Australia and New Zealand Best Stock Ideas

July 2022

Australia/New Zealand Equity Research Team

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Morningstar's monthly Best Stock Ideas highlights high-quality Australian and New Zealand companies, which are currently trading at discounts to our assessed fair values. The ideas, chosen from our coverage of nearly 200 companies, are intended to have broad application in a variety of equity strategies, but individuals should consider their personal investment goals and positioning before investing. We provide brief descriptions of each best idea in this report and encourage investors to read our most recent stock reports for a more detailed appraisal. This month we have 15 companies in our Best Stock Ideas list.

We add Fineos Corporate Holdings to our Best Ideas List. Shares in Fineos are trading at a significant discount to our AUD 4.40 fair value estimate. We think the market underestimates revenue upside from the adoption of cloud software by insurers and the increasing stickiness of Fineos' carrier (insurer) customers. We think Fineos is in a good position to win new business supported by longstanding customer relationships and their referrals. Fineos is unprofitable but reinvests to solidify switching costs with its sticky customer base, help new business wins, and maintain its lead over would-be competitors. We anticipate share gains from more product holdings per client, new client adds, and expansions into new regions and adjacent verticals. There are also opportunities for cost efficiencies from client transitions to the cloud, automation of manual functions, and staff hires from emerging economies. We expect Fineos can self-fund its growth from here on.

We add Newcrest Mining to our Best Ideas List. No-moat-rated Newcrest Mining remains the better-value pick among the miners. We think this reflects market concerns around the outlook for gold as the world recovers from the COVID-19-induced downturn. Inflation and rising bond yields have the potential to increase the opportunity cost to hold gold. However, recessionary concerns potentially increase gold’s appeal as a safe haven asset. We think it's likely Newcrest can overcome recent production challenges at Lihir and both Lihir and Cadia remain much better than average gold mining assets. The company has numerous development projects in Havieron, Red Chris, and Wafi-Golpu. The market usually dislikes the material capital expenditure and development risk, and the wait for additional production and earnings. We are positive on all three developments, both adding volumes and lowering unit costs, but the longer-term wait for earnings means they’re likely not fully factored into the share price.

Company Name	Morningstar Analyst Rating	Fair Value (AUD)	Discount/ (Premium) to FV	Economic Moat	Uncertainty Rating
Recent Additions					
Fineos Corporate Holdings	★★★★★	4.40	66%	Wide	High
Newcrest Mining Ltd	★★★★	33.00	37%	None	High
Data as of 30 June 2022					

Best Stock Ideas

Code	Company Name	Market Price (AUD)	Fair Value Estimate (AUD)	Price/ Fair Value	Mkt Cap (AUD Billion)	Moat Rating	Fair Value Uncertainty	Forecast P/E	Forecast Yield (%)	Franked (%)	Morningstar Analyst Rating
A2M	The a2 Milk Company	4.39	7.60	0.58	3.27	Narrow	High	30.9	0	0	★★★★★

Shares in a2 Milk still trade at a substantial discount to our fair value estimate. The infant formula producer has come under pressure as a result of a slower-than-expected rebound in China, principally in English-label. Persistently high inventory through the sales channel has stifled reordering from key corporate daigou partners, weighed on market pricing, and led to the ageing of available product. But we think a2's narrow economic moat, underpinned by its strong brand, remains intact. Chinese-language-labelled infant formula continues to grow, and we are encouraged by a2 Platinum's solid brand health. We forecast 15% annual revenue gains to fiscal 2026 as channel inventory levels normalise and market share recovers, alongside improved EBITDA margins as profitability recuperates gradually from fiscal 2021 lows. (Angus Hewitt)

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AGL	AGL Energy	8.25	13.30	0.62	5.55	Narrow	High	21.3	3.4	0	★★★★

Narrow-moat AGL Energy trades at a large discount to our fair value estimate. Earnings in recent years were hurt by weak wholesale electricity prices, higher fuel costs, and unfavourable regulation. However, a strong rebound in electricity prices to extreme levels should underpin a strong earnings recovery in the medium term as hedging rolls. Risk remains high, though, as coal power station outages force the firm to procure electricity from other, far costlier sources. We see substantial long-term value in the business, which is one of Australia's largest generators and retailers of electricity. We expect slowing renewable energy supply additions, the closure of ageing coal power stations, and rising gas costs pushing up costs for gas-fired power stations to support electricity prices. (Adrian Atkins)

