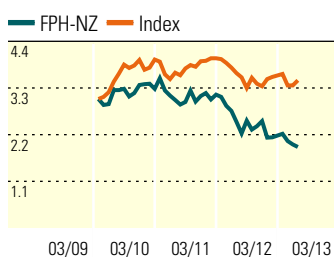


# Fisher & Paykel Healthcare Corporation Limited FPH-NZ

## Snapshot

Business Risk	Medium
Price Risk	Medium
Moat Rating	None
Fair Value \$	2.40
Market Cap \$Mil	1,027
Morningstar Style Box	—
Last Price \$	1.89
52 Week High/Low \$	2.63/1.90
Shares Issued Mil	538
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 %	—	—	6.9	6.9
P/E x	25.2	20.5	14.1	12.4

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.

## Declining share price provides opportunity

Analyst Recommendation: **Accumulate**

01 August 2012



## 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

► Fisher & Paykel Healthcare (FPH) has seen a precipitous fall in its share price over the last six to 12 months. The price decline can be attributed to a weaker-than-expected FY12 performance, particularly in the obstructive sleep apnea (OSA) business, and a stubbornly high NZD.

## Impact

- We believe the company's growth rate on a constant currency basis is likely to improve over the next few years, while operating margins will likely benefit from cost efficiencies and a better product mix. The company's pipeline of products is the strongest it has ever been and will likely underpin results going forward.
- The company is likely to maintain dividends at NZ12.4cps for the foreseeable future, unless a big decline in earnings occurs. Dividends are currently around 100% of NPAT and will likely converge to the company's target payout ratio of 60% over time.

## Recommendation Impact

We argue the stock looks attractive from a risk/reward basis, given the historically low valuations (a forward P/E of 16 times versus an eight-year average of 29 times) and an attractive dividend yield of over 6%.

# Fisher & Paykel Healthcare Corporation Limited FPH-NZ

**Nachi Moghe**

Morningstar Analyst

## Analyst Note

### Declining share price provides opportunity

Fisher & Paykel Healthcare (FPH) has seen a precipitous fall in its share price over the last six to 12 months. The price decline can be attributed to a weaker-than-expected FY12 performance, particularly in the obstructive sleep apnea (OSA) business, and a stubbornly high NZD. We argue the stock looks attractive from a risk/reward basis, given the historically low valuations (a forward P/E of 16 times versus an eight-year average of 29 times) and an attractive dividend yield of over 6%. We believe the company's growth rate on a constant currency basis is likely to improve over the next few years, while operating margins will likely benefit from cost efficiencies and a better product mix. The company's pipeline of products is the strongest it has ever been and will likely underpin results going forward. We retain our fair value of NZD 2.40 and our Accumulate recommendation on the stock. Stronger-than-expected constant currency growth and a decline in the NZD would be the main stock price catalysts.

We are very bullish on the prospects of the Respiratory and Acute Care business (RAC). This business enjoys good pricing power as a result of the company's 70%-plus global market share. The traditional, invasive ventilation business is seeing steady growth, but new applications such as non-invasive ventilation, oxygen therapy, humidity therapy and chronic obstructive pulmonary disease (COPD) offer exciting growth opportunities. We understand the company's market share is close to 100% for new products. The barriers to entry for this business are significant and include patents, technology, R&D, and most importantly, switching costs. It's not so much the cost of equipment or consumables that is a major deterrent, but changing providers and retraining staff is a major hindrance. And with a large market share, FPH has significant leverage over its hospital customers. We believe RAC, which currently makes up a little over 50% of revenues, will likely grow at a double-digit rate for the foreseeable future.

