Research Highlights

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

Morningstar Equity Research
Nov. 26-30, 2018

Contents

Research Highlights
1 Takeaways From the Annual Utilities Conference
3 Life Science and Diagnostics Industry Attractive, but Be Wary of Valuations
5 EVs, Pot, and Data: Can They Save Electricity Demand?

9 **Best Ideas**

Highlighted Stocks
11 Subsea 7 SUBC:NO
12 Salesforce.com CRM
13 Coty COTY

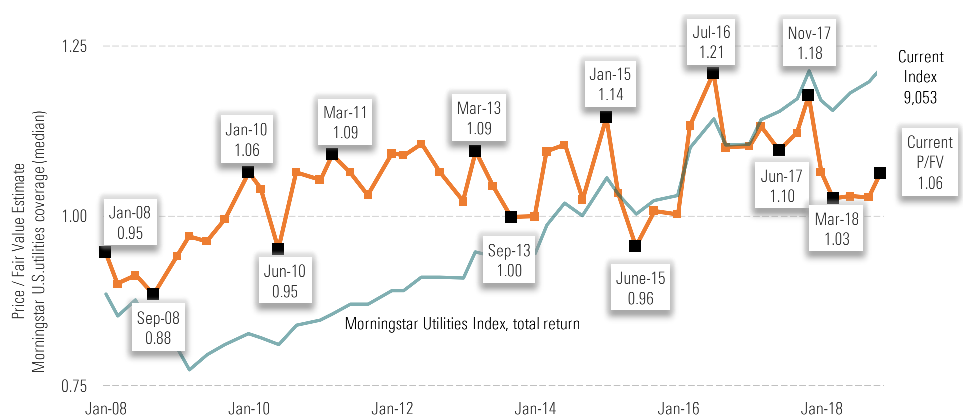
Takeaways From the Annual Utilities Conference

After meeting with management teams from 19 U.S. and Canadian utilities during the annual Edison Electric Institute Financial Conference in San Francisco, we remain confident that most utilities have attractive investment opportunities that will support healthy earnings and dividend growth. However, investors must be careful, as valuations remain frothy.

We forecast $336 billion of cumulative capital investment in 2018-20 among the 37 U.S. utilities we cover, driving 6.3% median annual earnings and 5.7% dividend growth. Still, the U.S. utilities we cover are 6% overvalued (Exhibit 1) on a median basis as of late November, and traditional valuation metrics suggest rich levels: 20.1 times forward price/earnings, 1.9 times price/book, and 3.1% dividend yield. We think industry consolidation is likely to take a back seat as utilities focus on strong organic growth opportunities.

Generally, we caution long-term investors against overpaying for utilities' dividend yields and growth, but we do see several opportunities. We think investors in PPL and Edison International are overstating near-term risks, presenting long-term investors with a buying opportunity. There are also several attractive utilities that don't carry as much uncertainty with strong economic moats and high-quality organic growth offering solid investor returns. These include Dominion Energy, Duke Energy, and Sempra Energy.

Exhibit 1 U.S. Utilities Sector Valuation



Source: Morningstar. Data as of Nov. 26, 2018.

- **Capital plans fuel growth:** We continue to be impressed by utilities' ability to identify growth opportunities, supporting mid-single-digit earnings growth over the next five years. Some utilities have even disclosed 10-year capital plans. We forecast $336 billion of cumulative capital investment in 2018-20 among the 37 U.S. utilities we cover, driving 6.3% average annual earnings and 5.7% dividend growth. We highlight Edison International, NextEra Energy, Sempra Energy, and WEC Energy Group as utilities that have earnings and dividend growth above their utility peers.
- **Interest rates:** With rising interest rates, executives remain comfortable in managing interest-rate risk. Our analysis of utilities' stock returns debunks the myth that rising interest rates will sink utilities—nor will another drop in interest rates necessarily pay off. In fact, the probability of utilities and interest rates moving in opposite directions over two- and three-year periods was similar to a coin flip during the last 25 years.
- **Renewable energy remains attractive:** Executives agree with our view that U.S. utilities will continue to incorporate renewables and natural gas-fired generation in their long-term resource planning as coal fleets dwindle. For the entire United States, we now project renewables, excluding hydroelectric, to grow 70% from 2017 to 2025, boosting renewable generation to 659 terawatt-hours, representing almost 15% of the U.S. generation mix from 9.6% in 2017.
- **Demand growth picking up:** For the first time we can remember, utility executives appear optimistic about demand growth in their service areas, providing support to our view that long-term electricity demand will remain above current consensus estimates. We think three emerging electricity demand sources—electric vehicle charging, data centers, and cannabis cultivation—will approach 6% of total U.S. electricity demand by 2030, offsetting energy efficiency and supporting our 1.25% annual electricity demand growth forecast through 2030.
- **Valuations remain rich:** Trading at an average of 6% above our fair value estimates, utilities remain richly valued as of late November, but we see some pockets of value. We think Dominion Energy, Edison International, Duke Energy, FirstEnergy, PPL, and Sempra Energy offer the best value in the industry.

