Research Highlights

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

Morningstar Equity Research
Sept. 3-7, 2018

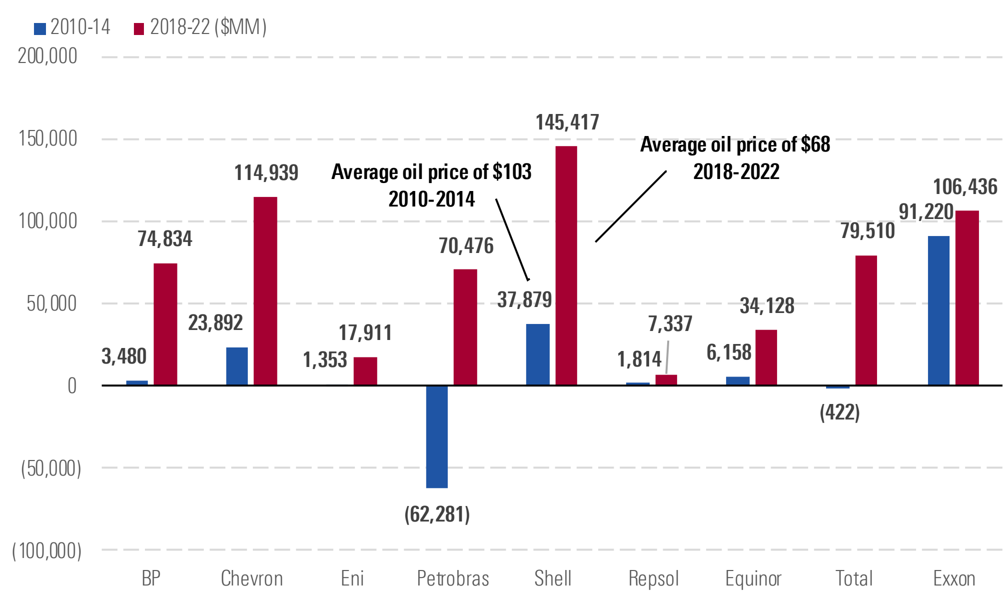
Contents

Integrated Oils: A Free Cash Flow Story

Integrated oils are set to reverse years of little or no free cash flow despite significantly lower oil and gas prices as high levels of investment give way to growth and capital restraint. We expect increased free cash flow from both upstream and downstream segments. In upstream segments, improved cost structures and the addition of higher-margin production will increase cash margins, offsetting much of the impact of lower oil prices. Meanwhile, service cost deflation, standardization, and simplification combine to reduce the capital intensity of key project areas such as deep-water, shelf, and onshore, creating the opportunity to do more with less. In downstream segments, continued strong market conditions combined with earnings growth lead to strong free cash flow generation. This results in financially stronger and healthier companies that can increase dividends and repurchase shares. Importantly, this improvement can occur at our midcycle oil price of $60 per barrel, well below current levels, and in many cases, the market is underpricing the improvement.

We think Shell and Total present the greatest opportunity.

Exhibit 1 We Expect Greater Free Cash Flow for Integrated Oils in the Next Five Years Despite Lower Oil Prices



Source: Company reports, Morningstar

- Integrated oils' free cash flow profile is set to improve materially as a 30% reduction in operating costs improves cash flow from legacy operations while new, high-margin production is added at capital costs that are in some cases nearly 40% lower than a few years ago.
- Downstream free cash flow generation should remain strong as continued favorable market conditions, thanks in part to IMO 2020, combine with past portfolio improvements to increase earnings.
- We have revisited our moat ratings in light of upstream cost improvements and are upgrading Shell and BP to narrow moats on the ability of their integrated portfolios to deliver excess returns at our midcycle oil price of $60/bbl.
- Improved free cash flow should lead to the resumption of dividend growth after years of stagnation, along with the repurchase of shares. Chevron, Shell, Total, and Equinor have the greatest capacity for both, in our view, thanks to strong free cash flow and reasonable debt levels.
- We are increasing our fair value estimates to reflect our positive outlook, leaving the group trading at an average 15% discount, despite our bearish outlook for oil prices. With non-E&P segments typically comprising nearly a third of earnings, and natural gas 50% of production on average, valuations are less leveraged to oil prices. More importantly, in many cases, current market values do not reflect the improvement in free cash flow we expect, even at $60/bbl oil, with Best Ideas Shell and Total trading at the greatest discounts.

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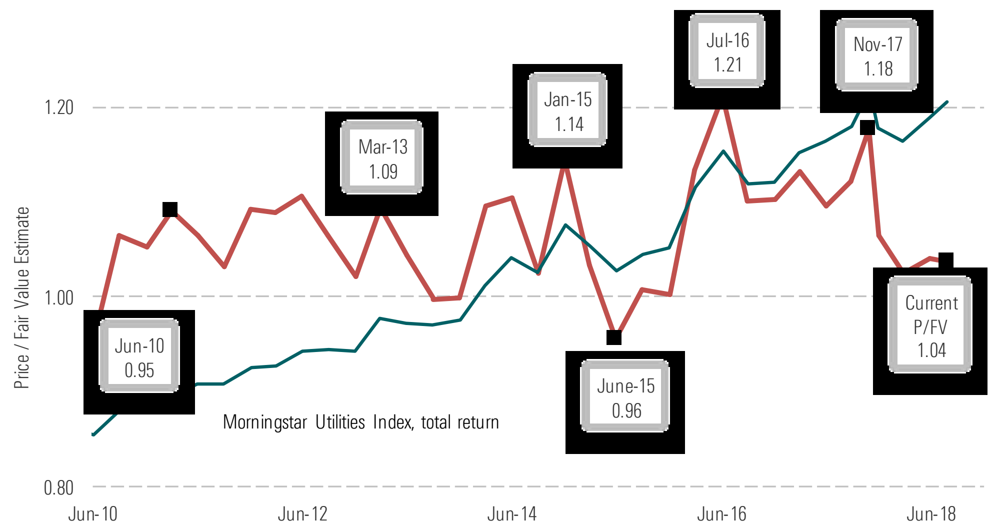
Will Utilities Fly or Flop?

