Research Highlights

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

Morningstar Equity Research
March 26-29, 2018

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

We'd Give No-Moat Spotify Some Time to Get Into a Rhythm

As Spotify approaches its first day as a public company on April 3, we value the company at a $21 billion market cap, or $118 per share based on the reported share count to be issued. Unlike a traditional IPO, Spotify's anticipated price range is unknown, as the firm will be listed on the New York Stock Exchange through direct listing. For this reason, we could see wide fluctuations in Spotify's stock price in the near term, and we assign a very high uncertainty rating to our fair value estimate.

Looking at the fundamentals, we consider Spotify a no-moat company. While we believe Spotify can benefit from various network effects that will help the firm increase its users and amass valuable intangible assets associated with user data and listening preferences, we do not have sufficient confidence that it will generate excess returns on capital over the next 10 years.

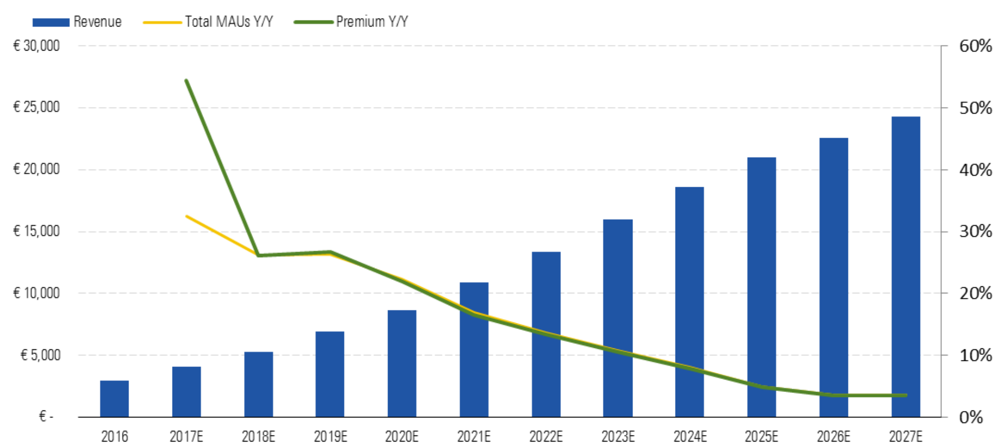
In our view, while Spotify is ahead of the pack in the growing music streaming market, it faces stiff competition from behemoths such as Apple, Google, and Amazon. Unlike Spotify, these firms don't rely solely on streaming music to drive profitability and can continue to run as loss leaders while monetizing users via other products and services. It might also be harder for Spotify to steal share from these competitors over time, as Apple Music users are likely entrenched with other Apple products, Amazon Music with Echo, and so on. Thus, they might be relatively more loyal to these music platforms than the users an operating-system-agnostic platform like Spotify can capture.

Competition aside, we think Spotify may be at the mercy of the record labels within the music industry, as it will need access to content to continue attracting more listeners. While the distribution side of the industry (Spotify, YouTube, Apple, terrestrial and digital radio, and so on) is fragmented, over 80% of licensing is controlled by the Big Three major record labels: Universal Music Group, Sony, and Warner Music Group. As these licensors gather royalties from Spotify and its peers, they maintain pricing leverage as content remains king.

For this reason, while we expect impressive revenue growth at a 20% CAGR for Spotify through 2027, we think margin expansion will be a tedious task, as the main component of the firm's cost of revenue, royalties, is variable. If the firm can reduce operating expenses, either in research and development or in declining customer acquisition costs, it may be able to create some operating leverage. We do expect gross margin to widen to 33% by 2027 from 21% in 2017, in line with management's long-term goals. While the firm recorded an operating loss of EUR 378 million for 2017, we project Spotify will end 2027 with an operating margin of 11%, resulting in operating income of EUR 2.7 billion.

