Fisher & Paykel Healthcare Corporation Limited FPH-NZ

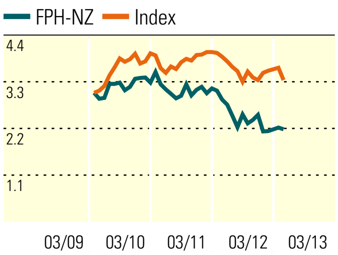
Disappointing OSA performance constrains earnings growth

Analyst Recommendation: **Hold** 28 May 2012

Snapshot

Business Risk	Medium
Price Risk	Medium
Moat Rating	None
Fair Value $	2.40
Market Cap $Mil	1,156
Morningstar Style Box	–
Last Price $	2.18
52 Week High/Low $	3.00/2.09
Shares Issued Mil	530
Sector	GICS - Healthcare

Price vs. Market

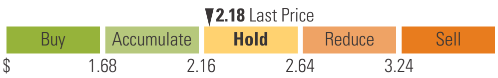


	03/11	03/12	03/13e	03/14e
NPAT ($Mil)	63.5	64.3	70.4	80.1
EPS ¢	12.4	12.2	13.4	15.3
EPS Chg %	-11.2	-1.2	9.5	13.9
DPS ¢	–	–	13.0	13.0
Franked %	0.0	0.0	0.0	0.0
Div Yld %	–	–	6.0	6.0
P/E x	25.2	20.5	16.3	14.3

Source: Morningstar analyst estimates.

Business Description

Fisher & Paykel Healthcare Corporation Limited (FPH-NZ) is involved in the design, manufacture and marketing of heated humidification products and systems for respiratory care and treatment of obstructive sleep apnea. Exporting to over 120 countries FPH's head office and manufacturing operations are located in New Zealand. Major clients are hospitals, home healthcare providers, distributors and manufacturers of medical devices.



Investment Rating

FPH is the world´s leading provider of Respiratory Humidification (RH) products and commands a high market share. It also produces CPAP and masks for treatment of Obstructive Sleep Apnea (OSA). FPH has unveiled a slew of new products and interfaces in respiratory and sleep apnea which should boost revenue and earnings over the long term. North America is a key growth area for FPH and a critical market for Obstructive Sleep Apnea (OSA). Earnings are sensitive to the NZ$/US$ exchange rate.

Event

► Underlying NPAT was NZD 64m, in line with management's NZD 62-67m guidance provided after the first-half results, and flat on the previous corresponding period (pcp).

► However, in constant currency (CC) terms, earnings were up 23%, slightly lower than the 25% growth projected by management.

► This was driven by double-digit growth in Respiratory and Acute Care (RAC), production cost savings from the Mexican facility, pricing gains - especially in RAC - and lower selling expenses due to the establishment of direct sales operations in certain markets like Japan.

► FPH maintained dividends of NZ12.4cps, equivalent to nearly 100% of NPAT. This is fully imputed for NZ shareholders.

Impact

► Going forward, management anticipates RAC revenues to be up by mid-single digits in the first half and between low-to-mid teens in the second half. In the first half, the firm will be up against comps off a strong base.

► Like RAC, management anticipates a similar growth trajectory for OSA in FY12. Second-half growth in expected to be stronger, driven by the introduction of new masks.

► We are modestly lowering our FY13 forecast from NZD 73m to NZD 70m and rolling out our FY14 forecast of NZD 80m. We are also taking this opportunity to reduce our fair value from NZD 2.70 per share to NZD 2.40 per share, due to changes to our longer-term profit projections.

Recommendation Impact

Our recommendation moves to Hold from Accumulate given the reduction in our fair value. Trigger levels have been amended as well.