U.S. utilities have underperformed the S&P 500 by 14 percentage points since November, and the sector now trades near fair value for the first time since 2015. As rising interest rates shrink the dividend yield premium utilities investors have enjoyed for several years, the road could get bumpy. But history suggests long-term utilities investors should put interest-rate worries aside and focus on fundamental yield, growth, and valuation. For income investors, we think Dominion Energy, PPL, FirstEnergy, and Duke Energy provide the best total-return packages. For value investors, we think unloved utilities like Scana and PG&E offer attractive risk-reward opportunities.

Exhibit 1 U.S. Utilities Back Near Fair Value



Source: Morningstar. As of Sept. 5, 2018. Morningstar U.S. utilities coverage, median.

- **Top income picks:** Utilities with higher dividend yields, better earnings growth, and depressed valuations should outperform their peers regardless of interest-rate moves. We think Dominion Energy, PPL, FirstEnergy, and Duke Energy are best-positioned (Exhibit 2).

Exhibit 2 Top Income Picks Combine Yield, Growth, and Value

	Dominion Energy	PPL	First Energy	Duke Energy	U.S. Utilities Coverage
Dividend Yield	4.6%	5.3%	3.8%	4.3%	3.3%
Dividend Growth 2018-22[1]	6.5%	4.0%	2.0%	3.9%	5.8%
Valuation Upside[2]	16.3%	13.2%	8.0%	4.2%	4.0%

[1] Morningstar estimate, annualized

[2] Based on current price relative to fair value estimate

Source: Morningstar. As of Sept. 6, 2018.

- **Top risk-reward picks:** Scana and PG&E will require investors' patience as each works through challenges in the second half of the year. PG&E has suspended its dividend, and Scana pays only a token dividend after cutting it 80% in the second quarter. Despite the headline risk, we think the market already is pricing in a worst-case scenario for both companies (exhibits 3 and 4).

Exhibit 3 Scana Faces Nuclear Dilemma

Issue

Management's decision to abandon its new nuclear plant project in mid-2017 created a political, legal, and regulatory headache that could persist for several years even with Dominion's acquisition bid in January 2018. We expect South Carolina regulators to issue several decisions related to the Dominion proposal and nuclear project rates by year-end.

Key Assumptions

We assume a 75% probability that regulators approve Dominion's all-stock acquisition offer. On a standalone basis, we assume regualtors deny recovery of about one-third of project costs, excluding the Toshiba guaranty proceeds, and require a $500 million customer rate credit.

Downside Risk

If regulators reject Dominion's offer and extend the state's recent 15% rate cut legislation, we expect it would reduce our fair value estimate to $40 per share, slightly above where the stock is trading as of early September.

Upside Potential

Scana investors have two potential favorable outcomes. First, if regulators approve Dominion's all-stock acquisition, Scana investors could realize 20% upside based on the proposed share exchange ratio and would own shares of our only wide moat utility. Second, if regulators allow two-thirds recovery of its investment to-date, we expect the stock to surpass our $55 per share standalone fair value estimate.

Source: Morningstar.

Exhibit 4 PG&E's Fiery Mess

Issue

California's inverse condemnation law and regulatory precedent suggest PG&E could be liable for more than $10 billion of damages related to the October 2017 wildfires.

Key Assumptions

We assume a 50% probability that PG&E faces $10 billion of liabilities on a gross pretax basis related to the October 2017 fires. This reduces our standalone fair value estimate by $5 per share.

Downside Risk

If California doesn't reform the inverse condemnation doctrine and regulators deny all recovery, we expect it would reduce our fair value estimate by $8 per share, or 15%, to $45 per share, slightly below where the stock is trading as of early September.

Upside Potential

Revisions to California's inverse condemnation law or full rate recovery for all fire liabilities would increase our fair value estimate $5 per share to $58, representing 20% upside to the stock price as of early September even after a late-August rally. If PG&E's $2.5 billion 2Q charge correctly reflects its liability, we estimate the stock has 16% upside.