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Life Science and Diagnostics Industry Attractive, but Be Wary of Valuations

We think there's plenty to like about the life science and diagnostics industry, including attractive growth opportunities and several competitive advantages that lead to economic moats. The industry tends to have a predictable and attractive growth outlook, especially in areas such as bioprocessing, analytical instrumentation, and genomics, in addition to being somewhat insulated from broader macroeconomic cycles.

Nearly every company under our life science and diagnostic manufacturer coverage also earns an economic moat thanks to intangibles often paired with high switching costs. However, Agilent and Waters are the only two life science companies to earn wide moats under our industry framework, thanks to low disruptive risk, high barriers to entry, a large installed base of instruments, and associated consumables, along with high customer switching costs.

Valuations already reflect the optimism, however, with multiples across the industry looking expensive, in our view. Currently, we think Waters, Agilent, Danaher, and Becton Dickinson reflect the best value, and all trade within 3-star territory, but we view Mettler, BioMerieux, and Qiagen as significantly overvalued.

- All of the life science and diagnostic manufacturers under our coverage look fairly to overvalued. Waters, Danaher, Becton Dickinson, and Merck KGaA all look like the most affordable names based on our fair value estimates, and all three trade within 3-star territory.
- Moats are common in life science tools thanks to intangibles and switching costs. While there's a variety of factors to consider, we generally award moats to life science and diagnostic firms that have records of consistent innovation, have a large installed base of equipment, and have a dedicated pull through of consumables on its instruments.
- While we think many segments of the life science tools market possess economic moats, the niche gas and liquid chromatography and mass spec markets led by Waters and Agilent create one of the few wide-moat segments. The GC and LC-MS market benefits from unique characteristics including low disruptive risk, high barriers to entry in a comfortable oligopoly, a razor-and-blade business model, and high customer switching costs.
- The outlook for the life science and diagnostic market remains stable with attractive pockets of growth. We estimate the market exceeds roughly $150 billion, growing at nearly 4%.
- We think the growth and economic outlook is stronger in the roughly $60 billion analytical tools portion of the market, including both life sciences as well as diagnostics. We estimate this market has been growing nearly 6% annually based on company-reported organic growth rates. Population growth, increases in drug research and volume, workflow improvements, a rise in manufacturing quality standards, and emerging fields in genetic research and testing are all key industry growth drivers.
- Biopharma remains a higher growth area, but comps are getting more difficult. While the global aging population demographic and increase in total prescriptions suggest favorable conditions ahead for industry suppliers, the ongoing shift to biologic medicines, including near generic equivalent biosimilars, is the main growth driver for select firms, which has consistently been in the low teens, by our estimate.

- Academic and government spending is currently favorable, but budget concerns could return. Although generally a lower growth market, the academic and government customer category has had a resurgence as of late, thanks in part to more favorable government spending as macroeconomic conditions have improved since the last recession.
- Applied markets have lower growth outlooks tied to more cyclical areas. Applied markets — which include industrial, chemicals, materials, energy, food, and environmental customers — tend to have growth more closely tied to GDP and economic cycles.
- Diagnostics represent larger market opportunity with higher growth in genetic testing. We still view clinical applications of genome sequencing and, to a lesser extent, molecular diagnostics, as two of the more attractive growth opportunities in the clinical market.

Exhibit 1 Our Life Sciences Economic Moat Framework

		Intangibles				Switching Costs	
Company	**Moat**	**Innovation**	**Disruptive Risk**	**Barriers to Entry**	**Product Difference**	**Customer Integration**	**Razor & Blade**
Thermo Fisher Scientific*	Narrow	Strong	Strong	Strong	Moderate	Moderate	Moderate
Danaher Corporation	Narrow	Moderate	Strong	Strong	Strong	Moderate	Moderate
Merck KGaA	Narrow	Strong	Strong	Moderate	Moderate	Moderate	Weak
Agilent Technologies Inc	Wide	Strong	Strong	Strong	Strong	Strong	Moderate
Becton,Dickinson and Co*	Narrow	Moderate	Moderate	Moderate	Moderate	Moderate	Weak
PerkinElmer Inc	None	Weak	Weak	Moderate	Moderate	Moderate	Moderate
BioMerieux SA	Narrow	Moderate	Weak	Moderate	Moderate	Strong	Strong
Illumina Inc	Narrow	Strong	Weak	Strong	Strong	Moderate	Strong
Mettler-Toledo Int Inc	Narrow	Moderate	Strong	Moderate	Moderate	Moderate	Moderate
Waters Corp	Wide	Strong	Strong	Strong	Strong	Strong	Strong
Qiagen NV	None	Weak	Weak	Moderate	Moderate	Weak	Weak
BioTechne	Narrow	Moderate	Moderate	Moderate	Moderate	Moderate	Weak

Strong =
Moderate =
Weak =

*We also include cost advantage for Thermo and Becton Dickinson because of their manufacturing economies of scale in certain product categories.
Source: Morningstar.