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AZJ	Aurizon Holdings	3.80	4.70	0.81	7.00	Narrow	High	13.4	5.6	70	★★★★

Shares of narrow-moat Aurizon trade at a discount to our fair value estimate. The shares offer an attractive yield of about 5.6%, mostly franked, underpinned by high-quality rail infrastructure and haulage operations. Considerable downside is already priced into the shares, which we think will prove overdone. Current high coal prices suggest the medium-term outlook for haulage volumes and earnings is positive. We think environmental risks are overblown, providing an opportunity for investors to buy a better-than-average company at a discount. The company largely hauls coking coal from globally competitive mines. A commercially viable alternative to coking coal in the making of new steel also appears a long way off. Our analysis suggests risks for investors are skewed to the upside from the current share price. (Adrian Atkins)

BXB	Brambles	10.71	12.70	0.84	14.85	Wide	Medium	19.4	2.8	30	★★★★

With wide-moat Brambles' shares trading at a sizeable discount to our valuation, investors underappreciate the substantial medium- and long-term secular growth opportunities available to the global pallet-pooling leader. Brambles is experiencing a combination of lumber, labour, and transport inflation and pallet cycle time disruptions. We expect margins to recover longer-term as contractual indexation supports the pass-through of higher costs to customers. The continued growth of Brambles' North American and European pallet pools is also likely to underpin strong sales and underlying earnings growth over the medium to long term. Moreover, longer-term opportunities for expansion into markets with minimal pallet-pooling are available and have the potential to be lucrative. (Mathew Hodge)

* FCL	Fineos Corporate Holdings	1.48	4.40	0.34	0.47	Wide	High	N/A	0	0	★★★★★

Shares in Fineos are trading at a significant discount to our AUD 4.40 fair value estimate. We think the market underestimates revenue upside from the adoption of cloud software by insurers and the increasing stickiness of Fineos' carrier (insurer) customers. We think Fineos is in a good position to win new business supported by longstanding customer relationships and their referrals. Fineos is unprofitable but reinvests to solidify switching costs with its sticky customer base, help new business wins, and maintain its lead over would-be competitors. We anticipate share gains from more product holdings per client, new client adds, and expansions into new regions and adjacent verticals. There are also opportunities for cost efficiencies from client transitions to the cloud, automation of manual functions, and staff hires from emerging economies. We expect Fineos can self-fund its growth from here on. (Shaun Ler)

GEM	G8 Education	1.06	2.00	0.53	0.89	None	High	28.6	2.3	100	★★★★★

G8 Education, the second-largest provider of childcare services in Australia, was affected by the coronavirus-related economic downturn, which exacerbated its already weak share price. However, the combination of additional federal government financial support for the childcare sector, a relatively large equity capital raising for G8 Education, and a recovery in childcare demand supported the company. We expect occupancy rates at G8's childcare centres to continue to recover during 2022 and drive a rebound in G8's profits, helping to close the share price/fair value discount. We remain confident in the long-term outlook for the childcare industry and G8. We expect childcare demand to grow with the population and female workforce participation. The federal government bears most of the cost of childcare services, and we expect this to continue, meaning that the sector is reasonably defensive. (Gareth James)

IVC	InvoCare	10.46	15.30	0.68	1.51	Wide	Medium	25.1	3.2	100	★★★★★

Shares in wide-moat InvoCare screen as attractive. Social distancing and an increased hygiene focus in the wake of the COVID-19 pandemic led to a virtually nonexistent flu season and lower mortality rates in calendar 2020 and 2021. Compounding this, government-imposed limits on attendance at funerals restricted InvoCare's ability to offer its full range of services and weighed on pricing. However, we expect impacts from COVID-19 to be transitory and forecast earnings recovering further in calendar 2022, the first year with practically no funeral restrictions. With a wide economic moat underpinned by well-known, highly respected brands and cost advantages over the long tail of smaller competitors in a highly fragmented market, InvoCare will continue to dominate the Australia deathcare industry, in our view. We expect the combination of a recovery in the death rate, modest price increases, and incremental market share gains to drive our five-year top-line CAGR forecast of 7%, with a reversal of negative mix shift amid pandemic-induced restrictions driving operating margin expansion over this period. (Angus Hewitt)

