

Europe Core Pick List

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January's edition of the Morningstar Europe Core Pick List features the most attractively valued, European-domiciled companies that possess sustainable competitive advantages. This month's list saw a slightly higher amount of turnover compared with last month's list, as there were more trading-level fluctuations and fair value estimate and moat rating changes during December.

Firms that left our list this month included **BT Group** (communication services), **Cie Financiere Richemont** (consumer cyclical), **Julius Baer Gruppe** (financials) and **Prosegur Compania De Segurida** (industrials). Our overall European coverage trades at an average of 87% to our fair value estimates.

Narrow-moat Cie Financiere Richemont left the list this

month, as analyst Jelena Sokolova maintained her fair value estimate of CHF 90, while the stock fell approximately 4% over the past month. Sokolova still believes the firm is well-positioned to drive revenue growth through an increasing number of high-net-worth individuals globally, some upside from existing client demand for jewelry, and increased distribution for smaller brands (notably Van Cleef & Arpels).

Narrow-moat-rated Prosegur Compania De Segurida left the list this month, as analyst Michael Field maintained his fair value estimate of EUR 7.10, while shares fell approximately 5%. Field continues to believe the firm can capitalize on several structural trends such as banks' and retailers' increased focus on outsourcing cash-related activities, which opens numerous opportunities in developed markets. While shares for both stock still look attractive, the price deprecia-

The Europe Core Pick List Strategy

The Morningstar Europe Core Pick List features our most attractively valued European-domiciled names with sustainable competitive advantages, or economic moats. Our top picks across each sector are chosen based on their uncertainty-adjusted discounts to their intrinsic value.

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Europe Core Picks—Consider Buying

Company	ISIN	Sector	Morningstar Rating	Current Price (Local Currency)	Fair Value (Local Currency)	Economic Moat™	Uncertainty Rating	Market Cap (EUR Mil)	Currency
HeidelbergCement AG	DE0006047004	Basic Materials	★★★★	53.38	81.00	Narrow	High	10,591	EUR
LafargeHolcim Ltd	CH0012214059	Basic Materials	★★★★	40.50	60.00	Narrow	High	24,187	CHF
★ Liberty Global PLC	GB00B8W67662	Communication Services	★★★★★	21.34	38.00	Narrow	High	15,706	USD
Telefonica SA	ES0178430E18	Communication Services	★★★★★	7.33	13.00	Narrow	High	38,105	EUR
Vodafone Group PLC	GB00BH4HKS39	Communication Services	★★★★	152.90	250.00	Narrow	High	40,854	GBX
Bayerische Motoren Werke AG	DE0005190003	Consumer Cyclical	★★★★	70.70	117.00	Narrow	High	46,014	EUR
★ Kingfisher PLC	GB0033195214	Consumer Cyclical	★★★★	207.50	300.00	Narrow	Medium	4,341	GBX
WPP PLC	JE00B8KF9B49	Consumer Cyclical	★★★★★	846.60	1,450.00	Narrow	Medium	10,683	GBX
Anheuser-Busch InBev SA/NV	BE0974293251	Consumer Defensive	★★★★★	57.70	103.00	Wide	Low	112,890	EUR
British American Tobacco PLC	GB0002875804	Consumer Defensive	★★★★★	2,500.00	4,500.00	Wide	Low	57,344	GBX
Imperial Brands PLC	GB0004544929	Consumer Defensive	★★★★★	2,377.00	3,700.00	Wide	Low	22,670	GBX
BP PLC	GB0007980591	Energy	★★★★	495.95	670.00	Narrow	High	99,982	GBX
Royal Dutch Shell PLC	GB00B03MM408	Energy	★★★★	2,340.00	3,250.00	Narrow	Medium	191,169	GBX
Credit Suisse Group AG	CH0012138530	Financial Services	★★★★★	10.80	22.00	Narrow	High	27,566	CHF
★ KBC Group SA/NV	BE0003565737	Financial Services	★★★★	56.68	80.00	Narrow	Medium	23,588	EUR
UBS Group AG	CH0244767585	Financial Services	★★★★	12.23	20.00	Narrow	High	45,595	CHF
↓ Bayer AG	DE000BAY0017	Healthcare	★★★★★	60.56	113.00	Wide	High	56,475	EUR
ConvaTec Group PLC	GB00BD3VFW73	Healthcare	★★★★	138.95	228.00	Narrow	High	2,732	GBX
Roche Holding AG	CH0012032048	Healthcare	★★★★★	243.40	333.00	Wide	Low	207,266	CHF
★ Babcock International Group PLC	GB0009697037	Industrials	★★★★★	489.30	830.00	Narrow	Medium	2,474	GBX
GEA Group AG	DE0006602006	Industrials	★★★★★	22.50	45.00	Wide	Medium	4,061	EUR
KION GROUP AG	DE000KGX8881	Industrials	★★★★★	44.33	90.00	Narrow	Medium	5,221	EUR
↓ Unibail-Rodamco-Westfield	AU0000009771	Real Estate	★★★★	10.85	13.30	Narrow	Medium	30,569	AUD
Atos SE	FR0000051732	Technology	★★★★	71.48	90.00	Narrow	Medium	7,633	EUR
SSE PLC	GB0007908733	Utilities	★★★★	1,081.50	1,380.00	Narrow	Medium	11,102	GBX

Data as of Jan. 2, 2019. | ↑ = Upgrade, ↓ = Downgrade, ★ = New Addition

tion across the entire market caused other names to become relatively cheaper.