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Nachi Moghe
Morningstar Analyst

Analyst Note

Disappointing OSA performance constrains earnings growth

FPH declared its full-year results for the year ending 31 March 2012. Underlying NPAT was NZD 64m, in line with management's NZD 62-67m guidance provided after the first-half results, and flat on the previous corresponding period (pcp). However, in constant currency (CC) terms, earnings were up 23%, slightly lower than the 25% growth projected by management. This was driven by double-digit growth in Respiratory and Acute Care (RAC), production cost savings from the Mexican facility, pricing gains - especially in RAC - and lower selling expenses due to the establishment of direct sales operations in certain markets like Japan.

Adverse foreign currency movements were to some extent offset by favourable foreign currency hedging. The effective NZD/USD exchange rate including hedging was around 66.4c, versus 62c in the prior period. The effective NZD/euro exchange rate was marginally higher at 48.2c in FY12. These currencies make up nearly 75% of FPH's sales and therefore have a big influence on the firm's revenues, margins and earnings.

FPH expects FY13 earnings to be between NZD 62-70m based on a NZD/USD exchange rate of between 0.75-0.80c for the remainder of the year. In CC terms, FPH expects revenues to grow by mid-single digits in the first half, increasing to between low-to-mid teens in the second half. It also expects gross and operating margins to improve as a result of further cost savings and increased sales of higher-margin products. Consequently, it expects operating earnings to rise by 15-20% in CC terms.

We are modestly lowering our FY13 forecast from NZD 73m to NZD 70m and rolling out our FY14 forecast of NZD 80m. We are also taking this opportunity to reduce our fair value from NZD 2.70 per share to NZD 2.40 per share, due to changes to our longer-term profit projections. Our intrinsic value is based on a DCF valuation incorporating a WACC of 9.4% and a terminal growth rate of 3%. FPH maintained dividends of NZ12.4cps, equivalent to nearly 100% of NPAT. This is fully imputed for NZ shareholders. The directors anticipate maintaining dividends at current levels in future, subject to earnings performance. Over the longer term, the company expects to pay dividends at greater than 60% of underlying earnings and aims to lower gearing to between 5-15% from 24% currently.

RAC delivered strong CC revenue growth of 13% for the full year, in line with the firm's 13-15% guidance. This was underpinned by a whopping 23% growth in the first half, reflecting inventory re-stocking by one of FPH's main hospital customers. However, the same customer reduced inventory in the second half, which negatively impacted revenue growth. The business benefited from the expansion into new applications such non-invasive ventilation, humidity therapy and oxygen therapy. Consumables used in these applications achieved CC growth of 24% and accounted for approximately 33% of RAC's consumables revenue. The humidifier business put on a credible performance, growing by 9% in CC terms despite the challenging economic conditions in the US and Europe. RAC prices increased modestly in FY12.

Going forward, management anticipates RAC revenues to be up by mid-single digits in the first half and between low-to-mid teens in the second half. In the first half, the firm will be up against comps off a strong base. We understand the inventory restocking that occurred in 1H12 boosted revenues by around NZD 7m during that period. Management anticipates stronger growth in the second half as comps get easier and new applications continue to gain traction.

While the RAC business performed strongly, the Obstructive Sleep Apnea (OSA) division suffered because of a significant slowdown in sales of consumables such as masks. As a result, the OSA business posted a modest 3% growth in CC terms, well below the 10-15% growth the business has achieved historically. Revenue growth was flat in the second half and was up 8% in the first half. We believe the lack of new products affected market share and constrained revenue growth.

On the other hand, flow generators, which account for approximately 30% of sales, achieved 18% growth in CC, spurred on by the continued penetration of ICON. This revolutionary product has been around for over a

Fisher & Paykel Healthcare Corporation Limited FPH-NZ

Nachi Moghe
Morningstar Analyst

year now and is helping FPH increase its presence in the premium end of the flow generator market. We understand ICON grew by around 40% year on year in the second-half, which was offset to some extent by the decline in the firm's traditional Sleep Style product. The OSA industry witnessed price declines of between 3-5% in FY12 due to competitive bidding. However, FPH managed to counter this through the sale of premium products like ICON.

