Research Highlights

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

Morningstar Equity Research
Jan. 28-Feb. 1, 2019

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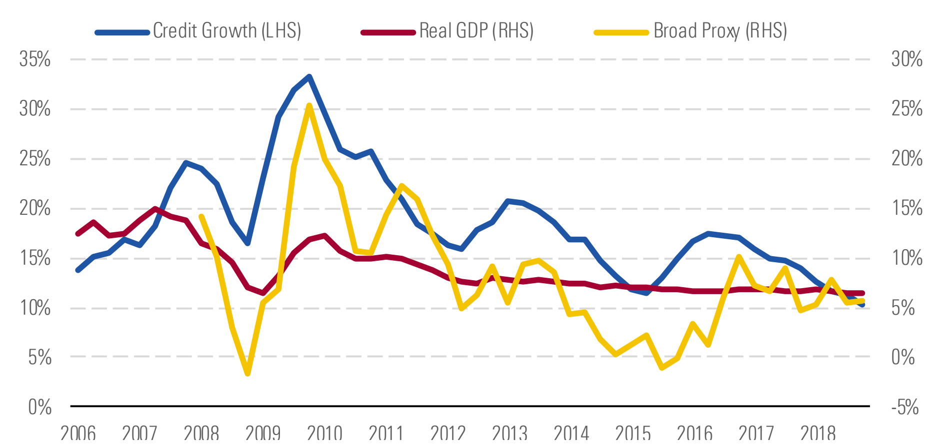
China Diagnostics: Fourth-Quarter 2018

China's economy is clearly slowing, but the extent is becoming more obscured because of deteriorating data quality and a shift in growth to areas of the economy such as services, where data collection is less robust. Despite media reports that focus on U.S.-China trade tensions and tariffs as the cause of the slower growth, substantial tariffs have yet to be implemented. Instead, slowing credit growth is the primary cause at this point. Beijing is already turning to stimulus efforts to prevent a further decline in growth. We expect stimulus efforts to be more modest than prior efforts, reflecting the fact that a high debt/GDP ratio is a constraint, and the extent in the short run will be determined by the progress of U.S.-China trade discussions and the ongoing impact on consumer expenditures and sentiment.

- Declining fixed-asset investment was a key driver of lower growth in 2018 than in 2017, likely because of the sensitivity of investment to slowing credit growth. A late-year acceleration in reported investment as well as investment materials production suggests that China could be gearing up for more stimulus, but we think stimulus will be limited owing to China's high debt load.
- Consumption growth started 2018 strong but rapidly decreased throughout the year. Demand volume for consumer durables is now shrinking. Autos have decreased the most, but the weakness is broad-based. Stimulatory policy measures will likely be focused on reversing this downtrend in consumption.
- Credit growth is continuing to decelerate, despite recent policy measures to increase system liquidity.

Exhibit 1 China's Slowdown in Growth Is Unsurprising, Given Contracting Credit Growth
Right axis: growth in official real GDP and our broad proxy of real activity. Left axis: growth in adjusted total social financing



Source: China National Bureau of Statistics, Morningstar.

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Fed Increasingly Dovish About Rate Hikes

As we expected, the Federal Reserve is no longer in any rush to raise interest rates, and the Federal Open Market Committee voted unanimously to maintain its target rate at 2.25%-2.5% in its first official meeting of 2019. There were more drastic changes in the language of the current release compared with the last release. First, the Fed removed language regarding future rate hikes being consistent with its goals, and instead simply said that it views an accomplishment of its goals as the most likely current outcome, without explicit reference to rate increases. Further, the Fed added the word *patient* with regards to future rate hikes. The FOMC's statement also removed language related to the risk outlook remaining "roughly balanced," and instead did not directly comment on this.

All of these changes point to a significantly more dovish turn, in our view. We have already updated our underlying rate hike assumptions for our banking coverage to include no rate hikes in 2019, and only a single hike in mid-2020. CME futures data continues to point to no rate hikes in 2019. As such, we expect some marginal net interest margin expansion in 2019 as the series of rate hikes in 2018 will have a full-year effect in 2019. We expect material increases in NIM to cease thereafter. We are maintaining our current fair value estimates across our banking coverage.

