Research Highlights

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

Morningstar Equity Research
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Note: There will be no Research Highlights published next week, Dec. 24-28, because of the Christmas holiday.

Uncovering Competitive Advantages in the Beauty Industry

The cosmetics industry has remained largely unencumbered by several of the dynamics weighing on the broader consumer goods space, including tepid volume performance, concerns around pricing amid inflationary headwinds and mounting competitive threats (from both branded operators and private-label substitutes), and a shift to the digital channel that has helped level the playing field for more inventive upstarts.

However, we contend that several traits inherent to the cosmetics market have helped it navigate this environment more nimbly than its consumer packaged goods peers. For one, beauty consumers are relatively price-insensitive, placing a greater importance on a proven formulation or brand image, which has allowed several manufacturers to demonstrate material pricing power and constrained the degree of private-label penetration to just a low-single-digit level. As a result, brand strength underpins competitive advantages in the cosmetics market.

Moreover, the leading beauty operators have made considerable investments to support this brand strength, with combined spending on marketing and research and development amounting to around one fourth of sales on average versus a mid-single-digit to low-double-digit rate for the CPG space at large, allowing them to more effectively bring value-added innovation to market and display the benefits of new offerings to consumers. We expect increasing rates of per capita beauty expenditures, as well as premiumization trends within the category's existing consumer base, will fuel mid-single-digit growth longer term, and that players with a competitive edge are best poised to benefit from these trends and maintain their share despite evolving distribution dynamics.

The Morningstar Cosmetics Brand Strength Framework

We introduce the Morningstar Cosmetics Brand Strength Framework to measure brand strength across five metrics: pricing power, the importance of safety/risk-aversion, industry concentration, protection from private-label competition, and the importance of conspicuous consumption. We found the makeup and skincare categories to be the most advantageous to supporting brand strength and determined that L'Oréal, Estee Lauder, and Shiseido had the greatest degree of brand strength among the leading cosmetics firms. We also consider the degree to which a company benefits from entrenched retail relationships when evaluating competitive dynamics, as we believe that these relationships allow the top firms to command attractive shelf space. Finally, we examined direct operating margins across the industry to identify firms with a cost edge, which is primarily driven by economies of scale in cosmetics.

We contend that the combination of substantial brand strength, enduring retail relationships, and a cost advantage warrant wide moat ratings for L'Oréal and Estee Lauder.

Companies Must Invest Behind Their Brands

Cosmetics companies invest an outsize proportion of their sales into brand-building (marketing and R&D), with spending in these areas averaging north of 25% of sales at the industry level versus the midsingle digits to low double digits of most other consumer goods firms. From our vantage point, this spending is essential for firms to maintain their market share and keep their competitive positioning intact. However, we don't think firms can merely spend their way to growth. Rather, we think it is important to monitor the ways in which a firm's allocation to marketing and R&D spending changes over time and compares to its peer set, as firms that consistently underinvest in their brands or cut into their spending as a way to expand their bottom lines are likely to falter.

Digital Becoming Key

The digital channel has become an important component of the global cosmetics market, with penetration standing at a low-double-digit level. Even within brick-and-mortar retailers, we've seen a shift away from department stores and toward specialty multibrand retailers, like Sephora and Ulta. However, we think cosmetics manufacturers will be able to preserve their brand equity as their distribution diversifies, thanks to selective distribution agreements (for example, online sales are primarily through brand websites and trusted retail partners) and consistent pricing across channels, particularly at the high end of the market. Further, we think the digital channel presents opportunities for companies to facilitate the discovery of their brands and engage with their customers after purchases.

Top Investment Ideas in Cosmetics

Coty: Discounted Valuation Offers Attractive Entry Point for Patient Investors

Shares of Coty have plummeted over the last year, trading at a 12 times forward multiple to earnings at present (less than half of the multiple warranted at the start of the year). We attribute this decline to growing pessimism about the firm's top-line prospects, as its consumer beauty business continues to languish, and its ability to integrate and extract cost efficiencies from the beauty brands it acquired from Procter & Gamble in October 2016. However, we don't expect Coty's road to recovery to be easy, as supply chain disruptions (beginning in the fourth quarter of its fiscal 2018) led to heightened promotional pressure and shelf space losses at its retail partners, and near-term execution risk remains a concern. Nonetheless, shares trade at a greater than 40% discount to our valuation, providing a substantial margin of safety.