Like RAC, management anticipates a similar growth trajectory for OSA in FY12. Second-half growth in expected to be stronger, driven by the introduction of new masks. Management believes the move towards home sleep testing (HST) and the shift in product mix in favor of APAC devices will increase the growth trajectory for the OSA industry from 6-8% currently to around 10-15% in the not-too-distant future.

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In perfect health

Bulls Points

► FPH is the global leader in providing humidification units and systems to transfer optimally humidified medical gases to the patient. New products and markets will spur growth and margins.
► Around 10% of the world population is affected by sleep apnea giving FPH a huge runway for growth as diagnosis and treatment rates rise.
► Barriers to entry such as a high level of technical expertise and regulatory approval by the Food and Drug Administration limit the number of competitors in the sleep apnea market, allowing existing competitors to generate excellent returns.

Bears Points

► FPH´s ability to sell products depends largely on the willingness of third parties to pay for treatment. Lower reimbursement rates for FPH´s products would hurt revenue and margin potential.
► FPH invests significantly in research and development. If it is unable to successfully introduce new products in the marketplace, sales, margins and market share may suffer.
► Unlike its peers, FPH is not well diversified geographically and derives an overwhelming proportion of its revenues from the US.

Key Valuation Assumptions	
Cost of Equity %	11.0
Weighted Avg Cost of Capital %	9.4
Long Run Tax Rate %	30.5
Stage II EBI Growth Rate %	3.0
Stage II Investment Rate %	12.6
Perpetuity Year	6.0

Thesis Last Updated: 28 May 2012

FPH is the world´s leading provider of Respiratory Humidification (RH) products. This business offers tremendous growth opportunities stemming from the firms ambition of expanding into newer markets. In the sleep apnea business FPH is experiencing high growth, but it is a distant third player in a market dominated by Resmed (RMD) and Respironics (RESP). We believe that a lot will hinge on how successful the firm is in fending off competition and achieving sustained growth in Obstructive Sleep Apnea (OSA).

The firm derives an equal proportion of revenues from RH and OSA products. We think that the business dynamics for RH are very favourable and FPH will continue to command a leadership position. Positive attributes of this business include lower competition, higher entry barriers and less pricing pressure. FPH has very strong R&D capabilities and is known for rolling out revolutionary products on an ongoing basis. The ThermoSmart CPAP which uses the patented heated humidification technology underscores the firms R&D strength. This unit has allowed the firm to not only gain market share in the faster growing OSA market but also enabled it to overcome pricing pressure. Product pipeline consisting of new masks, respiratory interfaces, controllers and CPAP´s remains healthy and augurs well for future growth.

We are enthused about FPH´s RH prospects. The firm has a range of products under development that will aid sufferers from a wider range of respiratory problems. These include non-invasive ventilation, oxygen therapy, COPD, Laparoscopic surgery and humidity therapy. These opportunities will increase the firm´s addressable market for RH from 5m patients to about 20-25m patients and help sustain mid teens revenue growth for the foreseeable future. In addition there is enormous scope from increasing the value of consumables sold per patient.

Nonetheless, heightened competition from bigwig OSA producers like RMD and Philips is the biggest threat to the firm´s earnings. Philips and RMD are tough competitors with deeper pockets and high market shares. To stay ahead of competition FPH will have to continually innovate or else see its market share deteriorate. To its credit FPH has done a good job of holding on to its market share. However the big question is; can the company in the long run successfully withstand the onslaught of its much bigger competitors who have a reservoir of resources at their disposal?

FPH´s near term free cash flow will remain under pressure due to an unfavourable currency and higher capital expenditure. Fortunately the firm is relatively under-geared and can therefore raise debt levels to support cash flows requirements. We expect FPH to deliver solid returns on invested capital over the long run. The stock will suit investors with a long term time horizon and a reasonably high appetite for risk.