The Fed does not release new economic projections or a new dot plot at its January meeting. Further, many economic data releases have unfortunately been postponed because of the government shutdown. Even so, the Fed does offer brief economic commentary in its written release, which was almost entirely unchanged from its previous, largely positive commentary. It does seem that the current consensus is for a moderate slowdown in GDP growth in 2019, but with no recession.

While rate hikes are arguably the key monetary policy tool for the FOMC, another important debate surrounding a second, less traditional tool for the Fed has also gained steam in recent months. This is the debate regarding the shrinking of the Fed's balance sheet. The Fed is now at the point where it is rolling off the maximum amount of treasuries, agency debt, and mortgage-backed securities from its balance sheet, up to $50 billion per month. The Fed currently has just over $4 trillion in assets, down from the high of roughly $4.5 trillion, but still far above the just under $1 trillion in 2007. In addition to its normal policy statement, the Fed also issued a brief statement about its balance sheet runoff. The Fed essentially affirmed that it would be willing to adjust the runoff of its balance sheet in response to changing conditions, and also confirmed that the final, appropriate size of the balance sheet is likely larger than what it was in the past.

The debate over the effects of the Fed's balance sheet normalization is a bit esoteric, seemingly the domain of abstruse academia. On one hand, it is very difficult to find definitive data on the tangible effects of the Fed's balance sheet movements. For example, some papers trying to estimate the effect of the buildup in the Fed's longer-duration assets estimated that the moves may have moved longer-term interest rates a matter of basis points to tens of basis points, nothing astoundingly substantial. With rates so low now, it would seem the runoff in longer-duration assets is hardly causing any massive spikes in longer-term rates. The runoff in shorter-duration assets should affect the total amount of reserves within the banking system, and this could affect liquidity and deposit pricing. In theory, liquidity effects are admittedly difficult to predict and model, and are often nonlinear. However, there does not seem to be strong evidence that the banking system is currently short on reserves or liquidity. These moves could indirectly affect deposit pricing as banks compete for increasingly scarce liquidity, but again, pricing has developed more or less as expected thus far. We also believe the Fed will likely normalize its balance sheet at a higher level than what was seen precrisis, which could give some more leniency regarding reserves in the system compared to the past. Either way, this remains a second key debate to watch, and at the very least represents another signaling mechanism for the markets the Fed must consider.

For a more detailed view of our expectations regarding interest rates and their effects on banking profitability, please see our December 2018 Observer The Return of the Bank: Net Interest Margins Reach a Turning Point--Funding Advantages and Net Interest Income.

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China Real Estate: Quality Properties Should Outperform

We think the market has been too negative on the outlook for retail mall owners in China. There are indeed headwinds, given the ample supply of retail space, slowing economic growth, and the rise of e-commerce, which point to uncertain prospects for retailers. For many, the ongoing consolidation of brick-and-mortar stores in the United States foreshadows what could happen to China's retail property assets.

However, we believe the future remains bright for operators of quality retail property assets in China. On the supply side, while there may be excess quantity on the surface, there is still a shortage of well-built and well-managed shopping centers and malls. On the demand side, consumption will continue to drive the economy, supported by growing household income, an expanding middle class, and an emerging consumption culture. Further, we think the rise of e-commerce is less a threat in China thanks to the country's population density, mass transit, and high retail productivity. For operators with expertise, funding, foresight, and access to a land bank, building and managing retail assets will remain lucrative. We expect long-run returns to exceed costs of capital for such players.

Our preferred stocks with exposure to this sector are China Resources Land and Hang Lung Properties. Both companies have high proportionate exposure to China retail rental and own well-located, quality retail property assets.

