Research Highlights

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

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

Stocks in Fashion: Dressing for an Amazonian Storm

With mall traffic on the decline, e-commerce steadily stealing apparel market share (reaching over 25% in 2017), and new entrants flooding the space, we think the apparel and accessories industry is on the cusp of a significant reinvention. Once-powerful competitive advantages, including a broad national brick-and-mortar footprint and the ability to garner economies of scale, not only no longer hold the advantage they once did but now can also be viewed as a disadvantage. Meanwhile, newer startups have seen success through an ability to be nimble and to harness the power of technology to improve products and the shopping experience.

We see e-commerce and, more specifically, Amazon as the largest disruptive force to existing apparel companies. Although e-commerce at its advent had some weaknesses that protected brick-and-mortar retailers, advances in shipping, targeting, merchandise display, and checkout—in addition to shifting consumer demand for convenience, reviews, and information—have tilted demand more favorably to online retailers, in our view. In this report, we analyze the changing competitive landscape and attempt to identify new company traits that are now rising to levels capable of yielding a competitive moat. We highlight TJX and Inditex as powerful investment ideas to capitalize on the shifting apparel retail environment.

TJX ★★★

TJX is a narrow-moat company, trading at an 8% discount to our $89 fair value estimate. With its Big Data capabilities, responsive supply chain, and some protection from e-commerce threats, we believe that TJX is well-positioned to continue to claim market share. From our vantage point, TJX offers investors an attractive domestic and international growth story, strong free cash flow generation, and a proven record of success in both strong and weak economic environments through its T.J. Maxx, Marshalls, Sierra Trading Post, HomeGoods, Homesense, TJX Europe, Trade Secret, and TJX Canada stores. With its experienced management team, compelling discounted offerings, and competitive advantage in scale and inventory management, we see low risk in strategy or execution.

Bulls Say

- With its off-price retailing model and last-minute inventory purchasing, TJX can perform better in a climate of economic uncertainty or low demand than many other competitive retailers.
- TJX has managed to profitably penetrate international markets, a feat achieved by few peers. This gives the firm significant growth opportunities in new and existing markets and a first-entrant advantage.

- Scale allows TJX to have more flexibility in inventory management, resulting in better localization of merchandise and mix and fewer markdowns.

Bears Say

- TJX may eventually have difficulty sourcing merchandise if the economy improves and suppliers have better sell-through or if more competitors enter the space, such as Macy's. However, this hasn't been an issue yet.
- TJX may become overstored, especially in the U.S., as it expands its total brick-and-mortar base by roughly 4% on an annual basis over the next 10 years.
- If consumer confidence stabilizes, wages increase, and spending improves, consumers may trade back up to full-price department stores and specialty retailers.

Inditex ★★★★

Narrow-moat Inditex is trading at a 26% discount to our EUR 33 fair value estimate. Inditex possesses a best-in-class responsive supply chain, Big Data capabilities, and distribution channel flexibility. We believe the company's model is defensible from outside competition, as the secret to its success is its centralized operations, feedback loop, and scale. Its strong brand intangible asset and cost advantages are the basis of our narrow moat rating.

Bulls Say

- With eight different concepts (most of which have been performing well) and a global platform, there is a lot of room for additional retail selling growth, especially in Asia.
- Economies of scale and a localized operations model give Inditex a cost advantage over competitors.
- Rapid manufacturing, frequent shipments, and a feedback loop with stores help minimize inventory risks, one of the biggest challenges facing retailers.

Bears Say

- The pace of new store openings could slow as markets become more penetrated, real estate more difficult to find, or the pace more difficult to manage.
- Inditex faces competition from other fast-fashion retailers, including H&M and Forever 21, as well as from e-commerce and traditional retailers trying to leverage a responsive supply chain. Expectations for mid-single-digit comparable sales growth could be more difficult to achieve.
- Further margin expansion could be limited by mix, distribution, and labor costs.

