Research Highlights

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

Morningstar Equity Research
Aug. 6-10, 2018

Contents

Hungover on Defense Stocks, but the Spending Party Hasn't Even Started Yet

Over the past several months, defense stocks have stalled, underperforming the S&P 500, but we believe that industry growth rates will accelerate through 2019 as recent increases in the U.S. Department of Defense budget translate into outlays to the industry.

Our regression tying industry revenue growth to U.S. defense outlays predicts double-digit revenue growth for some industry names by second-quarter 2019. In addition, we think the midterm elections slated for early November 2018 could provide an entry point into defense stocks, as uncertainty rises ahead of elections.

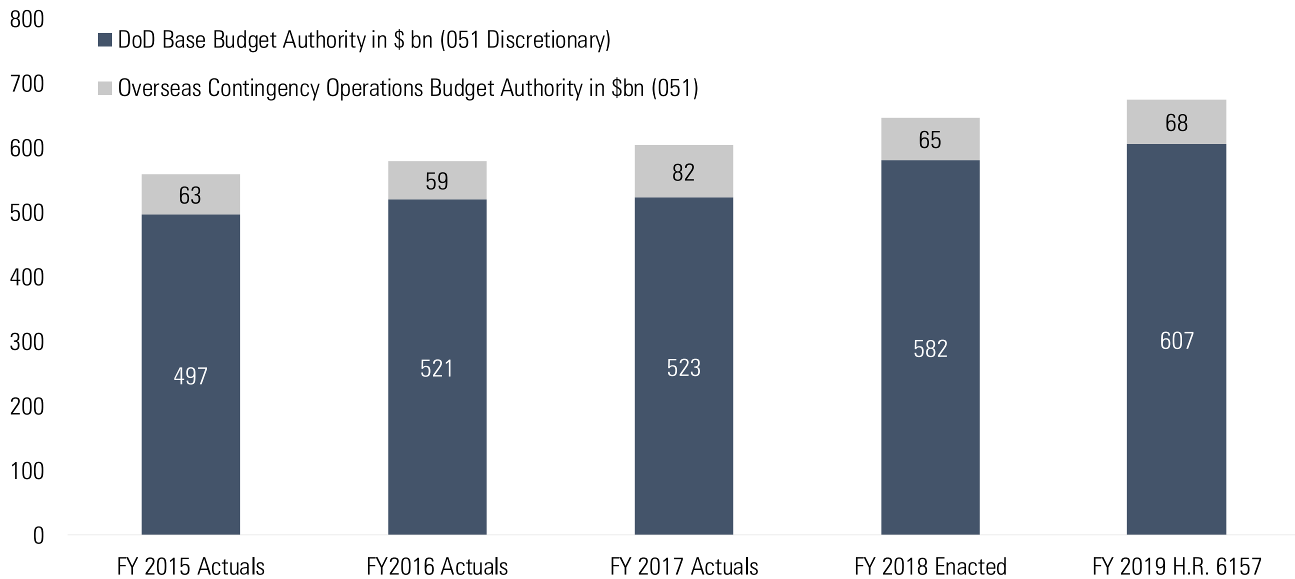
Over the longer term, we see defense budget growth stalling out in 2020 and beyond due to persistent budget deficits and rising national debt. The 2020 presidential election in the U.S. also represents a potential risk to defense spending. We continue to appreciate the sturdy moats in the U.S. defense industry, and we note that nearly all the defense names we cover possess wide moats. Stricter Department of Defense regulation of contract pricing, particularly in wake of tax reform represents the only threat to moats in our view.

Although it's tough to find cheap stocks in the defense sector, we like General Dynamics, trading at a price/fair value ratio of 0.88. The company isn't a defense pure play because of its business jet unit, but with the CSRA acquisition, defense and government-related activities now account for roughly 75% of consolidated revenue. For investors preferring a pure play on defense, we'd point them to Raytheon or Northrop Grumman, with both trading at discounts to our fair value estimates.

- Investors should increasingly focus their attention on the U.S. defense market. Despite international opportunities, the U.S. still drives 75% of prime contractor revenue, and this market is growing rapidly.
- Based on our model that uses defense outlays as the explanatory variable, we project industry growth accelerating through second-quarter 2019, when year-over-year growth should peak at around 10.5%.
- We've raised our revenue forecasts for all of the defense companies we cover, which in turn moved up our fair values. Our defense coverage is now trading at an average price/fair value of 0.96.
- General Dynamics is our top pick in the U.S. defense sector, and it appears on our global Best Ideas list.