- The Chinese retail sector will remain well-supported by growing household consumption. Continued urbanization and rising household income will enlarge and enrich an emerging middle class that is shifting from subsistence to consumption. Rebalancing efforts by the government and demographic trends will further boost wages and reduce savings, all supportive of growth in consumption. We project household consumption growth to outpace GDP growth by more than 50% over the next 10 years.
- Retail space per capita in China is below the level in other developed countries, even after adjusting for sales productivity. Further, a large portion of existing stock is strata titled and poorly managed, resulting in quick obsolescence. Quality retail space remains undersupplied.
- The threat of e-commerce is overstated. In the U.S., instead of the feared broad decline, there is an increasing bifurcation of performance among different types of retailers. In China, we expect retail assets to be generally more resilient because of the country's high population density, extensive mass transit, and high retail productivity. Retailers and brands will increasingly gravitate toward quality assets with complementary components, desirable market positioning, managed tenant mix, and omnichannel capabilities.
- A quality operator is key to the success of a retail asset. Such operators share the following characteristics: access to financing, timely acquisition of greenfield projects, deep retail expertise, and patience. We expect the established players, consisting of Hong Kong and Singapore landlords along with a few quality state-owned enterprise developers, to continue to dominate the field and develop a moat based on efficient scale and network effect, warding off new entrants.
- Among our coverage, we prefer Hang Lung Properties and CR Land. Hang Lung Properties is a pure play for those looking for exposure to quality retail assets in China. CR Land is a rare SOE with the requisite expertise as well as a commitment to retail assets. It is likely to benefit from the expansion of quality retail beyond the core cities in the years to come.

Hang Lung Properties | ★★★★

Hang Lung Properties announced full-year results, with underlying earnings of HKD 4.1 billion, or EPS of HKD 0.91. The results were 10% below our projection. The shortfall was largely attributed to lower property sales revenue in Hong Kong. The property leasing business in China, the company's earnings driver, was mostly in line, with the top line slightly below coupled with better margin. We adjusted our growth assumptions, reflecting the continuing asset enhancement initiatives in China and slower property sales in Hong Kong. We reduce our fair value estimate from HKD 24 to HKD 22, and maintain the company's no-moat rating.

We adjusted our assumption on rental revenue growth to reflect continued AEI at certain assets. The impact on earnings were offset by delayed booking from property sales in Hong Kong. Our thesis on the company as the purveyor of quality retail assets is unchanged. The shares are now trading at 15 times 2019 earnings, with a dividend yield near 5%, supported by recurrent income. We urge continued patience as the company grooms its assets.

Bulls Say

- The company's land acquisitions in Tier 2 cities were well timed. Given the low acquisition cost, the largest cost component, these assets should generate strong returns for the company.
- The company's strong balance sheet allows it to sustain the long build-out process and the long leasing cycles necessary to manage the assets to maturity.
- As an early mover and a proven retail asset manager, the company has a good chance to develop its assets into the leading retail destinations, despite the oversupply of retail assets in some cities.

Bears Say

- While its projects in Shanghai are successful, the company hasn't demonstrated that retail assets in Tier 2 cities can achieve similar level of sales productivity.
- The retail environment is fast evolving, increasingly filled by competitive overseas entrants with good retail management experience as well as upcoming domestic players with strong funding and local relationships.
- The rise of e-commerce will force retail malls to focus more on experience-driven stores along with food and beverage outlets. However, such tenants typically have lower sales productivity.

China Resources Land | ★★★

CRL is unique among Chinese real estate developers. Among large-cap developers, especially those with annual contract sales exceeding CNY 50 billion, CRL is the only one with a credible investment property business. While currently contributing around 10% of operating profit, the company's two lines of commercial offerings, MixC and Hi5, are projected to double in size and account for 20% of operating profit by the end of the projection period. Riding on the success of the Shenzhen MixC, arguably the most successful commercial project in a highly visible and competitive city, the company is looking to transition from a predominantly residential developer into one known for developing and expanding large-scale, mixed-use projects.

The residential development business provides the necessary fuel to power this growth. The company has benefited from a nearly annual asset injection from the parent company. During the past decade, asset injections totaled 25 million square meters in gross floor area, or GFA, at an average net asset value, or NAV, discount of 21%. To put the scale of the asset injections in perspective, the company's contracted sales over the past decade totaled 25.8 million square meters of GFA. The parent company has nearly exhausted its land bank, with only one sizable plot remaining. Asset injections may be coming to an end.

