Research Highlights

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

Morningstar Equity Research
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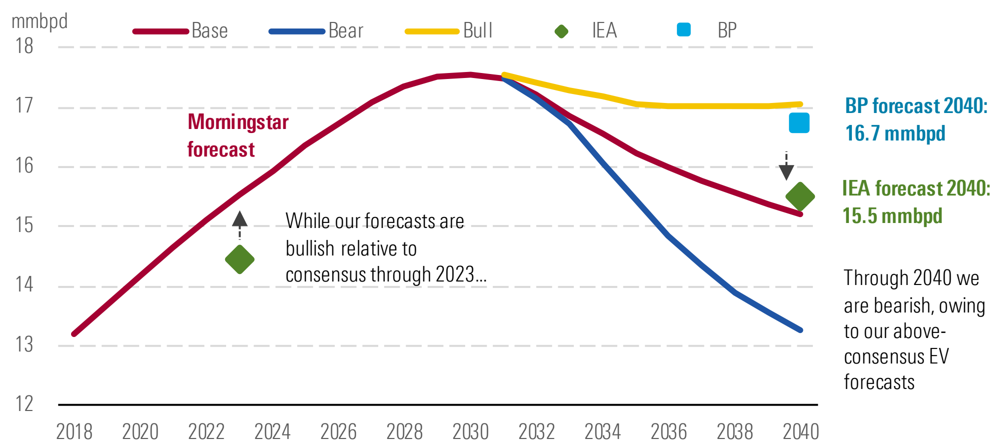
Contents

China Oil and Gas Demand

Consensus is missing the boat on China's medium- and long-term oil demand, but, interestingly, in different directions. Over the next five years, we're bullish. We think that by relying on China's inflated official GDP growth figures, other forecasters are underestimating China's income elasticity of oil demand. Looking from the bottom up, near-term improvements in China's fuel-efficiency standards will be more modest than headline requirements suggest. Also, others have mistakenly identified the decline of China's investment boom as necessitating the end of diesel growth.

Still, in the long run, electrification of China's vehicle fleet looms large for oil. We think China's EV adoption is primed to take off, reaching 25% of sales by 2028 and catalyzing peak oil demand for China as early as 2030. We remain bearish on long-term oil prices, with the belief that U.S. shale will sop up incremental medium-term Chinese demand. As such, investors should be cautious with oil-leveraged stocks. On the gas side, above-consensus forecasts for natural gas consumption drive our bullish view on China's LNG imports. Top LNG-related investment ideas include Cheniere Energy, ENN Energy, and Royal Dutch Shell.

Exhibit 1 Medium Term Looks Rosy for Chinese Oil Demand, but Disruption From Electric Vehicles Is Coming

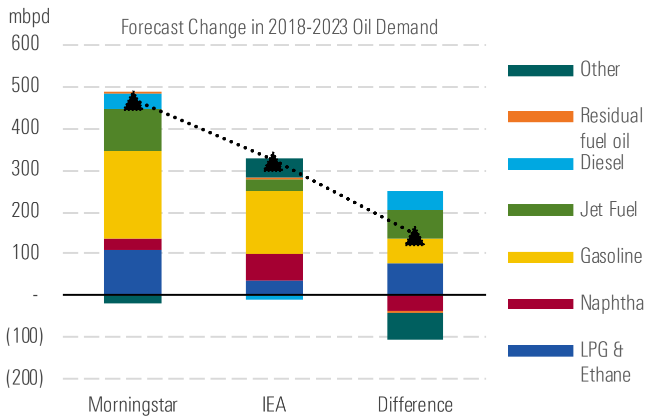


Source: International Energy Agency, China National Bureau of Statistics, Morningstar.

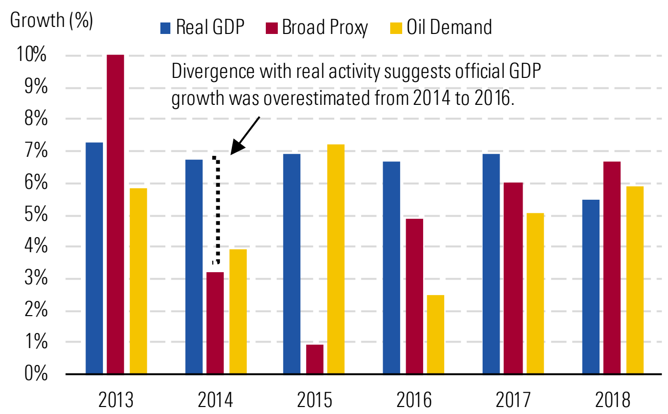
Disclosure

Exhibit 2 Key Takeaways: Our China Oil Thesis in Exhibits

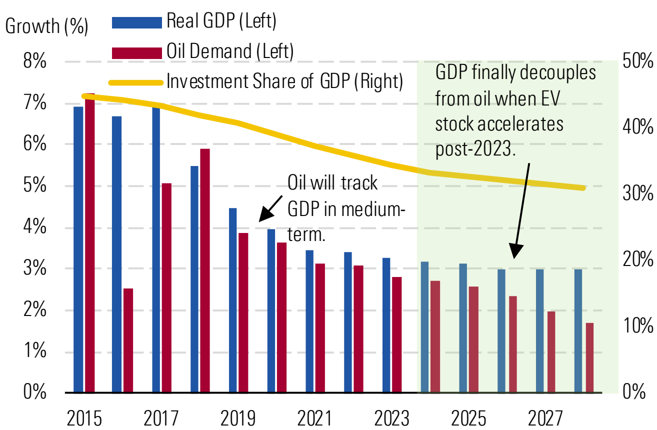
2a We are More Bullish Than Consensus on Chinese Oil Demand…



