

All the U.K. Telecom Companies We Cover Are Undervalued

While the United Kingdom has historically been one of the most competitive communication markets that we cover, with around 500 companies offering some kind of communication service, the best-positioned firms have succeeded in generating solid returns on capital. However, market sentiment has gone against the U.K. telecom industry recently, and all of these operators that we cover are trading in either 4- or 5-star territory. We believe a general misunderstanding regarding the nature of competition in the U.K. market, perhaps coupled with Brexit fears, has created a compelling opportunity to invest across the sector.

Though hundreds of firms compete in the U.K., only a few own networks, with the majority wholesaling capacity from a facilities-based rival. On the fixed-line side, nearly all operators wholesale at least some capacity from BT. On the wireless side, there are a significant number of mobile virtual network operators, or MVNOs, that rent capacity from one of the mobile network operators, or MNOs, but few have gained enough scale to be very profitable.

Three MNOs compete against BT: O2, owned by Telefonica; Vodafone; and 3 UK, owned by CK Hutchison. However, none of these rival operators owns a retail fixed-line network, instead wholesaling capacity from BT. BT's primary fixed-line competitor, Virgin Media, is the country's cable-TV operator, owned by Liberty Global. Virgin only operates on the wireless side as an MVNO. The largest pay-TV provider, satellite operator Sky, is also the second-largest broadband provider after BT, but Sky uses BT's network to reach its customers. Among undervalued U.K. telecom assets, BT is particularly attractive.

- ▶ Despite extensive competition in the U.K., we believe Telefonica, BT, Vodafone, Liberty Global, and Sky have narrow economic moats due to cost advantages and efficient scale.
- ▶ BT's acquisition of EE in 2016 created the only operator that owns both fixed-line and wireless networks. The firm is finally offering a converged product to take advantage of this unique situation.
- ▶ Several new companies have announced extensive fibre buildout plans, but we believe BT's size and scale advantage will enable it to remain the broadband leader in the country. Historically, Europe has been slow to move to new generations of wireless technology, but BT has announced aggressive rollout plans for 5G.
- ▶ Sky and BT have recently shown some restraint in bidding for content, which should help profitability and free cash flow.
- ▶ Ofcom has been one of the most aggressive regulators globally, so we don't see Brexit affecting telecom regulation, though it might have some impact on the companies' operations. We continue to believe that regulators won't allow consolidation amongst the large U.K. companies that we cover, but consolidation amongst the smaller operators would make sense in order to gain scale and rationalize competition amongst these players.
- ▶ All the operators we cover in the U.K. are currently undervalued, with Telefonica trading in 5-star territory and the rest at 4 stars. The telecom operators provide nice dividend yields while shareholders wait for market sentiment to turn. Telefonica, Vodafone, and BT remain on our Best Ideas list.

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	\$12.03	High	Narrow	0.62	4.76	Inton
Compass Minerals International (CMP)	★★★★	\$81	\$46.84	High	Wide	0.58	1.59	Goldstein
James Hardie Industries (JHX)	★★★★	AUD 21.2	AUD 15.08	Medium	Narrow	0.71	6.67	Slade
Martin Marietta Materials (MLM)	★★★★	\$250	\$175.5	High	Narrow	0.70	11.01	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 251.45	High	Narrow	0.70	24.95	C. Nichols
China Mobile (941)	★★★★	HKD 97	HKD 74.95	Medium	Narrow	0.77	1534.64	Baker
Telefonica (TEF)	★★★★★	\$13	\$7.79	High	Narrow	0.60	40.45	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.87	Medium	Narrow	0.65	34.13	Han
Vodafone Group (VOD)	★★★★	\$250	\$160.48	High	Narrow	0.64	42.88	C. Nichols
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	\$240	\$151.48	High	Wide	0.63	389.60	Hottovy
Anta Sports Products (2020)	★★★★★	HKD 55	HKD 37.3	Medium	Narrow	0.68	100.15	Su
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 74.18	High	Narrow	0.63	48.30	Hilgert
Cie Financiere Richemont (CFR)	★★★★	CHF 90	CHF 63.56	High	Wide	0.71	35.89	Sokolova
Dufry (DUFN)	★★★★	CHF 144	CHF 95.5	High	Narrow	0.66	4.82	Sokolova
Expedia Group (EXPE)	★★★★	\$180	\$119.59	High	Narrow	0.66	17.82	Wasiolek
General Motors (GM)	★★★★	\$46	\$35.11	High	None	0.76	49.55	Whiston
Hanesbrands (HBI)	★★★★★	\$27	\$13.8	Medium	Narrow	0.51	4.98	Swartz
InvoCare (IVC)	★★★★	AUD 16	AUD 11.23	Medium	Wide	0.70	1.24	Ragonese
Mattel (MAT)	★★★★	\$21	\$12.08	High	Narrow	0.58	4.17	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	\$69	\$47.27	High	Narrow	0.69	10.40	Katz
Walt Disney (DIS)	★★★★	\$130	\$113.39	Medium	Wide	0.87	168.80	Macker
WPP (WPP)	★★★★★	GBX 1450	GBX 870.8	Medium	Narrow	0.60	10.99	Mogharabi
Consumer Defensive								
A2 Milk (ATM)	★★★★	AUD 13.7	AUD 10.75	High	Narrow	0.78	8.24	Fleck
Anheuser-Busch InBev (BUD)	★★★★★	\$118	\$71.3	Low	Wide	0.60	141.51	Gorham
G8 Education (GEM)	★★★★	AUD 3.5	AUD 2.83	High	None	0.81	1.29	James
General Mills (GIS)	★★★★★	\$58	\$38.12	Low	Wide	0.66	22.73	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2422	Low	Wide	0.65	23.10	Gorham
Mondelez International (MDLZ)	★★★★	\$52	\$44.35	Medium	Wide	0.85	64.48	Lash
Energy								
Cenovus Energy (CVE)	★★★★★	\$21	\$10.6	Very High	None	0.50	13.03	Gemino
Diamondback Energy (FANG)	★★★★	\$148	\$96.32	High	Narrow	0.65	15.80	Meats
Enbridge (ENB)	★★★★★	\$62	\$43.11	Medium	Wide	0.70	78.82	Gemino
Enterprise Products Partners (EPD)	★★★★★	\$35.5	\$26.29	Low	Wide	0.74	57.38	Ellis
Royal Dutch Shell (RDS.B)	★★★★	\$83	\$60.57	Medium	Narrow	0.73	244.64	Good
Total (TOT)	★★★★	\$77	\$55.65	Medium	None	0.72	145.53	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 31.16	High	None	0.67	29.17	Taylor
Financial Services								
Agricultural Bank of China (601288)	★★★	CNY 4.2	CNY 3.57	High	Narrow	0.85	1232.53	Tan
Altaba (AABA)	★★★★	\$98	\$62.76	High	None	0.64	37.82	Mogharabi
American International Group (AIG)	★★★★★	\$76	\$37.29	Medium	None	0.49	32.99	Horn
BlackRock (BLK)	★★★★	\$500	\$387.27	Medium	Wide	0.77	61.45	Warren
Capital One Financial (COF)	★★★★★	\$127	\$80.39	Medium	Narrow	0.63	38.08	Plunkett
Credit Suisse Group (CSGN)	★★★★★	CHF 22	CHF 11.2	High	Narrow	0.51	28.59	Scholtz

Source: Morningstar. As of Dec. 14, 2018