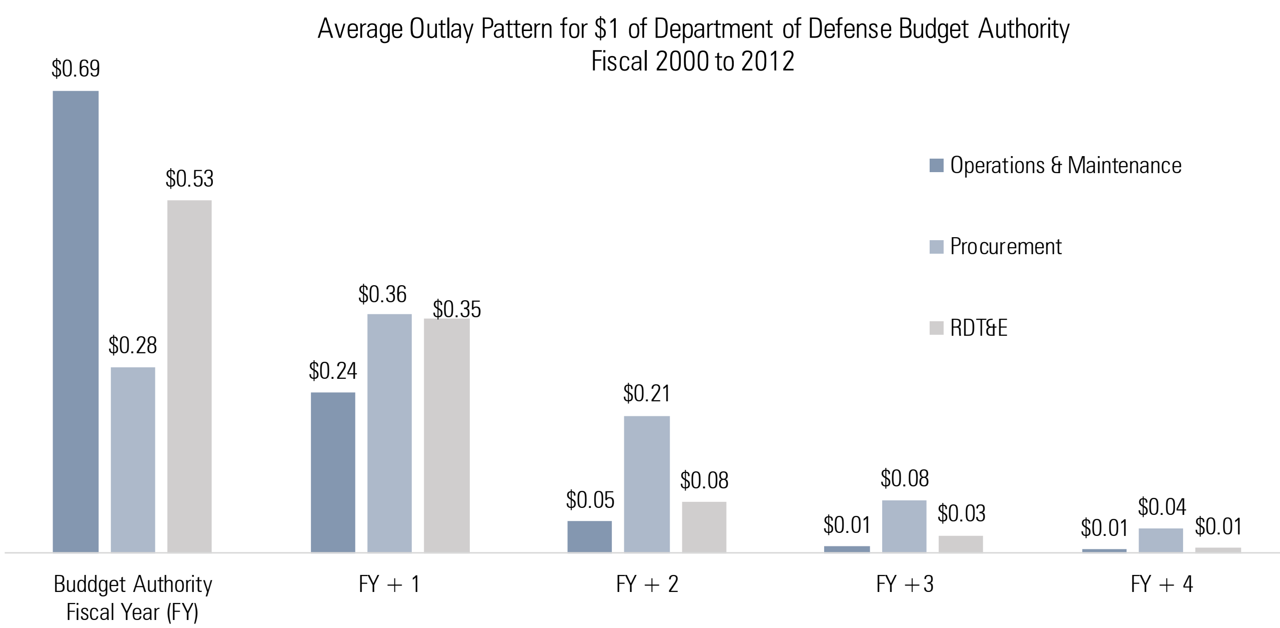
Exhibit 1 Why We're Bullish on Defense Industry Growth, in Four Charts

U.S. Department of Defense budget authority has increased …



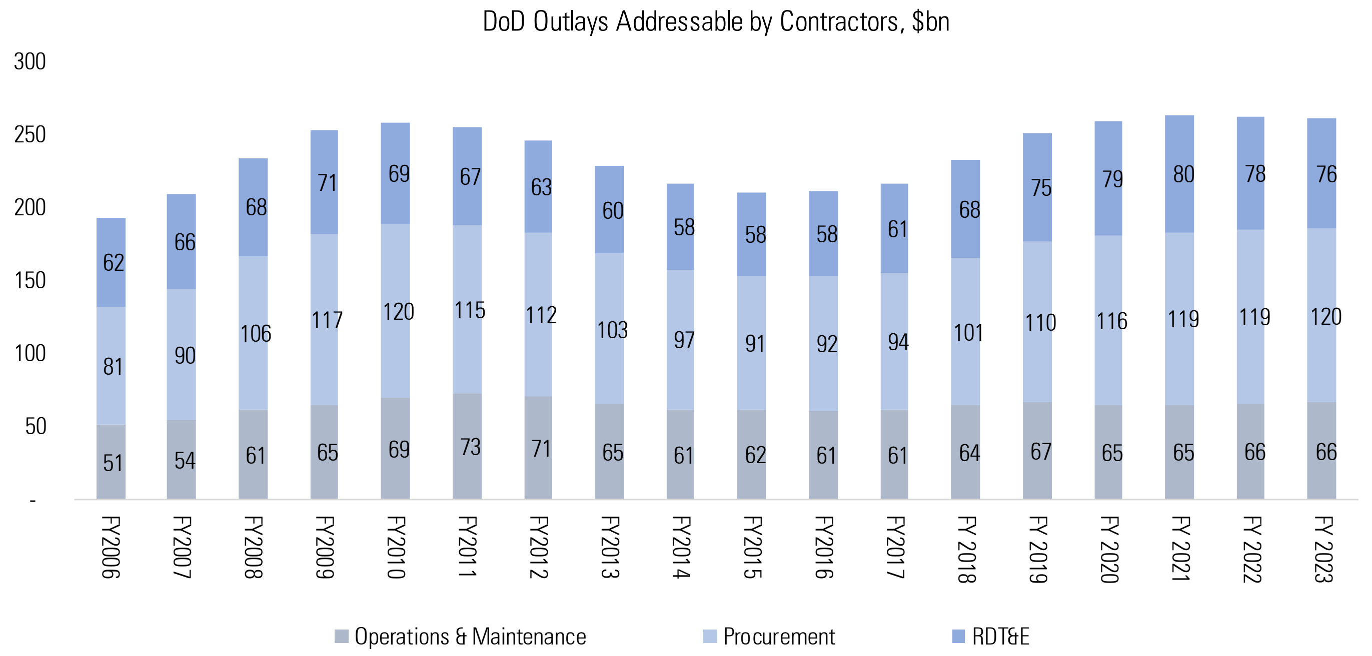
Source: Morningstar, Department of Defense Comptroller, CRS/FY = government fiscal year