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Midstream Energy Offers Efficient Scale Moats at a Discount

Midstream partnerships have long been one of the moatiest industries in the energy sector and a key example of our efficient scale moat source at work. Made up of numerous regional markets and further stratified by the quality and type of hydrocarbon transported between specific locations, the oil and gas pipeline industry meets many of the criteria we look for in an efficient scale market. While the underlying business model—transporting hydrocarbons for a fee—may be simple, changes in hydrocarbon flows present both opportunities and threats to the industry. Further, midstream entities are more than just pipelines; they own storage, fractionation, export, and petrochemical assets that provide opportunities to take advantage of changes in U.S. hydrocarbon flows and also differ in their degree of competitive advantage. Midstream entities with high-quality asset networks sometimes can capture additional profits via asset optimization or marketing activities, where they take advantage of time, location, and product arbitrage.

- There are high-quality midstream firms available at a discount. We highlight Enbridge, Spectra Energy Partners, Plains All American Pipeline and its general partner, and Enterprise Products Partners as wide-moat entities trading between 10% and 40% discounts to our fair value estimates.
- We think Enbridge is undervalued because of misplaced investor concerns about whether the Line 3 pipeline will proceed. Enbridge is a rare triple threat, boasting a wide moat, an attractive 6.5% dividend yield, and more than 50% upside.
- Spectra Energy is being valued by investors like some of its more volatile midstream peers at a P/E of 11.5 versus a stable utility, which its earnings stream most resembles and whose sector trades at a median P/E of 17.6. With reservation charges making up more than 95% of its revenue, Spectra carries no direct commodity price exposure.
- We don't think investors appreciate the wide moats of Plains All American Pipeline's and Enterprise Products Partners' businesses, nor the profitable opportunities available as U.S. crude oil volumes ramp over the next few years.

Many Efficient Scale Moat Characteristics Clearly Apply to Midstream

Our efficient scale work has identified several characteristics of an efficient scale market, and we think they can be applied to midstream moats quite well.

- *Mature demand.* If a market is growing slowly or is in decline, entrants won't see adequate opportunity to encourage entry.

Pipelines are built to resolve transportation constraints where two markets are experiencing a supply and demand imbalance, so the initial market entry is not necessarily to a mature market; a good amount of the time, new pipelines are built to serve growing sources of new hydrocarbon production. After the initial growth, basins' production peaks and can either flatten or decline over decades, protecting existing pipelines from new entrants. However, the overall maturity of U.S. demand for oil provides a measure of stability and ensures in many cases useful lives for assets last well over 20 years.

- *Excess capacity.* If existing players can meet incremental demand for the foreseeable future at no or very low marginal cost, would-be entrants are unlikely to see a profitable opportunity to add capacity.

  This is a key tenet of the efficient scale moat source for midstream firms. Once in place, pipeline capacity can easily be expanded via loops, additional compressors, parallel lines, or other types of interconnections for a much lower cost and quicker time to market than it would take to obtain regulatory approval and contracts from shippers for a new pipeline.

- *Commodity products.* If there is no opportunity to build a better mousetrap, potential entrants would be forced to resort to price competition to steal market share.

  Building pipelines is a well-understood process, and there's no disruptive innovation that will replace the need to physically transport molecules via pipe from one location to another. The high level of regulation around the industry also encourages a high level of standardization, meaning midstream entities compete primarily on price.

- *High sunk costs.* If an entry requires an investment in highly specialized equipment, forecasting attractive risk-adjusted returns will be difficult for potential entrants.

  Pipelines can easily cost over a billion dollars and stretch over hundreds of miles across multiple states.

- *Significant entry barriers.* If incumbent firms are unlikely to exit a market, would-be entrants' willingness to endure short-term losses will diminish.

  Pipelines have a useful life measured in decades, and some pipelines have been in service for over 50 years. Further, pipelines are only built if they can secure enough customer contracts to ensure an economic return on investment; they are not built on speculation. There's little economic incentive for a new entrant to enter the market without the security of knowing it has shippers willing to use its pipeline. Pipelines are approved by regulators only when there is an economic need, and pipeline development takes about three years, according to the U.S. Energy Information Administration. Regulatory oversight is provided by the FERC and at the state and local levels, and new pipelines under consideration have to contend with onerous environmental and other permitting issues.

- *Credible deterrence.* If an incumbent firm possesses strategic alternatives in the face of entry that are more attractive than accommodating a new rival, potential entrants will have difficulty forecasting attractive risk-adjusted returns.

