

- ▶ Integrated oils' free cash flow profile is set to improve materially as a 30% reduction in operating costs improves cash flow from legacy operations while new, high-margin production is added at capital costs that are in some cases nearly 40% lower than a few years ago.
- ▶ Downstream free cash flow generation should remain strong as continued favorable market conditions, thanks in part to IMO 2020, combine with past portfolio improvements to increase earnings.
- ▶ We have revisited our moat ratings in light of upstream cost improvements and are upgrading Shell and BP to narrow moats on the ability of their integrated portfolios to deliver excess returns at our midcycle oil price of \$60/bbl.
- ▶ Improved free cash flow should lead to the resumption of dividend growth after years of stagnation, along with the repurchase of shares. Chevron, Shell, Total, and Equinor have the greatest capacity for both, in our view, thanks to strong free cash flow and reasonable debt levels.
- ▶ We are increasing our fair value estimates to reflect our positive outlook, leaving the group trading at an average 15% discount, despite our bearish outlook for oil prices. With non-E&P segments typically comprising nearly a third of earnings, and natural gas 50% of production on average, valuations are less leveraged to oil prices. More importantly, in many cases, current market values do not reflect the improvement in free cash flow we expect, even at \$60/bbl oil, with Best Ideas Shell and Total trading at the greatest discounts.

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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)	★★★★	\$17	\$9.76	High	Narrow	0.57	3.95	Inton
Compass Minerals International (CMP)	★★★★	\$83	\$61.35	High	Wide	0.74	2.08	Goldstein
Martin Marietta Materials (MLM)	★★★★	\$265	\$198.3	High	Narrow	0.75	12.50	Inton
Communication Services								
BT Group (BT.A)	★★★★	GBX 360	GBX 220.4	High	Narrow	0.61	21.87	C. Nichols
China Mobile (941)	★★★★	HKD 100	HKD 75.65	Medium	Narrow	0.76	1548.97	Baker
Comcast (CMCSA)	★★★★	\$42	\$35.92	Medium	Wide	0.86	164.58	Macker
Telefonica (TEF)	★★★★★	\$13	\$6.77	High	Narrow	0.52	35.18	C. Nichols
Telstra (TLS)	★★★★	AUD 4.4	AUD 3.13	Medium	Narrow	0.71	37.23	Han
Consumer Cyclical								
Alibaba Group Holding (BABA)	★★★★	\$240	\$159.87	High	Wide	0.67	411.17	Hottovy
Bayerische Motoren Werke (BMW)	★★★★	EUR 117	EUR 80.73	High	Narrow	0.69	52.46	Hilgert
Expedia Group (EXPE)	★★★★	\$185	\$124.53	High	Narrow	0.67	18.61	Wasiolek
General Motors (GM)	★★★★	\$45	\$34.38	High	None	0.76	48.51	Whiston
Hanesbrands (HBI)	★★★★★	\$27	\$17.66	Medium	Narrow	0.65	6.37	Hottovy
InvoCare (IVC)	★★★★	AUD 17	AUD 12.65	Medium	Wide	0.74	1.39	Ragonese
Mattel (MAT)	★★★★	\$21.5	\$15.33	High	Narrow	0.71	5.28	Katz
Norwegian Cruise Line Holdings (NCLH)	★★★★	\$69	\$53.2	High	Narrow	0.77	11.78	Katz
Walt Disney (DIS)	★★★★	\$130	\$110.26	Medium	Wide	0.85	163.98	Macker
WPP (WPP)	★★★★	GBX 1500	GBX 1144.5	Medium	Narrow	0.76	14.44	Mogharabi
Consumer Defensive								
G8 Education (GEM)	★★★★★	AUD 3.5	AUD 2.09	High	None	0.60	0.95	James
General Mills (GIS)	★★★★★	\$59	\$47.01	Low	Wide	0.80	28.02	Vora
Imperial Brands (IMB)	★★★★★	GBX 3700	GBX 2692.5	Low	Wide	0.73	25.68	Gorham
Kao (4452)	★★★	JPY 8800	JPY 8744	Low	Wide	0.99	4262.01	Wei
Mondelez International (MDLZ)	★★★★	\$52	\$43.49	Medium	Wide	0.84	63.78	Lash
PepsiCo (PEP)	★★★★	\$123	\$113.5	Low	Wide	0.92	160.53	Vora
Procter & Gamble (PG)	★★★★	\$97	\$82.65	Low	Wide	0.85	205.73	Lash
Reckitt Benckiser Group (RB.)	★★★★	GBX 7300	GBX 6473	Low	Wide	0.89	45.76	Gorham
Energy								
Cenovus Energy (CVE)	★★★★	\$21	\$11.61	Very High	None	0.55	14.27	Gemino
Enbridge (ENB)	★★★★	\$64	\$44.99	Medium	Wide	0.70	77.18	Gemino
Enterprise Products Partners (EPD)	★★★★	\$35.5	\$28.96	Low	Wide	0.82	63.02	Ellis
Royal Dutch Shell (RDS.B)	★★★★	\$83	\$65.72	Medium	Narrow	0.79	271.11	Good
Total (TOT)	★★★★	\$77	\$60.55	Medium	None	0.79	157.92	Good
Woodside Petroleum (WPL)	★★★★	AUD 46.5	AUD 35.28	High	None	0.76	33.03	Taylor
Financial Services								
Agricultural Bank of China (601288)	★★★★	CNY 4.2	CNY 3.59	High	Narrow	0.85	1245.07	Tan
American International Group (AIG)	★★★★	\$76	\$53.9	Medium	None	0.71	47.89	Horn
Capital One Financial (COF)	★★★★	\$127	\$98.15	Medium	Narrow	0.77	46.96	Plunkett
Credit Suisse Group (CSGN)	★★★★	CHF 22	CHF 14.42	High	Narrow	0.66	36.78	Scholtz