2b …as Inflated Growth Figures Have Misled other Analysts



2c Oil Should Continue to Track GDP in Medium Term, Despite Rebalancing…



2d …Because Total Oil Demand Is Equally Consumption- and Investment-Driven

Per Capita Oil Product Demand Elasticities:

Contrary to conventional wisdom, diesel only modestly investment-driven

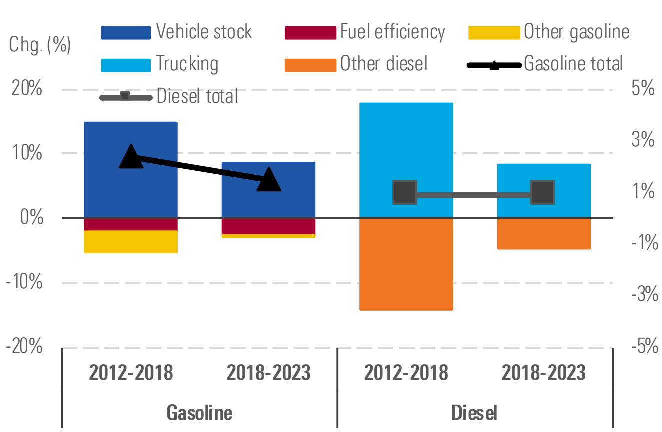
	Gasoline	Diesel	Jet Fuel	Petro-chems	Fuel Oil	Other	**Total**
Investment	0.11	0.42	0.44	0.70	0.63	0.72	**0.55**
Consumption	1.04	0.63	0.93	0.52	0.32	0.32	**0.57**
GDP	**1.15**	**1.05**	**1.36**	**1.21**	**0.95**	**1.04**	**1.12**
R squared:	*73%*	*91%*	*79%*	*63%*	*40%*	*65%*	*89%*

Strong Chinese consumption outlook bodes well for gasoline and jet fuel

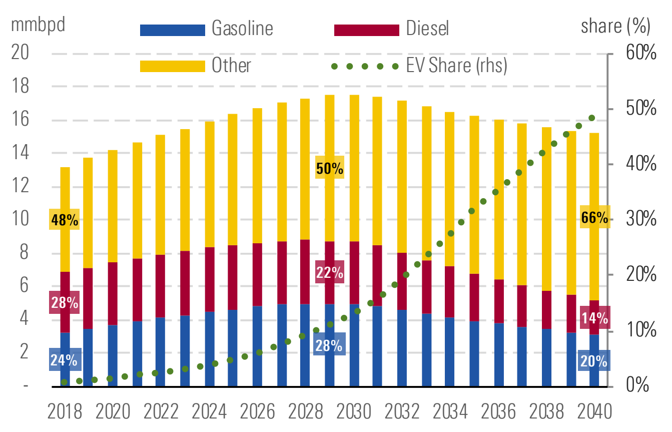
Total oil demand equally driven by consumption and investment

Methodology: Panel data regression of oil demand by product on consumption and investment expenditure (PPP) (all variables measured in percent changes). Sample: 65 countries 1980-2016

2e Consensus Is Missing Drivers of Solid Gasoline, Diesel Growth Through 2023



2f But Our EV Forecast Means We Are Bearish on Long-Term Oil Demand



Sources: 2a. IEA, Morningstar. 2b. China National Bureau of Statistics, IEA, Morningstar. 2c. IEA, NBS, Morningstar. 2d. World Bank, Morningstar. 2e. IEA, Morningstar. 2f. Morningstar