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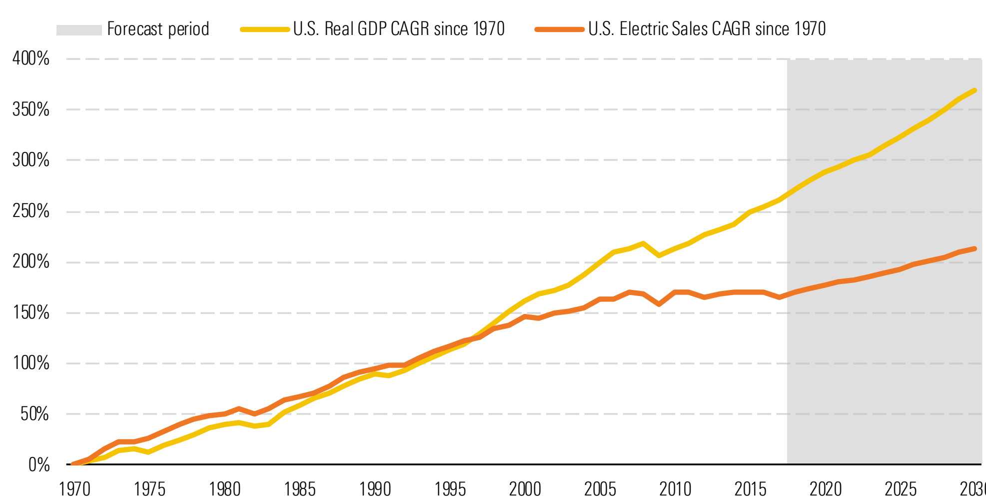
EVs, Pot, and Data: Can They Save Electricity Demand?

U.S. electricity demand has flatlined during the last decade, but we think it is set to spring to life. Energy efficiency will remain a drag on electricity demand, but those gains face diminishing returns. We think three emerging electricity demand sources—electric vehicle charging, data centers, and cannabis cultivation—will approach 6% of total U.S. electricity demand by 2030, offsetting energy efficiency and supporting our 1.25% annual electricity demand growth forecast through 2030.

Utilities will have to work hard to benefit from these new demand sources. The most successful must attract these industries by investing in grid expansion, smart networks, safety, reliability, and renewable energy during the next decade. Utilities that slack on investment now could face slowing earnings and dividend growth. Worst-case, utilities that miss out on this new demand might face the so-called death spiral, leaving investors with disappointing future returns.

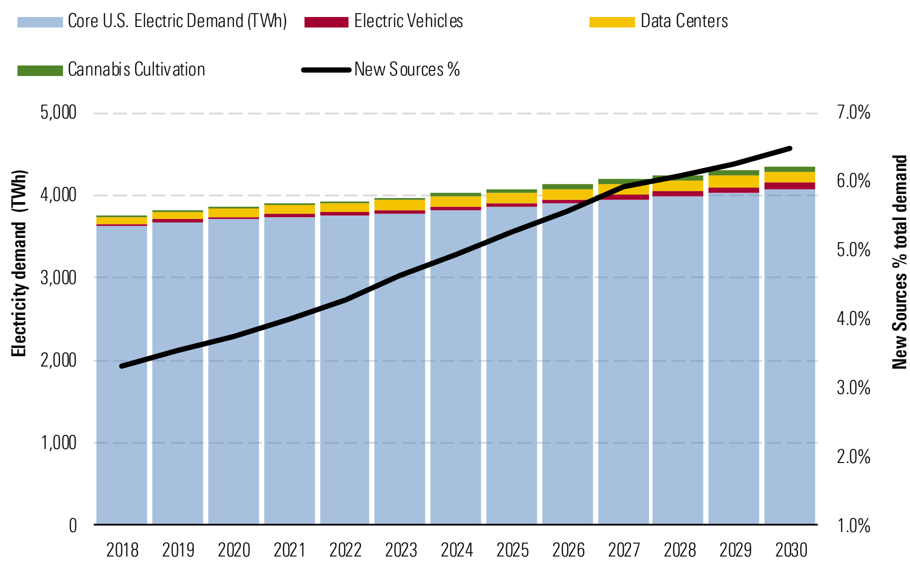
- We forecast 1.25% average annualized electricity demand growth through 2030 in the U.S., in line with our forecast published in 2016. Our core demand model continues to incorporate the relationship between population growth, real GDP, and electricity intensity of the economy, including the effects of energy efficiency. This year, we enhanced our forecast by including specific forecasts for three emerging sources of electricity demand during the next decade: electric vehicles, data centers, and cannabis cultivation.