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 (cont.)								
Invesco (IVZ)	★★★★★	\$38	\$24.22	Medium	Narrow	0.64	9.95	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 668.2	Medium	None	0.76	8739.18	Wu
Pendal Group (PDL)	★★★★	AUD 11	AUD 9.03	Medium	Narrow	0.82	2.53	Likos
Westpac Banking (WBC)	★★★★	AUD 35	AUD 27.8	Medium	Wide	0.79	94.14	Ellis
Healthcare								
Allergan (AGN)	★★★★★	\$263	\$190.5	Medium	Wide	0.72	64.66	Waterhouse
McKesson (MCK)	★★★★★	\$210	\$125.5	Medium	Wide	0.60	25.07	Lekraj
Medtronic (MDT)	★★★★	\$105	\$96.49	Medium	Wide	0.92	130.31	Wang
Ramsay Health Care (RHC)	★★★★	AUD 76	AUD 54.56	Medium	Narrow	0.72	11.03	Kallos
Roche Holding (ROG)	★★★★★	CHF 337	CHF 238.2	Low	Wide	0.71	203.88	Andersen
Industrials								
Anixter International (AXE)	★★★★★	\$107	\$70.25	Medium	Narrow	0.66	2.35	Bernard
Beijing Enterprises Holdings (392)	★★★★★	HKD 58	HKD 39.05	Medium	Narrow	0.67	49.28	Song
CK Hutchison Holdings (1)	★★★★	HKD 118	HKD 89.85	Medium	None	0.76	346.48	Tan
G4S (GFS)	★★★★	GBX 337	GBX 233.3	Medium	None	0.69	3.62	Field
GEA Group (G1A)	★★★★★	EUR 47	EUR 31.57	Medium	Wide	0.67	5.70	Molina
General Dynamics (GD)	★★★	\$220	\$195.24	Medium	Wide	0.89	57.85	Higgins
Grupo Aeroportuario del Pacifico (GAP B)	★★★	MXN 217	MXN 195.44	High	Wide	0.90	109.64	Higgins
Guangshen Railway (525)	★★★★★	HKD 6.5	HKD 3.35	High	None	0.52	28.04	Song
Johnson Controls International (JCI)	★★★★	\$53	\$38.83	High	Narrow	0.73	35.91	Bernard
Kion GROUP (KGX)	★★★★★	EUR 90	EUR 55.92	Medium	Narrow	0.62	6.59	Molina
Royal Philips (PHIA)	★★★★	EUR 42	EUR 37.14	Medium	Narrow	0.88	34.60	Vonk
Sodexo (SW)	★★★★	EUR 110	EUR 88.24	Medium	Narrow	0.80	12.85	Field
Stericycle (SRCL)	★★★★	\$86	\$61.95	High	Narrow	0.72	5.32	Young
Real Estate								
Aveo Group (AOG)	★★★★	AUD 2.8	AUD 2.29	Medium	None	0.82	1.33	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 111.8	Medium	Narrow	0.73	323.88	Zhong
Welltower (WELL)	★★★	\$74	\$67.46	High	None	NA	25.10	Brown
Technology								
Intel (INTC)	★★★★	\$65	\$47.26	Medium	Wide	0.73	217.92	Davuluri
Microchip Technology (MCHP)	★★★★	\$112	\$83.9	Medium	Wide	0.75	19.76	Colello
MYOB Group (MYO)	★★★★	AUD 3.82	AUD 2.92	Medium	Narrow	0.76	1.73	James
Synaptics (SYNA)	★★★★	\$64	\$45.97	Very High	None	0.72	1.63	Davuluri
TDK (6762)	★★★	JPY 12500	JPY 12060	High	None	0.96	1522.52	Ito
Tencent Holdings (700)	★★★★★	HKD 590	HKD 316.8	High	Wide	0.54	3016.64	Tam
Utilities								
Dominion Energy (D)	★★★★	\$84	\$72.25	Low	Wide	0.86	47.23	Fishman
Enel (ENEL)	★★★★	EUR 5.7	EUR 4.37	Medium	None	0.77	44.51	Fulop
FirstEnergy (FE)	★★★★	\$41	\$37.96	Low	Narrow	0.93	18.45	Fishman
Scana (SCG)	★★★★★	\$56	\$36.68	Medium	Narrow	0.66	5.23	Miller

