Research Highlights

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

Morningstar Equity Research
Feb. 26-March 2, 2018

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Online
Interactive web-based models are available for our Best Ideas at Trefis.

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Optimism Rising for Microchip

We like what we heard from Microchip Technology's first investor day and concurrent announcement that, as previously reported, the firm will acquire Microsemi for $68.78 per share ($10.15 billion in enterprise value and $8.35 billion in equity value) in an all-cash deal. We are raising our fair value estimate for wide-moat Microchip to $112 per share from $97, as we expect the Microsemi deal to close as targeted in June and be highly accretive. We also have greater confidence that the firm's long-term organic revenue target of 7%-9% isn't overly aggressive, in light of certain metrics that Microchip disclosed about higher attach rates of ancillary chips alongside of its primary microcontroller, or MCU, business. Further, Microchip hinted that near-term organic business conditions are still quite healthy, calling for 6% year-over-year revenue growth for the June quarter, as, in their words, the "canary has not died in the coal mine."

The price for Microsemi is quite reasonable, in our view, at 18 times trailing adjusted EPS, and the firm foresees $300 million of revenue and cost synergies by fiscal 2021, which seems achievable, if not conservative in light of successes in reaching greater cost savings from Micrel and Atmel. The merger will give Microchip greater exposure to the communications, data center and aerospace and defense, or A&D, end markets, and the firm foresees revenue synergies as it strives to sell existing products like MCUs and analog parts to Microsemi's existing customers.

With Microsemi in tow, Microchip is now targeting 63% adjusted gross margins, 40.5% adjusted operating margins (both of which are only slightly higher than its prior organic targets), and $8 of adjusted EPS by fiscal 2021. We view all of these targets as conservative and model even better profitability, as we think the firm's exemplary management team can find even more ways to extract synergies over time.

Regarding the merger, Microchip didn't rule out the possibility that another bidder could jump into the fray, but since Microsemi publicly explored sale options several weeks ago, we're skeptical that another bidder will come in. Microchip expects a quick regulatory review process, as it sees little product overlap, and at first glance, we agree. Strategically, the deal makes more sense to us on the A&D side of Microsemi than the storage end market, for example, but we won't rule out the chance that Microchip can cross-sell products into areas like storage that appear less obvious to us on the surface.

Financially, in addition to paying a reasonable premium (about 17% from Microsemi's last share price before it announced it was exploring strategic options) and multiple (18 times Microsemi's fiscal 2017 adjusted EPS, 16 times fiscal 2017 enterprise value/EBITDA, and 16 times fiscal 2018 adjusted EPS), we fully expect revenue and cost synergies to make this an even more attractive deal for Microchip. On the revenue side, however, the company was cautious to state that its long-term organic revenue target of 7%-9% for Microchip would apply to the new Microsemi business as well. Management commented that Microsemi's revenue growth was essentially flat for a decade (with a variety of Microsemi's mergers muddying the picture for outsiders), and while Microchip thinks it can do better with Microsemi's products and customers, 7% growth out of Microsemi might be a stretch. Nonetheless, we anticipate reductions in selling, general, and administrative expenses, which has been par for the course in many semiconductor deals in recent years.

Our only concern regarding the Microsemi deal is the high degree of leverage that Microchip is taking on to fund the all-cash deal, as Microsemi's management and shareholders wanted cash rather than a portion of the deal in stock. Microchip's leverage will rise to a debt/adjusted EBITDA ratio of 4.7 times, which is quite high for a chipmaker. We noted similar concerns among investors when Microchip bought Atmel, but that ratio peaked at 3.1 times. Microchip noted how it was able to quickly bring down leverage with the Atmel deal, down to about 1.05 times today before the announcement, and we anticipate that the firm will be able to do so again after the Microsemi deal. In Microchip's favor this time is that Microsemi is a far more profitable firm than Atmel, with a potentially sticky customer base in A&D in particular. Between our math and management's hint that they will be out of the acquisition market for a couple of years after this deal, we anticipate that Microchip will reach a leverage ratio of 2 times by fiscal 2021.

Outside of the Microsemi deal, Microchip spent much of the investor day discussing its core businesses, including MCUs, analog chips, and even some further insight into its smaller memory and licensing segments. We were most encouraged by the firm's comments around the attachment of analog and other peripheral parts alongside its core MCUs. Management has long cited three additional growth drivers that will allow Microchip to grow faster than a real GDP type of rate, one being additional content attachment. The firm disclosed that the number of parts designed into each customer project has been rising at a rate of 20%-plus year over year. Similarly, the number of projects with more than one Microchip product family included on the circuit board is growing at a 40%-plus pace.

