Research Highlights

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

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Your Search for Big Tech M&A Has Few Results Due to Antitrust Issues

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Technology companies have spearheaded US economic growth over the last two decades. Startups founded in garages, apartments, and dormitory rooms have grown from disruptors to industry incumbents with powerful network effects, intangible assets, and cost advantages protecting their competitive advantages. Our discussion of these companies, also known as Big Tech, encompasses Microsoft, Amazon, Meta, Alphabet, Apple, and Nvidia.

As these tech giants have gotten bigger, the attitude toward them in Washington, as well as European capitals, has evolved. After initially celebrating their disruption, creation of jobs, and promotion of economic growth, in recent years lawmakers around the world have become more critical as these companies have amassed sizable influence over slices of the global economy.

From court cases regarding market power to increased scrutiny of mergers and acquisitions, large technology companies face a plethora of regulatory headwinds. At the same time, the regulatory scrutiny they face depends on how aggressively the US government chooses to pursue existing court cases and how much oversight it provides on proposed acquisitions.

It Matters Who Is Steering the Wheel in Washington

We believe that the November presidential election in the US is consequential with regard to the regulatory landscape Big Tech will face in the coming years.

Since the election of Joe Biden as president in 2020 and his subsequent nomination of Lina Khan as the head of the Federal Trade Commission, we believe there has been a marked shift in how the US government has engaged with large technology companies. The Khan-led FTC has had a major impact on the Big Tech M&A playbook. The scrutiny of deals—from large ones such as Microsoft and Activision to small bolt-on acquisitions such as Amazon and iRobot—has been intense. We see a continuation of this approach if a Democratic administration remains in power.

While Donald Trump is far from a proponent of Big Tech, as evidenced by the Department of Justice under his presidency filing an antitrust suit against Google in 2020, we believe the Republican Party's general aversion to business regulation could be important as it relates to Big Tech. In particular, if Trump is elected to a second term, we expect a shift in how the FTC evaluates Big Tech M&A, providing these large technology incumbents a way to flex their acquisition muscles again.

Key Takeaways

- With burgeoning balance sheets loaded with cash, Big Tech companies have been unable to deploy their cash balances in blockbuster M&A deals.
- We believe increased FTC oversight of M&A has the potential to shape corporate behavior, with large tech companies hesitant to announce large deals, knowing the ensuing government pushback could block the plans.
- In recent years, we have seen unprecedented scrutiny of Big Tech deals, with deals small and large put under the microscope.
- We believe Big Tech firms have stepped up their own investment in new technologies, such as artificial intelligence, in order to deploy their significant cash balances.
- Big Tech has also leveraged reverse "acqui-hires"—buying a startup to hire its employees—and noncontrolling investment in AI startups as a way to circumvent increased regulatory scrutiny.
- We view the November US election as consequential when it comes to increased regulation of Big Tech.
- Under a potential Democratic government, we expect Big Tech to be on the defensive, using share buybacks and increased internal investment in technologies such as AI. We do not forecast any blockbuster M&A, given regulatory pushback.
- Under a potential Republican government, we expect Big Tech to play more offense in terms of M&A. While investment in internal AI tech should continue, we expect more deal activity in the AI space by large technology incumbents.
- In particular, we think Alphabet would be a beneficiary, with tuck-in M&A potentially allowing it to bolster its public cloud offering as it seeks to effectively compete with Amazon and Microsoft in the public cloud market.
- From an M&A perspective, we believe a Republican-led Washington to be the best-case scenario for Big Tech companies, as it will allow them to flex their M&A muscle, potentially formalizing some of their reverse acqui-hire deals and investment in AI startups as acquisitions.
- While European Union antitrust regulation is expected to remain stringent irrespective of US election results, we believe it is harder for Brussels to block deals on its own without Washington on the same page.
- Beyond M&A, there are other antitrust cases against all Big Tech incumbents that will likely continue, irrespective of which party occupies the White House.
- Even with more-moderate heads of the FTC and DOJ, we don't expect these monopoly cases to disappear. However, we believe that the nature of remedies proposed by the FTC and the aggressiveness with which it pursues antitrust enforcement would likely be toned down.
- Microsoft is one of our top picks with respect to regulatory oversight, as the company has demonstrated that it is adept at maneuvering behind the scenes even in a restrictive environment. Should the atmosphere ease, Microsoft has a large war chest and a clear strategy, so we think it would deploy

capital in AI-related bolt-on deals to accelerate its research and development efforts. That said, we think Microsoft shares are attractive regardless of which party comes out on top in November.

- While Alphabet, unlike Microsoft, is very much under the regulatory microscope, we believe the damage dealt to the firm's valuation as a result of antitrust challenges has been overly punitive, offering investors an opportunity to buy shares at an attractive price.

Antitrust and Tech

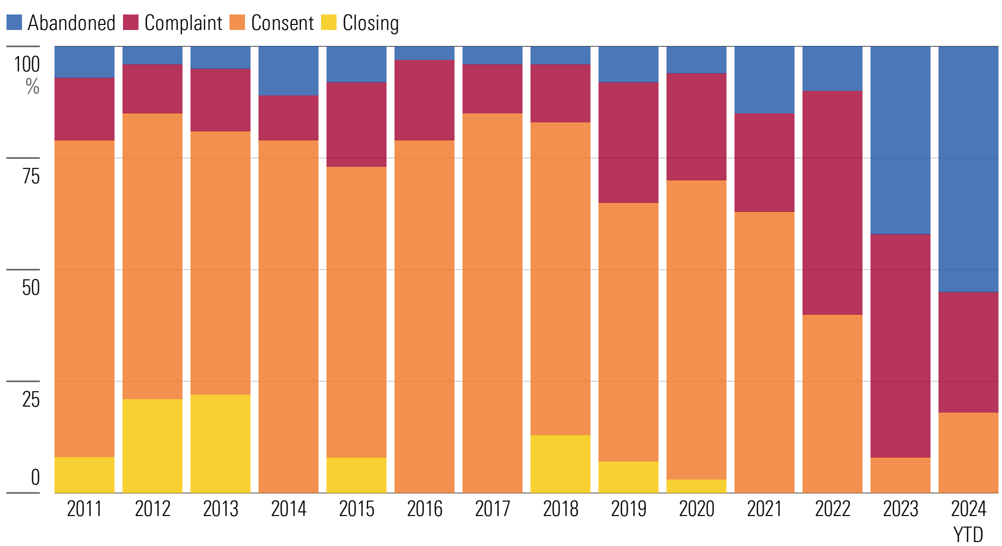
The recent scrutiny of Big Tech is not the first time that large technology companies have had antitrust tussles with the government. From the landmark monopoly ruling against Microsoft in the late 1990s to more recent antitrust cases against the likes of Google, Big Tech has faced antitrust regulation before.