Exhibit 1 Morningstar: U.S. GDP Growth (2%) Continues to Outpace Electricity Demand Growth (1.25%)



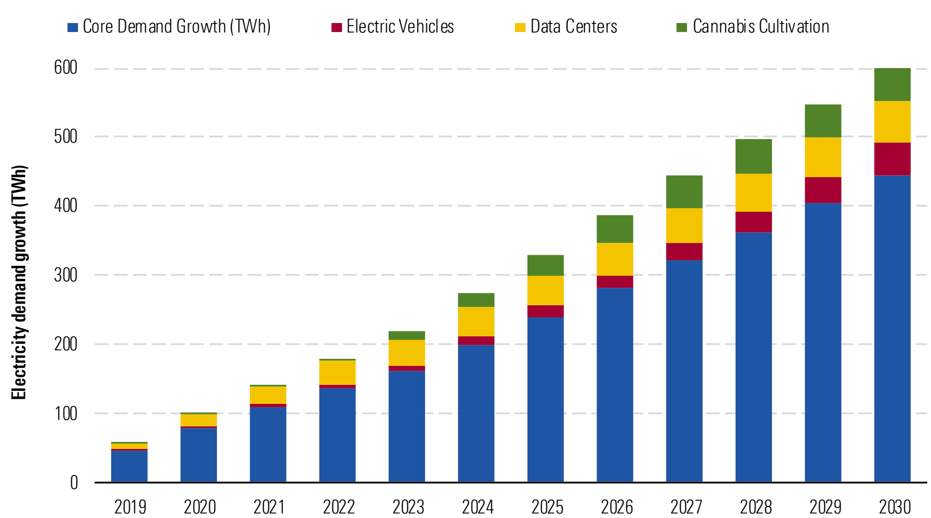
Source: U.S. Energy Information Administration, Morningstar.

Exhibit 2 New Sources Become Material Demand Contributors by 2030



Source: Morningstar.

Exhibit 3 New Sources Become Larger Share of Demand Growth in Outer Years

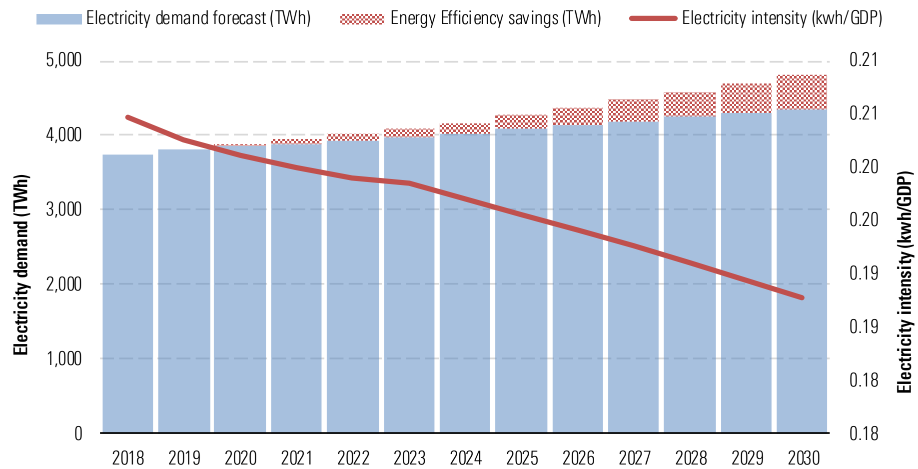


Source: Morningstar.

Energy Efficiency

- Energy efficiency is maturing but remains a substantial force suppressing electricity demand growth. We forecast electricity intensity of the U.S. economy will fall to 0.19 kilowatt-hours per dollar of GDP (kWh/GDP) by 2030. This is down from 0.22 kWh/GDP in 2017 and a peak 0.32 kWh/GDP in 1978. We forecast that the U.S. cumulatively eliminates the equivalent of a full year of electricity demand by 2030 and lowers annual electricity use by 15% from 2017 due to energy efficiency alone.

Exhibit 4 Without Energy Efficiency, Our 2030 Electricity Demand Forecast Would Be 10% Higher



Source: Morningstar.

- However, we expect energy efficiency gains to slow during the next decade once lightbulbs, appliances, and factories either reach their technical efficiency limits or reach a point where the economics don't support efficiency investments. Our forecast rate of energy efficiency gains during the next decade is half the 2% average annual drop in electricity intensity realized between 2010 and 2017.

Electric Vehicles

- Electric vehicles won't show up on the overall U.S. electricity demand radar for several more years, but they do represent the fastest-growing source of electricity demand growth in the outer years of our forecast, based on Morningstar's bullish EV sales forecast (September 2018 Electric Vehicle Observer) and our EV charging forecast model. We expect electricity demand from EV charging to climb 150% by 2030 and account for 1.7% of total U.S. electricity demand by the end of the next decade.
- Winners should include utilities that invest in local network upgrades and public charging infrastructure to support EV adoption:

Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap (Bil)
Edison International EIX	Narrow	Stable	USD	66.00	55.31	Medium	★★★★	17.6
Sempra Energy SRE	Narrow	Stable	USD	123.00	112.69	Low	★★★★	30.7
Portland General Electric POR	Narrow	Stable	USD	37.00	47.99	Low	★	4.3
Eversource Energy ES	None	Stable	USD	53.00	67.45	Low	★★	21.2

Data Centers

- We expect electricity demand from data centers to nearly double by 2030, climbing to 3.2% of electricity demand by the end of the next decade, up from 2% currently. We forecast significant growth in the early years as data center supply catches up with demand. Location is important, with the Southwest and Mid-Atlantic experiencing particularly robust growth. Winners should include utilities with reliable, efficient, secure, and smart distribution-level grids that can keep data centers operating around the clock with high levels of security and energy-management services. Renewable energy access also could be a key way for utilities to attract data center demand growth as many data-intensive companies such as Alphabet and Amazon seek to enhance their environmental impact profile.