- Spotify's market-leading position in music streaming and 157 million users still might not allow the firm to gain much negotiating leverage over major labels, as the content that labels license remains king.
- Opportunities to create network effect and intangible asset moat sources exist for Spotify, but intense competition and limited upside to margins may prevent the firm from generating returns above its cost of capital.
- There is fierce competition in the digital music streaming space, and while Spotify can improve its user interface and playlists, we think peers such as Apple, Google, and Amazon are likely to develop or maintain similar capabilities.
- Through various private transactions since June 2017, Spotify's market cap has ranged from $9 billion to $24 billion, which is further indicative of possible fluctuations we may see in the stock after the firm's direct listing on the NYSE.
- We value Spotify at $118 per share, or a $20 billion market cap, as we expect strong ongoing growth in the firm's premium and ad-supported users to drive the top line and be accompanied by some operating margin expansion.

Exhibit 1 Spotify Revenue and Listeners Continue to Grow
Figures in EUR millions



Source: Spotify data and Morningstar estimates

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Not All Healthcare Areas Are Easy Targets for Amazon

We've long been fans of the ostomy and continence care business and some of its key manufacturers, including Coloplast and ConvaTec. With Amazon making waves as a disruptive force in distribution and its initial foray into healthcare through Amazon Business, we take a closer look at its potential entry into the medical supplies market. Considering the lower barriers to entry for medical supply distribution, especially compared with pharmaceuticals, we wouldn't be surprised to see Amazon move in this direction.

At the same time, ConvaTec, Coloplast, and CR Bard have been arming themselves with the purchase of medical supply distributors. Upon closer examination, there are regulatory and service complexities that lead us to believe Amazon may remain focused on its business-to-business platform for its healthcare ambitions. ConvaTec is our top pick because of its narrow moat and appealing valuation.

- The acquisition of independent medical supply distributors allows ostomy and continence care manufacturers to focus on product differentiation and customer service, and to reduce exposure to distributor incentives to sell the lowest-priced products. However, owning distributors also leaves the manufacturers vulnerable if Amazon were to compete in this arena.
- Though the medical equipment and supply distribution business might seem to be a good fit for Amazon, we think insurance claims and high-touch customer service make this less attractive for the firm.
- We're optimistic about the steady growth prospects in the ostomy and continence care markets; we peg long-term annual growth at 4.5% and 5%, respectively. Most of the growth will come from meaningful innovation (which translates into price), aided by growth in underlying diseases, including inflammatory bowel disease, colorectal cancer, Parkinson's, and multiple sclerosis.
- ConvaTec shares remain attractively undervalued, in our opinion. During its ownership under private equity, the firm had underinvested in the moaty ostomy and continence care businesses, which contributed to it falling behind rival Coloplast. Now independent, management has focused on improving its share of new patient discharges, enhancing its product lineup, and lowering its cost structure, though recent stumbles with execution have dragged down shares.

Coloplast

Bulls Say

- Thanks to aging populations in developed countries, the incidence of colorectal disease is growing. Independent of age, the incidence of inflammatory bowel disease is also on the rise.
- Growing household income coupled with healthcare reform is making emerging markets an attractive target for Coloplast.
- The U.S. remains one of the largest ostomy-care and continence markets, and Coloplast has beefed up its footprint and made inroads in that geography.

Bears Say

- Complications from transvaginal mesh have cast a pall on the entire category, which includes Coloplast's vaginal slings for incontinence.

- Coloplast's wound-care portfolio is relatively limited, especially when compared with the breadth of products from Smith & Nephew, and ConvaTec, which includes high-tech solutions such as negative-pressure wound therapy, gels, and hydrofiber dressings.
- If Amazon were to enter the home health supply distribution, this could put price pressure on Coloplast and other chronic care product manufacturers.

ConvaTec Group

Bulls Say

- ConvaTec's well-established footprint in the U.S. ostomy market has paved the way to forge contracts with large group purchasing organizations, including Premier and Vizient.
- ConvaTec is well positioned to extend the Aquacel technology into the foam and disposable negative-pressure wound therapy subsegments in wound care.
- If ConvaTec could narrow the gap between its cost structure and that of Coloplast's, there would be upside to our intrinsic value.