… But Industry Outlays Lag the Budget, Especially for Weapons Procurement …



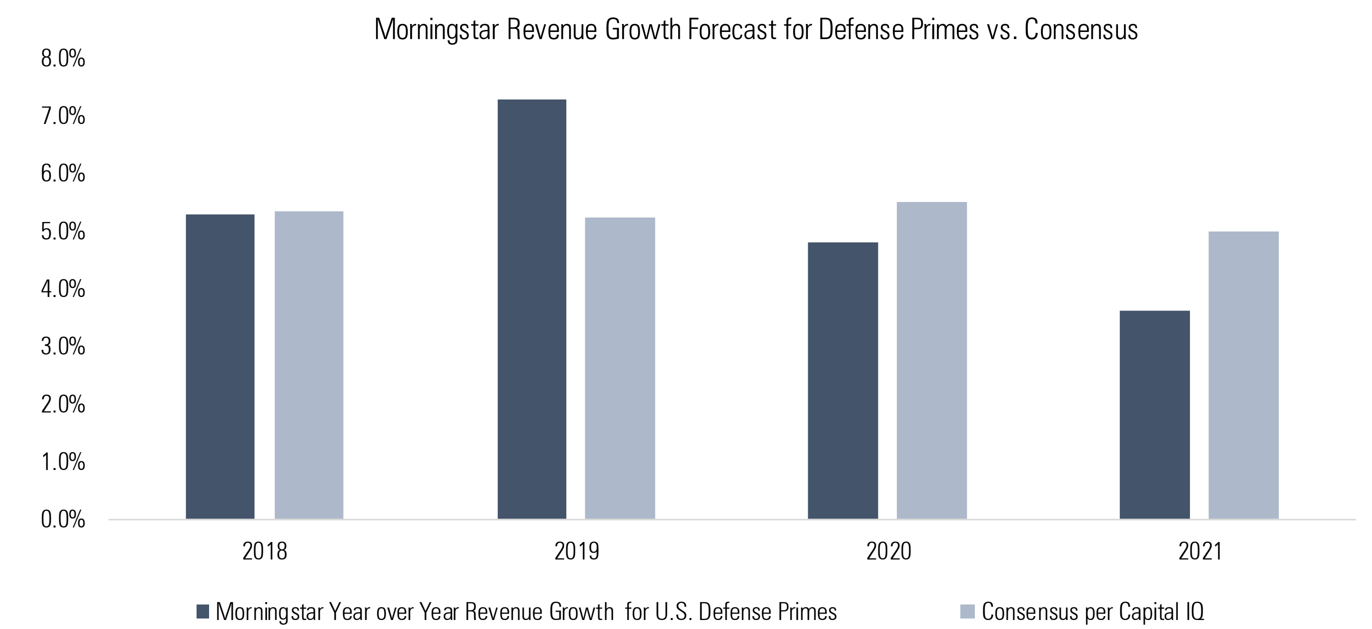
Source: DoD Greenbook, Morningstar /FY = government fiscal year

… Which Means Year-Over-Year Outlay Growth Will Peak in 2019 …



Source: DoD Greenbook, Morningstar/RDT&E = Research, Development, Test and Evaluation

… Driving Revenue Growth to Higher Levels Than the Market Currently Expects



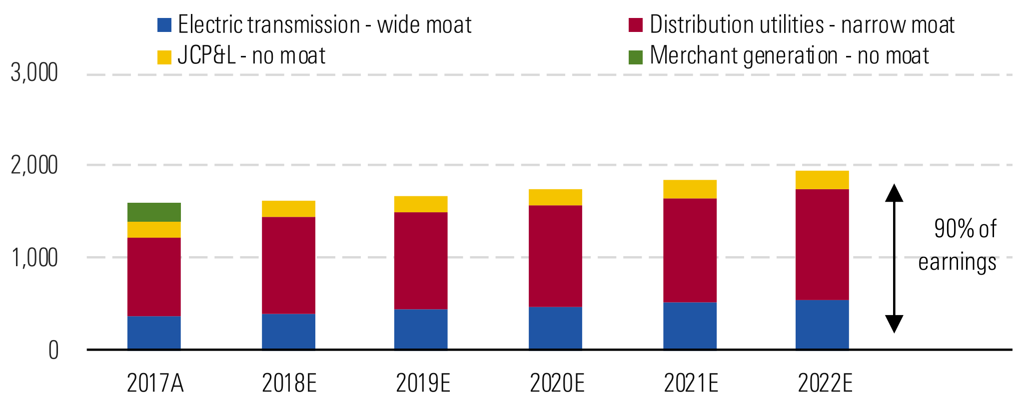
Source: Morningstar, Capital IQ

FirstEnergy: Life After FES Bankruptcy

On April 23, then amended on July 31, FirstEnergy announced an agreement to provide payments, assurances, and asset transfers to FirstEnergy Solutions' creditors that we estimate total about $2.7 billion, matching the amount we had forecast in a December 2017 report that FirstEnergy shareholders would be on the hook for. With the market converging toward our view on the FES bankruptcy, FirstEnergy's stock has rebounded—total return has outpaced the S&P 500 by 15% since we added the stock to our Best Ideas list at the beginning of the year. But we still think there's about 10% upside left in FirstEnergy shares.

We believe the market fails to fully appreciate the company's ability to invest over $2.5 billion per year in its wide-moat transmission businesses, which provide an almost guaranteed economic benefit to shareholders, and narrow-moat utilities in constructive state regulatory environments, which together will account for 90% of earnings. We are also seeing improvement in New Jersey regulation that should eventually benefit no-moat Jersey Central Power & Light and allow it to earn closer to its allowed return. We believe solid earnings growth and a growing dividend will be the catalysts for the market valuing FirstEnergy shares more in line with its regulated utility peers with economic moats.