- Winners should include utilities that can provide ultrareliable service at reasonable prices. Access to renewable energy and smart-grid services is also a plus.

Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap (Bil)
Dominion Energy D	Wide	Stable	USD	84.00	74.11	Low	★★★★	48.5
Pinnacle West Capital PNW	Narrow	Stable	USD	85.00	89.77	Low	★★★	9.9
Portland General Electric POR	Narrow	Stable	USD	37.00	47.99	Low	★	4.6

Cannabis Cultivation

- Whether you smoke it or swallow it, the cannabis-marijuana industry is set to give utilities a serious high. Cultivation is among the most electricity-intensive industries because of the bright lights and climate control systems that optimize indoor growing conditions. Producing one pound of retail marijuana requires as much electricity as a large home uses in an entire month. Our scenarios based on cannabis market share gains and public policy developments suggest the industry's electricity use could grow from 15 terawatt-hours to 65 terawatt-hours during the next decade and become as much as 1.5% of total U.S. electricity demand by 2030. Winners should include utilities that invest in grid reliability to support growers' around-the-clock demand while keeping electricity prices low and integrating renewable energy to enhance growers' green profile.
- Winners should include utilities that can provide reliable service, reasonable prices, and proximity to a large base of mostly residential customers.

Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap(Bil)
Edison International EIX	Narrow	Stable	USD	66.00	55.31	Medium	★★★★	17.6
Xcel Energy XEL	Narrow	Stable	USD	40.00	51.74	Low	★	26.3
Portland General Electric POR	Narrow	Stable	USD	37.00	47.99	Low	★	4.3
CMS Energy CMS	Narrow	Stable	USD	40.00	51.19	Low	★	14.4

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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)	★★★★	$19.5	$11.93	High	Narrow	0.61	4.81	Inton
Compass Minerals International (CMP)	★★★★	$81	$49.84	High	Wide	0.62	1.69	Goldstein
Martin Marietta Materials (MLM)	★★★★	$250	$196.81	High	Narrow	0.79	12.34	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 261.95	High	Narrow	0.73	25.90	C. Nichols
China Mobile (941)	★★★★	HKD 97	HKD 77.65	Medium	Narrow	0.80	1589.92	Baker
Comcast (CMCSA)	★★★	$42	$39.42	Medium	Wide	0.94	179.34	Hodel
Telefonica (TEF)	★★★★★	$13	$7.92	High	Narrow	0.61	41.16	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.93	Medium	Narrow	0.67	35.20	Han
Vodafone Group (VOD)	★★★★	$250	$167.76	High	Narrow	0.67	45.07	C. Nichols
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	$240	$156.28	High	Wide	0.65	401.94	Hottovy
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 72.85	High	Narrow	0.62	47.43	Hilgert
Expedia Group (EXPE)	★★★★	$180	$119.74	High	Narrow	0.67	17.84	Wasiolek
General Motors (GM)	★★★★	$46	$36.76	High	None	0.80	51.88	Whiston
Hanesbrands (HBI)	★★★★★	$27	$15.66	Medium	Narrow	0.58	5.65	Swartz
InvoCare (IVC)	★★★★	AUD 16	AUD 11.77	Medium	Wide	0.74	1.30	Ragonese
Mattel (MAT)	★★★★	$21	$13.76	High	Narrow	0.66	4.75	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$51.56	High	Narrow	0.75	11.44	Katz
Walt Disney (DIS)	★★★★	$130	$116.61	Medium	Wide	0.90	172.83	Macker
WPP (WPP)	★★★★★	GBX 1450	GBX 868	Medium	Narrow	0.60	10.96	Mogharabi
Consumer Defensive								
A2 Milk (ATM)	★★★★	AUD 13.7	AUD 10.35	High	Narrow	0.76	7.91	Fleck
Anheuser-Busch InBev (BUD)	★★★★★	$118	$77.24	Low	Wide	0.65	148.51	Gorham
G8 Education (GEM)	★★★★	AUD 3.5	AUD 2.8	High	None	0.80	1.28	James
General Mills (GIS)	★★★★★	$58	$42.21	Low	Wide	0.73	24.97	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2418	Low	Wide	0.65	23.20	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8358	Low	Wide	0.95	4021.21	Wei
Mondelez International (MDLZ)	★★★★	$52	$44.53	Medium	Wide	0.86	64.58	Lash
PepsiCo (PEP)	★★★★	$122	$118.27	Low	Wide	0.97	166.95	Vora
Procter & Gamble (PG)	★★★★	$97	$92.82	Low	Wide	0.96	231.25	Lash
Energy								
Cenovus Energy (CVE)	★★★★★	$21	$9.75	Very High	None	0.46	11.29	Gemino
Enbridge (ENB)	★★★★★	$62	$43.95	Medium	Wide	0.71	78.50	Gemino
Enterprise Products Partners (EPD)	★★★★★	$35.5	$26.3	Low	Wide	0.74	57.40	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$83	$62.44	Medium	Narrow	0.75	250.19	Good
Total (TOT)	★★★★	$77	$55.33	Medium	None	0.72	144.16	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 31.06	High	None	0.67	29.08	Taylor
Financial Services								
Agricultural Bank of China (601288)	★★★	CNY 4.2	CNY 3.57	High	Narrow	0.85	1230.02	Tan
Altaba (AABA)	★★★★	$98	$64.42	High	None	0.66	39.43	Mogharabi
American International Group (AIG)	★★★★★	$76	$43.44	Medium	None	0.57	38.43	Horn
BlackRock (BLK)	★★★★	$500	$422.94	Medium	Wide	0.85	67.11	Warren