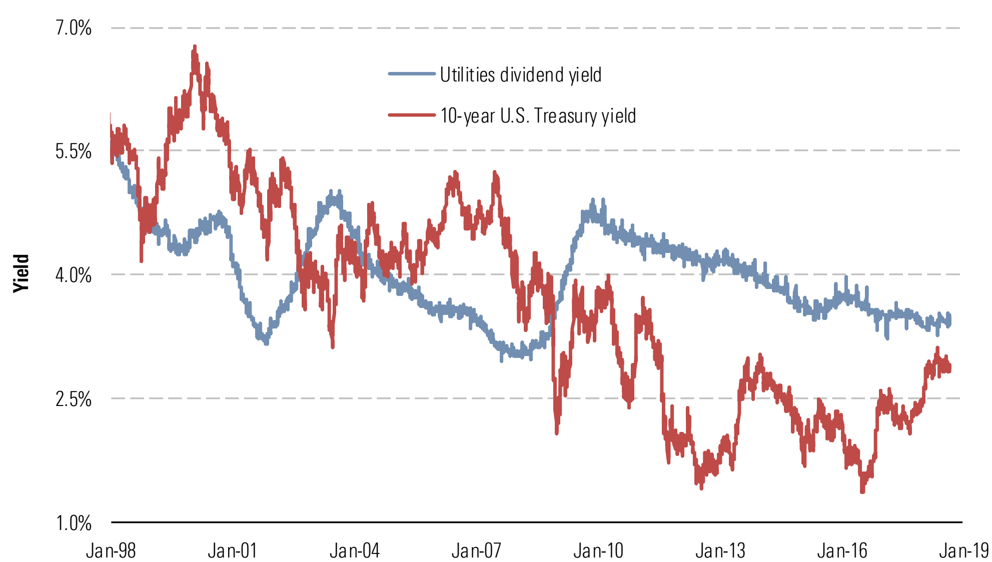
Source: Morningstar.

- **Macro has lost its mojo, part 1:** Our analysis of utilities' two- and three-year returns during the last 25 years shows that utilities and interest rates don't always move in opposite directions, as is the conventional wisdom. In fact, utilities and interest rates were just as likely to move in the same direction over longer holding periods. Rising and falling rates show no clear relationship with utilities' returns. It's more important for long-term utilities investors to dissect company fundamentals to ensure a positive return.

- **Macro has lost its mojo, part 2:** Utilities fall when interest rates rise? That almost never happened during the last 25 years over long-term holding periods. Utilities produced *positive* returns during all but 16 of the 2,392 rolling three-year periods when interest rates rose. Most recently, interest rates have doubled since July 2016, yet utilities are up 13%. Even this year, interest rates have climbed 50 basis points, but utilities are up nearly 6%, only slightly trailing the S&P 500.

- **The yield trade is waning, but it remains bullish for utilities.** In the last 25 years, utilities investors never lost money over three-year holding periods if they bought when utilities' dividend yields were higher than the 10-year U.S. Treasury yield. Utilities' current 3.5% dividend yield remains higher than the current 2.9% Treasury yield, a bullish indicator. However, the yield spread is down from 230 basis points in mid-2016 as interest rates have climbed (Exhibit 5). Buying utilities and selling bonds at the peak spread produced a 38% two-year return. Reversion to the mean suggests utilities still have room to run even if interest rates keep climbing.

Exhibit 5 Utilities' Yield Spread Has Closed but Still a Bullish Signal



Source: Morningstar. As of Sept. 6, 2018.

- **Dispersion of utilities' returns shows stock-picking is critical.** As interest rates have doubled since 2016, returns for the 42 U.S. regulated utilities in Morningstar's coverage have ranged from negative 37% (Scana) to 47% (NextEra Energy). The median return was 16%, with a standard deviation of 17 percentage points, illustrating the importance of fundamental analysis to identify winners and losers.

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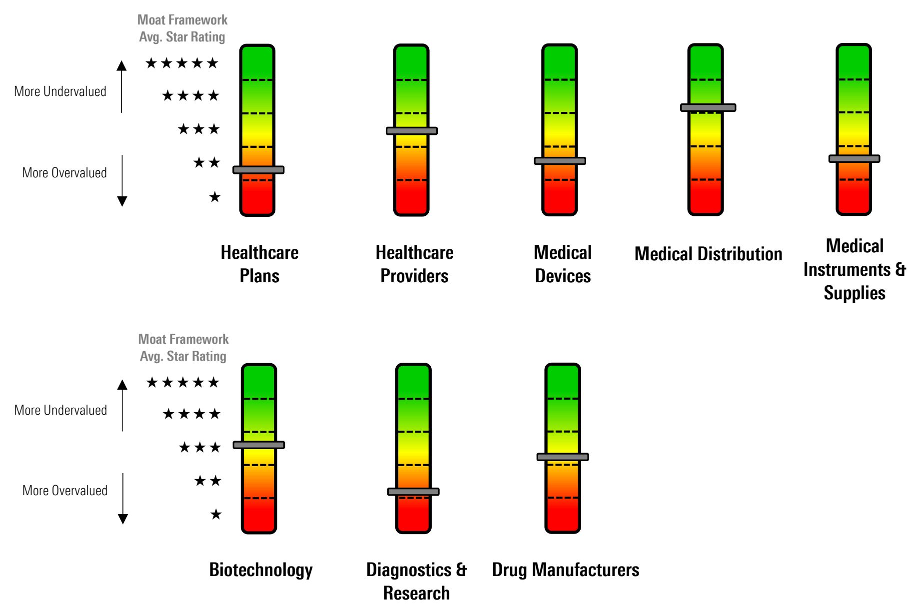
Moat Framework: Healthcare

The Morningstar economic moat frameworks are a critical tool we employ to fine-tune our economic moat analysis across different industries. This report includes moat frameworks that apply to our healthcare coverage, followed by actionable investment ideas from the industry groupings within each framework.

While the healthcare devices, instruments, and services industries mostly trade in overvalued territory, stocks under the medical distribution moat framework have an average 4-star rating. In these healthcare industries, wide-moat McKesson, a medical distributor, trades at the largest discount to fair value across the stocks we highlight in this report.