Pendal Group PDL:AU

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Financial	Stable	AUD	11	9.03	Medium	Narrow	0.82	2.53

Source: Morningstar. As of Sept. 7, 2018

We particularly like the firm's diversity across asset-class exposures and geography, as well as growth opportunities being explored in the United States.

Analyst Note, Sept. 7, 2018

Narrow-moat-rated Pendal Group was recently placed on our global Best Ideas list and remains our preferred pure-play domestic asset manager. We particularly like the firm's diversity across asset-class exposures and geography, as well as growth opportunities being explored in the United States. Furthermore, the industry continues to benefit from favorable demographic tailwinds and secular growth in compulsory superannuation contributions. On the other hand, the industry continues to face fee pressure from increasing competition, particularly low-cost passive alternatives, an uncertain political climate in the United Kingdom and the risk of weak investment markets globally. Nevertheless, the company screens as undervalued at current prices and continues to be supported by an attractive grossed up dividend yield of approximately 6% for fiscal year 2018.

In its most recent June quarterly update, Pendal reported a slight increase in total funds under management, or FUM, but the result was marred by a disappointing performance in the U.K. subsidiary, JO Hambro. The quarterly AUD 1 billion increase in total FUM to AUD 100 billion was the result of a net AUD 1.2 billion increase in Pendal Australia FUM and a net AUD 200 million outflow in JO Hambro FUM. Not long after the disappointing JO Hambro performance was disclosed, Pendal Group announced the departure of Ken Lambden, the CEO of JO Hambro, effective immediately. A global search for his replacement remains under way with no indication of when a replacement will be announced. Changes to the global executive team continued this week when Bindesh Savjani, who will begin his new role in February 2019, was announced global chief risk officer.

Another drag on Pendal's stock price in recent months has been Westpac's expected sell-down of its 10% stake in the asset manager. According to Westpac, it intends to sell when market conditions are favorable enough to do so. We anticipate this transaction to take place in calendar 2018, although should market conditions turn less favorable, would likely see it executed in 2019. Until they sell, expect some technical pressure on the share price.

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