The scorecard of the US government's antitrust suits against large technology companies is far from flattering, however. Time and again, the government's best efforts to contain and thwart Big Tech have resulted in judges siding with large technology companies. We saw this in 2001, when an appeals court overturned an initial ruling ordering the breakup of Microsoft, and in 2011, when a federal court approved Google's acquisition of ITA software following a DOJ antitrust case.

While the government's record of pursuing antitrust cases against Big Tech may not scream success, we have seen a marked shift in antitrust cases being pursued against large tech companies in recent years. In statistics, a regime shift refers to a nonlinear change in how a system (or a model) operates. We believe that the 2020 presidential election in the US and the subsequent nomination of Khan as FTC Chair and Jonathan Kanter as assistant attorney general for the DOJ Antitrust Division marked a regime shift in antitrust litigation.

As Exhibit 1 shows, since the confirmation of Khan and Kanter in 2021, the number of FTC and DOJ complaints against proposed M&A has dramatically increased. This increased regulatory scrutiny has also pushed up deal abandonments, as companies find it easier to drop their proposed M&A than to fight long, arduous legal battles against government regulators.

Exhibit 1 Aggressive Antitrust Enforcement Has Changed the M&A Landscape Since 2021



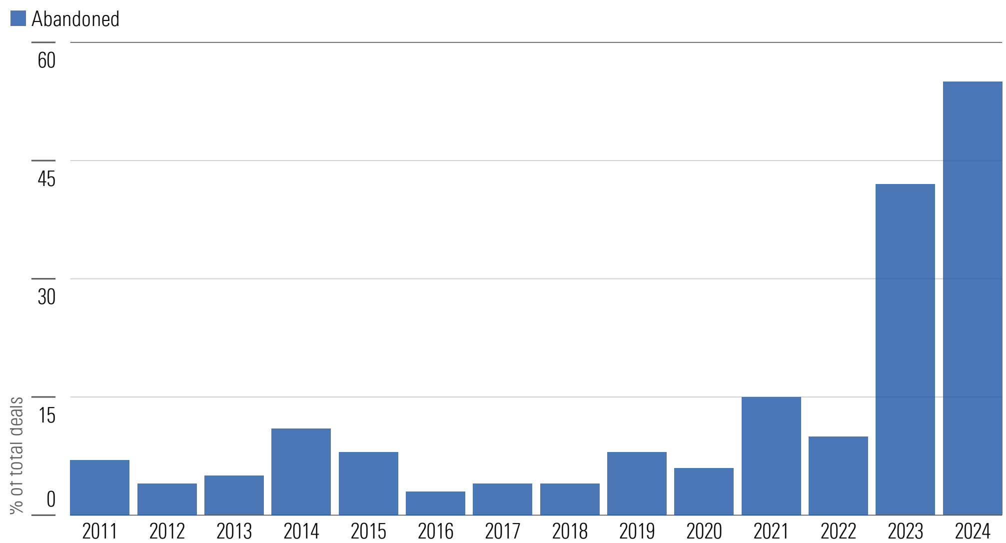
Source: Dechert Antitrust Merger Investigation Timing Tracker Report, DOJ and FTC press releases. Data as of Sept. 26, 2024.

The proportion of deals that received consent from the DOJ and FTC has gone from an average of 70% in 2011-20 to 32% in 2021-24. Conversely, the proportion of deals either being abandoned or facing regulatory complaints has skyrocketed. While the vast majority of these deals were not pursued by large tech companies, we see this exhibit as backing our thesis that a marked shift in antitrust litigation has occurred over the past three years.

Deal Abandonment

Abandoned deals as a percentage of total mergers investigated by the FTC or the DOJ have also trended up quite dramatically over the last three years.

Exhibit 2 Deal Abandonment by Parties Pursuing M&A, 2011-24



Source: DAMITT Report, DOJ and FTC press releases. Data as of Sept. 26, 2024.

We attribute this increase in deal abandonment to heightened regulatory scrutiny. We believe that as corporate actors have come up against an aggressive FTC and DOJ, the M&A calculus has transformed. Instead of going through multiple regulatory steps, including potential alterations to the deal or having to convince a judge that the merger or acquisition should be allowed to proceed, corporations have increasingly opted to bail on the deals.

Increased Deal Abandonment Has Shown Up in Tech M&A

We have seen deal abandonment as a response to heightened M&A scrutiny play out in technology, with notable examples affecting Big Tech players like Amazon, Adobe, and Nvidia.

Zoom and Five9

Zoom abandoned its $14.7 billion acquisition of Five9 in September 2021 after the FTC announced an investigation of the deal and Five9's shareholders appeared set to vote against it, largely due to regulatory headwinds.

While Zoom's current market cap is quite small compared with those of other big technology companies, it was approximately $80 billion around the time of the deal's collapse. We therefore view the Zoom-Five9 abandonment as the canary in the coal mine, with essentially all large tech players facing scrutiny of any proposed deal since Zoom's failed acquisition of Five9.

Nvidia and Arm Holdings

Nvidia terminated its $40 billion acquisition of Arm Holdings in February 2022 after 18 months of regulatory back-and-forth. The deal, which we viewed as unlikely to pass regulatory scrutiny, was also likely opposed by major Arm customers such as Qualcomm, Microsoft, and Apple.

Of the many tech M&A abandonments that have occurred since 2021, we viewed the tie-up of Nvidia and Arm as one of the most likely candidates to be blocked. We believe that the opposition from Arm customers—which likely viewed the acquisition as threatening Arm's status as a relatively independent and vital cog in the broader semiconductor ecosystem—bolstered the antitrust argument against the acquisition.

Adobe and Figma

After a 15-month saga of claims and counterclaims with relevant regulatory bodies, Adobe and Figma terminated their $20 billion merger agreement in December 2023. When the deal was announced, we believed there was a high probability that it would close, given the relatively inconsequential revenue Figma was generating, but our confidence waned over time as regulators in the US and Europe took a more combative approach toward acquisitions by large technology companies such as Adobe.

We believe the Adobe-Figma deal abandonment encapsulates the heightened deal scrutiny large tech firms are facing. For more than a year, Adobe and Figma tried convincing regulators that their tie-up wouldn't affect competition, but to no avail. In the end, Adobe paid a breakup fee of $1 billion to Figma and dropped the acquisition altogether.

Amazon and iRobot

The most curious case of heightened deal scrutiny, in our view, is Amazon's proposed $1.7 billion acquisition of iRobot. The deal was abandoned by Amazon and iRobot in January 2024 after more than 15 months of attempting to prove that it would not have an anticompetitive effect on the home robot market. While the UK regulatory authority agreed to the deal, regulators in Brussels and Washington did not acquiesce, ultimately torpedoing the deal.

The deal's size and scope were so limited that hardly any market participant saw the regulatory scrutiny coming. As evidence, when Amazon announced its plan to acquire iRobot for $61 per share in August 2022, iRobot's share price jumped to $59, indicating the market's expectation that the deal was unlikely to face any regulatory hurdles.

