Research Highlights

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

Morningstar Equity Research
Aug. 13-17, 2018

Contents

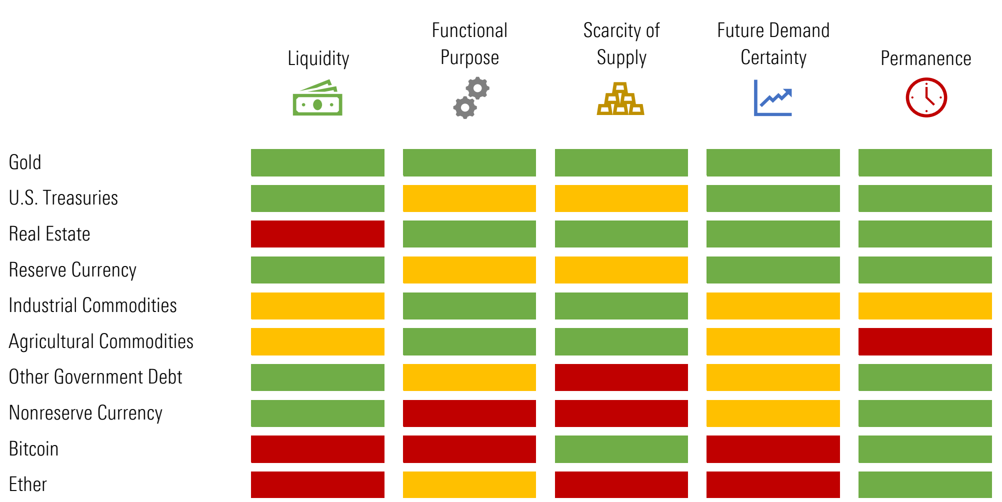
Cryptocurrencies No Threat to Gold

With their meteoric price rises in 2017, cryptocurrencies garnered the attention of even the most unsophisticated investors, and applications beyond the blockchain were explored. Amid the growing hype, some even floated the idea that cryptocurrency could one day replace gold as one of the world's most widely accepted investment assets. After all, the prospect of replacing physical mining that requires heavy machinery, deep tunnels, and chemical pools with computers running code is enticing.

If cryptocurrency were to displace gold's investment case, the implications for gold prices would be devastating: 40% of gold demand relates to investment, so a shift in investment from gold to cryptocurrency would be a seismic shock. Not only would nearly half of existing gold demand evaporate, but all inventory already held for investment would probably re-enter the market as supply, further crippling prices.

In this report, we provide a framework to grade the viability of various asset classes as safe havens. Through this framework, we conclude that cryptocurrency does not and will not challenge gold as a safe-haven asset class. Accordingly, we see some value across our gold coverage, with Goldcorp standing out as a unique long opportunity.

Exhibit 1 Our Framework Rates Gold as a Much Better Safe-Haven Investment Than Cryptocurrency



Source: Morningstar
Note: Green indicates overall strength, yellow indicates roughly balanced strengths and weaknesses, and red indicates overall weakness.

- Nearly 40% of annual gold demand would be at risk if cryptocurrency gained the same acceptance as gold for investment. However, we think this threat is unlikely to materialize.
- We've created a framework for assessing the safe-haven viability of an asset class on five key factors: liquidity, functional purpose, scarcity of supply, future demand certainty, and permanence. On the basis of these factors, we confirm gold's strength as a safe-haven asset while cryptocurrencies pale in comparison.
- Although our framework confirms gold's ongoing viability as a safe-haven asset, the investment case has continued to weaken amid rising real interest rates. However, we see upside for gold prices, given our bullish long-term outlook for jewelry demand in China and India.
- Goldcorp remains undervalued, in our view, as its current price reflects skepticism about the company's current 20/20/20 growth plan.

Goldcorp ★★★★

Goldcorp has a production base mostly in stable jurisdictions throughout North and South America. The company has divested noncore assets and acquired development projects as it seeks to achieve 20% production growth, 20% all-in sustaining cost reduction, and 20% higher reserves by 2021.

Goldcorp's largest mines include Cerro Negro in Argentina, Eleonore in Canada, and Penasquito in Mexico. Cerro Negro and Eleonore opened just a few years ago and have already become significant contributors to Goldcorp's production. Penasquito produces significant gold ounces along with silver, lead, and zinc. These byproducts help keep the mine’s production costs very low, though the mine will face low production in the near term because of mine sequencing.

We expect Goldcorp’s production to rise to roughly 3 million ounces by 2021, as new projects offset declining production at the company's older mines. Over time, we think Goldcorp's production, reserves, and cost targets are achievable as it rationalizes costs, opens new mines, and focuses on exploration to boost gold reserves.

