

Europe Core Pick List

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April'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 similar amount of turnover compared with last month's list, as comparable trading-level fluctuations, fair value estimate, and moat rating changes occurred in March.

Firms that left our list this month included **LafargeHolcim** (basic materials), **Dufry** (consumer cyclical) and **Swedbank** (financial services). Our overall European coverage trades at an average of 96% to our fair value estimates.

Narrow-moat LafargeHolcim left the list this month, as analyst Kristoffer Inton lowered his fair value estimate to CHF 55 from CHF 60, while the stock traded flat over the past month.

Inton's updated outlook lowers EBITDA, as he expects relatively low capacity utilizations and cost inflation will weigh on margin expansion. Narrow-moat Swedbank also left the list this month, as analyst Derya Guzel maintained her fair value estimate of SEK 232 but raised her uncertainty rating to very high from medium. Guzel's increased uncertainty rating stems from regulators intensifying their inquiries into Swedbank's involvement in money laundering schemes related to money flows from former Commonwealth of Independent States countries and regarding revelations in the Panama Papers. While shares still look attractive for Swedbank, the changed uncertainty adjusted price/fair value caused the name to be left off the list this month.

New additions to the list this month included **Basf** (basic materials), **Publicis Groupe** (consumer cyclical) and **Nor-**

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
★ Basf SE	DE000BASF111	Basic Materials	★★★	65.53	74.00	Narrow	High	60,188	EUR
↑ HeidelbergCement AG	DE0006047004	Basic Materials	★★★★	64.16	82.00	Narrow	High	12,730	EUR
BT Group PLC	GB0030913577	Communication Services	★★★★	222.95	360.00	Narrow	High	22,123	GBX
Telefonica SA	ES0178430E18	Communication Services	★★★★★	7.46	13.00	Narrow	High	38,780	EUR
Vodafone Group PLC	GB00BH4HKS39	Communication Services	★★★★★	139.80	250.00	Narrow	High	38,048	GBX
Bayerische Motoren Werke AG	DE0005190003	Consumer Cyclical	★★★★	68.75	117.00	Narrow	High	44,676	EUR
★ Publicis Groupe SA	FR0000130577	Consumer Cyclical	★★★★	47.73	60.00	Narrow	Medium	11,044	EUR
WPP PLC	JE00B8KF9B49	Consumer Cyclical	★★★★★	810.80	1,450.00	Narrow	Medium	10,231	GBX
Anheuser-Busch InBev SA/NV	BE0974293251	Consumer Defensive	★★★★★	74.76	103.00	Wide	Low	146,268	EUR
British American Tobacco PLC	GB0002875804	Consumer Defensive	★★★★★	3,194.00	4,500.00	Wide	Low	73,263	GBX
Imperial Brands PLC	GB0004544929	Consumer Defensive	★★★★★	2,624.50	3,700.00	Wide	Low	25,110	GBX
BP PLC	GB0007980591	Energy	★★★★	558.50	670.00	Narrow	High	113,663	GBX
Royal Dutch Shell PLC	GB00B03MM408	Energy	★★★★	2,428.00	3,250.00	Narrow	Medium	197,117	GBX
Credit Suisse Group AG	CH0012138530	Financial Services	★★★★★	11.60	20.00	Narrow	High	29,600	CHF
★ Nordea Bank Abp	FI4000297767	Financial Services	★★★★	70.75	104.00	Narrow	Medium	286,595	SEK
UBS Group AG	CH0244767585	Financial Services	★★★★	12.09	20.00	Narrow	High	46,658	CHF
↓ Bayer AG	DE000BAY0017	Healthcare	★★★★★	57.60	108.00	Wide	High	53,715	EUR
Grifols SA	ES0171996095	Healthcare	★★★★	17.68	22.50	Narrow	Medium	15,191	EUR
Roche Holding AG	CH0012032048	Healthcare	★★★★	273.20	333.00	Wide	Low	232,920	CHF
Babcock International Group PLC	GB0009697037	Industrials	★★★★★	493.50	830.00	Narrow	Medium	2,495	GBX
GEA Group AG	DE0006602006	Industrials	★★★★★	23.35	38.00	Wide	Medium	4,214	EUR
KION GROUP AG	DE000KGX8881	Industrials	★★★★★	46.59	90.00	Narrow	Medium	5,494	EUR
↓ Unibail-Rodamco-Westfield	AU0000009771	Real Estate	★★★	11.56	12.00	Narrow	Medium	31,985	AUD
Infineon Technologies AG	DE0006231004	Technology	★★★★	17.68	22.00	Narrow	High	20,002	EUR
SSE PLC	GB0007908733	Utilities	★★★★	1,187.00	1,380.00	Narrow	Medium	12,334	GBX