New additions to the list this month included **Liberty Global** (communication services), **Kingfisher** (consumer cyclical), **KBC Group** (financials) and **Babcock International Group** (industrials). Liberty Global and Babcock International specifically represent some of the cheaper European names on an uncertainty-adjusted, price/fair value basis; both currently trade at about a 20% discount to their respective fair values.

Narrow-moat Liberty Global is the largest cable-TV operator in Europe, with operations in the United Kingdom, Switzerland, Belgium, Germany, Ireland, Hungary, Romania, Poland, Czech Republic, and Slovakia. In total, it has 18.4 million television customers, 15.1 million Internet access customers, and 12.6 million fixed-line telephony customers. The stock was added to the list as shares decreased approximately 14% over the month while analyst Allan Nichols maintained his fair value estimate of \$38. Nichols anticipates average annual revenue growth of 3.2% for the next four years and expects growth will be driven by a combination of more subscribers and higher average revenue per user as more customers subscribe to additional services. Nichols believes Liberty Global has a narrow economic moat due to cost advantages and efficient scale. It is the largest pay-TV provider in Europe. The more subscribers on its network, the more profitable the business becomes, because a significant portion of the network's costs are fixed. In addition, the high cost of building a competing network keeps rivals at bay. With the high penetration rates Liberty has achieved (50%-70% of homes passed) it would be very difficult for a competitor to enter the market. These rates exceed the 50% penetration rates of the best U.S. cable firms. Building on its success in cable television, the company is providing additional services, such as high-speed Internet access and fixed-line telephony. As more subscribers sign up for bundles of services, they become less likely to leave, which further strengthens the moat. In addition, Liberty Global has recently increased the television content it produces or controls. Television programming can be a key differentiator between service providers. Offering the best programming can allow the firm to gain market share, which in turn provides the financing to buy more programming and outbid potential competitors when contracts come up for renewal, creating a virtuous cycle.

Narrow-moat Babcock International Group is a British engineering company specializing in construction and decommissioning of nuclear power plants and submarines; maintenance

support; fleet management for aviation, marine, and land; and provision of technical training and emergency services. In 2018, Babcock generated GBP 4.6 billion in revenue. About 38% of revenue comes from marine, 38% from land, and 20% from aviation, while the Cavendish nuclear division generated the remaining 4% of sales. While shares have decreased approximately 14% over December and analyst Denise Molina decreased her fair value estimate from GBX 870 to GBX 830, she still believes the shares are a good investment, since Babcock is one of the main beneficiaries of increases in the U.K.'s defense budget and the U.K. government's commitment to increased outsourcing to the private sector.

Molina contends that Babcock's narrow moat stems from switching costs and intangible assets. The United Kingdom promotes Babcock as the British Army and Royal Navy's strategic support partner, and the firm has ownership or operational control of key naval infrastructure. Control over the docks of Devonport, the only place in the U.K. where large ships can be taken out of the water, gives Babcock a unique advantage. Babcock's relationship with the British government is an intangible asset, as the government has a golden share in Babcock's Devonport operating company, which can block a foreign takeover. Additionally, the firm enjoys high switching costs, as long-term support services for strategically important assets increase customer loyalty. In highly regulated areas where safety is top priority, like mission-critical emergency services, changing suppliers can lead to significant operational and cost risk (such as the cost of failure) for customers. Babcock's high contract renewal rate of 90% and recent extension of the Phoenix contract (fleet management of the U.K. MoD's white fleet) supports Molina's view of high switching costs.

These and the remainder of our top picks for each sector for January 2019 are listed here. From a price/fair value standpoint, the overall list changed considerably (with an average decrease of about 350 basis points). Consumer defensive maintained its status as the cheapest sector on the list, followed by industrials and healthcare. One technology sector and one real estate sector stock made the list.

An Overview of the Europe Core Pick List

The Morningstar Europe Core Pick List features our most attractively valued European-domiciled names with sustainable competitive advantages, or economic moats. Our top picks across each sector are chosen based on their uncertainty-adjusted discounts to their intrinsic value.

The Core Consider Buy list only includes European companies with:

- A market capitalization of at least \$1 billion.
- Narrow or wide economic moats.
- A fair value uncertainty that is not very high or extreme.
- A minimum of one company from each sector, with a maximum of three companies in any one sector.

The Morningstar Approach to Investing

These are the four ever-present tenets of the Morningstar Global Equity Research methodology. We have more extensive documents available upon request, but here is a summary:

1. Finding quality investments is at the core of our methodology and culture. For every company we analyze, we identify whether there are sustainable competitive advantages (an economic moat) that will preserve returns on invested capital well into the future. All else equal, we prefer to recommend companies with economic moats over those without.
2. Next, we estimate a company's intrinsic value using a discounted cash-flow model. We have a large global research team that puts substantial effort into developing and justifying our long-term forecasts. We also use a variety of other fundamentally focused valuation methods to ensure the final output (fair value) is reasonable.
3. We apply margins of safety to all of our fair value estimates—the greater the uncertainty, the larger the discount or premium we require before making a buy or sell recommendation. Stable cash flow streams require only small discounts to our fair value estimate before our interest is piqued. For speculative companies with questionable business models, we require much larger discounts to our fair values before we can be comfortable making any recommendation.
4. Finally, we compare the current stock price to our fair value estimate to determine whether the market is overly optimistic, pessimistic, or realistic. In the end, excess returns can be achieved only when investors buy assets for less than their true value. This strategy has led to outperformance over long time periods for a wide variety of Morningstar investment products, and of course our hope is that the Europe Core Pick List will exhibit the same success.

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