- We are bullish on China's medium-term oil demand versus consensus (Exhibit 2a). We expect China's oil demand to increase an average 467 thousand barrels per day, or mbpd, annually through 2023 (3.3% growth), 145 mbpd higher than the IEA's forecast of about 322 mbpd (2.4% growth).
- China's economy still needs more oil to grow. Other analysts, comparing oil growth to inflated Chinese GDP figures, have prematurely concluded that China has already been shifting away from oil in recent years. A more accurate picture of China's GDP growth negates this story (Exhibit 2b).
- Therefore, we expect China's oil demand growth to track GDP growth in the next five years. GDP growth doesn't decouple from oil demand until after 2023, when our above-consensus electric vehicle forecasts begin having a material impact on China's vehicle stock (Exhibit 2c).
- Despite an unprecedented investment boom over the last decade, China doesn't stand out as an intensive oil user. This is because oil demand across countries is equally driven by both consumption and investment expenditure (Exhibit 2d). Therefore, China's economic rebalancing from investment to consumption isn't bearish for total oil demand growth.
- Our cross-country regression results also align with our product-level forecasts: Gasoline and jet fuel will both benefit from robust consumption growth (we forecast 6% through 2023); meanwhile, consensus is mistaken in assuming that diesel is doomed as China's investment boom unwinds.
- Gasoline and diesel drive much of our bullishness (Exhibit 2e). Strong vehicle stock growth will support gasoline demand growth. Near-term improvements in China's passenger-vehicle fuel efficiency will be more modest than headline fuel efficiency requirements suggest, owing to the generous extra credits given to EVs and consumers' enduring appetite for large vehicles like SUVs.
- Likewise, diesel's viability for continued growth from trucking has been obscured by a slew of temporary headwinds, notably switching from diesel in several nontrucking sectors (buses, rail, manufacturing fuels). These factors have largely played out, leaving robust trucking demand to drive diesel growth.
- Jet fuel demand in China is poised to increase 8% on average annually from 2018-28 based on expectations of a more than doubling in the number of Chinese consumers rich enough to travel. We expect jet fuel demand to increase 10% annually between 2018 and 2023 compared with the IEA's forecast of a 4% annual increase.
- We are bullish on liquefied petroleum gas and ethane demand but bearish on naphtha demand as new plants and cheap imported feedstock support substitution of LPG and ethane for naphtha in supplying petrochemicals. Meanwhile, other oil products are the one area where we are bearish versus the IEA through 2023, as this category will be hit hardest by the slowdown in investment expenditure.
- Drawing on our above-consensus forecasts for EV sales, Chinese oil demand growth will decelerate markedly in the mid-2020s, and we think peak demand will be reached by 2030, when the EV share of vehicle stock reaches 11%. By 2040, the EV share hits 50%, and our oil demand forecast of 15.2 mmbpd stands below consensus forecasts (Exhibit 2f).
- Our below-consensus midcycle oil price forecast of $60 per barrel Brent remains intact, despite our bullish view on China oil demand through 2023, which requires 13% higher annual incremental global supply relative to our prior forecasts. Our midcycle oil price is determined by the break-even cost for U.S. shale—the marginal producer in our framework. U.S. shale costs can support higher activity without materially lower break-evens, thanks to abundant service capacity and decades of highly productive Tier 1 inventory.

- Our China natural gas consumption and LNG import forecasts have increased significantly since our last update. We now expect China gas consumption of 329 billion cubic meters, or bcm, in 2020 versus our earlier expectations of 290 bcm, and LNG imports of 114 bcm compared with prior expectations of 75 bcm.
- China's goals to address environmental concerns are powerful drivers for long-term gas and LNG demand, especially since domestic natural gas production cannot meet the country's consumption needs.
- Our forecast for China's long-term natural gas demand is heavily influenced by government energy targets for 2020 and 2030. We see this as reasonable for the following reasons: prior success meeting energy targets; importance of natural gas consumption to China's leadership; and the government's influence on natural gas prices and thus demand.
- China's current five-year plan calls for natural gas to increase as a percentage of overall energy mix to 8.3%-10% by 2020 and 15% by 2030 from 7% in 2017. Our above-consensus forecast calls for gas to make up 9% of the energy mix in 2020 and to grow at 8% annually through 2030.
- With Chinese gas consumption surging, pipeline imports will fill a portion of the needed incremental supply, but we don't expect them to be fully utilized.
- China's natural gas production is unlikely to repeat the success of the United States', and we expect relatively flat internal natural gas production in China.
- Underwhelming pipeline imports and flattish internal production leave LNG to bridge the gap between China's gas demand and supply from the other two primary sources. Additionally, we predict that the LNG infrastructure necessary to support our demand forecast will be in place both within China and globally.
- We forecast surging Chinese LNG demand, with LNG imports growing at a robust 14% compound annual growth rate from 2018 to 2028. In addition to the supply gap, a lack of natural gas storage capacity, the inability of pipeline imports to respond effectively to demand changes, and the lack of a fully liberalized market for pricing gas will support LNG growth.
- Our 2023 forecasts for Chinese gas consumption and LNG imports of 407 bcm and 163 bcm are substantially above the IEA's 2023 expectations of 373 bcm and 87 bcm.
- Risks to our views include the potential for the government to loosen environmental restrictions as Chinese GDP growth slows.
- LNG is the most interesting piece of the Chinese natural gas puzzle and the piece with the most opportunity for investors.
- Our revised Chinese LNG demand forecast increases our global estimated 2025 supply gap of 160 bcm by 81 bcm, all else equal. We are leaving our midcycle LNG price of $8.50/mmBtu unchanged however. Our midcycle price estimate was originally based on the price needed for the marginal project to be constructed which we viewed as being greenfield US developments. We expect this to continue to be the case.
- Our top LNG-related investment ideas, highlighted on the next page, include Cheniere Energy, ENN Energy, Royal Dutch Shell, and Woodside Petroleum.

Top Ideas

Cheniere Energy LNG

Star Rating: ★★★ | P/FV: 0.93 | Moat Rating: Wide | Trend: Stable | LNG Exposure: High

Cheniere Energy is as close to a pure play on China LNG as investors can find, as it is a leader in the U.S. LNG exporting market, with over 30 million tons of capacity on line by 2020. We expect a material portion of the increase in Chinese gas demand to be met by U.S. LNG imports, either directly or indirectly by China buying from other countries if it enacts more substantial tariffs on U.S. LNG. Cheniere's corporate structure was recently simplified with the acquisition of its child Cheniere Energy Partners Holdings, making it easier for investors to understand.