Our long-term nominal gold price forecast is $1,300 per ounce in 2020. Investment demand will weaken further as the Federal Reserve raises interest rates, weighing on near-term gold prices. However, Chinese and Indian jewelry demand should eventually fill the gap left by investment demand. Strong preferences for gold in these countries drive high income elasticity, and rising incomes should result in robust jewelry demand growth over the next few years. Strong demand will lead to a production shortfall, requiring a higher incentive price to encourage additional mine production. However, cost deflation caps the potential upside from an otherwise strong demand story. Depreciation in producer currencies, lower oil prices, and general mine cost deflation stemming from the end of the Chinese-driven commodity boom have helped drive cost reductions, lowering the marginal cost of production.

Bulls Say

- Goldcorp's production costs will continue to fall as recently opened mines continue to ramp up and new projects are completed.

- Goldcorp's 20/20/20 growth plan looks achievable, resulting in higher production, lower costs, and more reserves.
- Gold companies tend not to follow general economic cycles. They can also provide a hedge to inflation risk.

Bears Say

- Goldcorp has relied on growth through acquisition, which exposes the company to risk of overpaying for assets.
- Goldcorp's historical geographic preference for the Americas has sometimes led to stiff competition for attractive acquisition targets.
- Investors looking for gold exposure can skirt company-specific risk by investing in gold-backed exchange-traded funds.

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NASH Market Opportunity Undervalued

A serious but often silent liver disease, nonalcoholic steatohepatitis has no effective treatment, as today's treatment options focus on lifestyle modification and off-label use of relatively ineffective therapies. However, a wave of targeted therapies is pushing through clinical development. We estimate that the global market will reach nearly $12 billion at the end of our forecast in 2027 on a probability-weighted basis and almost $26 billion if we assumed all modeled drug candidates gain approval.

Based on development timelines, pipeline promise, and company-specific areas of expertise, we believe Gilead and Intercept have the most potential in NASH over the next five years among the companies under our coverage. Over a longer horizon, among Big Pharma names, we believe Bristol-Myers Squibb and Pfizer could provide notable exposure to NASH should their earlier-stage drug programs continue to gain traction. Risk remains high in this indication, though; next-generation drugs continue to emerge from phase 1/phase 2 studies, and a dynamic clinical trial design environment makes comparisons difficult.

Exhibit 1 Gilead and Intercept Stand Out for Their Advanced and Effective Pipeline Candidates

Firm (Ticker)	Moat	P/FV	Key NASH Drugs (Catalysts)	Strategy
Intercept (ICPT)	None	0.76	Obeticholic Acid (H1 2019 Regenerate data)	FXR agonist obeticholic acid targets multiple metabolic and inflammatory pathways, and is the only drug candidate to have shown benefit on NASH resolution and fibrosis improvement. On efficacy it sets a high bar, but side effects leave room for competition.
Gilead (GILD)	Wide	0.89	Selonsertib (H1 2019 Stellar 3/4 data), combinations (Phase 2 data H2 2019)	Gilead's ASK1 inhibitor selonsertib showed a strong antifibrotic effect in phase 2, but comparability is limited by its shorter duration and lack of placebo comparator. We are more optimistic for Gilead's pivotal combination study testing doublet variations of selonsertib, ACC inhibitor GS-0976 and FXR inhibitor GS-9674.
Bristol-Myers (BMY)	Wide	0.93	BMS-986036 (Ph 2 data H1 2020 in F3/F4)	Met fat reduction, liver injury, and fibrosis endpoints in a small phase 2a study, but subcu delivery could make treating earlier stages/combinations challenging.
Pfizer (PFE)	Wide	0.91	PF-05221304 (Phase 2a data H1 2019)	Pfizer has several candidates in early-stage development, led by ACC inhibitor PF-05221304. Pfizer appears to be focusing on earlier-stage patients.