Valuation Last Updated: 28 May 2012

We have reduced our fair value from NZ$2.70 to NZ$2.40, with an Hold recommendation. Although the company´s underlying performance is doing reasonably well, the foreign currency headwinds are impairing the group´s reported financial results. We expect to see continued currency volatility over the next three years, which adds further uncertainty to FPH´s pricing risk. Our DCF model incorporates a WACC of 9.4% and a terminal growth rate of 3%. We have a five-year projected revenue growth rate of 10.7% and a five-year operating margin projection of 19.1%.

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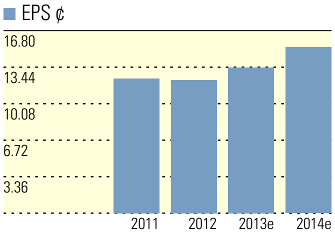
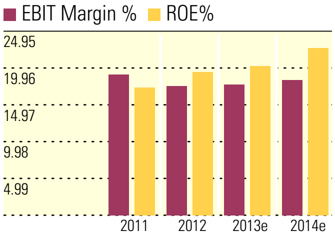
EPS



EBIT Margin vs. ROE



Risk Last Updated: 28 May 2012

FPH will have to continually innovate in a bid to maintain market share especially in the highly competitive OSA market. Market share losses either due to an inability to successfully launch new products or heightened competition could have dire implications. Intense competition could also put margins under pressure. Furthermore in order to support business growth FPH will require a commensurate increase in engineers to propel its R&D initiatives. There is a risk that finding skilled staff at that rate might pose a challenge. This could prompt the firm to establish an offshore development centre. There also remains a long term risk that a drug discovery of some sort, by one of the large pharmaceutical firms, could usurp CPAP as a more efficient, cheaper and an effective way of treating sleep apnea. Exchange rate fluctuations can impact profitability. FPH is highly sensitive to NZ$/US$ since 53% of its revenues are in US$.

Financial Overview

Growth

We expect FPH to achieve 10-15% revenue growth over the next 5 years in constant currency terms. RH growth will be spurred by new applications whilst the fast growing OSA market will propel OSA revenues. FX headwinds will add a risky dimension to reported results.

Profitability

We expect EBIT margins to remain range bound at between 19-20% over the next few years assuming a stable exchange rate. ROIC will continue to be in excess of WACC.

Financial Health

Capital expenditure is likely to increase remain at elevated levels due to the construction of the third building in Auckland. The firm´s balance sheet is relatively under-geared and can accommodate higher debt levels. Earnings also comfortably cover interest cost.

Strategy Analysis Last Updated: 25 Nov 2011

FPH is seeking to leverage off its strength by tapping into emerging opportunities that will help it deliver mid-teens growth over the long term. The focus is on expanding the product range, and offering products to treat a wider range of conditions while increasing sales presence in key global markets. Future expansion drivers are based around a consistent growth strategy with the development of complementary products and consumables. In the RH space FPH is seeking to develop products catering to non-invasive ventilation, oxygen therapy, COPD, Laparoscopic surgery and humidity therapy. These areas offer tremendous growth opportunities for FPH. Each AIRVO controller is expected to generate approximately US$1500 in sales. In addition it is anticipated that each COPD patient will go through at least four sets of consumables. In the OSA space FPH recently launched the ICON range of flow generators which has met with an encouraging response. We think FPH now has the right product to compete with the likes of RMD and Philips and we won´t be surprised if it is able to gain share overtime. In addition to delivering new products on a sustained basis FPH is looking at reducing costs by producing lower end commodity type products at its new facility in Mexico. Management thinks this facility is likely to contribute more than NZ$20m p.a. to annual operating profits within five years.