Exhibit 1 Wide- and Narrow-Moat Businesses 90% of Earnings After Separation From Bankrupt FES
Operating earnings, millions USD



Source: FirstEnergy, Morningstar; Note: Operating earnings exclude corporate and other

- The recent agreement with FirstEnergy Solutions allows FirstEnergy to avoid years of litigation separating itself from its bankrupt merchant unit. The company can now focus on accelerating investments in its wide- and narrow-moat businesses that should result in strong earnings growth and put FirstEnergy in position to begin increasing its common dividend.
- Together, wide- and narrow-moat businesses represent roughly 90% of earnings after the separation from bankrupt FirstEnergy Solutions, or FES.
- We expect 2018 consolidated earnings per share to decline almost 20% versus 2017 to $2.50 per share, due in large part to the loss of FES earnings and approximately $2.75 billion of additional equity needed to strengthen the company's balance sheet.
- After the EPS decline in 2018, we estimate that a fully regulated FirstEnergy will average annual operating EPS growth of over 5% between 2018 and 2022, driven by transmission businesses growing

8% annually. Transmission growth will be partially offset by regulated distribution segment EPS growing at only 2.4% annually, as we assume the Ohio distribution modernization rider is not fully renewed when it expires in 2019.

- ► We believe electric transmission is a wide-moat business due to its efficient-scale competitive advantage. The favorable federal regulatory framework virtually assures a transmission owner of earning the allowed return on its investment that is usually well above the cost of capital.
- ► We expect FirstEnergy to accelerate investment in its wide-moat transmission business and invest almost $6 billion over the next five years. By 2022, we estimate wide-moat transmission will represent almost 30% of operating earnings versus 23% in 2017.
- ► We have a high level of confidence that FirstEnergy's nine distribution utilities in Ohio, Pennsylvania, and West Virginia will earn returns on invested capital above our estimate of the cost of capital for at least the next 10 years, fulfilling our basic financial requirement for a narrow moat rating.
- ► Recent improvements in New Jersey regulation should allow no-moat JCP&L to earn above its cost of capital more often. With FirstEnergy investing more heavily in transmission and other jurisdictions, we estimate JCP&L will only contribute about 10% of consolidated operating earnings by 2022.
- ► FirstEnergy cut its dividend by 35% in 2014, and shareholders have not seen an increase since then, although the yield is currently slightly higher than peers. We believe dividend increases in line with EPS growth are likely, possibly beginning in 2020.

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Improved Insurance Results Lift Berkshire Hathaway

Wide-moat Berkshire Hathaway reported second-quarter results that were basically in line with our expectations, so we're leaving our $330,000 ($220) per Class A (B) share fair value estimate in place. Second-quarter (first-half) revenue, which now includes both unrealized and realized gains/losses from Berkshire's investments and derivatives portfolios, increased 19.3% (decreased 2.9%) to $68.6 ($119.0) billion. Excluding the impact of investment and derivative gains/losses and other adjustments, second-quarter (first-half) operating revenue increased 8.4% (decreased 0.8%) to $62.2 ($120.7) billion.

Operating earnings, excluding the impact of investment and derivative gains/losses, rose 67.3% (58.7%) year over year to $6.9 ($12.2) billion during the second quarter (first half) of 2018. When including the impact of the investment and derivative gains/losses, Berkshire's operating earnings rose 181.8% (30.7%) to $12.0 ($10.9) billion during the same period(s). With no share repurchase activity during the past year, net earnings per Class A equivalent share rose a similar amount to $7.3 billion ($6.6) billion for the second quarter (first half) of 2018.

Book value per share, which serves as a fairly good proxy for measuring changes in Berkshire's intrinsic value, increased 3.1% sequentially to $217,677 (from $211,184 at the end of the first quarter of 2018), which was better than our forecast of $216,464. The company closed out the June quarter with $111.1 billion in cash and cash equivalents, up from $108.6 billion at the end of March. This should have left Berkshire with around $86 billion that can be committed to investments, acquisitions, share repurchases, and dividends. There were no meaningful commitments to acquisitions during the second quarter, and the firm did not commit any capital to share repurchases or dividends.

Looking more closely at Berkshire's insurance operations, all three of the company's insurance units—Geico, Berkshire Hathaway Reinsurance Group (which now includes National Indemnity, Berkshire Hathaway Life Insurance Co. of Nebraska, and General Re), and Berkshire Hathaway Primary Group—reported earned premium growth during the second quarter. As for underwriting profitability, both Geico and BHRG Re saw marked improvements in underwriting results, while BHPG's underwriting earnings deteriorated a bit during the period when compared with the second quarter of 2017. While BHRG and General Re have effectively merged their operations, Berkshire is reporting results for the combined entities in a way that allows us to continue to differentiate the results of these two firms when talking about their underwriting results.

Geico's relentless pursuit of growth over the past couple of years, which had come at the expense of profitability, seems to have come to an end, with the firm positing a marked improvement in underwriting results during both the first and second quarters of 2018. The company's loss ratio, in particular, dropped to 77.7% during the first half of the year—well below the average loss ratio of 84.5% put up during 2016-17. Even so, Geico's earned (written) premium growth of 14.4% (13.3%) during the second quarter, and 15.0% (13.9%) during the first half of the year, remained elevated relative to historical norms. During the five-year period prior to 2017, Geico's earned premium growth averaged 10.7% per year. It then spiked up to 15.3% last year, as the company aggressively pursued business its peers were unwilling to go after. That said, while the auto insurer's first-half earned premium growth remained elevated, it is now being driven more by price increases than a relentless pursuit of new business, which has had a positive impact on profitability.

