Europe Core Pick List
May 2019

Alex Morozov, CFA
Director of Equity Research, Europe

May's edition of the Morningstar Europe Core Pick List features the most attractively valued, European-domiciled companies with sustainable competitive advantages. This month's list saw a similar amount of turnover as last month's, as comparable trading-level fluctuations and fair value estimate and moat rating changes occurred throughout March.

Firms that left our list this month included **Basf** (basic materials), **Publicis Groupe** (consumer cyclical) and **Babcock International Group** (industrials). Our overall European coverage trades at an average of 99% to our fair value estimates.

Narrow-moat Publicis left the list this month after being highlighted in April's commentary, as analyst Ali Mogharabi increased his fair value estimate to EUR 64 from EUR 60 and the stock appreciated approximately 15% over the past month. Mogharabi's updated outlook related to the firm's acquisition of Alliance Data Systems' target-marketing services company, Epsilon. He believes Publicis is now better positioned to offer its clients data analytics capabilities, which go well together with its creativity segment. While the stock is still considered undervalued, its price appreciation combined with other stocks in the sector becoming cheaper caused the name to be left out. Narrow-moat Babcock International also left the list this month, as Morningstar dropped analyst coverage of the name on April 14.

New additions to the list this month included **Lafarge-Holcim** (basic materials), **Dufry** (consumer cyclical) and **Prosegur Compania De Segurida** (industrials). Both Dufry

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.

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	DE0006047004	Basic Materials	★★★	72.00	82.00	Narrow	High	14,286	EUR
✶	LafargeHolcim	CH0012214059	Basic Materials	★★★	52.38	55.00	Narrow	High	31,228	CHF
	BT Group	GB0030913577	Communication Services	★★★★	229.05	360.00	Narrow	High	22,728	GBX
	Telefonica	ES0178430E18	Communication Services	★★★★★	7.43	13.00	Narrow	High	38,588	EUR
	Vodafone Group	GB00BH4HKS39	Communication Services	★★★★★	142.00	250.00	Narrow	High	38,235	GBX
↑	Bayerische Motoren Werke	DE0005190003	Consumer Cyclical	★★★★	75.90	118.00	Narrow	High	49,385	EUR
✶	Dufry	CH0023405456	Consumer Cyclical	★★★★	99.54	137.00	Narrow	High	4,947	CHF
	WPP	JE00B8KF9B49	Consumer Cyclical	★★★★★	956.40	1,450.00	Narrow	Medium	12,069	GBX
	Anheuser-Busch InBev	BE0974293251	Consumer Defensive	★★★★★	79.26	103.00	Wide	Low	155,072	EUR
	British American Tobacco	GB0002875804	Consumer Defensive	★★★★★	2,990.00	4,500.00	Wide	Low	68,584	GBX
	Imperial Brands	GB0004544929	Consumer Defensive	★★★★★	2,436.00	3,700.00	Wide	Low	23,306	GBX
	BP	GB0007980591	Energy	★★★★	559.00	670.00	Narrow	High	113,769	GBX
	Royal Dutch Shell	GB00B03MM408	Energy	★★★★	2,464.50	3,250.00	Narrow	Medium	199,800	GBX
	Credit Suisse Group	CH0012138530	Financial Services	★★★★	13.60	20.00	Narrow	High	34,106	CHF
	Nordea Bank	FI4000297767	Financial Services	★★★★	74.75	104.00	Narrow	Medium	313,653	SEK
	UBS Group	CH0244767585	Financial Services	★★★★	13.66	20.00	Narrow	High	52,733	CHF
	Bayer	DE000BAY0017	Healthcare	★★★★★	59.34	108.00	Wide	High	55,338	EUR
	Grifols	ES0171996095	Healthcare	★★★★	17.18	22.50	Narrow	Medium	15,034	EUR
↑	Roche Holding	CH0012032048	Healthcare	★★★★	268.60	343.00	Wide	Low	229,024	CHF
	GEA Group	DE0006602006	Industrials	★★★★★	24.92	38.00	Wide	Medium	4,498	EUR
	Kion Group	DE000KGX8881	Industrials	★★★★★	61.04	90.00	Narrow	Medium	7,198	EUR
✶	Prosegur Compania De Seguridad	ES0175438003	Industrials	★★★★★	4.63	7.10	Narrow	Medium	2,776	EUR
	Unibail-Rodamco-Westfield	AU0000009771	Real Estate	★★★	12.23	12.00	Narrow	Medium	33,604	AUD
	Infineon Technologies	DE0006231004	Technology	★★★	21.02	22.00	Narrow	High	23,779	EUR
	SSE	GB0007908733	Utilities	★★★★	1,144.50	1,380.00	Narrow	Medium	11,859	GBX