General Financials

Financials

Per Share	Historical 03/10	03/11	03/12	Forecast 03/13	03/14	03/15
Sales ¢	98.2	98.8	98.4	107.8	119.7	132.8
Adjusted Earnings ¢	14.0	12.4	12.2	13.4	15.3	17.7
Free Cash Flow ¢	20.6	7.3	4.7	8.3	8.5	9.7
Net Tangible Assets ¢	56.3	60.1	65.1	65.5	67.8	72.6
Book Value ¢	57.2	61.2	66.3	66.3	68.2	72.5
Dividends ¢	–	–	–	13.0	13.0	13.0
Franking %	0.0	0.0	0.0	0.0	0.0	0.0

Growth %	03/10	03/11	03/12	03/13	03/14	03/15
Sales Revenue	9.6	0.6	2.1	9.5	11.0	11.0
EBITDA	-0.7	1.8	-4.6	12.1	12.5	13.0
Pre-Tax Profit	25.3	-12.9	-0.3	9.5	13.9	15.8
EPS	18.2	-11.2	-1.2	9.5	13.9	15.8
DPS	–	–	–	–	0.0	0.0
Free Cash Flow per share	105.9	-64.8	-34.8	75.5	2.7	13.8

Profit & Loss ($Mil)	03/10	03/11	03/12	03/13	03/14	03/15
Sales Revenue	503.0	506.1	516.9	566.0	628.3	697.4
EBITDA	116.5	118.6	113.1	126.8	142.6	161.1
Depreciation	16.0	19.9	20.4	24.3	25.1	24.4
Amortisation	2.0	2.1	2.1	2.1	2.1	2.1
EBIT	98.5	96.5	90.6	100.3	115.3	134.5
Interest Expense	6.0	4.9	4.1	5.0	6.0	7.0
Interest Income	14.0	1.2	6.0	6.0	6.0	6.0
Profit Before Tax	106.5	92.8	92.5	101.3	115.3	133.5
Tax	35.0	40.3	28.2	30.9	35.2	40.7
Adjusted NPAT	**71.5**	**63.5**	**64.3**	**70.4**	**80.1**	**92.8**
Non-Recurring Items After Tax	0.0	-11.0	0.0	0.0	0.0	0.0
Reported NPAT	71.5	52.5	64.3	70.4	80.1	92.8
Free Cash Flow	105.6	37.2	24.8	43.6	44.7	50.9
Effective Tax Rate %	32.9	43.5	30.5	30.5	30.5	30.5

Cash Flow ($Mil)	03/10	03/11	03/12	03/13	03/14	03/15
Receipts from Customers	0.0	0.0	0.0	558.7	619.0	687.0
Payments to Suppliers	0.0	0.0	0.0	-427.0	-478.9	-527.4
Other Operating Cashflow	0.0	0.0	0.0	-39.4	-42.3	-50.5
Net Operating Cashflow	**0.0**	**0.0**	**0.0**	**92.2**	**97.7**	**109.2**
Capex	-48.0	-43.3	-67.5	-48.0	-53.0	-59.0
Acquisitions & Investments	0.0	0.0	0.0	0.0	0.0	0.0
Sales of Investments & Subsidiaries	0.0	0.0	0.0	0.0	0.0	0.0
Other Investing Cashflow	0.0	0.1	0.1	0.0	0.0	0.0
Net Investing Cashflow	**-48.0**	**-43.2**	**-67.4**	**-48.0**	**-53.0**	**-59.0**
Proceeds from Issues	7.0	23.9	24.4	0.0	0.0	0.0
Proceeds from Borrowings	-30.0	7.3	21.3	26.0	25.5	20.0
Dividends Paid	-68.0	-68.7	-70.2	-70.2	-70.2	-70.2
Other Financing Cashflow	0.0	0.0	0.0	0.0	0.0	0.0
Net Financing Cashflow	**-91.0**	**-37.5**	**-24.5**	**-44.2**	**-44.7**	**-50.2**
Net Increase Cash	-139.0	-80.7	-91.9	0.0	0.0	0.0
Cash at Beginning	0.0	7.0	6.1	6.3	6.3	6.3
Exchange Rate Adjustment	146.0	79.8	92.1	0.0	0.0	0.0
Cash at End	7.0	6.1	6.3	6.3	6.3	6.3