With regards to Berkshire's reinsurance arms, General Re posted another abnormal period of earned premium growth of 24.8% (30.0%) year over year during the second quarter (first half), driven by both new business and increased participations for renewals (along with favorable currency exchange) in its property-casualty and life/health units. The old BHRG unit, on the other hand, was always going to face an uphill battle this year, given the large retroactive reinsurance policy the firm underwrote with AIG last year, with earned premium growth up 8.8% (down 73.6%) year over year during the second quarter (first half) of 2018. Going forward, we expect General Re and BHRG to constrain the volume of reinsurance they are underwriting, given the excess capacity in the reinsurance market. While we have earned premium growth in negative territory for both firms over the remainder of our five-year forecast, we have always been quick to note that there could be some lumpiness in reported results, as both firms have a knack for finding profitable business, even when reinsurance pricing is unattractive. As for profitability, we expect tight expense controls and a lack of extremely adverse events over a multiyear period to allow both General Re and BHRG to keep their combined ratios below 100%.

Berkshire's noninsurance operations typically offer a more diversified stream of revenue and pretax earnings for the firm, helping offset weakness in any one area. We already had a sense of how things were likely to look for BNSF, given that the other Class I railroads reported earnings late last month. While Union Pacific is usually a good proxy for BNSF, given that both firms focus on the western U.S. market and have similar shipment profiles, there was some difference in their results during the most recent period. For starters. BNSF's second-quarter (first-half) revenue growth of 12.0% (10.2%) was better than the 8.0% (7.4%) top-line growth that Union Pacific put up during the same period(s). BNSF's revenue growth during the first half reflected a 3.6% increase in average revenue per car/unit (including fuel surcharges) and a 5.2% increase in volumes. Union Pacific, meanwhile, saw average revenue per car/unit (including fuel surcharges) rise 4.5% (4.7%) during the second quarter (first half) on higher fuel surcharge revenue and core pricing gains, with total volumes increasing 3.7% (2.8%).

BNSF's consumer products volumes increased 4.7% (5.4%) during the second quarter (first half) of 2018 because of higher domestic and international intermodal volumes driven by continued economic growth and tightening truck capacity. Union Pacific's premium volumes saw a nice recovery, up 6.1% (3.9%) during the second quarter (first half), driven primarily by growth in international intermodal shipments. As for industrial products, volumes at BNSF increased 10.4% (9.8%) year over year during the second quarter (first half), aided by an increase in shipments of sand, petroleum products, steel, and plastics for the energy and industrial sectors. Union Pacific's industrial volumes rose 5.9% (4.0%) during the second quarter (first half), driven by growth in construction products, increased metals shipments, higher volumes of industrial chemicals and plastics, and growth in lumber shipments.

Normally a beacon of stability, Berkshire Hathaway Energy reported a 9.7% (8.3%) increase in second-quarter (first-half) revenue, and a 9.7% (13.3%) decrease in pretax earnings due primarily to increased depreciation, maintenance, and other operating expenses, as well as less favorable rate case across its utilities and pipeline portfolios. BHE has typically been the least volatile of Berkshire's subsidiaries, given that the regulated utilities operate in an environment where in exchange for their service territory monopolies, state and federal regulators set rates that aim to keep customer costs low while providing adequate returns for capital providers. The only meaningful change in these operations tends to occur when BHE does an acquisition, with this subsidiary tending to be one of Berkshire's most aggressive when it comes to doing deals, or when it is coming off particularly strong/weak results year over year. In this case, it was more of a perfect storm of rising operating and interest costs, compounded by changes in rate structures across the portfolio.

With regards to Berkshire's manufacturing, service, and retail operations, the group overall recorded a 4.6% (4.7%) increase in second-quarter (first-half) revenue, which was in line with our long-term forecast calling for mid-single-digit annual revenue growth (exclusive of acquisitions) over the next five years. As for pretax profits, second-quarter (first-half) earnings increased 13.1% (17.6%) compared with the same period(s) in 2017, which to lifted the division's pretax margins to 8.2% for the first half of 2018, well ahead of our long-term forecast that calls for margins to improve 20-25 basis points annually over the 7.0% level that was produced during in 2017. We expect that the group will likely give some of this back as we proceed over the next year, but we may have to re-evaluate our long-term profitability forecast if the group continues to see a marked improvement in pretax margins.

Results for Berkshire's finance and financial products division—which includes Clayton Homes (manufactured housing and finance), Cort Business Services (furniture rental), Marmon (railcar and other transportation equipment manufacturing, repair, and leasing) and XTRA (over-the-road trailer leasing)—were somewhat mixed, with revenue increasing 17.3% (14.6%) year over year during the second quarter (first half) but lower pretax earnings from the railcar leasing business, due to a decline in lease revenue and higher repair costs, kept the expansion in pretax profits to 14.8% (12.4%). We continue to envision revenue increasing 5%-7% over the remainder of our five-year projection period, with pretax operating margins of 24%-26% (despite the 23.9% margin the segment reported during the first half of 2018).

As we noted above, book value per Class A equivalent share at the end of the second quarter was $217,677. The company also closed out the period with $111.1 billion in cash and cash equivalents on its books. With CEO Warren Buffett liking to keep around $20 billion on hand as a backstop for the insurance business, the firm's noninsurance operations generally needing between $3 billion and $5 billion in operating cash, Berkshire still has, by our estimates, around $86 billion available to dedicate to investments, acquisitions, share repurchases, or dividends. Along those lines, there were no meaningful commitments to acquisitions in the quarter, and the firm did not commit any capital to dividends or share repurchases. That said, we do expect Berkshire to whittle some of its excess cash next quarter, as it has already dedicated $2.5 billion to purchase Medical Liability Mutual Insurance as well as another $2 billion deal with Seritage Growth Properties. We'll also have to see if Berkshire's shares are trading at a deep enough discount to the firm's intrinsic value for Buffett and Vice Chairman Charlie Munger to finally start buying back stock after the company altered its share buyback program last month.