Source: Morningstar. As of Nov. 30, 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, Continued								
Capital One Financial (COF)	★★★★	$127	$88.87	Medium	Narrow	0.70	42.09	Plunkett
Credit Suisse Group (CSGN)	★★★★★	CHF 22	CHF 11.78	High	Narrow	0.54	30.07	Scholtz
Link Administration Holdings (LNK)	★★★★	AUD 8.5	AUD 6.99	Medium	Narrow	0.82	3.70	James
Macquarie Group (MQG)	★★★★	AUD 135	AUD 114.42	Medium	Narrow	0.85	39.28	Ellis
Pendal Group (PDL)	★★★★	AUD 11	AUD 8.46	Medium	Narrow	0.77	2.69	Likos
Westpac Banking (WBC)	★★★★	AUD 33	AUD 25.97	Medium	Wide	0.79	90.59	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$245	$155.24	Medium	Wide	0.63	52.36	Waterhouse
McKesson (MCK)	★★★★★	$210	$127.01	Medium	Wide	0.60	24.81	Conover
Medtronic (MDT)	★★★★	$110	$96.6	Medium	Wide	0.88	129.74	Wang
Roche Holding (ROG)	★★★★★	CHF 333	CHF 259.1	Low	Wide	0.78	221.01	Andersen
Industrials								
Anixter International (AXE)	★★★★★	$107	$63.28	Medium	Narrow	0.59	2.12	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 45.9	Medium	Narrow	0.79	57.93	Song
CK Hutchison Holdings (1)	★★★★★	HKD 118	HKD 81.8	Medium	None	0.69	315.44	Tan
G4S (GFS)	★★★★★	GBX 337	GBX 196.45	Medium	None	0.58	3.05	Field
GEA Group (G1A)	★★★★★	EUR 45	EUR 24.06	Medium	Wide	0.53	4.17	Molina
General Dynamics (GD)	★★★★	$216	$182.17	Medium	Wide	0.84	53.95	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 210	MXN 141.6	High	Wide	0.67	78.48	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.3	HKD 3.06	High	None	0.49	24.48	Song
Johnson Controls International (JCI)	★★★★	$46	$34.27	High	Narrow	0.75	31.67	Bernard
Kion Group (KGX)	★★★★★	EUR 90	EUR 51.08	Medium	Narrow	0.57	6.02	Molina
Sodexo (SW)	★★★★	EUR 110	EUR 91.22	Medium	Narrow	NA	13.29	Field
Stericycle (SRCL)	★★★★★	$83	$48.21	High	Narrow	0.58	4.37	Young
Real Estate								
Aveo Group (AOG)	★★★★	AUD 2.3	AUD 1.7	Medium	None	0.74	0.99	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 111.5	Medium	Narrow	0.73	323.02	Zhong
Welltower (WELL)	★★★	$72	$71.43	Medium	None	0.99	26.83	Brown
Technology								
Applied Materials (AMAT)	★★★★	$49	$36.54	High	Wide	0.75	35.92	Davuluri
Intel (INTC)	★★★★	$65	$47.7	Medium	Wide	0.73	217.70	Davuluri
KLA-Tencor (KLAC)	★★★★	$128	$96.69	High	Wide	0.76	14.80	Davuluri
Lam Research (LRCX)	★★★★	$185	$152.75	High	Narrow	0.83	23.87	Davuluri
Microchip Technology (MCHP)	★★★★★	$112	$74.42	Medium	Wide	0.66	17.95	Colello
Murata Manufacturing (6981)	★★★★	JPY 24000	JPY 17315	High	Narrow	0.72	3601.91	Ito
Tencent Holdings (700)	★★★★	HKD 499	HKD 312	High	Wide	0.63	2970.31	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$73.75	Low	Wide	0.88	48.41	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.75	Medium	None	0.83	48.60	Fulop
FirstEnergy (FE)	★★★★	$41	$37.15	Low	Narrow	0.91	19.00	Fishman
Orsted (ORSTED)	★★★	DKK 450	DKK 438.8	Low	Narrow	0.98	192.17	Fulop
Scana (SCG)	★★★★	$56	$46.11	Medium	Narrow	0.82	6.58	Miller