  Midstream firms can deny interconnections to oil or natural gas liquids assets; this is effective when a midstream firm has a large regional base of assets serving a single basin. Incumbent midstream firms can easily also add capacity at a lower cost than competitors to deter new entrants.

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Macau Gaming Stocks No Longer Undervalued

After an average 82% runup in share prices since the fourth quarter of 2016 for the six narrow-moat Macau gaming names we cover, we think the Macau gaming sector is no longer undervalued from a long-term investment perspective. After a review of prospective gross gaming revenue growth and margins over the next decade, we find the shares of Galaxy Entertainment, Wynn Macau, Wynn Resorts (70% of EBITDA from Macau), Melco Resorts and Entertainment, and Las Vegas Sands (55%) overvalued, as the market has not incorporated risks around any cyclical downturn or casino license renewals, for example, gaming tax increases or large renewal fees, over the next few years. We believe MGM China, Sands China and SJM Holdings are fairly valued, while MGM Resorts (20% of EBITDA from Macau) is slightly undervalued.

We now see 2018 and 2019 Macau gross gaming revenue up roughly 14% (4% prior) and 15% (11% prior), respectively, followed by declines of 1% (8% lift prior) and 5% (high single digits prior) in 2020 and 2021, respectively. The stronger growth in 2018 and 2019 is a result of an improved economic environment and the expected opening of major infrastructure that will alleviate the region's capacity constraints and greatly improve accessibility. The lower Macau gross gaming revenue forecast in 2020 and 2021, which is contrary to consensus, accounts for an anticipated economic contraction driven by the typical three- to four-year Chinese economic and housing cycle that has shown past correlation to the region’s gaming revenue growth. After the economic cycle normalizes, we expect mid-single-digit annual gross gaming revenue growth from 2022 to 2027, underpinned by Macau's low Chinese visitation penetration (around 2% of the population visited the gaming region in 2017) and continued infrastructure improvements.

We project Macau VIP gaming revenue to grow at 12% and 5% in 2018 and 2019, respectively, on the back of an improving economy and expanding credit, before dipping 11% and 9% in 2020 and 2021, respectively, as the economic, housing, and credit cycles turn lower. We estimate Macau mass gaming revenue will rise at 15%, 23%, and 7% in 2018, 2019, and 2020, respectively, on the back of a better economy but also due to improved visitor experience as key infrastructure developments are completed. For instance, the Hong Kong-Zhuhai-Macau Bridge, which is expected to open this year, will connect the three regions more seamlessly and reduce the travel time between Macau and Hong Kong's world-class international airport to 30 minutes.

Also, the scheduled opening of the light rail transit Taipa section next year will allow visitors to commute between customs and major casinos conveniently. Still, we think Macau mass gaming revenue will see a decline of 3% in 2021 due to a weaker economy. We expect a much milder downturn in mass gaming revenue relative to VIP play due to historical patterns and the higher contribution of more resilient grind mass.

Our fair value estimates for our Macau gaming coverage (which capture the recent upcycle but also the anticipated downcycle using a midcycle approach) do not have large changes, as we continue to expect Macau gross gaming revenue to average high-single-digit growth annually during 2018-20.

Our fair value estimates have increased for Galaxy by 6.5% to HKD 49 per share, MGM China by 14% to HKD 24 per share, and Sands China by 8% to HKD 42 per share. Our fair value estimates for Wynn Macau, SJM, and Melco Resorts are unchanged at HKD 22, HKD 7, and $22 per share, respectively. The higher fair value estimate for Galaxy is due to an earlier-than-expected completion of Galaxy Macau phases three and four and our belief that the company will be a long-term market share gainer.

We upgraded our MGM China fair value estimate due to early indications of strong performance by the company's new resort and our confidence in its ramp-up amid decent accessibility to the facility and its good execution. MGM Macau was the casino that lost the least market share compared with Grand Lisboa and Wynn Macau in the peninsula region when MGM China, SJM Holdings, and Wynn Macau did not have a presence in Cotai. We have upgraded Sands China as we believe the redevelopment and renovations at Plaza and Sands Cotai Central and its interconnected casino resorts will help the company regain market share in the next decade.