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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	$11.04	High	Narrow	0.65	4.39	Inton
Compass Minerals International (CMP)	★★★★	$83	$65.4	High	Wide	0.79	2.21	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$203.52	High	Narrow	0.77	12.82	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 229	High	Narrow	0.64	22.72	C. Nichols
China Mobile (941)	★★★★★	HKD 100	HKD 71.85	Medium	Narrow	0.72	1471.16	Baker
Comcast (CMCSA)	★★★★	$42	$35.49	Medium	Wide	0.85	162.61	Macker
Telefonica (TEF)	★★★★★	$13	$7.47	High	Narrow	0.57	38.79	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.84	Medium	Narrow	0.65	33.78	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★	$157	$147.79	Medium	Narrow	0.94	10.94	Akbari
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 84.81	High	Narrow	0.72	55.13	Hilgert
Expedia Group (EXPE)	★★★★	$185	$132.74	High	Narrow	0.72	19.84	Wasiolek
General Motors (GM)	★★★★	$45	$37.51	High	None	0.83	52.92	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 4.8	High	None	0.36	66.92	Su
Hanesbrands (HBI)	★★★★★	$27	$18.78	Medium	Narrow	0.70	6.77	Hottovy
InvoCare (IVC)	★★★★	AUD 17	AUD 14.37	Medium	Wide	0.85	1.58	Ragonese
Mattel (MAT)	★★★★	$21.5	$15.61	High	Narrow	0.73	5.37	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$50.95	High	Narrow	0.74	11.28	Katz
Walt Disney (DIS)	★★★★	$130	$114.16	Medium	Wide	0.88	169.78	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1217.5	Medium	Narrow	0.81	15.36	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★	AUD 4	AUD 2.33	High	None	0.58	1.06	James
General Mills (GIS)	★★★★★	$59	$45.27	Low	Wide	0.77	26.86	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2974.5	Low	Wide	0.80	28.37	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 8141	Low	Wide	0.93	3968.09	Wei
Mondelez International (MDLZ)	★★★★	$51	$42.16	Medium	Wide	0.83	61.83	Lash
PepsiCo (PEP)	★★★★	$123	$113.7	Low	Wide	0.92	160.81	Vora
Procter & Gamble (PG)	★★★★	$97	$81.41	Low	Wide	0.84	202.52	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6879	Low	Wide	0.94	48.61	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$12.92	Very High	None	0.62	15.88	Gemino
Enbridge (ENB)	★★★★	$64	$47.26	Medium	Wide	0.74	81.07	Gemino
Enterprise Products Partners (EPD)	★★★★	$35.5	$29.51	Low	Wide	0.83	64.21	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$67.74	Low	None	0.87	277.13	Good
Total (TOT)	★★★★	$74	$63.84	Medium	None	0.86	168.48	Good
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.61	High	Narrow	0.86	1253.13	Tan
American International Group (AIG)	★★★★	$76	$52	Medium	None	0.68	46.20	Horn
Capital One Financial (COF)	★★★★	$127	$97.62	Medium	Narrow	0.77	46.70	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 15.24	High	Narrow	0.69	38.86	Scholtz
Invesco (IVZ)	★★★★★	$38	$25.49	Medium	Narrow	0.67	10.47	Warren

Source: Morningstar. As of Aug. 10, 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 669.5	Medium	None	0.76	8756.18	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 8.9	Medium	Narrow	0.81	2.50	Likos
QBE Insurance Group (QBE)	★★★★	AUD 12	AUD 10.28	High	None	0.86	13.96	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 29.57	Medium	Wide	0.84	100.13	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$263	$184.06	Medium	Wide	0.70	62.48	Waterhouse
McKesson (MCK)	★★★★★	$210	$123.88	Medium	Wide	0.59	24.75	Lekraj
Medtronic (MDT)	★★★★	$105	$91.22	Medium	Wide	0.87	123.30	Wang
Ramsay Health Care (RHC)	★★★★★	AUD 82	AUD 54.8	Medium	Narrow	0.67	11.07	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 238.6	Low	Wide	0.71	204.56	Andersen
Shire (SHP)	★★★★	GBX 4990	GBX 4498.5	Medium	Narrow	0.90	41.13	Andersen
Industrials								
Allegion (ALLE)	★★★★	$91	$82.56	Medium	Wide	0.91	7.84	Bernard
Anixter International (AXE)	★★★★★	$107	$72.85	Medium	Narrow	0.68	2.44	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 37.2	Medium	Narrow	0.64	46.95	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.69	Medium	Wide	0.87	15.43	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 118	HKD 88.85	Medium	None	0.75	342.75	Tan
G4S (GFS)	★★★★	GBX 337	GBX 260.1	Medium	None	0.77	4.04	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 33.67	Medium	Wide	0.72	6.08	Molina
General Dynamics (GD)	★★★	$220	$192.57	Medium	Wide	0.88	57.05	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 217	MXN 178.38	High	Wide	0.82	100.07	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.8	HKD 3.94	High	None	0.58	32.57	Song
Johnson Controls International (JCI)	★★★★	$53	$37.33	High	Narrow	0.70	34.53	Bernard
KION GROUP (KGX)	★★★★★	EUR 90	EUR 59.76	Medium	Narrow	0.66	7.06	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 38.13	Medium	Narrow	0.91	35.52	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 95.3	Medium	Narrow	NA	14.13	Field
Stericycle (SRCL)	★★★★	$86	$61.58	High	Narrow	0.72	5.29	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.8	AUD 2.2	Medium	None	0.79	1.28	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 121.4	Medium	Narrow	0.79	351.69	Zhong
Welltower (WELL)	★★★★	$74	$63.46	High	None	0.86	23.61	Brown
Technology								
Intel (INTC)	★★★★	$65	$50.14	Medium	Wide	0.77	231.20	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$98.08	Medium	Wide	0.88	23.10	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 3.05	Medium	Narrow	0.80	1.83	James
ServiceNow (NOW)	★★★★	$221	$188.34	Medium	Wide	0.85	33.51	Fitzsimmons
Synaptics (SYNA)	★★★★	$64	$48.17	Very High	None	0.75	1.67	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 11240	High	None	0.90	1418.99	Ito
Tencent Holdings (700)	★★★★★	HKD 641	HKD 370	High	Wide	0.58	3523.23	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$71.03	Low	Wide	0.85	46.44	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.56	Medium	None	0.80	46.39	Fulop
FirstEnergy (FE)	★★★★	$41	$36.3	Low	Narrow	0.89	17.64	Fishman
SCANA (SCG)	★★★★	$56	$38.28	Medium	Narrow	0.68	5.46	Miller