Cheniere Energy Partners CQP

Star Rating: ★★★ | P/FV: 0.94 | Moat Rating: Wide | Trend: Stable | LNG Exposure: High

Cheniere Energy Partners is essentially a lower-risk and more stable version of Cheniere Energy. The master limited partnership owns the Sabine Pass LNG terminals, which means that its cash flows are based entirely on the stable fee-based contracts signed to export LNG, whereas Cheniere Energy also derives income from the more volatile marketing operations. Cheniere Energy Partners also pays a distribution, which we expect to increase in the coming years alongside cash flows, making it attractive for investors that value income.

ENN Energy Holdings 02688

Star Rating: ★★★★ | P/FV: 0.78 | Moat Rating: Narrow | Trend: Stable | LNG Exposure: High

ENN owns exclusive rights on its city gas operations with contracts that extend for decades. These contracts allow the firm to collect one-off connection fees as well as ongoing gas usage fees that differ by customer type. As Chinese gas consumption increases, ENN's volumes and fees follow, providing it with rapid growth.

Royal Dutch Shell RDS.A

Star Rating: ★★★★ | P/FV: 0.76 | Moat Rating: Narrow | Trend: Stable | LNG Exposure: Medium

Given the relatively high exposure to LNG, all integrated oil firms should benefit from a tightening of the LNG market. But with 45% of its production consisting of LNG in 2021 plus the greatest amount of portfolio volumes and 20% of its volume delivered at spot pricing, Shell stands to be a relative winner.

Woodside Petroleum WPL

Star Rating: ★★★★ | P/FV: 0.74 | Moat Rating: None | Trend: Stable | LNG Exposure: Medium

We think no-moat-rated Woodside is currently nearly 30% undervalued, and we rate it the best value of the three large Australian exploration and production companies, ahead of Santos and Oil Search. Our AUD 46.50 fair value estimate assumes 60% growth in annual production to 130 million barrels of oil equivalent by 2024. We don't believe the market sufficiently credits Woodside's ability to complete a capital-efficient second Pluto LNG train or to increase North West Shelf Joint Venture life to greater than 20 years, and unfairly so.

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2020 Defense Budget on Shakier Ground, but Near-Term Contractor Growth Is Locked In

Democrats gained control of the House of Representatives in the Nov. 6 midterm elections, while the Republicans retained the Senate. House Armed Services Committee ranking member Rep. Adam Smith, D-Washington, will now assume the chairmanship, while Rep. Pete Visclosky, D-Indiana, will take over as defense appropriations subcommittee chairman. We anticipate both will try to ramp up scrutiny of Department of Defense nuclear modernization, specifically the B-21 bomber (Northrop Grumman) and the Columbia submarine (General Dynamics). We also think they will increase oversight of overseas contingency operations spending. That said, Smith's district is in the Puget Sound region, and we believe he will be an advocate for Boeing's programs relative to other priorities.

Our bull case envisions bipartisanship and an avoidance of gridlock, which creates funding certainty for defense names, but our bear case anticipates budget chaos and sequestration for fiscal 2020. Our base case entails a muddle through in which a 2020 continuing resolution, which freezes funding at the previous year's levels, occurs but an agreement to avoid budget caps is eventually struck. Flying under investors' radar is the likely resignation of Defense Secretary James Mattis. Depending on who replaces Mattis and when, we think the Pentagon might be at a disadvantage as it battles for its piece of the fiscal 2020 appropriations.

Although we continue to forecast accelerating growth for the U.S. defense majors through the first half of 2019 as outlays ramp, thanks to previous budget increases, our projection for modest growth in the fiscal 2020 defense budget is now on shakier ground. However, any decrease or flattening of defense budget authority won't be felt until later in calendar 2020. We are maintaining our fair value estimates for the defense companies we cover, and wide-moat names General Dynamics, Northrop, Raytheon, and Lockheed Martin are all trading at slight discounts to our valuations.

When he was the ranking member on the Armed Services Committee, Smith voted for recent defense spending increases proposed by the Trump administration, but he's vocal about ramping up oversight of the military's overseas operations. We think this view combined with his opposition to some large programs could translate into more scrutiny directed toward the Department of Defense budget and in particular overseas contingency operations funding, which in turn could strain the procurement and research, development, test, and evaluation accounts—investment accounts that most directly affect defense hardware firms—within the base budget. In addition, modernization of the nuclear triad could be reviewed by Smith, who has said, "I think nuclear weapons are an area where we are spending too much."

Visclosky has been less outspoken than Smith, but based on his votes and policy stances, we believe his positions are similar: more transparency and oversight with Department of Defense spending coupled with a rethinking of the nuclear modernization program. The B-21 bomber, Ground-Based Strategic Deterrent (Northrop and Boeing competing), and the Columbia class submarine could face funding cuts.

Smith has also been an outspoken critic of Saudi Arabia's operations in Yemen, and this could affect U.S. companies' existing and pending contracts with the kingdom. On the other hand, Smith's ascension to the majority is probably a positive for Boeing; he represents the Puget Sound area of Washington, and although Boeing primarily focuses on commercial aircraft in the region, it does conduct work on the KC-46 tanker and P-8 there. And he worked effectively with the Republicans on the committee while he was in the minority, indicating that he's probably a bit more pragmatic on defense funding than some of his campaign rhetoric suggests. For his part, we think Visclosky may put greater emphasis on readiness, training, and military pay plus benefits at the expense of weapons development and procurement.