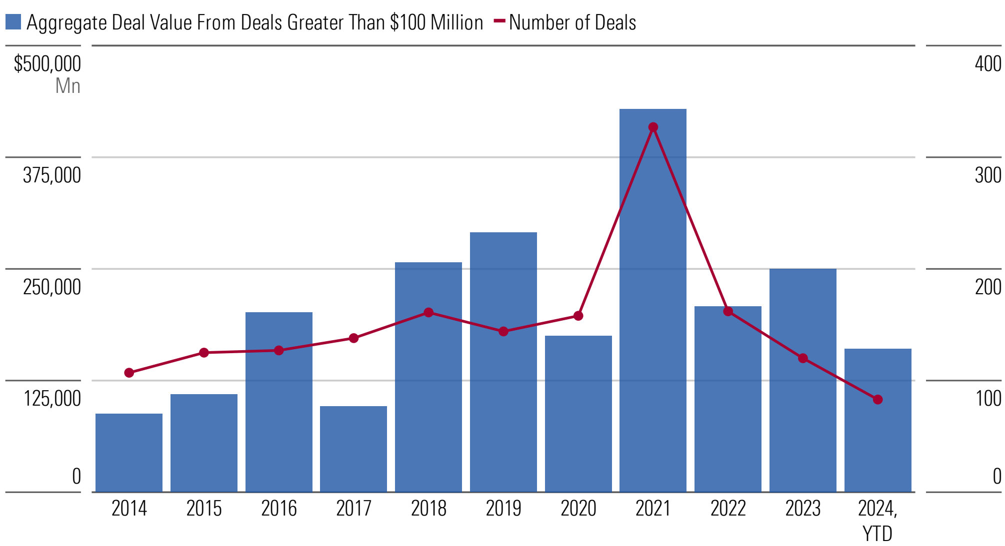
Alphabet and Wiz

Wiz walked away from a $23 billion offer from Alphabet in July 2024, just days after the deal was reported by major news outlets. The deal would have valued Wiz at almost twice its most recent fundraising round in May 2024.

While the exact reasons Wiz walked away from Alphabet's attractive offer weren't disclosed, credible news reports suggested that Wiz's board did not fancy a regulatory back-and-forth that could last longer than a year. While the deal was never formally announced—and as a result, the FTC and DOJ never opened an investigation of it—we find it highly improbable that after scrutinizing deals such as Amazon's proposed $1.7 billion acquisition of iRobot, the regulators would've let Alphabet make a splashy $23 billion acquisition.

As we look at the aforementioned proposed deals, we believe that almost all of them, with perhaps the exception of Nvidia-Arm, would have passed regulatory muster before 2021. With a combative, aggressive FTC and DOJ scrutinizing M&A activity, we have seen a precipitous decline in the number of large deals across sectors as well as the number of M&A deals that Big Tech companies have been able to close.

Exhibit 3 Large Deal Volume Has Dried Up in the Last Few Years Across Sectors



Source: PitchBook, Morningstar. Data as of Sept. 26, 2024.

While other factors, including tighter monetary policy, is likely responsible for some of the overall slowdown in M&A activity, we believe a hawkish FTC has further damped the M&A market, with deal scrutiny up markedly. This slowdown in M&A activity is also seen in the sharp downtick in Big Tech dealmaking, with the fear of regulatory oversight likely pushing these firms to rethink their capital allocation strategies.

Read the Full Report
Semiconductors: The industry enabling the modern world and driving a new wave of AI innovation.

In Semiconductor Industry, AI Promises to be Key Growth Driver

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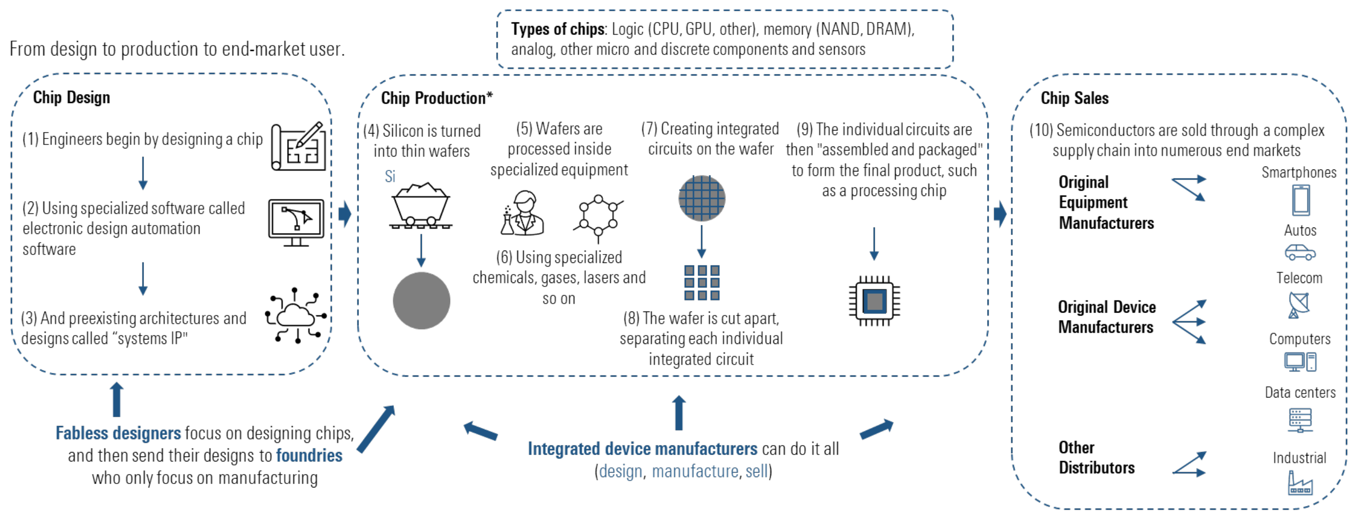
The semiconductor industry is vast and complex. First, a semiconductor product must be designed, which involves highly skilled engineers, specialized software, and building off existing design standards. Once a chip is designed, it is then produced by a foundry using specialized equipment, chemicals, lasers, and more. Once the product is ready for use, it is sold and distributed into a wide variety of end markets. Each step in the process involves different specialized players, each adding value to the supply chain, and getting paid for that value.

