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.

Automotive Chipmakers Nvidia, Intel in the Fast Lane

As we contemplate the future of artificial intelligence, or AI, the most topical and relevant application seems to be autonomous driving, or AD. At least this is what carmakers, Tier 1 suppliers, and even many leading semiconductor firms would have one believe. Today, cars are already seeing exponential increases in semiconductor content—both for mission-critical functions and entertainment purposes. By 2025, we estimate the AD opportunity for Nvidia and Intel to be $7 billion, implying a 51% compound annual growth rate.

Concerning self-driving cars, there are two schools of thought. The most popular and overhyped solution, in our view, is the development of a fully functional platform or perfectly turnkey solution that can be plugged into a car with requisite sensors to "see" its surroundings and ultimately perform full Level 5, or "eyes-off," autonomy. An alternative, more economically feasible, route is incrementally building on top of existing capabilities such as advanced driver-assistance systems, or ADAS, to approach and ultimately reach AD in a more systematic and scalable fashion.

At the forefront of these trends are leading processor vendors, including Nvidia and the Intel-Mobileye duo. Nvidia dominates the GPU landscape and has leveraged its expertise in PC-related graphics into new AI-related applications such as AD. The firm boasts its Drive PX platform as a fully functioning AD computer that is currently being used across 370 automakers, original-equipment manufacturers, and others in research and development settings. Meanwhile, Intel acquired Mobileye for $15.3 billion to jump-start its efforts on the automotive track, as there are roughly 24 million cars on the road today with Mobileye chips. Despite Nvidia's early mind-share traction among market participants, we don't foresee a winner-take-all market in AD platforms, and think Intel-Mobileye is also well-positioned to carve a meaningful portion of this opportunity. Consequently, Nvidia still appears significantly overvalued, in our view, while Intel is modestly undervalued.

- By 2025, we calculate the Level 2 through Level 5 AD market opportunity (which implies any AD from "hands off" to fully driverless vehicles) for Nvidia and Intel-Mobileye to be $7 billion, implying a 51% CAGR from our 2017 market estimate derived from Nvidia and Intel's automotive revenue.
- Given the nascent status of the current AD hardware market, we assume Level 4/5 will be split roughly evenly between the two firms by 2025, while Intel-Mobileye will build on its ADAS leadership to be the primary solution for Level 2/3 systems. We believe the consensus view is that Nvidia will be the sole winner in AD, and thus, we like the risk/reward of Intel today.

- The benefits of autonomous driving are well-understood (fewer accidents and more free time for drivers); however, the timeline for commercialization has been oversold, in our view. Nevertheless, semi- and full-autonomous platforms will still go into vehicles in the near future, though the software may remain unenabled due to regulatory concerns.
- Both Nvidia and Intel have positioned themselves to be major players in the AD platform market, which includes the advanced semiconductors that will perform the vital aspects of full autonomy. Nvidia and Intel boast economic moats stemming from cost advantages and intangible assets, that should grow stronger as automotive-related chips become a larger part of each broader business.
- Sensing, planning, and acting are the three main functions of an AD system, with a bevy of players vying for each. Mobileye is a sensing leader focused on building a comprehensive solution, while Nvidia intends to commercialize a turnkey solution that performs the latter two functions.
- We view the key criteria for successful AD solutions as performance, cost, and safety. Nvidia and Intel-Mobileye are poised to deliver on each of these criteria. We are skeptical that other processor vendors, such as Qualcomm, NXP, Texas Instruments, and others will emerge as viable third threats to the Nvidia-Intel duo.
- Nvidia is the first mover in AD, with its Drive PX module used in more than 370 partnerships. The Drive PX features a host of powerful GPUs and other chips that exhibit impressive performance metrics.
- Despite its initial advantage, we do not view the AD platform market as a foregone conclusion, given the rapid pace of innovation within technology and our concerns regarding GPU power consumption.
- We think the Mobileye acquisition grants Intel a seat at the automotive table for AD, and despite a high price tag, will prove to be worthwhile longer term given Mobileye's large existing customer base.
- We view Mobileye's approach to AD very favorably, as it looks to incrementally build upon existing products to enable full autonomy, working from ADAS up to Level 5 in a methodical manner.
- Given the nascent status of the current AD hardware market, we assume Level 4/5 will be split roughly evenly between the two firms by 2025, while Intel-Mobileye will build on its ADAS leadership to be the primary solution for Level 2/3 systems.
- Audi's zFAS centralized architecture features an Nvidia Tegra chip and Mobileye EyeQ 3 vision processor, with each chip performing differing functions for Level 3 autonomy, illustrating an early example of what a fully autonomous solution would look like (and why it won't necessarily be winner-take-all).
- Similarly, Tesla's autopilot also showcases how solutions can be swapped out (Nvidia replacing Mobileye), illustrating the potential for disruption in AD technology.
- Nvidia is today's leader in the AD hardware space, as the firm has successfully leveraged its GPUs for PC graphics into AI and AD. However, we think the market has priced in overly ambitious expectations for the firm. While we expect Nvidia's Drive PX to be prominent in future AD systems, we view current levels as significantly overvalued relative to our $120 fair value estimate.