Although less visible, changes at the Department of Defense are even more likely to occur now with Mattis probably leaving his post soon. We've already seen several high-level civilians walk out the doors at the Pentagon, and more could be in the offing. The departure may come at an inopportune time because the Department of Defense may need to protect its desired top line of $733 billion for total fiscal 2020 defense spending; the president has informally floated a lower $700 billion figure.

Regardless, our thesis that previous increases in defense budget authority will translate into accelerating defense contractor revenue growth through the middle part of calendar 2019 remains intact. Moreover, any pressure on the fiscal 2020 budget authority for the Department of Defense won't translate into significantly lower revenue growth for defense hardware providers until later in calendar 2020, given the natural delay between budgeted dollars and outlays. For more details on our forecast for U.S. defense budget and outlays, see our report Investors are Hungover on Defense Stocks, but the Spending Party Hasn't Even Started Yet.

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Initiating Coverage of Akamai Technologies

We are initiating coverage on Akamai with a no-moat rating, stable trend, and fair value estimate of $55, which implies a price/adjusted earnings multiple of 14 and an EV/adjusted EBITDA multiple of 8 based on our 2019 forecast, both below where the stock has traded in recent years.

Akamai operates a content delivery network, or CDN, which enables internet content providers to offer better user experiences—by improving latency, speed, and quality—while reducing their costs. Because we think CDNs will continue to be in high demand for the foreseeable future, we think the big cloud service providers are likely to push further into the space, and we see little that prevents them from succeeding, which would eat into Akamai's market share. To this point, Akamai has done an excellent job pivoting to areas with growing demand, offering top-rate service, and making smart acquisitions. In our view, management is focusing on the right things and developing great products, but we fear the firm is under constant threat of competitors chipping away at significant chunks of its business and must continue near-flawless execution to avoid business erosion.

Akamai has put more emphasis on its web business and security products in recent years as its biggest media customers, such as Netflix, retreated in favor of bringing their CDNs in house. Between 2014 and 2017, Akamai went from garnering over 18% of its revenue from its six big internet customers to about 8%, as the revenue it received from them nearly got cut in half. As a result, Akamai's media business went from providing 58% of total revenue to 47%. We think the fortunes of the media business are looking up now that the big six customers no longer provide a major chunk of the firm's revenue and the move to Internet-based TV consumption continues, all while Akamai continues to operate the largest CDN. However, we expect the media division to grow much more slowly than the web division.

Bulls Say

- A major shift in viewing habits to Internet-based TV and video directly increases the need for content delivery networks, of which Akamai's is second to none.
- The exodus of Akamai's six Internet platform companies is stabilizing, and they now represent well under 10% of sales, so they will no longer be a meaningful drag on growth.
- Akamai's intimate presence with so many companies gives it an advantage in developing top-of-the-line security products, which provide a big market opportunity and enhance Akamai's value to its customers.

Bears Say

- There is little proprietary about a content delivery network. Customers can set up their own CDNs as soon as they have a big enough internal need, meaning Akamai will continually be at risk of losing its biggest customers.
- Cloud providers run competing CDNs. With similar customers and the means to match Akamai's quality, they can encroach on Akamai's business if they ever see it as a big enough opportunity.
- Akamai's current growth is being driven almost exclusively by its nascent security business. As Akamai's security success gains notice, it will face more competition.

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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	$12.15	High	Narrow	0.62	4.93	Inton
Compass Minerals International (CMP)	★★★★	$81	$52.07	High	Wide	0.64	1.76	Goldstein
Martin Marietta Materials (MLM)	★★★★	$250	$188.38	High	Narrow	0.75	11.81	Inton
Communication Services								
Comcast (CMCSA)	★★★★	$42	$38.3	Medium	Wide	0.91	174.25	Macker
BT Group (BT.A)	★★★★	GBX 360	GBX 255	High	Narrow	0.71	24.73	C. Nichols
China Mobile (941)	★★★★	HKD 97	HKD 72.9	Medium	Narrow	0.75	532.59	Baker
Telefonica (TEF)	★★★★★	$13	$7.46	High	Narrow	0.57	39.00	C. Nichols
Telstra (TLS)	★★★★	AUD 4.4	AUD 3.04	Medium	Narrow	0.69	36.16	Han
Vodafone Group (VOD)	★★★★	$250	$147.08	High	Narrow	0.59	39.51	C. Nichols
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	$240	$148.99	High	Wide	0.62	392.22	Hottovy
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 73.86	High	Narrow	0.63	48.34	Hilgert
Expedia Group (EXPE)	★★★★	$180	$125.43	High	Narrow	0.70	19.13	Wasiolek
General Motors (GM)	★★★★	$45	$36.57	High	None	0.81	52.05	Whiston
Hanesbrands (HBI)	★★★★★	$27	$16.71	Medium	Narrow	0.62	6.03	Swartz
InvoCare (IVC)	★★★★	AUD 16	AUD 12.1	Medium	Wide	0.76	1.33	Ragonese
Mattel (MAT)	★★★★	$21	$13.92	High	Narrow	0.66	4.99	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$49.27	High	Narrow	0.71	10.92	Katz
Walt Disney (DIS)	★★★★	$130	$116	Medium	Wide	0.89	172.52	Macker
WPP (WPP)	★★★★★	GBX 1450	GBX 873.4	Medium	Narrow	0.60	11.23	Mogharabi
Consumer Defensive								
A2 Milk (ATM)	★★★★	AUD 14.6	AUD 10.42	High	Narrow	0.71	7.68	Fleck
Anheuser-Busch InBev (BUD)	★★★★★	$118	$74.61	Low	Wide	0.63	149.53	Gorham
G8 Education (GEM)	★★★★	AUD 3.5	AUD 2.36	High	None	0.67	1.07	James
General Mills (GIS)	★★★★★	$58	$44.44	Low	Wide	0.77	26.14	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2694	Low	Wide	0.73	25.39	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7650	Low	Wide	0.87	680.57	Wei
Mondelez International (MDLZ)	★★★★	$52	$43.94	Medium	Wide	0.85	63.47	Lash
PepsiCo (PEP)	★★★★	$122	$116.06	Low	Wide	0.95	163.83	Vora
Procter & Gamble (PG)	★★★★	$97	$91.36	Low	Wide	0.94	227.44	Lash
Energy								
Enterprise Products Partners (EPD)	★★★★★	$35.5	$27.38	Low	Wide	0.77	59.76	Ellis
Cenovus Energy (CVE)	★★★★	$21	$12.08	Very High	None	0.58	14.84	Gemino
Enbridge (ENB)	★★★★★	$62	$43.32	Medium	Wide	0.70	79.20	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$83	$64.83	Medium	Narrow	0.78	265.39	Good
Total (TOT)	★★★★	$77	$57.83	Medium	None	0.75	154.68	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 33.77	High	None	0.73	31.61	Taylor

