

# Europe Core Pick List

## June 2019

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June'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 lower amount of turnover compared with last month's list, as fewer trading-level fluctuations, fair value estimate and moat-rating changes occurred during May.

Firms that left our list this month included **HeidelbergCement HEI** (basic materials) and **UBS Group UBS** (financial services). Our overall European coverage universe trades at an average of 93% to our fair value estimates.

Narrow-moat UBS Group left the list this month after analyst Johann Scholtz lowered his fair value estimate from CHF 20 to CHF 17 after the firm reported disappointing first-quarter

2019 results. Scholtz still believes UBS is undervalued and offers good exposure to some good secular growth stories, such as the increased concentration of wealth, the growth of high-net-worth individuals in emerging markets, and an ageing population. However, the fair value estimate cut, combined with other stocks in the sector becoming cheaper, resulted in the company leaving the list. Narrow-moat HeidelbergCement also left the list this month, with analyst Kristoffer Inton maintaining his EUR 82 fair value estimate while shares depreciated approximately 7%. Inton continues to assign a narrow moat based on a low-cost advantage and high barriers to entry stemming from the low value/weight ratio of cement and aggregates, and the difficulty obtaining permits for new cement plants or quarries. However, like UBS, the company left the list this month because other stocks became relatively cheaper.

### 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	DE000BASF111	Basic Materials	★★★★	61.32	74.00	Narrow	High	56,321	EUR
↑ LafargeHolcim	CH0012214059	Basic Materials	★★★★	48.68	61.00	Narrow	High	29,022	CHF
↓ BT Group	GB0030913577	Communication Services	★★★★	201.65	320.00	Narrow	High	20,009	GBX
↓ Telefonica	ES0178430E18	Communication Services	★★★★★	7.31	12.50	Narrow	High	37,991	EUR
↓ Vodafone Group	GB00BH4HKS39	Communication Services	★★★★	133.68	210.00	Narrow	High	35,724	GBX
Bayerische Motoren Werke	DE0005190003	Consumer Cyclical	★★★★★	63.43	118.00	Narrow	High	41,227	EUR
Dufry	CH0023405456	Consumer Cyclical	★★★★	81.80	137.00	Narrow	High	4,066	CHF
WPP	JE00B8KF9B49	Consumer Cyclical	★★★★★	969.60	1,450.00	Narrow	Medium	12,235	GBX
Anheuser-Busch InBev	BE0974293251	Consumer Defensive	★★★★★	74.30	103.00	Wide	Low	145,368	EUR
British American Tobacco	GB0002875804	Consumer Defensive	★★★★★	2,838.00	4,500.00	Wide	Low	65,098	GBX
Imperial Brands	GB0004544929	Consumer Defensive	★★★★★	1,938.00	3,700.00	Wide	Low	18,542	GBX
BP	GB0007980591	Energy	★★★★	544.60	670.00	Narrow	High	110,827	GBX
↓ Royal Dutch Shell	GB00B03MM408	Energy	★★★★	2,479.00	3,100.00	Narrow	Medium	199,881	GBX
Credit Suisse Group	CH0012138530	Financial Services	★★★★★	11.59	20.00	Narrow	High	29,065	CHF
★ HSBC Holdings	GB0005405286	Financial Services	★★★★	647.70	790.00	Narrow	High	131,075	GBX
Nordea Bank	FI4000297767	Financial Services	★★★★★	68.83	104.00	Narrow	Medium	277,656	SEK
Bayer	DE000BAY0017	Healthcare	★★★★★	54.50	108.00	Wide	High	50,824	EUR
Grifols	ES0171996095	Healthcare	★★★★	16.10	22.50	Narrow	Medium	13,991	EUR
Roche Holding	CH0012032048	Healthcare	★★★★★	263.00	343.00	Wide	Low	224,626	CHF
GEA Group	DE0006602006	Industrials	★★★★★	25.39	38.00	Wide	Medium	4,583	EUR
KION GROUP	DE000KGX8881	Industrials	★★★★★	50.44	90.00	Narrow	Medium	5,948	EUR
Prosegur Compania De Seguridad	ES0175438003	Industrials	★★★★★	3.73	7.10	Narrow	Medium	2,235	EUR
↑ Unibail-Rodamco-Westfield	FR0013326246	Real Estate	★★★	136.40	150.00	Narrow	Medium	18,874	EUR
Infineon Technologies	DE0006231004	Technology	★★★★	14.87	22.00	Narrow	High	16,822	EUR
SSE	GB0007908733	Utilities	★★★★	1,088.00	1,380.00	Narrow	Medium	11,243	GBX