  Intel is the dominant player in server and PC CPUs, and the firm has built a broad portfolio of offerings via acquisition and internal development. These include FPGAs, custom chips, memory solutions, and vision processors from Mobileye. The latter will help Intel accelerate its revenue in automotive, and we view shares as modestly undervalued relative to our $56 fair value estimate.

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Sabre's Technology Underappreciated

In our view, the market has yet to appreciate the viability of Sabre's technology. As such, we haven't wavered on our stance that recent headwinds (which have constrained shares to a 6% drop the past year versus a 14% lift for the S&P 500 index) will prove temporary, as first substantiated in our December 2017 report Sabre Shares Set to Gain Altitude; Investors Should Buckle Up. And after traveling to Sabre's March investor day, we have increased conviction that its network, efficient scale, and switching cost moat sources are intact, leaving an attractive opportunity for long-term investors.

Our confidence is buoyed by a technology roadmap that includes progress toward cloud migration, reduced product customization and version support, and a company-shared platform utilizing microservices, all of which foster innovation and cost efficiency. Also, following Sabre's showcase of several industry-leading products, we have an increased appreciation for the skills of the newly formed executive team, which should aid continued technological evolution. Finally, we remain secure in our view that Sabre's network and efficient scale advantages will endure as airlines gradually shift to the New Distribution Capability, or NDC, protocol. With Sabre's shares 24% below our valuation, we think investors should hop on board.

- Cloud progress continues with the shopping complex moving over in 2017, the ongoing build-out of infrastructure through 2019, and migration of remaining functionality through 2023, leading to increased reliability, performance, and cost efficiency.
- Sabre's leading breadth of airline solutions will be enhanced by reduced versions and the use of microservices, supporting 7% average annual IT Solutions sales growth over the next 10 years.
- Industry-leading solutions, including a cloud-based hospitality and agency offering, along with market-leading data analytics and operational-based products, support Sabre's competitive positioning.
- Management's experience in the airline industry and in revitalizing products and platforms bodes well for executing on its technology roadmap.
- Shares trade at a 24% discount to our $26 fair value estimate, which is based on 5% annual sales growth and operating margins averaging 17% over our explicit forecast versus 16% in 2017.

Sabre's Competitive Position Brightened by the Cloud

The view outlined in our December 2017 report, where we suggested that Sabre's technology offering has remained viable (evidenced by some wins and some losses against Amadeus during the past few years) was enhanced at its March investor day. During this event, management highlighted the progress the company has made in shifting applications off higher-cost mainframe systems toward a more efficient and innovation-enabling cloud-based infrastructure, which supports the company's narrow-moat network, efficient scale, and switching cost advantages.

Relative to mainframe systems, a cloud environment offers performance advantages by improving latency (leveraging more location areas) and innovation (through easier coding and development), sustaining Sabre's competitive positioning. Additionally, a cloud landscape comes at a lower cost, as it allows for capital equipment and labor utilization efficiencies, along with the price of storage continuing to drop.

Sabre's transition to open-source and cloud-based solutions is nothing new, as it has been migrating off mainframe systems for several years. As a result, open systems today have around 50 times and 200 times the processing and storage capacity of mainframes, respectively, creating an environment for improved innovation and lower costs.