KGN	Kogan	2.78	11.70	0.24	0.30	None	High	103.0	0	100	★★★★★

Shares in no-moat Kogan trade at a significant discount to our AUD 11.70 fair value estimate. We ascribe the current weakness in the share price to a material moderation in sales growth and earnings declining from boomtime levels of 2020, as well as management's decision to temporarily suspend dividends. We aren't opposed to Kogan reinvesting its capital instead of distributing it to shareholders if it generates, as we expect, a return greater than its cost of capital. We anticipate profit margins to expand as marketing expenses as a percentage of gross sales are scaled back and top-line growth reignites in fiscal 2023 after exceptionally strong coronavirus-induced sales growth is fully lapped. As an online pure play, Kogan is poised to benefit more than omnichannel retailers from the secular shift to e-commerce. We expect it to successfully retain its share in the fast-growing Australian discretionary online retailing channel at around 2.5%. We forecast this segment of the Australian e-commerce market to expand at a CAGR in the high single digits over the next decade, in contrast to a CAGR in the low-single digits for discretionary retailing in Australia's brick-and-mortar channel over the period. (Johannes Faul)

LLC	Lendlease	9.11	14.45	0.63	6.28	None	High	32.4	1.9	0	★★★★

No-moat Lendlease has substantial earnings potential, thanks to its massive AUD 100 billion-plus project pipeline. Despite a paucity of development completions in the first half of fiscal 2022, the group looks on track to complete AUD 2 billion of developments in the June half, and we expect further increases in subsequent periods. We expect the group will eventually reach its medium-term goal of AUD 8 billion of development production per year, based on the status of Lendlease's projects, its record of execution, and the new CEO's emphatic commitment to meeting production targets. Governments are looking for opportunities to restore economic growth, and construction appears to be key to policymaker plans around the world, leaving Lendlease well placed. We view the stock as undervalued, with the first half of 2022 likely to have been the low point for Lendlease's earnings. (Alexander Prineas)

MFG	Magellan Financial Group	12.92	31.30	0.41	2.39	Narrow	High	6.5	13.9	75	★★★★★

We see several drivers of earnings growth for Magellan Financial Group. First, a return of fund performance to historical levels should help stabilise outflows and boost performance fees. The flagship Global Equity strategy's portfolio undervaluation, moat-focused composition, and above-average expected earnings growth give us confidence that it is strongly positioned to outperform its benchmark. Second, a cleverly designed product suite will help Magellan to capitalise on emerging investor trends—namely the need for retirement income (via FuturePay), passive investments (via MFG Core series), and environmental, social, and governance investing (via Magellan's Sustainable strategy). Third, we see earnings upside as its principal investments—notably Barrenjoey and FinClear—realise earnings growth. Finally, Magellan's sheer scale of funds under management means it is capable of increasing funds under management and earnings from the compounding of investment returns despite periodic outflows. (Shaun Ler)