General Financials

Financials

Balance Sheet ($Mil)	Historical 03/10	03/11	03/12	Forecast 03/13	03/14	03/15
Cash & Equivalents	7.0	6.1	6.3	6.3	6.3	6.3
Accounts Receivable	71.0	79.6	77.1	84.5	93.7	104.1
Inventory	72.0	80.1	84.4	96.6	106.8	118.5
Other Short-Term Operating Assets	30.0	20.7	27.2	27.2	27.2	27.2
Total Current Assets	180.0	186.5	195.0	214.5	234.0	256.0
Property Plant & Equipment, Net	233.3	254.3	311.6	335.3	363.2	397.8
Goodwill, Net	0.0	0.0	0.0	0.0	0.0	0.0
Other Intangibles	5.0	5.4	6.4	4.3	2.1	0.0
Other Long-Term Operating Assets	2.0	1.5	1.8	1.8	1.8	1.8
Deferred Tax Assets	11.0	8.8	9.7	9.7	9.7	9.7
Long-Term Non-Operating Assets	44.0	61.1	47.5	47.5	47.5	47.5
Total Assets	**475.3**	**517.6**	**572.1**	**613.1**	**658.3**	**712.8**
Accounts Payable	59.0	58.0	60.9	73.0	79.8	88.7
Short-Term Debt	25.0	17.1	80.2	0.0	0.0	0.0
Other Short-Term Operating Liabilities	15.0	9.1	9.5	9.5	9.5	9.5
Total Current Liabilities	99.0	84.2	150.6	82.6	89.3	98.2
Total Long-Term Debt	60.0	81.9	34.5	140.7	166.2	186.2
Long-Term Operating Liabilities	6.5	11.0	14.5	14.5	14.5	14.5
Deferred Tax Liabilities	15.0	27.2	24.3	27.0	30.0	33.0
Long-Term Non-Operating Liabilities	1.5	0.0	0.0	0.0	0.0	0.0
Total Liabilities	**182.0**	**204.3**	**223.9**	**264.8**	**300.0**	**331.9**
Common Stock	15.0	40.8	65.4	65.4	65.4	65.4
Additional Paid in Capital	0.0	0.0	0.0	0.0	0.0	0.0
Retained Earnings (Deficit)	196.0	184.7	184.0	184.2	194.2	216.7
Treasury Stock	-2.0	-2.1	-2.1	-2.1	-2.1	-2.1
Other Equity	84.0	89.9	100.8	100.8	100.8	100.8
Shareholders' Equity	**293.0**	**313.3**	**348.2**	**348.3**	**358.3**	**380.9**
Preferred Stock	0.0	0.0	0.0	0.0	0.0	0.0
Minority Interest	0.0	0.0	0.0	0.0	0.0	0.0
Total Shareholders' Equity	**293.0**	**313.3**	**348.2**	**348.3**	**358.3**	**380.9**

Profitability %	03/10	03/11	03/12	03/13	03/14	03/15
EBITDA Margin	23.2	23.4	21.9	22.4	22.7	23.1
EBIT Margin	19.6	19.1	17.5	17.7	18.4	19.3
Net Profit Margin	14.2	10.4	12.4	12.4	12.8	13.3
Free Cash Flow Margin	21.0	7.3	4.8	7.7	7.1	7.3
Return on Equity	28.8	17.3	19.4	20.2	22.7	25.1
Return on Assets	16.2	10.6	11.8	11.9	12.6	13.5
Return on Invested Capital(w/Goodwill)	28.4	20.2	12.2	15.8	16.4	16.9
ROIC (w/Goodwill) Less WACC	19.0	10.8	2.8	6.5	7.0	7.6