Our outlook for Coty incorporates top-line recovery after fiscal 2019, with low-single-digit sales growth longer term (below the mid- to high single digits we expect for its wide-moat peers Estee Lauder and L'Oréal) as it attempts to refresh brands like CoverGirl, which we suspect were underinvested in when part of P&G, and bring products that better resonate with consumer tastes to market. Further, a mix shift within its fragrance business toward more premium offerings (following the P&G deal) should also prop up sales. However, Coty will need to maintain significant investments in marketing and R&D, which should allow it to bring more innovative fare to market and tout its benefits to the consumer; we model combined annual expenditures in these categories amounting to nearly 26% of sales (or $2.4 billion on average) over the next five years. We expect average operating margin slightly below 9% over the next five years (80 basis points above its five-year historical average), but don't expect Coty to close the gap with its wide-moat peers, which we forecast to achieve operating margin in the high teens over this time frame.

Estee Lauder: Keep a Close Eye on Shares That Could Be Compelling at a Wider Margin of Safety
While shares of Estee Lauder are trading at a slim discount to our valuation, we'd suggest investors keep the name on their radar and wait for a more attractive entry point. We've seen occasional buying opportunities present themselves in response to more near-term concerns (for example, tariffs on cosmetics in China), and we remain confident that Estee Lauder's appealing competitive edge will support its long-term prospects. Further, with its sales entirely derived from premium fare (we estimate the firm holds a midteens share of the global prestige beauty market), we posit that Estee Lauder is best positioned to benefit from ongoing premiumization trends. Our valuation incorporates around 6% sales growth longer term, fueled by the skincare and makeup categories (that contribute more than 80% of sales), as the firm's distribution expands in the quickly growing specialty multibrand, online, and travel retail channels (which contribute roughly one third of sales). We also expect profitability to strengthen longer term as the firm continues to extract costs from its operations, with operating margin reaching 18% in fiscal 2023.

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Buy the Chip Equip Dip

In April 2016, we published a report on the wafer fabrication equipment, or WFE, space, When the Chips Are Down, Bet on Capital Equipment Firms, which highlighted the major equipment providers: Applied Materials, Lam Research, ASML, KLA-Tencor, and Tokyo Electron. Since then, the average stock price increase for these five players is 60%, even after the market's recent pullback. Over the same period, the S&P 500 has risen 23%. More recently, semiconductor stocks have been mired in a broad sell-off from recent highs stemming from an array of factors including macro-related concerns such as tariffs and the escalating trade war between the United States and China, inventory builds across key end markets such as smartphones, and memory price declines. This has led to concerns about a cyclical downturn that will negatively affect WFE levels in 2019 and beyond. However, we foresee a longer-term recovery in WFE thanks to end-market diversity beyond PC and smartphones for chipmakers, which includes the shift to the public cloud, rise in automotive chip content, investment in 5G, and artificial intelligence. Consequently, our top three picks (wide-moat Applied and KLA and narrow-moat Lam) trade at attractive discounts to our fair value estimates, with an average 41% upside.

For 2019, we anticipate a decline in WFE spending from record 2018 levels ($50 billion-plus) chiefly due to softer memory investments. Nonetheless, we remain positive on the space as stronger service revenue should support the overall top line of each firm, while logic and foundry investments related to leading-edge process technologies will also buttress overall WFE levels. Beyond 2019, we foresee healthy WFE growth as traversing the path prescribed by Moore's Law remains increasingly challenging and requires greater process intensity for advanced equipment, in addition to the aforementioned broader end-market diversity that should help normalize future WFE trajectories. Meanwhile, we believe chipmakers (especially memory customers) are better equipped to navigate "downturns" with greater cash cushions and profitability levels from the recent memory upswing, thanks to more rational behavior from a supply/demand standpoint. Consequently, near-term delays in equipment spending by the likes of Samsung and Micron in fact validate our view of a healthier, more diverse semiconductor market.