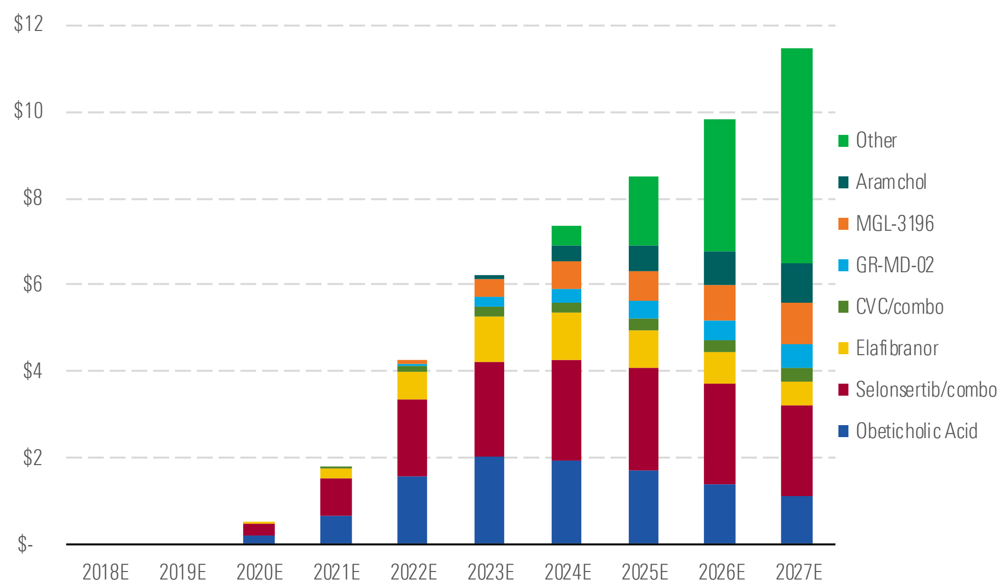
Source: Morningstar.

- NASH global market poised to reach $12 billion on probability-weighted basis in 2027. We estimate that there are roughly 2.8 million patients in the U.S. and Europe who are diagnosed with advanced fibrosis or cirrhosis and eligible for treatment, and we expect prices around $10,000 based on our analysis. While the advanced fibrosis (F2–F3) market is larger, we expect less competition in the cirrhosis (F4) market.
- We believe Gilead and Intercept have the most potential in NASH over the next five years among the companies we cover. Over a longer horizon, among Big Pharma names, we believe Bristol-Myers Squibb and Pfizer could provide notable exposure to NASH should their earlier-stage drug programs continue to gain traction.
- Intercept could be first-to-market in NASH, and shares remain attractively priced, as we think investors have outsize concern about side effects. For FXR agonist obeticholic acid, we model NASH sales of $1.6 billion in 2022, as the firm is an early mover in the space and has shown a well-rounded effect on liver fat, cellular ballooning, inflammation, fibrosis, and NASH resolution in an earlier phase 2 trial. However,

we expect sales to fall to $1.1 billion in NASH by 2027, as cholesterol elevation and severe itchiness leave room for competition, and FXR is the most popular target in NASH.

- Gilead's lead drug selonsertib and combination strategy allow for long-term NASH success. We expect Gilead to see $1.8 billion in NASH sales in 2022 and $2.1 billion in 2027 despite a tougher competitive landscape, given selonsertib's antifibrotic activity and potential of combinations with two other classes of drugs.

Exhibit 2 Probability-Adjusted NASH Market Expected to Approach $12 Billion in 2027



Source: Morningstar.

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Updating Our Potash Forecasts

Most potash producers have reported second-quarter earnings, so we've updated our near-term potash price forecast. We are increasing our 2019 price forecast to $300 per metric ton from $270 as we see new supply from K+S and EuroChem taking longer to ramp up than we had previously expected. Further, we see lower potash production from K+S' German potash mines also supporting higher prices in 2019, as the company is facing geological issues at its older mines. Our long-term price forecast of $310 per metric ton in nominal terms ($270 per metric ton in 2018 real terms) is unchanged. Over the long term, we think new supply from both K+S and EuroChem will eventually ramp up, which will balance the market from being undersupplied in 2019.

Although we are increasing our near-term potash price forecast, we think the move will have less effect on sulfate of potash, or SOP, prices as the spread between standard potash and SOP remains elevated. Historically, the marginal cost SOP producers make SOP from standard potash and, over the long term, we expect SOP prices to track standard potash prices plus the cost of production. Although we think standard potash prices will be slightly higher in 2019, we expect unit production costs to rise as well.

Due to our potash price update, our Mosaic fair value estimate increases to $35 per share from $34. Our Nutrien fair value estimates increase to $65 per share from $64 and to CAD 85 per share from CAD 83 due to the potash price forecast and a slight weakening of the loonie versus the dollar since our last update. We maintain our EUR 18 per share fair value estimate for K+S, our $55 per share fair value estimate for SQM, and our $83 per share fair value estimate for Compass Minerals.

Mosaic ★★★

Mosaic is a leading producer of phosphate and potash fertilizers, with each commodity contributing roughly half of the company's profits. Mosaic's U.S. phosphate rock mines and Canadian potash assets provide the company with a stable input base for its products. Mosaic will benefit from growing global demand for fertilizer. However, because it sells commodity products, it has no pricing power and operates in a volatile industry.