We don't expect more than a low-single-digit percentage increase to our MGM Resorts, Las Vegas Sands, and Wynn Resorts fair value estimates of $40, $67, and $166 per share, as much of our updated industry gaming forecast was incorporated after recent fourth-quarter results.

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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	$9.23	High	Narrow	0.54	3.62	Inton
Compass Minerals International (CMP)	★★★★	$82	$62.25	High	Wide	0.76	2.11	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 224.95	High	Narrow	0.61	22.32	C. Nichols
China Mobile (941)	★★★★★	HKD 110	HKD 72.3	Medium	Narrow	0.66	1480.38	Baker
Telefonica (TEF)	★★★★	$13	$8.2	High	Narrow	0.63	42.58	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.35	Medium	Narrow	0.73	39.84	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$159	$117.1	Medium	Narrow	0.74	8.66	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.87	Medium	Narrow	0.84	1.64	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 85.12	High	Narrow	0.77	55.27	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 43.16	Medium	Narrow	0.81	3.78	Faul
General Motors (GM)	★★★★	$56	$37.85	High	None	0.68	53.01	Whiston
Great Wall Motor (2333)	★★★★	HKD 14.9	HKD 8.88	High	None	0.60	119.94	Hu
Hanesbrands (HBI)	★★★★★	$29	$19.43	Medium	Narrow	0.67	7.00	Weishaar
Mattel (MAT)	★★★★	$22.5	$13.84	High	Narrow	0.62	4.76	Katz
TripAdvisor (TRIP)	★★★★	$55	$43.74	High	Narrow	0.80	6.08	Wasiolek
Walt Disney (DIS)	★★★★	$130	$103.24	Medium	Wide	0.79	155.24	Macker
Williams-Sonoma (WSM)	★★★★	$65	$55.03	Medium	Narrow	0.85	4.61	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1155.5	Medium	Narrow	0.77	14.65	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★	$61	$50.93	Low	Wide	0.83	28.98	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2479	Low	Wide	0.64	23.64	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7650	Low	Wide	0.87	3701.55	Wei
Mondelez International (MDLZ)	★★★★	$51	$43.39	Medium	Wide	0.85	64.54	Lash
Procter & Gamble (PG)	★★★★	$98	$78.67	Low	Wide	0.80	198.33	Lash
Reckitt Benckiser Group (RB.)	★★★★★	GBX 7400	GBX 5646	Low	Wide	0.76	39.76	Gorham
Energy								
Cenovus Energy (CVE)	★★★★★	$21	$10.58	Very High	None	0.50	13.00	Gemino
Enbridge (ENB)	★★★★★	$64	$41.06	Medium	Wide	0.64	69.60	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$76	$63	Low	None	0.83	257.03	Good
RSP Permian (RSPP)	★★★★	$55	$38.8	High	None	0.71	6.19	Meats
Total (TOT)	★★★★	$70	$57.23	Medium	None	0.82	152.03	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$54.66	Medium	None	0.72	49.33	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.7	Very High	None	0.89	24.52	Heathfield
Capital One Financial (COF)	★★★★	$120	$98.05	Medium	Narrow	0.82	47.68	Plunkett
Invesco (IVZ)	★★★★	$42	$32.92	Medium	Narrow	0.78	13.40	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 717	Medium	None	0.81	9437.75	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.77	High	Narrow	0.75	13.28	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 29.52	Medium	Wide	0.84	99.96	Ellis