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* NCM	Newcrest Mining	20.89	33.00	0.63	18.66	None	High	15.0	2.7	100	★★★★
No-moat-rated Newcrest Mining remains the better-value pick among the miners. We think this reflects market concerns around the outlook for gold as the world recovers from the COVID-19-induced downturn. Inflation and rising bond yields have the potential to increase the opportunity cost to hold gold. However, recessionary concerns potentially increase gold's appeal as a safe haven asset. We think it's likely Newcrest can overcome recent production challenges at Lihir and both Lihir and Cadia remain much better than average gold mining assets. The company has numerous development projects in Havieron, Red Chris, and Wafi-Golpu. The market usually dislikes the material capital expenditure and development risk, and the wait for additional production and earnings. We are positive on all three developments, both adding volumes and lowering unit costs, but the longer-term wait for earnings means they're likely not fully factored into the share price. (Jon Mills)											
TPG	TPG Telecom	5.97	7.40	0.81	11.10	Narrow	High	41.2	2.8	100	★★★★
Shares in narrow-moat TPG Telecom trade at an attractive discount to our AUD 7.40 fair value estimate and screen as the most attractive under our Australian telecom coverage. We see clear catalysts for earnings recovery on several fronts and forecast adjusted EBITDA CAGR of 8% over the next three years. Recovery from COVID-19 effects, benefits from a more rational mobile market, and synergies from the recent Vodafone merger will be the key drivers, augmented by projected growth from fixed wireless, the corporate division, and regional markets. Market concerns linger over NBN's damage on fixed-line broadband, timing of recovery from the pandemic, and the recent exodus of TPG executives in the aftermath of the Vodafone merger. However, we believe these concerns are more than reflected in the current stock price, especially given the longer-term tailwinds for the telecom industry as it transitions from 4G to 5G. All this is elaborated in our report, "Dialing Up TPG as Key Call in Telecom Down Under," published on March 30, 2022. (Brian Han)											
WBC	Westpac Banking Corporation	19.50	29.00	0.67	68.27	Wide	Medium	13.2	6.4	100	★★★★★
Wide-moat-rated Westpac trades at a meaningful discount to our AUD 29 fair value estimate. Share price weakness followed disappointing guidance on net interest margins and operating expenses, but we think both will improve over time. We expect margin headwinds to persist in the short term as the bank uses price to lift volume via the broker channel and the loan book shifts more to lower-margin owner occupier and fixed loans. But as Australia's second-largest lender, number two in mortgages and number three in business loans, funding cost advantages should allow the bank to reprice loans and generate better margins as the cash rate is increased. A large part of the bank's uplift in costs is tied to customer remediation and uplifting of risk management and culture. We believe a large part of these should phase out over time. While we see the bank's cost target as ambitious, after divesting several businesses there is an opportunity for management to reshape the cost base. The bank was losing market share, but in recent months this has begun to stabilise. This gives us confidence there are no serious issues with the bank's loan approval processes. Westpac continues to sit on surplus capital, is well-provisioned, and pays generous fully franked dividends. (Nathan Zaia)											
WPL	Woodside Petroleum	31.84	40.00	0.80	60.46	None	High	6.1	12.8	100	★★★★
Woodside Petroleum shares remain materially undervalued; we think the market is insufficiently pricing for liquefied natural gas growth potential. Woodside's excellent balance sheet and low costs are advantageous. The company is in extremely strong shape to weather periods of low crude prices, but at the moment enjoys strong crude and LNG pricing. The most important of the development projects from a fair value perspective remains Scarborough/Pluto T2. Major civil works for this LNG expansion project have begun. Gas has a rapidly growing role to play in fuelling the world, no matter how optimistic renewable energy targets may be. Australian energy companies like Woodside are highly gas-leveraged and freight-advantaged into Asia markets. Woodside's recent merger with BHP Petroleum strengthens the balance sheet, provides a clearer path to development, affords Woodside greater control in destiny, and increases asset diversification while retaining in-the-majority long-life/low-cost assets. We forecast a 10-year group EBITDA CAGR of 8.8% to USD 9.5 billion, projecting group production to more than double to around 230 million barrels of oil equivalent per day, or mmboe/d, by 2026. Our assumptions support a 10-year EPS CAGR of 4.9% to AUD 3.80 by 2031. (Mark Taylor)											
WTC	Wisetech Global	37.85	65.00	0.58	12.35	Narrow	High	76.0	0.3	100	★★★★★
We added narrow-moat-rated WiseTech Global to our Best Ideas List following share price weakness and increasingly negative investor sentiment toward the technology sector. WiseTech has many attractive attributes, including its switching cost-based economic moat, a large global addressable market, relatively low ESG risk, a strong balance sheet, an innovative culture, and a large recurring revenue base. We've previously held concerns about several aspects of the company, such as its global acquisition strategy, high capitalisation of research and development costs, relatively poor disclosure, and slowing revenue growth. However, we became more comfortable with these risks following an improvement in disclosure in 2021, which we discussed in our special report, 'We Turn Bullish on WiseTech After Reassessing Our Thesis,' published in September 2021. (Gareth James)											

Prices as of 30 June 2022