Mosaic is the world's largest producer of phosphate and has expanded capacity with the purchase of assets from Vale and the development of its Saudi Arabian joint venture with Ma'aden. Mosaic benefits from the vertical integration of its phosphate assets, as it mines its own phosphate rock, the key feedstock used to produce phosphate fertilizers. Being vertically integrated provides a cost advantage when rock prices are high, as nonintegrated producers must purchase phosphate rock on the open market. Nonintegrated players—which are the marginal producers—generally set phosphate fertilizer prices. Mosaic has benefited from this industry dynamic by operating lower on the industry cost curve. However, roughly 70% of global phosphate production comes from players that control their own phosphate rock mines, so Mosaic's vertical integration is not unique.

Mosaic is also a top-five potash producer. Potash prices are determined by the marginal cost of production as well. While Mosaic benefits from a cost position well below marginal cost, it currently sits above its Canadian peers on the cost curve due to brine inflow expenses. Mosaic's cost position is set to improve, however, as the company ramps up production at its new K3 mine at Esterhazy, which will eliminate the brine inflow expenses by the middle of the next decade. We expect potash prices to increase over the next few years as new greenfield mines have experienced delays that will cause supply will grow slower than demand.

Nutrien ★★★

Nutrien, the world's largest crop nutrient company, was formed in early 2018 as a result of the merger between Potash Corporation of Saskatchewan and Agrium. The company is the largest agricultural retailer in North America and Australia with more than 1,400 locations. Its retail centers sell fertilizers, crop chemicals, and seeds directly to farmers. In the highly fragmented farm retail industry, Nutrien is pursuing an acquisition strategy to expand its retail store base, which should improve bargaining power with suppliers. The company also benefits from selling proprietary and private-label products at its newly acquired stores. We expect this segment, which accounted for roughly two thirds of pro forma gross profit in 2016, to generate relatively steady cash flows.

In addition to its retail operations, Nutrien produces all three primary crop nutrients. With over 20% market share, Nutrien is the world's largest producer of potash by capacity. Its Canadian mines mostly sit on the lower half of the cost curve and have generated profits even when prices are below the marginal cost of production.

K+S ★★★

K+S has a middling cost position for its commodity products—fertilizer and salt—and as such, lacks a cost advantage. With high-cost potash mines in Germany and a low-cost mine in Canada, K+S sits in the middle of the muriate of potash industry cost curve. While K+S has a lower-cost position in the specialty fertilizer sulfate of potash, some of its competitors are lower on the industry cost curve. The company is also the world's largest supplier of salt, but in general, its mines lack the geologic advantages that lead to low costs.

K+S has lowered its position on the potash cost curve through the development of the Bethune mine in Saskatchewan. However, the benefits of this lower cost mine are partially offset by a continued decline in nutrient quality at the company's older German mines. Further, we are concerned that the high capital costs associated with the project will weigh on the company's return on invested capital in a lower potash price environment.

The firm's salt segment sells over half its volumes for use as deicing salt, which exposes the segment to climate change risk. One effect of climate change is for climates to shift north, which brings warmer weather and fewer snow days to northern climates. As a result, we expect a small decline in normal deicing salt demand due to less snow over time and limited prospects for sustained price increases.

SQM ★★★★

Through its access to high-quality mineral deposits, the Chemical and Mining Co. of Chile, otherwise known as SQM, is a large, low-cost producer of lithium, iodine, and nitrates used in specialty fertilizers.

SQM's crown jewels are its geologically advantaged lithium and caliche ore assets. SQM's low-cost lithium deposits in the Salar de Atacama boasts the highest concentration of lithium globally and benefits from high evaporation rates in the Chilean desert. As electric vehicle penetration increases, we expect mid-double-digit annual growth for global lithium demand, one of the best growth profiles among commodities. SQM is a major supplier in the lithium carbonate market and should benefit from the higher capacity that it has built up in recent years. The company is also investing in lithium hydroxide production capacity in Australia through a joint venture with Kidman resources that will mine and produce spodumene then convert the spodumene into lithium hydroxide. The project should boost profits in the next decade as the unit costs of the project should sit on the bottom half of the lithium hydroxide cost curve. SQM holds a joint venture stake in a low-cost brine resource in Argentina under development but agreed to sell its stake to Ganfeng lithium by the end of 2018.

Compass Minerals International ★★★★

Compass Minerals holds an enviable portfolio of cost-advantaged assets. Its Goderich rock salt mine in Ontario benefits from unique geology, and with access to a deep-water port, it can deliver deicing salt to customers at a lower cost than competitors. Additionally, the company controls one of only three naturally occurring brine sources that produces sulfate of potash, or SOP, a specialty fertilizer priced at a premium to standard potash. These operations at the Great Salt Lake in Utah can produce SOP at a significantly lower cost than producers that use a chemical process.