Leverage & Liquidity	03/10	03/11	03/12	03/13	03/14	03/15
Net Debt to Capital %	20.6	22.5	23.4	27.5	30.5	31.7
Net Debt/(Net Debt + Equity) %	21.0	22.9	23.8	27.8	30.9	32.1
Net Debt/Equity %	26.6	29.7	31.2	38.6	44.6	47.2
Net Debt/EBITDA x	0.7	0.8	1.0	1.1	1.1	1.1
EBIT/Net Interest Expense x	-12.3	25.9	-47.4	-103.8	3,392.3	130.1
Current Ratio (Current Assets/Current Liabilities) x	1.8	2.2	1.3	2.6	2.6	2.6
Dividend Payout Ratio %	–	–	–	96.9	85.1	73.5
Cash Per Share ¢	1.4	1.2	1.2	1.2	1.2	1.2
Net Cash Per Share ¢	-15.2	-18.2	-20.7	-25.6	-30.5	-34.3

General Financials

Financials

Valuation	03/10	03/11	03/12	03/13	03/14	03/15
			Historical			Forecast
Price/Earnings x	22.7	25.2	20.5	16.3	14.3	12.3
PEG Ratio x	1.2	-2.3	-17.0	1.7	1.0	0.8
EV/EBITDA x	14.6	14.3	12.6	9.9	8.8	7.8
EV/EBIT x	17.3	17.5	15.8	12.5	10.9	9.3
Free Cash Flow Yield %	6.5	2.3	1.9	3.8	3.9	4.4
Dividend Yield %	–	–	–	6.0	6.0	6.0
Price/(OCF per share) x	11.8	22.5	14.1	12.4	11.7	10.5
Price/(FCF per share) x	15.4	43.1	53.2	26.3	25.6	22.5
Price/Sales x	3.2	3.2	2.6	2.0	1.8	1.6
Price/NTA x	5.6	5.2	3.9	3.3	3.2	3.0
Price/Book x	5.5	5.1	3.8	3.3	3.2	3.0

Working Capital & Capex	03/10	03/11	03/12	03/13	03/14	03/15
Average Days in Inventory (1)	111.7	134.5	137.0	131.8	134.0	133.7
Average Days in Receivables (2)	55.1	54.3	55.3	52.1	51.8	51.8
Operating Cycle, in Days (1+2)	166.9	188.8	192.4	183.9	185.7	185.5
Average Days Payables Outstanding	92.0	103.4	99.0	97.5	100.7	100.0
Operating Cash Flow/EBITDA %	0.0	0.0	0.0	72.8	68.5	67.8
Free Cash Flow/NPAT %	147.7	58.6	38.6	61.9	55.8	54.9
Maintenance Capex/Depreciation %	125.0	100.5	110.7	82.2	79.6	81.9

Disclosure and Research Methodology

We seek undervalued stocks with a medium to long-term investment time horizon. Companies that make the best investments tend to be those able to grow earnings per share year after year and which are able to grow at rates above the average of the market. Earnings growth supports a solid and growing dividend stream which is the essence of shareholder return.

In searching for the best businesses in the market, we want to see an ability to turn revenue into profits and a record of strong returns to equity. The ability to generate strong free cash flow is critical as this is where the funds come from to pay dividends or to invest in new growth areas. The greatest free cash flow generators will have strong margins, good controls over working capital and limited requirement for capital expenditure. The best businesses will also have robust balance sheets including a not onerous level of debt. We believe in strong, experienced and disciplined management.

Recommendations

Our qualitative recommendations are simple and easy to understand:

- Buy: Substantially undervalued
- Accumulate: Modestly undervalued
- Hold: Appropriately priced, neither buy nor sell
- Reduce: Sell part holding
- Sell: Sell all holdings now
- Avoid: Not investment grade

Economic Moats

The pursuit of high quality businesses is central to our investment philosophy. These offer the greatest gains to the long term investor, so long as they are bought at a reasonable price. The concept of economic moats is valuable in assessing the quality of a business, with the phrase popularised by Warren Buffett and Charlie Munger. Just as wide moats protected castles from invaders in medieval times, businesses with wide economic moats have strong defences against their profits being competed away.