Exhibit 1 Semiconductor Supply Chain

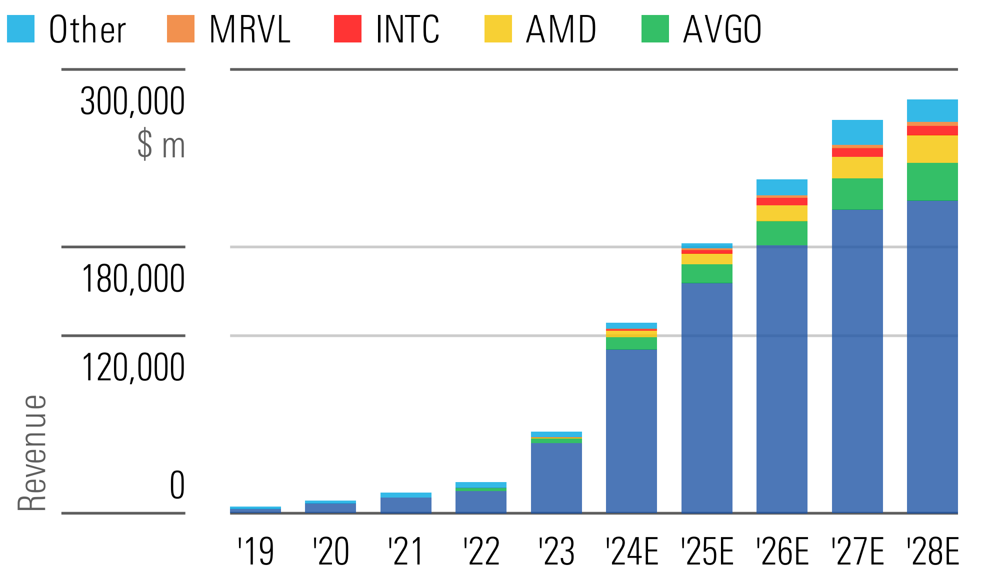


Source: Morningstar.
Note: not every semiconductor product is a chip manufactured on a silicon wafer, but because this is the most common method, we use it to illustrate the basic concepts behind semiconductor production.

Artificial Intelligence Is the Biggest Growth Driver

We expect AI accelerator (for example, chip) revenue will increase roughly four times over the next several years, making AI the largest growth driver in the semiconductor industry. This growth will be led by Nvidia. This firm will not be the only beneficiary as we see Broadcom as a strong second player, and AMD and others will also benefit. For many of these AI chip leaders, we expect AI accelerators to become primary growth drivers. AI is already Nvidia's primary valuation driver and we expect AI to be nearly 40%-50% of total company revenue for firms like Broadcom, AMD, and Marvell Technology.

Exhibit 2 Artificial Intelligence Is the Biggest Growth Driver



Source: Morningstar Direct.

AI-Related Growth Is More Than Just AI Accelerator

While the AI processing chips, especially those from Nvidia, are the most obvious beneficiaries of AI-related demand, there are also other parts of the value chain that will benefit. Specifically, we see material growth coming for networking firms (chips and ethernet connections), memory firms (high-bandwidth memory, as seen above), and equipment firms and foundries (rising complexity, increased structural demand). AI-related demand is expected to drive growth across a broad swath of the semiconductor value chain.

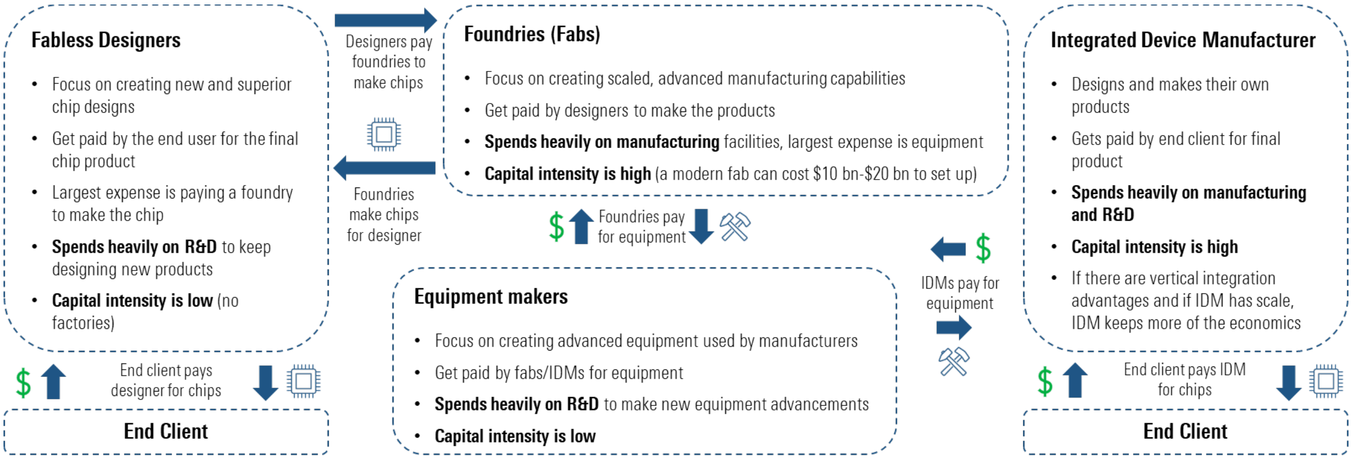
Analog Chips to Emerge From Cyclical Trough in 2025

Analog chip demand has suffered in 2023 and into 2024. This has been occurring across each key end market, but most especially across autos and industrial-related demand. We expect the current cycle to trough in 2024 and a pickup in demand to occur in 2025. Overall, we still like the long-term, structural growth tailwinds for analog chips that we see, including the increased number of chips per car, factory digitalization, and the rollout of 5G, among others.

Key Business Models

There are multiple key business models within the semiconductor industry. Fabless designers only focus on designing new products, contract manufacturers known as foundries operate fabrication plants, or fabs" and focus only on the manufacturing of products, and integrated device manufacturers are a combination of both, doing everything (design and manufacturing) in-house*. We also cover equipment makers, which make the equipment used by the manufacturers. There are other niches within the semiconductor ecosystem (software providers, wafer manufacturers, and packaging, assembly, and testing), but our breakout below covers the majority of the key models and differences you will see.

Exhibit 3 Fabless Designers, Foundries, IDMs, and Equipment Makers



Source: Morningstar.
Note that even IDMs technically do not do “everything” in house, and usually outsource certain parts of the manufacturing process where the investment in building out such processes outweighs any potential advantages of having those processes in house, such as packaging, assembly, and testing.

Industry Value Drivers—Foundries and Memory Makers

Revenue: Foundries sell processed disc-shaped wafers to customers while memory makers sell packaged memory chips. Foundry customers (the designers) are generally responsible for absorbing the costs of defective portions. Apart from wafers and chips, auxiliary revenue comes from mask-making and engineering services.

Cost of Goods Sold: Key inputs are depreciation, labor, raw materials, and utilities. Depreciation and labor are fixed costs once new production lines start operations. Raw materials and utilities are semi-variable. Because fixed costs can be so high, margins can change materially depending on production volumes.

Research and Development: The biggest portion of operating expenses as semiconductor manufacturers race to mass produce the next top-notch product. Commercial preparation starts years before production. While R&D is still important, it is generally relatively lower than for designers/IDMs.

Tax Rate: Usually lower than statutory tax rates owing to tax credits on research and development and having local plants in high-cost regions.

Capital Expenditure: Semiconductor manufacturers incur billions of dollars of capital spending a year. The biggest portion is spent on fabrication equipment, dwarfing buildings and land several times over. Capital intensity is HIGH.