About 60% of Compass' salt sales are to highway deicing customers. Sales volume is determined during the winter months and is strongly linked to the number of snow days per season. As such, weather has a big impact on Compass' year-to-year results. The deicing salt business also exposes Compass to climate change risk. One effect of climate change is for climates to shift north, which brings warmer weather and fewer snow days to northern climates. As a result, we expect a small decline in normal deicing salt demand over time and limited prospects for sustained price increases. Pricing for deicing salt has historically been stable, especially compared with prices for other commodities. Deicing salt has a low value/weight ratio, and transportation costs make up a significant portion of total delivered costs to the customer. With mines close to waterways like the Great Lakes and the Mississippi River, Compass can typically deliver deicing salt at a lower cost than competitors.

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Best Ideas

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	$10.42	High	Narrow	0.61	4.08	Inton
Compass Minerals International (CMP)	★★★★	$83	$61.1	High	Wide	0.74	2.07	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$202.51	High	Narrow	0.76	12.76	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 225.75	High	Narrow	0.63	22.40	C. Nichols
China Mobile (941)	★★★★	HKD 100	HKD 73.3	Medium	Narrow	0.73	1500.85	Baker
Comcast (CMCSA)	★★★★	$42	$35.66	Medium	Wide	0.85	163.39	Macker
Telefonica (TEF)	★★★★★	$13	$7.31	High	Narrow	0.56	37.97	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 3.08	Medium	Narrow	0.70	36.63	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★	$157	$159.49	Medium	Narrow	1.02	11.82	Akbari
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 81.8	High	Narrow	0.70	53.19	Hilgert
Expedia Group (EXPE)	★★★★	$185	$131.2	High	Narrow	0.71	19.61	Wasiolek
General Motors (GM)	★★★★	$45	$36.29	High	None	0.81	51.20	Whiston
Great Wall Motor (2333)	★★★★	HKD 6.6	HKD 4.48	High	None	0.68	62.18	Su
Hanesbrands (HBI)	★★★★★	$27	$18.26	Medium	Narrow	0.68	6.58	Hottovy
InvoCare (IVC)	★★★★	AUD 17	AUD 12.66	Medium	Wide	0.74	1.39	Ragonese
Mattel (MAT)	★★★★	$21.5	$15.2	High	Narrow	0.71	5.23	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$51.89	High	Narrow	0.75	11.49	Katz
Walt Disney (DIS)	★★★★	$130	$112.48	Medium	Wide	0.87	167.29	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1281.5	Medium	Narrow	0.85	16.17	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★★	AUD 4	AUD 2.4	High	None	0.60	1.09	James
General Mills (GIS)	★★★★★	$59	$46.6	Low	Wide	0.79	27.77	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2983.5	Low	Wide	0.81	28.45	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8100	Low	Wide	0.92	3948.11	Wei
Mondelez International (MDLZ)	★★★★	$51	$42.11	Medium	Wide	0.83	61.76	Lash
PepsiCo (PEP)	★★★★	$123	$114.25	Low	Wide	0.93	161.59	Vora
Procter & Gamble (PG)	★★★★	$97	$83.69	Low	Wide	0.86	208.22	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6773	Low	Wide	0.93	47.86	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$11.6	Very High	None	0.55	14.25	Gemino
Enbridge (ENB)	★★★★	$64	$45.92	Medium	Wide	0.72	78.78	Gemino
Enterprise Products Partners (EPD)	★★★★	$35.5	$28.6	Low	Wide	0.81	62.23	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$64.81	Low	None	0.83	263.62	Good
Total (TOT)	★★★★	$74	$59.7	Medium	None	0.81	155.13	Good
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.5	High	Narrow	0.83	1215.95	Tan
American International Group (AIG)	★★★★	$76	$52.46	Medium	None	0.69	46.61	Horn
Capital One Financial (COF)	★★★★	$127	$98.92	Medium	Narrow	0.78	47.33	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 14.71	High	Narrow	0.67	37.51	Scholtz
Invesco (IVZ)	★★★★★	$38	$24.59	Medium	Narrow	0.65	10.10	Warren