The company has some challenges ahead as it wades into the competitive land auction market. While blessed with a high-quality brand name and low funding costs, CRL has traditionally achieved lower gross margin and slower asset turns than its large-scale peers. Despite showing some improvements in recent years, the company still lacks the operational expertise in a fast-turn and asset-light model. Hence, it will likely continue to lag its peers, and will be less favorably positioned to capitalize on the consolidation trend sweeping the industry. The drive to expand the investment property portfolio is likely to stress the balance sheet, leading to further equity issuance.

Bulls Say

- ► CRL can capitalize its success at Shenzhen MixC, and build out similar projects in other cities.
- ► The company has a strong brand presence with a well-known reputation for quality. It benefits from considerable pricing power, even in a subdued market.
- ► CRL will continue to enjoy parental support, as the parent company can make additional acquisitions in the land market for future asset injections.

Bears Say

- ► The parent company has exhausted its land bank, and future asset injections are unlikely. This means the company will not have the opportunity to acquire assets at a discount to NAV.
- ► CRL will retain low ROIC due to its slow asset turn relative to other large developers.
- ► CRL has relied on heavy equity issuance for paying past asset injections and managing its gearing. The possibility of future equity issuance may weigh down the share price.

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Best Ideas

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Basic Materials								
Cameco (CCJ)	★★★★	$19.5	$12.12	High	Narrow	0.62	4.79	Inton
Compass Minerals International (CMP)	★★★★	$81	$52.25	High	Wide	0.65	1.77	Goldstein
James Hardie Industries (JHX)	★★★★	AUD 21.2	AUD 15.14	Medium	Narrow	0.71	6.69	Slade
Martin Marietta Materials (MLM)	★★★★	$240	$176.68	High	Narrow	0.74	11.08	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 232.4	High	Narrow	0.65	23.06	C. Nichols
China Mobile (941)	★★★★	HKD 97	HKD 83.15	Medium	Narrow	0.86	1702.54	Baker
Telefonica (TEF)	★★★★★	$13	$7.52	High	Narrow	0.58	39.08	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 3.08	Medium	Narrow	0.70	36.63	Han
Vodafone Group (VOD)	★★★★★	$250	$138.58	High	Narrow	0.55	37.03	C. Nichols
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	$240	$168.49	High	Wide	0.70	433.34	Hottovy
Anta Sports Products (2020)	★★★★	HKD 55	HKD 40.45	Medium	Narrow	0.74	108.60	Su
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 73.46	High	Narrow	0.63	47.81	Hilgert
Cie Financiere Richemont (CFR)	★★★★	CHF 90	CHF 68.9	High	Wide	0.77	38.90	Sokolova
Crown Resorts (CWN)	★★★★	AUD 15	AUD 11.85	High	Narrow	0.79	8.15	Ragonese
Dufry (DUFN)	★★★★	CHF 144	CHF 101.25	High	Narrow	0.70	5.11	Sokolova
Expedia Group (EXPE)	★★★★	$180	$119.25	High	Narrow	0.66	17.77	Wasiolek
General Motors (GM)	★★★★	$47	$39.02	High	None	0.83	55.07	Whiston
Hanesbrands (HBI)	★★★★★	$27	$14.99	Medium	Narrow	0.56	5.41	Swartz
InvoCare (IVC)	★★★★	AUD 16	AUD 12.28	Medium	Wide	0.77	1.35	Ragonese
Mattel (MAT)	★★★★★	$21	$11.84	High	Narrow	0.56	4.09	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$51.43	High	Narrow	0.75	11.31	Katz
Walt Disney (DIS)	★★★★	$130	$111.52	Medium	Wide	0.86	166.24	Macker
WPP (WPP)	★★★★★	GBX 1450	GBX 869.8	Medium	Narrow	0.60	10.98	Mogharabi
Consumer Defensive								
Anheuser-Busch Inbev (BUD)	★★★★★	$118	$76.44	Low	Wide	0.65	149.66	Gorham
General Mills (GIS)	★★★★★	$57	$44.44	Low	Wide	0.78	26.52	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2525	Low	Wide	0.68	24.16	Gorham
Mondelez International (MDLZ)	★★★★	$52	$46.26	Medium	Wide	0.89	67.25	Lash
Energy								
Cenovus Energy (CVE)	★★★★	$19	$10.26	Very High	None	0.54	12.61	Gemino
Diamondback Energy (FANG)	★★★	$120	$103.12	High	Narrow	0.86	16.92	Meats
Enbridge (ENB)	★★★★	$62	$48.01	Medium	Wide	0.77	97.07	Gemino
Enterprise Products Partners (EPD)	★★★★★	$35.5	$27.67	Low	Wide	0.78	60.39	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$83	$62.8	Medium	Narrow	0.76	254.30	Good
Schlumberger (SLB)	★★★★	$62	$44.21	High	Narrow	0.71	61.14	Caldwell
Total (TOT)	★★★★★	$77	$54.73	Medium	None	0.71	143.78	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 33.88	High	None	0.73	31.72	Taylor
Financial Services								
Agricultural Bank of China (601288)	★★★	CNY 4.2	CNY 3.72	High	Narrow	0.89	1284.74	Tan
Altaba (AABA)	★★★★	$98	$68.51	High	None	0.70	41.28	Mogharabi
American International Group (AIG)	★★★★★	$76	$43.23	Medium	None	0.57	38.24	Horn
BlackRock (BLK)	★★★★	$475	$415.08	Medium	Wide	0.87	65.86	Warren
Capital One Financial (COF)	★★★★★	$119	$80.59	Medium	Narrow	0.68	37.69	Plunkett
Credit Suisse Group (CSGN)	★★★★★	CHF 22	CHF 11.98	High	Narrow	0.54	30.59	Scholtz