Source: Morningstar. As of March 16, 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	$166.12	Medium	Wide	0.63	54.42	Waterhouse
Express Scripts Holding (ESRX)	★★★★	$92	$76.33	Medium	Wide	0.83	42.84	Lekraj
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.96	Medium	Narrow	0.82	3.42	Kallos
McKesson (MCK)	★★★★	$210	$153.96	Medium	Wide	0.73	31.77	Lekraj
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 63	Medium	Narrow	0.77	12.73	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 220.05	Low	Wide	0.69	187.85	Andersen
Shire (SHP)	★★★★★	GBX 4890	GBX 3159	Medium	Narrow	0.65	28.77	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$78.3	Medium	Narrow	0.73	2.61	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 43.4	Medium	Narrow	0.75	54.77	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.67	Medium	Wide	0.86	15.39	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 120	HKD 98.9	Medium	None	0.82	381.52	Tan
Fluor (FLR)	★★★★	$69	$57.31	High	Narrow	0.83	8.02	Silver
G4S (GFS)	★★★★	GBX 337	GBX 251	Medium	None	0.74	3.89	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 35.55	Medium	Wide	0.76	6.46	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP B)	★★★★	MXN 225	MXN 183.53	High	Wide	0.82	102.96	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 5.05	High	None	0.74	41.33	Song
Johnson Controls International (JCI)	★★★★	$53	$37.05	High	Narrow	0.70	34.31	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 74.5	Medium	Narrow	0.87	8.79	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 31.75	Medium	Narrow	0.79	29.41	Vonk
Stericycle (SRCL)	★★★★	$99	$63.31	Very High	Wide	0.64	5.42	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.65	Medium	None	0.85	1.54	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 129.8	Medium	Narrow	0.85	376.03	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$68.62	Medium	None	0.82	13.04	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$100	$85.6	Medium	Wide	0.86	6.84	Nelson
KLA-Tencor (KLAC)	★★★	$125	$120.81	High	Wide	0.97	18.92	Davuluri
LM Ericsson Telephone (ERIC B)	★★★	SEK 61	SEK 56.16	Very High	None	NA	184.77	Colello
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.18	Medium	Narrow	0.79	1.92	James
Qualcomm (QCOM)	★★★★	$75	$59.89	High	Narrow	0.80	88.66	Davuluri
Sabre (SABR)	★★★★	$26	$22.03	Medium	Narrow	0.85	6.05	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$127.22	Medium	Wide	0.88	93.06	Nelson
Synaptics (SYNA)	★★★★	$64	$47.96	Very High	None	0.75	1.65	Davuluri
TDK (6762)	★★★	JPY 11500	JPY 10060	High	None	0.87	1269.57	Ito
Tencent Holdings (700)	★★★	HKD 492	HKD 465.2	High	Wide	0.95	4418.76	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.28	Medium	Narrow	0.85	3.78	Atkins
Dominion Energy (D)	★★★★	$87	$71.24	Low	Wide	0.82	46.41	Fishman
FirstEnergy (FE)	★★★★	$40	$33.68	Low	Narrow	0.84	16.02	Fishman
Gas Natural SDG (GAS)	★★★★	EUR 21	EUR 18.83	Medium	Narrow	0.90	18.83	Fulop
SCANA (SCG)	★★★★★	$60	$40.38	Medium	Narrow	0.67	5.76	Miller

Source: Morningstar. As of March 16, 2018

Highlighted Stocks

HD Supply Holdings HDS

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Industrials	Stable	USD	45	39.20	Medium	Narrow	0.87	7.09

Source: Morningstar. As of March 16, 2018

We were impressed by the construction and industrial segment's fourth-quarter performance, with unit sales growing a whopping 16% and adjusted operating margin expanding 200 basis points to 7.2%.

Analyst Note, March 14, 2018

Fiscal 2017 was a transformative year for HD Supply. The narrow-moat industrial distributor sold its Waterworks business for $2.5 billion and used the proceeds to finally rightsize its previously debt-ridden balance sheet. With a healthy balance sheet, HD Supply was able to return cash to shareholders for the first time, and the company spent $541 million to repurchase approximately 17 million shares or about 9% of the firm's fiscal 2016 diluted share count. HD Supply ended fiscal 2017 with strong fourth-quarter results and the announced acquisition of A.H. Harris, which subsequently closed in March 2018.

We increased our fair value estimate to $45 from $43 per share. This increase was due to our stronger sales growth assumptions, primarily driven by the acquisition of A.H. Harris, our lower cost of debt assumption, which lowered our weighted average cost of capital estimate, and the time value of money since our last update. Now that HD Supply has a healthy balance sheet with no material debt maturities until 2021, we changed HD Supply's credit risk rating to low from moderate, which results in a 5.8% pretax cost of debt assumption, versus our prior 6.5% assumption.

HD Supply's fourth-quarter sales grew 9% year over year to $1.2 billion, which was about in line with the consensus estimate, and adjusted EPS increased $0.26 to $0.49, which beat the $0.44 consensus estimate. Full-year sales grew about 6% year over year to $5.1 billion, and full-year adjusted EPS of $2.31 increased 54% versus 2016 results.