Further, the company notes a 1.7 times boost to revenue if it can sell three parts to a customer (versus 1 times revenue for selling a lone MCU) and 3.1 times or more if it can sell four or more parts. In our view, all of these incremental data points seem consistent with Microchip's healthy analog revenue growth and give us increased confidence that the firm's organic 7%-9% growth rate target isn't overly aggressive.

Finally, Microchip also calmed some jitters, in our view, regarding near-term business conditions. First, as we previously wrote, although chip inventory ticked up in the December quarter, inventory is still at the low end of the firm's target range. Given that few of Microchip's products are leading edge and at risk of obsolescence, we have few concerns about near-term inventory levels. Second, the company indicated a healthy book/bill ratio of 1.09 as of February 2018 versus 1.00 in December 2017 and 1.05 in

September 2017. Thus, the ratio of 1.00 in December was not the start of a falling knife, but rather a "soft landing," according to management.

Third, the company's forecast for 5% sequential revenue growth in the June quarter, which will represent about 6% growth year over year, is in line with our prior forecast. We don't believe that midteens organic revenue growth, as seen by Microchip in most of calendar 2017 (fiscal 2018), is sustainable and that the firm may face some tough comparisons in calendar 2018 (fiscal 2019, ending March 2019). However, we would have few complaints if Microchip were to maintain a 6% growth rate over the next few quarters (excluding Microsemi). Microchip has long been considered a canary in the coal mine for the chip industry, given its extremely broad base of customers (now up to 115,000). And as management said, the canary hasn't died yet, and we have increased confidence that recent revenue growth deceleration is a sign of normalization, not the start of a crippling cyclical downturn.

Bulls Say

- Microchip sells to tens of thousands of end customers, so it is not overly dependent on sales to any one client or market segment.
- Microchip's focus on the MCU market gives it an advantage over larger competitors, in our view, as MCUs are only one of many segments within their larger businesses.
- Microchip has one of the highest dividend yields in the chip sector.

Bears Say

- Microchip faces competition in analog chips and microcontrollers from larger firms, such as Texas Instruments and STMicro.
- Microchip is the market-share leader in 8-bit MCUs but trails a couple of other firms in 16- and 32-bit MCUs.
- Microchip has done an exceptional job of integrating M&A targets in recent years, but has leveraged up the balance sheet to do so.

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Electronic Materials: Soaring Growth, Looming Consolidation, and New Investment Vehicles

Investors are instinctively on the hunt for well-run companies in under-researched sectors that generate rapid organic growth, possess economic moats, and are poised to benefit from secular trends. We believe the electronic materials industry fulfills these criteria. The EM sector provides the gas mixtures, chemical formulations, specialty materials, delivery equipment, and packaging and handling solutions that facilitate leading-edge semiconductors and other microelectronics underlying the proliferation of mobile devices, laptops, cloud computing, and the Internet of Things. EM growth is sprinting along at double-digit rates, riding the powerful waves of twin macroeconomic drivers. The first is rising investment in data-rich endeavors such as mobile devices, cloud computing, industrial automation and control, and artificial intelligence. The second driver is the fact that most current and future generation design and manufacturing innovations facilitating advances in miniaturization, chip performance, reliability, and productivity characterized by Moore's law are now inherently more materials-intensive than previous iterations. We think these forces are highly likely to remain in force indefinitely.

Consequently, our view is that EM growth will structurally exceed that of the underlying chip industry by a meaningful margin. From an investor's perspective, the creation and emergence of several new pure-play companies leads us to expect that the EM industry's heretofore low profile, a legacy of operating mostly as small units buried deep within much larger companies, is approaching an end.

The protagonist in the Jon Krakauer book *Into the Wild* unknowingly seals his demise when he crosses a low Alaskan river one sunny spring day to embark on a wilderness expedition, only to find a few months later that the thaw had converted the same narrow river into an impassible torrent, fatally preventing his return. Analogously, today's robust demand environment for electronic materials may obscure the rising competitive risks that most narrowly focused or niche suppliers will face once demand stabilizes and their powerful customer base becomes more concentrated, demanding, and selective. We believe the fragmented sector will ultimately consolidate down to a handful of broad-based suppliers possessing technological advantages, product breadth, global presence, and research and development and technical support with the ability to leverage strong relationships to squeeze out narrower or less committed rivals.