Source: Morningstar. As of Nov. 30, 2018

Highlighted Stocks

Subsea 7 SUBC:NO

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	NOK	127	92.54	High	None	0.73	29.74

Source: Morningstar. As of Nov. 30, 2018

We think the market is underrating the long-term prospects of offshore engineering and construction companies.

Analyst Note, Nov. 27, 2018

We're slightly lowering our Subsea 7 fair value estimate to NOK 127 per share from NOK 130 after reviewing the company's third-quarter results and incorporating updated near-term guidance. The lower fair value estimate comes primarily from a revision in our midcycle (2022) expectations for the surf and conventional segment and the renewables and heavy lifting segment (in U.S. dollar terms), slightly offset by about a 6% depreciation in the krone-dollar exchange rate since our last update. Our no-moat rating remains in place.

We're lowering our midcycle adjusted operating margin forecast for the surf segment to 12% from 13% previously to account for potentially heightened competitive pressures. Additionally, we've incorporated updated management guidance that now calls for likely slightly lower margins in 2019 versus 2018 as the effects of lower-priced contracts begin to play out. As such, we think the pace of surf segment margin recovery will be somewhat lagged relative to our prior expectations. In particular, we are disappointed that Subsea 7 has made slow progress on integration initiatives (particularly its alliance and joint venture with Schlumberger), which we think will lead it to underperform peer leader TechnipFMC in the near term as Subsea 7 struggles to catch up.

Our renewables segment margin forecast falls to 6.5% from 9% previously. This segment (mostly assembled from recently acquired businesses) has a short track record, and therefore the sharp drop in profitability in 2018 versus 2017 has a solid impact on our long-term expectations. Management is also guiding for a further profitability drop in 2019 as offshore wind installation activity slows down. For now, we are taking a more cautious view on the segment—we are worried that the high profitability achieved in 2017, driven chiefly by a single project (Beatrice), may have been an aberration.

Even with this reduction, Subsea 7 looks solidly undervalued, in our view. We think the market is underrating the long-term prospects of offshore engineering and construction companies. Whereas the market seems to expect these companies to experience the kind of pricing degradation that has afflicted the offshore drillers, we believe the E&C portion of the offshore value chain can't be so easily equated with the drillers and that pricing and activity will hold up much better.

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Salesforce.com CRM

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Technology	Positive	USD	180	142.83	Medium	Wide	0.79	107.59

Source: Morningstar. As of Nov. 30, 2018

We believe Salesforce benefits from strong switching costs and a network effect related to its platform-based software offerings.

Analyst Note, Nov. 27, 2018
Salesforce reported a good third-quarter result and consequently raised its full-year revenue and EPS outlook. Still, we had been expecting a strong result from this wide moat firm and only modestly adjust our full-year expectations. Our $180 fair value estimate is unchanged and we continue to see the firm trading at a discount. We believe Salesforce benefits from strong switching costs and a network effect related to its platform-based software offerings. Additionally, with the addition of MuleSoft and a concerted investment approach to artificial intelligence tools, we are confident in heightened stickiness around Salesforce's product portfolio.

For the quarter, reported and constant currency revenue rose 26% year over year to $3.39 billion. Total remaining performance obligation, or RPO, rose 34% to $21.2 billion, while current RPO increased 27% to $10 billion indicating a very healthy level of revenue in the future pipeline. Salesforce's bread-and-butter sales cloud and service cloud revenue grew 11% and 24%, respectively. Meanwhile, the smaller Salesforce platform & other and marketing cloud & commerce cloud platforms surged 51% and 37%, respectively. Although we expect some sales moderation in the more mature sales cloud business, we continue to forecast rapid growth for the less mature cloud businesses given a large total addressable market opportunity.

Enterprise demand for digital transformation products and services will remain a tailwind for Salesforce and we believe the firm’s leading status in customer relationship management, among other burgeoning lines of business, will underline the firm’s solid long-term standing in the market. Breadth and depth of the company’s product offering will also attract enterprises as they seek to simplify their IT and infrastructure. As a result, we are confident in Salesforce’s wide moat rating.

On the margin front, non-GAAP operating margins dipped 76 basis points to 16.9% and GAAP operating margins fell 303 basis points to 2.7%. We expect operating margins (both GAAP and non-GAAP) to surge over the next decade as Salesforce begins to benefit from operating leverage. Additionally, we think the firm is heavily investing in new product launches and development to amplify its TAM which understates its normalized operating margins.