We ascribe a moat rating to each stock researched: Wide, Narrow or None.

The moat is the competitive advantage that one company has over other companies in the same industry. Wide moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital. Without a moat, highly profitable firms can have their profits competed away. Other companies will see how attractive the market is and try to move in to reap some of the rewards themselves.

Sources of economic moats include innovation skills or first mover advantages, a superior cost position, the ability to provide a range of products to suit the needs of a variety of markets, high switching costs or locking out of competitors.

The moat rating is just one of the ingredients used in determining whether a company is undervalued, though it is obviously an important one. We are not saying that no-moat companies should be avoided. Simply, the very best long term investments are in wide moat firms bought when they are undervalued.

Intrinsic Value

Intrinsic Value (otherwise known as Fair or Underlying Value) is the analyst's interpretation of what the stock is worth today. The stock is considered to be undervalued when the quoted price is below this point or overvalued where the price is above it.

Whether to invest in a stock will depend on consideration of the prospective return and the risk undertaken. Prospective return includes both share price moves and dividend yield. Our analysts incorporate the stock's risk in their intrinsic value. Other things being equal, lower risk stocks will have greater intrinsic value than higher risk ones. A stock becomes a buy when the quoted share price is at a discount to intrinsic value that provides a sufficient prospective return.

Business Risk

Business risk encompasses all operational risk and financial risk. Companies with low business risk have the most reliable earnings streams. A change in business conditions may reduce earnings predictability and therefore increase risk. Examples are market entry of a new competitor, unfavourable shifts in the economy, changes in key management personnel, major investment in an uncertain new venture or acquisition, and increased interest burden caused by higher debt levels or raised interest rates.

Pricing Risk

Pricing risk reflects the premium or discount implied in the current price of the shares. Many growth stocks trade on high earnings multiples giving them high pricing risk though they may have low business risk. Investors should consider their risk tolerance before investing in the share market. Many investors will decide to have only low risk stocks in their portfolio though others will accept higher risk levels in order to pursue higher returns.

Declaration

Declaration of personal shareholdings, disclosure list.

These positions can change at any time and are not additional recommendations. AAO, ABC, ACG, ACL, ACR, AFI, AGK, AGS, AGX, AKF, ALL, ALS, AMP, ANO, ANP, ANZ, APA, APN, ARD, ARG, ASB, ASX, ASZ, ATI, AVX, BEN, BFG, BHP, BKI, BKN, BLY, BND, BNO, BOL, BOQ, BSL, BTU, BWP, BXB, CAB, CBA, CDD, CGS, CIF, CND, COF, COH, CPA, CPB, CRK, CRZ, CSL, CSS, CTN, DJS, DOW, DTE, DUE, EGL, EGP, EPX, EQT, ERA, ESV, EVZ, FMG, FXJ, GBG, GCL, GFF, GMG, GPT, GWA, HIL, HSN, HST, IAG, IFL, IGR, IIN, ILF, ILU, IPD, JMB, KAR, KBC, KCN, KEY, KMD, LEG, LEI, LLC, MBN, MCR, MFF, MIO, MPO, MQG, MSB, MTS, MUN, MYR, NAB, NEU, NHC, NMS, NUF, NUP, NVT, NWS, OSH, OST, PBG, PBT, PGA, PGM, PMP, PMV, PNR, PPT, PRE, PRG, PRY, PTS, QBE, QFX, QUB, RCR, REX, RFE, RHC, RHG, RIO, RKN, RQL, SAKHA, SEK, SFW, SGP, SGT, SHV, SMX, SOL, SRH, SRX, STS, SUN, SVW, TAH, TCL, TEN, TLS, TOL, TPM, TRF, TRS, TSE, UGL, UXC, WAL, WAM, WBB, WBC, WCB, WDC, WES, WHC, WHG, WOW, WPL, WRT, ZGL.