Equity investors attracted to the rapid organic growth, technological innovation, global presence, and healthy margins that EMs currently enjoy are limited to a handful of small- to mid-cap stocks with somewhat varied track records. However, competitive dynamics and healthy valuations are the catalysts driving the creation of new investment options via consolidation, mergers, and spin-outs. Industrial logic and financial incentives underlie this motivation. Large sophisticated chipmakers increasingly seek highly committed solutions providers as partners to collaborate with on their next-generation designs, an imperative that may not align with the resource allocation priorities of large, diversified companies whose EM activities comprise a small part of overall sales and strategic investment. Semiconductor equipment manufacturers likewise seek collaborators that offer the needed expertise, technical support, and responsiveness to streamline the next wave of innovation in production equipment and process techniques. Within the next year, the looming demerger of DowDuPont into three or more publicly traded companies will cause both current holders and potential new investors to evaluate the investment potential of a new electronic materials industry leader with large-cap equity potential.

- ► Electronic materials suppliers such as Versum Materials, Entegris, Cabot Microelectronics, DowDuPont, and others are enjoying robust growth and widening valuations due to rising chip production, as well as technology transitions that require more intensive use of their products and services.
- ► The $50 billion in revenue EM industry sits at the intersection of two oft-competing imperatives. One is to continually innovate to boost chip performance, while the other is to steadily reduce customers' production costs. While performance gains result from rising investment and development spending for novel techniques, new materials, and tailored processes, production efficiency often rises with standardization, process optimization, supplier and customer consolidation, and tightly linked regional supply chains. One common theme among EMs is ever-closer collaboration with their major customers.
- ► Sturdy narrow economic moats are built upon the high returns, sizable patent estates, and history of successful collaboration with key customers. A lengthy and expensive product qualification process raises switching costs and deters new entrants. While ROICs are becoming rather gaudy with soaring demand and naturally low capital intensity, it is their structural dependence on serving large, powerful customers in consolidating sectors that comprises the major stumbling block to a wide economic moat.
- ► Stock prices have soared and valuations have expanded over the past few years in the wake of double-digit revenue growth and step-change margin expansion. One subtlety aiding valuation may be growing recognition of the sector's secular ability to grow faster than the rate of the underlying chip industry.
- ► While none of the three pure-play choices seem fundamentally inexpensive, Entegris offers the best relative value based upon a combination of its broader, more specialized product mix, a proven ability to complete and integrate transformative acquisitions, and a more reasonable valuation.
- ► For the pure plays, medium-term challenges revolve around managing expected rapid growth and adroitly deploying free cash flow to exploit rising chip complexity. Among the dozens of diversified global industrials with electronic materials as a portfolio company or product line, we suspect many may follow Air Products' lead and seek either tighter focus or greater scale to optimize asset value.
- ► This remains a fragmented industry ripe for aggressive consolidation. A concentrated customer base will steadily opt to work with fewer, larger suppliers better able to protect their IP and commit the resources necessary to tackle the panoply of tactical operational and strategic technical challenges.

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How Broad Will Steel, Aluminum Tariffs Be?

After meeting with steel and aluminum executives at the White House on March 1, President Donald Trump announced that he'll be enacting a 25% steel tariff and a 10% aluminum tariff next week. It is unclear, however, if this approach will be applied in a blanket fashion to all countries or only to a targeted list of countries. This is a critical distinction, because we'd view a blanket approach as far more severe and, in turn, far more beneficial for the prospects of U.S. steel and aluminum producers. Our base-case expectations for U.S. steel prices, margins, and shipment volumes continue to assume that final sanctions will be targeted. If Trump instead pursues a more widespread approach, we'd probably increase the fair value estimates for the U.S. steel and aluminum producers we cover.

In its Feb. 16 Section 232 report, the blanket tariffs proposed by the U.S. Department of Commerce were 24% for all steel imports and 7.7% for all aluminum imports, both less severe than the figures indicated by Trump on March 1. However, the agency had also recommended 53% targeted tariffs for steel and 23.6% targeted tariffs for aluminum. Therefore, the actions proposed by Trump could be viewed as more punitive or significantly less punitive than the recommended sanctions depending on their scope.