Biotechnology companies and drug manufacturers are on average fairly valued, but we still see several undervalued names, including Best Idea Allergan and wide-moat Roche, which is also trading in 5-star territory. We believe that the diagnostics and research industry is expensive, with an average 2-star valuation.

Exhibit 1 Attractive Investment Opportunities Are Relatively Scarce Across Our Highlighted Coverage

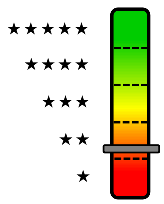


Source: Morningstar

Exhibit 2 Healthcare Moat Framework Valuation Dashboard

Healthcare Plans

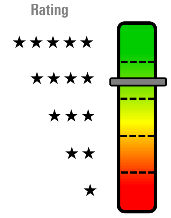
Moat Framework Avg. Star Rating



# Companies	Avg. Star Rating	Avg. P/FVE
7	★★	1.17

Managed-care organizations and pharmacy benefit managers provide health plan services to plan sponsors and payers (employers, government entities, professional organizations, and other groups). MCOs provide services on either a fully insured risk-based basis or a fee-based arrangement (sponsor insured). PBMs keep a portion of drug benefit plan savings provided to client members along with per-claim fees.

Company Star Rating

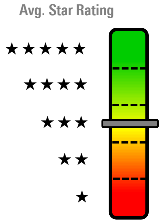


Highlighted Company	Star Rating	P/FVE
CVS	★★★★	0.78

CVS Health has vertically integrated one of the largest retail pharmacy chains in the United States with one of the largest pharmacy benefit managers. This combination makes it one of the premier healthcare firms in the U.S. The company processes approximately 1.3 billion prescriptions per year and operates more than 9,500 retail pharmacies across the U.S. The firm is now seeking to acquire Aetna, which will further extend its vertical reach and create the most integrated healthcare player in the U.S.

Healthcare Providers

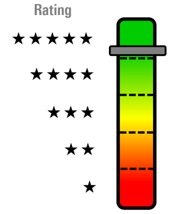
Moat Framework Avg. Star Rating



# Companies	Avg. Star Rating	Avg. P/FVE
15	★★★	1.06

The healthcare provider industry includes acute-care hospitals, ambulatory surgical centers, long-term-care hospitals, nursing homes, dialysis facilities, rehabilitation clinics, and other healthcare service companies. They provide essential medical services, including clinical visits, emergency care, rehabilitation, and surgical procedures, on an inpatient and outpatient basis.

Company Star Rating

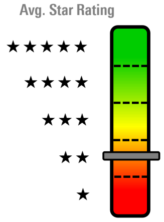


Highlighted Company	Star Rating	P/FVE
Ramsay Health Care	★★★★	0.69

Ramsay Health Care is Australia's largest private hospital operator. Revenue is derived from the Asia-Pacific region (46% of total revenue), the United Kingdom (10%), and France (37%). Ramsay operates 221 hospitals across six countries, employs more than 60,000 staff, and manages more than 25,000 beds.

Medical Devices

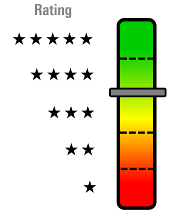
Moat Framework Avg. Star Rating



# Companies	Avg. Star Rating	Avg. P/FVE
11	★★	1.20

Medical devices tend to offer highly engineered, highly technical precision products, some with life-saving capabilities, that are often implanted in human bodies either temporarily or permanently to therapeutically address health issues such as cardiovascular disease, severe arthritis, and hearing loss. Device companies rely on constant innovation and marketing relationships to maintain their competitive positions.

Company Star Rating

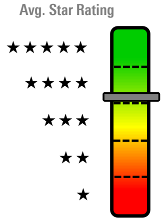


Highlighted Company	Star Rating	P/FVE
Medtronic	★★★★	0.91

One of the largest medical device companies, Medtronic develops and manufactures therapeutic medical devices for chronic diseases. Its portfolio includes pacemakers, defibrillators, heart valves, stents, insulin pumps, spinal fixation devices, neurovascular products, and surgical tools. The company markets its products to healthcare institutions and physicians in the United States and overseas. Foreign sales account for about 45% of the company's total sales.

Medical Distribution

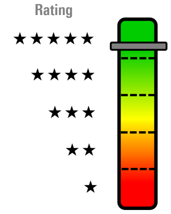
Moat Framework Avg. Star Rating



# Companies	Avg. Star Rating	Avg. P/FVE
10	★★★★	0.90

Healthcare distributors provide manufacturers of pharmaceuticals, medical equipment, dental equipment, and veterinary supplies with efficient distribution services to their end customers. These end customers consist of healthcare providers, wholesalers, and consumer retail chains, largely throughout North America. Market players can range from niche specialty distributors to multichannel firms.

Company Star Rating

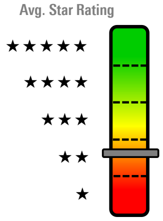


Highlighted Company	Star Rating	P/FVE
McKesson	★★★★★	0.62

McKesson is one of three major distributors of pharmaceuticals in the U.S. The firm also has significant specialty drug and medical product wholesaling operations. The firm plays a critical role along the pharmaceutical supply chain as it is able to procure and distribute drugs more efficiently than its pharmacy client and pharma manufacturing suppliers.