Source: Morningstar. As of Aug. 17, 2018

Best Ideas

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Financial Services (cont.)								
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 671	Medium	None	0.76	8775.80	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 9.13	Medium	Narrow	0.83	2.56	Likos
QBE Insurance Group (QBE)	★★★	AUD 12.5	AUD 11.1	High	None	0.89	14.98	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 30.33	Medium	Wide	0.87	102.70	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$263	$184.21	Medium	Wide	0.70	62.53	Waterhouse
McKesson (MCK)	★★★★★	$210	$127.09	Medium	Wide	0.61	25.39	Lekraj
Medtronic (MDT)	★★★★	$105	$91.1	Medium	Wide	0.87	123.14	Wang
Ramsay Health Care (RHC)	★★★★★	AUD 82	AUD 55.51	Medium	Narrow	0.68	11.22	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 239.95	Low	Wide	0.71	205.48	Andersen
Shire (SHP)	★★★★	GBX 4990	GBX 4443	Medium	Narrow	0.89	40.63	Andersen
Industrials								
Allegion (ALLE)	★★★	$91	$85.43	Medium	Wide	0.94	8.12	Bernard
Anixter International (AXE)	★★★★★	$107	$71.4	Medium	Narrow	0.67	2.39	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 34.7	Medium	Narrow	0.60	43.79	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.94	Medium	Wide	0.89	15.82	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 118	HKD 89.55	Medium	None	0.76	345.46	Tan
G4S (GFS)	★★★★	GBX 337	GBX 250.6	Medium	None	0.74	3.89	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 32.08	Medium	Wide	0.68	5.79	Molina
General Dynamics (GD)	★★★	$220	$192.44	Medium	Wide	0.87	57.02	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 217	MXN 179.19	High	Wide	0.83	100.53	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.8	HKD 3.52	High	None	0.52	30.75	Song
Johnson Controls International (JCI)	★★★★	$53	$37.62	High	Narrow	0.71	34.80	Bernard
KION GROUP (KGX)	★★★★★	EUR 90	EUR 57.16	Medium	Narrow	0.64	6.75	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 37.3	Medium	Narrow	0.89	34.75	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 92.74	Medium	Narrow	NA	13.75	Field
Stericycle (SRCL)	★★★★	$86	$61.47	High	Narrow	0.71	5.28	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.8	AUD 2.36	Medium	None	0.84	1.37	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 118.1	Medium	Narrow	0.77	342.13	Zhong
Welltower (WELL)	★★★	$74	$65.68	High	None	0.89	24.43	Brown
Technology								
Intel (INTC)	★★★★	$65	$47.17	Medium	Wide	0.73	217.50	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$81.79	Medium	Wide	0.73	19.27	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 3.11	Medium	Narrow	0.81	1.86	James
ServiceNow (NOW)	★★★★	$221	$182.03	Medium	Wide	0.82	32.38	Fitzsimmons
Synaptics (SYNA)	★★★★	$64	$44.96	Very High	None	0.70	1.58	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 11030	High	None	0.88	1392.48	Ito
Tencent Holdings (700)	★★★★★	HKD 590	HKD 337	High	Wide	0.57	3208.99	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$71.13	Low	Wide	0.85	46.50	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.43	Medium	None	0.78	45.05	Fulop
FirstEnergy (FE)	★★★★	$41	$37.07	Low	Narrow	0.90	18.02	Fishman
SCANA (SCG)	★★★★★	$56	$37.56	Medium	Narrow	0.67	5.36	Miller

Source: Morningstar. As of Aug. 17, 2018

Highlighted Stocks

Tencent Holdings TCEHY

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Technology	Stable	USD	76	44.17	High	Wide	0.58	395.21

Source: Morningstar. As of Aug. 17, 2018

We think the recent share price weakness present an attractive buying opportunity, with the current price level not fully reflecting Tencent's monetization opportunities, supported by the company's strong network effect built on its massive user base and ecosystem.

Analyst Note, Aug. 16, 2018
We remain positive on wide-moat-rated Tencent for its long-term growth outlook, but near-term uncertainty has risen because of the lack of visibility over the launches of new gaming titles. However, we had already factored in slower growth in 2018 due to the delays in approval for game monetization, and our earnings forecast is 10% below market consensus. We think the delay merely pushes off growth to 2019, when we expect game approvals to resume. Hence, we make little change to our key assumptions, but lift our full-year net profit forecast to CNY 74.6 billion from CNY 66.6 billion, to factor in noncash items classified in other gains. We think the recent share price weakness present an attractive buying opportunity, with the current price level not fully reflecting Tencent's monetization opportunities, supported by the company's strong network effect built on its massive user base and ecosystem.