There has reportedly been significant disagreement among Trump's advisors as to how severe the resulting tariffs should be. On one hand, trade hawks, including Commerce Secretary Wilbur Ross, U.S. Trade Representative Robert Lighthizer, and trade advisor Peter Navarro, have pushed for steep tariffs and quotas, while others, including Chief Economic Advisor Gary Cohn have supported a less heavy-handed approach. Steeper tariffs increase the risk of retaliation from trading partners as well as unintended negative effects on the profits of U.S. industries that are heavy steel consumers.

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Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

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	$8.94	High	Narrow	0.53	3.51	Inton
Compass Minerals International (CMP)	★★★★	$82	$58.9	High	Wide	0.72	1.99	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 240	High	Narrow	0.65	23.81	C. Nichols
China Mobile (941)	★★★★★	HKD 110	HKD 72.6	Medium	Narrow	0.66	1486.52	Baker
Telefonica (TEF)	★★★★	$13	$7.83	High	Narrow	0.60	40.66	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.27	Medium	Narrow	0.71	38.89	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$155	$117.51	Medium	Narrow	0.76	8.69	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.8	Medium	Narrow	0.83	1.62	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 85.3	High	Narrow	0.78	55.41	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 39.8	Medium	Narrow	0.75	3.49	Faul
General Motors (GM)	★★★★	$56	$37.79	High	None	0.67	53.02	Whiston
Great Wall Motor (2333)	★★★★	HKD 14.9	HKD 9.09	High	None	0.61	123.46	Hu
Hanesbrands (HBI)	★★★★★	$32	$19.51	Medium	Narrow	0.61	7.03	Weishaar
Mattel (MAT)	★★★★	$22.5	$15.85	High	Narrow	0.70	5.45	Katz
TripAdvisor (TRIP)	★★★★	$55	$39.76	High	Narrow	0.72	5.53	Wasiolek
Walt Disney (DIS)	★★★★	$130	$102.57	Medium	Wide	0.79	154.23	Macker
Williams-Sonoma (WSM)	★★★★	$65	$51.96	Medium	Narrow	0.80	4.37	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1280	Medium	Narrow	0.85	16.26	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★	$61	$50.57	Low	Wide	0.83	28.78	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2603.5	Low	Wide	0.67	24.83	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7635	Low	Wide	0.87	3694.29	Wei
Mondelez International (MDLZ)	★★★★	$51	$43.62	Medium	Wide	0.86	64.88	Lash
Procter & Gamble (PG)	★★★★	$98	$78.7	Low	Wide	0.80	198.40	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7400	GBX 5724	Low	Wide	0.77	40.31	Gorham
Energy								
Cenovus Energy (CVE)	★★★★★	$21	$9.4	Very High	None	0.45	11.55	Gemino
Enbridge (ENB)	★★★★★	$64	$40.78	Medium	Wide	0.64	69.13	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$76	$64.16	Low	None	0.84	263.72	Good
RSP Permian (RSPP)	★★★★	$55	$38.97	High	None	0.71	6.21	Meats
Total (TOT)	★★★★	$70	$56.53	Medium	None	0.81	142.76	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$56.47	Medium	None	0.74	50.96	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.4	Very High	None	0.87	24.05	Heathfield
Capital One Financial (COF)	★★★★	$120	$96.51	Medium	Narrow	0.80	46.93	Plunkett
Invesco (IVZ)	★★★★	$42	$31.81	Medium	Narrow	0.76	12.95	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 736.3	Medium	None	0.84	9691.80	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 10.12	High	Narrow	0.78	13.76	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 30.71	Medium	Wide	0.88	103.99	Ellis