Source: Morningstar. As of Feb. 1, 2019

Best Ideas

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Financial Services, Continued								
Link Administration Holdings (LNK)	★★★★	AUD 8.9	AUD 7.26	Medium	Narrow	0.82	3.86	James
Macquarie Group (MQG)	★★★★	AUD 135	AUD 116.41	Medium	Narrow	0.86	39.96	Ellis
NN Group (NN)	★★★★	EUR 48	EUR 36.92	Medium	None	0.77	12.56	Heathfield
Oversea-Chinese Banking Corp (O39)	★★★★	SGD 13.6	SGD 11.45	High	Narrow	0.84	48.65	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 7.65	Medium	Narrow	0.70	2.43	Likos
Sumitomo Mitsui Financial Group (8316)	★★★★★	JPY 5775	JPY 3943	Medium	None	0.68	5502.85	Makdad
T. Rowe Price Group (TROW)	★★★★	$112	$93.46	Medium	Wide	0.83	22.25	Warren
Wells Fargo (WFC)	★★★★	$65	$48.91	Medium	Wide	0.75	224.07	Compton
Westpac Banking (WBC)	★★★★	AUD 33	AUD 24.58	Medium	Wide	0.74	84.28	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$240	$143.98	Medium	Wide	0.60	48.56	Waterhouse
DaVita (DVA)	★★★★★	$81	$56.13	Medium	Narrow	0.69	9.32	Strole
Medtronic (MDT)	★★★★	$110	$88.39	Medium	Wide	0.80	118.71	Wang
Roche Holding (ROG)	★★★★★	CHF 333	CHF 263	Low	Wide	0.79	224.33	Andersen
Industrials								
Anixter International (AXE)	★★★★★	$107	$60.71	Medium	Narrow	0.57	2.03	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 44.7	Medium	Narrow	0.77	56.41	Song
CK Hutchison Holdings (1)	★★★★★	HKD 118	HKD 79.2	Medium	None	0.67	305.41	Tan
G4S (GFS)	★★★★★	GBX 337	GBX 195.55	Medium	None	0.58	3.03	Field
GEA Group (G1A)	★★★★★	EUR 45	EUR 24.02	Medium	Wide	NA	4.34	Molina
General Dynamics (GD)	★★★★	$209	$171.17	Medium	Wide	0.82	49.42	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 210	MXN 172.07	High	Wide	0.82	96.53	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.3	HKD 3.22	High	None	0.51	27.71	Song
Johnson Controls International (JCI)	★★★★	$46	$33.77	High	Narrow	0.73	30.72	Bernard
Kion Group (KGX)	★★★★★	EUR 90	EUR 50.42	Medium	Narrow	0.56	5.94	Molina
Sodexo (SW)	★★★★	EUR 110	EUR 91	Medium	Narrow	0.83	13.25	Field
Stericycle (SRCL)	★★★★★	$83	$44.08	High	Narrow	0.53	3.99	Young
Real Estate								
Aveo Group (AOG)	★★★★★	AUD 2.3	AUD 1.65	Medium	None	0.72	0.95	Sherlock
CK Asset Holdings (1113)	★★★★	HKD 81	HKD 64.75	Medium	Narrow	0.80	239.15	Zhong
Macerich (MAC)	★★★★	$59	$46.16	High	Narrow	0.78	6.51	Brown
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 130	Medium	Narrow	0.85	376.61	Zhong
Technology								
Applied Materials (AMAT)	★★★★	$49	$39.08	High	Wide	0.80	37.28	Davuluri
Carsales.com (CAR)	★★★★	AUD 14.5	AUD 12.43	Medium	Narrow	0.86	3.02	James
Intel (INTC)	★★★★	$65	$47.12	Medium	Wide	0.72	215.06	Davuluri
KLA-Tencor (KLAC)	★★★★	$128	$106.57	High	Wide	0.83	16.13	Davuluri
Lam Research (LRCX)	★★★	$185	$169.58	High	Narrow	0.92	25.88	Davuluri
Microchip Technology (MCHP)	★★★★★	$112	$80.37	Medium	Wide	0.72	19.01	Colello
Murata Manufacturing (6981)	★★★★	JPY 24000	JPY 16725	High	Narrow	0.70	3566.72	Ito
Skyworks Solutions (SWKS)	★★★★	$105	$73.04	High	Narrow	0.70	12.71	Colello
Tencent Holdings (700)	★★★★	HKD 499	HKD 348	High	Wide	0.70	3313.04	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$70.24	Low	Wide	0.84	56.76	Fishman
Enel (ENEL)	★★★	EUR 5.7	EUR 5.26	Medium	None	0.92	53.54	Fulop
ENN Energy Holdings (2688)	★★★★	HKD 83	HKD 74.9	Medium	Narrow	0.90	84.19	Lee
Entergy (ETR)	★★★★	$96	$89.19	Low	Narrow	0.93	16.77	Fishman