Following a down year in 2019, we forecast average revenue growth of 7.5% for our top three WFE picks through 2023. In contrast, we think current valuation levels imply average top-line growth of just 2.4% following 2019 for these firms. From a forward 2019 price/earnings standpoint, the average for the top three is 9 times relative to our fair value assumption of 13 times. We implore prospective investors to remain vigilant for attractive entry points for these high-quality vendors, which offer an appealing way to play the semiconductor market given that all types of chips are made using equipment from these companies.

- Leading wafer fabrication equipment firms boast economic moats stemming from cost advantages and intangible assets, in our view, that allow for sustainable excess returns.
- 2019 WFE growth will be lower than 2018 as memory investments subside, but logic and foundry spending should partially offset this weakness thanks to ramps of the latest process nodes from Intel and TSMC. Growing service revenue derived from large installed bases should also assuage near-term headwinds.

- We anticipate healthy WFE growth beyond 2019 as greater end-market diversity and process intensity further mitigate the cyclicality of future equipment spending by the likes of Samsung, Intel, and TSMC.
- We forecast a compound annual growth rate of 7.5% for WFE spending over the four years after 2019, thanks to more sophisticated process technologies for both memory and logic, with new materials and structures as well as smaller geometries and feature sizes.
- Although PCs and smartphones continue to dominate the semiconductor space, burgeoning trends such as the shift to the cloud, rise in automotive chip content, artificial intelligence, 5G, and virtual reality will collectively support healthy WFE levels as the range of chip types needed will become more heterogeneous.
- China remains a substantial upside driver for WFE spending in the coming years as it strives to develop its own national champions for memory and logic semiconductor manufacturing, with NAND flash storage serving as the lowest-hanging fruit, in our view. Recent spending trends from indigenous Chinese chipmakers support our thesis that China will remain a positive upside catalyst.
- Our top picks are wide-moat KLA-Tencor and Applied Materials as well as narrow-moat Lam Research, thanks to their powerful combination of attractive valuations, technology leadership, product breadth, and favorable end-market exposure.
- We forecast average revenue growth of 7.5% for our top three WFE picks from 2019 to 2023. In contrast, we think current valuation levels imply average top-line growth of just 2.4% following 2019 for these firms.

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Unprecedented Pricing Surge Drove Trucking Stocks to the Fast Lane

Following a mini freight recession in 2016, the truckload, or TL, shipping landscape enjoyed a remarkable recovery in the latter half of 2017, and operating conditions proved exceptionally robust over the past year. TL capacity entered an unprecedented tightening phase on the back of strong shipment demand, widespread adoption of electronic logging devices, and constrained driver availability, translating into a massive uptick in carriers' pricing power.

Less-than-truckload capacity isn't nearly as tight, but carriers are benefiting from healthy economic growth (solid freight demand) and spillover shipments from the supply-constrained TL sector. We think the trucking industry supply/demand balance will still favor carriers in 2019, but pricing will normalize in the years ahead as carriers continue calibrating to ELDs and drivers gradually enter the TL market. We've long baked that dynamic into the midcycle assumptions supporting our TL and LTL fair value estimates.

Importantly, investor expectations have been in the process of resetting in recent quarters as it's become more obvious that most truckers have little chance of matching the unparalleled rate gains (and related margin and EPS growth) achieved in 2018. Thus, market valuations are correcting, following a long stretch of our rating these stocks as highly overvalued. Most trucking names we cover now reflect more realistic long-term growth assumptions, and we think this sets the stage for buying opportunities.