Medical Instruments & Supplies

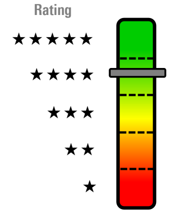
Moat Framework Avg. Star Rating



# Companies	Avg. Star Rating	Avg. P/FVE
28	★★	1.21

Medical instruments and supplies companies offer the instrumentation that enables procedures performed in the hospital setting and basic supplies that are used by healthcare providers as well as individual customers.

Company Star Rating



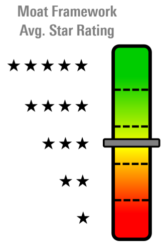
Highlighted Company	Star Rating	P/FVE
ConvaTec	★★★★	0.82

Originally spun out of Bristol-Myers Squibb, ConvaTec designs, manufactures, and markets advanced wound care, ostomy, continence care, and infusion sets for the acute-care hospital and chronic-care home settings. Advanced wound care and ostomy are the largest divisions, accounting for 33% and 30% of total revenue, respectively. Continence care contributes 21% of revenue and infusion sets 15%.

Source: Morningstar. Data as of Aug. 31, 2018.

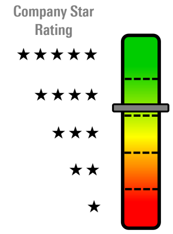
Exhibit 3 Healthcare Moat Framework Valuation Dashboard
Continued

Biotechnology



# Companies	Avg. Star Rating	Avg. P/FVE
30	★★★	0.99

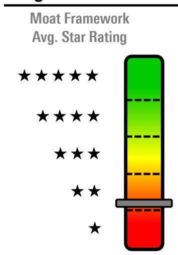
Biotechnology firms are typically smaller and more innovative but riskier versions of big pharmaceutical firms. They generally seek to discover new therapies using biologic rather than chemical processes, although today's biotechnology and pharmaceutical firms employ both methods. Biotechs tend to fall into three categories--established, emerging, and speculative (bimodal outcomes)--with moats residing mainly in the first two.



Highlighted Company	Star Rating	P/FVE
Biogen	★★★★	0.84

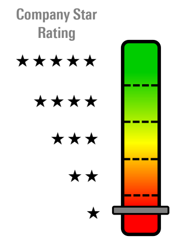
Biogen and Idec merged in 2003, combining forces to market Biogen's multiple sclerosis drug Avonex and Idec's cancer drug Rituxan. Today, Rituxan and next-generation antibody Gazyva are marketed via a collaboration with Roche. Biogen markets novel MS drugs Tysabri and Tecfidera independently. Hemophilia therapies Eloctate and Alprolix (partnered with SOBI) were spun off as part of Bioverativ in 2017. Biogen has several drug candidates in phase 3 trials in neurology and neurodegenerative diseases and has launched Spinraza with partner Ionis.

Diagnostics & Research



# Companies	Avg. Star Rating	Avg. P/FVE
21	★★	1.36

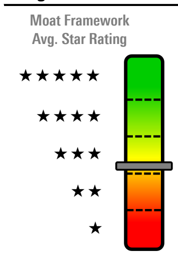
The diagnostic and research industry includes firms that sell products or services that aid in the chemical analysis, drug development, or diagnostic process. This includes equipment and consumables manufacturers and distributors, clinical research organizations, and diagnostic laboratories.



Highlighted Company	Star Rating	P/FVE
BioMerieux	★	1.63

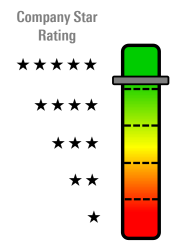
BioMerieux designs, develops, and manufactures a broad portfolio of in vitro diagnostics for detecting disease-causing pathogens and contamination. The company operates in four segments: microbiology (41% of sales), immunoassays (20%), industrial applications (18%), and molecular biology (19%). EMEA accounts for the largest portion of the firm's revenue (38%), followed by North America (38%), Asia-Pacific (17%), and Latin America (7%). BioMerieux is headquartered in Marcy-l'Étoile, France.

Drug Manufacturers



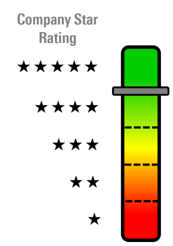
# Companies	Avg. Star Rating	Avg. P/FVE
30	★★★	1.15

Large pharmaceutical companies create, develop, and market drugs worldwide. Generating robust cash flows from patent-protected drug sales, pharmaceutical firms are well positioned to redeploy capital in creating new drugs to launch into their established distribution networks.



Highlighted Company	Star Rating	P/FVE
Roche	★★★★★	0.74

Roche is a Swiss biopharmaceutical and diagnostic company. The firm's best-selling pharmaceutical products include a variety of oncology therapies from acquired partner Genentech, and its diagnostics group was bolstered by the acquisition of Ventana in 2008. Oncology products account for more than 60% of pharmaceutical sales, and professional diagnostics for more than half of diagnostic-related sales.



Highlighted Company	Star Rating	P/FVE
Allergan	★★★★★	0.73

Allergan is one of the largest specialty pharmaceutical manufacturers. It specializes in aesthetics, ophthalmology, women's health, gastrointestinal, and central nervous system products. In 2016, Allergan sold its generics and distribution segments to Teva.

Source: Morningstar. Data as of Sept. 4, 2018.