Bulls Say

- The company's GDS network hosts content from all airlines and is used by many travel agents, resulting in a large industry share. Replicating the GDS network involves meaningful time and costs.
- The network advantage is supported by both new products and technology that further integrates airlines and agents into its GDS platform, emergence into underpenetrated geographies, and the Abacus acquisition, which closed in July 2015.
- The business model is driven by transaction volume and not pricing, leading to less cyclical volatility.

Bears Say

- Aided by technology advancements, airlines could have future success in driving more bookings direct to their sites and away from indirect platforms like GDS.
- Incentive costs continue to increase for Sabre's network business, as OTAs represent an increasing mix of GDS bookings, and these agents are lower margin for the company.
- As technology evolves, Sabre may have to invest incremental capital in its platform in order to sustain share and revenue growth, weighing on ROIC.

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Healthcare REITs Don't Have Moats, but Valuations Are Compelling

We are lowering our moat ratings for the healthcare REITs we cover (HCP, Ventas, and Welltower) to none from narrow. However, we believe there is significant value to be found in these companies' high-quality, well-diversified portfolios. All three have sold off in the past few months because of factors that are either short term or already baked into our long-term views, and we believe the market is ignoring long-term industry tailwinds. We see Welltower and Ventas as the most attractive names given their management's exemplary stewardship, and we have a slight preference for Welltower, as we believe its strategy of smaller-scale acquisitions is more viable. All three companies also currently have a dividend yield over 6%, and we see their dividends as well-covered.

After transferring coverage, we have lowered our fair value estimate for Ventas to $65 from $67 and for HCP to $25 from $26. We are maintaining our $74 fair value estimate for Welltower. These changes are the net result of some offsetting changes in our near- and long-term assumptions. While we had previously recognized that 2018 would be a down year for senior housing fundamentals and the next two years would also see slower NOI growth, we've lowered our near-term expectations further based on how the situation has developed.

Additionally, we are modeling more detailed dispositions in 2018 given what the companies have announced to date. This was the primary cause of the decrease in our fair value estimate in March for HCP, as HCP is estimated to dispose of $2 billion more of assets than we were previously expecting in 2018, and is disposing assets at a higher cap rate or lower price than we had previously anticipated. Partially offsetting these negative adjustments, after reassessing longer-term demographic trends, we now include several years of above average NOI growth starting in 2021 as supply growth slows and the baby boomers start to move into these properties.

Slowing senior housing fundamentals have weighed on the sector. The big three healthcare REITs derive 20%-45% of their EBITDA from operating senior housing. Supply growth caused occupancy to trend negatively in 2017, and construction as a percentage of supply is now at an 11-year high, suggesting that 2018 will be worse. Additionally, the flu season has been the worst in over a decade, leading to further occupancy declines in the first half of 2018. The companies confirmed as much in their guidance, saying that they expected occupancy to drop 100 to 200 basis points and that NOI could fall as much as 4% in 2018.

However, we think this concern over near-term headwinds is shortsighted and overblown. The flu season is a one-time event that will probably correct next year. Furthermore, construction starts as a percentage of total inventory have flattened out and even dipped a bit from the high point four quarters ago, suggesting we are at peak supply now. As interest rates rise and construction costs get more expensive, supply is likely to decline in coming years. The first baby boomers will turn 75 in three years, and the 80-plus population (which spends more than 4 times on healthcare per capita than the national average) will double over the next decade, so we should see a significant increase in demand when they start to move into these properties. For patient investors, we think the short-term supply issues are more than offset by the long-term demand wave that is going to hit the space.

Healthcare REITs have also declined since mid-December because of rising rates on U.S. Treasuries. Rising interest rates negatively affect REITs, because the high dividends provided by REITs become relatively less attractive compared with risk-free options. It has an even larger impact on healthcare REITs, because it affects their external growth. For the past decade, healthcare REITs have benefited from the large spread between the high-yielding assets they were acquiring and the low cost of debt and equity they could use to fund the acquisitions. Rising interest rates and falling equity prices means these companies can no longer accretively grow through external opportunities.