Depreciation and Amortization: Depreciation scales with equipment purchases of previous years. A typical depreciation schedule lasts 5 to 10 years. Amortization is limited as semiconductor manufacturers do not embark on large acquisitions. Software costs and intellectual property purchases are sometimes amortized.

Exhibit 4 Simplified Financial Statements: TSMC (2023)

Pro Forma Income Statement (TWD millions)	**2023**	**% of Sales**
Revenue 1	2,161,736	
Cost of Goods Sold 2	986,625	46%
Gross Profit	**1,175,111**	**54%**
Research and Development 3	182,370	8%
Selling, General, and Administrative	71,464	3%
Amortization, Restructuring, and Other	9,222	0%
Operating Profit	**912,055**	**43%**
Net Interest Expense	-42,215	
Pretax Profit	**954,270**	
Income Tax Expense 4	144,776	
Minority Interest	-486	
Net Income	**809,008**	**37%**
Discounted Cash Flow	**2,023**	
Operating Profit	**912,055**	
Taxes and Others	129,926	
Earnings Before Interest	**782,129**	
(Capital Expenditures) 5	-976,000	45%
Depreciation and Amortization 6	532,191	
(New Investment in Working Capital and Others)	-109,969	
Net New Investment (NNI)	**-553,778**	
Free Cash Flow to the Firm (FCFF)	228,350	

Source: : Morningstar, company filings.

Read the Full Report
Stock Pitch: Hanesbrands

Hanesbrands Is Getting Back to Basics, but Transformation Has Gone Under Radar

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Hanes' shares have badly trailed the broader market. Even after roughly doubling from 2023 lows, its shares remain down nearly 60% over the past three years. Among the problems:

- Once a hot brand and a big part of Hanes' valuation, Champion's sales have dropped off dramatically.
- Profitability has been poor as cost efficiency efforts have not been enough to overcome Champion's sales declines, higher input prices, and soft demand conditions for innerwear in the US and Australia.
- The combination of Hanes' declining results and its chronically excessive debt has stoked fears of financial distress and compressed its equity value.

We understand investors' apprehension concerning these issues but believe that Hanes is well on its way to addressing them. The Champion sale generated about $900 million in cash for debt reduction. Moreover, as Champion's poor results have depressed margins, its disposal will allow Hanes to concentrate on its core innerwear brands, which have superior market share, brand value, and profitability.

Exhibit 1 Hanes' Shares Have Plummeted Over the Past Three Years Due to a Series of Disappointments

Source: PitchBook. Data as of Sept. 27, 2024..

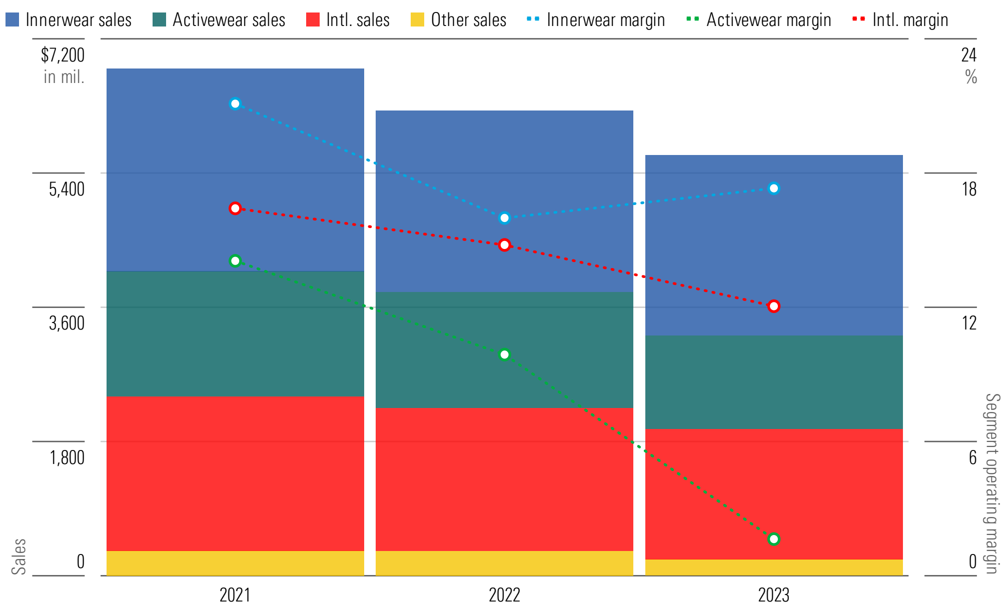
Champion's Difficulties and Depressed Demand for Innerwear Have Driven Investors Away

Like many activewear brands, Champion had a great 2021. Its sales for the year were 20% higher than in 2019, leading Hanes' management to forecast an even better 2022. Instead, Champion's sales went into a tailspin from which they have not recovered. Indeed, the brand's decline was so sharp that Hanes' activewear segment was barely profitable in 2023 (margin below 2%).

By late 2023, Hanes' management had decided that the time and investment needed to return Champion to relevance was too great. A few months later, it sold the brand to Authentic Brands Group. Hanes received about $900 million in cash (net of costs) as part of the initial and deferred closing. In addition, it could receive earnouts of as much as $300 million over the next three years.

Meanwhile, Hanes' innerwear results have been unusually inconsistent. In North America, the company's wholesale customers have operated with lean inventories as consumers have cut back on apparel spending due to inflation. In Australia, a tough economy has depressed consumer spending as well. Consequently, sales and margins for these units have been below normal.

Exhibit 2 Each of Hanes' Historical Segments Has Floundered, but Activewear Has Been the Biggest Problem



Source: Company filings. Data as of Sept. 23, 2024. These are non-restated numbers.

Hanes' Equity Value Has Been Crushed by Its Worrisome Debt

Hanes has struggled with excessive debt and low equity almost continuously since being spun off from Sara Lee in 2006. While it has made sporadic efforts to reduce its debt burden, it has also made many questionable capital allocation decisions, including an acquisition spree in the 2013-17 period, ill-timed stock repurchases, and offering an overly generous dividend.

Hanes' unwillingness or inability to prioritize debt retirement has proven to be a major problem in the years since the 2020 pandemic. Indeed, its poor EBITDA coupled with its onerous debt has meant that the firm has, at times, had to get waivers on its debt covenants. Moreover, there has been considerable doubt that its maturing debt could be refinanced or retired.

After its most recent round of financing, about 45% of Hanes' outstanding debt carries very high interest rates of around 9%. Retiring the most expensive outstanding term loan and bond debt is a priority.