Source: Morningstar. As of Nov. 9, 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								
Agricultural Bank of China (601288)	★★★	CNY 4.2	CNY 3.65	High	Narrow	0.87	260.47	Tan
American International Group (AIG)	★★★★★	$76	$44.25	Medium	None	0.58	39.30	Horn
Altaba (AABA)	★★★★	$98	$62.48	High	None	0.64	38.33	Mogharabi
BlackRock (BLK)	★★★★	$540	$409.87	Medium	Wide	0.76	68.28	Warren
Capital One Financial (COF)	★★★★	$127	$90.86	Medium	Narrow	0.72	43.04	Plunkett
Credit Suisse Group (CSGN)	★★★★★	CHF 22	CHF 12.98	High	Narrow	0.59	33.14	Scholtz
Link Administration Holdings (LNK)	★★★★	AUD 8.5	AUD 7.74	Medium	Narrow	0.91	4.10	James
Macquarie Group (MQG)	★★★	AUD 130	AUD 123.64	Medium	Narrow	0.95	42.44	Ellis
Pendal Group (PDL)	★★★★	AUD 11	AUD 8.36	Medium	Narrow	0.76	2.66	Likos
Westpac Banking (WBC)	★★★★	AUD 33	AUD 27.7	Medium	Wide	0.84	94.91	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$245	$169.31	Medium	Wide	0.69	57.11	Waterhouse
McKesson (MCK)	★★★★★	$210	$132.57	Medium	Wide	0.63	25.90	Lekraj
Medtronic (MDT)	★★★★	$110	$94.74	Medium	Wide	0.86	127.36	Wang
Roche Holding (ROG)	★★★★★	CHF 333	CHF 251.35	Low	Wide	0.75	214.67	Andersen
Industrials								
Anixter International (AXE)	★★★★★	$107	$68.18	Medium	Narrow	0.64	2.28	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 45.05	Medium	Narrow	0.78	56.86	Song
CK Hutchison Holdings (1)	★★★★★	HKD 118	HKD 79	Medium	None	0.67	304.64	Tan
G4S (GFS)	★★★★★	GBX 337	GBX 183.8	Medium	None	0.55	2.76	Field
GEA Group (G1A)	★★★★★	EUR 45	EUR 26.99	Medium	Wide	0.60	4.89	Molina
General Dynamics (GD)	★★★★	$216	$184.56	Medium	Wide	0.85	54.66	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 210	MXN 159.74	High	Wide	0.76	89.61	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.3	HKD 2.91	High	None	0.46	20.61	Song
Johnson Controls International (JCI)	★★★★	$53	$34.48	High	Narrow	0.65	31.89	Bernard
KION GROUP (KGX)	★★★★★	EUR 90	EUR 51.78	Medium	Narrow	0.58	6.12	Molina
Sodexo (SW)	★★★★	EUR 110	EUR 92.74	Medium	Narrow	NA	12.79	Field
Stericycle (SRCL)	★★★★★	$83	$47.86	High	Narrow	0.58	4.34	Young
Real Estate								
AVEO Group (AOG)	★★★★★	AUD 2.8	AUD 1.86	Medium	None	0.66	1.08	Sherlock
Sun Hung Kai Properties (16)	★★★★★	HKD 153	HKD 106	Medium	Narrow	0.69	307.08	Zhong
Welltower (WELL)	★★★	$72	$68.58	Medium	None	0.95	25.76	Brown
Technology								
Applied Materials (AMAT)	★★★★	$49	$34.94	High	Wide	0.71	34.65	Davuluri
Intel (INTC)	★★★★	$65	$48.99	Medium	Wide	0.75	222.36	Davuluri
KLA-Tencor (KLAC)	★★★★	$128	$97.05	High	Wide	0.76	14.77	Davuluri
Lam Research (LRCX)	★★★★	$185	$151.68	High	Narrow	0.82	23.54	Davuluri
Microchip Technology (MCHP)	★★★★★	$112	$74.45	Medium	Wide	0.66	16.63	Colello
Murata Manufacturing (6981)	★★★★	JPY 24000	JPY 18940	High	Narrow	0.79	38.97	Ito
Tencent Holdings (700)	★★★★★	HKD 590	HKD 279.2	High	Wide	0.47	658.05	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$71.22	Low	Wide	0.85	46.66	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.47	Medium	None	0.78	45.45	Fulop
FirstEnergy (FE)	★★★★	$41	$37.7	Low	Narrow	0.92	19.28	Fishman
Orsted (ORSTED)	★★★	DKK 450	DKK 452.9	Low	Narrow	1.01	185.88	Fulop
SCANA (SCG)	★★★★	$56	$40	Medium	Narrow	0.71	5.70	Miller

