

# Europe Core Pick List

## February 2019

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February'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 almost no turnover compared with last month, as the trading-level fluctuations and fair value estimate and moat rating changes in January offset each other.

The only firm to leave our list this month was narrow-moat **Liberty Global** (communication services). Our overall European coverage trades at an average of 94% to our fair value estimates.

Liberty Global left the list this month, as analyst Allan Nichols maintained his fair value estimate of \$38 while the stock appreciated approximately 15% over the past month. Nichols continues to anticipate 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. While Liberty Global continues to trade in 4-star territory, trading fluctuations across the market caused other names to become cheaper on a relative basis.

The new addition to the list this month was **BT Group** (communication services). **British American Tobacco** and **GEA Group** specifically represent some of the cheapest European names on an uncertainty-adjusted, price/fair value basis, currently trading at about a 40% and 30% discount to their fair values, respectively.

Wide-moat British American Tobacco, is neck and neck with **Philip Morris International** to be the largest listed global

### 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	★★★★	61.26	81.00	Narrow	High	12,155	EUR
LafargeHolcim Ltd	CH0012214059	Basic Materials	★★★★	47.27	60.00	Narrow	High	28,230	CHF
★ BT Group PLC	GB0030913577	Communication Services	★★★★	230.00	360.00	Narrow	High	22,822	GBX
Telefonica SA	ES0178430E18	Communication Services	★★★★★	7.52	13.00	Narrow	High	39,076	EUR
Vodafone Group PLC	GB00BH4HKS39	Communication Services	★★★★★	138.84	250.00	Narrow	High	37,099	GBX
Bayerische Motoren Werke AG	DE0005190003	Consumer Cyclical	★★★★	74.14	117.00	Narrow	High	48,241	EUR
Kingfisher PLC	GB0033195214	Consumer Cyclical	★★★★	225.50	300.00	Narrow	Medium	4,758	GBX
WPP PLC	JE00B8KF9B49	Consumer Cyclical	★★★★★	877.00	1,450.00	Narrow	Medium	11,066	GBX
Anheuser-Busch InBev SA/NV	BE0974293251	Consumer Defensive	★★★★★	66.78	103.00	Wide	Low	130,655	EUR
British American Tobacco PLC	GB0002875804	Consumer Defensive	★★★★★	2,710.00	4,500.00	Wide	Low	62,161	GBX
Imperial Brands PLC	GB0004544929	Consumer Defensive	★★★★★	2,559.00	3,700.00	Wide	Low	24,483	GBX
BP PLC	GB0007980591	Energy	★★★★	521.50	670.00	Narrow	High	105,662	GBX
Royal Dutch Shell PLC	GB00B03MM408	Energy	★★★★	2,384.50	3,250.00	Narrow	Medium	195,444	GBX
Credit Suisse Group AG	CH0012138530	Financial Services	★★★★★	11.98	22.00	Narrow	High	30,590	CHF
KBC Group SA/NV	BE0003565737	Financial Services	★★★★	59.44	80.00	Narrow	Medium	24,736	EUR
UBS Group AG	CH0244767585	Financial Services	★★★★	12.84	20.00	Narrow	High	47,853	CHF
Bayer AG	DE000BAY0017	Healthcare	★★★★★	66.97	113.00	Wide	High	62,453	EUR
ConvaTec Group PLC	GB00BD3VFW73	Healthcare	★★★★	142.35	228.00	Narrow	High	2,799	GBX
Roche Holding AG	CH0012032048	Healthcare	★★★★★	263.00	333.00	Wide	Low	224,328	CHF
Babcock International Group PLC	GB0009697037	Industrials	★★★★★	535.20	830.00	Narrow	Medium	2,706	GBX
GEA Group AG	DE0006602006	Industrials	★★★★★	24.19	45.00	Wide	Medium	4,366	EUR
Kion Group AG	DE000KGX8881	Industrials	★★★★★	50.96	90.00	Narrow	Medium	6,001	EUR
Unibail-Rodamco-Westfield	AU0000009771	Real Estate	★★★	12.39	13.30	Narrow	Medium	34,307	AUD
Atos SE	FR0000051732	Technology	★★★★	79.74	90.00	Narrow	Medium	8,519	EUR
SSE PLC	GB0007908733	Utilities	★★★★	1,180.50	1,380.00	Narrow	Medium	12,118	GBX