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	$9.76	High	Narrow	0.57	3.95	Inton
Compass Minerals International (CMP)	★★★★	$83	$61.35	High	Wide	0.74	2.08	Goldstein
Martin Marietta Materials (MLM)	★★★★	$265	$198.3	High	Narrow	0.75	12.50	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 220.4	High	Narrow	0.61	21.87	C. Nichols
China Mobile (941)	★★★★	HKD 100	HKD 75.65	Medium	Narrow	0.76	1548.97	Baker
Comcast (CMCSA)	★★★★	$42	$35.92	Medium	Wide	0.86	164.58	Macker
Telefonica (TEF)	★★★★★	$13	$6.77	High	Narrow	0.52	35.18	C. Nichols
Telstra (TLS)	★★★★	AUD 4.4	AUD 3.13	Medium	Narrow	0.71	37.23	Han
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	$240	$159.87	High	Wide	0.67	411.17	Hottovy
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 80.73	High	Narrow	0.69	52.46	Hilgert
Expedia Group (EXPE)	★★★★	$185	$124.53	High	Narrow	0.67	18.61	Wasiolek
General Motors (GM)	★★★★	$45	$34.38	High	None	0.76	48.51	Whiston
Hanesbrands (HBI)	★★★★★	$27	$17.66	Medium	Narrow	0.65	6.37	Hottovy
InvoCare (IVC)	★★★★	AUD 17	AUD 12.65	Medium	Wide	0.74	1.39	Ragonese
Mattel (MAT)	★★★★	$21.5	$15.33	High	Narrow	0.71	5.28	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$53.2	High	Narrow	0.77	11.78	Katz
Walt Disney (DIS)	★★★★	$130	$110.26	Medium	Wide	0.85	163.98	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1144.5	Medium	Narrow	0.76	14.44	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★★	AUD 3.5	AUD 2.09	High	None	0.60	0.95	James
General Mills (GIS)	★★★★★	$59	$47.01	Low	Wide	0.80	28.02	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2692.5	Low	Wide	0.73	25.68	Gorham
Kao (4452)	★★★	JPY 8800	JPY 8744	Low	Wide	0.99	4262.01	Wei
Mondelez International (MDLZ)	★★★★	$52	$43.49	Medium	Wide	0.84	63.78	Lash
PepsiCo (PEP)	★★★★	$123	$113.5	Low	Wide	0.92	160.53	Vora
Procter & Gamble (PG)	★★★★	$97	$82.65	Low	Wide	0.85	205.73	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6473	Low	Wide	0.89	45.76	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$11.61	Very High	None	0.55	14.27	Gemino
Enbridge (ENB)	★★★★	$64	$44.99	Medium	Wide	0.70	77.18	Gemino
Enterprise Products Partners (EPD)	★★★★	$35.5	$28.96	Low	Wide	0.82	63.02	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$83	$65.72	Medium	Narrow	0.79	271.11	Good
Total (TOT)	★★★★	$77	$60.55	Medium	None	0.79	157.92	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 35.28	High	None	0.76	33.03	Taylor
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.59	High	Narrow	0.85	1245.07	Tan
American International Group (AIG)	★★★★	$76	$53.9	Medium	None	0.71	47.89	Horn
Capital One Financial (COF)	★★★★	$127	$98.15	Medium	Narrow	0.77	46.96	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 14.42	High	Narrow	0.66	36.78	Scholtz

Source: Morningstar. As of Sept. 7, 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.)								
Invesco (IVZ)	★★★★★	$38	$24.22	Medium	Narrow	0.64	9.95	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 668.2	Medium	None	0.76	8739.18	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 9.03	Medium	Narrow	0.82	2.53	Likos
Westpac Banking (WBC)	★★★★	AUD 35	AUD 27.8	Medium	Wide	0.79	94.14	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$263	$190.5	Medium	Wide	0.72	64.66	Waterhouse
McKesson (MCK)	★★★★★	$210	$125.5	Medium	Wide	0.60	25.07	Lekraj
Medtronic (MDT)	★★★★	$105	$96.49	Medium	Wide	0.92	130.31	Wang
Ramsay Health Care (RHC)	★★★★	AUD 76	AUD 54.56	Medium	Narrow	0.72	11.03	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 238.2	Low	Wide	0.71	203.88	Andersen
Industrials								
Anixter International (AXE)	★★★★★	$107	$70.25	Medium	Narrow	0.66	2.35	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 39.05	Medium	Narrow	0.67	49.28	Song
CK Hutchison Holdings (1)	★★★★	HKD 118	HKD 89.85	Medium	None	0.76	346.48	Tan
G4S (GFS)	★★★★	GBX 337	GBX 233.3	Medium	None	0.69	3.62	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 31.57	Medium	Wide	0.67	5.70	Molina
General Dynamics (GD)	★★★	$220	$195.24	Medium	Wide	0.89	57.85	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★	MXN 217	MXN 195.44	High	Wide	0.90	109.64	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.5	HKD 3.35	High	None	0.52	28.04	Song
Johnson Controls International (JCI)	★★★★	$53	$38.83	High	Narrow	0.73	35.91	Bernard
Kion GROUP (KGX)	★★★★★	EUR 90	EUR 55.92	Medium	Narrow	0.62	6.59	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 37.14	Medium	Narrow	0.88	34.60	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 88.24	Medium	Narrow	0.80	12.85	Field
Stericycle (SRCL)	★★★★	$86	$61.95	High	Narrow	0.72	5.32	Young
Real Estate								
Aveo Group (AOG)	★★★★	AUD 2.8	AUD 2.29	Medium	None	0.82	1.33	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 111.8	Medium	Narrow	0.73	323.88	Zhong
Welltower (WELL)	★★★	$74	$67.46	High	None	NA	25.10	Brown
Technology								
Intel (INTC)	★★★★	$65	$47.26	Medium	Wide	0.73	217.92	Davuluri
Microchip Technology (MCHP)	★★★★	$112	$83.9	Medium	Wide	0.75	19.76	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 2.92	Medium	Narrow	0.76	1.73	James
Synaptics (SYNA)	★★★★	$64	$45.97	Very High	None	0.72	1.63	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 12060	High	None	0.96	1522.52	Ito
Tencent Holdings (700)	★★★★★	HKD 590	HKD 316.8	High	Wide	0.54	3016.64	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$72.25	Low	Wide	0.86	47.23	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.37	Medium	None	0.77	44.51	Fulop
FirstEnergy (FE)	★★★★	$41	$37.96	Low	Narrow	0.93	18.45	Fishman
Scana (SCG)	★★★★★	$56	$36.68	Medium	Narrow	0.66	5.23	Miller

