

Europe Core Pick List

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March'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 higher amount of turnover compared with last month's list, as there were more trading-level fluctuations, fair value estimate and moat rating changes in February.

Firms that left our list this month included **Kingfisher** (consumer cyclical), **KBC Group** (financial services), **ConvaTec Group** (healthcare) and **Atos** (technology). Our overall European coverage trades at an average of 82% to our fair value estimates.

Narrow-moat ConvaTec Group left the list this month, as analyst Debbie Wang lowered her fair value estimates to GBX

192 from GBX 228, while the stock also fell approximately 6% over the past month. Wang's updated outlook cuts projections for advanced wound care and ostomy growth and baking in more pessimistic and longer recoveries as the firm searches for a new permanent CEO.

Narrow-moat KBC Group also left the list this month, as analyst Derya Guzel maintained her fair value estimate of EUR 80 while shares jumped about 10% over the month. Guzel continues to like the bank insurance business model, where the bank leverages its retail branch network for the sale of insurance products as it offers diversification in terms of revenue and risk. Additionally, the collaboration between the bank and insurance distribution channels creates synergies and enables KBC to manage costs. While shares for both stocks still look attractive, the price depreciation across

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	★★★★	64.64	81.00	Narrow	High	12,826	EUR
LafargeHolcim Ltd	CH0012214059	Basic Materials	★★★★	49.40	60.00	Narrow	High	29,502	CHF
BT Group PLC	GB0030913577	Communication Services	★★★★	214.70	360.00	Narrow	High	21,304	GBX
Telefonica SA	ES0178430E18	Communication Services	★★★★★	7.58	13.00	Narrow	High	39,403	EUR
Vodafone Group PLC	GB00BH4HKS39	Communication Services	★★★★★	134.28	250.00	Narrow	High	35,880	GBX
Bayerische Motoren Werke AG	DE0005190003	Consumer Cyclical	★★★★	74.31	117.00	Narrow	High	48,343	EUR
★ Dufry AG	CH0023405456	Consumer Cyclical	★★★★	101.20	144.00	Narrow	High	5,109	CHF
WPP PLC	JE00B8KF9B49	Consumer Cyclical	★★★★★	825.80	1,450.00	Narrow	Medium	10,420	GBX
Anheuser-Busch InBev SA/NV	BE0974293251	Consumer Defensive	★★★★★	68.55	103.00	Wide	Low	134,118	EUR
British American Tobacco PLC	GB0002875804	Consumer Defensive	★★★★★	2,758.50	4,500.00	Wide	Low	63,274	GBX
Imperial Brands PLC	GB0004544929	Consumer Defensive	★★★★★	2,510.50	3,700.00	Wide	Low	24,019	GBX
BP PLC	GB0007980591	Energy	★★★★	534.40	670.00	Narrow	High	108,262	GBX
Royal Dutch Shell PLC	GB00B03MM408	Energy	★★★★	2,364.50	3,250.00	Narrow	Medium	192,594	GBX
↓ Credit Suisse Group AG	CH0012138530	Financial Services	★★★★★	12.34	20.00	Narrow	High	31,509	CHF
★ Swedbank AB	SE0000242455	Financial Services	★★★★	169.70	232.00	Narrow	Medium	189,500	SEK
UBS Group AG	CH0244767585	Financial Services	★★★★	12.70	20.00	Narrow	High	47,337	CHF
Bayer AG	DE000BAY0017	Healthcare	★★★★★	70.28	113.00	Wide	High	65,540	EUR
★ Grifols SA	ES0171996095	Healthcare	★★★★	16.82	22.50	Narrow	Medium	14,074	EUR
Roche Holding AG	CH0012032048	Healthcare	★★★★	277.30	333.00	Wide	Low	236,533	CHF
Babcock International Group PLC	GB0009697037	Industrials	★★★★★	541.00	830.00	Narrow	Medium	2,735	GBX
↓ GEA Group AG	DE0006602006	Industrials	★★★★★	21.07	38.00	Wide	Medium	3,803	EUR
Kion Group AG	DE000KGX8881	Industrials	★★★★★	50.12	90.00	Narrow	Medium	5,903	EUR
↑ Unibail-Rodamco-Westfield	FR0013326246	Real Estate	★★★	142.00	150.00	Narrow	Medium	19,637	EUR
★ Infineon Technologies AG	DE0006231004	Technology	★★★	19.30	22.00	Narrow	High	21,834	EUR
SSE PLC	GB0007908733	Utilities	★★★★	1,188.50	1,380.00	Narrow	Medium	12,200	GBX

Data as of March 1, 2019 (Feb. 28 closing prices) | ↑ = Upgrade, ↓ = Downgrade, ★ = New Addition

the entire market caused other names to become relatively cheaper.