We were impressed by the construction and industrial segment's fourth-quarter performance, with unit sales growing a whopping 16% and adjusted operating margin expanding 200 basis points to 7.2% despite rebar cost pressure, which is expected to persist in 2018 due to steel tariffs and a competitive environment. The facilities maintenance segment grew fourth-quarter sales 3.5% year over year and expanded adjusted operating margin 160 basis points to 13.9%.

Management expects healthy end market fundamentals to translate into strong financial results for HD Supply in 2018.

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Hikma Pharmaceuticals HIK:GB

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Healthcare	Stable	GBX	1,270	1,121.50	High	None	0.88	2.66

Source: Morningstar. As of March 16, 2018

Greater stability in Hikma's injectable and branded segments should continue to keep the firm's performance on track with our expectations.

Analyst Note, March 15, 2018
When excluding a roughly $1 billion impairment of its West-Ward Columbus generics operations, Hikma's results were better than expected during the second half of 2017 thanks largely to branded and injectable performance exceeding our expectations. Hikma's revenue nearly matched our estimate, and our prior 2018 total revenue forecast of approximately $2 billion fits into management's outlook for between $1.9 billion and $2 billion. We do not anticipate a change to our fair value estimate, and we are maintaining our no-moat rating.

Adjusting for the West-Ward impairment, the generic segment’s core operating margin was roughly 150 basis points higher than we expected for the period, but management expects a core generic operating margin in the low single digits for 2018, which is slightly lower than our previous mid-single-digit forecast. We were somewhat surprised by the magnitude of its roughly $1 billion impairment charge to its generic West-Ward business unit, but like many of its peers, Hikma's U.S.-based generic operations continue to suffer amid customer consolidation and accelerated competitor approvals. We expect near-term pressure to continue since Hikma still looks less well positioned in the U.S. generic pill market, in our view, and we remain skeptical of the firm's attempt at a generic Advair.

Greater stability in Hikma's injectable and branded segments should continue to keep the firm's performance on track with our expectations. The company's branded segment outperformed our expectations over the end of the year, noting improvement in Egypt, Saudi Arabia, and the UAE. Hikma expects new branded generic launches across key markets to generate mid-single-digit constant currency growth, an attainable goal, in our view. Hikma’s injectable operating profit margin fell roughly 445 basis points compared with the year-ago period to 41.3%, but its performance exceeded our 38.3% forecast. We still expect profitability to decline in this segment over time.

In February, Hikma announced that it had appointed Sigurdur Olafsson as CEO, with Said Darwazah transitioning to executive chairman. We think this is a net positive for the company given Olafsson's historical experience and knowledge of the generic pharmaceutical industry. Olafsson has led generic divisions at both Actavis and most recently Teva, but his oversight of the merger between these two businesses has left Teva in a tough position due to underperformance and high financial leverage.

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Valvoline VVV

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Energy	Positive	USD	24.50	23.09	Medium	Narrow	0.94	4.66

Source: Morningstar. As of March 16, 2018

Valvoline should be able to leverage its innovation abroad, with its faster-growing international unit (about a quarter of sales) gaining standing.

Analyst Note, March 15, 2018
We are initiating coverage of Valvoline with a $24.50 per share valuation and a narrow moat rating. Our valuation implies forward fiscal 2018 enterprise value/adjusted EBITDA of 12 and forward adjusted price/earnings of 18. Despite Valvoline's competitive advantages, we counsel investors to await a more attractive entry point. We expect Valvoline to leverage its brand to generate growth in its international and instant oil change units, capitalizing on its intangible asset-based competitive advantage. While the vehicle fleet is changing fast (favoring premium, longer-lasting synthetic products) and the prospect of electrification looms, we contend that Valvoline can use its product strength to keep pace.

In its core North American segment (about half of sales), we argue that the shift to premium lubricants favors Valvoline as it can leverage its high-quality lineup as oil changes become less frequent but more expensive. Valvoline has emphasized sales of higher-end products; its premium items accounted for over 45% of U.S. branded volume in 2017, up from 30% in 2013. Rising demand for such items in newer vehicles and a vehicle fleet that continues to age as increasingly reliable cars and trucks stay in service should act as tailwinds.