- TL capacity utilization surged to a staggering 100% in fourth-quarter 2017 and has hovered at unusually high levels since, according to FTR. Extremely tight supply pushed spot rates to unprecedented levels by June 2018 and contract rate gains weren't far behind thanks to a robust bidding season.
- ELDs have been the foremost driver of disruption (likely removing about 5% of TL-industry capacity), while the limited driver pool hinders truckers' ability to quickly offset lost productivity with fleet growth.
- Gains will moderate, but we expect TL-industry rates (excluding fuel) to rise around 2% in 2019 on strong 2018 contract pricing. As spot rates normalize and contract rates amortize in, pricing could come in flat-to-down slightly in 2020. Our fair value estimates bake in midcycle pricing/demand growth near 2%.
- TL leaders Knight-Swift and Schneider National are modestly undervalued—a dynamic we haven't seen in years. Best-in-class LTL carrier Old Dominion remains overvalued, partly because of investor enthusiasm over impressive execution and persistent share gains.

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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	$10.91	High	Narrow	0.56	4.32	Inton
Compass Minerals International (CMP)	★★★★★	$81	$39.96	High	Wide	0.49	1.35	Goldstein
James Hardie Industries (JHX)	★★★★	AUD 21.2	AUD 14.57	Medium	Narrow	0.69	6.44	Slade
Martin Marietta Materials (MLM)	★★★★	$240	$167.95	High	Narrow	0.70	10.53	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 250.05	High	Narrow	0.69	24.81	C. Nichols
China Mobile (941)	★★★★	HKD 97	HKD 75.35	Medium	Narrow	0.78	1542.83	Baker
Telefonica (TEF)	★★★★★	$13	$7.49	High	Narrow	0.58	38.89	C. Nichols
Telstra (TLS)	★★★★★	AUD 4.4	AUD 2.74	Medium	Narrow	0.62	32.59	Han
Vodafone Group (VOD)	★★★★	$250	$159.96	High	Narrow	0.64	42.74	C. Nichols
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★★	$240	$135.11	High	Wide	0.56	347.49	Hottovy
ANTA Sports Products (2020)	★★★★★	HKD 55	HKD 36.1	Medium	Narrow	0.66	96.92	Su
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 71.84	High	Narrow	0.61	46.74	Hilgert
Cie Financiere Richemont (CFR)	★★★★	CHF 90	CHF 62.1	High	Wide	0.69	35.06	Sokolova
Dufry (DUFN)	★★★★	CHF 144	CHF 91.48	High	Narrow	0.64	4.62	Sokolova
Expedia Group (EXPE)	★★★★	$180	$114.31	High	Narrow	0.64	17.03	Wasiolek
General Motors (GM)	★★★★	$46	$34.27	High	None	0.75	48.37	Whiston
Hanesbrands (HBI)	★★★★★	$27	$12.09	Medium	Narrow	0.45	4.36	Swartz
InvoCare (IVC)	★★★★★	AUD 16	AUD 10.4	Medium	Wide	0.65	1.14	Ragonese
Mattel (MAT)	★★★★★	$21	$10.04	High	Narrow	0.48	3.47	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	$69	$42.3	High	Narrow	0.61	9.30	Katz
Walt Disney (DIS)	★★★★	$130	$107	Medium	Wide	0.82	159.29	Macker
WPP (WPP)	★★★★★	GBX 1450	GBX 866.8	Medium	Narrow	0.60	10.94	Mogharabi
Consumer Defensive								
A2 Milk (ATM)	★★★★	AUD 13.7	AUD 10.54	High	Narrow	0.77	7.72	Fleck
Anheuser-Busch InBev (BUD)	★★★★★	$118	$67.78	Low	Wide	0.57	132.93	Gorham
G8 Education (GEM)	★★★★	AUD 3.5	AUD 2.61	High	None	0.75	1.19	James
General Mills (GIS)	★★★★★	$57	$39.07	Low	Wide	0.69	23.31	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2328	Low	Wide	0.63	22.20	Gorham
Mondelez International (MDLZ)	★★★★	$52	$41.16	Medium	Wide	0.79	59.84	Lash
Energy								
Cenovus Energy (CVE)	★★★★★	$19	$9.15	Very High	None	0.48	11.24	Gemino
Diamondback Energy (FANG)	★★★★	$120	$89.03	High	Narrow	0.74	14.61	Meats
Enbridge (ENB)	★★★★★	$62	$41.89	Medium	Wide	0.68	84.69	Gemino
Enterprise Products Partners (EPD)	★★★★★	$35.5	$24.51	Low	Wide	0.69	53.50	Ellis
Royal Dutch Shell (RDS.B)	★★★★	$83	$57.63	Medium	Narrow	0.69	236.84	Good
Total (TOT)	★★★★	$77	$52.24	Medium	None	0.68	136.40	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 29.92	High	None	0.64	28.01	Taylor
Financial Services								
Agricultural Bank of China (601288)	★★★	CNY 4.2	CNY 3.51	High	Narrow	0.84	1211.51	Tan
Altaba (AABA)	★★★★	$98	$56.71	High	None	0.58	34.17	Mogharabi
American International Group (AIG)	★★★★★	$76	$38.15	Medium	None	0.50	33.75	Horn
BlackRock (BLK)	★★★★	$500	$371.67	Medium	Wide	0.74	58.98	Warren
Capital One Financial (COF)	★★★★★	$127	$74.49	Medium	Narrow	0.59	35.28	Plunkett
Credit Suisse Group (CSGN)	★★★★★	CHF 22	CHF 10.71	High	Narrow	0.49	27.34	Scholtz