Source: Morningstar. As of Sept. 7, 2018

Highlighted Stocks

Iliad ILD:FR

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Communications	Negative	EUR	163	107.30	Very High	Narrow	0.66	6.16

Source: Morningstar. As of Sept. 7, 2018

With the faster subscriber growth in Italy, Iliad is gaining scale sooner than we anticipated, which should help keep its operating losses down in the country.

Analyst Note, Sept. 4, 2018
Iliad reported mixed first-half results, with weak revenue, but solid margins. We are maintaining our EUR 163 fair value estimate and narrow moat rating. The firm reported revenue that was basically flat year over year versus our full-year projection of growth of 3.8%. Results in France in both the fixed-line and wireless segments were below our expectation. In the fixed-line business, it grew its fiber-to-the-home, or FTTH, base by almost 75% to 734,000. However, its total broadband base only grew by 5,000 customers and actually declined during the first half. While we are pleased with its FTTH success as these customers pay higher prices, we are concerned with the drop-off in basic broadband customers. Management claimed it has implemented a number of changes including a reduced 12-month price with a one-year commitment at the regular price, which has already returned net subscriber growth to positive in July and August.

Likewise, on the wireless side, Iliad is showing subscriber growth in its higher-priced 4G offerings, which increased 23.5% from the year-ago period, but total wireless subscribers declined during the first half of the year as low-end customers left. This is a concern as a major focus of the firm has been to upgrade low-end customers to higher price points, which is generally cheaper than attracting wholly new subscribers.

Offsetting the weakness in revenue in France, was strong subscriber growth in Italy and better cost control. Iliad reached 1.5 million subscribers in Italy during August, which is far ahead of our previous projections. However, this is partly due to much lower prices, which started at EUR 5.99 per month and have now been increased to EUR 6.99 versus our expectation of around EUR 10. That said, the firm increased its EBITDA margin in France to 37.3% up almost 1% from the previous year.

Additionally, with the faster subscriber growth in Italy, Iliad is gaining scale sooner than we anticipated, which should help keep its operating losses down in the country. Thus, we are now expecting a smaller EBITDA margin decline in 2018 and 2019 than previously due to its entrance into Italy.

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Criteo CRTO

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Technology	Negative	USD	35	22.94	Very High	None	0.66	1.71

Source: Morningstar. As of Sept. 7, 2018

The market is overreacting to this news, creating an attractive opportunity for investors with high risk tolerance to invest in this no-moat and very high uncertainty name.

Analyst Note, Sept. 7, 2018
Criteo shares are down 11% as an article published in France on Sept. 6 indicated that the firm is no longer on Facebook's marketing partner list. In our view, the market is overreacting to this news, creating an attractive opportunity for investors with high risk tolerance to invest in this no-moat and very high uncertainty name. The stock is now trading at a 35% discount to our $35 fair value estimate.

We believe such reaction to the Facebook news is unwarranted for a few reasons. First, while Criteo is no longer a preferred marketing partner of Facebook and will not be able to test new features on the Facebook platform, the firm can continue to purchase ad inventory from Facebook. Second, Criteo's revenue dependency on Facebook ad inventory has been declining gradually during the last three years. According to Criteo, only around 4% of its revenue ex-TAC in the second quarter 2018 was from inventory purchased from Facebook, below the 9% in 2015 and 6% the last two years. And third, Criteo's guidance provided on the second-quarter call, which was disappointing, had likely considered the possible impact of Facebook's latest move.

Our view on the company has not changed, and we have not adjusted our top- or bottom-line projections for Criteo. We believe that while Criteo is beginning to implement various strategies to broaden its offering, and maintain or increase client retention rates, we think it will take time before the firm recognizes returns on these strategies. Apple's ITP move is forcing Criteo to invest further in development or purchase of additional products and technology in order not to remain solely dependent on net revenue from retargeting.

In addition, the company is now focusing more on attracting small- and mid-size businesses to its retargeting offering, which likely will be automated, possibly resulting in higher margin revenue. Plus, to make its offerings stickier and maintain its high client retention rate, the firm is also now positioning itself as more of a technology provider for enhancements of product development, marketing, and customer relationship management, rather than just an ad-tech company. To do so, Criteo is likely to increase headcount mainly in engineering and sales during the next 6-12 months. In addition, according to management, the firm will be focusing on helping retailers more effectively monetize their online properties by selling more ad inventories to brands and other advertisers, from which Criteo can generate additional ad revenue.