Frustrating Investors, Earnings Quality Has Been Poor

One issue for Hanes' shareholders has been the company's seemingly unending string of unusual charges, restatements, and adjustments. For years, Hanes has reported adjusted numbers for a variety of reasons, including charges related to sales, discontinued businesses, inventory, goodwill impairment, and restructuring. Consequently, the quality of Hanes' earnings has been generally terrible. In 2022, for example, Hanes reported a GAAP net loss of $127 million but an adjusted net profit of $343 million due to a variety of restructuring charges and the write-down of a deferred tax asset. Meanwhile, its operating cash flow for the year was a loss of $359 million.

Exhibit 3 Complicating Matters, Hanes' GAAP Earnings Often Been Light Years Away From its Adjusted Numbers

Source: Company filings. Data as of Sept. 23, 2024. These are non-restated numbers for 2022 and 2023.

A Refreshed Hanes Will Concentrate on Its Leading Brands and Markets

Although a driver of value in the past, Hanes' exposure to activewear has added volatility to its results recently. Now, with the sale of Champion, Hanes has largely exited the category and will have high exposure to innerwear. In this way, it is going back to basics and, in our opinion, focusing on the brands that provide a competitive advantage. Champion is popular, but not a market leader with significant pricing power in the crowded athleisure market. Thus, we do not think its sale will have a major negative impact on Hanes' competitive edge or profitability.

In contrast, Hanes' innerwear brands are market share leaders and, in our opinion, have pricing power that leads to excess profits. Post-Champion, Hanes' sales from innerwear account for about 90% and 70% of its sales in the US and internationally, respectively. Prior to the pandemic, its US innerwear segment generated segment-level operating margins of about 22%-24%, and we do not believe that the potential profitability of its basics has changed.

We estimate Hanes generates 72% of its revenue in the US, with much of the rest in Australia, Canada, and a few parts of Asia and Latin America. With the sale of Champion, the firm is completely out of Europe. Hanes' sales are concentrated in categories in which we think its products are competitively advantaged.

One of Hanes' advantages is its relationships with retailers like Walmart and Target. It also has a large business with Amazon. Hanes recently disposed of its unprofitable outlet stores. Going forward, about 97% of its domestic sales will be through wholesale channels. While this could be seen as a disadvantage for other apparel firms, most innerwear is still sold through physical stores.

Providing Comfort to Investors, Hanes' Underwear Still Dominates Down Under and at Home

Hanes has long led in men's underwear in the US ($7 billion retail market in 2023), and it has strong relationships with leading retailers. There is more competition and potential on the women's side ($16 billion market). Hanes' investments in new products and marketing are allowing it to gain share in both men's and women's. As US innerwear is Hanes' largest and most profitable business, investments in this business can lead to sales growth and margin gains and make up for the loss of Champion.

Through acquisitions, Hanes has become the leader in underwear in Australia, a market estimated at AUD 2 billion (retail) in 2024. Bonds is its leading men's brand, while its women's brands are Bonds, Berlei, and retailer Bras N Things. We attribute recent weakness in Hanes' Australia business to poor economic conditions rather than company-specific problems. An improvement in Australia's economy would increase Hanes' international sales and profitability. M

Stocks on Sale Wide-Moat Stocks Trading at 4 and 5 Stars

Company Name/Ticker	Sector	Star Rating	Fair Value Estimate	Price/ Fair Value	Uncertainty Rating	Moat Rating	Market Cap (B)
Edenred (France) EDEN	Financial Services	★★★★★	EUR 76	0.45	Medium	Wide	9.1
FINEOS Corporation FCL	Technology	★★★★★	AUD 3.1	0.46	Very High	Wide	0.3
Etsy ETSY	Consumer Cyclical	★★★★	USD 100	0.51	Very High	Wide	5.9
The Estée Lauder Companies EL	Consumer Defensive	★★★★★	USD 176	0.54	Medium	Wide	34.2
Elekta EKTA B	Healthcare	★★★★★	SEK 127	0.55	Medium	Wide	2.6
Rentokil Initial RTO	Industrials	★★★★★	GBX 620	0.58	Medium	Wide	12.1
Zimmer Biomet Holdings ZBH	Healthcare	★★★★★	USD 175	0.60	Medium	Wide	21.2
Melrose Industries MRO	Industrials	★★★★★	GBX 740	0.62	Medium	Wide	7.8
Jiangsu Yanghe Brewery Joint-Stock Company 002304	Consumer Defensive	★★★★	CNY 154	0.64	High	Wide	21.2
Harmonic Drive Systems 6324	Industrials	★★★★	JPY 5100	0.65	High	Wide	2.1
Yum China YUMC	Consumer Cyclical	★★★★★	USD 76	0.65	Medium	Wide	18.8
Luzhou Laojiao Company 000568	Consumer Defensive	★★★★	CNY 228	0.66	High	Wide	31.3
GSK GSK	Healthcare	★★★★★	GBX 2200	0.66	Medium	Wide	79.0
Tencent Holdings 00700	Communication Services	★★★★	HKD 704	0.68	High	Wide	565.3
Pfizer PFE	Healthcare	★★★★	USD 42	0.68	Medium	Wide	160.6
Polaris (Automotive) PII	Consumer Cyclical	★★★★★	USD 120	0.68	Medium	Wide	4.6
Roche ROG	Healthcare	★★★★★	CHF 379	0.68	Low	Wide	244.9
British American Tobacco BATS	Consumer Defensive	★★★★	GBX 3900	0.69	Medium	Wide	78.6
Murata Manufacturing Company 6981	Technology	★★★★	JPY 4000	0.70	Medium	Wide	35.7
Nike NKE	Consumer Cyclical	★★★★	USD 117	0.70	Medium	Wide	123.1
Reckitt Benckiser Group RKT	Consumer Defensive	★★★★★	GBX 6500	0.70	Medium	Wide	42.0
Rheinmetall RHM	Industrials	★★★★★	EUR 730	0.71	Medium	Wide	24.8
Taiwan Semiconductor Manufacturing Company 2330	Technology	★★★★	TWD 1380	0.71	Medium	Wide	795.4
Kubota 6326	Industrials	★★★★	JPY 2900	0.72	Medium	Wide	16.4
Baidu 09888	Communication Services	★★★★	HKD 154	0.72	High	Wide	39.3
Boeing BA	Industrials	★★★★	USD 216	0.72	High	Wide	92.8
Pernod Ricard RI	Consumer Defensive	★★★★★	EUR 185	0.72	Low	Wide	36.9
Nabtesco 6268	Industrials	★★★★	JPY 3500	0.72	High	Wide	2.1
Anheuser-Busch InBev ABI	Consumer Defensive	★★★★★	EUR 83	0.73	Medium	Wide	131.2
NXP Semiconductors NXPI	Technology	★★★★	USD 320	0.73	Medium	Wide	59.4
AmBev ABEV3	Consumer Defensive	★★★★	BRL 18.09	0.74	Medium	Wide	38.7
Veeva Systems VEEV	Healthcare	★★★★	USD 273	0.75	High	Wide	33.1
Universal Music Group UMG	Communication Services	★★★★	EUR 31	0.76	Medium	Wide	47.4
Campbell Soup CPB	Consumer Defensive	★★★★	USD 62	0.76	Medium	Wide	14.1
Spirax Group SPX	Industrials	★★★★	GBX 9650	0.76	Medium	Wide	7.2
Allegro (Poland) ALE	Consumer Cyclical	★★★★	PLN 44.5	0.77	High	Wide	9.4
Sony 6758	Technology	★★★★	JPY 3600	0.77	Medium	Wide	114.2
Airbus Group AIR	Industrials	★★★★	EUR 164	0.77	Medium	Wide	110.5
International Flavors & Fragrances IFF	Basic Materials	★★★★	USD 130	0.77	High	Wide	25.7
Bio-Rad Laboratories BIO	Healthcare	★★★★	USD 430	0.78	High	Wide	9.4
Bombardier Recreational Products DOO	Consumer Cyclical	★★★★	CAD 101	0.79	High	Wide	4.3
Julius Baer Group BAER	Financial Services	★★★★	CHF 66	0.79	High	Wide	12.5
Daifuku 6383	Industrials	★★★★	JPY 3500	0.79	Medium	Wide	7.0
Nestlé NESN	Consumer Defensive	★★★★	CHF 105	0.80	Low	Wide	253.2
Adobe ADBE	Technology	★★★★	USD 635	0.80	High	Wide	221.8
Fanuc 6954	Industrials	★★★★	JPY 5200	0.80	High	Wide	26.5
Alphabet GOOGL	Communication Services	★★★★	USD 209	0.80	Medium	Wide	2,049.3
Huntington Ingalls Industries HII	Industrials	★★★★	USD 322	0.80	Low	Wide	10.1
Endeavour Group EDV	Consumer Defensive	★★★★	AUD 6.1	0.80	Low	Wide	6.1