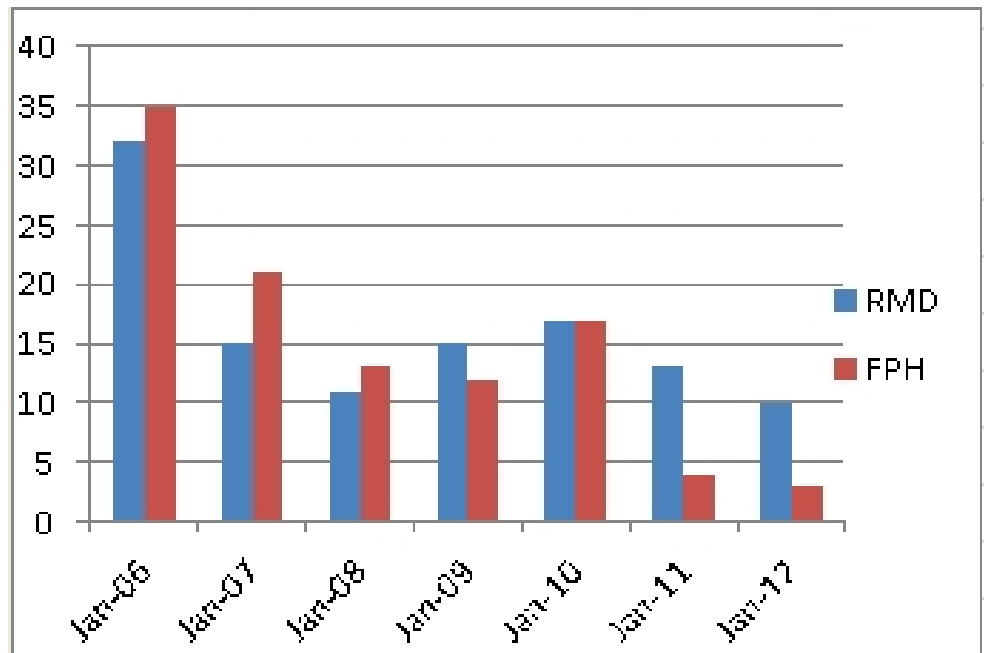
The Obstructive Sleep Apnea (OSA) business has exciting long-term growth prospects as well, but FPH remains a distant third behind ResMed (RMD) and Philips. The company's market share has slipped a bit after it failed to launch new products over the last 12-18 months. This is evident in the anemic 4% and 3% constant currency growth posted by the company in FY11 and FY12, compared to the double-digit growth achieved by RMD. Consumables and masks in particular saw disappointing growth, while continuous positive airway pressure (CPAP) devices did reasonably well on the back of the ICON product. We understand the company's market share for masks and CPAP is 11% and 5%, respectively. Masks account for 66% of the company's OSA revenues.

### Constant Currency growth: RMD versus FPH

# Fisher & Paykel Healthcare Corporation Limited FPH-NZ

**Nachi Moghe**

Morningstar Analyst



In addition to the company's self-inflicted woes, the OSA industry is also being impacted by the ongoing recession and the move towards home sleep testing (HST). HST is causing sleep labs to cut back in response to changes in technology that allow diagnosis to be conducted at home using an automatic CPAP device. While industry observers argue that HST will eventually lift industry growth rates in the long term (as it would increase patient compliance and reduce the overall cost for the insurer/patient), in the short term a reduction in sleep labs is hurting growth as the vast majority of patients are still being diagnosed at sleep labs. Consequently, it will be years before HST becomes a widespread form of diagnosis and a driver rather than a hindrance to growth.

Nonetheless, FPH is likely to regain share following the introduction of three new masks this year. Management anticipates constant currency growth in the mid single digits in the first half, rising to the low to mid teens in the second half. More importantly, the company is increasing its R&D efforts with the aim of introducing between one to three new products every year, in a bid to sustain growth momentum and avoid getting into a "new product vacuum" situation like that experienced in FY11 and FY12. We believe a growing emphasis on new products - especially masks - and cost efficiencies from the Mexican facility should improve operating margins going forward. We believe the industry-wide price decline of between 3-5% that has been occurring for several years will likely continue for the foreseeable future. However, FPH should be able to mitigate this through the launch of new masks and higher-end CPAP devices.

The company is likely to maintain dividends at NZ12.4cps for the foreseeable future, unless a big decline in earnings occurs. Dividends are currently around 100% of NPAT and will likely converge to the company's target payout ratio of 60% over time. The company will continue to offer bonus shares in lieu of dividends to preserve cash and keep gearing in check. Consequently, while dividends are unlikely to increase any time soon, the current yield of over 6% seems quite compelling.

# Fisher & Paykel Healthcare Corporation Limited FPH-NZ

## 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: 01 Aug 2012

FPH is the world's leading provider of Respiratory Humidification (RH) products. This business offers tremendous growth opportunities stemming from the firm's 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 Resironics (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 firm's 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?

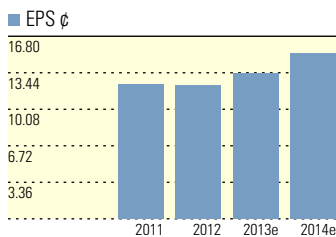
FPH's near term free cash flow will remain under pressure due to an unfavourable currency and higher capital expenditure. Fortunately the firm is relatively under-gearred and can therefore raise debt levels to support cash flows requirements. We expect FPH to deliver solid returns on invested capital 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

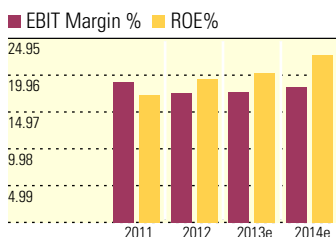
We have reduced our fair value from NZ\$2.70 to NZ\$2.40, with an Hold recommendation. Although the company's underlying performance is doing reasonably well, the foreign currency headwinds are impairing the group's reported financial results. We expect to see continued currency volatility over the next 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%.