Data as of April 1, 2019 (March 29 closing prices) | ↑ = Upgrade, ↓ = Downgrade, ★ = New Addition

dea Bank (financial services). Publicis Groupe and Nordea Bank, 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 fair values.

Narrow-moat Publicis Groupe is the world's third-largest ad holding company based on revenue. Publicis' services, which include traditional and digital advertising, public relations, and consulting, are provided worldwide, with over 80% of its revenue coming from more developed regions such as North America and Europe. The stock was added to the list as it traded down approximately 7% over the past month while analyst Ali Mogharabi maintained his EUR 60 fair value estimate. Mogharabi's valuation represents enterprise value/sales, enterprise value/EBITDA, and price/earnings multiples of 1.5, 8, and 13.1 in 2019, respectively. He expects revenue growth to be driven primarily by overall GDP growth, in addition to contributions from the firm's acquisitions and fluctuations from foreign exchange leading to an estimated 10-year CAGR of 1.4% through 2028. Mogharabi contends Publicis narrow moat stems from valuable intangible assets around the holding company's brand equity and the strong reputations of its various advertising agencies around the world. He also thinks the firm's continuing investments in consumer data accumulation and analysis gives it a sustainable competitive advantage. Finally, to a lesser extent, he believes Publicis benefits from customer switching costs associated with further integration of the firm's resources with its clients' marketing departments. Supporting Publicis' intangible assets, Mogharabi believes its reputation and brand allow it to compete mainly with the other Big Five (WPP, Omnicom, Interpublic Group, and Dentsu) for the larger accounts. When seeking ad agencies to create and manage large campaigns, the Fortune 500 companies allow only a few ad companies to pitch their ideas. This is where the reputation and brands of the Big Five come into play, as the known agencies associated with the Big Five are typically asked to pitch and compete for the account or a specific campaign.

Narrow-moat Nordea Bank is the largest Swedish bank by asset size and by customer base served, both in the Nordics and the Baltic region. As of Jan. 2, 2017, its subsidiaries in Sweden, Finland, Denmark, and Norway were converted into bank branches of the Swedish parent company to achieve a simpler legal and operational structure. Shares dropped 14% over March while analyst Derya Guzel maintained her SEK 104 fair value estimate leading to the stock's addition to the list. Guzel's fair value estimate implies 1.4 times book value and about 13 times earnings on our 2019 estimates. Nordea

Bank operates via four main markets that Guzel views as its home markets: Sweden, Finland, Denmark, and Norway. It possesses dominant share in these markets, holding mostly number-one and number-two positions. Close to 90% of its total operating income is generated from these markets, with the remainder from the Baltics (3.5%), Luxembourg (3%), and Russia (1.6%). It sources operating income from four main segments: personal banking (35%), commercial and business banking (20%), wholesale banking (25%), and wealth management (20%). Guzel believes Nordea Bank's narrow-moat stems from implicit switching cost advantages, driven by its leading position in its geographies and market share. In terms of operational cost, for the past few years, Nordea kept its cost/income level stable around 52%. The firm continues to focus on cost reduction, largely through simplification, reorientation, replacement of the core bank system, and digital transformation, as well as a fresh look at the cost approach.

These and the remainder of our top picks for each sector for April 2019 are listed here. From a price/fair value standpoint, the overall list changed marginally (with an average increase of about 6 basis points). Consumer defensive maintained its status as the cheapest sector on the list, followed by industrials and consumer cyclical. 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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