Bears Say

- Considering that ostomy patients tend to be brand loyal after the first year postdischarge, we expect ConvaTec's ostomy business to grow gradually as it takes greater share of new patient discharges.
- Because success in chronic and home care products often comes down to execution, ConvaTec may hit speed bumps if it doesn't do a good job on integrating the close to 10 acquisitions since 2008.
- Advancements in surgery have rendered more ostomies temporary rather than permanent. Further improvements in creating internal tissue pouches could reduce the need for external ostomy supplies.

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Refiners' Outlook Brightens, but Valuations Show It

We have updated our view on independent refiners to reflect a more positive stance. Our last published report expressed a cautious view following a period of strong share performance. Furthermore, we were concerned that improved market conditions in the wake of Hurricane Harvey would prove ephemeral based on a robust analysis of past hurricane activity. However, absolute inventory levels have not rebounded as we expected, particularly distillate.

Meanwhile, inventory adjusted for demand is below average historical levels. As a result, refiners' margin outlook has improved significantly. In addition, crude spreads have widened since last year, providing another tailwind to refining earnings. Against this backdrop, IMO 2020 standards could potentially support higher margins and wider spreads through 2021. Incorporating these more favorable conditions and tax reform increases our fair value estimates across the board but leaves valuations still full and reflective of midcycle conditions in most cases. The exception is Andeavor, where a disappointing fourth quarter and a dim view of West Coast margins have left shares trading at a discount to the group and to our fair value estimate.

- The outlook for refining margins has improved as inventory levels adjusted for demand are below historical average levels. The forward curve is now implying margins above what we consider to be midcycle levels on the strength of distillate margins.
- Crude spreads should remain a tailwind for refining margins as WTI-Brent should continue to trade close to our $5/barrel long-term estimate, as growing U.S. production will need to be exported and Canadian heavy spreads are likely to remain wide through 2020 until new pipeline capacity is added.
- Anticipated changes in the market from IMO 2020 play to U.S. refiners' competitive advantages and could lead to above-midcycle margins and crude spreads for several years. However, we anticipate that a fiercely competitive global refining market will adjust and eventually compete away excess margins.
- Andeavor is notable for its 25% discount to our fair value estimate. Its performance has lagged the group and the market is now valuing it based on below-midcycle conditions while overly discounting potential long-term earnings growth.

Andeavor Stands Out

By investing in improving its refineries' competitive positioning and integrating the recently acquired Western Refining assets, Andeavor should be able to drive an increase in refining earnings amid a stable margin environment. In combination with expanding its retail marketing and logistics segments, Andeavor could potentially increase EBITDA by $1.4 billion, or 45%, by 2020.

The recently completed acquisition of Western Refining added three midcontinent refineries that are well positioned to capitalize on the long-term growth of U.S. crude oil production to Andeavor's portfolio, while diversifying its California exposure. Through further cost reductions, yield improvements, and throughput increases, Andeavor expects to wring $200 million in synergies from the acquired assets by 2020.

At the same time, investments centered on its existing asset base, most notably plans to combine its Los Angeles-area refineries, should improve yield and feedstock flexibility while adding $175 million to EBITDA. Additional projects, including plans to produce xylenes for export to Asia, could ultimately increase that figure further.

Bulls Say

- Andeavor can increase earnings without an improvement in refining conditions, thanks to a slate of refinery projects and growth opportunities in its marketing and logistics segments.
- The acquisition of Western Refining added three refineries well positioned to capitalize on North American crude, while adding a foothold for its logistics business in the fast-growing Permian.
- Expansion of marketing channels should allow Andeavor to increase sales volumes and run its refineries at higher levels of capacity utilization. The advantage is key in California, which is often oversupplied.