Data as of Feb. 4, 2019. | ↑ = Upgrade, ↓ = Downgrade, ★ = New Addition

tobacco company: slightly larger than Philip Morris on net revenue, but slightly smaller on volumes. British American's global drive brands are Dunhill, Kent, Pall Mall, Lucky Strike, and Rothmans. The firm also sells vapor e-cigarettes, including its Vype brand; heated tobacco, with Glo; and roll-your-own and smokeless tobacco products.

While the stock is not a new addition to the list, we felt it would be a good opportunity to highlight the stock, since it trades at a 40% discount to analyst Phillip Gorham's GBX 4,500 fair value. Gorham forecasts an annual volume decline of 2% on average over the next five years, with price/mix of 5%, a touch below the levels of recent years. He believes a more significant risk to the company's valuation is the potential ban on menthol in the U.S., which could significantly reduce sales of the company's Newport brand. However, Gorham believes the firm's pricing power, which stems from its wide moat will alleviate possible volume declines. Gorham believes British American Tobacco's moat stems from its strong franchise in the tobacco industry, formed by the aggregation of intangible assets and a cost advantage.

Tight government regulations have made barriers to entry almost insurmountable in the tobacco industry and have kept market shares stable. Consumers are fairly brand-loyal, particularly in premium-price segments, creating another intangible asset that is no longer as prevalent in other consumer categories. Finally, economies of scale give the large-cap manufacturers an advantage in tobacco leaf procurement and distribution. Gorham's valuation implies 2019 multiples of over 16 times earnings, 13 times enterprise value/EBITDA, a free cash flow yield of 6%, and a dividend yield of 4%. These are roughly in line with historical valuations and are sandwiched between those of Philip Morris International, British American's closest comparable, with slightly higher implied multiples, and Imperial Brands. This is appropriate, in his view, because it reflects the companies' relative positioning in the heated tobacco category.

Wide-moat GEA Group, is an expert in food processing. It manufactures equipment for separation, fluid handling, dairy processing, and dairy farming, and designs and constructs process lines or entire plants for customers. Based in Germany, GEA Group is a global market leader, with number-one or -two positions in its markets. Its separators are used in hundreds of different, tailored applications. Every fourth liter of milk, third instant coffee line, third chicken nugget, and second liter of beer globally is processed with GEA's specialized equipment. Similar to British American Tobacco, we are highlighting GEA because it trades at just over a

30% discount to analyst Denise Molina's EUR 45 fair value. Molina thinks there are near-term headwinds as the firm's restructuring efforts take effect, but her medium-term revenue growth forecast at 4.4%, including acquisitions (around 40 basis points of growth), remains intact. Molina believes GEA's business and market positions reflect a wide moat. New entrants face a high barrier to entry trying to establish themselves in an industry where established firms are trusted to ensure that branded products are differentiated and consistent, and that they do not carry the risk of causing foodborne illnesses.

Existing market shares are stable for a similar reason: Food processing companies have a significant risk aversion to changing trusted suppliers. The sources of GEA's moat are its intangible assets and high switching costs. GEA's intangible assets come from its leading patent-protected technologies and reliability as a partner. In dairy farming and processing, it has been supplying to the market for more than a century. Its high switching costs come from barriers to entry created by regulatory requirements and the sensitivity of its customers to safety concerns and food scandals.

These and the rest of our top picks for each sector for February 2019 are listed here. From a price/fair value standpoint, the overall list changed considerably, with an average increase of about 480 basis points. Consumer defensive maintained its status as the cheapest sector on the list, followed by industrials and communication services. 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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