Source: Morningstar. As of Aug. 10, 2018

Highlighted Stocks

Ryman Healthcare RYM:NZ

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Healthcare	Stable	NZD	13.60	13.05	Medium	Narrow	0.96	6.53

Source: Morningstar. As of Aug. 10, 2018

Ryman has the least aggressive fee structure of major peers, and in Australia is clearly differentiated in "continuum of care," providing more aged-care beds at retirement villages.

Select Report, Aug. 9, 2018
Operating conditions in the Australian and New Zealand retirement living sector have been outstanding in recent years, with earnings buoyed by stimulatory interest rates settings. The sharp rise in New Zealand housing prices has had a similar impact on retirement units, juicing returns for operators. The exceptionally high returns on capital are unsustainable, as dwelling prices are unlikely to rise materially in the foreseeable future, and the returns on offer are triggering a supply-side response. Nonetheless, industry dynamics are still attractive, with an aging population delivering a powerful demand catalyst. Also, customers are cash rich—benefiting from recent growth in house prices—supporting solid prices and margins for newly developed or renovated units. Against this evolving backdrop, narrow-moat Ryman Healthcare screens as undervalued, trading at a slight discount to our NZD 13.60 fair value estimate. Ryman has the least aggressive fee structure of major peers, and in Australia is clearly differentiated in "continuum of care," providing more aged-care beds at retirement villages. This strategy delivers lower profit per village in the short term, but will reward over the longer term through higher occupancy, faster rate of sales for new villages, market share gains, and shorter down-time between residents.

Ryman's strategy of focusing on customer satisfaction and utility over short-term profit provides a long-lasting benefit and underpins our narrow moat rating, with the sustainable intangibles the moat source. Residents are often at a point of vulnerability when moving into a retirement village, so Ryman, with a rock-solid reputation, should win out over competitors, many of which are chasing a quick buck. Risks still exist, but most regulation has been through a recent review and update. The sector is also susceptible to a fall in house prices and we account for this by assuming unit prices trend sideways for five years before rising at 2% thereafter.

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U.S. Concrete USCR

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Basic Materials	Stable	USD	75	53.13	High	None	0.71	0.90

Source: Morningstar. As of Aug. 10, 2018

Though U.S. Concrete faced some weather-related headwinds during the first quarter, we saw little justification for its significant price decline.

Analyst Note, Aug. 7, 2018

Before U.S. Concrete's second-quarter earnings release on Aug. 7, its share price had fallen nearly 50% year to date. This decline was larger than any other U.S.-focused building materials company, with Martin Marietta down less than 10%, Vulcan down about 12%, and Summit down about 35%. Though U.S. Concrete faced some weather-related headwinds during the first quarter, we saw little justification for its significant price decline in absolute terms or relative to its peers.

Second-quarter earnings confirmed our belief, with shares up 10% as we write, driven by improved performance from the first quarter. Compared with organic revenue growth of just 2% for ready-mixed concrete in the first quarter, second-quarter growth was nearly 5%, with acquisitions adding another 9%. Aggregates looked even better, with organic volume growth of 10% and acquired growth of nearly 90%. In turn, higher volumes offset lower prices mainly stemming from a mix shift. Overall, the company generated a 19% year-over-year increase in revenue to $404 million and a 9% increase in adjusted EBITDA to $58 million. Adjusted EBITDA margins contracted about 120 basis points from the prior-year period to 14.3%, but this was mainly due to a mix shift and higher input costs that should be passed on via price increases in subsequent quarters.

Although our outlook for the legacy business is unchanged, we've adjusted our assumptions for the recently acquired Polaris operations. Our updated outlook more accurately reflects the impact of Polaris' lower-priced and lower-margin tons on our long-term forecast. As a result, our midcycle adjusted EBITDA margin assumption contracts by roughly 110 basis points to 15.6%. Accordingly, our fair value estimate falls to $75 per share from $85 for no-moat U.S. Concrete. Nevertheless, we still see shares as undervalued. Shares traded this high as recently as February, with the more recent share price decline unwarranted, in our view.

Aside from encouraging results in the second quarter, the positive stock price reaction was also driven by U.S. Concrete's first full-year guidance target announcement, which provided a more positive growth outlook than the first quarter may have suggested. U.S. Concrete expects to generate full-year revenue of $1.52 billion to $1.62 billion and adjusted EBITDA of $215 million to $232 million. This would represent 18% revenue growth and 16% adjusted EBITDA growth from 2017.