Source: Morningstar. As of Feb. 1, 2019

Highlighted Stocks

Royal Dutch Shell RDS.A

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	USD	83	62.69	Medium	Narrow	0.76	254.30

Source: Morningstar. As of Feb. 1, 2019

Shell's shares do not reflect this multiyear improvement, in our view, leaving them trading at one of the greatest discounts to our fair value estimate in our integrated oils coverage.

Analyst Note, Jan. 31, 2019
Royal Dutch Shell closed out 2018 by reporting better-than-expected fourth-quarter results, including strong earnings and cash flow growth. Most notable was the cash flow, which increased to $22.0 billion from $7.3 billion a year ago. Shell's cash flow generation has been plagued all year by increases in working capital and margin requirements for hedging contracts for the integrated gas portfolio, but both turned to a tailwind during the fourth quarter, to the tune of $9.1 billion and $1.9 billion, respectively, thanks in part to the fall in oil prices. Excluding the working capital impact, operating cash flow increased to $12.9 billion from $9.1 billion largely reflecting the increase in earnings.

During the year, Shell also completed its targeted $30 billion divesting program, bringing its gearing ratio down to 20.3%. It also ended its scrip dividend program and initiated a repurchase plan. To date it has repurchased $4.5 billion of its planned $25 billion in repurchases by 2020 and plans to repurchase another $2.5 billion through April. Finally, it delivered on the bulk of projects that will ultimately contribute $15 billion in cash flow by 2020, instilling further confidence in its $25 billion free cash flow target. While both earnings and cash flow might be negatively affected in 2019 given the decline in oil prices, Shell's targets are based on $60 per barrel, in line with current market expectations. However, Shell's shares do not reflect this multiyear improvement, in our view, leaving them trading at one of the greatest discounts to our fair value estimate in our integrated oils coverage. Our fair value and narrow moat rating are unchanged.