Bears Say

- Andeavor's rail/marine project in Washington failed to gain regulatory approval, eliminating a a pathway for its California refineries to access discount North American crude.
- Andeavor sports one of the lowest dividend yields among independent refiners.
- Legislation designed to curb carbon emissions may target refiners and result in higher costs and significant capital requirements.

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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	$8.95	High	Narrow	0.53	3.60	Inton
Compass Minerals International (CMP)	★★★★	$82	$58.85	High	Wide	0.72	1.99	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 225.75	High	Narrow	0.61	22.40	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 71.95	Medium	Narrow	0.71	1473.21	Baker
Telefonica (TEF)	★★★★	$13	$8.02	High	Narrow	0.62	41.68	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.14	Medium	Narrow	0.68	37.34	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$159	$115.98	Medium	Narrow	0.73	8.58	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.68	Medium	Narrow	0.81	1.59	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 85.56	High	Narrow	0.78	55.62	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 41.73	Medium	Narrow	0.79	3.56	Faul
General Motors (GM)	★★★★	$56	$35.47	High	None	0.63	49.68	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 7.87	High	None	0.58	110.97	Hu
Hanesbrands (HBI)	★★★★★	$29	$18.38	Medium	Narrow	0.63	6.62	Weishaar
Mattel (MAT)	★★★★	$21.5	$13.1	High	Narrow	0.61	4.51	Katz
TripAdvisor (TRIP)	★★★★	$55	$40.61	High	Narrow	0.74	5.64	Wasiolek
Walt Disney (DIS)	★★★★	$130	$98.54	Medium	Wide	0.76	148.17	Macker
Williams-Sonoma (WSM)	★★★★	$68	$51.84	Medium	Narrow	0.76	4.34	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1138.5	Medium	Narrow	0.76	14.41	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★★	$59	$44.35	Low	Wide	0.75	25.29	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2407	Low	Wide	0.62	22.96	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7932	Low	Wide	0.90	3908.69	Wei
Mondelez International (MDLZ)	★★★★	$51	$40.59	Medium	Wide	0.80	60.37	Lash
Procter & Gamble (PG)	★★★★	$98	$78.84	Low	Wide	0.80	198.76	Lash
Reckitt Benckiser Group (RB.)	★★★★★	GBX 7400	GBX 5997	Low	Wide	0.81	42.23	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$10.55	Very High	None	0.50	12.96	Gemino
Enbridge (ENB)	★★★★★	$62	$39.27	Medium	Wide	0.63	66.57	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$76	$64.8	Low	None	0.85	266.72	Good
Total (TOT)	★★★★	$70	$56.2	Medium	None	0.80	149.67	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$54.52	Medium	None	0.72	49.24	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.56	Very High	None	0.88	24.30	Heathfield
Capital One Financial (COF)	★★★★	$120	$94.27	Medium	Narrow	0.79	45.83	Plunkett
Invesco (IVZ)	★★★★	$42	$31.48	Medium	Narrow	0.75	12.93	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 696.3	Medium	None	0.79	9165.28	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.63	High	Narrow	0.74	13.09	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 28.62	Medium	Wide	0.82	96.91	Ellis