Source: Morningstar. As of March 2, 2018

Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Healthcare								
Allergan (AGN)	★★★★★	$263	$148.19	Medium	Wide	0.56	48.95	Waterhouse
Express Scripts Holding (ESRX)	★★★★	$89	$74.07	Medium	Wide	0.83	41.80	Lekraj
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.83	Medium	Narrow	0.76	3.18	Kallos
McKesson (MCK)	★★★★	$210	$146.54	Medium	Wide	0.70	30.24	Lekraj
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 62.62	Medium	Narrow	0.76	12.65	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 217.75	Low	Wide	0.68	186.51	Andersen
Shire (SHP)	★★★★★	GBX 4890	GBX 3222	Medium	Narrow	0.66	29.32	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$74.9	Medium	Narrow	0.70	2.49	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 42.55	Medium	Narrow	0.73	53.70	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.44	Medium	Wide	0.84	15.02	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 120	HKD 97.4	Medium	None	0.81	375.74	Tan
Fluor (FLR)	★★★★	$69	$55.78	High	Narrow	0.81	7.80	Silver
G4S (GFS)	★★★★	GBX 312	GBX 256.8	Medium	None	0.82	3.98	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 38.11	Medium	Wide	0.81	6.93	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP B)	★★★★	MXN 225	MXN 184.7	High	Wide	0.82	103.62	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 5.02	High	None	0.74	40.23	Song
Johnson Controls International (JCI)	★★★★	$53	$35.9	High	Narrow	0.68	33.25	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 73.14	Medium	Narrow	0.85	8.61	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 31.35	Medium	Narrow	0.78	29.04	Vonk
Stericycle (SRCL)	★★★★	$99	$62.04	Very High	Wide	0.63	5.31	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.61	Medium	None	0.84	1.52	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 131	Medium	Narrow	0.86	379.43	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$66.3	Medium	None	0.79	12.60	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$95	$81.03	Medium	Wide	0.85	6.22	Nelson
KLA-Tencor (KLAC)	★★★	$125	$111.21	High	Wide	0.89	17.42	Davuluri
LM Ericsson Telephone (ERIC B)	Under Review	Under Review	SEK 54.24	Very High	None	NA	178.26	Kundozerov
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.1	Medium	Narrow	0.77	1.88	James
Qualcomm (QCOM)	★★★	$75	$64.96	High	Narrow	0.87	96.16	Davuluri
Sabre (SABR)	★★★★	$26	$22.7	Medium	Narrow	0.87	6.23	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$119.43	Medium	Wide	0.82	86.26	Nelson
Synaptics (SYNA)	★★★★	$64	$45.51	Very High	None	0.71	1.57	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9340	High	None	0.81	1178.71	Ito
Tencent Holdings (700)	★★★	HKD 492	HKD 436	High	Wide	0.89	4141.40	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.22	Medium	Narrow	0.84	3.74	Atkins
Dominion Energy (D)	★★★★	$87	$72.35	Low	Wide	0.83	47.14	Fishman
FirstEnergy (FE)	★★★★	$40	$32.31	Low	Narrow	0.81	15.37	Fishman
Gas Natural SDG (GAS)	★★★★	EUR 21	EUR 18.29	Medium	Narrow	0.87	18.29	Fulop
SCANA (SCG)	★★★★★	$60	$39.76	Medium	Narrow	0.66	5.67	Miller

Source: Morningstar. As of March 2, 2018

Highlighted Stocks

Range Resources RRC

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Energy	Stable	USD	21	14.65	Extreme	None	0.70	3.42

Source: Morningstar. As of March 2, 2018

Still, we'd urge caution. Range still has high financial leverage, leading to a wide discrepancy between our bull- and bear-case fair value scenarios.

Analyst Note, Feb. 28, 2018
We're holding steady on our fair value estimate and no-moat rating for Range Resources after the company released fourth-quarter and full-year results. Range increased production in 2017 to 2.0 billion cubic feet per day, a 30% increase versus 2016. Southwest Marcellus production, Range's bread and butter assets, increased production by 34% year over year. The higher production combined with higher prices to drive revenue, earnings and cash flow up versus 2016. We expect the company's core Marcellus acreage will continue to drive production higher in 2018, in line with management's guidance of 2.23 bcfe/d. Looking even further ahead, we think management's five-year plan to grow production by about 11% annually is achievable, given the firm's drilling opportunities in the Marcellus. Companywide proved reserves increased 26% year over year to 15.3 trillion cubic feet.

Range has had less luck with its northern Louisiana acreage that was acquired in the merger with Memorial Resource Development. The company's activity in Louisiana has slowed to a near halt following disappointing drilling results in 2017, with Range only expecting to drill about 10 wells in Louisiana this year versus 100 in the Marcellus. We've cut our valuation for the Louisiana assets, but the effect was offset by a brighter outlook for the Marcellus.