Earnings increased to $5.8 billion from $4.4 billion the year before largely on the strength in the integrated gas and downstream segments. Integrated gas earnings increased to $2.4 billion from $1.6 billion on higher realized prices and trading margins as volumes were flat. Upstream earnings increased to $1.9 billion from $1.7 billion a year ago thanks to higher oil and gas prices. Production increased 1% but was 5% higher excluding portfolio effects on new field start and ramp ups. The downstream segment turned in a strong quarter, with earnings jumping to $2.1 billion from $1.4 billion last year primarily on stronger refining and trading results which offset weaker chemical results.

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Dell Technologies DELL

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Technology	Stable	USD	56	49.58	Very High	None	0.89	34.91

Source: Morningstar. As of Feb. 1, 2019

We're optimistic about its ability to upsell VMware and other cloud-based solutions, especially in high-growth areas of hyperconverged infrastructure and software-defined networking, but we do expect competitive markets to challenge the company's overall profitability.

Analyst Note, Jan. 28, 2019

We are initiating coverage on Dell Technologies with a $56 fair value estimate, no moat and stable moat trend ratings, and we view shares as modestly undervalued. As a very different firm than the Dell that went private in 2013, Dell Technologies offers a complete end-to-end product portfolio for IT infrastructure and is a leader across its major revenue streams. Substantial exposure to commoditized markets, a considerable debt load, and limited shareholder voting power drive our very high uncertainty rating.

Born out of Dell's 2016 acquisition of EMC, Dell Technologies is a preeminent vendor of IT infrastructure products and services, and its brands include Dell, Dell EMC, VMware, Boomi, Pivotal, RSA Security, Secureworks, and Virtustream. Although Dell Technologies has substantial exposure to commoditized markets and carries considerable financial leverage, we believe synergistic opportunities across its brands should make the company a key cog in businesses' hybrid-cloud IT infrastructures. Dell Technologies largest revenue streams of commercial PC and servers are within cutthroat pricing environments that rely on services and support to generate profit. We expect the overall PC market to continue consolidating towards an oligopoly and for consumer-based profits to come from high-end and gaming PCs sales. While storage is a challenging marketplace, we believe flash-based arrays and hyperconverged infrastructure provide rampant growth avenues. We think that the company's majority ownership of VMware and other cloud-centric software brands provide growth catalysts as firms augment hardware with software-based solutions.

After the acquisition of EMC, we view Dell Technologies as an end-to-end IT infrastructure provider that is supplementing hardware prowess with emerging software and cloud-based solutions. We're optimistic about its ability to upsell VMware and other cloud-based solutions, especially in high-growth areas of hyperconverged infrastructure and software-defined networking, but we do expect competitive markets to challenge the company's overall profitability.

We posit that Dell Technologies' debt burden may affect its ability to invest in the development and sales of future innovative products. Public shareholders have very little influence on the company's strategy and rely heavily on CEO Michael Dell and Silver Lake Partners making value-accretive decisions.

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Honeywell International HON

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Industrials	Stable	USD	150	145.27	Medium	Wide	0.97	106.33

Source: Morningstar. As of Feb. 1, 2019

While we expect the company to continue its exceptional performance, we'd want a larger margin of safety. Even so, we recommend putting this stock on a watchlist if shares trade down based on an overreaction to fears of a global economic recession.

Analyst Note, Feb. 1, 2019
Wide-moat Honeywell had a solid fourth quarter, and its full-year 2018 results were broadly in line with our expectations. As we roll our model forward for 2019, we may modestly increase our $150 fair value estimate for both the time value of money and recalibration of our homes and building technologies assumptions on higher commercial segment profit margins after the spin-off of Resideo. We also reiterate our wide moat, stable trend, medium uncertainty, and Exemplary stewardship ratings.

Full-year sales for the overall firm totaled $41.8 billion against our expectations of $41.9 billion. Total segment profits for the firm equaled $8.2 billion and income before taxes were $7.5 billion, nearly exactly in line with our expectations, while adjusted EPS came in at $8.01 per share against our expectations of $7.97 (we were slightly too aggressive in our tax assumptions for the firm). Results were propelled by both safety and productivity solutions (we really like the warehouse automation business) and aerospace.