However, we think that the sell-off from the news of rising interest rates is an overreaction and misses the long-term value that the healthcare companies have spent years cultivating. The companies are all trading below our estimate of their net asset values, indicating that the public market is pricing these companies below where the private market values the underlying real estate. Our fair value estimates for Ventas and Welltower are above our NAVs because of our belief that the exemplary stewardship that these companies exhibit will create value through leveraging relationships and operational expertise to drive higher internal growth. While we have viewed acquisitions as an unsustainable source of growth due to interest rates inevitably rising, we still trust these management teams to make smart investment and capital allocation decisions.

If investors are willing to overlook some short-term supply disruption in the senior housing space, we believe these companies are well-positioned to benefit from long-term demand for their assets.

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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	$10.6	High	Narrow	0.62	4.17	Inton
Compass Minerals International (CMP)	★★★★	$82	$67.35	High	Wide	0.82	2.28	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 240.3	High	Narrow	0.65	23.84	C. Nichols
China Mobile (941)	★★★★★	HKD 102	HKD 73.1	Medium	Narrow	0.72	1496.76	Baker
Telefonica (TEF)	★★★★	$13	$8.24	High	Narrow	0.63	42.83	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.6	AUD 3.08	Medium	Narrow	0.67	36.63	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★★	$159	$105.18	Medium	Narrow	0.66	7.78	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.75	Medium	Narrow	0.82	1.61	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 90.88	High	Narrow	0.83	59.13	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 39.16	Medium	Narrow	0.74	3.43	Faul
General Motors (GM)	★★★★	$56	$37.77	High	None	0.67	52.90	Whiston
Great Wall Motor (2333)	★★★★★	HKD 13.5	HKD 7.53	High	None	0.56	105.31	Hu
Hanesbrands (HBI)	★★★★★	$29	$17.62	Medium	Narrow	0.61	6.35	Weishaar
Mattel (MAT)	★★★★	$21.5	$13.45	High	Narrow	0.63	4.63	Katz
TripAdvisor (TRIP)	★★★★	$55	$41.64	High	Narrow	0.76	5.79	Wasiolek
Walt Disney (DIS)	★★★★	$130	$100.89	Medium	Wide	0.78	151.71	Macker
Williams-Sonoma (WSM)	★★★★	$68	$49.27	Medium	Narrow	0.72	4.10	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1156	Medium	Narrow	0.77	14.63	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★★	$59	$44.03	Low	Wide	0.75	25.10	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2355	Low	Wide	0.60	22.46	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7853	Low	Wide	0.89	3869.76	Wei
Mondelez International (MDLZ)	★★★★	$51	$41.01	Medium	Wide	0.80	60.83	Lash
Procter & Gamble (PG)	★★★★★	$98	$74.95	Low	Wide	0.76	188.47	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7400	GBX 5786	Low	Wide	0.78	40.76	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	$21	$12.7	Very High	None	0.60	15.61	Gemino
Enbridge (ENB)	★★★★★	$62	$40.49	Medium	Wide	0.65	69.01	Gemino
Enterprise Products Partners (EPD)	★★★★	$30	$26.65	Low	Wide	0.89	57.59	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$78	$72.85	Low	None	0.93	303.88	Good
Total (TOT)	★★★★	$74	$62.03	Medium	None	0.84	163.68	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$55.18	Medium	None	0.73	49.83	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 16.54	Very High	None	0.93	25.89	Heathfield
Capital One Financial (COF)	★★★★	$120	$98.35	Medium	Narrow	0.82	47.81	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 16.19	High	Narrow	0.74	41.29	Scholtz
Invesco (IVZ)	★★★★	$42	$31.22	Medium	Narrow	0.74	12.83	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 716.3	Medium	None	0.81	9428.54	Wu
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.89	High	Narrow	0.76	13.45	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 28.59	Medium	Wide	0.82	96.81	Ellis