Source: Morningstar. As of Nov. 9, 2018

Highlighted Stocks

Delphi Technologies DLPH

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Consumer	Negative	USD	52	18.23	High	Narrow	0.35	1.6

Source: Morningstar. As of Nov. 9, 2018

Delphi Tech benefits from globally ubiquitous clean air legislation that requires passenger vehicle and commercial truck manufacturers to electrify powertrains and enhance efficiency of internal combustion engines.

Analyst Note, Nov. 8, 2018
Narrow-moat-rated Delphi Technologies reported third-quarter EPS before special one-time items of $1.29, $0.05 better than the sell-side consensus EPS of $1.24 but $0.06 lower than last year's comparable pro forma EPS of $1.35. We think the outperformance relative to the consensus was mainly attributable to favorable currency effect but also solid operating performance that partially offset the negative impacts from the coming implementation of Worldwide Harmonised Light Vehicle Test Procedure in Europe and tariffs.

Management adjusted its 2018 guidance to $5.0 billion-$5.1 billion, down $100 million on the top end from the prior guidance range. Organic revenue growth of 2%-4% (excludes currency effect) was reduced from 2%-6% owing to WLTP in Europe. The new test procedure takes longer to certify vehicles, slowing the production of Delphi's European customers during the second half of this year. Management guides to an adjusted operating margin of 12.1%-12.3%, down 20 basis points from the prior range of 12.3%-12.5% due to tariffs and slightly higher input costs. Consequently, the top end of EPS guidance was lowered by $0.10 to $4.65-$4.85.

Our investment thesis remains intact. Delphi Tech benefits from globally ubiquitous clean air legislation that requires passenger vehicle and commercial truck manufacturers to electrify powertrains and enhance efficiency of internal combustion engines. We expect growth products like DC/DC converters, power electronics, and powertrain electronic control modules and software to offset the effect of greater penetration of smaller displacement engines (fewer cylinders) that negatively affect fuel injector and valve-train product volume growth. This 4-star-rated stock currently trades at a 19% discount to our $52 fair value estimate. In our opinion, the shares are attractively valued relative to our estimates for revenue growth, cash flow, and returns on invested capital.

Richard Hilgert | richard.hilgert@morningstar.com

Deere DE

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Industrials	Stable	USD	161	145.07	Medium	Wide	0.90	46.6

Source: Morningstar. As of Nov. 9, 2018

In our recent conversations with Deere equipment owners, three themes emerged: Brand loyalty is strong; equipment reliability is a significant selling point; and it is crucial that equipment is easily serviceable.

Analyst Note, Nov. 6, 2018
Our recent re-evaluation of Deere supports our wide moat rating. Deere has shown an ability to earn profits throughout various economic and agricultural cycles. The strength of its brand, the lucrative parts business, and its financing arm all contribute to this robustness. In our recent conversations with Deere equipment owners, three themes emerged: Brand loyalty is strong; equipment reliability is a significant selling point; and it is crucial that equipment is easily serviceable.

Farmers also expressed a desire to stick with what they know, as this simplifies operation and maintenance. Dealer relationships were also shown to be important as these are established over decades. Several farmers mentioned that they grew up with Deere and plan to stick with the brand. Deere's construction equipment strategy also appears on track. In late 2017, Deere acquired road-building equipment maker Wirtgen, which will strengthen its position in the global infrastructure build-out. All indicators suggest this acquisition is a good fit as it places Deere's somewhat small (compared with competitor Caterpillar) construction equipment business in a stronger position. Global trends such as urbanization support this conclusion.

We envision that most agricultural equipment will become more technologically sophisticated. Deere's precision agriculture solutions help improve productivity and increase yields. This technology encompasses sensors and software in the equipment, desktop solutions, and even cloud-based data storage. Our conversations with farmers suggest they are bullish about the benefits of this technology but are not fully utilizing all that Deere has to offer.

Farming continues to be a competitive business. As the growing sophistication of the technology increases, we believe two benefits to Deere will emerge: There will be more products to sell and switching costs will be increased.