Source: Morningstar. As of Dec. 21, 2018

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 8.5	AUD 6.59	Medium	Narrow	0.78	3.49	James
Macquarie Group (MQG)	★★★★	AUD 135	AUD 104.82	Medium	Narrow	0.78	35.98	Ellis
Oversea-Chinese Banking Corp (O39)	★★★★	SGD 13.6	SGD 11.07	High	Narrow	0.81	47.05	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 7.65	Medium	Narrow	0.70	2.43	Likos
Sumitomo Mitsui Financial Group (8316)	★★★★★	JPY 5960	JPY 3669	Medium	None	0.62	5134.40	Makdad
T. Rowe Price Group (TROW)	★★★★	$120	$87.3	Medium	Wide	0.73	21.01	Warren
Westpac Banking (WBC)	★★★★	AUD 33	AUD 23.83	Medium	Wide	0.72	81.71	Ellis
Healthcare								
Allergan (AGN)	★★★★★	$245	$135.63	Medium	Wide	0.55	45.75	Waterhouse
DaVita (DVA)	★★★★★	$81	$51.22	Medium	Narrow	0.63	8.50	Strole
Medtronic (MDT)	★★★★	$110	$89.9	Medium	Wide	0.82	120.74	Wang
Roche Holding (ROG)	★★★★★	CHF 333	CHF 243.4	Low	Wide	0.73	207.20	Andersen
Industrials								
Anixter International (AXE)	★★★★★	$107	$54.3	Medium	Narrow	0.51	1.82	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 41.4	Medium	Narrow	0.71	52.25	Song
CK Hutchison Holdings (1)	★★★★★	HKD 118	HKD 76.3	Medium	None	0.65	294.23	Tan
G4S (GFS)	★★★★★	GBX 337	GBX 188.9	Medium	None	0.56	2.93	Field
GEA Group (G1A)	★★★★★	EUR 45	EUR 21.81	Medium	Wide	0.48	3.94	Molina
General Dynamics (GD)	★★★★	$216	$154.61	Medium	Wide	0.72	45.79	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★★	MXN 210	MXN 161.01	High	Wide	NA	90.33	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.3	HKD 2.85	High	None	0.45	24.10	Song
Johnson Controls International (JCI)	★★★★	$46	$30.49	High	Narrow	0.66	28.17	Bernard
KION GROUP (KGX)	★★★★★	EUR 90	EUR 41.41	Medium	Narrow	0.46	4.88	Molina
Sodexo (SW)	★★★★	EUR 110	EUR 88.52	Medium	Narrow	0.80	12.89	Field
Stericycle (SRCL)	★★★★★	$83	$37.86	High	Narrow	0.46	3.43	Young
Real Estate								
AVEO Group (AOG)	★★★★	AUD 2.3	AUD 1.55	Medium	None	0.67	0.89	Sherlock
CK Asset Holdings (1113)	★★★★	HKD 81	HKD 57	Medium	Narrow	0.70	210.52	Zhong
Macerich (MAC)	★★★★	$59	$41.82	High	Narrow	0.71	5.90	Brown
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 113.1	Medium	Narrow	0.74	327.65	Zhong
Technology								
Applied Materials (AMAT)	★★★★	$49	$30.9	High	Wide	0.63	29.62	Davuluri
Intel (INTC)	★★★★	$65	$45.54	Medium	Wide	0.70	207.84	Davuluri
KLA-Tencor (KLAC)	★★★★	$128	$85.89	High	Wide	0.67	13.15	Davuluri
Lam Research (LRCX)	★★★★	$185	$128.31	High	Narrow	0.69	19.91	Davuluri
Microchip Technology (MCHP)	★★★★★	$112	$68.73	Medium	Wide	0.61	16.26	Colello
Murata Manufacturing (6981)	★★★★	JPY 24000	JPY 15035	High	Narrow	0.63	3206.32	Ito
Skyworks Solutions (SWKS)	★★★★	$113	$65.64	High	Narrow	0.58	11.65	Colello
Tencent Holdings (700)	★★★★	HKD 499	HKD 315.2	High	Wide	0.63	3000.78	Tam
Utilities								
Dominion Energy (D)	★★★★	$84	$74.82	Low	Wide	0.89	49.12	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 5.14	Medium	None	0.90	52.34	Fulop
ENN Energy Holdings (2688)	★★★★	HKD 83	HKD 68.3	Medium	Narrow	0.82	76.77	Lee
FirstEnergy (FE)	★★★★	$41	$37.4	Low	Narrow	0.91	19.13	Fishman
Orsted (ORSTED)	★★★	DKK 450	DKK 445.9	Low	Narrow	0.99	187.30	Fulop