Source: Morningstar. As of April 20, 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	$158.59	Medium	Wide	0.60	51.95	Waterhouse
Healthscope (HSO)	★★★★	AUD 2.4	AUD 2.03	Medium	Narrow	0.85	3.53	Kallos
McKesson (MCK)	★★★★★	$210	$147.1	Medium	Wide	0.70	30.35	Lekraj
Medtronic (MDT)	★★★★	$105	$80	Medium	Wide	0.76	108.43	Wang
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 63.47	Medium	Narrow	0.77	12.83	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 215.65	Low	Wide	0.67	184.83	Andersen
Shire (SHP)	★★★★	GBX 4890	GBX 3975	Medium	Narrow	0.81	36.26	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$78.2	Medium	Narrow	0.73	2.60	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 39.65	Medium	Narrow	0.68	50.04	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.64	Medium	Wide	0.86	15.34	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 124	HKD 93	Medium	None	0.75	358.76	Tan
Fluor (FLR)	★★★★	$69	$59.15	High	Narrow	0.86	8.28	Silver
G4S (GFS)	★★★★	GBX 337	GBX 260.3	Medium	None	0.77	4.04	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 34.54	Medium	Wide	0.73	6.65	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP I	★★★	MXN 225	MXN 197.43	High	Wide	0.88	110.76	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 4.31	High	None	0.63	36.93	Song
Johnson Controls International (JCI)	★★★★	$53	$34.01	High	Narrow	0.64	31.50	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 77.04	Medium	Narrow	0.90	9.09	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 32.96	Medium	Narrow	0.82	30.53	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 80.78	Medium	Narrow	0.73	12.01	Field
Stericycle (SRCL)	★★★★	$86	$60.85	High	Narrow	0.71	5.21	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.62	Medium	None	0.85	1.52	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 123.1	Medium	Narrow	0.80	356.62	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$66.2	Medium	None	0.79	12.59	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$100	$86.36	Medium	Wide	NA	6.90	Nelson
KLA-Tencor (KLAC)	★★★★	$125	$102.29	High	Wide	0.82	15.94	Davuluri
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.21	Medium	Narrow	0.79	1.92	James
Qualcomm (QCOM)	★★★★	$75	$52.57	High	Narrow	0.70	77.82	Davuluri
Sabre (SABR)	★★★★	$26	$20.59	Medium	Narrow	0.79	5.98	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$124.06	Medium	Wide	0.86	91.77	Nelson
Synaptics (SYNA)	★★★★	$64	$46.15	Very High	None	0.72	1.59	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9680	High	None	0.84	1221.61	Ito
Tencent Holdings (700)	★★★★	HKD 641	HKD 400.2	High	Wide	0.62	3803.18	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.31	Medium	Narrow	0.86	3.80	Atkins
Dominion Energy (D)	★★★★★	$84	$66.06	Low	Wide	0.79	43.10	Fishman
FirstEnergy (FE)	★★★★	$40	$34.87	Low	Narrow	0.87	16.63	Fishman
Gas Natural SDG (GAS)	★★★	EUR 21	EUR 20.67	Medium	Narrow	0.98	20.67	Fulop
SCANA (SCG)	★★★★★	$57	$35.99	Medium	Narrow	0.63	5.13	Miller

Source: Morningstar. As of April 20, 2018

Highlighted Stocks

TransCanada TRP

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	USD	54	43.33	Medium	Narrow	0.80	39.3

Source: Morningstar. As of April 20, 2018

The market continues to overlook the positive impact the growth portfolio will have on cash flows and the balance sheet, and it places too much emphasis on less important outside factors.

Analyst Note, April 16, 2018
TransCanada's stock hasn't fared well over the past six months, down 14%, underperforming the market. A perfect storm of outside factors—rising interest rates, uncertainty over the status of the Keystone XL utilization, and the Federal Energy Regulatory Commission's proposed tax disallowance, coupled with increasing leverage—has driven the stock lower.

We think the market is placing too much emphasis on these largely transitory factors and overlooking TransCanada's big picture. We expect TransCanada to meet its targeted 8%–10% annual dividend growth over the next three years, driven by a healthy pipeline of growth opportunities, highlighted by the Keystone XL. The widening of the heavy oil discount has given some investors pause as the higher differential hurts realized prices for exploration and production companies that are meant to expand production and fill the proposed pipelines. But the widening heavy oil discount only shows that new pipelines are needed now more than ever. With TransCanada's plan for the Keystone XL to serve the U.S. Gulf Coast solely, the project has contracts for 93% of its targeted capacity. The legacy Keystone pipeline will serve the U.S. Midwest, providing a more attractive market with higher netbacks for producers' spot production.