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Coty COTY

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Consumer	Stable	USD	12.70	8.34	Medium	None	0.66	6.40

Source: Morningstar. As of Nov. 30, 2018

We think he should be able to leverage this experience to help Coty successfully integrate the assets acquired from Procter & Gamble in 2016 while extracting cost synergies and reducing its debt load.

Analyst Note, Nov. 28, 2018

No-moat Coty announced that current CEO Camilo Pane, who has been at the helm since 2016, will be resigning immediately for family reasons. Pane will be succeeded by Pierre Laubies, who had recently served as CEO of coffee company Jacobs Douwe Egberts. We appreciate Laubies' operational experience in the consumer goods industry, which includes integrating the ex-Mondelez coffee business at JDE. We think he should be able to leverage this experience to help Coty successfully integrate the assets acquired from Procter & Gamble in 2016 while extracting cost synergies and reducing its debt load. We're holding steady on our $12.70 fair value estimate, which incorporates around 1% compound sales growth (including a decline in fiscal 2019) high-single-digit operating margin on average over the next five years, and Standard stewardship rating as we wait to develop a better sense of Laubies' strategic priorities.

Coty also announced changes to its board of directors. Peter Harf, who has been a board member since 1996 will be replacing Bart Becht as chairman. Harf had previously served as CEO of Coty (1993 to 2001) and chairman of Coty's board (from 2001 to 2011). We expect this experience has led Harf to have a cozy relationship with management, and consequently view the company's decision to begin a process to add two new independent board members as prudent. At present, seven of its nine directors are independent, though we note four directors are affiliated with JAB Holdings, which holds 39% of Coty's stock.

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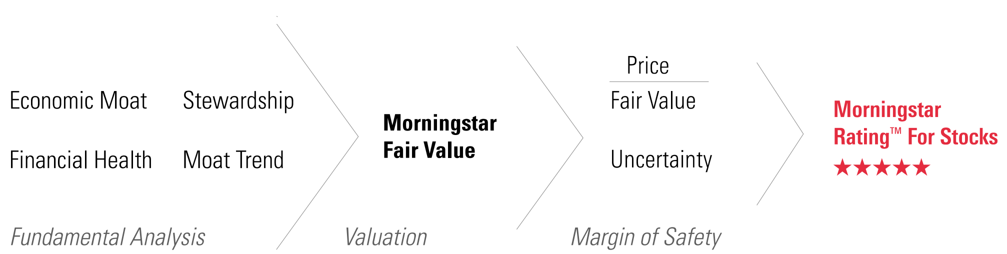
Research Methodology for Valuing Companies

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.

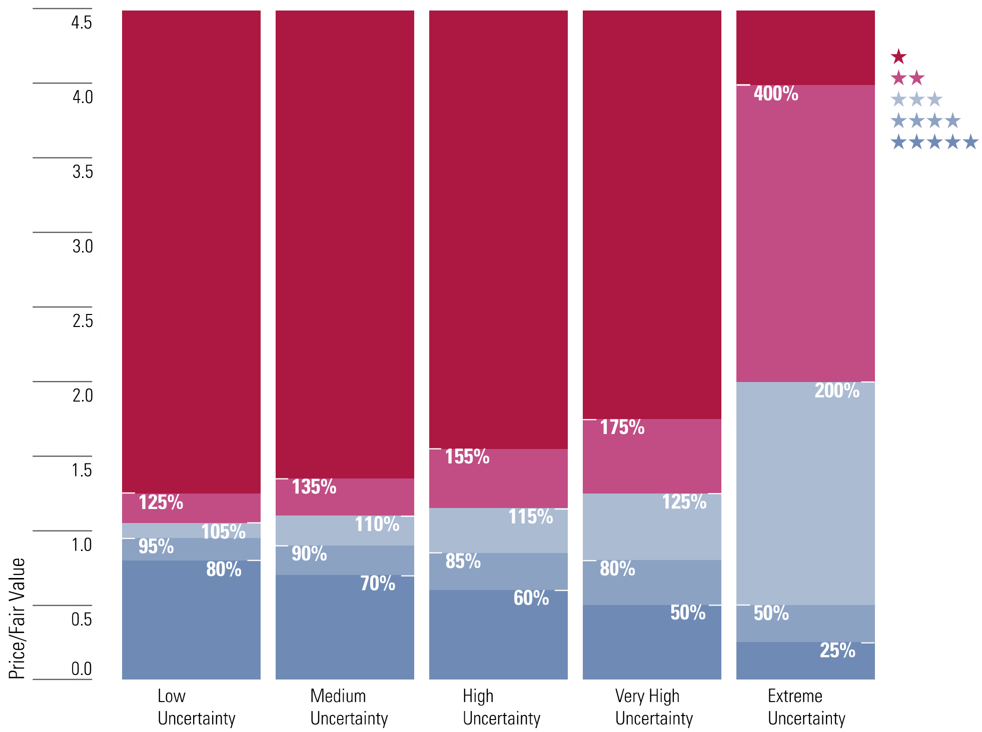
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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