Data as of June 5, 2019 (June 5, 2019 closing prices) | ↑ = Upgrade, ↓ = Downgrade, ★ = New Addition

New additions to the list this month included **Basf BASF** (basic materials) and **HSBC Holdings HSBA** (financial services). Basf and HSBC are some of the cheaper European firms on an uncertainty-adjusted, price/fair value basis. Both currently trade at about a low-teen percentage discount to their respective fair values.

Narrow-moat Basf is the world's largest chemical company, with products spanning the full spectrum of commodities to specialties. In addition, the company is a strong player in agricultural crop protection and has a sizable exploration and production business in oil and gas. Given its sheer size, Basf has a top-three market position in 70% of its businesses. About half of its sales are generated in Europe, while North America and Asia each account for about 20% of sales. The stock was added to the list after falling about 20% over the previous month. Analyst Rob Hales has maintained a EUR 74 fair value estimate, which implies a price/earnings ratio of 14 times and an enterprise value/EBITDA ratio of 9.5 times, based on 2018 estimates.

Hales thinks Basf has a narrow moat based on its cost advantage. The company's cost advantage stems from its unique Verbund production process, which amplifies the benefits of economies of scale from massive production facilities by clustering plants together and linking them through a system of pipelines. By linking plants, additional cost savings are generated through a reduction in transportation and energy expenses. Additionally, Basf's portfolio of specialty chemicals and catalysts, where certain businesses benefit from intangible assets or switching costs, further strengthens the firm's competitive position. For example, Hales believes Basf's agricultural solutions segment has traces of intangible assets.

This segment produces specialized fungicides, herbicides, and insecticides for crop protection. Similar to pharmaceutical companies, Basf invests significantly in research and development to create products that are protected by patents. It typically takes over seven years to bring products to market, and approved patents have protection that generally lasts for 20 years.

HSBC is one of the largest banks in the world with 38 million customers worldwide. It operates across 3,800 offices in 66 countries globally. Key regions include Asia, Europe, the Middle East and North Africa, and North America. The two largest markets for the bank are the U.K. and Hong Kong. The bank provides retail and commercial banking, global banking and markets, wealth management, and other services. HSBC

was added to the list this month as the stock traded down slightly, while analyst Michael Wu maintained his fair value estimate of GBX 790.

His fair value estimate represents a price/book ratio of 1.2 times and assumes a cost of equity of 9.5% for the bank. With the bank's restructuring in the rear window, he expects costs to increase at a more controlled pace, with investments directed at generating revenue growth. Combined with rising income underpinned by the normalization of U.S. interest rate and rising fee income on buoyant economic conditions globally, he forecasts cost/income to decline and profitability to improve in the medium term. Global growth is expected to track at an average of close to 3% over the next five years. He assumes a five-year compound annual loan growth rate of about 5.3%.

Overall, he expects profitability to increase steadily toward management's target of return-on-tangible equity of 11%. Wu contends HSBC has a narrow economic moat stemming from strong cost advantages and switching costs. From a funding-cost perspective, the bank benefits from a sizable market share in Hong Kong and the U.K., and its strong liquidity and capital position allows the bank to raise wholesale funding at favorable rates. HSBC also offers a deep network of connections worldwide to help clients conduct global trade, where banks help customers complete export and import transactions, and manage payments and working-capital needs.

The nature of trade finance means letters of credit and short-term loans are used, typically for 90 to 120 days, which means losses tend to be extremely low (letters of credit tend to default below 30 basis points and as low as a single basis point for certain products, and are the most common instrument, whereas loans tend to default at about 70 basis points and tend to be high risk).

Funding and deposit relationships are typically corporate and similarly short-term oriented, and thus less sticky relative to retail depositors. However, HSBC offers multiple services to corporate clients to enhance switching costs. In addition to trade finance, liquidity and cash management, and foreign exchange form the basic wholesale product suite. These products are sticky and generate recurring revenue for the bank, which makes up 70% of revenue for global banking and markets.

These and the remainder of our top picks for each sector over June 2019 are listed here. From a price to fair value

#### 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.

standpoint, the overall list changed materially (with an average decrease of about 560 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.

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