Further, FERC's proposal will have a minimal impact on TransCanada, only affecting 13% of the company's EBITDA and an even smaller portion of its growth projects. Finally, a return to a more normalized dividend yield would mean a higher price for TransCanada's shares in the face of rising interest rates. With its 4-star rating and narrow moat, TransCanada's stock offers 30% upside and an attractive 5.2% dividend yield. The market continues to overlook the positive impact the growth portfolio will have on cash flows and the balance sheet, and it places too much emphasis on less important outside factors. The time is right for long-term investors to capitalize on the stock's considerable upside while collecting a steady stream of growing income.

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American Express AXP

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Financial	Stable	USD	112	100.62	High	Wide	0.90	88.1

Source: Morningstar. As of April 20, 2018

Management now expects annual earnings to come in at the high end of its $6.90-$7.30 guidance.

Analyst Note, April 18, 2018
Wide-moat American Express reported year-over-year revenue growth of 12% in the first quarter of 2018, as growth in spending and borrowing benefited both sides of the company's business. Billed business grew by 10%, with international volumes (both consumer and small business) growing at healthy double-digit rates (16% and 20%, respectively). Loan balances grew by 16% during the year as well. Management now expects annual earnings to come in at the high end of its $6.90-$7.30 guidance. Our forecasts are in line with these expectations, and we are maintaining our $112 per share fair value estimate.

Operating expenses grew just 5% during the quarter, including a 3-percentage-point impact from currency movements. Marketing and business development spending grew 5% as cuts in marketing spend were offset by significantly higher payments to cobrand partners. We believe these increased payments are a result of the strengthening bargaining position of American Express' partners—the airline and hotel industries, for instance, have benefited from consolidation over the past two decades.

Similarly, cardmember services spending rose by 29% as American Express spent more on perks from partners such as airline lounge access and free bag allowances. All that said, the company was able to grow pretax income by 13% as solid growth in net interest income (up 23% year over year) and noninterest income (up 9% year over year) more than offset rising demands from partners. Furthermore, the company's tax rate fell to 21.5% from 32%, leading to a 31% increase in net income to common shareholders and a 38% increase in diluted EPS.

Yields on card member loans expanded by 0.50% year over year, as introductory rates rolled off and management increased pricing. American Express is liability-sensitive, and should experience rising deposit betas as its relatively sophisticated banking customers seek higher yields on deposit balances.

Seasoning of the company's loan book is continuing, and provisions for loan losses rose by 35% over the past 12 months. However, net charge-offs totaled just 2% of loans during the quarter (up from 1.7% in the first quarter of 2017). Given very low unemployment rates, we don't expect to see a significant increase anytime soon, but the company's heady loan growth is worth monitoring given the company's credit missteps ahead of the 2008-09 recession.

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Procter & Gamble PG

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	98	74.01	Low	Wide	0.76	188.5

Source: Morningstar. As of April 20, 2018

We expect the firm's continued investments behind core brands will lead to increasing consolidated sales growth.

Analyst Note, April 19, 2018
Lagging sales continue to dog wide-moat Procter & Gamble, with organic sales up just 1%, reflecting a 3% benefit from increased volumes and favorable mix, offset by a 2% reduction in price. This weakness (not dissimilar from the past few quarters) was concentrated within the grooming (10% of sales) and baby (27%) segments, which were each down 3% on an organic sales basis. While these results are far from a plus, we're encouraged by the improvement chalked up in its beauty (nearly one fifth of sales, up 5%) and fabric care (one third of sales, up 3%) segments. We think these gains showcase the first fruits of P&G's efforts to rationalize its mix. And while improvement has yet to prove broad-based, we expect the firm's continued investments behind core brands will lead to increasing consolidated sales growth and support its brand intangible asset.

Beyond its quarterly results, P&G also announced it intends to terminate its healthcare joint venture with no-moat Teva and has inked a deal to acquire German-based narrow-moat Merck's consumer healthcare brands for $4 billion (3.7 times trailing-12-month sales and 20 times EBITDA). In our view, this tie up (which is expected to close by the end of the calendar year) stands to replace the scale and technological know-how lost following the dissolution of its joint venture partnership. As such, we don't portend it signals a reversal in the firm's strategy to operate with a leaner brand mix.