Recent market jitters were driven by net revenue growth slowing to 30%—the slowest pace since third-quarter 2015—and a 2% year-over-year (23% quarter-on-quarter) decline in net profit. The slowdown reflects a lack of new game launches, which is leading to concern that the Chinese government is clamping down on gaming. While this is not confirmed, we would not be surprised to see no or slow approvals for 2019 because of an ongoing restructure of the administrations governing this space. While the approval process of new game titles remains cloudy in the near term, we think revenue could be less impeded going forward because Tencent has a pipeline of 15 games approved for launch, of which five are expected in the third quarter. Tencent has a chance to see its gaming revenue pick up.

Despite the near-term headwinds in online games, we think Tencent's core strength in gaining traffic from its massive user base is unchanged. The combined monthly active users, or MAUs, of Weixin and WeChat continued to rise 9.9% year over year in the second quarter, or 1.7% on a sequential basis. Meanwhile, fee-based VAS registration subscriptions rose 30.3% year over year in the second quarter, or 4.6% on a sequential basis. With MAUs exceeding 1 billion, Tencent's Weixin and WeChat platform covers more than 75% of the China's population and forms a solid base for the company's long-term growth and monetization opportunities.

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Vestas Wind Systems VWS:DK

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Industrials	Stable	DKK	570	410.50	High	None	0.72	80.32

Source: Morningstar. As of Aug. 17, 2018

Our positive stance is supported by eye-popping order intake growth (EUR 2.7 billion for second-quarter 2018 versus EUR 2.2 billion for second-quarter 2017) and increased combined backlog of wind turbines and service agreements (EUR 23 billion at end of June 2018 versus EUR 20.2 billion at end June 2017).

Analyst Note, Aug. 15, 2018
Europe's largest wind turbine manufacturer, Vestas, reported second-quarter 2018 results in line with our expectations, as strong revenue growth in service (sales up 11% with EBIT margin of 25.2%) was more than offset by continued pricing pressure in power solutions. We foresee continued price declines (the average selling price for order intake, expressed per megawatt-hour, declined by 12% year on year in the quarter), as the increased allocation for large renewable wind projects based upon the action mechanism is having a dampening effect on prices. In the second half of 2018, we expect large auctions in Argentina, Brazil, Colombia, and Australia. We also project intense competition among players due to overcapacity. Given this competitive environment, we think the Vestas performance in the quarter on deliveries (up 7% year on year), revenue (flat), and EBIT (margin of 11.5 of sales, down 110 basis points year on year) is a decent result. We maintain our no-moat rating and fair value estimate of DKK 570 per share for the Danish shares, and EUR 76 for the European shares. Given recent share price weakness, we believe the shares are attractively valued. Our positive stance is supported by eye-popping order intake growth (EUR 2.7 billion for second-quarter 2018 versus EUR 2.2 billion for second-quarter 2017) and increased combined backlog of wind turbines and service agreements (EUR 23 billion at end of June 2018 versus EUR 20.2 billion at end June 2017).

We are happy with the strong growth and rising profitability in the service segment (revenue up 11% year on year with margins expanding 570 basis points). Vestas' strong increasing installed base of turbines supports our positive view for the firm's high-margin service business as it helps to offset revenue and margin swings in the company's equipment offerings.

Vestas announced another share buyback of EUR 200 million at the second-quarter results, but we still believe an increased dividend payout ratio is a more appropriate instrument by which to adjust Vestas' inefficient capital structure (net cash position at end June 2018 stood at EUR 2 billion), given the firm's structurally improved earnings. Thus, despite the announced share buybacks and growth in the absolute dividend (the payout ratio remained at 30% in 2017), we clearly see scope for increased shareholder remuneration.

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Bayer BAYRY

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Healthcare	Stable	USD	36	22.74	Medium	Narrow	0.63	79.87

Source: Morningstar. As of Aug. 17, 2018

Glyphosate has been off patent for nearly two decades, and margins are likely on the lower end of Bayer's crop chemicals. Based on this, we believe glyphosate accounted for a low-single-digit percentage of Bayer's profits.

Analyst Note, Aug. 16, 2018
The multimillion-dollar verdict on Aug. 10 against Monsanto over glyphosate weedkillers, including the Roundup brand, is concerning for Bayer, which acquired the company in June, but we don't expect a major change to our fair value estimate. Bayer is appealing the ruling. If there are other lawsuits, they are likely to be litigated slowly, over many years, and, historically in cases like these, the final results tend to be more minor than the initial cases.

The Roundup product line makes up a small portion of Bayer's revenue and profits. Based on pro forma numbers from the two companies, we estimate that glyphosate, the chemical used in the Roundup brand, would account for less than 10% of Bayer's total sales and even less of Bayer's profits. For context, we expect all of the crop science segment to make up about 44% of Bayer's total revenue in 2019.

