83	8.38	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 31.36	Medium	Narrow	0.78	29.05	Vonk
Stericycle (SRCL)	★★★★	$99	$60.63	Very High	Wide	0.61	5.18	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.66	Medium	None	0.86	1.55	Sherlock
Vornado Realty Trust (VNO)	★★★★	$84	$66.53	Medium	None	0.79	12.64	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$95	$79.89	Medium	Wide	0.84	6.13	Nelson
KLA-Tencor (KLAC)	★★★	$125	$108.91	High	Wide	0.87	17.06	Davuluri
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.35	Medium	Narrow	0.83	2.03	James
Qualcomm (QCOM)	★★★	$75	$62.18	High	Narrow	0.83	92.05	Davuluri
Sabre (SABR)	★★★★	$26	$23.38	Medium	Narrow	0.90	6.42	Wasiolek
Salesforce.com (CRM)	★★★★	$138	$113	Medium	Wide	0.82	81.62	Nelson
Synaptics (SYNA)	★★★★	$64	$47.1	Very High	None	0.74	1.62	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9650	High	None	0.84	1217.83	Ito
Tencent Holdings (700)	★★★	HKD 492	HKD 453.4	High	Wide	0.92	4306.68	Tam
Utilities								
Dominion Energy (D)	★★★★	$87	$73.58	Low	Wide	0.85	47.43	Fishman
FirstEnergy (FE)	★★★★★	$40	$32.92	Low	Narrow	0.82	15.66	Fishman
Gas Natural SDG (GAS)	★★★★	EUR 21	EUR 19.01	Medium	Narrow	0.91	19.02	Fulop
SCANA (SCG)	★★★★★	$60	$39.93	Medium	Narrow	0.67	5.70	Miller

Source: Morningstar. As of Feb. 23, 2018

Highlighted Stocks

Telefonica TEF

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Communications	Positive	USD	16	9.90	High	Narrow	0.62	50.57

Source: Morningstar. As of Feb. 23, 2018

Our revenue growth and EBITDA margin expectations remain above consensus, and we expect to maintain our fair value estimate and narrow moat rating. We believe the shares are significantly undervalued.

Analyst Note, Feb. 22, 2018
Telefonica reported fourth-quarter revenue in line with our expectations, but EBITDA margins were a bit light. The firm's results continue to be hurt by the strength of the euro versus other currencies. In the fourth quarter, revenue increased 4.8% year over year on an organic basis but fell 4.1% when converted into euros, which brought its full-year reported revenue to a decline of 0.1%, spot on with our full-year projection. While its EBITDA margin only hit 29.7% in the quarter and 31.1% for the year versus our projection of 32.2%, we expect margin expansion to continue. Our revenue growth and EBITDA margin expectations remain above consensus, and we expect to maintain our fair value estimate and narrow moat rating. We believe the shares are significantly undervalued.

In Spain, total revenue was only flat in the quarter and still declined 1.2% for the year, due to a 2.6% revenue decline in business services and a 10.9% drop in non-converged services. However, we believe Telefonica continues to benefit from convergence and this scale will enable revenue to grow going forward. The firm's converged product, Movistar Fusion, increased accesses by 10% for the year to 20.3 million. This means 87% of its consumer pay TV base, 86% of its broadband base, and 79% of its wireless contract base are now in a converged product. This allowed its average revenue per user to increase 6% in the quarter.

In the U.K., Telefonica grew its revenue 3.2% in British pounds in the quarter, but only 0.5% in euros. For the year, revenue increased 2.2% in pounds, but fell 4.7% in euros. While total mobile accesses remained flat at 25 million, the firm grew its LTE base 7% to 12.9 million. The move to more customers using LTE is driving increased data usage, which more than offsets declines in the prepaid base. Telefonica also saw a 9.4% increase in handset sales in the country in the quarter. Higher data usage is a core feature of the firm's overall growth, which we expect to continue.

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General Mills GIS

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Negative	USD	61	52.98	Low	Wide	0.87	31.27

Source: Morningstar. As of Feb. 23, 2018

The deal strikes us as strategically sound, as it stands to improve General Mills' growth trajectory without compromising its ongoing efforts to enhance its bottom line.

Analyst Note, Feb. 23, 2018
Wide-moat General Mills has announced that it will buy narrow-moat Blue Buffalo, a natural pet food brand, for $8 billion, or $40 per share. We may slightly tick up our $61 fair value estimate for General Mills, and we have raised our valuation of Blue Buffalo to $39 per share from $28.50 to reflect the discounted value of the offer, assuming a late May close. This implies an adjusted EBITDA multiple of around 22 times, including synergies, which we view as fair, given that Blue Buffalo boasts higher growth (compound annual sales growth of 12% over the past three years versus mid-single-digit declines at General Mills) and margins (operating margins in the mid-20s versus General Mills' high teens). The transaction has already been approved by both boards; because Invus and the Bishop family control more than 50% of Blue Buffalo's outstanding shares, additional shareholder approval won't be required to close. With the mid-single-digit decrease in shares following the announcement, we think General Mills is a touch undervalued.

The deal strikes us as strategically sound, as it stands to improve General Mills' growth trajectory without compromising its ongoing efforts to enhance its bottom line. We expected the firm to look for inorganic growth opportunities, particularly in the natural and organic aisle, to prop up sales as top-line growth across the packaged foods landscape has remained elusive. While General Mills enjoys leading share in several domestic food categories, we've viewed its exposure to center store (which has faced declining traffic over the past several years as consumers opt for fresher alternatives in the perimeter) as a persistent headwind. As evidence, its cereal sales have averaged 3% declines the past three years, in line with the low- to mid-single-digit declines of the category, despite the company's 30% market share, with three of the top five brands in the U.S.