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PepsiCo PEP

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	123	113	Low	Wide	0.92	160.81

Source: Morningstar. As of Aug. 10, 2018

We don't foresee a material shift in Pepsi's strategy with Laguarta at the helm, given his 22-year tenure at the firm, extensive knowledge of its operations, and key role in setting its strategy as president.

Analyst Note, Aug. 6, 2018
We're maintaining our Exemplary stewardship rating for wide-moat PepsiCo after the company announced that CEO Indra Nooyi, 62, will step down on Oct. 3 after 24 years with the company, including 12 years in its top spot. Nooyi will be succeeded by Ramon Laguarta, who has been president of the company since 2017 and has experience as the CEO of Pepsi's Europe Sub-Saharan Africa business and president of its Eastern Europe region. We weren't surprised by Laguarta's appointment, since each of the firm's previous five CEOs have been chosen from within the organization, which we view as evidence of its deep bench.

We don't foresee a material shift in Pepsi's strategy with Laguarta at the helm, given his 22-year tenure at the firm, extensive knowledge of its operations, and key role in setting its strategy as president. Under Nooyi's leadership, the company bolstered its portfolio of healthier offerings, which now contribute roughly half of sales compared with about 38% in 2006, and better aligned its portfolio with evolving consumer tastes (with above 5% compound sales growth over this period). As such, we think that this trend toward more natural and wholesome fare will continue. We expect Pepsi will reinforce its brand-related investments, with combined expenditures on advertising and research and development approximating 7% of sales over the next 10 years, in line with historical rates. We contend that these investments will help the company develop and bring new products to market, ensuring that its competitive advantage remains unwavering. In this context, we're reiterating our $123 fair value estimate, which calls for 3% top-line growth and operating margin around 18% on average over our forecast period.

We also expect Pepsi's record of prudent capital allocation, with adjusted returns on invested capital averaging north of 30% over the last decade, and substantial shareholder returns, with dividends and share repurchases totaling over $6 billion in 2017, to continue under Laguarta's leadership. Its annual dividend has increased for more than 40 years and currently yields above 3%.

Our favorable view of the combination of Pepsi's food and beverage businesses remains unchanged. Nooyi had been a strong advocate for the strategic benefits of keeping these businesses integrated, and we surmise that Laguarta's lengthy tenure with the company should preclude a significant change of opinion on this matter.

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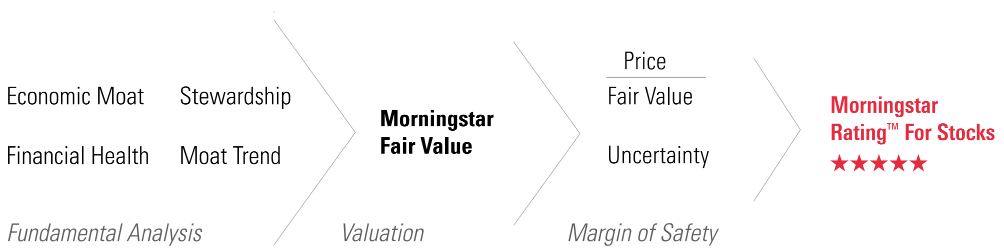
Research Methodology for Valuing Companies

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.

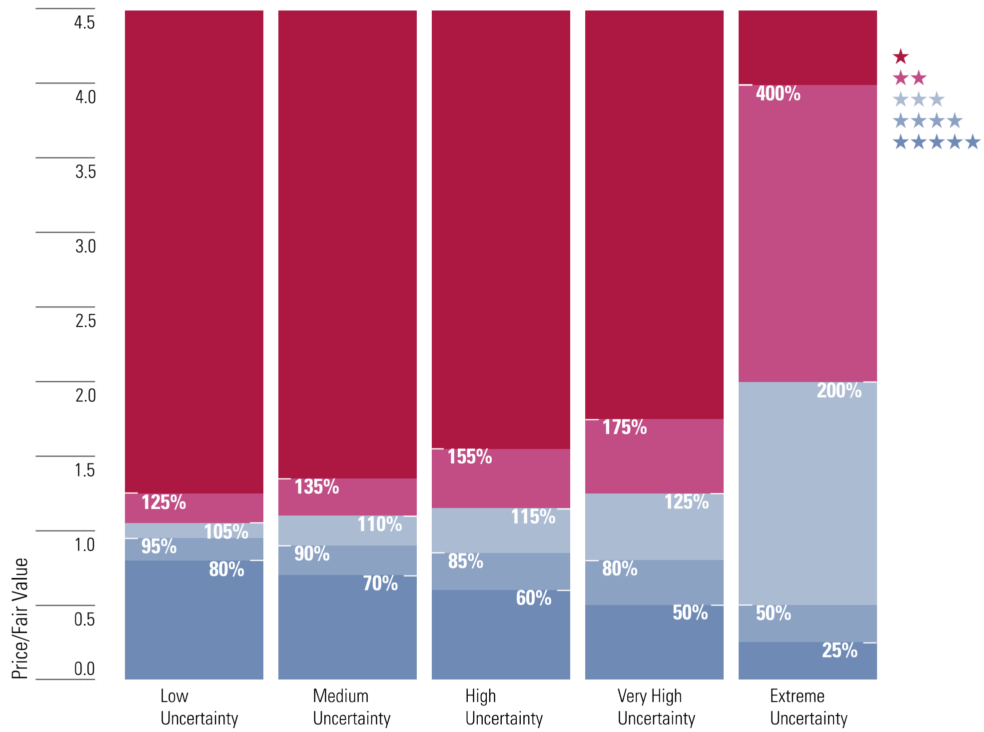
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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