Bayer does not break out glyphosate-specific sales, but in 2017, herbicides accounted for just 7.5% of total sales. We note that Bayer did have to divest some of its glyphosate assets (to BASF) to complete the Monsanto acquisition. Glyphosate has been off patent for nearly two decades, and margins are likely on the lower end of Bayer's crop chemicals. Based on this, we believe glyphosate accounted for a low-single-digit percentage of Bayer's profits.

In 2017, Monsanto's crop chemicals segment, called agricultural productivity, accounted for around 25% of total sales, but only 11% of profits. Monsanto, like Bayer, did not break out specific brands, but it sold only two major crop chemicals: glyphosate (under the Roundup brand) and dicamba. The majority of Monsanto's crop chemicals profits were from glyphosate, so we estimate Roundup profits to be 8%-9% of Monsanto's total profits.

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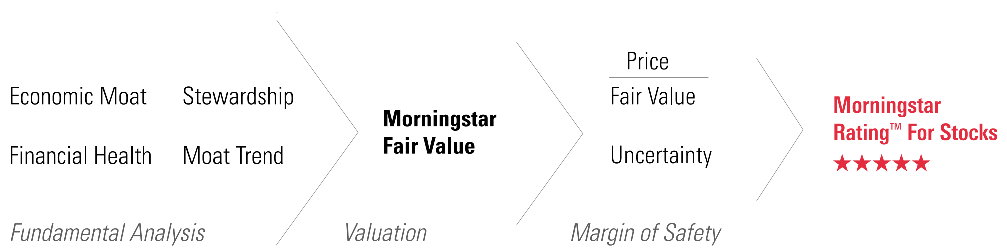
Research Methodology for Valuing Companies

Overview

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

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

Morningstar Research Methodology



Source: Morningstar.

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

Economic Moat

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

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

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

Estimated Fair Value

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

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

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

Stage II: Fade

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

Stage III: Perpetuity

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

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

Uncertainty Around That Fair Value Estimate

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

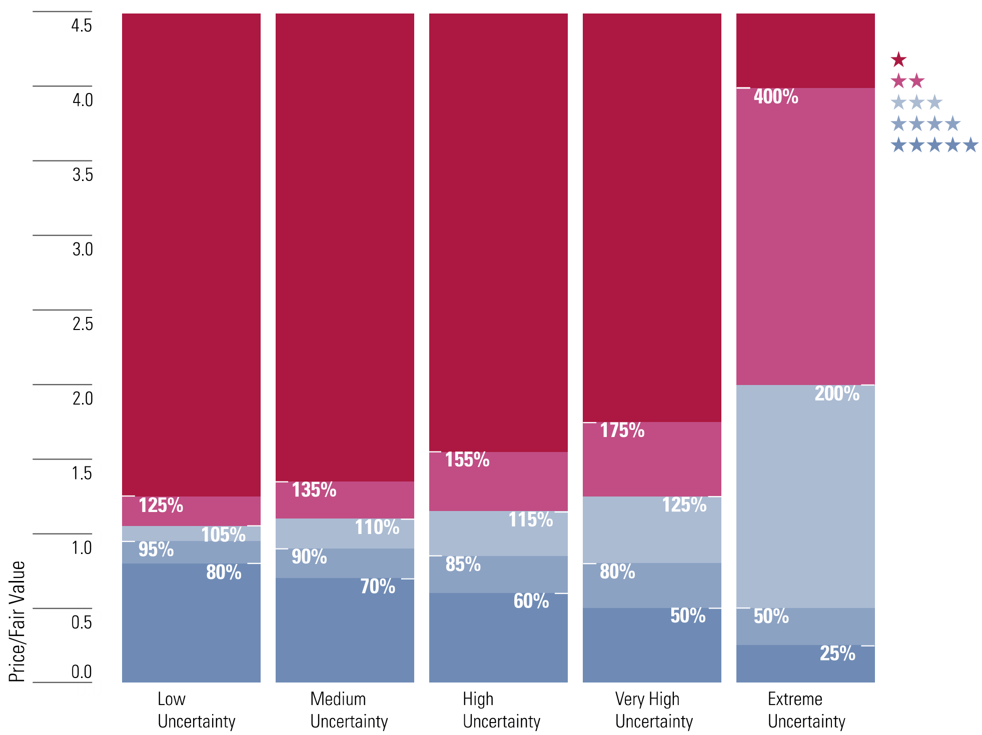
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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

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

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

Morningstar Equity Research Star Rating Methodology



Market Price

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

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

Morningstar Star Rating for Stocks

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

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

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

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

The Morningstar Star Ratings for stocks are defined below:

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

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

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

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

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

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