Valvoline should be able to leverage its innovation abroad, with its faster-growing international unit (about a quarter of sales) gaining standing. Valvoline can use its domestic strength to foster relationships with OEMs that can act as a beachhead into new markets (such as its Cummins joint venture). As incomes rise and motorists' dependence on their cars and trucks grows, we anticipate Valvoline benefits and takes share from small local players.
In quick lubes (also about a quarter of sales), Valvoline should be able to capitalize on its brand strength to take share in a fragmented industry. Furthermore, we expect its network of company-owned stores should deliver benefits as the firm works to differentiate its offering.

Our moat trend rating for Valvoline is positive, mostly as a result of the company's growing international presence and the benefits that come with scale in the quick lube sector. We believe these dynamics outweigh the longer-term threat posed by vehicle fleet electrification and lengthening service intervals.

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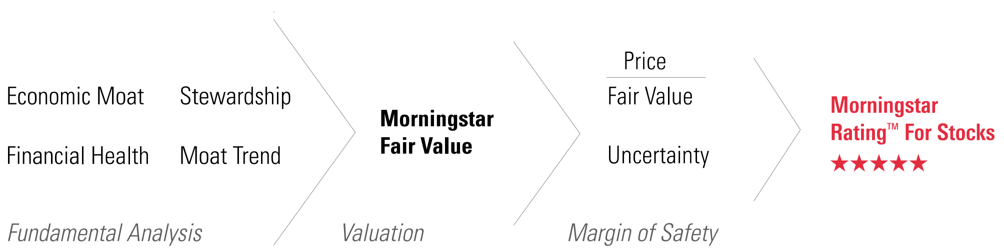
Research Methodology for Valuing Companies

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.

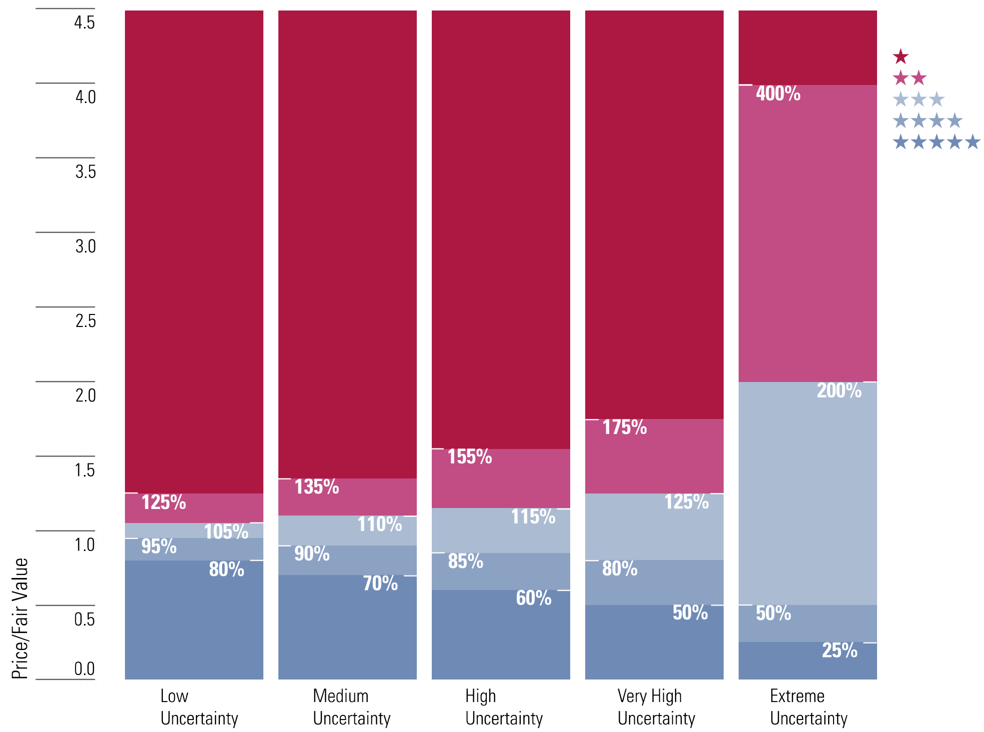
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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