Range trades considerably below our unchanged fair value estimate of $21 per share. Still, we'd urge caution. Range still has high financial leverage, leading to a wide discrepancy between our bull- and bear-case fair value scenarios, $43/share and $4/share respectively. The resulting extreme uncertainty rating means we'd label shares as fairly valued despite the wide gap between our fair value estimate and the current trading price.

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AMC Networks AMCX

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	71	53.37	High	Narrow	0.75	3.07

Source: Morningstar. As of March 2, 2018

AMC announced that it signed a carriage agreement with fuboTV, a sports-orientated over-the-top pay-TV distributor. While the deal should help AMC's main channel, the launch of AMC and the other networks on YouTube TV later this year will have a larger near- and longer-term impact for the company.

Analyst Note, March 1, 2018
AMC posted an in-line fourth quarter, with both revenue and EBITDA meeting consensus projections. Top-line growth in the international segment was offset by a sharp decline in advertising revenue for the U.S. segment, leading to flat revenue. We are maintaining our narrow moat rating and our fair value estimate of $71 as we await the firm's annual report. With shares trading in 4-star territory, the current price may provide investors with an attractive entry point.

Total net revenue was roughly flat year over year at $727 million. National Networks saw 7% growth in distribution revenue and a 10% decline in ad revenue, as "The Walking Dead" ad trajectory slowed down even faster than management expected. As we noted last quarter, ad revenue was up in the third quarter despite a 19% decline in prime-time ratings. While we expected a sequential decline in ad revenue growth due to the need to offer make-up, the decline was well above our projection and implies some weakness in demand. Affiliate fee revenue was up 7%, as the firm surprisingly expanded total subscribers by 11 million in 2017, or 3%, due to newer networks. Programming costs were up once again as a result of ongoing investment in original programming. We continue to expect programming expenses to increase over the near to medium term as AMC expands its slate. International revenue grew by 7% to $127 million, as the revenue growth at the international networks more than offset the sale of the Amsterdam media logistic facility. Overall adjusted operating income grew by 4% to $205 million, and adjusted operating margin improved by 90 basis points to 28.2% as the revenue decline at national networks outweighed the benefits from ongoing cost-control measures.

AMC announced that it signed a carriage agreement with fuboTV, a sports-orientated over-the-top pay-TV distributor. While the deal should help AMC's main channel, the launch of AMC and the other networks on YouTube TV later this year will have a larger near- and longer-term impact for the company. We think these deals highlight that AMC's scripted content and its appeal to younger viewers will help the firm gain carriage on the newer OTT distributors at the expense of other firms that have been also left out of the launch lineup of the new OTT skinny bundles. We continue to expect that these firms (primarily Discovery and Viacom) will struggle to be added to the channel lineups unless the subscriber growth momentum at the OTT distributors falters, which we do not believe will occur in the near future.

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Grupo Aeroportuario del Pacifico PAC

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Industrials	Stable	USD	120	95.98	High	Wide	0.80	5.42

Source: Morningstar. As of March 2, 2018

Expansion plans and commercial bids at Guadalajara and Tijuana will be important items during 2018, and we're expecting new retail at these locations to boost nonaeronautical revenue during the first quarter and food and beverage tenants to drive growth in the second quarter.

Analyst Note, Feb. 26, 2018

Despite rising costs at Pacifico, we're reiterating our $120 per ADR fair value estimate (MXN 223 for local shares). Management didn't change the 2018 guidance they gave in January, and based on that month's traffic statistics (9.1% growth), the company looks to be running in line with its full-year 8% air traffic growth target. Simultaneous with its fourth-quarter 2017 earnings release, the company announced that Raúl Revuelta Musalem will take over as CEO effective April 26, 2018. Revuelta Musalem currently serves as CEO of the company's successful Cross Border Express operations and he previously served in other executive roles at Pacifico, including CFO.

Total passenger traffic for the quarter increased 10% to 10.5 million, driving the sum of aeronautical and nonaeronautical revenue up by approximately 11% to MXN 2.8 billion. Guadalajara, Tijuana, and Los Cabos continue to drive growth, with these three locations accounting for 71% of the passenger traffic increase in the quarter. EBITDA margins adjusted for construction contracted 300 basis points year over year—landing at 67.6% in the quarter—due to higher maintenance costs and technical fees at the Mexican airports and increasing concession taxes at Montego Bay.