New additions to the list this month included **Dufry** (consumer cyclical), **Swedbank** (financial services), **Grifols** (healthcare), and **Infinion Technologies** (technology). Dufry and Swedbank specifically represent some of the cheaper European names on an uncertainty-adjusted, price/fair value basis; both currently trade at about a midteen percentage discount to their respective fair values.

Narrow-moat Dufry is the world's largest duty-free shop operator and leader in travel retail. It commands around 12%-13% market share in a fragmented global travel retail market, including over 20% in airport retail (more than double that of the next biggest competitor), through its presence in 64 countries and around 300 airports globally (airports represent 90% of the company's total revenue).

Dufry's main markets are Europe (accounting for almost 50% of revenue), North and Latin America (around 20% of revenue each), and Asia, the Middle East, and Australia (accounting for around 10% of sales). Perfumes, cosmetics, and food are Dufry's top-selling categories, accounting for almost half of revenue, with wines and spirits, tobacco goods, watches, and jewelry also representing important categories.

The stock was added to the list as price appreciation in other stocks made Dufry's relative valuation more attractive while it traded flat over the previous month. Analyst Jelena Sokolova has a CHF 144 fair value estimate, which implies 17 times 2018 adjusted P/E multiple (our adjusted earnings exclude amortization of acquired intangibles) and 10.6 times adjusted EBITDA.

Sokolova forecasts sales grow at an average 4%-5% annual pace over the next 10 years which implies 3%-4% passenger growth on existing routes and low-single-digit contribution from new concessions as the company gains share against smaller, less cost-advantaged peers, both organically and through consolidation (compared with the 5% annual growth in passenger numbers through 2040, according to the World Airport Traffic Forecasts). Sokolova contends that the length, diversity, and high renewal rates of Dufry's concessions in travel catchment areas and its purchasing scale advantages against peers will allow the firm to generate economic profits for the next decade, which forms the basis of the narrow moat rating.

Highlighting these advantages, the duty-free channel (62%

of the company's sales) is a perceived value-saving channel among traveling consumers. Thanks to exemption from local taxes and duties, prices in this channel can be as much as 40% lower on some items relative to street prices, according to Bloomberg.

This advantage, along with a captive audience, scale, and no direct competition (operators are usually the sole distributors of a product category in an airport), allows Dufry to achieve gross margins of almost 60%, significantly above the 30%-40% range of high-street retailers.

Swedbank is one of the oldest Swedish banks and is the fourth largest by asset size. In addition to Sweden, which is its main market, including the Baltics (Estonia, Latvia, and Lithuania), Swedbank has four home markets. It also operates in Norway, Finland, Denmark, the United States, China, Luxembourg, and South Africa. Swedbank has a market-leading position in the Baltics, with market share ranging from 20% to 55% in retail banking, where it generates 16% of revenue.

Shares dropped 18% over February while analyst Derya Guzel maintained her SEK 232 fair value estimate leading to the stock's addition to the list. Guzel's fair value estimate implies a 1.9 times book value and about 13.5 times earnings on her 2018 estimates. Guzel contends Swedbank's moat stems from its size, which produces cost advantages via economies of scale. Its Swedish banking segment (above 55% of 2017 revenue) serves the bank's domestic retail clients and includes the activities of Swedbank Hypotek, a fully owned mortgage bank that primarily offers mortgages to individuals.

Swedbank's main lending area is to the real estate sector. More than 50% of lending is for private mortgages, while 15% is to property management companies and 7% to housing cooperatives. With 25% market share, the bank has a leading position in mortgage lending (Handelsbanken 23%, Nordea 15%, and SEB 15%). Given its 20%-plus market share in deposits from the public (Handelsbanken 17%, Nordea 16%, and SEB 12%), she believes the bank possesses implicit switching costs. It had an average cost/income ratio of 44% for the past five years, which is below the peer average of 51% and 1 percentage point below closest peer Handelsbanken's 45% cost/income ratio.

Most costs associated with retail deposit-taking and mortgage lending are fixed, making scale a key factor in generating returns. In terms of profit generation, Swedbank's average 15% ROE (2012-17) also stands out versus a peer

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.

average of 13.4%, and exceeds a cost of equity of 9%.

These and the remainder of our top picks for each sector for March 2019 are listed here. From a price/fair value standpoint, the overall list changed modestly (with an average increase of about 97 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.

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