Data as of May 1, 2019 (April 30 closing prices) | ↑ = Upgrade, ↓ = Downgrade, ✶ = New Addition and Prosegur Compania De Segurida have been highlighted in previous editions of the pick list. However, they again specifically represent some of the cheaper European names on an uncertainty-adjusted, price/fair value basis; both currently trade at about a midteens percentage discount to their 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 65 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 down over the previous month. Analyst Jelena Sokolova has a CHF 137 fair value estimate, which implies 16 times 2019 adjusted P/E multiple (our adjusted earnings exclude amortization of acquired intangibles) and 10.2 times adjusted EBITDA.

Sokolova forecasts sales grow at an average 4% annual pace over the next 10 years, which implies 3% 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 (61% 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% of high-street retailers.

Narrow-moat Prosegur Compania De Segurida, is one of the largest security companies worldwide. Its operations are focused on emerging markets compared with peers (G4S and Securtias), with over two thirds of revenue coming from these regions, in particular Latin America. A majority of its revenue is derived from cash-in-transit services —that is, armored-car cash pickups—as well as ancillary services, such as ATM management, cash counting, and reconciliation.

Analyst Michael Field believes Prosegur has a narrow moat driven by its high exposure to the CIT business. Field believes this business has aspects of switching costs as the industry is consolidated, with five firms controlling 50% of the global market, and changing suppliers carries a higher risk of business disruption with the immediate loss of significant cash a risk that most businesses don't take lightly. This is evidenced by the high retention rates, long-dated contracts of around five years and generating operating margins of 20%.

Overall, Field has maintained his fair value estimate of EUR 7.10 and expects organic revenue growth to average close to 7.5% over his 10-year explicit forecast period. This growth will be driven primarily by Latin America where results have been skewed the past few years by severe foreign exchange movements. From an operating margin perspective, Field forecasts a moderate improvement, with adjusted margins increasing incrementally from a currency-related depressed level of 7.7% in 2018 and averaging 10% over his forecast period. This margin improvement is predicated upon further operating efficiency and continued discipline in shedding low-margin contracts in the manned guarding business.

Field also believes that increased growth in the alarms business, which is higher-margin than manned guarding, and upselling of services in CIT will assist in improving group margins over time. Field expects these margin improvements to continue and believes the stock currently represents an attractive investment opportunity.

These and the remainder of our top picks for each sector for May 2019 are listed here. From a price/fair value standpoint, the overall list changed materially (with an average increase of about 265 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.

MEDIRECT DISCLAIMERS:

This information has been accurately reproduced, as received from Morningstar. No information has been omitted which would render the reproduced information inaccurate or misleading. This information is being distributed by MeDirect Bank (Malta) plc to its customers.

The information contained in this document is for general information purposes only and is not intended to provide legal or other professional advice nor does it commit MeDirect Bank (Malta) plc to any obligation whatsoever. The information available in this document is not intended to be a suggestion, recommendation or solicitation to buy, hold or sell, any securities and is not guaranteed as to accuracy or completeness.

The financial instruments discussed in the document may not be suitable for all investors and investors must make their own informed decisions and seek their own advice regarding the appropriateness of investing in financial instruments or implementing strategies discussed herein.

If you invest in financial instruments you may lose some or all of the money you invest. The value of your investment may go down as well as up. Any income you get from any such investment may also go down as well as up. The performance figures quoted refer to the past and past performance is not a guarantee of future performance or a reliable guide to future performance.

MeDirect Bank (Malta) plc. Company Registration number C34125, is licensed by the Malta Financial Services Authority under the Banking Act (Cap. 371) and the Investment Services Act (Cap. 370).