Source: Morningstar. As of Oct. 4, 2024.

Stocks on Sale Wide-Moat Stocks Trading at 4 and 5 Stars

Company Name/Ticker	Sector	Star Rating	Fair Value Estimate	Price/ Fair Value	Uncertainty Rating	Moat Rating	Market Cap (B)
Adyen ADYEN	Technology	★★★★	EUR 1660	0.82	High	Wide	46.4
Dassault Aviation AM	Industrials	★★★★	EUR 227	0.83	Medium	Wide	16.2
The Walt Disney DIS	Communication Services	★★★★	USD 115	0.83	High	Wide	169.8
SF Express 002352	Industrials	★★★★	CNY 54.3	0.83	High	Wide	30.8
Wuliangye Yibin 000858	Consumer Defensive	★★★★	CNY 196	0.83	High	Wide	89.6
U.S. Bank USB	Financial Services	★★★★	USD 53	0.83	Medium	Wide	68.6
Corteva CTVA	Basic Materials	★★★★	USD 70	0.83	Medium	Wide	40.2
Pexa Group PXA	Technology	★★★★	AUD 17.25	0.83	Medium	Wide	1.7
The Charles Schwab SCHW	Financial Services	★★★★	USD 76	0.83	High	Wide	116.0
Philips PHIA	Healthcare	★★★★	EUR 35	0.83	High	Wide	30.1
Oriental Land 4661	Consumer Cyclical	★★★★	JPY 4450	0.84	Medium	Wide	41.6
ASML Holding ASML	Technology	★★★★	EUR 900	0.84	High	Wide	328.0
Diageo DGE	Consumer Defensive	★★★★	GBX 3100	0.84	Low	Wide	77.1
Shanxi Xinghuacun Fen Wine Factory 600809	Consumer Defensive	★★★★	CNY 259	0.85	High	Wide	37.9
Barry Callebaut BARN	Consumer Defensive	★★★★	CHF 1810	0.85	Low	Wide	9.9
Microsoft MSFT	Technology	★★★★	USD 490	0.85	Medium	Wide	3,096.2
Compagnie Financiere Richemont CFR	Consumer Cyclical	★★★★	CHF 154	0.85	High	Wide	90.1
ASX ASX	Financial Services	★★★★	AUD 75	0.85	Low	Wide	8.5
Brambles BXB	Industrials	★★★★	AUD 22	0.85	Medium	Wide	18.2
Kenvue KVUE	Consumer Defensive	★★★★	USD 26	0.86	Medium	Wide	42.7
Siemens Healthineers SHL	Healthcare	★★★★	EUR 61	0.86	Medium	Wide	64.6
Bristol-Myers Squibb BMY	Healthcare	★★★★	USD 63	0.86	Medium	Wide	109.9
Brown-Forman BF.B	Consumer Defensive	★★★★	USD 55	0.86	Medium	Wide	22.2
Altria Group MO	Consumer Defensive	★★★★	USD 58	0.86	Medium	Wide	85.3
Gilead Sciences GILD	Healthcare	★★★★	USD 97	0.87	Medium	Wide	104.8
Omron 6645	Technology	★★★★	JPY 7500	0.87	Medium	Wide	8.8
Saab SAAB B	Industrials	★★★★	SEK 262.5	0.87	Medium	Wide	11.9
BAE Systems BA.	Industrials	★★★★	GBX 1490	0.87	Medium	Wide	52.1
United Parcel Service of America UPS	Industrials	★★★★	USD 150	0.88	Medium	Wide	112.0
Inner Mongolia Yili Industrial Group 600887	Consumer Defensive	★★★★	CNY 33	0.88	Medium	Wide	26.3
Constellation Brands STZ	Consumer Defensive	★★★★	USD 280	0.88	Medium	Wide	44.2
The Hershey HSY	Consumer Defensive	★★★★	USD 210	0.91	Low	Wide	38.6
Hoshizaki Electric 6465	Industrials	★★★★	JPY 5500	0.91	Medium	Wide	4.9
Singapore Exchange S68	Financial Services	★★★★	SGD 12.7	0.92	Medium	Wide	9.7
Auckland Airport AIA	Industrials	★★★★	NZD 8	0.93	Low	Wide	7.7
VeriSign VRSN	Technology	★★★★	USD 195	0.96	Low	Wide	18.2

Source: Morningstar. As of Oct. 4, 2024.

Highlighted Companies

EasyJet Plc EZJ

★★★★	
Currency	GBX
Fair Value Estimate	640
Current Price	4.80
Price/Fair Value	0.75
Moat Rating	None
Uncertainty	High
Sector	Industrials
Analyst	Loredana Muharremi, CFA

Humana HUM

★★★★★	
Currency	USD
Fair Value Estimate	425
Current Price	241.78
Price/Fair Value	0.57
Moat Rating	Narrow
Uncertainty	High
Capital Allocation	Standard
Sector	Healthcare
Analyst	Julie Utterback

Repligen RGEN

★★★★	
Currency	USD
Fair Value Estimate	180
Current Price	139.06
Price/Fair Value	0.77
Moat Rating	Narrow
Uncertainty	High
Capital Allocation	Exemplary
Sector	Healthcare
Analyst	Jay Lee

Source: Morningstar. Data as of Oct. 4, 2024.
* Indicates new Morningstar coverage.