Source: Morningstar. As of March 29, 2018

Best Ideas

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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	$165.65	Medium	Wide	0.63	54.26	Waterhouse
Express Scripts Holding (ESRX)	★★★★	$92	$69.73	Medium	Wide	0.76	39.14	Lekraj
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.93	Medium	Narrow	0.80	3.37	Kallos
McKesson (MCK)	★★★★★	$210	$140.66	Medium	Wide	0.67	29.02	Lekraj
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 62.32	Medium	Narrow	0.76	12.59	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 219.1	Low	Wide	0.68	187.51	Andersen
Shire (SHP)	★★★★★	GBX 4890	GBX 3500	Medium	Narrow	0.72	31.88	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$74.35	Medium	Narrow	0.69	2.48	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 41	Medium	Narrow	0.71	51.74	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.98	Medium	Wide	0.89	15.88	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 124	HKD 93.9	Medium	None	0.76	362.24	Tan
Fluor (FLR)	★★★★	$69	$55.85	High	Narrow	0.81	7.81	Silver
G4S (GFS)	★★★★	GBX 337	GBX 246.4	Medium	None	0.73	3.82	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 34.08	Medium	Wide	0.73	6.20	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP B)	★★★★	MXN 225	MXN 179.63	High	Wide	0.80	100.77	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.64	High	None	0.68	38.83	Song
Johnson Controls International (JCI)	★★★★	$53	$34.29	High	Narrow	0.65	31.76	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 74.96	Medium	Narrow	0.87	8.84	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 30.89	Medium	Narrow	0.77	28.61	Vonk
Stericycle (SRCL)	★★★★	$99	$58.75	Very High	Wide	0.59	5.03	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.64	Medium	None	0.85	1.53	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 124	Medium	Narrow	0.81	359.23	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$67.52	Medium	None	0.80	12.83	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$100	$79.21	Medium	Wide	0.79	6.33	Nelson
KLA-Tencor (KLAC)	★★★	$125	$106.57	High	Wide	0.85	16.61	Davuluri
LM Ericsson Telephone (ERIC B)	★★★	SEK 61	SEK 53.96	Very High	None	NA	177.63	Colello
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.05	Medium	Narrow	0.75	1.84	James
Qualcomm (QCOM)	★★★★	$75	$54.7	High	Narrow	0.73	80.98	Davuluri
Sabre (SABR)	★★★★	$26	$21.27	Medium	Narrow	0.82	5.84	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$112.88	Medium	Wide	0.78	82.67	Nelson
Synaptics (SYNA)	★★★★	$64	$45.12	Very High	None	0.71	1.56	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9310	High	None	0.81	1174.92	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 409.6	High	Wide	0.64	3892.51	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.25	Medium	Narrow	0.85	3.76	Atkins
Dominion Energy (D)	★★★★	$84	$67.79	Low	Wide	0.81	44.23	Fishman
FirstEnergy (FE)	★★★★	$40	$34.39	Low	Narrow	0.86	16.36	Fishman
Gas Natural SDG (GAS)	★★★	EUR 21	EUR 19.39	Medium	Narrow	0.92	19.39	Fulop
SCANA (SCG)	★★★★★	$60	$37.33	Medium	Narrow	0.62	5.32	Miller

Source: Morningstar. As of March 29, 2018

Highlighted Stocks

Nissan Motor NSANY

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Negative	USD	26	20.68	High	None	0.80	43.98

Source: Morningstar. As of March 29, 2018

One impediment to the deal may be Nissan's reluctance to the combined entity being partially owned by the French government.

Analyst Note, March 29, 2018
News reports on March 29 have said that no-moat-rated Renault and Nissan are in talks to merge. The two automakers have been alliance partners, with Renault first owning a stake in Nissan, since 1999. Today, Renault owns roughly 43% of Nissan while Nissan holds about a 15% stake in Renault. The two companies had announced earlier this month that the alliance management team was negotiating closer integration to extract additional cost savings from economies of scale.

One impediment to the deal may be Nissan's reluctance to the combined entity being partially owned by the French government. France currently owns approximately 20% of Renault common equity. While we believe that a merger would better enable the objective, integration would be relatively rapid given the vast amount of already shared purchasing, engineering, and vehicle platforms between the alliance partners.

Currently trading at 2 stars with a 25% premium to our EUR 79 fair value estimate, we view Renault shares as overvalued. However, we think investors should consider Nissan shares. The 4-star-rated ADRs currently trade at 21% discount to our $26 fair value, while the Tokyo-exchange-traded shares are at a 25% discount to our JPY 1,450 fair value estimate. We think Nissan shares are attractively valued relative to our estimates for revenue growth, profitability, and return on invested capital.

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Targa Resources TRGP

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	USD	53	44.10	Medium	None	0.83	9.57

Source: Morningstar. As of March 29, 2018

Investors don't seem to appreciate Targa's rapid growth prospects over the next few years.