# Fisher & Paykel Healthcare Corporation Limited FPH-NZ

## EPS



## EBIT Margin vs. ROE



## Risk Last Updated: 01 Aug 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-gearred 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	Historical			Forecast		
	03/10	03/11	03/12	03/13	03/14	03/15
<b>Per Share</b>						
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
<b>Growth %</b>						
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
<b>Profit &amp; Loss (\$Mil)</b>						
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
Reported NPAT	71.5	52.5	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
<b>Adjusted NPAT</b>	<b>71.5</b>	<b>63.5</b>	<b>64.3</b>	<b>70.4</b>	<b>80.1</b>	<b>92.8</b>
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
<b>Cash Flow (\$Mil)</b>						
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
<b>Net Operating Cashflow</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>92.2</b>	<b>97.7</b>	<b>109.2</b>
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
<b>Net Investing Cashflow</b>	<b>-48.0</b>	<b>-43.2</b>	<b>-67.4</b>	<b>-48.0</b>	<b>-53.0</b>	<b>-59.0</b>
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
<b>Net Financing Cashflow</b>	<b>-91.0</b>	<b>-37.5</b>	<b>-24.5</b>	<b>-44.2</b>	<b>-44.7</b>	<b>-50.2</b>
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	Historical			Forecast		
	03/10	03/11	03/12	03/13	03/14	03/15
<b>Balance Sheet (\$Mil)</b>						
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
<b>Total Current Assets</b>	<b>180.0</b>	<b>186.5</b>	<b>195.0</b>	<b>214.5</b>	<b>234.0</b>	<b>256.0</b>
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
<b>Total Assets</b>	<b>475.3</b>	<b>517.6</b>	<b>572.1</b>	<b>613.1</b>	<b>658.3</b>	<b>712.8</b>
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
<b>Total Current Liabilities</b>	<b>99.0</b>	<b>84.2</b>	<b>150.6</b>	<b>82.6</b>	<b>89.3</b>	<b>98.2</b>
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
<b>Total Liabilities</b>	<b>182.0</b>	<b>204.3</b>	<b>223.9</b>	<b>264.8</b>	<b>300.0</b>	<b>331.9</b>
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
<b>Total Equity</b>	<b>293.0</b>	<b>313.3</b>	<b>348.2</b>	<b>348.3</b>	<b>358.3</b>	<b>380.9</b>
<b>Profitability %</b>						
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
<b>Leverage &amp; Liquidity</b>						
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
Net Cash Per Share ¢	-15.2	-18.2	-20.7	-25.6	-30.5	-34.3
<b>Valuation</b>						
Price/Earnings x	22.7	25.2	20.5	14.1	12.4	10.7
PEG Ratio x	1.2	-2.3	-17.0	1.5	0.9	0.7
EV/EBITDA x	14.6	14.3	12.6	8.7	7.7	6.8
EV/EBIT x	17.3	17.5	15.8	11.0	9.5	8.2
Free Cash Flow Yield %	6.5	2.3	1.9	4.4	4.5	5.1
Dividend Yield %	-	-	-	6.9	6.9	6.9
Price/(OCF per share) x	11.8	22.5	14.1	10.8	10.2	9.1
Price/(FCF per share) x	15.4	43.1	53.2	22.8	22.2	19.5
Price/Sales x	3.2	3.2	2.6	1.8	1.6	1.4
Price/NTA x	5.6	5.2	3.9	2.9	2.8	2.6
Price/Book x	5.5	5.1	3.8	2.8	2.8	2.6



# 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, ASZ, ATI, AVX, BEN, BFG, BHP, BKI, BKN, BLY, BND, BNO, BOL, BOO, BSL, BTU, BWP, BXB, CAB, CBA, CCL, CDD, CGS, CIF, CND, COF, COH, CPA, CPB, CRK, CRZ, CSL, CSS, CTN, DJS, DOW, DTE, DUE, EGP, EPX, EQT, ERA, ESV, EVZ, FMG, FXJ, GBG, GFF, GMG, GPT, GWA, HIL, HSN, HST, IAG, IFL, IGR, IIN, ILU, IPD, JMB, KAR, 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, PBG, PBT, PGM, PMV, PNR, PPT, 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, ZGL.