In comparison, we appreciate the attractive dynamics of the U.S. pet food market, which has increased retail sales at a 3%-4% rate over the past several years, outpacing the negative to low-single-digit growth in the traditional packaged food space. This growth has largely been driven by more wholesome and natural products, a category in which Blue Buffalo's fare enjoys a leading position and that is poised for further growth as premiumization trends continue. Pets have increasingly been seen as members of the household, in our view, and a bent toward humanization has led to trends in pet food that have mirrored those in human categories (including natural, high-protein, and grain-free fare). We think this has led to brand-loyal and price-inelastic consumers, particularly in the premium segment.

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Premier PINC

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Technology	Stable	USD	37	32.46	Medium	Narrow	0.88	1.76

Source: Morningstar. As of Feb. 23, 2018

The company has positioned itself as a one-stop shop for optimizing a hospital's supply chain.

Analyst Note, Feb. 23, 2018

We are initiating coverage of Premier, a North Carolina-based healthcare-services firm, with narrow moat and stable trend ratings. Our fair value estimate is $37 per share, which puts the shares at 4-star territory. This valuation implies 15.5 and 9.5 times our estimate of 2018 earnings and EBITDA, respectively, which combined with our medium uncertainty rating creates a compelling opportunity for investors, in our view.

Premier is the combination of two distinct yet complementary businesses that serve both inpatient and ambulatory facilities: a group purchasing organization and procurement function and a cloud-based healthcare technology platform. The company has positioned itself as a one-stop shop for optimizing a hospital's supply chain, providing access to the second-largest GPO in the country while leveraging its members' data to provide an analytics platform that few in the industry can replicate. Management has focused the company on achieving quantifiable cost savings for clients, which will only become more important as care reimbursement continues on the path toward value-based payment models.

While competition in healthcare services and IT has heated up in the past decade, we think Premier's unique position at the intersection of purchasing and analytics creates a defensible narrow moat for the franchise. Management has strengthened the firm's position through internal development and acquisitions that have culminated in meaningful competitive advantages, underpinned by cost advantages and intangible assets, which we expect will generate attractive returns for investors over the long term.

We forecast an organic revenue compound annual growth rate in the mid- to high single digits and a margin structure that stays flat in the coming five years. Additionally, the firm's near-zero net debt position creates substantial optionality as management looks to allocate shareholder funds to inorganic opportunities or further share repurchases.

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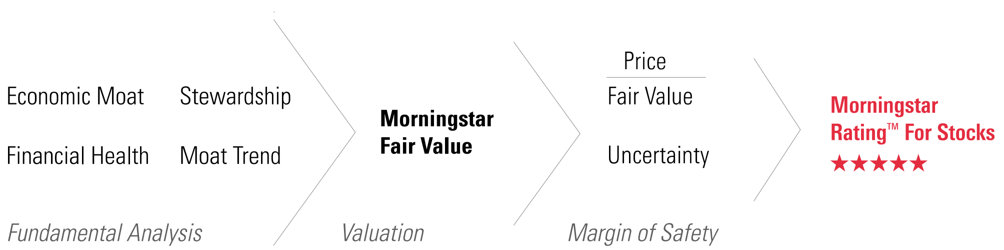
Research Methodology for Valuing Companies

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.

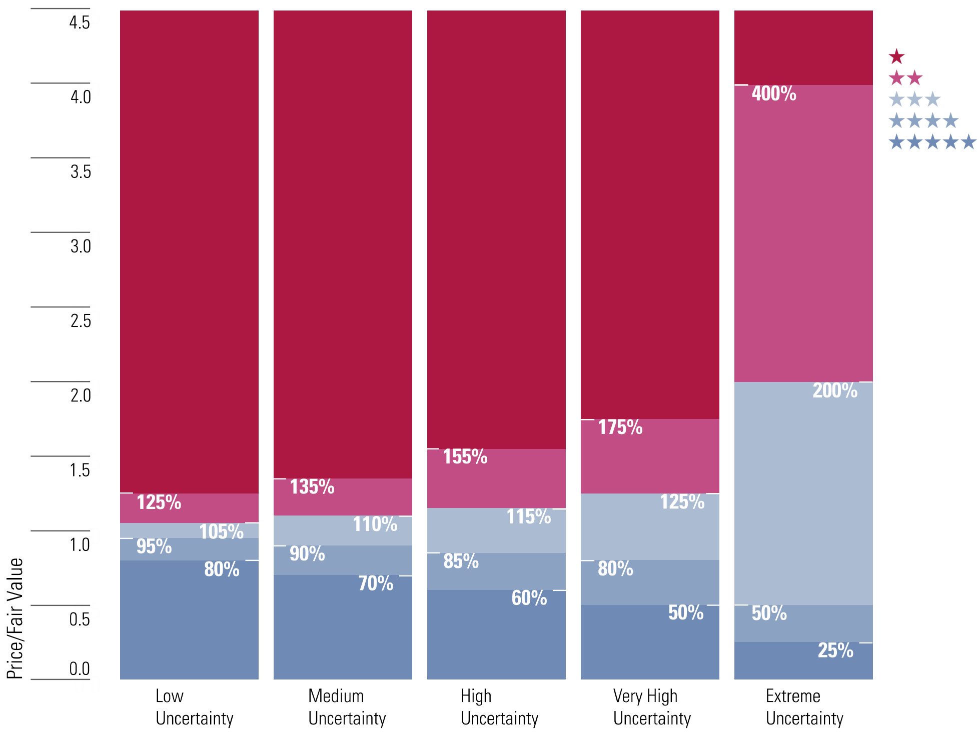
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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.

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