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Pendal Group PDL:AU

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Financial	Stable	AUD	11	9.03	Medium	Narrow	0.82	2.53

Source: Morningstar. As of Sept. 7, 2018

We particularly like the firm's diversity across asset-class exposures and geography, as well as growth opportunities being explored in the United States.

Analyst Note, Sept. 7, 2018
Narrow-moat-rated Pendal Group was recently placed on our global Best Ideas list and remains our preferred pure-play domestic asset manager. We particularly like the firm's diversity across asset-class exposures and geography, as well as growth opportunities being explored in the United States. Furthermore, the industry continues to benefit from favorable demographic tailwinds and secular growth in compulsory superannuation contributions. On the other hand, the industry continues to face fee pressure from increasing competition, particularly low-cost passive alternatives, an uncertain political climate in the United Kingdom and the risk of weak investment markets globally. Nevertheless, the company screens as undervalued at current prices and continues to be supported by an attractive grossed up dividend yield of approximately 6% for fiscal year 2018.

In its most recent June quarterly update, Pendal reported a slight increase in total funds under management, or FUM, but the result was marred by a disappointing performance in the U.K. subsidiary, JO Hambro. The quarterly AUD 1 billion increase in total FUM to AUD 100 billion was the result of a net AUD 1.2 billion increase in Pendal Australia FUM and a net AUD 200 million outflow in JO Hambro FUM. Not long after the disappointing JO Hambro performance was disclosed, Pendal Group announced the departure of Ken Lambden, the CEO of JO Hambro, effective immediately. A global search for his replacement remains under way with no indication of when a replacement will be announced. Changes to the global executive team continued this week when Bindesh Savjani, who will begin his new role in February 2019, was announced global chief risk officer.

Another drag on Pendal's stock price in recent months has been Westpac's expected sell-down of its 10% stake in the asset manager. According to Westpac, it intends to sell when market conditions are favorable enough to do so. We anticipate this transaction to take place in calendar 2018, although should market conditions turn less favorable, would likely see it executed in 2019. Until they sell, expect some technical pressure on the share price.

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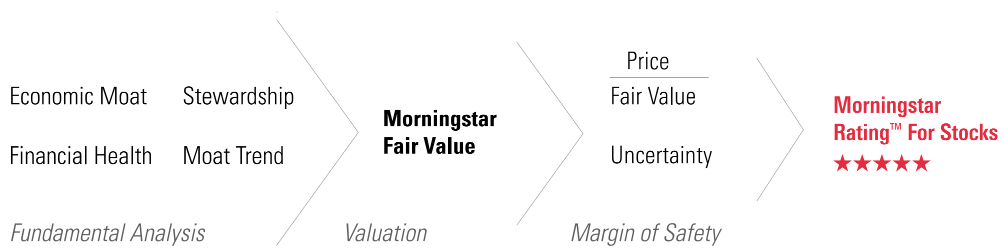
Research Methodology for Valuing Companies

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.

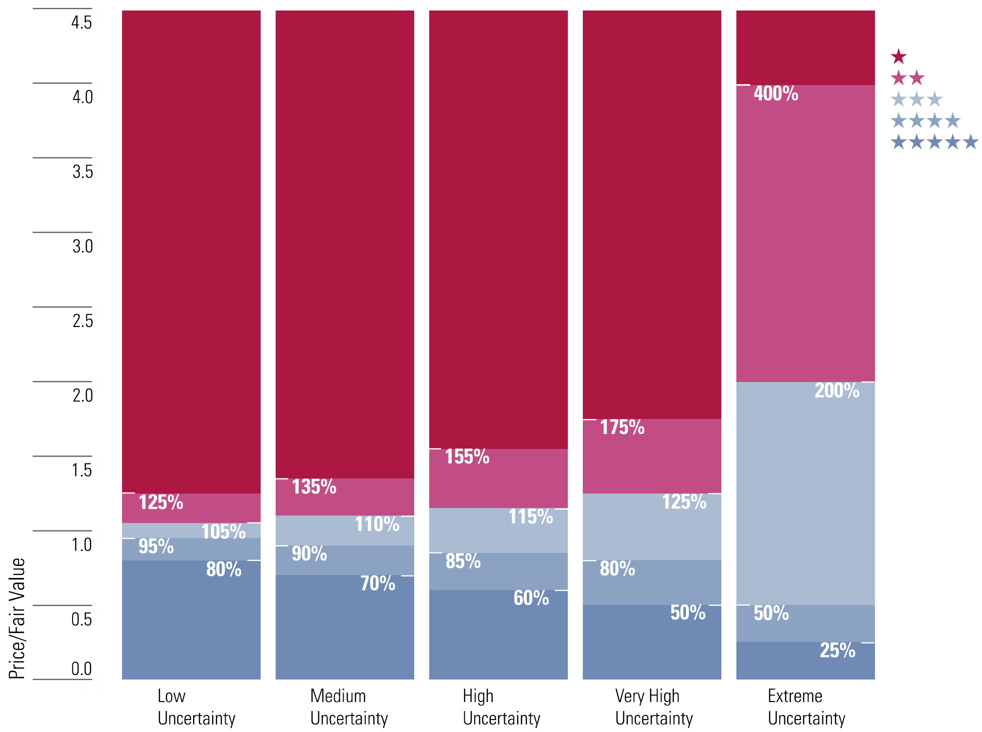
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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