At just 1%-2% of sales, we surmise this addition evidences management's openness to selectively bolstering its reach in attractive categories (consumer health growing midsingle digits) and geographies. After assessing the quarterly results and the consumer healthcare deal, we don't foresee a material change to our $98 fair value estimate. With shares down around 3% following this news, we'd suggest investors stock up on shares, which trade at a more than 20% discount to our valuation and boast a more than 4% annual dividend yield.

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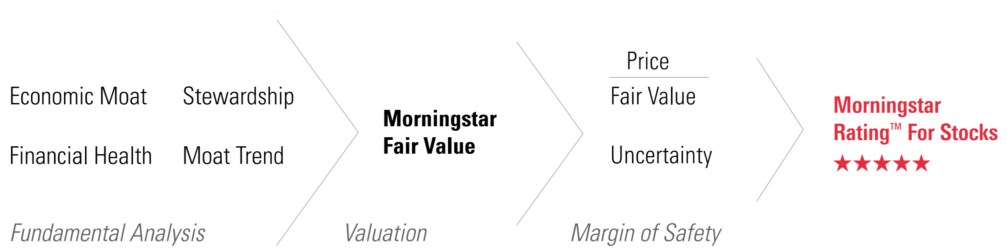
Research Methodology for Valuing Companies

Overview

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

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

Morningstar Research Methodology



Source: Morningstar.

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

Economic Moat

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

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

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

Estimated Fair Value

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

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

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

Stage II: Fade

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

Stage III: Perpetuity

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

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

Uncertainty Around That Fair Value Estimate

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

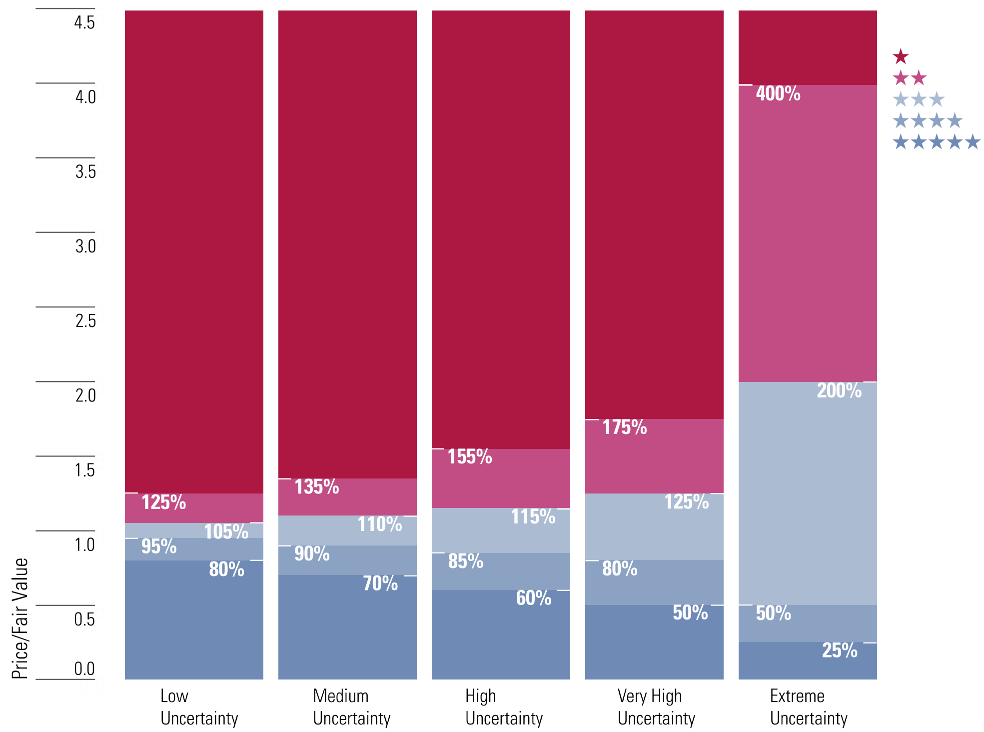
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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

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

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

Morningstar Equity Research Star Rating Methodology



Market Price

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

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

Morningstar Star Rating for Stocks

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

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

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

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

The Morningstar Star Ratings for stocks are defined below:

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

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

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

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

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

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