Source: Morningstar. As of Dec. 21, 2018

Highlighted Stocks

Computershare CPU:AU

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Technology	Stable	AUD	19	16.36	Medium	Narrow	0.86	8.88

Source: Morningstar. As of Dec. 21, 2018

Despite the risks, we are comfortable with narrow-moat Computershare's rapid expansion into the mortgage-servicing sector.

Select Report, Dec. 19, 2018
The U.S. mortgage-servicing sector has a patchy track record, with many banks and third-party mortgage-servicing firms receiving large fines in recent years for violating regulations, particularly during the global financial crisis. The sector is also vulnerable to an increase in delinquencies, which usually cause a significant increase in mortgage-servicing costs, and mortgage-servicing companies must continue to make mortgage payments to lenders in the short term at least. In some circumstances, mortgage-servicing firms can also be exposed to the credit risk of borrowers.

However, despite the risks, we are comfortable with narrow-moat Computershare's rapid expansion into the mortgage-servicing sector. The company's mortgage-servicing business is spread across both the U.S. and the U.K., and we believe the U.K. exposure diversifies and reduces risks as obligations of mortgage servicers are typically lower in the U.K. We also believe the mortgage servicer fines are more reflective of industry practices before the global financial crisis and subsequent increase in regulation, so it shouldn't be considered a recurring industry cost. Computershare has a long history of managing regulatory risks in similar industries, and its mortgage services are relatively highly rated by the credit agencies. The company also has a relatively low exposure to Ginnie Mae residential mortgage-backed securities, meaning credit risks are low. We expect Computershare to grow its mortgage-servicing revenue at a CAGR of 5% over the next decade, driven by growth in unpaid principal balances due to the acquisition of mortgage-servicing rights and contract appointments. We expect the division to become the largest in the consolidated company by fiscal 2021, excluding margin income.