CEO Darius Adamczyk gave some interesting color on the call regarding the macroeconomic environment. He expressed some conservatism, which we thought was an interesting contrast to his remarks nearly a year ago at the EPG multi-industrial conference. We think the conservatism is warranted, given that about 60% of Honeywell's businesses are short-cycle. Nevertheless, we reiterate our thesis that Honeywell is an ideal confluence of culture, process, and portfolio rolled up into one conglomerate. We expect its rigorous operating process will continue driving value and margin expansion for years to come, while portfolio businesses like warehouse automation will continue driving rapid sales growth at low double digits.

Honeywell's stock inexplicably dipped to below $125 on Christmas Eve, providing a rare opportunity to buy into one of the highest-quality multi-industrials at a fair price. Since then shares have increased between 15% to 20% as they rapidly converge on our $150 fair value estimate. While we expect the company to continue its exceptional performance, we'd want a larger margin of safety. Even so, we recommend putting this stock on a watchlist if shares trade down based on an overreaction to fears of a global economic recession.

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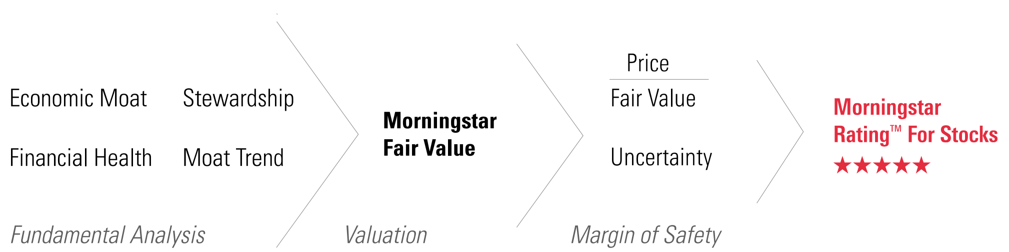
Research Methodology for Valuing Companies

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.

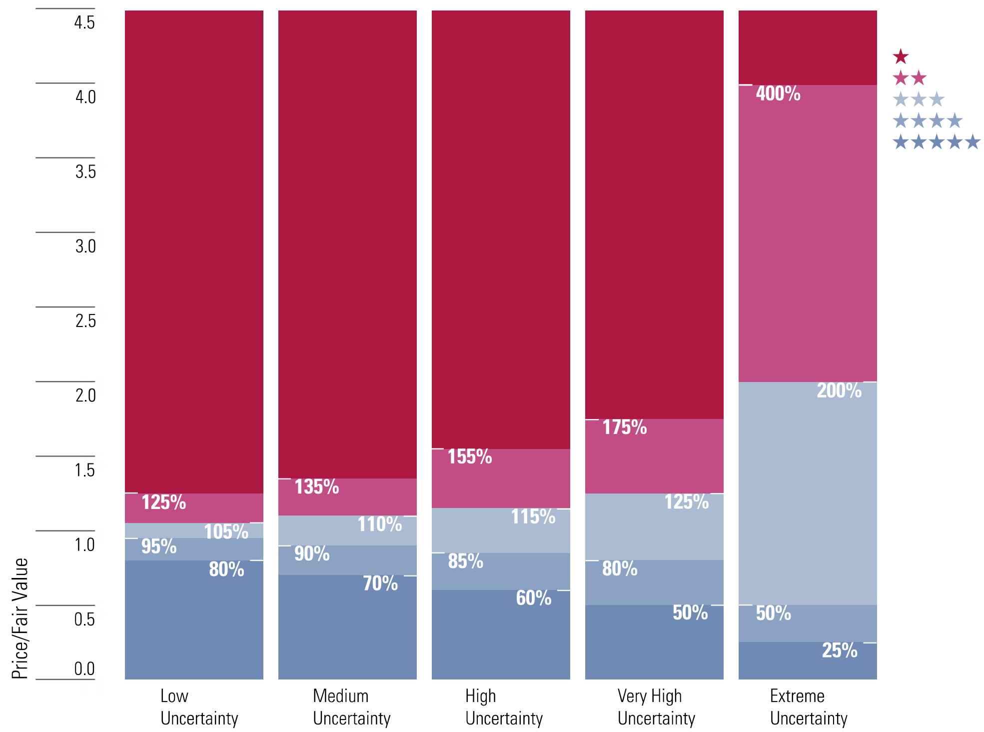
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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