Full-year aeronautical revenue increased 17.7% year over year to MXN 8.3 billion, and nonaeronautical revenue increased 15.8% to MXN 2.8 billion. Expansion plans and commercial bids at Guadalajara and Tijuana will be important items during 2018, and we're expecting new retail at these locations to boost nonaeronautical revenue during the first quarter and food and beverage tenants to drive growth in the second quarter. Another item we'll be monitoring is the preparation of the master development plan during the back half of this year, which will inform the new aeronautical tariff rates for 2020-24. Management thinks the new MDP will feature two to three times as much investment as the previous one.

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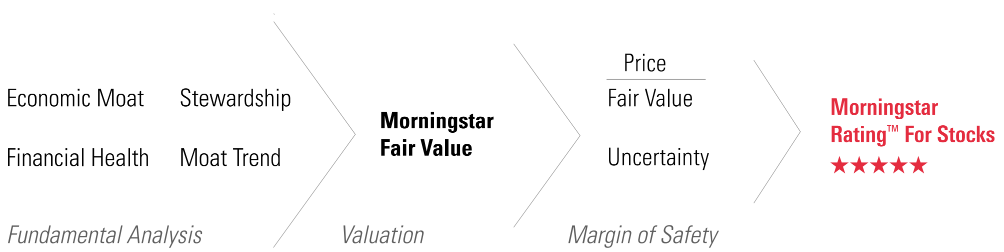
Research Methodology for Valuing Companies

Overview

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

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

Morningstar Research Methodology



Source: Morningstar.

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

Economic Moat

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

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

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

Estimated Fair Value

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

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

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

Stage II: Fade

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

Stage III: Perpetuity

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

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

Uncertainty Around That Fair Value Estimate

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

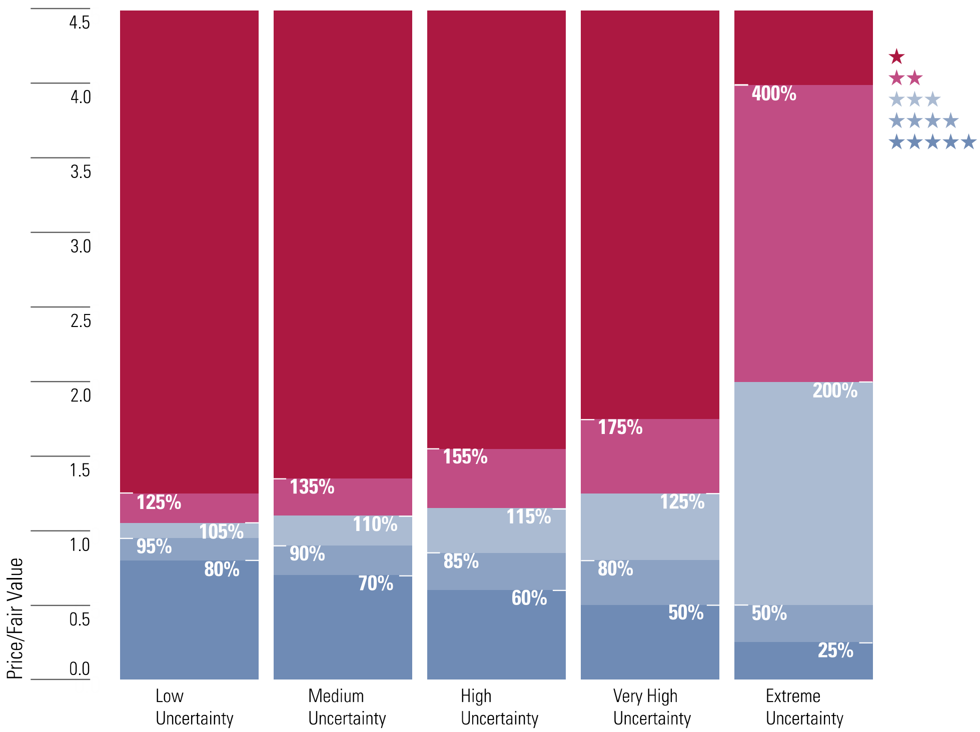
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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

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

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

Morningstar Equity Research Star Rating Methodology



Market Price

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

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

Morningstar Star Rating for Stocks

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

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

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

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

The Morningstar Star Ratings for stocks are defined below:

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

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

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

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

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

Risk Warning

Please note that investments in securities are subject to market and other risks, and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in the future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's uncertainty rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

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