- We expect Computershare's mortgage-servicing division to become the largest in the group by fiscal 2021, accounting for 28% of group revenue. Excluding margin income, we expect 39% of group EBITDA to come from mortgage servicing by fiscal 2021, or 24% including margin income.
- Computershare benefits most from slowly rising interest rates, which is what we assume in our financial model.
- Mortgage servicing is exposed to cash flow and credit risks in the U.S., but we consider the probability of issues arising to be low.

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Hologic HOLX

Morningstar Rating	Sector	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★	Healthcare	Stable	USD	45	37.99	Medium	Narrow	0.84	10.98

Source: Morningstar. As of Dec. 21, 2018

Hologic's narrow moat in diagnostics and breast health makes these areas worthy of investor attention.

Select Report, Dec. 19, 2018
Hologic's high-profile acquisition of Cynosure's cosmetic laser business taps into a new cash-pay market that has delivered double-digit annual growth historically. While the addition of medical aesthetic lasers offers an avenue for faster growth at Hologic, we don't think the laser division widens the firm's narrow economic moat, as the unconsolidated industry is characterized by quick innovation, low barriers to entry, and a dearth of clinical evidence. Even Hologic's comprehensive array of cosmetic lasers and substantial installed base aren't enough to translate into a moat.

On the other hand, Hologic's narrow moat in diagnostics and breast health makes these areas worthy of investor attention. By leaning on switching costs and intangible assets, Hologic remains a significant competitor in those markets, despite going up against larger rivals with deeper pockets. Though Hologic shares have recently appreciated, we think any stumbles that might crop up as the firm rebuilds its medical aesthetics business could be an opportunity to take a second look.

- ► As with any cosmetic laser manufacturer, Hologic is vulnerable to disruptive technology and the constant threat of new entrants. With relatively little high-quality clinical data available, manufacturers compete primarily on the basis of marketing.
- ► Nonetheless, the aesthetic laser market has grown 8%-10% historically, and Cynosure racked up 24% compound annual revenue growth from 2003 to 2016. Restoring this business to match market growth is a key catalyst for shares, in our opinion.
- ► In the meantime, we remain fans of Hologic's moatier businesses, including its molecular diagnostics, expertise in testing for sexually transmitted diseases, nucleic acid testing, and superior 3D mammography technology.

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Winnebago Industries WGO

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Consumer	Stable	USD	33	22.43	Very High	Narrow	0.68	0.71

Source: Morningstar. As of Dec. 21, 2018

The brand is young in towables, so it must play a delicate balancing act between protecting the brand while remaining competitive.

Analyst Note, Dec. 19, 2018

We are not changing our Winnebago fair value estimate after the company reported a good quarter to start fiscal 2019. Diluted EPS of $0.70 beat consensus of $0.64 and grew 22.8% year over year, while revenue rose 9.7% to $493.6 million, beating consensus of about $486 million. The company finally is seeing meaningful improvement from the restructuring efforts of the motor home segment, with segment EBITDA margin up 400 basis points year over year to 6.6%, despite a 3.6% decline in segment revenue. Motorized deliveries fell 10% despite a 94% rise in Class B sales.

Towable segment revenue grew 13% but segment EBITDA fell 8%. Management cited strong discounting pressure by the competition negatively affecting results for Winnebago-branded towables. The brand is young in towables, so it must play a delicate balancing act between protecting the brand while remaining competitive. The premium towable brand, Grand Design, never discounted when it started, which helps it maintain its premium positioning. Winnebago brand on both the motorized and towable side negotiates individually with each dealer on inventory; a practice management wants to change, but we think that will take a long time.

We are glad to see Winnebago's results were not affected by recent stock market volatility, and continued cost and efficiency measures in motorized should lead to more good news in fiscal 2019 provided the U.S. does not enter a recession. Management also reports that its customers' willingness to spend on discretionary goods and services has not waned, and the RV market is not experiencing any credit shortage problems. The company backed up this optimism by announcing a 10% increase in the quarterly dividend to $0.11 per share. The balance sheet also improved from year-end, with net debt/adjusted EBITDA down to 1.4 times from 1.6 times. Fiscal first-quarter free cash flow rose 72% year over year to $41.4 million on better working capital despite capital expenditures more than doubling.