Analyst Note, March 28, 2018
Targa has announced that it plans to extend its Grand Prix pipeline into Oklahoma, which we view as a smart move with numerous benefits—the most important is that the expansion provides additional flows for Targa's downstream fractionation and LPG export assets. The integrated nature of the assets prevents a third party from extracting economic rents by owning an asset that is part of the route to the most profitable market with the widest differentials. We view this as important, given international LPG prices can fluctuate substantially over a fairly short time frame. We plan to maintain our $53 fair value estimate and no-moat rating. We do see shares as undervalued, as investors don't seem to appreciate Targa's rapid growth prospects over the next few years as Permian volumes increase and its planned projects come on line.

The original announcement for the Grand Prix pipeline was to move volumes from the Permian Basin to North Texas, and then from North Texas to Mont Belvieu. After the joint venture announcements with Blackstone and Stonepeak, Targa retains 55% ownership of the economics of these flows. This extension at a cost of $350 million will transport NGLs to the North Texas connection point from southern Oklahoma and flows will be owned 100% by Targa. The North Texas connecting pipeline has a capacity of 450,000 bpd and is expandable to 950,000 bpd. The connection point will also receive volumes from the Permian Basin pipeline that has capacity of 300,000 bpd and is expandable to 550,000 bpd. Targa expects Grand Prix to be fully completed by mid-2019.

The expansion supports flows and fees for the downstream Targa assets and adds to Targa's fee-based income stream while also maximizing the value of Targa's gathering and processing assets. The pipeline is supported by extensive commitments for both transportation and fractionation, allowing Targa to capture additional fees from its fractionation assets at Mount Belvieu and supporting its planned addition of 100,000 bpd of fractionation capacity. Excess NGLs (mainly propane) can then be exported via Targa's LPG export facility.

The challenge for Targa now is how to efficiently finance this $350 million expansion as well as another $500 million investment into Delaware gathering and processing capacity (about 500 million mcf/d).

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Great Wall Motor 02333:HK

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★★	Consumer	Negative	HKD	13.50	7.87	High	None	0.58	110.97

Source: Morningstar. As of March 29, 2018

For 2018, the management targets sales volume of 1.16 million units, or 9% year-on-year growth. We consider this conservative.

Analyst Note, March 26, 2018

We walked away from no-moat Great Wall Motor's investor conference cautiously optimistic about the company’s growth outlook in 2018 and beyond. In our view, the company is gaining a solid footprint in the mid-end SUV segment with its Wey product lines, but its best-selling Haval brand will face rising competition. We expect Wey to become the primary growth driver going forward, but this will be partially offset by stagnating Haval sales. We lower our fair value estimate to HKD 13.50 per share (from HKD 14.90) after factoring in new operating assumptions and rolling our model. Our latest valuation implies a 12.2 times forward price/earnings multiple and 7.5 times enterprise value/adjusted EBITDA. We consider shares undervalued at the current market price relative to GWM’s improving net earnings growth potential.

We expect GWM’s 2018 net income and top line to rise 65% year on year and 22% year on year, respectively, to CNY 8.3 billion and CNY 122 billion. In our view, GWM has already rebounded in the fourth quarter of 2017 with net margin improving to 5.6% (versus 2.1%-2.6% in earlier quarters), and the momentum should continue into 2018, mainly on the back of improving product mix toward the higher-priced Wey. The company’s recently updated flagship Haval H6 will likely see a marginal price cut, given that the strong demand outlook and the company’s much more conservative inventory management strategy will further limit potential for a significant price rebate. In the longer term, we anticipate GWM’s net earnings and revenue to grow at a 13% CAGR and an 8% CAGR, respectively, between 2019 and 2022. We expect mid-end SUVs to eventually account for 33% of the company’s total SUV sales by 2022, which will help boost gross margin to 24.5% (from 21.4% in 2017) and hence drive faster net earnings growth.