We believe Deere is well-positioned to benefit from trends in the global agriculture industry. The United Nations estimates that world population will grow approximately 1.0% annually until 2030 and global crop production will increase 1.4% annually over the same period. Much of the development in emerging economies will increase through mechanization and other advances in crop production.

Scott Pope, CFA | scott.pope@morningstar.com

Summit Materials SUM

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	24.50	13.76	Very High	Narrow	0.56	1.5

Source: Morningstar. As of Nov. 9, 2018

Given that the company now expects net leverage to reach 4.4 times by the end of the year, one full turn higher than the prior year, we've also raised our uncertainty rating to very high.

Analyst Note, Nov. 7, 2018
Summit Materials' share price fell nearly 5% after the company reported third-quarter earnings. Although all building materials companies faced weather-related headwinds during the third quarter, Summit Materials struggled beyond wet conditions. We always preferred peers Vulcan's and Martin Marietta's geographic footprints and upstream focus, and these differences led to Summit's comparatively worse quarter. Because Summit generates more of its business on downstream products, cost inflation hit it worse during the quarter. Although this probably can be recovered in subsequent quarters through price increases, it reflects the fact that upstream products hold the economic rent in the value chain.

In addition, while we like that Summit has cement operations, its Midwest focus hurt it during the quarter as these states saw much weaker cement demand than previously anticipated.
As a result of these issues, although Summit's revenue grew 9% to $625 million, adjusted EBITDA remained roughly flat at $172 million as margin contracted 260 basis points. Given the continued struggles, Summit cut its full-year adjusted EBITDA guidance to $400 million-$410 million from $460 million-$480 million. We've updated our forecast for the latest guidance, which leads to a reduced longer-term outlook as we expect some delay before the company can raise prices to recover margin.

Our changes lead us to reduce our fair value estimate to $24.50 per share from $26.50 for narrow-moat Summit Materials. Given that the company now expects net leverage to reach 4.4 times by the end of the year, one full turn higher than the prior year, we've also raised our uncertainty rating to very high. Nevertheless, with the shares currently trading below $14, we do see risk-adjusted upside at this time.

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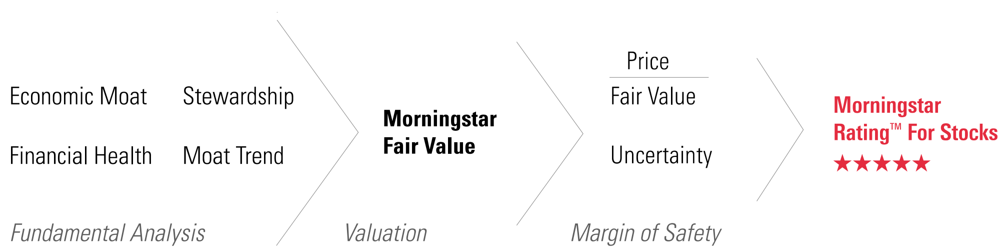
Research Methodology for Valuing Companies

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.

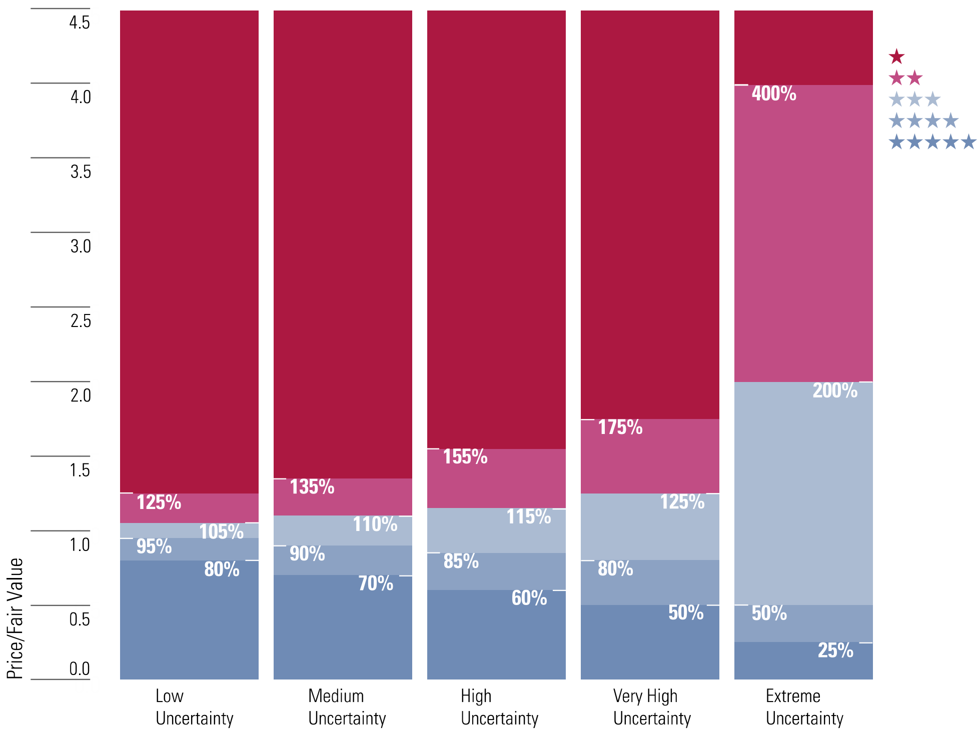
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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