EasyJet: Initiating With No Moat; GBX 640 FVE Driven by Improved Business Quality, Fleet Update

We initiate EasyJet with a no moat rating and a fair value estimate of GBX 640. The valuation is being driven by improved business quality and the company increasing its capacity in slot-constrained airports and its ancillary revenue offering.

We anticipate available seat kilometers to grow at a compound annual growth rate of 6.5%, driven by EasyJet's network optimization, fleet expansion, and modernization. The airline has expanded at primary, slot-constrained airports where demand is high and competition limited. The introduction of the Airbus A321neo, which can accommodate up to 235 passengers, will play a significant role in increasing average seating capacity from 179 in 2023 to 194 by 2028. This upgauging strategy is particularly effective at slot-constrained airports, enabling capacity growth without the need for additional flights.

We expect short-haul capacity in Europe to remain slightly below prepandemic levels over the next three years, primarily due to grounded aircraft from GTF engine issues and delivery delays from Boeing and Airbus. While EasyJet's fleet is unaffected by Pratt & Whitney's GTF problems, many competitors face significant operational disruptions. This will benefit EasyJet as we anticipate its growth in revenue passenger kilometers will continue to outpace ASK in the midterm, driven by the airline's focus on optimizing its network at key primary airports, particularly in International Air Transport Association Level 3 and Level 2 slot-constrained locations.

We expect revenue yields to moderate from current highs as consumer spending softens amid ongoing inflationary pressures and as the airline expands capacity.

Humana: Shares Steeply Undervalued as Uncertainty Around Medicare Advantage Profit Trajectory Rises

We are reducing our fair value estimate to $425 per share from $473 previously on news that Humana's Medicare Advantage star ratings have dropped substantially, which will negatively affect marketing for 2025 plans and 2026 bonus payments. Given this development, management also stated that reaching its target operating margin of 3% in that business may prove difficult by 2027. With increasing uncertainty around its intermediate-term profit trajectory, we have raised our Uncertainty Rating to High from Medium previously. We also reduced our intermediate-term expectations for the firm based on these disclosures, but we still view shares as significantly undervalued with shares trading at just 14 times 2024 expected earnings, which are expected to decline about 40% on challenges in the Medicare Advantage market.

Based on these disclosures, the challenges for Humana may persist longer than we previously anticipated. Specifically, for marketing in 2025, the company's star ratings will decline from an industry-leading 94% of members in 4-star plans or above to about 25% by management's estimates. The company highlighted that one of its plans that represents about 45% of its Medicare Advantage membership declined to 3.5-stars from 4.5-stars previously. This decline in star ratings will negatively affect marketing to seniors for the 2025 plan year, which is scheduled to begin in mid-October, and bonus payments for 2026. Management highlighted that it narrowly missed breakpoints and plans to engage with CMS to make ensure that there were no errors in its calculations or breakpoints, which could ultimately be reversed but perhaps not in time to affect marketing for 2025.

In general, for a company that already needs to boost its operating profitability, this development sets back its cause. As a result, we've significantly reduced our profit estimates through 2026, although we think the longer-term outlook for Humana remains largely intact.

Repligen: Initiating Coverage With Narrow Moat Rating and $180 FVE; Shares Undervalued
We are initiating coverage of Repligen with a narrow moat rating and fair value estimate of $180 per share. The firm is a leading provider of bioprocessing solutions for companies manufacturing biologic drugs, and its business lines include advanced filtration and fluid management systems, prepacked chromatography columns, proteins used in chromatography resins, and process analytic systems. We view the shares as modestly undervalued at current market prices.

The bioprocessing industry enjoys powerful switching costs driven by the complexities and regulations of biologics manufacturing. Like its peers, most of Repligen's products have direct contact with the manufactured drug substance and must be specified in the drug's regulatory filings. Once a drug is approved, the specified equipment suppliers typically enjoy long-term recurring revenue for the life of the drug.

We believe Repligen is at the forefront of the innovation frontier and its portfolio has a high degree of differentiation. Examples include filtration systems designed for process intensification, offerings for "new modalities" such as cell and gene therapies, or CGTs, and systems integrated with real-time process analytics that enable more efficient workflows. We think this puts it in a good position to expand its market share and grow significantly faster than the industry average.

In addition to strong growth, we think the company can improve its profit margins and forecast its adjusted EBITDA margins to reach the low 30s over the next decade, which we view as in line or slightly better than bioprocessing peers. We think a key driver will be its customers' pipeline progress. Unlike its peers, Repligen's sales are currently weighted toward clinical-stage drugs. However, as more of its customers' drugs obtain approval for commercial sale, we expect Repligen's product mix to shift from equipment to higher-margin consumables.

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. We think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (mines, for example), 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.

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.
4. the current market price.

This process ultimately culminates in our single-point star rating.

Economic Moat

The Morningstar Economic Moat Rating is a structural feature that Morningstar believes positions a firm to earn durable excess profits over a long period of time, with excess profits defined as returns on invested capital above our estimate of a firm’s cost of capital. The economic moat rating is not an indicator of the investment performance of the investment highlighted in this report. Narrow-moat companies are those that Morningstar believes are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those that Morningstar believes will earn excess returns for 10 years, with excess returns more likely than not to remain for at least 20 years. Firms without a moat, including those that have a substantial threat of value destruction-related risks related to environmental, social, and governance; industry disruption; financial health; or other idiosyncratic issues, are more susceptible to competition. Morningstar has identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Fair Value Estimate

Each stock's fair value is estimated by using a proprietary discounted cash flow model, which assumes that the stock's value is equal to the total of the free cash flows of the company is expected to generate in the future, discounted back to the present at the rate commensurate with the riskiness of the cash flows. As with any DCF model, the ending value is highly sensitive to Morningstar's projections of future growth.

Fair Value Uncertainty

The Morningstar 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, exposure to material ESG risks, and other company-specific factors. Based on these factors, analysts classify the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. Our recommended margin of safety—the discount to fair value demanded before we’d recommend buying or selling the stock—widens as our uncertainty of the estimated value of the equity increases.

Market Price

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

Morningstar Rating for Stocks
The Morningstar Rating for Stocks is a forward-looking, analyst-driven measure of a stock's current price relative to the analyst's estimate of what the shares are worth. Stock star ratings indicate whether a stock, in the equity analyst's educated opinion, is cheap, expensive, or fairly priced. To rate a stock, analysts estimate what they think it is worth (its "fair value"), using a detailed, long-term cash flow forecast for the company. A stock's star rating depends on whether its current market price is above or below the fair value estimate. Those stocks trading at large discounts to their fair values receive the highest ratings (4 or 5 stars). Stocks trading at large premiums to their fair values receive lower ratings (1 or 2 stars). A 3-star rating means the current stock price is close to the analyst's fair value estimate.

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