For 2018, the management targets sales volume of 1.16 million units, or 9% year-on-year growth. We consider this conservative, given our 18% growth forecast mainly on the assumption that strong WEY sales (170% year-on-year growth) will offset the virtually flat Haval H6 (2% growth). Our annual sales forecast of over 240,000 units is broadly in line with management’s target, given GWM’s target of rolling out four new WEY models in 2018. As for Haval, we agree with the management’s view that the brand’s long-term growth potential remains positive due to the emerging middle-class, but the performance among models in different price ranges will likely see rising divergence.

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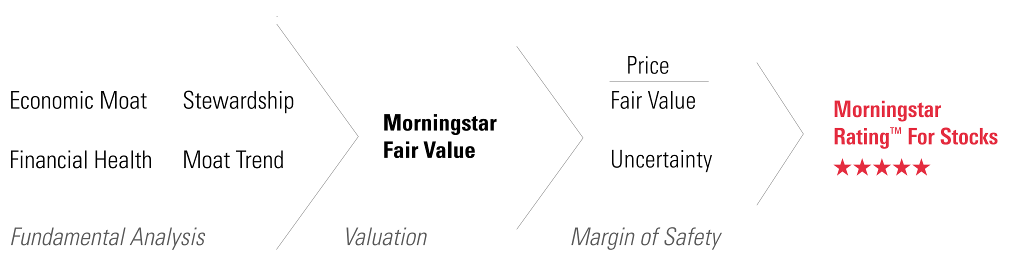
Research Methodology for Valuing Companies

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.

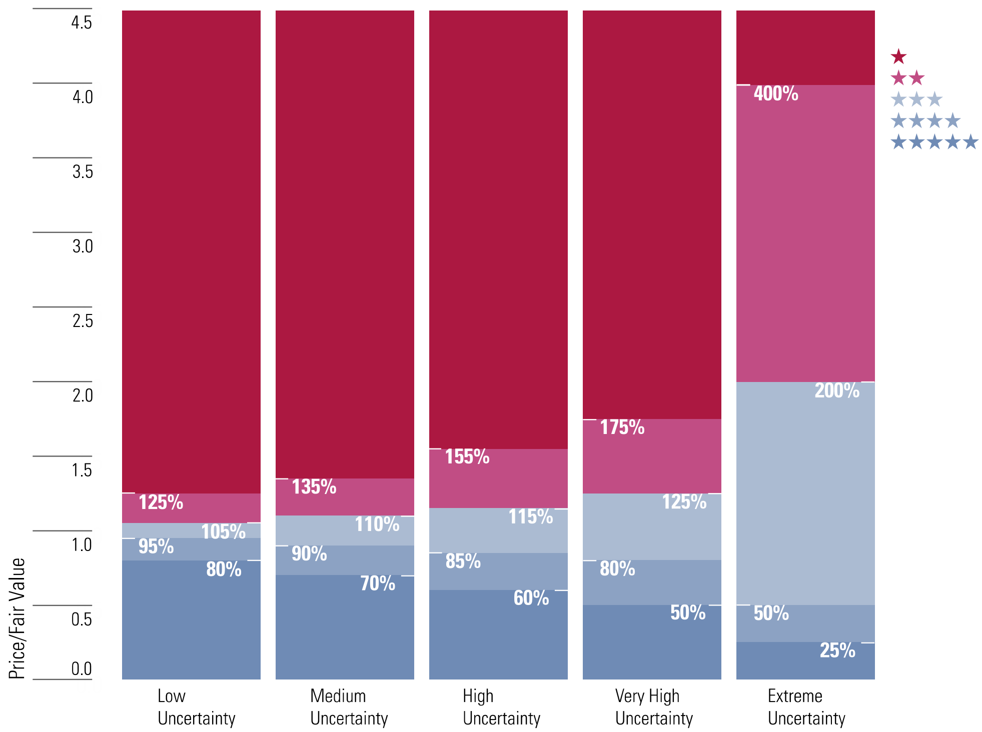
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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