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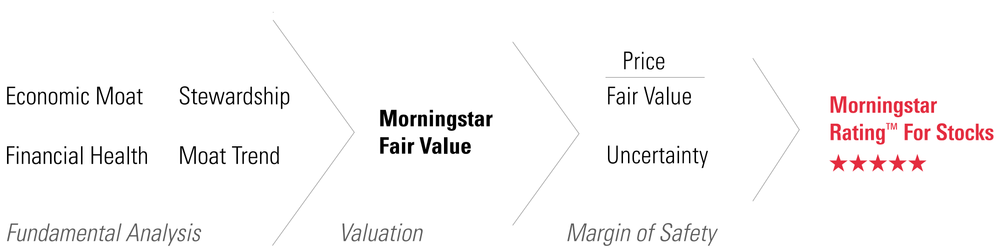
Research Methodology for Valuing Companies

Overview

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

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

Morningstar Research Methodology



Source: Morningstar.

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

Economic Moat

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

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

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

Estimated Fair Value

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

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

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

Stage II: Fade

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

Stage III: Perpetuity

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

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

Uncertainty Around That Fair Value Estimate

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

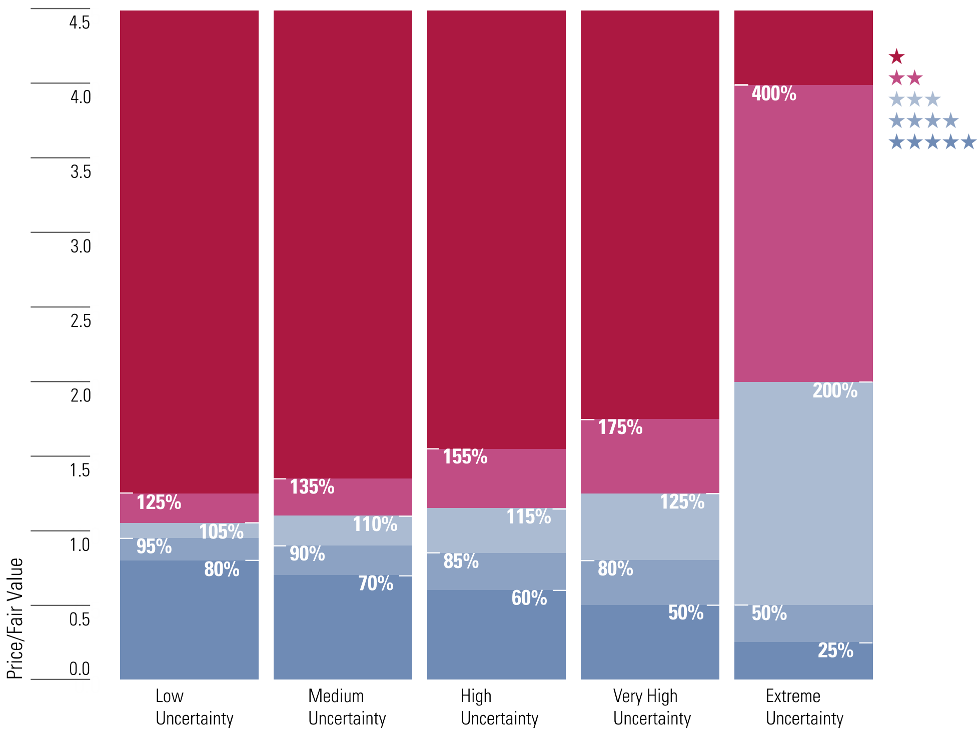
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than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

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

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

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

Morningstar Equity Research Star Rating Methodology



Market Price

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

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

Morningstar Star Rating for Stocks

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

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

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

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

The Morningstar Star Ratings for stocks are defined below:

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

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

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

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

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

Risk Warning

Please note that investments in securities are subject to market and other risks, and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in the future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's uncertainty rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

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